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RBC WEALTH MANAGEMENT

Global Insight

Focus Article

# China: The long march to reform

The drawn-out reform of sprawling state-owned enterprises is accelerating. SOE reform will be at the forefront of President Xi's second term in office, with important implications for China's equity markets and the economy.

Jay Roberts & Yufei Yang

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All values in U.S. dollars and priced as of September 29, 2017, market close, unless otherwise noted.

RBC Wealth Management

Focus article

# China: The long march to reform

Jay Roberts
Hong Kong, China
jay.roberts@rbc.com

Yufei Yang
Hong Kong, China
yufei.yang@rbc.com

The 19th Congress of China's Communist Party will be held October 18–25. This major political event held every five years will see President Xi Jinping consolidate his power heading into the second half of his 10-year term. China watchers will be looking for important economic policy messages, especially ones focused on any acceleration in the reform of state-owned enterprises and the associated reining in of the growth in corporate debt. Market calm prevails at present. The heads of China's brokerage firms have been told not to go on holiday during the Congress.

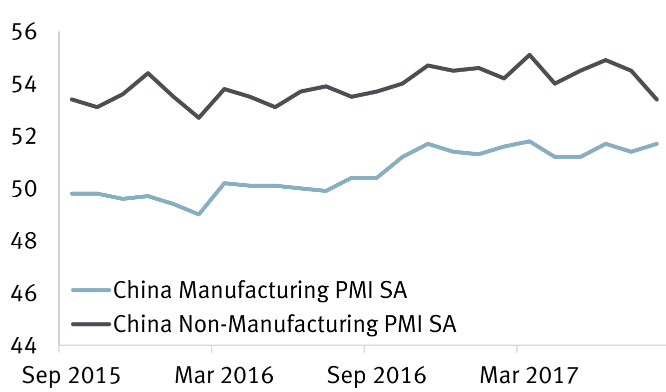
What have investors been focused on for the past year? Not China. The mercurial U.S. presidency has sucked up both attention and column inches. Investors have been focused on the drama in the West Wing, pondering when and if any pro-market election promises become policy. China has been an afterthought. The country did pop up briefly on the market's radar with respect to a possible trade war with the U.S., but that seemed to quickly recede after Xi Jinping's visit to the U.S. in April. More recently, the North Korea issue has brought attention back to China, but equity markets have largely faded the risks.

## Is no news good news?

For many investors, no news from China has been good news. The last time global equity markets corrected, at the start of 2016, China was in the crosshairs. Global equities retreated by 13%, but the Shanghai Composite fell by almost twice as much, 25%, in a matter of weeks.

At that time, some saw this severe selloff as evidence of a failing Chinese economy. In reality, it was more a technical selloff from a hugely overbought peak

### Leading economic indicators for China




The Non-Manufacturing PMI (i.e., services), the larger part of the economy has been steady. The Manufacturing PMI has slowly, but steadily, improved.

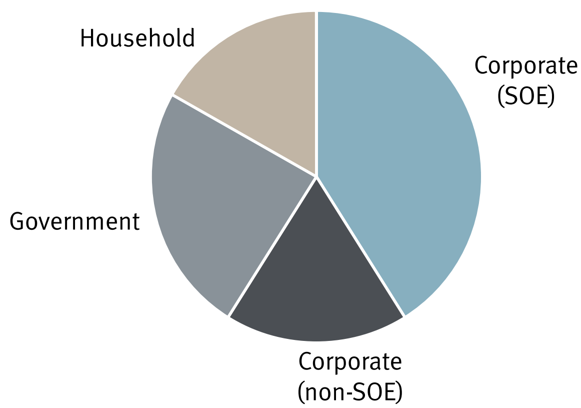
Source - RBC Wealth Management, Bloomberg; data through 8/31/17 though there were red flags that gave credence to the broken-economy thesis: major capital outflows, declining foreign exchange (FX) reserves, and currency devaluation.

The Chinese authorities face an acid test over the next few years as they tackle the large buildup in corporate debt.

Capital outflows, estimated at over $100B per month at one point in late 2015, have moderated significantly, partly in response to a raft of measures to stop money from leaving the country. Reserves have risen for seven consecutive months, and while the currency did weaken by 13% over three years (mostly due to broad dollar strength in 2016), it has regained about a third of that back so far in 2017 and is now within 6% of where it was prior to the August 2015 “mini-devaluation.”

Once again, the Chinese authorities have demonstrated their ability to address economic issues producing losses for speculators and some hedge funds in the process. However, they face an acid test over the next few years as they tackle the large buildup in corporate debt.

China total debt breakdown




China’s debt burden is dominated by the corporate sector, and especially SOEs.

Source - RBC Wealth Management, Moody’s

The bulk of Chinese economic data has been reasonably steady for a while. Leading economic indicators have been stable. Years of producer price deflation ended, helping to boost industrial profits. Renewed strength in parts of China’s complex property market has been met with targeted, local measures rather than the sledgehammer of national policy used in the prior tightening cycle. However, economic data did soften a bit over the summer and that trend may persist.

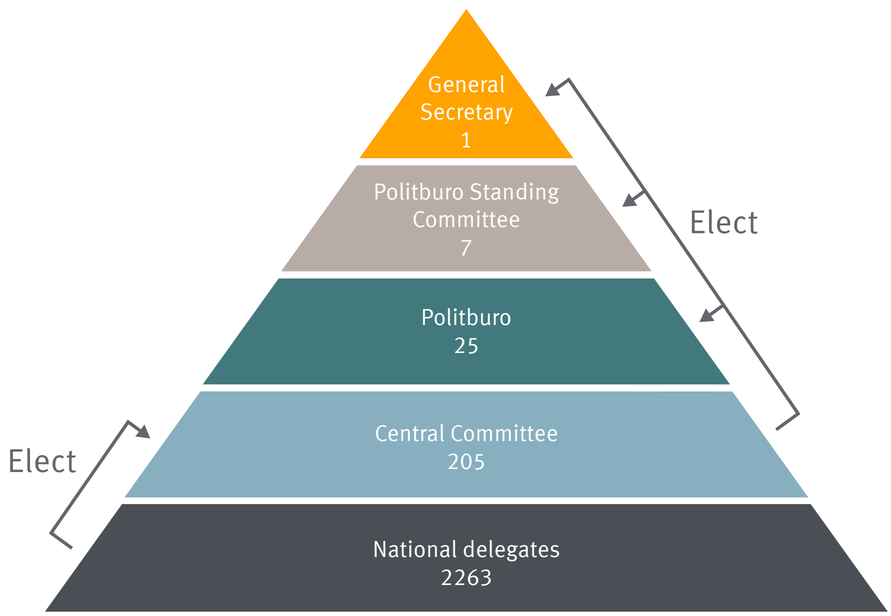
## Preparing for a transition

The 19th Party Congress will be held October 18–25. This is the major meeting of China’s political elite held every five years. The equity market has historically been well behaved going into the Congress but performance thereafter varies.

The Party Congress, with over 2,000 members, is a political event centered on selection of members of the Central Committee (several hundred members), Politburo (25 members), and the all-powerful Politburo Standing Committee (currently seven members). A large turnover in personnel is common. This year, five members of the seven-member Standing Committee may retire, marking major changes at the top. It is also a chance for outsiders to get their first view of potential candidates for president in 2022.

The national delegates elect the Central Committee. The Central Committee elects the Politburo, Standing Committee, and the General Secretary.

The Party Congress – Pyramid of power




Note: Current numbers shown; number of positions at each level may change
Source - www.people.com.cn, RBC Wealth Management

While a political event, President Xi's Political Report will most likely cover important aspects of economic policy:

- The continued shift to a slower, stable pace of growth;
- Dealing with systemic risks including those in the Financials sector (e.g., debt);
- Promoting Xi's hallmark "One Belt, One Road" strategy for building pan-Asian infrastructure ties and trade; and, importantly,
- The continuation of supply-side reform, of which state-owned enterprise (SOE) reform is a key feature.

## A generation of SOE reform ...

Many countries around the world have SOEs of one sort or another, yet they are most commonly associated with China due to its size and political structure. And while China has not been the focus of many investors over the past year, SOE reform has been gathering pace, evidenced by several megadeals. Around 50% of the market capitalization of a prominent equity index, MSCI China, is in SOEs. They dominate the weightings in most sectors, such as Energy, Financials, Industrials, Materials, Telecom, and Utilities.

SOE's dominance in the index is not necessarily reflected in the economy as a whole. For example, the number of private firms dwarfs the number of SOEs in China; the vast majority of people work for private firms, not SOEs; SOEs hold a minority, albeit still a very large amount, of corporate assets these days; and the fastest growing, new economy sectors, such as e-commerce, have very few SOEs. This dislocation between the composition of the Chinese equity market and that of the corporate landscape is arguably the key reason that the path of Chinese equity indexes often seems to be unrelated to broader economic performance.

SOE reform has been an ongoing process over at least the past 20 years, but under President Xi, the authorities have put their foot on the gas pedal.

SOE reform is not new in China. It has been an ongoing process over at least the past 20 years. But under President Xi, the authorities have put their foot on the gas pedal and we expect that to continue in the second half of his tenure. There are several reasons for the acceleration.

### … Has further to run

First, and simply, the current round of SOE reform took shape in 2013 at the start of Xi's turn in power. This has generated pressure to show meaningful results, with that pressure increasing as the 2017 Party Congress has approached.

Second, and similar to SOEs outside China, state enterprises remain less efficient than private enterprises. Efficiency ratios have actually been getting worse partly due to persistent overcapacity in certain industries while some SOE managers may prioritize the firm's size over its profitability. As a result, return on equity was a lowly 5.2% for SOEs in 2016. The combination of declining efficiency and profitability together with increasing debt is clearly unsustainable.

Third, there is open acknowledgement in China of the high growth rate in debt since the financial crisis and a new focus on "financial deleveraging." In China it is the growth in corporate debt which stands out. And SOEs have accounted for most of it. SOE debt is approximately $13T or a crippling 120% of GDP. Total corporate debt is around 170% of GDP. Thus, SOEs account for 70% of total corporate debt, despite being far fewer in number than private enterprises and somewhat smaller in terms of assets. So-called "mixed-ownership reform" whereby new equity capital is attracted to SOEs has been identified as a key way to reduce leverage.

### Committed to the task

SOE reform is no easy task. Some, such as the big banks, the big three energy companies, and the big three telecom companies, are critically important to the workings of the broad economy. Vested interests and political ramifications must also be considered. Also, big SOEs often employ particularly large numbers of people. In short, there is no simple solution, or magic bullet, for reform. Also, the degree of reform required may differ among industries and firms.

Strategies to date include mergers to reduce competition, increase operating efficiency, and create national champions; mixed-ownership to improve corporate governance, introduce private capital, and promote innovation; and reduction of excessive capacity. These strategies may have additional, important benefits: for example, improving operational performance by combining two SOEs will help to manage debt burdens. Recent examples of corporate activity in the pursuit of SOE reforms can be found on the following page.

### Recent examples of corporate activity to enhance reforms

- **Upstream/downstream merger**: In August, Shenhua Group, China's largest coal producer, and Guodian Group, China's second-largest power producer, announced a merger to form the State Energy Investment Co. Ltd. Unlike previous mergers of companies in the same industry, this merger is between companies that are in interrelated upstream and downstream businesses. Most of China's power is derived from burning coal. Coal prices in China are market-driven while electricity prices are largely controlled by the government. This means power plants cannot pass volatile coal prices on to customers. When coal prices rallied strongly in the first half of 2017, profits of coal enterprises surged nearly 2,000% (2016 was a bad year), while earnings for the five largest listed power companies dropped by 70% on average. The new company will have greater control over the entire value chain.
- **Mixed-ownership reform**: The National Development and Reform Commission approved nine SOEs to be the first batch of reform pilots at the start of 2017; 10 more were approved recently as the second batch. In August, China Unicom, China's second-largest wireless carrier and a famous SOE, became the first major SOE to introduce private capital at the group level. The company will sell a 35.2% stake of its mainland China-listed shares to 14 strategic investors, including the four largest Chinese internet companies. Additionally, the reform plan also includes an employee incentive plan, granting 2.7% shares to core staff. Management believes the reform will better align employees' interests with those of investors.
- **Creation of national champions and reduction of competition**: China North Railway and China South Railway, the world's two largest train makers, agreed to merge in 2014. The purpose was to avoid competition in overseas bidding and give them stronger pricing power.
- **Creation of national champions and reduction of excess capacity**: The Baoshan Iron & Steel and Wuhan Steel merger in 2016 created China's largest steel company and the second largest in the world with over $100B in assets. Wuhan Steel had been expanding aggressively before the merger and got into trouble in a market downturn. In 2015, the company posted a net loss of RMB 7.5B with a total debt ratio over 70%. But if part of the goal was to reduce excess capacity, why is China's steel production presently at record high levels? This is an example of how major industry overhauls can take many years to unfold. Currently, China plans to raise the steel industry concentration by increasing the market share of the top 10 steel producers to over 60% by 2025 from 37% in 2014.

Source - RBC Wealth Management

## Too early to tell

Reforming SOEs does not aim to get rid of them, nor does it mean mass privatizations. The government still emphasizes the important position of the state in key industries, which may lead to questions of how successful these reforms can be. But any reform that improves corporate governance and empowers employees by incentivizing the creation of shareholder value will be well regarded by investors. It is too early to judge the long-term success or failure of SOE reform under the current administration, although we can clearly see progress being made.

It is likely the composition of China's equity markets will continue to change, with the market capitalization of more profitable private enterprises increasing as they continue to outgrow their less efficient SOE peers. We believe the relatively new sectors of Technology, the internet, and Health Care all have long runways of growth ahead of them, boding well for index composition. China may have been out of sight lately, but it shouldn't be out of mind. The 19th Party Congress later this month provides an ideal juncture for investors to refocus.

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On the next page is an Appendix comparing the different compositions of China's two stock exchanges, Shanghai and Shenzhen, that sheds light on China's so-called two-speed economy as well as the excessive weighting to SOEs, particularly in the Shanghai Stock Exchange.

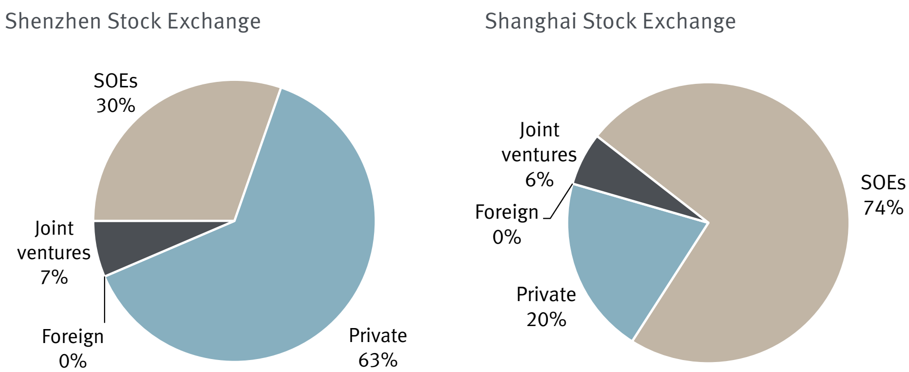
The China narrative should be reframed by looking through the "new economy" lens.

## Appendix: The two-speed stock exchanges

The different histories of China's two stock exchanges, Shanghai and Shenzhen, somewhat reflect the country's "two-speed" economy. This is a simplistic classification that broadly separates China's "old economy," such as heavy industry, and its "new economy," such as technology and health care. There is still a tendency to view China through the old economy lens (e.g., scrutinizing electricity demand) rather than the new economy lens (e.g., the growth in parcel delivery due to e-commerce). This narrative should be reframed, although the old economy performance and indicators are still vitally important.

The Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE) opened in 1990, yet they are already among the world's largest exchanges. There are 3,385 companies listed with a combined market capitalization of $8.7T, second only to the U.S. Shanghai is $5.0T and Shenzhen is $3.7T. Yet their composition and characteristics differ markedly.

### Market capitalization of listed companies




Source - Wind

When China set up its stock market just 25 years ago, a major objective was to solve the financing problem of state-owned enterprises (SOEs). Unsurprisingly, most of the first listed companies were state-owned and Shanghai was the place to list. Today, the core of the Shanghai market, with 1,342 listed companies, remains large-cap SOEs, accounting for approximately 74% of the market capitalization.

Shenzhen, a city of approximately 10 million people just to the north of Hong Kong, was originally set up as one of China's special economic zones and thus has a very active private sector. A number of China's private enterprise giants began life and are headquartered in Shenzhen, including Tencent, Huawei, Ping An Insurance, and Vanke Property. More recently, there has been a wave of innovative start-ups listing in Shenzhen. In all, there are 2,039 companies listed.

SOEs account for only 30% of Shenzhen's market capitalization. That figure should decline further due to the better growth in private firms and more private firms listing. The Shenzhen Exchange has been more supportive of small and medium-sized enterprises (SMEs) via the development of the Small-Mid-Enterprises Board (SME Board) and also the Growth Enterprise Market Board, more commonly

Outsized new economy growth points to significant pockets of largely unheralded expansion in China.

referred to as ChiNext. Consequently, the SME Board surpassed the Main Board in terms of both the number of listed companies and total market capitalization in 2015.

Sector allocations are quite different between Shanghai and Shenzhen. Financials, Industrials, and Energy are the biggest components of the Shanghai Composite Index, accounting for 29.6%, 18.3%, and 10.5%, respectively. PetroChina and Industrial and Commercial Bank of China (ICBC) alone account for nearly 9% of the index. By contrast, the top three sectors of the Shenzhen Composite Index are Industrials (21.5%), Technology (20.2%), and Consumer Discretionary (16%). For ChiNext, Technology companies account for almost 40% of the index.

## Technology & innovation

After the Global Financial Crisis, China increased focus on the upgrading of its industrial base and on innovation. An important component of this was the establishment in 2009 of the ChiNext Board. Companies must be identified as innovative, growth enterprises in order to obtain approval for listing. There are 692 companies listed on the ChiNext Board with a total market capitalization of RMB 5.54T ($840B). The creation and growth of ChiNext has also helped activate China's venture capital market. A significant minority of the world's so-called "unicorns" (a start-up valued at over $1B) are from China, in fact second only to the U.S.

## Slowing down or speeding up?

The deceleration of economic growth in China is by no means universal across industries. The new economy companies that dominate the ChiNext Board, from industries such as media, electronics, environmental protection, and logistics, posted revenue growth of 20%, 23%, 30%, and 34% in 2013, 2014, 2015, and 2016, respectively. ChiNext companies' operating profits rose 30% in 2015 and 38% in 2016, powered by the Technology sector.

These outsized figures point to significant pockets of largely unheralded expansion in China. And they even show acceleration during a period when all the talk has been of the opposite. Revenue and earnings growth in 2016 were the highest in six years. Companies on the Shenzhen SME Board have also been posting growth that has diverged from the traditional narrative. Revenues grew by 17% in both 2015 and 2016, earnings by 11% in 2015 and 30% in 2016.

Before we all rush out to buy "new China" stocks, a note of caution on valuations. Rapid growth of these businesses is already captured in what investors pay for them. The SME and ChiNext Boards trade at price-to-earnings multiples of 44x and 54x, respectively (compared to 18.1x for the Shanghai Main Board).

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Kelly Bogdanov – Co-chair; Portfolio Analyst, RBC Wealth Management Portfolio Advisory Group – Equities, RBC Capital Markets, LLC

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Mark Bayko, CFA – Head, Portfolio Management, RBC Dominion Securities Inc.

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Janet Engels – Head of U.S. Equities, RBC Wealth Management Portfolio Advisory Group, RBC Capital Markets, LLC

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Christopher Girdler, CFA – Fixed Income Portfolio Advisor, RBC Wealth Management Portfolio Advisory Group, RBC Dominion Securities Inc.

Jack Lodge – Associate, Structured Solutions team, Royal Bank of Canada Investment Management (U.K.) Limited

Patrick McAllister, CFA – Canadian Equities Portfolio Advisor, RBC Wealth Management Portfolio Advisory Group – Equities, RBC Dominion Securities Inc.

Jay Roberts – Head of Investment Solutions & Products, RBC Wealth Management Hong Kong, RBC Dominion Securities Inc.

Alan Robinson – Portfolio Analyst, RBC Wealth Management Portfolio Advisory Group – Equities, RBC Capital Markets, LLC

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Additional *Global Insight* authors:

Yufei Yang – Associate Portfolio Adviosr, RBC Wealth Management Hong Kong, RBC Dominion Securities Inc.

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