NOMURA

Shanghai – Hong Kong Connect series

EQUITY STRATEGY

Vol 1: Opportunity knocking on the door

The top down perspective

Global Markets Research

7 August 2014

Anchor themes

We see the Shanghai-Hong Kong Stock Connect programme, to be launched in October, as the first step towards an orderly opening of China's capital market. We believe that it will offer unique opportunities to both onshore and offshore investors.

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The first step in opening up China's capital market

The much anticipated SH-HK Stock Connect programme may officially kick off in Oct-14, based on various news reports (*China Securities Journal, 21st CBH* and *Xinhua Net*). This, we believe, is likely only the first step in an orderly opening up of China's capital market. While the current scheme is for RMB300bn in aggregate value for offshore investors to trade in 568 A-shares and RMB250bn in aggregate value for onshore investors to trade in 266 Hong Kong stocks, we believe both the dollar amount and eligible stock lists will expand, the Shenzhen Stock Exchange may join the program and that commodities and even initial equity offerings could be added to the programme. To put things in prospective, China equities share ~20% of the free float market cap of the MSCI-GEM currently. In three to five years, as constraints for offshore money to trade in A-shares ease, China could make up 30% or more of MSCI-GEM, we estimate. This roadmap means to us that Shanghai, and to a lesser degree Shenzhen, will decidedly rise in importance among the regional financial community and that financial institutions may plan to allocate their resources accordingly.

More positive on A than H in the immediate term but win-win for both structurally

Anecdotally, QFII quota has become very tight over the past several weeks, as clients rushed to buy select A-shares before the Connect programme kicks off. Based on our meetings with clients, offshore value-focused money appears to be most keen on going long on A-share large-cap value names. We note that since 2008, A-shares have consistently de-rated in Chinese household asset allocation, falling behind physical property (investing along with local governments, i.e. bullish, monopolistic, and major stakeholders) and shadow banking products (i.e. China's risk-free junk debt placements). Now that these two preferred asset classes are losing some of their sizzle, the Connect programme could be the catalyst to bring about a revival in A-shares. For onshore investors, the interest seems to be in private equity that may develop an information edge by turning more stones among small mid-cap names listed in Hong Kong. An ultimate win-win, in our view, is for the Shanghai Stock Exchange to restore valuation on its large-cap value names, and for the Hong Kong Stock Exchange to see more robust trading volume. We detail in Fig. 4 large cap A-shares trading in the value territory with the selection criteria being dividend yield higher than 3% and P/E ratio less than 10x. We note that Chinese brokers listed in Hong Kong and the Hong Kong Exchange are names that stand to benefit from the Connect programme.

Fully closing the A/H valuation gap still some distance away

As the cost of short selling (融券, cf. p.11) A-shares is prohibitively high at high-single digits for most investors, we think arbitragers may prefer going long on undervalued H-shares over short selling overvalued A-shares. In comparison, shorting H-shares is far cheaper to execute, and this leaves room for a hedged strategy of going long on A and shorting H at counters with A trading at a discount to H. We note that given the trading dollar value cap, practitioners of a market-neutral strategy may find it difficult to put on large positions through the Connect programme.

Vol 1. Opportunity knocking on the door

We see the Shanghai-Hong Kong Stock Connect programme, to be launched in October, as the first step towards an orderly opening of China's capital market. We believe that it will offer unique opportunities to both onshore and offshore investors.

First step towards capital account convertibility in China

The Shanghai-Hong Kong Stock Connect programme marks the start of China opening up its capital market in a controlled manner, in our view. As Mr. Charles Li, CEO of HKEx, said during his presentation on 29 April 2014, the Stock Connect programme paves the way for mutual market access for other asset classes. A roadmap on what may be forthcoming after the HK-Shanghai Connect programme is given below:

- Mr. Zhang Xiaojun, spokesperson of CSRC, said on 11 April 2014 that the possible cooperation between Shenzhen Stock Exchange (SZSE) and SEHK in the future would be built upon the experience from the Stock Connect programme and supported by CSRC. Mr. Zhang suggested that SZSE and SEHK could work together on possible cooperation mechanisms including, but not limited to, Stock Connect.
- Mr. Xiao Gang, Chairman of CSRC, disclosed in an interview with the Shanghai Securities Journal on 10 April 2014 that CSRC and SFC have been looking into opportunities in "fund connect" between the Mainland and Hong Kong.
- "Futures and options connect" is also a hot topic among investors. Mr. Charles Li, CEO of HKEx, expressed his wishes on having more cooperation between the Mainland and Hong Kong on the commodity side. Mr. Yang Maijun, President of Shanghai Futures Exchange (SHFE), pointed out that SHFE has been actively developing option products while the China Financial Futures Exchange has made much progress in index futures.
- Following a series of market liberalisation efforts such as the expansion of QFII and RQFII programmes, MSCI initiated the review of China A-shares for potential inclusion into the MSCI EM Index in June 2013. Although MSCI decided not to include A-shares into its EM Index in mid-June this year, Mr. Xie Zhengbin, Research Director of MSCI Asia Pacific, suggested that the Stock Connect programme should have a positive influence on MSCI's evaluation of A-shares and may help speed up MSCI's inclusion of A-shares into the MSCI Emerging Markets Index in 2015.
- If the current inclusion plan stays unchanged, the pro forma MSCI China Index would be constructed based on one integrated China equity universe comprising A-shares, B-shares, H-shares, Red-chips and P-chips and a 5% Foreign Inclusion Factor (FIF) would be applied to the FIF-adjusted market cap of China A-shares in the pro forma MSCI China Index, in our view. According to a Reuters report (11 June 2014), there are ~USD3.4tn of capital benchmarked against the MSCI EM Index, Asia-pacific Index and Global Index, and the inclusion of A-shares into MSCI China Index would lead to USD12bn additional fund inflows into the A-share market. Taking the 30% foreign ownership limit into account, 221 A-share stocks would be included in the MSCI EM Index as disclosed by MSCI. The weight of China in MSCI EM Index will rise from the current ~20% to ~30%, assuming full inclusion (FIF = 100%).

Basic mechanism for "Shanghai-Hong Kong Stock Connect"

What are key milestones?

- 10 Apr: announcement of the Stock Connect program
- 2 Jul -15 Aug: End to End (E2E) tests
- Late Jul to early Aug: market rehearsal briefings
- By 15 Aug: exchange participants (EPs) to return E2E test results
- 23, 24 Aug: connectivity test (to be confirmed by HKEx)
- 30, 31 Aug: market rehearsal 1
- 13, 14 Sep: market rehearsal 2 (to be confirmed by HKEx)
- 20, 21 Sep: market rehearsal 3 (to be confirmed by HKEx)

- Oct: formal launch (to be confirmed by HKEx)

Eligible investors in the Stock Connect programme

Who are the eligible offshore investors?

- All Hong Kong and overseas investors.

Who are the eligible onshore investors?

- Only Mainland institutional investors and those individual investors who hold an aggregate balance of at least RMB500,000 in their securities and cash accounts.

Eligible securities on the Shanghai and Hong Kong Stock Exchanges

What stocks can offshore entities buy in Shanghai (northbound trading)?

- Offshore investors trading in Shanghai Stock Exchange (SSE) securities – 568 stocks as of 10 April 2014.
  - SSE180 Index constituents: 180 blue-chip stocks with good liquidity to best represent the overall performance of the Shanghai A-share market. All SSE180 Index constituents are large/mid cap stocks.
  - SSE380 Index constituents: 380 emerging blue-chip stocks issued by companies characterized by: (1) moderate size, (2) rapid growth, and (3) high profit. Most of SSE380 Index constituents are mid cap stocks.
  - All the SSE-listed A-shares traded in RMB excluded by SSE180 Index and SSE380 Index but with corresponding H-shares listed on the Hong Kong Stock Exchange (SEHK), except for those under risk alert board.

What stocks can domestic entities buy in Hong Kong (southbound trading)?

- Onshore investors trading in SEHK securities – 266 stocks as on 10 April 2014.
  - HS LargeCap Index constituents: representing the top 80% of the total market capitalisation of the HS Composite Index. (HS Composite Index acts as a Hong Kong market benchmark that covers about 95% of the total market capitalisation of stocks listed on the Main Board of SEHK.)
  - HS MidCap Index constituents: representing the next 15% of the total market capitalisation of the HS Composite Index.
  - All H-shares traded in HKD that are not included as constituent stocks of HS LargeCap Index and HS MidCap Index but with corresponding A-shares listed on SSE. H-shares with corresponding SSE A-shares under risk alert board are excluded.

Trading quotas: How much can investors buy in each direction?

How much Shanghai A-shares can offshore investors buy?

- The aggregate quota balance is RMB300bn, representing ~7% of the total free float market cap of the 568 eligible A-share stocks on the Shanghai Stock Exchange.
- Daily quota balance is RMB13bn, representing 21% of the 568 stocks' daily average value traded over the past six months.

How much Hong Kong stocks can domestic investors buy?

- The aggregate quota balance is RMB250bn, representing ~28% of the total free float market cap of the 226 eligible Hong Kong stocks.
- The daily quota balance is RMB10.5bn, representing 33% of the 226 stocks' daily average value traded over the past six months.

How does the quota system work?

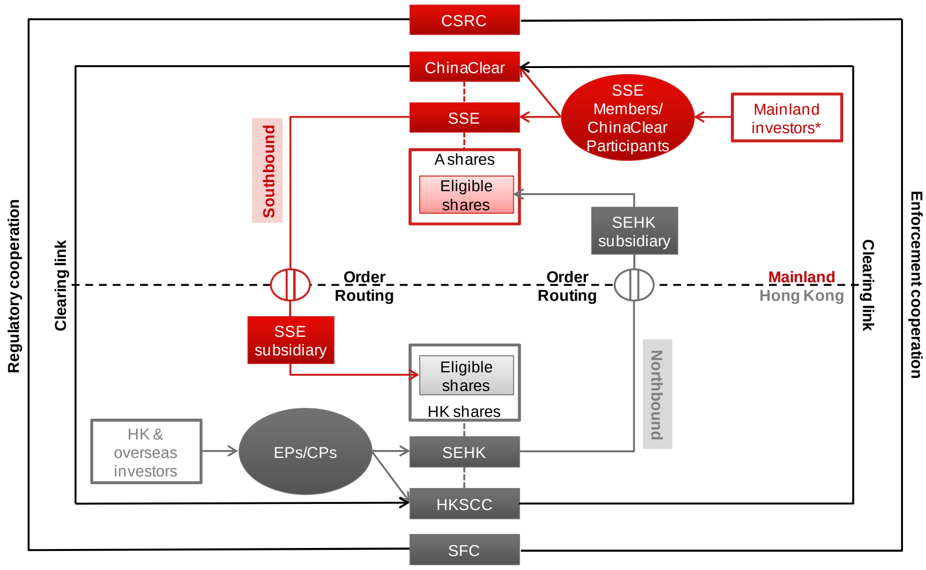
- Both aggregate quota and daily quota are on a "net buy" basis. Stock selling is not constrained by the quota system.
- Daily quota balance = daily quota – buy orders + sell trades + adjustments (cancellation/ rejection/ price adjustment/ etc).
  - Monitored on a real-time basis: once the daily quota balance drops to zero or is exceeded during the normal trading hours, no further buy orders will be accepted but sell orders will still be allowed.
- Aggregate quota balance = aggregate quota – aggregate buy trades + aggregate sell trades.

– Monitored on a daily basis after market close: if the aggregate quota balance is less than the daily quota, buying will be suspended in the next trading day until the aggregate quota balance returns to the daily quota level or above.

A carefully designed close system for stock and fund flows

- Clearing and settlement are on a net basis to minimise cross-boundary fund flows.
- The cross-boundary stock and fund flows in both directions will be in closed loops. Once offshore investors sell their A-shares or onshore investors sell their H-shares, the money flows back to their home market bank accounts.

Fig. 1: Stock and fund flows within the Stock Connect system



Source: HKEx

*Institutional investors and individual investors who hold an aggregate balance of not less than RMB500,000 in their securities and cash accounts

Trading currencies: Onshore pays RMB and offshore buys RMB on their own

- Onshore investors will buy Hong Kong stocks with RMB which will then be exchanged to HKD in Hong Kong by ChinaClear.
- Offshore investors will buy A-shares with RMB as well, and exchanging of foreign currencies to RMB will happen in the offshore RMB market.

Custodian systems

How does the custodian system work in northbound trading?

- The Hong Kong Securities Clearing Company (HKSCC) will act as the custodian for offshore investors holding A-share stocks.
- Offshore investors will not be allowed to hold SSE securities in their Central Clearing and Settlement System (CCASS) accounts, according to the current arrangements.
- They can only hold SSE Securities through clearing participants (CPs) or custodian participants of HKSCC.
  – If offshore investors hold SSE securities via custodian participants, they need to request their custodians to transfer SSE stocks to be sold on Day T to the selling EPs on Day T-1.

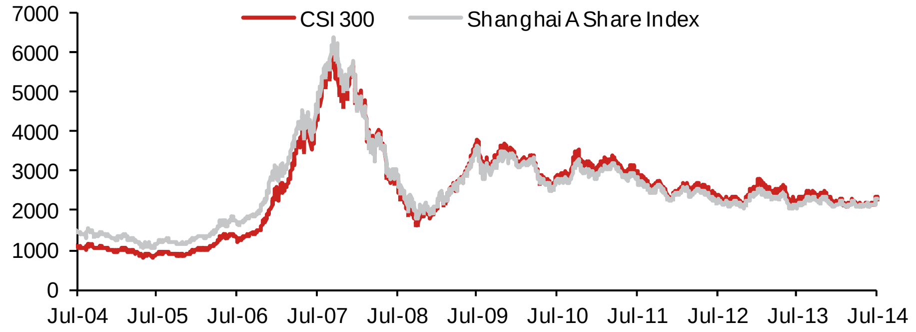
How does the custodian system work in southbound trading?

- ChinaClear will act as the custodian for onshore investors holding Hong Kong stocks.
- An onshore investor must designate a broker in advance as its agent and participate in trading through that broker to participate in southbound trading as required by the designated trading system (全面指定交易制度).

The Stock Connect Programme may trigger a re-rating of A-shares

Why has China's A-share market performed poorly in the past five years?
We attribute the weak A-share performance over the past five years to a host of reasons.

Fig. 2: Performance of CSI300 and Shanghai A-Share Index in the past 10 years

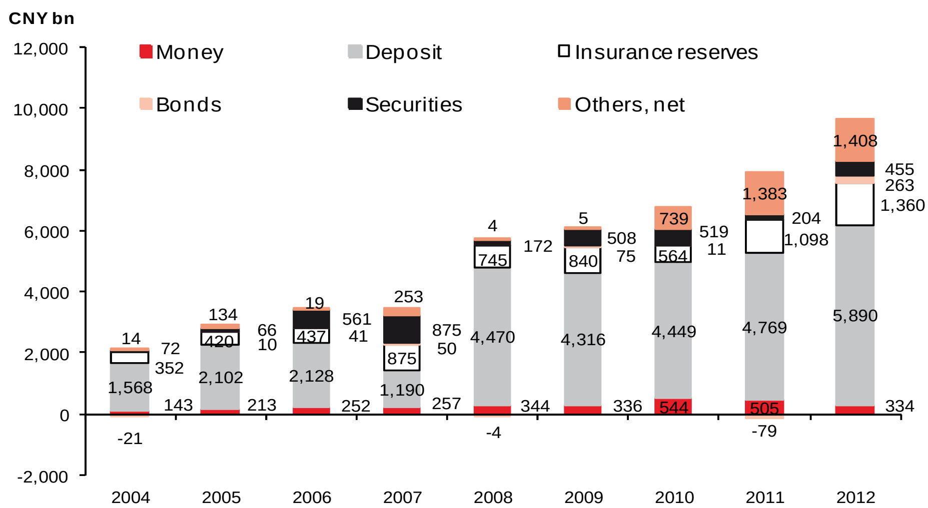


Source: Bloomberg data, Nomura research

First, there has been insufficient investor protection or rule of law being exercised on A-shares, such that it has been more known as a place for enterprises to raise money, and brokers to help them raise money, rather than for minority investors to earn a return. So retail investors in China have voted with their feet by putting money into physical property, which offers them distinct titles, and which aren't as easily wiped out as stock certificates, and they have also invested money in various shadow banking products (i.e. China's risk-free junk bonds) on the basis of the implicit principal guarantee offered by financial institutions. Indeed, there has not been much fund inflows into the A-share market given its de-rated status as a household asset class, in our view.

Fig. 3 shows that net annual additions to securities held by households have fluctuated within the RMB204bn-519bn range from 2009 to 2012. The total net additions to securities held by households from 2009 to 2012 accounted for merely 5.5% of the total net increases in household financial assets in the four-year period. It appears that households maintained their preference for deposits, the risk-free assets, while allocating more funds to the "others" category, of which we reckon various shadow banking products likely accounted for the majority.

Fig. 3: Net annual increases in household financial assets by category



Source: People's Bank of China (PBoC), Nomura research

Second, the central government was very concerned about having two asset bubbles in the physical property market and the stock market simultaneously in 2009-2010, and thus raised the supply of equity papers in the A-shares to pre-empt a potential new stock market bubble.

Third, while China is the second-largest economy in the world in terms of GDP, according to government reports, its competitiveness in the global supply chain is still limited. All that GDP growth may end up in the profit margins of the highly competitive and capable MNCs that are listed overseas, rather than local enterprises listed in Shanghai or Shenzhen. Ultimately, equity investors buy corporate earnings and if corporates are not competitive and earnings are not great, valuation multiples and returns will be second class, in our view.

Will offshore value-driven long-only purchases trigger a change?

Based on the current design of the Stock Connect programme, we think that the daily quota limit and lack of short-selling mechanisms may constrain hedge funds' ability to execute their strategies. We think that long-term value investors are likely to be the first movers into the A-share market via the Stock Connect programme.

We think that large-cap stocks with mid- to high-single-digit dividend yields and single-digit P/E may be of particular interest to these long-term value investors for their cheap valuations compared to the ones listed offshore. Most stocks falling into this category are financial institutions with others from the auto, consumer, energy, industrials and utilities sectors.

Fig. 4: Large-cap value stocks with mid/high single digit dividend yield and single digit PER

(As of end 31 July 2014)

Company name	公司名称	Stock Ticker	GICS sub industry	Total mkt cap (RMB bn)	Cross-listed	Free float mkt cap (RMB bn)	Avg daily trading value (3m) (RMB mn)	Past 12m dividend yield (%)	Fwd P/E FY14F (X)	P/B (X)
Fuyao Glass	福耀玻璃	600660 CH	Auto Parts & Equipment	19.5	-	12.2	94.6	5.1	9.0	2.5
Huayu Automotive Sys	華域汽車	600741 CH	Auto Parts & Equipment	29.4	-	11.3	142.3	3.3	6.8	1.5
SAIC Motor Corp	上汽集團	600104 CH	Automobile Manufacturers	179.6	-	31.1	302.8	7.4	6.6	1.2
Hisense Electric	海信電器	600060 CH	Consumer Electronics	13.3	-	7.1	127.0	3.6	7.9	1.3
Youngor Group	雅戈爾	600177 CH	Apparel, Accessories & Luxury	16.8	-	10.0	78.0	6.6	7.3	1.1
China Shenhua Energy	中國神華	601088 CH	Coal & Consumable Fuels	315.7	*	30.3	177.5	5.9	7.4	1.1
Sinopec	中國石化	600028 CH	Integrated Oil & Gas	632.9	*	29.1	245.8	4.6	8.4	1.0
China Merchants Bank	招商銀行	600036 CH	Diversified Banks	286.2	*	147.7	487.3	5.6	4.6	1.1
Minsheng Bank	民生銀行	600016 CH	Diversified Banks	224.8	*	134.9	530.5	3.2	4.8	1.1
Industrial Bank	興業銀行	601166 CH	Diversified Banks	210.9	-	135.6	693.4	4.2	4.4	1.0
SPDB	浦發銀行	600000 CH	Diversified Banks	182.8	-	103.2	773.8	6.7	4.0	0.8
BOC	交通銀行	601328 CH	Diversified Banks	346.7	*	79.6	313.6	5.7	5.2	0.8
ICBC	工商銀行	601398 CH	Diversified Banks	1320.9	*	62.3	199.6	7.3	4.5	0.9
ABC	農業銀行	601288 CH	Diversified Banks	833.8	*	60.5	193.8	7.0	4.4	0.9
Huaxia Bank	華夏銀行	600015 CH	Diversified Banks	78.4	-	36.1	170.3	4.9	4.5	0.9
China Everbright Bank	光大銀行	601818 CH	Diversified Banks	124.0	*	33.9	203.0	6.6	4.1	0.7
CCB	建設銀行	601939 CH	Diversified Banks	1184.6	*	23.6	104.9	7.2	4.4	0.9
BOC	中國銀行	601988 CH	Diversified Banks	778.2	*	16.1	85.5	7.2	4.4	0.8
CITIC Bank	中信銀行	601998 CH	Diversified Banks	206.1	*	13.5	169.6	5.6	4.9	0.9
Bank of Nanjing	南京銀行	601009 CH	Regional Banks	25.3	-	20.9	106.3	5.4	4.9	0.9
Poly Real Estate Group	保利地產	600048 CH	Real Estate Development	64.3	-	34.6	512.0	3.3	4.8	1.2
State Construction Eng	中國建築	601668 CH	Construction & Engineering	94.2	-	34.9	250.9	4.6	4.1	0.8
Power Construction	中國電建	601669 CH	Construction & Engineering	N/A	-	N/A	7.8	5.1	5.1	N/A
Daqin Railway	大秦鐵路	601006 CH	Railroads	106.1	-	35.8	160.6	6.0	6.9	1.3
Xiamen C & D	建發股份	600153 CH	Trading Companies & Distributor	17.4	-	10.6	93.5	3.3	5.4	1.1
GD Power Development	國電電力	600795 CH	Independent Power Producers	39.8	-	15.2	122.7	5.6	5.9	1.0
Huaneng Power Int'l	華能國際	600011 CH	Independent Power Producers	86.8	*	9.7	99.0	6.4	7.1	1.3
Shenergy	申能股份	600642 CH	Independent Power Producers	19.9	-	8.8	44.6	4.6	7.8	0.9

Note: 1. Total market cap is calculated as the sum of market cap for both A and H share classes if a stock is cross-listed on the two exchanges; 2. selection criteria for the stocks are: (1) free float market cap > RMB6bn, (2) dividend yield > 3%, (3) FY14F P/E < 10x; 3. Power Construction was suspended on 31 Jul 2014 and therefore no price data were available

* cross-listed stocks in A-share and H-share markets

Source: SSE, Bloomberg data, Nomura research

The RMB300bn of northbound aggregate quota balance is equivalent to 8.9% of the 175 eligible large cap A-share stocks (floating market cap > RMB6bn) or 26% of the 28 stocks listed in Fig. 4 above as of 31 July 2014. Therefore, if offshore investors do invest in large cap A-share stocks, we think the fresh money inflow may be able to lift the large cap stocks' prices at least in the short-term.

The Stock Connect programme vs. the existing QFII and RQFII programmes

What is QFII?

The Qualified Foreign Institutional Investor (QFII) programme was launched in 2002 to allow licensed foreign investors invest in China mainland securities in foreign currencies (i.e. exchange of foreign currencies to RMB happens in the onshore RMB market). Its current total quota cap amounts to USD240bn, of which USD56.5bn had been granted by end-June 2014.

What is RQFII?

The RMB Qualified Foreign Institutional Investor (RQFII) programme was launched in 2011 to allow licensed foreign investors invest in China mainland securities in RMB (i.e. exchange of foreign currencies to RMB happens in the offshore RMB market). Its current total quota cap amounts to RMB640bn, of which RMB250.3bn had been granted by end-June 2014.

Stock Connect: widening participation from investors

- Offshore retail investors will be able to invest in individual stocks listed on SSE via the Stock Connect programme while they can only invest in mutual funds to get exposure to the A-share market at present.
- Pension funds, insurance funds, mutual funds and charity funds are preferred investors under the QFII scheme to encourage mid/long-term investment as specified in the CSRC directive, *Measures on Administration of Domestic Securities Investments of QFII*: Chapter 2, Article 10. This policy puts investors with shorter investment horizons at a disadvantage. However, these less-preferred investors and other institutional investors without QFII/ RQFII licenses will also get direct access to the A-share market via the Stock Connect programme.

Stock Connect: unrestricted fund repatriation

There is no restriction on fund repatriation for investments via the Stock Connect programme, while QFII/ RQFII investors' fund repatriation is subject to SAFE's approval.

Stock Connect: more limited eligible securities

At this stage, the Stock Connect programme only applies to constituent stocks of SSE180 & 380 and cross-listed shares in A- and H-share markets with exceptions of stocks not traded in RMB, those under 'risk alert' and those offered in IPOs. In comparison, QFII and RQFII apply to a wider range of assets, including stocks, bonds, and securities investment funds, warrants, IPOs, bond issuance and index futures.

Stock Connect: daily trading quota limit

While there is no daily quota limit for sell transactions, buy transactions are subject to the maximum net buy value of RMB13bn under the Stock Connect programme. In comparison, there is no daily trading quota for QFII/RQFII investors.

How would QFII/RQFII be affected?

We think that the Stock Connect programme may divert some traffic away from trading using brokers' QFII quota and put some downward pressure on the commission rate charged by brokers in the QFII business. Nevertheless, we do not think that the Stock Connect programme will be a complete substitute for the existing QFII/RQFII programmes. We see a low likelihood of institutional investors abandoning their QFII/ RQFII quota and shifting to the Stock Connect programme.

What onshore investors may buy in Hong Kong?

The Stock Connect programme vs. the existing QDII and QDLP programmes

What is QDII?

The Qualified Domestic Institutional Investor (QDII) programme was launched in 2006 to allow licensed institutional investors to invest in foreign securities listed or approved by foreign regulatory committees that have signed a memorandum of understanding (MOU) with the CSRC. Under the programme, USD80.5bn was granted to banks, securities firms, asset management companies, insurance companies and trust companies by end-June 2014. Individual onshore investors may subscribe shares of the mutual and/or private fund products issued by QDIIs.

Of the existing 80 QDII mutual funds investing in equities in China, all are long-only and only two focus on small/mid-cap equities, as recorded by Morningstar. In comparison, some of the private equity funds' QDII products employ long/short strategies and pay more attention to small/mid cap stocks, as reported by *Simuwang*, a Chinese website about private funds.

What is QDLP?

The Qualified Domestic Limited Partnership (QDLP) programme was launched in 2013 to allow qualified domestic private RMB funds to invest in hedge funds abroad. Each approved asset manager has an individual quota of USD50mn. Investors of private equity funds are in great favour of the QDLP programme as they can tailor the fund products to meet their specific needs and get access to investment expertise overseas as reported by PwC.

Stock Connect: more big individual investors get access to Hong Kong stocks

Although individual investors can open trading accounts at Hong Kong securities firms, SAFE's requirements dictate that they can only freely exchange and send no more than USD50,000 per year abroad. To transfer more than USD50,000, innovative channels have emerged, some of which are extremely complex and involve significant risk. We think the Stock Connect programme will encourage large individual investors who have been deterred by fears of risks and complexities to invest in the Hong Kong stock market.

How would QDII and QDLP be affected?

At the moment, the QDII and QDLP programmes provide institutional investors reasonable frameworks to invest in a wide selection of offshore securities. In comparison, trading via the Stock Connect programme is subject to quota limits and eligible stock limits. Therefore, we see low likelihood for existing holders of QDII and QDLP licenses to shift to the Stock Connect programme. We think private equity funds and large individual investors who have not yet invested in the Hong Kong stock market may be the main users of the Stock Connect channel. In addition, similar to the impact of the Stock Connect programme on QFII, we expect brokers involved in the QDII quota renting business to see some traffic being diverted away and downward pressure on the commission rate.

Ongoing interest in small/mid-cap stocks

We believe that onshore private equity funds that are less concerned about liquidity issues have an information edge in small/mid-cap names as they can turn more stones at the ground level. Therefore, as we expect private equity funds and individual investors to be the main participants of southbound trading in the Stock Connect programme, we think that most of their investments may be directed into the small/mid-cap stock segment. As the RMB250bn of net fund flows into the Hong Kong market is equivalent to 64% of the sum of the eligible small/mid-cap stocks' free float market cap, we think that the Stock Connect programme will be able to lift the valuation of small/mid-cap stocks in Hong Kong by a considerable amount.

Access to names unavailable in A-shares

Notably, we see opportunities in the internet and Macau gaming sectors.

Internet

As many leading Chinese internet companies could not meet the listing standards in mainland China, they turned to stock exchanges in Hong Kong and the US for IPOs. Hence, we think that industry leaders such as Tencent (700 HK, Buy) and KingSoft (3888 HK, Not Rated) may attract onshore investors who did not have opportunities to invest in the big names before.

Chao Wang, our internet analyst, notes that Tencent and KingSoft are cheaper than their A-share peers.

Macau gaming

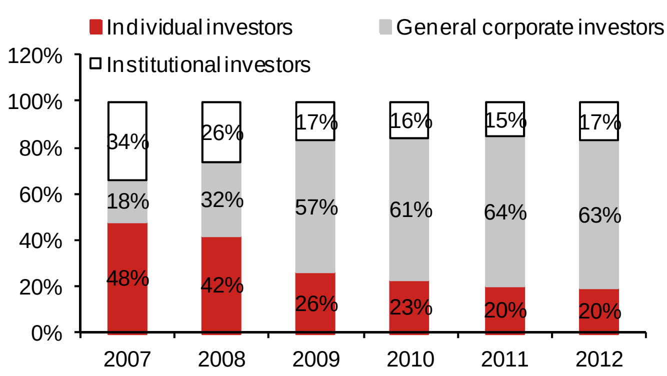
At the moment, onshore investors seeking exposure to the gaming industry could only invest in suppliers of gaming companies such as Yaoji Poker (002605 CH, Not Rated) and Anne Holdings (002235 CH, Not rated), or domestic lottery operators such as Zhongti (600158 CH, Not rated), GoHigh (000851 CH, Not rated) and Hongbo (002229 CH, Not rated). Through the Stock Connect programme, they would get access names not available in A-shares, we believe.

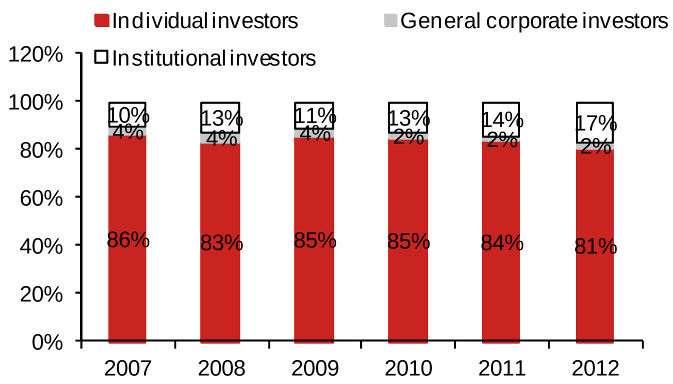
Louise Cheung, our Macau gaming analyst, reckons that Chinese portfolio managers may add Macau exposure once the Stock Connect programme starts.

A potential win-win for both the exchanges

Individual investors have played an active role in generating trading volumes in the A-share market. Despite shares held by individual investors in SSE in dollar amount dropping from 48% in 2007 to 20% in 2012, trading volume contributed by individual investors stayed steadily above 80%. By contrast, institutional investors account for 61% of the trading volume in the Hong Kong stock market, as reported by *Securities Star*.

Fig. 5: SSE investors' contribution to the value of shares held (LHS) and trading volume (RHS)





Source: SSE, Nomura research

In addition, the A-share market has been criticized for being treated as a casino where investors try to time the market (James Riedel, Jing Jin, Jian Gao: How China Grows: Investment, Finance, and Reform: Princeton and Oxford: Princeton University Press, 2007). As a result, trading activities have been tilted towards small-/mid-cap stocks that are more responsive to news and fund inflows/outflows with large cap stocks being left aside.

In comparison, the trading volume of small-/mid-cap stocks in Hong Kong has been low because institutional investors, the main force in the Hong Kong stock market, believe in fundamental analysis and value investing and tend to focus on large cap stocks with sufficient liquidity.

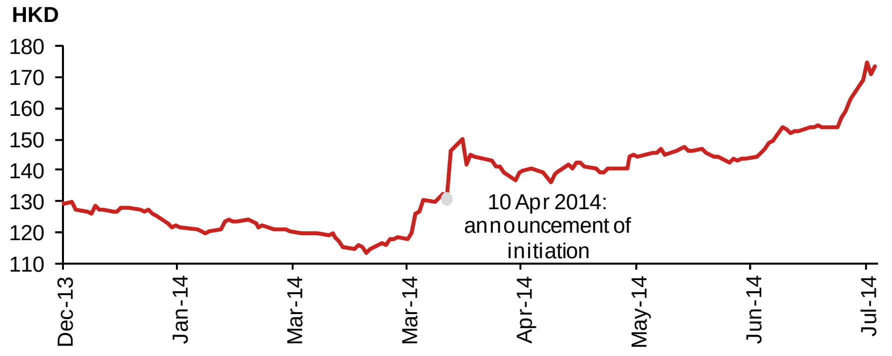
We believe that the Stock Connect programme will bring more individual investors to trade on the SEHK and contribute to trading volume growth in the Hong Kong small-/mid-cap stock markets.

Key beneficiaries: HKEx and Chinese brokers in Hong Kong

We believe that HKEx (0388 HK, not rated) and brokerage firms will benefit from increasing trading volumes. The current RMB13bn of northbound net-balance trading quota amounts to ~15% of the recent six-month average turnover value of the Shanghai Stock Exchange A+B Share Market and ~17% of the recent six-month average turnover value of the Hong Kong Stock Exchange.

HKEx's share price had jumped by 11.5% on 11 April 2014 in response to the announcement of the initiation of the Stock Connect programme and was up by 32.5% from 10 April 2014 to 31 July 2014.

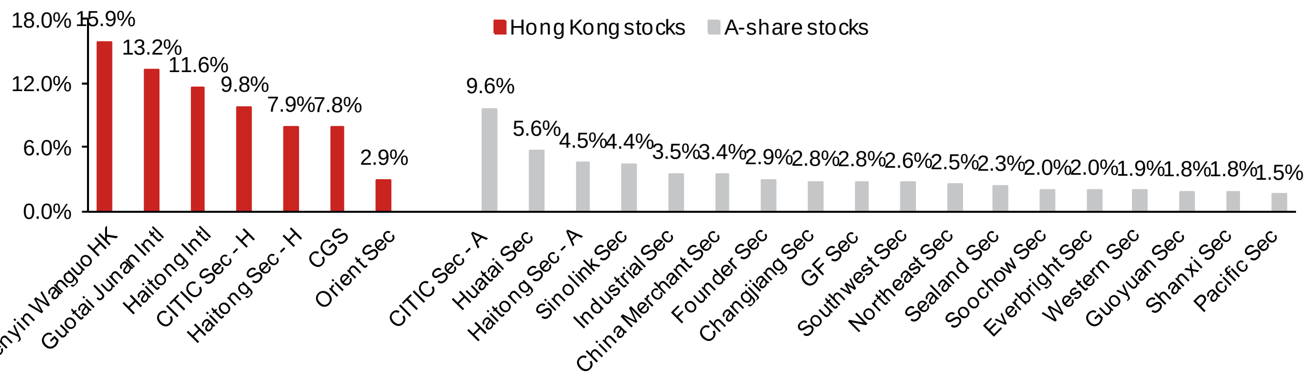
Fig. 6: Share price of HKEx boosted by the news about the launch of the programme



Source: Bloomberg, Nomura research

Brokerage firms' share prices were also lifted by the news. As shown in Fig. 7, share prices of all brokerage firm stocks listed in both H-share market and A-share market increased on 10 April 2014. Shenyin Wanguo HK, Guotai Junan International, Haitong International, CITIC Securities H-share and A-share, Haitong Securities H-share and China Galaxy Securities all posted noticeable gains that day.

Fig. 7: Share price increases of brokerage firms on 10 April 2014



Source: Bloomberg, Nomura research

Notes: The share price increases are calculated as percentage difference between closing prices and opening prices for the stocks

Game plans to position for price convergence

Short-selling

Can offshore investors short A-share stocks via the Stock Connect programme?

- Offshore investors are restricted from: (1) naked short selling; and (2) Mainland's margin trading and securities lending (融资融券) via the Shanghai-Hong Kong Stock Connect programme.
- The possibility of participation in the offshore market of margin trading and securities lending has not been ruled out and will be clarified in the future.
- However, we think that the breadth and depth of the offshore securities lending market via the Stock Connect programme may not be sufficient enough for offshore investors to take short positions in A-shares effectively.

Can onshore investors short H-share stocks via the Stock Connect programme?

No short selling, no margin financing or stock lending are possible.

Onshore investors' game plans

- We think that long-only onshore investors can keep taking advantage of their information edge in A-share stocks and buy undervalued shares.
- Meanwhile, long-short onshore investors can short sell overvalued H-shares and buy undervalued A-shares to play a hedged position on A-H share price convergence.
- Onshore investors can also buy undervalued H-shares.
- However, we think that onshore investors will be reluctant to short overvalued A-shares because the cost of doing so is prohibitively high at high-single digits vs. a low-single digit cost of short selling via stock lending in Hong Kong, as reported by Guangzhou Daily and China Securities Journal.

Offshore investors with limited options

- We think long/short offshore investors may go long on A-shares and short H-shares to play a hedged position on stocks trading at premiums in the H-share market.
- However, as there won't be sufficient mechanism for offshore investors to short sell A-share stocks, offshore investors can only buy undervalued small/mid-cap H-shares.

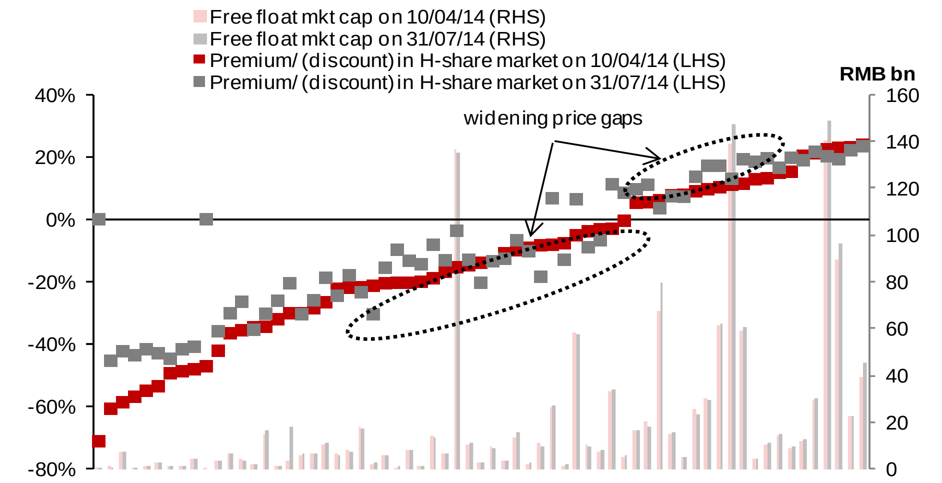
Inconclusive evidence on the close of price gaps

While we agree that the convergence of A- and H-share prices would be the general trend, we see inconclusive evidence showing that arbitragers will be able to close the price gap completely due to the lack of a short mechanism.

In Fig. 8, we examine the extent to which A- and H-share prices converged during the period from 10 April 2014 to 31 July 2014. We first calculate the stocks' premiums/ (discounts) in the H-share market relative to the A-share market on 10 April 2014 and 31 July 2014, respectively, and then sort the stocks by their premiums/ (discounts) in the H-share market on 10 April 2014 in an ascending order. We also note down their free float market capitalisation in the A-share market as a reference. Some key findings are as below:

- Stocks with larger free float market cap tend to trade at premiums in the H-share market, while stocks with smaller free float market cap tend to trade at discounts in the H-share market.
- Since the Stock Connect programme was announced on 10 April 2014, 40 of the 65 non-suspended cross-listed stocks have experienced price convergence, while other 25 have seen a wider price gaps between their A- and H-share prices.
- Among the stocks having experienced price convergence, most are the ones trading at extreme H-A share premiums or discounts.
- Among the stocks having experienced price divergence, most are the ones trading at smaller H-A share premiums or discounts, especially the ones trading at a discount of 3-22% or at a premium of 5-15% in the H-share market.

Fig. 8: Price convergence of A- and H-share prices from 10 April 2014 to 31 July 2014



Source: HKEx, Bloomberg data, Nomura research

Note: Free float market cap is calculated based on A-shares

Fig. 9: Stocks cross-listed in A- & H-share markets

Company name	公司名称	SEHK ticker	SSE ticker	H-A premium / (discount) on 10/04/14	H-A premium / (discount) on 31/07/14	Free float mkt cap on 10/04/14 (RMB bn)	Free float mkt cap on 31/07/14 (RMB bn)
Luoyang Glass Co Ltd	洛陽玻璃	1108 HK	600876 CH	-71%	N/A	0.44	0.60
Nanjing Panda Electronics	熊貓電子	553 HK	600775 CH	-61%	-45%	0.90	0.74
Chongqing Iron & Steel	重慶鋼鐵	1053 HK	601005 CH	-59%	-42%	7.22	7.55
Beijing Jingcheng Machinery Electric	京城機電	187 HK	600860 CH	-57%	-44%	0.63	0.72
Shenji Kunming Machine Tool	昆明機床	300 HK	600806 CH	-55%	-42%	0.88	0.90
Tianjin Capital Environmental Protection	天創環保	1065 HK	600874 CH	-54%	-43%	2.83	2.75
China Molybdenum	洛陽鉬業	3993 HK	603993 CH	-49%	-45%	1.13	1.48
First Tractor	第一拖拉機	38 HK	601038 CH	-49%	-42%	1.17	1.17
Sinopec Shanghai Petrochemical	上海石化	338 HK	600688 CH	-48%	-41%	4.46	4.18
Sinopec Yizheng Chemical Fibre Co Ltd	儀征化纖	1033 HK	600871 CH	-47%	N/A	0.83	N/A
Beijing North Star	北辰實業	588 HK	601588 CH	-42%	-36%	3.42	3.30
Shanghai Electric	上海電氣	2727 HK	601727 CH	-36%	-30%	6.67	6.72
Zhengzhou Coal Mining Machinery	鄭煤機	564 HK	601717 CH	-36%	-26%	4.24	3.84
Dalian Port PDA	大連港	2880 HK	601880 CH	-35%	-35%	1.99	2.38
Zijin Mining	紫金礦業	2899 HK	601899 CH	-34%	-30%	15.04	16.16
Sichuan Expressway	成渝高速	107 HK	601107 CH	-32%	-26%	1.52	1.49
Datang International Power Generation	大唐發電	991 HK	601991 CH	-30%	-20%	3.36	18.36
China Shipping Container Lines	中海集運	2866 HK	601866 CH	-30%	-30%	5.79	6.46
Metallurgical Corp of China	中國中冶	1618 HK	601618 CH	-29%	-26%	6.31	6.60
Aluminum Corp of China	中國鋁業	2600 HK	601600 CH	-27%	-19%	10.63	11.41
BBMG Corp	金隅	2009 HK	601992 CH	-22%	-24%	6.56	5.88
China COSCO	中國遠洋	1919 HK	601919 CH	-22%	-18%	8.25	7.66
Guangzhou Baiyunshan Pharmaceutical	白雲山	874 HK	600332 CH	-22%	-23%	17.68	17.37
Yanzhou Coal Mining	兗州煤業	1171 HK	600188 CH	-21%	-30%	2.38	2.71
China Southern Airlines	南方航空	1055 HK	600029 CH	-20%	-15%	5.88	5.61
Shenzhen Expressway	深圳高速	548 HK	600548 CH	-20%	-10%	0.79	0.89
Dongfang Electric Corp	東方電氣	1072 HK	600875 CH	-20%	-13%	8.22	7.92
Anhui Expressway	皖通高速	995 HK	600012 CH	-20%	-14%	1.26	1.07
China CITIC Bank Corp	中信銀行	998 HK	601998 CH	-19%	-8%	14.09	13.47
China Coal Energy	中煤能源	1898 HK	601898 CH	-17%	-13%	6.74	6.74
China Minsheng Banking Corp	民生銀行	1988 HK	600016 CH	-15%	-4%	136.93	134.91

Source: Bloomberg data, Nomura research

Note: N/A implies the stock was suspended either in the H-share market or in the A-share market.

Fig. 10: Stocks cross-listed in A- & H-share markets (contd.)

Company name	公司名称	SEHK ticker	SSE ticker	H-A premium / (discount) on 10/04/14	H-A premium / (discount) on 31/07/14	Free float mkt cap on 10/04/14 (RMB bn)	Free float mkt cap on 31/07/14 (RMB bn)
Jiangxi Copper	江西銅業	358 HK	600362 CH	-15%	-13%	10.36	10.95
China Eastern Airlines Corp	東方航空	670 HK	600115 CH	-14%	-20%	2.78	2.76
China Oilfield Services	中海油服	2883 HK	601808 CH	-13%	-14%	9.28	9.14
Maanshan Iron & Steel	馬鞍山鋼鐵	323 HK	600808 CH	-11%	-13%	3.40	3.42
New China Life Insurance	新華保險	1336 HK	601336 CH	-10%	-7%	13.79	15.71
China Shipping Development	中海發展	1138 HK	600026 CH	-9%	-10%	2.27	2.41
Great Wall Motor	長城汽車	2333 HK	601633 CH	-8%	-18%	10.99	9.36
PetroChina	中國石油	857 HK	601857 CH	-8%	7%	26.24	27.22
Guangzhou Automobile	廣汽集團	2238 HK	601238 CH	-8%	-13%	1.59	1.67
Haitong Securities	海通證券	6837 HK	600837 CH	-5%	7%	58.04	57.36
Shanghai Pharmaceuticals Holding	上海醫藥	2607 HK	601607 CH	-4%	-9%	10.05	9.53
Guangshen Railway	廣深鐵路	525 HK	601333 CH	-3%	-7%	7.50	8.19
China Everbright Bank	光大銀行	6818 HK	601818 CH	-3%	11%	33.29	33.93
Huadian Power International Corp	華電國際	1071 HK	600027 CH	0%	9%	5.34	5.84
Bank of China	中國銀行	3988 HK	601988 CH	5%	10%	16.37	16.13
Shanghai Fosun Pharmaceutical	復星醫藥	2196 HK	600196 CH	5%	11%	20.04	18.17
Bank of Communications	交通銀行	3328 HK	601328 CH	6%	4%	67.11	79.56
CSR Corp	中國南車	1766 HK	601766 CH	8%	7%	14.61	15.69
Air China	中國國航	753 HK	601111 CH	8%	7%	4.97	4.97
China Construction Bank Corp	建設銀行	939 HK	601939 CH	9%	14%	25.63	23.59
China Petroleum & Chemical Corp	中石化	386 HK	600028 CH	10%	17%	29.87	29.09
Industrial & Commercial Bank of China	工商銀行	1398 HK	601398 CH	10%	17%	61.34	62.26
China Merchants Bank	招商銀行	3968 HK	600036 CH	11%	13%	138.89	147.69
Agricultural Bank of China	農業銀行	1288 HK	601288 CH	11%	19%	59.02	60.46
China Communications Construction	交通建設	1800 HK	601800 CH	13%	19%	4.59	4.52
Tsingtao Brewery	青島啤酒	168 HK	600600 CH	13%	20%	10.72	10.81
China Railway	中國中鐵	390 HK	601390 CH	15%	17%	14.09	14.91
Huaneng Power International Inc	華能國際	902 HK	600011 CH	15%	20%	8.92	9.70
China Railway Construction Corp	中國鐵建	1186 HK	601186 CH	20%	19%	11.86	12.45
China Shenhua Energy	中國神華	1088 HK	601088 CH	21%	22%	29.70	30.27
Ping An Insurance Co of China	中國平安	2318 HK	601318 CH	22%	20%	140.85	148.65
CITIC Securities	中信証券	6030 HK	600030 CH	23%	19%	89.39	96.68
China Life Insurance	中國人壽	2628 HK	601628 CH	23%	22%	22.22	22.73
China Pacific Insurance	中國太保	2601 HK	601601 CH	24%	23%	39.39	45.17
Jiangsu Expressway	寧滬高速	177 HK	600377 CH	25%	22%	2.87	3.02
Anhui Conch Cement	海螺水泥	914 HK	600585 CH	36%	30%	33.70	31.71
China CNR Corp	中国北车	6199 HK	601299 CH	N/A	5%	15.27	16.01
Guangzhou Shipyard International Co Ltd	廣船國際	317 HK	600685 CH	N/A	N/A	N/A	N/A

Source: Bloomberg data, Nomura research
Note: N/A implies the stock was suspended either in the H-share market or in the A-share market.

What are the potential risks?

What if funds flow to HK massively and trade in A-shares?

While single-day net fund inflows into the A-share market is currently capped at RMB13bn, there is no limit on net fund outflows and thus massive single-day net fund outflows are not ruled out, meaning that there is a possibility of large-scale A-share sell-offs by offshore investors, creating considerable downward pressure. As a result, the A-share market may be more volatile after the launch of the Stock Connect programme than at present.

What if the currency makes big moves? Offshore clients need to buy offshore RMB in order to buy A-shares, so they may bid up RMB offshore.

According to Bank of China's "Interpretation of the BOC Offshore RMB Index" report, there were RMB1.5tn of deposits and RMB400bn of loans in the offshore markets as of end-2013. In addition, RMB137.4bn of dim-sum bonds and RMB246.6bn of RMB-denominated certificates of deposits were issued in 2013. We reckon that while both supply and demand for offshore RMB will grow rapidly, overall the current stock of offshore RMB should be able to accommodate the RMB300bn investment balance of the Stock Connect programme.

Nevertheless, we recognise that there may be a surge in the demand for offshore RMB fuelled by either offshore investors' good appetite for A-shares or onshore investors' sell-offs of H-shares. Such a surge may result in tight liquidity in the offshore RMB market and bid up RMB offshore. As reported by Oriental Daily, the HKMA is discussing with Hong Kong banks about the necessity to have additional T+0 repurchase agreement facilities to manage the offshore RMB's liquidity in Hong Kong.

Appendix A-1

Analyst Certification

I, Wendy Liu, hereby certify (1) that the views expressed in this Research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this Research report, (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Research report and (3) no part of my compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

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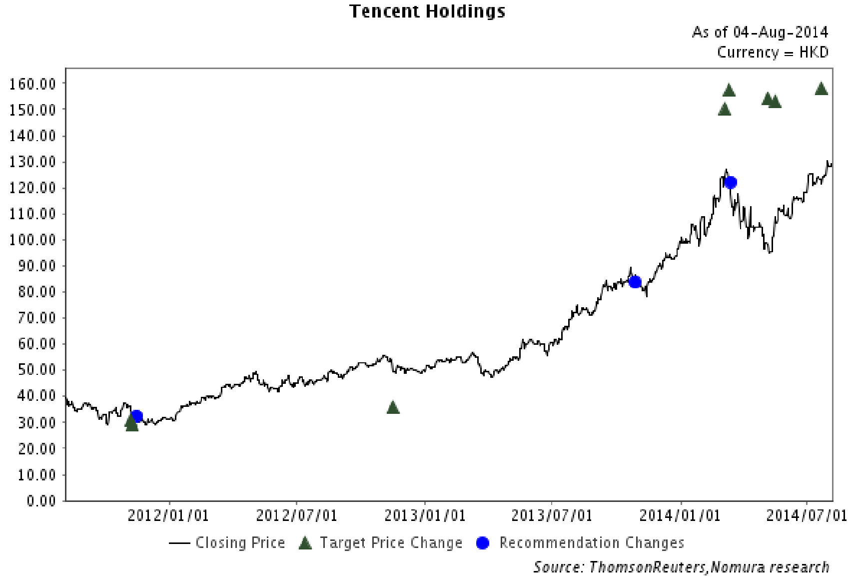
Materially mentioned issuers

Issuer	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Tencent Holdings	700 HK	HKD 132.90	06-Aug-2014	Buy	N/A	A10

A10 The Nomura Group is a registered market maker in the securities / related derivatives of the issuer.

Tencent Holdings (700 HK) **HKD 132.90 (06-Aug-2014)** Buy (Sector rating: N/A)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
21-Jul-14		158.00	121.50
16-May-14		153.00	106.50
05-May-14		154.40	98.52
11-Mar-14		157.40	123.50
05-Mar-14	Buy		124.50
05-Mar-14		150.00	124.50
19-Oct-13	Not Rated		85.96
15-Nov-12		36.00	49.84
09-Nov-11		29.20	33.30
07-Nov-11	Reduce		34.88
07-Nov-11		31.00	34.88

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology We use SOTP to value Tencent. DCF is used as as our primary valuation methodology to value its core business, as it captures the long-term growth profile and reflects the cash outflow related to capex and acquisitions. P/E is used as a reference, as it can be easily used for historical and peer comparison. Our DCF-based valuation returns an equity value of HKD152, assuming a 9% discount rate, 3% terminal growth rate, and 19% FCF CAGR from 2015-20E, implying 33x 2015F non-EPS of HKD4.75 and 24x 2016F EPS of HKD6.5. Adding HKD6 for the stake in JD.com, our SOTP-based TP is 158HKD. The benchmark index for this stock is MSCI China.

Risks that may impede the achievement of the target price Risks: high market expectations; any negative fund flow triggered by Alibaba's potential listing; company's aggressive spending on Weixin payments and overseas marketing; and any potential disruptive products and business models from its competitors.

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A rating of **'Buy'**, indicates that the analyst expects the stock to outperform the Benchmark over the next 12 months. A rating of **'Neutral'**, indicates that the analyst expects the stock to perform in line with the Benchmark over the next 12 months. A rating of **'Reduce'**, indicates that the analyst expects the stock to underperform the Benchmark over the next 12 months. A rating of **'Suspended'**, indicates that the rating, target price and estimates have been suspended temporarily to comply with applicable regulations and/or firm policies. Securities and/or companies that are labelled as **'Not rated'** or shown as **'No rating'** are not in regular research coverage. Investors should not expect continuing or additional information from Nomura relating to such securities and/or companies. Benchmarks are as follows: **United States/Europe/Asia ex-Japan**: please see valuation methodologies for explanations of relevant benchmarks for stocks, which can be accessed at: http://go.nomuranow.com/research/globalresearchportal/pages/disclosures/disclosures.aspx; **Global Emerging Markets (ex-Asia)**: MSCI Emerging Markets ex-Asia, unless otherwise stated in the valuation methodology; **Japan:** Russell/Nomura Large Cap.

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Explanation of Nomura's equity research rating system in Japan and Asia ex-Japan prior to 21 October 2013

STOCKS

Stock recommendations are based on absolute valuation upside (downside), which is defined as (Target Price - Current Price) / Current Price, subject to limited management discretion. In most cases, the Target Price will equal the analyst's 12-month intrinsic valuation of the stock, based on an appropriate valuation methodology such as discounted cash flow, multiple analysis, etc. A **'Buy'** recommendation indicates that potential upside is 15% or more. A **'Neutral'** recommendation indicates that potential upside is less than 15% or downside is less than 5%. A **'Reduce'** recommendation indicates that potential downside is 5% or more. A rating of **'Suspended'** indicates that the rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the subject company. Securities and/or companies that are labelled as **'Not rated'** or shown as **'No rating'** are not in regular research coverage of the Nomura entity identified in the top banner. Investors should not expect continuing or additional information from Nomura relating to such securities and/or companies.

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