OP Investment Management, October 2011

NAVIGATING THROUGH MUDDY WATERS IN CHINA

How to find winners and identify potential troubles

All companies aim for growth. Particularly in emerging markets, nominal growth in accounting profits is relatively easy to generate when nominal GDP is rising at 10% to 15%. However, some of these stocks prove to be disappointing and are in some cases a real blow, after seemingly strong performance that turns out to be an illusion.

Our selective investment approach is designed to distinguish between companies that seem to exhibit a similar profile, but with a different reality. Some companies are operating in the same sector with comparable growth, profit margins and valuation. However, over time, their stock performances can differ widely. What can the reasons be?

(Continued on page 2)

Coverage

- Why similar companies have different performance in their share price?
- Why some attractive companies prove to be disappointing investments?
- How to assess the quality of growth?

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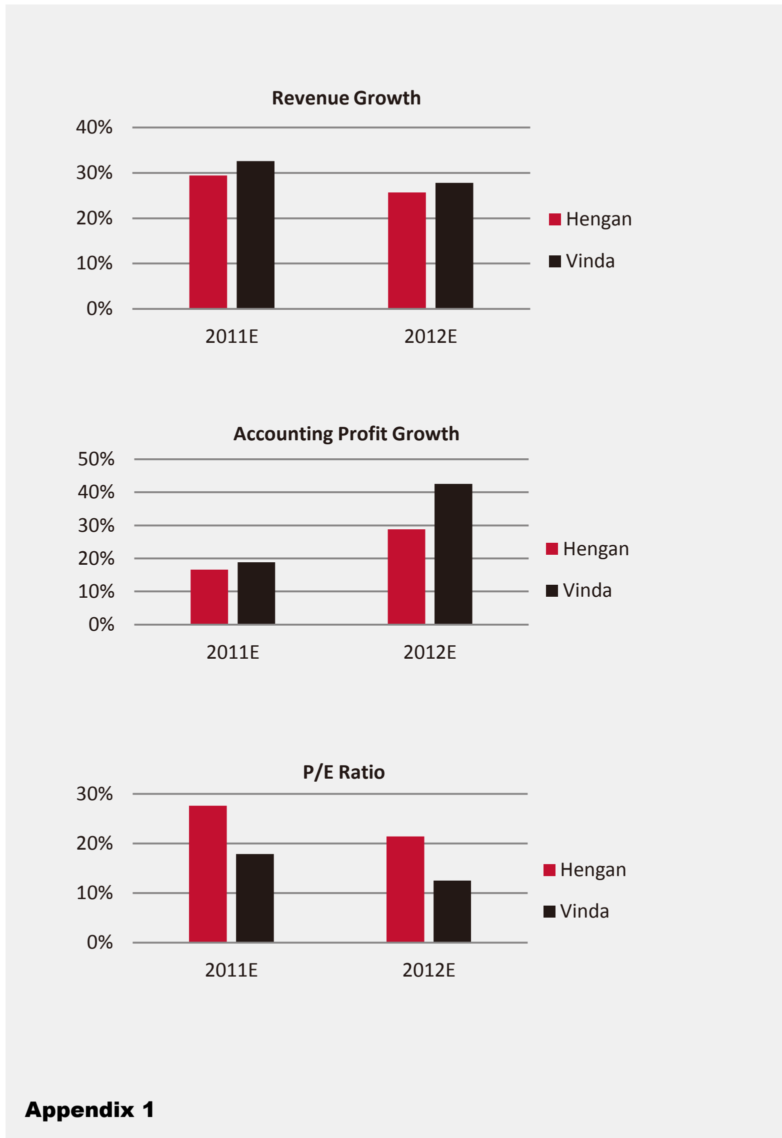
Case Study

Let's take two well recognized companies in China, **Vinda International Holding (3331HK)** and Hengan **International Group (1044HK)**. Both companies distribute their products (consumer staples) in the domestic market. Both produce fast growth in revenues (mid 20's), and have double-digit net profit margins. Looking forward, consensus numbers indicate that both are expected to generate top line and bottom line growth of very similar magnitude over the coming two years. Finally, valuations show that one is cheaper than the other. The surprise is that instead of mean reversion, the relatively more expensive stock is outperforming the cheaper stock by a wide margin.

Traditional fundamental analysis and valuation indicators do not help in the explanation of this discrepancy. However, if we look beyond commonly used approaches, there are specific and rational reasons, though seldom fully and properly discussed, that can lead to identify, among these two stocks with similar profile, the one that will be providing the better investment opportunity.

Accounting profits are subject to a lot of "fine-tuning" related to Generally Accepted Accounting Principles. Flexibility, interpretation and alternative ways to account for revenues and expenses may make the two companies look almost identical while they are not. To address that, our three types of measures - capital intensity, cash profits generation and funding profile - can reveal, between the companies, differences that are easily ignored by the investment public, who is sometimes excessively focused on growth in EPS. Our three measures provide a better understanding of the relative operational and economic performance among different companies.

In the case of Vinda and Hengan, seemingly similar companies, the contrasts are worth discussing. The traditional fundamental measures addressed earlier can be pictured on the chart in **appendix 1**. However, our analysis brings a different picture.



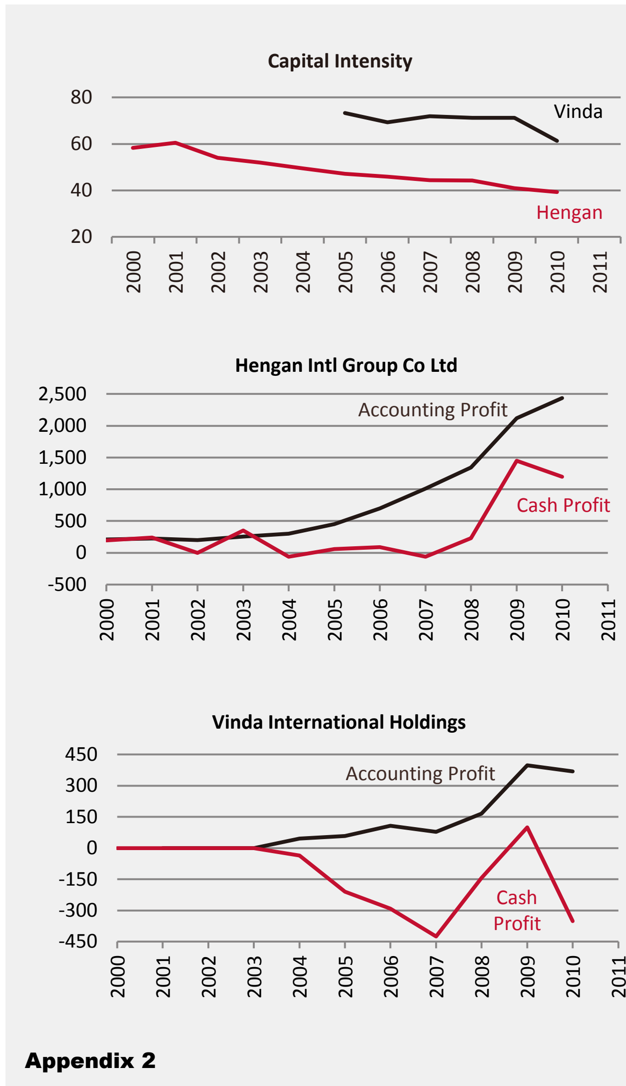
Appendix 1

OPIM's "Organic Growth" Selective Process

We start with capital intensity. Each company has its own in-house production model and outsourcing is limited. Therefore we are comparing apples to apples. Despite this, Hengan extracts more revenues from its productive asset base than that of Vinda. The difference in capital intensity is very significant, which is in excess of 50%. We explain this with several reasons. Hengan has a product positioning that is higher-end than that of Vinda. This commands superior selling prices relative to Vinda. Also, product mix between high and low margin segments is better managed at Hengan, reflecting the management business strategy. Finally the company exhibits a better organization and use of the manufacturing floor and productive equipments. All these factors give Hengan a fundamental advantage that neither revenue profile nor growth measure of EPS can help to identify.

Cash profits bring another contrast between the two companies. Cash profit is an enhanced measure of free cash-flow, adjusting for all forms of purchase of operating assets and for sources of cash emanating from working capital that are not a reflection of higher profitability. Essentially, Hengan has steady and positive cash profits, while Vinda is regularly in the red, despite the fast rise in accounting profits. How can this happen? The reality is that most business models require upfront investments in productive and operating assets over a durable period of time. This leads to a discrepancy between accounting profits and cash profits because accounting profits are not charged the entirety of the upfront capital investment but only a fraction of it, known as depreciation. The full depreciation of a producing asset takes place over several years as specified by accounting standards. However, certain economic sectors and business models demand a constant investment in new productive assets for a number of reasons such as technological developments requiring new and more expensive machineries or increasing intensity of competition. In addition, declining pricing power or natural attrition of average selling prices, and accounting depreciation too slow relative to practical reality also affect capital intensity negatively, making capital requirements proportionally heavier. These constantly required and fast rising capital expenditures can be a permanent cash drag on some companies that structurally will never be in a position to generate any cash profits. These companies are one day calling for trouble.

The troubles are visible when looking at the funding profile. Reviewing funding profile is a traditional step of financial analysis generally conducted. Though, funding issues are incompletely addressed when analysts examine balance sheet structures through debt and interest coverage ratios. Conventional methods focus on funding of going concerns. However, companies with negative cash profits need to permanently access financing, which is coming from either debt or equity issuance. Debt accumulation in nominal terms is therefore happening but will not transpire through ratios and percentages, as assets and accounting equity might grow at the same pace with nominal amounts of debt. A company that is seen with negative cash profit and debt accumulation, while accounting profits are rising, therefore represents the building of a house of cards that is vulnerable to any changes in the fundamental environment. The nominal accumulation of debt might appear bearable as long as earnings can cover debt servicing and asset values do mirror the debt accumulation. When firms are still operating reasonably, risk is potentially there but not excessively visible. However, if economic



Appendix 2

conditions change and operating revenues are affected, funding dries up while assets can only be sold at very distressed value. Then, accumulated debt becomes overwhelming and unserviceable while new equity issuance is not any more a possibility. The only outcomes are bankruptcy or acquisition by a buyer for a symbolic price. The analogy can be made with a bicycle that is in equilibrium thanks to motion but falls down if the rider stops peddling. Similarly, shareholders will have lost all when it is too late.

This is an extreme scenario but also the natural and inevitable outcome for companies with unattractive capital intensity and structural accumulation of negative cash profit generation that continue to grow. In the meantime, companies with such profile are likely under-performers and might one day bring more serious problems.

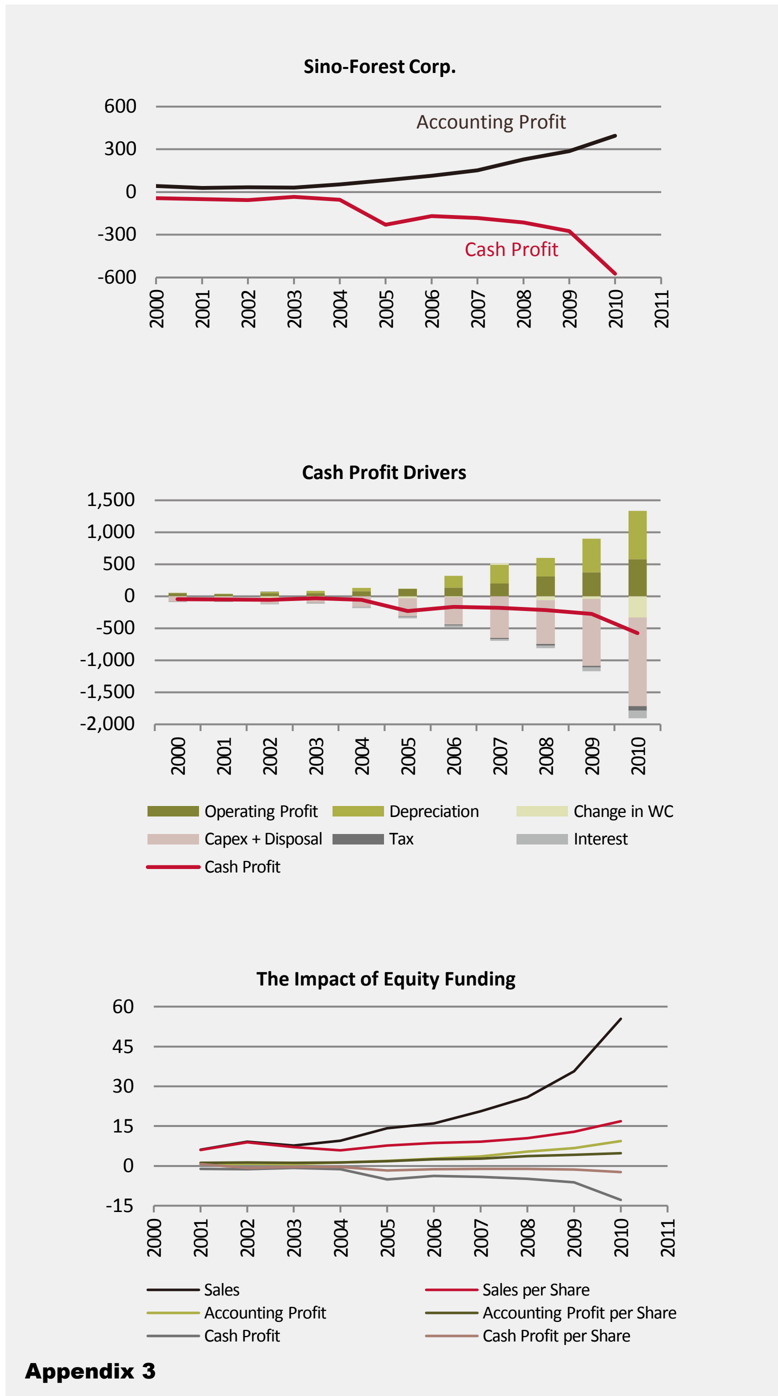
In the context of our two companies, there is no real risk of bankruptcy for Vinda despite its unattractive capital intensity relative to Hengan and its negative cash profits. The latter is negative but in modest amounts and the resulting higher debt than Hengan is manageable in proportion, as net debt-to-equity is 26% and total debt-to-equity is 40%. We are therefore talking here only about underperformance, not bankruptcy risk. However, while growth and profits of accounting nominal measures are comparable, our analysis of "organic growth" reveals a contrasting picture which explains why Vinda's share price has appreciated by a modest 34% over the last three years while Hengan has gained 155%.

Our "organic growth" selective process essentially highlights how different companies can be, even if analysts are often putting them in similar baskets. Our method helps us to emphasize the superiority of Hengan's business model, while traditional analytical approaches would rather focus on basic comparisons of growth and margins. In particular, it shows us potential risks that will never be identifiable, until it is too late, by investors who simply focus on basic comparisons. The charts in **appendix 2** show different pictures through our "organic growth" measures relative to traditional criteria.

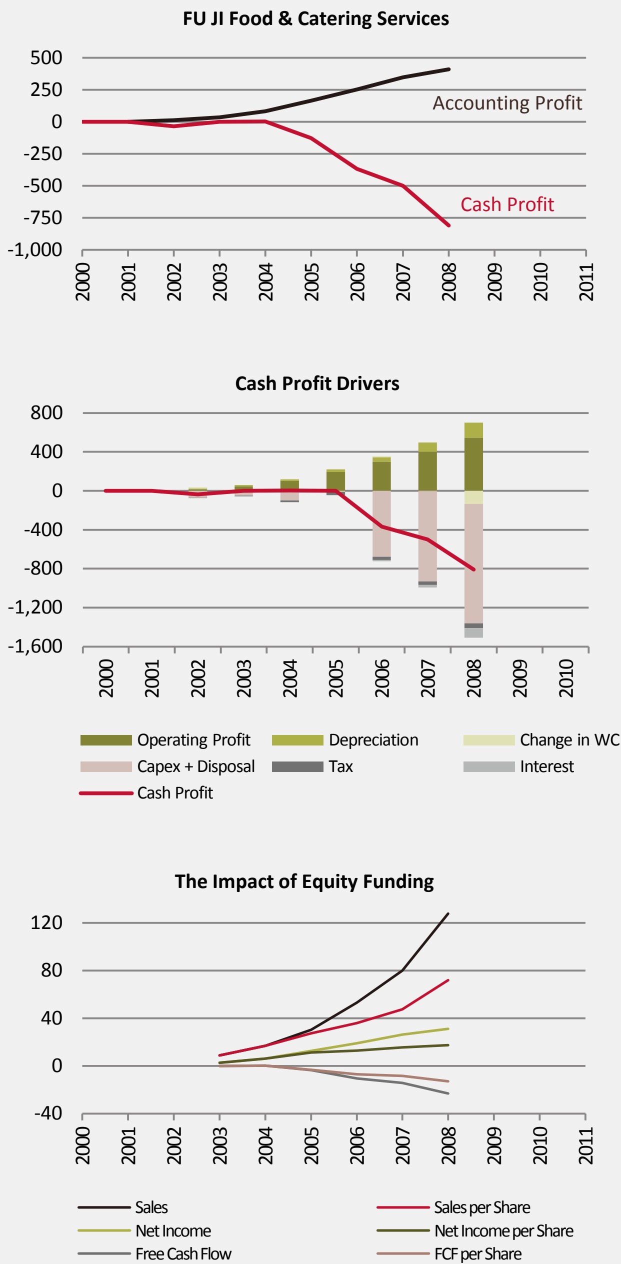
How to assess the quality of growth?

It is interesting to make use of our "organic growth" approach to review recent or past situations that have sadly made the headlines.

We start with **Sino Forest (TRE CN)**. We did not have a position in the stock and the company was not on our radar screen. However, it is interesting, considering the collapse of the share price, to review how Sino Forest "performs" within our "organic growth" framework. The charts in **appendix 3** clearly show the poor quality of growth, despite impressive accounting profits performance, as the immense cash drag requires funding in the form of both debt accumulation and dilution of equity shareholders.



Appendix 3



Appendix 4

Another interesting case is **FU JI Food (1175HK)**, because the company was a solid performer on the Hong Kong Exchange for several years before going bankrupt in a very short period of time in 2009. The charts in **appendix 4** show that the growth was imbalanced, potentially making the firm vulnerable to external shocks. We met and interviewed the management of the company a few months before the bankruptcy. Business was stable and growing though we did not feel comfortable with the capital intensity and funding needs. What we did not know at the time of the meeting is that the company was going to lose customers soon after and that the value of the assets disposal (cooking kitchens for factory canteens in China) was not going to match the amount of accumulated debt while servicing interest was becoming impossible with the decline in revenues. Bankers pulled out financing and no equity investor was ready to rescue the sinking ship. The house of cards collapsed because of losses in customers. Though would the business model have had better cash profits, bankruptcy would not have happened and the company would have likely gained new customers to rebuild its growth profile.

Conclusion

In summary, our "organic growth" approach helps us to contrast companies with similar growth and profit profiles. By going beyond accounting profit measures, we can better understand and contrast various business models. Our "organic growth" framework leads us to the winners, and also gives us superior confidence in our choices when markets exhibit high volatility. We know which company is vulnerable and represents potential source of serious troubles, and which one is rock solid and its share price will necessarily go higher over time.

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