FINANCIAL TIMES

In search of China’s top entrepreneurs

By David Stevenson
Published: September 24 2010 23:11 | Last updated: September 24 2010 23:11

China investment expert Clare Duan, who combs company accounts to spot pitfalls

It’s a warm day in northern China, but it’s cool inside our BMW limousine as it pulls out of the carpark at a new biodiesel plant in Tongchuan City, Shaanxi Province. My two companions clock up thousands of miles in these comfy cars on fact-finding trips around China, visiting dozens of small companies that might just be the next big growth story their investors are looking for.

Clare Duan and Tina Yu are American-educated investment professionals who work for Vision Opportunity China (VOC), a US-run, London-listed stock market fund. “We’re part of a large team of Chinese-born-and-bred researchers and analysts, all of whom are absolutely encouraged to get their hands dirty very early on. It’s a great place to learn,” Yu says.

On the road, they meet China’s next generation of entrepreneurs, many of whom receive backing from VOC. “All of the entrepreneurs are unique in their own walk of life and are all great people we want to learn from,” says Yu, 34. “Although most of them do not speak English and they sometimes have difficulties communicating with western investors they’ve all had legendary life experiences.”

Her colleague Duan, 25, is an intense, boundlessly energetic investment analyst whose job is to spot the financial pitfalls that can trip up investors in China. She combs through the company account books and investigates the underlying business operation.

Yu is old enough to remember the privations of the post-Mao years. She remembers visiting her grandparents in Shanghai and falling ill with a fever. Told to go down and wait in the ration line for a watermelon to cool her fever, the girl started to feel dizzy. “I asked my grandparents if I could go back home and have lunch and then come back again to the queue. But my grandparents were telling me, 'Don't wash your hands because I don't want you to erase that stamp on your palm.'" With no queue stamp there would be no watermelon.

Rationing is long gone. Yu's fund invests in a supermarket chain in the northern Manchurian province where hundreds of watermelons are now sold every hour. Business is brisk in China's consumer sector and every street corner seems to boast a convenience chain store.

Picking winners in China requires perseverance and luck, but also nerves of steel and very close attention to detail. On the road, these challenges become immediately obvious.

Tina Yu, who searches for investment opportunities in China

As we talk about the company we've just seen in Tongchuan City, we hit a vast traffic jam. Hundreds of grubby lorries are stuck on the road. Two miles and an hour later, we pass the problem: a road crew trying to plug a hole that is the size of a small building. Our rented limo, which has been specially lengthened to appeal to bling-loving Chinese tastes, just manages to skirt around the chaos and on to the sleek Xitong Expressway which goes to the tourist-magnet city of Xi'an (famous for its terracotta warriors). We speed south, but then come to a near-halt in the outskirts of the town, and creep past a giant building site where hundreds of new offices, apartment blocks and hotels are shooting up. Some of this is to service the tourists visiting what was once a capital of Imperial China, but Xi'an is also an industrial powerhouse, home of outfits such as the electric car pioneer BYD Auto – which has attracted investment from Warren Buffett.

BYD is big, but the role-model for a Chinese "shooting star" is Baidu. This Chinese rival to Google is now quoted, like many of VOC's investments, on the US markets and is worth $29bn. China has attracted Anthony Bolton, the UK's most famous investment fund manager, who has now relocated to Hong Kong. His Fidelity China Special Situations Trust launched with £460m of new money in April 2010.

Much of the new investment money is going into consumer sectors, tempted by growing Asian demand for luxury goods. Chris Ruffle is a British fund manager who has worked in China for decades and manages successful funds for Martin Currie. As consumer credit levels start to rise, Ruffle reckons China is set for a consumer boom. "You ain't seen nothing yet!" he tells me.

Despite the optimism, many western institutional investors have already been badly burnt in China. Back in 2005, along with other analysts and newspaper journalists I attended a presentation about investing in China run by London Asia Capital, a London stock-market-listed outfit run by a group of London bankers and Chinese entrepreneurs. They promised access to a series of fast-growing companies that were themselves in the process of listing on the London markets.

We saw lots of graphs forecasting profits. Suddenly London seemed to be the place to be if you were a Chinese entrepreneur (advised by London Asia, of course). Like many journalists in the room, I was impressed by these eager young entrepreneurs, with their talk of educating the Chinese masses or building wind turbines in Inner Mongolia. But by December 2008 the show was over. London Asia's stock market listing was cancelled.

When new managers were brought in they discovered that no formal accounts had been prepared since 2006. There was no cash in the UK bank account – not enough even to pay for the new CEO's airfare to Hong Kong – and many of those exciting small companies listed in London had vanished without trace.

Since then the new management has been working hard to untangle the web of investments it inherited.

It's a cautionary tale, but not an isolated one. Such is our enthusiasm for investing in China that it's easy to get carried away and invest in companies about which we know, and understand, next to nothing. The VOC fund invests in fewer than 5 per cent of the proposals put to it. Most companies fall by the wayside because they are in a low margin sector where competition is intense. The team is also cautious of investments in real estate and banks or in larger companies where state interference is more blatant.

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Most of Yu and Duan's best deals come via a network of friendly financial advisers and venture capitalists – who are themselves approached by companies eager to list on the western stock markets. But that approach is only the first stage of the "courting" – the Vision team moves through a detailed three-stage investigation process that can take many, many months.

Dr Randolph Cohen, a fund manager and academic, David Benway, director of VOC, Clare Duan and the writer at Shengkai Innovations, Tianjin

"The first stage would be operational due diligence," says Yu. "We do a top-down model, looking at the industry sector the company is in, looking for fast-growing sectors. Has the company got an interesting business model? The second stage is financial due diligence – we look at the company's income statement and balance sheet on a line to line basis. The third stage is the legal due diligence." This last stage includes extensive use of local investigators. This detailed process sounds dreary but Duan and Yu thrive on it.

Yu gained a PhD in chemistry from Princeton before switching into Wall Street as a biotech analyst. Duan also went to American universities: at school she was gifted at maths and her aptitude for numbers comes in handy as she spends weeks on the road, often on her own, talking to managers and checking accounts. Tax fraud is a problem. Underpaying Chinese taxes can land the guilty party in prison – yet Duan tells me many entrepreneurs are well-versed in using multiple companies and accounts to hide systematic underpayment.

In one recent case she'd had to visit 12 different banks with company managers in tow. Duan had asked to check a company's account summaries against banks' own internal records. "We wanted to know if the company had historically underpaid or overpaid tax. Had they committed a tax fraud?" Matters had been complicated by the fact that the chairman used his personal bank account to make the company tax payments – something that's not uncommon in China. Determined to get to the bottom of the web of transfers, Duan suggested to the company managers: "Let's go to the bank all together. Let's physically walk bank to bank. Let's read through all these bank statements. If those freshly printed bank statements in front of my eyes match perfectly with the records presented to us by the company, then that definitely increases our confidence level."

One company, fabulously profitable, had attracted international attention. On paper it looked a surefire bet. Yuan noticed it seemed to be producing margins way above the average. The books looked fine, the business seemed promising but the private investigators found out why the company was so special. "The supposedly successful company was using prison labour. That's why the company was able to have a high operating margin. Through your financial due diligence process, you know the labour costs are low but you don't know what kind of labour they use. Even if you go on site, they're not going to take you to the prison! That's when those private background checks come in."

Yu tells me about a piano-manufacturing business that had been winning rave reviews from its customers. The numbers looked good and the company appeared to have the potential to grow into a top player in this specialised market. The icing on the cake seemed to be the wondrous customer testimonials. But "some of the customers were not real customers ... probably their families and friends, faking as customers. And then through our local connections we talk to the real customers who actually told us about the [inferior] quality of this manufacturing company," Yu says.

We've arrived at another outpost of the oil distribution and biodiesel refining company we visited in Tongchuan City. China Integrated Energy, listed on the US markets in 2007, is now worth $250m – making the founder, Xincheng Gao, with his 64 per cent stake, worth $160m. Duan and Yu have briefed me that the energy infrastructure of China needs a complete overhaul – and entrepreneurs such as Gao are ideally placed to benefit. That's not bad for a civil servant who only started in business in 1999. When Gao started out, China's local banks would not lend without a promise of real estate as collateral. So China Integrated Energy turned to equity investors in the west.

In 2006 sales were $54m and within three years revenues had hit $280m, with compound annual growth rates of around 70 per cent for profits. Gao's company is now one of the largest biodiesel manufacturers in China and his new refinery in Tongchuan City should increase capacity by another 50 per cent in the next few years. Duan and Yu's boss, VOC director David Benway, reckons there are probably 40,000 small to mid cap companies like CBEH in China, most of which are growing at equally astonishing rates.

Xingcheng Gao at his company China Integrated Energy

Gao's company isn't even VOC's most successful investment to date – that is Shengkai Innovations, which will be our next stop. VOC's stake in the industrial valve business is up by 479 per cent. China Integrated Energy by contrast is up a meagre 254 per cent (in just over two years). Not all of its investments grow – China Gerui Advanced Materials is down by 97 per cent.

Overall, VOC has managed to produce a growth of 141 per cent in the value of assets under management in just over two years. With returns like these it's little wonder that Duan, Yu and their American colleagues, David Benway and Dr Randolph Cohen (a fund manager who is also an academic at MIT in Boston) are in ebullient mood later that evening as we head for dinner with Gao at one of Xi'ans finest dining rooms – we're to celebrate the opening of the new refinery.

Endless courses spin around the revolving table – my favourite is roast chicken hidden in a wooden pig, with a key to unlock the tasty contents. There is also lots of alcohol – something that is common at key business dinners in China. One China hand tells me later that if you aren't good at drinking, "it would be a significant impediment to your career in China."

It's hard to believe that Gao has only been in business for 11 years. He spent most of his life working for the government – not uncommon among entrepreneurs. Local army railway lines ship his oil, while local government partnerships make sure feedstock prices are pegged and agreements signed with peppercorn farming co-operatives. Many western commentators like to draw a dividing line between the private sector and the state-owned large companies and SOEs (state-owned enterprises). But the reality is that very little gets done in China without state approval and support.

What China cynics worry most about is not the growth potential of this vast country. That's not in question. The problem is corporate governance. At its core sits the (mis-) alignment of three core groups – the party, the entrepreneur and the investor.

The Asian Corporate Governance Association (ACGA) issues regular surveys on corporate governance and fights the corner for outside shareholders. Its research ranks China constantly in the bottom three for corporate governance, just above the Philippines and Indonesia. The ACGA says that China's record is improving but it's clear that progress will be from a very low base. Ruffle at Martin Currie says corporate governance is improving: "I've been reading Chinese accounts now for about 20 years and certainly we're on an improving trend." But there are worrying practices in supposedly mature stock markets such as Hong Kong, where many growing Chinese companies list their shares. "These Hong Kong companies vote themselves a general mandate: they can do whatever they want ... They give themselves a right to issue 20 per cent of stock without reverting to share holders. Five weeks after they have done it, you discover they've raised money to invest in half an airline or some property development."

Duan and Yu also look for patterns of family ties. Often, senior management have financial links to external, family-controlled companies. Duan says this is a "very common phenomenon ... there are so many, it's beyond our imagination!" Many of these "third party" structures involve the chairman owning real estate which is "draining cash out of the company you want to invest in to a different business which is completely unrelated."

Michael Pettis, a finance professor at Guanghua School of Management at Peking University, is a critic of many of China's economic and financial policies. He says there's a profound structural problem with Chinese financial reporting. "Well, I wouldn't want to use the word 'lie', but I think there are a lot of discrepancies in accounting numbers especially and there's also just a physical problem," he suggests. There just aren't enough people to do the jobs. "A couple of years ago, it was estimated that China needed about 250,000 accountants a year and it was producing 50,000."

Companies such as China Integrated Energy represent the vanguard of a corporate governance revolution. Gao, who chose to list in New York, has three independent directors on the board and employs top-rate auditors.

Shengkai Innovations, Tianjin

Next day, on the road again, we head to Tianjin in the north-west, a vibrant old port city surrounded by new building sites. We're here to visit Shengkai Innovations in the enormous Tianjin Airport Economic Area. Once this new facility is complete, Shengkai expects capacity to more than treble. Its long-lasting valves are exported to oil and energy customers around the world.

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I give up counting the cranes towering over building sites here. it looks impressive but Pettis believes this extraordinary expansion across China will eventually destroy investors' returns. He thinks the Chinese development model is a Communist party version of the Asian model of expansion perfected by Taiwan and Japan in the postwar years, but that these countries have both been black holes for investors during the past few decades. In this model, the priority for development is output growth in export sectors, using subsidised local capital from local citizens' savings accounts and a controlled currency regime. A policy of output growth at all costs means that investors in growth stocks are "not sure why these companies are making money," Pettis says. He worries that if you lose the implicit subsidies – by increasing interest rates or revaluing the local currency – these fabulous profit margins will vanish.

More encouragingly, Chris Ruffle believes that despite all the governance issues, China's share of the world stock markets simply has to increase, if only because of the growth of its economy. He estimates that local stock markets currently make up, by value, a measly 1 per cent of the combined value of the world's equities (as measured by the MSCI Index) yet China already comprises 6.9 per cent of global GDP.

And how do my companions Duan and Yu feel about China's future? Hugely optimistic. Yu says that the "next 30 years will be even more spectacular ... I still think most western investors may potentially underappreciate the growth potential." As we rush past the numberless cranes looming over the motorways of China, I can't help but agree.

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