Is it time to buy China?

This has been a frequently asked question over the last weeks. With the new year beckoning we suspect it will play on investors' minds even more. But it leaves us wondering if it is in fact the right question.

As bottom-up stock pickers it will not come as a surprise to many of you that we believe making money in China is more about what you buy, rather than when, or indeed if. In recent years we have carved out the China portfolio of AGEM to see how we are faring against the market, as well as a range of China funds. In the near decade that the strategy has been running the MSCI China returned almost exactly 100%, while our portfolio has returned a somewhat better 242%. There is certainly a high degree of correlation, i.e. when the market goes down, so does our portfolio, and vice versa, but fundamental valuations play a much more significant role for us than market timing.

So, when asked "is it the right time to buy China?" we would say, which China? Bottom fishing in the highly leveraged and largely bust property sector? Not a chance. Given that the private sector is under the government cosh what about the SoEs? No thanks! as few meet our cash return and profitability criteria. But dig a bit deeper and there are rafts of entrepreneurial companies which are: a) operating in areas of the economy witnessing structural and rapid growth (our universe of the like exceeds 1,000 companies, with 120 on our watchlist), b) have little or no debt, c) have strong or improving operating cash flow and return on equity, and d) are now very attractively valued.

The emergence of local Chinese brands has been one such structural change we have witnessed in recent years. Li Ning in sportswear and Proya in cosmetics are two examples of companies operating in sectors offering strong underlying growth, which in their cases is boosted further by taking share from foreign brands. Li Ning will grow earnings by well over 100% this year and has just announced 40% plus sales growth in the recent quarter. Profit growth will slow from here but around 30% per annum seems achievable over the next couple of years. Proya likewise has just announced a 30% growth in net profits for the third quarter, on the back of 21% revenue growth. This was driven by huge gains in online sales, a key strength of the company. Both companies have strongly net cash balance sheets, good cash flow to support their growth and 33% and 22% ROE's respectively. Rather than correct with the market, these have traded sideways for much of this year, for reasons now justified by these exceptional results.

Contrast this, however, with food delivery and hospitality super app, Meituan, which has had a more torrid time in the face of new anti-monopoly regulations, as well as tighter rules on the treatment of their delivery drivers. Both regulations are sensible measures of which most western bureaucrats would be proud. But removing "exclusivity" deals from a strong number one player in food delivery is a little like closing the stable door once the horse has bolted. Giving the riders better health and pension benefits, while preserving their flexibility, is just a very sensible compromise. Yes, it will add to Meituan's delivery cost and temporarily impact profitability, but it also clears a major overhang on the stock. In case we had forgotten, through all this, the business has not stood still, with revenue growth of over 60% this year likely to be followed by 40% on average for the next couple of years. You had to pay 12x forecast sales for this at the start of 2021, you now pay 4x.

Another example would be NIO, one of the leading Chinese "Tesla pretenders". While not yet profitable, that moment is approaching rapidly as sales explode upwards and China cements its leadership position with regards electric vehicles. Ironically, this has been helped hugely by Tesla creating the critical mass and the associated "manufacturing cluster" in southern China. NIO's cash flow is remarkably strong for what is little more than a start-up. In January this year, NIO was valued at 18x 2021 sales, perhaps a little excessive! Today it is valued at 7x 2022 sales, or 5x 2023. In other words, a bargain.

To lump all of China together is often to miss the huge opportunities available within. We cannot tell you what the MSCI China or indeed any other index will do from here, and frankly, we don't really care. But there are so many Chinese stocks which excite us, and we have little doubt that they will prove rewarding investments over the next year or two. And many of these are much more attractively valued than they have been for a while.

Performance

Net Performance (USD) as at 30 September 2021	YTD	1 Year	3 Years	5 Years	7 Years	Inception
Aubrey Global Emerging Markets Strategy*	2.1%	20.5%	85.6%	120.1%	115.6%	246.6%
MSCI TR Net Emerging Markets USD (NDUEEGF)	-1.2%	18.2%	28.0%	55.5%	46.6%	48.1%

*The above figures have been calculated using a combination of OMGI Fund GBP share class (14Mar12 to 31Mar15) and the AGEM Fund IC2 USD Share Class from 01Apr15 which have been recalculated to simulate USD performance over the same period using GBP to USD FX Daily Spot Rate sourced via Bloomberg. The resultant combined performance is calculated in USD and presented net of management fees and transaction costs. The OMGI Fund GBP performance has been used to simulate the past performance of the AGEM fund because they have both followed the same strategy. However past and simulated performance is not a reliable indicator of future results and you may not get back what you originally invested and investment returns may increase or decrease as a result of currency fluctuations.

Biography

Rob Brewis | Fund Manager

Rob Brewis is one of the three fund managers responsible for the Aubrey Global Emerging Market strategy.

An engineering graduate from Cambridge, Rob began his career in 1988 at Thornton Management in London before moving to Hong Kong in 1989. There he managed the Asian Special Situations Fund for Credit Lyonnais. Having been an early investor in a number of nascent Asian markets during the 1990s he also managed several single country funds investing in India, Pakistan, Indonesia and Thailand as these markets opened to foreign investment and grew in size. Rob co-founded an emerging markets investment boutique, BDT in 2000 before joining Aubrey in 2014.

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