JASPER CAPITAL

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A STAR Is Born

A History of Trading Science & Technology Stocks in Greater China

Last month witnessed the birth of the Shanghai STAR Market, Beijing's latest attempt to introduce Western-style free-market structures into the economy while also facilitating access to capital for China's burgeoning technology sector. In this monthly letter, we will assess the opportunity presented by the STAR Market ("Board" or "Exchange") by analyzing historical comparators to create a framework for understanding the possibilities.

Exchange Nexus

The STAR Market is pilot project that aims to provide investors with a less-tightly regulated exchange with features more traditional Western-style exchange features and issuance guidelines. As with most policies in China, it also serves political and social goals.

Witnessing the successes of Alibaba, Tencent, and Pinduoduo on foreign exchanges, policymakers wanted a way to attract technology IPOs to the mainland so that domestic investors can prosper as these companies grow. This also serves the purpose of keeping activity and prosperity local, a priority for Beijing. This is particularly important in China's new economic order as this would compel foreign inflows and boost the capital account as the current account tips into deficit.

Additionally, China's rise as a global technology player has seen much of that innovation and capital accumulation concentrated in the south, leading to Guangdong becoming China's most dynamic province with an $1.2 trillion economy. This has important consequences for domestic dynamics. STAR Market is a way to diversify the economic opportunity of the technology sector to the north, which is atrophying as the old economy deteriorates. The political dynamics is another story.

Exchange Specifics

There are three main features of the STAR Market that are of consequence to market dynamics and constitute a titanic shift in onshore exchange operations.

Currently, new issuances are first approved and then priced by divisions of the CSRC (China's SEC) and have a strict upper limit of 23x price-to-earnings ratio. The new Board allows for companies to register with the exchange rather than seek regulatory approval and allows for a more market-driven pricing mechanism. With registration also comes more Western-style contract details such as green-shoe options, claw-back provisions, and share allocations; all of which are prevalent in Hong Kong.

Notably, the Exchange also loosens profitability requirements to allow small companies that have yet to earn a profit to list whereas traditionally a track record of profitability had to be established to list and maintained in order to remain on the exchange. This facilitates access to capital to companies that are in targeted growth industries, such as technology and healthcare, and should compel proper corporate governance as management no longer has to skew results in order to maintain listings.

STAR also allows for wider up/down price limit of 30% for the first five trading days after which trading is halted for 10 minutes. The trading range is then relaxed to 20% (versus the traditional 10%). The board also allows for securities lending and short selling. The Exchange will also expedite the delisting process and permanently bar companies that are found to have committed major violations.

These changes, while small, are huge wins for free-market advocates. What remains to be seen is whether STAR keeps its current form. At its launch, the ChiNext also had market-based pricing and no trading limits but these were gradually phased. The ChiNext also exhibited comparable performance and trading behaviors in its opening month.

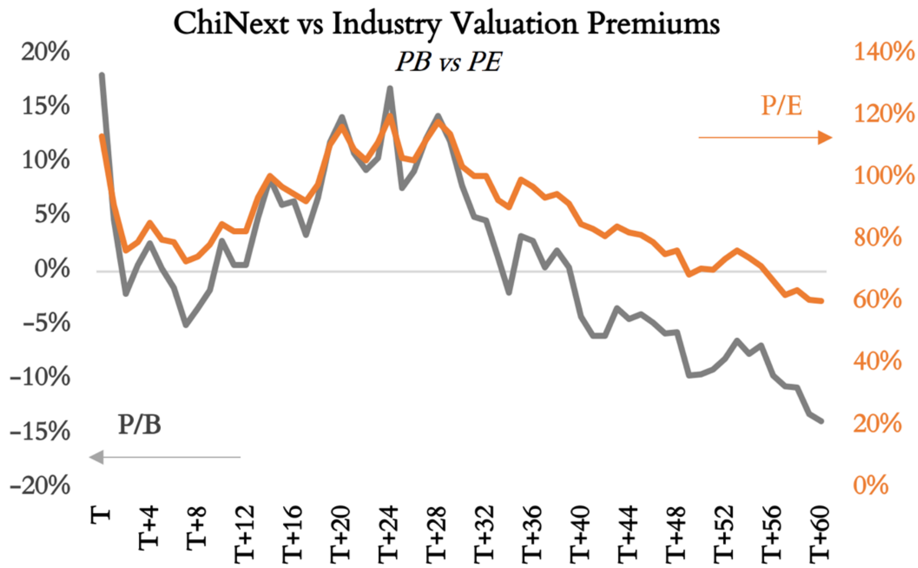
What else can we learn from other index launches and free-market policy transitions?

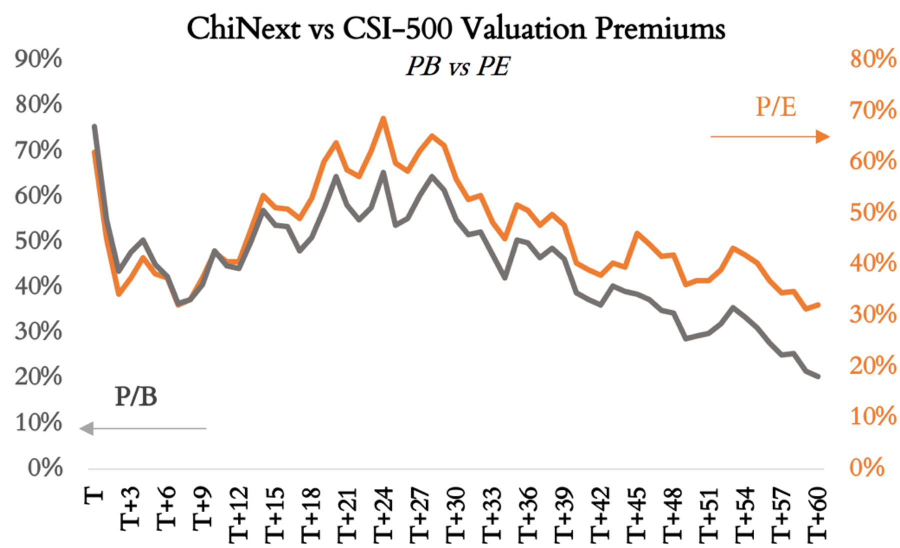
The Lessons from History

Short-term Valuation Premiums Call for Medium-term Price Suppression

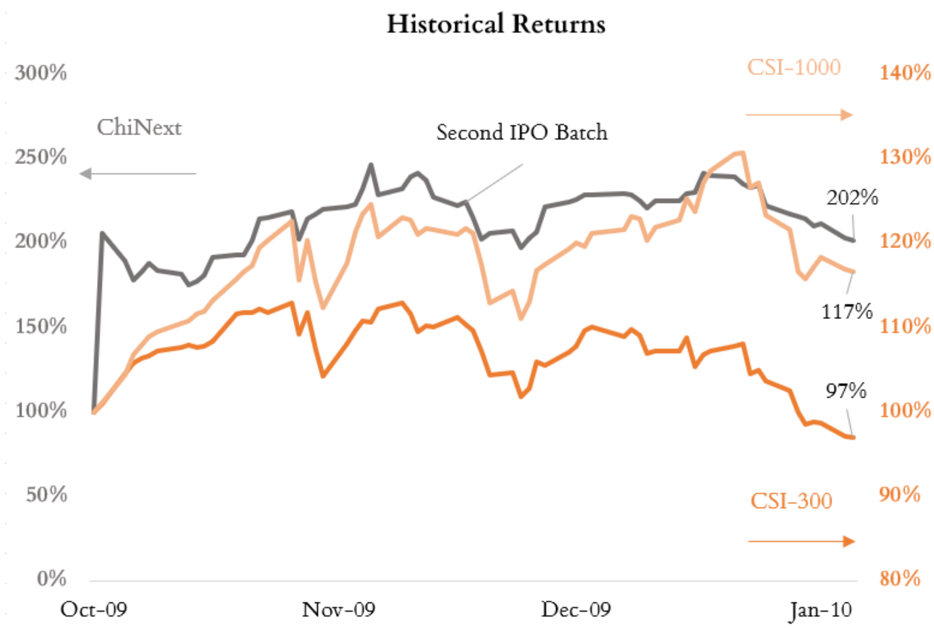
Most China-watchers may have read articles on the STAR Market's performance in the first days of trading with some, such as Anji Microelectronics, rallying over 400%. While extraordinary, the average return on the first day was a more moderate but still impressive 140% with a P/E of 53.6x. While this seems outrageous by U.S. standards, China's technology sector tends to trade at a valuation of 30-40x earnings.

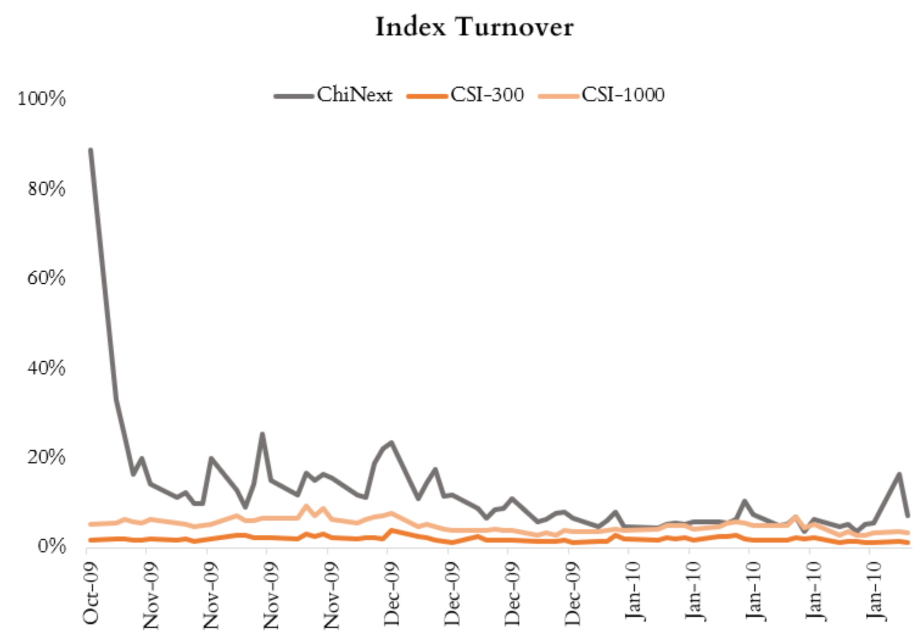
When the ChiNext debuted in October 2009 the average price increase on the first day of trading was 106% and the average P/E ratio was 56.6x. Throughout the first months of new IPO issuances, the ChiNext consistently traded at a valuation premium relative to industry and index peers. Below we show the ChiNext price-to-book and price-to-earnings valuation premiums over sector peers and the CSI-500, respectively.





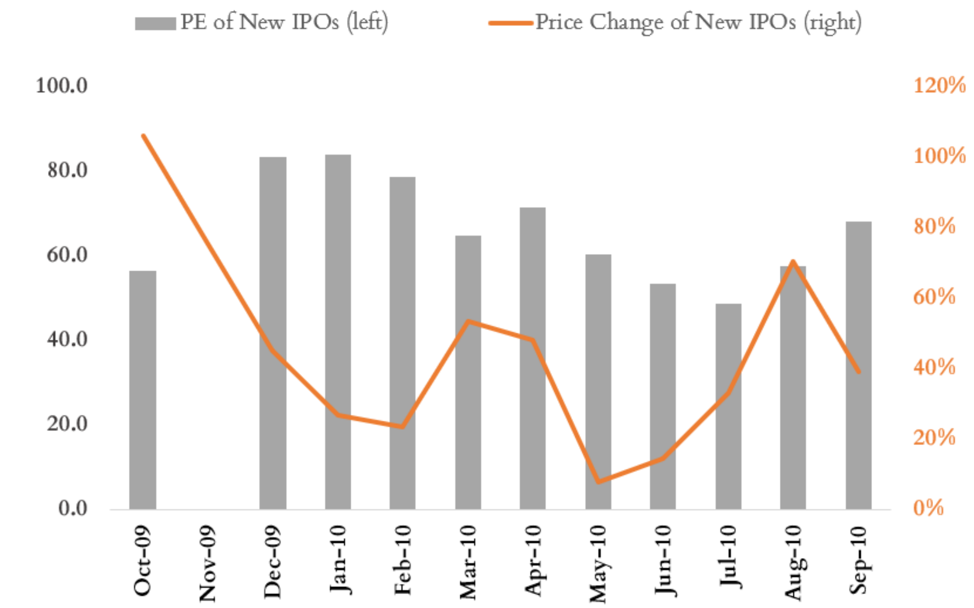
These premiums had knock-on consequences for index performance over multiple time horizons. The chart below ("Historical Returns") shows that return profile of the ChiNext over the first three months of trading versus CSI-300 and CSI-1000 returns. We do this comparison to show the performance of the top and bottom market capitalization stocks to get a sense of broad market performance. We see that following the first day rally of 106%, the ChiNext was essentially flat over the subsequent three months whereas the CSI-1000 returned 17%. This followed the normalization of trading volumes across indices.





Furthermore, the spike in valuations occurred for every monthly tranche of new IPOs that listed on the ChiNext. The progressive increase in ChiNext valuations had consequences for initial performance of new IPOs over the first full year of trading.

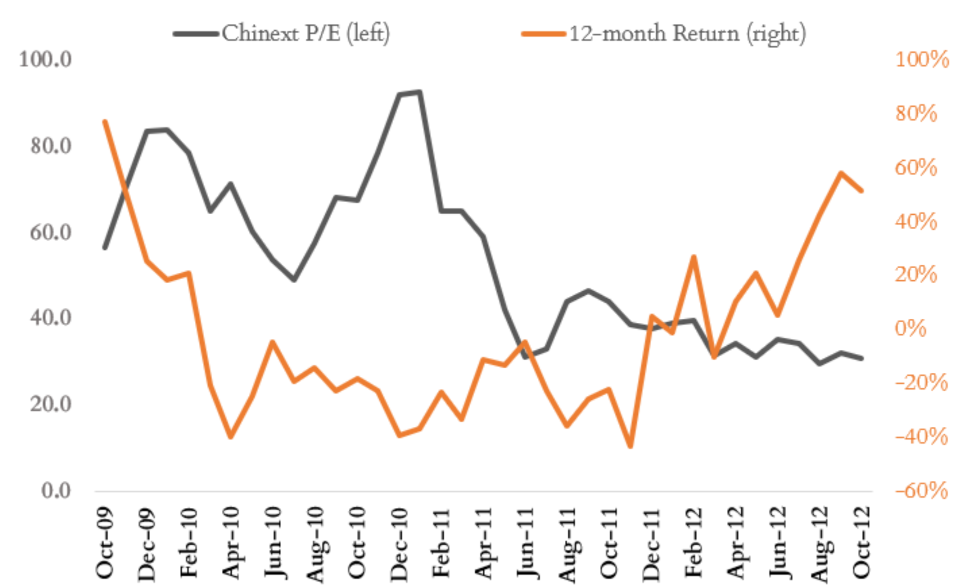
ChiNext New IPO Performance and P/E Ratio



* There were no ChiNext IPOs placed in November 2009.

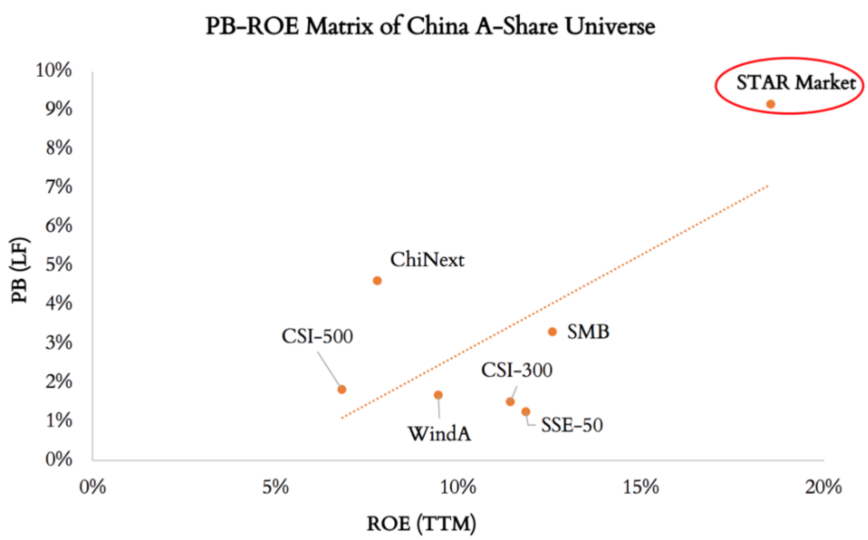
The gradual and sustained increase in ChiNext valuation in the first 12 months of trading placed downward pressure on the expected returns of the index, causing prices to decline over the first 22-months of trading until valuations reverted to historical averages of 30-40 times earnings.

ChiNext IPO Valuation vs 12-month Return

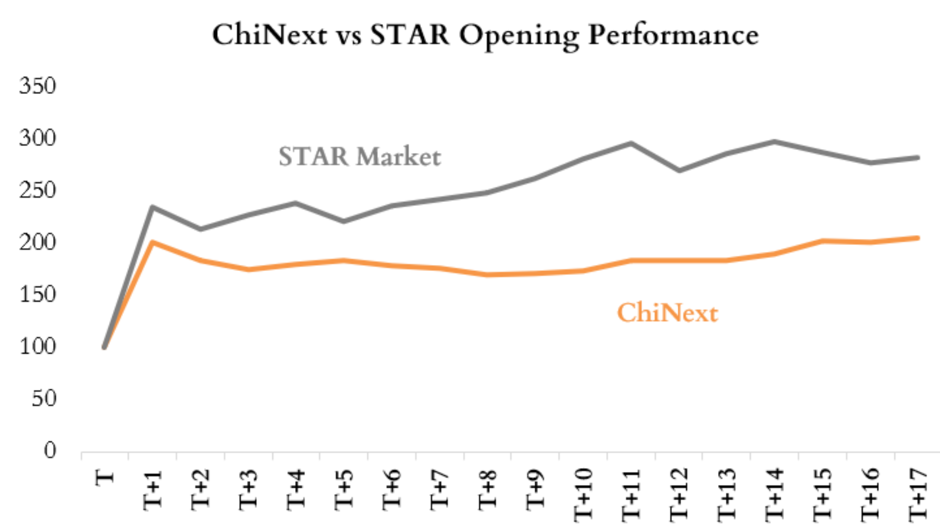


So, while the ChiNext did wonders for raising capital, high valuations skewed fundamentals and suppressed prices for almost the entire first two years of trading. This made participation in the exchange uninteresting beyond the opening day, particularly when considering that trading volumes fell precipitously after the first day, making other exchanges more attractive vis-à-vis turnover. It is not until fundamental valuations return to averages that expected returns look attractive once again.

But we all know that past performance is not indicative of future returns. Yet we would be foolish to disavow the lessons of history lest we become relegated to it. With this in mind we check to see how the first crop of STAR stocks are valued against other A-share indices using our preferred valuation measure: PB-ROE matrix. We see from the chart below that the STAR Market already greatly exceeds both P/B and ROE metrics of the broader China A-share universe.

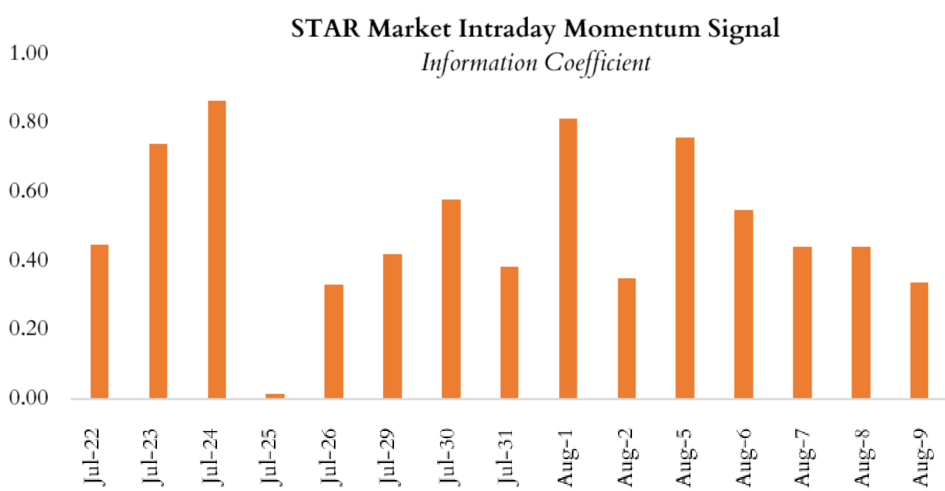


Furthermore, similar to the ChiNext open in 2009, STAR is currently enjoying its initial outperformance over other indices. We also note that the Board also outperformed the ChiNext's opening debut as illustrated below.



If history repeats or rhymes, then these data would suggest that the current trend is not sustainable, and returns will begin to suffer. The benefit of this is that the STAR Market allows for short selling and securities lending. Already, our friends who deploy discretionary long/short strategies are placing shorts following the frenzy. However, the cost of carrying that position will begin to take its toll as history suggests that the adjustment is gradual and borrow is limited in China, this increases the probability that borrowing costs rise faster than prices fall.

As quants, we would rather focus on developing signals from the lessons of history outlined previously and from our experience trading technology stocks in Shenzhen for the last six years. For example, using opening prices and VWAP, as a proxy for the mid-point of the order book, we can create an intraday momentum signal to trade the close for the STAR Market in its current frenzied state. Below is a chart of the intraday momentum signal information coefficients that result from this signal example. We stress that the below information coefficients are transient given the historical path of exuberance and volumes. For us, this is a better way to generate alpha during the current state and expected path of returns in the coming months rather than waiting to catch an inflection point.



Jasper Capital takes the approach that not all situations are opportunities, and sometimes the juice is not worth the squeeze. We investigate and see where and how we can leverage our competitive advantages to generate the best possible risk-adjusted returns for our clients. Given the analysis presented in this newsletter and taken into the context of other historical examples (such as that of Taiwan in late 1990s), we choose to mitigate the risks that come with a new exchange and new policy experiment. Instead we will selectively take advantage of opportunities as they arise and systematically incorporate the STAR Market once we are more comfortable with its permanence and evolution.

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