FSSA Investment Managers

China Update

Domestic revival gaining traction despite external headwinds

May 2025

Investors started to turn more positive towards China after the government stepped up support for the economy last September. Domestic developments in artificial intelligence (AI) had also helped to boost market sentiment. But in recent weeks, global markets – including China equities – have been upended with chaotic announcements from the US about trade tariffs on goods imports from around the globe.

It's worth noting that most of our holdings in China are domestically focused businesses – in aggregate they derive less than 10% of revenues from the US.

And so, despite the noise about escalating trade wars, for us, it remains business as usual. We continue to look for well-managed companies with strong franchises, attractive growth prospects and sound balance sheets. We have been meeting the management of our portfolio holdings as well as new ideas in China, and we remain quietly confident that quality companies should perform well in the long run, as they have in the past.

As long-term investors, and given our time horizon of 3–5 years or more, we have a more considered perspective on China's growth prospects. In that context, we believe the government's market-oriented reforms will provide a supportive environment for Chinese companies to generate attractive returns for investors.

For example, the government has pushed state-owned enterprises (SOEs) to become more efficient and improve their profitability and total shareholder returns (TSR), echoing the "value up" programs in South Korea and Japan.[1] This led to a surge in dividends and share buybacks, which drove up the share prices of SOEs with low price-to-book valuations. The state-owned banks, such as Bank of China, China Construction Bank and Industrial and Commercial Bank of China, performed well in this scenario and the omission of these companies was a key reason we lagged the broader benchmark last year. However, we believe their history of low returns on equity and governance/alignment issues makes them unattractive long-term investments.

Moreover, the growing focus on TSR is no longer limited to SOEs.[2] Private sector companies in our China portfolios, such as Netease, Shenzhen Mindray and Anta Sports have also announced higher dividend payouts and share buybacks. Given their solid profitability and low debt, we believe these firms can return cash to shareholders on a more sustainable basis. We expect this trend of increasing dividends and buybacks to continue, which should support our investee companies' returns and improve alignment with shareholders.

Domestic innovation is another structural trend which can support Chinese companies' long-term performance. DeepSeek's AI model is one example of how Chinese companies have adapted and, arguably, disrupted the industry, and is indicative of the many other innovations in China we have noted. That said, we strive to be prudent during periods of market exuberance. Companies like Xiaomi and Alibaba both rose on the back of the DeepSeek-related enthusiasm, and not owning them was a key reason for our relative underperformance this year through April.

What we don't own

When we considered buying Xiaomi a few years ago, we could not build up conviction as it was mainly a hardware business with short product cycles and thin profit margins. Since then, Xiaomi has increased its focus on smartphone product development, producing higher-quality handsets which have improved its brand image and appeal more to the younger generations. The company also applied its R&D to other product segments, namely electric vehicles (EVs) and home appliances. Despite being a highly competitive sector where it had no experience – and where many companies have failed in the past – its first EV launch achieved strong sales momentum and exceeded expectations.

However, we would be cautious on extrapolating Xiaomi's earnings, given its EV sports car (the "SU7") was only launched in March 2024, and its quick success could indicate low barriers to entry and the potential for greater competition in the EV space. Xiaomi's valuations now look stretched and we believe the risk-reward does not look favourable.

As for Alibaba, a few years ago we saw its earlier dominance in e-commerce had eroded due to intense competition from companies like Pinduoduo and JD.com. We also had concerns about its corporate governance and shareholder alignment, as well as the increasing scrutiny from the government. We think some of these issues have improved – the company sold off its non-core assets and returned substantial capital to shareholders, while the recent meeting between President Xi and founder Jack Ma suggests a more benign regulatory environment.[3]

However, we still lack confidence in Alibaba's longer-term earnings prospects. E-commerce is still its main profit driver, and we question whether it can continue to perform well as the management turns its focus towards AI and cloud developments. Alibaba's cloud infrastructure has not achieved significant profitability and may struggle to earn decent returns given the competition and overcapacity in China. Based on our past observations, this risk is not low. That said, we continue to monitor both companies, particularly after their recent developments.

In general, we believe continuous innovation is a marker of company quality and can be a long-term competitive advantage which leads to greater market share and higher profitability. We own other innovative companies such as Tencent and Netease in the internet space, Shenzhen Inovance in factory automation, Shenzhen Mindray in medical equipment and Contemporary Amperex Technologies in EV batteries. Even in "old economy" sectors like hotels and textiles, Chinese companies like H World and Shenzhou are applying sophisticated technologies and business practices to enhance their competitive edge. These companies have continually upgraded their capabilities and we believe they are well positioned to be the long-term winners in their respective industries.

Emerging bright spots for consumer demand

After experiencing several years of economic challenges, China's policy pivot last September gave the market a much-needed confidence boost. In contrast to previous announcements which had left investors disappointed,

1 Source: "SOE Profits, Share Value Prioritized." China Daily (January 2024). http://en.sasac.gov.cn/2024/01/31/c_16628.htm

2 Source: "Board's new mandate in China: managing market value." The Asian Corporate Governance Association (November 2024). https://www.acga-asia.org/blog-detail.php?id=92

3 https://www.theguardian.com/business/2025/feb/17/xi-jinping-meets-alibaba-jack-ma-and-chinese-tech-chiefs-amid-economic-slump

this round included large fiscal stimulus and consumer subsidies, signalling the government's willingness to step up its efforts.

While overall consumption remains soft, some companies in our portfolio have seen improved demand on the back of policy support. Midea and Haier Smart Home, two of the leading home appliances companies in China, have benefited from the government's "trade-in" programs. Despite operating in a mature industry, we think these two firms are well positioned to continue growing market share, given their reputable brands, strong distribution and focus on premium products.

Other segments, like sportswear and leisure travel, have seen growing demand with little need for policy support, which gives us more reason to be optimistic. This is partly due to a shift in lifestyles and cultural values, as Chinese people spend more on memorable experiences like camping and skiing. Anta Sports has stood out among sportswear companies with its robust sales and earnings growth, driven by brands like Arc'teryx and Descente in outdoor/winter sports.

We believe demand for leisure travel will continue to grow at a healthy rate over the long term, driven by increasing use of social media, better affordability and convenience. This view was shared by Mr Ji Qi, the founder and chairman of H World, when we met him last October. As the second-largest hotel chain operator in China, the company has a track record of building successful brands and strong digital capabilities. We expect it will continue gaining market share amid China's highly fragmented hotel industry.

H World uses an asset-light franchising model for over 90% of its domestic business. This allows the company to focus on brand-building and marketing while offloading the capital investments (mainly buying and developing real estate) and day-to-day operations to its franchisees. In turn, these franchisees pay recurring fees to the company. This model results in leaner cost structures and lower room prices, along with attractive profit margins and steady cash-flow generation. In our experience, such advantages tend to compound over time in a "flywheel effect."

Mr Ji started H World in 2007 after being the co-founder and CEO of Trip.com, a leading online travel services provider. Though he lacked formal hotel experience, he brought a fresh perspective to an entrenched industry, removing costly facilities he considered superfluous, such as ballrooms, restaurants and swimming pools. Instead, he focused on what he considered most important for guests – a clean and comfortable room in a good location at a reasonable price.

Drawing on his technology background, he introduced automated check-in systems, real-time pricing changes on bookings and delivery robots for room-service orders. These features led to the lowest staff-to-room cost ratio in the industry. He also launched a paid loyalty membership system, which helped to attract new customers and lock in existing ones while cutting out third-party agents. From our research on international hotel chains like Marriott and Hilton, we think hotel membership programs are highly effective at generating repeat business. As customers accumulate membership points, they tend to become less price sensitive and more loyal to the brand.

Our meeting with Mr Ji strengthened our conviction that we were in safe hands. He came across as down-to-earth, responsible and driven. The company is investing for the next phase of growth via premium brands, expansion into lower-tier cities and higher service standards. Mr Ji seemed hands-on and focused on building the business for the long term – he talked about meeting franchisees, analysing competitors and visiting lower-tier cities.

His leadership style was also refreshing – he had no airs about him, was candid about his past mistakes and invited his colleagues at the table to speak. Reflecting on the disappointing acquisition of German hotel group Deutsche Hospitality (DH), he ruled out future acquisitions and said he was focused on franchising for future growth. This should leave cash available for a high dividend payout (supporting the 3% dividend yield) as well as plans to return USD 2bn to investors in the coming few years.

Amid the challenging global environment, domestically focused companies like H World should be relatively insulated from external shocks. With China's economy continuing to shift towards domestic consumption, we believe H World's branded hotels should gain market share and benefit from the growing spend on travel and leisure activities.

Limited fundamental impact from US trade tariffs

Geopolitics may remain a headwind for investor sentiment, but we expect limited fundamental impact on most of the companies in our portfolio. Despite increasing US protectionism since 2016 when Trump began his first term, China's exports have continued to grow, driven by demand from Europe and Southeast Asia.[4] Additionally, Chinese companies have been expanding their manufacturing and sales into new locations.

4 https://en.macromicro.me/charts/17660/cn-exports-markets

A prime example of this trend is Shenzhou, a leading contract manufacturer of sportswear and casualwear textiles. Its biggest customers are global brands like Nike, Adidas, Puma and Uniqlo, which together contribute more than 80% of Shenzhou's sales. After entering Cambodia in 2005 and Vietnam in 2014, more than half of its production is now located outside of China, while its China factories mainly ship to the domestic market and neighbouring countries like Japan and South Korea.

We have been shareholders in Shenzhou for over 10 years, given the quality of its management, franchise and sustainability practices. The leadership has a track record of making strategic decisions which helped the firm become a dominant player. When the company listed in 2005, its focus shifted from casualwear to sportswear, given the latter's growth potential. Despite rising labour costs over the past two decades, the company has maintained its profit margins with efficiency improvements, showing the management's ability to adapt.

Shenzhou's vertical integration means it controls every stage of the production process, allowing for quality control, shorter production times and better margins than its peers. The company invests continuously in R&D to upgrade its fabric technologies and manufacturing capabilities. For example, it created advanced fabrics with features such as moisture wicking and temperature regulation, which appeal to sportswear and athleisure clients. These capabilities have made Shenzhou a trusted partner in developing new products with its customers, setting it apart from other manufacturers.

On the sustainability front, we look for management teams that are genuine in their desire to raise standards. In Shenzhou's case, the care for its workers and the environment seems embedded in its culture. The company is known for treating its employees well, with comfortable working conditions, above-industry compensation and other welfare benefits (such as healthcare and education for its employees' children). This has resulted in low turnover rates far below industry averages, a competitive edge in a labour-intensive industry (Shenzhou has around 100,000 employees).

Shenzhou's advantages have steadily compounded over time, while profits have tripled since we first bought the shares in early 2013. In the past few years, Covid lockdowns and high raw material prices presented challenges, but the business appears to be regaining momentum. Shenzhou's overall order growth was solid in 2024, driven by wallet share gains among its clients. Its sales rose by 15% year-on-year, while net profit jumped by 37%.

Similar to Anta Sports, Shenzhou has benefited from China's robust sportswear demand on the back of rising health consciousness and more active lifestyles. We think the market has overlooked this trend, perhaps due to the global nature of the business (and its largest customers). Its valuations remain near decadal lows on concerns about weak end-demand from key customer Nike and US trade tariffs.

But Shenzhou's total exposure to the US was only 16% of its total sales in 2024, vs 28% to the domestic market. Orders from Chinese firms like Anta and Li Ning are growing rapidly, which should help to offset potential headwinds in overseas markets. If orders from the "big four" clients slow down, Shenzhou can add new customers to take on the available capacity. Recent additions include Lululemon and Ralph Lauren, and their orders have generated attractive margins and returns. Overall, we saw Shenzhou's weak share price as a buying opportunity and added to our position.

That said, we are monitoring the impact of US trade tariffs on the global economy and consumer sentiment. There is still much uncertainty given how fluid the situation is, and we do not try to predict the outcome. The net impact on China's economy will depend on the strength of the domestic recovery and the outcomes of the tariff negotiations. Until recently, the Chinese government has held back from deploying aggressive stimulus, likely in anticipation of escalating trade frictions. This suggests there is scope to support consumption more meaningfully, if external headwinds were to intensify.

Conclusion and outlook

After a challenging few years, we are starting to see pockets of healthy demand emerging in certain domestically focused sectors. The government is providing more support for businesses and consumers, perhaps in response to rising geopolitical tensions. And, through multi-year investments in R&D and supply chains, Chinese companies have become more competitive on the global stage. These are all reasons to be positive on the long-term outlook for China equities.

On the other hand, the recent news about US reciprocal tariffs have raised the uncertainty of the outlook, given the scale and breadth of the taxes. We don't pretend to know the end-result of the disruption to global trade nor are we trying to predict such outcomes. However, it is in times like this that the conservative approach with which we manage our portfolios comes to the fore.

As bottom-up investors, our focus remains on selecting well-run companies with capable leaders, strong franchises, attractive earnings growth and sound balance sheets. Our portfolio is aligned with the structural trends shaping China's economy: innovation, sustainability, and increasing shareholder returns. Overall, we believe our holdings in market-leading businesses, led by secular growth trends and underpinned by rising incomes, are likely to remain resilient through this period.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 30 April 2025 or otherwise noted.