CHINA Q2 INVESTMENT UPDATE

Investment specialist Ben Buckler and investment manager Sophie Earnshaw give an update on the China and China A Shares strategies covering Q2 2023.

Ben Buckler (BB): Welcome, everybody. Thank you for joining us for what is our first China quarterly update. We are here in the Baillie Gifford library and hope that over the next 10 minutes or so we can look at the performance of the two China strategies, China and China A. We can look at what's going on in the market and what we've been doing in our strategies and portfolios as a result of that.

And for a bit of excitement to finish, now Covid lockdowns are over in China, we've been able to get back on the ground, see our colleagues in Shanghai and meet companies, and we'll talk a little bit about that.

I'm Ben Buckler, an investment specialist on the strategy, and I'm very happy to be joined by Sophie Earnshaw, one of the managers of both the China and China A strategies.

So I think jumping straight in at the top, it's been perhaps a challenging time for markets in China, but also for performance of both of our strategies. And I wonder whether or not you can just say a word or two on what you're thinking.

Sophie Earnshaw (SE): Yeah. So, it's been another volatile quarter, lots of noise as usual on geopolitics. But I think the real driver behind the weaker short-term performance has been the weaker than expected macroeconomic recovery in China.

So, at the beginning of the year, we saw the recovery start reasonably strong. GDP growth in the first quarter was around 4.5 per cent. But since then, it's slowed quite substantially. So we've seen a rebound, a modest rebound in consumption. We've seen quite strong growth in services, but exports and the property market are really what's dragging growth. So, the market, I think, is basically waiting for stimulus. And while they wait, they're hiding in things like defensive stocks, but also in things like state-owned enterprises, neither of which we would really normally consider owning for our China strategies.

More positively, at the margin as the recovery has continued to be weak, we've seen recently the central bank start to cut interest rates and we've seen local governments start to relax home purchasing restrictions.

But I think it's important at this point just to take a step back and sort of remind ourselves what we're hired to do. So, you know, Baillie Gifford are long-term growth-oriented bottom-up stock pickers. And so, the key question for us as long-term growth-oriented bottom-up stock pickers isn't really anything to do with GDP. It's more, you know, how is China changing and what sorts of opportunities is this bringing up? And here I think, the structural trends that we're really excited about, things like the green transition, advanced manufacturing, the rise of domestic brands, all of these long-term structural trends are still very much at play and are continuing at pace. But they've been forgotten, I'd say, by a market that is very short-term focused on things like the domestic recovery and geopolitics.

BB: I mean, we know there is very little correlation between GDP growth and market returns. And fundamentally that's one reason why we take a bottom-up approach. And there's also been quite a lot of companies in our portfolios that seem to do, or have been doing well operationally. And yet share prices haven't been very strong against that backdrop. Do you want to just say a few words about some of those kind of companies?

SE: Yeah, I think at the company level, I think there are two main factors. So firstly, as I said, the market seems to be hiding in more defensive stocks and also state-owned enterprises. So, you know, we saw CCB and PetroChina, both state-owned enterprises, both flat in share price terms over the quarter in a market that's fallen. Neither type of company, you know, neither company we would really consider owning largely because of corporate governance concerns.

But we are challenging ourselves here. So, we just reviewed a state-owned enterprise, China Northern Rare Earth. This is a company with significant market share in some of these rare earth materials on the supply-side. We think demand is likely to be very strong given the electrification trend. So, from a fundamentals perspective, quite exciting. But we couldn't get over these corporate governance issues and this question of alignment between us as minority shareholders and the state-owned enterprise.

Second factor at the company level, we have seen some cyclical weakness in end markets. So as I said, property, but also in analog semiconductors. So, two of our biggest detractors, SG Micro is an analog semiconductor and Glodon on which is exposed to the property space.

BB: I know we deliberately don't think in short-term measures and are very much more focused on that long term, but when it comes to the portfolio, has the volatility or the weakness in markets started to provide any opportunities? And what have we actually been doing within the China and the China A Share strategies?

SE: To a certain extent. So the short answer is that we haven't done a huge amount. Why? Well, you know, again, taking a step back, we think the portfolio is very much geared into these longer-term structural trends that, as I've already said, are continuing at pace. So, whether it's changing consumption habits amongst Generation Z, whether it's the rise in domestic brands, whether it's the green transition, all of these things are continuing as we would like and we think the portfolio is very much geared into that, so well-positioned for the long run.

Second, I'd say that operationally a lot of the companies that we do own have been performing pretty well. It's just that this has been not reflected in share price terms yet. We think that operational performance, though, will be reflected in good returns and share prices over the long run.

BB: But I mean, we know some of the cyclical weakness, for example, in things like the semiconductors is the challenge between the cyclical weakness with the structural longevity and the things that we get excited about. But things like SG Micro, Silergy, we've been adding to them.

SE: Yeah, exactly. So that's one of the opportunities that I think this volatility has brought up. For the All China strategy, we've added to, as you say, SG Micro, Silergy, both analog semiconductor companies. Now the long-term structural trend for these companies is really localization. So, you know, China's import bill of semiconductors is larger than oil. It's an area that the Chinese really want to increase self-sufficiency in. And SG Micro and Silergy are really helping China do that.

But over the short term, the cycle has been much weaker, much harsher, than anyone really expected. And that's resulted in sentiment for both companies deteriorating and the stock price is correcting quite drastically.

We met with the founder of Silergy quite recently. He remains very excited about that long-term localization trend. Looking at what the companies have been doing. So both, despite this short term cyclical weakness, continue to invest in R&D. SG Micro, for example, launched 500 new products last year. It's those kinds of things that will drive the longer-term operational performance of these two companies, but will impact them in the short term in terms of financial results. And that's what the market doesn't like, but it's something that we really do like as a long-term investors, so taking advantage of this weakness in share prices to add.

In terms of additions, how have we funded that, for example? So, in both the A Shares strategy and the All China strategy, we've reduced Shenzhen Inovance. Shenzhen Inovance is an automation company very much exposed to China's move up the value chain in terms of advanced manufacturing. It's performed very well over the last three to five years operationally and in share price terms. So, it's grown its revenue and earnings at around 40 to 50 per cent per annum and taken significant market share.

We've decided to reduce, we think the long-term opportunity for this company and that competitive position remains very much intact. But over the near-term, we're a little bit worried that some of these market share gains may reverse as a result of supply chain constraints easing for some of their developed market peers. So, this isn't really in the valuation yet. So we're taking this opportunity to reduce slightly,

BB: So really, no change to the fundamental investment thesis, but just really sort of portfolio positioning and sizing.

SE: Exactly. Yeah.

BB: And maybe moving on to Covid lockdowns ending, this hopeful recovery that we're all expecting that hasn't yet come through and has been disappointing so far. But you were there in May for the first time in quite a while, seeing our colleagues in Shanghai as well as seeing companies. What were your major takeaways?

SE: Yeah, I mean, it was fantastic to be out there again. I was last in China in January 2020. At that point we had three investment professionals in our Shanghai office. We've hired an additional four investment managers. So continuing to add resource to our on the ground local presence. It was also fantastic, I think, to be out there with two colleagues from our global teams. As you know, one of the things that we think helps us generate alpha is this combination of local on the ground presence from Shanghai plus global perspectives. So it was really great to be sitting in on meetings with the founders of CATL, or PDD's management team, with two of my global colleagues who have been very early and significant investors and things like Tesla, Northvolt or Amazon.

More broadly the restaurants, very full, the Metro, very full, and digitisation continues at pace. So relative to January 2020, it felt much more difficult to get around in China without some of these local apps. Alipay, for example, for paying for stuff or Didi for ordering taxis.

BB: One additional trend I think I've heard you talk about, which I think plays to some of the things we've talked about, is this element of localization, self-sufficiency. We maybe sit over here in Edinburgh and talk a lot about geopolitics when it comes to China, but when you get on the ground, meet with management, speak to the local domestic investors that typically dominate the A-share market, you get a very different take on things, and it seems like that localization trend is gathering pace.

SE: Very much. I think there were three key sort of broad takeaways from the trip. First would be, as you say, localisation continuing at pace. We’ve seen this in a number of industries. Yonyou, for example, one of our strategy holdings is a software company, a lot of their clients are state-owned enterprises who are much more willing now to use domestic software providers as opposed to multinational.

We're seeing this in analog semiconductors and we're also seeing this in robotics. So, while I was there, we met a local a cleaning robotics company. Three or four years ago, their localization rate was 50 per cent. It’s now 90 per cent, and the components that they're able to source from China are as good quality but much cheaper price or cost than developed market alternatives.

So localization continuing at pace. Second takeaway would be the rise of domestic Chinese brands. Again, seeing this across a whole range of industries in consumption, for example, with the strategy holdings such as Proya in cosmetics, or Li-Ning, an All China holding in sportswear. But I think this is most pronounced, perhaps, in electric vehicles. So, China has one of the largest electric vehicle markets in the world. EV penetration now at 25, 30 per cent. The market is incredibly competitive and these Chinese EV brands have a supply chain advantage. And I think it's that combination of those factors that result in better domestically produced EV products at cheaper prices than multinational competitors. So I think actually the export opportunity for some of these local brands could be really very exciting. Within our strategies, we own a company called Zhejiang Sanhua, which is very much exposed to that trend. In [the] All China strategy we've just bought BYD, which is again very much exposed to that.

Final takeaway from the trip, and this would be more for the All China strategy. It's the, I'd say, relative stability of the regulatory environment and the increased confidence of some of our platform companies. So, valuations, as you know, for a lot of these platform companies [is] at rock bottom, really pricing in zero growth, I think the market views the regulatory crackdown as something structural, whereas we think it's much more cyclical. It's a result of the rate at which China has grown over the past decade or so. So ,I'd say increased confidence among some of these platform companies, again, is something that gets very much lost in the sort of broader commentary around China.

BB: It seems another one of the paradoxes of investing in China, all the focus on the role of the state and state-owned enterprises seems to miss out on just how entrepreneurial and innovative some of these private companies can be, as well as just how important private companies are to China's economy.

SE: Yeah, exactly. It’s staggering, really. I mean, the difference in the Western media sort of narrative around China being very, very negative, very SoE, very geopolitics-focused. Versus, you know, being on the ground, speaking to actual companies that operate there. You know, I'm seeing these really exciting pockets of opportunity. For me personally, I actually think it's a very, very exciting time to be looking at both Chinese equities and Chinese stocks.

BB: Thank you. I think that's probably a brilliant time to bring this to a close on the levels of excitement that we continue to have at the market. We'd like to say thank you to everybody for joining us.

We hope that a run through the performance has been helpful alongside what we've been doing in the portfolios. And then obviously, our own excitement about getting back on the ground, seeing our colleagues and looking at the kind of long-term trends that we hope will add value to portfolios.

Thank you for joining us.

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Annual past performance to 30 June each year (net %)

	2019	2020	2021	2022	2023
China A Shares Composite*	N/A	51.6	52.9	-23.5	-26.7
MSCI China A Onshore Index	N/A	12.4	40.4	-13.9	-19.5
China Equities Composite	-5.7	28.3	50.2	-35.0	-24.1
MSCI China All Shares**	-2.4	12.6	32.4	-25.4	-17.9

Annualised returns to 30 June 2023 (net %)

	1 year	5 years	10 years	Since inception
China A Shares Composite*	-26.7	N/A	N/A	7.9
MSCI China A Onshore Index	-19.5	N/A	N/A	2.7
China Equities Composite	-24.1	-2.2	6.4	6.8
MSCI China All Shares**	-17.9	-2.3	4.3	5.4

*Inception date: 28 February 2019
**(MSCI All China prior to 27/11/19, MSCI Golden Dragon Prior to 02/05/19)

Source: Baillie Gifford & Co and MSCI. USD. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.
Past performance is not a guide to future returns.

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