

## Three Investible Themes in China A-Shares



The China A-Share market presents a compelling opportunity for quality growth managers, thanks in part to its growing new economy. In this paper, we discuss three investible themes in China: a growing middle class, an innovation boom, and growth in healthcare spending.

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China has been transitioning from an economy focused on fixed-asset investment to an economy focused on domestic consumption.

This new economy—which is fostering new growth drivers and encouraging China’s economic transformation—covers a range of sectors, said Chinese Premier Li Keqiang in 2016. “It is not only the emerging forms of business including e-commerce, cloud computing, and the internet of things,” he explained. “It can also be found in smart manufacturing and large-scale customized production in the industrial sector.”

We believe the China A-Share market offers unique exposure to China’s new economy. Many opportunities it presents cannot be accessed by investing in Hong Kong- or U.S.-listed Chinese stocks. In both healthcare and consumer staples, for example, China A-Shares account for 90% of the market value of globally listed Chinese companies.<sup>1</sup> Retail, automotive, and insurance are other new economy industries in which China A-companies have a major presence.

Below, we discuss three investible themes in China: a growing middle class, an innovation boom, and growth in healthcare spending.

## Theme 1: China’s Growing Middle Class

The growth of China’s middle class is a well-known theme among emerging market investors, and we believe there is still substantial growth potential in Chinese domestic consumption.

### Rising Incomes and Savings

Chinese households classified as upper middle class or affluent are projected to constitute 57% of total households in 2020, up from less than 10% in 2010 and less than 1% in 2000.<sup>2</sup>

Complementing this income growth, savings rates among Chinese citizens are high, exceeding those of the United States and Japan, and are growing quickly.<sup>3</sup>

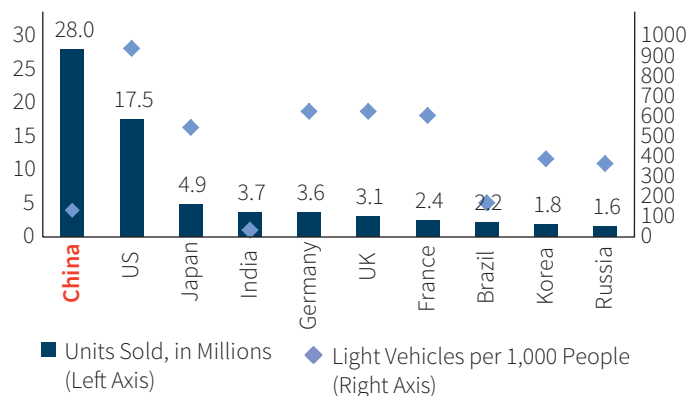
This should translate into a continued increase in Chinese domestic consumption over the next few years. China’s middle-class consumption is second only to that of the United States, and it is growing at a rate second only to that of India. In 2020, China’s middle-class consumption is expected to be the largest in the world.<sup>4</sup>

### Key Opportunities

With this as a backdrop, there are a number of consumer-related opportunities in China, including cars, spirits, travel, and personal care.

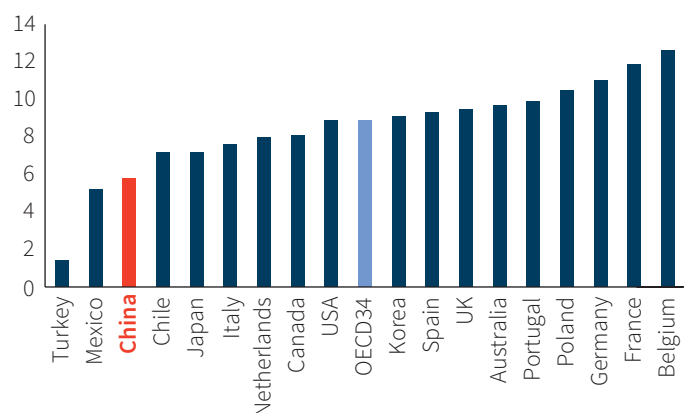
**Cars.** China has the largest auto market in the world, with nearly 30 million cars sold each year. This is substantially higher than in other countries, including the United States. Yet China’s market penetration, measured by vehicles per thousand people, is one of the lowest in the world, implying further growth. Figure 1 illustrates.

**Figure 1:**  
China’s Auto Market: Large and Unpenetrated



Sources: Bank of America Merrill Lynch Global Research, William Blair, as of 2018.

**Figure 2:**  
Low Per-Capita Liquor Consumption Supports Growth (Liters)



Source: OECD, William Blair, as of February 2018.

**Spirits.** Per-capita consumption of liquor in China is low compared with the world average, as figure 2 illustrates. But the potential for growth—and returns—is high. And the China A-Share market provides unique exposure to the Chinese liquor companies.

**Travel.** Growth in outbound Chinese tourism has been explosive over the past decade. But there is room for it to grow, as only 9% of Chinese citizens hold passports,<sup>5</sup> compared with 42% in the United States.<sup>6</sup>

**Personal care.** The rise of China’s consumer class has presented a massive, fast-growing market of people who want to buy expensive personal-care products. And the runway for growth in this sector is huge, with China’s per-capita spending on beauty products just 15% of the United States’, as figure 3 illustrates.

#### Example: A Leading Liquor Producer

The largest liquor company in China by volume, retail value, and market capitalization is the kind of company that could benefit from China’s domestic consumption story.

A producer of the traditional Chinese liquor Baijiu, this company has a famed heritage dating back more than 500 years, and maintains a strong brand. Indeed, it produces the only Chinese liquor served at national banquets hosted by Chinese presidents for visiting foreign dignitaries. The 500-milliliter bottles cost \$250 to \$3,000, depending on vintage.

This company has surpassed the world’s largest multinational liquor company in terms of market cap, net profit, and margins, as figure 4 illustrates. Its market cap is substantially higher than that of the world’s largest multinational liquor company, yet it operates in a fragmented market where its share is only 6%. This company’s revenues have grown at nearly 25% per year over the past 20 years, driven by both volume and average selling price increases.

In our opinion, limited supply, a strong brand, pricing power, and a relatively small market share, against a backdrop of Chinese consumers’ growing appetite for premium goods, make this company a compelling investment opportunity.

**Figure 3:**  
**Runway for Growth in Beauty and Personal-Care Products**

Country	2015 Per-Capita Spending	% of U.S. Level	2013-2015 CAGR	Years to Reach U.S. Level
US	\$248.90	100%	2.0%	NA
Brazil	\$148.50	60%	4.0%	13
Poland	\$98.80	40%	2.4%	39
Mexico	\$72.00	29%	3.5%	36
Russia	\$62.00	25%	9.4%	15
Turkey	\$46.70	19%	10.7%	16
<b>China</b>	<b>\$37.10</b>	<b>15%</b>	<b>6.5%</b>	<b>30</b>
Indonesia	\$16.90	7%	14.0%	21
India	\$9.10	4%	12.4%	28

Sources: CLSA, William Blair, as of 2015. CAGR refers to compound annual growth rate.

**Figure 4:**  
**Liquor Producer: Comparison of Key Financials**

	China’s Leading Liquor Producer	Largest Multinational Liquor Company
Market Cap (Current)	\$141,927	\$89,391
Revenue	\$11,802	\$17,128
Net Profit	\$5,450	\$4,195
Gross Margin (Current)	88.30%	61.70%
Operating Margin	62.20%	31.40%

Sources: Company data, William Blair, as of December 2018. Refers to fiscal year 2018 (12/31/2018 estimated for China’s leading liquor producer, 6/30/2018 for largest multinational liquor company.)

“China’s innovation boom has been supported by large capital investments, and in our view will continue to attract such investments.”

## Theme 2: China’s Innovation Boom

China is commonly characterized as a smokestack economy—addicted to debt, infrastructure investment, cheap manual labor, low-value exports, and polluting industries. But this is inaccurate, as the ongoing innovation boom is quickly transitioning China into one of the most innovative countries in the world.

### R&D Spending, Patents, Unicorns, and Human Capital

China’s research and development (R&D) spending is second only to that of the United States, and will likely soon surpass that of the United States given its accelerating growth, which figure 5 illustrates.

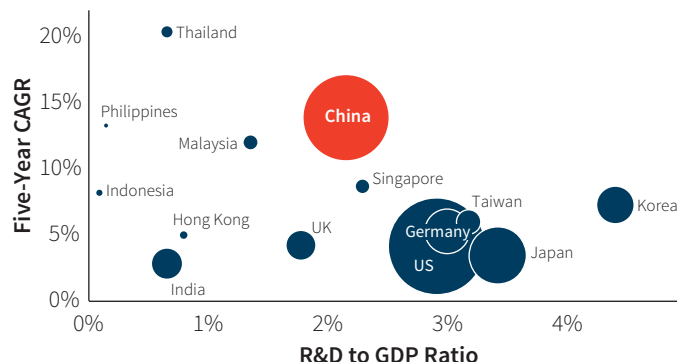
This is evidenced by the number of patents granted in China since 2012. China has filed for more patents than the United States, European Union, Japan, and South Korea combined, as figure 6 illustrates—1,205 in 2016 alone, versus 304 for the United States and 260 for Japan.

China’s innovation boom has been supported by large capital investments, and in our view will continue to attract such investments. As shown in figure 7, China is a prominent contributor to the world’s private start-ups valued at more than \$1 billion (unicorns). It has 34% of the world’s unicorns, second only to the United States, and accounts for 43% of the total value of the world’s unicorns, almost at parity with the United States.

In our opinion, China’s innovation boom will continue to be supported by the country’s high-quality human capital. The number of Chinese students who study abroad has increased materially over the past 20 years, as has the percentage of students studying abroad who return to China. The latter increased from as low as 15% in the early 2000s to 80% today.

Figure 5:

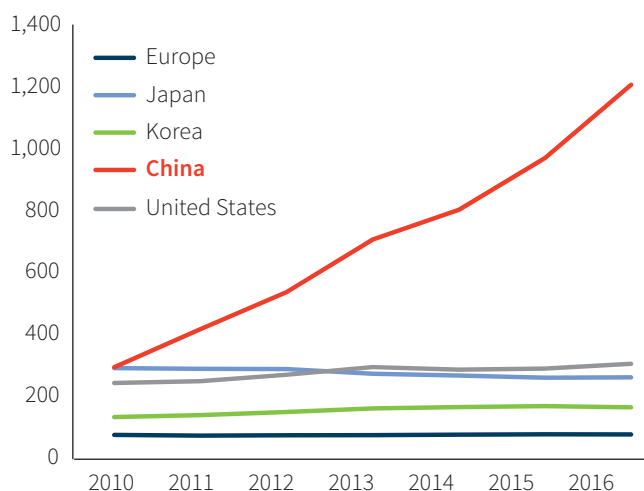
### China: World’s Second-Largest R&D Spender



Sources: UBS, William Blair, as of September 2017.

Figure 6:

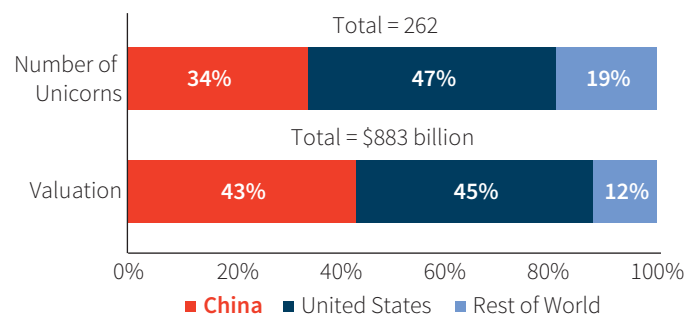
### China: Highest Number of Global Patents Filed Since 2012



Sources: UBS, William Blair, as of September 2017. Applications filed are in thousands. Includes only IP5 patent data. IP5 is a forum of the five largest intellectual property offices in the world.

Figure 7:

### Global Private Start-ups Valued at \$1 Billion or More



Sources: McKinsey Global Institute, William Blair, as of September 2017.

## Key Opportunities

The Chinese government has driven and supported China's innovation boom with its "Made in China 2025" mandate, prioritizing aviation, shipping, robotics, railroad equipment, agriculture, information technology, electric equipment, energy conservation, biomedical drugs and equipment, and new metals.

The Chinese government has also set domestic market-share targets for 2025. For example, China wants domestically produced goods to supply 80% of its demand for new energy vehicles, high-tech shipping components, and renewable energy equipment by 2025, and it wants such goods to supply 70% of its demand for high-performance medical equipment and industrial robots.

Automation, in particular, is a key opportunity, as China leads the world in the sale of industrial robots, higher than North America, the European Union, and Japan, as figure 8 illustrates.

China is also charging ahead with artificial intelligence (AI). It ranks second only to the United States in this development by three key measures: total capital raised, number of patents granted, and number of enterprises established, as figure 9 illustrates.

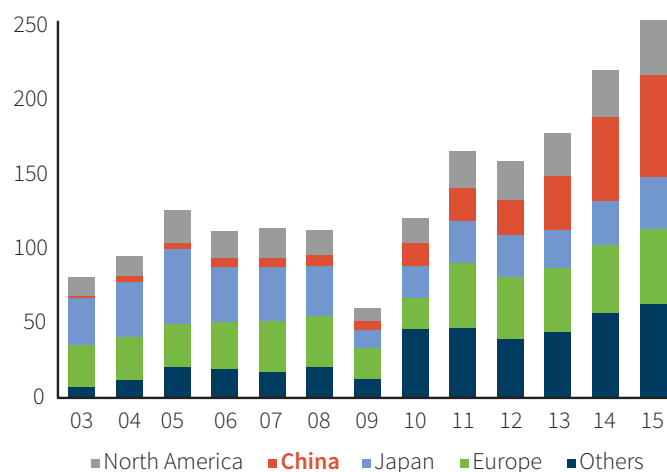
### Example: A Leader in Security Surveillance

The world's largest security surveillance hardware and software company holds 40% market share in China and 9% in the world excluding China. Yet its overseas prices are 20% lower than those of its global competitors, thanks to high operating efficiency.

Recently, this company has also ventured into areas of AI related to security surveillance, including visual recognition, smart cameras, and big data analysis. Its surveillance and machine vision businesses are estimated to grow at 61.7% and 15.5%, respectively, through 2020, versus 11.2% for its traditional surveillance business.<sup>7</sup>

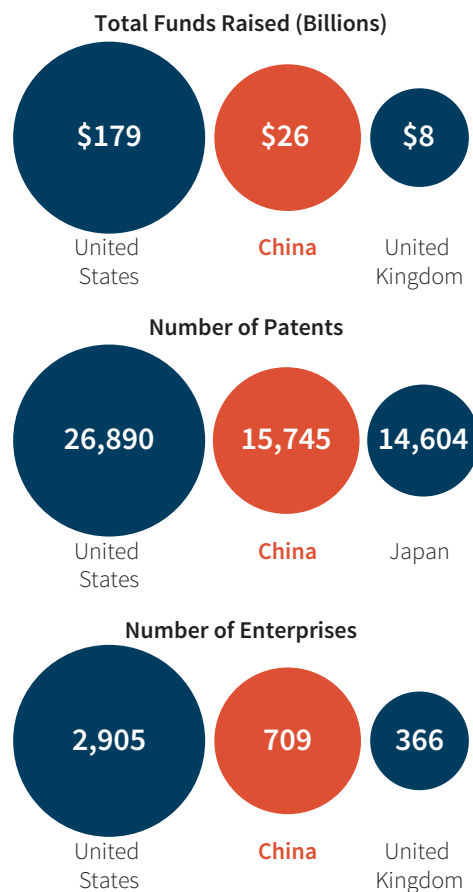
Limited sell-side coverage of China A-Share stocks presents an opportunity for active managers. Of 3,500 listed China A-Share stocks, 1,500 have coverage of fewer than five analysts, and the perceived quality of research coverage is lower than developed market standards.

**Figure 8:**  
**China Leads Sale of Industrial Robots (Thousands)**



Sources: Goldman Sachs Global Investment Research, IFR, National Robot Association, William Blair, as of August 2017.

**Figure 9:**  
**China Second Place in Artificial Intelligence**



Source: Goldman Sachs Global Investment Research, William Blair, as of August 2017.



“We expect this robust growth to continue, underpinned by China’s low healthcare spending.”

### Theme 3: China’s Secular Healthcare Spending Growth

Healthcare is underdeveloped in China relative to its global peers, in both total and per-capita spending. This creates the potential for growth.

#### Rising Disease, Underserved Market

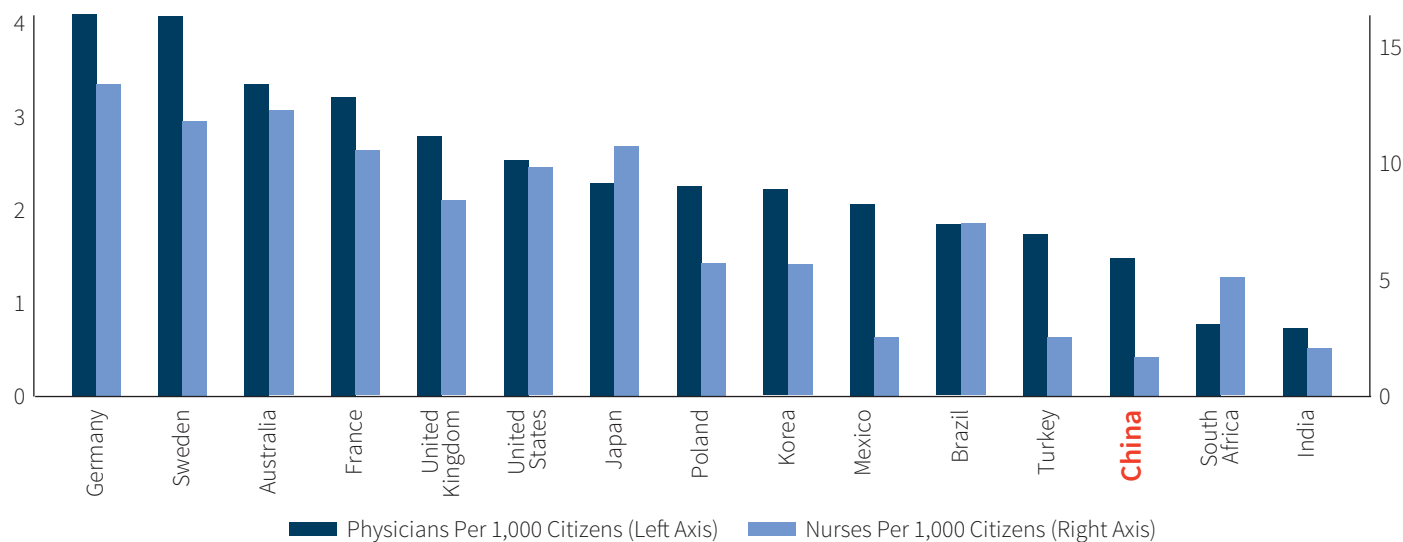
The prevalence of chronic diseases in China—such as diabetes, hypertension, and cancer—has risen significantly in the past two decades. Yet China is a largely underserved healthcare market,

with the number of physicians and nurses per 1,000 citizens among the lowest in the world. Figure 10 illustrates.

Not surprisingly, the Chinese healthcare industry has grown rapidly over the past decade, with an estimated compound annual growth rate of 17% from 2006 through 2018. The total industry market value is expected to reach nearly \$800 billion in 2018.<sup>8</sup>

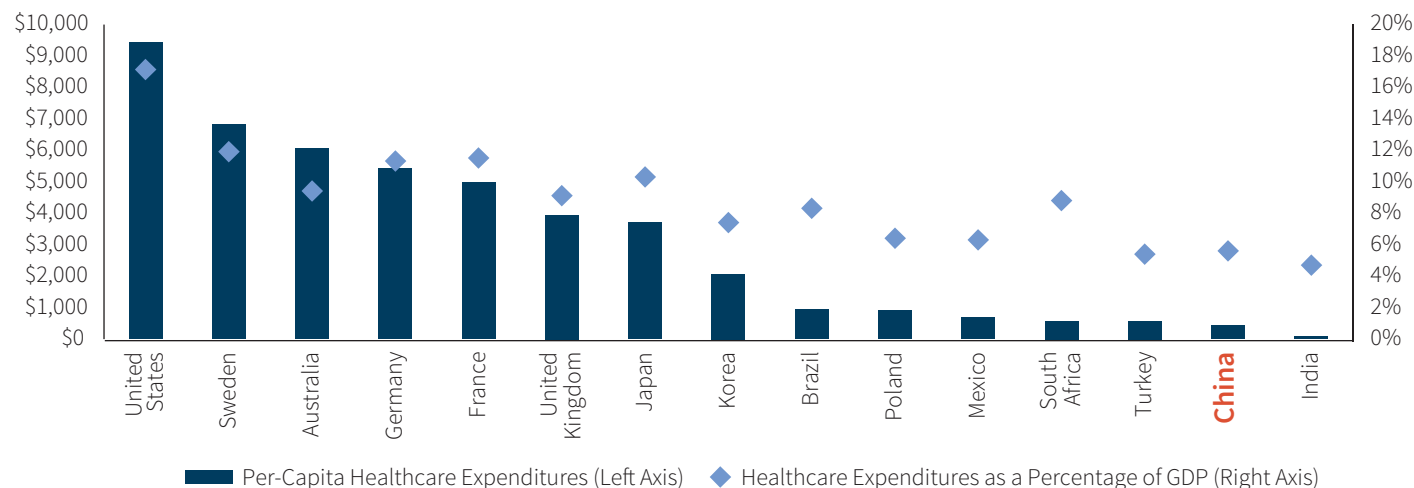
We expect this robust growth to continue, underpinned by China’s low healthcare spending. As figure 11 illustrates, Chinese citizens on average spend only a few hundred dollars per year on healthcare, among the lowest in the world, and a small fraction of

**Figure 10:**  
China’s Physician and Nursing Staff Levels Below Average



Source: World Health Organization, William Blair, as of December 2016.

**Figure 11:**  
Chinese Healthcare Expenditures Among World’s Lowest



Source: World Health Organization, William Blair, as of December 2016.

the United States' nearly \$10,000 per-capita healthcare spending. Total healthcare spending is also low, with its contribution to gross domestic product about 5%, one of the lowest in the world.

It is also notable that the China A-Share market has nearly 90% of the market cap of listed Chinese healthcare companies,<sup>1</sup> making the China A-Share market particularly attractive to investors who want to take advantage of the secular growth in China's healthcare spending.

### Example: A Frontrunner in Innovative Medicine

An innovative drug manufacturer in China has been consistently growing its revenue and net profit by more than 20% per year for more than a decade, as figure 12 illustrates.

Cancer drugs contribute to 43% of its total sales, reflecting the increasing prevalence of cancer in China over the past decade, which the Chinese government has sought to fight with an accelerated drug-approval process.

The company is a leader in R&D; R&D spending as percentage of total revenues rose from 8.9% in fiscal 2014 to 13.0% in fiscal 2017. Its large R&D spending has led to a strong product pipeline, with 10 major drugs under development and most expected to reach the market over the next two to three years.

### Active Management Essential

In summary, we believe China offers a number of compelling investment themes, thanks to its burgeoning new economy and secular growth in consumption. But to capture the potential via China A-Shares, active management is essential.

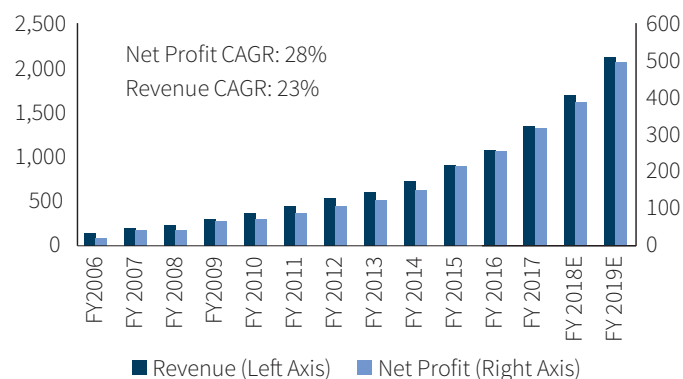
China's new economy accounts for less than 20% of the CSI 300 Index from a market-cap perspective, as figure 13 illustrates, and the old economy (including many state-owned enterprises, or SOEs) still accounts for a large part of the index.<sup>9</sup>

Moreover, we believe thorough fundamental research with a quality focus is key to exploiting this attractive opportunity while limiting some of the risks inherent in the asset class.

Seeking high-quality companies with sustainable growth characteristics is paramount. Such companies may perform well in up markets, protect in down markets, and produce attractive, risk-adjusted returns, as figure 14 illustrates.

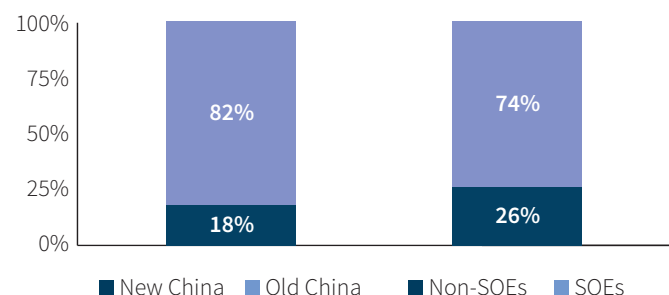
In searching for such companies, we look for organic value creation, peer-group leadership, consistent earnings growth, high return on capital and assets, positive earnings trends over time, and low leverage. ■

**Figure 12:**  
**Drug Manufacturer: Total Revenue and Profit (Millions, Renminbi)**



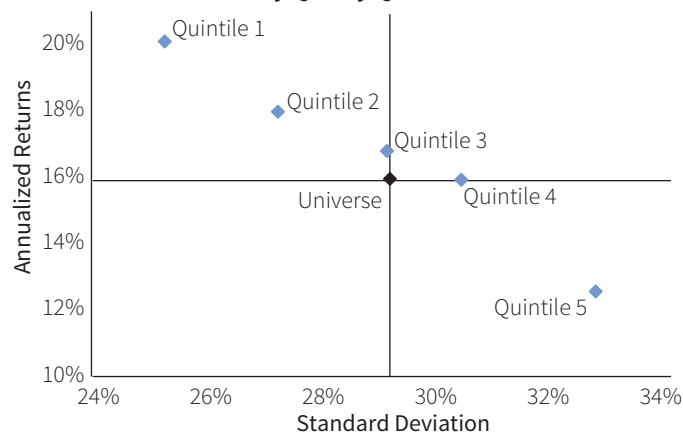
Source: Company data, William Blair, as of May 2018.

**Figure 13:**  
**Active Management Essential in China**



Sources: Goldman Sachs, William Blair, based on the CSI 300 Index, as of July 2017. New China includes GICS sectors healthcare and information technology and GICS sub-industries education, publishing, advertising, movies & entertainment, travel & leisure, internet retail, environmental services, and renewable electricity. SOEs are state-owned enterprises.

**Figure 14:**  
**China A Share Universe by Quality Quintiles**



Source: William Blair. Data is from May 31, 2005, through June 30, 2018. **Past performance is not indicative of future returns.** Performance information is based on William Blair's proprietary models and does not in any way relate to the return of any William Blair product or strategy. The strategy may or may not hold the companies included in the quality quintiles shown. Quality is defined as those companies with good balance sheet metrics, efficiency, and higher returns.

## Footnotes

1. Citi, as of September 2017.
2. McKinsey Global Institute. Affluent households are defined as those with more than \$34,000 in annual income, and upper middle class households are defined as those with \$16,000 to \$34,000 in annual income.
3. Maybank, as of June 2017.
4. McKinsey Global Institute, as of June 2017. Consumption growth is 2015-2020 estimated CAGR.
5. Jing Travel, as of January 2018.
6. U.S. State Department, as of January 2018.
7. Morgan Stanley, as of July 2017.
8. World Health Organization, as of December 2016.
9. The CSI 300 Index consists of 300 China A-share stocks listed on the Shanghai and Shenzhen Stock Exchanges.

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