

## **CHINA – OPPORTUNITIES ABOUND WITH WTO ENTRY A MARKET STUDY**

This report is designed to give the reader an understanding of the process that has led to China's emergence as the next big investment story for global investors.

It is also an attempt to focus on the opportunities that China's opening up might present to asset managers. It is possible to come up with reasons why China might not deliver the goods, but they are heavily outweighed by positive factors contributing to the overall impression that this current modernisation has gone further than all previous attempts.

On November 12<sup>th</sup>, China formally signed an accord to join the World Trade Organisation. Minister of Foreign Trade and Economic Co-operation Shi Guangsheng said at the time Beijing was determined to play by the rules of the WTO. By joining, China would provide "more and better business opportunities" for exporters and investors worldwide. WTO Director-General Mike Moore said China's entry would be one of the economic landmarks of the 21st century, while European Union trade chief Pascal Lamy said it was "the greatest leap forward in the history of the WTO".

This will be a crucial decade for China. The country has to contend with a change in leadership (when the term of current president Jiang Zemin ends in 2002) and it will have to accelerate reform as a consequence of joining the WTO. WTO entry means that China must implement a list of rules and regulations for membership to be effective, as WTO is essentially a formalised trade pact. The rule of law will have to be strengthened.

Winning the right to host the 2008 Olympic Games and pushing past the last negotiating barriers to join the WTO are major symbolic landmarks in China's history. It has taken China 15 years to complete the WTO negotiations, and even after the formalities are completed, observers say it will be at least five years before many of the trade barriers are lifted. But China is determined to establish itself as a market economy. Boosting domestic demand to maintain growth has become the central pillar of the party's economic policy.

China is no longer a market that investors can discount in the regional or even global context. Nor do they want to. Investors want a new story and China offers a whole host of reasons to believe that it is going to be the driver of recovery for the Asian region. China's growth is now more sustainable, less inventory-driven and more consumption generated. The increase in FDI is important and should continue.

This is a much better environment for Chinese markets, and especially so as the recovery in developed markets is likely to take longer than originally expected. There are now sufficient investable stocks, even for larger funds, and China's weighting in regional indices is increasing. The question is, given the historic volatility of the domestic markets, their immaturity and the inability of most of the major fund houses to produce consistent returns out of China-focused funds, what is the correct vehicle for investors wanting exposure to the China story?

### **The Need for Reform**

The economy of China differs from the economies of most OECD countries in various respects such as its structure, government involvement, level of development, growth rate, capital reinvestment, allocation of resources, rate of inflation and balance of payments. Since 1949, the economy of China has been a planned economy subject to one and five year state plans adopted by the central Chinese Government authorities and implemented, to a large extent, by provincial and local authorities, which set out production and development targets.

Although the majority of productive assets in China are still owned by the government, economic reform policies since 1978 have emphasised decentralisation and the utilisation of market mechanisms in the development of the Chinese economy. As such, China is in the

process of implementing far-reaching economic reforms and it is uncertain whether the impetus for economic reform will continue or prove to be successful.

In previous times, China wanted to develop, but without adopting western ideas of democracy, freedom and the rule of law. Chairman Mao believed that the world was heading towards World War Three (he may just have been right, but anyway) and that China had no friends. So material goods had to be sacrificed to build up China's defences. Deng Xiaoping came to power and admitted that Mao was wrong, at least some of the time. He suggested that China take the opportunity to implement the so-called 'four modernisations' by the year 2000. Deng oversaw the setting up of two domestic stock exchanges in 1990 and 1991 and little by little, China moved towards opening its doors.

Today, reforming the state sector and banking system remain China's biggest challenges. The private sector is being promoted as China's next growth engine and competition is being encouraged in all sectors, especially finance, to improve the efficient allocation of capital. Domestic savings in China are high (around 40% of GDP) and households have huge amounts of cash. The ratio of currency in circulation to GDP is extraordinarily high in China and has in recent years been running at over 10% of GDP and a ratio of over five times compared to the US, where roughly 2% of GDP is made up of currency in circulation.

Despite the high savings rate, China's financial system does not allow the money to flow to the deserving and is used instead to prop up the ailing state sector. With over US\$1 trillion in deposits in Chinese banks, the financial system has provided few outlets beyond basic savings accounts. Cheque accounts for households are rare. Practically all cards issued are debit cards rather than credit cards. Bank deposits yield 1.8% since a 20% tax on interest income was introduced two years ago. The potential here is fairly obvious, particularly for distribution of savings and fund products through the banks.

China is the next big story for global investors looking for growth and diversification. Although it has slowed this year, China's economy has maintained its projected GDP growth rate of 7%. With less reliance on exports, particularly to the US, China is expected to be able to survive the effects of the global downturn by stimulating domestic consumption and expanding regional exports. Export growth is up 7% in the first eight months of 2001, representing an US\$11 billion trade surplus.

Forecasters tend to agree that China's GDP of 7.5% in 2001 will be matched in 2002, with the impact of slowing export growth largely offset by fiscal and consumption policies and increased FDI. RMB exchange rates are expected to remain stable through 2002 and a mild 100bps increase in interest rates is forecast. Strong FX reserves will make the currency safe and eliminate the need for devaluation.

Inflation (at 1.5-2%) and money supply growth are still within the central bank's targets for 2001. Continued progress relies on a favourable social and political environment. Given this and the advantages of technology and knowledge transfer, it has been shown that emerging nations can become more modern societies far faster than formerly.

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## **Politics**

The Communist Party of China remains a Leninist organisation running a proletarian dictatorship. With no one allowed to question the authority of the party, or its members, corruption has flourished. Much of the wealth of the country has disappeared into the pockets and bank accounts of a tiny elite. Critics have been silenced and dissidents jailed. China's human rights record, although lamentable, is no longer treated as a serious impediment to global respectability.

The Communist Party has evolved quietly since Deng's death in 1997. Work has started in building a philosophical foundation under President Jiang Zemin's "Three Representatives" theory, whereby the party would adopt the most advanced productive forces for the benefit of the majority. The goal of an egalitarian utopia has been cast aside, but Jiang has not

considered political reform that would transform the CCP into a social democratic party, along the lines of, say, the UK Labour Party. He has rejected the option of allowing non-government organisations such as environmental, religious, or ethnic pressure groups, or independent trade unions, to form.

Jiang has allowed one major change to party composition: individual capitalists are now eligible for party membership. This will change the party, but only in the long term. The next year will see the start of a slow transfer of power from the generation of Jiang, Li Peng and Zhu Rongji to a younger set of leaders. It is almost certain that Jiang will remain in control of the Central Military Commission, and hence the reins of power.

The new leadership will be made up of people such as Wen Jiabao and Hu Jintao, who will be compelled to act in the shadow of their seniors, as long as these men retain top positions within the party hierarchy. Little is known about their political views, and although it is doubtful they will challenge their patrons directly, they may build a small momentum for genuine change.

China's old concerns of 'war and revolution' in the words of Chairman Mao, have been replaced by a new set of priorities: securing its borders, meeting the huge demand for food, oil and wood, and uniting the mainland with Taiwan. The recent statements in support of the war against terrorism, suggest China is seeking greater influence on wider political issues. At the same time, Beijing's recent military acquisitions – cruise missile technology, advanced Russian-built destroyers, jet fighters, attack submarines - point to a desire to increase its regional power.

The Chinese Communist Party has been shrewd in moving the country forward at a pace of its own choosing. The Party's power base rests largely on the army and the state-owned enterprise system, as well as on all sorts of interwoven connections. As a result, it resisted wide-ranging economic reforms for fear of losing its grip on the country, and the power and wealth that comes with it. Political tensions could yet be one factor that derails China's rapid economic growth.

The problem with the reform process is that it will almost certainly lead to near-term discomfort, with unemployment rates rising. Whether China is politically in a position to implement such reforms is still open to question. Yet if economic reforms are implemented only at a gradual pace, then the problems associated with abuse of power and market distortions will continue and will, down the line, have even worse consequences. However, with WTO entry, there is a sense now that the Party officials understand this.

The private sector is desperate for capital. Chinese banks are no longer strictly an arm of government policy, but they remain tightly constrained. To put things in perspective, the private sector accounts for four-fifths of industrial output. It is a wonder that it manages such impressive growth with essentially no access to bank credit. Part of the solution would be to break the reform-blocking power of local and provincial party (robber) barons. In order to wrest control of lending from the provincial bank branches, which were there to prop up local SOEs, the banking system has been reorganised on regional lines that cut across China's provincial boundaries, reducing the protectionist power of party cliques and returning control of monetary policy to the centre.

### **Net-based economy**

Not surprisingly, China is the fastest growing tech market in the world. It is expected to surpass the US as the world's largest internet market by 2010. The number of internet users, zero in 1995, is expected to reach 300 million by 2010.

Other key facts: From an investor's viewpoint, 'new economy' stocks are in short supply, but will increase dramatically in the next few years, providing international investors with plenty of opportunities.

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Despite growing more than 100% annually in the last five years, China's cellular phone penetration rate is only 2% (7% for fixed lines).

One in a 100 people owns a computer.

China's share of world trade is expected to double to 10% by 2010.

### **An Urban Boom**

Chinese cities are undergoing an unprecedented physical transformation, reflecting the economic and social reforms sweeping the country. Anyone who has been away from China's main cities for five years will be surprised by the extent of the change. Shanghai has become a modern city in the last eight years. In terms of its economic importance, it is already on a par with Hong Kong and Singapore (in terms of infrastructure, it has raced ahead of Manila, Bangkok and Jakarta). Shanghai is shaping up to become one of Asia's top three most important cities.

Yet appearances can be deceptive, especially in China. China's cities look far more modern than they really are. The country is still a long way from creating a modern welfare state, even for the 200 million urban elite. The vast majority of China's population still look to the state or their state-owned enterprise (SOE) to take care of them. They are tied to their jobs and houses by the residence permit system, the hukou, which makes it impossible to move around the country.

Some parts of China will move almost from an agrarian economy to high tech in a relatively short time span. China could have 15 cities with a population over 15 million by 2015 and 30 cities with over 30 million by 2030, according to a recent study by MSDW in Hong Kong. Thus far, economic development has been restricted to 20% of the population along the south eastern coast, which now accounts for 50% of the country's GDP and 75% of exports.

In the first flush of a market economy, the rural areas that supplied vegetables, fish and meat to nearby cities, were the first to prosper. A construction boom started in the country, as farmers built new brick and tile houses for themselves. This, in turn, fuelled the growth of other small rural enterprises. The coastal parts of rural China prospered even faster, as overseas Chinese (in some cases, illegal immigrants from the coastal provinces) funnelled investments in. By the end of the 1990s, the market economy had spread to the remotest parts of inland China. There remains genuine concern that the disparity between town and country may not be redressed in the foreseeable future. This depends to a large extent on the effectiveness of the government's education policy and the equitable distribution of investment.

The MSDW report suggests that if WTO-inspired reforms are carried out, that China's economy could be worth US\$10 trillion by 2020. Continuing reforms have already attracted large amounts of equity funding, which now accounts for 42% of total new financing, compared with 25% between 1993 and 1997.

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China is already the second-largest recipient of foreign direct investment in the world. It absorbed a staggering \$46bn of FDI in 2001. In anticipation of a gradual removal of trade barriers and spending related to Beijing's winning bid to host the Olympics in 2008, multinationals are focusing their attention on China and relocating regional headquarters there. Four hundred of the top 500 largest corporations in the world have set up businesses there. French Telecom giant Alcatel relocated its HQ to Shanghai and has invested \$30 billion in the country. Nokia and Ericsson both claim that China is now their largest manufacturing base.

China is also the largest trading partner of most Asian nations and exerts more influence on them now than Japan. Countries that have export-oriented structures similar to China's will be

forced by its economic power to reform themselves and to adjust their economies to sell into China rather than compete head-on with it.

However, even if this most optimistic scenario were to come about, the ride is possibly going to be bumpy, especially for foreign investors. The recent history of investment into China shows that many foreign companies lost money during the 90s, because they over-estimated the growth of the domestic consumer market, setting up ill-fated joint ventures.

### **The Recent History of China Stocks**

The first batch of shares available to foreign investors in the early 90s (B and H shares) were hand-picked by the government and were perceived to be the elite Chinese companies. However, investors soon learned of the inefficiencies of these SOEs in a deteriorating economic environment and, having been drawn in on the back of a bull run, investors saw their share prices drop steadily. You may remember that the foreign investment trusts launched at around this time (1993) moved fairly quickly to discounts in the region of 40%, and stayed there.

Red chips, based on their China connections, were the next category of China stock to garner interest among foreign investors in the mid-90s. These shares did well until the middle of 1997, when the flaws of the asset injection scheme became apparent.

A second generation of China-related stocks is now emerging. These companies are more representative of China's broad-based economy and allow investors exposure to faster growing regions. A key driving force behind this phenomenon is China's gradual acceptance of foreign direct investment and the technology transfer that comes with it. For example, it took only about six months for Legend Computer to come with its own version of the Palm Pilot, that is now one of Legend's best selling products. The move towards greater transparency, the acceptance of the private sector and the launch of the GEM in Hong Kong and another secondary market on mainland, will help to increase the size and scope of the Chinese stocks available to foreign investors. This market is potentially enormous and will certainly be a much greater area of focus for global fund managers going forward.

The problem so far has been a lack of clearly defined regulations and enforceable laws, exacerbated by widespread corruption. The hope is that as China opens up its domestic economy, with WTO membership acting to firm up the operating environment, the chances for investors to make money will increase.

### **The development of capital markets**

China is engaging in a progressive market economy experiment, and the use of the capital markets will help get the right result. The stock market will be a major fund-raising route for Chinese companies. Restructuring efforts are already bearing fruit. SOE profitability is rising and this is having a positive impact on consumption, fiscal revenues and the stock market. The giant stocks that are coming to the market now are a direct result of these reform efforts. They include Petrochina, Beijing Land, Cosco Pacific and China Mobile. WTO will work to accelerate the restructuring process in the state sector.

The state-owned sector represents around 100,000 SOEs, many of which are now strengthening their management and adopting more profit-oriented business models through the 'corporatisation' process (essentially dropping a board of directors over the state-controlled company). Over US\$40bn in bad debts have been transferred to Asset Management Companies and bank lending is being directed by commercial, not political, factors.

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The private sector has emerged as an important alternative to the state sector as an engine of growth. From 1992 to 1997, the private sector's industrial output grew at a 61% compound rate, accounted for 18% of national industrial output and employed 16% of the urban

workforce. Township enterprises in small rural towns employed over 150 million ex-farmers and accounted for over 70% of the country's rural output in 1998.

The recognition of the private sector comes at a time when it is emerging as an important alternative to the state sector as an engine of growth. About half of all SOEs were losing money by the mid-1990s, compared to only 10% in 1985. Despite this, the central government has continued to favour these companies, thus severely restricting the ability of many profitable private firms to raise capital.

Chinese companies by-passed the cumbersome government approval process to raise money on international markets. Backdoor listings became a popular method, starting in the mid 90s, where Chinese entities acquired a listed shelf company in Hong Kong, injected assets and raised capital. Red chip stocks, not all approved by central government, listed in Hong Kong. The parent companies were nonetheless government-related entities. For example, Shanghai Industrial and Beijing Enterprises are ultimately owned by the Shanghai and Beijing municipal governments, respectively. Other, smaller companies, mainly private, have listed in other world markets. For example, there are maybe 20 China-related companies listed in Australia.

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Now, the capital markets are no longer an experiment. The People's Bank of China (PBOC), which previously oversaw the whole financial system, is now a truly independent central bank. The China Securities Regulatory Commission (CSRC) contracted outside help, in the form of former Hong Kong SEC chairman Tony Neoh, to build a regulatory framework to match international standards.

As a result of China's first ever securities law (July 1999), a clear regulatory framework has been put in place. Stock markets are no longer an experiment and all companies can now list. For foreign investors, the prospect of investing in liquid stocks with acceptable standards of corporate governance is a realistic one. Morgan Stanley's Andy Xie believes inefficiencies in the financial sector, such as the high level of speculation and domination of state-owned enterprises in the stock market, will have to be stamped out and that the most important thing is the opening up of the IPO market.

By 2010, McKinsey estimates that China's capital markets will be the largest in Asia, ex-Japan, with annual corporate debt and equity issuance of around US\$35 billion domestically and US\$100 billion internationally.

If the recently launched Growth Enterprise Market (GEM, set up in Hong Kong as a Nasdaq type market for Chinese companies) is a success, an additional secondary market will become operational in China (probably in Shenzhen) targeting the private sector. Listing requirements are low and eligible companies need only to have been in operation for two years and do not need to have profits for three years.

China's two stock exchanges, established in Shanghai in 1990 and Shenzhen's special economic zone (in south China) in 1991, could be dismissed as irrelevant were it not for the fact their combined market capitalisation now exceeds \$600 billion. In August 2001, China Petroleum & Chemical (Sinopec) issued \$1.4 billion of shares on the Shanghai stock market. UBS Warburg has predicted that by 2005, China could be raising all the capital it needs inside its own markets. In 2000, China raised \$21 billion in overseas markets, but only \$1.4 billion in the first nine months of 2001. \$11 billion was raised in China this year to end September.

There are 1,200 listed companies in China and 90% of those are majority owned by the state. Until the creation of new regulations within the CSRC in March 2000, party bosses in the provinces decided which enterprises would be listed. The shares would invariably triple in value in a few days after listing and party insiders would pocket a handsome profit. The CSRC's new system involved the creation of 33 authorised underwriters who compete to take enterprises public. Some companies have already been de-listed. In August, the Shenzhen listed arm of the former military-owned pharmaceutical concern Sanjiu Enterprise Group was

censured for false disclosures and misappropriation of \$300 million in shareholder funds. All listed companies must now appoint at least two independent directors and must begin issuing quarterly financial reports from next year. A market reformer and experienced investment head, Zhou Xiaochuan, has been appointed by Premier Zhu Rongji, to chair the CSRC.

Why would the Party try to clean up a market that was rewarding them handsomely? For the same reason China is joining the WTO. The communists need to modernise so that they can hold on to power. But is it that easy? No, especially if the markets do not perform to order. Previous attempts to clean up the markets have been undermined by Beijing's fear of a bear market. Since the exchanges were opened, rising equity prices have been used to bolster consumer confidence, support SOE reform and prop up teetering state banks. The result is a market that trades at a P/E ratio of more than 40, compared to multiples of 10 for Chinese companies listed in Hong Kong. Tony Neoh observes that there is still too little incentive for market players to behave properly.

It is estimated that the stock market capitalisation of Greater China (including A shares) is about one-third bigger than Japan, with market turnover projected to be 50% higher than Japan. 'A' shares will eventually be available to foreign investors, while the B share market is likely to be merged into the A shares at some stage. Red chips are likely to wither, as they are fundamentally un-appealing and they have become an obsolete funding vehicle for mainland companies. However large companies seeking international exposure will continue to favour the H shares market, because Hong Kong will retain its traditional advantages for many years, no matter how fast China progresses. China is likely to follow Taiwan's example of stock market liberalisation, in which qualified foreign institutional investors (QFIIs) will be first allowed to participate, in order to control currency movements.

### **China Market Capitalisation**

<b>Shares No</b>	<b>Market Cap (US\$ billion)</b>
A	1,087
B	113
H	54
R	47

*Figures to mid September 2001*

A Shares – For domestic investors only

B Shares – Originally reserved for non-domestic investors. Since February 2001, Chinese can invest in them (the major reason for the surge in prices in the following five months).

H Shares – Chinese companies listed in Hong Kong

N,L,S & T Shares – Listed in New York, London, Singapore and Tokyo

Red Chips – Mostly registered in Hong Kong, main assets or controlling shareholder in China

P shares – private companies from China, most of which are listed on the GEM

### **Mutual Funds**

Another important development will be in the area of mutual funds. With an estimated savings pool of RMB 5 trillion (\$600 billion) in China, the government wants to develop the mutual fund industry to take the pressure off the banks. By 2010, McKinsey estimates the mutual fund assets could range between US\$55 billion and US\$90 billion.

China's experience with mutual funds began in the early 1990s when a number of unregulated funds were set up. In October 1991, the Wuhan Securities Investment Fund was launched with a capitalisation of RMB 10 million. Other funds included the Shandong Township Enterprise Fund, with a capitalisation of RMB 100 million, which was the first to list on the Shanghai Stock Exchange in 1993. By early 1994 there were 73 funds, with RMB 6 billion of assets, and a third of these were listed in Shanghai or Shenzhen. The PBOC halted the establishment of new funds in 1999 as part of the austerity programme.

Fund launches in China are similar to A share IPOs, where retail investors apply for shares. One of the boom areas for unregulated funds is in offering guarantees of 8-10% and providing a form of gearing, in a market that is entirely momentum driven. One market observer expects to see major problems in this area highlighted in the next 6 months.

A number of sino-foreign joint venture China funds for foreign investors were set up from 1993 onwards, often with disappointing results. In April 2001, the government passed a new trust law, which separates legal ownership (by funds) from beneficial ownership (by investors). In September 2001, the first of a new breed of joint venture funds was launched. The CSRC authorised two funds, one to be run by Huaan Fund Management, advised by Jardine Fleming, the other run by Huaxia and advised by Schroders. In the short term at least, the advent of mutual funds will merely increase the amount of money chasing a limited number of stocks, which is why it is disappointing that the Shenzhen smaller companies market has been stalled. However, Zhou Xiaochuan of the CSRC has confirmed that the plan is still live, but awaits senior party officials giving the go-ahead. The feeling is they unlikely to do this until they see an upturn on global market sentiment.

The government is aware that mutual funds can efficiently channel individual savings into the capital markets. However, it is wary of developing the industry too quickly for fear of massive bank deposit withdrawals. The pension fund and insurance industries should be further developed and are integral to China's overall financial system reform efforts. McKinsey believes that China's new pension system will increase pension assets to US\$840 billion by 2010 (behind only Japan and Singapore within Asia). China will need to develop a range of liquid investment instruments for its pension funds to invest in, allowing greater diversification, potential returns and reduced costs.

Once China enters the WTO, the government has promised to let foreigners take minority stakes in domestic fund managers, but that may not be attractive to the big players like Fidelity, who will not like ventures in which they have no control. This may present opportunities for those smaller players who are willing to take that gamble.

### **Venture capital**

Despite its advancing technological base, China has not received a significant degree of venture capital funding, largely because of the absence of exit options for investors. If the emerging technology companies can successfully tap into the expanding capital market, this will help China attract far more private equity investment, encouraging a virtuous circle of increased VC funding, expanded capital markets and the development of a vibrant technology industry in China. Goldman Sachs estimates that if this trend can be established, that China's domestic stock market will reach approximately US\$2 trillion (65% of GDP) by 2010.

### **Hong Kong's Future**

Hong Kong's strong services industry, financial sector and capital raising ability are seen as adding value to China's economic development and the official line from Beijing is that the two economies can prosper together. Equally, the neighbouring countries of the region can expect, in time to benefit from increased exports to China and a lesser reliance on trade with US.

Hong Kong has been the primary channel for China's offshore fund-raising. Direct investment and inter-bank fund flows grew rapidly in the 90s. By the end of 1998, 41 SOEs were listed in Hong Kong through the issuance of H shares, raising more than HK\$52 billion. 30 China funds have been authorised by the SFC to invest in B shares and H shares, worth around US\$800 million. China's treasury bills were first listed in Hong Kong in 1998.

China's concerted effort to undergo rapid structural reform and lure foreign capital has resulted in a huge rise in FDI by Japanese, American and European companies. These efforts have continued to accelerate and cast Hong Kong in the role that it always set for

itself, as the hub for capital raising into China. On one level, Hong Kong does feel, with some justification, that it has become marginalised by the growth of China. But this was inevitable if China was ever going to fulfil its potential. The challenge for Hong Kong was to lay claim to a niche in the interior before anyone else did. As of June 2000, the number of foreign firms doing business in Hong Kong had risen year on year by 20%, to 3000, which is around the peak level of 1997. Of these, 855 have made Hong Kong their base of operations in Asia. The Chinese government has supported this trend with the creation of Invest Hong Kong, which offers assistance to businesses in setting up, gaining authorisations and raising funds. About 30 per cent of the US\$470 billion (HK\$3.66 trillion) earned in trade revenue last year was re-exported via Hong Kong.

### **Investors**

*“Sixty million mainly clueless retail investors, driven to trade almost entirely on rumour.”* (Far East Economic Review)

China's investor base has grown at an astonishing speed from zero a decade ago to 60 million stock market investors (calculated by the number of registered accounts) by the end of 2000. These investors will form the backbone of China's emerging middle class. Stock, bonds and homes are transforming the People's Republic into a nation of private owners.

Shanghai and Shenzhen have each grown in valuation at a compound average annual rate of 21% over the last five years. Local Chinese investors account for 90% of the \$2.5 billion daily average turnover of the stock markets and because of the paucity of reliable information, they tend to buy and sell on rumour.

### **Investment themes**

- Foreign demand can only increase
- China overlooked by foreign investors
- Investors underweight Chinese equities
- Increased coverage by major securities houses
- Increased weightings in major indices

### **Investment Driven Growth**

Three sources of growth

- strong fiscal pump priming – RMB 200 billion of bond financing
- Influx of FDI to capture China's market, sustainable for another few years in view of the size of the market
- A new round of SOE investment to upgrade competitiveness in response to WTO entry

**Key Growth areas:** Transportation, Power, Consumer, Financials, Autos, Real Estate.

### **Major beneficiaries of China's entry to the WTO**

From increased economic activity

- power, toll roads, transportation

to participate in lucrative monopolistic sectors

- key state investment companies in telecom and finance

From fewer restrictions and elimination of quotas on exports

- textiles and apparel, footwear and household appliances

From increased imports of consumer goods

- food and beverage, household appliances

### **Impact of Olympic Games**

- Beijing will spend US\$18bn on 50 major infrastructure projects
- An expected jump of 20% in the amount of tourism in next seven years

- 1.5 million new jobs created in Beijing area
- Total direct income of US\$1.6 billion, together with indirect incomes, could boost China's GDP by 0.3% per annum
- The Games are likely to be a catalyst for peace across the Taiwan Strait as military conflict would ruin the games altogether

### **Other themes and trends**

SOE Reforms leading to more competitive state sector

Increasing environmental concerns provide opportunities for infrastructure companies, implications for auto manufacturers

Major liberalisation of previously restricted industries (motor vehicles, finance, distribution, transport, telecoms)

Development of Western Inner Regions (tax and other incentives)

Global Outsourcing: China as a production centre for the world

### **Currency issues**

The RMB currently is not a freely convertible currency. The State Administration for Foreign Exchange ("SAFE"), under the authority of the People's Bank of China ("PBOC"), controls the conversion of RMB into foreign currency. Prior to 1st January, 1994, RMB could be converted to foreign currency through the Bank of China or other authorized institutions at official rates fixed daily by the SAFE. RMB could also be converted at swap centers open to Chinese enterprises and foreign investment joint stock limited companies, subject to SAFE approval of each foreign currency trade, at exchange rates negotiated by the parties for each transaction. Effective 1st January, 1994, a unitary exchange rate system was introduced in China, replacing the dual-rate system previously in effect. In connection with the creation of a unitary exchange rate, the Chinese Government announced the establishment of an inter-bank foreign exchange market, the China Foreign Exchange Trading System of China ("CFETS"), and the phasing out of the swap centers. However, the swap centers have been retained as an interim measure.

The value of the RMB is subject to changes in central government policies and to international economic and political developments affecting supply and demand in the CFETS market. The RMB experienced a significant devaluation on 1st January, 1994 in connection with the adoption of the new unitary exchange rate. On this date, the official exchange rate for conversion of RMB to US dollars changed from approximately RMB5.8 to US\$1 to approximately RMB8.7 to US\$1, representing a devaluation of approximately 50%. Since 1994, the official exchange rate for the conversion of RMB to US dollars has been stable and the RMB has appreciated slightly against the US dollar.

### **Key Risks**

#### **Economic**

- Global recession will undermine exports and FDI
- Major slump in domestic consumption
- Widening disparity between urban and rural population

#### **De-regulation**

- Policy changes on China's WTO entry
- Protected industries with abnormal returns will see them decline
- Competition may result in shutdown of inefficient enterprises

#### **Market**

- High PE multiples of China A & B shares
- Strengthened supervision will drag market down

## The Market Opportunity

I believe there is an opportunity to be ahead of the game in catering for the latent demand for China investments. Investors are asking about China and this is just the beginning of a new trend, brought about largely by a need for new investment ideas. However, China is not merely the best thing we can come up with at the moment to satisfy that demand, it is one of the most compelling investment stories we are likely to see in our lifetime.

An active portfolio is a key consideration because:

- China's markets are developing rapidly and are not efficient
- There is poor correlation between B shares, Red chips and H shares
- And a high level of IPO's not available to index funds
- High stock risk in key indices

## **Active Management - Variation in Stock Performance**

	2001	2000 3 yrs to 12.00	
H Shares			
Top 5	319%	93%	30%
Bottom 5	5%	-56%	-75%
Shanghai B Shares			
Top 5	207%	352%	492%
Bottom 5	87%	61%	-9.70%
Shenzhen B Shares			
Top 5	366%	175%	169%
Bottom 5	89%	1.50%	-35%

China remains a high-risk market in view of the significant uncertainties to corporate earnings from the implementation of major reforms. However, it does represent a tremendous opportunity for any company with the ability to find the stocks that will continue to enjoy growth and which remain at reasonable valuations.

## **CHINA - BETTER EARNINGS OUTLOOK FOR 2002**

Sector	Market cap US\$ million	EPS growth		PE x		P/B x
		2001f	2002f	2001f	2002f	2001f
Telecoms	74,480	21.9	32.2	18.6	14.1	3.6
Oil & Gas/Chemicals	58,489	-9.8	1.2	5.9	5.8	1
Diversified Industrials	12,205	2.4	4.1	9.7	9.3	0.9
Consumer electronics	4,195	13	10	21.1	21.4	2.7

Power	5,920	22.6	3.6	7.6	7.4	1
Infrastructure	4,621	-14	11.8	9.6	8.6	0.6
Aviation	2,944	-7.1	33.2	17.5	13.1	1
Autos	2,302	14.3	4.9	7.6	7.3	1.4
Food & Beverage	1,158	19.6	24.1	16.2	13	1.2
Property	2,791	61.7	6.8	13.3	12.5	0.6
Transportation	1,182	7.5	-0.5	11.6	11.7	0.6
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Market	174,231	-0.2	9.7	9.4	8.6	1.4
Market ex-Telecoms	99,751	-5.1	3.2	6.8	6.6	1
ex-Oil & Gas/Chems	115,742	15.1	20.3	13.8	11.5	1.8
ex-O&G/Chems/Telcos	41,262	9	8.2	8.9	8.3	1

source: Schroders

### **Possible Developments in China**

16<sup>th</sup> National Party Congress in September 2002 – the rise of the 4<sup>th</sup> generation leadership

Growth in open-ended funds

JV Investment companies

Chinese Tracker Fund

Merging of stock markets

Merging of A and B shares

Free Market for Foreign Insurance

Liberalisation of pension and Insurance Funds Investment

Development of unit-linked insurance and 401k style pensions

Privatisation of second pillar pensions (individual accounts)

Convertibility of the Renminbi

International investment by institutions

### **On a 10 Year View**

Chinese Economy doubles in size to GDP of US\$2 trillion.

Stock Market Cap - \$2 trillion

50% retail with 10 million investors

The development of the institutional market to form the other 50%

The development of pensions – today, unfunded pension liabilities is a big problem.

By 2010, pension funds will help stabilise and develop stock markets.

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**Richard Newell**  
**November 2001**