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First State Stewart
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First State Stewart Asia – China and Greater China Equities

Client Update

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The new guard in China

In mid-October, the 19th National Congress of the Communist Party will take place at the Great Hall of the People in Beijing. Held every five years and typically lasting a week, the Congress is arguably the most important and widely anticipated event in China's political diary. Xi Jinping, current party leader, military chief and president, is widely expected to command a second term, while Xi's supporters are expected to fill a number of positions on the Standing Committee of the Political Bureau, China's most powerful political body.

With Xi secure in his position and his support strengthened, we do not expect significant policy changes. Announcements are likely to emphasise economic reforms already in place, such as supply-side reforms, sector consolidation and mixed ownership initiatives. This approach – bringing market-oriented practices to the bloated state-owned sector – has helped China manage its slowing economy and – so far – avoid a painful "hard landing" amid a global contraction.

Although critics suggest that the progress of reforms has been slow, this can partly be attributed to the weak external environment following the global financial crisis in 2008-09. Today, however, the economic outlook is much more stable: the US recovery looks likely to be the longest on record; growth in the Eurozone is picking up; and China, too, is believed to have bottomed out.

A recent report from the International Monetary Fund (IMF) suggested that China's economy is on track to deliver 6.7% year-on-year growth in 2017, a forecast that has been revised upwards twice already this year. As policies remain supportive, we believe China's growth could continue to surprise on the upside, especially as current expectations are not high.

Supply-side reforms in the state-owned sector have reduced overcapacity and driven up commodity prices, while sector consolidation has seen "national champions" swallowing weaker players. In August, Shenhua Group – China's largest coal miner – merged with China Guodian – a top-five power generator – to form the world's largest power company, now renamed China Energy Investment Corp.

This deal – and others similar to it – is creating a group of Chinese goliaths designed to be big enough and strong enough to compete on the global stage. Supported by the state and with seemingly bottom-less pockets, Chinese state-owned companies have entered new markets overseas with cross-border M&A transactions. 2016 saw a raft of high profile deals such as the China National Chemicals Corp (ChemChina) US$45 billion acquisition of Swiss agri-chemicals company Syngenta and State Grid's US$12 billion acquisition of Brazil's CPFL Energia.

There has also been a flurry of announcements to introduce private sector oversight and improve corporate governance at ailing state-owned companies. China Unicom, one of the three major telecoms groups, announced in August a shareholding restructure that would introduce major strategic investors to the group, including tech heavy-hitters Alibaba Group, Baidu and Tencent Holdings, as well as financial institution China Life. In our view, the addition of such strong strategic partners should help Unicom improve its marketing savvy, enhance cost efficiencies and, ultimately, increase shareholder returns.

We have been watching Unicom's performance for some time and believe that a turnaround is afoot. In 2015, China Telecom's previous chairman (whom we hold in high regard) was appointed Unicom's chairman and chief executive officer; since then, we have seen new marketing campaigns and competitive pricing strategies at Unicom, which has helped grow its 4G subscribers.

While the Unicom deal is not the first mixed ownership/partial privatisation to be pushed through, it is the most high profile one so far and the first of the 18 or so centrally-administered state-owned enterprises (larger and more powerful than local SOEs) with proposals submitted to the government earlier this year. If Unicom's restructure is successful, it could open the gate to more ownership reforms across the state-owned sector.

MSCI gives blessing to A-shares

Amidst much fanfare, MSCI announced in June that after broad consultations with global institutional investors, it had decided to include 222 large-cap China A-share stocks in the MSCI Emerging Markets index from June 2018. This would be based on a 5% partial inclusion factor and represent approximately 0.73% of the index on a pro-forma basis.

While this is a tiny proportion of the overall market and likely to have minimal impact in the short-term, it is a promising start. MSCI have said that the allocation is likely to grow, as A-shares become more accessible to foreign investors. At the moment, there are approximately 1,500 eligible stocks listed on the Shanghai and Shenzhen stock exchanges that are tradeable by international institutional investors via the Stock Connect program (around half of the total number of stocks listed on these two exchanges), a factor in MSCI's inclusion.

The MSCI decision is significant in its acknowledgement of China's efforts in liberalising its capital markets. As we discussed in a previous note, China has implemented a series of financial market reforms in recent years, adding to the broad internationalisation of China's currency and recognition of the renminbi as an important tool for global trade. With President Xi remaining in his position, ongoing market reforms should ensure that standards will continue to evolve and improve over time.

We believe that this is also an indication that global institutions are more inclined to include A-shares in client portfolios. Although full A-share inclusion is still some years away (and MSCI will no doubt continue to consult with global investors on aspects of market standards), we expect foreign institutional investors in the A-share market to rise steadily and, at some point, could even exceed the proportion of domestic retail investors in the market. Then, fundamentals – a matter of earnings growth and valuations – should be the main driver of market performance, rather than the wild swings of momentum-driven retail investors.

Some new additions...

Chinese equities have been one of the best performing equity markets year-to-date, underpinned by robust earnings growth of 22% year-on-year (based on the 4,000-or-so Chinese companies listed in mainland China, Hong Kong and the US that had reported first half earnings at the time of writing). As a result of market exuberance we have struggled to find good quality companies at cheap valuations; although looking beyond the popular large-cap stocks there are some that we find reasonably attractive.

Tapping into the secular trend of China's rising health care expenditure, we purchased **China Resources Phoenix Health Care**, a mixed ownership experiment between **Phoenix Healthcare Group**, the largest private hospital in China, and **China Resources**, one of the largest state-owned conglomerates in China. In 2016, a shareholding restructure saw China Resources becoming Phoenix's largest shareholder with an effective stake of 36%.

Phoenix has a decent track record, with revenue growth of around 17% CAGR for the last four years and return-on-equity of 12%. At the hospital level, revenue per bed at Phoenix's hospitals are twice as high as at China Resources' hospitals. We expect the profitability of China Resources' hospitals to catch up over time.

Phoenix's business model is to acquire under-performing hospitals and improve services and profitability (although the social considerations of hospitals means that it can never be too profitable). The backing of the China Resources group gives Phoenix better access to public hospitals as well as financial support.

There is huge long-term potential growth in China's health care sector. The public health care system is woefully under-invested, with often long queues for public health care services, high mark-ups on drug prices, and issues of bribery and over-dosing as doctors' incomes are so low. Largely due to these inefficiencies, there is a long list of potential targets for Phoenix to acquire.

It remains to be seen whether or not China Resources and Phoenix can work well together and this is one area that we are monitoring closely. Earlier meetings with Phoenix suggested that China Resources is quite hands-off from the day-to-day operations and participates mainly through its board representation (it has four board seats) and the CFO, whom China Resources appointed.

The backing of China Resources, with its good corporate governance track record, adds a level of comfort. Dr Fu Yuning, chairman of the overall China Resources group, has been named the honorary chairman of China Resources Phoenix Healthcare – the only company in which he holds such a position – which highlights the importance of Phoenix within the group despite its small size.

Phoenix's current valuations are below the historical mean and insiders have been buying. Despite being the largest general hospital operator in China, Phoenix's market share is only 0.2%. We bought a toehold on expectations of consolidation in the market.

Midea Group, China's largest home appliances company, is another recent addition to our China portfolios. After years of focusing only on scale resulting in a mediocre track record, Midea had revamped its strategy in 2011 and is now looking much more attractive. A strong emphasis on R&D, streamlined products and greater control over distributors has resulted in market share gains for almost all of its products. Margins have improved (from 6% net margin prior to the restructure to 9.6% now) and cash flow generation has been strong (57% free cash flow CAGR over 10 years).

Midea is one of the few Chinese private enterprises that have appointed professional managers, with the family stepping back from the day-to-day operations. Only one family member remains on the board. Management execution has been strong, as evidenced by the fast turnaround in the business since the change in strategy; and management ownership is around 11% which ensures alignment.

All of its product categories booked strong growth in 2016 with the exception of air-conditioners which suffered from channel de-stocking (however, 2017 profit growth on the air-conditioners segment should be much stronger as channel inventories have now reached a historic low). Meanwhile, Midea has been able to keep increasing ASPs as higher incomes give rise to the "premium-isation" trend in China.

We believe overall profit growth of 10% CAGR in the next five years is not too onerous a target for Midea in light of its strengthening market share and low-to-mid single digit industry growth. Recent acquisitions of Kuka (top 4 industrial robot company) and Toshiba (Japanese premium brand home appliances) add new areas of growth, especially in areas such as logistics and industrials, while Kuka's industrial automation could improve cost efficiencies in Midea's own manufacturing production line.

Valuations have rerated somewhat as the stock is now trading at 16.6x P/E 17E, but given the franchise value, growth profile and cash flow generation, we believe it is justifiable.

Performance highlights

Performance in the China market has been highly concentrated on just a few stocks and themes. E-commerce companies in particular have performed well, with the majority reporting a significant growth in revenue and profitability. Rising smartphone adoption and the emergence of a tech-savvy consumer helped to boost China's online retail sales to US$457 billion in the first half of 2017, up 33% over the same period last year. By comparison, US online retail sales amounted to just US$218 billion – around half the dollar amount of China's.

These kinds of figures have generated a huge amount of excitement around the potential growth of China's e-commerce players and valuations have soared. **Alibaba Group**, China's largest e-commerce company, reported revenue growth well above expectations. Despite having monitored the company for some time, we only recently bought (albeit indirectly), taking a small position in **Softbank**, the investment vehicle that owns a 27.5% of Alibaba. Softbank's discount-to-NAV looked attractive, and the valuation meant that it was trading on par with its Alibaba stake, while also owning Japan Telecom, Sprint and ARM.

We prefer **Tencent Holdings**, which we wrote about in a previous note and is owned more widely across the China portfolios. PC and mobile gaming growth continues to be a strong revenue generator, and advertising has started to pick up on the strength of e-commerce. Tencent's Tenpay (which owns WeChat Pay) has been growing market share and is catching up to leader Alipay in the mobile payments segment. Together, Tenpay and Alipay have more than 90% of e-payments cornered in China – the biggest e-payments and e-commerce market in the world. Tencent is not cheap, trading at around 44x FY17 PE and 13x PB; we continue to take profits and control our position size.

Alibaba Group and Tencent Holdings together accounts for around a 30% weighting of the MSCI China Index, which explains a large portion of the index performance year-to-date (up 35%[1]). It also highlights the folly of using such an index as a performance benchmark. We see absolutely no sense in holding such large positions in just two stocks; and delighted that our investment process allows us to construct portfolios from a blank sheet of paper and not with an index as our starting point.

On the negative side, **Vipshop Holdings**, an online discount retailer, has de-rated significantly, from 40x P/E to just 13x P/E, on market concerns around the sustainability of its "flash sales" business model. Its revenue growth is slowing, customer acquisition cost is high, and margin is under significant pressure. Meanwhile, JD.com's recent investment in Farfetch and Alibaba's interest in Yoox Net-a-Porter, both luxury brands e-commerce platforms, could intensify the competition. We sold our position after seeing weak operating profits in the second quarter. We suspect it could get worse.

The second theme that has been driving market performance is the smartphone upgrade cycle. **AAC Technologies**, one of the main suppliers of acoustic components (speaker boxes, receivers) and haptics (provides tactile feedback such as vibrations) to Apple, reported a jump in profits on strong sales growth to smartphone manufacturers.

Estimates for the total addressable market for AAC's products is in the range of US$10 billion (2016 figures) and set to grow 20% by 2020. We expect AAC to maintain its leadership in sales to Apple and to increase market share in both the non-Apple and the Chinese smartphone market, providing solid revenue growth for the next 3-5 years.

ASM Pacific Technology, which makes semiconductor back-end equipment and Surface-Mount-Technology equipment (also called pick-and-place machines; they install semi-conductor chips in smartphones and other electronics) is within touching distance of its previous peak in 2010. First half operating profit grew by more than 86% year-on-year. Although there is probably little downside risk in the very short-term, as a major supplier to Apple, revenue growth could slow significantly in 2018 (the Apple upgrade cycle is every 2-3 years).

Sunny Optical reached an all-time high on strong deliveries of its lens and camera products. In August, shipment of Sunny's smartphone handset lens increased by a massive 96% year-on-year, predominantly to Korean and Chinese customers, while vehicle lens increased by 65% year-on-year.

Sunny Optical is one of two main players in the handset lens market. There is a clear trend of smartphone camera upgrades, as smartphone manufacturers build in higher megapixel and dual-lens cameras. (Apple was one of the first to market with dual rear cameras on the iPhone 7 Plus, which allowed users to take portrait-style photos with a blurred background effect.)

Consumer companies also generally performed well, in line with the stabilising economy. **Gree Electric Appliances** has been a beneficiary of the rising incomes in China, with its premium models gaining traction. In addition, generally hot weather in China and low channel inventories contributed to robust sales growth in the sector.

Gree remains one of our top holdings across the China portfolios; its high margins, superior return-on-equity and large cash balance makes it an attractive investment proposition. However, we have in general trimmed the position across our China portfolios, given the correlation of sales to the slowing property market; and we have concerns around the chairlady's succession plans.

Qingdao Haier, another home appliances group reported decent earnings results, driven by market share gain and ASP increases. We believe Haier's broad product range, regional coverage and improved pricing power should help limit its share price downside when the cycle turns. Although Chinese property prices have continued to rise, the pace has decelerated as the government's efforts to cool the market start to make an impact.

Last words

We have again become concerned over irrational behaviour and market exuberance. It amazes us to learn how much investors are willing to pay for growth. And although the economy has stabilised, there are still fundamental issues that have not been resolved. Rising property prices have raised concerns about affordability, with many predicting significant falls in the property market. Despite tightening measures, outstanding individual mortgage loans rose 30.8% year-on-year at the end of June, to a total of RMB20 trillion. Total outstanding social financing, that is, all private sector loans in the system, reached RMB167 trillion. That is a lot of debt. It has even caught the eye of the International Monetary Fund, which highlighted concerns on China's debt as well as overcapacity and inefficiencies at China's "zombie" state-owned enterprises as reasons to be cautious on China.

However, it is not all negative. Improved accessibility to A-shares has meant that we have found new investment opportunities to add to our China portfolios; we continue to widen our research efforts through country visits and company meetings to search for quality companies.

[1] As at 31 August 2017

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