China: stimulating the dragon

Notes from the road

For Professional Investors Only | Marketing Communication

Richard Farrell
EM Equity Portfolio Manager

Angel Su
EM Equity Associate
Portfolio Manager

Published December 2024

"Compared to March when we were last in China, the overall sentiment on the ground has clearly shifted in a more positive direction."

A note on China's plan to breathe fire back at Trump's tariffs:

We timed our research trip to China to arrive immediately after the U.S. election, and over 10 days, visited six cities in the south and southeast of China. We decided to visit not just the large, well-known metropolises but also lower tier cities such as Changsha, Xiamen, Ningde, and Shanwei. In our view, visiting these types of cities provides a better feel of on-the-ground sentiment, as well as giving us the opportunity to meet lesser-known companies. In the past, less economically developed, lower tier cities in China were associated with safety and cleanliness issues, but we have observed significant improvements over the last decade. Travelling to see management teams where they are based pays dividends, as we have the opportunity to meet with senior management and visit their offices, factories, and production centres. More importantly, it allows us to enhance our relationship with our portfolio companies.

Compared to March when we were last in China, the sentiment has clearly shifted in a more positive direction, after the government's stimulus announcements since late September, despite the overhang of potential Trump tariffs. Our sense this time is that there is something of a disconnect between investors and management teams in China. Investors, particularly international ones, seem concerned that a simple debt swap would not directly boost consumption, however in more than one meeting, it was argued that one of the factors behind weak consumption, other than the decline in property prices, has been the inability of local governments to pay their employees and suppliers on time. We have seen pay cuts for employees, and even job redundancies in extreme cases, as the decline in land sales reduced local government revenues. A debt swap that enables these arrears to be paid and reduce the interest costs should go some way to helping consumers and, as a result, business sentiment.

We found getting around China surprisingly easy, despite the vast distances, especially if you can reach your destination using the high-speed train network. Over the years, the development of China's railway infrastructure has continued to accelerate, reaching a total network length of 160,000 kilometres, of which 29% of the network is high-speed rail[1]. This also means China has the world's largest high-speed railway network[2]. Today, 96% of the country's major cities (33 provinces out of 34 provinces), including Hong Kong, have access to high-speed rail, significantly reducing travel times between major metropolitan areas. On our first day of the trip, we took a 4-hour, high-speed train from Hong Kong to Changsha. Purchasing tickets is very convenient. Simply buy your ticket online, and your ID or passport information is linked. In some stations, you can even scan your face on a screen to get through the gate.

Our journey began in Changsha, the vibrant capital of Hunan province, which is bustling with 10.4 million residents. Changsha has long been famous for its millennia-old history and being the place where Mao Zedong started his political career, having studied there from 1913 to 1918. Nowadays it is known for being home to China's largest construction machinery manufacturing companies. We met two such companies, and for both of these businesses, exports was a bright spot. Management assured us they can absorb tariffs of around 10-20%, but their long-term strategy is to build more products in their largest export markets.

"During our company site visits, we did not witness a stereotypical industrial environment. Instead, we observed factories nestled within gardens that included picturesque ponds, creating a peaceful and scenic environment."

Our next stop was Xiamen, an island city off the east coast of Fujian province. Xiamen has a strong trading history, given its location, and it is the closest city in China to Taiwan, only 200 miles from the Taiwanese mainland. It is also widely recognised for its liveability, considered to be one of China's most comfortable cities because of its lush gardens and subtropical climate. During our company site visits, we did not witness a stereotypical industrial environment. Instead, we observed factories nestled within gardens that included picturesque ponds, creating a peaceful and scenic environment. This is also reflective of companies placing increased focus on creating friendly work environments for employees, which is particularly important for those who perform repetitive tasks. We also learned that these companies provide free meals to factory workers.

Canteen experience in a factory – free meals provided to staff.

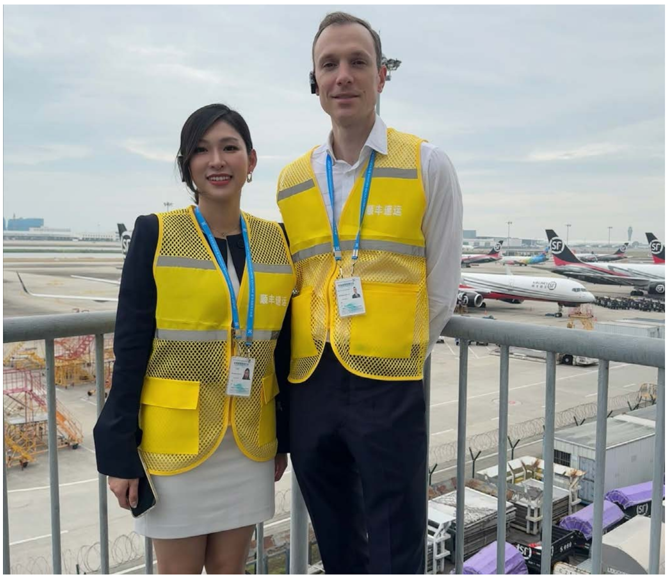
The two leading industrial companies we met are amongst the top three players globally in the niche areas in which they operate, from a sales volume standpoint. Like other industrial companies with sizeable overseas exposure, tariffs are a concern for them. To mitigate the associated risks, one company has already diversified production beyond China, while the other is in the process of ramping up its overseas production. In terms of the domestic market, both companies believe the renewable growth story is still ongoing, driven by the State Grid's accelerated investment in predominantly upgrading the electrical grid system in China.

After Xiamen, we took the high-speed train to Ningde, a tier 4 city in the north of Fujian. This city of 2.8 million inhabitants is mainly known for being the home of the world's largest battery maker[3]. We had the opportunity to tour one of its battery manufacturing sites, where we saw the latest generation of the lithium iron phosphate ("LFP") battery being manufactured. It became clear to us that the company's competitive advantage comes from not only the R&D that goes into the chemistry and structural design of its battery packs, but also the efficiency and speed of the production process. We were also impressed by the company's focus on environmental sustainability. It aims to be Scope 1 & 2 carbon neutral by the end of 2025 by using wind, solar and nuclear sources of electricity. As of now, it already has four manufacturing sites that are carbon neutral.

Moving down the coastline, we arrived in Shanwei, a city near Shenzhen, to meet the world's largest electric vehicles ("EV") manufacturer and the second largest battery manufacturer. The company overtook Tesla at the end of 2023 to become the largest seller of battery electric vehicles ("BEVs") and it is on track to sell over 4 million BEVs and plug-in hybrid electric vehicles ("PHEVs") in 2024. It showed us around one of its flagship production facilities, and we were impressed by its high level of supply chain integration, manufacturing its own batteries, motors, semiconductors, and other core components.

1 China's railway network surpasses 160,000 kilometers - Chinadaily.com.cn.
2 China's High-Speed Rail Miracle - Newsweek.
3 A boom city built on electric batteries - Global Times.

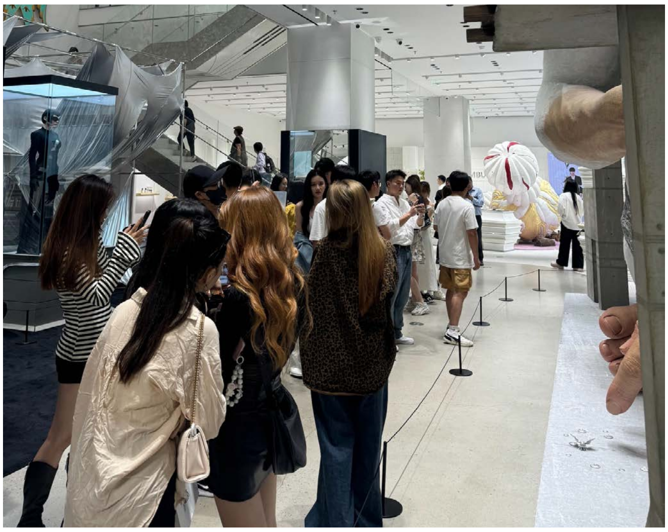
In Shenzhen, we visited the aviation hub and drone delivery centre of Asia's largest – and globally the fourth largest – integrated logistics service provider. The company offers a comprehensive range of offerings, including time-definite express delivery, freight services, on-demand intra-city delivery, and supply chain management solutions. Riding on the supply chain relocation trend, the company is now expanding its business focus from China to elsewhere in Southeast Asia, through business acquisitions.



A visit to a pharmaceutical company's distribution centre.

"While real disposable income growth in China has recovered, consumer spending remains subdued,"

Beyond the industrial advancement observed during our company visits, we also delved into aspects of consumer trends. While real disposable income growth in China has recovered, consumer spending remains subdued, with much of the income being allocated to savings. The consumer companies we met told us they have seen trends of trade down and premiumisation simultaneously, depending on the product category and consumer group. Promotions have become more important for both mass market and premium products to ensure consumers feel they are getting value for money. Our overall impression is that consumers have become increasingly selective about where they choose to spend their money. Experience-related spending continues to be an area where we see strong momentum. We met with a leading property manager and saw busy traffic in one of their directly operated malls, even on a Tuesday afternoon.

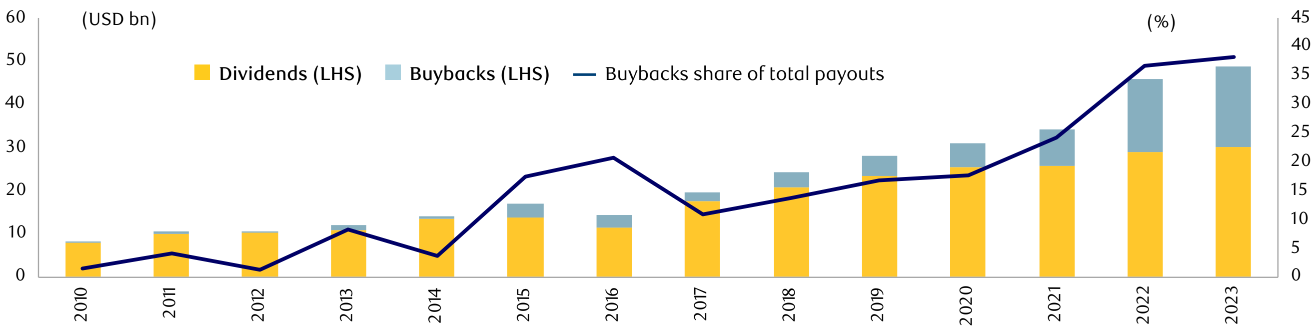


Store visit in a local mall on a Tuesday afternoon in Shenzhen.

The last stop of our trip was Hong Kong, where we met with two leading Chinese real estate companies. The bursting of the real estate bubble has presented a significant drag on overall economic activity, however both companies were more positive on 2025 compared to when we last spoke with them in January. In particular, they cited the most recent primary sales data from the top tier cities, which are the cities they are most exposed to and ones where sales over the October Golden Week national holiday were up compared to last year. That said, management felt that they need to see prices stabilise for a longer period in order for households to fully step back into the market.

One final observation is around corporate governance. This speaks to something we have been highlighting for several years: improving corporate governance is benefiting capital allocation in the Chinese market. Exhibit 1 shows how dividends and buybacks have increased significantly in recent years, and the 2024 run rate is set to eclipse the total last year.

Exhibit 1: Increase in shareholder friendly policies by Chinese corporates



Source: CLSA, FactSet, MSCI, as at 30 September 2024.

Authors

Richard Farrell, CFA

Portfolio Manager

Richard is a portfolio manager on the RBC Emerging Markets Equity team at RBC GAM and is responsible for research on China. Prior to joining the firm in 2013, he spent three years at a major U.K. asset manager providing fundamental equity analysis in the energy and materials sectors within global emerging markets. Richard began his career in the investment industry in 2005 as an equity analyst in the mergers and acquisitions team of a large multinational bank.

Angel Su

Associate Portfolio Manager

Angel is an associate portfolio manager on the RBC Emerging Markets Equity team at RBC GAM, assuming this role in 2023. She works closely with portfolio managers to support both top-down and bottom-up research. Before joining the organization in 2019, Angel completed a number of internships in Hong Kong, which included roles at a global assurance, tax, and consulting services firm, a U.S. management consulting firm, and a major Chinese firm offering investment banking and securities brokerage services. She started her career in the investment industry in 2019.

Published December 2024

RE/0172/12/24

RBC BlueBay
Asset Management