DANIEL'S TOUR OF CHINA

September 2018

HAWKSMOOR
FUND MANAGERS

3. CENTRALLY PLANNED ECONOMY / POLITICS

To a certain extent, market forces do not apply in China, meaning anyone trying to analyse China from a developed market perspective will only be looking skin deep.

The government allows market forces to play a part until such a point where exuberance occurs resulting in a clampdown, or a slowdown occurs resulting in some form of support. This can result in sections of the economy swinging between hot and cold until an equilibrium is met and the government steps away again.

"The government has had a long held belief in 'bird cage economics' where the bird is gradually given the perception of greater freedom as the cage gets bigger – but it is still kept in a cage!"

Influence on the property sector

The current focus is on the property sector; imposing new restrictions on borrowing, forcing deleveraging, new mortgage guidelines, encouraging the reporting of non-performing loans (NPLs), allowing defaults and supporting mergers and acquisitions in the sector, private and public.

Such new regulations can be imposed literally overnight meaning companies need to be financially secure with appropriate funding sources in place, hence the importance of the offshore dollar market when they don't need it rather than waiting until they do.

At the same time as this deliberate slowing of the property market, the government is telling the local governments to borrow to increase spending on domestic infrastructure. Banks are the natural buyers of these bonds whether they like it or not.

"However, what came across very clear during the trip is that there is little risk that these domestic bonds will default as it is all intra-government money and self-funding, much like Japan, so negative commentary about the rise in public debt misses the point."

So a financial crisis is unlikely but with all these taps being turned on or off, a policy error is probably the most obvious risk to the short term economic growth of China. A calm deceleration of 25-50 basis points each year and a rebalancing of the economy is the ultimate goal but it is a delicate balance that the government will do well to achieve.

AGENDA

24th September - Hong Kong

- Head of Moody's China
- Moody's Asia Property
- Kaisa Group Holdings (Property Developer)
- BNP Paribas top ranked China strategist
- Agile Group (Property Developer)
- Gleneagles Hospital (Private Hospital)
- Head of Moody's South East Asia
- Deutsche Chief Economist
- Deutsche Asia Chief Economist

25th September - Shenzen

- Shenzhen Investment Holdings (State Owned Property Developer)
- Shenzen Investment Holdings' new science park
- Huawei headquarters and innovation centre (technology company)
- SF Holdings distribution centre (logistics company)

26th September - Shanghai

- Fosun International (conglomerate)
- Greenland Holding Group (State Owned Property company)
- Shui On Properties (Property Developer)
- Xintiandi – new mixed use retail/ dining centre developed by Shui On
- Yingde Gas (industrial gas producer, owned by private equity)

27th September - Beijing

- Metallurgical Group (State Owned Steel producer)
- Aluminium Corporation of China (State Owned Aluminium producer)
- Orient Advisers (State Owned Asset Management Co.)

28th September - Beijing

- Bank of China (State Owned Bank)
- Lenovo campus and technology centre

The role of SOEs

State Owned Enterprises (SOEs) play an important role within this centrally planned economy. We met SOEs in important sectors such as banking (Bank of China), property (Greenland & Shenzhen Investment Holdings), steel (Metallurgical Group (MCC)) and aluminium (Aluminium Corporation of China).

There was a contrast between the management of SOEs and private businesses - with the former more akin to civil servants and the latter showing more flair and entrepreneurial talent - but I was told that the quality of SOE management and their corporate governance has improved greatly in recent years. Some are obviously better than others with Greenland and MCC essentially **reading from a script and not forthcoming with answers to more searching questions**, while Shenzhen Investment Holdings and Bank of China were very slick with some staff having American accents - having been educated or learning their trade in the US.

It seemed as though government policy can benefit but also harm these companies very quickly, such as forced deleveraging, forced consolidation of peers or forced shut down of production (to aid the environment, heavy industries like steel and aluminium producers must shut down their plants in the winter which stretches from October to March). This, in my opinion, makes them difficult to assess as an equity investor but I didn't feel the same for their bonds given their strong cashflows, high interest cover and their numerous sources of funding.

Political risk

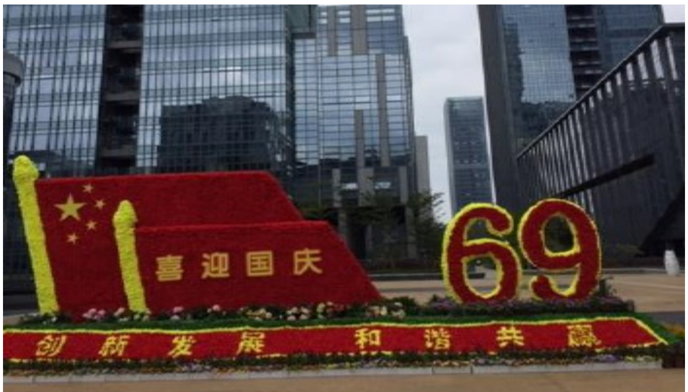
A broader risk from the increasing influence of the government, whether directly implemented or via the SOEs, is that of crowding out private enterprises. It seemed no coincidence that Jack Ma announced his retirement from Alibaba around the time that Xi Jinping abolished the fixed term presidency implying he could be president for life.

"A return to a harsher communist era is a real worry and is making entrepreneurs and the middle class population think twice about their expansion or consumption plans."

It is worth remembering that China in its current form is relatively young at just 69 years old from when Chairman Mao took over on 1st October 1949 and introduced the one-party People's Republic of China after a long period of imperialism and constant unrest.

The public holiday was shortly after our return but there were large displays celebrating the birthday and reflecting the patriotism of the nation, but I wonder if that will wear thin if people see their standards of living drop or stagnate after years of steady improvement.

At one of our more political-based meetings, it was mentioned that Xi will probably not last more than two terms given his unpopularity within his own party and down the hierarchy to local government officials. Most of this is conjecture as evidence is hard to find, but the fact that he has changed the heads of the military **twice in the space of a year** raises some questions. China now has the second largest navy in the world, second only to the US, and there are fears that it may use force to aid its expansion to other territories if the Belt and Road Initiative fails or slows (see part 5 for more on this).



A 69th birthday display within the Shenzhen Science Park (similar to Canary Wharf)