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LOOKING BEYOND THE HEADLINES

ON THE ROAD IN CHINA

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China's days of turbocharged growth may be a thing of the past, but the country's economic evolution has put it in the vanguard of some powerful long-term growth trends. A research trip to two of China's fastest growing cities revealed more.

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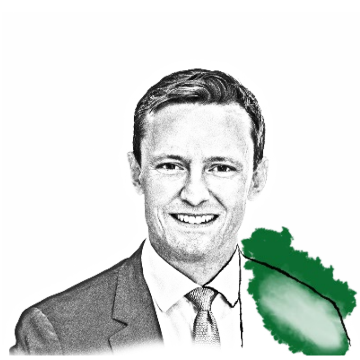

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Ten years ago, two members of Walter Scott's Research team, Charlie Macquaker and Tom Miedema, visited Chongqing and Chengdu in southwest China. Back then, neither city featured high on the itineraries of investors. Shanghai and the southern seaboard's Greater Bay Area were where the action was. Yet, despite being relatively 'off the radar', Chongqing and Chengdu were far from backwaters. Boasting a combined population of 14 million, they had an infectious energy and confidence lacking in many large Western cities.

Revisiting Charlie and Tom's notes from that trip, it's hard not to feel a pang of nostalgia. Whilst far from being hymns to China – none of the companies visited passed muster from an investment perspective – they are undeniably optimistic in tone. Understandably so. The economy was booming, shiny new infrastructure was shooting up everywhere, and Western brands were making hay. Geopolitics fell into the tail-risk category and ever-greater economic integration between China and the West seemed inevitable.

RETURN TO CHONGQING AND CHENGDU

A decade on from Charlie and Tom's trip, we spent a week in Chongqing and Chengdu. Much has changed in the intervening years. China's economy is most definitely not booming, the country is proving a much trickier market for Western brands, and geopolitical risk looms large. Ever-greater economic integration between China and the West no longer appears inevitable.

One constant, however, is the dynamism of Chongqing and Chengdu. Both still crackle with energy (if you haven't been, watch an online video to get a sense of their verve and scale). Two of the fastest growing cities in China, they are the focal points of the Chengdu-Chongqing Economic Circle, the first national-level economic development zone in the west of the country. Whilst late developers relative to their more illustrious peers in the south and east, their economies are now amongst the most vibrant thanks to the growing presence of high-end manufacturing alongside low-cost renewable electricity and affordable housing.

"Ever-greater economic integration between China and the West no longer appears inevitable"

Across a series of meetings, we spoke with companies from a diverse range of sectors. An on-the-ground opportunity to quiz the management teams of some fascinating businesses, these meetings also yielded insights into industry growth trends and wider macroeconomic conditions in China.

Three areas were of particular interest:

- China's booming electric vehicle (EV) industry and the impact on Western manufacturers
- The implications of China's huge investments in decarbonisation
- Baijiu, China's iconic national drink, and the read-through to the Chinese consumer

AN ELECTRIC VEHICLE SUPERPOWER

Scroll back to 2021 and China's auto manufacturers lagged well behind the traditional exporting powerhouses of Germany, Japan and South Korea. Today, the country is the world's leading exporter of passenger cars. How China managed this impressive feat is in large part due to its expertise in EVs.

Contrary to the popular narrative of China being a copier of Western innovation, the country's EV players are amongst the most innovative auto companies globally. State support has been vital to their development, but these are no mere subsidy junkies. Many are efficient, leading-edge businesses. Not only are their vehicles considerably cheaper than those of Western peers, but they can develop and release new models much more quickly. Little wonder that they have come to dominate the global EV market. Even Elon Musk, once dismissive of Tesla's Chinese rivals, has grudgingly acknowledged that its auto manufacturers are "the most competitive car companies in the world."

All of this signals tough times ahead for the Western marques operating in China today. The likes of BMW, Mercedes, Audi and Tesla (which recently exported its millionth vehicle from its Chinese manufacturing facility) might still dominate the premium end of the market, but the domestic competition is stealing a march on them with better technology, longer battery ranges, and lower price points. This looks like being an increasingly competitive market for Western brands, many of which have staked a great deal on success in China.

> *"[China's] EV players are amongst the most innovative auto companies globally"*

It's not all good news for China's EV players, however. The imposition of trade tariffs by the US and EU has complicated the export route map, an unhelpful development at a time when many companies are looking to overseas expansion as an offset to intense domestic competition.

Speaking with Changan, one of the major Chongqing-based auto players, it was clear that its export focus for now is South-East Asia, a market with enormous potential and fewer geopolitical complications. The share of Chinese-made autos in the region is projected to grow from 13% in 2023 to 27% in 2030, with EVs accounting for 60-70% of vehicles sold.

GREEN SILICON VALLEY

Rich in natural resources and access to clean energy, the Chengdu-Chongqing Economic Circle is central to China's ambitions of achieving energy independence. In today's uncertain geopolitical environment, Beijing has identified a reliance on imported energy as a strategic vulnerability. This desire for energy security, more than environmental considerations, has prompted huge investment in low-carbon technologies in recent years.

Whilst still heavily dependent on imported fossil fuels, China is now the world leader in solar and wind power, with installed capacity massively outstripping other major economies. It has also established dominant positions in renewable supply chains. In solar, it is estimated to have around 80% of the world's polysilicon, wafer, cell, and module manufacturing capacity. Meanwhile, four of its wind turbine manufacturers are in the world's top five.

The Chengdu-Chongqing Economic Circle is home to China's "Green Silicon Valley", a vast ecosystem of companies involved in the solar power supply chain. GCL Technology, for example, manufactures polysilicon for use in photovoltaic solar panels. An unremarkable business until quite recently, the acquisition of SunEdison's solar business enabled GCL to commercialise a polysilicon manufacturing process called FBR. Cheaper, cleaner and reputedly producing polysilicon of a higher quality than the prevailing process, FBR has transformed the company's prospects.

> *"China is now the world leader in solar and wind power"*

Like other players in the solar supply chain, however, GCL has endured a hugely volatile few years. An explosive upswing in demand when China formally embarked on the path to decarbonisation and energy independence was inevitably followed by a period of over-supply and plummeting prices across the entire supply chain. Now, with many companies struggling to operate well below their cost of production, supply is starting to exit the industry. Once that process has played out, the long-term outlook for those companies left standing should be extremely bright.

WELCOME TO LIQUOR CITY

Although its exact origins are unknown, Baijiu, China's national drink, is thought to date back several thousand years. A colourless spirit typically made from a variety of raw materials, including sorghum, rice, corn, barley and wheat, the drink is an inseparable part of Chinese etiquette and a must-have at events and celebrations. Mao Zedong presented baijiu as a gift to Joseph Stalin when the two met in 1950 and it was served at the welcoming banquet for Richard Nixon's epochal trip to China in 1972. In 2023, global sales of baijiu were estimated at US$167 billion.

A couple of hours outside Chongqing is Luzhou, also known as 'Liquor City' and home to some of China's largest and most storied baijiu producers. One of these, Luzhou Laojiao, operates 400-year-old fermentation pits, in which sorghum grain is fermented over a period of months. Over time, the unique microbiome of each pit develops ever-more complexity. This unparalleled maturity creates a strong brand narrative and acts as a major barrier to entry for Luzhou Laojiao's ultra-premium baijiu.

Also based in Luzhou is Wuliangye Yibin, China's second largest baijiu producer and the second most valuable spirits brand globally (its fierce competitor Moutai is first, with Luzhou Laojiao third). For comparison, Wuliangye's brand was valued at US$26 billion, more than four times that of the nearest Western brand Hennessy.

Wuliangye plays at the higher end of the baijiu price curve and so is well positioned to benefit from the 'premiumisation' trend of Chinese drinkers trading up in quality. It recently released a hyper-premium product costing over 2,000RMB per bottle (around US$280), tapping into the ever-increasing demand from the richest in Chinese society.

> *"[Baijiu] is an inseparable part of Chinese etiquette and a must-have at events and celebrations"*

However, both Wuliangye and Luzhou Laojiao spoke of headwinds from a slowdown in consumer spending. Big occasions for high-end baijiu consumption, such as banquets and business celebrations, are happening less frequently, and the propensity for gift giving is also subdued. Whilst this has been offset by the structural growth of the market and the trend towards premiumisation, it may take time before growth accelerates to the eye-catching levels of the baijiu boom of a few years ago.

PRISING OPEN THE CHINESE WALLET

Reinvigorating consumer confidence, alongside stabilising its troubled real-estate sector, is the key challenge facing Chinese policymakers. The downbeat messaging of the baijiu houses in Luzhou was echoed by companies we met with when we attended a conference in Hong Kong to round off our trip. Companies from the beauty, apparel and luxury sectors spoke of a challenging environment in which consumers are choosing to save rather than spend. The one silver lining appears to be that this caution is sentiment driven rather than due to falling incomes or genuine economic hardship. In short, the Chinese consumer is worried.

The million-dollar question now is whether Beijing's recently announced package of monetary stimulus and still-vague statements concerning supportive fiscal measures will be enough to resuscitate the animal spirits of the Chinese consumer and stabilise the country's troubled real estate sector, which has been a key drag on consumer confidence and industrial activity. Can Beijing pull off its own "Draghi moment", a "whatever it takes" intervention that puts a floor under property prices and establishes mechanisms for clearing inventory?

In the immediate aftermath of the announcement, the market signalled its approval, sending Chinese stocks on an explosive rally in the closing days of September. The euphoria did not last long, however, and investors have since been more circumspect. The onus is now on policymakers to follow through on their initial communications with concrete details of substantial and well-crafted fiscal support.

> *"Reinvigorating consumer confidence, alongside stabilising its troubled real-estate sector, is the key challenge facing Chinese policymakers"*

FINAL THOUGHTS

Travelling around China can serve as a useful antidote to the negative media coverage of the country we are often exposed to in the West. Contrary to some of the more doom-laden headlines, there is still a huge amount of economic dynamism and innovation on display. The country is also making genuine progress in its efforts to move up the manufacturing value chain as it attempts to transition away from its old investment and property-led model.

That said, there are clearly issues that the country needs to address. The visitor does not have to look too hard for evidence of real estate overbuild and industrial over-capacity, whilst outside the gleaming big cities signs of economic pain are more prevalent. As mentioned above, the authorities have work to do to boost the average consumer's sense of financial security.

What does all this mean for investors? Well, we don't subscribe to the view that the China 'story' is over. True, the days of breakneck economic growth may be a thing of the past, but as the country positions itself at the forefront of emerging trends, such as renewable energy and electric vehicles, it is becoming an ever more important component of the global economy. China, in our view, will continue to offer exciting opportunities for the right company, with the right strategy and the right product.

If you would like to learn more about Paul and Michael's research trip to China, **please listen to our Q3 podcast Talking Research: Challenging Thinking on China** https://www.walterscott.com/talking-research-challenging-thinking-on-china/

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