The convergence of the Chinese and Western takeover markets

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Abstract

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The evolution of the Chinese takeover market and its integration with the international takeover market are analysed in three ways. First, the paper charts the legal and institutional changes in China in the last two decades to develop a decentralised “Anglo-Saxon” takeover market. Second, the paper provides statistical and case material on the extent to which the Chinese takeover market has in practice become aligned with that of the US and UK. And, third, it presents case evidence on early failure and success in attempts to integrate the domestic with the world takeover market.

The convergence of the Chinese and Western takeover markets

In developing over the last two decades the largest transition economy, the fastest growing major economy, and the second largest economy in the world[1], the Chinese authorities have introduced many of the characteristics of the world's two largest takeover markets, the US and the UK. Private ownership, trading of shares on a regulated stock market, promotion of joint stock companies, development of a takeover code, and policies to restructure and privatise many state-owned enterprises, create favourable conditions for the development of such a takeover market. And harmonization policies, such as joining the WTO and adopting International Financial Reporting Standards, have combined with these domestic policies to reduce the entry barriers between the Chinese and international takeover markets. The "go global" policy in 2002 (Liu, 2007) and very recent policy changes, in particular the July 2009 Regulations on the Use of Foreign Exchange (SAFE, 2009), are designed to promote more cross-border M&A by Chinese firms.

This paper explores the development of the Chinese domestic takeover market from an international business perspective. First, it provides a comparative analysis of the development of this market, using as benchmark the practices of those Western countries which rely heavily on takeover for industrial restructuring (the US and UK in particular). At first sight, Chinese policy has been tending towards this "Anglo-Saxon" system of industrial restructuring via the decentralized, stock market-based takeover mechanism rather than China's own previous state-based system, or than a bank-based

[1] On a purchasing power basis (Bernanke (2006)).

system of the sort associated with, for example, Germany. In this respect it represents an experiment in comparative business organisation relevant to the broad international business community, and especially to transition economies. The diverse institutional and policy changes which have removed barriers to the development of a takeover market are brought together in the paper.

Second, the different legal forms of takeover are reviewed in their international context - some similar to those in the West, some of them special to China. Measures are provided of the scale of the takeover market for listed companies, its growth and its components: these are hand collected from a wide range of sources.

Third, key characteristics of the Chinese takeover market are analysed against the yardstick of Western markets: the market for corporate control, the role of the state, and the conflicts among stakeholders familiar in the West.

Finally, the paper considers the cross-border takeovers in this market: its new size means that China is potentially one of the biggest sources of targets for international M&A activity as cross-border M&A represents one of the fastest ways for Chinese business to integrate with international business and for foreign bidders to enter the Chinese market. Particular cases are analyzed with regard to the accessibility of the Chinese market to foreign bidders.

This paper is organized as follows. Section 1 reviews the institutional developments in the Chinese takeover market in an international context, and sets out the historical record. Section 2 analyses the resulting economic characteristics of the domestic Chinese takeover market, against benchmarks from Western markets. And Section 3 views the Chinese market from the perspective of a foreign bidder.

Section 1 The Institutional Background and the Historical Record

Milestones in the development of the domestic Chinese stock exchange and takeover market

1990 – Inauguration of the stock exchange

The Shanghai Stock Exchange opened in December 1990.

1992 – Sale of state-owned shares

SOAAB(1992) is the first government policy that stipulated that state-owned shares could be sold to non-state controlled sectors (although the transfer had still to be approved by the government). In practice, however, this led to few cases of the acquisition of state-owned shares in listed companies (LCs) during the early years of the Chinese stock market (see Table 3 below) because the concept of takeover was relatively new to the market and the related regulations created obstacles (see, for example, the caps on private shareholding discussed below).

1992 – Delegation of control of state-owned enterprises (SOEs)

CCP(1992) corporatized SOEs, formalising a process begun in 1989 and completed by 2001 of converting SOEs into separate legal entities to conduct management independently and to carry sole responsibility for gains and losses even though the state retains the ultimate ownership and oversight (Li Rongrong, 2002). This separation of ownership and control has features in common with the separation in the US and UK (Berle and Means, 1932): control is concentrated in the hands of managers; and they are the prime movers in takeover activity. Owners, whether private shareholders or government, retain an oversight role, with some power to block takeovers initiated by management.

1996-9 – State ownership to be concentrated just on strategic sectors

In the 9th Five-year State Plan, the Chinese Communist Party (CCP, 1996) famously stipulated that the strategic way to restructure the SOEs is to “grasp the large and let go of the small”. And in the 15th Communist Party Congress held in September 1997, private ownership was formally recognized as an important part of the Chinese Socialist market economy with state ownership reserved for a controlling stake in the key and strategic sectors. The areas chosen for continued state control were subsequently defined by CPC (1999): national security, natural monopolies, industries providing

important public goods and services, pillar and high and new technology industries. SOEs should gradually withdraw from other areas. These policy changes invited the acquisition of SOEs by private investors.

1999 – Promotion of joint stock companies

CPC(1999) also facilitated private ownership in the stock market by stipulating that where the state maintained control, large and medium-sized SOEs should diversify their ownership structure and be transformed into joint-stock companies, with only a few SOEs remaining wholly state-controlled.

1999 – Chinese Securities Law

Crucial to takeover, this Law abolished the 1993 Regulation which limited to just 0.5% the shareholding of any individual in a listed company.

2002- The first Takeover Code

CSRC (2002a) provided a framework for the transfer of shares, including provisions to protect different shareholder groups (see below), and provided rules for valuing those shares which were not traded on the stock market (linking valuations to audited book values). By the time of the second Takeover Code (2006), such rules were unnecessary, as non-tradeable shares were being converted to tradeable ones (see below).

2005 – The reform of non-tradeable shares

One distinctive institutional feature of the Chinese stock market has been the existence of non-tradeable shares and the concentration of these shares in the hands of SOEs or other state-owned asset management agencies. This shareholding system has supported the Chinese model of gradually adapting the market mechanism to fit the Socialist economy (Nolan, 1995). Before the reform of the shareholder structure in the LCs, the "state shares" and "legal person shares", designed in 1992 (SCES, 1992), were non-tradeable, whereas personal shares are listed and tradeable. State shares are

held by the central government, local governments, or solely SOEs, whereas legal person shares are owned by domestic institutions ranging from investment banks, and non-bank financial institutions, to state-controlled enterprises with at least one non-state shareholder. But most legal person shares are state-owned in nature ultimately. And these non-tradable state shares and legal person shares which concentrate ultimately in the hands of the government accounted at their peak for about two-thirds of all the shares of the LCs (see Table 1).

CSRC(2005) introduced reforms designed to achieve conversion of these state and legal person shares to tradeable shares. This conversion was to take place over a one-year transition period; and this was succeeded by a lock-up period, which prevented the sudden sale of large blocks of shares: after one year, 5% could be sold, after two years, 10% could be sold. So the barriers to full trading of the sort seen in the West are being dismantled, though the process is still incomplete.

2006 – Promotion of merger and acquisition

CSC (2006) contains Guidelines to promote State-owned capital adjustment and State-owned enterprise restructuring. This reiterated that state-owned capital should further concentrate in the key industries and areas related to national military and economic security, and that the shareholding reform and the restructuring of large-sized SOEs should speed up. Non-state controlled enterprises were encouraged to participate in the process of reorganizing, reforming and rebuilding of SOEs by way of effecting mergers, acquiring controlling shares and holding shares.

The consequences for shareholding

The combined and cumulative impact of these changes has been substantial. Table 1 highlights some of the developments in shareholding. From 1993, the first year for which we can gather comprehensive data, to 2008, the market capitalisation of shares increased 34 fold. So shareholding outpaced even the rapid growth of the Chinese economy during this period: the market capitalization

was the equivalent of 10% of GDP in 1993, but 40% by 2008[2]. Then the promotion of the private sector, along with the reform of non-tradeable shares, have meant that the tradeable shares – the ones most amenable to market-based takeover transactions – have increased in value 52 fold between 1993 and 2008.

Table 2 sets these developments in international context: it reports the World Bank's cross-country comparisons of the ratio of market capitalization to GDP. The precise numbers in this Table have to be treated with caution, especially for years when stock prices were changing rapidly: the capitalization figure is very volatile between years; and even within years there are substantial changes, which explain the differences between China's figures in Tables 1 and 2: the number can change substantially according to the day on which it is measured. And for that reason we rely chiefly on the three-year average in the final column of Table 2.This shows Chinese market capitalization at around 100% of GDP – still substantially below the levels of long-standing Western stock market economies such as the US and UK; but similar to China's large Asian neighbours, Japan and India, and much greater than Germany, which has followed a growth path less reliant on the stock market. Comparing the recent years with 2000 shows limited change for the US and UK, but more than doubling of the ratio for China, reflecting the major policy shifts we have outlined in this section.

In terms of listed companies, the number has grown from zero at the start of the nineteen-nineties to 1608 by July 2009 (SSE, 2009).

Legal form of acquisition activity; and scale of acquisition activity in modern China

A detailed analysis of the methods of completing acquisitions in China, the relevant regulations, and examples of acquisitions in each category cannot be included here for reasons of space, but is available from the authors. Here we provide a brief summary of the four main methods:

[2] This number is very volatile, because of fluctuations in stock market prices. Thus in 2007, the booming stock market produced a market capitalisation of 131% of GDP.

Takeover by offer: This device is similar to US/UK practice, and is conducted via the market. When a bidder has a minority stake in a potential target, it issues a general offer, open to all the target's shareholders, to raise its stake in the target and secure greater control.

Takeover by agreement: This is an off-market transaction, involving the transfer of up to 30% of the target's shares at a mutually agreed price.

The other two mechanisms are formally subsets of the "by agreement" category. But it is useful to separate them out because they illustrate some special features of recent Chinese experience which would not be found in the US/UK:

Free transfer: This restructures state-owned enterprises. An SOE is transferred to the control of another SOE. No money changes hands.

Judicial transfer: This device is associated with financial distress. For example, a legal person shareholder may be insolvent, and the shares may be transferred by a court decision to another organization, with exemption from the normal general offer obligation. In one such example, discussed below, the buyer is a foreign enterprise.

An aside: open market purchases: It is common practice in the US and UK for a bidder to buy the shares of a target directly on the stock exchange without the cooperation of the target – to effect a hostile bid. In China, this practice has been almost impossible, just as it was in Germany until recent years[3]. We have found no cases within our population during this period, and therefore the category is excluded from the tables. Section 2 below explores the reasons for this omission.

Table 3 reports the number of acquisitions of listed companies in each of these categories in the period 1997-2005. These and subsequent data used in the paper are hand collected from a wide range of sources: there is no systematic electronic source. Thus the population we examined here is

[3] For example, the successful hostile bid by the UK's Vodafone for German Mannesman provoked outraged opposition at the highest level of the German government: the German Chancellor argued that the hostile takeover would "damage the corporate culture" and underestimates the virtue of co-determination" (www.eurofound.europa.eu/1999/11).

collected from the websites of LCs, Workstation of Shanghai Gildata Co., Limited, Shanghai Wind Information Co., Limited, Shanghai Securities News, China Securities Journal and Securities Times in China during the period April 1993 to December 2006. The tables distinguish acquisitions which achieved substantive control – at least 30% ownership, and ones which achieved majority control. The former population comprises 174 companies, the latter 83. As might be expected following the regulatory changes outlined in the previous section, there is a strong upward trend in the aggregate series, with annual figures rising from 1 in 1997 to peaks of 51 and 30 respectively in 2004. The two categories, "agreement" and "free transfer", dominate the totals, for reasons we explore below.

For the takeovers reported in Panel B of Table 3, Table 4 provides valuations based on our own calculations of book value from the individual accounts of the participants. On these measures, the same categories dominate the totals. In aggregate, in the peak year for takeover activity in Table 3, 2004, the book value of the acquired listed firms totalled some 1.3% of the market value of all listed companies reported in Table 1. And this corresponds to some 0.3% of GDP. Now this understates the overall ratio of takeover activity to GDP for two chief reasons. First, the takeover activity is measured at book value rather than market value; and secondly, the takeover activity for our population in Table 3 includes only listed targets. Nevertheless, the figure suggests how small takeover activity still is in China by international standards when compared to Megginson's (2005) estimate that in the takeover peak year of 2000, takeover deals took place globally, which equate to 10% of world GDP.

Section 2 The Resulting Economic Characteristics of the Domestic Chinese Takeover Market

The market for corporate control

One key function of takeover in the theory of decentralised capitalist economies with active stock markets is to discipline managers who, because of shirking or perks, fail to maximize profits. The principal-agent problem has been well-rehearsed for both socialist economies (Kornai (1986) on the

soft budget constraint for managers in state-owned business) and capitalist ones with dispersed, absentee shareholders. Early in the world's first capitalist industrialisation, Adam Smith (1776) identified the agency problem with the joint stock company which China has chosen to copy in its industrialisation:

"The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery [partnership] frequently watch over their own…Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."

And these problems are known to be more acute, the wider the dispersal of share ownership – another feature of the Chinese transition: the dispersal may exacerbate information asymmetry and increase the free-rider problem in securing the interests of owners. An active takeover market has been seen as a device for mitigating these problems, because it can create incentives to reduce the agency costs. A disciplinary takeover can bring the acquirer substantial benefit:

"Share price, or that part reflecting managerial efficiency, also measures the potential capital gain inherent in the corporate stock. The lower the stock price, relative to what it could be with more efficient management, the more attractive the takeover becomes to those who believe that they can manage the company more effectively. And the potential return from the successful takeover and revitalization of a poorly run company can be enormous" Manne (1965: 113).

Table 5 examines the financial performance of Chinese takeover targets for evidence that this disciplinary role has been significant in the recent experience of takeover on the Chinese stock exchange. It reports an analysis of the pre-takeover performance of the population of listed Chinese companies which became takeover targets in the years 2000-2005. The population corresponds almost exactly with that presented in Table 3 Panel B above: just 3 of the 83 companies in Table 3 Panel B

had to be excluded because adequate data were not available. Two measures of performance are used, accounting profitability (AP), and cash flow return(CFR), defined respectively as:

AP = Pre-tax total profit/average net assets

CFR = Operating cash flow/average net assets.

Net assets are defined as total assets minus current liabilities (Meeks, 1977: 79).

Pre-tax profit is defined as total profit after depreciation, but before tax (Meeks, 1977: 78).

Operating cash flow is defined as sales minus cost of goods sold, minus selling and administrative expenses, plus depreciation and goodwill expenses (Healy et al., 1992: 139).

We use both profitability and cash flow measures to complement each other as both measures are imperfect (see Meeks (1977) and Healy et al. (1992)). While the pre-tax profitability measure is affected by accrual accounting rules and estimates, operating cash flow measure has the problem of neglecting the expenses related to the capital expenditure used to sustain such operating cash flow returns. Using two measures, we hope to benefit from different perspectives on the operating performance of event firms: inferences supported by both measures will be more robust.

For the Table, the performance measure is then expressed as a difference between the measure for a company in the takeover population and the respective matching company: a comparable listed company matched by industry (Datastream definition) and size (net assets). Thus a positive number in the Table indicates that the takeover target out-performed its match in the respective year, and vice versa. Thus, three years ahead of takeover, median accounting profitability for takeover targets adjusted for the matching firm suggests that the prospective target was typically performing somewhat better than its match; but by the year immediately before the bid, the position had reversed. For the alternative, cash flow return, the matched return was negative in two of the three years as well as in the pooled results for the three years. The median is preferred because of the common problem of outliers with such ratios (Meeks, 1977). In none of the cases was the performance difference

statistically significantly different from 0 at the 10% level with a two-tailed test. So taken together, the lack of unanimity and the lack of statistical significance do not give support to the proposition that the typical target was significantly under-performing ahead of takeover, as the disciplinary takeover hypothesis would suggest.

In this respect, the evidence, and the performance of the market, are consistent with Western studies of the disciplinary takeover hypothesis (e.g. Singh (1975), Franks and Meyer (1996), Dickerson et al (2002)). At first sight, in neither the Western nor the Chinese cases do takeover targets seem on average to perform significantly worse than their peers, as would have been expected if a primary role of the takeover process were to displace under-performing management.

Among the explanations in the Western literature are free-rider problems in the takeover market (Grossman and Hart, 1980), and the suggestion that, if the takeover deterrent is perfectly effective, then there will be no disciplinary takeovers, because potentially under-performing managers will be deterred from shirking or perks – just as a nuclear deterrent resulted in no nuclear wars (Hannah and Kay (1977)).

In the Chinese case, there have been additional idiosyncratic barriers to such a market for corporate control. First, due to the ownership structure of the LCs, most acquisitions are friendly since approvals from numerous government bureaux are required. Second, in China even a poorly performing company may have an unusually high share price by Western standards. While price/earnings ratios (p/e's) for most developed markets have historically fallen between 10 and 20, for most of the 1990s p/e's in China were above 40 (Green, 2003:145). Therefore, takeover by agreement is much cheaper because non-tradable shares can be transferred at prices linked to (the typically lower) book value, and can be bought in one lot. Third, when acquisition is done by open market purchases, the 1993 Stock Trading Provisional Regulations require a Legal Person to make a public announcement when it passes the first 5% threshold in the share capital of a LC and each 2% afterwards. In the 2002 Takeover Code the regulatory threshold disclosure requirement is changed to each 5%. Such regulations increased the barriers to acquisitions on stock exchanges: bidders cannot

build up positions by stealth. Thus in our sample there are no such cases in which 30% or more shares were acquired by open market purchases. And we have found no examples of hostile takeover of listed companies in our analysis period of 1997-2005[4].

A State managed market for corporate control

Although hostile or disciplinary takeover through conventional Western market mechanisms has not been prominent in China, a disciplinary mechanism which utilizes takeover has been deployed. However, the prime mover has been not a private sector predator, but instead the State. Such a mechanism has not usually been found in Western economies, with exceptions such as the recent banking crisis, where government responses in the US and UK to distressed banks have resembled the process in China.

When confronted with ailing or distressed companies, Chinese stock exchanges stipulated from 1998 that if an LC was loss-making for two consecutive years, it would be in the Special Treatment category (ST) which means it was subject to a 5% daily price limit. In 1999 stock exchanges further stipulated that if a ST LC incurred losses for three consecutive years, it would be transferred to the Particular Transfer category (PT) whose personal shares were traded only on Fridays and were also subject to a 5% daily price limit. And these PT LCs would be de-listed by CSRC if their problems were not solved. To prevent such kinds of situation from happening, the local government owners of the PT LCs were given notice to restructure them. And these owners had the incentive to do so because the listing places of these PT LCs were of great value[5]. Therefore, the state-owned shares of some LCs were transferred to other parties during the restructuring process. In 2001, CSRC reformed the regime and announced that a LC would be de-listed if it had three consecutive years of losses

[4] There was a famous case of hostile takeover by open market purchases in 1993. Between September and October 1993, Shenzhen Business Group bought a succession of tranches of shares in Shanghai Yanzhong Industry Co Limited, securing a holding of 18%, the largest shareholding in the company.

[5] Before March 2001 an IPO in China was subject to administrative approval, and for most companies it was hard to get one of the quota of listing places which would allow them to raise capital in the stock market. From March 2001, this control was gradually lifted and in February 1, 2004, a sponsor system was introduced (CSRC, 2004).

unless it had made feasible plans to return to profitability. And this stimulated further takeover activities of ST LCs and other loss-making LCs. Moreover, an acquirer was freed from making a general offer if it intended to rescue its target LC and this reduced the cost of such kinds of takeover.

For example, Shanghai Forever Co., Limited was put in the "ST" category on April 29, 1999 for making huge losses for two consecutive years, and was suspended from listing on the Shanghai Stock Exchange temporarily from 14/5/2001 to 28/6/2002 for making losses in three consecutive years. Shanghai Zhonglu Group Company Limited started to save this LC from bankruptcy and de-listing through asset restructuring from July 2001. In Dec 2002, Shanghai Zhonglu Group Company Limited, which is a non-state controlled company, acquired 143,640,000 state shares held by Shanghai Qingong Holding Group Company. These represented 54.07% of the shares of Shanghai Forever Co., Limited (CH: 600818); but the acquirer was exempt from making a general offer. In 2004 Shanghai Forever Co., Limited made profits and was removed from the "ST" category by Shanghai Stock Exchange and returned to normal trading on March 31, 2005.

Related examples include the 2004 purchase of a 39% interest in Daye Special Steel Co Limited by a foreign enterprise, CITIC Pacific Limited, after the target company's main shareholder had become insolvent; the restructuring of the electricity power industry by China Power Corporation's 2003 purchases of large shareholdings in Chongqing Jiulong Electric Power Co and Shanxi Zhangze Electric Power Co Limited; and the privatisation of Jiangsu Wuxi Commercial Mansion Group Co in 2004 by the Jaingsu Wuxi State-owned Asset Management Committee.

As Table 6 shows, non-state-controlled acquirers accounted for only a minority of the takeover activity reported above in Table 3: for 21 of the 174 acquisitions which gave the buyer at least 30% of shares, and for just 15 of the 83 deals which gave the buyer majority ownership.

As we discussed earlier, this dominance of the State in takeover transactions is reflected in Table 1, which shows the structure of shareholding in Chinese listed companies. Tradeable shares have accounted for a minority of total shareholdings. Most shares were either "state shares" or "legal

person shares”. Neither category was tradeable; the former were held by central or local government, or exclusively state-owned enterprises, the latter by banks and other financial institutions, and by state-controlled enterprises with at least one non-state shareholder.

These legal arrangements for shares combined with two other institutional features to strengthen further the hand of the State in takeover transactions. First, valuation rules made the untraded shares particularly attractive as means of securing voting rights: while traded shares enjoyed huge multiples of earnings (see above), state shares and legal person shares changed hands at prices related to book values. Table 7 summarises the ratio of market values of companies to book values in this period. Only rarely does the typical ratio fall below 2. So a buyer could more cheaply gain a controlling interest by dealing with the state owner than by open market purchases.

Second, the influence of the State was magnified by pyramid structures of the sort analysed in the international study of La Porta et al (1999)). By the end of 2001, despite owning only 46% of shares, the state was in ultimate and absolute control of 81.6% of 1136 LCs (with the average controlling stake of the largest shareholder being 47.9%) via two control patterns: government direct control of 9% (with the average controlling stake of the largest shareholder being 38.1%) and government indirect control of 72.4% via stock pyramids (with the average controlling stake of the largest shareholder being 49.1%) (Liu and Sun, 2005: 48)[6] .

Conflicts among stakeholders – controlling and minority shareholders

Such high concentrations of shareholding present problems familiar from the Western literature (e.g. La Porta et al. (1999): are the interests of the minority shareholders protected, or is their wealth

[6] Here the pyramid definition is slightly different from that of La Porta et al. (1999:477) who define a firm’s ownership structure as a pyramid if it has an ultimate owner who owns at least 20 percent of the voting rights, and there is at least one publicly traded company between it and the ultimate owner in the chain of 20 percent voting rights. In the Chinese case, the intermediate companies between the firm and its ultimate owner in the chain of 20 percent voting rights can also be unlisted domestic holding companies and include: SOEs (58.9% of all intermediate companies); state-controlled unlisted companies (10%); state-controlled LCs (2.6%); and state-owned academic institutions (1.1%)(Liu and Sun, 2005:52).

expropriated by the controlling shareholders? This is not just a matter of equity or fairness: it can have a feedback effect on the efficiency of the stock market: potential minority shareholders may be deterred from investing in shares (Shleifer and Vishny, 1997). There do exist regulations to protect minority shareholders in China; but in a number of cases priority may have been given to achieving other policy objectives in the restructuring of companies. Here we enumerate three such examples.

Transfer of state shares and legal person shares

The transfers of state shares and legal person shares have to be approved by relevant government agencies. And the 2002 Takeover Code stipulates that the general offer price of these non-tradable shares should be determined with reference to the most recent audited book value per share of the target company. These regulations intend to regulate the industries where state-owned capital should keep control, and protect the value of state-owned assets during the takeover period. However, they mean that shares do not trade at their market value, and this can distort the takeover market: if market value exceeds book value, the existing owners of tradeable shares would lose out from this policy as new buyers would effectively obtain their shares at a discount. Table 7's estimates of the ratio of book value to market value for the Chinese stock market show that, on average, market values have consistently and significantly exceeded book values: the median market to book ratio ranges from 1.44 to 5.07.

The 2006 Takeover Code does not stipulate separate principles for the offer price of these non-tradable shares any more because all the non-tradable shares will have been converted to tradable ones in 2007. It only requires that the offer price be not less than the highest price paid for the same class of shares during the past six-month period. This actually will raise the offer price of what were originally non-tradable shares which have been converted into tradable ones because they can sell as listed shares now. A recent case illustrates this point. CITIC Pacific Limited made a general offer to all other shareholders of Daye Special Steel Co., Limited (CH:000708) at 2.62 yuan per share for all shares from 1/11/2006 to 31/11/2006; under previous arrangements, the price for non-tradeable shares would have been constrained below that: the book value was 2.15 yuan (Daye, 2006).

This is because Daye Special Steel Co., Limited had implemented the scheme to convert non-tradeable shares into tradeable ones before the general offer was made.

Exemption from making a general offer

The 2002 Takeover Code stipulates that when an acquirer holds 30% of the outstanding shares of the target and wants further to increase its holding, this acquirer should issue a general offer to acquire all the shares held by other shareholders of the target company. The new Chinese Takeover Code (2006) also permits a partial offer to be made to acquire part of the shares held by other shareholders and this change is intended to reduce the cost of takeovers. However, in both the 2002 Takeover Code and the 2006 Takeover Code, there are circumstances in which the offer obligations can be waived to help lower the cost of takeovers for the acquirer. Among them, two are specified for the transfer of state-owned shares among state sectors. First, the transfer will not result in a change in the real controller of the LC. Second, the transfer resulted from government administrative approval. These two rules boost the takeover activities of listed companies which have large state shareholders and, therefore, facilitate the restructuring of state-owned assets and SOEs. In fact, in our sample there were no general offers by state-controlled domestic entities: all the general offers in acquisitions from 2003 to 2005 were made by non-state controlled enterprises (see Tables 3 and 6).

In addition, there are also two circumstances in which the offer obligations can be waived to reduce the cost of the transfer of state-owned shares to some private entities or foreign invested enterprises: first, if the transfer intends to rescue a LC under both the Takeover Code (somewhat similar to the UK's regulation, see the Panel on Takeovers and Mergers (2006)); and second if the shares are transferred by a court decision under the Takeover Code (2002). Under these circumstances, in cases where the acquirers are non-state controlled, the takeovers are exempted from a general offer obligation and this will encourage the private sector to take part in the takeovers. An example is the rescue case discussed above (Shanghai Forever Co., Limited). In our sample there are 10 cases where non-state controlled enterprises implemented acquisitions and were granted exemption from making a general offer from 1999 to 2005 (see Table 6).

Acquisition of the listed shares and the protection of minority shareholders

The regulations on the acquisition of tradeable shares on the open market are relatively similar to those in developed economies. The regulations have specified the regulatory threshold disclosure requirements for takeover to be carried out by open market purchases which we have discussed above. In particular, the 2006 Takeover Code stipulates that an investor who acquires 5% of a LC must make a public announcement about the change in interests, and that an investor who acquires 20% or more must make a detailed disclosure of its acquisition. And both the old and new Takeover Code also specify the offer price limits. The Takeover Code (2002) stipulates that the general offer price for tradable shares should be no less than the higher of the highest price paid in the preceding six-month period or 90% of the arithmetic average daily weighted trading prices of such listed shares in the past 30 trading days, whereas the Takeover Code (2006) only requires that the offer price not be less than the highest price paid during the past six-month period.

These regulations are intended to protect the interests of the target company and especially those of the tradeable shareholders who are normally minority shareholders of the target before the non-tradeable shares reform. However, due to the distinctive institutional features of the Chinese stock market, most takeovers have been implemented by agreement between or among large shareholders with government administrative orders or approvals. Therefore, the acquisition of tradeable shares is not critical: control can be secured without the approval of a majority of the holders of tradeable shares. Even if many takeover bidders have made general offers, normally few tradeable shares have been tendered for sale because the offer prices are not attractive – they did not need to be in order to secure control. In developed economies, historically the offer prices are, on average, 20 or 30% on top of the market price (Jensen, 1986; Jensen, 1988:22; Andrade, Mitchell and Stafford, 2001), whereas in China the price in practice generally was about 90% of the arithmetic average daily weighted trading prices in the past 30 trading days[7]. Thus these regulations do not actually protect the minority shareholders of the target company effectively but reinforce the incentive to effect takeovers by the

[7] Calculated for our population of acquirers: most acquirers followed the rules of the Takeover Code (2002).

transfer of non-tradeable state shares and legal person shares, avoiding the cost of open market purchases resulting from regulatory threshold disclosure requirements.

Another feature of the treatment of minority shareholders also has similar effects. As with regulations in the UK (the Panel on Takeovers and Mergers, 2006), the Chinese Takeover Code (2002) requires a full mandatory bid when a bidder acquires 30% or more of the shares of the target. But in the UK, the offer is usually made contingent on acceptance by 90% or more of shares outstanding, and the offer lapses if less than the stated number of shares is tendered and this type of transaction has characterized the great majority of the UK takeovers of LCs (Franks and Harris, 1989). However, in China a general offer can be made by an offeror not to terminate the listing place of an offeree company. If a bidder acquired more than 75%; or, more than 85% when the total share capital of the target exceeded RMB 400 million, the target had to be de-listed. In addition, if a bidder acquired more than 90%, the target has had to change its enterprise form. And in practice most general offers which happened from 2003 to 2005 did not result in mergers but helped the offerors meet the general offer obligations (see Tables 3 and 6). Thus the buyer in China can acquire voting control first and then complete a full merger with the target through a freeze-out of the remaining target shareholders if it sees the need to merge and this is somewhat similar to the arrangement in the US under the Williams Act (Raaijmakers, 2002). The Chinese Takeover Code (2006) will further boost this practice in China because an investor will no longer be required to make a general offer when taking control of LCs. This may reduce the barriers to takeover, making for a deeper takeover market, but at the cost of less protection of minority shareholders.

Conflicts among stakeholders – target managers and shareholders

In the early years, the regulations were designed to prevent privatizations through takeovers. The 1993 Stock Trading Provisional Regulations stipulated that nobody could hold more than 0.5% of the shares of an LC and the result was to protect LCs from takeover threats. But in order to develop a takeover market, this regulation was abolished in the 1999 Chinese Securities Law. And since then the

regulations have been changed gradually in favor of acquirers and some basic rules on takeover defenses have been specified as well.

In China, in response to an offer announced, a target may seek alternative bids from other firms, but cannot take other actions - such as asset disposal, business activities adjustment or other actions that would have a material effect on the target's operating performance – in order to frustrate the bid. It should continue its normal business operations and implement resolutions passed by the shareholders' general meeting. This practice is similar to that in the UK but is quite different from that of the US where a target is permitted a wide range of evasive maneuvers including asset sales, re-capitalization, and restructuring (Bruner, 2004:730-733). Therefore, these regulations relatively favor bidders in takeover activities and facilitate the transfers of state-owned shares in listed companies. And now targets are becoming more vulnerable to takeover activities as the non-tradeable shares reform is taking effect, and bids via the stock market can take a more prominent role.

But there are some regulations which the targets still can use to protect themselves against takeovers. For example, in Chinese Company Law, one regulation is that if a merger or division happens, all creditors can demand to be repaid; another is that directors cannot be changed until the expiration of their term if there is no proper reason. In contrast, in most foreign markets such barriers do not exist or do not have serious consequences (Tenev et al., 2002). Some regulations in the PRC Anti-Monopoly Law, which was passed in 2007 and came into effect on August 1 2008 (CPG, 2007), can be also used to help protect some domestic companies from predators, especially international ones. For example, if international investors bid for some companies which are involved in national security, then the transactions must be scrutinized by the government

Section 3 The Chinese Takeover Market from the Perspective of a Foreign Bidder

Barriers to the integration of the Chinese and world takeover markets

Section 1 outlined the gradual dismantling of barriers to takeover bids on the model of the US and UK markets. Foreign bidders, however, have faced additional barriers, which, until recently, have made it almost impossible for a foreign bidder to gain control of a Chinese LC through share purchases on the stock exchange. Steps have more recently been taken to lower these barriers.

2002 – Foreign access to domestic shares

Prior to 2002, Chinese company shares fell into two classes. A shares were denominated in Chinese currency and limited to Chinese mainland nationals, whilst B shares were denominated in foreign currency and available only to investors who were not Chinese mainland nationals. CSRC (2002b) relaxed these rules, permitting the transfer of non-tradable shares to foreign investors of some standing by open bidding and giving approval for a "Qualified Foreign Institutional Investor" (QFII) to invest in the tradeable A-share market, but applying a cap of 10% to such holdings – in other words, falling short of takeover.

2005- Lifting the cap on foreign strategic holdings

MOFCOM (2005) lifts the cap on foreigners' holdings of the A shares of a company which has implemented the reform of its non-tradeable shares. Instead there is a lower limit, of a 10% holding for strategic investors. But there is no cap on strategic investments except that there are limits in the Catalogue for the Guidance of Foreign Investment Industries (2002, 2004, 2007) as well as in industry-specific regulations such as Provisions for Foreign Investors to Merge Domestic Enterprises (MOFCOM, 2006). These remaining restrictions are those concerning industries such as defence, which remain in state ownership.

2008 – Completion of shift to tradeable shares and subsequent lock-up period

Technically, strategic international investors are able to take over a Chinese LC now. According to the Measures for the Administration of Strategic Investment in Publicly Listed Companies by Foreign Investors, foreign investors can definitely acquire the shares of a LC by agreement or through the

target company's targeted shares issue. But it is not clear whether foreign investors can acquire a LC only by open market purchases. We noted above the policy changes in recent years to convert state and other non-tradeable shares into tradeable ones, and the rising percentage of shares which are tradeable. But we noted the lock-up provisions which will continue to restrict takeover activity. In addition, even after lockup periods, these non-tradable shares, which are tradable after reform, have to be transferred through the block trading systems of stock exchanges if they account for more than 1% of the total issued shares of an LC (CSRC, 2008). This means that these trades are at every step disclosed to the market; and this may well make it more difficult for international investors to acquire a LC piecemeal, without publicity in the open market, and without provoking counter-bids.

The extent of foreign acquisition activity in China

In practice, there has been very little takeover activity of listed Chinese companies by foreign firms. The dominant entry mode chosen by foreign investors was to establish international joint ventures before 1997, and wholly foreign-owned enterprises thereafter (Tse et al., 1997; Peng, 2006 ; Puck et al., 2009). Our review of the records of all listed companies up to 2009 shows one foreign company gaining 44.43% of the ownership of a listed company (CH: 600182) by way of judicial transfer in 2003. Citic/Daye, the case discussed above, secured 39% ownership change in 2005-6 (but Citic is actually a Chinese state-controlled foreign company). The only case where 50% ownership of a listed company has been achieved by a foreign buyer is SEB in 2007, a case analysed below. To help identify the circumstances where a foreign bid for a Chinese listed company might succeed in the current political and market regimes, we compare that successful case with a foreign bid which failed.

Failure and success in foreign bids for Chinese listed companies

Failure

On October 25, 2005, Carlyle Group offered to acquire 85% ownership of Xugong Machinery Company which is the largest shareholder of Xuzhou Construction Machinery Science & Technology Co., Ltd. (CH: 000425), holding 43.06% of this LC's outstanding shares (Li, 2007). The negotiations

were protracted and the institutional background was changing at the same time, as previous sections of this paper have shown. For example, the original offer was for state-owned shares, valued at 2.5 yuan per share in 2005 (net asset value). But then the reforms of 2006 meant that these shares were transformed into tradeable shares; and by 2007, their market price had reached 14.45 yuan on March 14, 2007, the day before Carlyle increased its offer to roughly the market price[8].

Political obstacles also appeared. Sany Heavy Industry Co,. Ltd (CH: 600031), another Chinese construction equipment manufacturer, argued against the takeover (Ding, 2009). The Chinese Ministry of Commerce (MOFCOM) delayed approval of the acquisition. Although in 2006 and 2007, Carlyle Group lowered twice the percentage of ownership it intended to acquire, it did not obtain the Chinese regulatory backing. It was argued that Carlyle's takeover would threaten national security and fair competition (Ding, 2009). In July 2008, Carlyle Group abandoned the deal.

Success

The contrasting success story is of a French company which acquired 52.74% ownership of a Chinese listed company in 2007 by way of both agreement and partial tender offer. By August 31, 2007, SEB Internationale S.A.S., a French Manufacturer of household appliances, had already acquired 30% ownership of Zhejiang Supor Cookware Co., Ltd (CH: 002032), a Chinese non-state controlled

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[8] It is not straightforward to identify the price offered per share. According to Li (2007), on March 15th, 2007, the revised offer of Carlyle Group was 1800 million RMB YUAN for 45% ownership of Xugong Machinery Company. But Xugong Machinery Company held about 3700 million RMB YUAN market capitalization of Xuzhou Construction Machinery Science & Technology Co., Ltd. (CH: 000425) by April 18, 2007, indicating that Carlyle could obtain 1665 million market capitalization of Xuzhou Construction Machinery Science & Technology Co., Ltd. after acquisition. If the whole price offered by Carlyle Group is for the shares of Xuzhou Construction Machinery Science & Technology Co., Ltd., the premium is about 8.1%. However, Xugong Machinery Company also invested in 9 other state-owned enterprises which had very good profits. So the actual premium paid for the shares of Xuzhou Construction Machinery Science & Technology Co., Ltd. should be much lower than 8.1% (We cannot obtain the exact number of premium as we do not have the data for profitability of Xugong Machinery Company which is not a LC).

cookware manufacturer and wholesaler. It achieved this partly by way of agreement acquiring a stake of 11.48% and partly by a targeted IPO acquiring a 18.52% stake, or 40m. new ordinary shares. On Nov 21, 2007, SEB Internationale SAS made a general offer to all the other shareholders of Zhejiang Supor Cookware Co., Ltd with an offer price of 47 Chinese yuan per share to acquire a further 22.74% stake, or 49.123m. ordinary shares. And by Dec 20, 2007, it completed its tender offer and raised its interest in the target to 52.74% (SEB, 2007).

Table 8 isolates the characteristics which distinguish the failed and the successful bids. First, Carlyle's bid predates SEB's by two years, during which, as we have described, the stance of public policy towards takeover generally and foreign takeover in particular, has become more supportive. Second, Carlyle bid for a state-owned target, SEB for one in the private sector. Third, Carlyle's target was in a sector deemed to be strategic, so the state was reluctant to lose control. Fourth, in the Carlyle case, competition issues were raised by one of the target's rivals in the industry; and this caused delays. And finally, SEB offered the target's shareholders a premium of 230% over the arithmetic average daily weighted trading prices in the previous 30 trading days (47 yuan versus 14.23 yuan) (Guosen, 2007); whereas Carlyle's offer included scarcely any premium. In the West, premia in the range 20% to 50% are the norm; and in cross border acquisitions, the premium tends to be higher still (Weston et al., 2004)[9].

The two cases illustrate the special character of the Chinese situation for foreign bidders. Two interest groups need to be satisfied: the government and the existing shareholders; whereas in the majority of cases in the US or UK, only the latter have to be persuaded. Government approval is necessary, and how difficult this will be to obtain depends on the industry in which targets operate and the standing of the target in that industry. Shareholder support is now necessary, after the reform of share structures; and as we know from the West, that support has to be bought: while there is disagreement about the gains from takeover to most stakeholders, there is unanimity that the target shareholders typically gain from the process (Jensen and Ruback, 1983; Andrade et al., 2001).

[9] This case reveals also a benefit for acquirers in China which is not usually available in the West: SEB could maintain a listing for its target under the 2006 Takeover Code – allowing the foreign investor to raise money in the Chinese stock market and also project its image in the Chinese market.

Conclusion

The paper outlines the major legal and institutional changes underpinning the Chinese transition to a takeover market resembling that of the "Anglo Saxon" economies of the West, changes ranging from the establishment of a stock exchange to the refinement of a Takeover Code. From a zero base in 1990, the ratio of stock market capitalisation to GDP now exceeds that of Germany, and is comparable with that of Japan, but still falls well below the two leading takeover markets, the US and the UK. The takeover of companies listed on the stock exchange has grown substantially, but in relation to GDP is still far below that of the major western takeover markets.

Section 2 explores the characteristics of this emerging takeover market. First, it follows literature for the US and UK testing for a disciplinary role for Chinese takeover: as in the West, no strong evidence is found that a dominant role for takeover has been to discipline under-performing management. Theories from the western literature and idiosyncratic features of the Chinese market are advanced to explain this result.

In the Chinese case, however, disciplinary or rescue takeovers have been effected, but – similar to recent bank rescues in the West – led by the state rather than the market. In our period and (listed) population the majority of takeover activity was state-led. The state's power was reinforced by the structure of shareholding, the rules on valuation, and pyramid structures of control.

The old valuation rules are being dismantled, so different shareholders will no longer have unequal rights. But, for example, provisions still exist to exempt bidders from making a general offer: this facilitates state-led takeover, but at the expense of private shareholders.

State-led takeover has been used to rescue distressed companies, replace insolvent shareholders, restructure a major industry (e.g. electrical power), and privatise firms.

As in any takeover market there are potential conflicts of interest between different shareholder

groups. In the Chinese case, the interests of minority shareholders have tended to be secondary to those of the (often state) majority, and this has led to relatively low valuations of shares and provided potential opportunities to “freeze out”. The traditional conflict between target managers and shareholders has had a resolution closer to the UK than to the US model, with less freedom for target managers to frustrate bids which they do not welcome.

The dismantling of barriers to domestic takeover has been accompanied by a policy regime increasingly favourable to takeover of domestic companies by foreign firms; but so far this has resulted in little inward takeover investment. Analysis of failed and successful bids by foreigners suggests that parts of the Chinese listed company population are now accessible to foreign bidders, provided that the deal is consistent with national industrial policy objectives and that sufficient premium is paid.

Table 1

Shareholding in Chinese companies

Year	State share	Legal person share	Tradable share	Market capitalization (100 million RMB)*		GDP(100 million RMB)*	Market capitalization/GDP	
				Tradable shares	All shares		Tradable shares	All shares
1992	42	26	31	NA.	1048	26923	NA.	4%
1993	49	21	30	862	3531	35334	2%	10%
1994	43	23	34	969	3691	48198	2%	8%
1995	39	25	37	938	3474	60794	2%	6%
1996	35	27	37	2867	9842	71177	4%	14%
1997	32	31	38	5204	17529	78973	7%	22%
1998	34	28	37	5746	19506	84402	7%	23%
1999	36	27	37	8214	26471	89677	9%	30%
2000	39	24	37	16088	48091	99215	16%	48%
2001	46	19	35	14463	43522	109655	13%	40%
2002	47	17	36	12485	38329	120333	10%	32%
2003	47	17	35	13179	42458	135823	10%	31%
2004	47	16	36	11689	37056	159878	7%	23%
2005	45	13	38	10631	32430	183217	6%	18%
2006	52	13	35	25004	89404	211924	12%	42%
2007	48	10	43	93064	327141	249530	37%	131%
2008	44	9	47	45214	121366	300670	15%	40%

Souces: CSRC, Shanghai and Shenzhen Stock Exchange, National Bureau of Statistics of China, Shanghai Wind Information Co.,Limited, and own calculation.

NA: No data available.

*current prices
Comprises the Chinese mainland stock market, excluding the Hong Kong and Taiwan markets

Table 2

Market capitalisation as a percentage of GDP

	2000	2005	2006	2007	2005-2007 average
UK	178	136	158	139	144
US	154	137	148	145	143
China	48	35	91	194	107
Japan	68	104	108	102	105
India	32	68	89	155	104
Germany	67	44	56	63	54

Source: ddp-ext.worldbank//ddpreports; own calculations

Table 3

Panel A Acquisitions with substantive control in the Chinese stock market: 1997-2005

Year	Tender offer	Agreement	Free Transfer	Judicial Transfer	Total
1997		1			1
1998		2			2
1999		2			2
2000		2	2		4
2001		7	15		22
2002		11	15	1	27
2003	3	14	11	5	33
2004	6	17	25	3	51
2005	2	10	17	3	32
Total	11	66	85	12	174
	6.32%	37.93%	48.85%	6.90%	100%

Note: here acquisitions refer to the cases in which LCs are targets and remain listed after takeover and the acquirers obtained at least 30% of their ownership.

Panel B Takeovers with absolute control in the Chinese stock market: 1997-2005

Year	Tender offer	Agreement	Free Transfer	Judicial Transfer	Total
1997		1			1
1998		2			2
1999		0			0
2000		1	0		1
2001		0	5		5
2002		5	7	1	13
2003	3	8	5	1	17
2004	5	10	14	1	30
2005	2	5	7	0	14
Total	10	32	38	3	83
	12.05%	38.55%	45.78%	3.61%	100%

Note: here takeovers with absolute control refer to the cases in which LCs are targets and remain listed after takeover and the acquirers obtained at least 50% of their ownership.

Table 4

The pre-event year total assets of the LCs acquired in takeovers with absolute control in the Chinese stock market 2000:2005 (Units: RMB 10,000 Yuan).

Event Year	Tender offer	Agreement	Free Transfer	Judicial Transfer	All takeovers
2000		62653.56			62653.56
2001			1441459.2		1441459.2
2002		383046.22	1571335.41	79871.06	2034252.68
2003	626610.74	1421069.65	1011696.94	86667.46	3146044.79
2004	493503.34	2120772.98	2251578.49	51409.02	4917263.83
2005	336187.7	567614.32	1113493.99		2017296.01
Total	1456301.78	4555156.72	7389564.02	217947.54	13618970.07
Percentage of all takeovers in terms of size	10.69%	33.45%	54.26%	1.60%	100.00%
Percentage of all takeovers in terms of numbers	12.50%	36.25%	47.50%	3.75%	100.00%

Source: own calculation, using the financial accounts of individual targets

Table 5

The pre-takeover median matching firm adjusted profitability and cash flow returns of the targets

Year relative to takeover	Median Profitability	Median cash flow returns
-3	2.31%	0.66%
-2	0.37%	-0.08%
-1	-0.45%	-1.63%
Median for the three years pooled	0.81%	-1.24%

Note:

Here the performance for 80 targets is examined. For these targets, more than 50% ownership was acquired by bidders in the period between 2000 and 2005. The following definitions for operating performance measures are used: Profitability = Pretax total profit/average net assets; Cash flow returns = Operating cash flow/average net assets; Net assets are defined as total assets minus current liabilities (Meeks, 1977:p.79); Pretax profit is defined as total profit after depreciation, but before tax (Meeks, 1977:p.78); Operating cash flow is defined as sales minus cost of goods sold, minus selling and administrative expenses, plus depreciation and goodwill expenses (Healy et al., 1992:p.139). The performance measure in this table is then expressed as a difference between the measure for a company in the takeover population and the respective matching company: a comparable listed company matched by industry (Datastream definition) and size (net assets).

Table 6

Panel A Acquisitions effected by non-state controlled acquirers

Year	Tender offer	Agreement	Free Transfer	Judicial Transfer	Total
1999		1			1
2000		1			1
2001					
2002					
2003	3	3		1	7
2004	6	1			7
2005	2	1		2	5
Total	11	7	0	3	21

Note: here acquisitions refer to the cases in which LCs are targets and remain listed after takeover and the acquirers obtained at least 30% of their ownership.

Panel B Takeovers with absolute control effected by non-state controlled acquirers

Year	Tender offer	Agreement	Free Transfer	Judicial Transfer	Total
1999		0			0
2000		1			1
2001					
2002					
2003	3	2		0	5
2004	5	1			6
2005	2	1		0	3
Total	10	5	0	0	15

Panel C Mergers and acquisitions between LCs in China: 2003-2005

Year	Mergers	Tender offer	Agreement	Free Transfer	Judicial Transfer	Total
2003			2			2
2004	2		1			3
2005			2			2
Total	2	0	5	0	0	7

Note: there is only one case in our sample where one LC obtained the absolute control of another LC after takeover and the target remains listed. This case happened in April 2005 where Baoshan Iron & Steel Co., Limited (CH: 600019) acquired by agreement the state shares of Shanghai Baosight Software Co., Limited (CH: 600845) that was held by Shanghai Baosteel Group Company which is the mother company of both the LCs.

Table 7

Market to book ratios in the Chinese stock market

Market Value/Book Value	2000	2001	2002	2003	2004	2005
Mean	13	7.66	5.89	4.26	3.34	1.98
Median	5.07	4.83	3.86	2.76	2.28	1.44

Source: Datastream and own calculation

Table 8

Characteristics of failed and successful bids for Chinese listed targets

	Failure – Carlyle	Success – SEB
Timing in the transition	2005	2007
State-owned target	Yes	No
Strategic sector	Yes	No
Competition issues	Yes	No
Premium	c.0	230%

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