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GREATER CHINA EQUITY

INVESTOR LETTER – Q3 2022

Value with focus on the Chinese market. Fund managed with a fundamentals-based investment style and long-term view. The portfolio is relatively concentrated. In-depth analyses, rigorous due diligence and analysts on the ground to monitor the risk of fraud.

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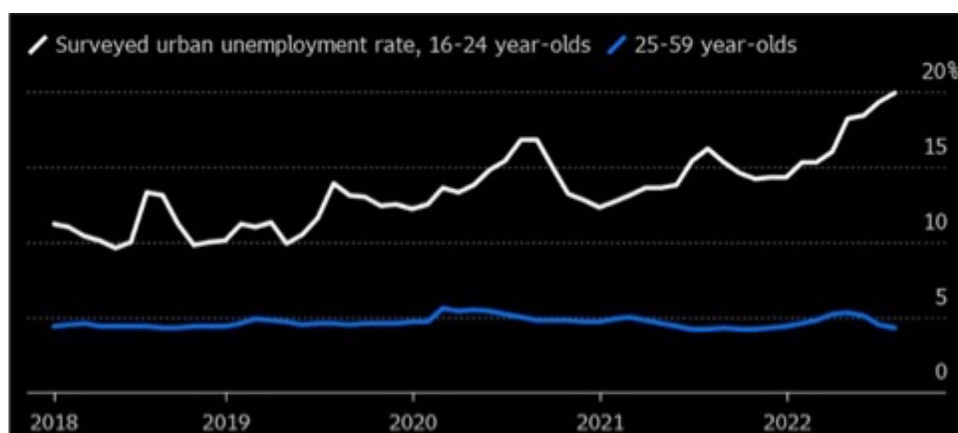
A BUMPY ROAD TO A BRIGHTER FUTURE

"*Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future.*" – Warren Buffett.

"*You can't predict. You can prepare.*" – Howard Marks.

As our job is to pick companies that will survive and thrive irrespective of the economic backdrop, we generally prefer not to write about the health of China's economy (also, forecasting will only make us look silly in due course; see some of our past predictions and Buffett's quote above!). That said, given the pervasive fear and uncertainty among foreign investors and commentators, we thought it made sense to write down some brief observations about China's economic outlook and discuss one of the Fund's major holdings, **Guangdong Great River**, in depth.

Regular readers won't be surprised to hear that we believe **China's best days lie ahead**. That said, its economy is facing formidable challenges in the near-term – the country's GDP barely grew last quarter, consumer confidence has plummeted since the Shanghai lockdown, and youth unemployment is approaching 20%. Its pain is primarily due to the choices its policymakers have made regarding COVID-19 and the country's housing market, as well as some policy inertia in the run-up to the upcoming 20th Party Congress, a weak global economy, and worsening geopolitics. However, except for the tense geopolitical situation which is likely here to stay given the "New Cold War" between China and the US, we view the other issues as transient – i.e. we would be surprised if they were headwinds in three or four years from now.



Source: China National Bureau of Statistics. Bloomberg.

So let's briefly unpack them.

Firstly, COVID-19. China has taken a much more cautious approach to battling the disease than most other nations. This difference is likely due to several reasons, including:

1. Chinese society reveres the elderly, of whom tens of millions remain unvaccinated (for various reasons).
2. Its homegrown vaccines are less effective at preventing hospitalisation.
3. Its hospitals could quickly become overwhelmed should cases surge.
4. Its leaders have made keeping people safe their primary objective.
5. The long-term costs of "long COVID" are likely to be significant.

China has made the difficult decision to prioritise its citizens' lives and long-term health at the expense of its economy, its corporate sector, and the mental health of tens of millions of its people. We expect the cautious approach to continue over the next few quarters but remain hopeful that policies will become more accommodating over time, especially should vaccination rates increase and its homegrown vaccines improve (the country could also get lucky should COVID evolve to become less harmful).

Secondly, real estate. It is a complex issue that we've written about extensively. In short: it seems that the government is instilling much-needed discipline into the sector in a relatively controlled fashion. Authorities are tackling speculation by various actors who previously viewed property as a one-way bet. While painful in the short-term, this will ultimately be in the best interests of China's people and its economy.

Thirdly, the leadership transition. Policymakers, the Chinese people and global investors are looking forward to the conclusion of the 20th Party Congress later this month, which should provide – at a minimum – certainty about who the key leaders will be for the next five years. However, we may have to wait until Q1 2023 to obtain greater clarity regarding their central economic policies.

Fourthly, a weak global economy. We don't feel confident predicting how long the world's inflation problems will last other than pointing out that China seems relatively well-positioned to deal with rising prices. It has excess labour and productive capacity in many industries; China is the "world's workshop" and hence it is less exposed to the challenges of rising shipping costs and shifting supply chains; unlike many other countries it has not engaged in ultra-loose monetary policies (it has positive real rates, a rarity these days!); it has also proactively secured supplies of many essential commodities over the years.

Finally, geopolitics. Another tricky and subjective topic, difficult to unpack in a paragraph, and virtually impossible to forecast with any degree of certainty. Suffice to say that we expect the US and China to increasingly compete for resources and geopolitical influence globally. That said, we hope and expect that military conflict between the two nations won't happen any time soon (though this cannot be ruled out completely). In the meanwhile, we have negligible exposure to Chinese exporters.

In short, we are relatively sanguine about China's near-term issues.

Concerning its long-term trajectory, we've long held three "big picture" macro views:

1. China will likely enjoy reasonable growth for many years from a (still) low base.
2. Consumption and services will become more important - from a (still) low base.
3. The renminbi is undervalued vs the US$ - currency depreciation is unlikely to be much of a headwind for long- term investors.

While we continue to believe that this "top-down" roadmap applies, we don't spend much time updating it (it has been unchanged since we launched the Fund over a decade ago). Instead, we focus on finding the best Chinese companies, i.e. those that will survive and thrive in the good times and the bad. These companies have excellent management teams and superior products/services gaining market share. Moreover, they are currently trading at compelling valuations, considering our view of their long-term profitability and growth potential. Hence, despite the recent "bumps in the road" – both for China and for the Fund – we believe that the future is bright indeed.

China vs EM and DM real policy interest rates (%)

Source: CLSA, BIS, Refinitiv.

GUANGDONG GREAT RIVER – NIMBY CONSOLIDATOR

An example of an enduring company trading at a compelling valuation is the Fund's holding in **Guangdong Great River** ("GDGR"). It owns and operates petrochemical storage tanks in ports along China's southern and eastern seaboards. Because of their flammable and toxic nature, petrochemical products are shipped on large vessels for long-distance travel and then transferred to trucks, smaller vessels, or pipelines linked to factories for the so-called "last mile delivery". These deliveries are ordinarily modest in volume but high in frequency. In practice, these storage terminals serve as transfer points and provide customers with a way to manage their inventories across the cycle. As a result, they represent **mission-critical infrastructure assets in the petrochemical supply chain**.

We like businesses with assets that are hard to replicate, whether these are scarce intangible assets – e.g. brands, licenses, network effects – or scarce tangible ones.

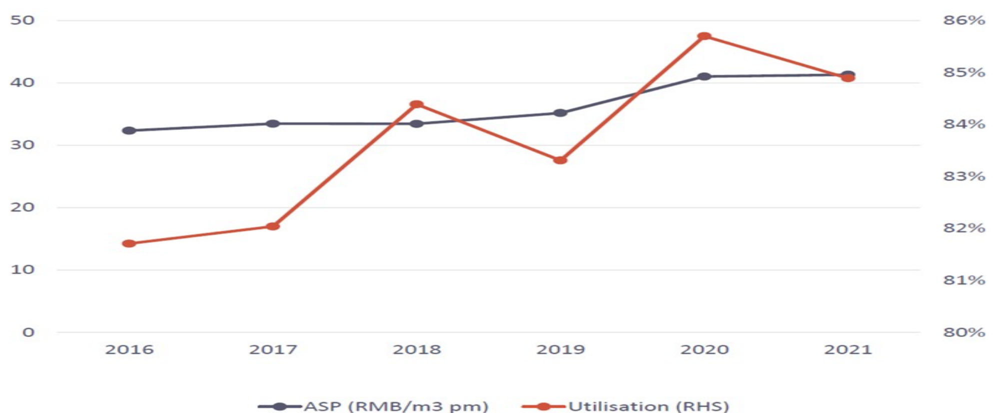
GDGR's petrochemical storage terminals is an example of the latter. Due to some high-profile accidents in recent years, local government officials and residents do not want new petrochemical terminals anywhere near them – the definition of NIMBY ("not in my backyard") assets! Moreover, several government departments must approve a new project, meaning that the lead-time for new construction can be up to five years (if approval is granted). Indeed, legislation such as the "Yangtze River Protection Law" has barred new projects along this all-important watercourse to protect its fragile ecosystem.

The industry can broadly be divided into two groups. The first group includes the large SOE refineries and petrochemical producers – the likes of Sinopec and Sinochem – which have their own logistics facilities. The second group consists of third-party operators and is quite fragmented - GDGR is the most significant player with c. 10% market share. Every project has a natural service radius that it could cover, which is typically 100-150km. Therefore, while there is ample supply at the national level, regional supply-demand dynamics are what matter. Both the Yangtze River Delta and the Pearl River Delta are attractive markets, as they boast two of China's most vibrant economies coupled with limited supply. This is where most of GDGR's facilities are based. Some of these facilities are effectively local monopolies.

To be clear, this is not an easy business to run. Hundreds of petrochemical products with unique characteristics and potential hazards need to be handled and stored separately. However, in its 15 years of operating history, the company has a perfect safety score. Its founder Chairman Lin takes safety so seriously that he leads the Health and Safety Committee. The company also hires third-party consultants to inspect its projects' safety and pays them based on the number of suggestions they make. A typical project is visited every three days by either clients, consultants, or regulators; most of these visits are unannounced!

Ironically, GDGR is not only the safest operator in the industry but also the most efficient. For example, its unloading and uploading services are available 24-7; our channel checks suggest that these are also done much faster than the industry average. GDGR's "product attrition" rate is 0.01% vs 0.2-0.3% for its peers, which leads to meaningful cost-savings for its clients (storage costs are typically 1% of the products' value).

2016-2021: GDGR utilization and ASP



Source: Company filings.

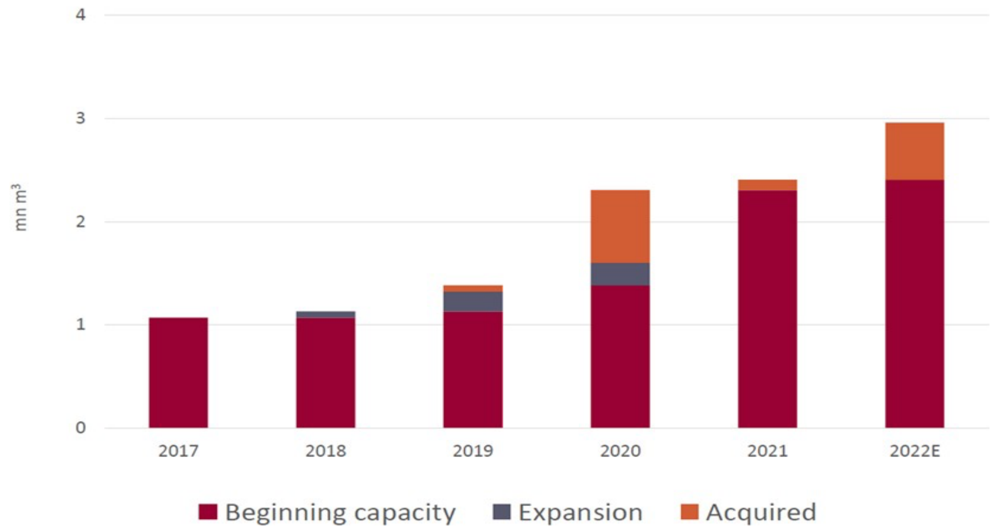
As a trusted player, client demand for the company's facilities is high: GDGR boasts an average utilisation rate of 85% vs c. 60% for the rest of the industry.

As with many of our other holdings, the key driver of its operational efficiency is the corporate culture created by its senior management team. Chairman Lin is an industry veteran who started his career trading petrochemical products in the early 1990s. He realised that the storage tank business was likely to be more enduring than oil trading, which led to the birth of GDGR. The company is highly meritocratic, and employees are well incentivised. Outperformers are rewarded with bonuses, share options, and the opportunity to take on more responsibility. This is possible because GDGR keeps adding new projects. Best practice is shared across multiple projects, ensuring that new projects can be quickly integrated.

The industry's high entry-barriers mean that, besides modest expansion opportunities at some of its existing projects, most of the company's growth will come from acquisitions. The good news is that this is a fragmented industry with plenty of sellers and only one buyer, GDGR. So why would existing owners sell? Partly because of the ever-increasing regulatory hurdles, but also because many of the previous generation of owners are close to retirement with no natural successors (GDGR's recent acquisition of Hong Kong-listed Dragon Crown is a case in point). The company has a dedicated M&A team to map out and approach potential targets. An example of the value that GDGR's focus and efficiency can add to an acquired project is its Changzhou terminal, which it acquired in early-2020 from the well-run SOE China Resources. Before the acquisition, the project's capacity utilisation rate was 60% with net profits of RMB27mn in 2019. Since then, its utilisation rate has reached 70% and net profits jumped to RMB53mn in 2020 and RMB71mn in 2021.

GDGR has almost trebled its capacity in the last five years, from c. 1mn m3 to c. 3mn m3. We expect it to grow at +20% p.a. to reach 5mn m3 by 2026. In the long run, we believe that at least a quarter of the industry's 40mn m3 capacity is worth acquiring; hence, a long-term target of 8-10mn m3 appears feasible. While the business requires a significant upfront investment (the bulk of which can be debt-funded), it should be highly cash-generative in the long run with modest maintenance capex requirements. We expect the price of its services to continue to grow steadily at roughly the inflation rate, irrespective of the economic backdrop. It is currently trading at 12x next year's forecasted EBITDA, which we view as attractive given the durability of the business and its high and visible growth potential.

2017-2022E: GDGR capacity expansion (consolidated)



Source: Company filings.

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