Portfolio

AsiaView

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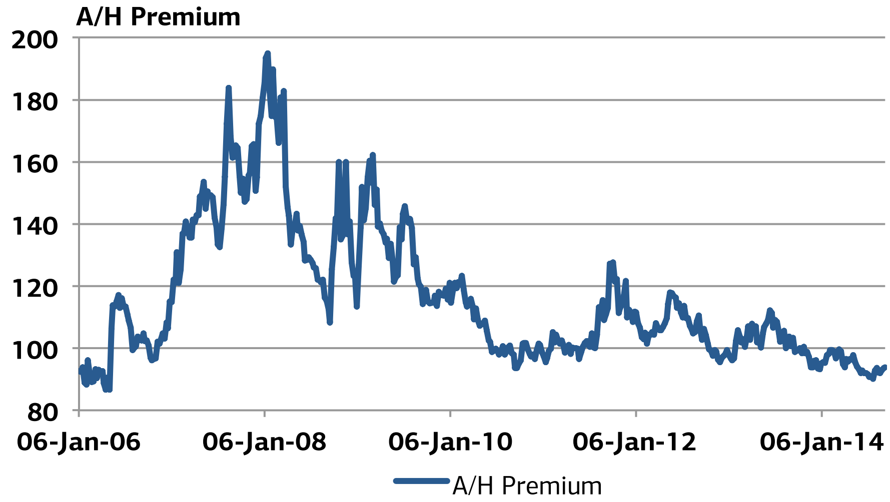
Companies discussed

- **Kweichow Moutai (600519 CH)**
- **SAIC Motor (600104 CH)**



Source: Bloomberg, J Capital Research

Buy the A-share discount?

SH-HK Stock Connect: an investor's perspective

+ Shanghai will still be a retail-driven market

Northbound aggregate quota of USD 49 bln is significant. But even after this, foreign institutional investor levels will only be around 5-6% of the Shanghai Composite's (SHCOMP) market cap.

+ A-shares are not as cheap as they look

A current SHCOMP average PE of 11x looks cheap vs. the 19.4x average since 2004. But over the last 3 years, the average PE has been 11x.

+ A-shares can continue rallying short term

The Northbound quota is large, the Chinese government is encouraging buying and there's a lot of hype. This is ultimately a liquidity and momentum-driven market.

+ Financials dominate A-shares

Financials are almost 1/3 of A-share market cap and drive the apparently cheap market valuations. Ex-financials, A-shares are not cheap at all.

+ What to look out for and what to buy

Poor corporate governance, poor capital management, a lack of transparency, very high volatility and junk rallies feature.

It's difficult to find investable A-shares. Kweichow Moutai and SAIC Motor are 2 companies which make the grade.

KEY POINTS

1. Short-term A-share rally can continue.
2. SHCOMP will still be retail-driven.
3. Hard to find investable A-shares.

By Kevin Yeoh

I managed a top ranked China A-share QFII fund over a five-year period that stretched across the massive A-share bull market during 2007-08 and the long bear market beginning in 2009. During the bear market, the fund was ranked no.1 and made positive absolute returns over 3 years, while peers on average lost 9%.

What follows are my thoughts on the Shanghai-Hong Kong Stock Connect and what I learned from investing in A-shares, a market many don't even think is a proper stock market.

Lots of hype

There is much hype and anticipation towards the Shanghai-Hong Kong Stock Connect. Sellside brokers, hungry for trading commissions, are naturally amongst the most excited and have been pushing various ways to play the expected valuation convergence between A and H-shares.

We are more skeptical.

We do expect the A-share market's rally to continue in the short term because it's a heavily momentum and sentiment-driven market. But it's more akin to a casino, than a stock market. Even after Stock Connect, institutional investor participation will only be a small percentage of the overall market, which will remain retail-driven.

Unless a large-scale expansion of the program occurs (and there are a myriad of ways that the program can be expanded), we think that Stock Connect will purely be a short-term shot in the arm for A-shares. After this initial boost, we can't see the market continuing to rise without government stimulus and / or supportive policy measures.

Shanghai will still be a retail-driven market

Northbound trade is expected to dominate the Connect. Existing approved QFII quota is USD 50 bln, with around USD 40 bln in A-shares. Existing approved RQFII quota is around RMB 400 bln. Combined this is less than 4% of the Shanghai Composite Index's USD 2.78 tln market cap.

➲Stock Connect is doubling the existing QFII quota.

The RMB 300 bln (USD 49 bln) Northbound aggregate quota is similar in size to the existing QFII quota. In effect, Stock Connect is doubling the existing QFII quota.

In total, foreign institutional participation will be around 5-6% of overall Shanghai market cap post-Stock Connect. This means Shanghai will still be a retail-driven market, with all of the associated quirks.

Mainland retail unlikely to impact the Hang Seng

Southbound trade will be a larger proportion of the Hang Seng's market cap vs Northbound trade's proportion of Shanghai. The Southbound aggregate quota of RMB 250 bln (USD 50 bln) will be around 3% of existing Hang Seng market cap. So it's possible that Southbound trade will have a greater impact on HK than Northbound trade has on Shanghai.

However we think Mainland retail investors are unlikely to buy a lot of HK shares. Given their experience with QDII funds, which invest in Hong Kong, Mainland retail buyers will be cautious: since their inception in 2007, the first three QDII funds have lost between 20-30% of their value.

The high RMB 500k minimum account size will also dissuade Mainland retail.

From a valuation point of view, H-shares are trading at a premium to A-shares, so this could also put off Mainland investors.

➲Obvious Southbound trade is Tencent and Macau.

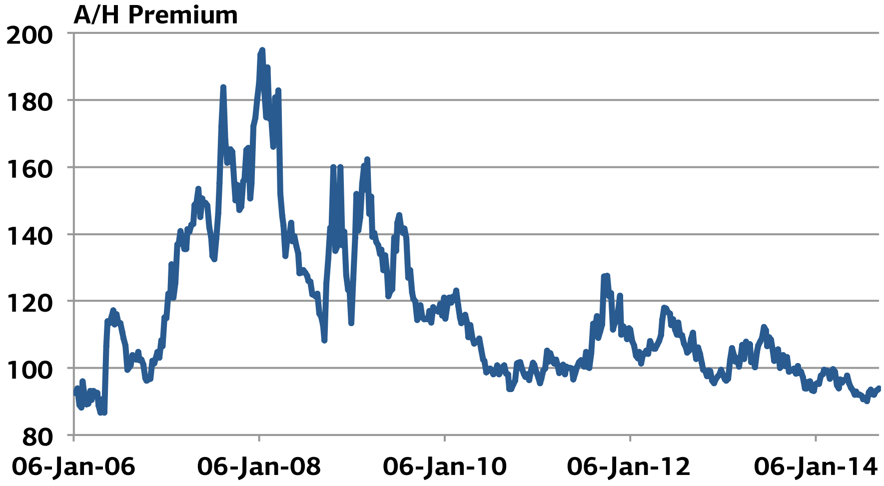
The obvious trade is in stocks not listed on the Mainland. Key beneficiaries could be Tencent and Macau casino names. However we think this would only be a short-term momentum boost.

A-shares now trade at a discount

As shown by Chart 1, the intoxicating A-share bubble of 2008 saw A-shares trade at an 80%+ premium to H-shares. These were the days when IPOs could potentially double in price on listing day and then halve the next day.

The A-share premium fell rapidly during the financial crisis, but then shot back up after China's RMB 4 tln stimulus package in 2009. However since then it's been water torture for A-share investors with the ensuing long-term bear market. If anything, the A-share market has been an accurate proxy for the state of the Chinese economy. It is a schizophrenic market, which is very sensitive to government policy and liquidity.

Chart 1. A/H Premium / Discount



Source: Bloomberg, J Capital Research

Buy A-shares on discount closing?

➲Why the A-share discount may not close.

This is the obvious short-term trade and the main one pushed by brokers. Momentum will likely see a lift in A-shares, which trade at a discount to their H-share counterparts. A few things should be noted:

- The existence of QFII hasn't really resulted in any noticeable effect on converging valuations.

- **It's not an arbitrage mechanism**: Shares have to be bought and sold in the same exchange, so it's more of a bet on Mainland investors placing a similar value on stocks in HK.

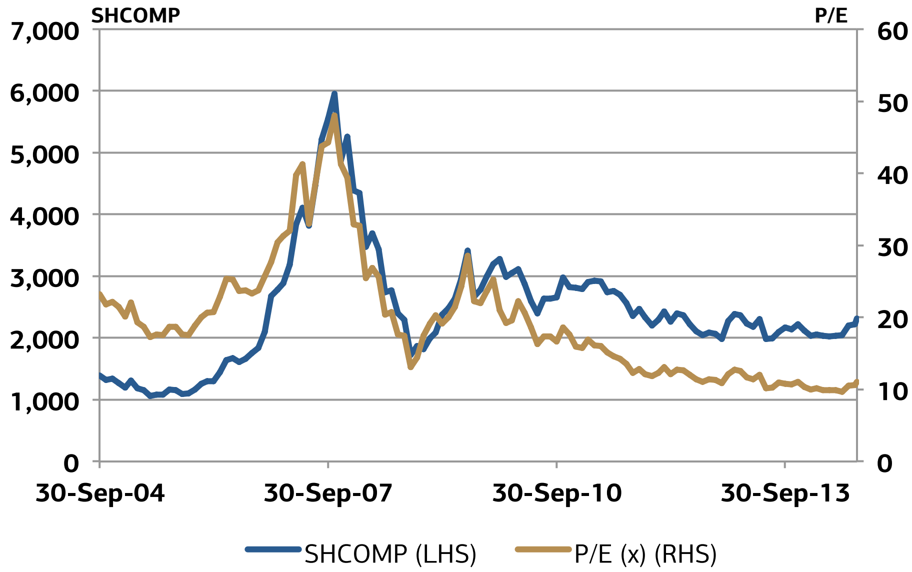
- **Capital gains tax uncertainty**: Throughout the existence of QFII, foreign investors have never had clarity on capital gains tax implications. Stock Connect is potentially more complicated because investors do not have direct ownership of Northbound stocks—it is indirect ownership via ChinaClear, the PRC's central clearing house.

- **Not a large opening of the capital account**: The Southbound aggregate quota of RMB 250 bln (USD 41 bln) is around 2.4% of total new bank deposits from Sep 2013 – Aug 2014 (RMB 10.3 tln). Netted with Northbound trade, capital flight is not that large.

Not so cheap

The Shanghai Composite looks cheap vs. history trading at around 10-11x PE, vs. a mean PE of 19.4x since Sep 2004.

Chart 2. Mean PE of 19.4x since Sep 2004



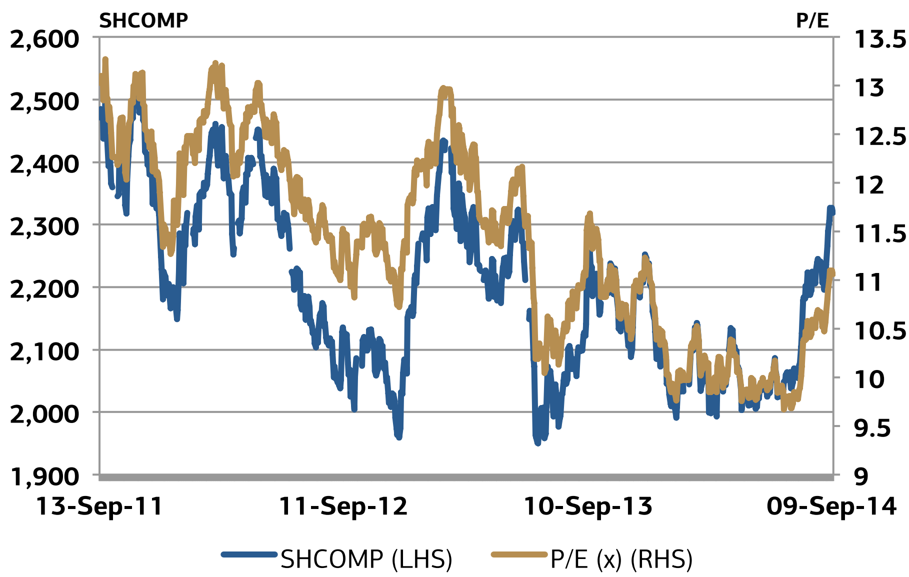
Source: Bloomberg, J Capital Research

However, the current PE is equal to the mean PE of the last 3 years. This period is arguably more representative of true market value vs. the bubble years leading up to 2007-2008.

The mean PE also represents the large percentage of financials in the SHCOMP, which account for almost one third of total market cap.

➲Trading in-line with the last 3 years.

Chart 3. Current PE in line with mean PE since 2011



Source: Bloomberg, J Capital Research

Several reasons to be bullish in the short-term

Aside from A-shares trading at a discount to H-shares, there are several reasons to be bullish on the A-share market in the short term. However, none relates to underlying stock fundamentals. They are purely liquidity and momentum reasons.

- **The quota is large:** The Northbound quota is around the same size as existing QFII, which took over a decade to achieve.
- **Chinese government encouraging buying:** There have been numerous headlines in the Chinese local press spruiking equity investment.
- **Uncorrelated to global equity markets:** With concerns over Emerging Markets selling off given the end to Fed tapering, it's possible that the A-share market completely ignores this. As a domestically focused and momentum-driven market, the A-share market often moves in the opposite direction to most global markets, including Hong Kong. While Stock Connect will see additional foreign institutional investor participation, this is unlikely to really sway current A-share investor behavior.

Stock Connect in the context of the Fed taper

➲A partial response to Fed QE and plunging FDI.

We think that Stock Connect could also be a partial response to the end of Fed QE and plunging FDI.

The end of Fed QE and the beginning of Fed rate hikes could have a serious impact on China as less hot money is attracted to high shadow banking interest rates. The reversal of hot money flows would be negative as Chinese onshore interest rates would likely rise and the RMB would likely depreciate, putting further pressure on China's brittle financing edifice.

The Northbound quota of USD 49 bln is significant. It's equivalent to 0.53% of China's 2013 GDP and 42% of 2013 FDI. As a % of 2014 FDI it could be even larger given FDI plunged in July and ongoing anti-trust cases against foreign companies potentially slowing down future FDI.

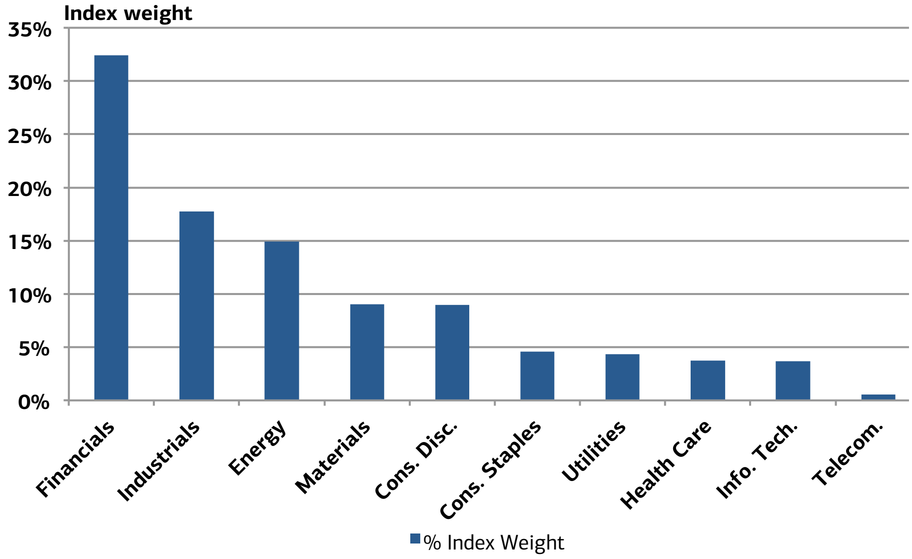
That both Northbound and Southbound trades need to be settled in RMB also shows an attempt to shore up RMB demand.

SHCOMP dominated by financials

The reality of playing A-shares via an index exposure or ETF is that almost 1/3 of your investment will be in black-box Chinese financial—you are basically loading up on China slowdown risk.

Chart 4. China slowdown risk: Financials almost one third of SHCOMP

➲Black-box financials dominate.



Source: Bloomberg, J Capital Research

ICBC (5.54% of SHCOMP market cap), Agricultural Bank of China (4.30%) and Bank of China (3.11%) are the 3 largest financial index constituents.

Based on Price/Book, the A-share banks with the largest P/B discounts are ICBC (13%), China Merchants Bank (7%) and China Everbright Bank (10%). While we think these 3 banks could see positive price momentum in the short-term, investors getting involved in Chinese financials should go in with their eyes wide open.

We do not recommend buying any of these banks at current valuations, as we don't think they are adequately pricing in true NPLs.

Table 1. A-share P/B discounts suggest ICBC, CMB and China Everbright Bank will benefit from Stock Connect

Bank	A-share P/B	H-share P/B	A-share (discount) / premium
ICBC	0.92	1.06	-13%
CCB	1.01	1.01	0%
Agricultural Bank	1.02	1.02	0%
Bank of China	0.84	0.83	0%
BOCOM	0.76	0.76	0%
China Merchants Bank	0.94	1.01	-7%
China Minsheng Bank	0.97	0.90	8%
China CITIC Bank	0.76	0.76	0%

China Everbright Bank	0.78	0.86	-10%
Industrial Bank	0.90		
SPD Bank	0.82		
Huaxia Bank	0.84		
Bank of Beijing	0.92		
Bank of Nanjing	0.87		

Source: Bloomberg, J Capital Research

Non-financials? Highly geared and not cheap

Given our unenthusiastic view of A-share financials, what about non-financials?

We screened the 50 largest non-Financial constituents of the SHCOMP. We found that on average these companies were highly geared and did not have particularly attractive valuations.

➲Non-financials are highly geared and not cheap

- Largest company was PetroChina (601857 CH) with RMB 1.48 tln market cap (USD 240 bln) and smallest was Offshore Oil Engineering (600583 CH) at RMB 35.86 bln market cap (USD 5.83 bln).
- **High leverage**: average debt/equity was 90%.
- Average 1-year revenue growth was 11%.
- Average Return on Equity was 16%.
- **Not cheap**: Average Price/Book was 2.9x and Price/Equity was 32.6x

What to look out for

These are some of the challenges I encountered when managing an A-share fund:

➲It's normal to find real estate and equity market exposure on balance sheets.

- **Poor capital management and corporate governance.** It is not surprising to find significant and questionable real estate and equity market exposure on balance sheets. Stock market speculation was rife during the bubble years of 2007-2008. It was very common for company management of a consumer company to tell you that its balance sheet had 20% exposure to equities as they would "go up" or that "it was a good use of our spare cash".
- **Lack of transparency and hardly any English language financials.** Outside of the dual-listed A-shares, hardly any companies produce English language financials. This is compounded by A-share Chinese language financials providing very scant disclosure. **Here in also lies an opportunity** as I seriously doubt whether many QFII

managers actually conduct serious due diligence on their investments, outside of meeting with company management.

➲Very volatile.

- **Volatility.** It is not unusual to see stock prices go up 5% and then down 5% *intra-day*. A-share volatility is legendary, given how momentum-driven the market is. It's possible that Stock Connect could make the SHCOMP even more volatile.

- **Junk rallies.** Being an institutional investor in the A-share market is tough because it is common for junk rallies to leave the better stocks for dead. During the bubble years, small and mid-caps completely outperformed large cap stocks. But during the long bear market that followed the 2009 stimulus, junk stocks completely died. A strong bias to large cap stocks was key to maintaining positive investment returns during the bear market.

- **Inability to short.** So you can only go long, but finding well-priced fundamentally strong A-share companies is very difficult.

- **Suspensions.** A-shares tend to be suspended more frequently vs. H-shares and for longer time periods.

- **Operational risk of new exchange mechanism.** At least in the early days, there are likely to be teething issues.

- **Open position risk.** Stock Connect is not open on either Mainland or HK holidays. So during the Chinese New Year or National Week public holidays Stock Connect will be closed for potentially up to a week, while the rest of the world continues trading.

What to buy

It's very difficult to find investable companies in the A-share market. This is due to the large percentage of financials and poor corporate governance and capital management. Outside of dual-listed stocks, there are only a handful of companies that would be considered investable and even these have their own corporate governance issues. Two companies that make the grade include:

Kweichow Moutai (600519 CH)

- Moutai is the no.1 premium white spirits brand in China. While Moutai has come down from its highs in 2012 due to the corruption crackdown and concerns over inventory levels, Moutai's brand is very strong and it is among the very few Chinese spirits companies that remain profitable.

- **Strong returns**: ROE 38%.
- **Attractive valuation**: 12x PE vs 5-year average PE of 23x.
- Net cash.

SAIC Motor (600104 CH)

- China's largest auto company. 85% of sales are foreign brand cars given SAIC has JVs with Volkswagen and GM.
- **Strong returns**: ROE 20%.
- **Attractive valuation**: 7.5x PE.
- Reasonable gearing with debt/equity of 35%.

Both of these blue chip companies do have similar corporate governance issues. They have both had high cash holdings for many years and there is ongoing uncertainty over what they plan to do with all of their cash.

A final note on ChinaClear counterparty risk

Under Stock Connect, Northbound investors do not have direct custody of their stocks. Investors will place trades with Hong Kong Securities and Clearing Company Limited ("HKSCC"). HKSCC will become a participant of ChinaClear, China's national central clearing house.

HKSCC will open and maintain an omnibus stock account with ChinaClear to hold Shanghai stocks on behalf of investors.

HKSCC has stated that in the event that ChinaClear goes into liquidation, HKSCC will *"work in good faith to seek recovery of the outstanding stocks and monies from ChinaClear through available legal channels and through ChinaClear's liquidation process. HKSCC will in turn distribute the stocks or monies recovered…on a pro rata basis."*

While the risk of ChinaClear default is remote, a few things should be noted:

- A ChinaClear default is likely to be highly correlated with a credit crisis in China.
- Given SHCOMP is dominated by financial stocks, negative performance in SHCOMP is likely to increase the likelihood of ChinaClear default.

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