INVESTMENT
research

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by Mathieu L'Hoir and Aidan Yao
Research & Investment Strategy

News on Chinese equities

We are more constructive on Chinese A-share markets

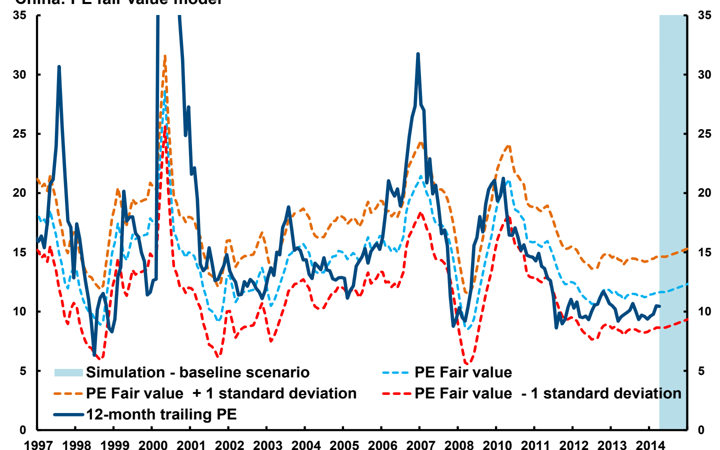
Key points

- Recent developments have made us more constructive on Chinese equities and we now recommend holding Chinese stocks in portfolios.
- From an earnings perspective, the government is accelerating corporate-sector reform. If successful, this should lift the competitiveness and profitability of state-owned enterprises, while creating a level playing field that fosters growth and efficiency in private-sector companies.
- From a valuation perspective, moves to rebalance the Chinese economy and deflate the asset price bubble are helping to reduce the equity market risk premium. Liberalisation of the capital account, through the HK-SH Stock Connect scheme, is expected to boost liquidity in A-share markets, assisting the re-rating process.
- There are tentative signs that Chinese banks are starting to deal with their non-performing loans through asset sales, capital raising and cooperation with "bad banks". Further movement in this direction could help remove uncertainties and boost valuation of equity markets.

Exhibit 1

The Chinese stock market is still 10% below fair value

China: PE fair value model



Source: IBES, MSCI, Bloomberg, Datastream and AXA IM Research

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We have been negative on Chinese equities until recently. However, **recent developments have made us more constructive on Chinese equities and we now recommend holding Chinese stocks in portfolios**.

Why we were negative on Chinese equities

We have been advocating caution on Chinese equities for some time, mainly for two reasons: weak and decelerating earnings growth amid rising concerns about cyclical momentum, and increasing doubt about financial stability. The latter has weighed on Financials, leading to a significant de-rating of Chinese equities, to the point that they now trade at a 40% discount compared to Global equities based on 12-month forward PE – a level not seen since early 2000.

With regards to earnings, the **GDP growth premium has not been reflected in the earnings growth premium**. Three factors have weighed heavily on EPS growth. First, Chinese companies' margins have deteriorated due to the predominance of state-owned enterprises (SOEs) - implying a lack of competition and weak incentives to improve profitability - and a loss of competitiveness, with wages increasing faster than productivity, especially in lower-range products. Second, because Chinese companies have developed highly operationally-leveraged businesses, relying heavily on sales and asset turnover to generate earnings, they are extremely vulnerable to a deceleration of economic activity. Accordingly, the economic slowdown has resulted in poor sales growth (Exhibit 2).

Exhibit 2

Top-line growth and margins have been under pressure

Source: MSCI, Bloomberg and AXA IM Research

Third, the dilution effect on EPS due to the high level of issuance, i.e. new shares coming onto the market, has been significant, owing to the limited size of the corporate bond market. Measuring dilution by comparing the market cap of the MSCI China to the price level of this index shows a dilution rate of 4% p.a. since 2012, vs. 0.3% in the US.

We were especially cautious on Chinese Financials, and more specifically on banks and real estate developers, which represent a large share of Chinese equities (40% of total market cap of the CSI 300). First, strong credit growth, mostly in the shadow banking system, raised fears of a credit crisis, with the threat of a sharp increase in non-performing loans (NPLs) from low official levels, forcing banks to write off part of these non-performing assets or engage in distressed selling of assets. We were particularly concerned about the risk posed by the surge of banks' off-balance sheet lending, e.g. wealth management products. Second, the slumping property market put property developers under pressure, with the risk of a spillover to banks.

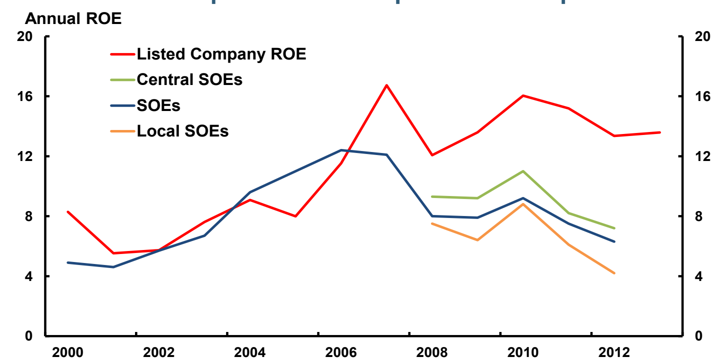
In our view, **many of these concerns have materialised and been factored into market expectations**. In the remainder of this note, we will discuss recent developments that have made us incrementally more constructive on Chinese equities.

SOE reforms to lift corporate profitability

From an earnings perspective, to fundamentally improve the performance of A-share listed companies, in which SOEs are over-represented[1], the government needs to push ahead with corporate-sector reforms. Despite the various privileges enjoyed by SOEs in terms of accessing cheaper credit and state resources and in facing fewer market restrictions, common measures of operating performance, such as profitability, asset returns, productivity and leverage, suggest that SOEs have still significantly underperformed private-sector listed companies in recent years (Exhibit 3).

Exhibit 3

SOEs have underperformed their private-sector peers



Source: CEIC and AXA IM Research

Encouragingly, **the government is taking decisive action to push ahead with corporate-sector reform by restructuring the SOE sector and unbridling private-sector enterprises**. On the first point, central and local governments recently announced a number of policy initiatives, including developing mixed ownership, encouraging asset sales, improving corporate governance and changing management structures. Some local governments also published explicit execution timelines, trying to fend off concerns about a lack of implementation. The aim of these initiatives is to realign the

[1] SOEs account for over 60% of market capitalisation. In some industries, such as energy, utilities and banking, which are traditional strongholds of SOEs, concentration can exceed 95%.

operational practices of SOEs with market standards, with reduced political influence, so as to improve their efficiency, competitiveness and profitability**.**

Besides the SOE reforms, **the government has also been removing rules and regulations that restrain the growth of private-sector companies**, trying to create a level playing field. According to Premier Li Keqiang, administrative approvals have been abolished for over 600 items since the new government took office two years ago. This has led to explosive growth in new business registrations, which jumped over 50% yoy in 2013, and another 60% for the first eight months of this year. In addition, new policy initiatives and reforms are being taken to realign the accessibility and cost of resources for private companies vis-à-vis SOEs, such as 1) interest rate liberalisation and the PBoC's targeted policy easing measures, which improve the accessibility and lower the cost of credit for SMEs; 2) fiscal reforms and encouragement of Private-Public-Partnerships, which allow private capital to access official projects; 3) SOE reforms, which reduce the market barriers for private companies to enter monopoly industries; and 4) numerous initiatives have been announced and implemented to support "new strategic industries", which, coupled with increased investment in research and development, should help the Chinese economy move up the value chain and allow listed companies to reduce operating leverage and increase profit margins.

Measures to reduce the liquidity premium

Moves to liberalise China's capital account are expected to increase liquidity in A-share markets. The upcoming Shanghai-Hong Kong Stock Connect programme has stirred significant excitement among offshore investors wanting to gain exposure to A-shares. Low valuations make Chinese equities attractive for long-term investors. Domestically, the recent market rally has reignited investors' interest in equity markets, with trading volumes and equity-account openings rising to multi-year highs. From a structural perspective, changing the relative attraction of domestic investment options may add to equity market inflows. In particular, a prolonged housing market correction coupled with tighter regulation of shadow banking, affecting wealth management products (WMPs), might have already started a capital migration from housing and WMPs to equity markets. Such a structural shift should be welcomed by the authorities and may accelerate the re-rating process for A-shares (cf. below).

Some signs that banks are tackling NPLs

The latest bank earnings reports showed a continued rise in NPLs and further declines in operating margins. However, the official NPL ratio is still barely above 1%, which, in our view, grossly under-estimates the balance sheet problems in the banking system. We see this as a Damocles sword hanging over Chinese equities. Having said that, there are tentative signs that banks may be starting to deal with the NPL problems by selling assets and issuing preferred shares to boost capital positions. In addition, recent fund raising activities by some asset management companies – so called "bad banks", which were created in late 1990s to remove NPLs from banks – have caught investors' attention, suggesting they may be called upon again to help banks cleanse their balance sheets. Although evidence for this line of argument is still patchy and sparse, making it difficult to ascertain whether the NPL disposal process has indeed started, equity markets have already priced in a lot of bad news from banks, reflected in their rock-bottom valuation. We think even though "bad bank" involvement cannot be completely guaranteed on the existing evidence**, the fact that banks are shrinking their shadow banking exposure and actively raising capital to shore up balance sheets is incrementally positive for their equity prices and the wider market**.

What to expect in the next 12 months?

As mentioned, **these changes should impact Chinese equities mainly through two channels: 1) a reduction of the risk premium, which should help Chinese equities to re-rate and converge toward their fair value in the short term; 2) a reassessment of earnings growth which should lift their fair value in the medium term**.

With regards to earnings growth, a significant risk of deceleration is already incorporated in market expectations, leaving room for positive surprises. The consensus expects EPS to grow by 10% over the next 12 months, in line with global equities, despite a significant nominal GDP growth premium in favour of China. This shows that market participants expect a further deterioration in corporate profitability, in a context of still tight financing conditions and a labour shortage, and have priced in the fact that economic activity has already peaked. However, the measures and reforms to reduce the cost of funding, increase total factor productivity and improve SOE profitability should help to stabilize profit margin expectations. Interestingly, the last three months have seen consistent upward revisions to the estimates, meaning that **the consensus has gone too far in downgrading its views. Further upward earnings revisions are likely, which should support equity performances**.

However, we think the most important driver of Chinese equities returns in coming months will be the partial normalisation of the risk premium. The market has gone too far in its assessment of the price of risk, even if significant challenges remain in the medium/long term. As a result, the implied equity risk premium over 10-year Chinese bond yields is now 0.75 standard deviations above its long-term average despite rising bond yields (Exhibit 4).[2]

At the same time our dividend discount model reveals that despite rebounding significantly since May, Chinese stocks

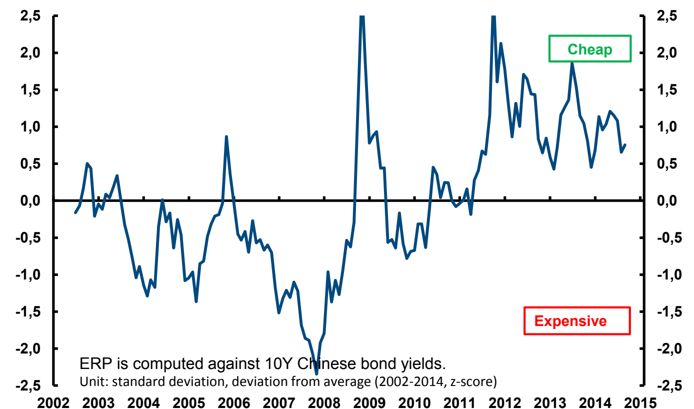
are still undervalued by more than 10% compared to the level implied by their current fundamentals (Exhibit 1).

We therefore expect two effects: first that **the market will close the gap with current fair value, at least partially, helped by improved market liquidity; and second that fair value itself will move progressively higher as investor sentiment improves with regard to the achievability of growth targets and the stability of the financial system**.

This is likely to be a slow motion process, but factoring in all these elements, **we think that the Chinese market could deliver between 5% and 10% total return (i.e. including dividends) over the next 12 months, which justifies having Chinese stocks in portfolios.**

Exhibit 4

The equity risk premium remains elevated



Source: IBES, MSCI, Bloomberg, Datastream and AXA IM Research

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[2] We use our dividend discount model to estimate Chinese stocks' PE fair value and equity risk premium. This model links the earnings yield to future earnings growth expectations and to the discount factor corresponding to the market's required rate of return. We use the average pair-wise correlation of Chinese stocks and the distance between China real GDP growth and a 7% threshold to account for changes in the risk premium. We extract the resulting discount rate from current multiples, and the ERP is obtained by subtracting the 10-year Chinese bond yield from this discount rate.