FSSA Investment Managers



Client Update

A fast thaw after a long winter

March 2023

After suffering negative performance for nearly two years, China equities have rebounded sharply since early November. The government suddenly scrapped most of its pandemic restrictions and added policy support, targeting troubled sectors like property and technology. The geopolitical climate also thawed to some extent, after President Xi Jinping and US President Joe Biden met in person and expressed their willingness to improve relations.

If we look back over the past decade, the last two years presented the most difficult stretch for us as China equity investors. Our approach was put to the test as China equities were among the worst performers in global markets. But amid the widespread pessimism, we did not waver from our philosophy or process, and continued to buy high-quality companies at attractive valuations.

It was a harsh reminder of the volatility inherent in the China market, but also showed the advantages of having a long time horizon. While we had similar concerns as everyone else, such as tightening industry regulations, geopolitical tensions and China's prolonged Covid Zero policy, in our view much of the negativity was already priced in – and we believed sentiment could improve quickly once China opened up.

We also thought the structural investment themes in our portfolios remained intact. For example, we hold dominant consumer franchises and brands which should benefit as the population becomes wealthier. China's ageing population and rising spend on healthcare should support the companies providing drugs and medical services. And technology champions in niche markets should benefit from the trend towards localised production. Therefore, we were able to be contrarian and add to our high-conviction holdings – the cash levels in our portfolios decreased over this period.

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The difficult environment also gave us a chance to deepen our understanding of the companies under our coverage and reassess our conviction. We believe the quality of a company starts with the people. We met with many of the top managers or founders at these companies and gained a better sense of their thinking and character as we observed how they were weathering the storm.

One example where our conviction increased is Shanghai Hanbell, a leading maker of screw compressors which are used in cooling and general industrial applications. The company is also an emerging player in vacuum pumps which are used in solar and semiconductor industries, among others. We were impressed after meeting the chairman, who seemed strategic, optimistic and devoted to the business. He stayed in the firm's employee dormitories in Shanghai amid the citywide lockdowns, which bolstered our confidence in his alignment. The operations seemed well run with clear budgets for each business line, and he answered our questions with candour. In an industry prone to industrial cycles, the team values steady growth and high-end products with good profitability.

Since the timing of China's reopening was unknowable, we looked for companies which took the opportunity of the downturn to streamline and focus on improving for the long term. We favoured businesses which were able to adapt according to the situation. Examples included cutting costs amid slowing sales, which we saw with home appliances maker Midea; passing through price increases from input inflation, as shown by Beijing New Building Materials with its gypsum boards; or investing in new capacity and innovation to gain market share, like in the case of pneumatic components supplier Airtac.

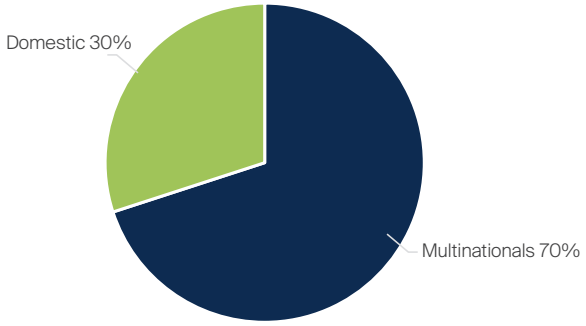
Overall, our China strategies declined slightly over the second half, though our portfolio companies were reasonably resilient during the down-market and have since rebounded strongly. This supports our view that good companies tend to hold up well under market stress and should bounce back more quickly once sentiment changes for the better.

Performance review

During the second half of 2022, healthcare companies frequently ranked among the key contributors to performance in our China strategies. These included medical device makers like Shandong Weigao and Autobio Diagnostics, drug developers like CSPC Pharmaceutical, and pharmacy retailers like Dashenlin, Laobaixing and Yifeng. While the healthcare industry has faced various policy headwinds in recent years, we have found attractive investment opportunities in some of the leading companies in these sub-sectors. We believe these companies should benefit from continued industry consolidation and growing preference for domestic over foreign products.

One example is Autobio Diagnostics, one of the top in-vitro diagnostics (IVD) companies in China. Autobio gained market share during 2022, as key competitor Roche saw its China IVD revenues decline. This fed through to Autobio's strong profit growth, with management expecting growth to accelerate this year. As domestic players hold only 30% market share in IVDs, we believe there is further scope to gain share from foreign companies.

In-vitro diagnostics (IVD Market Share)

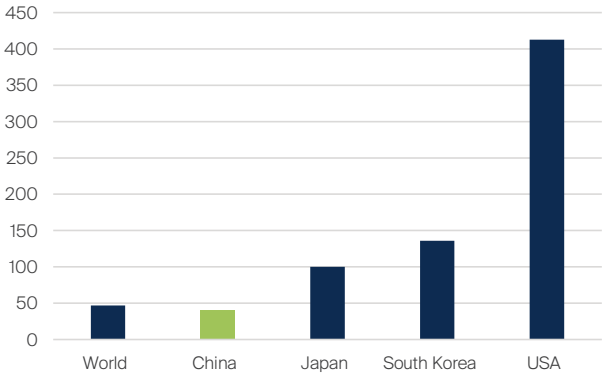


Source: Company data, FSSA Investment Managers, as of October 2022.

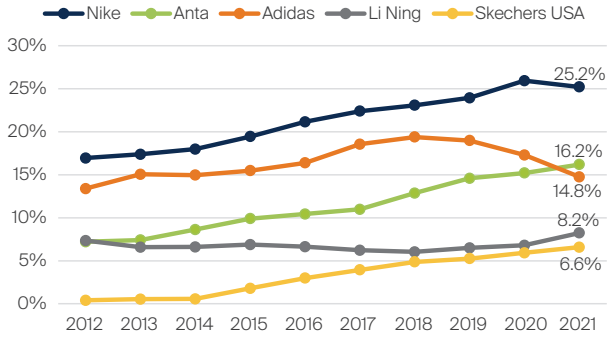
Another key contributor was CSPC Pharmaceutical, one of the largest drug makers in China. Despite being challenged by regulatory price cuts, we think industry leaders like CSPC can grow by more than 10% per annum, given its operational capabilities and new drugs in the pipeline. Its performance has been resilient, with core profit increasing by 10% during the first half of 2022 despite a 30% jump in research and development (R&D) spending.

Outside of healthcare, other contributors to portfolio performance included Anta Sports and ZTO Express. Anta, a leading domestic sportswear company, had resilient sales despite headwinds from Covid-related store closures and weak consumer demand. The company has consistently invested in R&D and branding, and has been able to attract outside talent. The management seeks to grow revenue by double digits, mainly through premiumisation of the brand and gaining new customers, especially for its children's and women's wear. We believe China's sportswear sector will continue to grow over the longer term and we expect Anta to take market share from global peers like Nike and Adidas, as shown in the second chart below.

Sportswear consumption per capita in 2021 (USD)



China sportswear market share, top 5



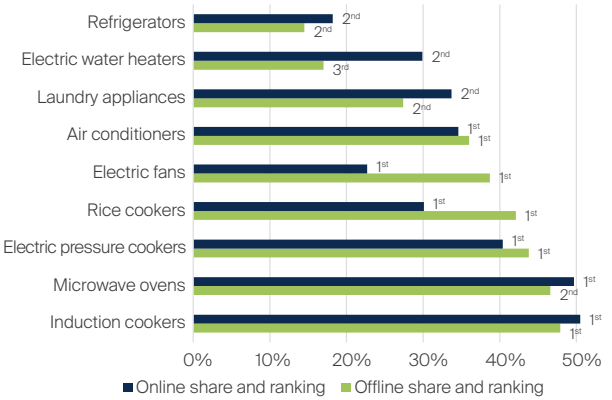
Source: Factset, Euromonitor, Nomura, J.P. Morgan, FSSA Investment Managers, as of 30 June 2022.

ZTO Express, China's largest express delivery company, benefited from rising parcel volumes and market share gains amid a weaker industry environment. We like ZTO's strong execution as well as its better service and lower costs compared to its peers. Over 90% of its parcel volume is related to e-commerce, while the company is relatively asset-light. We believe profits should grow at a decent rate in the coming years, as price competition has eased and the major operators have chosen to focus on premium services rather than volume.

On the negative side, key detractors included Midea, China Merchants Bank and Taiwan Semiconductor.

Midea, China's leading home appliances maker, was affected by sluggish demand and inventory destocking in its consumer business due to the slowing economy. However, we like the company's long-term track record and its ability to control costs when raw material prices rose. There are some concerns on overseas demand, as 40% of its sales are exports, but falling raw material prices and a weaker yuan should be supportive. With potential new areas of growth (like its robotics business, Kuka), we believe the stock looks attractive on a three to five year horizon. We added to our position during the pullback.

Midea is a market leader in home appliances



Source: FactSet, Midea Annual Report 2021, FSSA Investment Managers. As at 30 June 2022.

China Merchants Bank (CMB) declined after the bank's president was suddenly removed in April, and was revealed to be under investigation by the government's anti-graft agency. Meanwhile, China's property market slowdown fuelled concerns on mortgage repayments and bank stocks in general.

We added to our holdings at attractive valuations, as we believed the negative market reaction was overdone. The bank has a strong culture and franchise which should mitigate the risks inherent to management changes. More recently, the government has announced measures to support property developers, with banks such as CMB rebounding as a result.

Taiwan Semiconductor (TSMC), the world's largest dedicated contract chip manufacturer with more than 50% market share, fell on concerns about a semiconductor down-cycle and geopolitics. We had previously trimmed our position as we were concerned about oversupply (TSMC had raised its annual capex 10-fold in 10 years, from USD 3bn to USD 30bn). While it's difficult to predict a bottom for the chips cycle, we think the long-term structural growth trend for semiconductors remains valid in light of the ongoing tech-intensification we see around us.

On the other hand, we think geopolitical issues are likely to persist. The key is how TSMC positions itself in the long run. It manufactures mainly in Taiwan, and its employees and management are mostly all Taiwanese, but the US and China are its largest customers, so it is in a difficult position. Recently TSMC has been building plants in the US, which should help the supply of advanced chips to Western customers.

What we bought and sold

New purchases over the second half of 2022 included Boya Bio-Pharmaceutical, a plasma products business with 29% held by China Resources Group (via CR Pharmaceutical). Incorporated in 1993 and listed in 2012, it went on to acquire a number of generic drug, active pharmaceutical ingredient (API) and distribution companies.

Compared to its peers, the company is highly profitable due to its balanced revenue mix and centralised production. After China Resources (CR) Group took control in 2021, we expected further volume growth and efficiency improvement. The company targets to increase its collection stations from 14 to more than 30 by 2025, as well as benefit from organic growth from its existing stations.

We believe CR Group's involvement will help to improve the governance, by introducing employee share ownership plans (ESOPs) for management, disposing of the non-plasma businesses and assisting with obtaining government approvals for new plasma collection stations.

Across our China strategies, we added more broadly to Netease, the second-largest gaming company in China. The company has gradually developed a portfolio of mid-sized games with high user stickiness and longevity, and has a strong pipeline that should support decent growth prospects. Internet stocks had weakened on concerns about the regulatory environment, which we saw as a buying opportunity given our long-term outlook, while the recent resumption of new gaming licenses is a positive sign of normalisation.

With a long track record and impressive returns over the past 20 years, we like the company's strong alignment and mind-set for returning value to shareholders. Over the past 15 years, it achieved 20% compound annual growth rate (CAGR) for its earnings per share (EPS), while book value per share plus dividends per share (BVPS + DPS) grew by 30% CAGR without any major acquisitions. It also has the highest insider ownership among all internet companies globally, with a relatively pristine structure (no dual-class shares, no connected-party transactions, no outside businesses owned by the chairman and no major insider selling).

We think these unique features are due to its founder William Ding, who founded the company in 1997 at age 26. He has a strong interest in products like gaming and music, and seeks to offer the best products to customers. He is also more prudent than many of his peers, and is willing to spend decades to fine-tune a game. This philosophy of focusing on products rather than near-term market share has helped Netease build a strong product portfolio which generates recurring revenue over the long term.

We also added more broadly to H World (formerly Huazhu Group), a multi-brand hotel group in China. We like the alignment with its reputable and entrepreneurial founder, and its track record of building brand leaders in different market segments. The company stands out in a fragmented industry, and as the second largest player we think H World will benefit from the likely consolidation.

The founder Mr Ji was an industry outsider with no formal hotel experience, which allowed him to start the company in 2007 with a fresh perspective. He went against the norms by foregoing unnecessary facilities which were costly and unproductive, such as ballrooms, restaurants, large lobbies and pools. Instead, he focused on the elements which he thought were most important for customers, namely the location, hygiene and sleep quality of the hotels. By doing so, he offered a superior accommodation experience at a lower price to customers.

His prior experience in the internet industry also carried over to H World in the form of leading technology innovations and efficiency, with automated check-in systems, real-time pricing changes and delivery robots. These resulted in the lowest staff-to-room cost ratio in the industry. Under his leadership, the company also launched a paid loyalty membership system, which increased the switching cost for customers while simultaneously lowering the firm's reliance on third-party traffic. H World's membership system is known to be the best in the industry, which combined with their growing hotel network has also resulted in network effects for the company.

While the hotel industry has historically been cyclical and asset heavy, this is shifting as the market consolidates and hotel groups increase scale via franchising. The company has an asset-light approach to growth, which features high margins and is cash generative. As China's economy continues to shift towards domestic consumption, we expect branded hotels to gain market share and benefit from the growing travel and leisure spend.

In terms of key divestments, we sold Alibaba Group on concerns about tightening regulations and increasing competition from the likes of Tencent, JD.com and Meituan. As e-commerce penetration has reached a high level and more internet players entered with different formats, Alibaba struggled to maintain its growth and lost market share. We were disappointed as the management was slow to react to the aggressive encroachments and the company's centralised support structure was inefficient in dealing with these changes. After we sold Alibaba, we used the funds to add to our other internet holdings such as Meituan, JD.com and Netease.

Outlook

As Covid Zero draws to a close, we are mindful about not getting swept up in the market's newfound optimism for China stocks, and are treading more cautiously compared to 6-12 months ago. There are still risks to bear in mind, such as high inflation globally which could mean higher-for-longer interest rates. Geopolitics will continue to be an overhang, given China's historical relationship with the West, as well as unresolved issues like the Russia-Ukraine war and mainland China's relationship with Taiwan. And Western economies are slowing, as seen in weaker demand for Chinese exports in recent months.

On the other hand, despite the sharp rally in recent months, valuations in China are still reasonable, as shown in the charts below. Chinese companies are exposed to different cycles compared to those in the West and China's economy will need time to recover as pent-up demand is released. As such, we favour those with more exposure to the domestic economy, such as dominant consumer franchises, healthcare companies and technology leaders. As the China market is likely to remain volatile, we continue to focus on high-quality companies with strong franchises, balance sheets and management teams.

After the recent rally, valuations in China are still reasonable





Source: Factset, FSSA Investment managers, as of 20 February 2023.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at February 2023 or otherwise noted.

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