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This week's \$4.9bn initial public offering of China Unicom, China's second largest telecommunications company, promises to be the biggest Asian IPO outside Japan. It will also precede a wave of offerings that will test the readiness of China to allow overseas investors to influence the management and governance of its state-owned enterprises.

The challenge is vital for Hong Kong because the character of the former colony's vibrant bourse is becoming inexorably more mainland Chinese. China Telecom HK, which represents only a portion of the mainland telecoms company's mobile telephony assets, is already the biggest company listed in Hong Kong and in the Asia-Pacific region outside Japan.

It is equally important for mainland China. If the 20 or so large, state-owned enterprises queuing up to raise capital in offshore stock markets are unwilling or unable to improve their management and transparency, investors will rapidly become disenchanted. China would then not only find its reform efforts blunted but its access to global capital restricted.

The initial signs are not hopeful. "The main purpose of going for an overseas listing is to raise capital," says Cao Fengqi, a professor at the Guanghua economic management college of Beijing University. "This type of listing will not have a big impact on the current management staff, the structure of the company, or the way the company is run."

David Zweig, associate professor of social science at the Hong Kong University of Science and Technology, concurs. "Listing doesn't mean they are privatised. The main purpose is not so much to increase efficiency but rather to get their hands on capital. I don't think the government has any intention of privatising the large, state-owned enterprises."

The wave of public offerings following that of China Unicom is sizeable. The planned listings on the Hong Kong market should swell its capitalisation from \$569bn at the end of April to \$629bn by the end of the year, according to Andrew Sheng, chairman of Hong Kong's Securities and Futures Commission. Within this, the capitalisation of mainland companies is expected to grow from \$125bn to \$156bn.

The mainland companies that plan to list include Baosteel, China's largest steel company; Sinopec, the second largest oil company; the China National Offshore Oil Company, another state oil concern, and a financial holding company assembled by Citic, the leading state investment trust company.

But all these offerings are likely to involve minority stakes, leaving control in the hands of the state. "Governance theory and reform is predicated on separation of ownership and management," says Nicholas Howson, partner at the Beijing office of the law firm Paul, Weiss, Rifkind, Wharton and Garrison. "To date, no such separation has occurred. Instead, the government or a proxy for the state has continued to own most of the newly issued equity interests and exercise absolute control."

China Unicom, which may raise as much as \$5.6bn - eclipsing China Telecom's \$4.5bn record in 1997 - is expected to conform to this pattern by offering 25 per cent of its share capital on Hong Kong and New York. The problem with this is that state ownership in China carries considerable state obligations. Beijing frequently frustrates corporate plans to restructure and reduce employee numbers because of concern that this would provoke social unrest.

The stamp of state authority is clearly visible from Unicom's prospectus. Yang Xianzu, chairman, and Wang Jianzhou, president, were both senior government officials before they were appointed to Unicom in 1999. Worries over Unicom's poor track record on disclosure are heightened by the fact that the company does not make clear in its prospectus which branches of

Beijing's government own it. The company merely says the shares to be listed are owned by a company registered in the British Virgin Islands.

The omission of a clear identification of Unicom's state owners is significant. The company's history has been marred by public infighting between the different ministries and 13 other state shareholders. Some commentators argue that if, as is widely believed, the company's main shareholder is the Ministry of Information Industries (MII), there is a conflict of interest because the MII also controls China Telecom, the dominant state player.

Unicom's fortunes are already closely linked to its relations with the MII. Wu Jichuan, China's powerful telecoms minister, ordered the winding-down of about 46 Unicom ventures with foreign partners in the past year, leaving the company to pay compensation. Mr Wu also declared before China Telecom's Hong Kong listing in 1997 that "a foreigner who buys some shares will have no impact on the [company's] operations in China".

Uncertainty over state ownership is not the only issue facing overseas investors who buy shares in state-owned enterprises. They also face uncertainty over whether profits will stay with the listed entity, or will instead flow back into a state-controlled holding company. An example was the offering this year of PetroChina, the listed vehicle of the largest state oil company, China National Petroleum Corp (CNPC). PetroChina remains 90 per cent owned by CNPC, and most of the listed vehicle's profits will return to the parent. The latter is an inefficient state apparatus with nearly 1m employees, which is bound by no disclosure requirements.

There are also problems of transparency within the listed companies themselves. Although these companies list in Hong Kong, the overwhelming majority of their operations lie on the mainland. State-controlled companies tend to reveal little to the international media based on the mainland, and almost never hold news conferences. They instead release news in Hong Kong, where journalists are unfamiliar with the mainland because of restrictions on reporting access.

Despite these difficulties, the listings are starting to have some effect. PetroChina was obliged before its listing to institute an unprecedented system of specific targets on budgets, revenues, profit and production for all managers. Their pay is to be linked to their performance as evaluated on the basis of individual targets. Some managers are also starting to talk the language of shareholder value. "Our target is to give investors a return on their investment. That is our only aim," says Jiang Jiemin, vice-president of PetroChina.

The future character of business in mainland China will be heavily influenced by whether PetroChina, Unicom and the others pay more than lip service to improved corporate governance. It will also affect Hong Kong itself, given the growing influence of these companies within the stock market. Any nasty surprises borne from poor disclosure and inadequate corporate governance among mainland corporations could have the effect of tainting all China issues.

There is a precedent. Feverish demand for the shares of so-called "red chips" Chinese companies in the summer of 1997 prompted huge queues for their share application forms in Hong Kong. But since then, underperformance by many companies has left investors disillusioned. "The era of the red chips was over in 1997. The fate of the H-shares [another category of mainland shares] is not much better. Fund managers can't stifle a yawn when you talk about them," says Joe Zhang, head of China research at UBS Warburg.

There is a lot at stake in the China Unicom offering. If the officials that run listed mainland companies simply regard Hong Kong as a pool of capital to be tapped, an opportunity for much-needed corporate restructuring will be missed. That in turn will curb the ability of Chinese companies to excite the kind of interest that Unicom should provoke this week.

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