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Background

We continue to hear critics complain about large Chinese SOEs, with most of the charges centred around lack of transparency and/ or lack of progress in privatisation. However, it has been our experience that when confronted with push back very few people seemed to have much data to argue their. This independent research has been written tracks the progress made since Q4 2020 on six of the larger, more visible mixed-hybrid reforms, four which involved public markets and two major domestic mergers-which will likely result in large IPOs . It should be noted that this progress has been achieved in very turbulent Chinese equity markets and international political uncertainty.

While China had completed than 4,000 cases of mixed-ownership reform with more than RMB 1.5 trillion of non-State capital involved during the period 2013-2020*(1)*; in H2 2020, China undertook moves to upsize these to larger SOEs both to sharpen competitiveness and spur longer term growth by injecting these SOEs with private capital. Specific H2 2020 measures included:

- Major SOEs will be encouraged to sell significant stakes to outside strategic partners during a three-year action plan for SOE mixed-ownership reform
- Launched a "big ticket" national fund, with initial capital of RMB 70.7 billion, raised from 20 shareholders to facilitate such reforms. China Chengtong Holdings Group Ltd, a State-owned asset-operating company, is leading the fund (under SASAC)

<u>Q4 2020</u>

China Southern Airlines – multiple group company reforms

China Southern Airlines General Aviation (CSAGA) is a leading general aviation company and 2nd largest flight operator in the offshore oil and gas industry The company, based in Zhuhai, operates 25 general aircraft and four marine producing bases. In May 2019, CSAGA was listed in the fourth batch of pilot enterprises for "Mixed Ownership Reform in Key Fields" by the National Development and Reform Commission (NDRC).

In November 2020, CSAGA the air cargo unit of China Southern Airlines (SSE listed), started its mixed-ownership reform (parent started its mixed-reform in 2019) formally implemented the mixed ownership by adding three new investors which in turn implemented employee shareholding.

On the same day, China Southern Airlines officially signed a contract with three investment entities, an ESOP platform, and China Southern Airlines at the Beijing Equity Exchange. After the completion of the mixed reform, CSAGA registered capital increased from RMB 1 billion ($153.9 million) to RMB 1.34 billion adding three new investors; SOE Reform Development Fund Management Co Ltd (14.1%), China Southern Power Grid Industrial Investment Group Co Ltd (10%), China Southern Airlines Capital (10%) and a Zhuhai company (8%) as well as the employee ESOP. China Southern Group still owns 57.9%, but now has both external capital and Board members.

(1) Source: SASAC- The State-owned Assets Supervision and Administration Commission of the State Council is a special commission of the PRC, directly under the State Council.

In December 2020, Hidden Hill Capital, a subsidiary of GLP (Singapore) announced it had made a RMB 745 million (circa $114million) investment in China Southern Airlines Cargo Logistics, the cargo subsidiary of China Southern Airlines. China Southern Airlines Logistics provides cargo services to 243 destinations in 44 countries and regions through more than 3,000 flights a day. China Southern Airlines sought out private and foreign investment for its cargo business as part of its mixed-ownership reform pilot *(2).*

Xugong Group Construction Machinery Co Ltd

Xugong Group Construction Machinery Co., Ltd. (Xugong) is a core business of the Xuzhou Construction Machinery Group Co., Ltd (XCMG). Xugong is a SOE reform "double-hundred enterprise", the first batch of mixed-ownership reform pilot enterprises in Jiangsu Province. It ranks No. 1 in the domestic industry, No. 3 in the global industry, No. 4 in China's top 100 machinery industry and No. 409 in the world's top 500 brands.

XCMG's route to mixed-ownership took 15 years. Since its founding in 1989, it had been previously owned by the city government of Xuzhou. In 2005, Carlyle Group agreed to purchase an 85% stake for $375 million in cash. However the proposed deal was blocked for numerous reasons. Carlyle made several attempts to restructure the deal before it was finally abandoned in 2008.

In July 2020, Xugong was officially announced as a mixed- ownership state run enterprise. The announcement stated that the company will introduce strategic investors through stock transfers and capital increase, which still left the provincial government with 51%. Strategic investors and employee stock ownership platforms (2%) will hold 49%. Several sources quoted major western investors including BlackRock, Harvest, Vanguard, the Florida State Board of Administration and Norges Bank Investment Management acquired a (combined) 9% stake.

On 15 December 2020, Xugong announced the sale of a 10.5% stake to GIC (Singapore) and CITIC Private equity for $2.25 billion. The GIC/CITIC deal would make the two Xugong's single biggest shareholder among a dozen new investors (not yet named), which will own a total of 46%.

Xugong will then inject $2.1 billion in assets into Shenzhen listed XCMG - of which it owns 38% - which recorded 2019 revenues of $2.4 billion. Xugong will be dissolved after shareholders receive XCMG stock. Xugong intends to complete the process by the end of 2022

(2)*The mixed-ownership reform trial of China's three major airlines (China Southern Airlines, China Eastern Airlines and Air China) started with their cargo subsidiaries since the reform of air freight is urgently needed. In recent years, the Chinese logistics industry has developed rapidly, while the air freight business has been gradually marginalized (10% of revenues) and profitability remains low.*

2021

GREE/Hillhouse Capital/Philips Home Appliances

In October 2019, GREE Electric Appliances (GREE) – sold 15% interest to Hillhouse Capital for $7.5 billion, launching its mixed-hybrid reform. The move made Hillhouse Capital, one of the largest and most sophisticated Asian/Chinese PE firms with investments in Tencent and jd.com, the largest shareholder of GREE, one of China's leading air conditioning manfacturers. After Hillhouse's 15% stake, GREE's three top shareholders are Zhuhai Mingjun (15%), Hebei Jinghai Guarantee Investment Co Ltd (8.91%) and Zhuhai Gree Group (3.2%).

In March 2021, Dutch Philips AG announced that it agreed to sell its home appliance unit to Hillhouse Capital in a deal valued at € 4.4 billion ($5.2 billion). The Philips Domestic Appliances business has annual sales of € 2.2 billion in 2020, and was active in more than 100 countries. It owns a number of successful home care products including the Airfryer, Fully Automatic Espresso Machine, Perfect Care Elite steam generator, Air Purifier, and SpeedPro Max vacuum cleaner. The business employs approximately 7,000 employees globally. While the Philips business in the Chinese market was declining, it has a sound brand reputation and wide world channels.

Hillhouse Capital's acquisition marks another example of Chinese household appliance manufacturers/PE firms to acquire foreign appliance brands for global expansion; Hisense acquired EU home appliance manufacturer Gorenje (Slovenia) and Toshiba's Visual Solutions (Japan) TV business , Skyworth acquired the television business of German electronics company Metz; Midea acquired Toshiba's home appliances business; Haier (backed by KKR) purchased GE Appliances and Candy, a manufacturer of household appliances (Italy)

Philips business is closely aligned with GREE's domestic business thus combining these two businesses someday would create a global leader by helping it broaden its product categories and opening a fast channel to the global market. Such a merger would also lift GREE to the same level of Midea and Haier – its Chinese peers.

In the interim, Philips was convinced that Hillhouse could provide capital and digital expertise to bring new technologies or apply other commercial strategies to the business.

Eastern Air Logistics (EAL), a subsidiary of China Eastern Airlines Group

In June 2017, China Eastern Airlines Group (China Eastern) announced an agreement with private investors Legend Holdings, Global Logistic Properties (GLP), Deppon Logistics and Greenland Financial and a representative of its core staff team to diversify the ownership structure of EAL by selling a majority stake.

EAL is the integrated service business of air logistics, which integrates business functions such as air express transportation, cargo terminal operation, multimodal transport, warehousing, cross-border e-commerce solutions, inter-industry project supply chain, aviation special cargo solutions and direct origin solutions. At the time, EAL had not been performing well.

In the deal, China Eastern kept only 45% of EAL holdings, while the four private firms held 45% shares (25% by Legend Holdings, 5% by Greenland, 10% by GLP (Singapore) and 5% by Deppon Logistics). EAL's core staff team held the remainder 10% (125 workers bought the shares, with the general manager holding less than 1% stake for his RMB 30 million ($4.4 million) of stock.

The move marked an important step for SOEs mixed-ownership by attracting private investors. It also helps EAL to be able to complete with Fedex and UPS.

In 2019, EAL submitted plans to list that year, but elected not do so. In 2020, the company was able to obtain new capital from the proceeds from a large capital raise by its parent, China Eastern Airlines.

By the end of 2020, China Cargo Airlines, a subsidiary of EAL, operated 10 cargo planes and 725 passenger planes. Through its partnerships with SkyTeam, the route network reached 1,036 destinations in 170 countries around the world. EAL has 17 self-operated cargo terminals and covers 12 airports. Among them, Shanghai Pudong Airport and Shanghai Hongqiao Airport are the main bases of EAL, while Shanghai Pudong Airport is the third largest airport in the world in terms of cargo and mail throughput.

Financially, EAL made considerable progress from 2016 -2020, operating income nearly trebled from RMB 5.8 billion to RMB 15.1 billion, total profit was increased from RMB 485 million to RMB 3.6 billion, the asset-liability ratio decreased from 86% to 37%, and net assets by nearly 7X. Clearly EAL performed very differently than from under its prior ownership.

In June 2021, EAL was listed on the main board of Shanghai Stock Exchange (SSE), issued "the first share of mixed ownership reform of aviation". It soared 44% on listing day and its share price reached the upper limit of RMB 22.7 ($3.55) per share at the SSE.

Thus, EAL's IPO came at time when the demand for air cargo not only recovered from COVID-19 epidemic crisis, but also continued to grow. EAL has also been an active transportation of vaccines and other important materials. EAL has flown to more than 20 countries and carried out all kinds of anti-epidemic flights, transporting more than 70,000 tons of medical materials.

This marks that EAL, being one of the 1st batch of pilot businesses countrywide and the 1st pilot business from civil aviation sector in the MOR program, has gone through the "3-step" reform journey (equity transfer, capital increase (2017) and listing) in a beyond-expectation manner and grown into a public company

State Grid to Merge Units with XD Group to Create Chinese Electrical Gear Giant

In September, China established electricity equipment giant through a merger which involves companies affiliated with State Grid Corp and power engineering company China XD Group. The new company has a registration fund of 100 billion yuan ($15.47 billion). The three unlisted units of China's State Grid- Xuji Group, Ping Gao Group, and Shandong Electrical Engineering and Equipment Group (RMB 70 billion assets) , plus 3 other companies - will merge with China XD Electric's controlling shareholder China XD Group (RMB 40 billion) to form a power equipment group with combined assets of over CNY100 billion ($15.5 billion). Shares of all listed companies with some involvement in this deal increased upon the announcement between 6-10%, so the market responded very positively to this plan.

The move is part of China's efforts to reform state-owned companies to drive efficiency. The merger will create a large equipment maker and service provider that can compete well in BRI countries.

While this transaction was only announced in Q3 2021, in December 2020 listed companies including China XD Group said they were preparing for a merger. In February, State Grid stated that it will gradually strip out its traditional manufacturing business - beginning of the process to spin off State Grid's assets in transmission and distribution equipment manufacturing.

State Grid – new focus on Energy Internet- $350 billion investment

The announcement brings State Grid another step closer to spinning off its non-core business (there are still other non-grid businesses to separate out) to prepare it to focus on future growth as State Grid has huge priorities in clean energy.

In January, CEO Xin Baoan, delivered a speech at World Economic Forum's "Davos Agenda" via video link during the "Accelerating Clean Energy Transition" session. During his speech, Baoan said that in the next five years, State Grid will spend an average of more than $70 billion a year ($350 billion over 5 years) to upgrade the power grid to the "Energy Internet" and promote the transition to clean and low-carbon energy. Energy Internet is a smart energy system based on a strong smart grid that integrates advanced information and communication technology, control technology and energy technology.

State Grid will provide a configuration platform for the large-scale development and use of clean energy. By 2030, China's installed wind and solar power generation capacity will reach 1.2 billion kilowatts or more. State Grid is also building a highway fast charging network covering 171 cities, building the world's largest smart car networking platform and accumulating 1.03 million charging piles.

China Logistics Group (CLG) launched

In early December, China announced the launch a new state owned logistics group, China Logistics Group (CLG), designed to strengthen domestic and global supply chains amid widespread disruptions caused by the pandemic. CLG is to become a “global supply chain organizer" by developing international trade links and freight services, as well as cross-border e-commerce.

CLG has been formed through a merger of several companies dealing in material storage and transport, international logistics and logistics packaging; China Railway Materials, China National Materials Storage and Transportation Group, Huamao International Freight Limited Company Shenzhen Branch, China Logistics, and China National Packaging Corporation.

CLG currently covers 30 Chinese provinces, is present across five continents, and operates three million vehicles. CLG also has property rights on 24.3 million m² of land, owns 120 designated railway lines and has 42 futures delivery warehouses.

China’s State Council/SASAC and CLG each hold 38.9% of the shares, while the three strategic investors, all publicly-listed organisations and global brands hold the remaining 22%: China Eastern Airlines (10%), COSCO Shipping (7.3%), and China Merchants Group (4.9%).

The merger comes at a time when the pandemic continues to disrupt global supply chains, especially in Chinese ports, where even one positive COVID-19 case can result in operations being suspended. It also represents the next set of steps needed to reduce the operating performance gap between Chinese logistics costs and those of other major countries (circa 7% currently).

Conclusions

While six companies do not represent an official sample of all Chinese SOEs, they are actual major Chinese SOEs, most are global brands and did in fact achieve considerable progress in achieving mixed-hybrid status since Q4 2020 including:

- logistics (and other businesses) within China Eastern and China Southern Airlines
- China’s market leader and a global brand in cranes and construction equipment
- the largest 2021 China outbound consumer investment, acquired by the largest shareholder in GREE, China’s largest air conditioning company which could be merged at a later date
- Creating a large domestic electricity equipment giant-and in the process freeing up State Grid to invest in a $350 billion energy internet over the next 5 years
- Creating a new 30 province logistics group, to become a “global supply chain organizer" by developing international trade links and freight services, as well as cross-border e-commerce

In addition to domestic Chinese strategic, institutional and PE investors, these transactions also attracted investment from ASEAN strategic investors, major PE funds and sovereign wealth funds as well as institutional investors from North America, EU and the UK.

The financial markets in 2022 will continue to pose challenges, but we believe that there will be increased activity in this segment – maybe not at the pace Western governments want – but it is the process is moving and can be a model for countries such as Uzbekistan as they begin to implement privatisations of some of its SOEs.