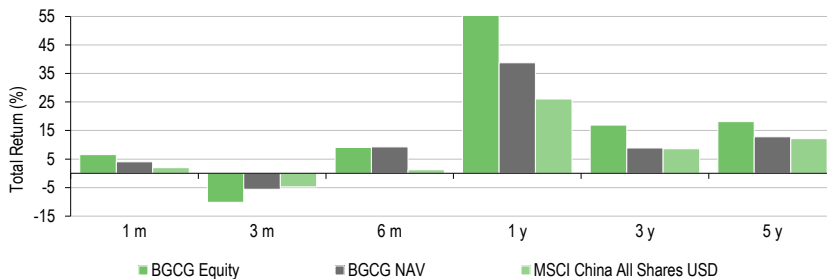


# Baillie Gifford China Growth

Year of a bull in motion

Baillie Gifford China Growth (BGCG) is a recent entrant to Ballie Gifford's (BG) house philosophy of investing alongside current trendsetters and future large-scale potential winners. It emerged in September 2020 as BG took over management of the trust, changing the strategy from broader Asia Pacific equities to a mandate of pure Chinese equities (see our [initiation note](#) on BGCG). Despite negative newsflow on China over the past few months clouding last year's euphoria around investing in Chinese equities, the investment case stands firm. Amid heightened risks, for the time being China appears to welcome foreign investors, as it remains in expansion mode within the global financial markets.

## BGCG's relative performance to end April 2021\*



Source: Refinitiv, Edison Investment Research. Note: \*WPC prior to 16 September 2020 managed by Witan.

## Why BGCG now?

BG believes that picking outperforming emerging markets (EM) stocks is heavily dependant on the country and geographic market of their businesses, and China remains its top country of choice. The market's reaction to regulatory scrutiny from the Chinese financial authorities over the past few months might have been overdone. According to BG, the China growth story remains robust despite regulatory spats being a regular feature of the Chinese market. With just two other pure China equity closed-ended peers currently on the UK market, BGCG is a potentially timely offering. The chart above shows its solid relative performance over the last six months (to end-April 2021) following the fund's restructuring.

## The analyst's view

EMs have been a 'mixed bag' in terms of performance in the past few years, with big divergences between countries. BGCG's pure China strategy effectively competes with other single EM country and broader Asia mandates. While acknowledging relatively high risk due to short-term market volatility, BG positioned itself to realise the high return potential in the equity market of the second largest world economy over the cycle. Over the past 10 years, the number of listed companies in China has trebled and the managers note their pronounced quality. BG engages with the in-house ESG team and companies regularly. Collaborating with the ESG team forms a crucial part of the core investment process.

**NOT INTENDED FOR PERSONS IN THE EEA**

Investment trusts  
China growth equities

4 May 2021

**Price** 492.3p  
**Market cap** £291.9m  
**AUM** £270.2m

NAV\* 465.1p  
Premium to NAV 5.8%

\*Including income. As at 29 April 2021.

Yield 1.5%

Ordinary shares in issue 59.3m

Code BGCG

Primary exchange LSE

AIC sector Country-specialist Asia

Benchmark MSCI China All Shares

52-week high/low 640.0p 305.6p

NAV\* high/low 554.3p 337.0p

\*Including income.

## Gearing

Gearing at 31 March 2021 nil

## Fund objective

The investment objective is to produce long-term capital growth by investing predominantly in shares of Chinese companies. Performance is measured against the MSCI China All Shares Index. Previously the trust aimed for capital and income growth from a diversified portfolio of investments in the Asia Pacific region. Baillie Gifford took over management of the trust from Witan Investment Services on 16 September 2020.

## Bull points

- BG's team's sound expertise of direct investing in China, dating back to 1994.
- Excellent track record of strategy performance over 12 years.
- The portfolio contains a mix of public and private businesses, which potentially increases the strategy's total return.

## Bear points

- Only suitable for long-term investors with high volatility tolerance.
- Private equity exposure (<20% portfolio) increases risks.
- Single country strategy, so exposed to China-specific risks (eg trade wars, geopolitics, long post-COVID-19 recovery, internal regulation).

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## The manager's view and China's equity market

BG believes that the recent actions taken by Chinese financial regulators over the past few months imply that anti-monopoly regulations apply to all enterprises, big and small. BGCG's fund manager, Sophie Earnshaw explains that formal and distinct regulations, stopping anti-competitive behaviour, give comfort to international investors. Following rapid exponential growth in e-commerce enterprises such as Alibaba and Tencent in a very benign, relatively unregulated environment, BG welcomes actions by regulators to create a universal corporate regulatory framework.

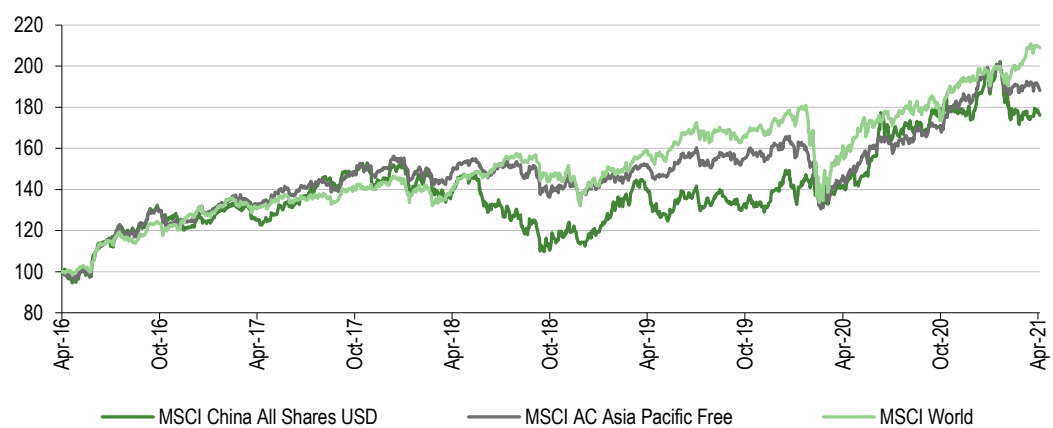
With recent actions including a \$2.8bn fine on Alibaba (top 10 holding at 9.1% of the portfolio at 31 March 2021, see Exhibit 2), regulators acted to stop the company opening shops on other smaller platforms and 'squeezing' competitors out. The regulators focused on one of the major anti-competitive practices – merchant exclusivity where a company/seller would have been required to only sell its goods and services on Alibaba's merchant platform (they would have had to choose between doing business with Alibaba or its rivals). BG considers the \$2.8bn fine as a positive outcome, and an amount that Alibaba can easily afford. It accounts for around 4% of Alibaba's domestic revenues. The platform remains intact and operational after this fine, with a long-term growth opportunity in e-commerce and its cloud segment.

The financial press interpreted these events as a steep change in the government's actions. BG does not view it in this way. The government is trying to regulate big businesses in China in the same way that the US and now Europe are trying to regulate big tech. The Chinese government is very reliant on private companies for innovation. As it depends to a large extent on these businesses, the government is unlikely to break them up completely, according to BG.

The publication of draft anti-monopoly regulations by the Chinese financial regulator at the end of 2020 and suspension of the expected high-profile \$34bn Ant Group's IPO in November last year sent Chinese equities markets into a downward trend over the past few months. Lingering international investor concerns over potential tightening rules on the nation's technology sector and an ongoing dispute with the US have resulted in the MSCI China Index returning 2%, compared to the MSCI World rising by 21%, over the past six months, on a TR basis in GBP.

Exhibit 1 shows the Chinese equity market selling off materially from its highs in February 2021.

**Exhibit 1: Equity markets' performance**



Source: Refinitiv, Edison Investment Research

Regulatory scrutiny of Chinese corporations coupled with uncertainty over US/China relations, have kept the performance of Chinese equities subdued year to date. While China was the first country

to emerge from the pandemic about nine months ago, global newsflow continues to be dominated by COVID-19, contributing to investors' cautious stance about the Chinese market.

Alibaba has ample room not only to further expand its Chinese e-commerce division, which is still growing at double-digit rates, but also its cloud business, which is currently c 8% of total revenues. According to Earnshaw, Alibaba's market-leading cloud segment, which has a 45% market share in China, could be 5–10 times larger in five to 10 years and currently presents a very large growth opportunity. Scale matters for cloud infrastructure businesses, as it can create cost and pricing advantages for the market leader. BGCG's team has frequent conversations with Alibaba – while the company's management is keen to comply with regulations, it is excited about growth opportunities. According to BG, Alibaba still intends to float Ant, but has not yet specified what Ant's business will be, following recent regulatory changes.

#### Exhibit 2: Top 10 holdings

Company	Sector	Portfolio weight % at 31 March 2021
Tencent	Communication services	9.9
Alibaba	Consumer discretionary	9.1
Ping An Insurance	Financials	4.5
ByteDance	Communication services	4.3
Meituan Dianping	Consumer discretionary	4.0
Kweichow Moutai	Consumer staples	3.4
China Merchants Bank	Financials	2.7
8 Bilibili	Communication services	2.6
Zai Lab	Healthcare	2.3
Li Ning	Consumer discretionary	2.1
Top 10 (% of portfolio)		44.9

Source: Baillie Gifford

The country is opening its financial markets to attract more investments as it seeks to expand its economic base. According to Fang Xinghai, vice chairman of the China Securities Regulatory Commission, China plans to increase inclusion of A-shares' in quoted companies that are traded in mainland China, in major global indices, and continues to expand the scope of inclusion to attract more foreign investment. April's Boao Forum, which is known as 'the world economic forum of Asia', was attended by a number of global representatives, such as the heads of the International Monetary Fund and United Nations and western business leaders, including Apple's Tim Cook, Tesla's Elon Musk, Blackstone Group's Stephen Schwarzman and Bridgewater Associates' Ray Dalio. Fang said on the forum that foreign institutional investors such as mutual funds, pension funds and insurance funds are 'very welcome' in China. He added that as of the end of March 2021, foreign capital held 5% of China's stock markets.

The A-share market is c 80% retail dominated. According to BG, the government intends to stabilise the market make it more standardised and internationalise the RMB over the longer term. As an illustration of its progress, China has put a lot of effort into opening the bond market. A recent example in April was the successful \$3bn convertible bond placing by one of BGCG's top 10 holdings, Meituan Dianping (4%), which was run by two Western banks. The investment manager sees a similar development and international maturation pattern in the equity market.

Meituan Dianping, an online marketplace for the local service industry in China, operates in more than 200 categories in 2,800 cities. It has a strong market share in on-demand restaurant delivery, in-store dining, hotel booking and film ticketing. Over the long term, the managers view these segments, all in the early stages of development, leading to strong growth expectations for many years to come. This is despite short-term volatility in the company's share price. Recent newsflow around the company has been mixed and resulted in the share price falling by over 30% from its February peak to end-April. In April, the company raised c \$7bn equity and c \$3bn debt. Meituan intends to use the proceeds from the stock and bond sales for technology innovation, including research and development of autonomous delivery vehicles, drone delivery, other cutting-edge technology and general corporate purposes. Shortly after the capital raise the State Administration

for Market Regulation announced an anti-trust investigation into Meituan's activity. The company said that it would actively cooperate with the investigation and make efforts to comply with the regulations, and that it is currently operating as usual. BG considers the State Administration's actions as a step in creating a more formal and universal corporate regulation system in China.

The managers bought their first holding in private company ByteDance, a social media and short form video company (top 10, 4.3%) in December 2020. BG has been invested in the company since May 2019. The managers believe that ByteDance is currently at a fairly early stage of monetisation of user activity and has a very large growth opportunity in advertising in addition to more nascent areas.

Little surprised by short-term volatility, the BG team is optimistic about the prospects for long-term investments in China. It expects China to be one of the key markets in the coming decade. The team sees the fundamental backdrop as favourable for Chinese equities due to robust earnings growth and global portfolios gradually increasing their exposure to China. The IMF's January 2021 expectation is for the Chinese economy to grow 8.1% in 2021 and 5.6% in 2022. Together with growing consumption from the Chinese middle class, this increase should provide support for corporate earnings and equity markets.

## Performance

Following the reorganisation in September 2020, BGCG returned 9.2% over the six months to end-April, outperforming the MSCI China All Shares Index, on the NAV total return basis. The trust underperformed the MSCI World Index over six months and shorter periods, as shown in Exhibit 3, as its exposure to a number of large Chinese companies, which fell more than the global index, affected performance. BGCG outperformed the BG China open-ended fund over the three short periods since its takeover by BG.

**Exhibit 3: Share price and NAV total return performance\* relative to indices and BG China equity strategy (%)**

	One month	Three months	Six months	One year	Three years	Five years	10 years
BGCG price	6.5	-10.2	9.0	57.4	59.8	130.0	185.0
BGCG NAV	4.0	-5.6	9.2	38.7	28.9	82.6	122.8
Price relative to MSCI China All Shares	4.5	(5.7)	7.7	24.9	24.8	29.5	27.2
NAV relative to MSCI China All Shares	2.0	(0.9)	8.0	10.1	0.7	2.8	(0.5)
Price relative to MSCI AC Asia Pacific Free	5.4	(11.0)	(3.7)	21.1	25.2	21.0	21.9
NAV relative to MSCI AC Asia Pacific Free	2.9	(6.5)	(3.5)	6.7	1.0	(3.9)	(4.7)
Price relative to MSCI World	2.1	(18.4)	(9.8)	18.3	6.4	9.7	(13.1)
NAV relative to MSCI World	(0.3)	(14.3)	(9.6)	4.3	(14.1)	(12.9)	(32.1)
Price relative to Baillie Gifford China B ACC	2.7	(2.2)	2.8	5.7	(4.2)	(26.0)	(18.5)
NAV relative to Baillie Gifford China B ACC	0.3	2.8	3.0	(6.9)	(22.7)	(41.2)	(36.3)

Source: Refinitiv, Edison Investment Research. Note: Data to end-April 2021. Geometric calculation. \*Shows the trust's performance under Witan's management until the mandate change on 16 September 2020.

While BGCG was launched recently, the superior performance of BG's Chinese strategy is illustrated in Exhibit 4 by the performance of the BG China OEIC, launched in November 2008. It continues to outperform the closed-ended Asia Pacific sector average over 3, 5 and 10 years.

**Exhibit 4: Selected peer group as at 30 April 2021\***

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (cum-fair)	Ongoing charge	Perf. fee	Net gearing	Dividend yield
<b>Asia Pacific closed-ended peers</b>										
Sector average (nine funds)	513.9	53.3	47.0	133.5	182.4	(2.2)	1.0		103	1.4
Baillie Gifford China Growth	291.9	38.5	27.9	81.3	122.3	7.3	1.0	Yes	100	1.5
<b>China closed-ended peers</b>										
Fidelity China Special Situations	2,237.1	74.9	69.3	192.2	372.6	(0.9)	1.0	No	129	1.0
JPMorgan China Growth & Income	563.9	63.9	106.3	275.8	338.2	4.3	1.0	No	109	3.3
Baillie Gifford China B Acc	782.3	50.0	70.6	220.9	275.2		0.8	No		0.0

Source: Morningstar, Edison Investment Research. Note: \*Performance to 30 April 2021 based on cum-fair NAV. TR = total return. TER = total expense ratio. Net gearing is total assets less cash and equivalents as a percentage of net assets.

Positive contributors to BCGG’s performance during the period included healthcare holdings such as Zai Labs, an innovative biotech company, WuXi AppTec, a leading contract research organisation, and Kingmed, a diagnostics company. Other positive contributors include CATL, China’s leading electric vehicle battery maker, and Estun, a prospective future leader in robotics and factory automation. Notable detractors over the period include Brilliance China, BMW’s partner in the Chinese auto market, and Berry Genomics, a gene sequencing company.

## Dividend

The new investment policy aims to produce long-term capital growth only. Given this, investors should not expect to receive the same level of (or any) income after FY22 as they did before the trust was restructured. To mitigate the transition of the strategy to growth from ‘growth and income’, the board agreed the 7.15p per share dividend in respect of FY21 (to 31 January 2021), in line with the FY20 level, and intends to pay the same dividend in FY22. The dividends will be paid in October and June, respectively, from the company’s £11.6m (at 31 January 2021) revenue reserves.

## Premium stabilised

BGCG currently trades on a 5.8% cum-fair premium to NAV. We believe that this is a healthy premium level and in line with that of many other BG investment trusts. The premium, shown in Exhibit 5, was very volatile in the first few months following the company’s restructuring. Due to high investor demand, the initial 10% of the additional share capital authority, approved by the board and shareholders in June 2020, was allocated quickly after the BG’s appointment, and the premium spiked. The next 20% of capital authorisation was approved in November 2020 and exhausted by end-March 2021, when the company authorised another 20%. Since then, the company has issued c 300K shares and continues to issue them.

**Exhibit 5: One-year discount/premium to cum-fair NAV**



Source: Refinitiv, Edison Investment Research

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