China 2014

**Chronology of China Development & summary**

After the Cultural Revolution, Deng Xiaopeng reformed and ushered a Social Market Economy for China. That set off a monopolistic SOEs infrastructure, where they could get cheap loans to grow, and size was the end game that defined success.

This practice groomed a generation of managers who put (1) growth before profitability for companies and (2) their personal wealth before any concerns of integrity and righteousness. This manner of business building incubated an economy of overcapacity with inefficient cost control and low returns, resulting in the high level of non-performing debt at the local governments' level that the country currently faces today.

A few years ago, there was a uTube video clip of Chinese children being interviewed about their future dream jobs, one kid shamelessly commented that he aspires to be a '贪官', corrupt government official, and another innocently said, a '奸 商', crooked businessman! Real or fictitious, the clip vividly depicted the low level of probity in business practices across China.

Repercussions are now obvious. We see overinvestment, inefficiently operated SOEs, individual values that are rotten to the core, as China eagerly and happily "insourced" the work of all the factories in the world in the past few decades, to urbanize the country and bring citizens above poverty levels. However, in the course of doing so, people have made their water undrinkable and blue skies a thing of the past. Is that what they call building a future for our next generation?

China is now the 2nd largest economy in the world and growing at a rate more than twice that of the US. Any investor looking for growth cannot ignore this market. We want to understand the risk and opportunities from top down perspective to benefit our bottom up stock selection process.

**Those 'glorious days'**

From 1979 until 2010, China's average annual GDP growth was approx. 9.91%, reaching an historical high of 15.2% in 1984 and a record low of 3.8% in 1990. Based on the current price, the country's average annual GDP growth in these 32



Imperial Capital

years was 15.8%, reaching a historical high of 36.41% in 1994 and a record low of 6.25% in 1999. In other words, in the last 30 years, China has been growing close to 10% annual

Most of the growth originated from SOEs which still make up the bulk of equity market capitalization and the economy, particular those activities that pertain to national security, including power, energy and telecom.

In 2009 for instance, 85 percent of loans were issued to SOEs, because banks themselves are state-owned, and are directed to let credit flow to other state-owned businesses. SOEs can get money more cheaply, paying lower rates for borrowing, and are more blasé about repaying these loans.

This incestuous SOE environment led to too much capital steering their way and subsequent overinvestment in even low demand sectors, esp big infrastructure projects with little real returns. This was encouraged to some extent by evaluation yardsticks where local officials' performance was judged by growth without much regards to borrowings incurred to generate the growth.

**Growth trajectory coming to a halt**

Abundant liquidity, favourite terms of borrowing, and poor investment returns sowed the seeds for a potential debt crisis. If the sub-prime crisis was about solvency risk of the US household sector, here in China, the culprit is in the corporate sector, which has been grossly leveraged since 2008.

The insolvency risk is worsening, total social financial growth still far outpaces nominal GDP growth, investment still figures prominently in economic activities, i.e. more capacity, while end demand growth stays lackluster.

The official Non Performing Loan (NPL) ratio of below 1% must be taken with a grind of salt at best, as lots of debt continually rolling over short term with imaginary returns on a growing pile of bad debt, masking rising default risk.

That said, official banking sector borrowing is not as bad as some fear in terms of becoming a full blown debt crisis.

Most importantly, banks and its shadow banking industry in China are by and large isolated and unlikely to set off a Lehman Brothers type global panic as there are no interconnectedness with the rest of global banking system.

Imperial Capital

**All the Right Moves**

The new leader, Xi Jinping, who has a more worldly perspective on country management came along in 2013 and vowed to tackle graft, corruption, high local government level debt, inefficiencies, pollution, amongst myriad other problems. To face slower growth is inevitable as the country now looks to rebuild the foundation on which it has woven 3 decades of high growth.

There is no other choice, as it is now obvious that underneath those 30 years of strong GDP growth are but deepening problems of deteriorating corporate quality as well as individual core values. To provide a sustainable growth story Xi is now ready to implement major financial and social reforms. There seems to be worldwide consensus that the move is correct, urgent, but also risky, as so many stars need to be aligned to reform successfully. However, if nothing is being done, the can will reach the dead end street sooner or later.

**Can Central government manage the level of expected bad debt?**

We think the answer is yes for the following reasons.

1. It is an investment, not consumption

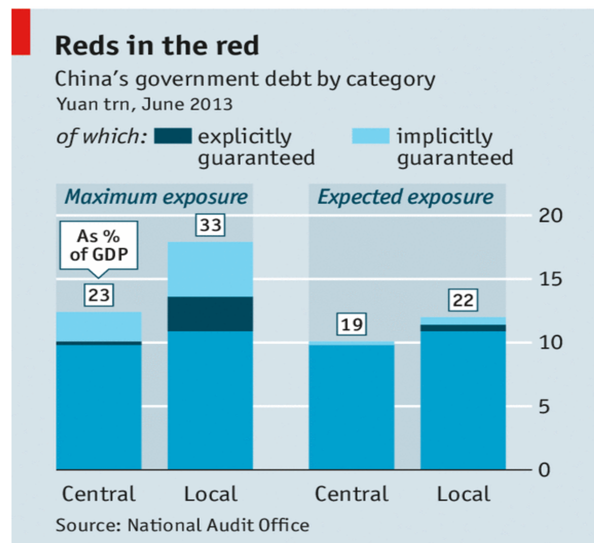
Even though capital spending may be excessive, and rate of return are low, at least the local governments borrowed to invest, while other governments borrow for consumption or to pay salary. And not all debt will go sour and most investments should generate some return.

2. Manageable Risk at Central Government level

During the 3rd quarter of 2013, 54,400 auditors from NAO (National Audit Office) went around the entire country to scrutinize the books of local officials to tally Chinese government's liabilities. 31 provincial-level governments, 391 cities, 2778 counties and over 33,000 townships were examined. Results announced at the end of December 2013 showed that local governments owed approx. US$1.8trn as at the end of June 2013, with some additional explicitly guaranteed debt, and another few hundred billion implicitly guaranteed debt, coming to a total of approx.. US$2trn, or 1/3 of China's GDP. It is more appropriate however to look at the sum of all of these liabilities as not all will become bad debt. Based on historical precedence, local government will likely to have to eventually bear approx. 19% of explicit and 15% of implicitly guaranteed debt. See chart below.



Imperial Capital




Based on this assumption, the expected value of local government liability shrinks to 'only' Rmb 12 trillion, approx.. 22% of GDP, as the chart shows. Even adding central government's debt, would bring total to roughly 50% of GDP, not an alarming level and China government as a whole should be able to sustain its debt without undue strain to the economy.

Although overall levels of debt appear manageable, specific localities are ostensibly overstretched. NAO found that 3 provincial governments, 99 cities, 195 county-level administrations and 3,465 townships had direct debts exceeding 100% of their annual economic output.

3. As all the debt was borrowed at local currency and at rates below growth rate of the economy, theoretically they can roll over indefinitely as long as the positive gap remains. It is important for China to maintain high level of growth as it tackles bad loans, although rolling over loans to a bad investment obviously only pushes the can further down the path.

4. It has been argued that China's investment rate is both overstated and less problematic than many believe, even though there is undoubtedly a case of over investment and low returns. The extraordinarily high level of investment in China's economy is often cited as evidence of looming economic ills and a sign of severe economic imbalances. Some see the phenomenon as an indicator of a growing stock of white elephants, i.e. government-driven real estate and mega infrastructure

Imperial Capital

projects, encouraged to prevent the economy from collapsing as export growth slows.

Many people point fingers at the rapid growth in China's capital spending and its unusually high share of GDP. Fixed-asset investment (the most widely cited figure, because it is reported monthly) has grown at a breathtaking annual rate of 26% over the past seven years. Yet these numbers are misleading. They are not adjusted for inflation and they include purchases of existing assets, such as land, that are inflated by the rising value of land and property. A more reliable measure, and the one used in other countries, is ***real fixed-capital formation***, which is measured on a value-added basis like GDP. This has increased by a less alarming annual average of 12% over the past seven years, not that much faster than the 11% growth rate in GDP in that period.

**Real Culprit to risk of hard landing**

Known to many now, the real culprit that may catalyze a hard landing of the China economy is the shadow banking sector.

The shadow banking sector is the most vulnerable part of the financial system and playing a key role in bad debt rollover. Many are now worried about default risk in shadow banking sector, and monitoring closely the (1) potential LGFV (local government financing vehicle) default, (2) land price declines and (3) WMP haircuts as likely triggers in 2014. Credit crunch will surly drag economy and equity prices down.

**Can the Central Government defuse the debt bomb** while maintaining growth and stability of the economy?

How does the new leadership tackle and avoid bull blown shadow banking debt crisis?

In response to what may precipitate into a full fledge trust crisis, NAO just announced that an audit of shadow banking sector, including trusts and WMP (wealth management products). It is expected that once regulators are able to gauge the extent of shadow banking activities and how connected the formal banking sector is to the shadow banking sector, likely sometime around June 2014, some degree of a ***managed default may be undertaken*** to 'teach investors a lesson in risk management' and begin to adjust trust/WMP investment practices on one hand and encourage creditors to price their risks appropriately on the other.

Imperial Capital

Even before the full report is out, the Government has already drawn up new rules to contain risk in its shadow finance sector by formalizing the role of non-bank lenders in the economy and has been giving examining the risk from banks' off balance sheet businesses and banned wealth management products from being pooled into undefined trust firm projects.

It is worth mentioning that the Government wants to use supply to control exuberance in property market, rather than policies or interest rates to halt price rise, which will have other impact on the economy. A full blown property sector collapse is therefore not likely as well as unthinkable.

**Deliberate shocks at play already**

Interest rates, the Shibor, has surged twice in the past year, June 2013 was deliberate credit tightening by PBOC as warning bell to banks to rein in unsafe lending practice, while December 2013 was reportedly not caused by PBOC though it still pumped liquidity to avoid near meltdown to interbank market which could threaten to unleash a cascade of defaults throughout the economy. Some argue whether it may actually be a good idea to allow a default to take place, although this may be too big a gamble on the economy by triggering panic outflows across the trust and related wealth management product asset class, leading to a full blow liquidity crisis. This can be seen as a 'warm up' that the Government provides to lenders before allowing some managed defaults.

**First taste of bitter medicine**

Sure enough, this theory was tested just as this note was written, around the end of January 2014, when an outright default of a trust product issued by China Credit Trust Co of a coal miner, Shanxi Zhenfu Energy Group, was averted by an unknown third party bailed out at an "11th hour" deal before the ICBC paper is due to roll over on 31st January, and after a few days of market anxiety, lenders are now assured that they will be able to get back their principal. For those following the development of China debt crisis, this seems to be very much a news to be expected. Shibor again shot up and government injected liquidity after a brief panic.

While a real default will be negative to the market, it would not cause any Lehman-like crisis as the magnitude of the mining Trust (estimated to be Rmb150-200bn) is small (approx. 1% of total banking loans). In total, Trust loans were

Imperial Capital

reportedly only 6.1% of overall banking sector loans by 2013. At 0.8x P/B, market has now already priced in 8-9% normalized ROE, or nearly 10% of NPLs for the Chinese banks.
In the long term, ***a default should and is increasingly looked upon to be a very positive milestone event*** to curb shadow banking growth and establish the credit culture. The challenge is in the execution such that it would not trigger widespread panic that deter economic activities.

In practical terms, an explicit default is still unlikely at this time as the country still lacks clear legal procedures for resolving municipal insolvency, such as America's "chapter nine" bankruptcy code. The overhaul of its fiscal system should see to it that a municipal default becomes a manageable process before it would be allowed to take place. In the meantime, it is also unthinkable for an 'unknown third party' to continuously bail out trust products as this affectively perpetuate underpriced risk assets taking future bailouts for granted.

It takes two to tangle, the government has been active in encouraging vigilance for creditors, many still think it would help send a clear signal to allow a bond go default, as this would force creditors to price their risk appropriately, although the risk may just be too big to swallow if it dents confidence too much and choke off growth too much and cause economic activities to spiral out of control.

It is reported that a new evaluation yardsticks have been devised whereby local government officials will be accessed not only by growth but also the level of debt they incur, in order to align growth with cost.

The Government seems to be appropriately targeting the source of debt problem.

Addressing the potential debt crisis is just one of the many challenges faced by the new leadership, targeting the uncompetitive and highly geared SOEs, and removing the oxygen masks given to them since Deng era, is certainly a step in the right direction to bring China closer to a market economy.

**Moving towards market economy**

At the recently concluded 3rd plenary, the Government pledged to give the market a decisive role in its economy; this is a significant move as it would mean that interest rates, currencies, capital accounts will be more reflective of market forces. Both economic and social policies will be structured around the reform agenda in the coming years.

In order to achieve its long term goal of sustainable and higher-quality development, the government is prepared to reduce government intervention and allow financial markets to have a bigger say in allocating resources, and promoting domestic consumption at the expense of investment and exports.

The success of the social and fiscal reform will be judged by:

(1) whether domestic consumption can replace investment and export led growth, and GDP growth maintained at above 7%
(2) quality of growth, and not just quantity
(3) achieving a more market driven economy that has a more level playing field and is not dominated by highly geared SOEs that generated low/no returns (and in the course of doing so, heavily violated ESG practices.)

**Implication for our investment strategy**

Our base case scenario is one where China sees moderate slowdown in a tighter credit environment, but one of improved credit quality. Many uncompetitive SOEs will be restructured or face close down as non-strategic sectors become fully open to competition, benefitting privately owned enterprises and multinational corporations entrants to China. Interest rate will remain firm supporting the Rmb, benefitting net Rmb earners, but not too high as inflation is still below target of 3.5%. 10 year interest rate is expected to move towards 4.5% in 2014.

Urbanization theme will continue to push ahead by Central Government policies and gain priority funding by local governments, so that farmers can monetize that agriculture land rights and gain legitimate status in city and willing to bring entire family with them to become permanent city dwellers.

While internet plays are technically non-strategic in many countries, for China, it is a 'quasi-strategic' sector as the country remains extremely restrictive about politically sensitive information flow. As such, local companies like Tencent is likely to continue to enjoy a virtual monopoly in an uneven playing field, shutting out major and otherwise legitimate international competitors. The company is likely to continue to enjoy a monopolistic environment for its services and remain extremely profitable without any overseas rivals in sight, as more and more users go online.

**Who cares about ESG?**

Ultimately, it may not be debt that threatens China's future, but the lack of ESG discipline (Environment, Social and Corporate Governance) that leads to evaporation of foreign capital and an economic collapse. Reading the plenary communique through the lens of a sustainability champion, the content of the plenary has much to do with incorporating good Environmental, Social and Governance practices into enterprise management.

Government has started to enforce environmental measures more stringently but much damage has been done and many operators try to bypass government scrutiny by operating at night and/or passing waste water underground etc. Closing down SOEs that are emitting excessive carbon in coal, steel, energy sectors and allowing efficient ones to take over are first steps in addressing pollution and so is restricting auto in the cities. More must be done before much of China can see clear skies. Governance is another of our big concerns investing China companies, and this problem may taking even longer to address, and has been deterring us from tapping China growth directly from listed China enterprises.

We believe our focus on ESG of our companies must be the right approach to select equities which will provide attractive total return per unit of risk that we take on. Much of the risk that we see may not be assessed or taken into consideration in other investment processes. These risks are irrelevant until they are uncovered and threatens profitability and sustainability of the business practices that we invest in.

As an article from the Yale Global website pointed out, history tells us that territorial and various political disputes do not necessarily trigger war, it is those events that threatens the survival of a nation. Water is becoming a prized commodity and an increasingly tense topic within our region as it has less fresh water per capita than any other continent except Antarctica. China's new leadership is earnestly tackling the water and air pollution problems. How does one even begin to quantity the social and economic cost of environmental degradation caused by air and water pollution in China? In a World Bank report published in 2007, it was roughly estimated at between 3.5 to 8% of GDP.

On this front, I cannot sum it better than Jack Ma, founder of Alibaba, in his plead for Chinese citizens to care more about how they make their money. He says, "Our water has become undrinkable, our food inedible, our milk poisonous and worst of all the air in our cities is so polluted that we often cannot see the sun," and furthered that, "Twenty years ago, people in China were focusing on economic

survival. Now, people have better living conditions and big dreams for the future. But these dreams will be hollow if we cannot see the sun."