



Fresh China Perspective

As a portfolio manager with a global perspective my goal is to reduce the risk of the unknown through due diligence. The resources of the digital age are generally quite effective at gathering information. One place where there are significant limitations is China. It is very difficult to find third party sources that corroborate reported information. Prior to my going to China the biggest unknown was whether the unprecedented rate of growth was sustainable. China's demand for natural resources impacts almost every global commodity. China's manufacturing prowess impacts the Cost of Goods Sold for most western multinational companies. During 2009 the lending by China's state owned banks more than doubled. To what extent were the banks making bad loans to meet the central planning target of 8% GDP growth? To answer this question and more I spent the first half of March 2010 in China meeting with senior managers from 39 companies in Beijing and Shanghai.

Humbling Scale

Having grown up in New York City I am used to a big city; however, the scale of the China's urban industrialization is humbling. China's central planners have determined that the most effective path forward is breakneck urbanization on a scale that has no historical parallel. By 2025 China plans to urbanize 350 million people.

Sink or Swim

The Chinese in tier one cities are remarkably motivated by the opportunities presented and the fear that exists in a system with few safety nets. Everywhere you turn in China you are reminded of the struggle to succeed. Construction sites run seven days a week 8AM – 9PM. Until five years ago construction sites ran 24 hours a day. Retail stores are open seven days a week 8AM – 11PM with some variation in the open and close. China is an atheistic society for the most part so Sunday is another work day for many. The Chinese do not tip. The gift is to have a job in a country where there is a seemingly endless supply of labor.

First Tier Cities

The first tier cities, with the exception of Beijing, are the former colonial trading ports or capital cities of provinces. China opened these cities earlier than the rest of the country as special economic zones. Access to the first tier cities is very sought after by the Chinese but access is heavily restricted by the Hukou (residence) identity cards. Outside of these first tier city states I was frequently reminded about harsh living conditions in rural settings and the inequality between first and second tier cities.

Shanghai is truly a world class cosmopolitan city that speaks of strong European influences. The city is building a beautiful park system but noticeably absent are birds. Air pollution is a very serious issue and steps are being taken to reduce pollution, e.g. cement batch plants are no longer allowed on job sites due to particulate pollution they create. This means China's roads have a new addition, cement trucks.

Consumer Market Observations

The Chinese people like to eat everything and the young Chinese love to buy. In a country where the sheer number of people is a defining element, feeling exclusive for the affluent consumer is important. The amount of retail space devoted to high-end western goods is stunning. The consumer side of the economy is almost completely untracked. Approximately 85% of all transactions including cars are paid in cash which creates an interesting opportunity for electronic payments if the government will open the market. There is a thriving black market. The 5-year planning system is at the heart of the Chinese system; however, the struggle to survive is very real and people have had to improvise. When a production run for a western company is complete there is clear evidence that additional units are produced and sold. The black market is so deep for Apple iPhones that it has effectively negated the value of Apple's Chinese iPhone product launch.

A Brief History

In the 1950's the Communist Party confiscated all property in China. At the core of the current wealth generating system is land. The Chinese land rush has a non-Western twist. To this day no one can own land in China. It is the people's land but the government will grant lease rights up to 70-years. The current ownership structure in China has evolved. In the late 1970's the central government told farms in what was truly a collective society that they were entitled to own the product of the land. The Tiananmen Square student uprising in 1989 set the stage for a decisive turning point. The central government watched the staged implosion of the Soviet Union's Eastern Block. Previously, the Chinese central government which had been indecisive about turning right or left, realized for its own survival it needed to embrace more openness to the West. As a further liberalization in the 1980's the government decided to allow the ownership of products produced in factories and permitted the ownership of buildings on leased land.

The Core of the Wealth Generating System

Wealth creation is a function of securing the granting of lease rights from local officials. The enticement for local officials is the creation of jobs and local tax revenue that will help them meet targets established by the central government. In a society where ownership rights are not well-defined this also opens the door for backroom deals. The first movers in this land rush associated with China's western expansion can create enormous wealth without capital. With the lease right in hand the connected entrepreneur can then get a mortgage on the land from a state owned bank if the industry supports a directive under the 5-year plan. If that option is not available, there is abundant private equity financing or the vendor financing from the sponsoring Western company. An enterprising entrepreneur repeats this process 100 or more times and then can pursue taking the company public. Last year 36 new Chinese billionaires were added to the Forbes' billionaire list.

Opportunity and Risk Aversion

The Chinese in the first tier cities are keenly aware of the opportunity and wealth that can be created. This wealth is then being pumped into a vibrant and rapidly developing capital market. Most students of first tier cities are no longer interested in studying in the U.S. under a four-year program. They do not want to miss out on the opportunities at home and are opting for one and two-year programs. The daily share trades on the Shanghai Exchange already exceed the daily volume of the New York Stock Exchange. China already has a 106 security firms and over 100 domestic hedge funds supporting enormous capital market activity. Average stock turnover on the Shanghai Exchange consistently exceeds 300%. Risk aversion is extremely low and many investors view stock ownership as a lottery ticket. The other favored asset class is real estate. Unlike Japan and the U.S., China's property bubble is building in the first tier cities and the price verification feedback loop is creating greater confidence to step out on a limb.

A Pragmatic Response

Immediately following the glory of the Summer Olympics, Chinese leadership was broadsided by the vicious turn of events during the fall of 2008. China lost export markets around the world as consumer demand went into the deep freeze. The challenges faced by Chinese leaders were compounded by the fact that their investments in the West were cast into great doubt. The central government decided they needed to stabilize internal markets for Chinese companies. To foster 50% or greater market share for domestic companies, the government created indigenous innovation standards. These changes along with a well constructed and well executed stimulus package helped China fare better than most during the financial crisis.

An Unfair Response

The U.S. government unwisely put 'buy American' requirements in the U.S. stimulus bill which opened the door for a direct response from other countries. While every political system is going to afford special rights to the interests they represent, there is a point where the special rights cross the line. The indigenous innovation standards go too far when combined with the recently passed patent laws. Last year China accounted for half of all the complaints filed with the World Trade Organization, while at the same time Chinese leadership requested and received a 15-year phase in of WTO rules for government procurement. While Chinese leadership is doing what is best for their domestic industry development, the level of fairness in these rules must be revisited. The openness in key industries such as finance is still lacking. It is also important to note that the indigenous standards are also imposing technology standards that the Chinese people do not want on their laptops and state owned enterprises do not want on their cell networks.

Challenges for China

The growing wealth discrepancy between the have and the have not which in turn is feeding the rapidly appreciating real estate prices in tier one cities. Inflationary pressures associated with the housing stock and raw materials threaten to spill over to other parts of the economy. Water shortages are a very serious issue. Pollution levels are broadly compromising access to clean water. China also has to contend with desertification which by government estimates is annually claiming over 2,000 square miles of much needed land. The other big challenge is China's need to develop more of a healthcare and social security safety net.

Challenges for the U.S.

The U.S.'s greatest asset is its unchallenged store of intellectual property. Protecting and investing in this asset is of paramount importance since the value is lost once it is commoditized. At the same time the U.S. needs to invest in its industrial base so that the U.S. economy is more balanced. Right now our biggest export is IOU's and that cannot last for ever. The U.S. is still putting off difficult decisions about reforming the cost of our healthcare and benefits system. We recently addressed access to healthcare but failed to address the cost component of the equation.

Strong Baltimore Connections

Baltimore, Maryland, has strong historic links to China. Part of downtown Baltimore is named after Canton, which changed its name to Guangzhou in 1918. Following the War of 1812 a robust China trade emerged as fast Baltimore Clippers plied the waters to China. The Maryland Center in Shanghai is host to 16 in residence companies.

Conclusion

I come away with the unexpected conclusion that China's development is farther along and bigger than I thought. The sustained rates of growth coming out of China are stunning. The tier two cities have yet to benefit fully from the pending development. By 2025 the Chinese government is committed to executing a plan to urbanize a population greater than the U.S. Through measured openness and adaptation China has gone from rationing food 30 years ago to being the world's leading manufacturer. The China of today is still very much an authoritarian government that does not tolerate dissent; however, capitalism is richly infused.

Useful reference for future information:

http://www.mckinsey.com/mgi/publications/china_urban_billion/