

Lazard Insights

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The Invisible Hand of the Market: Ten Observations on China

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China's economic transformation has been an engine of growth for the global economy. Many investors want to participate, but others consider China's socio-economic model unsustainable. The following observations are from a recent visit to China to see the conditions on the ground at first hand.

Challenging the Dualist Framework: Communism, Capitalism, and Centralization

By the mid-1980s, the world was divided relatively cleanly into two ideological camps. In the United States, Ronald Reagan had been elected to join Margaret Thatcher on the political right, both firmly believing in the power of the market and entrepreneurs. At the same time in China, Li Xiannian stressed the importance of the state and its bureaucrats, joined ideologically by Mikhail Gorbachev of Russia. This dualism existed and was easy to understand. And it is still the framework we believe most journalists and investors appear to use when they assess China within the international landscape.

Observation #1

The Han Chinese Move into the Market

This dualism has collapsed as both "hard capitalism" and "hard communism" have become intellectually discredited by events. We believe that both sides are converging, with the "invisible hand" of capitalism and the "iron fist" of communism both partaking of each other to some extent. The center of global entrepreneurship may no longer be Wall Street, but in fact could be the army of Chinese business owners who pursue profits, albeit within an authoritarian framework. The Han Chinese, or ethnic

Chinese, which form 92% of the population of China, are becoming more visible in the market. The People's Republic of China (PRC) has, to some extent, acknowledged that social harmony can only be realized with a strong private sector, even if that private sector must operate within a centralized framework. The government is gaining its legitimacy from their competence in delivering economic growth.

An example of the growing entrepreneurial culture is EVA Precision Industry Holdings (EVA), an office equipment supplier in Shenzhen. They award stock options to the three hundred most senior engineers, far beyond what is typical at many Western firms. The CEO indicated that they engage in this practice because that is what Google does to attract the best people, and they believe EVA needs to do it as well to stay competitive. A similar demand for excellence is present at Wumart, the Beijing supermarket chain, where if an employee is ranked as "adequate" in a 360° review for three consecutive years, they are fired for not being excellent. This is a huge contrast with Japan, where the "job for life" ethos continues to prevail in many of the *kieretsus*, or corporations.

At the same time that communism has adopted parts of capitalism, we have seen Western countries begin to adopt leftist rhetoric in response to the perceived inadequacies of unfettered capitalism. An example of this is shown in Exhibit 1, the Chevron webpage. The text box seems purposely designed to address social issues and looks like a placard in a student demonstration.

Exhibit 1 Western Companies Address Social Concerns



As of 14 June 2011

Source: Chevron, www.Chevron.com

Observation #2 Transcending Dogmatism: Centralized Government Can Have Some Advantages

Again we challenge the dualist assumption that free markets inevitably lead to economic prosperity and individual freedom and state control inevitably leads to poverty. Judged economically, centralized government can have some advantages over democracies in periods when dramatic transitions are required. Small groups tend to make clearer and faster decisions. In warfare, democracies have a poor record against authoritarian states. Similarly for major public investments, for example smart grids, making a top-down decision for a national rollout is more efficient than having individual states voting on which version they would like to adopt.

If democracy, with its rule of law, procedure, and checks and balances, is thought of as a brake, centralized government is an accelerator pedal. This can lead to terrible human suffering if it is poorly executed, as we saw in the Cultural Revolution. However, we argue that in the modern era, the rapid industrialization of China would not have been possible without its centralized political system as seen by its extensive capital investments in Exhibit 2.

In the last decade, the average Chinese citizen has seen a remarkable improvement in their standard of living, something which is unlikely to have been achieved under a *laissez-faire* approach. There is an interesting contrast with India. The legacy of British rule in India was both democracy and bureaucracy. In the same time period that China has industrialized, large parts of India, the world's largest democracy, have been plagued by malnutrition. Judged purely on the outcome for the majority of people, one could make the case that regular meals are more important than regular elections. Nevertheless, even if the outcomes have been good in the last decade, there is the constant risk of a catastrophic policy

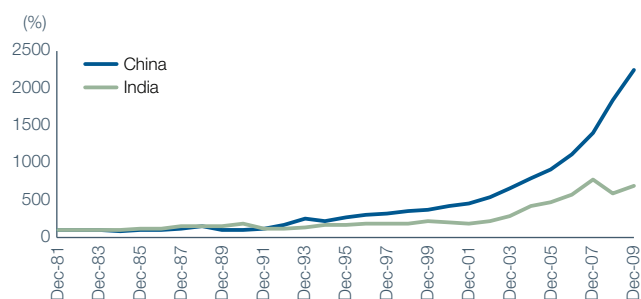
failure. For this reason, we believe the Chinese system will ultimately only be as sustainable as its ability to grow the economy.

Observation #3 Growing Pains: The Middle Kingdom Feels Squeezed from All Sides

China is unsure as to its position in the post-dualist framework and its new position as a soft communist economic powerhouse. Many Chinese people feel misunderstood by the West, and they are engaged in very defensive and nationalistic discussions. This may seem contradictory. For example, the Bank of China's management seemed quite strident in defending the command economy and pointing out the failure of free markets, yet they are still promoting their company to Western investors to seek investment capital and to increase their share price. The tension caused by the new cocktail of entrepreneurial culture within a communist framework is manifesting itself on the streets of Beijing. For example, BMWs are sold in lavish showrooms, but advertising which stresses their elite status is not allowed. China's tensions in adapting to the new framework appear similar to those faced by the West following the global financial crisis. The U.S. president is committed to free markets, but with "adult supervision." We believe this is symptomatic of the move towards paternalism which is the mirror image of China's *de facto* transition to a wider private sphere.

However as China's economy and society develop, the need to keep it "on message" with communism is more intense than ever. The "Arab Spring" was not unnoticed in Beijing, and serves as a case study in authoritarian regimes losing legitimacy. Social networking sites are viewed as a particular threat, although they can also be useful as a tool in enforcing central control of local govern-

Exhibit 2 Cumulative Fixed Gross Capital Formation

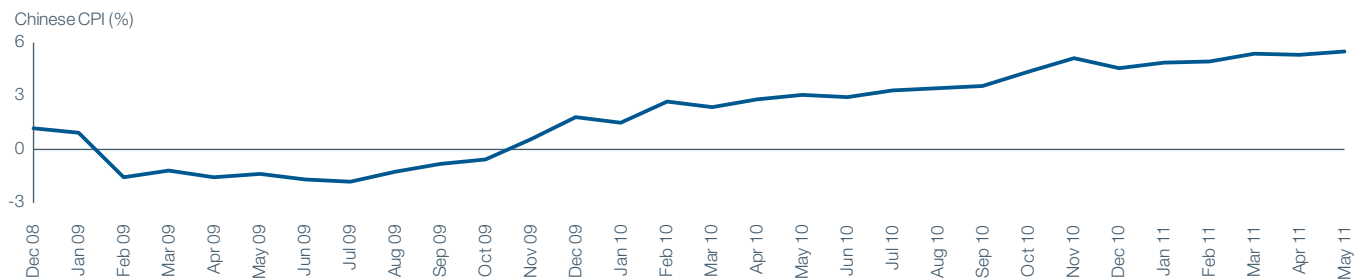


As of 31 December 2009

Gross Capital Formation (including the private sector) was converted to USD using WM/Reuters and FactSet spot mid exchange rates then divided by the relative populations for a per-million-capita comparison.

Sources: Exchange Rate: WM/Reuters and FactSet; India: Ministry of Statistics & Programme Implementation; China: National Bureau of Statistics of China; Population: IMF

Exhibit 3 Inflation



As of 31 May 2011

Percent change from same period in previous year; not seasonally adjusted.

Source: National Bureau of Statistics of China

ments. As stated, the recent success of China in managing the economy means the risk of an uprising is apparently low, although there is the constant threat that a policy error could change this.

Managing the Transition: Inflation and Demand

Observation #4 Inflationary Mindset and Inflationary Pressures

Perhaps the biggest threat to the current regime is cost inflation, which has continued to rise over the past year and a half, as seen in Exhibit 3.

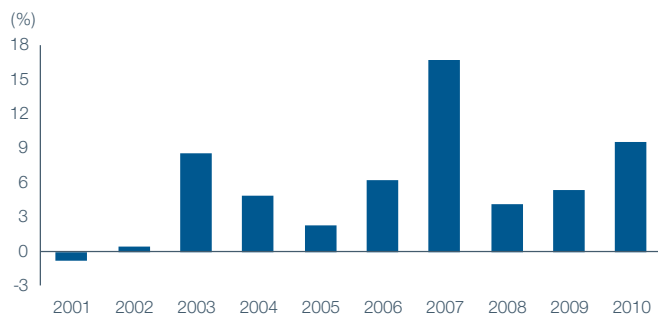
Many people think the “Arab Spring” was caused by Facebook. This is a convenient explanation; however, a major catalyst for the “Arab Spring” was the same as the French Revolution, namely food price inflation. We believe cost inflation, whether food or other non-deferrable items, is the biggest threat to the Chinese regime because it threatens to impoverish the population. Two areas of particular focus are food price inflation and property price inflation as seen in Exhibits 4 and 5. Given that food and shelter are fundamental to human life, and their absence is a driver of

acute social disharmony, if either should prove to be unmanageable, it would threaten the control of the government.

Most people consider food inflation to be the biggest threat. However, the government appears to be relatively relaxed about food inflation, as long as it is modest, because food inflation can be seen as a transfer of wealth from richer city dwellers to the poorer rural farmers that produce it. This promotes equality, and hence, it can be considered a positive outcome for a communist. However, there is no such positive outcome for property price inflation. This is a transfer of wealth from the poor renter to the rich speculative landlord and affects those most financially sensitive. The expense of urban condos was the subject of a recent Chinese television program until the issue became too sensitive, and the show was cancelled.

It is important to recognize that both China and the West face cost increases as commodity costs increase, arguably as a result of the response to the global financial crisis, which saw quantitative easing and currency debasement. However, it is critical to understand that in China this is inflationary, where in the West it is deflationary. In China, the labor market is tight and higher costs

Exhibit 4 Annual Food Price Inflation



As of 31 December 2010

Data represent YoY % change

Source: National Bureau of Statistics of China

Exhibit 5 Cumulative Property Transaction Prices



As of 31 December 2010

Data are indexed to 100 as of 31 March 2008

Source: CMEI—China Monthly Economic Indica

are leading to higher wages. Provided cost inflation is not out of control, wage increases—currently running at 15% per annum for factory workers—ensure there is no fall in the standard of living.¹ This is a huge contrast with the West, where high unemployment rates generally mean that higher costs are not leading to higher wages, and therefore, deferrable income is falling, leading to lower asset prices.

The response of China to cost inflation is the micro-management one would expect from a communist regime. The conventional policy would be to increase interest rates. However, this would increase the value of the Renminbi and make China's exports less competitive. Their response is, therefore, to take specific targeted action on areas of inflation.

Observation #5 Housing Affordability and Social Housing

Vikram Mansharamani, a lecturer at Yale University, has an interesting analogy for the Chinese economy. He compares the Chinese economy to the bus in the film *Speed*. In the film, a bomb is placed on a bus, which will explode if its speed falls below 50 miles per hour. It is similar to the Chinese system, which bases its legitimacy on economic growth. If the economy falls below a certain “speed limit,” or level of GDP growth, the system could explode.

As any economist will tell you, GDP growth can come from labor growth, capital growth, or productivity gains. The One-child Policy has meant that the labor force risks falling, not increasing. Growth in capital is needed, as seen by the need for communist company managers to meet with Western capitalists, but cannot be relied upon. Hence, productivity improvement is needed. In our view, the real solution is urbanization. Instead of a farmer digging a field, he can be a factory worker on a production line. Thus, to ensure the bus does not fall below a certain speed, China would have to urbanize.

Critically, this urbanization is currently being hindered by property inflation. Exhibit 6 depicts a dorm building in Shenzhen. Generally, conditions are miserable, as there are often twelve men or women sharing factory-owned dorm rooms. These dorms are needed since condominiums are currently so expensive. The problem is that one cannot raise a family in a dorm room. This means when workers reach a certain age, they are forced to abandon their urban factory jobs and return to tier two cities or the countryside, often with partners they may have met at the factory. This chokes off urbanization, which as we have argued is critical in driving GDP growth.

We believe the solution is social housing. In the most recent five-year plan, the government unveiled an ambitious plan to construct ten million units of social housing. Essentially this subsidized

Exhibit 6 Housing Development



As of June 2011; Source: Lazard

housing will be affordable and will allow the sustainable increase in labor productivity, which can only be achieved through urbanization. The factory worker will be kept in the factory, and the miner will stay in the mine. In a meeting with China Vanke, a construction developer, they confirmed that while ten million units could be a stretch target, the construction of social housing is real and huge in scale.

Observation #6 Build and They Will Come

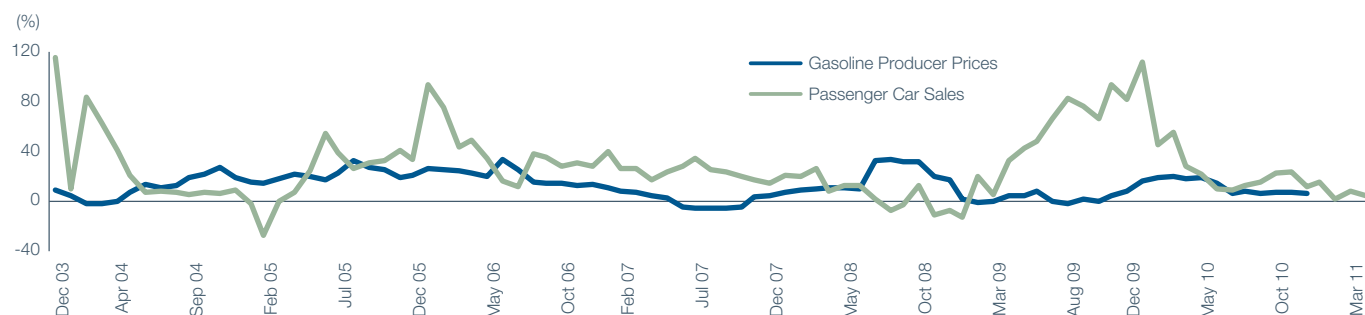
It is a very popular pursuit of American investors to fly to China to take photos of empty condo buildings. In some ways it is similar to the English fad some time ago for flying to India to hunt tigers. The investors have heard that there are fields with sixty-five million beautiful empty condo buildings, and they want to shoot a few of them.

Sadly the reality is different. There are popular urban legends of ghost-towns like Ordos in Inner Mongolia, which is a city without people, and orchestras are bused in to play to empty concert halls. However, recent visitors now report that a huge mine recently opened near Ordos, and the city rapidly became more populated. Hence, appearance and reality can often be very different. While vacancy rates of developments vary, it is currently reported that it is around 10% in total, and 17% in new developments.²

At the same time we ought to be aware of the risk that cheap money and asset inflation has created in China. Huge capacity has been created not just for condominiums, but also in retail stores and factories. As asset prices have inflated, companies have become profitable, and the level of non-performing loans at banks has been very low, encouraging them to increase lending and fuel inflation.

We believe the main risk in these conditions is of poor resource allocation. This is a risk in all economies without free markets,

Exhibit 7 Increased Gas Prices Affect Car Sales



As of 29 April 2011

PPI of gasoline price shown as YoY % change, neither are seasonally adjusted.

Source: National Bureau of Statistics of China

and hence without price discovery. It seems strange that empty condominiums are sitting near factories which are running at full capacity utilization and desperately need capital to expand fixed assets and working capital. It is just as surreal to walk into a shoe store in Beijing which has no customers but a large staff and pairs of shoes costing \$5,000.

Observation #7 War in Sight

From an investment perspective, this creates risks in certain sectors. An industry which we believe could be at risk is mass automotive manufacturers. The consensus view of the Chinese automotive industry is uniformly positive. Wage inflation means that people have money, car ownership is very low, and therefore some believe car sales ought to grow 25% per year for the next decade. After visiting a number of car factories and speaking with managements, and also speaking with foreign journalists in Beijing, a different picture emerges. Just as condo developers have a “build and they will come” attitude to property, the automotive companies have a “build and they will drive” attitude to production capacity. Some companies are tripling their capacity in the coming years. At the same time rising fuel costs and rising costs of ownership, as seen in Exhibit 7, indicate that generally people cannot afford to run their vehicles. Conditions are in place for a sharp drop in capacity utilization. In unconsolidated industries, like mass auto in China, we believe this means a price war is on the horizon. However, the situation is very different from the luxury segment where companies like BMW sell very profitable cars to rich Chinese consumers who have been made rich through asset inflation and want to show their success. Conspicuous consumption is very much in fashion in China.

Politics Meeting Economics: the Financial, Industrials, and Consumer Sectors

We will now apply our assessment of the underlying themes at play in China to three key sectors and draw some additional investment implications.

Observation #8 The Ministry of Banking

Unlike many Western economies, which recently have nationalized parts of their banking system for the good of the population, Chinese banks have always been explicitly state-controlled. The control of loan growth in China is the central mechanism the government uses to control the velocity of money. Banks in China are instructed at what level they will grow their lending and to which sectors they will lend. This is obviously very different from Western banks which lend money based on an expected return to the bank. The confusing part is that the managements of Chinese banks appear desperate to show they have a Western philosophy, even if they defend their role in the command economy.

The government is slowing the economy not by increasing interest rates, but by increasing the reserve rate requirement, which is the amount of money the bank needs to put aside for safety. As an investor, the challenge is that this has the same negative effects as raising interest rates for a bank, namely that loan growth slows and loan quality gets worse. However if interest rates are increased, banks normally have an offset in that the net interest margin increases. Put bluntly, they make more money on their loans. But in China this mechanism is denied, so financial productivity risks falling dramatically.

Observation #9 The Industrial Complex

In visits to a range of factories we witnessed how modern and efficient they were. There is no noticeable difference between the efficiency levels at Chinese operations and those in Europe and Japan, even if there is likely to be a huge difference in product quality, which one cannot see on a factory tour. Interestingly, we saw that Japanese automation equipment was very popular. Management suggested this was due in part to superior accuracy, but also because Chinese companies trusted that Japanese and German companies would protect their intellectual property, but other Chinese companies might not.

We believe the main risk of the Chinese industrial sector is that it is being constrained on three fronts. First, the supply of electricity is constrained as a result of subsidies to power generation companies being limited. The issue is not generation capacity, as is commonly thought, but the utilization level, which is running at just 60%.³ This means many factories are being forced to operate on three-day weeks unless they have the political leverage to be deemed strategically important, in which case they could have unlimited power.

The second issue as we discussed earlier is the shortage of labor, which is a result of unfavorable demographics and the rising cost of property in tier one cities. The reform of the One-child Policy, which is de facto being phased out in certain provinces, in addition to social housing construction, may ease this in the medium term.

The last constrain is the most damaging, in our view. This is the constraint of capital seen in Exhibit 8, as the PRC slows loan growth by increasing reserve rate requirements at the banks. This is affecting the companies' ability to finance growth, and is resulting in a sharp fall in demand for capital equipment. Construction equipment data shows sales have fallen very sharply in the last two months.⁴ Some interpret this as a sign that the system is about to collapse, but we think it is important to distinguish between countries which we believe are tapping the brakes (China) and those which appear to be fiscally 'tapped out' (the United States).

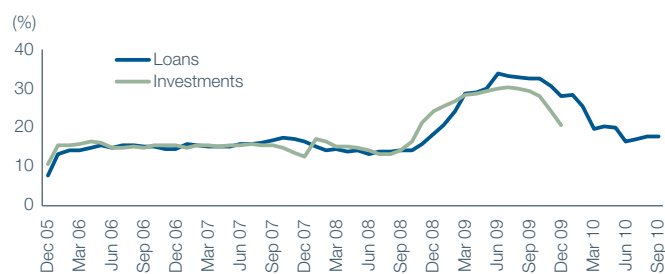
Observation #10 Splurge Global, Taste Local

We argue that in the consumer space one needs to focus on global brands at the luxury end, and local brands at the bottom end. The reason is that luxury brands are vital in demonstrating financial success. There is a fixed number of luxury brands, and they benefit from incredibly strong pricing. You cannot enter the space if you do not have a long period of pedigree.

In contrast, at the low end it is striking how specific tastes vary in different regions. Local players seem best placed to adapt. In Malaysia a local player makes a coffee product. In one packet you get some instant coffee, a sweetener, powdered milk, and a sexual stimulant. The company is very profitable, but it seems unthinkable that Starbucks could enter this space while maintaining their global brand integrity.

In summary, we believe the dualist framework is no longer an accurate framework for assessing China. Authoritarian governments can have some specific advantages, even if they are fundamentally fragile in drawing their legitimacy from delivery rather than democracy. Inflation, urbanization, and housing are linked issues which are critical to understand. And from our understanding of these themes, we are able to refine our bottom-up understanding of opportunities for investors over the long term.

Exhibit 8 Gross Capital Formation and Industry



As of 30 September 2010

Sources: Loans—Global Insights; Investments (PPI)—National Bureau of Statistics of China

Notes

- 1 Source: Lazard estimate
- 2 China Realty Research, June 2011.
- 3 Deutsche Bank, CEIC, June 2011.
- 4 Source: Lazard estimate

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Published on ___ June 2011.

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