Inside the Great Wall

December 2019

Having just returned from a fantastic 15-day journey to Hong Kong, China, and Singapore, I felt that sharing some reflections from my trip would be a great jump start to a newsletter. Before diving in, since this is the first letter, I will quickly direct readers to www.conoveradvisory.com to learn more about my company. In short, we leverage our experience to partner with performance-oriented investment organizations to provide them with perspective and scale in a customizable manner. And now with that out of the way…

The impetus for my trip was the ValueAsia investment conference in Shenzhen, China. ValueAsia was modeled after another conference, ValueX, in Switzerland which forgoes bank sponsorships in favor of no frills, collegial idea-sharing and networking. I enthusiastically recommend both events. This was the third year for ValueAsia and, though I was originally an organizer, I am no longer involved in the planning so can happily deflect all credit while singing its praises. During the extended weekend, we drank from a firehose learning about Chinese businesses, visited several Shenzhen-based companies, and made great new connections. Having first travelled to Asia in 2008 and China in 2013, I grow increasingly excited about the investment opportunity there each time I go. This trip was no different. Despite my enthusiasm, I am surprised by the response investing in China receives from many Americans, often some form of:

> "Won't the government just snap their fingers and take your assets one day?" or
> "Ultimately, communism doesn't work, look at places like Cuba and Venezuela."

Mei Too

Despite my differing opinion, I empathize with this sentiment. Unfortunately, the US media does a "fake news"-worthy job of covering China. For example, a Wall Street Journal ("WSJ") website search for significant news on the Chinese company Meituan Dianping returns exactly one hit: a Barron's article entitled "6 Internet Stocks for China's Post Growth Era." Leaving the ridiculous Post Growth Era tag aside… Meituan Dianping is a $65 billion Chinese "Super App" facilitating 600 million users by selling just about anything: food delivery, travel booking, and ride sharing to name a few. Meituan raised $4 billion in an IPO just over a year ago, its stock has doubled in 2019, and it may be the best positioned challenger to the Baidu, Alibaba, Tencent supremacy in the Chinese internet.[1] Oh, and the company was founded only nine years ago. It's clear whose interests our media feeds as our headlines are dominated by stories of our government's sanctions on Huawei or issues with ByteDance (owners of the infamous video sharing app, TikTok, with 1 billion users) and little mention of the wild economic successes of a Meituan or ByteDance. Of course, our government's dealings with Huawei and

[1] I will note that, of course, Tencent is already a major backer of Meituan

ByteDance are significant stories, but ongoing coverage of the world's largest internet IPO since Alibaba seems worthy too![2,3]

Assisted by poor news coverage, a perception persists likening China's economy to those of the former USSR, Venezuela, or Argentina. The latter regimes serve their citizens sky-high inflation rates, shrinking economies, corruption, and government takeovers of private business. Meanwhile, China, with a unique form of **Chinese capitalism**, has nurtured globally dominant companies, built the second largest economy in the world, and most importantly, lifted hundreds of millions out of poverty – with hundreds of millions more to come – by **liberalizing** its economy away from communist/socialist roots. Even since just 2010, when Chinese growth has been "slowing," per-capita GDP has more than doubled to $9,800 (a number that is many multiples higher in first-tier cities).[4] Risks associated with investing in China, with their all-powerful, single-party government and strict capital controls, are not trivial, but it is difficult to imagine the political drive from Beijing to upset their successful trajectory powered by liberalizing their markets. Look no further than leading Democratic Presidential Candidate Elizabeth Warren's plan to break up Big Tech as a reminder that political risk in investment can be found in all corners of the world.

Here Today, Gone Yesterday

I would guess most Americans have never heard of the Chinese city of Shenzhen, where I spent much of my visit. A Google Trends comparison shows Shenzhen on level footing with the aardvark in US searches. Shenzhen's history, or lack thereof, is fascinating. And what has happened there is nothing short of an economic miracle. Around 1980, Shenzhen was officially designated as a city and shortly thereafter by Deng Xiaoping as the first special economic zone in China in the post-Mao-era. Since then, Shenzhen has become a city of transplants that puts even my own city of Charlotte to shame. Sprouting up just 15 minutes by high speed train away from the economically independent Hong Kong, it has exploded into the fourth most populous city in China with 13 million permanent residents (estimates including migrant workers put the population at 20 million).[5] According to the Economist, over that period Shenzhen's **inflation-adjusted GDP** grew at a 22% annualized rate to an overall level higher than Hong Kong's. Shenzhen initially grew on the strength of its manufacturing base and proximity to Hong Kong but is now the most modern and tech-centric city in China, and perhaps the world. Roughly 4% of that GDP is plowed back into R&D to the tune of companies in Shenzhen filing for more international patents than they do in France or Britain.[6] Restaurant patrons order and pay for their food seamlessly from their phones. As with the rest of First Tier China, residents enjoy a world-class public transportation system, high speed rail connections, and a beautiful airport. This city, which now ranks 9th in the 2019 Global Financial Centers Index, almost literally **did not exist 40 years**

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[2] https://www.reuters.com/article/us-meituan-ipo/tencent-backed-meituan-raises-4-2-billion-in-ipo-priced-near-range-top-sources-idUSKCN1LT05D
[3] To be fair to the Journal, they did cover Meituan at IPO
[4] https://data.worldbank.org/indicator/NY.GDP.PCAP.CD?locations=CN
[5] For the compounding geeks, the difference between 13 or 20 million is just 7% vs 8% annualized for 39 years
[6] https://www.economist.com/special-report/2017/04/06/shenzhen-is-a-hothouse-of-innovation

ago.[7] The saying about a competitor playing chess while everyone else is playing checkers alludes to two games, one dramatically more sophisticated than the other, played on the same board… in Shenzhen, China has moved beyond chess on a checkers board to virtual chess in the cloud, backed by a machine learning algorithm. And where did this success stem from? Xu Youjun, vice-chairman of the Shenzhen division of the Chinese People's Political Consultative Conference, a government advisory body, credits success not to the Communist Party directly, but to its policy of allowing people to go "**beyond** the planned economy."[8] Shenzhen is the poster child for modern China.

Fists of Fury

A stark contrast simmers across the Sham Chun River in Hong Kong. During my trip, I found myself at the center of a large, peaceful demonstration in Central, Hong Kong. The protests, which have been ongoing since June, were sparked by an infamous Extradition Bill (since withdrawn) that would have allowed Hong Kong residents to be tried for crimes in the mainland. I was also in the city to see the shorter-lived demonstrations of the Umbrella Movement in 2014. The protests this time are more violent, spread further about the city, and more widely supported locally. Two million people, or roughly **30% of Hong Kong's metropolis population**, took part in one mass demonstration.[9] Since the Extradition Bill has been withdrawn, but the protests remain, it's clear that deeper issues exist. Hong Kong's desire for democracy is huge, but there are critical economic and social factors too. Under British rule the city enjoyed economic prosperity earlier than mainland China. However, that prosperity, which has been only amplified by reunion with China, has been reserved for the top of the economic food chain, including many foreigners and mainland Chinese, and made things difficult for those at the middle and the bottom of the ladder, particularly Hong Kong's youth. Housing provides a pertinent example, with the city boasting the highest average real estate prices ($1.2 million) in the world.[10] I can only imagine trying to manage a household on the local minimum wage of less than $5 per hour. Residents in Hong Kong, unlike those born in, say, New York City with comparable housing costs, have no nearby alternative with cheaper housing to move to.

Political control of Hong Kong, as a Special Administrative Region ("SAR"), is technically separate from mainland China. The government has democratic elements but is ultimately controlled by Beijing. This blend seems to suffer from the issues of democratic governments (namely slower moving bureaucracy and politicians in bed with business tycoons) while lacking the benefits (the optionality to change leadership). How the situation ultimately resolves itself is difficult to predict. Separation from China is off the table. A move to real democracy is unlikely. China and the Hong Kong government have thus far been commendably restrained in their response, but the protests are turning more violent. Local frustration with protestors ended the Umbrella Movement in 2014, but with the US wading in with the Hong Kong Human Rights and Democracy Act and recent election results where pro-democracy

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[7] https://en.wikipedia.org/wiki/Global_Financial_Centres_Index
[8] https://www.economist.com/special-report/2017/04/06/shenzhen-is-a-hothouse-of-innovation
[9] https://www.pbs.org/newshour/show/nearly-2-million-protest-in-hong-kong-as-chinese-forces-gather-near-the-border
[10] For comparison, Vancouver, the highest in North America and heavily influenced by China as well, is a "mere" $850,000

parties took 17 of 18 district council seats, pressure sits with Hong Kong's government to answer the bell.[11,12]

In the short run, only the local Hong Kong economy suffers with tourism down significantly, daily life disrupted, and hotels sitting empty. Beijing seems content with a wait-and-see mode. In the medium term, China needs Hong Kong. The SAR remains the lynchpin of China conducting business with the West and vice versa because it is an open economy and carries special trading designations. As China wishes to directly control its currency, economy, and many of its companies, all while hoping to benefit from foreign capital and the presence of foreign companies… Hong Kong is their window to the outside world until they open more of their economy. I don't see any other cities in the region able to take Hong Kong's place. In the long run, however, as the mainland economy continues to grow more open, Hong Kong's importance as a finance and trade center should weaken (calling Shenzhen?). Though for more than one reason (starting with sky-high prices) I am not looking for a real estate broker in Central, the turmoil does not deter my long-term interest in investing in China. To wrap up, I can only hope that citizens of Hong Kong and their government find a way to work together to end the violence and address its root causes soon.

Closing

I hope to use these letters to provide investment insight into the way I think, in this case, about China. Despite my enthusiasm, I will note that I have just five percent of my personal assets invested in the country today. I can envision that number growing to 10-15% over time, assuming I find attractive opportunities with trustworthy partners. In China, working with trusted local experts is paramount. Accordingly, the thrust of my recent trip consisted of meeting and networking with exceptional local investors searching for these potential opportunities. I share contacts and details from these meetings with my clients. If any readers are interested in speaking with me about China or investing generally or believe that working with Conover may be beneficial, please reach out to me at inquiries@conoveradvisory.com. I look forward to hearing from you.

Sincerely,

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[11] https://www.scmp.com/news/china/politics/article/3039303/china-tries-brush-pro-democrat-victory-hong-kong-election-and

[12] https://www.nytimes.com/2019/11/20/business/hong-kong-human-rights-act.html

Extra Credit

1. The Economist: Shenzhen is a Hot House of Innovation
   - https://www.economist.com/special-report/2017/04/06/shenzhen-is-a-hothouse-of-innovation
   - An older link, but with excellent highlights on Shenzhen
2. Himalaya Capital founder Li Lu's Speech at Peking University
   - https://offpisteinvesting.com/li-lu-speech-peking-university-2015/
   - This speech (translated by my friend Graham Rhodes) provides a sense of China's likely economic road map from one of its greatest investors; the speech was a turning point in my own thinking on China
3. The China History Podcast
   - https://recordedhistory.net/china-history/
   - A great resource on China's history, including the History of Hong Kong from episodes 101-110
4. The Financial Times: India's Shadow Banking Crisis Raises Spectre of Contagion
   - https://www.ft.com/content/61fb4894-f634-11e9-9ef3-eca8fc8f2d65
   - Many formerly high-flying stocks in this sector are down 70-90%; public sector has announced a $10 billion recapitalization of public-sector banks to get liquidity flowing
5. The Financial Times: US Regulator Issues First Approval for a Chinese Cancer Treatment
   - https://www.ft.com/content/26cb4414-0763-11ea-a984-fbbacad9e7dd?shareType=nongift
   - Further evidence of China's economy evolving and modernizing