Dadao Capital

Overview of the Chinese Stock Market

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OVERVIEW OF THE CHINESE STOCK MARKET

The Structure of Mainland China is made of two major stock exchanges, Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE). More than 1572 companies are listed on SSE with a market capitalization of 7.62 trillion USD as of July 2021 and more than 1673 firms are listed in the Shenzhen Stock Exchange with a market capitalization of 5.59 trillion USD as of July 2021. The products traded on these exchanges are stocks, fixed-income securities or bonds like the treasury bonds, corporate bond, convertible bond and local government bonds, funds like the ETF, close-ended fund, open-ended fund and money market fund, and derivatives like warrants, stock options (ETF50 option) and index futures.

The Chinese domestic stock market was introduced in 1990, both Shenzhen and Shanghai stock exchanges underwent rapid growth. Another stock exchange of China is in Hong Kong, which majorly focuses on the equities of the local based firms, but now mainland companies can enter Hong Kong exchange through “H-shares”. The H-shares can’t be traded on mainland China normally, neither can they be converted into other stocks that could be traded in mainland China. Hong Kong Stock Exchange is quite crucial as mainland Chinese firms heavily rely on Hong Kong Stock Market as they have access to the foreign capital. The Shenzhen and Shanghai stock exchange cater to mainland companies in SMEs, high-tech firms, and big firms. It is open to foreign investors that possess a special license like QFII or RQFII. The ranking of the stock markets by Market Value is shown below.

Rank	Exchange	Market Value (USD)
#1	NYSE, United States	$25.87T
#2	Nasdaq, United States	$22.53T
#3	Shanghai Stock Exchange, China	$7.62T
#4	Euronext, Europe	$7.17T
#5	Japan Exchange Group	$6.6T
#6	Hong Kong Exchanges	$6T
#7	Shenzhen Stock Exchange, China	$5.59T
#8	London Stock Exchange, UK & Italy	$3.8T
#9	TMX Group, Canada	$3.16T
#10	National Stock Exchange of India	$3.14T

Market Capitalizations as of July 2021, Source: Statista, SSE & NYSE

A Shares

The A share stocks are traded in mainland China, specifically the Shenzhen Stock Exchange (SZSE) and the Shanghai Stock Exchange (SSE). Initially, these shares were only available for Chinese citizens due to the restrictions on foreign investment. Since 2003 foreign institutions with Qualified Foreign Institutional Investor (QFII) license could access these stock shares. A-shares are quoted in renminbi (RMB) for valuation. Other ways to access these stocks by a foreign institution is via the Stock-Connect program or Renminbi Qualified Foreign Institutional Investor (RQFII) program.

H Shares

H shares are stock shares or securities from the mainland companies that are listed on the Hong Kong Stock Exchange (HKSE). H-share follows international or Hong Kong accounting standards. H shares unlike A shares and B shares are listed and traded in Hong Kong dollars. There is generally a variation in the price of H-shares and A-shares, A-shares of a particular firm trade at a premium to the corresponding H-shares. The premium mainly arises because an H-share is more liquid than an A-Share.

B Shares

The B share denotes the equity investment, these shares are traded in the mainland exchanges (SZSE) and (SSE). Even though B-shares are shown in RMB they are settled either in USD (Shanghai) or HKD (Shenzhen). The equities market in China is relatively new having started in 1990s. The Chinese class B shares are another way for foreign investors to invests in China. Initially, the B-shares were only open to foreign investors but later it was open for mainland Chinese too who hold legitimate foreign deposits.

Red Chips

Red chip shares are released by a firm that is incorporated outside the People's Republic of China and it trades on the (HKSE) and it is partly, directly or indirectly affiliated to mainland state entity with most of the revenue and assets from the mainland China.

P Chips

P chip refers to shares of firms that are located outside mainland China (mostly Hong Kong) and are listed on the (HKSE) and are mostly owned by the private sector of China meaning the mainland Chinese firms or individuals who are established in mainland China.

BRIEF HISTORY OF THE CHINESE STOCK MARKET

The history of the Chinese stock market starts in the 1880s when foreign businessmen founded the “Shanghai Sharebrokers’ Association” in Shanghai as China’s first stock exchange. In 1904, the Association applied for registration in Hong Kong and it was renamed the “Shanghai Stock Exchange”. By the 1930’s, Shanghai had emerged as a financial center in Asia, where foreign investors and Chinese could trade stocks, government bonds, and futures. However, in 1949, the Shanghai Stock Exchange closed after the Communist revolution.

In 1978, China’s reform and financial opening up began. From the establishment of the Shenzhen Special Economic Zone to Deng Xiaoping’s 1992 Southern Tour, China’s financial opening mainly revolved around the introduction of foreign capital. Deng stood by his reforms, reopened the Shanghai Stock Exchange in November 1990, and open the Shenzhen Stock Exchange in December 1990.

The Securities law was passed by the National People’s Congress of China on December 29, 1998, and it was revised in the year 2014. The regulatory reforms like the restriction of price limit were introduced in 1996 by the Chinese Securities and Regulatory Commission (CSRC) the regulatory authority of the Chinese securities market. This price limit was introduced to moderately large price fluctuations and this restriction does not typically present in the more developed countries like the US.

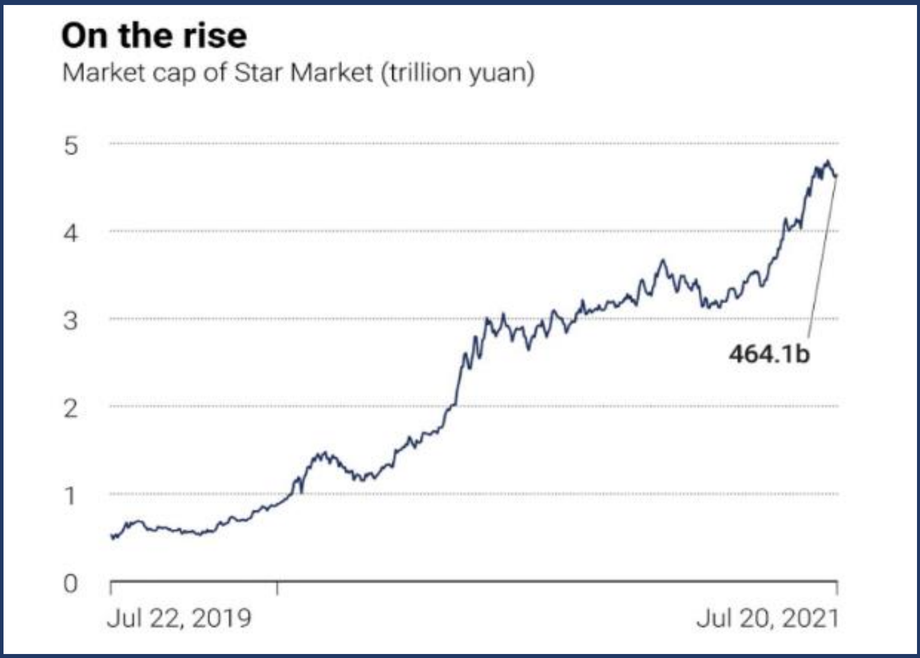
In 2001, China joined the World Trade Organization (WTO) to promote free trade, emphasizing low and predictable trade barriers deals with other WTO members. China began fulfilling WTO commitments and participate in international financial competition and cooperation on a larger scale and on a deeper level. This has brought tremendous pressure to the financial industry in China and became a major drive force for a new round of financial reforms.

In 2002, the stock brokerage fee was reduced and in 2009 stamp duty fee was reduced, this shows how important regulatory actions were taken by the authorities to induce investment inflow into the market. In 2005, split-share structure reform was made which mainly helped in mitigating agency conflicts between minority shareholders and controlling shareholders. The year 2010 introduced ETF50 options, stock index futures, and government bond futures and margin trading.

Boards like the small-medium enterprise board (SME board) were introduced in 2004, the growth enterprise board (GEM board) was introduced in 2000. For foreign investment, licenses like the QFII were brought in 2002, QDII was brought in 2006 and RQFII was introduced in 2011. On June 20, 2017, Morgan Stanley Capital International added China A-shares to its emerging market index, increasing China’s stock market size by USD $11 billion.

With high-level communications infrastructure and efficient functioning of the securities market, the Chinese exchanges grew and the number of investors over the past few years making these exchanges an interesting emerging capital marketplace. World Federation Exchange (WFE) declared the Shanghai stock exchange to be 2nd in capital raised, 4th in total turnover, and 3rd in market capitalization compared to other major stock exchanges around the world by the end of 2020. The Agricultural Bank of China holds the record of being the world's largest IPO at a staggering amount of US$22.1 billion, this shows the strength of Chinese domestic firms.

In 2018, Chinese President Xi Jinping announced the launch of the Shanghai stock Exchange Science and Technology innovation board (SSE STAR market), which meant to attract investments for advancement in sci-tech innovation projects. Since trading commenced on July 22, 2019, listings on STAR Market have increased from 25 to 311 companies, with a combined market value of US$716 B.



Source: Shanghai Stock Exchange

In August 2021, President Xi Jinping announced a new exchange in Beijing during a speech to the International Fair for Trade in Services. CSRC mentioned that the exchange would be similar to Shanghai's STAR market and will focus on small and medium-sized enterprises.

CHINA STOCK EXCHANGES

Shanghai Stock Exchange

The Shanghai Stock Exchange (SSE) is the largest China Exchange with a market capitalization of 7.62 trillion USD as of July 2021. Most of the companies are large, state-owned companies and most investors are pension funds and banks. The exchange covers especially companies in the financial industry.

No.	Name	Market Cap
1	Kweichow Moutai	2.098 T
2	ICBC	1.275 T
3	China Merchants Bank	1.056 T
4	Agricultural Bank of China	960.9 B
5	Ping An Insurance	811.2 B

Source: SSE, Market Values in RMB

Shenzhen Stock Exchange

The Shenzhen Stock Exchange trades mainly shares of private-owned businesses with a market capitalization of 5.59 trillion USD as of April 2021. These privately owned businesses are usually more innovative since it includes a lot of tech companies. The biggest sector of this exchange is manufacturing and then mining.

No.	Name	Market Cap
1	Contemporary Amperex Technology	1.202 T
2	Wuliangye Yibin Tech	820.8 B
3	Midea group	503.5 B
4	BYD	503.3 B
5	Hikvision	498.8 B

Source: SZSE, Market Values in RMB

Hong Kong Stock Exchange

The Hong Kong Stock Exchange is the third-largest stock exchange in Asia, behind the Tokyo Stock Exchange and the Shanghai Stock Exchange.

No.	Name	Market Cap
1	Microsoft-T	7.662 T
2	Tencent Holdings	4.934 T
3	Alibaba Holdings	3.669 T
4	Cisco-T	1.605 T
5	Intel-T	1.567 T

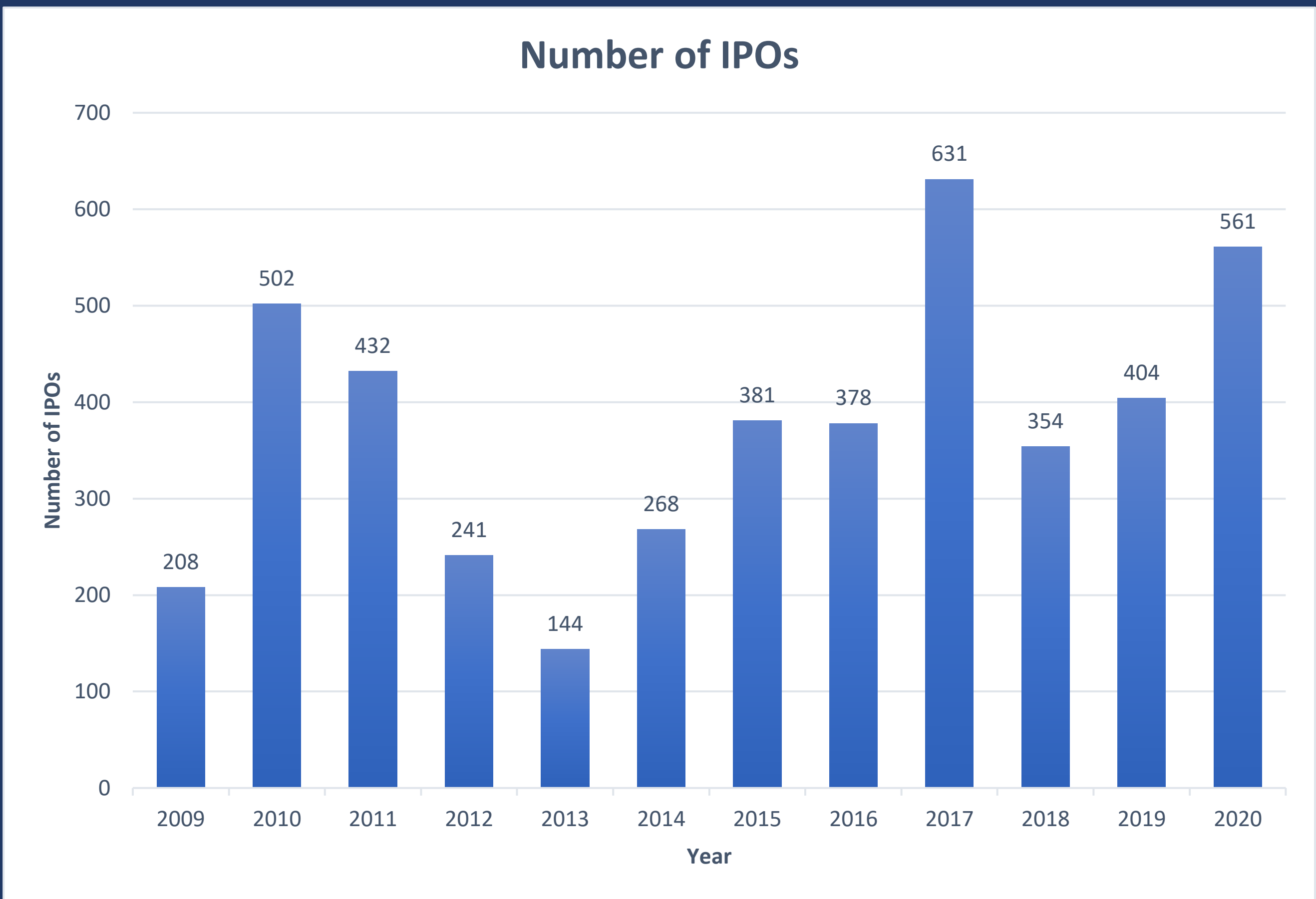
Source: HKEX, Market Values in Hong Kong Dollars

INITIAL PUBLIC OFFERING (IPOS)

In contrast to almost all regulatory frameworks in the developed economies, whose IPO procedures are based on registration, the Chinese regulatory framework is still based on approval. The administrative control over the approval procedure is highly extensive.

It is widely agreed among bankers that the regulators employ implicit quotas for different districts and different industries. This rigid quota system pushes many eligible firms to buy the “shells” of firms that were listed but went broke, issuing new stock under the name of the “shell firms.” It is widely believed that the approval framework benefits the SOEs and enterprises with close connections to the government, hence the limited supply of new issues has increased speculative interest in those that do come to market.

In terms of the number of IPOs, Greater China is the region with the highest number of IPOs with 561, followed by the United States with 224 IPOs in 2020. The number is significantly higher than 2019 despite the outbreak of Covid-19.



Source: PwC & Statista

Requirements

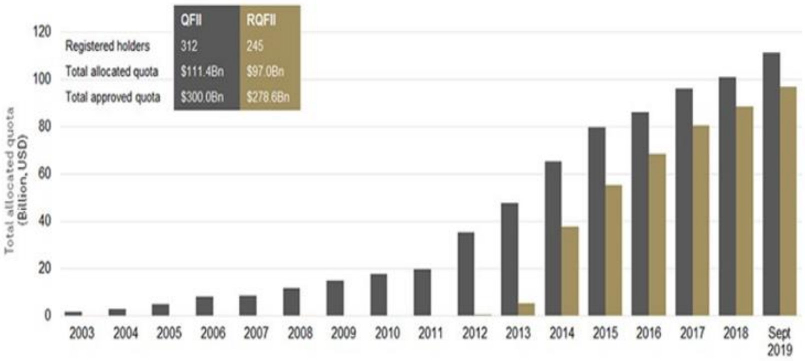
The CRSC lists a series of requirements in information disclosure, accounting quality, usage of proceeds that are to be raised from the stock issuance and the operations of the firm for it to be listed on the exchanges. It also sets strict requirements on the cash flow of the issuing firm. Some important requirements are the following:

1. Earnings to be net positive over the last three years
2. The cumulative operating income should be more than 300 million yuan.
3. Accumulated earnings must exceed 30 million yuan.
4. Accumulated cash flow not less than 50 million yuan in the past three years.
5. The minimum capital stock must be more than 30 million yuan before the IPO.

Delisting

Firms that experience losses for more than two consecutive years are put into special treatment firms and if the firm experiences losses for more than three consecutive years face a warning for delisting. Voluntary delisting also happens when the firm is completely privatized, and an involuntary delisting occurs when the firm either violates regulations of CSRC or does not meet the financial expectations set by the exchange. It is not a common sight to see firms being delisted in the Chinese stock market. Recently in the year 2016, Zhuhai Boyuan Investment Ltd was delisted for malpractices in their operations, becoming the first company to be delisted on the Chinese mainland.

Investment Opportunities for Foreign Investors



Source: State Administration of Foreign Exchange, data as September 30 ,2019

China is a unique place with many routes for foreign investors. In recent years, China has been further opening its capital markets and lowering the barrier to entry for offshore capital. In November 2020, Chinese regulations combined the QFII (Qualified Foreign Institutional) and the RQFII (Renminbi Qualified Foreign Institutional Investor) programs to improve the convenience of foreign investors. Originally, the QFII was established to allow licensed foreign investors to invest in yuan-denominated “A shares” of Chinese companies. The investors must convert their foreign capital into renminbi before investing in Chinese securities. Later, the RQFII was established to allow foreign investors to invest directly in Mainland China’s bond and equity markets.

From the perspective of foreign investors, the main benefits of the new QFI regulations are the following:

- Further increase the attractiveness of A-shares to foreign investors
    - Improved convenience in investment
    - Lower barriers to entry
    - Simplify application documents and administrative licensing, shorten the time limit for approval
- Expand the scale of foreign holdings in A-shares
- Diversify the products and strategies of foreign participation in A-shares

Source: State Administration of Foreign Exchange of the People’s Republic of China

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About

Dadao Capital

DADAO CAPITAL is a boutique investment and consulting firm focused on cross-border investment and trade opportunities between China and North-South America.

DADAO's services includes: cross border transactions, M&A, capital raising and strategic advisory.

Our team includes hands on experienced professionals graduated from top universities. We speak fluent Spanish, Chinese and English.

About Our

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