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portfolio construction JOURNAL

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VOLUME THREE | ISSUE TWO | SUMMER 2006/07
5th ANNUAL PORTFOLIOCONSTRUCTION CONFERENCE EDITION

RESEARCH PAPER

PRODUCTS (TAKING STOCK)

Gugai and other important reforms in China

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Chinese authorities have embarked on Gugai, the Mandarin word for share reform. The aim is to address inefficiencies in the country's share markets, such as different share classes for foreign and domestic investors, restrictions on foreign investors, and non-tradable, government-owned majority share holdings in many listed companies. The authorities also want to improve the countries much-criticised banking system and relieve some of the social tensions and environmental pollution arising out of China's fast economic growth.

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China's economy has been the best performing major economy in the world for close to two decades, yet its share markets have fared poorly in comparison.[1] As a result, Chinese authorities have embarked on "Gugai", the Mandarin word for share reform. The aim is to address inefficiencies in the country's share markets, such as different share classes for foreign and domestic investors, restrictions on foreign investors, and non-tradable, government-owned majority share holdings in many listed companies.

As well as reforming China's share markets, the authorities want to improve the country's much-criticised banking system and relieve some of the social tensions and environmental pollution arising out of China's fast economic growth.

Banking is a troubled industry in China. Bad loans are rife due to unchecked lending to state companies and poor internal controls in the past. Repeated fraud investigations have undermined confidence. Most bank internal systems are antiquated and banking practices are often at odds with what many would consider sound practice (borrowing rates, for example, are generally not layered to account for risk.)

Social tensions are rising in China because large income disparities have emerged between urban and rural citizens, the health system is almost nonexistent so the poor are not properly covered, and there are little to no social security benefits to help those gaining least, if anything, from China's economic rise. There are also considerable mounting environmental problems.

Chinese authorities have given top priority to financial and social remedies. They recognise the country's share markets need reform so performance better reflects the country's impressive economic growth. Authorities acknowledge the banking system needs to tackle flaws that could destabilise the country's economy. They can see that social tensions must be eased to ensure social stability, and they are concerned that damage being done to the environment could threaten future economic growth.

Stock market reforms

China's share market reforms consist of two parts. The first is to encourage more foreign and private investors to buy Chinese shares by blurring the distinction between A- and B-shares, and by easing controls on foreign investors. Restrictions have been modified on foreigners dealing or owning A-shares (shares denominated in yuan that were originally only for domestic investors) while domestic investors have been allowed to buy B-shares (shares denominated in yuan but paid out in US or Hong Kong dollars that were exclusively for foreigners).

The government has eased some of the thresholds and restrictions that were previously in place for issuing Qualified Foreign Institutional Investor licences (more commonly known by the acronym QFII). For example, the asset size for insurance companies or fund managers to be eligible for these licenses has fallen to $US5 billion from $US10 billion. As well, these companies now only need an operating history of five years instead of 30. Furthermore, Qualified Domestic Institutional Investor licences (or QDIIs) have been created to allow domestic investors access to foreign markets. These investors will gradually be allowed to invest in Hong Kong and other markets.

The second aspect to China's share reforms – and where the term Gugai specifically applies – is the plans underway to reduce the level of non-tradable shares. In mid-2005, when authorities announced steps to solve the problem, about 65% of domestic Chinese shares were non-tradable.

The split between tradable and non-tradable shares is a result of the central government trying to maintain control of state-owned enterprises, even as it gave shares to worker collectives and other third parties that were traded over-the-counter before the Shanghai Stock Exchange reopened in 1991. While identical in terms of face-value and shareholder's rights, the dual structure created inefficiencies. Corporate governance was hampered because the board, shareholder and auditor committees were often controlled by the holders of non-tradable shares. Non-tradable shareholders did not benefit from a rise in the stock price, so they were often indifferent to creating shareholder value. Non-tradable majority stock holdings prevented the consolidation

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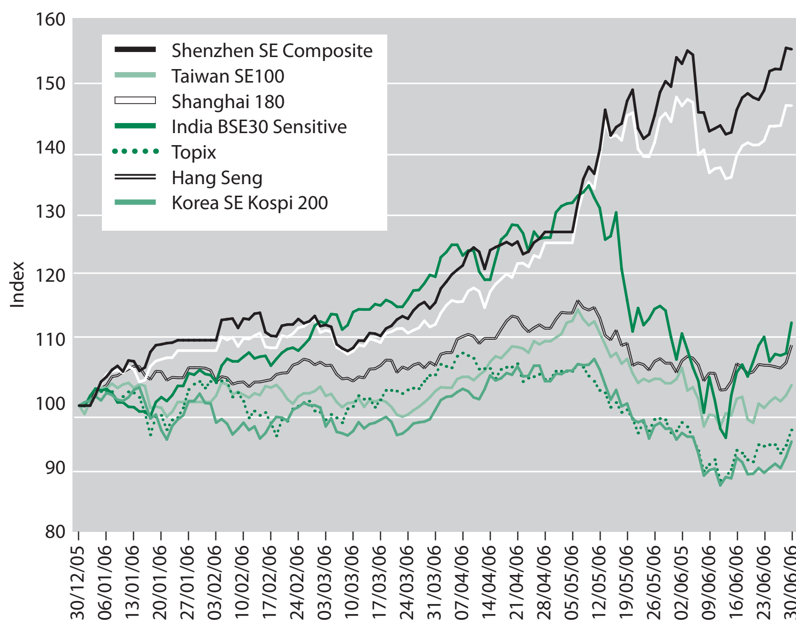
needed in some industries. Meanwhile, the price of tradable shares was seen as suppressed because of a concern that a future sale of non-tradable shares would flood the market with supply.

Figure 1: Asia's stock markets – Q1 and Q2 2006



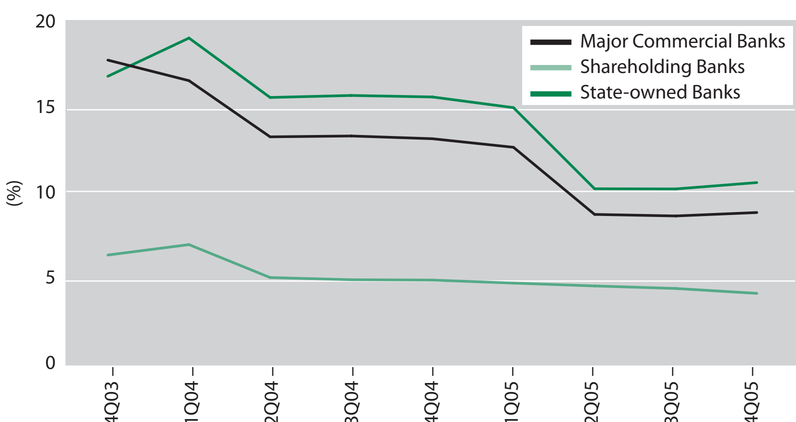
Notes: All indices in local currency terms *Source: Fidelity, Thomson Financial DataStream*

Figure 2: Causes of non-performing loans in China

%	CAUSES OF NON-PERFORMING LOANS
30%	Planning or administrative intervention.
30%	State-owned banks supporting state-owned enterprises as state policies dictate.
10%	Structural adjustment proposed by the state.
10%	Intervention by local governments that involved a lack of protection to creditors.
20%	Banks' internal management problems

Source: People's Bank of China 2001-2002 Survey

Figure 3: Non-performing load trend in China's banking sector



Source: Merrill Lynch

To address these inefficiencies, China's government announced plans in 2005 to sell its holdings in domestic companies through a new share class – G-shares – which can be traded alongside A- and B-shares. All listed companies on the mainland stock exchanges were encouraged to change the status of their large holdings of non-tradable shares so that they could be bought and sold. The reforms were to enable the government to cut stakes in many of the companies it controls. The process involved compensating minority shareholders, whose holdings would be automatically diluted, for example, by giving them three shares for every 10 they owned and segregating minority voting rights to ensure an independent voice. Timetables were arranged to avoid a sudden flood of equity to the market, and initial public offers were suspended for the better part of 12 months.

The government started selling its non-tradable holdings on 30 December 2005 and indices were created for G-shares on the Shenzhen and Shanghai Stock Exchanges. Since then, about 20 companies a week have issued G-shares which effectively reduced the government's holding to a non-blocking minority stake. At this pace, all companies should have completed their reform of non-tradable shares by end of 2006.

This transfer of shares from government to private ownership is expected to better align management with shareholder needs, making access to capital easier and Chinese markets more attractive to investors. It explains in part the improving sentiment surrounding the China market. As Figure 1 shows, the Chinese share markets were the best performing of the major Asian markets in the first half of 2006.

China's A- and B-share market underperformance

China has been a perfect example in recent years of how even a booming economy can do little for a country's stock market, as shown by how China's A- and B-share markets have struggled in recent years. From 1 January 2002 to 28 April 2006, the Shanghai Composite Index fell 12.5% in local-currency terms whereas the MSCI China Index gained 150.0% in absolute terms, for an annual rate of increase of 23.6%.[2]

The reason for the difference between the indices is that A- and B-share stocks only comprise a tiny portion of the stocks found in the MSCI China Index, often around just 1% of the index.[3] Most of the stocks found in the MSCI China Index are Hong Kong-listed Chinese companies (so-called H-shares, Red Chips and other Hong Kong-listed stocks). These are typically the larger, more liquid Chinese stocks that have performed strongly in recent years.

The major reason China-listed stocks have struggled even though the Chinese economy has thrived is tied to the fact that the majority of companies listed in Shanghai and Shenzhen are minority-tradable holdings, are poorly managed, and do not focus on shareholder returns. These companies are yet to convince investors they have robust corporate governance, and they are

under-researched. Therefore, they are yet to gain the confidence of investors. In addition, the fact that some have reported poor earnings and have low dividend yields has undermined performance.

The performance of the MSCI China Index in recent years highlights how China's largest and most well-researched stocks have posted higher earnings and gained investor confidence during a period when China's economy has been one of the world's best-performers.

The more interesting question regarding the A- and B-share markets may well be why these shares surged over the 10 or so months to 30 June 2006. Firstly, the reforms the government has introduced have been well accepted. Secondly, investors have gained more confidence in the sustainability of the earnings growth of Chinese companies, resulting in investors having more confidence to invest in smaller and Chinese-listed stocks. Lastly, China's economy is powering ahead and shows no signs of slowing to any marked degree. The economy grew 11.3% in the second quarter of 2006, its fastest expansion in 12 years.[4] The economic outlook is upbeat because the prospects for investment, consumption and exports are strong.

Banking reforms

Chinese authorities are motivated to reform the banking system because they are aware that the Asian financial crisis of 1997/98 highlighted how weak banking systems can destabilise economies. They also know that local banks will face stiff competition from foreign banks that can enter China from the end of 2006, a concession China agreed to when it signed onto the World Trade Organisation.

Beijing's banking reforms incorporate five broad themes.

Firstly, the government has tried to reduce the level of non-performing loans on the balance sheets of the Big Four banks which had the closest affiliations with state-owned enterprises.[5] Notably, the state has spent vast amounts over the past two years propping up several banks by injecting foreign-exchange assets and selling bad loans to asset management companies. Since then, many of the struggling banks have made significant gains in reducing their non-performing loan ratios, as shown in Figure 3.

Secondly, authorities created new regulatory bodies to improve supervision. The China Banking Regulatory Commission, for instance, has taken over bank supervision from the central People's Bank of China, to ensure that banks upgrade management and meet capital-adequacy requirements. Moreover, China has adopted international standards for loan classifications and has set up internal credit-rating systems in order to meet the requirements of the Basel II capital agreement. It has also implemented on-site and off-site auditing inspections to ensure risk controls are carried out regularly.

Thirdly, the government is encouraging banks to list on the stock exchange, in the belief that the demands placed on publicly-traded companies make them more efficient. The Bank of China, the third-largest state-owned lender, listed on the Hong Kong and Shanghai stock markets in mid-2006, the third state bank to do so.[6] The China Merchants Bank debuted on Hong Kong's stock market in late September 2006. The Industrial & Commercial Bank of China, the country's biggest lender, listed one month later in both Hong Kong and Shanghai.

Fourthly, the government has moved to improve internal bank management and external supervision. It has tried to achieve this by tackling fraud, implementing a performance-assessment-and-incentives system to improve the quality of staff, and by closing loss-making branches. Statistics show that the number of branches fell to 85,000 in 2003 from 142,000 in 1995, while the number of employees declined to 1.3 million in 2003 from almost 1.7 million in 1995.[7]

Finally, the government has pushed for banks to adopt a fee-based approach to business and to upgrade technology, particularly for small and medium-sized banks. A fee-based approach is seen as making banks less vulnerable to cyclical economic downturns.

Reforms aimed at easing social tension

Along with tackling problems found within the financial sector, Chinese authorities have recently taken steps to boost social stability and ease environmental pollution. At the annual meeting in 2006 of China's National People's Congress, which decides the direction of government policy, there was a shift in focus away from economic policies towards those that are likely to improve the lives of rural Chinese and narrow the income disparity between rural and urban citizens.

To ease social tensions, the government announced plans to implement a free, nine-year compulsory educational system for all rural children, build a nationwide rural healthcare system, and increase pension coverage for urban poor. Authorities also announced plans to boost investment in rural China to improve roads, power, water supplies and irrigation systems.

To limit environmental damage, the government said it will aim to reduce unit-energy consumption by 20% and pollution by 10% via technology upgrades. To achieve these targets, it said it will build wind-power projects, impose stringent environmental protection policies and stricter regulation on high-waste industries, and introduce energy-saving programmes for those enterprises with high energy use.

Conclusion

To date, China has implemented numerous reforms to address the many challenges in its financial system and capital markets, and to ease social tensions that arise from the country's rapid economic expansion. While no one is pretending that these changes will cure all the problems that need solving, they do appear to show how China's leaders are committed to ensuring a successful transition to a more market friendly environment.

Officials in China and China analysts appear optimistic that the share reforms will help the stock market's performance to better translate the economy's activity. They appear upbeat that the reforms will help bolster China's banking system, ease social tensions and reduce the environmental consequences of China's rapid industrialisation.

ENDNOTES

1. China has expanded at an average annual rate of about or above 9% a year since 1988. Source: International Monetary Fund, World Economic Outlook, April 2006. www.imf.org

2. DataStream.

3. The only B-share companies in the MSCI China Index on 30 April 2006 were China Intl. Marine B (0.45% of the index), Guangdong Elect. Pwr. Dev. B (0.2%) and Zhijiang Se Elec. Pwr. B (0.17%). There were no A-shares in the index on that date.

4. Bloomberg.

5. The Big Four banks are the Bank of China, the Construction Bank of China, the Industrial and Commercial Bank of China and the Agricultural Bank of China.

6. Bank of Communications Ltd, China's fifth biggest lender, and China Construction Bank, the country's third-largest lender, listed in 2005.

7. Merrill Lynch 2005.

ABOUT THE AUTHOR

Oliver Trusler is Senior Manager, Consultant and Research Relations with Fidelity International. He is a CFA charterholder and has over seven years experience with Fidelity. Oliver currently manages Fidelity's relationships with Australian consultants and research houses, and the management of the review process. He joined Fidelity in London in February 1999 as a Portfolio Analyst.

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