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Asset Management

BAT – China's new revolutionaries

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In Brief

Thematic Advisory Board Update

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PICTET-DIGITAL COMMUNICATION ADVISORY BOARD

The Advisory Board is an important source of information on the long-term trends that shape the prospects of companies operating in the new digital economy.

The Board is made up of industry experts who advise fund managers on the market's long-term investment opportunities.

Once known for its low-cost manufacturing and copycat culture, China is playing host to an innovation revolution that could transform the industrial landscape both within and outside its borders.

But what sets this metamorphosis apart from the country's previous mutations is that it has not been engineered by its venerated state planners.

It is instead the work of a group of home-grown and ferociously competitive internet giants that have taken full advantage of China's ban on the likes of Twitter and Facebook.

In less than 10 years, Baidu, Alibaba and Tencent (collectively known as BAT) have between them amassed 1.8 billion users.

Moreover, these firms now have a growing influence on consumer behaviour, finance, manufacturing and the overall economy. A study by McKinsey Global Institute projects that the expansion of the Internet could add up to 1 percentage point to China's GDP growth rate to 2025.

But, as discussed at the Advisory Board for the Pictet-Digicom fund, BAT are not just rewriting the rules of Internet in China.

The sheer scale of their operations – not to mention their ambitions – also threatens a diverse range of industries such as commerce, media or finance.

Gaming and messaging firm Tencent, for instance, can exploit its massive presence in mobile, with 650 million active users on its messaging apps WeChat and Weixin. Baidu, China's answer to Google, dominates the mainland search market with a 70 per cent market share. Alibaba, meanwhile, controls nearly 80 per cent of China's e-commerce.

In the past few years, each of these companies has extended its reach by acquiring start-up businesses operating across a broad range of industries. Their purchases have included travel companies, banking firms and health groups.

Collectively, BAT accounted for more than 40 per cent of domestic acquisitions in the Internet sector in 2015, according to data compiled by Bloomberg.

Homing in on the consumer

All three have been locked in a battle for the wallet of the middle class consumer. The intensity of the rivalry has served to turn retailing on its head.

An ever larger portion of the Chinese is opting for the convenience of online shopping and home delivery rather than deal with polluted air and traffic gridlock. Shopping is an activity that is increasingly taking place on mobiles, which is how nearly 90 per cent of users in China access the web.

Consumers have been using their mobiles to order local goods and book anything from cinema tickets to restaurants. This is why China's Internet giants have been investing heavily in local services, in the hope of attracting more users to their own platforms.

The online-to-offline sector (O2O) market in China is estimated at CNY12 trillion (USD1.8 trillion) according to JP Morgan.

In June 2015, Baidu invested USD3.5 billion in Nuomi, a subscriber-based e-commerce site similar to Groupon.

Alibaba and Tencent swiftly followed by merging their two start-ups, Meituan.com and Dianping.com, creating a dominant player with a combined valuation of USD18 billion.[1]

Alibaba in particular has moved aggressively to expand its already broad portfolio of businesses. The company paid USD4.6 billion last August for a 20 per cent stake in bricks-and-mortar electronics distributor Suning with the idea that customers can try out a product before purchasing it on Alibaba using their phone.

In one day alone - Singles Day on November 11 – Alibaba sold goods with a value totalling more than Suning's annual revenue, illustrating consumers' massive shift to online. It is also rolling out food delivery in hundreds of cities to push out supermarkets, and already controls 50 per cent of the market.

A revolution in finance

Another sector that is about to be transformed by the BAT juggernaut is finance, our advisors report.

When the government decided to grant five banking licenses in 2015, Baidu, Tencent and Alibaba duly responded.

Tencent built a 30 per cent stake in WeBank while Alibaba now owns MYbank, the first online bank in China, which is developing pay-with-a-selfie payment technology using facial recognition.

Alibaba is also active in financial services through its Ali Loans unit, a provider of consumer and business credit. The business could generate as much as USD 1.7 billion from consumers and merchants within three years – a sum which dwarfs the USD730 million in revenues that US-based online lending marketplace Lending Club is projected to generate in 2016.

With half of transactions on Alibaba's e-commerce sites paid through Alipay, its mobile payment processing platform, the company collects vast amounts of valuable data which can be used to mine insights about customers. Alipay handles USD800 billion in e-transactions a year -- three times more than US rival Paypal.

Betting on the cloud

China's Internet giants are competing on other fronts, too. Cloud computing could be an important area of growth. Alibaba is following the path taken by Amazon with Ama-

BEATEN-UP CHINESE INTERNET STOCKS SET FOR RECOVERY

Fears over softening growth in China and emerging economies have weighed on stocks since the beginning of the year, and Chinese tech stocks have suffered some of the sharpest falls. The sector has fallen X since its peak in the fourth quarter of 2015, while the tech-heavy US Nasdaq Index and the MSCI Emerging Markets Index have declined X and X per cent respectively over the same period.

Pessimism about the health of the Chinese economy looks excessive, particularly as the country is still expanding faster than any other major economy, and its government has shown it is ready to deliver more monetary and fiscal stimulus.

As economic conditions stabilise, China's technology companies are well placed to reap the benefits.

Cash flow and earnings growth projections for companies in the sector look sustainable, particularly in segments such as e-commerce, digital advertising, online travel and gaming. The spread of mobile-based business models across both services and manufacturing industries, meanwhile, represents another source of growth.

In addition, Chinese internet stocks Alibaba and Baidu will benefit from their inclusion in MSCI indices, which is due to take place in May. Last November, index provider MSCI announced that they were among the 14 Chinese companies trading on US exchanges that will be included in both its China and global emerging markets index.

The addition will take the weight of Internet stocks in the index from 14 per cent to about 23 per cent.

As a first step, MSCI added the companies to the indices at half their December 1 2015 free float-adjusted market capitalisation - the value of shares publicly held -, and will implement the second phase on May 31 2016 at its semi-annual review. It is estimated that the changes could trigger up to USD70 billion of investments into these 14 stocks by passive funds that track these indices.

MSCI China has traditionally only included stocks listed outside the mainland. China has pushed for its domestic stocks to join MSCI indices in order to attract capital and lift its global status, but the lack of accessibility to foreign investors has kept A-shares, which trade in the mainland, out of indices. MSCI is due to review its decision on A-shares in June.

[1] Based on each company's reported figures, although total may include double counting. Baidu: 657m mobile search Monthly Active Users in December 2015 (source: Q4 2015 results press release), Alibaba, 407m annual active buyers (source: Q4 2015 results presentation), Tencent: 860m users for its most popular QQ IM app at end-September 2015 (source: Q3 2015 results investor presentation).

zon Web Services by investing in cloud services at home and overseas. Not to be outdone, Tencent is ploughing USD1.6 billion into cloud computing over the next five years.

These services currently only account for a fraction of their revenues but analysts expect the business to expand in the coming year provided they can overcome customer concerns over the security of data stored on Chinese servers.

Risks loom

Few can dispute BAT's disruptive potential. But if they are to continue to transform industries such as retail, finance and technology both within and outside China, they must avoid a number of potential pitfalls.

Each company is at risk of overstretching itself financially, particularly in areas such as O2O. Although it is the fastest growing sector in China, the service is heavily subsidised, with companies charging low commissions to attract merchants. That business model looks unsustainable in the long run.

Another threat looms in the shape of the Chinese authorities. As BAT move further into sectors such as finance and media, they venture into areas that have typically been closely controlled by the state.

This may be why Alibaba and its two peers are increasingly investing through proxies, and battling it out not only on their home turf, but abroad. In ride-sharing for instance, Baidu has invested in US company Uber while Alibaba and Tencent are backing Uber rival Lyft.

Although it remains to be seen how much an economic slowdown in China could affect their growth ambitions, Internet-related businesses are here to stay as they form a major part of the country's transition to a consumer-driven economy. They have become a vital part of people's lives. Global technology groups of the West should take note – the real tech revolution is happening in China.

INVESTING IN THE DIGITAL TRANSITION

Pictet-Digital Communication invests in companies that will profit from the digital transition, a structural trend that is evolving independently from economic cycles. Because it draws on mobile, social, cloud and big data, the portfolio provides different exposures to traditional technology investment funds.

The fund invests in several rapidly growing segments: e-commerce, online advertising, interactive devices, network operators, data analytics and cloud-based software.

Investors can tap into the superior growth potential of Asian technology companies through investments in the region that form 25 per cent of the portfolio.

Contact details

For further information, please visit our websites:

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