The Investment Landscape for Chinese ADRs
J.P. Morgan’s DR Group: A history of leadership in Asia

First-ever ADR program in APAC (SONY: 1961)
First GDR listing on Singapore Stock Exchange (Uttam Galva: 2007)
First HDR listing on Hong Kong Stock Exchange (Vale S.A.: 2010)
First HDR offering on Hong Kong Stock Exchange (SBI Holdings: 2011)
Six new clients year-to-date in 2014: (Fast Retailing, iKang Healthcare, Weibo Corp, Leju Limited, Tuniu Corp, Zhaopin Limited)
50% market share in new China IPOs year-to-date in 2014
Most number of Level 3 ADR programs in China

In addition to the operating excellence that our depositary bank delivers each day, we provide a range of market-leading, advisory, analytic and support services that help optimize the performance of our clients’ ADR programs. One of these services is the provision of capital markets intelligence, such as the findings of our annual investor survey.

Like our previous surveys, this year’s research presents the current investment landscape for Chinese ADRs. We gathered analyst and portfolio manager opinions on a range of issues related to investing in China, such as the country’s growth outlook and most attractive features, its greatest risks, and investors’ appetite for participating in equity offerings by China-based issuers. With regard to IPOs, our survey also reveals what investors expect from the chief financial officers and investor relations officers of Chinese companies that are going public.

I am pleased to note that nearly 50% of investors have overweight expectations for China on a three-year basis. This bodes well for companies that are contemplating an ADR offering and for the market valuations of those with existing ADR programs.

Also within this report we analyze major investment trends in the ADR market. We gauge investor appetite for Chinese ADRs; examine shifts in investment and changes in ownership between North America, Europe and Asia; identify which sectors of China’s economy have been attracting the most investment; show the progression of trading in Chinese ADRs; and also look at the significant increase in investment by hedge funds in recent quarters.

I trust you will find our research insightful and a valuable source of information for the development of your company’s ADR program and your overarching capital strategy. If you have any questions about this report, please do not hesitate to contact me.

Warm regards,

Kenneth Tse
Asia Pacific Head
Depositary Receipts Group
J.P. Morgan
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J.P. Morgan commissioned Ipreo to conduct a telephone-based survey of 25 investment professionals at North American and European firms that currently hold or have previously held Chinese ADRs. The purpose of the survey was to understand prevailing investor opinions of Chinese companies. As of May 15, 2014, these firms managed a combined $2.5 trillion in equity assets, $19.3 billion of which are holdings in Chinese ADRs, or approximately 27% of all Chinese ADRs held by active investment managers outside of Asia. This study also examines ownership trends (across different categories such as sector, regional ownership, and investor type) and historical trading volumes over the last five years, in order to provide a quantitative view of the investment landscape for Chinese ADRs.

The telephone interviews were conducted in March and April 2014, using the following open-ended questionnaire, which allowed investors to freely discuss their views and opinions.

- What is the most attractive aspect about investing in China?
- What is the greatest risk about investing in China?
- On a 5-point scale (1=no confidence and 5=extreme confidence), what is your current level of confidence regarding investing in China? Has this improved over the past year? Why or why not?
- What are your one-year and three-year outlooks for China? Why?
- Will you participate in new equity placements for Chinese companies? Why or why not?
- What industry in China is most attractive and why?
- What are the most important expectations that you have for the CFO of a soon-to-be-public Chinese company?
- What are the most important expectations that you have for the IRO of a soon-to-be-public Chinese company?
The Evolution of Chinese ADRs

Over the past five years, one of the most interesting subsets of the equity markets has been the rapidly changing Chinese ADR market, which has experienced erratic peaks and troughs during this relatively short time period. Between 2008 to May 15, 2014, there were more than 70 Chinese ADR IPOs, nearly half of which took place in 2010. After 2010, initial public offerings of Chinese ADRs started to slow due to investor concerns about a number of accounting scandals and the sustainability of China’s rapid economic growth. Despite continued concerns about transparency, management credibility, and the economic slowdown that investors cite in the current survey (see Section 2, page 8), the overall trend of investment in Chinese ADRs during the last five years has been positive. In the following sections, ownership trends are examined by investment type, region, and sector to show how the investment landscape of Chinese ADRs has changed. Historical trading volumes are also examined in this context.

Historical Ownership of Chinese ADRs

Figure 1 below depicts the total capital invested via Chinese ADRs since 2008, based on public ownership filings. Although there has been an increase in Chinese companies raising capital in the U.S. markets, which contributes to the growth shown in the total value of investments, it is hard to ignore the general upward trend over the past half-decade.

Figure 1: Total Investments in Chinese ADRs

1. To learn more about these issues, please refer to J.P. Morgan’s 2012 Investor Survey.
Amid the IPO boom from 2009 through mid-2011, there was little resistance in the equity markets for Chinese companies, as the economies in the U.S. and Europe were still recovering from the 2008 financial crisis. However, as several cases of accounting fraud at U.S.-listed Chinese companies later came to light, the appetite in the ADR market subsided from mid-2011 to early-2013. Despite myriad concerns of the investors, as highlighted in J.P. Morgan’s 2011 and 2012 surveys, demand for Chinese ADRs has returned. In the second half of 2013 and early 2014, there was strong net buying by institutional investors, as seen in Figure 2 below.

As this year’s survey reveals, North American and European investors still maintain some degree of caution when considering Chinese companies. Nevertheless, their willingness to consider Chinese companies has strengthened due to positive political and regulatory efforts in China, which supports the investment growth seen in the latter half of 2013.

In addition to the general upward trend of investment in Chinese ADRs, it is interesting to note that a majority of this growth was driven by active money managers, rather than passively-managed funds. To an extent, this is not surprising because relatively few new-to-market Chinese ADRs are included in widely-tracked indices, which play a large role in passive investments. However, this is an important aspect of ownership to highlight because passive management adds a certain amount of stability to securities. In other words, Chinese ADRs are more prone to trading volatility.

Figure 2: Net Activity in Chinese ADRs by Investor Region

![Net Activity in Chinese ADRs by Investor Region](image_url)

*As of 05/15/2014

Source: Ipreo Research
Regional Ownership of Chinese ADRs

Given the growth in total investment in Chinese ADRs since 2008, it is important to understand how the geographical breakdown of shareholders has shifted. Figure 3 below shows the proportion of Chinese ADRs owned by each of the major investment regions: North America, Europe, Asia, and Rest of the World.

It is not surprising that a majority of the owners are located in North America, where most Chinese companies list and raise capital. However, as Figure 3 shows, the proportion of North American ownership has been decreasing since 2008 when it was over 83% of institutionally-held ADRs. Currently, North American investors account for 68.4% of Chinese ADR ownership, while European investors have increased to 17.7% from roughly 10% five years ago. This trend is in line with general capital allocation trends among European money managers. Following the financial crisis in 2008 and the Eurozone crisis that followed shortly afterwards, many European institutions diversified their investments geographically – there have been greater inflows into globally-focused mutual funds than region-specific mutual funds.

In addition to looking at proportional ownership trends, there are also several distinct trends in each region’s net activity, as measured by open market buying and selling activity within quarters. Figure 2 on page 3 shows net buying and selling activity in Chinese ADRs over the last five years.

As seen in Figure 3, North American investors are the primary holders of Chinese ADRs. Their net buying activity has primarily been driving the rise in the price of these ADRs. From late 2011 through 2012, investors’ attitudes turned negative and global institutions were net sellers of Chinese ADRs by the end of 2012. North American investors were particularly bearish and were net sellers throughout the latter year. However, investment activity in Chinese ADRs has become positive recently, with each of the major investment regions all being net buyers in the last quarter of 2013. This pronounced shift toward net buying activity is promising for Chinese ADRs. Moreover, the bullish investor sentiment revealed by the survey supports this optimistic view.
Chinese ADR Investment by Sector

Investor sentiment toward specific sectors of China’s economy has also shifted during the past five years. Looking at Figure 4 below, in the beginning of 2008, the sector that attracted the most investment in terms of ADRs invested was the country’s Energy industry. At the time, there was robust demand for new alternative energy investments. The Consumer Services space was also a sizable portion of the publicly-traded ADRs, due to investor expectations of consumer-driven economic growth in China. The Technology sector has grown at an incredible pace since 2008 and now makes up nearly 70% of total Chinese ADRs in dollar terms. As seen later in this report, this trend mirrors the investor sentiment revealed by the survey.

While there have been numerous IPOs during this period, with an influx of internet companies in recent quarters, it is interesting to note how the ownership has shifted over time. According to investors who participated in the survey, the withdrawal of government subsidies for alternative energy companies has led investors to shy away from the Energy space. Meanwhile, investors also revealed their continued interest in the prospects of China’s rising middle class and increasing consumption levels, as these relate to Consumer Services. This too mirrors the stable historical presence of the sector among ADR investments. When looking at Technology, it is important to note that Baidu Inc. alone accounts for 45% of total investment in Chinese ADRs. However, even after removing Baidu from total sector ownership, Technology remains the largest sector among Chinese ADRs. Investor opinions gathered through the survey indicate that Technology should remain the most-favored industry, at least in the near-term.

Figure 4: Proportion of Chinese ADR Investment by Sector

Source: Ipreo Research

*As of 05/15/2014
Trading in Chinese ADRs

Although investment in Chinese ADRs rose in dollar terms over the last five years, there was a downward trend in average trading volume during the same period. In mid-2008, average daily value traded (ADVT) peaked at $34M. However, since then volumes have fallen off, resulting in ADVT bottoming at $7.6M in the fourth quarter of 2012. Nevertheless, as seen in Figure 5 below, along with the U.S. equity market’s historic rise, trading volumes began to recover steadily in 2013, accelerating through early 2014, and reaching $21.4M ADVT in the first quarter of that year.

While this renewed interest in Chinese ADRs is encouraging, it is more important to note where this interest is coming from. Further analysis reveals that hedge funds have led the uptake in trading volumes, as Figure 6 below indicates.

Looking back at the IPO boom in 2010 and 2011, hedge fund investment in Chinese ADRs peaked in the beginning of the latter year. However, hedge funds largely stepped away from this market eventually, and along with it, trading volumes diminished significantly. More recently, hedge fund investment has surged, increasing to all-time highs in early 2014 and driving incremental growth in ADVT for Chinese ADRs.
Broad Market Sentiment on Investing in China

Survey participants point to notable economic, political, and regulatory events in China as key drivers of the attractiveness and risks associated with investing in China. Figure 7 below shows the major events over the last five years.

While quantitative analysis of ownership and trading volumes provides insight into how the investment landscape of Chinese ADRs has shifted over time, it does not reveal the sentiment that has been driving investors’ buying and selling decisions. The following pages of this report contain the key findings of the investor survey. Like previous surveys, it uncovers prevailing investor opinions and expectations of Chinese companies.

Figure 7: Total Investment in Chinese ADRs

*As of 05/15/2014

Source: Ipreo Research
Most Attractive Aspects of Investing in China*

![Graph showing the most attractive aspects of investing in China](image)

- Secular Growth of Emerging Market: 84%
- Addressable Market Size: 32%
- Attractive New Investment Opportunities: 28%
- Consumption Growth: 16%
- Economic Reforms: 16%
- Technology Developments: 16%
- Cheap Valuations: 16%

*Participants had the option of providing multiple responses. The top 7 responses are graphed.

As expected, institutional investors agree that the most attractive aspect of investing in China is its secular growth trend as an emerging economy. This trend is expected to benefit the social, economic, and investment landscape over the long term. Regardless of their near-term outlooks on the Chinese economy and concerns about investing in Chinese companies, investors recognize China as one of the most important emerging countries in the world because of its enormous addressable market and economic scale. Although investors acknowledge that the recent slowdown in GDP growth indicates a necessity for a market- or policy-driven correction, they see significant long-term, value-accrative potential for Chinese companies as the country shifts toward higher-value-added activities, continues to industrialize, demonstrates greater technological innovation, and undergoes economic maturation with the support of the new administration.

Along these lines, institutional investors are keen to see the National People’s Congress (NPC) demonstrate a clear focus on reforms that will shift the economy away from a State-controlled, investment-heavy model to a privately-led, consumption-driven growth model that would mirror the historical economic development of the United States. Following the NPC’s Third Plenum in November 2013, the government’s 60-point Economic and Social Reform Plan was announced. While not necessarily directly correlated, strong ownership and net buying activity trends for Chinese ADRs in recent quarters (Figure 7) parallel the market’s positive reception to the new reforms.

Investor Commentary

“China is going through a transition period where there are a lot of opportunities for growth from a low base. The GDP per capita is really low, so you can expect continued industrialization and more wealth that will help with consumption growth and productivity improvement.”

“Obviously, growth is slowing in China, but it is still growing much faster than the U.S. and other parts of the world. Also, there is a lot less coverage in China, especially on the small- to mid-cap companies, so there are new opportunities that are lesser known.”

“There are a lot of business models that are well-established in the U.S. and Europe that are just getting rolled out in China. You can make a lot of comparisons and assume that if they are able to replicate those business models, you will see great businesses emerge and have the opportunity to invest early in those businesses.”
**Investor Commentary**

“The most attractive aspects about investing in China are the huge market size, growth opportunities, and cheap valuations. A lot of the valuations for companies in China are cheaper than comparable companies in other countries. The growth in China is being driven by developments in e-commerce, mobile, online advertising, and cloud computing. Generally, consumption in China is growing, which should help many industries.”

“The most attractive aspect about investing in China is the enormous potential for growth and the relatively immature development of the Chinese market. The Chinese market is relatively undercovered and underinvested. There is also huge potential for consolidation in many industries in the Chinese market.”

Along with this economic transition, investors are keen to discover new investment opportunities at attractive valuations in China before the market matures, as they expect current domestic industry leaders have the potential to become multi-national leaders on the global stage. Furthermore, given China’s relatively immature capital markets, many investors look forward to financial liberalization, in terms of increasing efficiency, openness, and transparency, as drivers of overall investments into China. There is little doubt within the North American and European investment communities that China is an attractive market for equity investments, given its immense long-term potential and upward economic momentum, regardless of investors’ concerns about near-term volatility and their dissenting views on timing.
Many of the risks that investors cite stem from their prior experiences with investing in China. This cautious sentiment complements the trends in total Chinese ADR ownership and net selling from 2011 to 2012 (Figure 7), a time when several prominent cases of accounting fraud became headline news.

When discussing the greatest risks associated with investing in China, survey participants cite as a principal concern the general lack of transparency into corporate activities and financial performance. They approach investments in Chinese equities with extra caution because there is a greater level of opacity at both the operational level, given the prominence of VIE ownership structures, and financial level, due to sparse disclosure and occasional misleading reporting. Following several instances of accounting fraud, investors express skepticism about the reliability and veracity of financial reporting and auditing in China, citing their past experiences with fraudulent Chinese companies as harsh lessons learned.

Participants also express concern regarding the integrity of management teams, as they have encountered Chinese executives who proved to be over-optimistic, inexperienced in capital markets conduct, and lacking in accountability. Based on their previous experiences, investors require greater proof of management credibility before engaging them with complete conviction.

Greatest Risks with Investing in China*

<table>
<thead>
<tr>
<th>Risk</th>
<th>Percentage</th>
</tr>
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<tbody>
<tr>
<td>Lack of Transparency</td>
<td>64%</td>
</tr>
<tr>
<td>Uncertain Management Credibility</td>
<td>36%</td>
</tr>
<tr>
<td>Accounting Fraud</td>
<td>32%</td>
</tr>
<tr>
<td>Economic Slowdown</td>
<td>28%</td>
</tr>
<tr>
<td>Poor Investor Communications</td>
<td>28%</td>
</tr>
<tr>
<td>Corporate Governance Risk</td>
<td>28%</td>
</tr>
</tbody>
</table>

*Participants had the option of providing multiple responses. The top 6 responses are graphed.

Investor Commentary

“There are questions as to whether or not investors can even trust the Big Four audit firms in China and their local partners. The honesty and accountability of management ownership is also a risk. Concerns with the accuracy of the accounting details of Chinese companies are very important because, as an investor, you can potentially lose your entire investment based on fraudulent reporting.”

“Some of the risks of investing in China are due to the reforms of the new administration. We are starting to see that some of the secular growth trends may be delayed in the shorter term. Risks of a slowdown in the growth of the economy are also concerns. Sometimes Chinese companies’ management teams tend to be optimistic and mis-communicate to investors. Investors also have to take into consideration the level of corporate governance risk with Chinese issuers because some companies do not think about shareholder friendliness and corporate governance issues. A lot of Chinese companies do not understand that management is working for the shareholders of the company when it is a public entity.”
Investor Commentary

“The greatest risks with investing in China are the imbalances that come from a rapidly growing economy. It will be interesting to see if the government can manage the country’s transition into a normalized, slower-growth economy. The economy needs to adjust to slower growth and the government needs to smoothen out the inconsistencies taking place during the transition. Also, there are still many Chinese companies that have not transitioned to best practices for transparency, communication with the market, and overall investor relations.”

Related to this sentiment, investors also cite capricious executive teams as sources of poor communications and corporate governance risk. They cite repeated instances of selective disclosure as examples of shareholder unfriendliness and reasons for their distrust of Chinese companies’ communications. Furthermore, given the high level of opaqueness at Chinese companies, investors often question if their management teams are aligned with minority shareholders, noting that some companies exhibit inappropriate use of equity offering proceeds and a lack of internal risk and compliance controls. Notably, they also attribute these patterns of behavior to the generally ‘loose’ rule of law in Chinese capital markets. They state that domestic capital market regulations do not strictly hold individuals accountable for fraudulent behavior and that foreign holders of ADRs are offered minimal protection, as evidenced by the recent SEC auditor proceedings and the continued overhang of de-listing risk for Chinese ADRs.

While investors worry about these potential risks based on prior track records at individual Chinese companies, they also discuss government intervention and currency volatility as macro threats that are attributable across all industries in the country. Survey participants state that the NPC has proven to be inconsistent and unpredictable in its support for various industries, which adds risk to investing in China, especially for companies that are heavily reliant on government subsidies. Furthermore, as with any emerging market, currency risk is a strong consideration for investors, but more specific to China, the market is focused on the possibility of forthcoming yuan revaluation and the challenges it may pose to domestic Chinese companies.
Investor confidence in investing in China has an overall average rating of 3.20 on a 5-point scale (where 1=no confidence and 5=extreme confidence). Additionally, their average level of confidence has remained stable over the past year. According to survey participants, this is due to the compelling, long-term structural story of China remaining intact. However, they temper their enthusiasm because of the slower-than-expected growth in 2013 and the aforementioned risk factors. Investors agree that there have not been any major developments during the past year that have improved or weakened their confidence regarding China. Although this finding is not in line with the renewed interest indicated at the total ownership level, the next section reveals that investor confidence does not necessarily translate directly into buying decisions. Nevertheless, investor confidence is still important to analyze because, as shown earlier, a reversal in confidence is directly correlated with a drop in both trading volume (Figure 5) and buying activity (Figure 3) for Chinese ADRs.

Investors who are highly confident have extensive experience with Chinese issuers and hold great conviction in their own ability to perform thorough due diligence and distinguish attractive investment opportunities among China’s many companies. Most of these respondents say their increasing level of confidence over the past year is due to macro improvements that have been driven by greater regulatory oversight in the capital markets and promising government reforms that should support business development and create more investment opportunities. At the company level, they note that there have been an increasing number of investible Chinese companies with solid growth strategies and cheap valuations, coupled with declining fraudulent activity in China because the market is now more vigilant.
CONFIDENCE IN INVESTING IN CHINA

Investor Commentary

“Overall, we are positive about the Chinese market, especially for technology, media, and telecom. Over the past year, my confidence has remained the same. We see secular growth in the internet sector. Even though it is macro-related, we still see secular growth opportunities.

“My confidence depends on the specific company I am looking to invest in. It all depends on the fundamentals. Over the past year, my confidence has remained the same since I do not look at China’s entire economy. Rather, I look at specific companies, and in that respect, my confidence in the companies I invest in has not changed.”

Investors with waning confidence cite their concerns about economic deceleration, near-term volatility stemming from impending government reforms, weakening financial results at Chinese companies, a continued lack of transparency, and inflated expectations and valuations given the rebound in investor interest. Participants who have maintained the same level of confidence continue to err on the side of caution, given the generally underwhelming track record of Chinese companies and a lack of significant positive changes to alter their confidence.
PARTICIPATION IN NEW EQUITY PLACEMENTS

Will you participate in new equity placements for Chinese companies?

- Yes, 92%
- No, 8%

As mentioned earlier, despite mixed levels of confidence in investing in China, nearly all survey participants will consider participating in new equity placements by Chinese companies. Most of these investors believe that regardless of broader market factors, they take a bottom-up approach to investing and make decisions to partake in Chinese ADR equity placements on a case-by-case basis. In order to invest, they will thoroughly assess the company’s business fundamentals, management credibility, relative valuation, purpose for the offering, industry trends, and growth prospects. Many of these investors agree that the opportunities to find exciting, new investments in China outweigh the risks of investing in there, and therefore note that self-conviction in their due diligence process is critical.

The small subset of investors who do not plan to participate in new equity placements have lost all confidence in investing in China because accounting scandals and corporate governance problems have directly impacted their firms’ China funds. Their firms have since reallocated personnel and capital toward other countries and regions and do not have any near-term plans to reinvest in China.

Investor Commentary

“I will participate in new equity placements for Chinese companies depending on the valuations and attractiveness of the companies. I invest in Chinese companies with long positions because I expect to see robust growth from the Chinese economy over the long-term.”

“I will participate in new equity placements for Chinese companies. I prefer to take a long-term holding in new equity placements since we are overweight Chinese companies. It would not make sense to take a short position. Whether or not I invest in a company depends on the fundamentals of the specific company.”
With regard to IPO and Follow-on offerings (FO) by Chinese companies, most investors have no preference as long as the investment case is sound. Regardless of their responses, the survey participants’ views on this issue offer valuable insights into their perceptions of Chinese equity placements.

Investors highlight that the main benefit of a FO offering is a proven track record. They find more comfort in the lower risk profile that comes with the ability to track and measure a company’s historical record of executing the strategy, the credibility of its management, its operational history, and its financial performance. Given an appropriate purpose for a FO placement and a clear intended use of the capital, investors also appreciate that these offerings increase trading liquidity and increase a company’s market capitalization, which improve the investability of an ADR.

However, when discussing drawbacks of investing in secondary offerings, some survey participants point out that companies usually raise more equity when they have already outperformed, and thus, the valuations tend to be at a higher premium than with IPOs. As expected, investors agree that IPOs carry more risk, particularly for Chinese companies because they lack performance track records. Given this added uncertainty, some investors are attracted to IPOs because the ADRs are typically discounted and market skepticism provides greater valuation upside potential (again with the qualification that they must feel confident in their due diligence before investing). Nevertheless, they agree that IPOs carry greater burden of proof for long-term investing because there are numerous examples of U.S.-listed Chinese companies that have lagged relative to their IPO prices. A subset of survey participants interestingly notes that some Chinese companies become overly optimistic about true market value during the pre-IPO process, which puts the longer-term performance and marketability of the ADR at risk.

“Investor Commentary

“I prefer FO placements over IPOs because FO offerings provide you with a longer track record. FO placements come with a history that you can quantify and get context around. Companies issuing an IPO usually give you the information that they want you to know and that will paint a positive picture of the company. They do not do a good job of showing investors the more difficult aspects of the business model.”

“I prefer to invest in IPOs rather than follow-on offerings of established Chinese companies because most investors are skeptical of IPOs; therefore, it provides me more opportunity for a greater return.”

“It is more likely for us to invest in a FO of an established company. We are not very active in the IPO space. Based on the way we invest, a company has to have somewhat of a performance history and track record before we invest in it.”

Preference for Equity Offering Type

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<thead>
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<th>Preference</th>
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<tr>
<td>IPO</td>
<td>16%</td>
</tr>
<tr>
<td>FO</td>
<td>28%</td>
</tr>
<tr>
<td>No Preference</td>
<td>56%</td>
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</table>

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As expected, investors agree that IPOs carry more risk, particularly for Chinese companies because they lack performance track records. Given this added uncertainty, some investors are attracted to IPOs because the ADRs are typically discounted and market skepticism provides greater valuation upside potential (again with the qualification that they must feel confident in their due diligence before investing). Nevertheless, they agree that IPOs carry greater burden of proof for long-term investing because there are numerous examples of U.S.-listed Chinese companies that have lagged relative to their IPO prices. A subset of survey participants interestingly notes that some Chinese companies become overly optimistic about true market value during the pre-IPO process, which puts the longer-term performance and marketability of the ADR at risk.
Generally, institutional investors’ forward-looking perspectives on China are based on their outlook on the timing of impending government reforms and the expected impact of these measures on economic growth. Most survey participants maintain conservatism over the near-term and shift toward more bullish outlooks over the longer term. These investors who hold an underweight or neutral one-year outlook anticipate that increased market volatility and economic deceleration caused by the expected growth model transformation will offer significant near-term headwinds for Chinese companies. Furthermore, given uncertainties surrounding the NPC’s implementation of reforms and the SEC’s suspension of Chinese accounting units, as well as continued concerns about transparency and recent price inflation of Chinese equities, these investors find it too risky to be overly constructive presently.

As evidenced by the increasing overweight outlooks on China over three years, most investors look forward to the benefits of the NPC’s economic reforms resulting in greater capital markets stability and sustained economic growth, which will benefit Chinese companies. Furthermore, these participants also expect that over time Chinese capital markets will become more efficient and transparent through improvements in the regulatory framework, corporate governance practices, and management credibility, while foreign institutional investors continue to develop greater aptitude for investing in Chinese equities, both of which will drive overall investment in the country.

As a departure from the majority opinion, the outliers of the survey population are investors who move from overweight to neutral or underweight over the next three years. These participants argue that specific sectors look attractive currently because of pending support from government subsidies and that select companies appear undervalued. However, they exercise more caution in their three-year outlook because they question the sustainability of these trends. Again pointing to the structural issues facing China’s economy and the NPC’s large task at-hand, these investors believe that significant risks will persist beyond the next three years and that current market expectations are inflated.

**Investor Commentary**

“**My one-year outlook is neutral because China is in the process of undergoing economic reforms that will take time to improve the quality of the market. My three-year outlook for China is overweight because the hope is that the new government will implement sufficient reforms to shift the old model to a newer, more sustainable, and high-quality growth model.”**

“I expect the economic reforms to have positive effects on the long-term outlook of the Chinese market. It all depends on how the current issues are tackled and how the reforms of the government are executed. If this goes positively, I think there is a lot of value in today’s market of Chinese companies.”

“It is a relatively cheap market at the current moment. My outlook shifts from overweight to neutral because there are a lot of structural issues that China has to sort out. While that happens, a lot of the large companies that we can invest in are going to face headwinds. The structural problems the country is facing will take five to ten years to sort out.”
Regardless of their current and future outlook for China, most investors agree that a macro view may not necessarily capture the pockets of opportunity that exist in specific sectors throughout the country. Survey participants re-emphasize the importance of performing thorough due diligence and investing strategically when considering the Chinese equity market. In order to gauge where investor interests currently lie, investors were asked which sectors of China’s economy they find most attractive.

Consistent with data showing the proportion of Chinese ADR investments by sector [Figure 4], recent new equity placements, and the pipeline for pending Chinese IPOs, investor sentiment shows a clear preference for the Technology sector. While the investment trends in Tech have been seen across developed and emerging markets, ADR investors see immense opportunity for Chinese technology companies to benefit from rapidly-growing consumer demand for technology. At the mid-industry level, nearly all of these survey participants point to Software & Services as an exciting space driven by the increasing prevalence of internet, e-commerce, mobile platforms, and social media. Investors state that the growth of consumption and wealth within China’s massive addressable consumer market will continue to fuel widespread internet usage, allowing Chinese companies to establish innovative business models and achieve economies of scale. They view the growth of e-commerce as a major retail channel and the shift of internet traffic from PC to mobile as drivers of investment opportunities in the space. Notably, a few investors who acknowledge that Tech is appealing also point out that the recent popularity and headlining IPOs of the sector have inflated valuations, which dampen their enthusiasm for investing in it.
When discussing Industrials, most investors are focused on Environmental Services because the NPC has acknowledged the overwhelming pollution issue and highlighted environmental protection as a top priority. Survey participants expect substantial government subsidies that could benefit companies that supply environmental solutions, pollution control, and waste management. Interestingly, no investors mention Energy as an attractive sector, and similarly, our quantitative analysis shows that the industry has declined since previously dominating the Chinese ADR market (Figure 4). This shows that over time, investors reallocated their Energy investments elsewhere. While recent sector ownership still does not show an influx of asset allocation to Industrials, this qualitative sentiment may shed light on the forward-looking proportion of Chinese ADR investments by sector.

Given the expected consumption growth trends that will be aided by economic and social reforms, North American and European investors see attractive opportunities in both Consumer Services and Consumer Goods. Investors understandably expect increased demand for consumer discretionary products and services due to China’s rising income levels and growing middle class. More specifically, some survey participants highlight Retail, Media, Education, and Travel/Leisure as appealing areas within Consumer Services, while a few others look to Automotive and Electronic Equipment as pockets of opportunity within Consumer Goods. This insight is consistent with sustained ADR ownership of the Consumer Services sector over the last five years (Figure 4).

A smaller set of investors highlight Financials because they believe market concerns about transparency and industry reforms have led to depressed valuations within the sector, which is attractive from an entry-point perspective. Meanwhile, investors who cite Healthcare as an attractive sector anticipate that demand will increase over time, in light of China’s aging population and substantial pollution problems throughout the country.

Investor Commentary

“The government is committed to reforming the environmental, healthcare, and education service industries. I think these types of service industries will flourish and develop. For example, the government is looking to overhaul the energy industry by changing the energy mix to control pollution more.”

“I find any sectors that are impacted by domestic consumption to be the most attractive in China because these sectors will be helped dramatically by the economic reforms that are underway. The reforms will encourage more people to allocate their wealth toward consumption spending rather than fixed investments or savings.”
Most investors indicate that Chief Financial Officers (CFOs) and Investor Relations Officers (IROs) of Chinese companies typically fall short of market expectations. Therefore, they are unconvinced there will be any significant changes to this situation. However, they believe this presents a tremendous opportunity for executives of newly-public Chinese companies to approach the market in a differentiated manner, one that could foster strong relations with the investment community outside China.

The investment community values discussions with the CFO of any Chinese company planning to go public as an instrumental part of their due diligence process. As evidenced by the wealth of responses to this area of the survey, investors rely heavily on the CFO of a company not only for honest, transparent financial color, but also in-depth, balanced strategic discussions. Survey participants state that the CFO of a Chinese company should demonstrate a keen ability to articulate a clear overview of the company’s strategy, competitive positioning, operations, and growth prospects, all within the context of quantitative data and supported by underlying financial reasoning. In fact, many survey participants acknowledge that rather than proficiency in English or general financial expertise, they prefer to speak with CFOs who have a deep understanding of the specific companies where they are employed. Related to these expectations, some investors also cite the importance of a CFO with a long-term strategic perspective, who can both support and challenge the CEO’s vision instead of solely playing the role of a “bookkeeper.” Relaying a longer-term view of financial performance as it relates to strategic initiatives also lends credence to a CFO during the IPO process because investor decisions are predicated on their confidence in a company’s growth prospects.

Important Qualities for CFOs of Chinese Companies*

<table>
<thead>
<tr>
<th>Important Qualities</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Business and Industry Knowledge</td>
<td>60%</td>
</tr>
<tr>
<td>Financial Competency</td>
<td>36%</td>
</tr>
<tr>
<td>Honesty</td>
<td>36%</td>
</tr>
<tr>
<td>Transparency</td>
<td>32%</td>
</tr>
<tr>
<td>Straightforwardness</td>
<td>32%</td>
</tr>
<tr>
<td>Long-Term Strategic View</td>
<td>28%</td>
</tr>
<tr>
<td>Relevant Experience</td>
<td>24%</td>
</tr>
<tr>
<td>Conservatism</td>
<td>20%</td>
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</tbody>
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*Participants had the option of providing multiple responses. The top 8 responses are graphed.

Investor Commentary

“The CFO should be able to link the financial numbers of the company to the underlying content of the strategy. The numbers should be the CFO’s expertise, but he or she should also be able to discuss the numbers in the context of what they represent. This makes the financial discussion more meaningful.”

“The CFO of a soon-to-be-public Chinese company should not misrepresent the company’s financial statements. They should also be able to push back on the CEO, if needed. They should be open and communicative with investors. As expected, the CFO should have a background in financial accounting and control. I expect the CFO to be sharp and competent.”

“My main expectations for the CFO of a Chinese company are integrity, command of the financial numbers, and an understanding of how to set low expectations. A lot of CFOs talk during the quiet period or partake in selective disclosure, which raises questions about their integrity.”
While knowledge and financial competency are essential, most investors also discuss the necessary intangible qualities of a CFO, especially for Chinese companies, given market concerns about fraud and accountability. Investors highlight three distinct characteristics that collectively lend to the credibility of a CFO of a Chinese company going public, which in turn, determines their level trust and confidence in making an investment. First and foremost, the investment community expects honesty, in terms of truth and integrity in the CFO’s statements, which provides assurance that information on financial performance, capital strategy, and operational metrics is not being falsified. Secondly, investors expect transparency, which is reflected in the breadth and depth of financial color that the CFO conveys to the market. The third tenet of CFO credibility is straightforwardness, which is measured by the ability to answer questions in a clear, direct manner and to discuss a balanced investment story that covers both positive and negative aspects of a company’s outlook. While trust takes time to build and many investors have been scarred by past investments in Chinese companies, CFOs of newly-public companies in China can set an encouraging first impression by demonstrating these traits.

A smaller portion of survey participants state they have added confidence in Chinese CFOs if their résumés include prior experience in a high-level finance position within the company, sector, or a U.S.-listed multinational company. Investors also place emphasis on conservatism, stating that best-in-class CFOs should be realistic about growth targets and financial performance in order to prevent overpromising and underdelivering. In general, they agree that underperforming versus guidance that is communicated during the IPO process is highly negative for any recently-public company, but particularly for Chinese companies because there is already a stigma about transparency and management credibility.

Investor Commentary

“I expect the CFO of a Chinese company to be transparent, accessible, and knowledgeable about the business. I would like for the CFO to be someone who focuses on and understands the operations of the company.”

“My main expectation for CFOs of soon-to-be-public Chinese companies is for them to provide quality disclosure of financial numbers that adheres to credible accounting standards. It is important for the CFO to understand how the market works. If they are trading publicly, then they need to be aware of their public statements about the company. The market is going to react to the actions and statements of these executives. If they give certain guidance, they have to stick to it.”

“My main expectation for the CFO of a soon-to-be-public Chinese company is for him or her to have deep knowledge of corporate governance, in terms of how the Board of Directors is being run, who the members are, and what skills they bring to the Board. I also expect the CFO to provide transparency into the operations of the company.”
When providing suggestions for IROs of soon-to-be-public Chinese companies, investors discuss their observations of the role that investor relations typically plays in U.S.-listed Chinese companies and offer recommendations based on them. Consistent with previous surveys, accessibility and responsiveness are important qualities for any IRO, but IR representatives of Chinese companies should be especially mindful of the international investment community and investors’ different time zones. While global investors understand that the latter is an innate impediment, they also expect IROs of Chinese companies to be equally attentive and timely in responding to their requests. Beyond the logistical requirements of the role, some survey participants state they have few or no definitive expectations of Chinese IROs based on their previous experiences, because they have noticed that the IR function is typically only a conduit to executive management and lacks autonomy and the ability to add value beyond providing basic information. They state that IROs of Chinese companies are usually trained to tell the basic investment story only and what they communicate is ultimately superseded by the Chairman, CEO, or CFO with regard to strategic issues. In order to combat this market perception of IR within Chinese companies, survey participants recommend that IROs showcase a deep knowledge of managements’ long-term strategic goals, in order to partake in high-level discussions with investors as well as broker analysts. Some also suggest that IROs should be well-versed in topics that extend beyond the company, in order to thoroughly discuss industry trends, macroeconomic developments, and the regulatory landscape.

**Important Qualities for IROs of Chinese Companies***

<table>
<thead>
<tr>
<th>Quality</th>
<th>Percentage</th>
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</thead>
<tbody>
<tr>
<td>Accessibility and Responsiveness</td>
<td>56%</td>
</tr>
<tr>
<td>Strategic Knowledge</td>
<td>40%</td>
</tr>
<tr>
<td>Open and Honest Communications</td>
<td>36%</td>
</tr>
<tr>
<td>Ability to Answer Questions</td>
<td>28%</td>
</tr>
<tr>
<td>Macro Knowledge</td>
<td>20%</td>
</tr>
<tr>
<td>Capital Markets Experience</td>
<td>16%</td>
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<tr>
<td>Financial Understanding</td>
<td>16%</td>
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</table>

*Participants had the option of providing multiple responses. The top 7 responses are graphed.

**Investor Commentary**

“I expect IROs of Chinese companies to have openness, honesty, and strong communication skills. My professional experiences with IROs of Chinese companies going public have forced me to have low expectations of them in general. When the company has atypical questions to address, management tends to step in and handle the situation.”

“A lot of times when we meet with Chinese companies, the IR and management teams have a very bureaucratic tone that is not very helpful. Usually, we look to the IR teams for information. The IRO should have good knowledge of the direction of the company and potential issues that may come up.”

“I have much lower expectations for the IRO of a soon-to-be-public Chinese company. I would appreciate someone who has experience communicating with investors. Ideally, you want to have an IRO who is very responsive and not just an extension of the PR department. They should work collaboratively with C-level executives to get them to disclose things that are relevant to the Street.”

When providing suggestions for IROs of soon-to-be-public Chinese companies, investors discuss their observations of the role that investor relations typically plays in U.S.-listed Chinese companies and offer recommendations based on them. Consistent with previous surveys, accessibility and responsiveness are important qualities for any IRO, but IR representatives of Chinese companies should be especially mindful of the international investment community and investors’ different time zones. While global investors understand that the latter is an innate impediment, they also expect IROs of Chinese companies to be equally attentive and timely in responding to their requests.

**EXPECTATIONS FOR CFOs AND IROs OF SOON-TO-BE-PUBLIC CHINESE COMPANIES**

Continued
Moreover, participants expect IROs to demonstrate an understanding of finance that enables them to appropriately relay updates to the market and properly guide market expectations for financial performance.

Equipped with business, macro trends, and financial knowledge, IROs can credibly articulate the investment case, effectively provide greater transparency, and factually answer investor questions. Investors agree that IROs can only serve as valuable resources both during and after the IPO process if they have access to C-level insight and the business and financial acumen to provide additional color to published information. Rather than redirecting questions to management, providing unreliable answers, or evading sensitive topics, best-in-class IROs are tuned in to management’s discussions, which gives them access to a deep well of knowledge when fielding investor questions.

Additionally, a portion of participants value IROs that have capital markets experience because it allows them to understand how best to communicate with the broader investment community, what is most important to investors and analysts with regard to financial modeling, and how the equity markets function generally.

Notably, given the language barrier that typically exists between global institutional investors and executives of Chinese companies, it would be understandable for investors to expect CFOs and IROs to speak English fluently. However, only a few survey participants highlight this trait as a key expectation, which proves that knowledge, credibility, openness, and experience are the critical factors that Chinese executive teams should prioritize.

Investor Commentary

“Outside of China, European and American companies not only provide financial information, but also non-financial indicators. For example, investors care about corporate governance and sustainability as well, in terms of how the company is thinking in these areas. It would be helpful for IROs of Chinese companies to be able to talk about some of these non-financial issues on top of the financial topics.”

“The IRO needs to have good communication skills and be responsive to investors’ requests. They should not shy away from sensitive topics. Quite a few IROs will deflect when they do not know answers to questions. Rather than giving a generalized answer, the IRO should go back to management and follow-up with the answer to investors. IROs are the first point of contact that we have with the company.”

“My main expectation for the IRO of a soon-to-be-public Chinese company is for him or her to have a detailed understanding of the financial numbers related to the company. They should also be available to actively communicate and relay that understanding to investors. The IRO should also have knowledge about the industry that the company operates in.”
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