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Credit Ratings In China Can Be Mere Guesswork

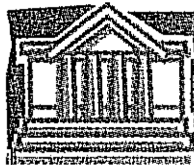
By JOEL BAGLOLE

Hong Kong

INTERNATIONAL CREDIT-RATING companies charging into China are operating in such darkness that many investors question the value of their work in the country.

Demand for credit ratings—an assessment of how willing and able a borrower is to repay debts—is growing as more Chinese companies raise capital from international investors. But faulty accounting, poor corporate governance and a lack of disclosure hamper the raters' efforts.

China doesn't adhere to international accounting standards, and publicly listed companies can be controlled by private parent companies that aren't required to disclose financial information. To make matters worse, the government issues misleading statistics.



CREDIT MARKETS

Whether rating companies succeed in enhancing transparency among Chinese companies is a key test as the nation attempts to develop world-class capital markets.

If Fitch Ratings, Moody's Investors Service and Standard & Poor's can push companies into releasing more information and their ratings are seen as reliable, that could help bolster confidence in China as it looks to foreign investment to fuel its growth.

Though China is opening, it's a slow process. Brian Colton at Fimalac SA's Fitch Ratings in Hong Kong, rates China's sovereign bonds. Part of his job is to assess China's economy. But Mr. Colton says he's never sure how reliable the data are. He often tallies the gross domestic product figures of China's 23 provinces and seven administrative regions and finds the total is different than the national GDP figure issued by Beijing. "Sometimes you have a column of figures that don't add up to the total at the bottom. It's that bad," he says.

However, China is a potentially lucrative market, with more than eight million corporations and 130 banks hungry for capital to expand. Since 1998, the annual value of initial public offerings in China has increased nearly 50% while bond issuance has doubled, according to financial data provider Thomson Financial.

So far, the international ratings companies combined have rated fewer than 100 Chinese enterprises. Ratings companies charge as much as $80,000 for an initial rating and up to $40,000 a year to maintain surveillance on companies and adjust ratings as needed.

Critics say the raters' work in China is useless

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China's Murky Data Cast Doubts on Work Of Credit Agencies

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because it's based on limited information. They are also alarmed by the willingness of the companies—which have been criticized in recent years for failing to spot trouble at Enron Corp. and other accounting blowups—to work around big problems. "If you have any credibility, you would probably be rating everything junk in China," says Scott Kennedy, an assistant professor at Indiana University in Bloomington, Indiana, who specializes in China's political economy.

Brad Aham, an Asian equities portfolio manager at State Street Corp., who has $2 billion invested in emerging Asian markets, puts it this way: "Credit rating agencies can keep the markets abreast of ongoing structural problems in China, but in terms of data that affect markets on a daily basis, rating agencies aren't that useful."

Fitch, Moody's and McGraw-Hill Cos.' S&P are focusing on the Chinese government's sovereign bonds and companies listed on stock exchanges outside the mainland, where disclosure is better than at nonlisted enterprises. Publicly listed companies such as China Mobile (Hong Kong) Ltd. and Huaneng Power International Inc. have had their bonds rated investment grade.

Charles Chang, an associate director at Fitch Ratings in Hong Kong, was able to rate a Chinese retailing company that was considering a bond issue in 2002, despite the fact that there was little information available about China's retail sector or the company's finances. To compensate, he constructed "stress scenarios," and hypothesized about the company's ability to cope if retail sales fell sharply or the economy slowed suddenly. "It wasn't easy," he says.

Fitch and Standard & Poor's have begun conducting public-information ratings, which use publicly available information and media reports to evaluate a company rather than consultations with management. Fitch and S&P say such ratings are necessary in China, where company cooperation is hard to get. But in China such ratings can rely on censored media reports. Moody's has stopped public-information ratings, saying they're inaccurate.

Indiana University's Mr. Kennedy says the rating companies give Chinese institutions inappropriately high ratings because they weigh favorably the country's huge economic growth and government support of state-owned enterprises. Fitch, Moody's and S&P each tie their ratings on China's banks to the ratings on the government's bonds. But executives say they have to do this because the country's banks are insolvent, with nonperforming loans accounting for as much as half the total loan portfolios.

Ratings companies say problems are inevitable as China moves from a state-planned economy to a free market economy. They add that they are more critical than China's domestic credit-rating firms. And they say that China is making efforts to improve corporate governance, making it mandatory for public companies to report financial data on a quarterly basis rather than every six months and opening two national accounting institutes to train people in international accounting.

"You'll never have all the facts," says Wei Yen, a China bank analyst at Moody's, a unit of Moody's Corp., in Hong Kong. "You get what information you can and make a decision based on your logic."

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China Stocks Evoke Ghost of 1990s Tech Bubble

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food and beverage sector. That is also more than double the 20 times trailing earnings of Anheuser-Busch Cos., which owns a stake in Tsingtao.

Despite booming demand for new cars in China, auto companies also look pricey. Qingling Motors Co. trades around 20 times last year's estimated earnings, compared with 14 for the world automobile and parts sector; Honda Motor Co. trades at less than 10 times trailing earnings. Analysts add Brilliance China Automotive Holdings Ltd., up nearly threefold last year, is no bargain at 17 times trailing earnings. That is especially true because it is in an ownership dispute with its former chairman, Yang Rong, who fled China in May 2002 after a provincial government seized his stake in the company.

HEARD ON THE STREET

"There's often a gray area in terms of property rights when you're buying Chinese companies," says Chris Lively, a portfolio manager at Citigroup Asset Management. Not a comforting thought at any valuation.

Then there is the IPO market. Chinese initial public offerings totaled $7 billion last year. Half of that came from China Life Insurance Co.'s $3.5 billion IPO, which is up more than 60% since its listing in Hong Kong and New York last month. People's Insurance Co. of China's PICC Property & Casualty unit has also risen more than 90% since its November initial public offering.

More Chinese companies are queuing up to list, including China Construction Bank, one of the country's four large state-owned lenders, with a $5 billion offering and state-owned China Netcom, a fixed-line phone company, with a $2 billion IPO. China's leading chipmaker, Semiconductor Manufacturing International Corp., is also considering a $1 billion IPO.

In all, Merrill Lynch forecasts that Chinese IPOs this year will raise $15 billion worldwide.

The big jumps in stock prices alone suggest investors are oblivious to the risks they are taking. There are other ways to measure the froth. Take the China Fund, a closed-end fund that trades on the New York Stock Exchange and invests in small and medium-size Chinese stocks.

The fund, whose largest holding is in Sohu.com, rose 77% last year. More amazing, the $280 million fund, which is about 60% owned by individual investors, trades at a 57% percent premium to the value of its stock holdings.

Not surprisingly, co-manager Shifeng Ke, a director at asset-management firm Martin Currie, based in Edinburgh, Scotland, says Chinese Internet stocks are just starting their runs, though he's unloading some more-mundane names, such as Conch Cement, on valuation concerns.

There are other concerns that in a more normal environment would give investors pause. Chinese companies, for example, don't adhere to U.S. or international accounting standards. And credit-rating agencies are unable to rate most of the Chinese companies listing overseas because of a lack of transparency and disclosure. Finally, the Chinese government is involved in one way or another in most of the companies listed on the markets.

Yet like the tech mania that gripped the U.S. in the late 1990s, investors say that China stock market fever could thrive far longer than the naysayers expect.

"We're cautious on China," says George Hoguet, head of emerging markets for State Street Global Advisors. "But with so much media attention on China, there continues to be a lot of positive momentum. The market could move higher for months."

China Stocks Evoke the Ghost of Bubble Past

Investors Who Haven't Forgotten Late 1990s Technology Wipeout Warn Wealth Could Be Destroyed

By Craig Karmin
And Joel Baglole

WHEN CLEAR-HEADED investors sounded the alarm about the technology-stock bubble in the late 1990s, they were roundly ignored.

Today, another group is raising the same call about China. And many investors, who have apparently wiped their tech-stock losses from their minds, don't seem to be listening.

So it is worth going through all the reasons why Chinese stocks could destroy shareholder wealth just as efficiently as tech stocks did after early 2000.

HEARD ON THE STREET

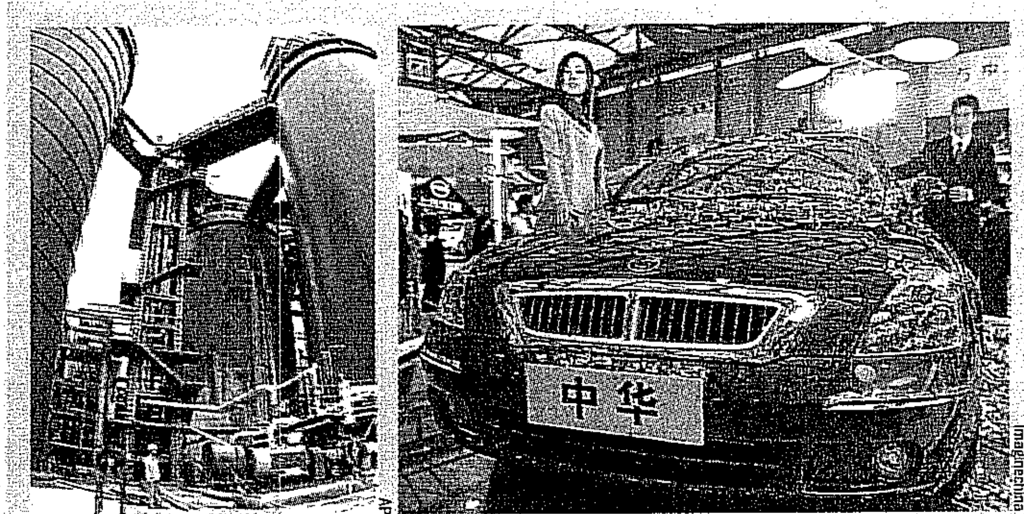
"China looked like a bubble at the start of last year," says Mark Madden, manger of Pioneer Emerging Markets Fund, who has been selling shares in Chinese companies even though he believes in China's long-term potential. "It looks like a bigger bubble today."

Consider last year's performance. The Chinese market as measured by the Morgan Stanley Capital International China Index gained 81% in 2003. While it did trail the Nasdaq's 86% return in 1999, it should be enough to get people nervous. Chinese stocks that trade in Hong Kong rose 152% last year. The Chinese market is up 6% this year.

With performance like that, many Chinese stocks are among of the most expensive in the world for their industries. And of course companies of all stripes are rushing to cash in on the bonanza by going public, even though their financial situations are mixed at best and their disclosure is generally dismal.

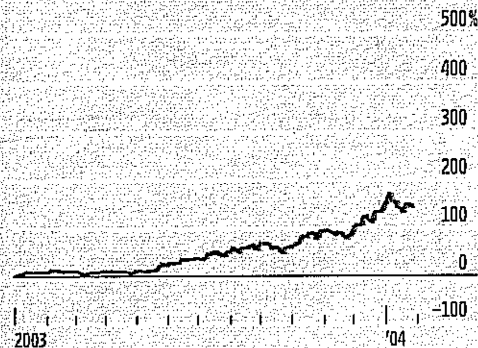
"My fear is that the reality of China won't meet investors' expectations," says Qu Hongbin, an analyst at HSBC Bank in Hong Kong. "A lot of people could get burned."

The list of most outrageously priced companies must by tradition be led by Internet companies such as China's top three portals—**Sina Corp.**, **Sohu.com Inc.** and **Netease.com Inc.**—each rose between 220% and 420% in 2003. And then there is



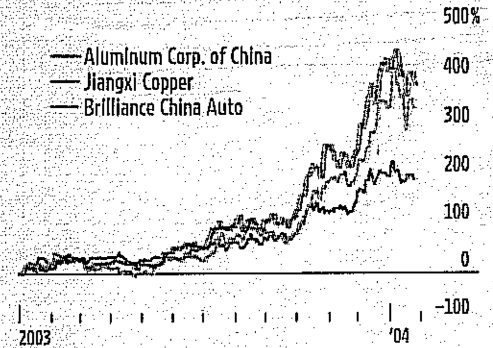
A Year of Good Fortune?

Hang Seng China Enterprises Index Soars...
Tracks overall performance of 32 mainland Chinese stocks that trade on the Hong Kong Stock Exchange



Source: Thomson Datastream

While Some Companies Do Even Better
Performance since Dec. 31, 2002



the requisite dot-com IPO as in **Ctrip.com International Ltd.**, which rose 89% on its first day of trading last month, the biggest first-day jump in three years. (Related article in World Stock Markets, page C18.)

But the real proof that valuation is out of kilter is the prices investors are paying for mundane industries such as beer producers and carmakers. Typically, a new and volatile market such as China would trade at a valuation below the 15 times trailing 12-month earnings that is the average for emerging markets, which themselves rallied strongly last year. But China now trades at 17 times trailing earnings.

Tsingtao Brewery Co., for instance, trades at a whopping 42 times its trailing earnings, even though the Chinese brewer fell short of its target for beer sales in 2003. Its valuation compares with a global average of 18 times for the MSCI World

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