Fund Manager Q&A

China Equities

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Winston Ke
Portfolio Manager

Winston joined FSSA Investment Managers in 2015 and has more than 15 years of investment experience, covering Greater China equities. Winston is the lead manager of the FSSA All China and FSSA China A-Shares strategies.

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Portfolio Manager

Helen joined FSSA Investment Managers as a graduate in 2012, focusing on the Greater China markets. She is the lead manager of the FSSA China Focus and FSSA China All Cap strategies. She is also the co-manager of the FSSA Greater China Growth strategy.

Tianyi Tang
Investment Analyst

Tianyi joined FSSA Investment Managers in 2017, providing research support to the portfolio managers with a focus on the Greater China markets. With 8 years of investment experience, she is also the co-manager of the FSSA Hong Kong Growth Strategy.

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How do you see the concerns around consumption downgrading?

Helen: Recently, consumption downgrade is a concern widely held in the investor community. In my view, it reflects the reality on the ground. On the demand side, incomes are not growing in the near term, and on the supply side, competition between companies is quite fierce at the moment. But we also see some of the premiumisation trends are still happening in China. For example, if we look at higher-value consumption, such as luxury products, their sales are decent even though the growth decelerated from a high base. And for food and beverage, we can see some of the premium liquor and premium beer brands are still selling well.

It could be called a K-Shaped recovery. In other words, consumption is holding up for the higher-end premium and lower-end mass products. But the mid-end products are more challenged. For example, for China Resources Beer, Heineken and Snow Draft have both been selling well. Similarly, Anta's high-end brands like Descente, Kolon Sport and Arcteryx are still selling quite well. But meanwhile, some of the mid-end products, such as SuperX under CR Beer and the Anta brand under Anta sports are facing more competition.

So companies are fine-tuning their products to make them more differentiated, in a bid to rejuvenate their growth. We think consumer brands need to have more balanced portfolios, with products catering to different needs. They also need to manage the brands well to adapt as consumer habits change.

Tianyi: There are some ongoing trends for the consumer sector. For example, younger people are willing to spend more on travel and leisure, despite the weak macro environment. Another interesting theme is many young people are leaving the tier one and tier two cities to return to their home town, or to live in the tier three and tier four cities. As a result, demand in the lower-tier cities in China has been growing quite strongly. And the people who used to live in big cities are bringing the popular brands to the lower-tier cities. Hence, there are opportunities for multinational brands, as well as domestic brands, to expand in those areas.

So regardless of the macro environment, there are interesting consumption trends that could offer structural opportunities.

What is your view on Chinese internet and gaming stocks?

Tianyi: The crackdown on the Internet sector started in 2021 and there has been some back and forth in the policies. I think we are close to the end of the policy scrutiny. For the past two years, the focus for internet companies was streamlining their business lines and focusing on profitability instead of growth, and this trend has started to reverse. Companies are turning more positive on the policy direction, and more willing to invest into new businesses. On the other hand, the very high growth period of Internet companies is probably behind us.

Now the key is identifying companies with quality growth, rather than those that expand the top line without much profit and cash flow. Therefore, focusing on the people and their long term strategy matters even more today compared to the past.

There are a few criteria we look for in terms of management quality. The first is ownership and alignment. One example is NetEase, the second-largest gaming company in China. The founder, William Ding, owns around 45% of the company. He only reduced his shares once in the 24 years' listed history and remains fully committed to the operations. He also has a strong focus on minority shareholder returns.

NetEase is one of the first Chinese internet companies to buy back shares and pay dividends. It has a very consistent dividend payout history, with the total shareholder return (dividends plus buybacks) around 3% per annum. And the company has a good board with only one executive director, who is the founder, and the rest all being independent directors. We think board independence is an important feature to consider, especially in China, as the majority of these internet companies are still founder-led.

This company also has a strong focus on generating returns. For example, in its history it sold the e-commerce business to Alibaba because it was a loss-making business. Even though the growth rate was very strong, the management believes focusing on the quality of returns matters more than the scale. We think these kinds of companies share similar values as us, and we feel aligned with their long-term strategy.

What opportunities do you see from import substitution?

Winston: The Chinese economy started from a very low base 30-40 years ago, and foreign companies have gradually entered the market. As Chinese companies learned new technologies, they gradually moved up the value chain. At the same time, China also cultivated many talented people and experienced engineers. So with the capital, people, and capable companies, China has reached a point where it can produce many things within its own supply chain. We have seen this trend in many areas, including medical devices, semiconductors, and other industrial sectors like automation. It is one of the key opportunities we see in the medium and long run.

One example is Shenzhen Mindray, a medical devices company. It produces patient monitors, ultrasound machines and other medical devices for hospitals in China. Many years ago, the founder studied overseas and learned the technology to produce patient monitors. When he visited his doctor friend at a local hospital, he saw that the patient monitors were all from foreign companies, and were quite expensive. He made the decision then to produce

Chinese-branded medical devices. Over the years, Shenzhen Mindray has reached around 30% market share in different categories in China, and is expanding overseas.

What are some interesting opportunities you saw in Taiwan?

Helen: The first is around artificial intelligence (AI), which will make a lot of changes to how we live and operate in the next 10-20 years. Taiwan has quite a few companies which could benefit from such a trend. For example, Taiwan Semiconductor (TSMC) benefits from the large increase in demand for graphics processing units (GPUs). MediaTek, despite its low exposure in the near term, can eventually benefit from the opportunity in Application-Specific Integrated Circuits (ASICS), and edge AI for smartphones, tablets and PCs. But in the near term, there is a lot of excitement around AI, and some of the valuations and expectations have gone beyond what the companies can deliver in the next few years. So we are quite selective in this area and we try not to be overly excited.

Secondly, we saw some recovery in consumer electronics demand which can benefit some of the technology companies. They expanded quite a bit in the up-cycle in 2021-22, and then suffered from the lower utilisation in 2023. Now demand is picking up, and they should benefit from an increase in utilisation. So there is some recovery in that area.

Thirdly some non-tech companies are becoming more interesting because the expectations have been lowered for some of the verticals, such as renewable energies and autos. The valuations have also become more attractive, with 4-5% dividend yields.

Geopolitical risk has grown and is likely to stay for some time, so we need to incorporate it into our analysis on the companies. But it also brings some opportunities. China is keen to localise industries such as semiconductors, so Chinese companies can benefit and grow their capabilities to adapt to the changes.

For example, we have invested in some semiconductor equipment companies which benefited from China's localisation trend. Their market share has more than doubled and could potentially double again in the next couple of years. And in other areas like industrial and medical, we also see the localisation trend in China. So geopolitical risk could be a catalyst which helps to accelerate import substitution, with support from the government.

How do you think about investing in electric vehicles (EVs)?

Winston: Globally, we can see the penetration of EVs has been increasing rapidly over the last few years. In China, we also want to identify some opportunities in the EV supply chain. For the original equipment manufacturers (OEMs), the competition landscape has been constantly changing. At the current stage it's very difficult for us to identify the final winner. Some of the newer players are gaining market share, but are still loss-making businesses. We also find the valuations unattractive.

That said, we have identified some opportunities in the EV supply chain. In certain EV components, we can see some of the players have dominant market share in their specific areas. We are more favourable toward these businesses because their sectors have been consolidated and we can expect stable margins given their dominant market share. At the same time we can also benefit from the growth of EVs overall.

Amid all the concerns, why should investors still consider China?

Helen: Now people think that China is un-investable, but 2-3 years ago, China was the market darling. Our job is to try to be a bit contrarian and invest when the market is fearful. There are a few reasons that China can do well in the next few years.

First of all, China has a very deep market, so there are many companies in different industries for us to choose from. And we believe we can find the winners if we pick carefully. Secondly, many Chinese management teams are very devoted to their businesses and they have long-term vision to grow and strengthen their franchises.

For example, in its history China was a leader in terms of developing its technology and internet sectors. Chinese companies also managed to move up the value chain in the industrial and medical fields, and there are a lot of new companies emerging in China.

Tianyi: I think there are still reasons to be positive about China. Firstly, China was the worst-performing major stock market in 2023. However, China's corporate earnings are expected to outgrow the developed markets. So I think this offers an interesting opportunity to buy some quality China stocks at cheap valuations.

Secondly, China is still an innovation-driven country, home to the largest number of engineers and scientists globally. It's also a leader in certain technologies such as electric batteries, solar panels, and drones. So there are still ample opportunities for us to identify companies with cutting-edge technologies that could grow over the long term. We think it's important to be selective when investing in China, and also important to be patient.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 8 March 2024 or otherwise noted.