Examining Holdings with Chinese Exposure Amidst Market Turbulence

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Given the constant bombardment of negative headlines on China, we’ve taken the opportunity to examine a few holdings with exposure to China in our International strategy. Our conclusion is that we are very comfortable with our current holdings exposed to China and, in fact, see greater opportunity to add to them over time as market dislocations take place. We emphasize that our international investing philosophy, in China and elsewhere, is based on fundamental valuation analysis of individual businesses, with each investment having its own idiosyncratic thesis. That being said, the holdings outlined below do share one similarity: they are all exposed to China’s expanding urban middle class and their continued consumption upgrade towards quality goods and services over a multiyear period.

Understanding China’s Rising Urban Middle Class

China has an expanding urban middle class and many potential investment opportunities as a result. Yet at the same time, some ordinary Chinese people have grievances about housing affordability and income disparity, as not everyone has benefited from the country’s rapid economic rise. This dichotomy is emblematic of the many contradictions and nuances investors face when allocating to China. Before discussing three of our portfolio holdings exposed to Chinese consumption, we’ll examine a few important aspects of China’s urban middle class.

First, China’s urban middle class might be a misnomer, as it’s neither the majority nor the middle of society as it is in developed countries. According to a report by McKinsey, only 12 percent of Chinese households were considered “mass affluent or above” in 2018, defined as those with disposable income of $30,000 or higher per year. China’s “mass affluent or above” segment is expected to more than quadruple to 58 percent of Chinese households in the next decade, but today, it is still a relatively small portion of the total population.

China’s urban population, which stands at 59 percent today, is relatively lower than the 70 to 80 percent urban penetration in developed countries, such as the U.S. and Japan. Still, China’s urbanization population percentage continues to rise. Every year, 14 million Chinese people, almost twice the population of New York City, move from rural areas to urban city centers in search of employment and better living conditions. Although rural residents comprise almost half of China’s population, the agricultural sector accounts for less than 10 percent of China’s GDP, and there is an abundance of excess labor in rural areas. In the future, we expect China’s rural population percentage to steadily converge toward the agricultural sector’s contribution to GDP. Therefore, continued urbanization in China will support the expansion of its urban middle class.

Understanding China’s Unique Cultural Context

Before immigrating to the U.S., I spent my childhood and adolescent years in Changchun, China, a city of 8 million people, or roughly the population of New York City. Situated between Siberia in Russia and North Korea, the city was once a major heavy-industry hub, but is

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now known as the “Rust Belt” of China. Despite growing up in China’s laggard northeast region, I witnessed firsthand how unique cultural dynamics facilitated the consumption upgrade of China’s urban middle class.

My parents’ generation was the lucky beneficiaries of China’s housing privatization in the late 1990s, where they were afforded their first apartment in urban areas at prices substantially below market value. Since then, rapid wage growth has allowed these early beneficiaries to accumulate more savings and buy more properties, thus riding the real estate boom in China over the last two decades. Housing privatization and rising incomes have been the major drivers of wealth accumulation in China by the urban middle class.

My generation is the byproduct of China’s “one-child policy,” where our parents were mandated to have only one child per family. Because of the collective nature and close bonds of Chinese families, we have constant interactions, which include emotional as well as financial exchanges with our parents and grandparents. They often subsidize our living expenses, as we are the only child or only grandchild in the family. This support can range from parents buying our first house and/or car, providing us with a monthly stipend, or helping financially support and take care of our children, their grandchildren. With a portion of our living costs subsidized, my generation is able to allocate a good portion of our discretionary income to consumption upgrades. Therefore, China’s unique culture of family collectivism and inter-generational wealth transfers will continue to be a tailwind for growing consumption of China’s urban middle class over the next five to ten years.

Understanding China’s Consumption Upgrade

“In the 1980s, when incomes were very low, people focused on things like bicycles, electric fans and basic furniture sets. In the 1990s, they started to buy pricier household goods such as washing machines and air conditioners, and by the end of the decade, China became the world’s fastest-growing cellphone market. The 2000s brought a huge upsurge in purchases of auto, and the private housing boom created large new markets for even more home furnishings and appliances.”

—Arthur Kroeber, author of “China’s Economy: What Everyone Needs to Know”

As Kroeber mentions above, at the beginning of the consumption upgrade cycle, Chinese consumers gravitated toward branded goods. Today, they are increasingly focused on consumption of services, such as entertainment (i.e., gaming, video and music streaming, movies, and sports), tourism, health care, and education. Although China has an aging demographic that may spend less on goods, they will still need to pay for health care-related expenses, buy health and/or life insurance, etc. Therefore, the consumption upgrade by China’s urban middle class is not solely reliant on the purchase of higher-quality branded goods, but also on the consumption of services.

Current Holdings with Exposure to China

Although our International portfolio is constructed from the bottom-up based on our assessment of each individual business, the following three companies do share the common thread of being positively exposed to China’s urban middle class and aforementioned consumption upgrade.

Tencent Holdings Ltd.

With more than 1 billion users in China, Tencent’s WeChat is the dominant social media platform in the country. However, it is much more than just an app. WeChat serves as a marketing and distribution channel for goods, content, and services for individuals, businesses, and institutions, and is able to close the loop from user traffic to sales with its built-in mobile payments. Tencent is also the largest mobile-game publisher in China and owns the largest video streaming, music streaming, newsfeed, and reading apps in the country. Tencent and its many properties, or businesses, are the main gateway for personal, business, and institutional communications in China. Our thesis is premised on Tencent’s large and sticky user base, its strong content generation and distribution capabilities, and its dominant position on both sides of the network. Given the ubiquity of Tencent’s properties, the company is exposed to both consumers and businesses in China, as they are involved in the provision and consumption of goods, content, and services. We are very comfortable with our direct China exposure via Tencent, which is at the epicenter of innovation in social e-commerce, industrial internet, artificial intelligence and big data, allowing us to keep an eye on the latest tech and internet trends in China.

Investing in China is not without its risks. One in particular is the government intervention/policy risk, and by no means is Tencent shielded from this risk. In early 2018, the Chinese government froze new game approval and licensing for all game publishers in China indefinitely in an effort to crack down on content creation. Partly due to this regulatory issue and partly due to general fears about the broader Chinese economy, Tencent’s shares sold off enough that we were able to initiate a position last year at a healthy discount to our estimate of intrinsic value.
Fortunately, the regulatory ban was short-lived and was over by year-end. Tencent was able to weather this headwind better than gaming peers due to its more diversified business model, deriving revenue from gaming, advertising, subscriptions, financial services, and cloud computing services. In the last few years, Tencent has invested in many health care startups in China, seeking to combine technology, data, artificial intelligence and health care, lowering China’s health care costs and improving medical access for all. We cannot foresee when the Chinese government’s “visible hands” will intervene again in the future, but we believe the government needs the private sector’s help in order to address some of the long-standing social issues in China. We believe that Tencent is among the better-positioned private sector firms to help the government solve big problems, which should partially shield the company from onerous regulations.

Shandong Weigao

Weigao is one of China’s largest medical device manufacturers, with a broad product portfolio in medical consumables, interventional products, and domestic brands of orthopedic implant devices. The company has a dominant share in an expanding market that will benefit long term as China broadens its national health insurance coverage. Different from its competitors who are selling through distributors in China, Weigao has its own network of direct sales associates covering over 2,000 hospitals in China, a reach that would be difficult to replicate. This competitive advantage allows Weigao to have better control over its pricing and accounts receivables, which leads to a better cash conversion cycle. Moreover, we believe Weigao will be the local winner of import substitution and accelerated market consolidation among domestic medical device providers. Last but not least, Weigao also benefits from the secular trend of higher health care spends by the aging and ailing population in China. Combining all of the above with an attractive valuation and a solid balance sheet, we are very comfortable owning Weigao.

Similar to Tencent, government intervention/policy risk applies to Weigao as well. The Chinese government has introduced new policies to reduce inefficiencies in China’s health care system. This, unfortunately, has created some near-term pressure on pricing and margins for all medical device manufacturers in China. While another example of Chinese government’s “visible hands” at play, we actually see this as a long-term positive for Weigao as a consolidator in China’s fragmented medical device industry. Weigao’s scale should allow the company to squeeze out smaller domestic suppliers, while foreign competitors will struggle due to the Chinese government’s eagerness to promote domestic players that are able to deliver technology innovation into “national champions.”

LVMH Moet Hennessy Louis Vuitton

LVMH is the world’s largest luxury conglomerate with over 70 brands, the most renowned being Louis Vuitton, Christian Dior, Bulgari, and Hennessy. Our investment in LVMH is premised on its diversified portfolio of luxury brands across multiple product categories, such as fashion and leather goods, jewelry and watches, perfume and cosmetics, liquor and wine, etc. Its size gives it a material scale advantage over peers and offers potential inorganic growth opportunities. With a long-tenured management team, large insider ownership, solid balance sheet, and decently attractive valuation, we felt the return was skewed to the upside. We’ve owned LVMH for several years now, but added to the position in early 2019 when the market was overly concerned about China’s economic slowdown, the sustainability of Chinese consumers’ affinity towards luxury brands, and uncertainty over trade disputes with the U.S.

While China accounts for more than 30 percent of LVMH’s sales, the company is well-diversified geographically across U.S., Europe, and other markets. While it is true that China has been a big driver of luxury market growth in recent years, we recognize that top-line revenue growth will slow at some point for LVMH, given the cyclicality of the luxury market. Additionally, we believe in the supremacy and diversification of LVMH’s brands globally, its price discipline and grip over distribution, and its ability to cut back marketing and control costs in a macro slowdown, whether in China or elsewhere. Last but not least, LVMH’s solid balance sheet grants it the opportunity to take advantage of potential “fire-sales” in a global economic downturn.

In conclusion, we strongly believe in our current holdings with direct or indirect exposure to China and are optimistic about the continued consumption power of China’s expanding urban middle class, which serves as a secular tailwind to several of our holdings in the International strategy.