FOR PROFESSIONAL INVESTORS ONLY

A View from Asia

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Derivative: in finance, a derivative is a contract that derives its value from the performance of an underlying entity. This underlying entity can be an asset, index, or interest rate, and is often called the "underlying".

A look back at asset performance for 2015 makes it starkly clear: any derivative of Chinese demand suffered immensely. In keeping with that same sentiment, when I look back at the performance I generated for our fund, I was disappointed at myself for two reasons, both related to China.

In keeping with my contrarian approach on cyclicals, in 2014 I bought then out-of-favour Chinese cyclicals. However, as the Chinese market rallied in the first half of 2015, I made, in hindsight, the mistake of not selling into this rally. I might be able to hide under the fact that valuations for cyclicals were still significantly depressed relative to their mean valuations, but is no comfort that I gave away gains that I could have captured. As the travails of UK-listed mining group Glencore aptly demonstrate, when debt becomes the dominant issue, mean valuations get thrown out of the window for cyclicals.

The second mistake was an emotional response to the sell-off in China in Q3 2015. While trying to understand the reasons behind the sell-off in the 'A' share market, it became clear that we are, in China, facing the 'impossible trinity'. Economic theory states that a central bank can reasonably manage only two of the three variables: a stable exchange rate, free capital movement (the absence of capital controls) and an independent monetary policy. China's drive to internationalise the renminbi (RMB) and further liberalise its equity and debt markets to foreign capital is coming at a time of slowing growth, a pile up in debt and possible reversal of easy liquidity conditions by the Federal Reserve. Facing a period of possible capital outflows from China and a surprise devaluation of the RMB in August, I did believe that the repercussions would negative and far reaching. The sell-off in August and September was brutal, but contrary to my expectations, very short-lived. The Fed deferred a much anticipated September rate hike, while the People's Bank of China choked capital outflows. There was not much I could have done except remind myself that since the 2008/9 crisis central banks will go to any lengths to prevent asset price deflation.

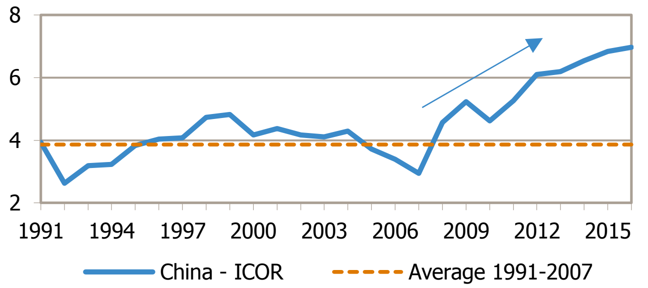
China: GDP growth is all that matters

As we look to the current markets, it does not surprise me that developments in China remain in focus. In my view, post the Q3 2015 sell-off in stocks, <u>maintaining GDP growth is the only concern for the Chinese authorities</u>. It seems very probable that the authorities saw what reforms could mean to asset prices and have decided that achieving a minimum 6.5% GDP growth is an imperative. The costs to underwrite that growth will be ever increasing quantum of debt.

Over the years, capital productivity in China has steadily deteriorated. Since the massive stimulus policies were unleashed in 2009, that dynamic has worsened further. Take a look at the incremental capital output ratio (ICOR), a measure of a country's production efficiency, measuring the marginal amount of investment capital needed to generate the next unit of production.

Declining capital productivity rates in China

China – ICOR Rate (cap formation rate / real GDP growth rates)

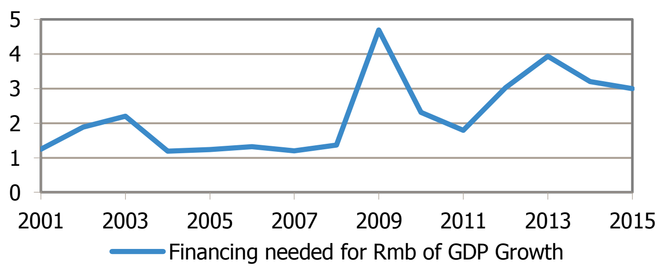


Source: IMF, Macquarie Asia Equity Strategy Research

Compounding this worsening is the increased leverage across the economy to generate that additional GDP growth. It is no surprise that the credit impulse for the China's economy has kept on rising. This, too, can be attributed, in my view, to the indiscriminate lending and shadow banking loans post the 2009 stimulus.

Rising credit impulse

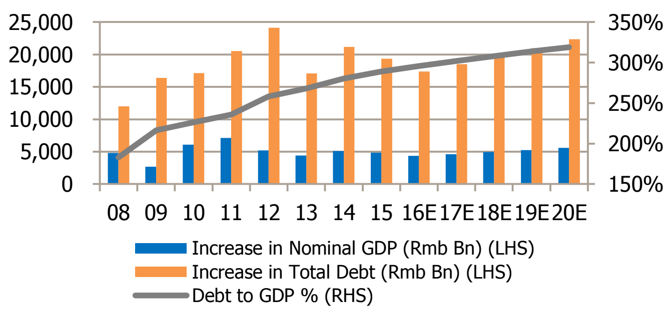
China - Incremental Leverage (x)



Source: IMF, Macquarie Asia Equity Strategy Research

Let's assume that China does manage to achieve an annual rate of 6.5% GDP growth till 2020. Further, assuming that the trends of credit impulse and ICORs of the past six years prevail (and do not get any worse), that 6.5% GDP growth target will lead to an ever increasing pile of debt, taking us into levels not seen before in an emerging market economy.

China debt to GDP ratio - How far can this go?



Source: Macquarie Asia Equity Strategy Research

As to the currency depreciation, the economic rationale is a slowing economy faced with a currency which has appreciated approximately 20% on a trade-weighted basis against all currencies (excluding the US dollar) since 2013. The Chinese want to get ahead of the approaching US presidential election to try and depreciate the currency by as much as they think they can get away with. As to the magnitude of the depreciation, who knows? One thing is for sure, the process will remain opaque. This quote from Mr Eswar Prasad (previously chief of the Financial Studies Division in the International Monetary Fund's research department and before that head of the IMF's China division) sums it up:

"Back in 2004, when I ran the China desk at the International Monetary Fund, my team sent some written questions to Beijing ahead of our meetings with Chinese officials. China's central bank had claimed that the value of the currency, the renminbi, was determined by market forces. But to the rest of the world, it looked like the currency's value was tightly managed — so tightly that its value relative to the US dollar did not change. We asked how this was possible if the exchange rate was truly market determined. After all, market exchange rates among major currencies fluctuate a lot. The response from the central bank nicely summed up the Chinese approach to market forces: 'The exchange rate is fully determined by market supply and demand. The authorities endeavour to manage both supply and demand in a manner that promotes the stable formation of the exchange rate mechanism.'

In the midst of this negativity and sell-off in Asian markets, I am starting to turn a bit more optimistic. By no stretch of imagination am I suggesting that we do not have issues to deal with. The risks from China are obvious and repercussions across the region could be severe. The debt overhang across many countries impedes growth (we have, in effect, borrowed from the future to consume) as well as affecting valuation. Increased debt in a disinflationary, low growth environment is a big problem. Some even suggest that with central banks at the end of their tether, we might be facing a serious crisis. All of this is certainly a very real possibility.

Three reasons for some cheer

But I do think that some requisite conditions for turning positive on Asia are starting to fall into place. The first of the three conditions I note, and one of the most important ones, is a change in attitudes from entrepreneurs across the region. After years of being accustomed to growth as if it is inevitable, companies are increasingly talking about restraint. Capital expenditure plans are being curbed and cost control is now a focus. Companies are thinking of defending margins, conserving cash and managing for low growth. That means firms are starting to refocus on return on capital and not just growth for growth's sake.

As an illustration, this week I met the CFO at Hengan International. Long considered one of the best consumer staples businesses in China, it sells tissue paper, diapers and sanitary napkins and became a proxy for Chinese consumption. I used to hold the stock in the portfolio – Hengan met several criteria we look for in our companies (high return on capital employed, high return on assets, strong cash flows, defensible margins and growth, just to name a few). But I sold out in 2014. Apart from the business challenges, from competition from multinationals and the changing nature of distribution through e-commerce, what I least appreciated was Hengan's foray into financial engineering.

Between 2009 and 2014, total borrowings grew approximately six-fold, from close to HK$4bn (US$500m) to HK$22bn (US$2.9bn). The company generates so much cash that it does not need to borrow. But borrow it did, to execute a 'carry trade', borrowing in Hong Kong dollars to invest in RMB deposits. The CFO now describes these trades as 'avoidable' FX transactions. When the RMB appreciated, Hengan made gains, but in the past three months the company has scrambled to unwind those trades and book exchange losses. This is how a Hong Kong-listed, so-called well-managed, cash flow-generating business behaved. Hengan is not alone in this. I've seen many other HK-listed companies do the same thing. As to the 'A' share-listed firms, several bought stocks in the frenzied markets of H1 2015. Besides unwinding this financial engineering, Hengan mentioned it is freezing wages for 2016, while capex is now being recalibrated and reducing inventories is a priority.

The second trend I observe is a slowdown in bank lending. Finally, most banks (ex-China) now accept that we are in an economic slowdown in Asia, even facing a crisis in some cases. Banks are no longer looking to grow but are focused on preventing non-performing loans – too late in my view – or recovering bad loans. As this trend accelerates, the first casualty, theoretically, should be unviable and unprofitable businesses. A slowdown in loans will certainly reflect lower demand growth, but in the long run the inability to access credit helps reduce the number of irrational competitors. What I do really want to see is whether the 'funny money' from venture capital and private equity funds gets turned off as well. Surely, with markets in this state, there must be an impact on valuations for new businesses? If that indeed does follow, we could witness a fall in the indiscriminate funding for online businesses. All that these start-ups did was generate top-line growth by throwing away money. Neither profits, nor margins, nor cash flows mattered. This will directly affect several listed firms, who will start to see lower irrational competition. I can't say this is already happening, but believe it could be a logical fall out.

Finally, we are seeing low valuations combined with revulsion for the asset class. On valuations, I do not want to suggest cheap P/Es or low price-to-book values for the Asian market are totally representative. With Chinese banks and other financials, as well as commodity-related cyclicals, accounting for such a large part of the listed universe, those valuations in my view are misleading. But I mentioned Glencore previously. That is an apt analogy to draw. When debt levels rise as they have, the key valuation parameter to consider is EV/EBIT multiples (enterprise value / earnings before interest and tax). This volatility in markets and especially currency deprecation is, in my view, the best thing to happen for long-term investors. As emerging markets (and more recently Asian markets) have performed so poorly for the past five years, 2016 could be the year when there is general revulsion towards these markets. If that happens, I would hazard a guess that we are being set up for a very good longer-term investment opportunity.