RESEARCH INSIGHTS

Wong Hui Ting Rachel
htrwong001@mymail.sim.edu.sg

Consumer Descretionary Companies
On China Economy & Markets

Amidst historic turns of events, we take a closer look into the workings of the Chinese economy's influence on Chinese Consumer Discretionary Companies and the possible opportunities that lies ahead.

China's Economy at a glance

China has been a socialist country since 1949, and, for nearly all of that time, the government has played a predominant role in the economy. In the industrial sector, for example, the state long owned outright nearly all of the firms producing China's manufacturing output. (Britannica, 2023)

China's History

Since the early years of China, the country has decided to create a "socialist market economy", where governments are in charge of redistributing wealth and narrowing the gap between the poor and the rich. With a planned economy structure, China growth and key decisions are mostly centered amongst the power of its politicians, with private and public companies acting as a secondary support, down to the locals, who have minimal say in the country's policy and political decisions. A double edge sword for China's growth companies, as Chinese companies are restricted by their government decisions. Regardless, the Chinese Discretionary sector has undeniably played a vital role in its economy, contributing to the majority of the local work labour force. China's economy has since grown rapidly, playing a major role in the global economy today, as its GDP hits nearly $18 trillion in 2021, constituting 18.4% of the global economy (He, 2022), with a continuous GDP growth of at least 5% since 1991. (Lin, 2006)

The Role of Chinese Companies

China has grown at an average of 7.4% annual growth on average between 2010-2019. Whereas the compounded annual growth rate for China Growth companies is at 6.7% in 10 years annual average returns, accommodating for most of the growth in China. (Lin, 2020) Growth companies have played a crucial role in moving China's economy in the past year, especially the five biggest software companies: JD.com, Alibaba and Meituan. The essence of economic growth is a continuous improvement in productivity, which has been mostly achieved by technological innovation in China, as more and better products are produced per unit of labour. (Lin, 2020)

China has always been known as a socialist country where its government takes precedence of any private companies decisions, as they are being rolled out in a planned economy format.

With such high political risks, these high growth companies find themselves more susceptible to taking a toll in their earnings and uncertainty in sustainability, as compared to other growth companies like Google and Amazon in the states, where they are entitled to higher scope of freedom.

Although China's growth companies have been the main drivers of its accelerating economic growth in recent years, we cannot completely rule out the government's authority in getting rid of their existence like what they did with Didi's IPO due to a breach in antitrust issues. Didi, a once promising growth company equivalent to Grab, was sent to its tailspin when their ride-hailing app was banned in China due to an involvement in the illegal collection and use of personal data, with no specific violations being cited. (Reuters, 2022)

The company has no control over the government's decision and was being wiped out months after its Initial Public Offering, sending warning to investors with China's increasing political risk that could sweep any well regarded companies to its death with no prior warnings.

Capitalism vs Socialism

With China's stringent control, all legal production and distribution decisions are made by the government, with individuals dependent on the state for food, employment, healthcare, and everything else. How is this fairing as compared to the rest of the world?

In United States, capitalism has always been the prevailing system. Private individuals and businesses in its economic system have the freedom to own and control the factors of production. Capitalism's success is dependent on a free-market economy, driven by supply and demand, whereas the government determines the amount of output and pricing levels of goods and services in a Socialist country. This has led to the disparity in treatment towards growth companies in China and US respectively. Looking at the tech crackdown in the states and China, we would have seen a huge disparity in the treatment of two companies in the two different countries. In US, when Facebook was caught with the violation of its users' data through deceiving its users by sharing data of users' Facebook friends with third-party app developers, it was fined with a hefty amount of $5 Billion and submit to new restrictions and a modified corporate structure to hold its firm accountable for users' privacy.

However, apart from its penalties, the government did not restrict Facebook's freedom in the free market and it continued to operate with higher privacy for users as required by the Federal Trade Commission.

Such freedom in the free market has also cultivated a safe space for Facebook to venture into untapped opportunities, leading to a first mover's advantage in revolutionising our daily social connection. Introducing Meta, Facebook company's new name has recently started its metaverse project with an aim to allow us to reimagine social connection, by bringing 3D virtual spaces to live where humans can experience life that they could not in the physical world.

This would not have been possible for Chinese Tech Companies, where that amount of freedom to innovate would have been stripped away by the Chinese government. Alibaba, well known as Amazon of China has been forced to confirm to its government, when its daily operations were greatly disrupted by the government when their popular internet browser on mobile was forced to be taken down from several app stores in China after state media criticised it for allegedly allowing misleading medical advertising, before being ordered by the government to divest and dump its media assets as authorities grew more concerned about the tech giant's influence over public opinion.

In the United States, the Biden administration is recruiting high-profit leaders in the big Tech antitrust space, in hope to improve transparency and accountability in the industry, whereas Beijing's solidified their political control to ensure that no private company is able to supersede the ruling of the Chinese government and deviate from serving the political and economic goals set by China.

As seen in the differing treatment resulted from the two different economic systems, we could see how an oppression from the government would hurt Chinese firm's growth in the long run and prevent them from innovating freely, leading to a cap in their potential. This could be shown when Chinese tech CEOs have been left with little room for negotiation with regulators since. An example would be the abrupt suspension of ANT's IPO by Chinese regulators after Jack Ma, the founder of Ant Group criticised China's financial regulatory system for stifling innovation. (Wang, 2021)

The Covid-19 Pandemic

During the Pandemic, China's government had decided to adopt a COVID-Zero policy, where mass testing and quarantine was legally enforced to keep covid cases close to zero. China's health authorities have announced major shutdowns in August and September, putting 33 cities and 65 million people in full or partial lockdowns, including Chengdu, a city of 21 million people which was locked down completely. Mega-cities like Shanghai and Beijing also went on a mass lockdown for months in 2022. With China's new lockdown measures set to put supply chains into a halt, we could see the rippling effects that are felt throughout the world.

E-Commerce companies like JD.com and Alibaba's daily operations were forcefully disrupted, putting local consumption of goods and export goods to a pause. International consumers of Taobao, the ecommerce app of Alibaba could not purchase their items as there were no workers and logistic providers available to facilitate the goods. The indefinite timeline of the Covid-19 in 2022 has affected the company's business, leading to huge losses as goods sat in their inventory, with no revenue brought to the company.

Since then, Cainiao, Alibaba's logistic enterprise that works behind the scenes to deliver parcels to customers, has seen a severe slowdown in their revenue growth to only 5% year on year in FQ1'23, when they were the growth driver for Alibaba exceeding 50% in growth just 2 years ago.

Chinese Discretionary Companies were forced to take a hit in their earnings with China commerce year on year growth plunging to 1%, with a total revenue of 0% growth. This has given rise to e-commerce and logistic risks in China, as E-Commerce companies like JD.com and Alibaba have since seen its logistics operations being negatively affected, in turn slowing down China's economy. (Seeking Alpha, 2022)

	Three months ended June 30,			
(in RMB millions, except per share data and percentages)	2021	2022	YoY%	% Total Revenue
Total revenue	**205,740**	**205,555**	**(0%)**	**100%**
China commerce	144,029	141,935	(1%)	69%
International commerce	15,202	15,451	2%	7%
Local consumer services	10,099	10,632	5%	5%
Cainiao	11,601	12,142	5%	6%
Cloud	16,051	17,685	10%	9%
Digital media and entertainment	8,073	7,231	(10%)	4%
Innovation initiatives and others	685	479	(30%)	0%
Income from operations	**30,847**	**24,943**	**(19%)[2]**	**12%**
Share-based compensation expense	7,811	6,725	(14%)	3%
Amortization of intangible assets	3,073	2,751	(10%)	2%

It is not all gloomy, as China has recently moved away from its COVID-Zero policy, resuming its local production as cities are no longer locked down with home isolations allowed for mild or asymptomatic cases. It has also adopted a covid tracking system similar to our local "trace together" app where clusters and covid cases can be quickly identified and reduced. This has allowed logistic operations of E-Commerce to resume, with operations resuming back to normal, we would be able to expect an increase in goods consumption due to the rapid acceleration of digitalisation that Covid-19 has forced the world into. However, we would still have to be cautious with the surging covid cases, as China eases its restrictions with more communities mingling amongst each other.

Case Study

Alibaba, a growth company known as a large e-commerce retailer, has created 40.82 million jobs in 2018, accounting for a proportion of China's workforce as cited from AliResearch in 2020. The company's platform has served many small and medium-sized Chinese businesses to facilitate selling of their goods both domestically and in the global marketplace.

Referred to as the "Amazon of China", Alibaba develops and implements digital technologies that assist online transactions, including mobile commerce infrastructure, cloud computing, logistics platforms and its payment service known as Alipay. The firm plays a crucial role in China's economy, with its mobile payment app Alipay, being entrenched into the lives of the locals. Cash is no longer a preferred option for locals to make payment for the purchase of their daily goods and services.

However, even with such a vital role played by the tech giant, it could not match up against the government's decisions. In 2020, the affiliate company of Alibaba, Ant Group's world record-setting initial public offering in Shanghai and Hong Kong was suspended by China authorities, in fear of the dangerous accumulation of systemic financial risk spewing out from the firm's business model, after its founder criticised Xi Jinping, the country's top leader. Xi Jinping has brought an uncompromising edge to their tactics for enforcing the communist party's will. Investors of what would have been the world's largest share sale were getting refunds, affirming the dangers of its political risk.

In Comparison to International Markets

The innovation from both consumer discretionary companies namely, Walmart from US and Meituan from China have seen a huge difference in their technological innovations that would shape the future of their companies. The pandemic has accelerated the use of technology, with food delivery companies adopting drone deliveries to deliver parcels to its consumers in a faster and more efficient way.

With Covid-19 and the lockdown in China, Meituan's drone delivery demand has skyrocketed as many locals were stuck in their homes, with a record breaking of 100,000 complete drone deliveries in 2022 by Meituan with delivery of parcels within 3 km range (Pandaily, 2023), whereas Walmart in the states, only made 6,000 drone deliveries, with packages within 1.5 miles of their drone hub. Walmart has also announced plans to expand their DroneUp delivery network to 34 sites by the end of 2022, providing the potential to reach 4 million US households across six states, providing them the ability to deliver over 1 million packages by drone in a year with their upcoming R&D innovations.(PYMNTS, 2023)

Meituan has also since launched its first normalised route of unmanned drone base in Jinshan District, Shanghai in December 2022 and stay ahead in the drone delivery space. With China's R&D moving ahead of the rest of the world, we can see how the Chinese firms still manage to remain competitive in the market, despite the many restrictions they had in the past year.

Conclusion

China, being the world's second largest economy has accelerated its economic growth over the years with its government taking a socialist approach. The Chinese economy is driven by its growing population, leading to a favourable business environment and government policies in support of their development. One of China's key economic reliance is manufacturing and exports, which has been gradually shifting towards a more service-oriented economy. The national government has played an important role in fostering a well regulated environment for industry players to ensure its continued competitiveness between companies to boost its economy with its anti-monopoly policies.

However, with such tight regulations from the government, it is clear that the strategies at the national level have brought zero room for negotiations for its local companies to take precedence over the government's ruling, regardless of the direction where its policies might take the economy to. Local companies could have their earnings and growth oppressed by the slightest shift in policies from their regulators, serving as a double edge sword to its economy. Despite its success, China faces significant challenges in the medium term to address growing imbalances in its economy, as different provinces are growing at different rates, alongside asset price inflation. China's macroeconomic levels will need to evolve to ensure a sustainable growth and closing the gap between the rich and the poor.

On the industry level, the rise of Chinese growth companies has become a favourable business environment in China. The country's strong culture of entrepreneurship has led to a strong culture of risk-taking and innovation in the country. (Tse, 2016) With industries cultivating a vibrant startup ecosystem, it has paved the path for a large number of companies to be founded and growing rapidly. Overall, Chinese growth companies have played a vital role in driving China's economy and is expected to be further boosted in the coming years.

Chinese tech giants have proved themselves to be increasingly competitive in the global market, as they have contributed a substantial amount to China's workforce.

Reforming the Chinese economy system could eventually create more room for greater growth, by adopting parts of US free market ideologies. By redefining the role of government, allowing private companies to have more freedom for innovation, Chinese Growth Companies will eventually be able to gain more local market share and adopt more users on their platforms, raising its revenues and China's economy as a whole. Building an alliance between a power balance of both growth companies and the government may bring about a common ground for China's economy to accelerate even further, while ensuring China's safe environment for consumers. Policymakers may also loosen up their regulations, to make room for technological advancements and economic growth to tap into the less developed areas of the China market.

Writer's Opinions

The Opportunities

Chinese growth companies have been increasingly competitive in the global marketplace. With the rise in competition of growth companies globally, it is prudent to approach the Chinese socialist economy with a sensible dose of skepticism, as Chinese growth companies may not be able to catch up with its international competitors if continuously oppressed by its local government. As growth companies in the technology and commerce sector gradually become an intrinsic part of our everyday lives and our global economy, it is worth noting that an accelerated economic growth can only be achieved with a certain amount of freedom given to companies to innovate. We must not dismiss the political risk in Chinese Growth Companies, where a shift in a political stance could easily depress their earnings with the lack of room for negotiation.

As of now, Chinese growth companies are still the key drivers of the Chinese economy, with an unlikely occurrence of its government imposing policies that are strong enough to remove their trace in the global market. As with the pandemic, it will take time for a more effective resolution for these companies to remain competitive globally, one which China should consider to loosen their regulations in order to boost companies' growth. Perhaps, once more freedom is given for China companies to tap into their consumer in a sensible manner, we will see an acceleration of the Chinese economy to potentially supersede the United States position in becoming the world's largest economy. This could shape our society in unimaginable ways as we pave the road towards a shift in our major global player.

When narrowing down China's economic outlook to an industrial level, we could still see the great potential in investing in such companies as they have done exceptionally well in driving China's economy and have remained extremely competitive in the global market. Companies like Alibaba have allowed us to reimagine consumption of discretionary goods, while becoming more competitive in the digitalisation world.

From the transformation of brick and mortar stores to adopting online shopping, and eventually the creation of an ecosystem that bridges our daily needs with the tap of your fingers, Taobao, a subsidiary of Alibaba, the largest ecommerce company, has brought about a revolutionary retail experience while ensuring a smooth shopping journey, from the development of its Search Engine Optimisation, with a picture search function, to connecting the best sellers to the buyers and on to the smooth delivery of goods.

We have seen the company thriving through the digitalisation era with its singles day sales breaking striking record highs, even with the restrictions of Covid-19. In my opinion, companies that have been able to emerge as drivers of China's economy while having increasing comparative advantage despite constantly being susceptible to its government policies shows that it is a great company to invest in.

Moreover, as drivers of its economy, it would be mindless for the government to completely tarnish the company, adversely affecting their own GDP and labour supply. With the right balance in national policies and giving Chinese growth companies a degree of freedom to further innovate, we would be able to see great investment opportunities lying amongst them and even more prosperity being brought to China.

Disclaimer

Any names of financial assets listed during the sessions are for educational purposes only. It is not an offer to solicit any buying or selling of shares. Any recommended trades or investment undertaken will be of your own responsibility and will have nothing to do with SIM Group, SIM-INC, or any of the members from the Market Research Department. We are not a licensed trader or remisier and are therefore not allowed to many any buy or sell calls in relation to and financial asset. If you wish to invest or trade, please consult your licensed remisier or broker. Any names of companies listed here are not an advertorial of the group's products or services and solely for educational purposes only. Opinions and estimates offered constitue our judgement and are subject to change without notice, as are statements of financial market trens, which are based on current market conditions. We believe the information provided here is reliable, but do not warrant its accuracy or completeness. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The views and strategies described may not be suitable for all investors. This material has been prepared for informational purposes only, and is not intended to provide, and should not be relied on for, accounting, legal or tax advice. References to future returns are not promises or even estimates of actual returns a client portfolio may achieve. Any forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation.