LINDSELL TRAIN

Dragon Quest

August 2018

Whilst on his death bed, the 13th century Italian explorer Marco Polo was given the opportunity to retract some of the more fantastical observations from his book detailing his visit to China. Instead he responded with the famous last words "I have not told half of what I saw".

At Lindsell Train we make regular research trips to our key developed markets of coverage - Japan, the US and Western Europe. Less frequently do we find ourselves (in a professional capacity anyway) scouring the emerging world, yet I am recently returned from a fascinating visit to mainland China, our first since 2011. We have no direct investments in China, or in any other developing economy, and are probably quite a long way from initiating one. We lack perhaps the expertise to navigate unfamiliar legal and regulatory regimes and to date have preferred to gain EM exposure (currently a 25% weighted average by revenue for our Global Equity representative portfolio) from our developed market-listed, but globally active holdings. But as managers of global equity portfolios we're frequently reminded of China's substantial and mounting relevance. Economic growth has averaged 9.6% pa since 1989, making China integral to the ambitions of many, if not most, global companies. It's also increasingly spawning internationally relevant companies of its own, particularly from the domestic tech sector. The recent inclusion of Shanghai and Shenzhen listed A-shares to the MSCI emerging market index (a meaningful $1.9 trillion benchmark) makes this an even hotter than usual topic of discussion.

In truth, I struggle to think of many LT portfolio companies operating in complete isolation from China's influence and spending power. Many already owe a meaningful chunk of their revenues to the Chinese and look to them as an ever bigger part of their futures. Our Japanese holdings in particular are doing all they can to leverage their Asian heritage to lure this increasingly important consumer. China is the biggest overseas market for Kao, Shiseido and Milbon with each growing sales there at over 30% pa. One third of all luxury spending worldwide hinges on the wallets of Chinese shoppers (at home and on holiday), a fact not lost on our UK portfolios' more rarefied constituents; Burberry and Rémy Cointreau, the latter of which already boasts a Beijing boutique selling $80,000 per bottle Louis XIII methuselahs.

It's the colossal scale[1] of China that makes it so difficult for business to overlook, and whilst it's tricky to impart a feel for this titanic size without resorting to cliché, here are some data points that at least made me blink:

- China now has over 100 cities with populations topping one million, compared to the entire continent of Europe which has a paltry 34. Ever heard of Zhengzhou? Don't worry if not, it's a tier two city in Henan province that only just makes it into China's top 20, yet it has a bigger population than the whole of Denmark. Expressed another way, China already has more millennials than the US has people.
- China is of course the world's second biggest economy and poised one day to reach the top, but consider this: if its per capita wealth were to catch up with that of Hong Kong's, then its resulting GDP would not just surpass the United States' today, but triple it. This is more simply reflected in the fact that each year approximately 35 million Chinese enter the middle and affluent classes. No wonder multinationals around the world are flinging everything they have at the country.

A phenomenal amount has changed since 2011 and it's important for unfamiliar observers to appreciate quite how technologically advanced the country now is. With little legacy infrastructure to hamper development and 717m smartphones in circulation (i.e. a mobile penetration higher even than Japan's) the country is by some measures more 'digital' than any other. Payments are the best example where cash, if not quite dead, is certainly dying. Mobile payments are widely penetrated offline via scanned QR codes, generating 38 trillion RMB of volume in 2016, which is already over fifty times that of the US. The two leading platforms; Alibaba's Alipay and Tencent's WeChat Pay each have over 500m users (claiming 53% and 40% domestic volume shares respectively) and are used to settle any manner of bills from bubble tea to plane tickets. As a joint consequence of this and the lack of a fully developed bricks-and-mortar modern retail channel, ecommerce in China is also now enormous -

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totalling 42% of the world's online retail transactions. Penetration is as high as 25-30% in some key categories. This digital shift has been exceptionally disruptive to traditional retail models and coupled with the vast, addressable single market has created unprecedented opportunities for the emerging Chinese internet players.

Whilst there I met with several of these companies, including three quarters of the somewhat awkwardly acronymed 'BATJs'[2]. Analogous to the western FANGs, the group comprises Baidu, Alibaba, Tencent and JD.com, often idly referenced as the Google, eBay/PayPal, Facebook and Amazon of China. Of the four, Alibaba with its 70% share of Chinese ecommerce (via Taobao and Tmall) and Tencent with its billion strong monthly active user base (via the WeChat social messaging platform) are the biggest and most influential. This is clearly seen by the dominance they exert over new companies - together the two companies account for half of all venture capital flows in mainland China. They spent $30bn between them in 2017 buying other domestic companies and as a result Tencent now owns 16% of JD, Alibaba 36% of retail giant Sun Art and both invest in DiDi, the native ride hailing app that carries more than double the passengers of all its global rivals (Uber and Lyft included) combined. JD is already China's biggest retailer, expanding from its commanding 40-50% market shares in electronics and appliances to other categories, aiming to match Amazon and Walmart's existing offerings in the West (minor ambitions then). Baidu, a little disorganised at present as it grapples with peripheral business divestures and management changes, still has a dominant 70-80% share of search, which notably is even higher than Google's in the US.

An interesting result of this consolidating ascendancy is that all of the above have become heavy investors in media content (for which the Chinese are increasingly willing to pay); an area they also largely dominate. Alibaba owns Youku (the streaming website filling YouTube's vacant shoes in China), Baidu founded, and still part owns iQiyi (a Netflix-like video platform with over 60 million paying users) and Tencent (who openly reference Disney's business model and also claim around 60 million paying video subs) hosts 70% of all music streamed in China. Sport is increasingly important and Tencent have acquired multi-year rights to most major sporting leagues/events including the NBA (reportedly paying $700m for five years), NFL and the Olympics, whilst Alibaba streamed the World Cup. This is of particular interest to us as investors in European football teams as whilst basketball is the most followed western team sport in China (190 million Chinese mobile streamed the 2017 NBA finals), football is steadily gaining ground. LT-held Juventus has already seen both Milanese rivals (Inter and AC) taken over by Chinese investors - at prices considerably higher than Juve's coeval market valuation.

Tencent also now claims the crown as the biggest computer games company in the world. This is an industry that's three times bigger than film's global box office receipts and China is by far its biggest market. Hence thanks to its dominant freemium mobile platform and publishing assets, Tencent earns nearly half its $35bn of revenues from hosting and developing online games. The market is so large that its latest hit, 'King of Glory', became the highest grossing game in the world last year and still has at any one time more people logged in playing it than there are people in Germany. These stats are of particular relevance to our investment in Nintendo which has global characters and IP recognised by Chinese consumers despite 15 years of legally enforced absence. Recently un-banned, Nintendo can finally begin to explore its role in the country, which given Tencent's position is unlikely to proceed without some form of partnership. Fortunately last year the two signed a distribution deal to release Tencent games for Nintendo's Switch platform. We watch with interest for future developments.

The initial impetus for the trip was in fact to hear from a western company, Pernod Ricard, who chose China's southern economic engine Shenzhen as the location for their 2018 Capital Markets Day. Pernod is a fantastic, family run company with a superb collection of spirit brands (Martell, Glenlivet, Absolut, Chivas Regal, etc) and alongside Diageo, one of the world's big-two western liquor companies. For many reasons, not least a long term commitment to building sustainable brand equity, Pernod fits very well with our investment philosophy. Yet, still waiting for a good entry point into the stock, we haven't to date owned it[3]. Nevertheless we've long admired the business and follow it closely within our select universe of great global companies. This therefore constituted an important opportunity to update on their strategy, particularly in their key Asian markets. Sensibly they chose Shenzhen to emphasise their leadership position in premium international spirits in China, an important differentiator versus many of their competitors.

The Chinese backdrop also made clear quite how challenging it is to do business in a country where according to accepted wisdom 'five years is a generation'. It's worth then emphasising just how important Tencent's key platform WeChat is for marketers and brand owners to get right. Only seven years old it's already a force unto itself, comparable perhaps to an integrated combination of WhatsApp, Twitter, Instagram and Facebook, and much more besides. Users can do almost

anything on the platform including booking travel and doctor appointments, paying utility bills and applying for visas. It has the official stamp of approval and in many situations replaces the government issued physical ID card. The fact that you can now even file for divorce via WeChat was recently picked up by the international media as a quirky bit of trivia, but I doubt anyone in China will have batted an eyelid, so deeply embedded is the platform in everyday private and public life. Chinese consumers live their lives in symbiosis with their mobile devices and running out of battery is close to catastrophic (though panic not, there are WeChat activated charging stations in bars and restaurants everywhere). This is on top of the core social, content and aforementioned payment functionality, the last of which acts as a critical frictionless conversion tool for Tencent, making ad-driven social ecommerce a credible proposition.

This last feature in particular cements WeChat's role as an essential tool for consumer goods companies to promote and retail their brands. Understandably then, Pernod were keen to highlight the partnership they have with Tencent which (along with their work with Alibaba) they consider critical to their Chinese prospects. A big part of this is the importance of access to consumer data. Fortunately in digital-China there's plenty of this to go around and the major tech players have ongoing investments in AI and machine learning designed to exploit the immense data sets they generate. Three of the four - Tencent, JD and now Baidu - even have a data sharing partnership that comprehensively covers the social, shopping and search habits of hundreds of millions of people. Unsettling perhaps, but it's clear that this makes them an essential partner for brand owners, domestic or foreign, trying to sell anything to the mobile enabled Chinese population.

As noted above, we don't currently invest in Pernod, but instead remain long term holders of fellow booze merchants Diageo, Rémy Cointreau and Brown Forman - likewise owners of irreplicable global brand portfolios. Indeed Diageo and Pernod have much in common; both share an oligopolistic position in scotch whisky (with c.60% of the global market between them), both own big volume driven vodka brands (Smirnoff for Diageo, Absolut for Pernod) and both have hundreds of years of heritage to draw from (e.g. Diageo's Guinness is 259 years old and Pernod's Martell 303). As noted however, an interesting point of differentiation concerns the geographic bets each company has placed, best evidenced by the split between their North American and Asian revenues. Diageo earns a third of its sales in the US and a tiny direct amount (3%) in China, whilst Pernod has a lower weighting (18%) to America but a very relevant position (c.10%) in China. This makes China Pernod's joint second biggest geography alongside India.

The skew stems largely from the brands each company has acquired, particularly those divvied up when Seagram's was digested in 2000. Diageo took Captain Morgan and Crown Royal, both with big positions in North America whilst Pernod got Chivas Regal and Martell, currently the top scotch (24% share) and cognac (44% share) brands in China. Martell has had the biggest impact and now counts for over three quarters of Pernod's Chinese sales. This reflects the cultural relevance of cognac which gained a foothold in the country a century and a half ago and remains the imported spirit of choice for the country's business and social elite. As a result it's developed an aspirational cachet that helps explain its dominant 'share of throat', at more than twice that of scotch.

So is Diageo missing out on the Chinese miracle? Perhaps, but the Chinese premium spirits market is still in very, very early days. Just 1% of the entire market volume is made up of international spirits. The rest, a staggering 1.2 billion nine litre cases per annum (trouncing global vodka volumes) is made up of a local white liquor known as baijiu. Fast forward to a more developed Asian market like Japan where the local spirit shōchū has only a c.10% share of alcohol consumption and the opportunity becomes tangible. Diageo it seems still has time to make headway, and has in its stable some fantastic brands (Johnnie Walker, Talisker, Tanqueray, Zacapa, etc.) that should eventually resonate with the Chinese middle and upper classes as they emerge. The high-end, invitation only Johnnie Walker Blue Label boutiques were a notable recent initiative to this end.

Reflect for a second though on the above baijiu volume figure. 1.2 billion cases. That really is a lot of baijiu. It's worth then pausing here to consider the investment potential for China's native spirit itself. The country's leading premium baijiu, Maotai, has a lot of what we look for in a brand, not least heritage. Officially designated a National Liquor by the People's Republic of China in 1951, Maotai has been made in its small eponymous town for around 400 years. It was used to staunch the wounds of Red Army soldiers during their Long March and served to Richard Nixon and Henry Kissinger during China's rapprochement with the West. As a result it's held in almost mythical esteem by the Chinese and has a bullet-proof association with the country's history. The favourite drink of Chairman Mao, no banquet is complete without a toast from the iconic red and white

striped bottle, which reputedly carries higher brand recognition than Apple. Kweichow Moutai (A shares) listed in Shanghai in 2001, is still majority owned by the Chinese state and overtook Diageo last year to become the biggest spirits company in the world by market cap - currently at over £100 billion.

Maotai spirit itself is relatively cheap to produce and has startling scale (fifty thousand tons worth in 2017), yet thanks to its unique national prestige, sells for over $200 per bottle. That's if you can find it - it flies off the shelves faster than they can be stocked. This has earned its parent operating margins and ROEs that have averaged 63% and 35% since listing. The shares trade today at a punchy 15x sales, so whilst the price (and perhaps governance uncertainties) might put us off for now, as a company it clearly warrants further consideration. Notable here is Diageo's investment in the 600 year old Shui Jing Fang distillery (founded in 1408 - making it the oldest continuously operating distillery in the world), producer of a lesser but still resonant premium baijiu brand.

Still Shui Jing Fang really only represents a dipped toe for Diageo and ultimately it's up to us as investors to assess the wisdom of this hesitance. And they're not alone amongst our global investee companies in limiting the scale of their Chinese ambitions. Heineken, in contrast to its major European competitors Carlsberg and AB Inbev, have long viewed China with caution, judging it to be a low-end volume market, awash with employment-providing, government-backed breweries supplying undifferentiated local brands. Up until now they've been broadly right, with low-priced volume the market's defining characteristic. Snow beer (a brand that few in the West have even heard of) sells more than double the global volumes of Bud Light, its nearest western rival, but is priced on average at less than a third of the equivalent US beer. Dismissing the market's sophistication entirely, however, may no longer be fair. Beijing and Shanghai sport a thriving craft beer scene (I can personally recommend Great Leap Brewing and Boxing Cat) and international premium brands are of growing relevance. AB InBev for example claims a 16% share of the Chinese market, largely thanks to Budweiser's well cultivated image as a premium-priced, aspirational brand. Having toiled away in China for over 20 years, Budweiser has taken 60% of the premium segment and now dominates the country's beer profit pool - clear rewards for playing the long game. Heineken in contrast has a less than 1% share, which is disappointing for a brand that prides itself on its global availability. With the recently announced alliance with China Resources (owners of the Snow brand) Heineken takes a significant step towards addressing this - but at a cost of €2.7bn.

But how disappointed should we be? Is China the only big growth market of the future? It might be hard to claim otherwise in the short term, but over a multi-decade investment horizon there are plenty of other vast geographical swathes - India, Africa, Latin America and South East Asia - waiting to come into their own. Diageo and Heineken have made substantial and far sighted investments in these markets. Diageo's 2012 United Spirits acquisition gave it the leading volume share in the Indian market (now 10% of its sales) and thanks to Guinness' historical resonance in Africa (Nigeria has long been the beer's second biggest market) they have an important route to market for their spirits across the continent. Heineken owns all or part of Asia Pacific Breweries (a 1931 joint venture), Foster Vietnam (acquired in 2007) and United Breweries (inherited through the 2008 purchase of Scottish & Newcastle), giving them important positions across the rest of Asia - including leadership of Vietnam's premium beer segment (the fourth biggest market for the Heineken brand globally). Having opened their first African brewery in 1900, they also lead Nigeria (set to become the world's third most populous country by 2050) with a semi-monopoly 70% market share in beer. In a similar vein, Unilever has only entered China relatively recently (though still earns over a billion Euros from Chinese personal care) having instead focused on buttressing historic strengths in markets such as India (where they've operated for over 100 years), Brazil and Indonesia. Together these three countries account for a full 20% of their sales.

So where do we go from here? As long-term investors, finding a steady and stable home for our clients' capital still seems like something of a challenge in a market that changes so rapidly. It's not that value isn't being created - particularly in big tech[4] - but it's happening at a judderingly frenetic pace that makes the sort of steady long-term cashflow compounding that we favour hard for us to identify. As the baijiu discussion illustrates though, the country isn't short on heritage and the prospect of accessing pockets of this at a sensible price perhaps has a more tangible appeal. But even here there are other practicalities to consider - the spirits company Kweichow Moutai for example is listed in Shanghai, which means restrictions on overseas ownership and differing governance and accounting requirements.

These are not necessarily insurmountable barriers, but we're not sure we're quite ready to hurdle them ourselves. In the

meantime we're confined to peeking over the top and must content ourselves with our Global Equity representative portfolio c.5% Chinese revenue exposure. A slightly higher figure than that of say the average US listed company (c.4% according to Morgan Stanley) but still not an enormous number. For many of our investee companies however, China is, and will likely remain, their most important emerging market geography. Hence, it's crucial they stay attuned to developments and that we monitor their progress as they do. At the end of the day though we essentially want to understand and own great global businesses, wherever they're located. These are a rare species for which China, directly or otherwise, is providing an increasingly fertile habitat and if for no other reason than that, China remains uniquely difficult to ignore.

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Footnotes:

1. As Charles de Gaulle once sagely noted, 'China is a big country, inhabited by many Chinese'.
2. I met with each of the BATJs (Tencent via a Pernod coordinated group meeting) save Alibaba for logistical reasons - China is a big country - but with whom we are scheduled to follow up via conference call.
3. ...unfortunately, it has to be said, as Pernod's shares have returned a healthy 12.5% pa over the past 20 years vs. 5.6% for the MSCI World. To be fair, LT-owned Diageo, Rémy Cointreau and Brown Forman shares have also performed well over long time horizons - with total 20 year returns of 10.5%, 12.7% and 13.5% respectively. We've said it before, but booze is clearly the place to be.
4. A much discussed Kleiner Perkins report recently drew attention to the fact that nine of the world's 20 biggest tech companies are now Chinese. Both Tencent and Alibaba have market capitalisations approaching $500bn, with Tencent very close to catching Facebook, and Alibaba already more than double the market value of PayPal and eBay combined.

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LTL 000-209-9 1 August 2018

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