FSSA Investment Managers

Fund Manager Q&A

Addressing recent investor concerns on China

September 2023

Martin Lau
Managing Partner

Martin joined the team in 2002 and he is the portfolio manager of a number of strategies, including the FSSA Greater China Growth and Asian Equity Plus strategies.

In response to the recent client interest around China's stock market and the challenging performance year-to-date, we had a conversation with Martin Lau, managing partner and lead portfolio manager for the FSSA Asian Equity Plus and FSSA China Growth strategies. The discussion took place on 23 August 2023.

Do you expect the Country Garden default will have spill-over effects to other industries and lead to systemic risks? What risks and opportunities do you see from this incident?

Rather than focusing on this particular case with Country Garden, we think the market is more concerned about the growing number of defaults in the property sector, like we saw with Evergrande, Sunac and Shimao in the past two years. Property is a key engine for China's economy, so we expect the ongoing weakness will have a negative impact. It has implications for other areas such as banks, construction, home appliances and building materials. It also affects personal wealth and consumer demand. However, we don't think there will be systemic risk, like Lehman Brothers in 2008 which had a domino effect.

There are a few reasons for this. In China, nearly all the banks are owned by the government. If they choose to roll over their debt to a company, that can stop the company from failing. That is, unless the government wants something to fail. When Lehman went bankrupt, the market was wondering where the next Lehman will be. Like a self-fulfilling prophecy, this made banks scared to lend and led to a global financial crisis. We think this is not likely to happen in China today, due to the high levels of government control and ownership.

Another reason is that there is very little foreign debt in China. The 1997 Asian Financial Crisis started in Thailand and spread to several other countries, due to its large holdings of foreign debt. In China, most of the debt is in renminbi, so it's less likely to trigger a global contagion. More than half of the private property companies with large US dollar debt have already defaulted.

To some extent we believe the Chinese government wanted this to happen because previously defaults were so rare, which led to some moral hazard and excessive borrowing. The government is now focusing on quality growth and moving away from the old model which relied heavily on property and debt. We expect it will take some time to adjust and muddle through.

To date, our preference for quality and being conservative has helped to preserve capital. We have never invested in companies like Country Garden, Evergrande and Shimao, because we thought they were too aggressive. The few property stocks we hold, mainly China Resources Land (CR Land) and China Overseas Grand Oceans, have been relatively resilient. Consolidation is likely to continue and they should benefit as a result. Country Garden and Evergrande were much bigger than CR Land, so when they lack financing and exit the market, it should give more opportunities for CR Land to buy land and projects at lower prices.

Domestic demand is considered a key driver for economic growth in China. However we see unemployment remains high and consumer confidence is turning more pessimistic. Have you changed your top holdings within the consumer sectors? Do you see any new opportunities arising from the change in demographics?

Companies are telling us that growth has slowed across the board, and this is true for consumer demand as well. But we think the longer-term trend around consumer upgrading is intact, and this remains a key structural driver in our portfolios. Our top holdings such as China Mengniu Dairy, Anta Sports, China Resources Beer (CRB) and Midea have not changed and we still have conviction in them. These companies have the markers of quality that we look for, like strong financials, steady growth compared to peers, cashflow generation, and premiumisation.

When most investors are negative on China then perhaps it's time to buy more, and we have been doing so across our top holdings. We believe that in the long run, share prices follow earnings growth. Anta announced a big increase in first-half profit, more than 30% year-on-year, and the share price jumped afterwards. The company has a good track record of building successful brands and gaining market share. Meanwhile CRB achieved around 4 to 5% growth for both volume and selling prices during the first half this year. Its premium products grew faster, with nearly 60% increase in the volume of Heineken beer.

These are a few examples of benefiting from sector consolidation and premiumisation. Hopefully the companies we invest in will continue to grow their earnings over the long term.

New loans fell and credit growth weakened in the third quarter. Do you think this will impact the growth and earnings outlook of Chinese enterprises? Will it impact China's R&D expenditure and progress in moving up the value chain?

We think weak credit growth is a concurrent indicator which reflects a weak economy, rather than a driver or leading indicator. When confidence is weak, people are not buying houses but paying down their existing mortgages, and banks are hesitant to lend as large developers are defaulting. In the past five years, more lending was needed to generate each unit of GDP growth. This likely caused concern for the government by showing the limits of credit driving the economy.

Meanwhile investors are concerned today because they are also seeing the limits to what the Chinese government can do, or is willing to do. The economy has become highly leveraged and many companies are experiencing problems. Against this backdrop, China is likely to slowly deleverage over time, so loan growth may stay weak and near-term earnings growth for companies would also be impacted.

Companies will probably cut back on research and development (R&D) as revenue slows down. But we favour companies that invest more into R&D, such as Shenzhen Mindray, which has been able to grow new businesses like endoscopes and anaesthesia machines. Often it's more about incremental improvements to existing products or processes, rather than having the most cutting-edge technologies. For example, we own a few companies exposed to industrial upgrading, like Shenzhen Inovance. It used to spend over 12% of sales on R&D, and now it's more like 9 to 10% which is still high. It has gradually moved up the value chain. The same goes for Shanghai Hanbell, which makes vacuum pumps. It started by targeting air conditioners, then solar and now semiconductors.

We also favour companies which can expand overseas, such as Mindray, Haitian International and Midea, because it's another sign of moving up the value chain. We believe when the domestic economy is weak, a good company can find growth in other markets. We saw this in Japan, with companies like Fast Retailing (Uniqlo), Toyota, Sony and Nintendo.

There are some parallels between Japan's experience and China going forward, like the ageing population and slowing economy. But one difference is that it's much harder to go global today vs 30 years ago. Geopolitical headwinds are stronger today, like how the US put a halt to Huawei's global expansion. But China is running out of labour, so regardless of geopolitics it needs to move production outside.

The China Growth and Asian Equity Plus strategies recorded bigger drawdowns than the market in 2023 year-to-date. Can you share why you think the portfolio looks less resilient this year? What measures did we take to mitigate risks? Any new opportunities that make you excited?

At FSSA, we have always been long-term, benchmark-agnostic investors with a focus on absolute returns. We would also argue that this year-to-date timeframe is too short to draw conclusions, given our long-term horizon. We believe businesses, and their performance, should be evaluated over at least 3-5 years, if not longer.

That said, a big reason for our deviation versus the index year-to-date is due to what we don't own. The market sell-down has been largely driven by foreign investors, so the more widely owned stocks have fallen more while the US-sanctioned stocks like China Mobile and CNOOC have performed better, but we don't own them. In addition, this year the market has favoured cheap (low price-to-book value) state-owned enterprises (SOEs) due to optimism over reforms.

In our view, the stocks in our portfolio are of higher quality but are less cheap. For example China Merchants Bank fell more year-to-date than the lower-quality SOE banks like Agricultural Bank and Bank of China. In terms of our regional strategy's performance, the major theme this year has been artificial intelligence (AI) and we don't hold many software or AI-related companies compared to some of our peers.

We believe investor sentiment is very weak. Many companies have been reporting results recently, and the stocks will often drop afterwards even if the results are decent. The other risk is the uncertainty around government support. Anticorruption crackdowns, like we're seeing in the health care industry, tend to be negative for near-term economic growth even though they may be positive in the longer term.

We try to mitigate risk by picking quality companies with strong financials and competitive moats, and holding them for the long term. When performance is under pressure, in our view, the key is not to rebuild the whole portfolio but to follow our conviction. We believe sentiment is cyclical but earnings are a structural driver for share prices. Amid the recent pessimism, we have been adding to our top holdings across the board.

References:

1. Background on recent China defaults:

https://www.theguardian.com/world/2023/aug/18/china-property-crisis-deepens-as-developer-country-garden-at-risk-of-default-evergrande

https://www.bondsupermart.com/bsm/article-detail/shimao-group-s-usd-bond-was-finally-defaulted-RCMS_257381

https://asia.nikkei.com/Business/Markets/China-debt-crunch/Developer-Sunac-China-admits-default-on-750m-bond

https://www.washingtonpost.com/business/why-china-evergrande-defaulted-and-what-happens-next-for-bondholders/2022/12/12/0211ad6e-7a08-11ed-bb97-f47d47466b9a_story.html

2. Most Chinese bonds are denominated in RMB:

https://www.morningstar.co.uk/uk/news/217180/chinas-bond-market-a-quick-primer.aspx

(as at 29 November 2021)

3. Default rate of Chinese real estate USD bonds has risen to over 50%:

https://www.bondsupermart.com/bsm/article-detail/a-list-of-30-key-chinese-developers-latest-development-ongoing-update-RCMS_255744

(as at 28 July 2023)

4. Anta first half results and share price reaction:

https://www.yicaiglobal.com/news/antas-shares-jump-as-sportswear-giants-first-half-profit-gains-40

5. China's economy is highly leveraged:

https://www.wsj.com/world/fueled-by-long-credit-binge-chinas-economy-faces-drag-from-debt-purge-e4621859

6. Effects of anticorruption crackdown on China's economy in the past:

https://www.bbc.com/news/blogs-china-blog-26864134

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 23 August 2023 or otherwise noted.

Important Information

The information contained within this material is generic in nature and does not contain or constitute investment or investment product advice. The information has been obtained from sources that First Sentier Investors ("FSI") believes to be reliable and accurate at the time of issue but no representation or warranty, expressed or implied, is made as to the fairness, accuracy, completeness or correctness of the information. To the extent permitted by law, neither FSI, nor any of its associates, nor any director, officer or employee accepts any liability whatsoever for any loss arising directly or indirectly from any use of this material.

This material has been prepared for general information purpose. It does not purport to be comprehensive or to render special advice. The views expressed herein are the views of the writer at the time of issue and not necessarily views of FSI. Such views may change over time. This is not an offer document, and does not constitute an investment recommendation. No person should rely on the content and/or act on the basis of any matter contained in this material without obtaining specific professional advice. The information in this material may not be reproduced in whole or in part or circulated without the prior consent of FSI. This material shall only be used and/or received in accordance with the applicable laws in the relevant jurisdiction.

In Hong Kong, this material is issued by First Sentier Investors (Hong Kong) Limited and has not been reviewed by the Securities & Futures Commission in Hong Kong. In Singapore, this material is issued by First Sentier Investors (Singapore) whose company registration number is 196900420D. This advertisement or material has not been reviewed by the Monetary Authority of Singapore. First Sentier Investors, FSSA Investment Managers, Stewart Investors and Igneo Infrastructure Partners are the business names of First Sentier Investors (Hong Kong) Limited. First Sentier Investors (registration number 53236800B), FSSA Investment Managers (registration number 53314080C), Stewart Investors (registration number 53310114W) and Igneo Infrastructure Partners (registration number 53447928J) are the business divisions of First Sentier Investors (Singapore).

First Sentier Investors (Hong Kong) Limited and First Sentier Investors (Singapore) are part of the investment management business of First Sentier Investors, which is ultimately owned by Mitsubishi UFJ Financial Group, Inc. ("MUFG"), a global financial group. First Sentier Investors includes a number of entities in different jurisdictions.

MUFG and its subsidiaries are not responsible for any statement or information contained in this material. Neither MUFG nor any of its subsidiaries guarantee the performance of any investment or entity referred to in this material or the repayment of capital. Any investments referred to are not deposits or other liabilities of MUFG or its subsidiaries, and are subject to investment risk, including loss of income and capital invested.