

Chapter 5

The Entrepreneurs versus the SOEs

For decades, China's industries have been dominated by the country's state-owned enterprises (SOEs). These businesses are still ubiquitous in China, but with rare exceptions they are not the places where investors will make money. More to the point, investors should stay away from almost every SOE stock they encounter. This is because private businesses have already become the most important drivers of China's growth, displacing the inefficient and wasteful state-owned enterprises.

The strength of entrepreneurial businesses is evident to those investors who know what the numbers in China really mean: China's 2005 growth rate of 9.8 percent included all of the nonmonopolistic SOEs, which collectively lost money. They were actually a drag on the economy. Yet, American mutual fund managers and exchange-traded funds that are investing in China continue to put most of their capital in these SOEs. We'll cover more of the dangers awaiting investors who buy "China" funds in Chapter 11, but for now, you should know that funds that are heavily weighted in SOEs should be avoided.

The reason so many fund managers and Wall Streeters focus on SOEs is that they were the dominant industrial force in China for four decades. That is no longer true, and by knowing this you will set yourself apart from the millions of investors who will put their money in danger by putting it in SOEs.

The real force behind the China Miracle is the Chinese people and the new age of entrepreneurs. They are, and will continue to be, the long-term stewards of corporate and future economic growth in China. In the process, they are creating entirely new industries that are servicing long-suppressed needs on the part of both consumers and businesses.

You should understand a bit about the role of state-owned enterprises versus private entrepreneurs. To that end, I'm going to walk you through the SOEs and the rise of China's entrepreneurial class. The existence of these two business factions underlies the China Miracle—for better and for worse. They also provide us with a way to differentiate the old way of doing things in contrast to the new era of private sector commerce. The old way is epitomized by the SOE and the creation of China's exchanges, while the new era is defined by entrepreneur—individuals who are creating companies so big and profit table that the money they are generating is eclipsing the performance of America's best-known entrepreneurs.

Let's begin by talking about the SOEs. These strange businesses came about as a direct result of a centrally planned economy as the official policy in China. Central to the planned

economy's basic philosophy was the creation of large companies that were owned and operated by the government. Every significant means of production—factories, power plants — was controlled by the state. Private enterprise was for all practical purposes eliminated and disappeared between the 1940s and 1980s. The concept was that all production belonged to all the people, and that everyone would benefit equally from shared interest in the creation of goods and services. That was the stated goal, anyway.

Each SOE had its own territory and covered its respective area of production. Party bureaucrats were put in charge of these facilities, usually as a result of their status in the Communist Party. Ability to manage was not a skill required for these jobs; party loyalty was. Many of these bureaucrats enriched themselves regardless of how well their businesses were run, and corruption ran rampant. Cronyism, graft, fraudulent accounting, nepotism, and outright theft were part and parcel of the SOE managerial mind-set.

By the mid-1980s, there were 300,000 SOEs and they generated about 80 percent of China's gross domestic product (GDP). When reforms began in the late 1980s, it became apparent to government leaders that these businesses were bloated, unwieldy, and unprofitable. In the face of substantial gains by free-market businesses, SOEs were systematically merged and shut down. By 2003, SOEs were greatly reduced in stature and generated barely 30 percent of GDP.

Today, after two decades of market reform, there are fewer than 100,000 SOEs remaining, and the biggest of them have been consolidated into 157 primary central business units. Yet because SOEs still control about half of the country's industrial assets, the government has kept many of them artificially alive by infusing them with capital.

To its credit, the Chinese government recently took a tougher stance on the SOEs' business practices by demanding that they become self-sufficient in the near future. To demonstrate that the government is serious about this, China's State-Owned Assets Supervision and Administration Commission (SASAC) has reported that some 2,000 SOEs will go bankrupt before 2008, subject to government approval. After that, all remaining SOEs will have to adhere to a national bankruptcy code and fend for themselves.

Despite the changes and reforms, SOEs are still generally not well-run businesses. There are many policies that linger from the Mao era, including poor accounting and little transparency. Typically, SOEs are not subject to much regulation or scrutiny. Many of them are unprofitable due to management corruption and waste, and they rarely return the kinds of profits to the government that are required to expand and maintain the country's rapidly growing infrastructure.

Another effort employed to try to straighten out these SOEs has been to list them on stock exchanges. It's too bad for the Chinese government that in many cases making them public companies has had little effect. The vast majority of these SOEs are, and probably always will be, bad investments. Corporate governance is characteristically nonexistent, and management still likes to reward itself before it rewards stockholders. Most SOEs don't stand a chance competing against the much more nimble and effective private businesses run by entrepreneurs who have a burning desire to succeed.

On a brighter note, improvements are being made to align the interests of a few SOE managers and their shareholders. In the past two years, some of the better managed publicly traded SOEs went through management compensation reforms. Senior managers are demanding an equity stake through company shares to better profit from their work. As an investor, I want to see more SOE compensation policies that tie pay to performance, which would benefit these companies by giving their management incentives to work hard.

The reason I'm going into so much detail about SOEs is that several of the remaining SOEs control China's biggest businesses, notably those in communications, energy, finance, and materials. These are some of the industries that you'll want to look into when investing in China. Within them, there are a very select few SOEs that have the proper combination of political clout, monopolistic power, and respectable management necessary to make an attractive investment. This comes from market advantages they enjoy specifically because the playing field is tilted in their favor. And quite honestly, these SOEs that are exceptions to the rule are excellent candidates for a strong China Miracle portfolio.

The China National Offshore Oil Corporation, better known as CNOOC (NYSE: CEO), for instance, has been given special power by the government: monopoly drilling rights for the entire South China Sea, which contains perhaps the greatest untapped underwater oil and gas reserves in the world. The huge natural gas discovery there in June 2006—which potentially contains enough gas to supply China for four years—is likely to be just the tip of the iceberg.

Due to its favored status, CNOOC gets a 51 percent interest in any gas and oil discovered in the region, no matter who finds it. And this SOE doesn't have to put up a penny to finance the costs associated with the exploration. To date, over 75 oil and gas companies have signed agreements with CNOOC to explore in the South China Sea, and all CNOOC has to do is sit back and wait for the profits. To me, this special status makes companies like CNOOC the best investment opportunities in the world today.

Several other SOEs enjoy similar status. China Mobile (NYSE: CHL) is practically a monopoly as the world's largest provider in China's exploding wireless industry. Sinopec (NYSE: SNP) is the biggest seller of gasoline in China and will benefit as the government allows gas prices to increase. Huaneng Power (NYSE: HNP) is the largest power producer in China. China Aluminum (NYSE: ACH) is the largest producer of primary aluminum in China and the second largest in the world. China Life (NYSE: LFC) is the leader in China's heavily protected life insurance industry.

What sets these SOEs apart from the rest of the pack? They have superior management, operations in high-growth and heavily regulated industries, and special support given them by the government in Beijing. I'll talk more about these companies in the next few chapters, because they are among only a handful of SOEs that you should even consider looking at as holdings in your China Miracle portfolio.

The businesses that should attract your attention are those companies run by entrepreneurs who are building incredible companies on their own merits and profiting from doing business in a free market. Coupled with international businesses that are making money in China, they will form the basis of long-term profits for investors ready to get rich from China's historic growth.

China Aluminum and China Southern Airlines

Even though I think China Aluminum is a strong long-term China play, I sold my early stake when the initial momentum stalled (see Figure 5.1). This doesn't mean I won't get back in, but as I've mentioned, I tend to look for new opportunities after I've sold my stake in a particular company.

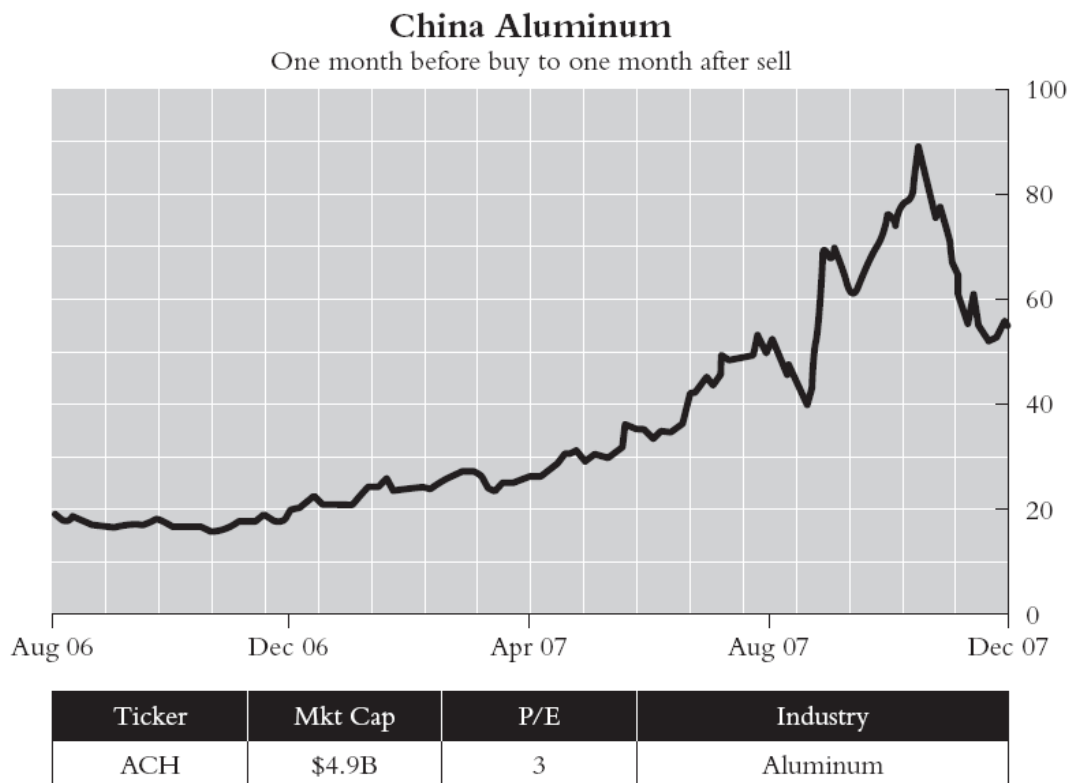


Figure 5.1 China Aluminum Chart

SOURCE: InvestorPlace Media, LLC.

Here's the reasoning on why I took profits when I did. China Aluminum's tight grip on the aluminum market ensured that it would have market share and profit potential for years to come. But based on the point at which I bought the stock, the momentum associated with that timing had evaporated. What happened was that Chinese Premier Wen Jiabao unexpectedly postponed the Qualified Domestic Institutional Investors (QDII) pilot project that would allow Mainland Chinese individual investors to invest directly in Hong Kong stocks. (See box at the end of Chapter 6.) He said that Beijing needed to do more research and planning before allowing this to proceed.

This announcement put a brake on the continued upward momentum of the state-owned companies that Mainland Chinese individual investors love to buy. Over the long run, more Mainland Chinese money will continue flowing into Hong Kong because of institutional investment, but in the short run, the psychological aspect of preventing more direct

investment into these SOEs was enough to slow their momentum. That included China Aluminum.

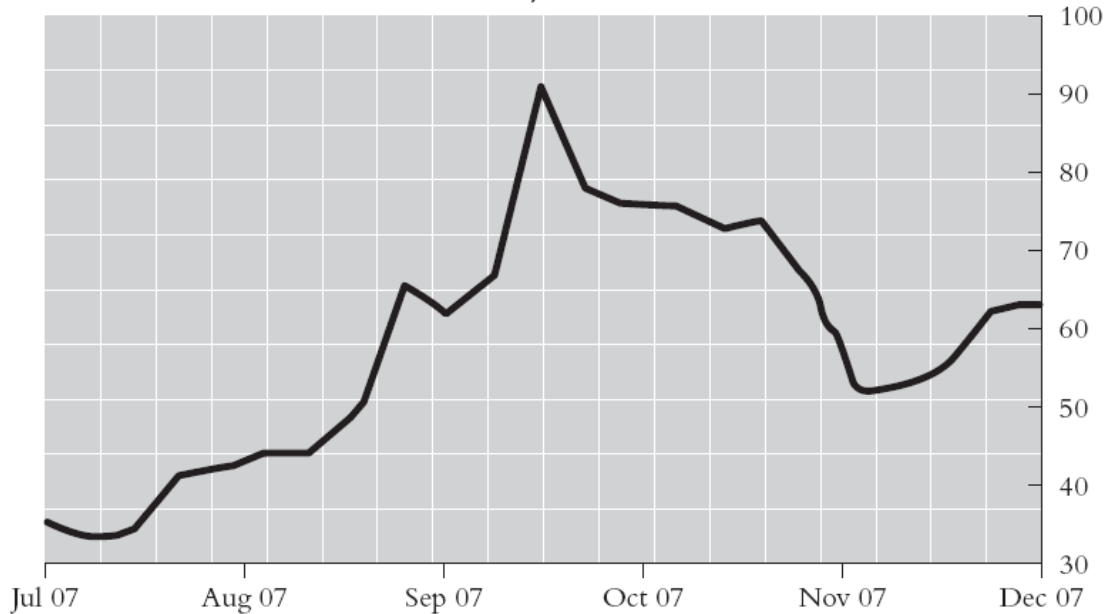
With that momentum stalled, I sold my position for a 285 percent profit. I'll take that level of return any day of the week.

It was the same announcement by Wen Jiabao that prompted me to take my profits from China Southern Airlines (NYSE: ZNH). (See Figure 5.2.) Another one of the strong SOEs, China Southern Airlines—along with Air China and China Eastern Airlines—controls about 80 percent of the nation's domestic aviation market and nearly all of its overseas passenger traffic. China Southern Airlines provides passenger, cargo, and mail airline services throughout Mainland China, Hong Kong, and Macau, as well as in Southeast Asia and other parts of the world. The company operates approximately 30 percent of the country's total aircraft, and its flight network covers a large majority of commercial and economic centers in Mainland China.

And the future looks great for Chinese airlines. Normally, aviation grows at 1.5 times a country's GDP growth rate, but the airline industry in China has posted a growth rate of nearly double GDP. The country's commercial airline fleet has more than doubled over the past 10 years, and there are 147 airports in operation. That number is set to rise to 190 by 2010. By then, nearly \$ 20 billion will have been spent on building and expanding airports in China, because the country has ambitious plans to create three international hubs in Beijing, Shanghai, and Guangzhou.

China Southern Airlines

One month before buy to one month after sell



Ticker	Mkt Cap	P/E	Industry
ZNH	\$4.6B	26	Major Airlines

Figure 5.2 China Southern Airlines Chart

SOURCE: InvestorPlace Media, LLC.

When I recommended taking a position in China Southern Airlines, the airline had pushed through 2007 with strong ticket sales and the appreciation of the yuan against the U.S. dollar. It had momentum. But Wen's announcement threatened any further increases in the stock price. I decided to take my gains immediately, which were a very nice 50 percent in only 90 days.

If the country puts its investment program back in place, the affected stocks could regain their momentum. Or, should I say, they could gather some new momentum. It's important that you understand that I buy and sell based on the momentum that a stock is experiencing at a particular point in time. Stocks can build momentum many times over the life of a company: right after an IPO, after the awarding of a lucrative contract, while riding a wave of industry-wide growth, and so on. Drops in momentum are opportunities to take profits and invest in other stocks that are experiencing their own momentum.

If you are so inclined, it is worth monitoring the performance of a strong player even after you've sold and collected your profits. If all the fundamentals that attracted you to the stock the first time are still in place, it is quite possible that it will experience another surge of momentum that will benefit your portfolio.

Be Wary of New IPO s

The best privately owned and operated companies are thriving and taking market share away from the big, state-owned manufacturing companies left over from the centrally planned economic model. Under the old planned economy system, the purpose of SOEs was simply to provide employment and churn out products, so they were never concerned with the bottom line. This is an unsustainable model in a genuinely free market.

Because the best private companies in China have enjoyed such tremendous growth, many are now big enough to be publicly traded, which is exceptional news for investors. However, I must warn you again that a growing number of smaller Chinese companies are getting listed, many doing it through less reputable means such as the Pink Sheets (I'll give you a complete discussion of how China's stocks are listed in Chapter 6). These companies are very risky, and I recommend you stay away from them. You should invest only in recognized and established Chinese industry leaders. This not only minimizes your risk, but it also focuses you on where the best opportunities are. China's climate favors big businesses, and it is simply smart investing to stick with those stocks that are number one or two in their respective industries.

The Foundation of Great Companies

It might surprise you to learn that many of the new crop of big companies were created by people who had little more going for them than an idea and determination. They are not products of SOEs, nor are they foreign investors. They are people who grew up in China under economic repression, and some of them were mere children when Deng Xiaoping began instituting reforms. Their success reveals the true nature of the China Miracle: The entrepreneurial spirit of the Chinese people is driving this boom. I stated this at the outset of the book, and I want to give you examples of just how true this is.

Consider this: *Forbes* magazine's most recent list of the world's richest people includes 66 Chinese billionaires. China now has more billionaires than any other country except the United States. Just one year ago, there were only 16 billionaires in China. Something else to consider is that six of the world's 10 richest women entrepreneurs are Chinese. In fact, the richest person in China is a woman: 26-year-old Yang Huiyan, who holds the majority of stock in Country Garden (Hong Kong: 2007.HK), a real estate development company founded by her father. Yang went to school at Ohio State University, returned to China, and is now worth five times more than Donald Trump.

The roster of self-made Chinese millionaires and billionaires who have built great companies in just the past decade is astounding. Even more astounding is the variety of industries in which they've succeeded. From power to paper to the Internet and advertising, they have changed the entire dynamic of China's economy by using the free market system to their advantage. I'll talk about many of these people and their companies in the following chapters, but let me introduce a few of them to you now.

Dr. Shi Zhengrong left his home in Wuxi to study physics and solar energy at Australia's University of New South Wales. After receiving his PhD, he returned to China with \$ 200,000 in savings. In 2001, with some additional venture capital, he started Suntech Power

Holdings Co., Ltd. (NYSE: STP) to produce solar power products. Today, just seven years later, Suntech has a market capitalization of \$ 11 billion and Shi is a billionaire five times over, making him one of the wealthiest men in China.

Michael Yu's parents were both farmers in a rural Chinese village, and his father built a pen for their pigs from rubble and stones. Yu taught himself English as a teenager, and then left his village to attend Peking University. Upon graduation, he took a job teaching English for \$12 a month. After failing to get a student visa for postgraduate studies in the United States, Yu started a test preparation school for other Chinese students who also desired to study abroad. He founded New Oriental Education & Technology Group (NYSE: EDU), the leading English test preparation company in China, and today 45-year-old Yu is worth more than half a billion dollars.

Huang Guangyu, 36, grew up poor in Guangdong province and spent his childhood selling plastic bottles to make money. At the age of 16, he went to Beijing and set up a roadside stall. There he sold electronics that he bought cheaply from factories in his hometown. That stall led to the creation of GOME Electrical Appliances (Hong Kong: 0493.HK), which is now one of China's leading electronics stores. Huang is now worth more than \$ 2 billion.

The founder of advertising firm Focus Media (NASDAQ: FMCN), 34-year-old Jason Jiang, is worth close to \$1 billion. This Shanghai native started out as a literature student at Huadong Normal University, and then saw the potential for selling advertising on video screens placed in strategic locations like grocery stores and elevators. He created Focus Media to do just that, and now more than 90,000 of his company's screens are found in nearly 100 cities in China.

Zhang Yin is the richest self-made woman in the world. She was born in Heilongjiang province during the Cultural Revolution, the daughter of a soldier. She eventually moved to Hong Kong and started a company that bought waste and recycled paper, much of it from the United States. Her company, Nine Dragons Paper (Hong Kong: 2689.HK), used the paper to manufacture cardboard boxes for use by Chinese companies. She's now worth more than \$6 billion.

Zhu Jun is the entrepreneur behind The9 (NASDAQ: NCTY), one of China's innovative online gaming companies. In 2004 he acquired the rights to operate the world's most popular multiplayer game—World of Warcraft (WoW)—in China. The success of WoW has made Zhu a wealthy man. At the age of 41, he is worth an estimated \$ 300 million. Zhu is also the owner of a professional soccer team in Shanghai, and is known for offering his players cash incentives to encourage them to play better.

James Liang won China's first national computer programming contest at age 13, and then headed to the United States to attend Georgia Tech. He worked for software giant Oracle before returning to Shanghai and founding travel company Ctrip with three former classmates. Using a \$ 250,000 investment, Liang built Ctrip into China's leading online travel web site. Today, he's worth more than \$ 200 million.

These entrepreneurs, and thousands more, have driven China's economy to unprecedented heights. Most of them don't talk publicly about themselves, but I can tell you that they all

share very similar traits that make them different from other businesspeople, especially those who do little more than manage companies.

I've found that there are four types of businesspeople that you'll find running businesses in China today. I categorize them as bureaucrats, multinationals, technocrats, and cowboys. Bureaucrats are common in SOEs, which still operate like cumbersome government bureaucracies rather than for-profit businesses. Multinationals are managers trained overseas in large foreign companies who then come to China, often as expatriates. Technocrats tend to be engineers and programmers in technology-related businesses. And cowboys are the aggressive and opportunistic local entrepreneurs who understand the fast, Wild West—like environment of Chinese business today.

Most of China's successful entrepreneurs are cowboys or technocrats. Few of the bureaucrats and multinationals have the requisite passion to make their businesses succeed in a China's growing economy. In addition, bureaucrats and multinationals are limited by their experience: They are accustomed to operating in safe environments where they are protected by the sheer size of government organizations or huge corporations.

Succeeding in China requires vision, flexibility, nimbleness, and dedication. Those traits aren't nurtured by lumbering megacorporations. In marked contrast to American or European entrepreneurs, you don't hear much about China's new breed of rich entrepreneurs. That's because, on the whole, Chinese culture values the hard work, not the fame. As such, these remarkably successful entrepreneurs keep a low profile and let their accomplishments, and the return to their investors, speak for themselves. They are hardworking—even after they've made their fortunes—and are passionate about their companies.

Their determination has heaped substantial rewards on those investors who understand how essential the entrepreneurial spirit is to the China Miracle. Investors looking to make their own fortunes by putting money into government-run businesses that care little about sharing the wealth—yet are favored by so many uninformed investors and analysts—are looking in the wrong place.