

Schroders TalkingPoint



The next stage of Chinese development: implications for European capital goods companies

I recently spent two weeks in China, visiting companies to gauge the state of the capital goods sector. In this note I summarise the main conclusions to be drawn from my visit.

Highlights

- Chinese investment has supported the capital goods sector but this demand will slow as China transitions to a more consumption-driven economy.
- China's economy faces other structural challenges; we would be wary of companies that are over-reliant on Chinese demand.
- Chinese capital goods firms will try to gain market share and compete on quality as well as price.
- For capital goods investors in Europe, stockpicking will be key. We prefer companies with sustainable competitive advantages that allow them to defend market share and margins.

The European capital goods sector comprises a wide variety of companies producing machinery, tools, components and services across a vast array of end markets. This level of heterogeneity makes generalisations tricky; however, a common theme across the sector over the last decade is that China has been the largest single driver for growth.

China's investment-driven model has reached its limit

Having grown at over three times the global average over the previous decade, China contributed an average of 12% of sector sales in 2014 – up from just 2% in 1999.

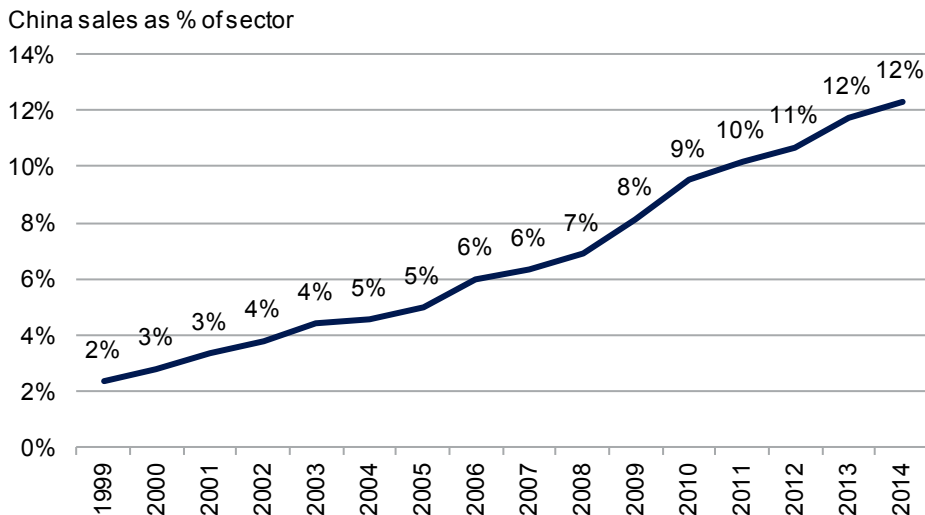
In fact, this headline figure will significantly understate the importance of China to the sector by ignoring the related impact that Chinese demand has had on other markets and commodities, as well as the upward pressure that Chinese demand has put on global prices – not to mention the fact that Chinese sales are often more profitable.



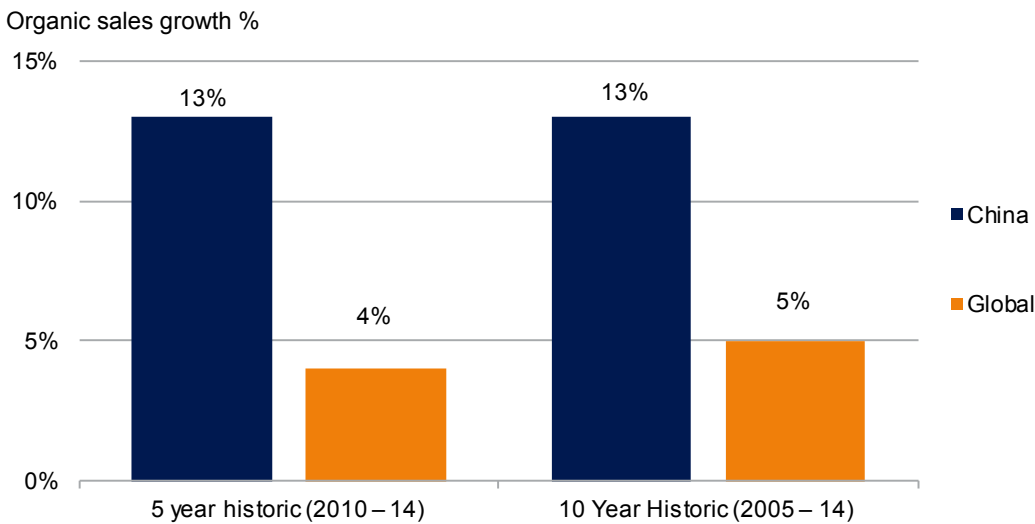
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Source: Redburn, company analysis, April 2015.

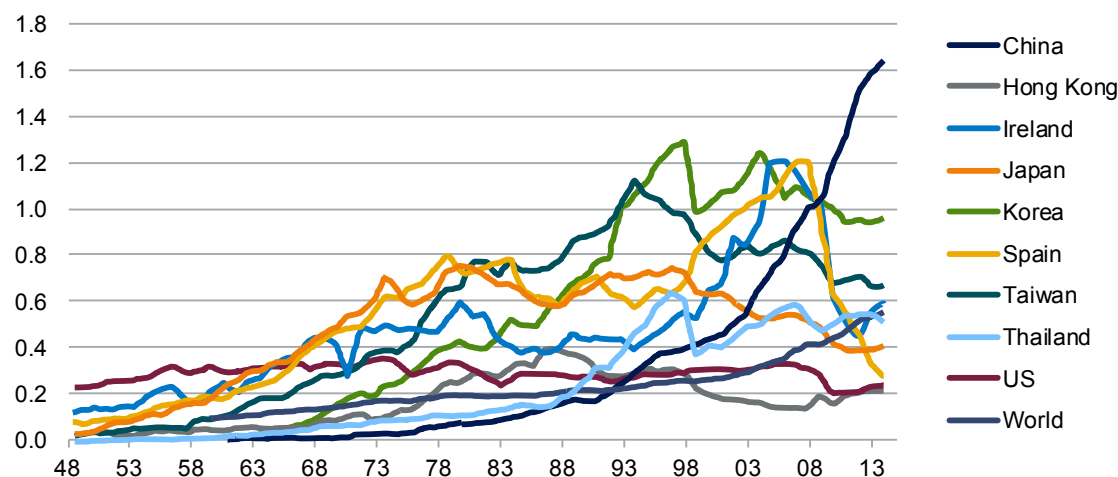


Source: Redburn, April 2015.

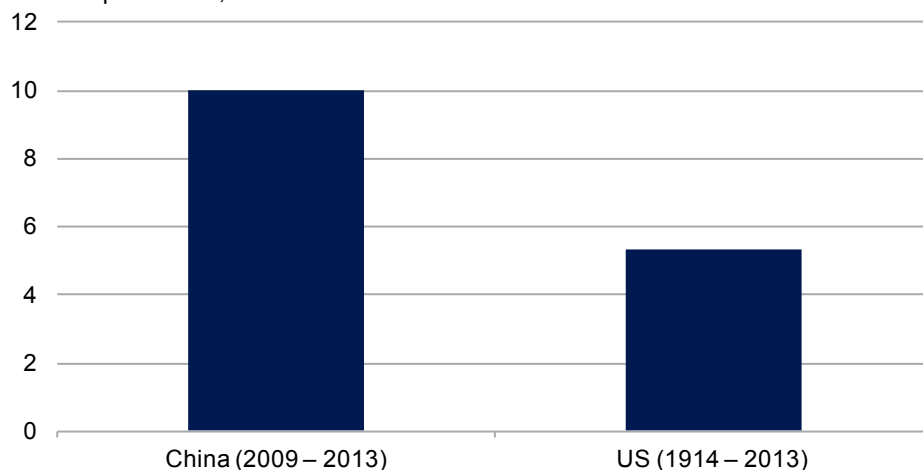
However, the investment-driven development model that China has adopted over the last three decades and which has driven the demand for capital goods has now reached the limit of its effectiveness. It will need to be adapted if the country is to continue growing. Investment’s share in GDP is currently 49% in China which is over 10 percentage points above the level where investment peaked for other “growth miracles” in the past, of which there are many – Germany following the Second World War, Japan in the 1960s and 1970s, Spain in the 1960s, Brazil in the 1960s, Argentina in 1920s and 1930s. In all of these cases growth has at best slowed significantly once investment has peaked and there is no reason to suggest that China’s trajectory will not do the same.

Illustrating just how much investment has gone into China over the last few years, the following charts show that China consumed more cement in five years than the US in the last 100 years.

Cement production, in tonnes per capita



Cement production, in billion metric tonnes



Source: US Geological Survey, Macrobond, BNP Paribas estimates

China faces significant structural challenges, though policy flexibility means a sharp correction is unlikely

Assuming China’s growth trajectory is similar to other “miracle” economies, over the coming years, investment’s share of GDP will decrease and economic growth will slow. In this context it is very clear that the >20% growth that the capital goods companies have historically enjoyed is now a thing of the past and we expect that some end-markets will in fact see significant declines.

This transition to a consumption-driven economy will not be easy and the challenge is made even greater by the fact that this point in China’s development is coinciding with several other challenges, each of which present a material economic and political threat in their own right. I will not go into them in too much detail here but, as well as transitioning its economy, over the next five years China will also need to deal with: a peak in its labour force; a construction bubble in Tier 2/3 cities; oversupply in several key industries; high wage inflation risking competitiveness; a behaviour distorting corruption crackdown; and social issues around inequality and pollution. Put together, these issues make it very hard to be bullish on China and medium-term consensus GDP expectations of c.7% seem way too high.

Having said this, we also recognise that China has a large amount of policy flexibility which should mean that the likelihood of a sharp correction in the next two to three years is slim. However, longer-term these policies cannot tackle the structural issues the economy faces and ultimately will only serve to magnify an inevitable correction. As such, I would be very nervous around any investment thesis that is based on the assumption of high-single-digit GDP growth in China.

Chinese capital goods firms are starting to compete on quality and innovation, not just price

If China's 30-year domestic investment boom does continue to slow, a key question for the European names will be whether China exports precipitate global pricing pressures and market share losses. Because of this potential threat, we met several local competitors across various industrial end-markets. For now, it is clear that a quality gap still remains between Chinese and Western producers; however, the gap is rapidly narrowing as the local competitors develop expertise and improve production processes.

At present the large international players will typically dominate the "high end" market in their respective industries, where product quality and innovation are key, whereas the local players compete (typically on price) in the volume end of the market. As Chinese manufacturing improves and growth slows, we expect to see local operators increasingly trying to take share higher up the value chain, both in China and internationally. This could create a negative pricing headwind for many capital good names which do not have defensible competitive advantages or where switching costs are low.

Where we would seek to invest

After two decades of Chinese expansion fuelling growth for the European capital goods names, we believe that demand will continue to trend downwards and that this will result in local competitors trying to take share, both in China and internationally, from the large European companies. Under these conditions we believe that stock selection will be key to investment returns in the European capital goods space over the next few years.

We will look to avoid companies where the investment thesis is reliant on strong Chinese demand, where we believe expectations are still too high on a medium-term view (particularly those exposed to end markets where we see the highest risk such as property), and those where customer switching costs are low (opening up to the threat of increased competition).

Where we do invest in businesses exposed to China, we will favour end-markets that offer structural growth, such as healthcare and consumer, or where businesses enjoy sustainable competitive advantages which will allow them to defend their market shares without giving away margin. For example, more stringent regulation in the elevator industry will likely lead to market consolidation in China which will benefit the European companies despite the slowdown in demand. Bought at the right valuation, we believe that these businesses will continue to deliver growth and offer superior investment returns.

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