IML Market Musings – April 2014

Welcome to the IML's April 2014 Market Musings. The author is our Head of Research Hugh Giddy. He has written an account of his recent experience in China.

In April I visited Hong Kong and China on another fact finding trip, having been several times before. At the end of my trip I was asked if I had "round eye disease", a reference to Westerners' eyes widening at the sheer scale of everything: the number of people, the cars, the buildings, and the impressive yet often congested infrastructure.

In one week it is hard to get a true picture of China, and probably at least a month of travel and meetings would be required. Most of the focus was on property development and steel, as these companies could provide some colour on the outlook for steel demand in China, steel production and consequently demand for Australian iron ore and coking coal, and likely exports from China of things that are still made in Australia such as steel and cement. While I could attempt to provide a detailed analysis of the current situation and outlook for the Middle Kingdom, I have instead chosen to share an anecdotal travel diary with readers.

Contrary to many expectations at the time of the handover to China of Hong Kong in 1997, not much appears to have changed, apart from significant growth in buildings and activity. Property prices are still extortionate, with an iconic apartment block on the slope of "The Peak" on the main island (three attached towers, the middle tower leaning or at an angle) commanding breathtaking prices. A three bedroom apartment would set you back over USD 100,000 ... to rent, each month! A few years ago an apartment in the building sold for USD 50m, easily comparable to the highest prices in Manhattan and London.

Land is continuously being reclaimed from the harbour with incredible skyscrapers being built on this new land that I would have thought to be unable to support such high buildings. On the Kowloon side there is a huge construction site on the water which is to be the station for the high speed rail link to Shanghai and then Beijing at the northern end of the high speed network along the Chinese coast. China already has 10,000 km of high speed rail lines and plans to build a further 7,000 km by 2020. Mooted high speed rail between Sydney and Melbourne or Canberra is apparently too expensive to be economic. Chinese high speed rail is not economic either, with the price of tickets well below what would be required for the railway to earn an adequate return by Western standards.

In Hong Kong we met with a few Chinese developers and with Mark Daniel, CEO of Loscam, a pallet business similar to Brambles (Chep). Loscam has been very successful in China, apparently growing 25-fold since merging with China Merchants in 2010. They were well behind Chep at that point but are now the market leaders in SE Asia. A key differentiator aside from quality and service has been that they are now "Chinese". An interesting observation made was that the workforce is very educated with many double degree employees. Receptionists and assistants have degrees too, since people of that calibre need to take such roles to all find work. Mark observed that a major change in recent times has been the seriousness of the new Xi Jinping regime in cutting corruption. Lavish corporate dinners, corporate golf, gift giving and so forth are now frowned on, particularly in State owned enterprises (SOEs) which include most of the major companies. Luxury goods companies have generally reported slower sales growth in Asia and China, although Macau continues to attract cashed up gamblers in record numbers.

Chinese developers have experienced mixed fortunes over recent years. Some have built or been involved in "ghost cities" while others appear to have been singularly successful. Ghost cities reflect the extraordinary operation of the Chinese political and economic system. When the global financial crisis (GFC) was dragging the whole world economy in its wake, China was not immune. The central government embarked on a massive stimulus, instructing banks to lend freely and endorsing a wide range of construction and infrastructure projects. Local governments oversee a lot of the actual workings of government, such as education and healthcare. They borrowed freely as the central government loosened credit, keen to report strong growth in their regions. Uneconomic railways, roads, and towns were built. Cities such as Ordos are famous for being fully built cities without a real purpose of being there, and are therefore shunned by potential inhabitants and property owners. Wenzhou, a coastal city, experienced a crash of over 60% in property prices as the bubble in prices and development ignited by loose lending unwound.

James Rickards describes in *The Death of Money* (pp98-100) how seven cities are being constructed south of Nanjing, once the seat of China's capital. Each has luxury hotels, skyscraper office blocks, golf courses and housing. The cities are under construction and are empty. The local officials and developers seem to believe "build it and they will come", although the parallels with places like Ordos are ominous. The Nanjing south railway station, attached to the Beijing-Shanghai high speed railway, which will serve the "metroplex", apparently boasts 128 escalators.

"People, not Paving", *The Economist. Apr 19th 2014.* describes the station in Zhengzhou, a central city I had not heard of, as "the largest bullet-train station in Asia [which] opened in 2012: a $2.4 billion edifice with a plaza in front which together cover
240 hectares (about 340 football pitches). The station is half deserted."

The developers we met were more profit focused. CC Land Holdings (China Chongqing Land), a private company, has established an impressive track record of growth. Initially focused on the huge city of Chongqing in central China, the company is also now undertaking projects in places such as Chengdu, Xi'an and Kunming. Pre-sales are common in China, with the practice permitted in different areas at various stages of completion of the foundation or portions of the building. The entire amount for an apartment may be received 24 months before completion, resulting in very good cash flow.

For the most part CC Land does not sell what we would consider to be a completed apartment. Buyers like to do their own fit out and buy only the shell. Over time people will realise that doing their own fit out is expensive and no doubt time consuming. "Fit out" does not mean just curtains and furnishings – it means complete bathrooms, kitchens, flooring, wardrobes and so forth.

Chongqing, which we visited later in the trip, is home to 32 million people, significantly more than Australia. It is a beneficiary of the central government's definite intention to close the wealth gap between the poorer western regions and the relatively prosperous east coast. An inland free trade zone has been established there, and manufacturers are now able to export products to Europe via rail (through Kazakhstan, Russia and Eastern Europe) rather than by rail to Shanghai and thence by sea to markets. Apparently half the world's computers are made in Chongqing, although we were unable to get a meeting with the computer company factories.

China Overseas Land Holdings, an SOE, pointed to liquidity tightness slowing the property market. The government is clearly worried about property speculation, and so the LVR (loan to valuation ratio) maximum is 70%. Most properties are bought with the help of parents on both sides so that six people are effectively funding a purchase for first home buying couples, and given the one child policy few parents have to help out more than once. Bubbles may exist in less desirable locations – the outskirts of Beijing (sixth ring and beyond), and smaller, less significant cities without employment growth.

Beijing, our next stop, is a relatively drab city, made more so by an unpleasant grey haze of pollution. The vast city is home to the tourist attractions of Tiananmen Square and the Forbidden City, and is a short trip to the Great Wall. Otherwise one is confronted by large boulevards teeming with relatively expensive cars, and endless government buildings amongst the many high rise apartments.

We met with steel traders, building materials companies and an iron ore mine. A common theme was the committed focus of the government on the environment. It has become a serious issue for many people and the new government is enforcing pollution curbs and spending money on water treatment. Older steel mills and blast furnaces are being closed in Hebei (a province adjoining the vast area that is the municipality of Beijing, itself apparently geographically the size of Belgium). This is not leading to any supply fall as the industry is not operating at capacity; indeed steel production is at record levels, but no one in China is expecting much growth, the most optimistic forecast being half the rate of GDP growth, which is itself slowing.

The government is more tolerant of slower growth and understands environmental costs and regulations will hamper growth. Iron ore inventories are at very high levels, particularly at the ports. Because of the tighter liquidity some businesses are using commodities (including iron ore) as collateral for finance, distorting commodity prices. State owned enterprises such as China Railway Materials Corporation (essentially an iron and steel trader) used to have abundant credit and would lend to customers, effectively providing vendor finance. Now the company's own credit is subject to limits.

Passing a WalMart between meetings we decided to stop and look around. The store was a bit shabby but otherwise not that different to ones I've seen in America. However, the merchandise was interesting, with several tanks for live fish and crustaceans, and a large section devoted to Salt/MSG.

We flew to Shanghai from the domestic terminal rather than the stunning, spacious and modern terminal built for the Olympics. Despite impressive infrastructure throughout China, this building was a reminder that Chinese development still has a way to go. Our delay, apparently quite common because the airspace is very crowded, was particularly painful as the building appeared to lack air-conditioning and we could not get comfortable in our business attire.

Shanghai boasts a very different feel to Beijing, with bright lights and advertising illuminating the smart skyscrapers lining the Yangtze in Pudong opposite the historic Bund district. Local corporates seem to spend freely in the expensive bars and restaurants, although the anti-corruption drive was mentioned in almost every meeting.

Close to our hotel is the soon to be completed 121-storey skyscraper that will tower over Pudong and Shanghai, second only to Dubai's Burj Khalifa in height. Although Shanghai's pollution is noticeably better than Beijing, I imagine the higher levels will seldom have much of a view. The photo was taken on a good day.

Our hotel was next to the IFC mall in Pudong, a glittering testimony to the Chinese affection for luxury goods, with large stores by Prada, Cartier, Dolce and Gabbana and so forth.

In addition to meeting local companies such as Baosteel, the premier steel company in China, and 51Jobs, an online recruitment company, we met Australian companies operating in China such as ANZ and Bluescope Steel. The themes of slower growth, tighter liquidity, anti-corruption, pollution and the environment, and a wish to deal with income inequality were raised again. The Baosteel campus is most impressive:

With the slowdown in activity, companies are focussed on efficiency and cost cutting like their overseas counterparts, a phenomenon which is undoubtedly quite novel in China. For example, Bluescope is now trimming staff numbers and consolidating sites.

While the Communist party is clearly very much in control and directing things, social media is powerfully transforming society. We could not access Facebook or news sites like the Sydney Morning Herald, Marketwatch or even a government site like the Bureau of Meteorology (bom.gov.au) to check if my garden was getting some rain. By contrast, local social media sites such as Weibo and Tencent's "Wechat" have a huge following. If a local party official is seen doing the wrong thing, bloggers post about it and share photos. If pollution is out of control, the same thing happens. In this way the population is gaining a voice and it will be interesting to see if this changes the course of politics in China over time. Nevertheless, Reuters reported on March 14 that the government had shut down dozens of popular Wechat accounts, including those of widely followed journalists.

Despite this, sensitivity to popular feeling is clearly strong. Many people worry about a crisis in Wealth Management Products (WMPs), which amount to RMB10 trillion in assets (almost AUD 2 trillion). China has a very high savings rate but savers do not have a lot of attractive options. Official deposit rates are controlled at a low level (below inflation), it is not possible to invest significant amounts abroad, the stockmarket has been a poor performer despite fantastic GDP growth and corporate governance can be suspect, and the property market boasts some bubble characteristics and the government makes it hard to own property other than one's principal residence.

Apparently couples sometimes get divorced so that they can buy two properties! The paucity of investment options has pushed savers into a hunt for "safe" yield, in a similar trend to what has happened elsewhere for somewhat different reasons, and that has lead them to WMPs. Issued but not underwritten by banks, the WMPs have channelled money to poor credits including developers, entrepreneurs and local government schemes. Even the governor of the People's Bank of China referred to the WMPs as a Ponzi scheme given the actual returns on investments do not match the returns promised to investors. They may yet cause a crisis but for now people believe WMPs are guaranteed by the issuing banks. The government forced a sponsoring bank of a failed WMP, that was not actually legally liable, to repay savers' investments in full after a protest outside the bank and a storm on social media.

Our final stop was Chongqing. Chongqing is on the Yangtze River near its source in Western China. Cloudy skies and drizzle combined with pollution made visibility very poor of the high rise apartments as far as one could see in every direction.

A population of 32 million is hard to get one's head around. We visited some factories where we learned the average wage is about RMB 3,000 per month ($500), and then saw property developments catering to the wealthy costing millions. In one development under construction, Phoenix, dubbed "American style", the advertising hoardings feature an older Western couple excited at the prospect of taking up residence there. One property compound featured 50 quite large houses or villas on small blocks where the shell is sold for RMB 30 million ($5.5m), and the fit out would cost another RMB 10m.

The show home was very ostentatious with grand bathrooms, a gallery overlooking the lounge, maid's quarters, and a massage room with a large indoor spa bath. In the large dressing room adjoining the master bedroom and in the office the decorator had scattered coffee table books about. "Kobenhavn", about the Danish capital, in Danish, a German architecture book and "New Zealand", in English, were amongst the curious choices. Wealth inequality is very visible, and so too was this cultural cringe. I'm sure Prada and Hermes don't mind.

Unfortunately I cannot give a definitive prognosis for China. For Australia, the focus on the environment and the shift to the service sector could dampen demand for our mining exports. In China there has been an enormous misallocation of resources into uneconomic and wasteful projects. Many bank loans and WMPs would default and lead to write offs in a truly free market economy. China is centrally controlled so the government will do everything in its power to defuse a crisis. Supposedly free market Western governments saved banking systems and socialised losses in the GFC; one should not expect China to behave any differently.

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