PORTFOLIO INSIGHTS

Opportunities in public and private equity in China

Selectively tapping Asia's long-term promise

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IN BRIEF

- During China's years of transformational growth, returns available to foreign investors were less than impressive, but the possibilities are expanding dramatically in both public and private equity.
- We believe active investing opportunities that tap into important long-term growth trends in Asia can help investors meet a range of objectives and preferences.
- In public markets, Chinese companies are establishing leadership in tech-enabled domains, including autonomous vehicles, artificial intelligence and e-commerce.
- In private equity, China has seen a huge rise in venture, growth and buyout deals, offering another path for active investment management teams with the analytical resources, skills and access.

AUTHORS

EMERGING MARKETS AND ASIA PACIFIC EQUITIES

Howard Wang
Managing Director, Head of Greater China Investments

Rebecca Jiang
Executive Director, Greater China Equities Specialist

GLOBAL MARKET INSIGHTS

Tai Hui
Managing Director, Chief Market Strategist, Asia

Hannah Anderson
Associate, Global Market Strategist

PRIVATE EQUITY GROUP

Naoko Akasaka
Executive Director, Portfolio Manager

Irene Koh
Executive Director, Portfolio Manager

CHINA REMAINS ONE OF THE STRONGEST ENGINES OF GLOBAL ECONOMIC GROWTH, ITS ECONOMY EXPANDING AT A PACE IN EXCESS OF 6% PER YEAR. IT BOASTS THE WORLD'S LARGEST POPULATION, HIGH INTERNET AND MOBILE USE, AND THE WORLD'S SECOND-LARGEST STOCK MARKET.

During China's earlier years of transformational growth, the returns available to foreign investors were less than impressive. Today, however, the possibilities for investors are expanding dramatically—in both public and private equity—offering opportunities to tap into the long-term growth trends we believe represent the most exciting aspect of the Asia growth story. Here, we will discuss how active investing, and a focus on corporate and economic fundamentals, can now access more of that growth, helping investors meet a range of objectives and preferences.

CAPTURING NEW ECONOMY GROWTH

China's onshore (A-share) market and its private equity market both give investors access to high quality companies operating in areas of structural growth, such as affluent consumers, an aging population and technological innovation. They open opportunities in the tech-enabled domains in which China is a pioneer and establishing leadership, including autonomous vehicles, artificial intelligence (AI), e-commerce and mobile payments. And China's recent efforts to further open its financial markets to foreigners have made these domestic opportunities easier for international investors to access.

J.P.Morgan
Asset Management

China has one of Asia's largest private equity (PE) markets. The market has seen a huge rise in deals—venture, growth and buyout—as China has become a global tech innovator and disruptor. Private equity offers another path for active investment management teams that have the right analytical resources, access and skills to access strategic opportunities.

Weighting within EM equity indices could approach 50% over a decade

In 2018, MSCI took the landmark step of including China A shares in its emerging market (EM) equity indices. While inclusion was a watershed moment, MSCI's plan was a gradual one, starting with large cap stocks and an inclusion factor of only 5% (full inclusion, enjoyed by most countries' markets, is 100%). Early in 2019, MSCI announced that mid cap stocks and a number of ChiNext (a Nasdaq-style trading board) stocks[1] would be added and the inclusion factor raised to 20% at its November 2019 semi-annual review.

It would be hard to exaggerate the importance of this latest development, which will have added 421 Chinese stocks to an 830-stock emerging markets index in a span of 18 months. We estimate this will give China's domestic stocks a weighting of 3% to 4% of the MSCI EM index by the end of this year, which is expected to rise to more than 15% over time as China continues to open. Given our view of their quality, and of the structural growth underlying many of these newly available stocks, we believe it makes sense to gain exposure early rather than waiting for the index to catch up over time. Investors with passive index exposure will have to wait for China's importance to be reflected, which may mean getting only limited exposure to some of the highest growth areas of the Chinese economy.

Active investing with a dedicated China sleeve

With China's weighting within emerging market equity indices expected to approach 50% over the next decade, the case for investing with a separate China sleeve, rather than within an EM allocation, becomes quite compelling. Managers with dedicated, on-the-ground resources and broad coverage of the market may be best positioned to identify the companies most likely to generate strong returns for investors. Conversely, gaining exposure through a traditional market cap-weighted index or ETF will result not only in the incrementalism mentioned above but exposure dominated by the largest stocks, some of which represent China's state-owned past rather than what we believe will be its consumer- and innovation-led future.

WHAT ARE A SHARES?

A shares are renminbi (RMB)-denominated ordinary shares issued by domestic, onshore companies incorporated in China. The market has grown from 10 stocks to about 3,500. A shares are:

- traded on the Shanghai and Shenzhen Stock Exchanges
- quoted in renminbi
- governed by China's Qualified Foreign Institutional Investor (QFII) regulations that permit participation by licensed internationals
- tracked by the benchmark CSI 300 Index
- more heavily weighted toward health care (6% vs. 3%), infotech (7% vs. 3%) and consumer staples (8% vs. 3%) than the MSCI China Index. The CSI 300 also has a much greater representation of mid cap companies (about 50%) than the MSCI China Index (about 35%).

A-SHARE OPPORTUNITIES: LIQUIDITY, DIVERSITY, LOW CORRELATION

Over the nearly two decades since China officially joined the global economic community with admission to the World Trade Organization in 2001, the size of its economy has more than quadrupled in real terms. Investors prescient enough to buy the market at the close of 2001 and hold it to today would have enjoyed similarly outsize returns.[2] However, the lion's share of those gains were realized in the first six years, a period that ended with the global financial crisis. While the economy powered ahead for a decade after the crisis, Chinese equities, after experiencing significant volatility, ended roughly where they started.

[1] The ChiNext Market of the Shenzhen Stock Exchange was created to foster innovative, emerging industries; it is tracked by the 100-stock ChiNext Index (comprising large, liquid A-share stocks). "ChiNext Index (CNI)," Shenzhen Securities Information Co., Ltd., 2018.

[2] MSCI China Index (USD).

While disappointing, this was not an entirely surprising outcome. Until recently, domestic growth and market performance were de-linked. Most investors didn't have access to the most dynamic, highest growth parts of the market. Shares available to international investors were predominantly in state-owned enterprises (SOEs) listed offshore in Hong Kong (see sidebar **"Accessing A shares"**).

Today, although China's overall growth may be slowing, foreign investors have more opportunity to capture structural growth in the consumer, health care and IT sectors. The country's expanding middle class is both supporting and demanding an increasingly sophisticated set of consumer goods, a demand more often being met by domestic brands. Chinese companies are also moving up the technology curve, from lower margin commodities to higher value areas, creating emerging opportunities in household durable goods, food and beverages, leisure and entertainment and tourism. In tech and automation, advances are being made in handset components, software services and factory automation, for example. In health care, we see innovative services and drug R&D, including in traditional Chinese medicine. In some cases, China is pursuing its own business models—for example, in payment systems, gaming and fintech. As the traditional sectors (energy, telecom, utilities and financials) have receded in importance, internet retailers, media and software companies have come to the fore—an evolution we believe is still in its early stages.

ACCESSING A SHARES

We recommend accessing A shares through a combination of Stock Connect, QFII and participatory notes programs.

The Shanghai-Hong Kong Stock Connect, launched in 2014, lets international investors purchase A shares traded on the Shanghai Stock Exchange through brokers in Hong Kong. In December 2016, a similar program was launched with the Shenzhen Stock Exchange. Together with Hong Kong, these exchanges have a combined market cap of about USD 10.3 trillion and cover about 80% of the mainland exchanges' market capitalization and over 1,500 companies.

The Shanghai-London Stock Connect launched in 2019.

The opportunity for international investors to capture some of these developments comes thanks to the opening of the A-share market, a broad and liquid set of higher quality domestic (onshore) companies previously available only to locals and sophisticated institutions. And because the A-share market has been relatively uncorrelated to offshore China equities and other major asset classes globally, it can provide the further benefit of diversification.

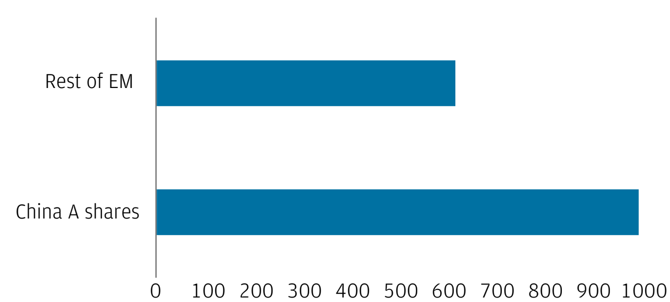
A surprisingly liquid market

A shares have typically traded at a premium to the traditional MSCI China names because of the historically captive nature of the domestic China market and because a higher share of quality and growth-oriented businesses have issued A shares. However, with the policy-driven volatility of the past few years (particularly the past year), A shares are trading at a discount to much of their history, despite the impressive growth we continue to find in a large number of A-share companies.

What many investors may not know is that A shares are extremely liquid. In aggregate, A-share liquidity is rivaled only by that of U.S. (which has a huge lead) and Japanese stocks. To put this liquidity in an emerging markets context, there are more China A-share stocks with a daily trading volume above USD 10 million than in all the rest of the emerging markets combined. (**EXHIBIT 1**).

The A-share market is retail driven, broad and liquid

EXHIBIT 1: NUMBER OF STOCKS WITH MORE THAN USD 10 MILLION IN DAILY TURNOVER



Source: Bloomberg; data as of June 19, 2019.

Contending with high volatility

One reason for the A-share market's liquidity is the dominance of retail traders in China. The short-term, momentum-driven nature of this investor base has generated significant market swings in the past, and 2018 was no exception.

Less sophisticated investors focused more on momentum and short-term trading, moving into and out of positions as sentiment shifts, make A shares highly volatile. By way of illustration, the Shanghai Composite, the A-shares index, has declined 30% or more once a year, on average, in each of the past four years. (After falling 29% in 2018, the index rose 27% in the first quarter of 2019 and fell 9% in April and May.) We believe such volatility and widespread pricing inefficiencies present an opportunity for investors to pick up quality companies at bargain prices. Moreover, we expect that over time, as the influence of institutional investors grows, the domestic A-shares market will come to behave more like other large markets.

We believe China welcomes increased international investor participation, for obvious reasons: Greater participation by international institutions will help elevate the Chinese market's global status and introduce international best practices in corporate governance and investment philosophy. Second, China's long-reported current account surplus may over time become a deficit, requiring a significant inflow of overseas funds. It's not surprising that Chinese authorities would be actively pursuing policies and regulatory changes that win the support of index providers such as MSCI, which are in a position to influence how much global institutions allocate to China.

A-share risk areas

The Chinese government has a history of intervening in markets through its regulators, with little or no consultation or notice. Such actions were particularly disruptive in 2015, when the securities regulator took extreme measures to address what it perceived as excess speculation in public equities markets. The measures included the suspension of IPOs and secondary issues, circuit breakers triggered by extreme market movements and trading suspensions for individual company shares, all of which froze much of the local market for six months. The impact of these measures on sentiment and market performance was profoundly negative on a global scale, and we believe the government learned from the experience. For one, the China Securities Regulatory Commission put in place clearer guidelines covering the use of, and disclosure around, stock suspensions. We believe such steps contributed to MSCI's inclusion of A shares in its indices last year.

Corporate governance in China remains another risk and an area where experienced managers' scrutiny and selectivity can be critical. Transparency and discipline in allocating capital also remain uneven, although they have improved over time. For these reasons, we believe in-depth knowledge of individual companies and management teams—rather than a passive approach—will be key to success in investing in China's domestic market.

PRIVATE EQUITY: ANOTHER PATH TO CHINA'S GROWTH STORY

Private equity offers another path for active investment management teams with on-the-ground experience and a disciplined investment selection process. Over the past decade, PE in China has provided access to China's growth story, allowing investors to gain larger exposure to growth sectors such as consumer discretionary, technology, media and telecom and healthcare. PE investing has also offered earlier access to leading companies within these sectors, along with the opportunity to potentially outperform public markets.

China is one of Asia's largest PE markets, with venture, growth and buyout deals growing tremendously as the country has become a global tech innovator. Many of China's leading public companies, such as Alibaba and JD.com, were initially venture or private equity backed. Private equity is an important source of capital supporting the new companies—whose formation and success have risen rapidly alongside technological advances, the emergence of disruptive business models and tech-savvy, sophisticated consumers with a relentless demand for new products.

China's consumer market (second only to the U.S. in size) is driven by a burgeoning middle class and the shift in spending patterns from staples to discretionary items. China's 330 million millennials (five times more than the U.S. cohort) look poised to become the world's most influential demographic, creating important consumer-related investment opportunities. China has 829 million internet users[3] and the world's biggest online community, and it leads the world in e-commerce adoption, mobile payments and social media use. China is a leader and pioneer in technology-enabled domains, with the Chinese using online services not only for finance, social media and shopping (online sales registered USD 650 billion in 2016) but also entertainment and gaming (together a USD 22 billion

[3] "The 43rd China Statistical Report on Internet Development," China Internet Network Information Center (2019).

China views technology as the path to prosperity, making it a fertile breeding ground for startups

EXHIBIT 2A: CHINA IS CLOSING THE R&D SPENDING GAP WITH DEVELOPED MARKET COUNTRIES

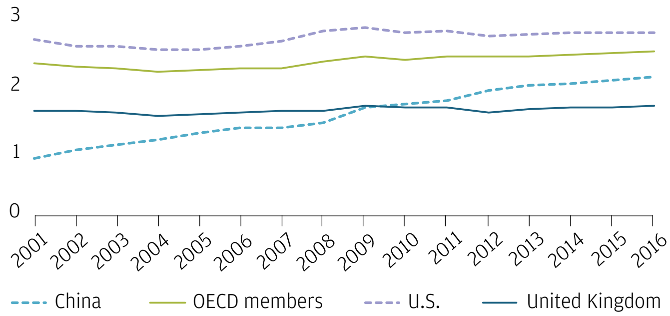
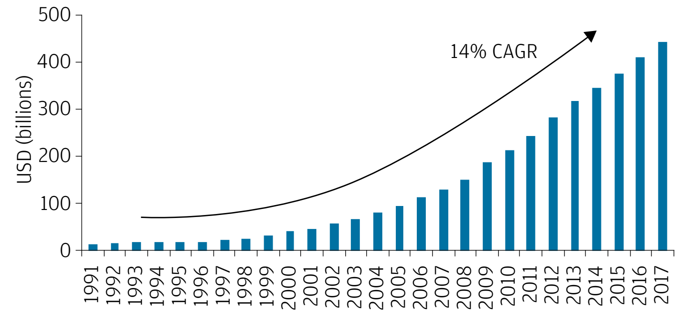


EXHIBIT 2B: CHINA'S R&D SPENDING GREW SHARPLY FROM 1991 TO 2017



World Bank Development Indicators; data as of April 24, 2019. CAGR: compound annual growth rate.

industry). Chinese social media platform WeChat, for example, used by more than 1 billion people in 2018, integrates so many functions—making mobile payments, booking doctors' appointments, paying traffic fines and bills, ordering food delivery, etc.—that it's been described as an "app for everything."

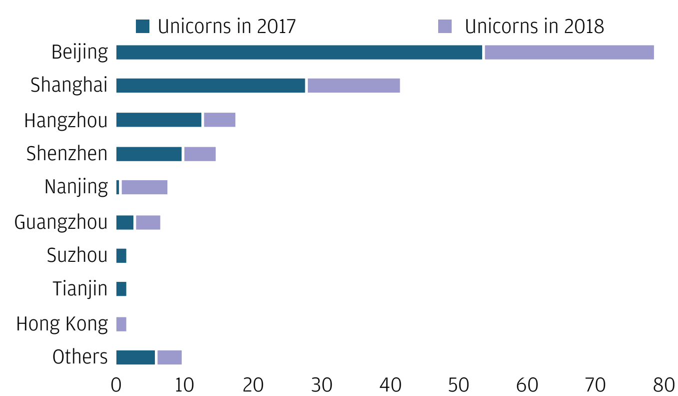
Scientific infrastructure: Creating a breeding ground for unicorns

With its strong backbone of technological infrastructure and a supportive policy environment, China is well positioned for innovation, as evidenced by rising R&D spend (**EXHIBITS 2A** and **2B**). China has been the global leader in number of patent filings. For decades, it has graduated more scientists and engineers than all Western countries combined. The government and its citizens widely view technology and idea-driven innovation as the path to prosperity. This has provided opportunities for startups, particularly in retail, health care and transportation. We consider invented-in-China brands, robotics and AI to be fertile grounds for creating the country's next unicorns.[4]

The number of unicorns in China is rising; currently, it boasts 186, more than half of those in the world, including three of the largest five (number one, financial services firm Ant Financial, has a valuation of USD 150 billion). Unicorns are found across industries such as health care, transportation, media and education, and have broad geographic distribution: Beijing, Shanghai, Hangzhou and Shenzhen were home to most fast-growing Chinese startups last year (**EXHIBIT 3**).[5] Additionally, Chinese startups have tended to grow much faster than those in the U.S. as new apps and services have sprouted and spread.[6] We believe this is due to the willingness of China's large mobile user base to try new things and the country's vibrant industrial-commercial ecosystem.

China is home to more than half the startups worth more than USD 1 billion in the world

EXHIBIT 3: CHINESE STARTUPS WORTH USD 1 BILLION BY CITY, 2017 AND 2018



Source: Huran Research Institute; data as of 2018.

China's dynamic industrial-commercial ecosystem

China is one of the few countries in the world with a complete industrial-commercial ecosystem. It has the full life cycle, ranging from manufacturing to service and from fundamental research to advanced applied R&D. Technology has been

4 Private startup companies valued at over USD 1 billion.

5 The combined value of China's unicorns tops RMB 5 trillion (USD 736 billion). "Hurun Greater China Unicorn Index 2018," *Hurun Report,* January 2019.

6 As of 2017, the average Chinese unicorn internet company's trajectory from startup to a USD 1 billion valuation took four years, vs. seven for a U.S. internet startup's journey to a USD 1 billion valuation. "Decoding the Chinese Internet," The Boston Consulting Group, AliResearch and the Baidu Development Research Center, September 2017.

comprehensively implemented across nearly every aspect of the economy, ushering in productivity gains as well as better consumer products and services. Consumers may purchase Baxi ice cream, a leading domestic ice cream brand, online through e-commerce retailers like JD.com thanks to the cold-chain logistics system built in the last few years. Combined with advanced mobile payment services such as WePay and Alipay, food takeout app growth has skyrocketed; on-demand local services provider Meituan-Dianping, for example, delivers over 20 million orders per day. Technology has also let new entrants disrupt existing business models at a faster pace. Luckin Coffee, which features data-driven, app-based purchase and delivery services, was founded a year and a half ago and today is the second-largest player after Starbucks.

More IPO exits than in the U.S.

Twenty-four Chinese technology companies went public in 2018, surpassing the number in the U.S., including smartphone giant Xiaomi Corp. and Meituan-Dianping. China has enacted supportive capital market policies encouraging IPOs. On the Hong Kong bourse, new listing rules are expected to attract more IPOs and help make the exchange a hub for "new economy" companies. The Shanghai Stock Exchange launched the Science and Technology Innovation Board (also called the STAR market) in June 2019 with new rules likely to speed up the process for listing shares.

Investment selection is key

Successful private equity investing requires skill. Even with ample capital and private equity sponsors in China, it has become ever more critical to partner with the top PE sponsors. They bring extensive networks and a reputation for accessing the best companies and entrepreneurs, strong insights for selecting the right companies in the right sectors, an ability to perform in-depth due diligence to reduce risks, and deep-rooted, relevant expertise and resources to help companies grow.

The key risk of PE investing in China remains investment selection. The dispersion of returns among private equity investments (from top to bottom quartile) is significant, both in absolute terms and relative to other asset classes. Due to this dispersion, the selection of PE investments in China can be even more important than the decision of how much to allocate. Any sponsor without the requisite experience in its area of focus—whether industry, growth stage or other—will likely disappoint, regardless of the fund's other characteristics (size, terms, structure, etc.).

THE NEXT STAGE OF ECONOMIC DEVELOPMENT: FOCUSING ON QUALITY INSTEAD OF SPEED

The macro growth backdrop

Somewhat counterintuitively, the positive story comes just as China's GDP growth has slowed (it now hovers between 6% and 7% a year).[7] In part, this slowdown is cyclical, due to a deliberate effort to deleverage. But it is also occurring because the economy is maturing and population growth has slowed. The changes we anticipate in the A-shares and private equity markets, however, reflect fundamental, structural changes—in income, consumption, consumer credit, urbanization and fast-moving innovation, which are independent of economic cycles. China's consumer market—second only to the U.S. in size—continues to grow rapidly.[8]

Macroeconomic risks

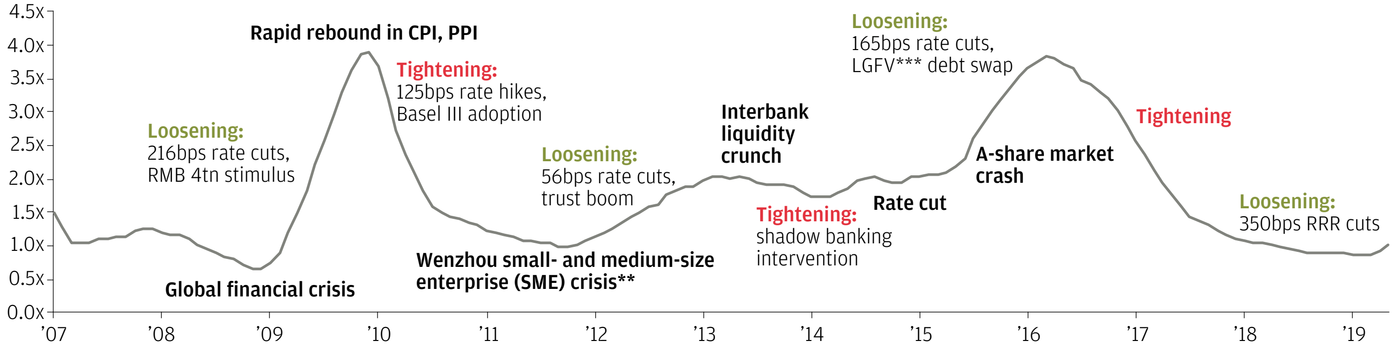
Potential macroeconomic headwinds include the U.S.-China trade war, a downturn in China's property market and excess leverage at state-owned enterprises. These macro concerns are fluid. However, we feel the government's longer-term course toward sustainable rebalancing is a positive one and has achieved notable successes. Debt-to-GDP is stabilizing, and the shadow banking sector has contracted. Still, rebalancing must proceed in the face of a hurdle: the need to adjust fiscal and monetary policy in response to internal and external events.

[7] We expect a more accommodative stance by the People's Bank of China, and increased government spending will allow growth to resume acceleration after bottoming out around mid-2019.

[8] We note that while China has significantly more consumers than the U.S., they have less spending power than their U.S. counterparts.

China has enacted much-needed deleveraging since 2017, but the tide is changing

EXHIBIT 4: CREDIT GROWTH TO GDP GROWTH: BROAD CREDIT MEASURE,* RATIO, Y/Y CHANGE, 3MMA



Source: CEIC, China Central Depository & Clearing Co., People’s Bank of China, Shanghai Clearing House, J.P. Morgan Asset Management; data as of May 31, 2019.

Credit-growth-to-GDP-growth ratio utilizes rolling 12-month nominal GDP and broad credit. CPI: consumer price index; PPI: producer price index; LGFV: local government financing vehicle; RRR: reserve requirement ratio.

*All reported bank claims on the domestic economy, plus bankers’ acceptances, entrusted loans, trust loans, new net corporate bond and nonfinancial equity financing, issuance of asset-backed securities and interbank loans.

**Wenzhou SME crisis refers to the wave of bankruptcies and funding problems faced by a large number of small and medium-size enterprises in Wenzhou in 2011.

The deleveraging process that shrank the shadow banking sector also caused unwelcome shifts in banks’ books of loans from the private to the public sector. The government has succeeded in consolidating the steel and aluminum industries, but there have been challenges elsewhere (**EXHIBIT 4**).

China’s economy has remained resilient and continues to grow at more than 6% a year. China is focusing away from its reliance on capital investment and export and toward consumption and services. While this shift is expected to slow short-term growth, it should build foundations for more sustainable long-term business expansion. Demographic shifts and an aging population may present both challenges and opportunities in various sectors. Government policy changes may impact certain industries, but this is not unlike other markets.

Geopolitical friction presents other risks, and increasing U.S.-China trade tensions top many investors’ worry lists. Our base case remains that an all-out trade war would be in no one’s best interests and so would be unlikely. Nonetheless, recent trade tensions could accelerate China’s development in two ways. First, it would likely foster technological innovation to reduce dependence on global suppliers. Second, it could lead both international and Chinese companies to diversify their production capacity by moving some of it outside China.

As for the impact of current U.S.-China trade tensions on the A-share market, A-share companies are not mainly exporters but source about 80% of their revenues within China. Still, A shares fell as each new headline warned that U.S. tariffs might lower Chinese imports into the U.S. and potentially prompt retaliation from Beijing. The route to resolution is likely to involve further market volatility along the way.

A strong case for active management

China continues to be one of the defining economic growth stories of the 21st century. The case is strong for active management to access strategic opportunities today. We expect investors may have another generation of transformational earnings growth ahead, along with rising valuations that more fully reflect the positive change, which was not always the case in the past. With a team that has the right analytical resources and access, and potentially through a separate China sleeve, investors should be able to meet a range of objectives and preferences.

FOR MORE INFORMATION

Please contact your J.P. Morgan representative.

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