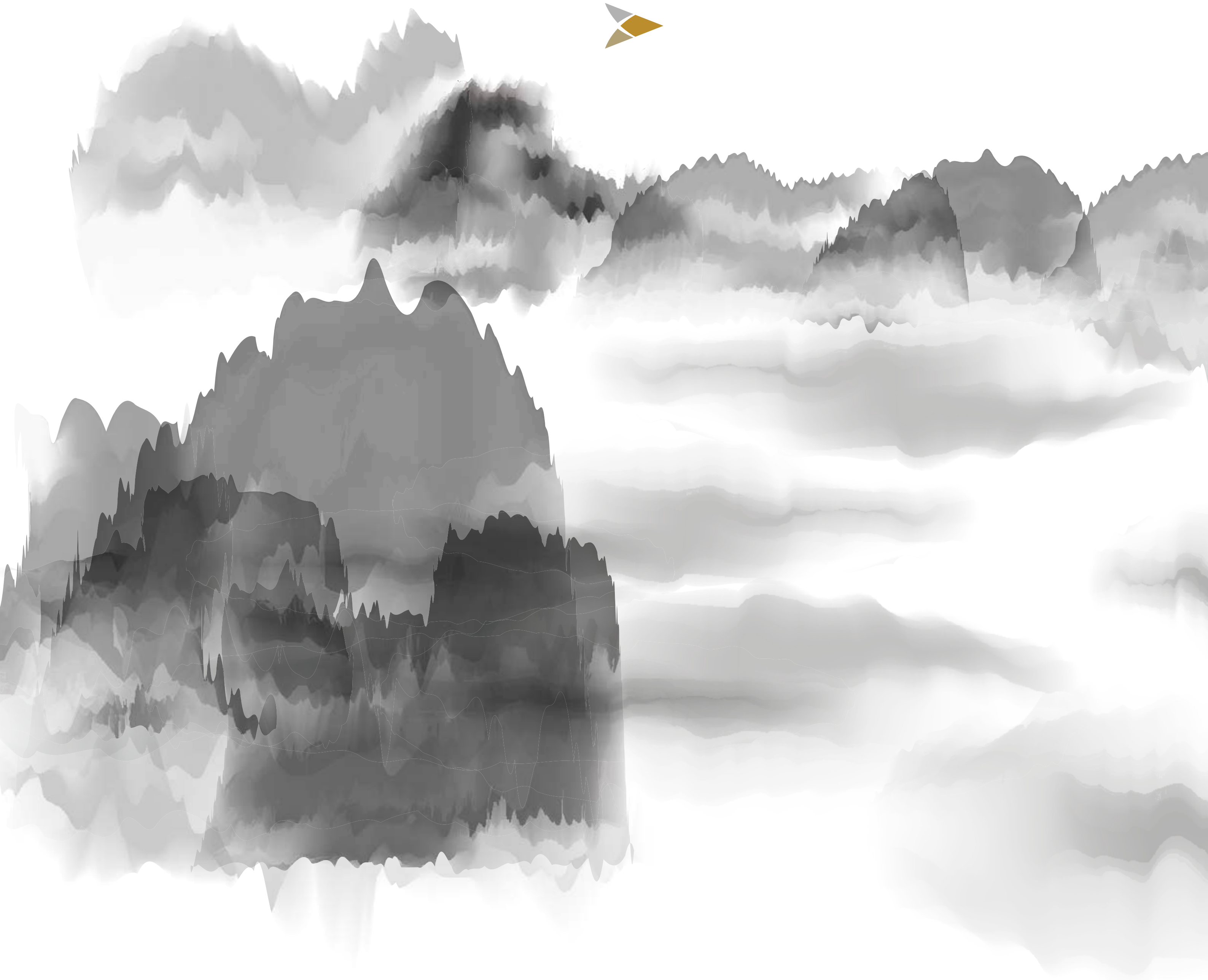
Taking stock in China

UNDERSTANDING INVESTING IN THE WORLD'S SECOND LARGEST ECONOMY



Two members of the Walter Scott research team recently returned from a research trip to China. Impressed, as always, by the array of opportunities on offer, they were also reminded of some of the risks that come with investing in the world's second largest economy.

Two members of our research team recently embarked on a two-week research trip to Beijing, Hangzhou and Shanghai. The trip was a chance to get a sense of things on the ground in China, challenge our existing perspectives, and hear the views and opinions of more than 30 companies, Chinese and non-Chinese, owned and unowned. Such trips are an essential part of our research-intensive investment process; we want to see for ourselves rather than take things on trust.

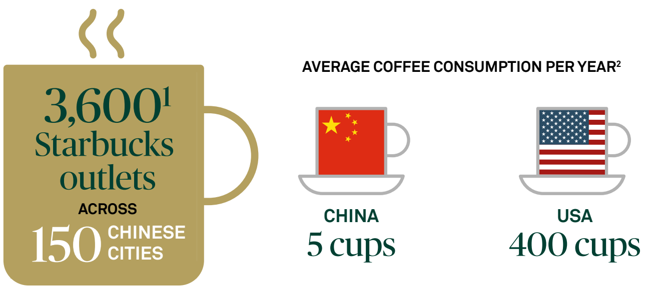
We've been visiting China for many years and need no reminding of the huge opportunity the country presents for investors. While recent headlines might have been dominated by talk of trade wars and slowing GDP growth, the country remains one of the most potent engines of growth in the global economy.

But we're also acutely aware of the risks that come with investing in China and, reflective of our relatively conservative philosophy, we chart a cautious course when deciding how best to gain exposure to the country. This shows in our preference for investing indirectly rather than directly. This isn't to say we won't invest directly in Chinese companies, but we believe our more prudent approach offers a degree of insulation from some of the risks involved, while still allowing our clients to participate in the country's long-term growth story.

We received a very visible reminder of one of these risks on arrival in the nation's capital, as it geared up to celebrate the 70th anniversary of the founding of People's Republic. Each Sunday, Beijing went into lockdown to allow for the necessary preparation and dress rehearsals. Walking down streets festooned with the national flag of the People's Republic you quickly become aware of the fact that, in China, the government is everywhere.

This pervasiveness is as true in business as it is in for most other facets of Chinese life. Not only is government very often a company's largest shareholder but many businesses also rely on it for a substantial proportion of their revenues. And unsurprisingly in a centrally planned economy, the direction of policy can dictate business fortunes for better or for worse. Of course, government plays a role in every market in which we invest, but China's "socialist market economy" demands particular scrutiny of corporate structures and the rights of minority shareholders. We should stress that these are not insurmountable obstacles. Where Chinese companies adhere to high standards of corporate governance, meet our strict financial criteria and align the interests of shareholders with those of the state, we are more than willing to consider them as investment candidates.

Despite our limited direct exposure, we apply the same level of research focus to China as we would any other country. The companies that meet our rigorous investment criteria will be world-leading companies with strong balance sheets, high rates of internal wealth generation and the ability to grow earnings over the long term. Increasingly, many such companies have operations in China and Chinese demand can be an important driver of revenues. Starbucks, for example, has in the region of 3,600 outlets across 150 Chinese cities[1]. The scale of the opportunity open to Starbucks is vividly demonstrated by the fact the average Chinese citizen currently consumes a meagre five cups of coffee each year, compared to the 400 drunk by their American counterparts[2]. Louis Vuitton owner LVMH, meanwhile, is laser-focused on a country that should soon account for 40% of all luxury good purchases globally[3].



1 Source: Starbucks, 13/12/2018
2 Source: US-China Today, June 2019
3 Source: China Luxury Report 2019

After Beijing, our trip took us to Hangzhou and cosmopolitan Shanghai. The companies we met were as diverse as the cities visited. Among them were healthcare providers, fast-food chains, travel operators and elevator manufacturers. Many of these companies are plugged into the long-term trends driving opportunities in China, such as urbanisation, rising incomes and digitisation. Not all were natural investment candidates for Walter Scott, but every meeting yielded valuable insights that will inform our ongoing analysis and debate back in Edinburgh.

In Hangzhou, we met with Ctrip, owner of Skyscanner, and China's leading online travel agent with over 60% market share[4]. The Chinese travel industry has experienced a slowdown over the last year, but the long-term outlook is very positive. Ctrip expects Chinese tourist spend (inbound, outbound and domestic) to total CNY1.3 trillion by 2022[5].

CHINESE EXPECTED TOURIST SPEND

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Hangzhou is also the centre of China's surveillance industry. Hikvision, the country's leading manufacturer of surveillance products, is a highly profitable company with a strong balance sheet. Perhaps unsurprisingly, given the scale of China's surveillance network – over 200 million cameras and counting[6]. The industry comes with serious ethical concerns, however, and the use of Hikvision equipment in Xinjiang Province, where the government is involved in a long-running security crackdown, adds an extra dimension to any investment debate around the company.

Shanghai provided us with the opportunity to meet several fast-food operators, including Yum China, the operator of KFC, Pizza Hut and Taco Bell. There is a burgeoning eating-out culture in China, with the country's restaurant industry soon to be the largest in the world[7]. Speaking to the owner of a chain of traditional hot-pot restaurants, a popular casual-dining format among Chinese families, we also gained some insight into the African swine fever crisis that has hit the country. The epidemic has been extremely challenging for China's food industry, given the ubiquity of pork in the nation's diet. However, improved food standards seem a likely, if unintended, consequence. Not only are supply chains having to diversify, but there is increasing demand for traceability of ingredients.

Towards the end of our stay, we paid a visit to Kone, the Helsinki-based company that makes and services escalators and elevators and a genuine global success story. The company is the market leader in China, which accounts for two-thirds of all new escalator and elevator equipment orders globally and more than a third of the world's existing stock[8]. Servicing and efficiency have been central to the company's success at a time of increased regulation around maintenance and energy use. With the migration of people to China's cities expected to continue apace over the next ten years, the country's importance to Kone's long-term prospects is only going to grow. In this, Kone will not be alone.

We never leave China anything other than impressed by the innovation and dynamism on show, not to mention excited by the sheer scale of the opportunities on offer. Of course, the country, and indeed every market across the world, has its own particular risks. We consider these risks through the prism of our bottom-up analysis, discussing and assessing all investment candidates on merit alone. Our quest is for companies that can generate wealth over time: world-class businesses that are able to succeed regardless of the market they call home. Finding those that can take advantage of the powerful secular trends that are evident in China will continue to form a key dimension of our research endeavours.

4 Source: Barron's, November 2019
5 Source: Travel China Guide, 2019
6 Source: Business Insider, August 2019
7 Source: South China Morning Post, September 2019
8 Source: Kone, September 2018