



Jonathan Worrall, CEO, Mergent, Inc., and Peter O'Shea

FROM  
WALL STREET  
TO THE  
GREAT WALL

How to Invest in China



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*How to Invest in China*

JONATHAN WORRALL  
PETER O'SHEA

Foreword by  
Ivan Chung



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# **FROM WALL STREET TO THE GREAT WALL**

# FOREWORD: INVESTING IN CHINA

IT IS not unusual for investors to complain about the reliability and quality of data about China, ranging from macroeconomic data to company financial statements. It is even less unusual for investors to be amazed at the spectacular growth in China, ranging from gross domestic product (GDP) to the value of an apartment in Shanghai. Apparently both are right.

Yet the massive flows of foreign direct investment (FDI) into China and increasing investments in overseas listed Chinese stocks (Warren Buffett's Berkshire Hathaway Inc., for example, owned 13.35 percent of the publicly traded shares in PetroChina at the time of writing) reveal that the second school of thought dominates. After all, lack of quality is not an issue unique to China but a generic issue with all emerging economies. What makes China a unique source of lucrative investment opportunities is its gigantic critical mass combined with its progressive migration to a market economy. In other words, investment success in China depends largely on the ability to diagnose and envision these two critical and dynamic driving forces. However, given China's limited transparency, relevant reliable research tools remain scarce. As such, the tools and research methodologies introduced in this book give investors an unparalleled edge to make sensible and well-informed investment decisions that can maximize their returns and minimize the risks.

China's economic reform started with the liberalization of its labor force and the progressive introduction of private property and

foreign investment rights in and after 1979. The reform policies succeeded in mobilizing largely dormant labor and resources to economic production, thus substantially increasing the productive input to the economy. These reforms have been key drivers of the strong economic growth over the past 25 years.

Some China skeptics argue that the growth has been manipulated and is not real. There are indeed reasons to cast doubts on the validity and quality of some reported Chinese government data but, even so, the situation is improving. Furthermore, official data from China's trading and economic counterparts—U.S.-China trade deficit data, data on European Union FDI into China, China's holding of U.S. Treasuries figures, together with reexport figures from Hong Kong—provide solid evidence of China's sustained economic growth. A simple count of the number of television sets in Chinese households and automobiles on the roads proves that standards of living have improved substantially in both urban and rural areas in recent years.

Here begins the fascinating part of the investment research process. Under the backdrop of sustained economic growth and progressive migration to a more market-oriented economy, how does an investor pick the winners? What qualities do these winners have? Will current winners become tomorrow's losers?

As market forces become more and more prevalent, the range of variation among companies will become broader. Stronger companies have grasped the opportunities presented by market liberalization while weaker companies are losing market share as the support from the state fades out. But, according to our three years of experience in applying international standards to rating 180 Chinese companies, valuable research covers more than simple market factors and takes into account more considerations than we would cover in a developed market.

After all, China is still migrating to a full-fledged market economy. The true picture of the economy and of China's corporations is much more sophisticated and profound. First, control of shares

of many corporations, including many listed companies, is still in state hands. Strategic sectors such as utilities, oil and gas, telecoms, aviation, and banking are dominated by state-controlled enterprises. In these areas, it is difficult to enhance disclosure and corporate governance and motivate the managers to be purely profit-oriented. Furthermore, prices of electricity, gasoline, cell phone services, air tickets, and interest rates are only partially liberalized and are still significantly regulated. Yet most upstream sectors like crude oil are already tracking global market prices. As a result, there are conflicts and pressures between upstream and downstream sectors of the economy. These sectors and most corporations within each sector are almost solely controlled by the state, making interest distribution among entities something that goes beyond economic logic. Thus, selecting winners is not straightforward and requires an understanding of China from the inside out and, more importantly, an ability to see and appreciate the dynamic changes in progress.

The following examples illustrate the point. Fueled by China's strong economic growth and huge population, there are now 300 million cell phone users (and still increasing), with service providers seeing fast-growing revenues. Yet China has only two mobile telecom service providers, with the dominant provider, China Mobile, enjoying a lucrative earnings before interest, taxes, depreciation, and amortization (EBITDA) margin of more than 55 percent. However, nearly all of China's 40-odd cell phone makers, most of which have entered the market in the past three years, are losing market share to Nokia, Motorola, and Samsung, and are suffering growing losses. Another example: While power shortages pushed electricity companies to increase their electricity output in 2005, driving up the price of coal, which follows global commodity prices, regulated tariffs increased only modestly during the period because of the corresponding socioeconomic impact. As a result, power companies reported substantial increases in revenues but reduced profit margins and net profit.

Even so, we believe that good investments in China present the same qualities as their counterparts in other countries: consistent delivery of growth in profitability, dividends, and returns to investors. These qualities mirror those of their international peers as leading Chinese companies become more and more active in the international capital markets and engage in cross-border acquisitions. Moreover, China's economy is becoming more and more liberalized and globalized—a trend that has been reinforced by a series of recent government policies, including the transformation of the previously rigid USD/RMB currency peg into a multicurrency peg with a wider trading band, as well as the implementation of a program to convert nontradable shares into tradable shares in listed state-owned enterprises.

With its valuable insight into the unique Chinese market and its credible guide to exploring Chinese companies, this book provides readers with a pioneering advantage, allowing them to grasp the lucrative opportunities in the Chinese market as its economy becomes increasingly market oriented.

In the years to come, the contribution of *From Wall Street to the Great Wall* to China's investment research landscape will be proven to be unprecedented, as China reforms itself to be one of the world's great economic powers.

IVAN CHUNG, CFA  
Managing Director, Credit Ratings  
Xinhua Finance  
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# INTRODUCTION: THE NEW FACE OF WORLD ECONOMICS

**J**OB MIGRATION. Shortages of skilled workers. Competition within industries. All these symptoms of growth tell us something. Growth comes in a variety of shapes and sizes, but when we see it occurring along with emergence of technological and skilled levels of manufacturing, it is significant.

Historically dominated by an agricultural population, China today is undergoing a vast migration, not only in the sense of where people live, but also the types of jobs they hold and seek, their wages, and the entire economic viewpoint among working people and industry. Many nonagricultural manufacturing sectors in China are growing in double digits each year as the country's industrial economy explodes.

In this environment, the country struggles with the problems typical of an emerging economic base: the need for improved training programs, unemployment, energy demand, and housing. But the problem is not what to do with a labor force; the problem is competition among industrialized cities within China to attract young workers. In 2005, a major manufacturing center in South China, Shenzhen, found only 53,000 applicants for 105,000 skilled technician openings. The city estimates demand for more than two million skilled workers over a five-year period beginning in 2005. Shanghai, another center with a growing demand for skilled workers, anticipates similar problems filling jobs in the future.<sup>1</sup>

This explosion in skilled jobs has positive ramifications for investors, both in China and elsewhere in the world. The lack of skilled labor is certainly an impediment to growth, but as growth pangs go, it is a more desirable problem than the alternative, a lack of available jobs for existing skilled workers. As the country works to adjust to the ever-growing demand levels in skilled vocations, advance company training programs and investment, and manage a population shifting toward industrialized areas, investors from the United States and other trading partners of China may realize the investment potential within Chinese industry, on many fronts.

For investors outside China, the problem is in determining how to invest capital in a range of promising industries, not only technology and manufacturing, but many others as well. China's growth is rapid and occurring across many investment sectors. Investors who understand this growth curve may want to be involved, but do not know how to go about moving capital from traditional western markets to the massive and ever-expanding Asian economy.

This book presents an overview of the current situation, the background, and the potential for investment in China and in its potentially lucrative industries. Equally important, the book provides suggestions for exactly how capital can be invested without having to move funds overseas. In many countries, including the United States, the complexity of opening accounts in foreign countries, working with stock exchange rules dissimilar to their domestic exchanges, and managing risks is simply too extensive. As a consequence, many investors who desire multinational asset allocation or who recognize the potential in China's market have simply decided that, without more knowledge, it is not prudent to attempt to move funds into that market.

This book shows you how you can invest directly in China's emerging growth boom—without the complexity and risk associated with investing overseas. Using domestic outlets, you can become an international investor. This book explains not only how to move money into the Asian market safely and easily; it also pro-

vides you with vast resources for analysis and identification of profitable companies and industries.

As the opportunities continue to present themselves for investment in a dynamic and growing economy, you will find many ways to put capital to good use. The growth pains identified by the symptoms of skilled-labor shortages and competition among industrial areas are problems, of course; however, they also serve as symptoms of strongly positive change. These problems are typical in growing and productive economies.

We present information to you in two sections of this book. Part I, *A Premise for a New World View*, demonstrates how China is emerging as the leading economic power in the twenty-first century. As the world becomes truly global in economic terms, a variety of shifts must be expected to occur. Agricultural, manufacturing, high-tech, medical, and research industries—among others, of course—are already shifting away from traditionally dominant economies in North America and Europe toward China, India, and other Asian growth centers. Part I shows how and why this is occurring. The shift in economic and monetary influence is both rapid and profound; the implications of these changes are as significant as the Industrial Revolution was in Europe of the past; and new developments will change the way that workers function within the economy of each region or country. For example, in the future, the primary competition may not be between the United States and Asia as a whole, but between China and India *within* the larger Asian market. The potential for changes such as this affects every investor in every country. Along with changes in centers of economic influence come changes in investment opportunities.

In Part II, *Methods and Strategies in the New Market*, you will discover exactly how China is growing and which industries are the strongest. Like all economic centers, the Chinese economy is partially self-reliant and partially dependent on outside resources. The growing population and manufacturing base of China will make it

the future's leading energy-buying nation. In the past, the United States held this role; but changes in economic as well as in demographic realities will also change the relative demand base for natural resources.

China faces many challenges in its promising future. Although you as an investor can observe a lot from the economic situation in that country, you also need to be able to assess the situation from a new perspective. In the western world, growth has usually been associated with labor *shortages*. In China today, there is no shortage of unskilled labor, but there is fierce competition for skilled workers in the fastest-growing sectors, primarily technology. The challenge of gearing up to better train people to fill skilled jobs is huge, and it is difficult to imagine in terms of time, investment, and social changes. At the same time, China also needs to balance its industrial needs with the equally important needs of its agrarian base. There are, in fact, two Chinas in this respect. The heavily industrialized China and the agricultural segment are separated in many respects. Income levels and requirements, employment, poverty, geography, and cultural priorities are among these; also of great importance is the challenge to China of how it balances the priorities of industrialized and agricultural population groups.

Investors who are aware of these cultural and social forces will be well equipped to determine exactly how their investment resources can be put to work. Although foreign investors will normally funnel their capital through domestic outlets—and appropriately so—it is not enough to simply trust an adviser. In the United States, for example, history has shown that advice is not always sound, nor is it given in the best interests of the investor. Most experienced investors have discovered, often at great expense, that they need to be very selective and critical of the advice they receive and act upon. This has not changed.

In this book, you are provided with resources you can use to perform your own research or to locate and maximize information provided by objective research outlets. However, decisions invari-

ably are better made with high-quality research. This book is not intended to make research easier; it is designed to help you focus your research efforts intelligently, so that you will be able to avoid the common problems investors face in any specialized plan. This includes investing in specialized or risky products, unfamiliar industries, or foreign countries. The resources you find in this book will help you to identify the risk elements you need to be aware of, and to make informed decisions based on objective research. As with any investment plan, this is a sensible formula for reducing risk and finding out how to protect capital.

As a potential investor in Chinese growth, you face the usual challenges every investor faces: identifying opportunities, matching appropriate risks, and proceeding through the appropriate venue. You also face the additional challenges of a dissimilar culture and social order. This book helps you to understand these aspects of your investment decisions, and to improve your knowledge of this new and promising market.

# CONTENTS

Foreword: Investing in China <i>by Ivan Chung, CFA</i>	vii
Acknowledgments	xi
Introduction: The New Face of World Economics	xiii

## **Part I A Premise for a New World View**

CHAPTER 1	An Economic History of China	3
CHAPTER 2	Worldwide Change and the Globalization of Investments	25
CHAPTER 3	Economic Forces at Work	51
CHAPTER 4	Emerging Investment Themes: Global Supply and Demand	69
CHAPTER 5	Stock Markets: Domestic and International	91

## **Part II Methods and Strategies in the New Market**

CHAPTER 6	An Investor's Road Map into China	109
CHAPTER 7	Developing a China Strategy	123

CHAPTER 8	An Analysis of Chinese Stocks and Funds	147
CHAPTER 9	The World of Tomorrow	167
CHAPTER 10	Research in the New Global Investment Environment	181
Appendix:	Information Sources and Research Tools	187
Notes		191
Index		199



**PART I**

**A PREMISE FOR A  
NEW WORLD VIEW**