The VIEW *from* BURGUNDY

OCTOBER 2010

GREAT WALLS, WIDE MOATS & RED FLAGS

THE PEOPLE'S REPUBLIC OF CHINA'S RAPID DEVELOPMENT IS THE ENVY OF THE WORLD. The prospect of 1.3 billion people reaching income thresholds that usually portend rising personal consumption levels has many investors, leading economists and business people forecasting a new era of consumer demand and economic growth. Chinese growth may offset the effects of the deep recession on the developed economies. For Burgundy, this would hold out the possibility of great returns from companies that sell to China, and even better, for those that sell their goods in China. Still, reasons for concern exist and all is unlikely to unfold as forecasted. In this *View from Burgundy*, we review China's booming economy and also outline our cautions and concerns.

While most of Burgundy's investments in Asia to date have been made in Japan, we have been very active researching China's economy, looking for ways for our clients to profit from its rise to power and influence. For more than a decade, we have been visiting China and meeting with many foreign and domestic companies doing business there. We have also met with auditors, lawyers, Canadian consular and embassy staff, consultants and business people in an effort to build context around how things work in China, and to better understand the risks and opportunities of investing there.

Red Flags

Our view on China boils down to this: while the pace of economic development and the rise in prosperity in China is dramatic, portfolio investors should proceed with caution. First, economic growth does not automatically mean great investment opportunities. Economic growth in China attracts intense competition and competition erodes corporate profitability. Second, China's underdeveloped legal system provides little protection for companies trying to build competitive advantages. Third, the quality of management and corporate governance in Chinese companies is questionable. And finally, valuations of Chinese companies are unattractive, both absolutely and relative to comparable businesses elsewhere.

Great Growth

The potential of the Chinese market has been the stuff of myth in the West ever since the Industrial Revolution began. In the mid-19th century, a calculation determined that if all Chinese lengthened their garments by one inch, the resulting demand could fill the textile mills in Manchester. For 150 years, such a development was only a myth, but today, with a huge and growing urban population, rapidly rising per capita incomes, massive infrastructure spending and a burgeoning consumer market, the myth is finally a reality and the world is learning to live with the consequences.

According to a recent report published by the McKinsey Global Institute, nearly one billion Chinese could be living in an urban centre by 2025.[1] The migration of hundreds of millions of Chinese from rural communities to urban centres is a fundamental trend that has enabled continuous rapid growth in China's per capita GDP at a rate of about 8% annually for more than 30 years. If the Chinese government's blueprint for development is credible (and so far it has been), we should expect a further tripling of per capita GDP by 2020. In fact, many believe that by 2025 China will have replaced the U.S. as the world's largest economy.

As anyone who has visited China in the last two decades can attest, the scale and pace of development is incredible. The government's massive investment in infrastructure over the years has played a huge part in the country's growth. Investment into railways, airports and roads is staggering and is one of the key factors propelling the economy forward. For example, the Chinese Ministry of Rail program is calling for 18,000 kilometres of new high-speed rail by 2020.[2] To put this into perspective, it took the Japanese 30 years to complete their world-renowned 2,500-kilometre Shinkansen network. The Chinese are building a rail network more than seven times larger in a third of the time! China's Ministry of Transport started construction on 111 expressways in the first half of 2009 and plans to add 60,000 kilometres of new highways over the next few years. This compares to 75,000 kilometres of the entire U.S. Interstate system.[3]

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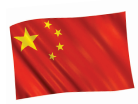
The Chinese market is well on its way to becoming the world's largest market for just about anything you can think of. There are more than 400 million Internet users and almost 800 million cellphones in use in China today. It is the world's largest market for motor vehicles, even though car ownership in China is a fraction of that elsewhere in the world – 40 vehicles per 1,000 people versus 800 vehicles per 1,000 in the U.S. With such a compelling growth story, why is Burgundy cautious about jumping into Chinese investments?



Great Growth Equals Competition and Competition Erodes Profitability

Our first concern addresses a common misconception among investors that economic growth automatically leads to superior investment opportunities.

China's economic growth is undoubtedly impressive, but translating this growth into corporate profitability is anything but assured. Academics have done studies on the correlation between economic growth and stock prices. None yield a definitive positive correlation. In fact, most studies draw the opposite conclusion. For example, a 2005 report by the highly regarded investment firm Brandes Investment Partners & Co. showed that countries with the highest GDP growth posted the worst stock market returns.[4] That study covered 53 countries and included 105 years worth of data.

It may seem counterintuitive, but economic growth is only valuable if a company can translate it into profit and free cash flow growth. Investors make money on companies through high returns on invested capital, not simply through top-line growth that tracks a growing economy.

Finding companies that can grow profitably in China is much harder than one might expect. On our last trip to China, we met with the local senior executives of several multinational companies whose stocks we own: Nokia Corporation, Diageo plc and Shiseido Co., Ltd. All stated that China was simply too large a market for them not to be competing there. The top executive at Shiseido China put it this way: the size of the cosmetics-buying population in China will expand to more than six times the scale of Shiseido's home market (Japan) by 2020. Because of this potential, all of Shiseido's peers (Estée Lauder Inc., L'Oréal Group, Procter & Gamble Co., etc.) are investing heavily in this market. And competition for Shiseido in China is not just coming from these foreign multinationals. Local manufacturers, whose skills and technologies have improved remarkably over the years, are legendary for their ability to introduce look-alike and me-too products.

When you visit Shanghai and Beijing, you soon realize that these markets are the epicentre for competition. Every global company is there and all are fighting for market share. It is vital that we find companies with competitive advantages, which help insulate a business from such intense competition. Only companies with competitive advantages will be able to grow their intrinsic values over time.

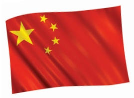
Warren Buffett summed it up for us when he said: "The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage. The products and services that have wide, sustainable moats around them are the ones that deliver rewards to investors."[5]

Not-So-Great Legal Protections

Finding companies with wide moats is difficult anywhere in the world, particularly in China where competition is fierce, the economy is highly regulated and the legal system is underdeveloped. This brings us to our second concern about China: the Chinese legal system provides little protection to companies trying to build competitive advantages.

Burgundy tends to invest in companies with intangible assets such as unique technologies, licences, brands, patents and trademarks that are hard for competitors to replicate or for customers to find elsewhere. These assets enable a company to differentiate itself and earn higher margins and returns on capital than its competitors. Companies with high-quality, intangible assets are resilient to economic downturns and resistant to competitive pressures over time.

Amusing as examples like "Pizza Huh" and "Adidos" may be, the fact that China's legal system is still evolving and does not provide basic protection of private ownership rights is a major impediment for companies trying to build a sustainable competitive advantage, and is a major concern for Burgundy. As long-term buy-and-hold investors, we need the assurance that our property is protected by the legal system. The fact that property rights in China are routinely infringed and that the perpetrators go unpunished is worrisome, to say the least.



Not-So-Great Governance

Having a competitive advantage may not matter if the companies we invest in have poor management or lack corporate governance. Both issues lead us to proceed with caution when investing in China.

One of the major differentiating factors between the Chinese economy and other developed and developing countries is the extent of direct and indirect government involvement. Three quarters of approximately 1,500 companies listed as domestic stocks in China are former state-owned enterprises that have sold minority stakes in themselves, but remain firmly in the hands of Chinese government entities.

Hang Seng Stock Market Index

Top 10 Companies	Approx. Government Ownership Stakes (%)
HSBC Holdings PLC	0
China Mobile Ltd.	75
China Construction Bank Corp.	60
Industrial & Commercial Bank of China	70
CNOOC Ltd.	65
Bank of China Ltd.	70
China Life Insurance Co. Ltd.	70
Petrochina Co. Ltd.	85
Sun Hung Kai Properties Ltd.	0
Tencent Holdings Ltd.	0

Source: Company filings

The chart above lists the 10 largest companies in the Hong Kong Hang Seng Stock Market Index. Seven of them account for about 40% of the index's total market capitalization and are controlled by the Chinese government.

The risk of owning companies controlled by the Chinese government is that the political and social objectives of the government will conflict with the objectives of minority shareholders. Is the China Construction Bank (60% owned by the Chinese government) lending money solely on commercial terms that compensate it for credit risk? Is China Mobile (75% owned by the Chinese government) investing in a new wireless communications network developed and subsidized by the Chinese government purely on expectations of higher profits and returns on equity? We suspect not. While many state-owned enterprises enjoy privileged status within their industries, efficient capital allocation is not the sole priority of government and may not even be deemed important. Management of these companies will also be difficult to assess, since the career paths of many top executives travel through positions in various companies, in the government and in the Chinese Communist Party hierarchy.

Management and corporate governance quality is often an issue even if a company is not controlled or owned by the government. Burgundy likes to invest in companies in which we are reasonably certain the management has a sense of trusteeship and responsibility towards its shareholders. We have yet to find a company in China where self-dealing by management was not a real concern. This is by no means a problem unique to the country, as a glance at the compensation schemes of Wall Street investment banks or indeed almost any Fortune 500 company will prove. Nonetheless, in the absence of avenues of redress, the presence of so many examples of self-dealing is of particular concern to us in China.

To illustrate, look at an example of a common boilerplate disclosure we often find when investigating potential investment ideas in China: "The principal shareholders of our affiliate Chinese entities have potential conflicts of interest with us, which may adversely affect our business."

Many Chinese companies with stock market listings outside mainland China are incorporated in places like the Cayman Islands and, as such, are considered foreign companies under Chinese law. Due to Chinese foreign ownership restrictions, many of these companies are not allowed to own the licences required to operate their businesses. Therefore, the companies enter into contractual agreements with their management (or even friends and family of management) who, as registered Chinese citizens, then hold the business licences on their company's behalf. Such arrangements would normally be a huge red flag for investors; in China, however, they are commonplace and something, we are told, "we'll have to get used to." To which we respond, "what, if anything, do shareholders really own if someone else has the right to operate the business?"

Great Companies Don't Always Make Great Investments

Whether it is intense competition, an underdeveloped legal system and lack of protection for property rights or poor management and governance quality, investing in China offers plenty to worry about. Still, these are not the only impediments Burgundy faces when considering Chinese investments. Finding high-quality companies with sustainable competitive advantages is fundamental to our investment approach, but so too is buying those companies at attractive valuations; and the valuations of excellent Chinese companies that we have found are currently unattractive. The following list includes some Chinese companies we have researched. They are all fast growing, profitable and have dominant market positions in their respective industries. They are a select group of companies that would meet most of Burgundy's quantitative and qualitative criteria:

- Hengan International Group Co., Ltd. is one of China's largest producers of baby diapers
- Tingyi (Cayman Islands) Holding Corporation is one of China's largest snack food and beverage makers
- New Oriental Education & Technology Group helps Chinese students with entrance exam preparation
- Baidu, Inc. is the Chinese equivalent of Google
- Ctrip.com International, Ltd. is a leading Chinese travel service provider for hotel accommodations, airline tickets and package tours

The major issue with owning these companies today is not so much our concern about business quality, but rather our concern about valuations. The average price/earnings ratio of this group is 58 times last year's earnings and 38 times next year's. Great companies don't always make great investments. No company is so good as to be immune from the consequences of overvaluation.

To illustrate, the following table compares these Chinese companies to a group of their international peers:

Companies Must Compound Earnings Significantly To Meet Their Peers

Company	Trailing Price/ Earnings Multiple	Required Earnings Growth Per Year (5 years)
Hengan International Group Co., Ltd.	**36x**	**17%**
Kao Corp. (Japan)	16x	
Tingyi (Cayman Islands) Holding Corporation	**35x**	**16%**
PepsiCo, Inc. (U.S.)	17x	
New Oriental Education & Technology Group	**50x**	**27%**
MegaStudy Co., Ltd. (Korea)	15x	
Baidu, Inc.	**119x**	**43%**
Google Inc. (U.S.)	20x	
Ctrip.com International, Ltd.	**51x**	**26%**
Expedia, Inc. (U.S.)	16x	

Source: Bloomberg

In this table we have included our estimate of how fast these Chinese companies would have to grow over the next five years in order to bring their price/earnings ratios in line with their international peers. Hengan, for example, trades at 36 times trailing earnings and would have to grow its earnings per share 17% annually for five years to trade at a similar multiple to Kao Corp., which currently trades at 16 times earnings.[6] This assumes that profit margins and taxes stay at today's levels. Tingyi would need to grow its earnings at 16% per year for five years to trade at a similar multiple to PepsiCo, Inc., which currently trades at 17 times earnings. And so on.

Maybe these Chinese companies can continue to dominate their industries, to grow quickly and to maintain their already high profit margins? Maybe they will be able to find ways to protect themselves from the onslaught of competition? If the answer is "maybe not," the consequences would be severe for those who own these stocks at current levels. The quickest way for an investor to lose money is to overpay.

Use Great Caution

While the pace of economic development in China is astounding, portfolio investors should proceed with caution.

China has had an incredible 30-year run of remarkable economic growth. In late July 2010, the Chinese government announced that it had overtaken Japan as the world's second-largest economy, but trees don't grow to the sky and the Chinese government has not repealed the business cycle.

Just as the rulers of the great Chinese dynasties built the Great Wall to protect themselves against intrusions from northern invaders, so too must companies build their virtual walls and defences against the destructive forces of competition currently widespread in China. And like the Great Wall, wide moats take time, money and effort to build. In the meantime, we think we already own several Asian and global multinational companies that have large and established businesses in China and will be able to compete successfully behind wide moats of established brands, financial strength and high-quality human resources. Their valuation discount to their Chinese competitors makes them even more compelling as investments.

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There are a number of ways to approach the Chinese opportunity, which is unquestionably the biggest in the world today. There will be fine opportunities to invest directly in Chinese companies for patient investors. An old Chinese proverb says, "dig the well before you are thirsty." While we wait patiently, we will be continuing our search for those companies with great walls or wide moats and avoiding red flags.

1 McKinsey Global Institute. "Preparing for China's Urban Billion." March 2009.
2 J.P. Morgan. "China's High Speed Rail Boom – a New Era of Mobility." March 30, 2010.
3 Financial Times. August 25, 2009.
4 The Brandes Institute. "New Insights Into the Case for Emerging Market Equities." July 2005.
5 Attributed at Sun Valley Conference. July 1999.
6 Adjusted for goodwill amortization.

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