

Doing Business in China Today . . .

Julie and I just returned from China where we traveled to three of China's largest cities to meet with the managements of 23 small, publicly traded companies. While it will take some time to distill the entire experience, I thought I would share some of my initial reflections on what it is like to do business in China today.

At the risk of stating the obvious, the first thing that strikes you about China is its sheer size. Geographically, the country is about the same size as the United States. But most of its 1.3 billion people live in the densely populated eastern coastal region. This concentration has left the country highly urbanized. Consider that today more than 180 cities in China have populations greater than 1 million. And the three cities we visited, Beijing (12 million), Shenzhen (10 million) and Shanghai (20 million), are some of the world's largest.

The extensive changes brought

on by the country's economic expansion are also impressive. The most obvious evidence is the vast forest of construction cranes spread across the fairly polluted skylines. Thanks to the upcoming Olympics, Beijing appeared under the most development although Shenzhen and Shanghai were building at a furious pace as well. In Shanghai, the 88 story Jin Mao Tower is now being eclipsed by the 101 story Shanghai World Financial Center and in Shenzhen, we traveled for two hours through unending high rise apartments and industrial sites to see one company's manufacturing facilities.

Evaluating the business prospects of a company operating in an economy growing 10% per year requires something of a mind-shift. To achieve rapid earnings growth, U.S. companies typically need to come up with some remarkable product innovation or dramatically cut costs. While product breakthroughs occur in China, most

of the companies we saw were growing quickly just by rolling out basic products and services to an increasingly prosperous population (think bottled water, agricultural machinery and standard prescription drugs).

So what makes for an attractive business in China? Most firms we met with discussed their "first mover advantage" and the importance of building customer loyalty through brand recognition. This approach makes sense in a country where rapidly growing income levels are allowing consumers to focus more on product quality. Businesses with central government support

also have a huge leg up. Two of the companies we saw, for example, were in businesses aligned with the government's plans to improve domestic security. Their "preferred supplier" status was so important that one of them used pictures of President Hu Jintao at a product introduction as a core piece of marketing material.

Finally, having the ability to raise funds is also critical in China today. Up until recently, much of China's economy was dominated by large, inefficient state-owned enterprises. The rest of the market was left to thousands of small, often family-run businesses. In an effort to improve efficiency, the Chinese government is slowly dismantling many of the state companies and encouraging consolidation of the smaller players. China's recent stock market gains are also fueling an acquisition boom. Beijing based General Steel, for example, has used funds from a recent public offering to buy two smaller steel operators and is planning more acquisitions in the next two years. American Oriental Bioengineering has acquired four firms since 2003 and has two more now in the pipeline. In these cases, acquisition related cost savings enhance each firm's already favorable growth prospects.

For the most part, the executives we met appeared quite capable of taking advantage of the current boom market. Most, in their 40s, had international business experience and English language skills. Several had graduated from business schools here in the U.S. The investor presentations, even for most of the smaller companies, were professional and could have come straight out of any Wall Street firm. My guess is that much of this generations' strong work ethic and ambition results, in part, from having lived through the economic and educational deprivations brought on by China's Cultural Revolution (1966-1976). It will be fascinating to watch how these men and women, and the generation following them, handle China's opportunities and challenges going forward.



The old meets the new in Shanghai

An Investor's Day in China . . .

I met with over 20 companies in China last week. Most of them were small-cap and driven by highly energetic entrepreneurs that recently had offered shares on the U.S. OTC market. Of all the things I saw and experienced in China – and this was a lot – few things impressed me more than the restless energy, drive, and smarts of the young CEOs who had built these companies out of nothing.

The place that left the biggest impression on me during the week was neither the historic capital of Beijing, nor sophisticated, soaring Shanghai. It was the factory city of Shenzhen and its surroundings. Shenzhen was just like the small companies I had been seeing all week. It had risen out of nothing but sheer energy, drive, and profit motive. That is why it sometimes was disparaged for not being a real city and for lacking history and culture. At other times it was admired as a boomtown.

The first time I came to Shenzhen was 19 years ago, when it already had had eight or nine years under its belt as a special economic zone. That made it different from any other Chinese city I visited. There were high-rises, fancy hotels, and discos for foreigners. Back then, I could easily grasp the city's size and scale. I could see where the city stopped and started because bright green fields farmed by men and women in straw hats surrounded it. This time, I really couldn't tell how big Shenzhen was. The downtown sprawled, the outskirts melded into surrounding factory towns, and there was no farmland anymore – just factory after factory in a thick polluted haze that blotted out the sun.

One of my most interesting days in China was when I visited a bottled water factory an hour and a half away from Shenzhen. The company is a consumer play because bottled water consumption will rise as individual incomes increase and more attention is paid to health. This company projected a doubling or trebling in profit the next two years, and actually, this seemed perfectly credible to me.

The water factory operated 22 out



A bottled water factory in China

of 24 hours, with the remaining two hours left for equipment maintenance. Huge bags of PET resin were transformed into plastic water bottles. Water was filtered in two stages and purified via reverse osmosis. Bottles were filled, sealed, and packed. And the workers – mostly young women between about 17 and 23 – must all have had their own stories about coming here from distant hometowns.

The CFO who guided us through the factory was a smart, energetic man in his mid-40s with excellent English and a great sense of humor. Only later, when I talked to him further, did I find out that he had grown up in Hong Kong, gone to school in the U.S., and in total, lived in the U.S. for a decade and a half. He left his IT job in California because the opportunities in China were too great to ignore. Opportunities arose, he said, because in China you could never say that one company dominated any market. Industries were too fragmented, and the market was just so big. This was true for his company, and just as true for Coke. That was a recurrent theme throughout the week. Nearly every company I saw emphasized how fragmented its industry was and how well positioned it was to become the industry consolidator. The CFO's personal story also became familiar throughout the week. I met people from Singapore, Hong Kong, Europe, and the U.S. – ethnic Chinese and not

– who had come to China to grab their own piece of opportunity. Later, I found out that the CFO had been in his job for all of 20 days.

Acquisition was a major strategy for the water company, and 12 were planned in the next year alone. Management invited us to visit a bottling machinery company in which it had just bought a minority interest, so we got in the company cars and drove an hour deeper into the countryside to see a facility with 300 to 500 workers. Here we saw raw metal transformed into machine parts, bottle molds created by computer-aided design, and workers assembling machinery by hand for shipment to Japan, the Middle East, and points all over China.

Later, we pulled into a dusty parking lot in front of a restaurant the size of a stadium. We took one of the private banquet rooms that lined a hallway about a quarter mile long. The place was abandoned and looked worn at 2:30 in full daylight. But I suppose that in the evening, when things were lit up and you weren't the only ones there, it could have turned into a festive, rowdy place. After the soup, the asparagus, the watercress, the whole chicken (with head intact), the stewed pork, the mutton, the crisped tofu, the lobster on noodles, the fried pork skin, and the whole fish, we begged them to stop. They agreed by finishing up with fried rice and a porridge made with the lobster head.

On the way back to Shenzhen, heavy traffic forced us to crawl through the factory town of Dongguan and fully absorb the awesomeness of its factory landscape spreading out for miles. A few miles in, I began to believe that half of what I own started here – as buttons, running shoe insoles, circuit boards, memory cards. I know there must have been more out there, but from the highway, you saw no restaurants, libraries, gymnasiums, pool halls, or schools. There were only factories, thousands of anonymous dormitory windows, and probably, that many individual stories of emotional dislocation, loneliness, and – perhaps once in a while – success.

The Golden Age . . . Still Waiting . . .

Cash dividends represent the bedrock of return for Value investors. When you get cash in the pocket there is no question what your return is. Dividends have been a very important component of stock returns historically. Since 1928 total return has averaged 10.4% annually and forty percent of this has been the dividend. Many companies paid out between 50-60% of their earnings each year in cash. The nice thing (for the most part) about the dividend component of total return is you know what you are going to get and you can count on it.

Well things changed dramatically after the 1970s. As the chart below shows, the dividend payout ratio has slipped from 50-60% of earnings to half this now. Last year the dividend payout was 28% and only 77% of the S&P 500 companies even paid cash dividends versus 94% in 1980.

There was reason to hope that things would change for the better after 2003. In that year the top Federal tax rate on dividends fell to 15%, the same rate as for capital gains. Now the argument that paying dividends triggers an onerous double taxation, first at the corporate level and then when the dividend is paid at the individual level, no longer holds as much water. The tax rate for individuals today is at the lowest level anyone can remember. Also in 2003, Microsoft, the poster child for a rapidly growing growth stock, started to pay dividends for the first time. It was expected that

many traditional non-payers especially in technology would follow suit and institute a dividend.

Well unfortunately not much has changed the past four years. The dividend payout ratio and the number of companies paying dividends have actually continued to slip. Companies argue however that they have put in place something even more valuable than a dividend, the stock buyback. As you can see in the chart in the upper right, companies are buying back a lot more stock than is being issued through initial public offerings and secondaries. Last year the net repurchase of stocks totaled \$305 billion compared to \$252 billion in dividend payments.

Why the preference for buybacks over dividends? First the cynical answer. Buybacks, all things being equal, lift the price of a stock since there is now a big new buyer on the scene. Managements are chock full of stock option packages which are worth a lot more the higher the stock price. Ergo a preference for buybacks.

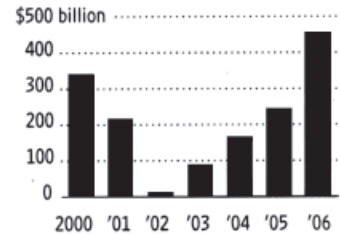
A more business-cycle rationale is it is easier to turn the spigot on and off with buybacks than with dividends. Certainly the dividend can be cut but it's embarrassing and not a good sign for a company. Stock buy-backs are not set in stone to start with so they can easily be changed.

Us Value investors would love to see companies get a bit less stingy with dividends. It is hard to see stock returns

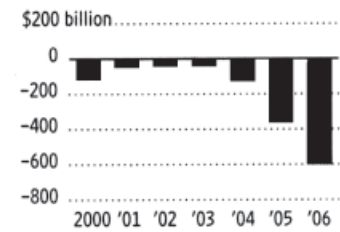
Buyback Effect

Issuance for U.S. nonfinancial companies

Bond issuance



Stock issuance



Source: Federal Reserve

SOURCE: Wall Street Journal

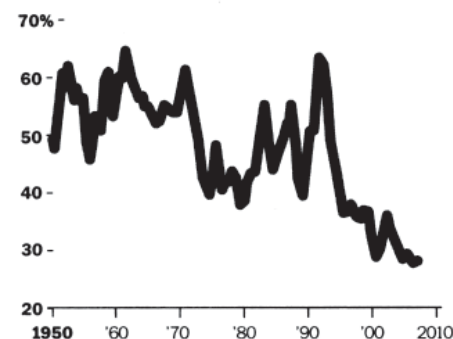
averaging 10-12% in the future if the dividend yield on the S&P 500 stays at 1.7% where it is today. It is conceivable that we could get the overwhelming majority of our return from capital appreciation in the future but based on history, where the dividend yield has been 40% of the total return, it raises a lot of questions. Corporate earnings tend to go up by 6-7% a year over longer periods of time. It is logical that stock prices should also go up by 6-7%. Add in the dividend return and this gives you your total return. With the dividend yield under 2% we are looking at returns going forward more like 8% instead of 10-12%. Now of course if price to earnings ratios increase we still could get the 10-12% return but any long term increase in PEs is a big if to say the least. In fact it has never happened. We have gotten spikes in PEs before like the high tech blow-off in the late 1990s but multiples have always tended to revert to the general average of 15 over time.

The baby-boom generation is about to retire. The oldest of the group born in 1946 is now 61. There should be a big push for cash in the investment return as retirement income gets more important. Let's hope corporations get the message. We could use a bit more up front return in the equation today.

Headed South

The percentage of earnings that S&P 500 stocks pay out as dividends now stands at half the level reached during the 1980s. Instead, corporations have been pouring money into share buybacks.

S&P 500 Dividend Payout Ratio (operating)



SOURCE: Barron's

| S&P 500 Sector | - Dividend - | |
|------------------------|--------------|---------------|
| | Yield | Payout Ratio* |
| Telecom | 3.2% | 52% |
| Utilities | 2.9 | 51 |
| Financials | 2.5 | 33 |
| Basic Materials | 2.3 | 35 |
| Consumer Staples | 2.3 | 42 |
| Industrials | 1.9 | 36 |
| Health Care | 1.6 | 31 |
| Energy | 1.5 | 17 |
| Consumer Discretionary | 1.1 | 24 |
| Technology | 0.6 | 15 |
| S&P 500 | 1.8 | 30 |

*Dividends as percentage of annual earnings. Source: Morgan Stanley