

# POSTCARD FROM CHINA

BY EMIL WOLTER

***If one swallow doesn't make a summer***, 3 days in a hotel in Beijing hardly makes for a rounded impression of the Chinese economy. Nonetheless, below you will find some core impressions resulting mainly from meeting with representatives of around 25 corporates last week. These companies were involved in a wide range of activities from semiconductors, healthcare and pharmaceutical, retail (on-line and off-line), basic manufacturing, industrial automation, hotel management, on-line gaming, property development, port and airport operations, internet and education.

On the more light-hearted side (especially if you happen to live there), the weather in Beijing was remarkably good and the air-quality surprisingly better than during my last visit (one year ago). In 2013, David and I spent the week amazed by the complete lack of complexity in the Beijing sky – a phenomenon caused by the thick smog – and marvelled at the fact that you had to travel for 3 hours on the new ultra-fast (and very nice) train towards Shanghai before that changed. This time around, while not exactly “light”, the air quality did feel noticeably better and indeed we had something pretty close to clear blue skies. If this is the result of new premier Li's re-focus of priorities and a bi-product of a slowdown in manufacturing... long-live both!

***On a more concrete level, signs of the economy slowing down*** continued to be visible across most segments: travel, retail, property and manufacturing. Still, this will hardly be a surprise to anyone who has followed the economy and the stock market in recent years.

Incrementally, this is still leading to decelerating top-line growth in a number of industries with for example retailers still talking of “Negative same-store-sales growth”, property seeing slower transactions,

airports slower traffic growth and even food packaging experiencing a marked slow-down.



Figure 1: Beijing blue skies

Because adjusting a business takes time, this situation continues to exercise pressure on companies' cash flow. Indeed, the extension of the cash-conversion cycle was an apparent and repeated feature amongst different industries. In the healthcare and pharmaceutical sectors, problems with payments from hospitals continue to be an issue. In retail, higher inventories – especially amongst the high-end luxury guys – clearly are still an issue. For manufacturers, a widening gap between receivables and payables. Part of the issue here was that many companies were slow to recognise (some still haven't) the change in the operating environment. On-going expansion despite visibly slowing demand is still quite common.



Figure 2: Li Keqiang

All of this means the need for additional external financing has been a priority for many businesses; which in turn has led to a boom in the issuance of convertible bonds. The mention of convertible bonds as a “cheap way of getting extra money” was very commonplace and blatantly lagged consideration for possible dilution down the road. Given the relatively low valuations at which these instruments have been issued, investors need to be mindful of their impact to EPS down in the future.

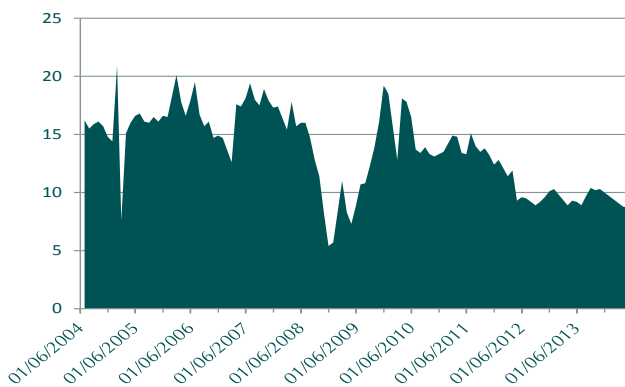
Other avenues of financing have also been pursued with property companies keen to take advantage of trust funding and over-seas debt (“it has no restrictions and is typically cheaper”). A prominent developer told us that some 80% of its home-buyers now use mortgages and for these top-up mortgages are easily available and often used. This could suggest that more leverage exist amongst property buyers than generally believed – not an atypical characteristic this late in the cycle. Even the on-line sector cannot entirely free itself of this trend; the leading on-line real estate site we met had to extend credit to the agents which advertise on it and cut prices only the day after we met them. The shares promptly dropped 17%.

***To be clear, not everything is gloomy.*** If the general trend still appears to be a slowing down, in several places the pace is now moderating. In some places a gentle recovery is visible. Budget hotels reported 95% occupancy (although partially based on “inter-day occupation”), a discount on-line retailer is seeing sales growth exploding, life insurance premiums are up 35%YoY YTD and an industrial robot maker was looking for 42% sales increase compared to last year to mention but a few. Thus, it certainly remains possible to find growth – even very rapid growth – in China, despite the wide reports of a slowdown. It’s just that you need to be selective and if you don’t want to be too exposed to multiple risk, a little contrarian too.

Two problems have been notable in recent years : sharply rising costs (which combined with a slowing top-line is obvious bad news) and a lack of pricing power, most often the result of over-capacity. Here the news could be read as cautiously optimistic with most companies suggesting that the pressure on wages remained upward but probably in a moderating fashion; ie from double digit to single digit increases. Equally, given the dramatic expansion in retail space – especially amongst department stores and malls, see below – rents should also be peaking.

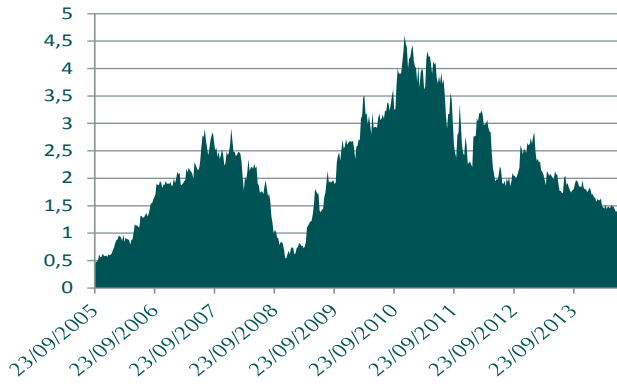
Indeed, speaking to retailers, the department store expansion – which is on-going if slowing down – is coming at a time where questions are increasingly asked about the business model.

Malls have emerged as a primary competitor and in many cases appear to be getting the upper hand. There is however no easy answer to the question of who wins, since different retailers have different preferences and generally the quality of operations (of the two formats) vary very widely dependent on who is in charge. As both formats are rather fragmented, the conclusion would seem to be that the overall outlook for rents will be soft but that the best operators with the best locations will suffer relatively less from an



**Figure 3:** China Value Added of Industry YoY  
Source: National Bureau of Statistics of China

expanding overcapacity. Of course, with slowing sales and negative same store sales growth, the ongoing expansion appears irrational.



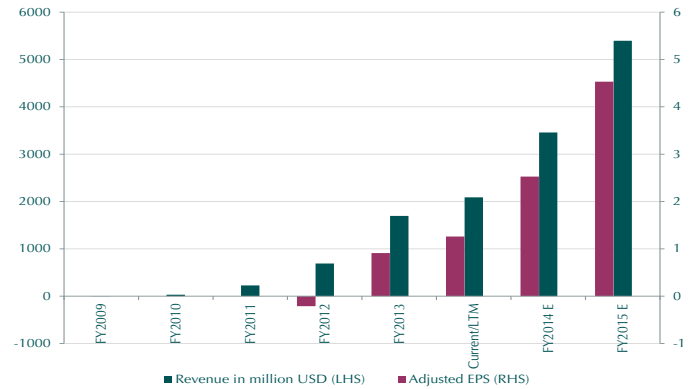
**Figure 4:** The share-price of Hengdeli, a leading watch retailer, illustrates the recent faith of high-end retailers  
Source: Bloomberg

Chinese Convertible Bond Insurance							
2014 YTD		2013		2012		2011	
Nb	Value	Nb	Value	Nb	Value	Nb	Value
52	\$ 9,434,216,930	81	\$19,983,369,121	29	\$5,280,309,600	35	\$9,298,720,700

**Figure 5:** Chinese convertible bond insurance  
Source: Bloomberg based on bonds issued with country of risk being HK and China.

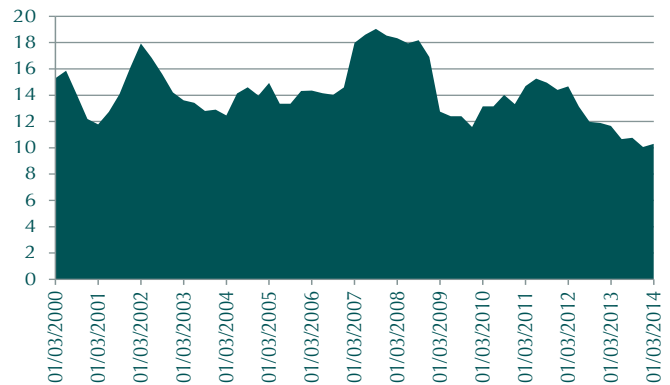
Meanwhile, the healthcare and pharmaceutical sector is another area where the growth promise is very high as a consequence of low current levels of spending and on-going reforms. These changes should drive near-certain high growth over the medium term but many business models are still seemingly risky. In addition the clamp-down on past bad-practises in the form of corruption or a re-orientation of emphasis from a narrow set of “champion” hospitals to a broader group, is wrong-footing many players. A few interesting reform measures caught my attention: Firstly, a proposal which will allow doctors to practise in more than just one hospital, giving them better flexibility to monetise their long education and sought-after skills. Secondly, a move to increasingly allow private sector participation for an increasing number of services with prices that aren’t fully government controlled.

This should help supply keep up better with demand and raise overall levels of service. And finally, the increasing penetration of private healthcare insurance coverage which will help fund all of the above.



**Figure 6:** One amazing grower: VIP Shop revenue from \$3m to \$2bn in 4 years  
Source: Bloomberg

***Ultimately it appears much of the bad news regarding China is well reflected*** in the prevailing negative sentiment amongst fund managers; until the bounce in share prices that started in early May, attendance for the conference looked to be down 20% yoy. In the end it was flat. And yet, in a sign that after a bear-market which has now lasted 6.5 years clearly opportunities exist for stock-pickers.



**Figure 7:** China Urban Wages YTD YoY – growing at the slowest pace in more than a decade  
Source: Bloomberg indices

Foreign investors are supposedly keen to buy domestically listed A-shares and a meeting with the CEO of the HK Exchange revealed that the newly proposed “through-train” investment program which effectively gives anyone current investing in HK access to the Shanghai stock exchange too, will be fully operational from October. The same gentleman also stated that the initial quota should be seen as flexible, likely to increase and even eventually abandoned altogether soon if the initial launch goes according to plan!

Thus, in aggregate my take-away was simply that notwithstanding the general challenges and economic pressures so widely discussed in the popular press these days, the opportunities to pick good businesses at attractive valuations are today present in China to an extent – both from an industry and a market cap perspective – unrivalled in other markets. Put differently:



**Figure 5:** China Growth expectations

Source: BofA Merrill Lynch Global FMS

*Nothing from this trip suggests a major macro turning point is approaching in China, although perhaps a moderation of recent trends can be assumed. Still, what is clear is that following the dramatic decline in investor sentiment in recent years, it is now possible to identify a rising number of strong franchises mostly with adequate management at increasingly low valuations.*

While China is a vast and rather complex country undergoing large change (in the economy and financial markets) and as such, it is certainly “difficult” and resource intensive to undertake the research needed but if done diligently and with a nose for opportunity, the rewards could be substantial.



**Emil Wolter** was born in Denmark and graduated from the University of London with a BSc in Financial Economics. He has worked as a financial analyst since 1995 and as an analyst and portfolio manager on Asian and Emerging Markets equities since 1997. Initially an analyst and portfolio manager with Pictet Asset Management in London, Emil went on to head up the emerging markets franchise at Polar Capital Partners in both London and Singapore. More recently he was Head of Asian Equity Strategy in Singapore at the securities broking units of Royal Bank of Scotland and Macquarie. Emil joined Comgest in 2012 as portfolio manager covering Asian and Global Emerging Market equities.

**FOR PROFESSIONAL INVESTORS ONLY**

This material is for information purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of any security. The contents of this document should not be treated as advice in relation to any potential investment.

The securities discussed herein may not be held in the portfolio at the time you receive this presentation.

The value of all investments and the income derived therefrom can decrease as well as increase. This may be partly due to exchange rate fluctuations in investments that have an exposure to currencies other than the base currency of the Fund.

The information and any opinions have been obtained from or are based on information from sources believed to be reliable, but accuracy can not be guaranteed. No liability is accepted by Comgest in relation to the accuracy or completeness of the information contained in this document. All opinions and estimates constitute our judgment as of the date of this presentation and are subject to change without notice.

Comgest Group comprises Comgest S.A., Comgest Asset Management International Limited, Comgest Far East Limited, Nippon Comgest Inc, Comgest Singapore Pte. Ltd.

Comgest S.A. is regulated by the Autorité des Marchés Financiers (AMF). Comgest Far East Limited is regulated by the Hong Kong Securities and Futures Commission. Comgest Asset Management International Limited is regulated by the Central Bank of Ireland. Nippon Comgest Inc. is regulated by the Financial Service Agency of Japan (registered with Kanto Local Finance Bureau (No. Kinsho 1696)). Comgest Singapore Pte. Ltd. holds the Capital Markets Services Licence to carry out the regulated activity of fund management in Singapore and is an exempt financial adviser pursuant to the Securities and Futures Act (“SFA”), Financial Advisers Act (“FAA”) and the relevant regulations under the SFA and FAA of Singapore.