



China's A-Share Market: More Investable than Skeptics Might Think

China's domestic A-share stock market grabbed global headlines in 2015 with its roller-coaster performance and frequent government intervention. "China's stock markets have given investors a stomach-churning ride," commented the Financial Times at the time.¹ More than two years later, such impressions still linger but China's A-share market has grown too large for investors to ignore. With US\$8.5 trillion in market capitalization and more than 3,400 listed companies,² China's A-share market is the second-largest stock market in the world, behind only the U.S. market.³ In recognition of this, index provider MSCI recently decided to allow 222 of China's large-capitalization domestic A-share stocks to be gradually included into its Emerging Market Index, starting in mid-2018. The inclusion of the A-share market is set to alter portfolio allocation strategies.

During conversations with investors, we often have found that their hesitation to invest in A-share companies stemmed from a perception of poor corporate governance. Is the A-share market really a jungle too difficult for investors to navigate? We would argue that it isn't; however, investing in A-shares has its pitfalls. State-owned enterprises (SOEs), for example, accounted for over 60% of the CSI 300 Index weight and about 80% of total revenue in 2016.⁴ (China's domestic CSI 300 Index tracks the largest A-share companies in Shanghai and Shenzhen.) SOEs historically have been poor capital allocators and SOE managers have been prone to putting government directives ahead of shareholder interests. This means a passive approach to investing in A-shares could lead to excessive exposure to SOEs in portfolios. Also, investor concerns remain about the possibility of poor disclosure and accounting standards among companies in the A-share market. Furthermore, retail investors tend to dominate the trading in the market, often leading to higher levels of volatility.

Seeing Investment Opportunities

Nevertheless, we believe China's domestic A-share market provides attractive investment opportunities. It is important to recognize that the breadth and depth in the A-share market are much greater than those offered by offshore Chinese equities. Over 200 health care companies with a market-cap value of US\$100 million or more are listed in the A-share market, for instance, while only about 80 companies are listed in offshore markets.⁵ Also, leading producers of Chinese distilled liquor—a market with sales of US\$115 billion in 2015—are listed only in the A-share market.⁶

Overall, the A-share market opens more opportunities for global investors to take part in China's dynamic economy that is taking shape as the country shifts away from exports and manufacturing and more toward innovation, consumer consumption and services. Non-domestic access to A-share stocks also has been improving. China's regulators further opened the country's capital markets by creating "Stock Connect," a trading link that connects the Shanghai and Shenzhen stock exchanges to the Hong Kong Stock Exchange, enabling foreign investors to buy A-shares with fewer restrictions.

Next, we will explore the reasons we believe the A-share market has become more investable, including improved corporate governance and better disclosures, the ability of companies to create value for investors, company discipline around capital allocation and the fading role of state ownership in certain sectors.

Disclosures Point to Better Governance

Fair and relevant disclosure of financial and operational information is an important component of good corporate governance. A-share companies are outdoing Chinese companies listed in offshore markets in areas such as comprehensive disclosure requirements and stricter regulation on potential conflicts of interest (see table on page 2). In addition, executive compensation and company ownership changes are required to be disclosed regularly for China A-share companies but not for those listed in Hong Kong.



“We believe good corporate governance practices are critical to delivering long-term, risk-adjusted shareholder value.”

COMPARISON OF A-SHARES VS. HONG KONG COUNTERPARTS

	A-Shares	Hong Kong-listed Shares
Reporting Period	Required Quarterly	Required Semiannually
Financial Statements	Consolidated and Parent-Company Level Statements Required	Only Consolidated Statements Required
Cash Flow Statements	Quarterly reporting required	Available once per year in annual reports

Source: Matthews Asia

Compared to other Asian markets, the post-vetting of company announcements by stock exchanges is more comprehensive among A-shares. Disclosures by A-share companies are regulated by both the Chinese Security Regulatory Committee and the Shanghai and Shenzhen stock exchanges.⁷ The multi-layer regulatory regime means additional scrutiny. A-share stock exchanges review periodic and ad hoc company announcements and issue official inquiries publicly if they discover irregularities. They may request further disclosures from the companies and failure to provide a reasonable response can lead to disciplinary actions. Such inquiries aim to reduce information asymmetry and protect public shareholders.

Creating Value for Investors

We consider companies that generate returns for investors that exceed their cost of capital as “value creators.” Our research indicates that only about 30% of A-share

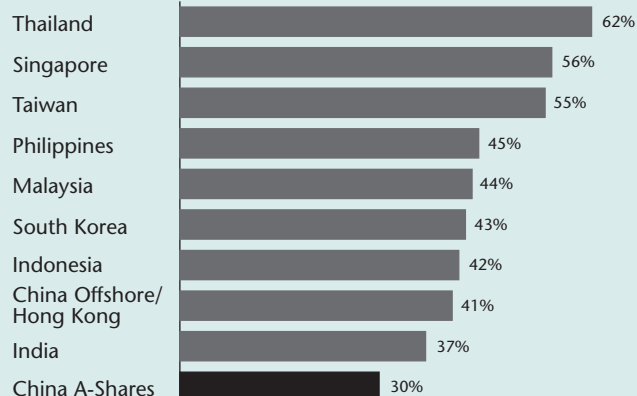
non-financial companies were value creators over the past five years. A 30% figure might sound low, but let’s put that number into context. The A-share market provides much greater depth and width with more than 3,000 non-financial companies that have a market value above US\$100 million,⁸ more than double the number of Chinese companies listed offshore. Around 30% of this universe translates into 971 non-financial companies that create economic value, more than the total number of value creators in Taiwan and South Korea combined in our analysis of 10,044 non-financial companies in the region.

Focusing on Capital Allocation Discipline

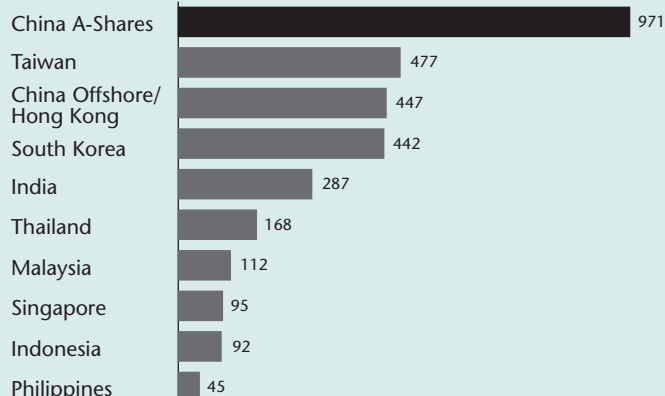
When researching A-share companies, we pay special attention to a company’s discipline in capital allocation. During China’s fast-growing decades, Chinese corporations focused on allocating capital to create growth in many industries, resulting in overcapacity in some cases and erosion of shareholder returns. In recent years, we have observed an encouraging improvement in Chinese leadership’s attitude toward capital allocation. It is no longer about more capital, but about ensuring that capital goes to the right places. The government encourages banks to lend to private enterprises, offers companies incentives to pay out higher dividends and incorporates environmental metrics when evaluating the performance of government officials. Such top-down governance changes are reflected in better capital allocation by listed companies. One measure of capital allocation discipline is capital expenditure in excess of depreciation. A rising surplus usually means accelerating capacity expansion, while a falling surplus usually means moderating capacity

VALUE CREATORS BY PERCENTAGE AND BY NUMBER OF COMPANIES

Value Creators, by Percentage of Total



Value Creators, by Number of Companies



Value creator is defined as a company whose 5-year average ROIC is higher than its cost of capital.⁹ Only non-financial companies are included in the calculations. Source: Calculations by Matthews Asia using data sourced from FactSet Research Systems; Wind Information Data as of September 7, 2017

“Active investment strategies have the advantage of selecting investments among a higher percentage of non-SOE companies.”

growth. Our recent analysis of 495 A-share companies in the materials sector indicated that state-owned companies and non-state-owned companies both have cut back on the speed of their expansion since 2012.

The materials sector is not an anomaly. We observed similar results in some consumer staples businesses where excessive supply exists. A few A-share listed breweries have begun closing down some small production facilities and cutting idle capacity in order to improve operating efficiency. As a result, the value of their fixed assets—property, plant and equipment—declined for three straight years. Among state-controlled companies, we are seeing instances where companies dispose of noncore assets to focus on their core businesses.

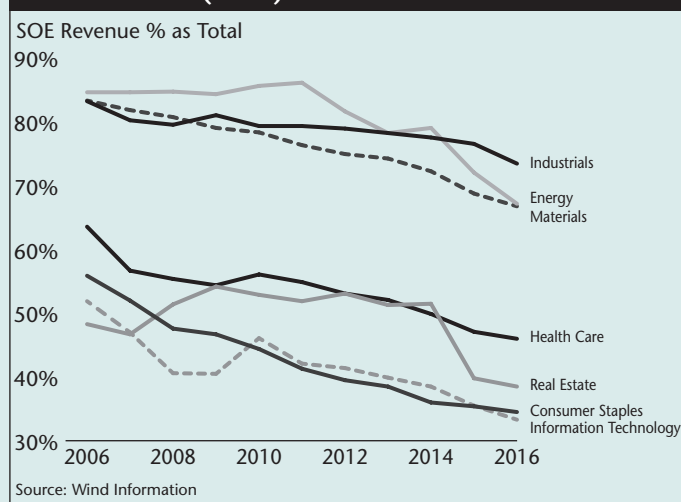
Scrutinizing A-Shares from the Bottom Up

Understanding the nuances of the state’s ownership in A-shares and individual companies is a critical aspect of our research process. SOEs clearly play an important role in the Chinese economy, but not all SOEs are created equal when it comes to corporate governance. The Chinese government requires that SOEs comply with different evaluation criteria depending on the types of businesses. Only the SOEs in a fully competitive industry are evaluated based on economic value creation and return on assets. For the SOEs in the industries critical to national security and social welfare, serving the national interest and public service are the top priorities. The weight placed on economic value creation and profitability in evaluating such companies is lower.

State ownership varies by sector in the A-share market. By sector, we find high SOE revenue representation in energy, materials, telecommunications, utilities and industrials and low representation in technology, consumer and health care. SOEs, for example, accounted for only 36% of companies and 34% of revenues among A-share-listed consumer staples companies in 2016.¹⁰ As the Chinese economy becomes more service-oriented, these sectors provide many potential investment opportunities.

It is important to note that active investment strategies have the advantage of selecting investments among a higher percentage of non-SOE companies. SOEs, due to their large sizes, have a much higher representation in the CSI 300 Index. SOEs accounted for 80% of revenues from the index constituents in 2016.¹¹ In addition, the revenue share from SOEs has declined over time for most sectors in the A-share market. SOEs in the health care sector, for instance, contributed 46% of the sector’s total revenue in 2016, down from 64% in 2006.¹² Similar trends in a number of sectors reflect the market-share gains of companies without state ownership and China’s shift to its consumption and service-oriented economy.

REVENUE SHARE FROM STATE-OWNED ENTERPRISES (SOEs) DECLINED IN MOST SECTORS



Taking a Deeper Look

With a better understanding of the A-share market, a long-term strategic view and a disciplined company due diligence process, investors can find opportunities in the A-share market. At Matthews Asia, we apply our tested framework of corporate governance to carefully evaluate a company on many metrics under interest alignment, checks and balances and transparency. Good corporate governance practices are not absolute requirements for short-term stock performance, but we believe they are critical to delivering long-term, risk-adjusted shareholder value.

Our focus has been on taking a fundamental approach to finding leading A-share companies that are poised to benefit from the country’s structural shift toward its domestic economy, looking beyond the indexes and the headlines. We are encouraged by the trend of China’s market liberalization efforts and reform measures. As China’s A-share market evolves to become increasingly driven by company fundamentals, we believe Matthews Asia’s long-term, bottom-up investment approach is well-poised to tap into compelling investment opportunities.

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¹ “Q&A: China’s market tumult,” July 17, 2015, Financial Times

² Source: Wind Information, September 2017

^{3,4} Source: Wind Information

⁵ Source: Bloomberg, August 2017

⁶ “1,000-Year-Old Chinese Liquor Wants to Be the New Tequila”, October 5, 2016, Bloomberg

Source: “A Comparative Study of Continuing Disclosure in Hong Kong and the PRC,” September

⁷ 2008, Hong Kong Institute of Chartered Secretaries

⁸ Source: Bloomberg, August 2017

⁹ ROIC (Return on Invested Capital) is a calculation used to assess a company’s efficiency at allocating the capital under its control to profitable investments. The return on invested capital measure gives a sense of how well a company is using its money to generate returns.

^{10,11,12} Source: Wind Information



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Index Definitions

The MSCI Emerging Markets Index captures large and mid-cap representation across 23 Emerging Markets (EM) countries. With 833 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Indices are unmanaged and it is not possible to invest directly in an index.

CSI 300 Index is a capitalization-weighted stock market index designed to replicate the performance of 300 stocks traded in the Shanghai and Shenzhen stock exchanges. The index, compiled by the China Securities Index Company, Ltd., has been calculated since April 8, 2005.

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