

MLC Viewpoint

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On the ground insights into China



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Ben McCaw of our Capital Markets Research team went on a 10 day research trip through Zhōngguó (China). Ben outlines some of the interesting issues facing businesses in the country and implications for our asset allocations.

Output growth in China is pivotal for Australian investors. Exports to the “Dragon” economy account for over 20% of all export trade, and covers off nearly 3.5% of total domestic output. Over time, we’ve bolstered our research on China and have recently travelled the country from East to West, to glean a greater insight into China.

Backdrop

From a future historian’s perspective, the climate we observe today could well be part of an historic change where the balance of economic power adjusted from the West to the East of the country.

Such scenarios are seductive and resonate well with the domestic corporates, investors and policy makers who have hitched their medium term prospects to a China that continues to industrialise, whether coupled to the rest of the world, or not.

At a summary level, the problems facing China are predictable and easy to understand. A prolonged export boom, fuelled by an artificially low exchange rate, boosted both capacity and money supply at the same time. During the initial phase of the boom, increases in both capacity and productivity helped quell any inflationary pressures caused by the rapid growth in output and money supply. Largely because labour relocated from relatively unproductive rural engagement toward higher value-add activities within the expanding capital stock (factories). This disinflationary force found its way out of China into the West (via exports), keeping interest rates low and thus supporting the consumer side of the Western credit binge in a self reinforcing cycle that was ultimately quashed by the Global Financial Crisis.

China responded to the threat posed by the sharp downturn in external demand for exports by stepping up the already high rate of investment into fixed assets - adding rail, road, housing stock and other capacity at breakneck speed. Most of the growth was financed by lending, and owing to the speed of deployment, has probably resulted in an inefficient allocation of capital.

Nonetheless, these actions achieved the short-term goal of maintaining growth and supporting employment, but had the consequence of compressing demand for key raw inputs eg bulk metals and other commodities. This, combined with a dwindling demographic dividend, accelerating real wage growth and food supply disruptions, stocked domestic inflation pressure.

As is typically the case, the market has re-based future expectations of China on the recent momentum in activity. Thus, it is presumed that the current demand for bulk metals will continue for an extended period. Such a scenario may well play out, but it assumes a persistent unbalanced growth profile, and therefore carries significant risks. Understanding this, forms an important consideration in our asset allocation process.

The uniqueness of China’s political structure, against global peers, makes assessing the macro environment through traditional lenses difficult. This is compounded by the fact that third party research, and views on where China is headed economically, has become a commodity of two broad opinions that can be as much anecdotal as they are based on objectivity:

- **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, while



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- o **bulls** cite on-going urbanisation and the continued industrialisation as an engine to sustained growth over the longer term.

In reality, neither of these views are likely to be correct as the reality probably lies somewhere in between.

Seeing the issues first hand makes separation of fact from fiction a little clearer.

Research trip insights

An on the ground research tour through China helped put the numbers and anecdotes into perspective. We visited four key economic centres as part of a research trip with JP Morgan and JCP Investment Partners. The tour included visits to companies across various industries, as well as local fund managers, policy makers and ended with the JP Morgan China Conference 2011 in Beijing. Finishing with the conferences helped marry-up the disjointed micro issues from our tour with the prevailing macro and policy setting environment.

As a credit to JCP and UBS, the organising broker, meetings with company management were open and engaging, allowing us to glean an insight into key issues facing the real economy.

Two themes emerged at the micro level: margin pressures - with a twist, and credit conditions that are tighter than we would otherwise infer from the macro data.

Inflation control, government objectives and margins

With the exception of food producers¹, management teams vented concern about ever shrinking margins. Input costs of both raw materials and labour are rising faster than on sale prices, shrinking margins and eating away at profitability. While expanded capacity in the pursuit of volume is a key culprit, a more obtuse frustration of management is pressure from the government, often a strategic shareholder, to

¹ Agricultural producers are left alone to pass through cost increases in order to encourage continued supply of staples.

limit price increases and therefore restrict non-core inflation. Within the framework of corporate China as it exists today, such pressure does indeed help but there is no free lunch: equity holders wear the cost of a continued contraction in margin as input costs continue to rise and selling prices stagnate. This poses a new challenge for investors used to deploying capital into free market industrials and highlights the existence of 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 near-term impact of strategic forces where the ultimate objective goes beyond the exclusive welfare of company shareholders.

Credit is scarce

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

Outside of property, smaller firms appear more impacted by tighter conditions than larger State Owned Enterprises who have better access to both equity and debt - somewhat offsetting the negative impact of the inflation-centric strategic initiatives discussed above. Lending rates are materially higher than the 6.5% 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 available funds.

A food processing company in Chengdu (Sichuan Province)

Client talking points:

- o Output growth in China is pivotal for Australian growth (and therefore investments).
- o Our research on China focuses on the risks and opportunities from a portfolio perspective, which is different to our investment managers' research.
- o The Chinese government's strategic objectives to rein in inflation are clashing with those of businesses to grow their profit, by restricting margins and limiting affordable funding for expansion.

illustrates just how dire funding conditions have become. Despite running a solid food processing business, supplying both export and domestic markets (including the military), the company is unable to access credit at single digit rates, and is experiencing difficulty raising pre-IPO funds. If these issues are indeed indicative of an extremely difficult funding environment - rather than something company specific - then extrapolation across the important small mid enterprise sector of the economy suggests that both investment and perhaps industrial production will slow in the nearer term.

Implications

The issues posed by China for the global multi-asset investors are complex. Positioning portfolios to control risk involves understanding as much as possible about how the current environment will evolve. The combination of China's size and governance structure complicates this process, making it harder than usual to contemplate future paths. Our scenarios process takes account of the risks and opportunities posed by China to Australian investors in the same way that we think about other factors. Our current Strategic Overlay scenarios set includes both bullish China scenarios, where growth continues and demand for commodities remains in check, and adverse scenarios that capture both generic and specific risks that might precipitate a China-induced interruption to global growth.



Visiting China greatly aided our understanding of nuances within the economy and how these flow through to the macro issues. This in turn informs our scenarios process, helping us better map out the likely paths forward and enhancing our ability to position for opportunity and against risk.

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