

# Business China

FORTNIGHTLY REPORT TO MANAGERS OF CHINA OPERATIONS

## The big test

Beginning with PetroChina's February IPO, some of China's largest and most strategically important companies are lining up to tap overseas capital markets. How they are received will have important implications for the government's state sector reform programme

After years of throwing peanuts to the international investment community, the Chinese government is finally getting out the crown jewels. To date, international investors hungry for a China play have had to make do with uninspiring companies hailing from a grab-bag of struggling sectors, such as agricultural machinery, chemicals and steel. Almost one-third of the H-share and red-chip companies listed in Hong Kong lost money in their last reporting season; more than half have seen their share prices fall over the past year.

One of the few exceptions to Hong Kong's dismal roster of mainland companies has been China Telecom (Hong Kong), or CTHK, which has been a star performer since it listed on the Hong Kong Stock Exchange in October 1997. As a repository for some of China's largest mobile phone networks, it offers investors at least the illusion of buying into a vital piece of China's national infrastructure (see "Neither fish nor fowl", *BC*, Jan 18th 1999, pg 1). Whether or not outside investors are actually in a position to influence CTHK's management is another question, especially as they are not represented on the board of directors. But buying into a company like CTHK is still considerably more attractive than shelling out for just another Chinese expressway, power plant or tractor factory.

Investors have had to wait a long time for another company of CTHK's heft to come to market. But the long drought is almost over. PetroChina, which hopes to raise US\$5-7bn in Hong Kong and New York next month, has inherited the productive domestic assets of China National Petroleum Corporation (CNPC)—the largest of China's two monopoly oil companies—but less than one-third of its 1.5m employees. The more than 1m workers left with CNPC, most of whom are attached to non-productive units (company hospitals, schools and such), will be laid off gradually. Indeed, one-third of the proceeds from PetroChina's initial public offering (IPO) will go to CNPC, and most of this will fund severance schemes.

### Good companies or good soldiers?

PetroChina's assets include 29 refineries, a handful of petrochemical complexes, and the Daqing Oilfield, China's largest. Daqing produces 55m metric tonnes of crude oil a year, one-third of China's total output. All of the oil and natural gas fields controlled by PetroChina account for 61% of China's output.

PetroChina will also be a player on the international stage. By output, it is the fourth largest oil company in the world, after BP Amoco, Exxon Mobil and Royal Dutch/Shell; it produces 780m barrels a year (worth US\$20.3bn at market prices).

PetroChina's IPO will be the biggest ever by a Chinese company, surpassing even CTHK's US\$4.2bn flotation. If its IPO is successful, PetroChina will be followed to market by a series of other national corporate giants. These include China Petrochemical Corporation (Sinopec), CNPC's principal rival; China National Offshore Oil Corporation (CNOOC), which controls China's off-shore oil and gas fields; China Unicom, the weaker of China's two national telecommunications providers; and Bao Steel, a unit of China's largest steel producer.

This is not to say, however, that the government is finally ready to forfeit control over key sectors of the economy, such as petrochemicals and telecommunications. Indeed, the listing of companies such as PetroChina can arguably be seen as a very cynical exercise.

In return for their money, international investors will get only very small stakes in, and no representation on the boards of, unproven companies still subject to government fiat. In the case of PetroChina, for example, the international investment community will be invited to pay as much as US\$7bn in return for only about a 15% stake in the company. CNPC, which has a history of doing dumb things in the national interest, will control the remainder.

For example CNPC, which was spun off from the Ministry of Petroleum, entered into a series of misguided projects in Kazakhstan, in part because they served the Chinese government's geopoliti-

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cal aims in Central Asia (see "Just desserts", *BC*, Jul 5th 1999, pg 8).

PetroChina will not be inheriting any of CNPC's overseas boondoggles. But some potential investors are sceptical that the company will put their interests above national ones. Ma Fucai, chairman of both CNPC and PetroChina, is referred to as "Minister Ma" by many of his employees (and even some of his Western bankers). "We have a saying in China that it is easier to move a mountain than to change a personality," says one industry consultant. "Dressing these executives in Western suits will not turn them into efficient operators. They know so little about looking after the interest of shareholders."

It is precisely to counter such scepticism that PetroChina will open its boardroom to independent outsiders—something CTHK has yet to do. Those offered invitations to sit on its board include Franco Bernabe, former head of Italian oil giant ENI; Tung Chee-chen, chairman of Orient Overseas (International) and younger brother of Hong Kong chief executive Tung Chee-hwa; and Wu Jinglian, a leading mainland economist.

To further mollify the investment community, the remuneration of PetroChina's senior executives will be tied to the company's performance. Nor will PetroChina be pricing its IPO too aggressively. Banking sources say the company's shares will probably be priced at a P/E of less than ten times earnings. PetroChina is being cautious not least because of the example of CNOOC, which tried—and failed—to launch a US\$2bn IPO last

October. CNOOC had demanded that investors swallow a P/E of 24.

### Same, same but different

Such concessions point to an important difference between CTHK and PetroChina. Both are large, strategically important companies. As such, the government's willingness to sell bits of them to overseas investors (albeit without surrendering any real control over their operations) is an extremely important development. But only CTHK is in a sexy enough industry that outside investors are willing to suspend the scepticism with which they typically view Chinese state-owned enterprises. PetroChina's future prospects are nowhere near as promising as CTHK's. After China joins the WTO, the government will find it harder to protect the company from cheaper imports, and also from foreign competition in the distribution and retail sectors.

Whether PetroChina gets the better of international investors in its IPO, or vice versa, will not be known until its listing prospectus is released. Only then will it be clear how much investors will pay, and how their money will be spent. But one thing is certain: investors are going to drive a hard bargain—not just for PetroChina, but for the other corporate giants that will follow it to market. And more importantly, after it is listed they will monitor its performance like a hawk. That is a healthy development for the international investment community, and for China as well.

## Godot gets nearer

In this issue, *Business China* looks at three key sectors to be opened upon China's accession to the World Trade Organisation—securities (below), agriculture (pages 4-6) and banking (pages 6-8). Finally, on pages 8-9, we consider whether or not the US Congress will snatch defeat from the jaws of victory by denying China permanent normal trade relations (NTR)

### 40m and climbing

In less than ten years, China has built one of the largest equity markets in the developing world. Almost 1,000 firms are listed on the Shanghai and Shenzhen stock exchanges, which at the end of 1999 had a combined market capitalisation of more than US\$100bn.<sup>†</sup> More than 40m individuals have opened share-trading accounts.

And all this is just the beginning. Each year, about 100 additional firms are allowed to join the party.<sup>††</sup> The rapid growth and immense potential of China's equity market have attracted the keen

interest of foreign brokers, investment bankers and fund managers. Many have set up shop in Shanghai, waiting for the day they will be allowed to buy, sell and underwrite renminbi-denominated A-shares, which are still reserved for domestic investors only. (China's B-share markets, in theory reserved for foreigners, have been abject failures—see "Less than zero", *BC*, Apr 26th 1999, pg 6.) To date only one foreign-invested company, CCIC, a joint-venture investment bank established by Morgan Stanley and China Construction

<sup>†</sup> At the end of 1999, the total value of issued shares, including non-tradeable state and legal person shares, was Rmb2.76trn (US\$332bn). This is expected to increase to Rmb13.3trn (US\$1.6trn) by 2010. The government, which holds about two-thirds of most listed companies in China, has announced its intention to float more state and legal person shares on the stockmarkets. In particular, it is keen to sell down its holdings in companies in "non-strategic" industrial sectors.

<sup>††</sup> Listing slots are allocated by quota. Each year the State Development Planning Commission (SDPC) and the State Council decide how much money may be raised through new listings. Listing slots are then farmed out to provincial governments and central government units, which then pass them on to, respectively, local and subsidiary companies. 104 companies secured listings in 1998, 112 last year, and 115-20 are expected to receive approvals to list this year.