The China Rambler

An Occasional Letter On Topics Of Interest To China Investors

Issue #2. "Seek Truth From Facts" **Jan. 2nd, 2025**

In this edition: What China Lilang (#01234) reveals about problems in China's banking system, why Café de Coral is still too expensive and how I'm setting up for 2025.

The Curious Case of China Lilang (#01234) And The Light It Sheds On Systematic Rottenness In China's Banks

China Lilang is a mid-market men's apparel retailer. I judge them to be a solid enterprise, and I own the stock. However, something strange happened to their balance sheet in 2022 (below) which sheds an interesting light on problems in China's banking system.

	Note	2022 RMB'000	2021 RMB'000
Non-current assets			
Property, plant and equipment	12	1,212,944	1,200,183
Investment properties	13	271,900	118,772
Right-of-use assets	14	250,147	289,437
Intangible assets	15	4,679	6,919
Deposits for purchases of plant and equipment		9,834	20,558
Lease rental deposits	14	41,625	44,296
Pledged bank deposits	18	200,000	—
Fixed deposits held at banks	19(a)	650,000	—
Deferred tax assets	24(b)	64,821	55,053
		2,705,950	1,735,218
Current assets			
Inventories	16	885,142	893,737
Trade and other receivables	17	842,625	795,076
Prepaid income tax	24(a)	2,643	—
Pledged bank deposits	18	81,227	12,104
Cash and cash equivalents	19(a)	960,114	1,571,619
		2,771,751	3,272,536
Current liabilities			
Bank loans	20	249,499	72,620
Trade and other payables	21	887,818	870,083
Lease liabilities	22	75,241	97,568
Contract liabilities	23	29,346	46,429
Current tax payable	24(a)	197,179	174,766
		1,439,083	1,261,466
Net current assets		1,332,668	2,011,070
Total assets less current liabilities		4,038,618	3,746,288
Non-current liabilities			
Bank loans	20	187,027	—
Deferred tax liabilities	24(b)	12,675	9,217
Lease liabilities	22	56,685	63,683
		256,387	72,900
Net assets		3,782,231	3,673,388

NEW

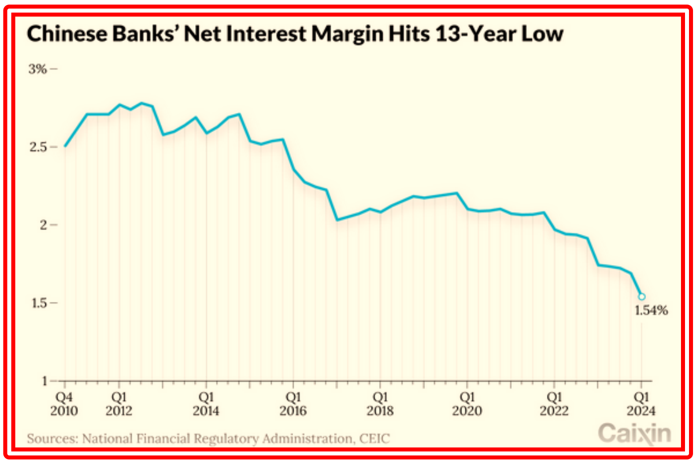
DIP

POP

NEW

In short. Despite a healthy cash position, they took on debt they didn't need in 2022, and not unnaturally I wondered why? I didn't wonder long though as they were kind enough to tell me what was going on in a conversation after their 2022 results presentation.

Here's the flavour of that exchange. Me, 'Why did debt *and* deposits go up in 2022?' Them, 'We were approached by a bank who asked us to take a loan and place a deposit at the same time'. Me, 'Why would you do that?' Them, 'They're paying us a spread'. Me, 'Huh, they're paying you to borrow money from them?' Them, 'Yes'. Me, 'I see, you're helping them misrepresent their lending to small businesses then?' Them, 'Hey, *they* approached *us*, besides, it's a riskless return from which our shareholders benefit'. Me, 'Oookaay…' In the context of China Inc. I didn't see a red flag and have chosen to remain invested.



Here's the bigger issue. Chinese banks are poorly rated for, among other reasons, multi-year declining Net Interest Margins (NIMs). The picture on the right was extracted from a Caixin article last June and is crystal clear. Part of the problem must be NIM-costs generated by loan inflation and Lilang is almost certainly just the tip of a phantom-lending iceberg.

If I'm aware of this issue authorities in China must be too. For all our benefit then here are some reminders of how elements of this faux-lending practice are not only just shabby, but they're also value destructive.

Element of The Practice	**Value Destructive Consequence**
Foie-gras-goose feeding loans into companies	Accounting confusion leads to lower valuations for firms affected, and thus the market overall
Paying companies a spread to play the game	For banks: lower NIMs/profit, lower valuations. For China Inc.: lower govt. revenue, misallocated capital
Regulators turning a blind-eye	Faith in competence eroded. Lower industry multiples, higher cost of capital. Lower industry returns
Misallocation of capital	Lack of trust in the system, lower investment, lower long-term returns, better businesses retarded

As noted, when I became aware of this process I didn't immediately cry 'Shenanigans!' and move on. Hate the game not the players; but it'd be a better game if the stewards would promulgate a rule change preventing this sort of play in future.

Stockwatch: Café de Coral #00341

Summary of a recent closer look

Basically: (All historic) P/E 14x. Yield 7.2%. P/B 1.6x. Market cap. H$4.5bn (U$577m). 3m Average Daily Volume 1.2m shares. Business: fast food restaurants and catering services.

Among Hong Kong listed companies this is regarded as somewhat of an aristocrat. They opened their first restaurant in 1968 and have grown, give or take a bit, steadily since then. Recently though they've faced adversity and at the same time I believe suffered a permanent negative shift in circumstance which isn't, yet, fully reflected in their share price.

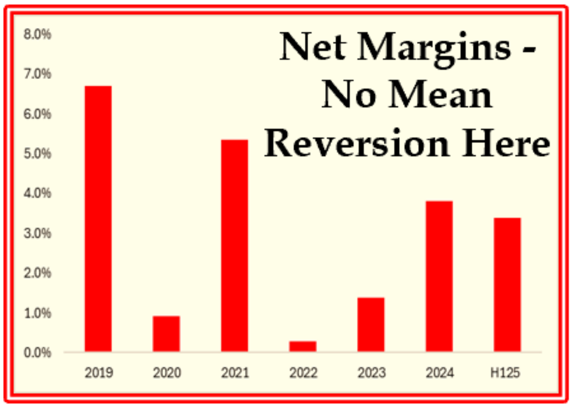
COVID was tough but at the same time accelerated an exponential increase in competition. It used to be just other street-level operators. Five, ten perhaps per location? Food delivery has changed that bringing in competitors in the thousands, many who work for nothing or run loss making businesses. They're dealing with it but there's no going back to the way things once were.

Not to like: They took out a loan they didn't need a while back. They say they panicked in early COVID. So why is the loan still outstanding? Another Lilang perhaps?

To like: Net cash, responsive IR, legacy, established brand and multi-year demonstrable competency. Business is difficult, but they're not taking it lying down.

Would I buy them? Yes. At the lower end of a fair-yield range. Fair being? 8%~5%. H1 results (March Y/E) revealed a deeply impacted NPAT and I don't see why H2 (and beyond) will be any better. I'm assuming therefore an EPS drop of 30% (last year H$0.57) for the full year and a dividend of 85% of that. That'd suggest a DPS of H$0.34 and a FV range, based on the target yield range above, of H$4.25 (8%) ~ H$6.80 (5%).

Target ingress would be H$4.75 where upside exceeds downside by 4x and I'd be getting a yield in prospect of >7%. Cheeky? Perhaps, but the future here can in no way resemble the past. Even aristocrats fall on hard times, from which recovery can never be certain.



How's My Investing?

Performance summary, review of recent trading and thoughts on the path ahead

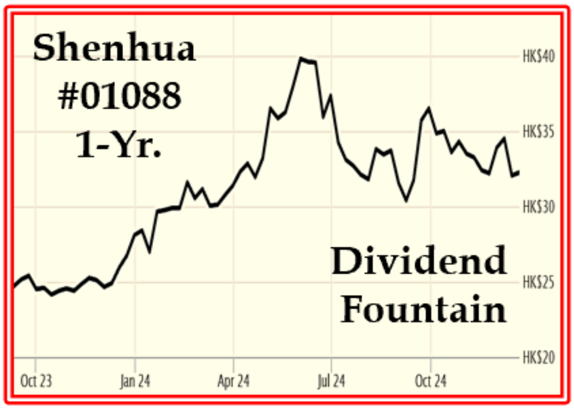
December Performance:	**+1.5%**
Performance Since Inception (Nov. '24):	**+1.8%**
Cash Percentage of Portfolio:	**30%**

The tidying up of idle cash from my Fund's winding down kept me busy in December. I said in the November update I'd get to 50% cash and 50% stocks and pause there, but on reflection and a closer look at valuations I've gone to 70% stocks and 30% cash.

In December I reacquired the following and added to some legacy holdings as follows:

Stock	Argument
01234 China Lilang	Nice folk, yield, products, and the stock is cheap
01088 China Shenhua	Coal, forever-fuel, and the stock's a divi. fountain
00966 China Taiping Insurance	P/Embedded Value is wrong. Very, very wrong
03306 JNBY	Rising domestic quality brand, and a super yield
00914 Conch Cement	Market leader, net cash, recovery play
03360 Far East Horizon	Like a bank, but not a bank, better in many ways
02689 Nine Dragons Paper	Knocked out consumption/recovery story
01157 Zoomlion	Buybacks add grist to an already dynamic mill

Ahead: The collapse of the crypto complex and repricing of America's tech sector by at least 30% are when, not if, future events. In time, this adjustment could trigger greater global interest in non-dollar denominated markets of which China would be an obvious beneficiary, but... There'd be a lot of turmoil before we got there and having a war-chest in anticipation is, to me at least, self-evidentially prudent. ***"The big money is not in the buying and selling...but in the waiting."*** Charles T. Munger (riffing on Jesse Livermore)



Datawatch

Key Releases In The Last Month

Mostly 🙁 One 😐 No 😊

Trade 🙁: Nov. Exports +6.7% (Oct. +12.7%), Imports -3.9% (Sep. -2.3%). Imports were a negative surprise. Domestic economy in focus.

Prices 🙁: Nov. CPI +0.2% (Oct. +0.3%), PPI -2.5% (Oct. -2.9%). The PPI has declined 26-months in a row. China is now in a deflationary cycle.

Credit 🙁: Nov. M2 +7.1% (Oct. +7.5%), Total Social Financing +7.8% (Sep. +7.8%). Dismal readings, again.

Consumption 🙁: Nov. Retail Sales +3% (Oct. +4.8%). A negative shock. Stocks on the release day got slapped hard in response.

Industrial Activity 🙁: Nov. Industrial Production +5.4% (Oct. +5.3%). Industrial Profits -7.3% (Oct. -10.0%), 2024 will be the worst in 20+ years.

New Home Prices 🙁: Nov. -5.7% (Oct. -5.9%). A 17th down month. The *rate* of descent was the slowest in the last 17 months. Huzzah?

Business Confidence 😐: Dec. Purchasing Managers Indices. Mfg. 50.1 (Nov. 50.3), Services 52.2 (Nov. 50.0). Could've been worse. Thin cheer.

That wraps it up for December. What's here isn't advice or recommendation, it's what I've been up to, how I'm looking at the world and a small piece of the market puzzle which, combined with yours, I hope may be of some use.

"He who receives an idea from me, receives instruction himself without lessening mine; as he who lights his taper at mine, receives light without darkening me". Thomas Jefferson.

Good Luck with ***your*** investing. Feedback please! to me at nial@nialgooding.com