GLOBAL EMERGING MARKETS

MARTIN CURRIE
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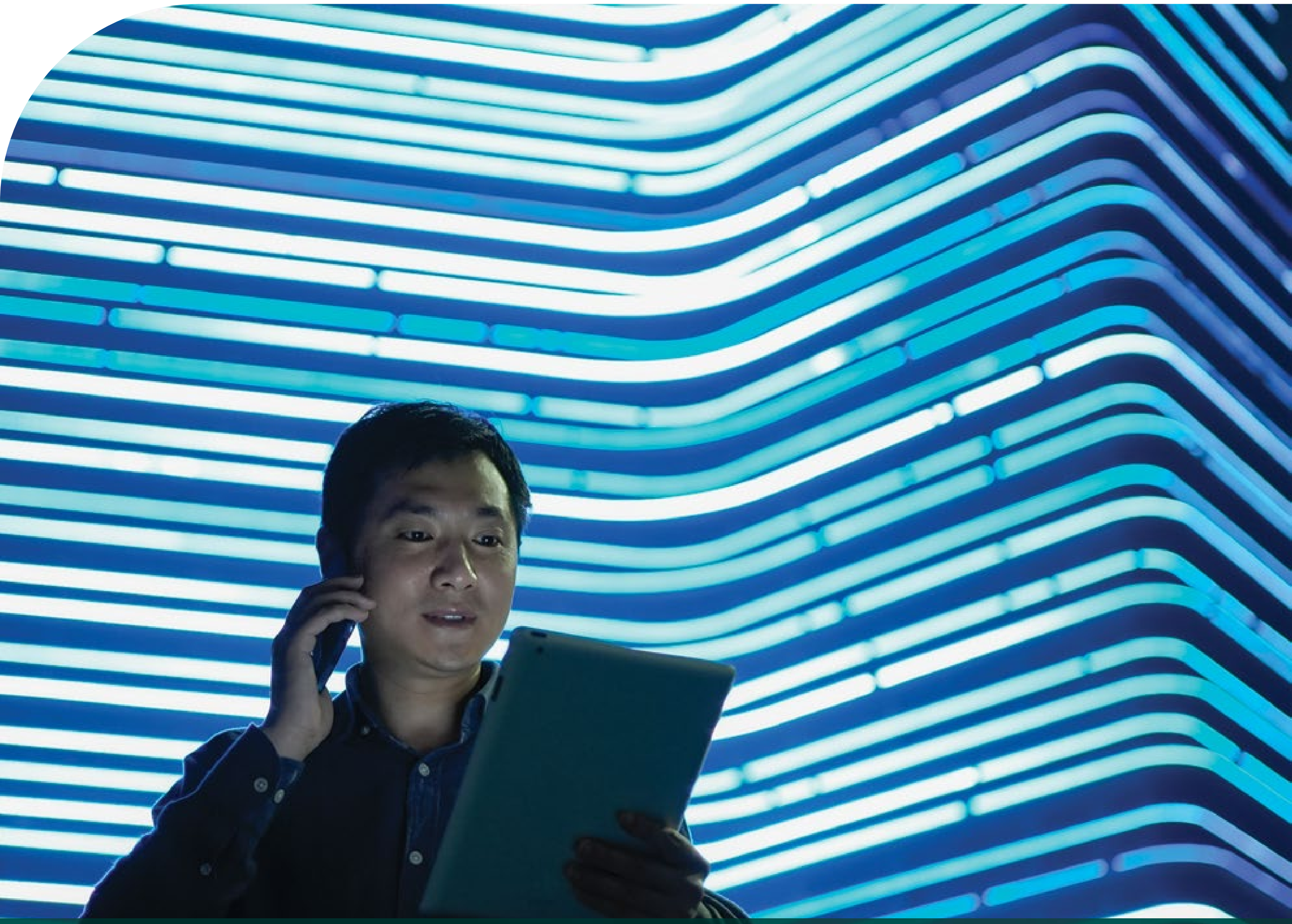
ALIVE AND CLICKING

Putting the spotlight on China's internet sector



Over the last few years, investors have significantly decreased their exposure to Chinese equities as both growth and sentiment have been impacted by the slowing property market.

From a macroeconomic perspective, it is estimated that nearly c.30% of Gross Domestic Product (GDP) in China is linked to property either directly or indirectly. Historically speaking, real estate's contribution to GDP has stayed relatively stable over the last ten years, with a direct contribution of c.8-10% and an indirect contribution of c19-22%[1].

With the recent weakness in the property market apparent, we highlight the difference between the stock market and the economy, as well as our thoughts on the Chinese internet space:

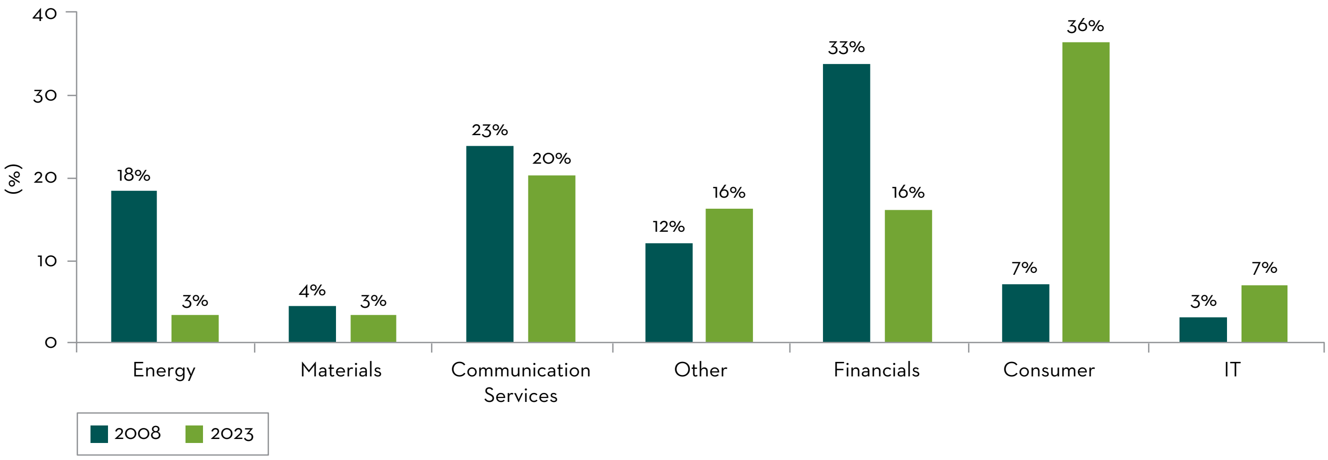
1) The Chinese stock market is under-indexed to property and property related names. State-owned enterprises (SOE) and heavy industry have decreased over time while new economy names have grown to be more important within the MSCI China Index. We are now seeing a move from traditional 'bricks and mortar' to an increased weighting in newer consumer and IT sectors; a switch from bricks to clicks.
2) Chinese internet names are not only important from a benchmark perspective but can also offer a good balance of profit growth with an increasing focus on shareholder returns.

Evolution of the Chinese stock market

The composition of MSCI China has undergone a dramatic transformation over time. In 2008, the top three sectors were financials, communication services (largely telecoms), and energy. While by the end of 2023, the top three sectors were consumer, communication services (Tencent is nearly 40% of this sector), and financials[2].

Besides the obvious de-weighting of old economy sectors such as energy, materials, and financials, we see the growing importance of consumer names within the Chinese equity market. Today, consumer stocks account for over 30% of MSCI China.

Changing sectors
MSCI China Sector Weights



Source: Factset, MSCI and KraneShares CSI China Internet ETF as at 31 December 2023.

Investors may believe that consumer staples are a large part of the Chinese market, however this is limited to c.5% of the index. In contrast, consumer discretionary names (c.30% of index) are largely exposed to new economy names. Chinese internet stocks are distributed across both the consumer discretionary and communication services sectors, by analysing the weighting of Chinese internet holdings within MSCI China as a whole, we can distill their current scope of importance within the Chinese equity market[3].

[1]Source: National Bureau of Statistics of China, January 2024

[2]Source: Martin Currie and the MSCI as at 31 December 2023.

[3]Source: FactSet and KraneShares CSI China Internet ETF as at 31 March 2024.

How meaningful of an exposure are Chinese internet stocks?

Chinese internet stocks now account for nearly 40% of MSCI China and nearly 11% of MSCI Emerging Markets. To provide context, these internet stocks have a higher weighting within emerging markets than the countries of Brazil and Mexico combined (6.4% and 4.2% respectively)[4].

	2019	2020	2021	2022	2023
China Internet % of MSCI China	37.7	44.5	36.5	39.1	40.0
China Internet % of MSCI Emerging Markets	12.9	17.4	11.8	12.6	10.6

Source: Bloomberg, as at 29 April 2024.

Internet sector versus MSCI China

Looking at the internet sector from a financial metric perspective, we see that overall it has delivered far superior quality (measured by returns on capital and leverage) and growth over MSCI China (measured by sales and earnings per share growth). The current valuation of the sector is compelling given its superior history of delivering quality and growth.

Quality/growth/valuation attributes

	China Internet	MSCI China
Sales growth 5 years	2.3	(0.4)
EPS growth 5 years	35.1	20.4
Return on capital	8.3	6.2
Debt/equity	23.6	87.3
Forward P/E	12.5	8.9

Source: Bloomberg as at 31 March 2024.

When looking at the two largest constituents of the Chinese internet space, Tencent and Alibaba, valuations are sitting at multi-decade lows. Alibaba is currently at 8.7x price-to-earnings (P/E) ratio and Tencent is at 13.7x.

Best P/E ratio

Source: Bloomberg, as at 29 April 2024.

The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.

[4]Source: Bloomberg, as at 29 April 2024.

The emerging theme of shareholder returns

Many stocks in the internet sector are proactively increasing shareholder returns. In the first quarter of 2024 many of the large companies in the space announced new dividends and buyback policies[5]. These should support share prices and investor sentiment. Below are recent details from the two largest names in the space:

- **Alibaba:** Committed $35bn to be spent on buybacks, evenly over 3 years, alongside regular annual dividends. Given the current market cap of $190bn this buyback is nearly 18% of market cap[6].
- **Tencent:** Committed to double the share buyback this year from $6.3bn in 2023 to $12.8bn in 2024. Upsize the regular dividend to $4.0bn (+42% year-on-year) – together they represent a 5% yield[7].

Generally speaking, we are seeing a trend within the Chinese corporate ecosystem of announcing more shareholder friendly policies (higher payouts or buybacks in the most recent results season). This creates some support to buoy foreign investor sentiment while the national team continues to buy mainland Chinese ETFs. Chinese state owned assets have also been focusing on increasing shareholder returns and recent compensation changes align the State Assets Supervision and Adminstration Commission (SASAC) entities with a performance of share price return[8].

The Artificial Intelligence (AI) opportunity

Finally, we have seen increasing focus from the digital giants on AI monetisation. The companies are already speaking about the impact that AI tools are having on monetisation of their respective customer bases. For example, in the case of Tencent, the management team has been growing their advertising revenue in the video accounts format, which has been coupled with an AI tool to create better consumer targeting and ad conversion[7]. Alibaba, during a recent investor road trip to its headquarters in Hangzhou, commented on the use of adtech (advertising technology) and algo tools (algorithm tools) to increase the take-up rate of both Taobao and Tmall[9] (online shopping platforms).

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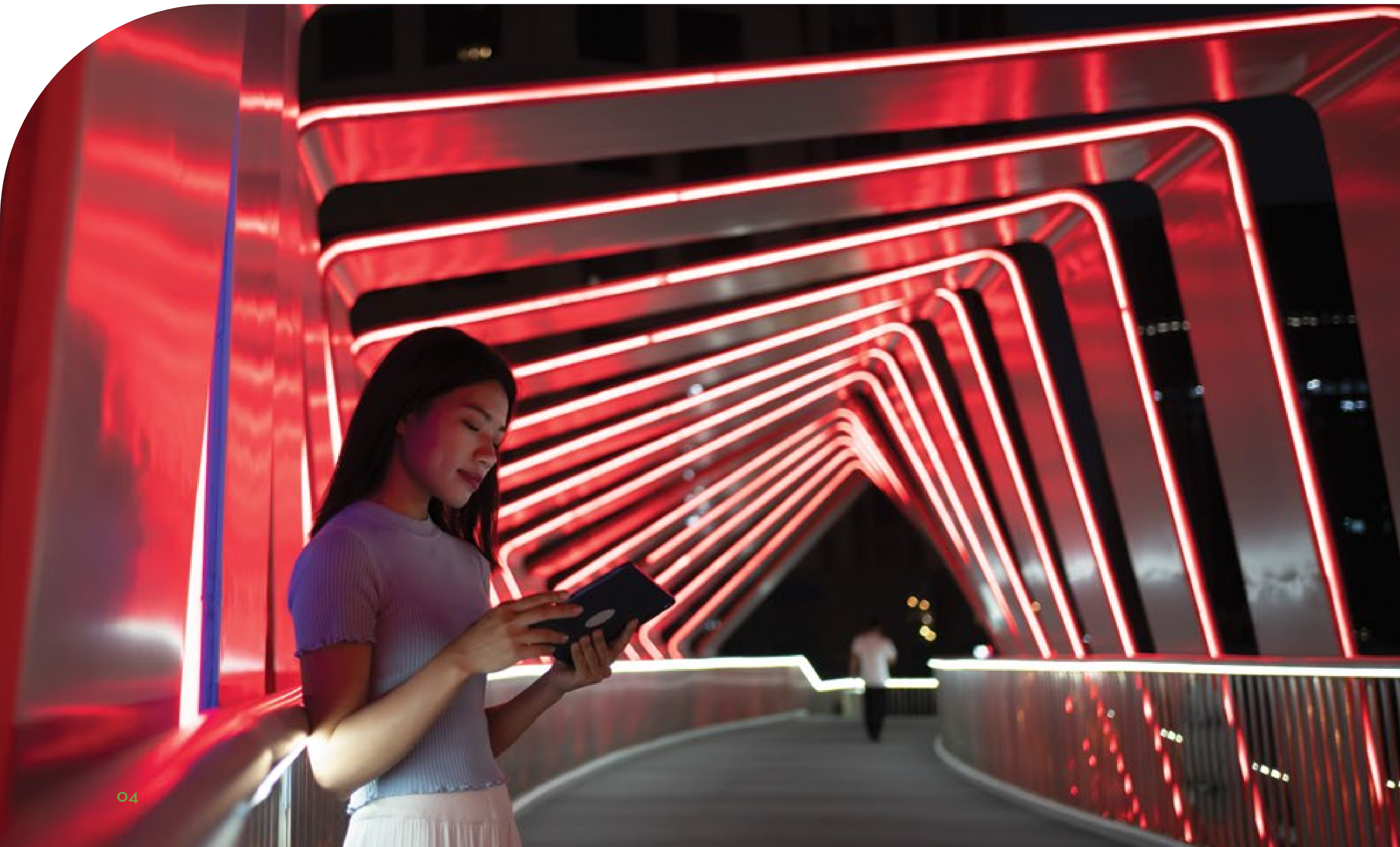
5Source: Bloomberg as at 20 March 2024. https://www.bloomberg.com/news/articles/2024-03-20/tencent-sales-disappoint-after-pervasive-chinese-slowdown-bites

6Source: Bloomberg and Alibaba, April 2024. Alibaba December Quarter 2023 results, 7 February 2024.

7Source: Bloomberg and Tencent, April 2024. 2023 Annual and fourth quarter results, 20 March 2024.

8Source: Supervision and Administration Commission of the State Council (SASAC), 31 January 2024. http://en.sasac.gov.cn/2024/01/31/c_16628.htm

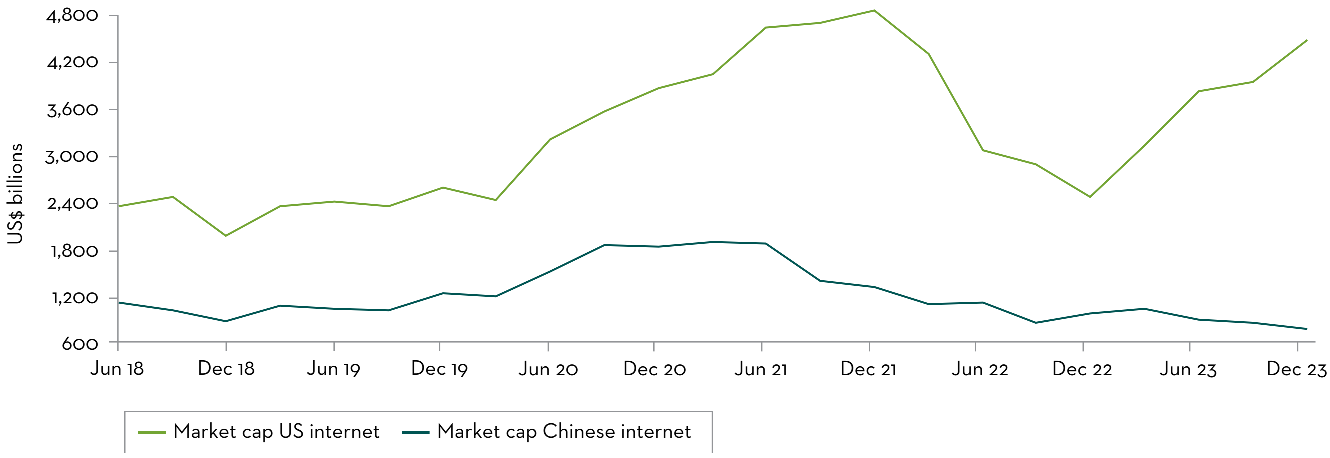
9Source: Goldman Sachs as at 29 March 2024. China Internet Trip takeaways: Reigniting core business growth; Buy.



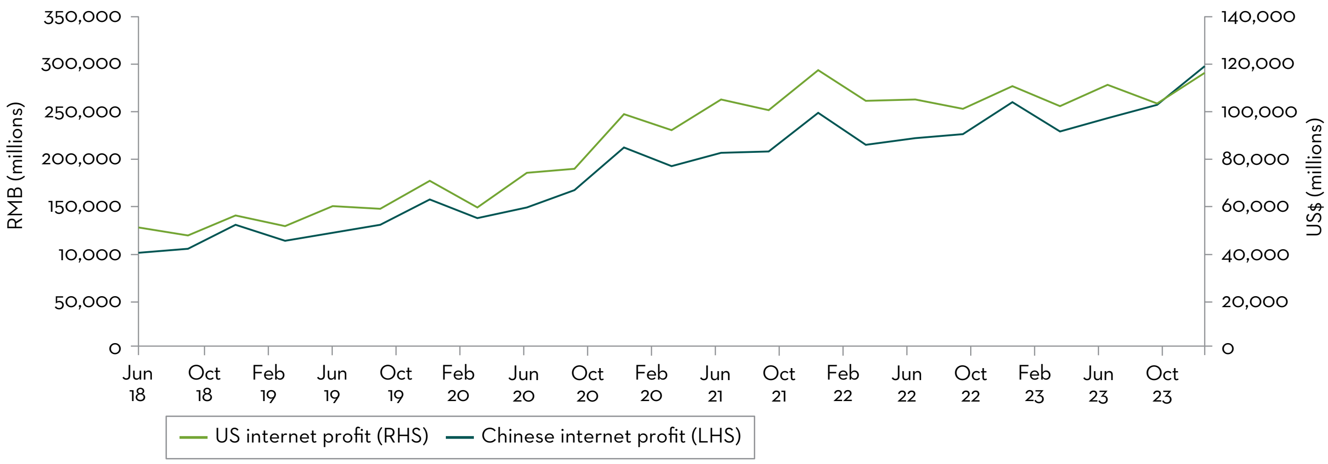
How does China's internet sector compare to US?

Interestingly enough, Chinese internet names have not underperformed from the perspective of revenue growth. Below we track the cumulative revenue of the big four Chinese internet names (Tencent, Alibaba, Meituan, PDD) relative to the largest US internet stocks (Alphabet, Amazon, Meta, Netflix). However, the market experience of these businesses have dramatically diverged.

Market cap: US internet versus China internet



Revenue of China and US internet companies



Source: Bloomberg and Bank of America, as at 31 December 2023. Chinese internet names (Tencent, Alibaba, Meituan, PDD) relative to US internet names (Alphabet, Amazon, Meta, Netflix).

Chinese internet stocks may be set to benefit from three key drivers

To sum up, we believe that most investors do not realise that MSCI China is more heavily weighted toward consumption than the broader Chinese economy (i.e. property and fixed asset investments). Chinese internet giants are taking advantage of the AI opportunity at present and are playing a critical component of the digital transformation as well as a recovery in consumption. The risk for global asset owners is that exposure in these names has diminished significantly over the last few years as we highlighted earlier. For Martin Currie's Emerging Markets strategy, we believe that the time is now to own Chinese internet stocks. Exposure to these companies represents nearly 11% of our portfolio[7] and is poised to benefit from three key drivers. First, a return of general Chinese consumption and positive consumer sentiment. Second, continued strong earnings momentum and increasing shareholder returns. Finally, we believe that these quality growth names in China are offering compelling intrinsic and relative value.

The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.

[7]Source: Martin Currie as at 31 March 2024. Representative Martin Currie Global Emerging Markets Portfolio shown.

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- Investing in foreign markets introduces a risk where adverse movements in currency exchange rates could result in a decrease in the value of your investment.
- This strategy may hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the strategy's value than if it held a larger number of investments.
- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.
- Emerging markets or less developed countries may face more political, economic or structural challenges than developed countries. Accordingly, investment in emerging markets is generally characterised by higher levels of risk than investment in fully developed markets.
- The strategy may invest in derivatives Index futures and FX forwards to obtain, increase or reduce exposure to underlying assets. The use of derivatives may result in greater fluctuations of returns due to the value of the derivative not moving in line with the underlying asset. Certain types of derivatives can be difficult to purchase or sell in certain market conditions.

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Martin Currie Inc, incorporated in New York and having a UK branch registered in Scotland (no SF000300), 2nd Floor, 5 Morrison Street, Edinburgh EH3 8BH

Tel: (44) 131 229 5252 Fax: (44) 131 222 2532 **www.martincurrie.com**

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