

Chinese equities: Over the great wall

China's debt and growth woes obscure opportunities in new-economy Chinese equities

By: UBS Emerging Markets and Asia Pacific Equities Team

After years of underperforming developed markets, emerging markets (EM) equities have turned positive, and investors are slowly increasing their allocations. But many investors remain on the sidelines when it comes to Chinese equities despite what we believe are underappreciated opportunities.

Until recently, several factors such as the buildup of debt combined with falling competitiveness, productivity and commodities prices have held EM back, especially EM Asia. But we are seeing a turnaround and we believe EM Asia will tend to do especially well as growth there begins to outpace debt.

Although growth in China is slowing and debt remains high, we believe the growth of its consumer-based economy creates opportunities for investors, especially as domestic markets open further to foreign investors. While we expect the Chinese equity market to experience periodic volatility, as it did in the days after the 2016 US presidential election for example, for investors with a long-term horizon, we expect competitive returns.

The China opportunities

Investor concern about China's debt and slowing growth is a major factor holding back allocations to Chinese equity markets, and the complex Chinese equity share structure also plays a role. Until recently, it was difficult to invest in some Chinese private-sector equities. These factors have obscured what we believe are growing opportunities in China's large and growing new-economy consumer and service sectors.

Leverage has increased rapidly in China over the last several years, reaching 260 percent of its gross domestic production (GDP) by 2015.¹ Much of the debt was used towards financing

relatively unproductive assets like real estate and is increasingly used to finance working capital and interest payments. China's corporate debt is concentrated in old-economy companies, while new-economy companies are growing quickly, financing growth internally with little or no debt.

China's GDP growth is slowing from double digits a few years ago to an expected 6.5 percent to 7 percent in 2016. We believe that China's GDP growth will continue to slow, which should not overly worry investors.

Much of the drag on China's economy is centered in its state-owned enterprises (SOEs). Much of China's debt resides in this sector, which represents the old economy in China. In contrast, privately owned companies (POCs) in China are expanding with little or no debt. These companies are heavily concentrated in the new-economy consumer-driven sectors that we believe will continue to grow at a faster pace than developed markets over the next several years.

New-economy Chinese equities are more open to foreign investors

It is important to understand the different classes of Chinese shares in order to understand the new opportunities in the market (see exhibit 1). China's different share classes have different dynamics because of foreign exchange control, different market structures and different market participants. Across its several classes of shares, the market capitalization of China's stock market stood at just over USD 8 trillion at the end of 2015.² China's various share classes have hampered foreign investment, particularly in some of the fast-growing private-sector companies.

¹ Source: CEIC Data, Haver Analytics, UBS estimates.

² Source: The World Bank.

Exhibit 1: A summary of different classes of Chinese shares

	A-share	B-share	H-share	Red chips	P chips	ADR
Definition	A-shares are incorporated in China, listed in domestic stock market, and open to foreign investors via QFII/RQFII and Stock Connect schemes	B-shares are incorporated in China, listed in domestic stock market, and open to foreign investors	H-shares are incorporated in China and trade in Hong Kong and other foreign exchanges	Red chips are incorporated outside of China, trade in Hong Kong, and are usually controlled by or affiliated with the Chinese government	P chips are incorporated outside of China, trade in Hong Kong, and are owned by private sectors in China	Primarily Chinese internet companies traded in US
Listed exchange	Shanghai and Shenzhen stock exchanges	Shanghai and Shenzhen stock exchanges	Hong Kong	Hong Kong	Hong Kong	Primarily in US (NYSE and Nasdaq), also traded in EU (Berlin, Frankfurt, etc), Singapore, etc.
Quoted currency	RMB	USD in Shanghai and HKD in Shenzhen	HKD	HKD	HKD	USD
Quota requirement	QFII/RQFII: no daily quota requirement; overall quota is subject to the rules set by the SAFE Stock Connect: daily quota of Rmb13bn for each of Shanghai and Shenzhen Connect	No quota requirement	No quota requirement	No quota requirement	No quota requirement	No quota requirement
Maximum holding limit	A foreign investor's shareholding in a company (regardless of the channels) is <=10% of the company's total issued shares; and total foreign investors' holdings in the A-shares is <=30% of the total issued shares	No restriction	No restriction	No restriction	No restriction	No restriction
Price movement limit	10% daily price movement limit	10% daily price movement limit	No limit	No limit	No limit	No limit

The daily quota for trading under Hong Kong-Shenzhen connect refers to the maximum net buy value of daily cross-boundary trades of RMB 13 billion. The maximum holding limit for a single foreign investor is not allowed to exceed 10% of the company's total issued shares, while all foreign investors' shareholding in the A shares of a listed company is not allowed to exceed 30% of its total issued shares. Price movement limit refers to the daily stock price movement of 10% imposed in the China domestic market. Source: UBS Asset Management, Hong Kong Exchanges and Clearing Ltd., FAQ, November 25, 2016.

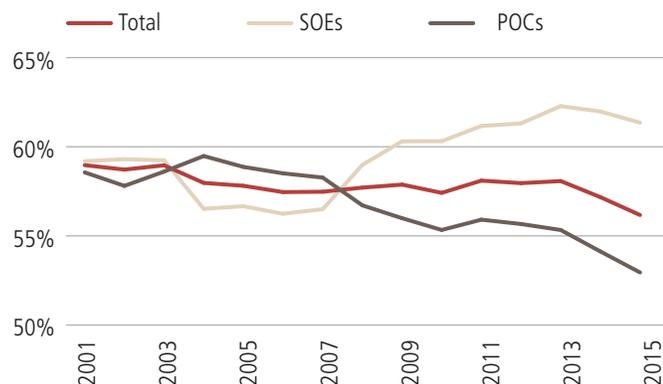
A-shares are listed domestically on the Shanghai and Shenzhen stock exchanges. B-shares are listed on the domestic stock exchanges and also are open to foreign investors. H-shares are traded on the Hong Kong exchange. Red Chips are Chinese companies incorporated in Hong Kong or offshore locations like the Cayman Islands, and are usually controlled by or affiliated with the Chinese government. P-chips are privately owned companies (POCs) listed in Hong Kong. ADRs are Chinese companies available in the US on NASDAQ or NYSE exchanges.

Currently, the Chinese equity market is dominated by SOCs, but their level is steadily dropping, while POCs are expanding. POCs dominate in the new economy of consumer-driven sectors, including services, healthcare and education, where earnings growth has outpaced the developed markets. The private sector is poised for growth (see exhibit 2). Small cap Chinese equities in particular trade at very attractive valuations. While we expect volatility in Chinese equities to remain high, if you have a long-term horizon, we expect competitive returns.

Global investors gained much broader access to Chinese stock markets through the 2014 launch of the stock connect program between Shanghai and Hong Kong, which allows investors in either market to trade shares on the other market. Recently, the Shenzhen-Hong Kong stock connect opened China's second

Exhibit 2: Private companies have healthier corporate balance sheets

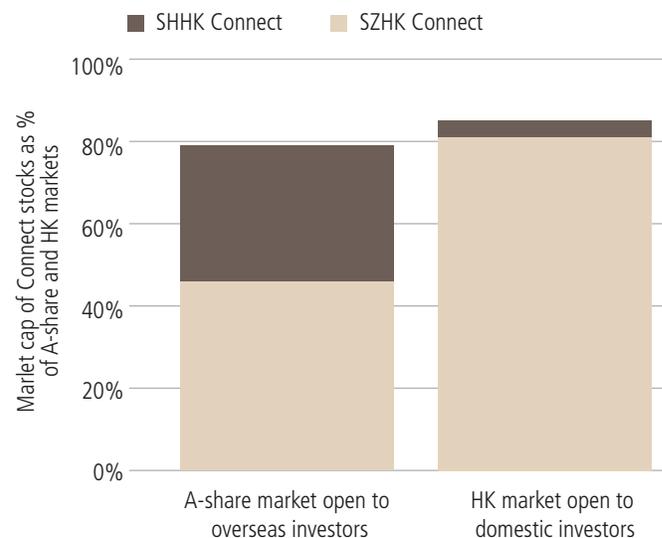
Debt to asset ratio for industrial enterprises



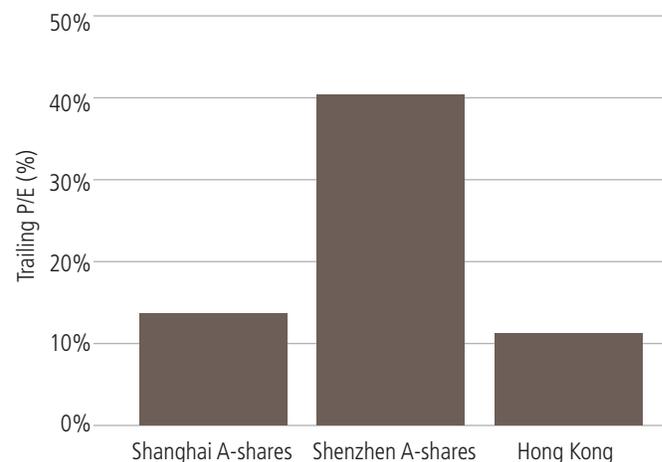
Source: NBS, Morgan Stanley Research, as of June 2016. Service sector excludes infrastructure and real estate related services.

Exhibit 3: SZ-HK stock connect—further opens up the market

a. *With Shenzhen (SZ) and Shanghai (SH) connects, China opens up about 80% of its total market cap to global investors*



b. *For mainland investors, HK offers small/mid cap stocks at more attractive valuations*



Source: Wind, Bloomberg Finance LP, UBS estimates as of August 25, 2016.

largest stock exchange to the Hong Kong exchange, making about 80 percent of China's market capitalization available to global investors, including many attractive POCs, A and H shares that will be essentially integrated, as shown in exhibit 3. The daily quota is RMB 10.5 billion (USD 1.5 billion), the same as for the Shanghai stock connect.

Today, we believe the market does not recognize the long-term significance of Shenzhen-Hong Kong Stock Connect in terms of capital market and capital account liberalization for Chinese equities. One example of the importance of these connections to the market is that, in Hong Kong, small caps are trading at a discount to blue chips. In the Asia market, small and mid caps tend to trade at a significant premium to blue chips. Once the market is more integrated, this will probably converge to some degree.

New-economy companies are underappreciated

One of the clear signs of structural change in the Chinese economy can be seen in the differing growth rates of its primary, secondary and tertiary industries. Its primary industry, which involves the extraction and collection of natural resources, and its secondary industry, which involves industry and construction, are both slowing significantly.

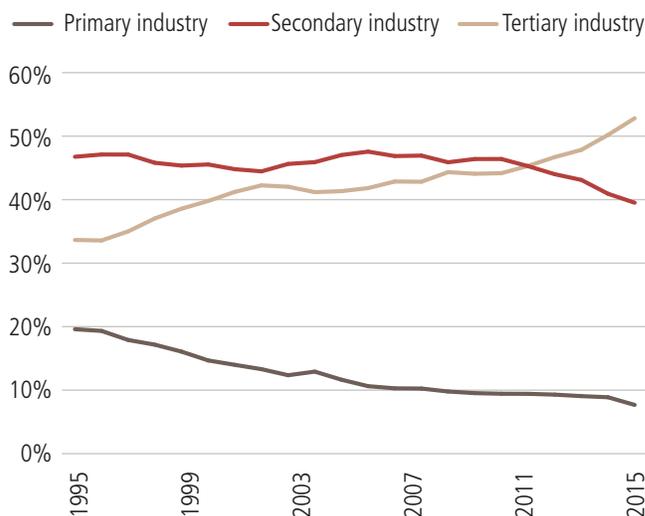
Its tertiary industry, which involves many consumer and service sectors such as transport, storage and post, wholesale and retail trade, hotels and catering, financial intermediation, real estate, and others, is growing. In 2011, the tertiary industry surpassed the secondary industry to make up the largest share of GDP, a trend that has continued through today, with tertiary industry estimated to contribute approximately 54 percent of GDP to around 38 percent for secondary industry and 8 percent for primary as of June 2016 (see exhibit 4). Tertiary industry also has the highest year-over-year growth rate.

We believe this shift is a clear indication that the Chinese economy is becoming more balanced and more service- and consumption-driven.

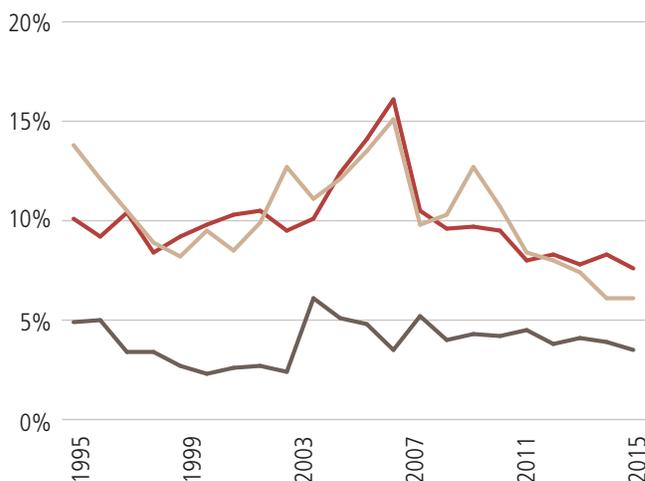
In the past two years, the MSCI China benchmark has increased the weight of ADRs representing new economy segments such as IT and healthcare sectors, especially in two large jumps at the end of 2015. ADRs have been in existence for a long time, but were not included in the benchmark until more recently (see exhibit 5).

Exhibit 4: Tertiary industry is now the largest component of China's GDP and is growing

a. Share of GDP (%)

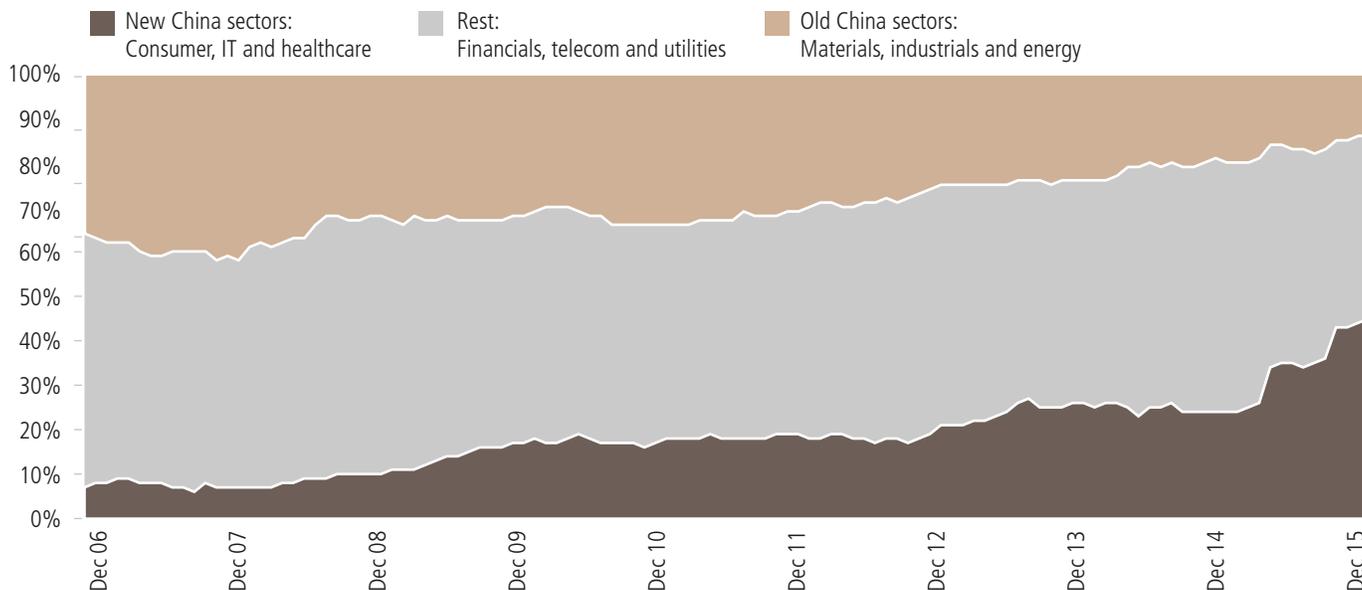


b. YOY growth



Source: FactSet, UBS Asset Management. Data as of June 2016.
 Note: Primary industry involves the extraction and collection of natural resources. Secondary industry refers to industry and construction. Tertiary industry refers to transport, storage and post; wholesale and retail trade; hotels and catering services; financial intermediation; real estate and others.

Exhibit 5: Benchmarks are boosting 'new economy' sector inclusion, but not fast enough



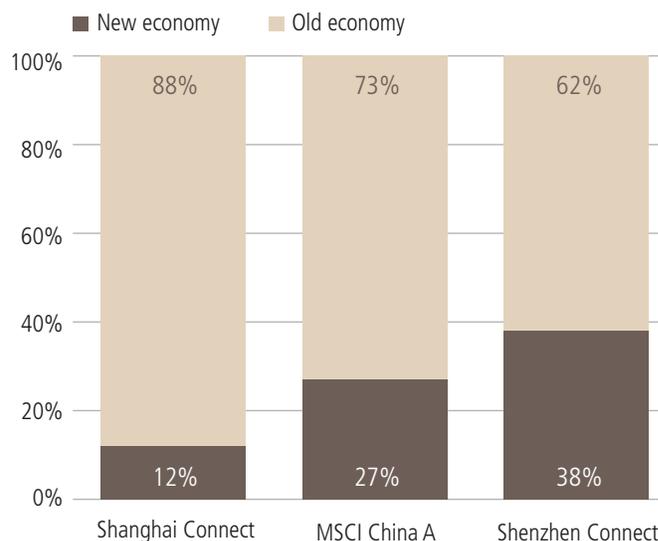
Source: MSCI, Morgan Stanley Research as of September 7, 2016. Using MSCI China Free Float-weighted average.

But we believe China equity benchmarks generally tend to be behind the curve and backward-looking when it comes to changing sector weights, which will put index investors at a disadvantage. We believe the SOE sector is still too high and we expect benchmarks to further increase the weighting of new-economy sectors in the future. Investors that position themselves in advance of benchmark weight changes can benefit.

Although Shanghai Connect increased the availability of new-economy equities to global investors, Shenzhen brings far more new-economy companies to the global market (see exhibit 6). We believe the MSCI China A benchmark underweights these equities.

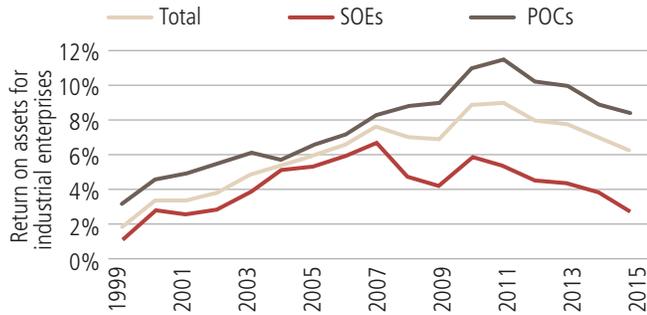
The overweighting of old-economy companies in Chinese equity market benchmark indices magnifies China’s debt problem and leads investors to believe there is a debt crisis. Corporate debt issuance is concentrated in the old economy, frequently SOEs. POCs tend to be focused on the new economy and have healthier debt-to-asset ratios and tend to be more profitable (see exhibit 7).

Exhibit 6: Proportion of old versus new economy sectors



Source: MSCI, Wind, UBS quantitative research. Note: Data as of end of September 2016 closing.

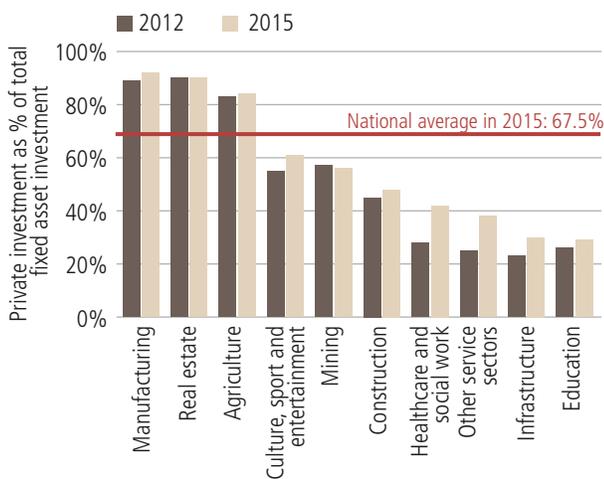
Exhibit 7: Old-economy companies are holding back Chinese equity markets



Source: NBS, Morgan Stanley Research as of June 2016. Service sector excluding infrastructure and real estate related services.

We believe that the SOE sectors are still too big a part of China's economy and will continue to shrink, improving overall economic efficiency. As seen in exhibit 8, POC involvement is still low, with room to grow, especially in sectors such as education and healthcare. Overall, the services-sector penetration is very low. Even in a slowing economy, some of these services sectors should continue to do well and may well track the historic trajectory of developed market countries.

Exhibit 8: Increasing private participation in most service sectors to drive growth

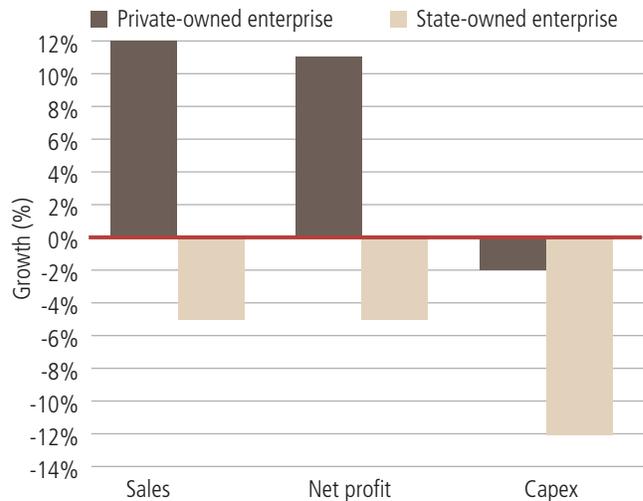


Source: UN, IMF, Morgan Stanley Research as of 2015.

One sign that the Chinese economy is reforming is to compare contributions from the private sector to those of the public sector.

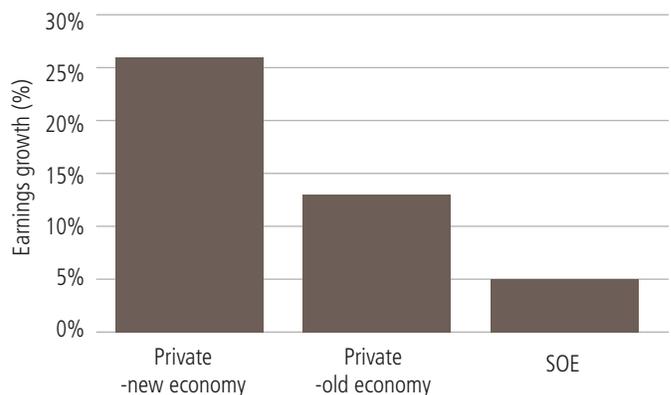
By just about every measure, POCs have done far better than SOEs in recent years. If you look at future growth indicators such as sales growth and cap-ex spending, POCs look much better than SOEs (see exhibit 9). Earnings growth has been much stronger for POCs than SOEs over the last five years, and we expect this trend to continue (see exhibit 10).

Exhibit 9: Private vs. State, ex financials-2015



Source: FactSet, Macquarie Research as of May 2016.

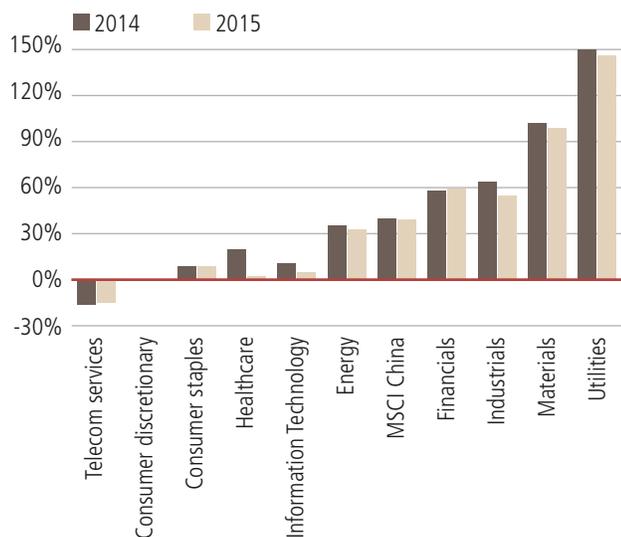
Exhibit 10: Private new economy vs. old economy vs. SOE-Earnings CAG 2010-2015



Source: FactSet, Macquarie Research as of May 2016.

We believe that when it comes to making an investment in Chinese equities, investors should not avoid the country because the macro economy is slowing. Investors who can identify the right sectors and companies can do very well despite the slowing economy.

Exhibit 11: Leverage in new economy sectors is low



Source: Bloomberg Finance LP, HSBC, Data as of December 2015.
 Note: Financial sector only includes properties; Industrial sector excludes CITIC (267 HK).

EM equities have underperformed the developed markets over last four to five years, leading to outflows, yet recently we have been seeing significant inflows again.³ We believe this is not just a one-time event. We think the lower interest rate environment in the US will drive investors to look for sources of better long-term returns, even though EM equities are generally more volatile than developed market equities.

In terms of valuation, Chinese equities are among the lowest in the region and globally, and we have a positive outlook for Chinese equities for the next few years.

China requires a different perspective

While China’s growth rate has fallen from the highs of the early 2000s, at 6.5 percent to 7 percent it is still one of the fastest growing economies in the world. As its economy continues to shift from a government-led fixed asset investment economy to a more services-led economy, we expect the quality of growth, the efficiency of the economy and, consequently, cash flows and profitability to improve.

China is also in the process of significant structural change. GDP growth will slow, but the growth model is changing too. China is moving towards a sustainable, balanced economy and should still hit its 2016 growth target of 6.5 percent. Concerns are beginning to recede after the surprise currency devaluation in 2015. We believe investors have also realized that China’s foreign reserves are strong enough to cope with outflows.

With government bond yields in the majority of developed markets falling to record lows – and in some cases, negative territory – investors, who traditionally allocate a significant part of their portfolio to fixed income, are facing a challenging environment. Many are seeking alternative sources of return.

We think Chinese equities will benefit from an increased allocation to emerging markets equities, particularly as valuation multiples are among the lowest globally.

We believe the market still does not recognize the long-term significance of agreements to open China’s domestic stock exchanges to the global market. The recent Shenzhen-Hong Kong Stock Connect is important in that it opens many new-economy private companies to global investors. It is big in terms of capital market and capital account liberalization for Chinese equities.

The keys to success in the Chinese equity market

- Do not let benchmark weightings drive investment decisions. We believe Chinese market indices are behind the curve in recognizing the growing importance of private enterprise. Focus instead on identifying long-term winners early in the business cycle.
- Don’t rely too much on sell-side research. Proprietary research by analysts with deep understanding and a presence in the market is crucial.
- Take a long-term view. Look for a dominant player (or players) in key industries. Companies that can adapt to change will benefit from long-term trends, such as structural changes and economic reforms, that can last 10 to 15 years, maybe even longer.

³ Source: EPFR Global, Equity Fund Flows Database, Morgan Stanley Research. Data as of September 7, 2016.

UBS Asset Management is a seasoned investor in China

UBS Asset Management has been investing in China since 1997. Over the years, we have developed extensive local expertise.

In May 2003, UBS AG was the first foreign investor to be awarded the Qualified Foreign Institutional Investor (QFII) status with the largest quota. In 2005, UBS SDIC Fund Management Co. Ltd was the first Sino-foreign fund management joint venture in which the foreign stake reached the 49 percent upper limit. UBS Securities, incorporated in 2006, was the first and only fully licensed securities company managed by an international financial group.

UBS Asset Management (China), 100 percent owned by UBS, was set up in 2011 to provide all non-securities and alternative investment management and advisory services. UBS Asset Management (Hong Kong) obtained a Renminbi Qualified Foreign Institutional Investor (RQFII) license in 2013 and today has a significant quota. UBS Asset Management (Shanghai) was officially set up on August 19, 2015 as part of the Shanghai Qualified Domestic Limited Partner (QDLP) scheme, serving domestic investors who invest offshore.

2015	UBS Asset Management (Shanghai) Ltd is established and obtains QLDP license. UBS (China) Ltd obtains RQFII license.
2014	UBS Futures Co. Ltd is established.
2013	UBS Asset Management (Hong Kong) Ltd obtains RQFII license
2012	UBS (China) Ltd , a wholly owned subsidiary, is set up.
2011	UBS Asset Management (China) Ltd is a 100% wholly foreign-owned enterprise (WFOE)
2010	UBS SDIC Fund Management Co., Ltd obtains the QDII fund.
2008	UBS/Gemdale Investment Management Ltd is a 50:50 joint venture with Gemdale, one of the largest listed real estate developers in China.
2006	UBS Securities is the first and only fully licensed securities company managed by an international financial group (incorporated December 2006). UBS Asset Management (Singapore) Ltd obtains QFII license.
2005	UBS SDIC Fund Management Co., Ltd is the first Sino-foreign fund management joint venture in which the foreign stake reached the 49% upper limit.
2003	UBS AG obtains the first QFII license and has one of the largest QFII quota.
1998	UBS Asset Management (Hong Kong) Ltd begins China offshore institutional mandate business.

Source: UBS Asset Management.

Disclosure

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