FAR EASTERN ECONOMIC REVIEW

Essays

December 2005

The Mystery of China's Sinking Stocks

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It is one of the greatest paradoxes of the Chinese economy that its stock market, called the A share market, has lost half of its value in the past five years, while the economy has grown by 50%. Many attribute the stock market decline to the "overhang" problem. Until recently, two-thirds of all the shares of companies listed on China's stock exchanges were "temporarily nontradable," but there had been repeated indications that these shares would be freed up sooner or later. Some argue that it is such a prospect that depresses the market because of the fear these hitherto nontradable shares will flood the market once freed up.

It is against this background that the regulators launched, around the middle of 2005, "share reforms" aimed at resolving the overhang problem by making nontradable shares tradable. This, undoubtedly, is the right decision, as the existence of a large amount of nontradable shares is an anomaly for any market. However, the belief that the so-called overhang was the chief culprit of the dismal performance of the stock market has led to measures to monetarily benefit tradable shareholders in the process of converting all shares into tradable shares and to suspend capital raising. The hope is that happier shareholders and a frozen supply of stocks will help prop up stock prices.

The real reason for the depressed A share market is more fundamental. A comparison of the stock prices of Chinese companies which are simultaneously listed on domestic and overseas stock exchanges gives some indication of the real story. On average, these dually listed companies are still traded at a 30% premium in Hong Kong, or the H share market, over the price of the same stock in the A share market. To be sure, the price gap between domestic and foreign exchanges of the dually listed companies has been narrowing, from about 380% five years ago to only about 30% today. But the A share market is hardly cheap; it remains overvalued compared with overseas markets.

Historically, the large price differentials between A and H shares might very well be caused by excessive liquidity or too much money chasing too few shares in the A share market as capital controls prevented arbitrage between domestic and overseas markets. This is in fact how market bubbles are built anywhere in the world at times. From a policy point of view, excessive speculation should not be encouraged because, as the saying goes, what goes up must come down. Eventually, the price will "correct" to reflect real fundamentals. When such corrections inevitably occur, the effect is usually devastating, as much wealth is destroyed when a stock market bubble bursts.

While a stock market crash may merely represent a natural return to reality when a speculative bubble can no longer sustain itself, such as when the Internet bubble burst in the U.S. in 2001, a prolonged downturn, as opposed to a precipitous bottom-out, is usually induced by economic recession. The stock market usually mirrors the performance of the broad economy. The market may run ahead, but it almost never goes in the opposite direction of the economy. In fact, rarely, if at any time, can a bubble be built when the economy is fundamentally weak; equally rarely does a stock market go into a continued decline when the economy is booming. China seems to be an exception to the rule given that the continued decline of its stock market coincides with a rapidly growing economy. What has caused this sharp and wide divergence?

The real reason can be found in economic fundamentals. China's economic growth is so driven by capacity expansion, or fixed-asset investments, that investments now account for more than 50% of the gross domestic product, more than any other country at any time in the history of economic development. The relentless capacity expansion has led to economy-wide overcapacity and overcompetition, to such an extent that the profit margins of the firms are constantly squeezed. Data show that the prices of Chinese exports to the U.S. have fallen by more than a quarter since 1997 whereas the price index for China's raw materials has risen by about 20%. If growth only translates into ever declining profitability for Chinese firms and decreasing return to their shareholders, is there any wonder why their stock prices also fall?

Moreover, the Chinese stock market has never been a fair game. To be permitted to go public has long been considered a policy favor often reserved for weak firms requiring government support. This has led to some well-known abuses and corruption cases as weak firms desperate for financing are motivated to go out of their ways to obtain permissions. A relatively junior official of China Securities Regulatory Commission is currently on trial for selling the names of the randomly chosen members of the Commission's listing committee so that firms aspiring for a public listing could bribe them before listing applications were up for review. The practice of meting out policy favors as a way to select listing candidates has created a mix of some good quality firms and a lot of bad ones on China's stock exchanges. In addition, the parent companies of many poor quality firms are also known to have helped themselves with the money raised by their listed subsidiaries in the public market, further weakening them.

Therefore, the performance of the Chinese stock market, not surprisingly, merely reflects economic fundamentals of the listed companies. Concern over the so-called overhang is overblown. Moreover, there is no evidence, nor is there any economic logic, that the government plans to dump all, or a substantial amount, of the shares it holds onto the market. If it had wanted to do so, it could have done it in the H share market. If it exits at all, it would exit in an orderly fashion in order to fetch the best possible price.

It should be noted that the market capitalization of H shares has grown much larger than that of the domestic stock markets. H share listings total $369 billion, compared to $295 billion for all the companies listed in Shanghai. The state-owned controlling shareholders of H share companies are generally free to sell down their shares at any time if they should wish to. They have not done so and nobody believes that they will do so any time soon. Nor have their stock prices reflected any fear over such an enormous "overhang." In fact, the H share index has been rising in the past few years as more and more of the best Chinese companies, denied access to domestic markets, have opted to go public in overseas markets, including some of the largest offerings ever done by Chinese companies this year.

But the notion of an overhang has given rise to the argument that nontradable shareholders should pay tradable shareholders before the shares of the former are allowed to trade. The stated justification for "making payments" is based on the fact that the offering prices for the shares issued to public shareholders when these companies first went public were higher than the investment costs of the founding shareholders who now hold non-tradable shares. This was deemed unfair and therefore the nontradable shareholders should now compensate tradable shareholders for such historical wrongs.

The regulators agreed and made it a rule that nontradable shareholders must pay tradable shareholders regardless if such tradable shareholders have just become a shareholder the day before they are required to register to receive such payments. There is no standard for how much payment is to be made or in what form; whatever payment terms must be approved by two-thirds of tradable shareholders before nontradable shares to receive the label of "tradable," although they are still required to be locked up for a period of time.

To date, some 300 listed companies, out of 1,370 or so, have announced plans by their nontradable shareholders to pay tradable shareholders. Of them, over 100 have completed making payments and have thus become what is referred to as "G share" companies. The payment schemes typically consist of nontradable shareholders giving for free their own shares and cash to the other group of shareholders. On average, tradable shareholders receive about 30 free shares for every 100 shares they hold. Furthermore, some nontradable shareholders have also given warrants to entitle tradable shareholders to buy shares from them at specified prices. To assure tradable shareholders that there is value in these warrants, nontradable shareholders have also committed cash, in billions of yuan, to support the stock price should it fall below the exercise price of these warrants.

In any stock market, it is unthinkable for a group of shareholders, controlling or otherwise, to be forced to give up their property before being allowed to trade their shares. Most of Hong Kong's publicly traded companies are controlled by some major shareholders. They are free to sell or buy shares in the open market. They may choose not to do so, as is also their right. There is no basis, either in law or in practice, either in China or overseas, for one group of shareholders to be forced to give up their property rights to another group of shareholders.

Respect for property rights is a major pillar for any market. No market can function normally without it. Due to historical reasons, the respect for property rights is already lacking in China, which is the reason for such widespread market ills as infringements on intellectual property rights, counterfeiting, and disregard for safety and the environment. It is regarded as major progress in China's march towards a market economy that the protection of private property rights were written into the P.R.C.'s constitution for the first time only about a year ago. Therefore the de facto expropriation of one group of shareholders' property rights by another, be they state or private owners, undermines the market.

Another major pillar of the market is the rule of law. The practice of shareholders making pledges to support their stock prices directly contravenes China's securities law against stock price manipulation. Regardless of the objective, such disregard for established laws and regulations cannot be conducive to the development and maturation of a stock market.

Furthermore, gifting shares to tradable shareholders cannot boost the share price as hoped and it is likely to be counterproductive. This is because free shares reduce the average holding cost of shares, providing incentives for the shareholders to sell. In fact, a rational investor is likely to sell free shares to lock in profit. The selling induced by gifted free shares can only depress the share price.

Finally, justice cannot possibly be served by compensating the wrong shareholders. The turnover rate in China's stock market is about three times per year. The current shareholders may be completely different from those who had bought shares when the company first went public. Even assuming that the original tradable shareholders were wronged because they paid higher prices than the founding shareholders for the stocks of the company, a preposterous notion to anyone remotely familiar with the concept of rewarding risk-taking by the market, how can justice be served by compensating someone other than the alleged victim of a wrong-doing?

To date, over 100 companies have completed the transition from "partial circulation" to "full circulation" of their shares, or have become the so-called G share companies. To obtain these rights, the non-tradable shareholders have given up their property in terms of shares, cash, warrants and other forms of economic interests to tradable shareholders. How have the G shares fared so far? And how has the stock market performed as a result of these changes?

Unfortunately, in both cases not very well. The stock prices of G shares have under-performed the market, and G share companies have lost about a quarter of their market value on average. Analysis conducted on the data of G share companies as of the end of October of 2005 show that the more free shares that the nontradable shareholders gave to tradable shareholders, the greater the fall in the prices of these shares, as one would expect. In fact, their share prices have fallen so much that the total holdings of the tradable shareholders, if they have not sold, are on average worth less today than before they received free shares. Therefore, both tradable and non-tradable shareholders in general have been left worse off as a result of the latter giving their properties away to the former.

The Shanghai Stock Exchange Index indicates that the market has declined as well and is now hovering below the psychological barrier of 1100 points. Even so, the index now overstates the true performance of the market. This is because free shares are not taken into account when computing the index until physical delivery has been made. If 100 tradable shares are entitled to receiving 30 free shares and if the share price is 6.5 yuan, then the true value of each share can only be derived by dividing 6.5 by 1.3, or 5 yuan, as one share really contains 1.3 shares. But in computing the index, the share price is assumed to be 6.5 yuan, with no adjustment made for the inevitable dilution, until after the receipt of the free shares. When free shares are delivered, the price promptly falls to the adjusted level and further as shareholders sell off their holdings. The index is inflated as long as it contains a large number of companies which have announced free share schemes.

Not only are G shares punished by the market, the Chinese stock market as a whole has also become more, as opposed less, speculative. Capital is enticed to flow to the shares of those companies about to become G shares in anticipation of receiving free shares and cash. Once these gifts are delivered, the shares are dumped as investors lock in profits and move on to the next target. G shares are no longer attractive because there is no chance they will receive any more free shares and cash. And so the process continues to repeat itself. As long as free money continues to fall out of the sky, G shares are deserted regardless of their fundamentals. The consequence of all this is that G shares will be depressed before the entire market is converted into G shares. As the number of G shares increases, the market is expected to continue to trend down as well.

What has the reform achieved? It has not made nontradable shares tradable, at least not for the time being as they remain locked up for some years to come. Has the reform succeeded in reducing the state holdings of shares of public companies? Not at all. On the contrary, a number of large companies have seen the holdings of the state-owned controlling shareholder increase, because the parent companies have bought more shares to support the share prices than the shares they had given away earlier.

Therefore, the “overhang” is not reduced in the least. It has only become greater, except the market now knows that these shares will be allowed to float after the pledged lock-up period expires. If overhang will indeed depress the stock price, then the worst is yet to come, to a different group of tradable shareholders, no doubt. Why such a prospect is of no concern to policy makers and why no further compensation is contemplated to future tradable shareholders who will bear the brunt of the potential “flood” is never explained.

Meanwhile, the stock market is basically shut down for new issues, either by the listed companies trying to raise fresh capital or by nonlisted companies attempting to go public. The policy is motivated by the same concern that more issuances may further dampen the market as it increases the supply of stocks. Because of the depressed state of the stock market, no G share companies have been allowed to issue new shares or otherwise raise capital through the market even after they have completed the reincarnation into G shares.

In fact, even if G share companies are now allowed to raise capital in the public market, they may not want to or may not be able to do so, because their share price has become so depressed. By the rules of state asset management authorities, no state-controlled companies can issue stocks at prices below their net asset value.

Even some market leaders have seen their share price falling through that level after the G share transition. If the belief is that new issuance only depresses the market further, the regulators will likely continue to limit capital raising activity for a long time to come.

If banks and the stock market are regarded as the two major engines of economic growth for China, the stock market engine has sputtered and basically shut down, while bank lending has increased substantially year after year in the past five years. Last year, bank lending increased by some $230 billion, but the capital raised from the A share market was an insignificant $7 billion. This year, capital raising activities in the domestic stock market have been entirely suspended.

For a major economy such as China's, it is difficult to calculate the economic costs of shutting down the stock market and depriving public companies of the ability to raise capital. How can the stock market grow more healthy if listed firms are starved of capital and new listings are barred? The inability to raise equity capital in the public market only weakens listed companies, which will further weaken the stock market. The right cure for the ills of China's stock market is to make listed firms stronger by improving their capital structure and to improve the mix of listed companies by introducing new listings of quality companies. To do otherwise can only be counterproductive.

An unintended consequence of closing down the stock market is to increase the risks for Chinese banks. Denied access to equity capital through public market, firms will have to rely more on bank loans. Equity is the cushion against insolvency risk for lenders. Insufficient equity increases the risk of bank loans turning bad. 2005 is a banner year for China's banking reform as several major state-owned banks have cleaned up their balance sheets, brought in foreign investors and gone public on Hong Kong Stock Exchange. For the reform to succeed, the underwriting criteria of Chinese banks will be further tightened. The dynamics of the odd combination of more disciplined bank lending policies and the lack of equity capital bode ill for public companies, for the stock market and for the economy for years to come.

Denied access to the domestic stock market, quality firms have flocked to overseas markets for capital raising in record numbers. The H share market has risen partly due to the improvement of sentiment towards China and partly because good quality companies attract more investors. The performance of the H share market should serve as guidance to China's domestic market. To cure the ills of the market, one must fix the fundamentals by improving the quality of listed companies and by bringing better companies to the market. Otherwise, the stock market will continue to languish, exacerbated by the policy-induced pursuit of stocks which are yet to receive free gifts at the expense of G share companies.

China has largely avoided major policy blunders in its 25 years of economic reforms by, in the words of Deng Xiaoping, "crossing the river by groping for the stones under the water," one step at a time. The reform of the stock market, however, has not achieved the intended results. Only by focusing on fundamentals and by boldly opening up the market to qualified companies can China's stock market improve its health and function as a major engine of economic growth. [*Mr. Shan, an economist by training, is a private equity investor.*]