Allianz Global Investors

EMBRACING DISRUPTION

What China's transformation means for European companies

China is an important market for European investors in many ways. European companies tend to have more international exposure than their US peers. China's impressive economic growth over recent decades has created huge market opportunities for European companies.

The list of companies which have exposure to the Chinese market is long and covers a broad range of sectors such as technology, raw materials, capital goods and consumer goods.

Grant Cheng
Senior Portfolio Manager

Prominent examples are ASML (semi-conductor equipment maker), BMW (premium carmaker), Rio Tinto (resources company) and Richemont (luxury goods company).

China is not only an important sales destination for European companies. According to some statistics, China's share of global manufacturing rose from less than 10% in 2003 to 31% in 2021. As China has developed a dominant position in global manufacturing (c.f. US 16%, EU 16%), many European companies have direct or indirect value chain exposure to China.

In many cases, it is hard to imagine a "pure" European product without the involvement of Chinese manufacturing.

Key Take-aways

- European companies need to adapt to China's transformation.
- High-end manufacturing, luxury, pharma and finance set to benefit.
- EV, batteries and renewable energy sectors could face challenges from Chinese competition.

Embracing Disruption

For example, Europe relies heavily on China for the production of some important pharmaceutical products, especially with regards to crucial ingredients (i.e. active pharmaceutical ingredients - APIs), and China is almost Europe's sole provider of photovoltaic panels. Even for industries such as robotics, where European companies dominate in final assembly, China is involved in the manufacturing of many components and the provision of raw materials.

Opportunities for European companies

After decades of rapid growth, China cannot continue to rely on the old model of heavily debt-funded property and infrastructure to generate growth. Besides, structural bottlenecks such as its ageing population are becoming increasingly apparent. Upgrading the Chinese economy, often referred to as "high-quality development" in policy documents, is the key focus of the Chinese government. Meanwhile, China has been trying to generate more growth from domestic consumption and reduce reliance on international trade through the "dual circulation" strategy.

When China was discovered as an investment theme 20 years ago, a popular phrase among investors was seeking companies which could "feed the Dragon". During that time, investment favourites were raw materials producers and energy companies which supported China's seemingly unsatiable demand for property and infrastructure. This analogy is still relevant, but the difference is that the Dragon has a different appetite. European companies specialising in high-end manufacturing, automation, and digitalisation will continue to benefit from China's industrial upgrade. As the role of consumption becomes more prominent, companies which offer luxury or unique consumer products will remain beneficiaries. Pharmaceuticals and wealth management are also interesting areas as Chinese society is ageing quickly.

Over the past years, AllianzGI's dividend-focused strategies have been positioned to capture the above-mentioned structural themes. One interesting name is a German logistics and courier company which derives a large part of the operating income from express business. It has particularly benefited from the strong growth of some Chinese e-commerce companies in Europe.

Investors used to seek companies which could "feed the Dragon". But nowadays the Dragon has a different appetite. European companies specialising in high-end manufacturing, automation, and digitalisation will continue to benefit from China's industrial upgrade.

Challenges for European companies

Nevertheless, for European companies, China's industrial upgrade may be a double-edged sword. For instance, China is forging ahead with the strategy of developing the "three new growth drivers" of electrical vehicles, EV batteries, and renewable energy. On the one hand, those industries offer potential solutions for Europe's renewable efforts. On the other, Chinese companies have become serious competitors for their European counterparts, especially considering that these industries in China are already facing huge overcapacity. Fierce pricing wars look inevitable.

The EV industry is a good case in point. The first cargo ship carrying 3,000 electrics cars "Made in China" docking at the port of Bremen made a lot of headlines in Europe.

It is widely believed that Chinese EV makers have about a 30% cost advantage versus their European peers. Their entry into the European market will exert huge competitive pressure on mass producers in Europe. These are really testing times for European car manufacturers, as well as their traditional supply chains.

Global capital markets face a very different geopolitical backdrop compared to the last three decades. European companies, which on average have wider global exposure, now need to consider various new geopolitical factors in their decision-making processes. A major Dutch semiconductor supplier, for example, will need to re-calibrate their growth opportunities in the future as the company faces rising export restrictions to China. Major companies in the automobile or the chemicals sector will need to adopt a "local production for local market" approach. In these cases, European companies will have to weigh more carefully between efficiency and security, which may lead to less attractive capital returns over time. In the stock selection process for the European portfolios, investors will need to give appropriate weight to these factors.

Chinese economy and capital markets – an international / European perspective

In the eyes of global investors, current uncertainty about China focuses on the following issues: 1) China seems to have hit a growth bottleneck, with its ageing population adding further pressure; 2) the property market, which used to a key growth engine, is facing huge structural problems; 3) heavy-handed regulation in the e-commerce and education sectors has stifled entrepreneurship; 4) rising geopolitical tension requires investors to assume a higher equity risk premium.

As bottom-up investors, it is observable that these unfavourable factors have led to an aggregate decline in the profitability of listed companies. Global investors will therefore need to closely consider how the roadmap to resolve the above issues develops before they re-engage in the Chinese equity story.

So far, the measures by the Government and the Central Bank to support the property market and reduce reserve rates are steps in the right direction. However, they are not considered sufficient as positive triggers for the market. It remains to be seen whether the government will introduce further fiscal measures to encourage consumption and resolve the local government debt issues and stabilise the property sector. The Government's 5% growth target laid out in the recent NPC, with a focus on high-quality development, means that the country may put more focus more on stimulating domestic consumption as well as continuous up-grades of industry, a challenging task which will also provide investment opportunities for European consumer goods and industrials companies.

No cause to be pessimistic about China's transition

The Chinese economy is in a transition. This provides both opportunities and risks for European companies, which investors need to carefully assess.

While most global investors are taking a "wait-and-see" attitude, we would like to strike a more optimistic note and quote the famous Song dynasty poet Lu You: " After endless mountains and rivers that leave doubt about a way out, coming through shades of willow trees, one encounters once again bright flowers and a lovely village - 山重水复疑无路，柳暗花明又一村".

Investing involves risk. The value of an investment and the income from it will fluctuate and investors may not get back the principal invested. Past performance is not indicative of future performance. This is a marketing communication. It is for informational purposes only. This document does not constitute investment advice or a recommendation to buy, sell or hold any security and shall not be deemed an offer to sell or a solicitation of an offer to buy any security.

The views and opinions expressed herein, which are subject to change without notice, are those of the issuer or its affiliated companies at the time of publication. Certain data used are derived from various sources believed to be reliable, but the accuracy or completeness of the data is not guaranteed and no liability is assumed for any direct or consequential losses arising from their use. The duplication, publication, extraction or transmission of the contents, irrespective of the form, is not permitted.

This material has not been reviewed by any regulatory authorities. In mainland China, it is for Qualified Domestic Institutional Investors scheme pursuant to applicable rules and regulations and is for information purpose only. This document does not constitute a public offer by virtue of Act Number 26.831 of the Argentine Republic and General Resolution No. 622/2013 of the NSC. This communication's sole purpose is to inform and does not under any circumstance constitute promotion or publicity of Allianz Global Investors products and/or services in Colombia or to Colombian residents pursuant to part 4 of Decree 2555 of 2010. This communication does not in any way aim to directly or indirectly initiate the purchase of a product or the provision of a service offered by Allianz Global Investors. Via reception of this document, each resident in Colombia acknowledges and accepts to have contacted Allianz Global Investors via their own initiative and that the communication under no circumstances does not arise
from any promotional or marketing activities carried out by Allianz Global Investors. Colombian residents accept that accessing any type of social network page of Allianz Global Investors is done under their own responsibility and initiative and are aware that they may access specific information on the products and services of Allianz Global Investors. This communication is strictly private and confidential and may not be reproduced, except for the case of explicit permission by Allianz Global Investors. This
communication does not constitute a public offer of securities in Colombia pursuant to the public offer regulation set forth in Decree 2555 of 2010. This communication and the information provided herein should not be considered a solicitation or an offer by Allianz Global Investors or its affiliates to provide any financial products in Brazil, Panama, Peru, and Uruguay. In Australia, this material
is presented by Allianz Global Investors Asia Pacific Limited ("AllianzGI AP") and is intended for the use of investment consultants and other institutional /professional investors only, and is not directed to the public or individual retail investors. AllianzGI AP is not licensed to provide financial services to retail clients in Australia. AllianzGI AP is exempt from the requirement to hold an Australian Foreign Financial Service License under the Corporations Act 2001 (Cth) pursuant to ASIC Class Order (CO 03/1103) with respect
to the provision of financial services to wholesale clients only. AllianzGI AP is licensed and regulated by Hong Kong Securities and Futures Commission under Hong Kong laws, which differ from Australian laws.

This document is being distributed by the following Allianz Global Investors companies: Allianz Global Investors GmbH, an investment company in Germany, authorized by the German Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin); Allianz Global Investors (Schweiz) AG; Allianz Global Investors UK Limited, authorized and regulated by the Financial Conduct Authority; in HK,
by Allianz Global Investors Asia Pacific Ltd., licensed by the Hong Kong Securities and Futures Commission; in Singapore, by Allianz Global Investors Singapore Ltd., regulated by the Monetary Authority of Singapore [Company Registration No. 199907169Z]; in Japan, by Allianz Global Investors Japan Co., Ltd., registered in Japan as a Financial Instruments Business Operator [Registered No. The Director of Kanto Local Finance Bureau (Financial Instruments Business Operator), No. 424], Member of Japan Investment Advisers Association, the Investment Trust Association, Japan and Type II Financial Instruments Firms Association; in Taiwan, by
Allianz Global Investors Taiwan Ltd., licensed by Financial Supervisory Commission in Taiwan; and in Indonesia, by PT. Allianz Global Investors Asset Management Indonesia licensed by Indonesia Financial Services Authority (OJK).

March 2023 3454427 (Admaster)