Investing in China: Tapping into Long-Term Opportunities

While the trade dispute between the U.S. and China continues to dominate the headlines, and its recent slowdown in economic growth has raised some concerns, institutional investors should be looking closely at opportunities to invest in Chinese equities for longer-term diversification and alpha, according to this *Pensions & Investments'* roundtable panel of experts. Demographics and structural shifts in China's economy underpin excellent growth prospects in many sectors, including consumption-related services, technology and more. In this discussion, Ghadir Cooper, global head of equities at Barings; Jun Li, chief investment officer at Sagard China; and Anik Sen, global head of equities at PineBridge Investments, offer insights from their long experience actively investing in China to highlight fascinating trends and share some of the sectors and companies they are invested in.

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Pensions & Investments: **A year into the tariff war between the U.S. and China, there's continued whipsawing in trade resolution talks. What are some of the major risks in China that institutional investors should pay attention to?**

ANIK SEN: Obviously, 2018 was fraught with the tit-for-tat trade war. While there are signs that real progress has been made in reaching a framework for a resolution, a wrench appears to have been thrown in the works during recent negotiations. Our assessment of official commentary is that the gap on trade issues purely may not be as wide as some think, but there may be strategic and geopolitical factors that are muddying the waters. Plus, the market has yet to know the details of what's being agreed [upon]. We've had some indication that U.S. goods will be allowed freer access into China. But the areas investors will be looking to focus on are intellectual property protection, market access and, more importantly, enforcement of those agreements. The devil will be in the details.

JUN LI: Investors should be aware that China and the U.S. are in a very competitive environment, especially in terms of technology and manufacturing, where China is pursuing its Made in China 2025 plan. While the Chinese economy has been growing very fast for the past 15 years, there is a gradual slowdown. That is something that we already anticipated due to the structural changes of China's transition from being less reliant on exports and manufacturing growth and more on consumption, innovation and technology. Although it's to the mutual benefit of both countries to reach a trade agreement, there will always be some uncertainty there. We should really consider investment opportunities for the next three to five years, with the understanding that China and the U.S. will be in conflict on and off, whether it is technology disputes or trade disagreements. So, within that broader context, we look at how fast China is expected to

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grow and whether the U.S. can sustain its economic growth, which has been strong, especially in the past two years.

P&I: **Despite last year's slowdown in the Chinese economy, its shift to a domestic services-driven economy is driving economic growth. Looking ahead, how does this shift affect your outlook for Chinese equities?**

GHADIR COOPER: There is no denying that the trade dispute between China and the U.S. has had a detrimental impact on the Chinese economy, both in terms of confidence and in terms of foreign investment. Despite the slowdown, we believe that economic growth will continue, but potentially at a slower pace. We expect that the administration's structural goals — to transform the economy to a service-driven one, upgrade to more value-added manufacturing, clean up the environment and better utilize the country's resources — will lead to a natural slowdown in the Chinese economy and then level out at a more normalized rate.

However, if we look at the Chinese market itself, and specifically at corporates, we're very encouraged. We are seeing positive and resilient earnings momentum among companies, especially domestically oriented ones. We believe they have attractive valuations. They also benefit from policy expansion that is now taking hold and will likely help corporate earnings going forward. As domestic factors — including changes in demographics, urbanization trends and the rise of millennials — become greater growth drivers and support consumption going forward, Chinese equities look increasingly attractive to us.

SEN: Due to the tariff situation that developed last year, there was a lot of pull-forward of demand. China's exports last year grew by just shy of 10%, and due to that pull-forward of demand in 2018, export growth this year will probably be in the low- to mid-single digits. As a result, it's quite possible that second-half [gross domestic product] may be sequentially weaker than what we've seen so far this year. That really shouldn't be a surprise, but it's quite possible that the market looks at the headline GDP number and thinks, "Growth is slowing." The reality is that it's a mathematical pull-forward resulting in a technical slowdown. The on-the-ground situation definitely is more buoyant, particularly on the retail and consumption side. China is also powering ahead on very strong export data. So if the headline is weaker, investors should look at the details of what's happening on all fronts.

LI: Historically, China's GDP has been less driven by consumption, at less than 50%, compared to the U.S. economy, which is driven more than 70% by consumption. Going forward, China's economy will be driven less by the industrial [and] export sectors, and more by the fundamental drivers in consumption and related services. From a policy, demographic and infrastructure point of view, we see a lot of business opportunities in consumption and related services.

China has a very large consumption base. We have

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1.3 billion consumers; arguably, a large, very phenomenal market. Historically, there were structures in place that limited consumers from fully unleashing their potential for consumption. Today, the population is getting richer, income per capita has been growing very fast, at 7% to 8%, and Chinese consumers tend to have high savings for rainy days, medical, educational or other needs. There are structural changes that benefit consumers and underpin the opportunities we see in China.

***P&I:* Year-to-date, the Chinese stock market has rebounded since its slump last year. What fundamental factors have underpinned that rally, and do you expect to see more interest from foreign investors?**

COOPER: Shorter term, the market has rebounded from the lows seen last year, which were driven by concerns about the global economy and trade issues. Over the longer term, as discussed, we expect that fundamental changes to the economy will drive corporate earnings. China has opened its domestic equity market in very gradual stages over the past several years. Previously, qualified foreign investors faced a lot of restrictions, making it difficult to invest. More recently, we have seen the Chinese authorities clearly move to open the market further, both on the equity side and the fixed-income side. Since 2014 — with the Shanghai and Shenzhen Stock Connect links, and with the allowance of wholly owned foreign entities — China's market has become much more open, which has improved the ability of institutional investors to gain exposure to the second-largest economy in the world. In fact, Barings now has an office in Shanghai. We are looking to become, hopefully, a manager of local assets for local investors.

SEN: This rebound in the equity markets is a classic V-shape recovery. It's V-shaped because it's the removal of a negative, it's not necessarily embracing a positive. The positive comes from fundamental demand growth. That positive in 2017 was nipped in the bud in 2018 due to new regulations taking effect at the same time in so many industries, but most critically in the provision of credit to small businesses, which is the backbone of the economy, through so-called shadow-banking. Going forward, we will start to see the positives in terms of real demand growth beginning to take over again in capital expenditures; in rising affluence leading to consumption; in the tax cuts feeding through, not just in China, but also in the U.S.; and in infrastructure investment.

We think there will be big winners and losers in China as technology creates very big changes in the competitive environment. Investors need to be very cognizant of their positioning, not just at the macro level and sector level, but at the sub-industry and stock levels, which will be much more important for the next two to three years, even five years. So the conclusion is [that] valuations are reasonable. They're not expensive and they're no longer cheap. But it is idiosyncratic, and the positioning will really matter much more.

***P&I:* The China A-Share market offers access to thousands of publicly traded companies that investors may not know about. What is your investment approach to accessing China's market, and what underpins that approach?**

LI: The inclusion of A-shares in the MSCI EMI index, China's economic growth and the fact that a lot of companies have become really sizeable and investable, even from a global investor's point of view, are all encouraging greater interest in Chinese equities. There have been qualified foreign institutional investors, [since] as early as 2003 or 2004, who have reaped the benefits of investing in China over the past 15 years. These investors, like my firm, Sagard China, have had very decent returns since 2004, and we're still optimistic about the economy going forward.

I would say that experienced investors in China are better equipped and better prepared to explore the new emerging opportunities in the A-share market. Here's one example: This month, China will open a new Shanghai Innovation Technology Board to encourage Chinese technology company listings. That is an exciting development for investors in China, and we are looking at potential listings in new areas like biological drug development, [artificial intelligence] technologies, chip manufacturing and chip equipment companies.

COOPER: We are active managers and, as such, we focus intently on identifying companies that we believe will perform well over the long term and provide attractive risk-adjusted returns for our investors. The domestic drivers for the China-A share market are very exciting to us. We talked about China becoming more driven by its service sector, and the economy being domestically led rather than just export-led. As income growth continues in China, identifying the beneficiaries of increasing urbanization and consumption is where we believe there is a real opportunity for investors. China has 415 million millennials. That is more than the entire working population of the U.S. and Western Europe combined. This group of consumers tends to be digitally savvy, confident, aware of their potential, happier about their prospects compared to their parents and outward looking. Altogether, this provides very clear tailwinds and results in opportunities for many domestic companies. It is rare to see that level of consumption anywhere other than

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> *PineBridge Investments*

in China. But the country is not without its challenges.

The working population in China peaked at one billion in 2010, and it is forecast to be 10% lower over the next 25 years. That decline in the workforce should present a strong impetus for the Chinese economy to automate. China supplies 30% of the world's robotics market, and as the economy changes, automates and allocates more money to [research and development], we will see increased value and growth drivers for companies that embrace automation and technology.

P&I: **Looking at the Chinese market today, what specific opportunities are you most excited about?**

SEN: China is an amazing demographic success story in so many ways. And the easiest way that you can see it is how China's consumption per capita increased almost exponentially over the last many years, and it continues to increase. More recently, China has moved to drive consumption spending over the next 12 months by cutting the [value-added tax], providing benefits via tax reform and even targeting stimulus in certain industries. We think the retail sector is extremely well placed right now. Valuations are only at historical mean levels, and there are a lot of very good, well-run companies that are well positioned for this demand-led recovery on the consumption side.

Another area we are likely to see a lot of interest in is the nonbanking financial sector, because the flow of investment into China is beginning to accelerate. Chinese authorities have made it relatively easier, at least compared to the past, to attract foreign capital. We think that the flow of foreign capital into China this year is going to be double last year's level. We also like the whole technology space. China had almost put [capital expenditure] spending on pause last year, with all the tariff uncertainty. With economic growth and the need for continued investment spending going forward, and China continuing to climb the value chain, we see higher-end technology spending in China on a long-term secular growth path.

We invest in many well-run companies that are not big benchmark names. We think investing in China is not best served by going through the [exchange-traded funds] because, by design, ETFs are market-cap weighted. The big market caps are in the older state-owned enterprises. The trends that we're talking about — technology and consumption-driven growth — are in the new China companies that are not heavily weighted in benchmarks or may even be off-benchmark. So we invest below the big heavyweight benchmark names because that is where we find the attractive return opportunities.

LI: Structural drivers toward unleashing consumption power are the government's move to lower income tax of its taxpayers, especially for those in lower tax brackets. A lot of different channels — e-commerce channels, shopping malls and chat rooms — are allowing people to shop at much more affordable levels. Examples are e-commerce players, like Taobao and Tmall that belong to Alibaba; and also even cheaper players, like PDD, for lower-income consumers.

We see opportunity related to the real tangible needs of Chinese consumers, which will be major growth areas in the long run. The first area is medical needs and medical services to serve China's rapidly aging population. Second, education is a big area of focus for Chinese families. So, K-12 education-service providers and all the related businesses will continue to see big demand. Other areas of opportunity are real estate services for homeowners, industrial and related services for businesses and the very large [information technology] services products and companies.

Two names that we like are Yili, the largest dairy business in China. This is an A-share, large mid-cap company, with a market cap of 180 billion RMB (US$26.1 billion), that provides dairy products, milk powder, yogurt and related products. It has a very well-developed distribution network with penetration into the Tier 2, Tier 3 and Tier 4 cities and well into rural areas. In the health-care space, we see opportunity in Hengrui Medicine, a large-cap company with one of the strongest pipelines in drug development. It has large growth opportunities in oncology and innovative drugs that are in huge demand, and it is also getting into the biopharma segments.

COOPER: We see five or six big opportunities in attractive sectors in China. The first is the internet, where penetration in China is now over 50% and at the tipping point of being able to deliver a host of services to consumers: retail, entertainment and

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gaming, and so on; if you look just at Chinese online retail sales, they've already surpassed the rest of the world.

The second opportunity is automation. In response to the peaking workforce and rising wage costs, companies in China have continued to embrace automation. That should improve productivity, expand profit margins, increase earnings and reduce labor costs. The third opportunity is the cleaner environment and resource maximization in China, which loses 1.6 million people every year to premature death because of the poor air quality. Structural changes are occurring in the economy — implementing electronic vehicles, closing old pollution-emitting industries, etc. — that offer the positive potential of reducing environmental damage.

Then there's the opportunity in consumption, which is the one everyone talks about. For example, China's sportswear sales, as a percentage of total athletic footwear sales, are very low compared to other emerging or developed economies, and we see significant potential there, as people are increasingly health conscious and exercise more. Another sector where we find attractive opportunities is pharma and health care, as China's aging population can afford private health care and take up insurance. Finally, there is a value-add opportunity for companies embracing new technologies. Disruption is happening everywhere, and China is no exception.

***P&I:* With an on-the-ground approach to understanding Chinese companies, what are key metrics in your own due diligence?**

COOPER: First and foremost, our large and experienced China team fundamentally analyzes companies on a five-year research horizon. We want to ensure that we understand the companies over the longer term and [do] not get bogged down by short-term events like trade issues and seasonal weather. Our investment professionals meet with management teams, visit operational facilities and analyze industry competitors to gain insight into the company's business model and sustainable competitive advantage. We look for an agile business model where the company is either a disruptor or not afraid of disruption, because technology brings change. We want to be able to see where the value creation of those companies exists for us as a minority shareholder — including improving franchises, unrecognized growth opportunities, operational efficiencies and competitive advantages.

In the course of our due diligence, we also look for competent management, a strong balance sheet, a resilient capital structure and business model, and positive [environmental, social and governance] dynamics and policies. We build conviction portfolios around these underlying factors, which we believe should drive returns for our clients.

SEN: Our due diligence in China is exactly the same as our due diligence anywhere else in the world. We look at the medium- to long-term because the market is often very focused on quarterly results or on near-term noise which, in China's case, has been incredibly volatile in terms of policy changes and so on. The key advantage in carrying out due diligence is our ability to leverage our on-the-ground presence in China through our joint venture, Huatai-PineBridge, one of the largest foreign-asset managers in the country. Our investment process is designed for the medium term. We look at the quality of the management team, the quality of financial statements, the amount of financial flexibility they have, especially for high-growth companies, and the valuation of those stocks. We also pay a lot of attention to governance and business-model sustainability.

LI: Due diligence is so important in China because this is an emerging market. Investors need to be extremely cautious about the kinds of companies they invest in. We look at, for example, market demand, competitive dynamics and business fundamentals: What's the competitive edge of the business?, Is that tangible?, What are key drivers of the business model, and is it sustainable? We look at whether management is credible, whether their interests are aligned with investors and, from a governance point of view, the structure and how they treat their minority shareholders and investors.

I cannot emphasize enough that all of these aspects are very important for an investor in China. We are on the ground and we want to make sure that first of all, we understand the business. In some cases, you may see very fancy business ideas and business models, but it's very important to understand whether it is real. We always have an operational mindset. We spend a huge amount of time talking to people in the industry — suppliers, competitors, customers and even potential consumers. We do consumer surveys, industry checkups and supply checkups to make sure that all the numbers match up, that the company meets a real need and its financial reporting system is sound. We always red-flag numbers that we are uncomfortable with or margins that look higher than normal industry levels.

***P&I:* For institutional investors currently looking at China, what's most important?**

LI: For investors in China, it's very important to understand that from a broader point of view, you should invest in companies that can capture the future growth of the Chinese economy, the future growth of consumers and the future of technology development. Underlying that investment philosophy, we really focus on understanding the companies that we invest in to make sure that they can unleash the power to deliver on their potential; i.e., we focus on the compounding power of the earnings growth capabilities of Chinese companies that are driven by entrepreneurship and a very hard-working and capable management team. We believe that philosophy itself is a very good investment strategy because buying those companies, and holding them over a reasonable amount of time, should allow you to reap [their] growth and, as a result, institutional investors could be positioned to get long-term compounding returns on their capital.

SEN: For an institutional investor who wants exposure to all the exciting things that are happening in China right now, you need to find portfolio managers who have feet on the ground [and] a proven ability to add alpha through stock selection while managing risk. Our conviction in China is driven by the country's proven ability to manage slowdowns. The reform activity that China has embarked on since 2017 will build better foundations. And there's a technical reason: China is not as correlated to other stock markets in a similar way to Japan. China offers diversification benefits. It offers growth and attractive alpha opportunity. If you're following a benchmark allocation, you're almost doing yourself a disservice, because China's impact on the world is far bigger than the weights being allocated right now.

COOPER: We are currently in the middle of a trade dispute between the U.S. and China. In itself, this has the potential to deliver significant opportunities for equity investors that are looking to unearth attractive opportunities and invest in companies over the longer term. Active investment in China is key because active managers can organize the information, conduct due diligence and mitigate some of the risks inherent in equity investing through effective portfolio construction. This, in turn, can deliver attractive risk-adjusted returns to our clients. It's an exciting shift in economic growth for the second-largest economy in the world, and it's not an opportunity that happens often. •

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