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Ninety One

Previously Investec Asset Management

Harnessing China's growth engine

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The fast view

- Chinese equities offer some of the most attractive revenue, earnings and cashflow growth opportunities globally.
- This is being fuelled by an economy that is rapidly shifting from investment-heavy export industries to more sustainable and shareholder-friendly, consumer-oriented areas, a trend accelerated by COVID-19.
- 'Old' economy sectors are reforming, while China's transformation to a consumer-led economy is geared toward a growing middle-class population.
- Investment opportunities are widespread, in particular consumer, healthcare and technologically-innovative companies, across both China's urban and rural areas.
- A strategic, active approach that takes a wide lens to China's equity market is well positioned to harness China's growth engine.
- We believe that China is relatively better placed to weather the acute growth shock to the world economy from COVID-19 as it has ample policy levers (both fiscal and monetary).

1. For further information on the investment team please see the Important information section.

China transitioning to a new normal

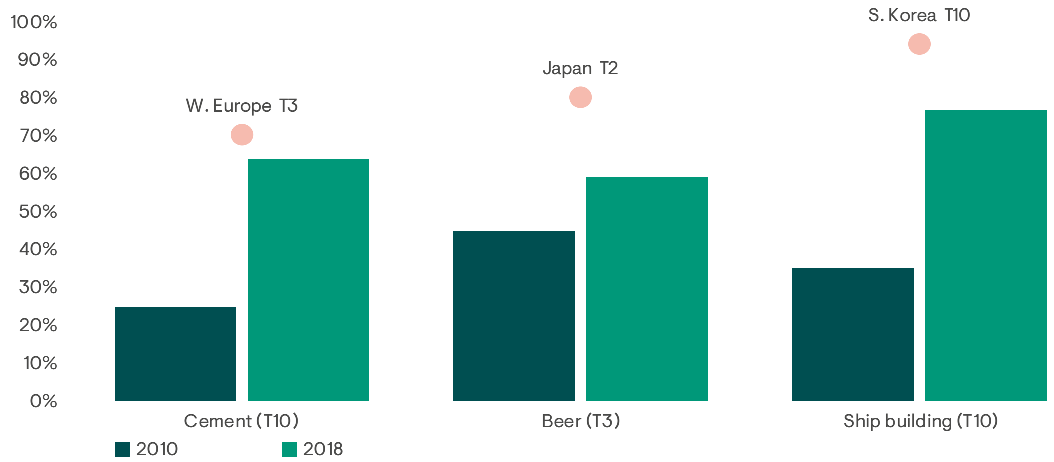
After decades of supercharged economic growth, the consensus view is that China's growth engines are exhausted, and output will slow for the foreseeable future. We believe that this view is incorrect, and that China is transitioning to a new normal. China's long-term growth prospects will be driven by the rebalancing of its economy away from exports to consumption, the rising wealth and sophistication of Chinese consumers and the transformation of its vast rural economy. For investors, this is an opportunity to get involved in the take off of Chinese consumption growth.

Opportunities emerge from reform

The rebalancing of China's economy has shifted the focus away from growth led by exports towards domestic growth fuelled by the increased spending power and sophistication of Chinese consumers. Chinese exports as a proportion of GDP are below 20% today, about half the level of 15 years ago[1]. The government has pursued significant reforms to 'old' economy sectors in order to combat overcapacity issues, namely in the steel, cement, coal and shipping industries. The state set ambitious supply reduction targets, in addition to implementing greater environmental regulation, which has also helped clean up polluting industries. This widespread restructuring has strengthened companies through improved cashflow, reduced capital expenditure and leverage alongside increased dividends.

This capacity consolidation also enhances pricing power and can set apart sector leaders. This is fuelling greater market concentration (Figure 1) and as active investors, therefore, it is crucial to distil which companies will be better positioned to withstand competition and emerge as winners over the long term.

Figure 1: Market concentration has increased due to capacity consolidation



Source: digital cement, MIIT, Euromonitor, Wind, JP Morgan, Bernstein, Nomura, as at December 2018. Note: T refers to the combined market share of top number of companies.

These 'old' economy sectors also tend to be dominated by state-owned enterprises (SOEs), where reform is essentially delivered through the government's role shifting from actively managing state enterprises towards controlling state capital. In other words, rather than influencing day-to-day operations, directing how much capital goes to strategic industries. Such moves are in addition to various anti-corruption measures and more conventional hiring practices, which has increased transparency and the quality of management at state-owned companies.

1. Source: World Bank, as at 31 January 2020.

The changing face of the China opportunity

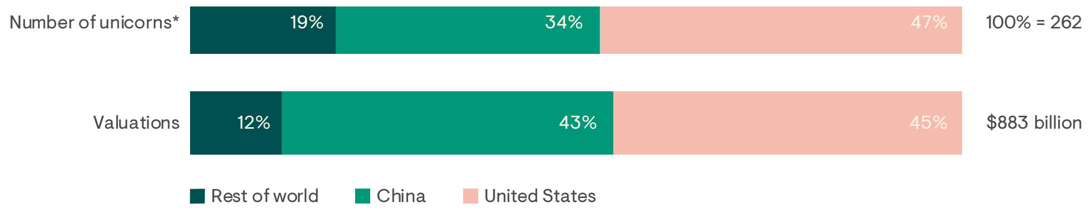
Despite an ageing population, there are many tailwinds for the consumption-led opportunity across multiple sectors in China. Rising affluence coupled with the propensity to upgrade purchases are supported by growing evidence of strong underlying growth in sectors such as healthcare and protection insurance. Moreover, China's pivot from industrial to innovation-led services means the levers of growth are driven more by technology than labour, which mitigates the potential demographic burden as the working age population peaks. This trend has been accelerated by COVID-19, as China has increased "new infrastructure" investments to boost long-term productivity by leveraging next-generation technologies. This includes 5G base stations, artificial intelligence (AI) and datacentres, intercity high-speed railways, industrial IoT, ultra-high voltage grids and electric vehicle charging stations, where investment in these sectors is estimated at almost $180 billion over the next 10 years, according to Morgan Stanley[2].

Case study: Anhui Conch

Established incumbents can be well-placed to benefit from the state's drive to flush out lower quality products, such as in the cement industry. China's second largest cement supplier, Anhui Conch[2], is focused on the Eastern seaboard, encompassing the provinces of Zhejiang, Shandong and Jiangsu, where cement prices are recovering sharply following the reduction of lower-grade supply. As China gets back to work, infrastructure-related materials, such as steel and cement, have also benefitted from the anticipation of higher construction. Anhui also has a strong balance sheet, and a healthy profit margin due to its focus on reducing costs. This should enable it to pursue acquisitions and further strengthen its market position.

Being at the forefront of technological innovation and achieving self-reliance in technology is a key priority for China. One clear example is the accelerated build out of 5G, in which China is arguably the global leader. Another example is the launch of its own Nasdaq-style 'STAR' board, a facility that encourages technology companies to list in their homeland. There is significant potential for new listings on this platform, especially given the more relaxed rules compared to other, larger bourses. For context, about 34% of unicorns – start-ups valued at US$1 billion or above – across the globe are estimated to be domiciled in China (Figure 2), so the scale of this opportunity is significant.

Figure 2: About one-third of global unicorns are located in China



Source: McKinsey and Company, April 2019. *Defined as startups valued at $1 billion or above

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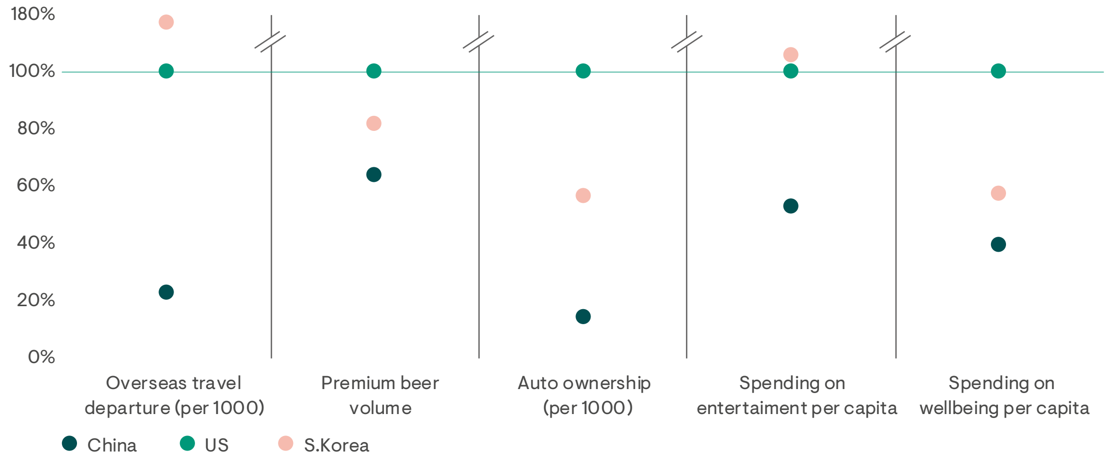
2. IoT Internet of things. Source: Morgan Stanley research estimates, company data, 'New infrastructure opportunities handbook', 22 March 2020.
3. Note: This company is held in 4Factor portfolios. No representation is being made that any investment will or is likely to achieve profits or losses similar to those achieved in the past, or that significant losses will be avoided. This is not a buy, sell or hold recommendation for any particular security. For further information on specific portfolio names, please see the Important information section.

China's transition from rural to urban

China is by far the biggest e-commerce market in the world, and roughly double the size of the US. There are more than 800 million internet users, which is likely to grow given the internet penetration rate across the country is just 58%[4]. A significant proportion of this penetration gap could be accounted for by rural dwellers, in our view. China still has 560 million people living in rural areas – about 40% of the overall population. As discussed in a recent paper on rural China, disposable income and e-commerce growth in rural areas is now outstripping that in urban areas[5], allowing rural dwellers greater access to products and services without having to move to a city. An additional area of potential growth is mobile payments in China, which are already some 11 times higher than in the US[6]. Growing smartphone usage has enabled a rapid increase in the use of mobile payments, and by the end of 2017, the proportion of rural internet users using mobile payments stood at 47%[7].

China's transition to a consumer-led economy will be a key driver of domestic growth in the coming decades. This should create opportunities in 'new' economy sectors, such as consumer discretionary, technology and healthcare, which are still relatively underpenetrated compared to developed markets (Figure 3). Despite this, China's scale is reflected by the fact it is already the world's second largest domestic consumer market[8]. We believe there is potential to access this increasing penetration that will drive the long-term growth of China's economy, alongside high barriers to entry which should protect these leading companies.

Figure 3: China' s consumer product penetration significantly lags the US and South Korea



Source: UNWTO, CEIC, Euromonitor, IWSR, Canadean, UBS, Goldman Sachs, Bernstein, Data rebased: USA = 100%, as at 31 December 2018.

Alongside this burgeoning middle class has been the growing focus on areas such as healthcare and insurance, driven by the country's unique demographics and technological advances. As McKinsey has noted, China has begun to experience the health afflictions of affluence that have already been experienced in the West – brought on by factors including pollution, diet and lifestyle changes[9]. In addition, with greater assets comes the need for insurance to provide cover in the event of losses. Innovative companies that provide solutions – often through the application of technology – to these relatively nascent industries are likely to be long-term beneficiaries of markets that are clearly here to stay.

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4. Source: Ninety One, 'The next half billion: China's rural residents,' November 2019.
5. Source: Don't forget the countryside, Professor Robert Ash, SOAS, June 2019.
6. Source: McKinsey Global Institute ('China's Digital Economy: A Leading Global Force'), August 2017.
7. Source: Statistical Report on Internet Development in China, 41st edition, China Internet Network Information Center, CNNIC, January 2018.
8. Source: World Bank, World Development Indicators, Households and NPISHs Final consumption expenditure (current US$), 31 December 2019.
9. Source: McKinsey & Company: 'Why China's next big innovation could be healthcare', May 2018.

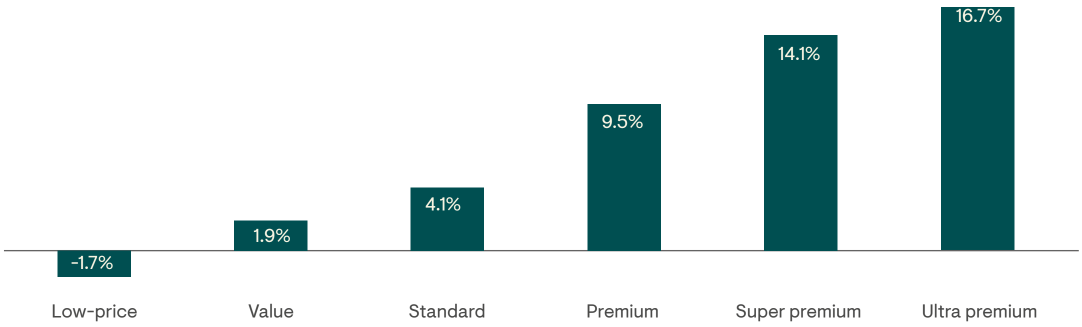
Case study: Hangzhou Tigermed

This clinical research service provider stands to benefit from two key factors: the increase in R&D spending by domestic Chinese pharmaceutical companies, and the greater level of clinical trial outsourcing by multinational firms. This market has high barriers to entry, and Tigermed[9] has built a strong reputation since inception in 2004. This long-term experience ensures that the company has an excellent network, which will help facilitate further clinical trial development opportunities despite the short-term disruption from COVID-19. With a business model that is asset light, the company generated attractive returns on investment, in addition to healthy cashflows that can be used to invest in organic growth or fund acquisitions. We believe Tigermed is well positioned to capitalise on the continuing advances in healthcare in China.

One further trend that offers potential investment opportunities can be found in the ongoing 'premiumisation' of the Chinese consumer, as an increasingly wealthy population typically chooses to upgrade their purchases to products perceived to be higher quality. For example, the concentrated national liquor Baijiu industry has grown significantly in recent years, and it is the key producers with strong brands that have a sustainable competitive advantage. Wuliangye Yibin[10] is a good example. This Chinese state-owned liquor producer sources most of its revenue from its flagship high-end product. According to recent analysis from Bernstein[11], it is this more premium end of the Baijiu market that is likely to experience the best retail sales value growth (Figure 4). Wuliangye Yibin aims to secure its market share as it builds out its own consumer marketing capability. This aligns with our investment thesis to seek companies with strong brands and market positions, alongside competitive advantages that are hard to supersede globally.

Figure 4: Ultra-premium Baijiu well-positioned to lead growth over the coming years

Baijiu volume growth 2018-2023(E)



Source: IWSR, NBS, Canback, Bernstein analysis & estimates, August 2019.

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11. Source Alliance Bernstein, 'The Long View: China alcohol premium is the new mainstream', August 2019.

What could stall China's engine?

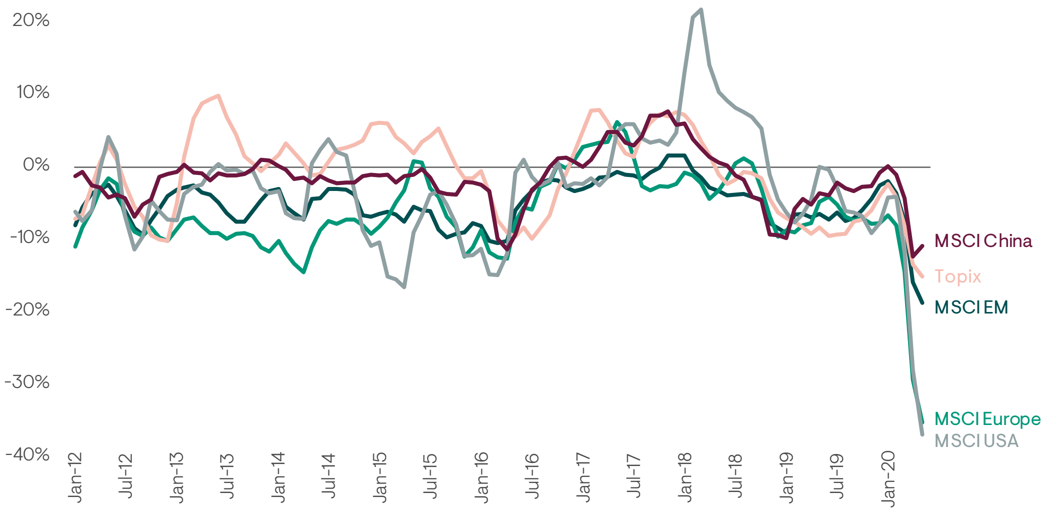
Chinese equities are trading at a discount to other global equities, particularly after the major correction in 2018, but it is important to remain aware of the risks. Unexpected headwinds – such as the recent coronavirus outbreak dented China's economic growth in the first three months of 2020. However, we believe that China has the fiscal headroom to rekindle growth. Its decisive actions have helped speed up progress towards returning to economic health[12].

There are also structural risks for investors to consider. For example, in the financial system, where hidden liabilities in rural cooperative banks, city commercial banks and rising domestic bond defaults could undermine confidence. Policy is heading in an encouraging direction, however, as China has pledged to step up measures to combat risks in the sector. In January, the China Banking and Insurance Regulatory Commission (CBIRC) outlined a series of measures including carving out bad loans, setting up a resolution fund, as well as promoting mergers, capital injections and the restructuring of high-risk institutions.

Geopolitics also remains a source of risk for China, such as the possibility of trade tensions with the US escalating. Even after the preliminary agreement agreed between the White House and the Chinese government, most border taxes remain in place, so a second, more comprehensive 'phase two' deal would do more to ease market concerns. Further tensions could result in rising supply chain dislocation for Chinese companies, tariff-induced growth weakness, restrictions on the flow of investor funds from the US into Chinese markets and, at the extreme end of potential outcomes, a delisting of Chinese firms from US exchanges.

Despite these risks and slowing GDP growth, it is notable that earnings revisions for Chinese companies are faring better than both emerging and developed markets (Figure 5). All regions closed out 2019 facing more downgrades than upgrades, but for MSCI China, the extent of the downgrades was less pronounced.

Figure 5: Earnings estimates for China are in better shape than global peers



Source: IBES, Datastream, Morgan Stanley Research. Monthly data as at 31 May 2020. Earnings estimate revision breadth definition = (Number of 12-month forward EPS upgrades - EPS downgrades)/Total number of EPS estimates available.

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12. Read 'First in and first out: China as the vanguard for COVID-19 recovery' for more information on China's path to the 'new normal'.

Growth looks set to stay

So why do we believe that China's growth engine won't stall? The government has stressed its commitment to pro-growth policies and shown a willingness to be accommodative should the trade situation with the US escalate. We have seen broad-based monetary and fiscal support so far, including liquidity injections as well as tax cuts. Going forward, infrastructure investments via an acceleration of local government bond issuance and selective easing in property markets have been part of China's tool kit. It is worth noting that to mitigate the economic impact of COVID-19, the government has initiated stimulus plans to revive the economy. China appears to have learnt from its past mistakes and instead acknowledged the role of the market and the private sector to secure its growth trajectory. At the beginning of 2020, the foreign investment law, which the National People's Congress approved last March, took effect. The legislation aims to give foreign businesses equivalent rights to those enjoyed by domestic firms, ranging from intellectual property rights to the overseas remittance of profits.

Another example is the opening up of China's capital markets to international investors. Efforts are being made to increase foreign investor participation in its mainland market through schemes such as the Hong Kong-Shanghai Stock Connect and the launch of the technology 'STAR' board, as discussed earlier. China also scrapped investment quota limits for Qualified Foreign Institutional Investors (QFII) and Renminbi Qualified Foreign Institutional Investors (RQFII) in September last year. Historically, international equity investors have tended to focus on the offshore market given its more open access and transparency. Another avenue to consider – especially now it is becoming more open – is the onshore A-share market, which offers direct access to China's domestic growth. This requires specific expertise, and a strategic, active approach to uncover the most attractive opportunities in China's diverse equity markets.

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