China Trip Report April

During our recent trip to China we visited around 25 companies primarily in the consumer, shipping/ports, industrial, mid/downstream gas supply, and the real estate sectors. We visited existing / previous portfolio companies as well as “new” companies as part of our due diligence process.

Sentiment among management teams was generally (cautiously) optimistic (with the exception of sectors with specific issues such as solar or shipping).

Most of the companies experienced a tough Q4 2011 which dragged down full year results (often below expectations). Reason for this was the extremely tight liquidity situation in Q4 which strangled the overall economy.

The vast majority of companies suggested that they had passed the low point in Nov/ Dec/ Jan. Since then the availability of liquidity in the economy is seen to have considerably improved. At a corporate level, companies reported about positive new order momentum, strengthening cash flows and stabilized or even gradually improving profitability levels. Most companies expect solid top line growth mostly in the low to high teens – a bit lower than in recent years – which should result in a solid growth in earnings in 2012.

With regards to Q1 around half of the companies we visited suggest that first quarter would still look weak due to a high comparison base and still weak January and February. Approximately half of the companies suggested that they intended to implement their original growth strategies as planned. The other half suggested that they were thinking about pushing capital expenditures back by one year and rather focus on increasing the utilisation of existing capacities. With a few exceptions the balance sheet of the companies we visited is strong (there is of course a selection bias).

From a valuation perspective most sectors and stocks are cheap with Price-Book-Ratios below 2008-09 trough levels (as none of the companies we visited is loss making, Price-Book-Ratios should be a fairly robust measure compared to more volatile earnings). The only exceptions are energy and in particular consumer companies which trade on average 20-30% above 2008-09 lows.

In the following we present a selection of meeting summaries representative for the current business conditions across various industries in China.
Dah Chong Hong

(1828 HK, 9.5x Dec12e PE, ‘11/’12e eps growth 24%, 3.3% dividend yield)

CONCLUSION: Very solid company, experienced management, more than 50 years of experience in car distribution, portfolio of strong car brands, strong execution capabilities, high growth opportunities in a fragmented market

- Dah Chong Hong (DCH) is one of China’s largest dealership owners, operates 65 4S stores (sales, service, spare parts and survey) in 23 major cities in China

- Car penetration in China remains low (68 vehicles per 1,000 people, well below other emerging economies), the car distribution is highly fragmented and professional repair and after sales services are still at a very early stage; in 2011 DCH sold 85,448 cars in 2011 (+45.2% yoy) vs. a total Chinese market of approx. 18.5m vehicles (+2.5% yoy) (including commercial vehicles)

- Q4 2011 was a tough quarter for DCH and the overall sector with poor margins as in particular locally produced international brands (including Toyota, Honda, Audi, Benz) had too high inventories and pushed them hard onto dealers; weak dealers with stretched balance sheets then started a price war and pushed cars at heavier than expected discounts to customers

- While Jan/Feb were still weaker than normal but March/April saw a strong recovery in sales

- 2012 sales growth should be at 20%+ driven by the opening 15 new dealerships in China and high single digit growth in same store sales

- 2012 margins should at least be at 2011 levels with strong growth in high margin after-sales-services providing margin support

- Not the most aggressive car distributor in China but for us the “safest pair of hands” to participate in a structural growth opportunity
Texhong Textile

(2678 HK, 8.9x Dec12e / 7.1x Dec13e PE, ‘11/’12e eps growth 305% / ‘12e/’13e eps growth 30%, 0.0% dividend yield)

CONCLUSION: Quality company in a highly cyclical sector, experienced management, sector leader well ahead of competitors, under-observed, low liquidity

- Texhong Textile (TT) is one of the leading yarn makers in China and the largest manufacturer of spandex stretch yarn

- Apparel market generally with high growth potential in China in coming years (the typical Chinese still only owns one or two (!) pairs of trousers worn at all occasions)

- Key competitive advantages are TT’s Vietnam operations (currently 40% of TT’s capacities; further capacity expansion in coming years will only take place in Vietnam and not in China) with 40-50% cheaper labour cost, 10-20% lower utility cost, low income tax, and most importantly, low sourcing cost for cotton: In Vietnam TT can source cotton at the international market price which is typically 20-25% lower than the domestic Chinese cotton price. China imposes duties on cotton imports to protect its cotton farmers. There are, however, no duties on yarn imports from Vietnam which provides TT with a substantial cost advantage compared to its Chinese competitors. Overall, TT achieves approximately twice the average industry net profit margin

- Are the advantages from the Vietnam operations sustainable? According to management it is highly unlikely that (i) China imposes taxes on yarn imports from “communist Vietnam” and (ii) that competitors replicate TT’s strategy due to a lack of management and financial resources (highly fragmented industry with very few companies having access to capital markets)

- Another earnings driver is the cyclicality of cotton prices with a boost (drag) to earnings in times of rising (falling) cotton prices: Yarn sales are done at market prices with a lead time of approx. 2 to 3 weeks. TT sources cotton 4 to 5 months in advance. So, at times of rising cotton prices margins expand (et vice versa)

- In 2012 production volume should expand by ca. 20% supported by a cyclical recovery after a trough in Q4 2011

- Cotton prices have come down close to 50% since the peak in early 2011 but are still ca. 25% above historic levels. Management believes that cotton price would remain at the current level or slightly weaken in the course of 2012 suggesting that margin pressure from the movement of underlying cotton prices should gradually fade out

- Overall definitely a quality company but investor returns highly dependent on getting the timing right
Trinity

(891 HK, 17.1x Dec12e PE, ‘11/’12e eps growth 20%, 2.9% dividend yield)

CONCLUSION: Overall attractive business model, strong execution, strong management, strong governance, strong parent (Li & Fung)

- Trinity LTD (TL) is a pure play on Chinese high-end menswear consumption, runs a 100% direct retail model (no franchises) and operates 458 (year end 2011) shops under its four brands Kent & Curwen, Cerruti 1881, Gieves & Hawkes and D’URBAN (first three brands owned, last licensed)

- TL focused on the high end with prices for its suits starting at Rmb10,000-12,000

- Taps willingness of wealthy Chinese to pay premium prices for quality products not made in mainland China (e.g. high end fabrics and suits made in Italy)

- Ownership of brands is an advantage over many other Asian listed firms (no risk that license is not renewed); on the other hand, virtually all sales are from Asia (and ca. 70% from China) which is an advantage over European/ US peers

- TL with a strong IT system, full transparency on inventories/ location of goods down to a shop level, and parent company support in the form of experienced employees for critical business functions (e.g. sourcing)

- TL management expects a 2012 top line growth of 20%+ (SSS of low teens following “soft but positive” SSS growth in Jan/Feb and opening of 40 new stores (net)) and a gross margin at around 2011 levels

Pacific Basin

(2343 HK, 52x Dec12e / 13.6x Dec13e PE, ‘11/’12e eps growth -67% / ‘12/’13e eps growth 280%, 5.1% dividend yield – 2012e performance trough in current shipping cycle)

CONCLUSION: High quality company in a sector still in crisis, strong balance sheet (net cash), highly experienced management, superior systems and client relationships, high attention to cost and asset returns

- Pacific Basin is one of the world’s leading owners and operators of modern handysize and handymax dry bulk vessels and a global provider of shipping services

- Management characterised 2012 as the “worst year since WWII” with freight rates and vessel values expected to fall further due to a surge in newbuilding deliveries
Supply-demand dynamics in dry bulk segment seen to improve markedly in 2013, with an absence of new orders/deliveries, accelerated scrapping and underlying mid to high single digit demand growth contributing to a more benign rates’ climate. Management more cautious than the majority of research analyst pointing to an improvement in market conditions in the second half of 2013 rather than early 2013

High visibility on 2012 profitability to due to a 66% forward cargo cover for Handysize and a 81% cargo cover for Handymax at rates above current market rates and cash cost

PB currently trades at a PB of 0.6x, similar to 2008/9 trough levels

EVA

(838 HK, 8.4x Dec12e PE, ’11/’12e eps growth 56.7%, 3.0% dividend yield)

CONCLUSION: Company with outstanding manufacturing skills, strong management team, increasing penetration with blue-chip customers, strong balance sheet and cash generation, strong operational turnaround after tough 2011

EVA provides precision manufacturing services in China with a focus on the production of high-quality moulds and components. EVA’s customers include Japanese office-equipment companies such as Toshiba, Konica Minolta, Kyocera, Canon, Fuji Xerox, Epson and Brother. More recently, EVA has begun to manufactures components for automobile products

Company was hard hit in 2011 by supply chain disruptions due to the Japanese earthquake which took utilisation levels down to 30-40% before recovering to around 70% by year end; 2011 results were nonetheless solid (net profit margin of 10.6% (but down from 17.8% in 2010)) highlighting the underlying strength of EVA

In 2012 gross margin will most likely be flat with upside thereafter as 2012 has an abnormally high portion of lower priced and lower margin printers as demand for high-end copiers/printers has yet to recover; anticipated sales growth of around 20-25% largely covered by existing orders

Rerating potential based on a recovery of margins and returns
Greentown

(3900 HK, 2.3x Dec12e PE, ‘11/’12e eps growth 4.0%, 0.0% dividend yield)

CONCLUSION: We visited the company to get a first hand update on the funding conditions in the market; Greentown is not a portfolio company of ASPOMA

- Greentown (GT) is a highly leveraged developer with continued pressure on its liquidity arising from the large amount of short-term debt when compared to the substantially lower cash balance and slow contract sales

- GT has sold several parcel of lands and project stakes in recent quarters to generate cash and to avoid insolvency

- Management commented that Q4 was the toughest quarter when it was virtually impossible to replace maturing loans through new bank debt; the only sources of funding were trust loans at a rate of 13-15% (which are repackaged and sold as wealth management products) or the sale of assets

- Per March/April the situation has gradually improved with banks becoming more ready to roll debt over/ replace maturing loans with loans for new projects (loans are normally project related and not for general corporate purposes)

- However, a major challenge for some real estate companies is the collapse in presales which will eventually result in a substantial decline in revenues and earnings in 2 to 3 years even if 2012 sales are still robust. Greentown’s 2011 pre-sales, for example, dropped by 38% yoy.

Growth in revenues and profits assured for 2012 and 2013 – the current weakness will hit earnings in 2014/15:

Source: Greentown

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results.