Investing into China, Inc.

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Executive Summary

"The cost of a government having absolute power to push through its policies is immense," according to Rob Gifford.[1] While this claim may be true for the controversial policy issues he cites, such as limiting the number of children its citizens may have or suppressing religious groups, the Communist Party of China's power creates tremendous investment opportunities when exercised in the world's second largest economy. This investment plan seeks to identify Chinese industries that not only suggest strong future growth but also offer avenues to capitalize on the government's power to manipulate competition, provide unfair advantages, and proactively create value. State Owned Enterprises ("SOEs"), domestic industry leaders in government subsidized sectors, as well as the Chinese currency itself all offer instruments to benefit from the power of the Chinese government, or China Inc. $900 million of the $1 billion of U.S. capital will be invested evenly into solar energy, wireless telecommunication, and wastewater management with the remaining $100 million invested into the Renembi. The following sections detail these industries and China's economy, provide risk analysis, and conclude with an action plan to invest the capital.

Economic Opportunities & Risk

It has been over sixty years since the People's Republic of China was founded, and the planned economy was introduced. After its founding, the PRC pursued a massive socialist industrial complex for the next 30 years. Despite the passage of time, the "socialist democracy", as the Chinese refer to their contemporary economy, has a strong legacy from the command economy implemented in the earlier years of the PRC.[2] Barry Naughton calls the strategy implemented during this period the "Big Push industrialization", since it focused intensively on maximizing investment into heavy industry. He too agrees that the command economy virtually shaped every aspect of the contemporary Chinese economy.[3] When the Big Push ended in 1978, it left a legacy of dissatisfaction with the socialist system resulting in an inclination to experiment and revise the economy. Chinese leaders and reformers have since transformed the system which they built during the Big Push to allow for greater flexibility and options as they pursue and currently hold a dominant role in the global economy.[4]

China successfully transformed its economy into a functioning market economy by the mid-1990s. Competitive markets have developed and enterprise ownership has diversified. Formerly close ties between SOEs and the government were severed and more legitimate ownership structures have been put into place. The private sector also became more significant due to its ability to compete with the SOEs being restructured.[5]

As China's economy became more competitive, foreign companies and entities began actively investing into China. The country's entrance into the WTO in 2001 further perpetuated foreign business and dramatically increased its trade deficit. Between 2001 and 2008, its trade surplus tripled, increasing from $80 billion to $263 billion USD.[6] This positive deficit also characterizes China as an exporting nation; however much of China's production is not Chinese owned. In fact, 63% of its exports are owned by foreign joint ventures ("JVs") or wholly-owned foreign enterprises ("WOFEs").[7] This is mainly due to the fact that as the market economy expanded and became more competitive, people were desperate for capital. As Tim Clissold recounts in Mr. China, Pat saw this on his trips to China after which he concluded, "First, that there was an enormous need for money, but no one was really in the market for providing it; second, that the real action was going to take place in China".[8] In addition to a need for capital, multinationals and investors are further enticed to put money into China due to its artificially low exchange-rate.[9]

The heavy industry focus of the planners, as well as China's rapid expansion nurtured many industries and heavily influenced the health of those industries today. China's dominate steel industry is an example of this phenomenon. For the past decade, China's steel industry has grown by more than 10% annually and it currently produces 37.7% of the world's total steel production.[10] Such staggering statistics along with the assumption that China will continue as the fastest growing economy explains why many investors see the Chinese steel industry as an enticing investment opportunity. However, these macro statistics overshadow an industry that is largely inefficient, fragmented, and artificially kept afloat.

80% of Chinese steel produced comes from SOEs, many of which were founded during the planned economy, and are thus still wrestling with many of the inefficiencies associated with that time.[11] Anshan Iron Steel Company, an SOE established in 1948, is one of the largest steel producing companies in China. The company relies on sixty-year-old equipment, using nearly extinct Soviet technology. Additionally, its 110,000 employees are less than 10% efficient as other steel producers' workforces such as Baoshan Steel's 10,000 employees.[12] A truly competitive market would drive such a poorly performing company out of business, but the country's state-owned banks keep Anshan alive for the sake of jobs as well as maintaining production levels.[13]

By contrast, Baoshan, also an SOE, "boasts an efficient workforce and management, and sales of $2.85 billion," says Matt Miller.[14] Despite this company's profitability in the world's largest steel producing economy, this proposal still recommends avoiding the industry because of probable forced consolidation. "The Chinese government is in the process of legislating and implementing consolidation policies in the steel industry both to improve industry strength and to change the focus to higher-grade steel output," claim Beth Doriani and Matt Roskopf.[15] This creates the concern that profitable entities like Baoshan may be forced to absorb failing companies like Aoshan.[16] The government is also under fire from the WTO for manipulating prices and providing unfair advantages to its domestic steel production.[17]

The telecommunications industry has also been affected by the country's entrance into the WTO.[18] Like the steel industry, the Ministry of Industry and Information Technology strictly regulates China's telecom sector.[19] This space is also dominated by large SOEs, however it is much more concentrated than the fragmented steel industry; there are only three major telecom service providers following the "six to three" reform in May 2008.[20]

These three SOEs (China Telecom, China Netcom, and China Mobile) benefit from a consolidated market, government support, and economies of scale. As analyst Lucas McGee points out, "Chinese telecoms benefit from rapidly increasing wireless and broadband usage within China, and the nature of the telecommunications sector protects the incumbent operators from cutthroat competition. As well, the telecoms are available at reasonable valuations, allowing patient, long-term investors to potentially benefit from the long-term rise in telecom usage in China". Since China's mobile penetration at the end of 2009 was only 56%, it can be expected that there will be significant growth in the space; especially when contrasted with 100% penetration in the U.S. and 75 % penetration in developing countries like Mexico.[21] China's telecom industry also benefits from being relatively new, so it was able to skip some earlier development stages and produce at lower prices by relying on already developed technology.[22]

An even newer tech driven industry is China's solar sector. This space is much smaller than both China's steel and telecom industry. Also, the majority of China's solar products are sold outside of the country; 98% of the 2009 photovoltaic ("PV") production was exported.[23] This is a sharp contrast to China's telecom industry which is almost all domestic and China's steel industry in which company's like Baoshan are only exporting 30% of their production.[24] However, the steel industry and solar industry are similar in the sense that both are highly sensitive to specific commodity prices. The price of steel is dictated by the price of alloy, at least in a truly competitive market, and the price of PV products is strongly influenced by polysilicon prices; both alloy and polysilicon are the basic commodities used to manufacture steel and PV products respectively.[25]

PV products, polysilicon, and solar installation are mostly done by self-governed, publicly traded companies like SunTech and GCL Poly. As stated earlier, the majority of these companies' products are exported, but there should be an increasing domestic demand as the Chinese government aims to continue adding to the country's solar capacity. Most recently, China has updated its original 2020 target from 1.8 GW to 20 GW.[26] The Ministry of Finance created programs like the Golden Sun and Solar Roof programs in order to reach this target.

The *CPC Central Committee's Proposal for Formulating the 12th Five-Year Program for China's Economic and Social Development (2011-2015)* document discusses how it wishes to nurture and develop seven new industries, including new and efficient energy, through favorable policy. It also notes the importance of services such as water for economic development.[27] "According to a report released by the Chinese Ministry of Construction, as of early 2006, there are still 278 cities in China that do not have any wastewater treatment facilities and 320 million people lack access to clean drinking water," says Ryan Dobrez and Tenzin Tsepak. However, unlike the previous industries discussed, the wastewater industry is much more the responsibility of local governments rather than the central government.[28] Accordingly, the industry is mainly foreign, like France's Veolia, or small domestics like Shenyang Zhenxing, rather than SOEs and requires strong relations with local governments to succeed.[29]

Policy Risks

Regardless of the country in which business is being conducted, government policy naturally has the ability to significantly affect business. What often overwhelms outsiders looking to invest into a country like China is the number of forces which shape policy. Actors in the policy process include: elites, national and local bureaucracy, other governments, experts, businesses, lobbyists, as well as other stakeholders.[30] Without fully analyzing potential policy risks before making investments, it's very easy to lose out on a lot of money.

Such was the case for Tim Clissold in Mr. China. A significant incident occurred with the break pad business in Zhuhai when Wang forged himself letters of credit for $5 million. As Tim said, "That brought the whole banking system into doubt and we had several hundred million sitting in accounts all over China. How could we continue to invest in China and hold cash in Chinese banks if we couldn't rely on the controls over payment?"[31]

Looking from a business' credit perspective, China's banking system can pose some serious threats for those accustomed to a private, more competitive financial industry like the U.S.'s. 72% of assets in 2003 were either in one of the Big 4 (Bank of China, China Construction Bank, Industrial and Commercial Bank of China, Agricultural Bank of China), one of the 3 policy banks (China Development Bank, Export-Import Bank, Agricultural Development Bank), or Rural Credit Cooperatives, all of which are products/survivors from the planned economy. The result is that much of the loan decision making is influenced from that era and has created a low efficient and high cost system for credit access relative to other financial systems. State-owned commercial banks (SCBs) continue writing inefficient loans, often to SOEs like Anoshan Steel.[32]

The credit risk is further enhanced by the government's powerful control over the banks' lending policies. It can be especially risky to borrow from the SCBs during periods of rapid growth and reform. This was the case for companies like Shi's rubber company in Tim Clissold's Mr. China. Once the central bank decided the economy was heating up too quickly, it made a sudden call on its short-term loans. At the time, Shi didn't have the cash to prematurely payback the loan, but fortunately Tim was able to provide him capital for an equity stake in the rubber company. This scenario is interesting in that it also provides an example of how foreign companies can take advantage of the credit risk facing Chinese businesses. Tim's fund was able to invest in Shi's company solely because the SCB was ordered to recall its short-term loans.[33] With its underdeveloped fixed income market, China's lack of sufficient lending as well as erratic loan calls can make debt intensive companies extremely risky.

Since the state-owned banks exhibit significant preference towards SOEs, credit is less of a concern for those companies. National security, intellectual property theft, and foreign exchange policies have a much more significant affect on these enterprises.

National security policies in China can make business difficult due to the CCP's ability to classify many of its economically significant decisions as matters of national security. The halt on rare earth exports in October 2010 is an example of this. The government abruptly halted the exportation of rare earths for unannounced reasons other than stating that there were national security concerns. This increased the price of rare earth which is an important element in the production of electronics and renewables, among other things.[34] If a similar scenario were to occur in the polysilicon industry, the solar industry would most likely see an extreme hike in its manufactured materials especially considering that, like rare earths, China produces nearly all of the world's polysilicon.

Other than the potential loss of customers due to frustrations with erratic supply, domestic companies are less affected by such policy risks than foreign companies are who depend on these materials to make their products. This differs from the credit risk in China which has more of an effect on companies operating within China. Internet regulation, however, is a national security policy which, like credit, can greatly affect company's abilities to do business in China. It seems that this risk is very limited, since foreign companies use VPNs and other loopholes to send confidential information back home. The risk could heighten if China ever decided to crackdown on these practices, but James Fallow says that "China simply could not afford to crack down that way".[35]

China may not be able to crackdown on certain national security risks, but the country certainly needs to crack down on intellectual property theft if it wishes to reach the economic status of other developed economies. 90% of software and film in China is pirated, and counterfeit pharmaceuticals can be found in 50 different countries. [36] China now files the second most patents in the world which may indicate that its people are ready for more political action regarding this issue.[37] The concern arises that until intellectual property receives better legal protection, it may be difficult for tech driven companies such as SunTech or China Mobile to compete on anything more than economies of scale. It also creates concerns for foreign companies looking to expand in China.

Foreign companies' concerns due to the above policy risks may be offset by its enticingly low currency exchange-rate. "Large multinational corporations, and Wall Street, are comfortable with a weak renminbi. Many of the biggest American conglomerates make goods in China (or sell them in the United States) and benefit from the undervalued currency," says Sewell Chan. While a suppressed currency helps foreign companies, it lowers the Chinese consumer's purchasing power, increases inflation risks, and may contribute to economic inequality.[38] A lower purchasing power creates issues for companies looking to sell to the Chinese consumer. For example, McDonald's Big Macs in China sell for 12.5 Yuan which is equivalent to $1.83 USD while the same product is sold in the U.S. for $3.54 USD.[39] Regardless of whether China is correct or not for keeping its currency low, China is ready to let the renminbi steadily appreciate at a gradual rate against the dollar.[40]

Political Risks

Clissold's incident with Wang discussed earlier also illustrates the political risks of the rule of law and corruption in China. Not only did the bank's employee take off with Wang, but the anticorruption bureau did little to help. In fact, the anticorruption bureau chief asked for a car and some cash to even start an investigation.[41] It wasn't until the end of his experiences with Chinese business that Tim learned to play by their rules. Corruption is not a new concept to the Chinese culture and foreign investors must understand the corruptive practices that are pervasive within China.

A contrast should also be made between corruption and guanxi. Guanxi translates to "relationships" and differs from corruption in that it does not imply illegal actions. Instead, guanxi is more about using connections to get things done, and it is a crucial asset in doing business in China. "Foreign and local companies alike spend heavily to establish and maintain relationships with those who run and influence China's powerful government organizations and state-owned conglomerates," says Scott Seligman.[42]

Despite the wild-west impression some outsiders paint of guanxi and overall business in China, there are consequences for the abuse of guanxi. Former party secretary Chen Liangyu and the 2007 multi-billion RMB pension fund scandal illustrate this. Chen was charged with several counts of bribery and abuse for his role in the Shanghai Labor and Social Security pension scandal, assisting businesses in illegally acquiring rights to purchase shares in SOE's, and abusing his public position to secure profits for relatives and friends, among other crimes.[43] Investors must be careful who they're making ties with because investigations such as Chen's often end up resulting in consequences for those with business ties to the accused.

Foreign investors should also be cautious of corrupt local governments when selecting cities to do business in, particularly the further from Beijing they are. "The sky is high, and the emperor is far away," as the saying goes, suggests that the central government is too far and has too many responsibilities to interfere with local governance.[44] James Fallows discusses this, citing how hard it is to get anything political done in China and how "decisions or goals announced in Beijing can mutate into something quite different when put into effect at the provincial or village level".[45] This disconnect between the state and local governments also poses a threat for those industries relying on state mandates to influence local action, particularly in industries like renewables or social services. Ryan Dobrez and Tenzin Tsepak explain that, "even though the Chinese government is passing laws mandating that ten percent of China's energy comes from renewable resources, like solar, by 2020, it does not mean that every individual township will follow the new regulation nor will they be able to afford it without the adequate budget."[46]

Labor Laws are another political risk, which the state government has had a marginal effect on. Despite international attention, the average Chinese employee only made $4,286 USD in 2008.[47] This explains why many multinationals and manufacturing firms see China as a viable place for cheap labor. Caution should be given concerning Chinese labor rights, particularly by those companies seeking to exploit China's seemingly endless workforce. Although only 10% of China's manufacturing force is in labor unions, protests are becoming more organized and more prevalent for better wages and conditions. A chain of Chinese auto-worker strikers in the summer of 2010 provides an example of what foreign investors may have to be weary of, particularly in manufacturing industries, when relying on China's cheap labor force. Lu Zhang tells how "a two-week strike at the Honda transmission and engine parts plant in southern China shut down the company's four assembly plants and many parts plants throughout China in late May. Striking auto workers demanded for higher wages, a better training system, and the right to democratically elect their factory's union officers. The Honda strikes had produced one of the longest and most significant work stoppages—and wage gains—for Chinese workers in recent years." The success of the Honda autoworkers' sparked a series of strikes in multiple regions and sectors as China's labor force sought higher wages and improved conditions through concerted collective action.[48]

Political policy risks such as these can have a severe affect on a company's ability to operate profitably. In issues such as labor rights, many foreign entities seem to have the impression that as long as they're operating within the boundaries of the local laws, there are no ramifications for their actions. However, in the provided example, Honda as well as other companies had to cease production for several weeks which can be extremely costly. Investors should aim to capitalize on policies like low wages or exercising guanxi, but must do so in a way that is consistent and acceptable with the Chinese political economy.

Action Plan

The investment plan's ultimate goal is to maximize financial returns while minimizing exposure to public policy and political risks. In order to maximize returns, this plan identifies multiple industries that have the support of the Chinese government, have significant growth expectations, and offer attractive investment avenues. The strategy seeks to capitalize on the power of the Chinese government to forcefully develop industries that it deems will benefit the People's Republic of China. The industries of interest are solar, telecom, wastewater management, and the Renminbi. The diversification of these sectors provides a hedge against industry risk while still maintaining focus on the CPC's political and policy agenda. Diversifying the investment instruments between equities, joint ventures, and currency deposits adds additional risk management.

"Within the next decade, China wants to generate 20 GW of solar power, which is equivalent to the world's total installed capacity," claims GaveKal Dragonomics in its 2010 profile of GCL Poly.[49] The CPC reaffirmed its support for the expansion of the country's solar capacity when it adopted the *Central Committee's Proposal for Formulating the 12th Five-Year Program for China's Economic and Social Development (2011-2015)*.[50] In addition to China's confirmed solar capacity goals, many other developed countries are making similar pledges. To capitalize on this, $150 million is going to be invested in the upstream component of China's polysilcon manufacturing and $150 million will be in domestic photovoltaic ("PV") manufacturing. Due to the importance of economies of scale in the solar industry, both of these investments are going to be equity investments into existing industry leaders.

Suntech Power Holdings is the world's largest producer of PV modules. It is a fully integrated solar manufacturer meaning it does everything on the solar industry's value chain from module manufacturing to project installation. The company listed on the New York Stock exchange in 2005 (NYSE: STP) which will be the medium of investment. Following the share purchase, significant attention will be paid to developments with China's domestic solar installation.

Suntech has significant guanxi in China, evident by several significant solar projects it has been rewarded over the past couple years. Of these projects, the most significant was being selected as the manufacturer and installer for the Beijing Bird Nest Stadium for the 2008 Olympic Games.[51] These powerful relationships are extremely valuable, particularly as the Ministry of Finance seeks proposals for projects in order to meet its 2020 capacity goals.

Several risks are involved with the assumptions of the Suntech investment, but the most significant is whether China will be able to continue rewarding solar project contracts to domestic firms like Suntech. Indigenous innovation has fostered the development of China's solar market, but the U.S. has been aggressively arguing with China that it "discriminates against foreign companies and imported goods in subsidizing alternative energy projects, and engages in other practices that harm U.S. interests and run counter to global trade rules," says Jing Yang in a Dow Jones newswire.[52] Since these government practices of favoritism in project assignment and subsidies is what this investment wishes to capitalize on, the equity ownership should be sold if the WTO or other interest groups jeopardize Suntech's ability to profit from these domestic projects.

While the investment into Suntech looks to earn a return on China's subsidized solar capacity installation, the other $150 million will be invested into GCL Poly; a leading polysilicon and wafer manufacturer. Since China manufactures 98% of the world's polysillicon, investing into a leading Chinese polysilicon manufacturer such as GCL Poly will provide a return as the global solar industry rebounds from the recession.[53] The investment will be made through the Hong Kong Stock Exchange (HK:3800).

By investing in both Suntech, a domestic PV manufacturer, and GCL Poly, a domestic Polysilicon manufacturer, there's significant exposure to the upside of the solar industry, but there's also an implicit hedge against China's currency exchange-rate policy. Since GCL Poly exports nearly its entire polysilicon production, an increase in the Yuan may hurt its business. Conversely, much of Suntech's 2011 growth is aimed at growing business in China through the discussed government initiatives.[54] If the Yuan does increase in value, Suntech can continue developing in Asia, benefit from increased purchasing power, as well as use its stronger currency to invest in foreign solar developments.

The $300 million investment into China's telecom industry will be similar to the solar investment in that it will happen through equity markets. Like the solar industry, economies of scale are critical to success in the telecom space making it less viable to compete with the already existing giants. The major difference is going to be the types of companies invested in. Where the solar investment is a composition of self-operating, public companies, the telecom industry investment consists of large SOEs. Another difference is that unlike the solar industry where photovoltaic cell is the clear champion technology, China's telecom industry consists of a couple competing technologies making the company selections a little more challenging.

China Mobile is the world's largest wireless company and is the only provider reaching all of China's 32 provinces. This has given it a considerable competitive advantage over China Unicom and China Telecom, resulting in an 80% market share of China's wireless communications industry. However, after an industry restructuring in 2008, the government granted China Unicom the technology for the more advanced 3G network. While analysts believe China Mobile will continue benefiting from the growing adoption of wireless in China in the short-term, it is less certain which technology will prevail in the long-run; China Mobile's basic 2G or China Unicom's 3G. China Telecom as yet to establish itself as a dominant competitor in the sector.[55]

Since it's difficult to pick whose technology will prevail, an equal equity investment of $150 million will be made into both China Mobile (NYSE: CHL) and China Unicom (NYSE: CHU). Following the stock purchases, it will be crucial to aggressively follow the developments of the two wireless technologies. All efforts should be exercised to establish rapport with the Ministry of Industry and Information Technology over the next couple years through meetings and lobbying in Beijing. Any connections that can be made with those that have guanxi with the ministry should be pursued as well. Ultimately, the goal is to find out whether the ministry intends to share the 3G technology with China Mobile or keep it exclusive to China Unicom. If the ministry is set on leaving China Mobile's massive network in the dust with old technology, the stake in China Mobile should be sold. The benefit of taking this basket approach to investing in the wireless telecom space is that regardless of which technology prevails, the equity investments will grow at least at the rate of the developing wireless telecom space for the short-term.

While the solar and telecom spaces have significant domestic industry leaders, the wastewater management industry is more difficult to pick industry leaders. However, this RMB 1 trillion industry has far too much potential to ignore as the Chinese government seeks to support the social necessity of clean water in its cities. Since local governments are mainly responsible for the wastewater management, it is important to have significant business relationships with different regions of the country in order to continue expanding.[56]

Accordingly, the $300 million will be invested as a joint venture with Shenyang Zhenxing. The sites for the treatment facilities will be in Northeast China near Shenyang Zhenxing's existing sewage treatment plants. This way the company will already have the necessary relationships and familiarity with the local governments to efficiently conduct business.

The success of the joint venture will be sensitive to local governments' receptiveness of Beijing's initiatives to improve the water treatment industry. As mentioned earlier, this is a similar policy risk shared with solar in that the local governments do not necessarily care to spend capital on orders from Beijing.

The remaining $100 million will be exchanged for RMB and put into an account with the Bank of China. This account serves two purposes. The first is that in case the joint venture with Shenyaung Zhenxing needs additional working capital or local officials need an extra "incentive" to contract the JV for their villages' water, the funds are easily accessible. The second reason is to take advantage of the imminent change in China's exchange-rate policy. China has received tremendous pressure to revalue its currency by as much as 20% recently.[57] Although 20% is considered quite extreme and unrealistic, even just a 5-10% appreciation would be significant.

Of course, the power to set the Chinese exchange-rate policy rests with the countries ever-powerful policy makers. Despite frustrations many foreigners express with the CPC's manipulation of everything from exchange-rates to market competition, the backing of the government can offer great returns. This investment plan capitalizes on those returns via investments into the subsidized solar industry, sheltered telecom SOEs, and JVs in the wastewater treatment industry.

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