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WHY INVEST IN ASIA?

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Asia has been a tremendous source of growth for businesses involved in the region over the past 10 years, but while these businesses continue to grow and prosper, Australian's still seem reluctant to invest in the area. This research paper explores the changes in Asia over the last 10 years, focusing on the economy, individual company case studies, corporate governance and engagement in world affairs. It also examines factors likely to affect prospects for the Asian region over the coming years. From the Chinese growth stories to the politics of India, this research paper gives insights needed to re-evaluate the investment opportunities in this region.

The question "Why invest in Asia?" would have seemed odd less than a couple of years back when investors concerned themselves more with *how* to invest in the region. The reasons for investing were apparent and Asia was looked at as the bastion of future economic growth. After all, Asia had high growth rates, large trade surpluses, and substantial foreign exchange reserves. Its large companies were well capitalised and the books of its banks were mostly free of sub-prime investment that afflicted their Western peers.

But for some time, the world - including the Asia Pacific ex-Japan region - has been in the grip of concerns emanating from the West-inspired financial crisis. It has also had economic implications for Asia through the trade route. Waning demand for exports proved a drag on the Asian economy and slowed the pace of regional growth. However, recent signs of stabilisation in economic data and resilience in some sectors of the domestic economy have revitalised the interest in the long-term investment themes in Asia.

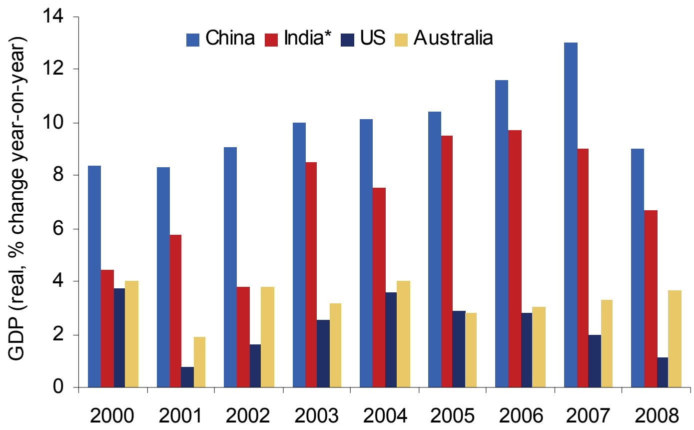
In addition to these secular trends, this paper also explores the developments in the region over the past decade or so in terms of politics, corporate governance, reforms and success stories of companies that have enhanced their growth and investment prospects.

Growing economic power

Illustrating the increasing significance of the region on the global economic map, the Asia ex-Japan economy has expanded from just over 30% of US GDP a decade ago to 60% in 2008[1]. Following nine consecutive years of annual economic growth of over 8%[2], China replaced Germany as the world's third largest economy in nominal dollar terms last year[3]. China and India alone are projected by Credit Lyonnais Securities Asia (CLSA) to match 60% of the US GDP in 12 year's time. The regions buoyant economy provides a conducive backdrop not only for expansion of Asian companies but also some of the global giants including Unilever, IBM, Intel, Citigroup and Siemens that derive more than a fifth of their revenues from the region[4].

Even though market capitalisation in Asia Pacific ex-Japan has increased tremendously over the past two decades from about 0.5 trillion in 1989 to about $12.8 trillion in 2007[5], less than 10% of the MSCI World Index was invested in the Asia ex-Japan region as at May 2009[6]. From almost a non-existent stock market in 1991, the market capitalisation of listed companies in China amounted to 194% of the country's GDP in 2007, higher than corresponding percentages for the US, UK or Australia[7].

Figure 1: High economic growth in China and India



Source: Bloomberg, June 2009, *fiscal year

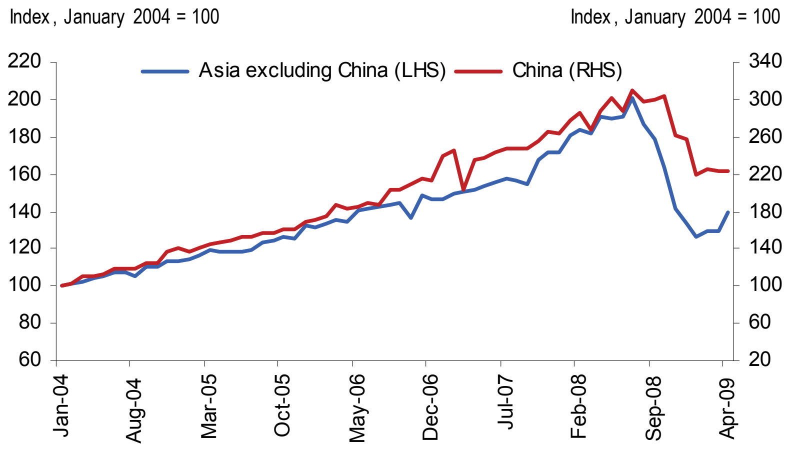
According to the BAS-ML Research Global Fund Manager Survey in May 2009[8], a net 46% of allocators were overweight in global emerging markets, up from 26% in April and a record 40% investors view this region as the asset class to overweight for the succeeding 12 months.

Some ties are still binding

The ongoing credit crisis exposed important linkages between Asia on one hand and Europe and the US on the other. Asian exports were severely impacted by a cutback in demand from their largest customer, US consumers.

Although Asia's foreign exchange position has strengthened dramatically since the 1997 Asian financial crisis, the sudden shift in foreign financing and the portfolio flows back to the West generated sharp depreciation in Asian currencies. According to McKinsey, Asia's stock and bond markets have deepened significantly since the last crisis; the value of equity and debt markets in Asia, for instance, has soared to 140% of regional GDP, up from 50% five years ago. However, along with this deepening has come significant foreign investment in some countries; 30% to 40% of the money invested in the financial markets of Hong Kong and South Korea, for example, has come from offshore investors[9].

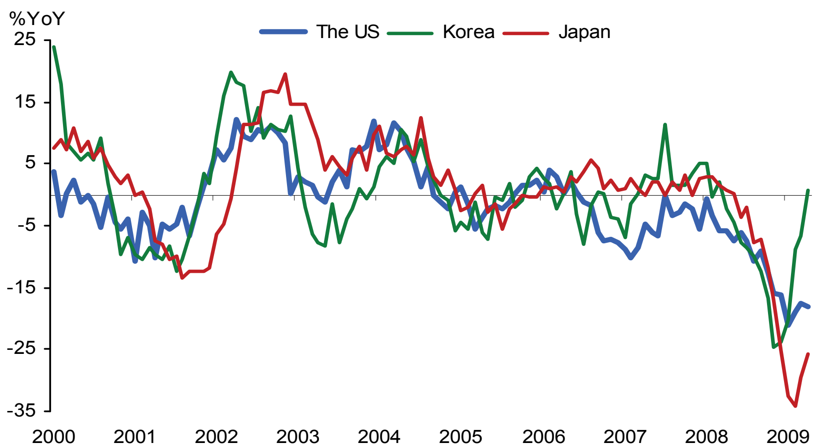
Figure 2: Asian exports appear to be stabilising



Source: BAS-ML, June 2009

As margin calls came due and investors sold shares to cover severe liquidity needs in Western markets, capital fled Asia, battering regional equities. Moreover, as Western banks began to deleverage, reducing their $2.8 trillion of credit to Asia, dollar liquidity dried up along with interbank markets and trade finance[10]. For instance, total foreign institutional investment in India's equity market fell from US$67 billion at the end of 2007 to $53.9 billion in March 2009. However, the year-to-date flows have been positive amounting to $7 billion[11]. Meanwhile, the Indian rupee and the South Korean won fell by over 20% against the US dollar from December 2007 to June 2009[12]. The consequent losses on currency-hedging products held by small and medium-sized Asian exporters combined with the freezing of trade finance began to force some of these companies into bankruptcy[13]. Recently the global shipment-inventory ratio, the leading indicator of Asian exports, has edged up suggesting a recovery in demand from G-3 nations.

Figure 3: Upturn in shipping-inventory ratio gives a positive signal



Source: BAS-ML, June 2009

Countries with large and growing domestic markets such as China, Indonesia and India are finding it easier to weather the storm. This is evident in the resilience in their GDP growth rates. Export-oriented economies of Singapore and South Korea contracted in the April-June 2009 quarter from a year ago, while the expansion in China surpassed analysts' expectations, helped by a resurge in industrial production and healthy growth in retail sales. Earlier in the year, Taiwan and Hong Kong succumbed to economic recession, however, India and Indonesia recorded buoyant growth in the first quarter of 2009[14]. Consequently, companies producing for domestic consumption are likely to fare relatively better than the broader market.

Asia's enormous emerging middle class

China and India, home to 37% of the world's people[15], represent the largest consuming population in the world. However, mere size is not enough to catapult the region into a high-demand economy. With the liberalisation of domestic markets and other reforms including reduction in import duties and reining in several protectionist policies, consumerism has taken hold and goods and services once considered as luxuries are finding their way into ordinary households in the two economies.

Although there are divergent views on the size of middle class, the World Bank estimates that the global middle class is likely to grow from 430 million in 2000 to 1.15 billion in 2030. The bank defines the middle class as earners making between $10 and $20 a day (adjusted for local prices).

A look at the geographic distribution is striking. In 2000, developing countries were home to 56% of the global middle class, but by 2030 that figure is expected to reach 93%. China and India alone will account for two-thirds of the expansion, with China contributing 52% of the increase and India 12%, World Bank research shows.

The growth in the mass of people with reasonably moderate disposable income is driving penetration-led growth in demand in a number of goods and services, as depicted in Figure 4. For example, China[16] and India[17] have each added at least eight million new mobile cellular subscribers to its user base every month since the beginning of this year. Increasing aspirations and changing lifestyles, along with recent government concessions such as shopping vouchers, tax cuts, subsidies and fiscal transfers to low-income group, have supported consumer demand in the face of sharp deceleration in global growth.

Figure 4: Low-penetration of household goods and services in Asia

	Households with television (%)	Mobile cell subs (per 100 people)	Passenger cars (per 1,000 people)	Personal computers (per 100 people)
China	89	42	18	6
India	53	21	8	3
Thailand	92	124	54	7
Indonesia	65	36	--	2
Mexico	98	63	147	14
Brazil	91	63	136	16
Russia	98	115	188	13
Australia	99	101	542	60
Japan	99	84	441	41
France	97	90	496	65
UK	98	118	457	80
USA	95	85	461	81

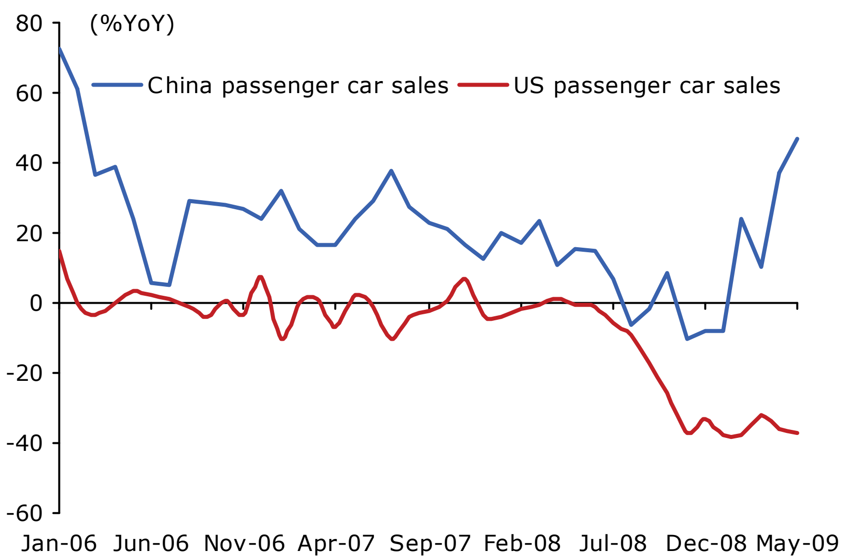
Source: World Bank, June 2009, latest available data

Typically, Asians have high propensity to save and have low debt levels compared to Western countries. Total household debt as a percentage of GDP is 11.4% in Indonesia and 15.9% in Thailand, compared to 97% in the US[18]. In China, credit cards are a relatively new phenomenon, which is picking up pace; from 2000 to 2008 the value of consumption through card transactions increased by 37 times to RMB 3.9 trillion[19]. Consumption as a share of GDP, amounting to 35% in China and 54% in India, has much room to grow as compared to the corresponding share of 71% in the US[20]. As a result, consumer financing companies stand to benefit from the rising trend in consumerism.

The region is also waking up to organised retailing, which has 20% of market share in China[21] and about 3-4% in India[22]. Chinese retail sales surpassed those in Japan in value terms in 2008, measuring to $1.5 trillion[23]. In India, retail business, the second largest employer after agriculture, is estimated to grow by 13% per annum from $322 billion in 2006-07 to $590 billion in 2011-12, according to the Ministry of State for Commerce and Industry[24]. The two largest retail chains, Pantaloon Retail and Shoppers' Stop, have been benefiting from buoyant sales growth through their presence in departmental stores and hypermarkets.

Decoupling from global trends is most evident in the automobile sector. Government support, lower borrowing costs and rising aspirations have led to a surge in car sales in the region given the non-saturated markets for consumer goods. China's Dongfeng Motor is a good example. The company has a joint venture with Japanese brands such as Nissan, Toyota and Honda. It is gaining market share and benefiting from rising vehicle sales since January 2009. Its management team has a good track record, its balance sheet is healthy with about RMB 5.4 billion net cash and it holds a leading position in most of its wide range of automobile business lines. Dongfeng Motor is well positioned to ride the earlier-than-expected recovery in car demand in financial year 2009, thanks to its unique multi-strategic-partner business model which will provide it with a steady flow of new models from its three strategic partners to drive its growth. Its stock has outperformed its peers since listing, with its passenger vehicles' market share having seen a consistent expansion from 5.4% in 2004 to 10.8% in 2008[25].

Figure 5: Car sales in China remain strong



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Source: DataStream, CLSA, June 2009

Compelling demographics

By the year 2015, more than half of India's and China's population will be in the productive and high-consumption age group of 15 to 49 years[26]. Asia ex-Japan will also have the lowest dependency ratios[27] compared to other regions. Inferring from the data compiled by National Science Foundation, Asians place special emphasis on education, resulting in a high savings rate and an increasingly educated labour force. For instance, the number of science and engineering doctorates received in Asia exceeds those in the US[28]. An educated population has the potential to enhance the services sector in these nations.

Fast forward to the future

According to a report by McKinsey Global Institute[29], 350 million people will be added to China's urban population by 2025. By that time, 221 cities in the country will have over a million people living in them, as compared to 35 in Europe today. Apart from massive mass transit systems, this will require an addition of 5 billion square meters of paved road and 40 billion square meters of floor space in about five million buildings. Out of these, some 50,000 will be skyscrapers. If these numbers look staggering, for the whole of Asia these numbers would be even larger. These trends hold challenges as well as opportunities and governments are preparing themselves to effectively meet the demands likely to arise in the future through planning, social measures and infrastructure.

Governments take economic growth into consideration

Asia is also undergoing gradual regulatory and economic reforms. Notably, countries are continually improving market access and ease of doing business by relaxing foreign direct investment norms and reducing the procedural and bureaucratic hindrances.

Many countries across the region have been involved in providing stimulus packages to spur domestic demand to counter the effects of faltering export demand. Since November 2008, about $953 billion dollars have been pledged by governments in Asia in the form of tax rebates, infrastructure expenditure, loan waivers, and expenditure on public services[30]. China announced a massive investment spending plan, with a total amount of more than 14% of GDP (RMB 4 trillion) to be spent by 2010[31]. The initiatives are expected to have noteworthy effects on cement, iron and steel producers amid a boom in infrastructure investment. Commercial lenders will benefit as loan ceilings are abolished, and medium-sized and small companies are likely to advantage from preferential lending policies. Property sector government concessions, including reforms that allow rural families to lease their plot, constitute historic measures that China's government is undertaking to support the economy.

In Asia, the speed of development and inclination to make a mark on the global economy is also evident from the number of business centres developed in the region. In 1980, not a single building in Asia figured among the 10 tallest buildings in the world. In 2009, eight of the world's tallest 10 structures are found in Asia[32].

The process of economic development has given way to an insatiable demand for commodities. China has had an investment-driven growth, including non-state investment; the total urban fixed asset investment grew by 38.7% in May 2009 from a year earlier[33]. In recognition of this trend, China has adopted a three-pronged strategy to secure its long-term supply of resources - through acquisition of foreign resources companies, oil contracts in exchange of loans as in its case with Russia, and capital spending commitments in Africa for commodities.

In India, the recent elections resulted in a highly favourable outcome for its political environment as well as economic policies. A near majority for the ruling United Progressive Alliance ensures political continuity and should lead to a stable government until the time of next general elections in 2014. A large, single party at the helm and marginalisation of regional and left parties means less hurdles and speedier decision-making in matters relating to economic, foreign affairs and social reforms.

In Indonesia, sound fiscal management over the past several years has left the country room to expand its deficit to support domestic demand, and still support its deficit target of 2.5% of GDP in 2009. The Democrat Party's victory in April augurs well for political stability.

Taiwan's cross-Strait ties with mainland China continue to improve with previous restrictions being removed, such as an absence of cross-Strait flights and regulatory hurdles on financial transactions.

These have limited Taiwan's economy and stock market. The liberalisation of direct and portfolio investment in Taiwan is likely to create more business opportunities for Chinese and Taiwanese companies. This will in turn, increase Taiwan's potential GDP in coming years. Improved sentiment, encouraging implications for the property market owing to capital inflows in the sector from China, boost to tourism and private investment are some of the outcomes of the improved relations. Mainland travellers, practically nonexistent at the end of 2008, suddenly surpassed the Japanese in mid-2009 as the largest group of total tourist arrivals to Taiwan, amounting for at least a third of the total inbound tourist arrivals[34]. In addition, authorities on both sides are mulling a Comprehensive Economic Cooperation Agreement, a broader policy liberalisation stance that would further reduce trade barriers and promote freer flow of goods, capital, technology and labour. The new policy would offer Taiwanese companies access to the massive Chinese market and benefit Taiwanese firms.

Generally speaking, Asian authorities have come a long way from the 1997 Asian crisis and are in a comfortable debt position, enjoying positive current account balances.

China has demonstrated willpower to support an accelerating path of growth in 2009 and moderate pace in the following year through their growth-oriented policies such as fiscal stimulus and expansionary monetary stance.

In Korea, several efforts have been made to restructure the banking system over the past decade including consolidation and sale of share holdings. For instance, following its restructuring in 2008, KB Financial Group became the largest bank-centric financial holding company in Korea in terms of asset size, offering diversified services. It has nine subsidiaries under the holding company umbrella, including Kookmin Bank, KB Investment & Securities, KB Asset Management and KB Life Insurance. A KB Financial-led acquisition and privatisation of government-owned banks is a positive trend in Korea. During the quarter ending June 2009, compared with the previous period, net interest margin contraction for KB Financial accelerated (from 33 basis points to 54 basis points), but the delinquency ratio significantly came down (1.05% vs. 0.84%)[35].

Moreover, the Korean stock market will be re-rated as it has been promoted to developed market status by FTSE, effective September 2009 (representing 2% of FTSE developed market portfolio)[36]. This may stabilise the Korean stock market as investors expect an increase in fund flows by international fund managers. The Korean government has deregulated remaining restrictions on stock and currency trading suggested by the FTSE committee[37], including off-exchange transaction, free delivery of securities between accounts and easing foreign exchange trading by foreign investors. The change in regulatory financial dynamics will ease financial product development and lower entry barriers into investment banking.

Elsewhere, Chinese and Indian banks have been relatively insulated from the credit crisis due to a limited involvement in global capital markets. Investors have confidence in the financial system due to higher capital adequacy requirements and a low loan-deposit ratio as compared to their Western peers (LDR of 77 in Asia ex Japan ex Korea versus 97 in the US[38]), plus there have been no major cases of bank insolvency.

Malaysia and Indonesia have gained a footing in the fast-growing Islamic funds management industry. Malaysia has overtaken Saudi Arabia in terms of the number of locally-domiciled sharia funds, and is second to the huge Middle East market in terms of sharia assets under management[39].

Preparing for the recovery

Unique to Asia is the cultural factor with premium placed on personal relationship building. Globalising Chinese and Indian networks across Asia and the world, expansion in new markets like the Middle East, Russia and Eastern Europe[40] as well as the preponderance of large Asian multinational corporations help reduce Asia's dependency on the US. For instance, the Chinese government has targeted US$100 billion in total trade with the Middle East by 2010, up from US$51.3 billion in 2005[41]. Companies have entered this downturn with relatively strong balance sheets[42]. The return on equity did not dip to the Asian crisis levels and appears to have bottomed out[43]. The de-gearing process undertaken by companies and affordable valuations has triggered merger and acquisition activity. According to a McKinsey report, in 2000 and 2001, the US, Europe, and Asia accounted for approximately 60%, 30%, and 10% of deal volumes by target, respectively. From 2005 to 2008, the distribution was much more balanced, at around 40%, 40%, and 20%. Cross-border activity grew from 23% of the total in 2000 to 29% in 2006 and 41% in 2007, falling back to 35% in 2008. Emerging Asia played an important role in this transformation; China and India together represented some 12% of all cross-border deals in 2008[44]. The next few years could present considerable opportunities for ambitious and disciplined acquirers, unlocking value for their shareholders. Asian acquirers, less affected by the credit crisis than their counterparts in Europe and the United States, will have a stronger incentive to look for overseas acquisitions as well.

Intra-regional trade

Over the past seven years, trade within Asia has risen 75% faster than its trade with Europe and the United States[45]. In fact, trade with the West is now half that of intra-Asian trade[46]. Asia's economies, with their burgeoning middle-class populations, are beginning to see each other as end markets rather than only primarily as links in the global supply chain.

Recent stock market performance

Foreign investors have turned net buyers in the Asia Pacific ex-Japan region, as indicated by Figure 6. Data indicating that the pace of decline in global economic activity was slowing enhanced foreign investors' appetite for risky assets, particularly in Taiwan, Indonesia, the Philippines, Korea, India and Thailand. Resumption in Initial Public Offers in China, liberalisation of Chinese investment in Taiwan, positive political developments, attractive valuations and improving macroeconomic data have underpinned the upswing in Asian equities since its March 2009 low.

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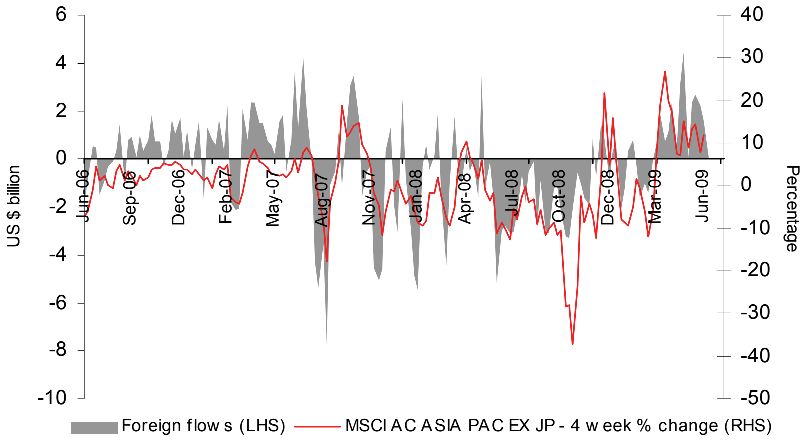
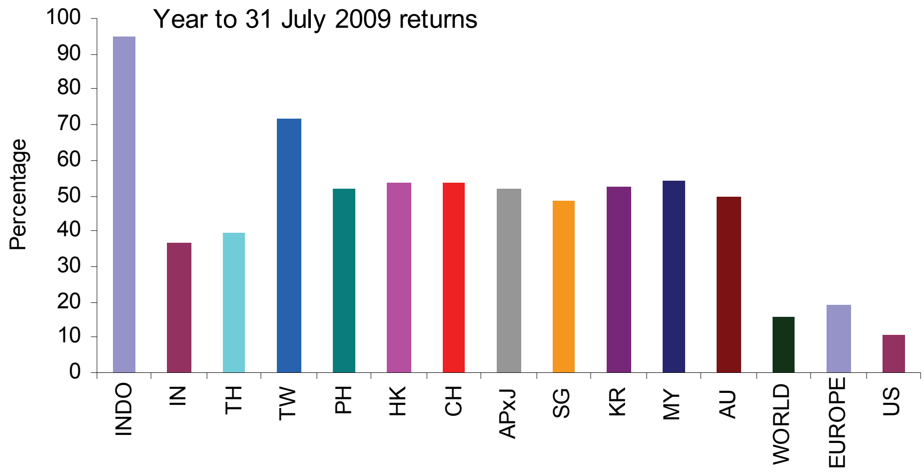
Figure 6: Foreign institutional investors return to Asia



Source: BAS-ML, DataStream, Fidelity International, June 2009, Asia includes India, Thailand, Korea, Taiwan, Philippines, Indonesia

Figure 7: Asia Pacific ex Japan region has outperformed the world since beginning of 2009



Source: MSCI country indices in US$ and S&P500 Composite index, total returns, DataStream, FIL International, August 2009

Looking ahead

The signs of stabilisation in exports and improvements in domestic economies have led to upward revisions in growth rates in the region. This was also partly due to aggressive downgrades at the end of last year. Even if softened by a weak first-half, the outlook for the region remains healthy as the underlying long term story remains in tact.

From an economic perspective, the outlook for the Asia Pacific ex-Japan region remains largely favourable, although growth rates have moderated (albeit from high levels).

From a portfolio perspective, the low correlations between individual Asian countries help alleviate single country risk. Asian stocks' valuations remain reasonable and are trading near their long-term average. At a company level, attractive dividend payouts, improved balance sheets and sound corporate governance are just some of the characteristics that should continue to appeal to investors. Against this background, the region continues to offer attractive long-term investment opportunities, with stock selection the key to unlocking this potential.

In summary, secular trends and structural factors provide solid ground for regional economic growth to sustain in the long run. The region's stock markets are developed and share prices are being driven by a number of key factors - improving macro economic news flow, healthy earnings growth, buoyancy of takeovers, industry consolidation, and a dynamic supply of liquidity in the market. Equities in Asia Pacific ex-Japan should remain volatile in the near term as they continue to be driven by global financial markets troubles and exports are under pressure. While the region is not without risks, corporate restructuring, political reforms, and economic improvements have brought Asia a long way from the 1997 financial crisis and transformed it into a more resilient, fast-growing economic region. This has given rise to a new generation of world-class companies that are increasingly capable of delivering very competitive returns to investors in relation to their global peers. Firms with strong balance sheets, good execution strategies and solid management teams should grow their market share and emerge stronger.

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