

## **Joint ventures in China: Is there a future?**

*Local firms show determination and desire to globalize*

By Michael J Shelley

To borrow a headline from the Financial Times on December 31, 2008 - 'World markets close 2008 bruised and confused' - a typically British understatement!

The FTSE All Share Index lost 32.8% - its worst annual fall since 1974. Similarly, the Xetra Dax was down 40.3%; the CAC 40 - 42.1%; Nikkei 225 - 42.1%; Kospi - 40.7%. In New York, the S & P 500 fell 38.5% being the worst drop since that of 47.1% in 1931. For the Emerging Markets, the MSCI tumbled by 55% in dollar terms. And in the commodities markets, the S & P GSCI index lost 46.5%

The so-called BRIC economies fell from between 55% and 72%. In short, 2008 witnessed six years of market gains vaporise - and on this occasion at least, indicated that diversification did not bring any rewards.

The HKSI finished the year recording a loss of 48.3% - and the Shanghai Composite Index 65.4%, having been the world's best performing market a year earlier in 2007. The markets saw out 2008, then, 'in a perturbed state after a year of dizzying turmoil' leaving little choice in havens of refuge. For the Chinese investors, even a slowly expanding range of choices does not provide much comfort.

### **Funds in China**

According to Cerruli Associates, the total AUM at the end of 2007 of the then 363 mutual funds was 3.33 trillion renminbi (US\$0.49 trillion) - 282% larger than the previous year of 856.5 billion renminbi. China AMC, Bosera Asset Management and Harvest Fund Management were the top three fund management companies each accounting for more than 200 billion renminbi.

However, by the end of June that year, the total AUM had already fallen 34% to 2.18 trillion renminbi - a fall greater than that in other regional markets. By the end of 2008, the funds had lost over 40% to 1.94 trillion renminbi. According to the published statistics from the China Securities Regulatory Commission (CSRC) there were 439 funds - including a few remaining closed-end ones - offered by 61 fund houses. Fee income earned by the fund managers was estimated to be in excess of 28 billion renminbi. China AMC still maintained its star position with assets of 188.86 billion renminbi; and the top ten managers reflected a market share of a little in excess of 50%.

While the best performing equity funds still managed to lose over 30%, according to Lipper, the average return on bond funds was a positive 6.77% and money market funds 3.47%.

So far this year, market gains in Shanghai have reflected close on 40% for the year having at least once broken through 2500 - but this is still well below the high reached in October 2007 of 6092. As one analyst phrased it - this is more of 'a sentimental recovery, not a fundamental recovery!'

Be that as it may, this has still prompted increased activity in fund issuance as it would appear the rate of fund approvals has been increasing alongside the market rally. So far in 2009, 26 new funds have been launched with ten more in the initial offering period.

Whereas in the second half of 2008, few equity funds raised more than 1 billion renminbi, both bond and equity offerings this year have been raising from 1.5 billion renminbi - 3 billion renminbi plus. Hence it would appear that a degree of confidence has returned.

Cerulli Associates, having become in 2004 one of the first international research firms to conduct proprietary surveys with the largest China asset managers - both domestic and joint ventures - believes assets can reach 4.1 billion renminbi by 2012 - reflecting a conservative compounded annual growth rate of 4.1% over the next five years.

### **Progress and innovation**

While there are around 50 closed-end funds, the majority are open-ended. From the original standards of pure equity, bond and balanced, in recent years the selection available has become a little more imaginative as experience and capabilities expanded. In addition, the choice on offer would now include money market funds, guaranteed principal funds, sector funds, index funds, listed open funds (LOFs of which there are now 25) and ETFs, there now being five. In spite of considerable encouragement in recent times to 'innovate', the CSRC saw fit late last year in December to issue a memorandum delineating the conditions, requirements and issues to put forward for the consideration of such a new style product - be it a domestic mutual fund or QDII fund. In so doing, FMCs would still be permitted to file applications for a more standard product simultaneously. This would allow sufficient time for the CSRC to carefully evaluate the new product design style and any inherent risks etc...

Possibly coincidentally, this could have led to the Shanghai Stock Exchange issuing a range of 14 new indexes this year to bring the total to 39. Most were launched in January, the latest in March being the 'SSE Central SOEs 50 Index'. It has been learned that ETFs are being prepared for this and others such as the SSE Industrials Sector Index and Governance Index by managers such as BoCom-Schroders, ICBC-Credit Suisse and Harvest.

This and related matters were the subject of some enlightening discussion with Sandra Lu, a partner at Links Law Offices in Shanghai - and an acknowledged expert in this field.

### **Fund managers**

From the published CSRC list, there are 61 active fund managers, 28 being purely home-grown, 33 being joint ventures or foreign invested. It is also understood that several more are in the process of being approved/launched by Aviva plc with COFCO, the Bank of New York Mellon with Western Securities, Scotiabank AM with the Bank of Beijing and the F & C Asset Management with Huaxia Bank and U.O.B with Ping An Securities. However, it is generally felt that approvals for others may be slower in the future so as to avoid overloading the systems and to ensure stability in a measured development. It is interesting to note that these new companies are to establish a joint venture from inception.

Even though it does not reflect the level of assets under management, the number of funds launched by those managers with foreign involvement slightly outnumbers those of the purely domestic ones. But as has been noted, the managers who control about half of the outstanding AUM are those who have retained their independence and control - as well as being some of the longest established. To a certain extent, they are entitled to the claim of having the responsibility of having launched the industry in China - a claim to which they can be justifiably proud.

## **JVs and foreign investment**

Currently, four of these companies occupy places in the top ten positions when judged in terms of AUM. This top ten also manages about half of the AUM. In terms of market share, the AUM split is approximately 60% - 40% in favour of purely home-grown companies, at least nominally. However, there are a number of instances where a foreign invested company may be considered more domestic than foreign in terms of management and investment style as well as brand recognition. One such obvious example is Harvest - one of the original ten companies incorporated. At the time when Deutsche Asset Management (DeAM) took a minority financial interest several years after its establishment, it already ranked the fifth largest. It has become one of the most successful and recognisable in many regards - now ranking second in most tables to China AMC, another domestic company. From most reports, it is very well managed - with little or no active involvement from DeAM.

To some, a true joint venture could be described as domestic and foreign partners establishing a fund management company from inception, with very active foreign input and participation in management including senior personnel appointments along with imported practices and procedures. This was, in fact, the original intention of the CSRC in those early days. Of those formed - for example China Merchants - ING, GTJA - Allianz, Fortis - Haitong, ABNAMRO - TEDA - numerically at least, they have recorded only mixed results. Better results have been forthcoming from later JVs, especially those formed with commercial banks when that became permitted - such as BoCom - Schroders and ICBC - Credit Suisse. In total, there are now eight such bank JVs. While it may be easy to draw easy conclusions from that, it might be premature!

Unquestionably, statistical, technical and other quantitative analysis could be expanded to develop other reasons and explanations. Fund and company performance could embrace such subjects as asset retention and turnover, product innovation, brand recognition, client mix, staff turnover and distribution. While all these and others are valid, the data produced only provides part of the total picture.

It is clear that there are some basic differences between a truly cooperative venture and one treated as a financial investment by a foreign party in order to gain the required exposure in this developing market that has so much promise. One needs to examine the motivations of the foreign party in seeking a domestic partner - though there is no choice - as well as equally the purpose and reasons for the domestic partner to seek foreign involvement. This is especially important when it has been demonstrated that this does not necessarily provide a recipe for success.

Similar reflections and considerations could also be applied to those who desire for policy or other reasons a wholly foreign owned operation. In this, one common denominator is the question of control - the attitude of the foreign investor in the market that both financial and operational control is the major ingredient for success.

This question was discussed with Alex Wong, Partner and colleague Frank Shan from PricewaterhouseCoopers - who compiled two comprehensive reports on this subject the first in 2007 with the second only just released.

Many of the points made in that report still stand and remain valid. Some, however, have mellowed a little over time and with experience. In short, where there was a divide that separated the two sides, it would appear to have shrunk somewhat as each has learned to consider and understand the viewpoints of the other.

Many basic factors have not changed that much. It is increasingly a fiercely competitive market for all companies and investor education while improving is still sorely lacking. Bank dominated distribution remains a major problem with such programmes being complex as well as the costs being daunting. As the number of fund products increases, the scramble for 'shelf space' will make it even more difficult. Market volatility is likely to continue to remain unpredictable and turnover of key staff is possibly even deteriorating. Margins are being squeezed to the extent that up to half of the existing managers are bordering on unprofitability.

### **Overseas operations**

Under the rules of CEPA (being the 'Closer Economic Partnership Agreement' between Hong Kong and the PRC), it was agreed that with effect from January 1, 2008, PRC domestic fund management companies specifically approved by the CSRC may establish subsidiaries in Hong Kong to operate relevant businesses. This followed on from such companies as had received approval for QDII products. Given that the CSRC had been encouraging companies to develop their overseas investment capabilities, it was not surprising that the Rules on the Establishment of Operations in Hong Kong by Securities Fund Management Companies was issued in December 2007 to become effective in April 2008.

Subject to the usual standard conditions, procedures and requirements, a domestic fund management company may establish Hong Kong operations in the form of a branch, a representative office, a subsidiary or other form of entities approved by the CSRC.

These rules also apply to equity participation by domestic fund management companies in asset management institutions in Hong Kong or other jurisdictions that have signed memoranda of regulatory cooperation with the CSRC - as well as the establishment of operations in such other jurisdictions.

It therefore follows that such equity stakes can be made in applicable institutions in Hong Kong as well as other relevant overseas jurisdictions. Such bilateral cooperative agreements have been made with about 35 countries. These rules also apply to establishing greenfield operations.

It can be seen that such regulations cater well to the ambitions of those who desire to expand overseas in order to achieve a global presence - and will enable them to dispense with the services of an overseas investment advisor for QDII products.

Companies known so far to have taken steps in this direction include China Southern, China AMC and E Fund.

### **The local market**

Like most markets globally, the Chinese market is suffering from a similar set of circumstances, but it is not without its own particular problems. Peculiar to this market is the question of the constant overhang of the 'locked-up' former non-tradeable shares on the one hand; and on the other is the destination of some of the huge amounts being lent by banks as part of the 'stimulus' programme.

As the lock-up periods of the non-tradeable shares expire, it has been estimated that an amount equivalent to 70% of the current tradeable capitalisation could swamp the market. This is said to be about 687 billion shares worth more than 4 trillion renminbi - all held by SOEs and other major shareholders. The current market capitalisation is said to be about 5 trillion renminbi.

For the first three months of 2009, fresh loans of 4.58 trillion renminbi have been made to both companies (SOEs) and individuals. This is more than for the whole of 2007. For the entire year, banks have forecast a total of 8 trillion - a rise of 57.2% on the 5.09 trillion in 2008. Some of this has been made through discounting bills - proceeds of which may be finding their way into the markets. This is known to be of considerable concern to the authorities.

Hence, as the trading activity has the effect of pushing the market up, the temptation to dump some of the potential free float increases. In addition, it should not be overlooked that IPOs have been suspended since September 2008. This will all contribute to a volatile and risky situation that causes the regulators to become very nervous!

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### **Developments – for measured stability**

*Sense of balance required for QDII and QFII products to succeed*

By Michael J Shelley

Some may consider that development has been slow - but the overriding concern with the diverse regulatory authorities is to maintain stability. However, this diversity can also produce a lack of regulatory uniformity that can project a distorted picture. This is particularly noticeable in the varying areas of conflict within the so-called 'QDII' products.

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