GRANT'S
INTEREST RATE OBSERVER®

Vol. 32, No. 11b Two Wall Street, New York, New York 10005 • www.grantspub.com MAY 30, 2014

Going down

On May 21, a leading Chinese daily, the *21st Century Business Herald*, crystallized the mainland's worsening real estate situation in a few well-chosen Mandarin words (which we have had translated into English): "The rich have sold, the banks are scared, the government won't come to the rescue and developers are frantic." Turning this predicament to profit is the topic at hand.

A short sale of a thriving Finnish elevator manufacturer, Kone OYJ, is the way forward, we propose (KNEBV on the Helsinki Exchange; KNYJY as a U.S.-sponsored American Depository Receipt). In ordinary circumstances, and at even middling valuations, we would entertain no such opinion. Kone, founded in 1910, is well-managed, well-financed and fast-growing. Our thesis is that circumstances are extraordinary. China, the growth driver of global elevator sales (among many other things), is having its credit comeuppance.

Real estate, the beating heart of the Chinese economy, has skipped a beat or two. Thus, in the first four months of 2014 compared to the like period in 2013, new residential starts plunged by 22.1% and the value of residential sales by 9.9%. It's not that the rich aren't buying; it's just that they're not buying in the People's Republic. According to CBRE Group, Chinese investors spent $1.4 billion on commercial real estate outside of China in the first quarter, up by 54% from the first period of 2013.

Some small developers, like Xingrun Real Estate, have fallen into bankruptcy. Developers of all sizes are slashing prices and relaxing credit terms, even in the biggest cities. To complete this worrying picture, the presiding central banker, Zhou Xiaochuan, protests that while there might be some isolated signs of a bubble, "if you look at the medium-term of urbanization, I think we still have a very good market for home sectors." In suggesting that the problem is contained, the gentleman would seem to be channeling Ben Bernanke, c. 2008.

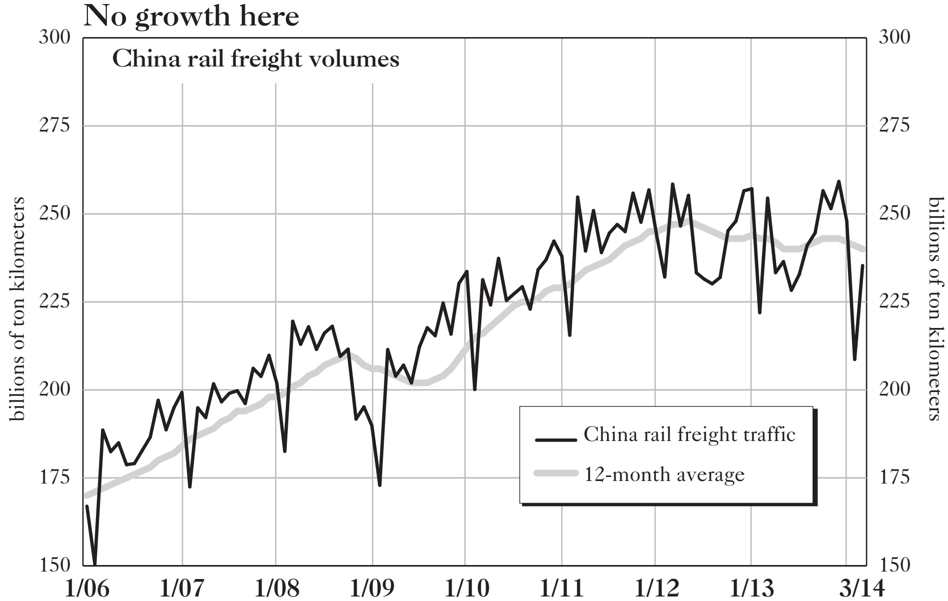
The problem is not contained, we are sure. Nor has China's growth come screeching to a sudden stop. The fact is, relates colleague Evan Lorenz, "China's actual growth has undershot official statistics since 2011."

Sen. John McCain, the Republican wit from Arizona, quips that Russia is a gas station pretending to be a country. If so, China is a bank pretending to be a country. The No. 2 economy boasts the No. 1 banking system, its assets footing to $26 trillion, a figure amounting to more than a third of global GDP.

All this credit feeds the world-famous Chinese building boom. Fixed investment accounted for 48% of China's output in 2012, the most recent period for which the government has disclosed GDP figures on the so-called expenditure approach. In the same year, according to the IMF, 14% of China's urban labor force was employed in construction.

As real estate goes, so go China's banks. The China Banking Regulatory Commission estimates that 38% of the nation's bank loans are secured either by property or by the signature of a real estate developer. (Nor does that figure encompass lending to local govern-

No growth here



source: The Bloomberg

ments or Chinese corporations, which often stump up land as collateral.) China's local governments, big debtors in their own right, derive 57% of their revenues from land sales or from the taxes laid on developers.

To appreciate the risks that Kone faces, it helps to understand that China's banks are twice constrained: by a chronic shortage of capital and by their regulators' belated concern over the risks attendant on years of overexpansion. Growth in loans has lately decelerated on account of both factors. Thus through April, credit growth of 7.2 trillion renminbi ($1.2 trillion) represented a 9.4% fall from the first four months of 2013.

In addition to being perennially short of capital—one of the consequences of breakneck lending—Chinese banks are caught in a cycle of self-defeating forbearance. If, for instance, a real estate developer can't meet a scheduled interest payment, chances are that the obliging lender will not write down, let alone write off, the debt. It will rather add the unpaid interest to the outstanding principal. A favorite banker's gambit is to restructure commercial loans as short-term interbank assets, the latter requiring less regulatory capital than the former. An authority with whom Lorenz consulted, and who asks to go unnamed, estimates that between 50% and 60% of banking assets are annually refinanced or reissued.

Needing new capital, banks are tapping all available funding sources: subordinated debt, common equity, private placements, preferred stock. As to the latter, Agricultural Bank of China and Bank of China, the mainland's third- and fourth-largest banks by assets, have announced plans to raise $29 billion in preferred.

Which brings us back to real estate, the "frantic" developers and the demand for elevators. That demand is immediately dependent on construction, which is duly reflected—or ought to be reflected—in real economic growth. Just how fast is the Chinese economy actually expanding?

By 7.4% in the first quarter, measured year-over-year, says the people's government. By a fraction of that rate, say we. We so infer from data over which Beijing would seem to have only indirect control. Thus, iron ore prices have fallen by 30% in the past six months, diesel fuel consumption is flat over the past two years, rail-borne freight shipments are below 2011 levels and quarterly revenues of our old friend, Zoomlion Heavy Industry Science & Technology, the Chinese construction equipment maker, are back to the levels of 2009. First-quarter revenues for Chinese companies listed on the Hong Kong exchange registered a 7.1% decline, Lorenz points out, the largest year-over-year drop since the world seemed to be ending in early 2009.

"If you look at what the local provinces are reporting," observes Lorenz's anonymous expert, "six or seven reported growth rates that are substantially below target. People have attributed this to a change in reporting incentives. That is probably true—local officials aren't being evaluated on GDP growth as much as they once were. But if you take the numbers seriously, they suggest an outright contraction in output from Q4 of last year to Q1 of this year in six or seven major provinces, which would be around a quarter of the country. It would mean an outright contraction of 1% to 2%, quarter-on-quarter, because many provinces dropped from 8%, measured year-over-year, to 4%, also measured year-over-year.

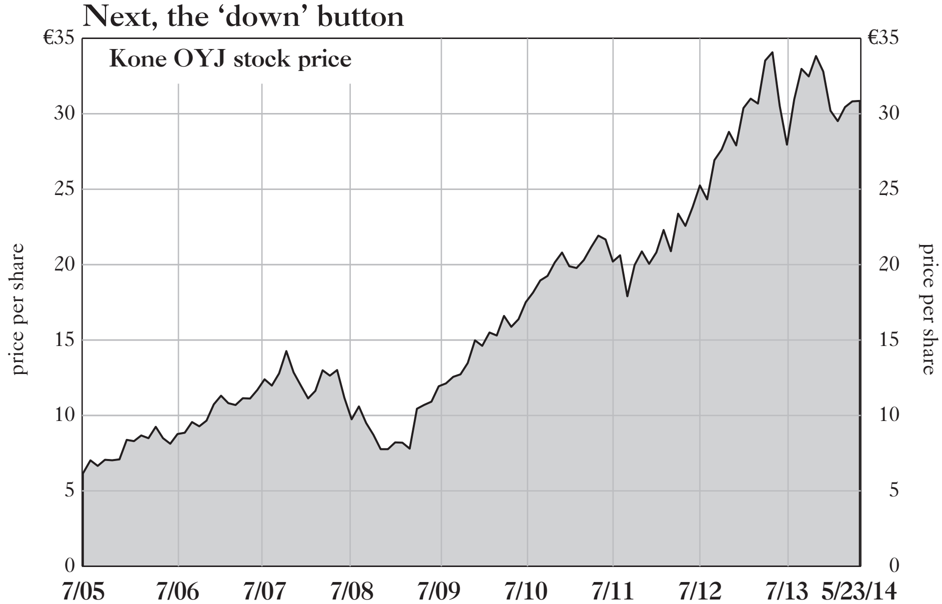
"Our belief is that growth is already, let's call it somewhere in the 4% to 6% range," our informant concludes. "You don't have to worry about China falling from the 7% to 8% range to the 5% to 6% range because it has already happened."

If we're right about China, the stock market is wrong about Kone. Trading at 22 times trailing earnings and offering a 3.3% dividend yield, the world's No. 2 elevator maker (Otis Elevator, a subsidiary of United Technologies Corp., takes first prize) is hardly valued for a Chinese real estate reversal.

With respect to the People's Republic, Kone's current vulnerability is the product of its past success. China delivered 30% of its sales and 40% of its new orders in the first quarter. Excluding Asia-Pacific from the corporate grand total, Kone's top line suffered a 4.7% year-over-year drop rather than the reported 3.1% year-over-year rise—which is to say that the Asian geographical segment contributed 203% of top-line growth in January-March 2014.

At a glance, you would almost certainly mark down Kone as a long. Vital signs—sales, earnings per share, free cash flow, operating margins—are in the pink. The March 31 cash position, net of debt and minority interests, totaled €221.1 million ($301.4 million) or €0.49 per share. In 2013, the company generated a 37.8% return on capital. Between 2005 and 2013, its share of new worldwide elevator equipment orders jumped to 18.5% from 10%. In the first quarter, elevator sales chipped in 48% of total sales; the maintenance business—950,000 elevators are entrusted to Kone's care—contributed 39% and the upgrading and modernizing business another 13%. Geographic breakdown was as follows: Europe,

Next, the 'down' button



source: The Bloomberg

Kone OYJ
(in millions of euros, except per-share data)

	2013	2012	2011	2010	2009
Sales to:					
Europe, Middle East and Africa	€3,157	€3,094	€2,894	€2,912	€2,953
Asia-Pacific	2,657	2,184	1,384	1,057	820
Americas	1,118	999	947	1,018	970
Total sales	6,933	6,277	5,225	4,987	4,744
Operating profit	954	829	725	696	600
Operating margin	13.8%	13.2%	13.9%	14.%	12.7%
Net income	702	601	644	535	466
Shares outstanding (millions)	515	514	513	513	508
EPS	€ 1.36	€ 1.17	€ 1.26	€ 1.05	€ 0.92
Cash	447	390	394	193	205
Debt	170	133	104	71	124
Net debt	(277)	(257)	(290)	(122)	(81)
Cash flow from operations	1,022	942	603	683	701
Capital expenditures	(77)	(113)	(92)	(46)	(43)
Free cash flow	945	829	511	637	658

sources: The Bloomberg, company reports

the Middle East and Africa, 47%; Asia-Pacific, 38%; and the Americas, 15%.

And if the foregoing were not enough to commend Kone for a place of honor in a long-only portfolio, there is another constructive fact to consider, namely that capital spending makes an impressively small drain on the company's bottom line. "We do not ourselves manufacture any components from scratch," the investor relations' manager, Katri Saarenheimo, tells Lorenz. "Our manufacturing is the assembly of components. For this reason, this is a very capital light business in terms of expanding capacity. You can, with a couple of million euros, build a new factory. Capacity expansion does not require a high level of investment."

Whatever the substantive merits of the bearish-on-China story, it does tick a fair number of contrary-opinion boxes. Kone and its competitors are as one in predicting another strong year for Chinese elevator sales in 2014. "[D]ouble-digit growth," Thyssen Krupp AG CEO, Heinrich Hiesinger, forecast on the company's May 13 conference call. "On China, while reports recently suggest a property market slowdown in parts of the country, we continue to see solid demand in housing and infrastructure in the first quarter," United Technologies CFO Gregory J. Hayes affirmed on the April 22 earnings call; Chinese new equipment orders for Otis Elevator were up 25% year-over-year in the first quarter, Hayes added. On the same date, Erich Ammann, chief financial officer of Schindler Holding AG, the Swiss elevator and escalator manufacturer, dismissed concerns over a Chinese property crash: "Overall, I have to say over the last three years, in the first quarter we always had these anxieties of slowdown in China." Schindler announced a 30% expansion of its elevator-manufacturing capacity in China.

"All global elevator companies, including the Japanese players (Mitsubishi Electric, Hitachi, Toshiba and Fujitec), are aggressively expanding their manufacturing capacities [in China] over the next two years," Barclays analyst, Rizk Maidi, reported in October. "We estimate these will have enough capacity to provide the market with circa 700,000 units by 2015, which is circa 45% greater than expected demand for 2013 and 30% above 2015 requirements."

Kone itself acknowledges that prices are under pressure. "I think that the pricing pressure is coming from the fact that the Chinese elevator and escalator market has quite a lot of players, lot of players with strong growth ambitions," CEO Henrik Ehrnrooth disclosed on the company's April 23 conference call. "I think I can't say for other players, it, of course, comes from competition—the price competition."

"Pressure on margins seem likely to follow, whatever the near-term trend in new orders," Lorenz observes. "Last year, Kone achieved an operating margin of 13.8%, up from 13.2% in 2012; the Street expects 14.1% in 2014. Price competition may put that target out of reach, even if volumes grow. In 2009, Kone achieved an operating margin of just 12.7%. Holding all else the same, a return to that level of profitability would slash net income to €1.40 a share from the consensus forecast of €1.56 a share. Should the Chinese market contract in the midst of the industry's capacity expansion, the downside can be even more severe."

In Helsinki, Kone trades an average of €30.1 million's worth of shares a day; stateside, the ADR trades an average of $360,000 a day. ADRs are there for the borrowing, though one must look to Finland for a deep and liquid market. Respecting as we do the management of this excellent company, we note that the Kone insiders have sold net 52,996 shares in the year to date for net proceeds of €1.6 million. Selling, they realized an average price of €30.33 per share vs. the current share price of €30.73. Perhaps the front office reads Mandarin.

•