Issue N° 17
September 2015

Equity Solutions

EQUITY IN A NUTSHELL

LEVEL

A and H-Shares of China

Chinese equity market is not open for all investors and has multiple restrictions that limit investments from outside of China. Also, there are different types of shares — A, B, H and Red Chips — issued by Chinese enterprises for different sets of investors. Below we explain the difference between A and H-shares (constitutes major portion of Chinese stock market) along with the scope and evolution of such securities.

A-Shares

The shares of mainland China companies that are listed on either the Shanghai or the Shenzhen stock exchanges are called A-shares. These shares are governed by Chinese law (through China Securities Regulatory Commission, CSRC) and are only quoted in CNY. A-shares are mainly available for trading to Chinese citizens; however, limited foreign investment in these companies is also allowed through a regulated mechanism called the qualified foreign institutional investor (QFII) system which was introduced by China in 2002. Investments by international investors in A-shares are limited by a specified quota which determines the quantum of money a licensed foreign investor is permitted to invest in China's equity markets.

H-Shares

The shares of Chinese companies that are listed on the Hong Kong Stock Exchange (HKSE) are termed as H-shares. These are issued by Chinese enterprises as per Chinese regulations but comply with the HKSE's listing requirements. H-shares are quoted and traded in HKD. These shares are open for trading by all investors, including international investors, and are not limited to Chinese investors and QFII.

History

In December 1978, Deng Xiaoping, Chinese revolutionary and statesman, announced China's Open Door Policy to allow setting up of foreign businesses in China and Chinese businesses outside China. Following which, HKSE began a project in 1991 to get Chinese companies listed in Hong Kong with the help of CSRC and other stakeholders. On 17 June 1993, HKSE announced amendments to the rules of listing Chinese enterprises in Hong Kong. Memorandum of understanding on Sino-Hong Kong regulatory cooperation was signed on 19 June 1993, which opened the door for the listing of mainland companies in Hong Kong.

Nine state enterprises were approved to list in Hong Kong on 6 October 1992. Tsingtao Brewery was the first company to get listed on HKSE and started its trading on 15 July 1993. The second lot of 22 companies was announced on 27 January 1994. Once the policies were in place more such companies started applying for listing in Hong Kong and the selection process became market driven.

Reverse benefits for Mainland Companies and the Hong Kong Stock Market

Listing on the Hong Kong market allows mainland companies to raise capital in an open market . Chinese companies can take advantage of higher liquidity in the Hong Kong market, which has better-regulated risk management and a wide range of investment products. Market dynamics in Hong Kong pushed for in-depth corporate reforms which in turn strengthened the corporate governance of Chinese companies. All stakeholders along with financial analysts of large financial institutions pushed for strong management, higher operating efficiency, transparency and better financial reporting. Hong Kong listing improved the market position of mainland companies globally and boosted investor confidence in terms of monetary protection. This resulted in attracting international strategic investors towards Chinese companies.

Listing of Chinese companies in Hong Kong increased the depth of the Hong Kong securities market, making it more attractive to global investors. From being a stock market predominantly for property and finance companies, HKSE evolved with diversification across securities and other financial products. Listing in Hong Kong resulted in the convergence of international financial institutions and professionals in Hong Kong to track these companies closely.

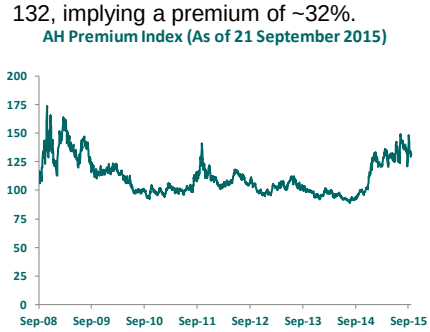
Market Statistics

Chinese companies have come a long way in last 21 years; from just six companies with H-shares at the end of 1993, there are 212 companies with shares listed on HKSE (as of July).

Market capitalisation of H-shares listed in Hong Kong has risen from HKD 18 bn (USD 2.3 bn) at the end of 1993 to HKD 5.7 trn (USD 735 bn) at the end of July, which is ~2.5x of Hong Kong's GDP.

What are the differences between A and H-shares price ?

Chinese companies that trade in both China and Hong Kong have a huge price difference. Due to an imbalance between supply and demand of domestic shares, A-shares generally trade at a premium over H-share. Growing demand from domestic retail investors driven by rising investible income lead to premium pricing. Premium gets pushed further due to high restrictions and regulations in the Chinese stock market. Hang Seng China AH Premium Index was launched in 2007 to track the price gap between A-shares and H-shares for the companies listed in both China and Hong Kong. This index measures the weighted average premium (or discount) of A-share prices to H-share prices of its constituents (58 as of June). If the index is trading at less than 100, it implies that A-shares are trading at a discount to H-shares, while if the index is trading at more than 100, it means A-shares are trading at a premium to H-shares. As of 21 September, the index was trading at 132, implying a premium of ~32%.



Source: Bloomberg

Shanghai and Hong Kong Bourse Connect Link

To promote further investments and provide stock market access across mainland China and Hong Kong, Shanghai–Hong Kong Stock Connect programme was launched on 17 November 2014. The link allows all Hong Kong and international investors to trade in eligible shares listed in Shanghai Stock Exchange, while only institutional investors and individual investors having CNY 500,000 in investment and cash in China are allowed to trade in Hong Kong-listed shares. Through this link, eligible investors can purchase shares via their local brokers.

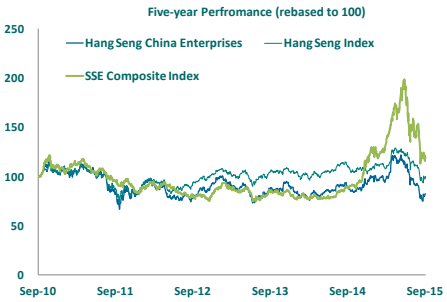
Currently only A-shares are part of this connect link. Hong Kong investors are allowed to trade in all constituent stocks of the Shanghai 180 Index and Shanghai 380 Index, and all the Shanghai listed A-shares that are not part of these indices but have corresponding H-shares listed in Hong Kong. On the other hand, investors from China are allowed to trade in the constituent stocks of the Hang Seng Composite Large Cap Index and Hang Seng Composite Mid Cap Index, and all H-shares that are not part of these indices but have corresponding A-shares listed in Shanghai.

The connect programme is a first of its kind that is controllable and expandable in nature. Trading through this link is subject to separate sets of aggregate and daily quotas. The northbound (Hong Kong and foreign investors trading in Shanghai stocks) aggregate quotas is set at CNY 300 bn, while the southbound (mainland investors trading in Hong Kong stocks) aggregate is set at CNY 250 bn. The quota is calculated on a netting basis at the end of each trading day. The daily quota limits the maximum net buy value of cross-boundary trades. The northbound daily quota is set at CNY 13 bn, while the southbound daily quota is set at CNY 10.5 bn.

Current Market Situation for A and H-Shares

Globally, everyone is arguing that China's policy-propelled bull market has become increasingly volatile. The Shanghai Composite Index ran up more than 130% between second week of August 2014 and second week of June 2015, but since peaking at 5,166.00 on 12 June, the benchmark has slipped ~38% as of 21 September. China's bull run was fuelled by investors leveraging heavily to buy shares and using margin financing to the most that surged nearly fivefold in the past year to ~CNY 2 trn (USD 323 bn). The correction was triggered by a wave of margin calls and deleveraging. The volatility in Chinese stock was also driven by PBoC's increasing attempts to propel mainland stock markets at all costs. The Chinese government has cut benchmark interest rates, suspended initial public offerings of stocks to curb a potential overflow of new shares, slashed trading fees in mainland stock markets and most recently depreciated its currency to boost exports.

Amid all these events, China's H-shares are also down, but less than the Shanghai market's A-shares. Hang Seng China Enterprises Index (which tracks H-shares) lost ~28% during the same period (12 June to 21 September) compared with the ~38% loss of the Shanghai Composite Index. Despite a relatively lesser fall in the Hong Kong market, in terms of valuation, the Hang Seng China Enterprises Index is trading at a current P/E of ~7x compared with ~15x of the Shanghai Composite Index.



Source: FactSet

Conclusion

Investing in A-shares is limited for global investors. However, Chinese stock markets are becoming increasingly accessible to foreign investors through various means: via H-shares, using QFII quota, and now through the bourse link.

Inexpensive valuation, availability to all types of investors and quality governance are key features of H-shares. Also, with bourse link fully operational, inflow of funds towards Hong Kong from mainland should gather pace and create more demand for H-shares.