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Closing Views

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# China's state-owned enterprises: Board governance and the Communist Party

*As the state-owned sector attracts strategic investors, they find themselves befuddled by the role of an almost invisible power: the Communist Party.*

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**As more and more** major Chinese state-owned enterprises list in Hong Kong and on international exchanges, the governance of those companies has become an increasingly important issue. This trend has been reinforced by the fact that foreign strategic investors are now allowed—for the first time—to acquire a significant shareholding in state-owned enterprises listed on China's renminbi-denominated A-share exchanges, in Shanghai and Shenzhen.

Too often, however, investors and independent international directors remain unsure how governance really works in China's state-owned enterprises and how it is changing. Outside directors on boards may be frustrated or simply puzzled by the seemingly invisible forces that make important decisions about, for example, appointments of chief executives or major acquisitions. In China's state-owned enterprises, the board of directors often seems to have no more than the ability to rubber stamp the big decisions.

Investors are rightly concerned about how key decisions are made in companies in which the majority shareholder is still the government and the Communist Party plays a powerful if shifting role. By better understanding that role in the governance of state-owned enterprises, foreign companies can learn to deal with them more effectively.

China has 70 million party members, and a typical state-owned enterprise may have hundreds if not thousands of them on staff. Consequently, as long as a company remains a state-owned enterprise, the Communist Party committee plays a pivotal role in key decisions—for example, the nomination of top executives, executive evaluation and compensation, asset acquisitions and disposals, and annual budgets. Sometimes the party committee may even get involved in operational decisions, such as whether to take on a specific major supplier or to purchase housing for key employees.

True, the party recognizes that boosting the market value of state-owned enterprises is good for the economy and therefore in its own best interests. It also understands that conflict between the board and the party committee will hurt the valuation of a state-owned enterprise because of the "governance discount" that foreign investors apply. As a result, the party is paying greater attention to investor reactions and increasingly willing to seek out and test solutions.

This is easier said than done, however. Although most academics, government and party officials, and company executives accept broad best-practice principles, few are putting much effort into designing the details necessary to implement good governance, because of the apparent domestic sensitivities and complexities involved. Foreign investors, in other words, shouldn't expect China's state-owned enterprises to reach world-class standards of corporate governance anytime soon.

Which is hardly to say that there isn't an evolving debate in the government about the party's role in decision making: there is. Key questions that have arisen recently include just how many directors the party should appoint, which decisions it should influence, and how involved it should be in evaluating executives and determining which posts they should move to and when.

By following the current debate and trying to understand where the party committee draws the line, foreign investors will be able to focus their efforts more successfully. On some issues they'll have little leverage: for instance, on appointments of top personnel, at least for the foreseeable future, outside directors can express their views, but the party committee will make the final decision. On issues concerning company strategy or major deals, however, the party values the views of strategic investors more highly. A seat on the strategy committee can be crucial because it exposes outside directors to issues and their associated data before they come before the full board. At one company, by the time investment decisions worth hundreds of millions of dollars came before the board, the role of that body was typically just to conduct a yes-or-no vote based on a one-page summary. By joining the strategy committee, one international board member was able to gain greater influence over decisions, to introduce international benchmarks on capital intensity, and to influence the timing of the company's investments.

Strategic investors should thus strive to ensure that the directors they appoint join the strategy committees of the companies in which they invest. The best time to put this arrangement in place is during the negotiations over the initial strategic investment, when investors have maximum leverage. Too often they let this moment slip by. Any agreement should specify which committees the outside board members will serve on and whether they will chair those committees. A more assertive stance would have investors spelling out key items that should appear regularly on the agenda of the strategy committee. Once on it, strategic investors should endeavor to encourage meaningful and challenging debates during meetings. Given the greater experience of a multinational in drafting market- and investor-oriented strategies, it has a powerful rationale for asserting a leadership role.

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Investors wanting to affect decision making in broader areas will need to recognize the influence of the party committee and to devise a plan for communicating with it. Even if the goal is merely to create a partnership with a major state-owned enterprise, lobbying and presale communications should target both senior executives and members of the party committee. And, yes, there is considerable overlap between these two groups: all senior executives serve on the party committee except those recruited from abroad and from multinationals operating in China. Other high-ranking company officials are party committee members charged with looking after purely party-related matters, such as party discipline or unions.

Best practice is to obtain the state-owned enterprise's organization chart showing both party committee members and senior executives. Then investors must ask themselves whether they have covered most of the real decision makers (including those who don't speak the investors' home language) and whether their influence is broad enough to get the party committee's attention.

Foreign strategic investors have a crucial role to play in upgrading the standards of corporate governance in China's state-owned enterprises. Unfortunately, we've seen far too many foreign investors fail to appreciate the importance of the Communist Party. They should actively participate in the ongoing governance debate in China, the better to safeguard their own investments and to help state-owned enterprises move closer to international best practice. While a confrontational push for a major change of direction will achieve little, constructive input on how to move forward step by step can create real momentum for change. Q

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