JCP Investment Partners - Investing in Practice

Impressions of China

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Levi Spry, JCP's Senior Resources Research Analyst, recently spent a week travelling through China, specifically Xi'an, Wuhan, Hefei and Shanghai. He met with a range of companies operating in industries such as coal, steel, iron ore, property, auto, machinery, cement, aluminium, mineral sands and copper. The goal of these meetings was to assess the level of demand for commodities and the general state of the Chinese economy, given China's immense importance to the Australian economy.

Four major themes emerged from the wide range of meetings:

1. **Industries remain burdened with overcapacity and are increasingly looking to export excess volumes**
2. **Despite overcapacity, limited closures are in sight given high barriers to exit**
3. **Widespread expectation that 2016 will be a challenging year, but hope for improvement in 2017**
4. **Transition to consumer/service economy more advanced than expected**

What does it mean for JCP?

Following this trip, we are more bearish on commodities. Specifically, we will look to revise our forecasts lower for coal: both thermal and coking. Additionally, we will be revising down our aluminium forecasts, especially alumina, however the outlook for copper appears ok. Overall, the Chinese economy appears to be slowing with little evidence of the reforms required actually being implemented. SOE reform is very slow and is yet to filter down to the provisional level, as such, high barriers to exit still exist in many of the heavy industries. The 13th 5 year plan is expected to be handed down in November/December, which will be interesting to assess how the Central government plan to address some of these challenges.

Industries remain burdened with overcapacity and are increasingly looking to export excess volumes

The consistent theme of old economy industries burdened with over capacity is not getting any better. Many miners and smelters expressed the view that they were suffering from excess volumes, including factory parts/equipment and construction service companies.

In the steel sector, only one company entertained the prospect of production cuts, whilst others suggested they are waiting for competitors to cut first. Wuhan Iron and Steel have no intention to cut production further, given they did this previously and lost market share. They expect the industry to get worse, with any improvement likely to take 3-5 years. Wuhan also felt that peak steel production in China is occurring now, which is consistent with JCP forecasts. Given domestic end user demand is weak; many steel mills have been looking to export their excess capacity, despite export prices weakening. The recent depreciation of the RMB will assist, however most companies expressed a view that the RMB depreciation is done for the short term but that more devaluations are likely in the medium term. One steel mill expressed a view that the local steel industry is "dead". They expect a recovery is at least 3 years away with 2016 unlikely to be a bottom.

A manufacturer of steel furnaces/equipment expressed a view that 100% of their revenue will be derived from the export market within 3 years. Ma Steel expects this year will be very tough, having experienced a loss of RMB1.2bn in the first half. Although the price of input costs continue to fall (such are iron ore and coking coal), this is not enough to offset falling demand for their end products, with no rebound in orders on the horizon. Overall, the steel mills felt that the economy is deteriorating, with little visibility over the next year.

In regards to coal, the Chinese thermal coal industry could return to being a net exporter, with the Chinese players having their eye on displacing some Indonesian coal in the market. Shaanxi Coal and Chemical Industry Group are of the view that thermal coal net exports will increase. China was a net exporter prior to 2004, a net importer between 2005-2014, and it could be a net exporter again in 2016 and beyond. Adding further supply to the global thermal coal market at a time of such depressed prices will bring further challenges to coal producers in Australia, as such we will be reviewing our forecasts.

In regards to cement and concrete, Huaxin Cement suggested that the Chinese concrete market was down 8% yoy in the first 8 months of this year, with 8 provinces experiencing a growth rate of -15%. Overcapacity continues to be a major issue; particularly given accumulated concrete consumption to date (tonnes per person) suggests China's build is essentially done. Companies we met appeared excited about the potential for exports, enticed by relatively higher international cement prices. Many are targeting regions such as the Middle East and Africa.

Despite overcapacity, limited closures are in sight given high barriers to exit

Significant barriers to exit exist across many of these industries. Such barriers exist to ensure workers remain employed and SOEs remain relevant. Bureaucratic procedures, such as government signoff and various incentive structures, like capital allocation based on levels of production rather than profitability, ensure that adjusting the cost structure, such as the labour is very difficult.

There were many examples of companies holding on to labour, effectively deploying them to other roles, given the difficulty in sacking staff. Wuhan Iron and Steel for example gave their staff a 10% pay cut and moved 300 of their steel workers into security roles. Additionally, Baosteel recently turned on a big project after 8 years of investment, despite the project being loss making and the media stating ' born at wrong time'. Pressure remains from local governments to run these types of projects given the capital invested and the impact on local employment.

Another barrier to exit is the banks. A number of the government owned banks don't want to shut down production at many of these heavy industries because this will trigger the realisation of bad debts.

Widespread expectation that 2016 will be a challenging year, but hope for improvement in 2017

Feedback from the meetings was far more bearish than expected, particularly in regards to the short term, with a lack of visibility beyond the next 12 months. At best, companies were hopeful of improvement in 2017, however this appeared to be purely hope rather than anything more fundamental.

Wuhan Iron and Steel's outlook is bearish for at least the next 18 months, expressing the view that they were "hoping one of their competitors will die" to improve the supply/demand dynamic.

In the property construction sector, Centaline Property Consultancy suggested that the city of Xi'an has 2.5 years of inventory in residential property and 5 years for office property, as such their outlook was flat at best. The investor segment of the property market has changed dramatically, with investors making up more than 50% of the market prior to 2012, however has now fallen to ~10% following limits on the number of investment property purchases permitted. Coli City, another property developer suggested that their sales in Xi'an are down 50% yoy, whilst China Resources National sales are down from 110-120 units per month to 80-90 units per month. They have been cutting prices to encourage sales.

China Vanke, the largest residential property developer in the world, forecast a pending ceiling for residential construction in China. They felt that the urbanization process while important, is decreasing. As such, they expect volume growth to slow. To insulate their business from the slowdown, they are moving into property management and logistics.

In the auto sector, volumes have fallen to +1%/flat growth. Commercial has experienced negative growth (down -30%), with the only bright light being sales of SUVs and electric vehicles. In the manufacturing sector, Shaangu Power stated that they are looking for a recovery in 2017, which appeared to be largely based on hope. The outlook from both mineral sands and aluminium producers was also bearish. Sigma Metals noted that most aluminium plants were losing money. Such is the immense over supply in this sector, secondary smelters that usually use recycled/scrap aluminium (such as drink cans) are actually using new primary aluminium bars to create their value added products (often supplied to the auto sector), because the new bars are currently cheaper than scrap.

On a more positive note, Xinren Aluminium suggested that CPI and CHALCO have applied to shut one third of their production. They are not expecting any improvement in the economy or prices within the next 18 months and expect further shutdowns in the next 12months. Additionally, the government is trying to close polluting/old smelters in Shandong. Xinren are also expecting new investment to be pulled back, with 4 out of 7 smelters stopping their expansion plans.

In the mineral sands sector, CNNC, who produce titanium dioxide for the pigment industry suggested that industry prices are down 20% in the last half year and volumes also down 20%. Despite the falls in price and volume CNNC expect to continue to increase capacity to 350ktpa in 2016 and 450ktpa in 2017. Their hope is to squeeze out competitors both domestically and internationally.

Copper appeared to be the only commodity with a reasonable outlook, but this is further out. Supporting the outlook for copper is the fact that China only produces approximately 1.0mtpa, so is very short copper. China remains the biggest demand market for copper, driven by the auto and manufacturing sectors and the grid roll out. Real demand appears ok, with consumption running at 2-3% p.a, although this is down from its peak.

Transition to consumer/service economy more advanced than expected

Despite the bearishness in the commodity based industries, China's transition to the consumer and services economy is clearly under way. Wanda Property, the largest commercial property developer in China, has built over one hundred 1.5km long commercial streets across China. Up to 50,000 people visit these high end consumer shopping streets each day, growing to over 100,000 on weekends and holidays. Additionally, Wanda has 115 plazas across China that primarily operate in tier 1 and 2 cities with a goal of increasing to 200 by 2020.

In regards to the Chinese consumer, Wanda explained that revenue from the mall we visited in Wuhan had increased from RMB 3m per day to RMB4m per day this year, driven by a combination of more people shopping and delivering a better product mix. In regards to product mix, they have learned that international clothing brands and local cuisine sells better. Given their expectations for continued growth of the Chinese consumer, Wanda expect to open 1 new plaza every month across China, with an expectation of 100% occupancy and strong rental yields given 4.5m people per day visit Wanda sites.

Conclusion

As mentioned above, we are bearish on commodities and as such will look to revise our forecasts for both thermal and coking coal. Aluminium forecasts, especially alumina will also be revised down, while the copper outlook appears ok. Overall, the Chinese economy appears to be slowing with little evidence of much needed reforms. The absence of SOE reform filtering down to the provisional level means high barriers to exit still exist in many of the heavy industries. The anticipated 13th 5 year plan expected in November/December and will be particularly telling for how the Central government plan to address some of these challenges.

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