In Case You Missed It: CSOP's Weekly China Wrap Up

MSCI gives A-Shares the nod

After performing their fourth global consultation, index provider MSCI announced inclusion of China A-Shares in their Emerging Markets (EM) index.[1] The share class will initially represent 0.73% of the EM index and 5% of China exposure. The logistics of including the 222 selected A-Share names will begin with a 2.5% addition in May 2018 and conclude with the remaining 2.5% in August 2018.

Fourth time's a charm:

For the past three years, MSCI has deliberated whether to include A-Shares. Although many global observers thought 2016 would be the year that A-Shares were added, MSCI declined, citing lingering repatriation restrictions, rampant delistings, and the continued need for regulatory permission to launch new A-Share products. Displeased with MSCI's decision, China worked to implement the necessary liberalization measures, loosening the QFII/RQFII programs and launching the Hong Kong-Shenzhen Stock Connect scheme.[2] MSCI too compromised, revising their proposed criteria before the 2017 decision. To increase the odds of including China, MSCI decided to consider only 169 names instead of the previous 448, and indicated that they would only evaluate shares accessible through Stock Connect that had not been suspended for the past year.

Are A-Shares about to take off?

In the short run, the decision's impact is symbolic rather than material; it represents the "smart money's" stamp of approval of Mainland China. Because A-Shares' initial weighing is .5% of the entire EM index, the much-ballyhooed inflow of funds into China will not yet manifest. In the long run, however, the decision is expected to send an estimated USD 400 billion of funds into the A-Share market over the next decade.[3] MSCI has cited that, upon full A-Share inclusion, China's proportion of the index will eventually grow from 28% to 43%, with A-Shares representing over 20% of China exposure. As an estimated USD 2 trillion in passive money tracks the EM index, this reallocation will result in an estimated USD 500 billion flowing into China over the next decade.

CBRC mandates commercial banks report exposure to overseas acquirers; stocks of Wanda, Fosun plummet[4]

China's banking regulator urged commercial banks to report their exposure to highly-leveraged overseas acquirers Anbang, Wanda, HNA, and Fosun.

The skittish market did not take kindly to the announcement. The news caused temporary suspension of Wanda's stock after it was pummeled close to limit-down (-10%); the company's bonds faced a similar beating. Fosun too was hit hard, trading down nearly 6%.

Reason behind the regulation?

Seeking to ward off a Lehman-like collapse, regulators seek to analyze whether the highly-leveraged firms pose a "systemic risk" to China's financial system. Although they dominate different industries, the companies have adopted similar strategies to fuel their rapid growth. The multi-step methodology includes: 1.) cultivate friends in the Communist Party; 2.) leverage the relationships to secure regulatory approval and cheap funding from state-owned banks; 3.) construct a nebulous, far-reaching holding company structure; 4.) remain unlisted and under the regulatory radar; 5.) begin aggressive overseas acquisition spree as a hedge against a slowing China and weakening RMB.[5] As a result of this strategy, the four companies have purchased over USD 55 billion of overseas assets in recent years.

In scrutinizing the business model, regulators have become alarmed that the quality of funding sources and acquisitions might be insufficient to pay back the overwhelming debt. Some onlookers believe that the recent (though unconfirmed) imprisonment of Anbang's chairman fueled the investigation; it is possible that Wu Xiaohui confessed something that spurred China's Top Brass to take action.

China to categorize investors and financial products, impose restrictions on non-professionals to limit market volatility

China is considering a plan to sort investors into professional and non-professional categories and will restrict some of the non-professionals from purchasing securities deemed risky or volatile. In the new scheme published by the Securities Association of China, government bonds, money market funds, municipal bonds, and policy bank bonds will be grouped in the lowest risk category and available for all investors. In contrast, A-Shares, B-Shares, and high-tech SMEs on Hong Kong's 'New Third Board' are only available to more experienced market players.[6]

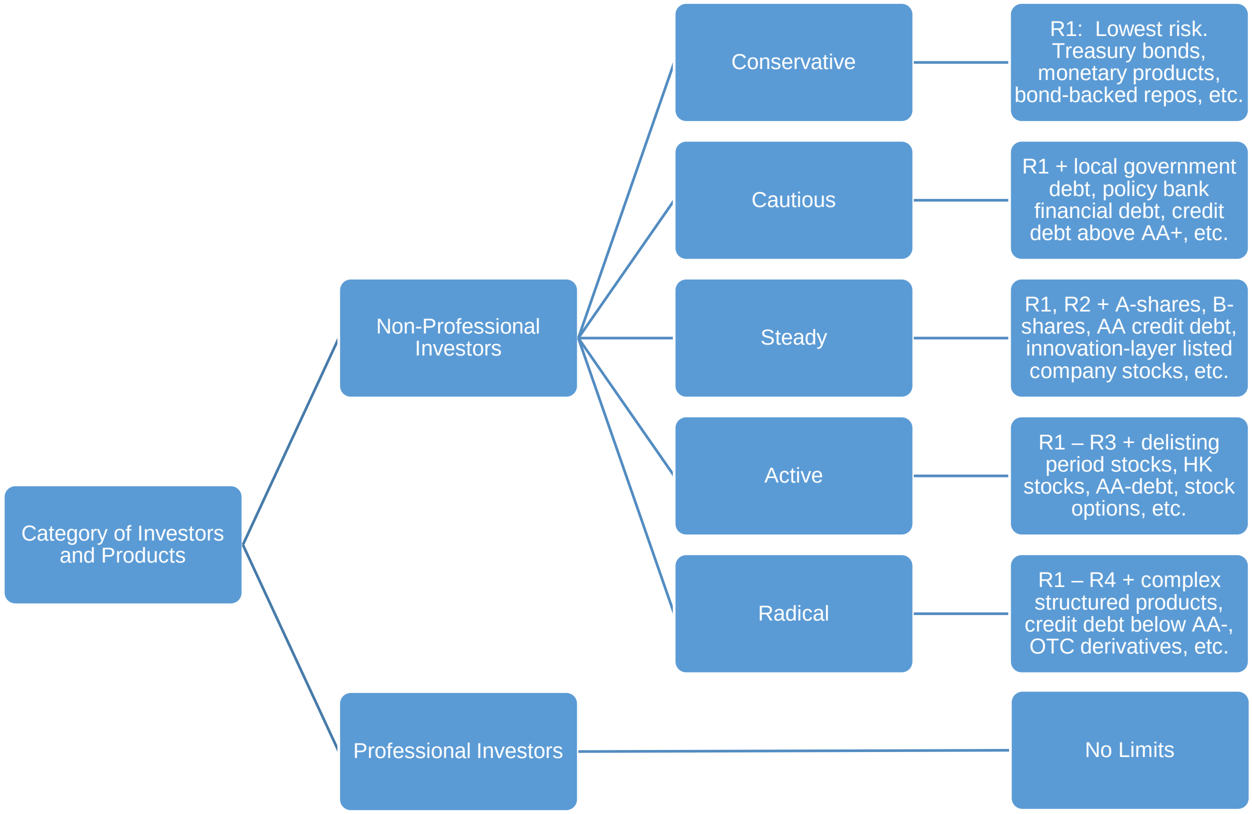
Purpose of the rules: de-retail China's market

If confirmed and implemented effectively, the new rules will help reduce the dominance of retail investors in Mainland markets and thus reduce volatility. Whereas the US market sees roughly 10% retail participation, that figure is closer to 90% in China's A-Share market. Higher participation rates from professional and institutional investors is expected to fuel the maturation of China's stock market.

Making these changes now is important. The A-Share market could become increasingly volatile given China's plans to establish de-listing mechanisms and a registration-based IPO process. Under the registration-based process, companies meeting certain requirements will be qualified to list without the arduous government-led intervention currently involved. Lacking professional investment skills, retail investors should be shielded from partaking in these sophisticated and risky securities transactions.

Theoretically sound, but still lacking

Although these changes are theoretically wise, some critics have uncovered misaligned incentives that threaten to undermine the entire scheme. As the rules are currently written, brokerage houses have incentive to categorize retail clients as professionals to allow the brokers to continue earning commissions. Reconfiguring profit structures will be critical to the success of the scheme.



Notes: The Securities Association of China Report uses the terms R1-R5 to connote Risk Level 1 through Risk Level 2.
Professional investors are defined as:
A. Those with no less than RMB 500 million in financial assets, or annual earnings no less than RMB 500 thousand in the last 3 years
B. Those with over 2 years investment experience related to securities, funds, futures etc., or have worked with financial products, investment and risk management, or related topics for more than two years
Source: Securities Association of China

JD.com sets record with USD 17.6 billion single-day sales

China e-commerce giant JD.com announced a record RMB 119.9 billion (USD 17.6 billion) of sales on June 18, 2017, a promotional day commemorating the company's 19th birthday.

China's consumer class keeps on rising

Demanding higher quality goods and a more convenient shopping experience, China's rising middle class is sparking the success of online e-tailers. The appetitive class is increasingly turning to the sites for items like mobile phones, paper rolls, air conditioners, small home appliances and TVs—goods which represented JD.com's five best-selling categories during the June 18 holiday. Although customers in Tier-1 cities like Beijing and Shanghai mostly drove the 700 million item purchasing bonanza, Tier-2 cities like Chengdu made a strong showing, suggesting great purchasing power potential in mid-west China.[7,8]

A number of new players have emerging to capitalize on the growth of China's online market. Whereas the United States' e-commerce realm is dominated by the monopolistic Amazon, China's remains up for grabs. Giants like Alibaba and JD.com are rapidly ceding ground to US-listed VIPShop and Netease and China-listed Suning Commerce, making the online marketplace a fascinating sector to observe.

Tailwinds ahead?

Despite the impressive headline figures, critics argue that these types of promotional days have diminishing return. Online retailers often increase prices before big sale days, and consumers are gradually becoming aware of the psychological trickery and are thus less inclined to splurge.

Fueled by stock market IPOs and property boom, China's private wealth to grow 14% in 2017

China's private wealth is forecasted to grow 14% in 2017 to RMB 188 trillion (USD 27.5 trillion), according to a new report from China Merchant Bank and Bain & Co. The study found 1.6 million Chinese in possession of at least RMB 10 million (USD 1.5 million) in investable assets, representing a 600% increase in wealth between 2006 and 2016.[9]

What caused the boom?

China's stock market is the biggest contributor to the growth in High Net Worth Individuals (HNWIs). Initial public offerings are key vehicles for wealth creation; the report indicates that Tencent's stock floatation alone created 4,000 new HNWIs. In addition, the rapid escalation of real asset prices—especially Tier-1 urban property—minted thousands of paper millionaires. In Beijing alone, housing prices in prime neighborhoods have increased twenty-fold since 2007.

Who cares? Wealth management firms and regulators, mostly

The rise of China's *nouveau riche* brings salivating opportunities for domestic and international wealth management firms. Currently, Chinese banks and non-banking wealth managers dominate the domestic, while international banks are tapped to manage transactions across borders. As China continues to liberalize and both parties seek to expand their influence, unprecedented turf wars are likely to manifest between the well-connected home team and the well-branded foreigners.

Regulators, on the other hand, do not seem to relish the increase in complexity and sophistication. They seek to stem the outgoing tide of HNWI assets that flow to property markets in Hong Kong, Australia, Canada and the United States. Their desire for control is exacerbated by the countervailing desire to paint China as a safe haven for foreign wealth, which mandates a loosening of capital controls.

Notes:
1. MSCI Emerging Markets Index: The MSCI Emerging Markets Index captures large and mid-cap representation across 23 Emerging Markets (EM) countries. *One cannot invest directly in an index.*
2. QFII/RQFII: Qualified Foreign Institutional Investor and Renminbi Qualified Foreign Institutional Investor, programs that allow foreigners to invest in Mainland China's securities market
3. USD: US Dollar, the official currency of the United States
4. CBRC: China Banking Regulatory Commission
5. RMB: Renminbi, the official currency of the People's Republic of China
6. SME: Small and medium enterprises
7. Tier-1 cities are those directly controlled by the central government with populations over 15 million and GDP over USD 300 billion
8. Tier-2 cities are those with populations between 3-15 million and GPD between USD 68 billion and USD 299 billion
9. Investible assets are defined as surplus assets outside of primary residences and living expenses