GiB ASSET MANAGEMENT

On the road: Engagement in action

Value unlock in China

Sleeping Green Giant's Conundrum

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Our Active Engagement approach leans on identifying hidden value in businesses and using the tool of Engagement to unlock and drive its greater market recognition. Following our recent Engagement trips to India, Korea, Taiwan, Vietnam and Indonesia, we turn our attention to China.

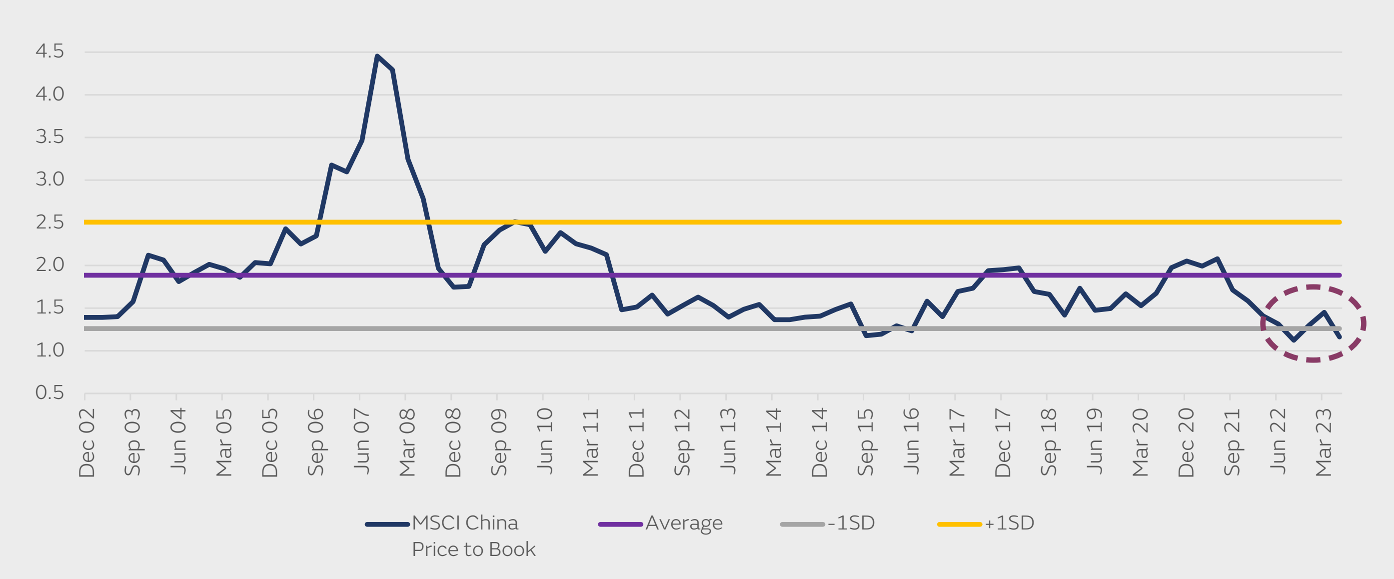
The state of bilateral relations between US-China is an important consideration for investors. In addition to the troves of multinational businesses continuing to seek ways to decouple from China driven by the growing pessimism surrounding the current state of affairs, the changing regulatory landscape and extended lacklustre property cycle on the home front have resulted in the weak performance of the Chinese equities market in the last couple of years.

In the short term, we believe there are multiple reasons to be constructive on the China equity market with a consumption recovery well under way, albeit patchy, and the government having multiple levers for potential stimulus (both fiscal and monetary). The implications of the geopolitical relationship between China and the US are harder to analyse. Whilst it is difficult for equity investors to predict any political development, taking an appropriate approach at the portfolio level can help better manage potential risk on this front. Focusing on businesses with internally developed intellectual property (IP) and primarily tailored to serving their large domestic market helps to mitigate risks related to any deterioration in bilateral relations. These opportunities often span across various sub-sectors that presents potential upside that was unimaginable just a few years ago.

As we search for bright spots amidst uncertainties, we spent a week meeting companies on-site in Hong Kong and Shanghai in order to obtain a clearer understanding of the investment landscape since re-opening post pandemic. We had constructive in-depth discussions with five portfolio companies, and interacted with 20 other companies from various sectors, which included sportswear retail, semiconductors, renewable energy, software, industrial automation and healthcare.

China – A bargain?

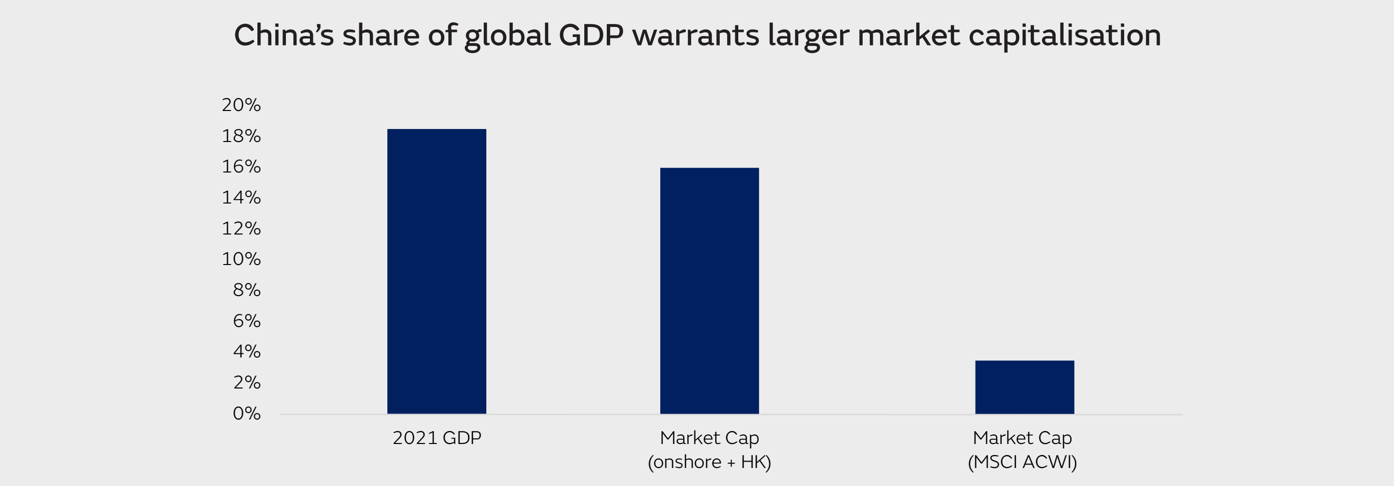
At one standard deviation below its 20-year average on a price-to-book basis, China is attractively valued today.



Source: Bloomberg, MSCI

Underrepresented within global investment markets

Comprising about a third of the MSCI EM index[1], China continues to grow in scale, importance and relevance whilst its share of global GD, in our opinion, implies larger equity market capitalisation over time. The second largest economy in the world is home to the one of the world's largest populations of over 1.4 billion, and to the world's fastest growing middle class. Recognising that the past decades of high growth model based on investments, low-cost manufacturing and exports have just about run its course, China today is pivoting towards domestic consumption and innovation for sustainability of long-term economic developments. As it transitions to higher quality growth and the move up the manufacturing value chain with a focus on higher-end equipment and industrial goods, local champions have subsequently emerged in affiliated sectors like semiconductors, industrial automation and artificial intelligence.

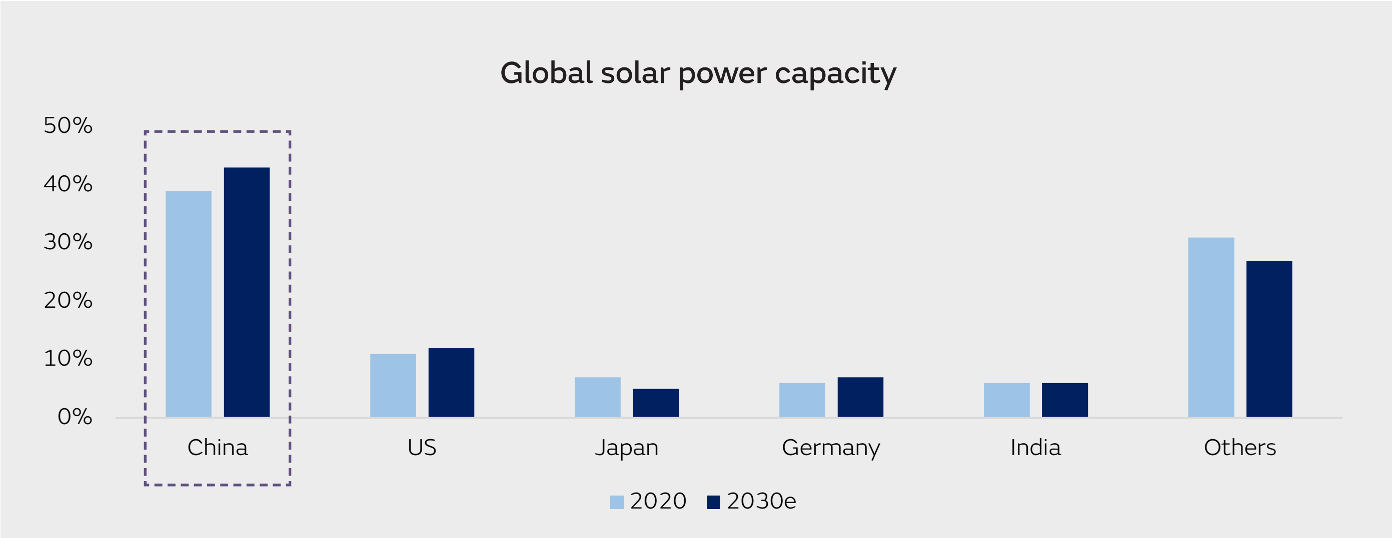


Source: World Bank, World Federation of Exchanges, MSCI, Morgan Stanley Research (Feb 2023)

[1]Bloomberg ; July 2023

Leading the world in renewables

Further underpinned by the firm belief that this is the decade of the decarburisation revolution, China's role in leading the renewable energy transition in Asia and contributing globally as the biggest producer of solar and wind energy today has consequences.



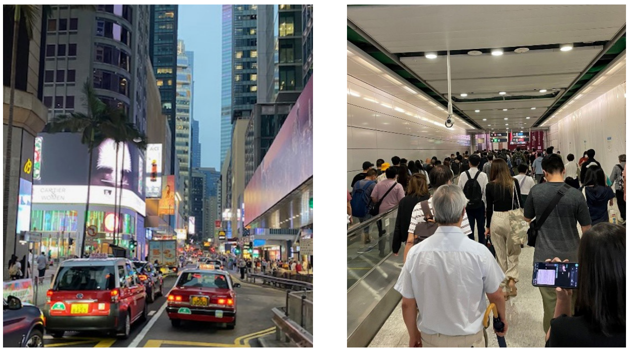
Source: Fitch Solutions (2020)

China: unloved but misunderstood?

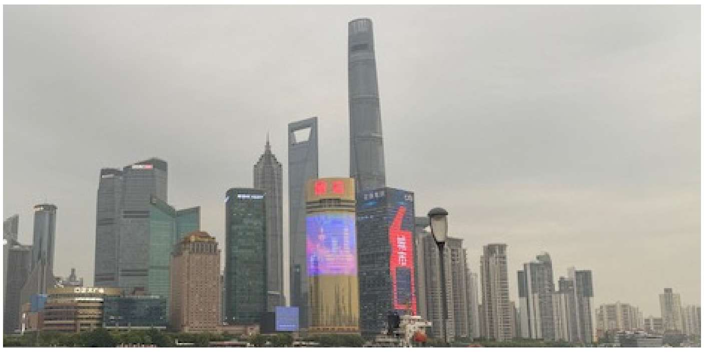
Hence, in the context of emerging markets investing, China is too large a market to ignore.

Equity investors in China have faced a challenging period over the past three years, with the MSCI China Index declining by more than 20%, significantly underperforming the MSCI World Index by a substantial margin of over 60%. This has meant its valuation discount to the MSCI World Index has extended to more than 40%[2].

Several factors have contributed to the relatively weak performance of the China equity market during this time. One significant factor is the increased regulatory scrutiny on sectors like technology and education, which has created uncertainty and dampened investor sentiment. Additionally, geopolitical tensions between China and the United States have introduced market volatility and increased caution among investors. Concerns surrounding China's property market and rising debt levels have further compounded the market's challenges, which have all contributed to intensifying headwinds.



Bustling streets of Hong Kong in the rush hours – both over land and underground



Vibrant Shanghai's Bund district – overlooking the financial centre district of Huangpu

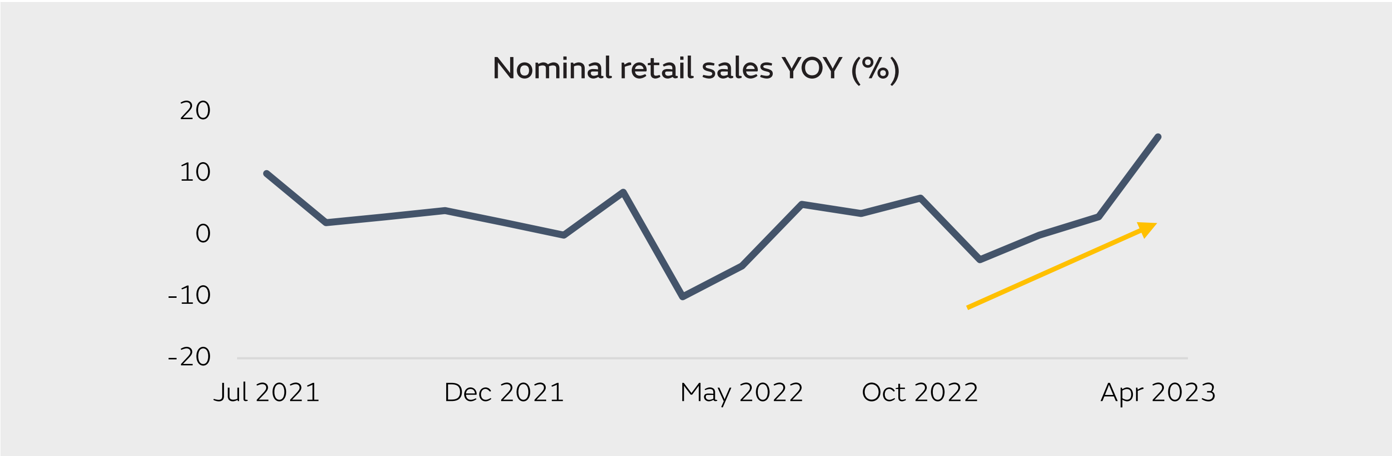
[2] Financial Times (https://www.ft.com/content/ffa533bc-2825-4bab-bd5e-f53fd99c124a); May 7, 2023

Uneven consumer demand recovery – slow yet real

China's post-COVID demand recovery has been more gradual relative to analysts' and economists' expectations. As a result, there have been various speculations around the underlying causes of the slower recovery in sentiment. Regardless, China's slower demand recovery serves as a reminder that even robust economic forces require time to regain their pre-pandemic strength.

The initial results from the first quarter reveal an asymmetrical recovery within the consumer space. The staples sector has experienced a stronger rebound compared to discretionary and export-oriented industries in the industrial/manufacturing sector. Particularly, the beverage and food product industries have seen significant increases in revenue and earnings, surpassing the levels recorded in the first quarter of 2019.
Sales of sporting goods were also much higher than April 2019 levels at roughly 174%[3]. Despite the slower growth rate of overall consumer spending in April 2023, we believe that the longer-term consumer led recovery has more room to go.

Recent rebound of nominal retail sales



Source: CEIC

Encouragingly, recent data indicates a robust recovery trend on services that has lagged initial recovery rebound, as domestic visitors and tourism revenue have surpassed the levels observed during the Labour Day holiday in 2019. These promising indicators suggest a sustained improvement in services consumption and point towards a potential closing of the gap, leading to a more balanced recovery within the consumer space.

[3] National Bureau of Statistics of China

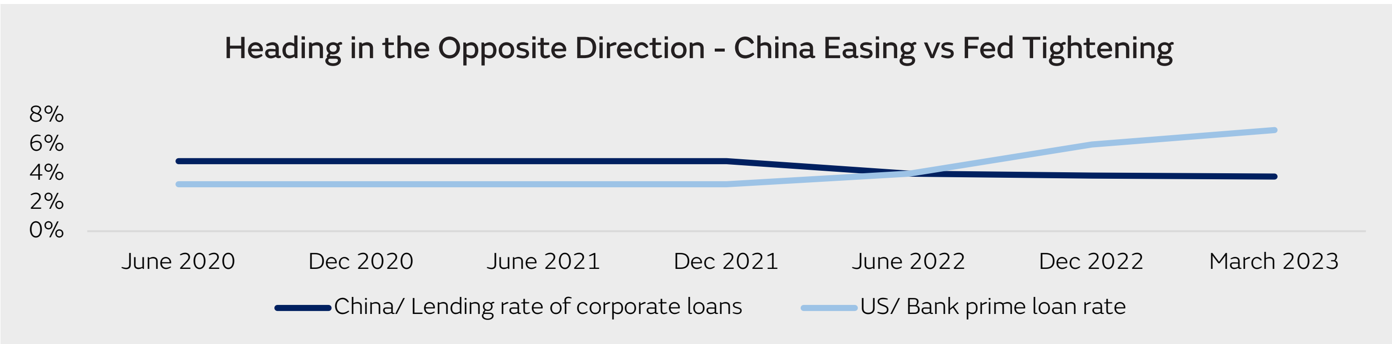
Recovery rebound – Tourist volume and revenue vs 2019

Source: Ministry of Culture and Tourism (China); Daiwa Securities

A domestic liquidity supercycle?

Chinese households today are well-endowed with cash; they have the means to spend if they want to. It is estimated that Chinese households have accumulated RMB13tr (USD1.8tr)[4] in additional deposits because of weak spending, lower home purchases and financial investments over the last 3 years. Net increase in household bank accounts is equal to USD 6.9tr, which is greater than the GDP of Japan in 2022 and equal to 118% of China's 2019 retail sales.[5]

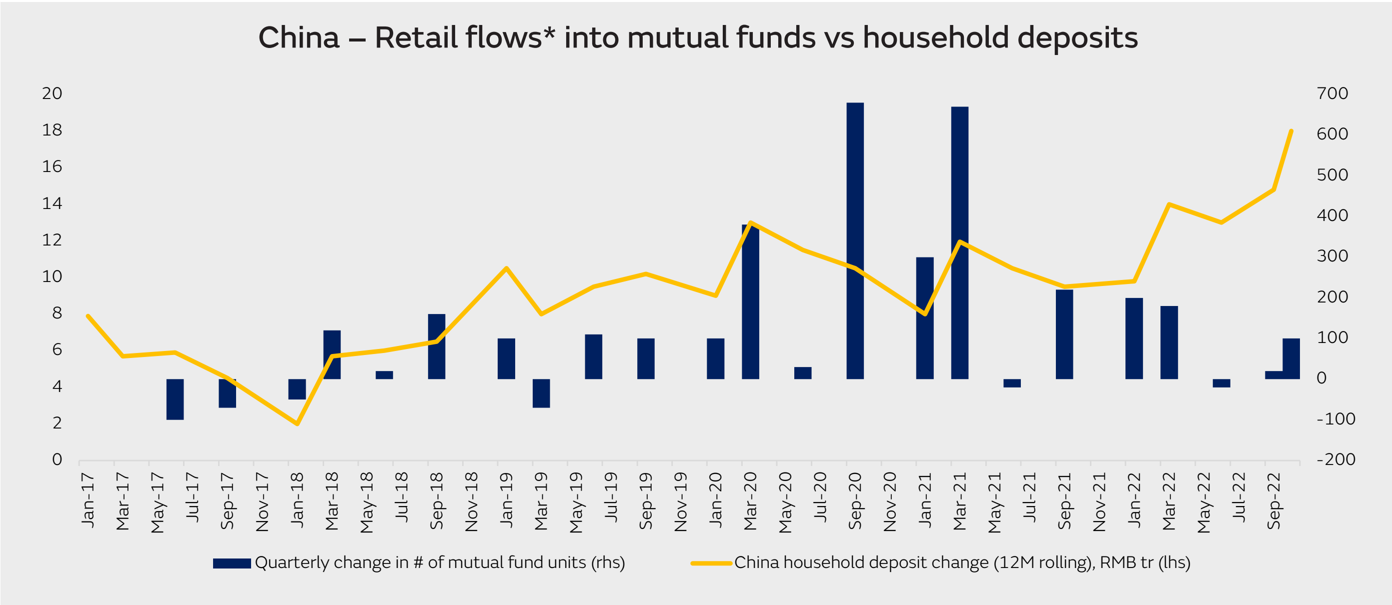
Pockets of opportunities emerge as reopening momentum continues before giving way to a more meaningful recovery phase where policy support will be key. Likely, the Chinese government, who so far has been trying to rejuvenate growth organically, will step in with more stimulus if indicators continue to miss expectations. In this respect, given the approach since the pandemic has been more conservative relative to Western countries, the lack of inflationary pressure with sufficient tools available give us comfort that there is bandwidth to further support the economy if needed. For a start, the China's central bank has started to ease rates while the rest of the world is tightening.



Source: CEIC, Federal Reserve Bank of St. Louis

[4]Bloomberg (https://www.bloomberg.com/news/articles/2022-11-14/china-s-property-woes-drive-household-savings-to-record-high)
[5]National Bureau of Statistics of China; World Bank

Against this background, there is room for a continuing consumer spending rebound (albeit patchy with more discern) and a recovery in mainland equities where domestic investors hold about 95% of the market[6]. As Chinese retail inflows into mutual funds have been muted in 2022, this may pick up more meaningfully with any recovery in general sentiment in the months to come.



Source: Wind, CEIC
*Onshore mutual fund issuance used as a proxy for retail flows. (March 2023)

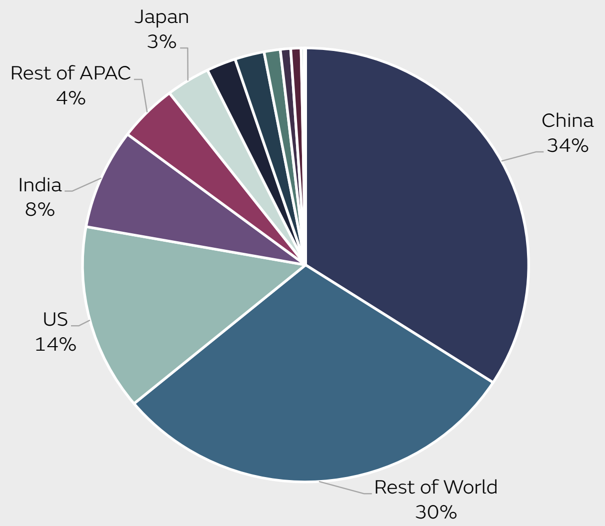
Pathway to Net Zero: mission critical

As the current largest emitter globally, China's pursuit of decarbonisation and its success in reaching peak emissions by the end of the decade will have significant implications for countries and companies worldwide. China's commitment to achieving Net Zero carbon emissions by 2060 alone represents two-thirds of the approximate 48% of global emissions pledged by countries committed to Net Zero goals[7]. Since President Xi's previous announcement of the aim to achieve Net Zero emissions in September 2020[8], China has taken further action by releasing updated climate pledges and detailed policies. These include revised targets as part of the 14th Five-Year Plan (FYP) and comprehensive decarbonisation strategies to be implemented. Key targets include increasing non-fossil energy consumption to 20% by 2025, 25% by 2030, and an ambitious goal of 80% by 2060[9]. Additionally, China aims to reduce carbon intensity per unit of GDP by 18% between 2020 and 2025[10]. In preparation for the COP26 conference in November 2021, China had additionally clarified its targets to achieve peak carbon dioxide emissions by 2030 and Net Zero greenhouse gas emissions by 2060[11].

Climate risk is investment risk and financial institutions are increasingly lining up behind Net Zero targets. Sustainable investors will closely analyse national emissions pathways to determine their future portfolio decarbonisation objectives and prioritise engagement efforts. To date, an estimated $72 trillion in global assets under management incorporates considerations for achieving Net Zero emissions into their portfolio strategies[12]. In this regard, the global Net Zero transition will contribute to shape portfolio outcomes over the coming years, especially so in Emerging Markets given the key role the region plays.

[6] https://www.msci.com/www/blog-posts/diversification-for-home-biased/03480913590
[7] Carbonomics: China Net Zero - The Clean Tech Revolution Goldman Sachs; Jan 2021
[8] Statement by H.E. Xi Jinping President of the People's Republic of China At the General Debate of the 75th Session of The United Nations General Assembly (fmprc.gov.cn)
[9] International Energy Agency – An Energy Sector Roadmap to Carbon Neutrality in China; Sep 2021
[10] International Energy Agency – An Energy Sector Roadmap to Carbon Neutrality in China; Sep 2021
[11] International Energy Agency – An Energy Sector Roadmap to Carbon Neutrality in China; Sep 2021
[12] GS Sustain: The Net Zero Guide, Goldman Sachs; July 2022

Share of global fossil fuel related CO2 emissions (2020)



Source: European Commission Joint Research Centre and World Bank (2020)

Net Zero - a material engagement opportunity

As part of our investment approach, we encourage our portfolio companies to take proactive steps towards decarbonisation and establish targets well in advance of regulatory requirements. We strongly believe that engaging with management teams early on to plan and achieve carbon neutrality can lead to both financial gains and cost savings for the company. The increasing pressure from regulators, investors, and customers is driving corporations to take decisive action.

When we initially discuss the concept of Net Zero and its implications with our portfolio companies, we often encounter resistance from management teams, particularly if they perceive themselves as asset-light businesses with minimal environmental impact, such as those in IC semiconductor design, software, e-commerce, or retail industries. We seek to address this gap in mindset due to misinformation. The reality is that while the company itself may have a limited carbon footprint, its suppliers can have a significant environmental impact. Furthermore, customers are increasingly demanding greater transparency and accountability for carbon emissions throughout the entire value chain. To highlight this point, we often cite Apple's commitment to full decarbonisation of its global supply chain by 2030.

A summary of our Net Zero Framework

Measurement & Disclosure

-**Map out sources of energy** and measure them

-**Measure and disclose** Scope 1,2 & 3 emissions

-Implement the reccomendations of the **TCFD framework**

Strategy & Targets

-Clear and quantified strategy to demonstrate how the company will achieve its climate targets

-Disclosure of action plan describing methods employed to achieve decarbonisation

-Verified long-term and interim science-based targets

-Aim for absolute emission reduction

Governance

-Aligning climate performance with executive remuneration

-Assigning responsibility to ensure that there is accountability

-Constructing boards with climate/transition experience

Source: GIB Asset Management, Emerging Markets Team

During our trip, we had an opportunity to meet one of our portfolio companies from the semiconductor/ IC Design sector. In our discussion, we revisited topics that were previously covered in our engagement presentation. These included addressing corporate governance structure concerns and implementing a Sustainability agenda for the company. In addition to these topics, we introduced a new discussion point in our engagement plan, emphasising the need for the company to establish a Net-Zero strategy and set targets. While this is a relatively new subject for the company, we had a fruitful discussion about the significance of carbon emission reporting and the establishment of long-term goals. We believe that this topic will become particularly important for technology companies exposed to consumer related products.

Engagement progress in China

Over the course of meetings with our portfolio companies, we focused on previously identified and communicated engagement points which we believe can positively impact the value of the company through 1) driving higher compounding power of the business and 2) lowering the implied cost of capital. Most meetings were positive – be it the level of receptiveness to our ideas or willingness to explore any opportunities that can potentially enhance business value creation.

Quick Service Restaurant (QSR) operator

One of our portfolio companies, a market leading Quick Service Restaurant (QSR) operator, impressed us with the resilience of their operating model. Our initial investment is predicated on deep and durable competitive advantages shaped by their brand equity, consistent menu innovations, market leading digital capabilities alongside cost advantages stemming from buying scale and sourcing efficiencies. However, the challenges and disruption caused by COVID-19 had the potential to disturb their competitive position.

As the Chinese market recovers from lockdowns to a gradual re-opening, our portfolio company has nimbly pivoted from a defensive position of cost cutting and driving efficiencies to a more aggressive strategy of reinvestment. This tie-in with our ongoing engagement with the company of creating tangible equity stories through disciplined reinvestment that optimises for returns on incremental invested capital.

In particular, the company focuses on expanding its store footprint through much of China's third and fourth tier cities where clear market opportunities await. Success here relies on their much-vaunted focus on menu innovation, powered by a 27,000 square foot innovation centre in Shanghai and a vast data pool accrued from their 380m digital members. They introduced over 500 different menu items last year alone which caters to a diverse range of tastes – a necessary condition for successful regional expansion. Further reinvestment into the coffee industry represents a promising opportunity. The company is blessed with superior customer acquisition costs through seamless cross sell efficiencies, whilst the addressable market is underappreciated. Who knew that Shanghai boasts nearly 8,000 cafes – surpassing even London as the single city with the highest number of cafes globally?

Despite these competitive strengths, we believe the business remains undervalued. Our engagement work with the company focuses on suggestions that aim to further enhance their compounding power and return profile.

During our meeting, we outlined our view that one of the brands operated by the company is undervalued by investors. We expressed our hope that recent IPOs in Hong Kong, which have commanded higher valuation multiples, can serve as a benchmark for the business and potentially enhance its valuation in the future.

Building on our previous discussions with the management and our recommendations, the company is enthusiastic about exploring franchising opportunities in China. This approach will allow them to expand their network into remote locations in a cost-effective manner and represents an unaccounted source of cash. Like many other companies in our portfolio, this company faces a 'good' problem to solve — a strong balance sheet with substantial cash reserves and a robust free cash flow profile. We are confident that the company will continue to achieve robust business growth and deliver improving capital returns to investors through increased dividends and share buybacks.

Chinese sportswear brand operator

One of the two largest domestic sportswear player in China, this portfolio holding company still achieved net profit margin expansion during the market downturn years due to the pandemic. This is largely attributed to the superior execution and efforts of management to improve supply chain, products, channels and retail operations footprints. Despite improved returns and superior growth to some, the company is still trading at a discount relative to global peers.

Engaging with the management of the company has so far been rewarding and they remain appreciative of the commitment and constructive suggestions we have put forth since our first interaction. To date, company has taken onboard our proposal for 1) improving board independence and diversity, the importance of 2) improving quality of supply chain audits and 3) ensuring robust sustainable sourcing policies disclosures to further improve the company's standing globally.

For further value unlock, we discussed and suggested the merits of communicating a clear capital allocation plan to the market and alignment of incentives for value creators, starting with a refresh of outdated ESOP. There has been precedence set for value destruction through diminishing returns on invested capital (ROIC) or an under optimised balance sheet despite strong free cash flow generation. With reference to the above premise, we explored ideas of reinvestment needs of the business that can be balanced with capital efficiency via increased commitment in R&D to enhance pipeline of quality product footprints driven by technology, premiumisation of product offerings and the use of more sustainable renewable materials in products. We also proposed for the further enhancement of operating working capital efficiency with the upgrading and synchronisation of inventory management system to support capacity and store expansion plan. Clearly communicating these plans that enhance the compounding power of the company will give investors confidence that ROIC is protected and that management are thoughtful in driving long-term shareholder value.

Flagship store visit

Financial Technology Provider

A leading financial IT technology provider in the country with significant market share in each vertical in which it is operating, this portfolio company is well placed to ride on the financial digitalisation wave in China. Promising growth outlook is driven by financial market expansion, reform and innovation, supported by its clear competitive strengths due to its dominant market position, R&D capability and solid yet diversified customer base.

Building on our previous successful suggestion to entrench commitment to sustainability with 1) senior members of the management driving the process, 2) conducting a materiality assessment to identify the most relevant issues to the company and all stakeholders and 3) publishing a sustainability report in line with Global Reporting Initiative guidelines, we explored new engagement ideas of how company's compounding power and standing can be further enhanced.

As strength of the business model remains unknown to many outside of China, we proposed the organisation of an on-site Investor Day to engage the global investment community. Not only will this help attract both foreign and local interests, it also enables the company to display its R&D superiority, alongside future product lines and strength of the management in an interactive way. In the same process, with adequate bilingual disclosure, revenue recognition and seasonality of earnings impact on unnecessary volatility of share price issue will be addressed.

Given the company's ability to generate free cash flow with profitability despite challenging market conditions, its balance sheet strength drives optionality. We proposed the introduction of a five year Capital Allocation vision with a particular focus on 1) opportunistic buybacks (to re-incentivise talent), 2) roadmap of accretive M&A to further drive ROE higher, 3) formalise a progressive dividend policy and 4) reinforcing ROIC focus through KPI alignment. This helps to enhance the compounding power of the company and weatherproof sustainability of its business model to the future.

Proprietary technology platform of system performance, financial progress and share price tracker

Conclusion

"In the short run, the market is a voting machine but in the long run it is a weighing machine."

Benjamin Graham

Since late 2020, we live in a world defined by growing uncertainty, which has ranged from increasingly troubled developed market financial institutions, stubborn inflationary pressures and the ongoing strained relations between Washington and Beijing. More than ever, the dispersion of stock returns has increased which opens up opportunities for active management and stock pickers.

With China projected to account for over 35% of global economic growth in 2023[12], the longer-term prospects for Chinese equities remain intact as the global giant continues to evolve, rebalance and adapt. We believe that attractive opportunities still exist within certain sectors despite the overall negative investor sentiment.

The combined approach of our active engagement investment philosophy and under-appreciated opportunities in China today firmly favour the prospect of long-term value creation.

[12] IMF Report; May 2023.