Investment Proposal

E393: China's Political Economy

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Executive Summary

This report outlines my plan to optimally allocate a fund of $1 billion toward Chinese investments. Specifically, my plan is to create a world-class dairy processing company, purchase and revitalize a Chinese Basketball Association (CBA) team, and invest in the Hong-Kong-listed equities of five major players in Macao's gaming, entertainment, hospitality, and real estate industries. (Please see Appendix for proportional investment breakdown.) Main economic risks include the CBA's recent financial struggles and the effect that a speculative real estate bubble may have on China's hotel and real estate sectors. Policy risks include limitation of foreign ownership within the CBA and possible anti-foreign sentiment against the dairy company's plan for rapid expansion and market penetration. Political risks include political instability within China, labor issues that may affect employees within the fund's dairy and CBA operations, and, in the case of formal legal issues, the immaturity of the Chinese legal system.

Economic Risks

China's Economy

The overriding theme for China's economy during the past thirty years has been relentless growth and diversification. The nation's swift march toward globalization and market reform has meant that China's year-on-year GDP growth has outstripped that of both the U.S. and the world average in every year since 1978, and has not dipped below 5% since 1990.[1] While not immune to the recent global financial crisis, China has coped relatively well compared to the rest of the world, continuing to enjoy its status as a hot spot for emerging market investment.[2] Many high-return investment opportunities still exist in China's far-from-mature economy.

Comparison of Investment Opportunities

The most practical way for an investor to compare investment opportunities in any market is with respect to a sector's expected profitability, derived from opportunity and risk factors. In keeping with this philosophy, I have outlined three sectors of China's economy in descending order of expected profitability. All three are ultimately ripe for investment and have been incorporated into my investment action plan.

Gaming and Entertainment Industry

As James Fallows notes in his *Postcards from Tomorrow Square*, gambling potential in Asia is seemingly limitless.[3] Capitalizing on its pan-Asian accessibility, the strong and growing Chinese economy, and a natural Chinese propensity for gambling, Macao has become a world-class gambling mecca, first surpassing Las Vegas in total gambling revenue in 2007.[4] As Fallows put it, "Financial analysts are basically high on all six of the licensed casino companies [in Macao]," and rightly so.[5] Since Fallows published *Postcards* in 2008, however, the full brunt of the global financial crisis has been brought to bear on Macao's gambling industry, resulting in lowered revenues and disappointing Hong Kong IPOs for companies like Wynn Macau and Sands China.[6] This short-term downturn represents an excellent opportunity to invest in Macao's gaming companies and, by proxy, China's entertainment, hotel, and real estate sectors, before the island's inevitable return to long-term growth trends.

Dairy Industry

China's dairy industry is an unusually attractive opportunity for foreign investors due to several complementary factors, including domestic demand's consistent outpacing of supply, an emerging consumer base with no tradition of drinking milk, and consumer demand for dairy products of higher quality.

Consumption of dairy products increased more than threefold from 1993 to 2002, with Chinese citizens consuming a per capita average of 10.2 kg per year of dairy by the end of this period.[7] Precipitous demand growth, when combined with the generally small-scale of China's dairy farms, these farms' relatively less advanced technologies, and a lack of high yielding dairy cow breeds, has meant that demand for milk and dairy products consistently outpaces supply.[8] This imbalance signals opportunity for foreign exporters of dairy products and prospective direct investors into the industry.

Along with swift growth has come the emergence of dairy consumers with no history of dairy use. This emergence has been driven in large part by the government's National School Milk Program, which is targeted to supply 10 million packages of milk per day to primary and middle schools across China.[9] Large-scale consumption of dairy products by China's youth has increased exposure to knowledge about milk and its nutritional value, and will logically encourage further consumption growth among China's general populace.[10]

The milk scandal of 2008 has also opened up unexpected investment opportunity due to the weakened market positions of major industry players and increased demand by China's consumers for improved dairy quality. As a result of the milk scandal, major player Sanlu was ultimately driven to bankruptcy, and prominent dairy producers such as Mengniu, Yili, and Bright all received negative press deriving from their melamine test failures.[11] Sanyuan Group, whose milk was cleared in the nationwide melamine test, has capitalized on this debacle, acquiring much of Sanlu's former operations, expanding production and doubling its distributors in the Beijing area, setting up a subsidiary in Shanghai, and launching a series of high-end products. These moves helped Sanyuan realize a 138% growth in net profit during the first half of 2009.[12]

Hotel Industry

China's hotel industry is also filled with latent investment opportunity. China's economic growth and resulting business travel and tourism, travel infrastructure expansion, and the industry's fragmented nature create considerable opportunities for foreign investors.

China's ten-year average real GDP growth of 9.4% has naturally translated into greater business travel that has been a boon to the hotel industry.[13] A considerable portion of this business travel can be attributed to large-scale business conferences and exhibitions, with more than 4,000 held in China each year.[14] In addition, China is projected to be the world's number one tourist destination by 2020, a fact that implies a need for hotel rooms that meet the standards of international guests.[15]

The expansion of China's travel infrastructure, including the construction of an extended network of airports into second and third tier cities, has increased domestic travel and played a major role in the success and growth of foreign hotel chains. Citing improved travel infrastructure as a factor, New York-based Starwood Hotels and Resorts , which runs 47 hotels in China, has seen its domestic proportion of travelers increase from 42% to 58% since 2008 and plans to open 15 new hotels in 13 cities by the end of 2009.[16]

Additionally, the relatively fragmented nature of the hotel industry reveals opportunity for market penetration and expansion. As of 2002, only 16% of China's hotels were chain operated, with most of those being 3-star or above.[17] This indicates both potential for brand building and outsized growth in the low-end market segment. Another key factor fragmenting the market, to the benefit of foreign investors, is the prevalence of local protectionist policies within the industry. These policies are enacted by localities against the entry of competing domestic firms, meaning that a foreign company has an easier time establishing itself nationwide than does a Chinese company.[18]

Policy Risks

Foreign Exchange Regime

Since 1997, China's fixed peg and subsequent crawling peg to the U.S. dollar has been a boon to Chinese economic growth that, according to Yale University's Stephen B. Kaplan, "transfers narrow rents to the foreign invested and export-led manufacturing sector."[19] These rents, while relatively consistent during the past decade, are less than certain in the future. China's premier, Wen Jiabao, has stated that China's objective is to "gradually establish a market-based floating exchange rate system…in accordance with China's needs for reform and development."[20] This statement, with its lack of time or methodological specificity, is representative of the opaqueness with which the Chinese government manages foreign exchange policy. For foreign investors in China's manufacturing and other sectors, this opaqueness constitutes an important risk to the "narrow rents" they have heretofore enjoyed.

A decision by China to implement a one-time revaluation or increase the speed of market-based revaluation could occur for a variety of reasons, including that of foreign pressure or, perhaps more likely, desires to reduce speculative capital inflows and inflationary pressure or "redistribute some rents from the coastal manufacturing sector to the interior."[21] Such a decision, regardless of its impetus, would have important negative consequences for many foreign investors. For investors in manufacturing and exporting industries, an obvious loss of competitive advantage within the global market would result.[22] While exporting industries would be hardest hit by the renminbi's appreciation, China's entire economy could potentially experience a "hard landing" and deflationary pressure, thus affecting any foreign investor with Chinese assets or a Chinese customer base.[23] A particularly vulnerable sector is that of real estate, which has enjoyed rapid, largely speculative growth since the mid-1990s. Deflationary pressure would have severe negative effects on existing property investment values and returns.[24]

While the risk magnitude of substantial or swift policy-based appreciation of the renminbi is relatively high, the probability that such an appreciation will occur is relatively low in the short to medium term. After abandoning its strict peg in July of 2005, the Chinese government allowed the renminbi to appreciate gradually to approximately 6.8 renminbi per dollar over the course of three years, before again implementing tight controls in the face of the global financial crisis.[25] The Chinese government has thus far shown that any changes in foreign exchange policy will be both gradual and flexible.

Intellectual Property

Incomplete and inconsistent intellectual property protection is also a policy issue with major implications for foreign investors. Intellectual property rights are important not only to the software industry, but also to technology-based and R&D intensive sectors, including those of computers, semiconductors, and pharmaceuticals. Chinese domestic courts tried 668 intellectual property rights cases in 2007, as compared to only 43 in 2001, evidencing the fact that intellectual property right infringement is a risk of both high magnitude and increasing probability of occurrence.[26]

While the overall outlook on IPR protection in China is relatively grim, there is evidence of improvement that is relevant to its long-term development. In 2003, over half of patent applications for new inventions were filed by Chinese citizens, demonstrating that Chinese inventors "are beginning to find it worthwhile to start protecting their own intellectual property."[27] Additionally, Chinese affiliates of U.S. multinationals spent 9.2% of their value added on R&D in 2004, as compared to the average rate of 3.3% for U.S. affiliates in all overseas locations.[28] This expenditure implies some level of confidence that the IPR of R&D outputs will be sufficiently protected.

Competition Policy

As with IPR protection, foreign investors whose activities are seen as materially affecting the competitive environment of China's markets are at the mercy of Chinese law, its interpretation, and enforcement. Because of the relative immaturity of China's legal system and prevalent bias against foreign firms and in favor of local firms, competition policy represents a risk of high magnitude and relatively high probability of encounter for large-scale foreign investors.

At the forefront of China's emerging competition policy is the Antimonopoly Law, enacted in 2007. This law, designed to discourage "anticompetitive" behavior, is vague in many areas and provides room for judges and officials to apply "public interest" exceptions in ways that may lead to inconsistent, if not contradictory judgments.[29] A high-profile and controversial application of the Antimonopoly Law was the Ministry of Commerce's March decision to block Coca-Cola's acquisition of Huiyuan. In this case, MOFCOM utilized as yet undefined guidelines for competitor and consumer interest, as well as market power, thus giving credence to the idea that the Antimonopoly Law can be used as a government tool to insulate sensitive sectors from foreign influence, protect the interests of "national champions," and shield smaller domestic firms from larger, more efficient foreign competitors.[30]

Political Risks

In addition to economic and policy risks, foreign investors are subject to many political risks that may materially affect their investment returns and ability to conduct business in China. Three primary political risks are political instability, labor issues, and legal issues, in ascending order of the product of likelihood and potential level of harm to investment.

Political Instability

While the Chinese government has achieved a high level of economic openness during the course of the past thirty years, its political openness, including freedom of religion, speech, and other human rights, remains very limited.[31] Many hypothesize that this repression of human rights, often directed at certain religions, ethnic groups, and social classes, will lead to "a single reform episode of sweeping regime change," in which the Communist Party will be suddenly thrown from power.[32] Such a sudden regime change would almost certainly have massive negative impacts on foreign investors, and may even cause the total loss of all previous investments. Evidencing this risk's existence are organized groups, such as the Falun Dafa, that have already demonstrated their willingness to covertly exercise unapproved rights in the face of government repression. The Falun Dafa has "learned how to cope with the Communist Party's security apparatus," utilizing loose organizational structures, technological savvy, and unpredictability as its modus operandi.[33]

While the potential negative impact of regime change is immense, the likelihood of its occurrence is relatively low. As An Chen notes, despite modern demonstrations for increased political freedom, "the communist party-state's ability to dominate Chinese society has not been significantly undermined," with any loosening of societal control occurring "according to the party-state's own agenda."[34]

Labor Issues

China's low labor cost has been one of the main factors attracting foreign investment into China and driving the nation's export economy. At the same time, however, any foreign company with Chinese employees faces risks related to labor issues such as wages, work-related injury, or dissent against or within management. In a political climate where labor laws exist, but are not consistently applied or enforced, labor issues within a Chinese company often take the form of worker violence or litigation.[35] With the advent of unionization in China, a tightening labor supply, and new economic pressures, like high consumer inflation, facing China's workers, it is more likely than ever that a foreign firm will be the target of adversarial labor movements.[36] The consequences of such movements may include financial loss, political impairment, or complete dissolution, meaning that the emergence of labor issues within a firm is not only probable, but also carries a high potential for damage to investment.

As mentioned, labor movements can take the form of violence within the workplace, resulting in operational turmoil and the risk of physical harm to workers and management. In the case of the Far East Concrete Factory, wage table disputes and animosity between Chinese and Taiwanese partners of the joint-venture resulted in a union-organized riot that was condoned by local authorities, injured Taiwanese managers, and resulted in deep anxieties about personal safety in China within the Taiwanese business community.[37] The risk that tension between domestic and foreign management may lead to violence is further illustrated in *Mr. China*, as

Clissold's Jingzhou factory union leader urged workers to "seize control and kick out the foreigners."[38]

While litigation was a worker recourse used relatively infrequently until recently, authorities' realization that there is a need to curb the problem of work-related injury and other labor issues has led to an increased success rate of worker-filed lawsuits.[39] This increased success rate has encouraged more and more workers to utilize the legal system in resolving their grievances, leading to increased litigation-based financial losses for all firms concerned.[40]

Legal Issues

As evidenced by the increase of labor-related litigation, China's legal system is playing an increasingly important role in every sector of the economy. While the more orderly resolution of disputes that this transition promises is beneficial to foreign firms, the immaturity of China's legal system leads to problems such as corruption, lack of judicial independence, and the expression of previously described biases against foreign companies in official rulings. Since all foreign firms are affected by their reliance on, or inability to rely on, China's legal system in the resolution of formal disputes, firms are very likely to encounter legal risk in China. Because of the breadth of issues that legal disputes touch upon, potential losses to foreign firms as a result of legal risk are essentially unlimited.

China's modern legal system has been in existence for only three decades, and its relative immaturity has meant that it is not able to effectively replace the nation's reliance on guanxi for the resolution of business issues, disputes, and legal problems. Under the guanxi system, corporations may feel compelled to pursue expensive business strategies, such as hiring Chinese government officials to lobby the agencies they once served or employing the son of a state-owned firm's contract negotiator in order to win a bid for that firm's project.[41]

When foreign firms do choose to cast their lot within China's courts, they face the risk of unfavorable rulings deriving from both a lack of judicial independence and biases against foreign firms. Because they control judges' salaries, court finances, and he process by which judges are appointed, local governments are able to interfere in judicial decisions in order to protect the interests of local industries or officials, often to the detriment of a foreign counterparty.[42]

Action Plan

With a fund of $1 billion at my discretion, I have the ability to help my clients fully capitalize on nearly any opportunity that the Chinese economy presents. With consideration of China's current economic, policy, and political risks and opportunities, I plan to execute an investment strategy that capitalizes on opportunities in China's dairy, gaming, entertainment, and hotel industries in complementary ways. First, I plan to establish a world-class national dairy processing company and purchase the Yunnan HongHe Running Bulls Chinese Basketball Association (CBA) team. The dairy processing company will give my clients a channel through which to capitalize on China's booming dairy demand and heightened quality expectations, with the potential for international expansion. The CBA team, which will be strongly linked to the dairy company through sponsorship and promotion, will allow my clients to benefit from China's strong basketball fan base and the CBA's ongoing cooperation with the NBA, while at the same time providing a prominent national platform from which to advertise the dairy company.

Secondly, I plan to make my clients major stakeholders of various gaming and entertainment companies operating in Macau, including Wynn Macau, Sands China, SJM Holdings, the Melco International Development Group, and the Galaxy Entertainment Group. These investments, made in the form of equity purchases, will give my clients a stake in several diverse and booming sectors of China's economy, including entertainment, gaming, hospitality, and real estate. At the same time, due to Macau's prominence as a pan-Asian gaming and entertainment capital, my clients will enjoy the risk-reducing, profit-augmenting benefits of an international customer base.

Dairy Company

Due to the highly localized nature of dairy distribution within China and my goal to build a nationally recognized brand for my clients, I plan to build twenty world-class dairy processing facilities, dispersed geographically according to current demand trends and expansion opportunities.[43] The company, which I tentatively call *chaoniugongsi* (超牛公司) or "Super Cow Corporation," will construct two plants in each of the greater Beijing and Shanghai areas, as well as in the Jiangsu and Guangdong provinces, and one plant in each of the following provinces: Shandong, Tianjin, Shanxi, Ningxia, Inner Mongolia, Gansu, Jiangxi, Heilongjiang, Guangxi, Yunnan, Xinjiang, and Hainan.

I estimate that each processing facility will cost $3.5 million dollars to construct based on a 1993 study of U.S. dairy processing facility construction costs. $3.5 million is derived from the calculation of inflation adjustment and further adjustment for the purchasing power parity of the Chinese yuan vis-à-vis the dollar.[44] Eight acres of land are needed for each facility, translating to approximately $2.15 million per parcel at a median industrial use land price of RMB450 per square meter.[45] My total cost estimate for initial land purchases and facility construction is $113 million.

In addition to these capital costs, annual variable costs of approximately $4.3 million will apply to each facility based on conservative adjusted estimates derived from the aforementioned 1993 study.[46] Total annual operating costs for all twenty facilities are estimated at $86 million. In order to maintain operational liquidity and managerial flexibility, I plan to maintain $258 million, or three times estimated annual operation costs, in cash and cash equivalents (e.g. bonds, treasuries, marketable securities).

Since Super Cow will be a wholly-owned foreign enterprise, Chinese partners will not be a consideration. As described earlier, the government has put forth several policies to further promote milk consumption in China, including the National School Milk Program. Super Cow will build rapport with the Chinese government and penetrate the market by donating milk to this program.

CBA Team

With an estimated 300 million Chinese citizens playing basketball, the market potential for Chinese basketball is arguably greater than that of the United States.[47] As China's national basketball league, the Chinese Basketball Association has become an even more attractive investment opportunity following the NBA's commitment to become a financial partner of the league.[48] The acquisition of the Yunnan Honghe Running Bulls, or *yunnanhonghebenniu* (云南红河奔牛), franchise represents a chance to take part in the growth process of commercial basketball in China, build a championship caliber (i.e. profitable) team, and promote the newly formed Super Cow brand.

It was announced in June of this year that the Running Bulls were up for sale after management failed to pay wages and debts.[49] In addition, the Bulls were temporarily kicked out of the CBA for the 2009-10 season as punishment by the league.[50] This financial loss resulted from growing pains felt by the entire CBA during the 2008-09 season, as game schedules expanded from 200 to 450 games, and the league realized total losses of $16.8 million.[51] My plan is to buy the Bulls and reinvent them during their temporary suspension from the CBA. The team will emerge at the beginning of the 2010-11 season as the Yunnan Honghe Super Cows (云南红河超牛队), the CBA's highest funded team. Management's goal will be to win a league championship within the first two seasons of the team's reincarnation.

It is estimated that it will cost $4 million to buy the Bulls and pay off outstanding debts. The cost estimate for the team itself is $3 million, and is based on news in July of this year that Yao Ming will acquire full ownership of the Shanghai Sharks for the same price.[52] Team debt of approximately $1 million was calculated using total CBA debt divided by the number of teams in the league. Operating costs per season are estimated at $2.2 million.[53] As with the dairy company, I plan to keep three years of estimated operating costs, or $6.6 million, in cash or cash equivalents. In addition, a discretionary fund of $10 million will be set aside for the purpose of making the Super Cows the most talented and best known team in the CBA and, in the process, promoting the dairy company.

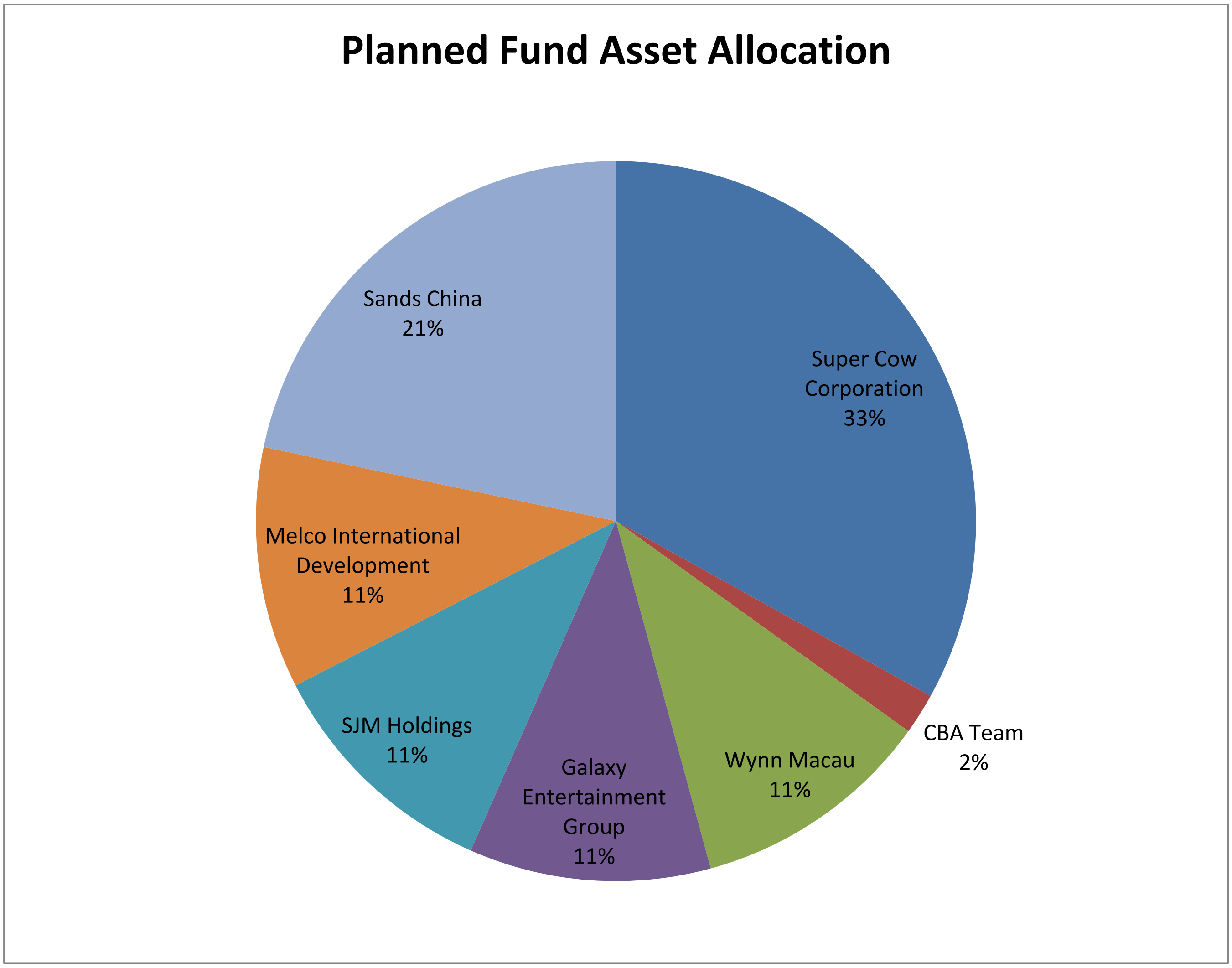
A primary risk involved with the purchase of the Bulls is uncertainty as to how much financial interest the Chinese government will allow a foreign entity to have in a CBA team, many of which are state-owned.[54] A substantive precedent was set in September of 2007 when the Chinese government agreed to cede the NBA 90% of all its subsidiary entities in China, with 5% going to major U.S. media companies, and 5% going to Chinese investors.[55] With the goodwill generated through its dairy investments, a willingness to support the Honghe County community through strategic donations and investments, and a commitment to raise the profile of the Bulls, the fund will likely be able to obtain terms similar to or better than those acquired by the NBA. With Chinese ownership of less than 10%, control and management of the franchise will not likely be a major issue. Total capital reserved for acquisition and management of the Bulls franchise is estimated at $20.6 million.

Gaming and Entertainment Investments

I plan to invest $121 million per company in the Hong-Kong-listed equities of Wynn Macau, the Galaxy Entertainment Group, SJM Holdings, and the Melco International Development Group. I will invest $243 million in Sands China. Wynn Macau, Galaxy, and Sands China will provide access to Macao's high-end gambling market, as well as to the development of Macao's hospitality and non-gambling entertainment industries. SJM Holdings, owned by long-time Macao gambling mogul, Stanley Ho, specializes in Macao's low-end, pure gaming market. Melco, chaired by Ho's son, specializes in ancillary gaming technology and services industries, as well as real estate investment.[56] Other opportunities tying into the fund's dairy and CBA investments are inherent in these investments. For instance, Sands China now has a sports arena attached to its newly opened Sands Venetian hotel complex, and held two NBA exhibition games there in October of this year, with both of these games selling out within 10 hours of initial ticket sales.[57] As a major shareholder in Sands China, the fund has a clear chance to initiate a cooperative relationship between Sands, the NBA, and the Super Cows in staging games and introducing the Cows to a global audience.

Since these investments will be in the form of equity, no direct risk with respect to Chinese partners and government relations exists for the fund. Risk factors that may affect stock performance include the frothy state of China's real estate market, local security conditions, and government's willingness and ability to crack down on organized crime and other criminal activities. One of the key advantages of this investment strategy is the flexibility that these equities' ready marketability affords.

Appendix


Planned Fund Asset Allocation
Sands China
21%
Super Cow
Corporation
33%
Melco International
Development
11%
SJM Holdings
11%
Galaxy
Entertainment
Group
11%
Wynn Macau
11%
CBA Team
2%

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