1. OCTOBER 2021

China Focus – by H&A Shanghai

As the world's second largest economy gearing up for more financial openness, China is the market that any investors with global view cannot miss. Yet, its profound dynamics in economics and policy environment require on-the-ground knowledge. This monthly newsletter by our dual team in Shanghai and Frankfurt is an endeavor to illustrate our investment thoughts and prove digestible insights on China's market and policy trends.

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1. Highlights of the Month

Slowing manufacturing activities provide leeway for policy easing. The Caixin manufacturing PMI, a widely used indictor to gauge factory activity, reported at 49.2 in August, the first time dropping below the 50-mark since April 2020, which indicates a contraction.

In our view, the above is significant in certain ways: 1) It could be a turning point of a relatively tight monetary policy since earlier this year. Private sector will likely see better liquidity, as the market expects a reduction in reserve ratio. Infrastructure expenses are likely to be raised too. 2) Regulatory policies against new economy is likely to moderate as we see this month compared with it was in August. The speech by Vice Premier Liu He reassured the supporting of the private economy in spite of the recent crackdown policies.

The looming expectation on Evergrande's default represents a major risk on China equities but looking at figures we think it can be contained. Evergrande's chance of default has been somehow anticipated by the market for years, as its bond was once issuing at over 13% but also widely purchased by international investors including Allianz, Ashmore and BlackRock. Of Evergrande's total debts, listed banks own less than 10%. Most of debts (30%) are in the hands of local government owned banks, as well as insurance and trust companies, 20% were issued overseas.

We see further short term impacts on property price and difficulties along the value chain. Yet financial institutions except trust companies are in very good capital position, therefore it is unlikely that it will cause a systemic breakdown. Debts issued by trust companies are on hands of individuals which may cause social problem in case of an outright default, yet most of its direct creditors are state-owned and they would consider the government's top agenda which is social stability. For the same reason, we believe that the government will first make sure Evergrande will deliver projects on hand and avoid a sudden blackout.

Source: Bloomberg, *H&A; data as of Asia market-close on 30/9/2021*

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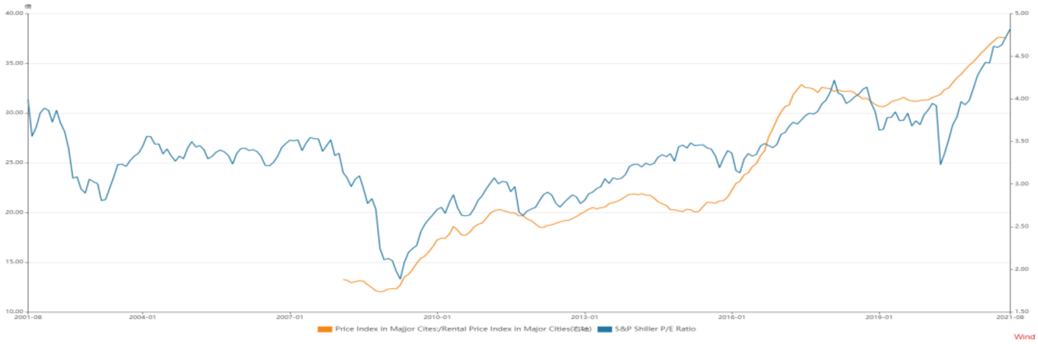
2. PM Talk – Invest in China after excess liquidity age *by Brian Yu*

The extraordinary return from excess liquidity may be gone in the future. In the past decade, liquidity has been pumping on an unpreceded rate, with the balance sheet of the US Fed expanded by 8 times since 2007, and more than doubled in the past year. It was similar for the other biggest central banks, namely BOJ, ECB and PBOC, such that the global money has been chasing for limited amid expanding assets. The world's largest asset by market, namely, US equity and China property have seen higher valuation and lower expected return.



Source: WIND Financial Terminal, Data as per 31.08.21

In general, the intrinsic return of most assets has decreased nowadays. As long term investor, we believe too much reliance on liquidity is fragile. **Instead of forecasting the liquidity, we look for assets with intrinsic return to build a portfolio with higher level of resistance against inflationary and liquidity risks.** China, hosting the world's second largest capital market, is still having a good portion of stocks which are in reasonable valuation in our view. For instance, in the A share market there have been significantly higher proportion of companies trading at PE of less than 30x than 2016-2018. Whereas, they are upholding similar level of ROE and earnings growth across the period.

Intrinsic return other than liquidity condition can be attributed to 3 main sources, are namely Static value (dividend including repurchase), Value recreation (reinvest on retained earnings), and Revaluation (mean reversion of mispriced stocks, which often comes from changing growth or risk outlook by investors).

- **Dividend:** Dividend can be estimated objectively from corporate governance track record, operating cashflow and CAPEX forecast, etc. This is the first layer of intrinsic return. We are expecting 2-5% in most value position in China. While in some extreme cases it could be as high as 10%。
- **Value Recreation:** Or reinvest on retained earnings - basically ROE minus dividend payout. The ROE of A share in the past two year stood at 9.49% and 8.92% respectively, amid Sino-US trade conflicts and Covid-19 pandemic. The long term growth, after deducting certain dividend payouts, would still be a nice figure of 6-7%, which we consider is the underlying growth of share prices. Our strategy mostly focus on better quality companies, which means the value recreation part of the portfolio in china could generate at least 7% return.

  The sum of the above two sources already provide a return of 9-12% in long term, had the fund manager avoid low valuation-creation inferior stock, it could be better.
- **Revaluation:**
  However, the reality is not so simple, and we believe the most challenging part is the proper risk pricing so as to generate positive revaluation return. The stock that provided no actual return after 10 years is because of underestimated risk-pricing, i.e. the market misconceived a stable trend but in converse the actual risk was much higher than what priced-in. For example, if we backtrack China National Pharmaceutical (1099.HK) which is near-monopoly in pharma distribution in China and had ROE of over 10% in 2010, has been mostly welcomed by institutional investors with a stable dividend payment. But its PE was 60x back then.

- With hindsight, the valuation revealed the underestimated policy risk for the reform of the pharma distribution which had been looming for long. If one held the stock for 10 years till 2020, the total return would be -30%. In other words, identifying the appropriate level of risk-pricing would avoid a misery return; and identifying those mispriced would give an astonishing long-term return

Source: WIND Financial Terminal, Data as per 31.08.21

Traditional Value strategy has natural advantage in dealing with the change in risk pricing for the follow reasons:

1. Most value stocks have been negatively rated by investors for a long time, which means the risk is adequately considered. And the higher dividend yield it has, the more resistance for devaluation.
2. Value strategy focuses more on evaluating risk factors. Under our contrarian value strategy, as we call it, we avoid crowded trades. That does not simply mean buying on low valuation, but also averting value traps, which is our chief task.
3. In a momentum-driven retail investor market like China, patient long-term money on insightful investment can be handsomely awarded.
4. Even for value stocks in China, there are still handful choice with double digit “low growth”. Their returns in terms of revaluation can be significantly enhanced once the market recognize their earnings certainty or growth value. In other words, their risks are overly priced. They can be regarded as underpriced growth stocks.

   Having said that, we are intended to invest in a portfolio which will benefit from, but not solely rely on, China growth.

Outlook on the investment environment

No one knows when the excess liquidity ends. Although when the time comes it will be painful, but can delay for a very long time, like such in the past 10 years.

As described earlier, the liquidity condition has led to a declining return of investment, and may blow further as excess liquidity subsides. Here is our take for long term capital: Insist on the primary principle of value investing, search for long-term intrinsic returns regardless of liquidity environment, and lift up resistance level for various risks.

3. How we view the policy risk in China? *By Antony CHENG*

Investors have heard about government interventions in the internet, education, video game, real estate and pharmaceutical sectors. For instance it has crackdown on private education and at the same time set stringent control on the time allowed for internet games by youngsters. These have brought tremendous impact to relevant share prices. New Oriental (9901.HK), a private educational services provider in China, has seen share price slashed since the policy unveiled in July. That has led to investors wondering which industry is next on the hit list.

Is the Chinese government being unpredictable? Has it become impossible for many investors to set an appropriate risk premium for buying company shares?

Summarizing the recent policies, the Chinese government aims at the below objectives:

- **Social cohesion:** Companies that run counter to the social goals of policy makers are concerned by the government. As an example, the rapid falling birth rate announced in March that received wide attention hinted a policy response. Extracurricular tutoring is targeted as they are blamed for being burden on the children and the parents' budget. Other examples include companies that rely on labor for services such as takeaway delivery. These companies could come under pressure to pay their workers more. Internet giants can also be targeted because their monopoly behavior is also seen as harmful to society.

- **Data security controlled by internet players:** Examples include US-listed Chinese Internet companies that amassed mountains of day-to-day household data like DiDi. The requirement on US-listed companies to submit operational data offshore led to China government's tighter grasp on those companies that collects.

- **Closing regulatory loopholes:** Example was the call-off of Ant Group's IPO, as its consumer finance business laid outside the frame of current regulation. Regulation grey areas especially in the financial industry now come under policy target.

In a historical context, however, enforceable regulations are quite common in the Chinese economy. In 2004 and 2005, the authorities took action against small, poorly managed steel mills that were disrupting the market. In 2008, Chinese food companies were targeted after a series of quality scandals. In 2011, banks were required for a tighter capital standard as debt level ballooned after the 2008 global financial crisis. In 2013, the anti-corruption campaign has put moutai (Chinese white wine) consumption on alert. And from 2016 to 2017, pharmaceutical companies came under scrutiny following a string of deaths from counterfeit vaccines and drugs.

At the end, we know that a lot of stocks in those sector recovered and delivered mega returns to investors, such as Mengniu Dairy (2319.HK), Kweichow Moutai (600519.CH), Hengrui Medicine (600216.CH) and a lot more. We would like to highlight the investment approach as below:

- **To always know the ultimate policy objectives.** In this round of crackdown, the government aims at providing a healthy nurturing environment for the next generation, and a level-playing field for businesses. Those had previously been well addressed by the authority.

- **To identify the underlying growth unaffected by policies.** For example, the expenditure on e-commerce is still robust. As long as there exists a solid capital return (instead of mere cash-burn as for some players), the market should come back for a fair valuation when policy is fully-priced and policies become largely visible.

- **Do not catch the falling knife.** China investors do not act contrary to policies. It takes time, usually 6-18 months, for policy details to be announced, digested, and executed. In the past, we see similar timeframe for adverse policy cycles. There are usually sufficient entry opportunities when valuation bottoms and Chinese investors turnaround on their policy perception.

Our Investment & Research Team

Portfolio Manager: Long (Brian) YU, CFA

- Joined Hauck Shanghai in May 2021 as Portfolio Manager
- More than 16 year experience in investment and has been PM since 2014
- During the last 6.5 years he achieved compound return of 25%, top 5% in the industry
- Won numerous awards, e.g. the 9th “China Private Equity Golden Bull (Three-Year Equity) Strategy Awards” held by China Securities Journal, the 5th “China Fund Industry Ying Hua Awards-The Best Private Equity Investment Manager in 3 Year” organized by China Fund News
- Worked in China Galaxy Securities, China Everbright PGIM and HSAM (under Sequoia Capital)

Head of research: Hua (Jason) YU. Hua

- Joined Hauck Shanghai in February 2021 as Head of Research
- Ten year experience in Chinese equity market research
- Worked in Westpac, China Everbright PGIM and UBISOFT
- Qualified member of CPA Australia
- Received Master's degree in accounting from Macquarie University in Australia and a Bachelor's degree in Accounting from Fudan University in China.

Analyst: Da HUA

- Joined Hauck Shanghai in September 2020 as Investment Research Analyst
- Previously worked at Allianz Global Investors, FERI Trust GmbH and Hauck & Aufhäuser Privatbankiers in Germany
- Has a deep understanding of investment and risk appetites of European investors especially investors in German-speaking areas

China Desk Researcher from H&A Frankfurt Office: Antony CHENG

- Joined the China Desk team of Hauck & Aufhäuser Privatbankiers AG in September 2021 as Researcher
- Previously, he built up the equity research team at Fosun Hani Securities and Cinda International in Hong Kong, and possesses over 17 year experience in equity and economic research, M&A and institutional sales in Germany, Hong Kong, Beijing and New Zealand.
- Received his Master of Economics and Bachelor of Economic & Finance degrees in the University of Hong Kong.

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