

China: undervalued or a bubble?

Investors should look at the basics of future cashflows to determine whether to buy, hold, or sell their China equity exposure



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double digits from the beginning of the year, they have given up almost one third of their value in the last four weeks, and have been getting a lot of attention lately due to extreme volatility with daily intra-day movements in excess of 6 per cent, as markets switched between market-boosting attempts by the Chinese government and selling pressure from over-leveraged investors. This has resulted in extremely divided market commentary at both extremes.

Turnover on Chinese exchanges reached extreme levels in the last few months. The nature of the closed Chinese market has caused extreme dispersion in valuations of many sectors, whereby it is no longer possible to conclude that “China” is either undervalued or a bubble. A much deeper look is needed, so that investors can make a more informed decision.

China bears have plenty of examples that can be used to conclude that the Chinese equity market makes no sense and is completely divorced from reality. For example, Hanergy Thin Film Power started its seemingly inexorable rise in 2014, and after a gain of 800 per cent briefly made its chairman the richest man in China, at least on paper.

Two months ago the stock lost half its value in a single day as an investigation by Hong Kong regulators was initiated, as it seemed that Hanergy was doing most of its business with its parent company, while

the said parent company wasn't doing much business at all. The stock remains suspended pending the findings of the regulators' investigations.

But cases of fraud in China are not rare, and an investor does not need to look far to find more bizarre situations. In February 2015, a small Chinese company listed in Hong Kong and in the five months since its IPO (initial public offering), has become probably the best performing stock in Hong Kong, gaining +3,763 per cent, for an annualised return of +1,053,304 per cent (compounding at 3,700 per cent leads to some interesting returns).

It is currently valued at a P/E (price-earnings ratio) of 278x. Investors would be forgiven for thinking that this must be a high growth company, maybe in the technology or Internet space. Instead, the company is Jicheng Umbrella Holdings, and it manufactures and sells plastic umbrellas. It also “designs” and “researches” said umbrellas, in case investors thought umbrellas were a simple business.

The Shenzhen stock market has a handful of companies trading at over 1,000x P/E, and a month ago a full one-third of companies were valued at over 100x earnings.

It's easy to look at the above and con-

clude that the whole Chinese stock market is heavily overvalued. However, the largest 50 stocks in Shanghai (A50 index) are trading at 12x earnings. A deeper look within this index of the largest Chinese companies shows sectors that are even more attractively valued than this index.

The large Chinese banks continue to trade at deep discounts to the overall market, on average at P/Es below 6x, with dividends above 5 per cent per annum.

Elsewhere, China government's announcements of large infrastructure projects to link China to Europe via railways caused large gains in the various state-owned railway/infrastructure companies – gains which have since been reversed in the current selloff. The sector trades below 10x earnings and is trading at a P/E to growth rate of below one.

China's inefficient market is dominated by momentum investors which has resulted in significant abnormalities that are not normally found in more mature stock markets. The broad market is no longer a good indication of valuations, but is instead an average of a very extreme dispersion of different sectors. More importantly than ever, investors need to go back to the basics of valuations of future cashflows to determine whether to buy, hold, or sell their China equity exposure. **W**

AL Wealth Partners is an independent Singapore-based company providing fund management and advisory services to accredited investors

BACK in June 2014 we highlighted mainland Chinese equities as the cheapest stock market in the region as well as the most ignored; year after year of losses while the rest of the world's equities marched higher had caused many investors to throw in the towel.

In investing, a year can be a lifetime, and China has proven this, with the market now on most investors' minds.

In the past 11 months, mainland Chinese equities experienced a roaring bull market, with the Shanghai Composite gaining +130 per cent, while the Shenzhen Composite gained +160 per cent. The deep undervaluation of the market coupled with a limited opening up to foreign investors via the Hong Kong-China connect, was further boosted by government policies to counter a slowing GDP (gross domestic product), igniting investors' interest.

Common ETFs (exchange-traded funds) listed in Hong Kong for the onshore China market also experienced strong performance, with the iShares FTSE A50 (2823.HK) gaining 85 per cent, while the CSI 300 (3188.HK) gained 125 per cent.

While Chinese equities are still up