HARDING LOEVNER

# Growing In Hard Times: Reinvesting During China's Turbulence

**Companies that can plow profits back into their own businesses create a competitive advantage they can tap when the economy slows.**

April 2024

## Key Takeaways

- Companies with strong balance sheets that generate free cash flow are in a better position to weather storms and even expand in difficult times.
- Chinese companies taking advantage of their financial strength can be found in industries such as logistics, consumer staples, and retail.

After growing at breakneck speed for more than two decades, China's economy has stumbled due to the combination of a decimated real-estate sector that accounts for roughly 70% of household assets, a slowdown in population growth, and tight financial conditions. The economic malaise has led to a sustained downturn in Chinese equities: in early February, the Shanghai Composite Index hit a four-year low, and the China CSI 300 Index hit a five-year low.

There are scores of companies in China whose businesses are solid despite the overarching environment. Their earnings and revenue are growing, and they are reinvesting in their businesses. The current negative sentiment has caused the shares of some of these companies to fall to levels far below their fair value when one looks at the state of their businesses, offering an opportunity for investors.

The companies in which we invest must meet four criteria: competitive advantage, sustainable growth, financial strength, and quality management. We believe that companies that meet these criteria are most likely to succeed, and offer strong market returns, over the long term. These qualities are especially important during challenging macroeconomic conditions, as companies which have them are more likely to survive, and even thrive, as others suffer. In the short term, the shares of such companies may not reflect the quality of the underlying business.

When business conditions deteriorate, financial strength becomes paramount. Companies with strong balance sheets that generate free cash flow can not only continue to operate effectively, but they can also fund their own expansion without being beholden to external credit conditions and are thus in a better position to weather storms, and even expand in difficult times. Here are five Chinese companies that are investing heavily in the future of their businesses to create growth opportunities.

## ZTO Express and SF Holding

ZTO Express and SF Holding are two of the leading companies in China's parcel-delivery industry. Express-delivery companies in China delivered 100 billion packages in 2023, up 19% from 2022; that is 60% of the global total.

ZTO is China's largest express-delivery company. The company operates sorting hubs and linehaul trucks, while working with network partners that provide pickup and delivery services to end customers. The result is a system able to serve 98% of Chinese cities.

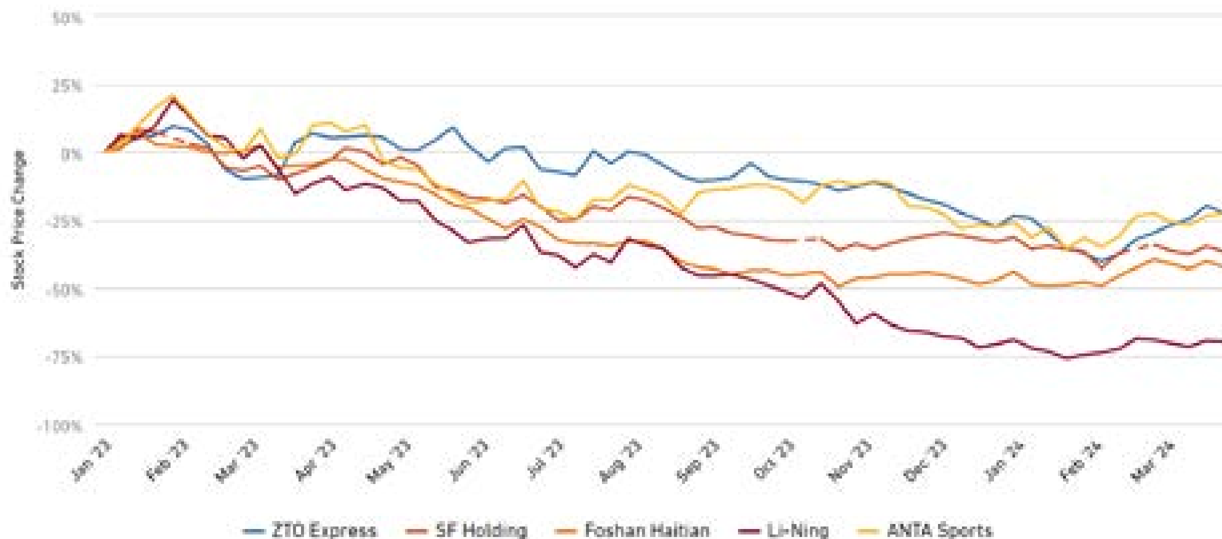
ZTO has spent an average of more than 20% of its sales on capital expenditures over the past seven years, including investments in large, automated sorting centers and larger-capacity trucks that allow it to offer lower prices and better service. The company noted recently to investors that these efficiency measures allowed it to deliver 24% more packages year-over-year at 8% lower unit pricing, but with 15% lower unit costs, increasing its profit margins. In November, the company reiterated its 2023 guidance of 20% to 24% full-year volume growth, while strengthening its long-term competitive edge in cost, delivery time, and reliability.

Over the past three years, it has made more than US$3.4 billion of capital investments, fully funded out of its US$3.5 billion in net operating cash flow. In addition to the cash-generative nature of its business, ZTO's balance sheet is cash rich, eschewing debt. ZTO is therefore well-positioned to continue self-financing its expansion in spite of any further tightening of financial conditions in China.

SF offers ground and air delivery services both within China and internationally. Its size has allowed it to extend its business and

**Under Pressure**

**Stock changes in percentage terms since the start of 2023**




Dashes represents trading holidays.

Source: FactSet

offer more comprehensive services to corporate customers, such as so-called "front-end" operations including production, supply, marketing, and distribution. It has also built big-data analysis and cloud-based services for logistics including warehouse management, sales forecasting, data analysis, and settlement management.

SF has spent nearly US$7 billion over the past three years on capital expenditures, funded out of US$9.2 billion in net operating cash flow. That translates into more warehouses, trucks, and planes and the ability to deliver more packages. In January, for example, SF's airline-delivery subsidiary launched a new route from central China to Pakistan. The service runs three times a week with the capacity to carry 300 tons. It is also acquiring a leading delivery service in Thailand.

The growth of these delivery companies illustrates how the elements of our investment criteria can reinforce each other. Effective management can use a company's financial strength to invest to ensure sustainable growth, which can result in a lasting competitive advantage.

## Foshan Haitian

Companies taking advantage of their financial strength can be found in other industries as well. The food and beverage industry includes brands that have been around for centuries and cater to a huge domestic market, such as Foshan Haitian, China's largest maker of soy sauce, oyster sauce, and other condiments.

Soy sauce is not exactly a young industry in China, but Foshan Haitian is still a growth business despite its 18th Century roots. The opportunity for the company is to consolidate one of the most fragmented consumer products in China and extend its brand to other seasonings. For instance, Haitian has only 15-20% domestic market share in soy sauce, while Kikkoman has 40% of its home market in Japan.

The company's plan is to expand production and sales throughout the country and use the proceeds to diversify and improve its product lines. Its research and development group works on creating new flavors and styles of its products—hot soy sauce, sweet soy sauce, organic soy sauce, light soy sauce, and more. The group comprises 600 employees, about 8% of Haitian's total staff, and the company spent 750 million yuan on R&D in 2023.

Beyond developing more products, Haitian is working to increase its efficiency in making and distributing them. The company has 600,000-square-meters worth of large-scale glass sun-drying pools and fermentation tanks, and ten production lines where it works to improve and perfect brewing and drying soy sauce. Haitian says it can package up to 48,000 bottles per hour and has improved its warehousing efficiency to the point where it can send out goods for delivery 120 seconds after it gets an order.

In the past decade, Haitian has nearly tripled its inflation-adjusted gross plant, which includes land, equipment, and construction, financed by its net operating cash flow, which has exceeded capital expenditures for each of the past ten years. The company earns a return on assets nearly four times that of Kraft Heinz while maintaining a net cash balance sheet compared to roughly 30% leverage for the famous ketchup maker.

**Funding Secured**

**Free cash flow and capital expenditures for the years 2022 and 2023**

Even during China's pandemic lockdowns and economic slowdown, companies such as ZTO Express, ANTA, and Foshan Haitian were able to fund capital expenditures out of free cash flow.

Source: FactSet

## Li-Ning and ANTA Sports

The pandemic and the lengthy mobility restrictions in China made business particularly difficult for retailers. But China's two most popular sportwear companies, Li-Ning and ANTA Sports, have been able to self-fund growth and even expand their physical footprint despite those challenges.

Li-Ning was founded by its namesake, who won six Olympics gymnastic medals in 1984. Li-Ning continues to invest in its future through significant spending on research and development. In 2022 its capital expenditures were US$304 million, funded out of US$638 million of cash flow. These expenditures included new product launches such as a high-tech fiber it created called Boom Fiber, infrastructure, and the company's supply-chain system. For each of the past eight years, in fact, its net operating cash flow has exceeded capex. The company has negligible debt and a net cash balance.

ANTA sells sportswear, with a particular focus on two of the best-selling brands in China: the functional mass-market brand ANTA and the premium lifestyle brand Fila, which it acquired in 2009. Covering both ends of the market allowed ANTA to benefit from the growing sportswear market in China. Indeed, its sales have grown from US$1.2 billion in 2012 to US$8 billion in 2022.

It also owns a range of global brands, including Descente and Amer's portfolio of outdoor brands, notably Salomon, Arc'teryx, and Wilson. Its acquisition of Amer Sports gives it a more diverse global brand portfolio well-positioned to take advantage of rapidly growing participation in outdoor sports. (ANTA acquired Amer in 2019 for US$5.2 billion in a consortium with Anamered Investments and Tencent Holdings; the trio bought 60% of the shares in Amer's February 2024 IPO.)

And it is investing in its future growth as well. Ten years of consistent free cash flow generation have far exceeded the company's capex. In 2022, for example, its capital expenditures were US$241 million, financed from US$1.8 billion of cash flow. That money has been used to build out its network of owned stores (as opposed to franchises), remodel older stores, and improve its inventory replenishment system. Those moves have been an outgrowth of a concerted effort over the past decade to position itself as an upscale retailer and its brands as high-end. It too has a net cash position and sustained growth in its rental expense.

None of this of course is a guarantee that demand will necessarily grow, but the fact of the matter is that the ability to self-fund your own productive capacity—especially in an environment where credit is constrained—is an envious demonstration of financial strength. And this strength does tend to prove itself. Apart from one company in one year (Haitian in 2022) all five of these companies have grown their sales and earnings each year since 2014. The resiliency of their growth—despite the massive disruptions of the past few years—hasn't been matched by their share prices, but in our experience, strong, growing companies set themselves up for the possibility that their fundamentals will be recognized by the market over the long term.

## Contributors

Co-Deputy Director of Research Tim Kubarych, CFA, contributed research and viewpoints to this piece.

## Disclosures

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