China Briefing

China's equity capital markets: Shift to onshore

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Executive Summary

- *This month we continue our focus on China's capital markets by mapping China's large, liquid, and complex equities landscape.*
- *China still has a miniscule share of global capital flows given its overall economic clout. That is because its equity markets are young and prone to pronounced boom and bust cycles, in which you can gain or lose a fortune quickly across different company types, sectors, and individual stocks.*
- *Such volatility is understandable given how young China's capital markets are and the history of how they developed. Today, there are three different markets, each with their own traits and all of which list Chinese companies. But there are still overhangs, overlaps, and iniquities leftover from the past that we need to be mindful about.*
- *The government is torn: it can be highly interventionist as it tries to manage volatility and prevent what it sees as over-financialisation and inadequate focus on real economic issues, but it also wants to integrate into global capital markets and have their best and brightest companies list at home rather than abroad.*
- *With the US market becoming progressively closed off, people who want to participate in China's growth story will need to go into China's onshore markets.*

China Briefing

As we illustrated in the last Briefing, China's capital markets are an unusual beast. Access is hard (except when you try through Hong Kong), demand comes from different sources (unlike the western capital markets with less institutional participation), and it has an interventionist Communist Party running the state and regulating the markets.

Much of that goes back to the start. Not only did China's reformers have to decide how to introduce markets, but they also had to decide how to do so for a capital-averse Communist Party. Practice and behaviour led rules and regulations; changes frequently occurred prior to the establishment of adequate legal or regulatory frameworks.

Ambitious Chinese firms looked outside to raise capital. Why? Because China's own equity markets were not ready. The listing requirements at home bourses were too strict, the IPO timeline was at the mercy of the regulator (long queues not uncommon), foreign capital was blocked from investing in several sectors (including telecommunications), fundraising was more expensive at home than going overseas (owners could keep control of their company more easily abroad via so-called variable interest entities)[1], and, lastly, there were caps on valuation to deter aggressively-priced IPOs.

Chinese companies raised billions of dollars in international stock exchanges, mostly in Hong Kong and New York. The most well-known of these were tech giants, such as Alibaba, Tencent, and Baidu. But state-owned enterprises (SOEs) including China Mobile and China Unicom and two oil refiners, PetroChina and Sinopec, also listed abroad.

The desperation was such that even China's government got in on the act, restructuring hundreds of local telecommunications firms to make one national giant, China Telecom, so that it could list in Hong Kong and New York with the help of Goldman Sachs. China Telecom had not even existed eight months prior to its listing in 2002.

Today, access to China's growth can come from simply buying US-listed shares. The stock movements of China's American Depositary Receipts (or ADRs, which are certificates issued by a US bank that represent shares in overseas markets) are closely monitored on a global scale. The Goldman Sachs bankers who used to run IPOs for the bank are now moving to China to work for the tech giants, and as we showed in the last Briefing, China's onshore markets are rapidly reforming too.

Yet, foreign investors continue to have minuscule exposure. China did not particularly encourage foreign investment in local equities for years and investors were deterred by the market's severe volatility and consequential government interference. In 2015, more than half of all listed Chinese companies, or 40% of the country's market cap, halted trading for weeks. Companies suspended trading due to the unwinding of margin loans amid the market rout.[2] In response, new paths for international investment opened up and institutional investors were welcomed.

China's equity markets are no longer an afterthought for international investors. This is new for both China and investors alike. In the early days of China's onshore equity markets, international investors were perhaps seen more as trouble than of value. Instead, enterprises raised funds from international investors in Hong Kong or the US, which would subsequently be delivered onshore. Today, the tides seem to be pushing investment into China despite the global headwinds of US-China relations and government intervention.

Chinese shares trade in 3 distinct markets: China, Hong Kong, and the US

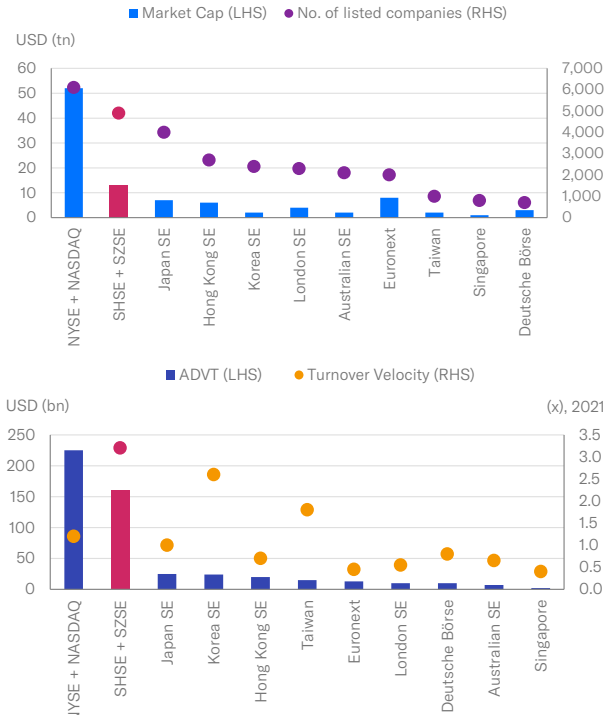
Among foreign investors looking to gain China exposure, the US and Hong Kong are the most popular markets. This is largely due to the stellar growth of e-commerce, media, and gaming companies, including Alibaba, Baidu, and Tencent (all dual-listed in the US and Hong Kong), over the past decade. On the other hand, until recently, China's onshore markets have seen limited foreign participation despite a much larger, rapidly maturing opportunity set.

[1]Refers to a legal business structure in which an investor has a controlling interest despite not having a majority of voting rights. This is because the controlling interest is arranged via a contractual relationship rather than direct ownership (Source: Investopedia).
[2]The government tried to cool the market by clamping down on margin account financing. The ensuing sell-off triggered margin calls on both a retail and corporate level. Corporates had used their own stock to secure loans from banks (a common practice in China).

China has two major onshore financial centres: Shanghai and Shenzhen. Together, they represent the world's second-largest equities market, listing approximately 4,200 mainland Chinese companies, also known as A-shares.

China's onshore market can be described as vast, liquid, and volatile. The combined average monthly turnover of the Shanghai and Shenzhen exchanges is USD 2tn. To compare, the New York Stock Exchange, the largest in the US, also trades an average of USD 2tn each month.[3]

China A-shares make up the 2nd largest equity market globally by market cap and cash turnover



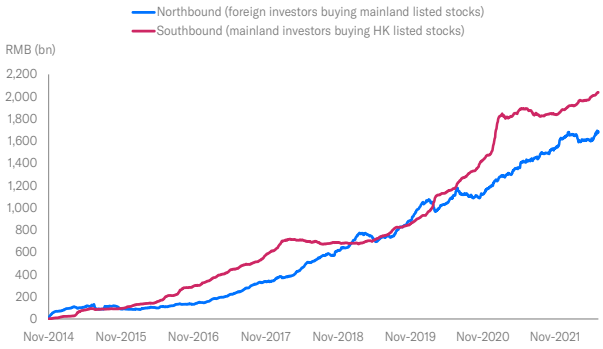
Source: WFE, data compiled by Goldman Sachs Global Investment Research as of 31 Dec 2021

The structure of China's market drives some of the volatility. The bulk of onshore equities are not tradable since they are either state-held or regulated, and most tradeable equities are owned by speculative retail investors or high-net-worth individuals, unlike other markets with buy-and-hold institutional investors owning most of the stocks. This creates pronounced boom and bust cycles, stock prices deviating from fair values, and a large dispersion of returns within and across sectors (herding mentality).

Part of the reason for this structure is that, traditionally, it has been hard to buy Chinese shares. Large institutional investors overseas have had access to onshore equities through the Qualified Foreign Institutional Investor (QFII) and Renminbi QFII schemes since 2003 and 2011 respectively[4], but A-shares have only recently become more accessible with the emergence of Stock Connect in 2015.

Stock Connect allows any investor with a brokerage account in Hong Kong to buy and sell A-shares, including companies in secular growth industries that were previously inaccessible. Instead of setting a quota for each investor, Stock Connect applies an aggregate quota for total purchases. The greater flexibility and convenience of Stock Connect has made it the preferred channel for foreign investors to access the onshore market. The scheme was also instrumental in MSCI's decision to include A-shares in its Emerging Market and China indices.[5] This "forced" global allocators to grapple with China's onshore market in earnest for the first time. While participation has steadily increased, foreign investors are estimated to own a mere 4% of free-float.[6]

Aggregate net purchases in the Stock Connect programme show steady growth in two-way flows since launch



Source: Bloomberg, Wind

To access China's massive growth, investors often went overseas to trade in Chinese shares. Offshore, the primary market is the Hong Kong Stock Exchange (HKEX), which trades a diverse spectrum of Chinese stocks alongside Hong Kong-based firms. These equities are classified into two categories: red chips, which are Hong Kong firms with significant activities in mainland China, and H-shares, which are Chinese enterprises listed in Hong Kong.

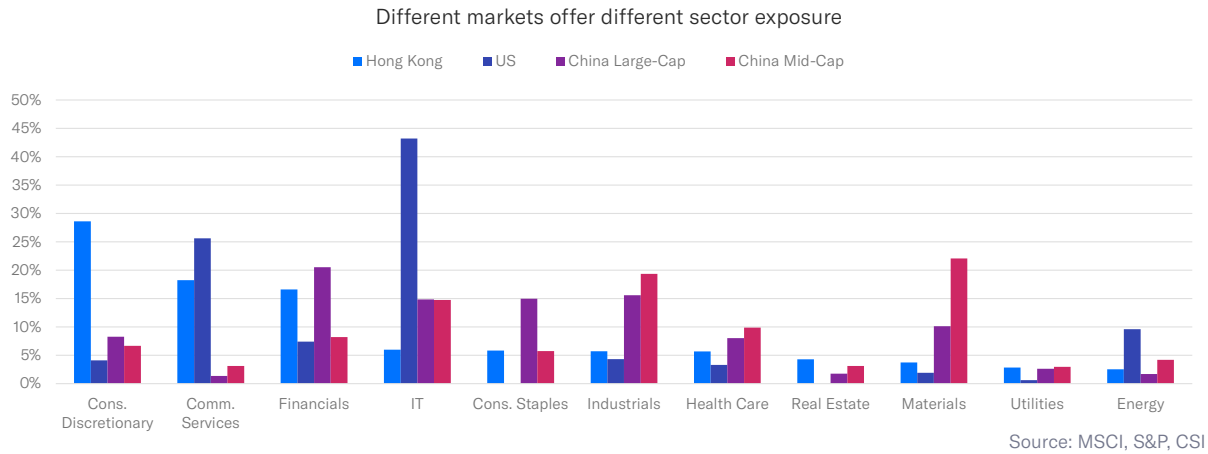
[3]Data extracted from CEIC (NYSE), Shanghai Stock Exchange, and Shenzhen Stock Exchange.
[4]QFII allows a restricted amount of foreign investment in onshore financial markets. Investors complete an approval process to open an account and receive a quota it can put in, using home currencies to buy. RQFII allows investors to use offshore RMB accounts to invest - this quota grew rapidly.
[5]To date, MSCI has included A-shares at a 20% inclusion factor.
[6]Portion of shares owned by public investors v.s locked-in shares of promoters, company officers, controlling-interest investors, or governments.

The HKEX has consistently ranked the world's number one IPO venue in the last twelve years. It is the first choice for Chinese companies with global aspirations and for global companies that want to access China.

Finally, Chinese companies are listed in the US primarily through ADRs. In 2020, the US made it more difficult for Chinese companies to issue ADRs and several have since withdrawn them to list their shares in Hong Kong or Shanghai. This trend is primarily driven by geopolitical considerations.

The complexity of Chinese marketplaces is becoming obvious at this point. Different opportunities must be accessed through different exchanges in different markets with different rules and regulations as well as market participants . The discount rate, the kind of companies listed, the profits they produce, and the dividends they pay are vastly different. So China's onshore and offshore markets are complimentary but not always well synchronised.

The resulting inefficiency creates arbitrage opportunities that can be exploited by skilled managers to generate 'risk-free' returns. Take Ping An Insurance as an example. The company is listed both in China and Hong Kong. The A-share ticker (601318.SH) typically trades at a premium or discount to the H-share ticker (2318.HK), adjusted for currency. Arbitrageurs can buy the ticker that trades at a discount and sell the ticker that trades at a premium to generate a profit. The systematic analysis of historical premiums and discounts combined with efficient access can provide a consistent return stream, uncorrelated to the direction of the market. Currently, such opportunities are not available to retail investors in China (single-stock shorting not permitted).



Investments wanted, but risks remain

The overall direction is very clear: China wants capital markets, specifically equity markets.

China's government is able and ready to encourage its own winners. Beijing is expanding its presence up and down the country's IPO pipeline. Over the past decade, so-called "government guidance funds" have raised more than USD 900bn to ensure enough early funding flows to companies from favoured industries such as high-end manufacturing, renewables, and biotech.[7] These public-private investment funds, set up by or for government agencies, carry a dual mandate of furthering Beijing's policy aims and delivering financial returns. IPO fundraising for Chinese firms has nearly been all amassed in domestic markets, where state-run investment banks such as CICC and Citic Securities dominate deals, while top Wall Street banks such as Goldman Sachs and Morgan Stanley miss out on Hong Kong and New York listings, which have delivered billions of dollars of annual fees in recent years.[8]

[7,8] How Xi Jinping is reshaping China's capital markets by Hudson Lockett, *The Financial Times* (12 June 2022)

Therefore, there are both more assets shifting to China's onshore market and more state capital deployed. Sectors that were previously not as important, but are now explicitly supported by government planning (due to strategic relevance), are set to experience strong growth in years to come while carrying limited regulatory risk. Among several others, sectors such as advanced manufacturing, semi-conductors, renewable energy, electric vehicles, and biotech are receiving tremendous state support.

The influence of the Communist Party is also not restricted to SOEs, which affects the market's perception of China's shares. President Xi Jinping has presided over a drive to reassert Party influence. Both private and state companies in China must balance political and regulatory demands with the needs of their business and seek to benefit from government largesse when possible.

That said, the Chinese government is very keen to start filling these gaps. As last month's Briefing outlined, there have been considerable activities to bring about more efficient, institutionalised capital markets. China's leaders have red lines — capital has to serve the real economy, benefit onshore investors, and there is to be a limit to financialisation — but the direction is very clear indeed.

The problem is that there is a conflict between the need for regulation and the moral hazard associated with the government intervening in the market. For example, when President Xi Jinping interfered in the capital markets in 2015, plans went awry: a group of state-affiliated investors spent an estimated USD 234bn in an effort to support the equity markets but, instead, it suffered a strong correction. Furthermore, it diminished foreign investors' faith that central leaders would leave markets alone.

Therefore, despite the rules changing for the better as we described last month, there are still significant overhangs. For instance, if you are an institutional investor, you know that there is a systematic bias for SOEs that sell off assets. To stop asset stripping, a rule states that once purchased, shares cannot be sold for less than their reported Net Asset Value. But often, as in the example mentioned, shares are bought by SOEs. So even if you bought the shares to help the state, the state would not help you sell them afterwards. Therefore, specific risks remain.

There are also some rules that will need to change for the equities market to flourish. For instance, the timing of public listings is currently orchestrated by a government entity rather than in the hands of the company. IPOs are also still priced using a cap on valuations prior to trading in the secondary market.

Additionally, the question of political trust persists. Given recent wobbles in China's bond market, developments in the equity markets regarding IPOs, and what is widely perceived as a regulatory crackdown on technology and fintech companies (see our Briefings on Ant and Alibaba), a confidence-building exercise is perhaps needed with a more stable framework in sight to reassure market participants.[9]

Finally, there is an elephant in the room that connects all of these factors: Beijing's relationship with the White House remains problematic. The first major concern is that the US wants Chinese firms to open their books to Public Company Accounting Oversight Board inspection (to protect investors and ensure equal treatment). Secondly, there remains a US sanctions list with thousands of entities on it, all blocked from international financial transfers, many unable even to open up bank accounts. Finally, there exists a range of data privacy issues on both sides.

Neither China nor the US are willing to budge on these issues. Apart from the handful of SOEs listed in the US, China also has a slew of large technology businesses listed in US markets. Both sets of regulators will take a firm stance against them under data privacy laws. Even if a settlement is reached, some businesses would still delist. Didi, for example, has already taken action, aided by its lack of favour with Chinese regulators, whom they snubbed while listing.

[9]Take Hong Kong and China as an example. The price divergence between these two markets is related to differences in market rules (e.g. max. daily stock move of +/- 10% onshore vs. no limit in HK), regulations (no single stock shorting in China), market participants (retail domination plus leverage) and newsflow (China vs. Western media).

What are the implications for investors?

China's equity markets have developed rapidly over the past decade and have now become the second-largest market in the world.

We can see a range of traits that hold across China's equity markets. First, although well-intended, government intervention has contributed to the boom and bust cycles. This is a trait of the China market and will continue to be. Secondly, market access has improved markedly with the introduction of Stock Connect. Foreign investors now have access to a vast pool of maturing companies with deep liquidity and of decent size (over USD 1bn in market cap). Stock Connect will continue to be expanded both in terms of securities and products (e.g. ETFs start to trade from 4th July onwards). Thirdly, there is low foreign ownership in A-shares, but this will continue to grow.

What follows next for Beijing is evident. They are intervening to transition their capital markets to more modern financial products. They are also looking to diversify their investor base as the local market still has an insufficient number of pension funds, insurance firms, and hedge funds. China's policymakers continue to aim for increased institutional investors and portfolio inflows. They have a strong pitch which is unfortunately poorly communicated to foreign investors.

As China builds more sophisticated equity markets, there will be many fluctuations. But these will create major opportunities for both those who use traditional analysis and those who focus more on modern machine-based methods alike. That is because now one can get money from equity markets in more ways — China now allows short selling and other techniques, and so managers can do more than purely going long in the equity markets. Further, as it becomes more difficult to make money in one's home markets, the chance of higher returns in China will push global hedge funds and others into the Chinese markets.

Given this, we believe the following most likely: US listings become less important as Chinese companies start to relist in Hong Kong and/or in China, as there is increasing political pressure from all sides to do so, and also as it becomes easier to list in China. We also think that there will be new companies outside the current internet-based tech giants that will gain the spotlight — probable winners include electric vehicles, renewables, and semiconductors. While accessing these new growth opportunities will require shifting onshore to China, and dedicating further time and effort to understanding this more opaque market, the possible rewards are many. These companies are likely to grow strongly, much like the internet platforms themselves did two decades ago.

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