PODCAST TRANSCRIPT

Talking Research: Challenging Thinking on China

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Katie Boyce: As investor sentiment continues to shun China, two of Walter Scott's Research team recently visited mainland China and Hong Kong. Chengdu and Chongqing in the south west, are the fastest growing cities in China, with a combined population of more than 50 million. Both felt fast paced and brimming with innovation. The two weeks served as a healthy reminder about the danger of making generalisations about a country as complex as China.

Hello and welcome to *Talking Research*. I'm Katie Boyce, an investment writer at Walter Scott, and this podcast is an opportunity to hear directly from our Research team on what they've been up to and the topics at the forefront of their debates. Today it's a real pleasure to be joined by investment managers Paul Loudon and AJ Kyle. Paul, AJ, welcome.

Paul Loudon, Ashley-Jane Kyle: Hi, Katie. Hi.

KB: Paul joined Walter Scott's Investment team a decade ago, and has rotated around all three of the regional teams as well as a stint working in Client Service. He's visited China on a number of occasions, including this most recent visit.

AJ's career at the firm began in 2017, and she's been on the Asia and European teams. Prior to Covid, she made two research trips to China and, in recent weeks, she's been chair of the Research team, a mantle that has now been passed to Paul, so both are well positioned to talk about the team's activity as well as their takes on China.

> Before we get started, a reminder that the podcast is intended for investment professionals only and should not be construed as investment advice or a recommendation. Any stock examples discussed are given in the context of the theme being explored, and the views expressed are those of the presenters at the time of the recording.

Paul, perhaps you could start off by telling us what you're up to?

PL: Sure. So we had a fantastic two weeks in China and Hong Kong, myself and my colleague Michael. We started out in Sichuan province, where we met with a range of companies across all sorts of industries in cities like Chongqing, Luzhou, Leshan, Yibin, Chengdu. Now, many of these are quite unheralded cities but, as you pointed out in your intro, Katie, Chengdu Chongqing combined are more than 50 million people. So these are, you know, really important cities for the Chinese economy, especially given, quite recently, they have been designated as an economic circle, that is essentially a super cluster that the Chinese government hopes will ultimately rival Shanghai, Beijing and the Greater Bay area.

So because of that, a lot of state directed investments into the region, which we were able to see first-hand. So it was a fantastic first week watching that all play out. The second week we went to Hong Kong where we met with a range of Hong Kong-based companies. We also attended a CLSA conference called the Investors' Forum. And this is a pan-Asian conference where over 400 companies from around the continent all descend into Hong Kong, and we met with 40-odd companies between myself and Michael. A fascinating but also very efficient way to really get a good sense of how things are playing out in what is obviously a very dynamic region.

KB: And in terms of the macro, I mean, headlines here in the West paint a pretty bleak picture of the Chinese economy, but how was it on the ground?

PL: So I'd be delighted to share some anecdotes but I do want just to give two very important caveats up front. And the first thing is Sichuan Province, it is an important province, but it is ultimately still a relatively small part of an enormous country. So I'd be careful about extrapolating any anecdotal evidence across what is obviously a very big region. And then, secondly, you know, we had lots of high-quality meetings, but given we met with a number of state-owned enterprises (SOEs) and the state is often very involved in Chinese corporates, there is often a sense of maybe slight obfuscation where you never know you're getting the full picture.

With those caveats, I think the main kind of takeaways we had, the main punchline would be it's a mixed bag, in our perspective. So, on the one hand, there are certainly positive messages to share. Chengdu, in particular, we think was very, very impressive. They're obviously experiencing strong growth there. We saw some very, very modern, impressive, gleaming new office buildings. We saw generally quite a vibrant nightlife and what seemed to be, on the surface, a fairly buoyant consumer. We also saw the seas of cranes, which speak to that positive development that we're seeing. And we flew out of one of their airports, which is brand new. They kind of ran out of space at the old airport that was bursting to the seams, so they had to build a brand spanking new one.

So, again, that all speaks to fairly positive dynamic signs. But, on the negative side, there were a few more concerning indications. One example, we met with the Bank of Chengdu. Whenever you're going to a region, it's often very helpful to meet with a local bank because they are best placed to really give you a sense of how things are playing out on the ground. While they were talking up their exposure to the Chengdu CBD, in doing so, they implicitly acknowledged that areas outside of a fairly small part of Chengdu were a lot more challenged. So, parts of the broader Sichuan province definitely feeling a bit more pain, especially in the real estate sector that we've been reading all about. And, on that, whenever you go to China, you're looking for the classic telltale signs of overbuild and we definitely saw lots of empty tower blocks, which speaks to that overcapacity that we've been reading about.

Elsewhere, signs of weakness. We met with a range of baijiu manufacturers. For those who don't know, baijiu is the iconic Chinese national spirit, quite often associated with banquets and celebrations and big business deals being signed. So when a lot of the baiju players are telling you they are seeing softness, volumes are down, they're trying to make up with price, I think that's quite a strong indication that maybe the mood of the Chinese consumer isn't quite as buoyant as it has been for the last several years.

Still on the consumer theme, we were travelling obviously within China and going to travel retail locations, duty free stores. Whenever you entered a duty free store, we were immediately hounded by a desperate salesperson who was bombarding us with a barrage of discounts, which is never a great sign.

And then maybe on the industrial setting, just to round off the conclusions, I think, again, a mixed bag here. So, you know, we did certainly see some real signs of innovation and some amazing developments in different spheres of the industrial economy, but alongside that, there's clearly been massive overcapacity in various different realms. So, with that, you have a cyclical downturn, you have challenges, you have layoffs, etc. So, yeah, broadly speaking, quite a mixed bag.

KB: And like the rest of the world, China is clearly working hard on its renewables, as you saw when you visited, what I believe is known as China's “Green Silicon Valley”, if you could tell us a bit about that?

PL: Yeah, absolutely. So one of the main takeaways from the trip was that the drive for energy independence in China is very, very strong indeed. This is not about China being a good corporate citizen, being good for the world and trying to decarbonise their economy just for the sake of the planet. For us, what we’ve learned is that this is really more about self-sufficiency and energy independence. At the moment, China still imports quite a bit of fossil fuels to run their economy, and I think they see this as a strategic weakness in an economy that is bifurcating around the world. They don't want to have this potential kind of stranglehold or weakness, vulnerability. So, in light of that, they are desperately trying to become as self-sufficient in their energy landscape as possible. And renewables is at the centre stage of this. So, in Sichuan Province, certainly around the Leshan area, that, as you mentioned, has been dubbed the Green Silicon Valley. And really, this is the heart of some of the key renewable supply chains for China. It helps that there is enormous hydropower in the region because of the Yangtze river and others, so a lot of hydropower, which provides very low-cost electricity. And they're using this to really develop enormous solar supply chains in particular. And we explored this in depth, especially the photovoltaic supply chain.

KB: Sorry, what's that?

PL: So that is basically the core of solar power. And the raw ingredient that goes into making solar cells that obviously converts sunlight into electricity is polysilicon, and the manufacturing of polysilicon is a highly energy-intensive, labour-intensive, capital-intensive endeavour. And what we saw was amazing, just the scale of the developments and the manufacturing capacity being put down, using this cheap electricity to really create enormous capacity for polysilicon. It's the combination of human ingenuity and just sheer capital that is creating this very dynamic supply chain. And what this is ultimately doing is causing the cost of solar power to plummet, which is a great thing ultimately for all of us around the world, if we want renewables to become ever more cost competitive. So, great on one hand, but it also means that there has been a real sharp cyclical downturn, because these profit-making companies are really, really struggling to generate any positive cash flow in the shape of this oversupply and therefore collapsing prices. So yeah, very, very interesting seeing this first hand, a lot of dynamism, lots of ingenuity and innovation, but very much short-term pain as well.

KB: And earlier you referred to the SOE mindset of many of the businesses you met with. For international investors, Chinese companies can sometimes feel a bit difficult in this regard. Did you have any particularly tricky interactions?

PL: So I wouldn't say that we found the meetings difficult. I think the whole trip was seamlessly organised. We met with senior representatives of these firms that put on a great show and were very keen to meet with us as international investors. We had an excellent translator, so the quality of meetings were very high in this regard. But, to your point, there was maybe a slight frustration about just the lack of real open disclosure, potentially some state-directed messaging, being wary of talking down the economy.

We were obviously pressing on the state of the economy, trying to get first-hand anecdotes as to how the local property market is doing, how the consumer is faring. But we just came away from many meetings with a sense that there was a guardedness and an unwillingness to potentially reveal what's really happening on the ground, whether that is companies talking up their own book, whether there is a top-down, state-led directive to being a bit more circumspect, I'm not sure, but that was definitely a feeling we had.

AK: That state involvement element is quite interesting because we often think about it as just being a shareholder. But I remember back to my first trip when I went to China, we met with a lot of SOEs, and they were saying the state is also a very big customer to a lot of us, they can account to sort of 50-70% revenues, and they can be quite tricky. They might only pay their bill once a year. It really ties up your working capital, and so you often have to think about the state's involvement in many different ways of being a shareholder or potentially directing the message from the top down, but also as a tricky customer at times as well.

PL: Yeah, it's an excellent point.

KB: And Paul, turning to your second week in Hong Kong, it's obviously a tough time, whether it's the pro-democracy protests, the national security law, very, very strict Covid protocols. How did you find it being there?

PL: I've been lucky enough to go to Hong Kong a dozen times or so over the years, so I do know the city well, but this was the first time I'd been since Covid. So, for me, it was a very interesting chance to compare the kind of pre-Covid to the post-Covid world and some of the challenges that you articulated. And my overarching impression is that it feels a bit tired. Now, I don't want to convey a message that Hong Kong is down and out, but you do get a sense of a lack of dynamism, especially in comparison to what we witnessed over the border in China and the Chengdu area. So it's not dead and buried by any means. But, in previous visits, you really feel that you're at the gateway to China, you're in a modern city at the heart of an extremely exciting, dynamic region. Whereas now, I just couldn't help but feel that some of that dynamism and vibrancy was lost.

Just to give you one example, maybe to bring it to light – payments, I think, are the heart of any economic system, they're really the plumbing of an economy. And we're seeing rapid developments on that front in China, where you're paying everything with WeChat or Alipay. You can't pay with cash at all. In Hong Kong, it was the exact opposite. On the day I arrived, I wanted to take a local commuter ferry to a small island just off Hong Kong. I hadn't had the chance to take out any cash. I was unable to buy a ferry ticket without cash, which just seems mind boggling to me in this day and age, 2024, in a city that is aspiring to be the economic heart of this exciting region. It's the same with taxis as well, famously, so there were certain feelings like that where you thought it should be doing better, it should be more on the front foot, like some of the competing regions nearby.

AK: And it's really interesting hearing that too, because you contrast it to the likes of China, where I remember on both trips it was really, really hard getting around trying to pay because they wouldn't accept cash at all, but also really wouldn't accept our cards unless you were locked into that network of WeChat or other ways to pay. So it is interesting hearing that contrast with Hong Kong.

KB: And, given that backdrop, what did you hear from companies in Hong Kong?

PL: We still had good quality meetings with some of the Hong Kong-based companies. So, for instance, we met two of the pan-Asian life insurance companies, AIA and Prudential there. And, actually, they had a fairly positive message to say about mainland Chinese visitors, in particular, coming back over the border after years of that border being closed due to Covid. They're certainly seeing much more cross-border traffic and also, in China itself, given the challenges of the real estate market there and consumer sentiment around property being a vehicle to save money for the long term, a lot of Chinese individuals are much more inclined to look for the formal life insurance and savings policies offered by the likes of AIA and Prudential. So, while there has been negative sentiment towards these types of names, we actually think the fundamentals are trending in the right direction. So that was encouraging.

And then we also met with Jardine Matheson, a storied pan-Asian conglomerate and, in fairness, their Hong Kong-based property exposure probably is struggling and will be for several quarters to come. There isn't an obvious inflection point that will really see a big uptick there. But, on the other hand, there's definitely more positive stories to be told about some of their, you know, ex-Hong Kong-Asian exposure, countries like Indonesia, like Thailand, like Vietnam. We're definitely seeing much more growth there as some of these countries benefit from a “China Plus One” supply chain diversification strategy. So I think having good exposure to much more faster growing countries like that definitely bodes well.

KB: Yeah, really interesting. And AJ, back to you. Paul and Michael obviously had a great two weeks in China and Hong Kong. Where else have the team been out about?

AK: Yeah, so still loads of trips going on. Over the quarter, we had Des travelling, he went to California and he met a whole bunch of med-tech companies there. We also had trips to Finland and Rio as well. And this continues right now, so at the moment we've got Fraser and Connor who are out in India for two weeks. And, in fact, I'm heading out to Switzerland next month to meet some healthcare companies and also some industrial automation suppliers out there.

KB: And looking back at this, the third quarter of 2024, what have been some of the most noteworthy developments with companies over the quarter?

AK: Some of the interesting developments I'd like to highlight are probably in the healthcare market. Firstly, so you look at a company like Edward Lifesciences. This is a med-tech company. They had reports of potential slowdowns in their TAVR procedure growth. We also saw a lot of other companies across the semiconductor industry have quite big share price moves, so the likes of Intel with their headcount cut, but also Nvidia, and that all weighed on the markets.

Consumer weakness was another theme that we actually saw play out across a lot of companies, but, interestingly, not all businesses. Some actually were thriving. I'd probably shine a light on companies such as TJX and Costco, two retailers which were seeing quite good levels of same-store-sales growth come through. But it was interesting that that weakness we were seeing was seen right across the spectrum, in terms of businesses like McDonald's saying that, having a value offering, a $5 meal deal, was really, really important for their consumers and that there was potential worries that weakness was possibly spreading up from the lower income to the middle income class.

And, actually, we did see that being echoed by some of our luxury names out in the industry. I think of a company like LVMH, or even Hermès, although they were still growing in the quarter, it was a sequential slowdown in growth and, I think, really echoed by a lot of peers in the market. Again, you look across the consumer landscape and you think of a business like Nestlé in the food and beverage space, or even a business like O'Reilly, which is a retailer in auto parts, again, they shared quite similar comments on consumer weakness.

But I think what's really important is, in uncertain times, consumers save, and that's really good for businesses like life insurance companies. And so, when we look at a company like AIA or Prudential, both of which are Asian life insurance businesses, they have really pointed to seeing that with Chinese consumers. So although weakness in the Chinese consumer market, those consumers are saving much more.

KB: And either out on the road or at home here in Edinburgh, what have been some of the highlight meetings over the quarter?

AK: I'd probably pick on Des's trip firstly, so his trip in California, he met over 20 med-tech companies there, all of which sharing their interesting anecdotes on being innovative providers of technology, pioneers in the industry. And one of the standout meetings that he had was with Intuitive Surgical, which is a robotic surgery manufacturer. It was with their new president, David Rosa, who was really solidifying the company's leading position there in the industry. And we've really seen that come through in the numbers as well, so when you look at the most recent set of quarterly results, we're seeing the fastest levels of growth in its installed base that we have actually seen over the last ten years.

And we had loads of management meetings in the office. I'd probably highlight one of note, which was with Waters. This is an analytical and measurement business. We had the CFO in the office and a really interesting read across for the whole industry, actually, because the CFO was highlighting that the life sciences equipment part of the business has now seen its seventh consecutive quarter of negative growth which, when you contrast that with historical cycles, they've typically only lasted sort of four to seven quarters. And so, this could indicate that we're actually likely to be at the bottom of the cycle for both the industry and Waters itself. And, I think, coupling that with the fact that there has been several years of underinvestment in upgrading equipment, we could see quite a meaningful upgrade come soon after this.

KB: AJ, as mentioned, you have recently been chair of the Research team. Could you give a quick recap on what that role entails, please?

AK: Sure thing. This is a rotating role that every investment manager on the team does at some point during the year. And really your key role is chairing the research meetings, you'll also be summarising the views and the outcome of the team, and then ultimately sharing those views and thoughts to the investment executive.

KB: Great. Well, that's been an excellent update all round. Thank you, Paul and AJ for your time today. To our audience, thank you for listening. Goodbye.

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