FSSA Investment Managers

Client Update

FSSA China Equities

June 2021

Broad-based recovery underway

While the pandemic is still far from over, a number of key leading indicators point to a healthy and broad-based recovery in China. Industrial production, trade activity and retail sales have been strong; and in stark contrast to the lockdowns and travel restrictions in early 2020, domestic travel, tourism and the leisure sectors in China have sprung back to life.

China's early strict measures to contain the virus meant that it was one of the first countries to reopen its economy and resume growth. This has translated into a sharp bounce back for our portfolio holdings.

> Our investment approach, which focuses on purchasing high-quality companies for the long term, has performed as we might have hoped — which is to say our portfolios have been resilient during market shocks and rebounded more quickly as things normalised.

On the other hand, there is always something to worry about and more recently it has been the risk of tighter regulations on internet companies. We have always found it difficult to invest alongside the government in emerging markets, or anywhere else for that matter, as they can change the rules anytime they feel like it. Governments are not to be trusted anywhere, but in particular where they control pricing or, in this case, the licence to operate.

RISK FACTORS

This is a financial promotion for The FSSA China Strategy. This information is for professional clients only in the UK and Switzerland and elsewhere where lawful. Investing involves certain risks including:

- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- **Currency risk:** the Fund invests in assets which are denominated in other currencies; changes in exchange rates will affect the value of the Fund and could create losses. Currency control decisions made by governments could affect the value of the Fund's investments and could cause the Fund to defer or suspend redemptions of its shares.
- **Single country / specific region risk:** investing in a single country or specific region may be riskier than investing in a number of different countries or regions. Investing in a larger number of countries or regions helps spread risk.

For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document for each Fund.

If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.

Notably in China last year, Alibaba was hit by the halt of Ant Group's IPO, increasing antitrust regulatory pressure and a multi-billion dollar fine. The regulator has warned most other internet companies on anti-competitive behaviour as well. While the capital requirement for Ant Group is a prudent step and we believe will likely be enforced, we are less concerned about the impact of the new antitrust guidelines. JD.com and Pinduoduo already act as a counter to Alibaba's dominance, as evidenced by their growing market share at the expense of Alibaba's.

> It is no surprise that the Chinese government has started to take action against the powerful technology platforms, but in reality this has been a global reckoning.

Global tech giants Facebook, Amazon, Apple, Microsoft and Alphabet's Google (the "FAAMG" group) have all faced increasing regulatory scrutiny on varying issues such as alleged platform dominance, anti-competitive behaviour, data privacy and the spread of misinformation.

Good for the industry; good for consumers

In our view, the Chinese technology platforms have grown too large, too fast; and now the regulatory environment is starting to catch up. Fierce competition and a "winner takes all" mind-set means that participants have had to dole out huge sums to subsidise sales (often to below cost) in order to cross-sell services to their broad customer bases and continue to secure high growth rates. This cash burn is simply unsustainable in the long run.

Despite our general misgivings about governments, we believe that tightening regulations will be good for the industry and consumers alike in the long run. Clearly, unfettered power in the hands of a few tech company moguls cannot be good for society. If we look at the main goals of the antitrust guidelines issued by the State Administration of Market Regulation (SAMR), they are designed to promote fair competition and a healthy, innovative market.

> By reining in Alibaba, a hundred other flowers might bloom.

This would be a good outcome. The regulations have also pushed existing internet companies to invest more into new businesses and new technologies, driving innovation in the sector. While it is still early days, some of these may have the potential to bear fruit in the long run.

Meanwhile, technology has provided us with many benefits, but its rising dominance has also led to the destruction of existing business models and a number of social issues. It is time for the internet giants to take more responsibility for their employees' social welfare. While this may drive up operating costs and put pressure on margins in the short term, over time we would expect those with stronger franchises to grow more sustainably while policy risk will have been reduced.

Portfolio impact

In terms of the impact on our portfolios, the major concern with Alibaba is whether the company and the state are still aligned. For whatever reason, the Chinese government has decided that Alibaba has become too powerful. With the turning tide, Alibaba will likely have a much tougher time being number one. This should give real cause for concern, in China as in any other market or economy around the world.

On the other hand, Alibaba is not expensive in terms of price-to-earnings (PE) multiples at 23x 2022 earnings. By our calculations, the value of the core e-commerce business is around 10% below the current market capitalisation. After adding back the cash, the cloud business and Ant Group can be had for free. Additionally, though Alibaba may be losing share to JD.com, its franchise remains strong and its financials are solid. The turning point, if any, should not happen overnight.

We believe Tencent is also likely to be fine, as the company has shown it is capable of innovation and is proactive in terms of regulations. Its mini programs on Wechat means that businesses – including other tech platforms JD.com and Pinduoduo – can build private traffic and cultivate relationships with Key Opinion Leaders (KOLs, in marketing parlance) without having to pay for clicks. The antitrust guidelines are unlikely to be an issue here.

Meanwhile, in 2019 the gaming industry faced tighter regulations to protect teenage players, curb gaming addiction and manage in-game spending. Tencent was unaffected as it had already implemented its Healthy Gameplay system (one year ahead of the new regulations), which included playtime limits, parental-set limits on in-game purchases, minimum age limits and identity verification. The key issue to watch will be game approvals, as a suspension in this area (like in 2018) will have an impact on Tencent's bottom line.

For JD.com, the regulator had meted out the equivalent of a rap on the knuckles for its pricing irregularities around the Singles Day sales. We do not expect much more in terms of further clampdowns. Looking forward, 2021 will be another year of investment for the group, as they grasp new business opportunities in JD Supermarket (e-groceries), JD Digits (its cloud and Artificial Intelligence (AI) business) and Jingxi group purchasing.

While these new businesses should bring in incremental profits, it does mean that JD's earnings growth will probably be lower in the near term. However, we expect margins to continue to expand as JD.com continues to gain scale and operating efficiencies.

> "Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."
>
> Winston Churchill

The Chinese e-commerce industry is entering a mature stage of development and further re-rating will be increasingly difficult to achieve. Nonetheless, growth is still decent and Alibaba, Tencent and JD.com are supported by their strong franchises and solid financials. We have been adding to Tencent and JD.com as they both generate strong free cash flow and are by no means expensive on conventional valuation methods such as PE or free cash flow yield.

Resilience through the pandemic

One of the key characteristics we look for, and perhaps the most critical indicator of quality, is a strong and effective management team with a proven track record over multiple cycles. We believe that a good management team can ensure the continued success of a strong business by executing well and making the right decisions (operationally, capital allocation, respecting other stakeholders' interests, etc), during good times and bad.

Often, these managers take advantage of unfavourable market conditions or negative externalities to improve the business strategy, enhance efficiencies and seek opportunities to gain market share. We see evidence of this in the resilience of our portfolio holdings during the events of the past year or so.

Yum China, which operates KFC and Pizza Hut in China, is one such example. At the peak of the outbreak in February 2020, around 35% of its stores were closed. Same-store sales fell 40-50% during the Lunar New Year period. However, thanks to its digital and delivery capabilities, operations recovered faster than peers and the company's revenue actually grew from Q3 2020 onwards. The company also remained profitable in every quarter throughout 2020.

These results are testament to the investments made by the CEO, Ms Joey Wat, since she joined the business in 2014. Originally appointed as the head of KFC, she saw the importance of digital and delivery and made them a priority. Membership sales from its loyalty programs were a key support for the company during the pandemic, with sales contribution rising in 2020 for both brands.

Entering 2021, Yum China reported strong results in the first quarter with sequential improvements and better-than-expected margins. Same-store sales were just 5% shy of Q1 2019 levels. With its strong balance sheet, we believe the company can further take advantage of the pandemic's damage to smaller restaurants and accelerate its expansion across China.

Accelerating existing trends in automation

Shenzhen Inovance, which makes key components that automate the manufacturing process, seized the opportunity to increase market share amid the pandemic last year, as the importance of automation, efficiency management and labour replacement became apparent.

> In early 2020, when multinational corporations (MNCs) had to shut down their manufacturing plants due to rolling lockdowns and travel restrictions, China was starting to get back to business.

Amid supplier issues and widespread shortages of materials and components, Chinese industrial and automation companies stepped into the breach.

As operations at Inovance resumed, demand for its products skyrocketed and its market share jumped. The company was able to secure 200 new customers, with major MNC clients among them. Though supply shortages have since normalised, Inovance's sales have continued to grow. Earnings results for fiscal year (FY) 2020 and Q1 2021 were better than expected, with organic sales growth driven by broad-based strength across most segments.

Over the past year, our conviction in Inovance's quality has grown. We believe the company stands out in terms of its stable management team, its energetic drive and its hungry "wolf culture". We believe further uplift could come from new reforms, as it plans to improve its corporate structure (similar to Huawei), reduce wastage through better strategy and planning, and enhance processes to reduce working capital.

The management team has shown a clear focus on the company's long-term goals, using every opportunity to improve the business. While the business is clearly cyclical and valuations are not cheap after the recent recovery, we believe this is one of the best A-share companies to hold for the long term.

Domestic brand building

Leading sportswear company Anta Group exemplifies the power of a strong brand, which helped the company rebound from its initial pandemic weakness. In FY2020, Anta grew sales by 5%, with sales growth in the second half of 2020 more than offsetting its weak first quarter. Our confidence in the business has grown as we followed its performance.

In our view, Anta is China's most successful sportswear company, and one of the few Chinese companies that has proven its ability to build and run multiple strong consumer brands. It has been steadily gaining brand value over the years. This year, the Anta brand ranked 17th in the list of *2021 Global Top 50 Apparel Brands* from Brand Finance (up from 18th in 2020, 21st in 2019 and 28th in 2018). FILA (the high-end brand for which the Anta Group holds the licence in China) also received a special mention in this year's Brand Finance report as being among the "ones to watch".

Few companies know Chinese consumers better than Anta, as its direct retail sales and data- and survey-driven consumer analytics bring the company much closer to its customers. We believe the "Anta System" that enabled FILA's success can be replicated across its other brands as well. As a fashion-related brand, there will always be some level of customer attrition, but as long as Anta can attract new customers (with Kids, Fusion and its performance sportswear range), we believe it can significantly prolong its brand life-cycle and continue to grow sales.

Banks and property

Banks are a proxy for the underlying economy and its inherent financial risks, so it comes as no surprise that earnings results were generally good for this sector as the economy rebounded. China Merchants Bank (CMB), which is particularly strong in the retail banking business, reported that consumer and credit card lending recovered and asset quality stabilised from Q3 2020 onwards.

In our view, CMB is the best commercial bank in China. It has more than 144 million retail customers, of which 2.7 million are members of its premium-service Sunflower Club. The bank continues to focus on growing its wealth management business, which has the potential to improve returns in the medium to long term.

China Resources Land (CR Land) also benefitted from China's economic reopening and posted a strong recovery in its shopping malls in the second half of 2020. While China has clearly seen a rapid credit expansion and property bubble over the past 15 years, CR Land has evolved into a leading property developer and has built a credible rental property portfolio which it intends to grow over the next 5-10 years.

CR Land's determination to build a rental portfolio is unique in a China context. From its base in Hong Kong, the management at CR Land noted that recurrent rental income has helped Sun Hung Kai Properties (its neighbour in Hong Kong) and Swire Property to survive previous severe downturns, and provided cash flow for these property groups to grow over time. Rental income now accounts for around 15% of CR Land's revenue, of which 75% comes from shopping malls, while 12% and 13% are from offices and hotels respectively.

Outlook

In the short term, we expect corporate earnings growth to be generally strong from a low base in 2020. The main risks are from rising raw materials costs, which could affect profitability if companies are unable to pass these on or find efficiencies elsewhere. In the medium and long term, we still see major challenges with excessive liquidity in global markets, which continues to drive ineffective pricing mechanisms and inflated asset prices. Our strategy against this backdrop is to be selective in our investments, seeking to buy quality companies to hold for at least 3-5 years or more.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 31 May 2021 or otherwise noted.

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