Asia Insight

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Stock-Trading Link Allows Access to the "NASDAQ of China"

China's regulators took another step toward opening its financial markets, recently announcing that the Shenzhen–Hong Kong Stock Connect program (Shenzhen Connect), the trading link between the two sides, should go live by December.

Investors buying into Shenzhen via the connect mechanism will have access to any stock in the Shenzhen Stock Exchange Component Index and Shenzhen Stock Exchange Small/Mid Cap Innovation Index (about 900 stocks). Trading will be subject to daily limits for net purchase amounts equal to 13 billion renminbi (US$1.9 billion) flowing into Shenzhen and 10.5 billion renminbi (US$1.6 billion) for outflows from Shenzhen into Hong Kong.

In addition, there will be an expansion of the eligible Hong Kong stock list for mainland Chinese investors to include constituents of the Hang Seng Small Cap Index (more than 400 stocks).

What Does it Mean for Us as Investors?

The launch of Shenzhen Connect will offer international investors access to some of the most innovative, dynamic Chinese companies. The Shenzhen stock exchange can be characterized as the "NASDAQ of China" and the city of Shenzhen is often likened to the "Silicon Valley of China." The Shenzhen stock exchange is home to three-quarters of the listed information technology A-share companies in China.

Did you know?

- Shenzhen is the world's 8th largest equity market (by market cap)
- The Shenzhen stock exchange had the 3rd highest trading volume worldwide, as of the end of 2015
- Over 75% of companies listed on the SZSE are privately owned (not state-owned enterprises)
- 94% of companies on the Shenzhen Stock Exchange are small/mid caps

Companies on the forefront of speech recognition, video content and streaming, and automated financial services and wealth management will now be more accessible to foreigners. Over 70% of Chinese companies focused on industrial automation and green technology are listed in Shenzhen. These companies produce high-end robotics, sanitation recycling equipment, market leading re-chargeable battery manufacturing and water treatment technology.

When it comes to online-mobile business and social media, China can compete with the U.S. Millions of Chinese consumers use mobile devices to pay their bills, order services, watch videos and bank online, and social media innovation is rampant. In many ways, Facebook and Twitter are playing catch-up. For example, a consumer can order lunch, pay for it, hail a cab to go get the lunch and then take a selfie or stream live video in front of the restaurant—all from the same app. That's functionality that has been popularized in China.

Other areas in mobile e-commerce are just as exciting. The rise of middle class China is driving innovation for the "ease of spending." Individuals are investing, transferring cash and reimbursing each other via digital wallets—bypassing the need for credit cards. The bottom line is that the sheer size and changing dynamic of the Chinese economy (with over 75 cities of more than 5 million people) is a motivator for innovation in sectors that are well-represented in Shenzhen.

How Can Asset Managers Take Advantage of This?

Historically, the Chinese government has made it difficult for foreigners to access local shares. Foreign asset managers were limited to cumbersome mechanisms like the QFII Scheme (Qualified Foreign Institutional Investor) whereby qualified institutional investors were given limited access to China's capital markets. Slowly, foreigner access has been improving and more asset managers are holding local Chinese shares within their portfolios or in some cases, offering dedicated products focused on local shares. As Asia investors, we are pleased to see more choices for accessing this market offered.

Matthews Asia

> "Overall, the opening of the Shenzhen–Hong Kong Stock Connect is a positive step and reinforces the Chinese government's continuous efforts to liberalize the capital account and flow of money both into and out of China."

Passive: A-share exchange-traded funds (ETFs) are available, and can offer limited access to the Shenzhen stock market.

- Typically these passive vehicles are cap-weighted and are blind to management and business quality.
- The A-share market has its share of compelling, well-run businesses, but it also has a large contingent of companies that lack basic corporate governance and transparency, which we believe warrants a very hands-on active investment approach.

Active: The MSCI China Index will eventually include A shares, and some of those companies will be listed in Shenzhen. However, their inclusion will most likely take place gradually over several years. As active managers we are not beholden to index weights.

- While there are global emerging markets (EM) strategies, which contain significant China exposure, we estimate that the typical active EM manager currently has less than 2% in A-shares and less than half of those will be listed in Shenzhen. This is because Shenzhen-based companies are not included within the MSCI EM equity benchmark.
- Dedicated China strategies, which may include some A-share exposure, are also available to us as Asia investors. These present a good start, but are not pure plays on China A shares, or Shenzhen in particular.
- Dedicated Chinese small-cap strategies: Outside of an active dedicated A-share strategy (very few exist in the U.S.), a China small-cap strategy may offer the best access to the innovative, dynamic companies accessible through Shenzhen.

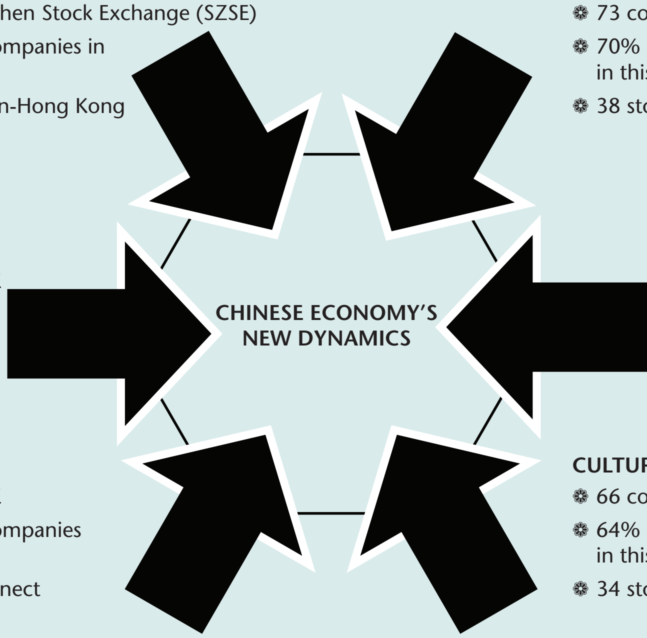
Matthews China Small Companies Strategy Should Benefit

The Shenzhen–Hong Kong Connect does not only impact Shenzhen-listed companies. We believe this new link could be a re-rating catalyst for small-cap stocks in Hong Kong. The expanded list of eligible small caps in Hong Kong could more generally increase investor flows into small caps. We believe mainland investors allocating money offshore will utilize the newly available Hang Seng Small Cap Index stocks as a way to diversify holdings.

EMERGING INDUSTRIES CONTRIBUTING TO ECONOMIC TRANSITION

INFORMATION TECHNOLOGY
- 196 companies listed on Shezhen Stock Exchange (SZSE)
- 78% of total China A-share companies in this industry
- 146 stocks eligible for Shezhen-Hong Kong Stock Connect (SZ Connect)

HIGH-END MANUFACTURING
- 73 companies listed on SZSE
- 70% of total China A-share companies in this industry
- 38 stocks eligible for SZ Connect



GREEN INDUSTRY
- 172 companies listed on SZSE
- 76% of total China A-share companies in this industry
- 91 stocks eligible for SZ Connect

HEALTH CARE
- 85 companies listed on SZSE
- 78% of total China A-share companies in this industry
- 59 stocks eligible for SZ Connect

CONSUMPTION
- 385 companies listed on SZSE
- 57% of total China A-share companies in this industry
- 166 stocks eligible for SZ Connect

CULTURE
- 66 companies listed on SZSE
- 64% of total China A-share companies in this industry
- 34 stocks eligible for SZ Connect

Note: Periodic review of eligible stock list in line with half-yearly rebalancing of underlying indexes. Subject to regulatory approval, details of eligible secutities will be announced prior to the launch of Shezhen-Hong Kong Stock Connect.

Source: Index Department of SZSIC, Wind

"The sheer size and changing dynamic of the Chinese economy is a motivator for innovation in sectors that are well-represented in Shenzhen."

What is an A-Share?

- China A shares are the shares of companies incorporated in mainland China and traded in Shanghai or Shenzhen, quoted in renminbi (RMB)
- Previously restricted to domestic investors, the A-shares market is now open to foreign investors
- The expected opening of the Shenzhen–Hong Kong Connect will improve foreign investor access to A-share companies
- As of October 2016 there are approximately 3,000 listed companies on the Shanghai and Shenzhen exchanges

What are some of the notable characteristics of small caps in China?

Valuation: Historically, Hong Kong-listed China small caps have traded at a discount to large caps.

Stock performance: the MSCI China Small Cap Index has outperformed the MSCI China Index in the last five, seven and since inception periods though October 31, 2016.

Employee incentives: to this point, there are 415 companies with employee stock incentive plans listed on the Shenzhen stock exchange as of August 2016, compared to just 141 for Shanghai. That is a difference of 2.9x in employee stock participation!

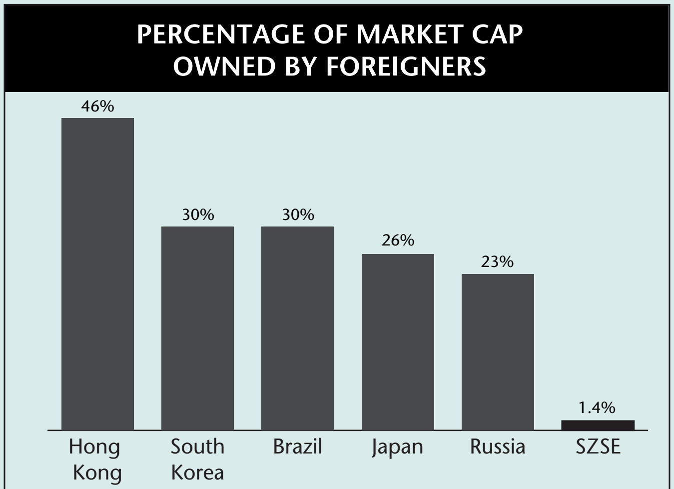
Alignment of interests: Founders of private companies tend to be major shareholders. As a result, the major shareholder interests are aligned with minority shareholders.

Investing for the future: smaller market cap Shenzhen and Hong Kong companies have been outspending those companies listed in Shanghai for future growth. The average research and development expense-to-sales ratio of Shenzhen-listed companies is 4.4%. This is more than double the ratio spent by the Shanghai-listed firms. In terms of patents, Shenzhen-listed firms in aggregate have over 1.5x more patents filed than Shanghai-listed ones.

Less volatile: MSCI China Small Cap stocks have been less volatile than the broader MSCI China Index over the last five-year and since inception* periods. The lack of dependency on debt and the innovate-or-die nature of smaller companies boost their idiosyncratic nature making them less susceptible to the systemic ups and downs of the broader market.

What do we think?

Overall, the opening of the Shenzhen–Hong Kong Stock Connect is a positive step and reinforces the Chinese government's continuous efforts to liberalize the capital account and flow of money both into and out of China. Mainland Chinese companies are under-owned by foreigners. Other major emerging markets typically have between 20% and 30% of foreign ownership. Foreigners own approximately 45% of Hong Kong-listed stocks. However, foreigners only own about 1.4% of stocks listed in Shenzhen. We believe foreign ownership could significantly increase over time, boosting demand for shares and broadening the investor base contributing to a more balanced flow of investments.



Source: Shezhen Stock Exchange (SZSE), CSRC; SZSE data as of 9/30/16, other data as of March 2015

On the ground, we are seeing a macroeconomic environment within China that is stabilizing. In addition, we see evidence of an improving earnings cycle and relatively attractive valuations in many sectors of the market. If you consider the notion that a large contingent of investors is underweight China because of recent macro noise, the prospects for Chinese equities appears even more attractive, especially among those innovative small and mid-cap companies that are well-represented on the Shenzhen stock exchange.

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*Volatility as measured by Bloomberg classical model for estimating historical volatility.

Investing in small- and mid-size companies is more risky than investing in large companies as they may be more volatile and less liquid than larger companies.

The MSCI China Small Cap Index is a free float–adjusted market capitalization–weighted small cap index of the Chinese equity securities markets, including H shares listed on the Hong Kong Exchange, B shares listed on the Shanghai and Shenzhen exchanges, and Hong Kong-listed securities known as Red Chips (issued by entities owned by national or local governments in China) and P Chips (issued by companies controlled by individuals in China and deriving substantial revenues in China). The MSCI China Small Cap Index was launched on June 1, 2007. It is not possible to invest directly in an index.

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