Chinese equities: an ongoing compelling story

Invesco Greater China Equity strategy

March 2021

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Mike Shiao
Invesco Asia Equity Investment Team,
Hong Kong

We continue to see many compelling bottom-up opportunities in China, driven by a strong domestic economy and rising digitalisation.

We believe China is a land rich in compelling bottom-up investment opportunities. This is based on our expectations that its domestic economy will emerge as a reliable driver of growth. In particular, the increasing digitalisation of Chinese society is opening up new markets which some companies are taking advantage of to enhance their product offerings. While selecting stocks, we favour private enterprises which demonstrate entrepreneurship and possess a notable track record in running businesses for their shareholders.

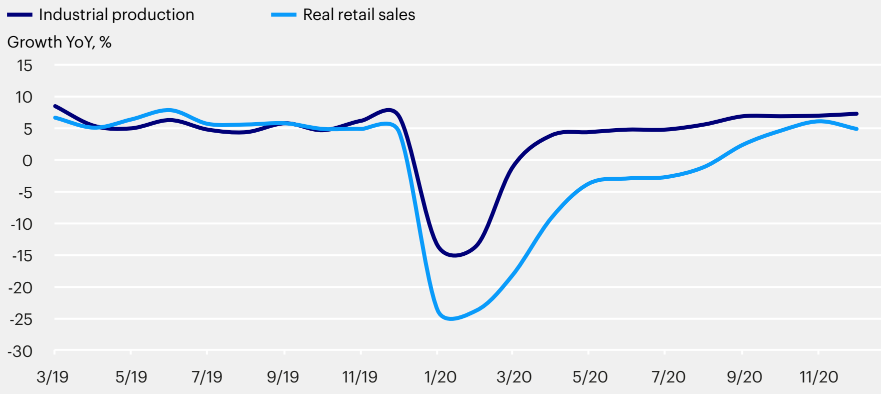
The Invesco Greater China Equity strategy is managed by the Invesco Asia Equity Investment team. The team has extensive local knowledge which supports the bottom-up stock selection process. This process has resulted in notable exposure to stocks reliant on the domestic economy which we believe have the potential to deliver sustainable returns.

Higher earnings visibility and growth offered by domestic sectors

China's domestic sector has grown significantly and now constitutes a dominant share of GDP. The domestic economy has staged a recovery following the disruption caused by Covid-19 and remains resilient due to several factors.

Firstly, China has imposed strict control measures to contain the outbreak and we believe the government has demonstrated its capability to manage the situation. Secondly, policy support is evident with lending rates and banks' reserve requirements being cut several times to enhance liquidity. At the same time, the budgetary fiscal deficit has increased and special Covid-19 government bonds have been issued to boost infrastructure spend and employment. As such, domestic sectors such as industrial production and

Figure 1
Chinese economy is on the path to recovery



Source: NBS, Morgan Stanley Research, as at December 2020. Smoothed line.

retail sales have been improving since March 2020 (figure 1) and we expect them to gather momentum as economic activities normalises further.

Ongoing geopolitical risk has led to a greater tilt towards consumer-related stocks

The past few years have seen a rise in geopolitical tensions between the world's two largest economies. We are closely monitoring the situation given the change in presidency in the US. We believe tensions between these two countries are unlikely to go away given their strategic rivalry. That said, we believe the new US administration might take a different approach while dealing with competition from China. We believe the risk of further market disruptive policies being introduced has declined.

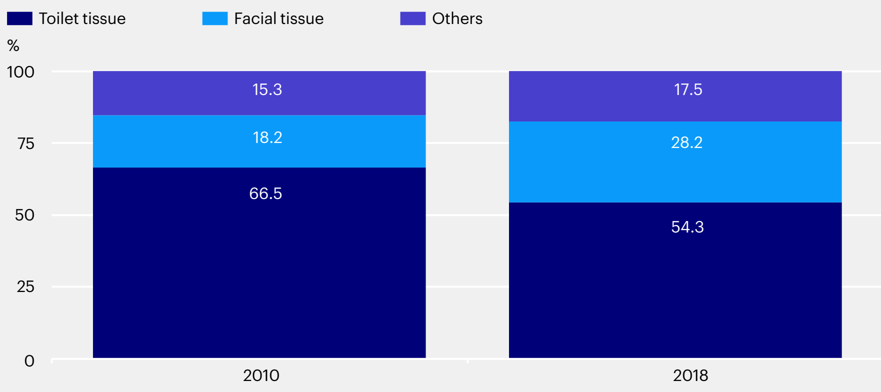
Domestically focused companies offer higher earnings visibility and growth

We have positioned the strategy to capitalise on domestically focused companies, by selecting stocks benefiting from structural growth trends. We believe these stocks offer higher earnings visibility and growth, and will deliver sustained returns for investors.

Our analysts on the ground have noticed a strong increase in consumers' wealth which is driving up overall spend as well as demand for more high-end products. Since the latter can be sold at higher prices than lower-end products, some companies are improving their product offerings to meet this demand. This has led to our investment in a large tissue producer, a long term holding in the strategy.

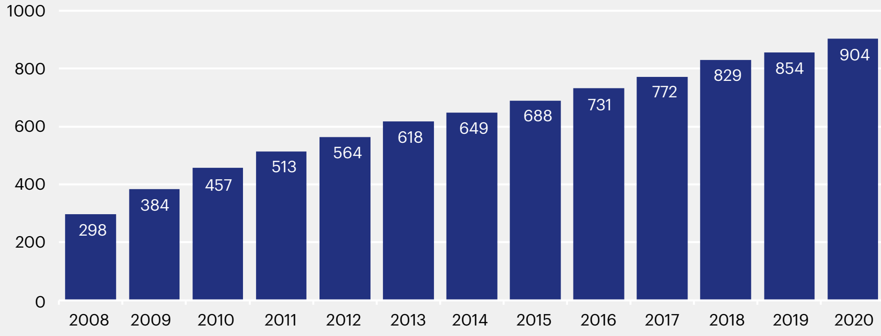
The company is moving its product mix towards mid-to-high end tissues and is doing so, within a growing market. The per capita tissue consumption in China has grown at a CAGR of 8% (2010-2018) versus global growth of 3%[1]. In particular, non-toilet tissues including facial tissues, as well as higher-end products have experienced rapid demand growth (CAGR of 13%) over the same period. Against this backdrop, the company has focused on facial tissues while continuing to launch higher quality toilet tissue products (figure 2). We believed that the company's valuation did not fully reflect its potential to deliver double-digit organic sales growth while maintaining a healthy margin, as it continued to position its business to benefit from this strong premiumisation trend.

Figure 2
China's tissue consumption volume mix



Source: China Household Paper Industry Association, Citi Research, as at October 2019.

Figure 3
Internet users in China have tripled in the past decade



Source: Statista, as at March 2020.

Digitalisation is opening up new value-added opportunities

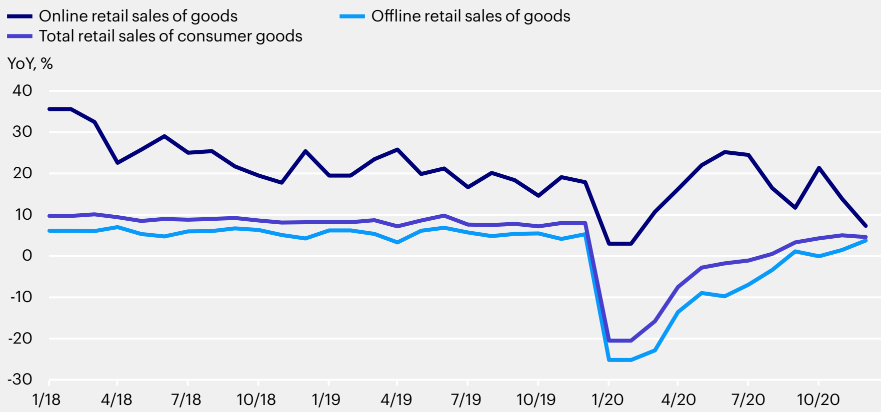
Digital trend is supported by improving infrastructure spend and innovative corporate strategies
Compared to five years ago, the average download speed of mobile broadband in China has increased by about six times while the fee for mobile internet (mobile phone users accounted for 99% of the internet users) has dropped by over 90 percent. A faster internet service at lower cost has greatly boosted usage growth. China is now a digital society with more than 900 million internet users (figure 3). It has pledged to invest more than US$3.78 trillion in new digital infrastructure over the next 5 years[2]. In 2020 alone, as much as US$423 billion has already been allocated to projects including 5G base stations, data centres and artificial intelligence.

The digital trend is very evident. A Chinese consumer's daily life involves frequent engagements with different types of online platforms offering both products and services. This has encouraged many internet companies to use innovative strategies to engage consumers. The importance of the digital trend can be seen in the MSCI China index composition where the communication services and consumer discretionary sectors constitute more than 20% of the index. The large companies in these sectors are mainly in the internet space.

A good example is our holding in an online platform which is capitalising on the growing digitalisation of consumer markets. Despite being a late comer to the food delivery market, the company gained market share from its competitors to become the number one platform for food delivery. Using this position, it has been successful in cross-selling higher-margin lifestyle services in leisure and entertainment.

Covid-19 has added fuel to the digital trend by opening up new opportunities
The Covid-19 outbreak is accelerating the digital trend by encouraging the purchasing of products and services on-line. E-commerce platforms acted fast to capitalise on this growth by launching a new shopping festival, Double Five, throughout which customers were provided with discounts and incentives to generate strong sales growth. The Covid-19 outbreak also encouraged other new strategies. For instance, a leading internet conglomerate (a holding) introduced an international version of its cloud-based video conferencing tool in more than

Figure 4
Resilience of e-commerce retail sales during Covid-19
Growth rate of online & offline sales of consumer goods



Source: NBS, Morgan Stanley Research as at December 2020.

100 countries to capture market share. These strategies resulted in the e-commerce retail sales growth remaining resilient during Covid-19 (figure 4).

The Covid-19 backdrop also led to the emergence of new markets such as the telemedicine market. During the crisis, e-commerce platforms, which had previously just delivered drugs or booked appointments, began to provide treatment and advice. For example: a subsidiary of our holding in a large online platform claimed that monthly consultations had grown tenfold since the outbreak: an arm of another large platform (a holding), launched a free "online clinic"; and WeDoctor, an app backed by a leading internet conglomerate (a holding) mobilised 20,000 physicians to work online during the epidemic thereby encouraging the use of its platform going forward.

A focus on private enterprises

Our investment strategy favours private enterprises. They are highly competitive and innovative, constantly utilising new technologies to deliver market leading products and services. We are positive about their growth as they continue to improve efficiency and productivity. From a corporate governance perspective, we believe that the interests of private enterprises are more aligned with our interests, as investors.

A private company that is moving online to stay relevant to customers
A good example that showcases private enterprises' agility is a long term holding in a hypermarket. As one of the largest hypermarkets, it's management reacts timely to capitalise on opportunities within its online operations, in our view. Following an investment by a leading e-commerce platform (late 2017), the company began a digital transformation that ensured that during Covid-19, the company achieved stable revenue thanks to its rising online presence. Meanwhile, we saw similar investment by this e-commerce platform in state-owned enterprises (SOEs) and changes are generally not as fast in these businesses.

Private enterprises are managed inline with investors' interests unlike many SOEs
In our view, private enterprises are more likely to manage their businesses in the interest of shareholders, and in doing so, take corporate governance seriously. Within our bottom-up stock selection process, we attach a high level of importance to ESG factors.*

Our view has been reflected in our lack of exposure to a leading liquor producer in China. Although the company has achieved strong earnings growth, we were concerned about its corporate governance. The company is indirectly owned by the local government and there have been several high-profile cases that involved senior managers being removed from their posts by the local watchdog. We believe a lack of transparency in distributor selection is an issue for the company.

Conclusion

In conclusion, we are positive towards the domestic economy in China. We like the rising digital trend that is being accelerated by the recent outbreak of Covid-19. In particular, we favour private enterprises thanks to their agility and sound corporate governance. We are positioning the Invesco Greater China Equity strategy to capitalise on our views.

We believe it is important for investors to adopt an all share approach to capture the best opportunities in China. We define this as searching for the best investment ideas across all China's share classes irrespective of listing locations. We believe offshore equity markets provide a large selection of opportunities with growth potential, particularly among the consumer, services and technology companies. These are mostly large private enterprises, which were listed offshore as a result of their entrepreneurship and financial strengths. In addition, we see increasing opportunities within the onshore market, particularly among the consumer and healthcare companies, as it continues to mature.

Notes
1 Source: Citi Investment Research as of October 2019.
2 Source: Haitong Securities as of May 2020.

*** Whilst the fund manager considers ESG aspects they are not bound by any specific ESG criteria and have the flexibility to invest across the ESG spectrum from best to worst in class.**

Investment Risks

The value of investments and any income will fluctuate (this may partly be the result of exchange-rate fluctuations) and investors may not get back the full amount invested. As a large portion of the strategy is invested in less developed countries, you should be prepared to accept significantly large fluctuations in value. As this strategy invests in a particular geographical region, you should be prepared to accept greater fluctuations in value compared to a strategy with a broader investment mandate. Investment in certain securities listed in China can involve significant regulatory constraints that may affect liquidity and/or investment performance.

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