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China's Emerging Financial Markets

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> *If you have a strong constitution and do not try to be a clever stock-picker, but rather decided to buy every existing (Chinese) B-Share issue, and every (Chinese) issue that came, I have little doubt you would make a lot of money over the years.*
>
> —Benjamin H.B. Wrey, Chairman, Henderson Administration Group PLC

> *Police with cattle prods and batons battled to keep order last night as thousands of Chinese thronged to Shenzhen for the chance to buy shares in a wave of get-rich-quick fever.*
>
> *China's capitalist revolution went mad with a deluge of people hoping for the chance to buy shares in the city's Stock Exchange.*
>
> *Queues formed outside more than 300 locations, sparking disturbances and surprising the authorities who were preparing for a potentially explosive situation when doors opened this morning...*
>
> *So great was the demand for stocks and so small the number of shares that the announcement of new issues caused mayhem.*
>
> -Kennis Chu and Gary Chan
> "Shenzhen Shares Frenzy: Thousands Queue For Capitalism,"
> *South China Morning Post*, Front Page Lead Article, August 9, 1992

After a long break over the Chinese New Year's holiday, Tom Lee, president and managing director of Asia-Pacific Investment Consultancy (APIC), returned to his office located in the Bank of China Tower on the morning of Friday, February 19, 1999. He was not anticipating much work today. Most of his clients were also observing the holiday. More importantly, the Asian financial crisis that started in the summer of 1997 had significantly

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Prepared by Kulwadee Wangkeo under the direction of Professor Wei Li, Darden Graduate School of Business. The authors gratefully acknowledge the financial assistance of the Darden School's Batten Institute. This case was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation.

reduced the demand for his consulting services as investors fled emerging markets. He had built his consulting business by cultivating client relationships and by recruiting the best and the brightest. After the Russian default in 1998, he had to lay off one-third of his employees, the toughest decision he ever made. But the worst seemed to be over. Stock indices in Southeast Asia and China started to rebound in the fall last year, and the devalued regional currencies appeared to be stabilized. He was hopeful that investments would start to flow back and his business would pick up. He sat down at his desk with a cup of tea and started to examine the to-do list that his assistant prepared for him. He paid no attention to the view from his office window of the Victoria Harbor in Hong Kong. There wasn't enough on the to-do list to keep him busy for a day. He thought perhaps he should go home early and start calling his clients in the United States in the evening.

Then the phone rang. It was Susan Ellison, one of Tom's long-time clients and a co-manager of a United States-based diversified international mutual fund. Susan parked a small portion of her mutual fund in Asia's emerging markets before the crisis and suffered large losses in 1998 when she liquidated her holdings of emerging markets stocks in Asia. As the markets showed signs of recovery, Susan wanted in. But she was more cautious this time.

"Prices look reasonable in Hong Kong and Singapore," she told Tom over the phone. "But what is most intriguing to me is the growth potential in China," she continued. "The impact of the financial crises in Asia and Russia did not seem to have much impact on China. So we are really interested in exploring investment opportunities in the Chinese stock market. But first we want to understand the Chinese market."

Before she called Tom, Susan had spent some time analyzing China's stock markets. She noticed the rapid expansion of the stock market with hundreds of new firms listed every year in the past five year. She also uncovered some puzzling features about the Chinese market. China, like a number of other countries, imposed ownership restrictions on foreigners seeking to acquire shares in domestic firms. Much more unusual, however, was the fact that China also restricted the amount of shares that could be purchased by domestic investors. Uniquely, foreign investors in China paid much less than domestic investors for intrinsically identical shares. Before she decided to invest in China, she wanted to know what made the Chinese market so special. Knowing Tom's expertise in the Chinese financial market, she called to pick his brain. She also wanted to get Tom's advice on how best to approach investment in China.

After he spoke with Susan, Tom pondered what he should say to her. While China was a fast-growing economy, there were many things to consider before making a portfolio investment. China's stock market remained tightly regulated in some aspects but loosely regulated in other aspects. Tom promised Susan he would send her a preliminary report and a recommendation in a week.