China equities: Intact structural opportunities

We recognize a growing number of uncertainties taking a toll on the outlook for the world economy. Though, the opportunity set for the Greater China equity market that we highlighted at the end of 2019 did not derail.

In our previous 2020 outlook report published at the beginning of the year, we outlined how structural growth opportunities in China could become a major winner, including the companies that participate in consumption upgrade, 5G related hardware, e-commerce, private tertiary education and healthcare. The resilience and performance of those sectors amid the pandemic strike over the last six months have epitomized the case.

1. Consumption upgrade

We reinforce that consumption will continue to be the backbone of the Chinese economy in the future. During the first quarter, when the virus raged on the mainland, the danger was that consumer activity weakens considerably as a result of the lockdown caused by COVID-19. Though, specific premium consumer products have delivered an impressive recovery.

We take the high-end white liquor as an example. The distinguished baijiu brand, Kweichow Moutai saw its premium Feitian Moutai market price per bottle recovered swiftly in May to near its historical high recorded prior to the COVID-19 outbreak.

Another notable example is the upgrade trend in sport shoes. In China, the average price for a pair of sports shoes has grown to RMB 335 in the first quarter of 2020, from RMB 288 over the same period in 2019[1].

In the long term, catalysts remain rising middle-class population and household income. Each year to 2025, an extra 11 million will join the ranks of China's high-income groups[2]. While individual saving levels are among the highest in the world and consumption still only accounts for a smaller proportion of the GDP in China compared to developed countries such as Japan and the U.S., this situation is set to change markedly.

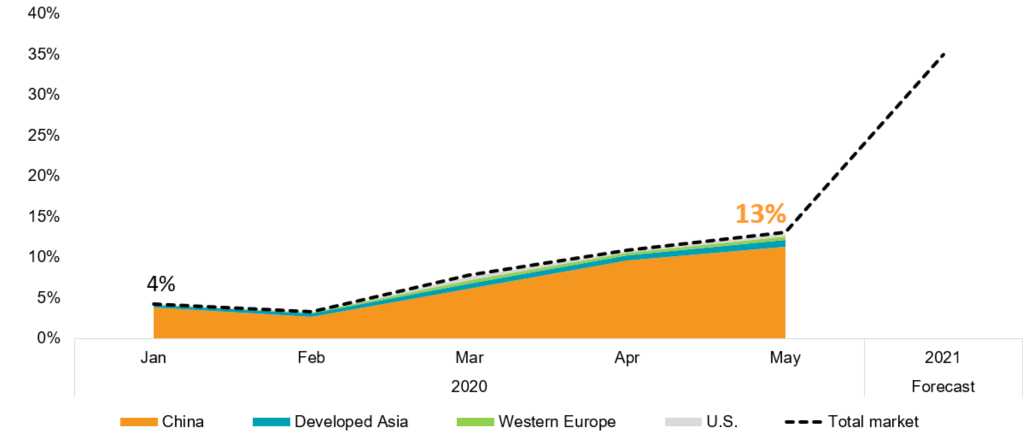
2. 5G network

The 5G network rollout and capital expenditure deployment remains solid despite a global pandemic. For instance, the total 5G smartphone sales has been resilient (Fig 1), led by China, which rose from single digit percentage in the first quarter to 13% of global total sales in May; and it is expected to reach 35% in 2021[3].

Moreover, the deployment of 5G networks is set to open up more growth avenues, from consumer to industrial levels. This will span a broad spectrum of industries over the next three to five years, including hardware and software development, cloud servicing, and other support applications. On individual

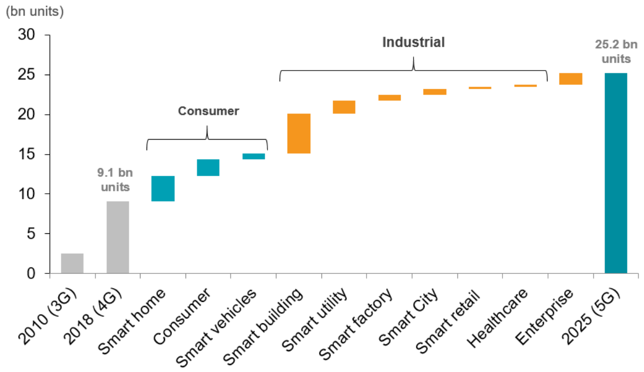
1 Source: Wind, Bloomberg. 31 May 2020
2 Source: CEIC, Morgan Stanley, Citi Research, January 2019 Merrill Lynch Global Research
3 Source: GfK, June 2020

Fig 1: Penetration of 5G mobile phones



Source: Gfk, June 2020

Fig 2: Exponential growth of 5G connected devices



Source: Merrill Global Research, Dell'Oro, GSMA

Fig 3: Total addressable e-commerce market in China

Leading e-commerce platform		Online service platform	
Segment	Addressable market size (RMB bn)	Segment	Addressable market size (RMB bn)
China retail market excluding automobile, fuel, catering and other services	27,978	Restaurant dining and delivery services	9,615
		Hotel booking	625
		Transportation tickets	5,857
		Car-hailing service	2,242
		Bicycle-sharing	102
		Online movie tickets	318
		Other services	1,772
		Total	**20,620**
Total revenue	229	**Total revenue**	**27**
Monetization rate	0.82%	**Monetization rate**	**0.13%**
		6x Growth Potential	

Source: iResearch, Analysis, iMidea, J.P. Morgan, National Bureau of Statistics, company disclosure; addressable market includes both online and offline

level, we envision that Internet-connected domestic appliances, or the so-called Internet of Things.

Fig 2 indicates that the number of network connected devices is expected to increase from 9.1 billion in the current 4G era to 25.2 billion thanks to 5G network that offers much enhanced bandwidth and connectivity[4], resulting in a double digit annual growth rate in the sale of hardware devices. This represents a strong upside potential for companies that participate in this trend such as upstream component suppliers.

Apart from the intact opportunity set, this space though faces some unknowns over the near term. The re-escalation of Sino-U.S. conflicts towards the midyear is a major risk ahead and its impacts on the 5G value chain of Asia should not be overlooked.

However, we see a reshuffling of the supply chain means reshuffling the set of winners and losers in the region. We closely monitor the negotiations between China and the U.S. and analyze the potential consequences and corporate reactions towards the transformation.

3. E-commerce

Online-to-offline services, such as home delivery for food, have gained traction when social distance among people is much appreciated to avoid virus contagion. The new norms during the outbreak have provided an additional boost to the adoption trend and growth across online platform operators.

The services provided involve far more than simply transacting offline goods and services online via mobile applications.

4 Source: Merrill Global Research, Dell'Oro, GSMA

Behind the scenes, complex data volume and optimization algorithms are at work, determining the most efficient delivery routes and bulking of orders.

Yet, despite the great variety of online services now available, penetration, especially in lower-tier cities, remains low from a monetization rate perspective (Fig 3).

4. Private tertiary education

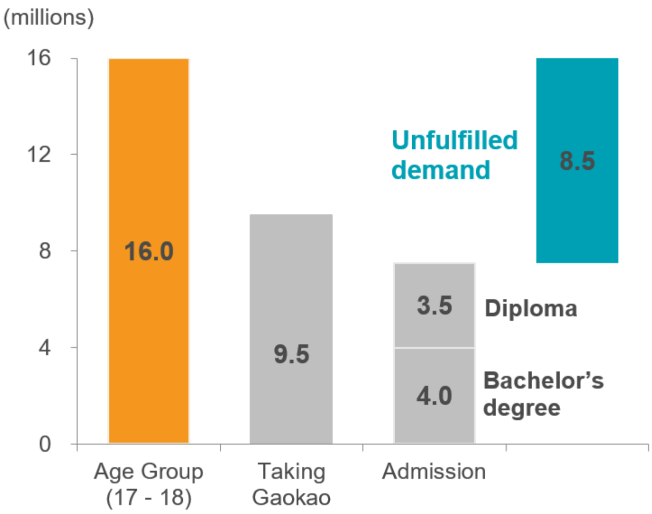
In China, the government's long term agenda for the economy involves moving up the value chain – which implies the country intends to transit towards a more knowledge-intensive manufacturing destination from the previous labor-intensive one. To accomplish this, China is in need of an advanced and sound tertiary and vocational education system that would allow to nurture a vast amount of skilled talents domestically.

During the pandemic, the authorities increased college admission to more than one million in April. This is to encourage youngsters to pursue higher education and better training before entering the job market. Though, such an increase would not fulfill the accumulated inadequate supply. In 2019, some 9.5 million candidates sit for the National College Entrance Examination, the Gaokao, but only 7.5 million[5] find places in tertiary education, creating a supply gap for the remaining two million without places (Fig 4). Penetration of higher education in China is still at an early stage but set to grow markedly. China's gross enrollment rate, currently only 52% compared to 93% in the U.S.[6]. It is a target to increase to 65% by 2035.

Increases in tuition fees represent the increases in 'ground rent'. Currently, private universities in China charge annual tuition fees of US$2,250 on average, whereas in the U.S. the average can be as high as US$25,000[7] (Fig 5). China's tuition fee is expected to grow by 5% per over the next five to ten years, on par with the country's GDP growth.

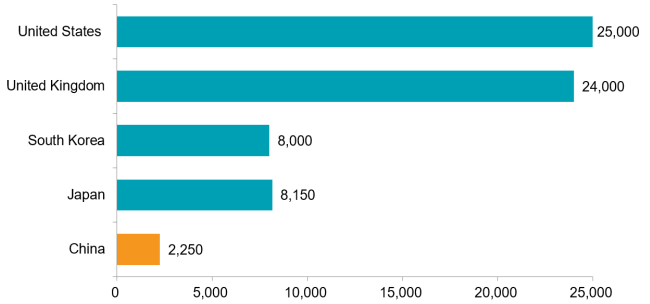
Currently, the Chinese education market remains highly fragmented, indicating the availability of merger and acquisition opportunities. Smaller private universities and colleges in China might well be prepared to share their ownership stakes with bigger players in order to benefit from economies of scale. In addition, the Ministry of Education in China announced the policy that would encourage leading higher education players to transform their independent colleges for a better profit profile over the medium term. The favorable environment may create rooms for the merger and acquisition among independent schools and the active private operators. Taking all these factors into account, Chinese higher education has significant potential to be a source of strong and stable investment and income growth in future.

Fig 4: Insufficient supply remains to be fulfilled



Source: CSCI Research, Frost and Sullivan, Morgan Stanley

Fig 5: Average tuition fees of private higher education in 2019/20 (in USD)



Source: UniPage, Value Partners

5. Healthcare

In the first half, the sector outperformed on the back of its defensive nature and certain sub-sectors such as medical equipment rallied supported by strong demand pick-up amid COVID-19. Despite the rally, our long-term conviction towards the sector in China is unshaken, as the mainland's healthcare system continues to undergo an unprecedented reform cycle which create long-term investment opportunities.

The backbones driving the current reform are twofold. Firstly,

5 Source: CSCI Research, Frost and Sullivan, Morgan Stanley
6 Source: Minstry of Education in China, World Bank, Trading Economics, Goldman Sachs Global Investment Research, October 2019
7 Source: Unipage

an aging population. The over-65 population in China is expected to reach 170 million by 2020 - 12% of the total population[8] - inevitably increasing the need for improved healthcare and treatment solutions for chronic diseases, including cancers and diabetes, in particular.

Secondly, medical spending per capita in China is only one-fifth of the U.S. and still lags the world's average[9] (Fig 6). The gap is expected to narrow due to the rising middle class which seek for better healthcare treatment and the expansion of medical insurance coverage nationwide.

That being said, key policy reforms started in late 2018 focus on few areas including the expansion of medical insurance scheme, scrutinizing drug sales to ensure the medicine quality and fostering innovation drug sector. Such policies created both risks and opportunities within the sector. For instance, the implementation of the National Reimbursement Drug List (NRDL) and the centralized procurement program led to sector consolidation since late 2018.

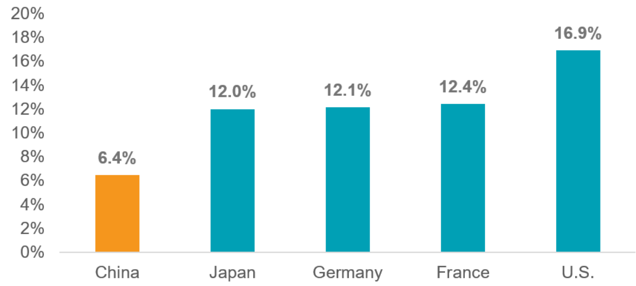
Against this backdrop, leaders in pharmaceutical area will continue to be our focus as they could absorb the price pressure from the centralized procurement program better while maintaining the growth from their stronger research pipeline over innovation and biosimilar drugs.

Fig 7 reports the forecasts for earnings per share growth for Chinese corporates represented by the MSCI China Index and the healthcare sector for 2020 and 2021. The healthcare sector is expected to deliver a double-digit growth and to outrun the broad index.

Conclusion

While China's macro recovery is ahead of the curve and prospects remain strong, we expect corporate earnings recovery to be diverging among sectors. Due to the unprecedented COVID-19 situations that present many unknowns globally, we expect disparity on company earnings and macro expectations to emerge. With that in mind, it is particularly crucial for active managers to select quality companies that are supported underlying fundamental strengths, which we believe would be much more rewarding in China's recovery path.

Fig 6: Medical spending in proportion to GDP for China and four major developed markets



Sources: National Health Commission, IMF, OECD, statistics bureau from the respective country, medical expenditure, 31 December 2019

Fig 7: Healthcare section versus index earnings-per-share growth

	2020E	2021E
MSCI China Index	0.9%	16.6%
Healthcare sector	**26.2%**	**17.9%**
Healthcare equipment	13.7%	15.2%
Pharmaceutical, Biotech and Life Science	32.9%	19.2%

Source: CICC, June 2020

8 Source: Population Pyramid, Statistics Bureaux of various countries, October 2019
9 Source: World Bank and Bernstein Research