A China update – Shanghai vs. Hong Kong! Government vs. markets?

Enjoy!

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Investment Outlook

CHINA – A Contrarian Hunting Ground

This week in Shanghai we visited 15 companies in the wealth management, tourism, recruitment, and e-commerce sectors. They are mostly listed on NASDAQ, have fallen up to 30% in the past month, and some have up to 50% of their share price in cash.

On the ground, nothing much has changed. Yes, the 'New Normal' for China is to grow about 5%, not 7 to 10% as in past decade but then China is now a middle class country with average income US$8,000 per capita like Europe, Japan, Korea or Taiwan. Shanghai is a world class sophisticated urban centre of 20 million comparable to New York or Tokyo in style and wealth. The economy's theme is no longer exports, infrastructure, or heavy industry: it is domestic consumption, tourism, and financial reform.

The sudden end to the Shanghai A share 'bubble' market is a healthy development for China's long term evolution, towards a 'western' savings and investment culture, of mutual funds, pension funds, and rational long term investing, as opposed to the 'Casino' gambling culture of Macao, or Shenzhen. What we observed, was the rapidly growing seeds of a fund management industry, with 'wealth management products' producing fixed income returns of 6 to 8% p.a., real estate trusts (a form of REITS), venture capital and PE funds, hedge funds and long only equity products.

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The largest private, non-bank, wealth manager controls about US$10 billion AUM, and smaller competitors growing at 50% p.a. can be found for 10 times P.E.

One of the best managed businesses is Hua Zhu (or China Lodging), which controls about 2100 mid-level hotels in China, and will sign a deal with the French group Accor, to manage 100 higher priced hotels, with an on-line booking link, for China's estimated 120 million outbound tourists. This company and others we interviewed, are managed by US Ivy League educated 'returnees' an impressive group of top notch managers – mostly women.

The online e-commerce business is booming while 'offline' retail brand name sales are in recession (one can see this in the Hong Kong shopping centres of empty shops with luxury brands). China seems more advanced, than Western nations in this respect, with Alibaba's sales of over US$550 billion, now dwarfing Amazon, or E Bay. Tencent and Baidu and their affiliates make up the core galaxy of competition, (nearly 600 million Chinese have smart phones).

The Shanghai Stock Exchange now has US$5 trillion of listed companies, and an average US$100 billion daily trading volume (larger than New York). They will now relax listing procedures to allow internet start-ups to list on a 'new industry board' (akin of Nasdaq). Clearly the government intervention has had mixed results especially the many suspended listings, which backfired badly: but Chinese officials learn quickly from experience, and we expect that by the end of 2015, the market will become more open and tradable with RMB convertibility (and the IMF's imprimatur of the Yuan as a reserve currency), and the Shenzhen-HK Connect opening.

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In summary, China's 'miracle economy' era is over. The 'new normal' is lower growth: but GDP growth and share prices are not always correlated (ie. Japan 1975-1990). We believe this summer's sharp correction is an extraordinary opportunity to accumulate patiently long term positions, in some great businesses, at reasonable valuations. We have positioned our Bamboo Fund for a strong recovery with all engines firing – not only in China but also Japan, India and South East Asia. The ongoing correction in commodities led by oil, gold, and metals is a positive 'tax cut' for Asian consumers.

Deflation is beneficial, and will spur inventions and discoveries, as it always has done historically in the 1870s and the 1930s.

Robert Lloyd George
3rd August 2015

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