

Three long-term investment themes

Electric vehicles, online education and online-to-offline consumption are multi-year trends in China which are expected to deliver above average returns

BY CLIVE McDONNELL

TRADING on 700 times trailing earnings, Chinx-listed Qtone Education is symbolic of the bubble-like characteristics that have recently emerged in China's domestic equity market. We at Standard Chartered would caution against chasing stocks with similar eye-watering valuations. Nevertheless, companies like Qtone Education are at the forefront of the structural pivot of the Chinese economy towards consumption and services and away from investment and manufacturing.

While this pivot is taking place at a slow pace from an economic perspective, investors have been quick to switch their attention towards companies with exposure to the sectors expected to drive future growth.

Standard Chartered sees three key consumption themes emerging:

- Electric vehicles
- Online education
- Online-to-offline (O2O) consumption

Electric vehicles

EVs are viewed as one of the answers to China's pollution problems. China has a target of having five million EVs on the road by 2020 with new 40 new launches expected this year. The market is currently dominated by local manufacturers such as BYD which has a 35 per cent market share. Foreign brands have struggled to gain traction in the EV market due to price differentials with local brands related to subsidies which can reduce the prices of the latter by up to 60 per cent.

There are challenges to growing the EV market in China, but this is where the investment possibilities exist. Charging stations and high powertrain (EV engine) costs are cited as two key obstacles. The ratio of charging stations to EVs in China is 180:1, compared with 30:1 in the US. If China is to achieve its target of five million EVs by 2020, and assuming it aims for a charging stations to EV ratio of 50:1, it will need to build 100,000 charging stations. Clearly, it will need the private sector's help to do this, which represents a potentially attractive investment opportunity.

High powertrain costs are one of the key drivers of Tesla's decision to build the Gigafactory in Nevada. China faces the same challenge to bring down powertrain costs, but it does not yet have plans for its own Gigafactory. Companies such as BYD have the experience in batteries to consider such an investment and with Warren Buffet's Mid America Energy owning



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25 per cent of the company, it may have the ability to raise the capital for such an investment.

Online education

Chinese parents have embraced online tutors as a solution to the fiercely competitive exams Chinese students face for entry to university. This is in line with trends observed in Hong Kong, Taiwan and Singapore, where parents are similarly willing to spend considerable sums on tutors to give their children an edge. From an investment perspective, the difference in China is the numbers involved, combined with the low marginal cost of adding additional students. Whether this justifies the eye-watering valuations following a tenfold rise in Qtone Education is debatable, but other opportunities related to this theme exist.

The low marginal cost of adding students to online tutorial classes is a key differentiator from the offline business. High rental costs for centrally located classrooms, high wages to attract star tutors and rising advertising costs are factors that have combined to undermine the attractiveness of traditional classroom-based tutorial schools as an investment opportunity.

Online education has the potential for significantly higher margins as star tutors can now be in two places at one time; rental costs are no longer an issue and advertising is targeted via social

media and peer reviews.

China currently spends 4 per cent of its gross domestic product (GDP) on education, compared to the Organisation for Economic Cooperation & Development (OECD) average of 6.2 per cent. The percentage urban residents spend on education is likely to be higher and as urbanisation continues, we expect the share of GDP spent on education to rise. As the Chinese economy shifts away from manufacturing towards services, the importance of a college education will only increase, accelerating growth towards the OECD average.

O2O consumption

This is an important emerging trend within China. Alibaba, the biggest retail marketplace in China, was one of the first to pioneer this trend when it acquired a stake in Hong Kong listed Intime department store in 2014. O2O is viewed as the answer to the challenges posed by consumers who browse in physical stores only to place orders with a different retailer online. O2O gives consumers the convenience of browsing in a bricks-and-mortar store while still being able to order online with the added convenience of being able to collect the goods as opposed to waiting for delivery.

Forecasts that O2O marks the end of the shopping mall are greatly exaggerated. In Singapore, <http://www.qoo10.com/> – which has a similar business model to

Alibaba – is in negotiations with local mall operators to set up a physical presence. Alibaba is believed to be in discussions with Dalian Wanda, which operates a chain of 100 department stores in China, on creating a similar presence at Wanda's malls.

H shares

Many investors cite the doubling of the ChiNext and CSI300 indices over the past twelve months as a reason for avoiding the Chinese equity market. While we agree that markets such as ChiNext do have bubble-like characteristics, overseas-listed Chinese stocks, such as H shares listed in Hong Kong, are trading on reasonable valuations. H shares trade on a 10 times consensus earnings for 2015, compared to 20 times for the CSI300 and 96 times earnings for ChiNext.

Banks dominate the H share index, with a weight of 40 per cent. Given this concentration risk, we believe that fund managers have the potential to add value by investing in a more diversified manner in order to reduce portfolio risks. The themes that we have identified – electric vehicles, online education and online-to-offline consumption – are multi-year trends which are expected to deliver above average returns and are independent of short-term fluctuations in economic growth. **W**

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