FSSA Investment Managers

China equities: Keeping a long-term view

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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.

RISK FACTORS

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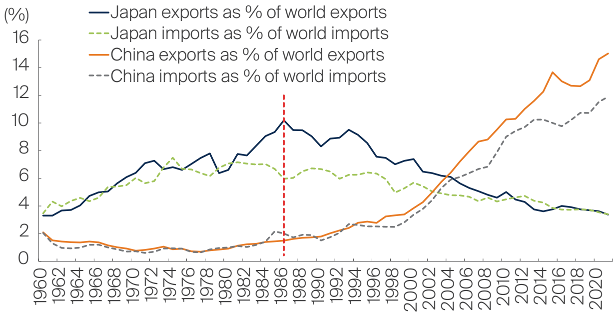
In the final part of this three-part series, Martin Lau, managing partner and lead portfolio manager of the FSSA China Growth strategy, shares the key long-term investment themes in his portfolio as the strategy celebrates its 30th anniversary this year.

China's Covid lockdowns have lasted longer than expected, taking a toll on the economy and investor confidence. Despite this, we continued to buy high conviction companies at more attractive valuations, as we viewed the near-term weakness as temporary. China's structural drivers are still intact, even if we don't return to the heady growth of 10 to 20 years ago. The companies we invest in should benefit from trends such as rising incomes and wealth, increasing demand for premium goods and services, and growing sophistication in technology and manufacturing.

The chart below shows how a long-term trend can endure. Since the 1990s economic reforms, China's role in global trade continues to increase, beyond Japan's peak in the mid-1980s. This bodes well for exports as well as consumption, which is partly a result of China becoming wealthier from selling to other countries. But as the availability of cheap labour fades, there is a growing need for Chinese companies to innovate and move up the value curve.

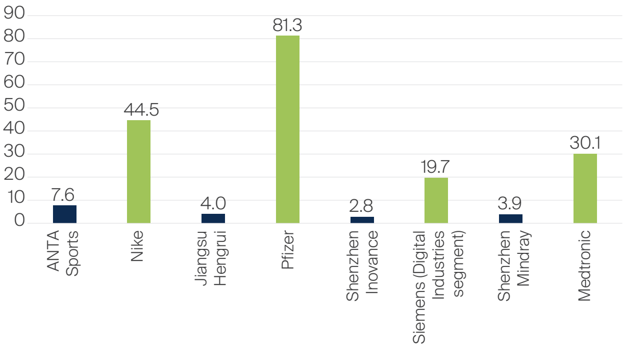
China has become a bigger part of global trade while Japan has faded



Source: WDI, CICC, FSSA Investment Managers, December 2022.

To give us an idea of the growth runway for Chinese companies, we compared the revenue of a few of our holdings with their global peers. For example, Nike is a global company and considered to be the best sportswear company in the world. In China, we believe ANTA Sports is the best sportswear company domestically. A side-by-side comparison implies that there is plenty of room for ANTA to grow.

Global winners – revenue comparison (2021, USD billions)



Source: Bloomberg, FSSA Investment Managers, December 2022.

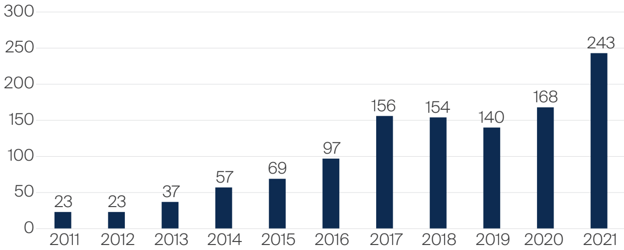
Likewise, we believe that the best pharmaceutical company in China is Jiangsu Hengrui; the best automation company in China is Shenzhen Inovance; and the best medical equipment company in China is Shenzhen Mindray. We like these companies for fundamental reasons. It has nothing to do with government policies, property measures, interest rates, the state of the economy, or GDP growth. Rather, it's based on their ability to gain market share, earn higher margins, create more valuable brands, and having strong management and alignment.

Below we discuss these companies in more detail, and why they are likely to remain as our long-term holdings.

Industrial automation aims to offset shrinking workforce

China's automation market enjoys strong secular tailwinds, given labour shortages and the government's goal to become self-sufficient in "hard technologies". China's working age population is declining due to the earlier one-child policy. From 2022 to 2050, China's workforce — people aged between 15 and 64 — will contract by 22% or 217m people, according to United Nations (UN) projections. There is increasing demand for robotic equipment as well as components that can improve efficiencies or improve the production process. With this in mind, we have been closely following companies in industrial automation and general automation for a number of years.

Annual installations of industrial robots in China (1,000 units)



Source: International Federation of Robotics, FSSA Investment Managers, December 2022.

We own Shenzhen Inovance, an industrial automation company with leading positions in inverters, servo motors and new energy vehicle (NEV) controllers. The ownership and alignment are strong, with a dedicated founder team that has grown Inovance from a small inverter maker into China's most successful automation company.

Inovance has repeatedly proven its capability in developing new products and entering new markets, where it can compete with multi-national peers. The company has generated 28% per annum shareholder returns since its IPO in 2010, with 40% compound annual growth rate (CAGR) in sales and 35% net profit CAGR. Despite its size, we think Inovance can continue to generate attractive growth over the next 5-10 years, as it gains market share and continues to innovate.

Another example is Airtac, the second-largest pneumatic components supplier in China with around 25% market share. Demand for pneumatic components is also driven by industrial automation. Airtac is a rare type of Taiwanese company, one which has built its own channels and brands to compete with global companies like SMC, rather than focus on manufacturing for third-party companies. The chairman seems to be clear in his goals, treats employees well and positions for long-term growth by identifying attractive markets. Airtac is also moving into linear guides, which he believes are a stepping stone to larger, high-end pneumatic customers, as there is a big customer overlap between the two businesses. Over the longer term, we expect 10-15% growth per year.

Leading healthcare companies stand to gain market share

Healthcare spending in China is much lower than in developed countries, and should continue to grow with the ageing population. The 65-plus population will increase from 14% of the total in 2022 to 30% in 2050, according to UN estimates. In the healthcare sector, we own pharmacy businesses, independent contract laboratory (ICL) companies, and medical device manufacturers.

The pharmacy sector is highly fragmented, but we think consolidation is likely and the industry leaders would benefit. There are 1,200 pharmaceutical companies in China and the largest two, Jiangsu Hengrui and Sino Biopharm, have 3.1% market share each, followed by 2.7% share for CSPC (we own all three companies). By comparison, the global pharmaceutical sector is also fragmented, but leaders tend to hold 5-6% market share.

We also hold Shenzhen Mindray, China's largest domestic medical devices company and a market leader in patient monitors and life support systems. The company has been gaining market share from global leaders as it expands its presence overseas, with more than 40% of its sales through exports. Meanwhile, the penetration level of medical devices in China is still low and there is a growing preference for import substitutions.

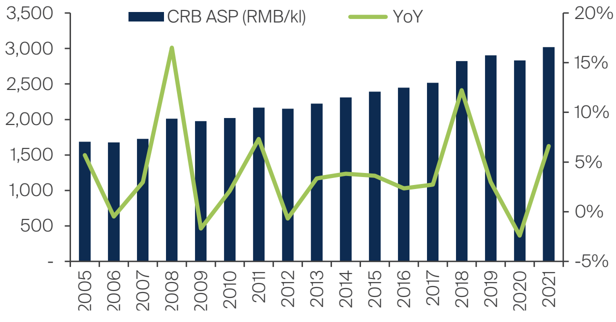
Domestic brands may benefit from premium consumption

China's easing of Covid restrictions is gathering momentum. This should enable a return to structural growth in consumption and tourism. Amid the weak consumer demand over the past two years, we have focused on buying the higher quality franchises and market leaders. This means companies with above-average margins and returns, and the ability to premiumise and raise selling prices.

For example, China's beer market is different from most, as beer volumes have been in decline since 2014. On the other hand, as the economy and middle class have grown, so has the opportunity in premiumising and improving unit economics. China Resources Beer (CRB) is the largest beer company in China, with around 30% market share. The Chinese beer market is highly consolidated, with the top three companies (CRB, Tsingtao and Anheuser-Busch Inbev) sharing 75% of the market. As a result, competition is rational and measured.

Despite tepid sales, margins and profitability have improved as beer companies consolidated their breweries. CRB's share of premium sales has grown with help from a 2019 merger with Heineken China, resulting in higher average selling prices (ASP). Although the company is a State-Owned Enterprise (SOE), China Resources businesses have typically been well run, with returns comparable to private enterprises.

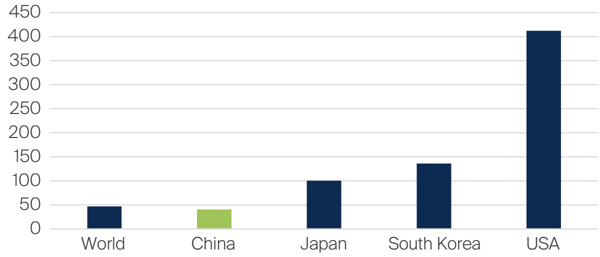
ASP has grown consistently



Source: Company filings, FSSA Investment Managers, as at 30 June 2022.

As China's reopening gathers momentum, we expect people to return to a more active and sporty lifestyle. This should benefit Anta, 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. In the longer term, sportswear consumption in China has the potential to increase as incomes rise, judging from the per capita spending on this segment in Japan and South Korea.

Sportswear consumption per capita in 2021 (USD)



Source: Euromonitor, J.P. Morgan, FSSA Investment Managers, as at 30 June 2022.

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 long as Anta can attract new customers (with Kids, Fusion and its performance sportswear range, as well as more efforts to target the underrepresented female customer segment), we believe it can prolong its brand life-cycle and continue to grow sales.

As always, the key for us is quality

While much about China has changed over the last 30 years, our investment process remains the same. The key for us has always been the quality of the business and management, backed by structural growth drivers.

So what will the next 30 years look like for China? Drawing upon the parallels in Japan, Olympus, Komatsu, and Sony have become world-class companies; we would expect some of China's domestic champions to reach similar levels of competence and acclaim. Meanwhile, the median age in Japan is now 49 years, compared with 38 in China, and Japan's average life expectancy is 85 years, compared with 78 years in China. As China's economy matures and its people grow older, it could heed a few other lessons from Japan's experience — like how to age gracefully, with growing wealth, wisdom and happiness.

References to specific securities should not be construed as investment advice or a recommendation to buy or sell the same.

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

Important Information