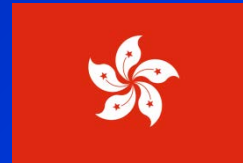
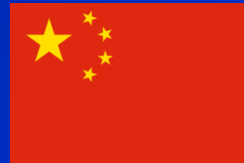


Challenges for China  
Beyond minority listings of SOEs  
and  
Red flags in Corporate Governance



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at

CARE Conference

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# No more low-hanging fruit

- When you start from command economy in 1979, it is hard not to produce prosperity - the only way is up.
- Easy wins come from liberalizing street prices, freedom to choose whom you work for, abandonment of production quotas etc.
- It took 11 years to re-open the stock market, in Dec-1990
- I worked on a Shanghai B-share IPO in 1992: the Chairman told me “let’s be clear, I won’t pay as much interest on my shares as on my bank loans, OK?”. He thought shares were financing, not ownership
- 2 decades later, most of the national SOEs are listed
- But almost all of them are still state-controlled. Investors hold minority positions in a giant conglomerate, China Inc.
- Top management are party appointees, often shuffled between listed entities (banks, airlines, telecoms, petroleum etc.) or in and out of govt
- Market forces are not at work

# China, Inc.

- In 2009 GFC, China commanded banks: go forth and lend. Policy-driven and corruption-driven lending, not based on credit analysis
- Before bank IPOs, bad loans were taken out, but not bad lenders
- At end of 2013, top 40 SOEs with HK listings had market value, based on all-shares, of US\$2tn, or about 21% of GDP (US\$9.4tn)
- SASAC results for 2013: its 110 national enterprises had consolidated revenue of CNY24.2tn (US\$4.0tn) and profit of CNY1.3tn (US\$214bn)
- That excludes banks under Central Huijin (owned by China Investment Corp), China National Tobacco monopoly (~\$100bn revenue), etc.
- Head of SASAC (ex-Petrochina) has been arrested for alleged corruption, amongst many others
- Entrepreneurs are promising, but many had to cut legal corners to succeed, and might not treat their minority shareholders any better. A substantial discount should be applied relative to developed markets
- Private sector crowded out by policy SOE lending
- Capital diverted to uneconomic infrastructure to pump-prime

# What market economy?

- The State controls:
  - Capital movement in/out
  - The media, via propaganda department
  - The internet (censorship, including microblogs domestically, and blocking via the Great Firewall of China)
  - Foreign exchange rate (less so now)
  - Interest rates on bank deposits (capped) – leading to \$1.8tn trust products time-bomb
  - When companies can go public (on/off/queue)
  - Appointments to SOEs (musical chairs in various sectors)
  - Policy-driven lending to SOEs
  - Where you can live and obtain education, healthcare and welfare (Hukou system)

# Group Finance Companies

- Many large SOE groups have GFCs, controlled by parent. Listed children are expected to support parent and siblings with inter-company loans via GFCs or even directly.
- Filial piety may be a Confucian ideal, but it has no place in good governance.
- Example: China Resources. 6 listcos. 2 got voted down by independent shareholders (ex-Chairman now arrested for corruption).
- If listed companies are so interdependent, then they should be merged. Otherwise, surplus capital should be returned to shareholders, not abused in this way.
- Remember the lessons of Japan's main-bank system
- Do we really want a "Chibatsu" system?

# Change or be changed

- The easy work is done. GDP/capita now ~\$6k
- The 1-party state has prevailed since 1989 with prosperity
- The next doublings of GDP depend on a real market economy and liberalization
- Freedom of speech & free media to hold leaders accountable, or corruption will remain endemic
- Sell-down SOEs to 0%, break up monopolies, allow market forces to work
- Freedom of capital movement
- Abolition of foreign ownership limits to enhance competition
- Abolish Houkou, reform local government finance; money follows citizen
- Progressive democratization
- 2 ways to get there – visionary leaders produce smooth transition; or dislocation when an economic crisis produces a “Chinese spring”

Now, while I am here...



# Listing rule: All boards in HK must have 3 INEDs...





# And 1/3 must be INEDs

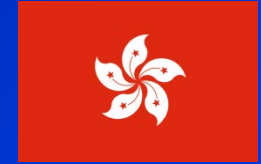
<b>Date</b>	<b>Cos. with 9 seats</b>	<b>Cos. with 10 Seats</b>	<b>Share of cos.</b>	<b>Share of cos.</b>
1-Jan-2012	261	144	17.5%	9.7%
1-Jan-2013	351	66	22.8%	4.3%

# INEDs

- Most markets require independent non-executive directors, but only in name
- If the controlling shareholder can vote on INED elections, then the INEDs are dependent on the controller, not independent of it
- Consequently INEDs are often just rubber stamps
- Independent directors should be elected by independent shareholders. Controlling shareholders should be required to abstain
- May-2014: UK FCA becomes first regulator to require approval by independent shareholders for INED elections
- Boards could still nominate candidates, but candidates would have to be acceptable to independent shareholders
- INEDs would have a mandate, and be held accountable at the next election
- Failing that, we should scrap the requirement for INEDs rather than provide false comfort. Boards would either be credible or not.



# Red flags



- Investments in securities, yachts, antiques, structured products...
- Loans to “third parties” or “entrusted loans” in PRC
- Skewed balance sheets, apparently hoarding cash while borrowing
- Repeated transactions with BVI shells, no owners disclosed (Renhe!)
- Converting trade receivables into loans (Moulin, Egana,...)
- Improbably high profit margins (Ocean Grand Chemicals,...)
- “Earnest money” deposits for possible acquisitions (Egana, Tack Fat...)
- INEDs who presided over problems at other companies
- Auditors, sponsors with a disproportionate number of imploded clients
- Multiple listed entities under common control
- Controlling shareholder not on the board (Real Gold Mining,...)
- Issues of unlisted warrants
- Excessive use of share options, particularly with non-employees
- Ongoing related party transactions for supplies or sales (Greencool,...)
- Excessively high fixed-asset costs

# About Webb-site

- Founded in 1998. Not-for-profit, the site and related activity takes about half my time. Partly funded by speaker fees (not today), but mostly funded by me
- The other half, I research and invest in HK small-caps, currently holding >5% of 12 listed companies
- Corporate horror stories end up as *Webb-site Reports* (time permitting)
- under-valued well-governed companies go into my portfolio
- Over 20,000 subscribers to a free newsletter, opt-in/out
- Opinion polling
- Hall of Shame for jailed directors, CCB watch, SFC watch, ICAC watch
- Site covers economic governance too, advocating free and fair markets, transparency, accountability, civil liberties, tax reform, land revenue reform, minimal intervention and economically-rational policy-making
- *Webb-site Who's Who* database covers all HK-listed directors, auditors, advisers since 1990; legislators, district councilors, statutory/advisory bodies, CE election committee, and the relationships between them
- *Webb-site Total Returns* series – since 1994, all HK stocks including delisted
- Tracking all SFC-licensees, and all HK-incorporated companies (over 1 million live)
- CCASS Analysis System for stock movements



# Thank you!

