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Observations on Chinese Equities

Over the past several years, China's onshore equity market went from being essentially closed to foreigners to now representing one of the largest equity markets available to global investors. With the opening of this market, investors can now build a diversified exposure to corporate cash flows in the second-largest economy in the world. In these *Observations*, we provide observations on Chinese equities and address some of the biggest questions we hear from institutional investors on the topic.

Why has Chinese equity performance been so weak in recent years, amid a global equity rally and strong growth in China?

Markets discount future conditions and react to changes. Classically, markets tend to price in a continuation of the recent past, extrapolating recent conditions forward. A decade ago, nominal growth in China was running at about 20% a year, and equity markets priced in such growth rates continuing indefinitely. As the Chinese economy shifted to more sustainable (though still very high) growth rates, discounted future growth rates declined, weighing on equity prices. This process looks much like what other equity markets experienced when significant shifts in growth rates took place.

Looking at the individual sectors in the economy, the shift in forward expectations is even more pronounced. As policy makers moved to rebalance the economy, old-economy sectors with high concentrations of state-owned enterprises (SOEs) contributed the most to weak performance as their future growth rates were repriced.

In recent years, Chinese EPS growth has been much weaker than profit growth as a result of significant share issuance and dilution. Should investors expect to accrue the gains of future profits in the companies they own?

The rapid pace of issuance and share dilution in China has actually been roughly in line with what has occurred in several historical cases when economies and capital markets underwent a rapid expansion. Looking at a range of equity markets over time, significant dilution during periods of strong profit growth as economies undergo growth spurts is more the norm than an exception. Motivated by high potential returns, existing and new firms raise capital and compete to capture the strong growth in the economy such that original investors in a company do not enjoy above-average rates of growth for sustained periods. We share our study across ~30 such cases.

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Give Feedback

How should investors think about Chinese equities' large concentration in state-owned enterprises (SOEs)? Given their significant underperformance in recent years, should one exclude them from one's portfolio?

State-owned enterprises (SOEs) comprise a meaningful part of many emerging market equity indices. Our study of a large number of SOEs across the world suggests that they often have slower earnings growth and higher cash flow volatility than similar private companies for a host of reasons (e.g., weaker corporate governance standards). As a result, they typically trade at a valuation discount to compensate investors, just as high-yield bonds offer a higher coupon than investment-grade credit. In other words, we believe that markets appropriately discount SOEs' expected cash flows based on what is known and react to changes in expectations. Over time and across countries, SOEs have historically been as likely to outperform their privately held peers as they have been likely to underperform. Of course, there are alpha opportunities for investors who correctly assess mispricings in the markets.

Coming out of the financial crisis, investors in Chinese stocks were pricing in overly optimistic earnings growth scenarios for SOEs. Their traditional valuation discount was eroded as SOE valuations were pushed up to about par with those of comparable private companies, and equity markets did not price in the coming rebalancing away from old-economy sectors, in which SOEs are concentrated. As SOEs' realized earnings came in weaker than expected, these expectations were revised down. After years of underperformance, Chinese SOEs now trade at a more typical discount to their privately held peers.

Should I invest in Chinese stocks onshore given the risks of capital controls, government intervention, share suspensions, etc.?

The onshore Chinese stock markets are developing rapidly and exhibit many of the challenges that are prevalent in markets undergoing similar expansion. When we look across a number of dimensions, the Chinese stock markets look within the range of typical emerging equity markets—worse in some measures (e.g., legal protection and foreign accessibility) and better in others (e.g., market capacity, political stability). Overall, Chinese financial markets are large, liquid, and increasingly accessible to foreigners, and the kind of issues associated with China are part and parcel of participating in a market like China, which offers its set of opportunities and risks.

Below, we discuss each of these issues in more depth, starting with an attribution of the backward-looking performance.

Before jumping in, it is important note that we believe the best way for global investors to get a diversified exposure to corporate cash flows in China is to buy the mix of Chinese companies that best reflects the Chinese economy, including both Chinese firms whose stocks are traded onshore in China as well as Chinese companies traded in stock markets outside of China. In these *Observations*, we focus most of our time on the Chinese stocks traded onshore, since they have only recently become available to foreigners and have prompted the bulk of questions from investors.

Give Feedback

Attributing Chinese Equities' Performance

Below, we look at the attribution of Chinese stocks' performance since 2011. Chinese stocks have not performed well in recent years, despite the global equity rally. A few observations on this performance:

- As policy makers moved to rebalance the economy, old-economy sectors with high SOE concentrations contributed the most to weak performance. A diversified mix of Chinese stocks (i.e., onshore and offshore) outperformed the stocks traded onshore in large part due to the increased exposure to innovative new-economy firms, especially in the technology sector, which are largely traded offshore.

- Strong growth in China over this period has translated to strong profit growth for Chinese firms—much stronger than profit growth in the developed world or the rest of the emerging world in the same period. However, a rapid pace of share issuance and dilution led to only moderate earnings-per-share growth, roughly in line with the developed world.

- A decline in P/E ratios led to weak overall performance of Chinese stocks in recent years, as the rest of the world enjoyed a broad P/E expansion following a compression in high risk premiums coming out of the financial crisis.

China Equity Market Performance: Jan 2011 to Today

			Price Change		EPS Growth	
Market Slice	Mkt Cap Weight	Price Change	Due to P/E Change	Due to EPS Growth	Due to Shares	Due to Total Earnings
Dev World		54%	27%	27%	-5%	32%
EM ex-China		29%	41%	-13%	-24%	12%
China Diversified*		14%	-12%	26%	-93%	119%
China Onshore Breakdown						
Total Market		-1%	-29%	28%	-89%	116%
Consumer Staples	9%	[illegible]	-9%	79%	-53%	132%
Healthcare	7%	50%	17%	33%	-57%	90%
Financials	26%	48%	-24%	72%	-30%	102%
Utilities	3%	14%	-38%	52%	-49%	101%
Consumer Discretionary	11%	12%	-17%	29%	-102%	132%
Information Technology	8%	6%	-21%	28%	-323%	350%
Telecom	1%	-14%	7%	-21%	-47%	27%
Industrials	18%	-33%	-26%	-6%	-84%	78%
Materials	12%	-48%	-24%	-24%	-118%	94%
Energy	5%	-58%	-14%	-44%	-38%	-6%
Old-Economy Basket		-37%	-30%	-7%	-86%	79%
New-Economy Basket		33%	-10%	43%	-105%	148%
SOE Basket		-12%	-36%	24%	-22%	46%
Non-SOE Basket		54%	1%	53%	-113%	166%

Compressing P/E ratios and rapid share dilution have been major drags

Old-economy sectors and state-owned enterprises have underperformed materially, dragging down the index

**A balanced mix of Chinese stocks reflective of the Chinese economy, including onshore Chinese A-shares and companies listed offshore (e.g., Tencent)*

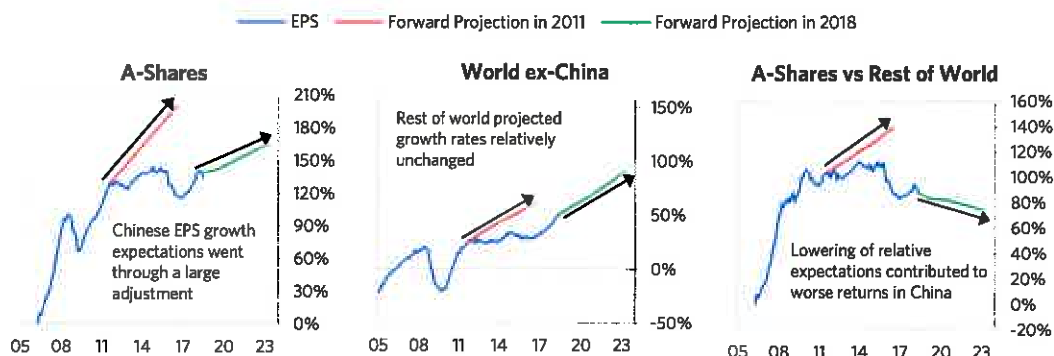
***Equity baskets are based on bottom-up aggregations of a sample set of companies and do not sum to total market*

Give Feedback

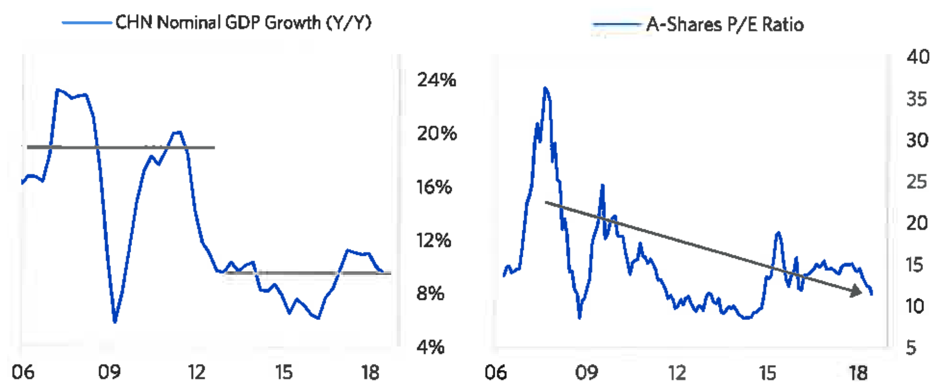
A Decline in Long-Term Earnings Growth Expectations from Elevated Levels Has Been a Sizable Drag on Chinese Stocks

A significant driver of weak Chinese equity market performance is a significant decline in long-term earnings expectations. Classically, markets tend to price in a continuation of the recent past, extrapolating recent conditions forward. A decade ago, nominal growth in China was running at about 20% a year, and equity markets priced in such growth rates continuing indefinitely. As Chinese growth slowed to more sustainable levels, expectations for long-term growth rates of corporate earnings shifted lower. As the charts below convey, coming out of the financial crisis Chinese equity markets were pricing in a continuation of the rapid earnings-per-share growth experienced until that point. As actual EPS growth came in below what was discounted, the market's future expectations were gradually lowered. For comparison, the earnings growth rate discounted for the rest of the world hasn't meaningfully changed over the same time period, so the shift in long-term Chinese earnings expectations has contributed to their poor relative performance.

EPS and Analyst Forward Projections



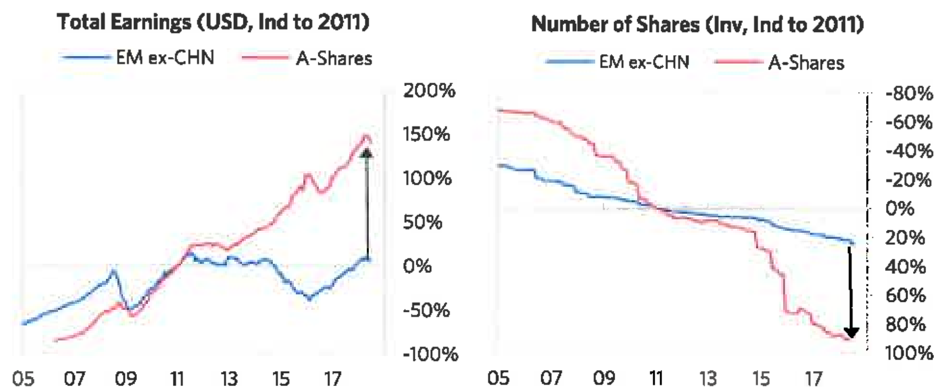
As shown below, the adjustment in investor expectations occurred as the Chinese economy went through a significant downshift in growth rates (from growing at a 20% rate pre-crisis to more like 10% after 2012), as policy makers increasingly shifted their focus toward creating more sustainable growth.



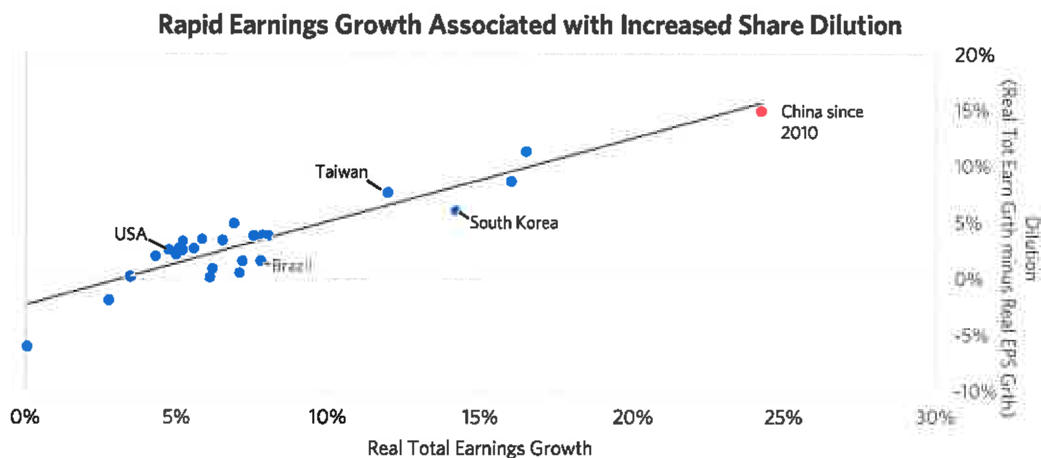
Give Feedback

While Share Issuance/Dilution Has Been Rapid in China, It Is Roughly in Line with Historical Experience for Developing and Expanding Equity Markets

In recent years, Chinese EPS growth has been much weaker than companies' profit growth as a result of significant share issuance and dilution. In other words, shareholders who invested at the beginning of the period haven't seen their cash flows grow nearly as quickly as corporate profits. Below, we show how while the aggregate earnings growth for listed Chinese companies has been significantly stronger than in other EM countries, this has been diluted by the much more rapid pace of share issuance. The picture is even starker relative to stocks in developed countries like the US, where instead of issuing stocks corporates are on net reducing outstanding shares through buybacks.



This rapid pace of issuance and shareholder dilution in China has actually been roughly in line with what has occurred in other cases through time. When we compare China to historical cases when economies and capital markets underwent a rapid expansion, China's pace of share dilution and issuance looks consistent. As shown below, across a large set of countries, we see significant dilution during periods of strong profit growth. Motivated by high potential returns, existing and new firms raise capital and compete to capture the strong growth in the economy such that original investors in a company do not enjoy above-average rates of growth for sustained periods.



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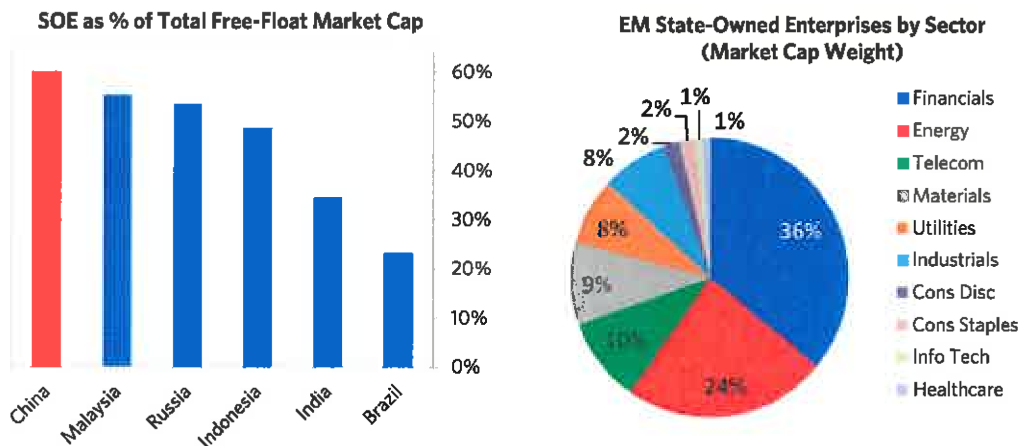
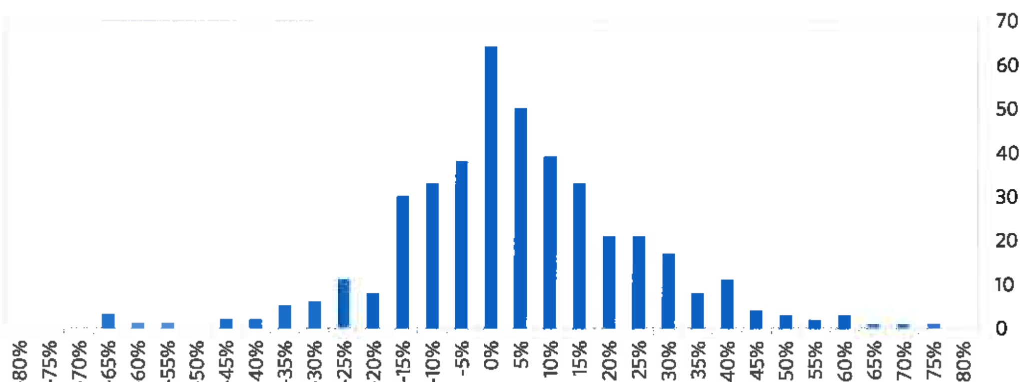
Putting Chinese SOEs into Context

State-owned enterprises (SOEs) comprise a meaningful part of many emerging market equity indices. While the concentration of SOEs in China is large (>50%), a high concentration of SOEs is not uncommon in emerging market countries. As shown below, Russia, Malaysia, and Indonesia all have pretty similar levels of SOE concentration. Across the emerging world, we see a wide range of SOEs across sectors providing a large and diverse sample.



Looking at a sample of 300 SOEs across the emerging world, SOEs generally tend to have slower earnings growth than their private market peers, and markets price them at a discount to account for the slower growth and host of additional risks that come with government ownership. Because returns over any given period are driven by how things transpire relative to what is priced in, over time and across countries SOEs have historically been just as likely to outperform their privately held peers as they have been likely to underperform. In other words, we believe that markets discount SOEs' expected cash flows based on what is known and react to changes, and aren't especially biased to do this less well in the case of SOEs relative to other companies. Below, we show the distribution of three-year realized returns relative to the sector within the same country across a range of SOEs globally since 2000, which is centered roughly around zero.



This analysis consists of 427 observations of annualized 3-year rolling returns of the biggest SOEs across Brazil, India, Indonesia, Russia, Malaysia, and China. Data since 2000.

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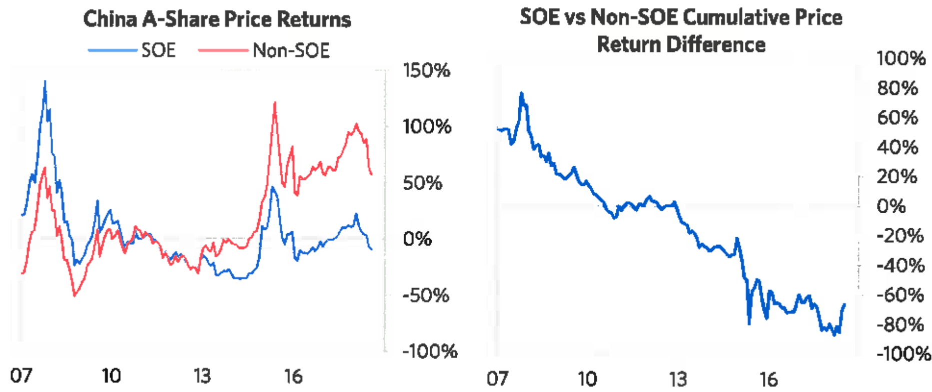
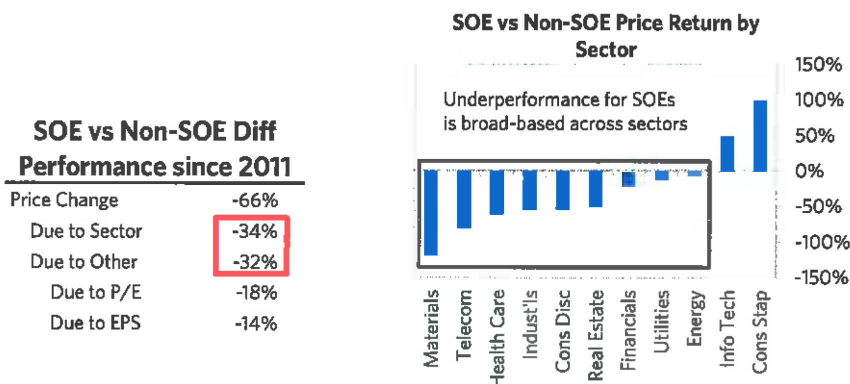
The Drivers of Recent Chinese SOE Underperformance

As shown further above, Chinese SOEs have significantly underperformed the broader markets in recent years, and their performance has been a sizable drag on the overall index performance.



Chinese SOEs have (1) underperformed their peers in most sectors and (2) are concentrated in the worst-performing sectors (mostly old-economy sectors), which have struggled as the Chinese economy has been rebalancing.



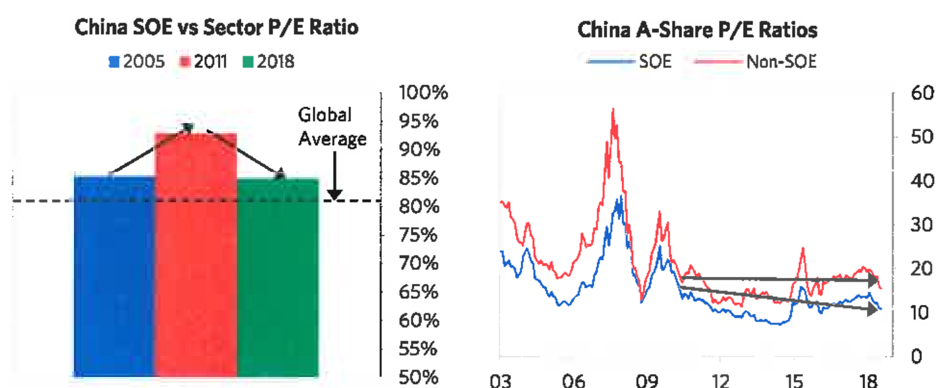
SOE vs Non-SOE Diff Performance since 2011

Price Change	-66%
Due to Sector	-34%
Due to Other	-32%
Due to P/E	-18%
Due to EPS	-14%

Note: the consumer staples sector has benefited from a few blockbuster SOE companies like Kweichow Moutai

Give Feedback

A significant driver of SOE underperformance has been investors in Chinese stocks pricing in overly optimistic earnings growth scenarios for SOEs post-crisis. As discussed above, across countries SOEs typically trade at a valuation discount to compensate investors for weaker earnings. In China, this traditional valuation discount was eroded a few years ago, as SOEs' valuations rose through 2011 relative to their peers within each sector. As SOEs' realized earnings came in weaker than expected, these expectations have been revised down. After years of underperformance, Chinese SOEs now trade at a more typical discount to their privately held peers.



Benchmarking Chinese Stocks

The onshore Chinese stock markets are developing rapidly and exhibit many of the challenges that are prevalent in markets undergoing similar expansion. Below we roughly benchmark Chinese markets across a number of dimensions of market development, drawing on research done by Professor Andrew Karolyi at Cornell University, who has incorporated information from MSCI, the World Bank, etc., alongside our own research on China. Overall, the Chinese equity markets look roughly in line with a typical emerging equity market. In particular:

- Market Capacity: How large are financial markets relative to the size of the economy?
  - China's financial markets by this measure are already among the more developed among "emerging" economies.
- Operational Efficiency: How easy/cheap is it to buy, sell, and settle financial transactions?
  - Here China is about on par with other EMs, as low transaction costs and high trading volumes were offset by short-sale and other restrictions.
- Foreign Accessibility: Are there any restrictions on foreigners investing?
  - China still ranks low on this measure due to a multitude of regulations affecting foreigners (registration, ownership caps, taxes, etc.). However, these regulations are rapidly evolving, and Chinese financial markets are generally becoming accessible to foreigners.
- Corporate Transparency: Is information about company operations and financials accurate and freely available?
  - China ranks around average on this measure.
- Legal Protections: Do they exist and are they robust?
  - China is a bit weaker than average here, particularly around investor protection (e.g., enforcement of insider trading laws and stockholders' abilities to hold directors accountable, etc.).
- Political Stability: Are policy makers stable and policies consistent?
  - China's political stability is above average in emerging markets.

Give Feedback

The table below summarizes this benchmarking.

	Measure	Source	China Ranking vs EM
Financial Accessibility	Market Capacity	Karolyi	Above Average
	Operational Efficiency	Karolyi	About Average
	Foreign Accessibility	BW Data, Karolyi	Below Average
Corporate Environment	Corporate Transparency	Karolyi	About Average
	Legal Protection	Karolyi, BW Data	Below Average
	Political Stability	BW Data	Above Average

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