MARKET INSIGHTS

MSCI'S A-SHARES INCLUSION A RIGHT MOVE FOR THE LONG TERM

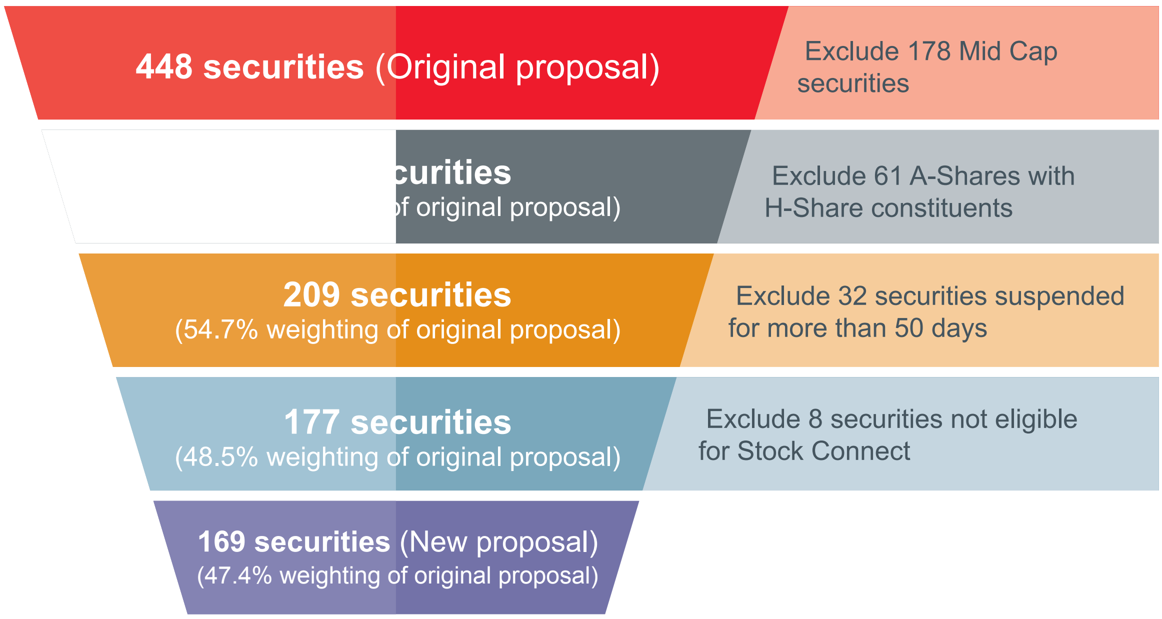
JUNE 2017

This month, MSCI will again decide whether to include Chinese A-shares in its global indices. This will mark the fourth annual attempt by MSCI and we think there is a 70% chance of a success, compared to last year's 50%.

The improved odds are helped by MSCI's latest proposal, which lowers the number of stocks considered for inclusion from 448 to 169 (Fig.1) and reduces their weightage in the MSCI Emerging Markets Index from 1% to approximately 0.5%, as well as a new framework that bypasses restrictions under Beijing's Qualified Foreign Institutional Investor (QFII) scheme and Renminbi Qualified Foreign Institutional Investor (RQFII) scheme.

The more gradual introduction is likely to find favour with most global investors, especially those who are still wary after the bouts of volatility seen in June 2015 and January 2016.

Fig.1. New proposal improves inclusion odds



Source: MSCI, as at May 2017.

Meanwhile, the launch of the Shenzhen-Hong Kong Stock Connect scheme in December 2016, some two years after the introduction of the Shanghai-Hong Kong Stock Connect scheme, allows MSCI to propose an inclusion framework based on the stock connect schemes.

Investors now have access to over 1,400 A-share companies listed in Shanghai and Shenzhen through the stock connect schemes, which have greatly increased the accessibility of the Chinese A-share markets for global investors. This marks a shift from MSCI's early approach based on the QFII/RQFII framework, which comes with inherent restrictions such as quota, limited capital mobility and the need to apply for a licence.

REGARDLESS OF THIS YEAR'S OUTCOME, INCLUSION IS THE RIGHT COURSE OF ACTION FOR THE LONG-TERM

Given the growing significance of the Chinese economy, investors should be given the opportunity to gain exposure into mainland-listed Chinese companies. Currently Chinese companies listed in Hong Kong and the US only account for a portion of China's economy, not an accurate representation of the gamut of investment opportunities available in China.

The investment potential is also evident looking at the size of the market as well as the corporate earnings.

China's A-share market is now the second largest in the world behind the US, totalling over USD7.2 trillion in market capitalisation[1]. Furthermore, Chinese A-share companies posted robust revenue growth and double-digit earnings growth in the first quarter of 2017, a result that has been hard to come by over the past few years (Fig.2). Well-run businesses are able to take advantage of the country's economic growth to produce positive earnings results which could translate into improved free cash flow generation and strengthen the case for increased dividend payouts.

BOTTOM-UP STOCK PICKING OPPORTUNITIES FOR VALUE INVESTORS

China A-shares have generally in the past traded at a premium over China H-shares. But following the relative underperformance of China A-shares in recent years, this premium has closed significantly. The price-to-earnings premium, for example, has quickly evaporated to low single-digits from as high as 60% just over two years ago, while the price-to-book premium gap has narrowed from a high of 80% to being on par with MSCI China (Fig.3). In other words, one could find good Chinese companies at reasonable valuations.

Fig.2. A-share companies' revenue and earnings growth

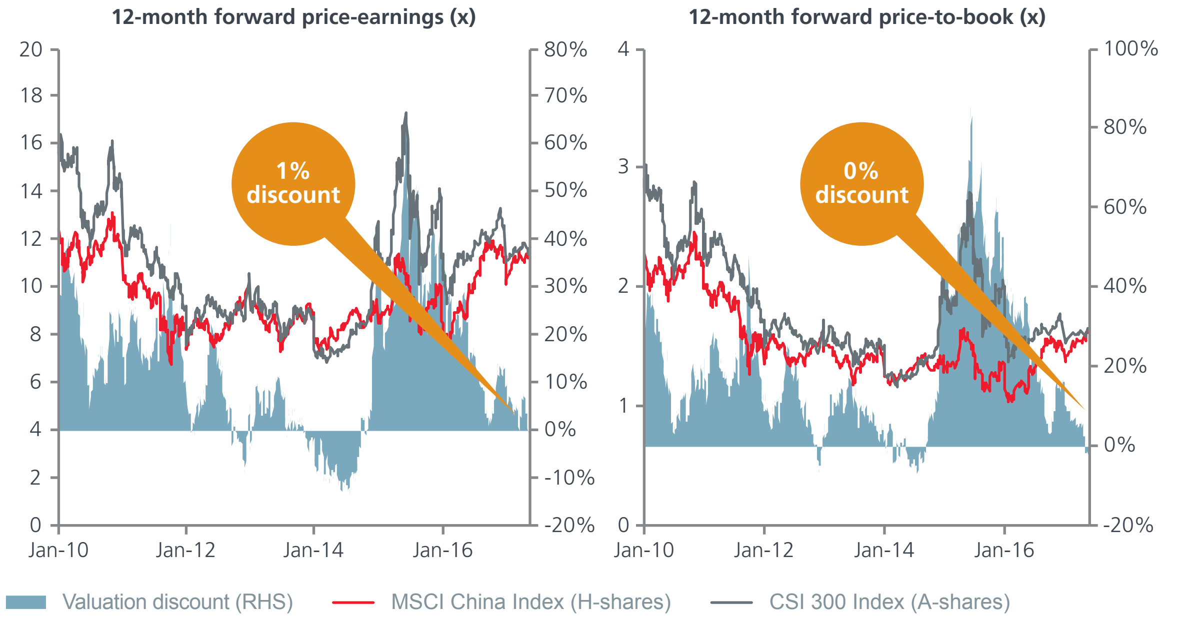
	Revenue growth				Earnings growth			
	2014	2015	2016	Q1 2017	2014	2015	2016	2017
All A-shares	6.2%	2.7%	8.6%	23.1%	6.9%	3.2%	7.2%	21.5%
A-shares excluding financials	4.5%	-0.5%	10.6%	28.2%	1.0%	-9.7%	27.5%	53.7%

Source: Wind, UBS estimates, as at May 2017.

[1] Data as at 31 May 2017.

All said, the China A-share market still has room to improve, in particular on issues such as corporate governance, financial reporting standards and investor education. While some would argue that these are the reasons against an MSCI inclusion, we think the inclusion could in fact help China A-shares align with global standards and more importantly result in a more accurate reflection of the global investment universe. MSCI's revised proposal is a step in the right direction.

Fig.3. Valuation gap has closed



Source: Bloomberg, as at 31 May 2017.

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