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China A-shares:

A convergence of parallel investment universes

"To boldly go where no man has gone before..."[1]

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Synopsis

- The domestic A-share market in China has become the second largest equity market in the world, yet it remains mostly outside the investment universes of international investors and asset owners.
- Foreign ownership and capital restrictions coupled with opaque listing rules has restricted overall foreign ownership to only 3% for the A-share market.
- If MSCI builds on its decision to introduce A-share companies in 2018 towards full inclusion, then Chinese companies may eventually represent over 40% of the MSCI Emerging Markets Index (Figure 1), reinforcing the country's continuing importance and growth in the global economy.
- The introduction of A-shares comes with a number of potential investment risks, however the broader opportunity set will also create opportunities for disciplined, long-term focussed value investors.

This paper discusses the details of the MSCI announcement to include China A-shares (A-shares) in their indices and how it increases China's importance in the MSCI Emerging Markets and Asia ex-Japan Indexes. Specifically, we will explore the background to the A-share market and how the new inclusion of A-shares broadens the opportunity set for investors and diversifies their global equity portfolios. The paper will also highlight the risks and opportunities that the integration of the A-share and offshore markets will create.

The domestic share market in China is beginning to open the doors to foreign investors, as local regulators also relax prohibitive measures on foreign investment. As a result, the investment opportunity available in Asian and emerging markets will expand vastly for investors. The Shanghai and Shenzhen Stock Connect programs, will now allow offshore investors to explore new sectors, markets and seek out companies that have different products, some of which we believe are well managed and have achieved impressive profitability over the long-term.

MSCI announced in June 2017 that China A-share companies will be introduced into the MSCI Emerging Markets and MSCI Asia ex-Japan Indexes from May 2018.[2] China is already a significant portion of the index through the Hong Kong market and US listed Chinese companies and over time will become even more dominant as the A-share integration progresses towards full inclusion (Figure 1).

Figure 1: Index weighting changes following A-share inclusion

	Asia ex-Japan			Global Emerging Markets		
Region	**As at 31/12/2017**	**Estimated 2018 Inclusion**	**Theoretical Full Inclusion**	**As at 31/12/2017**	**Estimated 2018 Inclusion**	**Theoretical Full Inclusion**
China	34%	35%	53%	30%	31%	45%
Greater China*	59%	59%	78%	41%	42%	57%
Asia	–	–	–	73%	74%	89%

*Greater China includes China, Hong Kong and Taiwan.
Source: MSCI, as of December 2017.

[1] Excerpt from Star Trek. "Space, the final frontier. These are the voyages of the starship Enterprise. Its 5-year mission: to explore strange new worlds, to seek out new life and new civilizations, to boldly go where no man has gone before."

[2] Generally MSCI is the most common benchmark used for these asset classes by international asset owners. The other global equity index data vendor of significance, FTSE, started their transition of relevant benchmarks to include China A-share in May-2015, with an initial China A-share combined weight of 5% for GEM with a view to rise to 32% should full inclusion occur.

The journey to China A-share inclusion

The Chinese equity market is composed of a domestic and an offshore market. The Shanghai Stock Exchange and the Shenzhen Stock Exchange are the two exchanges operating in mainland China, founded in their present form in 1990. The majority of Chinese stocks are listed on either the Shanghai or Shenzhen Stock Exchanges and these stocks are generally known as A-shares.

A-shares constitute China's domestic market; the A-share market has grown to over USD 9 trillion in total market capitalisation, making it second only to the United States in terms of market capitalisation.[3] While there will only be ~200 stocks in the initial inclusion of the MSCI benchmark there are 1,622 stocks with a market capitalisation greater than US$ 1 billion which when combined with the Asia ex-Japan region would make it larger than the number of stocks available in the European or US regions separately (Figure 2).

Figure 2: Expanding opportunity set with the inclusion of China A-shares

	Number of Stocks	
Region	**Market Cap > USD 1B**	**Benchmark**
Asia ex-Japan MSCI Asia ex-Japan	1,694	647
China A-shares Pending MSCI Inclusion in June-2018	1,622	222
US S&P 500	2,125	505
Europe STOXX 600	1,347	600

Source: Factset, as of December 2017.

Despite this, China remains mostly outside the investment universe of international investors and asset owners, with foreign ownership limited to only 3% of the A-share market.[4] Until recently, foreign investors had limited access to China's domestic equity markets. This has now changed, with the Chinese government opening the door to foreign investment in local Renminbi denominated equity markets (A-shares) through its Renminbi Qualified Foreign Institutional Investor (RQFII) program and most recently the Shanghai-Hong Kong Stock Connect Program (SH-HK Connect).

Even though the RQFII and QFII schemes were introduced in 2003 and 2011 respectively, their cumbersome regulatory requirements and the use it or lose it nature of the quotas, created significant restrictions. In contrast, Stock Connect which was created in 2014 following the relaxation of regulatory constraints by the Securities and Futures Commission (SFC) in Hong Kong and the China Securities Regulatory Commission (CSRC), enables foreign investors easier access to Chinese companies listed on Shanghai and Shenzhen stock exchanges.

Figure 3 outlines the Chinese share classes currently operating in parallel and how they can be accessed by investors:

Figure 3: Chinese share class availability

Type	Currency	Exchanges	Eligible investors
A-shares	RMB	Shanghai and Shenzhen stock exchanges	Chinese domestic investors, QFII/RQFII, Foreign investors (via SH-HK Connect Program)
B-shares	USD, HKD	Shanghai and Shenzhen stock exchanges	Foreign investors
H-shares, Red chips, P chips	HKD	Hong Kong stock exchange	All investors
N-shares & ADRs	USD	NYSE	All investors

Source: www.etfsecurities.com/retail/se/en-gb/china-a-shares

Chinese companies wanting to list have always had the choice of listing domestically or overseas. Now international investors seeking to invest in China have the same flexibility choosing whether to deploy their capital in either A-share or offshore markets.

Domestic and offshore markets converge

The most significant developments which have allowed international investors and asset owners to invest in A-shares are:

1. Access to China A-shares through Stock Connect

Stock Connect is the channel which allows trading, settlement and custody of A-share market stocks by institutional and retail investors outside of China through the Hong Kong Stock Exchange without the cumbersome licensing and other requirements of QFII/RQFII quotas. A parallel channel which allows investors within China the same access to Hong Kong-listed stocks also exists within Stock Connect (Figure 4).

Figure 4: Stock Connect channels

Stock Connect Northbound Channels	Established	Eligibility Criteria	Eligible Stocks	Daily Net Inflow Quota (RMBm)
HK-Shanghai	Nov-2014	Shanghai - Large Cap, Shanghai - Mid Cap	576	13,000
HK-Shenzhen	Dec-2016	Shenzhen Component, Shenzhen Small/ Mid Innovation	944	13,000

Source: Hong Kong Stock Exchange

[3] Bloomberg, October 2017.
[4] This is based on aggregating total QFII and RQFII quotas ever issued, plus net cumulative inflow through Stock Connect (Figure 4), then dividing by the market capitalisation of the relevant market. Data sourced from the State Administration of Foreign Exchange (SAFE) of China website.

Figure 5: Stock Connect flow growth since November 2014 to December 2017

Source: Bloomberg, as of December 2017

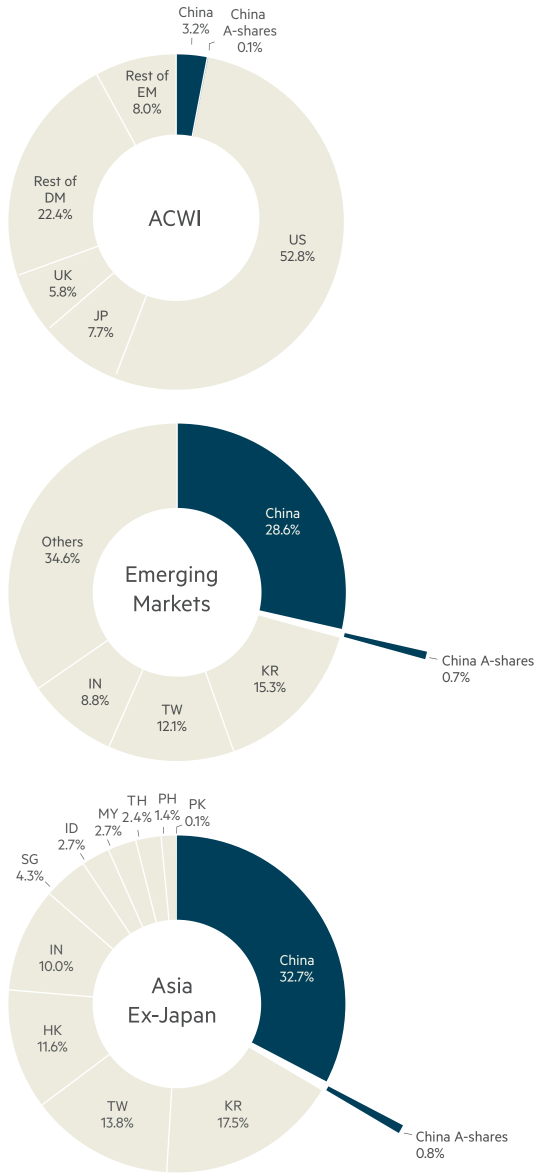
Stock Connect is now perceived as the preferred channel to buy/sell A-share companies and since the initial launch, Stock Connect has experienced steady net inflows growing to around RMB 500B (USD 75B) of foreign ownership in less than three years (Figure 5).

2. A-share inclusion in the MSCI set to grow from 2018

From 2018 A-share companies will be introduced into the MSCI Emerging Markets and MSCI Asia ex-Japan Indexes. The inclusion will initially be done in two tranches during May and August 2018. The initial stage of inclusion will involve significant changes to the composition of the Emerging Markets and Asia ex-Japan benchmarks with 222 new stocks to be added as per the June 2017 announcement. While the index weight impact will be negligible initially it is expected to grow significantly[5]. After the second tranche and based on a simulation by MSCI in June 2017 shown in Figure 6, there will only be an estimated 0.8% weight increase within MSCI Asia ex-Japan and 0.7% within MSCI EM.

It should be emphasised that any further A-share inclusion will be gradual and contingent on numerous uncertain factors. The most relevant previous example of a significant new market introduced into the MSCI benchmarks was South Korea, which initially entered the index in 1992. It took less than a decade to 1998 for full inclusion to result. Over a similar period, it is possible that Chinese stocks may eventually represent 45% of the MSCI Emerging Markets Index by the year 2025[6].

Figure 6: MSCI index impact will be marginal initially



Source: MSCI, ACWI, as of June 2017
EM = Emerging Market, DM = Developed Market, UK = United Kingdom, JP = Japan, US = United States, KR = Korea, TW = Taiwan, IN = India, HK = Hong Kong, SG = Singapore, ID = Indonesia, MY = Malaysia, TH = Thailand, PH = Philippines, PK = Pakistan

[5] See Figure 1 from MSCI on theoretical full inclusion. The number of stocks entering into the benchmark in 2018 (estimated to be 222 stocks in June-2017) is a reference only; the actual number will depend on a dynamic criteria based list with possible changes in the number and composition at inclusion date depending on the number of suspended stocks. MSCI data presented in Figure 1 for theoretical full inclusion.
[6] MSCI data presented in Figure 1 for theoretical full inclusion.

A-shares will offer broader exposure

The profile of the investment universes available in each Chinese market differs significantly in terms of industries and allocations (Figure 7). Using MSCI's wider China coverage of 1,263 stocks, the A-share universe has less Financial, and Utilities companies, as a percentage of the market but far greater numbers of companies to potentially invest in, as compared to Chinese companies listed in Hong Kong. The exposure to the Consumer Discretionary and Materials sectors is also significantly higher in the A-share market, both as a percentage and number of stocks, compared to the Hong Kong-listed Chinese companies.

Figure 7: A-share sector allocation vs. Hong Kong-listed

	Stock Allocation			
	China A-Share		Hong Kong Listed	
Sector	No. Stocks	%	No. Stocks	%
Energy	30	3%	9	5%
Materials	**167**	**16%**	**15**	**8%**
Industrials	257	24%	41	21%
Consumer Discretionary	**165**	**16%**	**18**	**9%**
Consumer Staples	60	6%	10	5%
Health Care	86	8%	14	7%
Financials	**56**	**5%**	**34**	**18%**
Information Technology	125	12%	16	8%
Telecommunications	**2**	**0%**	**4**	**2%**
Utilities	**38**	**4%**	**15**	**8%**
Real Estate	70	7%	16	8%

Source: MSCI, as of June 2017.

International investors will also gain access to sub-industries such as baijiu (Chinese white liquor), broadcasting, cable/satellite television, book publishing and newspapers. Historically these sub-industries have almost exclusively been listed only on the A-share market.

In terms of valuations, the MSCI China coverage universe of A-shares are more expensive and also have higher full market capitalisation weighted Price/Earnings versus the Hong Kong-listed Chinese stocks for all sectors bar Consumer Staples and Information Technology (Figure 8).

Figure 8: Price/Earnings multiples for A-share vs. H-share

	Price/Earnings	
Sector	China A-Share	Hong Kong Listed
Telecommunications	93.3	24.1
Information Technology	**50.7**	**55.6**
Health Care	42.6	34.3
Materials	42.0	20.2
Energy	40.5	26
Industrials	36.5	13.8
Consumer Staples	**36.4**	**40.1**
Consumer Discretionary	31.5	25.6
Utilities	28.6	17.6
Real Estate	21.3	14.7
Financials	14.2	10.8

Source: MSCI, Factset, as of June 2017

The main reasons for the premium valuations of the A-share market are China's closed capital account, combined with relatively few domestic investment options for the large domestic savings pool. Difficulties in shorting individual stocks also make a difference in comparison to other equity markets.

Charting a new course – expect some turbulence

Investing in the A-share market is not without investment risks, some of the most significant risks are outlined below:

1. Prevalence of suspensions causing index turnover

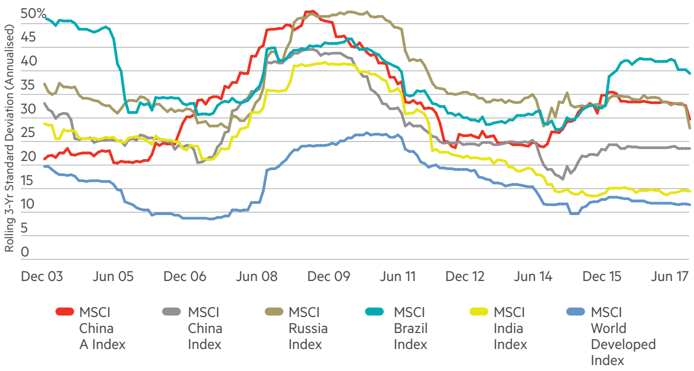
As recently as July 2015, approximately 1,300 companies in the A-share market were suspended following a margin-lending induced stock market bubble[7]. By avoiding companies with small market capitalisation and suspensions, the index turnover should become far less common. The subset of 222 stocks that MSCI has initially picked for inclusion in the A-share market, was chosen partly to avoid this problem.

2. Volatile nature of the market

High retail participation in the A-share market, along with the higher propensity for momentum driven speculation, have been key contributors to the increased volatility overtime. However the annualised standard deviation of the A-share universe shown in Figure 9, while significantly higher than the MSCI World developed index, is in line with that of other emerging markets such as Brazil, India and Russia.

[7] BBC article, "China Shares: Regulator Takes Action After Slide", dated 8 July 2015.

Figure 9: Volatility of A-share market in line with other emerging markets



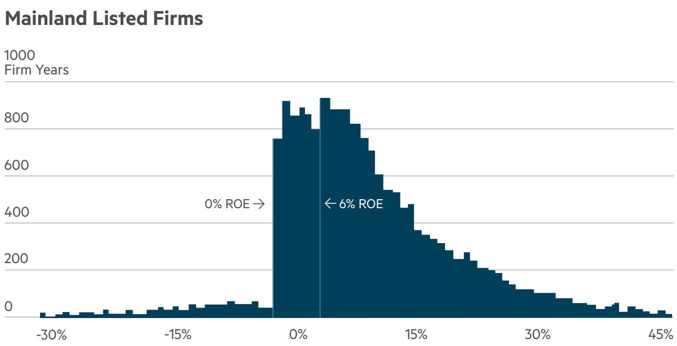
Source: MSCI, Bloomberg, as of December 2017.

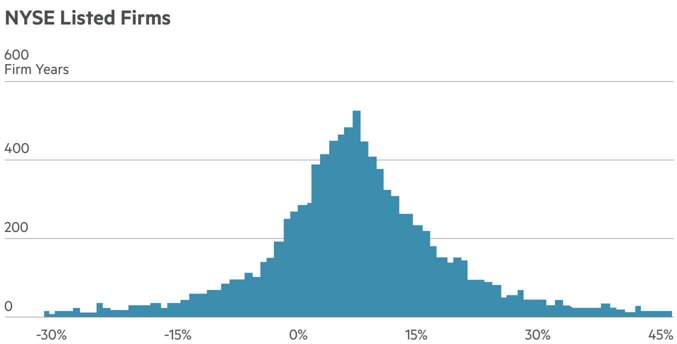
3. Concerns with company financial reporting integrity

In theory, nearly full convergence between Chinese accounting rules and International Financial Reporting Standards has been reached, but some concerns remain across the reported financials of the A-share market including:

a) Few companies with reported Return-on-Equity (RoE) less than 6%

Figure 10: No One Loses Money in China?





Note: Distributions of return on equity for Mainland and NYSE listed firms highlight the curious fact that very few Chinese companies seem to be losing money

Source: Brandon Emmerich from Wind Information, "A Primer on Chinese Financial Data Quality", 19 December 2016

Unlike developed market indices there are few companies that report losses in China (Figure 10). A possible explanation suggested by Emmerich is that listed companies in China with moderate or negative profitability are incentivised and often avoid reporting RoE levels less than 6%. The CSRC also enforces restrictions on new equity issuances and narrows the daily trading limits for companies with poor results.[8]

b) Potential governance concerns with limited use of global big-4 auditors

Only 6% of listed A-share companies use the global big-4 auditors.[8] This in itself is not enough to cause concern but it is fair to say that in most other markets this would be a red flag for global investors.

4. Corporate governance

Given the A-share market's relatively short history and high level of retail participation, the prevalence of trading based on insider information and share price manipulation is potentially significant. Similar to most Asian markets, insider ownership of A-share companies tends to be higher than US levels, making the principle-agency relationship more likely to have conflicts of interest between majority and minority shareholders.

New paths provide opportunities

Understanding the potential investment risks can also over time lead to new investment opportunities. Theoretically, active management should provide opportunities to generate alpha with the widening investment set of A-shares combined with a relatively negligible change in the benchmark. We believe there are profitable, well managed companies with identifiable examples of value/price mismatch that exist within the new Chinese investment universe currently available. Some of the key investment opportunities arising from the relaxed restrictions on foreign investors' ability to participate in the A-share market are as follows:

1. Access to under-researched companies

International sell-side firms which cover the A-share market on average cover less than 200 companies out of thousands which exist in the universe. Sell-side firms have struggled with high staff turnover which has hindered their efforts to roll-out broader coverage of the opportunity set within the region.[9] The domestic sell-side is vibrant in China and some firms have wide coverage, although looking into their forecasting process, almost all have short-term approaches with earnings forecasts typically based on company guidance as opposed to original fundamental analysis.

2. Improving financial data

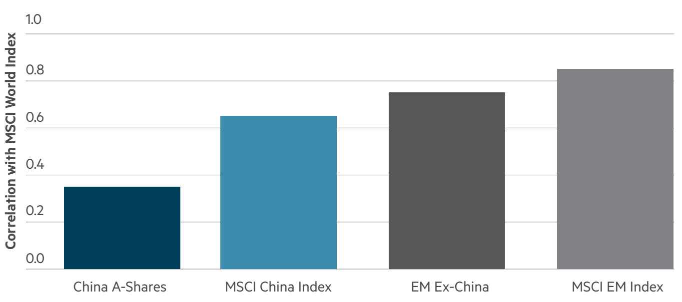
On the positive side, disclosure rules are more rigid for A-shares than Hong Kong listed companies with quarterly and annual reports of A-share companies improving. They are presented in Chinese text and are similar to the US 10-K style.[10] Generally we believe the quality of management discussion and analyses of their businesses are at least in-line with and in many cases better than H-share equivalents.

[8] www.seekingalpha.com Article by Brandon Emmerich from Wind Information, "A Primer on Chinese Financial Data Quality", 19 December 2016
[9] UBS Asia, November 2017.
[10] One difference is segmental splits between industries within a listed company is available only at the revenue and gross profit levels for A-shares. Hong Kong and US-listed counterparts also provide details at the operating profit, asset and capital expenditure levels.

3. Low correlation with other share markets

The uncorrelated nature of the A-share market relative to the MSCI World Index is shown in Figure 11. The A-share correlation with the world equity market is low at 34% and has ranged from only 50%-60% over the past five years, whereas the correlation with the MSCI China index is much higher at roughly 65% and with the MSCI EM Index it is higher still at around 85%.[11] This suggests greater diversification is available for investors in the A-share market when compared to other emerging markets.

Figure 11: A-shares exhibit low correlation with world equity market



Note: MSCI China Index includes total China equity except onshore listed equity. China A-shares are represented by the CSI 300 Index. Data as of December 2016.

Source: MSCI, Bloomberg

4. Access to profitable mega cap companies that are not in global portfolios

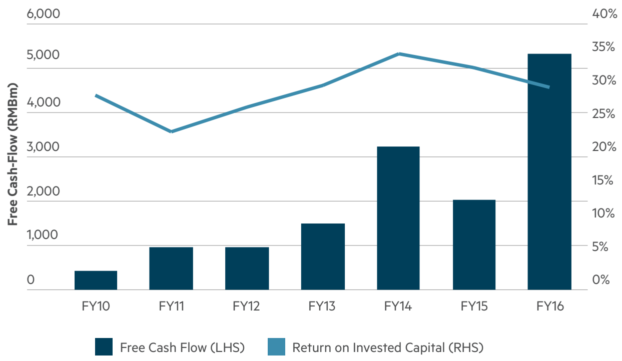
The A-share listing also provides the prospect to diversify portfolios and invest in large or mega cap companies that are profitable, well managed and not commonly allocated to by global investment managers. There are over 1500 companies with a market capitalisation of over USD 1 billion[12] in the A-share market which provides a fertile universe for investors to explore.

Case study: Hikvision

Hangzhou Hikvision Digital Technology (Hikvision) is a good example of the opportunities available in the A-share market. It has a market capitalisation of US$ 56 billion and is principally engaged in the research and development, manufacture and distribution of CCTV products and the related software, within Chinese and overseas markets.

From almost nowhere a decade ago, Hikvision has become the largest manufacturer of surveillance equipment globally, with the highest market share in Europe and China, and ranked second in the US. From a financial perspective, this market share gain has allowed a very impressive ~40% p.a. net income growth over the past decade. In fact all profitability metrics remain attractive even as they've been growing dramatically (Figure 12).

Figure 12:. Hikvision impressive financial metrics



Factset, as at June 2016.

The global sales of surveillance equipment (of which CCTVs are the dominant product) grew ~55% in the five years through 2016[13]. Hikvision's manufacturing and installed units' scale advantages have been the main drivers allowing it to become the cost-leader within its market globally and the main driver for global market share gains overtime. Going forward further growth for the company is expected with continued market share growth in individual markets as well as a higher proportion of profit expected from the software revenue division.

Strong management led by the founder of Hikvision, Mr. Gong Hong Jia is a key reason for the company's growth overtime. He has managed to own ~15% of the company despite its overall State Owned Enterprise status with ~42% of the company state owned. The company's large market cap of ~US$ 56B makes it one of the most covered A-share companies by the sell-side although the valuation of > 40x historical P/E takes it out of the investable range for most value managers. Hikvision is an example of an A-share listed company that has successfully made the transition to the global market. Within the A-share market there are numerous companies that have quickly risen from obscurity to now competing on the global stage.

[11] https://personal.vanguard.com/pdf/ISGCHI.pdf
[12] Source: Figure 2- Expanding opportunity set with the inclusion of China A-shares, Factset January 2018
[13] Source: Wall Street Journal article, "Surveillance Cameras Made by China Are Hanging All Over the US", by Dan Strumpf, Natasha Khan and Charles Rollet, dated 12th November 2017.

5. Price anomalies between domestic and offshore companies

There are approximately one hundred Chinese companies which are dual-listed in both the A-share and H-share markets simultaneously, in some instances there are pricing discrepancies between the two markets even for large and liquid dual-listed companies. For instance, as at December 2017, PetroChina A trades at a ~78% premium to PetroChina H. The Hang Seng China AH Premium Index, which tracks the average price difference between such listed pairs, has narrowed from 40% during 2015 to 30% currently, although the range of premium within this group is still diverse.[14] With more capital flows going into and out of both markets simultaneously, we expect further convergence overtime.[15]

There are also numerous examples of Chinese companies with significant overlaps in economic exposure that trade at vastly different valuations in a range of markets. Typically this difference occurs due to the parent company being listed in one market and a listed subsidiary from which the parent derives most of its earnings listed in another. For example, the H-share listed China Resources Pharmaceuticals with a current P/E of ~18x is the parent of three A-share listed drug manufacturers with a higher average P/E of ~23x. Similarly, the vertically integrated pork producer WH Group has a P/E of ~16x which is Hong Kong listed yet derives roughly half of its operating profits from the Shuanghui Group listed on the A-share market with a P/E of ~23x.[16] In an ideal environment, where capital flows are not restricted and information is symmetric, the A-share market and H-share market should converge and similar valuations should prevail in both markets.

And so the journey begins...

The widening of the investible universe now available with the convergence of the A and H-share markets in China will create significant investment opportunities in new sectors and markets, whilst providing access to profitable, large, liquid companies that many investors haven't previously had exposure to. The low correlation with other major markets, the under-researched environment that many of these Chinese companies trade in, along with the market inefficiencies that exist between the A and H-share markets provides optimal conditions for active investors to investigate adding diversification and alpha to their portfolios.

[14] Source: https://www.hsi.com.hk/HSI-Net/static/revamp/contents/en/dl_centre/factsheets/FS_AHPe.pdf

[15] The inability to short A-shares is an impediment to this convergence.

[16] Factset, December 2017.