



# The Return of 'China Heavy'

by Jack Perkowski



**F**OR MUCH OF the period since China joined the World Trade Organization in December, 2001, the country and its economy have been in overdrive. GDP has been growing at double-digit rates, exports have quadrupled, property prices have soared and the Shanghai Index had an incredible run, quadrupling to its high water mark in October of last year.

In the meantime, with the added catalysts of Beijing's preparations for the 2008 Olympics and Shanghai's for the World Expo in 2010, China has been made over like no other country ever has. New highways are everywhere; it's difficult to find a city without a new airport; and Beijing and Shanghai are architecturally among the most spectacular cities in the world.

With unprecedented economic growth, incredible wealth creation, development oriented government officials and a shiny new facade, it's no wonder that China has been such a magnet for investment. When top corporate executives or the heads of private-equity firms arrive in Beijing or Shanghai today, they see cities that do not

look anything like what they expect to see in an "emerging market." In fact, parts of China are now so modern that it's entirely possible to spend a week or two in the country with the Chinese characters on the signs serving as the only reminders that you're in China. In Beijing or Shanghai, you can stay at one of many five-star hotels, eat at upscale restaurants on a par with anything else in the world, and drive off in the latest model car to visit modern factories located in any one of China's many economic-development zones.

This is what I call "China Light." It's not the China I first experienced in 1993, and in many ways it's a bit misleading. All of the new development around the major cities encourages the notion that doing business in Beijing or Shanghai is just like doing business in New York, London, or Paris. That's a dangerous impression to have.

With the economy expanding at a blistering pace, the Shanghai market at an all

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time high, and property prices at bubble levels, the China government began to take steps late last year to slow things down. These measures worked only too well, particularly as China begins to feel the pain of the global economic crisis. The result: 2008 will be the first year in many when growth falls below double digits; the Shanghai Index is off more than 60% from its high, trading at 2001 levels; property prices have softened considerably; and growth in 2009 may slow to less than 8%.

After experiencing “China Light,” it’s difficult to imagine that “China Heavy,” the darker, less economically and legally developed side of the country, still exists. However, a slowing economy and a dramatic decline in asset prices are demonstrating that China Heavy is alive and well, and investors should beware. Like rocks in a river that only become visible when the water-level drops, signs of China Heavy are now coming to the surface as the country’s economic waters recede. Recent articles on troubled investments in China, by foreign and domestic investors alike, are once again highlighting corporate governance and other legal issues that were the subjects of the China stories of the 1990’s.

What should investors pay particular attention to in today’s tougher economic environment? Following are a few due diligence items that warrant enhanced scrutiny:

- ✿ *Accounts Receivable have always been problematic.* Despite the substantial progress made by Chinese banks, the country still does not have an efficient system for distributing capital. When times are good and property and stock prices are rising, bank loans secured by real estate or shares are plentiful. When the markets turn, the banks are quick to demand repayment. As a result, customers that looked financially secure a year ago may now be problem accounts.

- ✿ *Understanding the true profitability*

*of a company in China is often more art than science.* Rapid asset inflation has made it even more difficult. For example, historical profits of many Chinese companies have been bolstered by stock-market gains. Like individuals, companies in China flocked to a rising stock market and made money on the way up. Those profits cannot be counted on in the future, and there may even be hidden, unrecognized losses on the balance sheet.

- ✿ *Recent sharp declines in raw material prices mean that inventories may well be vastly overstated.* In a post 2005 world when raw-material prices seemed to rise ever higher on a monthly basis, the temptation to overbuy at current prices has been strong. Also, some companies have sought to lock in prices of raw materials by entering into futures contracts with suppliers. Prior to the economic crisis, that seemed like a safe bet. Today, it can represent a large off-balance-sheet liability and an overhang on future earnings.

- ✿ *Off-balance-sheet liabilities are especially difficult to find and quantify in China.* A recent example: the shareholders of a company made certain promises to its workers which they chose not to disclose to the new owner, a prominent Chinese businessman, when they sold him the company several years ago. As the factory’s fortunes turned down this year, the workers demanded payment and took the new owner hostage when he refused to pay.

- ✿ *Getting proper title to land use rights is challenging in China.* Furthermore, in a fast growing market where getting into production as quickly as possible is the prime concern, it is often put off until later. Rapidly escalating property prices have presented an ideal opportunity to sell off or pledge real-estate assets as a way to get cash. In the current environment, investors would be wise to clarify title early in the process to determine both true ownership and the nature of any outstanding claims.

Granted, all of the above represent problems that an investor might find in companies in any part of the world, not just those in China. Several aspects of the environment in China, though, are reason enough for heightened concern.

First, in the go-go atmosphere of the past five years when the government has become increasingly protectionist and private-equity investors have had to compete with high stock-market valuations, just getting a deal done has been a major accomplishment. Under these circumstances, the natural tendency is to overlook, or underestimate, the adverse potential impact of issues such as those above. With a softer economy and less competition from a high-priced China stock market, a return to stricter due diligence is warranted.

Second, China is a long way from where it needs to be in terms of corporate governance. Even in publicly traded companies, the chairman often rules with absolute authority and little real oversight from the company's board of directors. Under these circumstances, the potential for off-balance-sheet commitments being made, unknown even to the board, is considerable.

Third, transparency in China remains a big issue. Clarifying title, ownership and the nature of off-balance-sheet items is a difficult exercise in the best of times. With a seller, potential partner or local government under financial pressure, it may be nearly impossible.

Finally, if the worst happens, investors cannot count on the legal system to re-

dress grievances. Though progress has been made, enforcement remains the key issue. The term "home-court advantage" has new meaning when applied to China. If an investor is pitted against strong local vested interests, chances are that local interests will prevail, no matter the merits of the case.

When the dust settles and companies and investors once again look to expand their businesses, finding opportunities that offer growth will be one of the few ways to earn adequate investment returns. Leverage can no longer be counted on, and there is a limit to what cost-cutting can achieve.

As a big, growing economy, China should represent one of the best opportunities for investment in the world. Moreover, the decline in China's stock markets should lead to more realistic expectations on the part of companies seeking investment.

Publicly traded companies, no longer able to sell their equity at prices well above those prevailing in the global markets, may now be more receptive to private-equity valuations. Companies that have not had the benefit of issuing shares in Shanghai or Shenzhen are likely to do the same.

To take advantage of the opportunities that a large growing economy and such revised expectations may represent, experienced investors, as well as new investors who may be drawn to the country, will do well to remember that the appearances of a physically modern China can be misleading, and that China Heavy lies just beneath the surface. ■

*The term 'home-court advantage' has new meaning when applied to China where local interests prevail.*