Two Investable Themes in China

The China A-Share market presents a compelling opportunity for quality growth managers, with note two investible themes: a growing middle class and healthcare spending growth.

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Theme #1: 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. With this as a backdrop, there are a number of consumer-related opportunities in China.

Opportunities Abound

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.[1]

Spirits. Per-capita consumption of liquor in China is low compared with the world average.[2] But the potential for growth—and returns—is high. And the China A-Share market provides unique exposure to 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[3] compared with 42% in the United States.[4]

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'.

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.[5] 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.

Theme #2: Healthcare Spending

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.[6]

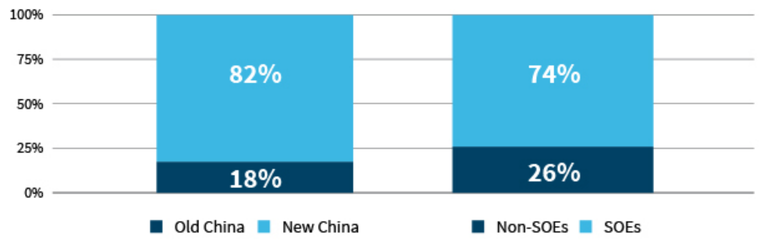
Not surprisingly, the Chinese healthcare industry has grown rapidly over the past decade, with an estimated compound annual growth rate of 17% from 2006 through 2018. The total industry market value is expected to reach nearly $800 billion in 2018.[7]

We expect this robust growth to continue, underpinned by China's low healthcare spending. 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 the United States' nearly $10,000 per-capita healthcare spending.[8]

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,[9] making the China A-Share market particularly attractive to investors who want to take advantage of the secular growth in China's healthcare spending.

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.

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.

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

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, and the old economy (including many state-owned enterprises, or SOEs) still accounts for a large part of the index.[10]

Moreover, we believe 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 the chart below 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.

FOOTNOTES:

1 Bank of America Merrill Lynch Global Research, as of 2018.
2 OECD, as of February 2018.
3 Jing Travel, as of January 2018.
4 U.S. State Department, as of January 2018.
5 Company data. Refers to fiscal year 2018 (12/31/18 estimated for China's leading liquor producer, 6/30/18 for largest multinational liquor company).
6 World Health Organization, as of December 2016.
7 World Health Organization, as of December 2016.
8 World Health Organization, as of December 2016.
9 Citi, as of September 2017.
10 Goldman Sachs.

William Blair