NOTES FROM THE ROAD: CHINA

MARCH 2023 CHINA

By:
Jimmy Chen
Jasmine Kang
Jimmy Yang
Baijing Yu

Greetings from Comgest's China Investment Team!

When the Chinese government announced that they would finally abolish their strict Covid-zero policy and re-open the country, our Comgest China investment team in Hong Kong immediately hit the road to visit local Chinese companies on our Quality Growth radar. Overall, our team spread out over 9 cities to meet 40 companies.

After three years of lockdowns and mass Covid testing, the team was pleased to find transportation via air, rail and road extremely efficient. Factories were running as per usual. At the same time, while certain tourist hotspots bustled with Chinese tourists and moviegoers filled the cinemas, local shopping malls still seemed to be a bit subpar in terms of customers.

TRANSFORMATIVE EVOLUTION

Transformation best describes the country's ongoing economic shift towards consumption and innovation. Domestic consumption remains the core secular growth driver. Chinese brands are gaining prominence with young consumers due to effective brand building and omnichannel strategies. Direct-to-consumer (DTC) marketing strategies are common and clearly working: we saw many young teenagers wearing **Anta Sports** sneakers on our store visits. We also noted that **Chow Tai Fook** has leveraged traditional Chinese craftmanship to produce handmade gold jewellery and innovative gem set collections, which have gained appeal with the younger generation. Chow Tai Fook is no longer viewed as a traditional "basic gold" brand, but rather a modern one. In the travel sector, we ventured beyond the Marriott and IHG hotel groups to spend the night at Orange, a midscale hotel operated by **H World.** H World has gained popularity among domestic travellers for their efficiency, contemporary style and culture-rich services.

These in-person visits have reinforced our promising views on domesic brands. When China reaches a high enough GDP per capita threshold, consumption will consistently grow in the foreseeable future, following the path of a few neighbouring countries like Korea in early 2000s or Japan in 1980s. China reached a **GDP per capita** of around USD10,000 in 2019 and USD12,000 in 2021. Although the country's strict Covid-zero policy caused disruptions in consumer behavior and weighed on consumer confidence in recent years, it's more a matter of time as to when consumption will bounce back, rather than doubts on long-term confidence. Middle income families will continue to pursue their basic quality of life needs (i.e. food, clothes and housing) while also seeking more desirable levels of healthcare, travel and cultural activities. All of these mega social trends offer a lot of opportunities for local brands and service providers – which is where we have positioned our portfolio.

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EV: DRIVING SALES AND NEW OPPORTUNITIES

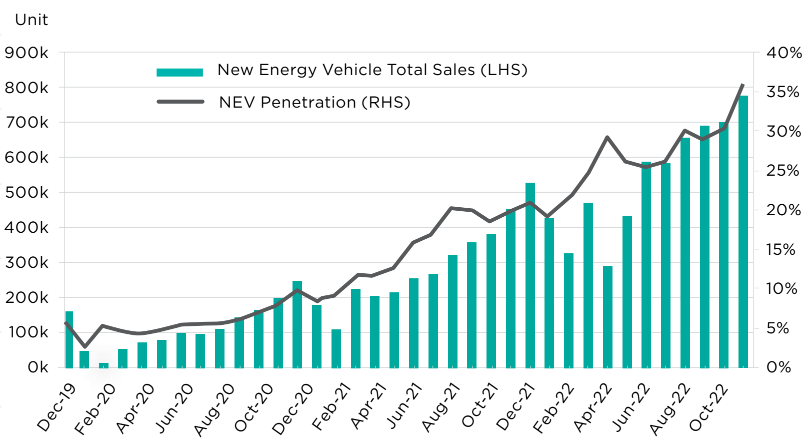
Meanwhile, getting around China is becoming more efficient: EV sales doubled in 2022 to around 7 million units, or 35% of domestic auto sales *(figure 1)*. Taxis are driving some of the electric surge: the fleet in Shanghai are all Roewe models (a **SAIC** brand), while in Shenzhen the fleet are represented by the Chinese auto giant **BYD** (for "Build Your Dreams"). Although domestic brands are flourishing, **Tesla** has also gained ground in the country since building a gigafactory in Shanghai in 2020. As more and more EVs fill the streets, many businesses in the value chain are quickly forging new opportunities. From our meetings with management and their public announcements, we learned that **Minth** has benefitted from aluminium battery housing orders by VW and BMW, **Inovance** has expanded its inverter technology to the EV powertrain[1], **Sanhua** has developed new thermal management systems for EVs,[2] and **Centre Testing** has increased their number of contracts for EV electronics testing.[3]

Portfolio Manager
Jasmine Kang
Li Auto

Another stop on our road trip was a factory in Changzhou owned by **Li Auto**, a developer and manufacturer of premium smart electric vehicles which gained success thanks to their unique extended range technology, is now expanding their product portfolio. Our intrepid analysts/portfolio managers road tested their new L7 model, which was launched in early February with a price range of RMB 320,000–380,000 (USD 47,120–55,960). We were impressed by the 15.7" LCD central control panel and entertainment functions, but not as excited by the **L2 level automated** driving system as a human at the wheel must be driving and constantly supervising the automated features. We were, however, pleased to learn the company is working on an urban navigation pilot program that is being launched in late 2023. The factory's general manager walked us through the lean and automated assembly lines where we saw a big leap from conventional auto assembly lines. This onsite factory visit provided us with a better understanding as to why Li Auto can generate a gross profit margin of over 20%[4] while the other Chinese EV players range between 10%–15%.

Portfolio Manager
Baijing Yu
Sanhua

Figure 1. Total EV Sales in China, Monthly (Dec. 2019 – Nov. 2022)



Source: China Passenger Car Association

[1] Minth final results announcement, December 2021Inovance: https://www.inovance-automotive.com/
[2] https://www.yicaiglobal.com/news/sanhua-falls-despite-announcing-exclusive-deal-to-supply-parts-to-bmw-china-ev-platform
[3] Source: Centre Testing Annual Report
[4] Li Auto Annual Report

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For our next research stop, we ventured to Hangzhou to visit an industry leader in thermal management components for air conditioners and EVs. Their factory manager for EV components walked us through the importance of their capability to customise equipment and internally develop software, using their production know-how and operational efficiency improvement. According to our research, industrial automation is growing strongly in China as manufacturers seek to offset rising wages, and domestic players are taking a greater market share, especially in new industries.

In Shenzhen, we met with another leading supplier of automation components. The company is already strong in small programmable logic controllers (PLCs), servo drivers (an automatic device that helps you control the position, velocity or torque of a motor), and motors. They also have ambitions to expand into new markets, such as large PLCs and pneumatics. We also met another smaller sized competitor, **Megmeet** – where we learned the founders of both companies were colleagues at Huawei and left to form their own businesses around the same time. Elsewhere in the automation sector, we dropped in on the industrial machine vision company, **OPT**, which is seeking to break into this space, currently dominated by Japanese players. Their big break has been in new verticals like batteries and EVs, where Chinese manufacturers dominate the market.

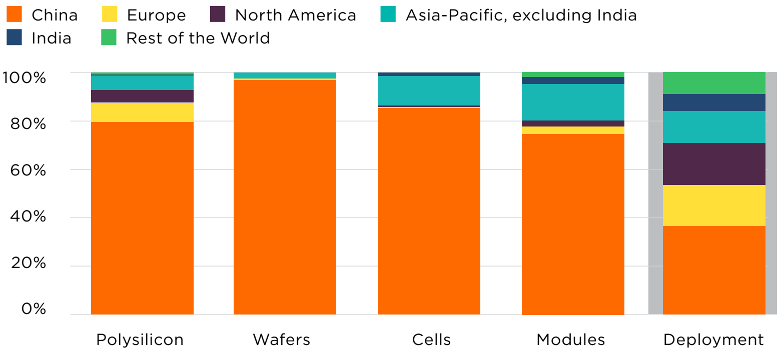
Analyst Jimmy Yang (left)
and Portfolio ManagerJimmy Chen (right)
Inovance

Battery players that have benefitted from the growth of EVs, are seizing further opportunities via the market penetration of battery energy storage in other sectors. We met with **Do-Fluoride**, which produces inorganic fluoride products, and **Tinci**, which focuses on lithium-ion battery materials, daily chemical materials and specialty chemicals, which together produce around 65% of global electrolytes, a key ingredient commonly used in lithium-ion batteries. At **Semcorp**, which makes lithium-ion battery separator films for electric vehicle batteries, we viewed their 200-meter long production line that melts and stretches polymer materials into battery separators that are 5 micrometers in thickness (for comparison, a human hair is about 100–150 micrometers thick), 6 meters in width and thousands of meters in length. Meanwhile, **Huayou Cobalt** has vertically integrated itself from mineral extraction to the production of NCM cathode (for the "EV layperson": N = nickel, C = cobalt, M = manganese) used in lithium ion batteries. In general, the higher the nickel percentage in a battery, the higher the energy density that the battery can provide, which positively impacts the battery pack's weight and dimensions. Huayou is now cooperating with **LGES** to extract nickel, cobalt and lithium from used batteries. The overarching views during our conversations tended to include a general agreement on the dominance and capabilities of **CATL**, the world's leading battery maker; how cost effective the Chinese supply chain is; and that the **US government's efforts to cut reliance on China's high-tech sectors faces a long and difficult path.**

Portfolio Manager Jimmy Chen
tests his selfie skills
at **Flat Glass**

Figure 2. China Dominates Solar Manufacturing

Solar PV manufacturing capacity and solar deployment by country and region, 2021



Source: Canary Media, IEA, "Special Report on Solar PV Global Supply Chains", 2022

SOLAR'S EXPANDING SUPPLY CHAIN

Solar is another new energy sector in which **China has become dominant** *(figure 2, above)*. In Jiaxing City (Zhejiang province), we visited **Flat Glass** which is the second-largest solar glass producer in the world. We were pleased to learn that there is no anticipated change in the current solar glass technology (i.e., ultra-clear rolled glass) in the solar industry.

Our time on the road included visits to businesses that make equipment for companies such as **LONGi** that produce the polysilicon ingots, wafers, cells, and solar modules used in solar panels. **Shenzhen S.C. New Energy** and **Maxwell** both focus on cell equipment – but on two technologically different routes. Shenzhen S.C's technology seems dominant, but we believe the jury is still out. At **Jinsheng**, which focuses on high-end manufacturing equipment, we were surprised by their ambitions to expand into other synthetic crystalline sectors including semiconductor-grade silicon, silicon carbide, synthetic sapphire and fourth generation semiconductor materials (which interestingly included synthetic diamonds).

SEMICONDUCTORS: SEEKING A HOME FIELD ADVANTAGE

Despite a significant technology gap with developed markets, China's semiconductor sector revenue has been growing by 18% CAGR from 2011 to 2021, as per *figure* 3. The country is ambitiously trying to transition from being the world's top semiconductor consumer to becoming a strong manufacturer by increasing its self-sufficiency rate from around 20% to 70%. Although the US has tried to block the country from moving to advanced nodes[5] for semiconductor manufacturing,[6] Chinese leaders of mature nodes,[7] where a self-sustained ecosystem has been established, believe that they will eventually increase their domestic market share. During our visits to **3Peak** (a fabless semiconductor company focused on analog integrated circuit (IC) products/systems) and **SG Micro** (which designs, markets and supports high-performance and high-quality analog ICs), we shared in their excitement that analog IC design companies will benefit from rising demand from motion control and energy management. **Hua Hong**, the second-largest Chinese foundry focused on specialty mature nodes, has secured their wafer supply for domestic clients and expect to outperform their international mature node peers in China in the future.

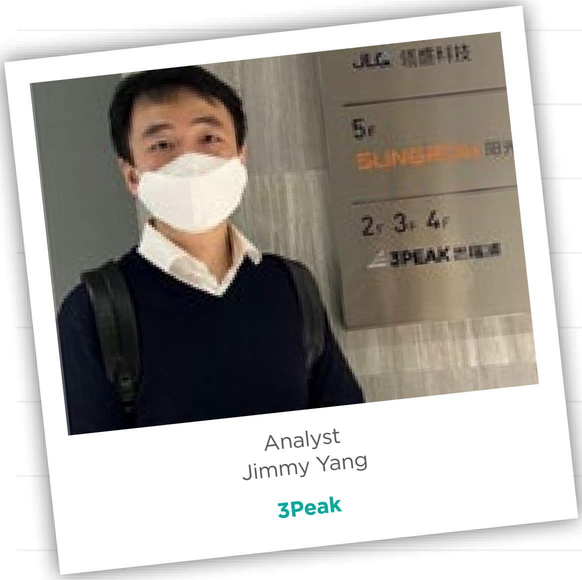
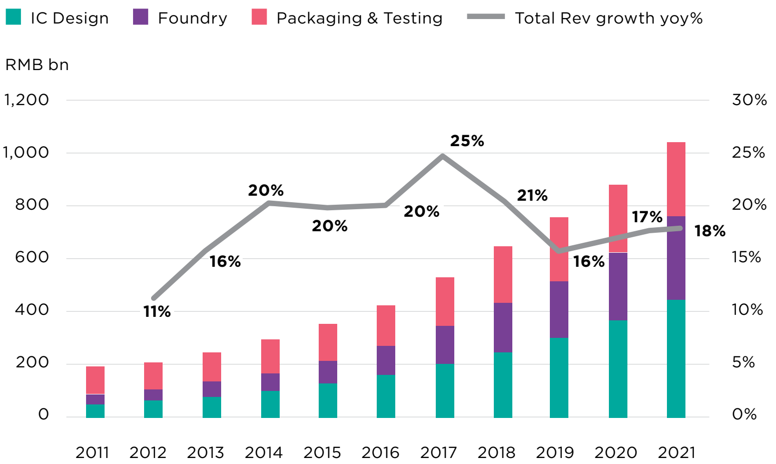


Figure 3. China Semiconductor Industry Growth



Source: SEMI association

[5] https://www.scmp.com/tech/tech-war/article/3211863/tech-war-us-chip-firms-walk-tightrope-they-try-keep-china-business-amid-escalating-sanctions-experts?module=perpetual_scroll_1&pgtype=article&campaign=3211863

[6] Nodes in semiconductor manufacturing indicate the features that node production line can create on an integrated circuit, such as interconnect pitch, transistor density, transistor type, and other new technology.

[7] Mature process nodes are generally defined at 40nm and above and require older manufacturing processes.

The chairman of a leading Chinese semiconductor automated test equipment (ATE) company with a 10% domestic market share,[8] revealed that they had made critical technology breakthroughs in analog ATE, where their product quality is now on par with international market leaders. Such a test equipment leader stands to benefit from the secular growing demand of analog and power semiconductors. Potential market share gains in higher-end products such as System on Chip (SoC) architecture and memory testing should further fuel their growth. And some of these companies have already gained reputable clientele around the world.

Portfolio Managers
Jimmy Yang and Jasmine Kang

Huafeng Test

CONCLUSION

China has been closed to the world since 2020, and even as social and economic activities return to normal, many Chinese wonder why the government clung to the zero-Covid policy for so long. We believe it could take a few years to rebuild citizens' confidence in the state. Nevertheless, consumption power from the middle class and younger generation remains strong. The desire for a better life can be fulfilled by many well-known global brands and increasingly domestic leaders who are taking greater market share in sportswear, jewellery, medtech, travel and more. Despite lagging long-standing global brands, successful Chinese leaders have been consistently investing in their brand, R&D and operational efficiency. These thriving brands will continue to win young people's hearts.

Transformation in the industrial sector was another highlight from our trip. After the abrupt end in December 2022 to the strict Covid lockdowns, we found that companies on the ground in China are even more heavily driven by innovation. The EV and solar industries are flourishing. It's not just a few leaders in EV manufacturing or solar farms. There are various visionary companies tackling business opportunities along the value chain, such as EV batteries, powertrain, solar equipment and components, and so on. Hosting the complete value chain – from upstream raw material to the end-user application – gives China the foundation to become a strong global player in future. While we see demand booming from new industries, Covid expedited companies' application of automation to improve their efficiency, and many are now launching automated production lines.

Finally, amid the ongoing geopolitical challenges, companies have been responding by building their own intellectual property to meet demand where the US is no longer exporting or will not export in the future. As the Chinese started investing in the semiconductor sector much later than many countries, the technology gap is big today, but the rising geopolitical pressure might turn into an opportunity for domestic leaders seeking to grab market share in mature nodes and analog ICs. It's still a bit early to find potential global leaders from China in the semiconductor space, but a domestic champion could be rising from the areas mentioned above.

[8] https://company.cnstock.com/company/scp_gsxw/202004/4526544.htm

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- Because the portfolio invests in a single country, its performance could be more volatile than the performance of more geographically-diversified portfolios
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