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China's stock market: Out of the valley in 2004?

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Summary

- There were no major policy shifts in stock market policy in 2003 and the market spent the year without much direction. The priority of the new government appears to be retail bank reform, and rightly so. Stock market policy is dedicated to the quiet implementation of corporate governance reforms at listed firms, growth of institutional investment, a gradual opening up to QFII investors, and efforts to improve the issuance framework. Several reforms regarding share issuance mean that the quality of firms allowed to issue shares should improve in 2004. The Shenzhen Stock Exchange will start listing A-shares, signalling the beginning of a multi-level capital market.

- However, despite these reforms regular scandals in 2003 continued to undermine investor confidence and listed companies' results did not provide much cause for optimism. Privatisation of listed firms continued, as did debates about its effect. A shift to 'value' investing took place in the second half of 2003 as fund managers targeted large-cap, generally profitable, stocks. A two-track stock market, of highly-priced 'blue-chips' and also-ran small companies, began to emerge. By the middle of 2004, a blue-chip bubble could well have developed.

- Given weak proprietary trading and underwriting revenues, most securities companies, already insolvent, became more dependent on brokerage fee income. Massive consolidation in the sector is only a matter of time. In contrast, investment funds are enjoying rapid growth. Redemption pressures will, however, be strong during 2004 as new, more sophisticated products attract money and insurance funds become able to invest in equities directly.

- In February 2004, a State Council white paper laid out the government's intention to continue developing the stock market and its commitment to resolve the non-tradable share issue. Given a healthy macro-economic environment, strong demand from institutions, including some QFII money, and continuing – if slow – improvements at listed firms, 2004 will likely see the market more 'out of the valley'. However, given the sensitivity and practical difficulties of this issue, doubts remain over whether progress to liquidate state shareholdings can be made in 2004.

Out of the valley?

China's stock market has spent much of the last three years passing through the valley of the shadow of death. After plummeting in July 2001, the market spent the following fifteen months more or less stagnating. The new government's reform energies have concentrated on the retail-banking sector, leaving the stock market scarcely mentioned in official statements. Analysts started talking about it as the 'third world' of China's financial system (after banks and insurance). Speculative cash fled stocks into real estate. The chairman of the China Securities Regulatory Commission (CSRC), Shang Fulin, seems to have decided that there are few worse evils than speaking publicly about the market or policy.

Frequent scandals and poor company results kept retail investors away. A survey by Sina Inc. and *Securities Market Weekly* in September 2003 found that 90% of 10,000 retail investors said that they had lost money since July 2001. Half of those questioned said that they were going to sell their shares and never buy any again.[1]

With demand for shares so weak, the rate of share offerings has slowed considerably in 2002-03 since the boom period of 2H 1999 - 1H 2001. Only 63 companies made initial public offerings (IPO) in 2003, compared to 110+ a year during 1999-2001. Companies knew where they were appreciated and those that could fled overseas to raise capital. The Rmb63.9bn ($7.7bn) raised on the A-share market at home in 2003 was only slightly more than the Rmb54.2bn ($6.5bn) raised in the United States and Hong Kong, as Table 1 shows.

TABLE 1. CAPITAL RAISED FROM SHARE AND CONVERTIBLE BOND ISSUES, 1991-2003

	2003	1991-2003
A-share (IPOs and rights issues)	63.9	734.6
B-share (IPOs and rights issues)	-	39.0
H-shares (overseas)	54.2	223.3
Convertible bonds	18.1	26.9

Source: CSRC

But then a funny thing happened. During November – December 2003, prices rose, the Shanghai index ended the year up some 10%, and rumours flew that the CSRC was ready to boost prices with new policies. Annual financial results at securities firms are expected to be much healthier than feared. A statement issued by the State Council in February 2004, although lacking any real substance, set out the government's intention to continue developing the stock market along market-friendly lines. Just the fact that the market was still being considered at the highest level of government cheered investors.

2004, analysts agree, is the year when the market will grow again.[2] Is such optimism justified? This report examines developments on both sides of the market, the first section examining what has happened at listed firms in the last year, and the second looking at securities and investment fund management companies.

Listed company performance and corporate governance issues: plus ça change?

At the core of a decent stock market is a group of quality companies. The good news is that the average results for China's 1,278 listed firms is improving. In April 2004, when the 2003 annual reports are published, the average earnings per share should be around Rmb0.20 and the average return on assets 7%. In 2002 those figures were Rmb0.13 and 5% respectively.[3]
However, these figures will be largely thanks to the so-called blue-chips, the likes of the large and hugely profitable Baogang Steel, China Unicom, Sinopec et al. In the first three-quarters of 2003, the top 20 profit-makers among listed firms accounted for 42% of the aggregate profits made by all the listed companies and a similar concentration of profits is likely for 2003 as a whole.[4] Moreover, healthy macroeconomic demand were also partly responsible for the higher earnings.[5] Earnings were up across industry.

The majority of listed firms still turn off most investors. Corporate governance reforms, such as the creation of boards one-third filled with independent directors and civil suits by retail investors, appear to have stalled. By May 2003, only 62% of companies had met the CSRC's demand that a third of the board should be made up of independents.[6] Despite the 2002 move by the Supreme People's Court in January 2003 to allow civil suits against listed companies, no provincial court had apparently ruled in favour of wronged investors at the time of writing. The fiery days of 1999-2001 when Zhou Xiaochuan and Gao Xiqing led the CSRC and such corporate governance initiatives were formulated are clearly over.

Although the scale of the abuses has certainly been restricted, asset stripping, false accounting and stock manipulation continue to flummox the regulator and undermine confidence.

1. Although the CSRC has cracked down on various methods of asset stripping by large shareholders it still goes on. In November, for instance, Aikelamu Aishayoufu, the powerful chairman of Xinjiang Hops (stock code: 600090), a barley and beer firm, disappeared. He allegedly took with him some Rmb900m ($124.8m), mostly bank money lent to his other companies with the listed company acting as guarantor.[7] The CSRC banned such guarantees two years ago. This was not an isolated incident. On August 31st

2003, Lianhua Monosodium Glutamate (600186) shocked the market by announcing that Rmb858m ($102m) had been embezzled by its parent company, the Lianhua Group.[8] The problem was only discovered when CSRC officials visited the company. The Lianhua Group guaranteed to return Rmb500m ($69.3m) to its subsidiary before the end of the year, but this had not occurred by the time of writing. The listed firm has declared its intention to write off Rmb8.6m ($1.2m) as a provision for bad debt, a move which cuts the firm's net profit for 2002 in half.

2. Although the general quality of companies making IPOs has improved since the late 1990s, the IPO process remains less than reliable. In February 2003, for example, Huiquan Beer (003573) was listed. But within five months, the two largest shareholders had sold their stakes, and shortly afterwards the firm announced a 77% drop in its net assets to just Rmb7.6m ($915,000). 45 of the 169 firms forecasting losses at the end of July 2003, had just issued shares, either in an IPO or a secondary offering. In short, the CSRC is failing to stop bad firms issuing shares.

3. Fewer stocks are being manipulated these days. Staff at the exchanges and CSRC are better equipped to spot such scams, and punishments are getting more severe, at least for the high-profile cases. In September 2003, for instance, a Guangzhou court sentenced five people involved in the Yi-an Science manipulation case. Using some 700 different accounts and Rmb3.7bn ($450m) the group manipulated the firm's share price from Rmb7.6 to Rmb126.3 during 2000-01, generating illegal gains of some Rmb460m ($55.4m). The group received sentences of three and a half to two years. In October 2003, the chairman of ST Minfeng (600781) was sentenced to four years for manipulating the firm's accounts and share price. Dozens of other criminal actions are reported. But the bigger stick does not dissuade everyone. The case last Shiji Zhongtian (on which more below) proves that the ease of – and the gains from – manipulation are still too tempting for some to resist.

In addition to corporate governance reforms, there are two main strategies for improving listed company performance: buy-outs and ensuring that better firms are listed in the first place.

Better buy-outs?

Perhaps the best hope for most firms is to be bought out by a private investor with some substantial commercial experience, a hard budget and profit incentives. Large numbers of such deals, mostly involving non-tradable shares, have taken place.[9] By year end 2003, an estimated 437 listed firms had experienced a change in their controlling shareholder, leaving about 250 of them privately controlled.[10]

But such buy-outs are no panacea and there is now huge debate over whether they actually improve firm performance. Many deals are badly organised or organised by speculators to manipulate the listed share price. A number of these scams came to public attention in 2003. In June 2000 Shiji Industries bought control of Zhongtian (600540), a poorly-performing real estate firm. With the help of falsified accounts, exciting press releases and a booming estate market, Shiji Zhongtian's price rose fivefold, peaking in April 2003, before the scam became publicly apparent.

Other private buy-outs are simply organised to raise and then strip assets from the listed firm itself. In 2001, Fujian province's Shenlong Group bought control of Fujian Fulian (600659), and changed its name to Shenlong Shareholding. Between November 1999 and August 2001, the listed firm raised Rmb10.2m ($1.2m) through secondary share issues. Unknown to investors the money was then channelled to the controlling shareholders, mostly through loan guarantees. In September 2003, the company made additional guarantees worth Rmb38m ($4.6m) and HK$1.8m ($231.8m) and the case was widely reported shortly afterwards.

The CSRC is trying to get a grip on fake buy-outs. It now informally limits the sale of controlling stakes to once every three years, according to one source.[11] It also examines the details of proposed restructurings in greater detail. But it takes time for real restructurings to take effect and so it will probably be 2005-06 before the acquisitions made during 2002-03 have bedded down and have translated into substantial improvements in listed firm performance.

Issuance issues

The long-awaited re-start of listings at the Shenzhen Stock Exchange is occuring. Listings had been suspended in October 2000 in anticipation of the Second Board (or Growth Enterprise Market) being established there.[12] In February, the Rmb36.4m ($302m) issue of TCL (000100), a hugely successful electronics firm, on the Shenzhen board appeared to signal its revival.

The thinking is now that the Shenzhen market will develop in two phases. First, 40-50 companies will be listed, small and medium in size (less than 50m in tradable shares), on to the Shenzhen main board under the CSRC's current listing regime. If succesful, then a new Second Board comprised of these stocks and a few others could be 'budded off' from the Shenzhen market. Shenzhen might then become a small-cap, growth market for mostly private firms, and Shanghai could mature into a blue-chip market. The proposed merger of the two exchanges appears, at least for the moment, to have been put on the back burner.

In December 2003, the listing approval process was reformed, apparently one of the last acts of vice chairperson Laura Cha before she left at the end of her three-year contract.[13] The anonymous 80-member Issuance Approval committee, which was half-filled by government officials, was replaced by a 25-person committee made up of a broader range of government, financial sector and stock exchange staff, as well as academics and overseas professionals. While previously the names of those who decided upon an application were kept secret, the names of the seven people panels that decide on issuance applications will now be made public. The decisions of the committee will also be open to public scrutiny. The committee has already signalled its intention to be (or at least appear to be) more rigorous. At its first meeting this year, two out of five issuance applications were rejected, a much higher failure rate than before.[14]

In February 2003, a new regulation aimed at toughening punishments for underwriters who conspire to bring poor quality companies to market, will come into force. It holds underwriters accountable for their client's performance until two years after an IPO and one year after a secondary share offering and will ban them from further underwriting business in the event of misleading disclosures, dramatic downturns in performance, and related-party transactions after the issue.

However, despite these three reforms, the share issuance application process remains problematic. Enterprises that have passed the basic issuance requirements, including the need to have a 10% return on assets for three consecutive years, are all submitted to the CSRC's committee. Those firms that the committee chooses join the line for firms waiting to make an IPO. As of September 2003, there were rumoured to be about 70 firms waiting in this later queue and hundreds, if not thousands, going through the application process or the one-year pre-application preparation phase.

Although greater transparency is welcome, there are several problems with the current framework. First, the profit criterion is backward looking, and provides no guide about future performance. Second, once the basic criterion has been met, the better firms have to wait alongside the less good firms, delaying getting capital to the most productive places. Third, administrative control of the supply of new equity into the market leads to the restricted supply of firms since there are political fears associated with allowing 'too many' firms on to the market and thus impacting negatively on prices. The result of this is that the firms that do pass the issuance process tend to raise 'too much' capital. Chinese companies hold on to equity and they tend to spread capital around, away from their core businesses.

The issuance process could be improved by intensifying competition among applicants. Allowing securities companies to select which firms to bring to market (and when) would force them to select only the firms they were confident would attract investors. The underwriting risk of having to buy their shares if demand was not in fact sufficient would act as a self-regulating mechanism on the amount of shares issued, as it does in more mature markets. Of course, there would be considerable opposition to such a move, since it would that mean many former SOEs currently waiting in the listing queue would lose out to better private firms. However, it would likely improve the quality of firms coming to market.

The financial institutions

While listed companies continue their slow improvement, China's financial institutions – securities and investment fund firms – are experiencing extreme times.

The crisis at securities firms

For their part, securities firms are in crisis. During the first three-quarters of 2003, they made a net loss of Rmb3.4bn ($410m); 98 out of 131 firms recorded losses. Analysts predicted that losses for the year would exceed Rmb3.7bn ($446m), the loss sustained in 2002.

However, the upturn in market sentiment in the last quarter appears to have been enough to stabilise the situation.[15] The 55 securities companies which are members of the China Inter-bank Borrowing Center recorded a total net loss of only Rmb470m ($56.6m) for the year. 44 of the firms made profits and gross income was Rmb23.2bn ($2.8bn) in 2003, the same as in 2002, as table 2 shows. This suggested that net losses would not be as grave as in 2002 thanks to limited cost savings made during 2003.[16]

TABLE 2. GROSS INCOME FOR CHINA'S SECURITIES INDUSTRY, 2000-03

Year	*Income*
2000	49.1
2001	35.7
2002	23.2
2003	23.2
Rmb bn	

Source: Shanghai Weihai Investment Consultants[17]

Three companies achieved profits in excess of Rmb100m ($12.0m). Guoxin Securities was the most succesful with a net profit of Rmb220m ($26.5m).[18] Guotai Jun'an made Rmb51.4m ($6.2m), an increase of 169%, while Shenyin Wanguo and Everbright Securities also saw profits increase. For the first time, China International Capital Corporation (CICC) and Bank of China International (BOCI) also released pro forma annual reports. CICC realized a net profit of Rmb196m ($23.6m),

TABLE 3. BREAKDOWN OF SECURITIES FIRMS' BROKERAGE BUSINESS, 2003

Business type	Nominal Income, Rmb bn	Proportion of total brokerage income, %	Year-on-year growth, %
A-shares	18.6	79.8%	8.3
Government bond repurchase contracts	1.4	7.8%	100.0*
Government bonds	1.3	5.5%	-48.6

Source: Qin Hong, 'Zhanle Hangqing De Guang, Quanshang Shouru Gaobie Dieshi', *Shanghai Zhengquanbao*, January 16th, 2004. Sourced from: http://www.cfi.com.cn/newspage.aspx?id=20040116000029, February 2004.

a year-on-year increase of 90%. Its business model differed from other firms as its income was mainly derived from underwriting. BOCI, a new joint venture, recorded mediocre profits of Rmb4.29m ($500,000). In contrast, Minsheng Securities, a privately-owned firm failed to out-perform its state-owned peers and reported a loss of Rmb467m ($56.3m). Four other firms also suffered an annual loss of more than Rmb100m ($12.0m). Bankruptcy rumours hang over a number of these and other firms.[19]

Securities companies' income structures have not evolved much. New share issuance declined in 2003, meaning that brokerage income became ever more important to them, brokerage accounting for 92% of total income in 2002, and 95% in 2003 (compared to 52% in 2001). Aggregate brokerage income in 2003 was Rmb22.08bn ($2.7m).[20] Table 3 shows how brokerage fees broke down between different instruments. Of note is the rapid growth of brokering of government bond repurchase contracts (repos).

Brokerage income is composed of two main parts: the commission made on brokered trades and the interest rate spread that can be made on customers' deposits.[21] Some small- and medium-sized firms make 90% of their income from brokerage activities.[22]

Securities firms' increasing reliance on brokerage income is explained by a number of factors. First, proprietary trading made zero contribution to profits in 2003, as the index flat-lined and many of the firms' investments remained under-water. Second, the returns on the IPO market, previously a guaranteed source of profit for institutions with enough capital and enough (illegally-opened) share accounts to subscribe with, have fallen drastically. These returns are now less than a quarter of what they were three years ago, as shown in table 4.

TABLE 4. RETURNS ON INVESTING IN MAINLAND IPOS, 1999-200323

Year	Open Profit Rate (%) *(Sold at opening price on day of listing)*	Highest Profit Rate (%) *(Sold at the highest price on on listing date)*
2003	0.074	0.092
2002	0.142	0.156
2001	0.449	0.502
2000	0.438	0.550

Source: China Financial Information[24]

A third reason is that underwriting fees appear to have become even more competitive with firms chasing fewer issues. We estimate that fees averaged an extremely low 1.4% of capital raised in 2003, much lower than the mandatory fee of 2.5% previously charged.[25] Fourth, competition in the brokerage sector has also driven down margins. We estimate that brokerage commissions on A-share trading have fallen to an average of 0.2% (levied on both sides of the transaction).[26]

In terms of pro forma income (gross income pre-audit), Galaxy Securities topped the league table with an income of Rmb1.44bn ($173.5m), followed by Guotai Ju'an and Haitong Securities. Southern Securities dropped from fourth place in 2002 to seventh in 2003. The top ten firms are shown in table 5.

The pressure is leading some firms to desperate measures. On November 26th 2003, Heilongjiang's Jiamusi Securities, was closed by the CSRC because of undisclosed illegal activities. Ten days later, another small firm, Xinhua Securities in Changchun, went the same way. Then in December, China Southern Securities, the sector's fifth-largest player, was rescued and taken over by the CSRC.[27] Rumours of a Rmb8bn ($1bn) bail-out at Southern (and an acquisition by China Development Bank, were circulating at the time of writing. Other firms have responded to insolvency in less imaginative (and more legal) ways. Costs, including staff, are being cut. One estimate is that the average brokerage branch will have to cut half of its staff (based on 2001 levels) to break even.

The luckier firms have been allowed to raise additional capital. Many listed firms, cash-flush from their IPO, have injected funds and become shareholders. On October 1st 2003, the CSRC issued regulations which allow securities firms to issue bonds. Only the largest firms need apply. Guangzhou-based GF Securities and Beijing-based China Galaxy Securities are among the first batch of applicants with prospective issues worth Rmb960m ($115.7m) and Rmb3bn ($361.4m) respectively. CITIC, Guotai Junan and Haitong are also thought to be preparing issues.[28] 2004 will therefore see the largest firms gain the resources to grow larger and most smaller firms lose further ground.

Consolidation is inevitable – the sector can support 40-45 firms at most. The large firms are increasingly dominant. Of the 131 securities firms in 2003, the top 20 recorded aggregate nominal income of Rmb12.4bn

TABLE 5. RANKING OF SECURITIES COMPANIES IN TERMS OF PRO FORMA INCOME, 2003

Ranking	Company	Total Income	Brokerage income	Underwriting income
1	China Galaxy Securities	1,434.96	1,341.58	93.38
2	Guotai Jun'an Securities	1,348.13	1,259.66	88.47
3	Haitong Securities	1,013.69	1,005.65	8.04
4	Shenyin Wanguo Securities	946.90	935.34	11.57
5	Huaxia Securities	843.19	786.26	56.93
6	CITIC Securities	812.98	512.18	300.81
7	China Southern Securities	803.16	788.83	14.33
8	Guangfa (Guangdong Development) Securities	654.83	635.83	18.99
9	Guoxin Securities	556.96	520.15	36.81
10	China Merchant Securities	478.16	456.22	21.94

Rmb m

Note: These figures are estimated incomes, based on the firm's reported brokerage volumes and underwriting deals. They are not companies' official figures.

Source: Qin Hong, 'Zhanle Hangqing De Guang, Quanshang Shouru Gaobie Dieshi', *Shanghai Zhengquanbao*, January 16th, 2004. Sourced from: http://www.cfi.com.cn/newspage.aspx?id=20040116000029, February 2004

Note: CITIC Securities surprised the industry with its extraordinarily high underwriting income, mainly due to its underwriting of China Yangtze Power.

($1.5bn), accounting for 53.3% of the total income of the entire industry. Brokerage business is even more concentrated, with the top ten firms collecting Rmb8.2bn ($1bn) from A-share brokerage, some 37.3% of the total.

Given that trading is migrating online (making brokerage branches expensive luxuries), consolidation will inevitably mean more closures of small brokerages rather than acquisitions by the major players (who are at any rate too poorly financed to consider making large purchases). Provincial governments are, however, doing a sterling job resisting closures of local firms through providing financial support. It is likely that 2004 will see more CSRC-directed take-overs and closures of securities companies, though funds will have to be found to meet old liabilities, a fact which will also slow down the inevitable consolidation.

Rapid growth in investment funds

In the parallel universe of asset management, firms are proliferating and funds flooding in. By the end of 2003, 50 fund management firms (37 domestic, 13 Sino-foreign joint ventures) were managing over 100 investment funds. China's investors had 54 closed and 55 open-ended funds to choose from. Together the funds had some Rmb170bn ($20.5bn) worth of assets under management, up from Rmb81bn ($9.8bn) at year end 2001. No less than five fund companies had plans to launch ten funds directly after the Chinese New Year in January 2004.[29]

The rapid expansion of the open-end fund sector during 2001-03 is shown in table 6. In addition to the earlier pure equity funds, currency, bond and hybrid funds are becoming increasingly common. None of the ten funds to be launched in February-March will be pure equity funds.

However, the funds' presence in equities is still increasing. Since some 65-70% of the average fund's assets were invested in shares at year end, the funds owned some Rmb110-120bn ($13-15bn) worth of shares, some 8-9% of tradable market capitalisation. Given the rapid expansion of the sector this proportion could well rise to 15-20% by the end of 2004.

However, the movement of money into funds is not all one-way.[30] Redemptions take place when open-end fund unit-holders redeem their holdings, meaning that the fund decreases in size in both its units and the amount of capital it has under management. Among 56 fund managers, only four reported that net subscriptions had risen in the last quarter of 2003, down from 16 in the third quarter.[31] For the first time since their introduction of the funds in 2001, two have recently seen their outstanding units fall below 200m in number, the minimum needed for establishing a fund.[32] Another fund saw a redemption rate of 49.6% during the last three months of 2003, which meant that the outstanding units dropped in number from 1.9bn to 960m.

The large scale of redemptions is explained by two main factors. First, with the rapid development of new types of funds, it is natural for retail and institutional investors in older the funds to 'upgrade' their investments by transferring money to new funds better able to manage risk. Second, there are suspicions that during the initial buy-in periods for new funds that inflows of short-term money are arranged by fund managers. Such inflows make the subscription period

TABLE 6. OPEN-END FUND DEVELOPMENT, 2001-03

	Number of open-end funds issued	Capital raised, Rmb bn	Fund management companies opened/approved
2003	39	67.8	29
2002	14	44.8	21 during 1999 – 2002
2001	3	11.7	

Source: Beijing Qingnianbao

appear successful, thus attracting more retail investors to buy into the fund. However, large-scale redemptions then occur shortly after the fund has been established. Fund managers allegedly pay high net worth individuals a fee for 'lending' their money to the fund for this use. As well as channelling retail funds out of bank accounts and providing insurers with a better return on their assets than bank accounts, the CSRC hopes that fund managers will discipline the firms they own. This is beginning to happen:

- On July 20th 2002, the board of Zhongxing Tongxun (000063) announced that it wanted to issue H-shares. Eleven fund management companies, holding 12.77% of the company's shares, opposed the move, arguing that the H-share shares' low price-earnings (P/E) would drag down the price of the firm's A-shares. They petitioned for a shareholders' meeting and on August 28th one was held. 113 shareholders representing 66% of shares attended. However, 90% of shares present supported the issue.[33]

- Minsheng Bank (600016) raised the hackles of its fund investors with its Rmb4bn ($482m) convertible bond issue in February 2003. Fund managers were angry since the bonds, when converted into equity, will dilute their stakes. However, again, a shareholders' meeting decided to back the issue.

- An even more eye-catching case was that of Merchants Bank and its issue of Rmb10bn ($1.2bn) worth of convertible bonds. Fund managers furiously opposed the dilution of their holdings that such a move would eventually imply. Some decided to exit, selling shares, triggering a dramatic fall in the bank's share price.[34] But others spared little effort in getting their voice heard. Many openly criticised the company's desire for additional cash, some proposing alternative fund-raising schemes. Notwithstanding the price fall and its tarnished image, the board of Merchants Bank was determined to go ahead. A special shareholders' meeting was held at which 395.5m shares voted against the board.[35] However, the LP shareholders backed the issue and it passed. On the day following the vote, 48 institutional investors jointly released a statement calling on the CSRC to reject the convertible bond application. The board then attempted to calm their anger by offering to reconsider the size of the bond issue and to increase the amount to be placed with current shareholders.[36]

This was a landmark case. It revealed fund managers to be able to monitor corporate behaviour and, rather than simply exiting, to also be able to voice their opposition. The managers lost these cases – and will continue to do so as long as large blocks of shares remain non-tradable.

However, it is likely that company boards will now think twice before determining on a course of action that damages the interests of minority shareholders. This pressure, though, will be disproportionately applied to the blue chips in which the funds tend to invest. Non-blue chip firms, which are often the most in need for shareholder activism, will mostly not be subject to fund manager discipline since these are firms of which the funds mostly steer clear.

A blue-chip bubble?

Although the fund revolution is welcome, it presents a danger. The 'blue-chip rally' in late 2003 was mostly driven by the funds, with ever-more money to invest, buying up large-cap, blue-chip stocks. Contrast that with the securities firms whose portfolios tend to be over-weight in smaller-cap stocks.[37]

A kind observer would say that the funds wanted their year-end portfolios to be full of successful companies. Certainly with strong economic growth there were reasons to expect stronger profits at many firms operating in the steel, car, coal, cement etc. sectors. A less generous observer would argue that fund managers, with every incentive to play safe and to invest where other managers are investing, were engaging in herd-like behaviour.[38] Even less generous minds would wonder if fund managers could resist the temptation to manipulate prices given the huge financial resources now available to them.

The result, however one generous one feels, is that China's blue-chip stocks are gradually being cornered. At the end of July 2003, the total holdings of 29 funds in Baogang Shareholding (600019), for instance, was Rmb2,231.7m ($268.8m), with these funds on average investing 5.4% of their net assets in the shares of this one firm. Nine of the top ten shareholders in Baogang were funds, holding 2.3% of its 288m shares at the end of July 2003. Since the dominant shareholder, Shanghai Baogang Group, held 85% of the firm as state shares, the top nine fund companies held 15% of the firm's tradable equity.[39] Other blue chips reported similarly large concentrations of fund holdings.

Additional pressure is being created by QFIIs funds and insurance firms. QFIIs, with $1.7bn to invest at year end 2003, are concentrating their equity investments in blue chips. Average individual quota levels will likely rise from $100-200m at present to $300-400m by the end of 2004. It is anticipated that by year end 2004, there will be 20-30 QFIIs with total approved investment quota of $8-10bn. After an initial, high-profile entrance into selected stocks, however, some foreign investors have invested heavily in currency and bond funds, as well as convertible bonds, thus gaining exposure to any appreciation of the renminbi, while minimising the risks of the investment.[40] For their part, insurers have an estimated Rmb40-50bn ($4.8-6.0bn) invested in funds but will shortly be allowed to invest a lot more on their own account through wholly-owned asset management firms.

All these institutions are after the same 50-or-so stocks. As research standards improve, and firm restructuring beds down, institutions will probably be better able invest outside this blue-chip circle. However, in the short term there is the danger of a mis-match in supply and demand and that the performance of these firms might not warrant their share price.[41] There is the distinct possibility of a blue-chip bubble developing in the middle of the year.

Concluding remarks

There were no major policy shifts in stock market policy in 2003. Instead, the year was dedicated to the quiet implementation of corporate governance reforms at listed firms, growth of institutional investment, a gradual opening up to QFII investors, and efforts to improve the issuance framework. Among investors, there is the sense that the quality of secondary market regulation has greatly improved since 1998.

China's stock market does indeed appear to be out of the valley, with a fragile recovery in 2004 dependent on inflows of more institutional funds, domestic and foreign in origin. During the year we expect to see further appreciation of blue-chip prices as ever greater sums of institutional money chase a limited number of large-cap, generally profitable, blue-chip firms.

However, the market has not yet cast off the shadow of the state share issue. Despite the State Council's white paper re-statement of policy on resolving this problem, it is far from clear that it has a strategy in place. Given the risks associated with any of the options available to it – selling off the shares into the market, gifting them to current shareholders, transferring them to the National Social Security Fund, converting them into LP shares, or devolving down the decision to each company – odds are that 2004 will not see the issue tackled.

Endnotes

1 'Chinese Stock Investors Make Huge Losses', *Shanghai Daily*, September 26th 2003. Sourced from http://www.china.org.cn/english/NBA/76043.htm, January 2004.
2 See, for instance, 'Bullish market expected in 2004', *China Daily*, January 2nd, 2004. Sourced from http://www1.chinadaily.com.cn/en/doc/2004-01/02/content_295144.htm, January 2004.
3 This estimate is based on the fact that over the first three quarters of 2003 listed companies achieved an average EPS of Rmb0.16 and an average ROE of 6.19%.
4 Among these best performers, Sinopec, and two of its affiliates, Shanghai Petrochemical and Yangzi Petrochemical, made up of 16.51% of the total net profits in the first three quarters; three steel companies, Baogang, Angang and Ma'anshan contributed another 7.76%; and three utility companies provided the rest. See 'Nianbao Pilu Xiazhou Qimu, Yeji Tisheng Jicheng Dingju, Touzizhe Qidan Zengzhang de Chenggou', *Jingji Ribao*, January 10th, 2004. Sourced from: http://www.cfi.com.cn/idx/newspage.asp?200401100260, January 2004.
5 As of 13th January 2004, 21 of the 66 ST firms had announced losses for 2003. If their official figures in the 2003 annual reports published in April report the same, they will be automatically suspended.
6 *Zhengquan Shibao*, 'Duli Dongshi Zenme Yangle?', August 8th, 2003.
7 Xinjiang Hops made guarantees on bank loans worth Rmb1.8bn ($216.8m), compared to the firm's net assets of Rmb600m ($72.3m). The theft knocked some Rmb2bn ($240m) off the value of the firm.
8 Wen Jing, 'Lianhua Weijing Jinqian Danuoyi, Bohai Zhengquan Zao Chiyuzhiyang', *Zhongguo Jingyingbao*, January 31st 2004. Sourced from http://www.cfi.com.cn/newspage.aspx?id=20040131000036, January 2004.
9 On LP share buy-outs see Green, S., 'Two-thirds privatisation': How China's listed companies are - finally - privatising', Chatham House Briefing Note, December 2003 and Green, S., 'Two-thirds privatisation: Is it working?', Chatham House Briefing Note, December 2003.
10 There are various reported figures on the numbers of privatised listed firms. At the end of October 2002, Chen Jian reports that there were altogether 194 privately-controlled listed companies, representing 16% of the total. Among these 194 firms, 67 were directly listed (a percentage of 34.5%); 127 firms (65.6%) won listing status via a back-door listing. See Chen Jian et.al, 'Minying Qiye Shangshi, Jianjie Shangshi Rengshi Zhuliu', *Zhongguo Zhengquanbao*, January 10th 2003. Sourced from http://www.cnstock.com/cjxwzx/rdzz/200301100557.htm, January 2004.
According to one report, private capital controlled about 20% of the 1200 listed companies, See, http://www.ben.com.cn/WLZB/20031223/GB/WLZB%5E894%5E4%5E23R331.htm
11 Interview, Beijing, October 2003.
12 Liu Zhigang, 'Hounian Gushi Qida Xuannian', Beijing Qingnianbao, January 29th 2004. Sourced from Homeway, http://news.homeway.com.cn/detail.aspx?sl=1221&id=556057, January 2004.
13 We are grateful to Bei Hu for bringing these two issuance-related reforms to our attention. See Bei Hu, 'Mainland reforms listing panel', *South China Morning Post*, December 12th 2003.
14 Only 15 and seven applications were rejected in 2000 and 2001, respectively. The pass rate of the first application was about 50%, and 70% for the second application. Approximately 83% of issuance applications were approved and the rejcetion rate was only 17%. See Yang Bo, 'Zhengjianhui Fashenwei Xinnian Diyidao Shajijinghou, Sanna Hongbao Liangna Feidao'. *Huaxi Dushi Bao*, January 20th 2004. Sourced from http://www.cfi.com.cn/newspage.aspx?id=20040120000161, January 2004.
15 In December for instance, the entire industry reported brokerage income of Rmb2.49bn ($300m), a 150% year-on-year increase.
16 '2003nian Zhengquan Gongsi Weijing Shenji Nianbao Xianshi: 55jia Quanshang Zongti Kuisun 4700 wan', *Zhengquan Shibao*, February 4th 2004. Sourced from http://www.cnstock.com/cjxwzx/hgbd/t20040204_514841.htm, February 2004.
17 The later makes up about 30% of all brokerage income. See Qin Hong, 'Zhanle Hangqing De Guang, Quanshang Shouru Gaobie Dieshi', *Shanghai Zhengquanbao*, January 16th, 2004. Sourced from: http://www.cfi.com.cn/newspage.aspx?id=20040116000029, February 2004.
18 This constituted an increase of 279% on Rmb58m ($7.0m), Guoxin's net profit for 2002.
19 'Fenghuang Niepan Nengfou Chenggong, Baijia Quanshang Mianlin Shengsi Jueze', *Beijing Qingnian Bao*, December 3rd, 2003. Sourced from: http://finance.tom.com, January 2004.
20 Guangdong Securities for instance recorded a brokerage-to-total income ratio of 85%; Shenyin Wanguo and Merchant Securities had comparable figures of 84% and 83%, respectively. See Wang Ruyi, 'Jingying Huanjing Gaibian, Zhengquan Gongsi Chuantong Yingli Moshi Cun Sanda Buzu', *Renmin Wang*, October 22nd, 2003. Sourced from: http://finance.tom.com/1008/1009/20031022-26242.html, February 2004.
21 Investors deposit money with the securities companies at a low current saving rate. Securities companies then re-deposit the money with banks at a inter-financial institution rate of 1.89% per annum. As a result, securities firms make an annual risk-free spread of around 1%. See Hong Yuan, 'Quanshang Nailuo Zaowan Dedong', *Guoji Jinrongbao*, August 6th 2003. Sourced from: http://business.sohu.com/85/06/article211870685.shtml, February 2004.
22 The CSRC and PBoC have recently ruled that brokerage accounts must be centrally managed and deposited with banks, a threat to the arbitrage income. It is unclear to what extent firms have complied with this new rule.
23 Note: Open profit rate = [(opening price on day of issue – issue price) * allotment rate]/issue price. The allotment rate is the chance that one's application to buy IPO shares is successful. Due to the high demand for IPOs, allotment rates normally are extremely low. For

instance, the issue price for Huaxia Bank (600015) was Rmb5.6, the opening price on the day of listing was Rmb7.5 and the allotment rate was 0.63%. Thus, the opening day profit rate equals: [(7.48-5.6) * 0.63%]/5.6= 0.22%. Similarly, the highest profit rate uses the peak price of share on the day of listing rather than the opening price. The figures are the arithmetical average of all IPOs in each year. The high rates of return in 1999 are distorted by several IPOs in which prices were set at extraordinarily low levels. However, even excluding these cases, returns in this year were still considerably higher than years afterwards.

24 http://www.cfi.cn/newspage.aspx?id=20031231001194 (Data for 2003); http://www.cfi.cn/newspage.aspx?id=20021231001193 (Data for 2002); http://www.cfi.cn/newspage.aspx?id=20011231000962 (Data for 2001); http://www.cfi.cn/newspage.aspx?id=20001231000122 (Data for 2000); http://cfi.net.cn/special/newstock/zxtj/99sslr.htm (Data for 1999).

25 Assume that total income from underwriting was Rmb1.16bn [5% of total income of Rmb23.3bn (and 95% from brokerage fees)]. Total capital raised in 2003 was Rmb82.3bn [A-share IPOs, secondary offerings and right issues; B-share secondary offerings, and convertible bond. Thus, the average fee was 1.4% [Rmb1.2bn/Rmb82.3bn].

26 Total A-share trading value in 2003 was Rmb3.2trn while nominal brokerage income from A-share trading was Rmb18.6bn. We discount this later figure by 30% to take account of income made through the interest rate arbitrage, resulting in Rmb13.0bn. Trading commissions are charged on both the sell and buy sides, so the average commission rate is 13.0/(3200*2)= 0.2%.

27 Some securities firms have become involved in brokering Hong Kong shares and engaging in proprietary trading of Treasury bond repurchase contracts. Because of rising interest rates in the later half of the year a number of financial institutions, including a number of the commercial banks, have become exposed to falling repo bond prices. This may have been the case too with these securities firms.

28 All applicants will need Rmb1bn ($120.5m) in assets, and the issue can not be for more than 40% of the company's net assets. Most of the bonds will be placed with institutional investors, rather than sold to the general public.

29 Liu Zhigang, 'Jinnian Jijin Youjiang Yinglai Kuorongchao', *Beijing Qingnian Bao*, January 18th 2004. Sourced from http://www.cfi.com.cn/newspage.aspx?id=2004011800030, sourced January 2004.

30 Yang Daquan, 'Zaoyu Da'e Shuhui, Kaifangshi Jijin Guimo Shouci Diechuan Chengli Dixian', January 31st, 2004, *Shanghai Zhengquan Bao.* Sourced from http://www.cfi.com.cn/newspage.aspx?id=20040131000101, January 2004.

31 'Jijin Disijidu Zuhe You Sida', *Zhengquan Shibao*, February 2nd, 2004. Source from http://www.cfi.cn/newspage.aspx?id=20040202000134, February 2004.

32 Current rules state that the fund's NAV must remain below Rmb50m for 60 consecutive working days for the fund to become insolvent and be closed.

33 Shanghai Stock Exchange Research Center, *Zhongguo Gongsi Zhili Baogao* [*China Company Corporate Governance Report*], Shanghai: Fudan University Press, 2003, pp. 212-213.

34 Qin Hong 'Yinhanggu Weihe Chengle 'Quanqiangu'?, Jiangsu Tianding Consultancy, November 13th 2003. Sourced from: http://www.my0578.com/news/2003/11/13/1224258.htm, January 2004.

35 Since 51 investment funds held about 361,290,000 shares in total, and most shareholders present at the meeting were fund managers, it is thought that the vast majority of fund managers voted against the proposal.

36 Xu Hui, 'Jijin Fandui Zhaohang Fazhai Que Bingwei Paogu', *Zhongzheng Zixun*, October 20th 2003. Sourced from http://www.my0578.com/news/2003/10/20/1206030.htm, January 2004.

37 One reason for this difference in portfolios is that the securities companies are 'caught in history'. They used to manipulate the prices of these smaller-cap stocks, and given the market decline since 2001 they have been unable to sell these stocks without realising large losses.

38 For a discussion on the behaviour of fund managers see, 'Shangshigongsi Nianbao Pilu Riqi Jianji, Yejilang Huifou Zouxiang Jiazhi Touji', *Shenzhen Tequ Bao*, January 8th, 2004. Sourced from http://www.cfi.com.cn/idx/newspage.asp?200401080029, January 2004.

39 Hexun Financial Information. Sourced from http://www.homeway.com.cn/StockData/company/owner.aspx?stockid=600019&select=&x=0&y=8, January 2004.

40 'QFII Sida Caixiang, Kezhuanzhai Rengshi Zui'ai', Baixing Investment, February 2nd, 2004. Sourced from http://www.cfi.com.cn/newspage.aspx?id=20040202000398, February 2004.

41 We are grateful to Taylor Hui for comments on this issue.

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