Greater China Equities at a Glance

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I have had the privilege and opportunity of commenting on the greater China markets a number of previous times for Dr. Faber's report. My first contribution appeared in the December 1999 edition when I wrote an article entitled "Investing in China into the New Millennium". In subsequent articles I had addressed issues that pertained to specific issues most relevant at those times. Right now China seems to be at a crossroads. While it is clear that China has been a friendly partner in dealing with the global financial crisis, it has also become evident that it has turned more bold and aggressive in its dealings and discussions with other countries. Despite the worries, however, it is clear that China has grown up very fast over the last 30 years and one can only wonder what it will look like 30 years from now. This article highlights three important themes — namely, China's rising consumer demand, the Renminbi, and China's capital outflows. We then highlight some interesting investment ideas and update readers on Pacific Sun's development.

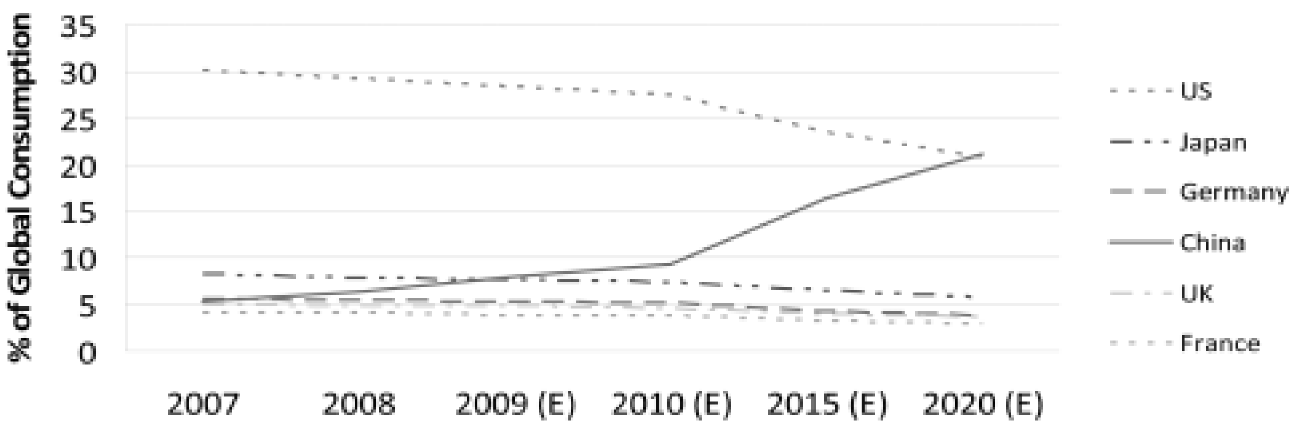
THE CHINA CONSUMER BECKONS

China's aggressive, timely, and ongoing stimulus package has had a very positive and stabilizing effect at a time when the global economy continues to try to find its footing. Besides mandating loans to infrastructure- and property-related projects, the government also introduced a number of progressive subsidy programs to various industries in a bid to awaken the Chinese consumer. Household appliance and automobile manufacturers have been prominent beneficiaries of these programs as China's emerging middle class ponders what to do with their increasing disposable incomes. China's domestic consumption is expected to increase dramatically in future years; according to the IMF, it is expected to match the US by 2020 and make up approximately 20% each of total global consumption (see Figure 1).

In a bid to boost domestic consumption and support GDP growth, Beijing announced in February 2009 the implementation of a nationwide four-year rural subsidy program on home appliances for rural residents, following a trial run in 14 provinces. TVs are included on the list and a 13% retail price rebate was offered to consumers. Domestic TV makers are dominating the subsidy program and control almost 100% of the total market share, with five manufacturers controlling about 85% of the total. Aside from the rural subsidy program, the Ministry of Commerce also initiated an "old for new" home appliance subsidy program in nine provinces and cities in June 2009. Under the scheme, domestic households are entitled to a 10% discount for the purchase of new products in exchange for old ones. The five products included in the program include TVs, refrigerators, washing machines, air-conditioners, and PCs. The one-year trial program will likely be lengthened and extended nationwide.

China's rapid urbanization is mind-boggling. The number of urban residents has grown to approximately 620 million today, from about 390 million in 1998, according to government data. The Central

Figure 1 **China's Consumption Growth**



Source: IMF

Economic Working Conference in December 2009 emphasized the priority of developing small and medium-sized cities up the urbanization curve. A major benefit arising from urbanization is the growth potential of disposable income for rural residents. The annual per capita disposable incomes for urban and rural households have risen approximately 12% a year since 2000 to approximately RMB18,000 and RMB5,200, respectively, to the end of last year.

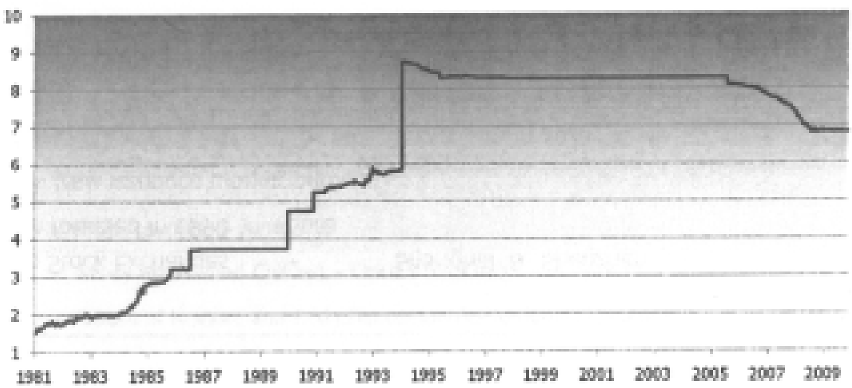
A STRONGER RENMINBI — ONLY A MATTER OF TIME

We believe it is only a matter of time before Beijing will be "*yuan i*" ("willing", in Chinese, sort of) to further allow its currency to strengthen versus the US dollar after almost two years of being virtually pegged to the greenback. The staggering amount of foreign reserves that China has accumulated over the years is clearly a by-product of a weak currency policy in support of its own export strategy. Since 1979 the Chinese currency has been devalued ten times against the US dollar, from 1.5 to 8.7 (see Figure 2). China's foreign reserves were US$2 billion in 1979, US$30 billion in 1990, and are now approximately US$2.4 trillion! The exchange rate is currently around 6.83 and this has been in place since July 2008 after the Renminbi had appreciated about 21% over a three-year period. We believe that, with export growth recovering and inflationary pressures starting to mount, a gradual appreciation will be resumed within the next few months via a "managed floating exchange rate regime". We believe an appreciation of 5% a year for the next few years is reasonable, and once this begins, other Asian currencies will also strengthen. Investors are best advised to increase their allocations towards Chinese/Asian-denominated currencies.

CAPITAL OUTFLOWS TO INCREASE DRAMATICALLY

China's capital markets are developing rapidly. Investors should pay most attention to China's Qualified Domestic Institutional Investor (QDII) scheme. While its ugly cousin the Qualified Foreign Institutional Investor (QFII) scheme, which involves foreign investment in China's mainland markets, has progressed at a snail-like pace since its implementation in December 2002, the QDII program, which started a trial run in April 2006, is flourishing. Currently around 90 domestic institutional institutions with a combined quota of around US$60 billion have been granted approval to launch overseas funds. This compares to the 90 or so approvals worth a combined quota of approximately US$16 billion that have been granted QFII approval.

Figure 2 **USD/CNY, 1981–2009**



Source: Bloomberg

Another development investors should be aware of involves the "underground" capital outflow. This is the by-product of entrepreneurs listing their Renminbi-invested companies outside of the mainland and being able to cash out in a global currency once their companies list. Overall, these trends will continue and will have a positive impact on offshore-listed greater China equities.

INVESTMENT CHOICES TO EXPAND DRAMATICALLY

We believe investors should consider all greater China-related equities. This means investors should have the flexibility to invest in any listed company worldwide that has significant exposure to the rise of China. Investors should not be restricted to mainland-listed A share companies, which are for the most part government owned and relatively expensive. Nor should investors in our view be restricted to large-cap Hong Kong-listed stocks such as red-chip China Mobile and H share behemoths Petrochina and China Construction Bank. Approximately ten or so Chinese companies dominate the major Chinese market indices.

According to our estimates, there are 5,195 listed companies around the world that we consider greater-China related (see Table 1). Moreover, we estimate that this number will increase 30% over the next three years to 6,741. Young companies that are backed by Chinese entrepreneurs and are listed outside of China will feature prominently in the future, and it is this area that will show the best investment opportunities. Hong Kong will continue to be the gateway for most of these listings, while the recent inauguration of the long-awaited second board in China, the Shenzhen Growth Enterprises market, will prove to be a vital fundraising venue for cash-hungry businesses. Valuations and the relative inability to access this new market will keep it hostile mostly to mainland punters. In the US there is a growing active business of companies gaining a listing access via reverse mergers, PIPEs, and by way of introduction/etc. This market is dominated by niche investment banks such as Roth Capital, Rodman & Renshaw, Brean Murray, etc. We estimate that in three years there will be almost 500 US-listed stocks, or 7% of the total, with significant exposure to the greater China markets.

In order for us to navigate the fast-expanding investment universe we utilize a proprietary stock screening model to assist our stock selection process. Immediately about half of the stocks are eliminated from our investment consideration, mainly due to market cap and liquidity considerations. From there we screen stocks by sector (and sub-sectors) and compare these stocks with a number of different financial criteria. From there our research efforts become more qualitative in helping us form our final portfolio. Our core holdings consist of emerging companies started by Chinese entrepreneurs that have attractive value/growth profiles. Many of our holdings trade below eight times next year's earnings, are growing in excess of 30% CAGR for the next few years, and are able to pay respectable dividends.

SECTOR AND STOCK IDEAS

Based on China's efforts to boost domestic demand and "go green", our favorite sectors include household durables, technology hardware, internet and software, food and agriculture, and alternative energy. As for stock selection, we prefer emerging companies from China's private sectors, and favor small and mid-cap companies as opposed to large state-owned companies.

TV maker Skyworth Digital (751 HK) is very interesting despite its very strong share price performance last year. The company is a direct beneficiary of China's effort to boost consumer spending, especially in the rural areas. It is the largest TV brand in China. It has approximately 16% market share in volume and 15% market share in revenue terms at the end of last year. Headquartered in Shenzhen, the company owns manufacturing facilities in Shenzhen, Guangzhou, and Inner Mongolia. Driving the company's growth is the burgeoning replacement from CRT TVs to LCD TVS in conjunction with the rural subsidy program. It has been the market leader with about a 30% share in the LCD TV sub-segment, and as a result, has benefited from higher average selling prices and margins. We project Skyworth to post an EPS CAGR of approximately 60% during FY09-12, with annualized revenue growth of around 30% during the same period supported by greater economies of scale. In the next year the company is expanding its capacity from 6 million units to 10 million units. FY3/11F sales are approximately US$3.8 billion with net profit of US$230 million. With a market cap of about US$3 billion we value the company at around 10x next year's earnings with a dividend yield of about 3%. We continue to like Yangtze River Delta-based Ju Teng (3336 HK), which is the leading designer and manufacturer of plastic casings for notebook computers. The company's ODM clients have reported strong sales in the first two months of 2010, up 56% year on year, and we project this growth to be maintained going forward as Chinese consumers increase their discretionary spending towards more affordable computers. The company has begun making casing products for LCD-TV's and this will be an increasing revenue driver going forward. The Taiwanese-owned company successfully raised new funds twice last year via a TDR (9136 TT) to support its future growth prospects. The company trades at 8 times 2010 earnings.

Vertically integrated food and beverage producer China Green (904 HK) is ripe for picking at current valuations. We bought the stock at its IPO in January 2004 at HK$1.28 a share and sold shares near its all-time high at around HK$10.60 in May 2008. We subsequently bought again a few months later when the shares dipped below HK$5 a share when the global markets crashed. Despite the phasing out of the companies tax holidays the past couple of years, we have been impressed with the management's ability to maintain high growth rates and margins. Ongoing new product launches, such as vegetable juices, will further enhance growth prospects and the company trades at about half the valuation of its closest peer companies such as Want Want

Table 1 **Greater China Equities-related Investment Universe**

	March 2010	March 2013
Hong Kong Main Board – including H shares and Red Chips	1,118	1,338
Hong Kong Growth Enterprise Market	52	68
Shanghai A-Share	853	1,188
Shanghai B-Share	53	53
Shenzhen A-Share	813	950
Shenzhen B-Share	54	53
Shenzhen Growth Enterprises Market	58	300
Taiwan Main Board	717	805
Taiwan Gre Tai Exchange	534	584
Singapore	302	380
Other Asia	278	408
US & Canada	280	468
London	65	104
Other Europe	18	42
Total	**5,195**	**6,741**

Source: Pacific Sun estimates

Holdings and Tingyi Noodle. In the internet space, we like online game developer and operator Perfect World (PWRD US) for its leading role in developing successful 3D gaming technologies. The company has grown steadily since its launch just a few years ago, and it separates itself from its peers with its development vision and ability to produce in-house games, as opposed to the reliance on foreign licensing of other firms. Perfect World is a play on entertainment for today's youth alternatives compared to other miserable options. China Valves (CVVT US) is a fast-growing valve manufacturer for various industries such as electricity, water, and gas. The company recently won a sizeable order from Dongfang Electric (1072 HK) to supply valves for many of its turbines. Growth is supported by an active merger and acquisition campaign. Investors should also look at Golden Meditech (801 HK) as a play on increased government spending on healthcare. The company is interesting from a sum of parts valuation, as its market cap is approximately US$328 million while the value of its "parts" is US$374 million, namely China Cord Blood (CO US; 44%-owned) US$160 million + FunTalk China (FTLK US; 30%-owned) US$88 million + Golden Meditech Hospital Management US$126 million. These businesses/investments are besides its main operating business, namely 100%-owned unit Beijing Jingjing Medical Equipment.

We have been net short major property developers the past few months, as well as Chinese banks to a lesser degree, and we expect to maintain these positions going forward. We project there are about 500 listed property companies in our investment universe. The property sector is of enormous importance to the overall stability of China's economy and is interrelated with many other important industries. We are not bearish on the entire property sector and we like Hopefluent (733 HK), a provider of comprehensive real estate agency services in Guangzhou and other areas of Guangdong Province. Rather, we have a more bearish view towards luxury property developers operating in major urban areas that will likely suffer when Beijing further clamps down on property speculation. We expect share prices of China Resources Land (1109 HK), Shimao Property (813 HK), and Evergrande Real Estate (3333 HK) to come under further downward pressure. Investors may want to avoid or short China Construction Bank (939 HK), ICBC (1398 HK), and/or China Merchants Bank (3968 HK). Chinese banks, while not expensive at current valuations, face slowing loan books, increasing non-performing loans (in the medium term), and aggressive earnings dilution via mandatory capital raising exercises. Some commentators have recently said that in a worst-case scenario, some banks may be forced to be bailed out following their forced lending to local government enterprises.

Pacific Sun Update

Earlier this year we announced a strategic partnership with Jiangsu Zhongtai Group Co. Ltd., an independent investment holding company based in Nanjing, Jiangsu Province, China. The group is involved in various businesses including alternative energy, information technology, venture capital, etc. The group's Chairman, Liu Xuezhong, is a shareholder of Pacific Sun. He has successfully invested in many early stage companies, including China High Speed Transmission Group (658 HK) in which he invested US$2 million in 2003 at HK$0.10 a share — the company listed in July 2007 and its share price closed at HK$18.96 at the end of last year! He is also an early stage and major investor in heat transfer manufacturer Greens Holdings (1318 HK), which listed in November 2009.

Cooperation with Jiangsu Zhongtai will extend to investment research, strategic advisory, possible deal flow, and sharing of resources. The relationship will enhance our information-gathering efforts. Jiangsu Province currently has a population of close to 80 million people and is a hotbed of entrepreneurial companies, both listed and to be listed in the future. Nanjing is the former capital of China and the second-largest commercial center in Eastern China.

The China Mantou Fund

We launched our current long/short investment strategy almost seven years ago with an aim to invest in the emerging companies from China's private sector. Since inception the fund's returns have been good, although with some volatility along the way. At the last board of directors meeting in May 2009, it was decided to take a more conservative portfolio approach and to limit individual position limits to no more than 10% at cost. (We occasionally took larger positions before.) Also, we will be inclined to reduce overall gross and net exposures more quickly if we feel it necessary to do so. Our key thesis, however, is to continue to use our network of shareholders/directors/advisors to seek out valuable investment opportunities of low-priced, high-growing, early-stage, and under-researched companies.

We are now targeting to raise an additional US$50 million before the 1H2010 peak earnings season starting in August, as we feel there will be tremendous opportunities for investors as the year progresses. The greater China investment story remains intact and investors should view the opportunity with a five- to ten-year view, at least. China's emergence has been extraordinary, and the prospects for equity investors are enormous.

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