May 20, 2011

Dear clients and colleagues,

Following our trip to Australia, which we discussed in last week's comment, we have spent the last 10 days in Hong Kong, attending two conferences and meeting over 60 companies (predominantly Chinese and Hong Kong smaller capitalization companies).

Most presentations were extremely upbeat and the mood at the conference was ebullient, almost bubble-like. We noticed there were very few investors from North America and Europe at these conferences (less than 10%).

We have found that Asian research is mostly done by local analysts. We believe having a team that covers global markets allows us to compare and contrast the different regions and gives us an advantage.

Growth in China and the rest of Asia is exceeding all expectations. Singapore grew at 8.3% in the last 12 months; Korea grew at 8.1%, Hong Kong at 8.2%, and China at 9.7%. Growth came from all segments, with consumption and investments leading on the upside. China's new five-year plan (2011-2015) is focused on policies to drive internal consumption and reduce reliance of foreign trade, leading to what they consider more sustainable growth. Those policies cover many industries, from the rapid expansion of the domestic transport infrastructure - particularly high speed trains and metro lines - to the expansion of the domestic tourism business. There are also proposals to implement a comprehensive health care system providing free care to all and those that seek massive investment in alternative energy such as wind and solar.

We read news daily about China, but the magnitude of some numbers and the opportunity they provide some companies are just hard to fathom. Here are some interesting statistics:

In the eight years since the first high speed train (Beijing-Tianjin) was inaugurated in China, the high speed train network (speed over 250km/h) has expanded to 15,000 km. This is already bigger than all high speed train networks in the rest of the world combined. In its next 5 year plan (2011-2015), China will spend 2.8 trillion RMB, (C$417B) to add another 10,000km.

China has over 100 metropolitan areas exceeding 3 million people (there are 14 in the US). Only a few currently have a metro system. Investment in local transit will exceed that of the high speed rail network.

China's expenditure on health care is currently 4.9% of GDP, most of it private pay. That compares with the OECD average of 10-12%. In the next three years, the government will spend 800 billion RMB (C$126B) to fund a social insurance fund to provide universal coverage.

China last year became the largest car market in the world. This comparison also holds true for many other sectors: Macau's gaming industry now dwarfs that of Las Vegas as it is more than 5 times the size.

China seems to be in a virtuous cycle. Disposable income per capita has risen over 400% since 2000 and continues to grow at more than 10% per year. The rising middle class, which already exceeds 250 million people, is driving consumption.

In addition, if confidence in social services such as healthcare and education improves, that might lead to a lower savings rate and even more consumption and upgrades in the areas of consumption to the more discretionary. Adding to that the rising government revenues from increased tax receipts, and many think China could continue to grow at 8-9% a year for the next 20 years and overtake the US as the world's largest economy. We believe that will probably be the case.

In the short term, however, there are important risks. The economy is overheating and inflation is difficult to control. The gap between the haves and have-nots has increased and the Chinese government has made it its top priority to control inflation. As such, we believe that the tightening cycle in China is far from over and will probably accelerate.

In addition, we believe that the residential real estate sector in China is a bubble and whether the government is successful in cooling it down is the key to any forecast. We have met many Chinese property development companies who seem to find it perfectly normal that 20 to 30% of apartments in any new project are purchased by investors and left unoccupied. Although no company confirmed the number of 64 million empty apartments in China, all companies confirmed that the number is in the tens of millions.

Property investment is part of Chinese culture just like equity investment is part of the North American culture. So one must not immediately think of a bubble. For us the bubble is driven by the increasing level of unaffordability, with prices now between 6x and 18x annual income depending on the region. The government will continue to adopt measures to cool down prices with the most extreme measure, although unlikely, to be banning the buying of a second dwelling. So China and Asia are full of opportunities but face important inflation and policy risks in the coming months.

What is our investment strategy?

We will avoid those sectors that will be affected by rising interest rates and policy risk. These include the property and property-related segments. In the next few months, you will see new companies added to the portfolio as our team invests time in identifying opportunities for future growth. We expect to add companies exposed to the Chinese consumer and/or benefiting from China policies. Sectors such as consumer discretionary and healthcare are favorites. Ideally, we will add companies that also demonstrate sales growth outside China. With strong growth prospects, we are looking for companies with no debt and strong cash flow to finance the growth without dilution to stockholders. Finally, we are looking for companies that, if the valuation is too low, could be takeover candidates.

In the next few weeks, we will focus on some specific industries in China in our weekly comments and we hope you will find these useful.

Have a good week.

The Global Alpha team