Bringing Their "A" Game

The China A-Share Equity Market and Foreign Investors

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One of the largest stock markets in the world is opening up to foreign investors. Chinese officials have taken significant steps to make China's mainland equity market, represented by A-shares, much more accessible. As a result, major index providers are incorporating them into their passive indices, and non-Chinese institutional investors are adding them to their portfolios.

Before investors take advantage of this extraordinary opportunity, however, they should do their due diligence. Chinese companies can be characterized as part of "Old China" or "New China"—a distinction that offers insights on individual companies, their place in the economy, and their outlook. Investors should also consider the current participants in China's A-share market, including retail and institutional investors as well as government regulators. An understanding of their expectations and goals can help investors more effectively balance risk and reward in this growing, and increasingly important, market.

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The A-Share Opportunity

Recent western media reports about China have been dominated by trade friction with the United States, but the reality is that China is actively inviting more foreign investment. One of the most significant shifts has been in China's equity markets. For most of the past decade, foreign investors have primarily accessed Chinese companies through ADRs listed in the United States or through the Hong Kong stock exchange—also called "H-shares."

However, the majority of Chinese companies—more than 3,000—are listed in China's onshore stock markets in Shanghai and Shenzhen. These companies, which are traded in renminbi (RMB), have been traditionally accessible only to Chinese residents. In the last few years, China has increasingly lifted restrictions on foreign investors and implemented reforms to open up its equity markets. As a result, MSCI started including China A-shares in its passive indices as of 1 June 2018. The inclusion will not only require passively constructed investments tracking the benchmark to acquire A-share securities—it could also compel active investors with no allocation to A-shares to consider adding them to their portfolios.

This represents a historic change in the global equity markets as less than 2% of Chinese equities today are owned by investors outside of China. To help foreign investors better navigate the Chinese A-share market, we describe the trends driving significant change in the Chinese economy, including how Chinese companies can be characterized as "Old China" or "New China." We also discuss the various public, private, and government stakeholders in the China A-share market, as well as their history, motivations, and expectations. Finally, we explain why investors should consider portfolio managers with the experience, resources, and local knowledge to take advantage of this investment opportunity.

The Opening of China's Equity Markets to Foreigners Has a Long History

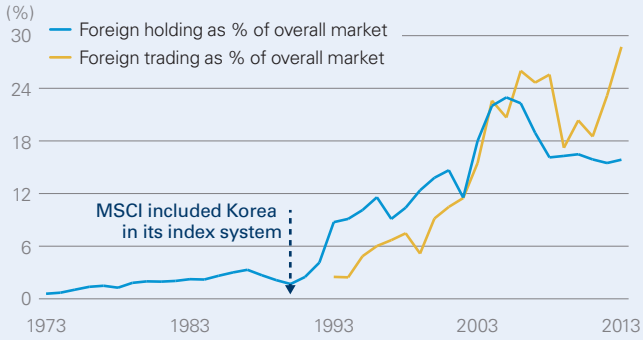
1978	China begins implementing reforms to become a market economy
1990	The Shanghai and Shenzhen stock markets open to the public
2002	Qualified Foreign Institutional Investor (QFII) – Select institutional investors are allowed to own A-shares but with restrictions; all transactions are in US dollars
2011	RMB Qualified Foreign Institutional Investor (RQFII) – Foreign investors get more flexibility to transact in RMB with fewer restrictions
2014	Shanghai–Hong Kong Stock Connect – Gives foreign investors near free-flow movement into and out of A-shares as long as the connect is within its daily trading limit
2016	Shenzhen–Hong Kong Stock Connect – Connection to Shenzhen offers foreign investors more options, especially in "New China" companies (e.g., tech, health care)
2018	MSCI Inclusion – Scaling up of a successful stock connect model, which encourages foreign benchmark-aware managers to invest in China

An Example to Follow?

One way to anticipate China's path is to look at other equity markets that have evolved similarly over the past several decades—especially Korea and Taiwan. Foreign ownership of Korean equities in the late 1970s was 1.4% of market cap, about the 2017 level for China. Foreign ownership levels were similar in Taiwan in the mid-1990s. After five years of MSCI inclusion, however, foreigners owned about 10% each of Korean and Taiwanese equities by market cap (Exhibit 1).

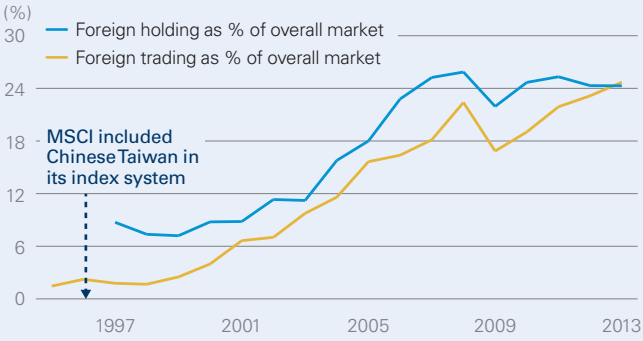
Exhibit 1
Foreign Investor Holdings Increased Dramatically after South Korea and Taiwan Were Included in MSCI Indices

Korea



Data from 1973–2013

Taiwan



Data from 1995–2013
Source: CEIC, CICC Research

A Snapshot of the Chinese Market

Some investors look at the Chinese market through the lens of "Old China" or "New China." This distinction can help A-share investors as it offers perspective on individual companies, their place in the Chinese economy, and their prospects in the market. We do not consider one group superior to the other because both, in our view, offer investment opportunities. However, we believe investors should be flexible because analyzing both groups through a single approach can result in blind spots.

"Old China"

Old China companies benefited from China's high GDP growth era (~10% GDP growth 1991–2011). During this period, the economy was mainly driven by fixed asset investment (FAI)—for example, material/metal & mining and traditional financials. Due to the high levels of FAI during this period, many of these industries today suffer from overcapacity, high leverage, and high non-performing loan (NPL) ratios.

However, Old China still offers investment opportunities in companies that can maintain strong profitability over the next three-to-five years. These companies tend to have low levels of growth, strong cash flow positions, and high dividends. In addition, they typically have low valuations because domestic investors have preferred growth and New China companies (more on New China below). Strong Old China companies also have the potential to outperform through catalysts, including changes in industry dynamics or supply-side reform.

Financials and real estate are dominated by Old China companies, and they have been severely penalized by investors over the past several years. In December 2018, the average price to earnings (P/E) ratio was 8.1x for financials and 6.1x for real estate—far below the benchmark (MSCI China A Index) average of 9.6x.

Much of the financials sector consists of traditional banking firms. Banks granted many loans to fund FAI projects over the last three decades, especially for stimulus in 2008 during the global financial crisis. Loan growth for Bank of China, for example, reached 50% year over year in 2008.[1] Because of this rapid growth, investors have been concerned about NPLs and the limited transparency of the banks' overall quality. Regulators have tried to address these issues. They have required that local government–financing vehicles and wealth management products be disclosed and put back on bank balance sheets. To make regulators more efficient, CBRC, CIRC, and some functions of the central bank, People's Bank of China, were combined in 2018.

Investors, however, continue to show little confidence in the A-share financial sector, regardless of the individual company's circumstances and characteristics. Some banks did not participate in FAI but instead focused on consumer lending in strong economic areas, sought to monetize customer data with a strong IT platform, and used their strong balance sheets to win market share. These banks may increase their profitability and issue strong dividends and yet they are trading at single-digit P/E levels.

Another area dominated by Old China companies is real estate, which has enjoyed a long-term boom for several reasons. Demand for housing has been high and Chinese investors have few places to invest their money. The sale of land is an important source of funding for local governments. In addition, buying a house can be important for some Chinese that are about to marry, so housing affordability can be a potent social issue. Therefore, the Chinese government focuses on this sector and has taken measures in the past to ensure price stability.

The government has implemented policies to curb speculation, such as increasing down payments for second home purchases and disallowing local governments to auction lands during certain periods. As a result, the whole real estate sector was de-rated by investors. As with financials, investors did little to distinguish among individual companies. For example, some companies have focused on the mid-to-low end to meet demand while also maintaining a strong footprint across the entire country. Others have focused on the commercial real estate sector. They do not build or acquire new projects but collect rents from existing tenants. These companies generate strong profits and cash yields at relatively attractive valuations.

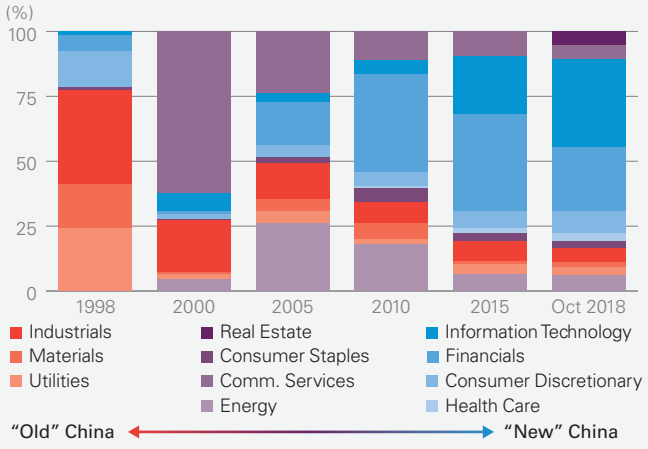
"New China"

New China consists of companies that benefit from the current lower GDP growth era (about 6% per year), in which China is upgrading its living standards. These companies address untapped demand in areas such as technology, the environment, health care, and education. Due to the structural change in GDP, these industries are characterized by rapid margin or volume expansion. A comparison of China's sector composition over the past two decades shows the growth of New China companies in the economy (Exhibit 2). In 1998, the three largest sectors were industrials (37%), utilities (24%), and materials (17%). In 2018, the three largest sectors were information technology (34%), financials (24%), and consumer discretionary (8%). Even though the financials sector is still significant within the index, the composition has changed. The big state-owned enterprise (SOE) banks still comprise a substantial majority of the sector by market cap, but growing numbers of FinTech/AI players are available for investors interested in capitalizing on disruption.

In New China areas of the market, investors will most likely benefit from companies that can deliver consistently high quality growth over the near-to-mid term. To identify these winners, investors should focus on companies with superior business models and higher earnings growth, and which appear undervalued. A risk for New China companies is government policy. The growth stories for many of these companies depend on benefits derived from new regulations. However, if the regulations are not implemented, or if they are implemented differently than expected, then growth for these companies might be threatened. Therefore, it is essential for investors in New China companies to closely monitor policy change.

Exhibit 2
The Chinese Economy Is Evolving toward "New China" Companies

Sector Composition (MSCI China)



As of 31 October 2018
Source: FactSet, MSCI

The technology and health care sectors are dominated by New China companies, which have been favored by investors. In December 2018, the P/E was 16.7x for information technology, 18.0x for communication services, and 17.8x for health care, well above the benchmark average of 9.6x.

Chinese technology has advanced significantly over an extremely short period of time. Most Chinese consumers, for example, do not need to carry cash or cards. They instead rely on Alipay and WeChat electronic payment systems for their daily needs, including dining, parking, shopping, etc. In the hardware space, Huawei, XiaoMi, Vivo, and Oppo have established strong brands and have positioned themselves as sources of higher quality goods at relatively attractive prices. Most recently, China is starting to recognize the benefits of AI-related health care products and services promoted by Baidu, Alibaba, and Tencent. This is evident in the sheer number of patients being treated and the volume of medical records.

As technology companies strive to become the next giants, many of their A-shares are trading at extremely high valuations while earnings are just breaking even. Many domestic investors are excited by their growth potential and are willing to pay as long as the company's story and progress remain valid.

However, it is notable that many Chinese tech companies with the strongest competitive positions and growth prospects are listed in Hong Kong as H-shares or in the United States as ADRs rather than A-shares on the mainland—e.g., Tencent, Alibaba, and JD.com. This reflects two listing requirements. First, according to the China Securities Regulatory Commission (CSRC), all shares must have equal voting rights (versus weighted voting rights in the United States). Many tech companies have a variable interest entity structure, where voting rights are not shared equally, investors cannot get access to accounts, and they are unable to check information. Second, the company needs to show a profit for the last three years. Many companies, especially in the tech sector, do not make a profit (at Alibaba's first IPO, it had negative earnings) and urgently need capital to grow.

Because Chinese investors have no access to the most well-known tech companies, they bid up the stock prices of many A-share tech companies despite their lower quality. However, this valuation gap might disappear as the CSRC is considering approval for CDRs, Chinese Depository Receipts, which would allow Chinese investors to buy ADRs in the United States. By that time, with additional options for investors in the tech sector, domestic A-share valuations for some companies will likely reach more reasonable levels.

Like technology, the health care sector offers significant long-term potential in China. The population is aging quickly because the baby boomers born in the 1950s are living longer but increasingly suffer from many kinds of diseases, such as heart conditions, cancers, diabetes, etc. The government has made extensive efforts to reform health care to make the new drug approval process faster and state-sponsored insurance schemes easier to navigate for citizens. For some diseases, China has become a leading innovator globally. The potential returns from Chinese health care have attracted investors and driven up valuations in this sector.

In summary, we believe it can be helpful for foreign investors to consider whether individual Chinese companies are part of "Old China" or "New China." Again, we do not mean to imply that one group is superior to the other—both, in our view, offer opportunities. We recommend investors do thorough due diligence on each company, or consider investing with a manager with sufficient resources and experience.

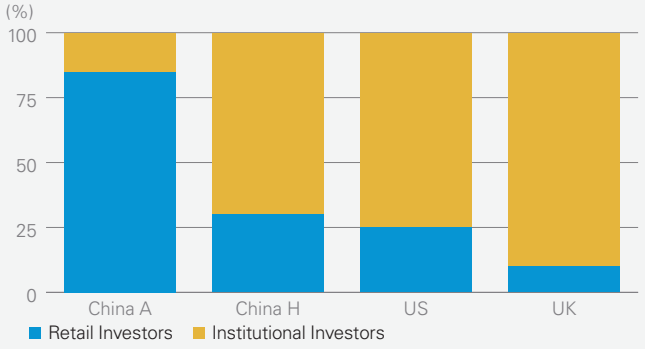
We also believe that foreign investors should study the Chinese A-share market and its participants. Chinese have their own unique history, expectations, and goals when investing, and this influences how the markets perform. Foreign investors with this background may have more insights into why: the Chinese A-share market is one of the most volatile; Chinese companies typically release less public information compared to western companies; the valuations of some Chinese companies may seem extreme; the Chinese government intervenes in markets; and Chinese authorities hope to attract foreign investors to A-shares in the first place.

Retail Experience

New investors in Chinese A-shares will be participating in an equity market that, in just three decades, has grown into one of the largest in the world. They will also be investing alongside approximately 200 million Chinese retail investors, who own the vast majority of Chinese A-shares and account for 85% of A-share trading (Exhibit 3). Chinese retail investors reported that 81% of them trade at least once a month—compared to 53% in the United States—and many prefer small cap growth companies.[2] This helps explain why China A-shares are among the most volatile in the world.

Exhibit 3
Chinese Retail Investors Account for Most China A-Share Trading

Turnover Contribution by Investor Type



As of 1 May 2018

Source: South China Morning Post, 1 May 2018, https://www.scmp.com/business/money/markets-investing/article/2144194/global-investors-take-their-positions-ahead-chinas

Chinese retail investors have turned to the A-share market for several reasons, including:

1. Investment instruments are limited in China, especially as wealth has grown rapidly. Unable to invest globally, most retail investors can only choose real estate, deposits (where interest usually lags the rate of inflation), and equities.
2. IPOs are often considered a reliable source of returns because IPO stock prices have historically risen. This confidence comes from the fact that A-shares must be approved by the CSRC, a process that takes several years and therefore identifies—in the popular mind—the best companies in China. In addition, retail investors believe CSRC approval implies the backing of the government. (To combat the popular belief that the Chinese government had assumed the risk of A-share performance, the Investor Protection Bureau was founded in 2012.[3] This government bureau sought to educate retail investors about risk in stocks and the government's role in the markets. However, it is notable that during market panics in China, such as in 2015, the CSRC intervened.) While market losses in 2014 and 2015 challenged these perceptions, IPOs remain popular and have generated strong share price performance.
3. Many Chinese retail investors prefer to select their own stocks instead of relying on professional guidance. This is reflected in the mutual fund industry's lackluster growth compared to the expansion of the Chinese equity markets.

It is also important to note that Chinese domestic investors and foreign investors may define growth differently. Domestic investors define growth in absolute price terms while many international investors focus on growth at a reasonable price. Therefore, many A-share stocks trade above 50x or even 100x P/E regardless of their growth rate.

Chinese Institutional Investors

In addition to retail investors, a small number of Chinese institutional investors also influence A-share market performance. The investment style of institutional investors has generally been biased to growth companies and has employed a horizon of less than one year. Chinese institutional investors believe that the China A-share market incorporates a lot of "on-the-ground" information and is therefore more efficient than developed equity markets.

Chinese institutional investors are more concerned about the risks inherent in equities than are many Chinese retail investors. They conduct intensive due diligence, visiting a company's value chain and competitors to get first-hand information and an in-depth understanding of its business. This reflects a market culture where company management, for the most part, sees little importance in talking directly to investors.

The China A-share market has the highest turnover[4] among the major equity markets. By attracting foreign institutional investors to hold A-shares, China hopes to make the A-share market more like the H-share market—e.g., an investor population more balanced between retail and institutional, with more stable and rational market moves, and greater company transparency. While this evolution is occurring, it will take time.

A-Share Investing Risks

Investors should be aware of some risks to investing in A-shares:

Legal Framework

Chinese security law, in some ways, has not kept pace with the evolution of the country's markets. The last amendment for the Chinese Securities Law was in 2005,[5] and a universal Chinese securities trading law does not exist (the Shanghai and Shenzhen stock exchanges have established rules to supervise their trading). We note that reform of the security law was a subject of discussion during the National People's Congress Conference in 2018, which should be regarded as a positive.

Financial Instruments

Even though the CSRC decrees that a share price movement cannot fluctuate more than 10% of the previous day's price, A-share equities have the highest turnover in the world. This is due to the preponderance of retail investors but also the limited number of financial instruments. Currently, the only available hedging instrument is index futures. In general, the Chinese financial industry is wary of hedging because it is viewed as hard to regulate and control risk. Chinese regulators are also aware of the failure of many large financial firms after the global financial crisis in 2008, and they have remained conservative about hedging. It is notable that this attitude did not prevent the 2015 stock market crisis, which was exacerbated by significant leverage. In light of these experiences and concerns, it is unlikely that Chinese authorities will relax their restrictions.

Quality of Analyst Forecasts

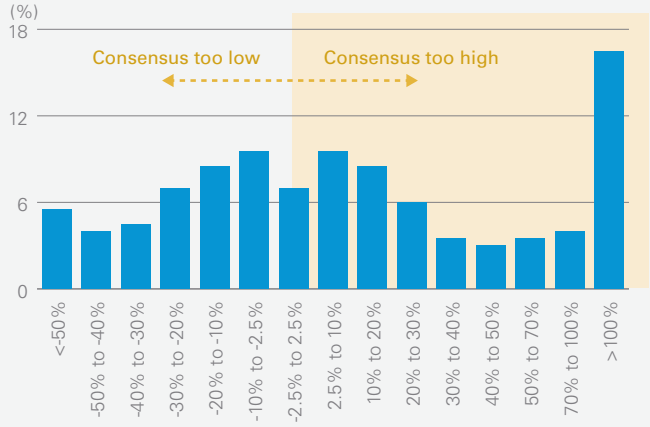
A-share consensus about company forecasts tend to be more extreme and less accurate than for H-shares (Exhibit 4). This reflects the fact that companies are typically not required to meet with investors or host public calls on results. In addition, some corporate officers are less experienced and still see little value in meeting with institutional investors. As a result, internal due diligence is more important for effective A-share investing. Sell-side analysis is usually less useful to investors than it can be in the H-share market.

Corporate Governance

Many institutional investors place a high value on environmental, social, and governance (ESG) factors, especially corporate governance. Chinese A-share investors, however, typically see less value in these factors, and there is no correlation between corporate governance and financial performance. In fact, the SSE 180 Corporate Governance Index (which is designed to reflect performance of stocks with good corporate governance) has generally underperformed the CSI 300 Index (which tracks the top 300 stocks traded in the Shanghai and Shenzhen stock exchanges) over the past five years (Exhibit 5).

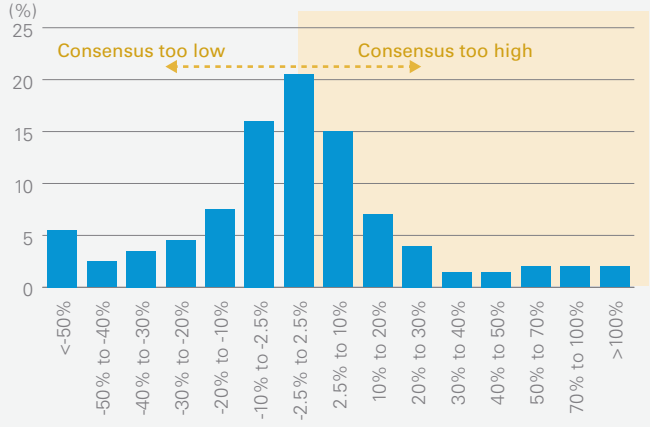
Exhibit 4
A-Share Consensus Tends to Be Extreme and Less Accurate

A-Share Consensus at the Start of Each Year Compared to Actual Earnings from 2013 Onwards



Within 500 largest stocks by market cap

HSCI Component Consensus at the Start of Each Year Compared to Actual Earnings from 2013 Onwards



As of December 2016
Source: Bloomberg, UBS, Wind

Accounting

A-share companies report according to Chinese Generally Accepted Accounting Principles (GAAP) requirements which, in many ways, can be considered more conservative than International Financial Reporting Standards (IFRS). However, Chinese accounting rules are sometimes less closely followed or strictly enforced. While the "Big 4" accounting firms (PWC, Deloitte, E&Y, and KPMG) have significant operations in China, they undertake the accounting for only 6% of A-share listed companies' market share.[6] The majority of Chinese A-share companies still use domestic Chinese audit firms, largely because the Big 4 are two-to-three times as expensive.[7] In addition, some Chinese corporate leadership believe the Big 4 do not have the local knowledge necessary to understand their businesses. It is also important to highlight that the Big 4's Chinese operations are run separately from the United States'. Different standards may be applied and the China businesses' liabilities do not impact the US-based company.

Exhibit 5
Companies with High Corporate Governance Rankings Have Mostly Underperformed Large Cap Stocks

(Index, 0=31 December 2014)

Data from 31 December 2014–31 January 2019
Source: Bloomberg

As a result, international investors should conduct accounting validation to get a true comparison of a company's financial standing with its global peers. However, it is even more important to have a local presence in Greater China to understand the true financials of Chinese A-share companies, which are at much higher risk than H-shares and ADRs.

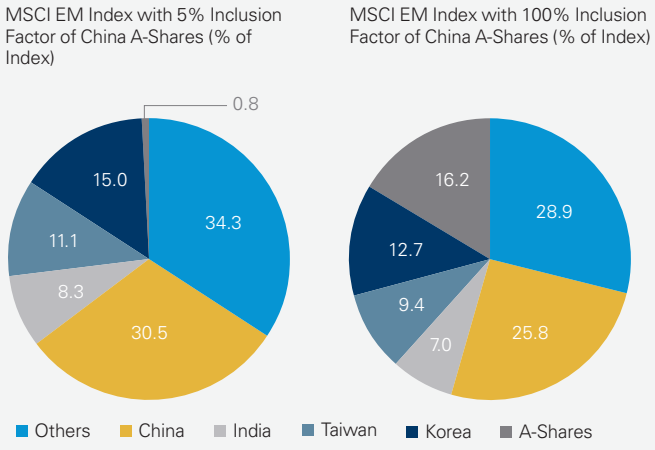
The Next Steps

Investor access to Chinese A-shares is likely to gradually increase. After MSCI first included A-shares in the index, the Chinese government demonstrated its commitment to opening up more to global investors by implementing more policies at an accelerated pace. Chinese authorities quadrupled the daily limit for Stock Connect on 1 May 2018. A Shanghai-London Stock Connect is expected to open in the first quarter of 2019 (with a tentative minimum investor threshold of RMB3 million). Companies available for trading are non-financial blue chip firms with a market cap of at least RMB20 billion and at least three years of listing history on an exchange. China has also eased joint venture restrictions for international companies. BMW, for example, purchased 25% of Brilliance-BMW JV, bringing its ownership to 75%.

The inclusion factor (or proportion of a security's free float-adjusted market capitalization that is allocated to the index) is expected to rise to 20% by August 2019 and will extend to ChiNext (China's NASDAQ) stocks.[8] In May 2020, inclusion eligibility will likely extend to mid-cap stocks. By that time, MSCI estimates that the MSCI China A Index will have 434 constituents, and the inclusion of China A-shares in the MSCI EM Index may lead to inflows (Exhibit 6).

On 2 November 2018, President Xi Jinping announced two major initiatives for China A-shares. The first is a pilot program for a registration-based system for IPOs in the Shanghai Stock Exchange. This will simplify the lengthy approval process, which may include site visits, of a system that is akin to the New York Stock Exchange

Exhibit 6
China A-Shares Will Likely Draw More Inflows as Access Rises



As of 15 May 2018

Based on data used for MSCI's May 2018 Semi-Annual Index Review. 222 China A-shares were added with an Index Inclusion Factor (IIF) of 2.5% of their market capitalization to the MSCI China Index on 31 May 2018. The second phase of their inclusion will increase their index inclusion factor to 5% and is expected to take place during the August rebalance. 100% inclusion is purely hypothetical.

Source: MSCI

(NYSE). However, there is no timeline yet or details that would indicate the scale of the trial. The second initiative is a new NASDAQ-style stock board in Shanghai. The CSRC confirmed that companies listed on this "technology and innovation" board will be subject to different profitability and ownership requirements but have yet to release listing criteria. Though not explicit, this confirmation implies that loss-making start-ups will be able to go public in the China A-shares market. These two initiatives are among the many President Xi has committed to in China's 2030 Globalization plan.[9]

Conclusion

The growing availability of China A-shares to foreign investors represents a historic opportunity. We believe they will bring enormous change to global markets, including:

- Chinese companies can be grouped according to "Old China" or "New China" characteristics, which offers insights on individual companies, their place in the economy, and their outlook. Companies in both groups may offer opportunities.
- A growing proportion of China A-shares will likely be held by foreign institutional investors compared to domestic retail investors. Markets will gradually become more rational and less volatile as institutional investors will likely step in during periods of high volatility to buy mispriced securities. Over time, China A-shares should act more like China H-shares.
- Institutional investors will demand greater accountability and transparency from Chinese companies, which will likely improve analyst forecasts.
- More effective securities law will likely be demanded by foreign investors. We have already seen positive steps taken by Chinese regulators.

We believe long-term investors in the China A-share market should be aware of the various roles played by retail investors, portfolio managers, and government regulators. Above all, investors who are not experts in China's A-share market should look for portfolio managers with experience, a best-in-class process, resources, and local knowledge. While a traditional investment process today may not be seen as the most effective method to select China A-shares, we expect this will change over the next decade.

Notes

1 Source: Bank of China Financial Statement 2008

2 China's approximately 200 million retail investors trade more often than any other investors in the world—81 percent said they trade at least once a month, compared with 53 percent in the United States, according to a recent survey by State Street. https://www.cnbc.com/2015/07/09/three-charts-explaining-chinas-strange-stock-market.html

3 http://www.gov.cn/jrzg/2012-01/12/content_2042326.htm

4 http://stock.jrj.com.cn/invest/2017/07/28083222810234.shtml

5 http://www.gov.cn/flfg/2005-10/28/content_85556.htm

6 http://app.news.esnai.com/?app=system&controller=esnai&action=wapnewcontent&cid=156732

7 http://finance.sina.com.cn/b/20041031/14091121345.shtml

8 MSCI "Consultation on Further Weight Increase of China A Shares in the MSCI Indexes", September 2018

9 https://www.bloomberg.com/news/articles/2018-11-05/china-to-create-stock-venue-in-shanghai-for-high-tech-companies

Important Information

Published on 26 February 2019.