

Navigation Through Muddy Waters

October, 2011

Opportunity 機遇



Value 價值

東英 ORIENTAL
PATRON

Linking Opportunities to Value

Navigation through muddy waters

Why buy stocks?

What drive stock prices?

How to assess the quality of growth?

Why buy stocks?



Why buy stocks?

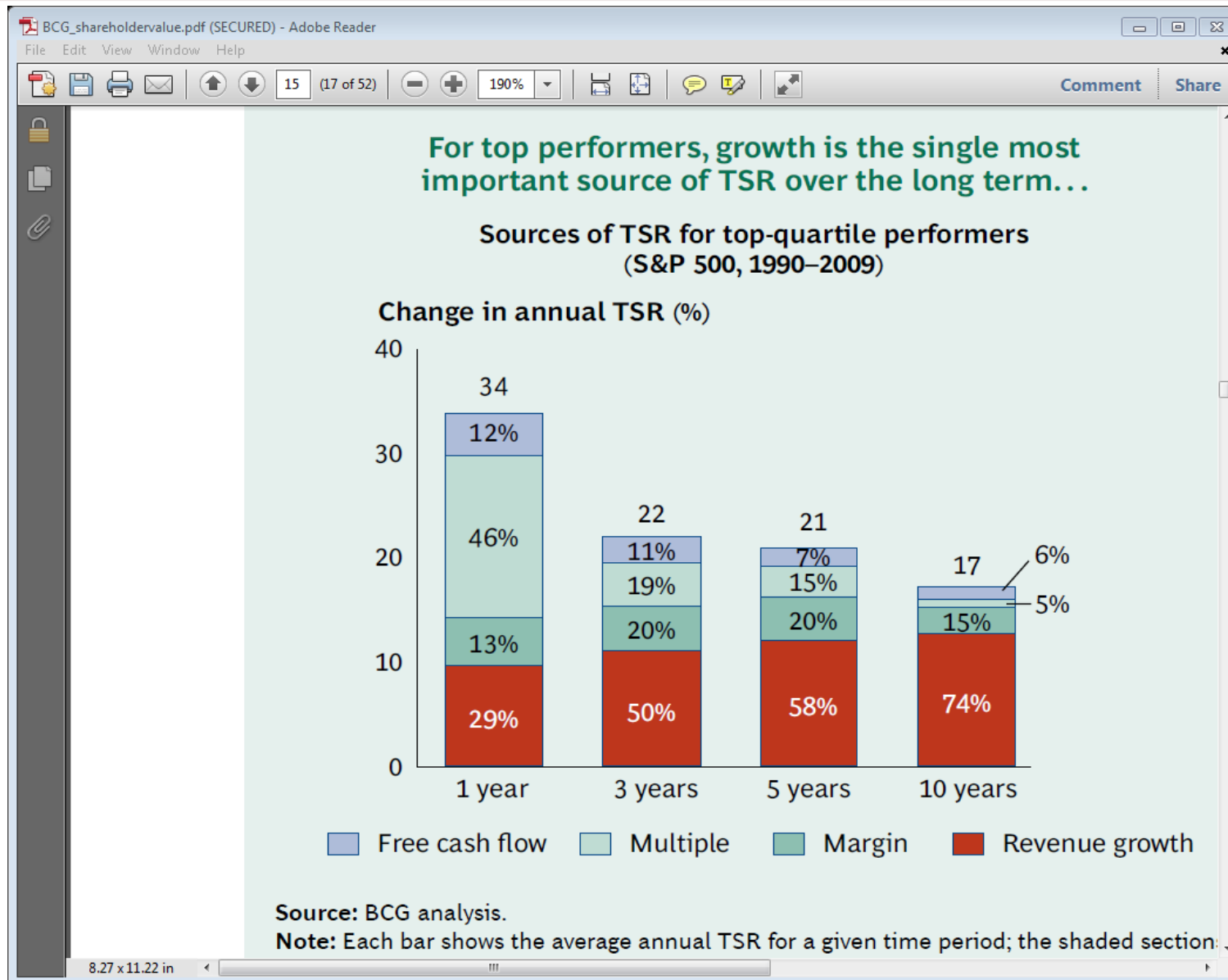
- ▶ A need to invest
 - Saving assets
 - Pension liabilities
 - Other liabilities
- ▶ The case for equities vs. other asset classes
 - Bonds
 - Commodities
 - Real estate
 - Currencies
 - Art, wine, precious stones
- ▶ Investing vs. Trading
- ▶ The challenge for equities
 - During recessions
 - Volatility
 - Life cycle and excess return mean reversion

What drive stock prices?

What drive stock prices?

- ▶ Companies fundamental factors
 - Growth in revenues
 - Improving profit margins
 - Cash flow generation
 - Financial strength including dividend distribution
- ▶ Market factors
 - Risk free rates
 - Risk premium (markets and companies)
- ▶ Demand supply factors
 - Flow of funds
 - Emotion
- ▶ The importance of time horizon
 - Factors vary with time perspective
- ▶ Growth dominates over time

What drive stock prices?



How to assess the quality of growth?

Growth drivers – we know the basics

- ▶ Top line growth is the initial growth driver
 - Capacity and volumes
 - ASP
 - New products
- ▶ Margins trend can boost or affect growth
 - Operating efficiency leads to higher margins
 - The reality of margins contraction
- ▶ Profit growth
 - A result of top line growth and margins trend

Reality check: growth in revenues and profit

growth p.a. % 3 yrs	sales	EPS
CHINA YURUN FOOD	35.5	38.9
CHINA NATL BDG-H	70.4	46.0
BYD CO LTD-H	30.1	60.1
CHINA CORN OIL	30.3	17.9
SA SA INTL HLDGS	15.0	14.1
DONGFENG MOTOR-H	27.3	46.2
BELLE INTERNATIO	26.6	18.8
APPLE INC	38.4	57.8

Reality check: market return 1

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EquityCOMP

COMPARATIVE RETURNS

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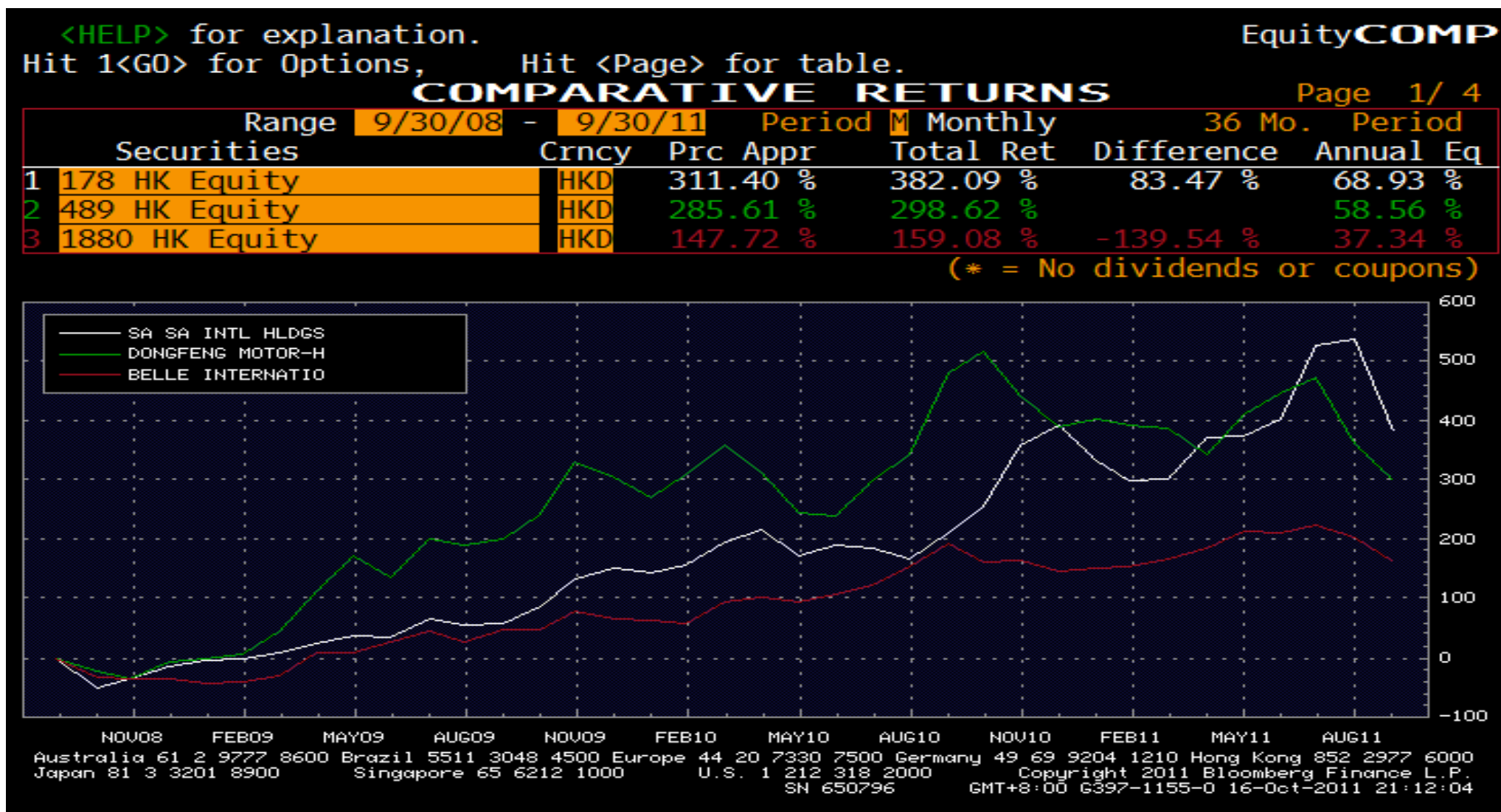
Range	9/30/08	-	9/30/11	Period	M	Monthly	36 Mo.	Period				
Securities				Crncy	Prc	Appr	Total Ret	Difference	Annual Eq			
1	1068	HK	Equity	HKD	-15.90	%	-11.56	%	-68.42	%	-4.01	%
2	3323	HK	Equity	HKD	54.36	%	56.86	%			16.19	%
3	1211	HK	Equity	HKD	2.65	%	3.19	%	-53.67	%	1.05	%

(* = No dividends or coupons)



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 Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
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Reality check: market return 2



Looking beyond accounting profits

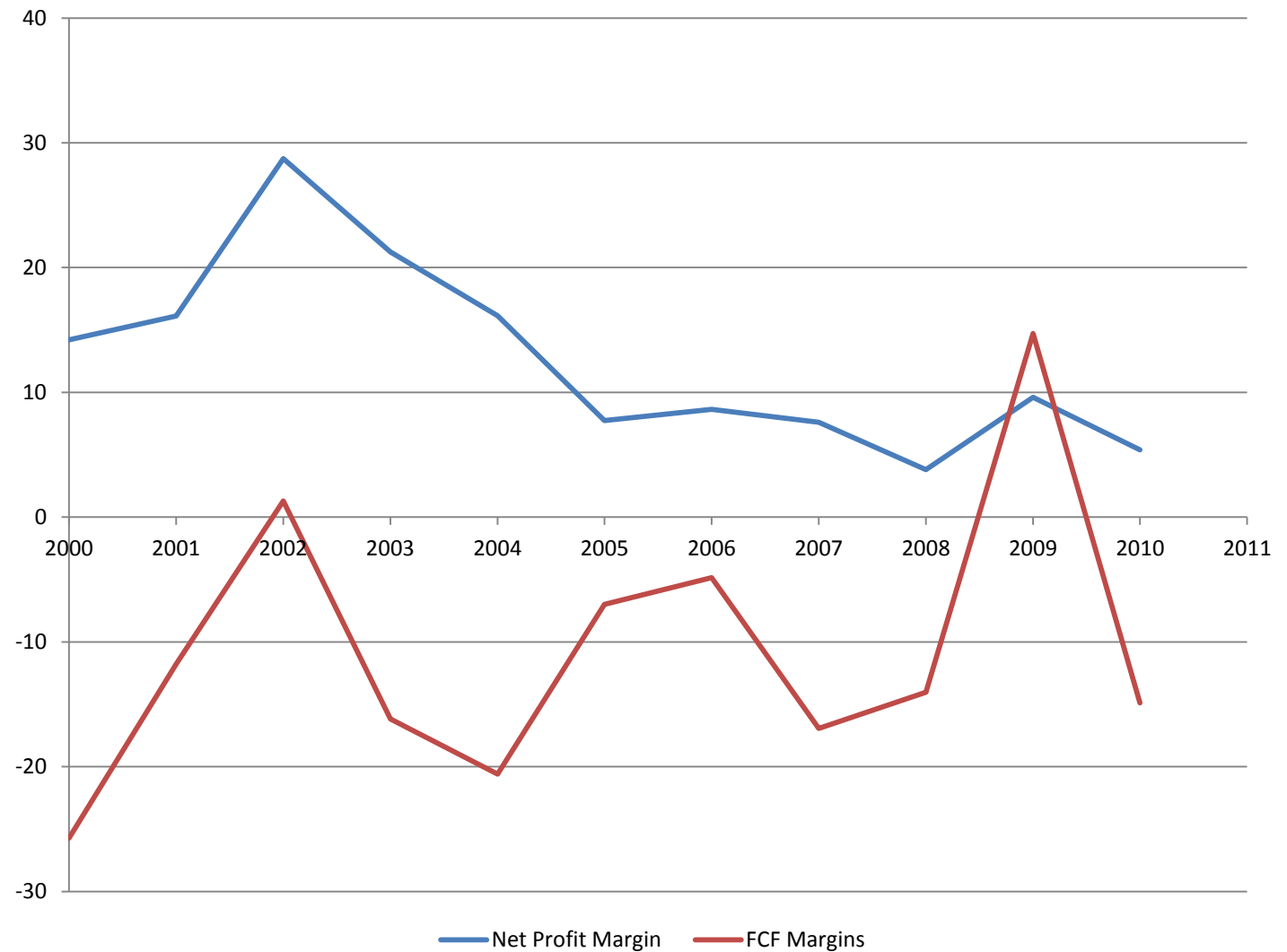
Research focus: How we look at growth

1. It is easy to grow nominal revenues and accounting profits
2. This is particularly true in China and Asia with fast nominal economic growth
3. However, the gap between nominal profits and free-cash-flow cannot grow permanently
4. Widening gap leads to financial challenges
5. This has major implications for investors



Research focus: How we look at profitability

1. High profit margins can be an illusion
2. Companies globally and particularly in Asia and China can produce high profits that never benefit investors
3. Profit margins don't really account for what the company paid
4. Profit margins don't tell us what the company actually received
5. Profit margins and free-cash-flow margins don't need to match but can't diverge permanently



Research focus: How we look at capital intensity

1. Analysts focus on capital expenditures and working capital
2. These quick measures don't fully tell about capital requirements
3. Capital intensity truly reflects these needs
4. Rise in operational intensity leads to negative impact on profitability unless margins rise in parallel
5. Chinese and Asian manufacturers face this challenge when offsetting wages increase with robotization



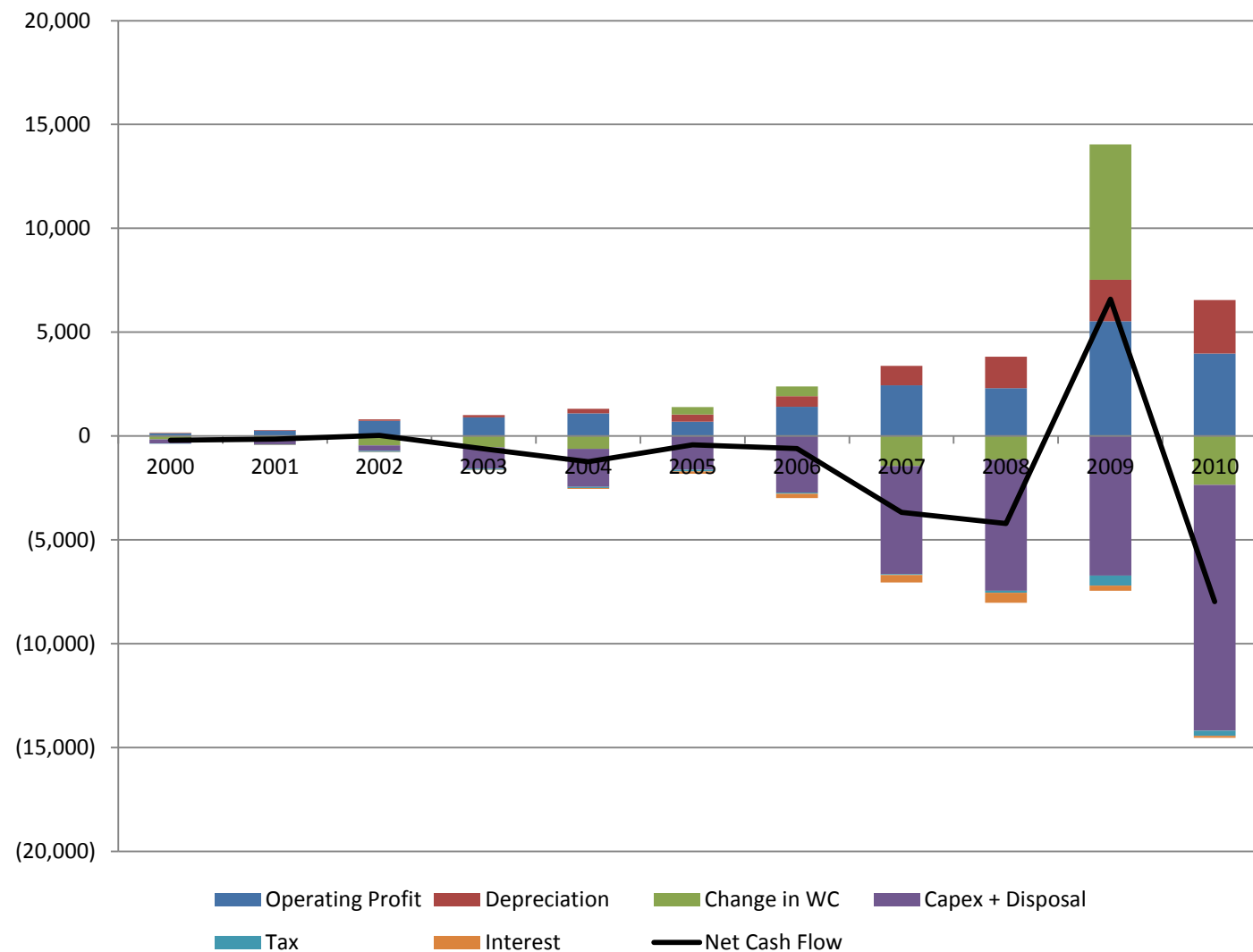
Research focus: How we look at cash flows

1. Measure of cash inflows and cash outflows provide essential information
2. Trends in cash flows reflect the financial profile of a business operation
3. It reflects the challenges of a particular industry or business segment
4. It ultimately drives future profits for investors



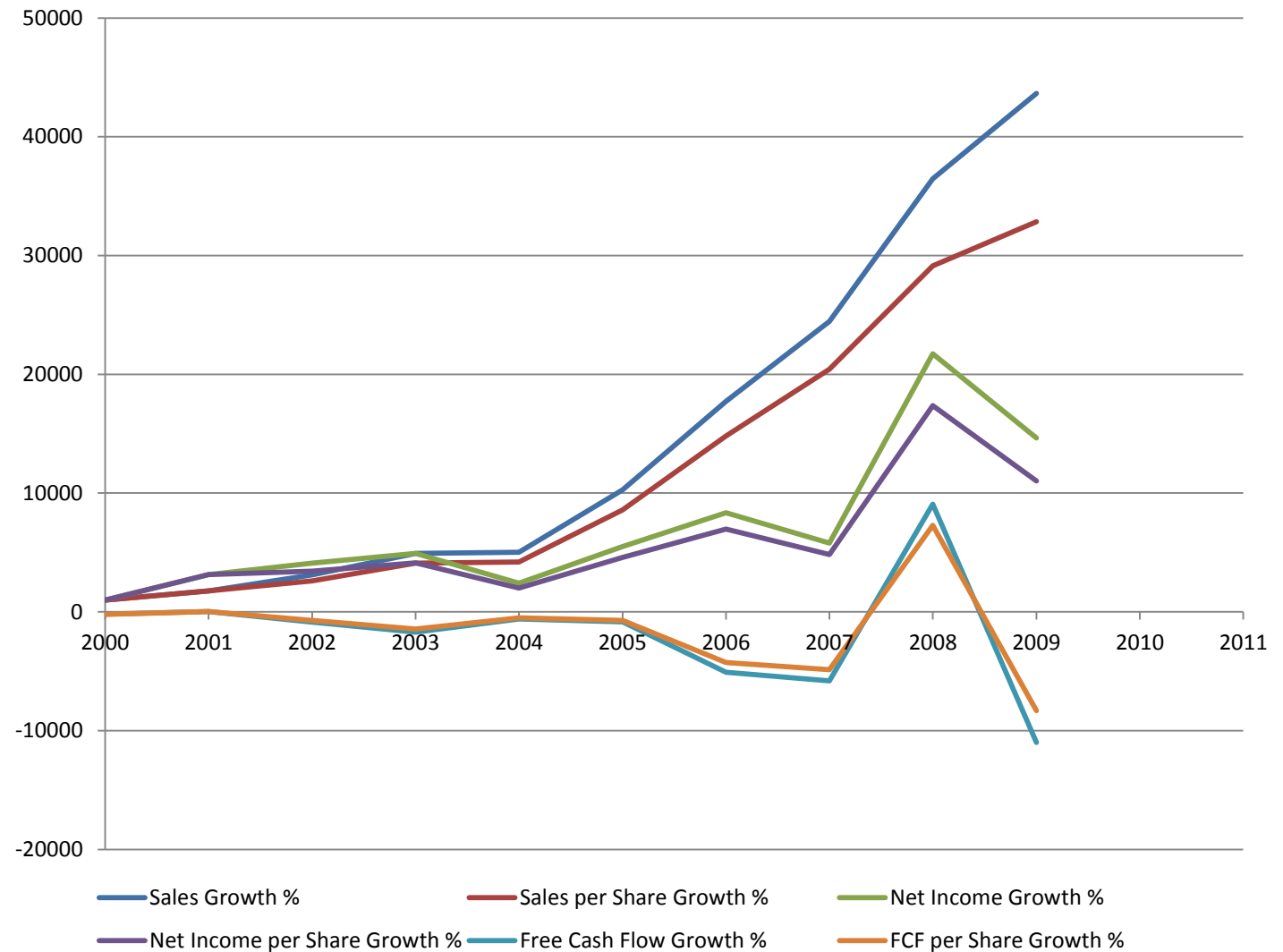
Research focus: How we look at free-cash-flow

1. Free-cash-flow breakdown clearly illustrate why investors may or may not benefit from profit increase
2. Free-cash-flow are always initially negative
3. Sustained negative free-cash-flows require debt accumulation, equity investors dilution or lead to financial bankruptcy



Research focus: How we look at ORGANIC GROWTH

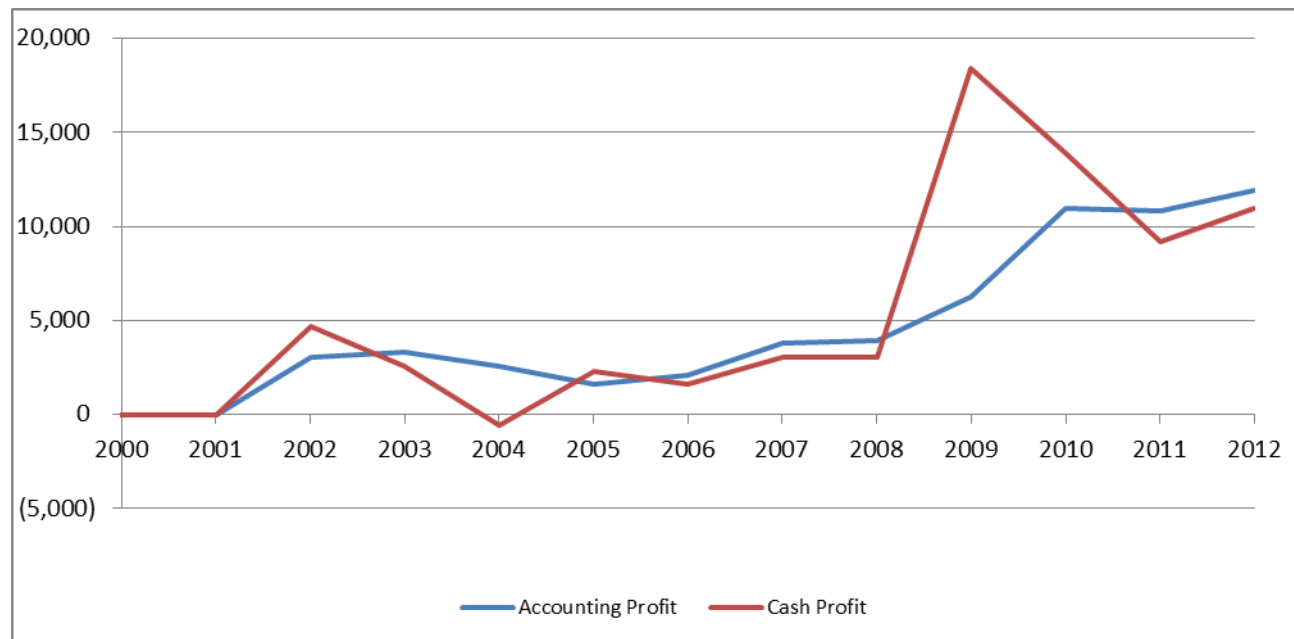
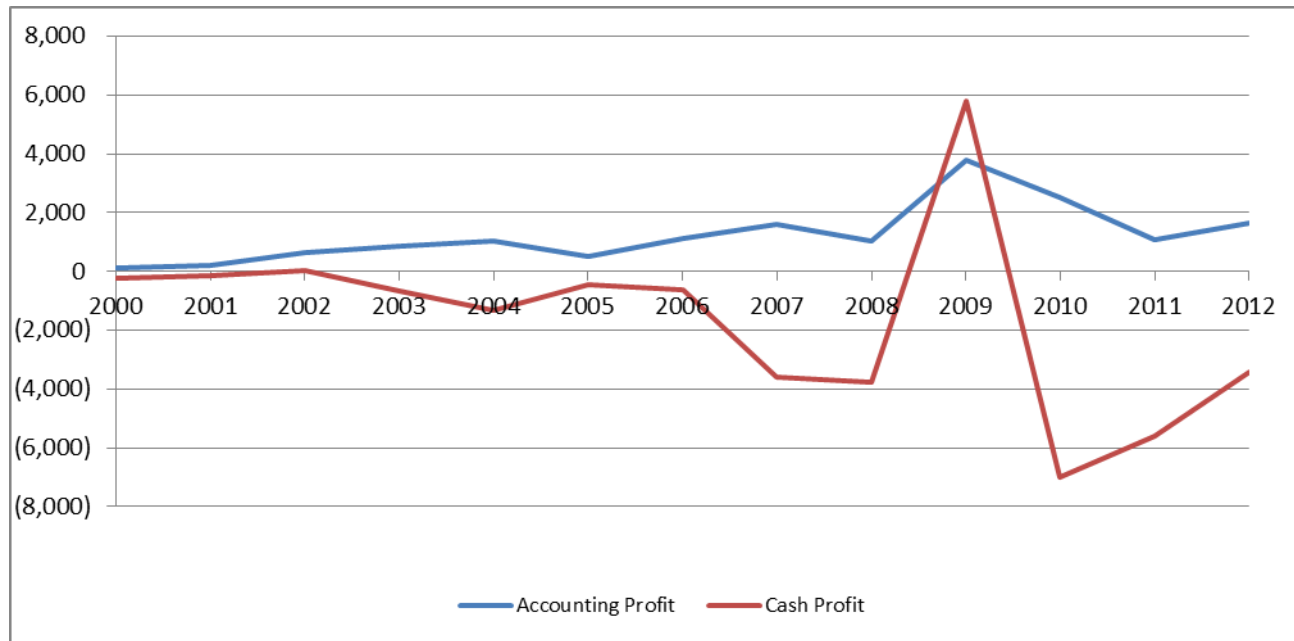
1. Organic Growth reflects a true evaluation of a company's growth and profitability
2. Organic Growth tells how shareholders can benefit from their equity investment
3. Organic Growth show the limitations of certain types of growth
4. Change in Organic Growth drivers has a direct impact on equity prices
5. Organic Growth stocks in Asia and China provide superior return to their shareholders



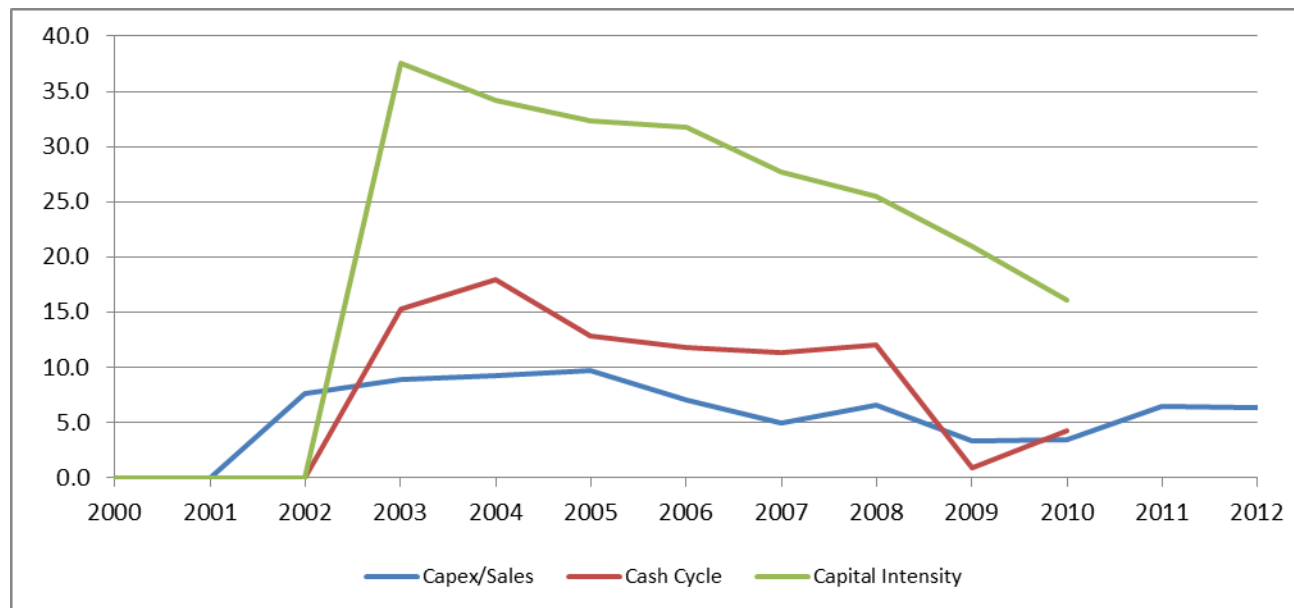
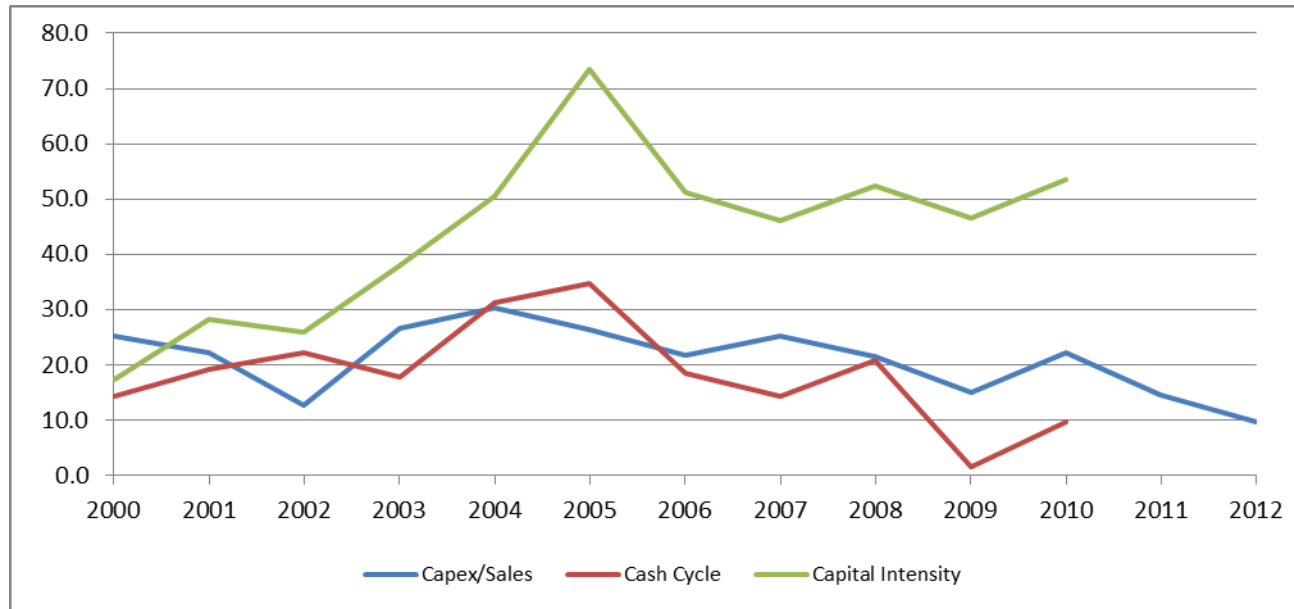
Case study



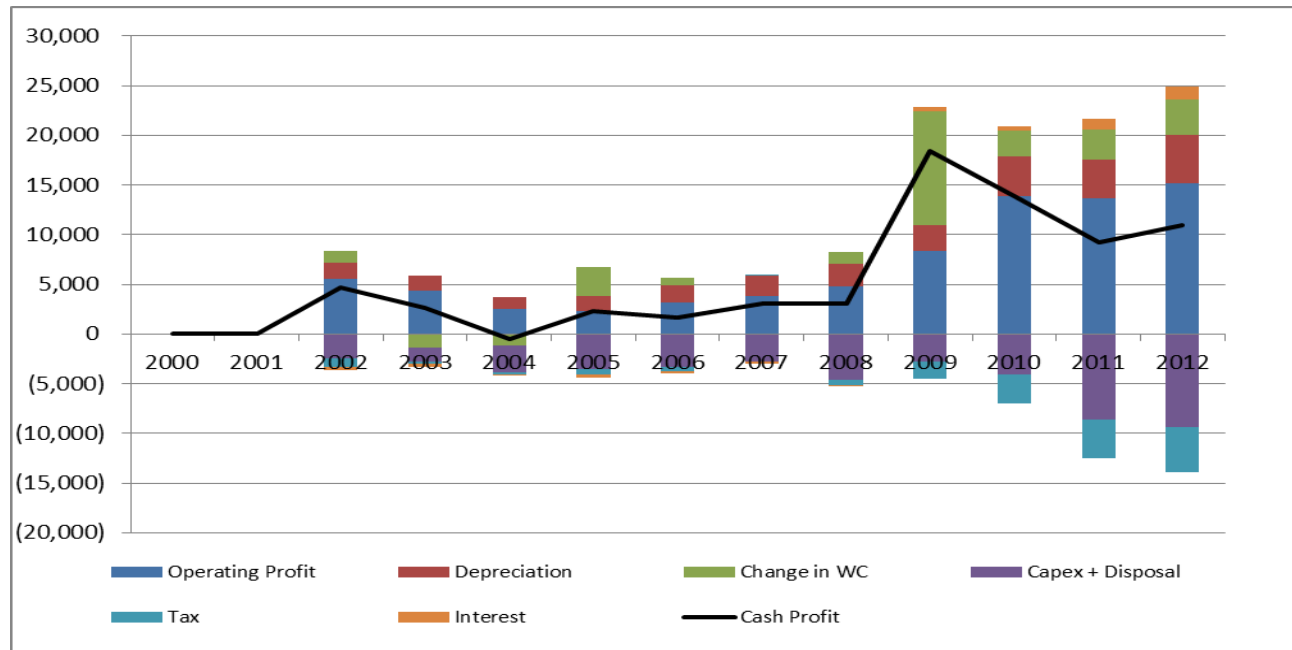
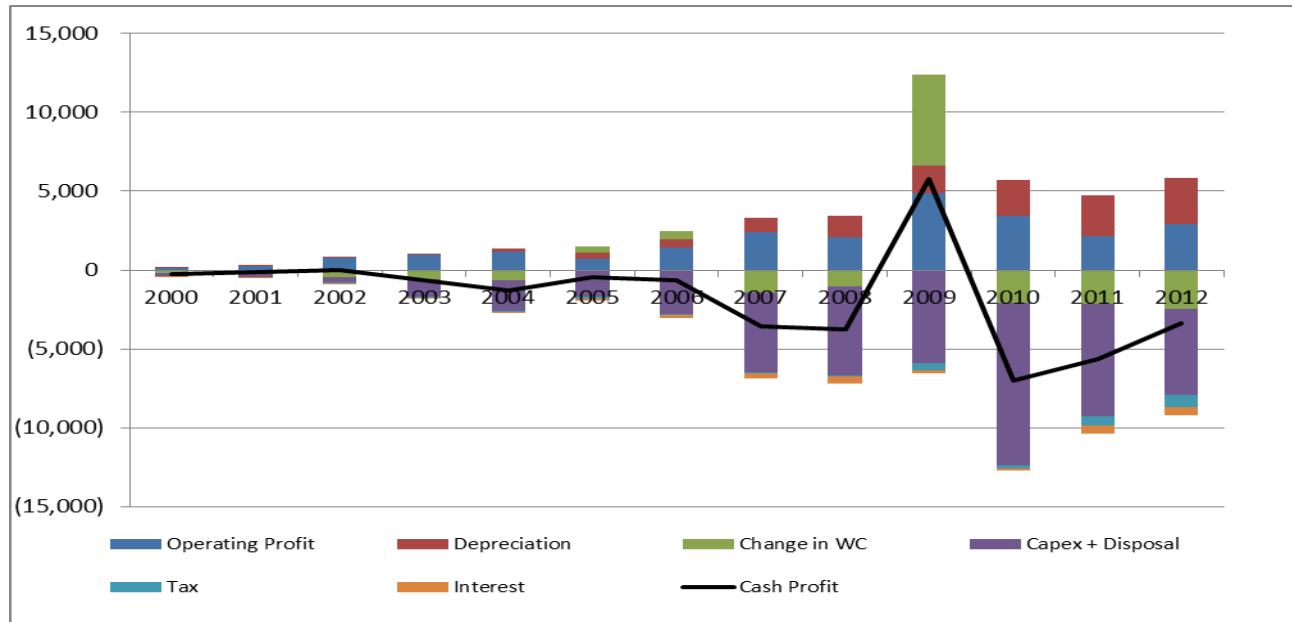
Case study: Profit profile



Case study: Capital intensity



Case study: Cash drivers



A market approach



Origin of the Organic Growth concept

- ▶ Recognition of the importance of Return on Capital (RoC)
- ▶ Selective analysis of growth, discriminating good vs. bad growth
- ▶ Extension of stock selection criteria to incorporate organic growth characteristics
 - Observing relationship between organic growth and share price behavior
 - Qualifying organic growth in relation to other key fundamental factors

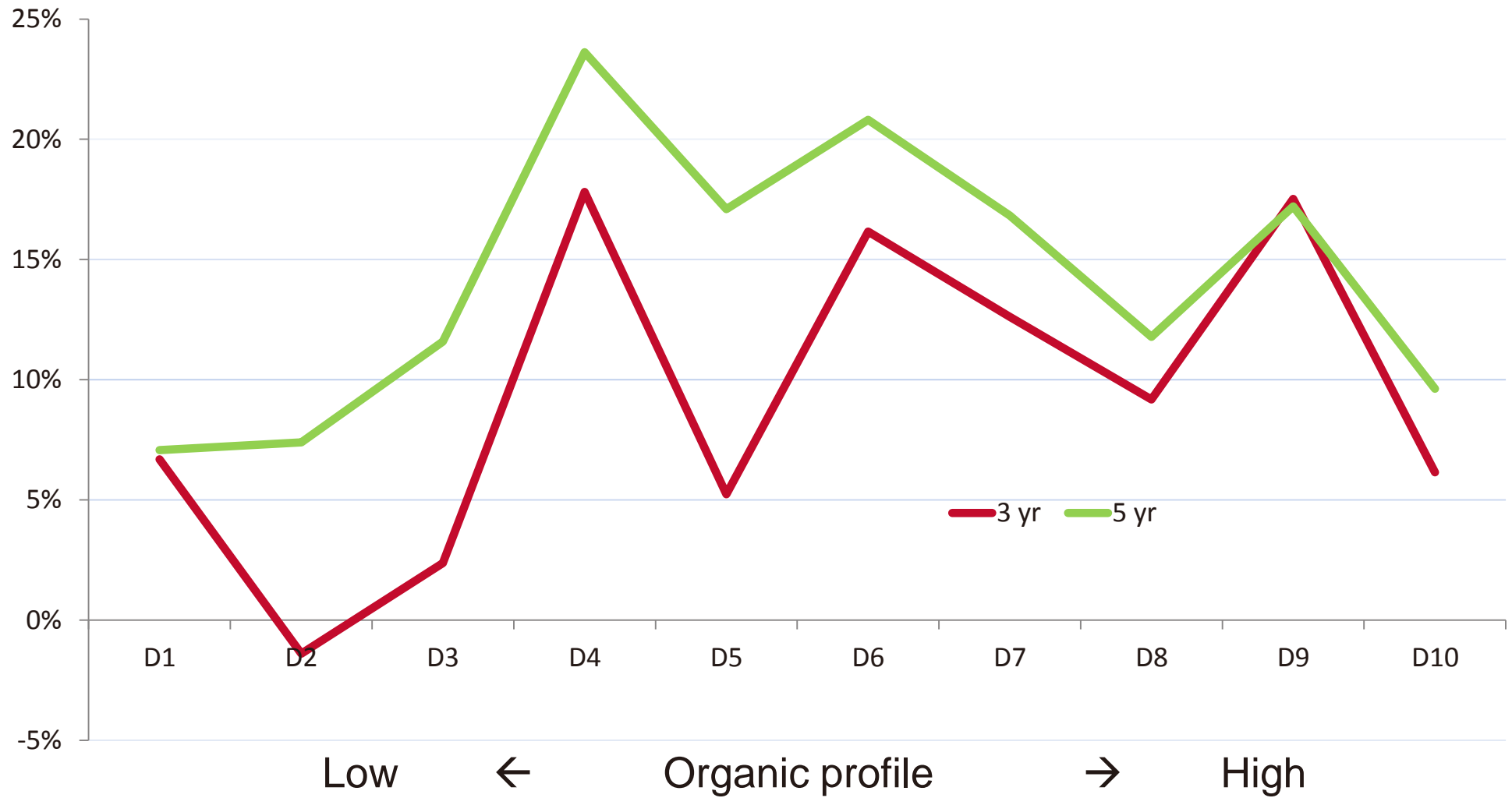
Organic growth stocks: observations

- ▶ Lower organic profile ultimately reduces return for shareholders
- ▶ Lower organic profile reflects financial weakness when companies
- ▶ Very high organic profile can also reflect companies with unattractive growth prospects. The two need to be combined together
- ▶ However, rather specific to the emerging investment universe, low organic profile can correlate to superior returns

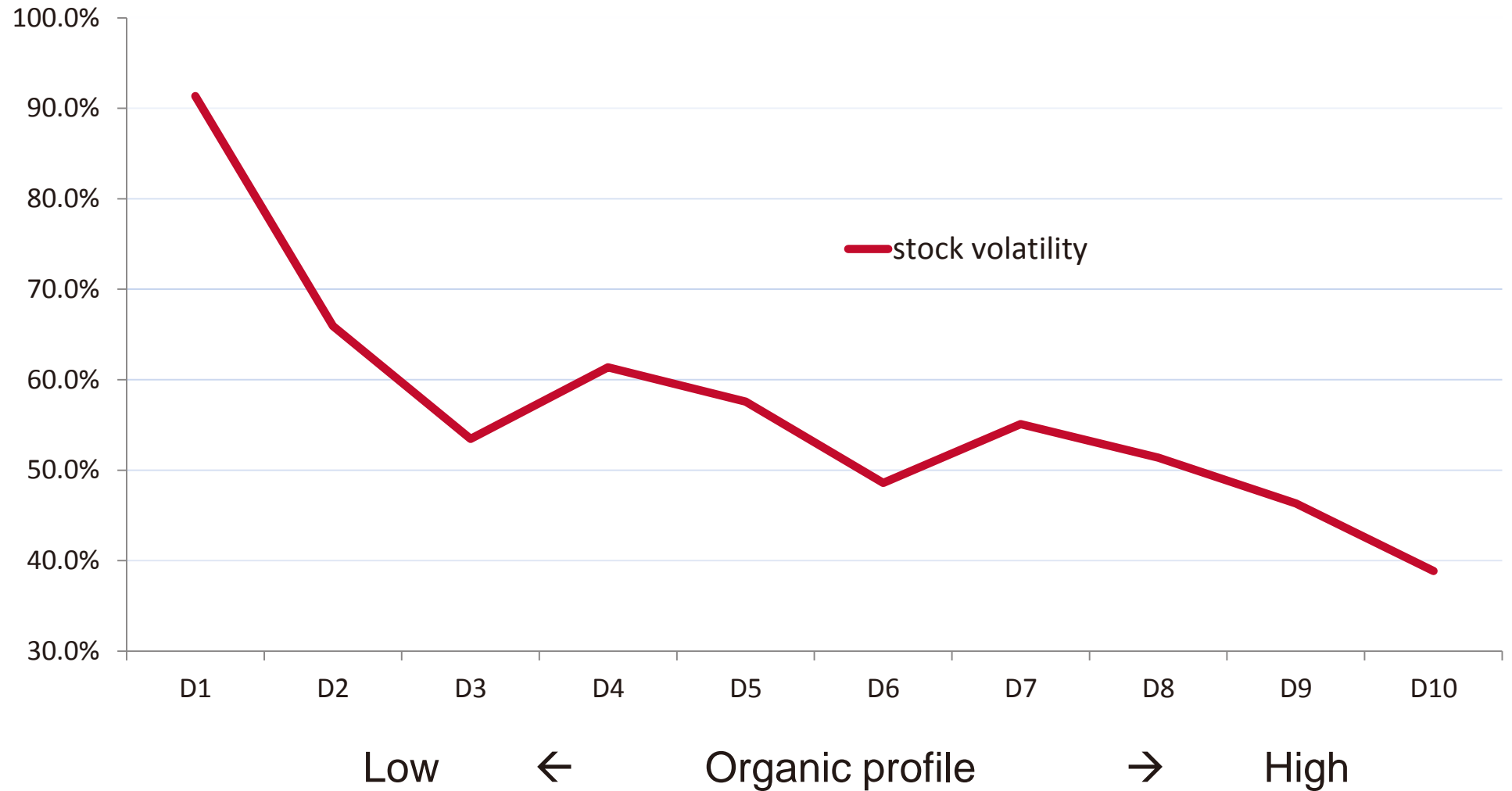
Organic growth: the investment case

- ▶ Our analysis of the investment universe
- ▶ Our understanding: all companies seek to grow
- ▶ However, some companies grow too fast
- ▶ While other companies structure their growth model rightly
- ▶ Our conclusion: the higher the organic profile...
 - The better the share price performance (next page)
 - The lower the share price volatility (following page)
 - The higher the RoE and FCF margins (last chart)

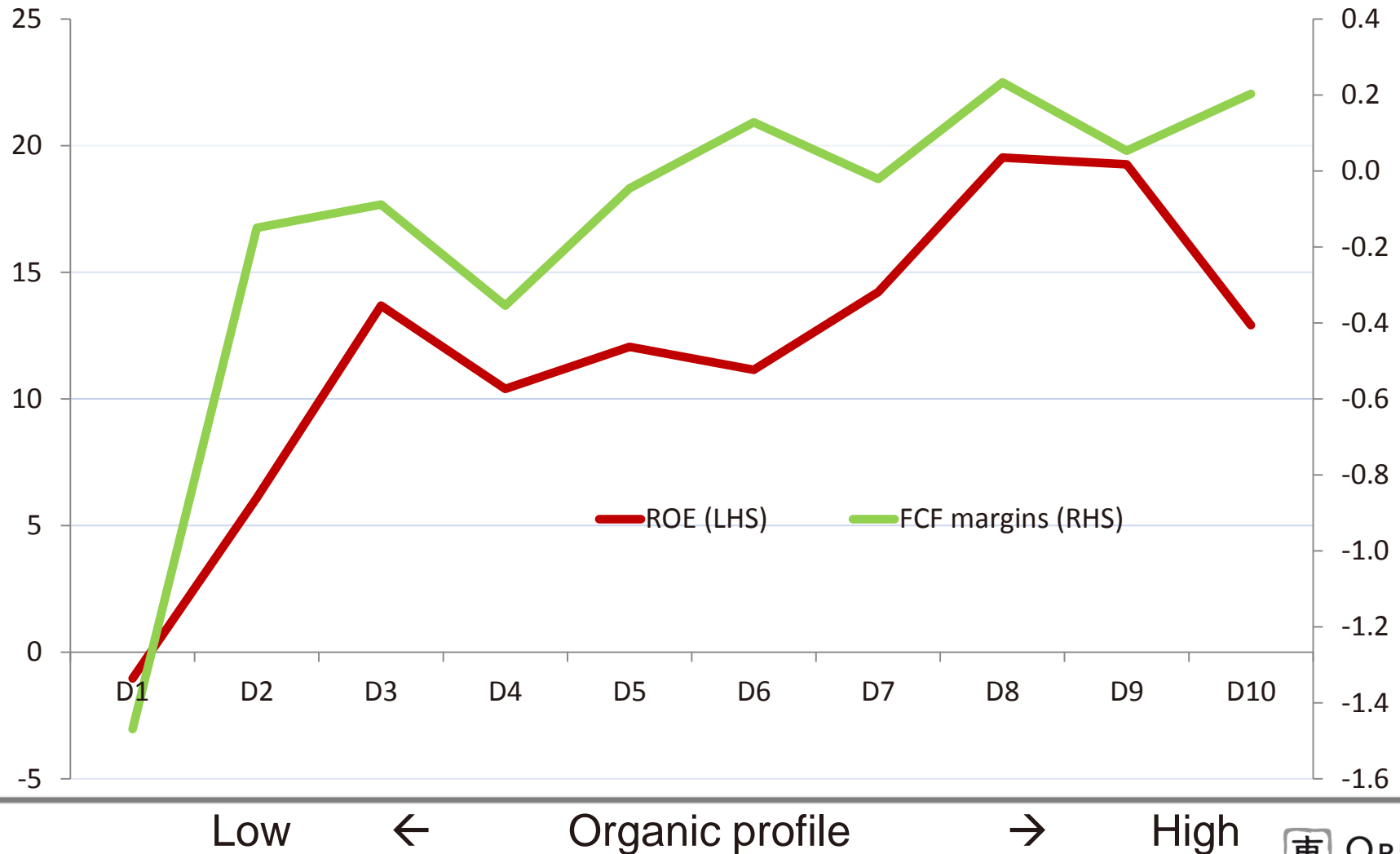
Organic growth and historical return



Organic growth and historical volatility



Organic growth and fundamental profile



Key learning's

- ▶ Stock prices are driven by various factors, growth tend to dominate
- ▶ Time horizon matters
- ▶ Growth profiles not always comparable
- ▶ Need to look beyond growth in accounting profit
- ▶ A measure of cash profits reveal the true profile of a company
- ▶ Some companies and businesses really look like a house of cards
- ▶ Growth in cash profits is a reliable stock price driver through cycles and crises



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