



## December 2018: Our View from China

Visiting China, or rather Beijing, in late 2018 proved to be an opportune moment in the life of the world's second largest economy. The headlines were doom-laden: trade war, slowdown, etc. But what of reality?

The first point to reiterate is that China is significantly less vulnerable to a US trade war than at any time in the past 20 years. Not only is China becoming a service-led economy, but the importance of the US as an end market for exports has shrunk considerably. Mr. Trump is a decade or so too late: China's adjusted resource gap (current account + net foreign direct investment) surplus peaked at nearly 14% of GDP in 2007, today it has all but disappeared, reflecting its much more balanced economy.

The second point is that income growth remains at a very healthy 8-9%, with retail sales (ex-autos – see below for why stripping autos out makes sense) running at around 10%.

There have been two conflicting drivers of consumption growth in China this year and both are government orchestrated. On the one hand the crack down on shadow banking and personal lending has been brutal. This is another, in many ways quite understandable, attempt to pre-empt this becoming a larger problem further on down the road.

But on the other hand, a massive tax break for the honest worker is on its way. When October pay packets hit the Chinese bank accounts, almost 30% of the working population stopped paying tax completely, as they fell below the newly raised threshold. More tax benefits are coming in 2019 for both consumers and small businesses

The somewhat unhelpful conclusion is, there are winners and losers in this process, depending on personal circumstances, but on balance we are encouraged, and at the end of the day it is our job to work out who wins and who loses, and position the fund accordingly.

A company in the right spot, like Mengniu Dairy continues to grow nicely, and our top line growth estimate of 15% looks achievable. On the one hand they are pushing into more rural areas, often with the help of new B2B APPs operated between Alibaba and local stores, which is low-cost distribution for Mengniu's brands. On the other, penetration of milk has far to go: Beijing might be at 50 litres/head, but lower tier cities are often closer to 10 litres, according to the company. Alibaba's new retail concepts like Hema, help even more, especially with their premium products such as yoghurt and fresh milk. Product innovation is key, and Mengniu are delivering this.

Meeting three of China's leading online lenders was an interesting, if somewhat chastening experience. Lufax (leading online and peer to peer lender), Lexin (lender to graduates), Qudian (lender to blue collar) have all been facing the tough environment and have de-emphasised the peer-to-peer nature of their businesses.

The latter two seek to be more tech companies than lenders: analysing the data, focusing on their niche and shifting the risk back to the banks. Lufax certainly believes the regulator has now started to ease.

As a broader test of consumer sentiment, the recent Singles day sale on 11<sup>th</sup> November, which is the Chinese equivalent of Black Friday, did see a slowdown on previous years...but still recorded a 27% year-over-year growth rate. Hardly a recessionary reading.

Alibaba did revise guidance down at the last quarter, from 60% to 50% year-over-year growth. They will hold back taking ad revenue from their new recommendation-based feed, until they are more confident the market can accept it, and that they have the right model so as not to under sell their proposition. Offline initiatives like the Hema hybrid supermarket/food experience/delivery hub are working well, and full rollout is coming. Alibaba continues to write the rules of modern retail in China, a strong position to be in.

Returning to auto sales, which has received significant press of late, and undoubtedly throw economic and consumer numbers considerably. Some context is required. Remember 2008? The year economic activity in the world stopped in its tracks? That year, Chinese auto sales still grew (albeit marginally), before exploding with pent up demand in 2009. Then, total auto sales were around 6mn units in a population of 1.3bn, it was what our wealth cycle would describe as the sweet spot for auto sales in China.

Roll on a decade. Chinese auto sales touch 25mn, by a factor of almost 50%, the largest auto market in the world. The big cities are congested, car licenses are either extortionate or heavily restricted, and alternatives abound: public transport (Beijing had 54km of underground rail in 1999, today it has 554km), ride hailing, ride sharing, car sharing, not to mention bike sharing, with its associated health benefits.



**Beijing 1978**



**Beijing 2018**

Electric vehicles have thrown another spanner in the works. Like everywhere, the temptation to wait for a better battery, with better range is holding many back, but unlike the rest of the world, the Chinese have significantly less mental baggage in this area.

The Chinese cannot be accused of lack of imagination and innovative solutions are ready to run you down on every Beijing street corner. Whether electric stand-on scooters, electric sit-on scooters, electric bikes, electric 3 wheelers, electric 4 wheelers of every size...everything has been tried. No doubt a few of the many hundreds of manufacturers will survive and thrive, perhaps Xiaomi's stand-on scooter, perhaps NIU's sit-on, perhaps NIO's luxury half-priced Tesla? But many won't....



### **Alternative transport**

Either way, the Chinese consumer has much more to choose from than we do, and is less hard-wired to old fashioned, petrol car ownership, and is at the forefront of globally changing behavioural patterns. In penetration terms, China will never close the gap, and the best days for Chinese car sales might well be behind them.

If there was another broad conclusion from visiting Beijing, apart from that the Chinese consumer still lives and breathes, it is that success in innovation is the key to stock selection.

Whether in retail (Alibaba's online/offline convenience and convergence), dairy products (Mengniu's premium yoghurts/pro-biotics), education (TAL's online after school offering, albeit still work in progress), consumer lending (see above, winners undecided), or hotels (Huazhu's newer brands like Ji are very sleek and simple, while Citigo is tech-filled and trendy), being on the crest of ever changing consumer tastes is vital.

As an aside, leaders in innovation almost exclusively emanate from the private sector – another player in the Chinese economy whose apparent demise looks premature – and very seldom, if ever, from state backed enterprises. Hotels are a case in point where among the top players, the “entrepreneurs” (Huazhu & Greentree) are leaders in design, style and operation, while the old state players (BTG & Jin Jiang) are close followers, but still followers.

Looking at what could derail the consumer further? Rising unemployment is one concern and recent Credit Lyonnais Securities Asia (CLSA) China Reality Research surveys are showing some softening in SME employment. There are bound to be more jobs lost in manufacturing, a trend that's been happening for some time as employers automate in search of productivity gains, but these continue to be soaked up by new jobs in the service sector. More importantly, the working age cohort of the population in China began its inevitable decline in 2011 and will continue to fall by well over 100 million over the next 20 years, and with it the challenge of finding millions of jobs every year, has all but evaporated.

Elsewhere survey data from the CLSA's China Reality Research suggest a more positive picture. Consumer data for December shows that “current income” and “current spending power” are near record highs, akin to levels last seen in 2013/14, no doubt boosted by recent tax cuts. “Outlook” indices for both are less positive, but certainly not falling. Interestingly, A-share sentiment popped its head above the parapet in December, after a long period in the doldrums.

The CLSA Property Survey also saw a bit more cheer from sales agents in January, after a slow couple of months late last year, with a few brave souls looking for price rises. Inventories of unsold apartments are at three-year lows, and mortgage rates look to have peaked.

Q3 numbers amongst our investments were strong, and recent contacts suggest Q4 will be on track too: Huazhu Hotels pre-announced very solid occupancy and average price data, and consequently expect to exceed their Q4 guidance. In recent contact with e-commerce enabler Baozun, they reiterated their guidance for 40-45% growth for the quarter.

Sentiment may remain fragile and open to unhelpful headlines, but for the right companies, growth is still strong, and valuations are now extremely attractive.

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