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DrobnyGlobal Guest Research

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The Sino-Pessimists Are Simply Wrong

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The thesis that I have been operating under since my first visit in 1993 is that China would repeat Japan's post-war industrialization feat, and in the process change the face of the global economy.

There are many differences between Japan and China. Strategies to profit from China's development have to take the unique characteristics of that great culture into account. And, a move from a centrally planned to a market economy create additional risk points.

But, back in 1993, everything pointed to rapid industrialization of China. Those forecasts were borne out over the next decade. A recent study by JP Morgan concludes that China has grown longer and faster than any country in history.

Today, there have been a number of articles on China warning against investing in China*. Also, there is widespread concern that the Chinese economy is going to "crash" and wreak havoc on investors there, as well as unsettle markets outside of China.

As a long-term Sino-optimist with a number of investment interests and responsibilities in China, these concerns were strong enough for me to revisit my core views on China and check on the Sino-pessimist case. The process took eight months and included three trips to China. It also included a number of meetings in North America, Japan the UK and Europe with bankers, analysts and investors.

My conclusions are:
1. China is not just another "trade," but a secular trend;
2. The Sino-pessimist perspective is short-term and faulty in its assumptions;

3. The Sino-pessimist view is pre-dominant, causing under-exposure to China;
4. China's securities markets are improving rapidly in terms of governance, transparency and liquidity.

In short, the Sino-pessimists are wrong, China will slow but not crash, and rather than avoid China, investors should strongly overweight China in investment strategies suited to take advantage of the unique opportunities available there at this time.

The Bear Case Summarized

There is no one China bear case. But the following statements encompass the Sino-pessimist view:

1. The stock market is too high;
2. Growth is just a huge inventory build;
3. There is massive overbuilding and mis-allocation of resources;
4. The government numbers cannot be trusted;
5. The best days of China growth are over;
6. There is no transparency and legal protection;
7. Many who invested in the '80's and '90's lost money;
8. The RMB is under speculative attack to force an upward revaluation;
9. Dysfunctional and bankrupt financial system;
10. It is an amazing growth story, but the chance for outsiders to make money is zero.

The basic message of the Sino-pessimist is clear: “Avoid China because you will not make any money there.” Further, economic growth is going to fall sharply, creating an economic crash that will negatively impact Asia and markets around the world.

Point-By-Point Rebuttal

1) The stock market is too high*-* Most stock markets are expensive globally at the present time, but China on both a relative and absolute basis is attractive. The average PE for Chinese shares is around 12 times 2004 earnings. This compares favorably to most major bourses.

More importantly, Chinese companies are smaller and growing much more quickly than similar companies in other countries. Thus, not only is the PE ratio lower in China, the PE ratio to expected growth ratio is much lower as well. The PEG ratio in China is 0.5x compared to a ratio that is at least twice as high in major markets. So you are buying companies at a lower PE in China than other countries, and getting growth at these lower prices. On a comparative basis, this is very attractive.

For comparison, the PEG ratio for Chinese shares over the last 10 years has averaged about 0.7 to 0.8, so Chinese shares are historically cheap. Blue chip firms such as Microsoft and GE now have PEG ratios of around 2 for comparison.

In addition, you have the opportunity to buy shares in basic, historically low risk industries, such as ports, water and power which are usually considered lower risk.

Another metric is the size of equity market valuation as a percent of GDP. China, at just over 50%, is at or below most countries, and less than half the US market's valuation. With the prospect of China's economy growing in the coming decade, the value of equity market capitalization will likewise increase.

Factor in the improvements in oversight and liquidity and China's equities should be revalued upward from the present discount to world markets.

2) Growth is just a huge inventory build - This concern states that unwanted goods are being manufactured and simply put into warehouses, inflating the extent of real growth.

This did in fact happen earlier when the government controlled over 90% of production. Several years ago, inventory represented up to 10-15% of GDP. But, the economy is now much more privatized; the government controls less than 50% of production. Inventory is estimated at around 1% and 2% of GDP presently, a relatively low number.

3) There is massive overbuilding and misallocation of resources- There has been significant misallocation of resources in the past due to central planning mistakes. But, even the most efficient systems are prone to error as seen by the NASDAQ bubble in the US, or Nikkei 40,000.

A cursory view of buildings being built in western Eastern China can easily appear as overbuilding. But, on my recent visit, I saw a development that looked empty several months ago, but is now entirely sold out and occupied. The sheer scale of many of the operations can overwhelm visitors, and cause unease. But demand presently seems to be high enough to match the large supply. Prices in some markets like Shanghai are up around 100% over the year, but countrywide, real estate is up only 5% yoy, an indication of reasonable supply/demand balance overall.

Office and hotels may exhibit some overbuilding in some cities. Like any country there are cases of poor investment decisions. So, due diligence is important in China as in every market. But the fear that government bureaucrats are misdirecting resource allocation from the top down is inaccurate.

4) The government numbers cannot be trusted- It is fair to view China's numbers with more than the usual suspicion. Statistics were very distorted in the past. But this is a decade old objection that is less valid now.

Since going to China in the early 1990's I have been privy to officials in various Chinese ministries, and had a chance to check official numbers with what actually could be observed on the ground. It seems that China's economic statistics are now reasonably accurate and getting better. The numbers today offer a reasonable guidepost as to what is happening in the real economy, and should not be a reason not to invest there.

5) The best days of China's growth are over - China's growth is slowing this year. But China's growth has consistently surprised over the past 10 years. A developing economy can rack up 10% plus growth years during the take-off phase. But, when investments in infrastructure are complete, growth slows. That will happen in China as well.

Despite this natural slowdown, China should still exhibit growth that will surprise the pessimists. Growth this year will not crash, but may slow to 8% per year, still a very high rate. At this time, the authorities retain some administrative ability to target slowdowns in certain sectors and regions. China has already slowed real estate, autos and steel selectively.

Furthermore, a slowing of growth does not mean that it is a bad time to invest. In fact, the opposite is the case, the best days for China’s growth are just beginning because foreign investors can increasingly access the market, even as growth numbers slow.

As a country develops, initially capital markets are undeveloped. High growth increases the size and complexity of an economy, accompanied by a maturing of the financial system. While stocks may go up during the rapid growth phase, there is often little to invest in. And, with capital markets illiquid, sizable investments are impossible.

This was the case in Japan during the miracle decade of the 1960's. Then growth slowed sharply during the 1970's and 1980's, but equity investment returns surged as the market developed. China is now about where Japan was in 1970. Growth will slow, but capital markets are opening up, allowing outside investors to participate.

6) There is no transparency and legal protection- This view is a historical legacy from the days when corporate governance, development of the legal system and market regulation were of secondary priority. However, it is now erroneous. China’s government and regulators now realize the importance of the development of the capital markets. Based on private meetings and public seminars, the Chinese Securities Regulatory Commission, People’s Bank of China and China Tax Authority all are focused on improving markets to better facilitate outside investors.

New markets are starting to trade that did not exist in China until recently. For example, the Second Section of the Shenzhen Stock Exchange just listed its first shares last month. This is the inception of the equivalent of China's NASDAQ, an exciting event that received little press. Another example is the convertible bond market which just came into existence in the last year or so. Both offer new trading and arbitrage opportunities.

This is now being translated into large, more liquid and transparent markets. Is there more to do? Yes. But the direction and velocity of change indicates that investing in China now is much safer than ever before, and is moving quickly toward world standards.

7) Many lost money during the 1980's and 1990's - Remember, money has been lost in many places, from Japan in the 1990's to the US at the end of the bubble, and in Russia in the late 1990's. Scandals elsewhere are fresh in investor's memory. Even in China, where a number of high profile losses, especially during the 1990's, created the impression for international investors that it was hard to make money in China.

After Tiananmen Square, investors ventured back into China amidst explosive economic growth. But, the legal system was not prepared enough to support the growth that took place in the 1990's. There were cases of fraud, corruption and malfeasance that cost western investors large sums of money. Some of the large institutions which lost money in the 1990's are still sitting China out.

But, that also provides an opportunity since it implies underinvestment by these funds. It is always possible to lose money investing. Conditions in China are now fundamentally improving to support investor rights. There may still be more to do, but past incidences are a poor reason to avoid China today.

8) The RMB is under speculative attack to force an upward revaluation- This is another reason to invest! If the currency is revalued, holders of Chinese assets will receive a currency gain.

The RMB is now where the yen was in 1960. In 1960, the yen was pegged to the dollar at 360 yen/dollar. As Japan developed, exports increased, the currency became convertible and allowed to float. The rate is now 110 yen/dollar. The RMB is now pegged to the dollar, exports are rising, and the currency will be made convertible and will float, so over time the RMB will appreciate versus the dollar.

9) Dysfunctional and bankrupt financial system- This is an old view, and does not take into account the fact that the financial system is developing quickly, and non-performing loans are being written off more quickly than many countries.

The government is using its ample reserves to improve bank capital. For example earlier this year, $45 billion was injected into banks. Banks are underleveraged, and will tap the huge domestic market for capital. In the immediate future you will see domestic and international placement of subordinated debt that will improve bank capital. Foreign banks are also adding capital to the banking system as minority shares of banks are being sold to strategic investors. The Chinese financial system is adding capital through large scale sale of equity interests to the public domestically and overseas.

Continued high economic growth will further support the improvement of the financial system as growth creates profits that add capital to the system directly, and through taxes that improve the government's ability to recapitalize the banking system.

China is aware of the need to improve the financial system efficiency and its capitalization. This is being done very aggressively, and moving China toward a modern economy. There will be large scale development of the financial system in the next five years, and is one of the most attractive growth opportunities in the world today.

10) It is an amazing growth story, but the chance for outsiders to make money is zero - This objection reflects fear, skepticism and lack of information. In today's world of overcapacity, high asset prices and lack of investment opportunity, there are few really excellent investment ideas and themes. But, "Global China Denial" really makes the China opportunity all the more compelling.

Not only is it possible to make money in China, the new fortunes for this century are now being created there. Many of the world's richest individuals are now Chinese. Foreign firms that have moved manufacturing to China have created tremendous value by lowering production costs, and their China investment has now increased in value as China has developed.

More importantly, as China developed over the past decade, markets and related infrastructure have also developed. China is now about where Japan was in 1970, right on the verge of a period that should be extraordinarily profitable for smart investors.

Investment Strategy

That raises the question of how to take advantage of the opportunities in China. Personally, I believe that the long only approach is a dangerous way in any market to produce superior risk adjusted returns. This is especially true in developing markets such as China. Instead, consider a multi-pronged strategy to make money in China:

(1) Invest in pre-IPO companies, and sell into the hot IPO market. This is a neat way to get long China. The primary strategy here is to buy companies pre-IPO, and work with the companies to get listed and launch an IPO. The exit strategy is to sell after the

IPO. The key is to find the right companies, get pre-IPO allocations, and then see the company through its IPO. My group are actively involved in this through domestic contacts and joint ventures. We can help you with this as well.

(2) For listed equity investments recognize the market will be volatile, and utilize a more absolute return approach, i.e., long/short with a long bias. Again, this is a tactic that we have developed to reduce risk and add return in an increasingly liquid market. There will be some clear losers as China develops.

(3) Given the overall size of China, information about China can be used to trade in markets outside of China. Profit from insights about China such as shorting European laser companies that will be hurt by new China developed lasers, or get long the HK dollar when the RMB is about to strengthen. Or sell Japanese bonds based on news on the Chinese economy.

Summary

China is developing more quickly and successfully than most people now imagine or appreciate. Just as the development of Japan changed the global economy so too is China, *only China is ten times the size of Japan.*

Invest now for the long run in strategies that are suited to the Chinese markets, and ignore the Sino-pessimists as they are simply wrong.

Please get in touch if you would like to learn more about our growing activities in China.

*** See 'China, There's Something Wrong in Paradise', Raoul Pal, DGM Guest Piece, Oct 29, 2003.**

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Andres Drobny comments: The comparison between China today and Japan in the 1960's and 1970's is a good one. A rapidly growing, competitive economy with a cheap currency that is converging strongly towards the rest of the global economy. The case *for an ultimate reval of the REMIMBI, at least in real terms (ie, either a nominal appreciation or more inflation in China than elsewhere,* **or both***), seems very well based. That adds to the case for outperformance of Chinese equities.*

But, that also raises a potential problem with the story. Japan's convergence to the advanced capitalist world occurred during a period of rapid global growth. With all the imbalances in the current global economy, China's process of convergence, based on export-led growth, could well face considerably more challenges if global growth disappoints, or global instability mounts, over the next 10-15 years.

In fact, the Raoul Pal view seems to hinge on a more pessimistic view of global growth prospects. If Raoul is right, then what may look like a good investment may well turn to tears and excess capacity. Especially when China growth has been overwhelmingly geared towards investment rather than domestic consumption.

More importantly, I suspect many of us fear China simply because we are outsiders and feel we will not get a fair shake. Of course, that's precisely where groups like Bill Lawton's SeaBright, with their local contacts and knowledge, can help chip away at the edge locals have, thus allowing more outsiders to exploit the opportunities over there.