MIKE SELL
September 2018

INVESTMENT NOTES FROM GREATER CHINA

ASIA FUND

Mike Sell, Alquity's Head of Asian Investments spent ten days in Greater China visiting 22 companies in Hong Kong and four in Taiwan. He was joined by Dan Billis, a new addition to the Asia Investment team. Despite being caught in Typhoon Mangkhut, Mike and Dan visited both existing and new potential holdings. ***Our regular on-the-ground meetings in September provided a good opportunity to discuss the relentless negative news relating to the global trade war with the companies we met; whether and to what extent the imposition of tariffs impacts the Chinese domestic economy.***

There is a very strong parallel with the current situation in China and the Indian demonetisation shock in 2016, in our view, albeit the latter was more sudden. In both cases, negative headlines dominated news flow and thus sentiment, which exacerbated the initial adverse market impact, but does not necessarily change the medium-term outlook.

This time, shaken business confidence has translated into weaker new export orders, as reflected by both official and Caixin PMI figures. However, due to the insulated nature and resilience of the Chinese domestic economy, complemented by economic stimulus measures delivered by the authorities (e.g. easier financial conditions, tax incentives, etc.), weak export orders were more than offset by stronger domestic demand. The pickup in internal demand was reflected in high-frequency indicators in August, which signalled that industrial production (6.1% YoY) and retail sales growth (9% YoY) slightly improved amidst trade tensions compared to July. The insulated nature of the Chinese economy is underscored by the fact that total foreign trade amounts to ca. 38% of GDP, while the openness of an average country is about 56% of GDP, according to the World Bank.

During their trip, Mike and Dan tested our long-standing in-house view that the Chinese economy is resilient and solid enough to withstand the shockwaves generated by trade tensions reverberating across markets.

PROPERTY

A misunderstood sector

As property companies are among the most sensitive to the Chinese domestic business cycle within the Alquity Asia Fund and the Alquity Future World Fund, it was of great importance to discuss the current outlook for the Chinese economy. We met with both our existing holdings, Shimao and Yuzhou. Both focus on affordable developments in key cities such as Nanjing (population ca. 8.3mn) and Shanghai (population ca. 24.2mn). Yuzhou's revenue rose 27.5% YoY in 2018 H1, supported by a rising average selling price. In the same period, Shimao's revenue increased 18.8% YoY, as average selling prices edged up, future contracted sales expanded 60.3% YoY and the gross profit margin widened 1.4ppt.

Furthermore, Shimao's cash flow improved significantly. We expect the financial performance of both companies to be in line with (or ahead of) their guidance for the remainder of this year and 2019. This confidence is supported by ongoing share purchases by the founder of Yuzhou and a share buy-back by Shimao. As a crosscheck, we also met with Ronshine Properties, who described a very similar picture and highlighted the sensitivity of the sector to government policy. This is not uncommon in China with even Tencent now suffering from government clampdowns. For the time being, we see very limited risks that regulatory change poses a downside risk as there are no signs of any further tightening for the property sector – and any easing would provide an upside surprise. Yuzhou and Shimao trade on price-to-earnings forecasts of low single digits, and each have a dividend yield above 5%. We conclude that the sector is unjustifiably cheap.

Our ESG rating for Shimao is 'C', whilst we assign a 'B' to Yuzhou following a recent upgrade. We engaged with Shimao on providing greater disclosure on staff turnover and HR policies as well as sharing the results of their customer satisfaction surveys, which demonstrate that the company is ranked within the Top 5 nationwide.

> ***Interestingly, since we launched the Alquity Asia Fund over four years ago, there has been a significant improvement in ESG disclosure by Hong Kong companies, noticeably in terms of environmental data. The improvement, which was primarily driven by the Hong Kong Stock Exchange, is hugely welcome. However, companies still comment 'we have never been asked that before' on more occasions than we would like, and we continue to engage more to drive further improvement.***

CONSUMER STAPLES
The key is premiumisation

Due to a misalignment in travel schedules, we were unable to meet the management of our holding in Dali Foods during this trip. However, we spoke to them by phone before our departure. Their growth outlook continues to benefit from Chinese consumers' increasing desire to move away from basic products to premium goods. These trends were reiterated by the management of China Resources Beer, who are seeing a significant product mix shift towards the mid- to high-end. This company is a recent addition to the Alquity Asia Fund and the Alquity Future World Fund. We have further increased our weighting during a period of unwarranted share price weakness. We will review our ESG rating of 'B' for China Resources Beer following this meeting to consider whether an upgrade to 'A' rating is appropriate, as many of our outstanding issues in relation to Governance have been addressed.

We aim to understand the entire ecosystem around the companies in which we invest, and to that end we met with another market-leading consumer staple company. This again reaffirmed our view that consumer demand has not dimmed. However, this company is desperately trying to launch higher-end products given the limited growth potential in their relatively basic portfolio. They are suffering, and not benefiting, from the increasing premiumisation within the Chinese market. This is therefore not a candidate for the funds, especially given concerns on their environmental standards raised by a neighbouring company in Hangzhou. If these are valid, then there is also a significant risk of government action impacting their production, revenue and profitability.

INSURANCE
Rising demand from an ageing population

China has a rapidly ageing population, which drives increasing structural demand for insurance products. Per capita life premiums are only USD 190 in China (2016 data), versus USD 3,599 in Taiwan, USD 7,066 in HK or USD 2,050 in Korea. We met with AIA, which is an excellently-run company and operates a best-in-class sales force across the whole Asian region. However, we continue to prefer Ping An, which has much greater penetration of the Chinese market and has a sustainable competitive advantage due to its 1 million sales agents servicing 179mn customers. Ping An's incubation of fintech companies also reinforces this and provides unappreciated upside potential in addition to the core business. Internet stocks, such as Tencent and Alibaba, have driven investors' returns over recent years. This growth story is well-understood. Fintech, however, is not, and has a similar transformational potential. Our meeting with our holding China Pacific Insurance Corporation (CPIC) was equally positive. CPIC focuses on smaller cities, where we forecast structural growth to persist for many years given the under-penetration of insurance products within China. Governance of the company is also solid, and our conversation revolved around health and safety policies, cybersecurity and ensuring their agents do not mis-sell life or savings policies.

We are always alert to disruptive threats to our companies, and therefore we met with Zhong An Insurance. This is an entirely online business model, backed by Tencent, Alibaba and Ping An. Their gross written premium rose 107% YoY in 2018 H1, and the company has written over 8bn policies since launch in 2013. The business will not become profitable for several years but has already had a direct impact on certain parts of the insurance industry. We believe that the business segments in which Ping An operates and the client base of CPIC are not at imminent risk of attack from Zhong An, but this is an area we will keep under constant review.

NOTES FROM GREATER CHINA

CONSUMER DISCRETIONARY

The Chinese consumer is alive and well

If you have been reading recent news flow or paying attention to the share price of many firms in the sector, you would be expecting to hear of a collapse in consumer sentiment and sales growth. This is not the case. Huazhu, a leading hotel chain with almost 6,000 properties across China (and adding 500-700 p.a.), stated that growth has been completely stable over recent months. Qtech, a manufacturer of cameras for Chinese smartphone manufacturers, commented that demand has been 'surging.' SF Express, the leading Chinese courier company, concurred that they were not seeing any impact from the trade war, nor did they expect it.

Xtep, a sportswear company, which we own across the portfolios, commented that revenue growth was slower in September than in July or August. In spite of the slower revenue growth in September, the management remains absolutely confident in their 20% growth target for 2018. This is combined with rising net profit margins over the next three years. The company will also be adding 200-300 stores pa (on a current base of 6,035), as saturation is very far away. This was perhaps the best meeting of the trip, further compounded by an increased focus on ESG reporting over the next year in conjunction with KPMG, which could result in our upgrading of the current rating of 'C.' We also undertook a meeting with a leading competitor, who confirmed the overall sales outlook. However, we have concerns on its governance (relating to related party transactions), and thus will not be undertaking further due diligence.

Meeting at Xtep

Oriental Watch, a leading luxury watch retailer (predominantly Rolex) in Hong Kong and China, commented that revenue had actually accelerated in August in both their main markets. The company's balance sheet is net cash, with a dividend yield of over 10% and a forward price-to-earnings ratio of below 5x. In our view, this is clearly a mis-priced opportunity. The opening of the Hong Kong-Shenzhen (and on to Shanghai) high speed railway on 23rd September 2018 will also boost demand, given the increased ease of access to Hong Kong for mainland visitors – many of whom do not have direct flight connections before. The journey time to Shenzhen will drop to approximately 20 minutes, vs. the 2+ hours it took us on this trip.

Our meeting with Grand Baoxin Auto in Shanghai, a leading auto retailer (predominantly BMW), painted a similarly positive picture. The management highlighted rising retail sales in both July and August across their 113 car showrooms, partly as professional, well-run companies gain share from sub-scale, individual dealerships. Higher sales combined with strict cost-control and rapid growth in the super-high margin after-sales division has translated into rising profitability, and thus this is a company we will investigate further.

We met with Robam Appliances in Hangzhou. Robam is one of the major Chinese manufacturers of kitchen appliances, such as cooker hoods, stoves and dishwashers, and benefits from both our themes of monetisable structural growth (with China's increasing focus on upgrading products and premiumisation) and sustainable competitive advantage (due to the quality of Robam's brand). Robam has gained market share consistently, including from foreign entrants, due to their focus on R&D and their skill in adapting products for Chinese preferences. The company's sales are entirely domestic, and thus not exposed to the trade war, unlike better known peers such as Gree and Midea.

Mike at Robam factory

Moreover, Robam is expanding into smaller cities (which still have populations numbered in the many millions). Compared to its competitors, Robam's excellence is clearly visible, which is underscored by the level of disclosure and the degree of transparency. Later that day, we met with an export orientated manufacturing 'A share' company, whose level of disclosure and transparency were underwhelming compared to Robam's. In addition, we uncovered that frequent acquisitions are planned by the founder's 27-year-old daughter. This led us to be concerned about governance.

NOTES FROM
GREATER CHINA

Although the share price of Robam has been weak, largely due to negative sentiment relating to China, the outlook for sales remains robust (10-15% for 2018, with potential for faster growth in 2019 due to a new distribution arrangement), while the balance sheet is in a net cash position. As well as discussing staff health and safety, training policies and overall governance, we also visited their highly-automated factory so that we could observe the operations in practice.

Robam's control room

ENVIRONMENTAL STANDARDS ARE INFLUENCING CORPORATE BEHAVIOURS

Our meeting with Lee & Man Paper was thought-provoking. The management highlighted the difficulty of adding capacity in China, due to ever-tighter environmental standards. This has been compounded by the US trade war, which has resulted in 25% tariffs on imports of waste paper, the critical raw material for their containerboard production. Sufficient quantities of waste paper are not available, and certainly not cheaply, in China. Thus, Lee & Man is forced to focus on production elsewhere in the region, such as Vietnam. Given Chinese companies' shrinking competitive advantage, we will research possible beneficiaries of this trend who will also meet our ESG criteria.

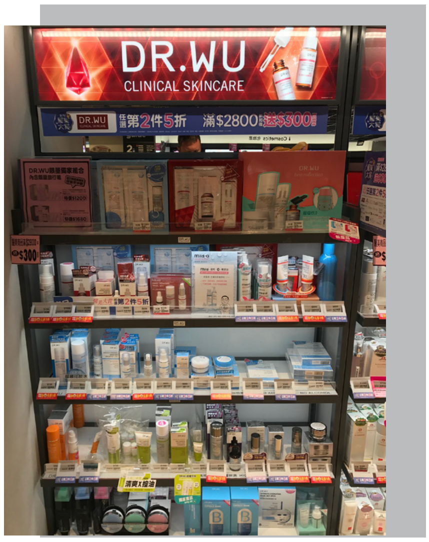
NOT ALL CHINESE BANKS ARE 'BAD'

China Merchants Bank is a private sector bank and thus is managed in the interests of shareholders, instead of the government like many of its state-owned peers. The bank's niche is retail customers in the largest cities, due to their greater service quality (they added 16mn customers in the last six months, reaching 116mn in total). This was our second face-to-face meeting with the management in Shenzhen this year, and our third meeting overall. Their recent results were stronger-than-expected, and the bank continues to expect accelerating loan growth in the second half of 2018 combined with further declines in non-performing loans. This provides further support to our macro-economic view.

TRAVELLING ON TO TAIPEI

Firstly, we met with Taiwan Semiconductor. This remains an excellent company, with a sustainable competitive advantage and a current market share of over 50%. Monetisable structural growth will continue over the next few years, driven by 5G network roll-out, artificial intelligence and the Internet of Things. ESG is excellent, and probably the best in the sector. However, we remain cautious on the outlook for the share price in the near-term due to the potential impact from the US trade war, an investigation by the EU competition authorities and ongoing margin pressure. Nevertheless, if valuations became compelling due to market or stock-specific sentiment then we would re-consider our view. We also met with Primax, which benefits from a structural growth opportunity in high-end speakers (e.g. for Amazon's Alexa). We have followed this company for several years, and recent share price weakness warrants greater analysis. Our initial ESG analysis is also positive.

A recurring theme in our meetings with both Poya and DR.WU was the weakness of the Taiwanese consumer, partly due to increased hostility with China, and thus fewer tourists. However, both businesses continue to navigate the headwinds successfully. Poya has benefited from strong cost control (for example, by replacing all lighting with LED lights) and has gained market share from struggling competitors, who are exiting the market. DR.WU is delivering sequentially better results, notably from Chinese e-commerce platforms. Our channel checks in both Taiwan and China demonstrate the quality and prominence of DR.WU's brand.



DR.WU

CONCLUDING THOUGHTS

The view from all our company meetings regardless of sector was undoubtedly positive. *Overall, we returned with our conviction on the macro outlook reaffirmed. As a result, we sustain our long-standing view that the Chinese domestic economy is in a solid and much better shape than most people believe, which also strongly implies that trade woes and the imposition of tariffs are very unlikely to derail the underlying economic momentum in China. Once the majority of market players realise that the domestic economy is well-insulated from external shocks, the high quality stocks of domestically-focused companies (of which we have successfully identified a number) will continue to deliver, despite recent sentiment-driven poor share price performance. We have been increasing the weighting of China across our portfolios and will continue to do so.*

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