CHINA – THE WORLD’S BEST CONSUMPTION STORY?

Roderick Snell, Investment Manager, Fourth Quarter 2016

BAILLIE GIFFORD

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Roddy graduated BSc Biological Sciences with Honours in Medical Biology from the University of Edinburgh in 2006. He joined Baillie Gifford in the same year and worked in the UK and European Equities Teams before joining the Emerging Markets Equities Team where he is an Investment Manager. Roddy has managed the Baillie Gifford Pacific Fund since 2010.

CHINA – THE WORLD'S BEST CONSUMPTION STORY?

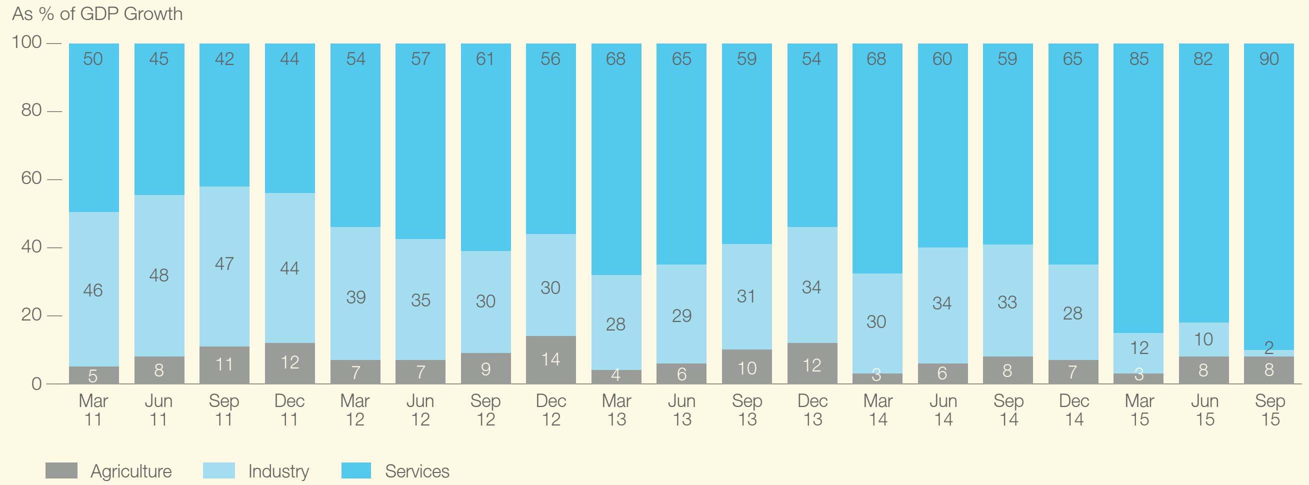
China's growth rate is slowing, but this does not mean the country is on the verge of economic collapse. Amid all the gloomy headlines, it is easy to lose sight of the fact that China is undergoing a planned economic transition from an investment- to a consumer- and services-led economy, which is imperative to securing the long-term success of the country. Yes, there will be casualties from the old economy, in particular the state owned enterprises that continue to destroy capital, and the country's banks that fund their operations, but it would be foolish to dismiss Chinese companies as an investment opportunity outright.

For those with long-term investment horizons able to look beyond the current environment of slower GDP growth, the new consumer-led economy presents investors with a number of the most interesting investment opportunities in the emerging markets universe. This paper will examine the three core drivers of this consumption story: economic rebalancing; innovation & technology; and China's world class technology companies. Combined, these are likely to make China one of, if not the, world's best consumption stories.

THE ECONOMY IS REBALANCING

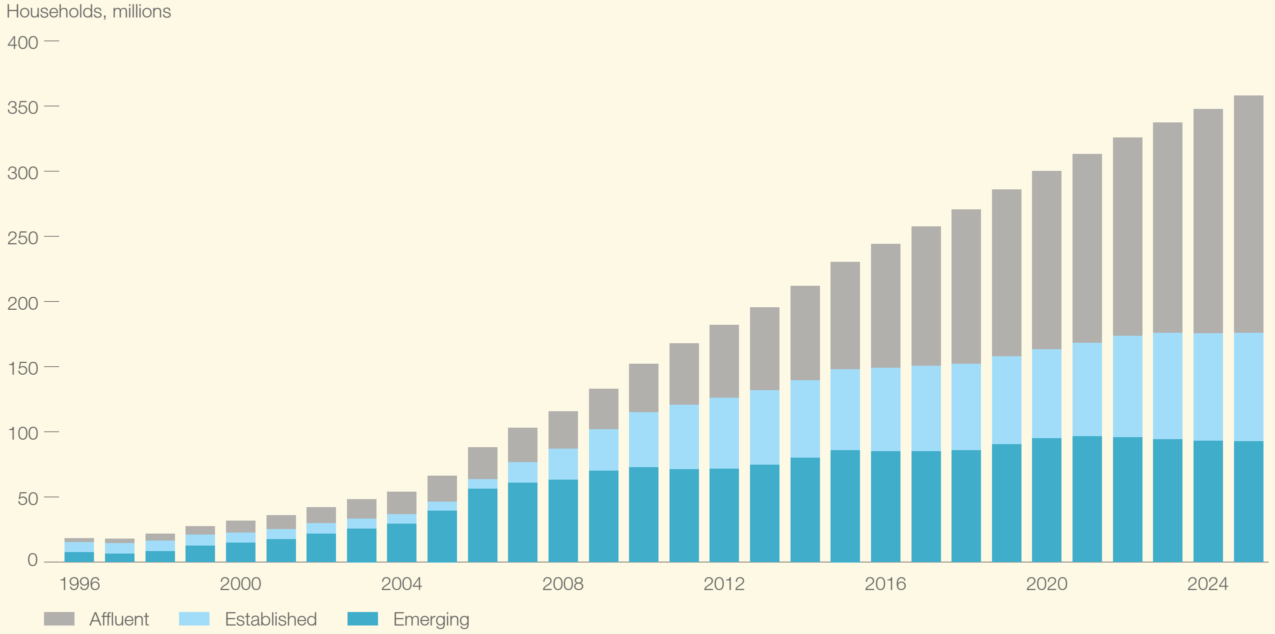
It may surprise some that the rebalancing scales have already tipped in favour of the 'new economy' with consumption and services already producing more than 50% of GDP, generating more than 90% of GDP growth and nearly all of the new jobs being created. While some of this rebalancing is passive, due to the significant slowdown in the old industrial economy, there are parts of the new economy growing impressively. Retail sales, for instance, have grown over 10% year-on-year (YoY), with a number of categories experiencing significantly higher growth rates. Sales of SUVs, for instance, have grown 40% since last year and, perhaps more strikingly, online sales in general have risen 30%. China's online sales figures are truly staggering: whereas eBay's total worldwide merchandise value for 2015 stood at around $80 billion, the online Chinese retailer Alibaba generated $14 billion of gross merchandise sales in just a single day last year.

China GDP Growth Share Breakdown by Sector



Source: Haver, NBS and Bernstein analysis.

China Households in each Income Group



Source: Gavekal Data/Macrobond.

This economic rebalancing has been reached thanks to the mounting number of affluent consumers who are driving the consumer- and services-led economy. Consumer spending and the propensity to consume certain goods does not grow in a smooth line, but lurches forward in waves as households cross certain earnings thresholds of affordability. For example, at the lower end, people start buying branded toothpaste at $1,000 per capita. At $5,000, consumers buy TVs and phones, and at $15,000 they feel secure enough to start purchasing luxury goods and holidays.

China has already experienced a couple of these 'waves'. The first was the rise of the 'emerging consumer' – households with incomes over $8,000 – which started to accelerate in the late 1990s and peaked around 2007. The emerging consumers caused a surge in demand for goods such as soft drinks and many consumer staples.

As incomes continued to rise, the emerging consumer gave way to the 'established consumer' as the main driver of consumption growth. The rapid expansion of the established consumer – that is families with incomes over $12,000 – began around 2003 and continued until 2014 when it levelled off. Over this period, car sales surged on the back of a six-fold increase in the number of families who could afford to buy an automobile (rising from 23 million to 145 million). While car sales will continue to grow over the next ten years, it is likely to be at a more pedestrian low-single digit level, not the heady 17% per annum level seen during the time of the established consumer.

Today, the fastest growing consumer segment is that of the 'affluent consumer'. Here, incomes have escalated upwards of $20,000 and we are likely to see the greater spending power being channelled over the coming years into areas such as travel, high-end goods and services.

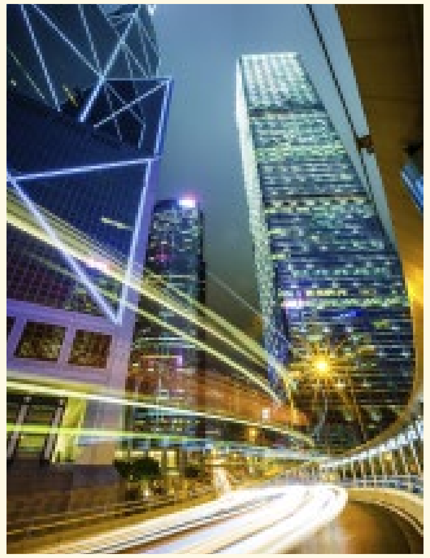
Therefore, the shrewd investor should not be turning their back on China, but be carefully aligning themselves with those companies best placed to benefit from the rise in the affluent consumer.

INNOVATION AND TECHNOLOGY – A GOLDEN CONSUMER AGE ONLINE

The paucity of certain types of Chinese infrastructure, such as modern shopping channels outside China's major tier 1 and 2 cities, has meant that entire industries are being built online from scratch, and with a far greater degree of sophistication and depth than anything consumers in the developed west are accustomed to. For investors this means we are entering a golden age where, even as economic growth slows, many of the leading Chinese internet and technology companies continue to grow at dizzying rates and the growth opportunity may be bigger than anything that has gone before.

The diagram below puts China's online retail growth opportunity into perspective. Having doubled in size since 2013, China has the largest e-commerce market in the world worth around $600 billion – almost twice the size of the US market. More importantly, the Chinese online market continues to grow rapidly and could easily surpass the $1–$2 trillion threshold over the coming years when one considers that internet penetration is still only half that of many developed countries, online retail penetration is just under 15%, and wages continue to grow at double digits.

China – The World's Largest E-Commerce Market



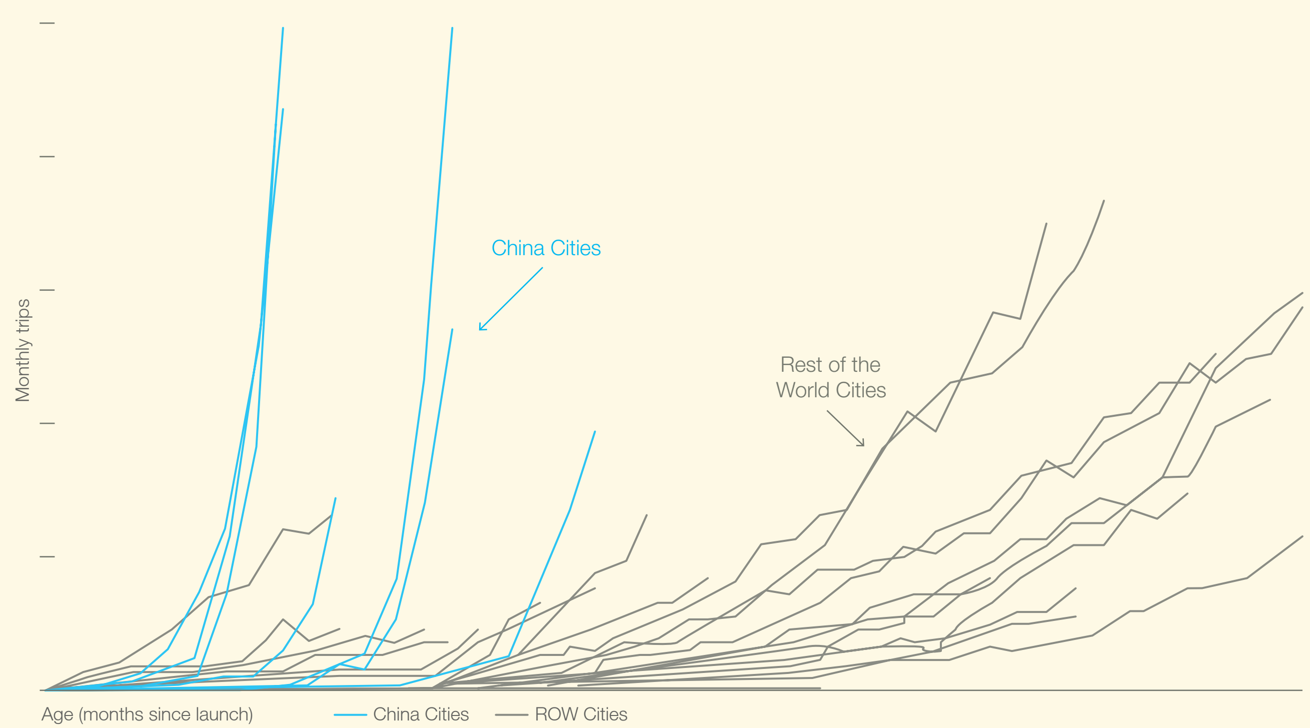
CHINA		US		UK	
2015	$606bn	2015	$349bn	2015	$94bn
2018 (E)	$1.2tr				

Source: EMarketer, iResearch, Goldman Sachs Global Investment Research.

A key to China's technological success is its rapid adoption of technology, which in many consumer areas is world leading. For instance, go to parts of Shanghai today, and people are not carrying wallets anymore, but instead are using Alipay (Alibaba's mobile wallet) via their mobile phones. And when it comes to hailing a taxi, China adopts Uber far more quickly and with much higher usage than any other country. (In August 2016, Uber China merged with local competitor, Didi Chuxing.)

The first traffic route paid with Alipay opens in Hangzhou.

Explosive growth in China



Source: CSLA, Uber.

OPPORTUNITIES TO INVEST – WORLD LEADING TECHNOLOGY FIRMS

Against this backdrop, there are a number of large, liquid companies which are growing rapidly and we own on our clients' behalf – Ctrip, for example, is growing revenues at 70% YoY, while Tencent, Alibaba and JD.com are all growing their top line around 40%. More importantly these companies are now clearly dominating their respective online verticals. Network effects are incredibly powerful and this has led to winner-takes-all markets both in the US and now, increasingly, in China. Whereas in America Google, Amazon and Facebook have dominated in search, retail and social respectively, in China it is Baidu in search (over 80% of market share), Alibaba and JD.com in retail (with 80% B2C market share between them) and Tencent in social (upwards of 800 million users).

Importantly, many of the leading Chinese players have arguably surpassed their western peers both in terms of technology and functionality, and are now the world leaders. Take Tencent's WeChat, the number one messaging app in China. Unlike our leading messaging apps in the USA or Europe such as WhatsApp or Facebook Messenger which only offer a basic messaging service, WeChat has pioneered ahead turning WeChat from a simple messaging app into an ecosystem crammed with functionality. Users are able to shop online, order taxis, settle utility bills, split dinner tabs with friends and book hospital appointments, all without ever leaving the WeChat universe. Such is the usefulness of the app that more than a third of all time spent on the mobile internet in China is spent on WeChat.

Percentage Revenue Growth YoY

Source: Bloomberg. Based on quarterly results as at 18 May 2016. Ctrip based on company guidance/Baillie Gifford estimates for Q1 2016.

– the dominant Chinese players are frequently superior at leveraging their user base and entering, or even creating, entirely new markets.

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Better yet for investors, amidst the general Chinese macro malaise, many of these world-class companies are available to us at very attractive valuations. Many of these US-listed Chinese companies have been shunned by investors that have taken fright at the Chinese macro-economic environment. Baidu for instance is forecast to grow its revenues by 22% next year, yet we estimate its core search business is trading on about 15x next year's earnings.

Online travel agent Ctrip is a relatively new position to our portfolio and so may be of particular interest. We believe that its market opportunity could grow nearly twenty-fold over the next five to ten years. This figure is based on the following long-term trend assumptions. The first is that the tourism market in China doubles. Currently, this market is growing at over 30% YoY. Even if this was to slow to a steady 15%, the tourism market will nonetheless double to $1 trillion in the near future. Next, we anticipate online travel penetration to quadruple. Current penetration is around 13%, but over time, this could move toward the 50% rates seen in a number of western markets. Finally, we believe that take rates, (the amount of money Ctrip takes per transaction), can triple to levels comparable to western peers such as Priceline.

Could competition destroy pricing and the market? We do not think so. After several years of intense competition which have lowered take rates and margins, Ctrip has emerged as the overwhelmingly dominant company in the sector. Having recently merged with its largest rival, Qunar, it now controls almost 70% of the Chinese online travel market. The best is yet to come.

CONCLUSION

China's economy is coming of age. With market commentators focused on the significant pain being felt in large parts of the old economy, most have failed to see the consumer-driven growth engine that is emerging as part of the world's second largest economy's planned economic transition. As the number of affluent consumers rises in the next five to ten years, companies that supply goods and services to this consumer segment will benefit the most. With world-leading innovation and technology and a Chinese public predisposed to adopting technology faster due to the lack of an alternative established infrastructure, a handful of winner-takes-all companies will continue to lead the charge. Such is the scale of the market opportunity open to them, we believe they – and by extension those who invest in them – will be rewarded with revenues even higher than the dizzy levels currently being seen.

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