

Management Incentives of Chinese State-Owned Enterprises: Shanghai Electric Group and THVOW Technology

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Abstract: Along with the continuing opening and reforming of the Chinese economic, the reform of incentive methods in state-owned enterprises had inevitably become an important topic for theoretical research. This research examines the extent to how the acquisition from state-owned enterprises cause the change in incentives methods during the recent economic period. We find support for the theory of state-owned enterprises: the SOEs prefer to maintain the centralized control of state-owned shares. Moreover, the incentives methods of those firms which was acquired turns conservative after the acquisition, which cancels or withholds the stock-based compensation plans. This research is carried through the case Shanghai Electric Group and THVOW Tech chosen from the recent acquisition cases in the China A-Share market.

1. Introduction

It had been long time since academics started to consider the factors which determine the incentive methods. According to the former research, a series of factors had been concluded by large scale empirical work and many cases study. These include 1) Capital Structure. This might be due to the limited retained earnings that could be used to divide, dividing the shares might scatter the control. 2) The industry that the firm in. Some industry, which reply less on specific management team or managers, are conservative in incentive systems to balance the benefit between multiple interest. 3) The develop history of the firm. If the firm is developed from a family business it would not like managers from outside the family have shares so the incentive system would also be conservative. 4) Political background. Especially in China, the institution and information environment show clear political effects, the political background of the firm can to some extent decide what compensation plans can the firm have.

Based on the thesis existed, we can analysis how the incentive system was built in companies. Firstly, examine whether opening incentive system is legal or cooperate with the regulatory requirements. Secondly, whether the capital structure of the firm can afford to decentralize the shares. Then, what history or special experience the firm had come through, get known about the style of owners and managers on managing the firm. Also during this process we can find out about the relationship between interest, such as the relationship between the firm and the local government (or specific governmental officers), or the relationship between the firm and the other competitors within this industry. Finally, a clear path on how the firm design, or in other ways, how the incentive system in the firm was decided.

2. Literature Review

The agency theory had long been discussed since the middle of 20th century, after the separation of management and ownership. The managers' interest is not always the same as the shareholders' interest. And it is important to design a system that can provide incentives for managers and employees to make efforts on satisfying the shareholders' interest (Jensen M.C., Meckling W.H., 1979). Due to the unclear of shareholder rights in state-owned enterprises, it had been observed that the managers are not eager to maximize the value of state-owned enterprises (Smith, D. A., & Trebilcock, M. J. 2001).

The business environment in China is different from the other countries. As a socialism country,

the CPC and the government has superior power and control of the society, especially the state-owned enterprises as they are important economic support of the country. Also, the institution and information environment in China is also different due to a series of factors including state controlling ownership, controlling of capital market, weak property rights and lack of local independent auditors (Joseph. D. Pitroski, T.J. Wong, 2013).

3. SOEs in China: A Combination of the Two Generations

The SOEs in China were first created during the socialism transformation in 1950's after the foundation of People's Republic of China. Transforming the industries and enterprises under control of the communist party was an important step in the process of industrializing, and with this historical basic, the incentive methods of Chinese SOEs were highly close to the incentive methods within the government and the party. As the mission of SOEs are not always maximizing the profit of the shareholders but to support the state budget and carry social responsibility if necessary.

After the beginning of opening and reform since 1978, the SOEs started to transform into normal enterprises while the entire society is also building a market-oriented economy. As most of the first listing firms are SOEs, the benefits of shareholders became one of the targets but the managers of the SOEs are still, most of them, assigned from the government or the party within the system (Taye Mengistate, Lixin Colin Xu, 2004). At this stage we can say that according to the law and discipline the managers of SOEs are not allowed to have stock or options as incentives within their compensation plan.

Given the lack of incentive ways the SOEs in China had been considered "low-efficiency" and bureaucracy. The employees, from the normal workers to the head manager were not tending to work hard (not all but a large portion of them) but corrupted the state assets. After the start of opening and reform in 1978, market competition was introduced into China and multiple SOEs failed in the competition, not only did harm to the domestic industry but also had negative effect on the entire market environment as the domestic firms are not as competitive as the foreign firms who came into China. Then when the capital market was re-open in China, some foreign capital and private capital were introduced, in this circumstance large amount of state-owned enterprises were acquired by those non-state-owned capital, which was described as "age of privatization" (Smith, D. A., & Trebilcock, M. J, 2001). Almost during the same period, pilot project of ESOPs (Employee Stock Ownership Plan) were set to explore a path to modernized corporate governance, started from a series of state-owned enterprises.

For most of the Chinese SOEs, the incentive method was simple, and can be divided into the following types:

1) Fix salary. The employees only receive the fix salary that written in their contracts, regardless of how the firm performed or how themselves performed in a specific period. Also, at this stage they were not easy to be fired as their identification are special comparing to other careers that can be found during at that time. Therefore, the managers and the other employees would not like to work hard as their income are not depending on how well they finish the work.

2) Fix salary plus bonus base on performance/ranks. This type of incentive system is better than the first type as the outcome of the employees are related to their income that could be given to them. But under this circumstance, the "stability" that a job in the "system" could provide is more important than the potential financial income that could get from their work. Therefore, the efficiency did not improve as expected, and due to the attraction of "stability" and lack of public recruitment, the employees do not have the ability than the aspiration to create value for the firm.

3) Salary base and ESOPs including shares and options. This system was first introduced in 1990's as a part of SOE reform. It had been proved in the experience of developed markets that the managers were professional agents hired from outside the firm or promoted from inside. With shares and options set to be award when specific targets were met, the employees and managers would make efforts to meet the target, which usually was set on the performance of the firm. On the other side, the risk of corruption and illegal actions to meet the target by unnormal ways, and the managers might use this chance to take over the power of the board, and use the firm's resources to

satisfy their own benefits.

Given the basic concepts and knowledge of agency theory, institution and information environment in China, the history and characteristic of Chinese SOEs, we can choose the typical merger and acquisition cases made by the state-owned enterprises, and analysis the process of the cases about the incentive systems. For this thesis, we choose the acquisition of THVOW Tech done by a state-owned listing company: the Shanghai Electric Group as a typical case.

4. Case Background

Between 2017 to 2018, in the Chinese A-Share market, 53 merger and acquisition cases done by state-owned enterprises. After the financial crisis in 2015 and experiencing the economic down-trend pressure during 2016 to 2019, the state-owned capital came into the market and played as the role of “white knight” for the firms in unpleasant condition. Within these cases, the acquisition of THVOW Tech from Shanghai Electric.

THVOW Tech was founded in 2001, mainly focus on electronic equipment and chemistry, was a head leading firm in Chinese manufacturing industry. As shown in the financial position of THVOW Tech, the financial status was not satisfying due to the macro-economic and low demand from the downstream. Therefore, the performance of THVOW Tech on the secondary market was not promising. In 2018, with the permission from the Shanghai SASAC (state-owned assets supervision and administration commission), the Shanghai Electric acquired THVOW Tech at the price of CNY 591,000,000, made it a state-owned subsidiary of Shanghai government. The acquirer, Shanghai Electric, first found in 2004, is a state-owned listing firm developed from a machine manufacturing company, is now a global head leading firm in the equipment manufacturing industry and first went on public in Hong Kong SAR in 2005, then went on public again in Shanghai in 2008 (a typical state-owned A+H stock). Till now, the Shanghai Electric Group had become the top 1 machinery manufacturer in China and top 5 in Asia.

5. Case Analyst

Before the acquisition in 2018, the THVOW Tech had been performed not promising in the market, and the main business had been in an unpleasant condition. Since 2011, the THVOW Tech started ESOP plan, including x % of total stocks and cover x employees from the department of technology and development. There are three main questions: 1) would the merger from SOE change the existing incentive methods? 2) Would the incentive outcome be changed after the merger? 3) As the acquirer and the target are in the same industry, will the SOE get experience in incentives from the target firm?

According to the regulatory, we can conclude the differences between normal companies and SOEs below:

Table 1: Comparison between regulatory requirements of listing normal companies and SOEs
(Sources: SASAC)

	Listing Companies	Listing SOEs
Basic requirements	Was not identified as default in the last three financial years.	Was not identified as default in the last three financial years.
target	Can include foreign employees.	Not applicable for any person outside the company including independent directors.
limitations	Under 10% of the total equity	Under 1% of the total equity
Rules of limitation	N/A	Expected return of stock and options awarded is not allowed to be more than 30% of the total compensation.
Source	Buy-back or seasoned offerings.	Could not be paid from only the state-owned equity.
Restriction Period	Above 12 months	Above 2 years
Special Requirements	N/A	Options: Not less than 20% of the options should be exercise after assessment period. Restricted Shares: Not less than 20% of the shares

		remove restriction after the assessment period.
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In December 2018 after the merger was finished, THVOW Tech continued to publish a buy-back plan for incentives. Comparing to the performance of 2018, in 2019 THVOW Tech showed profit. Under the current situation, it would need more data to be collected to test the change of state-control will affect the incentive outcomes.

As a pair of similar companies in the same industry, and THVOW Tech had been exercising stock incentives, the Shanghai Electric can get experience from the system and plans of THVOW Tech. On 23 January 2019, Shanghai Electric released the compensation plan that includes a share-based compensation, and it is the first company in the industry to release the plan. The target includes 209 employees from the management and 2291 engineers and scientists. We can compare the compensation plan of the two companies:

Table 2: Comparing the compensation plan of the two companies (Source: THVOW Annual Report, Shanghai Electric Annual Report)

	Shanghai Electric	THVOW Tech
Target	209 from the management, 2291 from the technology	23 from the management, 49 from the technology
Shares	14725.18	390
Shares to the total equity	1.00%	0.534%

We can see from the comparison that the plan of the two companies that their plans are similar, both took the technology department as majority of stock-based compensation. This can be due to the importance of technology for these firms with their core business in manufacturing industry. It is also considerable that many other SOEs started to use a share-based compensation plan after acquisition of the listing companies in the industry, figuring that the experience of share-based compensation could be absorb by the SOEs and be exercised by them. Further application in SOEs still face problems like “over investing” (Tang Yuhong, Zhou Rong, Yang Xiaoyu, Yang Yukun, 2017) and “insufficient incentives” (Shen Hongbo, Hua Linghao, Xu Jiji, 2018), would need more cases for large-scale empirical test and to find suggestions for SOE management.

6. SOEs in other countries: a symbol of capitalization

The institutional change did not just take place in China as China is not the only country that has SOEs. During the late 20th century in multiple socialism countries, state-owned shares and assets were sold to privates and former managers from the state, which turned thousands of former state-owned enterprises into private assets. Typical cases can be found in former soviet countries where “Oligopoly”, a specific class of the society who controls the most resources and power. This class was mainly rose from the political officers who were materially worked as managers, and, after the disassembling of the Soviet Union, the oligopolies who were controlling the firms made the firms their private assets. With thousands of state-owned enterprises were plundered the social economy of former soviet countries experienced long period of recession and corruption, the loss of state-owned capital also caused damage to the power of state as state-owned enterprises are important financial resources of the state. Given this background, it is understandable that those state-owned enterprises (or former SOEs) would like to keep a systematic design that can satisfy the interest of the managers and officers.

7. Conclusion

This research has analyzed the cases of THVOW Tech and Shanghai Electric Group. Maintaining control of the state-owned shares are consideration of managers, we found a path in the chosen case on how the acquisition of state-owned capital change the incentive control system of the target firm while the target firm had stock and option compensation before the acquisition. Before the acquisition the target firm experienced the process of transforming the incentive methods and MBOs, so if we assume that the state-owned capital, which representing the control from the

government, it will have the reason to centralized the shares rather than giving away through the compensation.

A limitation of this research is that as the cases started to come out recently, we haven't collected enough data for large-scale empirical test, as it would need further quantitative test on the relationship between state-owned capital acquisition and the change in incentive methods. It can be predicted that as the deglobalization and pressure of economy recession, more similar cases will occur because the state will put investment on supporting the economy growth, and for some firms who are not able to survive from the recession could be acquire by state-owned capital. After more cases came out, empirical test could be made.

Another considerable trend is that the reform of state-owned enterprises is also trying to explore a possible solution to exercise share-based compensation. In 2016, the central government had released the plan to include x firms into the pilot project of share-based compensation, given a signal of loosening the restriction on employees shares. The government decided to build up a "modern enterprise system" which had been proved to be "appropriate" in many ways. "Improving business environment" had been confirmed as an important target for further reform, and the opening of domestic capital market since 2018, it can be predicted that in the coming future, the state-owned enterprises will be more positive in designing incentive systems. Further research could also be made on finding a regression model that quantitatively explain the behavior and preference of state-owned capital in corporate management and the conflict between the institution and information environment with distinct Chinese characteristics and the decision-making process.

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