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China's Drivers Won't Get

Oil-Market Engine Racing

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Oil bulls have swapped friends in China, parting with the country's industrial complex in favor of its burgeoning class of car drivers. They are going to discover that these new pals aren't as dependable.

China's economy may be rebalancing away from investment toward consumption, and its petroleum use is starting to reflect that. Global energy investors can't afford to ignore these changes, given that China accounts for 40% of the world's oil-demand growth.

On the industrial side, the slowdown has begun. Because industrial inputs such as diesel, fuel oil and petrochemicals constitute 70% of this market, China's oil demand was mostly flat between January and July compared with a year earlier. Overall demand might spike later this year as Beijing releases stimulus in small doses, but the broader trend will be hard to change.

Take diesel, China's most widely used fuel. Its consumption shrank 1.2% year-over-year between January and July, according to consultants at Energy Aspects. Partly, this reflects the trucks that use diesel hauling less heavy industrial freight such as coal.

But China's expanding rail network is taking market share, too. Trucking itself has started adopting natural gas, which will displace 4% of road diesel demand this year and 10% by 2020, says Wood Mackenzie, a consultancy.

China's saving grace for oil now is gasoline. Demand soared 10.3%, year over year, during the first seven months, in step with consumers buying roughly 11% more cars during that period.

Most analysts expect Chinese car sales to keep growing, but that doesn't mean gasoline will keep up the pace.

Earlier this year, regulators proposed strict fuel-efficiency standards starting 2016. If approved, car makers will have to reduce fuel consumption by 6.2% on average every year between 2016 and 2020.

More generally, consumers demand nowhere near as much oil as industrial users do. For every 1% increase in gross domestic product, oil demand today increases by about 0.3%, says HSBC. That is down from 1.5% a decade ago, when China's industrial expansion was at full throttle.

Refiners outside China are already feeling this shift. China built too much capacity to process crude oil, including into diesel, says Citigroup's Ed Morse. Now it has begun to export that excess capacity much the way it floods the world with cheap steel. China has exported a net five times as much diesel these last seven months as it did all of last year, according to data provider CEIC.

This has helped push down refining margins across Asia, partly why shares in South Korean refiners SK Innovation and S-Oil have suffered this year. While China's major oil companies have pledged to trim investment in refining, it may take time for capacity to conform to the new reality.

China's economic emergence drove oil prices for much of the past decade. With consumers now in the driver's seat, investors may have to get used to a lighter foot on China's pedal.

-- Abheek Bhattacharya

Beijing's Mixed-Up Reforms

China is trying again to shake up its stodgy state-owned enterprises. Investors are right to ask whether these moves are transformative.

The current buzzword in Beijing is "mixed ownership," Communist Party jargon for introducing more private capital into government assets. Beijing hopes that this can nudge state-owned enterprises to be more commercially oriented, making the overall economy more efficient.

The reform push soon will reach state-owned banks, the linchpin of the financial system. Bank of Communications, one of the nation's largest lenders, said last month it is looking at options to boost private ownership, but it didn't elaborate.

At Bank of Communications, however, ownership is quite mixed already. HSBC holds a 19% stake, and the free float is 35%, relatively high for an SOE. The Ministry of Finance's direct holding is just 26.5%, though investments by the state pension fund and other SOEs keep government ownership near 50%.

The obvious way for SOEs to raise private ownership would be simply to increase their free floats by selling state shares on the open market. But Beijing will want to preserve control in key industries such as banking and oil, so it is unlikely to become a minority investor in those companies.

The government's own regulations also are a barrier, as it is forbidden to sell state assets at below book value. Many of the banks trade below that level, though, a sign of investor skepticism toward loan quality, which reflects why changes are needed in the first place. Hong Kong shares of Bank of Communications trade at 0.77 times book.

So what more could be done? China Petroleum & Chemical, or Sinopec, for instance, is selling a minority stake in its gas-station business to outside investors. Analysts speculate the banks could take a similar approach and seek outside investment in key businesses such as credit cards.

At Bank of Communications, another possibility is for management to own part of the company through share-based compensation. A group of bank executives took the unusual step of buying some shares in the Shanghai market earlier this year. In theory, this should align management's incentives with shareholders. But in reality, top management continues to be appointed by and beholden to the Communist Party.

Companies that have announced ownership overhaul plans have seen share prices jump. So there are near-term gains to be had for investors who can anticipate future candidates. Bank of Communications shares rose 6% the day news emerged it would be pursuing reforms, even without details.

Yet in the longer term, state-owned companies have been brutal to investors. The Hang SengChina Enterprises Index, dominated by SOEs, remains 5% below where it was five years ago. Introducing a bit more private ownership won't suddenly change these state behemoths into good investments.

-- Aaron Back

Overheard

China's anticorruption drive is creating some truth in advertising. Consider a company called China VAST Industrial Urban Development, an industrial real-estate planning to list in Hong Kong on Monday. It admitted in its IPO prospectus that "bribery and other misconduct which may be committed by our employees or third parties may be difficult to prevent or deter." This risk factor always existed in Chinese real-estate markets. But it may have become more apparent with President Xi Jinping's nationwide corruption crusade. China VAST also has to convince investors about its fundamentals. Revenue fell 60% in 2012, then rebounded in 2013, mostly because it restructured debt, notes J Capital's Anne Stevenson-Yang. If a corruption crackdown further hurts business, problems will seem vast.

Treasury Wine Estates isn't letting the small matter of circling buyout firms crimp its style. As TPG and a group led by KKR check the vintner's books, CEO Michael Clarke told analysts he is in the market for luxury-wine targets in the U.S. It is enough to make investors a bit nervous. The U.S. is a thorn in Treasury's side. It destroyed thousands of gallons of expired Beringer-brand wine there last year amid a glut of low-end vintages, prompting calls to sell the division. Treasury has room to buy more sources to satiate increasingly discerning palates. But is now the time? Treasury announced a A$101 million (US$94 million) net loss for the fiscal year ended in June, putting no pressure on TPG or KKR to raise their bids.

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