

# First State Stewart Asia - China Equities

## China Update

July 2016

In our previous China update, we provided a general overview of some of the economic reforms taking place in the world's second largest economy. We noted that financial reforms have progressed the most, with steps taken to increase the internationalization of the renminbi, liberalise foreign exchange and interest rates, and increase the depth and breadth of the Chinese stock markets. In other areas, such as the reform of state-owned enterprises, progress has been less advanced; however, China's concerns around the economy's structural slowdown may help to push forward further reforms in this area. Efficiency gains at laggard state-owned enterprises should improve rates-of-return – and improve the economy.

In this update, we highlight some of the key areas that investors should be aware of when investing in China's state-owned sector. We also include the latest investment highlights from our China portfolios.

### **Investing in state-owned enterprises – quality first**

Just as there are good and bad investment opportunities in the private sector, so it is in the state-owned sector. Ruling out state-owned enterprises from the investible universe would leave little investment opportunity for asset owners, especially in China, where state-owned enterprises still play an important part of the economy.

In our view, there are three broad questions to think about when investing in state-owned companies. Is the management high quality and trustworthy and is there an alignment of interests with minority shareholders? Is the company profitable and is there a focus on delivering decent, sustainable returns? And, to what extent does government ownership infringe upon the company's abilities to continue to deliver those returns over the longer-term?

Certainly, the first two questions are relevant to any company that we consider for investment. In this respect, the investment process for state-owned companies is just the same as for non-state-owned companies. Our stewardship and quality criteria are non-negotiable. We prefer to invest in well-managed companies with professional management teams that have the skills,

experience and integrity to make effective decisions on behalf of the company and its stakeholders. These are companies with a strong franchise, strong barriers to entry, a conservative balance sheet and a consistent track record that shows the ability to generate sustainable and predictable returns over a number of market cycles.

To answer the third question, we try to quantify the impact of the state as parent. Ideally, there should be a clear separation between the state and the management team and as little state interference as possible. We keep a close eye on management changes, as state-owned company executives are often shuffled around to lead other state-owned entities. And we pay particular attention to government subsidies, corporate leverage ratios, regulatory changes, price controls and tariffs, to understand the broader environment in which the company operates. Understanding these issues allows us to form a view on whether the company is of sufficient enough quality for investment.

### **Engaging on issues**

Of course, 'quality' is a subjective criteria and each of our portfolio managers and analysts have their own views on what

this means. There are few issues that can easily be categorised as either black or white. Usually, it is the nuanced assessment of the shades of grey that generates the most discussion within our team meetings.

In the China context, we come across many companies – state-owned or otherwise – that are still evolving – often towards a more modern corporate structure. China's stock exchanges, formed in 1990/91, are relatively young; some publically listed companies are only now starting to realise the benefits of investor communications and good corporate citizenship. Where there is an underlying sense of quality, we think that there is good reason to be pragmatic and to engage on matters of governance.

Some of the points we have engaged on in the past include ownership structures, board structures, management incentive schemes, succession planning, research and development, wealth management products and other investments, low dividend payments, health and safety, and other sustainability issues. Where we think we can provide a useful perspective, we will often put forward our views on best practice and in light of this, we consider an open dialogue with management to be a fundamental criterion of a quality company.

### State-owned enterprise reforms are nothing new

When investing in China, one of the problems we face is that state-owned enterprises – which divert scarce capital from private companies – are mostly inefficient and largely unprofitable. Average return-on-assets in 2014 for state-owned companies was just 4.6%, compared with 9.1% for private enterprises<sup>1</sup>.

Reforms designed to invigorate the state-owned sector had been met with large scale resistance in the past. Those in charge benefitted from their privileged positions and were reluctant to embrace market competition and diminish their status.

However, China's economic growth is slowing. Monetary policy levers such as interest rate cuts and lower reserve requirements have been supportive, yet trade data remains sluggish, industrial production has slowed and fixed investment continues to be weak. Traditional manufacturing sectors have been suffering from a glut of over-capacity and under-utilisation for some time now. Introducing market-oriented practices to improve efficiencies at state-owned enterprises would be one way to manage the protracted slowdown.

We have been here before. In the midst of the Asian financial crisis in the late 1990s as China's export-led economy slowed, unprofitable state-owned enterprises reached a crisis point. To stem rising losses, aggressive reforms were implemented across the state-owned sector. The worst-performing state-owned enterprises were closed down, merged or privatised and tens of millions of workers were made redundant.

As the newly restructured state-owned companies started to behave more like private companies, return-on-equity (ROE) rose from below 2% in 1998 before the reforms to above 15% a decade later<sup>2</sup>. At the same time, the private sector was encouraged to expand, in part to absorb the newly unemployed workers from the state sector.

Things came to a halt with the 2008 global financial crisis. As government-sponsored liquidity slowed, demand tightened and output from new factories built over the previous decade formed a surplus of inventory. State-owned companies, having over-invested in machinery and equipment, were now seeing factories lay idle. And, although ROEs had, on the surface, improved, much of it had been driven by favourable government policies, monopolistic markets, state subsidies and cheap loans from state-owned banks. Once this was accounted for, it turned out that many state-owned enterprises were still making huge losses.

### China's state-owned sector reform gets a boost

Fast forward to the present day and China's State Council is again reviving its reform program. The current guidelines propose a number of key areas for reform. Firstly, the importance of ownership diversification through private investment (i.e. partial privatisation) and employee stock ownership plans; secondly, increased private sector competition into sectors still dominated by state-owned enterprises (i.e. the breaking up of state monopolies); thirdly, further corporatisation and improvements to corporate governance (which would make state-owned enterprises answerable to shareholders and drive better allocation of resources); and lastly, the necessity of market-oriented practices such as market-driven pricing, management incentives and equal access to financing for private companies.

Alongside these reforms, an unprecedented campaign led by President Xi Jinping has targeted the root of corruption and cronyism. Hundreds of company executives and officials have been investigated and prosecuted for misappropriating state assets – sending a clear signal that corruption is not to be tolerated under the new era.

China's ongoing reforms, its anti-corruption measures, and the application of market-based practices – or, capitalism with a Chinese name – should help to generate a more profitable and sustainable economy in the long run. According to reports, there are around 150,000 state-owned enterprises in China, with around 122 trillion yuan (US\$15.7 trillion) of assets and employing over 30 million people<sup>3</sup>. Improving the state-owned sector should help increase ROEs and drive future economic growth.

There has been some noteworthy progress. Quite a few state-owned enterprises have embraced the modern corporate structure with boards of directors and independent committees. China Telecom, China Merchants Group and China National Offshore Oil Company (CNOOC) are a few such examples. These state-owned enterprises have high corporate governance standards and improved productivity levels.

We have invested in a number of these state-owned companies for our China portfolios. Our view is that investing in high quality state-owned enterprises can yield decent returns in the long run. We like those that are market-oriented and have minimal interference from the state. That is, state-owned companies that behave like private ones.

<sup>1</sup> Gavekal Dragonomics & Financial Times: China's state-owned enterprise reform plans face compromise, September 14, 2015. <sup>2</sup> China's unfinished state-owned enterprise reforms, Dong Zhang & Owen Freestone. Published in the Economic Roundup Issue 2, 2013, on the Australian Government: The Treasury website. Retrieved 1st June 2016.

<sup>3</sup> Ministry of Finance data, as at end March 2016.

## Where we have invested in China's state-owned sector

**China Telecom** (Telecom Services) is a good example of the kind of state-owned enterprise that we like. It has a well-regarded management team, good corporate governance practices and effective investor communications. Mr Wang Xiaochu, chairman and chief executive officer from 2004-2015, is considered one of the most commercial and market-oriented executives in the industry. Under Wang's leadership, business execution and financial prudence at China Telecom improved and the company turned into a more disciplined and steady operator.

Wang introduced a number of market-based practices to China Telecom. Employee morale was boosted with innovative measures to promote staff creativity and motivation, such as the creation of small regional units within the company that allowed staff to take on profit and loss responsibilities and share in the profits.

As a business executive, Wang oversaw the acquisition of China Unicom's loss-making CDMA mobile business in 2008 and turned the business around by offering bundled service packages (wireline, mobile, broadband and pay-TV) to segmented customers. Today, China Telecom has grown into one of the world's largest telecom service operators, with 133 million wireline local access lines, 116 million wireline broadband subscribers, 203 million mobile subscribers and around 75 million 4G users<sup>4</sup>.

In 2015, another reshuffle of top telecoms executives saw a direct swap of the chairman roles at China Telecom and China Unicom. Mr Wang Xiaochu moved to China Unicom as chairman and Mr Chang Xiaobing replaced him as chairman of China Telecom. Many of our reasons for investing in China Telecom was tied to the quality of management in general and our confidence in Mr Wang Xiaochu in particular. Following his departure, we trimmed our position in China Telecom and continue to monitor the situation carefully.

**China Merchants Group** is a state-owned conglomerate - with three core business divisions: Transportation and Related Infrastructure (ports, toll roads, logistics and marine-related maintenance), Finance (banking, securities, asset management and insurance), and Property (real estate development and management). The management team has a decent professional reputation and a commercial mind-set, while its group companies have proven to be returns-driven and concerned with shareholder interests.

We have held subsidiary company **China Merchants Holdings International (CMHI)** (Industrials) in our portfolios for quite some time. Our meetings with CMHI suggest strongly that this is almost a private company but with state oversight. It is now the largest container port operator in China and has overseas assets across Asia, Europe and Africa, as well as a growing logistics and cold storage business.

The management at China Merchants Holdings International is well-regarded and has a good track record. Dr Fu Yuning, an academic who studied both in China and overseas (he received

his Ph.D. in Offshore Engineering from Brunel University in the UK), joined the parent, China Merchants Group, in the early 1980s. He was instrumental in overseeing the restructure of the group in 2000 when he became director and president of China Merchants Holdings International (and was chief executive officer of the parent China Merchants Group at the same time). China Merchants Group was restructured to become a holding company with specialised, focused subsidiaries, while CMHI soon became the largest ports operator in China. Later, Dr Fu was to become chairman of CMHI (2010-2014).

Under Fu's leadership, CMHI sold off its tankers division to the parent company and injected its toll roads business into another listed group entity to reorganise itself as a focused ports operator. In 2005, the acquisition of a stake in Shanghai International Port Group (SIPG), boosted CMHI's presence across the Bohai, Yangtze and Pearl River Deltas, which in total account for around 81% of the Hong Kong/China throughput.

CMHI was a major beneficiary of the growth in global containerisation, increased trade growth and China's ascension to the World Trade Organisation (WTO) in 2001. It had taken a prudent approach to expanding port capacity, believing that critical mass was necessary for port investments. Furthermore, CMHI only chose top-tier ports locations (or second-tier ports that had the potential to become top-tier ones), which meant that the company was less at risk to irrational pricing practices.

All this contributed to strong earnings-per-share (EPS) growth, net cash flows and high margins at CMHI, (although the company was not immune to the global slowdown in trade following the 2008 financial crisis and suffered throughput declines as exports slackened).

Dr Fu Yuning moved on to become chairman of China Resources Group in 2014 and Mr Li Jianjiong, the former general manager of CMHI, was promoted to chairman, which should ensure continuity of the company's business strategy. We still own CMHI and continue to monitor the company.

## Investment highlights

Our China portfolios withstood significant volatility over the past six months. As we noted in our last update, we are even more focused on quality companies, which we believe should prove to be more defensive in an uncertain market environment.

**Gree Electric Appliances** (Consumer Discretionary), which we consider to be China's leading manufacturer of air-conditioning units, was among the top contributors to performance over the period. The share price rebounded from September lows as the company reported strong operating profits despite weakening sales and a challenging environment.

Earlier this year, Gree announced that it planned to acquire domestic auto company Yinlong New Energy, which would be a departure from its core business. Our initial reaction was cautious, as it was not clear whether Gree would have the necessary manufacturing and R&D skills for the new business. In addition, we have not been given sufficient information to understand the valuation mechanism and impact on governance that the proposed acquisition would take.

<sup>4</sup> Source: China Telecom website, as at 31 March 2016

Given the possibly small size of the transaction relative to Gree's net cash balance, we think that the purchase should not lead to a significant change in dividends, but is another point that we are closely monitoring. We are waiting for further details on the transaction before drawing any firm conclusions. Its shares have been suspended in the interim.

**Fuyao Glass** (Consumer Discretionary) also performed well, as weaker operating results were offset by FX gains due to the renminbi depreciation. Fuyao is a significant position in our China portfolios. It is the biggest auto glass maker in China with approximately 73% market share in the auto OEM market and around 10% market share overseas. The company derives around a third of sales from exports and now has production capabilities in the United States and Russia (to be closer to and to deliver more quickly to clients). Fuyao is currently the most profitable auto glass maker in the world. At around 12x price-to-earnings and with a 5% dividend yield, we think the company is still quite reasonably valued.

On the negative side, consumer staples companies such as **Want Want** and **China Mengniu** struggled as weak demand and greater competition from foreign brands impacted business performance. Of the two, we divested Want Want on increasing concerns with the lack of innovation at the company. Its mind-set seems to be that of a manufacturer rather than a consumer goods company, while its focus on distribution – rather than on things like brand management, research and development, and advertising and promotions – is rather negative in our view.

On the other hand, we kept the position in China Mengniu, currently one of the top two dairy product companies in China. In contrast to Want Want, China Mengniu plans to invest more into its main brand and link this with its sub-brands. It has been repositioning itself as a healthy provider, with new products in yoghurts, beverages and other non-dairy health products. Despite a weak environment, earnings were better than expected.

Other noticeable trades over the period include a new position in **Bank of Ningbo** (Financials), a quality commercial bank in China with a balanced board structure and high operational independence from local government, and a recent purchase of

**China South Publishing** (Consumer Discretionary), a leading educational publications company in Hunan province. We also initiated a toehold in **Jiangsu Hengrui** (Health Care), a leading Chinese pharmaceutical company that focuses heavily on research and development in the patent drugs market.

Meanwhile, we sold out of **Weichai Power** (Industrials), one of the lower conviction names in our portfolios, and divested **Zhejiang Huahai** (Health Care) on concerns around its clinical test data issues. We also sold **Yonghui Superstores** (Consumer Staples) which we thought was trading on excessive valuations.

Further on valuations, our view is that a number of companies trading on the China A-Share market are still quite stretched; more so when compared to their H-share equivalents. As a result, we switched from the A-Share to the H-Share for **Great Wall Motors** (Consumer Discretionary) and **Xinjiang Goldwind Science & Technology** (Industrials), the leading wind turbine manufacturer in China. We also sold **China Oilfield A-Share** (energy) on valuation grounds, but retain our holding in the **China Oilfield H-Share**.

### Outlook

We continue to pay close attention to the progress of state-owned enterprise reforms and look for evidence of market-oriented practices when considering potential investments in the state-owned sector. Further asset rationalisation and M&A activity seems likely, which would provide renewed opportunities for asset owners.

On the economic front, although the data is worrying, the good news is that domestic consumption remains largely stable and disposable incomes continue to rise – per capita income in China has been growing by around 11% per annum since 2010. As a result, Chinese consumers are changing their discretionary spending habits and there is significant potential to tap into the trend of consumers trading up.

While we are cautious on China's outlook in the short term, we believe that investing in quality companies at sensible valuations – and adding to quality in market dips – should keep us in good stead for the long-term.

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