Asian Values

- Finding long-term value within Asia's markets -

Monthly letter from an institutional research and investment firm based in Asia – a strategic overview of the region's markets that pinpoints the likely future turning points in the pricing of risk, for both debt and equity

Publisher:
Emerging Alpha Advisors Ltd., Hong Kong

Welcome to our inaugural issue of Asian Values, a monthly letter covering the capital markets, political economy and catalysts for financial change throughout Asia.

This first issue is a free trial copy, but please forgive its length. There was so much to cover on China and its relationship with the region that we had to devote a whole extra article to it. We shall have bumper issues occasionally in future, when market changes dictate the need. But generally the letter will use three distinct perspectives to examine ongoing events: 1) a strategic one for the portfolio planner, 2) a country focus on the pending catalysts and challenges of each of the 14 markets we cover, and 3) an industry overview that looks for the risks and returns available for the portfolio investor. In all cases, we take a three to five year view.

This is a letter for investors, not for traders; although, the latter may gain a useful perspective from it. We offer it on a one-year subscription for US$500 per year. For details on how to subscribe, please visit our website (www.emerging-alpha.com) or write us at asian.values@emerging-alpha.com. We also welcome your feedback over either of these channels.

In this issue:

Asian Values

- Finding long-term value within Asia's markets-

Publisher:
Emerging Alpha Advisors Ltd., Hong Kong

Opening Idea

Pollyanna Finally Gets Mugged

– The elite's vanity-at-risk (VaR) to the rise of the middle –

State-sponsored terror

In the last 24 months we have seen the world's capital markets and their regulators go from smugness to regret and recrimination. What is worse: ignorance or the refusal to learn what is already available to know? Pollyana-ism, as it is commonly presented, is supposed to be the former, even naïveté. It is, in fact, the latter. Ignorance is not innocence, but sin.[1]

Why would a pollyanna of any ilk turn suddenly into a dark alley, when better-illuminated paths – even short-cuts – were visible? Only vanity can explain this bizarre and destructive behavior. To be a bunch of pollyanas is the best claim financial regulators around the world can make, professing the impossibility of knowing where the various events of deregulation would lead. This pattern of deregulation evolved over the last 15 years from a progressive to a "laissez faire" attitude. That is in spite of well documented central bank findings over the last 20 years to the contrary. To understand better the risk we face from regulators, we need a new measurement of systemic and portfolio risk that might be called Vanity-at-Risk, or **VaR**.

So, we are doomed to repeat history, in a new and exaggerated guise – high growth followed by collapse and a long period of lower growth, while politicians compete to accelerate growth, at the cost of inflation. Current efforts to boost domestic demand may improve **Asia's** consumption picture eventually, but there will be no about-face on the export-led development strategy. All that the politicians, investors, their financial advisors and regulators can do now is to deny the unfolding consequences. They also seem to be denying themselves the imagination to see in what direction their previous and current steps are taking them. This is typical of the elite, both political and commercial, after a long period of incumbency. It underlines the importance of vigorous and persistent debate over the intellectual fashions of the day. Contrary to what a pollyanna might argue, it is not "truth" but the breadth and durability of utility that matters.

[1] Robert Browning

In this issue:

Risks of Asian vanity

Mostly, Asian regulators have been cautious. Foreign brokers and bankers often chided them as timid, but caution has paid off in some ways. The best example is the use of limited experiments in China. This has allowed ill-conceived ideas to be terminated with limited damage and lessons to be applied to other trials. The worst example is the chest-thumping of the **Korean FSC** in its rush to create yet another financial hub in Asia. A worthy goal, if carried out in a measured fashion. Yet, these were the same fearless and far-sighted leaders who decided that consumer credit would be the 3rd-stage growth engine that would lift Korea, rocket-like, from the last vestiges of the last financial crisis aftermath. Two years of decline followed that nation-wide experiment. By hamstringing banks in competition for domestic deposits but not allowing their funding costs to rise, they now have created a currency crisis on their banks' balance sheets. Repair and confidence restoration may take a year or more. Proper re-regulation could take longer – a huge amount of VaR.

Korean regulators were not the only ones who thought they had no vanity at risk. Since the **PRC** financial agencies have successfully forced growth through rising levels of directed (by NDRC, among others) fixed-asset investment, they forgot that their past efforts at export penetration had reached over 40% of GDP, a large amount of VaR and not uniquely Chinese. Somehow, they still think they can engineer a surge in domestic demand that will offset the collapse overseas. They forgot that most of the value added in Chinese exports is labor intensive, i.e. potentially labor destructive when the economy slows down.

Their attempt to go back after 25 years and enrich the farmer, the most populous and lowest consumer, is about a year too late – and only half-hearted at that. The growth dynamo will rev up again by next year (at a lower rate than before), but the CBRC should take advantage of this opportunity to finish the balance-sheet clean-up of its banks. It should accelerate the elimination of all their unaccounted-for non-performing loans and leave the Agricultural Bank and Development Bank as the "bad banks" they have always been, repositories of policy loans. (More on this on page 10)

The return of the Kuomintang (KMT) to power in **Taiwan** presents a wholly new test of an escape from the vanity that Chen Sui-Bian's presidency had descended into. As yet, it is hard to know whether the KMT and their cross-straits counterparts in the CCP are building the bright new future or more room for sibling rivalry. How far will the CCP go in wooing Taiwan into the fold? What will be the net transfer of funds and opportunity to the island state over the next five years, as the dowry? Will this make it a competitor to Hong Kong as a point of access to China, or a newly reliable partner? Will some political rapprochement with the CCP reverse recent militarist trends, or even dampen mainland irredentism? How long before the KMT's history of corruption comes back to haunt it? Certainly, in the short term, we can expect benefits unrelated to commercial merit to flow eastward across the straits – and a corresponding flow of even more Taiwanese in the opposite direction. Go West, young man.

The risk of a single tent pole is even more evident in **Thai** politics today. The VaR of the political and commercial elite in Bangkok is high and rising. Awareness of the approaching succession to the throne has been rising, raising with it the need for the elite in the metropolitan center to assert their political control. The rise of the middle class, both rural and those in the peripheral cities, has been a steady challenge to the political center over the last two decades and has encouraged many of the improvements in metropolitan life, in response. The current battle between two proxy forces for control of the political center is further proof of the risk of relying upon a single force, base or product as the basis of one's claim to power. As a result, the Thai discount is likely to continue in the domestic equity and G3 debt markets for several years, long after the return of earnings growth has pushed the SET back above 600 points again.

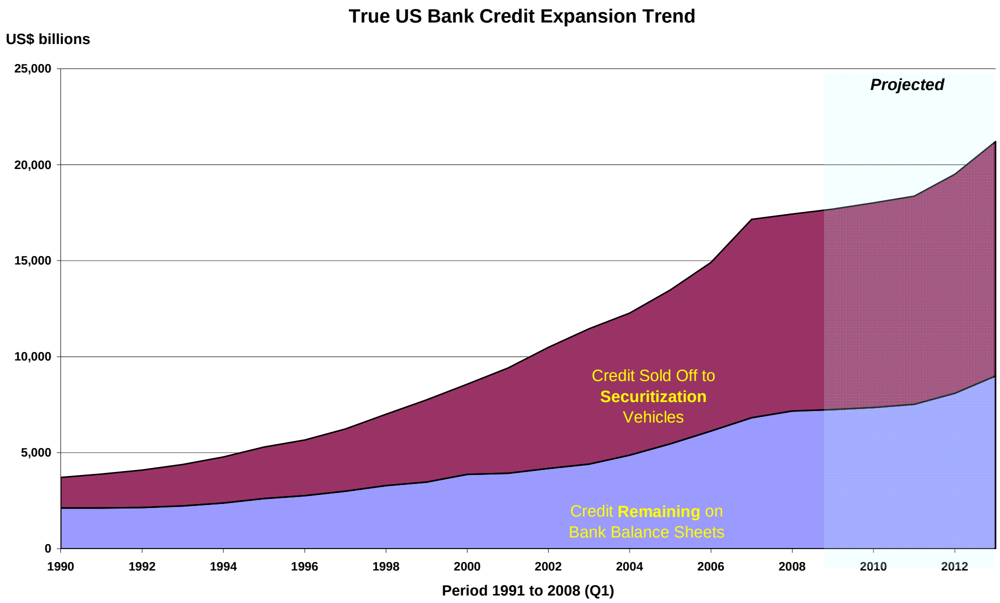
Malaysia suffers not only the problems of a hegemonic political party under attack but also the temporary mishap of being a commodity exporter. The electronics sector has been giving it a whipping for the last year too. The effort of the last five years to reduce its fiscal deficit has been praiseworthy but is now going in reverse. In addition to the common global need to prime domestic demand, there is also UMNO's, the ruling party's, need to hold the flock together against a rising opposition. UMNO's inability to root out its high level of corruption – a symptom of VaR if nothing else – has been the fuel for Anwar Ibrahim's return to political office and his current challenge. Based on past experience, this could soon become a bloody battle that will further dent Malaysia's credibility with investors, in spite of its many competent civil service technocrats and companies.

Japan's politics of paralysis, in spite of improvements among local regulators, will hold the market back for another year, at least until after the lower-house election, within the next six months. Even these regulators are divided on the cost versus the benefit to future generations of boosting public-sector demand today. Likewise, the fear of change struggles with the gradual-but-steady erosion of trust in the LDP within the hearts of Japanese voters. This depressing state, not the apparent stoicism of the public, is one reason why consumers have withdrawn from the stores and the market at home so quickly. The struggle between the preening Ozawa of the DPJ and the fearful but proud grandees of the LDP could drag on for years to a pyrrhic victory, the right to govern a further weakened economy.

Another threat to consumption in Japan is the huge decline in job security over the past decade, as part of the country's corporate "re-engineering". But it will make the uptake in employment faster, once consumption begins to rise again. And the last straw is the continued high share of mortgage payments within disposable income. This high household operating leverage has made savings once again a priority and driven consumers from the stores. Could things get any worse? Is all the bad news priced into the market? It depends on which segment.

Banking on the new world order

Given the disjointed domestic regulatory system in most countries and the lack of real coordination among countries outside the EU, the current rapid descent into recession may push politicians into setting up coordination talks. But as five years of meetings among the financial ministries of the ASEAN+3 countries have shown, the politics of local development will trump even the most-widely agreed blueprint for reform. The proclamation of a new financial world order that the British premier waves around like a Japanese tour-group flag may be momentarily inspiring, especially to his cabinet, but it will be trumped by populism. Only if global growth sinks into double-digit contraction (we give that about a 40% chance, today) will things become so bad that local political self-interest might be overcome to forge a "new Bretton Woods".



Sources: Federal Reserve Bank, other national & commercial agencies

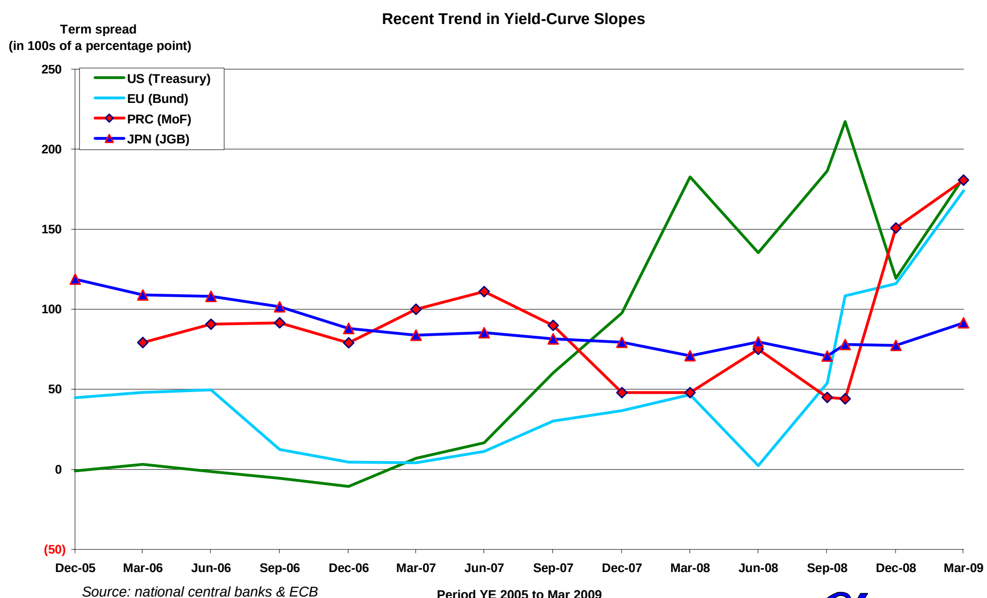
The more likely scenario continues to be the muffled thud, followed by the dead-cat bounce and several years of false springs. The money being poured into the banking and capital markets to jump-start the credit system may help form a premature bottom and put an end to the outright panic that rules the mob in the streets today. But the ratio of disposable income (adjusted for uncertainty) to debt-service obligations and lifestyle-maintenance goals will still be less than 1.0 – without yesterday's cheap credit to fund the gap. Many factories in Asia and Eastern Europe, built based on 2003-2007 rates of global demand growth, will likewise have to be shutdown; otherwise, we shall have to swim upstream against a global deflation that can no longer be localized to just China and its supply chain.

In other words, even **IF** all the trillions of dollars of bad assets can be warehoused for auction later on through a 21st-century Resolution Trust, the "new normal" level of demand growth will be hampered by the return to a more traditional, 1980s-like credit expansion. Over a 15-year period, US bank-generated credit to households and business expanded at an average rate of 11% per year, by shoving more than half of that new credit off the regulated balance sheet. But we may even see a 1970s-like credit contraction in 2010, once the stronger banks are free from government coercion. Thus, the engine of growth, private credit creation, will not be able to run at anything like the high rates of growth seen over the period of the global dotcom and housing bubbles. A substantial piece of the manufacturing capacity and service labor supplied to feed that abnormal demand growth must be idled, or we shall suffer significant deflation. Both options will further damage consumption, i.e. either through unemployment and bankruptcy or threat of debtor's jail.

More US political risk

Public-sector credit creation, the temporary alternative, is not triggering the needed consumption growth because households and businesses are terrified of the payback for the long party. The anger of the rabble today is proportionate to their sudden need to save and repay debts they were encouraged to think would never come due. If the US and European regulators opt for a Japanese-like policy of full repayment on consumer loans (rather than forcing the lenders to share half the responsibility for stupid behavior), this new religion of saving will cap world growth for years.

Unfortunately, rewarding bad behavior – all



Source: national central banks & ECB

around – and inflating away the cost of adjustment is the only way to square this circle. The steepening of yield curves shown above suggests the bond markets have reached a similar conclusion. Otherwise, years of very low growth and social conflict lie ahead. The politicians will be punished in either case. Somehow, they have not realized this yet. Thus, they will miss the opportunity for meaningful collaboration this spring, opting for the same empty rhetoric spent on the Environment and Trade so far.

Opportunity cost for Asia

The export-led growth model for economic development should come in for serious re-examination in Asia, given how complicit it was in the excessive credit-led consumption growth in rich countries. It is certainly taking its lumps now, but it is not clear whether more than a few governments will seek a sustained rebalancing of domestic and foreign demand for GDP. A significant amount of exports were part of improved trade integration in Asia, a process with many long-term benefits. But how dependent these exports were on rich-world demand can be seen in the trend lines since September 2008, down 20-50%. An OECD-wide collapse in demand may not happen again for many more decades, but for Asia's governments to pursue policies that explicitly encourage under-consumption is just as distorting and risky as the opposite policy (aka "the Philippine plan"). Taxing consumption, subsidizing investment and forcing all of the retirement-savings burden onto the individual are common methods which need moderation throughout Asia.

Without some change in this post-colonial development model, Asia's ability to deliver reliable earnings growth (versus the usual higher-but-highly-volatile kind) will remain illusory. Together with the closely related top-down, bank-driven development finance model, this will continue to penalize local small entrepreneurs to the benefit of large-scale, politically connected manufacturers, who prefer the export-led approach. In other words, this Atlantic-born crisis could provide the stimulus for a Pacific-wide adjustment in public policy toward more protection for the consumer, the household's welfare, rather than only the large-scale producer. Such a reform in thinking would lead to greater diversity for domestic and foreign investors and a better match between mobilized savings and social investment. But this challenge is not on the West's agenda. It will only be tackled if pushed by Asian-based politicians, business managers and investors, i.e. by people like the subscribers to this letter, Asian Values.

Country Coverage

Taiwan Redux

– The island state seeks its future in a larger confederation, but which one? –

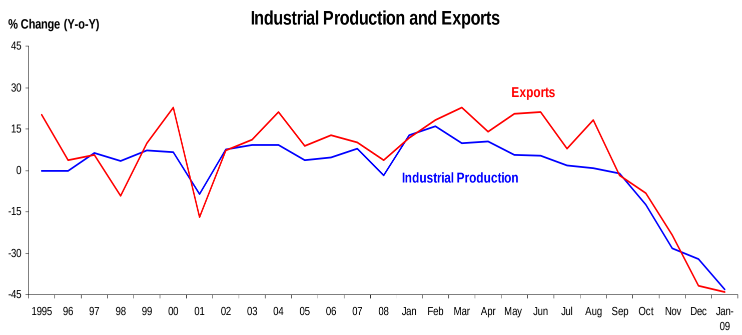
Changes ahead for Taiwan

- Severe economic down turn for 2008-2010
  - real GDP contracting 5-10%
  - cost of equity running 11-18%
- Increasing commercial links with PRC – entanglement or opportunity?
- Reforming its banks by sending them to a confused environment
- Moving semiconductors beyond the global-commodity position – What is next?
- What if the Island of Engineers were able to open its capital A/C to reach its potential – exposed?

A weak opening act

Taiwan, one of Asia's tigers and still the PRC's biggest consumer-goods middleman with the rest of the world, is now in very big trouble. Its exports, which are the main driver of GDP growth, have rapidly declined by over 40% in the year to 1Q09.

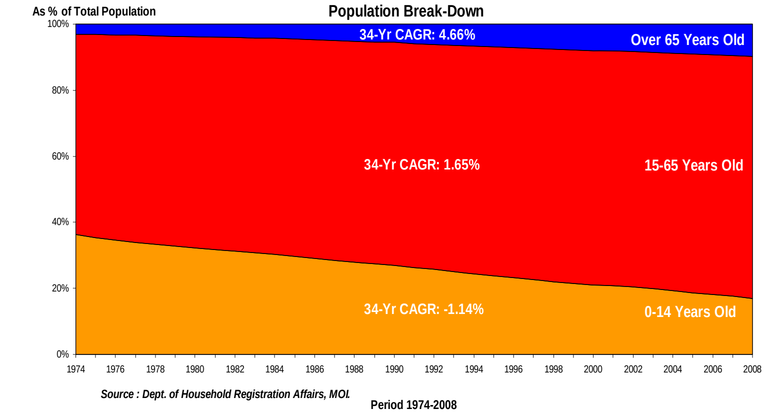
The country's think tanks are currently predicting



Source: Department of Statistics, MOF and MOEA **Period 1995- Jan. 2009**

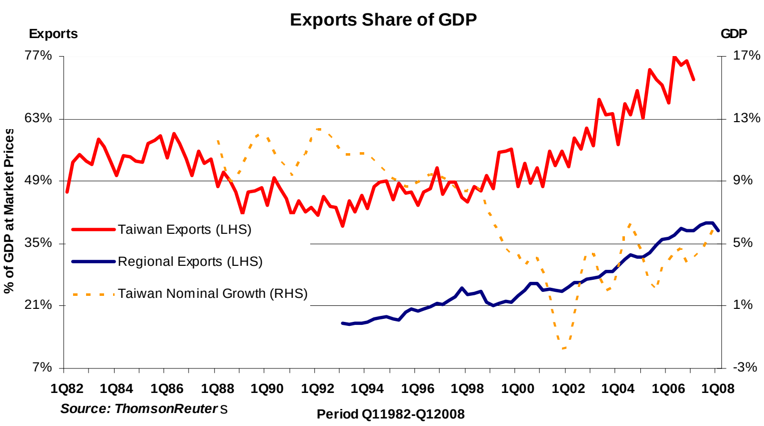
a 3% contraction for this year while foreign analysts predict a much harsher economic decline: Goldman Sachs at –6.5%, UBS at –6%, HSBC at –5%, Economist Intelligent Unit at –9%, and CLSA at –11%. This is mainly due to the fact that the country's electronics exports have been in rapid decline on account of the on-going global economic crisis and a previous excess manufacturing capacity. The government is in the midst of an effort to force some consolidation in this sector, as the price for financing its "retooling."

The majority of Taiwan's population is in the 15-65 age bracket. This means that most of the population still belongs to the country's workforce. However, as unemployment levels continue to rise, the government will be forced to re-think its economic stimulus plan and adopt more dramatic measures, clearly deciding



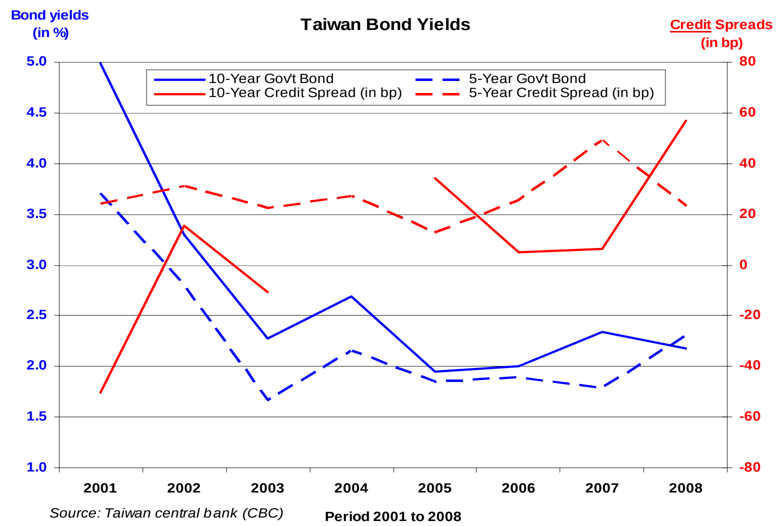
whether they want GDP growth to be more domestically, or PRC-driven in the coming years. Current levels of exports to GDP (over 70% of a decelerating nominal growth trend) have fuelled a higher rate of GDP growth than the island's 22 million inhabitants could have produced alone, but it has exposed them to more external volatility. Will focusing more on PRC investments and consumers improve the growth and stability prospects, or will increasing the range of countries for which it serves as the design & production middleman to the PRC do so better?

The Kuomintang or Nationalist Party (KMT) has returned to power after eight years in opposition. They claimed victory both in the presidential and parliamentary elections in early 2008. Part of the KMT platform is to foster economic ties with



China. They have since signed four agreements covering cross-straits air and sea transport, postal services, and food safety. Negotiations in 2009 will cover financial sector cooperation as Taiwan aims for 12 Taiwanese banks to open operations in the PRC in 2009. Beijing has even allocated US$19 billion in financing for Taiwanese companies based in China over the next 2-3 years. China is also encouraging Taiwanese farms to increase their sale of agricultural products to the mainland. The immediate challenge is to fill the demand shortfall that a 59% decline in exports to the PRC has caused. (Japan & Korea suffer a similar plight.) Beyond that, these and other mutual efforts to improve relations through economic cooperation have less than three years for a vote of confidence, when Taiwan holds its next national elections in 2012.

The country currently has foreign currency sovereign ratings of AA/stable outlook (S & P), Aa3/stable (Moody's), and A+/stable outlook (Fitch). But because the capital account is tightly managed and currency hedging is effected primarily through non-deliverable forward contracts, the country's credit rating is not consistently reflected in the NT dollar bond yields. This may be seen in the consistent flatness of the term spread (10-year less 5-year



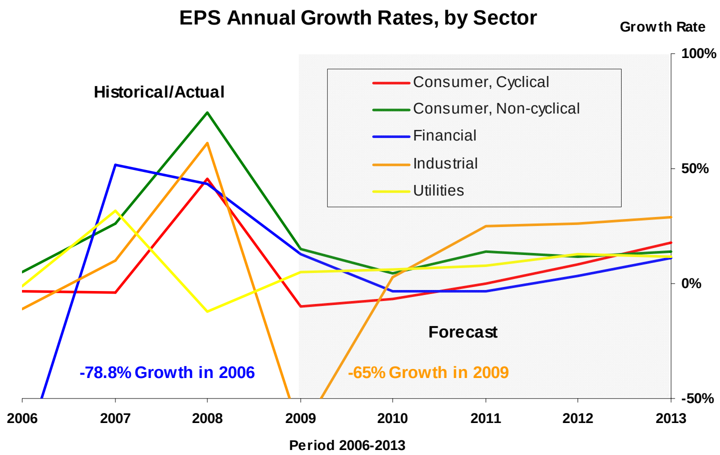
yields) and the highly stable medium-term credit spread, over the last eight years. Separately, Transparency International in its 2008 Corruptions Perception Index ranks Taiwan at 39th least corrupt in the world and 4th least

Industry	5-Yr Avg ROE	5-Yr Avg ROA	Weight in Mkt Cap
Basic Materials	6.4	4.2	12%
Communications	-4.0	0.4	8.6%
Consumer, Cyclical	4.4	3.2	6.8%
Consumer, Non-cyclical	3.7	2.8	2.5%
Diversified	-14.8	-9.1	> 1%
Financial	1.9	1.4	15%
Industrial	4.3	3.0	21%
Technology	2.8	2.5	28%
Utilities	7.2	4.4	> 1%

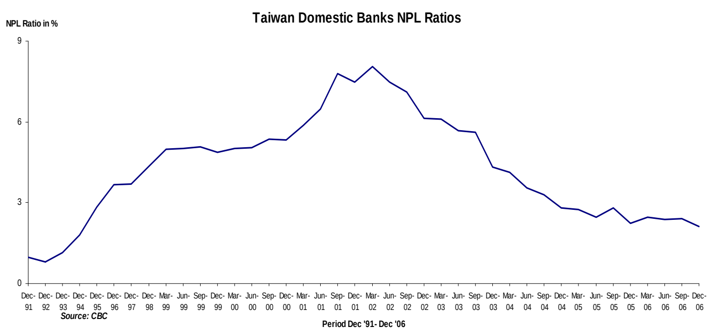
Source: Bloomberg LP-raw data; EAAL-adjustments

corrupt in Asia.

This table shows the past five-year average return on **equity** and on **assets** for Taiwan's industries. The subsequent chart compares their historical and prospective earnings per share growth. Among the different industries, the basic materials sector may benefit most during this recession from government plans to prime the economy with a range of large infrastructure projects.[2]



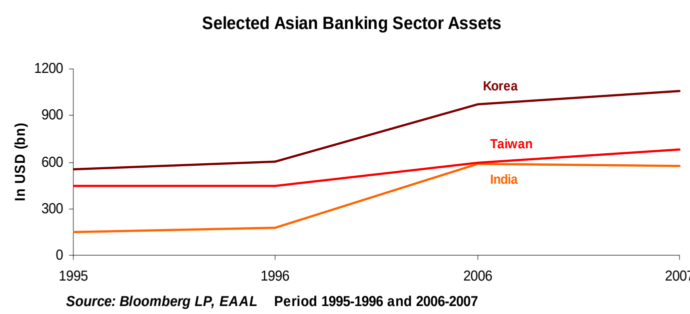
On the other hand, improving ties with the PRC may open opportunities for the financial sector, one of the three largest in Taiwan and famously resistant to reform efforts. It is one of the top foreign direct investors in China but its banks are currently not allowed to open branches in the mainland to serve either Taiwanese or Chinese companies. Government is now looking at some partly state-owned banks like Chang Hwa (2908.TW) to spur a second wave of consolidation in the financial sector and improve current conditions. This could be a chance to improve the quality of bank supervision as the window that is beginning to open in the PRC brings both greater opportunities and risks.



Sentiment in the industrial and technology sectors has been more upbeat recently, based on the PRC government's initiatives to boost domestic demand. Yet the voucher-based system for computers and household appliances may not support demand long or high enough to sustain the sector through the crisis. At 5-25% of the annual PRC market, the new-demand estimates as results from this stimulus hint at how much of this may be just PR "spin". There is even speculation that part of the recent increase in demand is only an inventory correction at the end of a destocking process started in the PRC early last summer.

At the same time Taiwan's government is in the middle of efforts to restructure its semiconductor sector. Since this would be in competition with the giant Korean firms in this sector that also manufacture in China, it requires some diplomatic caution. The initial plan to consolidate six firms into a holding company under a government restructuring grant and technical-assistance agreements from Japanese and US firms was still being renegotiated in late March.

As a new global economic bottom may be lengthening rather than passing behind us, Taiwan's government needs to improve investment conditions in order to attract investments. Thus far, the tax structure on fixed income products, for example, has improved somewhat: individuals and mutual funds are taxed 10% of interest income, but



corporations are still taxed at 25%. The Asset Securitization Law (2002) also widened investment choices; so, securitized instruments face a withholding tax rate of only 6%, compared with 20% for other investment income. The government has also removed all limits on securities investment trust funds investing in China-listed stocks, so long as the total invested amount is limited to 10% of net assets; the previous limit was 0.4%.

As Taiwan tries to adapt and balance its domestic and external demand, it is worth noting that recovery may not be in sight yet, even in the next year. Yet, Taiwan's regulators are still trying to show a picture of assertive response to market needs. They have gone so far as censoring negative remarks made on its markets, which leaves us to think that current prices may still not reflect the real EPS-growth outlook. A further problem is that by the time the economy recovers, the next dilemma could

[2] I-Taiwan ,12 Projects (see the Council for Economic Planning & Development's development & policy sections)

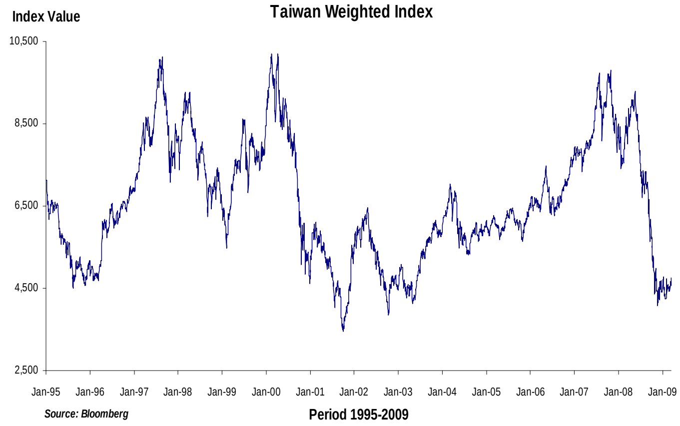
be the risks to policy continuity beyond the 2012 elections.

As rapprochement with China continues, Taiwan should enjoy improved growth prospects, if the government chooses to take the risk of increased dependence on China-based demand. The island's medium- to long-term growth may continue to be in competition more with Korea, which is concentrated on technology, shipbuilding and petrochemicals, than with Hong Kong, which is geared toward the financial sector. More importantly, Taiwan's technological competence complements, rather than competes with China's.

Institute	Technological Goal	Major Accomplishment
Academia Sinica	Conduct research in mathematics, physical and life sciences, and humanities and social sciences	Pushed for international collaboration in various fields; pioneered Chinese-language computer dictation system
Institute for Information Industry	Develop the information technology infrastructure and industry	Instrumental in initial digitalization of government and industry; aided the government's push to develop the digital content industry
Industrial Technology Research Institute	Support businesses in a wide variety of areas to develop products and manufacturing techniques	Oversaw the rise of the integrated circuit industry; involved in optoelectronics
National Applied Research Laboratories	Pioneer work in nanotechnology & IT	Launched satellites FORMOSAT-2 and FORMOSAT-3; developed earthquake-damage assessment system
National Synchroton Radiation Research Center	Operate synchrotron radiation facility	Provided beamlines to researchers in many fields

And while the tourism, financial, and technology industries may be tempting for investors looking to take advantage of investing early, it may take four years before the world economy stabilizes at a new normal rate of growth.

So, where will current policies and crisis reactions lead Taiwan five years from now? Will it find the confidence to further open its capital account and integrate itself more closely into a Greater China Confederation, or will fears of Communist Party irredentism continue to limit its policy options? In the former case, exports to the PRC for final consumption and related FDI could expand substantially within five years. Marine and inter-modal connections to the PRC should grow briskly in either case, causing some slackening of demand for Hong Kong's ports.



The Taiwan Weighted Index has recently been at levels last seen in the aftermath of the dotcom bubble's burst. The current bust has hit the high-fixed-cost large-scale industries of the island at the same time the usual 3-to-4-year cycle did, compounding the damage. It may be too early to write off the technology sector, just as it may be too early to bet on the KMT's success in finding the balance between risk and greater success with China or in shaking off the residual of its legacy of corruption. In both cases, one is likely to be mistaken in thinking the "beautiful island" will just muddle through the current mess. It will gain even more than the PRC from greater engagement with the rest of the world.

Industry Insight - Resources

Resourcefulness is not enough

– Operators seem once again complacent about future commodity prices –

Overview of the region

As the growth momentum lifted most Asian shares to their recent peaks in October 2007, the prices of Resource shares moved even higher above their long-term mean trend. The hyper-rapid expansion of global demand, especially that channeled through the Chinese export machine during the 2003-2007 period, ignited significant inflation in the prices of most basic commodities. For most of these goods, the market value is now at less than half that peak. Just as a credit bubble drove demand above mean trend, its correction in the form of a vicious and (in our expectation) long recession, is driving commodity prices back below mean trend. This macro view is consistent with that in the best-run resource firms, but seems to have surprised most of their shareholders. What, then, can we expect next?

There are a number of assumptions to address in answering that question. Are Asia's local firms organized and managed in a way that can cope with global demand and supply trends? How does this vary across sector and national market? How are inter-Asian financing practices affecting the pricing of these securities? How much does all this matter to Asians and the world?

There is much variety in the Resource sector. It ranges from Energy resources, which dominate the sales and market capitalization figures, to less visible Minerals that support construction and metallurgy, including a small gold segment. While the largest individual firms produce **oil & gas** (with USD**69 bn** in market value[3] attributable to oil exploration & extraction), Asian **coal** resources, 96% concentrated in China, have a larger value (worth USD**84 bn**). The higher fixed cost required to locate, extract and process oil & gas – compared to coal – means the industry is prone to vertical integration and a large scale per company.

This variety is also partly a matter of endowment; China is the largest owner, producer and consumer of coal in the world. But it is also in the nature of the business and its accessibility in Asia. The coal business is much less capital-intensive than oil in Asia and considerably less so than the Australian coal business has become, even though open-pit mines are common in Australia, China and Indonesia. Even the high percentage of deep-shaft mines in China has attracted relatively limited capital investment to date, a factor in their high labor-mortality rate. This leads to localized companies that can connect to a central rail network for delivery of the end product. By contrast much of Asia's recent oil is deep-marine based and requires a substantial amount of foreign technology in the early stages of its development.

Putting recent trends in perspective

Considering the level of global demand volatility over the past three years, the amount of valuation volatility that has resulted should not be surprising. The value of energy- and metals-development firms soared 1-½ to 4 times as much as the national index in which they reside during 2007. Ironically the **coal** segment has proven to be 50% more volatile than the **oil & gas** segment. Our sample of 21 coal and 8 metal-mining firms tended to have higher financial leverage (averaging 25% more) than the 13 oil & gas exploration firms reviewed. So, a slightly higher debt ratio may contribute (consistent with theory, at least) to volatility in price.

Company	Market Capital'n ($mn) Total	Attrib. Float	Reported RoA	RoTE
China Shenhua Energy	64,570	44,100	12%	19%
China Coal Energy	17,100	11,729	11%	12%
Yanzhou Coal Mining	7,822	7,720	13%	16%
ShanXi Lu'An Enviro'l Energy	4,860	1,540	19%	47%
PingdingShan Tianan	3,560	636	11%	20%
Inner Mongolia Yitai	3,370	3,161	24%	49%
SDIC Xinji	3,350	382	9%	23%
ShanXi GuoYang New Energy	2,880	2,765	8%	18%
Datong Coal Industry	2,600	1,022	7%	13%
ShanXi Lanhua Sci-Tech Venture	2,100	1,147	19%	46%
Kailuan Energy	1,940	1,036	10%	22%
Shanghai Datun Energy	1,660	332	17%	27%
Guizhou Panjia	1,620	721	5%	7%
Hindalco	1,600	1,196	4%	53%
Sesa Goa	1,612	627	59%	53%
MMTC Inc	15,590	73	3%	22%
National Mineral Development	13,260	214	42%	38%
Adaro Energy	2,376	473	4%	11%
International Nickel	1,790	229	56%	86%
Tambang Batubara	1,317	461	34%	53%
Bumi Resources	1,312	1,312	19%	100%
Indo Tambangraya	934	244	27%	39%
Aneka Tambang	907	317	13%	17%
Indika Energy	669	144	19%	25%
Timah Tbk	453	143	25%	43%
Nippon Mining & Japan Energy	3,658	705	5%	15%
Philex Mining	453	218	58%	60%
Straits Asia Resources	575	263	16%	38%
Banpu Public Co Ltd	1,614	696	13%	24%
Total Regional - Mining	**165,553**	**83,608**		
PetroChina	294,120	32,346	11%	15%
China Petrol'm & Chem (SinoPec)	105,850	1,852	4%	9%
CNOOC LTD	44,095	12,883	23%	30%
CNPC Hong Kong	1,872	812	28%	34%
Oil & Natural Gas	32,735	5,162	17%	27%
Cairn India	6,763	1,533	0%	0%
Medco Energi Int'l	619	87	17%	45%
INPEX	17,170	5,943	11%	16%
Nippon Oil	7,210	208	4%	12%
Nippon Mining & Japan Energy	3,658	2,016	5%	15%
Japan Petroleum Exploration	2,380	975	3%	5%
SK energy	6,630	55	4%	13%
PTT Exploration & Prod'n	8,885	5,331	19%	35%
Total Regional - Oil & Gas	**531,987**	**69,203**		

Perhaps the more important question for investors now is: how much confusion has this brought to exploration planning recently. A major factor in the commodity-price surge of 2006-07 was the absence of asset development over the previous decade, blamed by producers on the low consumer price of their end product. But for many global firms' directors, there was a strong incentive to use extra cash for share buy-backs rather than investing in reserve discovery, too. The shock of commodity inflation overrode that temptation starting in 2006, but many firms have again put exploration and development on

[3] These values reflect the free float of these listed companies and the proportion of sales attributable to exploration, extraction and production of these resources. Downstream revenues are excluded in this study, e.g. refinement and delivery are treated as separate businesses, as is refining and feedstock production. We have excluded most firms with a market capitalization of less than USD500 mn as of the end of Mar09; they constitute less than 5% of total.

the shelf because of the combination of a cash squeeze and lower prices.

Outside the real world, financial analysts have also been affected by the on-set of a global recession. Analyst headcount has been cut throughout the sell-side community and in some of the buy-side too. The Energy segment has more priority than, say, other Mining issues, but analyst coverage is decidedly lower in Asia, where it makes up less than 15% of the listed market's capitalization. With thinner coverage comes more variability in the valuation of cash-flows. Rising yield-curve volatility further complicates that process. Other complications creep in when comparing valuations of Shanghai A-shares with those listed in Hong Kong for the same firm. A-share premiums over 50% or discounts of 20% are common.

Outliers – Dogs or opportunities?

Over the past four years, when the analyst population was larger than today and champagne flowed freely at Asia's brokerage dinners, a significant amount of price variability has still been attributable to market mood swings rather than actual cashflow growth. This, in turn, has varied across market and product segment, as one would expect. Within the massive China **coal** sector 1/3 – 3/4 of price rises were attributable to investor expectations, rather than changes in operations; while, at least 3/4 of price declines came from expectations – perhaps a presaging of operations-induced declines ahead. This period corresponded with a marked increase in news about coal-mine accidents in China, as demand soared. So, the increased public accountability has been a factor in marking down book value over the last few years, but this asymmetry is significant. And it is strongest in the largest stocks, rather than the less liquid ones – suggesting a strong fidgety-foreigner effect, as is common across Asia.

This moodiness is common in the **coal** sector of India, Indonesia, Singapore and Thailand but stronger. Its asymmetry in rising versus falling markets, though, is almost identical. The metals-mining sector shows a similar level of excitability and – considerably more asymmetry (almost 1:3) in the Philippines. The availability of liquid futures contracts for these, as opposed to the less-liquid coal-hedging market, seems to make no difference. Political risk perceptions are higher (for Indonesia and the Philippines) too.

Hedging markets may not be a significant factor even for the large **oil & gas** sector of China, which shows an even lower level of price appreciation due to expectations rather than published reality (less than 1/3, on average). And there is a greater degree of asymmetry on the way back down (1:4 ratio). Here, however, the size of the free float is consistent with this variability – greater moodiness occurring in the less liquid issues. A similar pattern appeared in India, Japan and Thailand. In both these latter markets the asymmetry was a bit smaller, down to 1:3 in Thailand, where the pricing was decidedly less moody (averaging 1/3 above cashflow growth realized). But Japan's firms showed a higher degree of excitability for larger, more liquid issues with substantial institutional investor stakes than for those with smaller floats. But, then, Japan's reputation for confusing foreigners is better established than China's, and quite different in style.

One may argue that investors apply a discount rate to cashflows based on a range of relevant factors, but the discount implied by the pricing reviewed here is applied inconsistently. Analysts' opinions count for a lot where institutional investor stakes are high. The correlation of price corrections over the last year with weak or negative reviews by analysts is high (87%) for the **coal** sector, especially where the coverage is substantial (over 20). The willingness of such investors to delegate their analysis to the sell-side is well established, universally. Unfortunately, the performance of neither the analyst majority nor the stocks has been consistent with the evolving profitability trend over the last year. In that regard, stock selection appears to have been almost indiscriminate – not simply negative, just devoid of relationship to return trends or underlying business risk. The kindest explanation is the rapid decline in the analyst population over this period.

Likely changes ahead – implications

Our opinion remains that global demand will remain subdued for several more years, with many signs of spring followed by a late frost. Extra fuel in the bunker appears a better coping strategy than stocking up the F&B larder for this year.

The high cyclicality of all three segments of the Resources sector, amplified by coverage trends and institutional investor mood swings, make them a good means of gaining exposure to the demographic trends of the region. But the problem for many of the sub-segments is that the downside is not symmetrical with the upside, implying a risky snack – hardly a free lunch and generally less so for Chinese **coal** (less than 1:2 for all but the most heavily covered names). Although, the beta for the whole sector is higher than 1.2 and can reach 1.8, so the snack is definitely not free.

China Banks as Regional Tent Pole

– Internal PRC conflicts of interest still put the whole tent at risk –

Global dilemma

China has grown from the competitor other Asian exporters feared to a major export destination, both for re-exports to foreign consumers and for final consumption. Even as China's factories became more dependent on foreign demand (peaking at 42% of GDP in 2Q08), the rest of the world became more dependent upon China. This has been particularly true of other North Asian markets, for whom it had become the largest export market. For example, China's ability to start building factories, roads and pipelines again will be a big factor in the future earnings growth of many Japanese companies. Now that the US consumer is down for the count, that great supporter of global output over the last five years has passed the role of global economic tent pole to China. Will the PRC be able to keep the tent up? Is it willing to?

Expectations have been unjustifiably high for the China growth story over the last decade – partly a result of the PRC's own very effective financial PR. Politically directed bank lending has long been a major component of that high growth rate and a source of its high ratio of non-performing loans. The bank regulators are midway in the transformation of PRC banks from ATMs for politicians to effective intermediators of savings. The shift of labor from SOE under-employment to more productive work is also only at its midpoint – just when the US market has triggered a global demand shock. Now, much of the PRC's calculus of social and market transformation is at risk, and with it the pathway of global recovery.

Evolutionary detour

Twenty years ago China's banks were little more than arms of the national treasury, responsible for doling out cash as needed to keep the SOEs operating and the masses employed. Even then, in the late 1980s they were discovering the thrill of real-estate lending and their senior managers were learning what Deng meant when he said that to become rich is glorious. Since then the banks have gone through several transformations – and still have a few more to realize – on the way to becoming effective intermediators of credit.

So long as the banks were state entities, their line of duty was clear. However, the central bank (the People's Bank of China, or PBoC) began driving the banks toward a new role: as rational allocators of capital based on measurable credit risk, i.e. modern banks. This was part of the State Council's grand design to improve economic efficiency and system-wide productivity, as a means of lifting much of the population out of poverty. This grand social transformation has continued as the Chinese Communist Party's *raison d'etre* since the days of Deng Xiao Ping, but it is a highly ambitious one because of its rapid pace.

Old habits die hard – and so do the relatively new ones, such as making loans that are favorable to the politicians involved (since the mid-80s). Since the China Banking Regulatory Commission (CBRC) was formed in 2003 out of the PBOC's bank-supervision functions, it has worked hard to inculcate credit-based lending into the "big four" banks (all of which are listed abroad now), as well as the smaller city commercial banks and even some of the thousands of credit cooperatives and rural banks.

While credit analysis takes time to train in, the biggest challenge has proven to be helping banks "just say no" to local politicians with great project-lending ideas. But since virtually all lending is still (officially) based on collateral and the local politicians usually control access to property, politically directed lending is a hard habit for banks to break. Those loans have also proven the ones with the highest delinquency rates, especially once the economy slows down a tad.

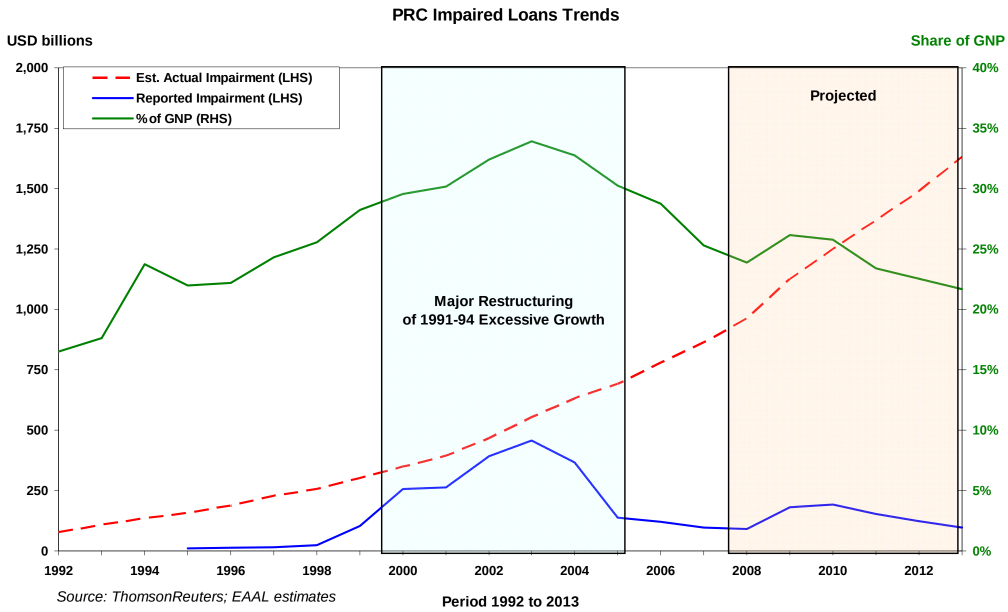
Part of this shifting of roles into the modern banking world involved updating the loan classification system and helping bankers document loans properly – so that the loan covenants could be enforced later, if necessary. So, the traditional four-class system was adapted to the internationally common five-class system. This slight increase in the intervals of measurement was meant to improve the early warning system. It probably has, along with all the training that the CBRC has sponsored. Unfortunately, the new system has not acquired a time-linked element that is common other national banking systems. While the CBRC inspectors have probably trained bankers in the value of keeping a calendar of 30-, 60- and 90-day delinquencies, they and the bankers are not required to report them officially, nor to use them in classifying loans. Naturally, this allows great flexibility in classifying loans due for provisioning or a write-down. The absence of a mechanical grading tool tends to reduce the volume of loans reported as doubtful or bad and relies heavily on the practice of on-balance-sheet work-outs.

The biggest challenge arose when the government decided to use the incentive of listing to motivate the bigger banks toward better lending practice. In addition to further accelerating the pace of lending reform and balance-sheet repair, banks found they had a new duty: to minority shareholders. To avoid manifold misrepresentation during the listing process, the banks had tried dumping their problem loans to clean up their balance sheets. In the first round, the worst assets went into so-called asset management companies (AMCs), but the prices these dud assets fetched as the AMCs tried to sell them were so low (single-digit percentages of face value) that it alarmed everyone. It proved a very public display of how poor the state of Chinese banks were in the 2000-2005 period. (NB: This is the same kind of dilemma the US government faces today with US bank's so-called toxic assets.)

So, as the planned listing dates approached, the selected banks entered into what amounted to an asset swap. They sold their bad assets to a special-purpose state-owned investment fund, at a slight discount to face value, and were required to buy most of the notes it issued to finance those purchases. Voila, bad loans became state-issued notes; a similar effect as if the government had issued a guarantee on the identified assets, since they remained on the lenders' balance sheets. (The US Treasury has taken note of this technique but can not get it past a bolshy Congress, at this writing.) In one straight-forward, quiet (but publicly announced) deal, over 10% of the listing banks balance sheets were scrubbed. Reported problem loans fell from 11% of total loans in 2002 to less than 2% in 2005.

But delinquent-loan production by all banks continued at high (if somewhat lower than previous) rates, because old habits do prove hard to change quickly. So, assuming that banks have improved their ability to discriminate good borrowers from bad ones, to improve their borrowers' behavior and to reduce somewhat the amount of politically directed loans they must accept, the ratio of delinquencies in new loans should have declined some in each of the last three years. But this evolution toward well-functioning banks has not brought the ratio down to single digits on a sustained basis, in our opinion.

The adjacent graph shows how we have modeled non-performing loans (NPLs) against those reported by the largest PRC banks (accounting for 92% of the total national bank balance sheet). The red dotted line shows the magnitude of NPLs in USD billions that would be reported if all PRC banks were required to use international norms in calendarizing their loan classifications and did not resort to the international practice of loan roll-overs and working-capital loans to pay other loans' interest. The green line shows that scale in relation to China's GNP, a bad-but-improving situation. We expect a significant "blip" this year and next, as the volume of politically directed loans soars, but the general trend is one of steady improvement.



Hijacked again

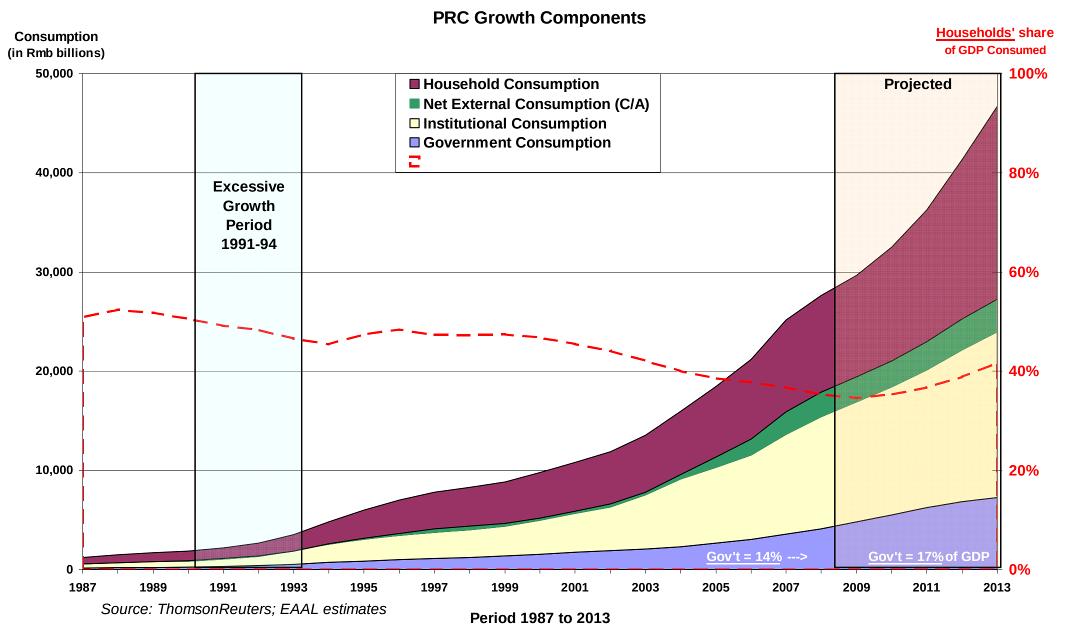
After over five years of hearing the mantra on disciplined lending and non-political loan operations, it must be disheartening to hear from Beijing that it is once again patriotic to lend to anything that moves and twice as much to anything that does not. Spraying liquidity out of a fire hose after several years of PBoC-induced restraint must be fun, but it is sure to get clogged in the gutters and flood far afield of the announced targets. Lending at the rate of $570 bn a quarter is not just three times as much as lent in 1Q08; it is more than lent in a whole year, on average, since 2003. To pretend that such credit expansion is boosting demand and countering the export demand shock is ludicrous, but most analysts seem to be falling for it – because they want it to be true. More "green shoots" theorists….

It would be nice if it were genuine lending, but signs are that much of it is going into the stock market and back into local politicians' "projects". Of course banks would like to lend for working capital and trade finance, capital expansion plans and – best of all – government-guaranteed infrastructure projects. We all are assured that the latter will absorb most of this emergency credit expansion; it will probably begin to do so from some time later this year. Unfortunately, there are not a lot projects that were ready to build at the end of last year and it takes several years for a project to move from concept to clearance to design completion to procurement to the first earth mover. This means that political expediency in China, as in most other countries, will cut corners in the rush to demonstrable spending. To be seen doing something is the primary goal for politicians globally. Why should the Chinese Communist Party be any different?

Does it really matter?

If we were speaking about small sums – the sort that usually gets lost in construction-related graft in most countries each year – this would be just political theatre. But this is a panicked fling at the fire of 12% of GDP in new lending all during the 1Q09. Since the true lending is probably less than half this amount, we may take solace in the thought that 2009 will see only about $150 bn in new NPLs (our estimate, at 25% of new commercial loans this year), rather than three times that many. But this is all about China. The underlying question is: what does this mean for the rest of us in Asia.

Once the additional infrastructure construction (over that already in the current five-year plan) kicks in there may be a boost to machine tool and some engineering service exporters – chiefly Korean and Japanese. The confidence increase that might come from some of this make-work spending might slightly improve the electronics and semiconductor business within China and for factories there capitalized by other North Asians. But the relief for all the Asian exporters to and investors in China probably will have to wait for another year or more.



The real concern is on the downside. The chance that Chinese consumers will not regain confidence readily and will become more cautious and nationalistic is the true danger. While the G20 may have chuffed up the nationalists, the Tiananmen 20 in two months will be another distraction from one's patriotic duty to consume. The urge to complain about growing job uncertainty is the least violent emotion the Migrant 20 million (or whatever the representative number may be) may feel during this slowdown. Big-spending packages are mostly meant for psychological value, since their ability to actually boost economic growth is very limited because of haste and inefficient allocation of capital. If the propaganda works, it will smooth some of the domestic rough ride.

Much of the new lending is supposed to be going into the countryside, through the Agricultural Bank and then through the local cooperative banks. The best thing about that approach is that it will tend to keep the Agricultural Bank what it has always been, a "bad bank," a vehicle for holding dud assets. This may limit the damage to the city development banks and the other big banks. But a much better way to rejuvenate the economy is to replicate Deng's experiment of 25 years ago and raise food prices. To that should be added the reform of giving the farmers true title to their land while encouraging them to incorporate and merge their stakes to achieve significant economies of scale. The combination of these two reforms would trigger serious investment and consumption in the countryside, stem some of the urban migration and give the current returning migrants a stake in their community rather than in getting revenge on the local politicians who rob them. The increased spending power would once again enrich those employed in the cities and the result would probably be a significant rise in domestic consumption, above the projected trend in the adjacent graph. This lessened dependency on export demand to reach the country's growth targets would make that growth more sustainable and the global economy more stable. Yet, it is not likely to happen this round, give the perception of runaway inflation the urban middle class would have – a bridge too far for the Party chiefs at this point.

Opportunities for investors

There will certainly be increased room for international investors to help finance all this shining new infrastructure. Even before Wall Street misused the funds from the big surplus economies, China's infrastructure budget was enormous, accelerating beyond $100 bn a year already. Now, however, the cost of credit has risen above the ridiculously narrow spreads that the "Asian Bid" (much of it recycled China surplus dollars) had produced in 2005-07.

To facilitate the required credit in today's more pragmatic markets, the PRC is actively promoting the creation of a domestic municipal bond market. It is setting up new trust banks to handle the escrow and collateralization. It is inviting foreign-capitalized firms into the domestic OTC bond market and has begun entertaining applications for these same firms to underwrite corporate and project bonds directly. An equity market temporarily closed to IPOs has led to a 60% jump in corporate bond issuance this year, $25 bn in new issues during 1Q09.

Two initial municipal notes have been issued this year, after the securities regulator and the National Development and Reform Commission pushed through a new law authorizing them. They had little to do with infrastructure, but this new market is in its trial stages. As the size of projects for true infrastructure gradually accelerate this year, there will be more variants on this idea, including issues by private concessionaires to build and operate new infrastructure. This will be more than a bonanza for the usual suspects in project finance. China aims to open up the field and expand the range of capital-markets instruments that can be brought to bear in this enormous task.

But the required improvement in design, construction and operations transparency will be a large challenge for the PRC legal and accounting system – as it will be to the usual bank syndicates that manage project financing globally. So, new entrants are even now being sought out, offering a chance for some private equity firms to convert themselves into lower-leveraged mezzanine-credit investors. This will also require deeper political-negotiating skill than many private equity firms have.

For those who missed the first four rounds of Qualified Foreign Institutional Investor applications, the door seems to have swung open again. In January there were ten pending new licenses, of which three were granted in March. These ten represent only about $2.5 bn in new A-share investment, or about 0.18% of market capitalization at end-of-March values. Even if one adjusts for all the state-owned shares, this equates to little over 1% of free float – still a tiny amount. So, the currency watchdog has started putting feelers out for the next round.

More importantly, the securities regulator has put IPOs on the back burner for this year – and probably some of next year too. It has also issued close to a dozen new mutual fund licenses this year and suggests that it will accelerate the pace, to include more equity funds in a field so far dominated by fixed-income funds. These are the forces that have lifted the Shanghai composite 42% above its 4 November low last year. In other words, market inefficiencies abound in the A shares and there is a significant alpha available to be extracted from them, but one must cope with recurring government interference. This rush to draw in new investors raises warning flags, especially of risk in the medium term, with little hope for real earnings growth until 2011. It appears that the government is luring in securities investors to replace the large decline in FDI investors. Value multiples are back at low-ish levels again, but *caveat emptor!*

The Strategy, Countries & Industries in Asia that the next few issues will cover are:

May	Misconceptions about Asia's markets – and Japan's role in them	Philippines	Semiconductors
June	Valuation swings coming soon, to a market near you	Thailand	Marine Transport

Published at the middle of each month. For subscriptions, inquire at:

asian.values@emerging-alpha.com, or +852-2838-7529.