CHINA'S NEW CATALYSTS

The latest slew of market initiatives has generated a new wave of investor interest in the world's second largest economy. Fund managers share their views on the opportunities and the pitfalls.

BY **KUEK SER KWANG ZHE**

The continued liberalisation of China's financial markets has attracted keen interest from global investors, who are taking a closer look at the viability of investments in the country as well as the prospects of Chinese companies that are listed on foreign bourses. The recent inclusion of China A-shares in the MSCI Emerging Markets Index and the launch of the Bond Connect scheme by China and Hong Kong have also sparked positive sentiment around the globe.

While the A-Shares will only have about 1% weightage on the index, the inclusion is largely seen as a symbolic move by MSCI. Nevertheless, this is expected to see a lot more inflows into China.

Sat Duhra, manager of the Henderson Asian Dividend Income fund, is of the view that China will further liberalise its financial markets. "You look at how China has been opening up its capital accounts [including financial markets] over the past 10 years. It is a pretty good move," he says.

"Think about where its economy was 10 years ago and compare that to what you see today. You can imagine that in the next 10 years, it will be a very open place for businesses. It will be the kind of place investors want to get into."

The liberalisation of the Chinese financial markets is a macroeconomic theme that many fund managers are riding on. It has sparked a lot of interest among local investors as well.

"The inclusion of China A-shares in the MSCI Emerging Markets Index has boosted overall market sentiment and will bring in new and long-term international capital into the market," says Lei Jing, managing director and chief investment officer for fixed income at Beijing-based Harvest Fund Management.

Besides opening up its equity markets, China recently launched its Bond Connect scheme linking overseas investors to the country's US$9 trillion bond market. Patrick Chang, chief investment officer at CIMB-Principal Asset Management Bhd, believes it is a good move and China is on the right path.

However, the interest has not fully translated into action among investors, he says. "The inclusion of China A-shares into the MSCI sparked huge interest among local investors. When I speak to investors, for the first time, there is a lot of appetite for China.

"There has been a very big shift in their mindset over the last 12 months. They want to diversify away from Malaysian equities into Asia-Pacific. They want to focus on large markets with huge growth. However, there is still a wall of concern among some of them [that is preventing them from investing in the market]."

This comes as no surprise as investors have many concerns. For instance, China's stock markets have the highest number of trading suspensions in the world.

In fact, only a month after approving the inclusion of China A-shares on its index, MSCI warned the country for having too many stock trading suspensions. The index provider, quoting data from Shanghai-based consulting firm Z-Ben Advisors, said an average of 265 stocks — or one out of every 13 counters — listed in China were suspended in July. The data also showed that the number had risen every month this year and was up by 30% from an average of 202 stocks in January.

Corporate governance is another concern for local investors. The Malaysian experience of investing

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Beware of the value trap

Investors who are interested in investing in China should avoid falling into the value trap, says Sat Duhra, manager of the Henderson Asian Dividend Income fund. This means buying companies that look attractive based on their cheap valuations. In fact, the companies' performance and share price tend to remain flat over the years.

Duhra says Chinese companies are typically state-owned enterprises across various sectors, including banking, industrial and property. "It is very easy to fall into the trap because these companies are constantly cheap and relatively attractive. You tend to think of buying into them and hope there might be an inflection point where things happen and the share prices rally. But if you look at the past five years, the share prices have been volatile and they have not rallied much. In fact, they always stay cheap and that is the trap no one wants to fall into."

Instead, he suggests that investors pay a premium to buy into well-run private companies that are profitable and have no debt. He advises investors to look at the companies' financial statements and talk to their management to see if they are experiencing structural growth. "It is better to pay a little more to buy into good companies in fast-growing sectors such as personal computer gaming and sport brands," he says.

As a dividend income fund manager, Duhra suggests that investors focus more on the companies' cash flow and dividend payout instead of their price-earnings ratio as it is not a good reference point for investors in Asia. The PERs highly depend on the accounting standards adopted by the particular country.

Also, corporate governance is an issue in some emerging markets. "Instead, you need to look at what kind of growth the companies have with the investments they make. More importantly, what is the cash flow they are producing? Are their operations strong? What are their actual returns like after deducting the cost of capital? If you don't look at companies in Asia this way, you will get burnt," says Duhra.

With good cash flow, these companies are more likely to pay attractive dividends, which could provide investors more confidence after realising their gains, he says. A consistent dividend payout also shows that a company holds enough cash and cares about the interests of its shareholders. This could reduce the possibility of any manipulation to its financial statements.

CHINA PLAY IN THE MALAYSIAN MARKET

Malaysia is China's largest trading partner in Southeast Asia and the recipient of large-scale investments worth up to RM400 billion in local port and railway projects. Investors can ride the China theme by investing in companies with ties to these projects as well as Chinese companies listed on the local bourse.

Patrick Chang, chief investment officer at CIMB-Principal Asset Management, says the One Belt, One Road initiative is an obvious play for investors to tap. This includes construction companies that will benefit from mega infrastructure projects that are being kicked off on the back of Chinese investments.

According to a Fundsupermart.com report, titled *Idea of the Week: The Belt and Road Initiatives Saga — Malaysia's Stake*, the mega projects include the LRT3 project, which will see the involvement of Beijing-based rolling stock manufacturer CRRC Corp Ltd. The project, which is now worth RM1.56 billion, will see three more packages worth RM2.5 billion kick in by the end of this month and funds have been exclusively allocated to Malaysian companies, says the report.

Another project is the RM55 billion East Coast Rail Link, funded by China Communications Construction Co Ltd and Export-Import Bank of China. It is the largest railway project undertaken by the private sector in Malaysia. The ECRL will connect Wakaf Baru in Kelantan to the Integrated Transport Terminal in Gombak and Port Klang, Selangor.

Chang says the tourism theme is another direct play. OldTown Bhd and Malaysia Airports Holdings Bhd (MAHB) are two examples of such companies. "About 40% of OldTown's revenue comes from product sales to Chinese tourists. I know many who visit relatives in China [often] bring OldTown white coffee with them.

"MAHB is another example. If you look at the company's statistics, the number of tourists has increased. Also, I go to Malaysian airports all the time and there are often long queues."

Chang says the growth of the tourism industry is expected to continue in the next few years. "As mentioned, there are 150 million outbound tourists leaving China every year. This is expected to increase to 200 million by 2020."

The weakening ringgit and eVisa — China's online electronic visa programme — have helped boost tourist numbers, he adds.

in locally listed China companies have not been encouraging. Just last month, *The Edge* published a report that showed most of the red chips (China-based companies listed on the local bourse) had corporate governance issues such as late submission of financial reports and inaccuracies in their financial statements.

From a macroeconomic perspective, investors are worried about China's high corporate debt and trillion-dollar shadow banking industry that fuels high financial leverage.

KEY REASON INVESTORS SHOULD LOOK AT CHINA: GROWTH

Despite the risks, fund managers note that there are compelling reasons for investors to invest in China. Growth is one of them. Last year, the gross domestic product of the world's second largest economy stood at US$11.2 trillion, having grown at a rate of 6.7%. By comparison, the US recorded a GDP of US$18.57 trillion while its economy grew 1.6%.

Much of the growth is happening in China's technology sector. This can be seen in the performance of players such as Tencent Holdings Ltd and Alibaba Group Holding Ltd. Just a few years ago, the tech sector had a weightage of less than 15% in MSCI China. Today, it has shot up to 35%, says Chang.

"The economic composition of China is changing. And the key reason why people are excited about the country is because they want to have exposure to its tech companies, which are expected to experience high growth," he adds.

The valuations of these tech companies are high, but their growth potential is enormous as they are diversifying into other sectors. This could justify the high price-earnings ratio of the tech giants.

"For instance, Tencent — one of the core holdings of the CIMB-Principal Greater China Equity Fund — started out as an internet-based company. It is now diversifying into other businesses such as online gaming, e-wallets and payments. It is one of the largest money managers in the world — and this is happening in a world where growth is scarce," says Chang.

"Then investors may ask about the high valuations. For now, the valuations of the tech companies are alright as the companies are producing earnings and their cash flow is strong."

Tourism is another sector in China that he is looking at. Ctrip — an online portal that provides travel services such as accommodation reservations, transport ticketing, packaged tours and corporate travel — is one of the bellwether stocks in CIMB's funds. Chang calls the company the "TripAdvisor of China".

The reason for the growth of this sector is the rising wealth of China's citizens as well as its expanding middle class. Travelling has become part of their life style. "There are about 150 million outbound tourists leaving China every year. Imagine the growth potential," says Chang.

"Also, the Chinese are fast adopters of e-commerce and online payments. This benefitted online portals such as Ctrip."

Both Tencent and Ctrip are H-shares, or the stocks of China-based companies that are listed on the Hong Kong stock exchange.

China companies can offer investors in other parts of Asia some unique investment opportunities. "There are companies operating in emerging industries such as financial technology (fintech), DNA sequencing and new energy vehicles. China has developed these industries into globally recognised ones while other industries have been growing rapidly," says Harvest Fund Management's Lei.

In the case of fintech, there are a number of up-and-coming players trying to make their mark on various industries. One of them is Ant Financial, the payment affiliate of Alibaba, which runs the Alipay mobile payment services. The company, valued at US$60 billion in April last year and more than double that ascribed to Snap, is planning to be listed on the Hong Kong stock exchange. However, it was reported that the listing plan had to be delayed to 2018 as the company needed to secure regulatory approval and focus on building its business.

According to a recent Bloomberg report, Ant Financial almost doubled its earnings in financial year 2017 as it expanded its wealth management business overseas. The report pointed out that the company had racked up a pre-tax profit of US$814 million.

In the DNA sequencing industry, BGI Genomics Ltd — one of the leading research companies in the genomics industry and the world's largest genomics organisation (according to its website) — made its debut on the Shenzhen Stock Exchange in July, raising US$250 million in its initial public offering. Founded in 1999, the company generates most of its income from fertilisation and health, basic research, complex disease and drugs research services. Prior to listing on the Shenzhen Stock Exchange, it failed in its attempt to get listed in the US and Hong Kong.

For new energy vehicles, Yutong Bus is a good example, says Duhra, who is with Janus Henderson Investors. "If you are in Singapore, you can see their buses. The company is growing internationally and it has a real edge in new energy vehicles. This is a unique business in China. If you compare it to the US, it can be like Tesla."

CHINA'S ECONOMY BETTER THAN CRITICS EXPECTED

Looking at the performance of the Chinese economy over the past 10 years, fund managers are of the view that it is on the right path. The economy has been growing consistently and the markets have gradually opened up.

Also, China has successfully avoided a hard land-

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A SCEPTIC'S VIEW

While many investment experts are bullish on the Chinese economy, some are not. John D Kuhn, author of *China Fortunes: A Tale of Business in the New World*, is one of the sceptics.

Kuhn, who first visited China in 1984 and invested about US$1 billion in private equity there in 2006, has not invested in Chinese publicly-traded securities since. And he has no plans to do so as the level of governance and disclosure required of listed companies there "is wholly inadequate".

"While a reading of China's rules on disclosure shows that it employs standards similar to those adopted by securities commissions, stock exchanges and accounting associations around the world, the practice of disclosure there is totally different. Why? Because there is no accountability or penalties [imposed on those who break the rules]," says Kuhn.

"For example, if General Motors did not voluntarily disclose in its public filings that, say, Warren Buffett had through various means accumulated 10% of the company's stock, the people responsible would be prosecuted. And if they were found guilty, they would serve a significant jail term. Nothing like that exists in China. It is just a different world and the people who pay the price are the common shareholders."

Kuhn says the same logic applies to the country's legal system. "The court is another example of the same phenomenon. Back in the 1970s after Chairman Mao died and China was coming out [to the world], various foreign experts worked with the country to implement a legal code and court system similar to those of first-tier economies. And the result is that the Chinese court system appears to be — on the surface — very similar to the functioning legal system in, say, the US or Europe. But if you try participating in it, it is not even worth a serious discussion."

Also, he does not believe that the inclusion of China A-shares in the MSCI Emerging Markets Index will enhance the level of corporate governance in the country. "I don't think it will improve its markets' transparency and corporate governance. I am not sure what will change the way China handles these things — maybe if something like what happened in Japan, where the market dropped precipitously and has never bounced back, [occurs in China as well]."

Kuhn's views are based on his first-hand experience as a private equity investor in China. "A typical portfolio manager, as diligent as he may be, usually sits at his desk in comfortable places like Hong Kong or Singapore. At best, he pays periodic visits to a company whose securities the firm owns. Even what that happens, the company can control what he sees and hears when he visits," he says.

"On the other hand, when you are a direct private equity investor, you experience first-hand the pathetic inadequacy of these systems. That is what makes a private equity investor's hair curl and causes one to realise how different China is from other investment milieus.

"Everyone is entitled to their own opinion. However, I wonder how many of them have dealt with Chinese warlords who, on a day-to-day basis, demand huge sums of money from various ill-gotten gains."

Kuhn is also of the view that while China's economy will continue to grow, it is "living on borrowed time" due to years of questionable practices and non-accountable borrowings. "The Chinese economy is just beginning to show cracks in the façade from years of corruption and rampant non-accountable borrowing. For evidence of the coming catastrophe, one only needs to look at Dalian Wanda Group. The same kind of behaviour was rampant in Japan in the late 1980s. This, together with its demographics situation, is one of the key reasons why its economy has not recovered since."

Economy continues to grow at a healthy pace

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ing as expected by its critics in the past two years. The country's foreign reserves have stabilised and the economy continues to grow at a healthy pace of more than 6% each quarter. On top of that, Beijing has started to clamp down on excess credit and shadow banking activities.

Duhra is of the view that China has shown it is doing better than critics have expected in recent years. "A few years ago, when its foreign reserves fell to below US$3 trillion [for the first time in six years] and its property market went down by about 10%, some were saying that China would have a hard landing. But what happened recently was its foreign reserves stabilised and the economy continues to grow. The government is starting to clamp down on excessive credit and off-balance-sheet debt," he says.

On the other hand, the level of innovation in the country remains high amid the government clampdown and consumer consumption and manufacturing production are still at healthy levels. "Amid all these, you see that the increase in the number of patents in China is very impressive. The retail sales numbers are high, as are the production numbers. China is in a very good place. You can't ignore these and say, 'I don't want to invest in China'," says Duhra.

CIMB-Principal's Chang is also positive on the Chinese economy and stock markets, judging by their recent performance. "We have gone through a lot of noise saying that China's growth has been going down, especially during the devaluation of the renminbi. But as you can see, year to date, MSCI China is up by more than 25%. The growth is slowing, but steady," he says.

"We have also seen earnings upgrades and the government reforming state-owned enterprises. The government is also cutting down on excessive credit, which has caused some companies to go bankrupt."

Chang believes that when markets are sceptical about China, it represents a good buying opportunity for investors to engage in relatively contrarian trades. This is what CIMB-Principal did two years ago.

Chang says he and his team bought some A-shares when the markets plunged due to the renminbi devaluation a few years ago. The team reaped a return when the markets recovered. "As I said, everybody has a wall of concern about China. But looking at the country today, its economy is quite stable. I am still very bullish on China."

Gary Lim, regional fund manager at Apex Investment Services Bhd, has a positive view on China's economic growth and the liberalisation of its financial markets, at least in the shorter term. "China is making structural improvements for the better and the markets are increasingly allowing investors to get exposure to attractive sectors in the country."

Lim says China's further integration into the global economy is expected to benefit global growth. "China has a rapid accumulation of domestic savings. This capital, when permitted to flow overseas by the Chinese government, could sustain global economic recovery even as the US appears to be on an extended and mature stage of recovery.

"The One Belt, One Road initiative is one such government-led initiative. We can debate about the rationales, motive and costs. But really, the capital-starved emerging economies must benefit in the short term from much-needed investments before we even think about the long-term implications whatever they may be." E