

The Modern Chinese Consumer – New Economy Opportunities

ViewPoint

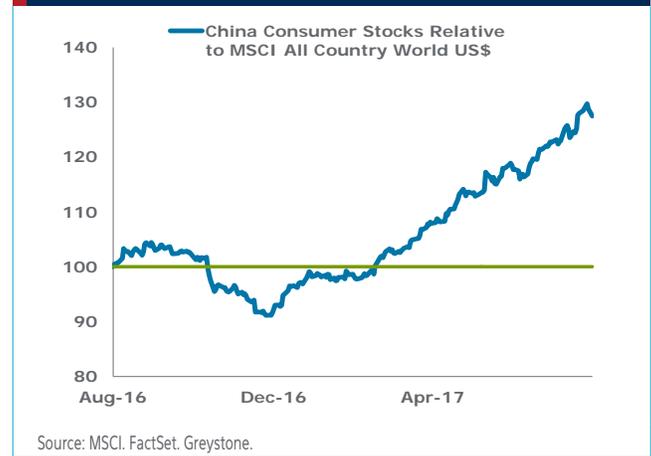


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The Chinese consumer market is expanding rapidly, aided by a burgeoning middle class that's driving economic growth in China. As their ranks swell, so will their effect on the global economy. One area of significant growth is the use of online platforms which are creating unique consumer experiences, and companies engaged in this area are said to be a part of the 'new economy'.

As we seek to invest in companies with sustainable business momentum, we believe that the rising Chinese consumer will continue to present attractive business opportunities for companies that are geared to understand and take advantage of their specific preferences and needs. Given the large size of the Chinese labour market and favourable macroeconomic trends, which include continuing urbanization, more service-orientated jobs, and rising incomes and wealth, the Chinese consumer will continue to support growth opportunities greater than the overall growth in the global economy. We have seen significant outperformance in global stocks that have exposure to the Chinese consumer over the past year (see Figure 1).

Figure 1: Global Stocks Benefitting From Chinese Consumer

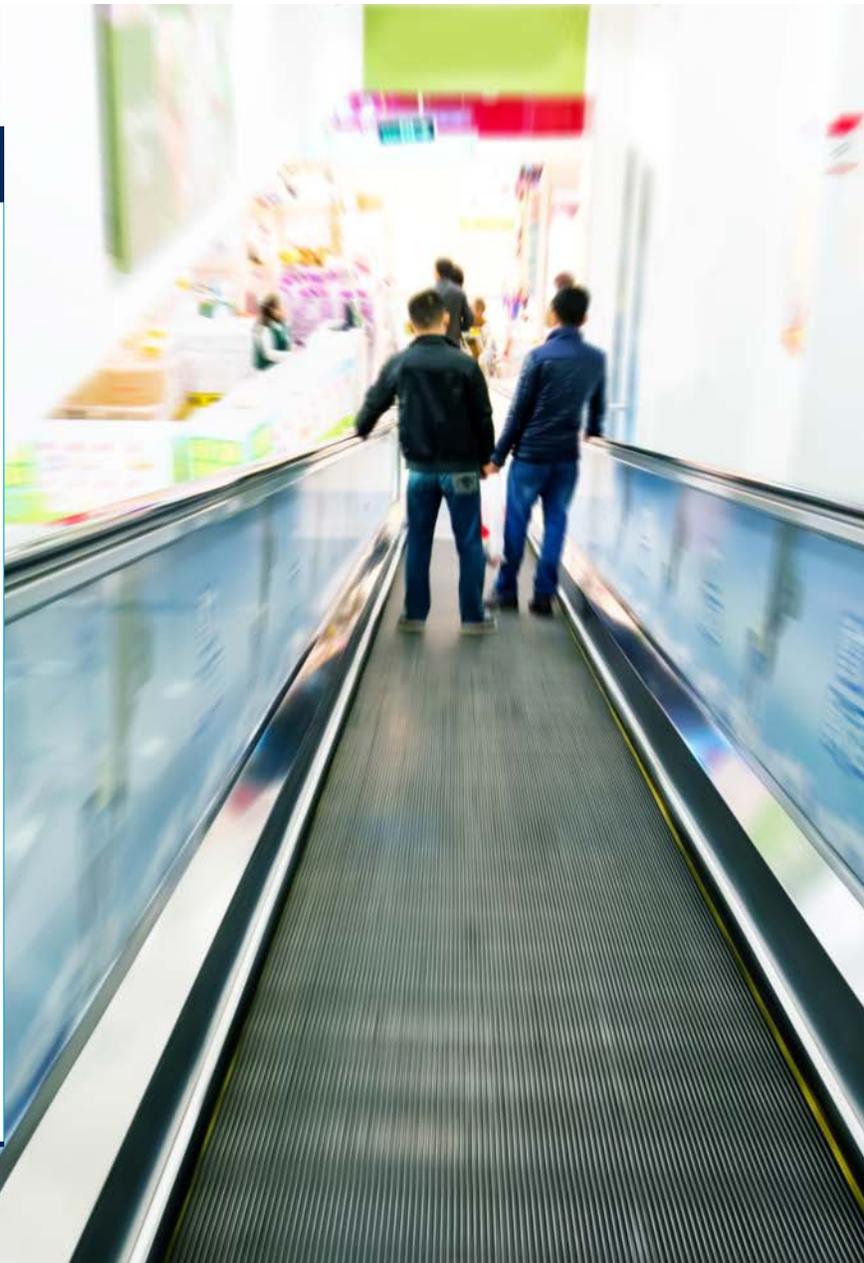
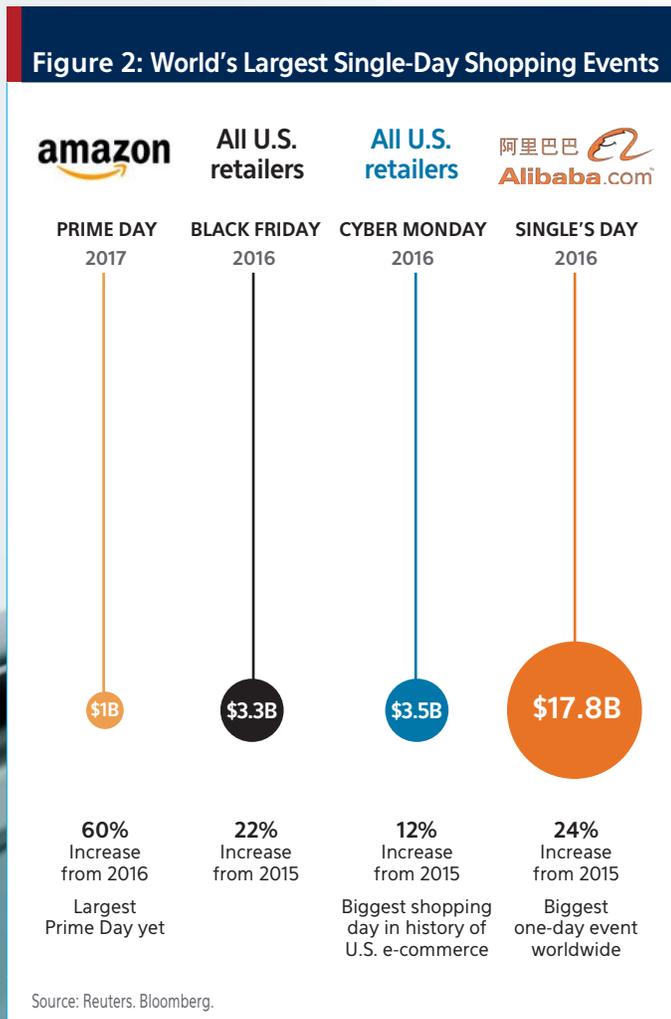


China has a unique retail history – there is a lack of brick-and-mortar commerce and limited access to a variety of consumer goods at a reasonable price, particularly in the Tier 3 and 4 cities. This has led to Chinese technology companies becoming world leaders in e-commerce and building out payment and delivery infrastructure to provide a better shopping experience for Chinese consumers. This has given rise to an advanced digital marketplace where news sites, games, videos and e-commerce are all interconnected in major online hubs. Supporting this trend is the wide adoption of cell phone usage, with Chinese households leaping the earlier trend of PC usage in other markets. As a result, China leads

the world in e-commerce activity with Chinese consumers spending 5 trillion yuan (US\$750 billion) online in 2016, up 39% from 2015 and exceeding total retail sales growth of 10%.¹ We expect e-commerce to continue its double-digit growth driven by increased spending due to rising incomes, and by new consumers from smaller cities and rural areas.

While online discovery of potential purchases is now a growing worldwide practice, Chinese consumers have come to rely heavily on this. Alibaba, the leading Chinese e-commerce company and the largest online third-party payment system in China, doesn't carry inventory or buy or sell merchandise, but rather operates like a virtual mall

that provides a place for buyers and sellers to connect. Consumers not only shop, but they go to be entertained and explore new trends. Alibaba's Singles' Day is now the world's largest single-day shopping event (see Figure 2). In addition to using technology to integrate its e-commerce marketplaces, Alibaba provides merchants with the ability to use data and analytics on consumer behavior to improve their marketing efforts. As consumers move across the digital marketplace, their data is unified and collected not only on shopping habits, but on digital media consumption, logistics needs, payments and credit history, search preferences, social networks and internet interests.



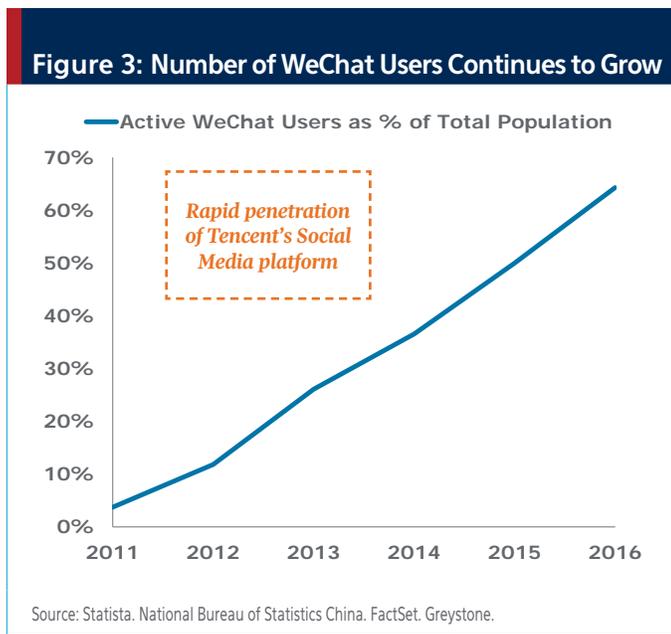
¹Bloomberg, National Bureau of Statistics of China, China Electronic Commerce Research Centre.

In addition to e-commerce, Alibaba is also positioned to benefit from other emerging segments in the cloud, entertainment and financial areas. Softbank made a series of two investments in Alibaba over a decade ago and, although it has made a partial divestment, it stands to benefit from growth in its investment in Alibaba and from Softbank's other growth drivers. Alibaba has experienced sales growth of 47.6%² over the last fiscal year, which is much higher than the growth in the Chinese or global economies, and has since surpassed that number in the recent quarterly review of earnings. We currently have indirect exposure to Alibaba through Softbank, a Japanese telecom company with a large stake in Alibaba (approximately 27%).

In addition to Alibaba, we also have exposure to the new economy in China through holdings in social networking services, gaming and live broadcasting. Tencent is a leading social networking company whose major revenue sources are gaming and online advertising. In addition, payment and cloud services could be future growth drivers for Tencent. Company management has a strong track record of M&A and strategic investments that include WeChat, a giant social media service that has experienced rapid penetration in the Chinese population (see Figure 3), and an investment in JD.Com (Tencent owns approximately 20%), which is the second largest e-commerce company in China. Tencent is displaying strong growth as sales are up 40% over the past fiscal year.

Our exposure to the Chinese consumer also includes NetEase, which provides internet technology services including online gaming, advertising, email, e-commerce and other services, and YY Inc., which manages an online social platform. NetEase and YY Inc. have experienced year-over-year top line growth of 49% and 32%, respectively.³

In conclusion, the MSCI announced in June that Chinese securities (A-shares) will be included in the MSCI Emerging Market Index beginning in 2018. Broadly, this acknowledgement is another example of China's importance in the world economy. Specifically, there will be huge investment opportunities in several new economy industries such as e-commerce, entertainment, online gaming and technology. We believe that the secular growth trends related to the Chinese consumer market will continue to present attractive investment opportunities for companies that can understand the Chinese consumer's preferences and needs. To take advantage of them will require not only an understanding of the secular growth trends outlined above, but also an investment strategy rooted in a deep examination of the business growth drivers of the individual companies in these sectors. Through our fundamental research process, we will continue to look for companies with the ability to successfully execute business strategies that can tap into this secular growth trend, have sustainable growth drivers and can successfully create intrinsic value for shareholders.



² FactSet.

³ Ibid.

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