Overview of China's equity and debt capital markets

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Understanding China's Capital Markets
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Overview of comments

Why does China have stock markets? Why did they develop before the debt capital markets?

"Original Sin" and China's stock markets

Problems of equity and bond pricing and valuation

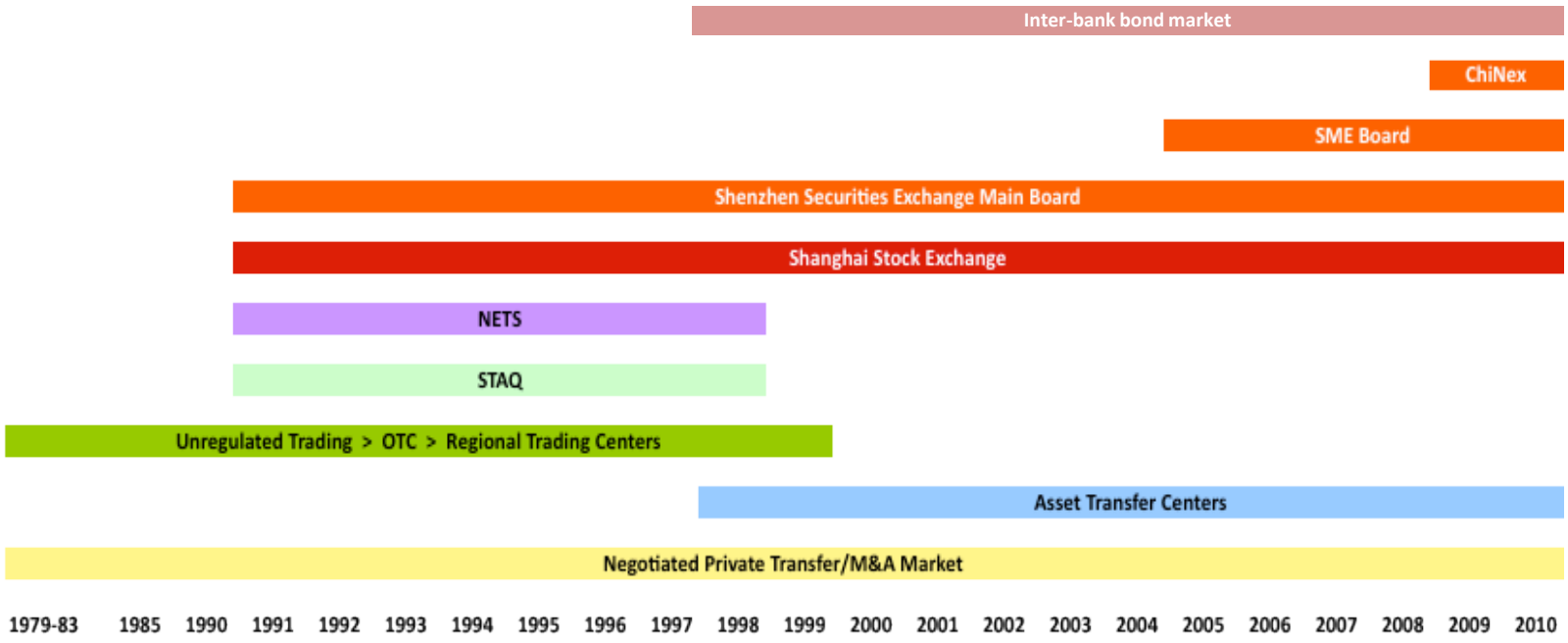
Evolution and implications of SOE corporatization

China's Sudoku yield curves and impact on trading

Institutional investors

Was Deng Xiaoping right?

Evolution of China's securities markets, 1979 - present

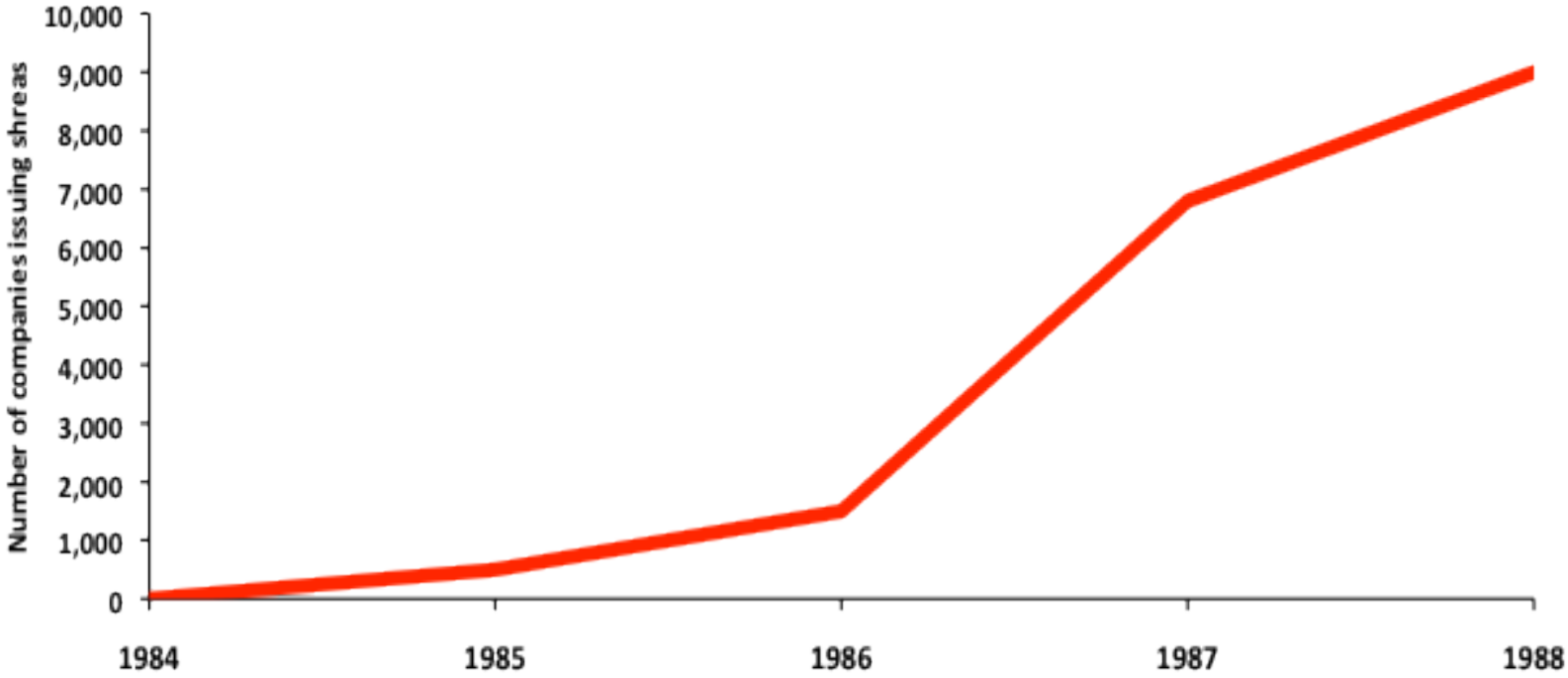


"Everyone – regulators, enterprises, officials – believe that the stock markets are a cheap source of cash."

50th Anniversary of China Banking

The 1980s: the real thing, companies raising equity capital

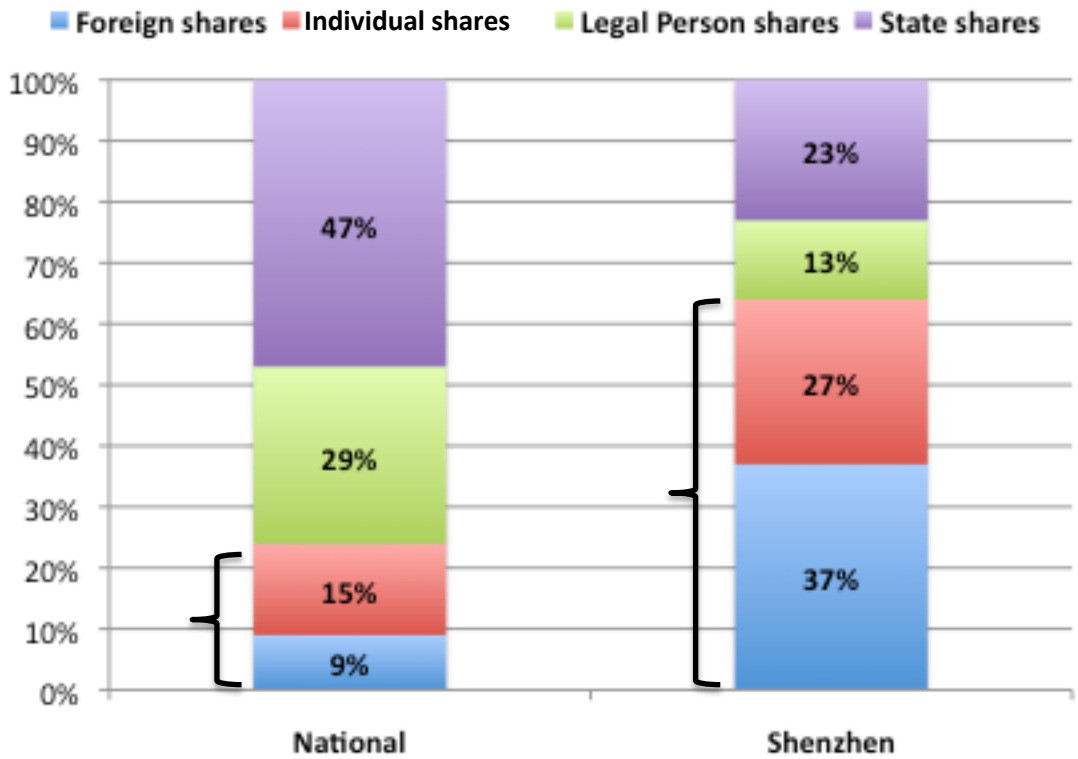
By 1988 over 9,000 entities had issued "shares"



Source: Liu Hongru 1992

The 1980s – spontaneous privatization

As of FY1991, the eve of Deng's Southern Journey



24% non-state **64% non-state**

Source: Walter and Howie, Privatizing China, p. 27

1990-1993 – the "Original Sin"

Consequences:

1. Ultimately created China's first national capital market
2. Ultimately led to creation of first national companies

BUT

1. Limited shareholding experiment to SOEs; forbade privatization
2. Created share classes based on holder's relationship to State
3. Subordinated Shanghai and Shenzhen development to HKSE
4. Failed to achieve Zhu's goal of SOE reform

Shanghai/Shenzhen combined share structure, 1999-2001

Non-tradable shares control the companies

Non-Tradable	1999	2000	2001	5/30/13
Promoter shares	1,746	2,165	3,121	
Legal Person shares	190	214	246	
Employee shares	37	24		24
Other share types	35	25	24	
Total Non-Tradable	2,009	2,428	3.415	
% Total Shares	67.8%	66.4%	67.6%	
Tradable				
A shares	813	1,078	1,331	
B shares	142	152	163	
Total Tradable	955	1,230	1,494	
% Total Shares	32.2%	33.6%	32.4%	

Source: Wind Information
Note: 5/30/2013 figures calculated based on ultimate ownership

Segmentation: Many markets, many regulators, same stock

Market capitalization = HK listed shares only

HKSE/NYSE

HKSE/SFC
SEC/NYSE

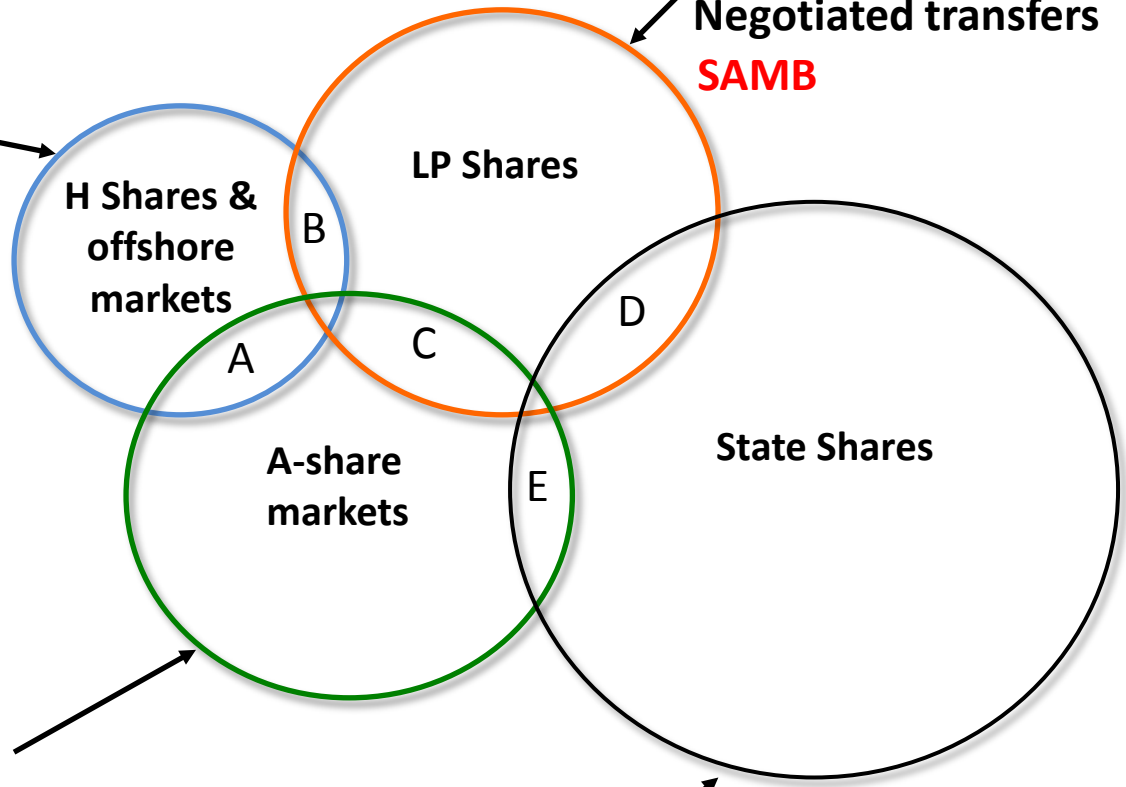
Legend:

A: QFII

B: Cross border M&A

C&D: Privatization

E: State share sale



Auction Houses,
Negotiated transfers
SAMB

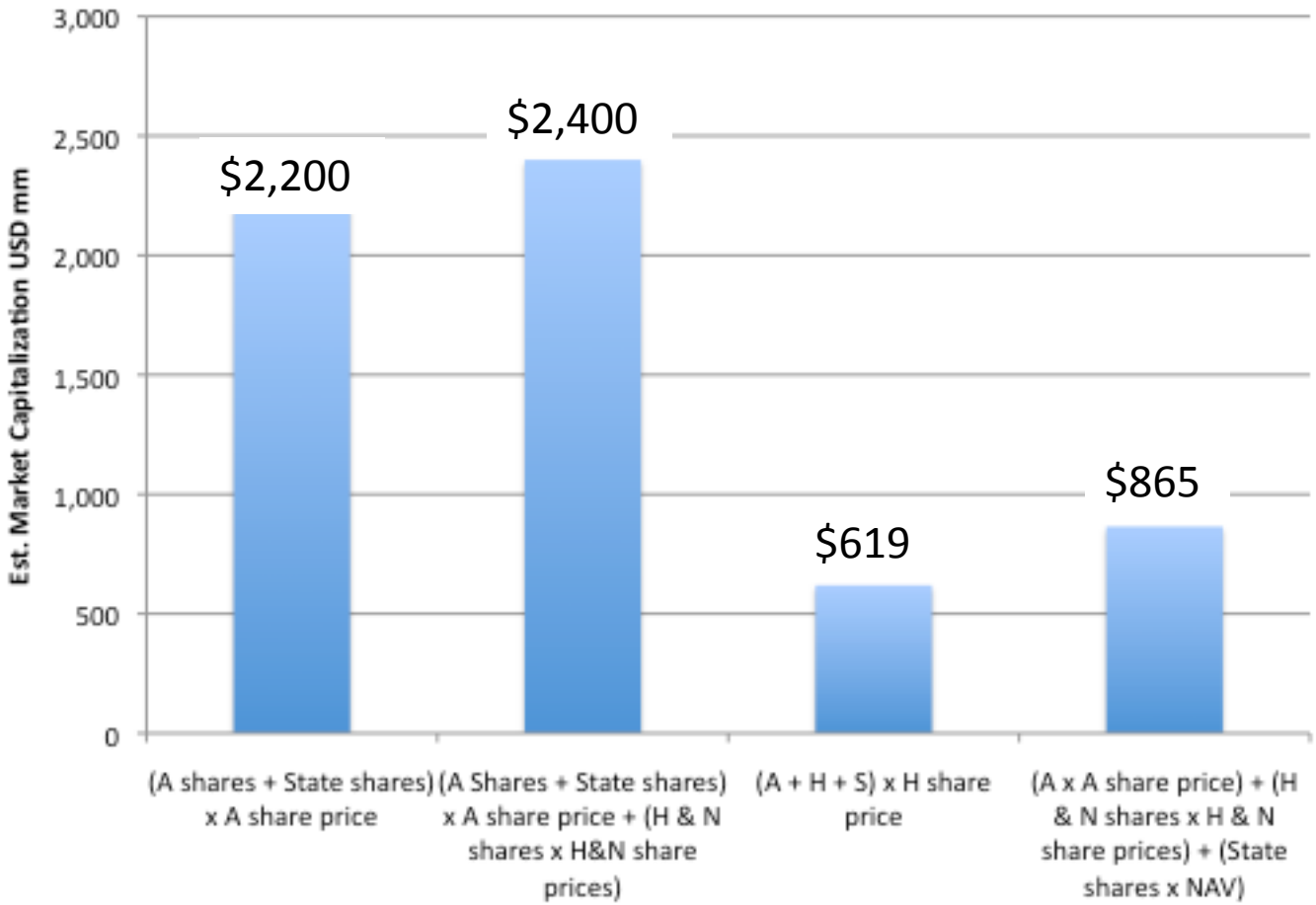
Shanghai/Shenzhen
CSRC

Market capitalization = A & B shares only

Negotiated transfers
SAMB

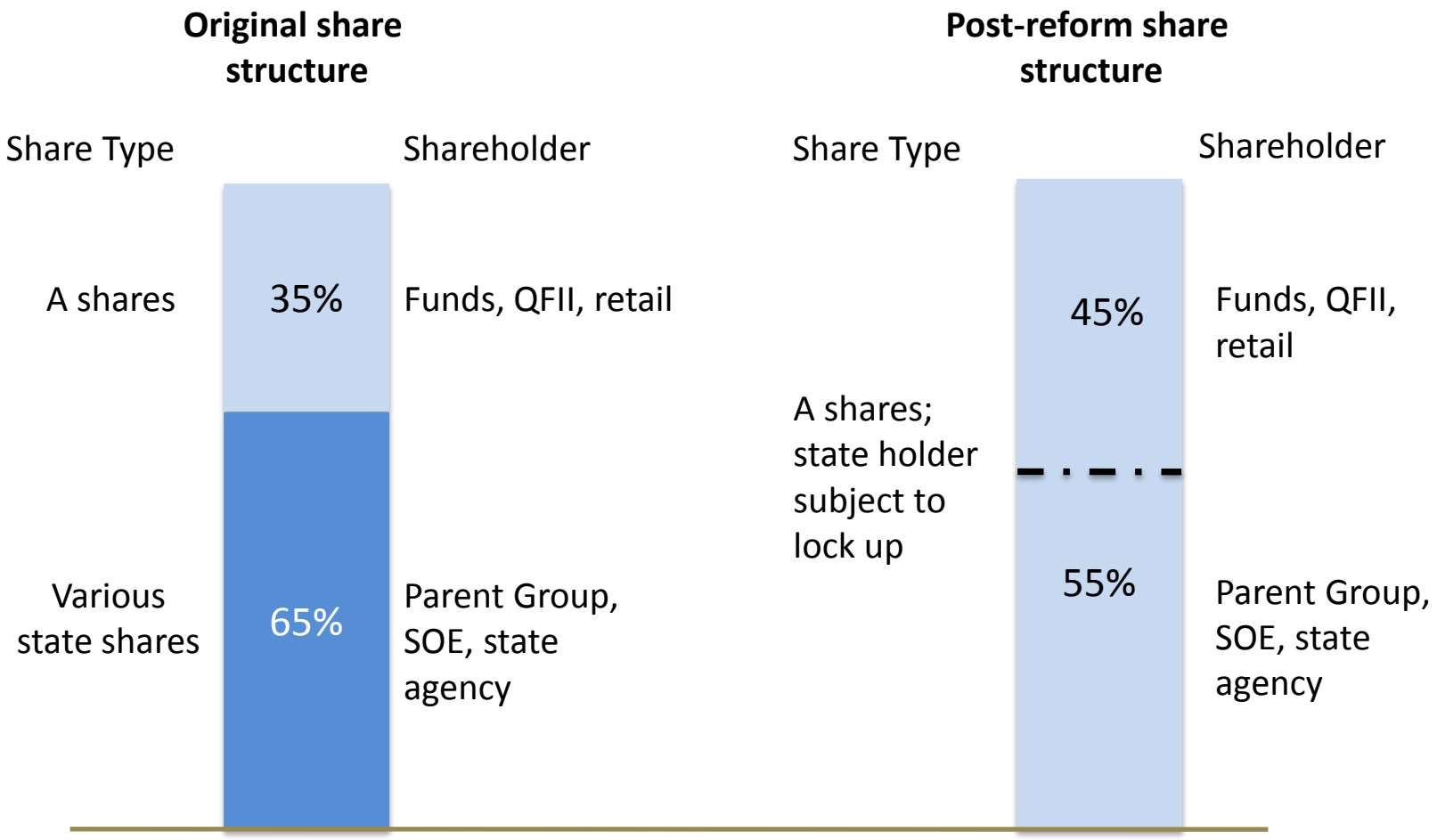
Note: SAMB = State Asset Management Bureau

What valuation for China Eastern?



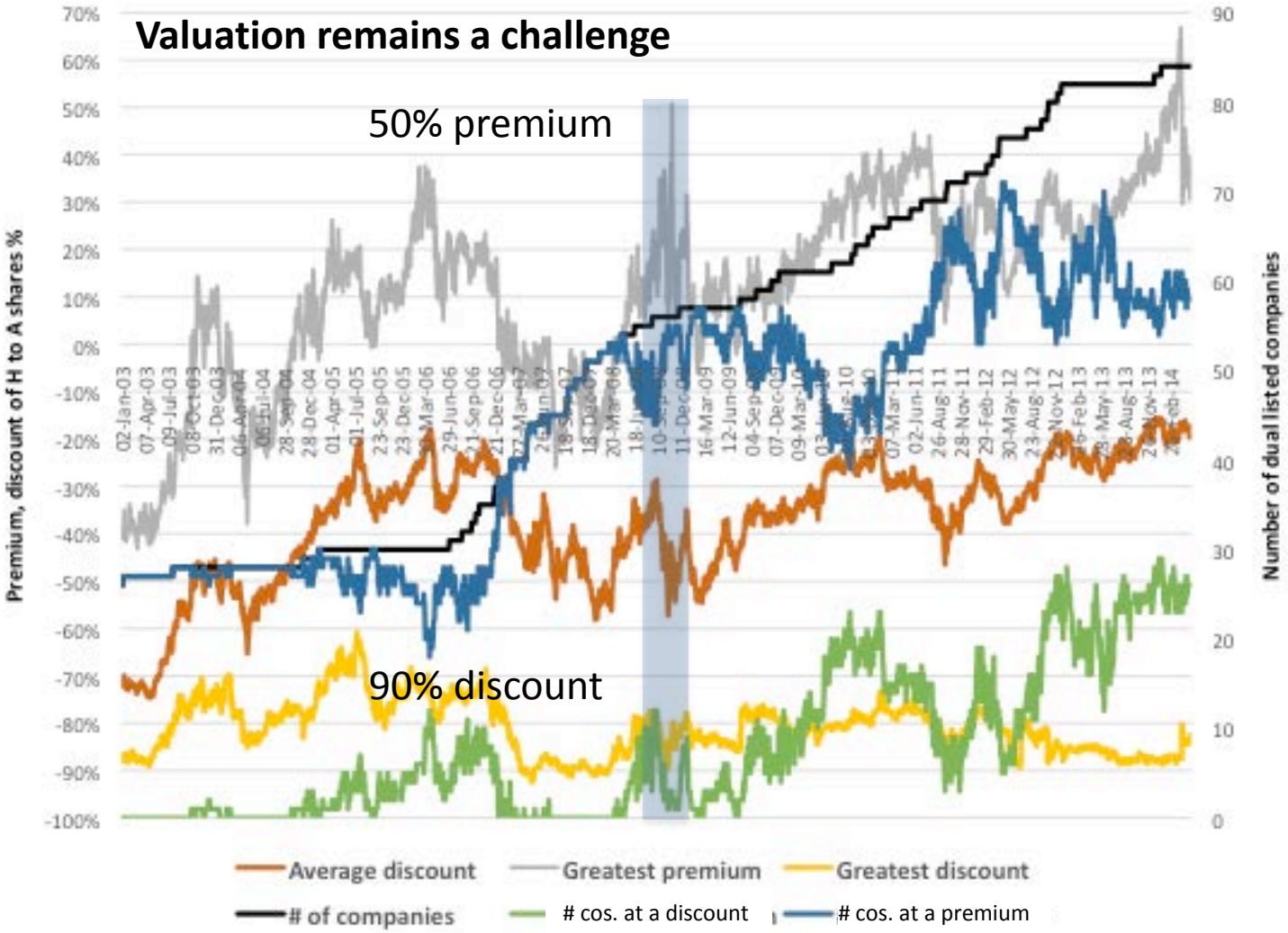
Source: Hong Kong, Shanghai Stock Exchanges, Bloomberg and Wind Information

The G-company reform, 2005 - 2008



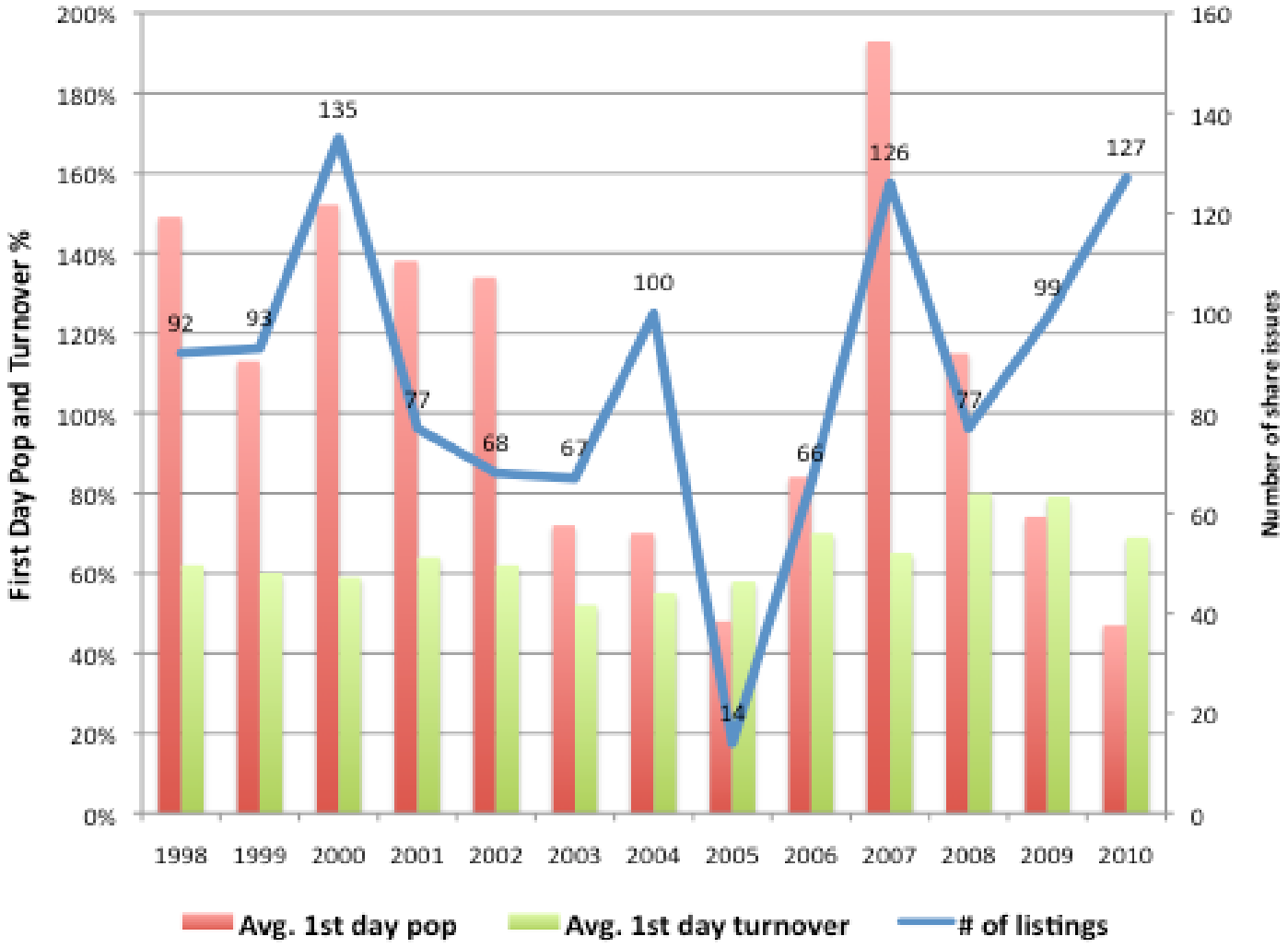
Retail got compensated for "Original Sin," CSRC became sole regulator

Valuation: the HK – Shanghai price differential remains wide

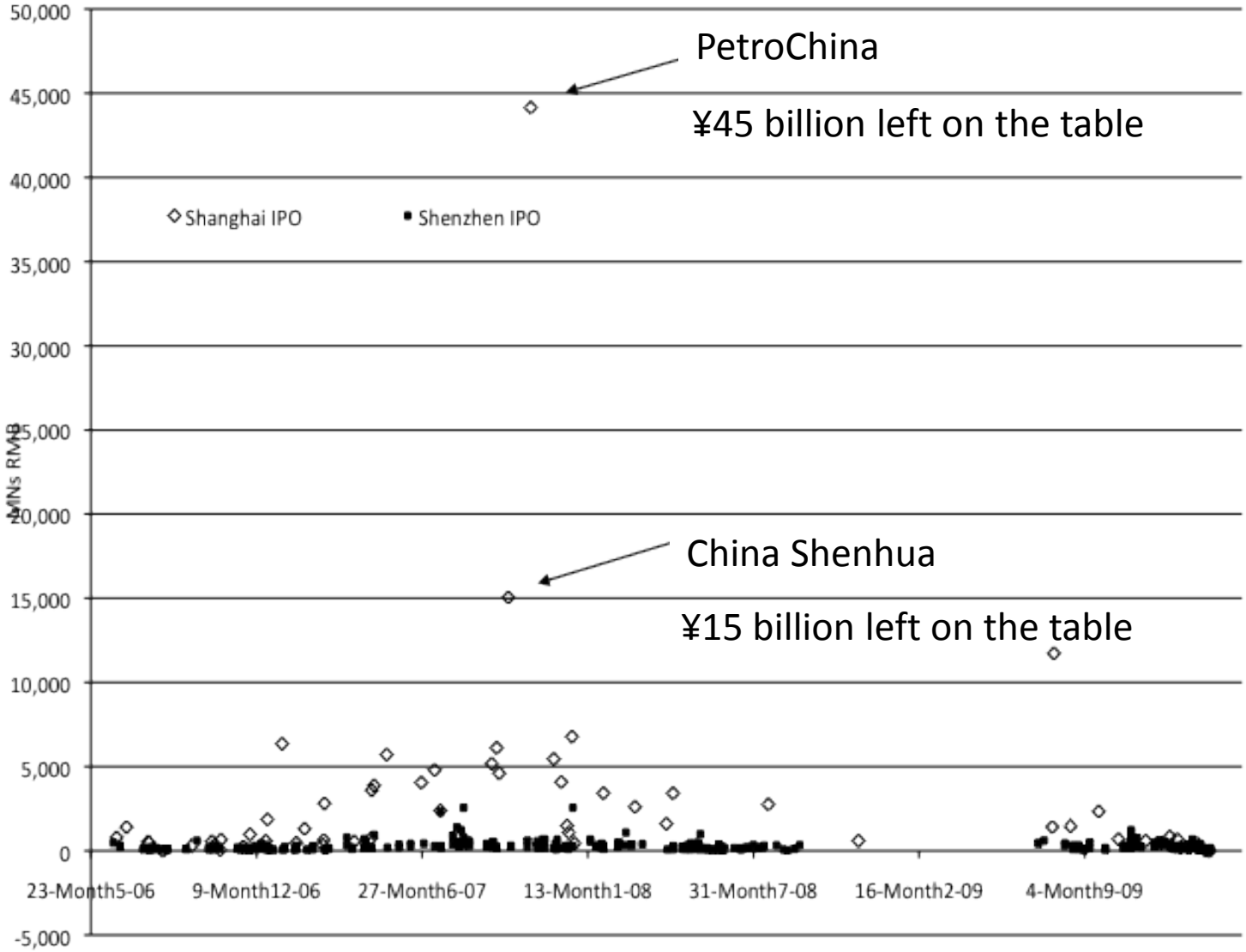


Source: Wind Information

Pricing: the famous IPO "Pop" in the primary market



Pricing: taking care of friends: the IPO pop, another view



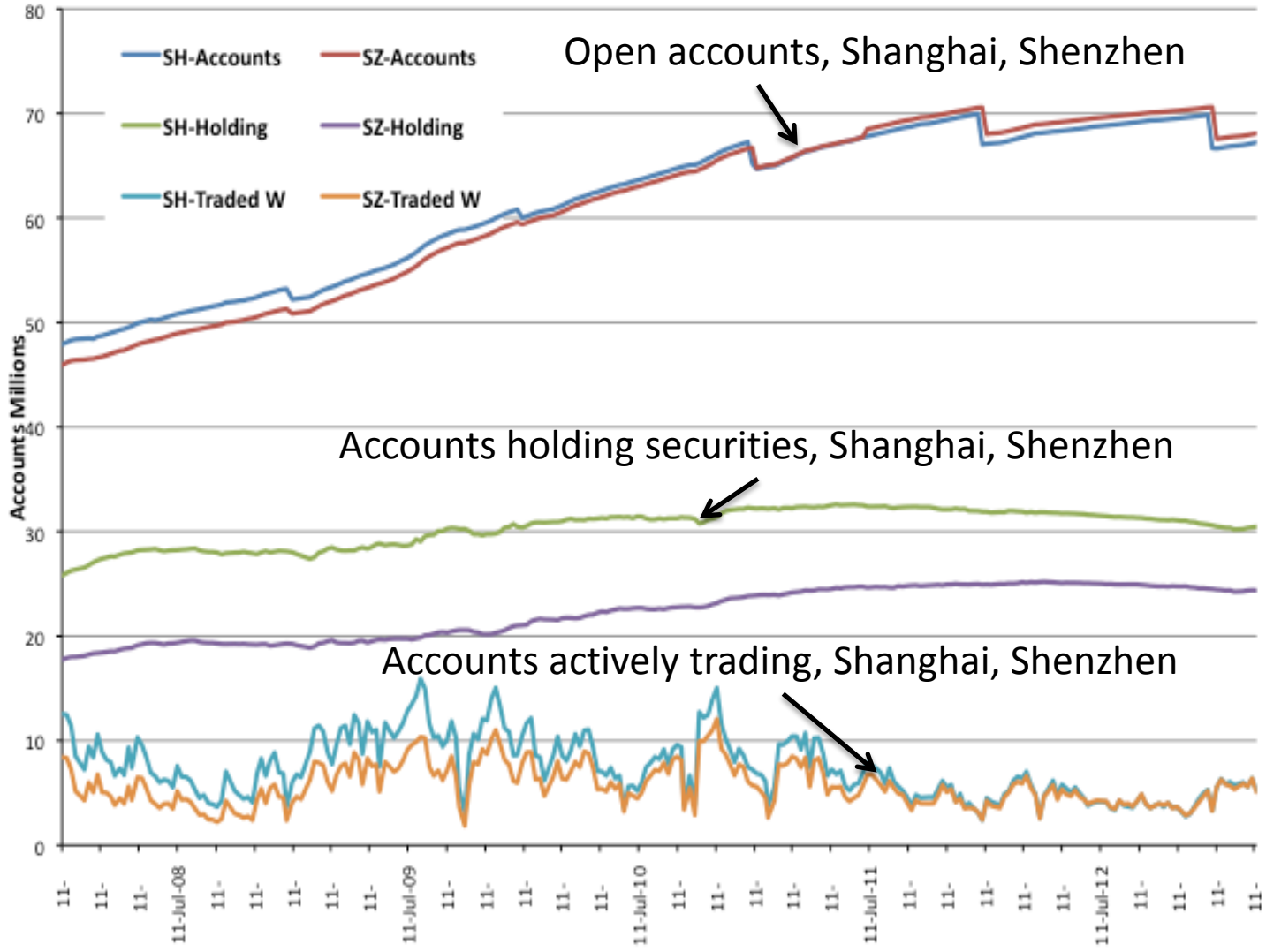
Pricing: the lottery system is rigged to favor large investors

	Allocation Basis	Participants	Basis of allocation	Subscription requirement
1993 - 1999	lottery	retail and institutional	number of subscription forms submitted	- full funding - existing shareholding ratio
2000 - present	lottery plus	retail	lottery	- full funding - existing shareholding ratio
	pre-offering strategic investors	institutional	full order	- full funding - lock up period

Implications:

1. Unlike HK, lottery success ratio is based on # of applications submitted
2. Need to fully fund each application favors big institutions with lots of cash
3. Led to creation of "Strategic Investor" category in 1998
4. Full allocation in return for a lock up period, but not true lock up
5. Distorted IPO market even further, leading to stress on interbank market
6. Gave false appearance of massive primary markets

Participants: actual number of accounts trading is small



Source: Wind Information

Participants: account breakdown, Retail vs. Institutional

Institutional investor accounts actually holding shares

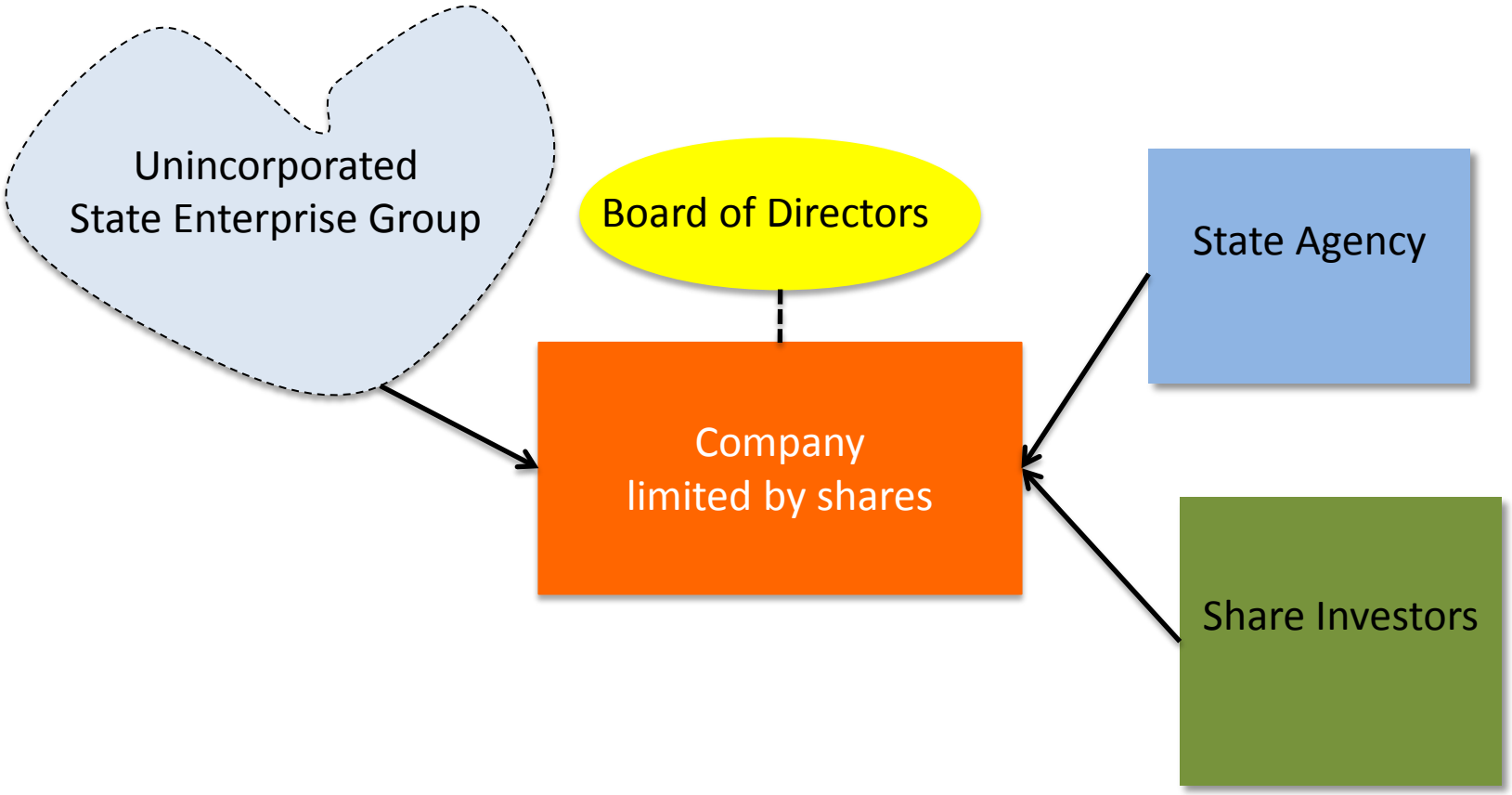
	Account Category	# Institutional Accounts	Assumed value per account	Category Value	% of Total Value Institutional	as % of Total Value Retail + Institutional
a	< 10,000 RMB	6,950	10,000	69,500,000	0.0%	0.0%
b	10-100,000	16,928	50,000	846,400,000	0.1%	0.0%
c	100-500,000	17,818	100,000	1,781,800,000	0.2%	0.0%
d	500-1,000,000	7,952	500,000	3,976,000,000	0.5%	0.1%
e	1-5,000,000	14,688	1,000,000	14,688,000,000	2.0%	0.3%
f	5-10,000,000	4,383	5,000,000	21,915,000,000	3.0%	0.5%
g	10-100,000,000	8,834	10,000,000	88,340,000,000	12.0%	2.0%
h	> 100, 000,000	6,063	100,000,000	606,300,000,000	82.2%	14.0%
		83,616		737,916,700,000	100%	17.1%

Retail investor accounts actually holding shares

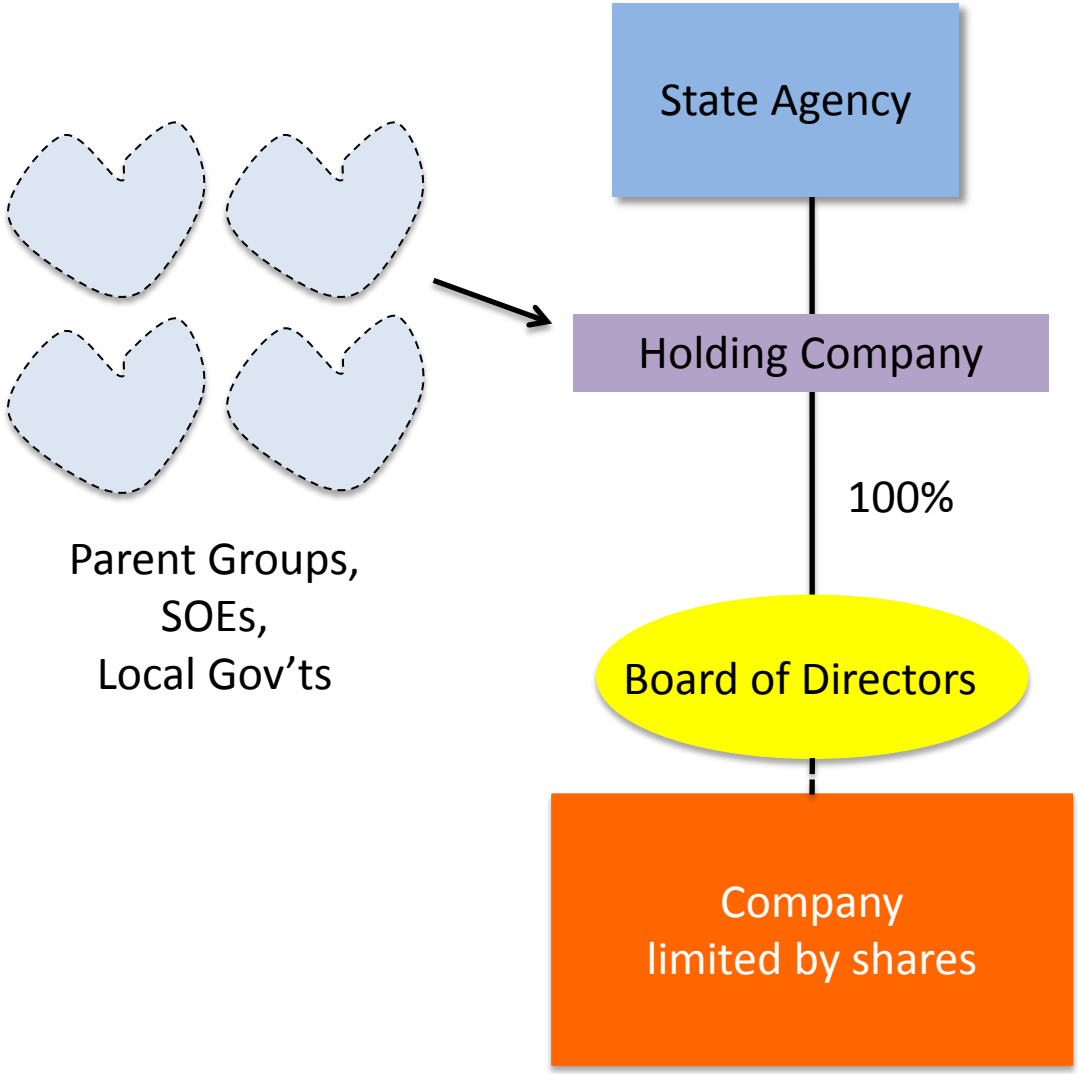
	Account Category	# Retail Accounts	Assumed value per account	Category Value	% of Total Value Retail	as % of Total Value Retail + Institutional
a	< 10,000 RMB	19,782,388	10,000	197,823,880,000	6%	4.6%
b	10-100,000	25,917,627	50,000	1,295,881,350,000	36%	30.0%
c	100-500,000	6,805,327	100,000	680,532,700,000	19%	15.8%
d	500-1,000,000	830,537	500,000	415,268,500,000	12%	9.6%
e	1-5,000,000	501,326	1,000,000	501,326,000,000	14%	11.6%
f	5-10,000,000	36,904	5,000,000	184,520,000,000	5%	4.3%
g	10-100,000,000	19,473	10,000,000	194,730,000,000	5%	4.5%
h	> 100, 000,000	1,128	100,000,000	112,800,000,000	3%	2.6%
	Total	53,894,710		**3,582,882,430,000**	100%	82.9%

Source: China Clear, February 2013, Table 2.10

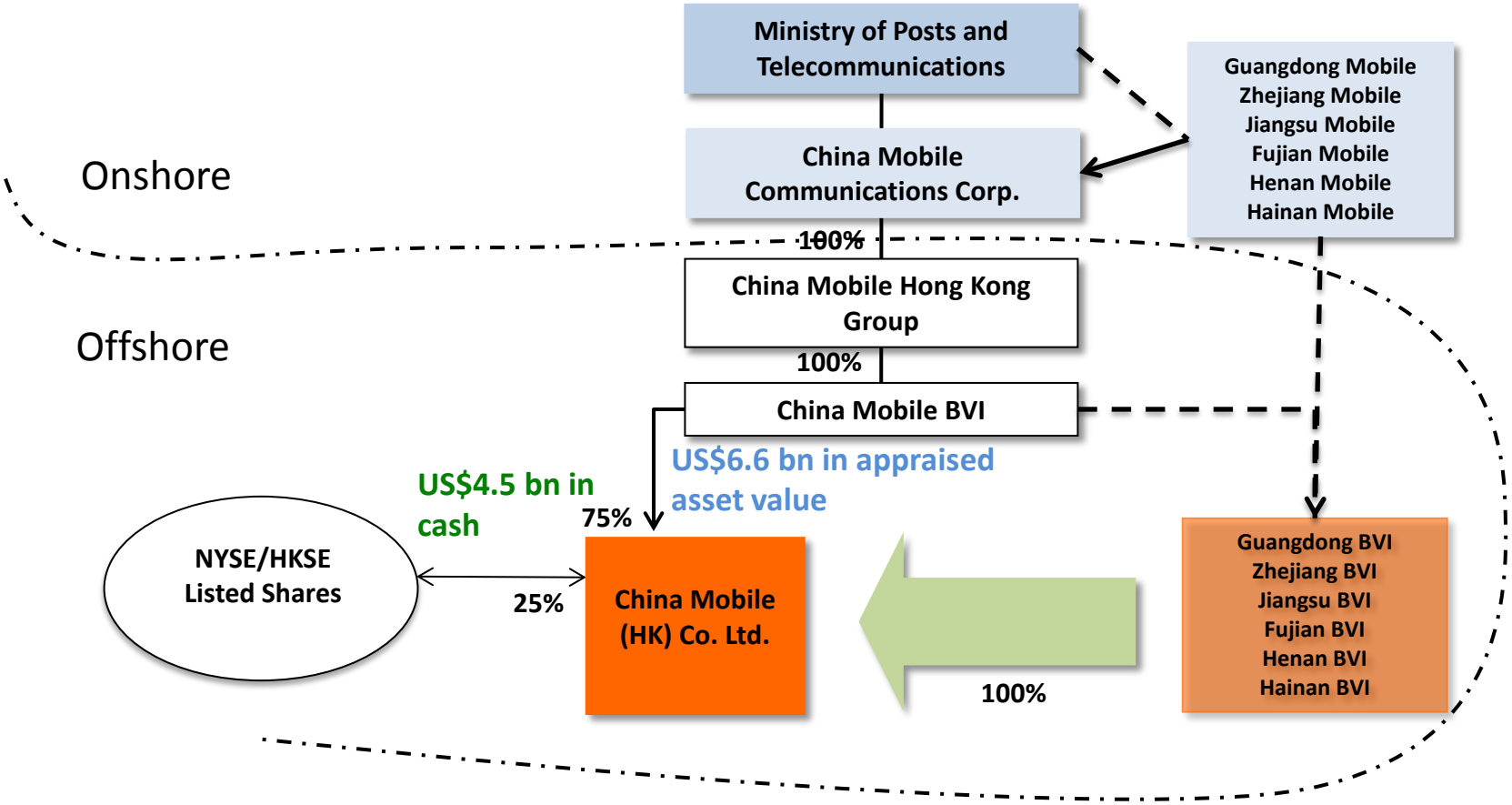
Corporatization: 1990s, who holds the shares, owns the shares



Corporatization: 1997: Red Chips lead to National Champions



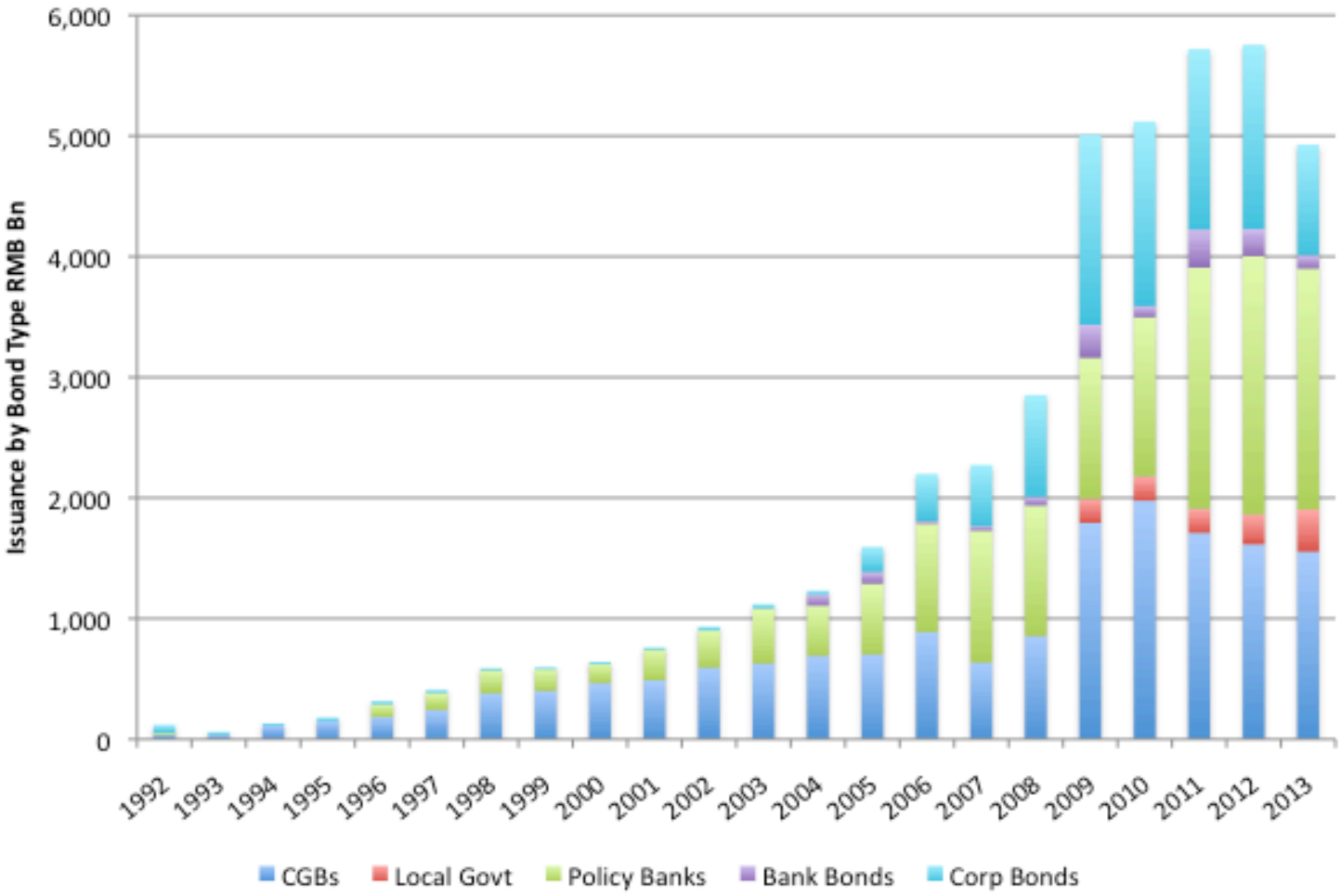
1997: China Telecom: at US$4.4 bn the first National Champion



This corporate structure demonstrates the political leadership's reliance on international law (of course, the assets and the cash are still onshore).

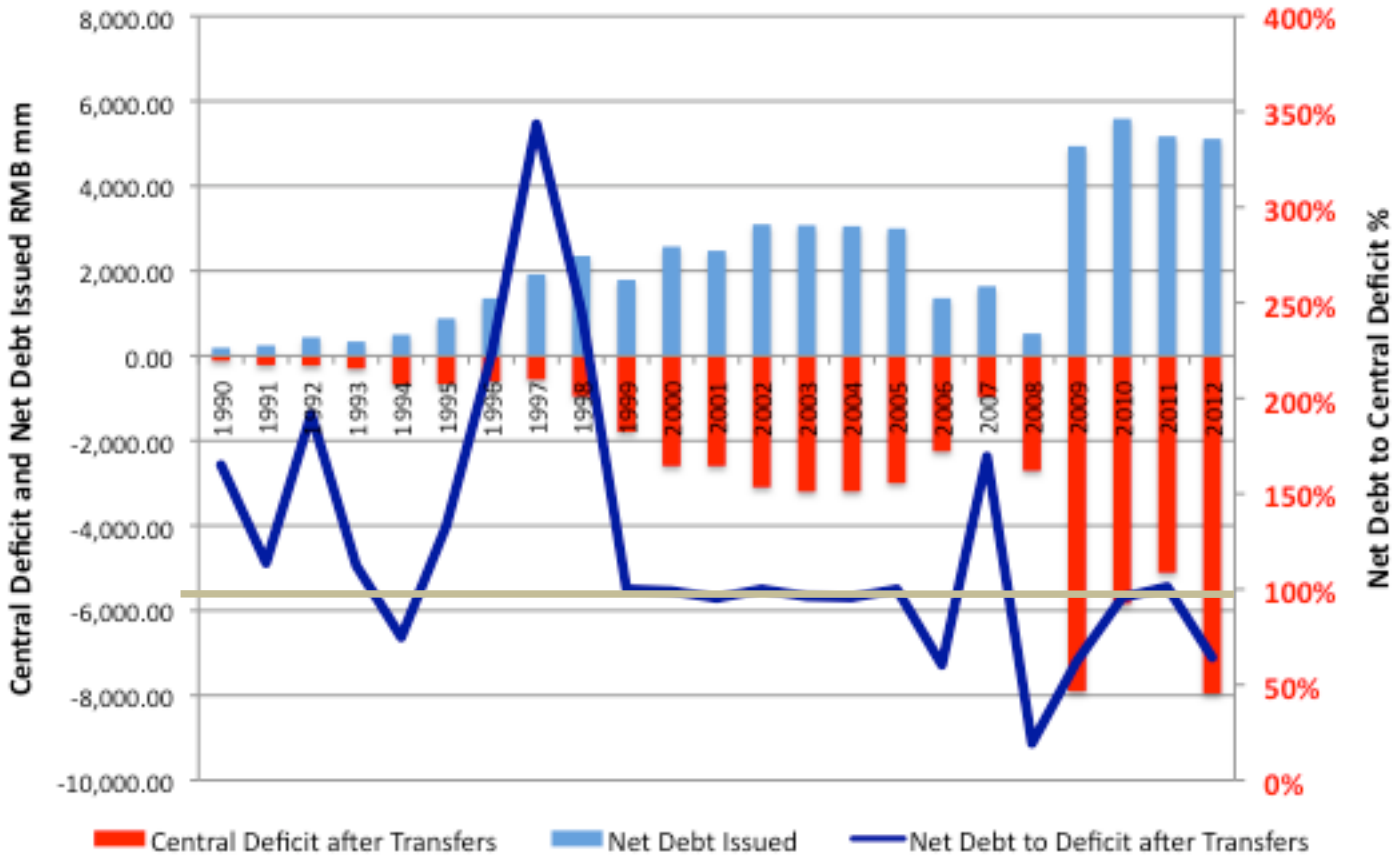
No longer an experiment

China has developed a large primary debt capital market



Source: Wind Information

Driver 1: Central government debt dependence



Source: Ministry of Finance; China Bond

Driver 2: corporate bonds developed by PBOC to reform market

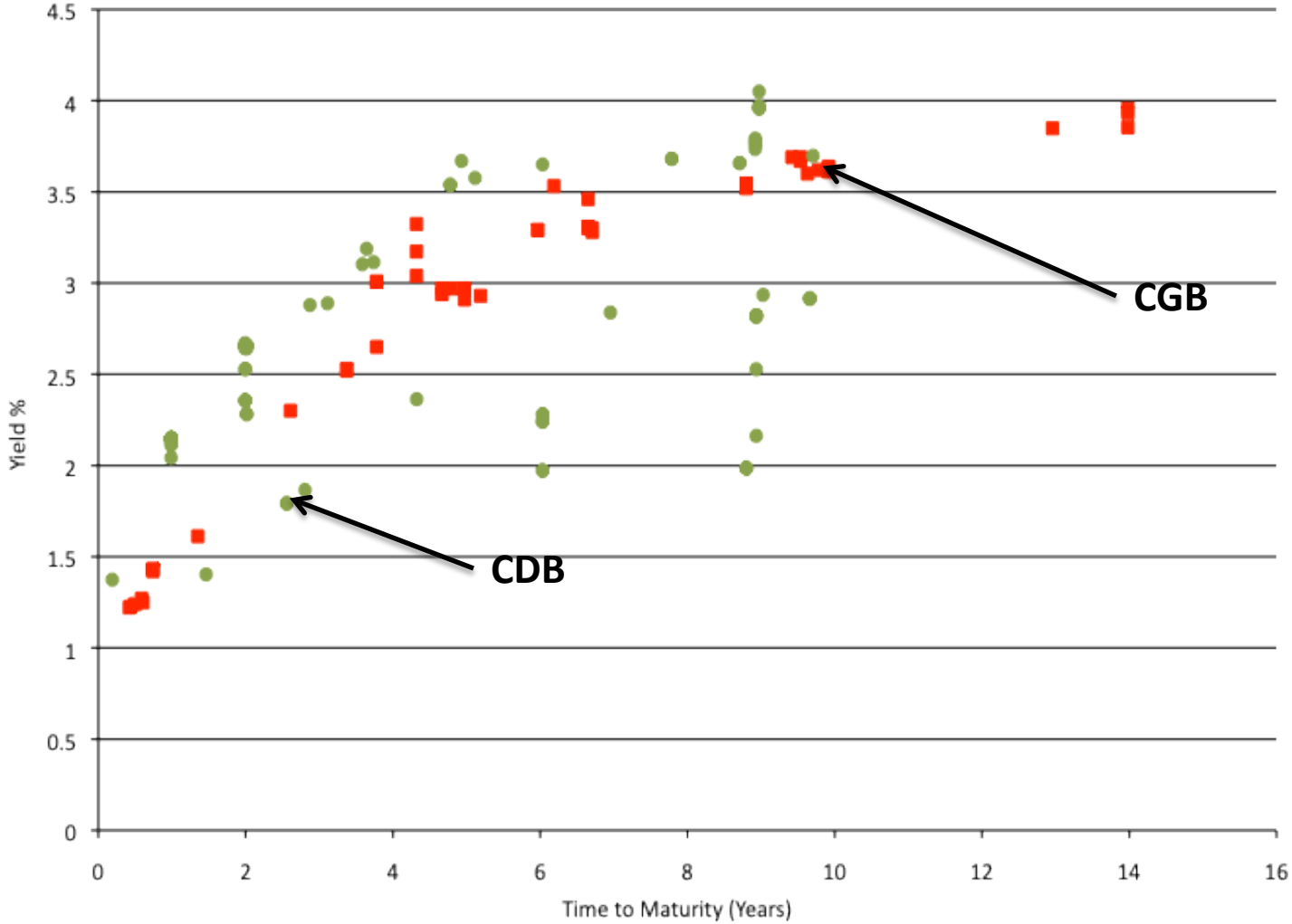
	Government Bonds	Enterprise Bonds	Convertible bonds	PBOC Notes	CP	MTN	ABS	Financial bonds	Trust products
Ministry of Finance	✔								
NDRC		✔							
PBOC				✔			✔	✔	
NAFMII					✔	✔			
CBRC							✔	✔	✔
CSRC			✔						

PBOC objectives:

1. Create a real RMB yield curve to support interest rate reform
2. Diversify corporate borrowing away from bank loans
3. Unify debt market regulation under PBOC

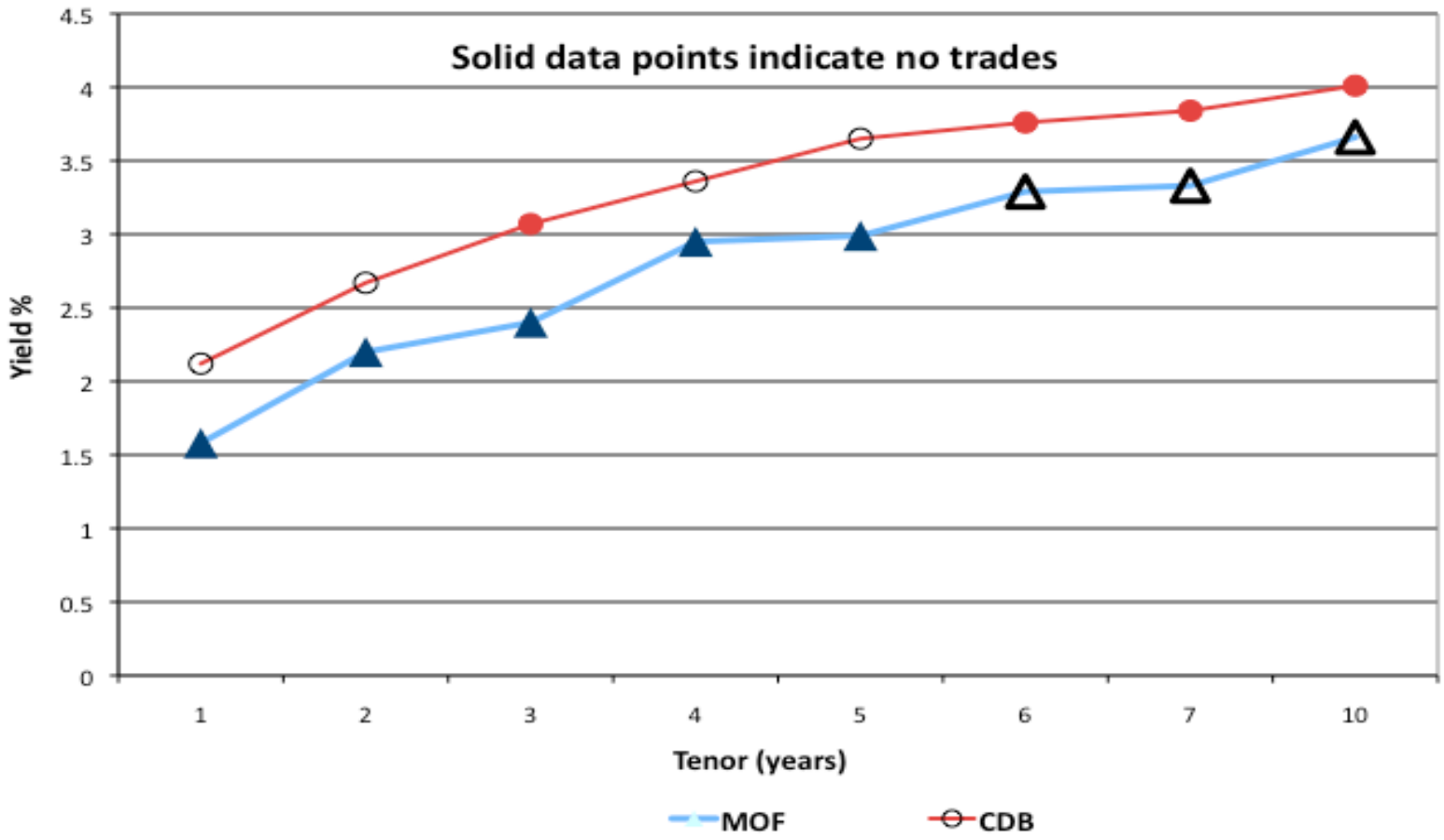
Results: too early to say?

Pricing gov't debt: what yield curve? 160 trades in one day



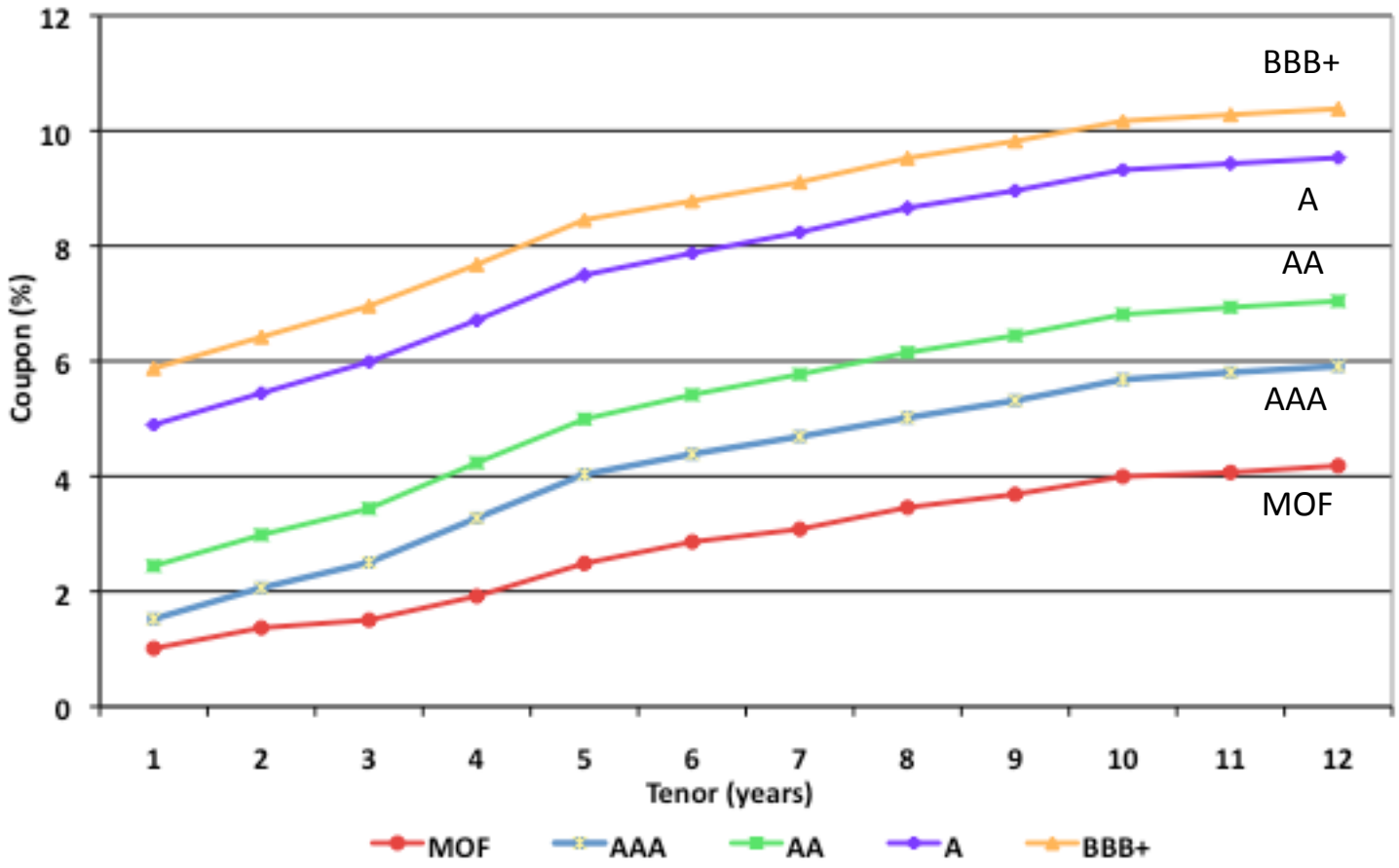
Source: Wind Information for 12/9/2009

Pricing: China's official PBOC-set yield curve



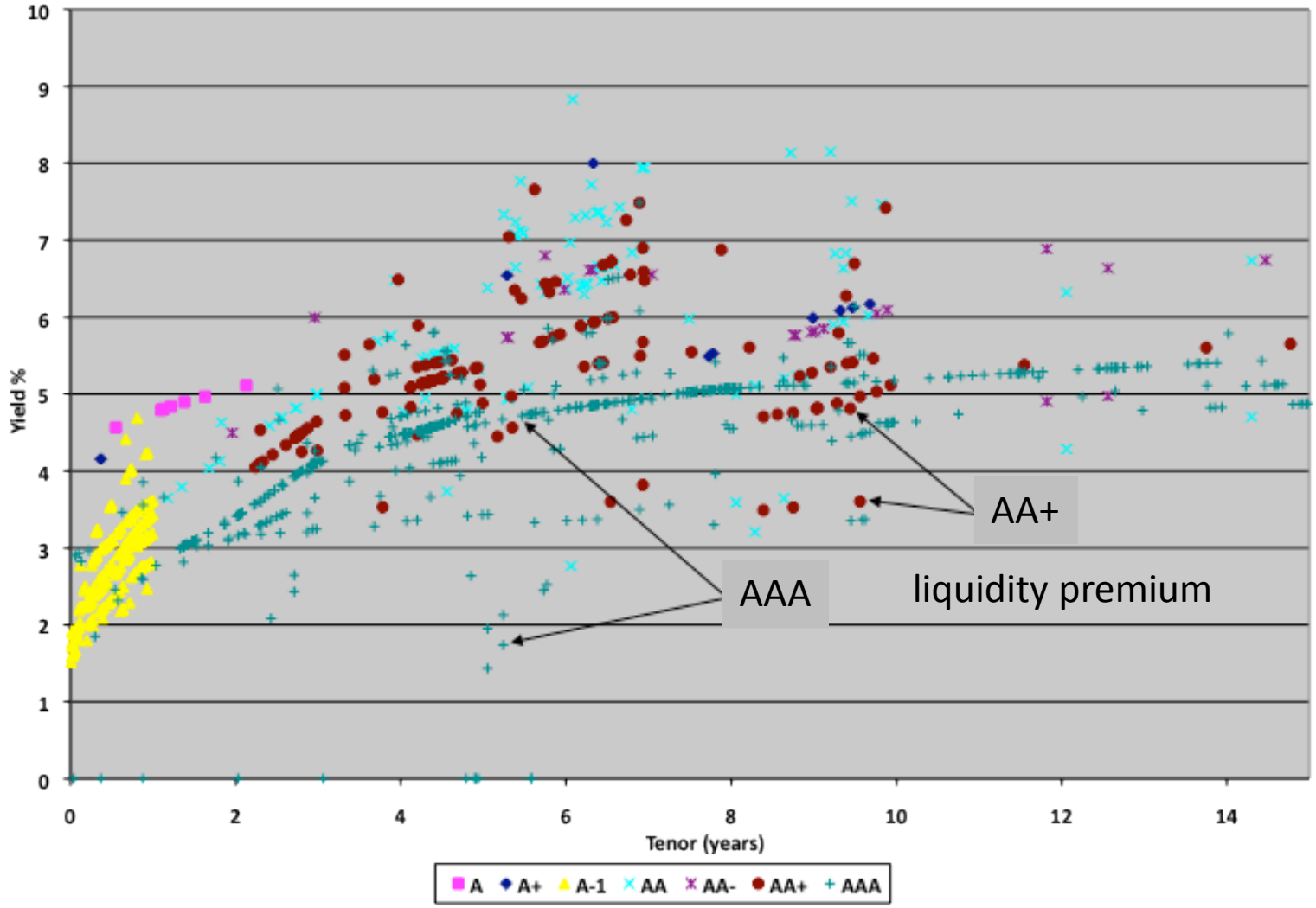
Source: Wind Information for 1/4/2010

Pricing: mandated minimum bond pricing



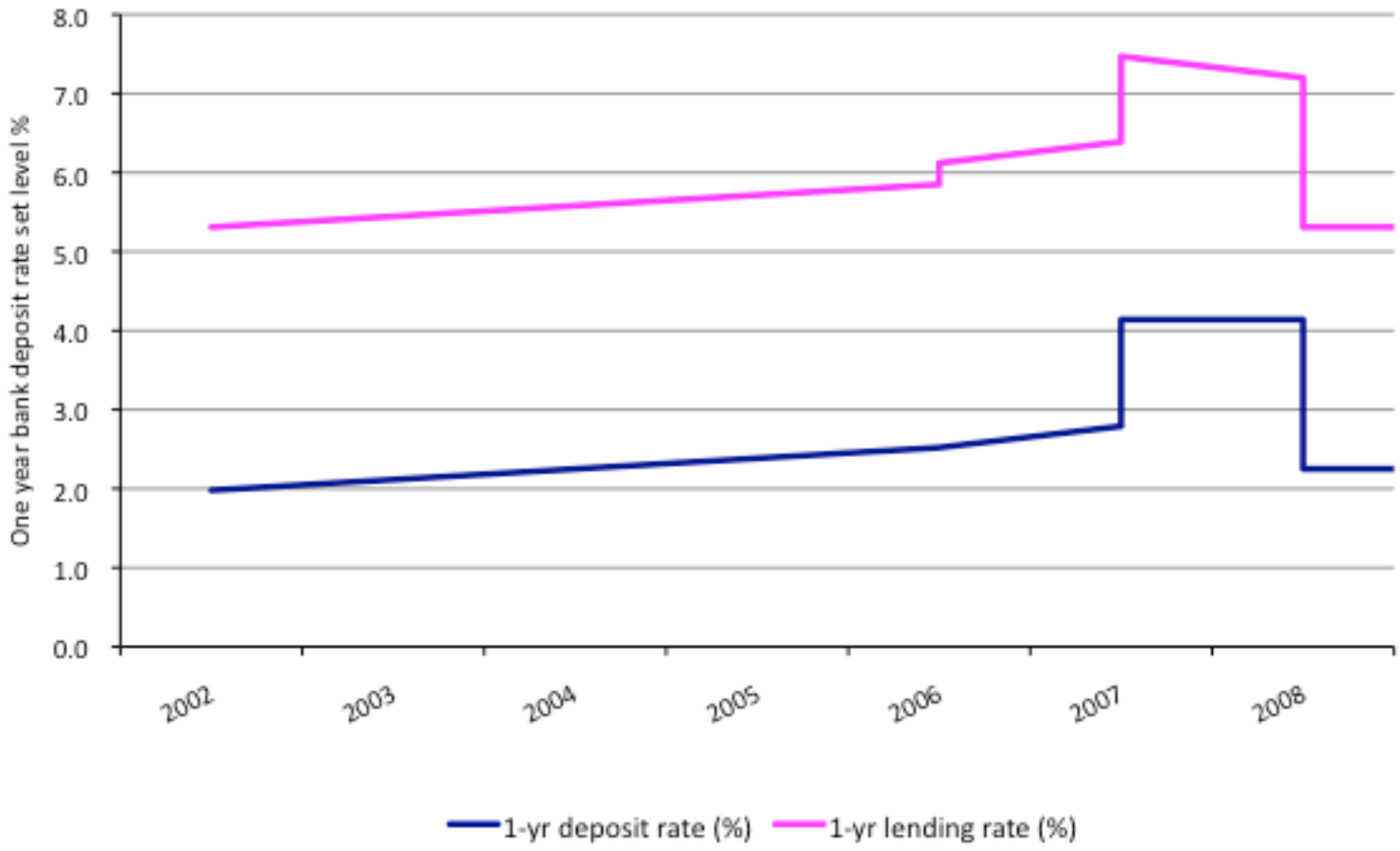
Source: China Bond

Corporate debt: 1550 trades a day, 9000 market members



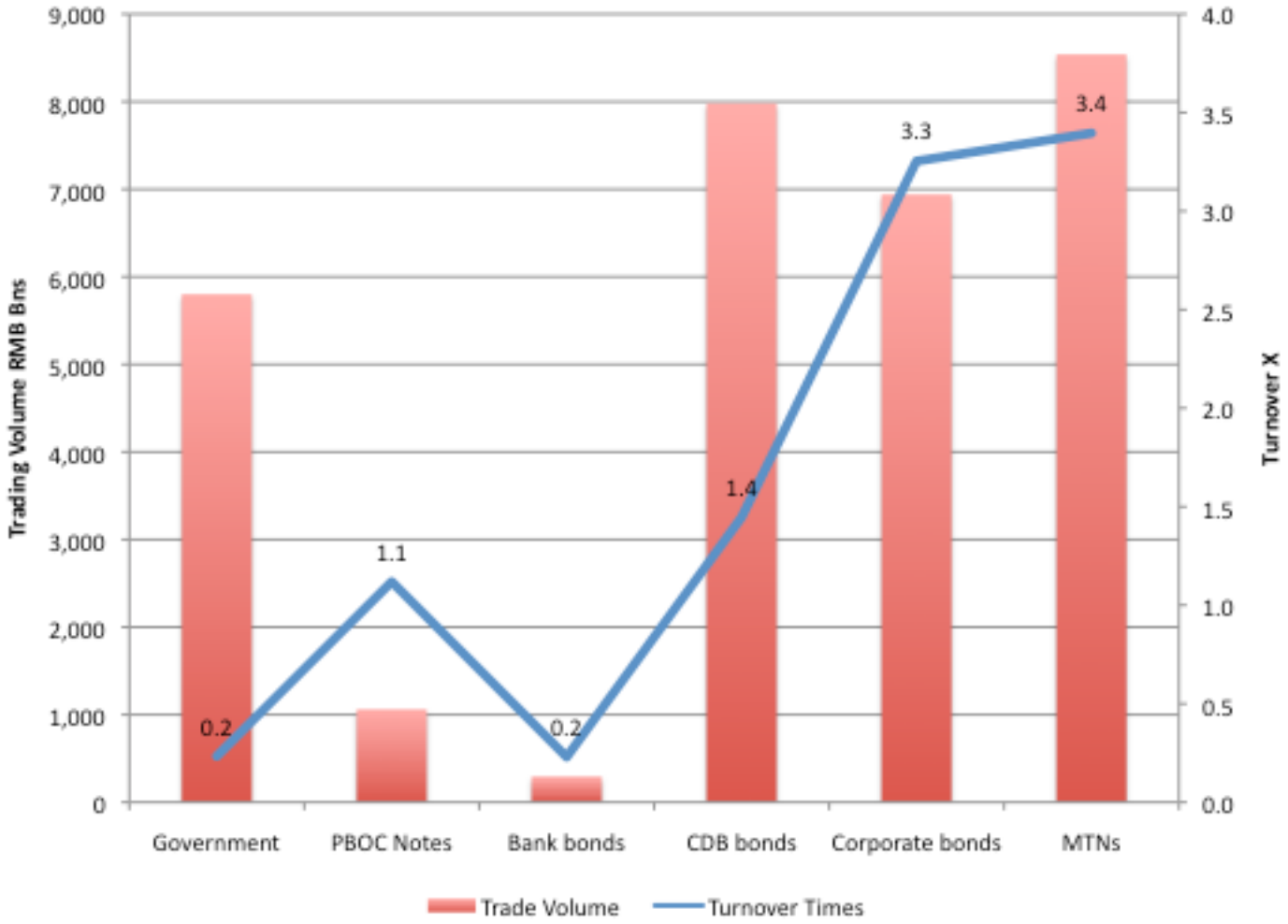
Source: Wind Information for 12/9/2009

Pricing: Mandated minimum loan and maximum bank deposit rates



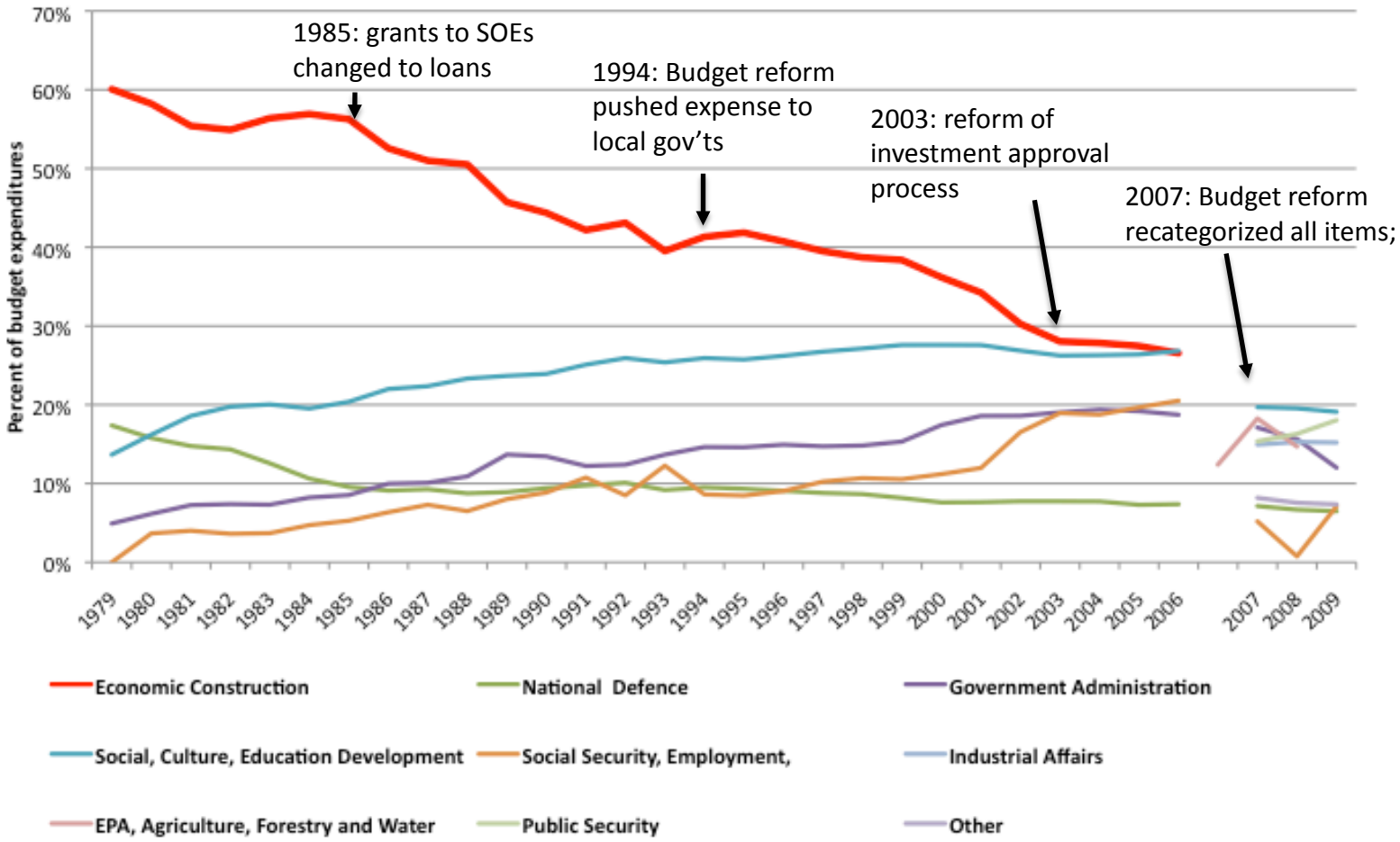
Source: China Bond

Liquidity: fixed income product trading turnover, 2013



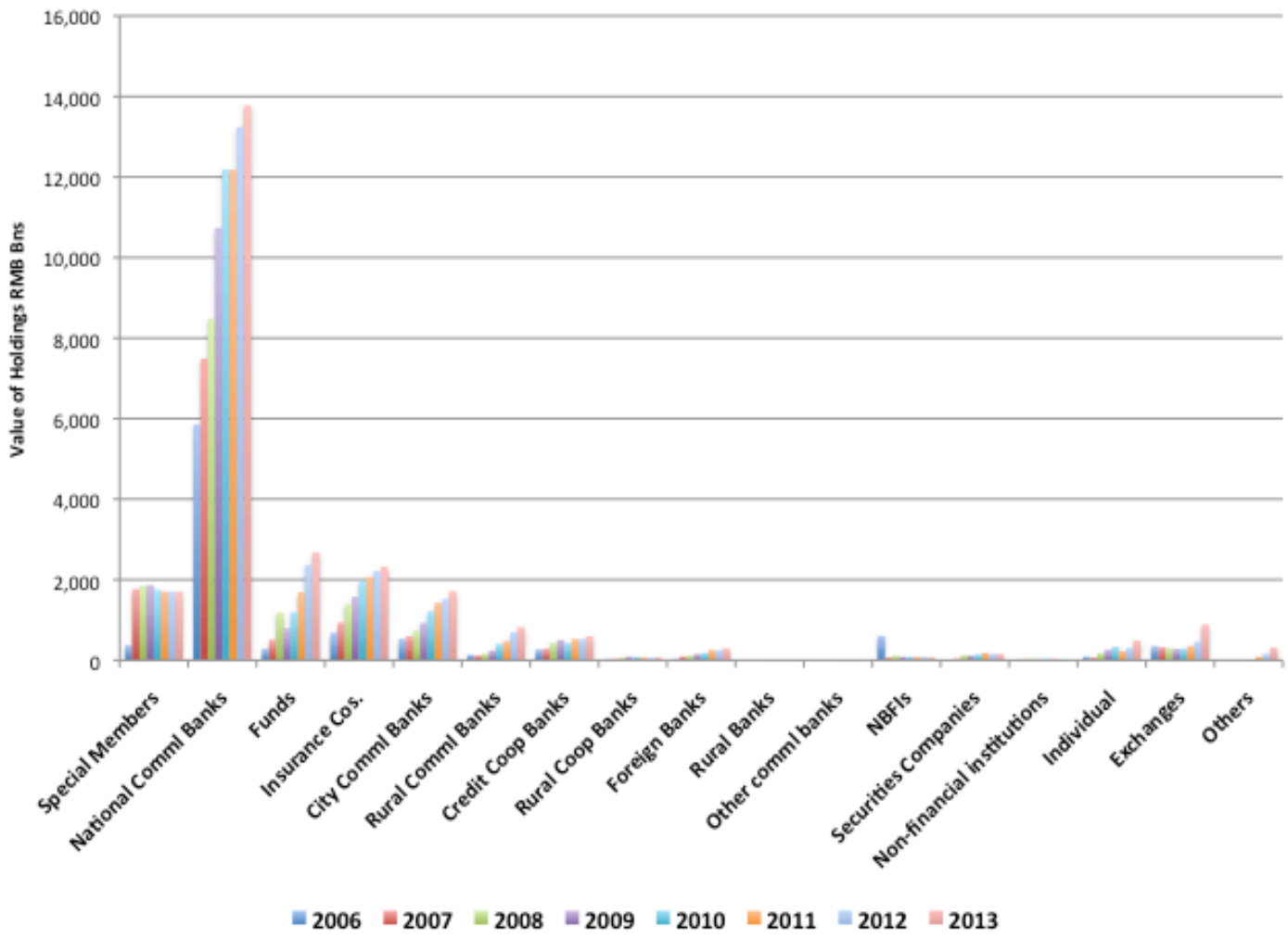
Source: China Bond

Investors: China's banks have been "fiscalized"



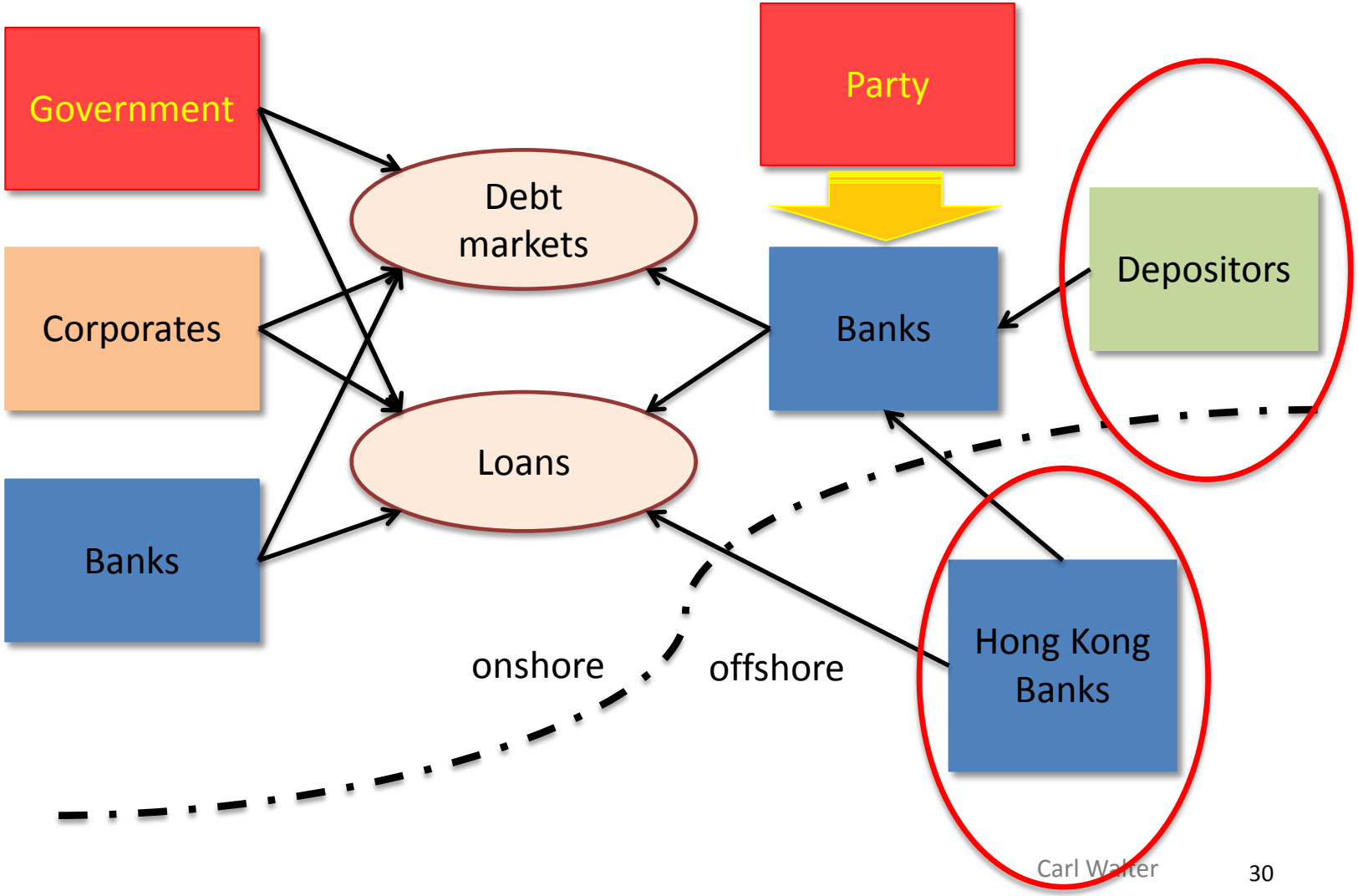
Source: Wind Information

State banks are China's institutional bond investors

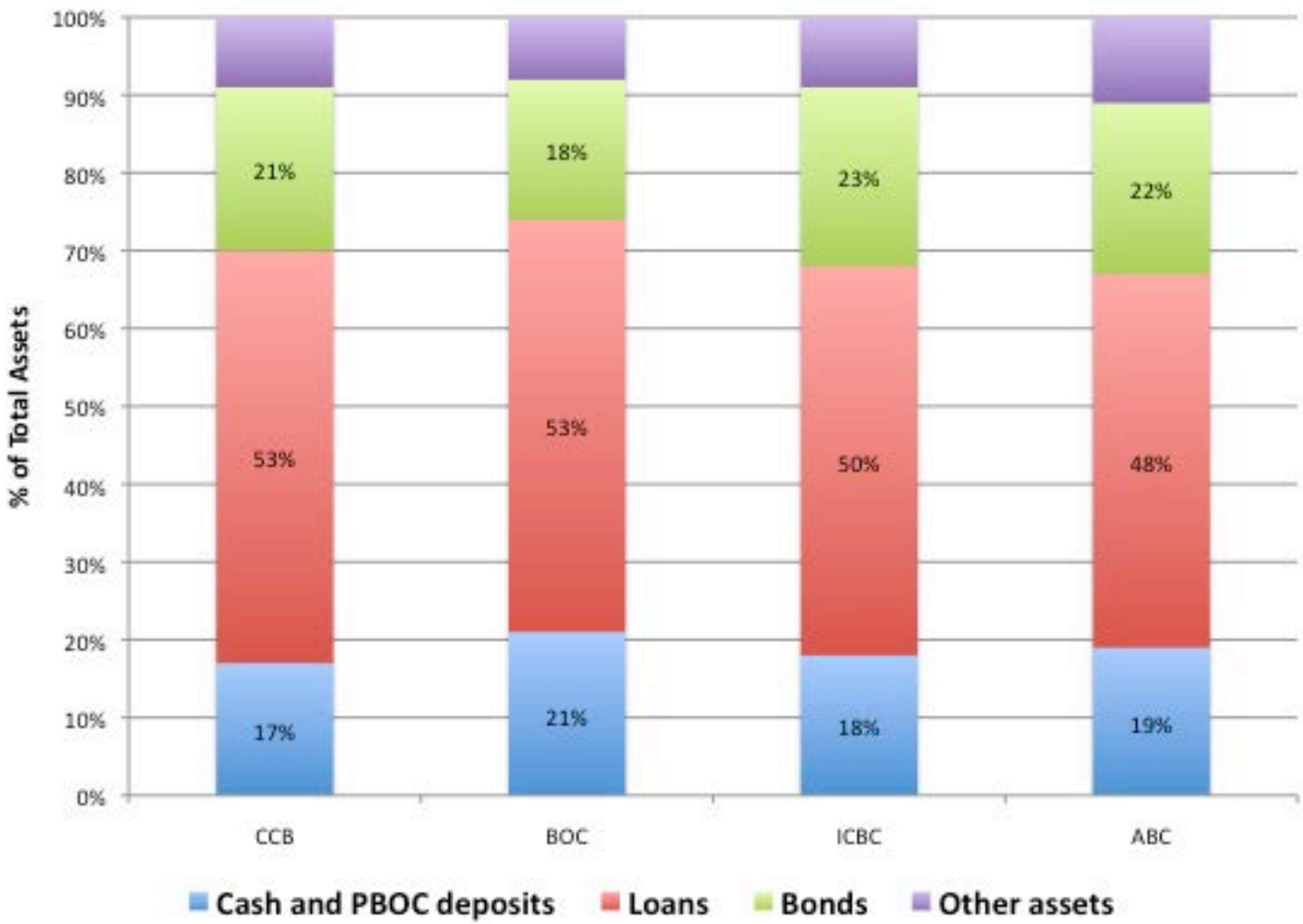


Banks are institutions in play

China's banks: not intermediaries, channels



State banks balance sheets are obstacles to reform



Source: State bank H-share annual reports for 2012

Summing Up

Pros:

1. For first time China has national capital market infrastructure
2. Corporatization of state sector has raised @USD1 trillion
3. Western law and accounting have created national corporations
4. Western accounting has enhanced financial transparency

Cons:

1. State remains issuer, underwriter and regulator: all investors invest in is simply moral hazard
2. Market, interest rate and credit risk is concentrated in state banks: major obstacle to real financial reform
3. Still no institutional grasp of market-based valuation or financial risk
4. Unclear if National Champions are real, integrated companies, but they are political obstacles to reform
5. Corporate governance at best remains a question mark
6. Market valuations of listed companies remain unclear
7. Market-based yield curves do not exist

Deng Xiaoping was wrong!