PHILO VANTAGE POINT

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PHILO CAPITAL ADVISERS

CHASING THE DRAGON:

KICKING THE TYRES IN CHINA/中国

Hugh Dive, CFA

Philo Capital Advisers

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Contact us:

Philo Capital Advisers Pty Ltd
Level 11, 37 York Street, Sydney NSW 2000 Australia
ABN 70 119 185 974 AFSL 301808
www.philocapital.com.au

Brett Sanders or Ashley Owen
P: 1300 303 323
P: +61 2 9112 2800
E: enquiries@philocapital.com.au

Kicking the tyres in the Middle Kingdom

Since China started to have a greater impact on the global economy and Australian companies from the early 2000s, the media have been awash with contradictory extreme viewpoints about the implications for Australian investors. Investors are told that either "*China is going to take over the world*" (mostly good for Australia) or that "*China is a house of cards that will soon fall in a heap*" (bad for Australian miners). This latter argument has intensified in 2014 with the weakening of the iron ore price and the slow-down of China's economic growth rate after almost a decade of consecutive double digit GDP growth.

In this paper we outline the main themes and findings from our latest series of meetings across China to assess the outlook for China and its implications for our portfolios for Australian investors

Last month Philo Research returned from an extensive trip around China meeting with companies, state owned enterprises (SOEs) and governments in the provinces of Beijing, Hebei and Shandong in the north, Hunan in the central region and Jiangsu/Shanghai on the coast. The purpose of the visit was to gauge the future direction of the Chinese economy and to provide a view on the outlook for Australian companies whose profits are linked to China. Given the influence of China on Australia and indeed on the companies in our Core Equity Portfolio, the Philo Capital Research Team seeks to meet with Chinese companies at least annually. In this paper we will run through the key points of interest for Australian equity investors and themes that were repeated across the meetings in different regions.

Misallocation of capital

A key theme that emerged from our meetings and observations across the country in a variety of industries was the misallocation of capital when making investment decisions. Typically a company makes a decision on whether to invest in a project by measuring the expected return on invested capital against the actual cost of that capital, and then comparing the expected return against other options such as retiring debt or returning it to shareholders. The aim of any capital expenditure decision should be to create value for shareholders. In an efficiently functioning capital market, potentially questionable decisions should be halted by resistance from the providers of capital, namely a company's shareholders or debt financiers (bond holders and/or banks). Companies with a poor track record of capital allocation will have trouble attracting funding from shareholders and will also be forced to pay high interest rates on bank debt if they can find banks to fund their projects.

In China, the State-Owned Assets Supervision and Administration Commission (SASAC) supervises the 117 centrally-controlled state-owned enterprises (SOEs) which include Sinopec (Asia's top oil refiner), China Mobile (world's biggest network of mobile phone users) and Baosteel (the second largest global steel producer). Key management personnel in these firms are chosen by SASAC and they tend to be political choices based on the recommendations of the Party rather than based on their proven management expertise.

The level of state control of companies across many sectors of the Chinese economy (including the banks that lend to them) leads to investment decisions that are often not motivated by the desire to maximise shareholder value; but rather by political motives such as maintaining growth or generating tax revenues in a particular province. Whilst the South Australia government would dearly like to see BHP expand the Olympic Dam copper, gold and uranium mine to offset the impending closure of General Motors Holden; unlike in China, the South Australian government possesses few powers to compel BHP to make the $30 billion dollar Olympic Dam investment.

Funding and shadow banks

As a result of the tight state controls over both the recipients of bank lending and the interest rates paid to retail depositors, a 'shadow' banking sector has developed in China. The growth of this sector is symptomatic of the misallocation of capital in China. Private sector borrowers want access to capital and savers want interest rates ahead of the inflation rate. The term '*shadow bank*' refers to the range of lightly regulated alternative credit providers ranging from trust companies to money market companies and even well-connected industrial SOEs that lend to private firms. As the major Chinese SOE banks offer negative real rates of return on deposits (i.e. 2% which is an interest rate below the inflation rate), savers are attracted to investing with trust products that offer rates up to 10%, especially when these products are sold by a branch of one of the major banks offering some level of implied government backing to the trusts.

An example of a trust product is a product developed by China Credit Trust and sold in the branches of the Industrial and Commercial Bank of China (ICBC), the world's largest bank by assets. This delightfully named investment is the ***2010 China Credit-Credit Equals Gold #1 Collective Trust Product***. This product offered returns of 10%, far higher than deposit rates of 2% and raised US$496M to lend to Shanxi Zhenfu Energy Group, an unlisted coal mining company. In January 2014 this product appeared to be destined to default after the CEO of Shanxi Zhenfu Energy Group was arrested and ICBC refused to compensate investors even though the trust deposits were sold through its branch network to its own customers. In response to investor unrest from ICBC's clients this product was restructured.

We believe that, as the shadow banking crisis unfolds the regulators will allow some of these high yield/high risk trust products to default. This would be a sign of maturity of the Chinese financial system and arguably this would raise risk awareness amongst investors of the returns that should be demanded from investing in the debt of shaky thermal coal miners and remove an element of moral hazard in the Chinese financial system.

Beijing

China Railway Construction Corp (CRCC) is the second largest SOE in China and, in terms of revenue, the world's top construction contractor. CRCC designs and constructs China's railways covering high speed, tunnels and bridges and urban rail. CRCC activities cover Mainland China, HK & Macao and also extends to 60 other countries around the world (mainly in Africa & Asia). Unlike some other Chinese companies, CRCC were generally pretty positive in our meetings as they are benefiting from a lifting state expenditure on rail projects as part of a mini-stimulus plan. Over the last four years China has on average spent A$86B on rail projects, though this is expected to lift to A$138B over the next two years to increase the total length of railway lines in the country to 120,000 km in 2015. As much of this is expected to be spent on building high steel-consuming metro rail systems and high speed rail links, demand for Australian commodities such as iron ore and coking coal should be supported.

Industrial and Commercial Bank of China (ICBC) is the largest bank in the world in terms of market capitalisation and assets and 71% state-owned. In 2013 ICBC generated A$42B in profit from its 4 million corporate clients and 282 million individual customers on A$3.2 trillion of loans. In comparison the big four Australian banks generated A$27B on A$2.5 trillion of outstanding loans. In 2013 ICBC reported non-performing loans of just under 1%, however when ICBC was recapitalised in 2004 19% of the bank's outstanding loans were non-performing. This turnaround either suggests a dramatic improvement in ICBC's lending skills or may reflect the practice of simply extending or restructuring problem loans in order to avoid recording a loss, or having to report it as non-performing (ie not meeting repayment obligations).

In our meetings, ICBC stated that the biggest challenge that the bank (along with other SOE banks) face is not bad property loans, but rather interest rate liberalisation. Unlike the Australian banks who compete for retail and institutional deposits to fund their lending, ICBC has a largely captive and high-saving domestic customer base that are offered negative real rates on deposits. Instead of lending to generate the highest risk-adjusted returns for shareholders, this cheaply-sourced pool of deposits is mostly on-lent to state-owned industrial enterprises at a low interest rates (3-5%). This effectively "crowds out" private corporate borrowers and forces the private sector to utilise the shadow banking sector at interest rates between 12-20% to finance their business activities. Obviously this funding differential gives the typically less efficient SOEs a significant advantage over the private sector and is part of a phenomenon in the Chinese economy entitled Guo jin min tui/ 国进民退 or "*the state advances, the private sector retreats*".

Curious investment decisions

As a result of the favourable allocation of capital by the state-owned banks to other SOEs, during this trip to China we continually came across some quite curious investment decisions in areas that were tangential to the individual company's core area of competence. Examples include toll road operator **Shandong Hi-Speed**'s (the Transurban of Shandong province) investment in a zinc and tin mine in Inner Mongolia and **Sinochem**'s (China's largest fertiliser company) undertaking property development projects in Changsha involving two 238m tall commercial towers, a shopping mall and 2,100 high end apartments. The management team of major toll-road operators are not usually the best developers of new mines, nor are chemical manufacturers likely to be the most efficient large-scale property developers. The common theme in these strange investments was that the SOE was deploying cheap capital to grow the size of the company or aid regional development; rather than allocating capital to maximise returns to shareholders. ICBC believe that PBOC (People's Bank of China) will take at least 3-5 years before tackling reform in the financial sector, which suggests that this systematic misallocation of capital will continue.

China Shenhua is a large vertically integrated SOE energy company, whose activities range from coal mining, to converting that coal into energy via 42 Gigawatts of power generation. Shenhua is also the largest global coal miner by volume, but is facing the twin pressures from falling thermal coal prices and rising environmental concerns.

Shenhua considers that the Chinese government is taking pollution control more seriously, especially around Beijing and that this is resulting in greater demand for coal with lower sulphur and ash contents. In the longer term, energy policy will move demand towards this cleaner coal, but nuclear power will be the winner, as coal's share of China's electricity generation falls from 75% to 60%. Generally in 2014 power consumption has been increasing in China, but the rate of increase has been slowing. Shenhua view that the fall in thermal coal prices has been magnified by increased hydro-electric production stemming from a wet winter.

Shenhua sees a large number of mines are unprofitable at current thermal coal prices, especially those in the Coastal provinces that compete with imported coal. However on a positive note, the labour costs for coal miners has decreased from A$21-25k per worker per annum to around A$8k per annum. Struggling Australian coal companies would have loved to enjoy this downward adjustment in variable costs.

Against this somewhat grim outlook, Shenhua is planning a big new strategy around converting coal to chemicals in Shaanxi province in concert with Dow Chemicals. Previously the Chinese government discouraged investment in coal to petrochemicals projects, as they were viewed as both expensive and Chinese firms did not have the best technology. Of more interest to Australian coal companies was Shenhua's plans to build UHV (ultra high voltage) power lines coming to the coast from the Northern coal centres. This could monetise stranded coal reserves in Mongolia, Shaanxi and Gansu provinces, delivering coal as power to the coastal cities. This has the potential to put further pressure on the imported prices of thermal coal, as seaborne coal from Australia will have to compete with these stranded coal deposits delivered into the coastal cities as electricity.

Proposed UHV Power lines from Interior Coal Deposits

Commodity-financing and the ports

Tianjin Port is the largest port in Northern China and the main entry to Beijing. It is the largest port in Mainland China and is the fourth largest in the world in terms of tonnage moving through it. The port processes shipping containers full of manufactured goods on the way out and bulk goods such as iron ore, coal and oil on the way in. The port's management was seeing increasing iron ore imports and single digit growth in the volume of containers being exported. In terms of iron ore stockpiles, like all ports Tianjin is holding a large amount of ore. However they are not concerned about iron ore inventories, as the decline in pricing in 2014 has been orderly. In 2008 the precipitous fall in iron ore saw traders absconding in the middle of the night, after ore bought at US$180/t suddenly fell to US$80/t. There is not the same level of panic this time.

Chinese ports are a hot topic for Australian investors for reasons ranging from iron ore inventories at ports to metal financing fraud at the **Port of Qingdao**, the third largest port in China. This scandal is related to a Chinese company Dezheng Resources using imported metal (in this case copper and aluminium) in bonded warehouses as collateral for multiple loans. In Qingdao, 100,000 tonnes of aluminium (worth US$180 million) and 20,000 tonnes of copper (US$140 million) were pledged as loan collateral multiple times, but according to Tianjin Port they avoid this risk as they match up the buyer and seller of the metal in their warehouses and thus take on little market risk.

The metal financing scandal is related to the underlying theme of the misallocation of capital in China's financial system; in that a portion of China's metal imports are used as collateral to obtain loans. Here private companies that are unable to access normal bank loans to finance their activities, can sign an import contract for a tonne of aluminium and then use this as collateral to obtain a six month letter of credit from a another foreign bank. The cost of a letter of credit is just 3-5% pa, whereas a 6-month loan from a bank may incur an interest rate between 10-15% pa, so this can be an attractive source of short-term funding. The bigger issue for Australia's commodity producers is the amount of metal sitting in warehouses collateralising debt, rather than being consumed by industry that could be released by the unwinding of this commodity-financing trade.

Fog in Shandong

The **China Hongqiao** aluminium plant was buzzing during our visit as Ma Lin (Beijing Olympics gold medal winning ping-pong player) was visiting the plant to meet the workers. **China Hongqiao** is based in Shandong province and is China's largest private resource company with 120,000 employees and is engaged in the manufacturing of aluminium products (5th largest global producer) and textiles. Unlike giant SOE aluminium producer **Chalco** that we met in Beijing, the privately owned Hongqiao is profitable and has its own coal fired power plants and grid with 4.4 gigawatts (GW) and is currently expanding this to 5GW. To put this in perspective the entire electricity generation capacity of New South Wales is 12.7 GW. This means that Hongqiao's power costs are half that of the non-integrated aluminium smelters and results in the company being profitable at current prices, a rarity in the aluminium world. The combination of the coal-fired power plants and aluminium smelting undoubtedly contributed to what was described as dense "fog" around the neighbouring region. Of interest to Australian investors in Alumina and Rio Tinto is that **Hongqiao** is currently expanding their aluminium smelting capacity by 500kt notwithstanding anaemic global aluminium prices.

11am: Heavy industry at work, boosting Sydney house prices?

Despite all this massive investment in aluminium smelters and coal-fired power stations, Hongqiao only trades on a price earnings multiple of 4.5 times earnings due to concerns about the future of the business. Apparently Hongqiao has not secured permits from the central government in Beijing for their aluminium expansions. These concerns by investors look to be well placed, with Chinese news sources reporting recently that Hongqiao's CEO had been arrested soon after our visit for unspecified reasons. One could argue that China's variability in protecting private property does little to incentivise investments such as scrubbers to reduce emissions from coal-fired power plants.

Shandong Hi-Speed is a SOE operating 1,936km of expressways and 743km of railways in Shandong province, including the world's longest bridge over water, the 42 km Jiaozhou Bay Bridge. Shandong is the third largest provincial economy in China with significant heavy industry and a massive port at Qingdao. Unlike portfolio stock Transurban (whose tolls increase with inflation), Shandong Hi-Speed has little control over pricing, as tolls are set by the state. Whilst traffic has been growing at ~10% per annum (combined passenger and commercials) over the last 2 years, from driving around these roads in peak hour there appears to be significant capacity of the company's tollways to carry more volume.

As **Shandong Hi-Speed** see few growth opportunities in toll roads, they are diversifying into zinc and tin mining in Inner Mongolia and have recently expanded into property development with 11 property projects (commercial and residential) across Shandong province. Whilst mining and construction would seem very tangential business lines for a specialist toll road operator, it is understandable in the context of capital allocation decisions in China. As a SOE, Shandong Hi-Speed not only generates excess cash from its roads, but more importantly unlike private developers it has access to cheap bank funding and land. These eleven property developments undoubtedly contribute to overall Chinese steel consumption. Also it is unlikely that these mining and property strategies would be undertaken by a toll-road operator in a market economy in the face of resistance from the company's investors and lenders.

Steel and heavy industry in spicy Hunan province

Hunan province is located in southern China with a population of 64 million and is regarded as having the spiciest food in China. The province is home to a range of heavy industrial companies with operations across China.

Sany Heavy Industry has grown from a small welding factory in 1989 to the world's sixth largest manufacturer of heavy machinery (excavators, cement trucks and road construction machines) and is regarded as a good barometer of the health of the Chinese economy. Overall Sany indicated that whilst business had been good over the first three months of 2014, demand had fallen off in the second quarter. The company had been hearing government talk about infrastructure stimulus packages, but Sany had not seen it flowing through into actual machinery orders. Regarding the financial health of Sany's diverse customer base, the company has seen receivables increase in 2014 and in response they have started increasing the deposits required to be posted by more "at-risk" clients. On a more positive note, in the second half of 2014 Sany expect higher machinery orders from the continuing rebuild in Sichuan after the 2008 earthquake and a potential stimulus package targeted in the Western provinces.

Moving back up the steel chain we then met with **Hunan Valin Iron & Steel,** one of the largest global steel producers that also owns of 15% of ASX-listed miner **Fortescue Metals**. Similar to Sany, Valin provides not only insight into the health of the Chinese economy, but is a major buyer of Australian iron ore and coking coal. Valin's percentage of imported iron ore used in its steelmaking operations has grown to 90% from 70% in 2010. This has occurred due to both domestic producers shutting down and higher quality Australian ore allowing Valin to meet reduced emission standards. Despite their shareholding in Fortescue, Valin only take 20-30% of their ore from Fortescue. The rest is sourced from BHP and RIO, which raises the overall quality of blended ore used in their mills.

Valin had no issues with the big-end users paying their bills on time, but saw that it was the smaller steel traders that are having troubles. They saw that property-related steel demand (fixtures and fittings) was weakening, but industrial users have clearly picked up from Q1 2014. Steel demand from the carmakers and utilities was strong and quite strangely so was steel plate for ships. The company then made a joke about China building battleships to take on the Filipinos in the South China Sea!

Large Development outside Changsha in Hunan

The picture shows a model of Sinochem's (China's largest fertiliser company) large property development project in Changsha involving 2 commercial towers (each 238m tall with helicopter landing pads), a shopping mall and 2,100 high end apartments.

The reason why this state-owned nitrogen producer is involved in a very substantial property development, is that they have the connections to get the land and can access capital from SOE banks at very low cost. This again raises the issue of capital misallocation in China and government-enterprises potentially "crowding out" the private sector in the competition for capital. Obviously this can lead to SOE industrial companies potentially making property development decisions that private sector developers, paying a market rate to access debt capital, may not make.

It is not just chemical manufacturers trying their hand at property development. In 2013 the largest listed sugar producer decided to change its name from **Xiwang Sugar** to **Xiwang Property**, exit the sugar business and move into real estate development. This move has not proved to be successful for the erstwhile sweetener producer, with the company recently reporting expanding losses as they timed their entry into the property development market during challenging conditions.

Property market

The **Sinochem**'s A$2.2B Changsha Meixi Lake project (pictured above) is in the early days of construction, though sales have been slower than expected, in part due to government regulations aimed at restricting investors from buying multiple apartments. Consequently the company is slowing the pace of development. However in China apartments are used as a store of value due to the paucity of investment alternatives available. Looking at the investment options available to Chinese retail investors:

a) Bank deposits currently offer negative real interest rates;

b) There is an understandably low level of trust in the equity market;

c) Ordinary investors cannot access global investments; and

d) Physical gold purchases are limited by the government.

In the last few weeks a range of Chinese cities including Tier 1 cities such as Beijing have been loosening restrictions on multiple apartment purchases to stimulate demand for real estate. In January 2014, 47 Chinese cities had ownership restrictions in place, of these 34 have either reduced or abandoned restrictions in a move to bolstering demand. Additionally the big four Chinese state-owned banks have been offering discounts on their mortgage rates, with average mortgage rates for first-time house buyers falling to between 6% and 6.2% in an attempt to support the property market.

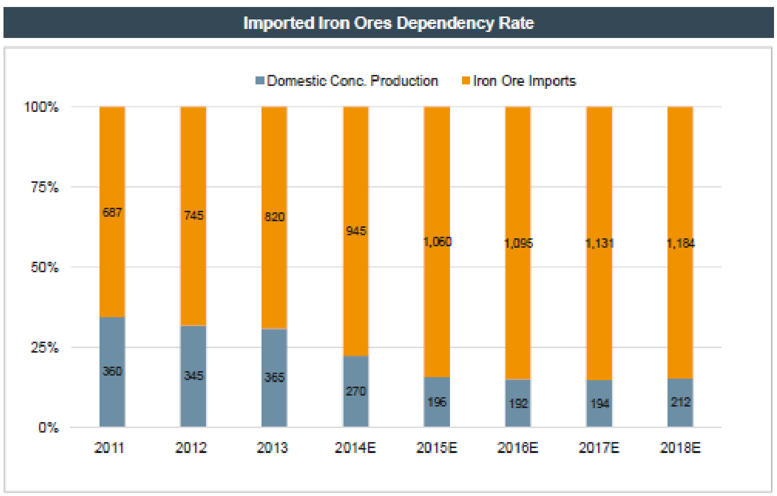
Iron ore and China

China's rapid industrialisation and its associated demand for raw materials have had a dramatic impact on the Australian mining sector. Australia's iron ore miners have been the greatest beneficiaries, due to China's lack of high quality iron ore. From the 1960s up until 2010, iron ore prices were set annually in negotiations between the miners and a group of Japanese steelmakers, usually represented by Nippon Steel. During this period prices were stable, with the Japanese buyers generally holding the dominant hand in these negotiations. The dynamics in the iron ore market changed as China dramatically expanded its steel industry and consequently its demand for imported iron ore swelled from 72 million tonnes in 2000 to 650 million tonnes in 2010. This resulted in the breakdown of the forty year old annual contract system into the current system of "spot" and quarterly pricing as Chinese buyers competed with the Japanese for iron ore. A big impetus for the breakdown of this system was a cultural difference as to the meaning of a contract. Certain Chinese steel mills defaulted on iron ore contracts during the GFC to buy cheaper ore on the spot market, viewing the annual iron ore contract as an option not an enforceable legal obligation.

Ongoing Chinese demand for iron ore will be a major driver of profit for the Australian mining sector with the mineral accounting for 52% of BHP's and 93% of RIO's profits in the August 2014 results season. As of July China appears to be on track to import a record 925 million tonnes in 2014.

Shanghai Metal Market (SMM) provides spot prices for over 300 base and precious metals along with rare earths and scrap metal, however, for Australian investors our focus is understandably on iron ore. Over the last month iron ore has weakened to below US$90/t, which has put pressure on the share prices of high cost miners like Fortescue and Arrium (formerly OneSteel, spun out of BHP in 2000) and has even caused iron ore junior Western Desert to collapse. This weakness has been ascribed to China's steel mills destocking iron ore and a wall of iron ore supply (mostly from the majors), leading some market commentators to suggest that the game is over for the Australian iron ore miners. The recent August results season suggested that whilst the future may be bleak for the high-cost junior miners, the additional volumes being sold by BHP and Rio Tinto are supporting profitability even as prices weaken.

Whilst supply has increased and the Chinese mills have run down their stocks, SMM revealed that a degree of the recent price weakness was due to companies using imported iron ore to obtain credit, and then having had their position sold out by the financing banks after 6 months of price declines. This ties into the recurring theme of the inefficient allocation of capital in the Chinese economy. Here private sector companies that do not make steel, will import iron ore to get access to credit at a price below what they would have been charged by shadow banks.



Data Sources: SMM &Steelease

We understand that 320kt of iron ore was sold into the market recently by banks and that there is approximately 10MT of iron ore sitting in Chinese ports tied up in these financing deals. Once this is digested, iron ore prices are likely to rebound in line with the traditional re-stocking before winter, which is positive news for the Australian miners. Further, SMM sees imported iron ore (primarily from Australia) gradually replacing the higher cost domestic ore in the table to the right. Chinese iron ore is high cost due to both the small size of their mines and the low contained iron content. Indeed China’s ore mined in 2013 contained an average iron content of 26% which is probably a similar content to the dirt at Perth Airport and a fraction of the 62% iron content of the ore shipped by the Australian majors.

Luxury not dead

One of the more bullish meetings on the tour was with **China Yongda Motors**, showing that the top end car buyers in China are not curtailing their purchases of luxury cars. Yongda has 130 dealerships and 38 under construction in coastal China across 41 cities, focusing on luxury brands like BMW, Cadillac, Audi, Bentley and Porsche. German brands account for about 70% of China's luxury car market and China is BMW's biggest global market. Yongda claim that they have not felt President Xi Jinping’s anti-corruption crackdown, as their main brand by sales is BMW. Officially government officials can only buy state-approved car brands, one of which is the highly favoured Audi. In 2014 the company was trading well with revenues up +20% from 2013 and profits up +25% due to the ultra-high-end brands. This is despite the almost Australian-level prices that Chinese motorists pay for their luxury marques. For example a Rolls Royce Ghost sedan is priced at A$715,000 in China and A$650,000 in Australia both of which are far above prices in the US (A$266,000) and the UK (A$285,000).

Summary

After meeting with over 40 companies across China on this trip it would appear unlikely that China is going to collapse in a heap any time soon. Nor is it likely to generate GDP growth of 10% as it did in 2010, courtesy of a super-charged US$586B stimulus package that delivered iron ore prices of US$180/t to Rio and BHP. Steel and aluminium production capacity is still being added and it would appear that the mini-stimulus plan targeted to support specific sectors like shanty towns improvement, railways, tax relief for small business and water conservation is having a positive impact.

The seemingly widespread misallocation of capital, funded by debt borrowed from both the official banking sector and the shadow banking sector, seems incompatible with the extraordinarily low officially reported levels of bad debts held by lenders. Much of the 2000s was spent cleaning up the pile of bad debts from the orgy of poor investments funded by poor lending decisions in the 1990s lending binge. It seems the Hu Jintao government (2002-12) learned few lessons from the 1990s lending binge and the 2000s clean-up, but the new Xi Jinping government appears to have more resolve.

Politically, Xi Jinping’s administration appears to be differentiating themselves from the previous government under Hu Jintao by focusing on reforms rather than just economic growth at any price. This should be interpreted as a higher tolerance for lower growth, but the Communist Party of China still has to deliver growth to remain in power and this will continue to be positive for Australian companies exposed to China.

As an interesting observation it would appear that the anti-smoking campaign in China, the world’s keenest smokers, is starting to work. During this trip, unlike previous trips, nobody smoked during the meetings and we were offered green tea rather than a pack of cigarettes at the start of each meeting. Whilst Amcor is a well-run company, I would be concerned about the value of their Chinese tobacco packaging division!

"**PHILO VANTAGE POINT**" – is a research series intended for serious long term investors interested in exploring and understanding big picture events, developments and structural shifts and their impacts on investment markets.

PHILO CAPITAL ADVISERS

Philo Capital Advisers Pty Ltd

Level 11, 37 York Street Sydney NSW 2000 Australia

P: 1300 303 323

P: +61 2 9112 2800

E: enquiries@philocapital.com.au

ABN 70 119 185 974 AFSL 301808

www.philocapital.com.au