

TRAVERSING THE GREAT WALL

A NEW ERA FOR SINO-FOREIGN SECURITIES JVs



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QUINLAN
& ASSOCIATES

THE AUTHORS

BENJAMIN QUINLAN

CEO & MANAGING PARTNER

BCom (Hons 1) / LLB (Hons), *Macquarie University*

YVETTE KWAN

COO & PARTNER

BCom (Merit), *University of New South Wales*
MBA, *Australian Graduate School of Management*

HUGO CHENG

CONSULTANT

BA (Hons), *University of Cambridge*
MSc (Distinction), *Imperial College London*

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EXECUTIVE SUMMARY

At the end of 2017, the Chinese government announced it would be implementing a wide range of regulatory measures aimed at liberalising the country's financial markets, opening the door for greater participation by foreign institutions.

In May 2018, a number of draft liberalisation measures were formalised by the CSRC. Among the raft of reforms in the process of being or proposed to be implemented, one of the most significant developments has been the lifting of foreign ownership caps for securities, fund management, and life insurance companies to 51%, with 100% ownership on the table by 2021. This landmark announcement has been viewed as somewhat of a holy grail for foreign players, allowing them to secure something they had been seeking (but couldn't attain) for many years: management control.

In the securities space in particular, we believe the recently announced reforms are true game changers. In addition to foreign players now having the opportunity to exercise full control of their onshore securities businesses, the relaxation of business scope and domestic partner requirements provide a gateway for aspirant firms to set up a JV without the need to operate an investment banking business (i.e. they can focus on their core competencies) or tie up with a domestic securities firm, which often presents major conflicts of interest. For the incumbent JVs, the announced reforms also address many issues faced by the global investment banks around scalability and continued management conflicts with domestic partners.

We are already witnessing a number of firms pouncing on these new reforms. In May 2018, J.P. Morgan announced its plans to re-enter the China securities market, applying for a

controlling stake in a new JV. In the same month, UBS further stepped up its efforts by applying for a controlling stake of 51%. A number of aspirant entrants, including Nomura and DBS, have followed suit, recently announcing their market entry plans. We expect to see further application announcements in Q3 and Q4 2018 by both global and regional players.

However, it is important to recognise that the recent regulatory changes are simply levelling the playing field between foreign and domestic players. Most JVs still remain extremely subscale when compared to the leading local securities houses, with operating income and headcount of the top 8 JVs dwarfed by a factor of 43 relative to the top 8 domestic firms. Moreover, many of the JVs are still running at painfully high cost-to-income ratios, weighing on profitability, though we do recognise some improvements in profit margins over the years.

We believe the Chinese securities market is on the verge of explosive growth and forecast the securities fee pool to reach RMB 708 billion (~USD 103 billion) by 2023, more than doubling 2017-levels. In particular, the relaxation of business scope requirements will provide opportunities for foreign firms to bring more innovative funding and investment products to the domestic securities market, with appetite supported by the growing sophistication of domestic institutional investors and corporates. In addition, efforts to drive cross-border investments, including various Bond and Stock Connect Schemes, as well as the inclusion of Chinese A shares in the MSCI Emerging Markets Index, are also expected to deliver a surge in capital inflows.

While the aggregate fee pool offered by the Chinese securities market presents a compelling proposition to foreign players (especially in light of recent liberalisation measures), effectively monetising the JV opportunity necessitates an in-depth understanding and review of the full spectrum of strategic, financial, operational, and implementation considerations that come with

setting up a securities business on the mainland.

For those who can successfully develop and execute an effective end-to-end JV proposition, it's time to traverse the Great Wall.

SECTION 1

INTRODUCTION

Since releasing our September 2016 report, *Sino-Foreign Securities Joint Ventures: Round 2* (“our previous report”),¹ the Chinese government has instituted wide-ranging reforms designed to further open up the country’s financial services industry to foreign competition. These include a raft of liberalisation measures across securities, banking, asset management, and insurance, ranging from aspects such as foreign ownership and administration, to foreign talent.

In the securities space, a number of issues arising from holding minority stakes in Sino-foreign securities joint ventures (“JV”) – including a lack of management control, cultural and / or strategic misalignment between JV partners, and sub-scale operations as a result of underinvestment – have historically made several firms reluctant to commit to an onshore presence. However, given the scale of ongoing regulatory reforms, we are now seeing global and regional players alike (including those currently sitting on the sidelines) taking a very serious look at their China strategies once again.

We suggested in our last report that the time was indeed right for banks to start dusting off and revisiting their onshore China strategies. Before the ink had even dried on our paper, J.P. Morgan became the first player to reveal its hand, announcing the sale of its stake in J.P. Morgan First Capital in late 2016 to its Chinese JV partner. The bank made this decision due to ongoing strategic misalignment with its partner, as well as the anticipation that it would soon be able to invest in a new venture with a more suitable partner when majority foreign ownership was green-lighted by regulators.

A number of other global banks established further footholds in their China securities businesses. By January 2017, Morgan Stanley secured regulatory approval to increase its stake in Morgan Stanley Huaxin Securities to 49%, despite the foreign ownership cap being lifted from 33% to 49% in 2012. At the end of June 2017, both HSBC’s 51%-owned and Bank of East Asia’s 49%-owned Qianhai free trade zone (“FTZ”) securities JVs were finally approved by the China Securities Regulatory Commission (“CSRC”) and have since commenced operations. There have been no subsequent approvals of FTZ securities JVs under CEPA, which in our view was used more as a transitional liberalisation measure.

In recent months, there has been an escalation of significant and meaningful commitments towards the opening of China’s financial sector. The most significant change has been the lifting of foreign ownership caps to 51% for securities, fund management, and life insurance companies, with the cap to be phased out by 2021. As such, foreign management control has finally been put on the table.

In response to these new measures, a number of global banks, as well as banks headquartered in Asia Pacific, are expressing a clear interest in setting up a securities JV on the mainland. While some firms are at a more exploratory stage, others are well into the process of lodging their formal applications to the CSRC.

It is clear that, unlike previous efforts to open the Chinese market to international investment banks, these measures are genuine game changers.

¹ Quinlan & Associates, ‘Sino-Foreign Securities Joint Ventures’, September 2016, available at: <https://www.quinlanandassociates.com/insights-sino-foreign-securities-joint-ventures/>

SECTION 2

THE NEW REGULATIONS

OVERVIEW OF KEY MEASURES

On 10 November 2017, Chinese Vice Finance Minister, Zhu Guangyao, announced that foreign investors would be able to hold a

majority stake in several types of Chinese financial institutions, amongst various other broad measures (see Figure 1). Further clarity was provided by the Governor of the People's Bank of China, Yi Gang, on 11 April 2018.

FIGURE 1: KEY LIBERALISATION MEASURES

	SECURITIES COMPANIES		OTHER FINANCIAL SERVICES COMPANIES	
	By 30 June 2018	By 31 December 2018	By 30 June 2018	By 31 December 2018
Ownership	<ul style="list-style-type: none"> Increase foreign ownership limit to 51% 		<ul style="list-style-type: none"> Remove restrictions on foreign ownership in banks and asset management companies 	<ul style="list-style-type: none"> Remove limit of foreign ownership in asset management companies sponsored by commercial banks
Holding	<ul style="list-style-type: none"> Domestic partner of Sino-foreign securities JV need not be a securities company 			<ul style="list-style-type: none"> Remove requirement for foreign investor to operate a representative office for two years before establishing an insurance company
Foreign Investment	<ul style="list-style-type: none"> Quadruple daily quota for Hong Kong Stock Connect 	<ul style="list-style-type: none"> Launch London Stock Connect scheme 	<ul style="list-style-type: none"> Allow qualified foreign investors to set up and operate insurance agency and assessor businesses 	<ul style="list-style-type: none"> Encourage foreign investments in other financial sectors
Business Scope		<ul style="list-style-type: none"> Remove business scope restrictions for Sino-foreign securities JV 	<ul style="list-style-type: none"> Expand business scope of foreign-invested insurance brokers to match Chinese counterparts' 	<ul style="list-style-type: none"> Significantly expand business scope of foreign-invested banks

Source: People's Bank of China

Specific measures in relation to the securities industry include the lifting of ownership and business scope restrictions for Sino-foreign securities JVs (see Section 3 for more details), the lifting of foreign ownership caps for futures

companies, and the expansion of the Stock Connect scheme. The new foreign ownership cap of 51% is expected to be progressively raised and ultimately removed in three years.

OTHER KEY LIBERALISATION MEASURES

Relaxation of foreign ownership caps and business scope restrictions for foreign investors in banks and insurance companies have recently been announced. Other relaxation measures mean that foreign-invested banks can now easily (i.e. without needing regulatory approval) enter new businesses, such as providing custody services for mutual funds and overseas wealth management products, engaging in treasury bond underwriting, and holding shares in domestic Chinese banks.

The Chinese government has also announced a merger between the banking and insurance regulatory bodies, the China Banking Regulatory Commission and the China Insurance Regulatory Commission. The merged China Banking Insurance Regulatory Commission is expected to reduce regulatory arbitrage across the banking and insurance

sectors, resolving historical issues around the delineation of supervision between the two supervisory bodies.

In investment management, the lifting of the foreign ownership cap for mutual fund managers mirrors that for other financial institutions described above. Additionally, since May 2018, many of the foreign senior managers of private securities funds can take qualifying exams in English, serving as another indicator of the breadth of reform.

In response to these measures, MSCI announced it would be adding over 230 China-listed shares to its emerging market benchmark in June and September of 2018.² This greater interconnectivity with global markets will be supported by the quadrupling of the daily mainland-Hong Kong Stock Connect quotas, as well as the launch of a Shanghai-London Stock Connect this year.

² CNBC, 'Index giant MSCI announces 234 China A shares to be added to indexes', 14 May 2018, available at: <https://www.cnbc.com/2018/05/14/msci-announces-234-china-a-shares-to-be-added-to-equity-indexes.html>

SECTION 3

UPDATED MEASURES FOR SINO-FOREIGN JVs


OVERVIEW OF KEY MEASURES

On 28 April 2018, after a brief period of public consultation, the CSRC updated its rules in relation to securities JVs when it enacted *Measures for the Administration of Foreign-*

Invested Securities Companies (外商投资证券公司管理办法). These rules provide the practical basis for the implementation of liberalisation measures in the domestic securities industry (see Figure 2).

FIGURE 2: KEY REGULATORY CHANGES (SECURITIES JVs)

	CATEGORY	OLD RULES	NEW RULES	IMPLICATION(S)
	Definition of Foreign-Funded Securities Company	<ul style="list-style-type: none"> (i) A foreign and domestic shareholder mutually agree to establish a securities JV (ii) A foreign shareholder is given or purchases the equity of a domestic securities company 	<ul style="list-style-type: none"> An additional applicability criterion (iii) has been added in relation to securities companies changing from domestic-funded to foreign-funded as a result of change in controlling shareholders or ultimate controlling shareholders 	<ul style="list-style-type: none"> Allows the ultimate controlling shareholder to change from domestic to foreign investor and widens the applicability for more complex organisational structures, including indirect holdings
CRITERIA FOR FOREIGN PLAYERS	Foreign Ownership Cap	<ul style="list-style-type: none"> 49% cap on foreign investor holding in JV Foreign investor(s) holding of listed securities firms capped at 20% for single investors and 25% in aggregate Requirement for one domestic investor to hold a minimum 49% shareholding 	<ul style="list-style-type: none"> Foreign investor cap lifted to 51%, rising to 100% within three years Removal of single and aggregate caps for foreign investor(s) of listed securities companies 	<ul style="list-style-type: none"> Foreign investors now allowed to be controlling shareholders of securities companies, enabling stronger management control and better strategic alignment with global operations
	Foreign Shareholder Requirement	<ul style="list-style-type: none"> At least one foreign investor was required to have financial business qualifications 	<ul style="list-style-type: none"> All foreign shareholders are now required to be financial institutions 	<ul style="list-style-type: none"> Ensures stability of the industry as the CSRC liberalises the market by ensuring all shareholders have relevant experience and capabilities
	Additional Foreign Shareholder Requirement	<ul style="list-style-type: none"> No severe penalty should have been levied against the foreign investor by any regulatory or judicial authority in the past three years 	<ul style="list-style-type: none"> In addition to the old rules, the foreign investor should not be under investigation due to suspected major violations of any law or regulation 	<ul style="list-style-type: none"> The expansion of the condition beyond actual penalties to investigations suggests a widening of the conditionality tests As the term 'major' is not defined and the applicability to entities within the same foreign group are not mentioned, the CSRC is able to exercise greater discretion in screening applicants, ensuring that only foreign investors of the highest standing need apply
CRITERIA FOR DOMESTIC PLAYERS	Domestic Investor Requirement	<ul style="list-style-type: none"> Domestic investor in the securities JV should be a securities company 	<ul style="list-style-type: none"> Major shareholders and controlling shareholders in the securities JV should have relevant financial services experience 	<ul style="list-style-type: none"> Domestic investors no longer need to be securities companies, removing potential areas of conflict The additional conditions ensure that domestic investors have the capabilities to enhance the JV and are strategically aligned
	Business Scope	<ul style="list-style-type: none"> Foreign-invested securities JVs initially limited in business scope to advisory, and underwriting and sponsorship of stocks and bonds Broking of foreign shares and bonds and other businesses could subsequently be approved by the CSRC subject to JVs meeting consecutive annual profitability hurdles 	<ul style="list-style-type: none"> Initial business scope of a newly formed JV should match the experience of its controlling shareholder or the largest shareholder in the securities business 	<ul style="list-style-type: none"> New entrants need not commence operations with underwriting and advisory businesses and can focus on their core competencies
	Individuals in Scope to be Compliant with Relevant Laws	<ul style="list-style-type: none"> N/A 	<ul style="list-style-type: none"> Shareholders, directors, supervisors, and senior executives need to be compliant with Company Law 	<ul style="list-style-type: none"> Greater expectations of wider accountability and professionalism

 Key changes for foreign players

Source: CSRC, Quinlan & Associates analysis

We believe the updated measures around foreign investor limitations / requirements, domestic investor requirements, and business

scope are the most relevant game changers for global players.

FOREIGN INVESTOR REQUIREMENTS

The most critical change to the limitations on foreign investors is the lifting of the ownership cap from 49% to 51%, with the promise to completely remove this restriction in three years.

The shift from minority to majority ownership has major implications for the governance framework and operations of JVs. With management control and the ability to strategically align the JVs with banks' global operations, foreign investors will be able to further leverage their experience and offshore capabilities to streamline operations and domestic product offerings, which should have a considerable impact on their competitiveness and profitability. Recognising the opportunity presented by the ability to exercise management control, a number of global players, such as J.P. Morgan and Nomura, have submitted applications to establish majority-control securities JVs.

The CSRC emphasises a prudent approach to the liberalisation of the Chinese market. In reality, it appears they will only allow the most qualified foreign investors to benefit from this regulatory change, laying out a number of additional qualifiers. Instead of having one foreign investor with financial business qualifications, all foreign investors are now required to be financial institutions. Furthermore, in addition to having no severe penalty levied by any regulatory or judicial authority in the past three years, the foreign shareholders cannot be under investigation for any suspected major regulatory violation.

These enhanced requirements ensure foreign shareholders have the relevant experience and capabilities to provide tangible benefits to the securities JVs, while being institutions of integrity and high credibility, in order to protect the stability of the industry.

DOMESTIC INVESTOR REQUIREMENTS

While domestic investors are required to have relevant financial experience, the CSRC removed the requirement that they need to be securities companies.

Previously, foreign and domestic partners in a securities JV faced significant areas of business overlap, leading to conflicts in product, geographic, and client prioritisation. With this restriction now removed, foreign investors can choose partners with significant financial expertise that are not securities companies, such as financial holding companies, which complement and / or enhance the capabilities of the JV instead of competing against it.

By eliminating direct business conflicts, new securities JVs can now operate in line with foreign players' key strategic priorities, making them considerably more attractive.

BUSINESS SCOPE

JVs were previously required to commence operations by providing underwriting, sponsorship, and advisory services. Only when specific profitability hurdles were achieved would they be allowed to apply for new licences, such as secondary brokerage or asset management.

This restriction was a major obstacle for international players with more niche capabilities, such as those specialising in derivatives, given they were required to operate businesses that did not reflect their core competencies overseas. By allowing foreign investors to offer services in areas in which they have relevant experience and expertise, the new regulations open the door for more specialised players to establish a foothold in the Chinese market, enhancing overall strategic alignment.

SHAREHOLDER REQUIREMENTS

Along with the aforementioned regulatory changes, the CSRC has also refined their requirements for securities companies shareholders. The CSRC categorises shareholders into four groups, being:

1. Controlling shareholders;
2. Major shareholders;
3. Shareholders with > 5% equity; and
4. Shareholders with < 5% equity.

Controlling shareholders are those with over 50% equity, or shareholders with sufficient voting rights to exercise significant influence over key decisions. Major shareholders refer to those with over 25% equity, or the largest shareholders among those with over 5% equity.

The CSRC has outlined a range of operational, financial, and strategic requirements for each shareholder category (see Figure 3).

FIGURE 3: SHAREHOLDER REQUIREMENTS

		Controlling	Major	> 5%	< 5%
OPERATIONAL	Good Business Track Record	✓	✓	✓	✓
	No Record of Operational Failure for Past Three Years	✓	✓	✓	✓
	Leader in Market Indicators	✓	✓	*	*
	Clear Equity Structure	✓	✓	✓	✓
	Reputable and Credible	✓	✓	✓	✓
	No Criminal Record / Punishments in Past Three Years	✓	✓	✓	✓
	Not Currently under Investigation for Criminal Activities	✓	✓	✓	✓
FINANCIAL	Net Asset (RMB)	> 100 bn	> 200 m	> 50 m	*
	Net Asset ≥ 50% of Paid-In Capital	✓	✓	✓	*
	Contingent Liability < 50% of Net Asset	✓	✓	✓	*
	Ability to Settle All Liabilities at Maturity	✓	✓	✓	*
	Profitable	Past 5 Years	Past 3 Years	*	*
	Cumulative Operating Income in Past Three Years (RMB)	> 100 bn	> 50 bn	*	*
	> 50% of Net Profit Derived from Main Business Line	✓	*	*	*
Ability to Replenish Capital	✓	✓	*	*	
STRATEGIC	Related Experience in Financial Services Industry	✓	✓	*	*
	Practical Plan / Strategy for Securities Company	✓	*	*	*
	Securities Company Aligns with Long-Term Strategy	✓	*	*	*
	Risk Mitigation Plans	✓	✓	*	*

✓ Required
 * Not Required

Note all shareholders also need to comply with any requirements the CSRC imposes based on the principle of careful supervision and regulation

Source: CSRC, Quinlan & Associates analysis

OPERATIONAL

There are a number of requirements laid out by the CSRC around the operational track record and credibility of shareholder(s). These criteria are designed to ensure that only capable foreign companies (i.e. those with no record of operational failure or criminal charges in the past three years) will be considered, protecting the integrity of the market.

The CSRC has also said it would screen foreign shareholder(s) based on whether they are 'leader(s) in market indicators', which may include – but are not limited to – size, revenue, profit, and market share. Without clear cut-offs or specifications, this selection criterion provides the CSRC with some flexibility in rejecting applications from organisations deemed unsuitable.

FINANCIAL

The CSRC has outlined a number of explicit financial criteria for shareholders of securities JVs. Of note, profitability hurdles for both controlling and major shareholders have been set relatively high (i.e. cumulative operating profit in the past three years of RMB 100 billion and RMB 50 billion respectively), suggesting these liberalisation measures are aimed at

attracting only the largest and most well-established global financial institutions.

Supporting requirements, including 'net assets need to be greater than 50% of paid-in capital' and 'over 50% of net profits must be derived from main business line', are designed to ensure the soundness of the shareholders' financial performance. These supporting requirements have likely been put in place to ensure sustainability around the ongoing financial capabilities of new market entrants.

STRATEGIC

As controlling and major shareholders have significant influence over the securities JVs, the CSRC requires them to have proven experience in the financial services industry. The CSRC also demands these shareholders demonstrate that their investment is a well-thought-out decision by ensuring risk mitigation plans are in place, and that the securities JV is part of the shareholders' long-term strategy.

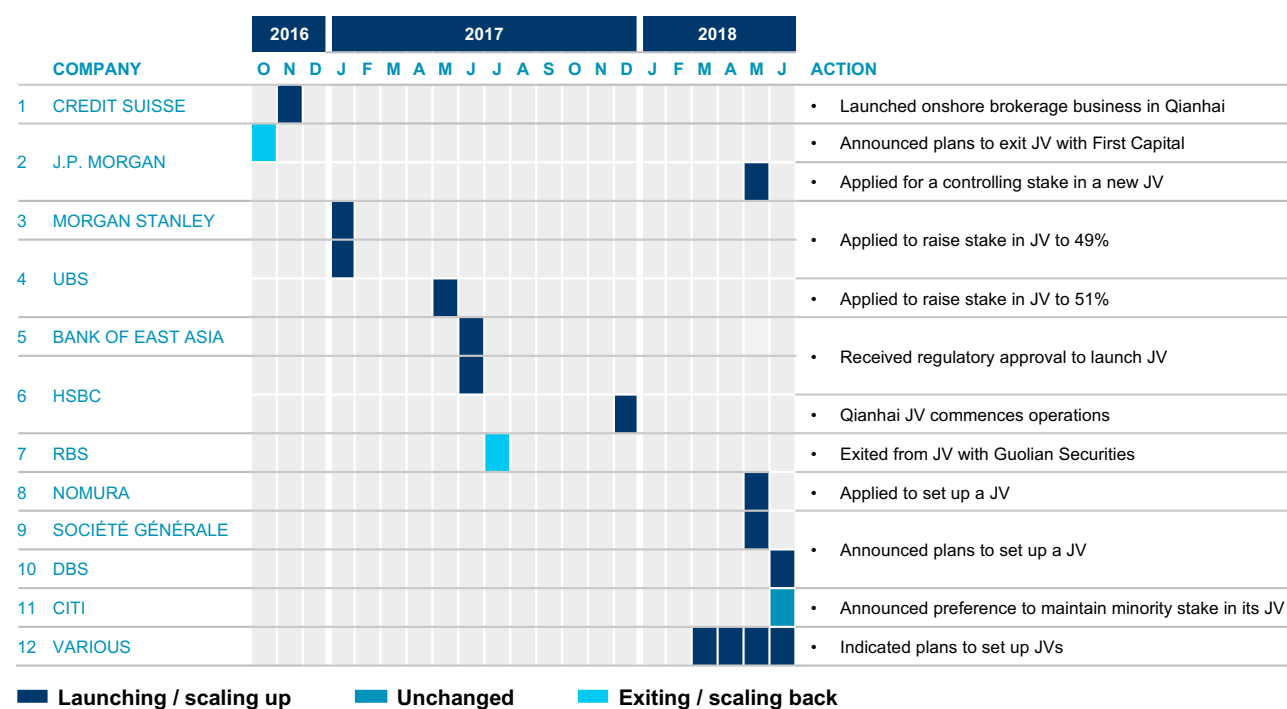
All shareholders need to comply with any other requirements CSRC deems appropriate based on the principle of careful supervision and regulation. While this may introduce some ambiguity into the approval process, it provides the CSRC with further flexibility in its selection of appropriate foreign investors.

SECTION 4 UPDATE ON JV STRATEGIES

Since releasing our previous report, a number of announcements have been made by both current JVs and potential new entrants around their existing businesses and future aspirations. In light of the upcoming regulatory changes, an

increased number of announcements have been made recently by international and regional players regarding their JV strategies (see Figure 4).

FIGURE 4: KEY ACTIONS AND ANNOUNCEMENTS BY FOREIGN BANKS



Source: Various press, company media releases

EXISTING JVs

In late 2016, J.P. Morgan announced its intention to sell its minority stake in its securities JV, J.P. Morgan First Capital, to its domestic partner. RBS also withdrew from its JV with Guolian Securities. A lack of control and ongoing management conflict have largely been cited as the reasons for these exits. However, with many of these problems being

addressed by the new regulatory changes, it is unsurprising to see that J.P. Morgan is planning to re-enter the China securities market, applying for a controlling stake in a new JV in May 2018.

Other international players have largely remained committed to the onshore market over the past few years. Credit Suisse's onshore JV, Credit Suisse Founder Securities, launched its onshore securities brokerage business in

Qianhai in November 2016 on the back of the Stock Connect initiatives and its expectation that Chinese A shares would be included in MSCI's Emerging Markets Index. Morgan Stanley and UBS sought to strengthen their JV footholds by applying to raise their equity stakes in their respective JVs to the previous cap of 49% in January 2017. In response to recent liberalisation measures, UBS further stepped up its efforts by applying for a controlling stake of 51% in its JV in May 2018.

Identifying the liberalisation as an opportunity, FTZ players, including HSBC and Bank of East Asia ("BEA"), have also applied for securities JVs, with HSBC's JV commencing operations in December 2017, making it the first foreign bank to hold a 51% majority stake. Nonetheless, HSBC's first-mover advantage will inevitably diminish as more international players secure their status as controlling shareholders.

Given the ongoing efforts of many foreign banks to bolster their onshore footprints, it was relatively surprising to see Citi announcing in May 2018 that it planned to remain a 33% minority shareholder in its JV with Orient Securities, citing the healthy profitability and the bank's satisfaction with the entity's existing performance as key factors.

POTENTIAL NEW ENTRANTS

A number of players that were previously sitting on the sidelines appear ready to capitalise on the new liberalisation measures, with Société Générale and DBS announcing plans to establish a securities JV in China in May and June 2018 respectively, while Nomura has already filed an application.

Since the announcement of the new regulatory measures, we have also been approached by a number of global and Asian banks to explore their potential China-entry strategies. While some firms are at a more exploratory stage of their planning exercise, others are well into the process of lodging their formal applications to the CSRC.

We expect a number of further application announcements in Q3 and Q4 2018 by global and regional players.

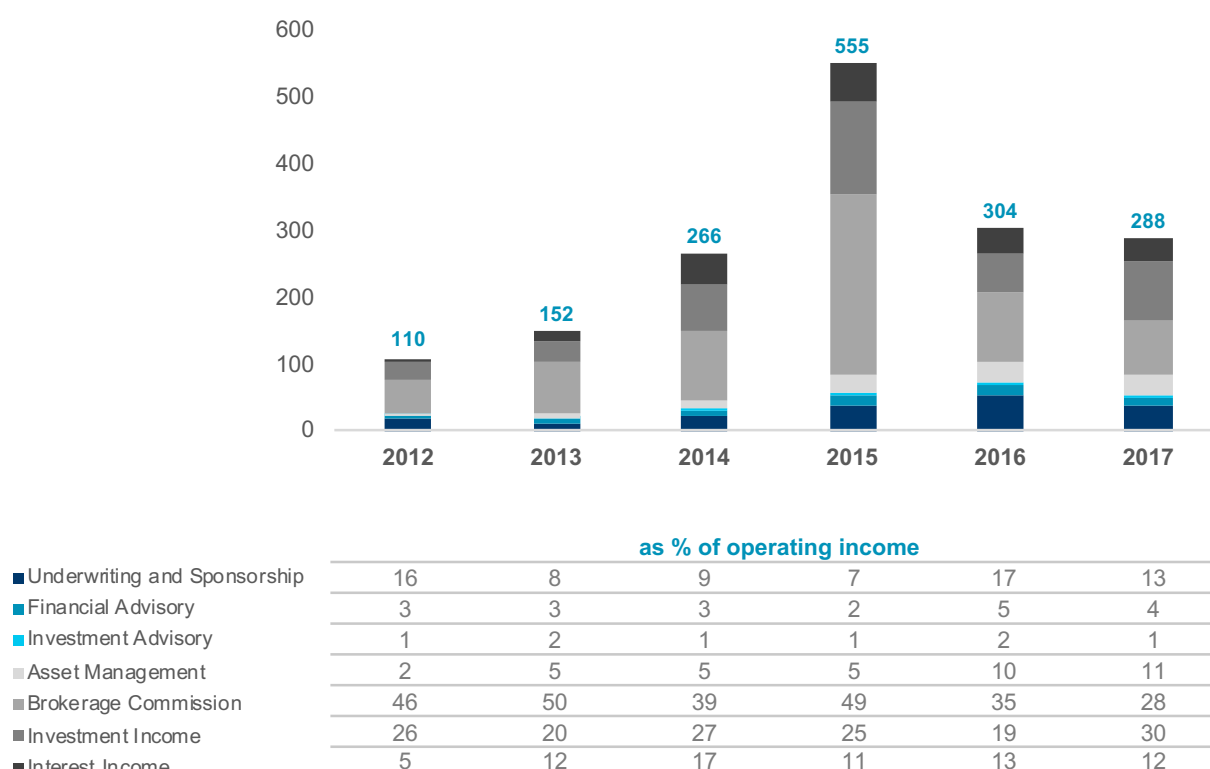
SECTION 5

UPDATE ON JV PERFORMANCE

After a particularly buoyant 2015 in the Chinese equities market, operating income for the domestic securities industry has returned to a significantly lower trajectory (see Figure 5).

Notwithstanding this, 2016/17 still saw among the highest operating incomes to-date in excess of ~RMB 300 billion (~USD 45 billion).

FIGURE 5: CHINA MARKET OPERATING INCOME (2012-17), RMB billion



Source: Securities Association of China, Quinlan & Associates analysis

The reduced contribution of brokerage commission (from 39% of operating income in 2012 to 26% in 2017) continues to point to margin compression in what has now become a highly commoditised space. This was partially offset by a 7% share increase in interest income from activities such as securities lending,

particularly on the back of a burgeoning domestic hedge fund landscape. This move up the financial services value chain is indicative of increasing financial sophistication in the Chinese securities market, including the market's readiness (and appetite) for more complex products.





Investment banking, including underwriting, sponsorship, and financial advisory, has remained relatively steady over the years, comprising ~15% of the total securities fee pool. We do note the increasing contribution of asset management income (from 2% of the total fee pool in 2012 to 10% in 2017) as indicative of the ongoing institutionalisation of savings in China, driving the growth of mutual and pension funds. In addition, ~23% (2012-17) of operating income is being generated from investment income, which includes changes in fair value of financial instruments linked to proprietary investments and derivative positions. This represents a considerable increase from 2011, when investment income only represented 4% of the total fee pool.

UPDATE ON JV PERFORMANCE

It is without question that the Sino-foreign securities JVs are starting from a very low base when compared to domestic players.

In 2017, the top 8 domestic securities companies' average headcount and operating income was 43 times that of the top 8 JVs, while total assets dwarfed the JVs' by a factor of 146 (see Figure 6). Historically, brokerage commission, with its reliance on a large national or regional footprint (and workforce), has driven the lion's share of operating income for the major domestic securities houses.

FIGURE 6: CHINESE SECURITIES MARKET SNAPSHOT (2017)

	 EMPLOYEES	 TOTAL ASSETS (IN RMB)	 OPERATING INCOME (IN RMB)	 NET PROFIT (IN RMB)
TOP 8 JVS (AVERAGE)	270	2.6bn	0.5bn	0.3bn
TOP 8 DOMESTICS (AVERAGE)	11,500	380bn	21.7bn	7.9bn
DOMESTIC-TO-JV MULTIPLE	43x	146x	43x	26x

Source: Company annual reports, Quinlan & Associates analysis

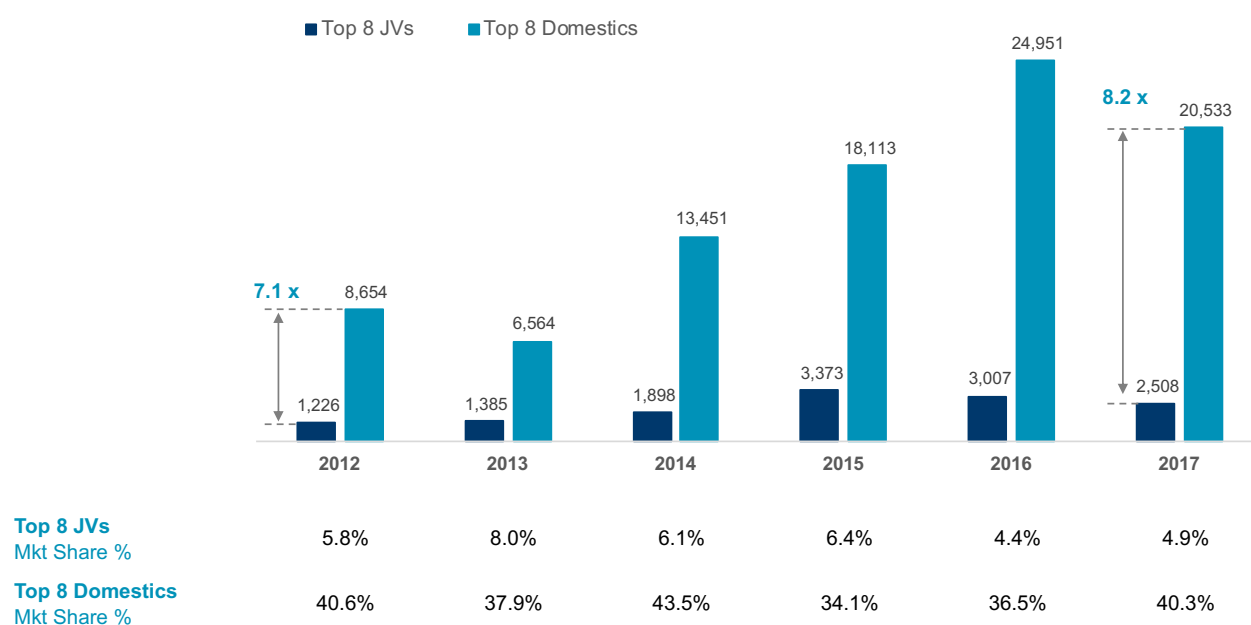
The performance of securities JVs continues to be challenged. In investment banking, the market share of total operating income of the top 8 JVs slipped to 4.9% in 2017 versus a high of 8.0% in 2013 (see Figure 7). By contrast, the

top 8 domestics held a combined market share of ~40% in 2017, in line with 2012-levels, with a domestic-to-JV operating income multiple reaching 8.2x in 2017 (up from 7.1x in 2012).

In addition to top-line performance being dwarfed by domestic incumbents, many of the JVs are still running at painfully high cost-to-income ratios (in excess of 90%), weighing on

profitability. However, we do recognise there has been some improvements to JV profit margins in more recent years.

FIGURE 7: INVESTMENT BANKING OPERATING INCOME (2012-17), RMB million



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

The growing dominance of domestic players points to the rising prominence of Chinese securities houses on the investment banking league tables, particularly in ECM and DCM, underpinned by their relative balance sheet

strength, aggressive pricing versus global players, and the depth (and breadth) of their relationship coverage with local Chinese corporates.

FUTURE IMPLICATIONS

For current securities JVs looking to increase their stakes to 51%, the levelling of the playing field brings both enormous opportunities and challenges.

Upon obtaining majority control, the financial performance of the JVs will become consolidated with group results. In addition to the capital implications associated with full consolidation, there will be considerable pressure on global management teams to ensure the JVs have the right strategy in place; from products, clients, and personnel, to operational aspects such as intra-group transfers and dividend policies. However, with the adoption of majority control, prior reticence to invest in expansion will be greatly alleviated, which opens up the potential to capture economies of scale that the current JVs have lacked for many years.

For new foreign entrants, the ongoing liberalisation of Chinese financial markets (particularly the relaxation of business scope requirements) will provide opportunities to bring more innovative products to the domestic securities market, including derivatives (both plain and complex), structured financing solutions, asset-backed securities, and a range of fund management products. We believe the

growing sophistication of domestic institutional investors and corporates will drive considerable demand for new investment and funding solutions.

We also see considerable opportunities arising from greater financial connectivity between China and the rest of the world, including cross-border investments. Much of this will be supported by a spate of regulatory relaxation measures, including the launch of Bond Connect in 2017, the quadrupling of the daily quota for both Shanghai and Shenzhen Stock Connect earlier in 2018, and the anticipated launch of the London Stock Connect scheme in December 2018. The inclusion of Chinese A shares in the MSCI Emerging Markets Index is also expected to deliver a surge in capital inflows.

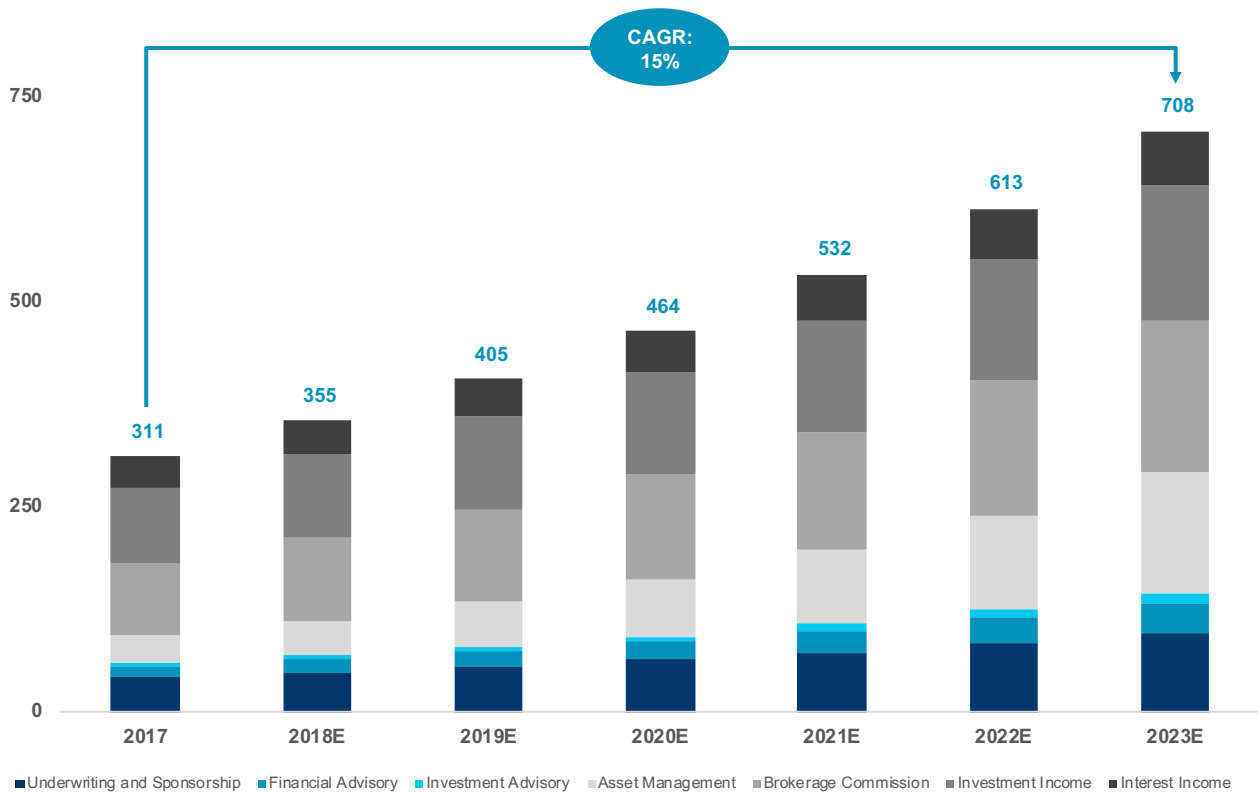
Apart from international players who are already evaluating their onshore China strategies, we believe there are significant opportunities for regional banks looking to secure a foothold in the domestic securities market. This is especially the case for banks that already have a robust Asian footprint, including those servicing their clients' intra-regional trading and financing needs between China and the rest of the region, piggybacking off the support offered by the Chinese government's One Belt One Road ("OBOR") initiative.

SECTION 6 MARKET OUTLOOK

Against the backdrop of these new liberalisation measures and the continued structural growth of the Chinese securities market, we forecast the total securities revenue pool to grow by a

compound annual growth rate (“CAGR”) of 15% from 2017-23, topping RMB 708 billion (~USD 103 billion) by 2023 (see Figure 8).

FIGURE 8: CHINA SECURITIES FEE POOL (2017-23E), RMB billion



Source: Quinlan & Associates forecast

Whilst we expect to see long-term revenue growth across every product / service line, we believe the composition of the domestic securities fee pool is likely to change in coming

years, given the different underlying dynamics between businesses that largely reflect their varying stages of evolution in China’s financial market growth cycle (see Figure 9).

FIGURE 9: INDUSTRY GROWTH DRIVERS (BY BUSINESS LINE)

	% FEE POOL (2017)	% FEE POOL (2023)	KEY DRIVERS
ECM	13	14	<ul style="list-style-type: none"> Strong growth of middle-market corporates (particularly Chinese Tech / FinTech firms) to drive IPO activity, supported by ongoing regulatory reform (e.g. ability for to issues RMB-denominated depository receipts) Follow-on issuance to be supported by Chinese corporates looking to fund their international growth ambitions
DCM			<ul style="list-style-type: none"> Rising NPLs, combined with government efforts to de-risk the banking sector (and wider economy), will drive companies to seek funding alternatives in bond markets, though rising yields may temper demand in the short term Long-term demand for dollar/Euro-denominated bonds buoyed by Chinese firms funding their offshore operations
FINANCIAL ADVISORY	4	5	<ul style="list-style-type: none"> Outbound M&A will continue to be supported by China's "Go Out Policy (走出去戰略)" and the simplification of deal approval processes, though mega deals (i.e. > USD 10 billion) and more speculative acquisitions that do not align to the core business of the acquiring firm will remain muted by ongoing regulatory scrutiny Inbound activity is likely to benefit from greater openness and enhanced regulatory clarity for foreign companies Domestic M&A will remain a key growth avenue for local corporates seeking to scale and diversify their operations
INVESTMENT ADVISORY	1	2	<ul style="list-style-type: none"> Growing sophistication of domestic fund managers (including the rising number of firms, particularly hedge funds) and greater availability of complex financial products to generate strong demand for sophisticated research/analysis Longer-term impact of offshore regulations (e.g. MiFID II) yet to be seen on the research business, but unlikely to quell demand in the short-term
ASSET MANAGEMENT	11	21	<ul style="list-style-type: none"> Rapid domestic wealth creation and China's strong underlying savings culture will continue to support AuM growth Ongoing institutionalisation of savings to drive appetite for more sophisticated investment management services, including demand for customised investment strategies and increased asset diversification
BROKERAGE COMMISSION	28	26	<ul style="list-style-type: none"> Brokerage commissions to be supported by rising international investment flows from Stock and Bond Connect Schemes, the recent inclusion of A shares in the MSCI EM Index, and ongoing RMB liberalisation Strong growth in trading of more complex, higher-margin products, including derivatives (e.g. options and futures) Longer-term margin compression from commoditisation of brokerage activity, including shift to electronic trading
INVESTMENT INCOME	30	23	<ul style="list-style-type: none"> Longer-term appreciation in asset values underpinned by China's economic growth fundamentals and rising investor demand Relative immaturity of financial markets vs. the West will provide unique opportunities to for securities firms to exploit market inefficiencies Long-term effects of international regulatory pushback on proprietary trading (i.e. Volcker Rule) may temper trading activity of some firms on their own account
INTEREST INCOME	12	9	<ul style="list-style-type: none"> Strong demand for more innovative financing solutions (e.g. securities lending for hedge funds and structured lending solutions for HNWI's) to spur growth in higher-margin lending products Rising interest rates on the back of government de-risking efforts to support NIMs, though this may impact overall demand for lending products (government de-risking efforts may also suppress growth in loan volumes)

 Underwriting & Sponsorship

Source: Quinlan & Associates analysis

SECTION 7

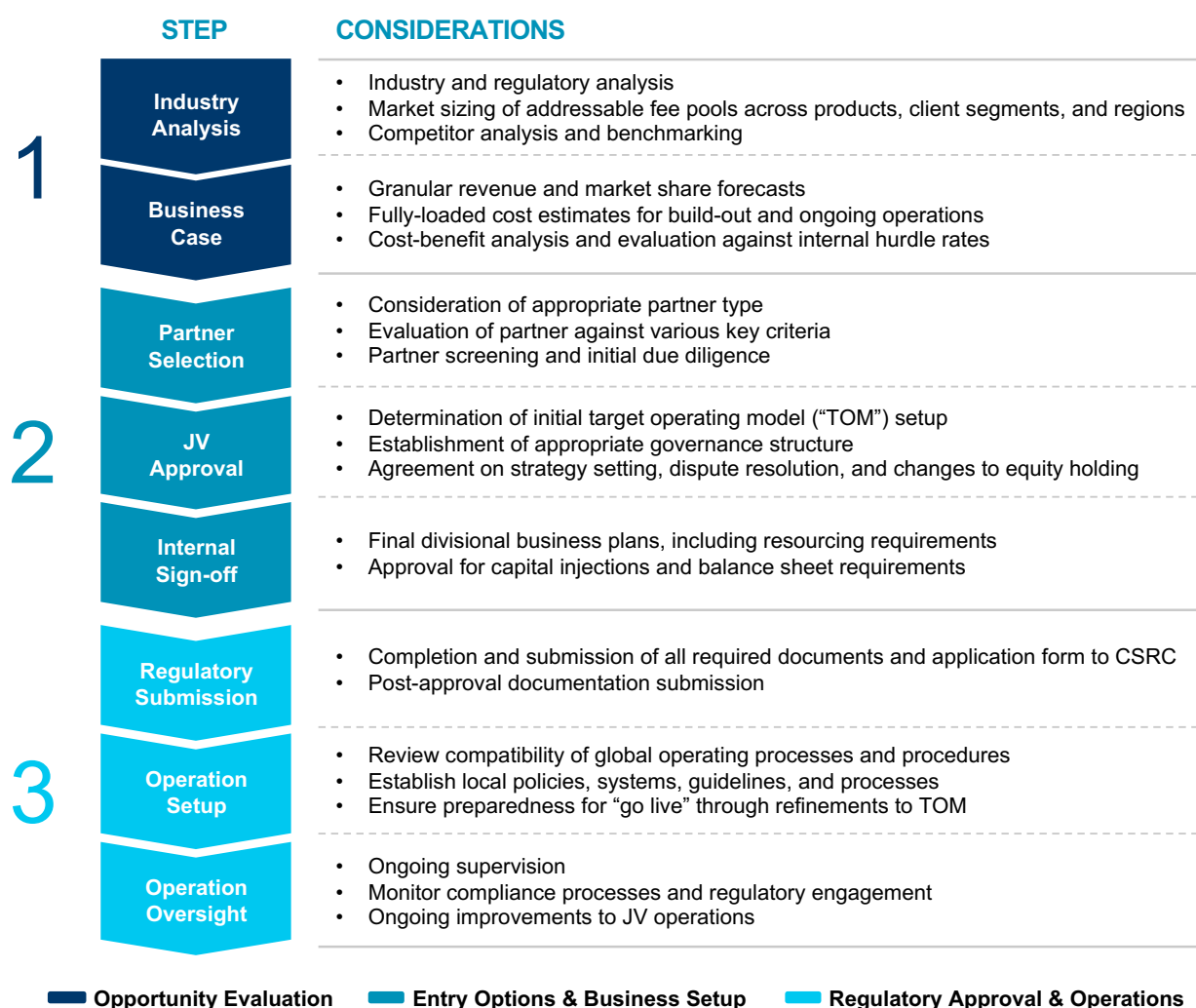
JV CONSIDERATIONS

NEW ENTRANTS

For aspirant JVs, we have identified a number of key steps that need to be considered in relation to their market entry strategies – from developing a deeper understanding of industry

and the competitive landscape, to establishing an effective governance and operating model that can effectively support the longer-term operations of the JVs over the long term (see Figure 10).

FIGURE 10: JV SET-UP PROCESS



Source: Quinlan & Associates analysis

1. OPPORTUNITY EVALUATION

While it is one thing to understand how large China's securities fee pool is, it is another to appreciate how much of the fee pool is really accessible.

As part of this process, new entrants will need a strong understanding of detailed wallet and profitability dynamics across their target products, regions, and client segments. The ability to capture these fee pools needs to be referenced against each firm's business model and core capabilities, as well as any physical limitations, such as the number of licences and trading outlets that they can operate out of. Attention should also be given to evolving regulatory and competitive dynamics onshore, as well as the firm's broader strategic priorities (both in China and internationally). Only then can a robust business case around market entry be developed, including the evaluation of fully-loaded costs and benefits against a firm's internal hurdle rates.

As part of this process, it will also be important for potential entrants to appreciate ongoing developments in the wider politico-economic landscape, including how current trade tensions between the US and China may play out. Furthermore, the long-term ramifications of offshore regulatory developments on China's capital markets, such as Europe's MiFID II and the upcoming Basel IV accord, will also need to be considered.

2. ENTRY OPTIONS & BUSINESS SETUP

Once foreign aspirants have established their business case for an onshore JV, careful consideration will need to be given to potential entry pathways (namely, selecting the right local partner) and how the JV will be set up.

First and foremost, foreign players will need to evaluate potential local partners against a

number of key selection criteria, including their expertise, existing relationships / network, and reputation in the market. In particular, we believe cultural fit and long-term strategic alignment will be crucial elements of this screening process.

Culture has always been cited as one of the key reasons why partnerships fail. This is especially important for Chinese-Western partnerships, where cultural gaps can be extremely pronounced (as we have witnessed with several failed securities JVs in the past). Long-term strategic alignment will also be crucial in minimising conflicts between foreign and local partners. While the CSRC has removed the requirement for the domestic partner to be a securities firm, there may still be situations where the domestic partner itself is competing against the JV for the same clients or deals (or potential cases where the local partner may expand offshore in the future and compete directly against the foreign partner). With this in mind, the JV should act as a complementary business for both domestic and foreign investors. Transparency (including upfront and open communication) around the strategic priorities of the local and foreign partners will ensure any potential conflicts are minimised.

Subsequent to the selection of a suitable local partner, the foreign partner must decide on its target operating model ("TOM") and overall terms of reference with the domestic firm. This will include a high-level outline of governance structures that need to be put in place (especially in relation to how decision-making and conflict-resolution are addressed), appropriate incentive mechanisms, and a clear strategy on how the local venture will integrate with a bank's international operations (including the ability to leverage its systems, policies, and processes). The allocation of investment commitments and a clear delineation of responsibilities (e.g. who is responsible for providing what resources) will be an important

part of this exercise, as will a plan or agreement for the distribution of assets and intellectual property in the case the JV is liquidated or wound down.

3. REGULATORY APPROVAL & OPERATIONS

There is an extensive list of documentation that needs to be submitted to the CSRC for approval of the JV, such as supporting legal opinions, audited financial statements, and a detailed business plan.

Once all submissions have been approved by the CSRC, foreign players must address a number of operational considerations around their setup and ongoing operations. This includes assessing the compatibility of global operating procedures with local regulatory requirements, including in-house trading systems, human resources procedures and staffing (such as talent sourcing and employee secondments), compliance processes, and branding, to name a few.

Compliance issues, in particular, will require sizable attention from new entrants. For example, China's 2016 Cybersecurity Law requires "personal information and important data collected and generated by critical

information infrastructure operators" in the country to be stored domestically, with companies required to build data centres onshore. Moreover, there are strict firewalls that prohibit the sharing of client information between related onshore entities (e.g. between a locally incorporated banking subsidiary and securities JV). Such requirements necessitate the establishment of robust processes to ensure ongoing compliance with local regulations.

Various other implementation issues around finance, treasury, and reporting will also need to be assessed by foreign entrants, such as the development of appropriate local reporting tools, cost allocation models for global systems, alignment of revenue booking models, and the development of cross-entity / cross-border incentive structures. New entrants will also need to evaluate the efficacy of global system localisation, including identifying local vendor solutions where global system migration may not be feasible.

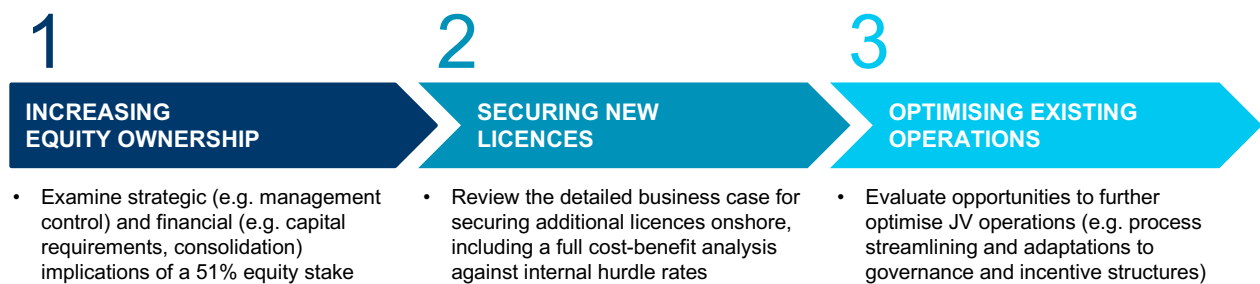
Broader managerial and operational issues will also need to be reviewed, including but not limited to premises, branding and marketing, the development of an appropriate local communication strategy, and protocols for ongoing regulatory engagement.

INCUMBENT JVs

Recent liberalisation measures have not only created a unique opportunity for aspirant

entrants; they provide incumbent JVs with the opportunity to critically re-evaluate their existing strategies and operations across three key dimensions (see Figure 11).

FIGURE 11: CONSIDERATIONS FOR INCUMBENTS



Source: Quinlan & Associates analysis

1. INCREASING EQUITY OWNERSHIP

It is without question that securing a 51% majority ownership has the potential to deliver major strategic and operational benefits to foreign partners of incumbent JVs, including the ability to exercise management control. However, as outlined in our previous report, any investment will need to be carefully considered in light of current capital adequacy rules (including capital costs and the implications of full consolidation), which 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 specific influence over the JV, including its existing governance framework and decision-making processes. Furthermore, foreign partners looking to secure management control also need to determine the most effective avenue to secure 51% ownership, be it via an additional capital injection or the partial acquisition of the domestic partner's existing equity stake.

2. SECURING NEW LICENCES

The relaxation of rules around business scope provides the opportunity for incumbent JVs to fast-track the expansion of their licences without needing to meet previously-set profitability hurdles in underwriting, sponsorship, and financial advisory (i.e. investment banking). Efforts to secure new licenses in recent years can already be seen in UBS Securities' acquisition of a futures licence in 2014, as well as the approval of Credit Suisse Founder Securities' A-share brokerage licence in the Qianhai FTZ in 2015.

With the launch of Shanghai-Hong Kong Stock Connect in late 2015, it became clear that most foreign players chose to monetise the A-share brokerage opportunity by ramping up their research and execution capabilities out of their Hong Kong office, with most bulge bracket firms now covering in excess of 200 stocks. However, the inability to service domestic Chinese clients under Stock Connect remains a key drawback of this model, especially in light of the rapid growth in China's asset management industry and the ongoing teething pains facing international managers in light of continued asset outflows from active funds and mounting cost headwinds from heightened regulatory obligations such as MiFID II.

With China's derivatives and asset-backed securities market on the cusp of explosive growth, as well as burgeoning demand for innovative financing solutions and market insights from Chinese corporates and fund managers, now is the time for foreign incumbents to revisit the business case for securing additional licences.

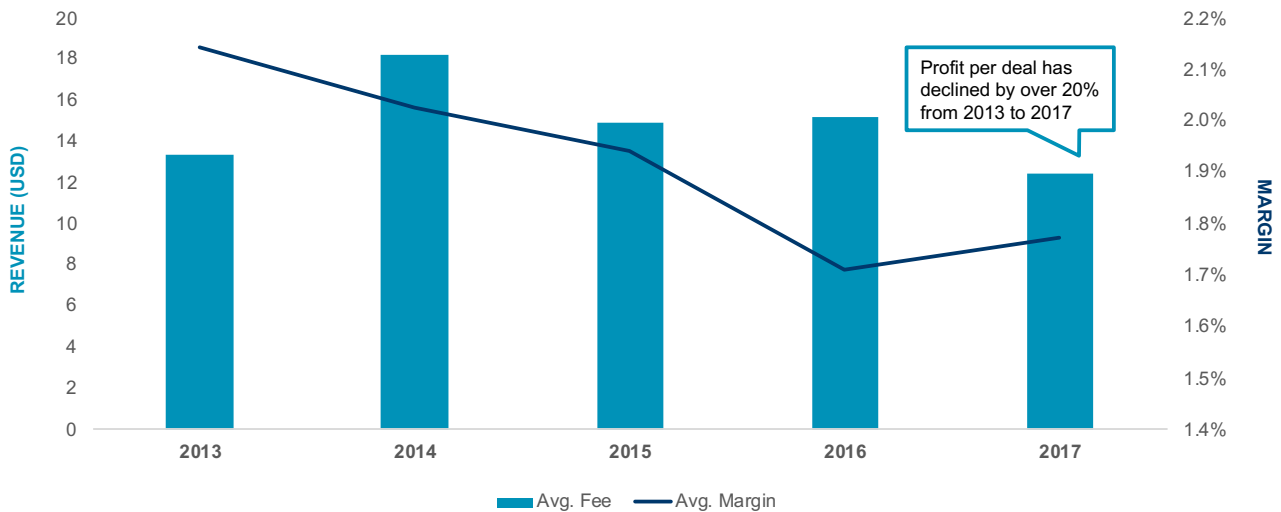
3. OPTIMISING EXISTING OPERATIONS

Given the poor profitability track record of existing JVs, we see significant scope to further optimise operations. Considerations of product offering and client targeting efforts, 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, especially now that management control is on the table.

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 must be put in place. This provides a product-neutral service offering to clients while recognising the effort of the onshore team to support offshore business (and vice versa).

It is important to recognise that intense competition from Chinese securities houses in more recent years has weighed on industry margins in the underwriting and sponsorship space (i.e. the traditional domain of the JVs). While having an onshore footprint provides foreign players with the ability to tap into local corporates for offshore listings (especially H-share listings in Hong Kong), fee compression is becoming all-too clear. In fact, data from Dealogic shows a notable decline in IPO margins on the Hong Kong Stock Exchange from 2013-17, with the average profit per deal falling by 20% over the period (see Figure 12).

FIGURE 12: IPO MARGINS, HKEX DEALS OVER USD 200 million (2013-17)



Source: Dealogic, Quinlan & Associates analysis

Moreover, growing competition between banks for the largest revenue tickets can be readily seen in the IPO space, especially in markets such as Hong Kong and China. For example, the 2016 IPO of Postal Savings Bank of China (“PSBC”) involved a record breaking 26 bookrunners underwriting a single deal. This ongoing trend of “bookrunner saturation” in Asia is having a considerable impact on the underlying economics of many big-ticket deals, which has major implications for the client targeting efforts of the JVs, given their more limited headcount (and hence coverage capabilities).

On the back of rapid developments in the regional FinTech space, we also see ample opportunity for JVs to explore process optimisation opportunities (including automation) through investing further in digital transformation efforts. We believe significant benefits are currently being left on the table by a number of firms, from the ability to streamline client onboarding times, to refining client targeting efforts and removing substantial overheads associated with manual processes.³

³ Quinlan & Associates, ‘Chasing The Tail’, June 2018, available at: <https://www.quinlanandassociates.com/insights-chasing-the-tail/>

CONCLUSION

The latest round of regulatory measures has finally put management control on the table for foreign investors operating securities JVs on the mainland. Moreover, the relaxation of business scope requirements, as well as the ability to partner with a domestic firm that is not a securities business, provide a critical entry avenue for more niche international aspirants. Together with a host of broader market and regulatory reforms designed to open up China's financial markets to foreign competition, many of the issues facing securities JVs – such as scalability, licence limitations, and management conflicts with domestic partners – can now largely be addressed.

Unlike previous reforms, we believe these measures are true game changers for global banks seeking to enter the Chinese securities market (or refine their existing operations). With the securities fee pool forecast to reach RMB

708 billion (~USD 103 billion) by 2023, we are already seeing considerable momentum from banks looking to capitalise on this opportunity, with a number of major announcements being made to setup onshore operations in recent months.

However, in many respects, the new regulatory measures act as a simple levelling of the playing field between foreign and domestic players. Although there is a sizeable fee pool up for grabs, the ability to monetise an onshore JV is not so simple, as evidenced by the performance of many of the first-movers in recent years. A carefully-designed strategy and operational roadmap are needed to fully capitalise on the changes; this applies as much to incumbent JVs as it does to aspirant firms.

However, for those who can successfully develop and execute an effective end-to-end JV proposition, we believe it is time to traverse the Great Wall.

SECTION 8

HOW CAN WE HELP?

Our Consultants and Subject Matter Experts have worked in depth in external and in-house capacities with a number of international and regional banks on their JV strategies. Our work typically includes the following:

ASPIRANT JVs

Per the steps outlined in Figure 10, the provision of end-to-end advisory and execution services around a detailed market entry exercise, from industry analysis and strategy formulation through to regulatory submissions, operating model setup, and ongoing implementation support, such as:

OPPORTUNITY EVALUATION

- Detailed industry and regulatory analysis, market sizing (by product, geography, and client segment), fee pool accessibility analysis, and competitor benchmarking
- Developing a detailed business case and forecasts around onshore entry

ENTRY OPTIONS & BUSINESS SETUP

- Strategic due diligence around domestic partner screening and selection
- Designing an appropriate target operating model, including governance structures, organisational mapping, and establishing JV terms of reference
- Reviewing capital valuation models and investment plans for management sign-off

REGULATORY APPROVAL & OPERATIONS (IMPLEMENTATION SUPPORT)

- Preparing the required application documents (including post-approval documentation) to the CSRC, including supporting business plans
- Refining the TOM in line with global suitability, together with the establishment of local processes, policies, and systems, where relevant
- Ongoing execution support around the design and implementation of compliance processes, regulatory engagement, and refinements to overall operations

EXISTING JVs

Conduct a comprehensive strategic review of the JV's operations to identify areas for future growth and further optimisation efforts, such as:

- Examining the implications of a 51% equity stake, including detailing the impacts of consolidation and conducting in-depth capital valuation (e.g. advising on the local rules around regulatory capital, Net Stable Funding Ratio ("NSFR"), Liquidity Coverage Ratio ("LCR"), leverage ratios, and other regulatory requirements)
- Assessing the business case for securing new licenses (e.g. onshore brokerage, futures, asset-backed securities, asset management), including a review of all strategic, financial, and operational considerations, together with detailed supporting calculations
- Conducting a review of the JV's operating models and processes to identify areas for further optimisation (e.g. compensation, incentive structures, and process automation, etc.)

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STRATEGY WITH A DIFFERENCE

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CONTACT US

@ info@quinlanandassociates.com

| www.quinlanandassociates.com

| [+852 2618 5000](tel:+85226185000)

✉ Level 19, Two International Finance Centre, 8 Finance Street, Central, Hong Kong SAR