



Analyst Trip to China

Matterley

Companies visited: HSBC, GKN, Spirax Sarco, IMI, Rotork, Jones Lang La Salle, Wartsila

With anaemic growth forecast in the UK and Europe many companies are keen to stress their exposure to the faster growing developing economies, especially China. Matterley has been fortunate enough to attend an analyst trip to Shanghai to meet with a variety of UK listed companies operating in the area to see how they are tapping into the growth opportunities presented to them. The aim of this document is not to regurgitate the well versed drivers behind the phenomenal growth that China has, and will, exhibit but more to highlight the areas that the companies visited saw as providing the most exciting growth potential and what they see as the key risks to their business and the Chinese economy.

Nuclear Spend

China needs energy. Currently it suffers from a dependence on coal fired power stations. This provides problems due to raw material dependency from foreign countries and a huge environmental impact. In Shanghai pollution clouds the sky, creating a brown haze in all directions. China has settled on nuclear as the answer. They plan to build 6-10 reactors every 1-2 years. The UK has 24 reactors and this is set to shrink. In contrast, China currently has 11 active reactors, 23 under construction and is planning more. The contracts to build these power plants have gone to non-UK Western contractors; however, many specialist components and systems controls are supplied by UK business into this growing industry. In addition, there are no doubt many other developing nations looking over at China and considering very hard increasing their nuclear generation capacity – the bull case for uranium seems to stack up. Companies investing in their nuclear product suite would seem to be investing in an accelerating growth market.

Capital Allocation Risk

The middle class awakening of China has lead to many parallels being draw between China now and the US in the 1950's. The big difference though is that there were fewer restrictions on the ability of new members of the middle class ranks in 1950's US to invest their money where they wanted. This is not true in China. The three main venues for Chinese investments are cash, earning a negative real return, the stock market, or the property market. There are tight restrictions on investing overseas and in alternative asset classes, such as gold. With a high savings ratio and moderate inflation the growing young Chinese middle classes have little choice but to buy property and shares. As the spectrum of investment opportunities increases the demand for each asset class will lessen. This is most likely an issue for the property market as the dynamics of the property market in China has been likened to that of gold in the West – both non-yielding assets acting as a store of value. As new markets open up property may no longer be the default option relieving some demand pressure.

Auto market

China is now the largest and fastest growing auto market in the world. The size of the market is astounding – China will make 600,000 trucks next year; the US will build 150,000 and Japan 50,000. As with many parts of China's economy last year the growth was fuelled by tax incentives and other stimulus measures. Just looking onto the streets of Shanghai one would not

think they were in the heart of an emerging economy – there are no bashed up cars spluttering around the streets. This is in stark contrast to the India's and Mexico's of this world where the roads are clogged with old VW vans and most cars seems to be in at least their third incarnation. The anecdotal evidence from China is that the demand for car parts last year was so extreme that they had to import them from other countries on a loss making basis. With better infrastructure and the increasing mobility of the population the auto market looks set to continue its growth. The aspirations of the middle classes in China can be summed up by the brand name of the fastest growing car manufacture in China: BYD – Build Your Dreams.

Stimulus misread as growth

China has just produced a 12% year on year GDP growth. This has been fuelled in part by the >\$500bln stimulus package that was announced at the end of the 2008 to try and immunise China from the fall out of the financial crisis in the West. The stimulus package was similar in size to that of the US's but was unleashed on an economy of 1/3 of the size. This turbo charged the economy throughout 2009. The government is now in a tightening phase, for example, putting restrictions of home ownership, on banks lending and slowing the approval of infrastructure spend. Similar to the West this puts the investment onus back on the Chinese private sector. Many of the western companies that we met in China highlighted the importance of focusing on business from non-government controlled companies. The stimulus withdrawal, and increasing bias of the government to awarding contracts to domestic companies, means that the large Western contractors may find it harder to win business in the future. However, niche business would seem well placed to continue to outgrow China's already impressive GDP figures.

Conclusion:

The thesis for China's continued growth is strong. The government has shown they have the desire and tools to manage this growth aggressively. Nothing on my trip, from the factories I visited to the people I spoke to, gave me the impression that China's growth is unsustainable; if anything I had quite the opposite thoughts. However, growth and value are quite different things; so, while China may continue to grow in the short term, this does not mean the Chinese equity bull market will continue without major hiccups. Most governments in the world seemed to have pinned their hopes on the emerging markets to bail us out and I am sure this is true of many market participants too. However, to continue to grow and develop at its current pace there are certain services and resources China needs that it cannot provide for itself. As an international investor these are most likely the safest way to invest in China's growth. China's demand for natural resources is well documented and will continue. Well financed resources companies working in close proximity to China will continue to benefit. Other than commodities China requires world class engineering expertise. This can be seen by their dependence in Western contractors to build their nuclear power stations. In time this dependency will diminish, however, China is racing against its own populations expectations of development and cannot afford the time to nurture these industries for the time being. China is instead playing catch up in some areas while trying to leap frog the West in others; in industries such as green tech. Indeed China wants to become the world's largest manufacturer of electric vehicles. It is hard to ignore China and I would urge everyone to visit this exceptionally exciting country.

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