The China Question

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How should China-dedicated investors position themselves, given that mainland stocks and high-profile H shares have skyrocketed in the past year or so? The risk/reward profile for A and H shares is definitely not attractive in the short term in light of the sharp run-up of these stocks. In my opinion, there are many compelling investment opportunities elsewhere in the China equity universe. A and H shares account for only about 30% of all the companies in the greater China universe — all those companies listed in China, Hong Kong, and Taiwan, and all other greater China plays listed worldwide.

WHAT ABOUT THE MAINLAND MARKETS?

Last year was a banner year for China's stock markets. The Shanghai and Shenzhen composite indexes, comprising A and B shares for each market, were up 130% and 97%, respectively, at year end. The strong performance has continued this year, with the Shanghai Composite Index up 11% and the Shenzhen Composite Index up 36% as at February 15. This robust market performance is a far cry from previous years, when the domestic markets halved in the four-year period to the summer of 2005 and reached six-year lows. Valuations for the 1,400 or so A shares and the 109 B shares listed in Shanghai and Shenzhen (81 of the 109 B shares also have listed A shares) were at close to 40x last year's earnings.

In order to reduce the speculative elements of the markets, Beijing bureaucrats have taken various measures and numerous government agencies have recently issued policy statements with an agenda of talking down the markets. Even the National People's Congress Vice-Chairman Cheng Siwei remarked that the mainland stock markets were developing into a "bubble" and investors were acting "relatively irrationally". After Mr. Chen's comments at the end of January the markets corrected by 5%.

Our fund started to invest in A shares near the market bottom in the summer of 2005 and we have done very well. Our preference has been to invest in the heavily discounted closed-end funds listed in Shanghai and Shenzhen. Once trading at near 70% discounts to their net asset values, the 50 or so funds are now trading at an average of around 30%. We still see value in holding a portion of our assets in these funds; however, we are reluctant to hold A shares outright given that we can find much better value within the greater China universe. Our core long positions of small to mid-cap companies from the private sector on average trade at single-digit multiples with a very attractive earnings outlook.

SHOW ME THE MONEY

Awash with more than US$1 trillion of foreign reserves, China is now setting up a framework for investing a large chunk of its reserves overseas, and its willingness to allow large foreign institutions to participate in the program has foreign managers salivating.

The development gathered pace in March 2006 when China's State Council gave approval for the country's pension fund, the National Social Security Fund, to start buying overseas securities and fixed income for the first time, thereby essentially paving the way for the implementation of the long-awaited qualified domestic investor (QDII) scheme allowing mainland-sourced capital to be invested overseas.

Then, last July, the China Bank Regulatory Commission (CBRC) granted QDII licences to six banks — ICBC, Bank of China, China Construction Bank, Bank of Communications, HSBC, and Bank of East Asia. The qualified banks are permitted to convert renminbi into foreign currency in order to purchase fixed-income products, primarily bonds and money-market instruments. The results thus far, however, have been lacklustre.

Bank of China, China's largest foreign currency deposit holder and number two lender, raised RMB578 million last September for its first QDII product, which was allowed to invest only in fixed income. The fund has returned only an annualised 1.3% since its inception, less than the 2.52% return for one-year yuan deposits.

The more than 50 domestic fund managers have also been allowed to set up QDII funds. Last November, a Shanghai-based manager was the first mainland investment manager to launch an open-ended mutual fund. The fund was allocated roughly 45% to fixed income, 35% to global equities, 10% to US REITs, and 10% to commodities. The scheme was the first of its kind that allowed mainland investors to access global equities or alternative investment products such as real estate or commodities.

Despite the slow start of the QDII program, it is expected that over time large amounts of capital originating from the mainland will increasingly find their way into overseas capital markets. The investment scope of the bank's QDII funds has expanded recently to include open-ended funds investing in Hong Kong and other Asian markets. This development should definitely bring offshore China-related share prices more into line with the mainland markets. Moreover, a special government investment vehicle, similar to Singapore's Temasek Holdings, may be set up in the near future to manage a portion of China's foreign

reserves. (This will be discussed at the upcoming annual National People's Congress meetings.) It is our belief that a major recipient of outward capital flows from China will be lower-priced China-related stocks listed outside of China.

CHINA STOCK PICKS — LONG AND SHORT

China Green

China Green (904 HK) is a leading vegetable and fruit grower, and processor, in China. We have owned its shares since it listed in Hong Kong in January 2004. Including dividends, the stock has returned around 350%, and 62% annualised, since listing.

The company operates 33 cultivation bases mainly in Fujian and Jiangxi provinces. In 2006, fresh produce, processed food products, and rice-related products contributed approximately 43%, 30%, and 12% of revenue, respectively. New corn-based beverage products were launched on a trial basis last year, and the beverage division already contributes around 10% of total revenue. Some 48% of sales went to the mainland, 42% to Japan, with the remainder to other countries. In the past year, new export markets have included Germany (canned mushrooms), Belgium (frozen vegetables), Italy (canned mushrooms), and Korea (*naganegi*).

We expect sales growth for the next few years to moderate to about 35% compared to the 42% CAGR achieved since 2002. As a leading domestic agricultural enterprise, China Green qualifies for preferential tax benefits, and gross margins are more than 50%. We estimate that earnings per share will grow 35% over the next three years and we value the company at 8 times next year's earnings (6 times ex-cash). It yields around 2%, and its return on equity is approximately 30%. The company has no gearing and has cash on hand of around RMB800 million, or about 20% of its current market cap of US$550 million. Other similar stocks in our proprietary stock screening model (around 30 companies listed on various exchanges) trade at about 20 times this year's earnings, yield around 1%, and are geared, on average, at around 50%.

The company issued a convertible bond to Goldman Sachs a year ago to help finance its next growth phase, the construction of a centralised processing centre in Shanghai, with the aim of distributing its products and non-brand items to a major supermarket chain in eastern China.

For our top portfolio positions we meet with or communicate with the company's management every two weeks and model our own earnings estimates. This is an integral part of our investment process, as it increases our confidence in the management team's abilities. China Green's October 1H07 numbers released on January 24 were slightly ahead of our projections, and the company has consistently surpassed or met our own internal earnings projections.

In our view, China Green is unjustifiably cheap and the stock remains below the radar screen of international investors. The stock isn't in any index, and at the time of this writing JP Morgan has just initiated coverage of the stock with a target price that is 50% higher than the current share price. The JP Morgan report, by the way, is the first ever to be issued by a tier one investment bank.

Zhenhua Port Machinery

Zhenhua Port designs, manufactures, and markets large-size port handling equipment, engineering vessels, large-size steel structures, and related parts (www.zpmc.com). Leveraging on China's cost advantage, the Shanghai-based company has developed into a market leader in the global port machinery industry.

It currently is the world's largest container crane manufacturer and it has 74% global market share in a business with very high barriers of entry. Major clients include practically all the major shipping players, including AP Moller (Maersk), Hutchison Port, PSA in Singapore, most shipping companies, including Evergreen and Cosco, and various container ports around the world. Its current order book is three years. Zhenhua Port is the only company of its kind to use its own shipping vessels (20 such vessels) to deliver cranes to its customers worldwide. It has diversified into new businesses such as bridge steel structures, and in 2006 it won the mandate to build the new San Francisco Bay Bridge.

We invested in the company's B shares in August 2005 and its share price has since quadrupled. We nevertheless still like the Shanghai-listed company and we value it at around 13x next year's earnings and a yield of around 2%. Its B shares are trading at about a 20% discount to its A shares.

Chinese Banks (Short)

Three of the four major state-owned banks have listed in Hong Kong and sold shares to foreign banks — China Construction Bank (CCB) to Bank of America, Bank of China (BOC) to Royal Bank of Scotland, and Industrial and Commercial Bank of China (ICBC) to Goldman Sachs. Bank of Communications, China's fifth-largest bank and largest non-state-owned bank, also sold shares to HSBC. The fourth state-owned bank, and the weakest of them all, Agricultural Bank of China (ABC), is now embarking on a restructuring program that will probably result in it listing like its three other state affiliates.

Agricultural Bank aims to complete its financial restructuring, which will include a government capital injection, by around year end. Central Huijin Investment, the government's investment unit, could inject up to US$30 billion into ABC to clean out bad loans. Huijin injected US$22.5 billion into each of CCB and BOC in 2004, and US$15 billion into ICBC in 2005. The strategic investments by the foreign banks then followed. ABC is likely to find foreign investors similar to the other three banks after a large chunk of the bad loans are stripped out. The injections helped lower the banks' non-performing loans and increased their capital adequacy ratios to international standards, thus paving

the way for their listing. ABC's goal was to lower the bad loan ratio to around 5%, from an estimated 23% at the end of last year (although the real ratio was probably much higher). ABC has the largest number of outlets in China.

In our view, Chinese banks have had their run and are now prime shorting candidates. The share prices of the banks, as well as of other Chinese financial heavyweights, have soared and appear to be massively overvalued. ICBC's H shares are trading at more than 30x last year's earnings with a price to book of 4.5x, while CCB and BOC H's shares are only slightly cheaper. ICBC and BOC's A shares are even more expensive. China Life's H shares are trading at 50x earnings, while its A shares are more than 100x earnings at a time when its premium income is clearly slowing.

I believe that, based on a two-year horizon, shorting Chinese banks is a no-brainer. Lending will slow this year and next, due to Beijing's efforts to slow the juggernaut economy to a more acceptable growth level, and also due to the government's clampdown on bank loans that have made their way into the stock markets. Financial stability and social unrest are two key risks China's government faces, and it will seek to moderate people's expectations should excess market speculation persist.

THE CHINA MANTOU FUND

The China Mantou Fund is a long/short fund and has positions in a diversified portfolio of greater China-related equities. The Fund is open for new subscriptions monthly. For further information on The China Mantou Fund, please contact Andy Mantel at Pacific Sun Investment Management (HK) Ltd.

THE GLOOM, BOOM & DOOM REPORT

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