ACTIVE
VIEWPOINT

MARTIN CURRIE
A Legg Mason Company

GLOBAL EMERGING MARKETS

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TALES FROM THE ROAD

Velocity of change: India & China

Paul Desoisa
Portfolio Manager,
Global Emerging Markets

Watching friends effortlessly split the bill after dinner in Shanghai highlighted perfectly for me the pace of change occurring in emerging markets. Using smartphones, the restaurant received payment and individual contributions were covered with just a few swipes – all in a matter of seconds. The small episode, for me, summed up a willingness to embrace innovation and growth that I witnessed from the companies and people I met in both China and India.

> In both India and China, the speed of change is evident at almost every turn.

CHINA

I, ROBOT

The first stop on my research itinerary was a factory run by auto-parts company **Minth Group** (not held in the strategy) in Ningbo, about three hours to the south of Shanghai. Known for its manufacturing quality and expertise, the Minth factory lobby showcased an impressive array of the company's products, back lit by blue lights, held up in Perspex and arranged in the shape of a Cadillac. On the shop floor, there were more 'space-age' elements, as autonomous robots navigated around the production line, guided by QR codes placed on the floor.

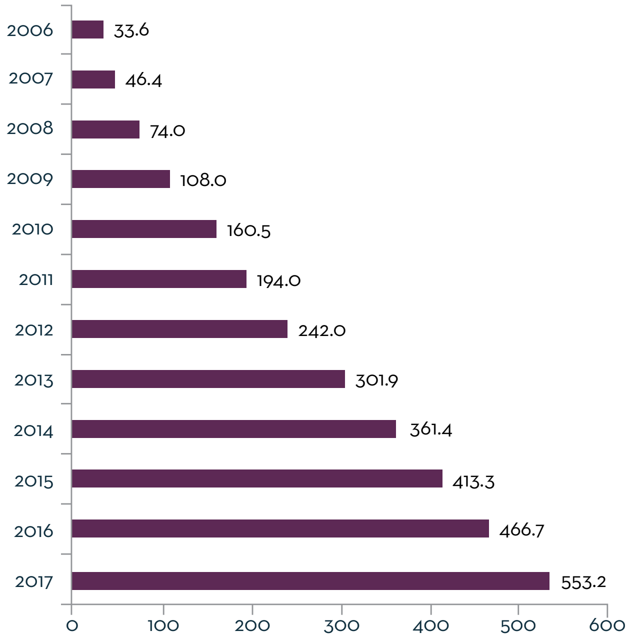
Automation has been an area of heavy investment for the company as it looks to improve the efficiency of its production capabilities and reduce costs. With over 16,000 employees, the majority of whom are directly involved in production, wage inflation is a constant challenge for Minth, and a large driver of its bottom line. Transitioning some of the labour-intensity in its operations to robots therefore seems a logical solution. What's more, the payback for a robot, that can cost as little as 200,000 renminbi (around US$29,300)*, is relatively inconsequential over a year, and the output (such as polishing and painting) is to a better standard than the human equivalent.

In 2017, the company bought more than 700 robots and it expects to invest in a similar number this year*. Importantly, Minth has considered the social implications of such a move, in particular the effect on morale that could come from a shift towards greater automation. In fact, the company does not view the move as impacting the existing workforce, rather maintaining a flat headcount as sales grow. Minth regards automation as a vital means of servicing a growing level of demand, while managing its margins.

AUTOMATE TO ACCELERATE

The sheer scale of demand growth, and the operational challenges of meeting it, was also a theme expressed by **ZTO Express** (not held in the strategy), China's leading express-delivery firm, which I met at a conference in Beijing. The company expects the industry to grow from processing 41 billion parcels in 2017 to 70 billion in 2020* – a result of the phenomenal rise in e-commerce and smartphone-enabled ecosystems, all driven by China's increasingly affluent population. Against this backdrop of growth, ZTO believes it has the potential to take an even larger share of what already is a fragmented industry.

Number of online shoppers in China from 2006 to 2017 (in millions)



Source: Statista and CNNIC.

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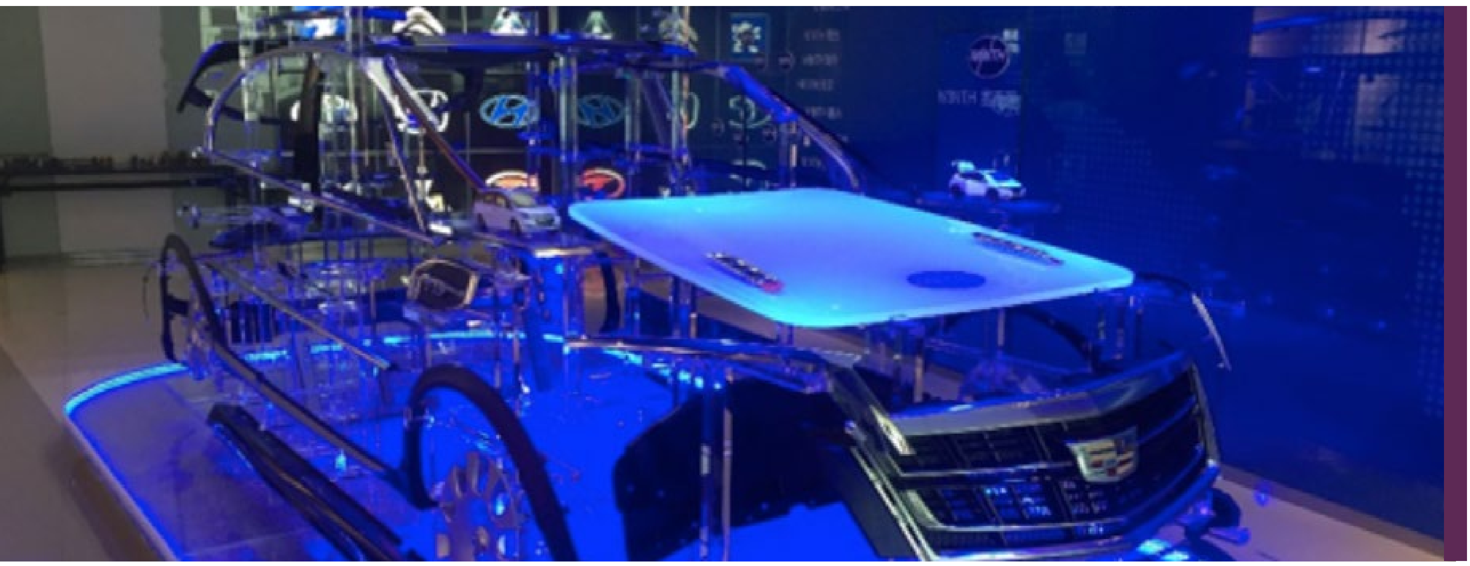
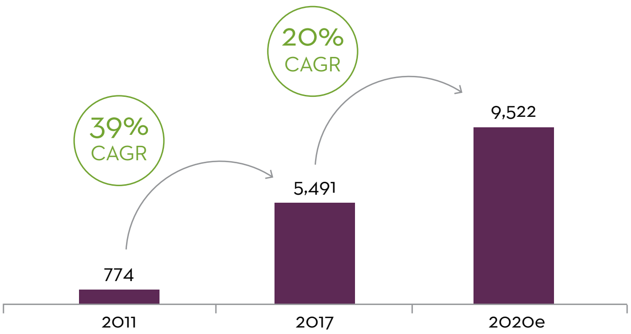
*Source: Martin Currie, company presentation.

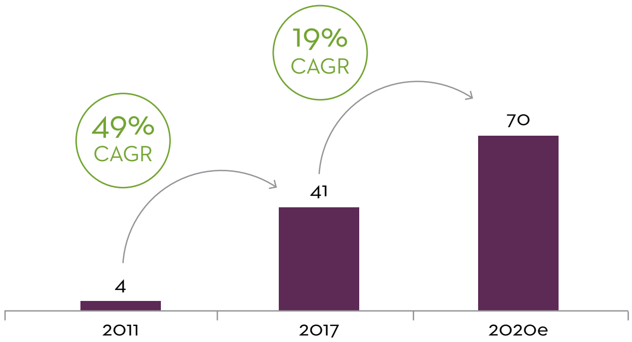


Last year, the firm processed more than six billion packages, and in May reported a 36% year-on-year rise in first-quarter revenue. However, continued strong growth is dependent on successfully scaling its operational ability. This is where technology adoption and increased automation will be vital. ZTO's sorting hubs currently process around 150,000 parcels per day, with each of its sorting personnel handling around 700 parcels per day. While impressive, these numbers pale in comparison with the kind of productivity gains the company believes is possible with automation, with sorting lines able to handle up to 20,000 parcels per hour*.

Market opportunities
Online retail sales (gross merchandise value) in China maintaining robust growth (RMB in billions)



Express delivery industry
Express delivery parcel volume benefiting from e-commerce growth (RMB in billions)



Past performance is not a guide to future returns.

Source: FactSet. Reproduced from ZTO Express Q2 of Fiscal Year 2018, Investor Relations Presentation – originally sourced from CNNIC National Bureau of Statistics and The 13th Five-Year Plan issued by China Post Bureau.

Unsurprisingly, ZTO's exposure to such a powerful growth theme is attracting significant attention. The day before my meeting with the company, e-commerce giant **Alibaba** (held in the strategy) announced it had led a consortium of investors to buy around 10% of ZTO, for a reported US$1.4 billion*. Alibaba has been expanding its presence in its logistics network for some time (it already has a controlling stake in a logistics affiliate, Cainiao). This move will provide further strategic partnering support to its own operations. The crucial question from here is around ZTO's ability to scale its operations, the sustainability of the current cost structure and whether its new Alibaba relationship will enable even greater access to the growth potential of e-commerce. We will continue to keep a close eye on this company.

RAPID SHIFT FROM COAL

The rapid pace of change is evident across several industries, as highlighted by a business held in the Emerging Markets strategy, **China Gas**, which I visited on this research trip. The company has seen fast expansion into rural areas, with a major catalyst being China's ambitious environmental programme. The country is seeking to shift from coal to cleaner-burning natural gas – a transition which is happening at a pace across a vast swathe of rural China.

As one of the country's leading gas distributors, the company has been more aggressive than its peers in pursuing the rural natural gas opportunity. I travelled to a rural part of Tianjin, about two hours outside Beijing, to see first-hand how people's lives are changing rapidly as a result. Not that long ago these households would be using coal for heating and cooking, but now they are being supplied with natural gas. I was hosted by a local resident in their home, who showed me their natural gas pipeline connection and new gas-operated cooker (which can also be sold to them by China Gas). The company plans to connect around 16.5 million homes (both in urban and rural areas) to its gas network over the next three years*. It is a huge growth opportunity. Of course, the growth outlook is intertwined with potential operational challenges that we will be monitoring with the company. It is not easy to connect this amount of homes over a three-year period, but we have a good understanding of the business model and will continue our dialogue with China Gas on its progress.

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*Source: Martin Currie, company presentation.

INDIA

DEMAND FROM ALL AREAS

The rural consumer was also a prominent topic at a conference I attended in Mumbai. Consumption rates outside India's cities were strong last year, with many companies at the conference predicting that growth would remain robust this year and into the next. A large proportion of rural incomes comes from either the regional or national government, and subsidies have been pouring into rural regions in the build up to elections to the State Assembly and a general election in 2019.

As a result, companies exposed to rural demand have fared well in recent years. This came across in my meeting with Indian motorcycle and scooter manufacturer **Hero MotoCorp** (not held in the strategy). Hero cited year-to-date industry growth rates of 14%, with 40% of its sales volume attributed to the rural economy*. The impact of government spending on levels of rural demand is stark. Hero's rural business underperformed the urban segment from 2012–2015 when the government was more focused on controlling its fiscal deficit.

USING THE DIGITAL FULCRUM TO LIFT HOME OWNERSHIP

Government funding was also behind another of the major growth themes discussed at the conference. Affordable housing has been a major policy objective for the Modi administration over the last three years, including aggressive growth targets for lower-income housing supply. Several reforms, such as incentives to low-income groups and an interest-subsidy scheme have resulted in a sharp rise in new housing projects in the affordable-homes segment. Most recently, India's Finance Minister Arun Jaitley announced a dedicated 'affordable-housing fund' that aims to boost construction specifically in rural areas.

These wide-sweeping initiatives are delivering some powerful opportunities for a range of businesses, including construction, banks and mortgage-financing companies. One company I spoke to on the trip, **HDFC Bank** (held in the strategy), has a broad exposure across a number of areas that will benefit from the Indian growth opportunity, providing products and services to urban and rural India, both via a physical and digital presence.

The company highlighted investment in technology as a significant differentiator for its operations. Similar to my meetings with ZTO and Minth in China, it is clear HDFC is also committed to harnessing the potential of technology: revamping its processes digitally for faster turn-around times, using improved data analytics to assist credit underwriting, as well as making the customer experience much smoother. And there's no shortage of ambition here. It wants to expand its digital capabilities to grow the hugely under-penetrated Indian mortgage market via fully automated approvals from its web platforms. New digital initiatives have included a 'Smart account-opening app' (which processes credit ratings and pre-fills forms); a virtual relationship manager; and the launch of Eva, an AI-powered 'chatbot', a conversational banking tool available via a mobile app. In our view, if HDFC gets this digital strategy right, it will establish a considerable competitive moat for years to come.

THE DATA EXPLOSION

The digital race was a theme among many of the companies I spoke to during the conference, but none more so than **Reliance Industries** (not held in the strategy). The company ostensibly engages in hydrocarbon exploration & production and petroleum refining, but has also developed significant operations in telecommunications, providing the largest 4G network in India.

Data consumption in India is a perfect example of the rapid pace of growth. Reliance Industries claims that India in just a few months, has risen from 155th in the world in terms of data consumption to first. Subscribers, on average, use around 10 gigabytes (GB) per month, which equates to a total of 5 billion GB consumed on its network per quarter. The driver of the rapid growth has been threefold: the introduction of 4G, a large market; and, crucially, incredibly low prices for data, with 28GB of data costing just US$2.50.

The impact of cheap data has been very significant. Indeed, Indians are already streaming broadcasts such as live cricket, rather than installing fixed lines in their homes. Key to this disruption is the increased take-up of smartphones among consumers. Around 9–10 million smartphones with 4G capability are sold per month, and the company estimates 210 million users have already shifted across to 4G. However, there are still around 550 million feature phones in the market – so significant room for growth remains*.

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*Source: Martin Currie, company presentation.

HARNESSING CHANGE

In both India and China, the speed of change is evident at almost every turn. Delhi's metro, for example, is close to becoming the fourth-largest in the world (it didn't exist 20 years ago). And the rapid pace shows no sign of letting up. In both countries, the foundations for further expansion are falling into place in terms of physical infrastructure and in the virtual domain.

From an investment point of view, this is exciting to say the least. Among other things, my most recent visit provided further evidence of how firms are tapping into strong trends such as e-commerce growth, digitalisation and the emergence of the rural consumer. As a result, this has given me increased confidence in the long-term growth prospects of companies which are already held in the strategy, as well as presenting a range of potential new investment opportunities to be dissected by the team back home.

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Alternatively please call our global offices, press office or global consultant team on the numbers below:

Edinburgh (headquarters)
44 (0) 131 229 5252

London
44 (0) 20 7065 5970

Asia and Australia
(61) 3 9017 8640

Global consultants
44 (0) 131 479 5954

New York
1 (212) 805 6000

Media
44 (0) 131 479 5892

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MARTIN CURRIE
A Legg Mason Company

Martin Currie Investment Management Limited, registered in Scotland (no SC066107)
Martin Currie Inc, incorporated in New York and having a UK branch registered in Scotland (no SF000300), Saltire Court, 20 Castle Terrace, Edinburgh EH1 2ES

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