You're missing the great China value trade

August 15, 2012

There is a fundamental shift occurring within the Chinese economy.

By Himanshu Shah

In the past 18 months, the Chinese equity space has been completely abandoned by investors. During this time the U.S. media as well as a majority of Western media have piled into a very heavy anti-China rhetoric and created a crisis of confidence. Investors are fixated on a few accounting scandals with U.S.-listed Chinese names, real estate sector bubble fears, and a slowing of export driven growth. Overzealous tightening by the Chinese central bank in 2010-11 to control inflation did not help ease perceptions that the Chinese economy could not sustain its expansion.

But investors' views are extremely short-term oriented and more "glass half empty than glass half full." They are overlooking that the drivers of a Chinese economy are becoming more balanced, leading toward economic sustainability.

China's slowing growth has been a huge topic of investor concern as it slows from annual double-digit increases since late 1990's to the high single digits more recently. While this has caused hard-landing fears for much of the investment world, we view this shift as extremely positive and supportive of long-term sustainable growth. Investors have missed how controlled and managed this slowdown has been. The Chinese government went through extreme quantitative tightening last year, dropping from nearly 29% credit growth in early 2010 to 13% by July 2012. This highlights the government's efforts to slow the economy, specifically in the areas of real estate development and local government financing vehicles.

The tightening succeeded in driving down inflation from a peak of 6.5% in July of 2011 to 1.9% by July of 2012, the lowest level in two years. High inflation had a tremendous effect on input prices, harming corporate profits, which negatively affected valuations through much of 2011. With inflation now within the 2-3% target, the government has tremendous room to guide the economy to a soft landing through interest rate cuts as well as bank reserve ratio cuts and has been doing so since November 2011.

There is also a fundamental shift occurring within the Chinese economy. The blockbuster double-digit GDP growth driven mainly by infrastructure expansion and exports is shifting to private consumption. Net exports have actually been a flat or negative contributor to GDP growth for the past four years. But consumption has been increasing steadily, contributing 43% to GDP growth in Q1 2012 compared with 27% a year earlier.

If we assume the middle class in China is 20% of the population, that equates to 280 million people or 90% of the U.S. population! This segment is flourishing and consistently increasing its standard of living. Chinese households are extremely underleveraged and therefore enjoy a lot more financial flexibility than their Western counterparts.

But fear of a hard landing means that U.S.-listed Chinese companies as well as many Hong Kong-listed Chinese companies are now trading at or near historically low valuations. In many instances, the companies are trading for significantly less than book values and in some instances, less than net cash! An investor may wonder how it is possible. The reason is very similar to the reason behind many northern European countries having negative bond yields—fear!

These low stock prices are not reflective of deteriorating business models. Often the companies are leaders in their markets, domestically and internationally, and gaining market share from their competitors.

Several of the companies in which we're invested do not receive the respect they deserve in the public markets. Domestic Chinese investors are also not stepping up due to fears about the potential impact of macro shocks related to the European debt debacle as well as concerns about China's political transition, which is set to take place in early October.

With such low multiples, it is highly likely that private equity firms or management buyouts will take many undervalued stocks off the market to list back in China and/or Hong Kong. Several funds have been raised in Asia to take advantage of this arbitrage. As many companies are growing their top and bottom lines by double digits, issuing healthy dividends, generating healthy cash flows and often trading at low single-digit valuation multiples, this opportunity won't last forever. We believe in light of these disproportionate low valuations, the Chinese equity trade is the best investment trade across all asset classes.

China, a country of 1.4 billion people, in many ways is a world of its own. Since the open market reforms in 1979, the central government has turned China into the second biggest economy in the world. The coastal cities boomed as the country took advantage of low cost manufacturing and developed an extremely efficient supply chain serving the Western world. Now development is moving inland, away from the coastal cities—meaning more urbanization, more infrastructure-building, and more spending power for non-coastal Chinese. Lots of companies are moving work to western and southern provinces/cities. More bridges, buildings, rail tracks, airports and roads are consistently being added to the capital stock. China's high-speed rail system expects to connect 50% of the country's cities by the end of 2013 and 100% of the network by the end of the decade.

Many Western pundits have criticized over-spending on infrastructure growth as a reason for imminent economic collapse in China. This is misguided as the country still has scores of infrastructure building needed to connect the country, provide affordable housing to the middle class, and support continued investment from the entire world. Just 10 years ago Hong Kong International airport was the only Chinese airport on the list of top 25 busiest in the world (ranked #15) and today there are four Chinese airports within the world's top 25, with Beijing ranked second.

The central government has also recognized not only the need for continued attention to physical infrastructure but is also bringing about more change in terms of open market reforms. The country has moved to allow further investment both domestically and internationally. If they did not have the wisdom to open up the economy for outside investment, China would not be where it is today in the global economic landscape. The leadership understands the necessity for it. Of course, there is room for more market reform, and we expect that to take place in a measured manner. The one-party political system also allows for quick decision-making.

It is also very important to note that the central government has tremendous flexibility to respond to global slowdowns and also continue to support 7% growth. The country's debt to GDP stands at 20% while much of the West is close to 100% and Japan is over 200%. Even with no tax revenue from estate transfers, real estate, capital gains or dividends, the Chinese government is close to the US government's tax intake (over $1.8 trillion). The Chinese government has no looming healthcare and pension liabilities and neither do the country's corporations. At the time of this writing, the U.S. has nearly $120 trillion in unfunded liabilities (with no serious entitlement reform imminent) and investors have completely ignored this disparity as U.S. 10-year bonds are trading at all-time lows of 1.5%.

While we can continue for many words and countless pages on the phenomenal growth of this country, the main crux at this point is what type of investment opportunity is presenting itself. Global markets are dealing with unprecedented debt issues in Europe, a fiscal cliff in the U.S. and also a global slowdown across the board. These issues have caused investors to become traders and simply invest in perceived safe havens (U.S. Bonds, multinationals and perceived blue chip momentum stocks). China is in a very sound fiscal position and offers the best growth in the world. When Moody’s recently cut debt ratings on 15 global banks, not a single one of them was from China. The glass is actually more than half full and due to misconceptions on many levels, buyers are able to buy assets at a large discount. China is the best investment trade across the board and as the consensus becomes more aware of the true underlying position, we expect the China fundamental trade to reward handsomely.

Himanshu Shah is the founder and chief investment officer of Shah Capital, a global long/short equity hedge fund based in Raleigh, North Carolina that invests in the U.S., China and, to a lesser extent, western Europe.

ISSN: 2151-1845