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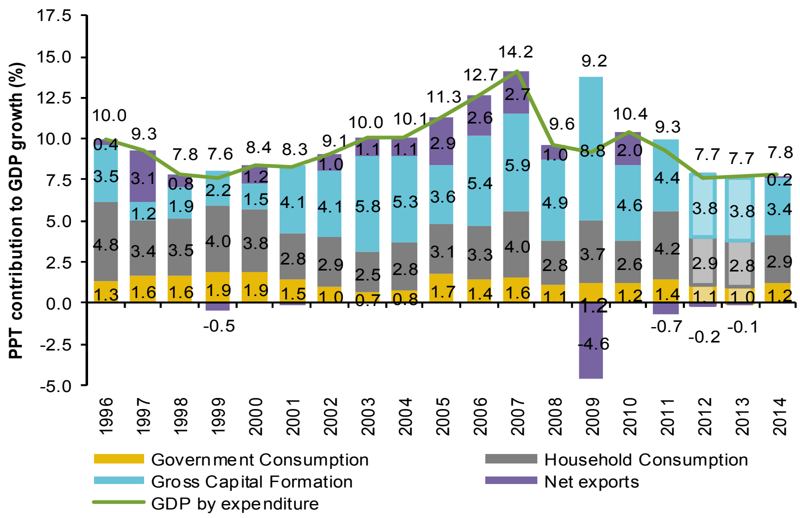
Vanessa Donegan
Head of Asian equities

China's reforms are creating investment opportunities even as growth slows to more sustainable levels

Having returned from a recent investment research trip to China, Vanessa Donegan is convinced that Beijing is serious about reforming the economy and cracking down on corruption. However, she believes the benefits of reform are unlikely to be realised quickly because of the complex challenges involved in driving through restructuring, while maintaining stability, traditionally the priority of China's leaders.

Following years of rapid growth, China's policymakers are seeking to engineer a transition to slower but more sustainable growth without causing a sharp cyclical slowdown. They are seeking to encourage higher-quality growth driven by domestic demand and the private sector, rather than by exports and the cheap liquidity that has distorted investment and imperilled the financial sector.

Figure 1: The changing pattern of China's economic growth



Source: Goldman Sachs, January 2014.

As part of this drive, the new Chinese leadership unveiled a number of economic reforms, described as the most sweeping in two decades, at the Third Plenum held in late November 2013. In a bid to reinvigorate the economy the authorities pledged to encourage more private investment in the state sector, loosen the one-child policy and provide better protection for farmers' land rights. They called for greater liberalisation of interest rates and the free convertibility of the yuan, and increased overseas investment. The number of smaller banks and financial institutions funded by private capital will also increase. Overall, the government pledged a bigger role for the free market in the economy. The transition to this new growth model is likely to involve a slower level of government-related investment spending than we have been used to, so it will be important to monitor whether the reforms can stimulate investment from the private sector to offset this slowdown.

In this regard, the recent announcement by China Petroleum and Chemical (Sinopec) that it will allow the private sector to invest in up to 30% of its downstream marketing segment is a significant step in the right direction. The government also announced reforms to state-owned enterprises (SOEs) and, as these are rolled out, new business opportunities will be created and we shall be looking to invest in those companies that are in a position exploit them.

Ending corruption is an integral part of the reform drive

The push for economic reform and the assault on corruption are linked. Interestingly the Xinhua News Agency, the state press agency of the People's Republic of China, noted in January 2014 that the economic reforms were designed to ensure that the market played a decisive role in allocating resources while also seeking to end excessive government interference, which the agency said was characterised by high administrative costs, low efficiency and corruption. President Xi Jinping has used the terms "tigers" and "flies" to signify that both senior and junior officials will be exposed for graft. In 2013, 182,000 officials were investigated and the state-run People's Daily even has a link to a video game where players can use an electric prod to attack – and shock – corrupt bureaucrats. The government is also bearing down on tax-payer funded activities, such as office parties, raffles and firework displays, in its campaign to eliminate waste.

Balancing stability with financial liberalisation provides a key challenge

Financial sector reform is perhaps the most pressing and difficult challenge facing the authorities because of the high risk of destabilising China's economic growth associated with the reforms. The SOEs that dominate the economy were the main beneficiaries of Beijing's stimulus programme following the global financial crisis, as funds flowed into Local Government Financing Vehicles (LGFVs) to drive investment and create jobs for those who had been displaced in the manufacturing sector. The worry is that much of this investment was mismanaged and that it is only a matter of time before the banks will have to recognise the impaired nature of the projects they lent to in the form of increased provisions for non-performing loans.

The authorities now face a fine balancing act: on the one hand they need to deliver a sufficiently robust level of economic growth to ensure social stability through job creation, while on the other they need to rein in credit creation, which appears to be spiralling out of control. Their solution is to ensure that capital is allocated more efficiently and to coerce the banks to manage their liquidity risk and interest rate risk more prudently. To underline the seriousness of their intent, the People's Bank of China is allowing interest rates to rise, at precisely the time when they would normally be looking to stimulate the economy. This on-going liquidity tightening is causing the stock market to de-rate as investors worry that the risk to GDP growth is on the downside as the strength of fixed asset investment growth tails off. However, over the medium term, the economy stands to benefit if higher interest rates ensure that capital is allocated more efficiently and projects that are only viable as a result of artificially-low borrowing costs no longer go ahead. We can expect the new Chinese leadership to deliver a lower level of economic growth, but of a higher quality than has been seen hitherto.

New banks to boost the private sector

It is important to remember that the Chinese authorities are committed to financial stability to underpin economic growth. While the central bank wants to keep money market rates at an elevated level to encourage deleveraging in the financial system, it is also seeking to avoid a serious credit crunch. A key plank of its strategy is to dispel the perception of an implicit "State guarantee" that has been the root cause of the misallocation of capital in favour of the SOEs and government projects over the private sector. Officials are keen to encourage small and medium enterprises (SMEs) and entrepreneurs to take up the slack in terms of employment growth following the restructuring and scaling down of the SOEs. As a Professor from the Institute of Economic Research at the National Development Reform Council (NDRC) said to me in Beijing last month, "China produces seven million graduates per annum and if just 10% of those became entrepreneurs it could make quite a difference to the economy".

As part of the plan to encourage the role of market forces in directing investment, new private banks will be licenced with the aim of boosting lending to SMEs and the private sector in general. If the plan to reduce the dominance of big state-owned banks is to be successful, sufficient capital must be made available to the SMEs at a price that allows them to generate a reasonable return.

Investment themes

Although the rate of economic growth in China is anticipated to slow to levels lower than investors have been used to, the reforms will also create opportunities, not just in the financial sector and in areas connected to SOE reform as discussed above. Below we highlight a number of themes that we are seeking to exploit:

- *Changing patterns of consumption*: One impact of the crackdown on corruption is that demand for high-value goods has fallen away as conspicuous consumption is avoided. Nevertheless, demand for more basic goods is very resilient. Take SUVs, for example, where low penetration rates combined with strong upgrader and replacement demand is underpinning 20%+ growth in unit sales nationwide. Rural consumption is roughly at the level where city consumption was 12 years ago with rural dwellers consuming only one-third of the goods bought by their urban counterparts. The authorities view this as a source of untapped growth. Indeed demand for online retail services in China, which is expanding far faster than in the US, is growing particularly fast in poorer regions, where malls are sparser and the number of people getting online for the first time is greater than in urban areas.
- *Urbanisation*: This is receiving fresh impetus under the country's new leaders who see it as a way of promoting low-end consumption. Just 52% of China's population was living in urban areas in 2012, compared to around 80% in the developed world. The target is to reach 55% by 2015. Giving migrant workers equal access to education, healthcare and social security in cities through the rollout of "hukou" (residency) reform should unleash extra demand for goods and services. Similarly rural land reform has the potential to increase the spending power of the farmers.
- *Cleaning up the environment*: China has embarked on a massive drive to address the environmental damage caused by its rapid industrialisation. The country invested US$61.3bn in clean energy alone in 2013, higher than in the US where the figure was US$48.4bn, according to Bloomberg. As part of the effort to clean up the environment, the government is keen to see a shift away from coal and towards gas and alternative energies, opening up fresh investment opportunities that we are exploring.
- *Automation*: Due to rapidly rising wages, which are fuelling domestic consumption, and China's desire to move up the value chain, businesses are increasingly seeking to invest in technology to replace labour. Over the next five years, industrial robots will transform China's factories, creating lucrative opportunities for suppliers of these technologies.
- *Mobile internet:* E-commerce will continue to boom in China thanks to the proliferation of cheap smartphones and the rollout of the National Broadband Strategy, which targets 85% fixed broadband penetration and 95% 3G/4G users by 2020. The internet space is consolidating fast and those companies that are able to monetize their existing social networking sites and search platforms, through providing new services in areas such as travel, internet finance and gaming, should continue to be rated highly by the market for their relatively exciting growth prospects.
- *Healthcare*: Rising living standards, an ageing population and enhanced social welfare system are boosting demand for healthcare. From 1% of GDP in 2002 healthcare spending in China has risen to more than 5% today, with a target of 7% by 2020. That translates into 15% compound annual growth rate of revenue during 2013-2020, at the end of which period it is projected to have tripled to one trillion dollars. Reforms announced at the Third Plenum such as the commitment to a more market-based system and the development of private healthcare service providers should provide exciting growth opportunities.

Conclusion

We are encouraged that the reform agenda laid down at the Third Plenum addresses some of the deep-seated structural issues in the Chinese economy. Progress on implementation will be hard to predict, especially given that deregulation in a number of areas will challenge vested interests. While economic growth may slow as the restructuring of the economy proceeds, we believe the reforms will eventually usher in higher-quality and more sustainable growth. As new investment opportunities arise from the rollout of the reforms, investor confidence in the sustainability of China's economic growth model should increase. As active managers we shall continue to look for themes, some flowing directly from the reforms, which can create profitable investment opportunities. Finally, it is important to remember that China's economic growth will remain high by global standards and that large parts of the economy could benefit significantly from being opened up to the private sector.