First State Stewart Asia
China Equities
July 2019 Client Update

FIRST STATE STEWART ASIA – CHINA EQUITIES

Trade tensions have continued to rattle the market, as negotiations between China and the US remain mired in strife. The bilateral trade account and the extent of China's willingness to open up its domestic market are among the primary areas of contention, along with accusations of forced technology transfers and lack of protection on intellectual property rights. Since the trade war began, the US has imposed import tariffs on USD250bn of Chinese goods (almost half the total value based on last year's trade flows) in an attempt to force a deal. China has responded with tariffs of its own on USD110bn worth of US products, with the impact of combined higher tariffs reverberating on the global economy.

By now, few expect a speedy resolution to the battle of ideologies between the world's two largest economies. Both sides have entrenched interests and battle lines that will be hard to cross. Though China has dialled back its 'Made in China 2025' strategy, aspirations to increase the wealth and well-being of its population and avoid the so-called middle income trap suggests that the government will continue to invest heavily into technology, automation, new energy and other industries of strategic importance – putting China squarely at odds with the US.

Huawei has been the latest prominent casualty to have been singled out by US sanctions, though other technology firms have been affected too. Unable to access products and services from American companies, Huawei estimates that its overseas smartphone sales have dropped by as much as 40%, and revenue is likely to stagnate this year and next. Component suppliers have also taken a hit, but have shifted their supply chains, with production bases being quickly set up in Southeast Asian countries such as Vietnam, Thailand and Cambodia. Furthermore, increased research and development (R&D) should stimulate home-grown innovation and eventually reduce reliance on US inputs.

Despite the doom and gloom, we expect well-managed companies to adapt accordingly and believe that the trade war will have limited impact on our portfolios in the long run. In our view, many of the businesses we own have proven that they are able to develop new capabilities, innovate and remain competitive in response to challenging headwinds.

Domestic champions expanding overseas

Though market volatility has impacted Chinese companies almost indiscriminately, several businesses within our China portfolios have managed to side-step the disruption from US tariffs. Fuyao Glass, one of the world's largest auto glass manufacturers, has pledged millions of dollars to new plants and machinery in the US, ramping up local production and creating thousands of new jobs. We added modestly to our A-share position, as valuations looked reasonable on 12x Price-to-Earnings (P/E) and a yield of more than 3%.

The US subsidiary, which initially suffered from cultural differences and a lack of expertise, has made huge strides toward training its new staff, boosting morale and increasing productivity. The business turned a modest profit in 2017.

The local base should help Fuyao gain traction with North American customers, particularly in the aftermarket, as increased proximity and readily available parts would result in a speedier response to client orders. As China's automobile market starts to mature, the overseas business – currently around a third of total revenue – should become an increasingly important contribution to profits. A similar expansion is underway in Europe with plants in Russia and Germany.

Fuyao's products, which include car windscreens with futuristic heads-up displays, and coated auto glass to block the harmful effects of ultraviolet and infrared radiation, are lighter, more durable and more energy-efficient than peers. We expect its superior glass to continue to win contracts from global car manufacturers.

Another of China's domestic champions, Wanhua Chemical, announced last year that it would build a new plant in Louisiana to circumvent import tariffs and ensure that its MDI (methylene diphenyl diisocyanate) products (which would otherwise be subject to 10% duties in the US), remain competitive. Wanhua has built a reputation of research excellence; and has consistently invested into R&D to develop in-house technology and specialty products.

We have owned Wanhua for many years and it remains one of the largest positions in our A-share strategy. The company has a proven management team with a strong track record of operational excellence, and its products benefit from high barriers to entry due to its technical superiority – good examples of the quality attributes that we typically look for in a company.

Wanhua has been expanding its overseas footprint since 2011, when its parent company acquired Hungary's BorsodChem and rescued the group from the brink of bankruptcy. By sharing technical expertise, investing into machinery and expanding the facilities, Wanhua increased BorsodChem's production capacity while making the plant more energy efficient and environmentally friendly.

The acquisition saved thousands of local jobs and, with Wanhua's specialised knowledge and financial backing, BorsodChem expanded into non-MDI specialty goods, tailor-making products for its customers. In 2014, BorsodChem returned to profit and has continued to increase profitability year-on-year since. It has grown into one of the largest chemical companies in Europe.

In 2018, after fully consolidating BorsodChem's operations, Wanhua became the largest producer of MDI globally. Although we have trimmed on strength to control the position size, we expect it to remain a significant portfolio holding. We believe there is a long runway of growth for specialty chemical products with high entry barriers, which should benefit Wanhua given its track record and ongoing new product launches.

These two companies illustrate our bottom-up process and the factors which go into our decision-making. We believe the trade war should have only a marginal impact on Fuyao Glass and Wanhua Chemical in the long run. Ongoing R&D and innovative products have helped to build them into globally-competitive franchises, while their strong management teams lend confidence to our view that they should be able to adapt and compete amid macro headwinds.

Seeking quality companies in China

Despite the sell-off, it remains an ongoing challenge to find businesses which meet our investment criteria and are attractively-valued. While growth in China is not hard to find, the kind of quality companies we like to own tend not to be cheap. Although there are more than 5,000 listed companies in the China universe, we own just 25-30 China A-shares (and another 35-40 offshore-listed China companies).

There are another 50 or so China companies on our active watch list, which is monitored on a regular basis as we build conviction. Some meet our overall quality requirements, but have only short listed track records, which makes it difficult to foresee how they might fare in the next downturn. Others are simply too expensive; and we wait for them to become more attractively-priced to provide a greater margin of safety.

Given our conservative approach and preference for quality companies, we initiated just two new positions in the A-share strategy over the past six months. The first is Weifu High Technology Group, which makes fuel-efficient diesel injection systems for heavy duty trucks, light goods vehicles and other commercial vehicles.

Weifu has been on our watch list for some time. We owned it in the past, but sold on peak valuation concerns and low earnings visibility. As Weifu mainly supplies to truck makers, earnings are prone to cyclicality and, in the recent downturn, the company had fallen to 8x forward P/E. With net cash on the balance sheet and a willingness to return cash to shareholders, we thought it an opportune time to rebuild a position.

Weifu has more than 70% share of the domestic market for common rail products (a type of fuel-efficient engine component), while Bosch is the dominant player globally with 60-70% market share worldwide. The two companies have a long history of collaboration, with Weifu licensing a Type-A Pump from Bosch as far back as 1984. Bosch now owns 14% of Weifu High Technology, as well as shares in underlying joint ventures Bosch Automotive Diesel Systems (66% Bosch vs. 34% Weifu) and United Automotive Electronic Systems (a 50-50 joint venture).

The business relationship has been steady and we are confident that it should remain a long-term cooperation. Both parties benefit: Bosch-related sales account for 70% of Weifu's overall revenue; while half of Bosch's fuel injection components are manufactured at the joint ventures with Weifu. Over the years, Weifu has successfully leveraged Bosch's technical expertise, while Bosch values Weifu's high-precision manufacturing capabilities. Although there are foreign players in China (Denso, Cummins and Delphi being the three largest), Weifu has the advantage in terms of costs and capacity.

We believe Weifu should benefit from the government's environmental policies; and Bosch's governance and R&D strength bodes well too. In the meantime, the stock offered 6% yield for the A-share (and 9% for the B-share although the latter is highly illiquid). On 1.2x Price-to-Book (P/B) and modest growth expectations, the stock offers decent upside potential over the next 3-5 years, though it could remain volatile in the short term.

We also initiated a small position in Xiamen Faratronic, a leading manufacturer of thin-film capacitors (used to store energy in electronic equipment), a niche segment in which Faratronic is the absolute leader in China. Domestic competitors such as Anhui Tongfeng are much smaller and struggle with profitability, while international suppliers such as Panasonic, Nichicon, Kemet and Vishay cannot compete with Faratronic on efficiency and margins.

As a team, we first met the company in 2014 and thought it to be a focused operator with attractive financials, but lacking in dynamism due to its conservative culture. Our past meeting notes also highlighted concerns about the ageing management and the company's opaque shareholding structure as a collective-ownership enterprise.

Since then, senior management has undergone a smooth transition, with younger leaders moving up from within the ranks to ensure continuity of strategy. The new managers come across as prudent and competent; and the collective-ownership scheme turned out to be fine, as the company focused on earnings, cash flow and dividends, rather than short-term share price performance.

The parent, Faratronic Development, owns 37% of the listed company, and is owned on a collective basis by the staff. Although the shares cannot be traded, employees are entitled to a share of the profits via dividends, distributed according to an individual's work contribution. The collective-ownership structure provides some alignment with minorities in terms of stability and dividends, though growth is likely to be steady rather than stellar.

Over the last 10 years, operating cash flow has been at least equal to net income, earnings per share have compounded at an attractive 17%, and dividends have increased consistently, with the pay-out ratio remaining at a high 60-70%. At 20x P/E and a 5% free cash flow yield, we have been buying on weakness.

While Faratronic's traditional markets of home appliances, lighting and industrials are declining or growing only slowly, the prospect of the electric vehicles (EV) sector is far more exciting. Thin-film capacitors can cost RMB300-400 for a passenger vehicle and RMB600-700 in an electric bus – much higher than say air-conditioners and light bulbs. Faratronic has around 40% market share in China and is expanding its global presence. As EV shipments grow, we believe Faratronic's addressable market could double within the next few years.

Our investment approach in China

Over the past year, China equities has been heavily impacted by trade war sentiment. We cannot predict which side will triumph or how long negotiations will continue; but, having invested in China A-shares since 2009, over numerous cycles and market scares, we believe that our bottom-up stock selection and focus on quality should continue to deliver positive returns over the long term, although this cannot be guaranteed. While our portfolios have not been immune to market volatility, the companies we own have preserved capital better during previous downturns.

Declining markets are often seen as a negative, but we view such periods as opportunities to buy high quality companies at cheaper valuations – which helps to compound returns in the long run. In our view, "*Investing in quality means asking ourselves whether we would be happy to add if the share price halved*." As valuations fluctuate on trade war concerns, we have taken advantage of share price corrections to add to existing holdings and initiate new positions from our watch list.

We define quality companies as those that are led by strong management teams, have dominant franchises, and exhibit a long-term track record of sustainable earnings growth. We look for good governance and disclosure as a minimum; and, though we have always considered environmental and social aspects, we have now started to incorporate sustainability analysis on a more systematic basis alongside traditional financial data.

While a company's financials can be downloaded from any Bloomberg terminal, constructing an informed opinion on the quality of a company is more complicated. In our view, it requires multiple meetings with senior and operational management to reveal a company's core beliefs, ethics and values. Management integrity is among our primary considerations, along with evidence of stewardship and protection of minority shareholder rights.

To this end, the team conducts hundreds of meetings in China each year. Though it is not always easy to gain access to the right people, this qualitative assessment is a critical part of our process. As long-term investors, we view management quality of particular importance – with the idiosyncrasies of China's stock market, we want to be sure that we have backed the right people in the event of temporary stock suspensions, restructurings and reforms.

To build conviction, portfolio managers and analysts make their case to buy, sell or hold a particular company. We take a conservative approach and debate the risks and merits of the companies we own at regular team meetings, reviewing meeting notes and any new analysis that could reinforce or change our view on a company's quality rating. Short-term market movements rarely feature in these discussions.

To guard against behavioural biases, all trade instructions are sent to all team members at the time of trade and are subsequently reviewed on a weekly basis, providing ample opportunities to raise concerns or provide constructive feedback. When questioned, portfolio managers are obliged to defend their investment decisions and convince the team of the merits of their actions.

Thus, our trading activity is relatively low and portfolio name turnover is typically in the low teens. We tend to take our time to evaluate and monitor companies, but once we have built conviction, we hold for the long term, unless we believe there has been a material change or an irrevocable impairment to the investment case.

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