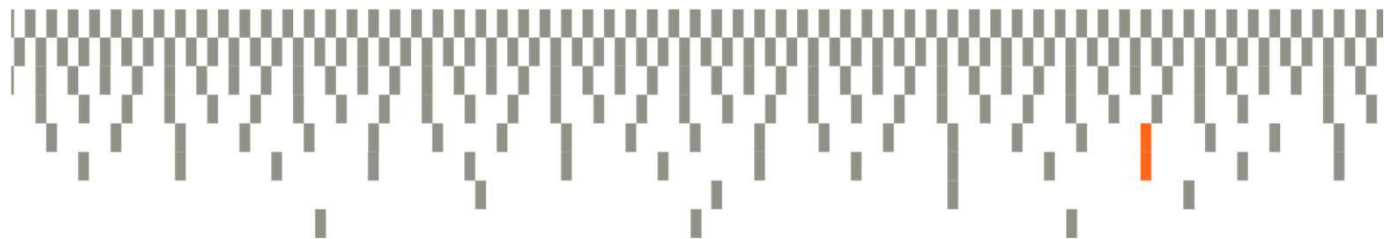




The fundamental thesis



China update

Chinese equities declined in August due to various factors, including property sector challenges and a lack of significant policy action. Towards the end of the month, market sentiment improved as the government implemented measures to support the economy and capital markets. Recent macroeconomic data indicated signs of stabilisation in the Chinese economy, with positive CPI, PPI, retail sales, and industrial production trends. However, concerns persist regarding the property sector's impact on the overall economic outlook.

- **Chinese equities declined in August, with the MSCI China and MSCI China A Onshore indices falling by 9.0% and 8.1%.**
- **August witnessed a net outflow of 89.7 billion Yuan from foreign investors in A-shares.**
- **China's CPI returned to positive territory in August, and the PPI improved compared to July.**
- **Retail sales rose by 4.6% year-on-year, and industrial production increased by 4.5%.**

Chinese Equities: The month of August in review

Chinese equities experienced a broad-based decline in August, relinquishing most of their previous month's gains.

This reversal was once again attributed to the absence of meaningful policy actions and the re-emergence of property sector woes, triggered by Country Garden, one of China's largest private developers, initially missing its bond payments (although this was later resolved within the grace period). Additionally, a Chinese asset manager named ZhongZhi faced a liquidity issue, causing a delay in the payment of maturing wealth products. For the month, the MSCI China and MSCI China A Onshore indices were down by 9.0% and 8.1%, respectively.

August witnessed a record net outflow of 89.7 billion Yuan from foreign investors in A-shares. Furthermore, Chinese mutual funds launched equity products at a significantly lower rate, ranging from only 10% to 20% of levels seen during historically more favourable periods.

However, market sentiment improved towards the end of the month as the government introduced new measures to support the economy and capital markets. These measures included a stamp duty cut, lower margin financing requirements, and a slowdown in new listings. In the property sector specifically, banks reduced existing mortgage rates, and local authorities relaxed home purchase restrictions in many tier 1 and 2 cities, including Beijing and Shanghai. These policies appear to be gradually moving in the right direction.

On the macroeconomic front, recent data indicated signs of stabilisation in the Chinese economy. In August, the Consumer Price Index (CPI) returned to positive territory, and the Producer Price Index (PPI) showed improvement compared to July. Year-on-year retail sales rose by 4.6%, surpassing the 2.5% increase observed in July, while the total value of industrial production increased by 4.5%, accelerating from 3.7% in July.



Data suggests signs of stabilisation in the Chinese economy.



Chinese equities declined due to policy inaction and property sector challenges.



Notable capital outflows prompted support measures from the government.

Despite these positive indicators, the situation unfolding in the property sector continues to be a critical factor influencing overall economic prospects.

The fundamental China thesis

As a reminder, the fundamental thesis for investing in China is that it is the second-largest stock market in the second-largest economy in the world but remains significantly underrepresented in global indices.

While there is no doubt that it has some unique risks, it also contains hundreds of companies delivering structural growth. This is either because they are selling higher-quality products to the world's largest population or moving up the value chain in manufacturing, be that in electric vehicles or medical equipment.

There is no better way to understand these dynamics than to see them for oneself. We recently accompanied a client on a research trip to Shanghai and Beijing, where they had the opportunity to explore various aspects of the Chinese economy and meet with some of our portfolio managers and investee companies.

Firstly, it was evident that daily lives and commercial activities have returned to normal post the pandemic. We encountered traffic congestion in both cities, highlighting the bustling nature of these economic hubs.

One notable aspect we experienced was the remarkable efficiency of online shopping and on-demand delivery services, showcasing what has become known as "China speed." Our client witnessed first-hand, the convenience and speed of obtaining niche products through e-commerce platforms.

Market sentiment improved towards the end of the month as the government introduced new measures to support the economy and capital markets.

During our visits to portfolio companies, we were impressed by their scale, efficiency, and innovation capability. One such company is Shanghai United Imaging Healthcare, an advanced medical imaging equipment manufacturer that competes directly with global giants like GE, Philips, and Toshiba.

Their latest scanner has the potential to shorten the cancer screening process from 23 days to less than an hour. This breakthrough allows patients to begin therapy sooner and at a lower cost. Like many other Chinese entrepreneurs in the sector, its founder, Xue Min, studied and gained experience abroad as a senior researcher at a top US clinical imaging institute before returning to China and founding his own company.

We also visited Li Auto, a leading domestic electric vehicle brand specialising in premium SUVs. We have written about this company several times in the past. Notably, their autonomous driving technology has made significant progress, reaching L3 capability (i.e., conditional autonomous driving, where drivers can take their eyes off the road when conditions are met).

During a test drive, we experienced the car driving itself on a highway, and the ride was remarkably smooth. Li Auto has achieved rapid growth by focusing on the domestic market. They have strategically allocated their new capacity to domestic consumers, with no immediate plans for export.

One of the key factors contributing to their success is their ability to customise their vehicles to meet local demand, whether it's adjusting the dimensions to accommodate the average Chinese family or designing the interior and integrating smart applications.



Visiting China revealed optimism despite recent challenges.



Chinese firms demonstrated impressive scale, efficiency, and innovation capabilities.

Additionally, we had the opportunity to explore the operations of SF Holding, the largest delivery services and logistics company in China. During our visit to one of their major logistics centres in Beijing, we witnessed the scale of their operations and high level of automation, handling a staggering 2.7 million parcels daily for the city.

Over the years, they have built a sophisticated conveyor system and a highly automated process, encompassing activities from loading/unloading and code reading to sorting and packaging. Previously, they required 2-3 people to operate each conveying line, but now they only need 3 people to manage 20 lines.

In conclusion, the visit reminded us that, despite recent challenges, there is much to be optimistic about, given China's numerous growth opportunities and high-quality businesses. Many of these businesses, such as SF Holding, trading at less than 20 times forward price to earnings, are currently valued very attractively.

The energy and level of innovation we witnessed first-hand, combined with the strong fundamentals of these companies, lead us to believe that their share prices will ultimately reflect their actual value.

A trip to Shanghai and Beijing yielded a positive outcome showcasing that daily lives and commercial activities in China have returned to normalcy following the pandemic.