Aberdeen Chinese Equities

Fund Manager Interview
September 2014

Nicholas Yeo*
Director &
Head of Equities
(China/Hong Kong)

Key points

- Proposals for state enterprises to improve efficiency and governance are steps in the right direction
- Over-supply in property market will put pressure on prices for some time to come
- Stocks attractively-valued on a forward multiple of 11.7 times for FY2014
- We invest in quality companies with sustainable businesses and healthy balance sheets
- Our Hong Kong investment team provides local expertise

* Nicholas Yeo is the Director & Head of Equities (China/Hong Kong), advising the Aberdeen Global – Chinese Equity Fund, the underlying fund of the Singapore-authorised Aberdeen China Opportunities Fund

How have China and Hong Kong markets fared?

The MSCI Zhong Hua index rose 5.8% in the year to end August. Sentiment was lifted by the brisk pace of economic growth in the second quarter. Investors were also encouraged by proposals for state-owned enterprises (SOEs) to improve corporate governance and efficiency. Stocks are attractively-valued on an absolute basis, trading at an estimated price-to-earnings ratio of around 11.7 times for 2014, whereas in the past it had traded at multiples of 18 times.

What is the outlook for corporate earnings?

We think earnings growth for companies are likely to be muted, probably below 10%. Operating conditions for businesses remain challenging, given the weaker environment in 2014. Corporate profits have fallen – exacerbated by the slump in the yuan as companies with overseas borrowings incur foreign exchange losses – and sentiment has been affected by tighter credit policies. As for our portfolio, we see little indication of financial stress among our holdings thanks to their healthy balance sheets and cashflow generation, as well as sustainable business models.

Name some standout performers in your model portfolio so far this year.

Stocks that did well included **Swire Properties** and semiconductor assembly equipment maker **ASM Pacific Technology**. The property developer's share price rose, aided by improved rental returns from its Hong Kong and China property portfolios. ASM Pacific Technology's stock rose due to robust customer demand and a solid order book.

What about those that have not done so well?

Laggards included retailer **Giordano** and hotel group **Shangri-La Asia**. Giordano's share price dipped after reporting weaker sales across key markets in the first half of the year. That said, we remain comfortable with the retailer as it remains well-capitalised and free cash flow margins have improved. Shangri-La Asia's share price was dampened by start-up expenses for upcoming hotel projects, which eroded profits.

Is Beijing right to direct the economy away from exports towards consumption-led growth?

Yes, absolutely. The global economic downturn has shown up the vulnerabilities

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that stem from a country's over-reliance on exports. Large and dynamic developed economies achieve a much better balance between growth through domestic demand and supplying goods and services for export. China is the world's second-largest economy, and yet, its people consume far less per capita than their counterparts in the developed world. Many Chinese save too much of their income because they have to pay for basic public services (such as healthcare and education) that are free or subsidised elsewhere. Therefore, the proposed reforms are correct to address social issues that bar people from accessing these essential services. However, the question remains as to whether reform efforts will be derailed by resistance from those who benefit from the status quo.

Will property prices continue to fall?

Yes. There is an oversupply in the property market that will put pressure on prices for some time. This problem is worse in smaller cities, away from the wealthiest tier-one urban centres of Beijing, Shanghai, Guangzhou and Shenzhen. Even so, there is a lot of variance. Property cooling measures (after rapid price gains) have curbed land sales and the launch of new developments. However, this gives us cause for hope because, by our estimates, this will allow the over-supply to work its way through the system as soon as 3Q next year. Meanwhile, long-term demand will be driven by a number of factors: China is committed to a policy of urbanisation; over 60 per cent of people already living in cities live in poor-quality housing built before 2000 and may seek to upgrade; Chinese households are under-leveraged by international standards and this is reflected in low mortgage default rates; and outside the tier-one cities, homes have actually become more affordable as wages rise faster than property prices.

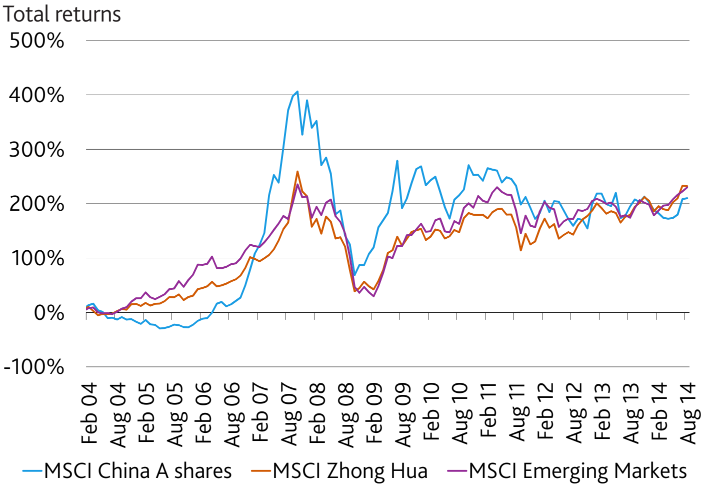
What are the best ways to gain exposure to the China market?

We have always advocated accessing these markets via shares of companies listed offshore. These could be non-Chinese companies that derive significant revenue from China. Companies listed in Hong Kong, for example, are subject to higher standards of governance and disclosure. Disputes are settled in a fair and transparent legal system. However, there is increasing foreign investor interest in Chinese companies that have so-called 'A-shares' listed in Shanghai and Shenzhen. This is a riskier strategy that potentially offers bigger rewards. Onshore bourses are dominated by retail investors and tend to be more volatile. Foreign investors are exposed to a currency that is subject to strict capital controls. However, the A-share market is also the place to look for those smaller and more nimble companies that are best positioned to exploit growing domestic consumption.

What about upcoming plans to link the stock exchanges of Shanghai and Hong Kong?

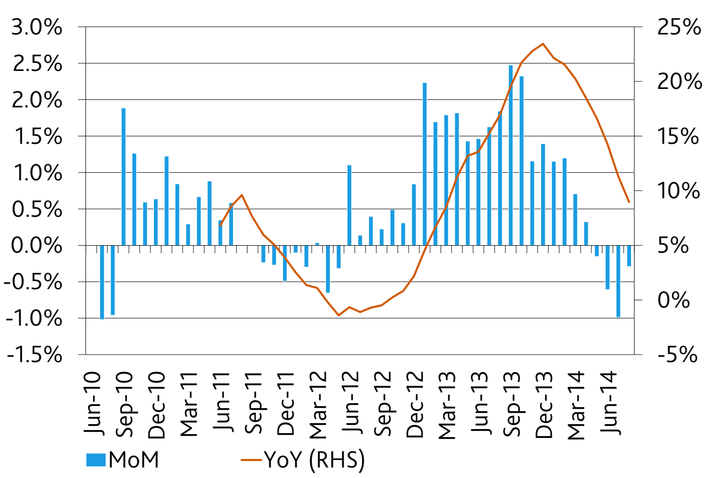
A direct share-dealing scheme between exchanges in Hong Kong and Shanghai will be launched in October. Hong Kong-based investors will gain direct access to Shanghai-listed stocks, subject to the daily quota of RMB13 billion, while mainland Chinese investors will be allowed to trade up to HK$13.2 billion of Hong Kong shares. This represents a significant first step towards the opening up of China's

Chart 1: Upturn in Chinese equities YTD



Source: Bloomberg, MSCI, August 2014

Chart 2: New home prices in tier-one cities have fallen



Source: Soufun, CRR, CLSA, August 2014

capital markets and internationalisation of the renminbi. Potential dual-listings on both exchanges could also create more investment opportunities. Having said that, investors must do their homework – due diligence and a disciplined stock-picking approach are important.

What are your views on China's banking and insurance sectors?

Chinese banks differ greatly from their Hong Kong counterparts in terms of operating style and risk management. As such, we like **Dah Sing**, which is well run and has a conservative balance sheet. We remain cautious on investing in listed insurance companies in the mainland. Firstly, many of them seem to focus on new business volume, rather than long-term profitability. Secondly, domestic insurance stocks are prone to speculative excess. We therefore gain exposure through Hong Kong-listed **AIA**, which has substantial business interests in the mainland. The company's success there is underpinned by a focus on profitability and an experienced leadership team.

Name other stock examples you like.

One name would be **Swire Pacific**, which has a solid portfolio of brands across property, aviation and retail sectors. The conglomerate is a proxy for domestic consumption growth in China and is undertaking significant commercial developments there, financing projects from its cash-generative investment properties in Hong Kong. Thanks to its conservative management, Swire's balance sheet has remained robust – unlike many of its weaker, highly geared counterparts in China. Another example would be **Hong Kong and Shanghai Hotels**, which owns and manages the Peninsula chain, among others. The luxury hotel operator has a good portfolio of assets and is helmed by an experienced team.

Tell us more about your stock picking approach?

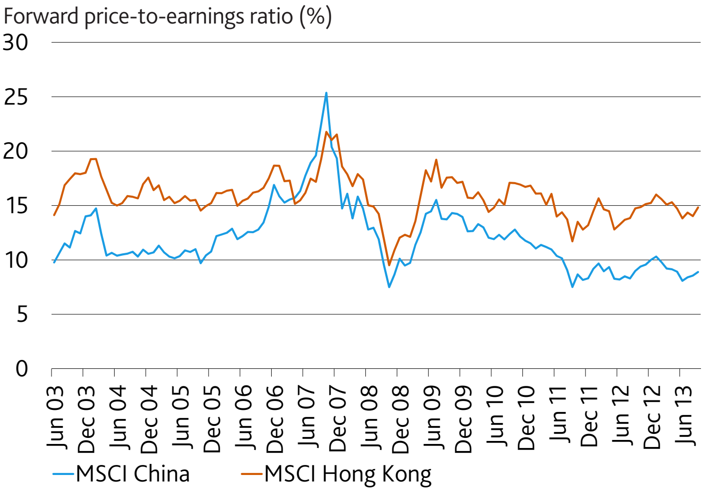
Stock selection is what sets us apart. We do our own company research and if a stock fails our screens we won't own it. Unlike many fund managers we're long term in our focus. That means we go back and visit companies again and again. The benefit of this is to isolate only the well-managed companies that have attractive long-term prospects and which represent good value. It's important for us to focus on price as well as quality – there's no point in overpaying however attractive a company might be.

How important is due diligence when investing in Chinese companies?

For an emerging market as large as China, due diligence is essential. The country scores poorly for its corporate governance. One explanation is that domestic companies are still young in terms of their management experience. Independent directors are few and board accountability is lacking. Minority shareholders are usually ignored so they get a raw deal. Instances of related party transaction are quite common. As a result, it's essential for us to see companies first and, as much as possible, speak to management. We held over 300 meetings with China/Hong Kong companies in 2013.

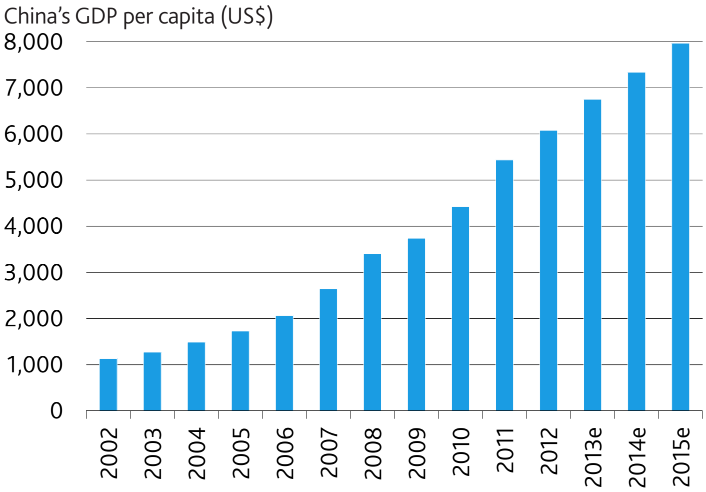
We hold the companies highlighted.

Chart 3: Chinese equities are attractively-valued



Source: Bloomberg, MSCI, March 2014

Chart 4: Rising affluence underpins growth



Source: IMF World Economic Outlook, April 2014

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For more information

Client Services Team
Tel: +65 6395 2701
Fax: +65 6632 2993

Aberdeen Asset Management Asia Limited
21 Church Street
#01-01 Capital Square Two
Singapore 049480
Tel: +65 6395 2700
Fax: +65 6632 2998
www.aberdeen-asia.com

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