INSIDE CHINA

A WEEKLY SERIES LOOKING AT THE BIGGER PICTURE

TODAY CORPORATE EARNINGS

Beijing pulls out stops to arrest economic rot

Authorities dig deep to give firms a strong boost, writes **Daniel Ren**

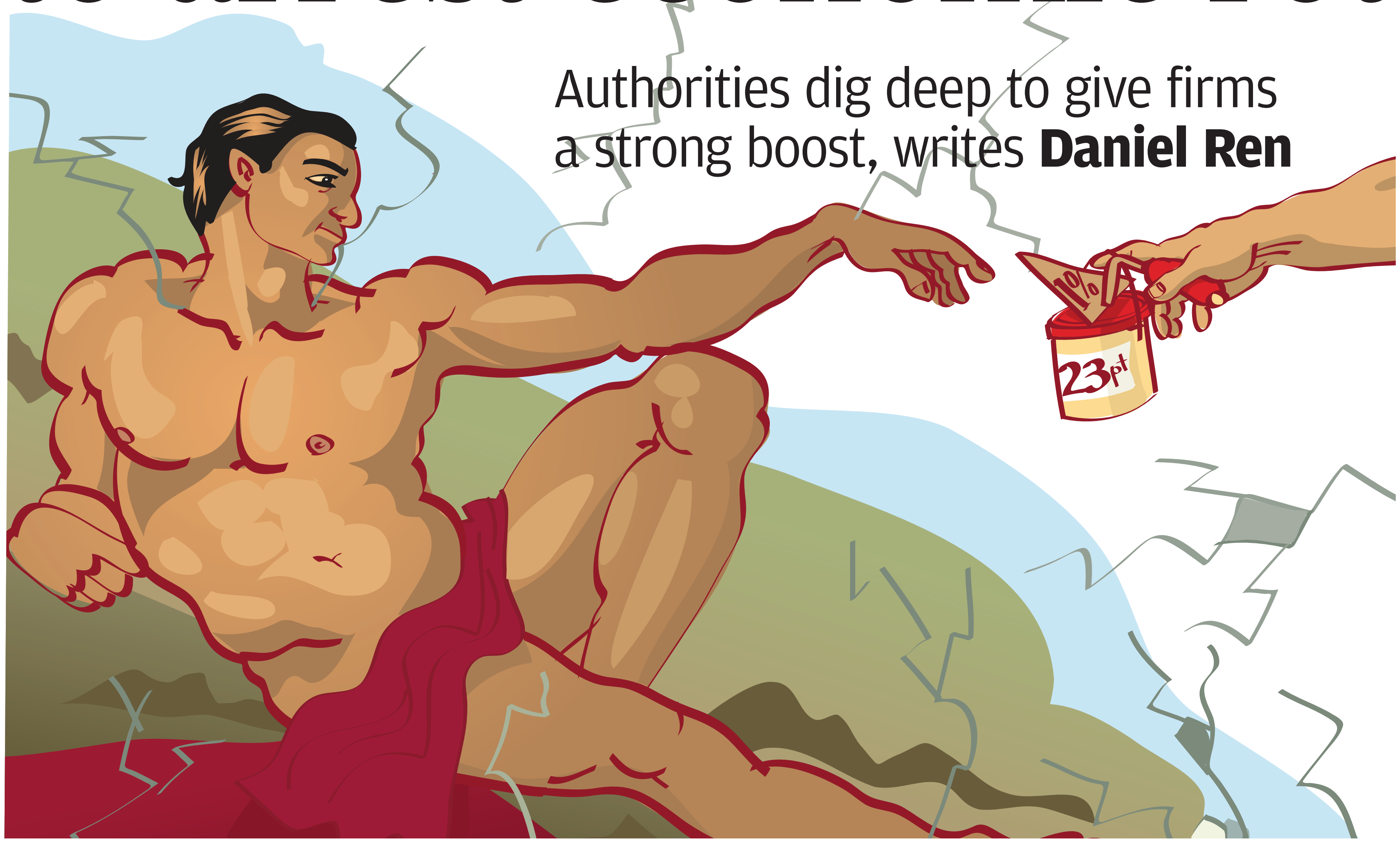

Illustration: Stephen Case (with apologies to Michelangelo)

The failure of China's financial regulators to arrest a sharp decline in the beleaguered stock market this year has been a bitter pill to swallow. But the failed attempt to pull the market from its death spiral has not been from want of trying.

In a surprise move aimed at spurring economic growth and shoring up investor confidence, Beijing announced on September 15 that it was cutting interest rates and lowering banks' reserve requirements. It was the first interest cut in rate in four years and an indication of how seriously officials view the economy's predicament.

Yet, the rate cut did little to dispel the gloom on mainland stock exchanges. The Shanghai Composite Index lost 4.47 per cent to 1,986.64 the following day, crashing below the significant 2,000-point level for the first time in 21 months, as skittish investors became convinced that the government was powerless to kick start the economy.

Officials had better luck on Friday when the benchmark surged by 9.46 per cent after Beijing scrapped a stock-trading tax and said it would buy shares in three of the largest banks. But that rally is widely seen as a flash in the pan and must be seen against the wider backdrop of the steady decline in share prices this year.

There is now growing concern that even cheaper lending costs will not arrest a slide in corporate earnings this year as the economy is buffeted by a growing global financial storm as well as difficult conditions at home.

The mainland stock market has slumped 66 per cent since late last year, battered by fears that the previously fast-growing economy is in a tailspin amid soaring inflation and slowing exports.

The rate cut was made "out of apparent concern that the economy may be slowing more sharply than previously anticipated", said Jing Ulrich, JP Morgan's chairman for China equities. "The slight moderation in China's economic growth in the first-half has brought a disproportionately large decline in profits for companies with high operating leverage and vulnerability to price controls."

However, the looser credit policy may be more symbolic than substantive. Analysts estimate the policy would probably increase loans available to companies by 300 billion yuan (HK$341.4 billion), with mainly the medium- and small-sized firms that are among the most cash-strapped enterprises to benefit from the policy.

"With the cloudy economic outlook, commercial banks are expected to tighten lendings to companies," Shenyin Wanguo Securities said. "In order to protect their own interests, banks will be extremely cautious with loans to small firms."

But the policy shift has heightened hopes in some quarters that Beijing will ease credit policies further as its shifts its focus from controlling inflation and preventing overheating to sustaining growth. The fact that the consumer price index slowed to a 14-month low in August may help.

Economists now expect the mainland to roll out a series of monetary easing and fiscal stimulus measures, including tax cuts and expansion in infrastructure construction.

The mainland's 14 listed banks reported handsome first-half profit, thanks to increased interest income and lower tax rates. They earned a combined 230 billion yuan, up 99.15 per cent from a year ago.

But analysts predict that growth has peaked and that lenders will have to brace for bumpier times ahead.

As the central bank readjusts interest rates, the margin between lending and deposit rates earned by banks will decline.

TX Investment Consulting banking analyst Wang Yifeng predicted that a 27 basis-point cut in lending rates will drag down banks' earnings growth by up to 7 percentage points next year.

By and large, the interim earnings of the mainland's 1,600-odd public companies also bode ill over the full year. First-half earnings were less than analysts had expected but the worst is yet to come as the mainland economy grinds into lower gear, they said.

Those companies reported a combined profit of 553.3 billion yuan between January and June which, though up 16.03 per cent from the year-earlier period, fell short of analysts' consensus prediction of 20 per cent growth.

It was the slowest first-half earnings growth since 2005 when listed companies posted a scant 4.16 profit rise. In comparison, companies saw earnings jump 70 per cent last year as the bull market and surging economic growth encouraged numerous stock listings.

But the devastating earthquake in Sichuan and the severe blizzards that struck early this year have made it even more difficult for public firms to repeat the robust earnings growth of last year. More importantly, the stricken stock market has meant huge losses on companies' equity investments.

The Shanghai index jumped 97 per cent last year as investors clamoured to get on board the bull market. When the key indicator retreated from its record high in mid-October, many still believed it was a short-term correction and expected the market to recover this year, betting that the mainland's economic outlook was sanguine.

But the bear market started to bite as the unfolding credit crisis in the United States and a stronger yuan took hold. Listed companies saw the value of their holdings of equities and other financial assets decline 2.07 billion yuan in the January to June period, a 35.31 per cent decrease from the same period last year.

> The rate cut was made out of concern that the economy may be slowing more than anticipated
>
> **Jing Ulrich, chairman for China equities, JP Morgan**

Exporters bore the brunt of the pain as overseas demand weakened and Chinese products lost their price advantage as the yuan strengthened. Exports from January to June were valued at US$666.2 billion, up 21.8 per cent from a year earlier but still slower than the 27.6 per cent expansion in the first half of last year.

Analysts are forecasting a bleak third-quarter and full-year earnings, contrary to the more optimistic 30 per cent profit growth forecast for this year at the end of last year.

According to TX Investment, 20 per cent of listed firms either reported losses or flat earnings in the first six months.

In addition, listed firms are facing serious cash-flow problems, a sign that profitability will deteriorate further, analysts said. The 860 Shanghai-listed firms held cash worth 666.7 billion yuan as of June 30, 45.33 per cent less than a year earlier.

Oil and gas companies were among the top losers as controls on the price at which they sell fuel crimp revenue.

Sinopec, the nation's second-largest oil giant, reported a net loss of 23.78 billion yuan, dragged by a 46-billion yuan deficit in its refining business alone as global crude prices surged.

PetroChina, the mainland's largest listed company, saw its first-half net profit slide 34.5 per cent to 53.62 billion yuan. High crude prices, control on retail fuel prices and a higher windfall tax on oil sales were the main reasons for the profit decline.

The company said its refining business would not break even unless crude prices fall to US$88 per barrel from above the US$100 mark.

A 16.7 per cent increase in petrol prices announced by Beijing in late June may help refiners but will eat further into manufacturers' earnings, analysts said. Retail electricity prices were raised 4.7 per cent on July 1.

An increase in factory-gate prices is already denting earnings. The producer price index for August climbed 10.1 per cent year on year, following growth of 10 per cent a month earlier.

In contrast, the consumer price index slowed to a 4.9 per cent gain in August compared with 6.3 per cent in July.

Real estate developers became one of the hardest hit this year as the central bank's credit tightening prevented lenders extending credit to new housing projects. By sales value, the figure represented a 37-per cent drop from the second half of last year.

Investors saw a ray of hope on August 20 when the stock market shot up 7.6 per cent following a JP Morgan report that Beijing was planning a stimulus package to bail out the troubled economy.

According to the report, Beijing might cut taxes by 200 billion yuan to 400 billion yuan to spur consumption and increase fixed-asset investment to maintain fast economic growth.

Frank Gong, the report's author and the bank's China chief economist, came under the spotlight with some doubting the authenticity of the plan. Mr Gong later clarified that the report was based on his own estimates and studies.

Nonetheless, the latest policy shift indicates the government has begun to launch economic sweeteners to bolster the economy. That could allow companies to embark on expansion plans to maximise profits.

Beijing is planning to readjust the value-added tax regime that will save companies up to 150 billion yuan annually. Companies will be allowed from next year to use fixed-asset investments to offset value-added tax payable to the government, according to sources.

But for the short term, Beijing's efforts to lift the economy will have minimal impact. The ongoing global financial meltdown and a less responsive domestic environment means Beijing may not have enough in its monetary and fiscal tool box to avert a serious slowdown.

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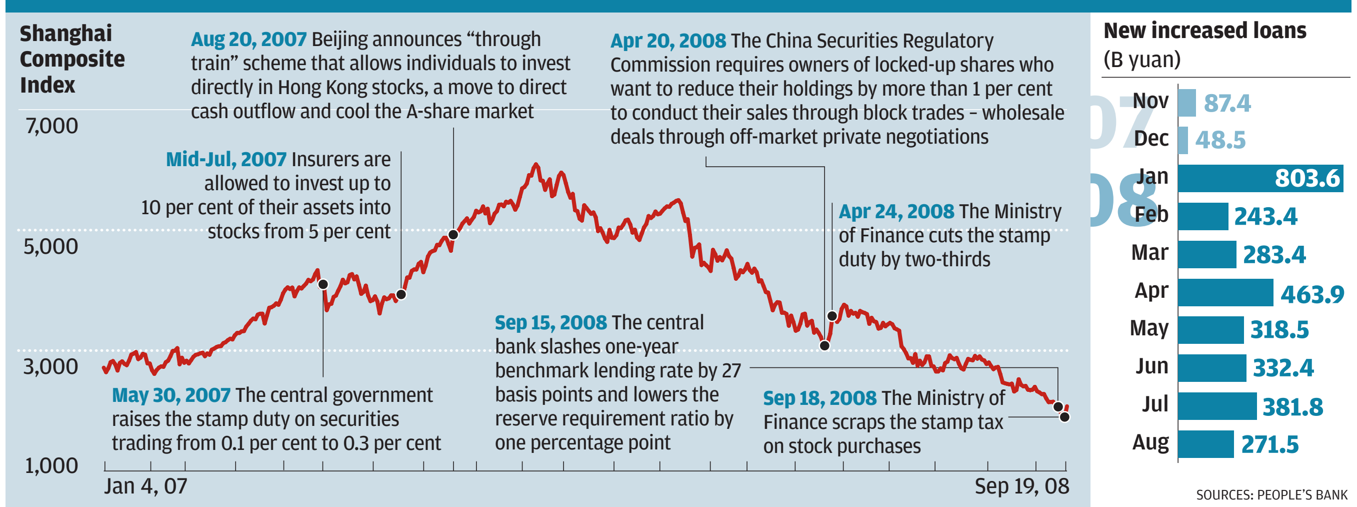
Market moves



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SOURCES: PEOPLE'S BANK OF CHINA, BLOOMBERG

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Management with Trevor McManus

Strengthening links in food-safety chain

Concerns about the quality of China's food have again been cast into the global spotlight this week, although these problems are far from isolated to the world's most populous nation.

Sadly, there appears to be an increasing trend towards large-scale food safety incidents across the globe and there is no country or region immune to this issue.

There have been significant incidents in most of the world's developed economies recently as we struggle to meet the surging demand for food.

Food is now a globally traded commodity. Supply chains – from production to consumption – are very complex, traversing and even re-traversing the globe, and there are an increasing number of stakeholders – producers, processors, distributors, importers, exporters, retailers and regulators.

Furthermore, the most important stakeholder – the consumer – has more diverse needs and greater expectations on both variety and quality.

> Squeezing supply-chain partners may tempt them to compromise safety

Any one of these stakeholders can compromise the safety of the food, whether it is produced in the neighbour's garden or on the far side of the planet. In simple terms, what is increasingly needed is "supply chain assurance". At any point from "farm to fork" there needs to be a high level of confidence that the processes are safe.

How then do we instil these disciplines in a global supply chain that involves so many diverse stakeholders – with often competing interests – and governments?

The knee-jerk reaction is to say "we need to test our food more", with the logical extension of this impulse being to test "everything for everything" at every stage of the supply chain.

This, of course, is neither rational nor feasible, especially in the complex interdependent environment that is the modern food supply chain.

Even the most technically sophisticated and ethical companies in countries noted for their food safety credentials – from Japan to Ireland – have been caught up recently in large-scale incidents where much suffering has been caused by a failure to maintain "supply chain assurance".

How then do we build this assurance, locally and across national borders? The answers are available, but they are complex and not easy to apply.

First, any food business needs to be commercially viable, but there needs to be ethical financial treatment of all stakeholders. Squeezing supply-chain partners may generate short-term profit, but it can tempt the partner to compromise safety.

Further, all partners need to embrace an independent third-party assessment of their safety assurance programmes. Confidence in safety performances can only be assured where there is independent verification. Governments, certification bodies and companies alone cannot independently provide this: there must be a transparent sharing of the verification responsibilities.

There also needs to be a common framework for food safety assurance, with compliance secured by an unbiased verification that stakeholders have "ticked all the boxes". A common framework, in fact, has existed for nearly 40 years. Known as Hazard Analysis Critical Control Point (HACCP), it evolved from an American space programme in the 1960s.

But while HACCP contains the basic principles for safe food production, it lacks independent verification because it has been adopted by partisan and non-partisan groups. Still, HACCP has been incorporated by the independent International Standards Organisation into the global food-safety management system, known as ISO22000, which is widely available.

Any solution to food-safety problems must incorporate global standards while being tailored to the specific safety needs of the food industry. It must combine the ethical financial treatment and education of stakeholders as well as transparent independent verification of safety programmes.

The solutions to this global dilemma may not be simple, but they are available.

Trevor McManus is a food safety specialist at Lloyd's Register Quality Assurance

Book Review with Samantha Kierath

Doing the hard yards pays off for coach

Executive coach Frank Gallo could have used a professional guide when he arrived in Beijing eight years ago from the United States to work for an international human resources consulting firm.

The credentialed leadership adviser had a wealth of experience to draw on but he struggled like any newcomer in his initial efforts to negotiate a fair price for a fair day's work with his mainland clients.

In the end, Gallo's realisation that he was not playing by his clients' rules came from a conversation with an employee rather than a coach but the point was just as well made – he had to change his rules of engagement to lead and grow a business in China.

The change paid dividends and one bonus of that labour is *Business Leadership in China*, Gallo's take on the reasons why all executives need to adapt best western leadership practice to the world of mainland business and some ways they can go about it. Now.

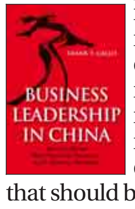
He suggests that the age of struggle is over on the mainland and the need for expert intervention has arrived. In the past many managers became bosses through personal resources and fortitude so their instinct is not to develop the next generation of leaders.

But, with a largely young workforce unable to draw on the corporate knowledge of predecessors, companies have to find ways to foster talent for the top in a globalised, market-economy era. For multinationals operating in China, the challenge is to look at their existing leadership programmes to see if basic in-house tenets such as risk-taking, trust and equality really translate.

Gallo describes a management environment in which a big car still means something, courtesy can trump honesty, and encouraging staff to take on new challenges can just lead to confusion and stress.

The question is how to make it all work in a Chinese context and in the second half of the book the author gets to grips with practicalities.

He points out handy ways to use face as a justification for presenting accurate information and methods to get around a lack of formal trust, two areas which can be a major source of frustration for unsuspecting western-style managers. Often the issue is simply a matter of a conceptual recalibration such as realising that a contract is a beginning not an end and something that should be viewed as an expression of intent rather than the final word in a business relationship.



Other times, it's planning ahead by having a decision-making group in place for times when quick answers are needed. In all cases, they are effective additions to the management toolkit.

One salient point in a Beijing Olympics age is the idea that nationalism is an expected inherent quality of Chinese business leaders.

Throughout it all, Gallo draws not only on his first-hand experience but also on the know-how of 18 other managers, offering their anecdotes as panels of direct quotes to break up the main text.

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