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Essence of China

China is a riddle wrapped in a mystery inside a phony press release, to adapt a line of Winston Churchill's. By official contention, the GDP of the People's Republic registered year-over-year growth of 7.3% in the fourth quarter. Yet, also in the fourth quarter and likewise measured year-over-year, profits at Chinese industrial companies tumbled by 5.8%. In December, the China Leading Index, which is derived from stock prices, credit spreads, a consumer expectations' survey, real estate investment and freight traffic, among other soundings, dropped to its lowest level since February 2009.

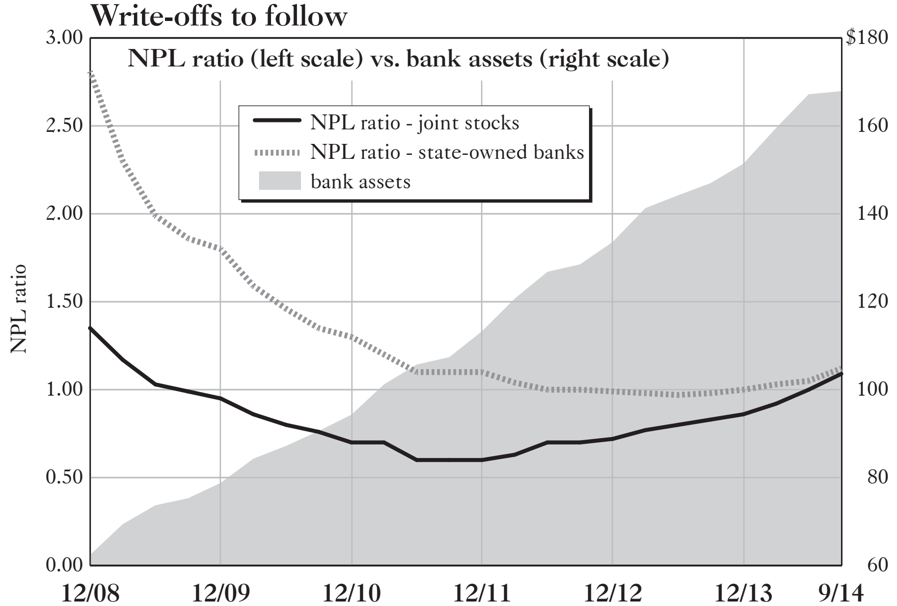
Ping An Insurance Group Co. of China (2318 on the Hong Kong Stock Exchange) is one of two featured topics in the essay now unfolding. The financial system in which this important company has its cosmetically luminous being is the second. In preview, we're bearish on the stock and astonished anew at the system. China, the supposed once and future driver of world economic growth, remains a laboratory experiment in how much debt a society can bear without actually collapsing.

"You have to keep in mind that the GDP number is a bureaucratic target, not an analytic result," replies Anne Stevenson-Yang, the co-founder and director of research of Beijing-based J Capital, in response to the question: Why do China GDP data seem to have so little to do with reality? "The State-owned Assets Supervision and Administration Commission, the nominal owner of all the state-owned companies, makes its budgets with reference to the posted GDP target. Each industry has a number that is based on a correlation to historic GDP figures and you are given that formula and that is your production target for that year. If the premier were to say, 'Actually, growth is 3%,' then SASAC takes down all the targets and it becomes a self-fulfilling prophecy. You can't afford to do that."

Grant's isn't the only observer that missed the run-up in the Shanghai stock market last year. Plenty of Chinese wanted no part of it, either. Outbound flows of local currency have pushed the renminbi-dollar exchange rate to an eight-month low. Once upon a time, the People's Bank bought dollars—all told, $4 trillion of them—in order to tamp down the renminbi's value. Now it is selling dollars—$150 billion in the six months ended December—to support the renminbi's value. In buying dollars, the PBOC expanded the money supply. It is selling dollars, it is contracting the money supply. Is this the way modern communist functionaries minister to a sickly economy?

Pity the Red planners (or try to). The government lashes the renminbi's value to the dollar through an administered trading band. The dollar has been on an upside tear. Beijing would welcome stronger exports. It chafes at the collapsing yen and euro. But an explicit devaluation of the renminbi could touch off a spasm of capital flight. Likewise, an explicit gesture of monetary easing might have undesirable consequences in a country in which—as Charlene Chu observed at

Write-offs to follow



source: The Bloomberg

the Fall 2014 *Grant's* Conference—debt is twice as large, and is growing twice as fast as GDP.

The authorities have opted for a kind of stealth easing. On Nov. 21, they cut the minimum rate at which banks can lend to businesses to 5.6% from 6%. On Dec. 27, they redefined the word "deposits" in such a way as to permit a rise in the system-wide ratio of loans to deposits. The move will unleash rmb. 5.5 trillion ($880 billion) in new lending reckons Shanghai-headquartered Haitong Securities. Or will it?

"I've been wandering around to banks asking, 'Are you going to lend more?'" Stevenson-Yang tells colleague Evan Lorenz. "They all say no. When I ask why, a lot of the reason is because all of the borrowers have their collateral already double hypothecated. There is no more collateral in the market. What borrowers have been doing is taking, through agents, a piece of the promised loan to buy collateral. But that only works if you can overstate its value. The problem is that real collateral values are falling now and the math doesn't work anymore. There are some scams out there but, for the most part, it doesn't work."

Chu had observed that for six years following the 2008 global financial crisis, the Chinese government fostered annual increments of lending and borrowing equivalent to 35% to 45% of GDP. "That is an astonishing amount," she reminded the audience. "If you were to put that in U.S. terms, we're talking about roughly $5 trillion in credit being extended six years in a row."

As far removed as the *Grant's* aerie at 2 Wall St. may be from the seat of Chinese finance, we are prepared to hazard that the People's Republic has overdone it in the leverage department. We conjecture as much to start with by the low level of admitted Chinese non-performing loans. They should be rising: the rate of credit formation has been breakneck, the return on invested capital has presumably been falling, and deflationary forces have raised the real cost of debt. The fact that acknowledged slow loans are barely rising prompts an informed suspicion that Chinese creditors are extending and pretending—capitalizing interest costs, "ever-greening" dubious debts.

A second item of evidence in support of the proposition that the debt rivets are (or should be) popping is Beijing's new scheme to shift the cost of servicing local-government borrowing. By this time next year, if the Party planners get their way, $2 trillion-plus of local government IOUs will have been converted to low-yielding municipal bonds. Instead of bank debt yielding, say, 8%, there will be municipal bonds yielding, say, 4%. Sound impossible? "Actually, it is not that difficult," a Hong Kong analyst advises Lorenz. "All you do is go to a bank balance sheet, scratch out rmb. 150 billion from the loans and put rmb. 150 billion in 'low-risk' bonds in the investment book." Bad for the banks—net interest margins will shrink as bad debts expand—but good for the macroeconomic optics.

Corruption—or rather the authorities' belated drive against it—further complicates the Chinese credit situation. Thus, Kaisa Group Holdings, a Shenzhen developer, missed a rmb. 162.8 million interest payment on Jan. 8, even though it showed rmb. 9.6 billion in cash on June 30. It seems that the company's accounts have been frozen since its chairman resigned in December, reportedly over ties to an allegedly crooked former secretary of the Shenzhen Municipal Politics and Law Commission.

"As I get the story," Lorenz relates, "what's changed is that giving a bribe has become retroactively illegal. Formerly, it was only receiving a bribe that got you in trouble. I understand that the switch may help to account for the rise in outward money flows. The government has put the fear of God in business people."

So all is gloom and doom? Not at all. Insurance, for instance, is a hopeful beacon. China is among the most underinsured countries in Asia, as Credit Suisse analysts Arjan van Veen and Frances Feng observe. "The central government has outlined a blueprint to promote private retirement savings as well as greater use of private health care insurance by local governments," as Bernstein Research analysts Linda Sun-Mattison, Thomas Wang and Min Zhou point out.

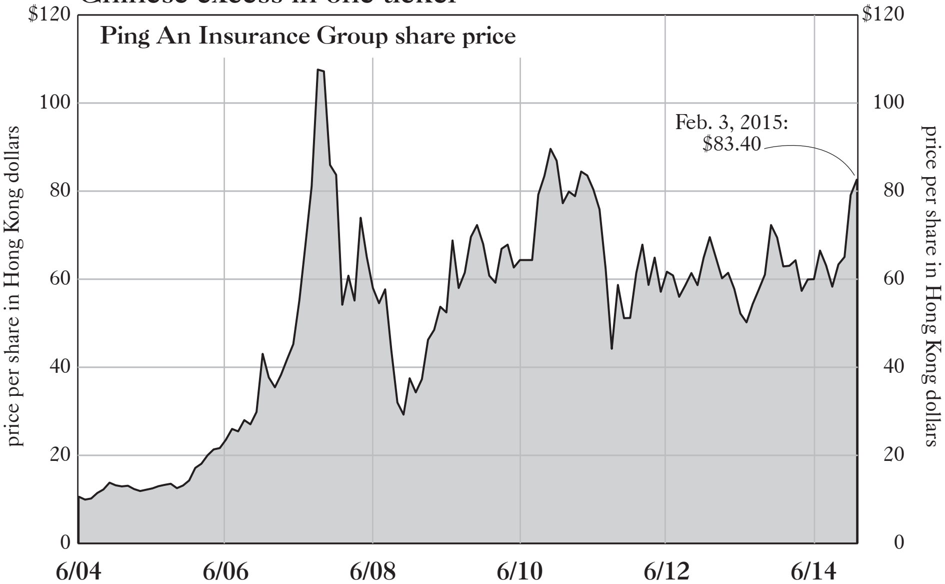
All the better, then, for Ping An, China's No. 2 insurer in both life and property-casualty (though life insurance in China has more to do with savings than protection against actuarial risk). Bulls swear by a management team that they say eschews market share for a shareholder-friendly focus on earnings. "The bull case is really that it is the best insurance company in China," van Veen tells Lorenz. "It has the most professional sales force. It is the most innovative in trying new things. It is spending a lot of money on trying to sell insurance direct. In motor insurance, where it is number two, it was the first one—rather than sell through agents or car dealerships—it was the first to go direct with outbound call centers, Internet and inbound call, and now half of that business is direct. It still has a first-mover advantage on that as well."

In dollar terms, Ping An boasts a $100 billion market cap and a $628.8 billion balance sheet. It has 212,000 employees and uses 608,000 agents. It ranks 128th in *Fortune* magazine's tally of 500 of the world's "Leading Companies." Of the 27 analysts who follow Ping An common, 26 profess to be bullish on it. The stock trades at 16.9 times trailing net income and 2.6 times book; the dividend delivers a 1.1% yield.

A respected worldwide brand, an institutionally coveted investment Ping An may be. Still, to us, it is the epitome of what's wrong with 21st century Chinese finance. "Thus," Lorenz points out, "it's an insurer that is buying shares in developers, insurers, banks. It has a bank and its bank is among the most aggressive in using accounting games to hide nonperforming loans. It has a trust bank, an investment bank and a guarantee business. It's paying fancy prices for 'trophy' properties in 'gateway' cities, including their recent acquisition of Tower Place in London for $482 million."

So Ping An is much more—or, at that, much less—than a well-regarded insurance company. In the first half of 2014, life insurance generated 36% of net income, P&C insurance 17%, banking 38%, securities underwriting and investment banking 2%, and trust management 3%. "Ping An strives to become the world's leading provider of personal financial services, establish a traditional business framework supported by the group's three pillars of business, namely insurance, banking and investment, and continue to promote the parallel growth of its traditional and nontraditional financial businesses," the corporate Web site modestly states.

Chinese excess in one ticker



source: The Bloomberg

Remember Sandy Weill's concept of the financial supermarket? Ping An is that soup-to-nuts emporium.

The bank is the principal source of risk. Ping An acquired Shenzhen Development Bank through a series of share purchases beginning in 2009. Today, the parent holds a 59% equity stake in the rebranded and separately listed Ping An Bank Co. (000001 on the Shenzhen Exchange). As of the third quarter of 2014, Ping An Bank reported assets of rmb. 2.1 trillion, amounting to 56% of the parent's overall balance-sheet footings. Rmb. 127 billion in equity stands behind those banking assets, indicating a ratio of equity to assets of 5.9%. At last count, which was the third quarter's, nonperformers amounted to just 0.98% of total loans and provisions were sufficient to cover 192% of those doubtful credits. On the face of things, then, credit quality would seem to present no insuperable problems. Then, again, this is the hyper-leveraged People's Republic. Besides, since 2009 the bank has compounded the size of its assets by an average of 25% a year. The pace of expansion does not suggest an over scrupulous attention to underwriting.

"I think Ping An Bank is possibly one of the worst banks in China," a Hong Kong-based observer who asks to go nameless ventures to Lorenz. "I find them an astounding institution. There is a loan category called 'overdue but not impaired.' It's exactly how it sounds. Ping An Bank and a lot of banks in China have taken that definition to a new extreme. The problem for the auditors is that the China Banking Regulatory Commission is not only supporting these accounting treatments, but is pushing back on the auditors trying to impair the loans." As of June 30, the "overdue but not impaired" category amounted to rmb. 21 billion, up from rmb. 1.4 billion at year-end 2011.

Not that the bank's problems are necessarily contained in the loan book. Loans, in fact, constitute only rmb. 1 trillion of the bank's rmb. 2.1 trillion of total assets. Another rmb. 0.9 trillion is deployed in interbank assets and in what is blandly called "investments." In point of fact, not a few of these so-called investments in corporations and local governments are really loans, but they will never generate an NPL—not as long as they are ticketed "investments."

Our anonymous informant and we are far from the only skeptics with respect to Ping An Bank. The parent, too, has seemingly had a bone to pick with its problem child, to judge by the admission of Shao Ping, president of Ping An Bank, as quoted in the June 25, 2014, edition of *Caixin* magazine. Thus: "It has been common for branch banks to extend new loans to companies so they can repay old ones, but to do so in the future, they will have to get the headquarters' approval."

"When Ping An Group bought Shenzhen Development Bank, it was your classic failed merger," J Capital analyst Matthew Lowenstein tells Lorenz. "Ping An management has very much an insurance mentality, meaning they think costs should be low. They really didn't know how to run a bank. For well over two years after the merger, Ping An Bank had the highest turnover of middle management of any bank."

Neither do retail deposits tend to stick. Lacking that stable funding base, Ping An has turned to flightier liabilities—bank acceptance notes and corporate deposits, for instance. Only 17% of Ping An Bank's rmb. 1.5 billion in deposits are of the retail variety vs. 47% for Industrial & Commercial Bank of China Ltd., the largest bank in the People's Republic.

A would-be short seller may wonder why the beloved parent is a better target than the tempting bank subsidiary that trades under its own name. For one thing, the bank trades only on the mainland, whereas Ping An Insurance Group is listed in Hong Kong as well as on the mainland. Then, too, parent Ping An changes hands at more than twice the multiple of the banking sub. Besides, as Lorenz notes, "shorting Ping An Insurance gets you exposure not only to everything that Ping An Bank has both on and off its balance sheet, but also the parent's asset guarantor, its peer-to-peer lender and its trust company."

Perhaps, gentle reader, if you were the CEO of parent Ping An, you would sell the bank and be done with it. After all, the bank is the ball and chain that has caused the government to stick Ping An Insurance with the unwanted label "systemically important insurer." But sell to whom? Another Chinese bank? A clean Chinese bank? Where?

China's trust companies issue "wealth management products," or securities backed by claims on companies that, as often as not, don't qualify for a bank loan. Ping An Trust, one of the country's top trust companies, managed some rmb. 377 billion as of Sept. 30. It markets its WMPs to 29,000 high net worth individuals.

"Products" of all kinds carry with them some potential liability for the manufacturer. Who bears the cost of a defective wealth management product? Even if not bound by law to make restitution, a highly regarded issuer—Ping An, for instance—will look to its reputation in case of trouble. It happens that Ping An Trust last year issued a WMP in the sum of rmb.

2.5 billion to the now troubled Kaisa Group Holdings. On Jan. 20, Bloomberg cryptically reported the following: "Ping An Trust Co. established the two-tranche trust product on behalf of Kaisa in April last year, the people said, asking not to be identified because the details are private. The money on the largest portion comes due Jan. 21 and an as yet undisclosed third party will take it over so investors can be repaid their principal plus interest, the people said." It seems a fair guess that Ping An bailed out its investors. If so, the associated contingent liability was nowhere recorded on the balance sheet.

"Ping An," according to Bernstein Research, "is likely on the hook in case of underlying investment defaults in Ping An Trust and Ping An Banks' WMP products. Insurance operations continue to grow, but a reliance on re-insurance for capital management, expansion into credit and guarantee insurance, and investment into high-yield assets leave the company more vulnerable than its peers."

"Numbers are sparse for some of Ping An's other businesses," Lorenz goes on. "Figures for Lufax, Ping An's consumer-to-consumer lending business (think Lending Club in Mandarin), aren't broken out in Ping An's filings. We know the business is growing fast—the 2014 semi-annual report says that Lufax's transaction volumes grew by nearly 10 times in the first half of 2014 from the first half of 2013. In September, Ping An announced that Lufax would finance down payments for home buyers on such liberal terms as to allow prospective buyers to put down not one red renminbi. We don't know how many assets in toto that Ping An's creditor guarantor subsidiaries stand behind, but we do know they guarantee all of the loans in Lufax."

Certainly, Ping An is diversified, but it is the diversification of error. "They can shift assets from this pocket to this pocket and another pocket without ever recording a write-down or without ever having a truly neutral party agreeing on a price," as Lowenstein says. "Ping An has all this dross and bad assets both on and off balance sheet that will just never get written down. Beyond that, they are the poster child for lending into property, mining, and pie-in-the-sky infrastructure projects. They are worse than most banks."

In China, that's no compliment.

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