

**CORPORATE GOVERNANCE, M&A MARKET AND REGULATORY
ENVIRONMENT OF M&A IN CHINA**

By

THESIS

Submitted to
KDI School of Public Policy and Management
in partial fulfillment of the requirements
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MASTER OF PUBLIC POLICY

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ABSTRACT

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By

Zhang Zhengrong

The thesis is intended to exam whether current regulatory environment of M&A in China is appropriate for development of M&A market in the context of a healthy corporate governance system. Based on the reconciliatory model drawn from comparative analysis of Anglo-American governance system and Japanese Keiretsu, and through examining how M&A activity is connected with corporate governance and how M&A mechanism to work, the thesis proposes a direction that M&A should be led to. It then looks into the current Chinese M&A surge and reveals elements inconsistent with the target of establishing a desirable governance system. At the end, policy implication is drawn for both the government and private sector.

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Introduction:

The recent M&A boom in China is not only a reflection of environmental change in economy and policy regime, it is also a device used by the administration to enhance economic reformation. Since M&A market constitutes an integrate of entire corporate governance system, which is considered as a critical element to determine economic competitiveness of a country, a discussion about M&A will be incomplete without putting it into the context of corporate governance. Actually, to build a healthy corporate governance system is the first-order important mission in nowadays China. Only through analyzing the broader background and drawing conclusion from it can I be sure that the overall discussion regarding M&A is not misled and is meaningful.

There actually exist close connection between M&A and corporate governance (CG). Firstly, the development level of M&A market is strongly influenced by the state of CG. Then, what policies we impose on M&A market should be consistent with the overall direction of what a CG system we intend to establish. Finally, Chinese government and academicians always cited as a reason to promote M&A market its function to improve CG system. We need a close examination on this assertion to check whether it is soundly grounded. How M&A market perform in a certain governance atmosphere? What direction we want it to evolve? How M&A has actually contributed to a better governance system? What kind of regulatory environment of M&A market is needed to build a better CG system? These are all questions I try to answer in this article.

Part I: General analysis of corporate governance

-----What a corporate governance system we intend to have?

Corporate governance has long been in the center of discussion and debate for academicians and policymakers, for it is crucial not only to the competitiveness of micro economic entities, but also to the macro economic efficiency of a country.

Two typical governance systems are usually referred to as models and are emulated by other economies: market-centered system represented by the US and UK and organizational control of Keiretsu in Japan. The German bank-centered governance resembles somewhat Japanese mode. Just as free-market principle has long been criticized as imperfect even if nobody can completely deny its effectiveness and revolutionary role in history, market-centered corporate governance system is criticized for resulting in agency problem and therefore leading to dead weight loss. More importantly, it is found to attribute to myopic managerial behavior and thus less competitiveness of US companies since 1970's than that of their Japanese rivals. No wonder that our world have witnessed a fad of Japan in 1980's and 1990's with especially regard to its organizational control and consensus culture and practice in decision making. However, the shock from financial crisis breaking out in 1997 and the so far bogged Japanese economy remind academicians to focus on another

dimension of corporate governance: vulnerability.

● ***Economic analysis of different governance systems***

A close look at two systems in terms of both efficiency and vulnerability can be helpful in understanding what a governance system is really desired.

Efficiency requires maximizing output and the same time minimizing cost. In financial market, to maximize output means to take positive NPV projects and to undertake necessary long-term investment, which is considered to bring about more future cash flow. Japanese Keiretsu is characterized with cross-holding ownership among relational companies and a central monitor role played by the main bank. Such a structure facilitates strategic cooperation among companies that can hardly be achieved otherwise and the durable bank-corporation relationship channels long-term investment to the corporation. While in a market-disciplined economy like the US, the separation of ownership and control of corporation gives rise to interest conflicts between shareholders and managers, the so called agency problems. Managers have internal incentive to maximize personal interest and sometimes at the expense of shareholders' benefit, thus forgoing positive NPV projects. Since to maximize shareholder value is regarded as a basic principle, personal compensation of managers is closely connected with share price; M&A market as an external mechanism to monitor managers also prompts them to boost share price to avoid becoming a hostile takeover target. Combing the fact that a corporate usually has to sacrifice short-run financial performance to generate long-term growth¹, academicians argue that US corporate governance has practically impeded long-term development of corporations and the economy as a whole.

Another determinant of efficiency is cost. Namely, four sorts of cost are involved in any given corporate governance mechanism: capital cost, information cost, monitoring cost and transaction cost. Durable bank-corporate relationship will lower interest cost for borrower since the bank is better informed about the company and the project on hand and it is able to effectively protect itself as a creditor. What's more, durable relationship can greatly ease corporation restructuring in case of financial distress. Main banks in Keiretsu thus have advantage of better protection of creditor interest over their US counterparts. As for another kind of capital, the cost of equity, which is composed of risk-less interest rate and risk premium, is substantially affected by protection institution of shareholders' interest. Weak protection results in high risk premium given the same level of risk aversion of shareholders. A protruding drawback of Japanese Keiretsu is the ignorance of minor shareholders, following an under-mature capital market. In this sense, we can expect higher equity cost in Japan

¹ A typical example is how a consumer production company choose to allocate expenditure on advertisement and promotion and on R&D. The former can bring about better financial record immediately, while the favorable effect of the later cannot appear maybe until years later (and possibly after the term of the current management team). This is not a problem in an efficient market since all concerning information will be incorporated into share price. In any less efficient market, common investors have reasons to believe actual numbers rather than uncertain prospect.

than in the US where minor shareholders' interest has been traditionally accentuated.

Information asymmetry between managers and outside shareholders and creditors give rise to a series of serious problems regarding corporate governance. So market supervision body mandates companies to disclose as much information as possible at the first time to diminish information asymmetry. Stakeholders, on the other side, exert their utmost to obtain valuable information that might remain unknown to other investors (given no market is perfectly efficient). Both information disclosure and information seeking are costly. Japanese Keiretsu partly solved the problem by cross-holding and main bank arrangement where crucial inside information regarding a company is shared among member partners including managers, main creditors and shareholders.

To address agency problems resulted from separation of management and ownership, monitoring mechanisms including internal and external institutions are introduced. Inside a company, the board of director is required to have seats standing for all major stakeholders' interest. To avoid abuse of power by any party, independent directors are required to exert necessary influence as an interest-mutual party. As for external monitoring, companies are subject to strict information disclosure regulation. External and internal auditors have been consistently emphasized by supervision body to ensure authenticity of these financial information. Except these imposed and costly mechanisms, product market and factor market (including corporate control market, stock market and market for professional managers) perform de facto monitoring roles. Japanese Keiretsu, contrast to situation in market-discipline economy, is much less burdened with monitoring cost. Organizational control is materialized in form of presidents council meeting where heads of relational corporations (and at the same time major stakeholders of the company) come to corporation decisions in align with interest of relational partners. What's more, a main bank functions a critical role in monitoring affiliate corporations. Its special stake of both bank loan and ownership on any affiliate and its central position in the group like a head of family give a main bank strong incentive to lessen conflict among shareholders, creditors and managers. Its relatively easy access to inside information about affiliates enables a main bank to provide effective monitoring as well as information services among member partners. Finally, in case of financial distress of any member company, a main bank is at the position to decide whether to liquidate or rescue it. In a word, main banks in Japanese Keiretsu can provide a "quasi-market environment" at a substantially lower cost than that expensed in market-discipline system². (Young-Ki Lee, 1995)

² However, there are also researches provided opposite argument and empirical evidence regarding the actual performance of Keiretsu system. Instead of solving interest conflict among stakeholders, they argued that the complex interdependence structure produced entrenched management and thus deteriorated agency problem. By comparing the post-merger performance of Keiretsu-related mergers and Keiretsu-independent ones, Tsung-ming Yeh and Yasuo Hoshino (2001) found that Keiretsu relationship was particularly detrimental to the merging firms' post merger performance.

Transaction cost is closely connected with liquidity of a capital market, which is determined by overall size of the market and efficiency of intermediary agencies. High level of liquidity is desirable because it provides investors with an outlet and thus reduces the risk of being got stranded. However, liquidity involves transaction cost like asset brokerage and agency problem between those intermediaries and ultimate investors. A lowly developed market has small number of transactions and low efficiency of intermediary agencies. In a well-functioned and developed market however, achievement of economy of scale in intermediary agencies can greatly diminish average transaction cost. So it can be the case that even though aggregate transaction cost noticeably increases when a market grows maturity, average cost per transaction and the portion of transaction cost accounting for aggregate market value of capital asset will decrease. In this sense, it is hard say which governance system is more cost saving.

So far, based on above analysis, Japanese Keiretsu seems to be more economically efficient than US market-centered governance in terms of both benefit and cost. However, discussion of a really desirable governance model has to go beyond this efficiency dimension. Vulnerability of macro economy as well as individual corporations has drawn intensive attention.

When Japanese economic bubbles burst and business giants collapsed overnight in the recent financial crisis, people all around the world are shocked. They started to rethink about and reevaluate the whole system. Strategic cooperation between commercial banks and corporations and long term perspective resulted in over-investment and accumulated huge amount of non-performing loan in banks' accounts. The central role of main banks, which once helped assimilate valuable information and deliver financial support for affiliated firms, now facilitates to spread disease to relational corporations. Furthermore, due to the web-structure within Keiretsu once a member partner got contracted other affiliated firms can hardly stay intact.

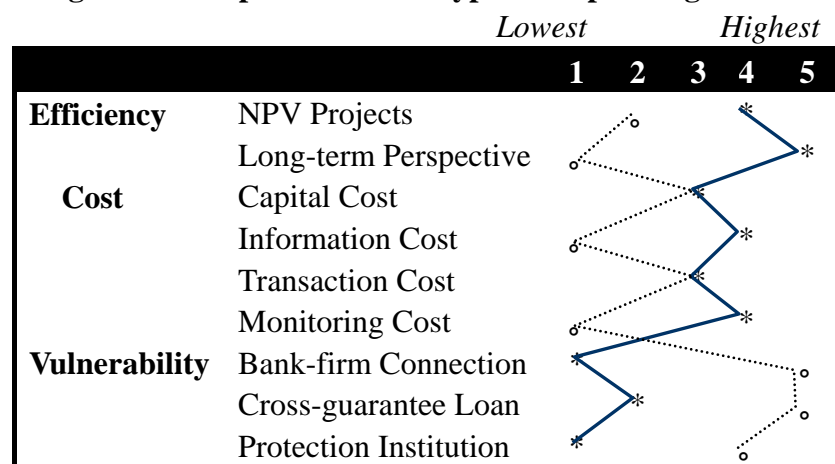
Another characteristic of Japanese Keiretsu system that was once ignored and now is drawing great attention is weak shareholder protection institution along with underdeveloped stock market. On one hand, weaker protection usually leads to higher debt ratio, especially short-term debt ratio of corporations. Eric Friedman, Simon Johnson and Todd Mitton (*Corporate Governance and Corporate Debt in Asian Crisis Countries*) found a significant correlation between corporate debt ratio and severity of macroeconomy shock experienced by suffered countries in the crisis, meaning that high debt ratio, which is correlated to weak corporate governance, can result in a vulnerable economy. On the other hand, as capital concentrates in banking system, to loosen money-base becomes the only solution to stir up bogged economy. But what if banks, the major money outlet, are reluctant to lend out money? Japan has seen this paradox recently. Despite the actual interest rate has been as low as zero,

commercial banks which hold one-third household savings are unwilling to extend credit to risky firms with apprehension of increasing NPL and courting bankruptcy. While the Japanese relationship banking may be advantageous in providing stable capital required for firms' growth, it has a drawback in the sense that such system may suffer from the potential absence of strong market discipline to prevent crony-capitalistic behaviors within business groups. Anglo-America market-principle economy is more advantageous in this regard. However, recent credit crisis stirred up by financial scandals of Enron, Worldcom and other well-known business giants exposed loopholes in investors' interest protection institutions even in the US.

● **Comparison of U.S. market-centered model and Japanese Keiretsu**

To sum up, a graph is drawn to illustrate and compare the two typical systems with regard to above economic dimensions. Admittedly, the grades are given based mainly on qualitative analysis and even intuition. The graph is also mere a sketchy picture and the parameters are not independent from each other, with all correlated more or less. But the graph is still useful for us to think about what a desirable governance should be like.

Figure 1: Comparison of two typical corporate governance system



Note: 1. The dotted line denotes Anglo-America market-principle governance, while the other one stands for Japanese Keiretsu system.

2. Both systems are graded in three dimensions. Score 5 stands for "excellent" and 1 means "very poor".

● **A reconciliatory model**

It is hard to say which one supersedes the other. Referring to above graph, market-centered governance is especially effective in defending from external hits (low vulnerability). While the strength of organizational control system lies in strategic cooperation among stakeholders and accordingly long-term perspective in business behavior. In the quest for a more satisfactory model, two tradeoffs seem to block the progress. Firstly, there is a tradeoff between owner-manager agency problem and majority-minority shareholder conflict. To think about the situation in Germany and Japan where the former is well addressed, but a weak protection for

minority shareholders' interest and consequently a small stock market cannot be satisfactory. Secondly, a tradeoff between to promote strategic alliance among relational companies and to cultivate M&A market which facilitates resource mobility but at the same time leads to short-term corporate behavior. A reconciliatory solution, if one has to be put forward, I think should emphasize three points in the ownership and controlling structure:

- 1. To foster more strategic investors, including active institutional investors, banks (as creditors) and relational companies (but cross-holding should be forbidden) and limit any absolute controlling power by either party.*
- 2. Board of director (or supervision board as in Germany) must have seats represent all major stakeholders respectively and have independent directors to ensure the mutuality of decisions.*
- 3. Outside shareholders should be effectively protected.*

Such a solution addresses the first tradeoff by focusing on solving majority-minority shareholder conflict and leaving the former to extra monitoring mechanisms. Strategic investors will change managerial myopia to some extent. But they will also make hostile takeover³ become more difficult.

What corporate governance system is most desirable? Even though the question seems answerless, we have actually seen convergence across countries. More and more of them are approximating the reconciliatory model. Institutional investors in the US are required to play a more active role in corporate monitoring. Sarbanes-Oxley Act was put forward after the recent credit crisis with intention to strengthen information disclosure and to give outside shareholders easier access to exert influence on listed firms. Japanese financial industry is under radical restructuring especially after the crisis. In Germany, super power of universal banks were bitterly criticized and has underwent radical reformation as well.

Within the context of corporate governance, we can expect some trend in M&A market as well. Since market principle economy has and will continue to be the direction of economic reformation in most developed and developing countries, M&A market will play an active role in these economies. More importantly, the merger market will become increasingly global with the recovery of Asian economies, the booming Europe common market and the worldwide industrial (adjustment) evolution. But we have reasons to believe that hostile takeover will be impeded in the long run due to the ideal ownership structure or controlling structure. Strategic investors are better informed of corporate status, thus leaving smaller space of undervalue. They prefer dialogue to hostile attempts to solve management problems because their majority proxy can enhance their leverage in negotiation. Besides, strategic investors might have not only capital but also various business operational connection with the corporation under question. There is hardly any bidder that is able to satisfy all

³ Economic analysis of hostile takeover is given below.

relational parties. So, M&A by agreement will be the dominant form.

Part II. Economic analysis of M&A

● *M&A and corporate governance*

To any individual corporation, M&A market is part of external environment. To an economy as a whole, M&A market constitutes an integrate element, interdependent with others, of corporate governance system. On one hand, its development does reflect the state of corporate governance in a country⁴. On the other hand, it is a powerful device to change ownership structure, M&A can reform corporate governance as well.

● *Environmental conditions for M&A market to work*

----How corporate governance influences the development of M&A market?

An environment in which merger or acquisition deals can be processed can not always be called an M&A market. M&A deals can happen occasionally or sporadically. For an M&A market, there should be sustainable existence of both supply and demand, a standardized process for the deal accomplishment, regulations that guide the process and various professional institutions to facilitate the deals. Even though Japan also witnessed some M&A deals before 1990's, there was no sophisticated M&A market existing then.

In discussion of M&A environment, another pair of concepts is usually differentiated: reconciliatory M&A (or M&A by agreement) and hostile takeover. M&A by agreement is usually less restricted by environment while hostile takeover cannot happen until some basic prerequisites are met. Besides facilitating mobility of resources, the function both forms sharing with each other, hostile takeover servers as an external mechanism to compel managers to enhance shareholders' interest (namely, to boost share price). This extra function is proved to be highly valuable in efficiency creation through M&A market promotion. Therefore, the following discussion about required economic environment is mainly confined to the scope of hostile takeover.

First of all, there should exist little limitation to obstruct M&A activities. This is applicable to both forms of deals. In pure economic sense, acquired or mergering firm, just like any other economic resource, should mobile to highest bidder without subject to any intervention. However, no country actually sticks to this principle. Even in the US, where M&A market is regarded as most sophisticated form, non-U.S. ownership of certain restricted industries is limited or regulated by the federal and state government for safety and security consideration. Obstacles exist in various forms from industry entrance barrier, administrator approval to requirement of mandatory tender offer. It is understandable that some obstacles are necessary to the overall

⁴ Obviously, corporate governance is far from the only determinant of M&A activity. M&A behavior can also be influenced by other factors such as policy, financing availability and general attitude towards it.

management of an economy, but to develop a sound and active M&A market, an environment as free as possible is desirable.

The second prerequisite for hostile takeover to function is dispersion of ownership. When firm stocks are highly dispersed among small and middle shareholders (without controlling shareholder), the small stake for each of them does not induce their enthusiasm to participate in management to generate more dividends. Instead, shareholders choose to “vote by foot”, referring share price as the only indicator to decide personal stance. By contrast, an ownership structure involving powerful controlling parties can greatly reduce the danger for the firm to become a hostile takeover target. Because putting a company “in play” often prohibits, rather than induce, dialogue between management and shareholders about the corporation’s long-term direction, which is in the interest of strategic investors. If frustrated with management, these investors would be more likely to enter into a dialogue and try to change a management team than to encourage a hostile tender since their majority proxy can enhance their leverage in negotiation. An extreme example is cross-holding structure in Japan Keiretsu and Korea in which a member firm holds not only a stake of share ownership, but also possibly stake of loan guarantee and various business cooperation. That any bidder can hardly satisfy all relational parties makes hostile takeover almost impossible.

Finally, a mature capital market in which market price appropriately reflect firm value is necessary, otherwise the payment by a bidder won’t match its gaining in a takeover bid. Arbitrage and speculation is important for the equilibrium (or fair) price to form, but a market teeming with speculation will deviate the price from an appropriate signal of firm value. Systematically distorted share price is especially detrimental to a healthy M&A market. For instance, unusually high price and high price-earning ratio owing to unbalanced demand and supply structure of stocks in China and a bullish market boosted by the government have induced corporations to seek for M&A as a way to attract money rather than a way to increase firm value. On the country, it is unfair for target companies to be purchased at a systematically undervalued price.

- ***Economic analysis of M&A market***

- How can M&A help improve economic efficiency and corporate governance*

- 1). Macro efficiency**

- M&A is usually referred to as an external mechanism in addressing agency problem by threatening to replace incumbent management and therefore induce managers to focus on shareholders’ interest. Another source of efficiency comes from actual replacement of poor management through takeover move. Additionally, M&A market facilitates resource mobility and makes synergy creation possible by rearranging or restructuring production or management.

In Chinese market, the function of M&A activity to change ownership and controlling structure of corporation is especially emphasized. Through merger or acquisition, the

government can finally break the business linkage with micro economic entities and separate itself from corporate operation. Through it, better management from private and foreign companies will be introduced into SOEs. In M&A market, economic resources that were irrationally allocated by administrative in central planning economy now have chances to be reallocated by invisible hand.

2). Micro efficiency

The following tables show empirical evidence reported by Jensen and Ruback regarding the effect of mergers and tender offers on stock price from the announcement date to the completion date. Significant price increase is seen in target firm after the announcement. Bidders also experience positive (but minor) increase in price. As for the negative figures in table 2, expensed cost in the unsuccessful attempts and possibly damped confidence of shareholders in the firm might explain.

Table 1: Abnormal Stock-Price Changes Associated with Successful Corporate Takeover Bids

| Takeover Technique | Target | Bidders |
|--------------------|--------|---------|
| Tender offer | 30% | 4% |
| Merger | 20% | 0 |
| Proxy contest | 8% | n.a. |

Source: chapter 30, Ross, Westerfield, Jaffe, "Corporate Finance" Mc Graw Hill

Table 2: Abnormal Stock-Price Changes Associated with Unsuccessful Corporate Takeover Bids

| Takeover Technique | Target | Bidders |
|--------------------|--------|---------|
| Tender offer | -3% | -1% |
| Merger | -3% | -5% |
| Proxy contest | 8% | n.a. |

Source: chapter 30, Ross, Westerfield, Jaffe, "Corporate Finance" Mc Graw Hill

To find out how an external and active stock market affect corporations' behavior, Mayer and Alexander (1991) compared the performance of matched samples of quoted and unquoted firms in the UK. They found that quoted firms outperformed their unquoted counterparts in terms of growth rate, productivity (as measured by sales over employment) and profitability (measured by both profit margin and rates of return on capital employed). Mayer and Alexander provided an explanation for the result. They note that quoted firms grew much more rapidly than their unquoted counterparts through acquisition. This is what exactly the M&A market in the UK has

allowed firms to do---to expand rapidly through acquisition.

cost

However, to run the M&A market is costly. Firstly, the most often mentioned weakness is to encourage managers to achieve job security and personal compensation by boosting stock price at the expense of long-term growth of corporation⁵. Secondly, defensive measures taken by managers in hostile takeover might obstacle a potentially profitable transaction and therefore harm firm value. Thirdly, excessive premium payment can dilute shareholder value of bidder firms and finally damage further development of it. Since managers in M&A deals are motivated not only by economic consideration from corporations' point of view, but also by personal ambitions and possibly uneconomic considerations of the firm, excessive premium payment is not uncommon in M&A deals especially competitive bids. Finally, merger and acquisition is a powerful device to achieve greater market power⁶. Klaus Gugler, Dennis C. Mueller, B. Burcin Yurtoglu and Christine Zulehner (2002) notice in research that mergers on average do result in significant increases in profits, but reduce the sales of the merging firms. Based on their research on comparison of firms' pre and post-merger market power and efficiency (measured by cost level), they confirm a hypothesis that most mergers' appearing success in enhancing profit comes from gaining of greater market power. Therefore, they conclude, if one categorizes mergers that increase market power or that reduce efficiency as welfare reducing, then a majority of the mergers taking place around the world over the last 15 years appear to be welfare reducing. Despite the existence of anti-trust regulations, it seems that they do not effectively forbid these efficiency-destroying deals. Increased market power will increase firm's micro efficiency. However, increased monopoly power of the company thru merger will cause loss in macro economic efficiency from the national economic point of view.

● ***Relevant topics regarding M&A***

The forces that drive the M&A market can be divided, like a balance sheet, into asset and financing-related components. Asset-related forces include land, capital equipment, natural resources, intellectual property and managerial talent. Financing-related forces include the level of real interest rates, the availability of equity, bank credit, share-price volatility, and so on. M&A behavior, in a large sense, is the application of notions of market equilibrium and market efficiency. Firms and individuals seeking to profit from imperfection in the utilization of an asset (violation of the model of equilibrium) or from the mis-pricing of corporate obligations⁷ (a violation of notion of market efficiency) take actions to benefit themselves⁸.

⁵ But the empirical evidence by Mayer and Alexander (1991) suggest the converse.

⁶ The term of "market power" connotes the ability to control price. Any merger that increases a firm's market power must, therefore, increase its ability to control (raise) the price of its products.

⁷ Theoretically speaking, there won't be any hostile takeover in an efficient market. But given no really efficient market existing, there does exist mis-pricing of corporate obligation.

⁸ Geoffrey Y. Boisi and Stuart M.Essig "Development of the M&A Market", Excerpted from "The Mergers & Acquisitions Handbook" Mc Graw Hill

To look into an M&A transaction, on one hand, we can simplify an M&A transaction into one similar to that of any other valuable economic goods. According to Coase Theorem, as long as transaction cost is zero, the resources will be finally transferred to the highest bidder (highest productive firm). In an imperfect market, however, to reduce transaction cost as much as possible is to enhance efficiency. In this sense, one can expect merger and acquisition by agreement might be more economically efficient than those accomplished through hostile takeovers. For academicians and policy-makers, Coase theorem also suggests streamlining M&A procedures, lifting the unnecessary barriers and fostering intermediary agencies.

On the other hand, M&A is far more complex than a transaction on common goods. A corporation's involvement of various stakeholders and conflicts among them make economic principles do not necessarily work here. Firstly, the highest bidder is not necessarily the most productive competitor (or the potentially most productive competitor), because managers can pay excessive premium out of personal interest rather than out of maximizing firm value. Secondly, benefit and cost occurred in and after M&A deals have to be distributed among stakeholders, while no distribution is involved in common transaction of goods. There are interest conflicts between creditors and shareholders and between majority and minority shareholders. From a corporation's point of view, the distribution arrangement influences their respective interest, while from the view of macro-economy, the arrangement is related to how much outside shareholders and creditors are protected and what attitude and stance we take in addressing several agency problems. Broadly speaking, it is related to corporate governance.

Part III: M&A in China

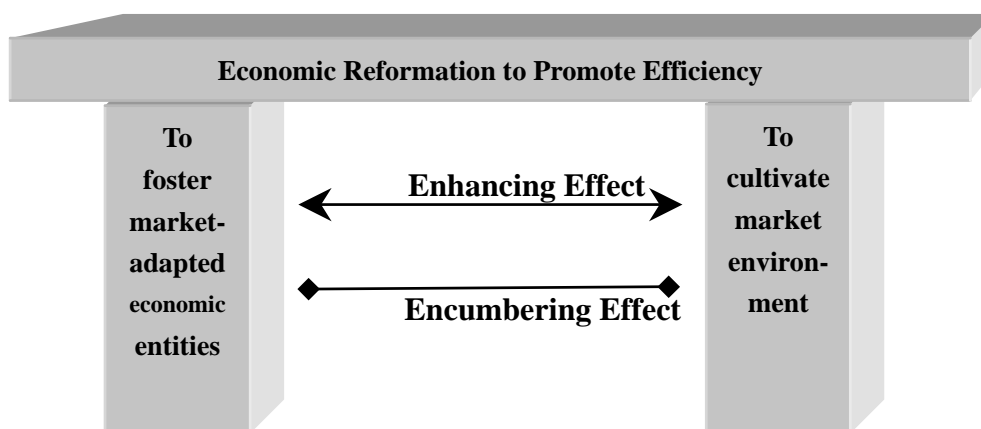
● *Background introduction*

Two-Leg Theorem

More than two decades of economic reformation undertaken in China can be summarized into two categories: those to foster market-adapted economic entities (firms) and those to cultivate a market environment. Reforming SOEs and encouraging private enterprises stand at the center of the first mission. As for the second category, emphases have been placed on replacing administrative pricing system with a pricing mechanism by "invisible hand" and on lifting regional, administrative and other unnecessary barriers against the free mobility of economic resources. The construction of capital market and other factor market (including M&A market) represents the most important progress. The two categories of reformation do not stand independently, instead, they go hand in hand. Progress in either one can help reinforce the other, while loopholes or lags in either side will also necessarily obstacle the progress of the other. (The following graph illustrates the interdependent relationship.) Such a relationship is described as "Two Legs Theorem". To function well, two legs have to develop in a coordinate and appropriate pace

respectively. Too long or too short of either of them will lead to malfunction.

Figure 2: Two-leg Theorem



From this perspective, M&A is superior to other alternatives, such as “people’s share-ownership program, which is to sell shares of state owned enterprises(SOE) at subsidized price. Ideal M&A is characterized with “exchange corporate control at fair price”, thus contributes to building market environment. It can also help modify corporate governance and improve efficiency of corporate entities. Therefore, M&A enhances both “legs” of the current economic reformation, whereas alternatives distort price signal, thus are unfavorable to at least one “leg” of the reformation target.

State-owned enterprise

Any discussion about the economic reformation in the past two decades is incomplete without mentioning the reformation on state-owned enterprises(SOE). SOEs played very important roles as production units after the immediate establishment of planning economy, but drawbacks were gradually exposed after three decades. Among them, low efficiency and lack of incentive were protruding problems. National budget also found more and more difficult to support them as before. Therefore, reformation on SOEs as a task was brought forward by the government. Coase Theorem, which believes the clarification of ownership is the first-order prerequisite to foster efficient economic entities, was taken as the guiding principle. Another principle is to separate the government from SOEs’ business operation.

The remedy prescribed by academicians and the government is to stockarize⁹ SOEs. State-owned properties were evaluated and differentiated into state-owned part whose management is entitled to the Bureau of State-owned Asset Management (BSOAM) and state-owned-legal person part which was hold by other SOEs. After stockarizaion,

⁹ The objective of stockarization is to clarify property right of interest parties on a given corporation. It answers the question “who owners how much”. It differs from privatization in that it does introduce new investors and it involves no shock purchase or sell. It is only a “stock allocation”.

ownership problem was partly solved. But the desired separation between government and business was not achieved owing to their close linkage in personnel and governmental behavior inertia. And SOEs still suffered from short of money due to the suspended instill of financial support from the government.

To address these problems, policymakers started to think about building a stock market that can not only absorb money from the public through direct finance, but also help improve the management and reinforce the reformation of SOEs by introducing public investors. But facts proved partly against the initial objectives. To meet the requisites to become a public company, SOEs usually choose to package¹⁰ a new company by injecting good assets, while leaving poor assets outside. The new company, therefore, can hardly be really independent from its parent company and is morally obliged to rescue the remaining part. In this sense, it is no more than a bait to attract money from the public. The concept of so-called “going public by package” violates the fundamental principle of honesty and leave the stock market teeming with fraud, under-table relational transactions and speculation from the very beginning. Another characteristic is to differentiate state-owned shares (SOS), state-owned legal person shares (SOLPS) and public shares. Except public shares, the first two categories are not publicly transferable and the right to transfer them falls to BSOAM and the holding SOEs respectively¹¹. The price for the SOS and SOLPS is usually far below that of the public shares even though they are equally entitled with voting and all other relevant rights¹².

The Latest policy development regarding reformation on SOEs is the proposal of “抓大放小”. The government will focus its efforts to rescue and foster a certain number of big companies and some conglomerates while retrieve from middle and small SOEs through auction, M&A and so on.

Stock market

Up to May 2002, out of the total 1218 listed firms in Shenzhen and Shanghai Exchanges, 1051 have “parent company” and 77% (813)of parent companies are SOEs. Taking the total 484 listed firms in Shanghai Exchange in 1999 as a sample, a research in Chinese Financial Review¹³ reports statistics about their ownership structure. (Shown in Table 3) Averagely, SOS and SOLPS count for nearly 65% and common shares about 35%. The research finds that contrast to SOLPS and public shares, weight of SOS is positively related to firm size. It explains it by referring to the fact that majority of big-sized listed firms result from restructured SOEs, whereas

¹⁰ Package: to present (as a product) in such a way as to heighten its appeal to the public (Merriam-Webster dictionary)

¹¹ On April 28,1994 for the first time, SOPLS is transferred through negotiation in the M&A case of Zhuhai Hengtong Group acquiring 12 million SOPLS of Shanghai Lingguang Corp. from its shareholder, Shanghai Constructing Material company.

¹² The so-called “equal share but unequal price and right” phenomenon.

¹³ “Ownership Structure , Corporate Governance , and Firms' Performance” taken from Chinese Financial Review Vol18, The internal publication of Center of Chinese Finance Research

the private and non-SOEs are usually smaller in size. Table 4 illustrates the high ownership concentration rate of listed firms. CR1 is extremely high and other shareholders, even the secondly biggest, are much less significant in weight.

This research tries to find out how different controlling shareholder influence firm performance. It concludes that the firms with no significant controlling owner function better than those having a controlling party regardless of its status. Among the two different controlling types, those dominated by SOPLS are better than those controlled by SOS.

The research further explores the relationship between ownership structure and corporate performance. No significant correlation is found between the weights of SOS, SOLPS or publicly trades shares and corporate performance. However, there does exist a statistically significant cubic relationship between weight of SOPLS and performance, with 0.227 and 0.674 as the two inflection points respectively. In the range of [0, 0.227] and [0.674, 0.75], performance is constantly improved with increase of weight of SOPLS, while when the weight falls into [0.227, 0.674], the two are negatively correlated. No similar relationship is found regarding SOS and common shares. Empirical result is illustrated in table 6 and table 7.

Table 3: Ownership Structure of Listed firms in Shanghai Exchange in 1999

| | Number of companies | SOS (%) | SOLPS (%) | Public traded shares (%) | Others (%) |
|---|----------------------------|----------------|------------------|---------------------------------|-------------------|
| Sample average | 440 | 41.8 | 21.9 | 33.0 | 3.3 |
| Categorized by firm size (Million Yuan) | | | | | |
| [138, 598] | 105 | 30.6 | 30.6 | 36.2 | 2.6 |
| [616, 996] | 112 | 33.6 | 27.6 | 36.1 | 2.7 |
| [1010, 1688] | 113 | 37.5 | 23.7 | 35.1 | 3.7 |
| [1745, 16507] | 110 | 48.5 | 17.7 | 30.4 | 3.4 |

**Table 4: Share Weight of the First Ten Shareholders of Sample Firms
----A Measure of Concentration Rate**

| CR1 | CR2 | CR3 | CR4 | CR5 | CR6 | CR7 | CR8 | CR9 | CR10 |
|------------|------------|------------|------------|------------|------------|------------|------------|------------|-------------|
| 45.3 | 52.8 | 56.1 | 58.0 | 59.2 | 60.0 | 60.7 | 61.2 | 61.6 | 62 |
| (18.1) | (15.7) | (14.9) | (14.4) | (14.2) | (14.0) | (13.8) | (13.7) | (13.6) | (13.5) |

Note: CR denotes the accumulative percentage of certain first shareholders. CR4, for example, stands for the total weight of first four biggest shareholders. The figures in parentheses are standard deviation.

Table 5: Concentration Rate Index of sample firms

| | Average | Median | S.D. | Minimum | Maximum |
|----------------------|----------------|---------------|-------------|----------------|----------------|
| CR ₁₀ (%) | 62.0 | 63.1 | 13.5 | 7.3 | 91.3 |
| H ₁₀ | 0.2535 | 0.2234 | 0.1609 | 0.0013 | 0.7847 |
| Z(times) | 48.7 | 10.4 | 113.8 | 1.0 | 1026.1 |

Note: 1.H10 is Herfindal index, calculated by summing up square shareholding weight of first ten biggest owners. Since weights are smaller than 1, squaring can exaggerate the difference among bigger and smaller ones. Herfindal index is used to illustrate ownership distribution among major owners.

2. Z = shareholding weight of biggest owner / shareholding weight of second biggest owner

Table 6: Empirical Result of relationship between different categories of shares and Corporate Performance

| | Q=share price/net asset per share | | | ROE=profit/net asset | | |
|-------------------------|--|----------------------|----------------------|-----------------------------|--------------------|--------------------|
| Intercept | 40.580 | 39.224 | 43.033 | - 46.1 | - | - |
| | (9.18) | (8.87) | (9.65) | (1.94) | 47.523 | 43.490 |
| | | | | | (2.02) | (1.80) |
| Weight of SOS | - 0.628 | | | - | | |
| | (1.08) | | | 1.361 | | |
| | | | | (0.43) | | |
| Weight of SOPLS | | 1.534 ^b | | | 2.145 | |
| | | (2.54) | | | (0.65) | |
| Weight of public share | | | - 2.436 | | | - 1.685 |
| | | | (1.01) | | | (0.26) |
| GROW | 0.025 | 0.029 | 0.034 | 0.146 | 0.151 | 0.152 |
| | (1.02) | (1.16) | (1.36) | (1.06) | (1.09) | (1.09) |
| SIZE | - 1.649 ^a | - 1.612 ^a | - 1.736 ^a | 2.591 ^b | 2.610 ^b | 2.471 ^b |
| | (7.71) | (7.64) | (8.22) | (2.25) | (2.27) | (2.16) |
| Adjusted R ² | 0.163 | 0.178 | 0.167 | 0.028 | 0.027 | 0.036 |
| F-value | 20.83 | 22.63 | 21.63 | 4.801 | 2.26 | 2.77 |

Table 7: Cubic relationship between weight of SOPLS and corporate

performance

| | Q | ROE |
|-------------------------|-----------------------------|------------------------------|
| SOPLS | 17.41 ^a (4.07) | 42.01 ^b (2.76) |
| SOPLS ² | - 70.26 ^a (4.73) | - 136.05 ^b (2.64) |
| SOPLS ³ | 69.09 ^a (5.18) | 104.9 ^b (2.41) |
| GROW | 0.025(0.99) | 0.150(1.09) |
| SIZE | - 1.645 ^a (8.02) | 2.548 ^b (2.22) |
| Intercept | 39.648 | - 44.65(1.86) |
| Adjusted R ² | 0.225 | 0.052 |
| F-value | 20.85 | 2.87 |

Note: 1. GROW refers to growth opportunity. $GROW = (\text{profit in year 1999} - \text{profit in year 1998}) / \text{profit in year 1998}$

SIZE = $\ln(\text{overall asset})$

2. The figures in parentheses are t-value.

3. a denotes 1% level of significance and b denotes 5%.

Because the Chinese stock market has a history only as short as 20 years, Chinese administrative has every reason to believe that both the firms and public investors are not mature enough and therefore the market needs strict supervision by government authority. With regard to the entrance control, CSRC (China Security Regulatory Commission) adopted a “licensure system”, in which the total number of firms allowed for IPO is strictly limited and CSRC is entitled the authority to check application firms’ qualification and to give approval to qualified ones. As for retreating mechanism of listed firms, however, no regulation was issued until 1998. In February 2001, CSRC promulgated “Scheme concerning Suspending Stock Exchange of and De-listing Financially Loss Firms”. This legal file is regarded as a milestone in sense that it breaks the myth of “no fail listed company”. The strict entrance limitation and ‘no failing record’ until recently make stock market a paradise for listed firms. At the same time, such mechanisms create a special “shell resource” in Chinese market. “Shells” refer to companies that are still listed in the Exchange but stock transaction is limited due to poor financial status. According to the “Scheme”, these companies cannot be allowed for new issuance until they recover to positive profit figure in a given period of time. This explains why a non-listed company can “go public by purchasing a shell”, through which it not only saves a shell company from the edge of being eliminated, but it also obtains a valuable seat for new issuance.

● *Development of M&A in China*

“Code on Merger”(tentative) defines a merger as the absorption of one firm by another. After the merger, the merged firm ceases to exist as a separate business entity. An acquisition is defined in “Code of Practice on Acquisition of Listed firms” (December, 2002) as a purchase behavior through which the acquiring firm obtains enough voting shares to control the firm, regardless by tender offer for public shares

or by negotiation with holders of untradable shares. After the acquisition, the acquired firm still exists as an independent business entity. Acquisition is the major form of M&A attempts in China.

A dramatic development in M&A has been witnessed in recent years in both terms of volume and value of deals.

1) Emerging M&A Activities during 1985 – 1996

Between January 1st of 1985 and December 31st of 1996, 180 M&A transactions with a total value of over \$5.3 billion took place in China (Even though 346 transactions took place in the period studied, only 180 of these reported the value of the transaction). Foreign companies were responsible for over 62% of these transactions. Between 1985 and 1990, M&A totalled only \$32.1 million; in the last six years (1991-1996) they totalled a remarkable \$5.27 billion. Furthermore, over 26% of the total value of M&A transactions took place in 1996.

2) M&A of Listed Companies during 1994-1999

The Chinese stock market provides a stage for M&A players. In 1994, Baoan's acquiring Yanzhong starts M&A activities of listed company. Statistics show that, in 1997, 210 listed companies accomplished 270 M&A deals; in 1998, the number of M&A cases in stock market is 624, participated by 389 listed companies; which accounts for half of all the listed companies that year. In 1999, the deals increased to 1,012, an 80% increase from 1998. The M&A wave has been a major characteristic of the emerging Chinese stock market.

● *Underlying reasons for M&A surge*

Strong incentive from both acquired and acquiring sides stands behind these increasing figures.

First of all, industrial evolution or industrial adjustment serves as the background against the M&A surge. Despite continuous economic growth, Chinese economy has suffered from deflation since 1997 for which over supply in low-end product is attributed to as one of main causes. Leather shoes, for instance, the total inventory went up to 4 billion pairs by December 2000. In 2001, State Statistics Bureau reported excessive supply in over 90% of light industries while in high-tech and most capital intensive industries domestic companies have little competitiveness and heavily rely on import. Therefore, to upgrade industrial structure has become a national objective in the future ten years. The "Code on Merger" explicitly states that M&A should be pursuant to national industrial policies and national economic development strategy. Combining with the fact that the implementation of industrial policies fall into the scope of the government (especially local governments) and their holding of SOS does enable them to participate in M&A deals, no wonder that M&A has been widely used as a device by the government to upgrade industrial structure. Except that economic resources are removed from "sun-setting" to "sun-rising" industries or from a poor-managed to a more competitive firm, M&A is also intended to foster some

conglomerates. This countrywide enthusiasm about super-corporation arises from seeking for economy of scale and global competitiveness like Japanese Keiretsu and Korean Cheabol. Small size of individual company along with big total number of companies is an outstanding characteristic of current industrial structure. Take beer industry as an example, among total 889 beer manufacturer, 805 have annual production capacity below 50 thousand tons and only 16 can produce over 100 thousand tons, the internationally regarded minimum level to obtain scale of economy. Starting from 1997, Qingdao Beer initiated a country-wide “merger storm” and followed by Yanjing and other major producers. The storm unveiled a contest to build conglomerate in beer industry.

Secondly, the need of domestic firms for foreign capital and technology combined with eagerness of foreign investors for domestic market and low cost production greatly boost the M&A surge. Chinese accession to WTO requires further openness of domestic market and some regulatory barriers have been lifted. Previously, three forms of foreign investment were allowed: to form a joint venture with domestic cooperation firm but not holding controlling stake, to form a wholly foreign capital firm or to invest on B shares of listed firms¹⁴. Now industrial entrance limitation is gradually released. According to the modified “Guiding Category for Foreign Investment” (April 1, 2002), tele-communication, gas, heat power, drainage and other municipal pipeline networks for the first time are listed in opening area. “Encouraged Category” was added from 186 items to 262, while “Limited Category” decreased from 112 items down to 75. Restriction on shareholding level has also been greatly released. The announcement on November 4, 2002 by CSRC that foreign investors can acquire SOS and SOLPS in listed firms opens the door for foreign companies to acquire significant stakes in Chinese listed firms. Furthermore, a Qualified Foreign Institutional Investor Scheme has also been launched, so that for the first time foreign institutional investors will be allowed limited access to domestically traded A shares.

Thirdly, “asset-related” incentive¹⁵ of domestic companies’ constitutes another driving force of the M&A surge. Sequels of central planning economy in the past leave broad space of this kind of efficiency improvement. A common situation is that a surging company finds needed resource less fully utilized in other companies (especially in middle-small SOEs) that has been allocated it under planning economy. There are also cases that all resources in a firm except manager talent are satisfactory, but poor performance resulted from inefficient and entrenched managers or administrative intervention can hardly be changed unless an external hit is imposed through M&A. In this sense, M&A is used as a device to help change corporate governance of an individual firm. The example of Huarun acquiring Vanke’s share illustrates how domestic firms seek for complimentary resources through acquisition

¹⁴ Chinese stock market is divided into two categories: RMB dominated A share for domestic investors and foreign currency dominated B share (US\$ in Shanghai Exchange and HK\$ in Shenzhen Exchange) for foreign investors. Two categories are not exchangeable and foreign investors are never allowed to purchase A share. Not until Feb 2001 that domestic investors got access to B shares in their foreign currency accounts.

¹⁵ Referring to the sub-title of “relevant topics regarding M&A”.

attempts. Beijing Huarun Real Estate group acquired 10.82% shares and became the controlling shareholder of Vanke Real Estate Development¹⁶. Vanke is a real estate company that is widely regarded as very successful in terms of management, marketing and rapid growth in recent years. But its weakness of limited land pool, the most important resource does concern managers. Wangshi, CEO of Vanke once admitted that he wanted to “marry” a firm that is able to make up Vanke’s weakness and provide other complimentary resources. When it finally chose Huarun, professionals expected the combination will create 1+1>2 synergy effect. Huarun is rich in land deposit¹⁷, and by relying on this endowment advantage, it has become the biggest real estate explorer in Beijing market and are eagerly seeking for expansion to countrywide. What Huarun expects from Vanke is its efficient management and marketing.

Finally, shell phenomenon explains a quite big portion of M&A deals taking place so far. On one hand, shells are eager for recovery to profitable and for restructuring to become qualified for new issuance. On the other hand, because of strictly limited access to the Exchange, “going public by purchasing a shell” is a less costly solution for a non-listed company hungry for equity capital. The restructuring process can also be called “asset exchange”. It starts from acquiring firm’s injection of enough good assets into the shell (sometimes combined with divestiture of poor asset from the shell as well and restructuring of debt). Consequently, the purchaser becomes the controlling shareholder; then it can exert decisive influence on shell firm to purchase remaining asset left in itself. After asset exchange, shell firm is rescued from edge of going de-listed and acquiring firm successfully controlled the new cash flow. In some sense, to purchase shells is mere a special form of “seeking for complimentary resource to enhance competitiveness” by both parties. In practice, however, many spurious M&A deals have been undertaken under a mere objective of duping investors and gathering money. The deals do not involve any modification in real sense except in financial reports. In “Code of Practice on Acquisition of Listed firms” and “Notice Concerning Asset Exchange of Listed firms”, provisions intended to forestall spurious M&A counts for large weight.

● *Main characteristics of the M&A deals*

Against specific historical and economic background, Chinese M&A market exhibits some characteristics. It is also a reflection of the corporate governance state.

There is no hostile takeover. As analyzed above, three prerequisites have to be met for corporate control market to work. These conditions, however, do not have existence in current Chinese market. Even though regulatory barriers against access to certain industries and financial instruments have been gradually removed, the market environment is still not free enough. More importantly, lots of invisible and uncertain obstacles lie in local government against cross-region or cross-ownership M&A

¹⁶ Unlike other listed firms, Vanke has an unusually dispersed ownership structure.

¹⁷ Land is not allocated in market. So a firm’s land endowment is largely determined and can hardly change.

owing to their regional or personal interest. Concentrated ownership structure can effectively protect a target company from a hostile attempt and big portion of un-tradable SOS and SOPLS further makes a hostile takeover impossible. Furthermore, given great price discrepancy¹⁸ between state-owned and public traded shares, actually few bidder companies would prefer a tender offer. Finally, since Chinese stock market is characterized with unusually high price-earning ratio and speculative behavior, the share price has little ground on discounted cash flow base, and therefore can hardly be an effective measure of real firm value.

The government plays a specially active role in M&A deals. According to the regulation on M&A, any deal requires a final approval from government authority. A series of factors including the government's responsibility to undertake industrial policies, local governments' interest in tax revenue and local economic development that is connected with local SOEs, and their heavy holding on SOS and indirectly holding on SOPLS give the government both incentive and capability to participate in corporate restructurings. This kind of intervention, on one hand, might manipulate M&A out of administrative will and with little regard to economic rules. On the other hand, the government's participation sometimes can facilitate to maximize benefit in a broader sense that cannot be achieved otherwise. Besides, government's participation into M&A deals can extend the business deals beyond economic scope. For example, local governments try to minimize local unemployment. But their emphasis on it will impose the bidder extra non-economic burden and consequently further discount SOS and SOPLS.

Unfair relational transaction¹⁹ is an inherent problem of Chinese stock market. Scandals that insiders or majority shareholders manipulate relational transaction and damage minority shareholder's interest emerge one after another. But unfortunately, so far no specific regulation has been promulgated to rule transactions among relational parties. As mentioned above, most listed firms are used as a bait to attract public capital by parent companies, which hold the controlling stake in them. Through unfair transactions, parent companies can prop capital out of its bait in good time and tunnel financial help to sustain its qualification to being listed in times of financial distress. It might be strange how can a listed company as an independent entity be influenced so much by the controlling shareholder. The phenomenon can be explained by a glance at the internal governance mechanism of a common listed company. There is no independent director until very recently. Among around 10 seats in board of director, except one for representative of employees and one or two for public individual investors, others are allocated based on shareholding. All decisions, no matter whether related to relational parties or not are subject to principle of majority. Relational

¹⁸ State-owned shares are priced based on replacing cost (calculated by replacing cost minus accumulated depreciation), while public traded shares has market price. According to principle of protecting state-owned property, SOS and SOPLS should not be sold under net asset value per share. For instance, in the case of Hengtong acquiring Lingguang shares, SOPLS was transferred at RMB4.3 Yuan per share (net asset value per share is RMB3.8 Yuan), whereas market price for public shares was around RMB15 Yuan then.

¹⁹ Unfair relational transactions are defined as transactions between relational parties especially at unfair price.

transaction itself is not blamable, because mutually beneficial cooperation is exactly the end of an M&A deal. But without due diligence of insiders (or other de facto controllers) and effective protection of outside shareholders, relational transaction is very detrimental to a healthy market.

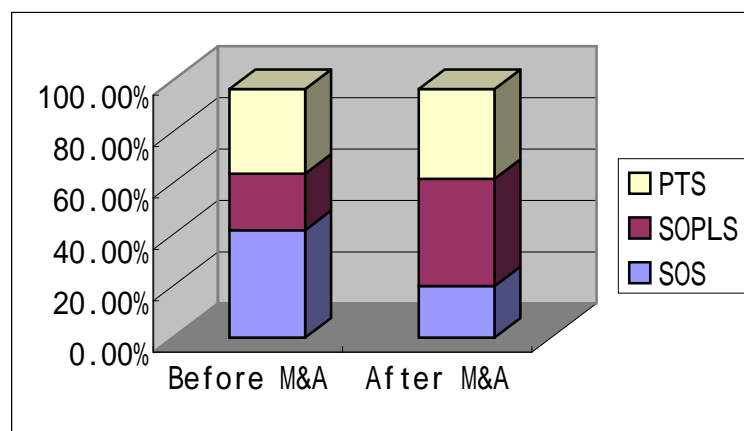
● **Efficiency Analysis of Chinese M&A market**

Discussion in this part will go in three steps: to analyze goodness, specious goodness and weakness of Chinese M&A market.

Goodness is obvious in that it facilitates the resource mobility, helps attract foreign capital and promote corporate management. According to conventions, to replace poor management is the major source of synergy creation in M&A deals. In Chinese market, even though there is few hostile takeover, most acquirers do change the management team after merger or acquisition. Additionally, M&A has successfully helped reform SOEs by introducing new investors and further to separate the government from SOEs' business operation.

There are opinions that M&A deals can also help improve ownership structure. Such opinions, however, are questionable. To discuss the issue, we need firstly a definition of "good" and "bad" ownership structure. Although no widely accepted opinion so far was established regarding the relationship between ownership structure and corporate performance, we have discussed an desirable corporate governance and accordingly an ideal ownership structure: dispersed ownership combined with several major strategic investors. Think about the common model of an M&A deal discussed above. Through negotiation, the acquirer purchases SOS from SOPMB or transfers SOLPS from other state-owned enterprises. Consequently, weight of SOS decreases on average, that of SOPLS increases and public traded shares is little influenced. The following figure illustrates the average change on ownership structure of listed firms that underwent M&A.

Figure 3: Change on Ownership Structure of Listed firms after M&A Deals



Obviously, the ownership is not more dispersed than before. Public traded shares do not increase much and the shift from SOS to SOPLS marks the major difference.

Admittedly, SOPLS can address the problem of “personification of property right”²⁰ better than SOS that is questioned to be unsuitable to participate in corporate management for this reason. Legal persons, having both ownership stake and business corporation interest in the corporate, can serve as strategic investors. However, empirical evidence shows that the increase of SOPLS will not help improve corporate performance when the weight falls in the range of [0.227,0.674]²¹.

Along with the goodness, the current M&A market does inbreed serious problems. In the first place, it is not a corporate control market in real sense. Benefits derived from hostile takeover market are not enjoyed here, especially as an external mechanism in corporate governance to align management with shareholders’ interest. Such a problem can never be utterly solved until SOS and SOPLS become publicly tradable or at least become minority portion. Chinese government has exerted great efforts on solving the problem. In 2002 when news about SOS would be released was publicized, the market price responded with plummet. Investors worried that limited public fund is not enough to sustain share price once the huge pool of SOS is released. Now, Chinese government is still seeking for a safer and broadly accepted solution without causing drastic influence on the market and shareholders. What can be expected is that the SOS and SOPLS will gradually and eventually be released but the process will take a quite long time.

Secondly, connected with M&A deals are relational transactions. Unfair relational transactions have greatly damaged minority shareholders’ interest. Lack of efficient protection institution discouraged investors. It is estimated that over 80% of listed firms have parent companies and more than 80% of listed firms once involved more or less in unfair relational transactions.²² Scandals such as Yin Guang Xia and Hong Guang are mere above-surface part of the iceberg, exhibiting seriousness of the problem. Efforts made by CSRC so far are mainly concentrated on information disclosure obligation of listed firms. CSRC requires they should report “important affairs” including relational transactions that might influence firm value and share-price in mid-year report and year report. Such post-affair obligation, however, has nothing to do with forestalling unfair transactions. Even if immediate information disclosure is required, academicians argue that, transparency alone cannot solve entire problem. Minority shareholders should be given extra reliable information what is the fair value of a transaction. For instance, company can publicize along a report from independent auditors. Furthermore, minority shareholders should have access to further information when having doubt. To avoid interest evasion by insiders (or de facto controllers), challenge system of interested party should be introduced into listed

²⁰ SOS is criticized for not being able to personalize property right. State-owned property belongs to the state and therefore to all people. But “belongs to all people” is the same as “ belongs to no people” because nobody can exclusively benefit from it or burden the loss of it. So either incentive or punishment mechanisms does not work here. SOS is therefore considered as low efficient. Once the ownership is endowed to another SOE, there is a specific legal person responsible to the property. Accordingly, to shift to SOPLS solves the personification problem to some extent. But the root is not touched yet.

²¹ Refer to the literature cited under the sub-title “Stock market”.

²² Source: Liu Baifang, Journal of Finance and Insurance

firms.

Thirdly, a dangerous tendency of cross-holding is in rise. Lessons from Japan and Korea tell us cross-holding can make an economy more vulnerable especially in a country like China where corporations are heavily leveraged. In promotion of conglomerates, some academicians and the government propose and encourage cross-holding structure out of the intention to build strategic relationship inside the group. Although up to now it is mainly limited between parent and affiliate companies (far less complicated than Korean Cheabols' web structure), the symptom of the dangerous tendency deserves intensive caution.

● *Regulatory Environment*

The legal framework ruling M&A in the US

The US is among the a few economies in which M&A is most likely to happen: free market discipline, nearly-efficient market in which price almost reflect inherent firm value and dispersed ownership structure. The whole legal framework ruling M&A embodies two principles: to protect the minority shareholders' interest and to prohibit any transaction that might damage competition environment. Both bidder and target firms are subject to strict information disclosure regulation throughout the transaction process in case that insiders take advantage of outside shareholders. For example, A Williams Act notice must be filed with the SEC once 5 percent or more of any class of a publicly held target's securities are acquired and this must include a statement of the purchaser's intentions. Dissident shareholders are entitled to require the firm to repurchase their held shares at fair price. Another pillar of the framework is anti-trust law. If a U.S. acquisition meets certain minimum size level (in general, a value of \$15 million or more) and the parties are of a certain size (with sales or assets of \$100 million or more in the case of one party and of &10 million or more in the case of the other party), a Hart-Scott-Rodino premerger notification must be filed with the Department of Justice and the Federal Trade Commission (FTC)²³. FTC is authorized to adjudicate whether the deal under question should be prohibited or not. However, even though the anti-trust regulation has existed since the Great Depression of 1929, the implementation is flexible and usually reflects the need of economic environment and the attitude of the authority in the US. To enhance the competitiveness of US firms in domestic and global market in the age of "New Economy", the ruling has been greatly relaxed in practice after a decade of strict regulation. The approval on Boeing-McDonnell Douglas merger in 1998 reflected such a tendency. The clearance announcement by FTC in the competitive merger case among the three biggest players in holiday cruise industry, Carnival, Royal Caribbean and P&O Princess is another example. (A similar tendency is seen in Europe.) As a whole, the US legal framework is effective in sense that it minimizes the transaction cost in M&A market and it makes the market a device to promote corporate governance.

²³ Source: "The Mergers & Acquisitions Handbook" Mc Graw Hill

Evaluation of legal framework ruling M&A in China

The first complete code ruling M&A of listed firms²⁴, “Code of Practice on Acquisition of Listed firms” was put into force on December 1, 2002. Before that, M&A activities were regulated by relevant articles in Corporate Law, Security Law and other regulations and notices. The new code, incorporating essence in other laws and based on accumulated experiences in practice, provides a comprehensive framework ruling M&A activities. It is composed of six chapters: General Principles, Regulation on M&A by Agreement, Regulation on M&A by Tender Offer, Conditions to Be Exempted from Mandatory Tender Offer, Supervision Body and Its Responsibilities and Interpretation of Critical Terminologies. The Code emphasizes due process of two forms of M&A and accentuates responsibilities of both acquiring and acquired companies in merger or acquisition process. As a whole, it embodies the intended direction of evolution of M&A market by Chinese authority.

Compared with the counterpart in the US, some provisions with “Chinese characteristics” are used to address special problems. CSRC designed these provisions on the basis of past supervision experience. For example, to eliminate spurious M&A deals, the new code requires checking a bidder’s payment capability to become qualified in a bid; and it forbids an acquirer to sell out any purchased shares of the acquired company’s in six months. Furthermore, to avoid collusion that has happened between a bidder and a target firm, the Code prohibits target firm to provide any form of financial support to the acquirer.

As for asset evaluation in M&A deals, there has long been contradiction between domestic practice and international convention. But the Code does not solve the contradiction by admitting legitimacy of three evaluation methods at the same time: replacing cost, market price and discounted cash flow. It leaves the problem to case-by-case negotiation among relevant parties. Additionally, as for the price of different categories of shares, the Code gives different criteria of “fair price”. Namely, market exchange price is the fair level of common shares, while that of SOS and SOPLS is based on net asset value. Replacing Cost method is most broadly accepted domestically. Especially when disposing state-owned asset, any SOE or government-authorized agency should not accept a price lower than replacing cost, otherwise the behavior will be considered as eroding state wealth. Replacing Cost exists as a bottom line. But in practice, sometimes it is also thought as ceiling level because management lacks incentive to maximize asset value. In the case Hengtong acquiring Lengguang shares, SOPLS was priced at RMB4.3 yuan per share based on replacing cost. Whereas when Hengtong sold its affiliate firm to Lengguang the next year, the price was determined in DCF method, much higher than the former. Therefore, this flexibility leaves a policy loophole for those SOEs that do not perform due diligence to their shareholders. Besides, foreign investors in M&A deals usually

²⁴ Since the new regulation has combined essence of all relevant materials, and M&A of listed firms is more complicated in terms of procedure and more strictly supervised regarding transparency and fairness than those of non-listed firms, I confine the discussion within the regulation without referring to other laws.

insist on discounted cash flow method. Discrepancy in evaluation method with domestic counterpart has been thought as an obstacle in deals.

Missing in the Code, if there is any, is possibly the lack of a provision regarding anti-monopoly and it does not mention dissent minority shareholders' right of repurchase requirement²⁵. The former, one of the two pillars supporting US legal framework ruling M&A market, is also necessary to maintain a good competition environment in any economy. The later, I think is equally effective to mandatory tender offer²⁶ in protecting minority shareholders, but less damageable in banning M&A activities.

The new Code is not very practical because its enforcement is bound to be impeded by existing conflicts between it and other regulations or the reality.

Firstly, the Code explicitly states that M&A deals, except those falling into the scope of national industrial policy, should not be subject to any industrial or regional restrictions. But local governments' interest will motivate them to intervene. Since there is no standard criteria about legitimacy of an M&A deal, the required final approval from government authority will only increase uncertainty in the process.

Secondly, even though the Code agrees payment by cash, stock exchange and other financing instruments including bank loan, new issuance of stock or bond, one cannot expect many cases financed by instruments other than reserved cash. Non-listed firms cannot exchange shares to pay the deal²⁷. Corporate bond market is too underdeveloped to be used as a financial source. Besides, according to "Regulation on Management on Corporate Bond", fund gathered from issuing corporate bond must not be used to purchase stock or deal with other risky investment irrelevant to main business of the corporation. Unlike in project financing, commercial banks see obvious imbalance of benefit and risk in M&A deals, thus reluctant to extend credit. Other instrument such as financing through investment banks is rare here, possibly because different from situation in other countries, so far investment banks have not played important roles in M&A market.

Thirdly, the Code emphasizes due diligence of managers and majority shareholders (or other de facto controller) of both sides. It also authorizes CSRC to check whether

²⁵ Dissent minority shareholders' right of repurchase requirement: A target company in an M&A deal will undergo so fundamental change that its investors need reevaluate their investing decisions and possibly not all of them will be optimistic about the company's future. Since GSM decisions are made in majority principle, dissent minority shareholders are in unfavorable position in protecting their own interest. Some countries entitled them to require company to repurchase their shares at fair price.

²⁶ Mandatory tender offer: once a bidder acquires a target company's shares beyond a certain level, say 25% or 30%, and has intention to increase its stake, the bidder must tender offer all public shares at fair price. The rationale for it is similar with that of Dissent minority shareholders' right of repurchase requirement. An investor should be given right the reevaluate a company once its ownership structure has changed so much that other critical elements might change accordingly and minority shareholders should be able to protect themselves by selling shares at fair price. Besides, mandatory tender offer can also be used as an effective barrier against M&A activities.

²⁷ Two Exchanges have altogether only 1218 firms listed.

due diligence is duly performed. However, it gives no regard to minority shareholders' self-protection. Most financially developed countries entitle shareholders to sue a company in case their interest is harmed by undue corporation behavior. If the interest of the corporation as a whole is damaged by inappropriate behavior of insiders including directors, managers or controlling shareholder, other shareholders can even resort to derivative suit²⁸. Newly-born Chinese stock market has little experience in wielding legal protection devices. Corresponding legal principles and procedures have not been established yet. Therefore, the new Code alone is not enough to protect shareholder's interest.

● *Summary and Conclusion*

The article connects M&A with corporate governance and treats corporate governance as broad background and context for the existence and development of M&A market. Starting from comparative analysis of economic efficiency and vulnerability of Anglo-American marketed centered governance system and Japanese Keiretsu, the article reach a reconciliatory model combining strengths of both systems. Actually, practice in various countries has shown such convergence. The reconciliatory model emphasizes dispersed ownership structure along with several strategic investors and pays much attention to protection institution of minority shareholders. One of the implications of the model, when connected with M&A, is to show its possible development tendency. For policy makers and private sectors, it tells what direction M&A market should be led to.

There are a lot of reasons underlying the recent M&A surge in China. Among them, governmental promotion with intention to improve governance structure of SOEs and corporations' eagerness to enhance competitiveness are especially important. However, due to a lot of regulatory and conventional barriers, the influence of M&A is still limited. Particularly, lack of suitable environment enables corporations be free from hostile takeover, thus forsaking a critical source of efficiency enhancement from M&A market. M&A deal' function to modify corporations' governance structure cannot extend far, either. Because the shift from SOS dominated structure to SOPLS dominated one represents only a small step forward. There is still a long way to go to reach an "ideal ownership structure" implied by the reconciliatory model. What's more, great bubbles exist in the recent surge. There are lots of spurious deals in which bidders care about "propaganda effect" to attract further fund from public investors

²⁸ Derivative suit: It is also called "representative suit". When insiders' behavior harms a corporation's interest, outside shareholders can ask internal governance mechanism (through board of director) to correct the failure. Upon requirement is refused, shareholders are entitled to take legal proceedings against them under the name of the corporation. All court costs incurred in derivative suit are burdened by the corporation, and compensation, if there is any, also belongs to it.

rather than intend to improve efficiency of corporations. Relational transactions, another characteristic associated with most M&A deals, impair minority shareholders' interest.

Policy implication can be drawn into three main aspects.

- 1) To lift barriers and streamline M&A process to lower transaction cost
- 2) To accelerate the privatization process and eliminate the different treatment on SOS, SOPLS and public shares
- 3) To constitute comprehensive and effective protection institution to defend minority shareholders' interest from being damaged

For private sector, with the promulgation of the "Code" and the "Scheme", room for profiting from spurious M&A deal is shrinking. Synergy creation and efficiency enhancement will get increasing attention. In this regard, it is time for them to make intensive study how to can an M&A deal help improve corporate governance in real sense and in the long run.

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