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Investing for a
world of change

Notes from the road: Are Chinese investment opportunities worth the risk?

POST CARD



China

Shanghai
Hangzhou

Shenzhen
Hong Kong

Despite China being a pivotal player in the global economy, it has also been one of the worst-performing equity markets over the last few years.

My journey across China gave me the opportunity to evaluate economic conditions post-COVID-19 lockdowns and a boots-on-the-ground perspective on investment opportunities in China's equity markets.

Duane Cable
Portfolio Manager and Head of SA Quality

The graphic is a postcard with a map of China as the background. The word "POST CARD" is written in large, grey, sans-serif capital letters across the top. In the top right corner, there is a postage stamp with a scalloped edge, depicting a traditional Chinese pagoda. Below the stamp are wavy lines representing a postmark. On the left side of the map, the word "China" is written in a simple font. Four red dots mark specific cities: Shanghai and Hangzhou are marked together in the east, and Shenzhen and Hong Kong are marked together in the south. To the right of the map, there is a vertical line separating the text from the map. The text on the right is in a clean, sans-serif font. The author's name "Duane Cable" is written in a cursive script, and his title "Portfolio Manager and Head of SA Quality" is in a smaller, sans-serif font below it.

In November we lost one of the greatest investors of all time in Charlie Munger, the legendary partner and friend of Warren Buffett. In one of his last public interviews¹, Charlie was asked for his view on China. At 99 years old, he was crystal clear in his articulation:

“My position in China has been that: (1) the Chinese economy has better future prospects over the next 20 years than almost any other big economy. (2) The leading companies of China are stronger and better than practically any other leading companies anywhere, and they’re available at a much cheaper price.”

Despite Charlie’s optimism, China has been one of the worst performing equity markets over the last few years and it’s hard to see how this will change given the current negative sentiment and weak economic environment. While some consider China to be uninvestable, as the second largest global economy, it is hard to ignore, especially given its meaningful impact on many stocks listed on the Johannesburg Stock Exchange. Views on China differ widely depending on your news source, but, despite the risks, I believe that China has some great businesses and valuations are attractive. Given potential opportunities, I wanted to see how conditions were unfolding on the ground and spent two weeks in December travelling across Shanghai, Hangzhou, Shenzhen and Hong Kong. I met with businesses across multiple industries, including State Owned Enterprises (SOEs), which provided some useful insights.

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The economy

The economic environment was softer than I had expected. I knew the recovery post abandonment of the zero-COVID policy had been disappointing, but I was hoping that conditions on the ground would highlight some green shoots. Unfortunately, I found very little to get excited about.

Fortunately, expectations are low and most management teams I met had attractive growth plans, despite no change to the current economic outlook built into forecasts. The hard COVID lock downs have taken a psychological toll on individuals, and while individuals have savings, they are concerned about job security and therefore are not confident to spend like they did before COVID.

1. Acquired Podcast on 29 October 2023.

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China is an important source of demand for luxury goods companies, representing c.30-50% of annual revenue for the likes of LVMH, Richemont and others. The signals on the luxury goods sector from our meetings were mixed. The high-end consumer is incredibly resilient, but there is a clear divergence in brand performance in China and only the ultra-premium luxury brands like Hermès and Chanel are benefitting.

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The Chinese property market feels like it will need meaningful stimulus to recover. I lost count of the number of unfinished building projects in our three-hour drive between Hangzhou and Shanghai. Most of the experts we met felt conditions could not get any worse, but they did not expect a strong recovery without significant stimulus, which appears unlikely at this stage.

However, one should not underestimate the ability of the Chinese to tackle problems. Pollution was a major concern for many years, but pollution levels were much lower than I had expected, and it was not only attributed to lower economic levels. China invested heavily during COVID in greening cities, the scale of which was breathtaking and has made a positive impact on the environment.

Government acknowledges the longer-term challenges of debt, demographics and deflation and would prefer an economic model focused on quality sustainable growth rather than providing a short-term sugar high from rolling out the old stimulus playbook. Their long-term approach being taken is admirable, but consumers lack confidence and won't spend until there's evidence of a sustained economic recovery. I believe that government needs to make some shorter-term compromises to kick start the economy in 2024.

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Innovation

The cutting-edge innovation I was exposed to in surveillance, artificial intelligence, industrial automation, autonomous driving, solar energy and health care technology was striking. China has long been regarded as a copier and not an innovator, but this is no longer the case.

Geopolitics was a topic that came up in several meetings. Chinese companies feel they have not been allowed to compete on an equal playing field globally due to sanctions. But rather than retract, companies have invested significantly in research and development and attempted to reduce their reliance on global supply chains. The efficiency gap between Chinese manufacturers and international counterparts is closing faster than consensus expectations. In the long term, I would not underestimate the ability of the best-of-breed Chinese companies to continue to thrive, driving innovation. Two examples are electric vehicles (EVs) and solar energy, where China is now the leading global producer.

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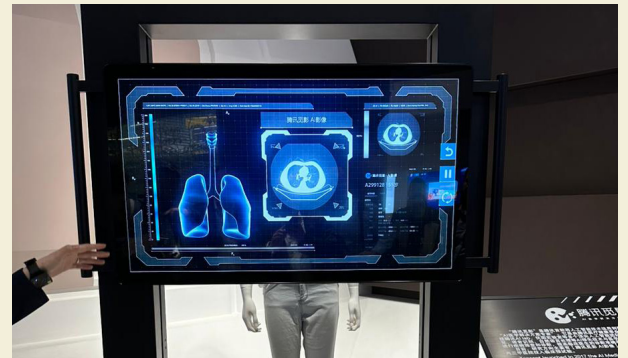
My trip highlighted progress being made in semi-conductors, and the expectation is China will dominate low-end semi-conductors as they become increasingly commoditised and longer term will continue to close the efficiency gap to the leading global high-end semi-conductor manufacturers.

A look behind the scenes

Unpacking some of the strides Tencent has made on artificial intelligence in healthcare and automation.



Technology development driving progress in cutting edge healthcare and diagnostics.



Real time digital imaging technology with a wide array of potential use cases, not limited to security.



Source: Ninety One.

Regulation

The message consistently communicated was that the regulatory environment was stable and the focus from government was on economic growth. Even variable interest entity (VIE) structures that have been a known risk in ownership structures of businesses like Tencent for several years have become more accepted and unlikely to be challenged. SOE's acknowledged that information asymmetry had been a problem and our meetings confirmed a desire to improve communication.

I had barely unpacked my suitcase, when on 22 December 2023, the National Press and Publication Association (NPPA) announced draft regulations to curb gaming spending. This was completely unexpected by the market and the share price responses were brutal with NetEase -25%, Prosus -17% and Tencent -12% on the day. The headlines went counter to all the information I had gathered during my trip from multiple sources, including SOEs. Fortunately, the unprecedented damage control which followed from government over the course of the next few days provided some comfort that messages I received on my trip were not empty promises. On Christmas Day, China announced 105 new game approvals, which it has historically not done during previous 'regulatory clampdowns'. On 2 January, China fired Feng Shixin from his position as head of the publishing unit of the Communist Party's Publicity Department as a direct fallout of the NPPA announcement on 22 December.

An article in Trivium China on 5 January 2024, flagged the ongoing fallout of the regulatory mishap and referenced scathing articles in Chinese state media criticising the approach of regulators and coming out in support of the platform companies. **“The most interesting thing about this mess is that it’s demonstrated the state’s commitment to make tech regulation more stable and predictable².”** Even though the actual regulatory impact might end up being a damp squib, sentiment has been damaged and bruised investors might need some time before dipping their toes into these choppy waters again.

2. Trivium China – China Markets Dispatch, 5 January 2024.

Conclusion

It is said that the secret to a happy life is low expectations. Expectations about the Chinese recovery are low at present, but I believe there are some exciting investment opportunities for long-term investors where valuations are attractive. Despite the negativity, China has many positives including world-class infrastructure, globally competitive companies, and a highly educated and hardworking labour force. China does have challenges, but one should not forget they have overcome adversity before.

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Looking forward the environment remains incredibly uncertain and risks cannot be underestimated. It's important that investors understand the probability of return expectations, especially when the forecast range is wide. Research suggests that people are too confident in their own abilities and predictions. As a result, they tend to predict outcome ranges that are too narrow. If they are wrong in those predictions and forecasts are too optimistic, the downside risks to portfolios can be significant.

Before we get too carried away, a point to confirm our allocation to China has not ramped up materially in portfolios. A balanced approach to risk management is key when weighing up the potential returns from available investment opportunities in China. Existing allocations to Naspers, Prosus, direct exposure to Tencent, Richemont, NetEase, Estée Lauder and BHP are all likely to benefit from a resurgent Chinese consumer. But our portfolios are not solely reliant on this view playing out to generate inflation-beating returns for our investors.



Duane Cable
Portfolio Manager and
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Duane is a portfolio manager in Ninety One's Quality team and heads the South African Quality business. He is a co-portfolio manager of the Cautious Managed Strategy. He is also responsible for analysing South African stocks. As part of the broader global Quality team, he researches global stocks.

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