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*Scott Kennedy is director of the Research Center for Chinese Politics & Business, Indiana University.***Rather than a surge in state-led takeovers, the last few years have instead seen a surge in private-sector deals****Comprehensive data on M&A deals is scarce in China, but there is a trove of information on publicly-traded firms****www.gavekal.com**

## China Policy Watch: Mergers & Acquisitions Moving Up The Food Chain

Mergers and acquisitions have played a central role in China's vigorous debate about the role of state-owned enterprises in its increasingly market-driven economy. Over the past few years, there have been several widely-reported cases of private companies selling out to SOEs in the coal, steel, electricity, and airline industries. These have led to a perception that successful private and foreign companies are increasingly vulnerable to forced takeovers by the state. Many China watchers fear that industrial planners are plotting to gobble up private competitors and lock out foreigners, extending SOEs' control into industries where non-state firms previously had extensive market access.

But our investigation into one of the few sources of systematic data on mergers does not support this common stereotype. In fact, China's M&A scene is evolving in rather unexpected ways. SOEs have for years dominated the M&A league tables, though most of the activity reflects consolidation among state firms. This pattern began to change quite obviously in 2009, but it was not because SOEs started buying up lots of private-sector firms. The fastest recent growth has instead been among private-sector companies, who are acquiring both other private firms, and most surprisingly, state assets. Although there are some sectors where SOEs still lead M&A activity, on balance mergers are increasingly a route for the advance of China's private sector, not its retreat.

The massive jump in private firms' acquisitions of other companies is part of the long-term trend of the growing size and financial wherewithal of China's private sector. As we have documented in previous research, private-sector firms have continued to increase both in efficiency and scale in recent years (see [A Healthy Debt Free Diet](#)). This has boosted their ability to raise money from markets, while the rise of shadow finance and the new enthusiasm of banks for lending to non-state companies have also increased their access to credit (see [Finally, A Piece Of The Pie](#)). While the consolidation of many industrial sectors—notably steel—has a long way to go, the surge in private-sector-led acquisitions points to the gradual formation of larger and more efficient Chinese companies.

### The answer is blowing in the Wind

For our analysis, we draw on data provided by Shanghai-based Wind Information, from its huge compilation of M&A activity among publicly-traded firms. Its database contains 26,000 M&A transactions since 2003, and approximately a third of these deals record the ownership form—state-owned, private, or foreign—of both sides of the transaction. While listed firms do not account for all of China's mergers, the data still capture a very wide swath of activity. And although there are some weaknesses in Wind's data (notably, transactions involving foreign companies seem to be under-represented), they are not crippling. As a result, we are able to develop a clear map of which kinds of Chinese companies are engaging in mergers.

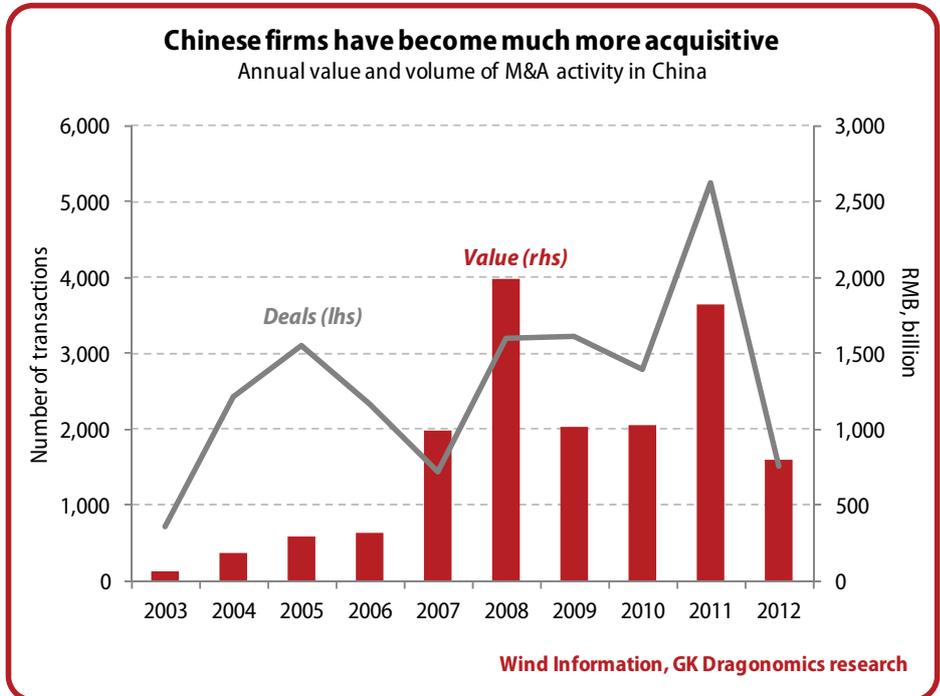
**Moving Up The Food Chain**

**M&A activity tends to come in waves driven by major changes in the economy**

**Deal-making has cooled off considerably this year as growth has slowed**

**Consolidation among SOEs has long been one of the biggest drivers of M&A**

There have been three waves of M&A activity over the nine years covered by Wind's data, a period that has seen the total annual the value of such deals jump 31-fold, to Rmb1.8 trn, or US\$290 bn, in 2011, from Rmb59 bn, or US\$9.3 bn, in 2003. The first wave came in 2004-05, driven by a round of SOE mergers as part of the reorganization of the state sector following the recapitalization of China's banks. The second wave came in the second half of 2008 as the global financial crisis hit, forcing some companies under and others to find shelter in the arms of stronger competitors. M&A activity then cooled in 2009 and 2010 as the economy recovered, but then in 2011 an even larger wave of M&A activity took off, encompassing every industry and all types of firms. Data from the first 11 months of 2012 show that as growth has cooled this year, M&A activity has slowed dramatically, with both the number and value of transactions down by over 60%.



Over this entire period, deals between two SOEs remain the largest single category in terms of the value of deals. Between 2003 and 2006 around half of all domestic transactions—and over 75% in value terms—involved SOEs acquiring other SOEs (our figures exclude deals Wind marked as involving foreign firms, since we think these are under-represented). Such acquisitions can be quite different from a normal commercial transaction, with bureaucrats calling the shots. And if asset values are measured at all, they typically use the book value rather than market value. In some cases, there may not even be a cash payment. For example, in 2010 State Grid Corp. prepared to consolidate and list a handful of its coal-fired power plants, but a year later the central government ordered it to sell them off instead. State Grid found a partner in Shenhua Group, the state-owned coal firm. According to press reports, Shenhua was handed these assets without paying a penny, though it may have sold the grid coal at a discount.

There has also been a steady stream of SOEs acquiring private firms over the years, though this is a relatively small category: on average this type of transaction has been 14% of the total in terms of number of deals, and 10% in terms of value. When SOEs acquire private firms, cash or shares

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**Acquisitions by SOEs are often driven less by markets and more by the government**

**The number of mergers led by private-sector firms has jumped dramatically in the last few years**

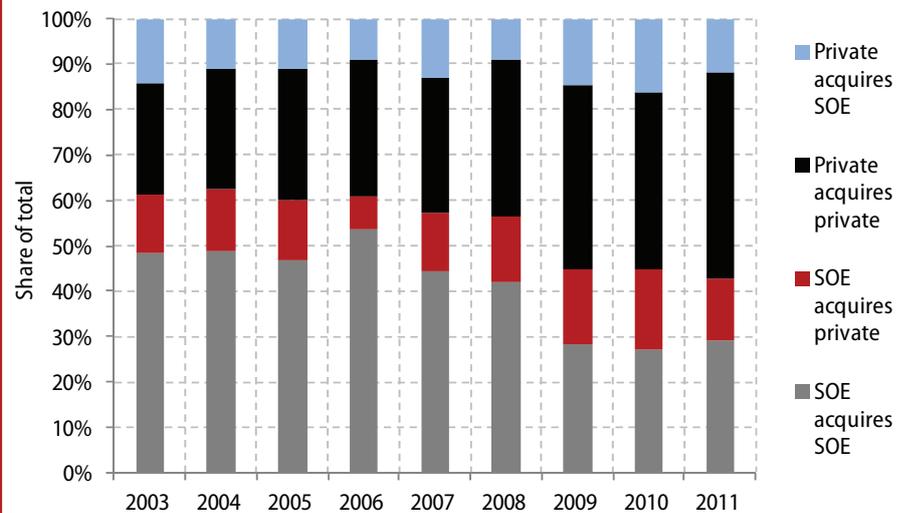
**The prices in private-sector M&A deals are much more likely to reflect market reality**

definitely change hands, but the buyers often get a very good deal with the help of government allies. In early 2009, for instance, flag carrier Air China tried to buy the private Wuhan-based airline Dongxing, which at the time had 20% of the regional market. Dongxing balked at Air China's lowball offer. But only a day later the aviation regulator ordered Dongxing to suspend its flights for apparent safety violations. A few months later Dongxing was forced into bankruptcy. Air China ended up buying its assets at auction for a mere pittance, Rmb23m, and Dongxing's founder, Lan Shili, was sent to jail for four years for tax evasion.

The biggest change in China's M&A activity, however, is the growing prominence of domestic private-sector companies. Since 2009, private companies have jumped into the lead: transactions with private-sector firms as the acquirers now account for a majority of deals. SOE-led acquisitions still account for a slight majority in value terms, but the average size of deals in which private firms are the acquirer have almost caught up with those of their SOE counterparts. With deals in which both firms are private averaging Rmb260m, or about US\$41m in 2011, private firms have entered the big leagues.

**Private-sector firms now lead most Chinese mergers**

M&A activity by firms' ownership form, by number of deals



Wind Information, GK Dragonomics research

The fastest growing type of transaction, those between two non-state companies, is much more commercially driven, with prices that have to reflect market reality. One good example is the electronics and appliance retailer Gome's efforts to capture market share through acquisitions of rivals. In 2006 Gome made a bid to acquire its smaller competitor Yongle in order to strengthen its position against the rising competition from fellow appliance retailer Suning. Gome paid cash and stock worth US\$666m, equivalent to an 8% premium on Yongle's stock price at the time (both firms were listed in Hong Kong). The deal made sense for both sides, and Gome's market share and profits continued to expand (for more on Gome, see our 2010 [profile](#)).

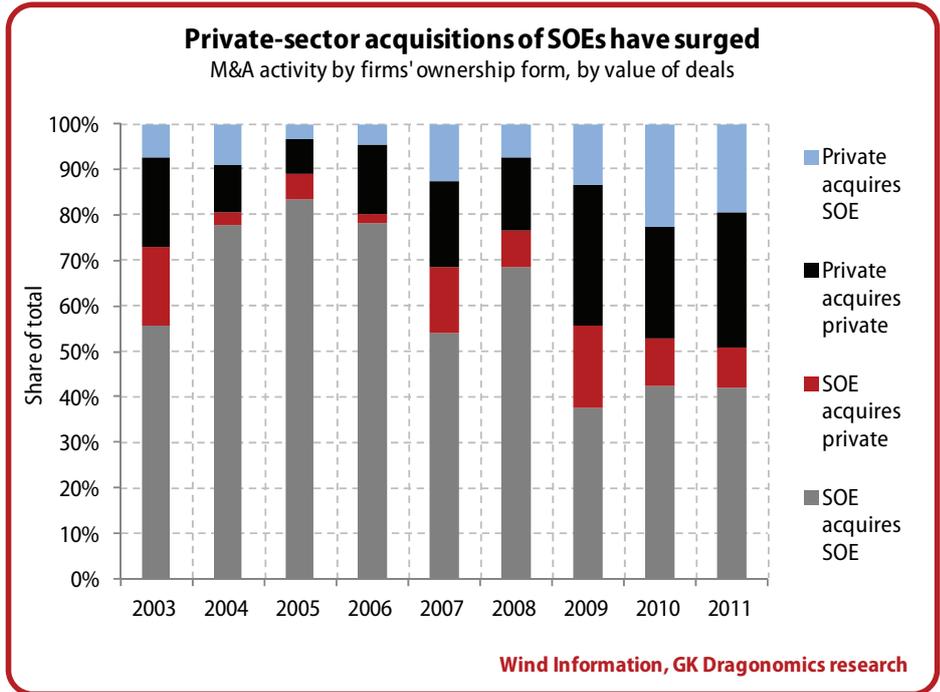
The most intriguing type of transaction in the Chinese context is the acquisition of an SOE by a private-sector firm. These are not particularly

**Moving Up The Food Chain**

**Private-sector buyouts of SOEs were unusually large in both 2010 and 2011**

**Selling an SOE to the private sector is a gamble for local officials, and some such deals have gone wrong**

common: most mergers are between two SOEs or two private firms, demonstrating that Chinese companies primarily do deals with firms of their own ownership form. The annual value of SOE acquisitions of private firms has usually been larger than private acquisitions of SOEs, but this trend has shifted notably since 2010: the total value of transactions in which private firms have acquired SOEs has been more than double those in which SOEs have acquired private companies.



A private-sector acquisition of an SOE is still a dramatic event in China, and typically only occurs when times are tough and local officials are desperate. But fire sales are always a gamble, as the tale of Jianlong, one of the country's largest private steel companies, demonstrates. In 2005 it purchased 36% of Jilin-based Tonghua Steel for Rmb1.4 bn, and in 2009 raised its stake to 66% with another Rmb1 bn injection. Although not chump change, Jianlong essentially paid 15 cents on the dollar for Tonghua's assets (then valued at over Rmb28 bn). But the sweet deal quickly turned sour when Tonghua's workers rebelled and killed the incoming manager sent by Jianlong to run the factory. The Jilin government got cold feet, forced Jianlong out and sold Tonghua off to Beijing-based Shougang Group instead.

The movement of assets between the state and private sector tends to vary greatly by industry, with little overall pattern. The effect of cross-ownership M&A deals is most noticeable in four sectors: utilities and mining have seen a big shift from the private to the state sector, while finance and real estate have seen a shift from state to private. This reflects dynamics peculiar to each sector: In 2009-10 state-owned coal mines bought up a handful of their private competitors, and the national power grid and centrally-owned electric generation firms acquired small private power plants around the country. In contrast, in 2010 the central government ordered all but 16 state-owned real estate companies to be restructured and privatized, opening new opportunities for non-state rivals. There has also been a shift from state to private hands in the financial sector, as several state-owned

## Moving Up The Food Chain

The movement of assets from private to SOE control is roughly balanced with those going from SOE to private

SOEs are buying private firms in utilities and mining, while private firms have snapped up SOEs in real estate and finance

The increased pace of consolidation suggests state and private firms are both reaching for national scale

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securities companies transferred assets to newly-created private investment vehicles.

Despite some well-known individual cases, by and large M&A has not resulted in a substantial net shift of assets into state hands or into the private sector. The net transfer of assets from private to state hands in electric power and utilities over 2003-11 totaled Rmb22 bn, less than 0.3% of the entire sector's total assets in 2011. Similarly, the Rmb99 bn in net shift to the private sector in real estate is equivalent to less than 0.5% of that sector's total assets. The story of "state advance, private sector retreat" is a fiction, at least in terms of corporate M&A (see [The Slow Retreat Of China's State Sector](#) for more on this question).

### SOE takeovers of private firms are focused in a few sectors

Total identifiable cross-ownership M&A, 2003-11 total

Sector	Number of deals	Net value, Rmb m*
Electricity, coal and utilities	113	21,848
Mining	127	17,406
Wholesale and retail	88	6,619
Manufacturing	83	4,096
Information technology	67	-1,026
Finance and insurance	108	-17,681
Real estate	409	-98,951

\* Positive figures mean a shift toward SOEs, negative a shift to the private sector.

Wind Information, GK Dragonomics research

Although the rise of private-sector-led deals is encouraging, it would be wrong to conclude that China's deal-making patterns are on the way to looking like those of other major economies. At 2.6% of 2010 GDP, the value of China's M&A activity is much smaller than that of the US (5.6% of GDP), though it is now approaching that of India (3.3%). But China's mixed pattern of both government- and market-driven deals looks likely to endure, as its legal framework encourages both. In 2005-06, the central government passed major legislation setting the foundations for company ownership and transfers of assets, which have enabled more private-sector transactions to take place. At the same time, there have been a series of regulations and policies emphasizing the need to protect state assets, which means both limiting corruption but also protecting the competitive position of the state sector vis-à-vis private and foreign players.

The trends in corporate deal-making do point to important changes in China's economy. Our data suggests that larger private companies have moved up the food chain, making headway at acquiring assets and expanding into nationally competitive firms that can hold their own in some sectors, sometimes by partnering with or acquiring SOEs. At the same time, central SOEs seem to be gobbling up local SOEs at a much higher rate than they are going after private firms. Though the pattern is messy and does not seem to reflect clear government policies, the result seems to be a gradual transition in China from regionally focused companies and fragmented local markets to larger private and state companies and a more unified national economy.