PM Capital

Demystifying China's *One Belt, One Road*

The Chinese Government is spending $330 billion on infrastructure better linking it to the rest of the world. However, this important initiative and its effect on China and markets have been neglected.

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One Belt, One Road

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KEY POINTS

Encompasses over 60 countries

Economic and geopolitical ramifications

Provides significant opportunities for countries and listed companies in the region

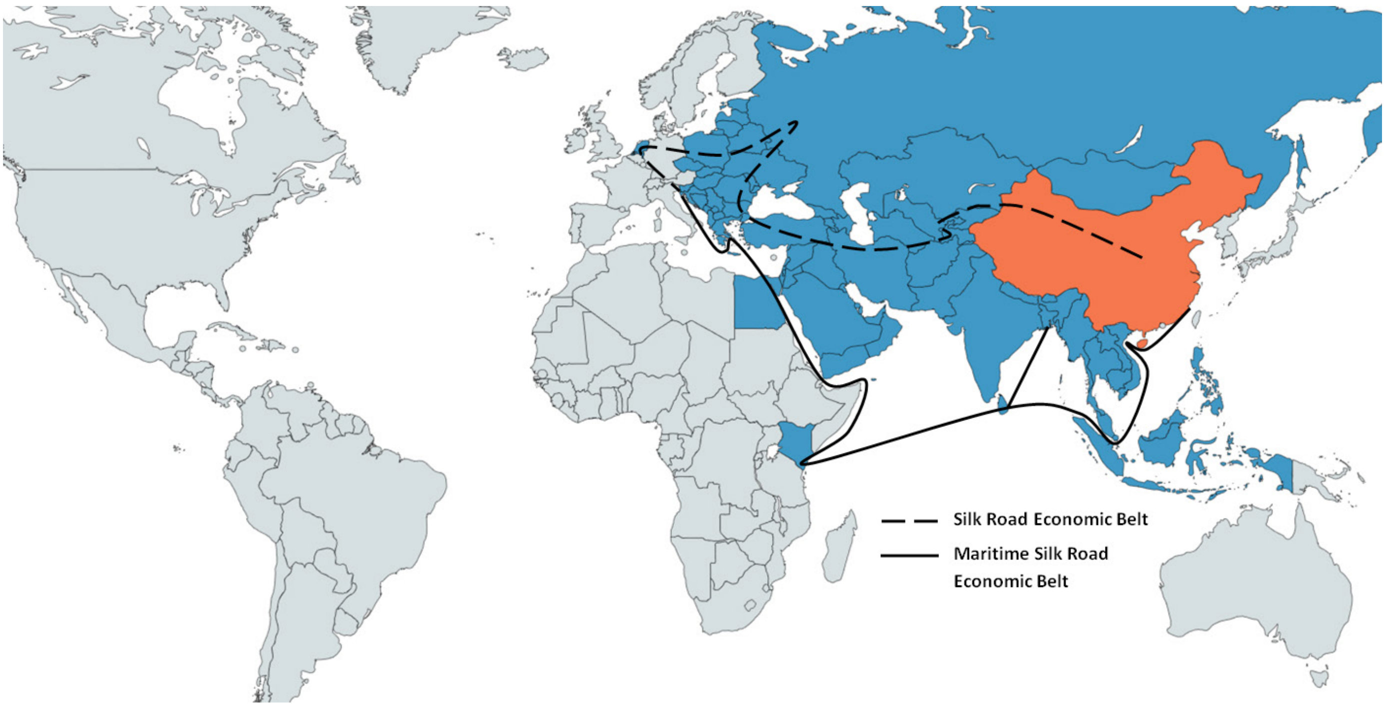
China's 'One Belt, One Road' initiative, commonly referred to as the 'New Silk Road' and the 'Maritime Silk Road' after the two central elements of the plan, has been widely referenced since being initially launched by President Xi Jinping in 2013. Despite being given broad coverage in the media, details of the plan are often neglected to the point where most people who do not follow China closely have a limited understanding of what the plan actually entails and what China hopes to achieve.

Why has China embarked on One belt, One Road and why is it so important? Why is it attractive to China's regional partners and how can portfolios concentrating on the Asian region positid to benefit?

Encompassing over 60 countries and with over $330 billion in funding pledged from the Chinese Government as well as regional and global infrastructure and development banks, One Belt, One Road marks China's evolution from a country focused predominately on development at home to one expanding its sights to the international stage.

The backbone of the plan is to develop the infrastructure network that links China to the rest of the world through two corridors. Firstly, the New Silk Road connects landlocked Central China to Europe through the Central Asian and Middle Eastern corridor. Secondly, via the Maritime Silk Road, China plans to foster the development of maritime transportation infrastructure linking China to Africa, the Middle East and Europe. Beyond these two central elements there is also considerable investment being made across Asia to improve the interconnectivity of the region.

Figure 1: One Belt, One Road trade routes



Source: PM Capital, Mapchart.net

One Belt, One Road

The One Belt, One Road terminology itself conjures up immediate thoughts of the roads, bridges and railways etc. which will be built to better connect China to the rest of the world but, in truth, the initiative is far more complex than your average run of the mill infrastructure investment program. From China's perspective the purpose is both economic and geopolitical.

ECONOMIC HIGHWAY

From an economic perspective improved interconnectivity allows Chinese corporates to better access export markets, particularly Asian emerging markets. As China's population matures, in the coming decades domestic infrastructure investment will inevitably slow, resulting in excess capacity across various industries. China recognises this and is restructuring industries such as steel and coal. It is also looking to develop export markets for its higher value add capital goods industries – power generation, telecommunications and construction equipment in particular.

> The One Belt, One Road initiative is targeted at emerging markets where localised competition is negligible, price is a principal consideration and China is generally viewed more favourably.

Chinese companies have found it difficult to break into the lucrative North American and European markets, with the presence of entrenched incumbents and a heightened level of China scepticism - both from a product quality and security perspective – stifling progress. The One Belt, One Road initiative is targeted at emerging markets where localised competition is negligible, price is a principal consideration and China is generally viewed more favourably.

Further to the benefits flowing to export industries, as the Chinese Government continues to increase minimum wages to drive consumption, commodity manufacturing industries will be forced to move offshore where production costs are lower. This will inevitably lead to a much more fragmented supply chain as no one country has the scale to single-handedly replace China. Improved transportation linkages between China and its neighbours will therefore become paramount for product supply chains in the region to operate effectively.

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From a geopolitical standpoint One Belt, One Road is evidence of China exerting regional leadership through investment. It is hard to debate China's growing ambitions to contest the influence of the United States on the world stage, particularly across the Asia region. The opportunity to do so has become more pronounced since the election of President Trump who has retreated from the United States' long held support for globalisation. Regionally, President Trump's 'America first' policies are a significant change of tack from that of the Obama Administration's 'pivot to the Pacific' policy and leaves empty shoes for China to fill. Greater trade ties and geopolitical influence also gives the Chinese Government a platform to promote the internationalisation of the Chinese Yuan, one of their major long term ambitions.

From the perspective of China's trade partners, the benefits of One Belt, One Road seem fairly obvious. Over the next decade significant investment is expected to be made in the economies of countries supportive of the initiative. Investment from third parties such as China has been welcomed by governments from Malaysia, to Pakistan, to as far away as Estonia. Governments in many of these countries are not in a position to invest heavily into their own infrastructure so a helping hand from China to stimulate their economies is appreciated.

On a recent trip to Malaysia I saw firsthand the impact One Belt, One Road is having on China's regional partners. Malaysia, situated on the Straits of Malacca, is ideally positioned to benefit from the Maritime Silk Road. Crippled by a decline in crude and palm oil prices in recent years, the Malaysian Government's budget position has come under significant pressure, leading to a reduction in investment. Offsetting the decline in government investment over the next few years will be over $40 billion (US$29.5 billion) of infrastructure projects, from rail lines to solar panel manufacturing plants, with links to Chinese investment and One Belt, One Road.

One Belt, One Road

Figure 2: Chinese investments in Malaysia

Lead Chinese Investors	Project	Cost (US$bn)
Road & Rail Infrastructure		
China Communications Construction Co.	East Coast Rail Line	12.9
China Communications Construction Co. & China Railway	Gemas-Johor Baharu Rail	2.1
China Harbour Engineering Group	Penang Bridge	1.1
Port Infrastructure		
Powerchina International Group	Melaka Gateway	7.0
Guangxi Beibu Gulf Int'l Port Group	Kuantan Port	0.7
Utilities		
Sinohydro Group	Bakun Dam	1.8
Sinohydro Group	Murum Dam	0.5
Logistics		
Alibaba	Malaysia Digital Free Trade Zone	1.6
Huawei Technologies	Data hosting & logistics centre	0.1
Manufacturing Facilities		
Guangxi Beibu Gulf Iron & Steel	Steel production plant	0.8
Shougang Group	Steel production plant	0.4
Comtec Solar Systems	Solar panel manufacturing plant	0.3
Daiyin Textile	Textiles manufacturing plant	0.2
CSR Corporation	Rail equipment manufacturing plant	0.1
		29.5

Source: PM Capital

For countries further afield, One Belt, One Road also provides a huge economic opportunity over the long term. Infrastructure investment opens up these markets to China and Asia which historically have not been major trade partners, giving them exposure to the consumers of tomorrow.

ROADBLOCKS

One Belt, One Road is an ambitious policy initiative with clear benefits for both China and its trading partners; however it is not immune to potential problems along the way. The most obvious threats for China today are capital outflows and the potential for a domestic banking crisis. Both would pose a serious risk to One Belt, One Road's progress as funds would need to be redirected to the domestic economy. Over the past 12 months we have seen the Chinese Government aggressively tackle capital outflows that has led to restrictions on foreign investments. Consequently, we have seen a slowdown in foreign investment in the short term – foreign direct investment fell 49% year-over-year in Q1/17. While capital flows appear to have stabilised, any acceleration in outflows would force the Chinese Government to act aggressively to once again address the issue.

The initiative also faces opposition from some groups sceptical of investment from China. These groups rightly argue that the economic gains flowing to participating countries in the near term comes come at the expense of economic benefits in the long run from relinquishing ownership of assets to Chinese corporations. But what politician thinks about the consequences ten years from now? Only one - China. Generally speaking though, economically and geopolitically the harsh reality is it will be better to be inside the tent than outside of it when it comes to One Belt, One Road.

> "...there are some opposition politicians in my country who say we are selling our sovereignty by agreeing to such projects. But I make no apologies for wanting to build world-class infrastructure for Malaysia..."
>
> Malaysian Prime Minister Datak Seri Najib Razak[1]

[1] Source: http://www.thestar.com.my/news/nation/2017/05/12/why-malaysia-supports-china-belt-and-road, Published 12th May 2017

STOCKS - EYES ON THE ROAD

We believe the investment implications of One Belt, One Road warrant greater attention from investors. Most of the analysis to date has focused on the benefits to China and Chinese firms – the engineering firms set to win construction contracts abroad or the domestic equipment manufacturers set to benefit from exporting their products globally. Among our Chinese holdings, logistics and infrastructure provider Sinopec Kantons is likely to be one of the biggest beneficiaries. As part of the Sinopec Group, it has invested along the Maritime Silk Road through the acquisition of Vesta Terminals in Europe and a greenfield oil storage development in Fujairah, United Arab Emirates.

We have also looked further afield for potential winners. Singapore listed DBS Group, one of the largest financial services and banking groups in the Asia region, has a strong corporate banking business throughout South East Asia and is well positioned to benefit from increased levels of activity. We have also recently initiated a position in Malaysia's largest cement producer, Lafarge Malaysia. Lafarge is set to benefit from a significant uptick in infrastructure expenditure in the country.

While these are three direct beneficiaries of One Belt, One Road we continue to look for further opportunities to expand our exposure to this theme in our portfolios.

Kevin Bertoli is the Portfolio Manager of the PM Capital Asian Companies Fund and PM Capital Asian Opportunities Fund (ASX: PAF). Kevin joined PM Capital in February 2006 and has managed the PM Capital Asian Companies Fund since inception in 2008 and the PM Capital Asian Opportunities Fund Limited, which listed on the Australian Securities Exchange in May 2014.

Kevin holds a Bachelor of Applied Finance and Bachelor of Business (Management) from the University of South Australia.

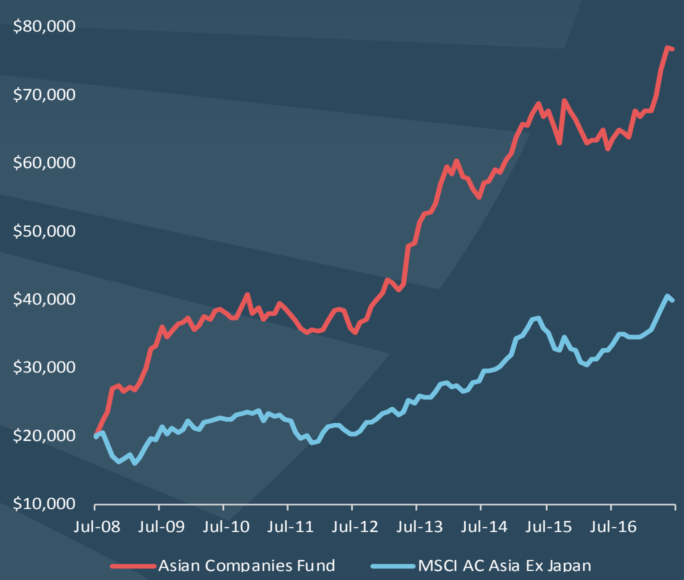
Asian Companies Fund

- **The Asian Companies Fund** aims to create long term wealth through a concentrated portfolio of typically 15-35 quality companies within Asia ex-Japan that we believe are trading at prices different to their intrinsic values.

- **The objective of the Fund** is to provide long term capital growth and outperform the greater of the MSCI All Country Asia (ex-Japan) Net Index (AUD) or RBA cash rate over rolling seven year periods. The Fund is not intended to replicate the index, investing in a concentrated portfolio of predominantly undervalued equities in the Asian ex-Japan region.

Fund category	Asian (ex-Japan)[1] equities
Investment style	Fundamental, bottom-up research intensive approach
Number of stocks	As a guide, 15-35 stocks
Minimum investment	$20,000
Suggested investment time	7 years +
Inception date	1 July 2008
Performance	5 years p.a. - 16.4% Since inception - 283.5%

Figure 3: Growth of $20,000 since inception



Further Information
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