Bocconi Students Investment Arena Newsletter: November 2022

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ABSTRACT

This year, central banks around the world have accumulated gold reserves at a pace never seen since 1967, when the U.S. dollar was still backed by gold. We will look at the reasons why banks buy and accumulate gold, mainly to mitigate risk, protect the economy from inflation, and promote growth in the real economy.

In the second article we will look at the concept of GDRs - Global Depository Receipts - from a perspective of Chinese equity securities (A-shares). The article will analyze the characteristics and differences of GDRs with other funding options for a company.

ABOUT US:

Bocconi Students Investment Arena was born in 2022 from the idea of bringing together students of different degrees and experience, but all with the same ardent passion for finance. Through dedicated competitions, masterclasses, and a members' forum, we aim to develop a community of students that fosters quantitative and qualitative skills like in-depth practical investments and valuation skills, teambuilding, and analytical skills.

The uniqueness of this association is that members would be able to put their investment knowledge into practice by competing against each other in two main events: portfolio competition and company valuation competition.

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Record High Gold Buying from Mystery Central Bank

By Marcello Fagotto

Central banks bought a record amount of gold last quarter as they diversified foreign-currency reserves, with a large chunk of the purchases coming from unknown buyers. The unreported purchases from institutions, although aren't uncommon, amounted to a "substantial" estimate, and this is because not all countries report their gold purchases regularly, including major ones like China and Russia. Almost 400 tons were scooped up by central banks in the third quarter, more than quadruple the amount a year earlier, according to the WGC. That takes the total so far this year to the highest since 1967, when the dollar was still backed by the metal.

Looking back: The Gold standard

The gold standard is a monetary system where a country's currency or paper money has a value directly linked to gold. With the gold standard, countries agreed to convert paper money into a fixed amount of gold. A country that uses the gold standard sets a fixed price for gold and buys and sells gold at that price, so that fixed price is used to determine the value of the currency. For example, if the U.S. sets the price of gold at $300 an ounce, the value of the dollar would be 1/300th of an ounce of gold.

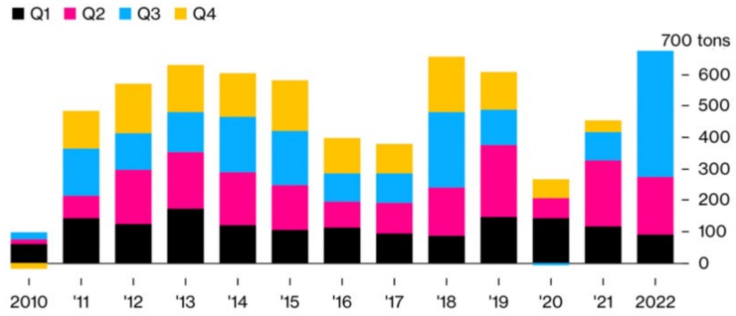
Britain stopped using the gold standard in 1931, and the U.S. followed abandoning the remnants of the system in 1973, which is not currently used by any government. The gold standard was completely replaced by fiat money, a term to describe currency that is used because of a government's order, that the currency must be accepted as a means of payment.

The appeal of a gold standard is that it arrests control of the issuance of money out of the hands of imperfect human beings. With the physical quantity of gold acting as a limit to that issuance, a society can follow a simple rule to avoid the inflation and to help promote a stable monetary environment in which full employment can be achieved. However, the main problem of this system is that the supply of gold cannot keep pace with its demand, mining gold is costly, and it is not flexible under trying economic times and for this reason it was abandoned by the US after the WWII to curb inflation and prevent foreign nations from overburdening the system by redeeming their dollars for gold.

Central banks are stocking up on gold

The official sector bought a net of 400 tons of gold in Q3 2022, which was 115% more than in Q2 and more than four times as much as in Q3 2021. It is the greatest demand for gold from central banks in a single quarter since the WGC series began, and nearly double the previous record of 241 tons set in the third quarter of 2018.

Central bank gold demand soared to a 55-year high



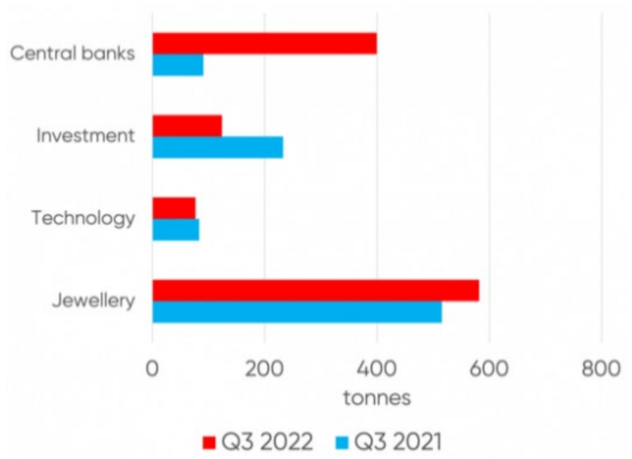
Source: World Gold Council

The bulk of the increase in the global central banks' net purchases of gold came from a couple of emerging market institutions:

- Turkey remained the largest reported gold buyer this year. It added 31 tons in Q3, lifting its gold reserves to 489 tons (29% of total reserves).
- The Central Bank of Uzbekistan continued to build its gold reserves, buying another 26 tons in Q3.
- The Qatar Central Bank was also a significant buyer in Q3.
- The Reserve Bank of India continued with its long-standing gold purchasing strategy in Q3. It bought 13 tons in July and 4 tons in September, pushing its gold reserves to 785 tons.

According to the WGC survey, one-quarter of respondents stated their intention to increase gold reserves in the next 12 months (up from one-fifth in 2021).

Gold demand by sector



Source: Statista

Why do central banks purchase gold?

Central banks serve a few primary functions, including setting interest rates, regulating monetary policy and controlling the printing and circulation of coins and bills. However, their most important task is to provide price stability to their national currency while preventing banking system collapse.

“Gold is money. Everything else is credit” said the famous quote of the American banker and financier JP Morgan, and these are the three primary reasons why gold is the reserve commodity of choice for national banks:

- Mitigating risk,
- Hedging against inflation,
- Facilitating stability and growth,

Gold is a well-known safe investment prone to acting positively in times of uncertainty, market volatility and it is viewed as an asset that holds no liability, adding to its ability to mitigate risk.

Moreover, gold’s role as an investment diversifier also aids in its ability to mitigate risk: Central banks have therefore traditionally held large reserves of gold to safeguard their financial systems, and in the case of a system collapsing, the gold supply provides the means to recover.

30-year Gold Price in USD/oz

Source: goldprice.org

GDR products from a Chinese perspective

By Xiaoyue He

Introduction to the GDR product

The term "GDR" refers to the securities that the depositary has issued, which are based on A-shares, and reflect the interests of the underlying securities. These securities are issued abroad. GDR provides a solution for A-share listed firms' needs to issue securities abroad and for international investors to purchase A-share listed companies' securities. As for the Chinese companies, by the GDR mechanism, A-share listed companies do not have to issue shares directly outside of China; instead, they can issue depositary receipts with shares as the underlying security, which allows foreign investors holding the depositary receipts to exercise "shareholder" rights like dividends, capital gains, and voting without actually owning or trading A-share listed companies' shares.

The issuance of GDRs can be broken down into the following categories:

1. **Stock issuance**: GDRs are issued without issuing any new shares; instead, they are generated based on the shares that already exist and traded on other markets without doing any actual financing.
2. **Issuance of new equity shares**: Able to issue new equity shares in addition to the ones already issued, as well as GDRs with newly issued A-shares as the underlying securities.

Since the launch of the China-Europe Stock Connect in December 2021, as of September 18, 14 new A-share listed companies have issued or intend to issue GDRs, and their issuance status is as follows (*Source: CITIC Securities, Huatai Securities*).

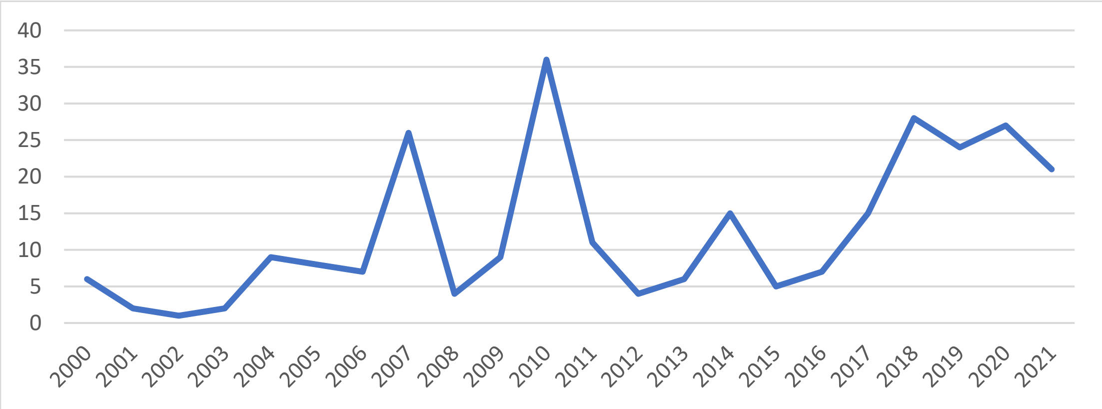
Stock Code	Stock Short Name	Announcement Date	Listing Time	Listed Exchange	Total Amount Raised (in USD million)	2022H1 Overseas Revenue Percentage
601615.SH	MingYang Smart Energy Group Limited	13/07/2022	13/07/2022	London	707	3.9%
600884.SH	Ningbo Shanshan Co.,Ltd.	24/07/2022	28/07/2022	Swiss	319	11.0%
600499.SH	Keda Industrial Group Co.,Ltd.	25/07/2022	28/07/2022	Swiss	173	50.2%
002074.SZ	Gotion High-Tech Co.,Ltd.	23/07/2022	28/07/2022	Swiss	685	8.9%
002340.SZ	GEM Co.,Ltd.	25/07/2022	28/07/2022	Swiss	346	35.0%
600031.SH	Sany Heavy Industry Co.,Ltd.	16/03/2022	To be listed	Swiss	-	41.3%
600516.SH	Fangda Carbon New Material Co.,Ltd.	16/06/2022	To be listed	Swiss	-	0.0%
600380.SH	Joincare Pharmaceutical Group Industry Co., Ltd.	22/07/2022	26/09/2022	Swiss	92	17.7%
603501.SH	Will Semiconductor Co., Ltd. Shanghai	16/07/2022	To be listed	Swiss	-	0.0%
605499.SH	Eastroc Beverage(group)co.,ltd.	06/07/2022	To be listed	Swiss	-	0.0%
300003.SZ	Lepu Medical Technology(Beijing)Co.,Ltd.	26/05/2022	21/09/2022	Swiss	224	12.8%
300207.SZ	Sunwoda Electronic Co., Ltd.	14/07/2022	14/11/2022	Swiss	44	40.6%

002444.SZ	Hang Zhou Great Star Industrial Co.,ltd.	01/07/2022	15/11/2022	London/ Swiss	155	94.3%
603613.SH	Beijing United Information Technology Co., Ltd.	23/08/2022	To be listed	Swiss	-	0.0%

Trading in secondary markets

In the present market for depositary receipts, companies in the Asia-Pacific region are more eager to issue securities, and institutional investors dominate trade. The total number of depositary receipts issued worldwide, according to FactSet's figures, is over 8,000. UK firms have the most issues, followed by Chinese companies with over 600 issues and Japanese, Indian, Australian, and Russian corporations with over 400 issues each. The Asia Pacific will receive billion. According to Citi, $5.9 trillion will be traded in worldwide depositary receipts in 2020, with some of the biggest transactions coming from Chinese businesses. From the graph below you may have a more direct feeling about the growing number of Chinese companies participating in the GDR industry. By the end of 2020, institutional investors would own $1.3 trillion worth of depositary receipts, with public funds, hedge funds, and custodians holding approximately 90% of the market value.

Number of Chinese companies issuing depositary receipts in the U.S.



Source: CITIC Securities

How listed firms and their shareholders profit from the primary and secondary markets of GDR products?

GDRs must be based on A-share equity, so they cannot be traded in the primary market.

The following distinguish GDRs from other funding options including Hong Kong IPOs and A-share fixed income:

1. **Corporate strategy**: The demonstration effect of issuing GDRs is substantial and significantly aids in the expansion of global business.
2. **Issue pricing**: According to the law, the GDR fixed issue price cannot be less than 80% of the A-share market price and the GDR issue price cannot be less than 90% of the A-share market price. The Hong Kong stock market is also undervalued.
3. **Review cycle**: The entire review cycle for GDRs is approximately 4-6 months, with the offshore review cycle lasting about a month.

4. **Trading Restrictions**: A-share fixed income does not require a transfer within six months, whereas GDRs can be exchanged after listing and can be redeemed after 120 days.
5. **Issue interval**: In general, the time between the issuance of A shares must not be less than six months, although there is no set amount of time between the issuance of GDRs or between the issuance of GDRs and A shares.

The GDR listing process is simple, the capital is international, and the domestic issuance also resolves the issue of foreign shareholders wanting to sell their shares, which is crucial for issuers and shareholders who require international capital. For issuers, the GDR mechanism stipulates that the issuer may remit funds outside of the country or retain them within the country for use to raise funds, making the use of funds for companies whose main business is still overseas more flexible. For shareholders, this mechanism can also meet the exit needs of many foreign shareholders as the underlying equity issue is located outside of the country.

The fundraising project is more flexible. For the A-share fixed issue, if the funds are raised through a non-public issue of shares other than the allotment, issue of preferred shares, or the board of directors' determination of the issuance target, the proportion of funds used to replenish working capital cannot exceed 30%. There are no special requirements on the fundraising project for the issuance of GDRs.

The financing currency of the GDR includes the Swiss franc, US dollar, and euro, and it is not required to swap back. This will increase the level of globalization and enrich foreign financing channels.