SINO-FOREIGN SECURITIES JOINT VENTURES

ROUND 2

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QUINLAN
&ASSOCIATES

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CONTENTS

EXECUTIVE SUMMARY 4

SECURITIES JV OVERVIEW 5

1. COMPETITIVE LANDSCAPE 10

2. THE CHINA OPPORTUNITY 19

3. STRATEGIC CONSIDERATIONS 24

4. CONCLUSION 29

5. HOW CAN WE HELP? 30

EXECUTIVE SUMMARY

From the early 2000s, what was seen as the unstoppable rise of the Chinese economy and stock markets meant that any international brokerage firm or bank with global aspirations saw a need to be on the mainland. Coupled with China's commitment to financial market liberalisation as part of its accession to the World Trade Organization in 2001, this paved the way for foreign investment banks to partner with domestic players in the Chinese securities market through Sino-foreign securities joint ventures (JVs).

Despite a recent slowdown in the country's economic growth, China has established itself as a global economic powerhouse, boasting the second largest economy and stock market in the world, as well as the largest capital market fee pool in Asia Pacific. In 2015 alone, China's core investment banking fee pool was larger than the next five Asia Pacific countries combined. However, for the JVs that set up in the past decade, the growth story has been much less compelling. Leading domestic firms continue to dominate the market, whilst cost structures are dragging on JV profitability. Licence restrictions, a lack of management control, and major cultural differences between both foreign and domestic partners have resulted in many JVs being significantly under-leveraged.

The JV landscape saw very little change from 2012 until the end of 2015: apart from a handful of exits by smaller foreign players due to international strategy changes, all tier-1 global banks left their onshore operations unchanged. However, in late 2015, Credit Suisse became the first foreign JV partner since UBS and Goldman Sachs to secure access to an A-share brokerage licence.

Since then, up to eight Hong Kong or Macau-headquartered and funded financial institutions – including Hongkong Shanghai Banking Corporation (HSBC) and Bank of East Asia (BEA) – have also applied under the Closer Economic Partnership Agreement (CEPA) Supplement X to set up securities JVs in various free trade zones (FTZs). Unlike the first wave of JVs that were set up in the mid-to-late 2000s, those established under CEPA Supplement X are fully-licensed and can be up to 51% non-PRC-owned.

With the competitive landscape rapidly evolving and regulatory liberalisation measures in full swing, we believe now is the time for foreign banks to revisit their onshore JV strategy. We see considerable room for existing JVs to both grow and further optimise their platforms, particularly with respect to better leveraging the powerful onshore-offshore footprint of their foreign partners. We also believe that despite limits to management control, there is scope to exert greater management influence. For the new FTZ entrants, much can be learnt from the first wave of foreign players to enter the market, and we feel the new regulations will provide them with a competitive edge. For aspirant JVs, the market remains ripe for the picking, particularly where competitive niches can be found.

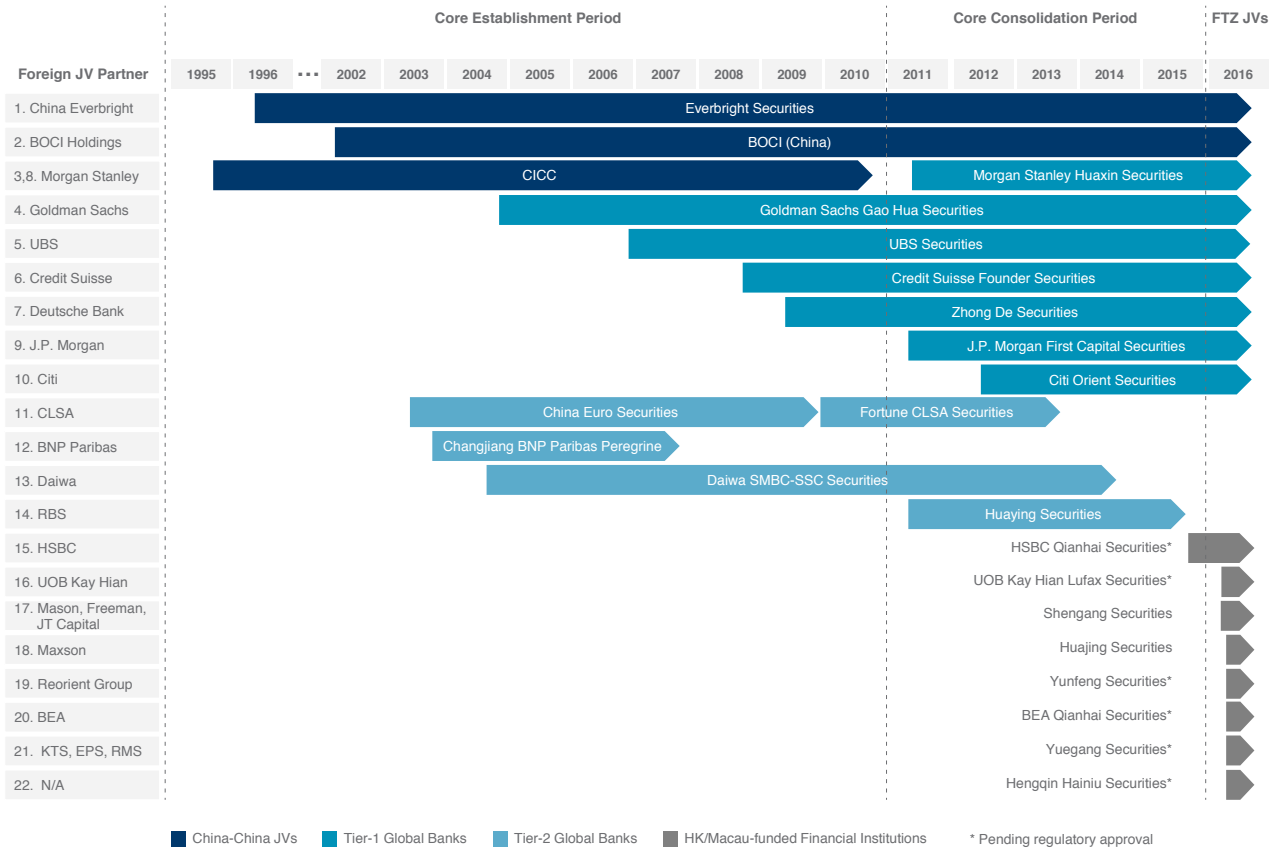
With China's core investment banking fee pool alone expected to exceed USD 7 billion in 2016, a mere 1% market share gain translates to USD 70 million in annual revenue. This is an opportunity simply too large to ignore. It's time to get ready for Round 2.

SECURITIES JV OVERVIEW

INTRODUCTION

The first JV, China International Capital Corporation Limited (CICC), was established in July 1995 by Morgan Stanley, China Construction Bank and various other parties. In the 21 years since it was launched, over a dozen foreign JVs set up operations on the mainland, though a number of tier-2 foreign partners have subsequently pulled out due to various reasons, including international strategy changes. Following the signing of the Closer Economic Partnership Agreement (CEPA) Supplement X in 2013, there has been a new wave of interest in China's securities market. Of the eight FTZ JV applications submitted between November 2015 and June 2016, two have already been granted regulatory approval (see Figure 1).

FIGURE 1: JV OPERATING TIMELINE



Source: CSRC, company reports and websites, Quinlan & Associates analysis

CORE ESTABLISHMENT PERIOD (PRE-2011)

Chinese regulators granted the first wave of JVs very limited access to the domestic securities market by restricting their range of permissible activities to bond and equity underwriting, and M&A advisory. In order to protect nascent domestic securities firms, foreign partners were also limited to holding minority stakes, generally capped at a maximum of 33%.

Only three of the early JVs (i.e. CICC, Goldman Sachs Gao Hua Securities and UBS Securities) were granted licences to conduct onshore A-share brokerage activities, including research, sales and trading (see Figure 2). Of these, Morgan Stanley held a ~35% stake and management control of the fully-licenced CICC JV, while Goldman Sachs was able to obtain management control of its 33%-owned JV through a complex share and loan agreement. UBS AG, with an initial 20% stake in UBS Securities, was granted regulatory approval to manage the day-to-day operations of its 'full-licence' JV for its consortium of non-financial partners, which included the Beijing Government and large state-owned enterprises (SOEs). Such generous terms were not to be offered again.

By the end of 2007, however, the playing field appeared to level off. JVs operating for five years or more (and in which at least three of those years were profitable) were permitted by regulators to apply for an onshore brokerage licence. The timing, however, was not so fortuitous for the foreign partners, as the global financial crisis (GFC) hit and many international strategies were de-prioritised.

CORE CONSOLIDATION PERIOD (2011-15)

The first sign that all was not well with the Sino-foreign securities JVs appeared in early 2000 when Elaine La Roche, the last Morgan Stanley-appointed head of CICC, stepped down from her role. Morgan Stanley's decision to cede control over the JV was driven by cultural conflicts over a number of issues, including management style, firm strategy and compensation. However, it would be another ten years before Morgan Stanley would fully exit from CICC.

FIGURE 2: JV LICENCES

	Joint Venture	Foreign Partner (s)	Chinese Partner (s)	Registered Capital (RMBm)	Licenses							
					Underwriting/ Sponsorship	Advisory	Brokerage	Proprietary Trading	Asset Management	Custody	Private Equity	Derivatives
1	Everbright Securities	China Everbright Limited (29.2%)	China Everbright Group (29.7%)	3,907	✓	✓	✓	✓	✓	✓	✓	✓
2	BOCI (China)	BOCI Holdings (37.1%)	1. CNP (15.9%) 2. SFDIF (10.5%) 3. YIG (9.1%) 4. JCC (5.3%)	2,500	✓	✓	✓	✓	✓	✓	✓	✓
3	CICC	1. GIC (11.9%) 2. TPG (7.4%) 3. KKR (7.2%) 4. Mingly (5.3%)	1. Huijin (28.4%) 2. CNIGC (5.5%)	2,307	✓	✓	✓	✓	✓	✓	✓	✓
4	GS Gao Hua Securities	Goldman Sachs Asia (33%)	Beijing Gao Hua Securities (67%)	800	✓	✓	✓	✓	×	×	×	×
5	UBS Securities	UBS (24.99%)	1. Beijing Guoxiang AMC (33%) 2. Guangdong Comm (14.01%) 3. China Guodian Cap (14%) 4. COFCO (14%)	1,490	✓	✓	✓	✓	✓	×	×	✓
6	Credit Suisse Founder Sec	Credit Suisse (33.3%)	Founder Securities (66.7%)	800	✓	✓	✓	×	×	×	×	×
7	Zhong De Securities	Deutsche Bank (33.3%)	Shanxi Securities (66.7%)	1,000	✓	✓	×	×	×	×	×	×
8	MS Huaxin Securities	Morgan Stanley (33.3%)	China Fortune Securities (66.7%)	1,020	✓	✓	×	✓	×	×	×	×
9	JPM First Capital	J.P. Morgan (33.3%)	First Capital Securities (66.7%)	800	✓	✓	×	×	×	×	×	×
10	Citi Orient Securities	Citi (33.3%)	Orient Securities (66.7%)	800	✓	✓	×	×	×	×	×	×
11	Fortune CLSA Securities	CLSA	Fortune Securities	500	✓	✓	✓	×	×	×	×	×
12	Changjiang BNP Paribas Peregrine	BNP Paribas (33.3%)	Changjiang Securities (66.7%)	600	✓	✓	×	×	×	×	×	×
13	Daiwa SMBC-SSC Securities	Daiwa	Shanghai Securities	500	✓	✓	×	×	×	×	×	×
14	Huaying Securities	RBS (33.3%)	Guolian Securities (66.7%)	800	✓	✓	×	×	×	×	×	×
17	Shengang Securities	1. Mason (15%) 2. Freeman (15%) 3. JT Capital (4.9%)	1. Saiking Capital (10%) 2. Changjia (10%) 3. BGCM (10%) 4. China Credit Trust (10%) 5. ZHI (6.6%)	3,500	✓	×	✓	✓	✓	×	×	×
18	Huajing Securities	Maxson (49%)	1. SEI (46%) 2. WQEIM (5%)	1,000	✓	✓	✓	×	✓	×	×	×

China-China JVs Tier-1 Global Banks Tier-2 Global Banks HK/Macau-funded Financial Institutions

Note: Current as at 1 July 2016

Source: CSRC, press releases, company reports and websites, Quinlan & Associates analysis

Cultural clashes resurfaced once again in 2007 when BNP Paribas agreed to sell its 33% stake in Changjiang BNP Paribas Peregrine. Differences in strategy between the two partners was cited as the reason for the sale. From 2011 to 2015, another three foreign players (CLSA, Daiwa and RBS) withdrew from the Chinese securities market, driven by changes in international strategies and limited progress made on the mainland.

Notwithstanding the global turmoil post-GFC, all tier-1 banks committed to maintaining their onshore presence in China. In fact, between 2011-12, three new JVs were approved, including Morgan Stanley Huaxin Securities, J.P. Morgan First Capital Securities and Citi Orient Securities.

FTZ JVs (2015 - PRESENT)

In 2013, CEPA Supplement X was enacted, enabling eligible Hong Kong/Macau-funded financial institutions to set up one fully-licensed securities JV in the designated FTZs, with a maximum Hong Kong/Macau shareholding of 51% (see Figure 3). Despite geographical limitations, the new provisions resolved two of the biggest challenges facing the traditional JVs: licence limitations and a lack of management control.

FIGURE 3: CEPA SUPPLEMENT X

CEPA Supplement X

WHAT IS IT?

- Enables eligible Hong Kong-funded and Macau-funded financial institutions (FI) to invest in one (1) full-licensed JV securities company in Shanghai, Guangdong Province or Shenzhen.
- Hong Kong/Macau shareholding is capped at 51%.
- Eligible investors must show sufficient nexus to Hong Kong. Similar criteria also apply in the case of Macau entities.

INVESTOR REQUIREMENTS

- Licensed FI or financial holding company registered and headquartered in HK
- 5-year operating track record in a regulated sector

If **Controlling entity** is a FI or financial holding company, additional criteria:

- Controlling entity registered and headquartered in HK

OR

- Investor's shares listed in HK, and
- Min. 50% of 3-year pre-tax profits derived from HK; or
- Min. 50% senior mgmt. are HK permanent residents

OR

- Controlling entity's shares listed in HK, and
- Min. 50% of revenues or pre-tax profits derived from Investor

Source: Hong Kong Trade and Industry Department (HKTID), Quinlan & Associates analysis

From late 2015 up to the first half of 2016, eight FTZ JV applications were made under CEPA Supplement X (see Figure 4). Two were approved by the China Securities Regulatory Commission (CSRC) in early 2016 and the other six are still undergoing regulatory review. HSBC's JV is the only firm under the FTZ scheme applying for the maximum allowable 51% Hong Kong/Macau shareholding.

Both HSBC and BEA are partnering with Shenzhen Qianhai Financial Holdings, which is affiliated with the Shenzhen government. The Hong Kong/Macau partners of the remaining JVs are typically individuals or consortiums of Hong Kong-listed financial holding companies. They have partnered with PRC consortiums involved in industries ranging from investment and property management to technology.

FIGURE 4: FTZ JVs

Joint Ventures	HK/Macau Shareholder(s)	HK/Macau Shareholding	Incorporation	Status	Licenses
Shengang	1. Mason Financial 2. Freeman Securities 3. JT Capital	34.85%	Shanghai	Approved	Fully licensed
Huajing	Maxson Securities (subsidiary of China Renaissance)	49%	Shanghai	Approved	No proprietary trading
HSBC Qianhai	HSBC	51%	Shenzhen Qianhai	Pending approval	Fully licensed
BEA Qianhai	Bank of East Asia	Minority stake (undisclosed)	Shenzhen Qianhai	Pending approval	Fully licensed
Yunfeng	Reorient Group	43%	Shanghai	Pending approval	Fully licensed
UOB Kay Hian Lufax (Yunnan) Securities	UOB Kay Hian	Undisclosed	Yunnan	Pending approval	Undisclosed
Yuegang Securities	1. Karl Thomson Securities 2. Eternal Pearl Securities 3. Realord Manureen Securities	30%	Guangdong Nansha	Pending approval	Fully licensed
Hengqin Hainiu Securities	Undisclosed	Undisclosed	Guangdong Hengqin	Pending approval	Undisclosed

Note: Current as at 1 July 2016

Source: CSRC, press releases, Quinlan & Associates analysis

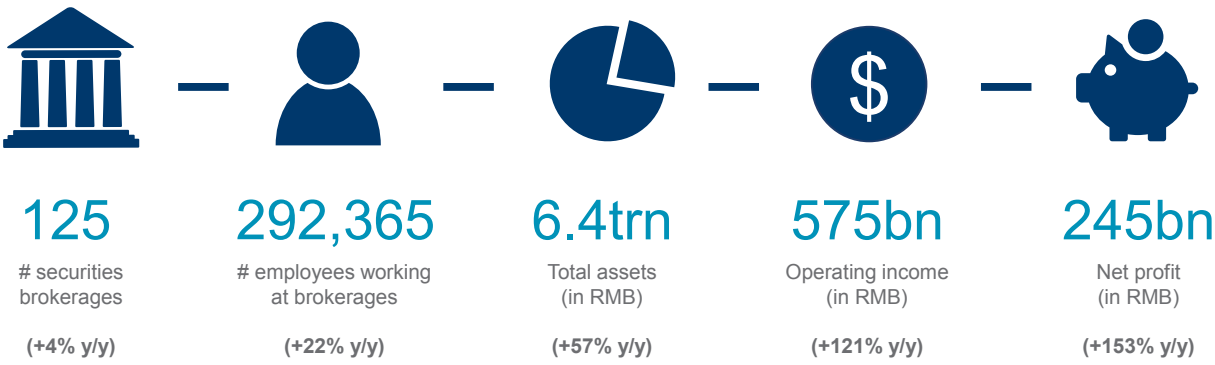
1. COMPETITIVE LANDSCAPE

OVERVIEW

The Chinese securities market has witnessed strong growth in recent years. An improved regulatory environment has protected the industry from many of the misadventures of the early 2000s, when the misuse of client funds led to closure of a number of firms.

There were 125 securities companies operating on the mainland in 2015, employing over 292,000 people. Together, these firms have a combined asset base of RMB 6.4 trillion, more than four times that in 2011. They also generated net profits of RMB 245 billion off an operating income of RMB 575 billion (see Figure 5).

FIGURE 5: CHINESE SECURITIES MARKET – KEY FACTS (2015)



Source: Securities Association of China, Quinlan & Associates analysis

Despite an abundance of competition, the top eight domestic securities[1] houses have cornered almost half the market. Combined, these firms generated 48% of the industry's operating revenue in 2015, and had 245 times the total assets (and 56 times the number of employees) of the top 8 JVs. JVs face specific challenges brought on by licence restrictions and a lack of scale, weighing on their ability to capture market share. Coupled with higher cost structures, profitability remains a challenge. Competition is only set to intensify as more players enter the market in the coming years.

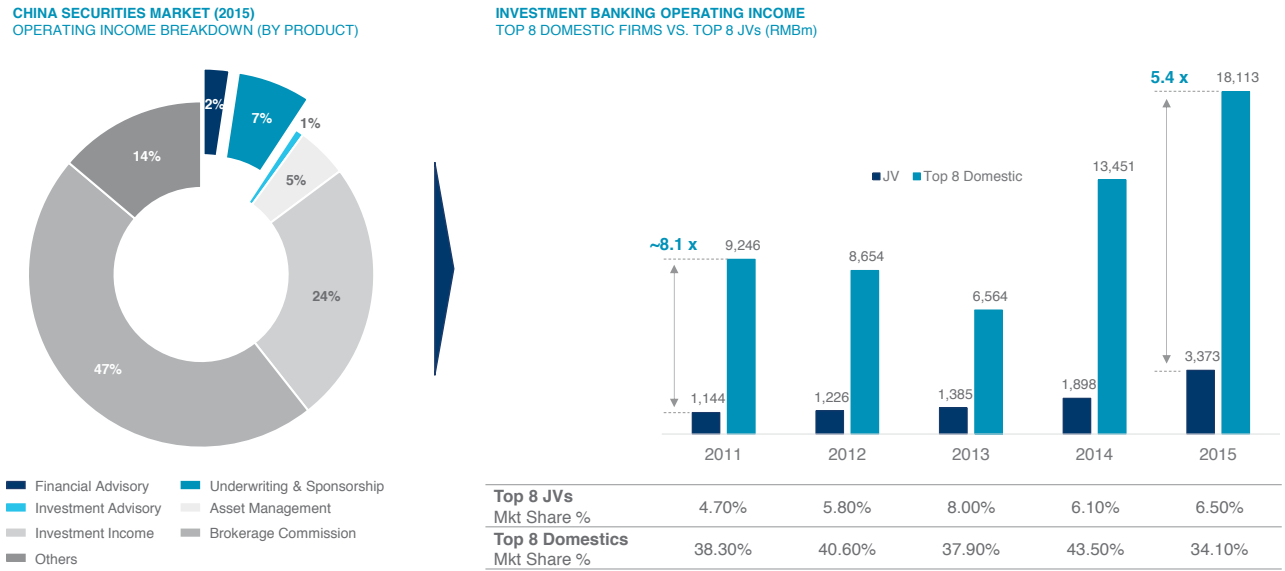
1 For the purposes of this report, the top 8 domestic securities houses are the largest 8 firms in China by assets, equity and operating income. In 2015, these were (1) CITIC Securities (2) Haitong Securities (3) Guotai Junan Securities (4) GF Securities (5) Shenwan Hongyuan Securities (6) Guosen Securities (7) Huatai Securities (8) China Galaxy Securities.

A. REVENUE & MARKET SHARE

Operating income for the top 8 JVs more than doubled from 2011-15 to RMB 4.2 billion. Despite strong headline growth, the combined operating income of the top 8 domestic securities firms was 68 times larger than that of the JVs, up from 32 times in 2011. Accordingly, the JVs' market share of total operating income fell from 1.5% to 0.7% over the period.

One could argue the loss of market share is a reflection of licence limitations, given most JVs are only licensed to engage in investment banking activities (i.e. capital markets underwriting and sponsorship, and financial advisory), which represented a mere ~9% of China's total securities market revenue pool in 2015. However, even within the investment banking space, operating income from the top 8 domestic securities companies dwarfed that of the top 8 JVs by a factor of 5.4 (see Figure 6).

FIGURE 6: JV MARKET SHARE



	2011	2012	2013	2014	2015
Top 8 JVs Mkt Share %	4.70%	5.80%	8.00%	6.10%	6.50%
Top 8 Domestics Mkt Share %	38.30%	40.60%	37.90%	43.50%	34.10%

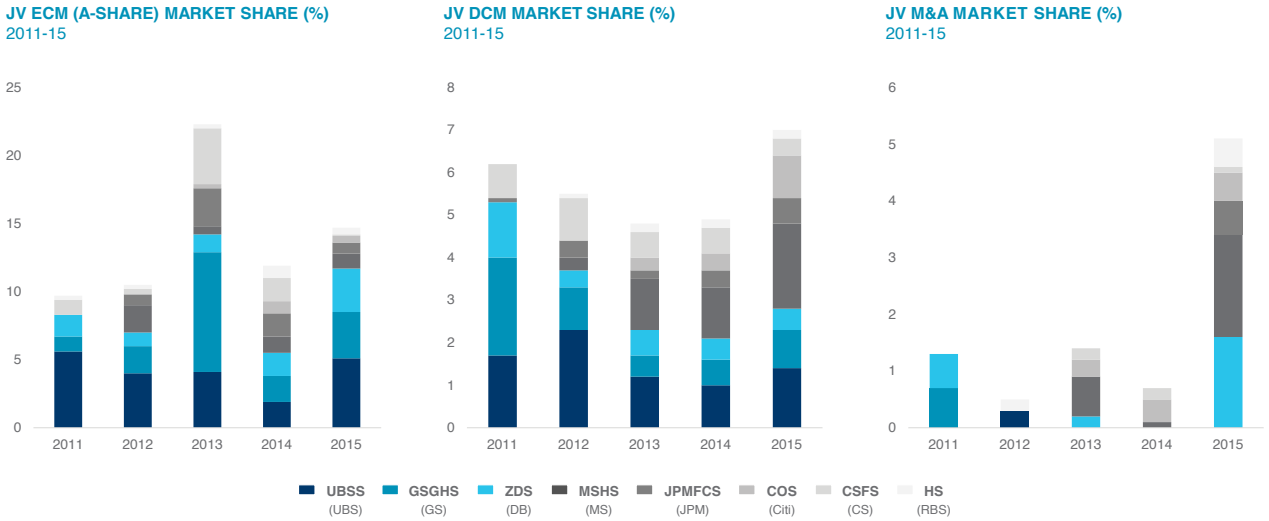
Source: Securities Association of China, company financial reports, Quinlan & Associates analysis

WITHIN THE INVESTMENT BANKING SPACE, OPERATING INCOME FROM THE TOP 8 DOMESTIC SECURITIES COMPANIES DWARFED THAT OF THE TOP 8 JVs BY A FACTOR OF 5.4.

We believe the key issue for the JVs has been one of scale. The international banks and JVs of the early 2000s only covered a defined list of state-owned enterprises (SOEs), many of which were headquartered in Beijing. The past decade, however, has seen a surge in corporate activity by private Chinese companies. Sub-scale coverage by the top 8 JVs (with an average investment banking headcount of 125) of geographically dispersed corporations has been inadequate when compared to the top 8 domestic firms (with an average investment banking headcount of 590).

The JVs' prospects were further hindered by the stop-start nature of the regulatory environment, including initial public offering (IPO) moratoriums to stabilise the market. This forced them to broaden their focus into debt capital markets (DCM) and mergers & acquisitions (M&A) advisory. Notwithstanding this, JV market share gains since 2011, if any, have been far from consistent, with all players struggling to break into the top 10 in the league tables (see Figure 7).

FIGURE 7: JV CUMULATIVE MARKET SHARE



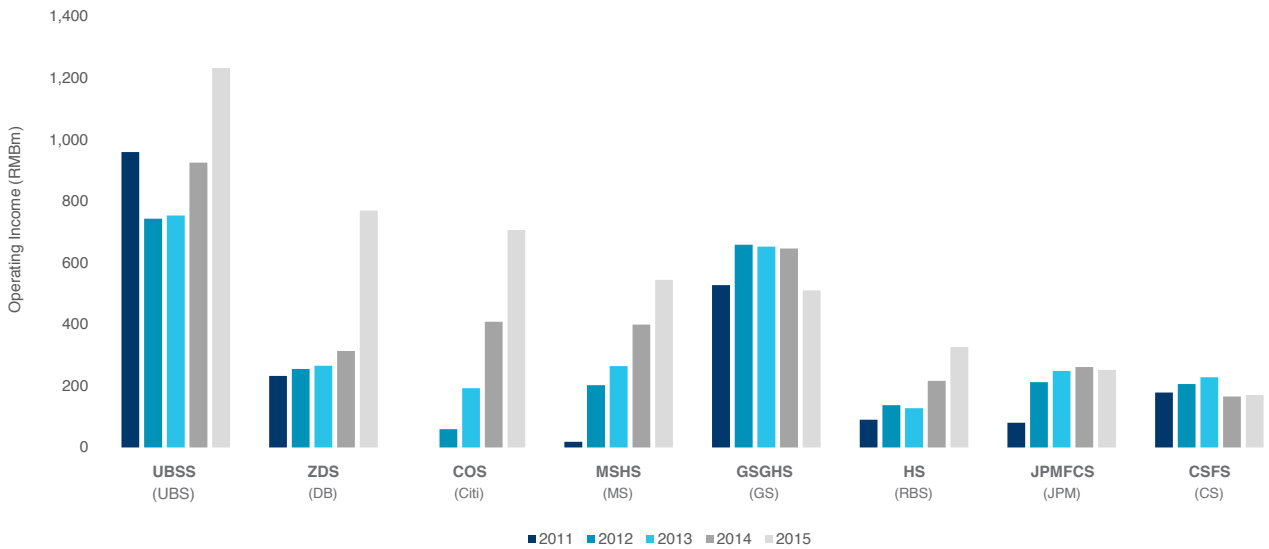
Note: Market share by deal value; ECM (A-share) data includes IPOs and follow-ons; DCM data includes government and corporate bonds; M&A data excludes cross-border deals

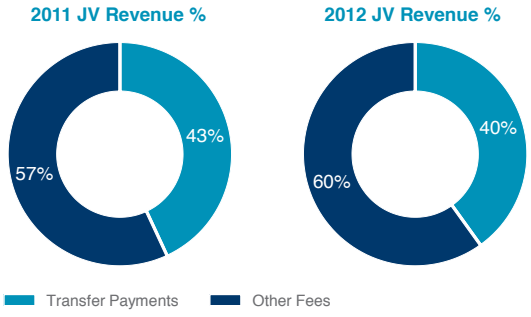
Source: Dealogic, Quinlan & Associates analysis

Even for those JVs with A-share brokerage licences, the institutional brokerage wallet targeted by the foreign banks only accounts for a small fraction of total brokerage commissions. Historically, the client base of these JVs has been even narrower, focused primarily on servicing Qualified Foreign Institutional Investor (QFII) quota trades of the foreign partner and its offshore clients.

Furthermore, a deep dive into the source of JV revenues reveals that in 2011 and 2012, the last years where such information was publicly available, roughly 40% of the total operating income of the JVs came from transactions with their foreign shareholder and affiliates. For example, of the RMB 658 million in revenues that Goldman Sachs Gao Hua reported in 2012, more than 90% came from the provision of investment banking project consulting services to Goldman Sachs Asia, its foreign shareholder (see Figure 8). For global banks, the implicit benefits of having an onshore securities JV are numerous. A closer, on-the-ground understanding of the market supports offshore research and sales efforts, whilst closer access to domestic clients can lead to referrals to offshore affiliates (for example, U.S. and H-share listings, as well as offshore M&A deals).

FIGURE 8: JV REVENUES





Transfer Payment %

	GSGHS	UBSS	JPMFCS	MSHS	CSFS	ZDS
2012	**91.9%**	27.0%	23.6%	19.2%	4.2%	3.9%
2011	**93.0%**	25.1%	59.2%	21.6%	42.8%	0.7%

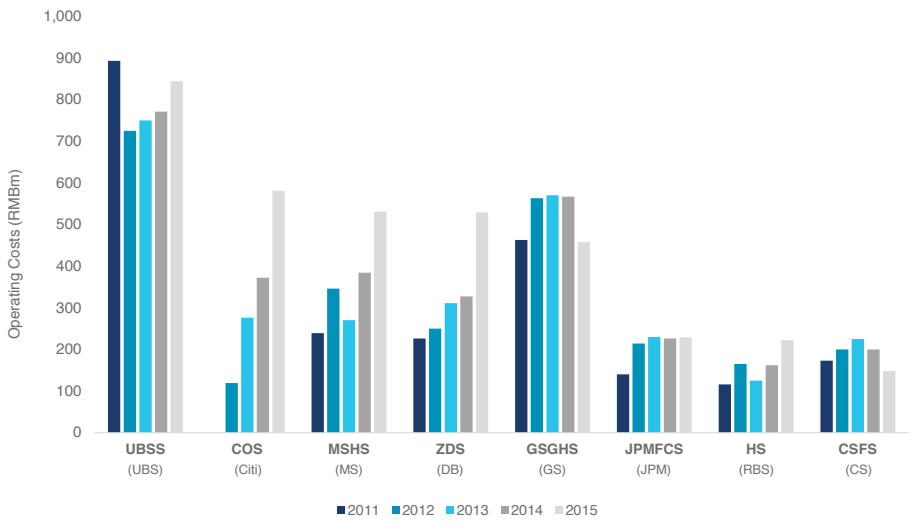
Source: Company financial reports, Quinlan & Associates analysis

In our discussions with a number of industry professionals, we found it not uncommon for foreign partners to 'subsidise' their JV platforms via annual transfer payments. This was driven, in part, by minimum profit requirements set by the China Securities Regulatory Commission (CSRC) for JVs to be eligible to apply for new licences. However, we are seeing such transfers come under intense scrutiny from internal audit and compliance teams and believe they will be much harder to effect going forward. In fact, we may even see declines in reported revenues for a number of JVs in coming years.

B. COST MANAGEMENT

Of the top 8 JVs, Citi Orient Securities, Huayin Securities, Morgan Stanley Huaxin Securities and Zhong De Securities have all ramped up their onshore headcount in recent years. As a result, operating costs for these firms rose by a compound annual growth rate (CAGR) of between 30-45% from 2013-15. The remaining JVs, on the other hand, including UBS Securities and Goldman Sachs Gao Hua Securities, reduced their headcount over the same period (see Figure 9).

FIGURE 9: JV OPERATING COSTS AND HEADCOUNT



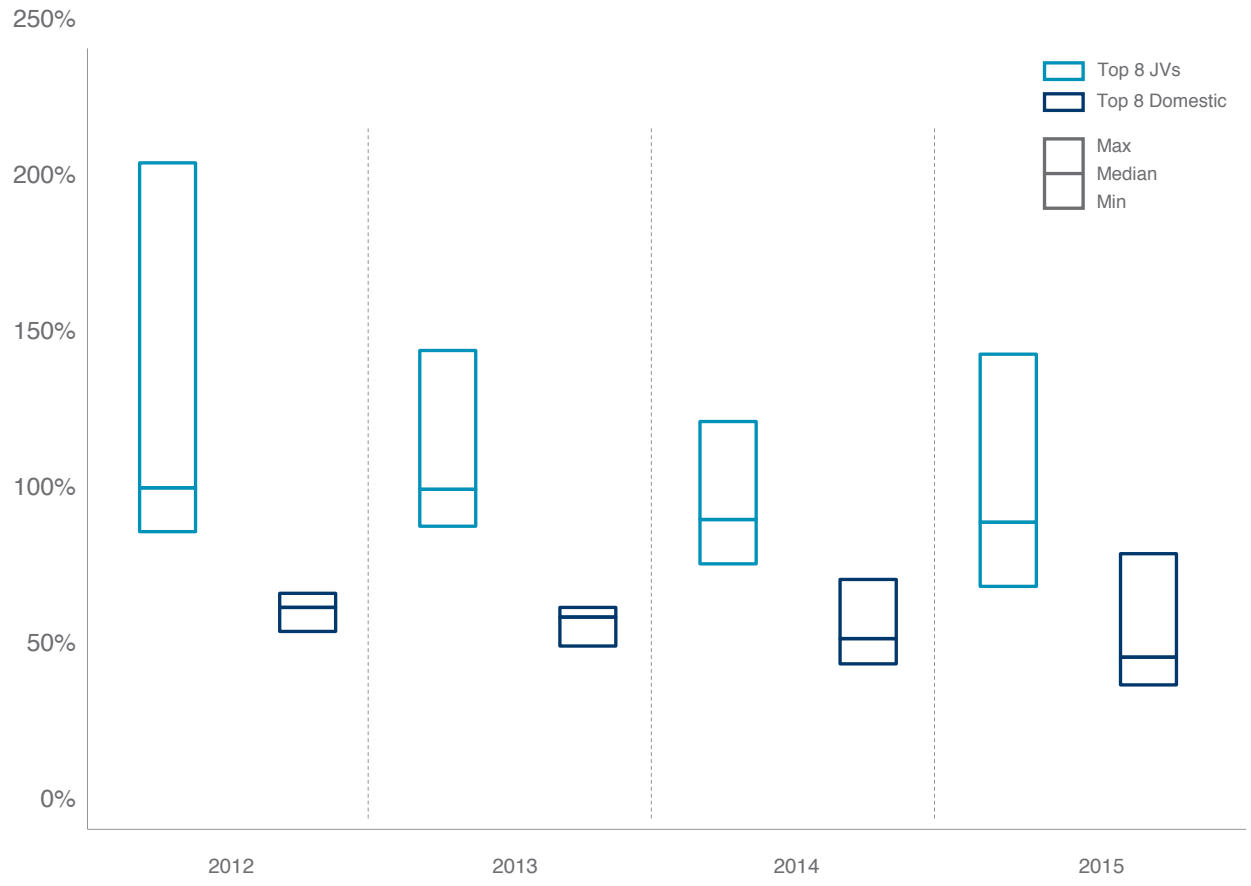
Headcount	UBSS	COS	MSHS	ZDS	GSGHS	JPMFCS	HS	CSFS	JV Total	Top 8 Domestic
2015	322	328	222	236	110	124	156	115	1,613	90,170
2014	347	257	204	229	129	138	126	132	1,562	67,790
2013	425	257	211	226	116	127	118	148	1,628	66,380
Headcount CAGR (2013-15)	-13.0%	+13.0%	+2.6%	+2.2%	-2.6%	-1.2%	+15.0%	-11.9%	-0.5%	+16.6%
Operating Costs CAGR (2013-15)	+6.0%	+45.0%	+40.3%	+30.5%	-10.3%	-0.2%	+33.3%	-18.9%	+13.4%	+79.0%

Source: Company financial reports, Quinlan & Associates analysis

Though the combined operating costs of the top 8 JVs grew by a CAGR of 13% from 2013-15, this was considerably lower than the 79% CAGR in operating costs for the top 8 domestic players. Following the 2012-2013 moratorium on IPOs, a widely touted pipeline of up to 800 IPOs awaited regulatory approval. In an effort to capture this opportunity, the domestic players were aggressive in poaching capital markets bankers, driving a spike in compensation costs across the market. This, in part, explains why capital markets-focused UBS Securities saw its cash compensation costs increase by a CAGR of 0.3% from 2013-15 despite a 13% decline in headcount over the same period.

Cost pressures have had a clear impact on JV cost-to-income (C/I) ratios. In 2012, the median C/I ratio of the top 8 JVs was 99.7%, while that of the top 8 domestic firms stood at only 61%. While more disciplined cost management saw the median JV C/I ratio fall to 89% in 2015, it still remains considerably higher than the top 8 domestic securities houses (see Figure 10).

FIGURE 10: COST-TO-INCOME RATIOS – JVs VS. DOMESTICS



Source: Company financial reports, Quinlan & Associates analysis

One explanation for the disparity in C/I ratios between the JVs and domestic firms is that the JVs are paying considerably higher compensation. In 2013, the average compensation per employee at the top 8 JVs was RMB 1.2 million, almost four times the top 8 domestic players (including their brokerage divisions). In 2015, this had narrowed to 2.5 times (see Figure 11). The JVs with foreign management control, in particular, have struggled to set appropriate remuneration levels across their onshore-offshore operations: whilst they have attempted to benchmark compensation with the local market, income disparity between offshore and domestic China has often led to staff disenfranchisement within the JV business, adding further cost pressure when retention becomes an issue.

FIGURE 11: COMPENSATION COSTS PER HEADCOUNT - JVs VS. DOMESTICS

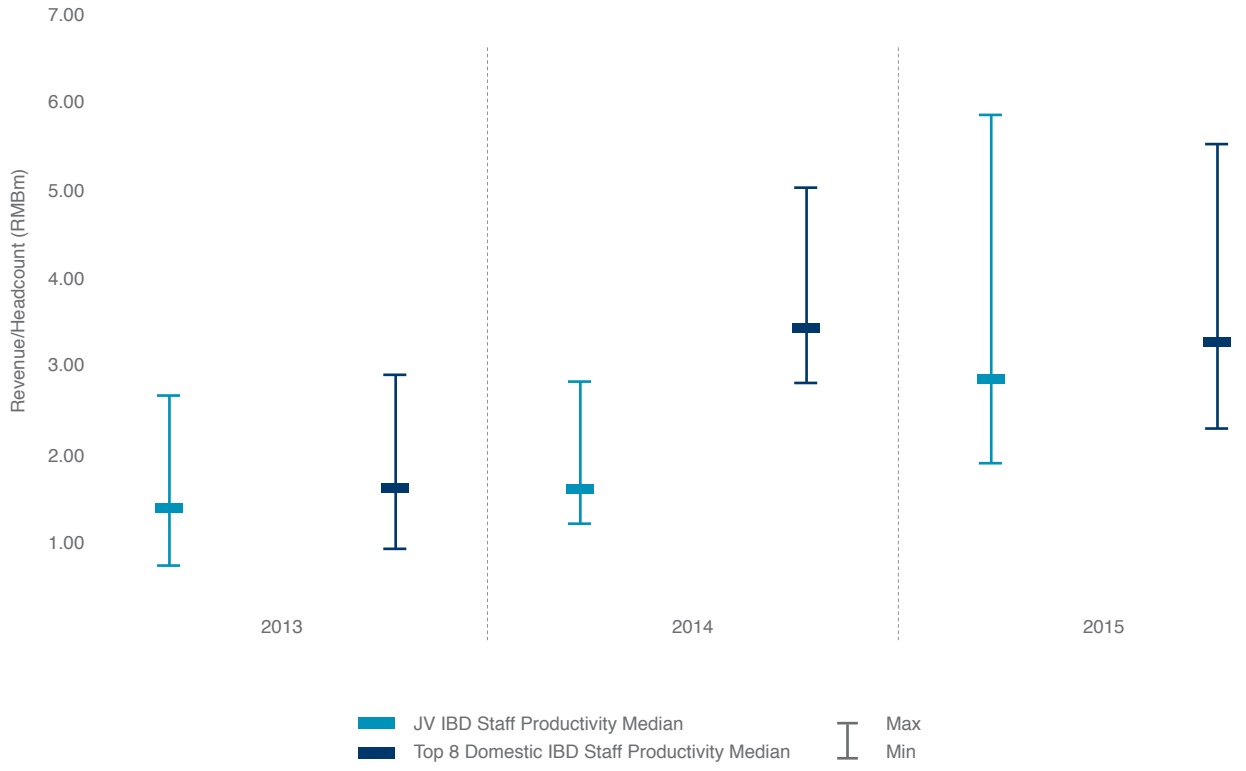
	2013			2014			2015		
RMB (m)	Min	**Avg**	Max	Min	**Avg**	Max	Min	**Avg**	Max
Top 8 JVs	0.71	**1.19**	2.55	0.63	**1.15**	2.45	0.81	**1.29**	2.82
Top 8 Domestic	0.24	**0.31**	0.40	0.27	**0.38**	0.54	0.30	**0.54**	0.69
JV : Domestic Multiple		**3.9x**			**3.0x**			**2.4x**	

Note: Figures represent cash compensation costs only

Source: Company financial reports, Quinlan & Associates analysis

Are JV employees justifying their compensation? Unfortunately, when investment banking revenue and staffing levels are viewed in isolation, we note that domestic players have shown higher productivity than the JVs over the past three years. In 2015, median banker productivity (i.e. revenue per front-office headcount) at the top 8 domestic firms was RMB 3.28 million, 16% higher than the median at the JVs (see Figure 12). However, we recognise that some of the JVs are more selective than domestic players in the deals they take on, given potential reputational risks that foreign partners are unwilling to assume.

FIGURE 12: BANKER PRODUCTIVITY – REVENUE PER HEADCOUNT

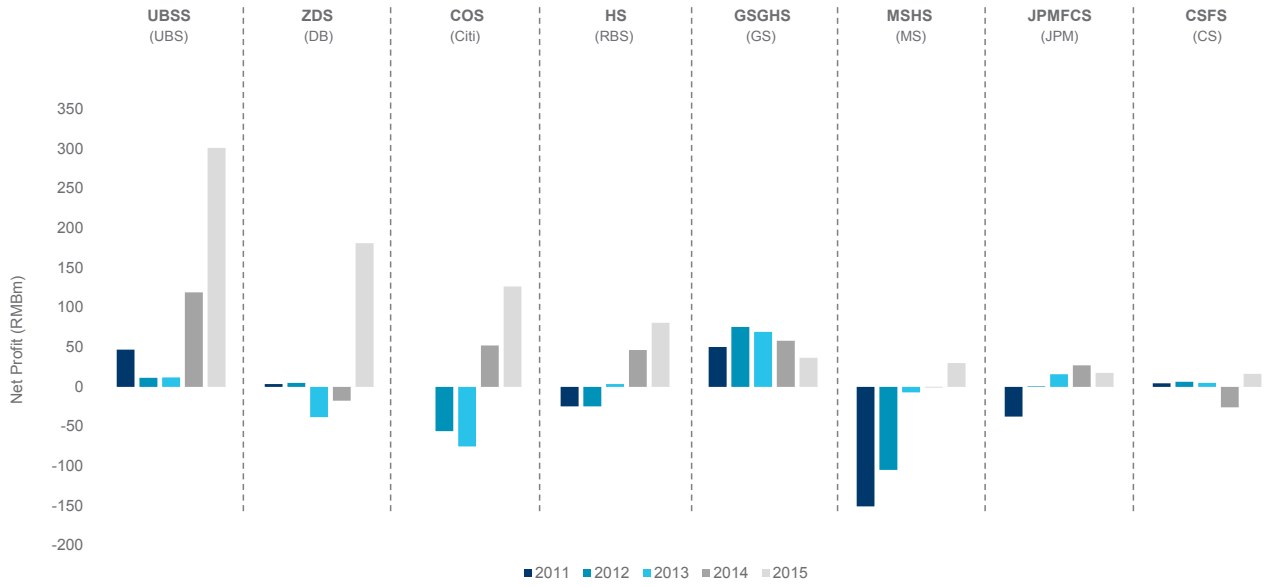


Source: Company financial reports, Quinlan & Associates analysis

C. PROFITABILITY

With limited access to the China securities market, the JVs have struggled to capture meaningful market share over the years. The absence of economies of scale, higher compensation costs and lower banker productivity have dragged on C/I ratios and, ultimately, profitability (see Figure 13). When removing revenues derived from transfer payments made by foreign partners, the true financial situation of the JVs remains even more uncertain. Given favourable market conditions and the dramatic growth experienced by the top domestic players, it is fair to conclude that the JVs are both underperforming and under-leveraged.

FIGURE 13: JV NET PROFITS



Source: Company financial reports, Quinlan & Associates analysis

Despite this, we believe securities JVs form a critical part of a foreign bank's China presence and need to be viewed as much more than a one-line 'investment in affiliate' entry in a bank's financial statements. Instead, we suggest a portfolio approach to evaluate the benefits of owning a securities JV. We believe foreign banks should consider a quasi-consolidation view of China revenues and expenses, both offshore and onshore, across the different entities that the foreign shareholder has a stake in. In doing so, they can better quantify some of the less tangible aspects of possessing a stake in one of the largest capital markets in the world.

2. THE CHINA OPPORTUNITY

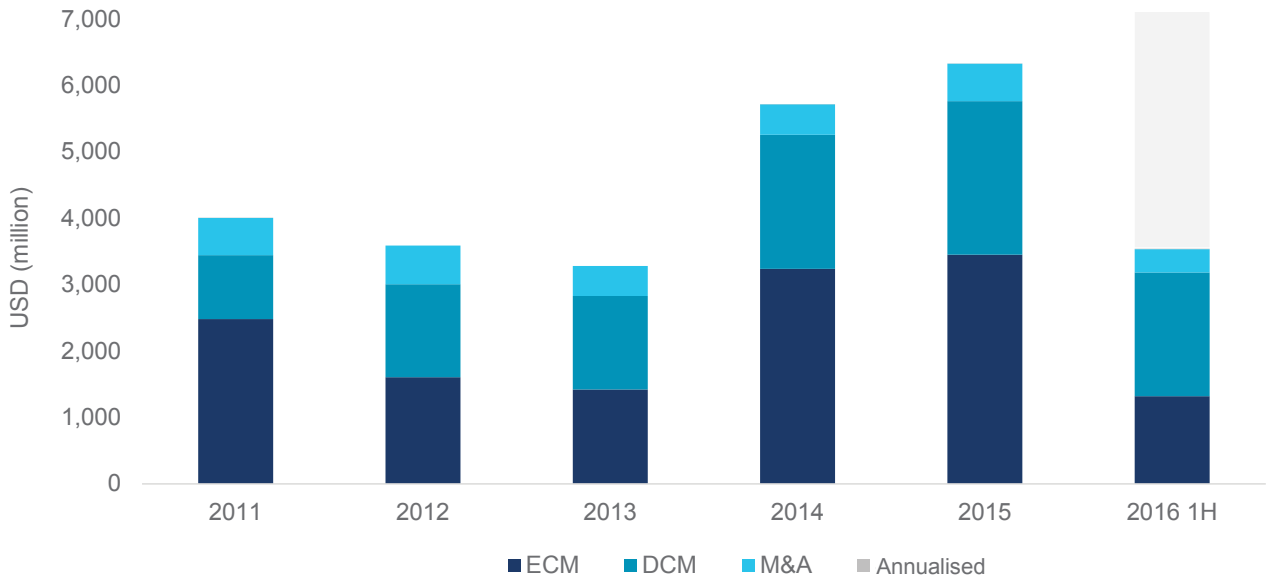
A. INVESTMENT BANKING (PRIMARY MARKET)

Despite the challenging situation facing the JVs, we still see plenty of opportunities ahead, given the importance that China plays in both the regional and global arena.

While economic growth has slowed, China is still the largest and second fastest growing economy in Asia Pacific (APAC). In 2015, China's GDP almost reached USD 11 trillion, larger than the sum of the next top eight economies in the region and representing almost half of the total APAC economy.[2]

Underpinned by robust economic fundamentals, China's core investment banking fee pool (i.e. M&A, ECM and DCM) is currently the second largest in the world behind the U.S., and is on track to exceed USD 7 billion by the end of 2016 (see Figure 14). However, the JVs need to be much more strategic in deciding which parts of the fee pool they should focus their efforts.

FIGURE 14: CHINA CORE IB FEE POOL



Source: Dealogic, Quinlan & Associates analysis

2 International Monetary Fund, *World Economic Outlook (WEO)*, April 2016.

ECM accounts for the lion's share of China's fee pool (~50% over the last five years). According to Dealogic, there were ~USD 110 billion of A-share and ~USD 70 billion of H-share issuances in 2015, with Chinese issuers representing the second largest fee pool globally at USD 3.5 billion (see Figure 15). Increasingly, as the Chinese capital markets mature, we are seeing issuers tapping the market for follow-on offerings: even without IPO moratoriums, three quarters of the A-share issuances in 2014 and 2015 were follow-ons. The ability to manage long-term client relationships, particularly by having an on-the-ground securities presence, will be especially important to capture such developments.

FIGURE 15: GLOBAL CORE IB FEE LEAGUE TABLE – BY PRODUCT (2015)

	ECM		DCM		M&A	
Rank	Country	Fee Pool (USDm)	Country	Fee Pool (USDm)	Country	Fee Pool (USDm)
1	United States	6,587	United States	9,098	United States	13,583
2	China	3,453	China	2,313	United Kingdom	1,701
3	Japan	1,390	Canada	1,048	Canada	1,029
4	Canada	1,375	United Kingdom	866	France	918
5	United Kingdom	1,125	Japan	824	Germany	808
6	Australia	700	Germany	803	Japan	723
7	Spain	408	France	650	China	563
8	Germany	383	Netherlands	514	Netherlands	481
9	Italy	325	Australia	443	Australia	453
10	France	323	Switzerland	407	Spain	369

Source: Dealogic, Quinlan & Associates analysis

Similarly, Chinese issuers also represented the second largest DCM fee pool globally in 2015 at USD 2.3 billion, according to Dealogic. The DCM market remains dominated by the Big 4 Chinese banks, development banks and the top domestic securities companies. Whilst it will be difficult for the JVs to directly compete with these players due to sheer balance sheet limitations, we feel there are pockets of the market where they can remain competitive, including corporate and enterprise bonds, both of which are now subject to less stringent approval hurdles, including shorter regulatory review processes. There may also be scope to selectively participate in small-to-medium enterprise (SME) private placement bonds, though the size of the market remains somewhat limited at present.

Beyond focusing on specific product niches, we believe JVs should look to increase their share of wallet from existing clients by providing a more integrated capital management offering across equity, debt and corporate banking. This could be achieved by working closely with their foreign shareholders, potentially through leveraging a wholly foreign-owned banking entity (WFOE). The JVs can also explore how to improve connectivity with their foreign partners for offshore referral opportunities, particularly in the dim sum bond space.

2015 was also a record year for Chinese M&A activity, with approximately USD 780 billion of deals across 5,700 transactions, making China

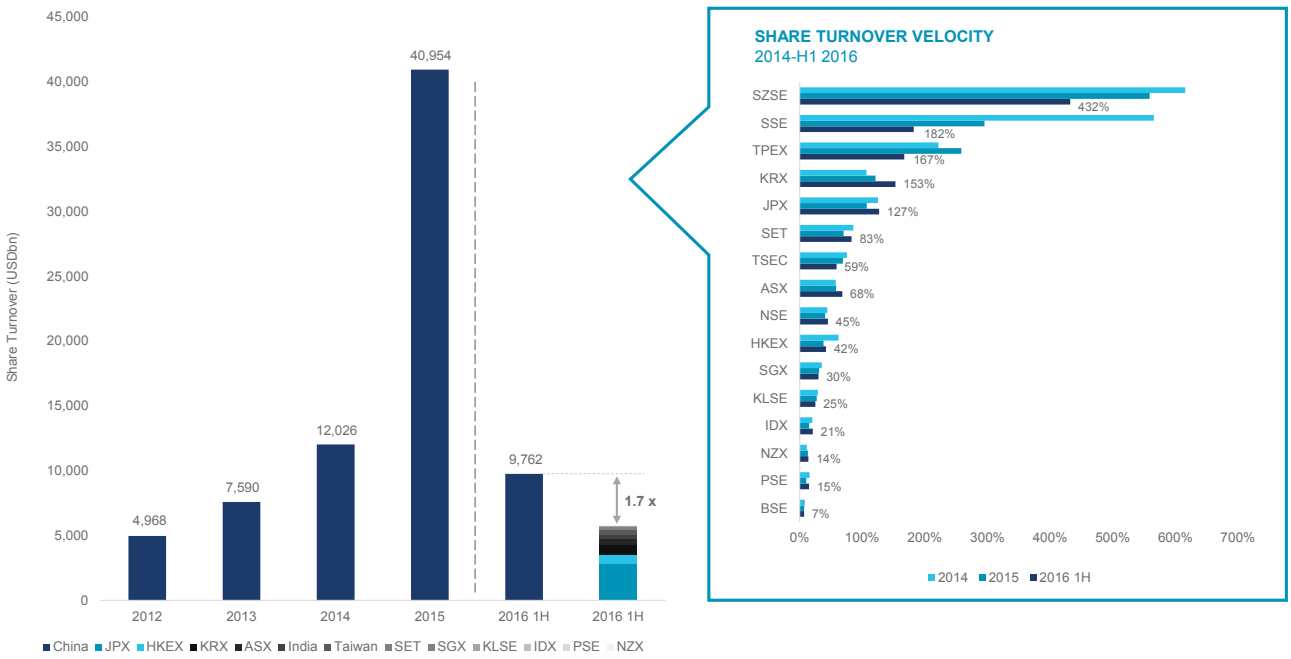
the seventh largest fee pool globally at USD 560 million, according to Dealogic. Domestic M&A was largely driven by economic transformation from heavy industry to services, as well as some sector consolidation, restructuring and inorganic growth strategies as the domestic market matures.

On the cross-border front, foreign inbound M&A appears to have reached somewhat of a steady state, though outbound activity is touching record highs, with domestic companies seeking out a mix of technologies, brands and know-how to bring back to the China market. This trend is expected to continue for the foreseeable future. We see outbound M&A advisory as one of the biggest opportunities for JVs, but succeeding in this space will require better co-ordination with their foreign shareholder to leverage global insights, cross-border experience and relationships with overseas targets.

B. INSTITUTIONAL BROKERAGE (SECONDARY MARKET)

Continued market liberalisation measures over the past 24 months, including ongoing grants of Qualified Foreign Institutional Investor (QFII) and RMB Qualified Foreign Institutional Investor (RQFII) quotas and licences, the launch of Shanghai-Hong Kong Stock Connect (Shanghai Connect), and the Mainland-Hong Kong Mutual Recognition of Funds, have attracted greater flows of capital both into and out of China. In fact, China is by far the most active and liquid equity market in the region; share turnover in H1 2016 reached USD 9.8 trillion, 1.7 times the rest of APAC combined. The Shenzhen (SZSE) and Shanghai (SSE) stock exchanges are also the top two exchanges in the region by share turnover velocity (see Figure 16).

FIGURE 16: APAC SHARE TURNOVER AND VELOCITY

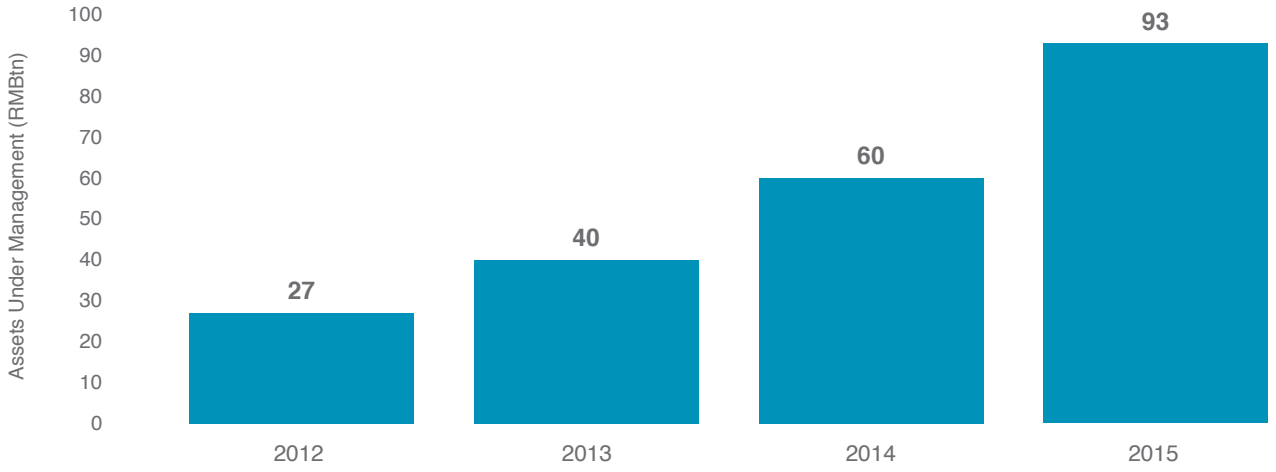


Source: World Federation of Exchanges, Quinlan & Associates analysis

China's total brokerage revenue pool stood at RMB 270 billion (~USD 40 billion) in 2015.[3] Even if we estimate total institutional revenues at USD 4-6bn (i.e. 10-15% of the market), capturing just 1% of the institutional wallet translates to USD 40-60 million in annual revenue.

With the increasing sophistication of domestic institutional clients (including hedge funds, asset managers and insurance companies), together with the ongoing shift in savings from bank deposits to managed funds, China's asset management industry has experienced explosive growth. Assets under management (AuM) soared by a CAGR of 51% from RMB 27 trillion in 2012 to RMB 93 trillion in 2015 (see Figure 17). We anticipate the institutional revenue pool to grow strongly in coming years and see considerable upside for JVs who can successfully compete in this space.

FIGURE 17: CHINA ASSET MANAGEMENT INDUSTRY – MARKET SIZE



Source: Wind, China Banking Association, Quinlan & Associates Analysis

Following the launch of Shanghai Connect in November 2014, access to China's A-share market was made possible without an onshore presence or QFII licence. With Shenzhen-Hong Kong Stock Connect (Shenzhen Connect) expected to launch by year-end, together with the removal of overall quotas for both the Shanghai and Shenzhen links (as well as plans to include ETFs as eligible securities), China has sent a clear signal to the world that it is serious about attracting international investors to the A-share market.

The launch of Shenzhen Connect is also likely to accelerate China's inclusion into MSCI's emerging market index, which has thus far been rejected due to concerns about market accessibility. We consequently see foreign investment into China's equities market on the verge of a major boom and believe the international banks and their JVs are in a prime position to capitalise on this.

3 Securities Association of China, Chinese securities company financial reports.

For those JVs with A-share secondary trading and research capabilities, having an on-the-ground presence with the coverage of upwards of 200 A-share stocks has provided them with a considerable edge over the other international players in China, who have been limited to tapping the A-share market through Shanghai Connect. While many of these players have ramped up their Hong Kong-based A-share coverage headcount over the past 18 months, the absence of an onshore brokerage platform has meant they have been unable to capture burgeoning south-bound demand for eligible Hong Kong stocks from Chinese institutional investors.

Moreover, unlike UBS Securities and Goldman Sachs Gao Hua Securities, these JVs have also been unable to capture commissions currently paid away to local Chinese brokerages for executing their international clients' QFII and RQFII trades. We feel this commission pay-away alone is a meaningful enough revenue opportunity for JVs to investigate setting up a light onshore brokerage presence.

C. OTHER REVENUES

There are a number of other businesses (and associated revenue pools) that foreign banks can look to access through their JV platforms, including proprietary trading, asset management, custody, private equity and derivatives. Combined, Chinese securities companies generated over RMB 250 billion in revenues from these products in 2015, representing 44% of the total securities revenue pool.

Investment income, of which proprietary trading forms a part, accounted for 24% of total mainland securities revenues in 2015, with CITIC Securities alone generating RMB 20 billion in revenue for the year. UBS Securities, one of only two JVs that holds a proprietary trading licence, generated RMB 97 million from fair value gains/losses on its investments in 2015. This represented 8% of the JV's annual operating income.

Some leading domestic securities companies also generate sizeable revenues from asset management activities. For example, Shenwan Hongyuan Securities earned RMB 2.4 billion in asset management net income for 2015, with a number of other firms earning well north of RMB 1 billion annually. UBS Securities is the only foreign player to date who has secured a Collective Asset Management license, though revenues from asset management services have been somewhat negligible to date.

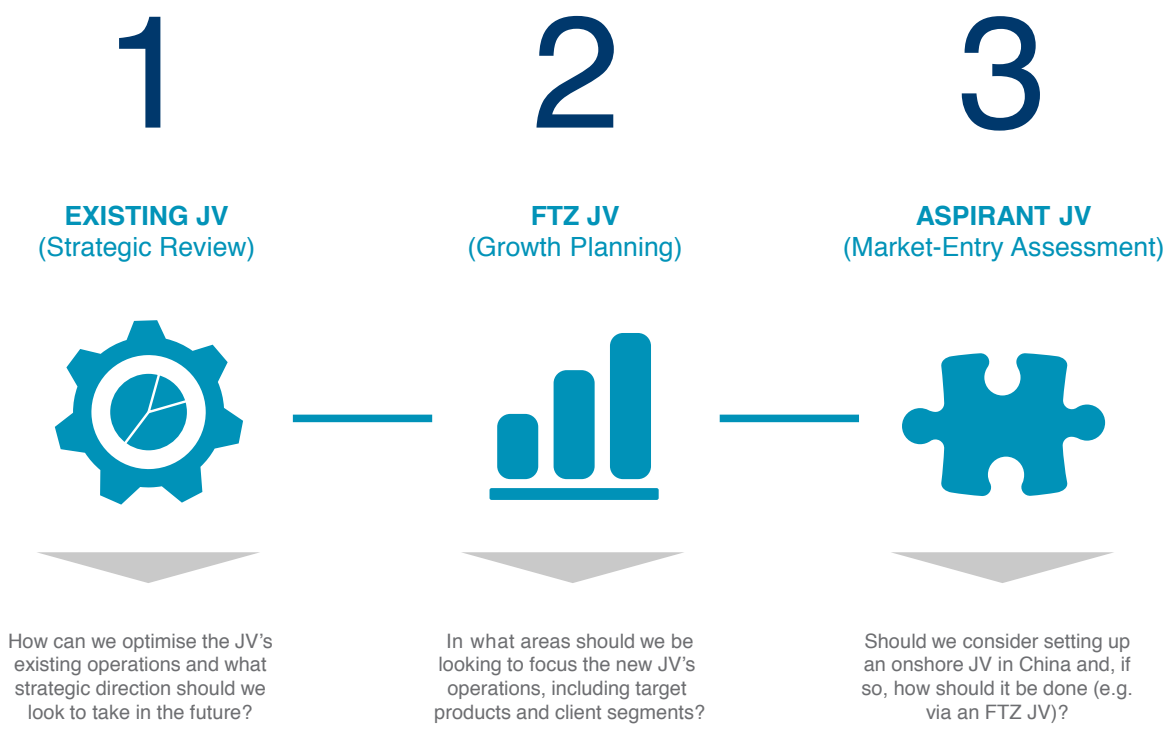
As China's high net worth (HNW) and ultra-high net worth (UHNW) population continues to explode, demand for wealth management services is also set to rise, especially as investors move from a savings to investment culture. As a consequence, investment advisory income has also experienced exceptional growth, with the total fee pool among securities firms rising more than four-fold from RMB 1.15 billion in 2012 to RMB 4.48 billion in 2015. The top provider in this space, Haitong Securities, earned RMB 580 million from these services in 2015, capturing 13% of the total market.

Financial futures products will be another area where we expect to see exponential growth, since the launch of the Hushen 300 Index (CSI 300) in 2010. Given the traditional strength of global investment banks in the derivatives space, we feel there is ample opportunity for them to compete.

3. STRATEGIC CONSIDERATIONS

We believe China continues to represent an attractive opportunity for foreign banks and their onshore JVs. However, strategic considerations will differ according to where each JV is in its corporate lifecycle (i.e. an existing JV, an FTZ JV or an aspirant JV).

FIGURE 18: KEY STRATEGIC CONSIDERATIONS – BY TYPE OF JV



Source: Quinlan & Associates Analysis

1. EXISTING JVs

For the existing JVs and their investors, we see their strategic options as three-fold: (1) grow their footprint; (2) optimise existing operations; or (3) exit.

GROW

Existing JVs can look to expand their footprint in one of two ways: through increasing their equity stakes and/or securing new licences.

Since 2012, China has allowed foreign JV partners to increase their shareholding in securities JVs (outside of the FTZs) to a maximum of 49%, up from 33% previously. Initial indications are that Credit Suisse is the first foreign partner looking to increase its shareholding in its JV to the maximum permissible level. Given current capital adequacy rules, any investment will need to be carefully considered in light of its capital costs and will require compelling arguments to set things in motion internally, even before negotiations with JV partners and regulators can begin. Consideration must also be given to the impact greater equity ownership would have on the foreign partner's influence over the JV, including its existing governance framework and processes.

As previously discussed, licence restrictions – and a consequent lack of scale – have been a key challenge for the JVs. Efforts to secure new licenses can be seen in the 2014 acquisition of a futures licence by UBS Securities and the 2015 approval of an A-share brokerage licence for Credit Suisse Founder Securities in the Shenzhen Qianhai FTZ. We believe now is the time for JVs to revisit the business case for securing additional licenses, especially in light of China's ongoing liberalisation efforts in the secondary space.

On the topic of growth more generally, we feel some lessons can be drawn from the Japan strategies of the international banks. As a dominant economic powerhouse in the 1980s, all the international banks sought to expand their operations in Japan. However, the domestic Japanese banks, with their strong corporate and institutional relationships, large asset bases and broad retail networks, remain the dominant players in the country's domestic capital market. Nevertheless, despite numerous pullbacks and rebuilds, the U.S. and European banks continue to maintain a presence in Japan and have, over the years, found select profitable niches to compete in, such as structured equities and cross-border M&A. We feel aspirations in China should be similarly tempered, to focus on select niches that the foreign partner already excels in internationally.

OPTIMISE

Given the headwinds facing existing JVs, we see significant scope to further optimise operations. Considerations of product offering and client targeting, as well as ways to improve offshore collaboration and cross-dissemination of culture, should all be reviewed. At a more fundamental level, we see ample scope to share resources, best practices and business leads between the JV and its offshore partner. To achieve this, foreign shareholders may investigate ways to increase management influence, as well as further align interests with their Chinese partners, even if they only hold a minority stake.

We believe the ability to harness onshore and offshore teams will be critical in addressing scale issues and enhancing headcount utilisation, whether in investment banking, sales and trading, or research. Additionally, to provide clients with a seamless onshore-offshore platform across such products, a robust inter-entity incentive framework should be explored. This provides a product-neutral service offering to clients while recognising the effort of the onshore team to support offshore business (and vice versa).

EXIT

An exit should be seen as a last resort for foreign shareholders, given the poor signal it sends to mainland regulators, as well as other relevant stakeholders (including shareholders and clients), about the foreign partners' commitment to China.

While we feel that an exit should only be considered in the event that growth or optimisation efforts have completely failed, there may still be merit to exiting a JV, especially if there are irreconcilable differences between foreign and local partners with respect to the cultural, strategic and operational direction of the firm. An in-depth understanding of potential re-entry options (including identifying an alternative local partner) will be crucial in ensuring any exit does not become prolonged or even permanent.

Looking at the case of CICC, Morgan Stanley took over ten years to exit the joint venture, such that it was unable to actively capitalise on its China securities aspirations for much of the early 2000's. However, it nevertheless ended up with a USD 700 million pre-tax windfall from its stake sale. Morgan Stanley also appears to be making the most of its 2011 tie-up with Huaxin Securities, with revenues growing by a CAGR of 34% from 2011-15 and the JV booking its first-ever annual profit in 2015.

WE BELIEVE THE ABILITY TO HARNESS ONSHORE AND OFFSHORE TEAMS WILL BE CRITICAL IN ADDRESSING SCALE ISSUES AND ENHANCING HEADCOUNT UTILISATION.

2. FTZ JVs

The FTZs will allow eligible securities companies to access an increasing array of onshore products, including futures, foreign currency, derivatives and bond markets, as well as potentially benefit from preferential tax rates (see Figure 19). We also expect any further financial liberalisation measures to be trialled in the FTZs.

For the existing JVs, in particular, expansion of their presence into the Shanghai and Guangdong FTZs will also greatly enhance their product range.

FIGURE 19: FTZ HIGHLIGHTS

		SHANGHAI FTZ	GUANGDONG FTZ
MARKET ENTRY		• Allow foreign financial institutions to set up securities JVs in the FTZ with the foreign shareholding capped at 49% • Domestic partners do not have to be securities companies • Broader coverage of business licenses	• Allow eligible Hong Kong or Macau-funded financial institutions to set up a full licensed securities company • Foreign shareholding limit raised to 51%
SUPPORTING INITIATIVES	OUTBOUND	• Support securities and futures companies to develop cross-border brokerage and asset management businesses, and trial spots for participation in offshore securities, futures and derivatives trading • Allow eligible institutions to invest in offshore securities and futures	• Support institutions in Guangdong, Hong Kong and Macau to jointly establish overseas RMB funds as a means of financing for the Chinese enterprises • Support securities companies in the FTZ to develop cross-border RMB businesses • Allow institutions in the FTZ to issue bonds denominated in RMB or foreign currencies offshore
	INBOUND	• Support the offshore parent companies or subsidiaries of the enterprises in the FTZ to issue RMB bonds onshore • Support eligible offshore institutions to set up wholly-owned or joint venture futures market servicing institutions in the FTZ to trade specified kinds of futures for their offshore clients	• Support onshore Hong Kong and Macau enterprises with direct investment in the FTZ to issue RMB bonds
	DOMESTIC	• Allow eligible institutions to invest in onshore securities and futures • Allow the securities and futures companies in the FTZ to have cross-over business licenses • Support securities and futures companies in Shanghai to participate in the inter-bank FX market and to develop spot RMB FX business and derivatives trading	• Companies registered in Qianhai which meet certain criteria are assessed preferential tax rate of 15%, compared to the conventional rate of 25%

Source: Shanghai Free Trade Zone, China (Guangdong) Free Trade Zone, Quinlan & Associates analysis

For the FTZ JVs, efforts should remain centred around growth planning, particularly with respect to client identification and product development. By carefully evaluating their own strengths and weaknesses against broader market and competitive developments, the FTZ JVs will be in a position to ensure any expansion efforts are well aligned with their core competencies. For example, we expect HSBC's FTZ JV to extend its debt capital markets and FX capabilities to China in order to capitalise on its historic relationships with corporates who have strong Hong Kong-China ties.

It is critical that lessons be taken from the experiences of the existing JVs in China. This is especially the case with respect to corporate governance matters and the cooperation model between the JV and the offshore entity of the foreign partner (e.g. for deal referrals). Moreover, given the FTZ JVs can be up to 51% foreign-owned, foreign partners will need to remain cognisant of the impact of financial consolidation.

3. ASPIRANT JVs

For foreign institutions looking to establish a securities JV in China, strong consideration will need to be given to how China fits into the broader strategic vision of the organisation. Whether this be to better service the company's existing clients, diversify its revenue base or expand its geographic footprint, the rationale for market entry needs to be both compelling and clearly understood.

For aspirant JVs, key strategic considerations will be around sizing the opportunity, evaluating internal capabilities, estimating setup costs, and identifying potential JV partners. Unlike the first wave of JVs in the 2000s, the FTZ rules allow domestic shareholders to be from outside of the securities industry. This opens up additional dynamics related to day-to-day management, as well as the ability to leverage new political and client relationships.

FOR THE FTZ JVs, EFFORTS SHOULD REMAIN CENTRED AROUND GROWTH PLANNING, PARTICULARLY WITH RESPECT TO CLIENT IDENTIFICATION AND PRODUCT DEVELOPMENT.

4. CONCLUSION

Over the past decade, China has emerged to become one of the largest capital markets in the world, both in the primary and secondary space.

Attracted by its robust growth prospects and the sheer size of the market, a number of foreign players rushed to establish securities JVs on the mainland during much of the early 2000s. However, due to a combination of stringent licence and ownership restrictions, access to revenue opportunities remained severely limited. Coupled with poorer cost control and lower productivity than the leading domestic securities houses, many of the JVs struggled to capture market share or even turn a profit.

Despite these challenges, we feel China remains an attractive opportunity for the securities JVs, especially in light of ongoing regulatory liberalisation measures. The relaxation of foreign ownership restrictions, together with various market access initiatives (including Shanghai/Shenzhen Connect and the establishment of FTZs), has spurred a renewed interest in the mainland from foreign investors. We believe the JVs are in a prime position to capitalise on these developments, though current strategies need to be revisited in order for these opportunities to be effectively captured.

For the JVs, Round 2 has only just begun.

5. HOW CAN WE HELP?

Our consultants have worked with a number of international banks on their China JV strategies. The scope of our project work is primarily determined by where our clients are in their operating lifecycle and typically include the following:

EXISTING JVs

Conduct a comprehensive strategic review of the JV's operations to identify areas for future growth, ongoing optimisation efforts and, where relevant, a potential exit, e.g.:

- Assess the business case for securing new licenses (e.g. onshore brokerage)
- Evaluate client coverage model and cost structures (e.g. compensation)
- Review existing governance model and onshore-offshore collaboration framework

FTZ JVs

Develop a detailed strategic growth plan for the JV, supported by clear financial and operational targets, together with development milestones, e.g.:

- Identify key product verticals and develop target client list based around core competencies and unique points of difference vs. competitors
- Estimate costs (upfront and ongoing) and incremental revenue of buildout efforts
- Establish terms of reference around governance and operational processes

ASPIRANT JVs

Prepare an in-depth market entry assessment:

- Determine appropriate market entry route (i.e. traditional JV or FTZ JV)
- Identify suitable domestic partners based strategic and operational synergies
- Conduct detailed market sizing by product and client segment

We believe there is considerable scope for JVs – current, newly-established and aspirant – to take advantage of China's rapid regulatory liberalisation measures. We also see a clear first-mover advantage for those JVs who are able to carve out a niche in an increasingly competitive environment.

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STRATEGY WITH A DIFFERENCE

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