- The Fund invests primarily in equity and equity related securities issued by companies with either assets in, or revenues derived from China.
- The Fund invests in emerging markets which may have increased risks than developed markets including liquidity risk, currency risk/control, political and economic uncertainties, high degree of volatility, settlement risk and custody risk.
- Investing in securities of small/mid-capitalisation companies may have lower liquidity and their prices are more volatile to adverse economic developments.
- The Fund's investments may be concentrated in China and single sector which may have higher volatility or greater loss of capital than more diversified portfolios.
- The Fund may expose to China market risk including repatriation risk, uncertainties to taxation policies and risk associated with StockConnects. The Fund may also expose to RMB currency and conversion risk.
- The Fund may use FDIs for hedging and efficient portfolio management purposes, which may subject the Fund to additional liquidity, valuation, counterparty and over the counter transaction risks.
- It is possible that a part or entire value of your investment could be lost. You should not base your investment decision solely on this document. Please read the offering document including risk factors for details.

First State Stewart Asia
– China Equities
Client Update
July 2018

FIRST STATE STEWART ASIA – CHINA EQUITIES

40th anniversary of reforms

It has been 40 years since Mr Deng Xiaoping embarked on his ambitious market-based reform program and began to open up China's economy. Since then, China has been transformed; while there have been stops and starts on the way, China was one of the fastest-growing countries in the world over the past four decades, averaging 10% growth a year.

Today, China is the second-largest economy in the world in terms of nominal GDP and is forecast to overtake the United States on this measure within the next decade. In terms of purchasing power, which takes into consideration the relative cost of local goods and services, China has already surpassed the US – perhaps unsurprising due to the relative size of the two nations' populations.

Chinese consumers are earning more and spending more, both at home and overseas. Rising incomes and consumption upgrading (trading up to premium quality products) should continue to drive China's economic growth in 2018, despite concerns of a slowdown. Within our China portfolios, this is a key investment theme underpinning many of our long-term holdings.

However, there is more to be done. At this year's annual Boao Forum (the Asian equivalent to the World Economic Forum in Davos), President Xi Jinping delivered a keynote speech about China's mission to "continue to improve itself through reform", in order to "meet its people's aspirations for development, innovation and a better life".

We have been following the reforms closely. Since 2015, two-thirds of China's central state-owned enterprises (SOEs) have been restructured, listed or have introduced some kind of shareholder reform. Stronger SOEs have swallowed up weaker ones, non-performing assets have been sold and inefficient 'zombie enterprises' – those that have been loss-making for years – have been allowed to go out of business.

Despite China's progress towards a market-based economy, companies or sectors at the core of domestic economic security or deemed to be of national importance will remain under some level of state-ownership and the Chinese government is to play a bigger role in the economy than ever before. The intention is to consolidate power within a few home-grown corporate giants, so that these mega-entities can compete with international players.

Though this seems to be a setback, the emphasis on bringing market-oriented reforms to the state-owned sector by way of mixed ownership is a positive step. This way, the private sector can introduce corporate governance best practice, influence decision-making, enhance efficiencies and improve shareholder returns, while the state retains a level of beneficial interest.

The results are starting to show. Market consolidation has driven cost savings and other synergies, while asset sales have bumped up productivity. Last year, China's central SOEs – with total combined assets of almost USD9 trillion – reported record high profits and an average of 15% profit growth, the highest in five years.

We believe SOE reform is an important step towards improving shareholder returns in the Chinese equity market. Some of the largest contributors to performance in our China portfolios are companies that have adopted market-based practices, such as **Wanhua Chemical, Gree Electric and CSPC Pharmaceutical**, which we highlight below. We also note a few of the more recent SOE restructurings and our expectations for these companies.

Mixed ownership models

Mixed ownership reform, which injects private capital into state-owned companies (and in many cases reduces government ownership to a minority interest), needs to be followed by equity ownership and incentive programs to align management with shareholders. Both steps are necessary to bring state-owned enterprises in line with private companies.

Some SOEs, such as **China Unicom**, implemented both steps at almost the same time. In August 2017, Unicom added 14 strategic investors – which included, among others, technology giants Tencent and Alibaba, industry verticals Suning and Didi, as well as insurance company China Life. Following the reform, strategic investors held 35% of the company, the government held 37% and 25% was in free float. The remaining shares, representing approximately 2.7% of the enlarged capital, was allotted as employee incentives.

Others, such as **Yunnan Baiyao** and **Tsingtao Brewery**, have, as yet, taken only the first step towards reform. In December 2016, the parent group of Yunnan Baiyao, a leading Traditional Chinese Medicine (TCM) brand well-known for its powdered herbal haemostatic medicine, restructured its share capital. New Huadu Industrial Group, a private conglomerate with business interests in supermarkets and retail shopping malls, was brought in as a 50-50 shareholder. In 2017, Jiangsu Yuyue, a medical equipment manufacturer, became an additional strategic investor, with New Huadu and SASAC[1] each reducing their holdings to 45%.

Baiyao's parent's five-member board of directors now comprises two members from SASAC, two from New Huadu and one from Yuyue, which should serve as a more effective decision-making process

1 SASAC – the State-owned Assets Supervision and Administration Commission of the State Council – is one of the most powerful agencies in China. It is responsible for managing China's State-Owned Enterprises (SOEs) and has been instrumental in pushing forward SOE reforms. All mergers and asset sales in the SOE sector must be approved by SASAC.

and allow Baiyao to introduce management incentives. An employee stock ownership plan (ESOP) is expected to be launched before the end of the year.

Meanwhile, Tsingtao Brewery, one of the oldest brewers in China and perhaps the only Chinese beer with a well-known brand outside of its home market, introduced Fosun International as a strategic shareholder in December 2017. Fosun bought an 18% stake in Tsingtao Brewery from Asahi Group Holdings, the Japanese beer maker. The unlisted state-owned parent company of Tsingtao Brewery bought Asahi's remaining 1.99% stake and remains the largest shareholder.

Signs of a turnaround at COFCO

At the central SASAC level, one of the largest state-owned enterprises is **China National Cereals**, **Oils** and **Foodstuffs Corporation (COFCO)**, a domestic leader in grains, oils and foodstuffs.

In 2016, a merger between COFCO and Chinatex, ranked first and third in China's agro-grain sector, kick-started an ambitious reform program. COFCO subsequently reorganised itself into an asset manager overseeing 18 specialised companies – each responsible for its own business operations, management appointments and staffing decisions. COFCO HQ would appoint directors to the boards of each subsidiary company but would no longer be involved in the day-to-day operations.

The goal was to make COFCO more commercial and competitive; and improve returns and profitability. Importantly, a stronger COFCO would ensure that China's international grain and food supply would be more secure for the future.

Since the restructuring, COFCO Group's profits have grown significantly. Its underlying listed group companies – **China Foods**, **China Agri-Industries**, **CPMC Holdings** and **China Mengniu Dairy** – have all reported notable improvements.

China Foods reorganised its business to focus on beverages, disposing of its consumer-pack edible oil business to China Agri-Industries. Resource consolidation resulted in synergistic cost savings and, earlier this year in March, both China Foods and China Agri-Industries announced record high profits due to improved operating efficiencies.

At CPMC Holdings, the management have executed as promised, cutting costs and consolidating manufacturing capacity to deal with problems of oversupply. Sales and profits rose 11% (albeit flattered by rising materials prices), while volumes grew by around 15%. Management believe that they can improve margins and return on equity further, given higher utilisation rates and use of operating leverage.

China Mengniu Dairy delivered strong results in FY2017[2], with accelerated revenue growth in the second half. Mengniu's brand-building efforts and football sponsorship has started to pay off, as it has increased market share and expanded margins. Last year, total revenue rose by 12% year-on-year, volumes increased by 9% and net profits reached a record high of RMB2.7 billion. Gross margins continued to improve from 31.4% in 2015, to 32.8% in 2016 and 35.2% in 2017.

Early reformers show positive results

We would likely see sustained productivity improvement and higher returns from these restructured entities over time, if we consider the likes of **Wanhua Chemical**, **Gree Electric Appliances** and **CSPC Pharmaceutical** as encouraging case studies. These state-owned companies were early reformers and have been operating akin to private companies for more than a decade.

Established in 1998, Wanhua Chemical (formerly Yantai Wanhua Polyurethanes Co) is one of the world's largest producers of methylene diphenyl diisocyanate (MDI)[3], with multiple overseas offices selling to more than 60 countries globally.

In 2005, reforms were implemented at the parent company, Wanhua Industrial Group. SASAC reduced its shareholding in the group to 60%, while at the same time 20% of the company was distributed to the management – providing alignment with minority shareholders – and another 20% to foreign investors. SASAC subsequently reduced its shareholding to 39%.

More recently, in June 2018, Wanhua Chemical announced that it would acquire its controlling shareholder, Wanhua Huagong, through an issuance of shares to the latter's five shareholders. After the acquisition, Wanhua Chemical's MDI capacity is expected to become the largest globally, overtaking current market leader, BASF.

In addition to ownership reform, Wanhua Chemical's management team supported market-based practices and provided commercial compensation schemes. Each divisional senior manager takes on responsibility for part of the business and is compensated accordingly.

Wanhua's long-term results have been impressive. Since listing on the Shanghai Stock Exchange in 2000, annual return on equity has averaged around 28%, while earnings per share has compounded at 27% over the same period.

Gree Electric Appliances, China's largest air-conditioner manufacturer, is another example of successful reform. In 1996, at the time of listing, parent company Gree Group (100% owned by SASAC) held 60% of the total share capital of Gree Electric. A series of rights issues, followed by a 2005 shareholder reform program, reduced the Group's ownership of Gree Electric to below 50%.

Concurrent to the shareholder reform program, Gree Electric introduced an incentive scheme which enabled management and technical staff to purchase shares at the prevailing net asset value if profits grew by a pre-determined annual growth rate. In FY05, FY06 and FY07, the hurdle rate was 20%, 10% and 10% respectively – actual realised profits growth for each corresponding fiscal year was 20%, 36% and 84%.

2 FY = fiscal year

3 MDI is a type of polyurethane that is used in a wide range of applications, from synthetic leather goods and textiles, to heat insulation materials for refrigerators and buildings exteriors.

Gree's success is often credited to its charismatic leader, Dong Mingzhu. Joining as an entry-level saleswoman in 1990, Dong proved to be an astute marketer and rose quickly through the ranks, eventually becoming chief executive officer in 2001 and chairwoman in 2011.

Over the past 15 years under Dong's tenure, Gree has delivered an average return on equity of around 28%, while earnings per share has grown by around 28% CAGR[4]. Dong continues to buy shares in the open market. Her personal net worth has multiplied along with Gree's market valuation.

Our final example is CSPC Pharmaceutical, which was owned by the state-owned Shijiazhuang Pharmaceutical Group (SPG). Listed in 1994, CSPC was one of the largest vitamin C and antibiotics manufacturers (classified as 'bulk pharmaceuticals') in China. Its results have been improving gradually and growth is likely to be reasonably visible over the next few years, as its core drug, "NBP" continues to take market share.

In 2007, the management of SPG along with Hony Capital, the private equity arm of Legend Holdings, executed a buy-out of SPG from the government and effectively turned the company into a private enterprise.

Following the shareholder reform, SPG pivoted away from the bulk pharmaceuticals segment, a low margin and cyclical business with little pricing power, and invested into research and development (R&D) for 'innovative drugs', largely in the form of being first to the China market with generic drugs or developing a new delivery mechanism for existing drugs in the China market.

In 2012, SPG injected all of its pharmaceutical manufacturing businesses, including "NBP", "Oulaining" and "Xuanning" – three of its top selling drugs today – into CSPC. "NBP", the largest contributor to profits due to its inclusion on China's National Reimbursement Drug List (NRDL), treats ischemic stroke and is patent-protected until 2023, while "Oulaining" treats dementia and "Xuanning" is used for the treatment of hypertension and angina.

After a series of partial share sales, Hony Capital fully exited CSPC in 2015. The chairman, Cai Dongchen now owns around 29% of CSPC, while the management own another 7%, indicating that the economic interests of the management team are aligned with minority shareholders.

CSPC's research and development expenditure has grown by around 32% CAGR since the restructuring and the company has approximately 200 new products in the pipeline, including treatments for cardio-cerebrovascular, metabolic, oncology, psychiatry and neurology diseases.

Over the past three years, margins have improved as the product mix shifted from bulk pharmaceuticals to innovative drugs – innovative drugs now contribute around 70% of CSPC's business operations, up from 15-20% before the reform. Profits have grown at 29% CAGR and revenue at 8% CAGR.

Portfolio activity

At the start of the year, we found it increasingly difficult to buy quality companies at reasonable prices as the general market rally lifted Chinese equity valuations. Blue-chip companies listed on the Shanghai Stock Exchange were particularly in favour, given the signs of economic recovery and the likely inclusion of China A-share stocks by MSCI indices.

As valuations in the A-share market rose, we took profits on expensive stocks and deployed cash into high quality, well-managed franchises listed on the Hong Kong and Taiwan exchanges that were more attractively-valued.

Some of the more expensive stocks which had been trimmed included **Foshan Haitian Flavouring**, which had rerated to around 40x PE, due to price hikes and stronger than expected sales, and **Jiangsu Hengrui Medicine**, which was trading at a valuation of around 60-70x price-to-earnings ratio (PE) – difficult to justify for 20% estimated growth.

We also took profits on **Sino Biopharmaceutical** when it was trading at 40x PE and trimmed our exposure to Gree Electric and **Qingdao Haier** – both of which had performed well due to unusually strong sales in 2017.

Notable purchases included Hong Kong-listed China Mengniu Dairy, one of the two largest dairy companies in China. After a challenging year in 2016, which included a substantial fall in profits at subsidiary companies Yashili and China Modern Dairy, Mengniu replaced its CEO, introduced new incentives for its sales team and re-positioned itself as a healthy product provider.

2017 marked a turnaround for Mengniu, with most of its key businesses and product lines delivering strong growth. Improvements to the product mix resulted in a healthy expansion in margins, while operating cash flow soared due to better inventory management. We believe margins could improve further from here, which could trigger a re-rating in the shares.

We also purchased H-share **China Telecom** at 0.7x price-to-book (PB) after it reported steady results. Earnings before interest, tax, depreciation and amortization (EBITDA) was up 7.4% and free cash flow increased by 20%. We added Taiwan-based **Delta Electronics**, a play on the automation theme, and built a position on share price weakness. Delta was trading on 17x forward PE compared to A-share peer **Shenzhen Inovance** (of which we own a small position) at 39x.

Performance review

There has been widespread margin pressure for mid and downstream companies due to a sharp rise in raw material prices. Portfolio holdings that performed well against this backdrop were companies with strong brands which were able to pass through these costs. Home appliance companies Gree Electric and Qingdao Haier both fell into this category and reported solid sales despite price hikes. Tsingtao Brewery hiked prices for the first time in a decade.

Foshan Haitian Flavouring and Yunnan Baiyao also exhibited strong pricing power and were positive contributors to performance. Sales of Foshan Haitian's core soy sauce and oyster sauce products actually accelerated due to improved sales and marketing. Meanwhile, results at Baiyao, with its proprietary Traditional Chinese Medicine products, were in line with expectations. Its toothpaste division was mostly flat on a high base.

Conversely, rising raw material prices dented margins at **Shandong Himile**, as the company chose to absorb cost pressures and maintain its customer relationships. The cost of steel – used in its tyre moulds – has risen significantly from the end of 2015 (though it has since come down from last December's peaks).

4 Compound annual growth rate

Himile's track record has been strong but cyclical – revenue almost tripled over the past three years, but slowed to just 9% in 2017. The share price has fallen by around 30% over one year; however, with moderating steel prices, a recovery in margins and, assuming a modest level of revenue growth, the risk-reward seems reasonable.

Meanwhile, auto component companies **Huayu Automotive** and **Fuyao Glass** have seen their share prices buffeted – partly from rising raw material prices and partly due to negative sentiment around trade tariffs, as 30% of Huayu's and 40% of Fuyao's total revenue is derived outside of China.

Outlook – on trade wars and tariffs

One of the key issues weighing on China (and the global economy) is the potential trade war with America. Tit-for-tat tariff proposals have sent global equity markets into a tailspin. Market volatility has returned, reflecting the level of uncertainty on a range of possible outcomes.

China has long been accused by the US of unfair trading practices and of disadvantaging foreign firms in its home market. The US tariff list targets USD50 billion worth of goods covered by the "Made in China 2025"[5] strategy, in a bid to slow down China's supposed hegemony. China retaliated with a list of its own, striking tactically at farmers, as well as strategically-important industries in the US, such as airplanes and motor vehicles. As negotiations continue, investor sentiment has veered between optimism and doubt.

On the surface, it looks like China would be at greater risk from a trade war. At the end of 2017, Chinese exports reached a record high of USD2.3 trillion with a global surplus of USD423 billion – its surplus with the US alone was USD276 billion.

However, China's economy is much less dependent on exports than it used to be. As a result of rising incomes and efforts to rebalance the economy, domestic consumption is now the largest contributor to China's economic growth. The US-proposed 25% import duty on USD50 billion of Chinese goods is equivalent to just 0.1% of China's GDP and affects only 2.2% of China's total exports.

Although higher tariffs would undoubtedly hamper trade volumes, the extent of its impact is unclear. Today, products are made up of hundreds of components manufactured in factories all around the world. Goods are no longer simply made in one country and sold in another. American tariffs on Chinese goods – and vice versa – would probably lower trade volumes globally, not just in China; and result in dampened business confidence and capital expenditures in global markets.

5 In 2015, President Xi Jinping unveiled the "Made in China 2025" strategy, prioritising investments in smart technology and innovation-led industries in a bid to advance China's manufacturing sector and shift its economy forward. The strategy aims to focus manufacturing on higher value-added products and move away from the lower-quality/mass-quantity manufacturing of the past.

First State China Growth Fund

Cumulative performance in USD (%)

	Since inception	10 years	5 years	3 years	1 years	6 months	3 months
First State China Growth Fund*	1,827.2	126.1	71.0	33.7	40.4	12.8	2.3
MSCI China Index	549.7	68.9	75.3	22.7	30.9	5.6	-1.5

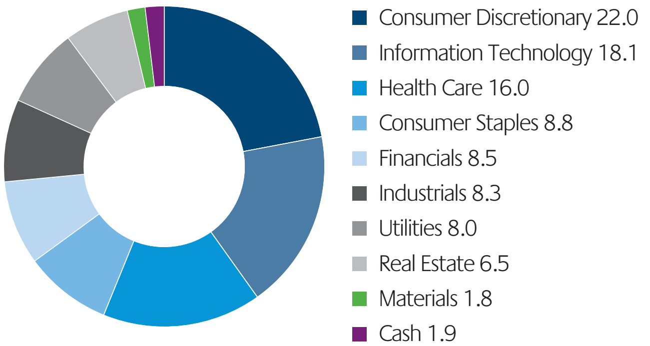
Calendar year performance in USD (%)

	2017	2016	2015	2014	2013
First State China Growth Fund*	55.7	-3.2	-4.0	-2.8	21.4
MSCI China Index	54.1	1.1	-7.6	8.3	4.0

Top ten holdings (%)

	Sector	Fund
Tencent	Information Technology	6.5
CSPC Pharmaceutical Group	Health Care	5.7
China Merchants Bank Class H	Financials	5.1
ENN Energy	Utilities	5.0
China Mengniu Dairy	Consumer Staples	3.6
AAC Technologies	Information Technology	3.6
Midea Group	Consumer Discretionary	3.4
China Taiping Insurance	Financials	3.4
Minth Group Limited	Consumer Discretionary	3.4
Shanghai International Airport	Industrials	3.3

Sector breakdown (%)



Source: Lipper & First State Investments, Nav-Nav (USD total return) as at 31 May 2018. Allocation percentage is rounded to the nearest one decimal place and the total allocation percentage may not add up to 100%.
* The First State China Growth Fund Class I (USD - Acc) - Inception date: 17 August 1999.

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