China's Economic Transformation

Opportunities for International Investors

October 2013

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Introduction

Against a backdrop of a slowing economy a lot of questions are being asked about whether China can sustain recent high levels of economic growth.

Domestic and offshore observers are concerned about the vanishing “demographic dividend” and the long term benefits of the “WTO dividend”. An economy being driven by investment is steadily declining in the face of major economic structural imbalances, however, reform, is the real driving force of China’s economy.

It is reform that is the key to solving China’s current problems. There is no doubt that, as in the past, so it will be in the future – as put by Premier Li Keqiang, “Reform is China’s greatest dividend.”

On July 3rd 2013, the State Council approved the China (Shanghai) Free Trade Zone Pilot Scheme, which clearly demonstrates the commitment of China’s new leaders to further promote reform. Expectations are that further significant reform measures will be revealed as the third plenary session of the communist party of China gets under way next month.

Continuous reform may help to dispel the problems in China’s financial markets and will contribute to a more liberal environment fully reflecting the achievements and prospects of the Chinese economy. China Universal is optimistic about China’s equity and bond markets which we see growing in sophistication, efficiency, transparency, size and trading volume.

In the past:

Reform has been the greatest driver of growth in China's economy.

Since the early reforms and 'opening-up' of China in 1978, the economy has grown at a steady 10% per annum. Between 2000 and 2010, China's economy doubled in size surpassing Japan as the 2nd largest economy in the world after the US. Meanwhile, China became the world's largest manufacturer and exporter.

By total GDP, China ranks 2nd in the world but on a GDP per capita basis, China still has a long way to go.

Country Ranking by Total GDP

Rank	Country Name	2012 (USD Trillion)
1	United States	15.68
2	**China**	**8.23**
3	Japan	5.96
4	Germany	3.40
5	France	2.61
6	United Kingdom	2.44
7	Brazil	2.40
8	Russia	2.02
9	Italy	2.01
10	India	1.82

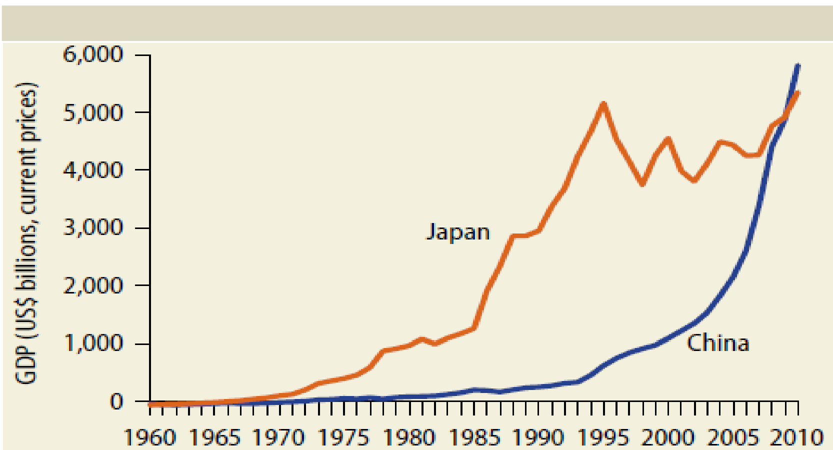
Source: World Bank

Country Ranking by GDP per Capita

Rank	Country Name	2012(USD)
83	Peru	6530
84	Saint Vincent and the Grenadines	6489
85	Iraq	6305
86	**China**	**6076**
87	Turkmenistan	5999
88	Angola	5873
89	Dominican Republic	5763

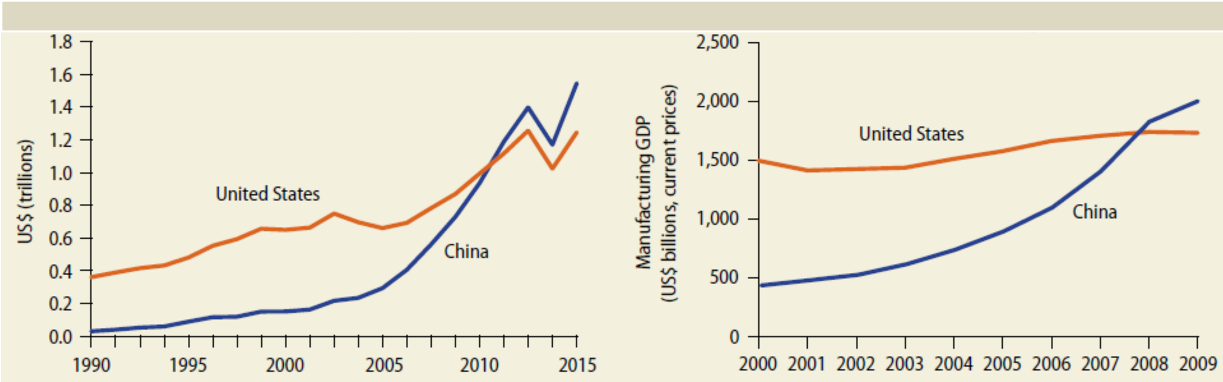
Source: World Bank

China is now the world's second largest economy……



Source: NBSC 2010; World Bank 2011b.

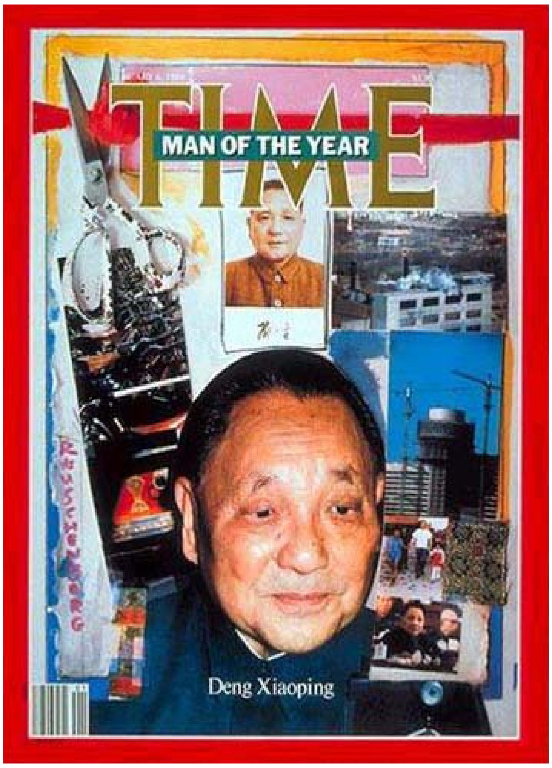
……and the world's largest exporter and manufacturer.



Source: World Bank

Commentators often refer to the "Demographic Dividend" and "WTO Dividend" as a way of explaining the miracle of the Chinese economy. But in fact these so-called dividends are simply the result of historical reforms promulgated by a government committed to creating systemic changes which benefit all aspects of the economy – the "Reform Dividend".

By the late1980s, China faced significant challenges at home and abroad. Political upheavals in Eastern Europe and the collapse of the Soviet Union, while at home, soaring prices and corruption threatened stability.

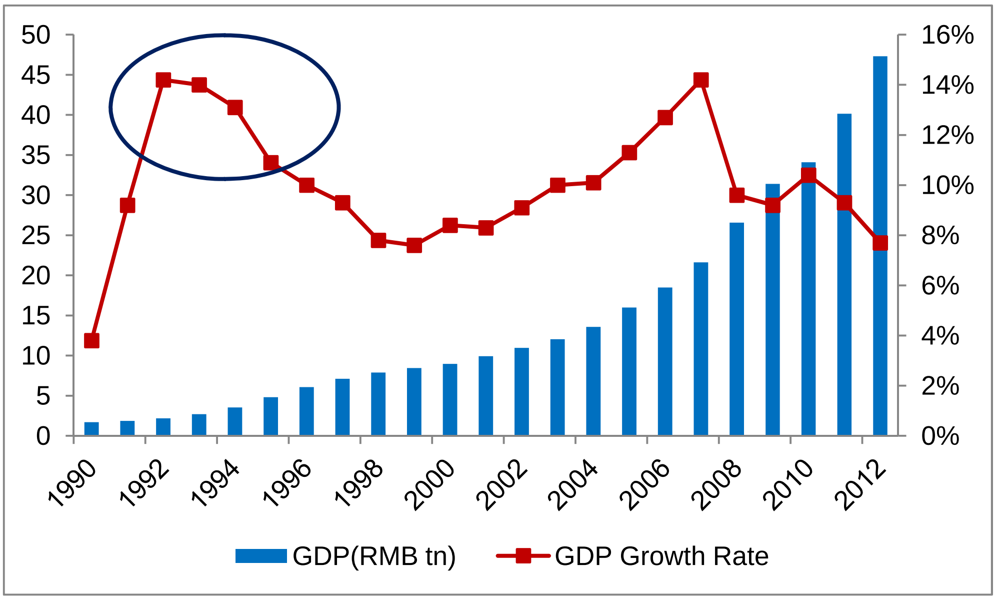


China was plunged into a mood of pessimism marked by the fallout from the "Tiananmen Event". Many foreign scholars and politicians predicted that China would be the next Soviet Union.

But Deng Xiaoping's South China Tour in 1992 helped loosen regulations and open up markets, which prompted the rapid development of regions like Pudong in Shanghai and the emergence of a private sector.

During this period China's securities markets emerged to eventually rank alongside the markets of the world's major economies.

China GDP 1990 to 2012



Source: CUAM, Wind.

Then in 1997 the Asian financial crisis threw up new challenges for China. Premier Zhu Rongji had already set about implementing a series of reforms which helped China's economy achieve a "soft landing" following the crisis and set the course for a new era of high growth.

Following the financial crisis, Zhu Rongji implemented a plan titled "one guarantee, three placements, and five reforms".

The guarantee had three parts: annual economic growth of 8%, inflation less than 3% and no devaluation of the RMB.

The three placements concerned state-owned enterprises which should regain profitability, the financial system which should be reformed and the size of government which should be cut (40 ministries were reduced to 29 and half of the public sector employees lost their jobs).

The five reforms included grain distribution reform, investment and financing reform, housing reform, health care reform and fiscal and taxation reform.

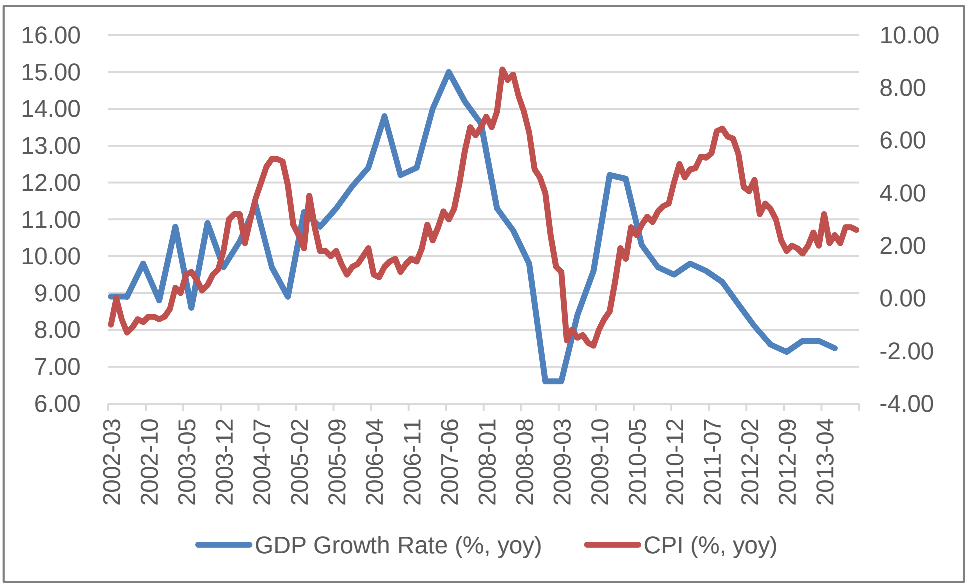
Reform of China's state-owned companies and membership of the WTO were the two biggest drivers of economic growth for China over the following decade.

In the future:

China's economy needs continuous reform to survive

In 2013, GDP growth continued its trend since 2009 falling from over 12% to less than 8%. China's GDP growth rate today is 7.5%. Questions have been raised about whether China can maintain growth and whether the country can escape the middle-income trap. These are real issues which China needs to solve.

China – falling growth and falling inflation since mid-2010



Source: CUAM, Wind.

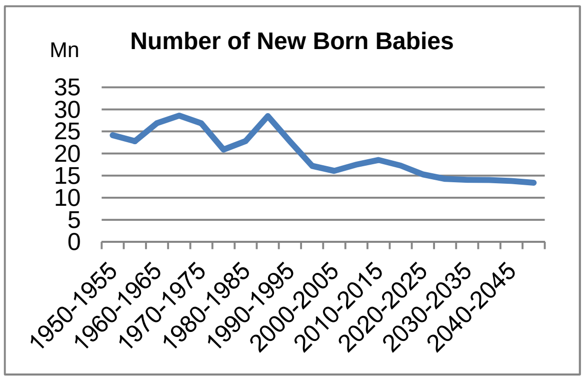
The following issues represent some of the more serious challenges to China's growth and prosperity:

A Shrinking Demographic Dividend

Population, an important economic factor for any country, has been a pillar of growth for the Chinese economy. China's dual "urban-rural" structure meant that a large labour force existed in rural areas providing an unlimited supply of low-cost labour. But, in recent years "Peasant Worker Shortages" emerged in the industrious coastal areas while at the same time labour costs kept rising. These phenomena have driven China beyond the so-called "Lewis Turning Point" thereby challenging China's demographic dividend.

According to the United Nations, if the current one-child policy is maintained, the number of new births in China will remain at a low level, and that between 2010 and 2015 the active labour force in the 15-59 years age bracket will enter a period of steady decline. The evidence of this is already visible in the market.

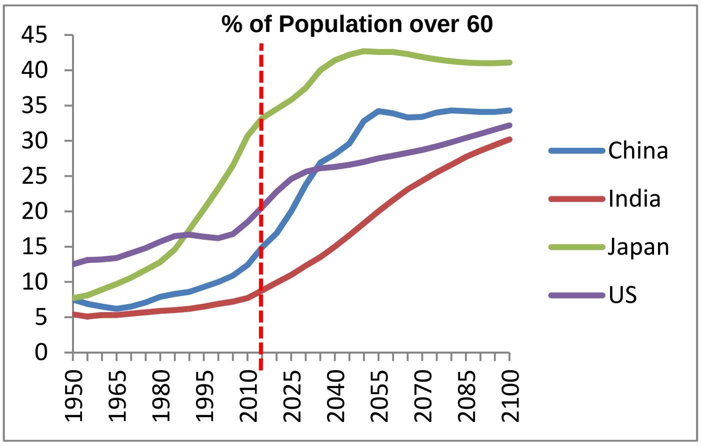
China's slowing birth rate……



Source: World Bank

Another factor contributing to China's declining demographic dividend is a rapidly ageing population. In 2010, the proportion of the population over 60 reached 12.4%, about the same level as Japan in 1980. But China's GDP per capita is only USD 6000, placing the country 86th out of 182 countries or regions; this is lower than Japan's GDP per capita at the time. The United Nations forecast that the proportion of ageing people in China will rise rapidly in the coming 20 years meaning China will "get old before it gets rich" providing a major headache for the country's pension system.

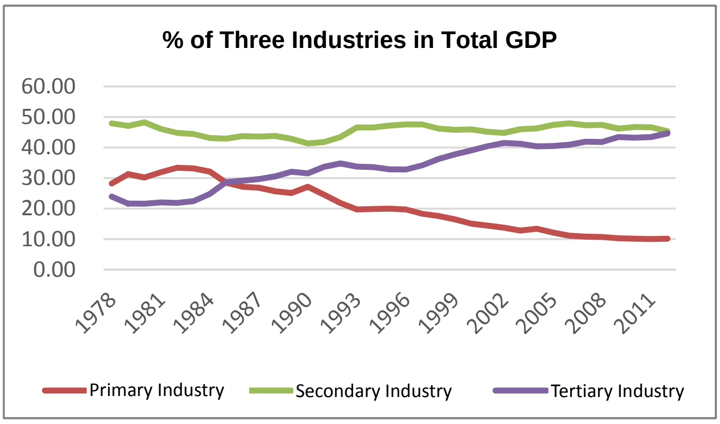
China's ageing population……



Source: World Bank

An Unbalanced Economic Structure

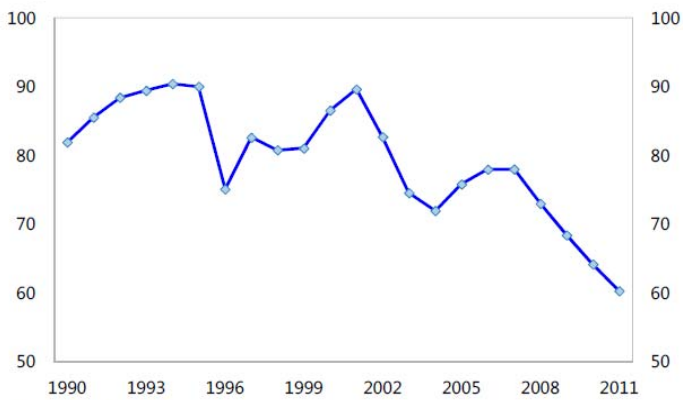
Today China is mid-way through a process of industrialisation with a high proportion of secondary industries making the economy heavily reliant on investment for growth. Investment as a proportion of GDP is close to 50% today. Correspondingly, the proportion of consumption to GDP is only around 50%, a worryingly low level compared to the rest of the world.



Source: CUAM, Wind.

These imbalances in China's economy result in poor investment efficiency and rising levels of bad debt. In a 2012 IMF report China's capacity utilization decreased to around 60% in recent years, a much lower than the figure of 80% which is typical of developed countries.

Average Capacity Utilization (In percent)



Source: IMF staff calculations.

After the global financial crisis in 2008, the central government launched a 4 trillion RMB stimulus plan. Credit and money markets were freed up and today, by most calculations, China's M2 money supply is the highest in the world.

Local Government Debt – Going Bad

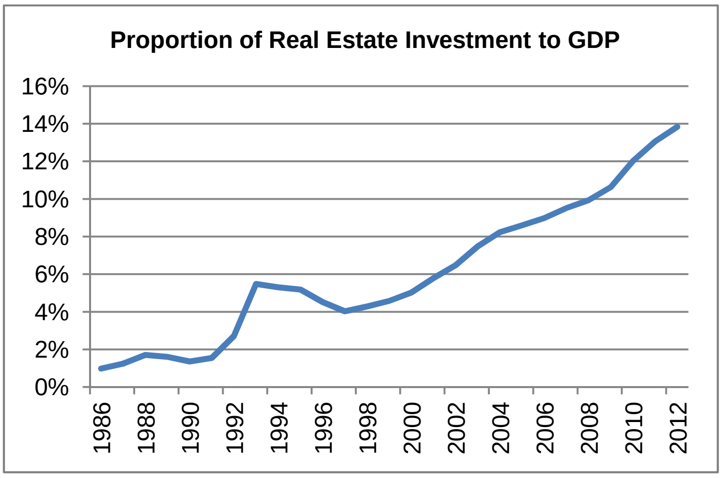
Rapid growth in investment and credit create concerns about profligate borrowing by local governments and the prospect of rising bad debt levels. But for now the bad debt ratio of commercial banks is relatively low.

In 2010 the State Auditing Administration revealed that local government debt had reached 10.7 trillion RMB, implying that today local government debt is somewhere between 15 trillion and 18 trillion RMB.

The government is aware of the risk of rising local government debt levels and has instructed the State Auditing Administration to conduct another audit as part of the process of containing and eventually eliminating this risk.

Overheating Real Estate Market

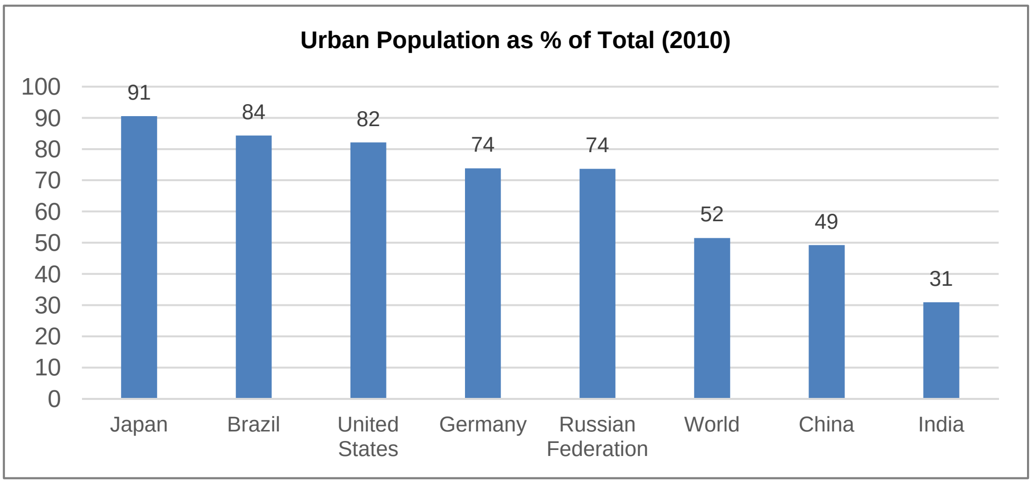
The state of China's real estate market is another worrying issue which demonstrates all the signs of overheating with housing prices rising rapidly in recent years. In the major cities including Beijing, Guangzhou, Shanghai and Shenzhen, growth year on year now approaches 20%. The proportion of real estate investment to GDP continues to rise reaching 14% at the end of 2012.



Source: CUAM, Wind.

Continuing Urbanisation

China is urbanising at a rapid rate although, at 50%, the proportion of urban to rural areas is still much lower than the global average. Government statistics of registered permanent residents indicate that the non-agricultural population accounts for 34% of China's 1.3 billion people. The difference between 34% and 50% is explained by the 260 million peasant workers living in China's cities. On the one hand, they are considered part of the urban population, but on the other hand, they are regarded as itinerant labour and cannot enjoy the same health care, education and other benefits that are provided to city residents.



Source: World Bank

Of course, this situation must eventually change. Premier Li Keqiang has proposed a new type of urbanisation emphasising “urbanisation of the people”. He aims to solve China’s city/country discrimination by allowing peasants to not only travel to cities but to be allowed to become residents of those cities. For this plan to succeed it needs further transformation of China’s currently inefficient economic structure.

Urbanisation will bring higher levels of income and will increase consumption giving rise to a stable middle class and the largest consumer market in the world. According to estimates by McKinsey, the proportion of main stream consumers in China will rise from 6% in 2010 to 51% in 2020. As urbanization expands and citizen income levels rise, China’s economic growth will no longer be dependent on investment.

Is Now A Good Time to Invest in China?

Although China may be faced with many future reform challenges the State Council, China's leadership forum, have already seized the opportunity to tackle these issues head on. From recent events it is evident that China's reform programmes have accelerated and that the leadership appears to be fully committed to putting China on course to become a more stable and powerful economy.

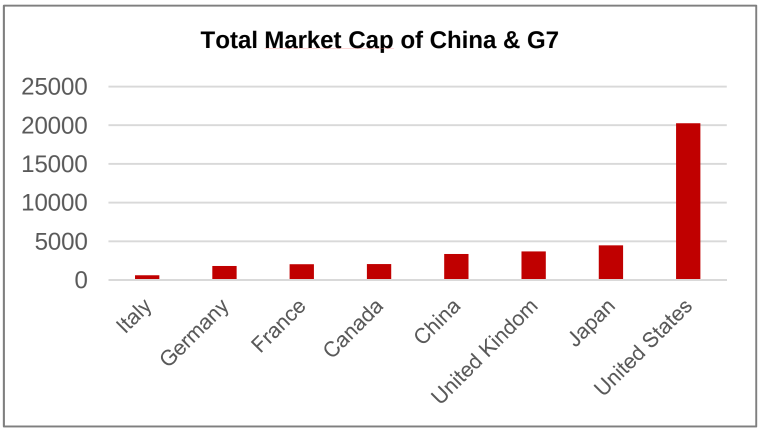
In the finance sector, regulation governing loan rates was loosened in July 2013 - a first step in interest rate liberalisation; in the economy, the establishment of the China (Shanghai) Free Trade Zone not only opens up cross-border trade, but also delivers the potential for Shanghai to build an offshore financial centre.

In addition, issues such as privately-owned banks, land transfer regulations and one-child policy have been heated points of discussion in private and public arenas. The Third Plenary Session of the 18th CPC Central Committee will open in November 2013 and is expected to feature a comprehensive deepening of China's reform programme. Following the recent spate of reforms as the new government settles in to its task, the market has high expectations with some major reform breakthroughs expected.

Investment Opportunity:

Stock Markets

China's stock market is the product of reform. It began in the early 1990s. Originally there were only 8 listed companies with a combined market cap of RMB 2.38 billion. Now there are 2,489 listed companies with a combined market cap of RMB 27.7 trillion. China's stock market is today the third largest market in the world although prior to the crash of 2007 it was the second largest.



Source: Bloomberg

Since 2007 China's stock market has disappointed, failing to match the growth of China's economy. Much of this can be attributed to a lack of market liberalisation. Plans to liberalise the IPO process, preferred shares, T+0 trading, market shorting mechanism, accessibility for foreign investors, liberalisation of the derivatives market will be implemented in the near to medium term.

Source: CUAM, Wind.

Although China's stock market is relatively immature, current valuations are lower than that of other emerging markets and even some developed markets. For such a large, high-growth economy, current valuations make it a very attractive investment opportunity.

Where to invest?

While the Shanghai Composite Index and Shenzhen Composite Index, representing China's A Shares market, have not performed well since the beginning of this year, the Growth Enterprise market index, representing small cap growth stocks has performed bullishly setting historical highs. The year to date growth of China's Growth Enterprise market index, ranks 2^{nd} on a global basis while the main boards in Shanghai and Shenzhen have disappointed.

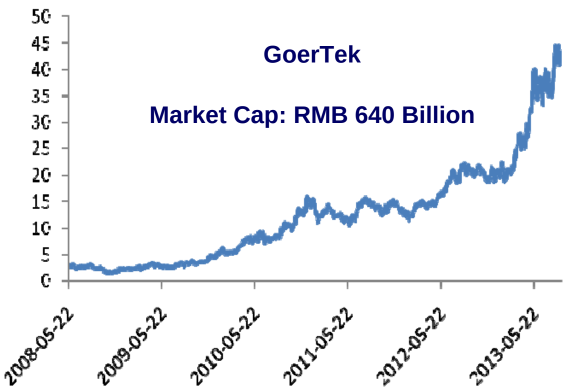
This strong growth among China's emerging companies leads us to believe that future investment opportunities in Chinese equities lie in following sectors:

Science and Technology

China’s economic transformation will be driven by Chinese companies. Chinese manufacturers are starting to take the lead internationally by adopting the pace of global technology reform.

GoerTek is an example of one such company. GoerTek produces miniature electronic components such as, Bluetooth headsets, dynamic 3D glasses, game controllers, Hifi headsets and camera modules; its products are widely used in mobile communication equipment, PC/iPad, digital devices and automobile electronics. GoerTek is one of the major suppliers for companies such as Apple, Samsung, Sony, Panasonic, Nokia, and Huawei.

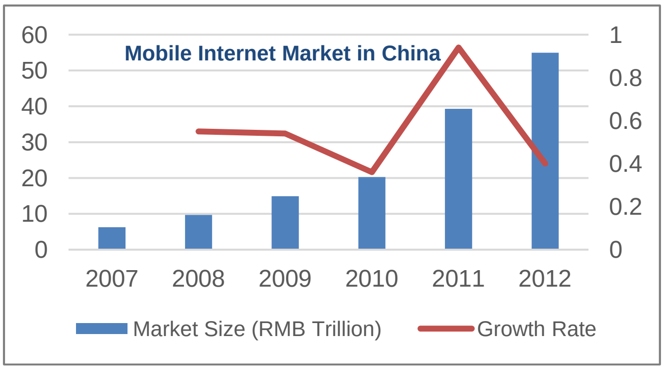
In the 12^{th} five-year plan, China’s continuing investment in security and protection was highlighted. In China today this market is about RMB 250 billion and is expected to double to more than RMB 500 billion. Hikvision is the leader in this industry, providing software and hardware, and the sale of security and protection solutions to the industry.



Source: CUAM, Wind.

Entertainment and Media

Against a background of strong government incentives, the drive to create a national entertainment and mobile internet industry has been dramatic with this sector poised to become a major pillar of China’s economy. Huayi Brothers, a leading company in this sector has seen its stock price grow by more than 5 times this calendar year. Huayi Brothers is mainland China’s most well known entertainment group with interests in movies, TV series and artist management. At the same time, it is expanding into online gaming and theme parks.



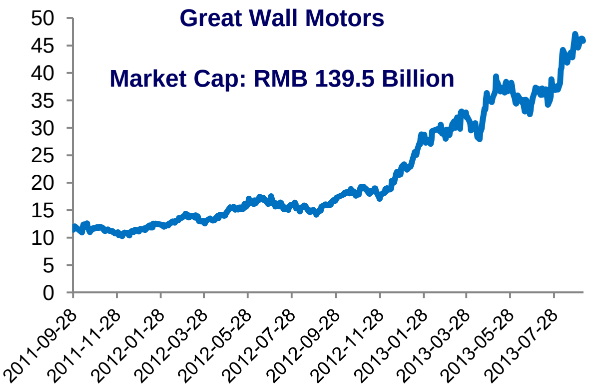
Source: CUAM, Wind.

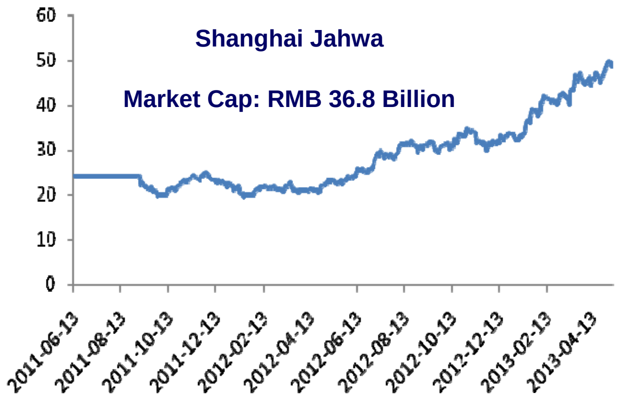
Consumption

Consumption will always be a driver of investment. The urbanisation of China is driving the forces of consumption creating opportunities in this sector. As an example, automobiles and pharmaceutical/cosmetic products are expected to demonstrate high levels of growth well into the future.

In recent years, the growth of SUV sales in China has been well above the average growth rate of the passenger car industry. We believe this trend is sustainable. Great Wall Motors are sticking to their strategic focus on SUV, pickup trucks as well as Class A cars. The company is currently ranked No.1 in SUV sales in China, a leading position that is likely to be maintained.

Shanghai Jahwa is the first listed company in the Chinese cosmetic industry and is one of the few Chinese companies that can compete with multinational companies. Shanghai Jahwa has established many popular brands in the mainland including “Liushen”, “Herborist” and “Maxam” and is building its international capability through careful research and brand management.





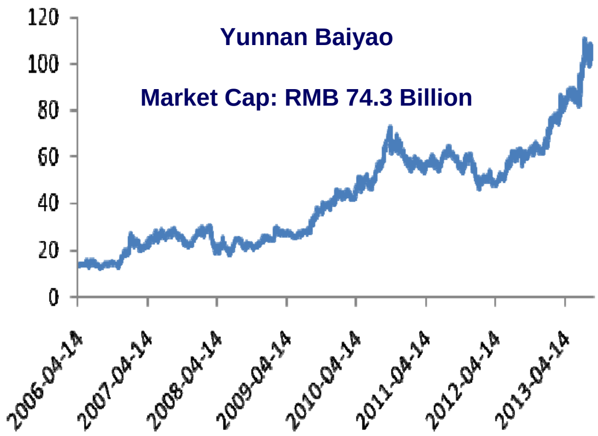
Source: CUAM, Wind.

Healthcare

One of China's biggest demographic challenges is a rapidly ageing population. There is no question that China's health care industry will benefit from this long term trend.

Tasly was set up in 1994 and was listed in 2002. The company had a break-through with the development of a traditional Chinese medicine product, Danshen dripping pills, used in the treatment of heart disease and angina. In 2010, the product was recognized by the FDA, a significant milestone for China's health care industry.

Yunnan Baiyao is another Chinese company actively expanding in the health consumer goods area following the success of its earlier product range. Yunnan Baiyao is building a brand strategy that proclaims "New Baiyao, Great Health". We are optimistic about this company's success in the healthcare field. We believe it will reproduce the success of Baiyao toothpaste and will become a major force in the field of skin care and 'cosmeceuticals'.

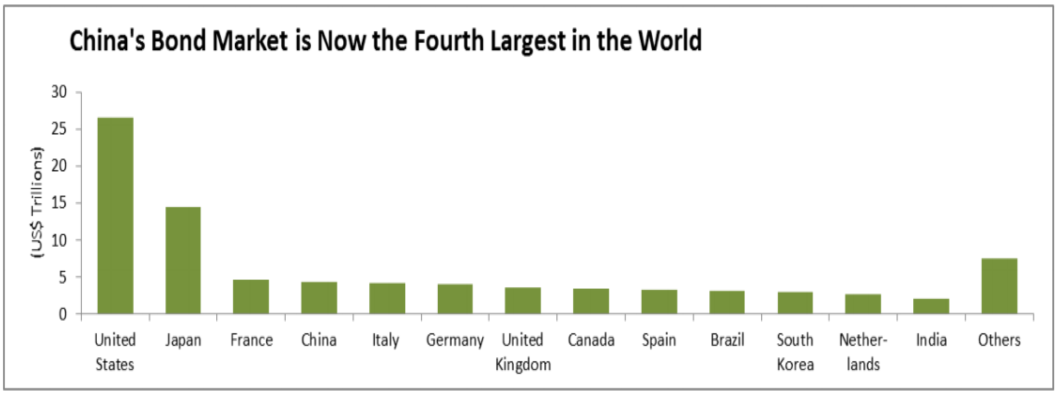


Source: CUAM, Wind.

Investment Opportunity:

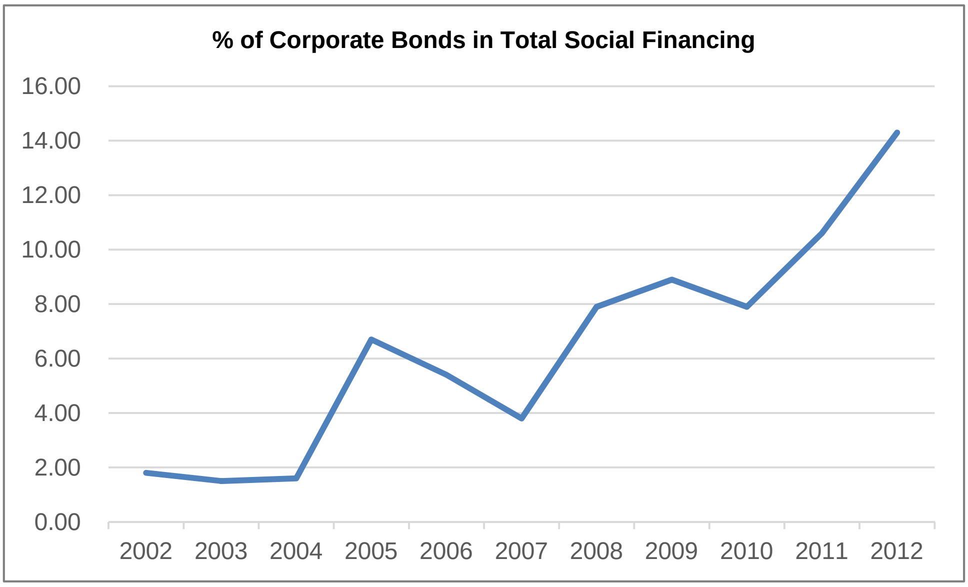
Bond Markets

Through the 1990's and into the 2000's China attached a great deal of importance to the development of the stock market and bank loan industry but neglected the bond market. Today, China's bond market is a different story, experiencing rapid development to rank 4th among the largest bond markets in the world. By the end of 2012, outstanding issues of RMB bonds reached RMB 23.7 trillion (about USD 3.8 trillion), an increase of 11.2% year on year.



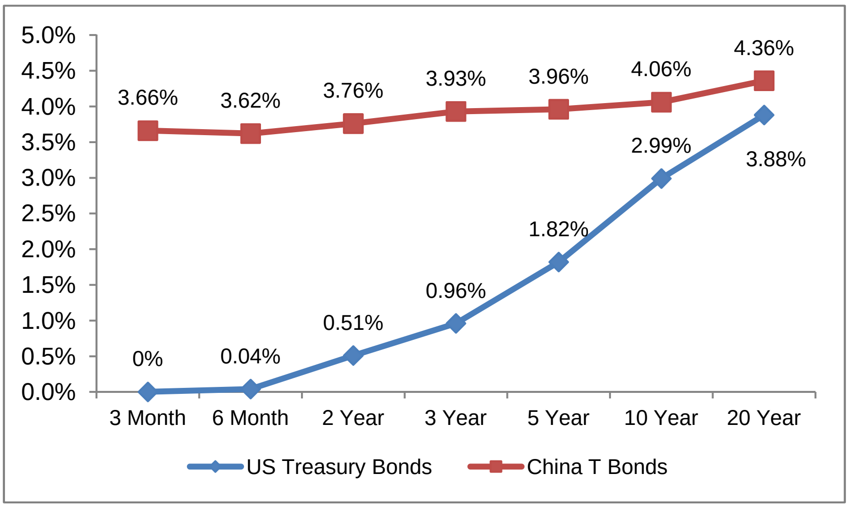
Source: ASIFMA

While the proportion of bonds in the market is increasing annually, the amount of bank loans is decreasing underlining the growing importance of bond financing for Chinese companies.



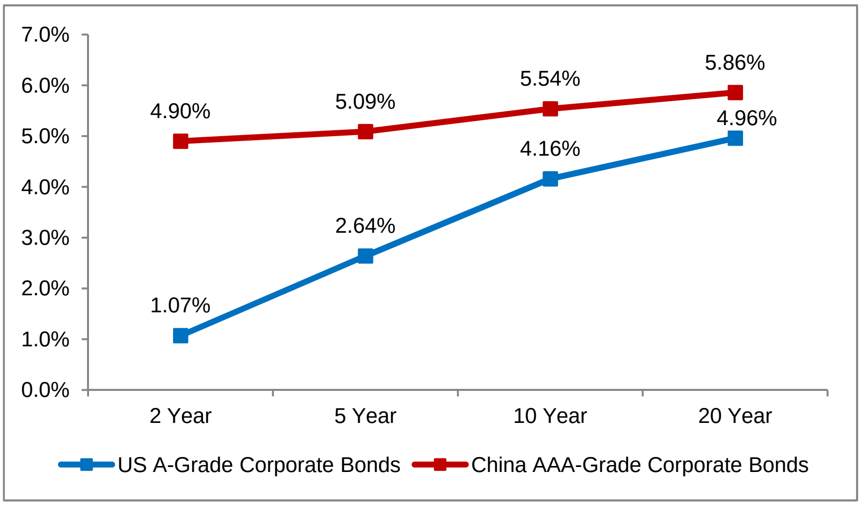
Source: CUAM, Wind.

Comparison of Treasury Yields – US v China



Source: Bloomberg, CUAM. Data as of 6 Sep 2013.

Comparison of Corporate Bond Yields – US v China



Source: Bloomberg, CUAM. Data as of 6 Sep 2013.

China's corporate bond default rate has maintained an impressive track record. In 2012, the default rate of China's investible bonds was zero.

2012 China's Default Rate – by Bond Type

Bond Type	Bond Amounts (Phase)	Bond Scale (Bn)	Default Rate (%)
Overall	**2401**	**5130.98**	**0.00**
Medium- and Long-term Bonds	1803	4342.92	0.00
AAA	886	3205.60	0.00
Short-term Bonds	598	788.06	0.00

Source: Moody's Investors Service, Inc., CUAM.

2012 Global Corporate Bond Default Rate

Country	Number of Default Issuers	% of Defaulted Issuers	Defaulted Debt (US$ bn)	% of Defaulted Debt
Global	**58**	**1.30%**	**48.27**	**0.3%**
North America	45	1.01%	28.83	0.18%
Eurozone	6	0.13%	6.59	0.04%
Emerging Markets	5	0.11%	3.06	0.02%
Others	2	0.04%	9.79	0.06%

Source: Moody's Investors Service, Inc., CUAM.

Although China's bond market is growing steadily, it is still only one sixth the size of the US bond market and smaller than the Japanese bond market by a factor of 4.

Although the future of China's bond market is correlated to the liberalisation of interest rate policies we are confident that the market will continue to grow in importance for both domestic and international investors.

Summary

China's commitment to continuous reform is a prime reason for our optimistic outlook on the Chinese economy and China's growing financial markets.

We are optimistic, but we cannot ignore the problems China is currently facing: a fading demographic dividend, unbalanced economic structure, high levels of local government debt, overheating real estate market, urbanisation challenges, to name just a few.

Nevertheless judging by the commitment shown by the Chinese leadership and the latest series of reform measures, we are full of confidence for the future of the country, the Chinese economy and the capital markets.