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China Equities

CHINA'S ALPHABET SOUP—MAKING SENSE OF MSCI'S A-SHARE ANNOUNCEMENT

KEY POINTS

- Index provider MSCI recently announced that, from 2018, it will begin including China's A-share stocks within its standard country and regional index series.
- While the MSCI China Index has historically included China B-shares and offshore-listed share classes, China A-shares have been excluded from the MSCI China Index (and hence, the global indices that use the MSCI China Index as a component) due to restrictions on foreign investor access.
- While regulators in China have sought to liberalize their capital markets in recent years by providing foreign investors with restricted access to China A-shares, the move by MSCI represents a significant milestone in China's capital market development.
- The China A-share market is home to a number of high-quality companies that are simply not available to offshore investors. Some of these companies are often overlooked by local investors as they are perceived as too boring. As such, they tend to trade at reasonable multiples, in our view, despite their high-quality and durable growth characteristics.

On June 21, 2017, after several years of consultation, index provider MSCI announced that it would begin including China's A-share stocks within its standard country and regional index series. This added ingredient into the MSCI China Index represents a significant milestone in China's capital market development. With this in mind, investment managers need to be asking this question: Are we ready for such a change?

China's equity markets are split into a number of different share classes depending on whether the stocks are listed onshore or offshore, their denominated currency, their place of incorporation, whether they are government owned or private, and the city of listing. Historically, the MSCI China Index has included the offshore-listed share

Figure 1: **China Share Class Alphabet Soup**

Mix A + B + H + Red-Chips + P-Chips + Overseas = 3,930 stocks[1]

Index	Share Class	Definition	Number of Stocks	Exchange (Currency)	Foreign Investors Access
MSCI China A	A	China securities incorporated in mainland China, listed on the Shanghai or Shenzhen Stock Exchanges and traded in renminbi (RMB).	1,173 1,753	Shanghai (RMB) Shenzhen (RMB)	Northbound Stock Connect (CNH) RQFII (CNH): all securities QFII (RMB): all securities
ONSHORE	B	China securities incorporated in mainland China, listed on the Shanghai Stock Exchange in U.S. dollars (USD) and Shenzhen Stock Exchange in Hong Kong dollars (HKD).	51 43	Shanghai (USD) Shenzhen (HKD)	No restrictions
OFFSHORE	H	China securities incorporated in mainland China, listed on the Hong Kong Stock Exchange (HKD).	139	Hong Kong (HKD)	
MSCI China	Red-Chips	China securities of state-owned companies incorporated outside mainland China, listed on the Hong Kong Stock Exchange (HKD).	90	Hong Kong (HKD)	
	P-Chips	China securities of nongovernment-owned companies incorporated outside mainland China, listed on the Hong Kong Stock Exchange (HKD).	484	Hong Kong (HKD)	
	Overseas (N and S)	China securities (including American depository receipts) incorporated outside greater China (mainland China, Hong Kong, Macao, and Taiwan) and listed on the NYSE Euronext—New York, NASDAQ, NYSE AMEX (N-shares)—traded in USD and the Singapore exchanges (S-shares) traded in Singapore dollars (SGD).	131 66	New York (USD) Singapore (SGD)	

[1]Sources: MSCI and Goldman Sachs; as of June 22, 2017.

classes as well as B-shares, and there have been no restrictions on foreign ownership in these categories. China A-shares, however, have been excluded from the MSCI China Index (and hence, the global indices that use the MSCI China Index as a component) due to restrictions on foreign investor access.

In recent years, regulators in China have sought to liberalise their capital markets. Through the Qualified Foreign Institutional Investor (QFII), renminbi QFII (RQFII), and Stock Connect programs, foreign investors have gained some access to the A-share market through quota and trading systems. However, the June 21 announcement formally establishes greatly improved access, beginning a process that could potentially transform global equity index composition over the next decade.

WHAT IS HAPPENING?

MSCI announced that it would add the first allocation of mainland China A-shares into its indices in two tranches: one at the end of May 2018 and one in August 2018. This will impact all indices that include the MSCI China Index as a component, including, for example, the MSCI AC Asia ex Japan Index, the MSCI Emerging Markets Index, and the MSCI AC World Index. MSCI will initially include only a small subset of the full A-share universe. Of the 2,926 A-shares currently available,* 222 are expected to be included from 2018. These initial 222 stocks are large-cap companies available through the Stock Connect program and have not been subject to any prolonged suspensions over the last 12 months. MSCI will apply a 5% inclusion factor (IF)—a 2.5% IF applied at each of the May and August updates—a figure representing the approximate percentage of the A-share market available to foreign investors.

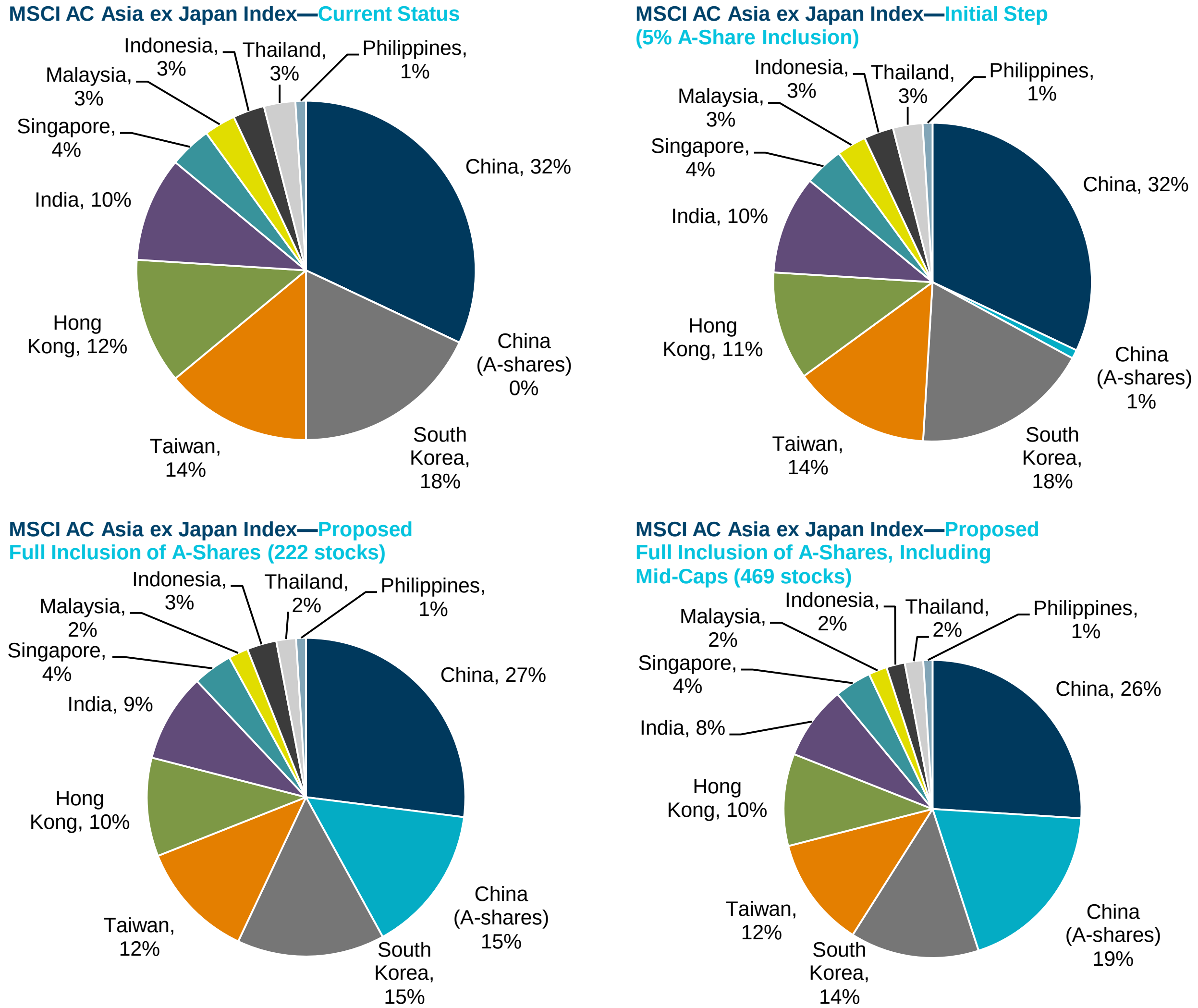
Over time, we anticipate that China's weighting in global indices will gradually increase. Changes could be driven by two key variables: (1) market access will push up the IF and (2) MSCI's methodology may revert to its standard

*As of June 22, 2017.

global system, thereby bringing more mid- and small-cap companies into the benchmark. Looking ahead over the next 10-plus years, China A-shares could potentially come to represent a very large part of the global index.

Following the initial 5% IF, China A-shares will still only represent approximately 0.9% of the MSCI AC Asia ex Japan Index. However, at full inclusion (100% IF) and with the universe expanded to include mid-cap stocks, China A-shares could make up around 19% of the MSCI AC Asia ex Japan Index.[2] China's overall weighting in these indices would also rise sharply. It is important to note that these are estimates only, based on today's index weights, and that this level of change is likely to occur over the next decade or more.

Figure 2: **The A-Share Impact—MSCI AC Asia ex Japan Index**



Source: MSCI as of June 22, 2017.

A-SHARE OPPORTUNITIES

For many foreign investors, the A-share market conjures up thoughts of retail-led boom-and-bust bubbles. But the reality is that it is also home to a considerable number of very high-quality companies that are simply not available to investors in the offshore markets. Broadly, we find these opportunities in the following categories:

[2]Source: MSCI; data as of June 22, 2017.

- *Unique consumer franchises*—the A-share market is home to some of China's leading consumer brands, companies with long heritages and strong market positions. Key categories include alcohol, dairy products, home appliances, health care, and traditional Chinese medicine.

- *Technology leadership*—high-end industrial companies that are leading China's technological upgrade. Key categories include industrial automation, equipment/machinery, and environmental protection.

- *Strategic assets*—businesses that benefit from government policy support and often have near monopolistic positions. Key categories include infrastructure, duty-free, and defense.

We find that these companies are often forgotten or overlooked by local retail investors as they are perceived as too boring. As such, they tend to trade at reasonable multiples, in our view, despite their high-quality and durable growth characteristics.

CHINA A-SHARE EXAMPLE—YUNNAN BAIYAO

The company produces "Baiyao," a traditional Chinese medicine (TCM) blood coagulant that has been in existence for over 100 years and is one of the most trusted brands in China. The Baiyao formula is designated as a state secret. The company also distributes TCM and pharmaceutical products and has a consumer goods business, including the second largest-selling toothpaste in China. Another interesting aspect is that Yunnan Baiyao, which is a state-owned enterprise, has been at the forefront of reform in this area. Late in 2016, Yunnan Baiyao announced that a private company had taken a 50% stake in its parent company. We anticipate that this "mixed ownership" model will become increasingly prevalent in China over time.

WELL VERSED AND READY

At T. Rowe Price, idea generation and portfolio construction have never been tied to the vagaries and changeability associated with index providers. A number of our strategies and/or funds have been investing in the A-share market since 2009 when we received a QFII quota, with the T. Rowe Price Asia Opportunities Equity Strategy similarly investing in the market since its launch in May 2014. Since 2015, we have been making use of the Stock Connect program for most of our access, and we anticipate that this will remain our primary trading channel going forward.

We have formal research coverage of a number of A-share companies, and we will focus on continuing to grow that coverage over time. Under our sector-aligned research model, most analysts on the Asian team are already looking at the China A-share market as part of their regional opportunity set. However, we also now have two analysts dedicated to looking for stock opportunities in the A-share universe. Our goal will never be to cover all 2,926 A-share companies but, instead, it will be to focus on a smaller subset of liquid, high-quality companies.

As of July 31, 2017, the T. Rowe Price Asia Opportunities Equity Strategy's exposure to China A-share companies represented 5.98% of the total portfolio. Looking forward, we are well placed to accommodate the upcoming change to our relevant MSCI benchmarks.

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