

MyConsultant

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Inside the belly of the Dragon



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Research on China often involves drawing on the research of others; invariably some bias creeps in due to personal standpoints and perspectives in a complex environment.

In addition, the sometimes opaque protocols and collection methodology make interpretation of official statistics difficult.

As part of our quest to better understand China we have travelled the country from East to West, gleaning greater insights into the dynamics of this emerging Dragon as seeing the issues firsthand makes separation of fact from fiction easier. In June 2011, I undertook such a research trip visiting companies, local investors and policy makers. This article gives a brief perspective into what we can learn firsthand inside the Dragon's belly, and how this helps us ask the right questions: for instance, how can we better exploit growth opportunities in this key market for our clients' portfolios, whilst managing the risks?

Manufacturing growth expected to slow

Views on where China is headed economically can be as much anecdotal as based on objectiveness. Bears point toward a housing bubble, stubborn inflation, tight monetary conditions, poor allocation of capital, excess capacity in various sectors including steel, and the prospect for loans to sour. Bulls cite ongoing urbanisation and industrialisation as the engines of sustained growth over the longer term. The reality probably lies somewhere in between.

The first meeting of my research trip was a morning session with buy-side analysts from China International Fund Management Company in Shanghai. This was a good start, comprising a high-level macro-overview session with local investment professionals before embarking on company and site visits. Surprisingly (at least to me), the meeting required a translator. The key point by the team was that tightening measures are flowing through to industrial production and that growth should slow. (Indeed, at the time of writing this article, Chinese manufacturing indicators have slumped to their lowest level since March 2009, vindicating the analysts' views.) While a slowdown in growth sounds negative, it will help quell inflationary pressure and provides a window of opportunity to invoke pro-consumption policy and improve resource allocation. These sounded like positive steps towards long term sustainability.

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Energy challenges

On a warm, humid Sunday in Chongqing, we visited a museum dedicated to the Three Gorges Dam. I was interested to learn that the hydro facility was designed to supply approximately 25% of China's power supply. The dam has created a huge irrigation problem in the downstream agricultural basin due to a less efficient catchment than previously envisaged.

This has forced authorities to balance energy generation and water release for irrigation, which has exacerbated summer power shortages. According to our guide, if significant upstream rainfall is not forthcoming by mid June, then the dam level will fall to a critical level where some of the turbine capacity will go offline, causing major disruption to the power supply. Though a specific example, it highlighted some of the huge challenges when transitioning a large number of people into more consumptive lifestyles in China, and the growing pressures on energy and infrastructure.

Wage pressures show no signs of abating

I took a workshop tour in Shanghai Electric, which manufactures big (massive) components for coal, gas and nuclear power generators. During the tour, I chatted to a foreman (in English) about wage pressure and the difficulty of attracting quality staff and retaining them. Unsurprisingly, wage costs at the plant are rising by approximately 10% pa. This is more pronounced for skilled factory labour (primarily welders and steel workers) than skilled office workers

(engineers). The main trend is an increase in unskilled labour requiring on the job training and certification. The company is also impacted by credit tightening making it difficult to obtain project finance to fulfil a larger than anticipated order book.

Equity investors need to be mindful of State ownership

We visited four companies in the Chongqing area in different industries, which gave a good cross-sectional view of some key corporate issues and economic trends that impact local equity investors.

Firstly, the ownership structure of the companies was similar and was a mixture of public and private holdings with a core business listed in Shanghai, Shenzhen or HK, of which some 50% was held by a State owned parent company. (Not all local listed companies are subject to State ownership though and it is likely to be more prevalent at the larger end of the market.)

This produces a structure where the interests of external equity holders (minorities in the listed company) are not necessarily aligned with the more strategic interests of the parent (State) company. This was most overt for Jialing Industries where the State owned portion is ultimately held by the Military Weapons and Equipment Company, with the listed subsidiary supplying motorcycles to the military.

Specifically, input costs are rising rapidly (labour costs by 10% p.a. as mentioned above and commodity inputs by 20% - 50% pa over the past few years), yet management is restricted from passing

this cost burden through to consumers due to both natural (capacity) issues and directives from the State parent to limit price increases as much as possible.

Shrinking margins and equity returns

With the exception of food producers, management teams vented concerns about ever shrinking margins. Thus input costs of both raw materials and labour are rising faster than on-sale prices, eating away at profitability. While expansion in capacity and pursuit of volume is a culprit, management is frustrated by interference by the State as strategic shareholder to limit price increases and therefore restrict non-core inflation. Within the framework of corporate China as it exists today, such pressure does indeed help to limit inflation but there is no free lunch: equity holders will wear the cost of a continued contraction in margin as input costs rise and selling prices stagnate. This poses a new challenge for investors used to deploying capital into free market industrials, and highlights the significant agency issues within the command economy.

While we are used to dealing with margin compression (and expansion) due to changes in resource allocation across the business cycle, it is far more difficult to navigate the impact of political forces where the ultimate objective goes beyond the exclusive welfare of company shareholders.

Net-net, this shifts the burden of cost pressures from consumers to holders of the listed equity stock, and as such the odds of earning a decent return are pared down.

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Another observation from some of these onsite visits was that iron-ore consumers are very reserved in dealing with Australians! We seemed to obtain a less-than-warm reception from those who I suspect were not happy with our high terms of trade denting their steel margins.

Credit is expensive and becoming tighter

With margins compressed, company executives are looking toward volume growth to prop up bottom-line growth. This in turn requires expansion and/or bolstered working capital to build out capacity and boost production. The tightening in monetary conditions has forced credit to be scarce and prohibitively expensive for many smaller enterprises, especially those operating within industries that the central government is trying to dampen. As a stark example, property development managers complained that they are prohibited from raising any form of capital (including public equity) from Chinese markets as part of the government's attempt to cool the property market.

Outside of property, smaller firms appear more impacted by tighter conditions than

larger State owned enterprises that have better access to both equity and debt. Lending rates are materially higher than the 6.5% pa overnight rate, with some firms reportedly paying up to 11% pa as both the lending quotas and reserve ratio requirements eat into the supply of credit.

Chengdu Canned Food provided the most pronounced example of the negative impact of the tight funding conditions. Despite running a sound food processing business that supplies both domestic and export markets, the company is unable to borrow funds at single digit rates, and is experiencing difficulty raising early funds before pursuing a full listing on a regional stock exchange. If indeed Chengdu's problems are more indicative of the funding environment, then extrapolating this across the economy also suggests that both investment and industrial production are likely to continue to slow in the nearer term.

Conclusions

The issues posed by China for global multi-asset investors are complex. China's size, governance and lack of transparency complicate this process, making it harder than usual to deal with the uncertainty.

Visiting China greatly aids our understanding of nuances within the economy and how these flow through to the macro. This in turn informs our Scenarios Analysis helping us better sketch out the likely paths forward and enhancing our ability to position for opportunity and against risk. Our current Strategic Overlay set incorporates both bullish China scenarios, as well as more adverse scenarios which assume some of the challenges described above remain unchecked.

Getting inside the belly of the Dragon helps us to understand these dynamics first-hand and prompts us to ask the right questions. For instance, are we getting enough exposure to the region's growth potential? Is it sufficient to rely on exposure via ownership of larger multinationals within Global Shares, and indirect exposure via resource companies within Australian Shares, or is it better to tap into domestic Chinese companies if one assumes some will grow faster than competing multinationals?

Answers to these and other questions will continue to be sought as we intensify our research into China and gain further insights from the inside.

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