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China Struggles with SOE Reform

The Case of Liaoning

Summary

One of the likely outcomes of China's rising debt will be a shortage of liquidity for more remote geographic regions, along with corporates with little access to the power centers in Beijing. One short-term solution is the debt-for-equity swap program, which is allowing local SOEs to place the debt in the banks in the form of equity, and permitting these firms to continue to borrow from the banks. This is one tool that is keeping local governments --- and their ailing state firms – alive.

However, although this program has come from Beijing, the leadership has been reluctant to allow local governments full control over the swap as it encourages continued waste of capital in inefficient, older industries. It may use political methods – the anti-corruption campaign – for fiscal ends.

Right now, the poster child for this struggle for capital is occurring in Liaoning Province over the debts of Dongbei Steel. ***The outcome of this dispute will signal Beijing's policies toward SOE debt restructuring.***

Liaoning Fights for Control

In September 2016, Dongbei Special Steel, a leading producer of special alloys for automobiles, defaulted on the repayment of seven bonds with a combined value of 3.1 billion renminbi. The State-owned Assets Supervision and Administration Commission (SASAC) of the Liaoning Provincial Government, which holds 46 per cent of the company's shares and was the largest shareholder, drafted a plan to resolve the company's debt problems.

In a surprising show of strength, the bondholders not only protested the plan — but asked investors nationwide to boycott bonds issued by any companies in Liaoning province. The bondholders and the banks both were protesting because the plan called for banks to swap 70 per cent of their loans to the steel company into equity, and for the lead underwriters of the bonds to lend the firm money to allow it to repay the remainder of the outstanding bonds. Essentially, the banks and the bondholders would be stuck with the bad debt, instead of the Liaoning government.

Liaoning Tries to Stay in Control of the Process

According to Caixin Magazine, "Banks were shut out of all meetings the government held to discuss how to resolve the problem, even though they are the largest creditors," according to an executive with one of the company's creditor banks. "The plan is all about protecting the government's own interest as much as possible, with no consideration at all given to the lawful interests of other bond holders," a bond investor said. "It is not feasible at all."

Who was responsible for the debt? Debt holders included state banks, private banks, and private investors through the bond market. ***Although it was not stated, the debt likely included Shadow Banking loans through the Trusts or the WMPs.*** Would the Liaoning government choose to: a) close Dongbei Steel; b) agree to the bondholder demands and find money to repay them; or c) use political connections to receive a bailout from Beijing?

The steelmaker entered bankruptcy proceedings last year and has administrators working on a plan for 7.2 billion yuan ($1 billion) of notes, according to an Oct. 18, 2016 filing.

The latter solution is quite likely. The banks may have had to accept the loss in this case because the Liaoning government is quite well connected. Liaoning's party secretary, Li Xi, knew President Xi Jinping in Shaanxi Province, where President Xi had spent seven years during the Cultural Revolution. However, recent events do not make this political outcome certain.

This is a brawl between competing financial and governmental groups, including private investors in public bonds and Shadow debt, local governments, and the banks. This is just one example among many that will play out across China.

Liaoning and China's "Zombie" Firms

Liaoning has among the largest group of companies with assets less than liabilities – defined in China as "zombies."

China's Zombie Companies

Location	Number	% Total
Central Government	345	6%
Chongqing	200	3%
Gansu	110	2%
Guangdong	3,385	55%
Hubei	125	2%
Inner Mongolia	90	1%
Liaoning	830	14%
Qinghai	31	1%
Shandong	321	5%
Tianjing	113	2%
Yunnan	135	2%
Zhejiang	450	7%
	6,135	

Source: IMF 2015

Majority of Bankruptcy Cases are State Owned

Liaoning has not been forthcoming about its fiscal situation nor has it been eager to perform any restructuring of its older, SOE firms. City and county officials in Liaoning made false claims about fiscal revenues and other data from 2011 to 2014. Fiscal revenues over the three years were exaggerated by around 20% overall. In some counties, the reported numbers were more than double the actual income, People's Daily said, citing official probes.

According to a December 2014 interview with a senior Liaoning court judge, Liaoning had 746 bankruptcy cases between 2008 and 2014, involving 314.8 million workers, or an average of 420,000 per company. More than three-quarters were state owned. That suggests Beijing is going to have to tackle the hardest part of SOE reform in Liaoning and other provinces: the state firms.

Xi Jinping Will Use Political Tools for Economic Ends

A sharp, political response by Beijing suggests that it will utilize the Party to force restructuring among local firms. This is an unorthodox – but very Chinese way – of instilling discipline in the financial system.

In September 2016, six months after Dongbei Steel defaulted on its first tranche of debt, Beijing made a formal attack. The Standing Committee of the National People's Congress (NPC) in Beijing voted to expel 45 of the 94 current NPC delegates from Liaoning and sack

523 of the 613 delegates to the Liaoning Provincial People's Congress. These Vice Chair Zheng Yuzhou. Xinhua described it as an "unprecedented" scandal involving vote buying and electoral fraud. However, the timing of the expulsions shortly after the Liaoning government attempted to force Dongbei Steel's banks and bondholders to accept sharp discounts for their holdings suggests impatience by Beijing at the pace and nature of local debt reorganization.

The National Impact Likely to be Severe

What does Liaoning mean for the rest of the country's indebted local firms?

Industry	# of Company	# of Zombie Company	% of Zombie Company
Banking	16	0	0.0%
Media	97	4	4.1%
Non-banking financial	43	2	4.7%
Computer	153	8	5.2%
Leisure Services	34	2	5.9%
Electronics	158	11	7.0%
Textiles & Garments	78	6	7.7%
Telecom	65	5	7.7%
Agriculture & Farming	85	7	8.2%
Food & Beverage	78	7	9.0%
Household Appliances	60	6	10.0%
Electrical Equipments	160	17	10.6%
Mechanical Equipments	270	29	10.7%
Chemical	259	28	10.8%
Construction Materials	72	8	11.1%
Healthcare	217	26	12.0%
Light Manufacturing	98	12	12.2%
National Defense	34	5	14.7%
Auto	124	19	15.3%
Non-Ferrous Metal	106	18	17.0%
Mining	57	10	17.5%
Transportation	91	16	17.6%
Public Utility	122	25	20.5%
Miscellaneous	41	9	22.0%
Commercial Trade	90	26	28.9%
Building Decoration	85	27	31.8%
Property	137	61	44.5%
Steel	35	18	51.4%
Total	**2,865**	**412**	**14.4%**

As the above chart shows, official statistics show a high percentage of zombie firms concentrated in a few key industries, most of them tied to property construction. Steel (51.43%), property (44.53%), building decoration (31.76%), commercial trade (28.89%) and miscellaneous (21.95%) are the top five sectors with the greatest proportion of zombie companies. In contrast, banking (0%), media (4.12%), non- banking financial (4.65%), computer (5.23%) and leisure services (5.88%) are the healthiest industries with the least proportion of zombie companies.

Breakdown of Zombie Firms		Zombie's as % of industrial sector
Loans to Non-financial Institutions and Government Depts (rmb T)	71,967	9,356
Assets (rmb T)	73.5	10
Revenue (rmb T)	97.8	13
Profits (rmb T)	5.7	1
No of Enterprises	352,365	45,807

The Importance of Liaoning

The outcome of the Liaoning situation will signal whether Beijing is going to place the debt squarely within the banks – or force local governments and SOEs to accept a discount for the equity that is swapped for debt. This could effect Rmb9 trillion in debt (using our estimates of total zombie firms) and additional loans from the Shadow Market.

Also interesting to watch will be how much Xi Jinping chooses to use ***non-economic methods*** to target debt restructuring. This would come through the anti-corruption campaign. Xi, through his State Council ally Wang Qishan. He is intent on bypassing the Communist Party Discipline and Inspection Committee (CCID) in favor of a new group, called the "Inspection Committee." The CCID applies only to Party members, and its members are appointed by the local Party Secretary. In contrast, the new committee **would apply to all government employees –** not just Party Members – and would be appointed from Beijing.

If Xi is forced to rely on the inspection committees to enforce discipline among local SOEs, that would suggest significant opposition to his reforms, slowing the pace of change. Although it is not clear exactly what reforms Xi has in mind, we assume that one intended outcome is to reduce the waste of capital on outdated industries such as steel, and to promote growth in the "New Economy." This will not go down very well in parts of the country with huge employment in older industries.

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