



How is China's Growth Creating Opportunities in Maryland?

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The Definition of Growth

There are many ways to look at investments. As a portfolio manager, I use growth at a reasonable price (GARP) as a framework to shape my observations. The GARP investment framework is a blend of growth and value investing. As a rule, value investors focus on the price of the security, the numerator of the P/E ratio, while growth investors focus on earnings offered by the security, the denominator of the P/E ratio. GARP represents a blended approach and is often referred to as a market oriented investment strategy.

When looking at an equity investment it is important to bear in mind that equity is a residual claim, i.e. what is left over after a company's liabilities. The residual claim does not increase in value unless there is growth in assets or the equity of the company was undervalued when the investment was made. In a nutshell, growth is very important to equities. The world's largest emerging market — China — offers growth; however, investing in companies benefiting from China's growth can be done at a local level. There are a number of Baltimore companies participating directly in China's growth.

The Chinese Consumer and GDP

The severe financial shocks of 2008 have created an uncertain environment which is not as friendly to growth. This is reflected in the generally anemic growth being experienced in the developed market economies around the world. Unprecedented government stimulus has been used to offset weak consumer demand. Given the challenges of the current operating environment, where are the growth opportunities?

Growth opportunities do exist; they are just harder to identify. One growth story we are familiar with is China. An emerging economic powerhouse, China has four times the population of the United States. The rising affluence of the Chinese consumers creates a huge potential; however, the contribution the Chinese consumer makes towards Gross Domestic Product (GDP) is very different. The easiest way to think of it is as an inverse relationship: 70% of the U.S. economy is driven by consumption while only 35% of the Chinese economy is driven by consumption. The inverse is true with industrial production which accounts for 30% of the U.S. economy, while industrial production accounts for approximately 65% of the Chinese economy.

This fundamental difference carries over into the imbalanced trade patterns between the U.S and China. China just surpassed Canada to become the largest exporter to the U.S. The dollar value of goods China exports to the U.S. is approximately five times what the U.S. currently exports to China.

The financial crisis of 2008 is creating fundamental changes in consumption patterns. The Chinese government is using vouchers and other stimuli to increase Chinese consumer demand, while the U.S. savings rate has swung from a negative figure to approximately 6%. Net U.S. consumption is falling, while structural changes are occurring in China geared towards stimulating greater internal consumption. The Chinese government is actively seeking to correct China's unhealthy export dependency which has been overly dependent on the U.S. consumer. This creates an export opportunity for U.S. companies that have products and services that meet China's internal consumption needs.

Marching into China

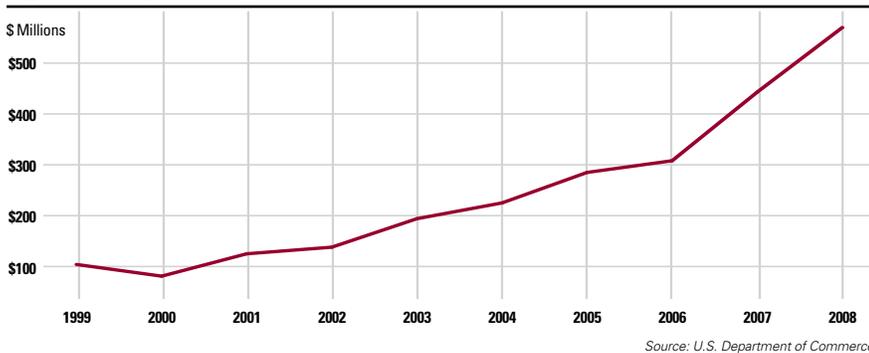
A less told story is the impressive success U.S. firms are achieving as they grow exports to China. For the purposes of this article the focus will be on how China's growth is creating opportunities for Maryland based companies. Detailed in figure 1 (next page) is the growth in Maryland's exports to China over the past ten years.

The chart indicates a significant accelerating rate of growth in Maryland's exports to China. After observing the significant rate of growth, the question becomes, what Maryland companies are behind this growth? What are the products and services which they provide? Is Maryland's export success just based on agricultural products such as soybeans and chicken parts, or is there more? The following narrative is a representative sample of the dynamic companies based in Maryland that are already benefiting from China's growth.

A Journey to China

If you were to take a trip to China, how would these Maryland companies possibly interact with your journey? The most common way of getting to China is flying. When a plane lands it needs to immediately reduce its speed. One of the largest sellers of thrust reversers to the Chinese airlines is Middle River Aviation Services (privately owned by GE). Thrust reversers are those doors that open up on the side of the engines and permit a reverse flow of air to slow a plane when

Figure 1: Maryland's Exports to China



it lands. Middle River Aviation Services headquarters is adjacent to Martin State Airport where it operates a 1.7 million square foot production facility. Now that you have arrived in China the question becomes: where to stay. Marriott (ticker MAR), a well established Maryland company, makes that decision easier. Marriott offers over 16,290 hotel rooms at 41 new and attractive properties. In the city of Shanghai alone Marriott has ten major hotel properties.

Now that you are rested, you are interested in getting a meal. You may be surprised to know that a growing provider of seasoning to quick serve restaurants in China is McCormick & Co (ticker MKC). The unfortunate problems associated with large scale food contamination in China have led to the first national food safety laws. This removes a thicket of conflicting provincial laws that restricted McCormick's growth to regional markets near its three production centers in coastal China. Now McCormick has the opportunity to pursue growth initiatives across the country as the new food safety laws come into force.

As you explore China you will notice numerous manufacturing operations. You may wonder what goes on in the factories. What is produced and how? If companies are producing coatings for fiber optics or coatings for automotive components, there is a chance that they are using ultraviolet curing systems manufactured by Maryland's Miltec (private). If the manufacturing facility is producing high technology items, they may have contracted Washington Laboratories (private) which specializes in Electro Mechanical Compatibility (EMC) certification, which is required by the Federal Communications Commission for any electronic goods exported to the U.S. EMC certification establishes that, among other things, new electronic devices will not interfere with airplane avionics or medical devices such

as pacemakers. During your travels you may decide to visit a store and find Black & Decker (ticker BDK) power tools for sale. Black & Decker is quietly building out a sales network in China as it expands its presence in the world's largest emerging market.

One travel concern that is always important is where to seek medical attention. The largest private hospital system in China is run by Chindex (ticker: CHDX) a Maryland based company. Chindex operates a network of private hospitals and clinics in Beijing, Shanghai, and Guangzhou. Chindex also sells western medical equipment and instrumentation to the Chinese market.

Conclusion

As you can see, China's growth is creating a number of opportunities for Maryland based companies. Some of the most promising investment opportunities are in companies that are positioned to meet China's growing consumer demand. From a GARP perspective the challenge is to identify the companies with a first mover advantage and that are positioned to capitalize on their market position. Beyond the forward thinking management teams at the companies mentioned, credit should also be given to the efforts of the Asia Office of Maryland's Department of Business and Economic Development which has helped facilitate the growing private sector initiatives.

Reference:

SEC filings
U.S. Department of Commerce
Press releases and company websites
Maryland Department of Business and Economic Development

Disclosures:

The author does not hold a position in any of the companies discussed
The report is not a recommendation or offer to sell any security