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State Ownership in China, a Different Shareholder Focus

The speed of Chinese economic growth over the past three decades has been phenomenal with little signs of slowing down. Within 10 years the world's No. 2 economy is expected to be the largest economy in the world. While the Chinese economy has eclipsed other global superpowers, China is still considered a less-developed emerging market with a mix of state-owned enterprises (SOEs) and private listed companies. This split between SOEs and non-SOEs creates a challenging dynamic for investors seeking to profit from China's economic expansion.

SOEs: The first stocks in China

When the Chinese stock market began trading in the 1990s all of the listed shares represented state-owned enterprises (SOEs). Although non-SOEs have grown over the years to represent just around half of mainland market cap, state-owned firms still make up a large part of the Chinese equity market, and dominate strategic industries like Finance, Energy, Construction, and Utilities. These government-sponsored entities often follow a mandate to fulfill the Chinese Communist Party's political and social objectives, rather than pursuing the typical Western commitment to enhancing shareholder value. Yet, up until the Global Financial Crisis of 2008, SOEs managed to post better stock market performance than their Chinese private listed counterparts.

Exhibit 1. State ownership in the Chinese equity market through the years

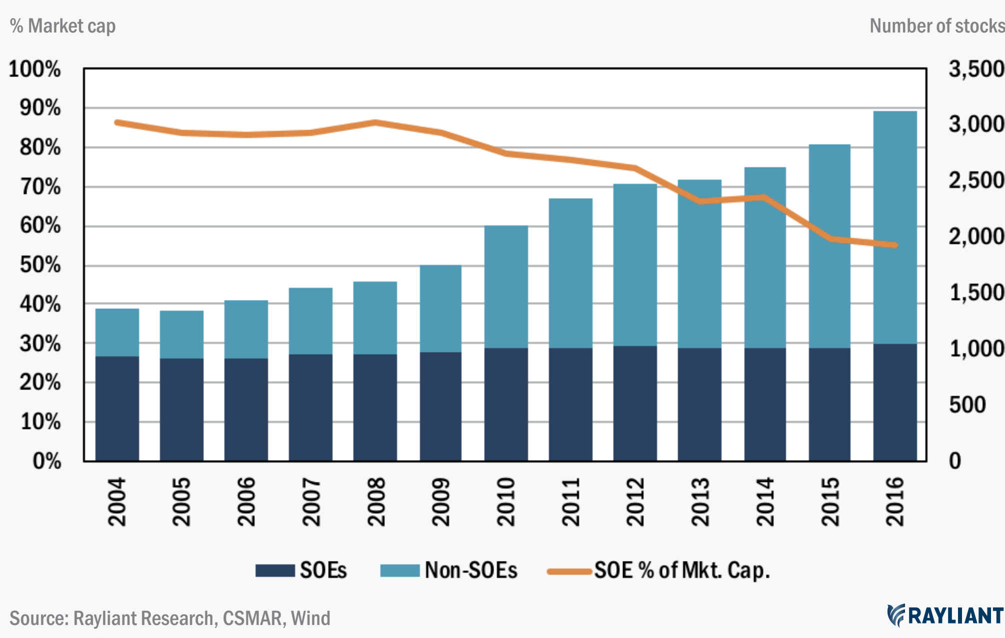
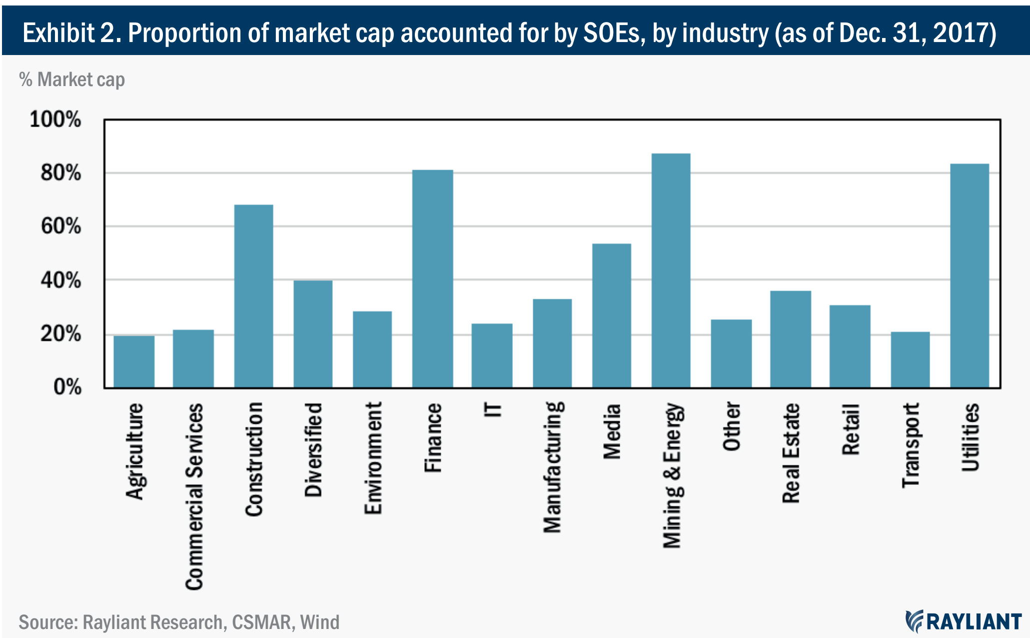


Exhibit 2. Proportion of market cap accounted for by SOEs, by industry (as of Dec. 31, 2017)

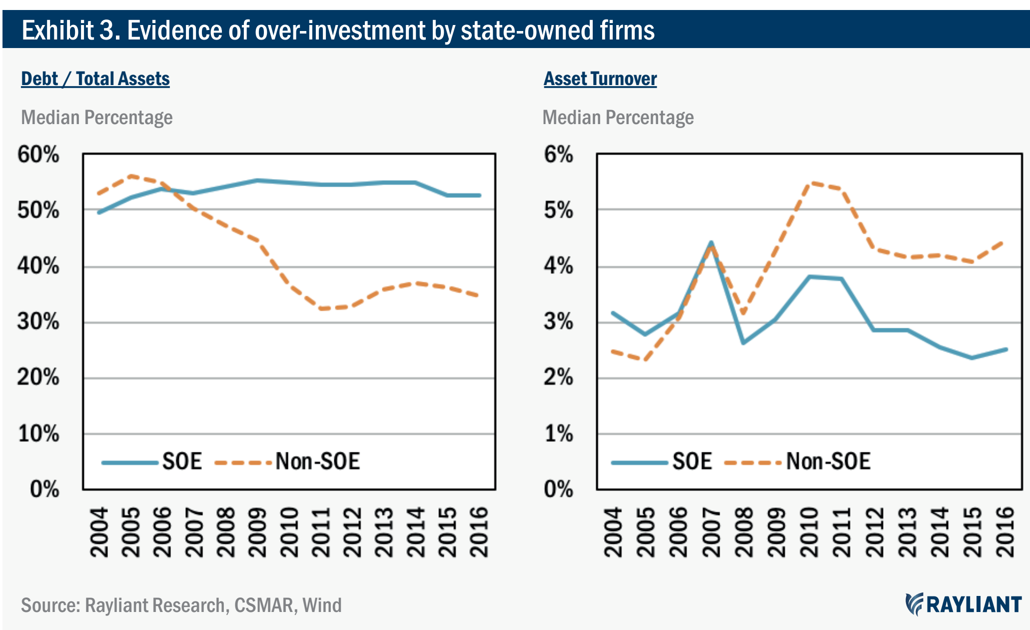


Source: Rayliant Research, CSMAR, Wind

Capital access drives over-investment

If capital drives economic expansion, then SOEs are in the driver's seat. The largest banks—most of which are also state-owned—tend to provide non-financial SOEs with easy access to loans at below-market interest rates. For private companies in China, by contrast, funding for growth projects is much harder to come by. Good for SOEs? Not necessarily.

Exhibit 3. Evidence of over-investment by state-owned firms



Source: Rayliant Research, CSMAR, Wind

As it turns out, easy access to loans seems to have resulted in SOEs allocating their large pool of funds to projects with great social value but questionable economic merits. While non-SOEs wisely scaled back their borrowing during the global economic contraction, SOEs maintained high levels of debt and appear to have

"over-invested" in stimulus-oriented projects. This may have benefited the economy but did little to help shareholders in state-owned companies, leading to SOEs posting weaker stock returns than non-SOEs over most of the post-2008 period.

That's history, what about today?

So, will future performance of SOEs follow the strong pre-2008 returns, or better match the weaker results in the post-crisis period? With continuing liberalization of China's economy and another series of major SOE reforms underway, that may be hard to predict. Given that state-owned firms represent over half of China's stock market capitalization, on the other hand, one thing is certain: SOEs are collectively too big to ignore. Rather than ask what the future holds for SOEs or whether they belong in a China equity portfolio to begin with, perhaps it makes more sense to take state-ownership as a given and ask how one might best select from among state-owned companies marching to different profit motives and investment policies than China's private listed firms.

Quant strategies for investing in SOEs

At Rayliant, we apply factor-based investment strategies to emerging markets like China. An important part of our research process is to acknowledge structural differences that make these markets interesting—like the distinction between SOEs and non-SOEs—and to adjust our approach accordingly. We base our strategies on quantitative research, as well as insights from fundamental investors with knowledge of local markets. This localized approach allows us to effectively combine the discipline and breadth of traditional quant strategies with region-specific adjustments aimed at reducing risk and enhancing returns, and to adjust rapidly as markets evolve and conditions change.

In the case of state-owned firms in China, our research shows that it is important to separately evaluate SOEs and non-SOEs on some factors to maintain sound apples-to-apples comparisons, an approach we refer to as *SOE neutrality*. This is particularly critical when applying a factor such as Value, where perpetually discounted SOEs would naturally dominate, even if they turn out to be cheap-for-a-reason value traps. Given the attractive growth opportunities in China, but the propensity of SOEs to over-invest, we have also found that an *SOE over-investment factor* can be an effective means of identifying SOEs with responsible investment policies—potential diamonds in the rough, unfairly underpriced with the rest of the state-owned sector.

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