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LESSONS LEARNED FROM THE ASIAN FINANCIAL CRISIS

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It was recently the 10th anniversary of Lehman's collapse; and in Hong Kong, warning signal 'Typhoon No. 10' had been hoisted, as the biggest hurricane-strength storm in recent history battered its way through the territory. With nowhere to go and time to reflect, I thought about the Asian Financial Crisis and the lessons learned; and whether there is any resemblance to what we are seeing in emerging markets today.

The 1997 Asian Financial Crisis had a widespread and catastrophic effect across the region. Countries including Thailand, Indonesia and Korea effectively went bust and it took years for the worse-hit economies to recover.

At the time, there was a 'double market play' adopted by hedge funds: shorting stock markets and currencies at the same time. When a currency came under attack, the central bank would have to hike interest rates to defend it; the stock market would tumble on rising rate fears; and that would again trigger uncertainties around currency values. Hedge funds benefitted on both ends as the vicious cycle continued.

In early 1997, the Thai baht came under sustained attack and the central bank found it increasingly difficult to maintain the currency peg with the US dollar. With hot money inflows, Thailand, like many other Asian countries, had borrowed excessively. Its foreign reserves were depleted and import covers were just 3-4 months' worth. Eventually, the International Monetary Fund (IMF) was brought in, followed

by tightening measures. Foreign debt doubled overnight.

During the crisis, Thai banks' non-performing loans (NPLs) rose to as high as 50%. Even those that could afford to pay, defaulted. Book values were wiped out. Banks encountered liquidity problems because of negative net interest margins (interest payments received were not enough to pay deposits because of NPLs).

Asset management companies and 'bad banks' were set up to house the delinquent assets so that banks could start to function again. Foreclosure laws were strictly enforced as many banks were reluctant to recognise bad loans on fears of dilution and loss of family control.

A few months after the start of the crisis, I attended a presentation where the speaker explained that if an economy cannot adjust through its currency, interest rates would have to rise and asset prices would deflate in order to restore competitiveness against neighbouring countries with weaker currencies. Although I felt that the theory was valid, I underestimated the extent of economic damage that was to be wrought across Asia.

When the baht devaluation started, many argued that it would be an isolated event. But, the contagion spread to most Asian economies. Pressure on the Philippine peso and the Malaysian ringgit followed and both were forced to abandon their US dollar peg. After the Indonesian rupiah became a free-float currency,

it weakened to a quarter of its former value, leading to out-of-control inflation and widespread looting and rioting.

In Hong Kong, the HKD had been pegged to USD since 1983 (and remains to this day). By October 1997, Hong Kong interest rates had shot up, triggering the Hang Seng Index to tumble 10% in one day. HIBOR¹ jumped to 20-30% and people rushed to call their banks to fix up time deposits.

Just as we are seeing in Argentina or Turkey today: when interest rates are so high, why bother with stocks, or even bonds? Valuation models do not work with 20-60% discount rates.

With rising interest rates in Hong Kong, property prices fell almost 70% over the six years between 1997 and 2003. A quarter of Hong Kong homeowners went into negative equity (money owed to the banks was more than the value of their properties). There was widespread deflation and many of the middle classes were ruined. Some wealthy families lost all of their assets overnight.

On the other hand, a number of countries were relatively cushioned during the crisis. They were usually closed economies with little foreign debt (e.g., China) or export-oriented economies with healthy current account balances (e.g., Taiwan). Malaysia closed its doors as Prime Minister Mahathir imposed capital controls (which turned out to be not such a bad decision).

A long list of lessons learned

China was one of few countries that remained largely unscathed during the Asian Financial Crisis. China's currency was steady; although there was a brief moment in 1998 when the market worried about RMB depreciation. At that time, Huaneng Power was trading at 5x price-to-earnings (PE), while earnings were growing at 15-20%.

An analyst I spoke to argued that 5x PE was not cheap enough because the currency could still fall by half! I noticed that investors tend to overlook distressed valuations when extrapolating currency depreciation. However, once currency expectations stabilise, these stocks tend to bounce back strongly.

Another lesson from that period is that stocks usually experience a market clearing before physical assets. The Hang Seng Index troughed in August 1998 at roughly 8,000 before the Hong Kong government intervened (down 50% from its peak a year earlier). Earnings bottomed-out a year after that, but property prices did not reach a low until five years later. Banks are late-cyclicals but their share prices troughed at the same time as the Hang Seng Index.

Market falls usually happen over several phases. In December 1997, Asian markets rebounded strongly on recovery expectations (which turned out to be false), before experiencing another major collapse. Though it is impossible to call the bottom of

the market (except in hindsight), there are usually extreme events happening at the trough, such as rioting and blood on the streets, or formidable politicians falling on the sword (in Indonesia, President Suharto stepped down in 1998 after more than a thousand people were killed in a riot).

On the other hand, when market recoveries do happen, many believe it is a false dawn. Market timing is usually not the best investment strategy for most people. In my experience, an initial market recovery starts with an expansion of valuation multiples (from a low base), as interest rates stabilise or start falling. The second phase follows with a recovery in earnings, or at least upward revisions. But, the outlook always looks bleak at the trough.

I also learned the hard way not to confuse cyclical concerns with structural ones. At market peaks, people would argue that cyclical tailwinds are structural; then at the bottom, they would believe that cyclical headwinds are deep-rooted too.

Interestingly, analysts become rather innovative in valuing stocks at the trough. For Sun Hung Kai Properties, first it was valued on book; then revaluation reserves were taken out on the argument that historic revaluations falsely inflate book values.

Sun Hung Kai Properties' share price finally troughed at 1x book value excluding revaluation reserves – or roughly HKD13 a share – meaning that all of its

prime rental properties were essentially being valued at its construction costs from the 1970s and '80s. Since then, the share price has gone up many times over.

On banks, share prices can be misleading because of dilutions at the trough. So, when PE and price-to-book (PB) valuation metrics did not work, market cap to deposits was used instead. On a conservative view, this measure can take future dilutions into account. Actual share prices (and stock market indices) took years to reach their pre-crisis levels, partly due to dilution effects.

During the crisis, Asian banks troughed at roughly 3-4% market cap to deposits. Or, they would typically find support levels at 2-3x price to pre-provision profit (PPOP), similar to non-banking stocks bottoming-out on 2-3x cash flow. When provision costs are as big as or higher than pre-provision profits, a stabilisation of NPL formation should lead to a surge in profit. This happened with Dah Sing Bank and one of the reasons that we bought Axis Bank.

On buying stocks which look cheap on asset valuations (e.g., on PB), we need to be assured that the company's balance sheets are strong enough to sustain a prolonged downturn. It would be preferable if its cost structure was better than peers, too.

We bought Hyundai Semiconductor on the basis that it was cheap on a PB basis and we believed the sector would soon reach the bottom. In 1998, it merged with LG Semiconductor and was renamed

Hynix. Our prediction was right; but the company went into liquidity problems before the final recovery.

On the flip side, at the very trough of the memory cycle, Samsung's cash flow was bigger than the market caps of all of its competitors combined. This was when the Japanese and Taiwanese DRAM² companies were going bust. Either a recovery would happen, or Samsung would snap up all its competitors with its cash flow. Since then, there has been a semiconductor super-cycle and Samsung has been one of the major winners.

In the run-up to the Asian Financial Crisis, corporate balance sheets were extremely leveraged. Samsung Electronics had over 100% gearing, with even more debt hidden in unconsolidated affiliates. It subsequently went bust along with the whole of Korea.

There was a lot of scrutiny on the mismatch of balance sheets – not just on currency but also duration. This was a time when banks were calling back loans and foreign capital was retreating. Companies with short-term loans faced huge challenges.

Many Chinese window companies (parents of red chips) issued exchangeable bonds (similar to the pledged shares that we are seeing with A-share companies today) and there were many companies which had shocking levels of gearing. Subsequently, the likes of Guangdong Investments, GITIC and Guangnan went bankrupt.

Sino Land nearly went bust with just 50% gearing as interest rates went up to 20-30% and banks called back loans. Since then, the concept of gearing has been distorted. With interest rates at historic low levels, acceptable gearing is now more like 100% and there is more of an emphasis on net debt to EBITDA³.

One key contrast is that today, many corporates are cashed up. As of today Samsung is sitting on more than USD50bn cash and Apple, the largest company in the world, is awash with cash. Conversely, consumer debt as a percentage of GDP is at a record high for most Asian countries. China barely had any credit card or mortgage debt in 1997; today its household debt is nearly 50% of GDP, with reportedly close to RMB1trn peer-to-peer lending unaccounted for.

This is clearly a concern – the next credit crisis could be triggered by consumers rather than corporates. We remind ourselves of this when deciding on the kind of multiples that we should pay for consumer companies.

Conclusion

It is still debatable how damaging the current emerging markets predicament will be. Every crisis is different, but the ingredients are often the same – after all, it relates to human nature and our propensity for greed and fear.

There is often a craze or exuberance in the run-up to a crisis; something which everyone

follows and only few people doubt. Before 1997, there was a huge red chip bubble when the market believed that the whole of China would be injected into certain companies. Long queues formed to participate in the IPOs of Beijing Enterprise in 1997 and Tom.com in 2000, or to buy properties at the Villa Esplanada in Hong Kong.

During the Asian Financial Crisis (and indeed after the asset bubble burst in Japan), an easy, winning formula was to buy exporter companies. At the time, Western economies were prospering, while Asia's cost base was deflating along with its currencies. Margins for the likes of Johnson Electronics expanded, along with decent revenue growth. Manufacturing in Asia started to rise, especially with China's entry into the World Trade Organisation in 2001.

China's exports subsequently went through 10 years of growth at 20% a year. Li & Fung grew by 15-20% each year. Valuations made it even easier for fund managers, as ASM Pacific was trading on just 5x PE and Hana Micro-electronics was yielding a generous 10%.

Today, Asia's export market has matured; and there are trade war risks, rising protectionism and populist governments driving up minimum wages. Margins for exporters are under pressure with little revenue growth to be found. Li & Fung is no longer growing at 15-20% and ASM Pacific is nowhere near 5x PE.

2 Dynamic random access memory – a type of semiconductor chip used as computer processor

3 Earnings before interest, tax, depreciation and amortisation

One problem that today's investors face is that the global money printing over the last 10 years means that valuations are still not cheap – even though it may look cheap compared to previous peaks. When analysing valuations, PB and EV/sales⁴ charts dating back to at least 20 years are more helpful in building

a complete picture – not just the last five or 10.

What is the craze or exuberance this time round? Are we in a crisis and where is the bottom? Inevitably, it will only become clear in hindsight. No one knows, not least us. This is the reason why, as a team we maintain our

strong investment discipline and our process of constant challenging of one another, so that we won't get carried away by our own greed and fear.

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