



CHINA – LOOKING FOR GOLD MEDAL INVESTMENTS

To mark the occasion of the Beijing Olympics I thought that it might be interesting to share some of my experiences of visiting China and looking at Chinese companies.

I first visited China in 1991 when I travelled over the border from Hong Kong into Shenzhen to visit Hong Kong companies that had set up manufacturing bases in the Special Economic Zone. This was literally a one day visit just to meet a couple of companies but even in that time I could sense how China was becoming a manufacturing power.

I did not meet any Chinese companies on that trip because at the time virtually everything was still state owned and the Shanghai and Shenzhen stock exchanges had only started in 1990.

It was on my second visit in 1992 that I realised the scale of the ambitions of the Chinese authorities. I was taken to meet the Pudong Development Company. (Pudong is the area of land on the opposite side of the river that runs through Shanghai.)

At the time Pudong was a giant building site and the Pudong Development Company showed me a scale model of what they hoped to build. I couldn't believe that they were trying to build so many skyscrapers. I have to admit that at the time I had my doubts about whether they would achieve these ambitious targets.

On this trip I also met some of the first listed companies on the Shanghai stock exchange. I met a machinery manufacturing company and a chemical company.

It was after this visit to the chemical company (Shanghai Chlor Alkali) that I realised just how complicated and risky it would be to invest in individual Chinese companies.

The management of Shanghai Chlor Alkali explained how their business worked.

They explained that they bought their raw materials (e.g. naphtha) from state owned chemical companies and sold their finished products (e.g. PVC) to other state owned companies. This meant that profits were completely in the hands of the government and market forces did not apply!

In a situation like this I get very nervous about investing. How much confidence could I have in determining how profitable the government would allow this company to be! I just felt that I did not know nor understand how the Chinese government worked and in fact it was probably even more complicated than that because local government was often the owner.

I also came away with the impression that this (local) government control was generally the case for most listed companies at the time.

I do not want to give the impression that I do not or will not invest in companies where the government can influence outcomes. In fact governments regularly influence outcomes. I have written about investing in Glaxo where governments have enormous influence over profitability.

I invest in companies where I think I understand how the rules work. This is a complicated subject that I am not going to go into in detail here so I might write a

future opinion piece on that very topic. (Suffice to say that I did not feel in 1992 that I understood how the rules worked in China.)

I went into China again in 1993.

This was a trip to visit Japanese companies that had set up manufacturing operations in the city of Dalian in North East China.

This trip was the first time that I felt I really had the chance to get out among the ordinary people. I began to feel that these ordinary people were similar to the people I had met in Hong Kong, Singapore and Taiwan, in other words a very entrepreneurial group of people that had finally been allowed to ditch communism.

I began to believe that China was in catch up mode. I began to believe that I was looking at a gold medal economy but I was still struggling to find gold (or silver or even bronze) medal companies to invest in.

My next trip to China was 1996 when I went back to Shanghai. Here I was four years on from my visit to the Pudong Development Company and all I could see was skyscraper after skyscraper.



Pudong, Shanghai.

I was convinced that there was a long term growth story happening but once again I was struggling to find companies that I could invest in.

That was the last time I was in China because in 1997 I changed jobs and the opportunity to visit never arose in my new roles.

Naturally enough I continued to read about China and I even met one or two Chinese companies that came through Dublin.

At one stage in 1999 in Setanta Asset Management we even invested in China Mobile the biggest mobile company in China (it is now the biggest in the world) but I was conscious of the risk of government interference.

I also met PetroChina when they were just about to come to the stock market. Once again I had the same concerns as I did when I met Shanghai Chlor Alkali. The government still had such control. They even required the company to provide schools and hospitals for their employees.

I recognised that PetroChina appeared to be cheap relative to oil companies in the rest of the world but I was concerned that the Chinese government might not allow foreign investors exploit that cheapness.

You can imagine my surprise when I learned that Warren Buffett decided to invest in Petro China. I thought that he would stay away just like he has done with Japanese companies. (There are plenty of cheap companies in Japan that sell at significant discounts to their assets and yet Buffett hasn't bought any of them. I thought that he would also stay away from PetroChina.)

I could have copied Buffett and bought some PetroChina shares but I continued to have concerns about the way the Chinese government would potentially interfere in their business.

Buffett sold out of Petro China some time ago and he made a substantial return on his investment. He managed to sell out before Chinese government interference began to create problems for all of the Chinese oil companies.

The Chinese government has been concerned about inflation and has attempted to keep down the price of petrol at the pumps. They have forced the Chinese oil companies to lose money on their refining businesses. This is the very thing that kept me away in the first place. It appears that Buffett got lucky. I think he could have made one of his very rare mistakes but then again it shows that he is human!

In conclusion I continue to believe in the China economic story but I have struggled to find Chinese companies that will win me as many gold medals as their sportsmen!

More on Buffett

Warren Buffett recently gave a series of interviews to CNBC entitled “Three hours with Warren Buffett”. If you have the time it is well worth watching at

<http://www.cnbc.com/id/19206666>

He mentioned that he tried to buy a half billion stake in an unnamed Chinese company! (He is having better luck than me in finding Chinese companies to invest in).