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2015 Morgan Stanley China conference feedback

Anchor Capital Fund Manager, Peter Little and analyst, Liam Hechter attended the *2015 Morgan Stanley (MS) China Conference*, which took place in Beijing from 27–29 May. Below we include feedback and summaries around the main points raised at the event.

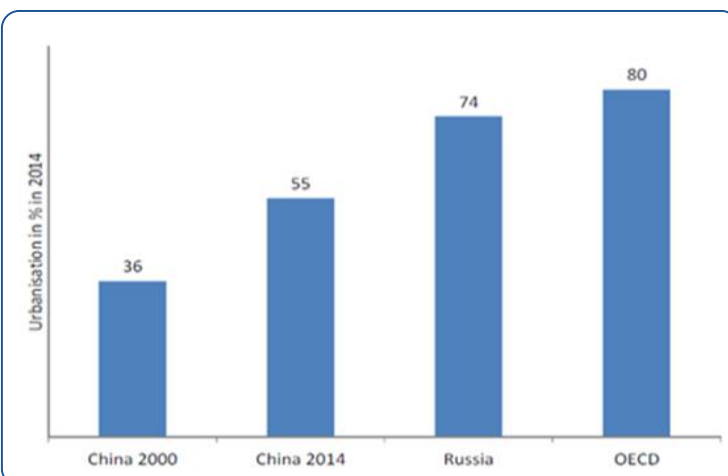
Peter and Liam attended about 30 sessions over the 3 days including panels and presentations by C-suite members of some of the largest and most innovative companies in China, industry experts, heads of government organisations & leading Asian investment professionals. Liam also participated in a 2-day trip prior to the conference in Chengdu and Chongqing which included visits to local banks and property developers. This summary contains some of their thoughts on the areas which have the highest potential from an investment perspective.

China's general economy:

China's growth has been phenomenal and the country has gone from contributing 5% of Global GDP in 2004 to a 13% contribution in 2014 (c. $10trn). Currently the population stands at c. 1.3bn (about 18% of the world's population). Demographic trends are unfavourable, largely as a result of a one-child policy which was implemented in the 1980s with births peaking in that decade, before dropping 23% in the 1990s, and a further 36% in the 2000s. Currently 10% of the populace are above 65-years of age, however, this number is forecast to increase to above 20% by 2023. China's workforce has also been shrinking since 2012 (3.7mn left the workforce demographic in 2014 alone).

Urbanisation is still far behind developed world levels and reform in this area should see approximately 100,000 people p.a. moving to urban areas. GDP per capital in some of the major urban areas like Beijing can be more than double that of the national average.

Urbanisation in China still has substantial upside:



Source: World Bank, Morgan Stanley Research

In terms of China's stock markets, they were worth $390bn in total in 2004 (the Hong Kong stock market capitalisation was about $1.1trn in 2004, of which about 40% of the market capitalisation was attributable to Chinese companies listed in Honk Kong).

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We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watchlist, which is continually reviewed and updated.

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Market capitalisation of Chinese listed companies is currently above $10trn (in addition, 40% of the Hong Kong stock market capitalisation of $4.2trn consists of Hong Kong listed Chinese companies). Earnings have slowed recently with the MSCI China Index recording a 1% earnings per share (EPS) compound annual growth rate (CAGR) last year vs the 9% growth historically. New economy counters including IT, consumer and healthcare stocks, have shown EPS growth of 8.2%, while the so-called old economy sectors and shares (such as materials, energy, construction, ship building etc.) have recorded a negative 2.3% EPS growth. The Shenzhen Stock Exchange is trading at a 62x trailing P/E (96th percentile), while the Shanghai Stock Exchange trades at a 29x trailing P/E (20th percentile). The MSCI China's return on equity (RoE) now stands at c. 11% and, although there are problems being experienced in the property and capital goods sectors, consumer sectors are still in good shape with high RoEs.

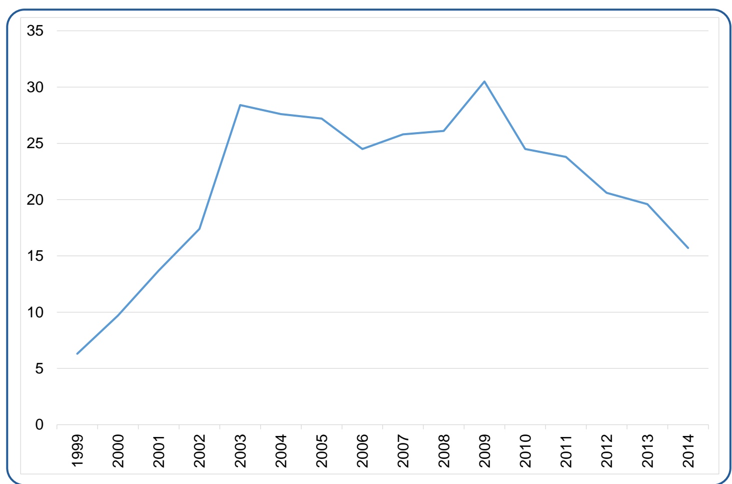
At the moment the difference between the performance of China's stock market and its economy is the broadest it's ever been and MS believes that either the market or the economy needs to react to correct this at some point in the near future.

China manufacturing value added is 40% larger than the rest of emerging markets (EMs) combined. The country's savings rate is high, standing at 45% compared with the US' 15%.

While welcomed, the Chinese government's anti-corruption drive has been a drag on GDP and China has also only achieved 86% of fixed-asset investment (FAI) in 2014 (the remaining 14% would've added 40 bpts to the country's GDP). The result is in 2014, local governments underspent by RMB2.7trn – this money still needs to be spent in 2015, which will be a boost to GDP.

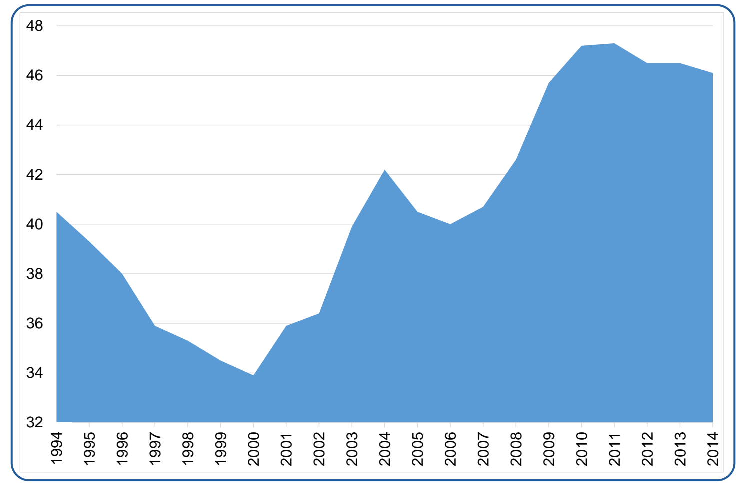
FAI, which has been the largest driver of GDP growth, is starting to slow. Property accounts for 20% of FAI (this segment is unlikely to grow in the near term), infrastructure also stands at 20% (and is expected to grow), while production capacity is at 60% (this segment is also unlikely to grow).

China YoY FAI growth, % change:



Source: Bloomberg, Anchor Capital

Capital formation (% GDP):



Source: Bloomberg, Anchor Capital

China healthcare:

In 2012, China's Healthcare spend was equal to c. 5% of the country's GDP (in the US, for example, healthcare accounted for 12% of GDP in 2012). From a product adoption perspective China is about 15% of where Japan and Korea were at similar stages of their development. However, over the past 2 years the Chinese market has changed in terms of healthcare with private hospitals becoming the focus and now accounting for 48% of the market. Public hospitals are by and large seen as inefficient and also have major funding problems.
The Chinese Ministry of Health recently introduced a five-year plan which includes the following:

- Increasing public hospital beds to 6/1,000 by 2020 (currently it stands at 4.5).
- Increasing private hospital beds to 1.5/1,000 by 2020 (currently it stands at 0.5 beds per 1,000). Lots of additional capacity here is expected to come from the privatisation of SOEs.

However, there are also challenges in China's healthcare sector. These include:

- A scarcity of doctors: Only two-thirds of medical doctors are practicing in hospitals and for hospital groups such as Chindex it is becoming increasingly difficult to find doctors practicing western style medicine.
- There is also a lack of family doctors providing general care in community hospitals.
- Of the c. 600,000 medical graduates p.a., only around 100,000 go on to practice medicine. Doctors are underpaid and there is increasingly a need to reform pay in order to attract talent.
- Central government concerns also remain around building hospitals in Tier-1 cities (the government does not want these cities to attract doctors away from the rural areas). According to *osio-china.com*, Tier-1 cities were the first to be opened to competitive economic development by the Chinese government. These cities are recognised for being densely populated as well as culturally and economically influential and generally attract the attention of foreign enterprises given their large middle-class representation and income levels which are well above the national average. Tier-1 cities therefore represent China's most developed markets in terms of consumer behaviour.

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- Public hospitals receive 60%-80% of their revenue from drug sales (these hospitals vastly over-prescribe and are often corruptly incentivised by kick-backs from pharmaceutical companies).
- In order to become government reimbursable, hospitals need to get fully in line with the public pricing model (price master). The government also sets annual caps on reimbursement which are often already reached by October.
- The government also controls public hospital procedures and won't reimburse those public hospitals that increase their spending by above 15% p.a.

Some facts around health insurance in China:

- In 2012, RMB2.7trn was spent on healthcare in China - 30% was paid by government, 36% by social security insurance and 34% by patients.
- Currently only 3.6% of China's population has private healthcare cover (vs ~ 60% in the US), and there are only 5 commercial healthcare companies in the country.
- 100% of the population is insured by government with:
    - outpatients getting 70% of spending reimbursed,
    - in-patients getting 80% reimbursed; and
    - there are also no waiting lists.
- Many believe that private healthcare in the country needs to control costs of medicine by reducing, for example, issues with over prescription.
    - Currently private hospital revenue accounts for 80% of medical services and 20% of drugs (the inverse of public hospitals).

Among the private healthcare providers we highlight the following companies:

- **Phoenix Healthcare (1515 HK; Price: HKD15.64; Market Cap HKD13.0bn; 12M fwd P/E 44.7x)** is a hospital operator. Although it doesn't own any hospitals the company is a government and SOE hospital operator and mainly deals with self-paid and government insurance (80% of its revenue comes from government reimbursements). The company does not manage specialised hospitals.
- **Hua Xia (8143 HK; Price: HKD1.35; Market Cap: HKD2.26bn)** owns and manages private hospitals. 80% of its revenue comes from two to three specialised services within these general hospitals. It plans to acquire more general hospitals and then to focus on specialties within those hospitals.
- **Chindex International** is a private company owned by TPG, Fosun and management. It is focussed on the middle, upper-middle and high-end consumer. It is 60% insurance paid.65% of its clients are locals with the remainder being expats. Chindex currently has 600 doctors nationally (with 60% trained abroad) and also has its own post-doctoral training programme (which includes training for nurses). Its first hospital opened in Beijing in 1998 and it now has 10 clinics around Beijing. It has a 100-bed rehab center and outpatient cancer-treatment centres (both unique in China), which are both being rolled out in other cities in the country. It has standardised records and access to data nationally. The company went private at the end of 2014 (when it was acquired by TPG, Fosun and its management).

__China travel and leisure__:

In China's travel sector, leisure travel is currently the strongest growth area by far with growth seen in internal travel (weekends away and summer holidays), as well as outbound travel (this segment is showing 15% growth p.a. with 30% growth p.a. in online bookings). Many countries have also relaxed their visa requirements to attract Chinese travellers (the EU started relaxing its requirements about 3 years ago and the US also relaxed its requirements last year). Currently, only 7% of the Chinese population have passports (vs 30% of the population in the US) so there is still significant room for outbound tourism growth. There has also been a major shift to online travel bookings with 30%– 40% of flights and hotels as well as 10% of package-tours being booked online. Most Chinese outbound travel includes some form of organised shopping and, as an example, the average Chinese traveller who booked travel to Hawaii using ctrip.com spent $2,000/day (excluding flights and hotels).

__**China online travel GMV, 2011–2018:**__

Source: iResearch

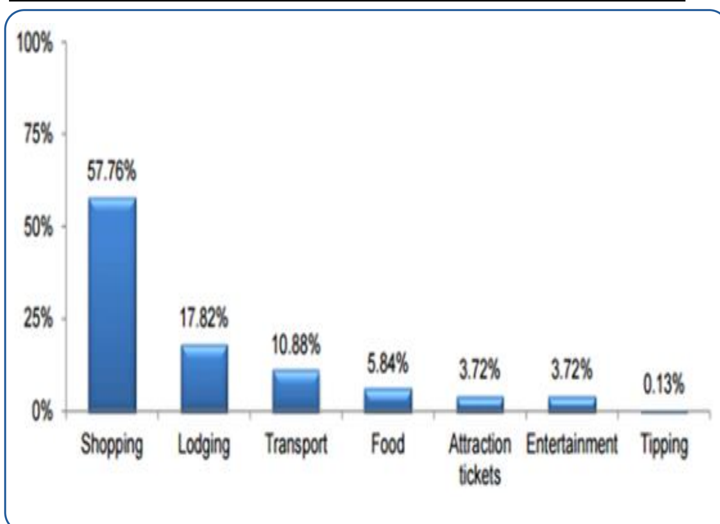
Note: Online travel gross merchandise volume (GMV) refers to the total value of travel products including air tickets, hotel rooms, vacation tours, etc. booked and successfully transacted online or via a call centre from online travel service providers. It includes online direct-selling of suppliers and online distribution of third-party OTAs.

The following travel companies operate in China:

- **Ctrip (CTRP US; Price $71.64; Mkt Cap: $10.5bn; P/E 89x)**. In 2014, the company recorded excellent growth in air travel (+64% YoY), hotel bookings (+60% YoY) and outbound travel (up > 100% YoY). It has a formal joint venture with Priceline for non-China business and it also owns stakes in competing Chinese online travel agencies ([OTAs], Elong and Tuniu). In 4Q14 the Group reported a $400mn loss which dropped to a $20mn loss in 1Q15 and for 2Q15 it is guiding to a profit. Ctrip aims for the high-end of the travel market with 50% business travel and 50% white-collar travel. 60% of first and business-class outbound tickets are booked on Ctrip. The business has a high-service model – it will arrange for evacuation of clients in the event of a natural disaster and it also self-insures against these natural disasters. According to the company 80%-90% of its clients are return customers.

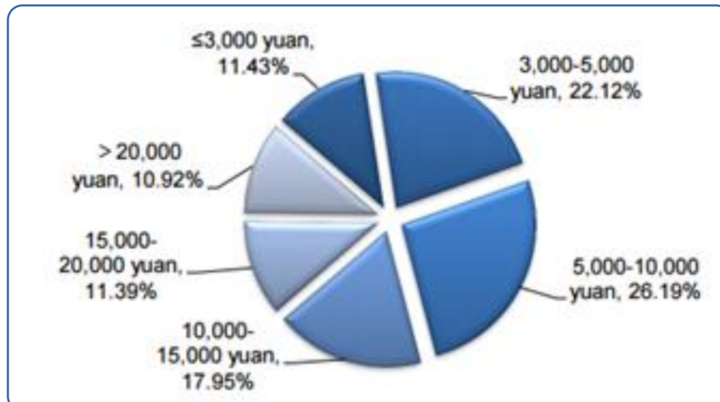
- **Tuniu (TOUR US; Price: $18.85; Market Cap: $1.2bn).** The company is growing at a rate in excess of 100% p.a. Ctrip owns a stake in Tuniu and has two members on its board, while JD.com is also invested in the business. The company focuses on packaged tours where margins are higher and price comparisons are more difficult.
- **China Lodgings (HTHT US; Price: $26.11Mkt Cap: $1.6bn; P/E 36x):** The company is a hotel operator with 2,000 properties (it is opening a further 700 properties this year). The Group is a leader in multi-brand strategy and has gone from 30% leisure guests in 2010 to 50% in 2014 (leisure travel is growing extremely fast). Currently 8% of bookings come through OTAs (the company prefers sourcing customers direct).
- **eLong (LONG US; Price: $18.47; Market Cap: $0.7bn).** eLong operates as a mobile and online travel-service provider in China, presenting its customers with travel information and the ability to book hotel rooms, air tickets, and other services utilising its mobile and web technology, and customer service centres.
- **Qunar (QUNR US; Price: $43.71; Market Cap: $5.6bn).** Qunar operates an online travel commerce platform in China. The company provides a range of travel products comprising flight tickets, hotels, vacation packages, and attraction tickets, as well as display advertising, train tickets, car services, smart lodging, and other services.
- **Dufry (DUFN SW, Price: CHF138.60; Mkt Cap: $9bn; Fwd P/E to December 2015 – 19x).** The company operates duty-free shopping in the US, France, Italy, Singapore, Mexico, Russia, Caribbean, UAE etc. So far only 5% of Chinese tourists have visited Europe and duty-free assets in Asia usually trade at greater than a 20x P/E while Dufry appears cheap on a relative basis.

Biggest consumptions of Chinese outbound tourists:



Source: World Tourism Cities Federation

Consumption for shopping of Chinese outbound tourists:



Source: World Tourism Cities Federation

Shopping spots chosen by Chinese outbound tourists:

Source: World Tourism Cities Federation

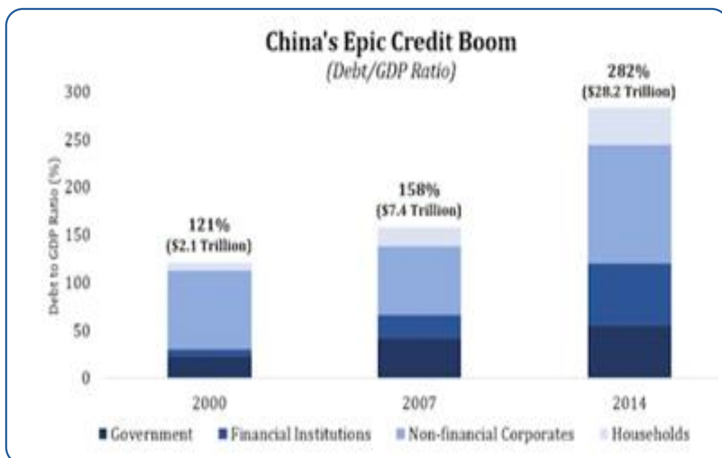
Banks:
In 2014 banks had assets of RMB179trn and liabilities of RMB166trn (liabilities included 73% deposits, 15% interbank). By 1Q15 banking sector net profit stood at RMB552bn (RoA 1.3% and RoE 17%). In terms of asset quality as at December 2014, non-performing loans (NPLs) stood at 1.25 and by March 2015 it had increased to 1.39 (with coverage of 212%). However, experts at the conference suggested this number could be 30%–40% understated. *The sector's common equity tier 1 ratio* (CET1) improved from 10.04 last year to 10.66 in 1Q15.

Government reforms have seen five private banks approved to operate in the country so far this year and foreign licensing standards have also been relaxed by government (foreign banks still make up less than 2% of the industry, and this has come down from 3.6%).

Real estate lending accounts for 22% of total bank assets of which 31% are mortgages and 25% are loans to developers, making mortgages 7% of total banking assets. 97% of mortgages have loan to value (LTV) ratios < 90% and 93% of mortgages relate to first home purchases. Loans to developers make up 5% of total bank assets of which 80% of loans have > 30% own funds contributed to the relevant development projects by the developer. Chinese banks are exempt from additional capital requirements for the global list of systemically important banks (GSIBs). Loans to the public sector have 20% risk weight (mortgages 50%!).

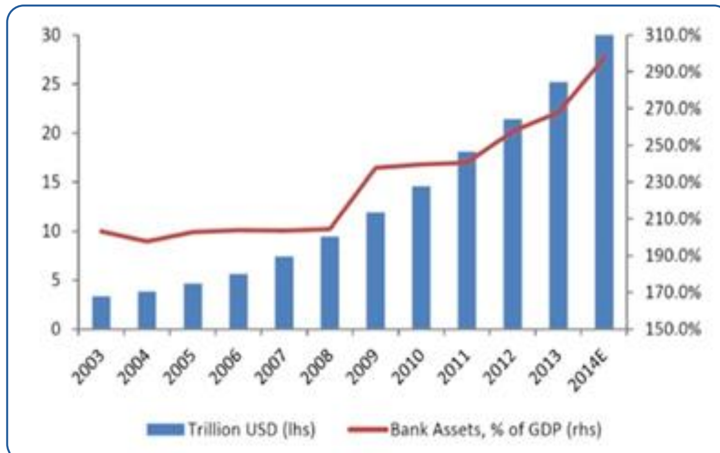
While Chinese banking NPLs are certainly understated, the problem doesn't seem to pose the systemic risks that some commentators fear. The government's debt swap program which will allow many of the Local Government Finance Vehicles to consolidate their debt at the provincial government level, where bonds will be issued, should have a large impact on the problem. One overhang for the sector does seem to be the possibility that the government may look to raise funds by selling additional stakes in the major state owned banks.

China's epic credit boom, (debt/GDP ratio);



Source: Mauldin Economics

Explosive growth in China's banking system assets:



Source: Logan Wright, Medley Global Advisers

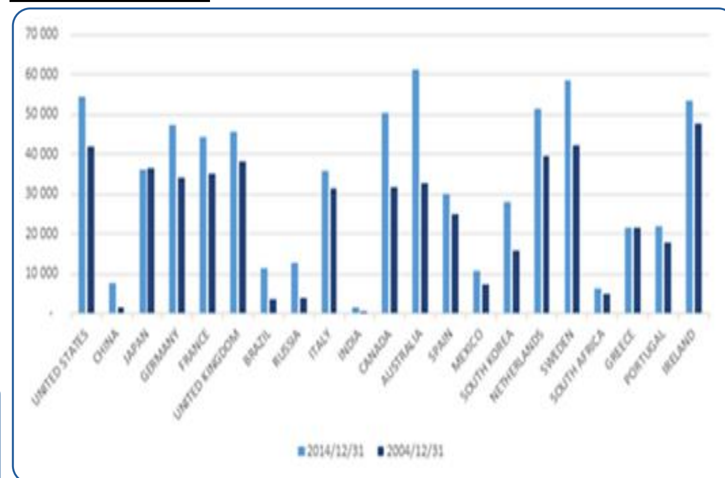
The current NPL cycle is different from the last one (10 years ago). In the previous cycle, SOEs needed to go public, so they had to spin off NPLs. 50% of NPLs at the time were caused by state policies and couldn't be collected. However, in the current cycle, it's a case of dubious credit, but with collateral and this has mostly been caused by liquidity problems. There has also been a high concentration in the property, steel trading houses and import/export companies. Missing inventories in the steel industry meant that land was often the only asset left as collateral. At present, decent loans can be bought at 30% discount to par value and can then earn an internal rate of return (IRR) of 10% p.a. The value of collateral is also severely understated. Currently there are also more financing tools available to restructure loans (for example by issuing bonds etc.) and the legal structure for collection is good (in the Yangtze and Pearl valleys).

The current major players in NPL digestion are the four SOE asset management companies which can digest c. RMB700bn–RMB800bn, the private sector (including foreigners, individuals and private companies) which can digest c. RMB100bn–RMB200bn and banks which need to digest c. RMB100bn–RMB200bn. Local governments in China have also been helping with NPLs by re-zoning land held as collateral.

Consumer:

In China c. 8%-10% of retail spending is done online (in the US this stands at c. 5%-6%), while 36% of GDP is consumption (~ $3.6trn). MS believes that China's online consumption is underestimated by ~ $2.0trn.

GDP per capita:



Source: Bloomberg

The top-20 retailers in the US have a 40% market share but in China the top- 20 retailers only have c. 12% market share.

JD.com (JD US; Price: $34.71; Market Cap: $48bn).

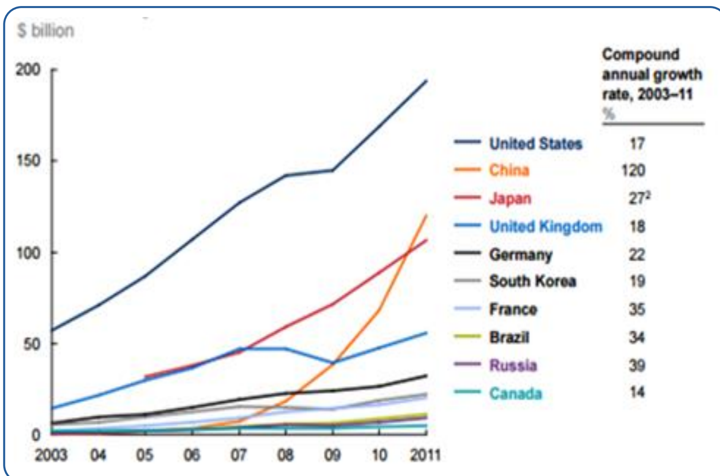
JD.com is the number-one retailer in China by net revenue and direct sales (in the US, for example, the biggest online retailer, Amazon, is in ninth spot), while the Group is also second in marketplace (behind T-mall). The business is growing at 64% p.a. (most offline retailers grow in the low single-digits, so it is also gaining significant market share). It started life as an online electronics retailer, but has been diversifying into other goods in its direct sales and also adding the marketplace segment to its business which will allow other merchandisers to sell their goods on its platform.

The company's gross margin currently stands at 7% vs~17% for its offline peers. This is mostly because it hasn't reached scale in all categories and its lack of investment in promotions. JD.com's expense ratio is 5% (much lower than its offline peers). In 2014, the company experienced 107% YoY GMV growth and 66% YoY net revenue growth and although it entered the marketplace segment much later than T-Mall, it is nevertheless growing faster.

JD.com is peerless in the logistics space and it has its own proprietary logistics business. It has 7 main service centres (each with over a 100 warehouses) in strategic geographic regions around China. The same goods are kept in all 7 of these service centres, allowing the company to decide which is closer to the customer and dispatch the goods from there. While the US model is to have good IT infrastructure to connect logistics companies, in China JD.com believe you need your own quality logistics to ensure quick and reliable delivery of orders. JD also has its own delivery staff, who it sees as the "face of the company" and these delivery staff are also local to certain areas. They are paid 1.5x better than the average delivery person's salary, which results in the company having a much lower staff turnover.

In 2014, JD.com recorded 107% YoY GMV growth and 66% YoY net revenue growth. Margins are also expanding (mainly because of the marketplace segment's growth). The business is investing in growth for 3–5 years hence, and we should see an expense ratio uptick as well. JD.com has surprised the market with its profitability for the past two results, but the company has guided that it does not expect that to happen going forward. The company is looking to achieve market dominance across multiple sectors. It is very cash flow positive and its marketing expenses can be easily scaled if the economy slows. JD also has good real-time inventory management (inventory turnover is, for example, much better than Amazon) and the average purchase per customer is growing (it stood at 7 p.a. in 2008, and is now at 18p.a.). It finances its merchants at 9% (and holds their stock as collateral). The company is currently trialling a consumer finance business on an invitation-only basis

China's e-tailing market has posted the world's highest growth rate, 2003-2011:



Source: Euromonitor, Forrester, US Census Bureau, Japanese Ministry of Economy, Trade and Industry, iResearch, McKinsey Global Institute analysis

1. *Excluding online travel.*
2. *Japan's CAGR covers 2005-2011.*

Peter Little
Liam Hechter

The business of money: Global asset management and stockbroking

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