Rising Dragon

The ripples from China's booming economy and growing middle class are being felt around the world. Investors may want to position their investment portfolios to benefit.

NO QUESTION: **China is booming. The country boasts the world's fastest-growing economy, one of the fastest-growing middle classes and a manufacturing and industrial base set to rapidly expand for the foreseeable future.**

Financial success mixed with rapid growth — and the widely accepted prediction that more of both is on the way — has given China a unique role in the international economic market. From 2001 to 2005, annual per capita gross domestic product (GDP) growth in China was a substantial 9.5%, according to Oxford Economic Forecasting, an economic consulting group based in the United Kingdom. And that growth is expected to continue, with OEF predicting per capita GDP growth of 9.1% through 2010.

But China's economic success has not been without controversy. For one, the ability of Chinese manufacturers to produce goods at a much lower cost than their Western counterparts places pressure on U.S. companies. In addition, some say China has moved too slowly in properly valuing its currency so it can maintain a price advantage on exports. And for others, its record on human rights and environmental protection remains problematic.

For interested investors, there are many opportunities to capitalize on China's booming economy. But investing in China can present some unique challenges, particularly as a result of its rapid growth and changes in its political and economic landscape. Despite these challenges, China presents an opportunity many investors can't ignore.

Some U.S. Companies Already Benefiting

China's economic success is having a mixed effect on U.S. companies. On the one hand, China's lower production costs are "already overwhelming certain American industrial sectors, like textiles," says Jean-Marc Blanchard, assistant professor of international relations at San Francisco State University. "But, on the other hand, there are American industries, like aerospace, automobiles and agriculture, that are profiting handsomely from dealings with China."

For investors seeking to profit from China's growth, a number of opportunities exist via Western companies that already are doing business in China, or are likely to do so in the near future. "Investors should think about how they can profit from the growing Chinese middle class, which wants better health, leisure and other services," Blanchard says. "They should also consider how they can profit from shifts in production and infrastructure development as [economically vibrant] coastal areas continue to grow."

Chinese Citizens Hold the Key

The growing Chinese middle class already is fueling opportunities for American fast-food companies and automakers. The China division of Yum Brands, which operates Pizza Hut, KFC and Taco Bell restaurants in mainland China, currently has nearly 2,000 locations in the country, up from a mere handful in the early 1990s. And sales for General Motors' Buick brand in 2006 soared 35.2% over the previous year.

And, by 2009, more Chinese citizens are expected to be accessing the Internet than anywhere else in the world. This prediction is leading Internet and software companies, such as Yahoo, Google and Microsoft, to seek ways to significantly expand their presence in the country.

Investors also may want to look at Western companies working with raw materials, commodities and infrastructure benefiting from China's boom. "China has significant production line capabilities," says James Pressler, associate international economist for Northern Trust. "But for everything it produces, it needs raw materials. When you look at China's development, it's going to require more high-end inputs across the board. So staying one step ahead of its development can be crucial."

Changes Bring New Opportunities

Recent developments in China's political and economic landscape present new opportunities to investors. For example, substantial change in the country's financial services sector looks imminent (see page 9), which could allow U.S. investors additional domestic opportunities to profit from China's growth.

"Today, investors should really pay attention to what new changes will allow them to get involved with opportunities that were not available in the past," says Fred Wong, managing partner with DiamondTech Ventures, a Silicon Valley-based venture capital firm that specializes in Chinese start-ups. "For international investors, I think it's wise to start paying attention to what the [new investment] vehicles are that you can now participate in."

Foothold Doesn't Always Equal Profit

During the past decade, Western multinationals and corporations, including many based in the United States, have represented one of the largest shares of direct foreign investment into China. According to the Washington-based U.S.-China Business Council, a record $60.3 billion in overseas foreign direct investment took place in China in 2005, the fifth straight year of increases. And this trend is expected to continue. However, the Organisation for Economic Co-operation and Development reports that a mere 5% — $3.06 billion — came from U.S. firms. Clearly, there is room to grow for U.S. investors in China.

Nevertheless, for many of the companies, the results have been mixed. "Just because you invest in China doesn't mean that you get any profits or any benefits from it," says Dr. Usha Haley, director of the Global Business Center at the University of New Haven, Conn. "Many companies have never been able to penetrate the Chinese market because they don't quite understand China. It's not one market. It's several." Haley says that profit margins can become "very, very slim" for U.S. or Western companies that try to set up shop there.

Direct Investment Opportunities Exist

For investors who prefer a more direct approach to investing in China, there are options as well. Direct investment in the Chinese market may offer the most potential for return, but it is also the most complicated and offers no guarantees.

"Over the longer term, there is money to be made [in China]," Blanchard says. "For those who cannot get directly involved, the best way [to invest in China] may be through a China-oriented mutual fund."

"China is going to continue to expand its global footprint," notes Pressler. "Right now, you don't see the kind of productivity in China that you see in the industrialized world. That means there's still a lot of potential to be unlocked." That is good news for investors who hold the key. ■

This discussion is general and is not intended to be an endorsement of any of the companies mentioned. Investors should consult their own advisors regarding any investment decisions.

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Open Markets & Looser Controls

As part of the 2001 agreement that allowed it to enter the World Trade Organization (WTO), China agreed to open its financial services sector to participation by foreign firms by 2007. Previously, only domestic companies could offer services such as banking, insurance, investment securities and retirement plans to a Chinese population rapidly gaining wealth.

This change is likely to allow some Western financial services firms into the Chinese market, either at the retail level or as partners with Chinese companies looking to expand their market share. And while these WTO covenants primarily address only one sector of the Chinese economy, the changes reflect what China as a whole is experiencing.

"This will be quite the adjustment, as the Chinese authorities will be letting a number of very established companies into a market which has basically been protected forever," says James Pressler, associate international economist for Northern Trust. "Now, foreign investors can enter into the financial market as majority holders, can buy out [domestic] companies and compete on a fair, level playing field."

Foreign participation in the financial services sector is also expected to offer another benefit: increased capital flows out of China and back into the West. While there is some question as to degree, most observers agree that China is likely to loosen its current controls over the amount of money that can flow back out of the country, particularly as it deregulates the financial services sector. And that can mean increased profits for foreign firms doing business in China.

"Foreign financial service institutions – such as investment banking and investment advisors – so far have been very limited in their ability to offer services in China," says Henry Wong, managing director of DiamondTech Ventures in Silicon Valley. "Foreign banks have not been able to provide consumer banking in China. That's obviously a huge market, and it is going to change very quickly."