



## Note to clients

### ***The Year of the Bear: The U.S. heads into recession, so what's a Chinese company to do?***

While the Chinese calendar has twelve animals, Wall Street's calendar only knows two beasts – the shoving, snorting, good natured bull that pushes the market up, up, up – and the snarling, vicious bear that tears all this hard work into bloody spouts of red ink. The problem is that unlike the well ordered Chinese calendar based on the movements of the heavens, you never know when the page on Wall Street's calendar is about to turn. But last week, events turned decisive. With U.S. jobless rates growing, the last of Wall Street's bullish economists admitted that the credit crunch that began last July had blossomed into a full blown recession. We are now officially in the Year of the Bear – and we don't know how long we will have to spend in the lair of this foul tempered beast.

With this in mind, we thought it would be a good idea to offer some thoughts to our clients on the forces that are driving the U.S. markets, what to expect over the coming months, and how to minimize the damage of a bear market and seize opportunities that emerge in every market downturn.

### ***Bear Markets: A User's Guide***

A bear market is defined as a period during which the vast majority of stocks are in decline and major stock indexes fall by at least 15% from their highs. Bear markets are normally driven both by deteriorating economic fundamentals and negative investor sentiment. In a classic bear market, these two factors will reinforce each other to create a vicious circle in which declines in stock prices lead to more conservative spending by businesses and consumers which leads to a weaker business environment which leads to further selling of shares, and so on and so on...

Many Chinese companies have gone public only in the last several years, and so may have never before experienced the impact of a true bear market on their stock price. Given that China for the moment continues to experience very healthy economic growth, Chinese management may feel that they are being unfairly punished for the sins of subprime sultans and junk bonds princes on the other side of the world. But the claws of the bear are not so discerning when there is blood in the streets.

Looking at the chart below, we can see that after a strong bull run in which the S&P 500 more than doubled since 2003, that index has now declined by 17.4% from its high of 1565 on October 9, 2007 to close at 1293 on this past Friday. The S&P represents the stocks that conservative investors typically hold. As measured by the values of America's "blue chip" corporations, the bear market has arrived.

Similarly, investors in technology and growth stocks have taken a drubbing. The NASDAQ Stock Market peaked slightly later on October 31 of 2007 at 2859, but has dropped 22.6% since then to close at 2212 on Friday. Ouch!

### S&P 500 (Mar 6 2006-Mar 5 2008)



### NASDAQ (Mar 6 2006-Mar 5 2008)



If anything, investors in Chinese stocks have fared worse than those who held U.S. blue chips or tech stocks. After tripling in value in only two years, the Halter China Index has since declined by 34% from its peak on October 17, 2007 at 8859, to close at 5885 on Friday. This index, which tracks every Chinese company that trades on a U.S. senior exchange, actually understates the pain inflicted on Chinese companies trading on the OTC Bulletin Board – many of which have declined 50% or more from their peaks over the last few months, while seeing trading volume dry up.

## Halter China Index (Mar 6 2006-Mar 5 2008)



In this environment, company management is likely to field angry calls from investors, face risks that planned financings will be cancelled or cut back, and even begin to doubt the sanity of the capital markets themselves. After all, China's GDP is forecast to grow at 9.6% \* in 2008, most Chinese companies continue to meet or exceed quarterly profit forecasts, and valuations are the lowest they have been in years – what's not to love about Chinese stocks? \*World Bank, Feb 2008

## ***The Return of Risk Premium***

To answer that question, return to the forces behind every bear market – deteriorating fundamentals and investor sentiment. The current bear market began in July of 2007 with a credit crunch that began in the subprime market, appeared to have been contained by September, and has since gone on to infect nearly every corner of the global capital markets – from commercial real estate to European banks to municipal bonds and now the corporate credit market that finances the daily operations of most U.S. companies.

The underlying theme of this crunch has been the Return of the Risk Premium. In normal circumstances, borrowers with shaky balance sheets will have to pay significantly higher interest than those with triple A

credit, while companies with volatile earnings streams can expect to have lower valuations than strong and steady growers with years of profitability. But during the period from 2003 to June of 2007 this risk premium dissolved in a flood of easy money and steady economic expansion.

In 2008, the Risk Premium has returned with a vengeance. The spread on high yield (or junk) bonds over treasury bonds has gone from 3% to 10% in some cases. Banks are tightening their lending standards across the board. And many markets for more exotic securities have simply shut down – with sellers unable to find buyers at any reasonable price.

### ***How does this impact trading in small cap Chinese stocks?***

On Wall Street, emerging market stocks are thought to contain more risk than those in developed countries, while the earnings of smaller companies are generally more volatile than those of large, established enterprises. In addition, investors may impose an additional risk premium on companies from China to compensate for risks posed by less secure property rights, nascent corporate governance principles, and concerns about accounting quality. Thus, on the spectrum of equity risk, from blue chip to penny stock, Chinese equities will be generally thought of as high risk, high return propositions. It is telling that retail investor interest and day trading in Chinese equities reached its highest point in September and October of 2007, after the long bull run in U.S.-listed China stocks was in its last stages and the credit crunch had already begun.

In a bear market, many investors will flee risk – either real or perceived – in a “flight to quality.” In addition, much of the “hot money” that flooded into Chinese stocks chasing the spectacular returns of the past several years is now gushing back out. Hedge funds and retail investors who borrowed money during the bull market to juice their equity returns are now facing “margin calls” from prime banks or brokerage houses that demand they sell their collateral – leading to more shares being sold into the market and further depressing stock prices. In this type of environment, buying and selling decisions may often not be rational, but driven by emotion or the need for sheer economic survival.

### ***Where Did All the Liquidity Go?***

In the face of declining equity values, many fund managers are facing the risk that their own investors may demand “redemptions” – forcing them to sell the equities they hold at unfavorable prices. But in a bear market, liquidity in thinly traded stocks often dries up – meaning that it may be impossible to dispose of these shares without driving the share prices sharply lower. This can result in wild swings in stock prices and periods of irrational valuations when the market is in disequilibrium. In the worst phase of a bear market even value investors who would normally pounce on these shares may hold back – believing they can buy the stock even cheaper if they wait. Liquidity in the market is like oxygen in a room; you don’t think about it until it is gone, but by the time you notice some people are gasping for life.

### ***What Should We Do Now?***

No one can predict with any certainty how long the current bear market conditions will be sustained. It could be weeks or it could be a year or more before the bull stomps back on the scene. But assuming that

the snarling bear will be our companion for some time to come, what can the management of Chinese companies do to make the most of current market conditions?

Based on our experience of past market downturns, we would suggest the following be elements of your Bear Market Survival Strategy:

- **Build public company infrastructure** – The best way to reduce the risk premium that investors apply to your stock is to build world class public company infrastructure. Many companies from China have been growing so quickly that they simply have not had time to build the systems to ensure solid financial controls and mature corporate governance. If you don't have an independent board of directors, now is the time to appoint one – and make sure your directors are qualified with substantial experience running overseas public companies and strong finance backgrounds. Now is also the time to recruit a Chief Financial Officer with strong experience in U.S. GAAP reporting and internal controls. Investors will have much more confidence in your numbers if they know there is a qualified CFO in place who can communicate with them effectively and a reputation at risk. In a market downturn, there is likely to be a lot more talent available. And if your company has been relying on high level financial targets to drive your business forward, now is the time to develop a formal and detailed annual budget and forecasting process – so you can quickly make adjustments if market conditions change. If you are not able to track your revenues, profits and cash flows on a weekly and monthly basis then your financial systems are not adequate to be a public company – now is the time to upgrade them.

- **Avoid headline risk** – In a bear market, a negative article in the financial press can decimate your share price. And in these volatile markets short sellers will be more than happy to feed ideas to reporters in the hope of making a fast profit when the stock declines. Now is the time to ask all the very tough questions before someone else does: Do you have any related party transactions that are questionable? What is the reputation of your audit firm? Do you have clear policies regulating the sales of stock by company management and insiders? Do any of your directors or associated persons have a history of SEC violations or promoting dubious companies? Are you truly meeting the environmental standards? How good are your product quality and product safety standards? Now is the time for management and the independent board to thoroughly scrub their operations and take corrective actions to correct any deficiencies. As a public company listed on the overseas markets you are expected to adhere to the highest standards. A good question to ask before taking any action is: "How would I feel if this appeared on the front page of the newspaper?" Because sooner or later it just might.

- **Stay visible** – In a declining market, many companies may be tempted to simply go dark. "If the market conditions are poor now, why not just stop communicating with investors until they are ready to listen?" In fact, during volatile markets investors need to hear from management more often than ever. Rumors breed in an information vacuum, and if you don't keep the market informed on your operations short sellers and speculators will be happy to spread their version of the facts. Remember, your long term shareholders are also under stress right now – hoping they are making the right decision by not selling your stock. If you provide them with accurate, detailed and frequent updates on your company's progress, you will build good will and credibility for years to come. If you abandon them now, they will never return. Companies that stay visible during bear markets are likely to experience more moderate declines in their share price – and more importantly will recover more quickly once market sentiment turns to the positive.

- **Keep an eye out for bargains** – The season of the bear is the time when the best deals in corporate history are made. This is certainly true for stock market investors, but even more so for corporate acquirers. If your company has a strong balance sheet and is able to continue to produce strong cash flows during the downturn, a bear market can be the best possible time to make

acquisitions. If you are considering overseas expansion, there will be plenty of attractive targets for sale over the next twelve months in the U.S. and even Europe. With private equity funds shut out of the debt markets, you have less competition for the best deals. And if your industry has too much capacity, now is the time to talk to your competitors to see if a deal can be struck. Now is the time to build a strong M&A strategy and the team to execute it. During a bear market only the strongest companies in each industry are able to access growth financing – and if you have strong cash position you will find many willing partners falling into your arms.

■ **Develop “Plan B”** – In periods of volatility, every company needs to have a “Plan B.” If your business has significant exposure to exports to U.S. consumers, now is the time to go back and spend time with your customers and make sure the growth forecasts you built your business plan on are still valid. If your business plan for 2008 depends on accessing outside financing, it does not mean that you should abandon that – many deals will still be completed even during a bear market. But it does mean that you should have an alternative strategy as to how you plan to manage and grow your business if the equity markets are not available to you for a period of time. That may mean a convertible bond or bank debt or vendor financing – or it may mean only growing as fast as your free cash flow can support for a period of time. This is where the hard work you put into world class financial systems will really pay off.

■ **Prepare for the Upturn** – The most important element of any Bear Market Strategy is to be prepared for the eventual return of the bull and attendant market upturn. If history is any guide, the stock markets will begin to trend upwards again long before the current U.S. recession is over. Once investor sentiment turns positive, investors will buy up shares of those companies who stayed visible during the downturn, developed credibility as excellent managers, and built public company infrastructure to match any company in the world. On Wall Street, windows to do financings can open up in a matter of a few weeks – but are only available to those that have prepared to seize the opportunity.

We hope that these thoughts have been of some value to our clients as they seek to understand the forces that may be impacting trading in their stock in recent weeks and prepare their company for a prosperous future. While Wall Street’s seasons can be difficult for anyone to predict accurately, there is one solace. With very few exceptions, bear markets usually pass with a few quarters, while bull markets often thunder on for many years.

Please feel free to contact us to discuss any of the above,

Best regards,

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