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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

China's Economy Shifting from Investment Focus to Consumer Spending

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SECTOR — GENERAL INVESTING

TWST: Could you tell me a little bit about the company?

Mr. Morton: Yes. We are a value-based equity long-only investor. We run several different variants of value. All are Asia- or Asia Pacific-focused. So we run a couple of offshore funds, a couple of mutual funds and institutional accounts, but all of them have a common analytical framework and platform grounded in traditional value analysis practiced in Asia.

TWST: What are some of the concerns now in the Asian economy, given some of the trends going on in some of the other parts of the world?

Mr. Morton: Sitting here, we feel stable compared to other parts of the world. Look, you can always find problems, and of course, the one that most people are looking at is the debt position in China. There's no doubt that has grown very dramatically since the financial crisis of 2008. The rest of the world should be grateful to China for doing that because it's made the comeback for the U.S. and Europe that much easier.

But growth has slowed in this part of the world relative to what we were used to in the last decade. However, that's hardly surprising. If your GDP has grown by three or four times over 15 years, you wouldn't expect to have the same growth rate over the next 10 to 15 years measured in percentages. That's not mathematically realistic.

So growth is changing both in amount, slower, and in composition, as more people in this part of the world start to reach a level where they can purchase things that were out of reach 10 to 15 years ago. So the nature of growth is changing, and any transition or change in economic structure of a country is bound to bring issues with it. So I think those are the two things one would highlight.

Of course, geopolitically, we all know North Korea continues to behave extremely badly, and there's no obvious solution to that problem. But it does seem, on the positive side, that it has brought China and the U.S. closer together and reduced the very real risk, when you and I last spoke in 2016, that we might see a trade war between those two vital countries to the world economy. That risk has receded.

TWST: Are you getting any sense regarding how the different countries in Asia look at President Trump and his policies?

Mr. Morton: Well, I can't look inside the heads of the various leaders. But you can see from their behavior where they're going and their priorities. To some extent, it's not a big issue, and you may think that sounds strange, but America under Trump has stepped back from this part of the world except with North Korea, largely.

In the Philippines, Duterte, who is a strange character, didn't like Obama for whatever reason but seems to be able to work with Trump. So I guess that's positive, but then he's made a big reach to China, and one of the first things he did as the new president was to go to China and say, "Look, I'm not worried about the court case over a few islands, give me lots of inward investment," and that seems to be happening.

In Indonesia, you've got Jokowi. I think he's pretty preoccupied with domestic issues, after his close associate lost the election to be re-elected mayor of Jakarta. He's focused on his own re-election in a couple of years' time. He had a good relationship with Obama. I don't think he has any relationship with Trump, positive or negative.

Singapore, again, preoccupied by regional issues. I don't think there is anything to add there. Malaysia, same, and in Thailand. I mean what is, as I said, most dominant is the lack of any particular view or action in respect of Trump's election by most local leaders.

The focus is very much on Asia, and in that, the two poles are India and China. So in China, you have One Belt, One Road being this sort of global initiative, which some people have said is the Chinese version of the Marshall Plan, except that we haven't had the devastation of economies that preceded the Marshall Plan. But it is impressive, and it's real.

It's taken a couple of years to move into gear, but it's happening now, and it's substantial in terms of infrastructure being built largely by Chinese companies in countries all over the region through to Pakistan and up into Uzbekistan, Kazakhstan and so forth. And then India, who was the only major regional country not to attend the One Belt, One Road conference in Beijing last month and is somewhat concerned about the possibility of being encircled by Chinese diplomacy because, as you know, there are still a number of issues lingering from a small-scale war that took place up in the Himalayas and Chinese destabilization both linked to Pakistan and Kashmir and in the territories adjacent to Myanmar.

So they're not terribly friendly, but again, none of it has anything to do with Trump, really. The only place where Trump has made a lasting impression is Korea, first of all with the THAAD missile deployment, which is currently suspended, and secondly with ratcheting up the pressure on North Korea because they have themselves ratcheted up after a number of missile tests. But as I said earlier, that has a silver lining, which is, it seems to have brought China and the U.S. closer together on an issue that is so important that they're putting other issues aside, and that in itself is a good thing.

TWST: Given some of these trends, did you want to highlight a company that you find interesting?

Mr. Morton: I think the country where there are the most interesting investment opportunities for value investors in our region continues to be China. India, the other big economy, does have the most potential for future growth, but there are so many problems, and institutional barriers to getting things done remain immense, in spite of recent progress, thus, I think, the willingness of investors to pay high multiples, and often 2 times the price/earnings growth ratio when growth investors have in the past felt the right cutoff was 1 times or less, even if the companies possibly have great prospects. This exposes investors to a negative rerating unless the companies and the country deliver on ambitious targets. The risk/reward ratio for me is out of kilter. I know that's a minority view at the moment. But in China, yes, I'd like to highlight a few companies.

One which I think reflects the changes is **Xtep** (HKG:1368), which is an athletic apparel company, really more of a shoe company than a clothing company, but I mentioned earlier that the economy is beginning to shift into more of a consumerism phase, and the government wants that to happen. China is trying to shift the balance of its economy away from an investment focus into more consumer spending. Policy direction is changing to support that objective.

By that I mean, they are putting more money into soft social projects, not just hard infrastructure. So you are seeing more money and reform going on in health care, you are seeing the same in education and also little change but some small improvements in pensions. All of these things are designed to encourage Chinese people not to save so much but to spend more domestically.

Xtep is one of what I would call the tier-2 Chinese sportswear companies. Obviously, the big brands, internationally, **Nike** (NYSE:NKE), **adidas** (OTCMKTS:ADDYY) and so forth, they are the go-to choices for aspirational Chinese purchasers who want status. You also have **ANTA** (HKG:2020) and **Li Ning** (HKG:2331), two fairly well-known Chinese brands, and then you have three or four below that, of which **Xtep** is one.

The reason I like this company is threefold. Firstly, the quality of the product has changed dramatically over the last five years. Five years ago, there's no question a **Nike** shoe was a completely different

Highlights

James Morton discusses Santa Lucia Asset Management Ltd. Mr. Morton is a long-only equity investor. All of the funds he manages are focused in Asia or Asia Pacific. In addition, they all use an analytical framework that is based on traditional value analysis practiced in Asia. Currently, Mr. Morton views China has having the most interesting value investment opportunities in the region. On the other hand, while he sees potential growth in India, he believes the risk/reward ration is out of kilter. Some of the opportunities that Mr. Morton sees in China are a result of the economy shifting toward consumer spending.

Companies include: Nike (NYSE:NKE); adidas AG (OTCMKTS:ADDYY); ANTA Sports Products Ltd. (HKG:2020); Yuzhou Properties Company Limited (HKG:1628); China Vanke Co Ltd (HKG:2202); Home Depot (NYSE:HD); Hopefluent Group Holdings Ltd (HKG:0733); Skyworth Digital Holdings Limited (HKG:0751); Tencent Holdings Ltd. (HKG:0700); Toshiba Corp (TYO:6502); Xtep International Holdings Limited (HKG:1368); Li Ning Co. Ltd. (HKG:2331); Country Garden Holdings Co. Ltd. (HKG:2007); Central China Real Estate Ltd. (HKG:0832) and Red Star Macalline Group Corp. Ltd. (HKG:1528).

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product to an **Xtep** shoe, but it's getting pretty hard to tell the difference now. And a **Nike** shoe is still twice the price of an **Xtep** shoe. So the value performance-price ratio is completely out of kilter.

1-Year Daily Chart of Xtep International Holdings Limited

Chart provided by www.BigCharts.com

months. And it should also, therefore, reduce markdowns, again helping margin all the way through the channel at retail, at distributor and, of course, **Xtep's** level as well.

So this business-model change, which will probably mean growth this year, maybe less than usual, but should pick up again next year to double digits. That should make for a better business model, and of course, we are operating — I should point out — in a policy friendly environment because there's a lot of emphasis now in China on health. That includes promotion of activities such as marathons, which are spreading around the country and getting more realistic as pollution levels are falling in a number of places, although not everywhere yet.

And at the same time, **Xtep** will be a beneficiary of the push to roll out soccer throughout the entire school system. President Xi is a big soccer fan, and that's probably a 100 million- to 200 million-pair market right there, which hasn't been around until starting last year. So both from a policy standpoint and from a new-market-category standpoint, additional growth opportunities, and **Xtep** is working to develop direct sales to schools in partnership with its local distributors.

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This is a shoe which might, if it had a **Nike** name on it, sell for 10% less rather than half the price, and in fact, **Xtep** is considered to be the top domestic running shoe, and it's been worn by more Chinese marathon winners than any other shoe. I think that tells you something about the quality and performance of those shoes. So it seems to me that as this is recognized, the extraordinary expenditure **Nike** puts into its brands to position them as a premium product will struggle to support the price gap, and if we see erosion of this extraordinary discount, and I think it has started in a small way last year and should progress, this will be very positive for **Xtep's** margins on its main product category.

The second thing I would say is that the industry is going through a structural transformation. Historically, the sportswear industry grew very, very fast. Then, it hit a speed bump because it got into a situation where they had stuffed the channel with too much inventory, and there were too many retail outlets that went through a period of reformation, including store closures and improving MIS and inventory control, and that phase is sort of behind us now. It was pretty much complete by the end of 2015, but it's now going into a new phase where the sportswear companies are improving their logistics and sourcing and speed of product from manufacturing to retail to make sure that they have better control of what sells and what doesn't, and in reordering.

Historically, this industry has been built around four-times-a-year big sales events, at which 95% of the product was ordered by their distributors and subdistributors at the retail level. They're moving to, not overnight, but they are moving now to more of a reorder program, where these trade shows will still take place, but the company will try to reduce the amount sold at those events and have more consistent product flow through the pipeline, and I think that will be helpful in two ways. First of all, it will probably reduce total inventory, which is roughly 4.5 to four

And the third reason is valuation. Here's a company that has net cash. So we're comfortable with the balance sheet; there is no financial risk here. There is a nice margin of safety in fact, and the company has capital to spend to open up these new business channels and opportunities if it wants to. It trades on a p/e of single digits, probably about 8.5 times at the moment, which is hardly expensive.

This year, yes, probably not too much growth because of the business-model transition, but next year, I would expect growth to be in the 12% to 15% range, and that's sustainable probably for several years, so a nice discount to growth, too. And then, the yield is roughly around 6.5% net. So on every metric, it scores. I think it's attractive to buy a branded product business in a growth environment with lots of upside and very little downside with these valuation metrics.

TWST: Is it possible we're going to see their products in the stores in the United States and in Europe more frequently?

Mr. Morton: You can find them, but you have to look hard at the moment. There's very little export. They probably will do more, but there's a lot of opportunity at home. And the problem in this category is that to attract consumers, you do have to have the name recognition. That means spending a lot of money. **Xtep** does intend to increase exports, but it's not a priority.

TWST: Did you want to mention another company?

Mr. Morton: Sure. I mean, as you will recall from our last conversation, I've been positive about the Chinese real estate market, and just about everybody else has been negative. You will see that one we talked about last time, **Yuzhou Property** (HKG:1628), has performed very well since we discussed it. Now, it is true that Chinese property market conditions have, on a macro sector level, deteriorated since you and I last spoke. Every first-tier city in China now has a number of property restrictions in place, varying from eligibility of purchaser to mortgage restrictions relative to number of properties, increased loan to value ratios and even higher interest rates. No two cities are exactly the same.

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This is an overall policy guideline from the center designed to take the heat out of the property market before too much of a bubble was created. But it's implemented at the city level in different ways depending upon local conditions. The emphasis is on making sure prices overall don't go up at the moment, after they had a good run into 2015 and in the first half of 2016. So you'll see it broadly applied in tier-1 cities where price increases were strongest. It's there in some form in every tier-2 city and most tier-3, plus even a few tier-4 cities, particularly those cities that are sort of satellite cities to tier-1 cities.

Now, in this environment, this does put stress to a certain extent on property developers because the market actually would pay in many places 10% to 20% even above where they are allowed to set price of a new launch. But what this means is that a lot of developers — those with the financial strength — are holding back product. It also means that in this environment, the big are getting bigger, and industry consolidation, which has been apparent now for several years, is actually accelerating. So the better companies, the ones we look at, the top 30, 40 names in the industry that are listed, they are gaining market share and are still growing strongly, many of them at 20% in terms of contract sales this year.

And as the dynamics have slightly slowed in the tier-1 cities and moved to the tier-3 and tier-4 cities, where there have been historically very large inventory overhangs, prices have started to move there. That's why **Country Garden** (HKG:2007) has had one of the best share-price performances in the sector this year. But I'd like to highlight one that hasn't done much yet, which is **Central China Real Estate** (HKG:0832), and the reason I highlight this is, again, there are three reasons why we like it.

One, it's the market leader in Henan province. It's based in Zhengzhou. I was there four weeks ago visiting a number of their projects in Zhengzhou, Luohe, Xuchang and also Kaifeng — so not the sort of places most analysts or portfolio managers visit. Zhengzhou is a regional capital, which is a city most people reading your publication won't probably recognize, but it has 10 million people, just to put it in context, and that sort of doubled over the last eight years or so, and there continues to be inward migration. So Zhengzhou is a healthy property market.

Central China's flagship residential development is just next to the CBD — Central Business District. The price per square meter there over the last 18 months has gone up from RMB 22,000 when Phase 1 was launched to RMB 48,000 today, to put things in context. So you can imagine given the cost of Phase 3 compared to Phase 1 is essentially the same. The margins are rather higher even after Land Appreciation Tax.

Now, Zhengzhou was made famous actually — so maybe some of your readers do recognize it — it was made famous because it was featured in that CBS "60 Minutes" ghost-city piece where they showed a terrible shopping mall that was falling apart, and nobody was in it. If CBS would like to go back to Zhengzhou and take a look, they'd find a thriving mall, renovated, full of shoppers and some traffic jams. Things do change quite quickly in China.

Now, the second reason I like it is because they have a lot of tier-4 and tier-5 developments, which had been moving very slowly and where prices have not changed largely at all between 2010 to 2015. But in 2016 and continuing this year in 2017, these prices are going up, and whereas there are property controls and restrictions in the main cities, these markets are just coming to life and have no such restrictions. So again, land bought, in some cases 10 years ago, at very low prices is now selling in an environment where prices are going up anywhere between 10% to 15% and, in some cases, even 20% over the last 18 months, with consequent impact on gross margin, and a number of those developments which were slow-moving are now selling quite rapidly.

1-Year Daily Chart of Central China Real Estate Ltd.

Chart provided by www.BigCharts.com

And the third point is that this company has developed an asset-light model. Now, what do I mean by that? The asset-light model means that developers that got into difficulties — and a lot of small local developers did — in what was a less supportive environment in many of these cities in the last three or four years, they struggled through a combination of their own lack of management skills, financial ties to banks, for various reasons, and they've now accepted sort of a management role for **Central China**.

The way this works is it usually lasts for a period of two to four years. **Central China** comes in, takes charge of marketing and the overall project development and possibly even financial arrangements, and in return, they get fees. The fee structure for each transaction is unique because it depends on the circumstances, location, and what's working well and what isn't. But a common feature will be some small upfront payment, a management fee over time, and then, most of these contracts also have a profit-sharing arrangement or occasionally a revenue-sharing arrangement.

1-Year Daily Chart of Red Star Macalline Group Corp.

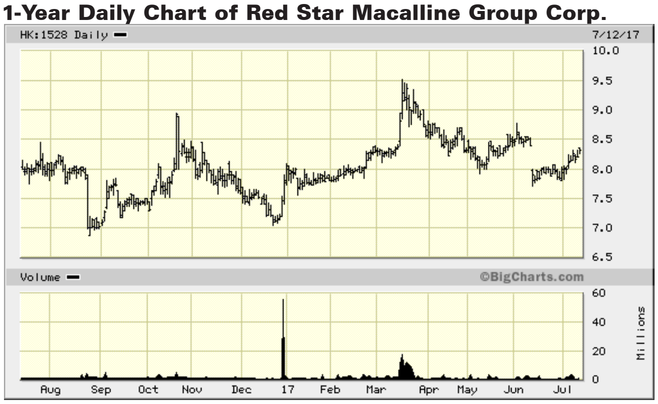

Chart provided by www.BigCharts.com

But really there is a show me, and let's wait and see, and we want to have the numbers before we are convinced that this new strategy really is going to deliver the profit growth that the company claims, means a skeptical consensus prevails among those analysts following the company. Thus, the share price has not rerated to reflect this new business potential.

If **Central China Real Estate** does not deliver, there should not be much downside impact, but if it does, the potential upside is significant. With nearly 50 projects, now we're talking a couple of billion renminbi to fall to the bottom line over the next three to four years on completion. This is transformational, and on that basis, the forward p/e multiple is well below the sector. It's probably in the region of 4.5 times this year. But the growth will be well above sector.

TWST: Did you want to mention another company?

Mr. Morton: Yes, sure. I could mention one which sort of links these two themes together called **Red Star Macalline** (HKG:1528), which some people have said is sort of the **Home Depot** (NYSE:HD) of China, but I don't think that's a very good analogy. What is true is that they are the largest operator of malls dedicated to furniture and everything you would need for interior decoration and to fit out a home or apartment in China. This company has 66 of these supermalls that it operates and owns, and over 130 that it manages for third parties. That adds up to nearly 13 million square meters of space.

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Now, the profit-sharing arrangements usually relate to the realized average selling price at the end of the project's handover relative to the price before **Central China** came into the picture. And given current dynamics and with **Central China** as the recognized local market leader in the province and the go-to name for quality, by taking over a project and essentially putting its brand on a developer without this recognition, it can raise the price pretty quickly. I visited several projects where the day they took over, they immediately put the price up 10%, and yet, sales volume seems to be coming through.

What's so wonderful about this model, of course, is no capital. Profit margin is extremely high and return on capital, well, essentially infinite. **Central China** has had its problems in terms of profit growth over the last couple of years, but it's recently brought in top professionals from **Vanke** (HKG:2202), and these have started to transform the development program.

But this is what I think is exciting. This asset-light model now has signed up nearly 50 projects, and the square meters under management is nearly as large as the square meters in the owned land bank. The company has put out quite punchy forecasts for profit this year from the asset-light activity, which I have to say, I'm a little skeptical about because I don't know quite how the accountants plan to allow them to do revenue and profit recognition, and I think given the nature of the contracts, that might prove to be more extended and less upfront. But what is clear is that in 2018, the company has every chance of doubling its base profit from development activities.

And the market has really not taken this onboard yet. One or two brokers have pointed this out and partially factored it into their forecasts.

To some extent, their business model is a bit similar to **Central China Real Estate**, only they've been doing it a lot longer, and they get involved usually with a property developer when things are still on the drawing board and take consulting fees upfront. Now, this has been a decent growth business. As the property market becomes more mature, generally, this will stabilize, but it benefits from two positive trends in China, one which is more developers are selling units that are fitted rather than bare shell.

TWST: Sure. What does that mean?

Mr. Morton: Well, bare shell means, bare walls and no floorboards either. If you're lucky, you might get a toilet, but probably not. Whereas fitted means you've got a kitchen, a bathroom; you've got wooden or ceramic-tile floors. It's what you would expect to buy in New York. But in China, most units, particularly in tier-3 and below cities, are still shell, which is exposed concrete and a few wires hanging out of the ceiling.

TWST: So with those kinds of properties, you're going to need to go somewhere and get the place fixed up before you can move in?

Mr. Morton: You are. And that's obviously their main source of revenue, historically. But in the tier-1 cities, what you're seeing is a lot more upgrading, and it's interesting to see — and we've visited eight of these malls now in various different cities in China — it's interesting to see how the tenant mix is changing, and things that weren't there five years ago, such as interior decorators selling services and banks selling financial packages, are appearing. Everything you need for the home can be sourced there.

Now, why do we like this company? Well, first of all, it is number one in its field, and it's a well-recognized brand and has positive, I would say, recognition in China. And because it's been there for a long time, it also has a lot of stores in good locations, and they are large, very substantial. It would be extremely difficult for anybody to replicate their network today — in fact, almost impossible without spending a huge amount of money, and so that's almost like a barrier to entry or moat around their core business model.

party business is probably mid-to-high single digits this year, but we expect it to revert to double digits going out into the future, and again, a nice yield 6.5%, 7% and sustainable with a decent balance sheet. There is some debt, but nothing at all alarming, particularly given the strength of the asset side of the balance sheet. So a solid, sensibly capitalized company with little financial risk, acceptable growth, very nice income generation and lots of potential upside if they can continue to do more transactions along the lines of the one just announced in Tianjin.

"It's interesting to see how the tenant mix is changing, and things that weren't there five years ago, such as interior decorators selling services and banks selling financial packages, are appearing."

Now, as a value investor, what intrigues me about this company is that some of these are really not actually in the best location anymore, because as the cities expanded, what was a peripheral site, where they'd plonk down a hundred-thousand-square-meter mall, is now probably encased in quite nice properties in a good suburban environment or even, in a few cases, in a downtown environment where the alternative use of property could be considerably higher. Now, that's not as easy, however, as it sounds. Getting a change of use in China is difficult. But when the city government wants it, that's a totally different story, and so some of these locations would be better off in the eyes of city planners performing some other function. There's potentially a lot of hidden value there.

We've been talking to the company about both this aspect of it and how they might monetize some of the hidden value possibly through a REIT process. So I was absolutely delighted to discover when I was at the CLSA conference in Tianjin last month that the company was announcing a plan to monetize its two sites in Tianjin. This is just two sites, you understand, out of 66, and they were talking about monetizing them at a value that was equivalent to over 6% of the enterprise value of the entire company. So this is, I think, a pointer to how much hidden value could be in there.

We don't know all of it. We don't know how easy it would be to unlock, but here we are; the company is looking to effectively, through a two-stage process, convert two of what I would say would be representative but not their very best malls into a REIT-type format in a separate listing that would essentially change the valuation basis. It is not a done deal yet, but the process has started.

So this, I think, could be part of a bigger restructuring, and part of the reason why I think this is going on is not because we've had nice conversations with the company, because we're not that big a shareholder, but because **Warburg Pincus** is. And **Warburg Pincus** is pretty good at extracting value from its investments. I'm sure they have played a role in this and will continue to play a role.

And then, just the fundamental valuation of the business — again, like **Xtep** earlier — is very attractive for a value investor. We don't really know what the net asset value mark to market per share is, but I would say it's double the current share price. So you're buying first-class assets at 50% — 50 cents on the dollar — and that may be conservative. If the Tianjin transaction is indicative of the portfolio as a whole, then the NAV is higher than I thought it was. It's on a single-digit p/e again.

Growth here as the company winds down a little bit its third-

TWST: Did you want to mention one final company?

Mr. Morton: Well, maybe I should briefly comment on the ones mentioned last time, would that be useful?

TWST: Sure.

Mr. Morton: It's always frustrating when you read about a company, and then there's no follow up. The good, the bad and the indifferent. **Yuzhou** is doing wonderfully well again in the context of a more difficult Chinese property market, 20% growth in 2017; the p/e is still low, around 5.5 times; and the yield should be 6%, even after the share price moved up about 35% since we last spoke about it, but a total return over 40% when you add in the dividend they paid.

1-Year Daily Chart of Yuzhou Properties Company

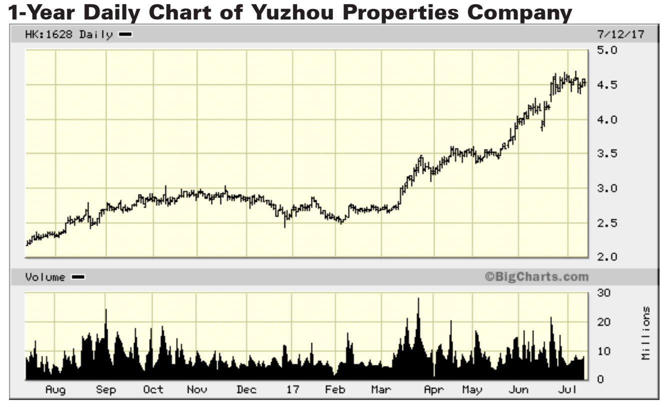

Chart provided by www.BigCharts.com

Chairman Lam is a great guy, very dynamic. He knows what he's doing. He's been less aggressive in buying land when prices are high. The biggest challenge the company faces is getting land at the right price, not sales. And with the high level of contract sales, earnings growth is pretty much baked in for 2017, 2018 and 2019 now.

Hopefluent (HKG:0733) continues to be the leading real estate agency in Guangdong and delivered a cracking set of 2016 results. By that I mean, sales were up 44%, and earnings per share rose by 34%. Unfortunately, still below the radar screen. Net cash, the share price is not that different than when we talked about it last time. Net cash per share is about 70% to 75% of the market cap of the company. Earnings growth this year and next should be in the 15% to 20% range. The ex-cash p/e is about 1.5, but the regular p/e is about 6, so again, a huge discount to growth.

They are increasing their dividend, and what's for me so exciting about this company is the composition shift of their revenue and profit. You can see more sources, not just in traditional agency business. About 30% of their total now is outside of that, particularly their peer-to-peer lending secured on property, which still hasn't had a single default after nearly two years, and nice to see the secondhand business is profitable, which it hasn't been for years.

And then, **Skyworth** (HKG:0751), which is the market leader in 4K ultra-high-definition televisions in China, they had a disappointing set of fiscal March 2017 numbers for two reasons. Their set-top box business had a — well, actually it's the same reason affecting two businesses. They had a huge run-up in the cost of a critical chipset, which they have not been able to pass through quickly enough, which caused their set-top box business profit to drop 70% in the last two quarters, and panel prices rose a lot — panel being the single-biggest cost component in the TV business. And again, although like-for-like prices are now going up in China, margin was squeezed. Gross margin came down roughly 150 basis points to 20%, which is still the highest in the industry.

Skyworth remains the most efficient manufacturer. And I think we've seen the bottom there. But on the other side, what's been exciting at **Skyworth** is their online services business, which is beginning to develop traction and will be profitable this year; they exceeded both the number of online active daily users against forecast, and their revenue was about 30% above what they had expected and guided, with faster acceleration this year.

Tencent (HKG:0700), the internet giant, has just bought 5% of **Skyworth's** internet services company for an RMB 3.9 billion valuation of that division because they see the smart TV as a critical portal of access to online services. And a smart **Skyworth** TV is out there in all these homes, 22 million now activated, which is still a small number for China, but it's not a small number in terms of potential consumers of services. So that operation contributed zero profit last year but is valued at over 25% of the enterprise value of the company.

You should not forget the property portfolio, which is worth pretty much the entire market cap today. **Skyworth** shares have been disappointing since we last spoke, and it has had a couple of hiccups. The set-top box business is going to take probably a while to turn around, but the TV business is turning around already. Although volumes are not strong in China, their export business, driven out of the Indonesian factory they acquired from **Toshiba** (TYO:6502), is growing very fast. Margins there are rising, although they're lower than they are in China.

So it was interesting that whereas the share took a dip on the profit warning, it's actually gone up on the results, and of course, what the market likes to see is the validation of a company like **Tencent** buying into **Coocaa**, the online business, and making it a core part of its lineup. I think it bodes very well for the most exciting part of its business portfolio.

TWST: Changing direction a little bit, when you consider investors in the United States or in Europe, why would they want to have investments in China or other parts of Asia as part of their portfolio? What purpose do those serve?

Mr. Morton: Well, you don't want all your eggs in one basket is a good place to start. China is the second-largest economy in the world, and not to have any investment in that economy, to me, would seem rather foolish. The Chinese market has become a lot better than it used to be in terms of quality of company. Still lots of problems, I wouldn't want to say they are all investable, but the quality of companies is getting better.

If you look at the valuations of these companies we've been talking about and compare them to similar valuations in the U.S., you're getting companies at half the valuation multiple or less with two to three times the growth rate. Now, normally, people would be falling over themselves to make that trade, but for some reason, people assume that China is some awful sinkhole. The evidence over the last 20 years would suggest it's not. And if people would just throw away their prejudices and look at the facts, I think there would be a big shift of money over here into these markets.

The MSCI just agreed to let 222 named Chinese companies enter one of their emerging-market indices with a 0.7 times weighting. That kicks in only in May and August next year and, as you might see from the weighting, does not add up to much money in an absolute sense so is unlikely to have much of an impact. Then again, this will be what I call dumb money going into tracker and index funds.

Still it does help sentiment and, all other things being equal, is a small positive for China. It will force more managers to think about how they should approach and allocate to China. The intelligent money is buying growth companies with strong balance sheets at 8 times earnings or less. I mean, what's not to like about that, particularly when they have 6%-plus yields.

TWST: Thank you. (ES)

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