FSSA Investment Managers

Client Update

Staying the course with quality companies

September 2024

As conservative investors, we seek to invest in high-quality companies run by people we believe we can trust, and where we can be long-term shareholders. In other words, we look for companies with capable management teams, sustainable business models and strong competitive moats which can drive consistent earnings growth and shareholder returns. Throughout our long history of investing in China, this unswerving focus on quality means that we are usually able to better preserve capital in down-markets, while still participating in China's growth story.

Our long-term performance, which remains reasonable despite the market volatility, continues to bear witness to our investment approach. However, in the past two years, there has been a broad market shift along with general investor pessimism on China's economic growth. Cheap cyclicals and state-owned companies with low price-to-book ratios and high dividend yields have performed well, while the quality growth companies we own in our portfolios (even those with decent dividend yields) have struggled.

The types of companies that performed well over the recent period are those that we tend to avoid. We don't invest in state-owned companies, for example, unless the management has some level of autonomy and a market-led approach to the running of the business. We prefer not to invest in cyclical companies either, especially those with persistently low returns, a lack of competitive moats and weak pricing power. No matter how cheap they may seem, we don't think we can perfectly time the entry and exit of such investments. These omissions may have impacted our relative performance, but we believe it would be a mistake to deviate from our time-tested investment philosophy to chase short-term "wins".

But it is the absolute numbers that we care about, as we aim to generate attractive absolute returns for our clients over the long term. Our recent performance in this regard has been disappointing, mainly due to our large shareholdings in consumer-related companies which have been de-rated. We like these companies for their strong returns on capital employed and cash flow generation, as well as their steady and predictable growth. In previous downturns, these quality characteristics served as defensive portfolio traits, but this has not been the case over the last two years. After the initial market euphoria around China's reopening post-Covid, concerns about growth and deflationary pressures have led to widespread weakness across consumer categories. This has persisted beyond our expectations.

Nonetheless, we believe the current gloom is unlikely to be a permanent state of affairs. While we cannot expect China's rapid growth of the past to be maintained, if we look five or ten years into the future, we still believe per capita incomes in China will rise. This should benefit companies with strong consumer brands as people choose to upgrade their lifestyle choices.

While quality may be out of favour, these structural growth trends remain firmly in place, underpinning the investment cases for many of our portfolio holdings. We continue to believe that there are pockets of growth to be found in China – even amid a slower economy – and that by investing in high-quality companies we can deliver decent returns for our clients in the long run.

A challenging period for dairy

China Mengniu Dairy, one of the two largest dairy companies in China, was among the main detractors over the past two years. We have been shareholders in Mengniu for over a decade, given its strong market position in segments such as premium ultra-high temperature (UHT) milk, fresh milk and cheese. We expect Mengniu to benefit from the "premiumisation trend" – or consumers choosing to upgrade to better quality products – as well as an increasing awareness of dairy products' contribution to nutrition and health.

Mengniu's "Milk Deluxe" (its premium milk range) contains more protein than basic milk and tastes richer and creamier. This has allowed Mengniu to charge more for Milk Deluxe compared to other basic milk — its price premium ranges from 50% to 400% higher. While Milk Deluxe sales have been resilient, overall demand for milk products has been sluggish as a weaker economy has led consumers to tighten expenditures.

Adding to its problems, the price of raw milk has fallen for 30 consecutive months, the longest down-cycle since 2008. Distributor inventories have grown due to supply and demand imbalances. This time the impact has been more meaningful, as raw milk suppliers were wrong-footed on predicted volumes for dairy demand. Mengniu noted that 2024 is currently the "toughest year for China's dairy industry since 2008". Its total revenue declined by more than 12% in the first half of the year.

We met with the new CEO, Mr Gao Fei, to discuss these issues and his plans to generate future growth and improve profitability. Earlier in the year we also met the head of Milk Deluxe who had taken on the liquid milk business after Mr Gao's promotion. These recent meetings were reassuring – the management believe that the worst is behind them, and the expectation is for revenue to turn flat or even slightly positive in the second half of the year. Demand has stabilised, inventory has been cleaned up, and the raw milk cycle is likely to turn around in 2025.

Mr Gao plans to cut capital expenditures and focus on the existing business rather than pursue acquisitions (which have had mixed results in the past). This should improve operating margins and returns on invested capital (ROIC). The company will increase its dividend payout ratio from 40% in 2023 to above 50% in the next two years and spend HKD2bn to buy back shares in the next 12 months. These are positive steps towards improving shareholder returns, in our view. As a long-term owner of the business, we have engaged with Mengniu on various issues, including its corporate governance, capital allocation and long-term strategy.

Mengniu's valuations seem attractive after the de-rating and its franchise remains strong and defensive in a cozy duopoly market. Near-term weakness aside, we believe consumers will continue to pay a premium for its brand and quality, which makes us optimistic on Mengniu's longer-term prospects. We will continue to monitor and meet with the management regularly.

Other notable detractors

China Resources Beer (CR Beer) also detracted from performance amid the challenging economic environment. CR Beer's recent first-half results showed overall revenue declined slightly from a year earlier, with a lower volume of beer sales partially offset by higher selling prices. The company sounded cautious on demand, as sub-premium categories and above grew by just single digits in the first half of 2024 (from 19% in 2023).

While we clearly underestimated the growth slowdown and the de-rating, CR Beer's execution operationally has been decent amid a difficult environment. In the beer business, the premium segment is still growing faster than the overall portfolio (albeit at a slower pace than before). At Jinsha (the baijiu business), inventory has been cleared (current channel inventory is around 3-4 months) and the target is to grow sales by 30% this year, from a low base.

The management remained optimistic about CR Beer's longer-term growth and its competitive advantages. We think CR Beer is well positioned in the premium market — the higher-end Heineken brand grew by more than 20% year-on-year, driven by nationwide expansion and growing consumer mindshare, and there is still room for margin increases as it becomes more established in other provinces. Product-wise, CR Beer is focused on developing the smaller high-end products such as Lao Xue, Amstel, and K-Lion, as consumers become more selective about their beer preferences.

Anta Sports, China's leading sportswear company, was a key detractor in 2023 despite strong operational performance and earnings growth. It is looking at another year of decent growth in 2024. Group sales and recurring net profit (excluding the Amer acquisition) grew by 14% and 17% respectively over the first half of the year. This was ahead of industry peers and followed 35% earnings growth in 2023.

We attribute this strength to the quality of Anta's management team and its multi-brand portfolio, which benefits from having more diverse offerings. Growth this year has been driven by Anta's relatively niche brands like Descente and Kolon Sport, which target high-end consumers engaging in fast-growing activities like camping and winter sports.

From our recent meeting with Anta's management, sportswear companies in China have become more restrained in their investments, acknowledging the weak consumption environment and turning their focus to profitability and shareholder returns. To this end, Anta has announced a higher interim dividend payout and HKD10bn of share buybacks over the coming 18 months, which together amount to a yield of 8-9%. We think Anta is a company to own for the long term; it is a core holding in our China portfolio.

Silver linings

As companies in China adapt to the slower growth environment, we remain optimistic about the long-term investment opportunities. Our conversations with management teams suggest that they have become more cautious in making new investments and have curtailed their growth targets. During these challenging times, they have been more focused on improving profitability and cash flow. Share buybacks and dividend payouts have also increased, which indicate better shareholder returns to come.

Midea Group, China's largest home appliances company, with a leading market share in items including air conditioners, fans and microwaves, is a good example of a company that has had to adapt to slower growth. The company has been a key contributor to our portfolios this year, having executed well and generated robust cash flow despite the challenging environment.

But it wasn't always this way. Midea expanded rapidly during 2006 to 2011, driven by urbanisation and government stimulus. This aggressive expansion led to mediocre products (cultivating a mass-market brand perception) and a lack of control over its distributors.

The founder and chairman Mr He Xiangjian made a strategic pivot in late 2011, in a bid to turn the ship around. Performance targets went from purely sales volume to more comprehensive metrics, including the percentage of high-end products sold. Products and distributor channels were streamlined, ensuring more consistent pricing at retail outlets, while non-core subsidiaries were sold. These reforms drove a cultural shift, and its business managers focused on upgrading the product mix.

Its alignment with minority shareholders also improved during this time. Incentives were restructured, with over 700 employees, particularly those in research and development, receiving employee stock options. Midea's products gained market share, its selling prices increased and profitability improved — operating margins averaged 8.4% during 2012-23, up from 4.9% in 2006-11.

Today, it seems that China's internet companies are following suit with their focus on profitability and shareholder returns. One of our largest portfolio holdings is Tencent, a top performance contributor year-to-date. We have been shareholders of Tencent since 2005 and have consistently found the management to be effective, stable and down-to-earth. Tencent's focus on its users has built strong competitive moats in its business, particularly through its "super app" WeChat, which has become an integrated part of daily life for more than 1.2bn users.

Tencent took advantage of the tremendous network effects created by WeChat to develop new features designed to enhance its users' experience. Today WeChat not only facilitates messaging, it has integrated social media, payments, ride hailing, e-commerce, and video streaming within its app, which together make up an ecosystem with high entry barriers.

Tencent has also been successful with its capital allocation. With the growing dominance of WeChat, Tencent could spot new trends early and leverage this insight to fund the most promising operators. It made early and subsequently very profitable investments into companies like JD.com, Meituan, Pinduoduo and Kuaishou, a testament to its ability to recognise the likely winners.

Tencent's profitability has improved, driven by the shift in its business mix. New businesses such as video account ads, e-commerce, mini-games, cloud software-as-a-service and non-payment fintech have higher gross margins than the group level and may continue to grow at over 15% per year.

In 2022 Tencent shifted its capital allocation focus to shareholder returns rather than growth. This has meant increased buybacks and dividends, fewer new investments and the divestiture of some portfolio companies.

One of these divestments was Meituan, the largest local services e-commerce platform in China. Meituan offers products and services that are transacted online but consumed offline. It is the leader in food delivery services and domestic hotel bookings, while in-store dining and travel services are major profit centres. After following the company for some years, we recently initiated a position in Meituan for the FSSA China Growth portfolio.

Meituan's valuations seemed attractive, considering the strong profits from its dominant core businesses (food delivery, where it holds 75% market share, and hotel bookings). The company has also been conducting share buybacks to improve total shareholder returns.

The problem was its recent foray into community group buying (CGB), a form of online shopping where residents in the same neighbourhood group together to buy products in bulk at a discount. As a business model, CGB has been loss-making and fraught with competition from Pinduoduo, Didi, JD.com and Alibaba.

After recognising that the mounting losses from CGB were not sustainable, Meituan shifted its focus by shutting down unprofitable operations, streamlining logistics and reducing promotional activities. As a result, its CGB losses have narrowed and could reach break-even by next year. Peers appear to have retreated from CGB as well, which bodes well for Meituan's remaining CGB efforts.

Overall, we are pleased with the management's willingness to admit mistakes, the steps taken to rectify the losses and its more prudent capital allocation.

ZTO Express, China's biggest parcel delivery company, is another addition to the China Growth strategy this year. The company benefits from the rise in e-commerce spending as buyers and sellers use its services to deliver the purchased goods. Although the e-commerce sector is maturing, we like the company's dominance within the industry and its focus on profitability.

After years of steady gains, ZTO reached 23% market share by volume in 2023 (from 13% in 2014) and takes the majority of the profit pool among the Tongda companies (its peers being Yunda, YTO and STO). We believe ZTO's industry leadership is likely to remain given its strong track record and management quality. Within the next 5-6 years, the management expect to benefit from industry consolidation, where the top 2-3 players should take 60-70% market share.

The company is relatively asset-light thanks to its "network partner model" where the first-mile pickup and last-mile delivery are handled by smaller local companies. The advantages of this include rapid expansion potential, flexible decision-making at local levels, and lower costs for the first- and last-mile logistics. The company continues to optimise its operations and improve its service.

Meanwhile it has been reducing capital expenditures and raising dividends, backed by higher free cash-flow. Valuations are undemanding, and there is an attractive yield (as well as the buyback), which we think translates into an attractive risk/return.

Outlook and conclusion

We cannot predict when sentiment on China might turn positive, or when quality companies will return to favour. However, our conviction in our portfolio companies remains strong as we believe their underlying fundamentals and potential growth prospects still look attractive in the long run. We think the China market contains plenty of investment opportunities for long-term-minded and quality-focused investors who are able to look beyond the current market malaise.

However, it is clear that China's slower economic growth is likely to persist, and companies — and investors — are having to recalibrate. Nonetheless, our investment philosophy is designed to seek out quality companies that can find ways to prevail despite the weak environment. We look to invest in companies that we believe can become long-term winners, in particular those that can sustain and strengthen their business through the cycles. With the ongoing market weakness many industries will consolidate, leaving the stronger players to reap the rewards.

As always, we thank you for your continued support.

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 August 2024 or otherwise noted.

FSSA Investment Managers