

# PENDO LLC



THE VALUE INVESTOR

## **International Value Strategy Quarterly Commentary Q2 2010**

July 1, 2010

### **De-Pegging the Yuan\***

In late June, the Chinese government announced that it would let the yuan float (the yuan has been “unofficially” pegged to the U.S. dollar since December 2008). The last time the Chinese government let the yuan float, 2005-2008, it appreciated by approximately 20% versus the U.S. dollar (~ 6% per year). It is unknown whether the de-pegging came about due to criticism from trading partners, or perhaps in order to fight inflation. It is also unknown whether the regulators will intervene to limit gains in the yuan to protect its exports (Pendo expects so). Since our Chinese and Hong Kong companies do business almost exclusively in yuan, a stronger currency will result in more assets, book value, and higher earnings. Of course, the opposite is true as well. It is the general opinion of most economists that the yuan is undervalued. We tend to agree with this opinion, and believe that this will have a net positive impact on our Chinese and Hong Kong investments.

*\*Yuan is the unit of currency; renminbi is the actual currency. Yuan renminbi would be analogous to pound sterling.*

### **Healthcare Reform**

We find the healthcare industry to be very interesting right now. On one hand, we have the big multinational pharmaceuticals trading at or around all time lows. This is despite appearing to be as well-capitalized as ever, and providing very lofty dividend yields, something that today’s investor should find quite attractive. On the other hand, we have the developing economies of the world with limited access to, but growing demand for healthcare. Although we cannot fully know where our domestic healthcare industry is headed, recent political trends point to the conclusion that profit margins along with incentives to innovate and produce, will only decrease. Currently, 88% of the world’s pharmaceuticals are used by 18% of the world’s population, with the other 82% sharing only 12% of the pharmaceuticals.

Today, large multinational pharmaceuticals are increasing their exposure to developing economies in order to diversify away from the Western Economies. They do this in various ways: through mergers and acquisitions, outsourcing, creating joint ventures, and so on. The common theme is an increase in exposure to generic drugs and to emerging markets, especially China. For instance, China is currently Pfizer’s tenth largest market; it expects China to be its second largest market by 2015.

Naturally, the large multinationals have an advantage in both intellectual and financial capital. They are placing vast amounts of resources into growing their exposure in emerging economies in Africa and Latin America, as well as in China and India. On the surface, to buy a pharmaceutical company in South Africa, Argentina, or Malaysia, may appear risky when one could be buying a “safer” Pfizer or Merck at 10x earnings and a 5% dividend yield. Indeed, we actually own one multinational (GlaxoSmithKline; see below). However, multinationals create not only currency exchange risk, but also political and antitrust risks. Smaller economies often do not have local healthcare companies, but are primarily dominated by the multinationals. Most economies of the world are not developed enough to create a market that is large enough to compete with the large pharmaceuticals. This is not the case with the Chinese economy or its healthcare industry. China has a population of 1.3 billion, a healthcare industry that is very underdeveloped, and a government that is not only actively supporting an improvement in healthcare for its people, but a government actively supporting its domestic healthcare providers. Its healthcare providers operate in the Chinese economy, in their own currency, have plenty of room for growth, and a friendly government. We find the Chinese pharmaceutical industry quite intriguing and unique.

*As an aside:* India also possesses an attractive healthcare market. However, as of this writing, only one Indian healthcare company is available to non-Indian investors. That company is Dr. Reddy (NYSE: RDY), which we are slightly invested in indirectly through a joint venture with GlaxoSmithKline. Dr. Reddy markets its products in India, and also in the U.S. and Europe.

According to IMS Health, a leading market research firm to the healthcare industry, China’s pharmaceutical market is the fastest growing in the world. It expects the Chinese pharmaceutical industry to double by 2013, adding \$40 billion in sales. For the same time frame, it expects the global pharmaceutical market to grow at a 4-6% compound annual growth rate.

With the exception of urban areas such as Beijing and Shanghai, the healthcare industry in China is very underdeveloped, having been devastated as a result of Chairman Mao’s 1966 *Cultural Revolution*. Although improvements have been made, long after the *Era of Reconstruction* began in 1976, access to healthcare remains limited. Many towns have no clinic, dated equipment, and in many cases no doctor. The government has made a commitment to change this. As part of the PRC healthcare reform, the government has pledged to build thousands of rural hospitals and clinics, and expand medical insurance to make healthcare available to its entire population. Companies such as GlaxoSmithKline, Sanofi-Aventis, and Pfizer have created joint ventures with Chinese counterparts in order to develop and provide medicines that are affordable. However, the government is favoring the Chinese pharmaceutical companies and supporting this through various antitrust regulations. One such regulation stipulates that the government for the most part shall not allow foreign acquisitions; instead, in most cases it allows joint ventures in which the foreign company can own no more than 20%.

One example of the Chinese government’s support for domestic entities would be Pfizer’s divestiture of its animal vaccine business to Harbin, China’s largest pharmaceutical group by sales. The transaction was required by the Anti-Trust Bureau of China’s Ministry of Commerce in relation to Pfizer’s acquisition of Wyeth. Pfizer had a 38% market share in animal vaccines, and Wyeth had a 12% market share. As part of Pfizer’s divestiture, it was required to provide Harbin with the technical assistance and training for up to three years in order to help Harbin learn how to produce the vaccine. Prior to the divestiture, Pfizer had produced the vaccine in Nebraska.

To a foreigner investing in China, events such as this may raise concerns, and if we were to buy Pfizer for its China exposure, this indeed would be the case. This is yet another reason why we favor investing in solid companies that the Chinese government favors, is partnered with, or is a direct shareholder of.

To participate in the Chinese and other emerging market healthcare developments, we have invested in the following three companies. One is a multinational with more than 350 scientists at a research center in China; one is China's largest integrated pharmaceutical company available to non-Chinese investors; and one is a much smaller state-owned integrated pharmaceutical company with a very desirable generic manufacturing and distribution network.

**Shangdong Luoxin** (HKEx: 8058, Price: HK\$9.73, OTC: SLUXF, Price \$1.25) is a Chinese pharmaceutical company. The company researches, develops, manufactures, and markets antibiotics and penicillin. Majority-owned by the local government of the province of Shandong, the company has a sales and marketing network covering 27 provinces. According to IMS China Hospital Audit, it was the 9<sup>th</sup> largest generic drug manufacturer in China as of December 2008. In excess of 21 of the company's products are among those included in the latest State Administrative Basic Medicine Catalogue. With a market capitalization of only \$900 million, this small-cap company is well-financed with a net cash position of \$39 million. Its dividend is negligible. The company's earnings have been growing at a very high rate: sales at 54% and net income at 103% on a year-over-year basis. Its profit margin has increased as the company has reached scale, and is now 35%. The company currently trades at 16x trailing earnings; no analyst estimates are available for the company. Based on a run-rate basis (multiplying the first quarter earnings by 4), the company trades at 13x. We find this to be an unusual opportunity and entry point.

**Sino Biopharmaceutical** (HKEx: 1177, Price: HK\$3.06, OTC: SBHMF, Price \$0.39) is a fully integrated biotechnology and pharmaceutical company engaged in the research, development, manufacturing, and marketing of biopharmaceutical products in the People's Republic of China. Founded in 2004, the company's primary drugs, representing approximately half of its revenues, are hepatitis medicines. The company also makes cardio-cerebral medicines, oncology medicines, and analgesic medicines. The company has 121 drugs included in the latest State Administrative Basic Medicine Catalogue. For the period 2005-2009, the company compounded sales growth by 34% and net income by 33%, annually. The company is very well financed with a net cash position of approximately \$305 million. It currently pays a 2.3% dividend yield and trades at 35x trailing earnings (22x 2011 estimates). We initiated this position last year, when the company traded at 17x earnings. Although the valuations are much higher now than then, we believe that this company will grow into its current valuation and prove to be very accretive to our portfolio.

**GlaxoSmithKline, Plc** (NYSE: GSK, \$34.01) is a British-based global pharmaceutical and consumer products company, and the world's largest vaccine company. Its pharmaceutical business is dominated by Advair, an asthma inhaler. Its consumer products include Sensodyne, alli, Nicorette, and Zantac. Founded in 1935, the company operates all over the world. Over the last few years, it has been working on diversifying away from its dependency on U.S. and Western Europe pharmaceuticals (white-pills). It has been buying and partnering with various smaller participants, especially in the generic segment, which is anticipated to be the fastest growing segment of the pharmaceutical industry. The company has been actively reducing costs and streamlining its operations, reduced its workforce in 2009, and is continuing to do so this year. Its fastest growing segment is the "Rest of World." This segment excludes the U.S. and Western Europe, and grew at 39% last year, now accounting for 34% of its revenue. The company is well financed, and currently trades at 9.4x 2010 earnings estimates with a 5.4% dividend yield.

## Where We Stand

We wish we could inform our readers of some newly discovered information that has brought us to a “Eureka!” moment this quarter. In actuality, as events continue to play out, our continued research merely firms our conviction as to the long-term benefits of our strategy (own necessary companies with steady growth, low debt, a solid balance sheet, high sustainable compounded earnings) in today’s volatile environment, as applied to the international landscape, and in relation to how we see the investment world moving forward. We are constantly reviewing the portfolio, searching and testing for weak links and potential problems. Presently, we find none. We believe that our only major risk premium, at this time, *is* time.

Regular readers of our writings (say *that* three times fast) have been aware of our negative view of the domestic environment for some time now. Last year we were called pessimists (and worse), because apparently we were the only ones so myopic as not to notice the “green shoots” that everyone else seemed to be tripping over. We were also derided for apparently not being as aware as some that “*unemployment is always a lagging indicator.*” If so, the economy today must be terrific, because unemployment appears to be *really* lagging. As we wrote in our 2009 year-end commentary ([available here](#)):

“Fundamentally, we believe that much data is being grossly misinterpreted. Some economists cite the 3Q 2009 GDP number finally turning positive at +2.2 (though revised downward 37% from the initial report of +3.5%) as proof that we’ve turned a corner. Let’s never mind that \$100 billion in government spending one-offs and transfers accounted for nearly 90% of that number (historically, first-positive quarter growth is +7.3%). By this measure, the Great Depression ended in 1933. And again in 1938. In fact, GDP growth in 1934 was over 10%. For what it’s worth, Japan has had over 50 positive quarters in the last two decades.

“Also misinterpreted is the axiom that unemployment is a lagging indicator to a recovery from recession. In the past that has been true in almost all cases where the recession is caused by an excess in production and inventory (manufacturing), and Fed tightening. These have occurred in cycles of overall expanding credit. Recoveries come sooner, and memories fade quicker. In a typical modern (post-war) manufacturing squeeze, unemployment lags by about one quarter. Historically this is not so when, as now, a downturn is caused by a prolonged period of credit contraction and asset deflation, coupled with a systemic banking crisis; 1-2 years is historically correct (and if this lagging indicator is good news, should we now be pessimistic if the unemployment rate reaches 4.5% again?).”

Since then, it would be more than a stretch to opine that things have improved, noticeably or otherwise. Alas, recent developments suggest that not only are things not getting better, but they could actually deteriorate further. The S&P destroyed \$1.6 trillion of wealth in the second quarter alone.

Now that bribes, *er*, “stimulus” incentives and give-backs have expired (\$8,000 for first-time purchasers and a \$6,500 tax credit for other buyers), the housing market has fallen off the proverbial cliff. According to the Mortgage Bankers Association ([www.mbaa.org](http://www.mbaa.org)), the new purchase index is down over 36% from a year ago, which was down 22% from the previous year. Nearly all of the mortgages that were written in the first half-year were fully insured by the government, via Fannie, Freddie, or the FHA: 97% over the last two years. In other words, there is no downside to the lending entity. David H. Stevens is the Assistant Secretary for Housing at the United States Department of Housing and Urban Development

(HUD), and Federal Housing Commissioner (FHA). He recently spoke before the MBA, and gave this rousing pep talk about the housing market: “[The U.S. housing market is] *purely on life support; sustained by the federal government. Having the FHA do this much volume [>\$50B] is a sign of a very sick system.*”

On a good note, unemployment fell from 9.7% to 9.5%. Never mind the fact that this trick was accomplished by removing 652,000 from the workforce ([www.bls.gov](http://www.bls.gov)). These people have been unemployed for so long that they are considered too discouraged, and are therefore ignored. What that means is, if you are unemployed, don't despair. Soon you will be too depressed to even look for work, and then you will no longer be unemployed. See how simple government math is?! Back in the real world, if just those recently (Q2) departed from the workforce are included, unemployment surpasses 10%. Setting a new precedent, approximately 46% of those unemployed have been so for at least six months. Using the broader U6 measure, nearly one-in-five members of the workforce are unemployed, underemployed, or too discouraged to even attempt to change that status. In the much-maligned “jobless recovery” to the 2001-2003 recession, this figure never surpassed 10.5%. The government is paying people to be unemployed for up to two years, and considering extending it further. This is what passes for a jobs program, and must be what “focusing like a laser on jobs creation” looks like.

By the government's own stated objectives, the stimulus has failed. Perhaps they should take heed of these words from noted free-market economist Milton Friedman: *“If you put the federal government in charge of the Sahara Desert, in five years there'd be a shortage of sand... I say thank God for government waste. If government is doing bad things, it's only the waste that prevents the harm from being greater.”*

What we have being proposed by our government as a solution to a debt and credit-caused crisis is increased spending (more debt/credit). We must spend our way out of debt, it has been suggested. At the recent G20 meeting, President Obama was roundly rebuked by the once profligate Europeans for this suggestion, as they appear to at least be aware that a good portion of their current troubles are self-inflicted via unsustainable spending and debt levels. We can't help but feel that some of our domestic economic policies are being driven by the ideological, rather than the practical (*“Dr. Krugman, paging Dr. Krugman...”*).

In its most recent fit of populist pandering, two weeks ago Congress reached a compromise on a broad financial reform bill that would take further powers away from the free market and private business and place them in the hands of the federal government. Said a teary-eyed Senator Chris Dodd: *“It's a great moment. I'm proud to have been here. No one will know until this is actually in place how it works.”* We now have landmark legislation, a bill so necessary that it was passed even though *“No one will know until this is actually in place how it works.”* An independent government body, appointed, unelected, and not accountable to any governing body, would have sole discretion as to what constitutes a “failing financial firm,” and the power to seize and wind it down. A council of regulators would be on the lookout for such targets, headed by the Treasury Secretary. The current Treasury Secretary failed to pay taxes from 2001-2004. He testified before the Senate Finance Committee that, in essence, he couldn't figure out Turbo Tax. With too many other egregious components to mention, the Dodd-Frank bill (which exempts Fannie, Freddie, and parts of the auto industry, among many other special interest carve-outs) is named after Senator Dodd and Representative Barney Frank. As two people who had much impact on and contributed greatly to the causes of the financial crisis, we can think of no more fitting tribute than to have their names permanently attached to this odious piece of legislation.

Today we face trillions in real debt, with trillions more in unfunded liabilities. We are nearing a point where just the debt service alone will have a deleterious effect on the economy and future growth. Our “stimulus” money has gone toward bailing out automobile companies that lost money on each unit sold, supporting bloated state and local government budgets, and increasing the size of government. In other words, not toward sustainable, job-producing entities with a long-term multiplier effect, but to creating and further expanding a dependent structure guaranteed to need future funding, and further drain private business. Pendo has no problem recognizing that an occasional Keynesian injection of liquidity can have a salutary effect on the economy. The problem is that after a while, not only does it not do any good, but it actually causes more harm and exacerbates the malaise it proposes to cure. Although we cannot pinpoint the exact inflection point, we believe we can aptly paraphrase Justice Stewart’s famous description of obscenity here: “I shall not attempt to define it, but I know it when I see it.”

### **The Middle Kingdom**

Looking overseas, investors became worried that China’s growth was too quick; unsustainable and perhaps in a bubble. The government responded with various practical tightening actions via fiscal policy, while at the same time taking measures that paved the way for a return to a free-float of the currency. All of this led to a 25% decline in the Shanghai stock market index and a 6% decline in Hong Kong’s Hang Seng index. Although recent numbers from China indicate that the government was successful in slowing the economy to a more manageable and, yes, sustainable and productive level, investors are *now* worried that Chinese growth is *slowing*. Auto sales have indeed slowed down, to “only” +10.9% YoY for June, vs. +25% YoY for May. GDP has also slowed to a rate of ~8%. These would be headline numbers in the U.S. We believe that it is a matter of time before the value of our companies within this forum is realized, and that our only real risk is a time premium. From our recent interview with [The Wall Street Transcript](#):

We believe that there is a secular growth story there that could lead for the next 20, 30, 50 years and it's something that we feel you risk avoiding at your own peril. People say there is a huge bubble in China, and that it's due for a correction. While that's certainly possible, the market is down 50% from their highs of two years ago and 20% from their more recent high. If you take the stand that China is going to crash, we could argue that they already have crashed and corrected. There is so much room for growth and not just the expanding economy, but the urbanization of the population as well. What may be a little bubbly these days is commercial real estate. People say they are building cities that are empty and that's true to a point. The difference is that they actually have the money to spend, number one, and number two, they have been doing this successfully since the 1990s. They have built cities in the past that have been vacant and then five years later, they were fully occupied.

Many of the critics of the commercial real estate situation appear to not have considered all of the facts surrounding the situation. Due to the tax structure, municipalities in China get the bulk of their revenue from businesses rather than residential real estate. The developer gets the bulk of his profit from the fatter margins on residential sales. This is where the dance begins. The developer must work out how much commercial real estate he is willing to “waste” in a sacrifice to be off-set by his expected profit from selling housing. When the number is reached, the permit is granted. Much of the commercial real estate is completely dismissed by the developer as it relates to his sales plan.

China is urbanizing at the equivalent of the State of California every year, and it's just part of a huge shift in the population from suburban and rural living, and from a farming economy to a more urban and industrialized economy.

### **Oh Canada**

Setting our sights north, we look toward the country with our second largest portfolio weighting, Canada (19%). While their recovery has slowed to more reasonable levels, they also started from a much more manageable point. They too have been beset by a weak housing sector and higher unemployment, but not nearly to the degree we see here, and it is not due to deep-rooted systemic problems. Housing/real estate has been kept in check by a stricter review of lending practices. Yes, as we come up with schemes to keep our market artificially inflated (see above), Canada, which had nowhere near the severity of problems that we did, is acting in a fiscally prudent pre-emptive manner. Not only did they not have the depth of a banking crisis that we had here, but they had virtually no exposure to sub-prime, statistically no increase in foreclosures, and not a single failed (or bailed) bank. GDP is expected to continue to expand (+6.1% in Q1, QoQ, annualized over 2%). Besides a solid financial system, Canada is physically the second largest country in the world, that is for the most part sparsely populated (31 MM people, 80% of whom live within 100 miles of the U.S. border), yet extremely rich in natural resources.

The primary focus of our investment exposure to Canada is through these various hard commodities (oil, natural gas, uranium, gold and silver). The reason for this is that we believe that world-wide demand for hard commodities will be greater than the supply over the coming decades as emerging economies develop, and as developed economies keep pace. Already, China is making huge investments in order to secure future shipments of hard commodities. Its most recent hard commodity investment is China National Nuclear Corp's (China's largest nuclear generator) agreement with Saskatchewan-based Cameco Corp. (CCJ) to buy 10,000 tons of uranium concentrate for 10 years through 2020 (China is committed to building 100 new nuclear power plants in the next decade). In addition to Chinese direct investments in Canadian hard commodities, President Hu Jintao met with Canadian Prime Minister Stephen Harper last month and announced his intent to double trade with Canada to US\$60 billion by 2015.

China has been so aggressive and successful in securing future commodity supply pipelines that India recently raised the amounts that its state-owned energy companies could commit to commodity investments, including Canada, without government approval. Over the last year, India lost approximately \$12.5 billion in energy contracts to China.

### ***Melhor Brasil!***

Brazil remains one of the most interesting (and potentially profitable) markets in the Western Hemisphere. It is our fourth largest country weight at 9%. Unlike the U.S., they are seeing a huge expansion of the middle class, and positive fundamentals that continue to surprise to the upside. Unemployment is near record lows at 6.8%, incomes are growing, and over 30 million people have been lifted out of poverty in the last decade. Final figures for Q1 show that the economy expanded 9% YoY,

for the fastest annualized rate since 1995. There was nearly a 15% growth in the industrial sector, YoY, and retail sales grew by almost 16%. GDP growth for the full year is expected to surpass 7%.

Anecdotally, this recent report from Bloomberg illustrates Brazil's increase in domestic demand: *"Brazil is running out of beer cans and farmers are leaving crops in the field as surging demand and Chinese-like growth leads to shortages in Latin America's biggest economy. Cia de Bebidas das Americas, the region's largest brewer, had to import beer cans for the first time in its 125-year history after local supplies were exhausted. Acucar Guarani SA, the country's third-biggest sugar producer by market value, left 10% of its crop sitting in the fields an extra 40 days because of a shortage of tires for its harvesters, even after the commodity hit a 29-year high in February."*

Brazil's domestic demand remains strong, with exports making up only 10% of GDP. Less than 10% of that is related to Europe, so any continuing problems there would have a negligible impact going forward. (For more on Brazil, see our [Q2 2009 commentary](#). All previous commentaries are available at our website, [PendoLLC.com](http://PendoLLC.com))

We at Pendo LLC hope that this review is helpful to you, and will better enable you to understand our thinking and strategy.

Please feel free to call and speak to us directly at 212.880.6446. We are sure that you must be every bit as concerned about your financial well-being as we are, and we look forward to hearing from you.

Sincerely,

Tina Larsson  
Chief Investment Officer  
Pendo LLC

Mark J. Foley  
President  
Pendo LLC

No information contained herein either in whole or in part may be reproduced or redistributed without the express written consent of Pendo LLC. Any statements of opinion constitute only current opinions of Pendo, which are subject to change and which Pendo does not undertake to update. Many factors affect account performance, including changes in market conditions and interest rates, and in response to other economic, political, or financial developments. References to future returns are not promises or even estimates of actual returns Pendo or the strategy may achieve, and should not be relied upon.