SKAGEN funds

Unpopular in China

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Shenzhen International Terminal 3, pictured here, cost USD 1.4 billion to build and is designed to resemble a manta ray, a fish that can alter its shape to that of a bird. Photo: Fuksas.

While Chinese equities might seem cheap on the surface, investing in the country is not for the faint of heart.

"Attendance is down 20% versus last year," whispered one of the organisers of the annual investor conference I attended in Beijing earlier this summer. While lower attendance is disappointing to a conference organiser, it is music to the ears of a contrarian investor.

Could China now finally be ripe for picking unloved companies?

After all, China´s $9.2 trillion economy is the second largest in the world after the US at $16.8 trillion. More importantly, the Shanghai Composite index is still less than half of its 2007 peak measured in local currency, making it one of the cheapest in the world – rivalled only by Russia.

Investing away recession

With a history dating back to long before any European country could claim to have an economy and predating the US by some 3,000 years, the country's economy has

grown to become the world's second largest – quickly closing the gap to the US.

At the same time, the combined market capitalisation of Chinese equities is only $3.4 trillion and dwarfed by the US at $23.5 trillion. Seen in light of a population of 1.3 billion compared with 300 million Americans, the comparison is even more startling. Put another way, Chinese equities are priced at $2,615 per capita; the US is at a staggering $78,333.

While Chinese equities may seem cheap on the surface, investing in the country is not for the faint of heart. The Chinese economy has been slowing since the financial crisis, something that has pushed investor sentiment and valuations to multi-year lows. Faced with lower demand for its goods overseas post-crisis, China cushioned the economic blow by pouring money into infrastructure, property and factory investments. The problem is that export demand has remained soft and domestic demand hasn't been able to pick up the slack.

The investment projects have also created some of the new wonders of the world. Brand new airports handle passenger flows with great efficiency supported by cutting-edge data systems. Landing at Shenzhen International Terminal 3, which opened in 2013, is a unique experience. With a $1.4 billion price tag, the terminal is designed to resemble a manta ray, a fish that can alter its shape into that of a bird. Flying in Chinese airspace can be a mind-bending experience in itself as most flights take circuitous and unanticipated routes to comply with military restrictions.

Ballooning debt

Premier Li Keqiang's government is now walking a fine line. He has brought forward railway spending, cut some banks' reserve requirements and reduced taxes. All to protect an annual growth target of about 7.5 percent. While economic expansion picked up to 7.5 percent in the April-June period from a year earlier, growth in the third and fourth quarters are set to dip back to 7.4 percent, according to median estimates in a recent Bloomberg News survey of analysts.

Maintaining the growth rate has come at the expense of a ballooning level of corporate debt, particularly among state-owned enterprises as these firms have been deemed less risky by the banks.

During the quarter ending June 2014, the average debt-to-equity ratio for anything other than banks in the Hang Seng China Index increased to 61 percent, which is the highest level since the third quarter of 2009, less than two months before the end of the post-crisis rally. During the same three month period, the combined free cash flow dwindled to a negative $21 billion, the lowest level since the end of 2011.

Greater investor confidence in China will require policymakers to cut debt levels, reduce overcapacity and increase consumption to achieve sustainable economic growth.

Bullet train ride...and a new silk road

Still, one should not overlook Chinese ingenuity. Making my way by train to Baoding, along with the other 200-odd passengers, I had been ushered past purple-uniformed 'queue directors' shouting directions (in Chinese) through giant megaphones.

Seasoned commuters were well-prepared with headphones firmly installed to block out the noise. While not the most pleasant experience, it was definitely efficient. Baoding is the home to Great Wall Motors, one of SKAGEN Kon-Tiki's largest investments.

I was there to attend the annual shareholder meeting, an all-day affair on the company's campus, which includes a private lake, and consisted of management presentations, a factory tour and a test drive of the much-anticipated H8 SUV. Earlier in the day, management – much to the market's dismay – announced the delay of the H8, sending the stock down 15%. We took the opportunity to buy more shares in light of the limited financial impact from the delay and the extensive pipeline of other newer models.

One of my flights in China took me to the southwest city Chongqing. As labour costs creep higher along China's coastline, companies are moving their manufacturing westward where costs are still comparatively low, benefitting sprawling cities such as Chongqing.

The city marks the start of the planned New Silk Road - a rail line traversing Kazakhstan, Russia, Belarus, and Poland before reaching Duisburg, Germany. The journey is set to take 21 days, about half the time of a 40-day ocean freight. While costs per container are higher via rail than by sea, they are only one third of the price of air transit.

Unsurprisingly, successful delivery of the New Silk Road depends on continued smooth relations between China and Russia, which are co-investors in several major freight forwarding service companies.

Behind the scenes logistics

Several days into the conference, the number of participants started to dwindle. However, the small group who remained was in for a treat when we toured the logistical parks in Shenzhen. The city has developed into a powerhouse in the world of logistics as the main link between Hong Kong and mainland China. The city is one of China's top checkpoints both for passengers and for cargo, much of which is a result of the rapid development of e-commerce. In Shenzhen, I observed some very impressive logistics facilities, complete with automation and refrigeration. The sheer volume of goods passing through these facilities helps explain why most internet purchases are delivered within 24 hours in the largest cities in China.

Searching for unloved investments in China is an exercise in patience, thorough extensive due diligence and a long-term perspective. As attendance at annual investor conferences may fluctuate, the old adage still holds: it is better to enter into an unpopular investment than a popular one, which is about to become unpopular.