

# Pitfalls, Perils and Possibilities for Investing in Asia: A Fund Manager's Perspective

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# I Don't Know What I Don't Know



# Framework: Focus on China

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- ❖ Investor rights and corporate governance are a “hot topic”
- ❖ The real issues—what happens when things go wrong
- ❖ Avoiding perils and pitfalls
- ❖ China versus the developed world

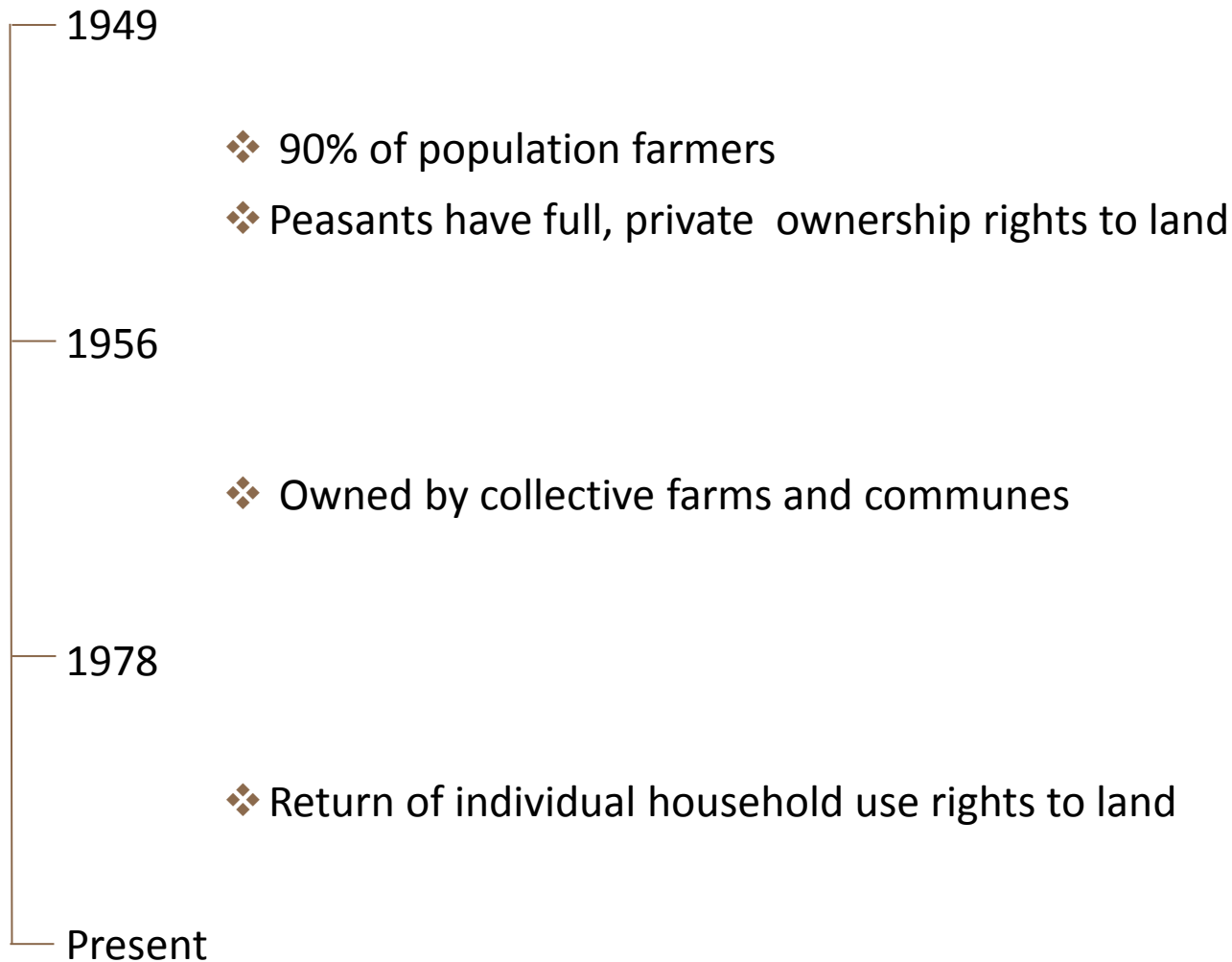
# What Are the Real Issues For Investors in Asia?

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- ❖ Land rights (or lack of thereof)
- ❖ Foreign ownership
- ❖ Sloppy accounting or outright fraud
- ❖ Disadvantages to minority investors

Source: CLSA Asia-Pacific Markets

# History of Land Reform in China



Source: CLSA Asia-Pacific Markets

# Case Study



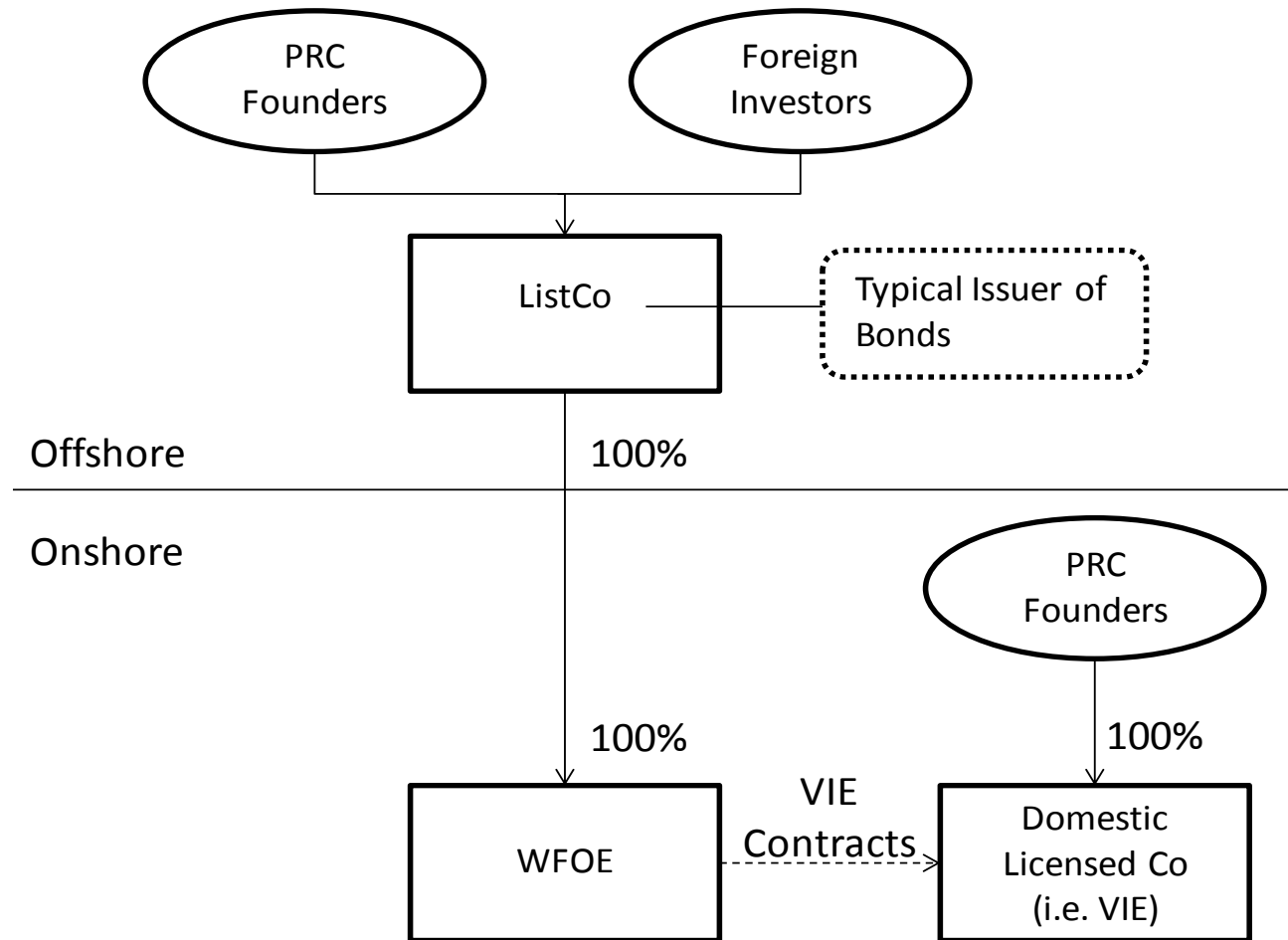
# Foreign Ownership is Restricted in “Strategic” Industries

- ❖ Art, Sports and Entertainment (Media, Internet)
- ❖ Telecommunications
- ❖ Farming, Forestry, Animal Husbandry & Fishery
- ❖ Mining and Quarrying
- ❖ Beverages
- ❖ Medical and Pharmaceutical Products
- ❖ Electric Machinery and Equipment Manufacture
- ❖ Production and Supply of Power, Gas and Water
- ❖ Education

Source: “Catalogue of Prohibited Foreign Investment Industries”, [www.xing.com](http://www.xing.com)

# Challenging Ownership Structures

## *Variable Interest Entity (VIE)*



Source: Cadwalader, Wickersham & Taft



# The VIE Structure is Common, But Not Riskless

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- ❖ VIEs are commonly used by Chinese companies listing in the U.S.
- ❖ Despite how common they are, VIE structures have risks
  - As an investor, your only asset is a contract
  - Chinese government has never said they're ok
  - Haven't been subject to legal tests

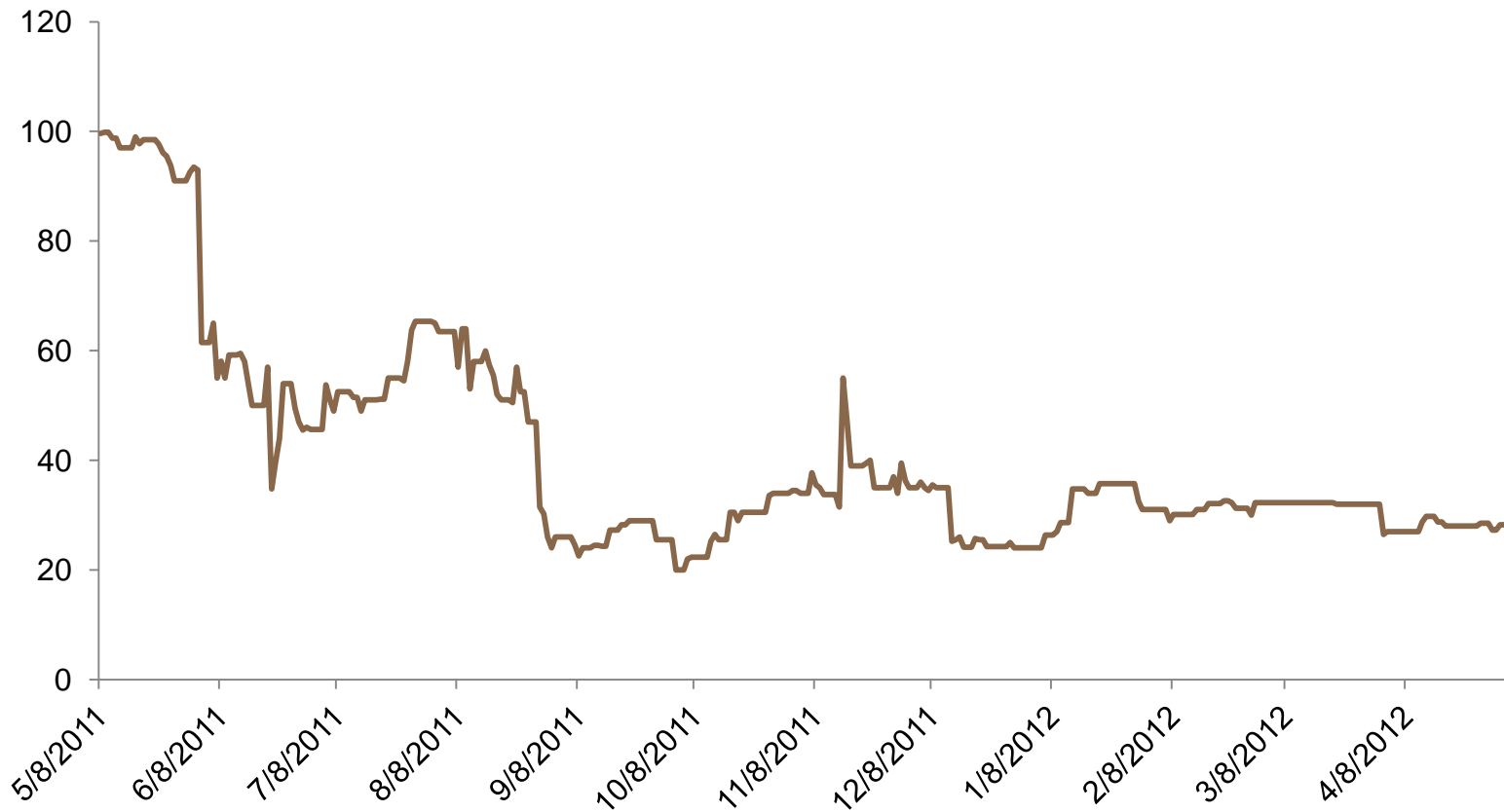
*If VIEs aren't enforceable under Chinese law, what are they worth?*

# Case Study



# Case Study

## Sino-Forest 6.25% Notes Due 2017



Source: Debtwire

# Sloppy Accounting or Fraud?

*Both lead to value destruction*

- ❖ Chinese companies fall into three broad categories:
  - **Red chips (State owned enterprises listed onshore)**—perhaps more difficult to get a group of party members to collude?
  - **Family owned businesses listed onshore**—collusion within the same family makes fraud easier, but same jurisdiction, language, makes cross checks possible
  - **Family owned businesses listed offshore**—perhaps most prone given family ties make collusion simpler to carry out. Various jurisdictions, language barriers make it more difficult for cross references
  
- ❖ Ultimately, we have to conduct adequate due diligence to determine whether risks and reward are justified

Source: Kroll and CLSA

# Cross-holding Ownership Structures in Asia

*Minority shareholders are often disadvantaged*

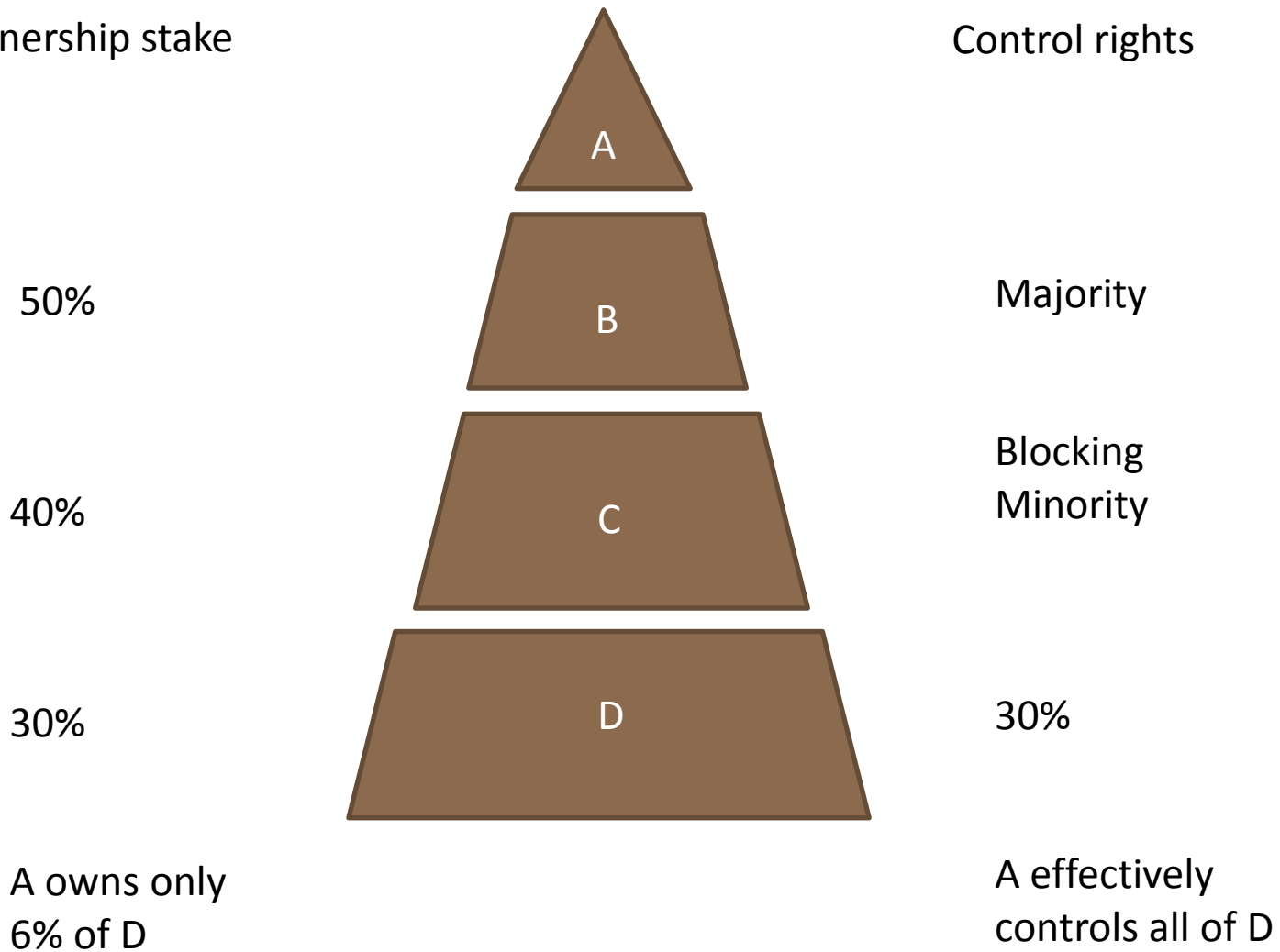
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- ❖ The eight largest conglomerates in the region exercise control over 25% of all listed companies
- ❖ The top 22 control one-third of all listed companies

# Economic Stake $\neq$ Control Rights

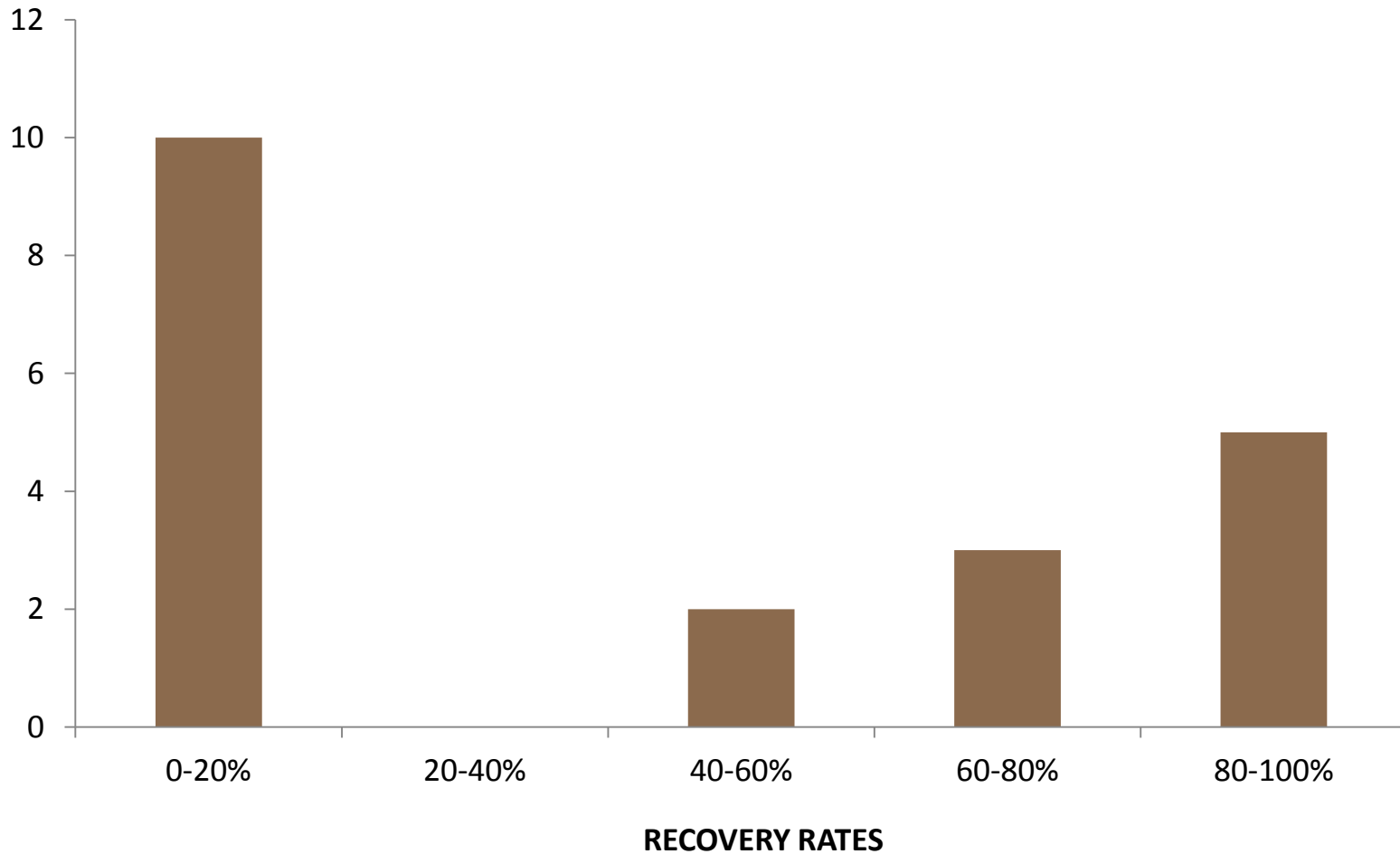
Ownership stake

Control rights



# Recovery Given Default

*Average recovery of 40% is in line with U.S. recoveries*



Source: Goldman Sachs

# Working Capital Inconsistencies are the Best Indicators of Financial Stress

- ❖ Fluctuations and inconsistencies in working capital levels are often leading indicators of financial distress
- ❖ Most bond indentures do not restrict expenditures on inventory and working capital (not a form of restricted payments), giving managers greater discretion in using company cash
- ❖ Large inventory purchases or increases in trade receivables
- ❖ Capex commitments can also trigger a cash shortfall



# Best Practices If We Suspect a Problem

- ❖ **Act with speed**
  - Start taking action as soon as problems emerge
- ❖ **Know your fellow creditors**
  - Vulture investors
  - Entry price matters
- ❖ **Press for change of legal representative**
  - A company's legal representative has all the power
  - He/she may refuse to cooperate with offshore equity holders
- ❖ **Appeal to a higher court**
  - Controlling shareholders of most Chinese companies have local political influence
- ❖ **Negotiate upfront**

# Conclusion

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- ❖ Investor rights and corporate governance are different
- ❖ Asking the right questions is key
- ❖ Perils and pitfalls equal opportunity
- ❖ Empirical research shows defaults and recovery experience in China is consistent with that of the U.S. experience