GREEN LIGHT FOR GLOBAL BOND INVESTORS AS CHINA SPRINTS AGAIN

By Eric Johnson

China's transition to a market-based, globally integrated economy has spanned nearly four decades, marching progressively forward but at a tortoise-like pace that even Beijing policymakers readily admit has been slow.

"China has gone through a long period of transition," the nation's central bank chief, Zhou Xiaochuan, acknowledged in June at an International Monetary Fund event in Washington.

Yet China's lumbering tortoise also has a reputation for breaking into sprints whenever prodded by market-jolting reforms. One such jolt came last February, when Zhou's People's Bank of China (PBOC) lifted all restrictions on foreign institutional investor participation in what's now a US$ 9 trillion bond market – the world's third-largest debt securities deck, behind only the United States and Japan.

Global investors immediately took note. Analysts hammered out reports. Asset managers rethought China portfolios. And potential bond issuers from state-owned enterprises (SOEs) to local governments in China's fast-growing cities saw in the PBOC decision fresh incentive to streamline debt management.

Weighing in with a China bond market endorsement was the World Bank, which August 12 said PBOC had approved its request to issue about US$ 2.8 billion worth of bonds denominated in its Special Drawing Rights "currency" and payable in yuan.

Meanwhile, among institutional investors familiar with the China playing field and its lengthy transition, the usual questions resurfaced. They asked: What's the risk? Has China SOE corporate governance improved enough that fixed-income investors can safely supplement credit extended by government-owned banks? Are indebted city governments shifting to more transparent budgeting practices to accommodate conservative bond holders?

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"We are very pleased to support China's growing role in global financial markets."

Jim Yong Kim
World Bank Group

LEARNING FROM CICC

Chinese Roots, International Reach

It's a mantra often heard in developing China: Learn from the West. But for China International Capital Corp. (CICC), the nation's leading financial services provider and most experienced investment bank, that mantra is clearly outdated.

Founded in 1995, when China's market economy was relatively young, CICC has been learning longer than any domestic rival. The firm still welcomes lessons from advanced countries. But as a pioneer in economic reform with thorough understanding of China's unique financial landscape, CICC is now a professor emeritus of the world's second-largest economy.

CICC opens doors to China for global investors, and helps investors plot strategies, execute deals and navigate the nation's regulatory environment. Now that China's bond market has fully opened to foreign investors, following a February 2016 reform by the People's Bank of China, CICC is helping overseas investors access the country's huge, fast-growing fixed-income market.

One-Stop Shop

"We have a reputation as 'the China expert' among overseas clients based on our unique understanding of China's macro-economic and industry trends," said Mr. Bi Mingjian, CEO of CICC. "If you want a professional opinion about a transaction, you want to do business in China, you want to know about the Chinese capital market, or you want to raise funds in China, you can always turn to CICC."

The evidence is overwhelming. Years ago, CICC was tasked by the government to play a key role in bringing capital into China, introducing new techniques and ways of banking, and deepening China's capital market. Its work was crucial to developing capital markets and state-owned enterprise reform. CICC helped shape the financial industry's regulatory framework. Today, it functions as a valued adviser to authorities facilitating the nation's market policies and works closely with most regulatory agencies.

CICC is a world-class investment bank with international reach and Chinese roots. Its largest shareholder, Central Huijing, and other overseas and domestic investors – including GIC, TPG and KKR – helped the firm write the strategic blueprint it now follows. The strategy led to a successful listing on the Hong Kong Stock Exchange in November 2015. Last April, the firm earned the highest international credit ratings issued to any Chinese securities firm: Baa1 from Moody's; BBB+ from S&P; and BBB+ from Fitch.

CICC has well-rooted client relationships, an in-depth understanding of China's capital markets, decades of industry know-how, and a strong cross-border platform. It also has a full-service investment bank framework based on a research foundation for developing investment banking, equities, FICC, wealth management and investment management. With offices in major financial hubs worldwide, CICC's one-stop service can help clients succeed globally.

Fixed-Income Skill

China's onshore bond market has grown rapidly since 2015,with China DCM volume reaching

CICC and Award-Winning Service

CICC's professional trophy case is filled with awards that reflect the firm's history of sustainable development, professional competency, appreciative clients and consistent, quality service. Key honors include:

- Finance Asia: Best Investment Bank in China – 2016, 2013, 2011-2004
- Global Finance: Best Investment Bank in China – 2015, 2013-2007
- The Asset: Best Domestic Investment Bank in China – 2015, 2013-2009, 2007-2003
- Asiamoney: Best Investment Bank in China – 2016
- Institutional Investor: All-China Research Team, Leaders Board (1st Rank) – 2015-2013
- Asiamoney: Fixed Income Poll 2015, "Best for Interest Rate Product and Sales"
- Capital Week: Crystal Ball Analyst Awards, first place overall in Bond Research – 2015, 2012-2009
- IFR Asia 2015 Regional Awards, Structured Equity Issue: Baosteel Group's RMB 4 Billion Exchangeable Bond
- IFR Structured Finance Awards 2014, Asia Pacific Structured Finance Issue of the Year: Volkswagen Finance's Driver China One RMB 796 Million ABS (Lead underwriter)
- Asiamoney 2016 China Deals and Investment Bank of the Year, "Best Securitization" category for a 3.015 billion yuan ABS issued by China Construction Third Engineering Bureau Co. and due in 2018

CICC Competitive Strengths for Fixed-Income

- Strategic position backed by solid government support, outstanding shareholder background
- Strong credit profile
- Recognized as China's investment banking pioneer
- Global network with distinctive international DNA
- High-quality, loyal, cross-industry client base
- Rapid, sustainable growth underpinned by strong capacity to innovate
- Leading and influential research
- Prudent, comprehensive and effective risk management
- Inspiring management team with deep investment banking experience

record highs. Dealogic said, as of July 19, China's year-to-date onshore-offshore DCM volume was US$ 497.4 billion, up 44 percent from the same period 2015 and the highest YTD volume on record. Activity totaled 1,858 deals – also a record high. Leading the increase was China's onshore DCM, which reached a record US$ 436 billion YTD as of July 19, up 59 percent from the same period 2015. The domestic bond market boom was due to China's diminishing interest rate trend, more flexible fiscal policies and relatively relaxed regulations for domestic issuers.

For the offshore market, China international DCM volume has grown rapidly over the past five years. It was US$ 60.3 billion in 2012, US$ 136.7 billion in 2015 and US$ 79.6 billion through August 5 this year, Dealogic said. Chinese issuers accounted for 49 percent of Asia (ex-Japan) bond issuance volume in the offshore market YTD. Undeniably, Chinese issuers have a strong presence and now play a key role in the offshore DCM market.

CICC's offshore platform is CICC HK in Hong Kong. It was launched in 1997, before any other mainland securities firm had a presence in Hong Kong. It's an experienced firm providing cross-border services and products to international investors. Other offices are in Singapore, London and New York.

Global reach affords seamless, cross-border services to CICC's domestic clients. CICC thus enjoys a special advantage as a guide to China's US$ 9 trillion market for government, financial institution and corporate bonds.

Bonds are often a focus when the firm's multilingual ratings and credit analysts regularly visit overseas central banks, asset managers and other institutional investors. These "road shows" come around as often as quarterly to update foreign firms as well as overseas units of Chinese investors. CICC's fixed-income research reports are considered the best in China. As China's most innovative investment bank, analysts are keen to provide investment banking, brokerage, and bond sales and trading research services.

Based on the leading fixed-income research, CICC is also a pioneer in onshore and offshore bond origination and secondary market trading. CICC's fixed-income origination team has more than 50 professionals originating and executing onshore-offshore bond transactions for products including USD, EUR and CNH bonds, Panda Bonds, Private Placements, Structured Notes, CBs, and a full spectrum of domestic bond products on the stock and interbank markets.

Telecom operator China Mobile was CICC's first corporate bond client. That was in 2001, and the issue raised only 8 million yuan. But it broke new ground at a time when banks were still handling almost all debt financing in China. Another milestone came in 2004 when CICC, on behalf of petrochemicals giant Sinopec, for the first time sold bonds to a foreign client through the Qualified Foreign Institutional Investor program.

Looking forward, CICC will continue reacting to the market's pulse while providing clients with innovative products and services. China's latest financial reforms include interest rate liberalization, internationalization of the renminbi and financial product innovations. CICC's professionals have the high-caliber vision and experience to anticipate such trends, keep pace with the market, and meet client needs.

Global Coverage

Today, CICC is poised to serve global clients seeking access to debt securities in China, including the full gamut of bond issues. "We have full coverage of every single credit bond" in China, said Mr. Liu Qingchuan, head of bond origination at CICC IB. "Even if it's not underwritten by us, we have full coverage. Every single name."

CICC calls itself the most innovative investment bank in China. It's a firm that's still learning from the West. But these lessons don't go far enough. China's financial market is vast and maturing, and its market and regulatory conditions are like nothing abroad. CICC's deep understanding of the domestic market and international vision are highly valued by domestic and overseas clients.

"You cannot just take everything that's done in the United States and plant it in China," said Mr. Wang Sheng, executive head of CICC IB. "That's why we tell clients we are the most innovative bank. We can work with regulators and clients, telling them how we analyze behavior, new transactions, and new products. We really are 'rooted in China' but with international reach." ■

Professional Depth, Inspiring Leadership

Bi Mingjian, CICC CEO

Mr. Bi is a veteran investment banker with more than 30 years of financial industry experience. He is one of CICC's pioneer executives who joined the firm at its inception in 1995 and spent subsequent decades contributing to its development. Mr. Bi previously held positions at the World Bank and HOPU Investment Management Co. Ltd. Under his direction, CICC has reached numerous milestones, including a successful listing on the Hong Kong Stock Exchange in November 2015.

Wang Sheng, CICC Managing Director, Executive Head of Investment Banking Department

Mr. Wang joined CICC in 2002. He successively participated in the reform and restructuring of a number of industries in China, including telecommunications, finance, manufacturing and healthcare. He also led numerous, large, capital market transactions of landmark significance. Mr. Wang has served a number of leading Chinese and overseas enterprises, and holds a key management position at the Investment Banking Department of CICC.

Liu Qingchuan, CICC Managing Director, Head of Bond Origination, Investment Banking Department

Mr. Liu has extensive experience with China's capital markets. He covers a variety of fixed-income products and has been working to cultivate good relations with government bodies. Mr. Liu manages CICC's fixed-income platform with a focus on bond origination, and he takes the lead in managing the integration and resource optimization of the expanding onshore-offshore fixed-income teams.

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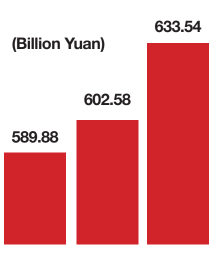
Jacqueline Zhang
Ping An Asset Management

"China's bond market on the whole offers opportunities that more than offset the risks. It remains a blue ocean worthy of offshore investor interest."

Total Foreign Investment

Foreign-invested, yuan-denominated onshore bonds under the custody of China Central Depository Clearing, the largest of three bond clearinghouses in China



Source: China Central Depository Clearing

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How might opening the debt securities market affect China's capital movement and currency exchange controls? And what about China's domestic bond ratings system... is it really reliable?

Straightforward answers seldom come easily in China. The market transition has never been formulaic. And the regulator rulebook is dynamic, subject to rapid adjustments and regional variations.

That authorities are now keen on attracting foreign investors into bonds reflects a deep interest in letting market forces decide the fate of indebted companies and state-owned enterprises in the context of the nation's ongoing economic slowdown. Bank non-performing loan ratios early in the second half 2016 were creeping toward 2 percent.

Beijing also sees a foreigner-friendly bond market as a preferred alternative to the so-called "local government financing vehicles," shadow banking and credit schemes that governments and many companies traditionally have relied upon whenever state banks, often under government orders, tighten lending.

Moreover, the bond market has matured to the point where authorities obviously feel comfortable about inviting overseas institutional investors.

Directing traffic are China Central Depository Clearing (CCDC), Shanghai Clearing House (SCH), and China Securities Depository and Clearing (CSDC). The first two clearinghouses handle interbank bond trades, while the third concentrates on bonds traded on China's stock exchanges.

CCDC, which focuses on government bonds, reported 40.08 trillion yuan (about US$ 6.12 trillion) worth of bonds under custody as of June. CSDC said bonds in its custody had a combined market capitalization of 5.53 trillion yuan (US$ 834 billion). Some 90 percent of CSDC's paper trades on the Shanghai Stock Exchange, the rest on the Shenzhen Stock Exchange. SCH, which handles corporate bonds and interbank certificates of deposit, pegged its custody total at 13.61 trillion yuan (US$ 2.05 trillion) in August.

These figures are so big that hard-to-answer questions obviously won't stop global investors from knocking on China's door.

"Foreign investors can't afford not to have a stake in what may eventually be the biggest bond market in the world," explained Edmund Goh, the Asia fixed-income team investment manager at Aberdeen Asset Management, which has US$ 96 billion in fixed-income assets under management.

It's also been argued that the latest bond reform should be viewed as part of a financial infrastructure-building process that deserves both trust and institutional investor support.

"China's bond market on the whole offers opportunities that more than offset the risks," said Jacqueline Zhang, assistant general manager of Ping An Asset Management, which as of December 2015 reported 1.6 trillion yuan worth of fixed-income assets under management. "It remains a blue ocean worthy of offshore investor interest."

After noting that corporate bond defaults had jumped in the first half of 2016, a recent Bank of China analysis frankly predicted a further increase defaults in the second half. But rather than fueling fear, the report said, these defaults prove the market transition is having a desired impact.

Indeed, at earlier stages of the transition, defaults were often prevented by governments keen to bail out taxpaying SOEs with big payrolls and official influence. Implicit bailout guarantees emboldened SOEs to build beyond customer demand, distorted retail investing and saddled banks with bad debt.

Efforts to end bailout guarantees, consolidate SOE operations and rein in shadow banking through stricter regulations were reform steps built into the market transition process in recent years. Now, bond defaults are being allowed.

The bond market now open to foreign investors is "equipped to manage and absorb default risk" through "risk control within the scope of what the market can bear," the report said.

Sharing that assessment is Liu Qingchuan, a managing director and IB bond section chief at China International Capital Corp. Ltd. (CICC), one of China's leading investment banks.

"If no one defaults, then all credit risk is equal... and there's no risk premium. Everyone looks the same," said Liu. "It's healthy for the bond market to see some defaults."

And Ping An's Zhang isn't worried. She said the current hazard level associated with the nation's economic slowdown is "not severe enough to result in large-scale defaults or systemic risk."

Holding Back

Before the February reform, a limited number of yuan-denominated bonds issued by China's central and local governments, SOEs and other entities were available to foreign firms and sovereign wealth funds, mainly through the nation's quota-based Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Institutional Investor (RQFII) schemes. The number of overseas participants had gradually increased after a small batch of foreigners became the first invited to

PING AN INSURANCE (GROUP) COMPANY OF CHINA

Internet Finance Drives Ping An's Global Ambitions

Located in the Central Business District of Shenzhen, China, the 117-story Ping An International Finance Centre is scheduled to open soon

The rise of the internet finance sector in China has dramatically transformed the financial services landscape in recent years, bringing new opportunities and spearheading growth. Traditional financial services firms sailing on the winds of change amid the internet finance boom are now benefitting from this new strategy as business activity, market share and customer totals increase rapidly. It's also a strategy that encapsulates recent developments at Ping An Insurance (Group) Company of China, Ltd. (HKEx: 2318; SSE: 601318), a leading personal financial services group in China. The company started as a small insurer in the southern city of Shenzhen nearly three decades ago. Today, the 117-story Ping An International Finance Center soon to open in downtown Shenzhen stands as a gleaming testament to the company's dramatic growth. Ping An rose from humble beginnings to become a financial services behemoth with core businesses in insurance, banking and asset management. Now, internet finance has emerged as a fourth pillar at the heart of its operations.

Diversified Business Model

A diversified business model has served Ping An well through economic cycles, buffering the firm during market volatility that negatively affected single-business peers. As of June 30, 2016, the group recorded 5.22 trillion yuan in total assets and 407.83 billion yuan in consolidated revenues.

Ping An's playbook for internet finance is premised on a two-pronged approach: "Integrated Finance + Internet" and "Internet + Integrated Finance". The approach centers on improving online platforms by offering various services and products, and then embedding financial services into the lineup of consumer offerings.

Ping An's position in traditional financial services affords strength in areas such as capital, risk management and financial market expertise. Crucially, the firm has a massive customer base built over decades that serves as a springboard for internet finance ambitions by promoting cross-sales and customer migration between core and internet finance businesses. The numbers attest to its success: Ping An's online user base grew 23.3 percent in the first half of 2016 to nearly 298 million. Another 212 million were registered internet finance users.

To serve everyday customer needs, Ping An has integrated online "Health, Food, Housing, Transportation and Entertainment" services and its financial businesses. The result is a "Wealth Manager, Health Advisor and Life Companion" for every customer. The group counts Lufax, an online marketplace for financial assets, and Ping An Good Doctor, an app offering real-time doctor consultations and healthcare services, as flagship internet finance products. Lufax is now the largest internet financial transaction information service platform, with more than 23 million users and a trading volume exceeding 3.2 trillion yuan as of June 30. Ping An Good Doctor is China's most popular online healthcare portal, with more than 89 million users and 250,000 peak-period, daily consultations.

Ping An's achievements are well known. The group was the only mainland Chinese financial firm named among the "Most Honored Companies" in Asia by Institutional Investor in its most recent All-Asia (ex-Japan) Executive Team rankings. Group Chairman and CEO Peter Ma was named Best CEO, while CFO Jason Yao and Board Secretary Jin Shaoliang were respectively named Best CFO and Best IR Professional.

Ping An Group President Alex Ren likens the company's next lap to an app upgrade, describing it as the "Ping An 3.0 Era." This represents a commitment to building out Ping An's vision of "Open Platform + Open Marketplace". Ren expects Ping An's four business pillars to drive robust growth, with the emerging internet finance pillar leading a customer-centric expansion, supporting its aspirations to become a world-leading player in personal financial services.

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buy bonds in 2010, reaching 328 institutional investors on June 30, according to CCDC.

QFII-RQFII players were on board in 2014 when Beijing introduced a reform program that, in a key market jolt, for the first time gave local governments permission to issue municipal bonds. Previously, only the central government's Ministry of Finance and financing vehicles could issue bonds on behalf of local governments to raise money for public works and other civic projects.

The muni market move gave local governments a green light to convert their financing vehicle debt, considered dangerously opaque, into bonds.

Nevertheless, neither the 2014 decision nor any subsequent reform measure apparently went far enough to attract more than a smattering of overseas investment. According to the State Administration of Foreign Exchange, foreign investors held less than 2 percent of all outstanding bonds by value last January.

The foreign share of the market climbed modestly after the bond reform announcement in February. As of June, some 2.6 percent of the interbank market's investors were foreign, while offshore institutions held 1.3 percent of the total available through in China's bond market.

The reform has added to the foreign inflows that had been steadily rising in recent years through QFII and other schemes. Between 2013 and June, Zhang said, offshore institution bond holdings doubled to US$ 105 billion. CCDC said 48 percent of that amount was in government bonds, 43 percent in paper for banks and other financial institutions, and the rest in corporate bonds.

So far, foreign investors have been playing it safe. Most of Aberdeen's holdings, for example, are in China's central government bonds "since they are the most liquid," Goh said.

What's holding back foreign players? It's not a lack of opportunity, as underscored by a bond demand boom in the first half of this year that CICC analysts said would likely continue in the second half. A CICC report said "ample liquidity and a scarcity of quality bonds" offer "the strongest logic" for the boom, which has been led by domestic investors.

Still, the negatives are nagging for many foreign investors.

One factor to consider is China's unique, foreign currency exchange system. A sharp devaluation of the yuan in August 2015 caught investors by surprise. Goh expressed a common opinion: "Most (foreign) investors will carefully consider the currency risk before committing" to China bonds, he said.

And the credit rating system, which is run by Chinese firms such as Dagong Global Credit Rating, has been shadowed by doubts. Goh called ratings in China "unreliable" and one of the "big impediments to foreign investors pouring money into the China bond market."

A recent Credit Suisse report by Hong Kong analysts Vincent Chan and Shen Hu called credit ratings "the Achilles heel" of the China corporate bond market and argued implicit government support for SOEs has yet to be resolved.

"China's corporate bond rating seems to not only reflect the financial position of the company but assumes that it will be somehow bailed out in case of any repayment problems," the report said.

Liu, however, sees the ratings environment in a different light. Only domestic agencies have what it takes to examine bonds in the China context, he said, particularly the hard-to-recognize relationships between bond issuer and one or more government entities.

"Rating is an art, not a science," Liu said. "Ratings agencies don't predict the chance of a default. It's all about opinions, perspectives. Dagong has its China-based perspective."

So how an international investor responds to China's latest invitation to buy bonds may ultimately reflect trust in the government's ability to deliver growth and steer the economy forward, even if that means moving as slowly as a tortoise.

Goh explained that Aberdeen's allocation to China onshore debt had been "pretty stable over the past few years" before the bond reform took effect because QFII quota restrictions "made it difficult for us to move capital in and out of the country." And the yuan "is still a currency that operates under many restrictions."

The environment since the reform was introduced in February has not changed significantly, Goh said.

"However, with the opening up of the China interbank bond market to foreigners, giving us greater access without having to rely on the QFII and Renminbi Qualified Foreign Institutional Investor schemes, we would consider increasing our exposure," Goh said.

Indeed, among institutional investors it's now clear this tortoise can really sprint.

Addressing the IMF, the PBOC's Zhou said the regulatory structure for overseeing China's financial markets – including the bond market – has been designed for a long-haul transition to a market economy. There are no shortcuts.

"China has gone through a long period of transition which has been reflected in the PBOC's institutional arrangement," Zhou said. "Ultimately, the transition to a market economy will, by and large, be completed." ■

Edmund Goh
Aberdeen Asset Management

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