BAILLIE GIFFORD | Emerging Markets

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China's little giants

It has become clearer than ever over the last 18 months that investing in China requires a view on the extent of policy alignment within each investment case. To that end we have been exploring new sources of information in our quest to find the next generation of China's champions that may benefit our clients' portfolios.

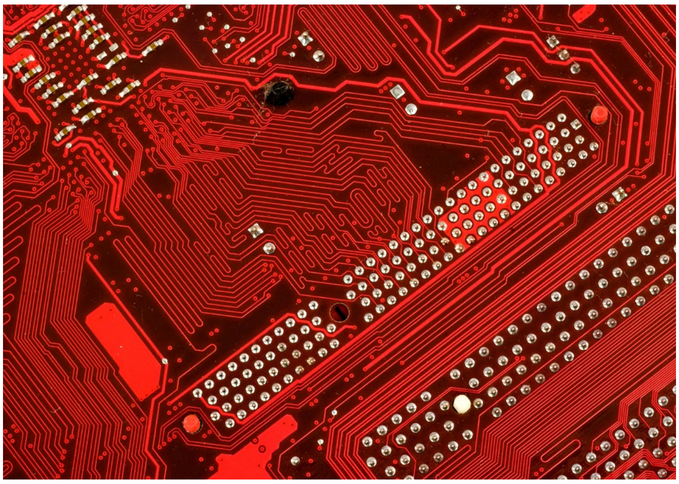
China has long been keen to learn from Germany's economic handbook to upgrade its vast manufacturing sector. The so-called 'little giants' program, launched in 2019, aims to nurture 10,000 highly specialised companies by 2025, emulating Germany's Mittelstand hidden champions[1].

As our clients know, we aim to foster a culture of collaboration between investment teams to ensure that our research capabilities benefit all clients. So, when it comes to understanding Chinese trends such as the 'little giants' program, or the companies within it, collaboration with our Shanghai research team is vital.

Little giants typically specialise in niche areas, command high market shares, and boast strong innovative capacity via a focus on research and development. China's motivation is simple:

- To occupy key nodes in supply chains for strategically important sectors, where China is keen to gain self-sufficiency.
- To push capital and resources down to small and medium enterprises (SMEs), which are crucial for innovation, employment, and wealth redistribution.
- To plug China's stubborn gaps in core technologies and move up the value chain from low-end manufacturing toward high-end production.

A few existing incubation positions in our China A-share strategy are already featured in the Ministry of Industry and Information Technology (MIIT) little giants list[2]. Examples include biochemical device producer Jafron, heating system valve manufacturer Zhengjiang Sanhua and advanced material producer Sincocera.



Policy tailwinds can be very powerful, as we have seen in the energy transition sector: In 2005, the State Council paved a new policy to develop renewables – today, seven out of the world's ten largest turbine producers are Chinese, and China produces 80 per cent of the world's solar panels. The electric vehicle (EV) industry is another example: a decade ago the State Council approved an EV industry development plan. As a result, China now accounts for 60 per cent of the world's EV production and China has the best EV battery production ecosystem. In recent years, this has informed our research into companies like CATL (EV batteries) and LONGi (solar).

However, being selective stock pickers remains critical, as domestic venture capital tends to chase state-stamped start-ups, which can inflate valuations. Therefore, companies with a core technological competency in sectors where the end markets also have strong structural growth ahead are exciting. For example, Sunresin's niche chemical separation and absorption products can be widely applied to bioscience, metal extraction, carbon dioxide processing, and water purification for semiconductor use.

[1] A term by Hermann Simon, referring to small and mid-sized companies that are relatively small but highly successful companies in niche areas. They are globally competitive yet often less-known, because their products are rarely directly visible to consumers (for example manufacturing equipment like labeling machines or components like valves and coatings).

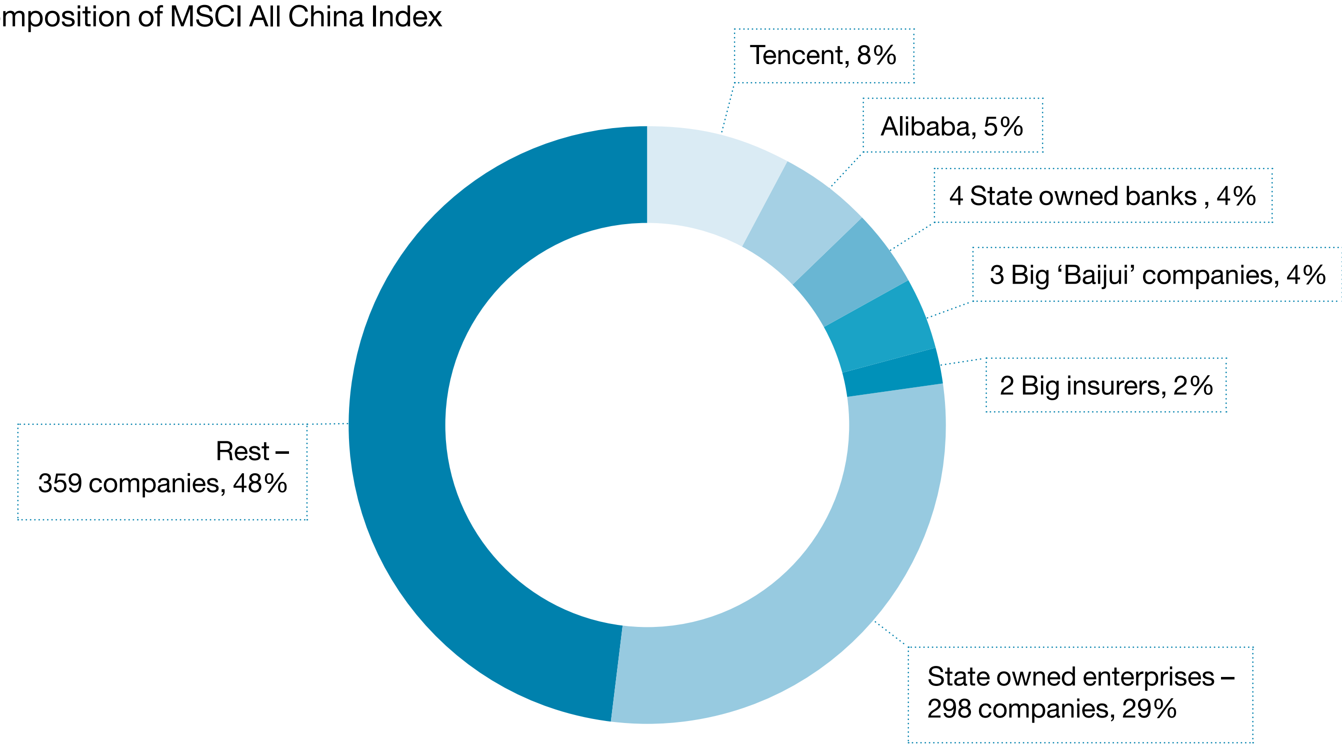
[2] According to Ministry of Industry and Information Technology of China, MIIT, to be termed a 'little giant', a firm must see a minimum 5% year-on-year average growth rate of its main business income or net profit in the past two years. More importantly, it must have two valid invention patents or other similar proofs of its innovation capabilities, and at least 3% of its top line must be dedicated to research and development, among other financial and operational criteria.

Around 5,000 little giants currently exist, of which 400 are listed domestically. Around forty per cent of those listed have less than a US$1bn market cap. This is an abundant market, home to the next generation of Chinese growth companies. So, while most of them are either not yet listed or still at earlier stages than we would typically invest in, keeping our ear to the ground will likely provide exciting opportunities for our clients. Our early private investments in Alibaba and Meituan are good examples of this. However, it isn't just about spotting new holdings; regular conversations with these companies can help us understand the broader underlying trends in China and feed into our research on existing holdings, as often these companies are customers or suppliers.

Little giants could play a significant role in an era of economic and societal transition. It is easy to forget that ten years ago, Alibaba, Meituan and Tencent barely existed in the public market's eye. Our job is to find and invest in the next generation of excellent growth companies for our clients, and the land of these little giants is likely to prove an abundant hunting ground:

Spotting next generation giants

Composition of MSCI All China Index



Source: Baillie Gifford & Co, MSCI. MSCI All China Index as at 31 December 2021.

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