**ASIA**

# China's Sci-Tech Board: Hope or Hype?

June 17, 2019

Jason Zhu
Director of Portfolio Management - China Equities
Franklin Templeton Emerging Markets Equity

China will be launching a Nasdaq-style stock market for technology and research-driven companies to list and raise capital. While it has some detractors, Franklin Templeton Emerging Markets Equity believes this upcoming board is of strategic importance to China. Jason Zhu, director of portfolio management—China Equities, says it could rev up China's emergence as a research powerhouse and help emerging companies grow into industry champions, but the team will be watching at least two key factors—the quality of companies listed and their valuations.

## Big Ambitions

In November of last year, Chinese President Xi Jinping unveiled plans to launch a science and technology innovation board on the Shanghai Stock Exchange. The board promises to accelerate innovation in China by offering a dedicated platform for technology and research-driven companies to list and raise capital. Market observers have been quick to draw parallels between the board and the United States' Nasdaq.

We are positive about the move. We believe the sci-tech board is of strategic importance to China as it presses on with economic restructuring. The board could rev up the country's emergence as a research powerhouse. Despite widespread perceptions of China as a skilled imitator, it has begun to lead as an innovator in several areas. Consider how it topped the world with a 43.6% share of global patent filings in 2017—more than double the United States' 19.2% share—or how its research and development spending has risen to 2.13% of its gross domestic product, compared with an estimated 1.96% for the European Union.[1]

In fields where China needs to catch up, the board could bring in funding and give it a vital leg up. Overall, we see the sci-tech board making an impact in several ways.

1. **Broaden Access to Private Capital**

Equity markets are central to capitalism—they link companies hungry for cash to investors seeking returns. China's liberalization in the past few decades has been accompanied by the blossoming of its stock markets, which helped fuel the rise of "old economy" giants in areas such as energy, mining, property and banking amid the country's investment-led growth. Most of these companies had proven themselves with established business models before they could list. But China's economic priorities have evolved. So too, should its financial markets. As China pins mounting hopes on innovation to drive higher-quality growth and technological breakthroughs, we think the sci-tech board's creation is timely. It would enable not just high-tech start-ups to raise cash, but also venture capital and private equity funds to exit their investments and redeploy capital. Altogether, the board could encourage private capital investments in the technology scene.

The implications go further. A stock market that better serves China's real economy can potentially improve capital allocation in a country that has been criticized for handing out state subsidies and other forms of aid. We see the sci-tech board creating room for the government to reduce support, which should strengthen the economy's efficiency and longer-term resilience.

2. **Deepen Capital Market Reforms**

China's equity markets, though massive, remain uninviting for some investors and high-quality companies looking to list. Among their concerns are strict practices that rein in market forces and impede efficiency. These include an approval-based system for initial public offerings (IPOs), a profitability requirement for listing candidates, an unofficial but widely observed cap on IPO valuations and daily price limits for stocks.

China has pledged to reform its capital markets, and we view the sci-tech board as a pivotal testing ground. It would mark several "firsts" in the country as it shifts to a registration-based IPO system and accepts unprofitable companies. It would also waive the implicit IPO valuation cap and loosen daily price limits. We expect these features to give market forces greater sway and make IPOs faster and more transparent. Some of these features could also be applied to other domestic exchanges in the future.

We believe the board reflects China's commitment to making its capital markets more open and competitive. For Shanghai especially, the board could aid its bid to become a global financial center. Beyond pulling in capital, the board is likely to inject dynamism into the financial ecosystem.

3. **Promote Industry Upgrade**

We view the sci-tech board as a critical prong of China's plan to move its industries up the value chain. Its economic rebalancing and technological survival would depend heavily on its ongoing transition from a cheap maker of low-end goods to a developer of high-tech and high-margin products.

In the sci-tech board's focus are strategic industries such as semiconductors, big data, advanced equipment, new energy and biomedicine. We note that China lags the West in some of these areas, and the infusion of private capital could give it a boost in catching up and building a lead. For companies with convincing strengths in innovation, the board is a prime channel of financing.

## Flourish or Fail

The sci-tech board has its detractors. Worries of a rapid boom and bust loom especially large. Chinese investors have historically shown outsized interest in new bourses and listings, driven in part by confidence in the IPO approval process and a belief that capped IPO valuations spawn easy returns later. ChiNext in Shenzhen, for example, had surged on investor exuberance shortly after its debut in 2009, only to sink when interest waned. Understandably, market excitement around the new sci-tech board has stoked caution. We believe China has gleaned lessons from the past, and has enacted measures to prevent bubbles on the new sci-tech board.

## What We're Watching

As fundamental investors in search of sustainable investment returns, we will be watching at least two key factors—the quality of companies listed and their valuations. To be sure, much remains to be seen until the board starts trading. By late April, 90 companies from industries ranging from advanced equipment to biomedicine had cleared the initial checks needed to list.[2] Most applicants were not high-profile market leaders, which is unsurprising as bigger names are more likely to be listed already.

Broadly speaking, we expect regulators to be mindful of the overall quality of companies listed, especially in the near term as they work to cement market confidence in the board. Short-term valuations on the sci-tech board could be choppy.

As a whole, we think the sci-tech board is well-placed to help emerging companies grow into industry champions in the long run. But identifying companies with the right potential would require investors to have strong research skills.

Especially for firms with short track records or early-stage innovation, financial analyses should be accompanied by hands-on research, including company visits and meetings with suppliers, regulators and other major stakeholders, to build a well-rounded view of their prospects. Shares of such companies could also be more volatile and less liquid, which would affect portfolio construction. Until we can identify good-quality companies that demonstrate enduring earnings power but appear mispriced by the market, we are likely to stay on the sidelines.

## All Aboard?

All said, we welcome the launch of the sci-tech board. We view it as a crucial step in China's economic restructuring, especially in its race to become a leading innovator and pursue technological independence from the West. The board is likely to broaden companies' access to private capital and deepen capital market reforms. It also has a significant part to play in upgrading China's industries, by unlocking a source of financing for homegrown companies in high-tech or research-intensive fields.

Still, we see a need to distinguish the macro from the micro. In our search for sustainable investment returns, we will be paying close attention to the quality of companies listed and their valuations.

## Important Legal Information



## What Are the Risks?

**All investments involve risks, including the possible loss of principal.** Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Investments in fast-growing industries like the technology sector (which historically has been volatile) could result in increased price fluctuation, especially over the short term, due to the rapid pace of product change and development and changes in government regulation of companies emphasizing scientific or technological advancement or regulatory approval for new drugs and medical instruments.

Actively managed strategies could experience losses if the investment manager's judgment about markets, interest rates or the attractiveness, relative values, liquidity or potential appreciation of particular investments made for a portfolio, proves to be incorrect. There can be no guarantee that an investment manager's investment techniques or decisions will produce the desired results.

1. Sources: WIPO (2018). World Intellectual Property Indicators 2018. Geneva: World Intellectual Property Organization; OECD (2019). *Main Science and Technology Indicators*, Volume 2018 Issue 2, Publishing, Paris.

2. Source: Shanghai Stock Exchange, “Q&A on First Round of Inquiries and Replies for Sci-Tech Innovation Board,” April 23, 2019.