

Client Update

Can China claw back performance in the year of the tiger?

January 2022

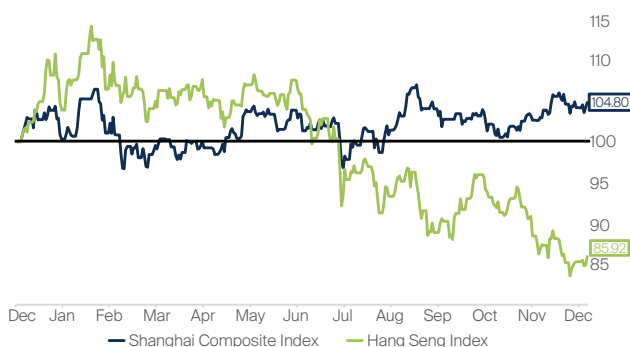


Once again, 2021 was a year full of surprises and challenges, with ongoing Covid disruptions and China turning from a global outperformer to underperformer. The Chinese government's policy crackdowns, especially in the internet, education and property sectors, were sudden and dramatic. Meanwhile, inflation globally has moved from "transitory" to an ongoing threat to stability, coercing central banks like the US Federal Reserve to tighten from record levels of money supply, with its dampening effect being felt on correspondingly high stock prices.

Fed tightening will likely affect Hong Kong markets as well, given the city's currency and interest rates linkage to the US. Over the past year, the Hang Seng Index has underperformed the Shanghai Composite by nearly 20 percentage points, mostly in the second half of 2021 as US inflation heated up, and the premium of A-shares over H-shares widened for large companies listed in both markets.

The year ahead also looks like a mixed picture – China is turning more accommodative in its policies but new Covid variants and persistent inflation remain key risks. The question on many investors' minds is whether China can claw back its strong performance of previous years, which seems fitting as we enter the year of the tiger in the Chinese horoscope.

The Hang Seng underperformed the Shanghai Composite in 2021



Source: Factset, FSSA Investment Managers as of 31 December 2021.

As bottom-up investors, we have observed how companies navigated through the crises, such as by adopting new technologies, cutting excess costs or deploying their marketing or research and development (R&D) budgets more wisely. Broadly speaking, valuations have been falling to more reasonable levels, and we have taken opportunities to accumulate quality companies throughout the past year.

For example, companies related to the consumption-upgrade theme, including **China Mengniu Dairy** and **JD.com**, have been challenged, particularly as the Omicron variant outbreak prompted new lockdowns in some large cities. Recent data showed China's retail sales grew by just 1.7% year-on-year in December, slowing from 3.9% in the prior month and missing expectations. We bought more of both companies on weakness – we are seeing competition in their respective industries ease, and their fundamentals remain solid.

We still believe that consumption upgrading will be a key growth driver for China over the next decade. Per capita consumption, from dairy to home appliances, insurance and sportswear, will structurally grow. In addition, preference for home-grown brands will continue to rise, helped not only by geopolitical tensions but also overseas travel restrictions. As usual, we look for companies with strong brands or other forms of competitive moats with long-term earnings visibility.

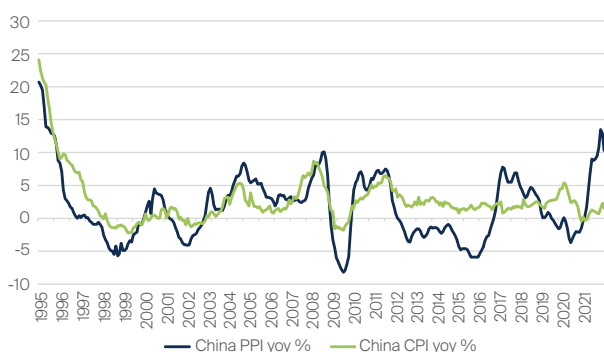
We recently bought **ANTA Sports**, China's most successful sportswear company, and one of the few Chinese companies that has proven its ability to build and run multiple strong consumer brands. We believe it can significantly prolong its brand life-cycle and continue to grow sales, as it attracts new customers with its Kids, Fusion and performance sportswear range. Although the recent Covid lockdowns were a headwind on sales, our conviction was reinforced after a recent call with management which showed a healthy recovery trend in the fourth quarter of 2021.

Another recent portfolio addition is **Xiaomi**, a top 5 global smartphone brand with a growing network of partners within its Internet-of-Things (IoT) ecosystem, and rising contribution from internet services (mainly advertisements and gaming). We like the company mainly for its recurring business model – selling low-priced handsets and then monetising its internet services, thereby fostering high customer retention. In addition, the company has a clear and consistent strategy, strong execution, high alignment of interests and dedicated R&D staff.

Ability to pass on inflation was a key differentiator

Unlike in the US where the consumer price index (CPI) has reached a multi-decade high of 7%, China's inflation in the past year was mainly driven by constraints on the supply side. Last year the producer price index (PPI) rose to 13.5% in October, the highest level since 1995, but CPI peaked at only 2.3% the next month. Companies in Greater China were better positioned to cope if they had vertical integration, economies of scale, or simply sat more upstream in their supply chains.

China's recent inflation has been led by producers



Source: Bloomberg, FSSA Investment Managers, as of 20 January 2022.

For example, **Taiwan Semiconductor (TSMC)**, the world's largest chip-maker with more than 50% global market share, benefited from the semiconductor shortage, with solid sales growth and improved profitability. The company has increased capital expenditure and added capacity in response to strong customer demand. TSMC remains one of our top holdings in the Greater China region given its strong franchise and high standards for governance. It has generated attractive long-term shareholder returns with high levels of free cash flow, while its dividends per share has almost doubled over the last five years. It has also been a leader in sustainability efforts, with its focus on energy consumption and raw material efficiency.

On the other hand, **Midea Group**, China's leading home appliances brand, performed less well last year as higher costs for raw materials and shipping put pressure on margins. In the longer term, we believe it should be able to pass through additional costs – either by increasing prices or by

upgrading the product mix. It has also been streamlining its distribution channels and increasing the use of automation in the production process. We believe the core business can deliver around 10% earnings growth per year via moderate gains in selling prices, growing market share and margin expansion.

In the fourth quarter we initiated a position in **Sinoseal**, a China market leader in mechanical sealing equipment for large industrial customers, mostly petro-chemical producers and oil refineries. We are confident in Sinoseal's ability to pass on inflationary pressures as mechanical seals have high barriers to entry, an oligopoly market structure, and a recurrent and sticky after-market. While mechanical seals are a crucial product for ensuring safety and output, the cost to the customer is quite low, and competition is limited. Sinoseal's product quality is on par with multinationals (MNCs) and it has earned a strong reputation domestically, while enjoying a much lower cost base than foreign peers.

Exports reach new highs despite tensions with the US

From a political standpoint, we believe conflicts between China and the US will likely continue, whether that be on exports and trade or other geopolitical issues. We divested **Hangzhou Hikvision** after it was added to the US sanctions list. Additionally, we switched our positions in **JD.com** and **ZTO Express** from the American Depositary Receipts (ADRs) to the Hong Kong-listed shares, due to policy uncertainties in the Chinese ADR market.

That said, we believe the heated rhetoric between the US and China mainly affects market sentiment, rather than having a major impact on the economy. China's economy is still very domestically driven and exports contribute only about a quarter to GDP growth.

What's more, China's export numbers continue to beat expectations and reach new highs. Before the pandemic, there were concerns that China might lose its manufacturing edge due to labour shortages. However, that concern is slowly diminishing. As global demand recovers, China has become a reliable manufacturing source for most markets around the world.

When the US-China trade war first started, Chinese exporters were sold off on fears of higher tariffs. However, looking at the exporter companies in our portfolio today, profit levels have been broadly unaffected despite the introduction of tariffs and many continue to enjoy growing overseas sales.

Techtronic, one of the world's largest producers of branded power tools, is an example of a stalwart exporter in our portfolio, with about 75% of its revenue coming from North America and another 15% from Europe. Founded in the mid-1980s and listed in Hong Kong in 1991, Techtronic now occupies a leading position in North America (around 24% market share by retail value of power tools) with key brands such as Milwaukee, AEG and Ryobi. Techtronic spends

significantly on R&D to improve existing products and create new categories, which has helped to boost margins. They were also the first to move towards cordless products (which eventually shaped the entire industry).

The stock performed well last year as it reported better-than-expected earnings. The company's sales growth outlook also looks rosy, as it should benefit from the proposed USD 2trn infrastructure bill in the US. In the past, its manufacturing base was only in China, but it is now developing in Southeast Asia – Vietnam, in particular – and also looking to expand in the US.

Smaller niche companies have also benefited from robust overseas demand. We recently purchased **Shenzhen Mindray Bio-Medical Electronics**, China's largest domestic medical devices company and a market leader in patient monitors and life support systems. The company has a strong track record and has been gaining market share from global leaders as it expands its presence overseas. During 2015-20, sales to overseas markets grew at a compound annual rate of 31%, faster than the 25% for China sales which we also find attractive. We believe there are significant opportunities ahead, as the penetration level of medical devices in China is still low and there is a growing preference for import substitutions.

Chinese regulators trading lightly around systemic risk

In the A-share market, we expect a gradual normalising after the pandemic-related events of the last two years. Unlike the US, Europe and Japan, China had been tightening for several years, which means the People's Bank of China has more room to ease to prop up the economy. Things came to a head last year as the "three red lines" policy¹ caused overleveraged property developers like Evergrande to default on bonds and halt certain developments.

In setting monetary policy, China will need to balance its goal of tempering supply-side inflation with a slowing economy, ageing population, and weak sentiment in the property sector. Policymakers started to reverse some policies once the risks of contagion appeared too big to ignore. The recent cuts to the reserve requirement ratio (RRR) and loan prime rate (LPR) signalled that Beijing is willing to add some cushioning. As rates start to tighten elsewhere, China may look more attractive to global investors as the government turns more pro-growth.

We expect further policy actions to come but the government will remain prudent and fine-tuned, as the goal is stability. Recently media reports said that policymakers plan to relax the three red lines policy by excluding debt accrued from acquiring distressed assets, which should encourage industry consolidation.

We believe **China Resources Land (CR Land)** is well positioned to benefit from such consolidation with its healthy balance sheet and strong portfolio of investments. Recent policy constraints have hurt profits at the more leveraged players, but conversely should provide a boost to less leveraged companies like CR Land.

One of the company's key strengths is its ability to acquire land through projects, which can be higher margin compared to land-bidding auctions. Additionally, its deep-rooted connections in Shenzhen and its reputation in investment property operations is a major advantage when competing for urban renewable projects and transit-oriented development projects. Revenue grew at 64% in 1H2021 with solid 31% gross margins, while net gearing declined.

While we have limited exposure to property companies, we own a number of holdings which should benefit from home upgrades. In our A-share portfolio, **Zhejiang Weixing New Building Materials**, a leading household drain pipe company, performed well over the year despite a pullback in the third quarter when it was challenged by rising raw material prices. There was strong growth in the retail market and the pressures from higher raw material costs have abated somewhat, with recent price hikes feeding into the company's bottom line. Government signals on the easing of real estate market restrictions also helped its performance.

The company's culture seems prudent about business development, an important trait in these volatile times for the property sector. On a recent call with the company, Chairman Jin Hongyang said, "Similar to the human body, the most important thing for operating a business is to maintain the health." As such, we believe the company will not be too aggressive to generate growth and acquire other businesses. This aligns well with our focus on investing in companies with quality and sustainable growth. Overall, we believe Zhejiang Weixing can achieve 10-15% earnings growth per annum through to 2025.

The robust performance of Zhejiang Weixing prompted a closer look at the sector, and we added peer company **Beijing New Building Materials**, the largest gypsum board company in China, to our A-share portfolio. The company has a strong franchise, with limited competition, resilient demand and more than 60% market share in both high-end and mass markets. Gypsum board is a good, low-cost building material and is lightweight, fireproof and a heat insulator. Consumption in China is low at 2.5 square metres (sqm) per capita, compared to the US (7 sqm), Europe (6 sqm) and Japan (4 sqm), which implies plenty of room to grow. The company also plans to build new capacity in overseas markets, and recently acquired a few companies to expand into the waterproofing business.

¹ Outlined by the central government in August 2020, the three red lines define limits on borrowings. They are: a liability-to-asset ratio excluding advance receipts of less than 70%; a net debt-to-equity ratio of less than 100%; and a cash to short-term debt ratio of one.

Observations and outlook

China is dealing with many of the same problems as other countries around the world – widening wealth gaps, an ageing population with low birth rates, and climate change (covered in our recent update on China's net zero drive). The recent reforms are not run-of-the-mill and will likely have lasting consequences. Meanwhile the Chinese economy may continue slowing on a structural basis, even as the population's wealth rises. Despite this, China is still a relatively poor country (USD 10-11k per capita income) and there remains plenty of runway for growth, even with a compromised outlook.

We ground our observations in what we see and hear from companies, on a bottom-up basis. The scale of the property market is unsustainable, while the investment-driven nature of the economy is already leading to materially lower capital-productivity, lower growth and lower returns.

Some of China's reforms are a rational response to these observations. While the Chinese economy is three-quarters the size of the US, the property market is twice the size, which shows how far things are out of balance. Most economists believe that property accounts for as much as 25-30% of GDP, which is two-to-three times bigger than most countries, while around the world, property (in this era of free-money) is generally regarded as being at historically high and unsustainable levels.

The newspapers have been replete with stories about ghost cities in China – empty apartments and 1.5 apartments per citizen – for the last decade. In that sense, the property market bubble has been called many times over the years, but there is now a sense that political will and economic development have collided, and there will finally be change.

More specifically, property accounts for around 80% of Chinese household wealth, which compares with the likes of Tokyo at 65% in 1989. The analogy should not be overdone, but Japan's bubble has been deflating ever since (though

Japan had already succeeded in becoming a rich, stable and developed country). The other similarity would be in demographics, with some making the observation that China will not succeed in becoming rich before it gets old (unlike Japan). All of this means that property-affordability is very low and debt levels are clearly high in China. Evergrande is but one part of this, with more than USD 300bn of debt.

On the other hand, we do not anticipate a Lehman-style bust, with the economy still mostly closed and the authorities able to provide liquidity, as well as direct the banks and other property companies to provide a solution. Absorption of these excesses will clearly take time and the most likely outcome is slower growth. In our view, irrespective of the policy risks, this should mean lower valuation multiples.

Meanwhile, efforts to rebalance the economy from investment (property and infrastructure) to consumption will likely prove challenging because it requires higher wages, which would undermine export growth. And it is imperative, for political and stability reasons, that the property market doesn't break. Muddling through would be a good outcome and per China's historical economic development seems quite likely.

"Common Prosperity" is the new name for this rebalancing and is part of the solution, with forcible redistribution from the internet companies, closure of the private tutoring industry, large "fines" and even larger "donations" across a range of businesses. This will help, but seems unlikely to lead to a significant shift in the near term. Meanwhile it is clearly negative for returns and growth, particularly in the private sector.

In such an environment, we strive to be careful, and to concentrate on persistency of returns and capital preservation with reasonable growth. As such, we continue to adhere to our long-established investment philosophy and process, with our broad exposure to the Greater China region including fabulous companies in Hong Kong and Taiwan as well as mainland China.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 24 January 2022 or otherwise noted.

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