

JCP - Investing in Practice

July 2010

Impressions of China

This report covers impressions, facts, reflection and analysis from travels through China in June 2010.

Wes Campbell (Head of Institutional Business & Portfolio Manager, JCP Investment Partners) and Peter Horn (Managing Director, JP Morgan Asset Management Australia) travelled to Shanghai, Taiyuan, Shijiazhuang and Beijing to meet with local Chinese companies (both listed and unlisted) across a range of industries, local advisers and various Chinese Government bodies.

We also met with China International Fund Management Co (CIFM), J.P. Morgan's JV fund manager in Shanghai, and attended the J.P. Morgan China Conference in Beijing. Beyond investing directly in China, an understanding of China is important in understanding the economic outlook for Australia and many Australian companies. Of course, no one can ever fully 'understand' China. We are happy to share our insights with you and would welcome your thoughts, contrary views and questions. Detailed meeting notes are in Attachment A.

Key Findings

Urbanisation in China will continue to be the dominant theme for the next decade, at least

The current level of urbanisation in China is 46.6% (which is where Japan was at in 1962), and is expected to reach 70% by 2050. There is a huge push by the Government to increase the level of urbanisation, which has been increasing by 1-2% p.a. for the past 20 years.

The trend is likely to accelerate in order to get the middle class to a standard of living they are comfortable with and as China moves from an export economy to a domestic consumer economy.

China currently has 60 cities with a population greater than one million; the illustration in Attachment A is an interesting representation of the size of Chinese cities and how they

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compare with global cities.

Urbanisation along the east coast of China is largely complete and it is now the inland cities that are growing quickly. However, urbanisation is not the whole story. Equally important is the development of new urban housing and infrastructure. In urban areas approximately two thirds of people live in housing that is more than 30 years old. The spurt to growth does not end when people have moved to the cities; it continues as the standard of living, housing and rates of consumption improve.

There is genuine competition among Tier 3 cities to be the first recognised as Tier 2. This competition is healthy for the economy in so far as it fosters productive investment and rapid learning from the experience of other cities.

However, there is the risk of invidious competition and poor resource allocation within many of these Tier 3 cities. They will not all grow at the same pace and the risk is that some cities get overtaken along the way and be left as ghost towns.

Expect China's growth rate this year to be 8-9% p.a.

Regulation: Policy shift from a stimulatory stance to a tightening stance

The two key drivers of investment in China are property development and infrastructure.

In April and May 2010 the Government implemented some austerity measures in order to control property prices. While turnover has declined, prices have remained stable. Expect property prices to fall and commodity prices to weaken in the 2H10. Many of the property developments are managed by private (or semi-private companies) and are experiencing both higher costs of capital and reduced access to capital.

However, the majority of infrastructure projects are administered directly by the State and enjoy both better pricing and access to capital than property developers. That said, through its control of infrastructure spending, the Government can control the rate of economic growth in different regions in the short run. In the long run the infrastructure needs to support productive activity and ultimately support the shift to domestic consumption.

There is evidence of overspend in infrastructure in some regions. Most of the cities with populations above one million now have world class roads and rail connections.

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It is sobering to note that China now has a highway network as large as the US, which is much better quality. The ratio of infrastructure to income is already well out of line in China.

Exports were up 48% in May 2010, staging a recovery. In Europe, the PIGS (Portugal, Italy, Greece and Spain) only account for 4% of China's exports, which is not a large exposure, but we are likely to see exports to European markets slow in the next few months.

Savings are huge: There is no short cut to increased household consumption

China's household savings are huge. The lack of investment alternatives mean that a large proportion of savings are held in cash. China's long term growth depends on its ability to shift household behaviour away from cash savings towards productive investment and consumption. There is no short cut to achieve this, but we note that important signposts along the way will include development of social welfare and health systems, and appreciation of the Yuan.

Corporate deposits: RMB 21.7 trillion, or 67.92% of 2009 GDP. House deposits: RMB 27.9 trillion, or 84.8% of 2009 GDP. The long term future of consumer spending is healthy.

Property market is over-heated: The Government is determined to bring house prices down

The Government appears determined to deflate the housing price bubble. Austerity measures to slow the property market were introduced in mid April. The austerity measures have resulted in volumes falling by 50% in Tier 1 markets and 20% in Tier 2 markets. Prices are pulling back, discounts of 5-10% are being seen, and we are likely to see prices trend downwards. Expect Tier 1 cities to experience 20-30% downside and Tier 2 cities to experience 5-10% downside. Chinese banks can withstand this correction as gearing levels are low.

Impact for construction materials: Short-term weakness but long-term demand remains strong

Home sales lead construction starts by 6-9 months. In the 4th quarter this year, we are likely to see housing starts trend lower. This will affect demand for commodities, specifically aluminium, copper and steel. Market prices are likely to fall 10-15% on average.

New taxes are also likely to be implemented; expect a stamp duty to be introduced ~ circa 0.8% on purchase and sale of properties. The Government has flagged that it is looking for a 30% drop in property prices, so far prices have fallen approximately 15% in 2010. Retail property markets look more attractive, especially in the Tier 2 cities where there is a lack of supply. Demand for commercial/retail property leasing is very strong, e.g.: ZARA expansion.

Wage Inflation: Should we expect a rise in unit production costs?

Wage inflation is a major concern in China. A 10% increase would increase CPI by 0.1%, but consumption would also increase substantially, e.g.: travel, dining, electronics. Wages are increasing across most industries, but total labour costs per unit of production are staying steady or decreasing through efficiency gains derived from the adoption of improved technology. We note the recent rise of organised labour and strike activity in China. Without doubt, labour now has more confidence to organise itself in to unions and to represent its interests to employers and the Governments at different levels. The share of profits going to labour has fallen relative to capital (and equity) and we expect this to be re-balanced.

The Government has publicly commented that it wants to reduce income inequalities, and has responded swiftly to outbreaks of industrial action; usually by supporting the workers. There is a shift underway and we should expect continued rising wages and improvements in conditions of work.

We note that labour costs have grown on average by 15% p.a. over the last 10 years but productivity growth has enabled per unit costs to fall. We also note that labour costs remain a small proportion of total production costs.

Looking ahead, the question is: can productivity growth continue to outpace growth in the costs of labour and other inputs?

We note that private companies tend to have better management, more efficient and typically have a lower cost of production. The challenge is for the spirit of entrepreneurship to be emboldened in China over coming years.

Coal demand still strong: China's transition from exporter to importer means prices will remain high

China only became a net importer of coal in 2007 and is set to become the largest importer of coal in the world this year, (overtaking Japan) importing 140-150m tonnes in 2010. China has abundant supply of thermal coal, but an acute shortage of coking coal, so expect to see a large increase in demand for coking coal in the future from offshore mines. China met coal (coking coal) demand is now 40 times that of the US. Consolidation of small mines is largely complete. Coal costs have doubled over the last five years to now be \$35-60 / tonne (fees plus taxes). The lowest fees and taxes in China are now higher than the coal price at the gate in Mongolia, which is why Chinese companies are now looking offshore.

Resources tax in China:

Likely to be implemented this year, but no agreed percentage as yet. Rumour is 2-5%.

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View on Australian RSPT: "You get the Government you deserve"

There was general agreement that the RSPT will not survive in its present form, and that the implementation of RSPT would lead to higher commodity prices, so that China would end up bearing the burden of the tax, given the supply/demand dynamics.

In responding to a question on the RSPT in Australia, Dr Gao, the CIO of the China Investment Corporation, paraphrased Alexis de Tocqueville when saying, "In your system, the people get the government they deserve".

The Future: China still has plenty of growth to come

The next decade's growth will come from the central and western region development. The Eastern area is far wealthier than the rest of China. Central and Western China have much room to catch-up in terms of highway penetration, retail sales, auto sales and airports. The Central and Western regions of China are ready to take off: land prices for commercial and industrial use are much lower, will attract manufacturers shifting their base from the East to the West and incentives from government are likely.

List of Company Meetings:

- China International Fund Management
- Shanghai Lujiazui Finance
- SAIC Motor Corporation Limited
- Shanghai Wanwa Garments
- Shanxi Xishan Coal and Electricity
- Power Co., Ltd
- Jinxi Axle Co. Ltd
- Bosun Tools
- Yihai Oil & Grains Industries Co Ltd
- Great Wall Motor Company
- China Coal and Energy Company
- Baosteel
- Baoshan Iron & Steel Co
- China Construction Bank
- Peabody Energy
- Noble Group Ltd
- China Longyuan Power Group

About Us

JCP Investment Partners is a research driven investment manager that specialises in building tailored, risk controlled portfolios.

With more than ten years experience, we have managed money through bull and bear markets.

Our strategies

JCP Investment Partners offers four strategies to investors and all strategies can be managed on an after-tax basis.

- Benchmark Based
- Benchmark Insensitive
- Long-short 150/50
- Absolute Return

For further information on our investment strategies, please contact Wes Campbell or Richard Balderstone.



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