

# ▶ CHINA'S DIVIDEND STOCKS: ON THE STARTING BLOCKS

**China's dividend-paying stocks have been overlooked. Technology stocks have taken centre stage. Dividend stocks are more attractively valued. What will trigger investor interest?**



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China's high dividend stocks have lagged the technology stocks, significantly, over the past five years (see Fig.1). A wide earnings growth differential appears one major reason for this performance disparity. The 3.9% annual earnings growth for the higher dividend-yielding sectors was swamped by the 28.6% growth recorded by China's technology companies<sup>1</sup>.

High dividend stocks – whether unfairly

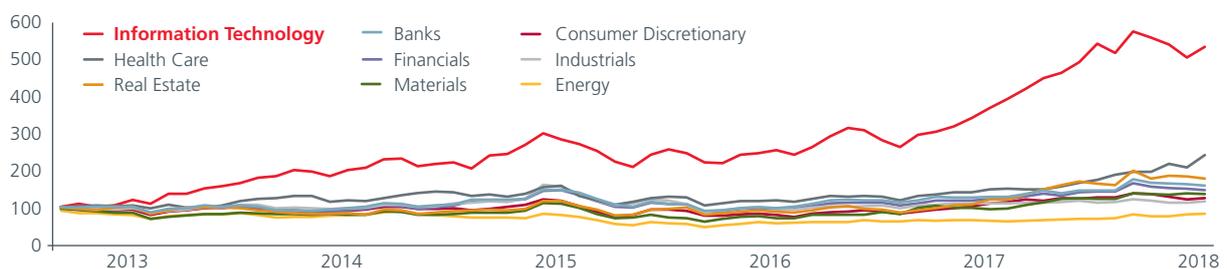
or not – are often viewed as being 'old economy' companies; they have thus neither captured the imagination of investors nor attracted the high valuations often associated with the tech-based 'new economy' companies.

In the midst of chasing 'hot' tech stocks, the emerging picture is that investors are grossly undervaluing China's dividend stocks.

This picture may be changing.

**Fig.1: China's dividend stocks have lagged tech stocks since 2013**

(Rebased to 100%) MSCI China sector indices



## DIVIDEND STOCKS OFFER ATTRACTIVE VALUATIONS AND SOLID EARNINGS GROWTH

Chinese tech companies' forward price-to-earnings (P/E) valuation is at a high of 27.3x<sup>2</sup>. With such a high valuation, there is little room for any earnings disappointment. The market has been highly intolerant of any growth or earnings misses in recent quarterly reports.

The renewed US-China trade dispute, which some believe is intended to contain China's momentum in technological development, is unnerving investors. Concerns have grown as President Trump's remarks have increasingly focussed on intellectual property rights with technology companies such as ZTE Corporation, and potentially Huawei Technologies, being caught in the crossfire.

In our view, this type of uncertainty should be an impetus for investors to look towards the stability of dividend stocks such as banks and energy (see Fig.2), which offer good value, good liquidity and good income.

On valuations grounds alone, the case for the higher dividend stocks looks compelling.

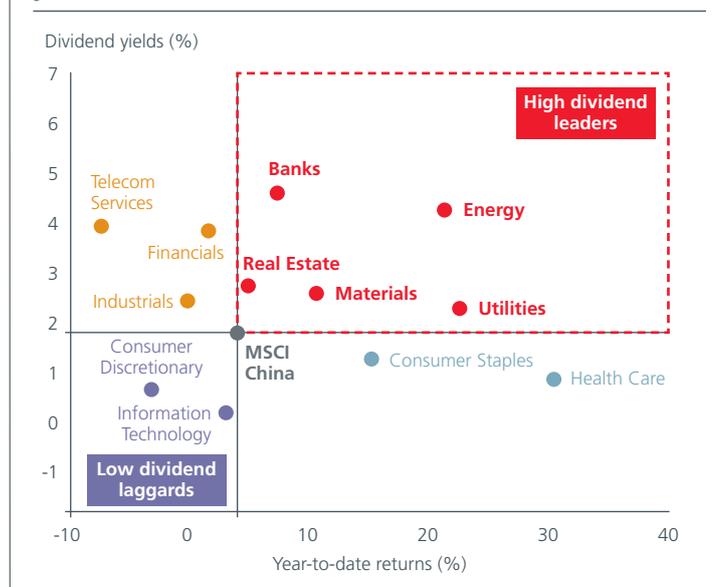
China's high dividend stocks, such as financials (including banks and insurers), energy, real estate and materials, are trading at attractive valuations in terms of composite P/E and price-to-book (P/B) measures. They appear alluring alternatives to the more highly valued consumer discretionary and information technology sectors (see Fig.3).

It is apparent from Fig.3 that financials, one of the highest dividend-paying sectors, is trading at a significant discount to the rest of the market. This gap largely reflects the low valuations being placed on China's banks (despite the MSCI China Banks index rising some 50.8% from its 2016 low<sup>3</sup>).

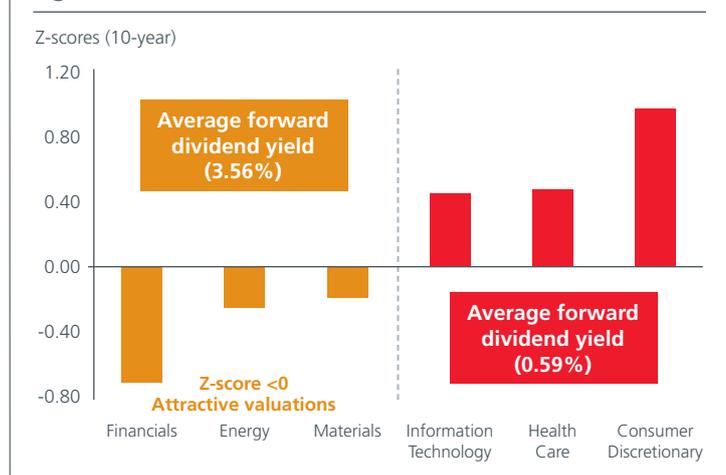
The obvious questions are 'What has led to the situation', and, 'Will it change?'

Much of the lower valuations can be attributed to investor fears surrounding non-performing loans and their adequate provisioning. Concerns

**Fig.2: Investors turned to high dividend stocks year-to-date in 2018**



**Fig.3: Z-scores (P/E and P/B) for MSCI China sector indices**



over shadow banking and off-balance sheet loans have complicated the picture. Chinese banks, as represented by the MSCI China Banks index, are trading at 0.8 of their book value, representing a 57% discount to the broader MSCI China index (see Fig.4).

We believe these concerns are overblown.

The P/E multiple discount that investors have been placing on the underlying earnings growth forecasts has stabilised at about 40% to

the broader MSCI China index since late 2016<sup>4</sup>; this stabilisation suggests that investors have significantly discounted their fears. With the discounts evident today, it looks like the Chinese banks offer an attractive buying opportunity.

## ADVANCES IN REGULATORY REGIME POSITIVE FOR UNDER-RATED CHINESE BANKS

The steady flow of new regulatory measures to tackle shadow banking and other structural issues in the financial sector appear to be boosting investor confidence.

The new deleveraging measures introduced in 2017, for example, were aimed at restricting off-balance sheet shadow banking activities and bond trading. The orderly execution of these measures should alleviate many investor fears on the non-performing loans and corporate governance issues.

In order to effectively oversee the deleveraging efforts, the National People's Congress decided in late March to merge the banking and insurance regulators<sup>5</sup>, and delegate more policymaking authority to the People's Bank of China (PBoC). This overhaul of the financial services industry, the largest in the nation's history, is a strong step in the direction of better oversight and stability.

This strategic move is specifically designed to tackle the credit problems arising from shadow banking, which has created a plethora of hybrid institutions and wealth management products that blur the lines between banking, insurance and securities.

The result is that improving fundamentals and governance standards are reflected in today's solid earnings growth forecasts and sustainable dividend payments. Investors in Chinese banks should also conduct in-depth research on the banks' quality, not to mention their liquidity and cash holdings necessary for longer-term development.

Not every bank looks to be in solid territory; banks with strong funding franchises and stronger asset quality – those who are net lenders to the

**Fig.4: Price-to-book (P/B) values for MSCI China Banks**



interbank market – are best positioned to benefit in the current environment. In addition, large state-owned banks have above-peer balance sheet quality and small exposures to shadow financing activities.

## THE DIVIDEND TRAP WE ACTIVELY AVOID

It is never this easy, of course.

Few want to invest in a high-dividend company which does not have a sustainable business; one where high yield signals 'danger' rather than 'opportunity'. In identifying high-dividend stocks in which to invest, this is one particular pitfall to actively avoid.

This is a particularly sensitive issue when it comes to China's higher dividend-paying stocks; they look attractively valued now, but it is also challenging to avoid the 'dividend trap'. Clearly patience and rigorous research are required.

As long as the reform measures are in place, we can expect to see more Chinese companies running their businesses with clearer goals to improve shareholder returns. Recently, we also see the development of employee share option schemes even within state-owned enterprises, thus aligning management incentives with shareholder returns. This improvement, along with the goal to pay sustainable dividends, are clearly positive developments.

China's dividend stocks are stepping up to the starting blocks.

Sources: <sup>1</sup>Thomson Reuters Datastream MSCI, from 31 May 2013 to 31 May 2018, represented by the 12-month-forward earnings per share (MSFI). Annualised average growth: MSCI China Financials, Telecom Services, Industrials, Energy, Materials, Utilities, Real Estate, Banks indices. <sup>2</sup>Thomson Reuters Datastream MSCI, data as at 31 May 2018. <sup>3</sup>Bloomberg, the MSCI China Banks index, total returns in US dollars with dividend re-invested, from 31 December 2015 to 31 May 2018. <sup>4</sup>Thomson Reuters Datastream, MSCI, 12-year rolling PE-Growth ratios of MSCI China Banks versus average of MSCI China, as at 24 May 2018. <sup>5</sup>The regulators include China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), and China Insurance Regulatory Commission (CIRC). Fig.1. Thomson Reuters Datastream MSCI, rebased at 100% on 1 January 2013, as at 31 May 2018, returns in local currency, total returns. Fig.2. Thomson Reuters Datastream MSCI, year-to-date (YTD) total returns (MSRI) from 31 December 2017 to 31 May 2018. Dividend yields (MSDY) are 12-month forward dividend yields as at 31 May 2018. MSCI China Information Technology, MSCI China Consumer Discretionary, MSCI China Utilities, MSCI China Banks, MSCI China Financials, MSCI China Real Estate, MSCI China Health Care, MSCI China Telecom Services, MSCI China. Fig.3. Thomson Reuters Datastream MSCI, 10 years ended 31 May 2018. Z-score takes 50% from forward P/E and 50% from P/B (normal distribution) for MSCI China sector indices. Fig.4. Thomson Reuters Datastream MSCI, five years ended 31 May 2018. MSCI China and MSCI China Banks's MSBP (price to book value).

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