Thoughts on China from the Desk of Barry Lau

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With global markets taking a nose dive in recent weeks, many have argued that it has been caused by a slowdown in the Chinese economy. I thought it is important to share with you my on the ground in China perspectives.

Without a doubt, China is slowing. After 30 years of rapid growth, the economy is now in consolidation mode and we have articulated that a normal sustainable growth rate would be 5%-6% GDP p.a. during the next 5 years projected by Economic Intelligence Unit, which in itself is an enviable growth rate for our European, American and Japanese counterparts.

Over the last couple of decades, China is trying to evolve from a manufacturing led economy to a consumption driven economy, or at any rate, that is what the government wants. Manufacturing has remained stable at approximately 40% of Chinese GDP over the last 20 years. On the other hand, consumption now represents approximately 58%, compared to around 40% 20 years ago, indicating a significant economic shift according to the World Bank. Presently, it looks as if China has retained its throne as the "Global Manufacturing King". That being said, the manufacturing value chain has evolved tremendously and remains an important component to the Chinese economy. We will discuss later how the evolution of the economy has called for a slightly different focus for the manufacturing sector.

In this article, we seek to achieve the following:

1. What we see on the ground in China
2. Future perspectives given new government led initiatives, e.g. One Belt One Road ("OBOR")
3. How to benefit from the above

A Local Perspective

It is unsurprising that one would be concerned with China given a few issues that have been in the media spotlight frequently:

a) The performance of the A-share market: -49% from Mid-June 2015 to Late-January 2016. Such volatility would make even iron man, assuming he has an iron clad stomach (which we know he does not), sick and vomit.
b) The unprecedented depreciation of the RMB, both offshore and onshore versions, would send shock waves to the most experienced of FX traders.
c) International spectators and investors have been largely bearish on China, e.g. George Soros, Kyle Bass amongst others.
d) All leading indicators appear to have dropped in perfect synchronization.
e) Discussions of looming NPLs and possible blow ups of SOEs, banks and municipalities.

We can only acknowledge the above as it requires an extensive paper to debate each of the above items. We wish to share with you what we see in China. We have a team of 20 professionals in China, not to mention our JV partner Ping An, with 26 offices across China's 31 provinces, 800,000 agents covering the country and an

extensive credit scoring system that can immediately provide a credible assessment of any individual or company.

First, we have to accept China is a vast country. 1.3 billion people spanning across 31 provinces with the third largest land mass on earth. China is undergoing an "economic rebalancing" brought by deleveraging, restructuring, urbanization and a rising middle class, shifting to a consumption-driven, services-oriented economy. According to the Ministry of Commerce, Lunar New Year 2016 has witnessed robust consumption growth. The retailers and catering firms recorded revenues of RMB 754 billion, up 11.2% increase over the same period last year. The Ministry added that the increasingly affluent Chinese are spending most on clothes, digital products, gold and jewelry and the catering sector. This proves that China's effort to make its economy more reliant on the consumption power of its vast population is paying off.

To assess China, one has to assess a collation of provinces. The country has a single commonly accepted language, a single currency and a unified set of laws. China is a well-run and operated federal system and can be argued is a comparable form of Japan or even the United States of America. Obviously, no one is perfect and no system is perfect, it is not easy to run a vast country with 4 times the population of the USA. If one considers the top 4 provinces Guangdong, Jiangsu, Shandong and Zhejiang, collectively they contribute to around 40% of Chinese GDP. These more advanced economies, whilst still growing, have gone through their respective growth spurts and are experiencing more stable, steady and sustainable growth. The remaining provinces around the country, some provinces are still experiencing double digits growth. Savvy investors have to discern the provinces in which they are willing to invest. We are happy to discuss and share which provinces we are happy to which to allocate.

Province	Q3 2015 GDP Growth (%)	Q3 2014 GDP Growth (%)	Q3 2013 GDP Growth (%)	Q3 2012 GDP Growth (%)	Q3 2011 GDP Growth (%)
Beijing	6.7	7.3	7.7	7.5	8
Tianjin	9.4	10	12.6	13.9	16.5
Hebei	6.5	6.2	8.5	9.3	11.3
Shanxi	2.8	5.6	9	10	13.2
Inner Mongolia	7.5	7.7	9	11.6	14.8
Liaoning	2.7	6.2	8.7	9.3	12.5
Jilin	6.3	6.5	8.8	12.1	14.4
Heilongjiang	5.5	5.2	8.4	9.6	12.4
Shanghai	6.8	7	7.7	7.4	8.3
Jiangsu	8.5	8.8	9.6	10.1	11.2
Zhejiang	8	7.4	8.3	7.7	9.5
Anhui	8.7	9.1	10.7	12	13.8
Fujian	9	9.5	11.3	11.4	12.3
Jiangxi	9.2	9.5	10.1	10.6	12.8
Shandong	8	8.7	9.6	9.7	11.1
Henan	8.2	8.5	8.7	10	11.4
Hubei	8.8	9.5	10	11.2	14
Hunan	8.7	9.2	10.2	11.2	12.9
Guangdong	7.9	7.6	8.5	7.9	10.1
Guangxi	8.1	8.3	10.2	11.2	12.3
Hainan	8.2	8.7	10.1	8.4	10.6
Chongqing	11	10.8	12.4	13.8	16.5
Sichuan	8	8.5	10	12.8	14.7
Guizhou	10.8	10.7	12.6	13.8	15
Yunnan	8.3	8	12.1	12.6	13.4
Tibet	11	10.7	12	11.4	12.8
Shaanxi	7.6	9.6	11.1	12.7	13.7
Gansu	8	8.5	11	12.3	12.8
Qinghai	8.3	9.5	10.6	12.3	13.6
Ningxia	7.6	7.6	9.5	11	11.4
Xinjiang	8.4	9.8	10.8	11.5	11.1

Source: National Bureau of Statistics of China

Let's focus on the top 4 provinces for the moment. They have a few things in common. The urbanization rate in China remains at just north of 50%, contrasting against other developed and emerging economies the average

is 75% or above, it is no surprise that these provinces are still growing. Migrant workers see these provinces to be paved with gold. Workers from remote villages end up in these provinces seeking for work to break out of the poverty trap. Shanghai alone, has an official population of 20 million registered inhabitants, an unofficial number would put that closer to 30 million with commuters from nearby cities. To put that into perspective, Australia has a population of 22 million. Many an overseas traveler has experienced the impossibility in booking a mediocre restaurant in Shanghai, the answer is almost impossible on the day and preferably a week in advance. Think back to 2008 during the height of the global financial crisis, I recall travelling to New York and London; even the most established restaurants required 20 minutes advanced booking such that they can have sufficient time to get enough staffers to come back to work. That may have been a slight exaggeration but in Shanghai today, if China really was going through a huge hard landing scenario, the main streeters certainly are oblivious to this possibility. People are spending and spending huge.

The above makes sense if one tries to understand the psyche of an average Chinese person. China as we know it as an economic powerhouse has only resurfaced in the last 30 years. Prior to that, throughout the Cultural Revolution and before, people have really suffered tremendously and lived in circumstances one would not begin to appreciate or fathom. Of course, during the economic boom since Deng Xiaoping's time in office, began the journey for most Chinese people to normality vis-à-vis the outside world. When economic situations improve, one naturally wishes to live better, eat better, dress better and generally upgrade one's standards of living. There is little surprise therefore that upmarket restaurants, clubs, and other establishments for the social elites remain sought after, but the spillover effects are even felt by the mass market segment. Shanghai is not in isolation on this. Beijing, Guangzhou and Shenzhen also share the same phenomenon.

Let us focus for a moment on the mentality of Chinese people. It can be said, generally, Chinese people are hardworking, self-driven, motivated, utilitarian and possess a firm moral foundation. This foundation has been ingrained in its values since the early stages of its cultural development, to date, that has been around for 5,000 years. Being the second largest economy in the world, with 1.3 billion of highly driven individual's attempting to break out of poverty, this in itself is greatly significant. The majority of the population remains incredibly poor and if given a chance, these individuals will not allow for any such opportunity to slip by. Thus the momentum generated by the sheer brute force of the people can change fortunes. Add on top of that China has been the chief beneficiary of foreign direct investments and also self-funded investments to maintain the stated aim of its GDP growth in the past, the country is not without. With a big population means a big market and a huge labor force. With it being an emerging market means cheap labor. With lots of foreign investment means capital is abundant. Finally with a central party sending unequivocal prerogatives, thus channeling resources, financial and human capital, it is not surprising that China can grow faster than any other country imaginable.

One has to question the above assumptions: a) large market; b) abundant capital; and c) efficient governance. Perhaps it is the last item that one may question. No government can be said to execute their policies correctly 100% of the time. Think recent history…US raising rates when it should not have done and it may have to contemplate cutting rates again? China is no exception. With that being said, Beijing did not jump on the bandwagon to cut rates and execute numerous rounds of monetary easing when the rest of the world did. In fact, after the large stimulus measure it released in 2009 as a response to the global financial crisis, China raised rates and increased reserve requirement ratio numerous times and rendering the Reserve Requirement Ratio ("RRR") for the big Chinese banks to a high of 21.5% in 2011 of their capital base according to the PBOC. RRR is

the equivalent to Basel III's 10.5% reserve requirement for significant banks. Chinese banks had twice more in reserves. To top it all, the loan to deposit ratio stood at a healthy ratio of 66%. Contrasting this to the rest of the world, this was clearly not the case. China pre-empted a hyper-inflation crisis and put in place policy tools well ahead of time which means when the country decelerates faster than desired due to external factors, the same set of tools to slow down hyper-growth in the first place can be utilized to accelerate.

China is not going through a sub-prime crisis which the US had gone through and caused the rest of the world to sink in 2008. In fact, since 2008, the world's liquidity has returned to a somewhat more normal level. There is no liquidity crunch. Sure, leverage in the system may have gone up but there is no funky synthetic exposure. Banks have instilled heavy collateral arrangements for any off-balance sheet arrangements. Things are more "bricks and mortar". Although China's debt to GDP ratio has reached a high level of 250-300%, similar to that of the US, what investors often fail to see is China's high savings rate, which todays stands at about 40% of output which is much higher than the 15% in the US and 25% in Japan.

The quantitative easing money has inflated asset prices and when the music stops, there may be an asset repricing exercise. However please note, this has nothing to do with China. Historically we have seen that China seems to get the blame for most global issues. Think back to 2011, the Greek crisis, H shares in Hong Kong slumped 33% according to Bloomberg, representing a greater drop than Greece itself!

China and Hong Kong has become a world crises barometer – if there is a crisis, short China, a notion not only unfair but borderline insane. The fundamentals in China remain good. It remains a huge market. The government does have more policy tools than the rest of the world, its benchmark interest rate is still very far from zero… it can also cut down the RRR. It is acknowledged that China does have some overcapacity issue. It is trying to transition away from an industrial to a services industry-led economy and it has to manage its ageing population whilst supporting social harmony by providing sufficient employment to the younger generations.

The abovementioned growing pains have been experienced by all developed economies. China will have to take its time to charter through the course of its development. It is not going to be years but rather decades. However, if one considers how Japan reached superstardom in the 80s and its downfall in the 90s but yet today it remains the third largest economy in the world, many commentators have likened China to Japan, with its momentous growth spurts and continued growth… and an eventual collapse (which has not happened and in our opinion will not happen) – but to the doomsayers, if following Japan's example, a collapse will still maintain China as the second largest economy… China will likely overtake the US as the largest economy in the world. In fact, if public-private partnership adjusted, some have argued it already has surpassed the US, then the earlier comment must be qualified to state that even after a collapse, China will remain the largest economy in the world in the future.

From a demographics standpoint, the US experienced its tremendous growth since the 1920s due to industrialization. In our industry, all things that are big and mighty all appear to be US oriented, even here in the Far East. The only reason was due to the development of the US domestic market with its local pension system thereby channeling capital, as long term investors, into asset managers, some of the household names today have significant impacts not just in the US but globally. There is no reason why over the course of the

next 20 or so years China could not and should not develop its own pension system which will mean that some of the local players will become chief beneficiaries of the capital formation created by the pension funds. Thus looking ahead, China's demographics remain very favorable from an investment standpoint: it will continue to have a huge market, with 1.3 billion potential consumers; it will have created its own source of capital base via a self-developed pension system; and it will have groomed a group of domestic experts that will charter the most efficient manner for the application of capital.

Manufacturing has and will continue to evolve in China. Their emergence as a manufacturing powerhouse has been astonishing. In seventh place, trailing Italy, as recently as 1980, China not only overtook the United States in 2011 to become the world's largest producer of manufactured goods but also used its huge manufacturing engine to boost living standards by doubling the country's GDP per capita over the last decade. That achievement took the industrializing United Kingdom 150 years.

Today, however, China faces new challenges as economic growth steadies, wages and other factor costs rise, value chains become more complex, and consumers grow more sophisticated and demanding. Moreover, these pressures are rising against the backdrop of a more fundamental macroeconomic reality: the almost inevitable decline in the relative role of manufacturing in China as it gets richer. Manufacturing growth is slowing more quickly than aggregate economic growth, for example, and evidence suggests that the country is already losing some new factory investments to lower-cost locations, such as Vietnam, sparking concern about China's manufacturing competitiveness.

With that being said, we see this phenomenon more as a movement from traditional low-skill manufacturing to more added-value manufacturing, where on a whole China is now commanding higher gross margins compared to the past. This shift is happening for a number of reasons. For one there has been a steady rise in factor costs, as the long term trend of the renminbi appreciating, and the wage rate rising no longer makes economic sense for China to fit the role of a low-cost manufacturing center. Most multinationals that produce labor-intensive goods, like textiles and apparel, are actively seeking to diversify beyond China in order to reduce costs. The other key reason for this change has been the rise in consumer sophistication. China's urban population has been growing at a tremendous rate, and thus the public's taste for innovative products has risen. China as a manufacturing center has been able to fulfil not only the local demand for these products, but also on a global scale, as they are now meeting the requirements of high-end customers for television panels that were once only achieved by their Japanese and Korean counterparts.

Thus we do not see the perceived slowdown in traditional manufacturing as a major concern in the coming years. It is part of the natural evolution process as an emerging market moves up the manufacturing value chain.

With respect to the often quoted Non Performing Loans ("NPLs") sector in China, NPL ratios have started to rise. The Chinese government is driving measures to encourage resolution and transfer of NPLs. In addition to high corporate leverage, slowing economic growth and the strong search for yield by China domestic investors, credit is expensive today, especially in the onshore bond market.

NPLs will likely continue to rise but the NPL cycle will be a long one as policy-makers seeks to avoid

widespread corporate defaults and a debt blow-up. China's credit market is still largely a closed one and dominated by state-owned Chinese banks. The pace of NPL recognition will be dependent upon policymakers' willingness to deal with moral hazard issues, namely the reliance on implicit government support for many borrowers.

We expect to see a gradual path towards the removal of implicit government support and continued persuasion of banks to roll over debt and this means that the absorption of NPLs will likely be a gradual process. We do not expect a sudden spike in NPL ratio to 10%, which would prompt the People's Bank of China ("PBOC") to print yuan on a massive scale to recapitalize the banking system and lead to a sudden devaluation of the currency.

One Belt One Road

Unveiled by President Xi in 2013, OBOR lies the creation of an economic land belt that includes countries on the original Silk Road through Central Asia, West Asia, the Middle East and Europe, as well as a maritime road that links China's port facilities with the African coast, pushing up through the Suez Canal into the Mediterranean. The project aims to redirect the country's domestic overcapacity and capital for regional infrastructure development to improve trade and relations with ASEAN, Central Asian and European countries.

Ignoring whether this whole notion of OBOR is a fad, a distraction or just another initiative, it is a central government stated objective and the likelihood is that there will be plenty of capital assigned to ensure its success (or some form of self-defined success). A great Chinese proverb: when the tide rises, it is easy to float a boat – the application of this proverb is most apt vis-à-vis OBOR.

The introduction of OBOR, in our opinion, is the government's objective to initiate what has already begun in the form of overseas M&A; it is a way for the government to direct capital to countries outside of China thereby managing the yuan to be semi-convertible within its self-defined game. Coupled that with the Asia Infrastructure Investment Bank, which China will head up, a competing body against the US dominated World Bank and the Japan controlled Asian Development Bank, China is trying to create a system with its own rules and is inviting participants who are only too willing to join as there is promise of Chinese money to help fund developments in the participating members' countries.

No basis for continued yuan depreciation

China's central bank has stepped up efforts to restore stability to the nation's currency and economy, with Governor Zhou Xiaochuan breaking his long silence to say there is no basis for continued yuan depreciation. According to the Governor, he views the nation's balance of payments as good, capital outflows as normal and the exchange rate stable against a basket of currencies. The tool that the PBOC has been using to support economic growth has been pumping cash into the financial system to offset capital outflows amid fears the yuan could weaken further. This has been positive as China's broadest measure of new credit surged in January on a seasonal uptick in lending, and as companies borrowed to pay off foreign debt. Aggregate financing likely grew 2.2 trillion yuan ($335 billion), sourced from Bloomberg.

The central bank has also been smart about not cutting benchmark interest rates too soon, leaving that option open if they need further stimulus. Instead they have turned to cash injections. Net injections have totaled more than 1 trillion yuan since mid-January, or about the same as a 1 percentage point cut to banks' required reserve ratios - the traditional way to boost liquidity. The difference is that injections are temporary and can be scaled back if policy makers do not roll over lending facilities, whereas a RRR cut is more permanent. The governor also stated that China has no incentive to depreciate the currency to boost net exports, and there is no direct link between the nation's gross domestic product and its exchange rate. This should surely ease fears of global investors.

Investors worry about a one-off drastic devaluation of the yuan. However, there is no reason why Beijing would need to do that given that in the midst of a global slowdown in trade, China's economy is gaining market share. Last year, its surplus in trade of goods set a record of US$600 billion versus the last record of US$390 billion set in 2007. Moreover, Beijing knows that if it were to devalue the yuan at one go, competitors such as Vietnam and Thailand would also quickly devalue their currencies. This would negate the positive impact from a one-off devaluation.

The notion that China is moving swiftly towards a consumption based economy rather than a manufacturing based one has held up. End user consumption is growing at 66% of GDP. Retail sales over the Spring Festival holiday rose 11.2% from the same vacation period a year earlier, with cinemas posting sharp increases in box-office sales. This is as exports have fallen 1.8% in U.S. dollar terms in January from a year earlier, while imports dropped 3.6%. As a result we see the recent currency fluctuation as a result of a reduction in demand for foreign goods as well as a natural step in the liberalization of the currency regime.

How do we benefit from the above?

Markets will remain volatile. When accessing China exposure, we continue to adamantly assert that investors should work with on the ground experts to structure downside protection to weather through the volatility and yet with upside potentials when markets calm down which they always do (it is just without a crystal ball, the probability for prophesizing is almost zero). We believe being local is the way to go and being able to invest across the capital structure is a key edge. Finally, working with Ping An Trust, which is the investment arm of Ping An Group within it the second largest insurance company in China, is a huge benefit that cannot be underestimated.

Where we differentiate from traditional Private Equity ("PE") peers is quite substantial. Over the last 10 years the average PE return in China has been around 15%, according to Bloomberg, however when you take out the home runs, such as Baidu, Alibaba and Tencent, you are looking at low single digit returns. The vast majority of Chinese PE funds were not exposed to such landmark investments thus have surely performed on the lower end. In addition, exits for investments have slowed tremendously with the halt in the Chinese IPO market as General Partners have been left holding on to assets which they have planned on crystalizing returns awhile back. Adamas is different in that respect.

Unlike private equity, Adamas structures most of its financing transactions as debt or debt-like instruments with periodic cash payments, downside capital preservation through the taking of real onshore security and

exits that do not only rely on IPO. This reduces the J-curve effect often experienced with PE funds and also shortens the investment horizon. It also allows us to generate consistent returns to our investors even during market downturns. To capture the upside, our strategy is to create a free or cheap call option payoff profile on the underlying equity so that we can share in the company's growth. However, capturing and selecting the right opportunities in a cycle is a key driver of sustainable alpha generation. The flexibility to invest across the capital structure allows us to invest where it makes the most sense from a risk-adjusted return perspective and look at strategies when it is the right time for them and not be pigeon-holed. Our investment strategy allows us to exploit temporal opportunities in all parts of a cycle by investing in different parts of the capital structure.

We believe the present part of the cycle would present us with the following opportunities where value can be unlocked at a discount to intrinsic value:

- Secured direct lending to performing businesses where traditional financing is now not available;
- Event-driven special investments including privatizations, recapitalizations and acquisition of debt at distressed valuations.

In addition, the recent trend of Chinese companies going abroad to acquire overseas assets and export excess domestic industrial capacity would bring about ample acquisition financing opportunities. Many of today's most aggressive Chinese acquirers are relatively unknown to Wall Street's banks (think Tsinghua Unigroup and Shanghai Pudong Science and Technology Investment Co.). Gone are the days when only the Lenovos and Fosuns were making overseas acquisitions. These lesser known corporates would often obtain credit funding from the local banks and funds. Already, we are seeing several enquiries from this front so far this year.

Although we have to admit that China has settled into a new norm, that is having no choice but to rebalance, we would like to emphasize that a slower China does not mean there are no opportunities. It means having to adopt an opportunistic bottoms-up approach with a top down macro thematic overlay to uncover opportunities. It requires a nimble and opportunistic approach towards capital deployment in different parts of the capital structure at different parts of the cycle. By financing the right companies which can weather an economic downturn and having the right financing structure in place to protect the downside, superior risk adjusted returns that is uncorrelated to the public markets can still be generated.

Being selective in this environment is essential. Adamas takes pride in having incredibly strong local expertise, sourcing the best possible deals that are rare for competitors to replicate and truly understanding and supporting management teams in order to generate the best risk-adjusted returns possible for our investors.

Best regards,

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