Global Asset Management

China: false start or turning point? Greater Bay Area

Notes from the road

Richard Farrell
Christoffer Enemaerke

EM Equity Portfolio Managers

RBC Global Asset Management (UK) Limited

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Our recent visit overseas comprised a pan-Asia conference in Hong Kong, followed by a bespoke research road trip in the Guangdong province of South China. This was our EM Equity team’s fourth visit to China in the last 12 months, but the first time the two of us had been on the road together since Covid. We found it helpful to exchange different perspectives and views on the market, following our many meetings together over the course of the week.

Overall, we felt that sentiment has improved notably in China since our team’s last visit in January, and especially since a trip late last year when the macroeconomic situation dominated discussions. At the time, weak economic growth and the apparent lack of government support was notable, with management teams hoping for large stimulus packages to boost the weak consumption environment following Covid.

This time around, despite the subdued economic recovery, our interactions with management were much more focused on individual company factors and what management have been doing in terms of strategy and improving returns.

While Hong Kong saw a significant outflow of people during and after Covid, it felt much busier this time around. The conference was very well attended, and the restaurants and streets were busy, reminding us of the environment prior to the pandemic.

Speaking to other investors at the conference, it was apparent that the market weakness last year was partly due to investors' disappointment that the government wasn't intervening more to support the economy. Many market participants seem to be waiting for a large-scale singular stimulus package, in particular to support the property sector. Instead, there have been a number of smaller, targeted stimulus packages to support approved property developers, urban village redevelopment, local infrastructure, green finance and strategic sectors, such as renewables and electric vehicles.

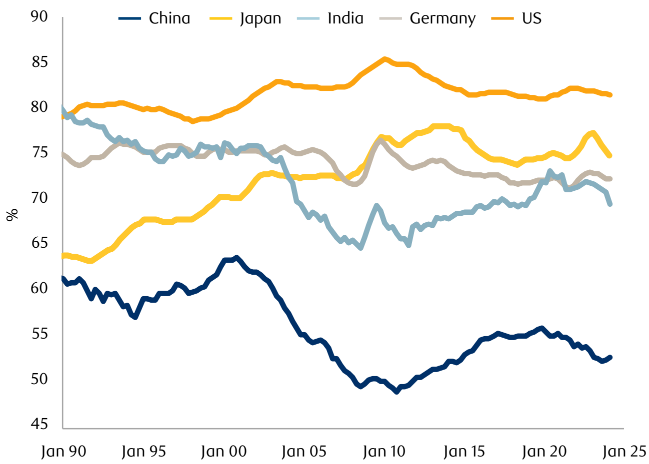
> **"People are now spending more on travel and leisure than they were pre-Covid, despite overall consumption remaining weak."**

Looking ahead, we think that China's most important long-term challenges come down to the so-called 'four Ds': debt, deflation, decoupling and demographics. One of the greatest challenges for China to be successful in the future will be its ability to shift economic growth away from debt-fuelled investment and replace it with more sustainable household consumption growth. China's low consumption share of GDP (Exhibit 1) means there is still plenty of scope for consumption to grow faster than the economy, as it did between the Global Financial Crisis and Covid. One interesting observation we made when we met with the CFO of a leading online travel company, Trip.com, is that people are now spending more on travel and leisure than they were pre-Covid, despite overall consumption remaining weak. This suggests more spending on experiences rather than goods, which has certainly driven a divergence in performance between consumer stocks.

The property sector remains one area of the economy that has yet to show a meaningful improvement. Sales, housing starts and completions have underwhelmed, and the government's latest policy initiatives, to boost public sector housing construction and channel more financing to real estate projects, have yet to bear fruit in terms of demand.

Touring a soy sauce brewing facility of leading Chinese consumer company, Foshan Haitian.

Exhibit 1: Consumption share of GDP for China versus other large economies*



Source: CLSA, Oxford Economics.
* Consumption = government and private.

Visiting a shopping centre, owned by China Resources Land, and a Tesla showroom inside the centre, in Shenzhen.

Touring a DaShenLin pharmacy store in Guangzhou.

Touring the facilities of Shenzhen Mindray, a patient monitoring and medical equipment manufacturer.

Whilst we were in China, we spoke to several industry experts about the property market. The evidence suggests that there remains underlying demand for housing, however households are understandably reluctant to put down money to buy new apartments off-plan, given the fear that developers won't be able to deliver in the current liquidity crisis. Prices continue to decline, however at a slower pace than last year. If we see secondary prices stabilise later this year, that will likely result in more demand coming into the market from buyers who are currently holding back due to falling prices.

Our on-the-ground due diligence in mainland China included a visit to a shopping centre, owned by China Resources Land, in Shenzhen. The company's investment portfolio, which includes shopping centres and offices that it leases and manages, now accounts for over 10% of sales and is growing rapidly[1]. Commercial real estate management is a nascent industry in China, but we think it has a lot of potential over the long term, given the huge amount of commercial property built in the last 20 years that needs to be managed. We see a significant opportunity due to the vast number of existing malls but limited numbers of quality mall managers.

We also met with DaShenLin, a pharmaceutical group in Guangzhou, and we toured its headquarters, distribution centre, and a local store. Angel Su, Associate Portfolio Manager on our team, recently completed a thematic report on the pharmacy retail industry in emerging markets. One trend identified is the shift away from people fulfilling their prescriptions at hospitals in China and instead collecting them from third-party pharmacy chains and online health companies. Given the country's ageing population and increasing health awareness, we think this is an interesting long-term trend.

One area of outperformance in the Chinese market in the last two years has been global exporters. Whilst property has been in crisis and consumption weak, exports have been very strong. China has several world class high-tech companies that are globally competitive, and this competitiveness has increased of late, as the Chinese renminbi has weakened against the US dollar and deflation has put downward pressure on prices. We conducted a tour of one such company that has performed relatively well in the recent downmarket, Shenzhen Mindray. The company manufactures patient monitoring, imaging and in-vitro equipment for hospitals, and it informed us that 40% of its sales are now generated from overseas. It continues to take global market share by offering healthcare systems, especially in other EM countries, and these critical devices are priced lower than western multinational competitors.

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Whilst in Shenzhen, we also met with Shenzhen Inovance. The company manufactures servos, inverters, and controllers for all kinds of industrial applications, from lifts to electrical vehicles to 6-axis factory robots. Shenzhen Inovance is exposed to the factory automation theme in China and although its direct exports are limited, its sales have proved robust as many of its customers are export manufacturers. In our discussions, we were told that the company invests over 10% of sales into research and development, and it continues to grow market share by offering complete automation solutions to its customers, with strong after-sales care at lower prices than western multinationals can offer.

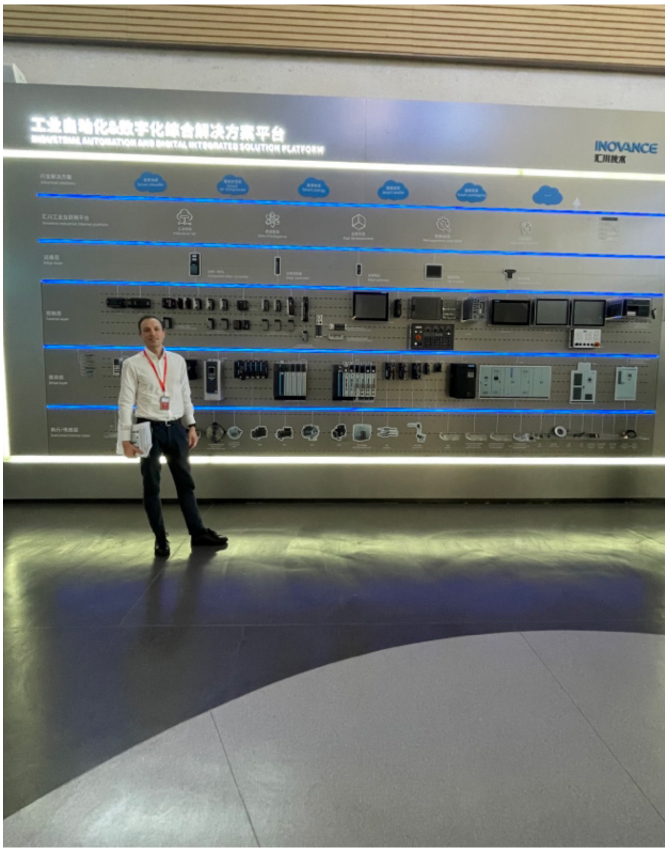
[1] China Resources Land.

Reflecting on our trip, we are left with an impression that investors had become too negative on the Chinese market. We've recently seen a strong rebound in Chinese stocks and the key question now is whether this is yet another false start or if it can be seen as a turning point?

Valuations are still cheap, and we see a number of high return companies in China that we believe remain attractive over the longer term. Recently, we have also started seeing improved capital allocation in some large cap stocks with record high dividend payouts and buybacks, which could signal an improvement in corporate governance.

A significant further positive would be if the government manages to restore confidence in the real estate market, which still accounts for more than 50% of household net wealth in China[2]. This means that confidence in the property market to a large extent drives the household sector's willingness to invest and consume.

China does still have a number of long-term challenges, notably the four Ds mentioned earlier, as well as on the geopolitical front. However, should we see an improvement in some of these factors, we are hopeful that this isn't just another short-lived relief rally for the market.



Visiting Shenzhen Inovance, an industrial automation company.

[2] CLSA.

Authors

Richard Farrell, CFA

Portfolio Manager

Richard is a portfolio manager on the RBC Emerging Markets Equity team at RBC GAM and is currently responsible for research in China. Prior to joining the firm in 2013, he spent three years at a major U.K. asset manager providing fundamental equity analysis in the energy and materials sectors within global emerging markets. Richard began his career in the investment industry in 2005 as an equity analyst in the mergers and acquisitions team of a large multinational bank.

Christoffer Enemaerke, CFA

Portfolio Manager

Christoffer is a portfolio manager on the RBC Emerging Markets Equity team at RBC GAM and is currently responsible for research in Latin America and Korea. During his time at RBC GAM, he has also specialised in India, China and Taiwan. Prior to joining the firm in 2013 as an investment analyst, Christoffer worked in the investment management division of a Nordic-based financial services group in Copenhagen. He started his career in the investment industry in 2010.

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