



# Analysis on primary focuses of reorganization among distressed enterprises

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In recent years, enterprises under the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) have actively adapted to the requirements stated in the three-year action plan for reform of state-owned enterprises (SOEs) proposed at the central economic work conference. Specifically, the disposal of low-productive and idle assets and non-principal and non-advantageous businesses within the SOEs has entered the stage of reorganization and divestiture. This article discusses methods and primary focuses for reorganization among SOEs, especially for low-productive and idle assets, non-principal and non-advantageous businesses amid reorganization, and divestiture.

## Business features

### ► About underlying assets

Firstly, underlying assets include low-productive and idle assets or a seller's non-principal business. Secondly, underlying assets have been lowly productive or idle for return on investment (ROI) in recent years, which was dependent on investment by a single shareholder, has been negative or lower than banks' interest rates on deposits. Thirdly, underlying assets do not align with the existing functional positioning and need to be adjusted or adapted while suffering from policy pressure as their industries are entering a downward phase of business cycle or have been waned. Fourthly, under financial regulation, there may be issues on the ownership of underlying assets, whose credit rating and credit facility are likely to be negatively impacted due to their potential impairment loss in the book. The underlying assets may feature higher financial costs, shorter-term debt cycle and greater credit maintenance pressure, irrational debt structure and widely distributed creditors and certain non-standard creditors are refrained from enforcing the debt when it falls due. Fifthly, the underlying assets of mixed ownership enterprises may disrupt business operation due to invalid governance procedures, inadequate implementation of "Triple & One" decision-making system and rising tension among shareholders. Meanwhile, mixed-ownership enterprises may face issues including dependence on a single shareholder and over-collateralization.

### ► About debts and collaterals

The debt and collateral transfer by financial institutions is essential to the divesture and reorganization of underlying assets (low-productive and idle assets and non-principal and non-advantageous businesses). Due to irrational debt structure and widely distributed creditors, many debts cannot be renewed when they fall due. Amid reorganization, creditors are unlikely to cooperate in the releasing of collaterals or resigning of the guaranteed contract, transfer of the debt and the releasing of mortgage.

### ► About personnel placement

The reorganization and divesture of the underlying assets of SOEs is usually associated with personnel placement, which will be more challenging in lower-tier cities. If the transaction is conducted between SOEs, both parties need to take personnel placement into careful consideration to avert unnecessary disputes.

To maintain stability, the reorganization party needs to consider all pros and cons of personnel placement based on a market-oriented option tailored to SOEs.

In case a large quantity of people is involved, it is necessary for governments to issue phased policies to support steady transition, including engagement by local SOEs, an increase in wage package and downward adjustment of indicators for assessment.

### ► About compliance through historical evolution

For the assets to be reorganized and divested by SOEs, the underlying assets are usually low-productive and idle assets, or are related to non-principal and non-advantageous businesses. This is also the case even if the SOEs suffer from non-compliance outcomes through historical evolution, especially among mixed ownership enterprises, as there are numerous non-compliance issues including illegal guarantees and illegal borrowing.

### ► About overseas asset transactions

Certain SOEs (especially central enterprises), engaged in mergers and acquisitions of offshore underlying assets through newly established overseas companies, propose to reorganize or divest their offshore assets due to downward market trend, tightening regulation and technical limitations.

Due to the misjudgment in the initial investment stage, certain onshore-managed offshore underlying assets have suffered from business distress with heavy operating burden, huge debts and prolonged losses, along with personnel redundancy, shrinking market demand and guarantee, personnel and debt issues that need to be addressed.

## Options for reorganization

Options for reorganization of the aforesaid assets typically include out-of-court reorganization and in-court reorganization.

### ► Agreement-based out-of-court reorganization and voluntary liquidation

1. Having a preliminary knowledge of underlying assets (including assets and liabilities, tax and litigation issues) is necessary to identify the underlying reasons for risks (including capital gap, property rights disputes, shareholder controversy, judicial seizure, income distribution-related issues).
2. Based on the findings, stakeholders are coordinated to focus efforts on the key points, including targets, existing creditors and regulators, to reach an agreement on asset revitalization, debt renewal and reorganization, judicial seizure, priority of claims of creditors and the amount for distribution to creditors. (As multiple parties are involved an agreement-based reorganization, income distribution options need to be adjusted.) In case that the underlying asset is partly invested by external investors, a process is required by the state-owned assets trading platform, including statutory appraisal, public auction, determining the winning bidder and executing the contract.
3. For certain projects that need to be revitalized with incremental capital, it is necessary to introduce incremental funds into the projects, including common benefit debt. Taking real estate projects as an example, developers that fail to be capable in follow-up development or build brand equity, need to bring in branded developers or construction agents and managing agents to secure project quality and sales capability.
4. Upon the conclusion of out-of-court reorganization procedure, greater value can be achieved in stages and the underlying assets will resume normal operation while performance is improving. Meanwhile, the disputes will have been addressed and the underlying assets will have been revitalized with higher availability of resources to protect against interests of all stakeholders, allowing parties involved to exit successfully.
5. For assets that need to be divested and liquidated, it is necessary to focus attention on the engagement of SOEs and trading platform for the detailed procedure while seeking market-oriented investment to conclude an agreement at trading platform level. Proceeds from disposal are used to repay debt and distribute earnings to shareholders.

▶ **In-court insolvency reorganization**

1. Firstly, it is necessary to determine the core business and the scope of reorganization in line with liabilities, operation, mutual guarantee and equity structure of the underlying assets, and communicate with relevant parties for comments based on analysis results, and report progress to competent authorities, judicial departments and regulators (government-court linkage facilitation mechanism).
2. For the underlying assets that need to bring in investors for reorganization, it is necessary to consider certain factors including investors' financial strength, industrial background and investment consideration to choose appropriate investors for reorganization. Taking a reorganization case for example, a large company, aiming to integrate company-wide core assets, revitalized its struggling business by bringing in strategic investors through judicial means, replenishing liquidity, and introducing a debt-to-equity swap program and an efficient operation system.
3. Upon the ruling by the court for reorganization, the judicial reorganization procedure has been completed, making the underlying assets resume normal activities and revitalize operation.

▶ **In-court insolvent liquidation**

1. For the assets that need to be divested through in-court insolvent liquidation, it is necessary to evaluate the assets to determine the scope of liquidation and the expected discounted value.
2. As for the assets to be disposed, it is necessary to conduct a statutory appraisal and complete reporting, approval and filing procedures required and sell the assets at public auction or dispose the assets at the platform designated by regulators. The proceeds are used to repay debts.
3. Upon the payoff of debts and payment of necessary expenses, the remaining proceeds will be distributed pursuant to articles of incorporation or laws and regulation.

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