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Redmayne Bentley

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RISK WARNING

Investments and income arising from them can fall as well as rise in value. Past performance and forecasts are not reliable indicators of future results and performance. There is an extra risk of losing money when shares are bought in some smaller companies. Redmayne Bentley has taken steps to ensure the accuracy of the information provided.

While the rest of the globe is already two months into its calendar new year, those observing this month's Chinese Lunar New Year will be hoping the famed new year greeting – "wishing you to make lots of money or a fortune" - will hold true to its translation. Rather fittingly, this year's zodiac - the Ox – gives an appropriate depiction of the bull run ensuing in the region's investment markets. The Chinese Government all but quashed the Coronavirus in short order, allowing its economy to open back up sharply, while the rest of the world still reels in its fallout.

As UK investors, we have watched in awe over the years at the meteoric rise of the Chinese economy. Throughout the 20th century, the country has transformed from the "sick man of Asia" into the second largest economy in the world, eradicating much of the poverty that plagued the nation's poorest regions. Today, an affluent middle-class live within China's abundant metropolises that burst with innovation. Though investment in China has been met with a little more hesitance, fears of a volatile political landscape and its emerging economy status have held it back from being a standalone allocation in portfolios. We think this is changing, and if the last year has taught investors anything, it is to diversify the risk and return drivers in a portfolio (See: Making its Mark). As a near self-sustainable and domestically focused economy, we are seeing more than ever the benefits of investment exposure, when global markets are otherwise interlinked to the pitfalls of its key economies. To facilitate the wave of investment capital, the Chinese Government has been tentatively opening its markets to the world. At the same time, policymakers have been keen to increase the attractiveness to foreign investors, relinquishing state control and aligning Chinese business to internationally recognised standards of corporate governance (See: Corporate Governance in China). There is still a long way to go, and now, more than ever, the spotlight is being shone on the country's record in corporate interference. After criticising the government's finance policies earlier in the year, Jack Ma (founder of Alibaba) disappeared from public for two months, raising concerns over the influence of the State. It is a sign that investors still need to be comfortable with state-control and oversight, which ultimately has the potential to limit innovation and growth prospects.

Innovation will continue to be key if China is to affirm its dominance in technology companies. Posting a record month for Initial Public Offering (IPO) raisings in January, the markets are full of new ideas across the sector, pushing for subscription-based online services to rival their behemoth counterparts in the US (See: New Year & New Dawn). Though, like the US, the region is not immune to stock market mania and potential eye-watering share price rises… and falls.

We now watch closely as the world emerges bruised from the pandemic, and China provides some certainty to its outlook. The Chinese version of communism remains prevalent, meaning some investors will struggle to get comfortable with the political system, but it offers a true opportunity for the next decade and beyond that is worth considering.

STOCK FOCUS

CHINA – NEW YEAR & NEW DAWN

This column would not have been written a decade ago. In fact, it was unlikely to have been written five years ago. The tenacious and precipitous rise of China as a global superpower has kickstarted the wealth management world into action. Investment managers are slowly dipping their toes into what has previously been characterised as dangerous waters, out of bounds for most investors.

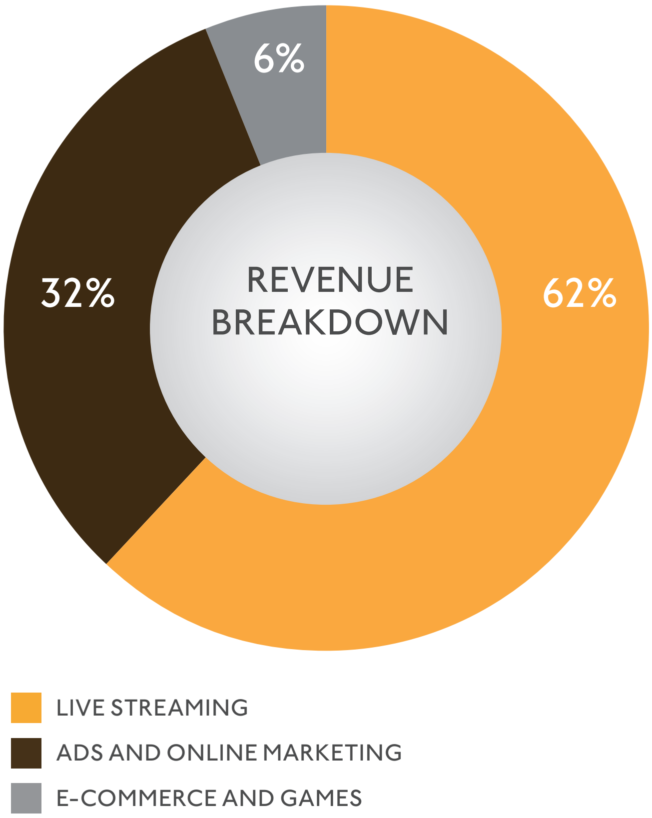
In truth, while corporate governance in China remains flimsier than in the West, and despite the questionable political and ethical policies and standards employed by the Government, the Chinese market has an array of supercharged companies. For every Amazon there is an Alibaba, for every Facebook there is a Tencent, and for every Just-Eat there is a Meituan.

But forgetting about these big names, the focus of this article is on **Kuaishou**, the Chinese video-streaming app which rose to prominence mid-February after it raised US$5.4bn overnight in the largest technology listing since Uber raised US$8bn in 2019. 'Asia's-decade' is certainly living up to its billing: a record US$13bn was raised through Asia IPOs in January.

Founded in 2011, the company allows users to share animated images (gifs) and is the world's second most popular short-video platform with 769m monthly active users. The millions of users check the Kuaishou app an average of ten times a day, spending an average of 86 minutes watching videos. If that sounds impressive, that its shares were more than 1,200 times oversubscribed in its IPO and nearly tripled on their first day of trading in Hong Kong, trumps the lot.

You may think that sharing short videos is a niche market, but it is turning out to be quite the battleground; ByteDance, TikTok's parent company, is considering a market-listing, with Douyin, its Chinese arm, already boasting over double the number of users as Kuaishou. Furthermore, Kuaishou's US$6.3bn of sales in the first nine months of last year may seem impressive, yet are dwarfed by ByteDance's US$30bn, albeit over the full year, while the latter generates more than three times the advertising revenue per user hour of Kuaishou. As we have learnt from the developed US tech market, advertising often lies at the crux of businesses revenue streams.

Yet, according to a local source, Kuaishou's strength lies in its ability to attract 'ordinary' Chinese users, who seem to remain extremely loyal to the platform. Moreover, Kuaishou has an advantage in developing online game-related business thanks to its ties with Tencent, while Kuaishou leads the race in online shopping - between December 2019 and May 2020, Kuaishou sold products worth 104.4bn yuan compared to just 11.9bn yuan on Douyin.



Nevertheless, retail investors were clearly intent on continuing the global theme of ignoring a business's intrinsic value, pumping more air into the ever-growing bubble.

What makes Kuaishou's first-day performance even more frightening was that it failed to raise eyebrows; shares jumping on their first day of trading has become the rule, rather than the exception – the visa-versa should certainly hold true in an efficient and stable market. Bubble, the dating-app, saw its shares swell 64% on day one, while Dr Martens was valued at over ten times what its past owners had paid on its market debut.

"You may think that sharing short videos is a niche market, but it is turning out to be quite the battleground..."

Kuaishou shares now trade at an enterprise value-to-sales ratio of 15x which, even by tech standards, is looking frothy. Additionally, it is not as if the corporate governance stands up for much; Chief Executive Su and Cheng Yixiao, the company's founder, effectively control the company through a special class of stock with ten times the voting power of ordinary shares. Moreover, regulators are scrutinising livestreaming e-commerce, while recent legislation has tightened controls on tipping on platforms such as Kuaishou. In China, tipping your favourite livestreaming host has become as common as tipping a waiter in a restaurant. With this accounting for 62% of Kuaishou's revenues over the past nine months, this is a sign of potential danger.

All-in-all, investors should be wary. Not only did the company fail to turn an operating profit in its latest trading update, Kuaishou is also operating in a highly competitive, politically charged and tightly regulated market; with pricing-caps now in place on users sending tips, there is effectively a limiter on the company's potential cash streams.

The likes of Tencent, which holds a c.22% stake in Kuaishou, alongside the investment banks which led the IPO, Bank of America and Morgan Stanley, will be pleased with their work. Retail investors should tread with caution. ■

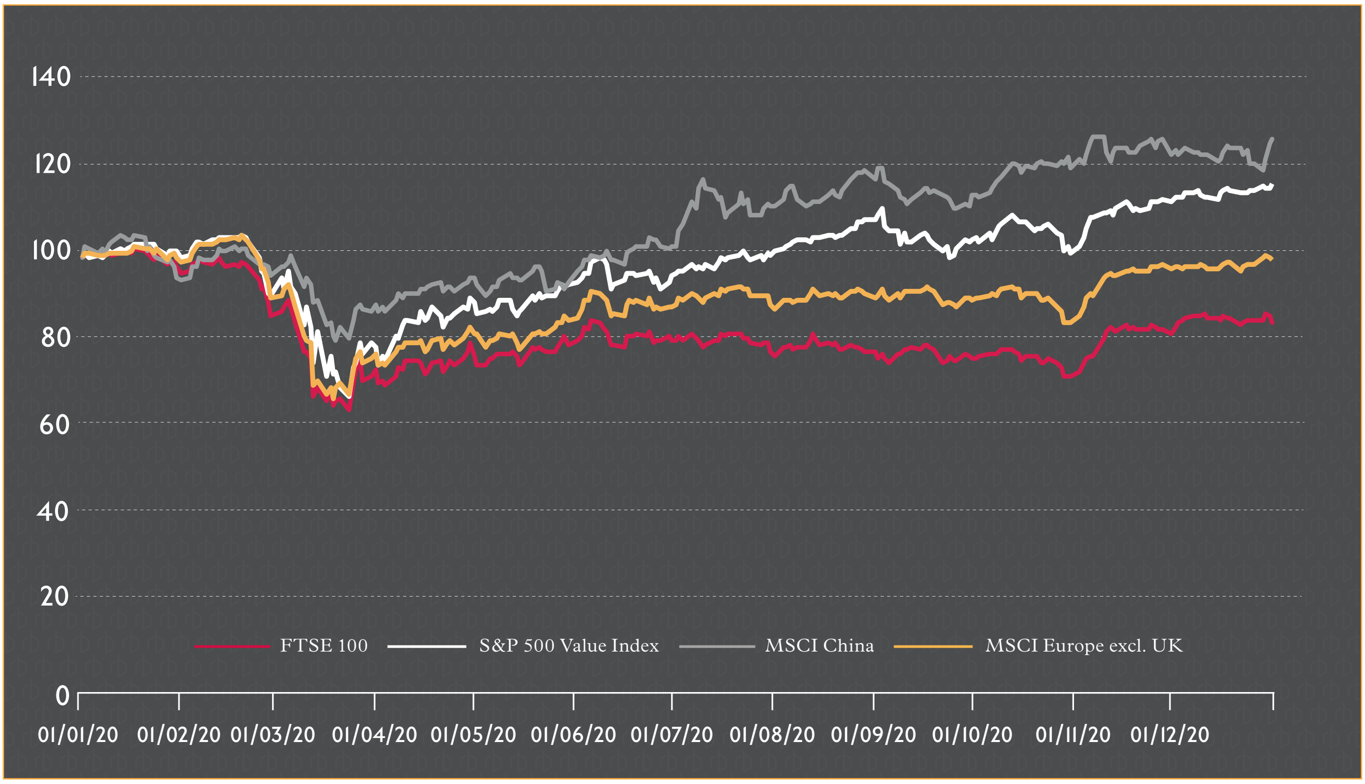
Please note that this communication is for information only and does not constitute a recommendation to buy or sell the shares of the investments mentioned.

INSIGHT

MAKING ITS MARK - CHINA'S MARKET DOMINANCE CANNOT BE IGNORED

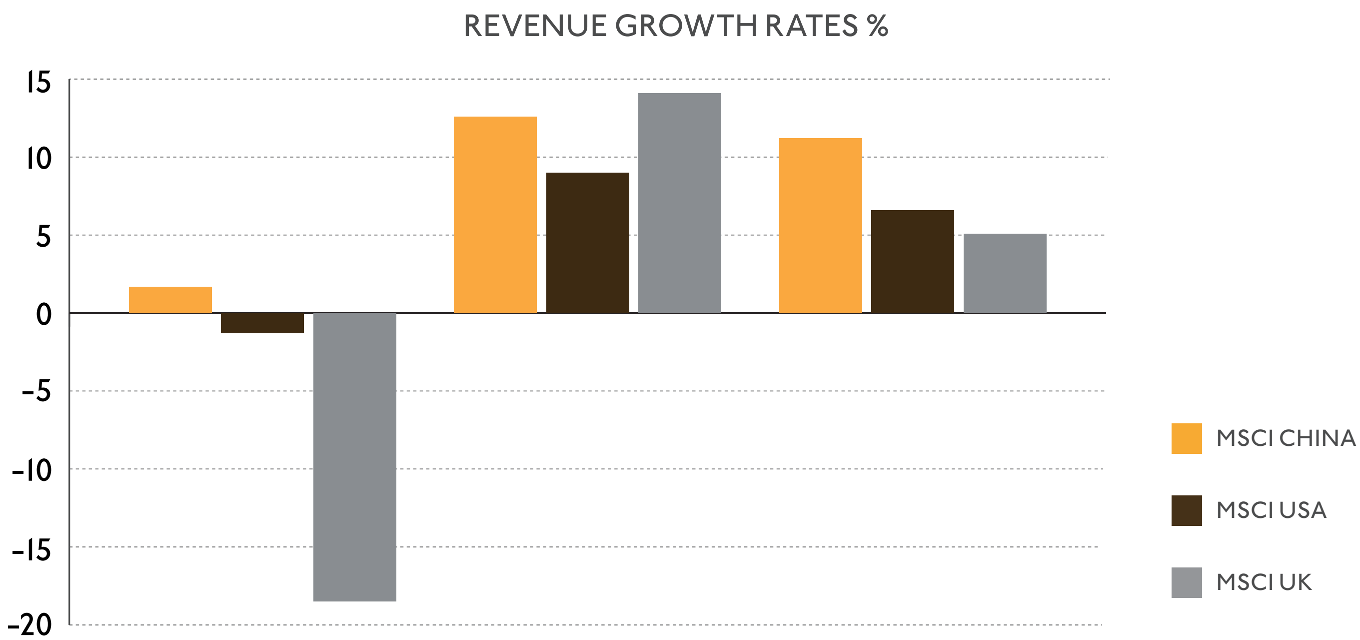
If the COVID-19 pandemic has taught us one investment lesson, it's that diversification remains key to helping guide investors through a variety of market cycles and significant financial shocks. Portfolio geography was particularly important last year as investors focused domestically, as is traditional amongst many in the UK, suffered poor returns and little in the way of downside protection. However, those investors, with exposure to a range of geographies such as Asia, North America and indeed Europe, were more likely to experience greater returns and lower levels of volatility, given the state of financial markets across such countries.

While many in the UK investor community have been hesitant to invest into China, the economic, demographic and corporate changes that have taken place in the past decade and continue to do so, are likely to provide a plethora of investment ideas to both diversify risk and improve overall portfolio performance. Taking a purely top-down view on China, the country possesses many of the key characteristics we would hope to find from a developing nation on the brink of 'developed' status, namely a population rapidly increasing its wealth, significant investment into infrastructure and globally emerging businesses with healthy finances. In fact, rather astonishingly, China's share of global GDP has risen from approximately 2% during the 1970's to around 13% as of 2020, mostly at the expense of Europe, the US and Japan. This translates into significant consumer growth, with the Asia Pacific region forecast to help lift nearly 1.5 billion people into the middle class between 2020-2030, with China responsible for over a third of this transition.



Source: Redmayne Bentley

Figure 1 – FTSE 100, S&P 500, MSCI China & MSCI Europe EX UK during 2020



Source: Factset Data Systems

This not only further cements China's position as a global superpower, it also means that over 500 million people will turn from subsistence to consumers as their incomes increase and discretionary spending increases with it, fuelling demand for products and services.

This, then, feeds into the bottom-up view for China, with companies both domestically and internationally capitalising on the structural changes within China and the general Asia Pacific region. In fact, Chinese companies have been able to sustain a high rate of growth consistently, with forecasts suggesting that this will likely continue at much higher levels than many of its global peers. One of the reasons that large UK companies have tended to underperform compared to their US and Chinese counterparts has been down to their lack of growth and attribution towards cyclical sectors such as banking, and traditional energy such as oil, gas and mining. This has meant that many such companies have limited long-term upside potential, given their maturity, as well as significant downside risk given their cyclicality. The COVID-19 crisis has both illustrated and exacerbated this point, with UK companies at far greater risk of significant revenue declines and poorer long-term forecast growth afterwards.

This greater level of consistency and growth compared to UK companies' often inconsistent growth over a longer period of time has meant that the Chinese market has soared in comparison to the UK. While the UK market often possess a value stock bias, leading to greater than average rebounds after economic shocks, the long-term growth trajectory is far less fruitful than across Asia, and China in particular.

Currency exposure has also been a key talking point in recent years with the British Pound severely impacted by Brexit and the US Dollar affected by global events such as the US-China trade war and the COVID-19 crisis. With this in mind, the appetite within the investor community to diversify currency exposure within portfolios has become an issue at the front and centre of portfolio construction. While investing internationally may help, the extent to which investors are actually diversifying their currency exposure with investments into Europe, North America and Asia, may be limited. In fact, the FTSE 100 accounts the US Dollar for approximately 23.35% of its revenues, and with emerging market assets increasingly linked to the Dollar through USD denominated debt and financial reporting, UK investors may be more exposed to a smaller handful of currencies than they believe.

Unlike traditional emerging markets, Chinese assets tend to provide investors with much less exposure to the US Dollar and greater exposure to the domestic Chinese Yuan, as well as other emerging Asian economies and currencies such as Vietnam and Thailand, which are often extremely difficult for UK investors to tap into. With a now significant and rapidly growing financial services sector, China has been able to reduce its reliance on Dollar denominated debt, as well as attracting other Asian economies to utilise the Yuan, helping to create not just a self-sustaining financial system but also one that is attractive internationally.

Given the macroeconomic picture for China over the next decade and beyond, coupled with the ever-increasing plethora of exciting and fast-growing companies emerging from the region, a direct, or at the very least, indirect allocation to China is likely a sensible decision from a performance and diversification standpoint. However, as a developing nation, China does possess a far less rigorous corporate governance structure, leading many to not overweight their portfolios towards Chinese assets. The Asia Pacific region and, in particular China, is likely to play a much bigger role in portfolio construction going forward as such issues are addressed by the government and corporate bodies. The diversification benefit of not only accessing previously untapped markets, but also dispersing one's currency exposure to countries that look set to increase their share of the global economic environment, will likely create a smoothing effect, reducing volatility in the longer term and building a portfolio that is able to create value across constantly evolving market conditions. ■

TOPIC OF THE MONTH

CORPORATE GOVERNANCE IN CHINA

The economic reforms introduced in the post-Mao era opened China to a wave of foreign investment and entrepreneurship, catalysing China's rise as an economic superpower and attracting global attention to the Chinese stock market. Until recently, the systems in place by which listed companies were governed and controlled remained a significant barrier to entry for most foreign investors seeking to take advantage of the ever-growing economy.

Prior to the 1990's, almost all Chinese companies were state-owned and with no established stock exchange or regulatory body to monitor the market, it was difficult for individual investors to get their foot in the door. It was not until the government created the Shanghai and Shenzhen stock exchange, along with the China Securities Regulatory Commission (CSRC), that the first steps were taken to create an oversight mechanism that would work towards international standards of corporate governance. In the past, individual minority shareholders have been discouraged from investing as their interests were not fairly represented; this was due to majority shareholders utilising their position to accumulate shares through in-party transactions. Since then, the introduction of several policies aiming to address the power imbalance between state and individual shareholders have improved the levels of corporate governance among listed companies. Nonetheless, Chinese enterprises are still heavily concentrated with state-ownership compared to other developed economies, which is an important factor to assess before investing in the region.

As a direct result of ownership concentration, boards of directors can be subject to government controls surrounding general operations and decision-making. The lack of independence among directors trickles down the business hierarchy, with supervisors unlikely to implement their own management styles and employees having little to no input on business decisions. Innovation within state-owned companies can therefore be limited as the state holds an influence over management while employees are encouraged to focus on their direct roles. It could be argued that this improves efficiency, although such influence presents the opportunity for corruption. It is possible that political objectives replace the maximisation of shareholder value as the indirect principles of management, with a self-interest culture also giving rise to insider trading.

On the contrary, state-ownership is not necessarily a disadvantage, as companies are backed by the government it is unlikely they will be left to fail. If necessary, the state will provide financial support and act as a safety net for underperforming businesses. It also allows ease of access to a continuously growing and stable customer base. According to a report in 2019, around 40% of Chinese companies are state-owned, with the rest partially owned or not at all. The implications highlighted will therefore have decreasing levels of impact as the portion of state-ownership decreases.

Corporate governance issues also persist in companies that are not owned by the state. One example is Luckin Coffee, which pledged to overtake Starbucks as China's biggest coffee chain when it went public in 2019 but was soon investigated by the State Administration for Market Regulation, uncovering £250m in fake transactions. The falsification of financial earnings remains an issue, however, it is clear the Chinese government is taking steps to solve complex issues with most listed companies subject to information disclosure rules, internal controls, and a vast improvement of investor relations. Many Chinese companies have also begun to participate in corporate social responsibility to combat the environmental impact they have as a country. ■

> *"...state-ownership is not necessarily a disadvantage, as companies are backed by the government it is unlikely they will be left to fail..."*

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