

ASIA

THE CHINESE CENTURY



INSIGHTS INTO THE ASIAN GROWTH STORY

MAY 2005

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CONTENTS

1. INTRODUCTION	PAGE 3
2. THE ASIAN ECONOMIES	PAGE 3
3. CHINA AND COMMODITIES	PAGE 4
4. THE RISE OF THE CONSUMER	PAGE 5
5. INVESTMENT IMPLICATIONS	PAGE 7

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INSIGHT INTO A BOOMING ECONOMY May 2005

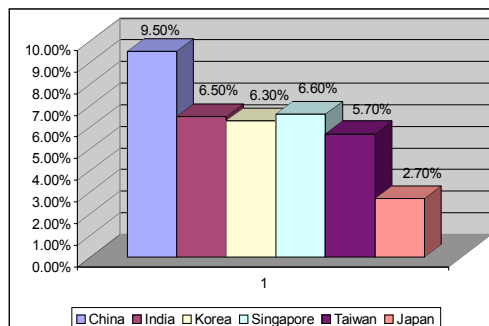
1. INTRODUCTION

This research report is a synthesis of a number of research articles on Asia, and in particular China. It aims to outline some of the key developments in the region and gives some insight into potential outcomes.

2. THE ASIAN ECONOMIES

Asia has become one of the fastest growing regions in the World. China, in particular, has become one of the hottest growth stories since the leadership of Deng Xiaoping in 1978. He initiated reforms to move towards a market based economy within a communist Government. Now, China's economy is growing at almost double-digit rates creating a growing middle class. Also, the removal of corruption, one of the drawbacks of the Chinese economy in the past, is a key focus of the Chinese Government. Similarly, many other Asian economies are becoming more sophisticated. The Asian crisis lessons of 1998 have been learnt and many economists and analysts are predicting solid and sustainable growth going forward. From a size perspective, 60% of the world's people live in Asia and 37% of the world lives in China and India alone. As a result, companies in these markets have huge home markets to tap into. As these companies grow, so will their influence and importance in the global economy.

GDP Percentage Growth 2004



Asian Populations 2004

China	1.3 billion
India	1.0 billion
Indonesia	223.8 million
Japan	127.0 million
Philippines	86.2 million
Thailand	64.6 million
Korea	48.0 million
Malaysia	25.5 million
Taiwan	22.0 million
Singapore	4.2 million

Goldman Sachs have published a report with growth projections for the BRIC (**B**razil, **R**ussia, **I**ndia & **C**hina) economies until 2050. The key assumption underlying their projections is that governments of the BRIC countries continue to support economic growth. Some of the key projections from their report were:

By 2025, Goldman Sachs predicts the BRIC economies to account for half the size of the G6 (US, UK, Germany, Japan, Italy and France)

THE CHINESE CENTURY



INSIGHT INTO A BOOMING ECONOMY May 2005

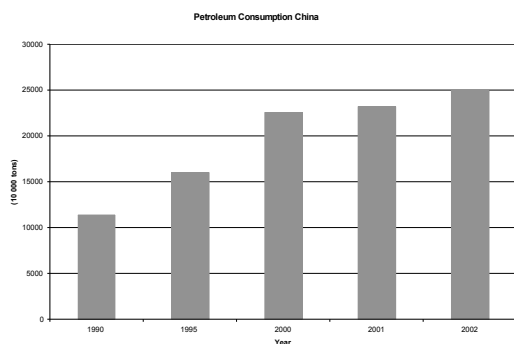
economies. They also predict that in less than forty years, the BRIC economies together will likely be larger than the G6 economies.

They predict China's economy to overtake Germany's economy in four years, Japan's economy by 2015 and the US economy by 2039.

Furthermore, they believe India has the potential to show the fastest growth in the next thirty to fifty years. In fact, they predict India to grow in excess of 5% per annum over that period.

3. CHINA AND COMMODITIES

Oil is a good example of the demand pressures building up in China for raw commodities. Ten years ago, China imported no oil at all as consumption was fully met by their own production. However in 2003, following massive increases in demand, it overtook Japan to become the world's second biggest importer of oil behind the US.



The graph above shows the rapid increase in oil consumption in China.

The increase in commodity prices is often called 'the China effect'. A Merrill Lynch report said "Chinese demand for commodities is revolutionising global commodity markets" and "China has already overtaken the USA as the largest consumer of iron ore, steel and copper."

In the same report, Merrill Lynch said "China, the world's sixth largest economy, now accounts for between a fifth and a third of the world's consumption of alumina, iron ore, zinc, copper and stainless steel."

The report also said some of the materials imported are manufactured into finished goods for export. China exports much of the iron ore it imports once it has processed it into steel, for example. Similarly, China's alumina imports are turned into aluminum for export.

China's exports are exceeded only by those from the US, Germany and Japan. If current growth rates are sustained they will exceed those of the US in less than a decade, said the Merrill Lynch report.

To support continued economic growth, China is searching for new oil reserves. Chinese officials have been visiting major producers of energy in order to secure long term supply contracts. For example, Petrochina Company Ltd has recently executed a memorandum of understanding with Enbridge from Canada to build a pipeline between the two countries which could result

THE CHINESE CENTURY



INSIGHT INTO A BOOMING ECONOMY May 2005

in 200,000 barrels of crude being imported per day by 2009.

4. THE RISE OF THE CONSUMER

In China, incomes are rising resulting in a growing middle class. The economy is trying to meet the expanding needs of a new generation of consumers. Chinese consumers now have a shopping list including fridges, televisions, phones, cars and entertainment. The process of "urbanisation" is unprecedented in human history. Twenty million Chinese people are moving each year from the countryside to the cities. This is equivalent to a city the size of Auckland being built every month! To build the necessary infrastructure (houses, factories, roads, cars etc), huge quantities of raw materials and services are needed. India is also following a similar process with the urbanisation and industrialisation of over a billion people.

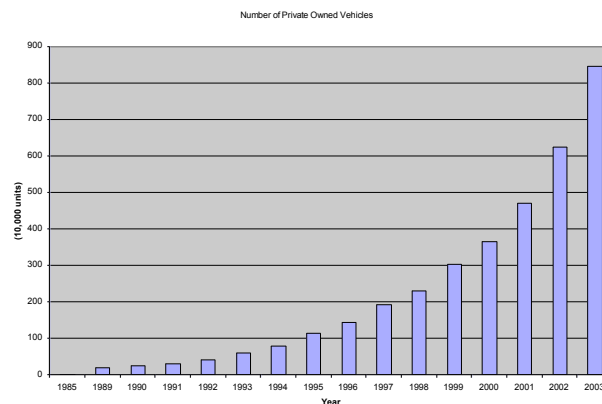
The increasing "consumerism" also shows in growing demand for Western consumer items, such as cars. Rupert Wingfield-Hayes, a BBC correspondent in Beijing recently said:

"Ten years ago, the [six lane ring] road was devoid of traffic, the odd bus, a few taxis, and lots and lots of bicycles, today it is gridlock. At five in the afternoon it is more like a six lane parking lot.

In the last few years the Chinese have taken to cars. Beijing has more

than two million private cars. Many are small hatchbacks, but there are a growing number of sports utility vehicles.

"Already Volkswagen sell more vehicles in China than in Germany, while China consumes the same amount of global commodities as the US," according to a JP Morgan Fleming report. The report also said: "By value, demand in 2003 for non-oil commodity imports will be up to approximately \$7bn compared with less than \$2bn in 1996. The growth is phenomenal and the impact on the world should not be underestimated."



Chinese have also taken rapidly to the mobile phone. The Ministry of Information released information that China had 114 million new phone subscribers in 2004 of which 64.8 million (or 56%) were mobile phone subscribers. China now has 647 million phone users.

Another insight into the rise of the Chinese consumer is to look at

THE CHINESE CENTURY

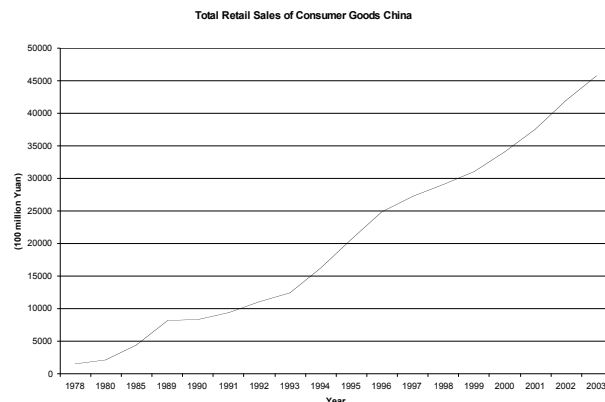


INSIGHT INTO A BOOMING ECONOMY May 2005

franchises. A Chinese word has been developed for 'franchise' (*jia eng*, roughly translating to "person joins group of other people"). The franchise concept has taken some time to catch on but China has recently adopted its first commercial franchise laws and franchises are growing, including international ones such as McDonalds, Century 21, Athlete's Foot and Subway.

In its first Consumer Outlook Survey for China, KSA, a retail and consumer products consulting firm, gathered in-depth information from more than 600 male and female respondents across all age groups, and from four cities - Beijing, Shanghai, Chengdu, and Shenyang - representing a middle-class section of China's population. Responses revealed emerging trends that will significantly affect the global retail industry.

The Chinese consumer is becoming more discerning, moving rapidly from finding the best price to seeking the best quality. Survey respondents said the critical factors in choosing a brand are trust in its quality (92%), a positive impact on health (81%), and its care for customers (76%); having a fair price ranked only fifth (73%). In choosing a shopping destination, quality (52%), service (39%), and variety (36%) were the top three factors, with value placing fifth (27%).



Survey respondents also showed a high level of brand awareness and loyalty. Asked to identify products made by a variety of brand names, 83% of consumers on average were able to do so. Seventy-eight percent said they buy toiletry brands they know and that they are unlikely to switch if their brand isn't available.

According to the same survey, Chinese consumers' preference for foreign or local brands differs greatly depending on the type of product they are buying. In electronics and home improvement, consumers have a strong preference for foreign brands over local ones. In the food and personal care products categories, they prefer local brands 2:1 over foreign ones. In apparel and footwear, the mainstream consumer did not show a preference for foreign or local brands. However, higher income and younger consumers both indicated a strong preference for foreign branded apparel and footwear products. The report said this has huge implications

THE CHINESE CENTURY



INSIGHT INTO A BOOMING ECONOMY May 2005

for both foreign companies wishing to profit from the consumer boom and also Chinese companies as they target their home markets.

Survey findings also revealed consumer dissatisfaction runs high in China. People shop once a month or less for items such as consumer electronics and clothing, suggesting shopping is not enjoyed by much of the population. According to the survey, 48% of women said they dislike shopping, outnumbering 30% of US women who say the same. Sixty-three percent of men said they dislike shopping, putting them roughly on par with their US counterparts.

The survey also shows a fragmented retail sector. Consumers do their food shopping at supermarket chains almost twice as often as they do at traditional open-air markets or hypermarkets. But hypermarkets are growing in popularity: about 40% of people are shopping more in these large-scale stores this year compared with last year. For apparel and footwear, respondents favored department stores. But they went to local specialty stores for consumer electronics, and superstore chains for home improvements.

In summary, the report said the growing awareness and consumerism of the emerging Chinese middle class represents an opportunity for both Chinese and overseas companies. However, the

market exhibits a number of unique characteristics meaning that there will be winners and losers in the rush to quench the Chinese thirst for consumer goods.

5. INVESTMENT IMPLICATIONS

From the research, it seems indisputable that China will have an increasingly important role to play in the world. However, the gains and losses may not be equally shared. Below is a summary of possible investment implications we have come across whilst preparing this report:

- Commodity prices are likely to continue to increase due to ongoing Chinese demand pressures and supply constraints. However, prices may become more volatile.
- Suppliers of commodities such as New Zealand, Australia and Canada may benefit from this trend. Over time this may lead to higher exchange rates for these countries.
- The growth of the Chinese economy may be positive for suppliers of technology such as Japan, Korea and Taiwan who use China as a re-export platform, due to the lower labour costs in China.
- As Chinese consumers become wealthier and more sophisticated

THE CHINESE CENTURY



INSIGHT INTO A BOOMING ECONOMY May 2005

there may be opportunities for strong global brands to take advantage of the world's largest and fastest growing economy.

- Suppliers of services such as investment banking, accounting, and consulting may have huge opportunities in China as the sophistication of local businesses increases.
- Some industries worldwide may be negatively impacted by the growth of China. For example, high cost manufacturers making low value products may be undercut by Chinese production. Companies with weak brands or inability to protect against imitation may see their sales and profits drop.

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