China — Moving on with Reforms

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I would like to brief readers on China's efforts in converting non-tradable A shares to tradable common stock, and examine the implications for global-minded investors.

There are currently 1,379 companies listed in mainland China and roughly two-thirds of the total market capitalisation consists of so-called legal person and state-owned shares that are non-tradable. The government has wanted to divest its interests in these companies to fund its pension program and improve corporate governance. Previous attempts to implement reforms in 1999 and 2001 were unsuccessful. This time, it appears the reforms will move forward.

In May the China Securities Regulatory Commission (CSRC) initially approved four A-share companies — Shanghai Zijiang, Sany Heavy Industry, Tsinghua Tongfang, and Hebei Jinniu Energy — to sell off some of their non-tradable shares on a trial basis. In June a second batch of 42 companies were selected, including numerous heavyweights, such as China Yangtze Power, Baoshan Iron & Steel, Shanghai Port Container, Shenergy, and CITIC Securities. Around ten of the companies are listed on Shenzhen's nascent Small and Medium Size Enterprise (SME) Board.

So far the reforms have been successful and, interestingly, the process has created unprecedented shareholder activism. One of the requirements for approval requires at least two-thirds of votes from all shareholders. Compensation plans, usually involving shares and/or cash, are offered to minority shareholders holding tradable shares on the expectations of share price declines once the non-tradable shares are floated. In some cases, minority shareholder discontent has led to amended payment terms.

The Shanghai and Shenzhen composite indices, consisting of both A and B shares, have dropped more than 10% since the reforms have been announced, and in the past 12 months they have been the worst-performing of 79 global benchmarks tracked by Bloomberg — each down about 40%. Mainland stocks are now at eight-year lows.

The overhang of the non-tradable share issue has probably been the biggest factor in why A shares have performed so poorly in the past few years. With the program now under way, more investors will invest in China. We feel that it is worthwhile now to start investing in the A-share markets, and in June we made our maiden investments via China's Qualified Foreign Institutional Investor (QFII) scheme. The average price/earnings multiples of companies from the main Shanghai index are now trading at about 12 times earnings, compared with 50 times a few years ago.

We expect volatility in A shares to continue going forward. At this time we have preferred to put money in investment funds listed in Shanghai and Shenzhen that are trading at around 45% discounts to their net asset values. Many of these funds are expected to open in the next couple of years. We also find convertible bonds and some select A-share companies interesting. We feel that once the reforms establish a successful track record, the past eight years of declining share prices may be matched by eight years — and perhaps more — of rising share prices.

Government intervention in the stock markets has been limited thus far, but this is changing. Recently, CSRC chairman Shang Fulin has spearheaded these efforts, including by extending preferential loans to struggling brokerage firms, allowing fund managers to use their own capital to buy their own funds, allowing companies to buy back their shares, and by lowering taxes on dividend income (from 20% to 10%). The two-year-old QFII scheme will be liberalised, and increased foreign ownership should increase dramatically. With the percentage of tradable shares due to increase, international rating services will give the green light for investing in China. I can certainly see this happening based on my first-hand experience in helping to set up one of the first QFIIs in Taiwan in 1991 and watching that market prosper ever since.

We still believe, however, that the best opportunities for investing in China are in companies listed outside of mainland China, and that is where we have most of our money. According to our analysis there are more than 3,000 listed China plays globally. We consider a stock a China play if it derives the majority of its business from mainland China (including Hong Kong), either by revenue, profits, and/or production.

Our core long portfolio companies trade on an average of about six times this year's earnings, with earnings growth of around 20% and 4–5% dividend yields. Many companies not affected by China's reforms have seen their share prices decline, offering very good opportunities. We have recently accumulated shares in Shenzhen B-share China International Marine Containers (CIMC, 200039 CH) after its shares fell more than 40% following the share asset disposal program starting. CIMC is the world's largest container manufacturer, with more than 50% market share. Only 16% of its shares are non-tradable (compare that to 78% for Baoshan Iron & Steel) and that belongs to a key partner and client within the COSCO Group. The shares are now trading at three times this year's earnings with a respectable yield.

Of course, it is also very important to be able to short in the China stock universe, and an interesting area to look for opportunities here is on the Nasdaq, where many early-stage companies are successfully listed by eager investment bankers. Some of these stocks typically crash a few months after listing once the venture capitalists cash out and new competitors copy the incumbents' business models. (Please see JOBS US, LONG US, and XING US.)