



China A-Shares... Concealed Value

July 2017

While the EM peer group is abuzz with the accession of Chinese mainland listed equities (A-Shares¹), investors interested in absolute returns should be focused on how to balance the opportunity in Chinese mainland stocks against the relative value of H-shares² given the backdrop of capital controls on the mainland. Rothko's models indicate that, although top-down valuations of A-shares look high, opportunities do exist in the huge and inefficient Chinese market. We explain here the bottom-up opportunity in the face of stretched top-down valuations and the more subtle risks involved in extracting that value.

Concealment Beneath the (AH) Premium

Rothko's approach benefits from the inefficiencies created by informational and behavioural barriers, many of which exist in international markets. One such barrier is illustrated by the Hang Seng AH premium index; which screams, "A-shares are overvalued" (see Exhibit 1 and 2). We will describe that this is a blinkered reflection of the A-shares market.

Of the approximately 1,480 equities available for foreigners to trade on the Shanghai and Shenzhen exchanges through the Connect³ scheme, only around 220 will be added to MSCI indices⁴ and only 96 of these have a dual listing in A and H shares markets. It is only this small number of names that feature in the *Hang Seng AH Premium Index*.

While these equities do bear a trivial resemblance to the Chinese domestic market (median market cap of USD6 billion, names concentrated in Financials (23) and Industrials (33) sectors), this is a spurious reality. We note that the A-shares market is one of the largest and most varied equities markets in the world, separated from global capital flows by liquidity barriers dominated by retail volumes and with <5% participation by foreign investors (MSCI, 2017). It would be surprising if opportunities did not exist for disciplined value investors that could reach into all corners of this market. Rothko is able to achieve this scope using our powerful systematic modelling pipeline.

Exhibit 1: Hang Seng AH Premium Index; A Shares Expensive

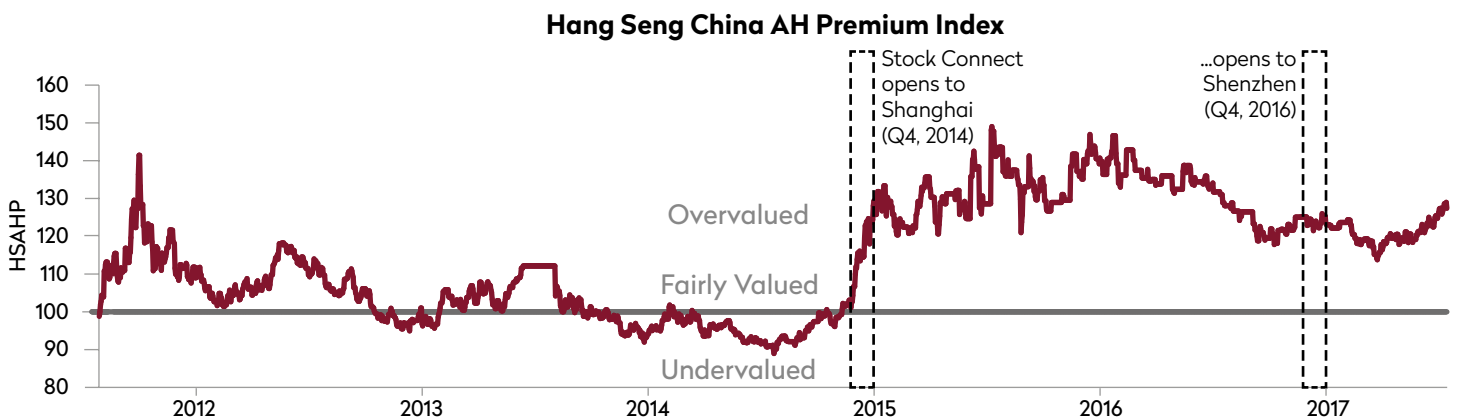


Exhibit 2: Side-by-side: A Versus H

Exchange	No.	Median Market Cap USDbn	Median PE	Median DY (%)	Median PB
Class A	96	10.04	20.46	1.20	1.90
Class H	96	6.43	12.46	1.56	1.05

Source: Factset, Rothko Investment Strategies, MSCI, HangSeng.

¹China A shares are Chinese companies incorporated in mainland China and listed on the Shenzhen or Shanghai exchanges.

²China H shares are Chinese companies incorporated in mainland China but listed on the Hong Kong exchange.

³Connect is a quota controlled scheme to allow foreign investors to access mainland Chinese stocks via Hong Kong, (without needing special status such as QFII). Shanghai was "connected" in Q4, 2014 and Shenzhen in Q4, 2016. Around 1,500 mainland listings can be traded from Hong Kong, settled in off-shore yuan (CNH). More detail can be found here

⁴MSCI elected in June 2017 to include 222 domestic Chinese stocks in their global EM benchmarks from June 2018. This takes June's Chinese weight in the MSCI EM Index from 28.6% to 29.3% (0.7% addition), with A-shares being initially weighted down to beneath their market cap weight in the index.

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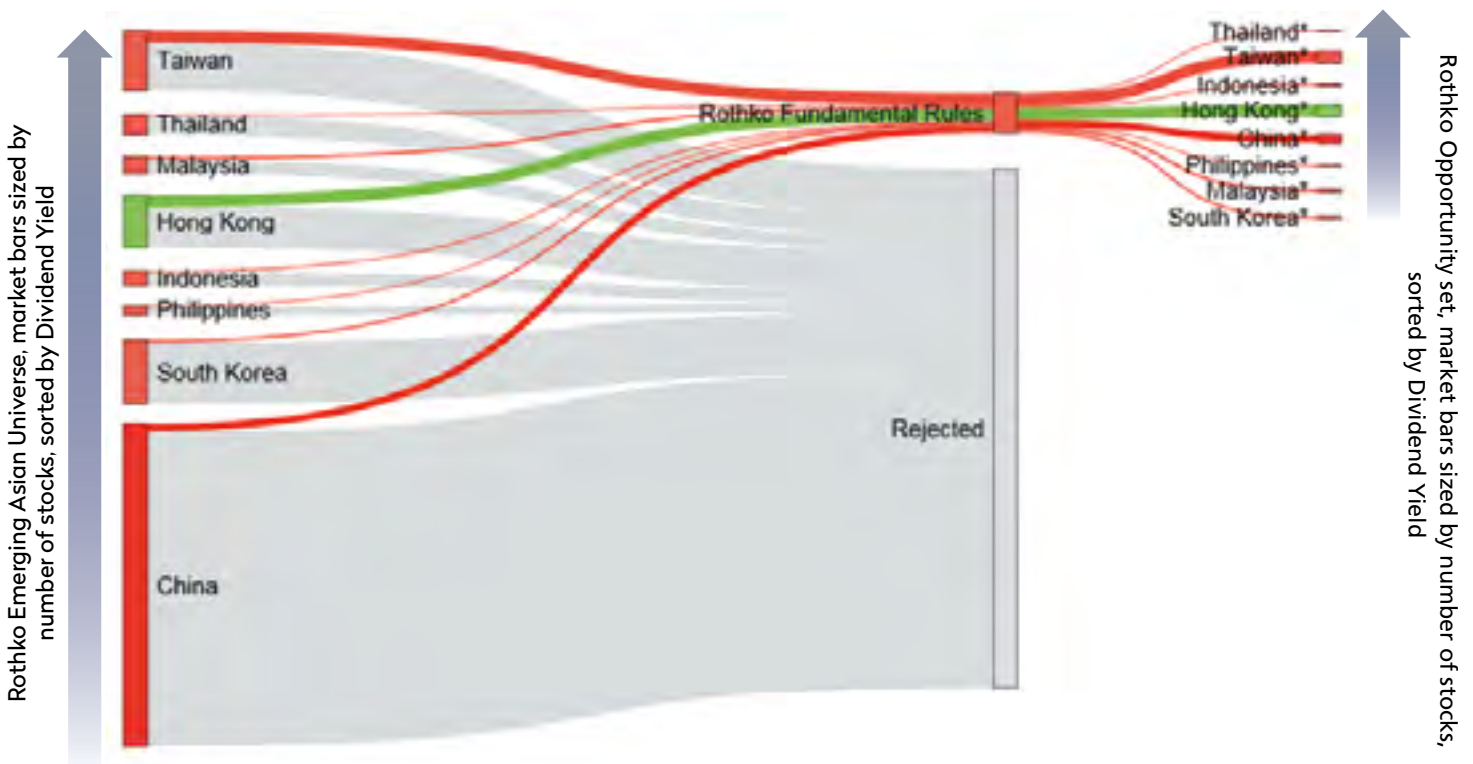
Rothko's A-Shares Picks: Nascent Bottom-Up Value

Almost by virtue of its size alone, there is value to be found in the A-shares market. While Chinese mainland listed equities look poor value from a top-down perspective, Rothko's models can identify value from the bottom-up. Exhibit 3 (left hand-side) shows that median dividend yields (and PEs) for Hong Kong listed stocks in the *Rothko EM Asia Universe* are more attractive than those for "China" listed stocks.

However, if we remove stocks from this universe that have poor valuations, earnings and capital structures – by applying Rothko's

Fundamental Rules – the picture is very different. Exhibit 3 (right hand-side) shows that in this select subset, Rothko's selected mainland stocks offer a similar dividend yield to Hong Kong stocks but with a superior dividend cover; two of a number of characteristics that contribute to future income potential in USD terms as our models define it. What is also notable is that mainland stocks are the 3rd most numerous in the opportunity-set (after Taiwan and Hong Kong). Conclusion: There is nascent bottom up value in A-shares.

Exhibit 3: Rothko Uncovering Value in A-shares: Emerging Asia Universe (left) to Opportunity-Set (right)



Note: Vertical bars are sized by number of stocks in the Rothko Emerging Asia Universe (left) and in the Rothko Emerging Asia Opportunity-set (right). The items are sorted by the median value of country dividend yield in the universe (left) and the Opportunity set (right). We point out that China (mainland) has the highest number of stocks of all Asian markets and almost 50% of the total outstanding equities in Emerging Asia. We also show here that the Rothko approach identifies a large proportion of Chinese stocks in the Rothko Opportunity-set (right).

*The relative size by number of stocks in each Country of the Rothko Opportunity-set.

Source: Rothko Investment Strategies, MSCI, Factset.

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Chinese “Command Capitalism”: Capital Controls, Liquidity and Suspensions

“Liquidity barriers” are a material contributor to return characteristics in International Equity markets, an inefficiency Rothko has been able to exploit. China’s “managed” capital account is one such inefficiency but there are risks to be considered.

Capital flight in China is something that the authorities do not abide. One measure of “flight” and perhaps the probability of the authorities stepping up capital controls, is given by falls in FX reserves. In a stylized sense, when capital moves out of China, the People’s Bank of China (PBOC) would sell US dollars to support the renminbi. Should there be a sharp fall in FX reserves, foreign investors should be wary of the Chinese authorities imposing capital controls and that might include hampering dividend payments or potentially limiting the liquidity quota for the Connect scheme. While the decline in FX reserves has abated this year, it is still down by USD150 billion in the 12-months ending June 30, 2017 (PBOC & SAFE) and this indicates that investors should remain cautious.

The second area of concern is voluntary trading suspensions and the “liquidity traps” they create. China A-shares suffer the highest level of trading suspensions of any world market. Despite reforms, over 100 names have been suspended this year so far. This is clearly an additional risk to consider.

The question for foreign investors is, will the authorities be tempted to lean harder on exchange controls⁵ if things turn for the worse in the future and will Chinese corporate management continue to be allowed to impose liquidity traps on investors? We believe the potential value in the A-shares market mitigates both these effects but investors should note that a conservative and risk aware investment approach – such as Rothko’s – is critical for an investment in A-shares.

Rothko: Watching and Waiting

Rothko’s strategy is diversified across country, sector and single stock and we believe we are well poised to benefit from a move into mainland Chinese stocks, should our models compel it, while extracting value from the Hong Kong market. We believe this orientation will allow the Rothko Emerging Markets All Cap Equity Fund, L.P. to continue to extract value from EM Equities in Asia, while continuing to provide defensive characteristics and strong upside capture over time.

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Mondrian Investment Partners Limited
Fifth Floor, 10 Gresham Street, London EC2V 7JD, UK
London +44 207 477 7000
Philadelphia +1 215 825 4500
www.mondrian.com

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