Corporate Restructuring in China
Cases of Listing as Consolidated Business Group

Re-Jin Guo
Department of Finance
College of Business Administration
University of Illinois
Chicago, IL 60607

and

Visiting Financial Economist
Research Center
Shanghai Stock Exchange
South Pudong Road
Shanghai, P.R.China

August 2006

Abstract

Recent regulatory changes in China have significantly increased the sensitivity of wealth of controlling shareholders to the market value of the firm. As a result, some controlling shareholders voluntarily engage in transactions which streamline and consolidate the business operations of firms within the same business group. This study makes a detailed analysis of three important corporate restructuring transactions. All three corporate restructuring transactions resulted/ will result in the listing of a consolidated business group. My analyses illustrate that those restructuring transactions, though initiated by large controlling shareholders, enhance firm value and benefit both large and minority shareholders at the same time within the framework of deal structure, market infrastructure, as well as the present regulation. Recommendations on changes of the marker regulation are made accordingly.

I would like to thank Ruyin Hu, Chun Chang, Fenghua Wang, Xiang Jian, Donghui Shi, Wen-Wei Zhou, Wen-Ying Lu, Huai-Zhong Yuan, and seminar participants at the Shanghai Stock Exchange for helpful comments and suggestions. All errors remain mine. Please contact Re-Jin Guo, Department of Finance, School of Business Administration, University of Illinois.

I. Introduction

Dated from the reopening of Shanghai Stock Exchange for trading in late 1990, the regulatory agency in China has stipulated that firm shares traded in local market be composed of multiple classes (股权分置). Various governmental institutions jointly issued the Regulated Comments on Stock Corporation (股份公司规范意见) in May, 1992. This policy on multiple share classes is further reinforced in 1994 by various official documents stating, "The government needs to ensure a dominant and controlling ownership in corporations operating in specific, important, and influential industries for the domestic economy (through state shares/legal person shares)";" … dominant and controlling ownership refers to a stock holdings of more than 50% ……".

Multiple share classes in China consist of (1) state shares (2) legal person shares, and (3) common A shares[1]. State shares are share holdings by the central government, local government, or government-owned enterprises. Legal person shares are ownership by business agencies, and enterprises of local governments that helped in starting up the public companies (Sun and Tong, 2003). These three multiple classes of stocks, distinctly different from stock classes in the other countries, carry the same cash flow and voting rights per share. It is the method of exchange/transfer which distinguishes the three classes of stocks: A-shares are floated in the stock market and traded among investors; while state and legal person shares are not publicly-traded and can only be held by corporate and legal-entity institutions. As a result, the state and RIS shares are fairly illiquid (Chen and Xiong, 2001), and the free float (freely tradable shares available to the investors) is extremely low in Chinese market. It is estimated that the free float ratio was 33.2% in 2001 in China, compared to 86.4% and 77.5% in developed and other emerging markets (Gao, 2002).

[1] In addition to A shares, which are traded among domestic investors, there are B shares trading in China for foreign investors. There are also H, N, L, and S shares, available for investors in global markets and listed in Hong Kong, New York, London, and Singapore, respectively.

Another characteristic of Chinese listed firms is the prevalent ownership by large (controlling) shareholders. In many corporations worldwide, large shareholder plays an intriguing role (see La Porta, Lopez-de-Silanes, and Shleifer (1999) on 27 wealthy economies; Faccio and Lang (2002) on western European countries, and Claessens *et al.* (2000) on East Asian countries). In those countries, large shareholders are known to have a strong financial incentive to monitor firm management. Their actions mitigate agency cost resulting from the separation of ownership and management, and therefore enhance firm value. However, a different agency conflict could arise. As large shareholders enjoy control power over designating and monitoring managers, they could become entrenched and pursue self-interest by expropriating minority shareholders (private benefit of control).

Large shareholders in China, however, were not able to reap cash flow benefits from their efforts in maximizing firm value. As analyzed by La Porta *et al.* (1999), large shareholders have strong incentive to engage in value maximizing activities for the firm value. But this would not be the case in China, as the shares of large shareholders (state shares/legal person shares) could not be liquidated in the market. Rather, state/legal person shares have to be transferred via private negotiation, often based on asset value. Loosely speaking, shares of Chinese large shareholders were indefinitely locked up. As a result, large shareholders lose incentive to engage in value-maximizing investment activities, but take the opportunity to benefit themselves by expropriating minority shareholders. Operation of many listed firms in China is known to be plagued by serious related party transactions[2], with large shareholders tunneling corporate resources into their own pockets. Consequently, firm value decreases, investors lose their confidence in the stock market, and the overall market suffers.

In the year of 2005, the China Securities Regulatory Commission (CSRC, 中国证监会) undertook a revolutionary strategy of share structure reform to dismantle the distinction

[2] Most of listed companies in China are "carve-outs" from business of previous state-owned enterprises (the promoters). Many assets are left behind with the promoters. As a result, the close and on-going business relationship existing between the promoter and the listed company generates significant related-party transactions.

between tradable and non-tradable shares. It stipulated that all shares of listed firms shall be freely traded by the yearend of 2006. In effect, the new regulation has re-connected the important link between the wealth of large shareholders and firm value. In this article, I suggest that some firms respond to the reform on non-tradable shares (股权分置改革) by voluntarily engaging in transactions which streamline and consolidate the business operations of firms within the same business group. This paper exemplifies such cases of corporate restructuring and makes a detailed analysis of three important corporate restructuring transactions. All three corporate restructuring transactions resulted/ will result in the listing of a consolidated business group (整体上市).

My analyses illustrate that those restructuring transactions, though initiated by large controlling shareholders, enhance firm value and benefit both large and minority shareholders at the same time. In some cases, the parent business group voluntarily infuses good assets into its listed subsidiary to be traded as consolidated business group. Such transaction enhances both the wealth of large shareholders and firm value, while at the same time greatly reduces the potential tunneling channel through related party transactions. The restructuring of Angan New Steel is a good case of corporate consolidation via asset infusion[3].

In other cases, the business group conducts freeze-out transactions, in which the parent firm buys back the minority shares of subsidiary firm using a cash or stock offer. After the freeze-out, the subsidiary firm would be delisted from stock exchange, and would be dissolved and its assets absorbed by the parent. Consequently, the combined assets would be traded as a consolidated business group. In this paper, the restructuring of TCL Group is a case of freeze-out transaction using stock offer, while the restructuring of Sinopec is a case of freeze-out using a cash offer. Analysis of these two cases illustrates the legal and valuation process of freeze-out transactions in China.

[3] How the restructuring transaction is formulated is related to implicit rules which the China Securities Regulatory Commission (中国证监会) would impose in reviewing the case at that time. It is noted that the public securities issuances are heavily regulated in China, and are subject to CSRC's approval.

The remainder of this paper is organized as follows. Section two provides a review of how the judicial system place legal limits on controlling shareholders and discusses important cases on freeze-out transactions in the U.S. market. Section three describes the deal structure and implementation process of three transactions of corporate restructuring in China: Consolidation of TCL Group (TCL集团), now considered as a classical case of corporate restructuring in Chinese market; consolidation of An-Gang New Steel group (鞍钢新轧钢股份), as well as the on-going corporate restructuring for Sinopec (中石化集团). Section four provides the theoretical framework used in analyzing merger and acquisition transactions, and provide the valuation analysis for those three transactions. Section five provides recommendations on changes of the marker regulation and concludes the paper.

II. U.S. Judicial System on Controlling Shareholder Behavior

Presence of large shareholders could mitigate the agency conflict arising between mangers and shareholders. However, conflicts could also arise between controlling and non-controlling shareholders, as (private) benefits of control accrued to the controlling shareholders are not shared with the non-controlling shareholders. Controlling shareholders could extract their private benefits in the following three ways: by taking a disproportionate amount of firm's assets/earnings; by selling their controlling ownership; or by freezing out the minority shareholders. The judicial system in every market imposes legal boundaries on extraction of private benefits by controlling shareholders, and provides protection on minority shareholders.

In a seminal paper by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV, 2000), the authors discuss the difference in laws and the effectiveness of their enforcement across countries, and argue that legal approach of accessing how investors are protected by law from the expropriation by managers and large shareholders is important in evaluating corporate governance across markets. In a subsequent paper, LLSV further provide empirical evidence based on 539 firms in 27 wealthy economics that firm valuation is higher in countries with better protection of minority shareholders.

Coffee (2002) and Reese and Weisbach (2002) provide evidence that firms domiciled in countries with poor quality laws, regulations, and policies related to corporate governance may cross-list their securities on market in countries with more rigorous governance standards to increase their financing opportunities in the domestic market. Since the U.S. is known for its well-established judicial system and equity market, we describe and discuss its legal protection on minority share interests in details in the following.

Different level of legal intervention exists on the three different scenarios of private benefit extraction (by taking a disproportionate amount of firm's assets/earnings; by selling their controlling ownership; or by freezing out the minority shareholders) in the U.S. market. In the case of benefit extraction from ongoing operations by controlling shareholders, two basic legal rules apply. First, if the controlling shareholder is a director, any contract between the controlling shareholder and the corporation is classified as an "interested transaction" and must meet the standards of statues like Delaware General Corporation Law §144:

"No contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participate in the meeting of the board or committee which authorize the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:

(1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorize the contract of transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved, or ratified, by board of directors, a committee or the shareholders."

The U.S. Delaware Supreme Court further specifies two categories of private benefits. The first category considers the business and strategic decision of the controlled corporation. The court system refers to the decision in the first category as "business judgments". The second category considers the controlling shareholder's direct dealing with the controlled corporation (such as transfer pricing, transfer of assets, use of controlled firm's assets as collateral for controlling shareholders' debt). A higher legal standard is imposed on the transactions in the second category. If there is a chance that the controlling shareholders could benefit and disadvantage the controlled corporation in any way, the more rigorous "fairness standard" applies. If fairness standard applies, it would be at the controlling shareholders' burden to prove that the transaction is fair. In effect, there is a limit on the private benefits for the controller associated with firm operation by the judicial system.

Alternatively, the controlling shareholder could wish to sells its control, usually at a premium reflecting the value of the private benefits from operating the controlled firm. There exists much less legal intervention in such transactions, based on the consideration that minority shareholders could share gains if the incoming controller would increase the (common) value of the firm[4]. In addition, the private benefits from operating the controlled firm are presumably limited by legal rules. As a result, the value of control

[4] There are exceptions. Rules exist to restrict controlling shareholders' rights to sell their control at a premium if "(a) The controlling shareholder does not make disclosure concerning the transaction to other shareholders with whom the controlling shareholders deal in connection with the transaction; or (b) It is apparent from the circumstances that the purchaser is likely to violate the duty of fair dealing in such a way as to obtain a significant financial benefit from the purchaser or an associate."

could be larger when capital markets are less developed. Dyck and Zingales (2004), based on 393 control transactions of 39 countries in 1990-2000, report an average 14% control premium for such transactions. The authors also report that a higher degree of statutory protection of minority shareholders and a higher degree of law enforcement are associated with a lower level of control premium.

Finally, the controlling shareholders may wish to freeze out minority shareholders. In such transactions, the controlling shareholder can easily benefit as the marker price of a controlled cooperation reflects a discount resulting from the controller's private benefits. There exists intensive legal intervention should the controller takes the opportunities to expropriate minority shareholders such transactions in the U.S..

Freeze-outs are also called going-private transactions. In such transaction, a controlling stockholder typically acquires the shares of the minority shareholders in a public company in exchange for cash, debt or stock, resulting in the delisting of the company (McGuinness and Rehbock, 2005). There exist two approaches to implementing freeze-out transactions in the U.S. under its current judicial landscape. In the first (traditional) approach, the controlling shareholder announces its intention to acquire the publicly held minority shares, delivers a proposal to the target company, and files schedule 13D/13G with the Securities and Exchange Commission (SEC) describing it proposal. The target firm responds with establishing a special committee consisting only of independent directors to evaluate the delivered proposal on behalf of its minority shareholders. The special committee retains its own financial and legal advisors, and is authorized to negotiate with the controlling shareholder. If negotiation between the special committee and the controlling shareholder is successful, the determined price and other terms/conditions of the freeze-out offer would be announced and recommended by the special committee to the shareholders in a merger agreement. The transaction would be completed subsequently pursuant to the terms of the merger agreement.

Delaware Supreme Court's decision in Weinberger v. UOP, Inc. in 1983 shaped the legal standard applied to the traditional freeze-outs. In this case, Signal corporation acquired 50.5% of UOP in 1975, and several Signal officers were appointed as UOP directors. Signal sought to buy remaining the remaining 49.5% ownership of UOP in 1978 and freeze out UOP minority interests. Two of UOP's directors were commissioned to study the value to Signal of purchasing the minority UOP shares, and concluded that any price up to $24 would be a good investment for Signal. Such study based on UOP confidential information was disclosed neither to the board nor to the shareholders. The Singal-affiliated CEO then proposed and advocated an offer of $21 per share, while the market price of UOP was $14.50 per share at that time.

The UOP board responded with the following action to Singal's merger proposal. Non-Signal (independent) directors separately discussed and voted for the merger. UOP Board recommended approval by the minority shareholders in proxy statement. Approval of the merger was made contingent on approval by a majority of the minority UOP shares voted at the shareholder meeting, and two-thirds majority of all outstanding UOP shares. A percentage of 92% of the voting minority shares voted for the merger, with a 56% of outstanding minority shares voted at the meeting. Finally, 76% of all outstanding shares voted for the merger (includes Signal shares) and the merger was approved.

The court nonetheless made a judgment that the UOP freezeout triggered an intensive review of "entire fairness" of transaction. The evaluation of "fairness" consists of review on the process by which the transaction is negotiated to ensure "fair dealing"; as well as review on whether there was a "fair price" of purchasing minority share interests. It is noted that, without the court judgment on application of "entire fairness" standard, minority shareholders are only entitled to their appraisal rights[5]. To exercise appraisal rights, shareholders could neither vote for the transaction nor accepting the payment from the merger proposal. A "class" appraisal procedure is also not authorized in appraisal action. The legal exposure for controlling shareholder in an appraisal action is therefore quite minimal.

[5] For a freeze-out transaction in which the payments consist of public shares as payment, the minority shareholders have no appraisal rights, unless the controller owns at least 90% of the target's stocks, and uses the short form merger procedure.

In contrast, in the case of Weinberger v. UOP, Inc., the controller was subject to a class action in which the price exposure was substantial. The Delaware court determined that the freeze-out merger was not a fair transaction since there was a breach of fiduciary duty of loyalty by those affiliated directors to shareholders. The court's judgment reads " While a plaintiff's monetary remedy ordinarily should be confined to more liberalized appraisal proceeding ….. the appraisal remedy we approve may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved. Under such circumstances, the Chancellor's powers are complete to fashion any form of equitable and monetary remedy as may be appropriate, including recissory damages". In the end, the court found that the purchase price of UOP share should have been $22.

Dated from 2001 case of *re* Soliconix Inc. Shareholders Litigation, an alternative (unilateral) approach has been used in the U.S. freeze-outs. In this approach, the controlling shareholder determines the price and other terms/conditions of its cash offer unilaterally. The controlling stockholder publicly announces an intention to launch a tender offer. The target often responds with establishing a special committee consisting of only independent directors. The special committee retains independent financial and legal advisors, evaluate the controlling shareholder's proposal, and publicly announce its recommendation of acceptance, rejection, or no position of the tender offer. If more than 90% of the shares of each class of voting stocks are tendered, the controlling shareholder then can conduct a short-form merger by filing a certificate with the State of Delaware to freeze out any non-tendering stockholders.

The Williams Act and 1934 Act require increased disclosure to prevent outsiders from taking advantage of ill-informed decisions:

1. Under §14(d)(1), the party presenting a tender offer must disclose
    a. its identity and background
    b. the source of funds used to make the purchase, and

c. the purpose of the purchase, including any plans to liquidate or change corporate structure.

2. a tender offer must remain open for 20 business days, blocking a bidder's effort to force hasty decisions. SEC Rule 14e-1(a).
3. if more shares are tendered than the bidder sought to purchase, the bidder must buy a pro rata portion from each shareholder. This prevents use of a first-come, first-served strategy to pressure shareholders. §14(d)(6) of the 1934 Act.
4. Bidder must pay the same price for all shares purchased. §14(d)(7).

In *re* Soliconix Inc. Shareholders Litigation, Vishnay Intertechnology first announced the acquisition of 20% of Siliconix shares from minority shareholders with a cash tender offer. A special committee of Siliconix independent directors was established to respond to Vishnay's proposal. Vishnay later decided to sidestep the Siliconix and replaced the cash offer with a stock-for-stock offer. The Siliconix special committee communicated its intention to reject the new offer, but however, did not make any public disclosure in SEC documents. A motion for injunction was brought to the court to intervene with the stock-for-stock offer.

The court determined that when a freeze-out transaction is executed using the unilateral approach, the business judgment rule (instead of the entire fairness standard) would be applied. It was determined that Vishnay had no obligation to demonstrate the "entire fairness" of its proposed tender offer, and that the Siliconix directors did not breach their duty of care of loyalty to minority shareholders. The Delaware court clearly distinguished the position of the board in a merger and a tender offer:

"[U]nder the corporation law, a board of directors which is given the critical role of initiating and recommending a merger to the shareholders traditionally has been accorded no statutory role whatsoever with respect to merger and tender offer is not satisfactory explained by the observation that the corporation law statues were basically designed in a period when large scale public tender offers were rarities. More likely, one would suppose, is that conceptual notion that tender offers essentially represent the sale of shareholders' separate property and such sale- even when aggregated into a single change in control transaction- require no "corporate" action."

In evaluating whether the minority shareholders are subject to expropriation in freeze-out transactions in the U.S., Bates *et al.* (2005) examine making the market response to such transaction. Assuming both the parent and the subsidiary are public firms, Bates *et al.* examine the shareholder wealth effects in the freezeout transaction using the following measures:

Cumulative abnormal return (CAR) for the time interval of $[t_0,T]$ is calculated as

$$CAR = \sum_{t=t_0}^{t=T} (r_t - er_t),$$

where r_t is the return at time t for a given stock, ,
and er_t is the expected return of the stock.

Abnormal market value (AMV) can be measured as:

AMV of subsidiary= before tender-offer MV of subsidiary *CAR (subsidiary)
AMV of parent= before tender-offer MV of parent *CAR (parent)

$$\text{Total AMV} = \text{bidder AMV change} + (1 - \alpha) * \text{target AMV change}$$

$$fractional\_surplus\_to\_target =$$

$$\text{Relative surplus to target} = \frac{\text{fractional surplus to target}}{1-\alpha}$$

Based on 148 freeze-out transactions taking place in 1988-2003 in the U.S. market, Bates *et al.* (2005) report that abnormal returns to controlling shareholders, excluding gains associated with the appreciation of subsidiary shares, are statistically similar to the returns for acquirers in M&A transactions. The minority shareholders also received 11% more than their pro rata share during the announcement period. These results are consistent with the argument that the legal standard and economic incentives are sufficient in protecting minority share interests in the U.S. market.

We have not been able to observe judgments from the court system on freeze-out transactions from Chinese judiciary system. Therefore, judgement could not be made the effectiveness of judiciary system on the protection of minority interest in China. How the merger and acquisition market evolves in China would be closely related to the rules/regulations implemented by regulatory agencies and exchanges. Chapter 4 of the Securities Act covers the regulation on takeover of listed firms. The Regulation on Acquisition of Publicly Listed Firms (上市公司收购管理办法), published in 2002, provides a set of guidelines of how to formulate a transaction structure and more detailed legal specifications on corporate acquisition than the Securities Act. These guidelines range from the declaration of basic principles behind the transaction (for example, Rule 4 states that the merger and acquisition transactions should be fair, and the agents involved in the transactions should be honest and trustworthy); to transaction specifics (for example, Chapter 3 of the Regulation on Acquisition of Publicly Listed Firms (上市公司收购管理办法) specifies the rules for tender offers. Specifically related to freeze-out transactions, rule 27 requires special notice on the tender offer documents on the intended delisting after the completion of the tender offer. Rule 31 also specifies that the board of the tender-off target should hire independent financial advisor to provide profession opinions on the proposed transactions. Rule 34 also specifies that the purchase price in a tender offer should be the higher of purchase price paid in prior transactions within six months, or 90% of average stock price in the prior thirty days). The rules are comprehensive, but always subject to interpretation.

There are also related disclosure requirements for the tender offer report in China (contents and format rule #17 for public firms). The basic disclosure requirements include: (1) basic information on the party lunching the tender offer, (2) terms of the tender offer, (3) acquirer's change in target's shares in the six prior to the tender offer, (4) source of the capital for share purchase, (4) operating plan on the target firm after the tender offer, (5) important related-party transactions between the acquirer and the target, (6) report from professional institutions, (7) other important items.

Currently, it seems to be the common practice that the target board would post a public notice with their recommendation, which include opinion from independent directors. There is a special procedure to be considered for a tender offer, when the tender offer becomes effective. Article 97 in Securities Law specify that, after the delisting of the target shares, holders of untendered shares could be sold back to the acquirer through the trading system of the stock exchange for a duration of two months. Afterwards, such service from the stock exchange would be discontinued and the holder of untendered shares may be subject to substantial loss.

III. Cases of Listing as Consolidated Business Group

II.1: Consolidation of TCL Group (TCL集团):

The business of TCL Group was established jointly in 1981 with the Huizhou municipal government in Guangdong province to manufacture telephone sets, TVs, and other home appliances. In the year of 1993, the TCL Communication was carved out from the TCL business group to be listed as a separate firm at Shenzhen Stock Exchange. Also carved out from the group is TCL Multimedia Inc., which is listed and traded at Hong Kong Stock Exchange.

TCL Group is initiated as a state-own enterprise, but has been known to be under the strong leadership of a professional manager Mr. Dong-Shen Lee. In 1997, Mr. Lee and the Huizhou municipal government formulated probably one of the few first profit sharing contracts established in China. The contract stipulated an initial 100% ownership of TCL by Huizhou municipality, with an annual reward of ownership stakes for Mr. Lee if the growth of TCL assets in a given year exceeds 10%. In the subsequent five years, business of TCL group soared. As a result, the ownership stake of Huizhou municipal government was reduced to 58%, with the stake of management/employees reached 42%. In return, Huizhou municipality benefited by doubling its portion of TCL assets, receiving substantial amount of tax revenues, and creating employment opportunities for the local community. In late 2002, TCL group teamed up with foreign strategic partners such as Nan-Tai Electronics Inc., Philips Electronics China B.V.、Lucky Concept Limited、Regal Trinity Limited、株式会社东芝 and 住友商事株式会社, with a total share ownership of 18.38%. The state ownership was further reduced to 40.97%, with a 40.65% ownership by managers/employees. Mr. Lee alone has a 9.08% share ownership. It was known in the market at that time that TCL Group was contemplating its A share listing, and was under IPO review with the CSRC.

However, having two public subsidiary firms (TCL Communication and TCL Multimedia) created obstacles for the IPO of TCL group. To qualify as a IPO firm, TCL Group decided to buy back all the public ownership of TCL Communication (via a freeze-out transaction). TCL business group initiated the consolidation process by first negotiating the purchase of legal person shares from various large shareholders, gathering 56.7% effective ownership of TCL communication. Having the majority ownership, the TCL group made an official disclosure on September 30th of 2003, proposing the following transactions to their shareholders: (1) TCL group would acquire TCL Communication via a stock-to-stock offer, with a price of 21.15 RMB per share, equivalent to a 15% premium over the 30-day price average of TCL Communication. (2) TCL group would go public, (3) existing shares of TCL Communication would be exchanged for IPO shares of TCL Group. The interlocking of the going public of TCL Group and going private of TCL Communication created inherent risk on the deal completion, added with the uncertainty in the value of exchanged shares of TCL Group subject to valuation in the IPO market. Such a valuation approach is considered an innovation, distinctly different from what is used in earlier transactions (with price determined based on asset value). With a lucrative 15% premium, the market greeted the announcement with positive response despite the complexity of the proposed transaction.

The trading of TCL communication was halted until October 9th. On the first day of resumed trading, the stock price of TCL Communication increased to 20.06 RMB, a 10% increase over its pre-announcement price[6]. A calculation of cumulative abnormal returns (CARs) in the event window of [-30,30][7] also indicates a 20.88% excess return for shareholders of TCL Communication. Figure 1-1 illustrates the pattern of the calculated CARs over the 2-month event window.

There existed many legal hurdles to overcome in such a stock-for-stock merger, and TCL proceeded with caution. The impending transaction, as required by law, has to be put to shareholders' votes. Both TCL Group and TCL Communication called for shareholders' meeting. First, as stipulated by Chinese Corporation Law(公司法)，a merger has to be approved by over two-third of shareholders present at the shareholder meeting. In addition, if the transaction is considered a related party transaction (关联交易) (stipulated by Rules on Listed Firms in Shenzhen Stock Exchange (深圳证券交易所股票上市规则)，the controlling shareholders should not cast their votes at the meeting. In a freeze-out transaction, this regulation ensures that the interests of minority shareholders are protected, and their votes determine whether such a transaction would be approved.

The process of TCL consolidation is well-articulated. The independent directors of TCL Communication played certain role in the TCL consolidation process. The board also issued a public statement addressing some frequently asked questions about the merger, including potential risk of the merger, proxy solicitation of proxies by independent directors, and the exclusion of votes from controlling shareholders. Three independent directors were also known to issue a public notice of their independent opinion, hire independent financial advisor on behalf of shareholders, and, with the approval from half of the independent directors, publicly solicited shareholders proxies to represent shareholders who are not able to attend the shareholder meeting. Anecdotal

[6] On December 25th, the price of TCL Communication closed at 24.85 RMB, a 17.5% premium over the exchange value of 21.15 RMB.
[7] The notation indicate an event window of measuring the cumulative return (CAR), which starts thirty days prior to the announcement date and lasts until the thirtieth days afterwards.

evidence also suggests that confidentiality of the TCL's consolidation underwriting was well-kept, and partly contributed to the success of the transaction.

From a valuation perspective, the TCL consolidation is a well-packaged deal. TCL business group needed capital infusion to finance its fast growing segment, TCL Mobile. Raising fresh money was closed for both TCL Communication (from the capital market due to two consecutive years of accounting loss) and closed for TCL Group (from lenders due to high existing debt-to-asset ratio of 69%). The stock swap transaction opened a financing opportunity, with a much larger asset size of TCL Group than that of TCL Communication. It is essential to buy back shares from the minority shareholders of TCL Communication, as the assets in TCL Group (left behind by the carve-outs of TCL Communication and TCL Multimedia) are not as profitable. As illustrated in Table 1-1, TCL Group increased its ROA from 2.92% to 3.99%, and at the same time increased its holding of very profitable TCL Mobile from 48.59% to 58.39% by merging with TCL Communication.

The merger was approved by shareholders of both companies. TCL Communication was subsequently delisted on January 7th 2004. The IPO price of TCL was determined to 4.26 RMB, and went public at Shenzen Stock Exchange on January 30th 2004. The IPO offering raised 2,513,400,000 RMB new capital for TCL Group, with 590,000,000 shares issued to new investors, as well as 404,395,944 exchanged shares for shareholders of TCL Communication Inc (with the corresponding exchange ratio as one share of TCL Communication for 4.96 shares of TCL Group). On the first day of trading, the stock price closed at 6.88 RMB (a 61.50% increase from the offer price).

Other examples of using similar approach of consolidation through share exchange include acquisition of Shanghai Hua Lian Co., (华联商厦）by Shanghai Bailian Group Co. (第一百货） (announced on 4/7/2004), and acquisition of Shanghai Port Container Co., (G 上港）by Shanghai International Harbor Business Group (上港集团) (announced on 6/6/2006).

II.2: Consolidation of Angang New Steel Company (鞍钢新轧钢股份)

With strong economic growth, China's crude steel consumption accounted for 32% of world's total in 2005. Correspondingly, the domestic steel industry experienced rapid growth in recent years, with the annual production of 352 million tons of steel in 2005 exceeds the combined production of the U.S., Japan, Korea, and Russia.

Despite a large annual production capacity of 420 million tons of crude steel, the rapid expansion of the industry in China has come from many medium and small plants. China's top ten steel producers produced only 36.89% of national total, and only eight Chinese steel companies had an annual production of 10 million tons. The country still relies on imports for high-end products such as cooled-rolled silicon steel and steel plate. Overall, the steel industry in China is in need of technical innovation and efficient industrial structure. With the impending reduced barrier of entry for its international competitors due to China' membership in the WTO[8], it is predicted that the steel industry in China would experience large-scale restructuring.

Angang Steel Group, along with Baoshan Iron and Steel Co. (宝山钢铁), and Wuhan Steel Processing Co. (武汉钢铁), are ranked as the top three steel manufacturers in China. Angang New Steel Company (ANSC), as a carveout from the Angang Business located in Angang City of the Liawling Province, went public in Hong Kong in 1997 with 890,000,000 H shares, and was listed later in the same year in Shenzen Stock Exchange with 300,000,000 A shares. After the stock ownership reform (股权分置改革方案) of ANSC in November 2005, stake of the parent business group was reduced to 1,130,503,576 shares, translating to a 38.15% ownership. Shares owned by the parent business group would be locked up for another three years.

As disclosed in various registration documents, the Angang parent business group has the complete manufacturing capacity to produce various iron and steel products, with production capacity of 11,570,000/ 11,330,000/ 9,580,000 tons of iron, steel, and steel

[8] It is known that Mittal Steel Co., the world's largest steel maker, has made a crucial move in Chinese market this year by buying 37% of stake Hualing in Hunan.

plates in the year of 2004. The business of the group as a whole generated an annual revenue of 50,142,107,000 RMB and net earnings of 6,486,284,200 RMB on an asset size of 70,672,048,400 RMB in 2004. However, as a carveout from the parent group, ANSC was allocated only retains the downstream manufacturing facilities with the more profitable upstream production line and iron ores retained by the parent. As a result, ANSC needs to purchase substantial amount of steel plates and molten steel as raw materials from affiliated companies affiliated companies, incurring 86.11% of its costs of good through related-party transactions.

ANSC announced its purchase of the affiliated company New Steel Iron Inc. from the parent business group on February 6th, 2006. The asset value of New Steel Inc. is re-evaluated by an independent party as 36,447,966,500 RMB (an increase of 5,084,858,100 over the book value of 31,363,108,400), mainly from the appreciation in value of land, buildings, and equipment. The purchase would be partly paid for by a private placement of 2,970,000,000 new ANSC shares with the parent group, with an ANSC share value of 4.29 RMB. The remaining balance would be debt of ANSC to its parent group, scheduled to be repaid in three annual installments. With the completion of this transaction, the majority of assets of Angang Business Group would be traded under the umbrella of ANSC[9]. The infused assets are highly profitable, bringing the ROE of 11.68% for unconsolidated ANSC to 22.34% of the combined firm. The transaction would also eliminate 34.27% of the related party transaction, enhancing the transparency of ANSC's financial record. It is also believed that the transaction would increase the ANSC ability to withstand competition within the steel industry through larger size, higher profitability, and increased efficiency through integrating stages of steel manufacturing process.

In contrast to the TCL restructuring, the transaction costs for ANSC consolidation is minimal, mainly due to the non-cash payment to purchase assets through private

[9] One very valuable assets maintained outside ANSC are the iron ores. However, it was disclosed in the purchase agreement that there has been an outstanding contract on the purchase price of iron ore from the Angang Parent Business Group. ANSC would benefit from this agreement which stipulates a 10% discount from the price quote of the imported steel ore as the purchase price.

placement[10]. Rule 14 of the newly amended Securities Law (证券法)requires only a review of private placement transaction with the CSRC, without registration document such as prospectuses. Further, according to the Official Notice on Major Asset Purchase, Asset Sale, or Asset Swap (关于上市公司重大资产购买、出售、置换资产若干问题通知), the private placement transaction would be reviewed by the Corporate Restructuring Committee (重组审核委员) for timely decision. However, it is well-known in the market that CSRC would not grant approval to cases in which the profitability of the combined firms decreases after the restructuring transaction.

With a well-intended restructuring plan and the well-disclosed Report on Major Asset Acquisition address to the shareholders, the ANSC stock gained 10.07% on the date of announcement. The abnormal return accumulated for the two month event period [-30,30] is 24.68%[11]. Figure 2 illustrates the pattern of the calculated ANSC's CARs over the 2-month event window.

Other examples of using similar approach of purchasing assets from its parent firm through private placement of share issuance include Shanxi Taigang Stainless Steel Co. (G 太钢) (announced on 6/15/2006), and Shanghai Automotive Co. (G 上汽) (announced on 7/12/2006), Jiangxi Changli Automotive Spring Co. (G 长力)(announced on 5/25/2006).

II.3: Consolidation of China Petroleum & Chemical Group (中石化集团)

The oil/gas section is a heavily regulated market in China. The three major oil/gas companies (Sinopec, PetroChina, and China Oilfield Service) are all business entities carved out from the previous state-owned enterprises. While the domestic prices

[10] CSRC issued a circular (关于进一步规范股票首次发行上市有关工作的通知) on September 18th, 2003; stipulating that for potential IPO issuing firms, there has to be at least three years of records dated from the business reorganization as a cooperation. CSRC would grant exception to this rule if the potential issuing firm is the consolidated business reorganized from previous state owned enterprises. This notice sent a signal to the market that CSRC encourages public listing of a consolidated business group.

[11] In order to exclude the industry effect, I use the equal-weighted average return of Baoshan Iron and Steel Co. and Wuhan Steel Processing Co. as the measure of expected return in this CAR calculation.

of crude oil and gas float with international prices, the prices of gasoline and diesel in Chinese market are determined by the government agency, National Development and Reform Commission (NDRC, 发改会). With the recent surge in prices of crude oil/gasoline/diesel (see Figure 3-1 for the recent trend of crude oil prices), it benefits most of the oil/gas industry, producers, refiners, pipeline companies, equipment makers, oil field service providers, and gas station operators in the international market. The world's largest integrated oil companies (Exxon-Mobile, BP, Royal Dutch/Shell) have all enjoyed new profits. Compared to their international competitors, the three major oil/gas companies (Sinopec, PetroChina, and China Oilfield Service) have not experience similar growth. The current price difference of 700-1000 RMB per ton of gasoline has imposed financial losses on domestic oil refinery business (see Figure 3-2 for the difference of international and domestic prices of gasoline). The chemical industry is also under pressure as crude oil is the major production input. Other than adverse effect of the price control of gasoline imposed by the government, the inefficient operation also contributed significantly to the sub-par performance of the three companies (Sinopec, PetroChina, and China Oilfield Service).

Dated from its inception as an independent firm, Sinopec has been charged with a given mission of restructuring its intricated organization. Sinopec's business encompasses exploration for and production of crude oil and gas; manufacturing of petroleum products and transportation of crude oil, natural gas and petroleum products. Sinopec is the second largest crude oil and gas producer (next to PetroChina), the largest oil refiner, and the largest petrochemical producer and distributor in China (see Table 3-1 for the comparison of reserves and production capacity of the three major Chinese petroleum/gas companies). However, Sinopec's business is not well balanced and integrated. First, Sinopec's exploration capability (reserves as well as capacity) is small, relative to the size of its downstream refinery and chemical operation. Sinopec has a disproportionally large retail/distribution segment. Figure 3-3 illustrates the operating revenues and profits of Sinopec's segments. According to the disclosed information in Sinopec's 2005 annul report, Sinopec's upstream crude oil exploration can only supply 20% of its inputs downstream refinery/chemical products production. Acquisition of upstream oil/gas exploring business would be a good combination with Sinopec's existing production mix. This prediction is consistent with the acquisition of Sinopec Zhongyuan Petroleum and Sinopec Shengli Oilfield in 2006.

Second, Sinopec has effective control over 13 public-listed oil/gas/chemical subsidiary firms. The direct public-traded affiliates include Sinopec Zhongyuan Petroleum Company Limited (中国石化中原油气高新股份有限公司), Sinopec Kantors Holdings Limited(中石化冠德控股有限公司), Sinopec Zhenhai Refining and Chemical Company Limited(中国石化镇海炼油化工股份有限公司), Sinopec Yizheng Chemical Fibre Company Limited(中国石化仪征化纤股份有限公司), Sinopec Yangzi Petrochemical Company Limited (中国石化扬子石油化工股份有限公司), Sinopec Shijazhuang Refining Chemical Company Limited (中国石化石家庄炼油化工股份有限公司), Sinopec Shengli Oilfield Company Limited (中国石化胜利油田有限公司,000406), Sinopec Shanghai Petrochemical Company Limited(中国石化上海石油化工股份有限公司), Sinopec Qilu Petrochemical Company Limited (中国石化齐鲁股份有限公司), Sinopec Bejing Yanshan Petrochemical Company Limited (中国石化北京燕山石油化工有限公司) (see Table 3-2 for list of Sinopec's subsidiaries). Subsidiaries are not integrated with the parent business. Asset quality, operation efficiency, size, and profitability vary widely among subsidiaries. However, many business relationships continue among the subsidiaries and the parent, --- they could be suppliers, customers, and even competitors. This intricated business network has resulted in many related party transactions and opaque financial records. In fact, when listing its H shares/ADRs in 2000[12], Sinopec has promised the regulatory agencies to engage in immediate restructuring within the business group.

Sinopec started its restructuring efforts by an asset-swap transaction of the subsidiary Hubei Hsin Hua (湖北兴化) with a transaction value of 779.53 million RMB in 2002. Hubei Hsin Hua was transformed from a petrochemical manufacturer to a electric utility company afterwards. The asset swap is an easy way to consolidate assets of the subsidiary back to the parent without having to incur substantial taxes and high transaction costs dealing with investors with the outside capital market. However, it takes

[12] Sinopec listed its H shares in Hong Kong and ADRs in New York and London in 2000. In the subsequent year, Sinopec had its A shares listed with Shanghai Stock Exchange with an initial price of 4.22 per share.

time to find a good counterparty. Sinopec used a similar approach with another subsidiary Chinese Phoenix (中国凤凰) in 2004. Chinese Phoenix Inc's limited asset size of 1,468 million RMB made it ideal for such type of transaction.

Sinopec waited until early 2006 to initiate large-scale restructuring. In February 2006, Sinopec announced its simultaneous purchase offers for minority shares for its four subsidiary firms (Sinopec Zhongyuan Petroleum, Sinopec Yangzi Petrochemical, Sinopec, Sinopec Shengli Oilfield, Sinopec Qilu Petrochemical). The tender prices for the four subsidiary firms are 12.12 RMB, 13.95 RMB, 10.30 RMB, and 10.18 RMB, translating to premium of 13.17%, 23.06%, 16.91%, and 21.97% over the prior closing price. The calculated premium is even more lucrative, 36.44%, 28.56%,43.80% and 28.34%, over the average price in the prior three months (see Table 3-3 for the terms of the tender offers). Figure 3-4 illustrates the pattern of the calculated CARs of Sinopec's four subsidiaries over this 2-month event window. The calculated CARs for the four tender offers are 12.63%, 1.06%, 12.63%, and 7% over the two-month event period.

Sinopec's restructruing transaction is reminiscent of an earlier one put together by its close competitor PetroChina in late 2005. In October 2005, PetroChina announced in the market that it would buy back all the minority shares of its three subsidiary firms (Liaohe Jinma Oilfield, Jinzhou Petrochemical, and Jilin Chemical Industrial) with premium of 18.76%,10.10%, and 6.92% over the current stock prices (see Table 3-4 for the terms of PetroChina's tender offers).The market responses were favorable, with CARs of 25.85%, 24.74%, and 19.92% for Liaohe, Jinzhou, and Jinlin for the two-month event period. Figure 3-5 illustrates the pattern of the calculated CARs of PetroChina's three subsidiaries over this 2-month event window.

Compared with the execution of TCL consolidation, the procedure of Sinopec's consolidation was not as well-planned. The board of each Sinopec's four subsidiaries receiving tender offer hired its own independent financial advisor, with declaration on from independent directors that the proposed transaction is fair. Unfortunately, the financial advisor was hired by a board of Sinopec's directors. the Sinopec encountered most difficulty in the tender offer for Sinopec Shengli Oilfield. First, the legitimacy of Sinopec's ability to launch a tender offer was challenged for its initial holding of 26.33% of Shengli Oilfield shares. Second, there existed controversy over the disclosure on oil reserve, which is an important valuation indicator for firms in the oil/gas exploration business. Shares tendered in the first five, ten, and fifteen days were only 6.58%, 19.67%, and 32.04%; considerably low with the targeted repurchase ratio of 48.47%. In the tendering process, the independent directors also came out with a notice for the shareholders, recommending shareholders to tender their shares. Sinopec finally prevailed, announcing the success of its tender offer on April 4th. Shengli Oilfield was subsequently delisted on April 20th. Over the two-month event period, there was a 22% CAR for stock price of Shengli Oilfield.

III.Valuation Analysis

III.1 Economics of Mergers:

The focus of our paper, listing of a consolidated business group (整体上市), can be broadly categorized as a merger transaction[13]. Let firm A, T and AT be the acquiring, target, and combined firms, with values of V_A,V_T, and V_{AT} respectively. An important economic measure in such transaction is "synergy", which is the potential efficiency gain (or loss) resulting from the combination of acquiring and target firms:

$$\text{Synergy} = V_{AT} - V_A - V_B\,,$$

An estimate of synergy translates to estimates from reasonable prices paid by acquirers. Since (potential) additional value is created by combining two firms, an acquirer would be willing to pay price premium in order to gain corporate control over target firm. Presumably, the higher the amount of synergy, the higher the potential price premium, as the potential (net) value gain from this transaction to an acquirer would be:

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[13] Multiple theories have been proposed to explain the phenomenon of mergers. First, it is argued that mergers create efficiency gains (synergy) by combining operation of two separate firms. Second, it is possible that mergers are motivated by

$$\text{NPV} = \text{Synergy} + V_B - \text{Purchase Price},$$

In other words, merger could be a win-win transaction (for shareholders of both acquirer and target) based on an unbiased estimate of the synergy. It can also be seen that, there is no “one” adequate purchase price for the target firm, as there would be variation in the amount of synergy among acquirers.

The same economics can be applied to listing of a consolidated business group (整体上市). There are several characteristics which distinguish such transactions from typical mergers: (1) both the acquirer and target are operating in the same business group; (2) either acquirer or target is not publicly listed (in most cases); (3) the acquirer possess controlling stake over the target prior to the proposed consolidation. Other than the synergy created in common cases of vertical integration, additional value could be produced in such transaction (整体上市) in consideration of the unique history and regulation environment now present in the capital markets of China. The sources of synergy and the potential benefits accrued to the controlling shareholders are outlined as the following:

Consolidation of TCL Group (TCL集团):

Sources of synergy:

1. Inclusion of marginally profitable assets as publicly traded company.
2. Opportunities to raise capital given the financial constraint/condition of pre-merger of the parent/subsidiary.

Consolidation of Angang New Steel Company (鞍钢新轧钢股份)

Sources of synergy:

1. Inclusion of highly profitability assets as publicly traded company which (may) commands high market valuation.
2. Increased efficiency of vertical integration between Angang New Steel and New Steel Iron Inc.
3. Increased transparency of financial records due to the elimination of related party transactions, which (may) translate to higher market valuation.

4. Increased competitiveness within the steel industry, which is capital-intensive and is predicted to experience significant consolidation in the near future.

Benefits to the controlling shareholders:

1. Increase of ownership of Angang New Steel Company from 38.15% to 69.11%, a majority stake.
2. Establish market value of the assets of New Steel Iron Company.
3. Proportional increase of its ownership value of consolidated Angang New Steel from the increased operation efficiency and transparent financial records.

<u>Consolidation of China Petroleum & Chemical Group (中石化集团)</u>

Sources of Synergy:

1. Increased efficiency of vertical integration within the business group.
2. Increased balance of Sinopec's upstream/downstream oil/gas business.
3. Increased competitiveness within the oil/gas industry, which is scheduled to be open to international competitors such as Exxon-Mobile. Shell, and BP. Those international competitors are more efficient and profitable.

Benefits to the controlling shareholders:

1. Proportional increase of its ownership value of Sinopec's from the increased operation efficiency and transparent financial records.
2. Future capital gain by acquiring of (potentially) undervalued assets by cash.

It is important that now the wealth of the controlling shareholders is closely linked to the well-being of the firm. As a result, the large shareholders have strong incentive in initiating and engaging in value-maximizing transactions.

III.2 Did Sinopec Overpay or Underpay?

The restructuring transactions, though initiated by managers/controlling shareholders, have to be approved by or consented to by minority shareholders. Minority shareholders obviously benefit from such transactions since they are often offered a "premium", price in excess of the current market value, in selling their share ownership back to the controlling shareholders. It remains an open question whether the controlling shareholders overpay. I use the following numerical analysis in addressing the possibility of overpayment by large shareholders for the case of Sinopec's consolidation.

As illustrated in the following table, the total costs of the tender offer of minority shares is 1,4274.1 million RMB.

	Shares Tendered (in thousand)	Purchase Price	Cost of Repurchase (in million RMB)
Zhongyuan(中原油气)	255,000	12.12	3,090.6
Yangzi(扬子石化)	350,000	13.95	4,882.5
Shengli Oilfield(石油大明)	265,828	10.30	2,738.0
Qilu (齐鲁石化)	350,000	10.18	3,563.0
Total			14,274.1

Potential profits earned on acquired minority interest:

	Shares Tendered (in thousand)	EPS 2003-2005	Estimated EPS (average)	Additional Annual Earnings (in million RMB)
Zhongyuan (中原油气)	255,000	0.60(2003) 0.72(2004) 0.83(2005)	0.72	183.6
Yangzi (扬子石化)	350,000	0.71(2003) 2.01(2004) 1.33(2005)	1.35	472.5
Shengli Oilfield (石油大明)	265,828	0.26(2003) 0.33(2004) 0.81(2005)	0.47	124.94
Qilu (齐鲁石化)	350,000	0.39(2003) 0.70(2004) 0.95(2005)	0.68	238.00
Total				1,019.04

Assuming 1% increase (based on Sinopec's three-year average ROA of 14%), the expected annual earnings increase due to improved operating efficiency from vertical integration would be:

=(increase in ROA)* asset size= 14%*1%*520,572=728.8 million RMB

Cost of capital (weighted average cost of capital)=10%
Present value of increased earnings (assuming annuity)=17,478 million RMB

As a result, Sinopec still benefit by the difference 3,204 million RMB. The numerical exercise illustrate that the consolidation could create a win-win situation for both parties, and that Sinopec did not overpay.

Another numerical exercise examines the possibility of whether Sinopec underpay. We adopt the methodology used in Bates *et al.* (2005).

	CAR	α	MV	AMV
Zhongyuan (中原油气)	22%	26.33%	265,828,392	58482246.24
Yangzi (扬子石化)	1.06%	84.98%	350,000,000	3,710,000
Shengli Oilfield (石油大明)	12.63%	70.85%	255,000,000	32,206,500
Qilu (齐鲁石化)	7%	82.05%	350,000,000	24,500,000
Sinopec (中石化)\	4.55%	-	2,800,000,000	127,400,000

The total AMV for the four tender offers =184,827,057.56

Surplus to the target=57,427,057.56

An average fractional surplus for the four subsidiaries=31.07%

The average fractional surplus of 31.07% is comparable to the average of 31.58% minority shares. Consequently, Sinopec did not underpay either.

IV. Policy Recommendation and Conclusion

After reviewing in details the freezeout transactions and the legal protection on minority interests in the U.S. and the Chinese markets in the corporate restructuring process, I would like to provide the following observation, recommendations, and suggestions:

1. The reform on non-tradable shares (股权分置改革) is a great stride toward a modern and well-functioning capital market. Well-established corporate theories, as well as experiences in many other countries, would predict that managers/controlling shareholders would voluntarily engage in positive corporate policies and strategies in maximizing the market value of their firms. As the controlling shareholders would now be able to float their shares in the market, their own wealth is closely linked with the firm market value. These private incentives are much more powerful than regulations alone in producing positive behavior from the corporate insiders. As of now, the reform is still underway, and most of the non-tradable shares are in the lock-up period. I would like to urge the regulatory authority to continue with the efforts of reform, and not to impose any additional regulation to diminish the insider's ability to transfer their shares in the stock market. Otherwise the effectiveness of the reform would be diminished.

2. There are many pubic-listed firms with good assets and capable managers in the Chinese market. However, the efficiency of their financing activities and the innovation of their financing strategies are plagued by the same intensive and restrictive regulatory review intended to capture corporate dishonesty. The other unfortunate outcome is that some good-quality firms opt out of the domestic system, and seek financing from overseas market instead. I would encourage the regulatory authority to consider a review system which provides flexibility for firms with good corporate citizenship with a timely approval of their applications. For example, senior and experienced CSRC officials could be in charged with conducting rapid reviews on cases submitted by firms with no records of financing irregularities (The multi-tier system should be, of course, free of political influence).

3. There exist numerous layers of decision makers for state-owned companies (now still accounting for approximately 70% of the public market capitalization). Anecdotal evidences, as well as conversation with many professionals in the investment banking industry, indicate a lengthy approval process of various government agencies for restructuring proposals even at the corporate level. This lengthy decision-making process is problematic for firms to operate in capital markets. First, a timely execution is important for an efficient restructuring plan. Many market opportunities vanish quickly, and cannot await lengthy approval process through various government institutions. Second, it is hard to maintain confidentiality through a lengthy process in which various parties are involved. In all the cases discussed earlier in this report, there existed incidences in which there were "rumors" of impending corporate restructuring. Our CAR calculation clearly indicated positive price response to the corporate restructuring before the announcement date. It is well-know that capital market operates on "expectations". Without the undue information leak prior to the official announcement, Sinopec and PetroChina could have saved millions in their repurchase costs of the minority shares.

   If it is feasible, the influence of government ownership could be exerted through the corporate board. Delegated directors from various government agencies could all participate in the discussion and decision process at the same time, reaching unified corporate decision. Once the board reaches a decision, the case is ready for regulatory review and public announcement.

4. There remains improvement to be made in the general quality and extent of corporate disclosure, especially in the event of complicated corporate restructuring transactions. For example, there were controversies in Sinopec's tender offer of Sinopec Shengli Oilfield Company Limited, in which Shengli's oil reserve was not disclosed adequately to the market. There were controversies in relevant information disclosed in the IPO prospectus of TCL Group, which was

not discussed in details in the merger proposal to TCL Communication shareholders released earlier. Corporate disclosure is an important communication vehicle in the capital market, and should be addressed with care. First, it is important that the information disclosed is accurate. A well-functioning capital market builds on an integral and capable accounting profession, with well-articulated accounting rules/principles. Second, it is important that investors have access to value-relevant information, unless the information is sensitive and should be maintained confidential for strategic reason. In the case of tender offer for shares of Shengli Oilfield Company, information of oil reserve is disclosed regularly in the international markets, and should be available promptly upon request from investors. Sinopec should also issue amendments to various documents with inclusion of such information. Finally, a good portion of corporate disclosure remains voluntary, and it is cumbersome to regulate the comprehensiveness of corporate disclosure. In my opinion, economic incentives from various market participants are still the best way for the market to reach a good solution. The following is an example in the US market on how good corporate disclosure is valued by the market (but not regulated):

The quality of disclosure is related to the amount of information disclosed, the level of details provided, and the timelines of the information. The Association of Investment Management and Research (AIMR) in the U.S. publishes its scores of disclosure quality which measures the overall informativeness of a firm's disclosure. Each year, the AIMR forms industry-based committee, composed of leading analysts to undertake comprehensive evaluation of disclosure quality for a subset of firms in a selected number of industry. The committees use a common checklist to guide their evaluation, and modify or augment the check list if needed. The final results of the evaluation is a numerical score representing the overall quality of firm's disclosure quality throughout the year, which is aggregated by the three categories: (1) the annual report and other required published information, (2) the quarterly report and non-required published information, and (3) investor relations and related activities. It has been reported that firms with more informative disclosure policy (high AIMR disclosure scores) have a larger analyst following, reduced estimation risk, lower information asymmetry, and lower cost of capital (Brown and Hillegeist, 2003; Lang and Lundholm, 1996).

5. How investors are protected by law from expropriation by managers and large shareholders is important in evaluating corporate governance across markets (Lopez-de-Silanes, Shleifer, and Vishny, 2000). The legal protection of minority share interest is clearly not sufficient. First, the legal consequence on controlling shareholders' tunneling activities should be clear, and the legal implementation should be prompt and effective. In freeze-out transactions, there have been no active and major roles played by the independent directors in representing the minority shareholders in negotiating with the controlling shareholders. I would suggest a practice similar to what is used in the U.S., of which a special committee consisting of independent directors is charged with the responsibility of hiring financial and legal advisor in evaluating merger/tender offer from the parent firm/controlling shareholders. It is also very important to have an effective judicial system, where corporations and investors could resolve disputes. Legal penalties imposed by the judicial system are the ultimate economic disincentive for controlling shareholders to engage in expropriating minority share interest. Judgments from legal system serve as the benchmark by which market participants know when the board directors have failed their fiduciary responsibilities.

6. Good institutions are essential for the development of a well-functioning capital markets. Professionals and institutional investors are quickly emerging in the Chinese market. I would encourage the regulatory authority to consider further opening of China market for international/domestic fund industry. The international fund industry not only would bring in fresh capital, but also introduce competition, demand, and good practices to the Chinese market. Institutions, equipped with their professional knowledge and large capital, would be able to exert pressure on corporations for better governance and disclosure.

Good institutions also have incentive to develop their reputation capital, as they would conduct repeated business over time in the market. Such need to develop reputation capital prevents business entity from engaging in short-term and opportunistic activities. Good institutions, in certain aspects, could alleviate the burden of intensive regulatory monitoring.

Figure 1: Cumulative Abnormal Return of TCL Communication (SZ 000542)

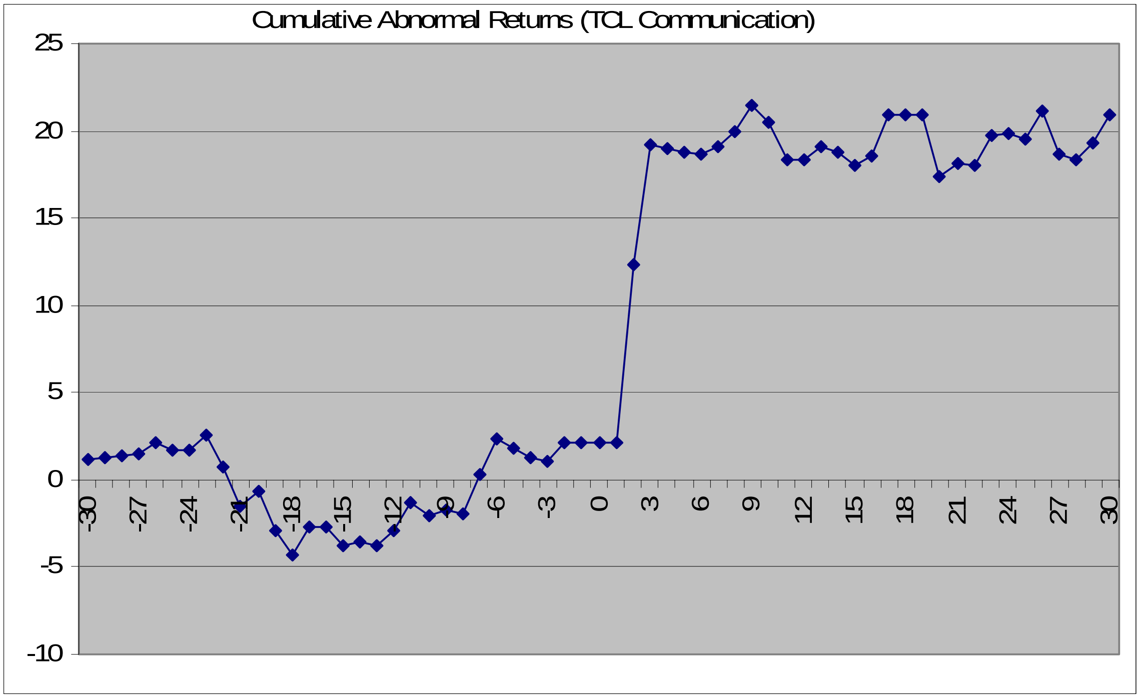


Table 1 Consolidation of TCL Group (TCL 集团)

	Acquirer		Target
Business Entity	TCL Group (TCL 集团)	TCL Group (noncosolidated)	TCL Communication (TCL 通讯)
Asset Size (6/30/2003)	17,192,800,000	14,790,043,000	5,559,080,000
Leverage (12/31/2003)	10,199,940,000	10,199,940,000	3,660,090,000
Revenue (9/30/2003)	12,705,680,000	12,705,680,000	5,257,750,000
Net Income (9/30/2003)	343,040,000	280,170,000	145,180,000
ROA	2.92%	3.99%	5.62%
Firm Status	IPO (pending)	Private	Public (A Shares to be delisted)
Ultimate Controller			TCL 集团
Ownership before	-	-	56.70%
Ownership after	-	-	100%
Synergy	Increased outside financing.		
Valuation	21.15 RMB per share, equivalent to a 15% premium over 30-day price average of TCL Communication		
Deal Structure	Freeze-out, IPO, exchange offer (换股吸收合并) One share of TCL Communication for 4.965 IPO shares of TCL Group		
Deal Size	Proceed of 2,513,400,000 RMB		
Expense	Underwriting fees of 72,768,000 RMB; auditing fees of 7,730,000; legal fees of 4,000,000; other fees of 9,298,508.		
Announcement Date	2003/9/30		
Regulation	The Regulation on Acquisition of Publicly Listed Firms (上市公司收购管理办法)		
Special Committee Recommendation	Yes (独立董事意见书)		
Shareholder's votes	Yes		
CAR [-30,30]	20.88%		

Table 2 Consolidation of Angang New Steel Company

	Target	Acquirer	Combined Firm
Business Entity	New Steel Company (新钢铁有限责任公司)	Angang New Steel Company (鞍钢新轧钢股份) Before Acquisition	Angang New Steel Company (鞍钢新轧钢股份) After Acquisition (Pro Forma)*
Asset Size	31,363,108,000	14,755,331,000	50,513,450,000
Leverage	3,493,576,000	4,2881,550,000	27,703,880,000
Revenue	39,353,882,000	23,227,617,000	-
Net Income	5,812,638,000	1,776,337,000	5,167,880,000
ROE		11.68%	22.34%
Operating Cash Flows	5,574,889,000	1,594,803,000	-
Gross Margin	-	15.13%	34.67%
Earnings Per Share	-	0.60	0.87
Book Value Per Share	-	3.53	3.80
Related-Party Transaction	16,887,640,000 (cost of good sold) 2,345,230,000 (sales)	-	-
Firm Status	Private	Public	
Ultimate Controller	鞍钢集团	鞍钢集团	鞍钢集团
Ownership before	100%	38.15%	-
Ownership after	0%	-	69.11%
Synergy	Increase vertical integration, reduce related party transactions		
Valuation	RMB 4.29 per share (20-day price average) of Angang New Steel.		
Deal Structure	Asset Infusion, Private Placement(定向增发合并) Issuance of 2,970,000,000 stocks and debt in exchange of assets valued at 12,741,300,000 RMB		
Deal Size	12,741,300,000 RMB		
Announcement Date	2006/2/6		
Regulation	《关于上市公司重大购买、出售、置换资产若干问题的通知》		
Special Committee Recommendation	NA		
Shareholder's votes	Yes		
CAR [-30,30]	24.68%		

* estimates given in the company's Report of Major Asset Acquisition

Figure 2: Cumulative Abnormal Return of Angang New Steel Company (SZ 000898)

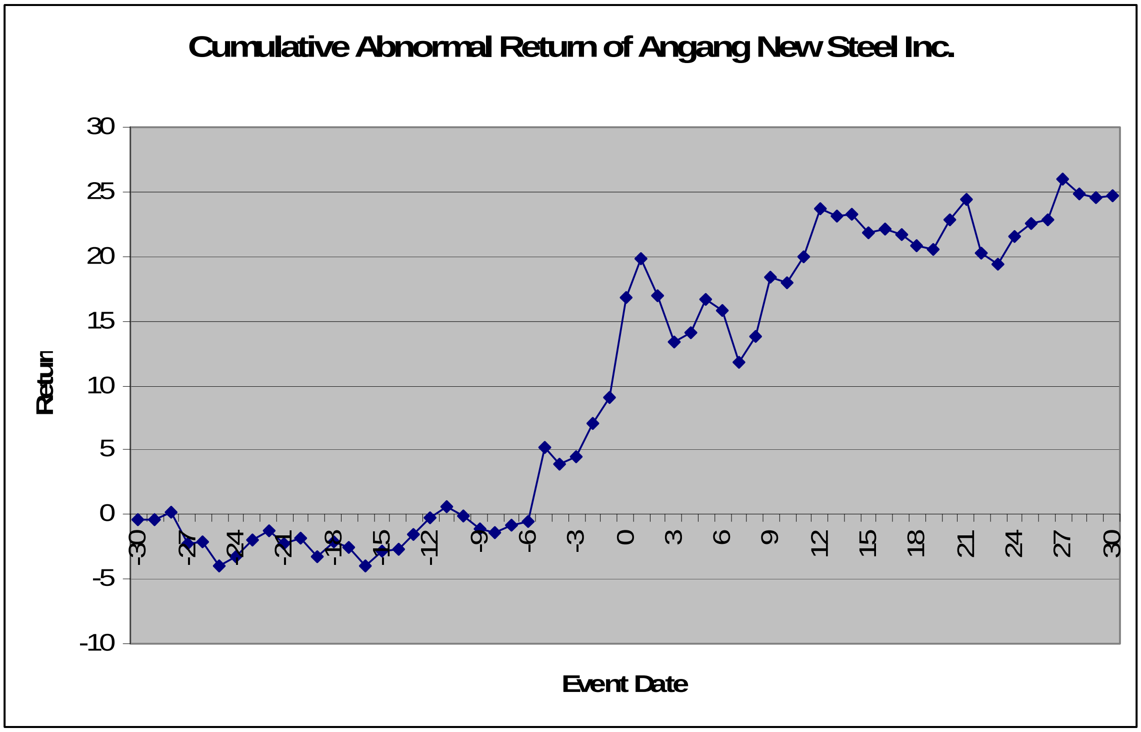


Figure 3-1 Price Trend of International Crude

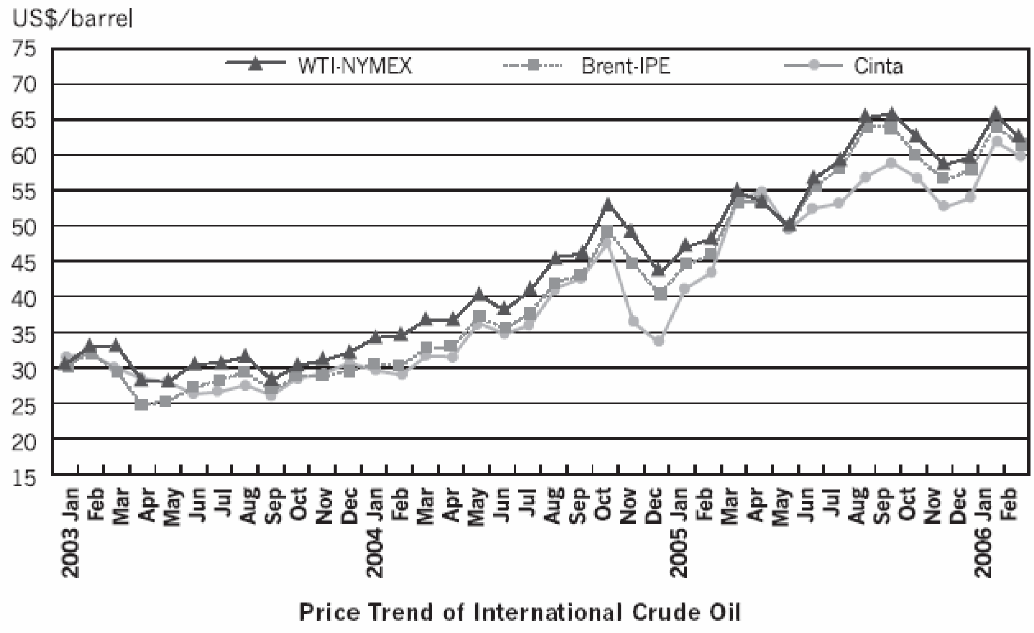


Figure 3-2 Difference of International and Domestic Prices of Gasoline

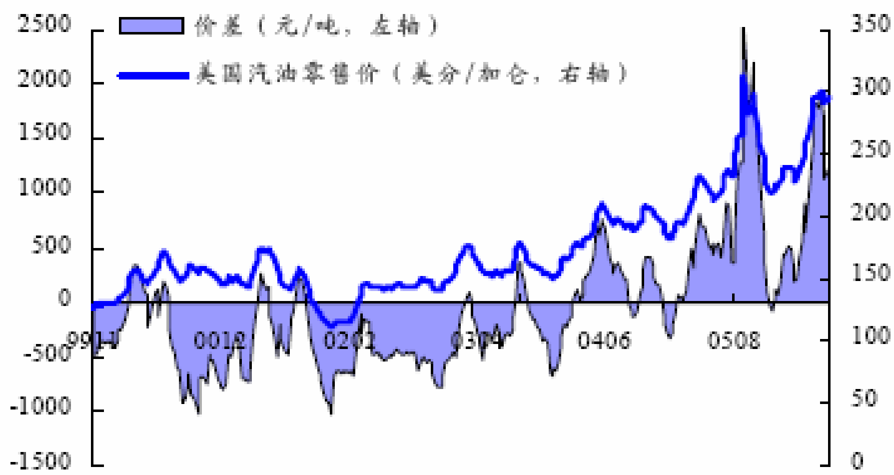
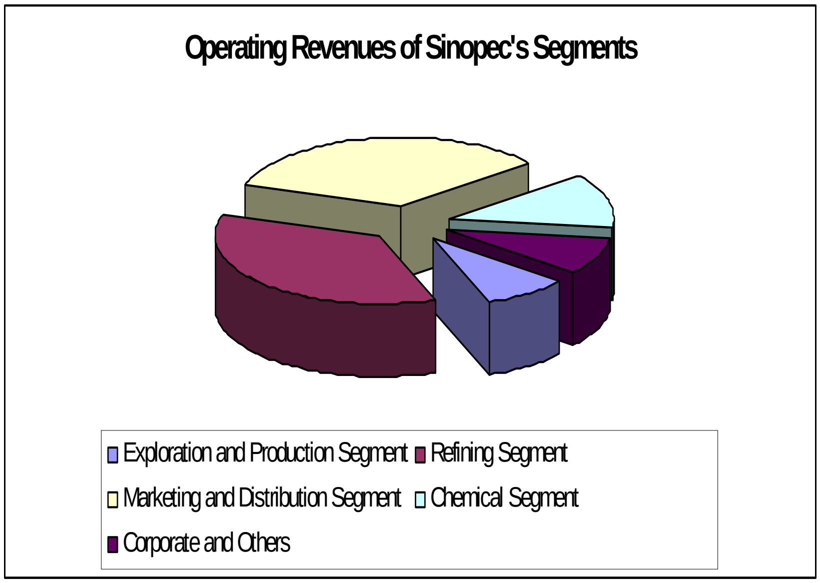


Table 3-1: Comparison of Three Major Petroleum/Gas Companies in China

	Sinopec	PetroChina	China Oilfield Service
Proved Developed and Undeveloped Reserves			
Crude Oil (million of barrels)	3,294	11,536	1,456
Natural Gas (billion cubic feet)	2,952	48,123	5,431
Combined (million barrel equivalent)	3,786	19,557	2,361
Reserve (barrel equivalent) per share	0.04	0.11	0.06
Production Capacity			
Crude Oil Output (million of barrels)	279	823	130
Natural Gas Output (billion cubic feet)	222	1,120	142
Combined (million barrel equivalent)	316	1,010	155
Crude Oil Refinery	1,029	752	
Gasoline	23	21.4	
Kerosene	6.6	2	
Diesel	54.9	43	
Reserve/Production			
Crude Oil	11.81	14.02	11.18
Natural Gas	13.3	42.99	38.19
Combined	11.99	19.37	15.25

Figure 3-3 Operating Revenues and Profits of Sinopec's Segments



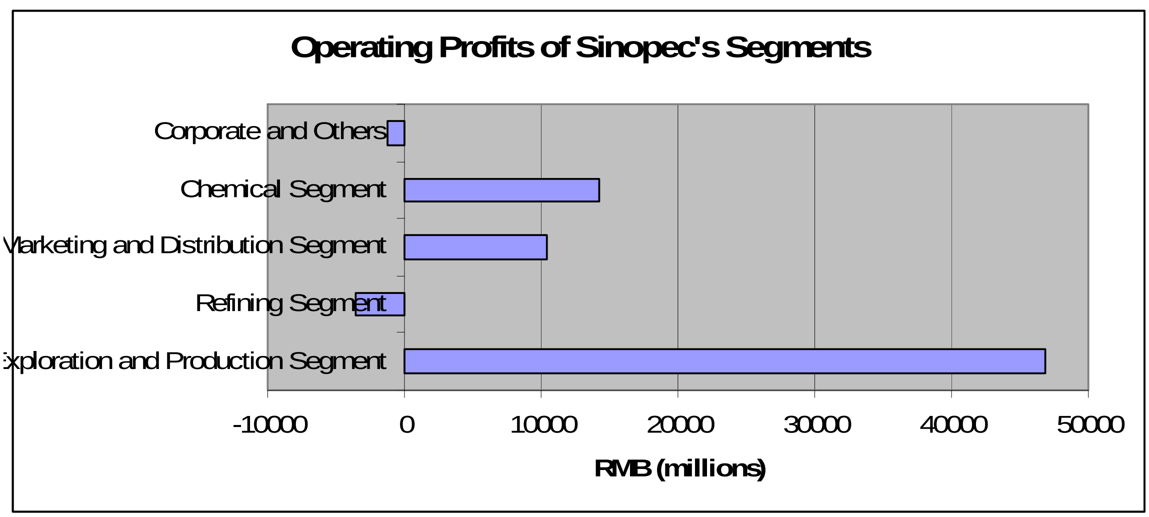


Table 3-2 List of Sinopec's Subsidiary Firms

Subsidiary Firm	Sinopec's Holding	Asset	Industry
Sinopec Zhongyuan Petroleum Company Limited (中原石油化工有限责任公司)			Chemical
Sinopec (Jiangsu) Petroleum Company Limited 中石化壳牌(江苏)石油销售有限公司	60%	735	Retail
Sinopec Kantors Holdings Limited 中石化冠德控股有限公司	72.40%	2,837	
BP Sinopec (Zhejiang) Petroleum Company Limited 中石化碧辟(浙江)石油有限公司	60%	725	Retail
Sinopec Zhongyuan Petroleum Company Limited (中国石化中原油气高新股份有限公司, 000956)	70.85%		
Sinopec Zhenhai Refining and Chemical Company Limited (中国石化镇海炼油化工股份有限公司)	71.32%		
Sinopec Yizheng Chemical Fibre Company Limited 中国石化仪征化纤股份有限公司	42%	9,985	
Sinopec Yangzi Petrochemical Company Limited (中国石化扬子石油化工股份有限公司, 000866)	84.98%		
Sinopec Sales Company Limited 中国石化销售有限公司	100%		
Sinopec Wuhan Petroleum Group Company Limited (中国石化武汉石油集团股份有限公司)	46.25%	635	Retail
Sinopec Wuhan Phoenix Company Limited (中国石化武汉凤凰股份有限公司)	40.72%	1,396	Refinery, chemical
Sinopec Shijazhuang Refining Chemical Company Limited (中国石化石家庄炼油化工股份有限公司, 000783)	79.73%		Refinery, chemical
Sinopec Shengli Oilfield Company Limited (中国石化胜利油田有限公司,000406)	100%	52,734	Oil and gas exploration
Sinopec Shanghai Petrochemical Company Limited (中国石化上海石油化工股份有限公司, 600688)	55.56%	27,102	
Sinopec Qingdao Refining and Chemical Co., Ltd. 中国石化青岛炼油化工有限责任公司	85%	969	Refinery and chemical
Sinopec Qilu Petrochemical Company Limited. (中国石化齐鲁股份有限公司, 600002)	82.05%		Chemical
China Petrochemical International Company Limited (中国石化国际事业有限公司)	100%		Trade
Sinopec Fujian Petrochemical Company Limited (中国石化福建炼油化工有限公司)	50%	4,226	Refinery and chemical
Sinopec Bejing Yanshan Petrochemical Company Limited (中国石化北京燕山石油化工有限公司)	100%	11,498	Chemical

Table 3-3 Sinopec’s and PetroChina’s Subsidiary Firms Sorted by Manufacturing Process

<table>
<tr><th></th><th>Sinopec</th><th>PetroChina</th></tr>
<tr><td>Upstream

(Exploration, Development, Production of Oil and gas)</td><td>Sinopec Zhongyuan Petroleum Company Limited (中国石化中原油气高新股份有限公司, 000956)

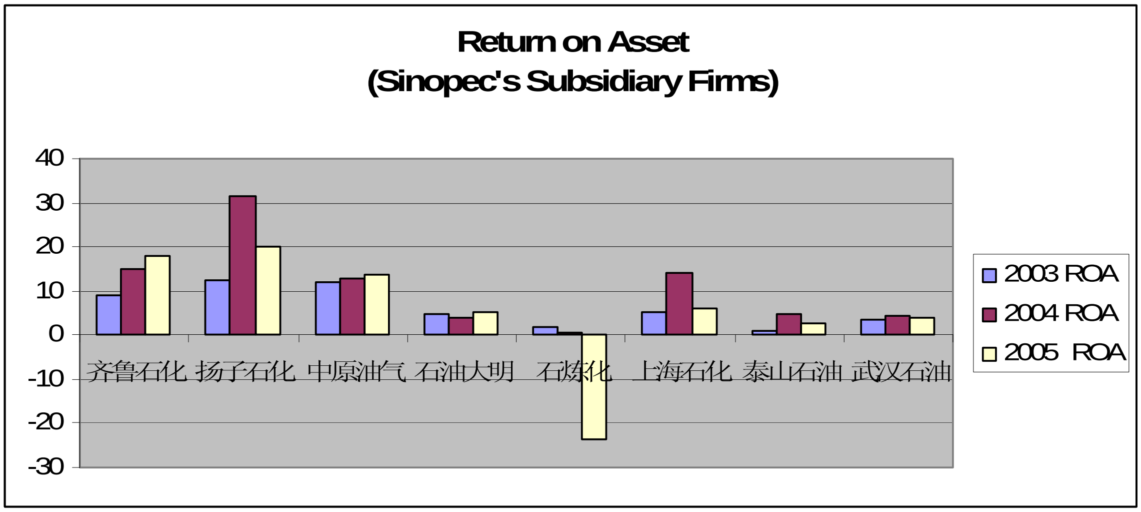
Sinopec Shengli Oilfield Company Limited (中国石化胜利油田有限公司,000406)</td><td>Liaohe Jinma Oilfield Compnay Limited.</td></tr>
<tr><td>Downstream
(Refining and Supply, Fuels Marketing, and Lubricants)</td><td rowspan="2">Sinopec Zhenhai Refining and Chemical Company Limited (中国石化镇海炼油化工股份有限公司)

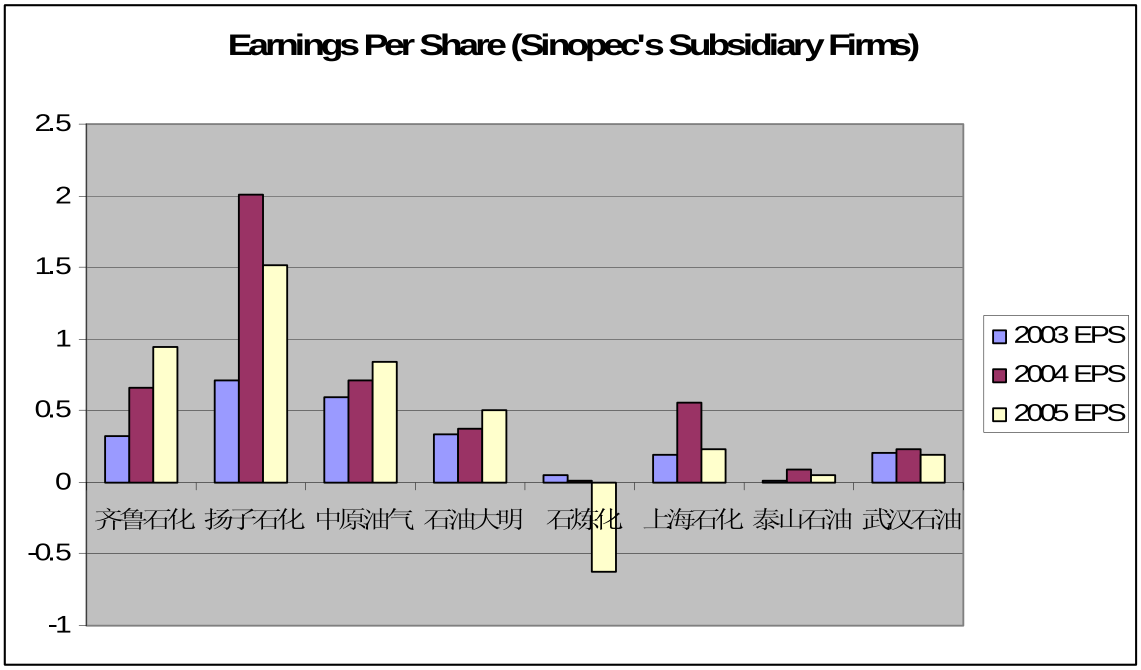
Sinopec Shijiazhuang Refining Chemical Company Limited (中国石化石家庄炼油化工股份有限公司)

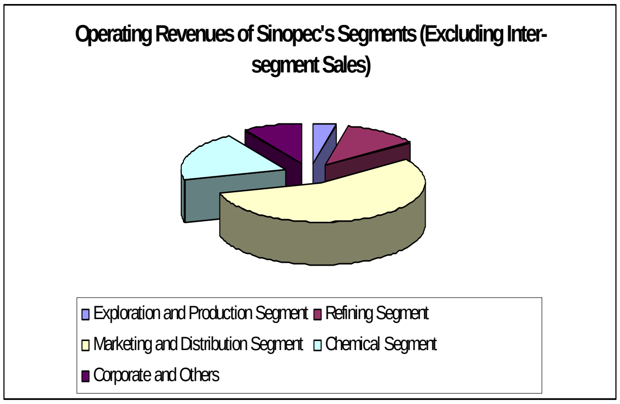
Sinopec Yangzi Petrochemical Company Limited (中国石化扬子石油化工股份有限公司)
Sinopec Qilu Petrochemical Company Limited. (中国石化齐鲁股份有限公司)
Sinopec Bejing Yanshan Petrochemical Company Limited (中国石化北京燕山石油化工有限公司)

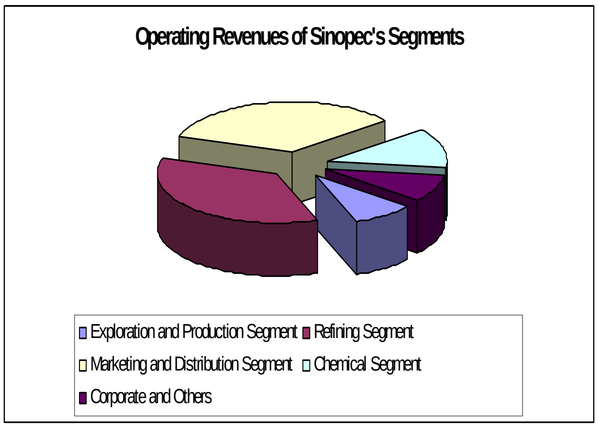
Sinopec Yizheng Chemical Fibre Company Limited 中国石化仪征化纤股份有限公司

Sinopec Shanghai Petrochemical Company Limited (中国石化上海石油化工股份有限公司, 600688)</td><td>Jinzhou Petrochemical Co., Ltd.</td></tr>
<tr><td>Chemicals</td><td>Jilin Chemical Industrial Company Limited.</td></tr>
</table>


Return on Asset
(Sinopec's Subsidiary Firms)
40
30
20
10
0
-10
-20
-30
齐鲁石化
扬子石化
中原油气
石油大明
石炼化
上海石化
泰山石油
武汉石油
2003 ROA
2004 ROA
2005 ROA


Earnings Per Share (Sinopec's Subsidiary Firms)
2.5
2
1.5
1
0.5
0
-0.5
-1
齐鲁石化
扬子石化
中原油气
石油大明
石炼化
上海石化
泰山石油
武汉石油
2003 EPS
2004 EPS
2005 EPS


Operating Revenues of Sinopec's Segments (Excluding Inter-segment Sales)
Exploration and Production Segment
Refining Segment
Marketing and Distribution Segment
Chemical Segment
Corporate and Others


Operating Revenues of Sinopec's Segments
Exploration and Production Segment
Refining Segment
Marketing and Distribution Segment
Chemical Segment
Corporate and Others

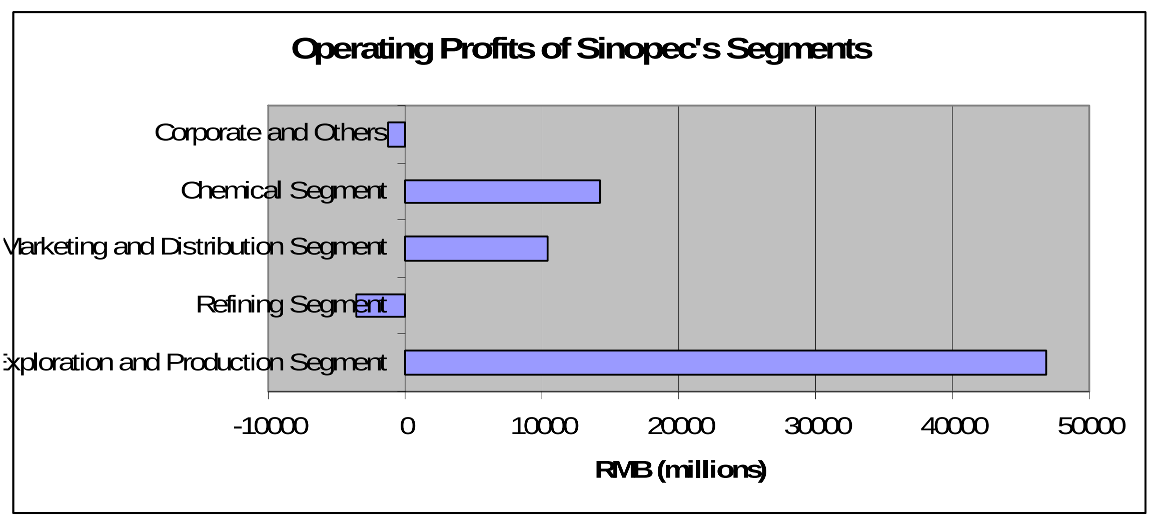

Operating Profits of Sinopec's Segments
Corporate and Others
Chemical Segment
Marketing and Distribution Segment
Refining Segment
Exploration and Production Segment
-10000
0
10000
20000
30000
40000
50000
RMB (millions)

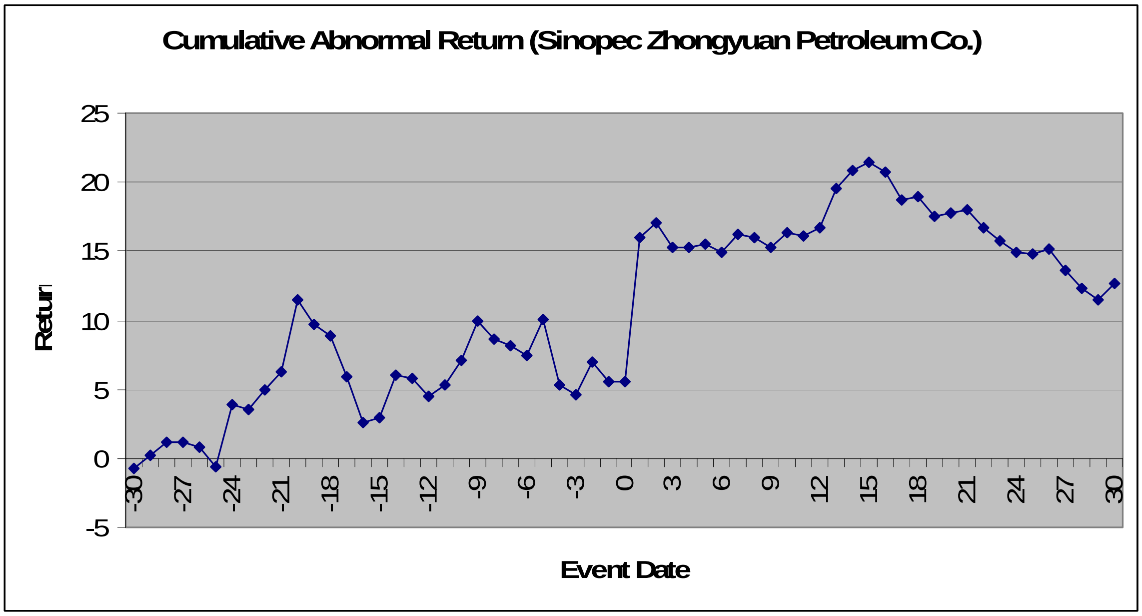
Table 3-4 Sinopec's Tender Offers for its Four Subsidiaries

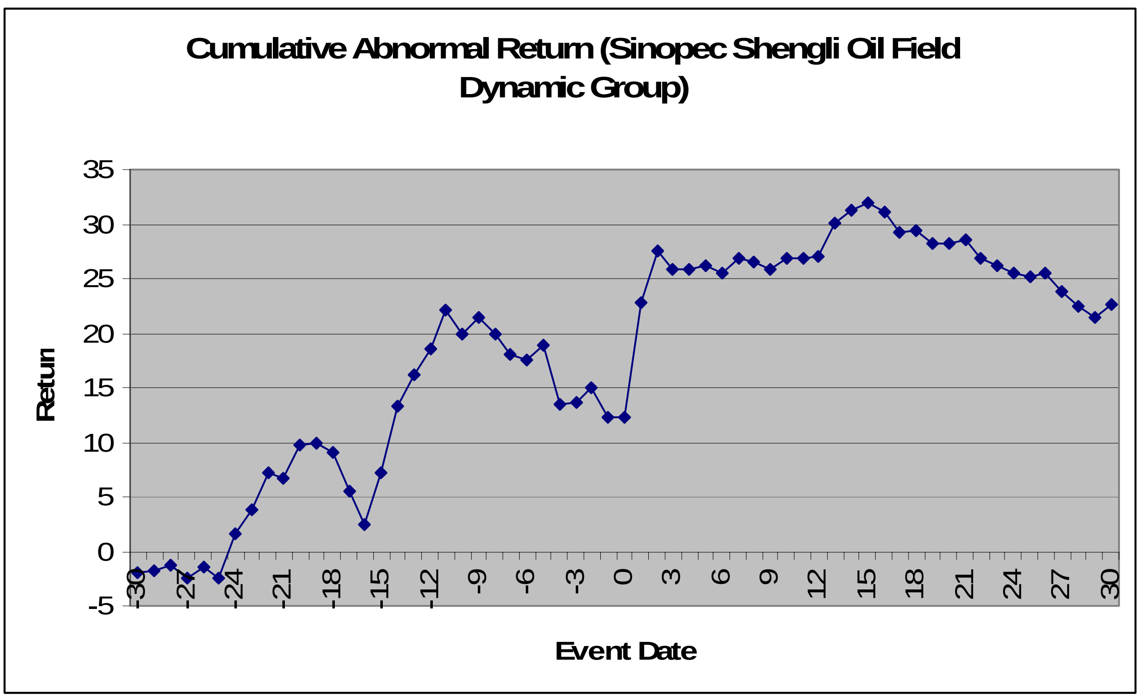
	Zhongyuan (中原油气)	Yangzi (扬子石化)	Shengli Oilfield (石油大明)	Qilu (齐鲁石化)
Tender price	12.12	13.95	10.30	10.18
Premium over Market price	13.17% (5 –days average) 15.14% (1-mon average) 36.44%(3-mon average) 51.86% (6-mon average)	23.06% (5 –days average) 19.31% (1-mon average) 28.50% (3-mon average) 36.64% (6-mon average)	16.91% (5 –days average) 17.39% (1-mon average) 43.80% (3-mon average) 58.22% (6-mon average)	21.97% (5 –days average) 18.05% (1-mon average) 28.34% (3-mon average) 38.63% (6-mon average)
Tender shares (in thousands)	255,000	350,000	265,828	350,000
% of shares outstanding	29.15%	15.02%		17.95%
Initial holding by Sinopec	70.85%	84.98%	26.33%	82.05%
Time period	3/8-4/6			
CAR[-30,30]	12.63%	1.06%	22%	7%

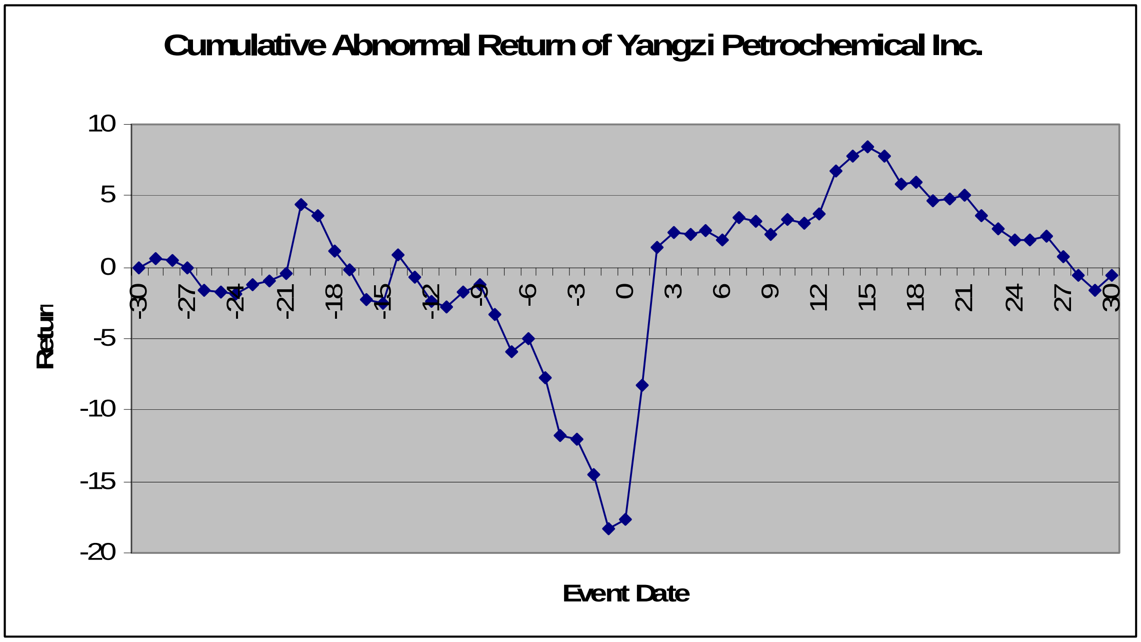
Table 3-5 PetroChina's Tender Offers for its Four Subsidiaries

	Liaohe Jinma Oilfield	Jinzhou Petrochemical	Jilin Chemical Industrial
Tender price	8.80	4.25	5.25
Premium over Market price	18.76% (5 –days average) 26.07% (1-mon average) 26.80%(3-mon average) 33.94% (6-mon average)	10.10% (5 –days average) 15.80% (1-mon average) 22.83% (3-mon average) 35.78% (6-mon average)	6.92% (5 –days average) 14.38% (1-mon average) 14.38% (3-mon average) 24.11% (6-mon average)
Tender shares (in thousands)	200,000	150,000	265,828
% of shares outstanding	18.18%	19.05%	H Shares: A Shares:
Initial holding by Chinapec	81.82%	80.95%	67.29%
	11/15-12/14		
Related party transactions		(rev)	
CAR[-30,30]	25.85%	24.74%	29.92%

Figure 3-5 Cumulative Abnormal Returns for Sinopec's Tender Offers






Cumulative Abnormal Return of Yangzi Petrochemical Inc.
Return
Event Date

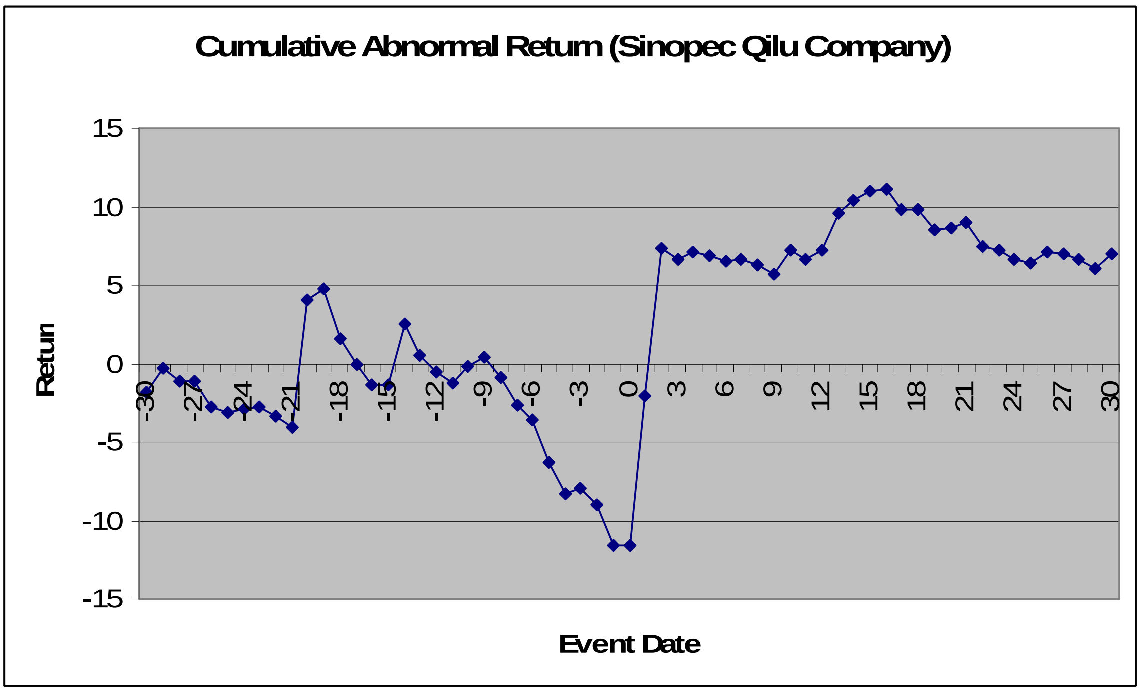
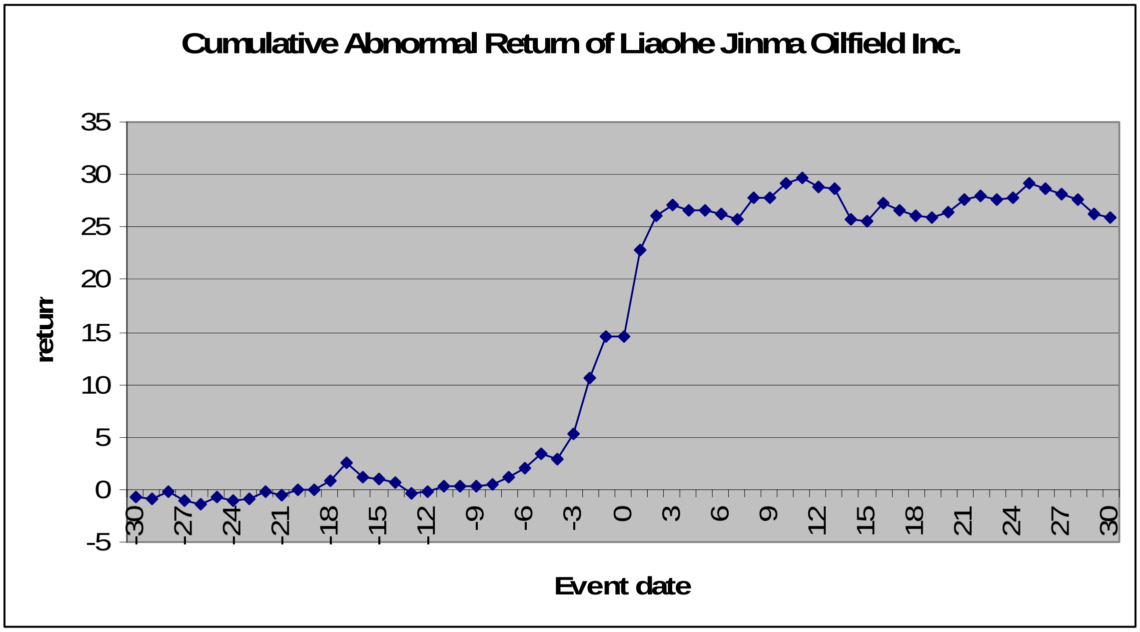
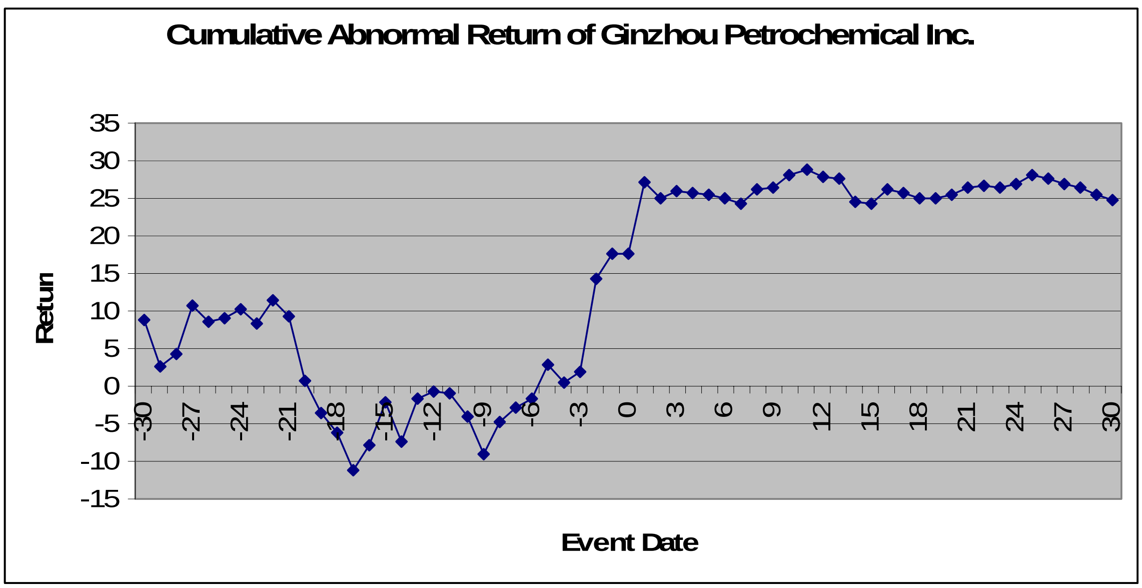
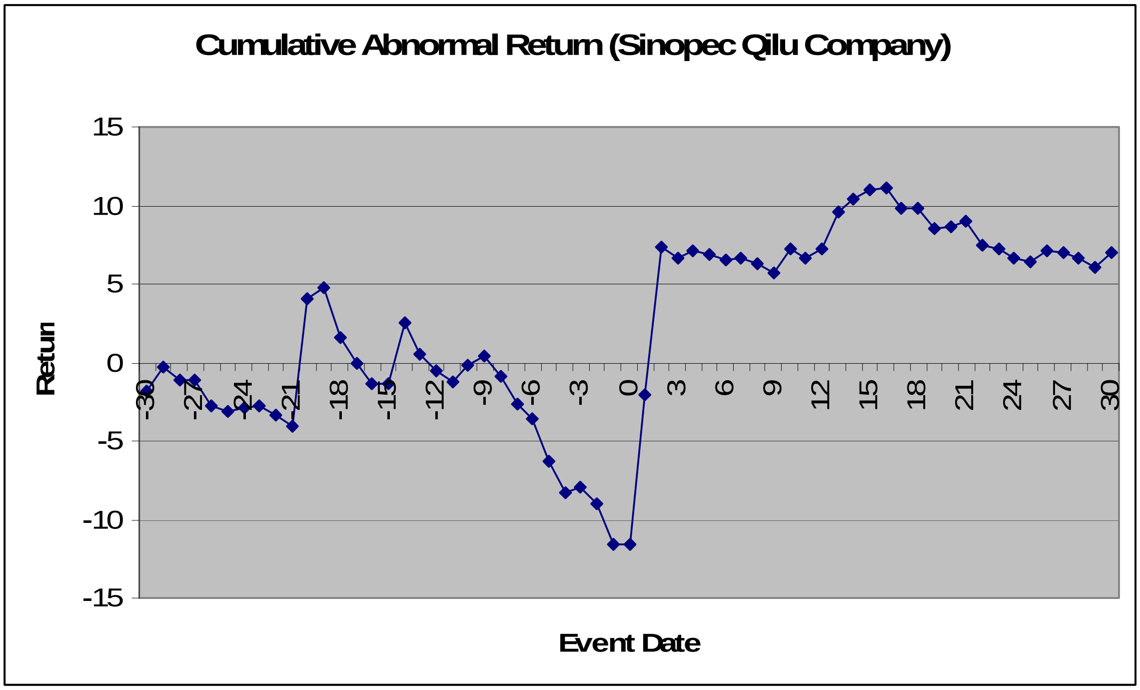
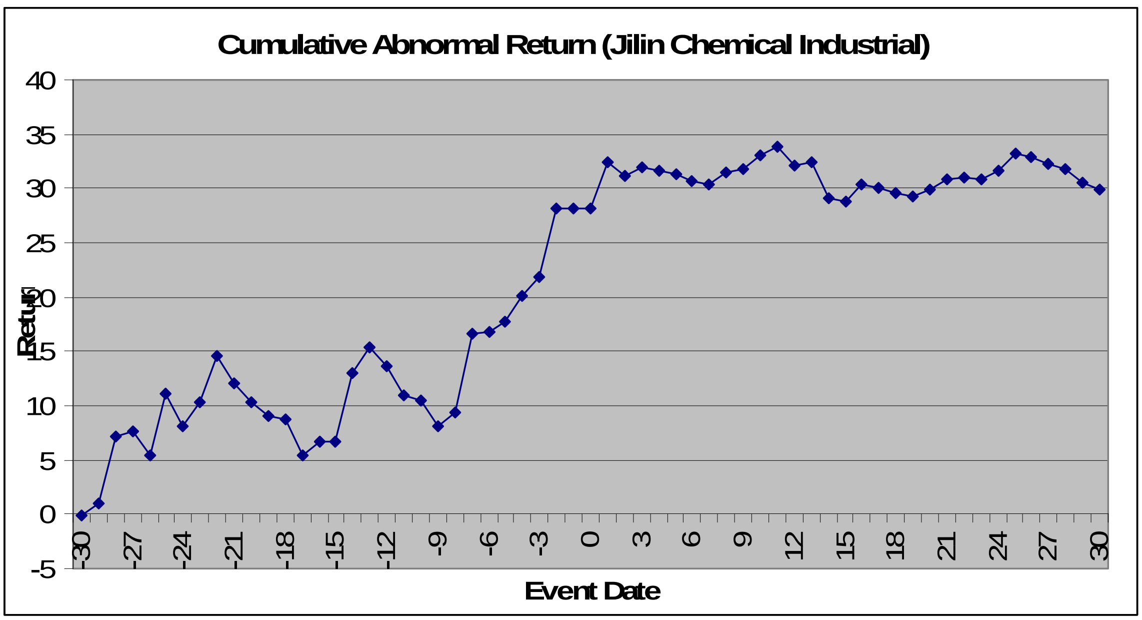

Cumulative Abnormal Return (Sinopec Qilu Company)
Return
Event Date

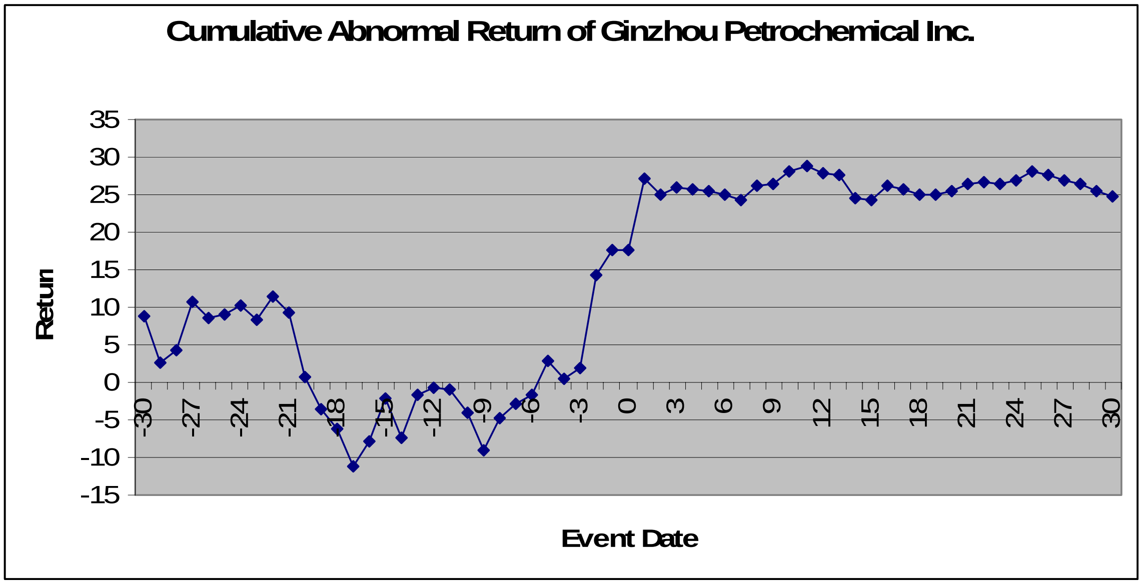
Figure 3-6 Cumulative Abnormal Returns for PetroChina's Tender Offers

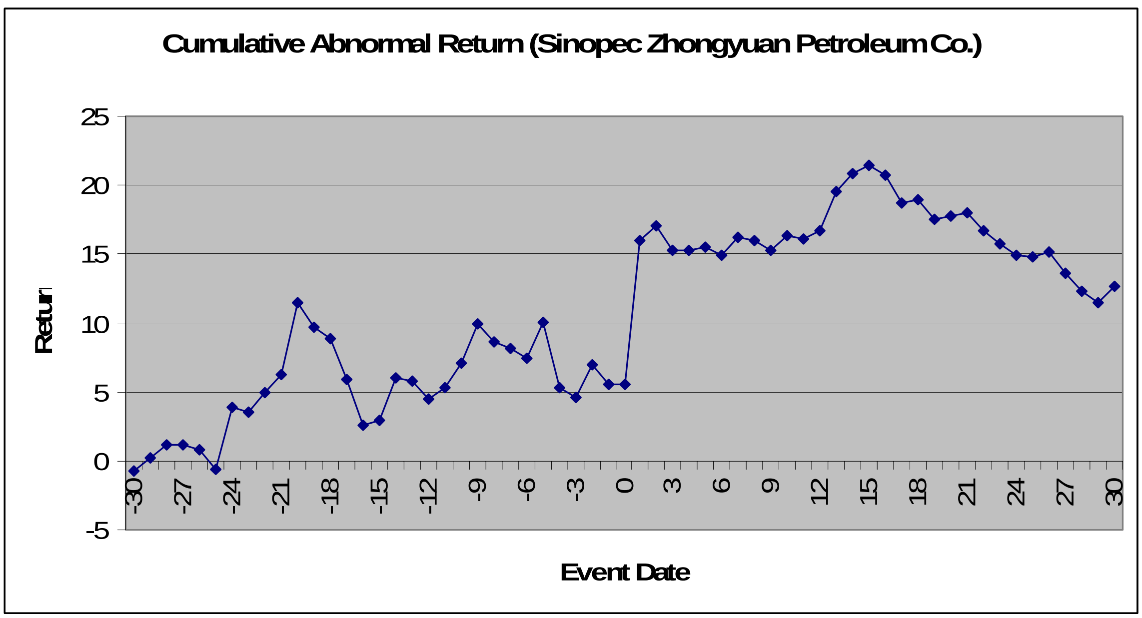


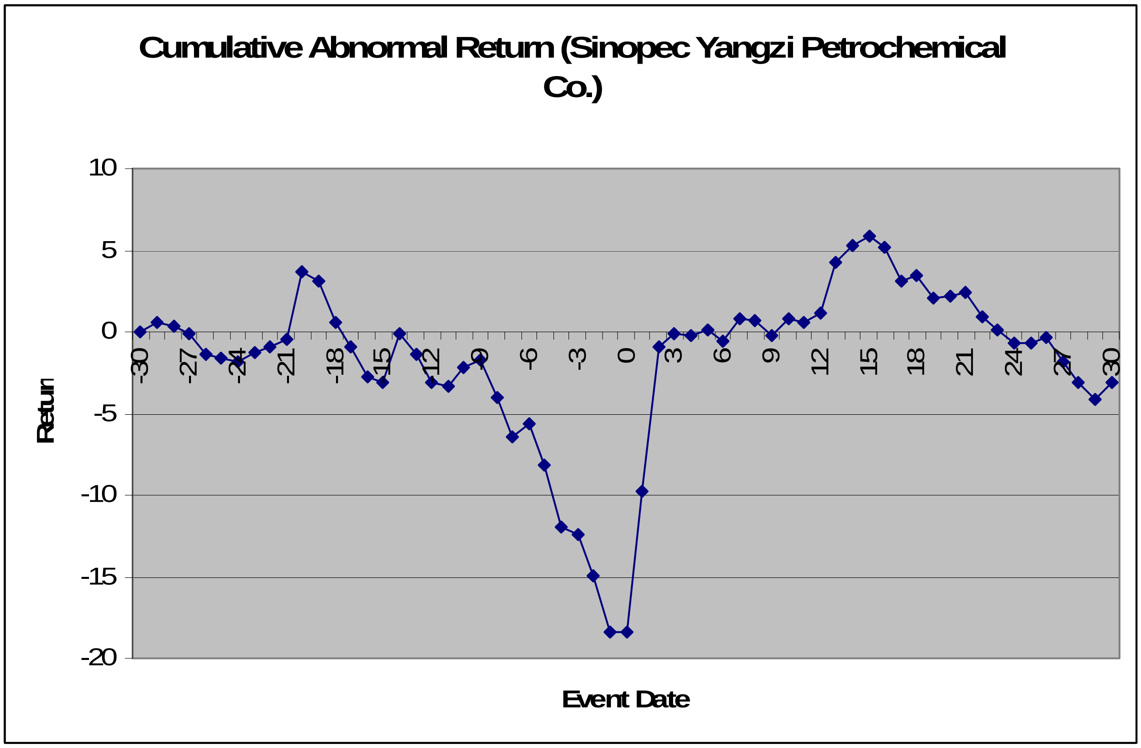



Cumulative Abnormal Return (Sinopec Qilu Company)
Return
Event Date


Cumulative Abnormal Return (Jilin Chemical Industrial)
Return
Event Date


Cumulative Abnormal Return of Ginzhou Petrochemical Inc.
Return
Event Date
35
30
25
20
15
10
5
0
-5
-10
-15
-30
-27
-24
-21
-18
-15
-12
-9
-6
-3
0
3
6
9
12
15
18
21
24
27
30


Cumulative Abnormal Return (Sinopec Zhongyuan Petroleum Co.)
Return
Event Date
25
20
15
10
5
0
-5
-30
-27
-24
-21
-18
-15
-12
-9
-6
-3
0
3
6
9
12
15
18
21
24
27
30


Cumulative Abnormal Return (Sinopec Yangzi Petrochemical Co.)
10
5
0
-5
-10
-15
-20
Return
-30
-27
-24
-21
-18
-15
-12
-9
-6
-3
0
3
6
9
12
15
18
21
24
27
30
Event Date

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