China in focus

Historically, we have not been able to find many interesting, really high quality companies in China which has largely centered on our discomfort with corporate structures, governance and alignment between majority and minority shareholders. While this continues to be the case, recent trips by members of the team have certainly provided plenty of food for thought.

Two decades of impressive economic progress

Views on the current health of the Chinese economy differ widely, but it's hard not to be impressed by the progress that has been made in the last 20 years. Examples abound, but two will suffice here. Gross domestic product (GDP) per capita has risen more than ten-fold to around $8,000 (USD) over this period, with much of this growth occurring in the last ten years alone. When Bear Sterns was getting into trouble back in 2007 there wasn't a single meter of high speed rail track in China. Now there is 22,000 km of it. Indeed, more than two thirds of all the world's high speed rail track is to be found in China. The pace and scale of change has been simply phenomenal.

Financial imbalances with...

Yet behind these achievements lie some well-known imbalances, especially in the financial system. Debt to GDP has ballooned in recent years from 140% to 280%. Much of this sits with state-owned companies or in the so-called shadow banking network. Official bank-sector non-performing loans are low, at just 3%, but few believe this reflects the true health of the banking system.

The issues here are too complex and multifaceted to lend themselves to easy explanation. Our general belief is that most of the problems lie in shadow banking. Liabilities are accrued from various sources — wholesale lending, wealth management instruments, life insurance products etc. — which are then priced at fixed rates. As far as the lender is concerned, they look like simple debt instruments in terms of risk and return. However, these are subsequently reinvested in a range of much riskier products, such as property, the stock market and so on. This system works fine as long the music keeps playing. It's only when it stops that the real problems arise.

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...uncertain implications

If China does run into problems, how bad might they be? China can certainly draw on a huge reserve of assets; $3 trillion (USD) of foreign exchange reserves for starters, as well as an (admittedly diminishing) current account surplus. Much of its debt is internally funded and has been incurred by expenditure on (largely) productive investments. Thus, many think that if there were a crisis today, China would have plenty of firepower to deal with it. But does the Communist Party of China ('the Party') really have the stomach for it? Dealing with the imbalances would require wholesale state-owned enterprise (SOE) reform and a cleansing of the financial sector — likely at a material cost to GDP growth. It seems unlikely that the Party — obsessed as it is with political stability and economic growth — would warrant this. In this scenario, the Party continues to kick the can down the road, propping up marginal growth with even more debt, escalating the problems, but delaying the day of reckoning further into the future. European central banks and policymakers wrote the playbook here!

Concentrating on what we can understand

So where does that leave us? All we can do is concentrate on the things that we do understand. This means staying clear of areas where we don't trust the system or the numbers: banks, life insurers and leveraged sectors such as property. Instead, we want to focus on the predictable; when we come back in ten years' time, the cash-rich middle class will have expanded by several hundred million, all eager to spend money on previously unaffordable goods and services. Some industries will be much bigger and the leading companies in those spaces will likely have done very well, regardless of whether or not there has been a financial crisis.

One anecdote is relevant here. Driving around Zaozhuang, a smaller city located between Beijing and Shanghai, we chatted to our taxi driver about life in the city. She earns about $10 (USD) per day. She had never been to the Zaozhuang Pizza Hut (we had), nor did she shop at Anta Sports or buy Mead Johnson infant formula for her children. But one got the sense that she would very much like to, if only she could afford it. The longer-term opportunities for companies that are plugged into this aspirational demand pool are significant.

Though valuations of some companies are at multi-year lows, there continue to be question marks over the common governance issues that are unfortunately present in many Chinese companies. However, there do appear to be interesting and largely neglected opportunities in some of the healthy, well-managed, cash-generating, consumer-facing companies that enjoy well-established and sustainable competitive advantages. While we already own some of these names in the portfolio (Yum Brands, for example), our visits have highlighted some potentially interesting ideas worthy of further investigation.

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