“If you want to get laid, go to college. If you want an education, go to the library.”

- Frank Zappa

Observations

Everyone in China is now back to work after a hellish “Golden Week.” When you have up to 740 million people on the move at the same time it is unlikely many felt they enjoyed a high quality vacation. Even with slower GDP growth in the 7s, at least those stressed out travelers have jobs to get back to. Looking to our own industry, in our beloved financial sector over 26,000 jobs were cut in the first seven months of this year alone. A recent report from Nomura predicts greater headcount reductions to come. From 2010 through the first half of this year, revenue growth at GS is down 31% while headcount is down just 1%. MS has seen revenue fall 14% over the same period but headcount is down 2%. Reportedly, JPM has actually increased headcount (+8%) while revenue fell. Banks facing greater regulation and waiting for a recovery that hasn’t materialized will have to continue to slash costs to stay in the game, said the analysts before they lost their jobs.

Go to Harvard, Join the Peace Corps

Not surprisingly, the quickly fading fortunes and ever modestglory to be won in the industry is having an impact on the career choices of the next generation of masters of the universe. Recent MBA statistics indicate a clear decline in the number of graduates choosing a financial services career. MBA puppy mill Wharton sent just 16.6% of its 2011 class to investment banks compared with 25% in 2008. Mitt Romney’s alma mater, the Harvard MBA program this year is also seeing lack of interest in finance with one third less graduates pursuing investment banking as a desirable career choice.

Looking further into the subject of education, we find that ever more students from China are leaving the country to study abroad. As of 2011, there were 340,000 of them overseas, a large number that has been growing at a 20% clip for a number of years. In the past, almost all of these “liuxuesheng” were
pursuing advanced degrees in foreign universities. No more. Now pre-university students are being sent abroad in record numbers and that segment is growing even faster at 30% pa.

In hyper-competitive Hong Kong, it was interesting to see the mass demonstrations against the Orwellian policy of “National Education” - brainwashing effluent mandated by Beijing to be beer-bonged into impressionable Cantonese youth. 10 days of protests which, by some counts, reached “tens of thousands” of angry citizens caused an immediate climb down by the new gov’t of CY Leung. Some, however, were ambivalent toward the subject as reported by the SCMP: said Leung Kee-cheong, principal of the Fresh Fish Traders School (the what??), “We will teach the good side of the country to make students proud, but we will also teach students the dark side of the country to make students committed to China’s future development.”

For me, one of the benefits of moving back to the US is I now walk my six year-old daughter, Asmara, to school every morning. She is learning pretty uncontroversial stuff, like how to tell time on an analogue clock, so I don’t feel like going out and protesting. And each day, mindful of my parental duties of instilling the correct moral tone for her upbringing, I tell her, “Study hard. Get a good job. Support your parents.”
So what of stocks? Markets are going up (and I believe will continue to do so) yet the street screams, “Sell!” The chart above comes to us courtesy of ML. The “Sell Side Indicator” is based on the average recommended equity allocation of Wall Street strategists as of the last business day of each month. This is a reliable contra indicator, according to ML’s Equity and Quant Strategist, Savita call-me-a-contrarian Subramanian. It looks interesting and either represents “the death of equities” or a great buying opportunity.

Fund flows into emerging markets continue to be positive. As Jae-Hun Lee points out in his weekly, “Liquidity Tracker,” a stronger ADXY index (which measures the relative strength of Asian currencies to the USD) is helping. The index is called the “JPM Asia Dollar Index” yetit doesn’t encompass then yen. (Recent layoffs in researchand a twenty-year Japanese recession mean maps at JPM don’t include Japan anymore). Since the start of September, the index is up 1.4%, a largish move for currencies.
The ADXY largely reflects the moods of the **Redback**; with a 37% weighting, the Rmb is dominant among the ten constituents. A strengthening Rmb should help to arrest capital flight, potential inflation (latent though it may be) and give Beijing more room to ease without fear; either with a continuation of looser monetary policy or fiscally with more spending and even tax cuts.

However, **pessimism reigns supreme in China’s equity markets**. According to Bloomberg, the number of Chinese stock accounts containing actual funds dropped by 1.1 million to 56.1 million in the year to September 21 – the most for a 12-month period. Currently, the Shanghai index is trading at 11.4 times earnings, the lowest level in 15 years and at a steep discount to fellow BRIC Brazil, at 19 times.

As the Welsh say, “**To the brave belong the fair.**”
Ruminations

Two weeks ago, CTRIP (CTRP US) sold $180 mn of five-year convertibles. What was unusual and worth noting was the structure and opacity of the transaction. I have looked carefully at CTRP’s recent issue and on the surface it does raise questions. Management bought $55mn of the deal and ostensibly will use the funds to buy back shares. But why go to all this trouble using a puttable CB (9/15/2017) and a warrant transaction with a “hedge counterparty,” when a straight share buyback program is so much simpler? Upon further investigation, however, here is what I found.

(Full disclosure: I own this stock. Unfortunately, I have owned it for a long time!)

CTRP re-priced share options for employees at the bottom of the financial crisis with longer maturities, thus causing predictable shareholder angst. The message was clearly communicated to management that this type of behavior is not acceptable and I think it might have some bearing on how they have structured this transaction.

The company has announced several share buyback programs totaling US$500-600mn, or 25% of outstanding shares. The most recent repurchase program was just announced on June 13th for $300 mn. Reportedly, in total CTRP has already bought back $200 mn and $300-400 mn is remaining to be executed. Initiating another program while the existing program has yet to be completed would not make much sense. There is also a tax benefit to getting money offshore this way without having to suffer a 5-10% “transfer tax” in the PRC. Funds raised from offshore, non-management parties in this transaction totaled $125 mn.

What has likely happened is management were approached by an investment bank who is loaning them the money to get the deal. Management bought $55 mn worth, or a third of the $180 mn CB. The coupon is extremely low: 0.50% per annum. This is due to the conversion feature and low pricing: 10%
premium to the closing price on September 18th. (Just for a somewhat unequal comparison, Tencent issued US$600 mn in senior notes last December, due 2016 with an interest rate of 4.625%).

From management’s point of view, assuming these assumptions are true, they get financing to buy stock they believe is cheap with downside protection (conversion feature), while receiving interest payments semi-annually. What’s not to like? From a shareholder’s point of view, management is putting their own money, in size, into the deal and this means they are confident in the outlook and believe the shares at current level are undervalued. Indeed, market reaction to the deal announcement was positive with the stock up that day 5.6% on trading volume four times higher than the three-month daily average.

So without any more evidence of “dirty deeds done dirt cheap” (just heard some AC/DC on the radio yesterday) you have to either give them the benefit of the doubt or sell the shares based on the assumption of future corporate mis-governance associated with this transaction.

However, if a guy were to dig a little deeper and calculate the vol of the embedded option to the realized and implied vol of the stock's traded options – would he find a disparity in favor of management? If this were the case, then shareholders should voice their displeasure.

What I did find even more interesting, however, was their terrible H1 results. Operating metrics for CTRP on any measure stink:

While net revenues were up 18% y-y, cost of those revenues rose 32%. Operating income plunged 35% and net income fell 34%, year on year. Share based compensation, however, leapt 32% to $33 mn. Overall, CTRP are facing falling hotel comms, falling air ticket comms and higher promotional expenses. Taken in isolation this is alarming. However, CTRP is “responding to competitive pressures in the market” as they had it too good for too long. I guess historical comparisons are going to look unfavorable as a
result for some time. They have hired more sales people and are spending more on marketing and product development. $700-$800 mn cash on the B/S is reassuring but I would be watching that like a hawk to see if their new battle plans are bearing fruit or just burying them.

My view: Don’t sell. Give CTRP time to turn things around. With positive signaling from management and an aggressive turnaround strategy in play, the stock is likely to move higher from here.

Research

Now is a good time to look at a bigger issue. CTRIP is a VIE (variable interest entity) and China’s government is looking at this structure more carefully. Change is in the air and that could be dangerous to shareholders.

“VIE” may be the airport code for Vienna but for our purposes it stands for “Variable Interest Entity” and is an imaginative paper shuffle created by desperate bankers to bring foreign money into restricted sectors of China’s economy where it is not allowed. Its sole purpose is to “Zouhou men,” or “Go through the back door,” as the Chinese like to say (and do). The structure was first used by Sina for their IPO in 2000, since then more than a hundred Chinese companies have utilized the VIE structure to obtain an offshore listing, including, Alibaba, Tencent, Baidu, Tudou, New Oriental, Focus Media, etc. In fact, almost half of US-listed Chinese companies are VIEs.

The VIE works not through direct equity ownership but by contractual arrangements. In a restricted sector there are real operating companies which have the necessary licenses, based in China and owned by Chinese citizens. So far, so good. The founder/main shareholder then establishes a Special Purpose Vehicle (“SPIV”), usually in the Cayman Islands or the BVIs, which will become the offshore listing
vehicle. This offshore entity then establishes a **WFOE** (Wholly Foreign-Owned Enterprise) in China which enters into contractual arrangements with the operating companies. The WFOE, via these paper contracts, assumes management control and all economic benefits (or losses) of the OpCos. Here is one diagram I ripped off from CTRIP’s registration statement:

It looks like a printed circuit board, doesn’t it? The risks here are many and pretty daunting. First, you the shareholder, don’t own anything other than an offshore shell company that has contracts with some Chinese companies. Usually, the major shareholder of the shell company is also the major shareholder of the operating companies – no chance of conflict of interest there. Finally, if the OpCo decides not to honor its contract you can sue. While paper money may have been invented in China, they have never had much time for paper contracts. Good luck with that lawsuit. Enforceability in China is pretty close to zero.

Actually, it gets scarier because China has never signed off on this type of arrangement. Beijing knows, of course, what is going on and has chosen – so far – not to say anything. But they could and they might. This is your sword of Damocles. Like being an outspoken critic of the Chinese government, it is fine until it isn’t. There’s a knock at the door late at night, thundering footsteps race up the staircase and that is it.
C’est la VIE

Recently, there have been two high profile cases of the VIE structure coming under attack. In July, **New Oriental Education** (EDU US) fell 34% in one day during their fiscal Q4 results announcement when they revealed an ongoing SEC investigation concerning the recent consolidation of their VIE. The stock swan dived another 35% the very next day when, with exquisite timing, shorting sharpshooters **Muddy Waters** released a negative report on the company.

The other, and more revealing incident, came last year when ownership of **Alipay** was “transferred” by Jack Ma from **Alibaba Group**’s VIE – without formal agreement from the other major shareholders, **SoftBank** and **Yahoo**. As if by magic, one of the 40 thieves that is the company’s namesake arrived on a magic carpet and “misappropriated” Alipay. The foreign shareholders were given the choice of whining…..or whining.

**Hong Kong Pulling in the Welcome Mat**

**Huawei** and **ZTE** are in the news after a US congressional committee recommended banning them from selling their networking equipment in the US. Given recent anti-China sentiment, cases of fraud at US-listed Chinese companies, increasing regulatory oversight coupled with the fragile nature of the VIE structure there is speculation in the market that that such companies will just decamp back to friendlier shores and list in Hong Kong. The reality is, however, slightly different.
While the Stock Exchange of Hong Kong has allowed listing of VIE companies in the past, most notably Tencent (700 HK), in August this year they quietly issued stricter regulations regarding the structure. A summary can be found [here](#). Contractual arrangements are considered “material in nature” and will have to be fully disclosed in future prospectuses. Furthermore, these contracts must have a rationale for existing – meaning they can only be for restricted businesses. Any future VIEs with IPO hopes in Hong Kong that are adopted for unrestricted businesses will be referred from the Listing Division to a case by case examination by the Listing Committee. I read this to mean they will just not be allowed.

**Dual Share Class is No Class**

Another potential stumbling block for US-listed companies that would like to move to the Hong Kong exchange is the little known difference of regulations regarding ownership structures. Now this is actually more interesting that it sounds. Hong Kong does not allow separate share class structures where voting rights are materially different. In fact, reportedly officials at the SEHK refer to the US exchanges, such as Nasdaq as, “The exchange of last resort,” for these types of companies.

**Facebook** – a company I love to hate – is one of the most recent and egregious examples. I am not “on” Facebook, much like I never got “in” to disco. (I tried it once, Facebook, not disco, and just had too many old girlfriends contacting me… Happily for the lawyers, not only did the IB’s completely screw up FB’s IPO, with some help from Nasdaq, of course, but there are two other worries out there. Firstly, **why would you want to own a stock where you effectively have no control over management?** The anti-social, media-shy king of social media, I am referring to adolescent man-child *Mark Zuckerberg*, owns 18% of the company, but through his Class-B shares which carry 10 times the votes of your Class A shares, he controls 56% of the company. He is founder, CEO and Chairman. There are no independent board members and nor a compensation committee. As the company put it in their registration statement (S1): **“This contractual control will limit your ability to influence corporate matters for the foreseeable future.”**
The other reason I would not want to own FB is the interesting mathematical problem of current float equaling 560 mn shares while 1.2 billion employee and early investor shares are coming out of lockup by the end of this year. This is a share tsunami. Seek higher ground.

Yet Facebook is not alone in treating shareholders like peons: according to Forbes magazine, about 6% of US companies employ this type of structure, including Google where the two founders own 21% of the company but control 73% of the votes. Viacom was even worse: 89-year old Sumner Redstone controlled 10% of the economic share of the company but had 79% of the votes. Studies have shown these types of companies, essentially run by a Louis XIV absolute monarch, among other things tend to waste cash pursuing vanity projects and take on more debt than is prudent.

It’s GOOD to be the King

My view: More likely than an unsuccessful migration to Hong Kong, many of the US-listed China companies will privatize or be bought out. Online gaming company, Shanda Interactivemay be the
model. The company Delisted from Nasdaq and was able to sell some assets to Chinese buyers at higher valuations than were priced on the US market. Another example is **Focus Media**, which has received a $3.5 bn buyout offer from a consortium of PE firms and the founder. Reportedly, 12 US-listed Chinese firms have announced plans to privatize and if the heat is turned up, many more will also consider this step.

### The Last Page

I’ve always wondered if it was an urban myth about missing pets and Chinese restaurants. It appears in some parts of the country there could be more truth to it than you wished. Last week a formerly unknown Chinese restaurant, the “Red Flower” in formerly unknown Williamsburg, Kentucky was closed by health inspectors. Nothing unusual in that, restaurants get shut down for minor infractions all the time. This, however, was more.

It seems that while dining customers saw employees wheel into the kitchen a large trashcan, dripping blood, that had a deer leg sticking out of it.

“It was real disturbing. There was actually a blood trail that they were mopping up behind the garbage can,” customer Katie Hopkins told TV news reporters.
When confronted by the environmental health inspector who was called to the scene by alarmed customers, the owner of the Red Flower claimed he didn’t illegally shoot the deer, which would be a crime. “Don’t worry. We found it along I-75,” the interstate highway, he explained helpfully.

Daily Special: Get your fill of road kill. Tonight we are offering Smear of Deer, or perhaps you would fancy a little Center Line Bovine, done medium rare with a touch of rosemary? You’ll notice on the kiddie menu our perennial favorite and highly recommended, German Shepherd Pie. And for dessert, may I suggest the Road Toad a la mode?

The animal had already been gutted and cleaned by the time the inspector arrived which, he drily noted in his report, “raised many health and environmental issues.”

“I don’t think I’ll ever eat Chinese food again,” Hopkins told reporters.

Pizza tonight for me.

Derek Hillen, CAIA
Mirae Asset Securities