KIERON KADER
October 2019

INVESTMENT NOTES FROM GREATER CHINA

ASIA FUND

Mike Sell, Alquity's Head of Asian Investments and Kieron Kader, Asia Investment Analyst spent 11 days in Greater China visiting 18 companies in Hong Kong and 12 across Shenzhen, Hangzhou, Nanjing and Shanghai. Mike and Kieron visited existing holdings to reassess the outlook for corporate earnings. They also visited competitors to understand the overall environment, as well as brand new investment ideas. This was a valuable opportunity to discuss the effects of the trade war on the Chinese domestic economy, and reactions to the stimulus packages issued by the Chinese government.

GDP has been growing at around 6.2% this year which we believe is a healthy growth rate for the Chinese economy. The makeup of the growth however has changed in the last few quarters and that is evident in the recent high frequency data, which has shown both good and mixed results.

For example, growth in manufacturing investment activity and industrial production volume both slowed in August, whereas retail sales were healthy at 7.5% yoy (9.3% ex-autos). The latest Caixin manufacturing PMI was 51.4% in September (beating expectations by 1%) where this was driven by new orders growing the fastest since March 2018. However, it was domestic orders that grew very quickly, and export orders continued to decline. This divergence, in our opinion, shows that the domestic economy remains resilient (e.g. retail sales), whilst production in the export-facing sectors marginally slowed.

The overall equity market, however, has shown volatility that has tested even the most intrepid investors. For the most part, political volatility has carried through to stock prices as the trade war talks have been up and down but ultimately intensified with tariffs increasing across the board. Given the whipsawing political environment and the separation of performance across industries, we believe it is more important than ever to understand the actual health of the economy as well as the fundamentals of our holdings.

5 KEY TAKEAWAYS FROM THE TRIP:

1. The main conclusion to draw from our trip is that there are definitely areas of brightness in the Chinese economy – particularly in our domestic growth focused sectors. Our long-standing view that the domestic economy continues to perform well has been confirmed.

2. Given the divergence of expectations across industries, we remain of the view that being selective is essential to strong investment performance.

3. The Chinese consumer continues to upgrade their preferences – the premiumisation theme is intact.

4. Property demand is still strong in the top-tier cities. This is a strong indication that consumer sentiment, particularly for the middle-class and above, is still positive

5. We found more opportunities in the Chinese "A-Share" companies compared to the better-known Hong Kong listed companies. This will be reflected in our research agenda for the coming months.

NOTES FROM GREATER CHINA

Through our extensive conversations with 30 companies, it is pleasing to report that selective domestic growth driven sectors such as property, sportswear, and beer all continue to perform well. However, given the divergence of expectations across industries, we remain of the view that being selective is essential to strong investment performance.

CONSUMER STAPLES

China Resources Beer (CRB) - Strong performing premium beer manufacturer

China Resources Beer is an existing holding that has been a particularly strong performer, returning over 60% year to date. The company has impressively achieved the biggest market share with its mass-market brand Snow and has also developed a premium range to meet the higher demands of Chinese consumers due to rising incomes. CRB also recently acquired the rights to distribute Heineken as a premium western brand.The company has consistently proven that Chinese consumers still want better beer, as average selling prices have consistently risen above inflation and their H1 results showed higher volumes as well.

> **The Chinese consumer continues to upgrade their preferences – our core theme of premiumisation is intact.**

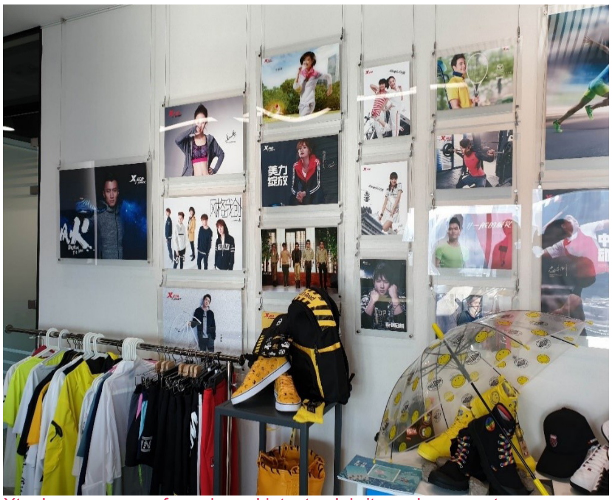
We also regularly engage with all our holdings to ensure they move towards the highest ESG standards. For CRB, we questioned their water consumption and learned that their usage is significantly lower than the large global breweries in the hop fermentation process.

Xtep / Anta

Domestic brands continue to gain recognition amongst the Chinese consumer.

Xtep is a Chinese sportswear brand that has gone from strength to strength. The stereotype of Chinese brands as being low-quality continues to be squashed as Xtep have continued to increase their market share in a very competitive segment. H1 2019 was particularly strong as profits grew 23%. Xtep continue to connect with Chinese consumers by releasing fashionable quality products, and having strong celebrity endorsements such as NBA basketball star Jeremy Lin. As an indication of their quality, Xtep ranked first in domestic sports brands at the Shanghai International Marathon – the winner also wore Xtep shoes!

This is a segment that has a multi-year horizon of monetisable structural growth and we have confidence in our large position in Xtep. We also met with Anta which competes at a higher price point to Xtep. They too have been growing market share; however, their governance and rapid pace of questionable acquisitions (such as a Japanese skiing brand) makes Anta an unattractive investment in our view.



Xtep's new range of goods and latest celebrity endorsements.

Yum China

Pizza Hut's higher prices are finally palatable

Yum China owns and operates KFC and Pizza Hut in China. KFC has been a stellar performer in the fast-food space and dominates the value segment, but Pizza Hut has been a laggard due to major competition in the higher-end pricing segment. However, speaking to management we learnt that this has finally started to turn around due to a combination of technology and revamping the menu, with the consumer willing to pay more for better food.

We also engaged with Yum on ESG issues, particularly the usage of antibiotics to aid the growth of chickens and other animals. Yum China generally have strong standards as they mostly follow the standards of the parent company Yum Brands – a US-based company. However, for antibiotics, they do not adhere to international standards which is particularly unsatisfactory as the risk of antimicrobial resistance is a well-documented concern with huge consequences for public health. For this reason, we choose not to invest in Yum China, though we continue to engage on this issue.

PROPERTY

Demand for properties in top-tier cities continues to be strong

The trade war has caused significant volatility in the share prices of property developers. However, on the ground, it is clear to see that buyers' sentiment is still strong, and the highest quality developers are seeing solid sell-through rates. We met our holdings Yuzhou and Shimao in China, and they conveyed that the fundamentals remain positive as end-demand is still strong in the top-tier cities.

This is a strong indication that consumer sentiment, particularly for the middle-class and above, is still positive. We visited sites for both companies, where the normal and high-end apartments were selling out at an exceptional pace (see below). The land banking environment is also promising where both have been able to acquire land in great locations with little cost premium attached. It is worth noting that Shimao mentioned weakness in the property markets for the weaker tier 3 cities and below, however we have near zero exposure here.

Overall we are confident that demand is still strong and that we have exposure to the rights parts of the market.

Jinmao residence entrance

Yuzhou's mid-to-high end project

Yuzhou's mid-to-high end project (collaboration with Jinmao) in Shanghai is shown above. A 3-bed apartment is approximately 4.5m RMB / £450k and the first phase has proven very popular as it sold out in less than 3 months. We looked at a number of apartments in the building and found the build quality to be very impressive.

Shimao's high-end apartments in Nanjing

Shimao's high-end apartments in Nanjing are located in the heart of the financial district of the Central Business District (CBD). The selling price on average is 45000 RMB/sqm and the first phase sold out in less than 3 months. Some apartments come fully furnished as in the picture above, and the build quality is comparable to that of a five-star hotel. The building is one of Shimao's LEED Gold-certified buildings (for being energy efficient).

Construction Site for the 2nd phase of Shimao's Honor of China project

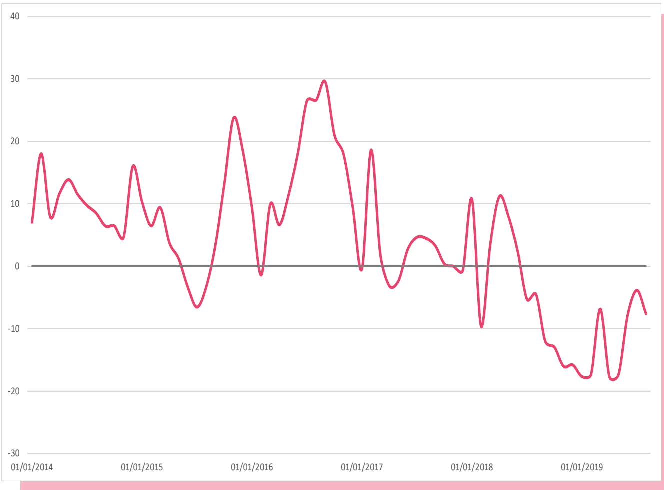
We also assessed the safety on the building site. Shimao takes employee wellbeing seriously, as evidenced by their recent "Best Wellness Employer" award which rigorously assessed physical and mental health indicators amongst others.

AUTOMOTIVES

Bright spots in the luxury segment, dimmer elsewhere.

Automotives has been a challenged sector with a persistent decrease in sales since Q1 2018. We met with both Yongda (one of the largest car dealerships in China) and Brilliance BMW (a joint venture with BMW) to see if the situation remained unchanged. We learned that auto sales overall continue to be weak, but the luxury segment has continued to grow throughout the industry downturn. This indicates that demand is still strong for the middle class and above. We also learnt that the organic demand for Electric Vehicles (EV) remains low. In the past five years, the government has heavily subsidised EVs leading to record growth, however these have recently been cut which has fed through to the weak auto sales. Given the lack of visibility for growth prospects in the Chinese auto industry, we continue to have zero exposure to this sector.

Figure 1: YoY Personal Vehicle Sales



Source: Bloomberg

INDUSTRIALS

A winner from domestic and global economic growth

CIMC Tianda manufactures passenger boarding bridges (the bridge that connects the airport to the airplane), fire engines and baggage handling systems. This is a company that is sensitive to both domestic Chinese growth and global growth as they provide the infrastructure to countries around the world including USA, Germany, UK and 138 others. Both elements are particularly strong. The Chinese government continue to build airports to satisfy consumers desire to travel, and to support business. The developed countries are also seeing strong demand well but mainly due to the replacement cycle as airport penetration is relatively mature.

CIMC Tianda have the most patents in the world for airport PBBs and have demonstrated their technological prowess by being number one in terms of market share in China and Germany and are growing quickly elsewhere. Given our base case of growth in both China and globally, this is a company of interest and also warrants further due diligence.

Mike and Kieron standing next to one of the Passenger Bridges

INCREASING REGULATION

A theme with clear beneficiaries

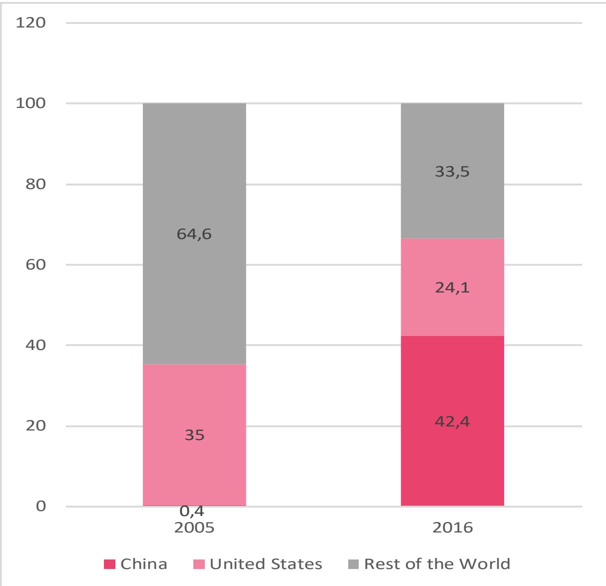
China's economy has developed steadily with a structural adjustment towards high-quality development. One of the key beneficiaries of this multi-year trend is **Centre Testing** (CT), a leading TIC (testing, inspection and certification) player that provides official accreditations for a range of products such as toys, food products, materials for laboratories and much more. Whilst accreditations for products are not new (to ensure safety and health standards etc.) the Chinese government have been a driving force by increasing the requirements for accreditation. CT are also able to compete with large global players as they offer a diversified set of services and have a faster turnaround time given their huge network across China. CT also have relevant defences in place against bribery; their clients can only communicate with the sales team, and the technicians in the lab can only identify products by barcode. Given the policy support, monetisable structural growth and commitment to ESG, we believe Centre Testing warrants further due diligence.

We also met with **Pax** – a global leader in point of sales payment terminals, and **Huifu**, a domestic merchant acquirer.

The latter provides the point of sale handset to merchants and also process payments. Huifu has seen stellar growth with transaction volumes growing over 90% from last year in the small and medium merchants' segment. Huifu recognises that governance and controls are paramount. Huifu also stay away from "risky" industries like gambling which has additional and complicated rules for payment processing.

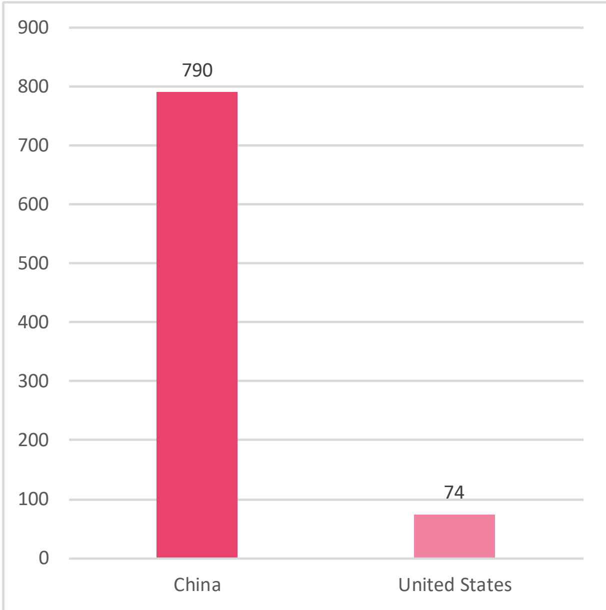
They also noted that weaker competitors have either lost their licences due to non-compliance or have given up due to the competition. Whilst this is a fragmented and difficult industry to get correct, we believe that Huifu warrants further due diligence given the reasonable valuations and potential for monetisable structural growth. On the other hand, we think Pax's technology is well-commoditised and thus lacks a sustainable competitive advantage which would lead to competition and oversupply in its bigger markets. This has already happened in China as many small vendors now operate in the space which resulted in a significant loss of market share for Pax.

Figure 2: Retail e-commerce transaction value (%)



Source: McKinsey Global Institute Analysis

Figure 3: Third party payments conducted through mobile transactions - 2016 ($, Billion)



Source: McKinsey Global Institute Analysis

CHINESE COMPANIES CONTINUE TO IMPROVE ON ESG

The level of commitment towards ESG issues has been vastly divergent amongst Chinese companies. For Hong Kong listed companies, the exchange now requires ESG reporting and we have seen vast improvements in disclosures since then. For the Chinese listed companies, the requirements are much lower, and a large proportion of companies only report the minimum required by the exchange. However, some are excellent and go well beyond what is required. We spoke to a number of companies including our holding Hangzhou Robam (a manufacturer of kitchen appliances) who are undertaking an increasing amount of environmental disclosures for the government and will be disclosing more to the public at the suggestion of the Chinese exchange. We currently rank Robam a "C", however this may be reviewed given the additional commitment to disclosures.

There are also industry specific updates – we met with Proya, a cosmetics company focusing on the Tier 2-3 cities. They confirmed that the Chinese regulators are considering withdrawing the use of mandatory animal testing for cosmetic products. This is an indication that minimum regulatory standards have begun to improve. Whilst this is positive, this will likely cause an inflow of competition from overseas players and may give concern on Proya's sustainable competitive advantage. Overall, we actually found more opportunities in the Chinese "A-Share" companies compared to the better-known Hong Kong listed companies. This will be reflected in our research agenda for the coming months.

Robam's Offices

An impressive roster of clients for Yuto packaging.

PRODUCTION CONTINUES TO MOVE OUTSIDE OF CHINA

China continues to move from low-cost manufacturer to producing high-end goods further along the value chain and is making use of the cheaper labour sources elsewhere in Asia. We spoke to various companies including Yuto Packaging (packaging for electronics) and Supor (kitchen appliances manufacturer) who both mentioned that they had set up or were in the process of setting up factories in places like India, Vietnam and the Philippines. Admittedly, the trade war was also a reason cited by some corporates for moving production outside of China. However, we think that the trade war simply caused an acceleration of this transition, rather than being the sole reason for moving production overseas.


Outside Yuto's bulding

CONCLUDING THOUGHTS

The main conclusion to draw from our trip is that there are areas of brightness – particularly in our domestic growth focused sectors. Our long-standing view that the Chinese domestic economy continues to perform well has been confirmed by the key industries. However, some corporates (particularly in exporting industries) expressed uncertainty for the near term, but also mentioned that government stimulus may provide support (e.g. further reserve requirement rate cuts, tax cuts, as well as industry-specific policy). Selective domestic growth driven sectors that we invest in (property, beer etc.) showed confidence for the short and medium term. We have also identified a number of high quality domestic-focused companies that are worthy of further due diligence.

Whilst overall growth is reasonably healthy, some areas are challenged and remain undesirable. However, there are areas of outstanding growth and we remain positive. Combined with the fact that valuations are attractive, we maintain a substantial weighting to the market.

For more information on the Alquity Asia Fund, please contact:

MIDDLE EAST, ASIA & UK
Suresh Mistry
+44 207 5577 854
suresh.mistry@alquity.com

EUROPE & UK
Benoit Ribaud
+44 207 5577 862
benoit.ribaud@alquity.com

UK
Alex Boggis
+44 207 5577 850
alex.boggis@alquity.com

LATIN AMERICA
Cyn Cano
+44 207 5577 871
cyn.cano@alquity.com

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Swiss Representative: FIRST INDEPENDENT FUND SERVICES LTD., Klausstrasse 33, 8008 Zurich.
Swiss Paying Agent: Neue Helvetische Bank AG, Seefeldstrasse 215, CH-8008 Zurich.