Will Asia Catch Europe's Cold?

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It's been a scary time for international investors. Greece is going up in flames - and not just figuratively speaking, alas. The fiscal conflagration in Europe potentially threatens the heart of the European Union and could potentially skewer the euro itself as a viable currency.

That hurts those who only have a half-way approach to diversification. If your idea of diversification into foreign assets is a 30 percent allocation to the MSCI, you aren't going to be a very happy camper, though you may get some temporary masking of the pain thanks to the depreciation of the dollar relative to other currencies, including the euro.

> "Compelling valuation of Asia Pacific ex-Japan equity markets, at 9.4X projected earnings."
> **Khiem Do, Investment Manager, Asia Pacific Fund, Inc**

A truly diversified portfolio, however, would contain a substantial allocation to Asia - which, thanks to the rapid growth in the Chinese economy, has anchored the global economy in recent years. Although the Asian economy is starting to slow, thanks to a period of anti-inflationary monetary tightening on the part of the regions' central banks, the case for Asia is powerful on both a technical and fundamental basis.

Correlations

A 2010 working paper from the Hong Kong Monetary Authority, bearing the somewhat dry title of "Dynamic Correlation Analysis of Financial Spillover to Asian and Latin American Markets in Global Financial Turmoil (Matthew S. Yiu, et. al), takes a look at the historical interrelation of the U.S., Latin American and Asian markets, including developments as recent as the Bear Stearns collapse of 2008 and subsequent collapse in risky asset prices. Their findings suggest that while there are global systemic risk factors in place that do cause risky assets worldwide to rise and fall in tandem to an extent, they seem to have more to do with the U.S. operating as the lynchpin of the global economy. The reason: While the authors found evidence of market contagion in Asia, historically, due to market events originating in the U.S., the reverse did not seem to be true: U.S. markets did not exhibit a significant negative reaction to market crises in Asia, provided that the Asian problems arose locally. More broadly, the authors found that advanced economies could drag emerging economies down with them; crises in emerging markets did not have the same effect on advanced economies.

> As an asset class, the better debt dynamics of the region will prevail.
> **-Percival Stanion, Baring Asset Management**

Their findings did not explicitly include the European markets in their analysis, but we find the results encouraging nonetheless. While money is fungible, the Greek crisis - and the Irish, Spanish and Portuguese crises lining up behind Greece - are still European issues, and are still left for the Europeans to solve among themselves.

The Fundamentalist View

It's encouraging to us to see that regional and emerging markets, other than the U.S., appear to have limited capacity to spread asset price collapses outside of their own back yards.

If anything, continued European difficulties may actually serve to enhance capital flows to Asian markets. The symptoms are technical - volume flees Europe but, dissatisfied with returns available in the debt-ridden U.S. - settles in Asia. But the root causes that should attract capital to the Asian Ex-Japan investment front are still fundamental:

- A strong savings rate across most of the Asian world. Savings rates range from 20.1% in the Philippines to 46.0% in Singapore to 54.0% in China compared to the US with a savings rate of 11.6%, according to data from Aberdeen Capital Management.
- A young population that will continue being productive for decades to come, even as demographics works against the U.S. and Europe.
- A labor market that is the most competitive in the world.
- A burgeoning middle class that accelerates demand for consumer goods and services
- Compelling valuations of about 10.7 times earnings in the Asia Pacific markets, ex-Japan. This is particularly favorable when you compare the relatively conservative balance sheets of Asian corporations to the highly leveraged balance sheets in the west. Asian managers are still able to deliver strong returns on an equity basis.
- Forward-looking earnings are even more compelling, at 9.4x projected earnings, region wide, according to Khiem Do, Investment Manager of the Asia Pacific Fund, Inc.
- Expected growth rates of 6-8 percent in coming years, driven by expanding middle class populations. This makes Asia the fastest-growing economy in the world, according to Do.

While advanced economies can export financial shocks beyond their borders, emerging markets still have a harder time doing so - except where they can directly influence fuel prices. However, this doesn't apply to Europe, since Europe is a net importer of petroleum and not a net exporter. Our outlook for now is that the problems in Europe will have little effect on Asia, barring a general collapse that significantly affects demand for Asian exports. If this happens, the European problems do have a significant chance of spreading to the United States. As the Hong Kong Monetary Authority white paper shows, problems in the U.S. do have a proven ability to cause asset price declines in Asia. But a U.S. recovery is also proven to have a beneficial effect in Asia as well.

A Global Reallocation to Emerging Markets

Meanwhile, as investors lose faith in the ability of the MSCI nations to manage their fiscal affairs, and as the U.S. Federal Reserve runs out of quantitative easing ammunition, we expect Asia to benefit by a massive shift in allocations by institutions all over the world. A few years ago, 5 percent was not an uncommon allocation to emerging Asian markets, pointed out Mounir Guen, founder of MVision Private Equity Advisors and a specialist in emerging markets investing. Now, institutions are in the process of recalibrating their allocations to emerging markets to 30 percent - much of which will be directed toward Asia. This represents a substantial flow of capital to the East, and should help support asset prices in Asia. If troubles mount in Europe, these capital flows should accelerate, supporting Asian asset prices and cushioning any contagion effects.

Anthony Michael, the head of fixed income investing in Asia and the Pacific for Aberdeen Asset Management, echoes Guen's sentiments: "Asia's bond markets are often regarded as a fringe market and a much misunderstood asset class by global investors," notes Michael. "Because of this, Aberdeen believes that many investment opportunities in the region have been overlooked." Meanwhile, even as western governments have been forced to increase their debt ceilings, Asian governments have been able to shore up their balance sheets. "Without a doubt, developing Asia is the place to be when considering the optimal risk-return profile," says Michael.

Currencies

A recent update, authored by Percival Stanion of Baring Asset Management, a leading player in regional closed end funds in Asia, noted that investors have been deserting foreign currencies in a flight to the safety of the dollar. This is a response to the short-term uncertainties in the European market, but it has affected Asian currencies as well. However, the underlying fundamentals have not changed. If anything, this development is favorable to new investors buying assets denominated in Asian currencies - whether they are stocks, sovereign debt, or anything else. Barings applauded the Indonesian government's move to shore up its currency. "As an asset class, the better debt dynamics of the region will prevail," writes Stanion.

Money talks: Barings' own portfolios are now "aggressively overweight" in Chinese equities, and in Asian emerging market currencies.

Agnes Deng, Investment Manager of the Greater China Fund Inc., a closed-end fund specializing in China, agrees with this positive stance towards China. "The Chinese economy continues to experience dynamic growth," comments Deng, "and 2011 has seen China surpass Japan to become the world's second-largest economy. The International Monetary Fund forecasts that Chinese economic growth will come in at 9.6% in 2011, followed by 9.5% in 2012. We continue to have a high level of conviction in the power of China's dynamic economy, with its enormous potential for transformation."

Conclusion

The bottom line: Yes, markets are global. And they will become more so. But there are still insulating factors between markets, which is a powerful argument for the value of global diversification. Finally, remember that the European problems are fundamentally driven by debt. Asia's biggest feature is strong balance sheets compared to Europe. Asian assets have strong arguments in their favor for investors, both from a fundamental and technical point of view. Our expectation in the long term: Asia is likely not going to be a victim of European debt woes, so long as exports continue, but the investors' antidote to them. ■

Taking the Chinese Boom Inland

- China Metro Rural Holdings

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By **Jason Van Steenwyk**

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China's massive urbanization - the migration of hundreds of millions of rural Chinese to cities like Shanghai, Beijing and Macau - helped to drive the stupendous economic growth of the past two decades. The gains have been real: China's economic transformation since the 1970s from a centrally-planned communist economy to an export-focused, market-friendly socialist economy represents one of the most remarkable economic metamorphoses in recorded history.

But amidst the gains, Chinese policymakers have some challenges as well.

The Problem of Logistics

China's large coastal cities are bursting at the seams. Huge cities like Shanghai are having trouble absorbing the economic and logistical demands of providing basic services and employment to the massive wave of migrants - a "floating population" now numbering well over 220 billion people, according to Li Bin, China's top member of the Population and Family Planning Commission. Meanwhile, exploding urban populations have placed greater demands on agricultural infrastructure to keep all these city-dwellers fed, even as Chinese agricultural communities function with fewer workers.

The Chinese government has therefore embarked on a series of initiatives to develop economies in 2nd and 3rd-tier cities. The goals: Relieve the population strain on the major cities by providing jobs and opportunities further inland, while building up the capacity of the Chinese infrastructure to support the movement of food and other supplies to the cities, and the movement of exports to the coastal ports.

Logistical City Construction

That's where China Metro Rural Holdings, Ltd. (AMEX - CNR) comes in. China Metro Rural specializes in colossal construction projects, turning underdeveloped plots of land near second-tier population centers into huge "logistical cities" with all the amenities of modern cities.

What do they build? Imagine a miniature Las Vegas or Disney World for logisticians. Each logistical city provides hundreds of warehouses, office spaces for logistics companies and those that support them, vehicle and tractor dealerships and repair facilities, high-end executive centers, rail and truck transshipment facilities, thousands of spaces for retail stores and markets, facilities for traders, and residential facilities for workers and their families. Each center is at a nexus of rail, provincial road and interstate transportation, and close enough to the huge coastal population centers to benefit from the huge demand for throughput. So far, the company has broken ground on three different logistical centers around northeastern China, and is actively looking for more opportunities.

"Furthermore, the both national and provincial government officials have also moved to streamline the construction approval process by cutting red tape, and co-locating agency offices on site"

"We're looking for opportunities where the demand is there, where the geography and the existing road and rail network support the increase in traffic, and where there are tax concessions and other favorable policies from local authorities," says Sam Sio, the chairman and chief executive officer of China Metro-Rural Exchange.

Supportive Government

What kind of concessions? Some of them are significant. While land in the major population centers has become extremely expensive, China Metro Rural was able to secure over four square kilometers of land adjacent to Tienin - for free. The Chinese government granted the land in exchange for development. China Metro Rural is free to build, sell and lease pretty much as it sees fit. In addition, China Metro Rural has also an exemption for land appreciation tax on any land sold at a profit.

Furthermore, the both national and provincial government officials have also moved to streamline the construction approval process by cutting red tape, and co-locating

agency offices on site. Not only do the government offices themselves make reliable anchor tenants on the property, but government officials are authorized to approve many permits and construction clearances on the spot - significantly tightening the permit request-to-approval timeline. The company is therefore able to put capital to work right away, without having to sit on idle funds for extended periods of time, nor do they need to pay for cranes and other heavy equipment and laborers to sit idle for long.

As a result, unlike most major land development projects of this scale, China Metro Rural was able to bring much of its Tienin project to completion within three years, and show operating profits in its first year in 2008. Profits have grown every year since then. Specifically, pretax profits went from 12.6 million in their fiscal year 2009 to nearly 43 million in FY 2011, which ended in March.

Strong Balance Sheet

What's more, they did so with a very reasonable amount of leverage. The company can boast a positive net worth, even with shovels in the ground in all three of their major projects, with total assets of 239.2 million against liabilities of $131.7 million. The company has increased its book value from $16 million in the spring of 2009 to $107.5 million as of the last public disclosure in March.

These are numbers that are nearly unheard of in the west. But it's much easier to show an early return on investment, of course, when land is free. "The concessions on the part of the government are part of the reason we are able to shorten the capital cycle," explains Sio.

A Value Play

At today's stock price of $1.23, China Metro Rural is trading at a miniscule 3.3 times 2011 earnings. With a market capitalization of $95 million at current prices, CNR is also trading well below its book value. Investors buying in now are essentially getting paid just to buy, and are picking up the future growth of the enterprise for free.

Viewed from a technical perspective, CNR is currently trading at the very bottom of its 52 week range, but as low as the company has ever traded since it had its IPO at $5 in 2007.

Case Study: Tieling

Of the three projects currently in development, only the first one, Tieling, is the first to approach fully-operational status now. The company completed Phase I construction earlier this year. Tieling itself is a major regional city in Liaoning province, with a population of 3.2 million. Geographically, the town is ideal for a logistics center, situated at a natural chokepoint: All ground-based traffic from Jinin, Hielongjiang and from Inner Mongolia must pass through Tieling. Currently, the area's four agricultural centers are handling some 3 billion kilos of agricultural throughput each year.

Liaoning's growth has been spectacular, even by Chinese standards: Average growth in the province has ranged from 17 to 28 percent over the last five years. Even as the huge centers like Shanghai find it difficult to grow, just from the sheer weight of land costs, much of the economic spillover from the major coastal centers is expected to benefit Tieling and the surrounding areas.

Currently, the Tieling logistical city actually boasts the largest commercial car market in China, with 23 separate 4S shops.*

For its part, the Chinese government granted 4 square kilometers of land, free of charge.

China Metro Rural envisions the potential of another 5 million square meters of land on top that, as the project reaches maturity. To support the effort, light rail service to Liaoning is expected to arrive at the site by 2013 - putting Liaoning commuters within 20 minutes train ride of all the Tieling projects amenities and facilities.

With Phase I, or commercial construction nearly complete, CNR will shortly be starting Phase II, which is the buildout of the agricultural support and logistics facilities. Even without the agricultural portion of the project up and running, though, the Tieling project has already generated over US$117 million in revenues last year, from leases and pre-sales. Currently, CNR has completed 440,000 square meters of construction, and pre-sold 269,000 square meters. Another 208,000 square meters are currently under construction, scheduled for completion by ________.

Dezhou

The second project, Dezhou, isn't running far behind. This project, commenced in 2010, is projected to be even bigger than Tieling. In Dezhou, a city of over 7 million people, China Metro Rural hopes to leverage annual regional GDP growth rates of 15 to 17 percent. The company plans to have over 5 million square meters of construction complete within three years. Again, the Chinese government supported the effort, donating 4 square kilometers of land for development, along with other concessions to encourage the build-out.

Dezhou is a large regional transportation hub, located at the nexus of 5 national roads, 14 provincial roads, 4 expressways, and just an hour's commute from Beijing via high-speed rail. China Metro Rural maintains ownership of 85 percent of the project, with a build-out potential of over 15 million square meters of gross floor area for sale or lease.

Qiqihaer

Qiqihaer is the largest industrial city in Heilongjiang Province, with a population of some 6 million. Local authorities have been struggling with a shortage of infrastructure and modern commercial and residential properties, given the powerful surge in demand in recent years. To remedy this, the government of Qiqihaer has granted some 5 square kilometers to the project, free of charge. China Metro Rural plans to transform the New City District of Qiqihar into an ultra-modern "green-concept" logistical and commerce center, complete with a high-end business and residential district featuring modern high-rises, megamalls and 5-star hotels to cater to business travelers.

The Path Forward

Going forward, the company's management plans to let each of their developments grow organically, while creating multiple streams of revenue from the projects. For example, in addition to the tax-advantaged sale of appreciated property and lease payments from thousands of tenants, Metro Rural China also plans to generate additional revenue from sources as diverse as property management to advertising revenue from billboards and modern digital signage throughout each of its projects.

Meanwhile, China Metro Rural will be doing its best to leverage its own brand name and prestige as a premier property developer in China to enhance its pricing power.

For future projects, the company will continue to seek opportunities in 2nd and 3rd tier Chinese cities, where they can find a combination of strong demand pull, ready access to road and rail infrastructure, and a supportive tax and regulatory environment from provincial and local governments.

Capital Strategy

With fairly young publicly traded companies with loads of room for growth and substantial appetite for new capital, the potential for dilution is always a concern. After all, if the company does another equity issue, all of the shares of existing stockholders is worth proportionately less. However, Sam Sio and his chief financial officer, Arthur Lee, are not anticipating further equity issues at this time. "As of right now, it is very affordable for us to borrow money, if we need to, to finance future projects," says Lee. "Currently, we can borrow for about six percent, which is a very easy capital hurdle for us to meet, given current growth rates, and the favorable policies of the governments in the areas where we are working."

That said, Sio does not want to overleverage or get too far ahead of demand. "We are planning a balanced growth strategy, with a prudent development plan and gearing policy," says the CEO.

With that in mind, although the company has ramped up its borrowing to finance the ongoing construction, the company's earnings before interest and taxes (EBIT) can comfortably pay the debt service more than 10 times over, as of the end of March.

*The Chinese term for authorized auto dealerships. The "four S's stand for Sales, Service, Spare Parts and Survey, respectively.

At the time of publication, the author holds no position, long or short, in China Metro Rural.Ferum ■