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China: Growing from Within

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At Janus, our goal is to deliver alpha by taking an unconstrained, in-depth approach to fundamental research. We extend this commitment to our clients and partners by providing access to the insights and opinions of Janus' seven global sector research teams via monthly analyst interviews. In this edition of *Analyst Viewpoints*, Janus' Stephen Lew discusses China and the implications of its increasing consumer wealth with Client Portfolio Manager Adam Schor. Lew also provides his bottom-up views on the Chinese property market and offers firsthand examples of the firm's research effort in the region.

Q: To begin, explain how you research and cover China as a U.S.-based analyst.

Stephen Lew: I am a native of Taiwan, so from a language and cultural perspective, I have a fairly convenient entree into understanding the system and the culture. As far as conducting research on China, every quarter I visit China or the Asia-Pacific region twice. Other colleagues who are part of Janus' Asian research effort join me on these research trips.

We believe one of our main competitive advantages in terms of looking at Asia is that we take a long-term approach. A lot of the market participants in the Asia-Pacific region tend to have a relatively short-term view. At Janus, we believe the Asia-Pacific region, in particular, China, has long-term development potential. Therefore, when we seek out investment opportunities, we look for companies with high return on invested capital and sustainable competitive advantages as well as good management teams that drive enterprise value.

To have conviction in our ideas, we tend to do a significant amount of local checks. That means we don't just talk to company management. We talk to competitors, suppliers and customers. We do a 360-degree type of research analysis to determine whether or not a particular company fits our investment profile.

Q: You and a few analysts and portfolio managers recently returned from a trip to China. Give us an overview of the trip and what you and your colleagues accomplished.

Stephen Lew: On that particular trip we went to the so-called "second-tier" cities—the lesser developed parts of the country—instead of going to Beijing, Shanghai and Guangzhou, which are the major first-tier cities. To us, the second-tier cities present a very interesting investment opportunity. Those areas are currently undergoing an even higher level of growth relative to the coastal areas. Therefore, it is very important to us to understand how consumers, manufacturers and the government think in those parts of the country.

Our schedule took us to the cities of Chengdu in Sichuan province, Changsha in Hunan province and Xiamen in Fujian province. We not only visited companies that we are researching, but also companies involved in supplying the makers of end products. It gave us a good understanding of local consumers' tastes as well as what the cost structures are like for the publicly listed companies we invest in. At the same time, we got a feel for the pulse of these cities so that we can better assess how to potentially capitalise on companies that have exposure to suppliers or consumers in that part of the country.

Q: Given your country expertise, how do you work with the global sector research teams and analysts that have specific sector skills?

Stephen Lew: I am on the financials team as well as the industrials team. One of the things that I think is very value-added for those two teams as it relates to China is that there are a number of foreign companies operating in China, and the competition is increasing. Since I am in China once every month and a half, I have immediate access to timely information that can be shared with my peers on those two sector teams, especially from a competitive-landscape perspective.

For instance, we recently had a discussion about Chinese auto companies. During our visits to China over the past several months, we have come to realise that the technological sophistication of Chinese automakers has increased significantly. However, their cost structure is still much lower than that of Western competitors. Several Chinese automakers have already gained in core indigenous technologies, such as engines and transmissions, and have plans to export their products aggressively to the Western market. We were able to have a good discussion about that and try to assess the long-term competitive threat to Western automakers in their home countries.

Q: Given China's desire to increase its manufacturing efficiency and move up the value chain, do you see it becoming a major value-added exporter and a different type of player than it has been during the last 20 years?

Stephen Lew: Yes, I do. I believe China is very similar to Japan in its development pattern. My view is that, as the country develops, its domestic economy will develop. The domestic leaders in various fields will see significant compounding of their cash flow longer term—say, in five to 10 years. As a result, their research and development budgets will expand significantly. As a consequence, these companies—these domestic leaders—will be able to significantly expand their R&D budgets and develop products that will be introduced into a very large market.

Because China has such large scale, the products that are popular or well-received in China will have the ability to be developed into major global products. When a company has a large domestic product that is introduced into the market successfully, the increase in volume allows it to lower its production cost. It is very much an economy-of-scale argument.

Once the domestic product becomes mature in China, companies will be able to export products into Western markets at a much lower cost. As a result, companies will be able to sell these products at lower price points, yet still maintain a healthy

The Economic Situation in China

The Chinese economy has recovered very nicely since the financial crisis, largely due to the government stimulus that was put in place in late 2008. The total package was approximately RMB* 4 trillion, and that was intended to be spent on infrastructure projects. Recently released data reports overall gross domestic product growth reached approximately eight percent, which is a fairly good development relative to the rest of the world.

Despite the rebound, we believe China is entering a period of relative economic volatility as a result of inflationary pressure. Prior to the current cycle, the government's aim had been to keep inflation as low as possible, preferably at zero, because the People's Bank of China—the Chinese central bank—has always had a very hawkish stance toward inflation. However, it appears that the government has become more open to a higher than historical average inflation rate in order to sustain the country's growth.

As long as China's inflation rate remains at a relatively contained level—around five percent—then the government is not likely to implement any draconian monetary policies. Should inflation rise dramatically, the Chinese government may increase interest rates which would likely bring additional money into Chinese hard assets, such as real estate. Longer-term, we believe the value of the Chinese currency will increase, albeit at a fairly measured pace. The Chinese government wants to increase the efficiency of its industries, and the current relatively low level of the Chinese currency value against many other major international currencies is keeping a lot of low-value-added industries in business. That, in the Chinese government's opinion, is not conducive to the country moving up the technological ladder.

*RMB is the Chinese currency, also known as renminbi.

profit margin. If companies can successfully formulate that strategy, they will be able to compete very successfully in Western markets.

Q: Can you discuss the similarities and differences between China and Japan in more detail?

Stephen Lew: Despite the development pattern similarities, there is a fundamental difference between China and Japan: Japan, in my opinion, is a relatively closed society. China, on the other hand, is very much a trade-based economy. And on top of that, China is a continental-size economy, where Japan is very much an island. So from a domestic consumption perspective, there is a significant amount of runway for Chinese companies to develop and compound value over the next 10 to 20 years.

It is unlikely that the growth of the Chinese market will mature as quickly as markets like Korea and Japan because of its sheer size. When we talk about China being an export-led economy, we always talk about China exporting its wares to Western markets. However, here is a different view: China is essentially an international market with two levels of development. The eastern coastal area of China is a developed market where per capita income is much higher and where demand for more sophisticated consumer goods is increasing very rapidly. Yet in the middle and western parts of the country, China is still very much a developing market type of economy. So the coastal area acts as an “export destination” for products that are being produced in the middle and western parts of the country where the cost of labour is lower, and where there is still a significant amount of room for upgrades in terms of manufacturing sophistication.

Q: There has been a lot of talk about the Chinese property market lately. What are your views on it?

Stephen Lew: We need to think about China not as a monolithic entity, but rather a combination of many local markets. The overheating of the real estate market is occurring in certain parts of the country, for example, in some of the first-tier cities like Beijing and Shanghai. But statistics show that property prices in some of the second- or third-tier cities have not increased as significantly as in the first-tier cities.

When it comes to the Chinese property market, there may be some misperception by many market participants. Again, the property market should not be seen as one market in China; it is a combination of many different markets. At any given time, there will be overheating in some parts of the country, while pricing will still grow and be under control in other parts of the country.

Q: Talk about the consumer sector in China—what is happening with consumer demand?

Stephen Lew: The consumer sector in China is very interesting to us. As the per capita income of Chinese citizens increases, their desire for material goods is also likely to increase. Right now the average per capita income is around $3,000. We see that number increasing significantly in the coming years. As a result, a continuing pickup in demand for various consumer items is likely. For example, the demand for autos is likely to continue to increase.

In addition, Chinese consumer shopping habits may also evolve. As consumers’ incomes rise, their tastes become more sophisticated. Their demand for high-quality domestic brands as well as foreign brands is likely to increase. We see that as the beginning of the cycle. This is very similar to the analogy made earlier with regard to the difference between eastern China and middle and western China. In a continental-size economy, there are different phases of development. Consumption growth will likely continue to be high in the coastal cities, but the true growth will likely come from middle and western China, where it is just beginning to pick up as people’s income levels begin to increase in a meaningful way.

Q: What types of companies are benefiting from the increasing consumer wealth and spending trend?

Stephen Lew: Shopping malls are one type of company benefiting from this trend because there is currently a shortage of premium shopping malls in China, particularly in the second- and third-tier cities. Hang Lung Properties, which is a Hong Kong-based property developer, is seizing on this opportunity. Its strategy is to acquire land banks in the most prime areas of a given large city, and then develop large-scale shopping malls and bring in foreign brand tenants to take up the space. These foreign brands will use Hang Lung’s shopping malls as a way to push their products to mid- to high-end domestic Chinese consumers. Hang Lung believes that these premier shopping malls can satisfy a significant amount of demand. And because it is a first mover, Hang Lung has a significant lead over other companies in terms of developing this type of shopping mall business.

Q: Can you provide examples of some research tactics you use to gain a better understanding of a company like Hang Lung and its competitive landscape?

Stephen Lew: For Hang Lung specifically, we have visited the company's existing shopping malls in Shanghai. We have spoken with the local mall managers and ascertained the true traffic and revenue-generating potential of these malls. We have also spoken with foreign brands that have stores in these malls to assess their view on the growth potential of mid- to high-end consumer groups in China, particularly at Hang Lung locations. More importantly, for the new developments in second- and third-tier cities, we have visited the sites personally to assess the construction process. At the same time, we have engaged in conversations and checks with vendors around the existing developments as well as property consultants in the city to understand the underlying demand profile of premium shopping malls.

The insight we gain through this approach is very helpful because we can't appreciate the value-creating potential of these projects by just trying to do a calculation from a spreadsheet in front of a computer. Being there really helps with understanding the value-creation process because we can understand why it is happening versus just looking at the numbers and trying to imagine how it happens.

Q: Do you believe the strong retail and auto sales and strong property prices we have seen are sustainable given the growing wealth trend in middle and western China?

Stephen Lew: Yes. However, it is not a straight line. The Chinese economy is still developing and still restructuring itself. Longer term we see those numbers continuing to increase, but in the short term we see some volatility in the overall economy because there are some signs that the economy has grown too quickly and the government will have to respond with policy measures.

Therefore, it is possible that because of these government measures, consumption demand in some parts of the country may not see a significant amount of growth this year. However, longer term we believe this trend will continue because there are two very powerful drivers in China. One is central planning and the strong role of the government, which is a major driver in the development of the economy. The second driver is income growth, which we discussed earlier. The combination of these two is likely to continue to increase the wealth of the nation and per capita income.

About the Featured Analyst

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Stephen Lew is an equity research analyst, primarily focusing on the financials, industrials and materials sectors within developed and emerging regional Asian markets. Prior to joining Janus in February 2005, he worked at Driehaus Capital Management in Chicago, where he was an equity research analyst focusing primarily on technology stocks. Mr. Lew received his bachelor of arts degree in business economics from the University of California Los Angeles and his MBA from the University of Chicago Graduate School of Business. He holds the Chartered Financial Analyst designation and is also a Certified Public Accountant. Mr. Lew has 11 years of financial industry experience.

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