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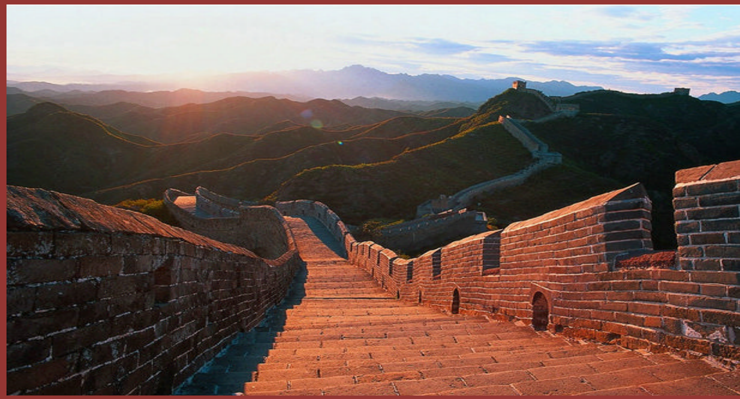

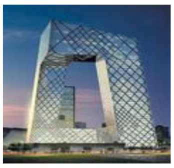


China Newsletter - April 2013

Inside this issue:

China's Policy Bank
China Development Bank – The Muscle behind China's Global Expansion

In 1994 The State Council for the People's Republic of China (PRC) established three policy banks: The Export-Import Bank (Exim), the Agricultural Development Bank (ADB), and the China Development Bank (CDB). These policy banks are charged with promoting and financing the construction of China's infrastructure, as well as promoting exportation and food production. In essence, they're the financial muscle behind the Chinese government giving the government the ability to implement both their domestic and international agendas. The largest and most influential of these policy banks is the CDB. [4]

Initially, the CDB was run as a department of the government. Its loans were directed by the government and its bonds were purchased by other banks at the direction of the government. Moreover, because it was viewed as just another department within the Chinese government, its financial controls were loose. Government officials, according to Henry Sanderson and Michael Forsythe in their book China's Superbank, viewed their role more as a disbursement agent for the government rather than as a banker. Moreover, it wasn't unusual for CDB employees, in the mid-1990s, to carry large amounts of cash on their business trips, sometimes as much as 100,000 yuan, in order to instantly provide loans in the cities or villages they visited. Most of these employees were not professional bankers. On the contrary, they were administrative people, engineers, and former officials who knew little about banking. Consequently, they would frequently lend money as though it was a distribution from the government, that didn't have to be paid back, rather than as an asset securitized loan. As a result, non-performing loans (NPLs) swelled during this period and the entire banking system in China became basically insolvent.

Another reason for this rapid increase in NPLs in the 1990s was that the government at this time directed its state-owned banks to make a great many loans to state-owned enterprises (SOEs), government owned companies that required a substantial amount of capital for their continued growth. The problem with this was that SOEs were designed, in addition to producing government designated products, to employ the maximum number of people possible. They were the antithesis of a lean and efficient business. However, to the Chinese government, that wasn't the most important consideration. Instead, the government believed that, by employing large numbers of people, and keeping unemployment to a minimum, it would promote a stable and harmonious society. The fact that SOEs made little or no profit and, in later years may have even lost money, was not as important to the government as insuring domestic tranquility through the creation of jobs. Consequently, as the government directed the CDB to continue to fund its SOEs, NPL's increased as SOEs were unable to repay their loans. It's estimated that, at this time, 40% of the entire lending of the Chinese banking system, or 110% of the China's gross domestic product - 9.4 trillion yuan, consisted of NPLs. [1]

Realizing that something had to be done quickly in order to stabilize the nation's largest policy bank, the government installed the vice governor of the People's Bank of China (the equivalent of our Central Bank), Chen Yuan, as Chairman of CDB in 1998. Chen Yuan immediately went to work creating a new infrastructure within the CDB and instilling a banking mentality throughout his staff. Rather than being what he termed "an ATM machine of the government," he put in place policies where each loan would be individually evaluated by merit after an internal credit rating, credit appraisal, and other procedures which had long been in place in Western banks. In addition, he took away loan approval authority from the audit department, where it had previously resided, and instead established individual loan officers for carrying out the risk review process. The national government also assisted in Chen Yuan's restructuring efforts by buying $100 billion yuan of the CDB's bad loans. The remaining $21.7 billion in bad loans was converted into equity of the defaulting company with the CDB as the shareholder. The results of Chen Yuan's restructuring was dramatic. Within a short period of time the bank moved toward profitability. [1]

The government deems the financial health of the CDB as a critical component of its domestic policy as well as for its future plans to expand its influence internationally. In fact, the CDB is the lynchpin of the country's expansion of its domestic infrastructure, as well as for obtaining the critical natural resources necessary to fuel this expansion. In accomplishing this the CDB provides the financing for projects the Chinese government deems to be in the national interest. In this capacity it supports the government's macroeconomic policies, as well as its national economic development and strategic structural changes in the economy. For example, when the government wanted to expand its natural resource and infrastructure abroad, the CDB provided the China National Petroleum Corporation (CNPC) with a $30 billion line of credit. In doing so it not only helped the government in increasing its access to natural resources, but also assisted CNPC in becoming more globally competitive. [2,3]

Over time, the policy banks' role as an extension of China's international policy has continued to expand. Today, China is a significant global lender able to impose its political will and extend its economic influence through the CDB and its smaller policy banks. In fact, through its policy banks China has lent more money overseas than the equivalent departments of the World Bank Group. Between 2009 and 2010, China lent more money to the entire developing world than was lent by the World Bank. Through the CDB, and to a smaller extent China Exim Bank, China has lent $110 billion to developing country governments and companies during that period. The World Bank, during this same period, lent $100.3 billion. The largest of China's policy banks, the CDB, is the world's largest development bank with over $980 billion in assets. It's also China's biggest lender with over $210 billion in outstanding loans in over 90 countries and regions throughout the world. [3, 6, 10]

CDB also extends lines of credit to foreign governments and foreign energy companies. In doing so it secures these loans with the natural resource reserves of the company or country and obtains repayment from the sale of the oil and gas to one of China's national oil companies. It's a win-win for the Chinese government in that it secures long term access to critical natural resources for its rapidly growing economy, provides it with a low-risk loans that are secured by valuable natural resources, and extends the influence of the Chinese government and its associated SOEs globally. In the event that the CDB lends money to a foreign government for infrastructure projects, the CDB will specify that most, if not all, equipment or labor be provided by Chinese firms. [3]

One example where China extends its international influence is Venezuela. Since 2007, the CDB has lent Venezuela $42.5 billion, collateralized by the revenue of its oil reserves. According to Charlie Devereux of Bloomberg, Venezuela accounts for 23% of all of CDB's overseas loans, more than the $29 billion the U.S. has spent rebuilding Iraq from 2003 to 2006. These loans give China a great deal of influence in Venezuela where, in addition to securing a great deal of oil, much of the money lent to Venezuela returns in the form of contracts to Chinese state-run companies. Among these companies are China Petrochemical Corp and the country's biggest oil and gas producer, CNPC. A similar oil-for-loans program is in place in Ecuador where oil-backed loans account for $7.3 billion, or a third of the Ecuadorian government's budget. [3, 5]

CDB's energy-backed loans are closely coordinated with the Chinese government and its SOEs. This is a well thought out and scripted long term strategic plan designed to further the Chinese government's objectives in various geographic areas, enhance its access to energy, and support domestic Chinese firms. [7, 10]

Another area in which the CDB is furthering the government's national objectives is by providing acquisition financing for Chinese companies to acquire foreign technology companies. These acquisitions will subsequently give the Chinese companies, and by extension the government, access to the acquired company's technology and intellectual property rights. With wages continuing to increase in China

the government is intent on diversifying the country from simply being a source of low-cost manufacturing to a country that also provides technology and intellectual property to other countries. In this effort, which is funded to a great extent by the CDB, Chinese companies are acquiring companies globally and integrating their newly acquired technology domestically. [7, 10]

China has long viewed securing access to Africa's natural resources, agriculture, and labor market as important components in the support of its domestic industries. Since a great deal of Africa is under-developed, when compared to Western countries, China's approach in Africa is somewhat different than it would take in Europe or Latin America. In Africa, China has established the China-Africa Development Fund (CADF) to invest in Chinese enterprises whose trade and economic activities have reached, or will reach, Africa. This differs from economic aid in that CADF makes investments in projects and theoretically requires an investment return. The funds' initial investment focus will be in the areas of agriculture, manufacturing, infrastructure, natural resources, and industrial parks set up by Chinese enterprises in Africa. [8]

The CDB not only provides financing for overseas projects, but for domestic projects as well. CDB has provided financing for the Shanghai Pudong International Airport, the North-South Water Diversion Project, the Three Gorges Dam, as well as other projects that offer economic stimulus such as airports, roads, and high speed rails. [2, 3] CDB's access to capital, for domestic as well as internal projects, is primarily obtained through the issuance of long-term bonds to institutional investors on China's interbank bond market and foreign markets. [3]

In the world of global finance, CDB is a game changer. Its sheer size and available capital give it the ability to dominate almost any market segment it chooses. Let's give you an example used by Frank Hochberg, the head of the US Exim bank, which is a fraction of the size of the Chinese policy banks, on what keeps him awake at night. One of Hochberg's insomniac moments is caused by Huawei, a Shenzhen telecom company that was founded in 1987 by a retired military officer, but did not begin to export its equipment until 1996. In the late 1990s the CDB provided Huawei with a $30 billion line of credit. Access to these funds allowed Huawei to reduce its cost of capital and offer financing to buyers at rates and terms better than their competitors. "None of the G-7 countries provided levels of financing anywhere near those of the CDB. That keeps me up at night," Hochberg said. Today, Huawei is China's largest phone equipment manufacturer and the world's second largest after Ericsson AB, with 65% of its revenue coming from outside China. [1, 9]

Henry Sanderson and Michael Forsythe also point out that CDB's credit lines are often used for vendor financing. They give the example of Tele Norte Leste Participacoes (TNLP), Brazil's largest landline company. When TNLP was shopping for equipment in 2010, Huawei had an immediate advantage over its competitors. They were able to provide TNLP with a two-year grace period on payments and an interest rate of 2% over the London Interbank Offered Rate (LIBOR). At that time this gave TNLP an effective interest rate of approximately 4% when other Brazilian companies were paying about 5.99% for their debt. Similarly, Mexico City-based Movil SAB's CFO, Carlos Garcia Moreno, reached the same conclusion when Movil was seeking $1 billion to upgrade their mobile network. [1]

Today China Development Bank continues to be the muscle behind China's global expansion. It's the financial arm for the Chinese government, promoting domestic as well as international growth. In doing so it projects China's political and economic agenda and influence throughout the world.

Newsletters and blogs on China can be obtained by visiting Thornhill Capital's web site's at www.thornhillcapital.net and http://thornhillcapital.info/ or by e-mailing us at info@thornhillcapital.net

Endnotes:

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April 2013 China Newsletter

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