Overview of China’s equity and debt capital markets

Carl E. Walter

Understanding China’s Capital Markets
2014 CARE / Hong Kong PolyU Conference

Hong Kong, June 9, 2014
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?
“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

![Bar chart showing ownership distribution](chart.png)

- **24% non-state** in National
- **64% non-state** in Shenzhen

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

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>5/30/13</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non-Tradable</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Promoter shares</td>
<td>1,746</td>
<td>2,165</td>
<td>3,121</td>
<td></td>
</tr>
<tr>
<td>Legal Person shares</td>
<td>190</td>
<td>214</td>
<td>246</td>
<td></td>
</tr>
<tr>
<td>Employee shares</td>
<td>37</td>
<td>24</td>
<td>24</td>
<td></td>
</tr>
<tr>
<td>Other share types</td>
<td>35</td>
<td>25</td>
<td>24</td>
<td></td>
</tr>
<tr>
<td>Total Non-Tradable</td>
<td>2,009</td>
<td>2,428</td>
<td>3,415</td>
<td></td>
</tr>
<tr>
<td><strong>% Total Shares</strong></td>
<td>67.8%</td>
<td>66.4%</td>
<td>67.6%</td>
<td></td>
</tr>
<tr>
<td><strong>Tradable</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A shares</td>
<td>813</td>
<td>1,078</td>
<td>1,331</td>
<td></td>
</tr>
<tr>
<td>B shares</td>
<td>142</td>
<td>152</td>
<td>163</td>
<td></td>
</tr>
<tr>
<td>Total Tradable</td>
<td>955</td>
<td>1,230</td>
<td>1,494</td>
<td></td>
</tr>
<tr>
<td><strong>% Total Shares</strong></td>
<td>32.2%</td>
<td>33.6%</td>
<td>32.4%</td>
<td></td>
</tr>
</tbody>
</table>

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

H Shares & offshore markets

Legend:
A: QFII
B: Cross border M&A
C&D: Privatization
E: State share sale

HKSE/SFC
SEC/NYSE

LP Shares

A-share markets

State Shares

Shanghai/Shenzhen
CSRC

Market capitalization = A & B shares only

Note: SAMB = State Asset Management Bureau

Auction Houses, Negotiated transfers
SAMB

Negotiated transfers
SAMB
What valuation for China Eastern?

Source: Hong Kong, Shanghai Stock Exchanges, Bloomberg and Wind Information
The G-company reform, 2005 - 2008

<table>
<thead>
<tr>
<th>Share Type</th>
<th>Share Type</th>
<th>Shareholder</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Original share structure</strong></td>
<td><strong>Post-reform share structure</strong></td>
<td></td>
</tr>
<tr>
<td>A shares</td>
<td>A shares</td>
<td>Funds, QFII, retail</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Parent Group, SOE, state agency</td>
</tr>
<tr>
<td>Various state shares</td>
<td>Parent Group, SOE, state agency</td>
<td>Funds, QFII, retail</td>
</tr>
<tr>
<td></td>
<td></td>
<td>A shares; state holder subject to lock up</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Parent Group, SOE, state agency</td>
</tr>
</tbody>
</table>

Retail got compensated for “Original Sin,” CSRC became sole regulator
Valuation: the HK – Shanghai price differential remains wide

Valuation remains a challenge

50% premium

90% discount

Source: Wind Information
Pricing: the famous IPO “Pop” in the primary market
Pricing: taking care of friends: the IPO pop, another view

¥45 billion left on the table - PetroChina

¥15 billion left on the table - China Shenhua
Pricing: the lottery system is rigged to favor large investors

<table>
<thead>
<tr>
<th>Allocation Basis</th>
<th>Participants</th>
<th>Basis of allocation</th>
<th>Subscription requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993 - 1999 lottery</td>
<td>retail and institutional</td>
<td>number of subscription forms submitted</td>
<td>- full funding</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>- existing shareholding ratio</td>
</tr>
<tr>
<td>2000 - present lottery plus</td>
<td>retail</td>
<td>lottery</td>
<td>- full funding</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>- existing shareholding ratio</td>
</tr>
<tr>
<td></td>
<td>pre-offering strategic investors</td>
<td>institutional</td>
<td>full order</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>- full funding</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>- lock up period</td>
</tr>
</tbody>
</table>

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

Open accounts, Shanghai, Shenzhen

Accounts holding securities, Shanghai, Shenzhen

Accounts actively trading, Shanghai, Shenzhen

Source: Wind Information
Participants: account breakdown, Retail vs. Institutional

Institutional investor accounts actually holding shares

<table>
<thead>
<tr>
<th>Account Category</th>
<th># Institutional Accounts</th>
<th>Assumed value per account</th>
<th>Category Value</th>
<th>% of Total Value Institutional</th>
<th>as % of Total Value Retail + Institutional</th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>&lt; 10,000 RMB</td>
<td>10,000</td>
<td>69,500,000</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>b</td>
<td>10-100,000</td>
<td>50,000</td>
<td>846,400,000</td>
<td>0.1%</td>
<td>0.0%</td>
</tr>
<tr>
<td>c</td>
<td>100-500,000</td>
<td>100,000</td>
<td>1,781,800,000</td>
<td>0.2%</td>
<td>0.0%</td>
</tr>
<tr>
<td>d</td>
<td>500-1,000,000</td>
<td>500,000</td>
<td>3,976,000,000</td>
<td>0.5%</td>
<td>0.1%</td>
</tr>
<tr>
<td>e</td>
<td>1-5,000,000</td>
<td>1,000,000</td>
<td>14,688,000,000</td>
<td>2.0%</td>
<td>0.3%</td>
</tr>
<tr>
<td>f</td>
<td>5-10,000,000</td>
<td>5,000,000</td>
<td>21,915,000,000</td>
<td>3.0%</td>
<td>0.5%</td>
</tr>
<tr>
<td>g</td>
<td>10-100,000,000</td>
<td>10,000,000</td>
<td>88,340,000,000</td>
<td>12.0%</td>
<td>2.0%</td>
</tr>
<tr>
<td>h</td>
<td>&gt; 100,000,000</td>
<td>100,000,000</td>
<td>606,300,000,000</td>
<td>82.2%</td>
<td>14.0%</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>737,916,700,000</td>
<td>100%</td>
<td>17.1%</td>
</tr>
</tbody>
</table>

Retail investor accounts actually holding shares

<table>
<thead>
<tr>
<th>Account Category</th>
<th># Retail Accounts</th>
<th>Assumed value per account</th>
<th>Category Value</th>
<th>% of Total Value Retail</th>
<th>as % of Total Value Retail + Institutional</th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>&lt; 10,000 RMB</td>
<td>10,000</td>
<td>197,823,880,000</td>
<td>6%</td>
<td>4.6%</td>
</tr>
<tr>
<td>b</td>
<td>10-100,000</td>
<td>50,000</td>
<td>1,295,881,350,000</td>
<td>36%</td>
<td>30.0%</td>
</tr>
<tr>
<td>c</td>
<td>100-500,000</td>
<td>100,000</td>
<td>680,532,700,000</td>
<td>19%</td>
<td>15.8%</td>
</tr>
<tr>
<td>d</td>
<td>500-1,000,000</td>
<td>500,000</td>
<td>415,268,500,000</td>
<td>12%</td>
<td>9.6%</td>
</tr>
<tr>
<td>e</td>
<td>1-5,000,000</td>
<td>1,000,000</td>
<td>501,326,000,000</td>
<td>14%</td>
<td>11.6%</td>
</tr>
<tr>
<td>f</td>
<td>5-10,000,000</td>
<td>5,000,000</td>
<td>184,520,000,000</td>
<td>5%</td>
<td>4.3%</td>
</tr>
<tr>
<td>g</td>
<td>10-100,000,000</td>
<td>10,000,000</td>
<td>194,730,000,000</td>
<td>5%</td>
<td>4.5%</td>
</tr>
<tr>
<td>h</td>
<td>&gt; 100,000,000</td>
<td>100,000,000</td>
<td>112,800,000,000</td>
<td>3%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>3,582,882,430,000</td>
<td>100%</td>
<td>82.9%</td>
</tr>
</tbody>
</table>

Source: China Clear, February 2013, Table 2.10
Corporatization: 1990s, who holds the shares, owns the shares

- Unincorporated State Enterprise Group
- Board of Directors
- State Agency
- Company limited by shares
- Share Investors
Corporatization: 1997: Red Chips lead to National Champions

Parent Groups, SOEs, Local Gov’ts

State Agency

Holding Company

100%

Board of Directors

Company limited by shares
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

<table>
<thead>
<tr>
<th></th>
<th>Government Bonds</th>
<th>Enterprise Bonds</th>
<th>Convertible bonds</th>
<th>PBOC Notes</th>
<th>CP</th>
<th>MTN</th>
<th>ABS</th>
<th>Financial bonds</th>
<th>Trust products</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ministry of Finance</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NDRC</td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PBOC</td>
<td></td>
<td></td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>NAFMII</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
<td></td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>CBRC</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>CSRC</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
</tr>
</tbody>
</table>

**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

Pricing: China’s official PBOC-set yield curve

Solid data points indicate no trades

Source: Wind Information for 1/4/2010
Pricing: mandated minimum bond pricing

Source: China Bond

MOF  AAA  AA  A  BBB+

Source: China Bond
Corporate debt: 1550 trades a day, 9000 market members

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”

1985: grants to SOEs changed to loans
1994: Budget reform pushed expense to local gov’ts
2003: reform of investment approval process
2007: Budget reform recategorized all items;

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!