

The broad reach of China's consumer

AT A GLANCE

- As China transforms from an export-led to a domestic demand driven economy, investing in companies leveraged to the growing consumption trend is where the smart money is headed. A sound understanding of the underlying drivers of this theme is the key to achieving strong returns over this decade.
- Investing in Taiwan and Hong Kong-listed companies offers another way to benefit from China's growing consumer trend. Many of these companies are either of Chinese origin or have a significant presence in the country. These markets are more accessible to offshore investors and offer a broader range of investment opportunities.
- Reforms in bilateral relations between Taiwan and China are set to attract more of China's yuan into the balance sheets of Taiwanese companies.
- Investing in China requires a proactive approach to assessing the breadth of opportunities and their inherent risks.

Investors eager to participate in China's consumer-driven growth over the coming years are presented with a range of alternatives. Industries that will benefit from this evolution in China's development extend beyond pure retailing to areas like tourism and financial services. Investment in industries linked to Chinese consumption is not confined to mainland China either, with a growing number of companies leveraged to the China consumer theme listed in neighbouring Hong Kong and Taiwan. This *In Perspective* looks at other ways of participating in China's consumer-led growth.

CHINA'S NEXT GROWTH PHASE

The money that was made over the past decade by investing in China's massive industrial expansion is unlikely to yield similar returns over the next ten years. The country's transformation from an export-led to a domestic consumption-driven economy will present new opportunities for investors in the years ahead. Rising incomes, expanded employment opportunities and the proliferation of western-style goods and services are factors that will provide a powerful synergy in driving the country's growth this decade. Understanding the Chinese consumer's aspirations and motivations hold the key to tomorrow's investment returns from this emerging market powerhouse.

THE CHINESE CONSUMER'S LIKES AND DISLIKES

Unlike the previous generation, China's current generation of middle-class 18-60 year-olds are rapidly evolving their spending habits. The previous generation existed on low nominal wages with a large proportion of income spent on staple, life-sustaining goods. Today's generation is set to spend a growing proportion of their disposable incomes on high-end imported apparel, technology, motor vehicles, air travel and financial products. Much of the previous generation lived in rural areas in basic houses or condominiums. The current generation have been moving to the cities, relocating into modern apartments equipped with the new necessities of air conditioning, European branded household appliances and custom-designed furniture.

With these changing dynamics, investors may be better-advised to look beyond its export-oriented sectors and seek exposure to companies that are well-placed to benefit from these emerging consumer trends.

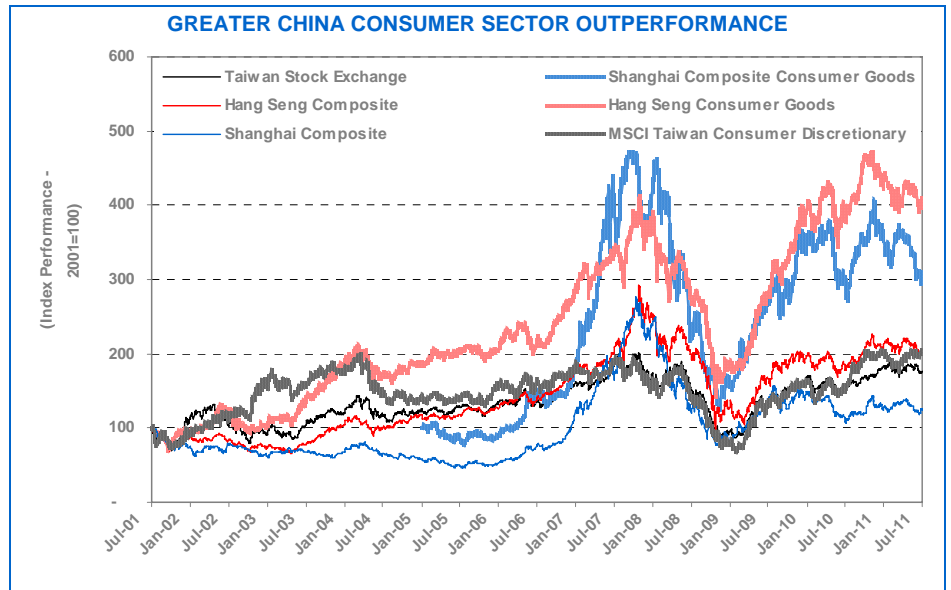
THE CHALLENGE OF INVESTING

Identifying the companies that will benefit from this trend is one task, being able to invest in the chosen companies as a non-resident is quite another matter. In order to control capital flows into and out of the mainland, Chinese authorities maintain a quota system, whereby foreign institutions need to apply for an allocated limit to invest in companies listed on the Shanghai or Shenzhen stock exchanges. The strict criteria means many institutions fail to qualify, and for those that do, the allocations are provided in measured quantities that remain in place over long periods of time. Of the 937 stocks listed on the Shanghai Stock Exchange, only 53 are open to investment by foreigners without quota restrictions.¹

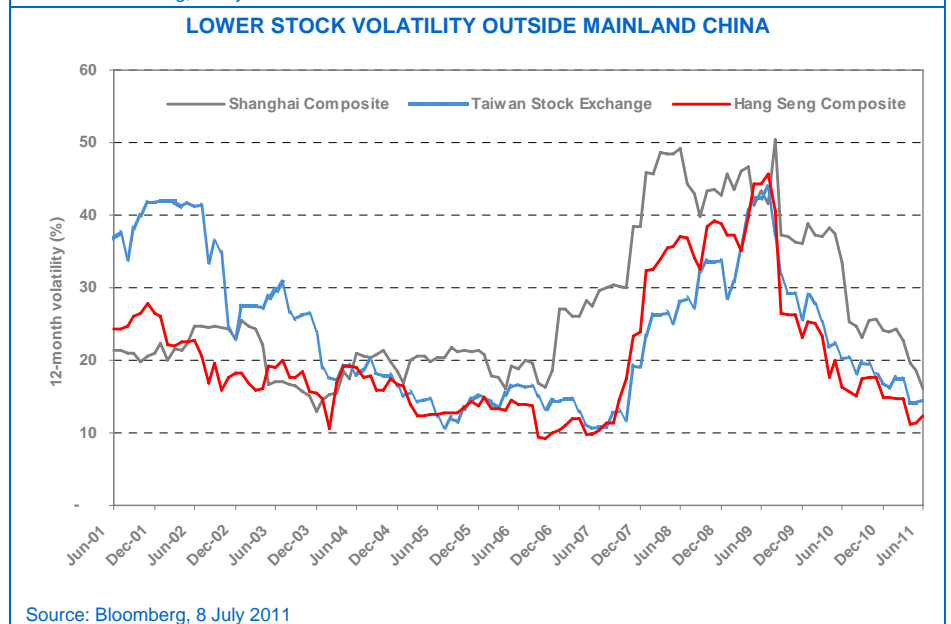
CHINA'S CONSUMER INDUSTRIES OUTSIDE OF CHINA

Companies driven by China's consumer trends extend beyond the mainland. Taiwan's and Hong Kong's stock exchanges offer exposure to a combined 248 companies within the consumer-related sectors, which broadens the scope for investment and diversification.¹ These markets also have more developed regulatory and corporate governance structures. Hong Kong's consumer sector has outperformed its mainland counterpart over the past few years and the market has been less volatile than stocks listed in China.

1. Source: Bloomberg, 8 June 2011.



Source: Bloomberg, 8 July 2011



Source: Bloomberg, 8 July 2011

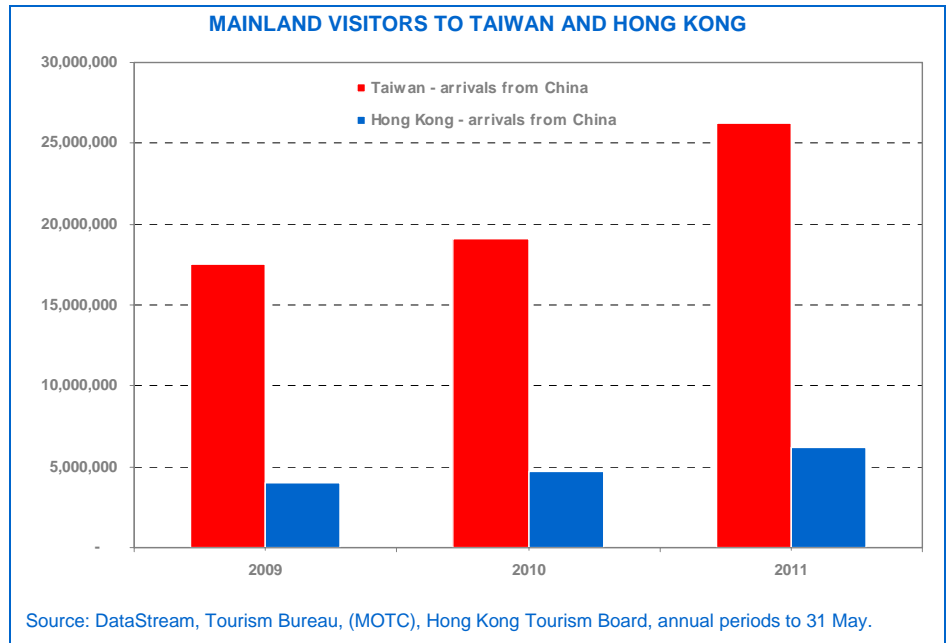
DON'T IGNORE TAIWAN

The convergence of business relationships between Taiwan and China highlights another opportunity to indirectly invest in China. Trade restrictions that were in place since 1949 have limited the flow of capital between Taiwan and China, but this is rapidly changing. Research suggests there are now more than 900 companies, or 73% of Taiwan's listed companies, that have exposure to the mainland.²

Individual travel to Taiwan by the Chinese was also banned from 1949. This ban remained in place until 2008 when President Ma Ying-Jeou came to power and expedited economic cooperation between the two countries. Since this time, Chinese travellers have been permitted to visit Taiwan, albeit only in groups.

Taiwan launched its Individual Visit Scheme in May this year— a program which has been designed to increase the flow of individuals between the two countries. The new travel allowance permits residents from Beijing, Shanghai and Xiamen to travel freely to Taiwan. Under this scheme, the number of flights between China and Taiwan will rise from 370 to 558 per week.

2. Source: Celent, "Financial Linkages Between China and Taiwan", 24 August 2010.



TAIWAN'S RETAILERS READY FOR THE NEW CHINA CONSUMER

More of China's consumer class will be eager to take up the chance to go shopping in Taipei, and Taiwanese retailers are preparing for the new visitors. In May, Taipei 101 – the nation's landmark 101-storey sky scraper, commenced a NT\$400 million (US\$13.9 million) project to remodel the fourth and fifth floors to accommodate more international brands. 101 Mall, which features the largest variety of watch brands of all department stores in Taiwan, has been visited by over one million Chinese tourists over the past three years. The easing of travel restrictions are likely to see even more visit Taiwan this year, potentially delivering earnings growth to Taiwan's airlines, hotel operators and retailers.

High-end wrist watches are among the sought-after items by Chinese visitors in Taiwan because they are 20-30% cheaper than in China. Mainland buyers also obtain a 5% tax refund on the way home. Counterfeit items are also more likely to be encountered in China than Taiwan, providing another reason for China's new breed of consumers to shop in Taipei. They are discerning shoppers, eager to purchase symbols of status and not at the expense of authenticity.

PROTECTING WEALTH IN CHINA

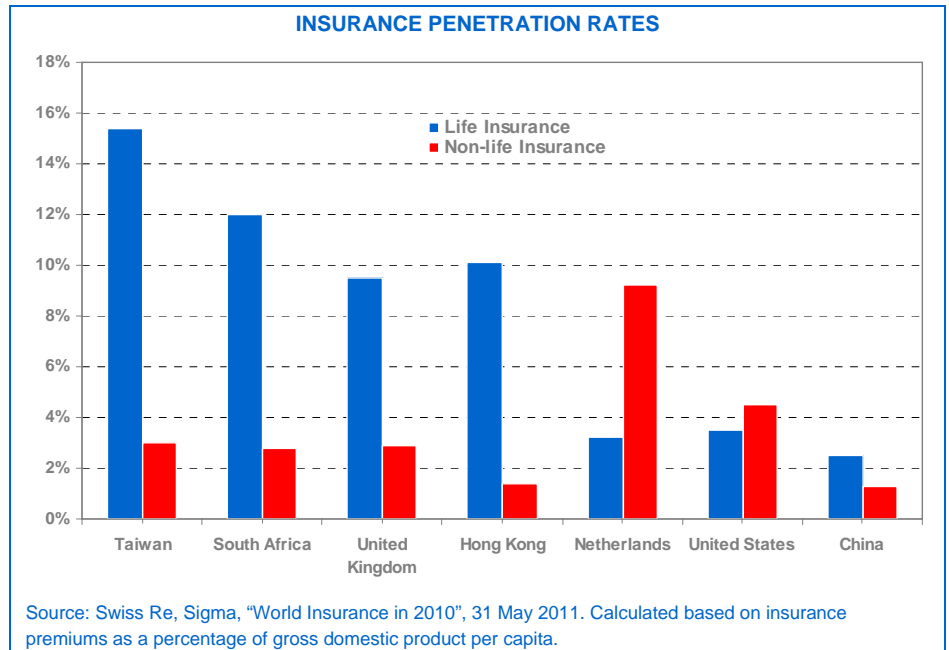
China's growing middle class may be ready to spend, but its spending patterns are likely to extend beyond consumer goods. Services like health and life insurance are set to become increasingly important to protect the growing wealth and well-being of this consumer class.

Insurance cover is often an afterthought and generally lags the wealth creation cycle. China's major insurance companies are likely to embark on extensive promotion campaigns over the coming years to educate China's wealth aggregators about the importance of insurance, at the same time seeking to grow their market share.

Taiwan's insurance companies may be a step ahead of their mainland competitors. To make inroads into China, local insurers have sought partners to establish businesses in mainland cities. Cathay Life joined China Eastern Airlines in 2004 to set up a life insurance company in Shanghai, and Taiwan's Shin Kong Life Insurance partnered with Hainan Airlines in 2008 to establish a life insurance business in Beijing.

Taiwan's insurance operators benefit from their experience in a more mature insurance market. Taiwan's market penetration rate was 18.4% last year, ranking it as the number one insurance market in the world, ahead of the US, UK and Japan. China's insurance industry is relatively immature, with a penetration rate of just 3.8%.³

3. Source: Swiss Re, Sigma, "World Insurance in 2010", 31 May 2011



NOT A QUESTION OF "HOW TO INVEST" BUT "WHAT" AND "WHEN"?

The limitations of investing directly in China don't necessarily limit the ability to invest in the Chinese consumer theme. Examples of non-Chinese companies with a direct link to the Chinese consumer include Italian luxury goods maker, Prada, and international travel goods manufacturer, Samsonite. Both companies listed stock on the Hong Kong exchange in June this year, raising capital for expansion in a market which is less restrictive to non-Chinese investors.

Other beneficiaries of China's consumption growth include e-commerce businesses, airlines, property developers and home appliance makers. These industries feature some of the strongest global brands, listed in Hong Kong and Taiwan with strategic footprints on the mainland.

Of greater importance is the decision to invest in the right company at the right time. For example, investing in insurance companies can turn sour if ill-timed as they are often heavily leveraged to returns from stock and bond markets. But actively monitoring the developing consumer theme in China and how it impacts your investments across the mainland, Hong Kong and Taiwan can deliver rewards over the next decade and beyond.



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