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Problems in China's Private Enterprises after They Realize Financing by Going Public and Precautions

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Abstract

Most private enterprises face many problems after going public, such as the honesty and credit issue, private entrepreneurs robbing the listed companies' capitals, and amounts of disposable capitals. All these problems are rooted in private listed companies' irrational stock structure, poor financial management, and imperfect system. In order to avoid these problems in private enterprises after going public, it is necessary to perfect these private listed companies' stock structure and stock relationship, improve their financial management, and execute strict and rational system.

Keywords: Private enterprises, Financing by going public, Problems, Precautions

In May, 2003, Hongkong High Court declared that Euro-Asia Agricultural (Holdings) Ltd. was in formal liquidation. Next, Jiangsu Qionghua, Zhengzhong Pharmaceutical, Shanghai Real Estate, China Special Fibrin, Far-East Pharmacy, Dongda Bright, and many other enterprises are mentioned in the black list for their cheating behaviors. What are the problems in private enterprises after financing by going public? And what are the essential reasons for these problems? How to avoid these problems at the very beginning? All these issues win great attentions from private enterprises that plan to go public and their entrepreneurs. This paper will chiefly analyze these issues.

1. Problems in private listed companies

1.1 Honesty and credit

Public enterprises should take honesty and credit as their base because investors usually make investment decisions according to their disclosed information. However, in China's most private listed companies, the only big stock is popular. Entrepreneurs control the listed companies and gain most interests. Therefore, they have stronger motivations to achieve financing by cheating or artificially steer the stock price.

The honesty and credit risk in private enterprises is chiefly originated from their casual development process. Problems of honesty and credit after going public mainly include: (1) Overrated contribution. For example, Nongkai Group went public in Hongkong was stopped in Sep, 2003, because it overrated enrolled capitals. (2) Hide sensitive information or untimely disclose sensitive information. For example, in less than half month after going public, Jiangsu Qionghua was criticized in public by Shenzhen Stock Exchange due to its fake information. (3) The financing capitals are not used properly according to the initial public offerings. For example, Ufida Software has gained nearly one billion Yuan by IPO. In its IPO introduction, it listed 29 investment projects and declared that the project budget that had passed state approval was 803 million Yuan. But later, it claimed that in order to improve the use efficiency of short-term capitals, the board had determined to invest no more than 300 million Yuan (32.7 percent of total capital offerings) in national bond. It means the 300 million Yuan will not be used according to the IPO introduction.

Along with the frequent emergence of problems in private listed companies, investors question their honesty and credit. The trust risk almost reaches a top. This kind of trust risk has already generated negative effects on private enterprises that plan to go or have already gone public. Many private enterprises that plan to go public have to defer or even cancel their schemes.

1.2 Big shareholders robbing capitals in private listed companies

In China, most private enterprises begin from family businesses. After a period of development, they choose to found enterprises and even go public, gaining more attentions. But, most of private enterprises still sustain their traditional management even after going public. It is the private entrepreneur who makes all decisions. Some private entrepreneurs directly possess capitals of enterprises, thinking that everything in enterprises belongs to them. They can use them as they like. In recent years, more severe punishment and media supervision focus on big shareholders who may rob enterprises' capitals. Therefore, rational big shareholders may obtain enterprises' capitals by editing fake accounting, associative transaction, and illegal guarantee, instead of directly occupying capitals in enterprises. For example, from 1999 to July, 2004, Zonglin Xu, Diamond's board present, illegally occupied more than 483 million Yuan.

According to data issued by China Securities Regulatory Commission, till 30th, June, 2006, 149 listed companies have capitals' illegal occupation issue, and the illegally-occupied capitals totally reach 32.8 billion Yuan. Thereof, the number of private listed companies is 62, and relevant illegally-occupied capitals reach 13.5 billion Yuan. Apparently, the problem of big shareholders occupying enterprises' capitals is not solved completely, which has already strongly affected listed companies' daily business operation. Once the behaviors of big shareholders who robbed listed companies' capitals are disclosed, investors will sale their stocks of these kinds of enterprises. As a result, these kinds of listed companies will face price slumping or even stock sign. According to an investigation on investors, once the big shareholders occupies capitals in listed companies, 77.05 percent of investors will sale their stocks, and 18.53 percent of investors will choose to protect their right by legal procedures, and even 91.29 percent of investors take this problem as one of the most important factors in their investment.

1.3 Without right investment project and amounts of disposable capitals

Disposable capitals have strong liquidity but poor profitability. A large quantity of disposable capitals will affect the profitability of listed companies and the safety of assets. Presently, many private enterprises can not find proper investment project though they successfully collect capitals by IPO. How to spend money becomes a difficulty for private entrepreneurs. For example, since Taitai Pharmaceutical (600380) going public in 2001, Baoguo Zhu, as the present, has always faced the pressure of spending money. Among the collected 1.69 billion Yuan, nearly 1 billion has already invested in 11 projects. However, two years later, all these 11 projects failed to achieve former expectations. Thereof, 6 projects had to be stopped due to smaller market shares, and waste of fixed assets. Today, Baoguo Zhu has nearly 700 million Yuan, the collected capitals, and 500 million Yuan, the operation cash. As the No.36 in Forbes' list, Baoguo Zhu is in a trouble of spending money.

As a result, many private listed companies choose entrusted financing. However, this investment behavior brings about more severe loss for private listed companies. For example, the son limited companies of Lanzhou Huanghe River, namely Huanghe River High-Efficient Agricultural Development Ltd. Co. and Lanzhou Huanghe River Science & Technology Venture Ltd. Co. changed their two kinds of national bonds into other enterprises' stocks in 2004, which caused a loss of 13,822,200 Yuan. It affected the whole operation performance of the enterprise in 2004. Lanzhou Huanghe River that has been expected to achieve a greater improvement became a tiny-profit enterprise.

Some private listed companies usually adopt the high-cash payout ratio policy as an important way to solve the disposable capitals. For example, Kangmei Pharmacy that has 0.41 Yuan earnings per share in 2001 set up a two-Yuan-every-ten-shares dividend scheme. Taitai Pharmaceutical that has 0. 391 Yuan earnings per share set up a three-Yuan-each-share dividend scheme. Lutai Group that has 0. 42 Yuan earnings per share set up a 3.18 Yuan every ten shares dividend scheme. Ufida Software that has 0. 70 Yuan earnings per share set a six-Yuan-every-ten-shares dividend scheme. Relevant data show that in Europe, 30% or 40% of after-tax profits in listed companies are used for dividends. And in Japan, the percent is from 10% to 15%. In contrast, the dividend proportion of private listed companies in China is relatively high. High cash dividend serves as a cause for private listed companies failing to find right investment projects. As a result, potential investors may question the development future of private listed companies, which will further affect the stock prices. When Ufida Software publicized its high dividend policy in 2001, its stock price decreased sharply.

2. Probe into causes for problems in private listed companies

Problems emerged in private listed companies heavily hurt investors' trust and expectations for them. In frustration, people may want to know what reasons are for these problems. As a matter of fact, these problems are caused by not only enterprises themselves but also the system.

2.1 Irrational stock structure

Issuing stocks in public is an important way for private enterprises breaking up close stock structure and play roles in society. After issuing part of stocks in public, family members will hold less stock. But families still refuse to give up the absolute control over enterprises. Therefore, in order to hide the fact of families' absolute control over enterprises, they choose to hold an absolute large percent of stocks, usually higher than 50 percent. As a result, the former family-complete-hold stock structure turns into the present family-big-stock structure. Take Chuanhua Stock in SEM board for example. Chuanhua Xu, Guanju Xu, and Guanbao Xu, father and sons, directly hold 42 million shares, accounting for 70% of the total shares, 60 million shares. Another case for example, 69.09% of shares of Xinhecheng in SEM board are held by Xinchang Chemical Enterprise.

One-big-shareholder stock structure can help to enhance the close connection between corporate interests and family interests. Under this stock structure, family managers can realize strategic program, operation management, and internal control over enterprises easily. However, in modern market economy, the stock structure serves as not only the precondition for stock market, but also the logical start for corporate governance structure. The stock structure determines the governance structure. Data show that the one-big-shareholder phenomenon is popular in China's private listed companies, which may lead to incomplete governance structure, and the right of the board may controlled by the board present solely. Lots of small and medium shareholders can not say any word in corporate management due to their smaller shares. Besides, the independent present is determined by the one big shareholder in private listed enterprise at present. All these factors cause to a failure of restriction mechanism. The board is completely controlled by the president. As the core of corporate governance, once the board is controlled by one person, it may pass any kind of decisions that may hurt small and medium shareholders' interests but benefit the president self, such as untimely disclosing or refusing to disclose information that is supposed to be known by small and medium investors or potential investors, manipulating listed companies' profits, robbing their capitals, and hurting interests of small and medium shareholders.

2.2 Poor financial management

Before going public, it is enough for the accounting reports in private enterprises merely to satisfy taxes payment and business management. It is the private entrepreneur who makes the financial management decisions. Therefore, the financial workers just complete necessary accounting what private entrepreneur want.

After going public, private enterprises have to obey a series of regulations and requirements finance, and information publication set up by the stock exchange. According to relevant laws and regulations, listed companies in China have to publicize their annual report, half-year report, and seasonal report. The annual report concerns with investment, finance, operations, profits division, associated transactions, audited financial reports, and additions. These contents include finance analysis, financial management, investment, operational capitals' management, dividend allocation, capital operation, accounting, and integrated reports. Besides, many factors should be taken into consideration in decision-making that is an extremely complex process. Therefore, the requirements for finance managers become higher. However, most private entrepreneurs grow from technology and sale fields. They usually focus on these two fields but neglect the finance management field, including the management idea, and the employees. In a sense, the position of finance management and the quality of finance workers fail to achieve same progresses along with the listed companies.

Poor finance management in private listed companies may cause a series of problems, including the imperfect finance management system, poor consciousness of risks, inefficient investment decision, amounts of disposable capitals, and many other issues. For example, as Jiangsu Qionghua was found its 35.55 million Yuan invested in national bonds, it protested that the board did not know everything about entrusted finance. It was the finance branch that made the investment. And after the board approved the investment in national bonds, the board mistook it as the investment was from self operation. Apparently, all these problems will directly affect enterprises' values and profitability, which will arouse reflection in capital market.

2.3 Reasons in history and system aspect

Because of history reasons, private listed companies are chiefly in production and process fields. And most of them have not advantage of scale and belong to competitive industries, such as small home machines, food process, and textile process. In market operation, private listed companies merely occupy one or few segment market. Even they have capitals, their market is limited. Because of their industries, many private listed companies could not find rational investment projects, which leads to a large amount of disposable capital.

Present system makes it more difficulty for private enterprises gaining opportunities of issuing initial public offerings (IPO). Therefore, purchasing a shell company becomes an important way for private enterprises going public. Purchaser must have powerful capitals in order to purchase a shell company. It may cost millions of Yuan or even billions of Yuan, which may make private enterprises face greater challenges since their capitals are always insufficient. Moreover, the banking industry in China is used to providing loan for state-owned companies. It is hard for private enterprises to obtain loans from banks, not mention other financing way. Therefore, private enterprises have to find a new way out of difficult financing. They can realize financing by purchasing a shell company, which can help them obtain capitals by legal or illegal way, such as Delong Series, Taiyue Series, and Yongjin Series.

Besides, in China there are no specific suit laws and regulations to protect small shareholders' interests or punishment measures, and no measures to punish big shareholders if they commit mistakes. Once illegal behaviors happen, the most severe punishment imposed by Shenzhen Stock Exchange or Shanghai Stock Exchange is nothing but criticize it in public. Data show that since April, 2001, 61 listed companies have been criticized in public by Shanghai Stock Exchange. However, because of the weak supervision and management, and lagged-behind legal procedure, the public criticism fails to generate ideal effects. For the behavior of big shareholders robbing listed companies' capitals, the punishment imposed by present laws in China is relatively light. They merely shoulder administrative responsibilities. If a case is more serious, the main responsible man may have to leave, and other top managers can escape from punishment. Therefore, the weak power of public criticism can not exert a warning effect on other listed companies.

3. Precautions for problems in private listed companies after they realize financing by going public

Keeping away from problems in private listed companies after they realize financing by going public can not only benefit their development, but also help to protect the interests of small and medium investors, and the healthy development of stock market, considering the fast development of private enterprises.

3.1 Improve private listed companies' stock structure and stock relationship

In private listed companies, the one-big-shareholder holds the capitals and the control right over production and operation. Moreover, differing from state-owned listed companies, the private enterprises have not restriction mechanism, which makes it become a blank part in capital market. It may lead to such a result that is more serious than that in state-owned listed companies. Therefore, it is urgent to change private listed companies' stock structure, separating and dividing the stock right of family big shareholders, changing an absolute control into a relative control. In specific, it is to institute relevant laws and regulations on securities and stocks. As private enterprises apply for going public, they must absorb some non-family investors, and each of them should hold certain stocks, which can separate the stock right effectively. Private enterprises that have already achieved separate stock right can relative- easily obtain approval.

As private enterprises choose to go public in China, they should avoid circulative, multi-level, and complex stock structure as much as possible. Under present imperfect supervision, complicated stock structure is easy to be abused by the big shareholders who may obtain cashes by associated transactions or illegal guarantees. But in western countries, family enterprises usually have simple stock structure as they go public. For example, the controlling shareholder of Microsoft Ltd. Co. is not Microsoft Group but Gates himself. And the controlling shareholder of Dell Ltd. Co. is not Dell Group but Dell himself. By taking reference from foreign countries, we can guide private enterprises to form simple stock relationship during their foundation and development.

3.2 Improve private listed companies' finance management level

It can focus on these aspects as follow.

3.2.1 Enhance capital management

Based on experiences and lessons in recent years, it is common for private listed companies being hurt by finance traps, such as big shareholders robbing capitals, debt risks from providing guarantee for other enterprises, and failures in investment. The loss may reach millions of or ten millions of Yuan. Therefore, it is vital to enhance listed companies' finance management. In author's opinion, it can focus on three aspects: (1) budget management; (2) risk management; (3) daily management.

3.2.2 Properly deal with the relationship between initial financing and re-financing

After obtaining capitals by initial public offerings, if private listed companies can provide with ideal returns for shareholders and its values realize a constant increase, it can achieve re-financing by issuing more offerings. Therefore, as private enterprises apply for going public, they should avoid unreal advertising or unpractical promise, which can help them to set up an honesty and credit image in investors. After going public, they should focus on businesses and management, trying to renew finance indexes, improve profit ratio, adopt proper dividend allocation policy, and pursue re-financing.

3.2.3 Re-build an internal finance management structure in private listed companies and improve finance workers' quality

Finance management is the core in private listed companies. Separation and specification between financing and accounting become a universal trend. As an optimized corporate organization, private listed companies should perfect the internal finance branches, forming two sets of institutions. One focuses on collecting and allocating capitals, financing programming and decision-making, evaluating investment schemes, and constituting investment strategies. The other focuses on enterprises' internal operations, checking, information process, and financing supervision. At the same time, the successful capital management in private listed companies must based on a team of managers who are good at manipulating capitals, and possess competitive consciousness, knowledge, and ability that can help them manage enterprises properly.

3.3 Avoid problems emerged in private listed companies from the system aspect

3.3.1 Supervise private listed companies and force them to execute relevant laws and regulations

In order to regulate listed companies' governance structure, China Securities Regulatory Commission and State Economic and Trade Commission issued the Code of Corporate Governance for Listed Companies in China on 7th, Jan. 2002, which is first file that generally and systematically regulates listed companies' behaviors. Its constitution is based on principles established by Law of Company, Law of Securities, and other relevant laws and regulations, and referencing from standards that are acceptable by foreign companies. This code is right for China's listed companies, including private listed companies surely.

3.3.2 Take reference from foreign experiences and continue to perfect relevant system

In general, America and Japan have relatively perfect laws. In America, the effects of laws on family listed companies are chiefly in two aspects. (1) Support. America has a nice legal environment. Private assets are protected by constitution. Its perfect legal system provides with sufficient credit source for private listed companies, simplifying transaction and improving efficiency. (2) Restriction. On one hand, the Anti-Trust Law restricts the family monopoly. In late 10th century, America made up Anti-Trust Law. Its execution weakens American family enterprises' control right and separates their stock right. On the other hand, the collective lawsuit right of small shareholders protects interests of small and medium shareholders. This right ensures that the benefits of every shareholder in wining a lawsuit will be shared by all shareholders. Therefore, as American family enterprises go public, no listed companies rob external small and medium shareholders by stock market, which is different from the fact in Asia or other regions and countries. Focusing on problems emerged in private listed companies in China we can take reference from these successful experiences and perfect the legal system.

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