

A Walk on the (Asian) Wild Side

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Grant's Fall Investment Conference
October 19, 2010
The Plaza Hotel

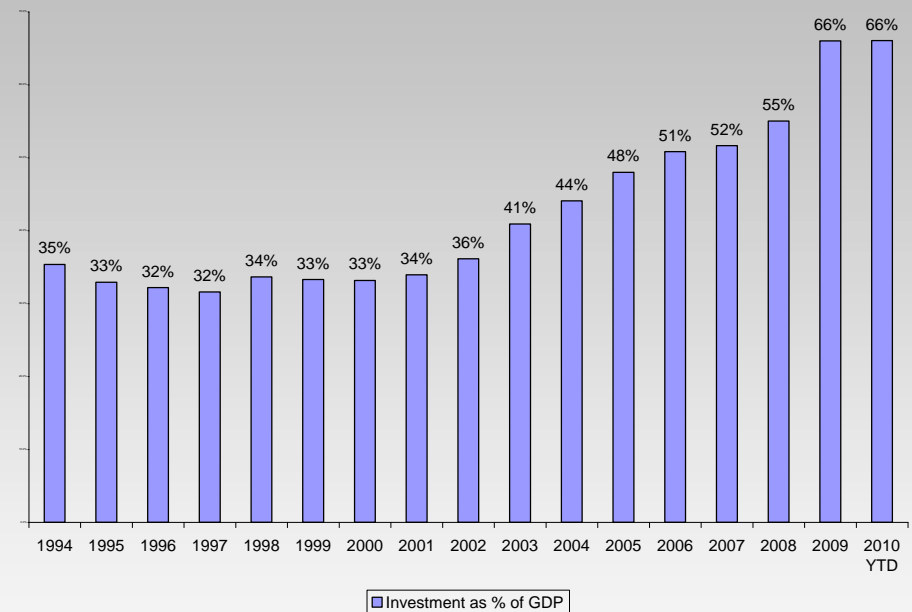
Asian Miracle II: Déjà Vu All Over Again

- The lessons of Asia's 'paper tigers': 1990's example

“Economic growth that is based on expansion of inputs, rather than on growth in output per unit of input, is inevitably subject to diminishing returns.”

Paul Krugman, 'Myth of Asia's Miracle,' 1994
- Unprecedented fixed asset investment boom
 - Fixed asset investment as a % of GDP in China has steadily increased from already high levels for more than a decade
 - Marshalling resources versus economic efficiency
 - Law of diminishing returns

Fixed Asset Investment/China GDP



Source: National Bureau of Statistics of China

Where Is The Capital Going?

- Large-scale capital projects grow sillier by the day
 - New South China Mall – world's largest and loneliest
 - New Ordos – empty city in Inner Mongolia
 - 'World's Tallest Village' – Huaxi Village
 - 'Pearl River Necklace Bridge' – passage for a select few
- Growing industrial and manufacturing overcapacity
 - RMB 5.9 trillion in urban manufacturing capital expenditures in 2009 which is 17% of GDP and 27% growth versus 2008
 - Textiles – up 14.8%
 - Chemicals – up 26.9%
 - Metal products – up 29.2%
- Economic depreciation being factored in?



Source: Doug Katner, New York Times

Explosive Growth Of Credit Fueling The Speculative Boom

- Recent record lending spree in China:
 - Massive 2009 stimulus (14% of GDP) primarily funded by debt
 - Official loans of RMB 9.59 trillion in 2009 (up 95% YoY)
 - Additional RMB 6.3 trillion of new lending YTD in 2010
 - Incremental lending 'off the books' via trusts
- State-owned enterprises and local officials in a race to spend funds
 - Wasteful allocation of resources
 - Diversion of stimulus funds to real estate
- Chinese culture of credit
 - The myth: China has no history of credit-fueled booms and busts
 - Reality: History proves otherwise
 - Over 40% of loans went sour in post-1990s boom
- Speculative fever spreading throughout China
 - Real estate prices still increasing
 - Garlic, jade, and rare tea



Source: Mike Adams & Dan Berger, www.naturalnews.com

The Underground Commodity Market



LGFVs: SIVs for the Chinese Economy?

- Drive local fixed asset spending
- Funded by large amount of debt:
 - RMB 7.7 trillion as of June 2010
- Recent CBRC study by Chinese banks indicates LGFV problems
 - 26% of debt designated as high credit risks
 - Additional 50% must rely on alternate sources for repayment
- Cross collateralization among LGFVs increases systematic risk
- Recent report by major investment bank likened LGFVs to early stages of subprime crisis

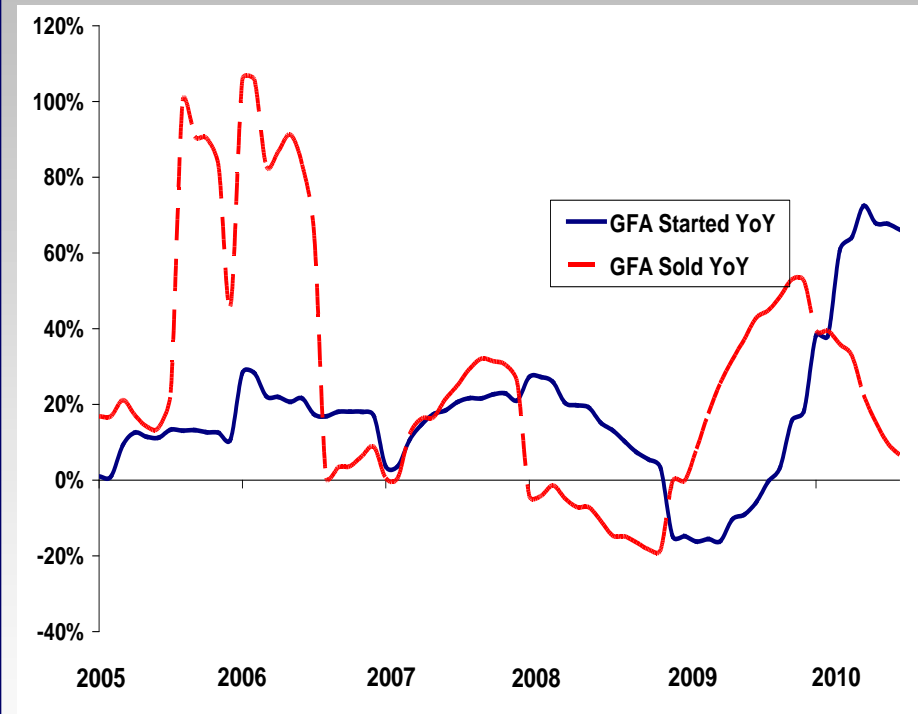


Source: *The Economist*

Real Estate Development Excess Is Evident

- Commercial real estate already in excess supply
 - 17% of office space is vacant in Beijing, 12% in Shanghai*
 - Office rents fell during 2009 by an estimated 26% in Shanghai and 22% in Beijing*
- Industrial and consumer companies now developing and selling property to boost profits
- Plenty of projects in pipeline
 - 5.7 billion square meters of total floor space was under construction at the end of 2009 in China (54% residential, 46% non-residential), a 21% increase versus 2008

Growth Rates of Gross Floor Area Started and Sold



*Source: CB Richard Ellis, UBS

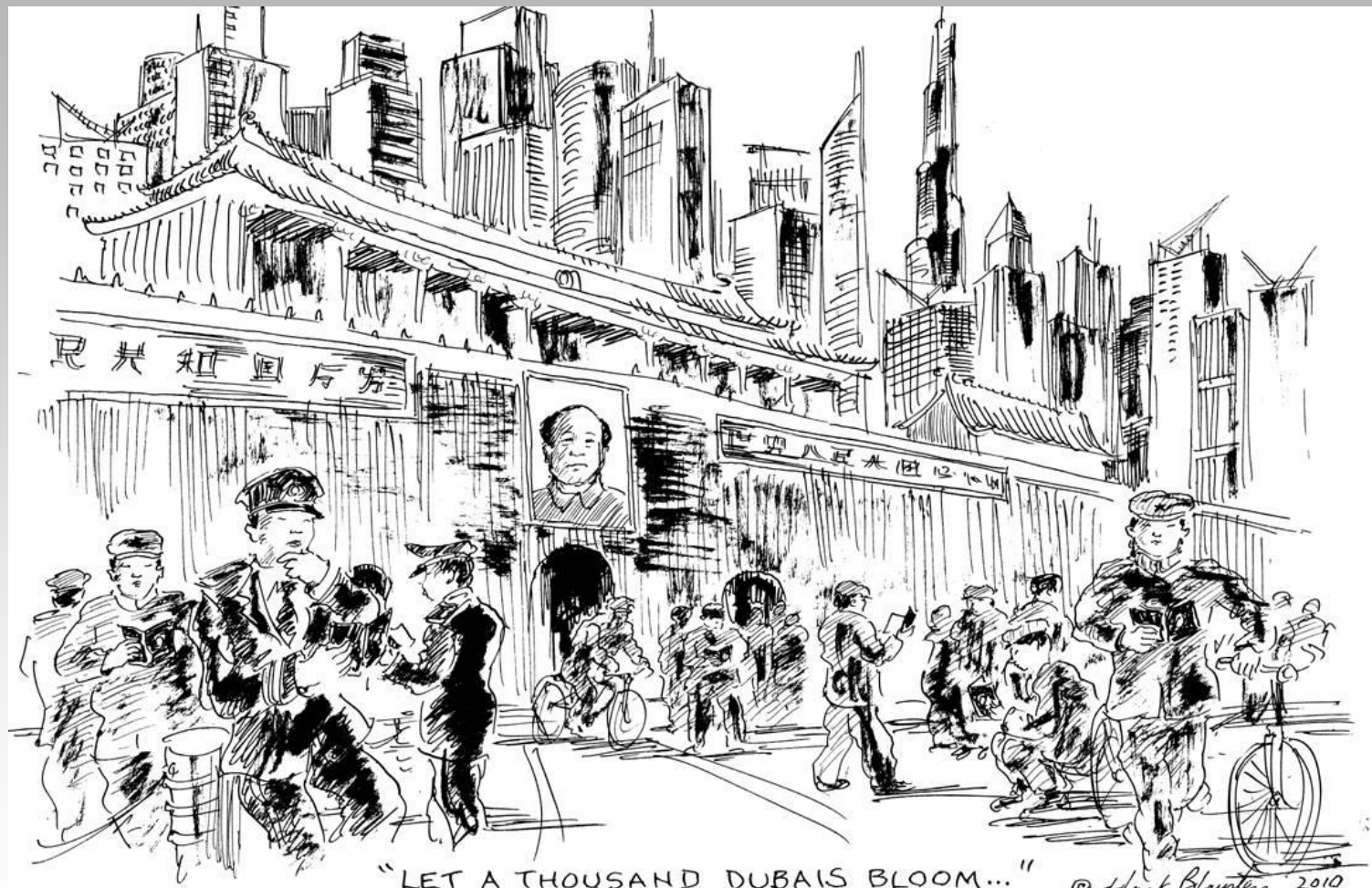
Source: National Bureau of Statistics

Dubai Times 1,000?

- Dubai is the poster child of the recent credit-fueled real estate boom
 - 2008 Total Real Estate Under Construction approximately 19.8mm sqm
 - 2008 Total Real Estate per capita: 12.4 sqm
 - 2008 Total Real Estate sqm per US\$ 1mm GDP dollars: 240 sqm/US\$1mm
- China's current urban real estate boom overshadows Dubai's
 - 2009 Total Real Estate Under Construction approximately 5.8bn sqm
 - 2009 Total Real Estate per capita: 9.3 sqm
 - 2009 Total Real Estate sqm per US\$ 1mm GDP dollars : 1,161 sqm/US\$1mm



Source: Associated Press



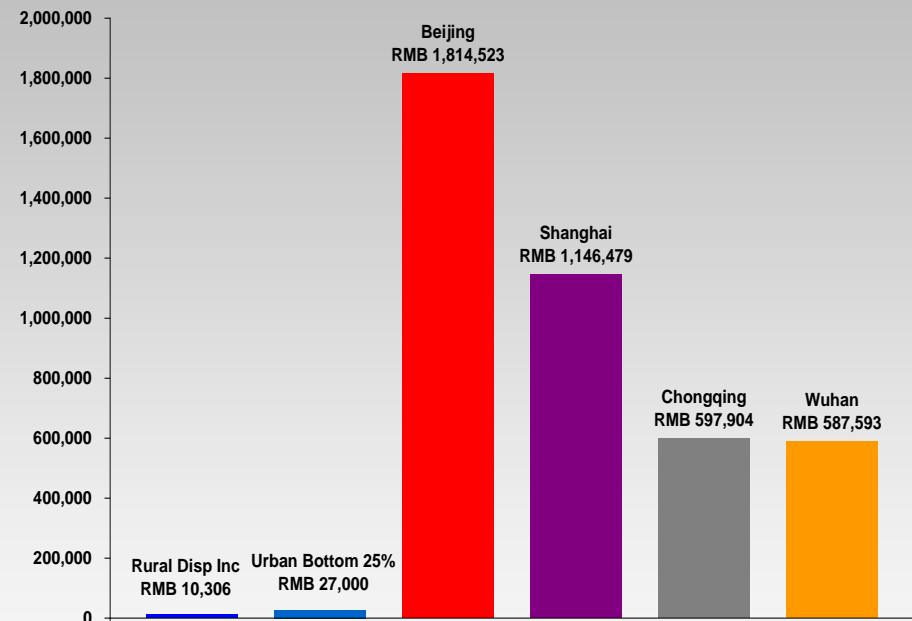
"LET A THOUSAND DUBAIS BLOOM..."

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Migration Myth Busted

- **Fact:** China's rural to urban is one of the largest human migrations in history
 - In 2009, approximately 8.5mm individuals moved into urban areas
 - Since 1998, approximately 118.7mm individuals moved into urban areas
- **Myth:** Rural to urban migration driving real housing demand
 - Structural issues: mortgage qualification
 - Hukou required for mortgage application
 - Must pay taxes for at least one year
 - Economic realities

Low Income Migrants versus Urban Residential Reality



Source: National Bureau of Statistics, Soufun. Real estate values as of Sept 2010. Assumes purchase of a 92.9 sqm unit.

Property Bubble – Tipping Point Near?

- Beijing determined to reign in property speculation
 - **"We will urge local governments to make sure that they strictly implement the differentiated housing loans policy to crack down on housing speculations."**
 - *Ministry of Housing and Urban Rural Development*
- More draconian measures ahead?
 - Increases in transaction volume and prices for September indicate that initial controls have not quelled real estate speculation
 - Recent Central Government statements indicate continued resolve
- Harvard's Ken Rogoff: Property bubble could cut China's growth to as low as 2% at some point in the coming decade



Source: Reuters



THE GREAT WALL OF FORECLOSURE 2015

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China Plays By China's Rules

- McDonald's 'Not so Happy Meal' episode
- Rio Tinto's arresting experience in China
- Recent derivatives contract disputes with Wall Street
- Intellectual property / Internet freedom
- 'Digesting' high-speed rail technology

The New York Times

December 2, 1996

McDonald's to Move Beijing Restaurant

THE WALL STREET JOURNAL

March 19, 2010

Australia Presses China For a Fair Rio Tinto Trial

March 19, 2010

Rio Tinto, Chinalco in Iron-Ore Venture

REUTERS

December 29, 2009

Chinese Firm Says Won't Pay Goldman on Options Losses

FINANCIAL TIMES

March 22, 2010

Google Set to Announce China Site Closure

July 9, 2010

China Renews Google Web License

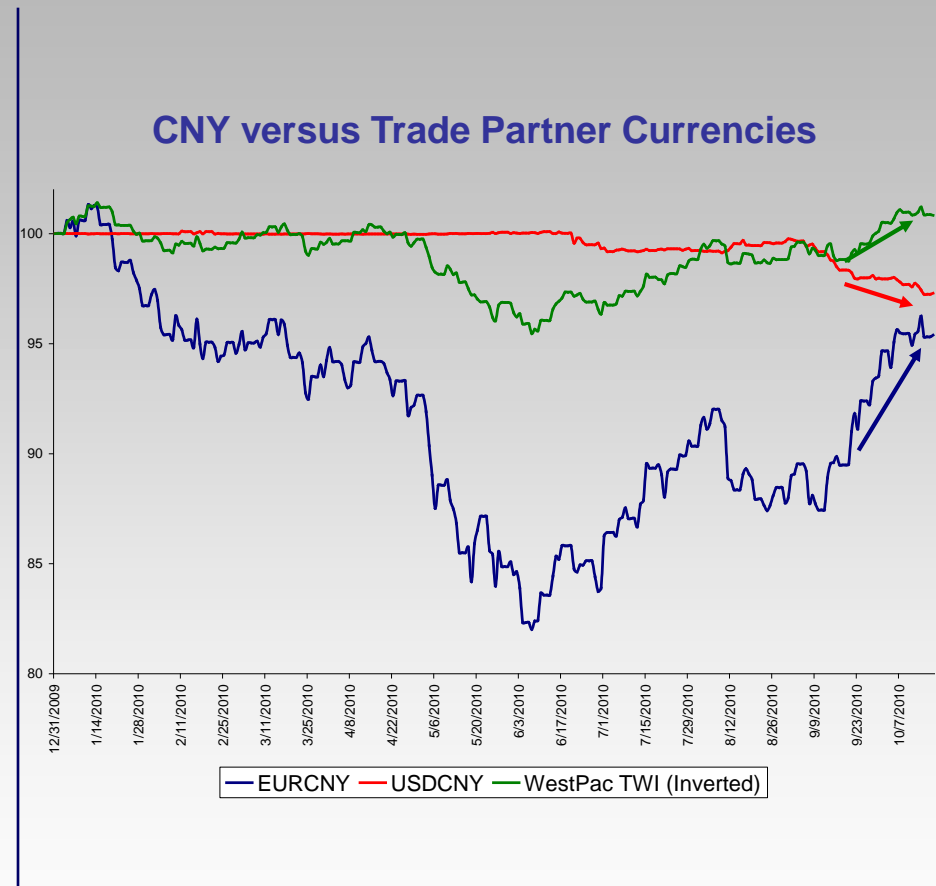
FINANCIAL TIMES

September 23, 2010

China: A future on track

China's Rules Increasing Global Tension

- China's New Era of Imperialism
 - China expanding global investments
 - China's military push
- Brewing trade war?
 - China's trade surplus growing again
 - Chinese companies winning contracts around the globe via 'low-ball' bids
 - Grumblings from the halls of Washington and Europe
- RMB currency crisis
 - China continues to peg its currency at perceived 'under-valued' level
 - Overly focused on the CNY/USD rate
 - RMB has recently declined on a trade weighted index basis
 - European and Asian trade partners crying foul



It Is All About 'The Number'

- GDP drives economic activity, not vice versa
- GDP versus 'China GDP'
 - Questions over regional versus national GDP figures
 - Shuffling assets \neq real economic activity
- 'Managed' data – Veracity of economic data in question
- Party officials and state-owned enterprises incentivized to maximize the 'top-line'... or 'lose face'



"We're agreed 9% is next year's GDP target...
So, how are we going to get there?" © Hank Blaustein 2010

CRAAP: Chinese Regularly Accepted Accounting Policy

- Politics not Profits
 - State-owned enterprises, which control 50% of industrial assets, are not driven by profit returns
 - Local party officials dictate land sales and control real estate development process
- What are investors really buying?
 - ‘Paper Profits’
 - Indiscernible organization charts
 - Cayman Island holding companies
- U.S. listed ADRs: worst offenders?
 - Usurp U.S. listing requirements through reverse mergers
 - Wave of ‘imitator’ IPOs



Source: Wikipedia

Caveat Emptor: Land of Opportunity for Western Investors

- 1.33 bn Chinese ≠ unlimited purchasing power
 - Median income per urban household still less than 15% of median U.S. income levels
 - 53% of the population is still rural
 - Demographic issues – ‘old before wealthy’
- Home team always wins: *Mr. China*
- Chinese Pirates
 - Estimated 90% of all Chinese entertainment software is pirated
 - Nearly half of all PC software
- Chinese real estate is not such a bargain
 - Tier 1 \$225 psf versus NYC \$345 psf
 - Tier 2/3 \$111 psf versus U.S. \$115 psf

Source: U.S. & NYC home prices from Zillow.com, as of Aug-2010.
Chinese pricing data from Morgan Stanley.



Source: The Daily Mail

China's Bubble Bursting – The Next Asian Crisis?

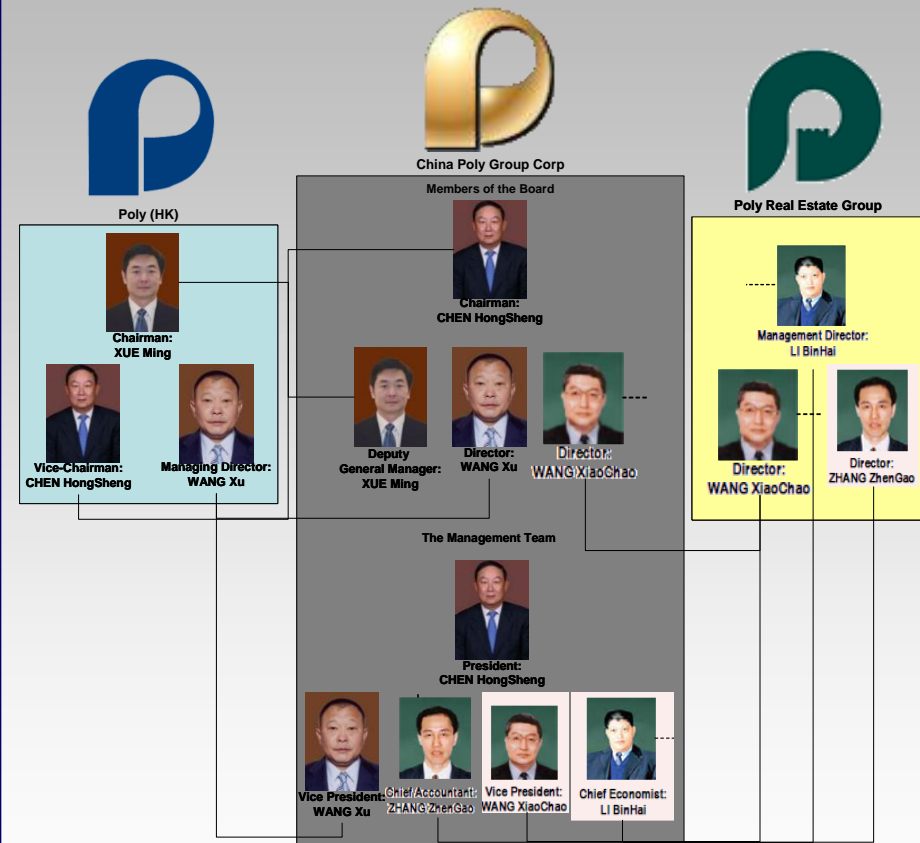
- Will generational savings be destroyed, exacerbating ticking demographic time bomb?
- Another roadblock to developing China's consumer economy?
- Unfunded liabilities and government guarantees may mute the support offered by the foreign currency reserves
 - Is the US\$2.7 trillion 'security blanket' full of holes?
- Global impact on construction materials prices?



Source: Wikipedia

Poly HK (119 HK): The Party versus the Western Investor

- Poly HK (Market Cap: US\$ 4.1bn) is a HK listed real estate subsidiary of China Poly
 - China Poly new to the real estate business
 - Originally a defense contractor, coal miner, shipping company, etc.
 - One of the 16 SOEs allowed to develop real estate
- No clear separation between Poly HK, China Poly (Parent), and Poly Real Estate (Shanghai listed Sister)
- Asset injections by China Poly are often paid for later by Poly HK shareholders
 - Asset injections have become increasingly speculative
 - China Poly has shifted to more cash compensation than Poly HK stock
- Does Poly HK make money?
 - TTM FCF remains negative despite asset injections at a discount



As of June 2010

China Merchants Bank (3968 HK): Real Estate 'Heavy'

- China Merchants Bank ('CMB', Market Cap: US\$ 11.6bn) has aggressively grown its real estate loan book
 - Total loans grew by 39% in 2009; mortgages up by 73%
 - Over 1/3 of loan portfolio is related to real estate (mortgages, property development & construction)
- CMB almost doubled its loans to LGFVs in 2009. LGFV loans are approximately 11% of total loans as of 1H 2010 (RMB 143bn)
- A predominant users of off balance sheet trusts
 - Allows additional real estate lending capacity
 - CBRC will force these loans back on balance sheet by the end of 2011
- 'Outstanding credit quality' - Really???
 - NPLs at 0.67% of total loans, coverage at approximately 300%. But...
 - Razor-thin allowances not sufficient to handle downturn in housing market
 - Allowances of RMB 26.3 billion may not be enough to cover problematic LGFV loans



Source: Reuters

Hong Kong Exchange (388 HK): Gateway to China

- Market Cap: US\$ 24.7bn
- Latest “hot money IPO” venue with 15-20% premiums to Western markets
- Issuers of questionable quality
- Regulatory oversight concerns
- Eventual shift to mainland exchanges?
- Valuation dependant upon average daily turnover growth
- Expected RMB benefit will require China to dramatically change capital controls and currency policies



Source: Paramount Pictures

Vale (NYSE: VALE): The China Shuttle

- Market Cap: US\$ 107bn
- Banking on China's voracious ore demand
 - 59% of 2009 iron ore sales up from 30% in 2008.
 - 2010 Capital Expenditure budget of US\$13bn; up 43% over 2009
 - New distribution center planned in China
- Brazil – China Shuttle: China Built and China Financed
 - 12 Chinamax 400k dead weight tons very large ore carriers ('VLOCs') on order from China's third largest shipbuilder, Jiangsu Rongsheng Heavy Industries
 - US\$1.23bn loan from Export-Import Bank of China and Bank of China Ltd. to finance 80% of the purchase price
 - “It's not our policy to make money in freight.”
Jose Carlos Martins, Vale Executive Director of Ferrous Minerals
- Recently announced plan for Hong Kong stock market listing

A New Maritime Power?



“We have the biggest fleet in the world. Only the U.S. Navy is bigger.”
Roger Agnelli, CEO, October 18, 2010

It's Not All Gloom and Doom...

- Macau Casinos
 - Going long corruption
 - U.S. run ventures with real numbers and cash flows
- Real estate developer yield/arbitrage opportunity
 - Recent medium term note issuances yielding 8-14%
 - Cost of debt exceeds cost of equity



Source: Associated Press

**Thank you to
Jim Grant and the
Grant's Interest Rate Observer**



China's Farmer Yang Says, "More Fireworks Ahead!"

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