

China Equities

Each year around the Lunar New Year, factories in China switch off production and close up shop for the Spring Festival period. Factory workers who had left their rural hometowns in search of better wages in cities travel home en masse for the celebrations. With three billion trips expected to be made over the period, this annual migration is said to be the largest concentration of people movement in the world.

Instead, as news of a novel coronavirus surfaced in Central China, the Chinese government announced a series of travel restrictions and called for large social gatherings to be banned in an attempt to contain the outbreak. At the epicentre, Wuhan (in the Hubei province) was placed under mandatory lockdown, with no one allowed to enter or leave the city. Quarantine measures were expanded to neighbouring cities and, with workers unable to return to their place of work, New Year factory closures were forced to extend beyond the usual two or three week period.

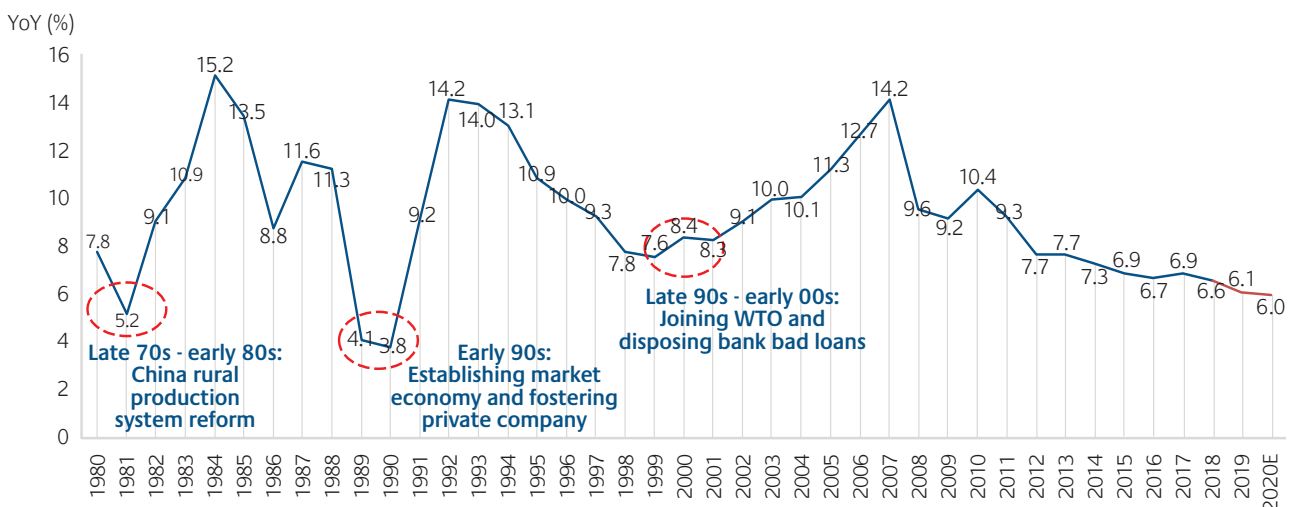
Although China's strict containment measures may have helped inhibit the total number of cases there (it could have been much worse), at the time of writing the virus had spread to more than 100 other countries¹. It has become a global problem. The US Federal Open Market Committee and the Bank of England have both instructed an emergency interest rate cut in a bid to prevent an economic slowdown. Other major central banks are expected

to follow suit with easing measures. Indeed, there has been much faith put into central banks' ability to solve every problem with "helicopter money"² should the economic impact be greater than expected.

In February, the People's Bank of China announced a series of targeted policy actions to support the economy. But, monetary easing and stimulus measures can only do so much. Manufacturing production data, producer prices, trade activity and retail sales for the first two months of the year have been significantly impacted by the temporary halt in activity. It is too soon to extrapolate, but the expectation is for China's full-year economic growth to be revised downwards in due course.

As the number of new cases of Covid-19 in China slowed, factories started to resume production – although, anecdotally, assembly lines have been operating at just half the usual rate. As China has only just started to return to work, it is too early to say what the economic impact will be. At the beginning of the year (and before the coronavirus), the Chinese government announced a growth target of "around 6%"³ – the priority being a sustainable level of activity that would still achieve the goal of doubling the size of the economy from 2010 to 2020. Although this might have seemed reasonable before current events, it now looks rather optimistic.

China's real GDP growth over the last 40 years



Source: CICC, December 2019. Figures for 2019 and 2020E updated by FSSA Investment Managers, March 2020

¹ Source: As of 13 March 2020

² "Helicopter money" refers to monetary expansion designed to stimulate the economy

³ Source: Reuters, January 2020 <https://www.reuters.com/article/us-china-economy-gdp-provinces/many-of-chinas-provinces-cut-2020-gdp-growth-targets-despite-easing-trade-tension-idUSKBN1ZL0EA>



Nevertheless, companies in China are still growing – albeit some at more sustainable levels than others. Pinduoduo, a Chinese online platform which combines value-for-money goods with social e-commerce, grew revenues by 650% in 2018. Sales more than doubled in 2019. However, the company has been burning through its cash with coupons, incentives and promotions to acquire users. It also has only a short track record, having listed in 2018. We found it difficult to put a value on such a business; and with no sign of profitability in the near term, we deemed the company uninvestible.

On the other hand, TAL Education is a market leader in after-school tutoring services. In 2019, TAL's revenues and profits grew by 49% and 64% respectively. We believe there is still considerable potential for TAL to continue to expand. Their teachers are top-tier university graduates and there is a strong research and development team on the back-end to standardise teaching materials. But, TAL has always been too expensively-valued – 3-year trough price-to-earnings (P/E) is 40x – which means there is little room for disappointment on earnings. We prefer to buy companies with a greater margin of safety, where the potential upside is sufficient compensation for the risk.

We have not invested in Pinduoduo (irrational business model) or TAL Education (too expensive). Our investment philosophy remains unchanged and we continue to focus on identifying well-managed businesses with dominant franchises and conservative balance sheets. Many companies in our China universe have become more attractively-valued amid the market volatility, although we have been surprised at how well some of them have held up.

Technology and innovation

Despite the slowdown, there are still pockets of investment opportunity to be found in China. We find similarities with the experience in Japan where, despite more than two decades of stagflation, the best companies managed to innovate and find new markets for growth. We expect high quality companies in China to do the same. We see evidence of this in the rise in research and development (R&D) expenditure, as Chinese companies move away from being “low-cost manufacturers” and start to climb the value chain.

There are now a number of market-leading companies in China with innovative products and the ability to compete globally. In 2018, China received more than 1.5 million patent applications – the highest number globally and more than the United States, Japan, Korea and Europe combined⁴. As China's technology manufacturers produce higher value and more technologically-advanced products, average selling prices (ASP)

have risen and margins have improved. This should contribute to more sustainable earnings growth over the long term.

We have been adding to companies that have been able to demonstrate this innovation trend. One example is a manufacturer of optical components (such as camera modules and lenses). This company has grown its R&D expenditure by 40% CAGR⁵ since listing on the Hong Kong Stock Exchange in 2007. There are more than 2,000 R&D staff, whose job is to explore and enhance new technologies for cameras in smartphones (the majority of its business), automobiles (advanced driver assistance systems and autonomous or driverless vehicles), as well as newer areas such as Augmented Reality, Virtual Reality and robotics – all of which use some form of camera sensor as inputs.

Optical design capabilities at this company have been developed over many years and the company is one of few which can produce both camera lens sets and camera modules. They invest across the whole value chain and aim to become a fully-fledged optical systems solutions provider, including optical lens, cameras, image sensors and smart eyes.

As a result of improved product specifications, the company has consistently increased its market share. The company's capex plan suggests confidence in the medium term. In addition, the broad adoption of 5G in China could provide a cyclical tailwind as smartphone sales return to growth. Camera upgrading in smartphones (higher resolution, dual-cam to tri- and quad-cam, 3D sensing, and better lens quality) is a structural growth trend, in our view, which helps to cushion this company's blended product ASP against annual price declines.

However, there are many moving parts. Major uncertainties include the risk of reduced orders, as a major Chinese telecoms company (which accounts for around 25% of the optical company's sales) has been banned in the US⁶; as well as increased competition, potential for yield improvement and foreign exchange volatility – all of which could affect earnings in the near term. Reassuringly, this optical company's track record has been outstanding among its peers in China, particularly with its focused strategy and vertical integration business model. In addition, the management team are young and diligent, and there is strong alignment with shareholders as 35% of the company is owned by management and ex-employees.

Expansion into new markets

Another example of a company we added to is the largest relay manufacturer in China and the third-largest globally (relays are electrical switches used in a variety of products, such as automobiles, home appliances, telecommunications

⁴ Source: World Intellectual Property Organisation

⁵ “CAGR” refers to compound annual growth rate

⁶ Source: Company reports, March 2020



and industrial automation). In the past, this relay company had enjoyed strong growth in the domestic market, driven by rising incomes and urbanisation (people were buying more cars and home appliances). However, in recent years, the volume of auto and home appliance sales has slowed due to high penetration levels and a slowing economy.

The company has taken steps to expand into new product areas and grow its overseas business. Firstly, as a leading supplier of auto relays for traditional vehicles, the company has leveraged its relationships with both domestic and global car manufacturers to expand into the high-voltage supply chain for electric vehicles (also called “New Energy Vehicles” – NEV). Compared to traditional auto relays, high-voltage relays for electric vehicles are around 5x more expensive, which implies much higher revenue contribution.

Since 2018, this relay manufacturer has been the exclusive relay supplier to Volkswagen’s full electric “MEB” platform, while Daimler’s Mercedes BEV models and Tesla’s Model 3 also use high-voltage relay technology from this company. As this manufacturer only makes relays and related components, they can respond quickly to client-specific demands and increase capacity as needed. They are especially nimble when compared to global industrial competitors where relay is only a small part of the overall business. We believe demand for high-voltage relays is likely to accelerate as the major auto manufacturers roll out new electric vehicles in response to stricter regulations on emissions. Indeed, the management expect this division to grow significantly – targeting RMB3bn revenue from both domestic and overseas customers by 2023.

Secondly, this relay company has started to break into the low-voltage market, which has a much larger market potential (around 5x bigger) than the niche relay market. This is a new and still-developing business area for the relay giant. Its low-voltage product range is still small; but, they believe they are able to differentiate by offering better-quality products. We have been impressed by the strong performance-driven culture here. Their standard defects rate is below “one ppm” (parts per million) – which is incredibly low – and they have a solid reputation of manufacturing high-precision, high-quality products.

Rising health awareness

Companies that tap into Chinese consumers’ spending behaviour form another key segment where we believe there are good investment opportunities amid a slowing economy. China’s per capita income has reached a level where people are starting to spend more on discretionary items and premium goods and services, evident in the sales breakdown of home appliances, automobiles, food and beverages, and domestic and international travel. However, consumers are becoming increasingly savvy about their choices – this is a highly competitive market and growth is likely to be bumpy.

As long-term investors, we believe that taking a bottom-up and selective approach – and carrying out detailed fundamental company research – is the best way to identify dominant franchises with long-term earnings growth potential. We have owned a plant-based food and beverages business for many years. Established in Hong Kong in 1940, this company produces soy-based drinks, ready-to-drink teas and tofu food products. Having studied the health benefits of soy beans, the founder developed a fortified soymilk drink in response to the malnutrition he saw in Chinese refugees fleeing to Hong Kong to escape the civil war. By the 1960s, this company had over 25% market share of the total Hong Kong beverages market, second only to Coca Cola.

The business is still a tightly-controlled family company, although it has been professionally managed since 2008, with two external CEOs since then. Both have helped to steer the company towards significant earnings growth and improved profitability.

This plant-based business has benefitted from the increasing level of health consciousness in China and growth on the mainland has accelerated. Around two-thirds of revenue is now generated in China and it is growing at a much faster pace than the rest of the business. Its mainland China plants are operating at a 100% utility rate, as they struggle to keep up with demand. In 2018, the company announced that it would invest RMB1bn to build a new plant in Dongguan (in Guangdong, Southern China), which should be fully operational by 2021.

The company aims to grow at more than 20% per year, which would mean growing faster than the industry. However, in a recent meeting with the CEO, we were reassured by his comments about “making the right decisions rather than chasing growth”, which suggests that the company understands the competitive landscape and the challenges of expanding into new markets. We expect quality and sustainable growth from this company in the future.

Our investment process remains unchanged

We continue to believe that China equities should be able to deliver attractive shareholder returns over the long term. Against the backdrop of heightened market anxiety and uncertainty surrounding the coronavirus, we believe it is more important than ever to maintain a steady hand and focus on the long-term opportunities. Our portfolio holdings – high quality companies supported by fundamental growth drivers – will undoubtedly be rocked by market sentiment. However, our investment style is generally suited to these uncertain times, as “quality” tends to hold up relatively well amid volatile markets.

We continue to adhere to our long-established investment process, focusing on quality of management, franchise and financials. A key part of our investment process is meeting with



management teams of the companies we own or might wish to own. We conduct around 1,600 meetings each year, of which 300-400 are in China. We have been investing in these markets since the establishment of the team in 1988 and have owned some portfolio companies for decades. We believe these long-standing relationships have provided us with a better level of access to management than we would otherwise experience.

As long-term shareholders, we look for management teams that are well-aligned with minority investors and respect all stakeholders, both in good times and bad. This is especially important in emerging markets, where corporate governance standards are still evolving. Boards are usually dominated by insiders, which can make it difficult to challenge executives or influence behaviour to achieve better outcomes.

In China, we rely on the integrity of founder-managers and their stewardship of these businesses. Many privately-owned companies are largely owned by the founders, who remain actively involved in operations and decision-making. As an example, during a recent research trip to China, we visited a zoo that the founder had built in front of the company's office building; elsewhere, another founder had constructed an educational academy the size of a factory.

However, we do not have to own any company (or sector, or country) that does not meet our quality criteria, as we construct

portfolios on a bottom-up basis and without regard to benchmark weightings. Our portfolios tend to be relatively concentrated, which allows us to focus on identifying companies with capable management teams and evidence of strong corporate governance. Once we are satisfied with management quality, we assess the quality of franchise (barriers to entry, pricing power, competitive advantages) and analyse the financials (how solid are the balance sheet, cash flow and earnings?).

Other than Governance, we are also mindful of Environmental and Social issues that make up the ESG trinity. China has introduced a number of policies to encourage a more sustainable level of growth. In cities, residential coal-power is being phased out in favour of cleaner, natural gas. Wind and solar power and "green energy" industries such as New Energy Vehicle (NEV) batteries have been boosted by subsidies and favourable government policies. Water conservation is also high on the agenda, as companies and citizens look for ways to reduce wastage. This has thrown up a number of investment opportunities (as well as challenges).

Due to China's geographical size and large population, its economic growth can have a huge impact on the environment and climate change. As long-term, responsible investors, we view it as part of our responsibility to guide our clients' capital towards more sustainable outcomes.



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