

System Archetype Analysis on Corporate Restructuring

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Abstract

With the advancing of China's reform and opening, Corporate Restructuring (CR), including M&A, spin-offs, and LBO, appeared in China in 1980s. From 1997, Mergers and Acquisitions (M&A), especially "M&A concerning listed companies" become significant economic phenomenon on China's new developing Securities Market. There is obviously difference in detail operation of M&A between China and western developed countries. The merger market based on incomplete market economy is full of complexity in China. Proprietorship, multi-motives for M&A, assets reorganization, synergy gained from combined companies and uncertainty and mobility of policy bring much risk to M&A.

With the emphasis on illustrating the importance and complexity of assets rearrangement and synergy creation, the thesis use System Archetype to analyze and explain the features unique to CR in reform era and the strategic plan underlying them.

The thesis begins with the review of three developing stages of Corporate Restructuring in China, focusing on the characteristics and problems of CR, especially CR concerning listed companies on China's newly developed Securities Market. Using System Archetype I-"Shifting Burden", the thesis highlights the causes and results of Cash Trading or Strategic CR, as well as the difference and relationship between them, with the attempt to curb Cash Trading and promote Strategic CR. The

fourth part describes the strategic process of strategic CR, assets rearrangement and synergy creation with the System Archetype II-“Limits to Grows”. Motivated by strategic development and based on performance improvement, the strategic CR promotes the efficiency of companies through successful assets rearrangement and synergy creation and maximizes the value of listed companies on Securities Market in China.

Background of Corporate restructuring (CR) in China

Corporation Restructuring, especially M&A, as the transaction of enterprise assets or the property right, are not merely one of the ways that an enterprise expands, but a major factor contributing to the evolution of enterprise strategy. Enterprise strategy sets the conditions and forms of M&A, determines the rearrangement and efficiency of assets, and thus affects the synergy gained from M&A.

At present, China is undergoing economic system reform and transition from planning economy to market economy. Traditional M&A theories and practice, based on the complete market economy, cannot be directly used to explain CR in China’s incomplete market economy. Considering the evolution of enterprise reform and strategy development, CR in China should be investigated in the background of incomplete market economy as advanced enterprise performance. CR reflects enterprises’ interests and demands in specific systems and reveals their strategic reaction to current regulations.

In June 1984, Baoding Textile Machine Factory and Baoding Boiler Factory separately took over Baoding Knitting Machine Factory and Baoding Air-blower Factory by means of taking over all the assets and liabilities of the targets firms.

From then on, CR has been experiencing three stages in China. During 1980s, the early stage of CR, most State-Owned Enterprises (SOE), having no sense of modern company, are merely manufacturing units in Plan Economy, so CR between them always intervened by Government or Administration, which initiated the M&A in China. According to statistics, there are 6226 enterprises took over 6966 enterprises in 1980s and most of them are “Strong Annexing Weak” (Well-perform Enterprise

takeover ill-perform one) with administration intervention. Moreover, government, owning or managing most assets of SOEs, always involved or even took part in the CR. With the intentions of eliminating the number of loss enterprises and shifting financial burden, the government fosters the M&A, especially the kind of “Strong Annex Weak”.

In the second stage, from 1992 to 1997, there are more companies involving in the CR in China’s Equity Market. This tide of M&A aroused with the background of the deepening company system reform and developing of Securities Market. In 1990s, the boom of China’s Securities Market provided a wonderful chance for the corporate restructuring and assets reorganizing. The Secondary Equity Market, Shanghai Stock Exchange, established in 1991, promoted the development of M&A. However, there were two problems in that stage. Firstly, the M&A mainly were limited in the shares transfer and just partly involved in assets transfer, so most mergers didn’t restructure the business in any sense. Secondly, the general problem of how can the acquire company and the target one fit to each other remained no answer. Both the dissention in internal management and the government intervention attributed to those problems. Moreover, some main stockholders operated illegally and make use of the listed company as “drawer machine”. As a result of all these factors, M&A in this stage were rarely successful, so just formed waves of “Stock-Trading” in Securities Market.

In 1997, the 15th National Congress of the Communist Party of China emphasized the superiority of the shareholding system in Market Economy. So the CR accomplished on Secondary Equity Market developed quickly and came into a brand-new stage. Up to the now, the M&A concerning listed company emerge in an endless stream. According to the statistics, there are about 40 percent listed companies reorganizing assets from 1997, with 110 M&A in 1997, 422 M&A in 1998 and 437 M&A in 1999, as shown in table below.

Year	Control-right Transfer	Expanding	Spin-offs	Internal Assets Reorganization	Total
1997	23	66	18	3	110
1998	78	196	91	57	422

1999	81	178	137	41	437
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Data from Shanghai Securities News

Problems of CR in China

At present, the main problems of CR in china appeared as below:

1. Although there are plenty of CR appeared successful in stock market and most acquire companies assert their M&A as “Strong Annex Strong”, in fact most M&A in China are “Strong Combine Weak”.

2. The listed companies’ performance after CR isn’t consistent. Because of the positive correlation between market response and company performance, the phenomenon of “Profit in first year, break-even in second year and loss in third year” is prevailing. It means that most corporate restructuring don’t intend to promote company’s management efficiency, but aim to earn the stock investment profit from the up and down prices during the M&A period.

3. Most listed companies transferring control rights to others always perform non-consistently. There are three main motives for transferring the control rights of listed companies:

(1) The poor-quality assets of listed companies can hardly make enough profit, which is required for further seasoned issues. The former controller has no valuable assets to input to the listed company, while the acquire company with well-performed assets takeover the controlling rights to realize the stock issuing on the Capital Market for further cash flow from financing though M&A.

(2) The new controller is strong enough to expand the business range of listed company horizontally and vertically so as to expand oneself and eliminate the competitors.

(3) The intervention or manipulation from government, esp. from local government often occurred in CR. For instance, state assets were sometimes donated to ill-performance listed companies for its existence.

4. Some listed companies undergo corporate restructuring continuously. According to the statistics from Internet, from 1997 to Nov. 30, 2000, there are 400 or

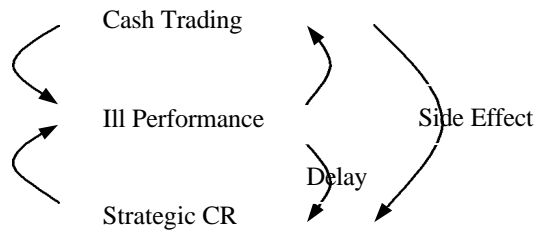
so companies undergoing 770 corporate restructuring in China. That means, averagely, one listed company has done CR twice. Moreover, among these companies there are 25 companies have been restructuring their assets continually in three years. There are numerous reasons for the increasing number of these successive corporate restructuring.

Some listed companies want to promote their assets quality and strengthen the development tendency by successive restructuring. Other ill-performance companies want to keep their right of seasoned issues and avoid becoming ST (Special Treated) or even being removed out of the Stock Market, so these kinds of CR, in fact, just insert cash and profit into the company and can't improve the assets quality and company performance. The basic resolution to the problems of ill-performance or almost bankrupted enterprises will be researching and seeking the very reason of the ill-performance, then taking root-oriented method such as providing capital, technology or management.

System Archetype I-“Shifting Burden”: Cash Trading or Strategic CR

Jay maintain that the cause of many pressing public issues from urban decay to global ecological threat lay in the very well intentioned policies designed to alleviate them. A standard “Shifting Burden” performs as follow: When people confront with the problems, they tend to stress the symptom and adopt symptomatic solution, while ignore the real cause underlying the problem and avoid fundamental solution, which usually involves time delay and takes a relatively longer period to effect. Most people tend to take the symptomatic solution, which seems easier and quicker. In this system, policymaker is lured into interventions that focused on obvious symptoms not underlying causes, which produced short-term benefit but long-term malaise, and fostered the need of still more symptomatic interventions. The structure of “Shifting Burden” explains why a lot of well-intentioned resolutions make the problem getting worse in the long run, while their quick-effect still have strong attempt. The result-oriented method alleviates the problem pressure, while they also reduce the chance of resolving the problem thoroughly.

In China the “Shifting Burden” SR explain why some Corporate Restructuring become Cash Trading, while strategic CR isn’t adopted.



To those ill-performance enterprises, corporate restructuring is one of the most significant methods to promote assets quality and company performance as well. There are two kinds of CR: Cash Trading and Strategic CR. Involved in Cash Trading, the listed corporation sells shares or even control rights for cash inflow so as to promote performance for keeping the rights of seasoned issues. While the Strategic CR usually transits large part of the assets of target company to acquire company or combines both assets of the two companies so as to improves corporate performance through strategic development.

Cash Trading in China

Cash Trading can improve performance quickly, but bring much risk and undermine the corporate ability of developing through assets reorganization and Synergy Creation. Many CR in China’s Equity Markets are merely Cash-Trading now, which inserts cash inflow and restates Finance Report only. There are many means of Cash Trading, some companies trade shares for cash, such as Shanchangling Company took over a sum of shares from one shareholder in Nov. 10, 2000, then sold it several days later and earned over RMB 70 million.

From 1999, listed companies acquired to raise Appropriate Allowance for Receivables and Investments according to policy of Ministry of Finance. However, some listed companies play new tricks and the Return Inwards are used as origin of profit by sold out these deducted Receivables and Investments for original value. ST (Special Treated for ill-performance) Baozhuang Company earned RMB 48 million just by selling out an item of share which has been raised total allowance.

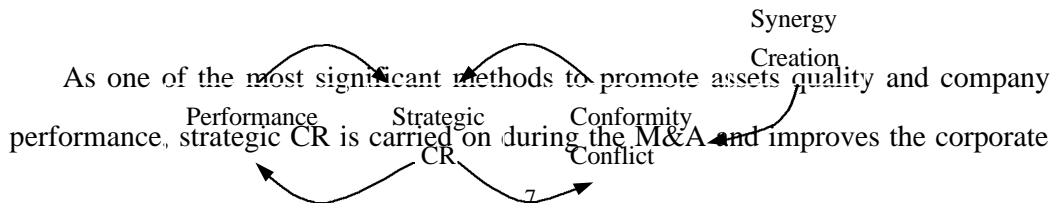
Another way is the big shareholder directly donates assets to listed company. ST Jinli Company and ST Baozhuang Company separately enjoy donated assets valued RMB 220 million and RMB 189 million, so as to increase the Net Asset and well prepared for issuing new stocks.

Though the means that the enterprise carries on the Cash Trading can be various, the purposes of them are same -- meeting the basic standards for keeping listing and seasoned issuing. Cash Trading is conducted without company diagnose before M&A and assets reorganization after M&A. In the process of CR, acquire companies don't pay attentions to the listed company's own quality, but are interested in the qualification of seasoned issuing. And the long-term fundamental goals of strategic CR are always reduced. Cash Trading promotes company performance in short term, while the performance turns to worse again two or three years later.

If the acquire company has no long plan for the future running, it will deal with the listed company as "cash-drawer". The assets won't be reorganized and management won't be improved, so the corporate restructuring fails finally. However, if the acquire company has strategic plan for continuous operation, it will make great efforts to carry on assets reorganization and try every means to improve management and performance.

System Archetype II-Limits to Growth: Synergy Creation

The basic principal underlined by SA-Limits to Growth is that growth can't be pushed, but achieved by removing the factors limiting growth. In each of these structure, the limit gradually becomes more and more powerful. After its initial boom, the growth mysteriously levels off owing to the compensation feedback. Eventually, growth may slow so much that the reinforcing spiral may turn around and run in reverse. Limits to growth structures often frustrate organizational changes, strategic CR in here, which seem to be gaining ground at first, then run out of stream.



performance significantly. However, the conformity conflict caused by assets reorganization and companies' conformity, one part of strategic CR, is becoming acute so as to offset the performance improvement achieved.

From the illustration, we can realize that achieving performance advancing form Strategic CR must deal with the Conformity Conflict. While corporate conformity means strategy conformity, business conformity, system conformity, Human Resources conformity and culture conformity. With the purpose of promoting the efficiency and performance of companies through strategic CR and successful assets reorganization, how to create synergy so as to remove conformity conflict is a main topic to be researched.

Conclusion

Recent years, the China Securities Regulatory Commission and the State Economic and Trade Commission jointly promulgated many laws and regulations concerned the listed Company Governance, Information Disclosure and M&A concerning listed companies. The policies and environment are very important in promoting the efficiency and performance of companies through strategic CR and successful assets reorganization, and creating synergy so as to remove conformity conflict.

Through the analysis of "Shifting Burden", we can see that the independence of listed company is very important to curb cash trading. Using "Limits to Growth", we realized that creating synergy is a systematic project needing a well-functioned policy system and environment.

The listed company shall sign a written agreement with the affiliated persons for the affiliated transactions. The listed company shall take effective measures to prevent the affiliated persons from interfering in the operation of the companies and impairing its interests. The assets invested by the controlling shareholders in the listed company shall be independent, complete and clear.

The listed company shall establish the independent director system according to the relevant regulations. The independent directors shall be independent from the company and its main shareholders. They shall not assume other posts in the listed

company. They shall fulfill their responsibilities and shall not be influenced by the main shareholders, the actual controllers and other units or individuals related to the listed company.

Enforcement of such laws and regulations will create a better environment for Corporation Restructuring, especially M&A of listed companies in China's developing Securities Market.

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