Value Partners
Since 1993

China Dividend Matters



1

Market analysis: increasing tailwinds for quality dividend stocks

In the final quarter of 2024, China's equity markets were driven primarily by policy. The government's introduction of a large and much-anticipated stimulus package on 24 September had caused markets to soar. The A-share market peaked in early October, however. Thereafter, investors' enthusiasm gradually waned because the hard numbers in the package were lower than had been hoped for. As a result, markets gradually retreated to their pre-stimulus levels, leaving them down for the fourth quarter overall.

Current expectations on the policy front have normalised. We think that some of the government's recent policies are meaningful, although the numbers behind them may not (yet) be large enough to have the desired impact.

Nevertheless, the policy package has served to reduce the risks in the market – for example, through repurchases in the real estate sector and the lowering of mortgage rates for homebuyers. Importantly, the risk from local-government financing vehicles has fallen too, with the central government deploying Rmb12 trillion to help local governments resolve their debt problems. Overall, much of the downside risk in the Chinese markets has been covered.

The second Trump presidency and the threat of tariffs continue to create considerable uncertainties for all countries, not just China. Although the challenges initially appeared less severe than the threatened 60%, the US has now imposed 20% tariffs on Chinese goods. We note, however, that Trump takes a seemingly transactional approach to international affairs, and there is a strong possibility that an all-out trade war will be averted through a signature deal. In any event, China has diversified its trading partners considerably since the last Trump administration. It now exports as much to ASEAN and BRICS+ countries as it does to the US and the EU combined. While this should help it manage the risk of higher tariffs, they remain a concern. In our view, China is likely to restore some selective policies to hedge the external risks, rather than to immediately roll out 'bazooka' stimulus.

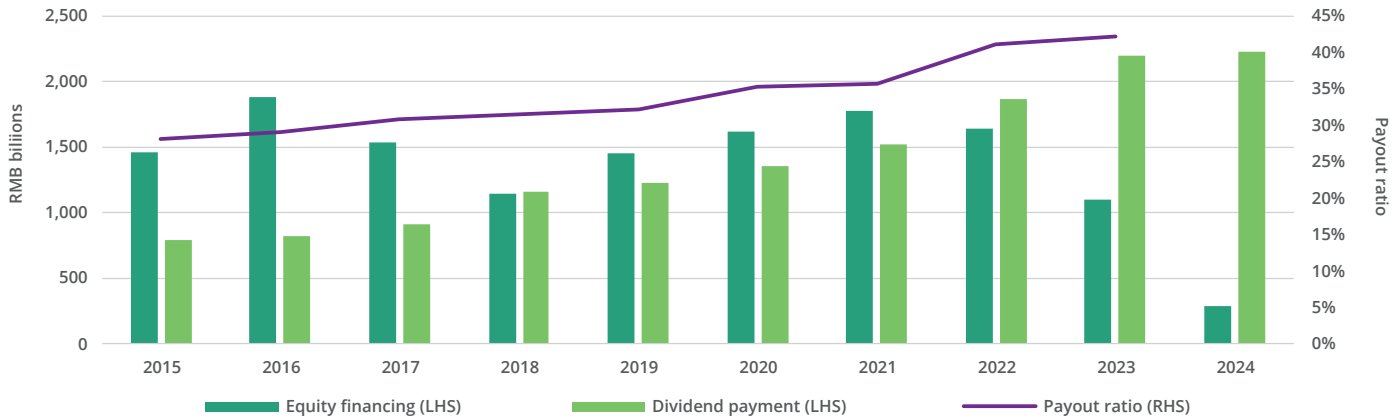
On the domestic front, we have recently seen remarkable innovations in the form of DeepSeek's low-cost large language model and Go2, the robot dog created by Unitree Robotics. These advances have boosted market and business sentiment considerably. 'Innovation' is certainly a bright spot for China at present, but this doesn't mean that China's overall domestic situation is completely rosy. Consumption is growing but more slowly than GDP growth, deflation is proving persistent, and the current policy stimulus seems too small to catalyse consumption. To drive the overall economy and the broader market, we need to see the roll-out of more concrete stimulus policies, and we need to see these start to take effect.

Given our view that stimulus packages will be measured and targeted, we think that the economy's recovery will be gradual and steady. We therefore believe that we are set for 'lower for longer' interest rates over the next one to two years. Such an environment would provide a tailwind for quality dividend stocks.

All that said, we think that the China A-share market is close to the bottom. Valuations are low, and so are market expectations, which means that the downside risk is limited. We expect the overall market trend to be upwards this year, but it's likely to be accompanied by volatility, given the uncertainties over Trump's tariffs, geopolitics and China's domestic policy – in particular, the question of whether we will see greater focus on the demand side rather than the supply side.

Our featured chart shows that China A-share companies are currently rewarding investors with a significant amount of capital, both in absolute terms and relative to their new issuance. This paradigm shift, of more dividends versus less issuance in the A-share market, will continue and should therefore provide further support for quality dividend stocks.

China A-share market dividends vs issuance



Source: Value Partners, March 2025



2

Fundamental free-cashflow analytics: hopes of a recovery rising

At Value Partners, a crucial part of our investment process is our analysis of companies' free cashflows. We have further translated this analysis into a proprietary 'Free Cash Flow to the Firm (FCFF) Cycle Index,' which serves to illustrate where we are in the business cycle.

The analysis covers 5,000 companies from the China A-share market, excluding the financial sector. These companies are divided into over 100 sub-sectors. Based on their FCFF, they are categorised into five cyclical phases, with scores ranging from 1 to 5. All sub-sectors are given an equal weight in the index. The average score is calculated quarterly, with higher scores indicating a more favourable phase of the business cycle: i.e. an overall rating above 3 indicates that the market is in an 'up' cycle.

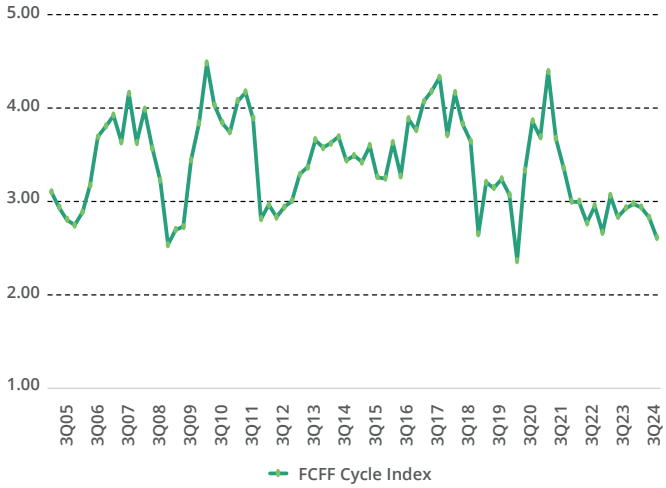
The most recent reading of 2.6 is the third-lowest level in the past 20 years. The only times that the index has produced lower readings were during the global financial crisis in the fourth quarter of 2008 and at the height of the Covid-19 crisis in the first quarter of 2020.

Although the current level is low, when it is considered alongside factors such as policy intervention and stimulus, limited downside risk and domestic technological innovation, we conclude that we are near, or at, the bottom of the cycle.

To give a fuller picture, we can compare the FCFF index with other key metrics for the same 5,000 companies. The comparison shows that free cashflows are still healthy, standing at over Rmb1 trillion, while earnings (EBIT) have been relatively stable, albeit with a slight recent deterioration. Meanwhile, destocking persists, as indicated by the rise in net working capital (NWC Change), which continued to contribute positively to cashflows. Most significantly, there has been an absolute decline in capital expenditure (CAPEX) for the first time. The capex-to-depreciation ratio has been decreasing since 2023, as companies rationally adjust their capacity to real demand levels.

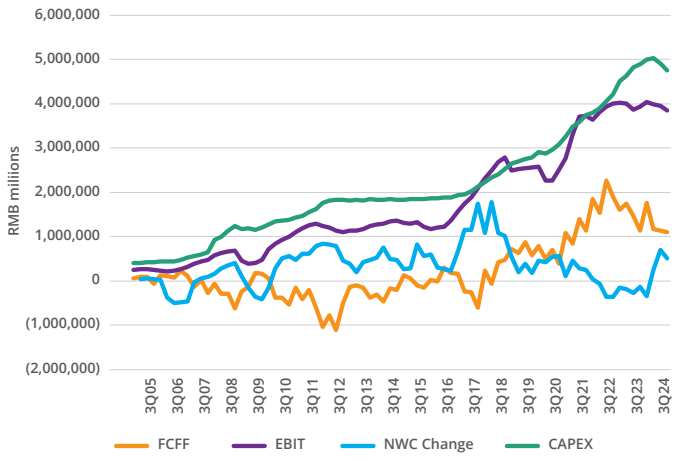
Around half of the 5,000 companies in our universe have pre-announced their annual results. The overall trend is still downward. However, based on the bottom-up analysis underpinning our proprietary FCFF framework, we expect to see less pressure from the supply side, on a lower level of capex. Thus, we believe that fundamentals are reaching the trough, and our hopes of a recovery are rising.

Proprietary China A-shares (ex-financials) FCFF Cycle Index



Source: Value Partners, Wind, March 2025

China A-shares (ex-financials) key metrics (trailing 12 months)



Source: Value Partners, Wind, March 2025

3

China's 'value up' programme: continuing policy progress

Japan and South Korea's 'value up' programmes of corporate governance reform have both attracted a lot of attention over recent years. But China also has a remarkably similar, but much less heralded, programme underway. In the past two quarters alone, we can point to two key policies that have been promoting China's 'value up' agenda.

The first is the refinancing policy adopted by the People's Bank of China (PBoC) in late September as part of the government's stimulus package. This provides listed companies and their largest shareholders with a lending facility to be used to buy back shares on the open market. The current quota is Rmb500 billion.

The facility allows companies with good cashflow and high dividend yields to undertake a lucrative carry trade. They can borrow capital at around 2% from the PBoC's facility and then receive a dividend of perhaps 3% or 4%. So the policy offers a potentially healthy arbitrage for companies with sustainable, quality dividends and their institutional shareholders. We expect that there will be incremental capital flowing into stocks with higher and stable dividend yields. This is likely to promote re-rating opportunities for quality dividend-paying companies.

The second key policy was announced a few weeks before Chinese New Year. This is designed to encourage long-term funds into the equity market. The policy has numerous components, but the most important part of the package is the requirement that insurance firms invest at least 30% of their new-premium income into the stock market. Given the inherently conservative nature of the insurance industry, most of these inflows are expected to be directed into high-quality, high-dividend stocks – providing additional support for the performance of quality dividend stocks in China.





4

Revisiting China's structural challenges: pension reforms

An important change at the end of 2024 was the expansion of the government's programme of individual tax-deductible pension contributions. In November 2022, the government introduced a pilot programme that allowed people in 36 cities and regions to invest up to Rmb12,000 in private pension savings; participants received a corresponding credit against their income tax liability. Since December 2024, this programme has been rolled out nationwide.

China's pension system rests on three 'pillars':

- **First pillar (public pillar):** This is mandatory public pension insurance funded by the government through taxes. It typically operates on a pay-as-you-go basis, providing longevity insurance through intergenerational transfers.
- **Second pillar (corporate pillar):** This is a voluntary, privately managed, accumulative pension insurance. It is usually encouraged by the government and links pension benefits to contributions made during employment, without intergenerational transfers.
- **Third pillar (private pillar):** This is a voluntary savings pension plan. It involves personal pension plans and commercial life insurance, providing higher retirement income for high-income groups with flexibility and voluntary participation. The government offers the aforementioned tax incentive for such savings.

Although the coverage of the first pillar is almost universal, the replacement rate – the percentage of their working earnings that people receive – is very low, at around 30–50%. Moreover, the country's ageing population poses a significant deficit risk to the state pension. The pension scheme's current revenue is around Rmb7.7 trillion, with income premiums accounting for around 70%, while the other 30% comes from local and central government subsidies. Current expenditure on pensions is around Rmb6.8 trillion. At present, the scheme has an accumulated surplus of Rmb7.8 trillion – or enough to cover 13 months.

For now, more people are contributing to the scheme than withdrawing, given that China's retirees make up just 20–30% of the population. But as time goes on, fewer people will be contributing – and more and more retiring and withdrawing. By 2029, there is a clear risk that the state pension scheme will be in deficit rather than surplus – with the remaining surplus entirely used up within 20 years of that. Therefore, the need for supplementary pension plans is becoming increasingly urgent.

The second pillar – corporate pensions – has only very low coverage at present because of its high threshold, such that only a small portion of companies have launched corporate annuities. Although the payments are high, they cover just 9% of the population (around 100 million people) and are currently the preserve of large state-owned enterprises. So this pillar falls far short of being able to make up for the shortfalls in the first pillar's replacement rate and, potentially, its funding.

For these reasons, the government is keen to boost the third pillar – private pensions – hence the nationwide rollout of the programme. The pilot scheme had only 70 million eligible participants, and only 30% of those have so far paid into individual pension funds. As this number grows, the multiplier effect is tremendous, and the numbers involved will quickly become very significant. For example, 100 million participants would entail a premium for individual pension funds of around Rmb1.2 trillion.

In future, we expect the tax-deductible quota to be raised from the current Rmb12,000 – perhaps as the first pillar approaches deficit and the accumulated surplus is used up.

Given pension investors' income requirements, we see this as highly positive for quality dividend-paying stocks. It is, however, a medium-to-long-term trend rather than an imminent prospect. But it underpins our long-term thesis that this part of the equity opportunity set will remain attractive for many years to come.



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China A-share high dividend strategy: portfolio update

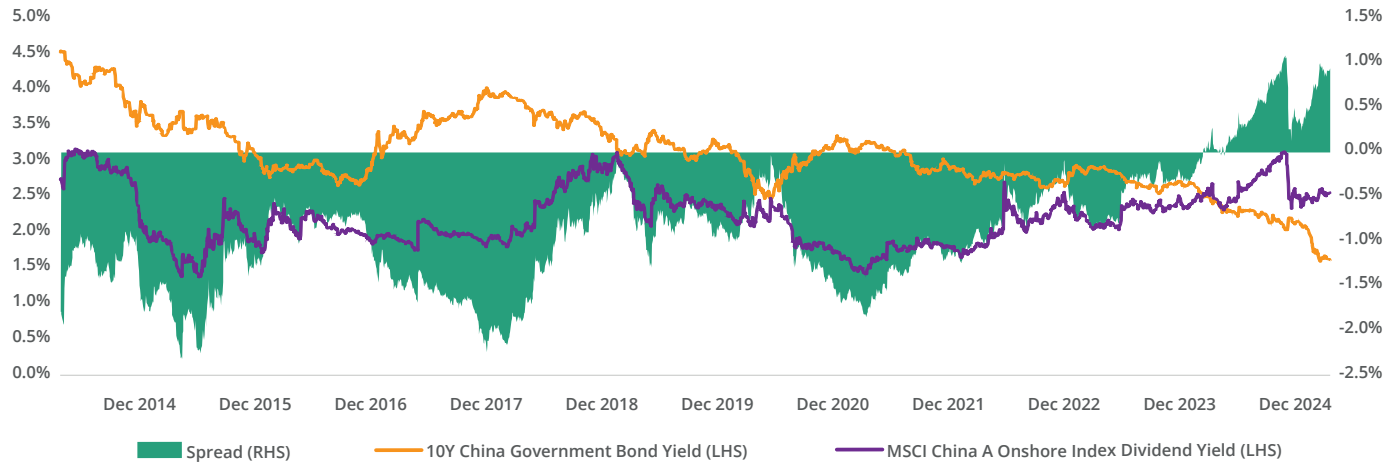
For the first time in over a decade, Chinese equities offer a higher yield than government bonds. Moreover, with interest rates set to be 'lower for longer', China's quality dividend stocks remain attractive.

Against a 10-year government bond yield of 1.7% at the time of writing, the China A Onshore Index yields 2.6%. Meanwhile, the Value Partners China A-share high dividend strategy portfolio offers a weighted average yield of 4.3%.

It is important to note, however, that our investment focus is first and foremost directed towards assessing the fundamental quality of a business. Return on equity (ROE) is the key metric we consider when considering the quality of an investment opportunity. We believe that a focus on ROE will ensure quality and, in turn, that such companies will be able to deliver a healthy and secure dividend stream.

We construct our portfolio through allocations to three distinct 'sleeves': sustainable high yield, cyclical high yield and dividend growth. On the back of our bottom-up fundamental research and consistent with our aforementioned views on the market and economic cycle, we have recently increased our exposures towards the high end of the range for stocks offering cyclical high yields (34%) and dividend growth (23%), at the expense of those with sustainable high yields (38%).

China A-share yield outstrips 10Y government bond



Source: Value Partners, MSCI, Bloomberg, 31 January 2025

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