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McKinsey on Corporate and Investment Banking
Asia-Pacific

The next decade of innovation and transformation in China's securities industry

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The Chinese securities industry is posting healthy numbers again, thanks to significant restructuring and a market recovery over the past ten years. Industry revenues increased from RMB 13 billion to RMB 163 billion between 2005 and 2011, despite three tough years in 2009, 2010, and 2011. Over the same six-year period, the industry moved from a loss of RMB 6 billion to a RMB 46 billion profit. But these gains offer a misleading picture: in our view, the business model on which the industry's success is built—retail dominated, cash-market focused, undifferentiated, and low skill—is unsustainable.

Most Chinese securities firms offer identical services and look alike from the outside. For example, they all collect commissions to execute trades, charging nearly the same prices to do so. In addition, the ups and downs of the market and uncertainties about China's future economic growth determine their fates. In 2012, the mood has turned sour again.

After the industry cleanup of the last ten years, we think a big transformation is necessary and probable in the next decade. During this period, securities firms will confront both long-term, highly predictable structural trends and less predictable external shocks. Structural trends include steady and deliberate regulatory changes, product and service innovation, evolution of customer behavior, and shifts in competitive behavior related to the increased maturity of the market in most Chinese provinces. Less predictable shocks are macroeconomic volatility and seesawing investor sentiment. They also include low probability but high impact events—for example, the entry of foreign competitors into China or the creation of a more integrated banking-and-securities market, opening the door to integrated wholesale banks similar to those that dominate securities markets in most of the world.

Experience from abroad shows that Chinese securities firms must decide which businesses to emphasize—retail brokerage, institutional brokerage, investment banking, asset management, or private equity. Experience also shows that they should develop more differentiated customer offerings within each of these businesses while simultaneously improving their economics.

Two factors will complicate these choices for the CEOs of Chinese securities firms. First, many of the successful business models in the West will be hard or impossible to emulate because of China-specific regulatory and customer behavior constraints. Second, unanswered questions about the pace of regulatory reform and high market volatility create significant uncertainty about the level of future revenue; for example, there's more than a 160 percent difference between the pessimistic and optimistic scenarios that we have developed about the financial industry's future.

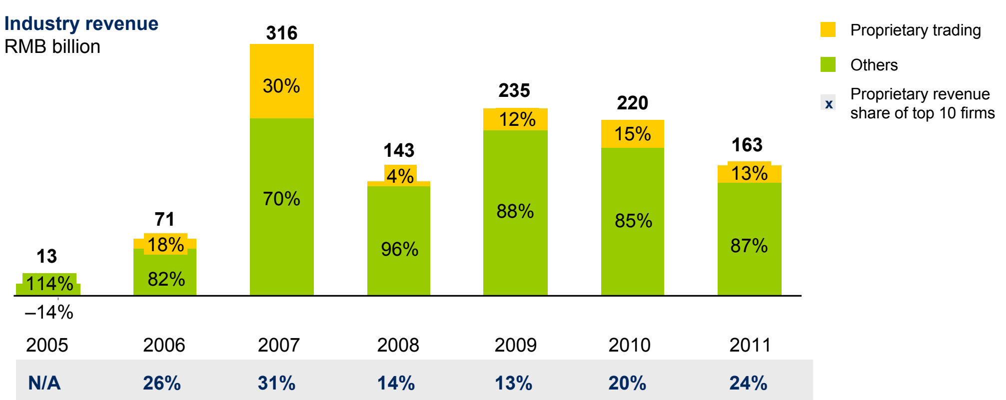
What is certain is that the industry will look very different by 2020. Securities businesses tend to be winner take all, at least when markets mature. Firms that aspire to industry leadership must make difficult strategic and business model choices today.

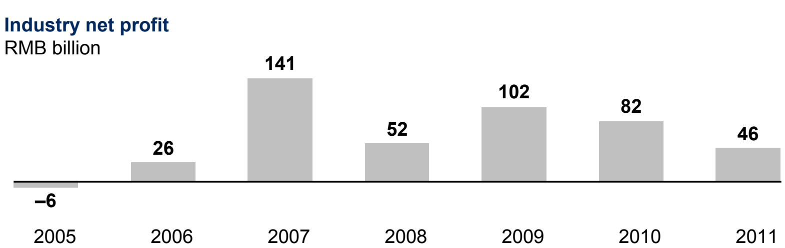
STATE OF THE INDUSTRY: TURNED AROUND BUT NOT TRANSFORMED

The industry hit bottom in 2002 as a collapse in market valuation and turnover exposed vulnerability in the economic models of many leading firms. Prominent failures led to industry restructuring, including several big mergers. In 2005, the industry suffered another collapse, prompting further restructuring and the creation of different categories of brokers.[1] Only the "advanced" category was able to engage in all businesses.

Since then, the industry has further consolidated: the number of brokers has shrunk from 175 to about 110, with the top ten players controlling about 45 percent of market share. The leading firms are also less structurally dependent on proprietary trading. Capital ratios have strengthened; firms are operating with significantly lower gearing, even by international standards. As noted, profitability has recovered, standing at RMB 46 billion in 2011. Most important, the industry has remained profitable through a cyclical market downturn, which it had not managed to do during previous cycles (Exhibit 1).

Exhibit 1 Profitability and concentration in China's securities market can be examined.





Source: Wind

1 There are four categories of securities firms: advanced, standardized, C, and D.

Growing institutional base

Retail investors still dominate from a volume perspective. However, the creation of a mutual-fund industry, the growth of segregated accounts, and relaxed investment rules for insurers (now allowed to invest up to 20 percent of their holdings in equities markets) all have contributed to significant growth in the institutional-investor base. These investors represent 70 percent of equities holdings and about 30 percent of equities turnover, which is likely to grow to more than 35 percent by 2016.

Increasingly diverse primary markets

Most large state-owned enterprises (SOEs) are now listed, and large companies have shifted from primary to secondary offerings. In 2011, about 40 percent of the capital raised by Chinese companies on the mainland and in Hong Kong came from initial public offerings (IPOs) compared with 60 percent five years before. The creation of ChiNext for midcapitalization IPOs prompted the listing of more than 300 firms; midsize enterprises[2] now represent more than 70 percent of total IPO revenue compared with 30 percent five years ago. The total market capitalization of shares listed on ChiNext hit RMB 743 billion by December 31, 2011.

Evolving economics of the cash equities business

Retail-brokerage commissions fell following deregulation in 2002. Retail commissions dropped to 10 basis points, from about 16, while institutional commissions dropped to 8 basis points, from about 11.[3] Still, commissions remain higher than typical Asian capital market averages. In addition, retail Internet brokerage exceeds 70 percent penetration, approaching levels in most mature Asian markets.

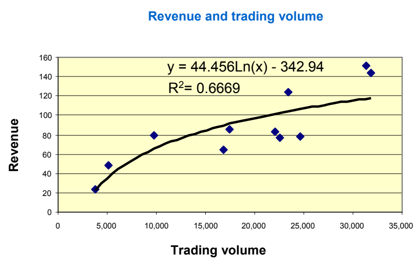
Despite these changes and a return to health, the securities industry is just starting its real transformation. It remains dominated by large and mostly undifferentiated domestic firms with revenue highly dependent on cash commissions and directional proprietary-trading bets; combined, these two streams represented 62 percent of the top ten firms' revenue in 2011. As a result, profits remain highly correlated with market turnover, mostly dependent on bull-market business models, and building scale in increasingly commoditized markets (Exhibit 2).

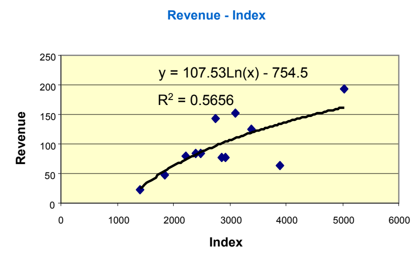
2 Midsize enterprises have annual revenues of between RMB 30 million and RMB 300 million.

3 Note that some firms are able to capture higher commissions—above ten basis points—from their institutional businesses by providing better research and services. On average, though, the industry has been getting below ten basis points.

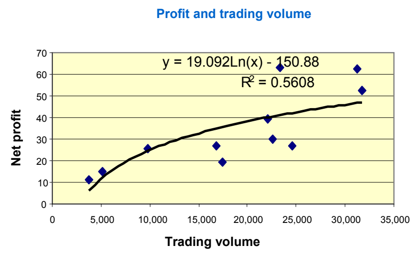
Exhibit 2 There are correlations between revenue/profit and index/trading volume.

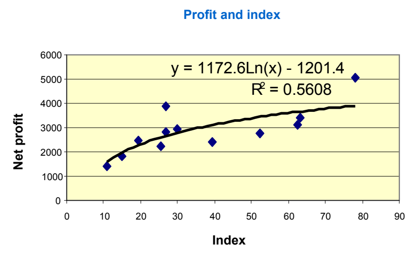
Correlation between revenue and trading volume/index





Correlation between net profit and trading volume/index





1 When conducting regression of revenue/profit and trading volume, data from H2 2007 was an outliner and thus was removed.
2 Numbers are on a half-yearly basis.

Part of the reason that profit is highly correlated with market turnover is that capital markets are still relatively immature. Despite significant growth, debt markets remain very small. There is still no market for corporate control. Cash equities markets remain highly volatile. In addition, securities firms have remained protected from foreign competition and have few incentives to differentiate themselves during the good times.

The remainder of this report explores what might happen in the next ten years. We argue that significant changes are likely—especially in what constitutes successful business models—and that Chinese securities firms able to anticipate them will be much better positioned than competitors.

MARKET SCENARIOS: SLOWER GROWTH WITH SIGNIFICANT UNCERTAINTY IN ECONOMIC OUTCOME

Before discussing the types of business-model changes possible over the coming decade, it is useful to address where longer-term structural shifts are taking the industry, where revenues are likely to come from, what external shocks may occur, and what competition may come from the outside. We developed three scenarios of the evolution of the securities market.

After years of fast growth, Chinese securities markets have experienced a downturn since 2010. What happens next is anybody's guess. Uncertainty is high—the difference between revenue levels in our market scenarios is 160 percent, much higher than in any other large financial services sector we have modeled in China. In generating these scenarios, we have considered several relatively predictable structural factors and taken note of significant uncertainty about the speed of market recovery and the pace of deregulation. CEOs of securities firms should ensure that their business models can respond to widely different revenue outcomes so that they can stay profitable.

Structural factors could lead to slower but comfortable 11 to 16 percent annual growth over the medium term

Many knowledgeable observers are pessimistic about the industry. Indeed, 2011 approached a five-year low in industry revenue, and 2012 has not brought much better news. But a bottom-up review of structural trends offers a somewhat contrarian view of industry growth potential. A scenario of relative stagnation with none or negative revenue growth remains possible. However, a more probable outcome would be annual revenue growth of 15.5 percent between 2011 and 2016 (slightly above nominal GDP) or 7.8 percent between 2010 and 2016 (slightly below nominal GDP). These rates are lower than historical growth but high enough for leaders to continue to expand and transform their businesses. We accounted for several structural factors.

Financial deepening will occur. Chinese financial services markets are already deep compared with those in other emerging economies. The market capitalization-to-GDP ratio stood at 46 percent in 2011, including both domestic and Hong Kong listings. However, a combination of continued macroeconomic growth, with nominal annual GDP growth of about 12 percent,[4] and financial deepening, with a market capitalization-to-GDP ratio reaching about 57 percent by 2016, would suggest strong underlying growth of 16 percent in market capitalization. While market valuation will undeniably weigh on this projection, the longer-term support for growth of market capitalization remains strong for the decade to come.

Price differentiation is unlikely to lead to downward pressure on average commission levels. Contrary to many industry experts, we do not believe that commissions have reached a structural bottom. Improvements in technology, such as direct market access (which has only a small market share today), will allow some firms to remain profitable at considerably lower commission levels in the future. However, we do not think that the average commission will drop significantly in the next five years. Rather, commission rates are likely to continue to differentiate further depending on the level of service provided; this is already the case in some institutional segments, where clients have shown that they will pay a few basis points more for better service, research, and access.

4 Global Insight; corresponds to 8.2 percent real GDP growth.

Secondary offerings and midcap IPOs will drive a recovery in volume. The flow of giant IPOs is unlikely to reach the levels of past years. Most of the large SOEs have listed, so the multibillion IPO pipeline will be much smaller than in the past. Instead, we see secondary offerings of large firms and growth in midcap IPOs as the two main growth drivers. For example, the demand for secondary capital from the banking industry will be considerable: it would need to raise RMB 2.3 trillion in 2012 to 2016 in capital if it is to sustain growth at even 60 percent the pace of the past ten years and maintain its current high dividend policies. In the same way, there is a pipeline of more than 700 firms waiting to be listed, with likely IPO values between RMB 200 million and RMB 20 billion.

Emergence of new products and a potential explosion in margin financing. New products and value-added services are beginning to appear. They include fixed income, currency, and commodities (FICC); prime brokerage; derivatives; and margin financing. There is little doubt that collectively these businesses will overtake cash commissions as the main source of revenue in the very long term; this has been true of all markets we have looked at overseas. However, most new-product lines will still represent a small share of industry revenue by 2016. The striking exception is margin financing. Experience from other Asian markets shows that margin financing could develop quickly. It could reach more than RMB 590 billion in financing balance in the next five years, with revenues (net of financing) of about RMB 35 billion, 33 percent of the industry revenue from commissions today. This could also lead to a change in the revenue model for retail brokerage similar to what we observed in other Asian markets, where cash commissions became a loss leader and financing the main source of profitability for the industry.

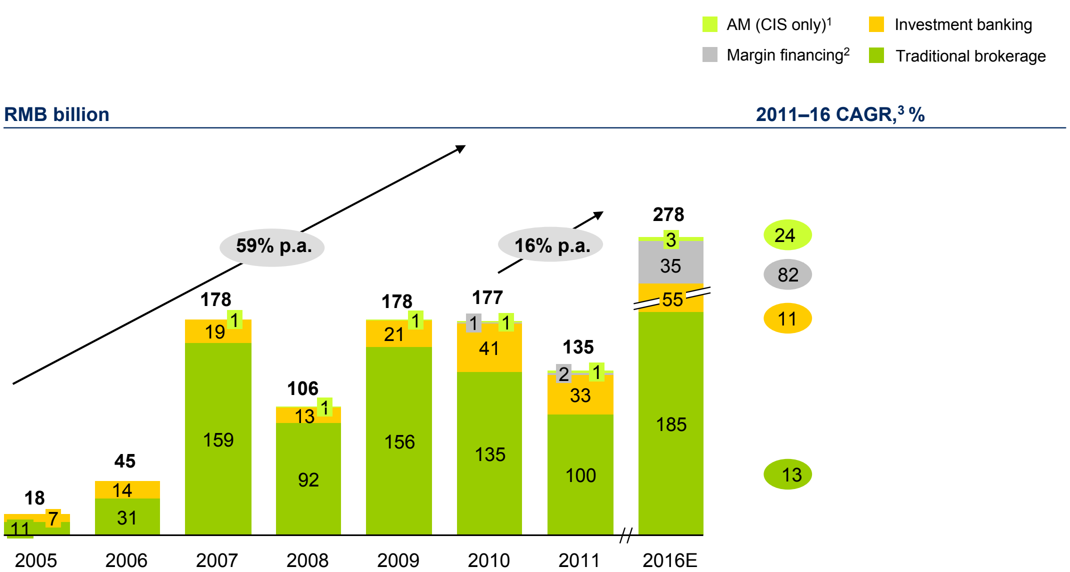
Over the longer term, one major uncertainty is FICC. In China, the market is divided into two submarkets: banks can do business in the interbank bond and foreign-exchange markets, as well as in derivatives, while securities firms can operate in the exchange bond market and derivatives. A review of overseas markets shows that FICC is likely to become a larger contributor to revenue, both client and risk driven, than equities. Also, in most markets, banks, with their larger balance sheets, have taken leading positions in the flow business while a few securities firms have managed to assume positions in structured and risk-oriented businesses. The pace at which the two currently separate markets become fungible will have considerable implications for securities firms' ability to build and secure a longer-term position in China. Our current estimate is that this will remain a relatively small opportunity in the shorter term but could be a major upside element in the longer term.

These structural trends would lead to relatively fast growth of more than 15 percent annually in the next five years, down from 40 percent annually over the last six years but still attractive by international standards. Total revenue[5] would grow

5 Includes the revenue of equity, margin finance, and other brokerages (including index future trading, warrants trading, mutual-fund trading and fixed-income trading, equity capital markets and debt capital markets, M&A, and collective investment scheme, that is, securities asset management).

from RMB 135 billion to RMB 278 billion (Exhibit 3). While retail commissions will remain the largest revenue driver, the wallet mix for the industry will shift, with retail commissions[6] dropping from a 43 percent to 36 percent share of total revenue, margin financing rising from 0 percent to 13 percent, and institutional customers growing from 15 percent to 19 percent. In this scenario of steady growth, the industry would still suffer from much slower growth compared with the past five years but would most probably muddle through relatively unscathed.

Exhibit 3 Total revenue for the Chinese securities market will grow relatively fast.



1 Here, collective investment scheme, or CIS, means securities firms' asset-management (AM) products.
2 Net revenue of margin financing.
3 Compound annual growth rate.

Source: Wind; McKinsey analysis

Considerable uncertainty remains

While several of the structural trends described above are highly predictable, there remains considerable uncertainty about the overall economic outlook for the industry. The two most important exogenous factors we considered are macroeconomic growth and pace of regulatory changes. While these factors affect the entire financial services industry, securities firms' revenues are much more sensitive to them.

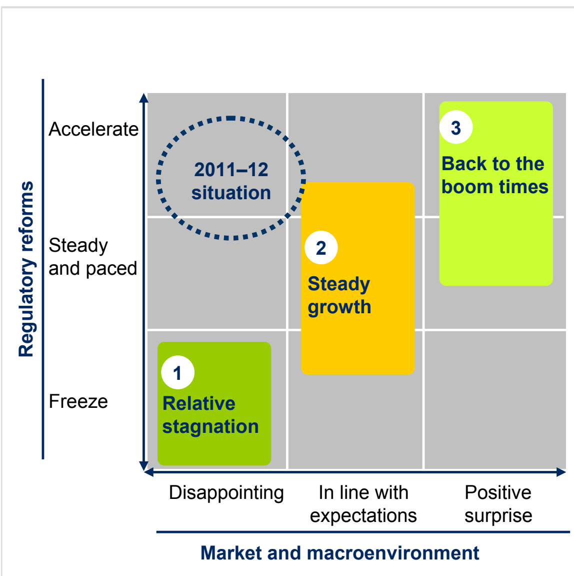
In a worst-case scenario of relative stagnation, market deepening would not increase, nominal GDP growth would stall at 10 percent annually, commissions would drop a bit,

6 Excludes margin trading commission income.

and proprietary-trading profits would all but vanish for a few years. This would result in 4.7 percent annual growth in revenue from 2011 and 2016, considerably below nominal GDP growth and—likely—below the structural increase in cost of doing business, thus leading to reduced or no profits for a large number of market participants.

In a best-case scenario, taking China "back to the boom times," continued economic growth, rational industry behavior, and innovation-friendly regulation would lead to a much more robust annual 26.8 percent growth in revenue between 2011 and 2016 (16.5 percent between 2010 and 2016) and probably faster growth in profits (Exhibits 4, 5, and 6).

Exhibit 4 There are three working scenarios for the Chinese securities industry.



1 Relative stagnation

- Macroeconomic slowdown is faster than anticipated
- Regulatory reform loses steam
- Margin pressure for market share

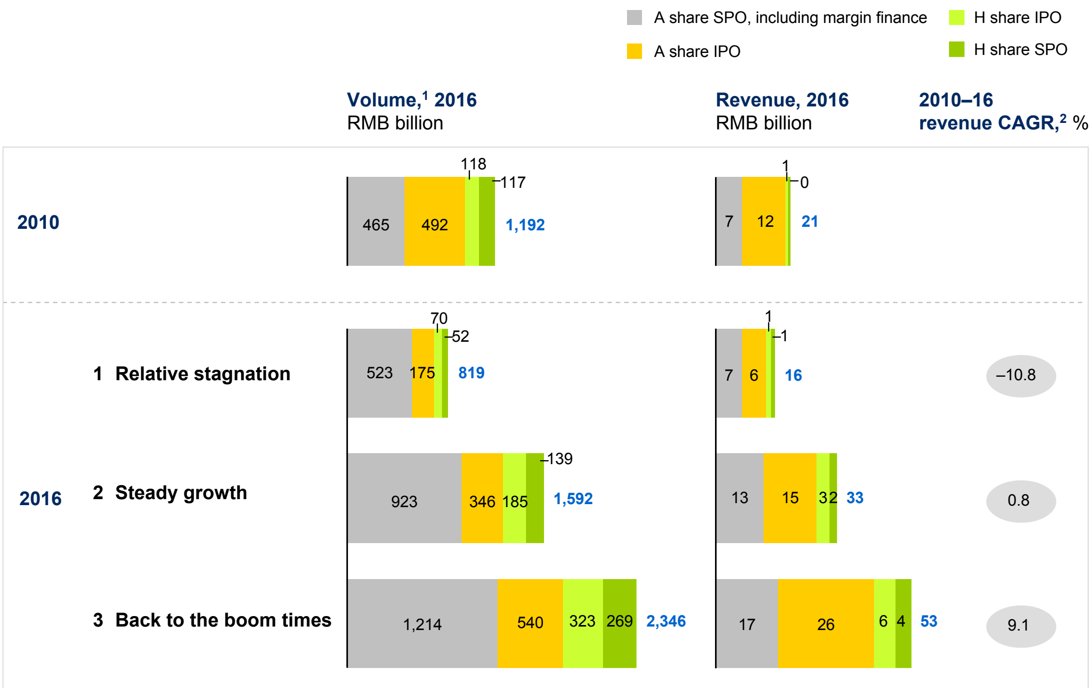
2 Steady growth

- Steady decline in economic growth but well controlled
- Gradual loosening of the regulatory framework
- Limited pricing pressure

3 Back to the boom times

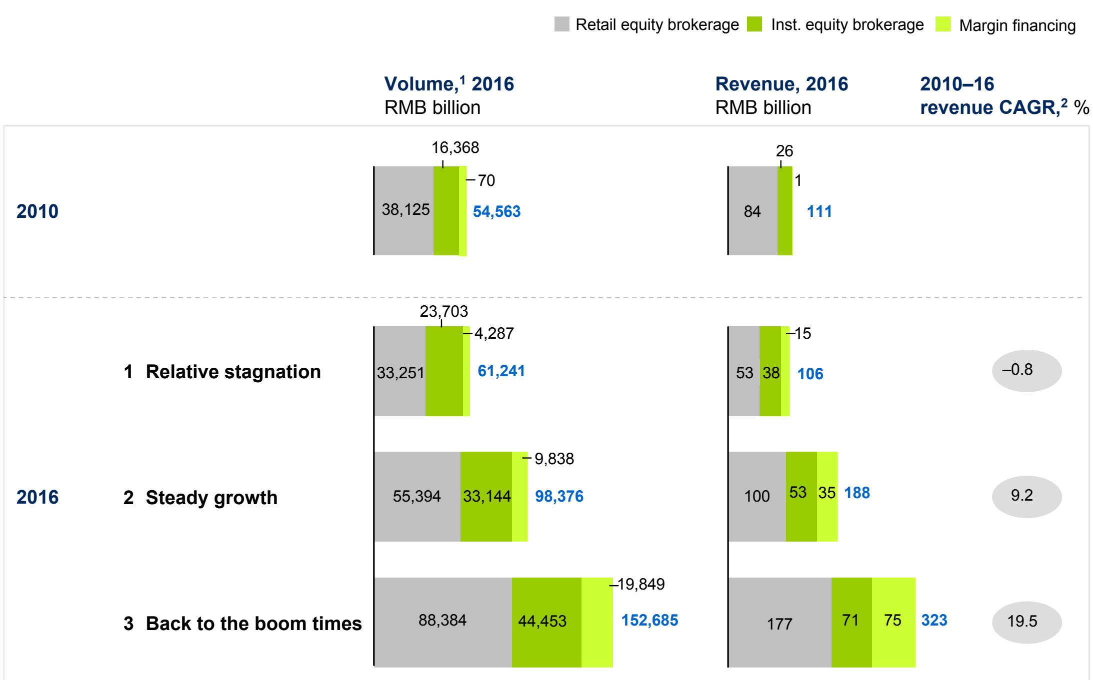
- Supportive macroenvironment and rebound of market valuations
- Faster-than-anticipated loosening of regulation to open new markets (eg, derivatives)

Exhibit 5 Scenarios can be modeled for primary market—equity capital markets.



1 Includes both IPO and SPO volume of A and H shares.
2 Compound annual growth rate.

Exhibit 6 Scenarios can be modeled for secondary market—A share trading.



1 A share trading volume.
2 Compound annual growth rate.

In addition to uncertainty about the level of market revenue, there are questions about who will capture these opportunities. Further and faster opening to foreign competition would provide a significant impetus to change but would create significant challenges for domestic securities firms. Foreign brokers in China captured only about 2 percent[7] of institutional brokerage revenue in 2010 and 2011 compared with 65 to 70 percent in India, a much more open market. Our view is that a fast, across-the-board opening to foreign firms is highly unlikely, precisely because few local brokers are ready for such an onslaught. But such a big change is possible within 10 to 15 years.

Another source of uncertainty comes from domestic competition from banks. Today, the market is fully separated by a Chinese version of the old US Glass-Steagall Act. But experience in most overseas markets shows that, once allowed to play in even a small way, banks become formidable competitors, especially in FICC and wealth-management services for affluent customers.

These kinds of shocks are low probability but would have high impact. Most firms tend to ignore them until it is too late but they should be part of the strategic thinking of any CEO of a Chinese securities firm.

NEXT-DECADE IMPERATIVES: DIFFERENTIATED OFFERINGS AND CAPABILITIES

So what should CEOs focus on over the coming decade? They can look forward to a relatively favorable long-term macroeconomic environment but will inevitably face significant short-to medium-term uncertainties. In a business with high fixed costs and tendency to marginal pricing, this will lead to wild swings in profitability for smaller and undifferentiated firms. Even short of some of the shocks described above, a gradually maturing market leading to slower growth, increasingly differentiated customer needs, and steady regulatory changes will create pressure for changes in business models. Top-five brokerages and firms able to differentiate their client offerings and capabilities will be much better positioned than their competitors.

Several recent developments provide hints of what is to come. Firms such as Noah are developing a higher-touch, more independent, high-net-wealth advisory model. Institutional brokers such as CITIC Securities are launching new prime services to support the emerging hedge-fund industry. Several prominent Chinese brokers have started to expand their businesses overseas with a focus on supporting Chinese companies—the latest and most striking example being the announced acquisition of Hong Kong–based CLSA by CITIC Securities.

The likely changes will depend on the specific product market. We think that the most successful firms will consider their choices at the client-segment level.

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7 This figure is 7 percent if BOCI and CICC are counted as foreign firms.

Serve a bifurcated retail market

While the needs of retail customers in China are mostly similar today, we believe that the market could bifurcate in the future. The most immediate potential for differentiation lies with services for affluent and high-net-worth clients.

There is a real opportunity for Chinese securities firms to address this segment in a way similar to that of large US brokers such as Merrill Lynch. Those financial institutions transformed themselves from pure commission-driven brokers to independent asset-gathering advisers by providing high-touch service to wealthier customers. The high-net-worth segment already represents 45 percent of savings in China and is likely to grow to 61 percent by 2020. These customers now receive mostly commoditized equity-brokerage services and receive many investment offers from a multitude of trust companies. A recent McKinsey survey of more than 600 high-net-worth individuals shows that professional advice from a relationship manager who understands them well was the most important criterion in choosing a relationship with a financial services firm.

Execution is likely to remain commoditized. But our recent survey of 5,000 Chinese retail customers shows that local securities firms have an opportunity to differentiate themselves by providing better advice and a broader investment platform—open or closed. Several firms have started to provide such services in China. For example, CICC has focused on high-net-worth individuals, while Guosen Securities offers personal advisory services to the mass-affluent segment. Billboards from Founder Securities at the Beijing airport advertise wealth preservation rather than outsized returns and are illustrated with pictures of babies and birds, suggesting long-term responsible planning, a far cry from the previous decade.

Over the past 20 years, other Asian brokers have undergone similar transformations. In Korea, for example, Samsung Securities developed an offering for high-net-worth individuals, while Mirae refocused on asset management. These kinds of transformations pose a double threat to incumbents. First, small, nimble attackers could scale up quickly and become profitable with only a few thousand wealthy customers, thus cherry-picking the most profitable segment. Second, examples from other Asian markets show that banks will seize this opportunity if securities firms do not step up in the coming three to five years. It is unclear to us whether a pure advisory offering could succeed in China, but there is potential for securities firms to build a new business model around asset gathering.

Another opportunity is a low-cost, no-frills, technology-based offering that would cater to cost-conscious, self-directed traders. E*Trade and Charles Schwab in the United States or Saxo in Europe offer examples of different versions of this business model. Similarly, Kiwoom Securities in Korea exemplifies how a relatively small firm can gain significant share on the back of cheap commissions. We believe that this approach may emerge as a de facto model for the largest retail brokers in China, a complement and—over time—replacement for their existing multichannel model. However, there are challenges to establishing this model for a new entrant.

Among them are regulations that limit retail investors to only one account and the requirement that customers must open accounts in person at a broker's office, making it difficult for a remote-only or branch-light attacker to capture significant market share quickly. Finally, existing low retail commission levels will make it harder to gain share as rapidly as Charles Schwab did after commission deregulation in the United States. As a result, we believe that this model will not lead to a revolution but that some of the large incumbents will migrate to it to improve their overall customer offering.

Upgrade and differentiate services to institutional clients

In the next ten years, the institutional brokerage industry will shift from a relatively simple model focused on execution and "tip driven" research to a variety of business models (for example, focus on execution versus insights) and a much broader set of products and services (such as prime services, equity derivatives, and corporate access). A similar transformation occurred in the rest of Asia, outside of Japan, over the past ten years and in Europe within the last two decades, with significant impact on how different firms made or, often, lost money.

In other markets, local firms seeking to remain relevant have focused on areas including best-practice execution, deeper research insights, and intermediating risk appetite between institutional and retail investors. In Asia, local firms have typically evolved into two categories—top-tier brokers that compete for wallet share in the foreign-institutional-investor segment and a second level that competes primarily for business from domestic institutional investors. Several strategic approaches are likely to emerge.

Compete on insights. For top-tier local brokers (for example, India's Infoline and Kotak and Malaysia's CIMB), the basis of differentiation may include research insights, corporate access, and some international distribution, combined with good execution and service in local markets. Client surveys, including those conducted by Greenwich Associates and McKinsey & Company, confirm that investors value insight and resources in the allocation of discretionary commissions. Brokers such as CLSA have differentiated themselves with unique regional insight; the ongoing opening of China to the West presents a clear opportunity for local securities firms to provide such guidance to global investors. Access to corporate management is singled out as the most valuable resource, which suggests that securities businesses linked to investment banking stand a better chance to benefit from this trend. In China, several brokers, such as CICC, have started to position themselves in this area.

Compete on execution. Execution-based strategies have become common in Western and Asian capital markets over the last decade. But it has become harder for firms to differentiate themselves through execution, with the cost of building and maintaining market connectivity increasingly prohibitive for new entrants and a strain on established players. In China, this strategy will be sustainable only for the largest and most cost-effective brokers committed to big investments in technology.

Compete on risk insights. In more mature markets, the primary driver of secondary-market order flow is the transfer of risk. Securities firms play a big role in the sourcing, packaging, and distribution of risk among market participants. In Asia, several large brokers have been able to match retail investors eager to take risk with institutional investors who want to hedge their bets. The approach may include disaggregation and repackaging of derivatives and structured notes, both listed and over the counter. While the ability to generate outsized profits from committing capital is increasingly under pressure from regulatory changes, better insights into the risk appetite of industry participants and the ability to design products that help intermediate these risks could be a winning strategy for leading players. No firm is applying this approach in China yet, although trust companies are creating products that get close.

Upgrade and differentiate investment-banking business models

Investment banking has evolved into three kinds of business models—advisory based, full service, and balance-sheet led. Advisory-based models (for example, Lazard) differentiate themselves primarily through talent and the high quality of corporate-finance advice provided. Full-service investment banks (for example, Goldman Sachs or Morgan Stanley) combine high-quality advice with access to businesses such as cash equities. Balance-sheet-led models (for example, Standard Chartered) are increasingly gaining share in a credit-starved environment where the investment-banking business benefits from the ability of the bank to commit its balance sheet to a deal (for example, through acquisition financing).

We believe that these three business models will coexist in China. Local firms will migrate to one of these models and rise to compete against global firms in different segments of the market. Talent sourcing and retention will be a key differentiator between successful and unsuccessful firms. In the past, many securities firms have attempted to boost growth by acquiring talent, leading to an overreliance on individual rainmakers. Lessons offered by other business-to-business industries suggest that focusing on the sales process can be a more powerful and cost-effective approach.

The biggest uncertainty regarding the success or failure of investment-banking models is whether one or a few local firms will be able to turn themselves into regional or global powerhouses by following their customers overseas. All other Asian securities firms have failed in this attempt, but the massive size of the domestic Chinese market may provide the base from which international expansion could occur.

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Securities firms are only beginning what we believe will be a decadelong transformation. This will require confronting two types of choices—mix of businesses and the chosen model within each business. Based on these options, players should focus on building specific capabilities. Developments over the next decade will likely provide a rich playing field for different approaches in the Chinese securities markets. The winners will combine a resolute focus on innovation and differentiation with resilience in the face of volatility and short-term shocks.

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