



# China's new Long March

A necessary evolution in a shifting geopolitical environment

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## Preface

On the face of it life in China is returning to some sense of normality. Since April all travel bans have been lifted for the country including the city at the epicentre of the original outbreak, Wuhan; restrictions on dining out have been relaxed and there was a surge in customers visiting restaurants. In the May golden week public holiday, the most popular travel time of the year for the nation, 115 million Chinese were on the move, according to the Ministry of Culture and Tourism.<sup>1</sup> Few ventured far, however, with most people visiting destinations within their home provinces. Travel further afield risked tourists being placed into quarantine on their return home, based on a colour-coded system from an app downloaded on to mobile phones.<sup>2</sup> While factories are operational again, many are suffering from a decline in orders due to a global demand shortage; a prominent example is Foxconn, Apple's largest supplier in the region, which reportedly asked some of its workers in Shenzhen to take extended leave from May to September.<sup>3</sup> In effect, this 'new normal' means businesses navigating new challenges amid weak global demand and restricted consumption.

The pandemic is exacerbating old challenges too. Nowhere is this more apparent than in China's increasingly fraught relationship with the U.S. whilst an underlying tension has been present for years, the fallout from COVID-19 has once again made a reappraisal of relationships a pressing necessity. After years of ideological misgivings between the world's two largest trading partners, policy-makers and Chinese corporates need to adjust swiftly as trade and geopolitical relationships falter.

Arguably the biggest challenge of all is China's own growth model. Investment-driven domestic growth does not have the same allure as it did after the last crisis in 2008: China's share of the global economy has tripled from 6% pre-global financial crisis (GFC) to 18% in 2017 while aggregate global demand is weaker.<sup>4</sup> The domestic debt burden is also much higher, with an estimated debt-to-GDP ratio of 298% at the end of 2020 compared to 154% pre-GFC, and with credit

now only half as effective as before at driving growth.<sup>5</sup> Chinese policy-makers need to work out a new investment framework to continue yielding productivity gains but without the same level of debt expansion.

Nevertheless, observing first-hand the changes being undertaken by Chinese companies and policy-makers gives us cause for optimism. In a scenario where some level of global 'decoupling' becomes inevitable, the country's domestic demand growing at 11% should provide a buffer.<sup>6</sup> On the trade front, even amongst the worst-hit export sectors, there are companies and industries that are well positioned to weather the storm. The service industry is being galvanised by the technology sector and is more vibrant and important than ever, retaining an attractive runway for the economy's future growth.

This paper will attempt to identify the four key trends that we expect will help to address these structural challenges that China faces.

First, companies are actively moving capacity abroad to reduce costs and stay close to the end consumer. Second, those that are able to move up the value chain are better placed to weather the storm, however some are still vulnerable. Meanwhile, growth can still be generated domestically from the most mundane traditional industries, such as logistics and real estate. Finally, the Chinese government is ready and willing to redirect its investment into targeted areas for the next phase of growth, as it did a decade ago. We will then look at how these changes affect investing in China. Whilst economic growth will be lower in future, from low double digit growth rates early in the past decade to mid-to-single digit in the next few years, the outlook for Chinese equity returns need not follow a similar path.<sup>7</sup> In fact, structural market changes could see returns increase in certain sectors, even as the overall growth slows, but the benefits will be unevenly distributed, making a selective investment approach particularly important.

<sup>1</sup> <http://www.chinanews.com/gn/2020/05-06/9176040.shtml>, <sup>2</sup> [https://k.sina.cn/article\\_1655444627\\_62ac14930200162pg.html](https://k.sina.cn/article_1655444627_62ac14930200162pg.html),

<sup>3</sup> [https://k.sina.cn/article\\_6897591804\\_19b20e5fc00100qd8o.html?from=job](https://k.sina.cn/article_6897591804_19b20e5fc00100qd8o.html?from=job), <sup>4</sup> Measured by as % of global GDP. Source: Haver, IMF,

<sup>5</sup> Source: CEIC, UBS estimates, <sup>6</sup> UBS estimates, 2021 domestic consumption growth, <sup>7</sup> Bloomberg consensus.



## Part I: Four key trends reshaping China's economic opportunities

### The backdrop: Changing landscape of Sino-U.S. relationship

Since President Nixon's visit to China in 1972, U.S. policy hope for China could be summarised pithily as one for which greater engagement would translate to greater liberalisation, both economically and politically. Bill Clinton described China's accession to the World Trade Organization as an "historic step toward continued prosperity in America, reform in China, and peace in the world . . . it will open new doors of trade for America and new hope for change in China."<sup>8</sup> In the 20 years since its accession, Chinese exports grew at a compound annual growth rate (CAGR) of 12.9%, far outstripping the growth in global trade (a CAGR of 5.8%), and U.S. foreign direct investment in China surged.<sup>9</sup>

However, over time, America's public attitude to China has shifted, as not all have benefitted from rising globalisation. In 2006, only 29% of U.S. respondents to a Pew Research poll said they had an unfavourable opinion of China (Exhibit 1).<sup>10</sup> In the aftermath of the GFC, a loss of blue collar manufacturing jobs and rising inequality have fuelled populism and growing resentment. At the same time, U.S. policy-makers have been dismayed by the lack of change in China's political landscape and this has resulted in a hardening of attitudes towards China. Donald Trump's election in 2016 then marked the largest shift in U.S. trade policy in decades, advocating for a fundamental shake-up of the world trading order from which China had benefitted. In 2020, the same Pew survey registers a 66% unfavourable rating, more than double the 2006 level.

Attitudes are also shifting in China, particularly over the last two years, which suggests a deepening ideological divide between the two countries. In a survey carried out by the Eurasia Group Foundation, 58% of Chinese respondents in 2018 said they had a positive view of the U.S., dropping to 39% by 2019.<sup>11</sup> This has been driven primarily by more negative systemic views on the inefficiencies of liberal democracy and the corruption of the system by vested interests such as lobbyists. Whether this is driven by propaganda is moot; the U.S. Congress passing the Hong Kong Human Rights and Democracy Act with near-unanimous support of late has further contributed to this nationalistic shift within China, perhaps even more than the trade war. The view that the U.S. and China are falling into a Thucydides' trap, where a 'war' between a rising global power and an existing one simply cannot be avoided, is also gaining popularity.<sup>12</sup>

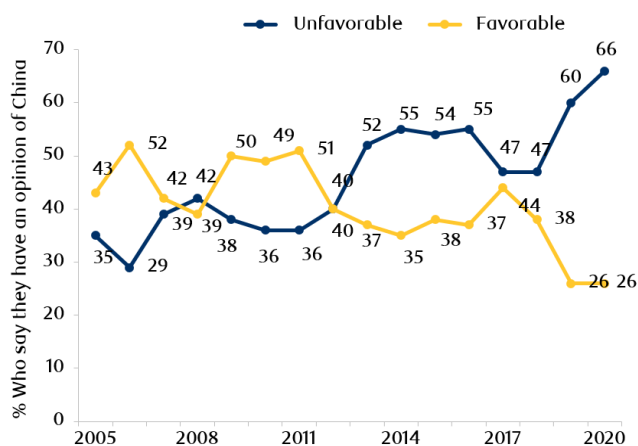
As the divide deepens, companies need to adjust.

### Trend 1: Corporate distancing - moving capacity offshore

For all the damage that the rounds of tariff hikes did to China's exports (which were -10% year-on-year in 2018 and -1% year-on-year in 2019), many companies had already begun the process of diversifying manufacturing outside of China. Capacity offshoring started a decade ago, either to reduce costs or to diversify risks. In a survey of more than 200 Chinese export-orientated companies, carried out by UBS at the end of 2019, over 50% of the companies that have direct exports to the U.S. responded that they had already moved some capacity outside of China.<sup>13</sup>

Even within some of the industries hardest hit by the trade war, such as the apparel & textile industry, companies with a diversified production base have actually fared quite well. In 2019, export growth for the apparel & textile industry fell 2% for the first time since the GFC.<sup>14</sup> However, the largest apparel supplier globally for three of the largest sportswear brands recorded 12% year-on-year earnings growth in 2019.<sup>15</sup> The company had started shifting production away from China as early as 2005 in order to mitigate rising domestic wages. Today it has around 35% of its manufacturing capacity located outside of China, mainly in lower cost countries such as Vietnam, and Indonesia, among others.<sup>16</sup> Despite the capacity migration, the company has been able to maintain an impressive return on equity (ROE) of over 20% since 2016.

**Exhibit 1: Negative views of China continue to grow in the U.S.**



Source: Pew Research: Survey of U.S. adults conducted 3-29 March, 2020 Q5b.

<sup>8</sup> <https://archive.nytimes.com/www.nytimes.com/library/world/asia/052500clinton-trade-text.html>, <sup>9</sup> World Bank, IMF. <sup>10</sup> U.S. Views of China Increasingly Negative Amid Coronavirus Outbreak. <https://www.pewresearch.org/global/2020/04/21/u-s-views-of-china-increasingly-negative-amid-coronavirus-outbreak/>, <sup>11</sup> EGF World opinion survey. <https://egfound.org/stories/independent-america/worlds-apart>, <sup>12</sup> Thucydides (c.460 – c.400 BC) was an Athenian historian and general. Known as the father of the school of political realism and by his famous work on Athens-Sparta war, he once wrote: "It was the rise of Athens and the fear that this instilled in Sparta that made war inevitable." <sup>13</sup> UBS Evidence Lab survey. <sup>14</sup> <http://info.texnet.com.cn/detail-799718.html>, <sup>15</sup> CICC estimates. <sup>16</sup> Shenzhen International 2019 annual results presentation, Macquarie estimates

While some companies have moved to reduce costs, others have done so to get closer to their customers. A Chinese auto glass manufacturer, for example, started moving production straight to the U.S. in 2015 and now has 20% of its production base there.<sup>17</sup> While the early move was not without its cultural clashes, something laid bare in the Netflix documentary 'American Factory', the company now has the largest market share (28%) globally in its product segment,<sup>18</sup> and the relocation has undoubtedly helped to limit damage during the trade war.

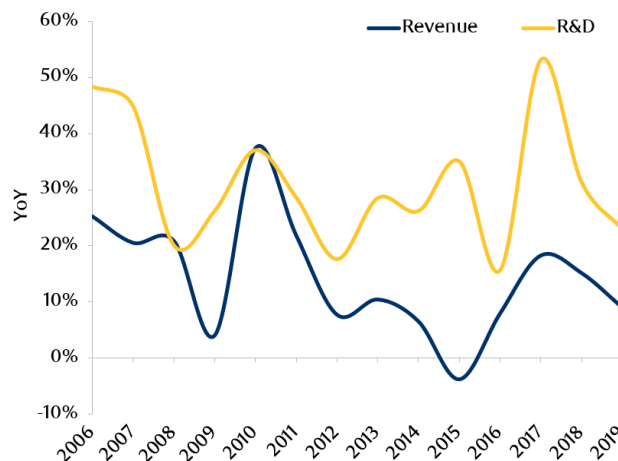
While it is clear that Trump's initiatives to drive investment in the U.S. have been aimed primarily at U.S. multinationals, companies that have already moved production to the U.S. would also surely have been a target to manufacture locally for the U.S. market. Unfortunately the aggressive rhetoric has not helped to encourage Chinese companies to shift their capacity to the U.S., and since 2018 its appeal has dropped sharply. A UBS annual survey of the export-heavy manufacturers (Exhibit 2) shows that before the trade war, the U.S. was amongst the most popular destinations for Chinese companies with 26% of respondents wanting to move there; by September 2019, however, the number had fallen to just 8% of companies, with the U.S. among the least popular of all destinations.<sup>19</sup>

**Trend 2: Moving up the value chain - easier said than done**

One way for companies to remain competitive in a decoupling of global supply-chains is to move up the value chain, and one of the most effective ways to achieve it is through investment in research and development (R&D). Since 2009, the growth rate of R&D spending across Chinese non-bank enterprises has consistently outpaced that of their revenues, and since 2016 we have seen this trend accelerate (Exhibit 3). These R&D dollars have paid off:

those industries that have invested the most in technology and talent, such as IT and biotechnology (R&D spending over 10% of their respective revenues), have had the most success in moving up in the global value chain.<sup>20</sup>

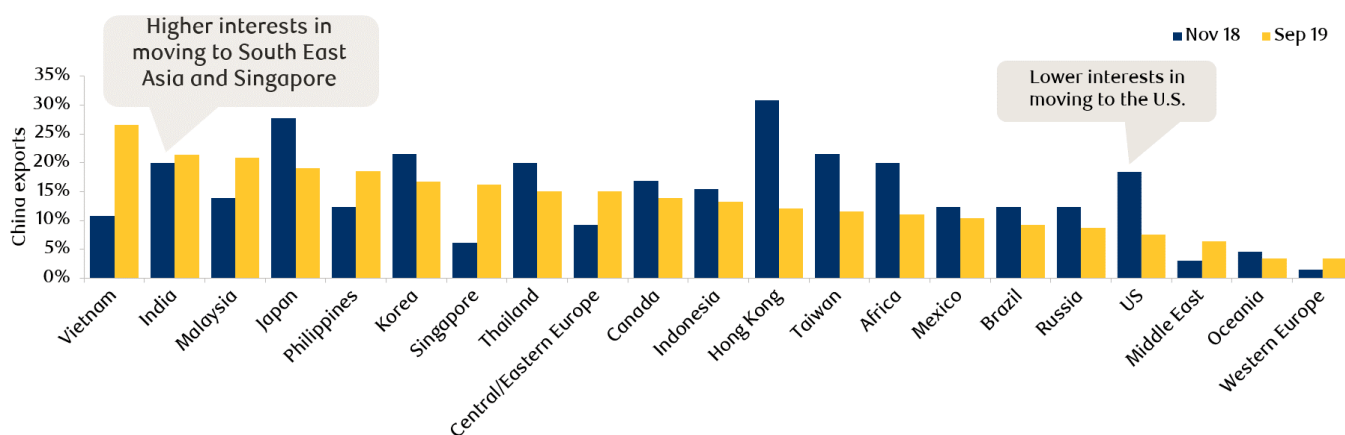
**Exhibit 3: MSCI China non-banks revenue, R&D expenses annual growth**



Source: WIND, Thomson Reuters, UBS. Data as at May 18, 2020.

However, the urgency with which Chinese tech companies need to develop has picked up pace. China's leading multinational technology company and one of its biggest mobile phone brands has shown how reliant China remains on the U.S. and other markets for advanced technologies, and the risks of not having a home-grown alternative for these companies. While R&D used to be a matter of business success, it is now becoming crucial to survival.

**Exhibit 2: Chinese exporters' shifting interests in the where to go next**



Source: UBS Evidence Lab survey, Sept 2019 & Nov 2018.

<sup>17</sup> Source: Goldman Sachs Research, IHS Global Insight, Company data. As of November 14, 2019, <sup>18</sup> UBS Evidence Lab survey

<sup>19</sup> Defined by top 10 companies by market capitalisation as of May 18, 2020. Respective company annual reports, <sup>20</sup> Bloomberg data, Huawei filling

### Hardware & semiconductor – moving up the value chain is now a necessity

2019 held much promise for the Chinese multinational technology company as it was due to launch a new flagship phone to compete directly with the iPhone X. With this phone, it would gain share in the smartphone market and, after years of technological development, the company was anticipating the launch of the world's first 5G solution globally in 2020. Things turned around quickly, however, and by May 2019 the company was added to the U.S. Entity list by executive order of President Trump, banning it from supplying the bulk of the U.S. market. A year later, the U.S. Department of Commerce has effectively cut off the company from the semiconductor market. To strike at such a company was to strike at the heart of China's technological advancement in recent decades: the company went from an assembler of simple phone switches in 1987 to become one of the most advanced 5G technology leaders globally.

The company's success stemmed in large part from its sizeable research spending. In 2018, its R&D expenditure was US\$15.3 billion, surpassing that of other market giants.<sup>21</sup> On the other hand, its Achilles' heel has been semiconductor chips which are crucial to both its smartphone products and telecoms business. This has been a difficult area for Chinese companies to penetrate. The learning curve in the tech hardware space is steep but semiconductors is particularly difficult: it took South Korea 30 years to become the world's second largest semiconductor producer with the help of some strategic M&A during the GFC.<sup>22</sup> As Trump has intensified sanctions on one of its biggest the companies, which effectively block its access to the most advanced chips, China probably doesn't have that sort of time.

At this point it is difficult to predict how the U.S. sanctions will affect the handful of Chinese telecom companies that are on the list. For the broader Chinese corporate community, the message is clear: fully penetrating the value chain is critical to ensuring long-term survival.

### Chinese biotech – from imitator to innovator

Biotech companies in China are still well behind their global peers in terms of early stage research capability, such as mechanism discovery or new target identification, but the gap is narrowing rapidly. Today China is already the world's second largest pharmaceutical market after the U.S. Once known for primarily producing copycat drugs, the industry has transformed into an innovator and 'fast-follower' (a company quickly adopts the strategy of its competitors wherever legal conditions allow).<sup>23</sup> Between 2014 and 2018, Chinese pharmaceutical R&D expenditure grew at a CAGR of

10% compared to 4% globally.<sup>24</sup> In the fight against COVID-19 Chinese firms have demonstrated their strength with as many as three companies, after fast track approvals, entering the clinical trials stage for their vaccine candidates within just three months.

Interestingly, regulators are actually helping foster innovation in the healthcare space. For years Chinese pharmaceutical companies were shielded by high margin generic drugs, lazily co-existing with global pharmaceutical companies that had the lion's share of sales thanks to their stronger drug offering in key therapeutic areas such as oncology, cardiovascular and diabetes. In recent years, however, as the Chinese regulator tightened quality standards, aggressively cut prices for generics, sped up approvals for new drugs by global companies and increased healthcare coverage for innovative drugs, Chinese companies were forced to improve and enrich their research pipelines in order to meet foreign competition. This has proven to be particularly beneficial for the rising Chinese biotechnology sector. In just 10 years, Chinese biotech sector has demonstrated a Cambrian explosion type of progress and becomes the world's second largest next to the U.S.<sup>25</sup> As the biotech sector in China blossoms, investor interest in the space is growing rapidly. Since the Hong Kong Exchange listing rules changed in 2018, allowing still unprofitable companies to IPO, 18 Chinese biotech companies were listed in the following 16 months,<sup>26</sup> and the sector-tracking index outperformed the Hang Seng Index by over 30% since its first launch in December 2019.<sup>27/28</sup>

In some areas of the healthcare space, Chinese companies grow quickly enough to compete with global leaders head to head. CDMO (Contract Development and Manufacturing Organisation) helps big pharmaceutical companies, as well as small biotech firms, to develop and manufacture drugs that are either not their speciality or are economically less efficient if manufactured in-house. It is an industry that is heavily reliant on research capability and scale. The CDMO industry in China has seen revenue increase dramatically in the past few years thanks to an overall surge in interest in new drug development, both in China and globally. China's largest biologics CDMO has built one of the world's largest research teams and it is now the third largest CDMO in the world by revenue. It has also forged long-term partnerships with other large global pharmaceutical companies. Currently, roughly 65% of revenue for China's largest CDMO is from overseas. Other CDMO companies, that focus on small molecules or those that are leaders in the, clinical research space, have all seen revenue CAGR of 25%-30% in the past three years.<sup>29</sup>

<sup>21</sup> Source: m.investkorea.org, <sup>22</sup> Chinese biotech: from copycat to innovator <https://www.ft.com/content/03812ddf-84a3-4540-9850-9a33cfe637d0>

<sup>23</sup> Source: EvaluatePharma, Macquarie Research, May 6, 2020, <sup>24</sup> Source: Nature, <https://www.nature.com/articles/s41587-019-0316-7>

<sup>25</sup> Source: Hong Kong Exchange, <sup>26</sup> Source: Bloomberg, Data as at June 4, 2020, <sup>27</sup> Source: Wuxi 2019 annual results presentation, <sup>28</sup> Source: Bloomberg,

<sup>29</sup> Source: The collective R&D spending of the top 100 domestic internet giants reached 153.87 billion yuan (\$21.86 billion) in 2018, up 45% year-on-year, according to the report released by the Internet Society of China and an information center affiliated with the Ministry of Industry and Information Technology.

### Chinese internet – the R&D titans

Few other sectors have seen the same commitment to R&D as the Chinese internet giants, and in this space cash burn can last for up to a decade before businesses start to see profit. However this is not holding them back. R&D spending of the top 100 Chinese internet companies was up 45% year-on-year in 2018, accounting for 10% of revenues and transforming some companies into global leaders.<sup>30</sup> China's two internet giants are well established in their own fields but they are newbies in the cloud computing space compared to their global peers. After a decade of intensive investment, however, the two are now among the top 10 globally in terms of market share. Less of a household name is the owner of the short video app that was launched in late 2016 and has since taken the U.S. by storm and has 800 million monthly active users worldwide now.<sup>31</sup> The company appointed Kevin Mayer, Disney's former Head of Streaming, its CEO, clearly underlining its ambitions with a potentially lucrative IPO on the cards for its parent company.

From R&D-driven hardware manufacturers to cutting-edge biotech firms, to internet titans, Chinese companies are increasingly emerging as strong global contenders with attractive growth profiles. Not surprisingly, a lot of their success comes with strong and long-term relationships with their global partners, most of which should continue even in a decoupling environment. For some sectors, however, such as semiconductors, de-globalisation requires businesses to be more aggressive in their R&D and more agile in their business strategies.

### Trend 3: Driving new avenues of growth from traditional industries

Policy-makers have been clear about their goal to redirect China's growth drivers, moving away from investment and towards consumption. One of the strongest enablers of this trend has turned out to be China's internet companies. Much like the FAANG stocks in the U.S., China has its own handy acronym for a group of stocks, BAT. These companies have been spearheading the digitalisation of information, commerce, and social interaction in China over the past decade and they have also provided platforms for hundreds of thousands of small and medium-sized enterprises (SMEs). E-commerce has grown to 24% of China's total retail sales in 2019 from 12% in 2014, and China accounts for 45% of the world's online transactions currently.<sup>32</sup> Notably, a lot of the first wave of digitalisation took place on smartphones, and nationwide 3G coverage in 2010 was a key enabler of the smartphone economy. As such, the government's enthusiasm for rolling out 5G is not just something to showcase China's growing global prowess in technology, it is also a catalyst through which it hopes to drive a second boost in productivity.

<sup>30</sup> Source: <https://wallaroomedia.com/blog/social-media/tiktok-statistics/>

<sup>31</sup> CEIC data, online goods sales/overall goods sales. Also see: McKinsey: Global Payments Report 2019: Amid sustained growth, accelerating challenges demand bold actions <https://www.mckinsey.com/-/media/mckinsey/industries/financial%20services/our%20insights/tracking%20the%20sources%20of%20robust%20payments%20growth%20mckinsey%20global%20payments%20map/global-payments-report-2019-amid-sustained-growth-vf.ashx>

<sup>32</sup> McKinsey: How Chinese consumers are changing shopping habits in response to COVID-19 <https://www.mckinsey.com/featured-insights/asia-pacific/how-chinese-consumers-are-changing-shopping-habits-in-response-to-covid-19>, <sup>33</sup> Source: China Qianzhan Industry Research Institute, <sup>34</sup> Source: Bloomberg

In the next 10 years the digitalisation of services is likely to become more ubiquitous: from holiday bookings and job searches, to ordering a quick meal or hailing a taxi, applying for a supplier loan or advertising a product. The coronavirus pandemic has accelerated the digitalisation of service: 74% of respondents to a McKinsey COVID-19 China survey said that they have increased online groceries shopping due to the pandemic, and 15% reported that they will shop online even more frequently after its peak has passed.<sup>33</sup> All of these ongoing trends have offered scope for investors to benefit handsomely from China's rapid pace of reform and innovation.

### New forms of off-line services are growing too

A changing economy is also creating new service industries. International logistics companies have been operating in China since the 1980s and over the past decade China's logistics market has become the world's largest. Domestically-focused firms have grown even more quickly. Within the logistics industry, delivery services have grown at an exceptional speed, thanks to the booming e-commerce market. Since 2016, the industry growth has moderated from 48% year-on-year to 20%-30%.<sup>34</sup> Meanwhile, industry consolidation is gradually taking place and leading participants started to outperform industry growth. In a sector where scale makes a big difference, we expect further market consolidation to eventually enable leaders to enjoy higher growth with better margins (Exhibit 4).

**Exhibit 4: Express delivery industry revenue size & growth rate vs top 5 companies**



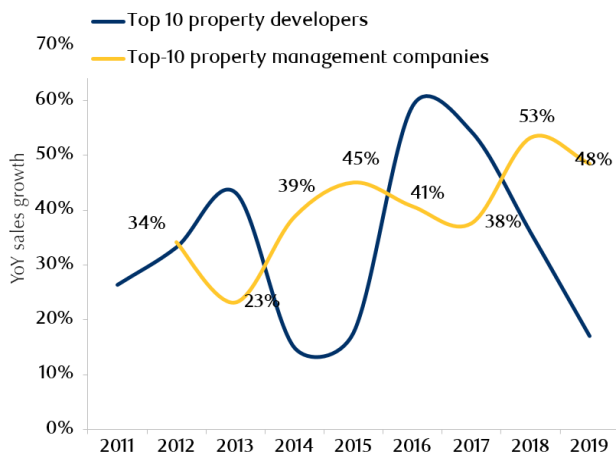
Source: CEIC, company data, Bloomberg, RBC Global Asset Management. Data as at December, 2019.

Likewise, the property management industry may be common in developed markets but it is only in the last decade that the sector has really emerged in China.



The first Chinese property management company was publicly listed in mid-2014 and since then more than a dozen have been listed with more to come.<sup>35</sup> Chinese property developers have benefitted enormously from years of booming house prices and the top 10 Chinese property developers have aggregate sales of Rmb4.5 trillion, which is a ten-fold increase since 2009 (Exhibit 5). However, policy-makers are no longer willing to support the already hefty property prices: “houses are for living in, not for speculation” has been a regular government refrain in the past two years.<sup>36</sup> While the property market could be reaching a peak, the property services industry is just picking up. In 2020, the top five property management companies have an aggregate market cap of US\$32 billion, up from just US\$2.5 billion in 2016.<sup>37</sup> While property developers focus on new home sales, property managers focus on both new and existing builds, thereby reducing cyclicality. Given the enormous growth in the Chinese property market in the past two decades, the addressable market for property managers can be quite immense.

**Exhibit 5: Property managers feature high growth and low cyclicality**



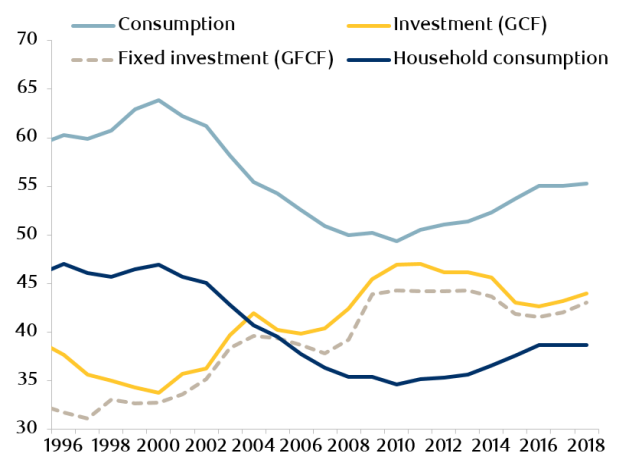
Source: Company annual reports, prospectus, Bloomberg, RBC Global Assets management. Data as at May 18, 2020.

#### Trend 4: The visible hand is still on the steering wheel

Few countries lay out their policy priorities with as much fanfare as China. Since its first Five Year Plan (FYP) in 1953-1957 right up to the present day, the Chinese Communist Party has implemented thirteen consecutive FYPs. These plans are top-down policy guidelines covering key parts of society and the economy, comprising a series of medium-term targets and ways to achieve those targets. Despite the bureaucratic undertones, reading between the lines of the messaging can give a good sense of the key areas

of focus for policy-makers and where businesses can expect to see the ‘visible hand’ of government. The 11th FYP (2006-2011) first emphasised urbanisation as a key focus area and, subsequently, the rate of urbanisation picked up significantly; in 2006, China’s urbanised area accounted for 43% of total while today the level has reached 60%, corresponding with a sharp increase in wealth per capita.<sup>38</sup> The last wave of urbanisation has been a key source of China’s productivity growth, equipping the country with a massive mobile workforce, increasing household income, and lowering unemployment (Exhibit 6).

**Exhibit 6: Share of China’s nominal GDP (%)**



Source: CEIC, China Bureau of statistics, UBS. Data as at May 18, 2020.

The benefits of China’s growth have not been distributed equally however. As at 2019, GDP per capita for the few mega cities are three times that of the less urbanised northern and western regions.<sup>39</sup> This is prompting a shift in investment focus over the coming decades. The first wave of urbanisation between 2006 and 2015 consisted mainly of fixed asset investment (FAI as a percentage of GDP increased from 40% in 2006 to 48% in 2010) and benefitted the mega cities and coastal areas the most. The next wave will focus on distributing the gains of China’s growth more evenly.<sup>40</sup>

In order to achieve these goals, the government will need to use a new set of policy tools. China’s ‘Urbanisation 2.0’ programme will consist of a multi-faceted approach, including both bottom-up and top-down measures (Exhibit 7). It will target larger city clusters with higher inter-connectivity, and join mega-cities by streamlining the governance structures into one single structure, thereby triggering even greater productivity gains and innovations.

<sup>35</sup> Source: <http://www.guandian.cn/m/show/236167>, <sup>36</sup> Data as of May 21, 2020, <sup>37</sup> Source: WDI, Haver, UBS, <sup>38</sup> Source: CEIC, <sup>39</sup> Source: CEIC, UBS

<sup>40</sup> Morgan Stanley Research: The Rise of China’s Super cities: New Era of Urbanization

## Exhibit 7: Urbanisation changes

	Urbanisation 1.0	Urbanisation 2.0
Reforms	Housing reform	Hukou reform. Land reform
Infrastructure	Physical (roads, railways, highways)	Digital (5G, IOT, video analytics, cloud, AI etc)
TMT disruption	Consumer internet	Industrial internet
Transportation	Autos(ICE), trains	EV, shared mobility, high speed commuter trains
Utility	Thermal-based power	Decarbonisation
Healthcare	Establish basic healthcare	Improve healthcare access through tech
Consumption	Baby boomers, physical necessities	Post Millennials, trading up and experience
Financial services	Financing to fuel infra spending	Better capital allocation and risk control
New urban jobs	Lower value-add manufacturing, construction	Higher value-add manufacturing, services

Source: Morgan Stanley Research: The Rise of China's Super Cities: New Era of Urbanisation. Data as at October 10, 2019.

The combined capex for Urbanisation 2.0 will be less than that of its predecessor, Urbanisation 1.0. Spending on digital infrastructure, high-speed rail and the smart power grid – the three key components of the smart super city buildout - will be less than US\$200bn p.a. between 2019 and 2030, only approximately 10% of China's annual infrastructure FAI over the past five years.<sup>41</sup> The mechanisms to fund these projects are also changing. Policy-makers are attempting to fund via more transparent measures, thereby limiting inefficient investments.

One 2015 OECD study on urbanisation pointed out that, on average, a 2%-5% increase in productivity can be achieved

for every doubling of population size.<sup>42</sup> If population size drives productivity as the paper says, China is already ahead in terms of set-up. The top five key city clusters already have an average population of 109 million. Morgan Stanley Research estimates that the average population size per cluster will reach 120 million by 2030 (vs. 109 million in 2020), close to Japan's current population of 127 million. Each one of these clusters is five-to-six times the size of New York City.

<sup>41</sup> The Metropolitan Century, 2015, <sup>42</sup> ROE of Chinese SOE in CSI 300 tallies a 8% (including financials) while private sector ROE is around 14%





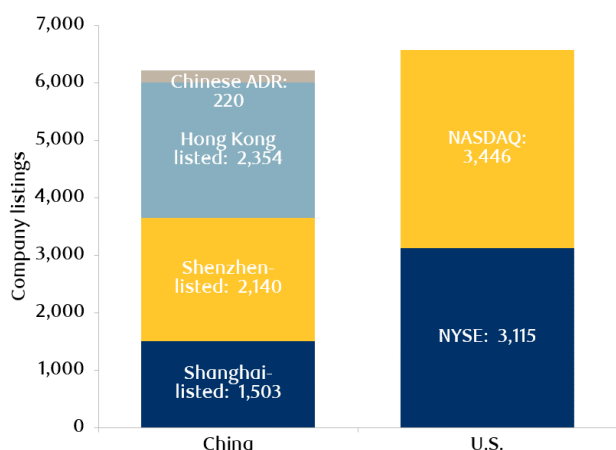
## Part II. China as an asset class

It is inevitable that Chinese GDP will slow, however history has shown that GDP growth rates have little correlation to stock market performance over the longer term, and changing market dynamics are making Chinese equity opportunities look attractive. The depth of the Chinese equity market alone means that there are significant bottom-up opportunities while the globalisation of the investor base, together with market reforms, could provide a boost to top-down returns. Being selective and carrying out in-depth due diligence is key to navigating the market, but the scope of investment opportunities is just too big to ignore.

### Too big to ignore

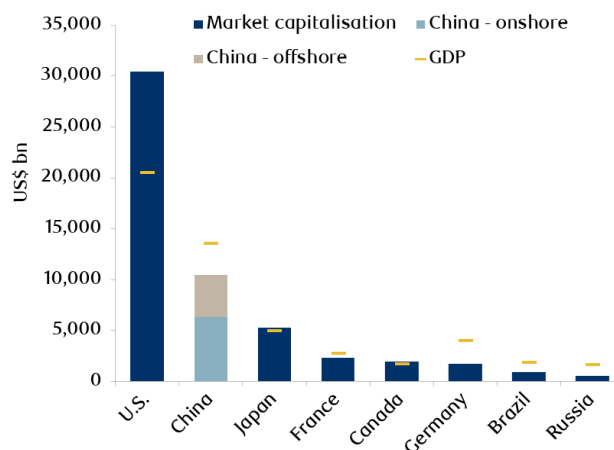
China is already the world's second largest economy at two-thirds the size of the U.S., with over four times the population, yet it is still enjoying the growth rates of an emerging market. The universe of listed Chinese companies is almost as large as that of the U.S. and its combined market capitalisation is already the second largest in the world (Exhibits 8 and 9). The sheer size of the Chinese economy and its equity market gives investors access to an immense opportunity set with market depth and liquidity.

**Exhibit 8: Number of listed companies in China vs the U.S.**



Source: RBC Global Asset Management. Data as at December 2019.

**Exhibit 9: Market capitalisation and GDP by country**



Source: Bloomberg, UBS. Data as at September 30, 2019.

## Privately-owned companies with strong earnings growth will drive market performance

Historically, Chinese equity indices tended to be heavily skewed towards state-owned enterprises (SOEs) that typically have lower returns and less dynamic growth profiles than their privately-owned peers; the ROE gap between SOEs and private companies has widened from 4.5% in 2010 to 6% in 2019.<sup>43</sup> Equity indices are finally starting to reflect this. In 2020, five of the top 10 MSCI China Index constituents are private companies compared with all 10 being SOEs back in 2008 (Exhibit 10).

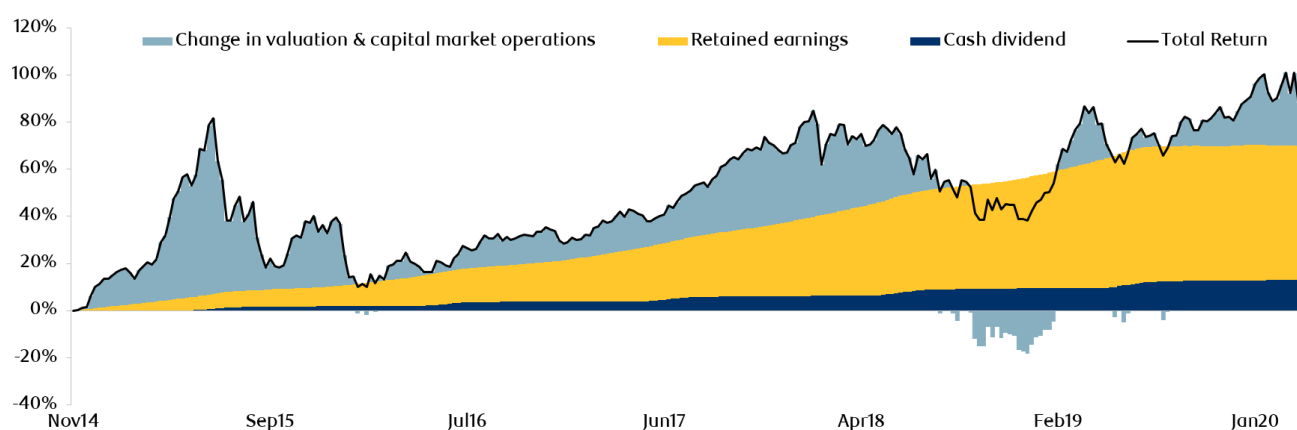
Over the past five years, the entire Chinese equity market (including both onshore and offshore markets) has mapped an accumulative return of 80% as of March 2020 (CAGR of 12.5%), most of which is derived from retained earnings growth (Exhibit 11). Looking ahead, sell-side consensus estimates point to a sharp increase from 6% to 9% (as of May 2020) in the aggregate economic return (CFROI) on 1086 Chinese private companies over the next two years.<sup>44</sup>

### Exhibit 10: The change in MSCI China's top 10 constituents

Company	GICS Sector	SOE/Private	Company	GICS Sector	SOE/Private
End 2008			April 2020		
China Mobile	Communication	Central SOE	Alibaba	Consumer Disc.	Private
ICBC-H	Financials	Central SOE	Tencent	Communication	Private
China Life-H	Financials	Central SOE	CCB-H	Financials	Central SOE
PetroChina-H	Energy	Central SOE	Pingan Insurance-H	Financials	Private
CCB-H	Financials	Central SOE	China mobile	Communication	Central SOE
CNOOC	Energy	Central SOE	ICBC Bank	Financials	Central SOE
Sinopec-H	Energy	Central SOE	Baidu	Communication	Private
Bank of China-H	Financials	Central SOE	Bank of China-H	Financials	Central SOE
China Unicom	Communication	Central SOE	JD.com	Consumer Disc.	Private
China Shenhua-H	Energy	Central SOE	CNOOC	Energy	Central SOE

Source: Bloomberg, UBS. Data as at March 24, 2020.

### Exhibit 11: Five-year performance of the Chinese equity market mainly driven by earnings increase



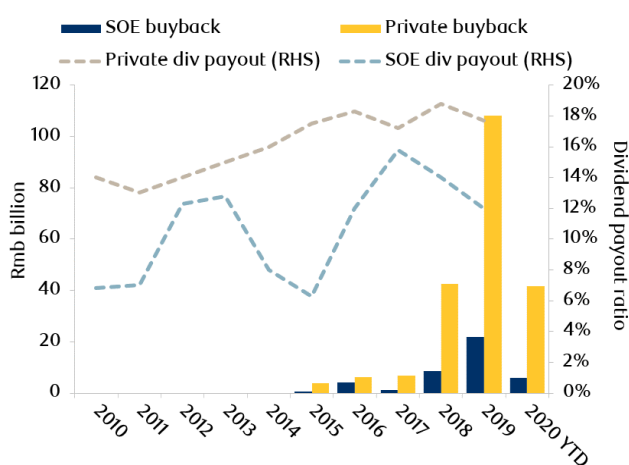
Source: WIND, CITIC Research. Data as at Mar 25, 2020.

<sup>43</sup> Credit Suisse HOLT. <sup>44</sup> Source: MSCI

### Chinese markets are becoming more interactive with investors' opinions better valued

In the past, investors were concerned about finding good investments in China because the market wasn't as open, company disclosures were often insufficient and, broadly speaking, governance was an issue. There are signs, however, that companies are becoming more transparent and more focused on investor returns. The aggregate dividend payout ratio has increased gradually in the past five years and company buybacks are also on the rise, particularly in the private sector (Exhibit 12).

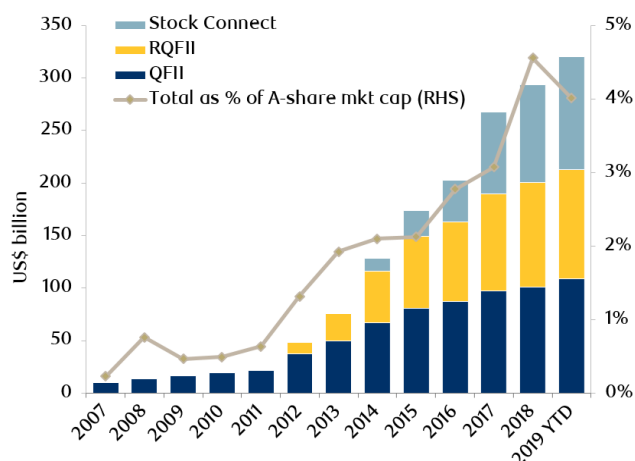
**Exhibit 12: Chinese onshore-listed companies' buybacks & dividends payout**



Source: CEIC, BofA Research. Data as at May 18, 2020.

A closed capital account and lack of fungibility have been an issue when investing in Chinese onshore equities. Before 2009, few foreign funds had the so-called Qualified Foreign Institutional Investors (QFII) licence which allowed them to access the Chinese onshore market (A-shares). The number of licences only increased marginally each year because foreign investors were subject to a cumbersome application process. There was also a set quota of how much, in aggregate, foreign investors could buy each year, as well as other restrictive foreign ownership rules. In 2012 and 2014, two different schemes, RQFII and Stock Connect, were introduced to allow better access to the onshore market. In 2020, the Chinese central bank completely removed the cap on foreign ownership through QFII in the onshore market, further increasing market accessibility. Albeit still small, the foreign participation in the onshore market has been growing at a fast pace (Exhibit 13).

**Exhibit 13: Offshore investors' participation in A-shares**



Source: WIND, UBS. Data as at September 30, 2019.

Foreign investors are also adding to the pressure on companies to improve returns and oversight; for instance, a recent accounting scandal surrounding a Chinese coffee house chain was uncovered by foreign investors. The overall environmental, social and governance (ESG) profile of Chinese companies, whilst still substantially lagging western economy standards, has improved over time and, although it may be early days, we believe that the influence of foreign investors on ethical investment is seeing some green shoots in the Chinese market. The Hong Kong Stock Exchange made the first move in early 2020, when it required all listed companies to outline their boards' consideration of ESG risks, and how it determines which ESG matters are material to the business. Following plans announced by the Chinese regulator, CSRC, the two Chinese onshore stock exchanges - Shanghai and Shenzhen - are expected to follow suit and require all issuers to increase ESG disclosures.

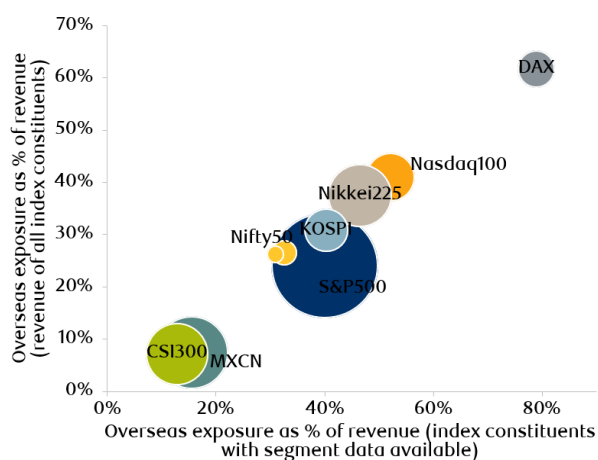


### Chinese equities offer good asset diversification

Among major markets, onshore Chinese equities have the lowest correlation with global equities. Even during the March 2020 sell-off when many global equity market correlations increased above 90%, China A-Share correlation remained significantly lower at 56%. We believe that being less correlated with other equity markets makes Chinese equities an attractive diversification tool for global asset allocators (Exhibits 17 and 18).

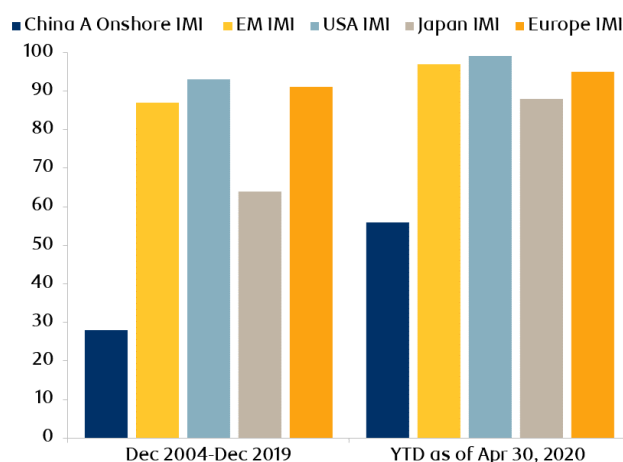
As we head into the latter half of 2020, the challenges facing China will garner increased airtime as it is likely that the trade war will intensify as we approach the November U.S. presidential election and the world continues to battle with the consequences of COVID-19. At the same time, Chinese policy-makers need to slow the build-up of debt while implementing the necessary investment to sustain long-term productivity growth. However, it is the many changes that we are witnessing – both structural and transformational – in Chinese companies and markets, that gives us the confidence to invest in China for the long run.

Exhibit 14: Global indices overseas exposure



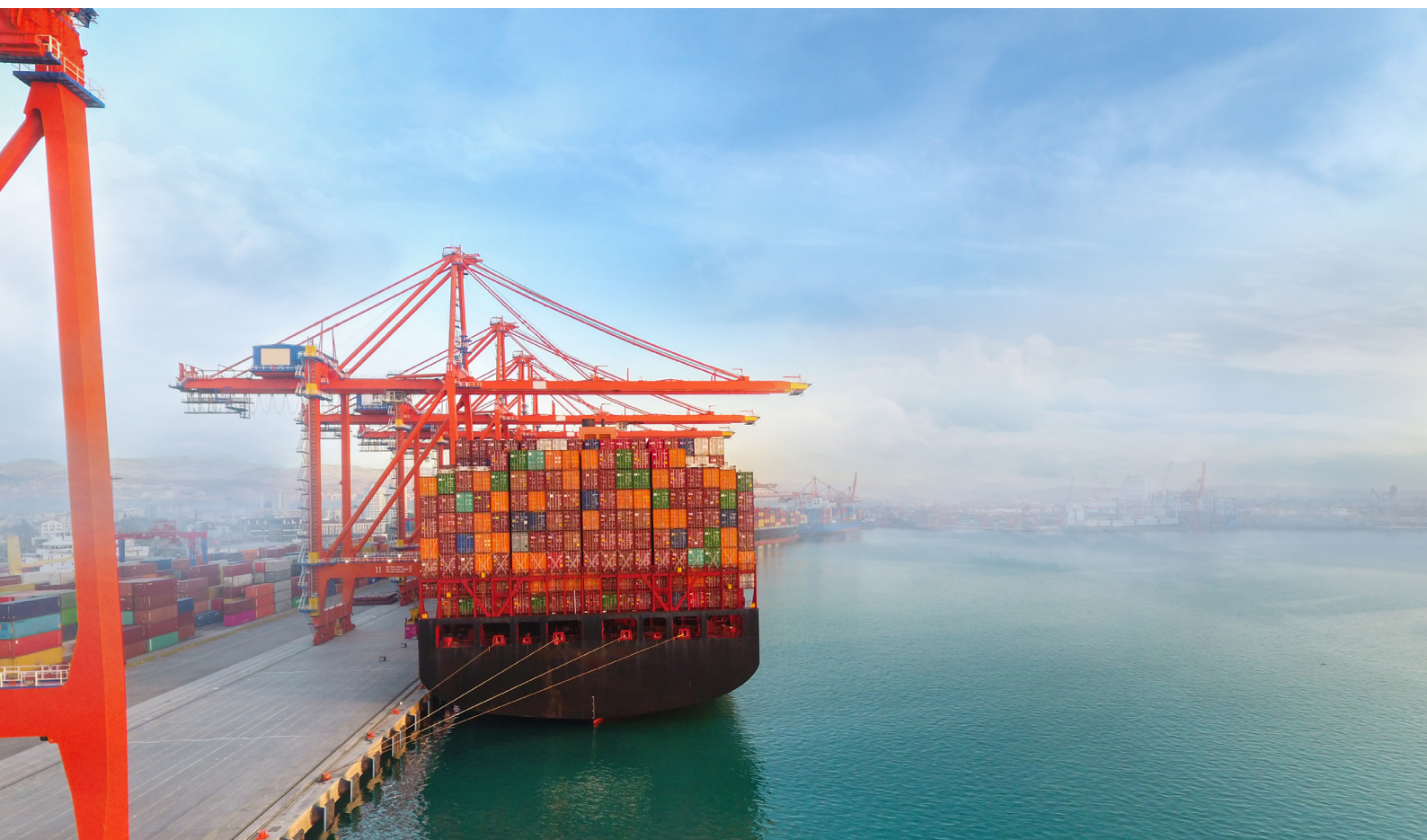
Source: CEIC, UBS. Data as at March 24, 2020.

Exhibit 15: % Year correlation vs MSCI World (weekly returns)



Source: MSCI. Data as at April 30, 2020.

<sup>45</sup> Source: MSCI.



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Publication date: (06.18.20)

