

Areté | CAPITAL  
ASIA

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CHINA: VALUE IN SELECTED NAMES

# CHINA EQUITY - OVERVIEW

## CHINA IS TAKING ITS PLACE ON THE WORLD STAGE

- China is a critical player in the world economy and is the world's largest economy on a purchasing power parity basis.
- Xi's position has been reinforced for the next 5 yrs and possibly beyond. The new leadership will retain existing key policies with a focus on economic reform and an emphasis on foreign policy.

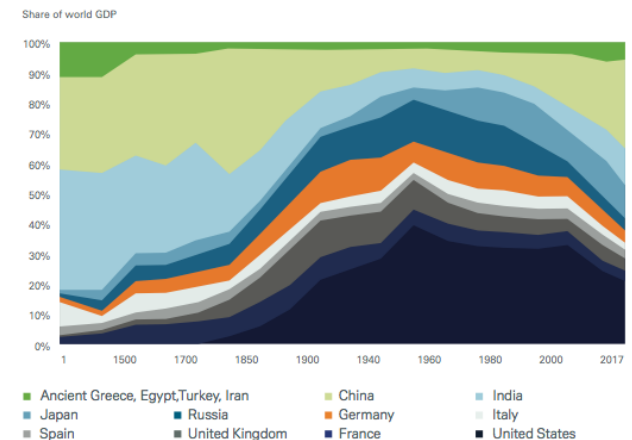
## ECONOMIC TRANSFORMATION WELL UNDERWAY

- 'Smokestack' industries (coal, aluminium and steel) and 'providing for populace' businesses (consumer staples and healthcare) are no longer so dominant and being overtaken by manufacturers and service companies.
- In many cases, these new 'service' industries are redefining business models in established sectors
- The China government has selected and carefully encouraged special policies/industries to have Chinese operations challenge the established order - internally and externally

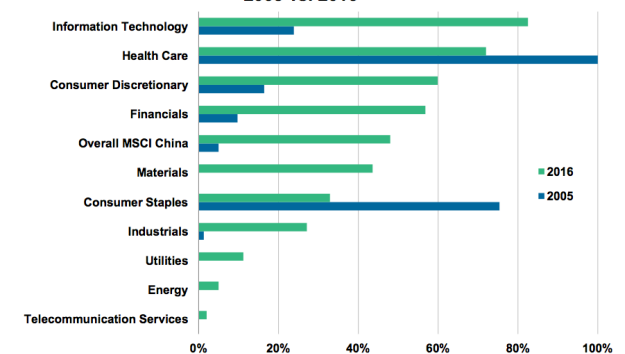
## INVESTMENT OPPORTUNITIES EXIST

- Amongst the many transformations taking place in China, there are numerous great investment opportunities. We do not recommend an index, but selected stocks
- Some of these stocks have made significant gains over the last 12 months, but there is still more to come

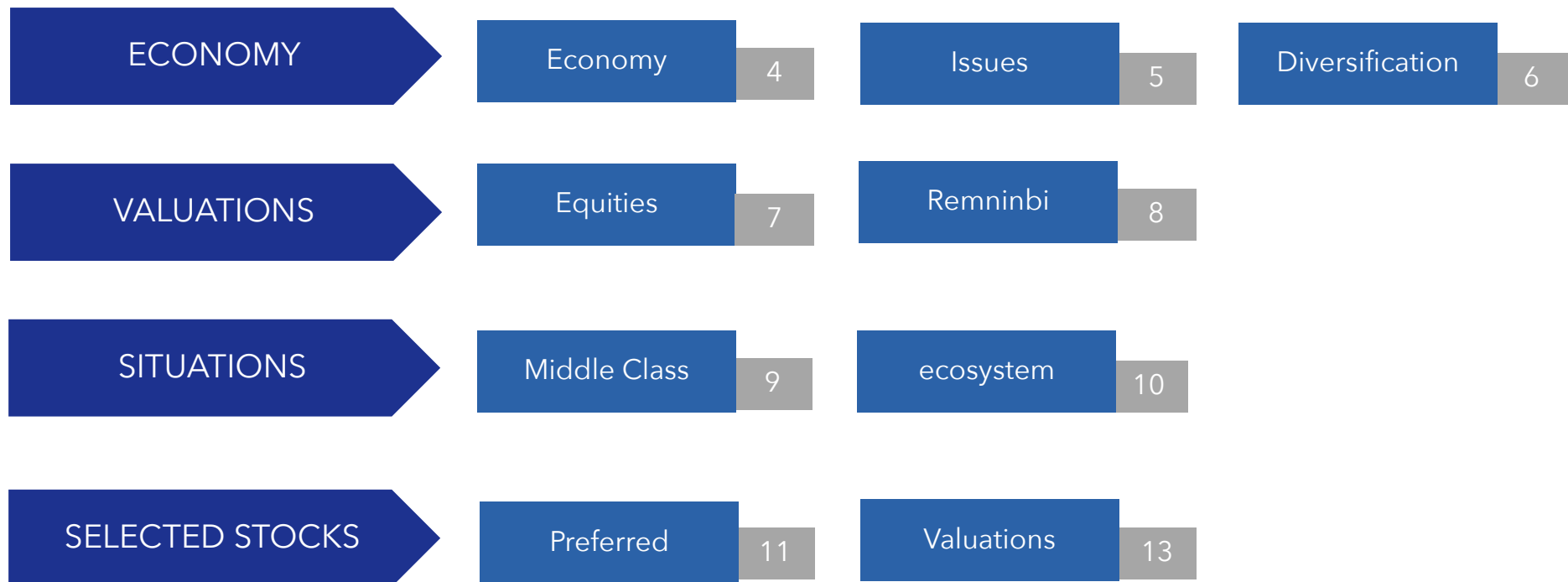
China regains its historic global economic role  
Source: Angus Maddison; IMF. Data as of September 2017.



Private Enterprise (Non-SOE) % of MSCI China Market Cap by Sector, 2005 vs. 2016



# CONTENT OVERVIEW

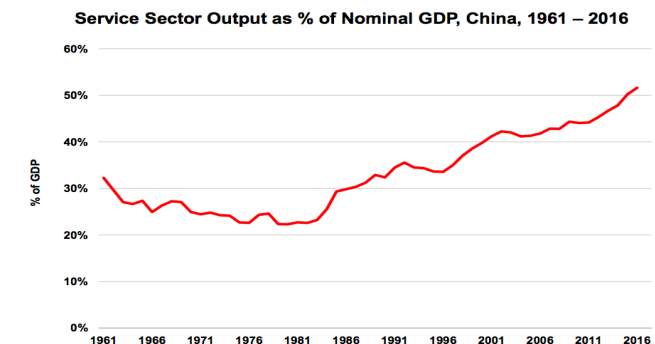
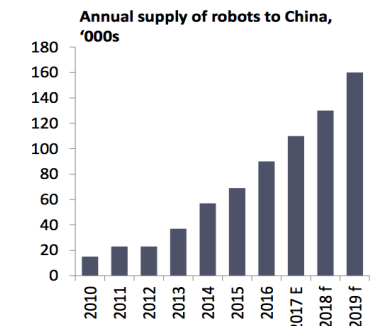
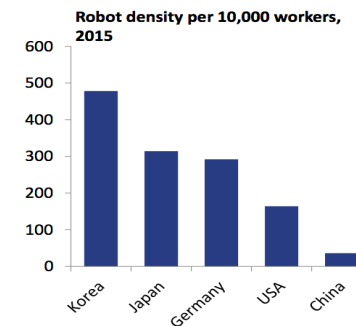
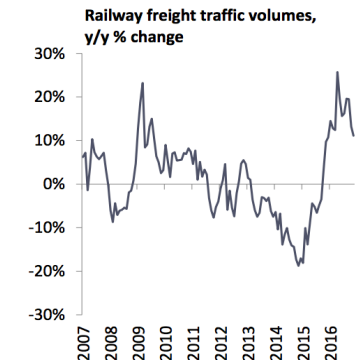
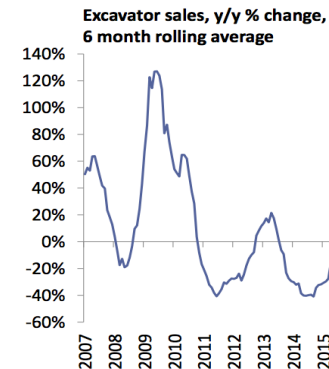


# CHINA - ECONOMY

## CHINA'S ECONOMIC GROWTH REMAINS RESILIENT ...

- IMF forecasts (not a leading indicator) for China real GDP were raised recently: 6.7% for 2017 and 6.4% for 2018. This growth rate has slowed, but is still stronger growth than most economies
- Real indicators (top 2 charts to right) of China's economy also show strong growth
- The manufacturing sector has scope to automate and is embracing this (lower 2 charts to right), enhancing capacity and efficiency
- China's economy is transforming (below) where services have grown to be biggest contribution -
  - From investment driven to greater consumption
  - From majority manufacturing to a more services driven economy

... WHILE THE ECONOMY MATURES.



# CHINA - ECONOMY IS NOT WITHOUT ISSUES

## RAPID RISE OF DEBT HAS CREATED RISKS ...

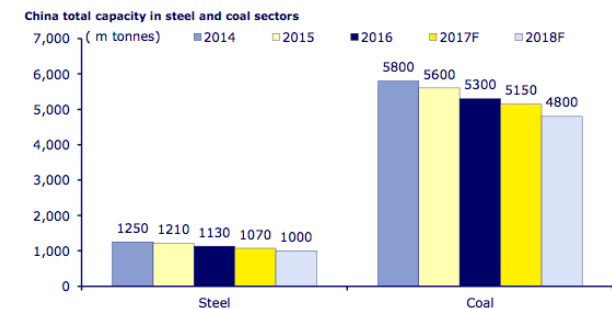
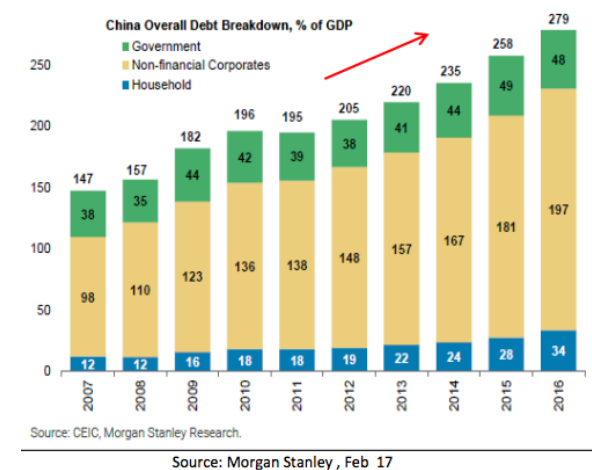
- Total debt to GDP is over 270% - pace of the rise is the biggest issue - but we believe manageable. The debt pool is largely in local currency and is financed domestically (the large savings pool).
- Corporates and SOE's are the main drivers.

## SOE'S VS PRIVATE COMPANIES

- Private enterprises are now a much bigger part of the Chinese economy, whereby SOE's remain large, but now do not dominate the economy
- SOE reform has slowed recently - mainly due to the government not willing to tolerate any short term economic pain

## PROBLEMS ARE BEING TACKLED

- Authorities have moved pro-actively over the past year to squeeze shadow banking and to pursue companies in unhealthy positions
- CBRC has tightened rules around loans used in wealth management products
- Government have shut down capacity of coal and steel mills at SOE's to reduce the over-production



... BUT GOVT HAS HANDLED THINGS QUITE WELL SO FAR!

# | CHINA - STATE SUPPORT FOR DIVERSIFYING ECONOMY

## STRATEGICALLY DEVELOPING THE ECONOMY ...

China has a command economy with capitalist features (blending economics and politics). Authorities have carefully promoted projects and sectors that simultaneously develop and grow the economy, extend China's influence, advance new technologies and expand trade

## CHINA IS POWERHOUSE OF INNOVATION

State actively supports the change from 'Made in China' to 'Created in China'.

- China produces 2.8mill science and engineering graduates annually
- Scale of research & development in China will exceed US in 2-3 years
- In 2015, China published 448,000 scientific research papers, 2nd only to the US

## OBOR POLICIES EXTEND REACH

Build a China centred trading network (road, rail and maritime) and extend China's influence

- Initial work has been infrastructure investment, but now trade increases follow

## CAR INDUSTRY IS THE LARGEST IN THE WORLD

China has become the worlds biggest producer of motor vehicles, making more than twice as many as the US

- No single China producer is in top 10 manufacturers
- Push to move to electric vehicles is bold (and undermines western manufacturers dominance)

## CHINA AND RARE EARTHS

China's rare earth industry is 97% of global rare earth trade, which also secures China supplies that are critical for producing batteries and special materials.

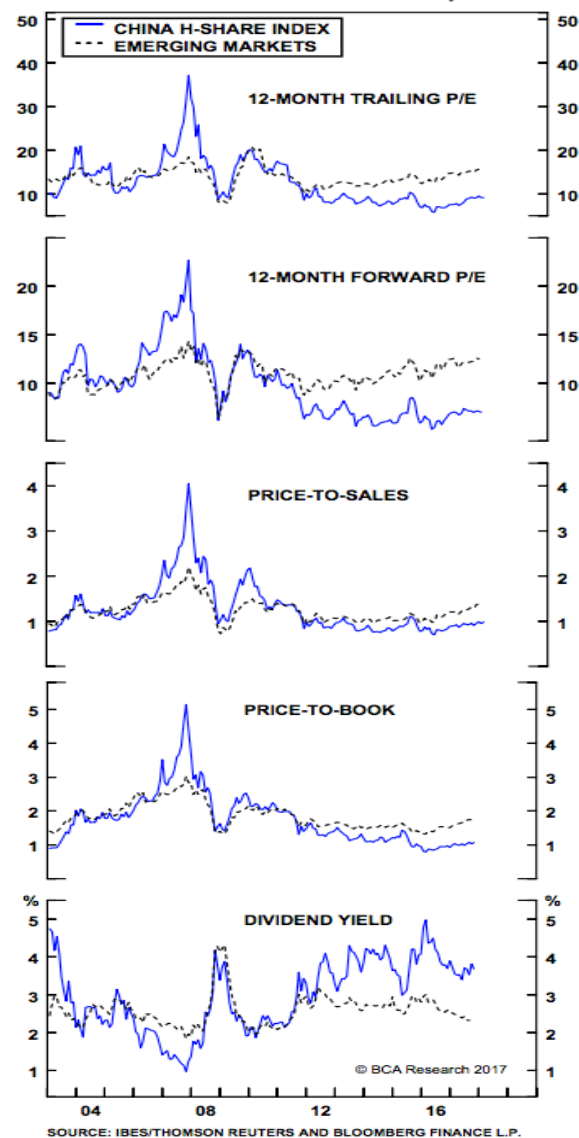
... WHILE ENHANCING CHINA'S INTERESTS.

# CHINA - EQUITIES IN PERSPECTIVE

## CHINA CORPORATES ARE REPORTING STRONG NUMBERS ...

- China's economic catch-up to other developed markets still has plenty of room to run. A doubling of China's per capita GDP from its current levels will leave still it as a fraction of the US GDP.
- China equities have appreciated this year with a lot of good news already priced in. But H Shares remain relatively good value compared to emerging markets - charts to the right
- Some positive views on Chinese equities include
  - MSCI China trades on PE of 14.5. Cheap relative to region and world
  - Recent earnings revisions have been more +ve relative to region
  - China industrial profits rose by 22.8% YoY in the first nine months of 2017
  - Some party led initiatives are encouraging improvements in some sectors
- Global and emerging market fund managers are still underweight China, representing an uncrowded trade. But they have been increasing their exposure through this year
- There are near term cyclical risks in China. But the China reflation trade continues to have much fundamental support

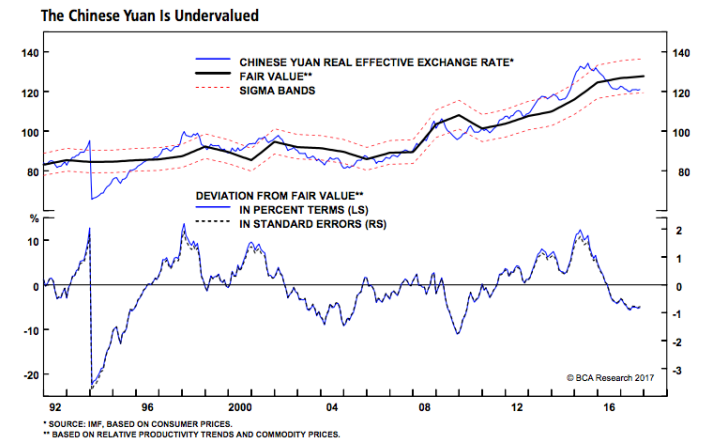
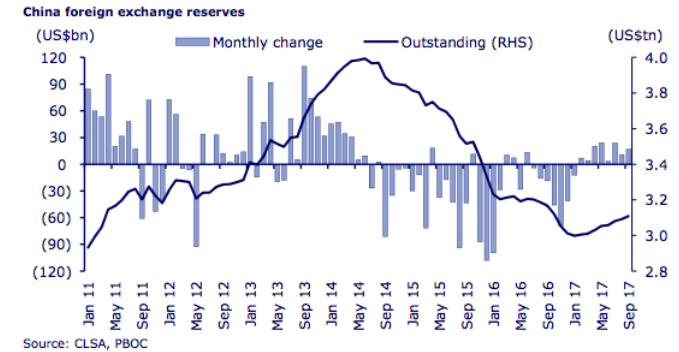
Chinese H-Shares: A Valuation Snapshot



# CHINA - REMNIMBI

## RMB IS UNDERVALUED ...

- Since bottoming at USD2.9tn in January, China reserves have risen by US\$110bn or 3.7%. We imply a balance of payment surplus in September and expect China to record a second straight quarter of a balance of payment surplus in 3Q17. The first quarters of surplus since 2Q15.
- Policy makers have taken measures to tackle capital outflows.
- The government has taken several steps to broaden the use of RMB by
  - Denominating gold and oil contracts in RMB
  - Formalised a domestic RMB bond market
  - RMB has been in the global SDR for some time
  - China has also been incorporated in MSCI indexes, although underweighted



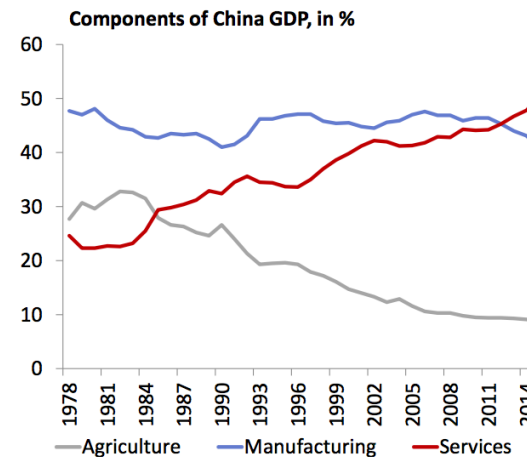
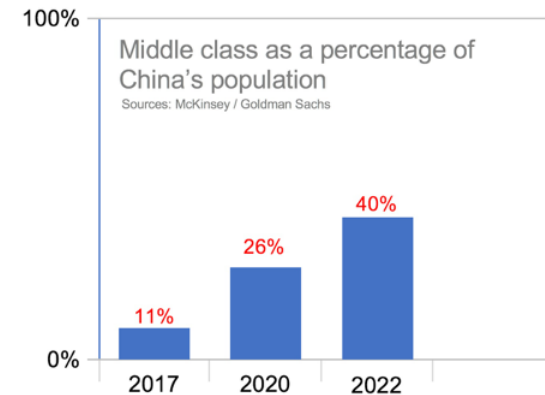


# CHINA - MIDDLE CLASS BOOM

## CHINA'S MIDDLE CLASS IS COMING ...

- In 2000, just 4 percent of China's urban population was considered middle class. By 2022, that figure will be a huge 76 percent. China's middle class will be over 700 million by 2022
- One consequence of this growing middle class is that China's economy is rapidly transitioning from a command and control economy to a consumer led economy (a la G20).
  - The consumer/service economy has grown and already is the major part of the economy
  - China has a 2 speed economy - the prosperous coasts vs. the industrialized northeast. One exception to this rule is Sichuan, which is inland, yet prosperous.
- The growing middle class in China is a phenomena that is definitely going to take place. This huge group of people will have a profound impact on China as well as around the world! Several investment opportunities arise from this phenomena

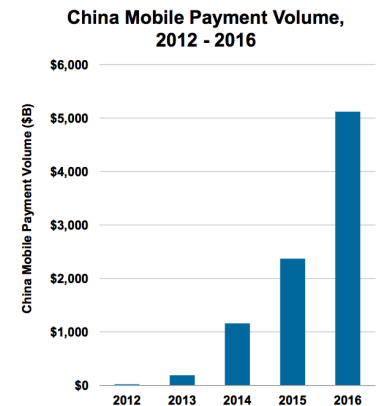
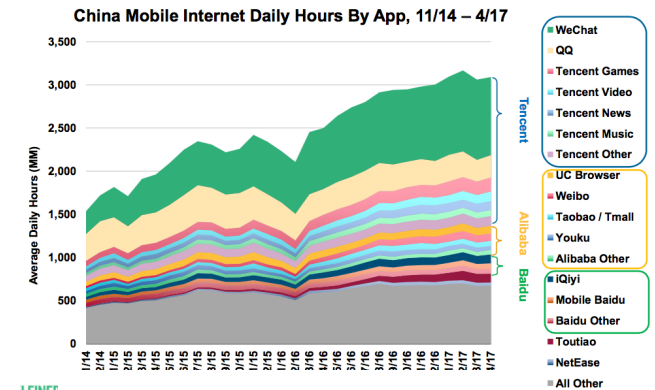
... AND WILL RE-SHAPE CHINA'S ECONOMY.



# CHINA - SPECIAL SITUATION

## CHINA HAS THE WORLDS LARGEST EFINANCE ECOSYSTEM ...

- China has very high mobile internet penetration that has supported growth of huge online ecosystems - covering gaming, shopping, livestreaming, finance, etc
- China consumers interface to all things finance (payments, investing, banking, insurance, loans, consumer financing, etc) is world leading and developing quickly.
- The scale (RMB79 trillion) and influence of this ecosystem is driven by online consumers and under-developed offline business. Growth potential is huge:
  - 500 mill epayment users
  - 400mill investors buy wealth management products online
  - Online borrowers number 160 mill
- These tech companies are re-shaping industries by taking on established players and eating into their margins (similar to amazon and retailers in the West).
- The efinance ecosystem in China is well established (16x the US) and a few players have a dominant position in China. They grow at a breathtaking rate and strive to expand their capabilities outside China.



... WITH ENORMOUS GROWTH POTENTIAL.

# | CHINA - PREFERRED SECTORS & NAMES 1 of 2

## CHINA DE-LEVERAGING

Beijings target to de-leverage the financial system is not widely appreciated, but some progress has already been made. For this theme we like several financials. Bank stocks are already re-rating. The banks in this selection will also benefit if inflation returns.

- China Banks: CCB (939.HK), ICBC (1398.HK).
- Insurers - Ping An (2318.HK), AIA (1299.HK)

## INTERNET/TECH

China mobile penetration will be the platform for many developments around the consumer/efinance environment and strong secular growth potential remains. Internet stocks are effectively domestic demand plays. The first two picks have businesses growing greater than 50% a year!!

- Tencent (700.HK), Alibaba (BABA.NY), JD.Com (JD.NQ), 58.com(WUBA.NY)

## TOURISM/TRAVEL

Chinese people are discovering more of their own country and the rest of the world. We recommend:

- Samsonite (1910.HK), Ctrip (CTRP.NQ)

## COMPANIES WITH STRONG INNOVATION FRANCHISE

- Sunny Optical (2382.HK)

# | CHINA - PREFERRED SECTORS & NAMES 2 of 2

## HEALTHCARE

The huge healthcare sector will modernise and also benefit from local companies developing new techniques and medicines. Our favoured names are:

- CSPC (1093.HK), Sino Biopharm (1177.HK), Hengrui-A (600276.SH), 3S Bio(1530.HK), Fosun Pharma (600196.SH), China Resources Pheonix Healthcare (1515.HK)

## GROWING MIDDLE CLASS

Many of the names above will also benefit from China's growing middle class. We would also suggest:

- Qingdao Haier (600690.CH), Kingsoft (3888.HK), Yum China Holdings (YUMC.NY)

## OBOR

China already has the biggest high speed rail network in the world. This policy extends trade routes to many countries near and far

- ABC (1288.HK), CR Power (836.HK), CRRC (1776.HJK), CCCC (1800.HK)

# CHINA - VALUATIONS OF SELECTED NAMES

SHARE	PE	Div Yld	1yr diff %
CCB (939.HK)	6.0	4.73%	23.0
ICBC (1398.HK)	6.6	4.36%	35.0
Ping An (2318.HK)	15.5	1.61%	92.0
AIA (1299.HK)			
Tencent (700.HK)	57.5	0.16%	99.0
Alibaba (BABA.NY)	51.1	-	99.4
JD.Com (JD.NQ)	-	-	49.0
58.com(WUBA.NY)	95.0	-	129.8
Samsonite (1910.HK)	21.5	1.63%	45.1
Ctrip (CTRP.NQ)	76.1	-	9.2
Sunny Optical (2382.HK)	66.0	0.23%	268.0
CSPC (1093.HK)	29.3	0.79%	101.8
Sino Biopharm (1177.HK)	42.5	0.64%	106.3
Hengrui-A (600276.SH)	64.1	0.17%	82.9
China Resources Phoenix healthcare (1515.HK)	-	0.63%	-19.5
3S Bio(1530.HK)	40.5	-	98.7
Fosun Pharma (600196.SH)	33.7	0.86%	75.1
Qingdao Haier (600690.SH)	16.9	1.30%	92.3
Kingsoft (3888.HK)	21.1	0.47%	24.3
Yum china Holdings (YUMC.NY)	27.4	-	56.8
AgrBkChina (1288.HK)	5.4	5.37%	15.4
CR Power (836.HK)	17.3	5.70%	18.1
CRRC (1776.HK)	16.9	3.33%	4.8
CCCC (1800.HK)	6.9	2.44%	-1.0

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