

Five Views of China

An Insider's Guide To The Forces Shaping Local Markets



October 2018

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Our Thinking: Thought Leadership

Our thought leadership papers deliver thought-provoking analysis of key investment themes. Through focused and unique insights into topical issues, we aim to provide investors with a deeper understanding of the challenges and opportunities within global investment markets.





Introduction

China's capital markets are opening up to foreign investors just as its economic growth is becoming increasingly driven by domestic demand. These 'local' markets are too big to ignore.

The world's number 2 economy has reached a crucial stage of its development: it is trying to reduce imbalances while transforming its growth model; it needs to decide whether its future lies in more government control or less; it has to convince the world its rise is benign rather than a threat.

We invited our experts on the ground to contribute short essays on issues important to them, in an attempt to better understand this vast country, the investment trends and the potential pitfalls.

Senior economist **Alex Wolf** discusses the spread of wealth outside China's big cities, recent setbacks in economic rebalancing, and progress on environmental protection. Investment manager **Edmund Goh** writes about the birth of defaults in the bond market and understanding state support for companies under duress. **Nicholas Yeo**, head of equities Hong Kong/China, talks about the first steps taken towards better corporate governance.

In the private markets, **Milan Khatri**, Asia's head of property research, examines urban planning, the growth of satellite cities and how the real estate investment landscape has changed. Finally, **Myron Zhu**, co-head of private equity in Asia, discusses smaller companies and the hunt for the next Tencent.

[Join us for a tour of China's local markets.](#)

The big picture



By Alex Wolf,
Senior Economist,
Emerging Markets – ASP

Spreading the wealth

China's rapid growth over nearly four decades has been nothing short of remarkable. Some 700 million people have been lifted out of poverty, while the country has been transformed from an impoverished agrarian society into an industrialised economy with a burgeoning middle class.

However, growth hasn't been evenly distributed. China's wealthiest regions are in the eastern coastal provinces that host Beijing, the capital; Shanghai, the nation's financial hub; the Pearl River delta, its workshop; and Shenzhen, China's answer to Silicon Valley. The country's interior is less affluent and scores worse on almost every measure of socioeconomic development.

This is changing, albeit slowly, as wealth fans out from the 'tier one' cities into the country's economic hinterland. For example, we took average nominal wages in 30 'autonomous' regions, provinces and so-called 'provincial level' cities, and converted those numbers into a percentage of the average nominal wage in Beijing.

We then looked at how those percentages changed in the decade to 2016 to get an indication of whether the income disparity had widened or narrowed. A percentage gain shows a narrowing of the income disparity, a percentage loss shows a widening.

The average percentage gain over those 10 years was 4.2 per cent, according to data compiled by the China National Bureau of Statistics and our own calculations. Tibet and Xinjiang – among the poorest regions – saw percentage gains of 12.7 per cent and 8.5 per cent respectively. Yunnan, a province that borders Myanmar, Laos and Vietnam, experienced a percentage gain of 4.4 per cent.

This was due, in some cases, to government investment to fast track the development of specific regions. However, it's also a reflection of how China's manufacturing migrated away from the coast to cheaper inland provinces such as Sichuan (where the percentage gain was 8.9 per cent).

Rebalance, rewind

There are worrying signs that efforts to rebalance the economy – a move away from government-steered, debt-fuelled investment towards a consumption and services-driven model championed by the private sector – have stalled. In some important respects, rebalancing has even suffered a reversal.

For example, household consumption as a share of GDP fell last year, after rising to 39.5 per cent in 2016, from a post-global financial crisis low of 35.5 per cent in 2010, according to data compiled by the National Bureau of Statistics and ASI calculations. Meanwhile, the industrial share of GDP rose in 2017, as did the investment share of GDP, the data show. This is a blow to China's new economy ambitions and a temporary reprieve for an older economic model that has seen better days.

Private sector profits fell in the 12 months to end-March, even as State-Owned Enterprises (SOEs) enjoyed profit growth. Private firms classified as 'loss-making' rose almost 40 per cent to some 32,000 in the nine months to end-March (the number of loss-making state-owned firms dropped). Asset-liability ratios, a measure of how much debt a company uses to fund its business, climbed sharply in the private sector (while the ratio fell for SOEs).

Government policies are largely to blame. As the economy slowed in 2014 and 2015, China responded with old fashioned stimulus and production quotas. Caps on the production of coal and other commodities raised prices, which benefitted producers – mostly SOEs – and penalised buyers, which are often private sector firms.

Policies to control shadow banking also cut financial lifelines to private sector companies which struggle to secure bank loans (because government-linked banks prefer to lend to government-linked borrowers). What's more, there are signs that domestic demand has weakened, based on the latest household consumption data.

China is at a crucial stage of development. It is trying to reduce imbalances while transforming its growth model. Many of these reforms to the economic model will entail significant political change. Until the government is willing to allow the market play a 'decisive' role and reduce state control, there's a risk China won't achieve its long-term economic goals.

“China is at a crucial stage of development. It is trying to reduce imbalances while transforming its growth model. Many of these reforms to the economic model will entail significant political change”

Turning green

That's not to say there hasn't been progress in other areas. When I was in China earlier this year I was surprised by the clear blue skies over the capital. Beijing is notorious for its smog and dust storms. When the city hosted the summer Olympics a decade ago, policymakers forced cars off the roads and shut down nearby factories to make sure air pollution didn't spoil the Games.

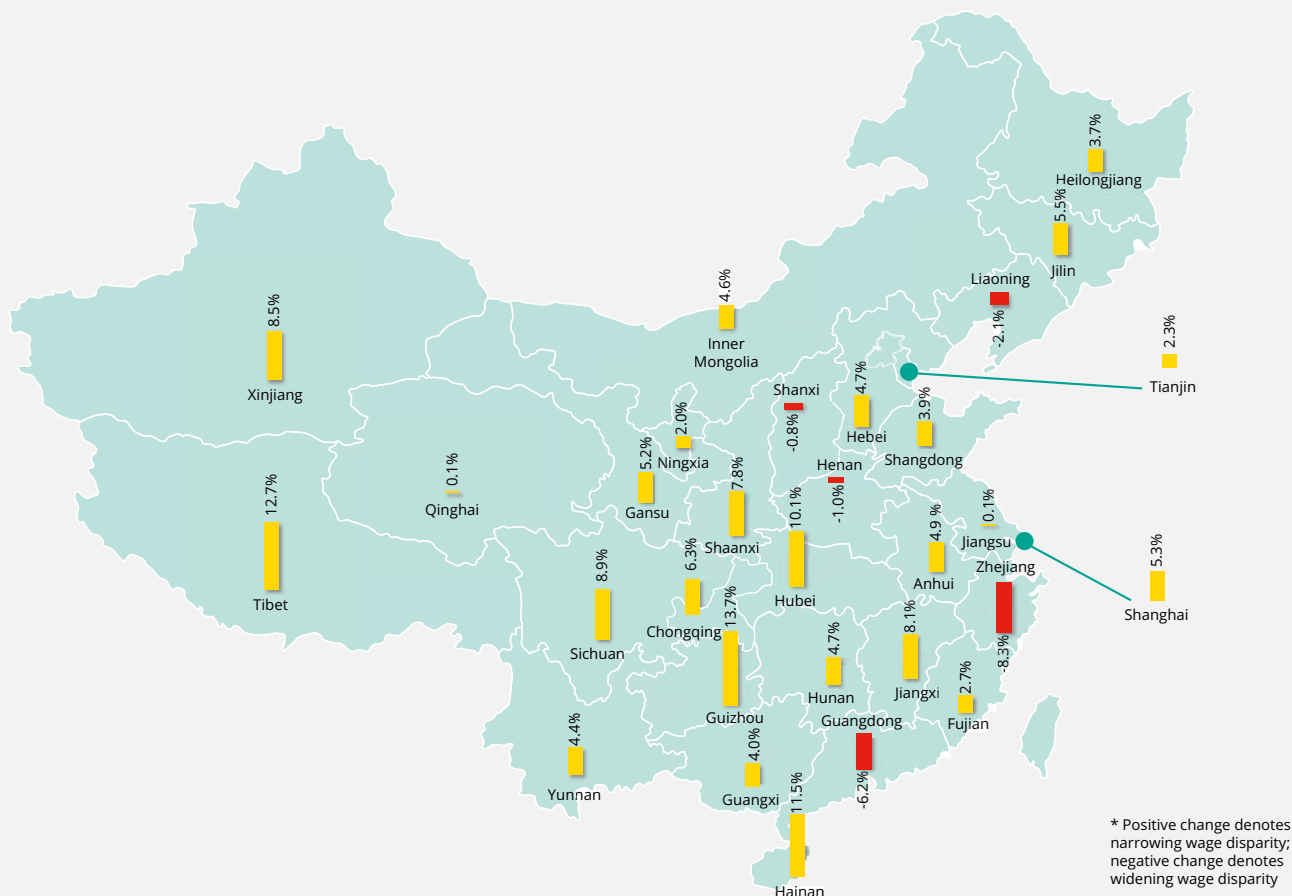
After decades of growth-at-all-costs China realised this wasn't sustainable. In 2013, China's State Council launched the Action Plan for Air Pollution Prevention and Control, which set targets for a reduction in dangerous PM2.5 air particles (those with an aerodynamic diameter of less than 2.5 micrometres); capped coal consumption; and mandated renewable energy growth, among other measures. The first phase of the programme spanned 2013 to 2017.

Last year Beijing enjoyed 226 days of 'good' air quality, with 23 days of heavy air pollution, according to CGTN, the English-language channel of state television¹. This compared with 58 days of heavy air pollution in 2013. Average concentrations of PM2.5 particles fell some 33 per cent from 2013 to 2017 in the 74 cities where this data is tracked, according to Greenpeace².

So things are getting better, but this is a long-term process and policymakers need to stay vigilant against backsliding for the sake of expediency. For example, improvement slowed last year when stimulus for heavy industry revived demand for coal, cement and steel. Too much of China's old economy is still linked to polluting industries and, as we have already seen, policymakers aren't quite ready to relax their grip on the economy just yet.

Wage disparity narrows

Nominal average wage in 30 locations as % of nominal average wage in Beijing, 2006 - 2016*



Source: China National Bureau of Statistics, Aberdeen Standard Investments, 31 Aug 18

¹Sales of Smog-Related Goods in Decline due to Cleaner Beijing Air, Meng Qingsheng, CGTN, 7 Jan 2018

²PM2.5 in Beijing Down 54%, but Nationwide Air Quality Improvements Slow as Coal Use Increases, Greenpeace East Asia press release, 11 Jan 2018

Guarantees not guaranteed



By Edmund Goh,
Investment Manager,
Fixed Income – Asia

Safety net

Understanding the relationship between bond issuers and China's central government is one of the most important issues an investor must master before venturing into the US\$12 trillion local-currency bond market – the third largest in the world after the US and Japan.

Many borrowers can claim some sort of link with the central government in Beijing, however tenuous that may be. Only a few years ago bond issuers would exploit this ambiguity. Encouraging belief in an implied government guarantee could secure funding, or cheaper funding, despite blatant credit risks. This, in turn, encouraged excessive risk taking, distorted asset pricing and made fundamental credit analysis redundant.

Moral hazard

This changed in 2014. Policymakers recognised the moral hazard they had created and so they stopped routinely bailing out troubled issuers and rolling over bank loans from government-controlled lenders. Bond default, once an exotic concept in China, became a real risk. Since then, government-linked issuers have had to demonstrate 'strategic' value to qualify for a government guarantee.

Bond defaults are on track to beat last year's tally, according to data compiled by Wind, a Chinese financial data provider, and our own calculations. Twenty seven bonds with a face value of some 27.1 billion yuan (US\$3.9 billion) have defaulted year-to-date (as of August 10, 2018) compared to 48 bonds worth some 37.6 billion yuan in 2017, albeit down from the 60 bonds worth 39.3 billion yuan that defaulted in 2016.

Strategic, not strategic

So what is considered 'strategic'? Organisations set up by China's State Council to execute national policy still provide the safest of safety nets. For example, China Investment Corporation, the sovereign wealth fund, is considered as important as the Ministry of Finance.

Also 'strategic' are the so-called 'policy' banks, such as China Development Bank, which play a major role in financing government-directed investments, as are the big commercial lenders, like Industrial and Commercial Bank of China, which are systemically important. Many companies under the auspices of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) are also covered. There are around 100 SASAC firms at the central government level, including state-sanctioned monopolies that operate the national grid and develop oil fields amongst other activities.

Local government debt – municipal bonds, local government financing vehicles (a legacy funding platform) and debt linked to 'market competitive' state-owned enterprises – is harder for bond investors to assess. There are close to 3,000 SASAC companies operating at the local government level and their 'strategic' value can often be difficult to gauge. One trick, however, is to look at whether a business provides a public service or is solely profit-focused.

For example, some government-linked companies are engaged in commercial activities such as property development and consumer manufacturing. Recent announcements have made clear they will need to make their own way in the world.

The authorities have tackled moral hazard in other ways. The new municipal bond market draws a clear line between local and central government risk; local governments have been forced to reclassify their debt into categories based on contingent risks, and to cut ties with entities that don't provide an obvious public service; local officials have been warned they would be punished if they flout these rules, even years after they've moved to new jobs.

Price is right

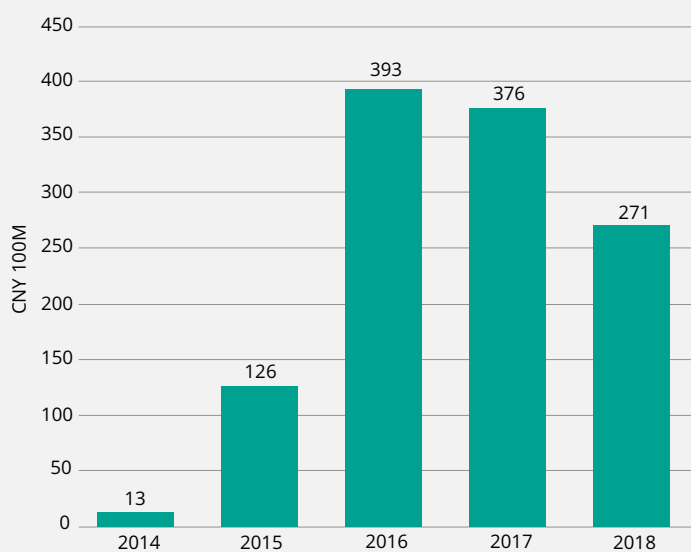
Since last year, we have started to see fundamental risk better reflected in bond pricing. We've seen this in the pricing of domestically-rated AAA, AA+ and AA paper, and we have even seen it for bonds that are assigned the same rating but differ in quality. But these fundamentals include political risks. The yields of bonds from issuers that are deemed strategically important, or are set to benefit from new policies, also trade at narrower yield spreads over government benchmarks.

These are encouraging improvements, but proper bottom-up credit analysis and credit-risk differentiation based on individual names are still a way off. As more foreign investors take their first steps into this market they will become aware of its many idiosyncrasies. These can pose risks for the unwary, but they also present considerable opportunities for those who are patient and can do their own credit analysis.

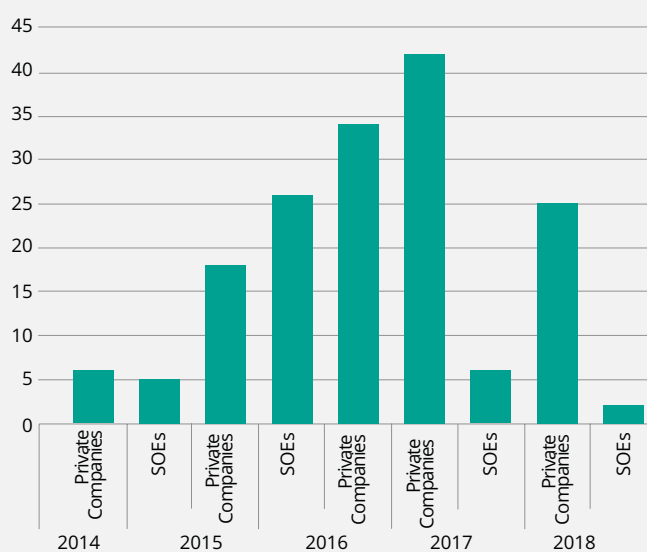


More defaults, moral hazard addressed

Nominal value of bond defaults



Number of bond defaults



Source: Wind, Aberdeen Standard Investments, 30 Jun 18

Finding the 'G' in ESG



By Nicholas Yeo,
Director and Head of Equities,
Equities - Asia

Pioneer generation

Hangzhou Hikvision Digital Technology is a pioneer in China. Its state-of-the-art video surveillance technology has enabled some of the latest advances in artificial intelligence and robotics.

The Shenzhen-listed company is also a pioneer when it comes to corporate governance (the 'G' in ESG). It is one of the few that routinely discloses information in English; it was one of the first companies with an employee stock ownership scheme; and its management is among the most accessible.

Unfortunately, companies like Hikvision are still rare in the domestic A-share market – renminbi-denominated shares listed in Shanghai or Shenzhen. The latest biennial study by the Asian Corporate Governance Association ranked China ninth of the 11 markets surveyed³. Only the Philippines and Indonesia were placed lower.

Baby steps

China has a poor track record on governance. Risks investors face include: excessive use of stock suspensions; company founders who wilfully overstep their authority; political interference; and the questionable independence of independent directors.

However, policymakers are well aware of the need to create viable capital markets that reward good companies with capital, while withholding investment from less deserving firms. The domestic stock markets need to be a safe place for long-term investments, as China's population ages and funding pensions becomes a national priority.

Companies such as Hangzhou Hikvision* show that things are changing, albeit gradually. Last year, around one-third of the nearly 3,500 companies in the A-share universe operated a stock option plan, according to data cited by sohu.com, a Chinese internet portal⁴.

Employee stock ownership schemes align the interests of management with minority shareholders, and they are something that we encourage.

From 2006 to 2017, the number of companies that made a stock exchange announcement in relation to stock options increased almost 10 times to 407, the data show. More than 90 per cent of the firms that made a stock options announcement last year were in the private sector.

Foreign influences

Over the years, policymakers have sporadically encouraged foreign investment in Chinese companies. In the 1990s, state-owned enterprises were encouraged to list in Hong Kong in a bid to make them more competitive through exposure to an international business environment.

Most recently, foreign investors were given unprecedented access to the domestic markets via the two Stock Connect trading platforms that link the Hong Kong bourse with its counterparts in Shanghai and Shenzhen.

With the inclusion this year of more than 220 A-shares in the MSCI's Asia ex-Japan and Emerging Market indices, foreign investor participation in domestic markets is only set to increase further. It currently accounts for some 5 per cent of the market.

We see this broadening of the shareholder base as a good thing because greater foreign ownership can help expose local management to global standards of accountability and international best practice.

Some companies even tell us they want more foreign investors, and especially foreign institutions, as shareholders. While this would invite greater scrutiny, foreign institutional money tends to be long term, or 'stickier' – a counterbalance to the speculative retail money that can often turn the stock market into a casino.

"The road to better Environmental, Social and Governance (ESG) awareness is a long one, but it's one in which the first steps have already been taken."

³ CG Watch 2016: Ecosystems Matter – Asia's Path to Better Home-Grown Governance, Sep 2016

⁴ A-Share Listed Company Equity Incentive Statistics and Analysis Report 2017 (Chinese language), Sohu.com, 13 Mar 2018

*For illustration only and should not be construed as an investment recommendation of individual stocks.

Getting engaged

Meaningful engagement between companies and foreign investors makes a difference. In our experience, open and regular dialogue has led to higher dividend pay-outs.

For example, Kweichow Moutai**, the world's most valuable liquor company, saw an increase in foreign shareholders from 2 per cent to almost 10 per cent between 2013 and 2017, which coincided with a rise in its dividend pay-out ratio from 30 per cent to more than 45 per cent.

Dividend pay-outs in general have been on the rise in recent years: particularly for the Shenzhen exchange, which hosts a greater proportion of private sector companies; less so for Shanghai, where more state-owned enterprises are listed.

The dividend pay-out ratio in Shenzhen rose from 32 per cent in 2010 to 53 per cent last year, according to data compiled by Bloomberg⁵. In Shanghai, there was a marginal increase from 34 per cent to 35 per cent over the same period, the data show.

Poor governance remains a serious concern but things are getting better. Investors ought to be cautious but they should also recognise the efforts of a handful of trailblazing companies. The road to better Environmental, Social and Governance (ESG) awareness is a long one, but it's one in which the first steps have already been taken.

Key governance features of 1,232 privately-owned companies listed in Shanghai and Shenzhen, 2013

Governance practice	Yes	%	No	%
Do independent directors meet the one-third minimum?	1,231	99.92	1	0.08
Unqualified audit opinion?	1,197	97.16	35	2.84
No public criticism?	1,193	96.83	39	3.17
Has the chairman of the board remained unchanged?	1,150	93.34	82	6.66
Have all four board committees been established?	1,142	92.69	90	7.31
Has the CEO remained unchanged?	1,041	84.50	191	15.50
Do directors own the company's shares?	942	76.46	290	23.54
Does the CEO own the company's shares?	887	72.00	345	28.00
Is the chairman and CEO separate?	653	53.00	579	47.00
Full attendance of directors at AGM?	624	50.65	608	49.35
Do supervisors own the company's shares?	494	40.10	738	59.90

Source: ACGA China CG Report 2018, Li and Hao 2014

⁵ Bloomberg, 31 Jul 2018. For illustrative purposes only. No assumptions regarding future performance should be made.

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“The pace of China’s urbanisation is unparalleled. Between 2011 and 2013 the country used more cement than the United States did during the whole of the 20th century.”



Cities of dreams



Milan Khatri,
Head of Property Research,
Asia Pacific, Real Estate – Asia

Urbanisation, appetite

The pace of China's urbanisation is unparalleled. Between 2011 and 2013 the country used more cement than the United States did during the whole of the 20th century⁶! Although this can be explained to some degree by differences in population size, and the type of materials used in housing construction, it nonetheless illustrates the scale and speed of this process.

The government has spent the last few years attempting to control home prices from spiralling upwards, and it does seem to have had some success. However, the underlying demand for housing remains strong in what is still an emerging economy. Housing provision, in terms of quantity and quality, is expected to fall short of aspirations as incomes continue to rise.

Population growth is modest at just half a per cent a year, compared to double this pace some two decades ago. Indeed, some areas are suffering from declining demand due to population decline and rapid ageing but, as a rule, the country's love affair with property remains undimmed.

City clusters

Urban planners are pushing a development model that's focused on regional city 'clusters' which has created new housing needs. While people will always prefer to live in established 'first tier' cities such as Beijing and Shanghai, population caps mean all but the luckiest will have to settle for satellite cities such as Suzhou, some 100 km northwest of Shanghai and among the fastest growing in the country.

That's why we see residential developments in these 'lower tier' satellite cities as offering some of the best opportunities for investors to participate in the next stage of urbanisation and economic development.

These places offer an escape from urban overcrowding, as well as an acceptable alternative for households seeking relatively more affordable homes, albeit still expensive on local salaries. There's also the attraction of a prized residency permit which gives access to schools and healthcare.

They also benefit from good connections with their giant neighbours through a rapidly expanding transport infrastructure. For example, China's high-speed rail network is already larger than the combined high-speed networks of the rest of the world and it is set to become even bigger.

Residential problems

Residential property outside of these city clusters has less investment appeal. Access to China's residential market has historically been through a ground-up development model – building mass-market homes for sale to the country's growing middle class. However, this model has run into several problems.

Onerous and ad-hoc interventions in the housing market to cool speculation have hurt the profitability of many residential developments, even in the best locations within established cities. What's more, the supply of land in these locations is running out, which may reduce future opportunities.

With housing needs undiminished, one of the ways the government is seeking to address the lack of affordable homes is through the provision of more rental housing. But with gross rental yields before operating expenses of just 1 to 3 per cent, there's very little here to attract foreign investors unless the government provides substantial subsidies.

Offices, logistics

Given the challenges of investing in the residential sector, we believe investors should widen the net to consider other real estate segments.

For example, in more established cities, we see opportunity in the provision of high-quality office space as demand is set to rise with the growth of white collar jobs. Only 10 per cent of China's office stock is considered world class, compared to 25 per cent in the US, so there is plenty of room for development.

Meanwhile, the explosive growth of e-commerce – which accounts for more than 20 per cent of retail sales, compared to 10 per cent to 15 per cent in the US and UK – has created a major opportunity in logistics properties. Online shopping has boosted demand for warehouses and other facilities for the storage, sorting and delivery of goods to customers around the country.

“Urban planners are pushing a development model that's focused on regional city 'clusters' which has created new housing needs.”

⁶ A Stunning Statistic About China and Concrete, Bill Gates, gatesnotes, 25 Jun 2014

Urban development: China's satellites cities





All the small things



By Myron Zhu,
Co-Head of Private Equity Asia
Pacific, Alternatives

Small is beautiful

Chow Tai Seng (CTS) is a brand that won't be familiar to anyone outside China. The Shenzhen-based company designs, manufactures and sells jewellery that reaches customers via a domestic network of more than 2,000 stores, mostly in China's smaller cities.

Set up in 1999, the company grew rapidly on a franchise model. An initial public offering in Shenzhen in 2017 made founder and chairman, Zhou Zongwen, a dollar billionaire.

We came to know the firm when we got involved in an earlier round of private equity funding. At that time, it was still a Small and Medium-sized Enterprise (SME) looking to finance the next stage of its development.

The story of CTS offers a glimpse into what's going on inside China. Here is a high-growth company that's achieved a market capitalisation of almost US\$2 billion in less than two decades; it has done so by targeting the discretionary income of consumers in the more obscure parts of the country; and it is a private sector company with no government links.

Many people still view China as a centrally-planned economy of heavy industry on a vast scale, and countless factories producing low-value goods for export. In many ways it still is, but that would only be part of the picture.

Hidden strengths

Up-to-date numbers are hard to come by, but SMEs and so-called 'micro' enterprises accounted for some 97 per cent of all firms, 80 per cent of urban employment and 60 per cent of GDP in 2013, according to a study by the Paris-based Organisation for Economic Co-operation and Development (OECD)⁷.

At that time, more than 60 per cent of small businesses (excluding the self-employed) were in the service sector, the OECD study showed. In 2014, nearly 79 per cent of newly-registered companies were also from the service sector.

There is no simple definition for SME in China. The National Bureau of Statistics defines SMEs by number of employees and

operating income, but applies different thresholds for different industries. As a general rule, we classify a company as 'mid-market' if it has an enterprise value of US\$250 million to US\$500 million.

An investment focus on the mid-market provides access to the sort of consumer, technology and healthcare firms that lie at the heart of China's consumption story. Domestic consumption provides investors with a degree of insulation against the swing towards a more protectionist trade environment.

Search for start-ups

Technology companies are perhaps the best known examples of the sort of fast-growing new businesses that excite us. Tencent (est. 1998), Alibaba (est. 1999) and Baidu (est. 2000) may be listed household names now, but they all relied on private equity financing when they started out. Many are now delaying listing for longer so that more of the value creation accrues to private shareholders.

Who knows? The next big thing could be a company like SenseTime. This unlisted developer of facial recognition technology completed its latest round of private equity fundraising in May 2018, which valued the business at US\$4.5 billion. SenseTime was set up in 2014.

There are big opportunities for smaller firms using new technology in innovative ways. For example, there's ample scope to improve on China's notoriously bad public healthcare system, especially with an ageing population that is becoming more affluent.

Urban consumers have demonstrated a willingness to spend more on better quality goods and services. As people's lifestyles change, they are paying for convenience, hence the popularity of food delivery apps, such as Ele.me (est. 2008) which, according to some estimates, handles almost 20 million orders a day.

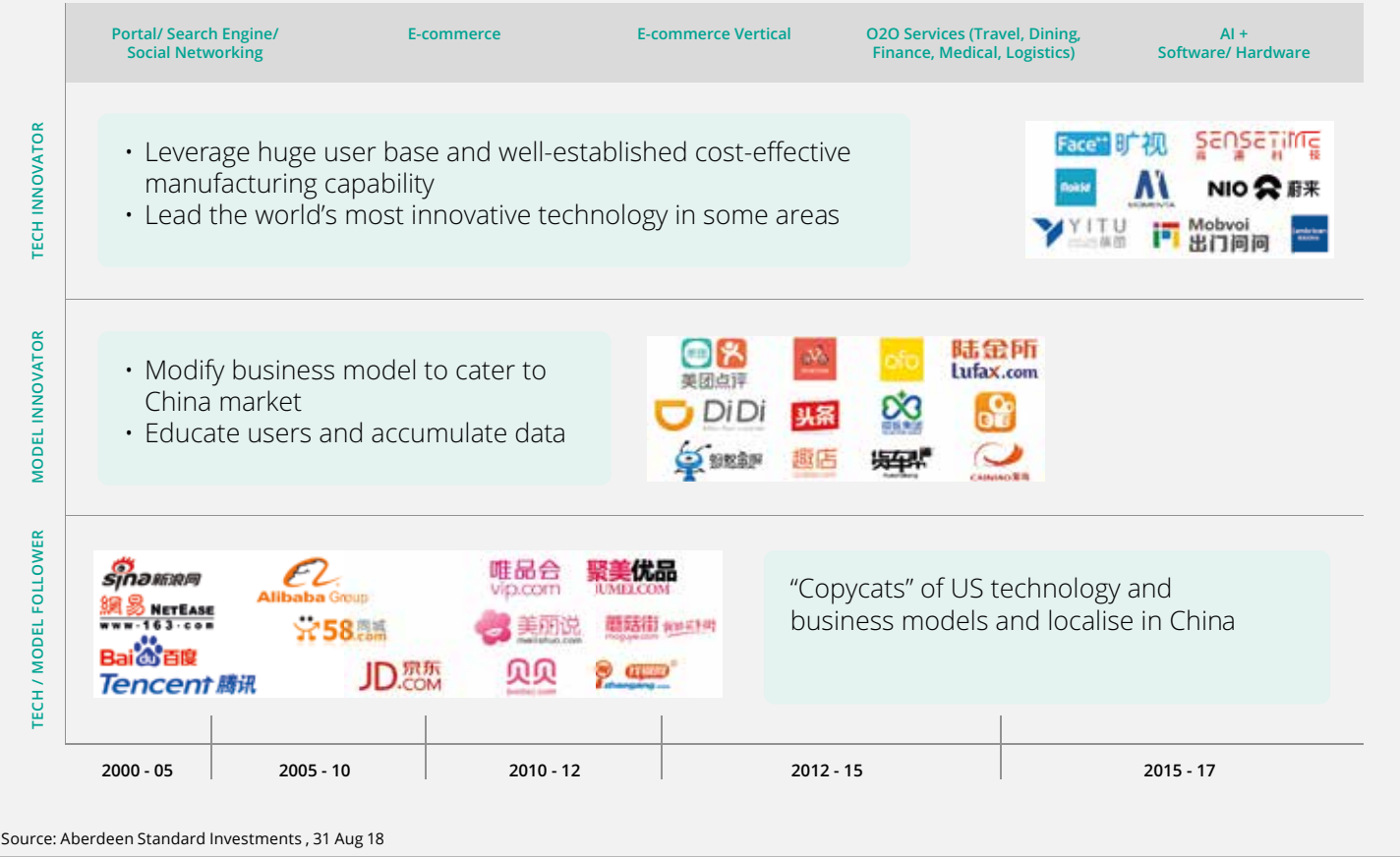
Passing the torch

Many SMEs have also reached an inflection point. Ageing entrepreneurs who set up companies years ago are facing succession problems. Single children born under the scrapped One Child Policy may have no interest in taking over the family business and company founders are contemplating selling to outsiders for the first time. This is good news for private equity investors.

There are risks of course. Some are unique to private equity, such as the difficulty of finding the right professional managers to run the business after a sale to private equity buyers. Others, such as poor corporate governance and accounting standards, are risks common to other asset classes, as is the risk of delays in repatriating profits if regulators impose foreign exchange controls. Identifying the right investment opportunity also involves fully understanding these risks.

⁷ 'China (People's Republic of)', in *Financing SMEs and Entrepreneurs 2016: An OECD Scoreboard*, OECD Publishing, Paris

From “copycats” to real innovation





“An investment focus on the mid-market provides access to the sort of consumer, technology and healthcare firms that lie at the heart of China’s consumption story”

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Who we are

Aberdeen Standard Investments is the largest active manager in the UK and one of the largest in Europe*. It has a significant global presence and the scale and expertise to help clients meet their investment goals. The investment needs of our clients are at the heart of what we do. We offer a comprehensive range of investment solutions, as well as the very highest level of service and support.

*as at 30 Jun 2018

Our thinking

Visit our website to access our range of thought leadership papers, insights on current events effecting markets, our market and economic forecasts, plus tools to help you make better investment decisions.

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