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IN THIS ISSUE

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The Capital Markets Issue

If Asia is to sustain its growth, emerging companies need capital to finance innovation. Transparent, efficient capital markets are critical for firms to tap the region's growing wealth.

It's a tradition that dates back thousands of years in China, and has not entirely disappeared even in modern Taiwan: *hu chu hui*, roughly translated as "mutual aid society," or simply *hui*, an informal system of borrowing and lending among friends and neighbors.

Here's how it works: a group of neighbors or colleagues gets together and forms a *hui*. Each month for a designated period of time, each member of the *hui* contributes a specific sum of money to a pool. Different members then make bids of interest for the pool of money, and the highest bidder gets to borrow that month's pool.

The basis of the *hui* is trust among people who live or work in close proximity to each other. The borrowers are more likely to live up to their

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The expansion of Asia's capital markets means international investors can invest with greater precision—not simply "buy Asia," but target specific asset classes.

BUYER'S MARKET
Indian investors study stocks on Dalal Street outside the Bombay Stock Exchange. A rise in discretionary income and the opportunity for better returns on savings are helping fuel the growth of Asia's capital markets.

obligations to repay when they come face to face with the people from whom they've borrowed every day. And if they don't, their lenders know where they live.

It's a "capital market" in the most literal sense, where people who need capital connect with other people seeking to lend or invest their money in exchange for a decent return. It's a way for a family to pay for a wedding, for a merchant to finance his inventory, or for an enterprising individual to launch a business. But it is inefficient and small in scale.

As with much of Asia today, tradition co-exists alongside transformation in the world of finance. If Asia is to sustain its economic growth of recent years, wider access to capital on reasonable terms is essential, especially for emerging, entrepreneurial companies that drive innovation and creativity. The banking system has tended to favor larger, more established companies and government policy has largely determined who received loans. That is why the formation of modern, efficient equity and debt markets in Asia is critical.

Strong capital markets are important not only to companies that need capital, but also to investors. With a growing middle class and rising personal wealth, individuals with more money in their bank accounts need additional alternatives for investing it. And with more money going into insurance products and pension funds, institutions need investment vehicles that will provide a healthy return combined with a measure of security to cover their long-term liabilities. For international investors, the expansion of Asia's capital markets means they can invest with greater precision—not simply "buy Asia," but target specific asset classes and risk parameters for greater diversification.

Even in modern capital markets, however, trust is still the basic element that determines their success or failure. The informal systems of yesterday must be replaced by a formal framework that makes capital markets function efficiently and fairly: law and regulation, consistency of accounting standards, transparency, accountability and effective governance. Here is where the greatest disparities exist among different countries today.

In this issue, we explore the state of Asia's capital markets from the perspective of companies at different stages of growth: start-ups and emerging enterprises that need seed money and working capital; companies that have achieved the necessary scale for going public; and mature companies that need capital to sustain growth.

Getting Started: Private Lending and Private Equity in China

CASH DEALS
An unregulated private lending market finances most small businesses and new ventures in China.

Entrepreneurial businesses in China often turn to family and friends first for financing. A growing private equity market could fill the void.

In China, as in other parts of the world, small and medium-sized enterprises (SMEs) are viewed as engines of job growth and entrepreneurial ventures are seen as critical for innovation. Yet, despite the rapid and remarkable growth of China's modern capital markets and an abundance of savings deposited in banks, SMEs still have trouble gaining access to capital. As a result, they are often reliant on private lending—literally, personal loans from family, friends and business associates.

No one can be sure how big the private lending market is—it is underground and unregulated. However, in a recent survey conducted by China's central bank branch in Wenzhou, about 230 miles south of Shanghai, some 89% of families and 57% of companies were found to be involved in private lending transactions. While reflective of just one city, it's remarkable that a clear majority of the urban populace is helping to underwrite the growth of smaller businesses through direct loans.

Virtually non-existent a decade ago, registered private equity funds in China now number well over 400.

BRIDGING THE GAP

Banks have long been the primary source of debt financing for established companies in China, where the corporate bond market is still developing and largely reserved for blue-chip, established household names. The banks tend to favor larger customers, however, such as current and former state-owned enterprises (SOEs) and government-supported corporations. SMEs are typically left out and underserved. The banks have historical ties with SOEs stemming from policy-driven lending practices of the past. They also have difficulty assessing and pricing SME credit risk, especially in light of the government's control over lending rates and generally insufficient collateral from SMEs. China's central bank recently imposed tighter credit measures and limited the new loan amounts that banks can issue, making it even harder for smaller companies to get loans through the formal banking system.

Private lending bridges the gap. One reason informal loans for SMEs are so prevalent in China is the potential for higher returns on lenders' capital. The one-year bank deposit rate in China currently stands at 3.5%, and the consumer price index has risen well above 5% in the past few months, meaning the real deposit rate has been negative for savers. And recent austerity measures imposed on the property market have curbed the flow of money into real estate, indirectly fueling the liquidity supply for private lending. China's contract laws stipulate that interest charged on private loans cannot exceed four times the bank lending rate on similar loans. In reality, though, rates in informal channels can range from the low teens for collateralized loans to well over 200% a year for uncollateralized loans.

THE RISE OF PRIVATE EQUITY

Private equity is evolving rapidly as an increasingly important financing alternative for SMEs and new ventures. Virtually non-existent a decade ago, registered private equity funds in China now number well over 400. The amount of private investments reached close to US$20 billion in 2010, up 40% from the previous year.

Much of the activity comes from the largest Western private equity firms with operations in China. Domestic firms have only recently begun to emerge, but because they face less regulation than their foreign counterparts, they are expanding more quickly. Meanwhile, the regulatory hurdles for foreign firms are gradually being lowered. The government recently implemented the Qualified Foreign Limited Partner program, which paves the way for foreign firms to convert their currencies more easily. So far, the program is limited to Beijing and Shanghai, with a quota of US$3 billion for each city.

The common complaint about private equity in China is "too much money chasing too few deals." Still, the country's fast-growing economy has provided fertile ground for rapid growth at many young enterprises. In 2010 alone, about 450 companies domiciled in China went public on various stock exchanges, many of them previously funded by private equity.

SEEING THE LIGHT
Assembling umbrellas at a Taiwanese factory. Private equity could give a boost to Asia's small and medium-sized enterprises that have historically had trouble obtaining bank financing.

THE VENTURE CAPITAL MODEL

Private equity plays a very different role in China from that in Western countries. In the U.S. and Europe, private equity funds commonly engage in leveraged buyouts and management takeovers of struggling but fixable companies. In China, obtaining debt financing and regulatory approval is difficult, making such strategies far less feasible. Instead of trying to find and overhaul companies in trouble, China's private equity funds are constantly on the lookout for fast-growing, well-run companies with IPO potential—much like U.S. venture capital firms—and the work involved after the investment is much less grueling than a corporate turnaround.

THE OUTLOOK

China's modern capital markets are still in their nascent stages compared to developed nations. The rules and regulations will continue to evolve for some time. As the capital markets become increasingly transparent, efficient and effective, more financing opportunities should become available for SMEs through the bond market and commercial banks, which could spell the gradual decline of unregulated private lending. This is potentially an important development in the economy, as SMEs are critical for sustaining the economic vitality that has characterized China's growth.

On the equity side, China's fast economic expansion is expected to create still more opportunities for private equity funds. From the investor perspective, a vibrant private equity market creates opportunities for institutions to diversify their portfolios and try to achieve superior returns. Exceptional wealth creation, the underlying engine of China's economic expansion in recent years, may continue to drive growth in the market, making China not only a destination but also a funding source for international private equity funds.

MICRO-FINANCE IN INDONESIA

HEALTHY RETURNS Selling vegetables in a market in Jakarta. Small loans are a big business in Indonesia, where even the largest banks are now providing microfinancing for merchants and farmers.

Microfinance is a means of providing financial services (including, but not limited to, credit) to people of low income who are without access to banking services. It has a long history in Indonesia, where only around 40% of adults have mainstream banking relationships and some 31 million people live below the poverty line. The rural population has relied largely on the system of village-owned and operated "Badan Kredit Desas" or BKDs, established over a century ago to take deposits and grant loans. An estimated 5,000 BKDs are currently operating.

In the past, major Indonesian banks were unwilling to lend to small- and medium-sized businesses, slowing economic growth. Today, however, state-backed commercial banks have figured out that the microfinance market is too big to ignore. Since 2004, bank lending for micro-, small- and medium-sized enterprises has reportedly averaged 20% annual growth.

Indonesia's largest bank has carved out a separate division of more than 4,500 "Unit Desa" or village units to serve rural areas. Each unit is financially self-reliant, independently managed and operates outside of government policy lending requirements. Micro loans of up to 100 million Indonesian rupiah (roughly US$11,000) account for approximately 30% of the bank's loan portfolio, with an average loan size equivalent to about US$795. Borrowers are typically small business operators in rural and urban areas. They qualify based on their income and perceived character, not on collateral. And they have paid their loans back—in the first quarter of 2010, the repayment rate was an extraordinary 98%.

In some countries, notably India, priority-sector lending policies have produced inefficiencies in microfinancing. Indonesia's system, in contrast, has remained relatively free of political machinations.

The World Bank estimates that Indonesia's 15.7 million small enterprises make up more than 90% of all businesses and employ up to 60% of the country's non-agricultural workforce. Small enterprises tend to employ poorer people, so stimulating their growth helps increase income levels and reduce poverty.

Microfinance is clearly a critical component of Indonesia's economy and, by fostering entrepreneurship, essential to its sustained growth. With little bureaucracy, fast approvals, localized services and flexible terms, microfinance—whether at the village or national bank level—provides rural entrepreneurs with much needed capital. And borrowers who pay on time can look forward to larger loans to fund expansion, which may ultimately elevate them to the world of mainstream finance.

Going Public: Asia's Growing Equity Markets

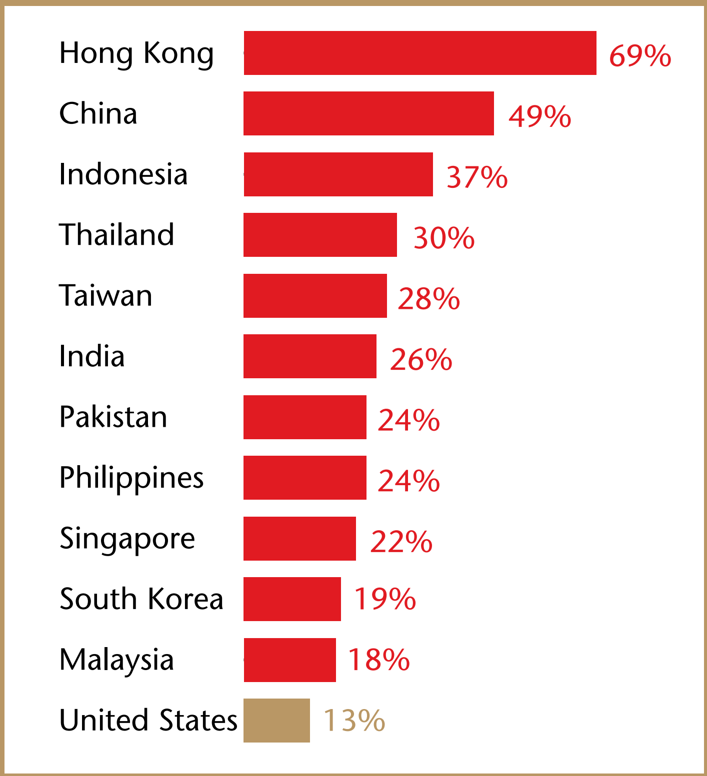
Asia's stock exchanges are evolving to meet the needs of emerging companies that have reached the IPO stage, giving them more choices—and more issues to consider.

The development of robust equity markets in Asia is the key to spreading economic democracy throughout the region. Historically, an overdependence on banks has led to high funding costs and, as noted in the discussion on private lending, discrimination against smaller businesses. Equity markets provide promising companies with a mechanism for going directly to investors. Still, while some Asian exchanges have become deeper over time, many have a long way to go on the path of efficiency, transparency, integration and innovation.

Asian equity markets are quite diverse in their degree of advancement, which generally correlates with the host country's economic development. India's Bombay Stock Exchange (BSE), despite

FEELING BULLISH Tracking Chinese stocks on the electronic board at the Shenzhen Stock Exchange. Shenzhen currently boasts the majority of IPO listings coming out of mainland China.

RATIO OF RECENT IPOs TO TOTAL MARKET CAP



Sources: Bloomberg, MICM

INITIAL IMPRESSIONS
Asia's equity markets are evolving rapidly as more companies go public. The chart shows the percentage of total market capitalization represented by companies that went public in the last 10 years. For example, recently listed companies in China account for 49% of that country's total market cap for all listed companies. In the U.S., with a more mature economy and much larger total market cap, recent IPOs make up a relatively small percentage.

being Asia's oldest exchange and claiming over 5,000 listings, is relatively less liquid than exchanges in Hong Kong and China. The Shenzhen Stock Exchange might have only a quarter of the listings the BSE has, but it is relatively liquid and expanding rapidly, as thousands of mainland Chinese companies line up to go public. Measured by aggregate market capitalization, the Tokyo Stock Exchange is still the largest in Asia and third-largest in the world. But new listing activity has been lackluster in recent years.

At the other extreme is the total or near absence of stock exchanges in countries such as Laos, Cambodia and Myanmar, which are in the early stages of developing their capital markets (see page 11, "Where is the Next Frontier?"). Established exchanges in Asia have a natural bias toward listing domestic companies, with the exception of the Singapore exchange, where foreign companies account for more than one-third of its market capitalization.

WHERE TO LIST

Issuers weigh several factors before deciding where to list. The primary consideration is figuring out where the company could raise capital at the most attractive valuations. Secondary factors include the company's home country, size, past performance, business model and growth plans. Other factors are the relative liquidity of the exchanges and initial and ongoing listing costs. Most new companies might prefer listing on their own countries' exchanges, in the belief that domestic investors would understand and value them the best and that dealing with local regulators would be easier. Language barriers and the high costs of listing overseas further encourage domestic listing in most cases.

Size and past performance might preclude a company from getting listed on the main boards, which have threshold criteria of past sales and historical profitability. A promising high-growth venture company, for example, may not have a track record of generating cash. It might end up listing on boards specially created for such companies. London's Alternative Investment Market has been a popular listing destination, with a lighter regulatory burden and greater tax advantages. Fearing competition, many Asian exchanges have also started accommodating emerging companies that show potential. Hong Kong's Growth Enterprise Market (GEM), Shenzhen's ChiNext, Singapore's Catalist, the Korea Securities Dealers Automated Quotation (KOSDAQ) and Japan's Mothers market are examples of sub-boards created by the main exchanges.

Not all such efforts, however, have met with success. Hong Kong's GEM has been losing market share to the Shenzhen Stock Exchange, which claims the lion's share of IPOs from mainland China. The GEM's regulatory requirements and lengthy approval process have become more closely aligned with its main board. Japan's Mothers market has been diminished by a dearth of IPO activity in recent years. KOSDAQ, in contrast, has been successful in listing over 1,000 companies since its inception in 1996, thanks to supporting policy initiatives such as tax concessions. It would be fair to say that smaller companies that have been denied debt funding are beginning to have access to equity markets.

The true litmus test of a vibrant equity market would be when entrepreneurs look at it as one of the first, rather than last, places to raise capital.

THE OVERSEAS OPTION

A company's business model and ambitions might also drive it to exchanges outside its natural home. An Internet company in India or China, for example, might choose to go public on the New York Stock Exchange, where investors may better understand its business model and support a better valuation. Another Chinese company might eschew the mainland exchanges, which are perceived to be restrictive to foreign investors, and list in Hong Kong or Singapore, where foreigners might assign relatively higher valuation to tap into China's growth.

A mainland Chinese player with international ambitions might want to list in Hong Kong to gain currency for cross-border corporate transactions, even though listing costs may be higher and standards more stringent. A foreign company with significant operations in China might want to get listed in Hong Kong for the same reason, as well as to gain name recognition in the growing Chinese market. An Italian luxury fashion house, which has ambitious expansion plans in the region, recently raised US$2.1 billion in an IPO in Hong Kong. Higher valuations in mainland China are also driving some major global brands to seek listings on the Shenzhen or Shanghai exchanges. Japanese companies might be interested in getting dual listings outside their country for valuation reasons.

IPO CELEBRATION
Corporate directors celebrate the IPO of a Hong Kong company on the Singapore Stock Exchange. Asian companies often list outside their home countries to gain foreign currency exposure, seek higher valuations or lower capital costs, and enhance their position in overseas markets.

IMPROVING EFFICIENCY AND EFFECTIVENESS

While Asian stock markets are keeping pace with a growing Asia, and are coming of age, their journey is far from over. The challenge is to make going public a viable option for as many companies as possible, while maximizing investor participation and ensuring efficiencies in prices and trading. Transactional efficiency can be improved through technology such as electronic trading, and share prices that accurately reflect market forces can be achieved by allowing short selling, which is less prevalent in Asia. Market participation can be enhanced by inviting foreign investors, which might require financial reforms to allow some degree of currency convertibility—something not all Asian economies are ready to embrace.

At the same time, opening the floodgates to foreign inflows could be counterproductive and might lead to asset bubbles, unless accompanied by more listings. One way to get more listings and greater liquidity is to encourage private equity and venture capital investments, as is done in developed Western markets, though many family-owned Asian businesses might resist the idea. The "demutualization" of exchanges—that is, turning them from non-profit associations of members to for-profit companies with shareholders—might also create the right incentives for them to allow more listings, reduce their costs and cut red tape. Making listings affordable without compromising regulatory and accounting standards would require investments in innovation and technology. The true litmus test of a vibrant equity market would be when an entrepreneur in Asia looks at it as one of the first, rather than the last, places to raise capital.

WHERE IS THE NEXT FRONTIER?

TAKING STOCK An electronic board displays share prices outside a securities firm in Hanoi. Though Vietnam has experienced rapid economic growth in recent years, its stock market has been slower to develop compared to neighboring Thailand.

In Asia's less developed countries, the capital markets picture is a patchwork. Stock markets in such places as Malaysia and Thailand are vibrant and healthy. In contrast, markets in Vietnam, Cambodia, Sri Lanka and Bangladesh are relatively nascent and underdeveloped. Why would one country's markets lag while its next-door neighbor's thrive? Why is Vietnam's stock market capitalization, at about US$33 billion, roughly one-tenth that of Thailand?

One answer is that the lagging countries have a recent history of severe strife. Vietnam endured more than 25 years of war and Cambodia suffered decades of internal conflict. Bangladesh fought for independence from Pakistan in 1971, then remained politically unsettled until the 1990s. Sri Lanka's civil war consumed the country for more than 25 years until 2009. Peace and stability are clearly prerequisites for investor confidence and healthy capital markets.

Today, Thailand offers a model for Vietnam, which has a somewhat similar culture, but a larger population. Market reforms and the conversion of state-owned enterprises into equity-issuing companies should bode well for the Ho Chi Minh Stock Exchange. A 49% foreign ownership limit has stifled local investors' liquidity, but that could change if the government implements new initiatives to allow for such things as non-voting shares for foreigners.

Neighboring Laos opened its first stock exchange to much fanfare in January 2011, with two listed companies. Cambodia has formed a securities exchange commission and its oft-delayed stock exchange is scheduled to open this year.

Bangladesh has two exchanges: Dhaka, launched in 1954 (when the country was East Pakistan), and Chittagong, established in 1995. The market, however, has been notoriously volatile. The Dhaka exchange doubled in value in 2010, only to experience its biggest one-day drop ever in January 2011, prompting riots in the streets. A lack of transparency and reliable data has left foreign investors wary of the market, which has only about 1% foreign ownership. (It doesn't help that the country ranked in the bottom quarter of the Transparency International "Corruption Index" for 2010.)

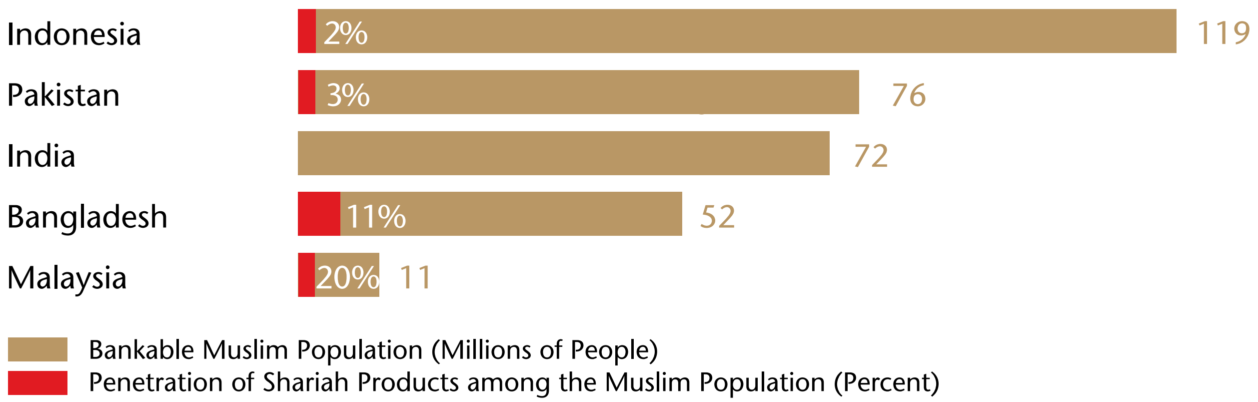
Investing in frontier markets is not for the faint of heart. However, the same was true of China and India two decades ago. Political stability, improved transparency, crackdowns on corruption and tighter accounting standards are all critical if these markets are to claim a bigger share of Asia's investment pool.

THE RISE OF ISLAMIC FINANCE

Islamic finance may strike many Westerners as a fairly new concept, having only gained prominence since the 1970s. However, the philosophies that define the system have been in place since the Islamic Golden Age of the 8th to 12th centuries. The entire foundation of Islamic banking is the concept of "Riba"—a Shariah term for the belief that no amount of money should be "manufactured" from other people's capital without a sharing of risk. In Islamic ideology, the primary purpose of capital allocation is for the betterment of society as a whole rather than an individual bank or borrower, and intertwined with benevolence and brotherhood.

Modern, organized Islamic banking began in the 1970s, when a resurgence in fundamentalist beliefs across the Middle East awoke demand for an alternative to conventional banking. The Islamic Development Bank (IDB) opened with the intention of becoming the primary inter-governmental Islamic financing institution, and with a mandate to foster the industry's growth. The principle of Riba necessitated a very different product set from mainstream banking, and

BANKING ON FAITH IN ASIA



Sources: Economist Intelligence Unit, Boston Consulting Group (as of 2007)

SHARIAH-COMPLIANT FINANCE has significant untapped growth potential in Asian countries, considering the size of the bankable Muslim population. Indonesia, for example, has nearly 120 million bankable Muslims, yet only 2% of financial products sold there are Shariah compliant.

ON THE RISE The iconic Petronas Twin Towers in Kuala Lumpur. Malaysia's capital is an important financial center with a large Muslim population, where Islamic finance has made strong inroads.

the IDB has been instrumental in developing programs to provide borrowers the same access to resources as conventional borrowers.

After 35 years, the IDB now has approximately 300 member institutions in more than 56 countries. Moreover, the majority of these institutions are still actively growing their loan books. With roughly 1.6 billion Muslims globally, there is clearly a very large addressable market for everyday lending—the entire Islamic financial system is estimated to exceed US$1.5 trillion by 2012. One of the largest opportunities lies with the Islamic "Sukuk" or bond market. Over the last decade, the Sukuk market has become an important alternative financing source for Shariah-compliant companies—not only in Muslim countries, but also internationally, as illustrated by the first (and very successful) U.S. dollar-denominated Sukuk issuance in 2010 by the Malaysian government. Islamic consumers, furthermore, have begun demanding access to Shariah-compliant investment funds and insurance products, or "Takaful." These asset classes provide real opportunities for growth in a fairly nascent, evolving industry.

There are also significant challenges in Islamic finance. Each country has its own Shariah Council that regulates domestic Islamic banks, resulting in inconsistencies among countries. The lack of standards prevents cross-border use of various products. Another real difficulty has been finding, training and retaining qualified people, given the industry's immaturity. These are just a few reasons why Islamic finance is a long way from becoming mainstream. However, given the industry's growth over a short period, Shariah-compliant financial products will likely play an important part in the future of the Islamic world's capital structure.

Government issues dominate, but Asia's local currency bond markets are an increasingly important financing alternative for large corporate borrowers.

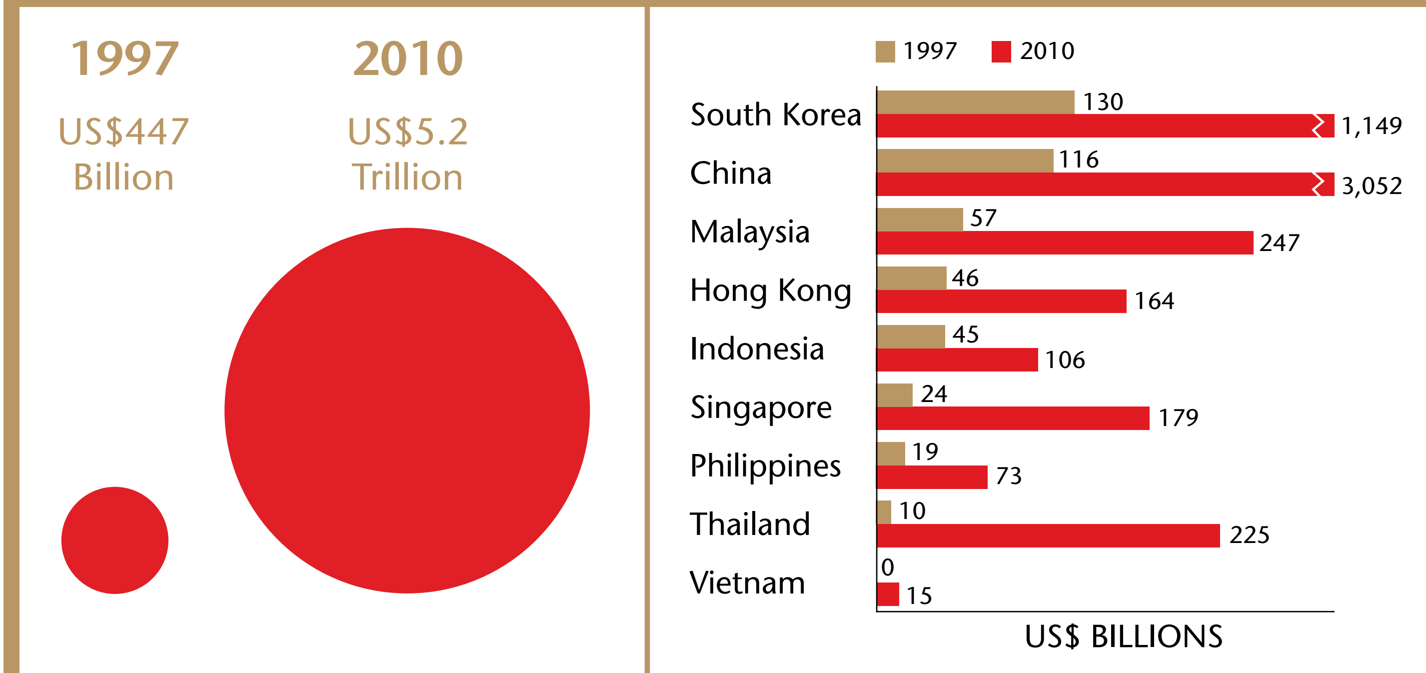
Sustaining Growth: Development of Asia's Bond Markets

The growth of Asia's local currency bond markets is one of the region's most important and remarkable economic developments over the last decade. At the time of the currency crisis of 1997, Asian countries (excluding Japan) accounted for only 2.1% of the total outstanding bonds in the world. By 2010, that figure reached 7.4%, still relatively small in absolute terms, but growing at an impressive rate.

The development of healthy local bond markets in Asia is significant for a number of reasons. It means a government can tap into its

THE GROWTH OF ASIA'S BOND MARKETS

SIZE OF ASIA EX-JAPAN LOCAL CURRENCY BOND MARKETS



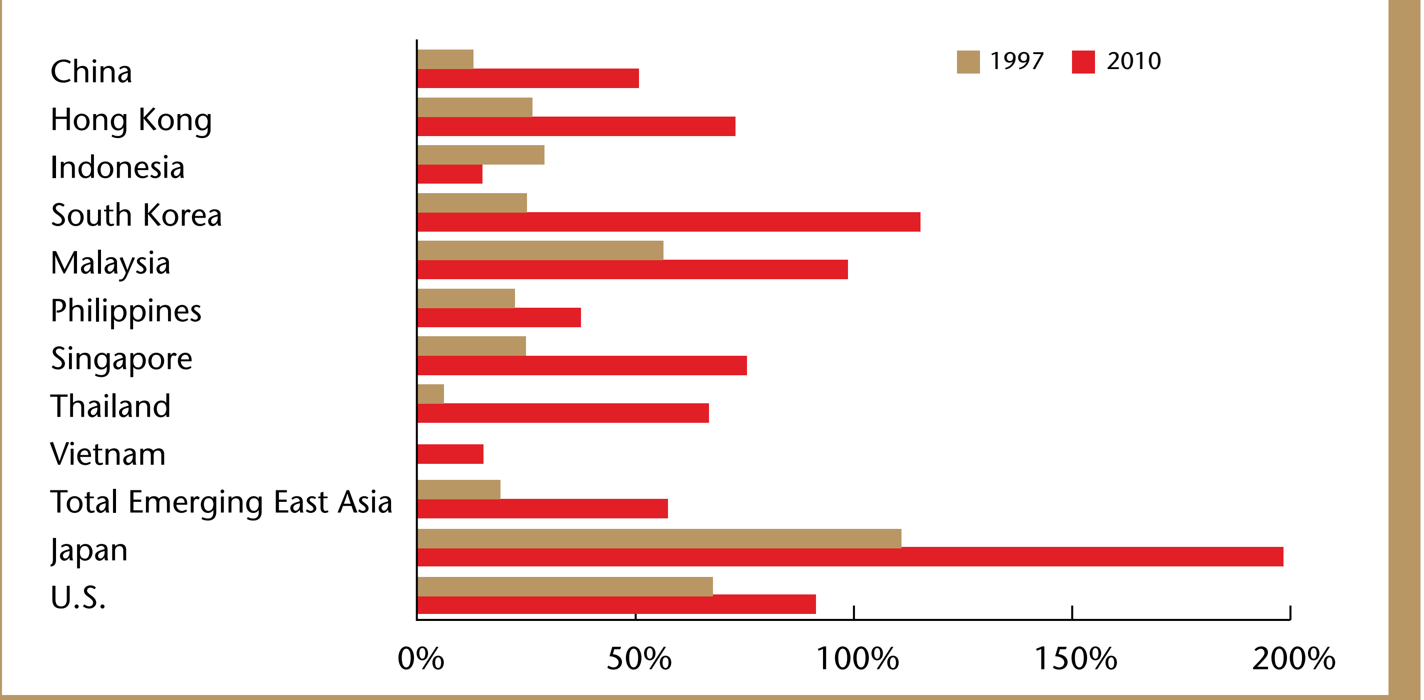
FAST TRACK: Since the Asian currency crisis, local bond markets have multiplied nearly 12 times.
Source: Asia Bond Monitor, November 2004 and March 2011

domestic savings pool and borrow in its own legal tender rather than borrowing in a foreign currency, making it subject to the volatility of that currency. For large corporations, it means an alternative to banks for financing—companies can go directly to the investing public and institutions and obtain capital at more competitive prices. For Asia's growing middle class, bonds provide another investment vehicle for diversification and the opportunity to get a better rate on their savings. And for large institutions—pension funds, insurers and banks—the bond market provides long-dated maturities that enable them to better match assets to liabilities, with diversified investment opportunities that mirror their liabilities.

One indicator of the stage of a bond market's development is its size as a percentage of GDP. Based on this measure, South Korea (115%), Malaysia (99%), Singapore (76%) and Hong Kong (73%) rank among the more developed local bond markets in the world. In terms of sheer size, however, China dominates the region. Excluding Japan, it accounts for about half of the Asia bond market, followed by South Korea and the countries that comprise the Association of Southeast Asian Nations (ASEAN) combined.

LEVERAGE ACROSS ASIA EX-JAPAN IS RELATIVELY LOW

BOND MARKET AS A % OF GDP



Sources: March 2011 Asia Bond Monitor for all countries except U.S. (IMF World Economic Outlook Database)

The continued growth of Asia's bond markets is likely fueled by a combination of domestic wealth generation and foreign investment.

GOVERNMENT VERSUS CORPORATE

About 69% of Asia's local currency bonds are issued by government entities, and the remaining 31% by corporations. Corporate issuers tend to be the biggest of the blue-chip companies, which in Asia typically means financial institutions and companies involved in infrastructure. For banks, the issuance of bonds provides an alternative funding source to bank deposits.

There is a stark contrast between government and corporate bonds in terms of liquidity. Most locally denominated government bonds are relatively liquid, with an average holding period of about one year. Hong Kong stands out as the single most liquid market by far. However, locally denominated corporate bonds are quite illiquid, with an average holding period of greater than 6 years. This means that locally denominated corporate bonds are primarily bought by buy-and-hold investors at issuance, with little liquidity in the secondary market.

This vast difference in liquidity is largely due to the relative size and the structure of the local markets. For local investors, their government bonds are their "risk-free" instruments. Just as U.S. Treasuries form the foundation for all U.S. dollar fixed-income portfolios, local government bonds are held by banks, insurance companies and pension funds as a core holding. Corporate bonds, on the other hand, represent their credit markets, requiring credit analysis and due diligence for each issuer. Furthermore, corporate bond issues tend to be comparatively small. All these factors result in the large liquidity gulf between the two markets.

A FOREIGN INFUSION

One of the most significant stories in the growth of Asia's bond markets has been the increase of foreign investors in local currency bonds. In countries with liberalized capital markets, the percentage of foreign holdings has increased dramatically over the last decade. With the disparity in liquidity between public and private sector bonds, foreigners are investing almost exclusively in government bonds. Foreign investors may have limited access to local corporate bond issues, since the underwriter might need international investors in order to place the bonds. And a secondary market is virtually non-existent.

There are a number of reasons behind the growth in foreign demand. Overseas investors are reallocating assets from developed to emerging countries in a quest for higher returns and diversification. Since the global financial crisis, U.S. fixed-income investors have seen a collapse in diversification. The bailout of Fannie Mae and Freddie Mac by the U.S. government means these instruments now reflect U.S. government risk. Investors looking for diversification now are compelled to look offshore. A third reason is a structural shift away from the U.S. dollar as the global reserve currency and toward a basket of currencies that reflect the terms of trade. As Asian countries garner greater market share in world trade, demand for their currencies, as reflected in holdings of central banks and sovereign wealth funds, has increased and will continue to.

The continued growth of Asia's bond markets is fueled by a combination of domestic wealth generation and foreign investment. With that growth should come greater liquidity and access for a wider range of corporate players.

DIM SUM BONDS: THE "NEXT BIG THING?"

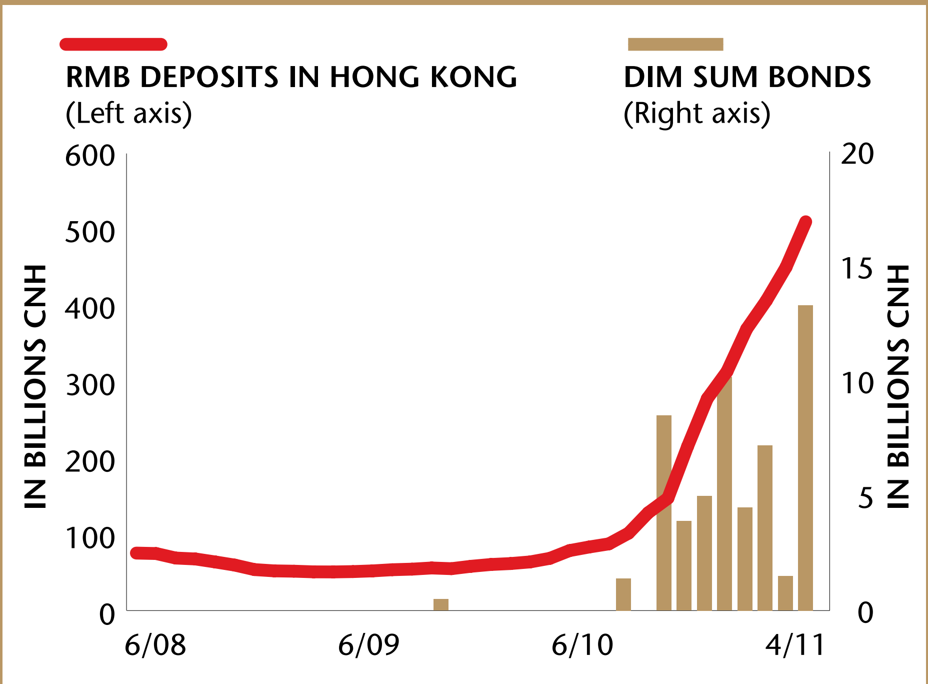
Foreign issuers are lining up for the latest addition to China's financing menu: "dim sum bonds," small issues denominated in Chinese renminbi (RMB) that enable foreign companies to fund their operations in China in the local currency.

Dim sum bonds grew out of China's need to allow its currency to appreciate in a gradual, controlled manner. China has a highly regulated capital account and tightly controlled currency. Having overtaken Japan as the second largest economy in the world, China has also become one of the most important international trading partners. As a result, global demand for its currency has increased dramatically over the last decade. China, however, has resisted international pressure to allow its currency to float freely against others, which might cost it its competitive advantage in exports.

Recognizing the strategic importance of its currency, China has embarked on gradual liberalization, using Hong Kong's special status as a global banking center. In 2004, the government began allowing

Hong Kong residents to deposit up to RMB20,000 (about US$3,000) per day in Hong Kong banks. With demand for renminbi exposure and a higher yield than Hong Kong dollar accounts, deposit growth has been staggering–more than RMB511 billion (about US$79 billion) as of April 2011, according to the Hong Kong Monetary Authority,

BIG APPETITE



Sources: Renminbi (RMB) deposits from HKMA; Dim sum bond data from HSBC

"CNH" is the currency ticker for renminbi (RMB) held in offshore (Hong Kong) accounts. Offshore RMB deposits have skyrocketed, but dim sum bond issuance has not kept pace, leaving banks with an oversupply of capital waiting to be tapped and an abiding hunger for dim sum bonds.

To provide banks with a market to invest these deposits, the Chinese government has invited large multinationals and Chinese companies to issue bonds denominated in renminbi—and several big names have taken the offer. The issues tend to be relatively small, since the proceeds are targeted to investments in China and the money cannot be taken onshore without the explicit approval of the Chinese authorities.

With the torrid pace of deposit growth, dim sum bonds get gobbled up at primary issuance by Hong Kong banks, and very few are available on the primary or secondary market for offshore investors. Perhaps that explains their nickname—with such small issue sizes, the appetite for them is never fully satisfied.

There are striking parallels between the birth of the dim sum bond market and the early development of the Eurobond market. The tightening of regulations in the 1950s made U.S. banks less competitive than their British counterparts. With the collapse of the Bretton Woods agreements and the gold standard in 1971, which had governed international monetary policy and exchange rates since World War II, international demand for U.S. dollars as a reserve currency increased. Offshore U.S. dollar accounts expanded, and most of that money went to London-based banks, fueling their dominance for decades. The London Interbank Offered Rate, or LIBOR, became the most liquid floating-rate U.S. dollar benchmark, and Eurobonds became the largest source of fixed-income bond capital for sovereign and corporate issuers worldwide.

Could something similar be in store for China's burgeoning offshore market? It's probably too soon to predict. But as long as deposits grow at their current pace, and demand for Chinese currency keeps rising, the appeal of dim sum bonds is likely to continue unabated.

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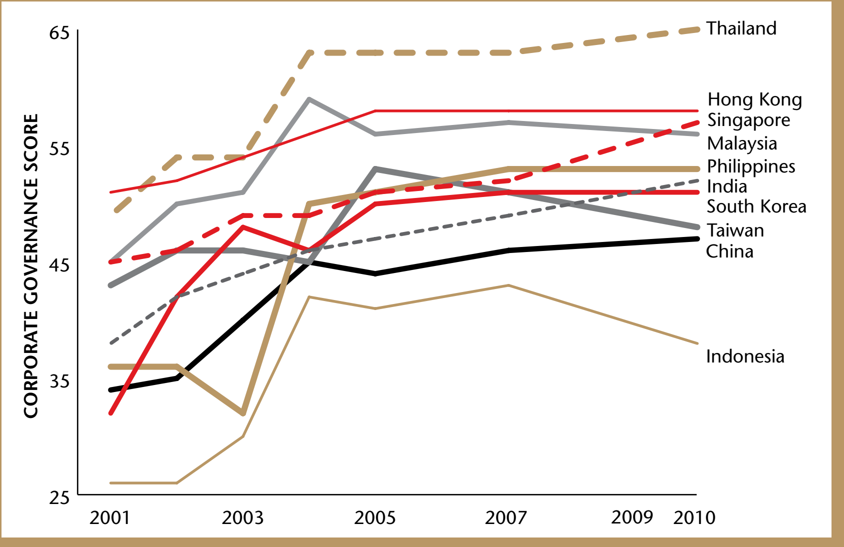
Steering Straight: Improving Corporate Governance in Asia

COMPANY CORPORATE GOVERNANCE



Scores are based on answers to a 46-question survey of 580 companies covering a wide range of corporate governance criteria, from independence of boards to shareholder equity to social responsibility. Sources: CLSA and Asian Corporate Governance Association

Legal infrastructure and a culture of corporate governance support the growth and development of capital markets. They can either be imposed by policymakers or be learned as competitive markets change behavior over time. The rules that dictate how market participants act are a mixture of laws, history and conventions—each reinforcing the other.

Knowing a country's political history is also critical in appreciating business cultures. Asia's socialist revolutions of the 20th century imposed their own laws and closed down many market institutions. China only reopened its stock markets in the early 1990s. Other countries have long had market institutions—The Association of Stockbrokers, the predecessor to the Hong Kong Stock Exchange, was established in 1891. Good corporate governance comes from the rule of law but also from long-running institutions. Rules may be imposed, but culture is learned.

In Asia, legal systems naturally differ from country to country, in part due to different legal heritage. The legal systems in Japan, South Korea and Taiwan were modeled after German and French civil codes of the 19th century. In Hong Kong and India, English common law was more prevalent since both were under prolonged British rule. Consequently, some legal systems may be more prescriptive (civil codes) and others more evolutionary (common law), which may impact the way the firms are formed, how they do business and how they relate to shareholders and government.

Over the past decade, Asian companies have made positive strides in corporate governance (see chart above). Perhaps more important than the country rankings is the general improving trend. Monitoring such change allows one to better understand each market's risks and helps security selection. Ultimately, however, governance is in the hands of a company's senior management. Therefore, understanding the micro level—board structure, management incentives and business interests—is as important as the legal and cultural environment.

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