Client: Chi Med
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8 Chinese crackers

Today (3 Feb) sees the Year of the Tiger give way to the Year of the Rabbit in the Chinese zodiac. Chris Menon and the *Shares* team take a closer look at how to choose the winners with exposure to the world's second largest economy

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Will China be able to bring inflation under control without derailing its economy? *Shares* thinks the answer to this question is yes. Our belief is the authorities will engineer a soft landing and therefore investors should continue to play the Chinese growth theme.

To gain that exposure we would highlight five UK-quoted plays and three funds for the more cautious to make up our list of eight Chinese crackers. Our company picks (see pages 34-35) include **Origo Partners (OPP:AIM)**, whose Mongolian raw material investments are set to benefit from Chinese industrial demand; and luxury fashion retailer **Burberry (BRBY)**, which last year took direct control of its 50 Chinese stores when it acquired them from a licensee as a play on the country's growing middle class.

We also like **Green Dragon Gas (GDG:AIM)** which sells compressed natural gas used as vehicle fuel, via its network of Chinese service stations. More intrepid punters could look at traditional Chinese medicine play **Hutchison China Meditech (HCM:AIM)** while our fifth company pick is **Asian Citrus (ACHL:AIM)**, China's largest orange producer.

Since a hard landing cannot be definitively ruled out, risk-averse investors might prefer to opt for a fund.

Our trio of selections on the funds front includes **Fidelity China Special Situations (FCSS)** as managed by legendary stock picker Anthony Bolton (see box, right). We would also flag **JP Morgan Chinese Investment Trust (JMC)** and **Henderson Far East Income (HFEL)** which have both built up impressive track records.

China's rise

China overtook Japan as the world's second largest economy after January's official gross domestic product (GDP) figures showed it expanded at a phenomenal 10.3% in 2010. This remarkable growth means China is arguably the most successful capitalist economy in the world, albeit one ruled by the iron fist of the Chinese Communist Party.

WikiLeaks has revealed how in 2007 top Chinese leader Li Keqiang commented, in his role as head of the Communist Party in northeastern Liaoning province, that local government GDP figures were largely 'man made'. As such, he added, they were inherently unreliable and best used for the extrapolation of trends only.

Legendary fund manager believes fears overdone

Bolton backs China

Chris Menon

Legendary investor and fund manager Anthony Bolton came out of retirement to launch the Fidelity China Special Situations fund on 19 April 2010. In an exclusive interview he tells *Shares* why he is still optimistic about China and believes concerns over inflation and slower growth are overdone.

'I don't think the risks of investing in China are steadily increasing,' says Bolton. 'The Chinese are better placed than many other economies to control inflation because they are more centralised and can put in place price controls and edicts that alleviate inflation over the short term. That said, we're in a two-speed world where growth in the emerging markets will be good but they will have relatively high inflation compared to developed markets.'

'I don't plan to alter my sector weightings as I believe inflation will alleviate in the second quarter, as it's driven by food inflation which will lessen in the second quarter.'

His fund is very much invested in areas exposed to consumer goods and services and Bolton believes Chinese efforts to increase domestic demand are working. He explains: 'Part of the new five-year plan is that the Chinese government wants to grow domestic consumption and become less reliant on exports. They got a great shock from the credit crunch and want to make themselves less reliant on America. If you talk to international companies going into China they see China as a big and growing market. For example, China has overtaken the US to become the biggest market for cars in the world.'

Ironically, he sees current concerns over China as a cause for optimism. 'Bull markets climb a wall of worry. When the markets stop worrying that is the time to be concerned. Currently the markets are over worrying about Chinese inflation.'

His own top holding is the **Bank of China Hong Kong (3988:HK)** in which he has 5.9% of his fund's gross assets: 'It's a subsidiary of one of the mainland banks but operates in Hong Kong. It is benefiting from the Chinese strategy to internationalise its currency, allowing more people to buy and settle in the the renminbi. Bank of China Hong Kong has a monopoly in this trade. If you believe, as I do, that these flows will grow then this bank is in a very advantageous position.'

Fidelity China Special Situations originally raised £465 million and demand for it has been so keen it is raising another £162 million through a convertible share (C share) issue at a price of £1 a C share. Subscriptions end on 15 February. From 19 April to 31 December 2010 Bolton delivered a 13.1% return to investors against 2.8% for the benchmark MSCI China Index.

That point notwithstanding, official Chinese figures released last month (21 Jan) did nothing to alleviate concerns inflation was a growing problem in China. For the month of December prices rose 4.6% month-on-month. This was slightly lower than November's 5.1% rate but for 2010 as a whole inflation was 3.3%, above Beijing's 3% annual target. Moreover, food prices were the main driver, rising 7.2% for the year.

To rein in this accelerating inflation Beijing has raised the amount banks must hold on reserve seven times over the past 12 months, and increased interest rates to 5.8%. Yet these attempts to cool the economy do not appear to have worked. Opinion is divided over how quickly and how high the Chinese government is likely to raise rates given the likely appreciation of its currency and consequent reduction in economic growth that could follow. In any case, the Chinese government appears to face difficult choices and there are fears of a hard landing.

Yet *Shares* concurs with Société Générale's base case for China, as set out in its report *The Dragon* which played with fire: will China overheat? Its central projection, to which the bank attaches a 70%

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Citigate Dewe Rogerson

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probability, is the Chinese government manages to bring inflation under control without derailing the economy. While both growth and inflation decelerate and the renminbi appreciates at a steady pace. Fidelity's Anthony Bolton also expects a soft landing.

There are risks. Saxo Bank, in a paper entitled *Outlook 2011* has expressed scepticism as to whether China can achieve real 10% growth this year. 'Lending quotas have been surpassed in 2010 as demand for loans remains high, but this is more or less another way of saying that growth is only kept high due to a continual surge in investments,' reads the paper. 'Consumers are still not ready to carry the economy on their backs, which forces the regions to look elsewhere for growth; and the choice almost always ends up being investment-driven growth.'

With global growth expected to be fairly modest in 2011 Saxo argues China will be hard pressed to find growth elsewhere. Thus the research concludes concludes: 'We expect economic activity to fall below market expectations, reaching 8% year on year at the end of 2011.' Nick Beecroft, the bank's senior markets consultant elaborates on the political risks of runaway inflation: 'Food prices are a tinderbox issue in China and were one of the driving forces behind the Tiananmen Square uprising.'

Manage the risks

Another issue that could lead to complications is growing trade tensions with the US, particularly over American claims China is manipulating its currency. Were Chinese growth to slow dramatically, the sectors most likely to suffer are those very cyclicals that have hitherto benefited from its extraordinary economic growth, most notably mining and commodities. Any proper trade war with the US could mean all bets are off.

Terry Smith, fund manager at Fundsmith, answering his own rhetorical question as to whether China could 'fall over', commented at a recent industry dinner: 'People tell you that it can't. I would like to point out that during my working life time, if we just deal with the Asia Pacific Zone, I was told that in the 1980s the Japanese economy was 'unstoppable' and again in the 1990s that the Tiger economies were 'unstoppable. Both of them came to a grinding and rather

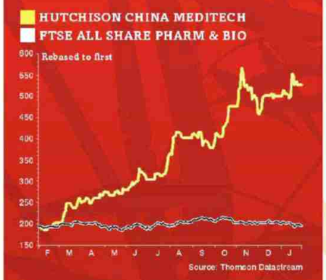
Asian Citrus (ACHL:AIM)

+BUY 81.5p

The largest orange producer in China **Asian Citrus (ACHL:AIM)** announced last week (27 Jan) that first-half profits would be up by more than 100%, exceeding market expectations. The firm should be able to offer several years of very strong growth. It has several plantations which include many acres of immature orange trees. This means output should grow substantially over the next five to six years. But that is not the limit of the company's ambitions. It is moving into the orange juice market which should lead to better margins. It is also increasing sales to supermarkets which in China provide better returns on sales than those to wholesalers. The company is also anxious to acquire further estates. A 25.5% increase in the winter crop's yield and a 9% rise in average selling prices were the dynamics behind the better-than-expected half-year trading update and we expect the company to continue to surprise on the upside. (JM)

THE WRITER HAS SHARES IN THIS COMPANY

Hutchison China Meditech (HCM:AIM)



+BUY 527.5p

Two loss-making start up businesses have just as much potential as **Hutchison China Meditech's (HCM:AIM)** booming traditional Chinese medicines (TCM) arm. As the early-stage deficits of the loss-making units diminish a powerful earnings momentum story will flourish. The firm has three complementary businesses, all of which have excellent long-term potential. Via MediPharma, the £272.9 million cap seeks to develop and commercialise drugs approved for Western markets, based on its knowledge of TCM in its domestic arena. November's investment in the operation by Japan's Mitsui gives this part of the business an implicit $102 million value, equivalent to 122p a share. The other loss-making unit is a thriving consumer products division that plans to tap the organic foods market, where a maiden profit is expected in 2011 as sales continue to rocket. While it is already doing well, the TCM arm should receive a further boost from September's launch of infant nutrition products, notably baby milk. (SK)

Three funds to provide portfolio sparkle

Given the heightened risks funds are one way into this marketplace for the cautious. You could go with a proven money manager such as Bolton, whose track record is such he is unlikely to slip up with **Fidelity China Special Situations**, or select one of a number of other funds.

Those who are bullish on China might want to stick with a fund that focuses on the country. Those who are a little more risk averse might prefer a more general Asian fund that offers exposure to other fast-growing markets in the region. In the former camp, **JP Morgan Chinese Investment Trust (JMC)** has returned almost 328% over the past ten years. In the latter, the **Henderson Far East Income (HFEL)** has had the best performance over ten years returning 528.6%. It has 34% invested in China and Hong Kong.

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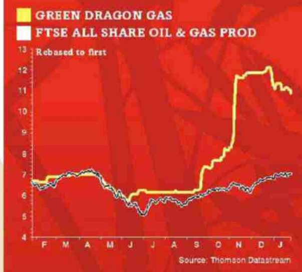
Origo Partners (OPP:AIM)

+BUY 40.5p

Private equity fund **Origo (OPP:AIM)** invests in companies that do, or will, feed China's economic growth. Its shares, quoted on Aim, have nearly trebled in the past year as the company has actively bought and sold investments which include mining and clean energy businesses. It has built up a portfolio of mining interests in Mongolia, which is rich with unexploited natural resources and has a transportation advantage over the traditional mining hubs of South America and Africa in being next door to the end market. China has built a railway to the Mongolian border so it can easily buy coal and other key raw materials to power its industrial expansion. Origo is tapping into China's plan to have more efficient and environmentally-friendly energy technologies. It has stakes in a producer of lithium-ion batteries for electric vehicles and a business which recycles plastic and tyres into fuel oil and other products. To benefit from growth in the Chinese media class, Origo has a stake in online entertainment provider iFensi which connects fans with Chinese stars and artists. In the clean technology space, it owns part of Aqualyng which is building one of the world's largest desalination plants in China. (DC)

Green Dragon Gas (GDG:AIM)



+BUY $10.90

Hong Kong-headquartered **Green Dragon Gas (GDG:AIM)** is a play on growing Chinese energy demand. A reserves upgrade, expected to accompany the group's listing on the main board of The Stock Exchange of Hong Kong later this quarter, is the next obvious catalyst. The company has an integrated model, owning the means of production as well as the pipelines and service stations which sell its gas. It is a coal bed methane (CBM) specialist, producing gas extracted from coal beds. It was substantially re-rated in the second half of last year, more than doubling in value to £1.4 billion. We see further upside potential – house broker Evolution Securities has a sum-of-the-parts valuation of $19 a share for 74% potential upside. The group raised $102.8 million through a placing in December. Green Dragon will use the proceeds to bring in 25 additional drilling rigs to ramp up production from its GSS block from one billion cubic feet (bcf) in 2010 to 18 bcf by the end of 2011. Green Dragon plans to sell a significant proportion of its output as compressed natural gas (CNG) for fuelling vehicles – getting a price of $13 to $15 per thousand cubic feet (mcf) at the pump against a US natural gas price of around $4 per mcf. (TS)

Burberry (BRBY)

+BUY £10.78

Fashion retailer **Burberry (BRBY)** originally operated in China via a licensee but last year acquired the licensee's 50 stores, situated in 30 different cities. This is part of the company's general strategy of seeking greater control over its distribution in its main markets. In the case of China it also ensured Burberry was able to enjoy a greater income from an important and growing market. This deal, expected to add £20 million to next year's operating profit, will be immediately earnings enhancing. Already it has led to dramatically better sales. In the company's third-quarter trading update the FTSE 100 firm confirmed sales in China had grown by over 30%, underlining the popularity of the brand with China's rapidly growing middle class. Burberry regards China as one of its main engines of growth over the next five years. We would expect it to double the number of stores over the next five years. (JM)

THE WRITER HOLDS SHARES IN THIS COMPANY.

spectacular halt shortly after being told that they were 'unstoppable'. Therefore I think there is every possibility.'

Well-resourced fund managers may be in a better position to deal with the risk of investing in non UK-domiciled companies where the company law of the country in question may not be robust in protecting minority investors. Mark Slater, manager of the **Slater Investments Growth Fund**, takes comfort in holding Hutchinson China Meditech, which at 9.64% is his largest position, in the knowledge Hong Kong-quoted **Hutchinson China Meditech (0013.HK)** is the majority holder (70.9%). He comments: 'The gilt on the gingerbread is the fact that Hutchinson Whampoa is the parent and has huge muscle in China and the corporate governance is good.' Hutchinson China Meditech is already one of our *Tips for 2011* (see *Cover*, 23 Dec '10).

Investors should be prepared to do their own research and be very aware the phrase 'exposure to Chinese growth' has come to be used as a marketing term by all manner of companies offering to deliver great returns. To minimise the risk of ending up in a stew during the year of the rabbit you will need to be selective when investing in China. ■

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