China SOE Reform 2015

Introduction

We see China's SOE reform agenda as one with two main objectives:

1) To transform Chinese economy from "Big government, small market" to "Big market, small government" and

2) To improve SOE's operational efficiency and profitability to sustain a long-term growth.

These 2 objectives are highly interdependent; the success of one reinforces the development of the other.

Objective 1 of "big market, small government" has been clearly defined in 18th Third Plenum. In the 15th-17th Third Plenum, ***market*** was described as playing a "basic" role in allocation of resources. However, in 18th Third Plenum, the wording had been changed from "basic" to "decisive", implying that ***market*** will play a more prominent role in China's economic development going forward.

Objective 2: The blueprint of objective 2 has also been laid out in "*The Decision by the Communist Party of China's Central Committee on Several Major Issues Concerning the Comprehensive Deepening of Reform*" ("*The Decision*").

According to "The Decision", there can be seven key initiatives that needs to be implemented to achieve this objectives. They include:

1) Shift from government-guided to market-based pricing;

2) Mixed ownership;

3) Simplify structure;

4) Improve corporate governance;

5) Better manage capital expenditure;

6) Increase dividend payout ratio and;

7) Opening up to private/foreign companies.

Part I/ Background

A juxtaposition of the performance of the Shenzhen Composite Index and the Shanghai Composite Index provides lends support to the Government's initiative to push through reform of China SOEs

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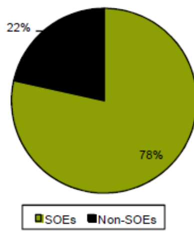
The Shenzhen Composite Index has outperformed the Shanghai Composite since 2009

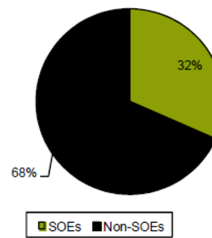
Source; Sanford Bernstein

The above chart shows the performance of SZCI (Shenzhen Composite Index) & SHCI (Shanghai Composite Index) during 2001-14. The SZCI has clearly outperformed SHZI since 2009.

As of 2014Q3, SOEs contributed 78% of total market capitalization at Shanghai Stock Exchange…



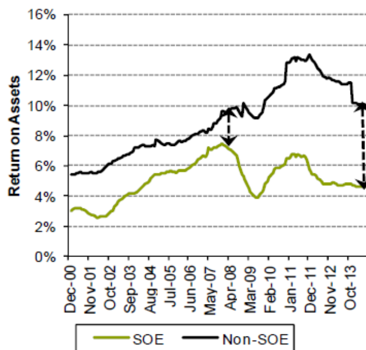
…while the majority of Shenzhen Stock Exchange's market cap is made up by non-SOE companies, at 68%



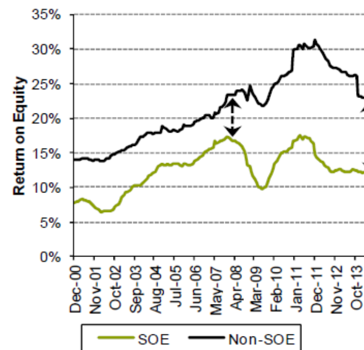
Source; Sanford Bernstein

The divergence in performance can be explained by the difference in composition of the indexes. For the SHCI, 78% of total market cap is contributed by SOEs, while for SZCI, only 32% of total market cap is contributed by SOEs.

SOEs Lag Non-SOEs in Return on Assets

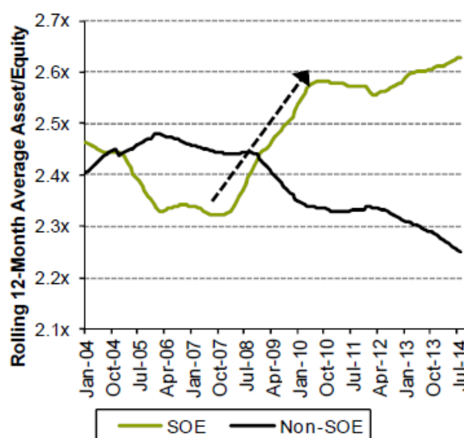


The Same Holds True for ROEs of the Two Groups



Source; Sanford Bernstein

It is clear from the charts that since 2008, ROE of SOEs has been declining, while that of Non-SOEs has been increasing. Not only that, the gap between them has also widened from ~5% to ~10%. That explains why SOE-dominated index underperformed a less SOE focused index.



Source; Sanford Bernstein

Above chart also shows that non-SOEs have been reducing leverage since 2009, while SOEs have been gearing up since 2008. Their leverage has increased from 2.4x in 2008 to 2.6x in 2014. Based on Du-Pont formula, this implies that the deterioration of operational efficiency (Asset Turnover) and profitability (Net Profit Margin) of SOEs are even more severe than that of ROE during the period. It seems obvious that the SOEs' low quality high growth business model is not a sustainable one.

This would be behind the Chinese government's call for a new round of SOE reform in 2014. From a macro perspective, at this stage, it seems Telecom operators and Oil & Gas industries are likely to the most pronounced reform.

Part II/ Impact on our Franchise pick - China Mobile (CM) – HK Listed Share

"The 7 Initiatives"	+ve/-ve	Progress	Content
Shift from government-guided to market-based pricing	+ve	Completed 2014	MIIT no longer reviews price changes made by the Telecom service providers. Result: More market forces determined pricing policy

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Mixed ownership	Very +ve	Expect deeper reform in 2015	Based on the similar restructure carried out at Sinopec, it seems likely that CM will let private investors invest into its Content, Media & App segment. Rationale: As CM is a Telco, it may not be the best one to operate the IT related business segment mentioned above. Inviting private sector participation should help improve the performance of this segment. In fact, CM is setting up a digital subsidiary to handle its Content, Media & App segment. There has also been some rumors that Alibaba will take a stake in this division or CM's instant messaging arm (Feixin).
Simplify structure	+ve	Expect more detail in 2015	Streamlining structure will reduce administration expenses and enhance operational efficiency. In addition, SASAC is likely to order another round of S&M expenses cut this year. The amount is expected to be ~CNY 19bn. Assuming 50% of the cut will be translated into subsidies of monthly fee, the remaining 50% of the cut is real cost saving, CM's 2015e EBITDA margin would increase by 1.4% to 39.5%.
Improve corporate governance	+ve	Expect more detail in 2015	Currently, CM's management are appointed by SASAC, and they are all government officials. In future, a Board will be set up. The Board will be responsible for hiring senior management who is more likely to come from outside and more entrepreneurial-minded with proven track record. The Board will also be responsible for evaluating the performance of the management and setting up a remuneration system. In other words, the Board will replace of role of SASAC. Although this arrangement will not take place overnight, SASAC has increased the portion of remuneration that is hinged on CM's financial result to make the management more market-oriented. SASAC has also changed the primary metric for measuring SOE's performance from "revenue growth" to "asset return". This can help better align interest of management with shareholders'.

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Better manage capital expenditure	+ve	Likely more details in 2Q15	A tower company will be set up by 3Q15. CM, CU & CT will all inject their towers into this company. In return, they will obtain 40%, 30.1% and 29.9% stake of the tower co. respectively. The setup of tower co. can help reduce CM, CU & CT's capex going forward (~8% of their capex). A schedule has already been laid out on the setup of tower co. Details will be released in 2Q15. CM is expected to realize a disposal gain equal to HK$5 per share. Also, the tower co is expected to get listed in 2016, CM should realize a disposal gain if materialize.
Increase dividend payout ratio	+ve	Likely starting from 2016	Chinese government has requested SOEs to increase dividend payout. While capex level will remain elevated in 2015 due to rollout of 4G, it is likely CM will start to do increase payout in 2016. Currently, CM's payout ratio is <50% (vs 70%-100% of regional peers).
Open up sector to private/foreign companies	Mildly -ve	Completed 2014	25 MVNO licenses were granted. However, as the wholesale price is set by the Telecom operators, it is difficult for the MVNOs to pose a threat to the Telecom operators. Also, MIIT only expects MVNOs to share only 3%/1% total subs/rev by the end of 2015.

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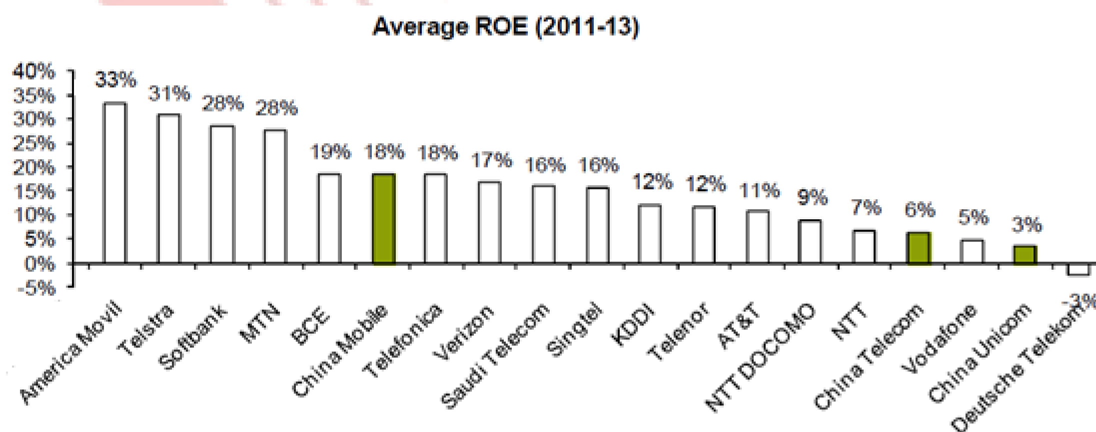

Source: Sanford Bernstein

As details are lacking, the overall impact, even if all the above mentioned measures are implemented, is hard to quantify precisely at this juncture. Looking at the above chart, from an operational efficiency perspective, there is still plenty of upside in ROE for CM. CM can

potentially increase its ROE by at least 55% to 28% (Due to its economies of scale, CM's ROE should be able to catch up with top-tier telcos like America Movil & Softbank, etc.).

Impact on CM Franchise value

"Simplify structure" (more responsive to market dynamics); and "Improve corporate governance" (more entrepreneurial-minded senior management) will result in better management quality in the long run. (+2 ppts to our fv score ranking)

"Mixed ownership", would mean a new partner (likely an IT giant), and can result in a more efficient and competitive development in CM's Content, Media & App segment. This will help CM provide a more diversified portfolio of products/services to its customers and may help increase their stickiness. (+4 ppts to fv score, 2 for Product Differentiation and 2 for Sticky Demand)

Impact to shareholder's value

"Control capex" is a hotspot and should result in capex saving and better FCF yield (+0.8% ppt). (+1 ppts to fv score)

"Increase dividend payout ratio" should result in better dividend yield (+0.8-1.2% ppt) (+1 ppts to fv score) as early as next year (2016).

Part III/ Impact to our franchise pick – Guangdong Investment (GDI) – HK Listed share

"The 7 Initiatives"	+ve/-ve	Progress	Content
Shift from government-guided to market-based pricing	+ve	No schedule yet	There have been talks about applying market-based pricing on water tariff. Currently, water tariff is set by government. And the formula behind is "cost + reasonable profit". As water is a necessity and increasingly a scarce resource, however, as it is directly related to social well-being. The setting of "reasonable profit" has been determined more from political rather than economical perspective. This results in underpricing of water in China. In fact, China's spending on water to GDP per capita ratio is only 0.7%, far below global average of 1-3%. Underpricing of water encourages overconsumption and wastage, and in the longer term, government is likely to apply market-based pricing on water tariff.

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			For GDI, assuming that spending on water to GDP per capita ratio raises from 0.7% to 2%, this can lift GDI's revenue by 28% (basing on 2014e revenue). There remains strong political implication, and any changes made would be gradual only.
Mixed ownership	+ve	Unlikely to happen	For a strategic water resource, unlikely. GDI to improve its operating efficiency by spinning off non-core segments, including office. mall and hotel, etc..) and focus on water segment.
Simplify structure	+ve	No schedule yet	Parent company Guangdong Holdings is likely to inject its water business into GDI. See next Initiative
Improve corporate governance	+ve	No declared timetable, continual periodic market speculation	Cosco/citic already saw asset injection, share prices surge…. GDI parent still has water assets. Likely to be injected into GDI ultimately. See footnote * for further detail.
Better manage capital expenditure	Mildly +ve	Limited room for improvement	Capex to sales ratio is already very low for GDI (~3%).
Increase dividend payout ratio	+ve	Possible if no asset injection or acquisition targets only.	With net cash and strong FCF (2015/15e FCF yield: 9.5%/11%), GDI is capable of increasing dividend payout. That said, the company is likely to continue to buy more renewable projects or acquire assets from parents, so the cash is unlikely to be paid out. And we view earning-accretive acquisition more +ve than increasing payout as this can create greater shareholder's value in long-term.
Open up to private/foreign companies	-ve	Very unlikely	Strategic resource

GDI's greatest reform related catalysts should come from adopting market-based pricing and asset injection from parent company.

***Asset Injection from parent company Guangdong Holdings (GDH)**

GDI's parent company GDH has several water assets which have the potential to be injected into GDI. As GDH is not a listed company, the operational efficiency of those assets can be enhanced via injecting them into GDI and help streamline GDH corporate structure.

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Assuming a 10% ROE for these assets and a project gearing ratio of 30%, this could add 4% to GDI's 2015e earning.

Figure 7: Parentco water assets and potential earnings impact

Company name	Stake	WWT/ Water supply Capacity ('000 ton/day)
Baoying	70%	90
Gaoyou Gangyou	60%	95
Yizheng Gangyi	60%	100
Wuzhou	51%	355
Zhaoqing	70%	90
Dongguan Changping	100%	280
Guangzhou Nansha	60%	400
Jianghe Gangwu	30%	520
Wuzhou Enviromental	87%	70
Others	NA	1,965
Total parentco (excl. GDI)		3,965
GDI		6,835
Parentco. total		10,800
Investment cost/ton		1,500
ROE assumption		10%
Equity assumption		30%
Total earnings contribution from new capacity		178
% of FY14E earnings		5.0%

Source: Deutsche Bank, Company website

Source: DB

Although the earning impact is not significant, market should still react positively as this shows that GDI is on track to transform itself into a pure water play.

Impact on GDI Franchise value

Asset injection from Parentco could help GDI transform into a pure water play, thus enhancing valuation. (+1 ppt to our fv score ranking)

Impact to shareholder's value

"Shift from government-guided to market-based pricing" should give GDI more pricing power in its China water supply segment. Assuming that spending on water to GDP per capita ratio raises from 0.7% to 2% in China, this can lift GDI's revenue by 28% (basing on 2014e revenue). (+2 ppts to fv score)

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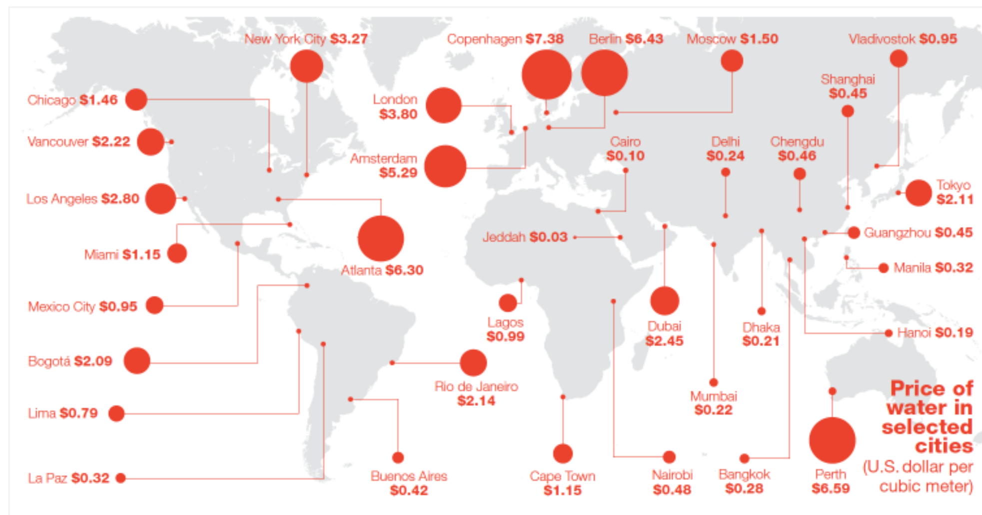
Complementary information:

1. Water tariff in China

Water is underpriced in China

Water is underpriced in China both in absolute and relative terms.

According to data from Global Water Intelligence, in 2014, the global average of water tariff is US$2.18 per cubic meter, compared to US$0.45 per cubic meter in Guangzhou and Shanghai. The graph below provided by Forbes India could help me better illustrate on this point. In fact, water tariff in China is only 1/5 to 1/10 of those in developed countries:



Sources: Forbes India

There are some places in EM where water tariff is well below that in China. However, if we take GDP per capita into consideration, water is still cheaper in China. The chart below illustrates this point. In fact, water tariff in China is showing a 30%-60% discount to those in EM:

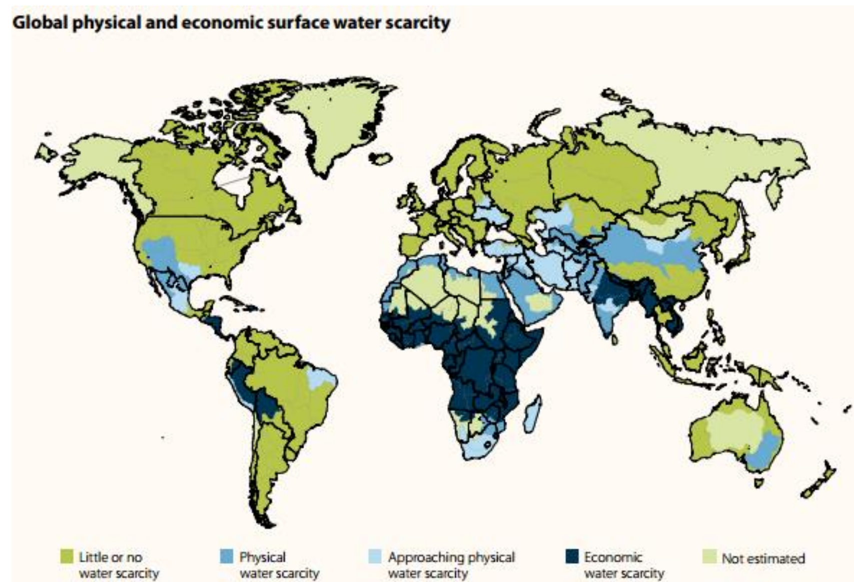
Cities	Spending on water to GDP per capita ratio
Guangzhou	0.7%
Shanghai	0.7%
Mumbai	1.5%
Manila	1.2%
Hanoi	1.0%
Moscow	1.0%
Mexico	1.0%
Brazil	1.9%

*Assuming that water consumption per capita is 100 cubic meter p.a.

Source: Global Water Intelligence and World Bank

Scarcity of water should be a driver of tariff hike

China's population is 1/5 of global total, but only possesses less than 10% of global water resources. From the graph below, we can see that northern part of China has been suffering from physical water scarcity.



Source: UN-Water

Take a deeper look into the water issue in China, you can see that there are actually 11 provinces which are below World Bank "Water Poverty Mark". Some of them are even with water supply less than the Middle East. That shows how severe the problem is in China.

Therefore, how to better utilize the limited water resources has become a major issue for Chinese government. And this should be a driver of tariff hike going forward (as this can reduce wastage).

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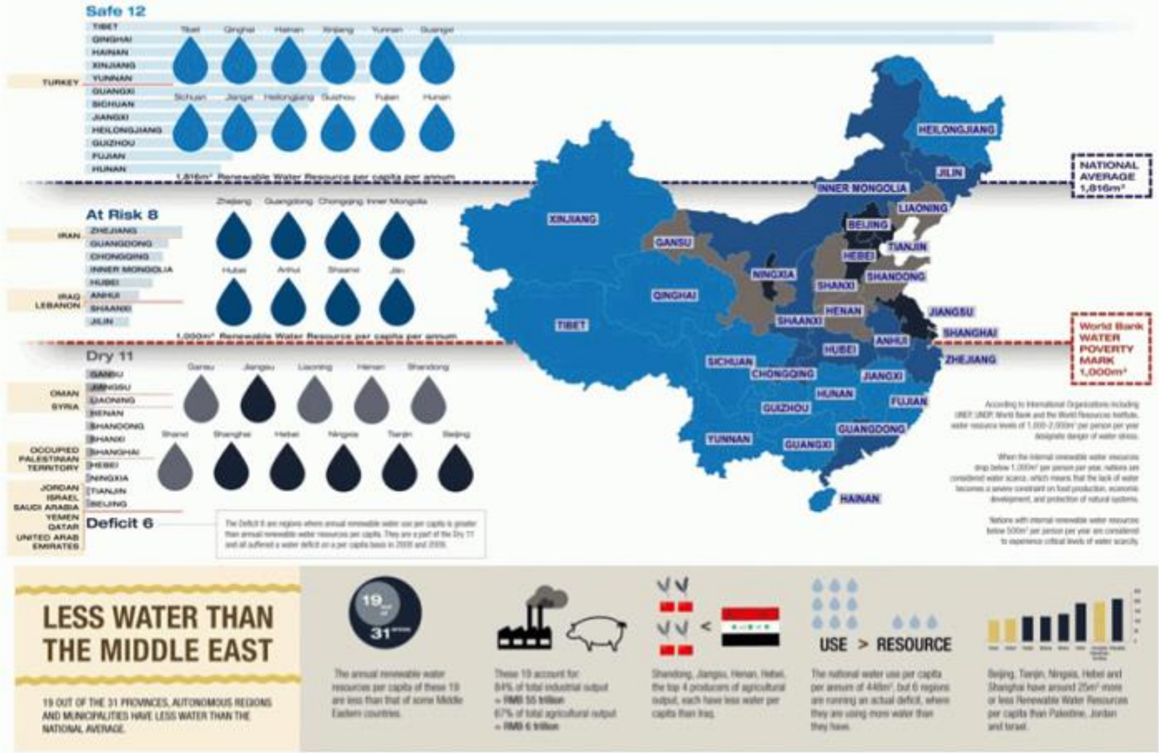
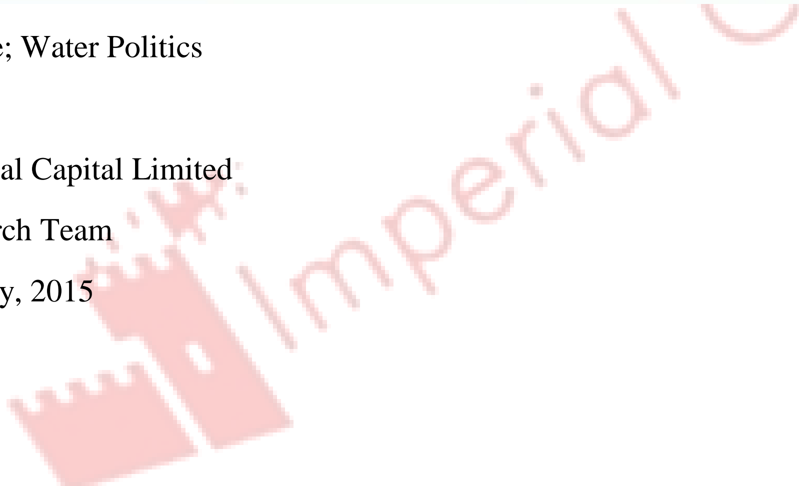


Source; Water Politics



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Research Team

January, 2015