China — Lost in Translation

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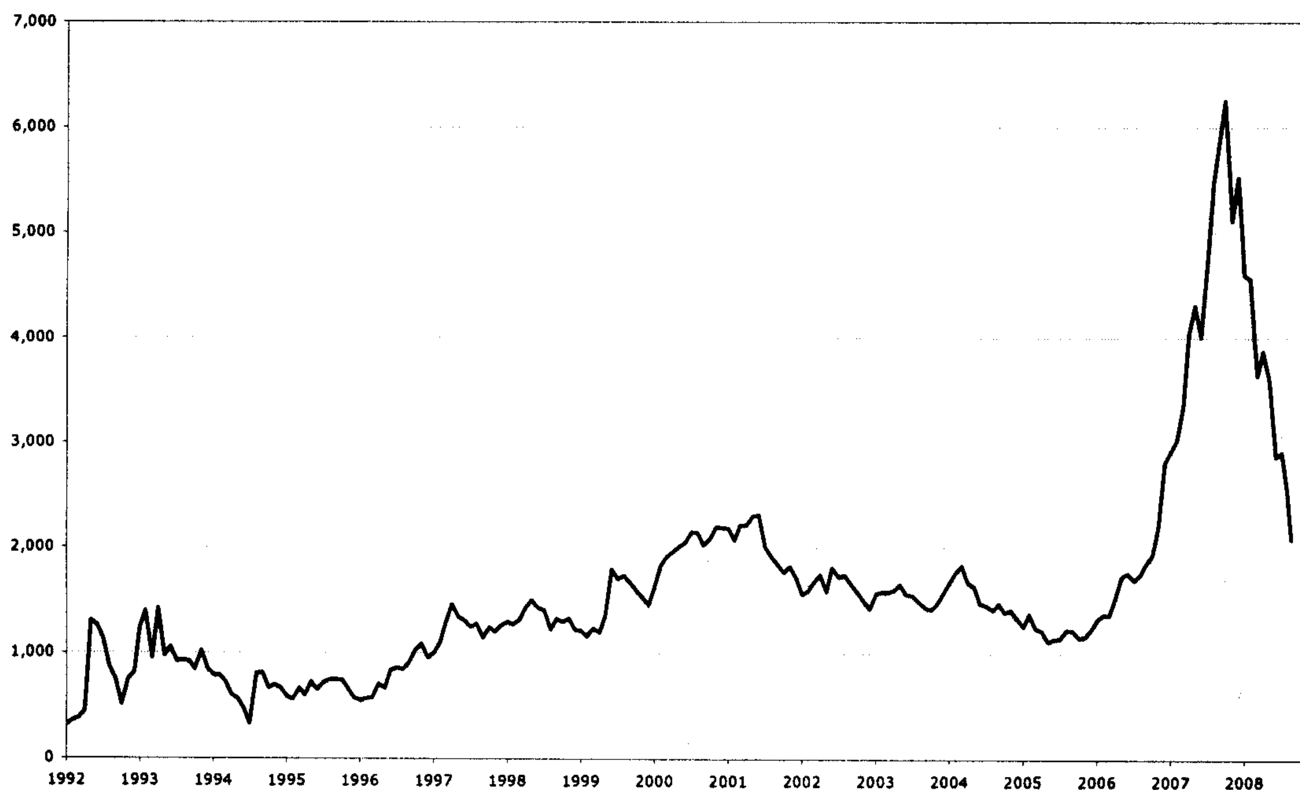
It was a little more than a year ago last August when the State Administration of Foreign Exchange (SAFE) announced that mainland citizens would be allowed to buy stocks directly on overseas markets. The so-called Individual Investor Scheme, also nicknamed "the through train", instantly created excitement throughout the investment world. Hong Kong was designated the first market for the program, and share prices of large-cap China-related stocks listed here — particularly financial, oil, and telecom names — surged over the following three months due to the expected flood of money from across the border. Investment banks jumped on the bandwagon and predicted huge fund inflows — Morgan Stanley proclaimed that up to US$100 billion of mainland-sourced funds could find its way to the Hong Kong market within a year, and sell side analysts rushed to raise price targets, in some cases doubling or tripling them overnight.

Fast forward to today and things couldn't be any more different. China's capital outflow program for individual investors has yet to materialise, and may not do so for some time. (Some investors, however, have been able to invest offshore indirectly via the slow-going qualified domestic individual investor (QDII) scheme.) Initially, the through train was to help deflate the surging equity markets in Shanghai and Shenzhen and provide an outlet for the excess liquidity that was sloshing around the mainland. From an eight-year low in July 2005 the Shanghai "A" Share Index rose more than 500% in a 27-month period until it peaked at 6,197 in mid-October of last year. Since then the index has lost close to two-thirds of its value and was hovering around the 2,200 level at the time of this writing. (See Figure 1, showing the Shanghai "A" Share Index weekly historical price chart since its inception in 1990.) With the domestic markets in a tailspin, there won't be any hope of resurrecting the through-train program any time soon.

TIME TO BUY "A" SHARES?

We bought "A" shares for the first time in mid-2005 via a basket of investment funds listed in Shanghai and Shenzhen that were trading at around 60–80% discounts to their net

Figure 1 **Shanghai "A" Share Index, 1992–2008**



Source: Bloomberg

asset values. Last November, we closed our "A" share positions and have yet to re-enter the markets. Although some investors have been calling a bottom for the past few months following the large corrections, we see more downside and recommend investors to be patient. Despite our optimistic view with regards to China's investment landscape, we feel that buying mainland-listed shares isn't the best way to get exposure to the China growth story.

What is casting a shadow over the mainland markets is the enormous amount of non-tradable shares that are due to become tradable over the next few years. In mid-2005, Beijing had seemingly found a solution in converting the non-tradable "A" shares to tradable common stock. Previous attempts to implement reforms in 1999 and 2001 were unsuccessful. This was the major reason why the Chinese markets, despite an economy that was growing at 10%+ annually with low inflation and very good corporate results, were in a bear market from 2001 to mid-2005. With approximately 1,400 listed companies and roughly two-thirds of the total market cap consisting of non-tradable legal person and state-owned shares, the government temporarily solved this problem by issuing free shares to investors of already held tradable shares in exchange for the right of the non-tradable shareholders to sell their shares over a certain period of time.

This dilemma is clearer if you consider the typical share capital structure of some of China's largest listed companies. Take Petrochina, for example. The oil giant first listed "H" shares in Hong Kong in early 2000 and subsequently raised more capital in both 2004 and 2005. Tradable "H" shares now account for around 11.5% of the total issued share capital. Last November, as part of an effort by Beijing to list more quality companies on the domestic markets, Petrochina raised RMB67 billion when it listed a mere 2.2% of its share capital as "A" shares on the Shanghai Stock Exchange. That leaves a total of around 86.3% of the company's share capital that is owned by the government and, according to China's original share reform plan, approximately 10% of the company's non-tradable shares should become tradable annually for the next few years. The same thesis applies to similar Chinese behemoths and their imperfect share capital structures. Thus, we view the domestic markets still as superficially inflated despite the seemingly attractive valuation levels — Shanghai is now trading below 20x historic earnings.

In some respects, Beijing is now back to the drawing board with its share reform plans. This time, efforts will focus on assisting with the unwinding of previously non-tradable shares. In March alone, non-tradable shares worth more than RMB300 billion were unlocked. That is why, in the past few months, Beijing has introduced some measures in order to limit or stall, if you will, the unwinding of new tradable shares. On this note, investors should realise that during China's bear market from 2001 to 2005 Beijing announced dozens of measures, but to no avail. Thus, we feel that any additional measures that may be introduced by the CSRC will likely fail to invigorate the markets any time soon. One positive factor, however, is the low penetration thus far of foreign funds by way of the qualified foreign institutional investor (QFII) program. The scheme was launched in 2003 and a US$4 billion quota was initially granted to select foreign investors. This amount was raised twice since then, to US$10 billion in early 2007 and to US$30 billion early this year. Any liberalisation of this program will surely benefit the "A" share markets.

SMALL IS BEAUTIFUL

We believe that the best investment opportunities are in emerging companies from China's private sector. These companies are listed offshore, have clean share capital structures, and are not affected by China's share reform measures, unlike the government-owned "H" shares and red chips. These entrepreneur-backed firms are mainly mid- and small-cap stocks and remain under-researched by the sell side community and under-owned by international investors. According to our analysis, there are more than 3,000 of these stocks listed in Hong Kong, Singapore, Taiwan, the US, and other markets where Chinese entrepreneurs have been successful in listing their mainland-based businesses.

Certainly, we feel that the heavy sell-down since late last year was warranted in specific areas of the greater China investment universe, namely mainland-listed "A"/"B" shares and large-cap "H" shares/red chips. But the market sell-off has also pushed down smaller companies almost to levels never seen before, and in some cases at early-stage private equity valuations. Our core long positions trade on an average of about five times this year's earnings, with earnings growth of around 30% and 5–6% dividend yields. One of our top positions, involved in the telecom and security surveillance equipment, is now trading at 1.5x current year's earnings, and is growing 30% CAGR three years forward and pays an 8% yield!

CHINA STOCK PICKS — LONG AND SHORT

Our favourite sectors include transport, food and agriculture, and consumer electronics. Rising consumer spending is a central theme to our investment philosophy, and we are seeing China's middle class willing to spend extra Renminbi to buy better everyday goods. Many of our core long positions are seeing expanding margins because of better product mix — a direct beneficiary of the China consumer.

In Hong Kong we like Singamas (716 HK), the world's second-largest container maker with a 26% market share. Its share price is down 75% in the past year due to worries over a slowing global economy. We feel that the slowdown was overdone, and their 1H08 interims announced a week ago show improving margins, in

part due to sales of higher-margin oil tankers used for liquid chemicals, for which they are a first mover. Singamas's valuation has now returned to the low end of its five-year range of 3.8x–25.4x P/E. It is also at a trough of its P/B range of 0.52–2.75x, and P/S is now at about 0.08 (see Figures 2–4). The extremely low valuation — FY08F sales of US$1.8 billion and a US$120 million market cap — has made the company, in our view, a potential takeover candidate by a major shipping or container leasing company. As we have recommended previously in this report, we still like vertically integrated food and beverages processor China Green (904 HK). We bought the stock at its IPO in January 2004 at HK$1.28 a share and sold shares near its all-time high in May of this year at around HK$10.60. The share price has now dropped back to around HK$6 and we recommend investors to take a look. The company's chairman, Sun Shao-feng, recently bought back shares for the first time in two years, boosting his stake in the firm to 46.8%. Its expansion into higher-margin beverages and instant noodles is the next growth driver and the company has started selling fresh produce to Walmart hypermarkets in Fujian, Guangdong, Zhejiang, and Hunan provinces. Another stock we like in Hong Kong is notebook plastic casing manufacturer Ju Teng (3336 HK). It is an innovator and leader in making new product launches and supplies most of the leading electronic manufacturers, including Compal, Wistron, and Quanta. We would also recommend investors to consider Singapore-listed greater China stocks, as many of these (more than 200 of them in our investment universe) have seen their share prices fall between 50% and 90% year to date. Savvy, well-heeled investors should consider ladies footwear manufacturer Hongguo (HGUO SP), a leading retailer in China's second-tier cities.

In light of the sharp market corrections, we would be wary of shorting too much at these levels. However, we feel that valuations of Chinese banks are still too high because of slowing loan books, increased non-performing loan risks, and investment losses stemming from falling equity prices. In this area, investors may want to consider shorting China Construction Bank (939 HK), Bank of Communications (3328 HK), and Bank of China (3988 HK). Also, we feel there is still more downside for selected Macau-related stocks given cannibalism from new market entrants, tight visa restrictions limiting mainland visitors, and poor infrastructure. We started shorting Melco (200 HK) last year at above HK$15 and it is now trading at less than HK$3.50. Not all is bad about Macau, though; if you are in the neighbourhood, it is highly recommended to stay at the sprawling Venetian Hotel & Casino and catch a Cirque du Soleil show.

CHINA SEEKS LESSONS FROM A YEAR OF TRAGEDY

By our head of research based out of Shanghai, Sage Brennan

After a year of tragic calamity, speculation that several hundred migrant workers and local villagers may be buried under two metres of iron ore waste following a landslide at an illegal mining operation in Shanxi Province has dashed hopes that the Olympic Games in Beijing might serve as a turning-point in China's fortunes.

Chinese people feel embattled but defiant in the face of a slew of natural and man-made disasters during 2008:

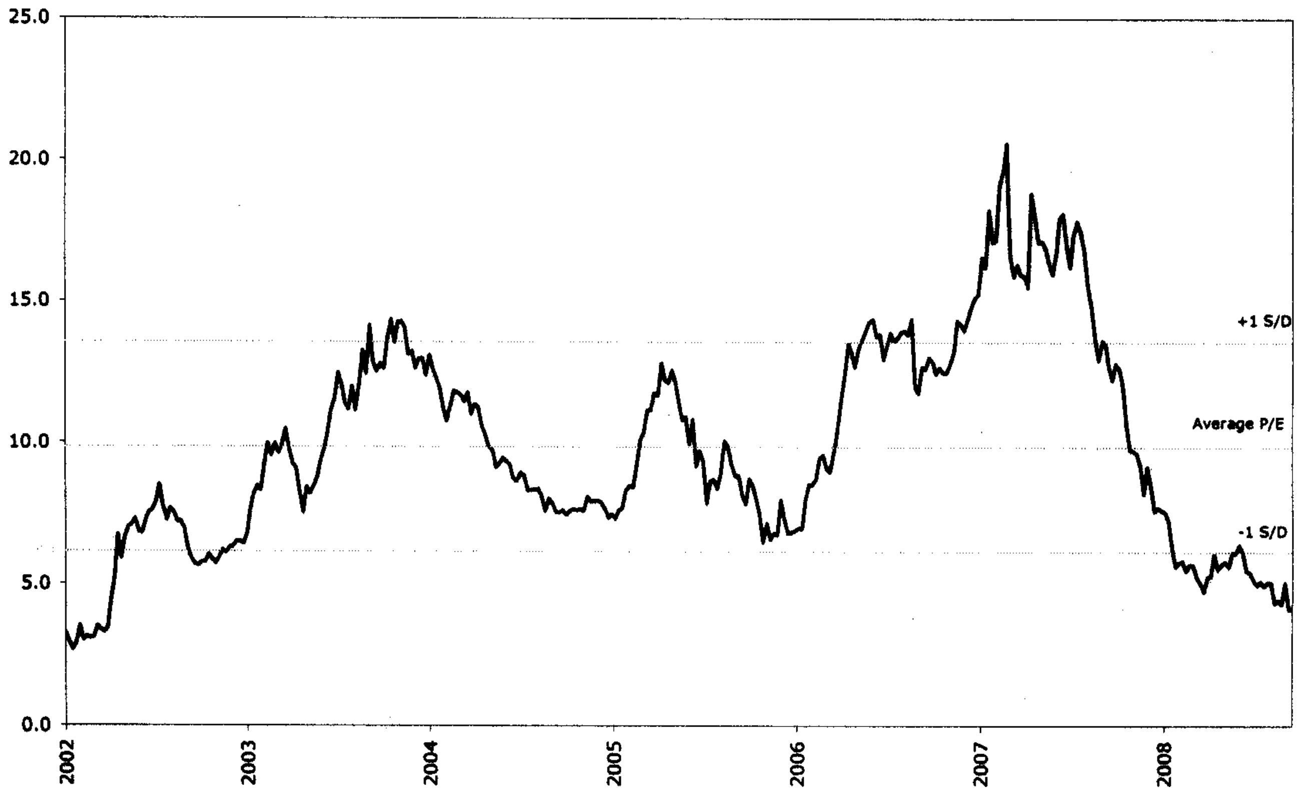
- The American sub-prime mortgage crisis triggers a global credit crunch that impacts foreign investment in China.
- Debilitating snowstorms paralyse much of China during the Lunar New Year celebration.
- A national pork shortage leads to widespread food price inflation.
- China's new national labour law takes effect, driving costs up dramatically for many low-margin manufacturers.
- Tibetan protests lead to embarrassing riots in Lhasa around the anniversary of the 1959 uprising.
- Protests of the Olympic torch relay in London and Paris, spurred by the Darfur and Tibet situations, draw international attention. (Most Chinese people remain only dimly aware of these protests, due to media obfuscation.)
- Demonstrations protesting Carrefour's rumoured support of the "Dalai Lama Clique" are quelled after scuffles involving foreign students.
- A deadly earthquake in Sichuan leads to a widely lauded response from China's central government and military.
- A head-on train collision in coastal Shandong Province kills scores.
- Beijing clamps down on entry visas of all types, citing terrorism and other disruptive threats in the run-up to the Olympic Games.
- Widespread flooding in China's southwest exacerbates the earthquake tragedy and threatens millions.
- Evidence of non-food inflation appears, spurred by energy prices and increasing demand.
- A massive algae infestation at the Qingdao site of the Olympic Sailing venue threatens to derail many events.
- Riots in Guizhou Province over the murky official handling of the suspicious death of a young girl lead to the burning of government buildings and the sacking of officials.
- A three-storey wave of iron ore waste inundates an open-air market in Xiangfen, Shanxi Province, following an accident at an illegal mine above the town, killing at least 150 villagers and migrant workers. Speculation puts the eventual death toll far higher.

FACING ADVERSITY, CHINA'S OUTLOOK REMAINS POSITIVE

Despite significant advances in GDP and living standards over the past 20 years, China remains a dog-eat-dog environment with a proud tradition of local corruption, remonstration, and periodic chaos — especially in the less-developed interior provinces.

On the flip-side, patriotism has once again become a steady, unifying

Figure 2 **Singamas Containers Price-to-Earnings Ratio, 2002–2008**

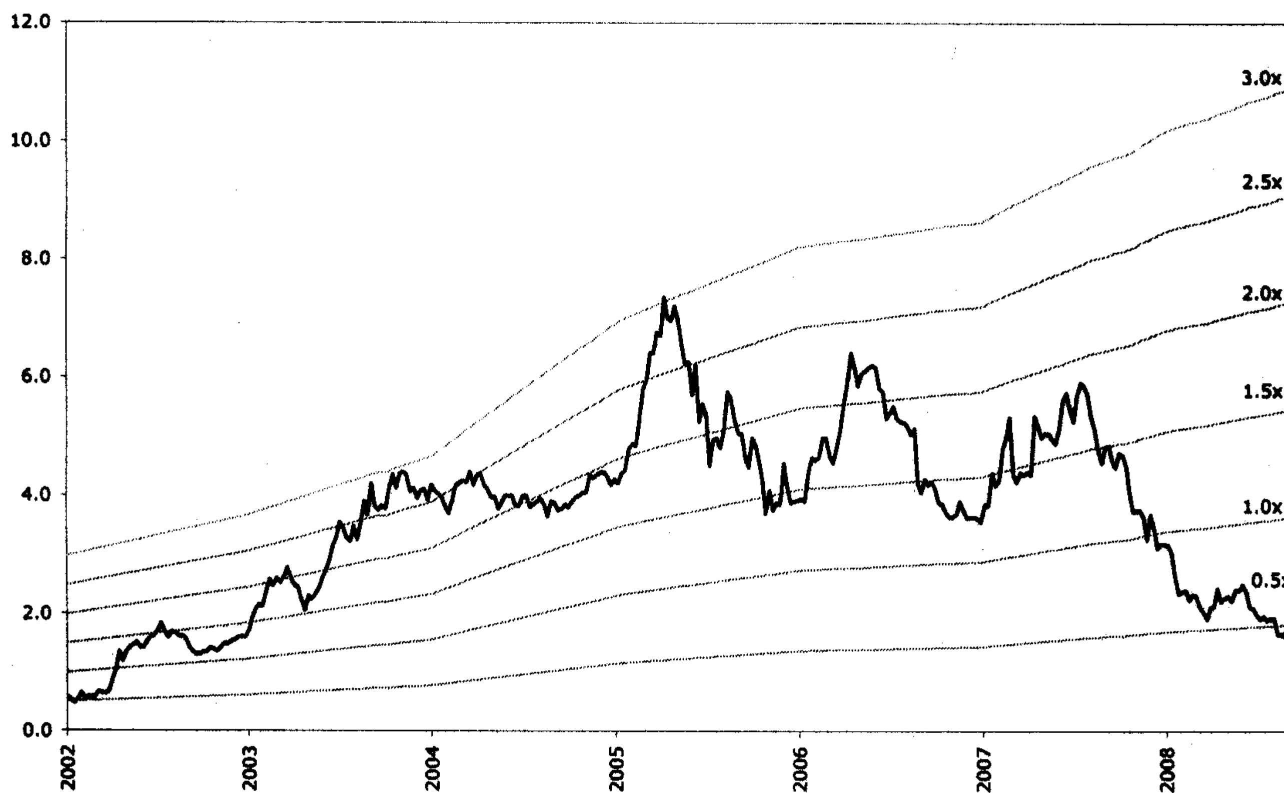


Source: Bloomberg

Figure 3 **Singamas Containers Price-to-Sales Ratio, 2002–2008**

Source: Bloomberg

Figure 4 **Singamas Containers Price-to-Book Band Chart, 2002–2008**



Source: Bloomberg

force, with widespread and fervent support for both the central government in Beijing and China's system of government — particularly in the wake of the leadership's productive response to the disasters of 2008 — even if people's support of local government potentates remains circumspect.

However the Olympics will ultimately be judged by foreign media, governments, and other observers, the Games were an enormous success in the eyes of the Chinese people — a key morale booster and a focus of positive energy for a society that continues to change at an astonishing pace.

FUTURE CHALLENGES WILL REQUIRE DIFFERENT TOOLS

China's growth remains on a steady and positive long-term trend, despite worries about a post-Olympic slump. Although Beijing will continue to manage China's growth with a firm hand, the next 20 years will require a new set of tools with which to steer the country through uncertainty.

After decades of hell-bent acceleration, China's leadership realises that the country needs to start thinking about *quality* of growth. Innovation, sustainability, quality of life, and other intangible issues that have long been the purview of Western academics and business leaders are starting to creep into China's public discourse. Corruption, inflation, and job security also remain key concerns for a majority of Chinese people.

The expected divot in China's third-quarter GDP, attributable to the enforced paralysis of economic activity in Beijing (and stretching across much of China, in many sectors) for two months, may prove to be a proxy for the true costs of repairing the astonishing destruction that China's 20-year boom has wrought on its environment.

In the 1980s, visitors to a just-awakened-from-slumber Beijing occasionally saw the air tinged with coal dust from local factories, but the skies were mostly blue, even in the natural summer haze. In more recent years, this "fog" has become a euphemism for the deathly vapour-cloud that envelops many of China's urban areas — a threatening cloud, about which Chinese people are beginning to worry.

Clearly, pressure from the outside world on issues such as human rights or civil society or environmental protection has little effect on Beijing, as we saw during the lead-up to the Games. The question remains whether Chinese people and business leaders will provide their own pressure.

CHINA'S LEADERSHIP SEARCHES FOR ... LEADERSHIP

Growing accustomed to its new-found status as a global industrial powerhouse, China will increasingly look to the United States, Europe, and Russia — in both current and

historical contexts — for cues on how to lead responsibly.

Observing as America flexes its muscle internationally in Iraq and Guantanamo Bay and elsewhere, for example, Russia takes the cue and protests what it sees as America's "unipolar" influence on world affairs by annexing South Ossetia.

China watches these super-powered antics very carefully, constantly assessing the strategic opportunities and threats — energy and resources, technology, labour and education, human rights, and so on — for the world's fastest-growing major economy.

The conclusions Beijing draws from the behaviour of the world's leading countries will inform China's participation in the next generation of superpowers.

THE CHINA MANTOU FUND

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

THE GLOOM, BOOM & DOOM REPORT

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