QV UPDATE

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View from the Harbour

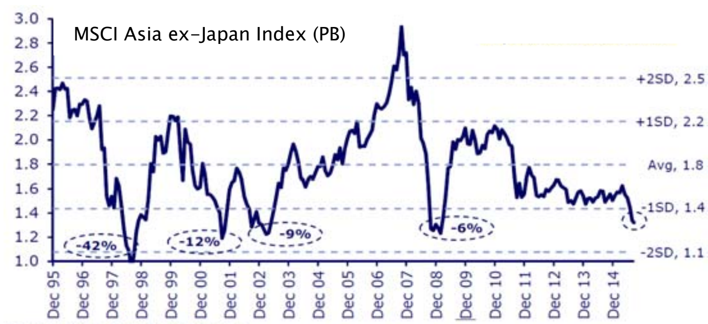
Last week QV Investors had the opportunity to attend the annual Asian-focused CLSA Investor Forums in Hong Kong. It was a whirlwind of corporate presentations, closed door management sessions, and thematic speeches. The conference was timely given recent market developments stemming from that region, specifically China. We returned with a better sense of some dynamics shifting that economy.

As released this week, China's flash manufacturing PMI (Purchasing Managers' Index - gauges the health of the manufacturing sector) for September fell for a seventh consecutive month to the lowest level since March 2009. The index showed a broad deceleration in output, new orders and even employment, all pointing to further cooling manufacturing activity. However, this is not the only driver contributing to China's slowing growth.

The government's anticorruption campaign has detained over a hundred high-ranking officials and leaders since 2013. This anti-graft cleanup has hampered the sales of many businesses. One of which is **Chow Tai Fook Jewellery Group** (SEHK:1929). Chow Tai Fook is the largest jeweller by market share in mainland China, Hong Kong and Macau. 85% of sales stem from its retail base and this has slowed. Same store sales (SSS) growth fell -24.1% in 2015, reversing the gain of +18.6% from 2014. Chow Tai Fook operates with relatively high fixed costs so a shrinking top line is leading to profit margin pressure. Its shares are trading at 1.7x price-to-book (PB), the lowest since its IPO in 2011. Negative sentiment is clearly weighing on this business.

The debt-induced growth that was evident in prior decades is also waning due to a new budget law that limits local governments from spending beyond their fiscal revenues. In addition, rising nonperforming loans point to a turning credit cycle, implying a lower growth rate going forward. **Bank of China Hong Kong Holdings Ltd.** (SEHK:2388, BOC HK) reported a -14.0% yoy decline in operating income from their division in mainland China for the first half of the year. The division's impaired loan ratio rose from 2.0% in December 2014 to 2.2% in June 2015. A small tick higher, but other banks are also showing the same trend. **Standard Chartered PLC** (LSE:STAN) which has 31% of its loan book in Greater China is also seeing a deterioration in asset quality as well as slowing loan growth. Weakening credit conditions and lower lending activity may continue to be headwinds for banks operating in China. BOC HK is trading at 1.3x PB, which is the lowest level since 2009. STAN trades at 0.5x PB, its lowest valuation in 20 years.

Another risk that may contribute to slower economic growth is an overpriced property market. Despite showing some volume recovery this year, elevated prices remain and are discouraging investment from property developers. One of which is billionaire investor Li Ka-shing's **Cheung Kong Property Holdings Ltd.** (SEHK:1113), a long-time contrarian developer that has intentionally been inactive from investing in Hong Kong and China due to higher land prices and construction costs. The company claimed that at current prices, it cannot make a decent return on investment and has decided to remain patient for better prices. Its shares trade at a depressed level of 0.9x PB as sentiment towards Chinese property developers have been dire.



Source: CLSA, Factset, Datastream

Clearly some of the drivers that contributed to China's expansion in the last decade are reversing course. The trailing PB ratio of the MSCI Asia ex-Japan Index trades at 1.3x, close to some prior historic lows and is evidence that investor sentiment remains depressed. Our intention is not to alarm. Treasure lies in ruins. There are durable franchises that will survive this downturn. We choose to view this lagging market with optimism in hopes of uncovering the opportunities that will grow our clients' capital. We returned with a stack of ideas to dig through along with a minor case of jet lag.