

PORTFOLIO MANAGER COMMENTARY – ASIAN RESEARCH TEAM
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AS THE SKY FALLS

A CONTRARIAN VIEW ON CHINA, FROM THE BOTTOM UP

The backdrop, as we see it

Set against apocalyptic headlines such as “The end of the Chinese Miracle” (FT, March 9th 2016) “Moody’s lowers outlook on China government bonds to negative” (WSJ, March 2nd 2016) and “Industry in China: The march of the zombies” (The Economist, Feb 25th 2016) investors are often surprised by Comgest’s significant current investments in the world’s second largest economy. What makes us stray from the crowd is our approach as fundamentally driven, long-term minded stock pickers who have learned that when everyone is standing on one side of the boat, it typically pays to be on the other if you don’t want to end up in the water.

Of course, no company operates in isolation and we will therefore start by addressing some of the major points of current popular concern. At the outset, it is worth reiterating that economic transition is not something yet to happen in China, but rather it is a project which has been in the making for at least the last 5 years and which in fact, is now quite mature.

So while the misallocation of capital, excess leverage and conflicts of interest so broadly covered and discussed by the press (and hence focused on by investors) do represent significant challenges to growth in what economists term the Secondary Industries, a steady ongoing expansion is visible in the Tertiary industry. From as recently as the fourth quarter of 2015, services contributed more than 90% of GDP growth and in excess of 55% of total output, illustrating the extent of the shift towards more asset-light, higher return services and consumption sectors. This move is supported by low household leverage, steadily increasing real incomes and structural reforms that attempt to free up very high savings ratios.

As a consequence of this change, overall economic growth will likely continue to moderate (although no longer surprise investors who have rationalised their expectations), yet as equity markets reflect this change in where value is created, we may soon see the first period where the growth in EPS (with rising ROIC) will exceed that of GDP. We have discussed in the past the complex correlation between GDP growth and value creation¹, so we won’t dwell further here.

A more recent area of concern has been the inter-related volatility of the RMB and the decline in foreign exchange reserves (in USD terms) since the summer of 2015. The general perception here is that these declines are a reflection of a substantial loss of confidence in the economy and the financial system inside China, leading to widespread capital flight. But let’s take one step back in that logic. The RMB has moved away from a quasi-peg to the US dollar to a managed basket of currencies (termed the CFETS basket). The catalyst presumably was the continued strength of the US dollar (or global currency weakness ex USD, depending on your viewpoint) but that should be viewed within the context of Beijing’s eventual aim for the RMB to sit alongside the US dollar, euro, sterling and yen as an instrument of global trade. Achievable or not, this aim has been clearly stated for many years and has been highlighted by China’s movement into the SDR (Special Drawing Rights) in November. On the road to a floating currency, the step from peg to basket is quite logical. What’s more, the authorities in Beijing have openly identified the basket and the weights that the currency will be managed against (the CFETS basket), most recently on 11th December 2015. Since that date, the onshore and offshore RMB have traded within 4% of the implied base exchange rate of the basket in both directions. Yet while the structural change in exchange mechanisms can be seen as partially responsible for some fluctuations in foreign reserves, it seems premature to conclude from the above that this marks the demise of China’s

¹ Wolter, Emil et al. “Postcard from China #2 - January 2015: Tracking Change in the Year of the Goat”. (<http://bit.ly/1St1EVL>)

financial system, particularly when, as a recent BIS report (“Dollars and renminbi flowed out of China” by Robert N McCauley and Chang Shu, March 6th 2016) highlighted, there is another dimension to the decline in forex reserves. It seems to be the result of a combination of three rational economic decisions including the switch from foreign to RMB-denominated debt, the decline in the offshore RMB market (a natural consequence of accelerated opening of the onshore market), and accelerated overseas investments by Chinese companies in technology, distribution and other assets (FDI). The most important of these decisions was the switch from foreign denominated debt to local currency debt.

This is logical as the exchange rate mechanism changes from fixed peg to moving basket and so firms move to reduce a risk which was previously not perceived as significant. Such a move may also help to explain the recent uptick in local credit growth statistics. Although it clearly does not lower overall debt, it does not raise it either and the removal of funding currency mismatches should be applauded. In aggregate these three factors are summarised to explain more than 75% of the decline according to the BIS, with the short-term consequence potentially being that the monthly numbers (of forex reserve falls) have peaked, or will do so soon, which may work as a fillip to market sentiment, indeed February data might be just such a movement.

Looking forward, the final piece of a more reassuring perception of the Chinese economy would be a reduction in its overall debt burden (an objective which would of course be highly desirable for many developed market economies - where credit to GDP levels are also at record levels) indicating the transition towards a less capital intensive business. We touched upon one factor above (foreign debt refinancing), but taken as a whole, recent bank lending and total social finance statistics do not look supportive of the positive view. The only positive news, in our opinion, is that while credit today continues to grow faster than GDP, it is decelerating more quickly too.

To judge the progress here the most recent economic policies worth monitoring are a renewed and what seems a rather sensible two-pronged approach which aims to re-establish the competitiveness of certain “Old China” companies by a) rationalising their capacity (widely reported supply side reforms) and b) improving their financial conditions (the more recent re-invigorated focus on debt-to-equity swaps). Naturally, such moves do impose pressure on capital levels for banks and the recapitalisation of that sector remains a central challenge but not one that we believe to be unsurmountable given current central government substantial net assets.

At the very least, all of the above suggests that Beijing does not have its head in the sand with respect to the need for continued reform of the economy. Consequently, without claiming any in-depth expertise, our assessment is that the potential for a “muddle-through” outcome in economic growth terms for China over the coming years is in fact rather good. That matters since this outcome, judged against current alarmist, short-term minded press headlines and investor sentiment, would represent the equivalent of “a blue sky scenario” for share price appreciation potential, while we would simply term it as a “constructive environment”.

Selective opportunities

All of the above needs to be considered within the context of what we continue to see from the bottom up. With that in mind, what follows is a brief discussion of some specific opportunities currently available to investors who dare to move in the opposite direction of falling share prices and the current, all-imposing negative sentiment towards the Middle Kingdom. In April, as part of our usual field research work, we visited 14 companies near Shanghai in the auto, advanced manufacturing, wealth management, healthcare and consumer sectors.

One company that highlights the rise in innovation is **Jiangsu Hengrui**, an oncology R&D-focused pharmaceutical company with US\$ 1.2bn of revenues in 2014. The company has been a leader in ‘me too’ and ‘me better’ generics in oncology and now also pioneers in patenting chemical drugs

and biosimilars. However, the interesting aspect is a move – supported by intense investment over the past decade and a surprisingly high number of home-bound scientists formerly working for the likes of Pfizer, Eli Lilly and Merck abroad – into its own proprietary products illustrated by a rich innovative drug pipeline in both China and the US. Although Jiangsu Hengrui is not a bargain in the traditional sense with a current forward multiple of 31x NTM EPS (a slight discount to the Nasdaq biotech index but with much more stable and predictable earnings) it does represent a changing Chinese corporate scene and the strong growth potential still available at the company-level in a country where slowing GDP growth seems to be leaving everyone downbeat (EPS growth has the potential to exceed 30% CAGR for the next 5 years).

Kweichow Moutai, the largest white spirit company in China with 800 years of history, illustrates the continuing rise in consumption. Its brand power is epitomised by the fact that Moutai is even served by President Xi Jinping to foreign leaders visiting Beijing. And while the downturn in premium alcohol consumption resulting from the government crackdown on corruption naturally affected the company, unlike its competitors, its sales were just flat (i.e. they did not fall) and subsequently its market share expanded from 10% in 2010 to 14% in 2014. Today, the consensus forecast of 11% CAGR in EPS for the next 5 years is based mostly on demand from the growing middle class and will be achieved at an average 37.5% ROE. Both of these statistics are higher than global peers, yet the current valuation at 15x NTM PE remains at a sizable discount to comparable global companies such as Diageo (21x) or Pernod Richard (19x).

We have witnessed more Chinese companies moving up the manufacturing value chain and becoming global leaders in the process. **Hangzhou Hikvision** sells surveillance solutions to governments, schools, museums and also households all over the world. The firm has 7000 engineers working on software that can transfer pictures into digital data, perform analysis and then suggest security actions for their clients. Thanks to this integrated service offering, they have expanded domestic market share from 20% to close to 30% in less than a decade, while exports have grown by 60% CAGR over the past five years. The company's security solutions are regularly winning public contracts overseas including recently for a state of the art surveillance system for the Memphis Police Department. The ongoing market rout has shaved 40% of Hikvision's share price, despite its recent climb to second place in the global security and surveillance market. At 14x 2016F PE with 5-year earnings growth in excess of 20%, we believe that the shares look inexpensive for a high return, net-cash business.

Industry consolidation amid a slower growth environment can represent a blessing in disguise for good quality companies. **Fuyao Glass** is the largest automotive glass manufacturer in China (with 63% domestic market share in 2015) and the second largest in the world (20% market share). Sustained R&D investments and a focus on auto glass has enabled Fuyao to maintain a high operating margin, around 15% above that of its global peers, while the rising cost of capital for smaller, undercapitalised competitors is limiting competition. It has no debt itself and generates plenty of internal cash flow to support a global expansion strategy. Its latest initiative has been to open a new, highly automated factory in Michigan which is expected, when fully ramped, to be big enough to supply a quarter of all auto glass used in North America. Led by charismatic entrepreneur Cho Tak Wong, Fuyao is an example of a private Chinese champion transforming itself into a true multinational company to be reckoned with. Investors, seemingly unimpressed, pushed the shares down from RMB 18 to 12 during the second half of 2015. While the share price has rebounded somewhat, the current 12x 2016F PE does not seem expensive when considering the 5% dividend yield, a consistent high Return-on-Equity or indeed the established leadership position and clear growth strategy.

Of course, also in China, the internet continues to change everyone's daily life. ZhongAn Insurance, China's first online insurance company, has teamed up with PingAn and Alibaba to launch the first cloud computing insurance-based business in the country. Its policies are supplementary to the burgeoning demand for traditional protection, instead focusing on covering 'new demand' such as return packages from e-commerce. For now, ZhongAn is private but **VIPShop** is an alternative attractive on-line consumer business listed on the NYSE and currently

disowned by investors. Modelled on TJMaxx and Vente Prive, VIPShop is the largest on-line flash sale platform in China, selling surplus apparel, home and mom & baby goods at 50-70% discounts during 5-7 day promotions. Interestingly, residents in second or third tier cities, who didn't previously have much choice, are their major customers. The company just reported 68% and 71% revenue and profit growth respectively in 2015. In absolute terms, this is no small company either – revenue exceeded \$6bn last year on which they earned a 24.6% EBITDA margin and a 5.4% net margin. Growth is expected to naturally slow but the company should still generate EPS growth above 25% per annum for the next half decade, yet the shares are trading at just 17x 2016 PE following a recent 60% decline in the price.

The recent research trip comprised one week in China during which we were only able to see a selection of companies, some of which are already in Comgest portfolios, some of which are on our Watchlist, and others that might never make their way there. We hope this update helps to illustrate why we believe that on-the-ground, Chinese economic transition continues and with it comes an increasing number of selective opportunities for stock pickers, even if the overall background remains a challenge. Ultimately the country is no longer driven by infrastructure or heavy industry, instead it is moving forward thanks to a flourishing consumption of goods and services assisted by a solid underlying infrastructure and continued reforms designed to raise overall economic efficiency. Given the scale and breadth of the Chinese economy, amidst a pervasive negative sentiment, we find the current time exciting for stock pickers looking to own high quality companies with good growth prospects at attractive valuations for the long term.

Sources: Comgest, Factset (EPS, PE consensus forecasts), China National Bureau of Statistics, company reports and statements; forecasts and estimates as of April 2016 unless otherwise stated.

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