# The Litman Letter

November 2017

***In 2015, China was expensive with a P/E over 70x…***
***At 37x, China might even be cheap. What's changed?***
***(And how on earth is 37x inexpensive?)***

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In 2015, at an APEC event of the Asia Pacific Economic Forum, I showed charts of Corporate China with scrubbed, globally comparable financial analytics of UAFRS*.

In 2015, the price to earnings showed to be highest in 20 years. The earning power of Corporate China had fallen year-by-year to a return on assets of a measly 4%. Forecasts that ROA would fall further turned out to be right. Over the preceding three years, companies had grown assets at a break-neck 3X of GDP growth.

It was an easy call to say China's stock market would fall.
Now, more than two years later, it's a different world.

First and foremost, corporate asset growth has fallen in line with GDP. With reasonable, sustainable corporate spending, earning power has recovered with uniform return on assets bouncing up from 2016's 3% to possibly 5% in 2017. Finally, the 780 firms analyzed under UAFRS trade at 37x uniform price to earnings.

Why is 37x inexpensive? Because of a simple issue that drives multiples, cost of capital, and investor's take-home return on equity investing. That is, *capital gains and dividends tax rates.*

Compared to the USA and other developed markets, China taxes stock returns at next to nothing. With certain holding periods, Chinese investors pay very little for dividends and capital gains from the stocks they hold.

That means that Chinese-owned stocks will naturally trade at multiples of 20% to 60% higher than in other nations, *even without any earnings growth.* Add-in solid earning power recovery and healthy GDP-like growth, and 37x becomes reasonable, if not inexpensive.

The combination makes for a stock market with upside, and several stock ideas jump out as ways to take advantage. These include Great Wall Motor and Haier. Stocks that appear quite inexpensive under UAFRS *even without the tax-break* include Tencent, Ctrip, Baidu, and Alibaba.

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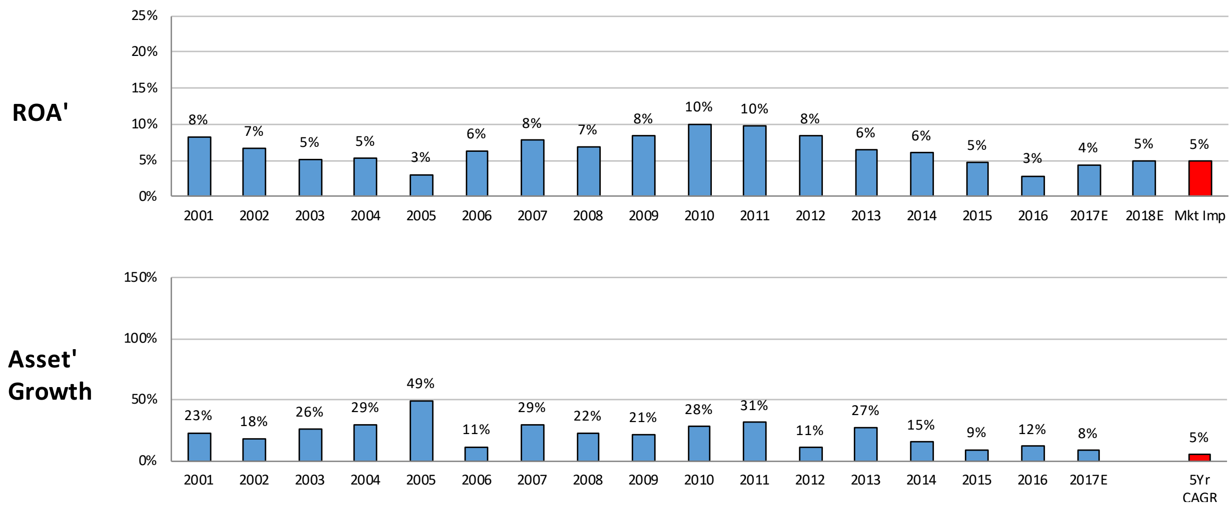
*UAFRS refers to Uniform Adjusted Financial Reporting Standards

## Performance and Valuation Prime™ Analysis

780 China Companies (Non-Financials)




Source: Capital IQ, Valens Research Analysis

Data Date: As of 20-Oct-2017

After multiple years of fundamental declines in corporate China's earning power, Valens is seeing the first signs of a recovery in 2017. However, market expectations for future returns remain low, as the markets are still waiting to see if this recovery is real and sustainable.

### China's returns are at cycle bottoms and markets don't appear to recognize this

China came into the 2000s with returns above corporate average, though they then subsequently saw those returns fade steadily. This partially appears to be because companies were not efficient at allocating investment, as they continued to ramp growth in Assets', even as returns faded from 2001-2005, seeing Asset' growth peak in 2005, just as ROA' was bottoming.

In 2006, as growth slowed, ROA' (refers to the uniform-adjusted ROA) inflected higher and continued to rise through 2010-2011, even as Asset' growth remained robust. Part of this can be attributed to the substantial stimulus that the Chinese government enacted from 2008 on. Corporations saw significant opportunities to invest at 20%+ a year, and were able to improve returns while doing so, seeing returns rise from 3% in 2005 to 10% by 2010.

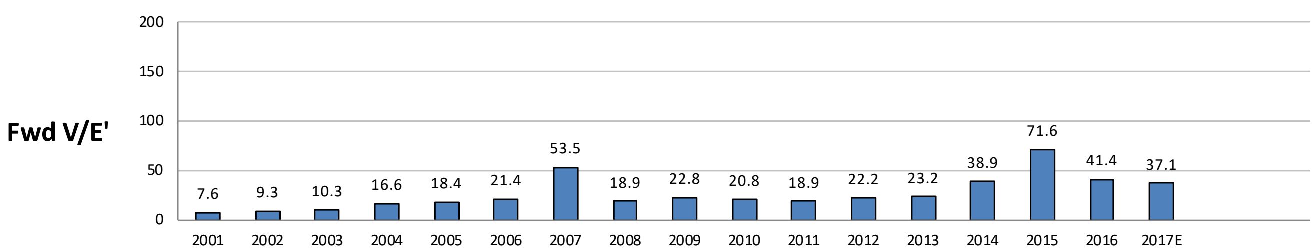
Subsequently, Chinese firms have seen a steady decline in ROA', which falls back to 3% by 2016. Initially, companies continued to invest in assets aggressively even as returns fell. However, since 2014, as returns have fallen, corporations have grown more rational in their investing, as it has slowed to around 8% a year.

The last time Chinese companies growth slowed to these levels, it specifically led to a significant expansion in profitability. So far, similar things are projected to happen in 2017-2018, when returns are forecast to recover from 3% levels to 4% and onto 5% levels. More rational growth in the face of weak profitability is starting to produce results.

The last time Chinese companies slowed growth like this for any period and were more rational, they saw ROA' rebound to 7%-8% levels – even before the stimulus of the late 2000s-early 2010s. However, equity markets are currently only pricing in ROA' in China to reach the 5% levels in 2018, and to plateau at those levels. Equity markets are also pricing in slower growth over the next five years than Chinese companies as a whole have produced at any period over the past 15 years.

The slowest that Chinese companies have grown in aggregate over the past 15 years was 9%, in 2015. However, markets are currently pricing in Asset' growth of only 5% a year going forward. With such low market expectations for growth and returns going forward, if Chinese companies just return to historically average returns, and have growth around 10%, there could be significant further equity upside.

## Even at a 37.1x V/E', Chinese companies are cheap




Source: Capital IQ, Valens Research Analysis — Data Date: As of 20-Oct-2017

The Chinese market currently trades at a 37.1x Fwd V/E'. This is high relative to historical valuations for the market, and also on an absolute basis relative to other markets globally. On an initial glance, the Chinese market appears expensive.

However, there are several key factors at work that highlight why the Chinese market may not be expensive, even at these valuations. The first factor is that it is rare for a country with growth, in particular for corporate growth, still as strong as China's to also have inflation as low as China has and is forecasted to have. Any short-term to long-term forecast of inflation expectations for China points to 2%-3% inflation expectations.

| Inflation | Dividend and Capital Gains Tax | Years | Average P/E |
|---|---|---|---|
| >4% | Low Tax | 5 | 13.5x |
| | High Tax | 26 | 11.2x |
| 0%-4% | Low Tax | 24 | 20.1x |
| | High Tax | 32 | 16.3x |
| <0% | Low Tax | 9 | 22.3x |
| | High Tax | 5 | 12.4x |

Data Coverage: Average from 1914 to 2017

This chart highlights the impact of high and low inflationary environments (and tax rates) on multiples in the US market. As can be seen, the difference between a low inflation and a high inflation environment on equity multiples can approach a 10-turn swing in equity multiples. With China having very tamed inflation rates for a developing market currently, and relative to itself historically, premium valuations are warranted.

One of the other factors that is a key driver of valuations, as highlighted in the above chart, is investor tax rates. Higher tax rates lead to lower valuation multiples, and lower tax rates lead to higher valuation multiples. As of 2015, when the government cut dividend tax rates in China, both dividend and capital gains tax rates are at 0%. If a low inflation, low tax rate environment can support premium valuations, a zero tax rate, low inflation environment can support even higher multiples, as seen in China.

Specifically, Valens calculates investors' current opportunity cost-of-capital when investing in the Chinese markets as 2.9%, due to these factors. That translates to a 34x V/E' absent growth. The Chinese market currently trades at a 37.1x V/E', only 3-turns higher than that rate, meaning the market is pricing in only a modest amount of growth going forward. Yet as highlighted above, Chinese corporations actually continue to invest in significant growth.

**This Chinese market is seeing improving fundamentals and low expectations, pointing to opportunity for investors**

While Chinese companies appear to be turning the corner for profitability, equity investors continue to take a wait-and-see approach. Chinese market multiples may appear high on an initial glance, but based on the current corporate environment, and inflation and tax regimes the country is in, valuations could have more room to run.

## Chinese companies to focus on

| TICKER | COMPANY | SECTOR | PRICE | MCAP (in mn) | ROA' FY1 | V/A' | V/E' |
|---|---|---|---|---|---|---|---|
| 2333:HKG | Great Wall Motor Company Limited | Cons Disc | HKD 9.37 | HKD 110,290 | 10% | 2.0x | 13.1x |
| 1169:HKG | Haier Electronics Group Co., Ltd. | Cons Disc | HKD 21.80 | HKD 61,060 | 24% | 3.4x | 13.4x |
| 700:HKG | Tencent Holdings Limited | Info Tech | HKD 411.40 | HKD 3,910,000 | 174% | 61.1x | 31.0x |
| CTRP:USA | Ctrip.com International, Ltd. | Cons Disc | USD 47.64 | USD 24,870 | 46% | 6.8x | 13.1x |
| BIDU:USA | Baidu, Inc. | Info Tech | USD 249.42 | USD 86,490 | 41% | 7.3x | 17.2x |
| BABA:USA | Alibaba Group Holding Limited | Info Tech | USD 191.19 | USD 489,670 | 288% | 86.9x | 27.0x |

### 2333:HKG – Great Wall Motor Company Limited

Great Wall makes SUVs/pick-ups and cars for the Chinese and global market, and benefits from the strong demand and brand name in their home market and the market is not recognizing this, expecting dramatically declining returns and growth.

### 1169:HKG – Haier Electronics Group Co., Ltd.

Haier and their parent, Qingdao Haier, are the appliance makers to the world. Haier Electronics is mostly focused on the Chinese market, in particular washing machines and water heaters, and as the middle class grows, they're likely to see continued strong demand – which their after-market service component makes very sticky. With current low market expectations, the market doesn't appear to recognize this.

### 700:HKG – Tencent Holdings Limited
### BIDU:USA – Baidu, Inc.
### BABA:USA – Alibaba Group Holding Limited

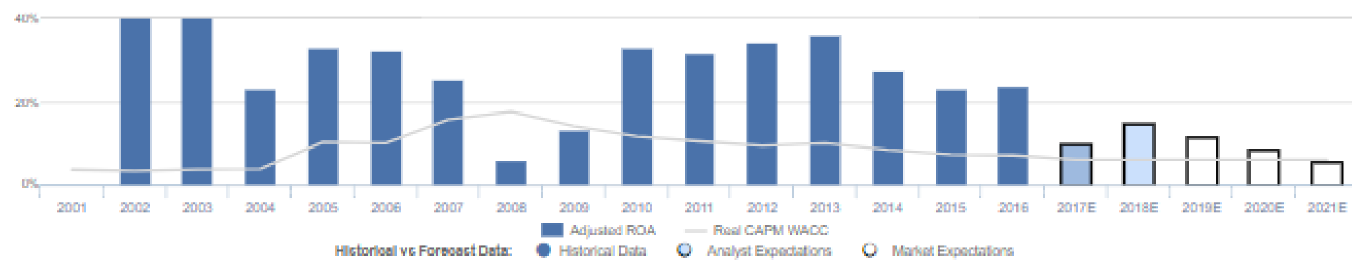
The Facebook (Tencent is this and more), Google (Baidu), and Amazon (Alibaba is this and the PayPal and much more) of China, all three of these companies benefit from the same robust trends that their US counterparts benefit from, and even more thanks to the stronger growth in consumer and aggregate demand in their end market, and even at the premium valuations they trade at, the market does not fully capture their fundamentals.

### CTRP:USA – Ctrip.com International, Ltd.

As Chinese consumers continue to gain spending power, travelling is a major area of focus for growing spending, and Ctrip controls that market, as the one-stop Expedia & Priceline for the Chinese market. Yet, at a 13x multiple, below EXPE and PCLN valuations, the market doesn't appear to recognize the fundamental strength Ctrip has.

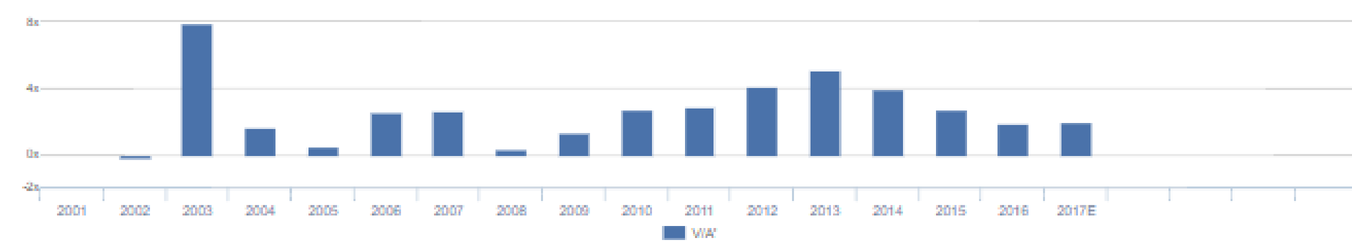
## Great Wall Motor Company Limited

ROA'

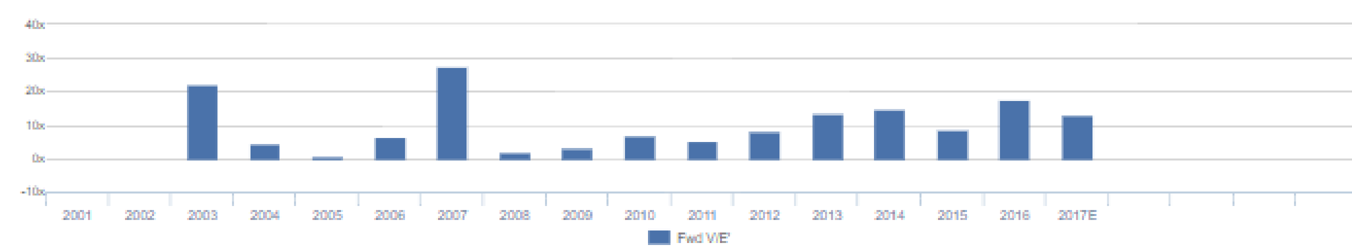



Asset' Growth


V/A'

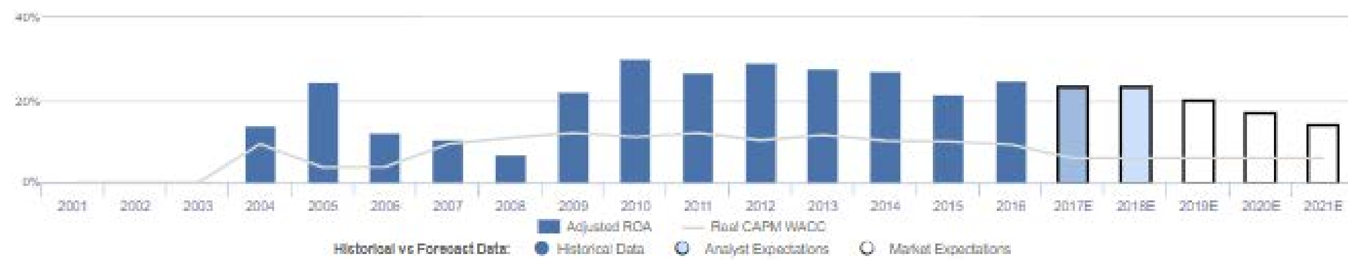



Fwd V/E'



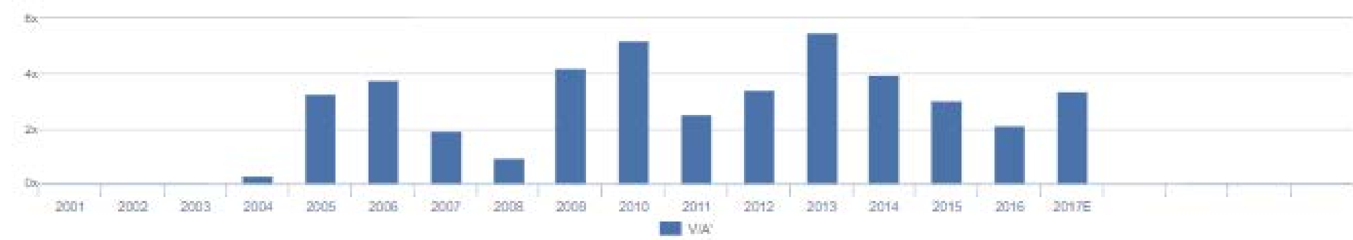
## Haier Electronics Group Co., Ltd.

ROA'

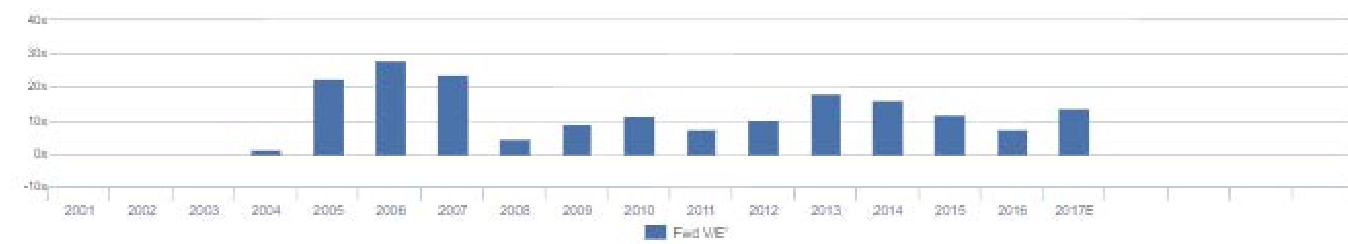



Asset' Growth


V/A'




Fwd V/E'



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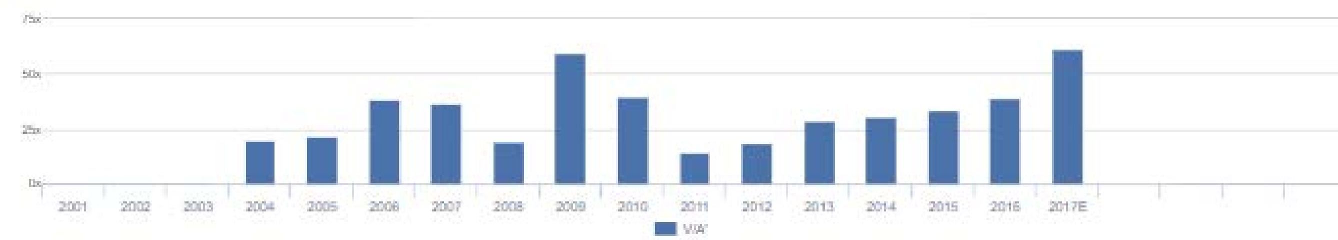
## Tencent Holdings Limited

ROA'


Asset' Growth


V/A'

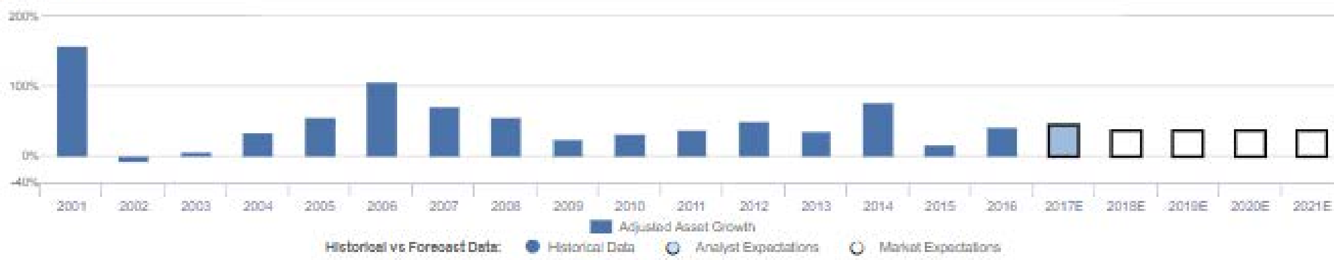



Fwd V/E'

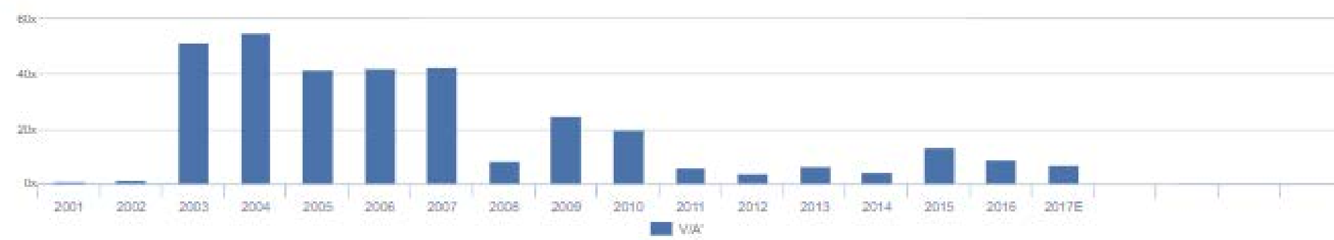
## Ctrip.com International, Ltd.

ROA'


Asset' Growth




V/A'

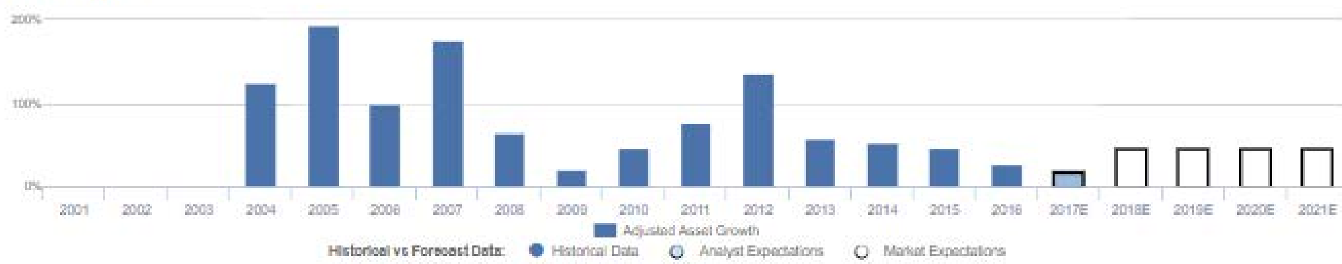



Fwd V/E'

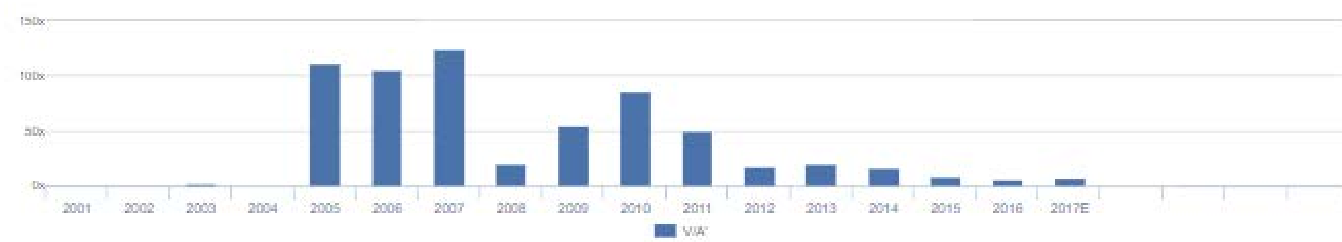
## Baidu, Inc.

ROA'


Asset' Growth




V/A'

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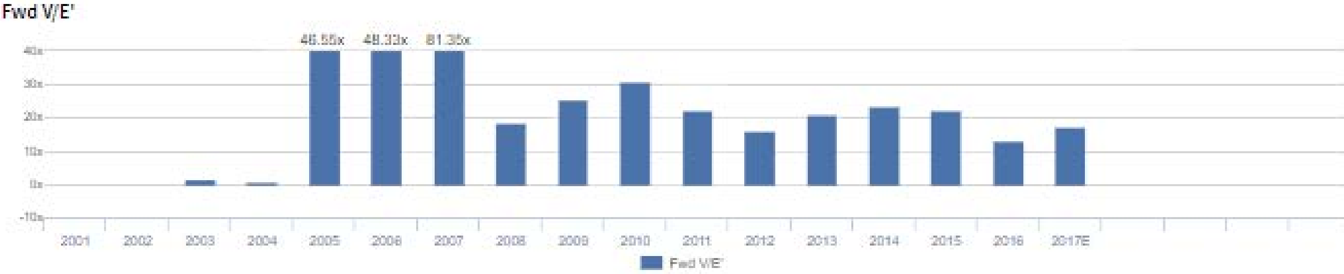
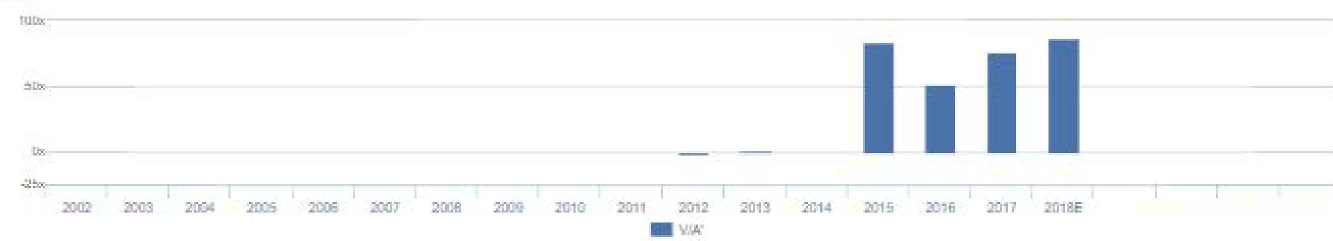


## Alibaba Group Holding Limited

ROA'


Asset' Growth


V/A'

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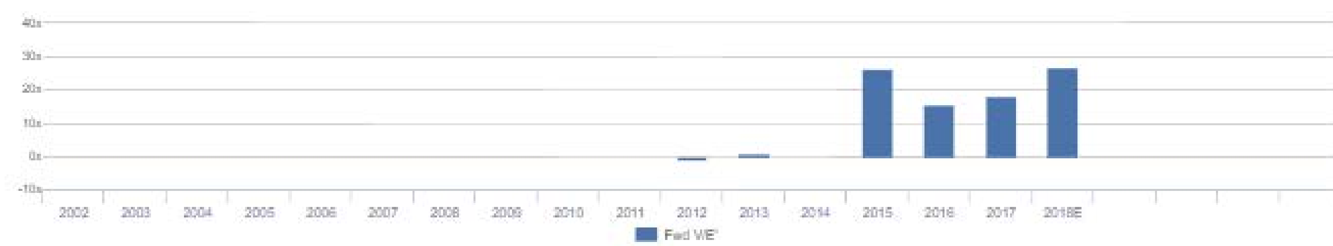

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