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China sneezes

Lesley Stahl, anchor of the eternal weekly American TV news program "Sixty Minutes," asked Wang Shi, chairman of China Vanke Co., the mainland's largest homebuilder and developer, if there's a real estate bubble in China. "Yes, of course," replied Wang, as if Stahl had asked if the air quality in Beijing leaves a little something to be desired. Beyond which, Wang added, developers have too much debt and the average Shanghai apartment costs more than 45 times the average resident's salary.

If *Grant's* readers merely nodded—to them, all this is old hat—Vanke's shares plunged by 10% on Monday.

Now under way is a speculation on the consequences of the current and—we think—lingering deceleration in Chinese growth for two of the People's Republic's most prosperous suppliers. If China is sneezing—and it surely is—Australia and Canada are among the leading candidates to catch cold.

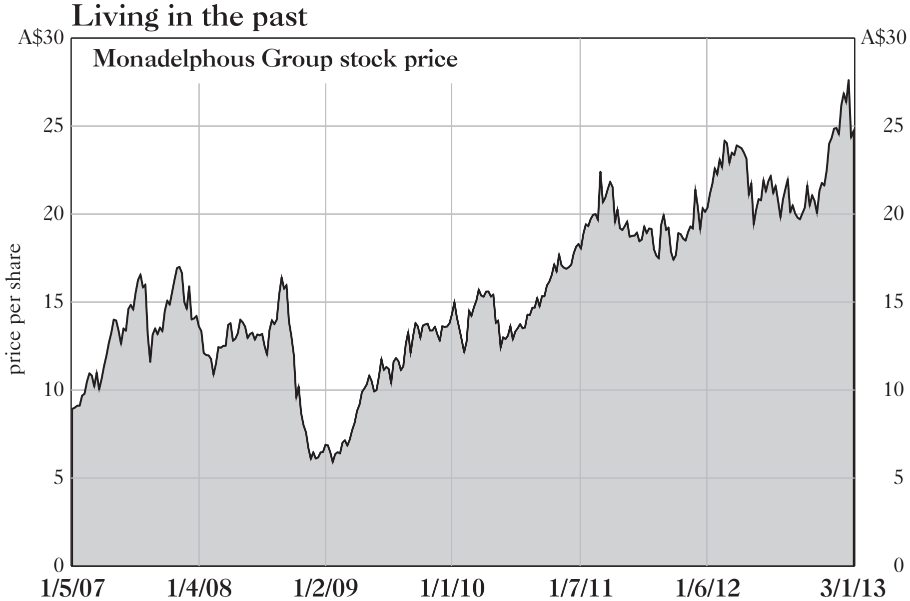
It wasn't Wang's candor concerning the Chinese housing situation that sent Vanke shares tumbling, but the government's new assault on property speculation. Edicts issued by China's State Council on March 1 include the requirement that buyers of multiple properties produce a down payment of 60%, up from 50%, and pay a rate of interest at least 10% higher than the central bank lending rate, which stands at 6%. A new 20% tax will be levied on the profits from the sale of a house. As for developers who are seen to be muscling up the prices of their wares, they will be punished in ways unspecified.

It's the *Grant's* thesis that the suppliers of raw materials to the immense Chinese urbanization project will also come in for chastisement. Even before the State Council and "Sixty Minutes" spoke, copper and steel inventories in the People's Republic were visibly burdensome. Thus, according to MySteel.com, a Chinese data provider, stocks of rebar, wire rod, cold-rolled sheet, hot-rolled sheet and medium plate have grown for 11 consecutive weeks to a record 21.8 million metric tons as of March 1, up 2.9 million metric tons from the year earlier. The inventory buildup preceded the crackdown.

But the government didn't call the top. On the testimony of, for instance, the CEOs of UGL Ltd. (UGL in Sydney) and Joy Global (JOY in New York), the boom in China and resource-related capital spending ended some time ago. "The peak is unquestionably behind us," UGL's chief, Richard Anthony Leupen, said on a company conference call last week. A project engineer and manager with subsidiary interests in real estate and the capital markets, UGL disclosed a 13% drop in overall revenue in the six months to Dec. 31, paced by a 34% plunge in engineering revenue.

Joy Global, the big American maker of surface and subsurface mining equipment, in announcing a 28.5% year-over-year decline in new orders for the fiscal quarter ending Jan. 25, described a new and austere commercial environment. "To make returns," CEO Michael

Living in the past



source: The Bloomberg

Sutherlin told dialers-in on last week's earnings call, "projects can no longer assume rising commodity prices, and new mines need to come on line in the lower half of the global cost curve. High-risk, high-return projects are out in favor of predictable returns."

Mr. Market, on the ball, performed an anticipatory culling of most of the affected share prices; Joy and UGL have fallen by 28% and 27%, respectively, from their 12-month highs. Quoted in 2010 at 12.9 times the earnings estimate, Joy today commands a forward multiple of just 9.9 times. So the capitalists caught on to the China bubble before the Communists did. But, we think, the capitalists have not fully exploited every short-on-China trade.

Australia, home to our micro short-sale candidate, Monadelphous Group Ltd. (MND on the Australian Stock Exchange), has bloodied the paw of many a macroeconomic bear. Not since 1991 has the GDP Down Under had a down year. While many indigenous virtues have no doubt contributed to this run, China's seemingly unstoppable boom has lately been the driver. In the 12 months through June 30, 2012, according to the Reserve Bank of Australia, resource extraction in all its permutations accounted for 18% of GDP, nearly double the share it contributed to national output eight years before.

"Concerning Monadelphous," we wrote in our first tilt at the project-construction company in the issue of *Grant's* dated Jan. 13, 2012, "we are exceedingly timid bears, inclined not to sell it, but, rather, to wait to buy it until after China has had its comeuppance." That, however, was then. "A year ago," notes colleague Evan Lorenz, "it was clear that China was a bubble and that Monadelphous would be severely impacted when that bubble popped. Today, miners are cutting capital spending even before China slows. When China stumbles—and the toxic combination of real-estate speculation, credit misallocation and state planning makes such a stumble seem inevitable—miners will cut even deeper."

Quoted at A$21.15 when we first took a whack at them, Monadelphous shares pushed to A$27.85 early this year before pulling back to A$23.47 at this writing. Supported by an 8.3% dividend, MND is no bear's idea of a pushover.

What commends the company to those in search of an actionable hedge against bigger problems in China is that Mr. Market continues to give Monadelphous the benefit of the doubt. "The shares trade at 13.4 times trailing net income and 13.3 times the fiscal 2013 estimate (June 30 is the end date)," Lorenz points out. "Seemingly embedded in the share price are forecasts of continued revenue growth—analysts at Hartleys Ltd. have penciled in top-line growth on the order of 5% compounded for the next five years."

There's no denying that wonderful things have happened. Thus, in the six months through Dec. 31, revenue and net income posted year-over-year gains of 46.6% and 37.5%, respectively. Construction revenue surged by 71% to A$877 million, and infrastructure revenue by 50% to A$96 million. Maintenance and industrial services revenue gained a more sedate 6.3% to A$331 million.

But margins have been weakening for two years and look set to remain under pressure. "Clearly, the environment's changed," CFO Zoran Bebic told investors on the earnings call two weeks ago, "and we've said that customers are pushing back hard and they're looking for cost reductions. They're looking to defer discretionary expenditure. So that has had some impact in terms of margin."

"Then, too," Lorenz points out, "the company isn't booking new work fast enough to replace current revenue. In the six months to Dec. 31, it reported almost A$1.3 billion in sales, but signed just A$860 million in new contracts and contract extensions. An integral part of the bear story on Monadelphous is that it will suffer later rather than earlier in the cycle, i.e., its troubles lie ahead. Leupen, the head man at UGL, suggested as much on his own call last week. 'Where you see the cost reduction mantra hit first, you see it … in the maintenance sector, which is us,' Leupen said. 'You won't see it for a year or two in the construction sector because it takes that long for projects to run out. We

Monadelphous Group Ltd
(in A$ millions, except per-share data)*

	TTM	2012	2011	2010	2009	2008
Revenue	A$2,307.3	A$1,897.5	A$1,443.9	A$1,275.4	A$1,122.5	A$954.0
Cost of revenue	2,050.8	1,675.1	1,268.0	1,126.5	987.3	832.5
Gross profit	256.6	222.4	175.8	148.9	135.2	121.5
Operating expense	58.0	57.3	47.2	38.6	36.3	33.4
Operating income	198.6	165.1	128.7	110.4	98.9	88.1
Interest expense	3.6	3.4	2.7	1.9	1.9	1.9
Other	23.9	25.6	5.6	6.7	7.1	13.6
Pretax income	218.8	187.3	131.6	115.1	104.1	99.7
Taxes	59.9	49.9	36.5	31.9	29.9	30.2
Net income	158.9	137.3	95.1	83.2	74.2	69.5
EPS	$1.75	$1.52	$1.07	$0.95	$0.86	$0.81
Shares (in millions)	90.7	90.3	89.0	87.2	86.0	85.6
EBITDA	$230.4	$195.2	$153.1	$127.2	$114.0	$100.8
EBITDA margin	10.0%	10.3%	10.6%	10.0%	10.2%	10.6%
Cash	$189.4	$203.6	$172.5	$149.2	$152.2	$126.4
Debt	63.0	50.6	43.0	32.6	24.9	24.9
Net Cash	126.3	152.9	129.5	116.6	127.3	101.6
Share price	$23.47					
P/E	13.4x					

*fiscal year ends in June

sources: company reports, the Bloomberg

had the boom of all booms just past and 2012 was probably the best year ever in the country's history; 2013 won't be too much short of it and 2014…will start to taper off.'"

Or maybe, we venture, the tapering has begun. Sometimes, a single, dramatic event is the cyclical tip-off, a sign that, in the words of the late, great investor Bernard M. Baruch, there's been a break in the "continuity of bullish thought."

Maybe that sign will come in connection with the proposed sale of U.S. dollar-denominated debt by China Vanke as early as next week. Rated BBB-plus by Fitch, the securities would be offered to investors who have just watched the chairman of the borrowing entity admit that the business in which his company is engaged is a "bubble." If the deal fails, a China bear may conclude that the big payday is closer than he or she might have imagined. If not, well, we know how to wait.

There is, of course, a macro dimension to the Chinese bubble. Australia and Canada are twice leveraged. Their economies are leveraged to the looming Chinese real estate troubles, and their consumers are in hock to their banks. For perspective, the American ratio of debt to disposable personal income topped out in 2007 at 129.4% (it has since subsided to 107.9%). Comparable ratios for Australia and Canada today stand at 147.8% and 166.6%, respectively. In America, the percentage of workers engaged in construction peaked at 5.7% of total employment in 2006. In Australia and Canada, the percentage of workers engaged in construction amount to 8.8% and 7.3%, respectively, today.

When China's debt and real estate problems finally crystallize, there will be repercussions far and wide. As of last month, some 7,100 miles from Shanghai, in Toronto, Ontario, 144 skyscrapers were rising, the greatest number of any city in the world. The bursting of China's bubble would newly impress on those developers and their creditors just how big the People's Republic is, and just how closely knit is the world's financial economy.