Client Update
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FSSA INVESTMENT MANAGERS

China Equities

China's e-commerce and online services were among the few bright spots against the dismal economic backdrop this year. Many companies reported a surge in online sales during Covid that has remained elevated even as the number of cases fell and lockdown measures eased. While sales at China's bricks-and-mortar retailers fell by 19% over the first quarter, online shopping grew by 6% over the same period.[1]

Chinese millennials[2] are largely responsible for this increased online expenditure. They have been feted as the key drivers of China's domestic consumption in recent years, accounting for as much as 65% of the annual growth[3]. Young and highly educated with steady jobs, on the whole this cohort has significant disposable income – particularly those still living at home and without family responsibilities of their own. Having grown up with technology at their fingertips, they are much more likely to purchase online than via traditional channels. Their preferences and behaviours have been instrumental in the growth of the technology sector in China.

During the height of the pandemic, the take-up of online services accelerated further as new demographic groups (such as the elderly) switched to online to buy food, healthcare products and other household necessities. Amid Covid-lockdowns and with few options available, China's e-commerce penetration reached 30% of total retail sales in 1H 2020 (up from 26% pre-pandemic)[4].

Until fairly recently, we had followed the rise of China's technology giants mostly from the sidelines. Our company research highlighted concerns with governance standards, transparency levels and high valuations. Many of these issues have diminished and in some cases have improved markedly. Over time, with additional research (and greater understanding of the risk vs. reward for such companies), we believed that a few stood out with the quality markers that we usually look for.

In this note, we have highlighted two companies that we believe should continue to benefit from the rising tailwinds of e-commerce. Meituan Dianping is a "super app" that has steadily increased users and monetisation, while ZTO Express delivers billions of packages containing online purchases each year.

Both companies are industry leaders, with strong, dominant franchises and competitive advantages that we believe are likely to persist. They have capable managers at the helm, high governance standards and a long-term mindset. We believe they will not only benefit from the growth in e-commerce, but should be able to adapt to the changing competitive landscape and grow sustainably over the long term.

Rise of the "super app"

With technology all around us, most of us have turned to mobile applications ("apps") to organise our daily lives. More than 10 years on from Apple's infamous catchphrase[5], there truly is an app for everything. From messaging to meal deliveries and everything else in between – our social activities can be managed with just a few taps of a smartphone.

In China, many of these services have been bundled into an all-encompassing platform – the "super app". Meituan Dianping is a good example of this integrated ecosystem at work. The app includes takeout food delivery, fresh food groceries, supermarket and pharmacy goods, restaurant and travel bookings, movie bookings and entertainment tickets,

[1] Source: China's Ministry of Commerce
[2] Note: Those born in the 1980s and 1990s
[3] Source: *Millennials: China's new economic force, Faisal Kidwai*, 16th January 2019, on chinadaily.com.cn
[4] Source: National Bureau of Statistics, CLSA, 1H 2020 figures
[5] In 2009, Apple's advertising for the first iPhone and its App Store coined the phrase, "There's an app for that!"

and transportation services. As an O2O (online to offline) business, Meituan offers products and services that are transacted online, but consumed offline "in the real world".

Meituan is strong in both the online (consumers) and the offline (merchants) arena. With more than 450 million users and six million businesses across the country, Meituan is by far the largest local services e-commerce platform in China. It is the leader in food delivery services (two out of every three food delivery orders in China are made on the Meituan app) and domestic hotel bookings (40% market share), while in-store dining and travel services are major profit centres.

Since its establishment in 2010, Meituan's business has evolved significantly. Its core offering began with local deals on restaurant dining packages inspired by the group-discount company Groupon, and has gradually expanded into movies, travel services and on-demand food delivery. Five years after launch, Meituan merged with Dianping, China's answer to Yelp, which closed the loop of *search-information-transaction* for restaurant bookings and other lifestyle service offerings.

Today, on-demand food delivery forms the majority of Meituan Dianping's gross transaction value (GTV). As a high frequency, low margin business it is just about breaking even; but, it serves as a relatively low cost way to capture new users and bring them into the Meituan ecosystem as most people use these services regularly.

Meituan's data suggest that its customers usually start with food services and then progress to other services over time. More than 80% of new hotel bookings on the app were made by customers who had ordered food delivery or booked in-store dining first; and around half of those who use Meituan for more than three years eventually take up more than five categories of services. Overall, the average number of transactions per user has doubled since 2016, to 26 purchases per year.

Meituan's strategy remains focused on growth. The company ploughs much of its revenue from advertising into customer and merchant incentives to increase its user-base and enhance customer stickiness. And its product offering continues to expand, as it explores new revenue streams to enhance profitability (such as community group purchasing).

We believe the management have been disciplined in the pursuit of growth, keeping a close eye on the return on investment (ROI) of its new initiatives. They have closed a number of Ella Supermarket outlets due to low ROI, for example, and shifted the car-hailing business from a direct model to an aggregator model to improve returns.

The chairman and CEO, Mr Wang Xing, is a serial entrepreneur whose previous forays into Chinese internet achieved some degree of success, but were short-lived. Xiaonei, a Facebook-like social networking website, was sold to China InterActive Corp due to lack of funding, while Fanfou, a Twitter-like microblogging platform, was subject to censorship from the Chinese government and forced to shut down.

Such experiences can often shape future behaviours. Our meetings with management and industry experts suggest that Mr Wang has faced numerous challenges and *"made all the mistakes entrepreneurs easily make"*. Today, he appears to be pragmatic and down-to-earth, and committed to making Meituan a success, while his share ownership (10%+) is reassuring from an alignment perspective.

We like the culture of mutual trust and accountability that Mr Wang has built here and believe it bodes well for the future of the business. A number of the senior management team are his long-term associates, either schoolmates or partners in earlier ventures. The team have executed well in the past and are highly regarded for their strategic decision-making, while senior managers from Tencent and Baidu add to the bench of experience. Additionally, younger managers are nurtured into the top roles as senior managers step back. This should help the firm progress and ensure continuity.

The board is also decent, with a good balance between the three co-founders/senior managers (Mr Wang Xing; Mr Mu Rongjun; and Mr Wang Huiwen), two representatives from investors (Tencent owns 19% of the firm, while Sequoia Capital owns 12%), and three independent non-executive directors with respectable backgrounds in finance, consulting and technology.

Meituan's recent earnings results were strong, particularly with Covid-19 accelerating the change in consumer behaviour and lifestyle choices. While revenue dipped in Q1, there was a sharp rebound in subsequent quarters with encouraging signs of a recovery underway.

On the other hand, there are still issues to monitor. Meituan's financial track record is short, having been founded in 2010 and listed in 2018. Profitability and operating cash flow only just turned positive in 2019. Nonetheless, there are encouraging signs: advertisement fees have been rising and, with more established consumer habits and a dominant share of the food delivery market, Meituan should be able to lower incentive payments from here. We believe profitability could come through rather quickly.

From a longer-term perspective, we believe Meituan has a long runway of growth ahead. As the market share leader and app traffic front-runner, we believe Meituan Dianping should continue to produce solid results – and deliver on its mission to *"help people eat better, live better"*.

China's express delivery market

In 2019, 63 billion parcels were shipped across China[6]. This translates to around 172 million parcels per day and more than 45 parcels per person. For the sixth year running, China's express delivery market was the largest in the world. We believe the sheer volume and growth potential of China's express delivery industry presents a unique opportunity for investors.

In China, there are five main express delivery companies each vying for a piece of the pie. Four of them – STO Express, YTO Express, ZTO Express and Yunda – were established in Tonglu, a small county in Zhejiang Hangzhou in the east of China. Due to their regional origins, the four companies are known as the Tonglu group, or Tongda operators (though they are separate companies).

SF Holding was founded in Shunde, Guangdong. In contrast to the Tongda operators, SF targets mid-to-high end business customers. SF operates a direct-managed model to maintain tight control over its business operations, as "time definite" services (guaranteed delivery by a specific time) are its main revenue drivers. While e-commerce is a growing part of SF's business, it focuses primarily on the premium segment (mainly luxury brands), while the Tongda operators serve the mass market.

Out of the Tonglu group, ZTO is, in our view, the best operator among them. It provides better services, is a cost leader and its network is the most stable. Over the course of ZTO's history, the founders and long-tenured management team have made careful and considered decisions to grow the business, while their core values, which emphasise fairness, transparency and shared success, have laid a strong foundation for the company's future.

The founder and chairman, Mr Lai Meisong, is a key figure behind ZTO's development. We find him to be a capable and visionary leader whom as early as 2003 conveyed the message that the company belongs to every stakeholder and not just a select few executives. ZTO's philosophy of *"shared success for all"* is therefore deeply rooted in its culture.

Mr Lai is supported by a senior management team who seem equally committed to the business. The financials are straightforward, the balance sheet is strong and there is significant cash on the books (53% net cash to equity) to buffer the business in the event of a slowdown.

The Tongda operators manage the main regional sorting hubs and the transportation between them, while localised network partners provide first-mile and last-mile services (parcel collection and delivery to customers), paying a fee to use the Tongda's brand. In a country the size of China, the network-franchise model has allowed the Tongda operators to expand their footprint nationwide.

However, this means that Tongda operators rely heavily on the efficiency of their local partners – it pays to incentivise them to carry out their part of the line well. ZTO's introduction of a multi-tier delivery fee system has proven to be a successful business strategy in this regard. Many of its network partners were loss-making up until this point, as they only earned fees on collection and provided delivery services for free.

In 2010, ZTO acquired most of its provincial-level network partners' operations (which consisted mainly of sorting hubs and line-haul transportation) with cash and shares, and brought the network partners' senior managers onboard as shareholders. This helped to align and incentivise them as major stakeholders in the firm.

ZTO is now the largest express delivery company in China by parcel delivery volume. We believe there is still room to grow, underpinned by the rise in e-commerce. Around 80-90% of parcel deliveries in China are related to purchases on platforms such as Alibaba's Tmall and Taobao, JD.com, Pinduoduo, and WeChat's e-commerce and live broadcasting channels.

This was already growing at a rapid rate pre-Covid, helped by China's large population of digital natives. For example, on Singles' Day 2019, China's equivalent to the Black Friday/Cyber Monday sales, ZTO received more than 200 million orders and collected 113 million parcels on the same day. More than 500 million parcels were delivered over the following week. In comparison, Australia shipped 934 million parcels in the whole of 2019[7].

Recent estimates put ZTO's market share at more than 21%[8]. We believe its superior operations and strategy should continue to strengthen and gain share from competitors, and cement its position as the industry leader.

Outlook

China is eyeing a broad-based recovery, as the country has effectively controlled Covid-19 and is recovering from the pandemic. From the economic data, industrial production, fixed asset investment and retail sales have all been improving steadily. The laggards are in travel and contract-based services such as leisure and entertainment, though

[6] Source: State Post Bureau of China
[7] Source: Pitney Bowes Parcel Shipping Index
[8] Source: Bernstein Research, as at Q2 2020

these segments are also starting to show signs of an uptick. Export remains strong, thanks to improved demand from the US and Europe, as well as manufacturing companies that have relocated their production to China.

Looking forward, we expect the domestic recovery to continue, as activities normalise and the government continues to pledge support to the economy. The global situation, on the other hand, remains uncertain. We believe the progress of recovery and its implications on China needs to be closely monitored.

From a bottom-up perspective, company performance has diverged. We believe quality companies with strong technical and execution capabilities, and those that have benefitted from the changes in consumer behaviour, will emerge stronger after the crisis subsides. We continue to focus on companies with solid fundamentals and visible earnings growth in the coming years. In the meantime, we have also been searching for undervalued opportunities that have suffered in the short-term due to Covid-19, but whose franchise remains intact.

* Company data retrieved from company annual reports or other such investor reports. As at 30 September 2020.