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Think Tiny: Asian Small-Caps Look Pretty

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THE RECENT BULL MARKET in Asian Stocks caught not a few global investors by surprise, and by the end of 2001, people were surely scrambling. The gains in South Korea and Taiwan are by now well known. But even in Hong Kong, where gigantic, widely held shares such as **China Mobile** and **China Unicom** have slid, smaller stocks are popping. Consider that outsource plays such as **Kingboard Chemical**, which makes laminates and PCBs; **Techtronic Industries**, which manufactures power tools; **Fountain Set**, which turns out knit-cotton fabric; and **Carry Wealth**, which makes cheap garments, have all shot up. Even **Texwinca**, the fabric-maker that shot up186% last year and has supplied clothing manufacturers that sell to **Kmart**, and ailing Japanese retailer **Fast Retailing** are up 10% year to date.

True, many of the stocks were coming off a low base anyhow, but they're still attractive to Cheah Cheng Hye. chief investment officer of Value Partners, which specializes in small-cap value plays in the China region. Cheah reckons that the newfound rally owes to assumptions, however iffy, that a global recovery is at hand, and to China's entry into the World Trade Organisation. Think what you like, but the biggest beneficiaries will be textile outfits, as well as companies of world-class status in their own humble niches. China, Cheah declares, "has proven its critical mass in terms of global outsourcing. Investors are instinctively seeking out Chinese exporters."

Cheah reckons the group above, as well as other small-cap shares that make up as much as one-third of the Hong Kong market, have sprung up to around seven times earnings from as low as two times, but the thinks they ought to trade at 12 times or so. That's a hefty discount to the Hang Seng index, which trades at 16 times earnings and whose companies are expected to lose money in the aggregate this year. By contrast, Cheah thinks these smaller stocks will post compounded annual growth of 10%-15%.

Outsourcing isn't the only theme Cheah is pursuing this year. He's back buying B shares, Mainland-listed shares denominated in foreign currency. B shares sold off last summer after jumping in the spring when Chinese authorities allowed domestic investors to buy them. Now they sell at 25 times earnings on average, about where they traded after China opened the market. He's a fan, for example, of **China Vanke**, China's top residential property developer It sports a market cap of $670 million, yields 2.4%, and trades at 1.6 times book and 12.5 times Cheah's current-year earnings forecast. Meanwhile, he thinks Vanke will grow earnings 15%-20% over the next few years. He also likes **Foshan Electrical & Lighting**, which makes fluorescent tubes.

Cheah is also buying what he calls "convergence plays," on the theory that valuation disparities between China's different share classes will vanish. Eventually. After all, there are A shares for domestic investors, B shares, Hong Kong-listed H shares, red chips and yet-to-come China depositary receipts. Consider that A shares trade at over 30 times earnings on average, by Cheah's lights, B shares at 25 times and H shares at nine times, all because of capital controls. Yet the barriers to Mainland investment are clearly eroding, and Cheah expects them to disappear within three to five years. "When capital controls are abolished, people in Shanghai will choose to buy **Sinopec** in Hong Kong," he says, with some conviction

Finally, he likes Chinese domestic-consumption plays. It isn't easy. Just 150 million consumers out of China's population of 1.3 billion have enough real wealth of $1,500 a year or higher to make significant purchases. Still, Cheah adds, newly minted customers are growing at a healthy 15% a year clip.

Here, he likes **Denway Motors**, which makes Honda Accords, **Qingling Motors**, which specializes in Isuzu trucks, **Cofco International**, which distributes palm oil and other food products, and **SIIC**, which is controlled by the Shanghai government and makes drugs for the Chinese market.

Yen-Yuan

For all of China's posturing about the yen's slide, it hardly matters to the yuan and Chinese authorities ought to stop jaw-boning about it. That's the view of Andy Xie, the frequently controversial regional economist at Morgan Stanley. He is worth listening to. Deflationary pressures are forcing manufacturers to relocate to China, the lowest-cost location. Xie observes that Japan's imports from China account for 6% of China's economy, and these are growing at a double-digit clip. And between 1% and 2% of China's economic growth, forecast at 7%-plus this year, may come, in fact, from factories that Japanese companies such as Sony have built in China. It's a trend that foreign investment promises to encourage.

Thus, reasons Xie, despite competitive devaluations over the past several years, China's share of U.S. imports has grown to 8.9% from 5.4% in 1993.

Contrast that with a decline to 11.1% from 18.5% for Japan. And China's neighbours may have a point. Their share of U.S. imports has fallen to a combined 13.2% from 16.2%. In Xie's view, a yen devaluation against the yuan is inevitable, given China's fixed currency. To stay in the export game, South Korea and Taiwan will need to "devalue constantly until they have the same living standards as China," says Xie.

Still, as rating agency Fitch pointed out last week, sovereigns "most directly in the firing line," particularly Korea, Taiwan and Singapore, are also "the most highly rated and best equipped to deal with external shocks."

Indian Bulls

India has been in a bad way for some time, weathering an earthquake, a financial scandal, the insolvency of its largest mutual fund, and then, in December, a terrorist attack on the Indian Parliament. All this, of course, occurred as the global economy collapsed.

The events burned a ton of foreign investors, who shovelled $2.65 billion into the country last year, India's biggest year for portfolio investment. What ensued was capital destruction on a major scale.

Jon Thorn runs **India Capital Fund**, an offshore outfit, whose stellar long-term record was bashed by last year's collapse in the market.

Last spring Thorn's fully invested fund dumped shares to raise 30% in cash. Still, the market headed south. Yet Thorn is sanguine, citing India's cheapness. The fund is now at 3% cash and spending more. "If I could leverage, I would," he says. For one thing, says Thorn, India has "the most secure GDP growth in the world," an unexpected 5.5% this year. "Adjust current world economic growth estimates for population growth," says Thorn, "and, in fact, most areas outside India are in recession."

Thorn still finds the big software companies once popular with U.S. investors expensive and subject to continued downgrades. Yet he likes **Bharat Electronics**, India's leading defense contractor and a company he shovelled into the portfolio last November on the theory that the world would boost defense spending.

Recently BEL, as it's known, jumped 19%. And yet it still trades at six times trailing earnings and has a return on equity of 22%.

His bets include cement-play **Grasim Industries**, which he believes will benefit from the global consolidation of the cement industry and which has a market cap of $500 million. In five years, he thinks Grasim and rival **Gujarat Ambuja Cement** will control 50% of the Indian cement market.

Meanwhile, a good monsoon this year means that Indian consumers have more in their pockets for new construction; and that, in turn, means bigger demand for Grasim. Thorn sees Grasim's earnings growing 10%-20% a year over the next 5 years. The cheapest of the four large Indian cement companies, he adds, it also has the lowest debt to equity ratio.