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Identifying Ultimate Controlling Shareholders in Chinese Public Corporations: An Empirical Survey

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Summary

By classifying various shareholdings in Chinese public corporations according to the principle of ultimate ownership and control proposed by La Porta et al (1999), we find that, by the end of 2001, approximately 84% of companies listed on Chinese stock market are ultimately controlled by the state, compared with about 16% of non-state-controlled ones in our firm sample. The Chinese official shareholding classification, by contrast, is ambiguous for the identification of ultimate owners in public companies, which in turn has misled a large number of previous empirical studies on the performance impacts of shareholding classes for Chinese corporations.

Introduction

Do the class and behavior of the ultimate controlling shareholder matter for public corporations?¹ The economics literature on the issue is rather underdeveloped partly because, in the Anglo-American corporate environment, dispersed shareholding structure is the norm in the majority of publicly listed companies where few group of shareholders have sufficient stocks to exert significant control over company affairs. Nevertheless, in the latest systematic empirical survey of the ownership structure of large corporations in 27 wealthy countries, La Porta, Lopez-de-Silanes, Shleifer (1999) find that the presence of ultimate controlling shareholders is a rule rather than an exception in the rest of the world².

Moreover, La Porta et al. (1999) also provide a detailed account on the various means controlling shareholders can use to maintain and extend their *de facto* control in downstream firms. Among them, the widespread pyramid shareholding scheme is applied by controlling shareholders to create a set of control chains, within which a publicly listed company may be controlled by another one, whose controlling shares in turn lie, directly or through several such similar chains, in the hands of the ultimate dominant shareholder group. So the immediate ownership data from the public corporations is not, in principle, adequate to present an accurate picture of the exact control pattern in these firms, and the tracing of ultimate shareholding structure is quite crucial to our understanding of the ownership and control in modern corporations.

Among numerous types of controlling shareholders, an extensive state control has been found in a number of countries such as Austria and Singapore in La Porta et al.'s sample, but unfortunately, China is not included in their data set. How could the government in China, the most populous country in the world with a fast-growing power for economic prosperity, manage to maintain their control over most of the public listed companies during its economic transition? What are the characteristics of pyramidal structure the Chinese government employs to achieve its ultimate control? Answers to these questions are worth exploring not only for the understanding of the corporate ownership and control in general, but also for that of corporate governance mechanisms in emerging markets and transition economies in particular.

In the spirit of ultimate ownership principle, we first cast doubt on the methodological validity of previous literature on the relationship between ownership structure and corporate performance based on the Chinese official shareholding classification. Then in this short article, we, for the first time, reconstruct a reformed ownership controlling structure on the

¹ We are grateful for Mr Zili Pu's research assistance to our survey of Chinese quoted companies, and to Shanghai University of Finance and Economics for financial support.

² Their methodology has subsequently applied into the analysis of the corporate ownership structure in East Asian economies by Claessens, Djankov, & Lang (2000) and in West European economies by Faccio & Lang (2002), and has yielded similar empirical results.

basis of the ultimate ownership principle for Chinese corporations, which will enrich our understanding of corporate ownership and control around the world. Concluding remarks and suggestions for future research, as usual, are provided at the end.

Shareholding Structure in Chinese Public Corporations

The Official Shareholding Classification and its Misleading Effects

As shown in table 1, the shares on Chinese stock market are officially classified as non-tradable state shares, legal person shares, employee shares³ and tradable public shares. While state shares are shares directly held by government agencies, such as state asset bureaus, legal person shares are those owned by domestic institutions, be they enterprises or other economic entities with a legal person status.

Table 1. Distribution of the Official Shareholding Classes in Chinese Publicly Listed Companies (%)

□	1997	1998	1999	2000	2001
Total Non-tradable Shares	65	66	65	64	65
State	32	34	36	39	46
Domestic Legal Persons	30	27	25	23	17
Overseas Legal Persons	1	1	1	1	1
Employee	2	2	1	1	0.5
Total Tradable Shares	35	34	35	36	35
A Shares	23	24	26	28	25
B Shares	6	5	5	4	3
H Shares	6	5	4	3	6

Source: China Securities Regulatory Commission (<http://www.csrc.gov.cn>).

Notes: State shares are shares directly held by government agencies, such as state asset bureaus. Legal person shares are owned by domestic institutions, be they enterprises or other economic entities enjoying legal person status. Employee shares are offered to workers and managers of a listed company usually at a substantial discount. The tradable public shares can be further broadly classified as A-shares, B-shares and H-shares: A-shares are the ordinary equity shares mostly held and traded by individual investors in RMB on the domestic stock exchanges. B-shares refer to those that were once exclusively traded by foreign investors denominated in foreign currencies until 2001, when domestic investors can also hold these shares. H-shares in the general sense concern the shares issued by Chinese corporations to foreign investors through listings on Hong Kong, New York and London Stock Exchanges. Since most of the shares are listed on Hong Kong, the H designation is used in this context.

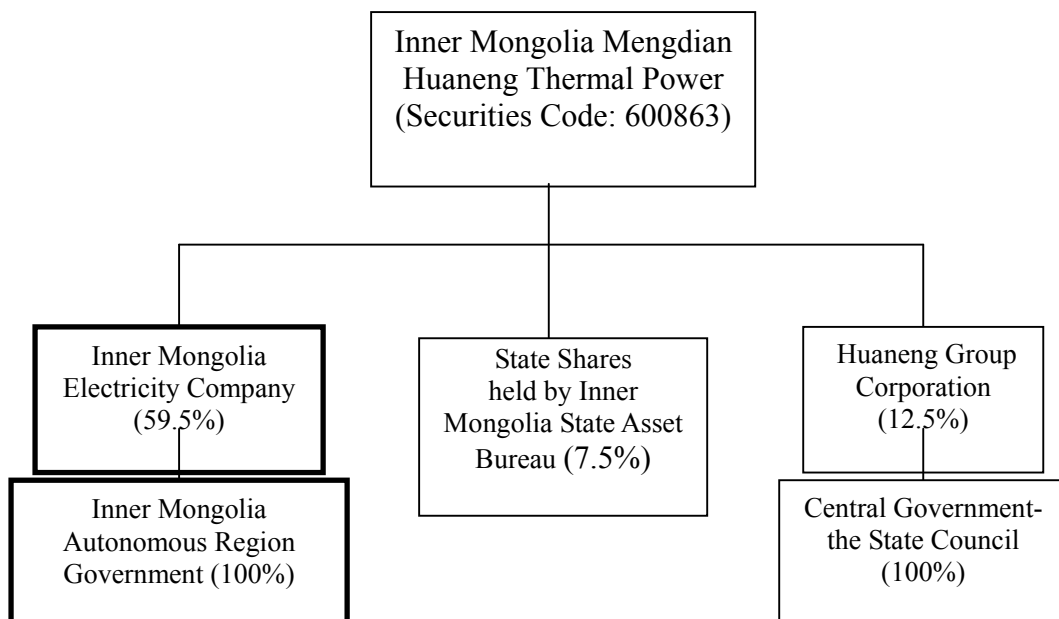
One problem of the official classification is that it fails to identify the ownership identity of the legal person shares, and it is unclear whether these legal entities are state-owned or non-state-owned institutions. It is quite possible that the owners of the legal person shares are enterprises or institutions ultimately controlled by the central or a local government. If so, grouping the legal person shares to an independent shareholding class in parallel with the

³ It should be recognized that non-tradable does not necessarily mean non-transferable, since state and legal person shares can be transferred among various institutions subject to the approval of the China Securities Regulatory Commission (CSRC), but the crucial point here is that after the transfer these shares still remain non-tradable and cannot be directly transacted on the market.

state shares and tradable public shares would be inappropriate, since the state controls the legal person who in turn controls the firm, and thus the ultimate owner of the firm is the state, not the legal person itself. Unfortunately previous empirical studies on the performance impacts of different shareholding classes, e.g. Xu & Wang (1997, 1999), Chen (2001), and Sun, Tong & Tong, are almost invariably based on such *ad hoc* classification.

For example, Inner Mongolia Mengdian Huaneng, a thermal power corporation listed on the Shanghai Stock Exchange. It is shown in Figure 1 that, the state asset bureau, as the third largest equity holder, directly controls 7.5% stocks in 2001, while the two largest shareholders are the Inner Mongolia Electricity Company (59.5% of shares outstanding) and the Huaneng Group Corporation (12.5% of total shares). If we strictly follow the official classification of state shares and legal person shares, the firm should be regarded as to be under the control of the legal person – the Inner Mongolia Electricity Company, since it is the majority shareholder of the firm. A closer inspection, however, reveals that the firm is actually controlled ultimately by the state, because its two largest legal person shareholders, the Inner Mongolia Electricity Company and the Huaneng Group Corporation themselves are respectively solely controlled by the Inner Mongolia local government and the central government (the State Council). Hence, the ultimate voting rights the state has in the thermal power corporation seems amount to 79.5% (59.5% + 12.5% + 7.5%) rather than 7.5% alone shown in the official record. Nevertheless, if we are misled to just uncritically refer to the state stockholding size of 7.5%, the exact magnitude of state shareholding and its control will be severely underestimated and unbiased assessment of the relationship between shareholding structure and firm performance is therefore hard to obtain.

Figure 1. Inner Mongolia Thermal Power Corporation



Apparently, the ultimate owner of the company is Inner Mongolia Autonomous Region Government that owns entirely the non-listed company, Inner Mongolia Electricity Company, which in turn holds 59.5% of the quoted company in the top box. Overall, the Inner Mongolia Thermal Power Corporation is controlled ultimately by the state that holds 79.5% (59.5%+7.5%+12.5%) shares in the total, rather than the legal person of Inner Mongolia Electricity Company that is regarded by the official shareholding classification as an independent entity in parallel with the state.

The mis-specification of state and legal person shares is pervasive in most of previous literature. For instance, on examining the relationship between ownership structure and corporate performance, Xu & Wang (1997, 1999) found a positive correlation between the fraction of legal person shares and firms' profitability, and a negative correlation between the fraction of state shares and profitability. They interpreted the results by equating the legal person shares to institutional shares, and so ascribed all the merits of institutional shareholders in industrial countries to the Chinese legal persons. The interpretation of legal person shares in this way is inconsistent with China's institutional context, because the legal person shares could represent a degree of state control via an indirect control form, as shown in our three cases, in which they are fundamentally different from the widely held institutional shareholders in western economies, such as insurance companies, mutual funds, and pension funds etc.

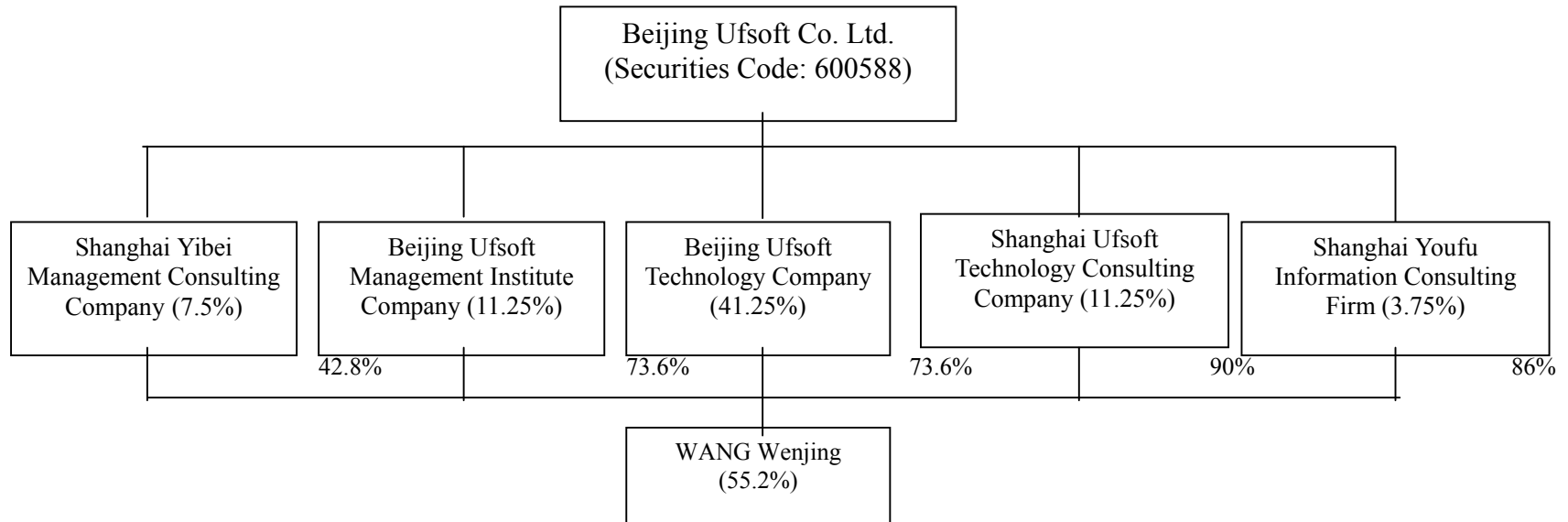
Another case is the Beijing Ufsoft Computer Software Co. Ltd, which was just floated on the Shanghai Stock Market Exchange in 2001. As illustrated in Figure 2, the five largest shareholders of the company, labeled as legal person shareholders in the official record, collectively control three fourth of total stocks in the firm. Unlike the first case, it is further found that the five holding companies are not ultimately controlled by the government, but by an entrepreneur named Wang Wenjing. In fact, Wang Wenjing controls the downstream company by acting as the dominant shareholder of the five 'legal persons' in the intermediate control chain. Hence it can be easily seen from the above two cases that, since legal person shares in the two public companies are qualitatively different (with different classes of ultimate controlling shareholders), it would not be a very meaningful way to pool all these legal persons shares together as an independent shareholding class when studying the performance impact of shareholding structure in China.

To pool the state holding and the legal person holding into one class in parallel with other classes for comparative performance study was evident in the study of Sun, Tong & Tong (2002). The study proposed indifference between state shareholders and legal person shareholders in Chinese public corporations, so that they regressed the sum of state shareholdings and legal person shares, as a proxy of government control, with performance measures of Chinese PLCs. Apparently, the work is arbitrary or biased since it overestimates the exact shareholding size of the state in their firm sample, since the class of legal person entities, as will be demonstrated in the next sub-session, still consists of 16% of the quoted companies that are non-state-controlled.

Ultimate Controlling Shareholders and the Pyramid Structure in Chinese Corporations

Identifying ultimate controlling shareholders through pyramid shareholding schemes is not easy, especially in the Chinese context. According to La Porta et al. (1999), a ultimate controlling shareholder can be identified via the pyramid structure in which at least one publicly listed company lies between the downstream firm and the ultimate owner in the chain of 20%/10% voting rights. If the intermediate company happens to be a non-listed firm, however, the case does not enter their sample, primarily because the exact ownership data of the non-listed firm is hard to collect, while the intermediate listed companies have the obligation to disclose their shareholding information to the public.

Figure 2. The Beijing Ufsoft Computer Software Co. Ltd



In this case, the five legal person shareholders which in total hold 75% of the company shares are not controlled by the government, but are in effect by an individual person. The entrepreneur Wang Wenjing ultimately holds more than half of the company's equities by holding the controlling stakes in the five holding companies of the listed firm (numbers shown beside the first control chain). His ultimate cash flow rights in the public company can be obtained as follows: $42.8\% \times 7.5\% + 73.6\% \times 11.25\% + 73.6\% \times 41.25\% + 90\% \times 11.25\% + 86\% \times 3.75\% = 55.2\%$.

Table 2. Who Ultimately Controls China's Public Listed Companies in 2001?

Status of the Largest Shareholder of a Publicly Listed Company	No of Companies as % of the Total Number Listed in the Market	Average Shares Held by the Largest Shareholder as % of Total Shares Issued⁴
State as the Ultimate Controlling Shareholder		
Direct Control: Government departments or agencies	8.5% (94 firms)	39.6% (16.1)
Indirect Control: State-owned enterprises (SOEs)	75.6% (836 firms)	47.3% (17.6)
In which of SOEs:		
(1a) State-controlled public-listed firms	1.4% (15 firms)	52.3% (20.8)
(2a) State solely-owned companies ⁵	32.6% (360 firms)	49.7% (16.7)
(3a) State controlled non-listed companies ⁶	40.6% (449 firms)	45.4% (17.9)
(4a) State owned academic institutions	1.1% (12 firms)	39.0% (14.1)
Total of State Controlled Companies	84.1% (930 firms)	46.5% (17.6)
Non-State Firms/Families as the Ultimate Controlling Shareholder		
(1b) Non-state-controlled publicly listed firms	0.4% (4 firms)	37.7% (24.9)
(2b) Non-listed collective firms & TVEs	7.0% (77 firms)	38.3% (16.9)
(3b) Non-listed domestic private firms	7.5% (83 firms)	33.3% (11.6)
(4b) Non-listed foreign private firms	1% (10 firms)	25.8% (6.5)
Total of Non-State Controlled Companies	15.9% (174 firms)	34.8% (14.7)
Grand total of Number of firms in the sample	100.0% (1105 firms)	44.6%

Notes: (1) According to China Securities Regulatory Commission, the number of companies listed in December 2001 was 1160, in which 95.3% of the total listed companies have responded to our survey on the economic status of their largest shareholders in 2001. (2) Brackets beside the percentage of shares are standard deviation of the average shares.

Unfortunately, this practice does not work in China, since most of the holding companies of the public corporations are not quoted on the stock market. As will be shown later in our survey, only 19 firms which are the controlling shareholders of the public corporations are themselves listed companies. Therefore, we relax the strict specification of pyramid and include non-listed holding companies in our survey, which is instrumental in obtaining the real picture of the ultimate shareholding structure in the Chinese public corporations. However, due to the poor information disclosure in emerging markets and China in particular, it is tremendously difficult, if not impossible, to get the detailed

⁴ Theoretically, being the largest stockholder in a company does not necessarily means absolute control of the firm if there exist sufficient large stakes held by the other large shareholders, but the situation is less likely to appear in Chinese corporations in which the largest shareholder always owns a sufficiently large number of shares, as shown in the table, to guarantee control.

⁵ This is a special type of company after the corporatisation in China, since there is no shareholders meeting in these firms, while the board of directors are directly appointed by state department or state-authorized investment institutions.

⁶ Comparative to state solely-owned companies, the general state controlled non-listed companies shall have the shareholders meeting because various state departments may have different levels of stakes in these companies, and it even could be the case that some domestic or overseas non-state companies hold some minority shares in the firms. In the same vein, all the fundamental decisions concerning merger and dissolution etc should be at least formally decided upon in the shareholders meeting.

ownership data in these holding companies, but we have made every endeavor to identify the real behind-the-scenes controllers of these companies through a careful study of company prospectus and annual reports, press release, company insider information, interviews with government officials, securities analysts, etc.

Table 2, we believe for the first time, reveals the identity of ultimate controlling shareholders in Chinese public corporations and how these ultimate controllers use different classes of shareholdings as ‘control instruments’ to direct the listed companies.

Not surprisingly, the shareholding structure in Chinese public corporations is still characterized by the state predominance⁷, in that the state is in the ultimate and absolute control of approximately 84% of our firm sample. Furthermore, the state is by no means an integrated monolithic entity in China. Rather, it extends its ownership from direct control to indirect control via its pyramid shareholding scheme. Besides the straightforward government direct control where government agencies act as the controlling shareholders in 8.5% of total companies, the pyramid structure is prevalent in 75.6% of our sample companies. Within the category of government indirect control, intermediate companies used in the control chain include: state solely owned companies (32.6% of the total firms, like the Inner Mongolia Electricity Company in case 1), state-controlled non-listed companies (40.6%), state controlled publicly listed companies (1.4%), and state-owned academic institutions (1.1%). The four types of intermediate companies are the key parts of *the Chinese-styled pyramid shareholding schemes*, which extends La Porta et al’s pyramid concept to the context of China’s enterprise reform.

On the other hand, a little bit surprisingly, private and foreign forces have already controlled over 170 public companies on the Chinese stock market via their own pyramidal structure. Among them, 83 companies are controlled by domestic private firms, which are in turn in the hands of individuals or families (like the Beijing Ufsoft Technology Company in case 2); 77 companies are found under the control of collective firms and Township & Village Enterprises (TVEs). Although lack of exact data, anecdotal evidence clearly indicates that on many occasions private firms choose to register themselves as ‘collective’ to avoid government’s unfavourable treatments in China’s unique transitional environment. Finally, due to China’s policy constraint, there is little involvement of foreign capital on the domestic capital market, as it only indirectly controls 10 listed firms.

Concluding Remarks

Based on the principle of the ultimate ownership and control suggested by La Porta et al. (1999), the paper establishes a new analytical framework on the shareholding structure of the Chinese quoted companies and finds that the main feature of the structure is the state dominance in terms of both the number of state ultimately controlled firms listed on the stock market and the proportion of the voting shares. On the other hand, although the private ultimate-controlled corporations are small at present, only 16% in 2001, it still raises a question that needs further scrutiny: is the current state-dominant shareholding structure in the Chinese public companies transitional or enduring? The dynamics of the evolution in corporate ownership and control in China, a unique post-communist country featured by gradualist transition, would be a fascinating research agenda in the future.

In contrast to the shareholding classification proposed in the paper, the Chinese officially reported shareholdings of the state and legal persons are ambiguous in identifying ultimate owners of corporations. The absence of state shares shown in a company’s annual report does not necessarily indicate the non-existence of the ultimate control by state. And the class of legal person shares is just a veil of various identities of ultimate owners including both state and private. This ambiguity has misled many previous studies in assessing the impact of shareholding classes on performance to varying degrees. Therefore, their empirical findings on the relationship between state shareholding and firm performance, whether the unambiguous negative correlation (Xu & Wang; 1997,1999) or the

⁷ This is due to the Chinese government’s policy of incorporating/listing the SOEs while maintaining at least indirect control and avoiding mass privatization since early 1990s.

U-shaped correlation (Tian, 2001)⁸ or even the inverse U-shaped one (Sun et al, 2002), must be treated with a pinch of salt, if not deemed as outright spurious.

The avenue for future research would naturally lie in the examination of the complex performance impacts induced by different types of controlling shareholders, such as state and family. And an even more uncharted territory could be the empirical investigation on whether there are any significant performance impacts of various control mechanisms applied by dominant shareholders. For instance, do different pyramidal structures, such as different classes of shareholding identities in the intermediate control chain, tend to be associated with different firm performance, despite the ultimate controlling shareholders remaining identical?

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⁸ Although Tian (2001) attempted to deal with the ambiguous shareholding classification of the legal person shares by strictly applying La Porta et al.'s pyramid concept, he only defined those whose largest shareholder is also publicly listed state controlled corporation to be state-controlled. Hence he missed a large number of corporations under the control of non-listed state owned/controlled companies. As a result, either his study is biased by defining the missing part of the corporations as non-state controlled, or unrepresentative of the population since its pyramid sample of 19 companies (and 4 of 19 are non-state-controlled) was too small to mean something.