Baillie Gifford

China Q2 investment update

July 2024

Investment manager Sophie Earnshaw and investment specialist Ben Buckler give an update on the China Strategy covering Q2 2024.

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Ben Buckler (BB): Hello, everybody. Thank you for joining the quarterly update for the China strategy. I'm Ben Buckler, one of the investment specialists for the strategy, and I'm very happy to be joined by Sophie Earnshaw, one of the managers.

Before we dive into the depths of the strategy itself, I thought it would be worth mentioning our emerging markets colleagues who this year have now been investing in emerging markets, including China, for 30 years and have written a paper and a podcast looking back over that time, which I would highly recommend.

Sophie, I know that you've also been involved as part of that, looking at China and managing the strategy for the last decade now.

And I just thought before we go into the quarterly detail, maybe we can just take a step back and I can ask you what your reflections are of that 10 years and to some extent of the last three that have also been a bit more challenging.

Sophie Earnshaw (SE): Yeah, so over the last 10 years, China has continued to cement its position as a leading global economy. It's continued to invest in R&D. And we've seen it continue to move up the value chain. So it's really no longer a low-cost manufacturing country. It's made huge strides in areas such as nuclear, industrial switches, EVs, AI, et cetera.

So we've really seen it in some areas start to sort of leapfrog the West. So that's a real positive. The other big positive, I'd say, is that China's middle class has continued to grow. And as a result of that, you know, for many global companies now, China is either their largest or their second largest market in the world. You know, you only have to ask sort of Tesla or Nvidia for that. So they're the real positives over the decade.

In terms of the negatives, we've seen over the past three years, a more volatile sort of regulatory landscape, though that has now we think normalized. But the real negative over the past couple of years has been the change in sort of geopolitics. That's really been a big headwind, particularly between China and the US. And that has affected some of our portfolio holdings.

BB: It's certainly been a challenging three years, but the sense and the sentiment on the ground in China seems to be that things might be picking up now.

So if we sort of take the three challenges of geopolitics, regulation, and the domestic economy, particularly the domestic economy, it feels like the government may start to be understanding the challenges it has and doing something about it. What do you think is driving some of the optimism in both markets and in local?

SE: Yeah, so I mean, just first point to note, we tend to think in slightly longer term time horizons, as you know. So we typically invest on a five-year timeframe. But talking a little bit about the recent past, it appears as if since February, we might have reached an inflection point. And we've seen markets rally since then.

Why is that? Well, I mean, firstly, valuations are incredibly cheap. Secondly, we're seeing a lot of companies now put more effort into sort of shareholder value creation. So we've seen buybacks increase, dividends increase.

But most importantly, I think we've seen the government really intimate to the market that they have sort of recognized the problems that the country is facing in property and are really taking measures to try and stabilize that sector. So actually now looking forward, our outlook on China is actually pretty positive from this point.

BB: I'm very happy to hear that. And if I corroborate that with what our emerging markets team are saying around what they call the three M's, the excitement for the emerging markets, including China coming from macro, micro, macro and markets, the three of them.

If I bring that into a China context and perhaps switch it towards the kind of companies that we like, I wondered whether it'd be worth highlighting our three M's of Moutai, Midea and Meituan as companies that are large holdings in the portfolio that we are still quite excited about.

SE: So these are our three largest overweight positions in the portfolio. You know, why do we like them?

Well, let's begin with Midea. So this is a white goods and air conditioning manufacturer. It is a leader in China, but it's increasingly popular and competitive overseas. So it's growing very strongly there. It's a fantastic quality business, growing its earnings at a low double digit rate, paying a 5 per cent dividend, and only trading on 11, 12 times earnings.

Moutai, very different to Madea. So Moutai is really operating at the high end. It makes a white spirit called Baiju. Interesting stat here, the Chinese drink more Baijiu than the rest of the world drink, I think vodka, whisky, rum, gin and tequila, yeah, combined. So Baijiu really is a very popular spirit in China, although we don't tend to drink it in the West.

But that's not really what's exciting about Moutai. What's exciting is that the company has a phenomenally killer and sort of impressive brand, hundreds of years of heritage, really emblematic of sort of China and Chinese heritage. And as a result of that, it's able to price its products at a very high premium and earn sort of fantastic returns and growth as a result. Moutai was actually a detractor in this quarter.

Meituan, one of our top performers over the quarter, again, completely different type of business. Meituan is a leading food delivery platform. The food delivery platform is really going from strength to strength. This is despite competition from ByteDance.

In addition, it's one of those companies that's really focused on shareholder return more recently. So they've been reducing some of the losses in some of their more speculative businesses and giving that cash back to shareholders. So they're the three largest overweight positions in the portfolio that we're really excited about.

BB: Given their starting points, given their valuations, and given the growth profiles, I think it's fairly easy to see how they can double their earnings in a five-year period, which is our hurdle to get into the portfolio.

One of the areas where we don't have much representation in the portfolio is the financial space. And to some extent, that has been challenging in an environment where the financial sector has performed very well. What are your thoughts on positioning now in that sector?

SE: Yeah, so as you know, we're trying to, you know, in the portfolio, we're trying to find the best 40 to 80 growth companies in China. We've really struggled to find growth opportunities, in particular, the state-owned banking sector within China.

Why is that? Well, these state-owned companies, they tend to not be growing their loan books very quickly. Their profitability, we think, is potentially sort of structurally challenged in this lower interest rate environment with net interest margins coming down. And in terms of corporate governance, the corporate governance of these entities doesn't tend to be very aligned with minority shareholders.

So that's the reason why we haven't invested in those types of companies and why we continue to feel as if that is the right decision, despite the fact that it has been painful over the most recent past.

BB: Well, maybe let's not spend so much time on the financials where we don't have money then. But given what's been going on in markets where valuations have changed on the back of volatility, but we're also seeing an element of operational growth at a number of companies. We have made a few changes in the portfolio. And I wonder whether you could just update on some of the ones that most excite you.

SE: So yeah, we've been taking a turnover in the portfolios picked up over the past couple of quarters, as we've been really taking advantage of some of this volatility in share prices. So we've taken this opportunity to add to holdings with very strong franchises, but have sold off, in some cases because of cyclical issues.

So examples there would be Silergy, which is an analog semiconductor company, or Jiangsu Azure. We've also added to BYD. In terms of funding for those ideas, we've sold two companies, Wuxi Apptec and Asymchem, both contract research organizations with significant overseas revenue, particularly in the US.

We think the ability for those companies to continue to grow in the US may be structurally challenged as a result of geopolitical issues.

In terms of new buys, two companies over the quarter, we bought a holding in a company called Fenjiu, which is a baijiu company. It operates at lower price points to Moutai, but is sort of earlier in its journey of really beginning to sort of take advantage of its brand. Again, it's a company with a very strong brand heritage, you know, hundreds of years heritage for that brand.

Or Luckin Coffee. So Luckin Coffee is increasingly challenging Starbucks in China. It's got a massive growth opportunity ahead of it. So a stat that might help you sort of conceptualize this. In China, Chinese people drink four or five cups of coffee a year versus, I think, 400 to 500 in the West. And Luckin is really driving that coffee penetration.

BB: Well, that's probably a good point to bring this towards a close. I know that you're a gamer, not a sports fan, but I think it's also worth just remarking upon the Euros Championship at the moment. And companies like BYD, AliExpress, Vivo are all advertising very heavily there.

So I know that one of the elements of our research framework for the next six months is looking at companies with global competitiveness. And I imagine that's something that we'll be coming back to talk about a fair bit in coming months.

On that note, I'll say thank you, Sophie, for joining us. And thank you, everybody else, for joining in this quarterly update.

Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com

China

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

	2020	2021	2022	2023	2024
China Equities Composite	28.3	50.2	-35.0	-24.1	-10.7
MSCI China All Shares*	12.6	32.4	-25.4	-17.9	-4.2

Annualised returns to 30 June 2024 (net%)

	1 year	5 years	10 years	Since inception**
China Equities Composite	-10.7	-3.2	2.7	5.7
MSCI China All Shares*	-4.2	-2.6	2.1	4.9

*(MSCI All China prior to 27/11/19, MSCI Golden Dragon Prior to 02/05/19)
**28 February 2006
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.

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Calton Square, 1 Greenside Row, Edinburgh EH1 3AN
Telephone +44 (0)131 275 2000 / bailliegifford.com