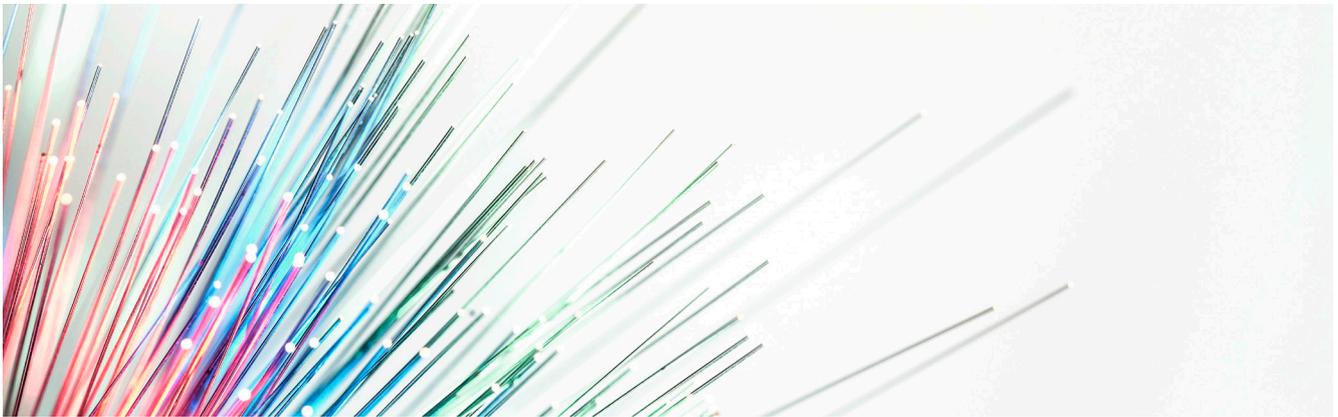


Three reasons why we are optimistic

UBS Asset Management | **China's tech sector**

By China Equities Team



While Chinese tech firms have had an outstanding run, we remain optimistic about their future.

If you'd invested in China's tech sector leaders five years ago, you would have likely done well.

Since then, killer apps have emerged, retail has shifted online, and 208 million people have become internet users, creating a wave of user traffic that has propelled sector revenues and stock prices.

But how confident can investors be about the outlook for the tech sector?

Is it possible for Chinese tech firms to continue expanding? What if they have reached their growth ceiling? And if not, how high is the ceiling?

Many, if not most, of these questions are top of mind right now.

But there are good reasons—three, in particular—to expect Chinese internet and tech companies to continue growing in the future.

¹ Telecompaper: China internet user base grows 5.5% to 772 million in 2017
<https://www.telecompaper.com/news/china-internet-user-base-grows-55-to-772-million-in-2017--1231106>

² Internet World Stats: Internet Usage Stats 2017
<https://www.internetworldstats.com/stats3.htm>

1. China’s online universe still has room for growth

At 772 million,¹ China’s online user base is huge, but it’s got room to grow, creating more user traffic and revenue for the sector.

Only 54.6% of China’s population are online,² well behind the UK (94.8%), Japan (93.3%), and US (87.9%), according to Internet World Stats.

But we’re expecting China to catch up.

Why? Firstly, as China urbanises and millions more people move to cities, it’s highly likely this will create lots more connected internet users.

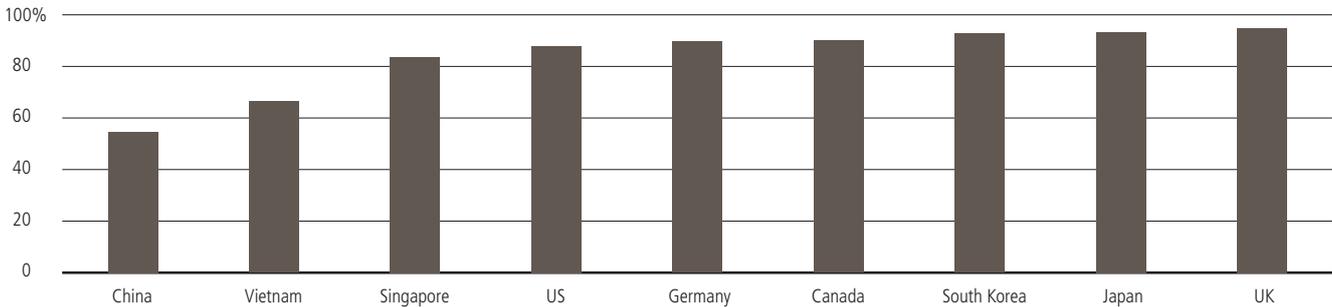
Secondly, because tech companies’ new initiatives, like mobile payment, make it essential for those new users, and existing ones, to be online.

But while audience size is one thing, the amount they spend is another.

We believe online spending is going to grow as incomes rise, mobile usage expands, and offline retail continues to shift online, creating the largest online retail market globally (see Exhibit 2).

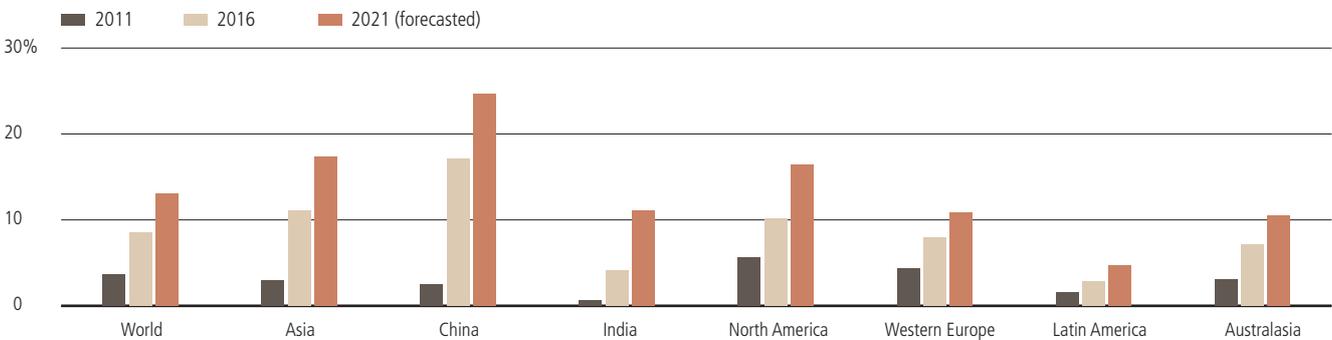
Pushing more users online creates user traffic and delivers the customers, sales, and data which is the lifeblood of Chinese IT firms’ business models.

Exhibit 1: Internet Penetration, Countries Compared, 2017



Source: Invesp, 2017³

Exhibit 2: Online Retail as % of Total Retail Sales, 2011, 2016 & 2021 (forecasted)



Source: Euromonitor⁴

³ Invesp: Global Online Retail Spending – Statistics and Trends
<https://www.invespcro.com/blog/global-online-retail-spending-statistics-and-trends/>

⁴ Euromonitor: Hong Kong’s E-commerce Ecology: Exporting to the World
<http://hkmb.hktdc.com/en/1X0A9SI6/hktdc-research/Hong-Kong%E2%80%99s-E-commerce-Ecology-Exporting-to-the-World>

2. China's tech companies are becoming more innovative

It used to be the case that Chinese companies copied overseas firms.

Not anymore. Chinese tech firms are leading the world with a whole range of new innovations in fields including smartphone apps, on-demand bicycle rentals, drones, online games, and self-driving cars.

It's not just about creating innovative products, it's about investing in your capacity to continue innovating—and Chinese companies are doing very well in this respect.

R&D spending in China grew 14% y-o-y in 2017, reaching USD 279 billion⁵ and 2.1% of GDP. China's tech companies are leading these investments too, channeling money into innovation campuses to create the ideas of the future.

3. China tech firms are just starting to expand globally

Chinese tech companies' success has been largely based in China, but they are starting to expand globally.

In 2016 they completed 222 deals worth USD 34.7 billion in total, 49% of global tech M&A deals,⁶ according to FTI Consulting.

For sure, these deals are a great way to access knowledge, but they are also a great way to enter overseas markets.

Notable deals include Chinese IT firms snapping up stakes in e-commerce companies in India and South East Asia, as well as in leading online services and new energy vehicles companies overseas, and via these deals they are tapping into fast-growing markets, and building platforms that will propel their future growth.

Long-term drivers for sustained growth

The trends underpinning the above three factors are long term in nature—raising internet penetration will take time, R&D spending needs time to bear fruit, and overseas expansion is a long-term strategy—and support what we believe will be sustained growth for the companies we look at.

The trends are also significant because they are related to the profound changes going on in China's economy, such as the growth of consumer demand, which official retail sales data shows is growing strongly (10.2% y-o-y in 2017)⁷ and remains largely unaffected by changes in China's headline economic growth numbers.

And the trends add up to compelling reasons to expect China's tech and internet sectors to continue growing.

We believe that investors will continue to benefit by holding a selection of the best companies in the sector and, with our rigorous stock selection process and disciplined investment approach, we believe we are well placed to unlock the best opportunities.

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⁵ Reuters: China spends \$279 bn on R&D in 2017: science minister
<https://www.reuters.com/article/us-china-economy-r-d/china-spends-279-bln-on-rd-in-2017-science-minister-idUSKCN1GB018>

⁶ FTI Consulting: China M&As Eye Western Tech: Tense Times Follow
<http://fticonsulting.com/2016/12/china-mas-eye-western-tech-tense-times-follow/>

⁷ Xinhuanet: China retail sales up 10.2 pct in 2017
http://www.xinhuanet.com/english/2018-01/18/c_136905576.htm

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