



# CHINA'S INDUSTRIES: THE GOOD, THE BAD AND THE UGLY

By Jim Trippon

*{EDITOR'S NOTE: In this second and final installment of our special China series, our author provides readers with an overview of China's major industries. He examines the status of each industry, the risks and potential for rewards facing the individual investor.}*

From day one, the tantalizing prospect of China's 1.3 billion potential customers has loomed very large. Every investor, entrepreneur and promoter has looked at the size of the Chinese market and seen staggering profit potential. The astonishing growth of the Chinese economy over the past two decades has created a gold rush mentality among new China watchers who seem to believe anything Chinese is assured of investment success.

If only it were that easy. Just as you might find anywhere, there are good and bad companies in China. And there are entire segments of the Chinese industrial colossus that are bad news "no-go zones" for prudent investors. Above all, watch out for the "ugly": over-hyped sectors and crooked stock promotions designed to suck your investment dollars into a bottomless black hole. The good, the bad and the ugly all rely on the Chinese mystique to lure investors.

## INDUSTRY OVERVIEW

In a mere 20 years China has transformed itself from a state run economic disaster to a successful practitioner of bare-

knuckled capitalism. Yet, the mainland China of today resembles an 1870s Industrial Revolution America. Just as America experienced its challenges with child labor, environmental damage, workers' rights and safety, and under-regulated financial markets, so too does the China of today. My knowledge and opinions come from more than 20 years of experience in the financial industry. I've spent the greater part of my career studying the ins-and-outs of the Chinese economy and have traveled there many times over the years. My understanding of China comes from firsthand experience, not from reading a book.

To get started, let's explore the following list, seen in **Table 1**, which summarizes the sectors of China in terms of investment access and viability of local Chinese enterprises available to U.S. investors.

## OIL AND ENERGY SECTOR: STRONG COMPANIES BY INTERNATIONAL STANDARDS

Some of China's finest companies are in the oil and energy industries. They share a captive consumer market, and many are scouring the world to acquire new resources. But that doesn't mean they are all profitable. Nor does it mean that their stock prices will always rise along with the phenomenal growth of the Chinese economy. Nothing is ever that simple in the People's Republic of China (PRC). Let's take a look at an ex-

**FIGURE 1: PetroChina Co. Ltd. ADR: Price History**



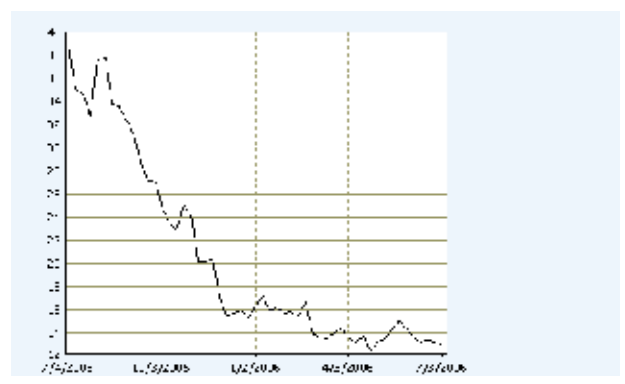
Source: Commodity Systems, Inc. (CSI)

**FIGURE 2: PetroChina Co. Ltd. ADR: 5-Year Chart**



Source: Commodity Systems, Inc. (CSI)

**FIGURE 3: Shanda Interactive Entertainment: Price History**



Source: Commodity Systems, Inc. (CSI)

ample. Consider the behemoth known as PetroChina (PTR). PetroChina produces fully two-thirds of China's oil and gas. It is widely diversified in the petroleum industry with a massive stake in domestic exploration, crude oil and natural gas extraction, pipelines, refining, petrochemical production and retail distribution.

PetroChina has a network of more than 17,000 service stations. Revenues grew by 28 percent last year to \$57 billion. Over five years, revenues have grown by an average of 17 percent. That's a very impressive track record. This might sound like a slam-dunk investment choice if there ever was one, but not so fast. From early May to mid-June of 2006, PetroChina shed almost a quarter of its value, off from a high of \$123 to just \$90. What happened? See *Figure 1*.

From a long-range perspective, absolutely nothing is wrong with PetroChina. Even the best Chinese companies are volatile by the standards of North American big-cap stocks. Why? Partly because trading volume is relatively light, averaging only half a million American depository receipts (ADR) shares per day on the New York Stock Exchange. That means small bumps in the road hit PetroChina harder. PetroChina suffered another setback when the Chinese government failed to raise the price ceilings on refined oil products. Government intervention is always a factor. Does that mean that even good stocks in China are too dangerous for the average investor? Not if the investor has good financial guidance and patience. Investors can only admire the long-range view of PetroChina's performance. See *Figure 2*.

#### COMMUNICATIONS SECTOR SEES CUSTOMER BASE SURGE

China's cellular phone market has grown to a truly breathtaking size: 420 million Chinese people have cell phones, and at least five million new subscribers are added every month throughout the country. Broadband Internet access has spread like wildfire. China's broadband user base grew to more than 35 million subscribers by the end of last year—a staggering increase of 52 percent year-on-year, according to the International Data Corporation (IDC) research firm. The biggest of the wireless companies is China Mobile (CHL) with more than a quarter of a billion customers. As big as it is, China Mobile has revenues of only \$30 billion a year. By comparison, operating from a smaller but much richer customer base in the United States, Verizon has revenues of almost \$80 billion. Nevertheless, the future is bright. The Chinese government plans to turn China into a major Asian hub for telecommunications and information services. China's telecom market is now growing at an annual rate of 17 percent.

#### TAIWAN IS A MAJOR PLAYER

Unlike other China stock analysts, we include Taiwan in our view of so-called "greater China." Taiwan has a much longer history of managing a capitalist economy, and we appreciate companies that are less tied to state control, as some are in the PRC. Chunghwa Telecom of Taiwan is a good example of that kind of company. Formerly a government directorate, Chunghwa holds an immense legacy of Taiwanese customers and an international infrastructure. Chunghwa's grip

on 98 percent of Taiwan's fixed line telephone customer base provides a stable platform for growth into wireless and broadband Internet services. Chunghwa's financials show a company that remains conservatively priced with a price/earnings ratio of just under six. But shares have risen more than 20 percent over the past two-and-a-half years. Even better, the company generates an annual eight-percent dividend.

### TECHNOLOGY: GOOD ACCESS ON A GLOBAL SCALE

Many westerners still think of China as a source of cheap consumer goods such as toys and textiles. But the picture is changing. A recent Deutsche Bank analysis shows that Chinese exports of sophisticated products such as vehicles, car parts, electronic equipment and telecommunications equipment are growing more quickly than sales of cheap commodity goods. Taiwan has a head start in semiconductors and telecom equipment, boasting one of the largest chip foundries in the world. It is so important that a Taiwanese earthquake several years ago disrupted semiconductor markets worldwide.

Mainland China is still lagging in this field even though it is graduating record numbers of engineers who could help build a much larger software and high tech hardware infrastructure. The shortfall is partly China's own making. Due to notoriously poor intellectual property enforcement, many high-tech entrepreneurs within China are now complaining that they can't raise the revenues they need domestically in order to compete internationally.

### THE LOWDOWN ON CONSUMER GOODS

Growth in this sector has been phenomenal, but investment opportunities remain very limited. The Chinese automobile industry is probably the most famous in this sector. Sales of passenger cars have more than tripled since 2000 and stories about air pollution and crowded roads in China have become commonplace. The shock felt around the world happened a few months ago when the two Chinese car companies went public with their plans to introduce ultra-low-priced Chinese cars to the North American market. These sub-compacts, the Geely and the Chery are expected to sell for less than \$10,000.

That may sound like a great growth opportunity for investors, but almost all of China's major carmakers are still state-owned enterprises (SOEs). The good news is that most carmakers have built alliances with multinational auto companies, and they are learning the ropes of efficient, high-quality industrial production. The Chinese government knows that most SOEs are not fit for international market listing until they meet world standards. The same is true of other consumer companies such as ap-

**TABLE 1: Investment Access and Viability**

Basic Materials (includes chemicals, commodities, oil and steel) –	Good
Communications & Utilities (mobile and land line telephone, and electric) –	Good
Technology (software, diversified electronics, semiconductors) –	Good
Consumer Goods (includes appliances, car makers, food, home furnishings, personal products) –	Limited
Financial (banking, insurance, real estate) –	Limited
Services (advertising, consumer services, restaurants, staffing) –	Limited
Healthcare (biotech, drugs, hospitals) –	Poor
Industrial Goods (defense, construction machinery, machine tools) –	Poor

pliance makers. They are still emerging from the shadow of communist central rule and reaching out for worldwide partnerships and even takeovers.

### BANKING ON FINANCIAL STOCKS

China's banks are bursting onto the world scene with a truly historic flourish. The biggest event was the initial public offering of the Bank of China on markets in Hong Kong and Singapore. It was the biggest IPO in the world this year, and more Chinese banks are preparing for international listings. As big as they are, Chinese banks are not without considerable risk. Many are riddled with bad loans issued to prop up insolvent state corporations under direct orders from the government.

China's real estate sector is also on shaky ground. Years of intensive investment and construction have created a glut of houses and apartments too expensive for the average Chinese consumer. This building boom is still underway, and the bubble has not yet burst. The Chinese government is ratcheting up interest rates and struggling to put the squeeze on real estate lending, but there is a real danger that the explosion of the real estate bubble could also hurt Chinese banks. China's insurance sector is emerging, and there are investment opportunities. There is a real and growing need for insurance products (pensions and annuities) among Chinese consumers who can no longer look to the government for cradle-to-grave security from the communist party.

### SERVICES FOR INVESTORS

Service industries are growing very rapidly. China is currently experiencing a tourist boom that can only grow larger as the 2008 Beijing Olympics approach. As with so many important industries, the service sector is slowly emerging from the shadow of central government ownership, and investment opportunities are very limited. Private entrepreneurship seems to be taking the lead in this sector as fledgling advertising agencies such as Focus Media (FMCN) have sought NASDAQ listings. But few major tourist facilities have hit the market as "pure" China investment plays.

## JUDGING THE HEALTH OF HEALTHCARE

Again, access is limited to this sector because most traditional healthcare investment vehicles are still in government hands. We know of only one privately owned hospital company in China: Chindex (CHDX), which is undergoing start-up challenges. Biotech is a breathtakingly risky field in any nation. Two of China's five listed biotechs deal in traditional Chinese herbal remedies and foods which now go under the more respectable name: nutraceuticals. There may be more stability and future strength in the few listed companies that deal in laboratory equipment, pesticides and hepatitis vaccines.

## DOES IT PAY OUT?

In general, we prefer to invest in companies that generate dividends. Dividends are a sign of stability and dependable cash flow, and they tend to smooth out the volatility of emerging market stocks to provide investors with greater stability and more reliable returns. Chinese Internet-based stocks generally do not fall into our value-investing model. It is true that there are estimated to be 100 million Internet users in China, and that number is probably an underestimate. The sector is expected to bring in about \$2 billion in total revenues this year. But by Chinese standards, these are very small numbers, split among many providers. The fantastic claims made by some Chinese Internet stock promoters do not stand up to serious scrutiny. Let's look at a few examples: eLong (LONG) is an Internet travel service, which has enjoyed a rise from a 52-week low of \$8 to a current value in the \$14 range. There's nothing wrong with a 50-percent gain in one year, but look a little closer. The share price is off sharply from its \$24 price peak at the company's IPO in the fall of 2004. Its volatility is hair-raising.

In its most recent earnings report, the company touted a 53-percent revenue increase in the previous quarter, and shares rose almost 12 percent on the news. These sound like impressive gains, but the hard fact is that eLong lost money last quarter, and it lost \$0.31 per share in the past year. So much for big revenue increases.

Let's take a look at another big player: Shanda Interactive Entertainment (SNDA). See **Figure 3**. The description of this company sounds fantastic: The company is the largest Internet game company in the People's Republic of China. Shanda offers a portfolio of online games that users play over the Internet. Shanda controls 50 percent of this market and is able to accommodate more than a million players interacting simultaneously. But its shares are in a nosedive. Just over a year ago, Shanda's shares peaked above \$40 as the popularity of Internet games grew. But tastes change, and free games are now becoming more popular in China.

## PROFITS FROM PENNIES?

Above all, we encourage readers to be cautious about Chinese penny stocks. Look out for companies that are traded on pink sheets or as over-the-counter "bulletin board" stocks. (You will see PK or BB in the stock's symbol if it is one of these.) Some entrepreneurs are capitalizing on the Chinese stock boom by conducting what they call "reverse mergers." A reverse merger allows a stock promoter to sell shares in a Chinese company without the usual legal and regulatory formalities. It works like this:

The promoter begins by looking for a home for his Chinese venture, perhaps a defunct silver mine far from the prying eyes of any investment firm that might wish to conduct due diligence. Next, the promoter finds a defunct American company that is still tradable on U.S. soil. Buying the American firm for next to nothing, the promoter then instructs the American shell to purchase the Chinese venture. After that, all it takes is a bit of paperwork and a name change. A defunct technology firm in California can be transformed into a Chinese mining firm and marketed to investors. Of course the promoter sells out after he has made a profit, and the remaining stockholders are left holding what may be an empty and worthless shell.

## WHAT TO DO NEXT

The rules are simple, and they boil down to a few guidelines. Stay away from speculative ventures, penny stocks and emerging market stocks on the pink sheets. Stick to ADRs, which trade just like stocks on the New York Stock Exchange and the NASDAQ. Finally, don't go it alone. Consult a professional financial advisor, a CPA or a respected source before you venture into any emerging market. You'll need help to tell the "good" from the "bad" and the just plain "ugly." ■

---

*Jim Trippon, editor of the **China Stock Digest**, is one of America's foremost authorities on China investing. He and his staff in mainland China, Hong Kong, Taiwan and the United States research investment opportunities in China's publicly traded equities. Trippon authored the 2005 Amazon best seller **How Millionaires Stay Rich Forever** and is the personal financial advisor to some of America's wealthiest families. For more information visit [www.chinastockdigest.com](http://www.chinastockdigest.com).*



Provided by permission of  
SFO Magazine. Originally published September 2006.  
© 2006 Wasendorf & Associates, Inc. • 3812 Cedar Heights Drive • Cedar Falls, IA 50613