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China Unexplored

# Going beyond the obvious to find tomorrow's winners

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## Are you positioned on the right side of change in China?

In **Why there's more to China than just big tech** we highlighted what we believe is the compelling breadth and depth of the investment opportunity that China offers, a market characterised by innovation and disruption. So, where can investors find those companies that are driving and harnessing the grass roots growth in China that carry the potential to deliver durable shareholder returns?

As we have advocated previously, it's important for investors to look beyond the largest mega caps where the majority of investor flows are directed. We believe the large universe of over 6,500 stocks offers a huge opportunity for active managers to invest in under-researched and under-owned companies in China today.

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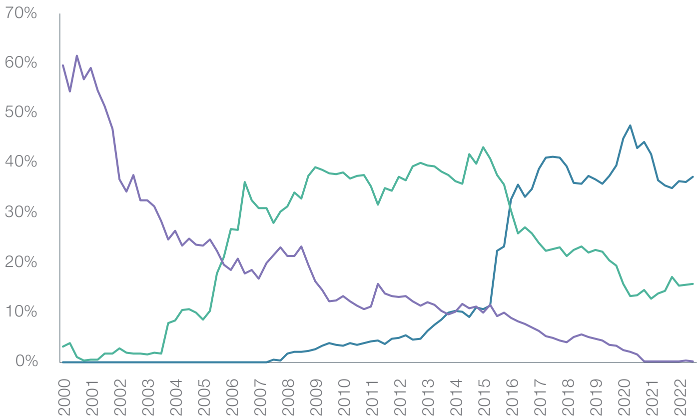
## Change equals opportunity

China is a fast-evolving market, with a high volume of IPOs (initial public offerings) in contrast to developed world markets. The share prices of well-managed, higher quality or innovative companies in China are increasingly driven by idiosyncratic factors rather than broader macro shifts or commodity cycles. And importantly for investors, growth is increasingly being sourced domestically through innovative industries such as technology, healthcare and other consumer-led sectors.

**Fig. 1:** The China universe evolves fast

*MSCI China sector breakdown 2002 vs 2022*




Source: T. Rowe Price uses the MSCI/S&P Global Industry Classification Standard (GICS) for sector and industry reporting. T. Rowe Price will adhere to all future updates to GICS for prospective reporting.

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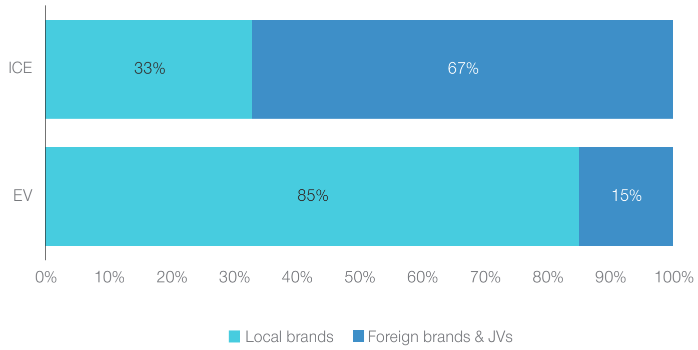
One unique dynamic about China is the constant change, both in terms of scope and pace. The process of industrialisation and modernisation was a 200 to 300-year process in most western countries. In China, this was condensed into several decades. The result is rapid change in economic structure and investment opportunities.

While the status quo is generally well understood, and efficiently valued, mispricing and opportunities for alpha generation arise in areas where future fundamentals will be different to the past. The change in sector weightings in the MSCI China Index illustrates this well (see Fig. 1). Two decades ago, telecoms was the largest sector with a weighting around 60% of the index. Ten years ago, financials dominated with around a 40% weighting. Today, internet plays the major role accounting for around 40% of the index. In a few years' time, it is possible the index could see other meaningful changes.

**Fig. 2:** Market share in ICE vehicles vs Electric Vehicles

*As at 31 December 2022*




Source: Goldman Sachs.

ICE vehicles are conventional vehicles powered solely by an Internal Combustion Engine (ICE).

The automotive sector is one such sector where change is rapidly taking place. We have witnessed clear shifts in consumer behaviour; firstly, as car buyers are moving from ICE (internal combustion engine) vehicles towards EV (electric vehicles) and, secondly, as buyers are showing a clear preference for domestically produced EVs. Fig. 2 shows the market share of local versus foreign brands in the ICE and EV market segments. In the ICE segment, Chinese brands are still viewed as lower quality, copycat vehicles - whereas we would argue that in the EV space, Chinese manufacturers are at the forefront of the industry.

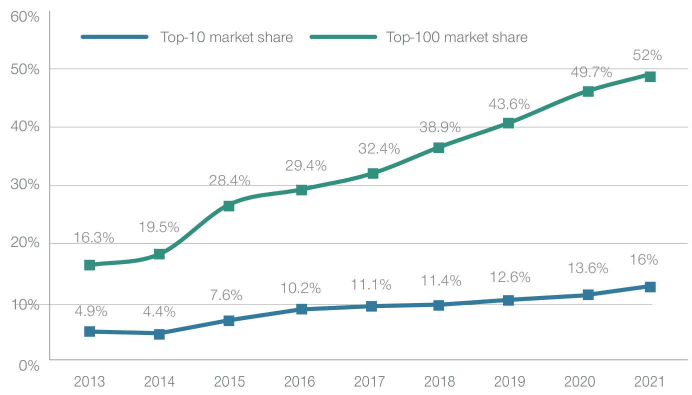
In this nascent sector, competition is fierce and while the path to profitability of OEMs (original equipment manufacturers) lacks visibility, the EV supply chain, where China arguably benefits from being the most comprehensive and competitive in the world, offers a fertile hunting ground for bottom-up stock pickers. This might be an auto glass manufacturer that can benefit from the higher glass content in EVs, for example, or a gear box manufacturer that can meet the higer technological content of EVs. Such companies that are on the right side of the "product cycle" can experience very rapid growth in a short period of time until competition eventually catches up. Understanding the idiosyncratic drivers of product and industry cycles is key in these circumstances.

## Fragmented markets provide room for leading companies to grow

Unlike many western markets, where there are typically a handful of dominant players in any particular industry, the Chinese market is still hugely fragmented which allows the most efficient and well-managed companies to structurally grow their businesses and take market share. As is typical in emerging markets, China is littered with nascent industries and nascent companies with a long runway for growth, whose potential is not recognised by the short-term nature of most market participants.

**Fig. 3:** China's market is still highly fragmented

*Property management sector as at 31 December 2021*



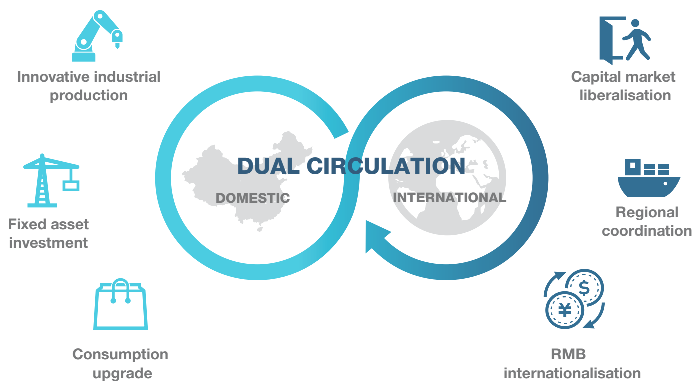

Source: Goldman Sachs Global Investment Research. Latest data available.

Take the property management sector, for example, where the top 10 companies account for 16% of total market share, and the top 100 just 52%! It's a similar story across many varied industries such as hotels, drug stores, restaurants and so on. These areas can offer an abundant source of mispriced but good quality companies with a clear visibility of growth at an early stage, with the potential for sizeable market share gains and industry consolidation.

## Change is the only constant

Since the founding of The Republic of China, its growth model has undergone several phases. The first phase, between 1949-1978, focused on "internal circulation". Since the economic reforms in late 1970s, growth was more levered on "external circulation". We are now entering the third phase called "dual circulation"

**Fig. 4:** China's dual circulation policy




Sources: Goldman Sachs, People's Bank of China, Organization for Economic Cooperation & Development

Under dual circulation, China's domestic market is expected to play a larger role to drive economic growth, industrial upgrade, and address potential vulnerabilities in supply chains. China continues to invest in more R&D to support home-grown companies, providing opportunities to invest in more innovative businesses. At the same time, it continues to emphasise the importance of "opening up" and internationalising its capital markets in an orderly fashion to promote growth.

All of this translates into a dynamic and fast evolving market that requires investors to constantly look for emerging trends and changes, rather than rest on current mega cap incumbents. Experience tells us that investing through the rear-view mirror is generally not a winning strategy, particularly when it comes to investing in China.

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