# Investment Opportunities in China


**BY**

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# Overview

- Macro Picture
- Stock Markets
- Demographics
- Pension System
- Banks
- Insurance
- Fund Management
- Investment Funds
- Sovereign Wealth Funds
- QFII/QDII
- Conclusion

# Section 1: Macro Picture

# Map of China


Greater China
Heilongjiang
Jilin
Liaoning
Xinjiang
Inner Mongolia
Beijing
Tianjin
Hebei
Ningxia
Shanxi
Shandong
Qinghai
Gansu
Shaanxi
Henan
Jiangsu
Shanghai
Tibet
Chongqing
Anhui
Hubei
Sichuan
Zhejiang
Jiangxi
Hunan
Guizhou
Fujian
Taiwan
Yunnan
Guangxi
Guangdong
Shenzhen
Hong Kong
Macau
Hainan

# China – The Macro Picture

| | In US$bn |
|---|---:|
| GDP in 2008 | 4,400 |
| Household and Corporate Savings (Deposits) | 7,000 |
| Foreign Exchange Reserves | 1,950 |
| Stock Market Capitalisation (Full Market Cap) | 2,250 |
| Insurance Assets | 500 |
| Pension Assets | 300 |
| Insurance Assets as % of 2008 GDP | 11% |
| Pension Assets as % of 2008 GDP | 7% |
| QFII Quota | 12.9 |
| QDII Quota | 71.5 |
| QFII Quota as % of Stock Market Capitalisation | 0.7% |
| QDII Quota as % of Household and Corporate Savings | 1.0% |

## Section 2: Stock Markets

# Stock Market Overview

- Two Stock Exchanges - Shanghai & Shenzhen
- Both founded in 1990
- Size

| Securities | Type | Shanghai | Shenzhen | Total |
|---|---|---|---|---|
| Shares | A Shares | 848 | 727 | 1,575 |
| | B Shares | 53 | 55 | 108 |
| Bonds | | 209 | 131 | 340 |
| Investment Funds | | 16 | 48 | 64 |
| Warrants | | 10 | 3 | 13 |
| **Total Market Capitalisation (US$ bn)** | | 1774 | 480 | 2,254 |
| Hong Kong | H Shares | 150 | | |
| | Red Chips | 93 | | |
| **Total Market Capitalisation (US$ bn)** | | 1,240 | | |

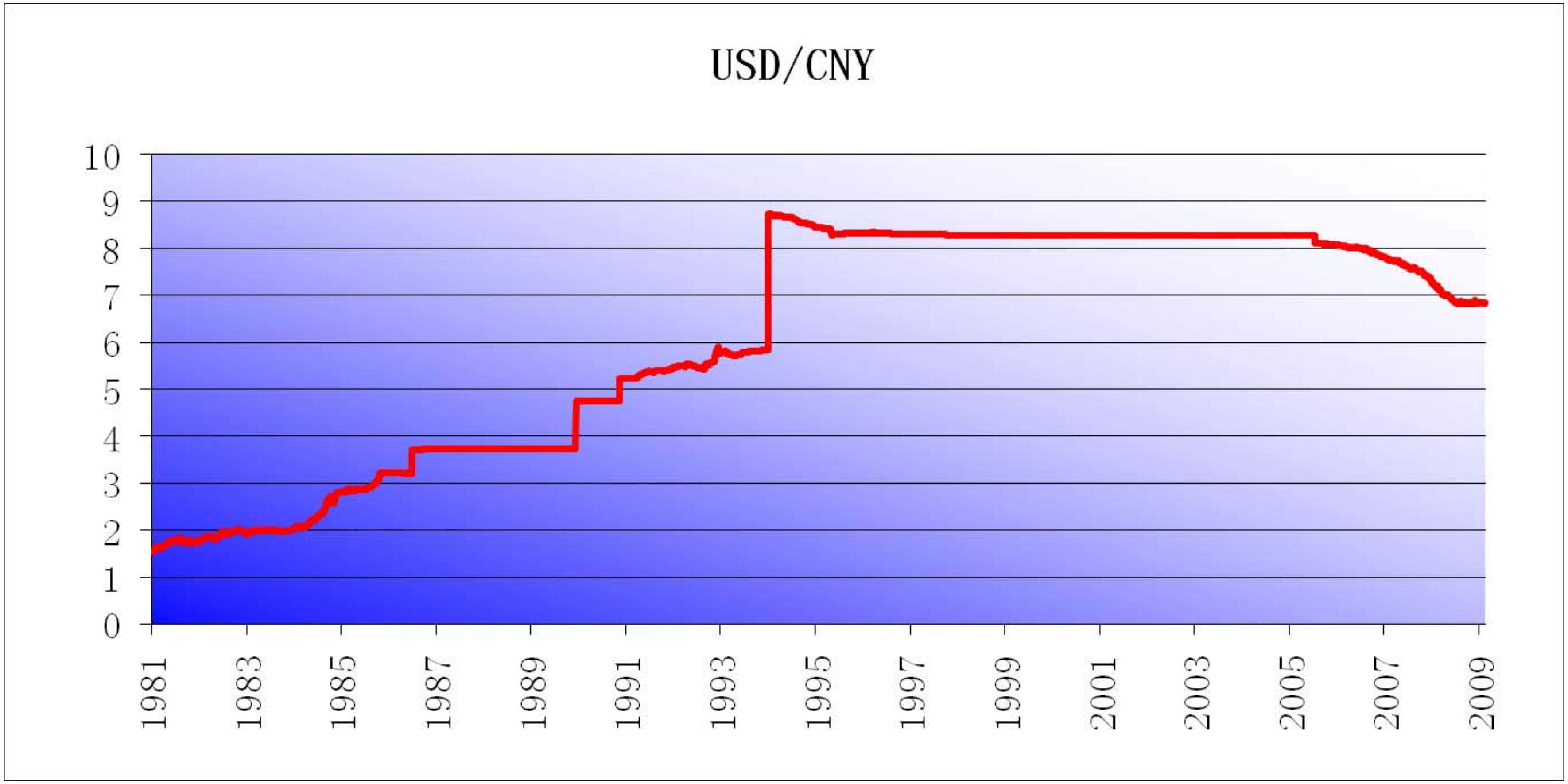
# China Equity Markets – Key Themes

- Markets growing
  - Total market cap rose from US$1.1trn at the end of 2006 to US$4.7trn in January 2008, and then fell to US$2.3trn now
  - Worst performer in Asia in 2008 – down by 65%
  - Best performer to date this year – up ~15%
  - Volatility is increasing
  - New issue market now slow – return of H share and Red Chip companies to domestic market later?
  - Decoupling from international equity markets? – not so far
- Hong Kong plus China have overtaken Japan (US$2.9tn)

# China Equity Markets – Investor Base

- Retail still dominates
- Institutions are growing
  - Fund management firms
  - Pension funds
  - Insurance companies
  - Corporates
  - Sovereign Wealth Funds
  - QFII

# China Equity Markets - Currency




Source: Bloomberg

# Section 3: Demographics

# PRC Population

- Total: 1.33bn
- Rural Population: 750mn
- Urban Population: 580mn

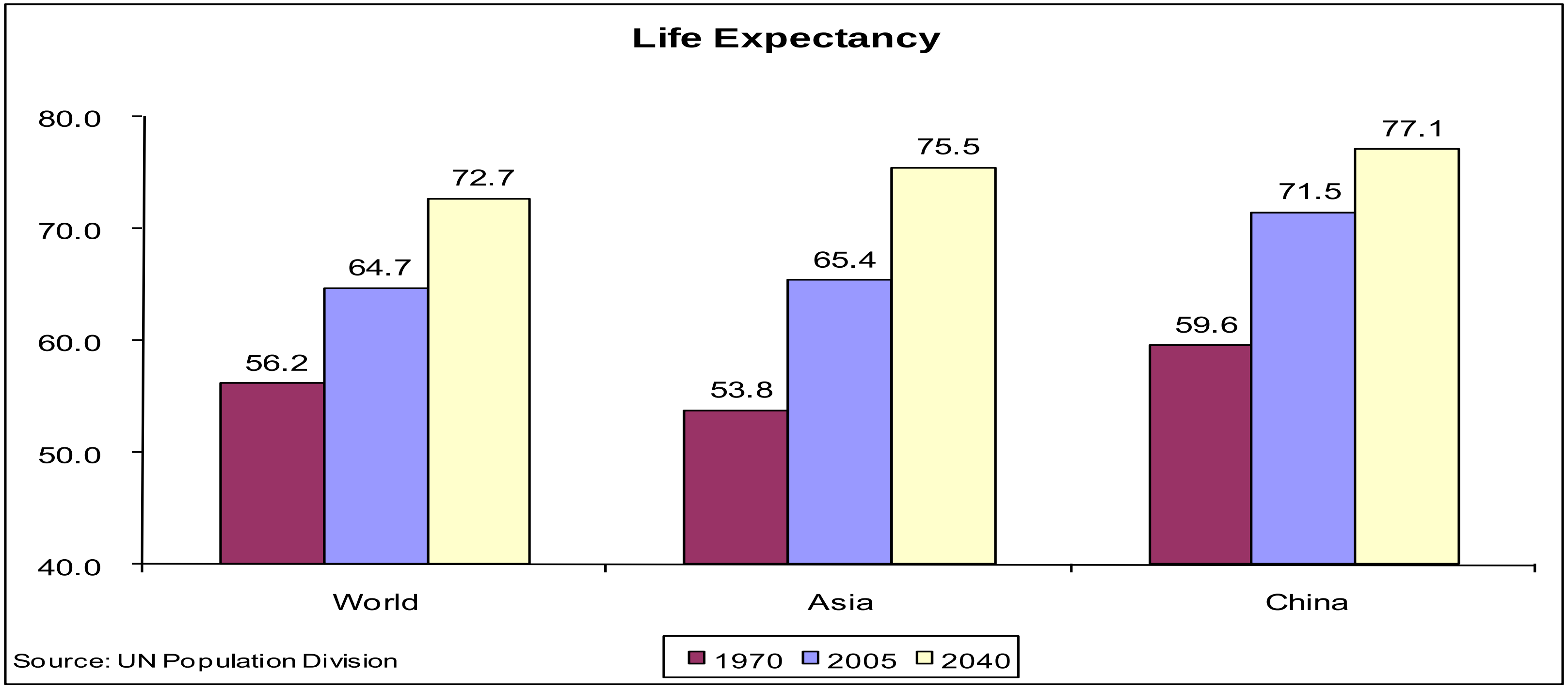
Population Ages:

- 0-14 250mn
- 15-59 900mn
- 60+ 180mn

Consider:

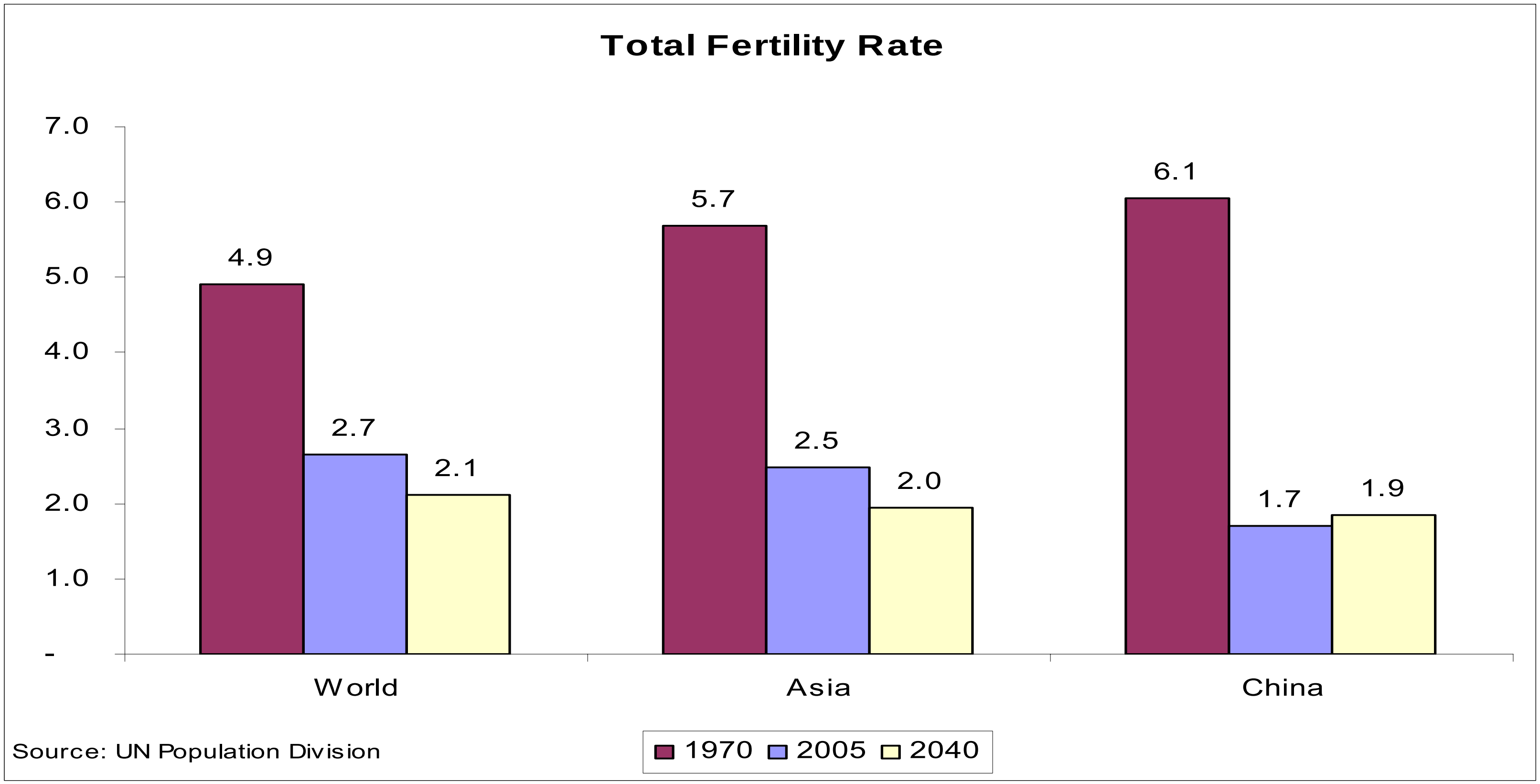
- One child policy
- Greatly improved life expectancy
- Dependency ratio deteriorating rapidly
- Population Sex Ratio(Male/Female): 1.068
- Solve population problem through migration? – NO!

# Demographic Changes Pose Challenges




Source: UN Population Division

# Demographic Changes Pose Challenges (Cont'd)




Source: UN Population Division

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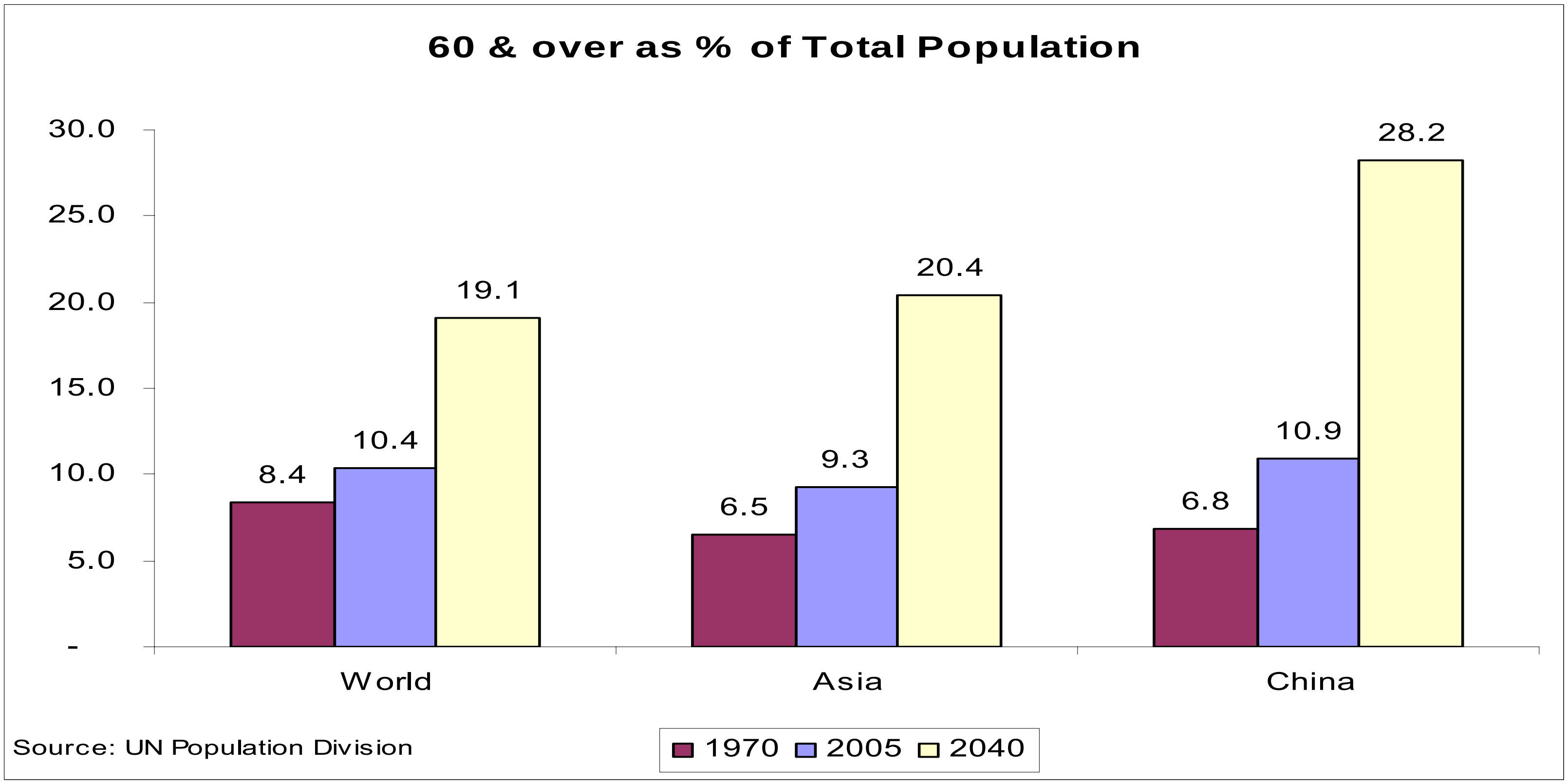
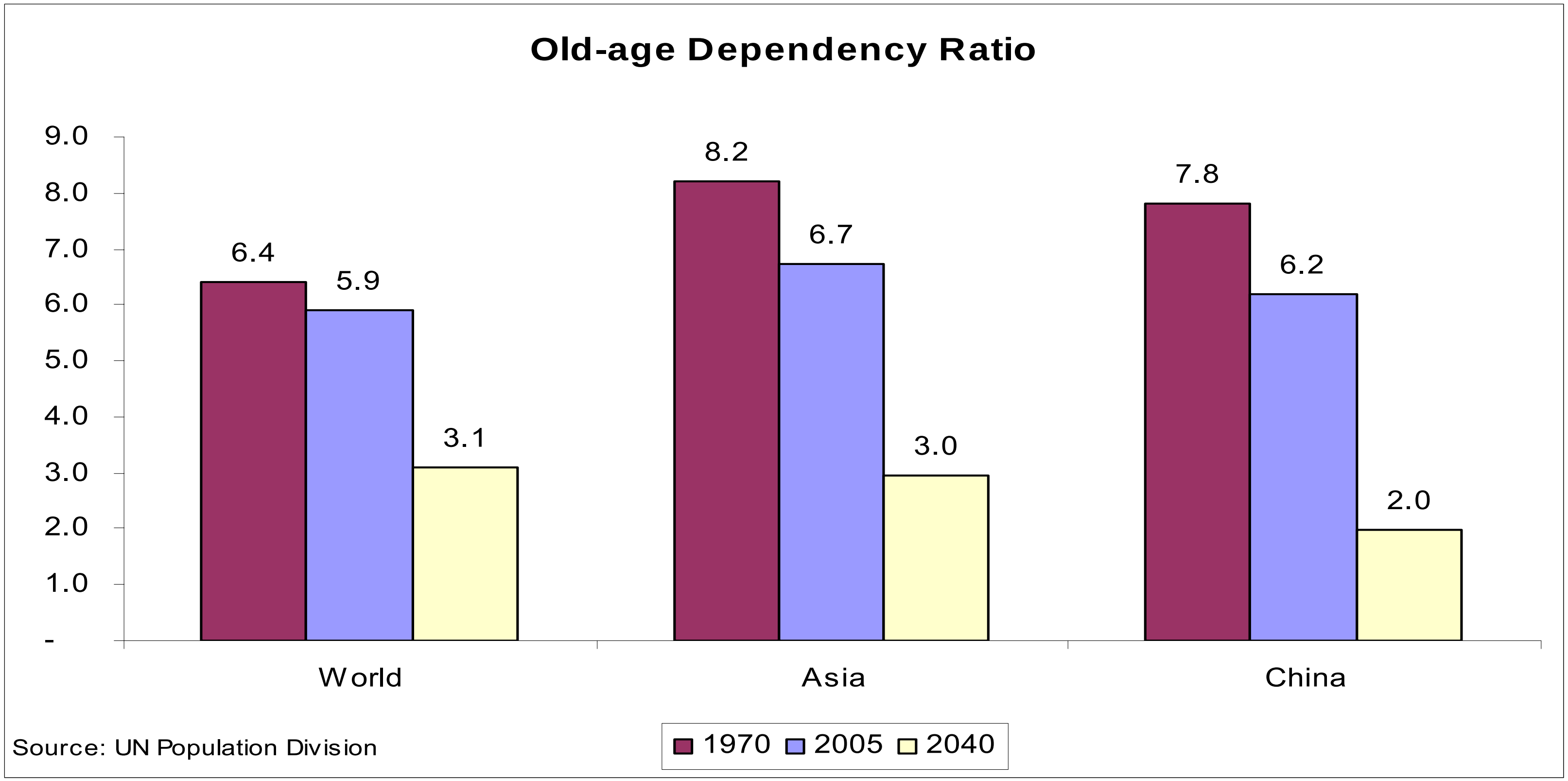



Source: UN Population Division

# Demographic Changes Pose Challenges (Cont'd)




Source: UN Population Division

# Section 4: Pension System

# Pension Reform in China

- Demographics will deteriorate rapidly
- New Unified Pension System Reform
  - Document 26 – July 1997
  - Document 38 – December 2005
- Expand coverage to all urban employees
- National Social Security Fund (NSSF) established in 2000 as a strategic reserve

# China's 5-Pillar Pension System

| Pillars (World Bank) | | Chinese Terminology | Funded Status | Current Assets |
|---|---|---|---|---|
| State | Zero | Minimum Guarantee (Di Bao) | PAYG | N/A |
| | I | Mandatory Social Pooling (Pillar Ia) | PAYG | ? |
| | II | Mandatory Individual Account (Pillar Ib, administered by the state) | Should be Funded | US$80bn? |
| Private | III | Voluntary Enterprise Annuity (EA, Pillar II) | Funded | US$20-25bn? |
| | | Other Voluntary Supplemental Pensions, e.g. Group Pension Insurance (Pillar III) | Funded | US$25-35bn? |
| Private & State | IV | Family support; subsidised healthcare and housing? | PAYG | N/A |

# Asset Allocation

| | Equities / Linked products | Financial / Corporate Bonds | G-bonds / Deposits |
|---|---|---|---|
| **Pillar 1a (state)** | - | - | 100% |
| **Pillar 1b (state)** | - | - | 100% |
| **Pillar II (EA)** | < 30% | < 50% | > 20% |
| **Pillar III (non-EA)** | < 20% | < 20% | < 100% |
| **National Social Security Fund** | < 40% | < 10% | > 50% |

# Opportunities for International Fund Managers

| Pillars (Chinese) | | Opportunities? |
|---|---|---|
| Pillar Ia | | No |
| Pillar Ib | Short Term | No |
| | Medium Term | Outsourcing by Social Security Bureaus |
| | Long Term | Like MPF or 401(k) plans? |
| Pillar II | | Need EA License |
| Pillar III | | Via insurance companies |
| NSSF | | Yes |

# Section 5: Banks

# Banking Sector Overview

- Regulator: China Banking Regulatory Commission (CBRC)
- Total Assets: US$ 7.4 trn as of the end of H1 2008
- Participants:

| Breakdown of Banking Industry in China | No. |
|---|---|
| Policy Banks | 3 |
| State-owned Commercial Banks | 5 |
| Joint-stock Commercial Banks | 12 |
| City Commercial Banks | 124 |
| Financial Asset Management Companies | 4 |
| Postal Savings Bank | 1 |
| Trust Companies | 54 |
| Locally-incorporated Foreign Bank Subsidiaries | 29 |

Source: CBRC 2007 Annual Report

# Foreign Banks in China

As of the end of 2007,

| | Foreign Banks | Wholly Foreign-funded Banks | JV Banks | Wholly Foreign-Funded Financial Company | Total |
|---|---|---|---|---|---|
| **Head Offices of Locally Incorporated Banks** | | 24 | 2 | 3 | 29 |
| **Branches and Subsidiaries of Locally Incorporated Banks** | | 119 | 6 | | 125 |
| **Foreign Banks Branches** | 117 | | | | 117 |
| **Sub-branches** | 9 | 152 | 8 | | 169 |
| **Total** | 126 | 295 | 16 | 3 | 440 |
| **Assets (US$, bn)** | | | | | 178 |
| **Share of Total Banking Assets in China** | | | | | 2.4% |

Source: CBRC 2007 Annual Report

# Overseas Expansion of Chinese Domestic Banks

- Establish Overseas Presence
  - Set up branches / subsidiaries / representative offices
  - M & A
- Motivations
  - Economic globalisation
  - International interest in RMB investments
  - Sufficient capital
- Benefits
  - Asset reallocation
  - Technology innovation
  - Risk diversification

# Overseas Expansion of Chinese Domestic Banks (Cont'd)

- International banks buy into Chinese banks
  - BBVA – CITIC (10%)
  - Bank of America – CCB (16.6%)
  - Deutsche Bank – Huaxia (13.7%)
  - Goldman Sachs – ICBC (5%)
  - HSBC – Bank of Communications (19.9%)
  - RBS – BOC (8.5%) – sold

- Chinese banks acquire stakes in international banks
  - CDB – Barclays (3.1%)
  - ICBC – Standard Bank (20%)
  - Merchants – Wing Lung (97.8%)
  - CCB – BoA(Asia) (100%)

# Section 6: Insurance

# Insurance Sector Overview

- Regulator: CIRC

- Industry AUM: US$500bn
  - Life: US$400bn
  - Non-life: US$100bn

- Potential funds for overseas investments: US$75bn

- Insurance companies and banks can invest in each other now

# Chinese Insurers Expand Overseas

- Ping An
  - Fortis Group ( 5% )
  - Value Partners ( 9% )

- China Life
  - Visa
  - Looking for similar acquisition opportunities in Asia, Europe and US
  - AIA?

# Section 7: Fund Management

# Investment Fund Houses Overview

- Regulator: China Securities Regulatory Commission (CSRC)
- Available Funds: 400+
- Mostly headquartered in Shanghai, Shenzhen and Beijing

| | No. of Houses | Current AUM (US$ bn) | Market Share |
|---|---|---|---|
| Industry | 61 | 300 | 100% |
| Domestic | 29 | 165 | 55% |
| Joint Venture (max. 49% holdings) | 32 | 135 | 45% |

Source: CSRC website, Stirling Finance Limited research.

# Domestic Fund Managers

| | | | |
|---|---|---|---|
| 1 | Guotai Asset Management Co., Ltd | 16 | China Nature Asset Management Co., Ltd |
| 2 | China Southern Fund Management Co., Ltd | 17 | Guangfa Fund Management Co., Ltd |
| 3 | China Asset Management Co., Ltd (hua xia) | 18 | Citic Fund Management Co., Ltd |
| 4 | Hua An Fund Management Co., Ltd | 19 | Lion Fund Management Co., Ltd |
| 5 | Bosera Asset Management Co., Ltd | 20 | Zhonghai Fund Management Co., Ltd |
| 6 | Da Cheng Fund Management Co., Ltd | 21 | Huafu Fund Management Co., Ltd |
| 7 | E Fund Management Co., Ltd | 22 | Orient Fund Management Co., Ltd |
| 8 | Yinhua Fund Management Co., Ltd | 23 | Soochow Asset Management Co., Ltd |
| 9 | Baoying Asset Management Co., Ltd | 24 | Tianhong Asset Management Co., Ltd |
| 10 | Greatwall Fund Management Co., Ltd | 25 | New Century Fund Management Co., Ltd |
| 11 | Galaxy Asset Management Co., Ltd | 26 | China Universal Asset Management Co., Ltd |
| 12 | Wanjia Asset Management Co., Ltd | 27 | Huashang Fund Management Co., Ltd |
| 13 | Golden Eagle Asset Management Co., Ltd | 28 | Yimin Asset Management Co., Ltd |
| 14 | Chang Xin Asset Management Corporation Ltd | 29 | China Post & Capital Fund Management Co., Ltd |
| 15 | First-Trust Fund Management Co., Ltd | | |

Source: CSRC

# Joint Ventures

| | | | |
|---|---|---|---|
| 1 | Penghua (Eurizon Financial Group) | 17 | BOC International (Merrill Lynch & BoCI HK) |
| 2 | Harvest (Deutsche Bank) | 18 | Franklin Templeton Sealand |
| 3 | Changsheng (DBS) | 19 | China International (JP Morgan Fleming) |
| 4 | Fullgoal (BMO Financial) | 20 | AIG Huatai |
| 5 | Rongtong (Nikko Asset Management) | 21 | ICBC-Credit Suisse |
| 6 | UBS SDIC | 22 | Bank of Communications Schroder |
| 7 | ABN AMRO Teda | 23 | Citic-Prudential |
| 8 | China Merchants (ING) | 24 | CCB Principal |
| 9 | Fortune SGAM | 25 | HSBC Jintrust |
| 10 | Morgan Stanley Huaxin | 26 | First State Cinda |
| 11 | Guotai Junan Allianz | 27 | Lord Abbett China |
| 12 | Fortis Haitong | 28 | Lombarda China |
| 13 | Invesco Great Wall | 29 | KBC-Goldstate |
| 14 | Aegon-Industrial | 30 | AXA SPDB |
| 15 | SYWG BNP Paribas | 31 | ABC-CA |
| 16 | Everbright Pramerica | 32 | Minsheng Royal (RBC) |

Source: CSRC

# Section 8: Investment Funds

# Domestic Funds

- Domestic PRC Funds
  - Permitted Investments
    - Equities
    - Convertibles
    - Warrants
    - Bonds
    - Deposits
    - Futures(expected)

  - Cannot invest in overseas securities unless authorized via QDII regime
    - H shares, issued by Chinese companies in Hong Kong, are treated like foreign securities
    - QDII funds

# Domestic Investment Fund Products

- Closed-end funds (over 50) started in 1998.
- Now predominantly open-ended funds (over 300), including:
  - Equity funds
  - Balanced funds
  - Bond funds
  - Money market funds
  - ETFs
  - Sector funds
  - Guaranteed funds

# Section 9: Sovereign Wealth Funds

# Sovereign Wealth Funds

- National Social Security Fund
- China Investment Corporation
- State Administration of Foreign Exchange
- The China-Africa Development Fund

# National Social Security Fund (NSSF)

- Pension fund of last resort in China
  - To help provinces with pension financing difficulties
- Source of funds:
  - State Shares equal to 10% of IPO proceeds
  - Allocations from central government
  - Lottery licence fees
  - Investment returns
- Assets:
  - Now about US$80bn total assets
  - Perhaps US$25bn in equities
  - US$2.2bn in international assets
- Acting like Sovereign Wealth Fund

# China Investment Corporation (CIC)

- Established in September 2007
- Mandated to manage a portion of China's foreign exchange reserves
  - Initial size ~ US$200bn
  - Domestic investments
    - US$67bn to acquire Central Huijin
    - US$50bn to recapitalise Agricultural Bank of China and China Development Bank
  - The rest for international investments – approximately US$83bn
    - Blackstone (9.4%, US$3bn)
    - Morgan Stanley (9.9%, US$5bn)
    - JC Flowers (US$4bn)
    - 4 US MM funds (US$11.3bn)
    - will include equities, bonds, and alternative assets including private equity
- Given its size and potential to sway the markets, every move of the CIC is closely watched

# International Mandates

| NSSF | |
|---|---|
| **November 2006** | **May 2008** |
| Global (ex-US) Equities | Active China Overseas Equity |
| US Equities | Active Asia Pacific (ex Japan) Equity |
| Hong Kong Equities | Active Emerging Market Equity |
| Global Fixed Income | Active European Equity |
| Cash | Active Global Equity |

| CIC | |
|---|---|
| **December 2007** | **February 2008** |
| Global Equity Active | Active Global Fixed Income |
| MSCI EAFE Active | Active Emerging Market Debt |
| Emerging Market Active | |
| Asia ex Japan Equity Active | |

# State Administration of Foreign Exchange (SAFE)

- China’s FX reserves as of end-2008: US$1.95trn
- 5% of the assets are allowed for overseas equity investments
- Hong Kong subsidiary (“SAFE Investment Company Limited”) established in June 1997
- Deals done through SAFE Investment or other nominee accounts
- In January 2008, paid A$200mn through its Hong Kong subsidiary to acquire:
  - Australia and New Zealand Bank (<1%)
  - Commonwealth Bank of Australia (<1%)
  - National Australia Bank (0.33%)
- Quietly built up stakes in over 50 European companies in 2008
  - No more than 1.6% in each
- US PE firm TPG (>US$2.5bn)

# China-Africa Development Fund (CADFund)

- Launched in June 2007 as the largest PE fund in China
- Also the largest fund invested in Africa
- Aims to enhance the China-Africa strategic partnership in various areas
- Initially US$1bn provided by China Development Bank; will increase to US$5bn
- Operating independently based purely on market economy principles
- Had invested about US$400mn in 20 projects by the end of 2008
  - Ethiopia: glass plant
  - Ghana: electric power plant
  - Zimbabwe: chrome plant
  - Egypt: Suez Economic and Trade Park

## Section 10: QFII / QDII

# QFII and QDII – What Are They?

- QFII
  - Qualified Foreign Institutional Investors
  - Allows foreign investors limited access to the Chinese capital markets
- QDII
  - Qualified Domestic Institutional Investors
  - Allows domestic investors limited access to overseas markets
- Partial liberalisation of China’s capital account

# QFII Overview

- Programme launched in December 2002
- Allows foreign institutional investors to invest in China's domestic securities markets
- QFIIs can either invest own money or channel client money to invest in China domestic market
- Currently 76 institutions with combined quota of US$12.9bn
- Quota will be increased to US$30bn
- Partial capital account liberalisation – capital inflow
- Restrictions prevail but constraints gradually easing
  - Relaxation of qualification rules
  - Multiple brokerage accounts
  - Investing on behalf of clients
  - Withdrawal of capital

# Current QFII Regulations

- CSRC, PBoC and SAFE Jointly Issued Regulations in August 2006
- Eligibility criteria specified for different types of investor
- Permitted Investments:
  - Listed bonds
  - Listed stocks (A+B shares)
  - Investment funds
  - Warrants
  - Other permitted investments

# Impact on Chinese Capital Markets

- QFII funds delivered excellent returns in 2006 and 2007, but reversed in 2008
- Emphasis on fundamental research
- Introduces discipline to investments
- Important institutional force in a retail-dominated market
- Influence far outweighs its relatively small size
- Expanding, although not as fast as foreign institutions wish
- The investment decisions of QFIIs are closely watched by market participants

# QDII Overview

- Converse of QFII – cash outflow
- Been talked about since 2001 - CSRC vs. SAFE
- April 2006 – PBoC Notice #5, allowing banks, fund managers and insurance companies to invest abroad
- Banking Sector
  - QDII rules revised (CBRC) in May 2007
  - MOUs with HK, UK, Singapore, Japan, US, Korea and Australia
- Fund management and securities companies
  - QDII rules issued (CSRC) in June 2007
  - MOUs with 35 countries
- Insurance sector
  - QDII rules issued (CIRC) in July 2007
  - MOU with Hong Kong (in March 2008)
- Currently 82 institutions with combined quota of US$71.5bn

# Types of QDII

- Pre-QDII institutional investors with existing foreign currency
  - Insurance companies with FX
  - National Social Security Fund (NSSF)

- Real QDII since April 2006 – conversion of RMB into foreign currencies
  - Commercial banks
  - Fund managers
  - Insurance companies
  - NSSF
  - Individuals – possible pilot programme to allow individuals direct investment in Hong Kong-listed securities

# Key Statistics

| Regulators | Types of QDII Institution | No. of Institutions with QDII Status | No. of Institutions with QDII Quota | SAFE Approved Quota (US$ bn) |
|---|---|---|---|---|
| CBRC | Commercial Banks | 24 | 21 | 17.1 |
| | Trust Companies | 2 | 0 | 0 |
| CSRC | Fund Managers | 26 | 10 | 35.0 |
| | Securities Companies | 9 | 1 | 5.0 |
| CIRC | Insurance Companies | 21 | 14 | 14.4 |
| **TOTAL** | | **82** | **46** | **71.5** |

# Market Reception to QDII

- Cool in 2006 and until summer of 2007
  - Stellar A-share markets
  - RMB appreciation expectations
  - Unattractive product designs – structured products, fixed income, too complicated

- Took off in September 2007
  - China Southern, Huaxia, Harvest and Chinese International all launched mega QDII funds, massively oversubscribed

- Cooled again since January 2008
  - Strong appreciation of RMB
  - Global economy slowdown
  - Global stock market slump
  - Underperformance of existing QDII products ( -60% in 2008 )

# Implications of QDII

- Limited initially due to size

- Modest current scope for QDII, big growth potential
  - Expansion in types of investors
  - Expansion in size of outflow
  - Expansion in investment choices

- Destiny of QDII programme
  - Full convertibility of RMB in the long run?
  - Full integration of Chinese market with global markets?

# Section 11: Conclusion

# International Involvement

| | Current | Potential |
|---|---|---|
| Pensions: | very small | large |
| Banks: | small | medium |
| Insurance: | some | medium |
| Fund management: | large | large |

The world needs to recognise that China is rising, and China is not simply a supplier of cheap goods

but increasingly a major source of capital!

# Thank You!

# Questions?