

Aaron Chaze

THE ASIA INVESTOR

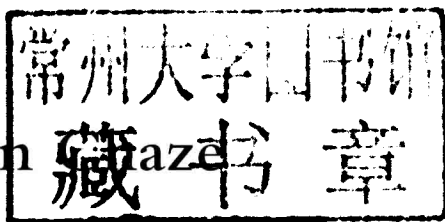


Charting a Course
Through
Asia's Emerging
Markets

The Asia Investor

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Asia's Emerging Markets*

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*In memory of my grandmother,
Linda Rodrigues.*

Introduction

Emerging Asia was the fairytale story to surface from the economic horror that enfolded much of the world in 2008 and 2009. Right through the slump and the nascent recovery of late 2009 and early 2010, Asian markets regularly made the headlines for extraordinary macro growth numbers or spikes in the stock index. More than the numbers, though, it was the swift response of these economies to government stimulus measures that was interesting to see. But the question frequently asked is whether Asian countries, especially China, will be able to sustain the pace of growth or whether their economies will collapse under their own weight, especially if the underlying drivers turn out to be more speculative than fundamental. The question is not how sustainable is the growth (for growth rates will inevitably slow) but whether these economies have what it takes to move away from an export-led, external-trade-dominated economic philosophy and truly embrace a free-market philosophy. The focus should be on whether these countries can develop their domestic economies. The answer is linked to whether or not they are able to

open their markets to domestic and foreign competition and whether they can go beyond manufacturing and enjoy a service-sector-led boom that pulls the tens of millions of unemployed or underemployed people into the mainstream economy.

Asia is buoyed by several trends that drive the opportunity across the region. These trends morphed into themes, the analysis of which forms the basis of this book. I have dwelt both on short-term factors that can be observed and tested today and on the longer-term themes that can be tested further down the road. In most cases, these powerful investment themes are shaped by events that affected Asian nations individually or collectively over the past decade and a half and thus have become deep-rooted.

The key crisis for Asia was the currency and debt crisis of 1997–98, which triggered changes in economic policies, systems, governance structures, and corporate strategies. The change has manifested itself in different ways: how Thai real-estate companies have redefined their operations; the emergence of Indian multinationals; the real evolution of regional trade in financial services; the emergence of a regional debt market; the evolution of a framework for Asian multilateral cooperation and the growing institutionalization of Asia; increased cross-border trade; a move up the value chain by commodity-dependent nations; and a move to diversify risk by commodity-surplus nations.

China and India are the oft-cited examples of Asian growth prospects but equally exciting are the emerging trends in Indonesia, Malaysia, and Vietnam. Riding these varied trends, too, are the older Asian tigers—Korea, Singapore, and Taiwan. There are also developments under way in once-stodgy Middle Eastern countries: the next decade or two could see their transformation into dynamic services-driven economies to rival Israel's current status as the region's only dynamic economy.

A number of companies are discussed in the book and are, for the most part, used for illustrative purposes only. The fact that they are mentioned should not be taken to mean that they are investment recommendations. In fact, some readers may recognize that a few of the corporate names discussed are not investment-worthy, for a variety of reasons. I have not made the distinction between investment grade

and non-investment grade names since all the companies mentioned help in uncovering the investment canvas or are useful for understanding unfolding trends in an industry. What the book is intended to do, however, is to provide a framework for analyzing the investment opportunity across the region and to help readers pick their own winners.

Contents

Introduction	ix
Chapter 1 Asia Rising: Emerging Themes and Trends	1
Chapter 2 The Changing Investment Canvas	33
Chapter 3 Asia's Infrastructure Build-Out: The Next Great Investment Opportunity	71
Chapter 4 Building Brands but Keeping an Eye on Traditional Strengths	95
Chapter 5 Asia: The Next Great Financial Supermarket	117
Chapter 6 The Economics and Politics of Energy	129
Chapter 7 Political Stability: Asia's New Investment Catalyst	151
Select Bibliography	169
Index	171



Chapter 1

Asia Rising: Emerging Themes and Trends

During the early years of the fifteenth century, the legendary Chinese admiral and navigator Zheng He led large armadas on voyages to the far reaches of Asia, eventually crossing the vast expanse of the Indian Ocean to reach the shores of Mogadishu in East Africa. These voyages—sometimes involving fleets of up to 300 ships—were an attempt by the prosperous and progressive Ming Dynasty to spread its influence in Asia and demonstrate its growing power. More than conquest, these voyages were meant to show off the tremendous achievements of the Chinese people. This age of Chinese expansion, however, was brief, lasting for only around three decades. The natural instinct to withdraw within the confines of its borders and its cultural embrace of modesty was too strong to resist, despite the tremendous domestic and international impact of a growing, prosperous, and increasingly powerful China. To compound the philosophical and

cultural tendency to introvert, the Chinese expression of power came at a time of European renaissance and renewal that led to a European golden age that resulted in the colonization, subjugation, and eventual decline of China, India, and other Asian civilizations.

Well before the economic and political growth in the Ming Dynasty, though, China had already emerged as a world trading powerhouse during the Tang Dynasty (618–907 AD), with merchant ships trading at ports in India, Sri Lanka, Persia, and Mesopotamia (modern day Iraq), and in Egypt, Ethiopia, and Somalia in North and East Africa. Chinese trade with kingdoms in India was recorded as far back as 2,000 years ago.

Economists and historians have estimated that toward the middle of the second millennium, between one-quarter and one-third of total global output came from China and India. Interestingly enough, by the 1890s China's share of global trade had fallen to just 1.5 percent, while India's had declined to 3 percent. By 1920, India's share had picked up to 4 percent, while China's had increased to just 1.9 percent. But China has had the industrial, financial, and human capital to be a dominant economic story from antiquity right up to the modern age. Like India, it has fascinated the West for a long time given its wealth and manufacturing ability. However, it was China's huge population (numbering over 300 million a hundred years ago) that emerged as a key driving force for Western traders (or factors, as they were known) to set up trading establishments or "factories" in China in the late nineteenth century. Economic writers who chronicled the early age of Western engagement with China (in the eighteenth and nineteenth centuries) pointed out that the only barrier to trade with China was the Chinese themselves. They were so conservative, introverted, and content with their own domestic production that they saw no point in trading with the West.

In the current era, the rapid recent growth and development of China is a miracle, even by its own historical standards. The story of this economic miracle that has unfolded over the past three to four decades has been well documented but merits a retelling since it has become a symbol of how a nation can collectively amplify its strengths and overcome its weaknesses while creating endless possibilities for its people. And as economic momentum swings eastward, Chinese

naval vessels are once again reaching out to Asian, African, and European shores and beyond, as China projects its growing political clout at a time of tremendous economic prosperity. With all the evidence before us it would not be far-fetched to say that we are likely witnessing a resurgent Asia, with China at its head.

China's path to economic growth commenced roughly a decade before the visionary reformist leader Deng Xiaoping began to formally push his country toward a more liberal economic agenda in 1978. As Figure 1.1 illustrates, China's growth rate over the past few decades has been by no means linear, with growth trends punctuated with sometimes extensive periods of deceleration followed by years of very significant acceleration. What is interesting is that, but for two years in the late 1980s, China has recorded annual growth of more than 8 percent for over 30 years. Even the United States, generally labeled as one of the world's first emerging markets, did not enjoy such sustained economic expansion during its early years. Over the past 15 years, China alone has accounted for 40 percent of the increase in the world's industrial output. India, which is now second only to China in economic growth and investment opportunity, will need to expand by 8 percent annually for 15 years before it reaches a size comparable with that of China today.

China's stock indexes have produced stunning results since stock trading was introduced on the mainland (through the Shanghai and

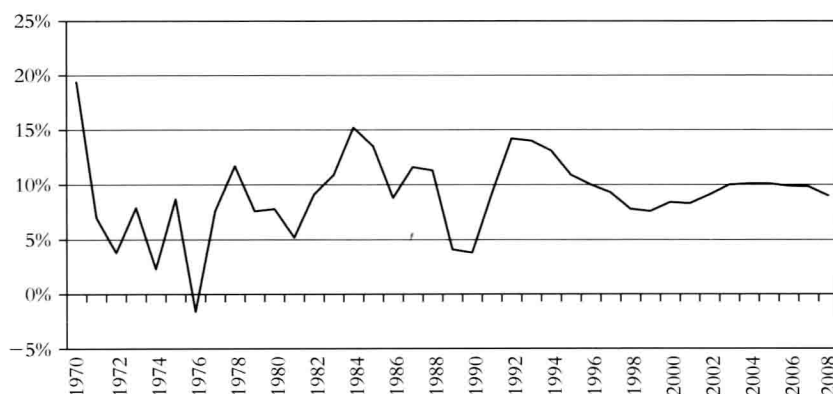


Figure 1.1 China's aggressive and remarkable 40-year GDP growth rate

SOURCE: Bloomberg

Shenzen exchanges) in the early 1990s. For foreign investors, however, it is the China H-shares listed in Hong Kong (which are mainland companies with listings on either Shanghai or Shenzhen as well) and the Red Chips (which are mainland companies incorporated in Hong Kong and traded only in Hong Kong) that are of interest. Here the returns from the Hang Seng China Enterprises Index (HSCEI), which represents both H-shares and Red Chips, have been spectacular too, as shown in Figure 1.2.

The average annual return on the HSCEI between 1996 and 2009 has been 9.8 percent, as compared to a 5.7 percent return for the S&P 500, an annual loss of 3.3 percent for Japan's TOPIX, and a 13.8 percent annual average gain for India's NIFTY Index.

India's equity returns have been among the best over different time periods from 1991 (the year that India's reforms process began in earnest), producing annual returns of nearly 14 percent, more than double that of the S&P. Even from 1993 onward, when the Hong Kong Exchange began to trade Chinese enterprises, the best total stock returns have come from Indian stocks, with an annual return of 13 percent over that 16-year period. While the risk perception of the markets in emerging Asia is certainly justified, the potential for returns remains undiminished for several good reasons, as we shall see later.

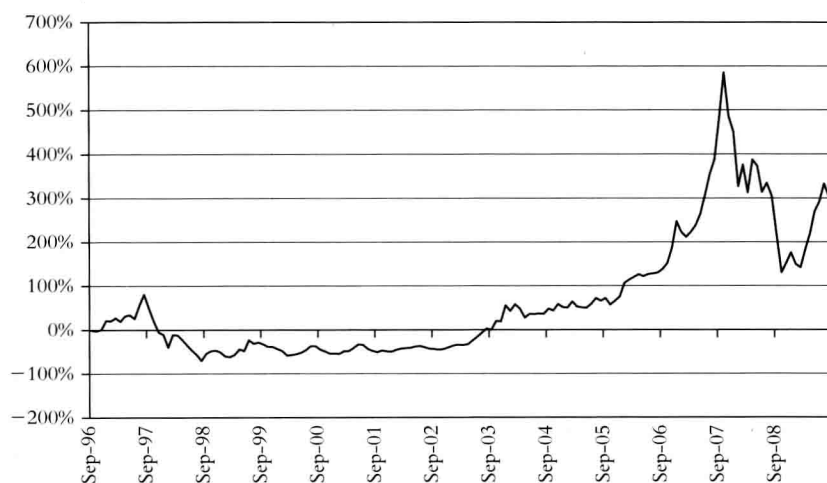


Figure 1.2 HSCEI returns, 1996–2009

SOURCE: Bloomberg

A New Economic Phase Begins for Asia

China's rise to prosperity in recent decades coincided with the surge in global trade and falling protectionism in major consuming regions. This trend led to extensive development of the coastal regions and cities that were the key to its economic strategy. But as the decade draws to a close, the economic structure that prevailed in the West for the previous five or six decades is beginning to look very different: the era of rapidly expanding global trade, open liberalism, and debt-funded consumerism is undergoing a drastic recalibration. Global economic relationships and national competitiveness are now being redefined in the wake of the global financial and trade crises that hit in 2007–08 as all nations seek to save more and protect their national economic interests by any means possible, giving rise to the specter of protectionism and reduced foreign trade.

Coincidentally, just as the developed economies face the prospect of years of slow growth and mediocre investment returns, East Asia—catalyzed by China—is entering the next phase of its modern economic era where the dominant themes will be linked to empowered domestic consumers and intra-regional trade. India for its part has long been focused on developing its domestic economy and has begun to accelerate that process. China has now begun to focus its collective energy on the development of its domestic market and its neglected hinterland. Given the lively pace of development and economic growth, Vietnam is being touted as the next Asian tiger and even Indonesia, East Asia's lumbering energy powerhouse always full of unrealized potential, is showing signs of breaking from the past and actually contributing to Asia's powerful growth story.

Significantly, the Chinese central government now sees the development of its domestic economy as a responsibility, not just to the Chinese people but to the rest of the world, and in keeping with its self-image as a “great and responsible” power. As China continues to open up its economy to competition through the slowdown it will become a powerful growth catalyst for a number of global economic sectors.

By Western standards the Asian consumer market has always been small, though growing rapidly for all that. Chinese growth has

been driven by a high savings rate, a high investment rate, and low levels of domestic consumption. For China to supplant the US as a consumption-driven growth engine for the rest of the world then its historic trends must be reversed; consumption has to rise and savings fall. It seems as if a nation of frugal savers has now to turn into a nation of frantic shoppers. However, the unfortunate reality is that Chinese personal savings rates, especially in the more prosperous urban areas, had been falling long before the recent financial crises, and under the current economic circumstances, may not fall very much further. Chinese economists have been pointing out for some time now that individual Chinese savers are saving less than before and their place has gradually been taken by corporate and government consumption.

The Chinese government's understanding of this fact led to a swift and very aggressive direction to state-owned banks to step up lending to Chinese households at very low rates of interest. In addition, the Chinese government has implemented a corporate policy clearly designed to shore up domestic confidence (no pay cuts, no retrenchments, and no delays in payments to domestic suppliers) and one that quickly began to take effect in the second quarter of 2009, pushing domestic spending and raising global demand for metals, fuel, and other industrial commodities. India too unveiled a new economic policy, soon after national elections in May 2009 were convincingly won by incumbent reformist prime minister Dr. Manmohan Singh, that aggressively targets domestic growth, infrastructure spending, and increasing the government's financial flexibility. India is different from other Asian economies in that it has built an economy with a very strong domestic story and very low dependence on global trade and, despite the impact of contracting credit, it came into these crises very well positioned for growth.

Despite the forecast and expectation of strong growth rates for many Asian nations, how reasonable is the notion that these nations will move from being high savers to high spenders? Is there hope that the domestic markets in Asia and, especially, in China and India will provide the necessary growth momentum and a fillip to the global economy? And will Asian governments succeed with their plan to use their substantial financial flexibility (given that both households and most governments are underleveraged) and controlled banking systems to trigger a sharp but sustainable increase in credit and consumption?

These are questions that may appear hard to answer in the short term, but there are trends unfolding that make for some very powerful longer-term fundamental changes. Intra-Asian trade mechanisms are being strengthened in an unprecedented manner, with 35 bilateral and multilateral free-trade agreements (FTAs) negotiated between Asian countries in various stages of implementation. Second, almost every major nation in the world pulled out a stimulus package for their economies, together pumping between US\$3–4 trillion into their recovery strategies. However, only India and China saw a powerful and quick resurgence in growth rates by the second quarter of 2009. While collectively the world economies—weighed down by the US, the Eurozone, and Japan—will experience a contraction for 2009 and small growth for 2010, only China and India among the major economies will push up toward their average growth rates. This is a powerful indicator of what the future might hold. It is almost certain that Japan's contribution to the Asian story will diminish over time. That role will be taken over by China, India, and the other large emerging economies of Indonesia and, possibly, Vietnam. Third, while the world has started wooing the Asian consumer, Asian companies are busy creating jobs across the world. Led once again by the indomitable Chinese, Asian companies are out there buying up corporate assets all over the place—from coal and iron-ore mines in Australia, auto-parts makers and auto plants in the US, equipment manufacturers and pharmaceutical plants in Europe, and oil projects in Canada, Africa, and Central America. According to an Ernst & Young study, between 2008 and 2009, some of the better-known Indian companies (including Reliance Communications, Wipro Technologies, and Tata Chemicals) made 143 acquisitions in the US alone, across a multitude of sectors including pharmaceuticals, IT, textiles, and manufacturing. One-third of these deals happened during the worst of the contraction in the US in 2009 and involved companies going bankrupt and about to close. In a similar vein, companies from other parts of Asia too have been buying up troubled companies in the US and elsewhere and essentially investing in those economies by saving jobs and keeping factories humming.

China's capital productivity has not compared well even with other fast-growing nations. China invests 40 percent of its GDP

to produce a 9 percent growth rate; India on the other hand invests 30 percent of its GDP to produce an 8 percent growth rate. So unless there is an improvement in capital productivity, as the Chinese investment rate slows so will its GDP growth. In a sense there is a bit of a role reversal between India and China; where China drove its GDP growth through higher investments and lower consumption, India drove it through higher consumption and lower investments. Now India has been accelerating its investments just as China is accelerating its consumption. China has already built up very significant manufacturing capacities in a number of industries and will now have to spend locally to utilize that capacity. Indian companies have increasingly been driving investment spending in India and in general it would be reasonable to expect an upswing in corporate earnings growth following a period of sustained growth in capital expenditure.

Whether or not Asia actually delivers on the high expectations being placed on it, the world's reliance on the economic power of Asian nations to bring about a measure of stability is a remarkable turnaround from the situation a little over 10 years ago, when so much in rapidly growing Asian economies depended on the largesse of global multilateral financial institutions and the financial backing of the US and Japan. China's ability to influence the global economy is becoming more pronounced because of how it is using its wealth and knowledge in shaping a new pan-Asian economic framework focused on its domestic economy and inter-Asian trade. It is also triggering dramatic changes in North and Southeast Asia in particular and in the rest of the world in general. East Asian nations in particular are redefining their economic agenda and rapidly fine-tuning it to complement China's emerging domestic strategy.

Stock market returns from China, India, Japan, South Korea, Singapore, and Hong Kong have been superlative ever since Asian markets bottomed out in late October 2008 and have produced stunning absolute and relative returns (see Figure 1.3). As foreign investors became shaky participants during the global slowdown it was domestic investors that piled into mutual funds, especially in China where stocks have returned 25 percent. In India, the return has been 15 percent, as opposed to a -14 percent return in the US. It is very noteworthy that it

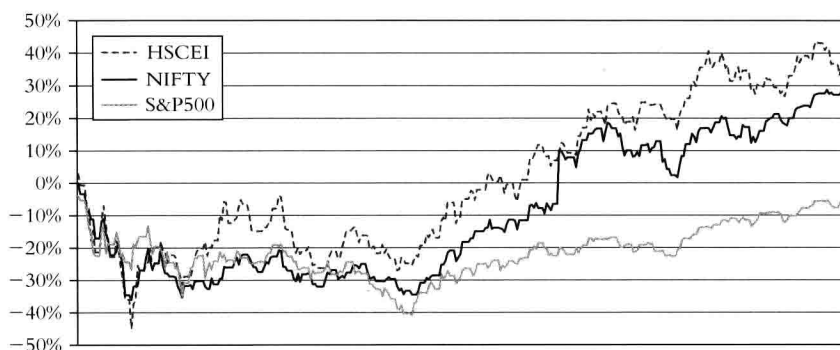


Figure 1.3 H-Shares (China), NIFTY Index (India) versus the S&P500 (October 08–September 09)

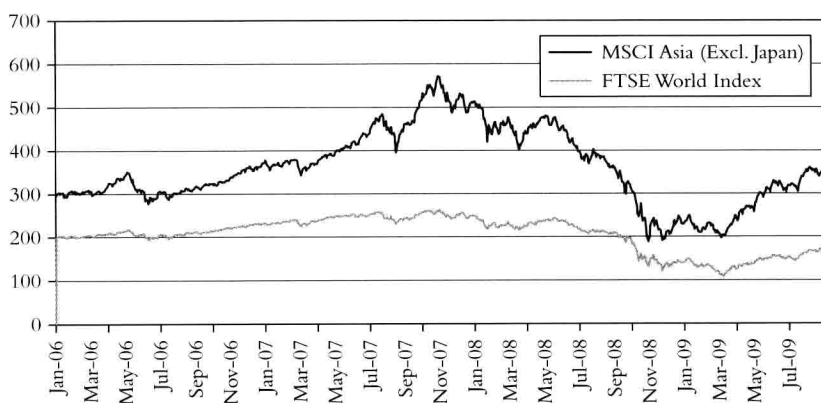


Figure 1.4 Emerging and developed-world markets compared

was the rally in China and key Asian markets that marked the bottom for global stock indices in October 2008.

The US markets followed five months later, in March 2009. This could signal the emergence of Asian markets as the trendsetters of the global economy and stock markets. It is also not surprising that declines or weakness in the leading Asian markets now tend to send ripples across global markets.

As Figure 1.4 makes clear, even when other Asian markets (with the exception of Japan) are included, the superior performance of