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"A little learning is a dangerous thing. Drink deep or taste not the Pierian spring; There shallow draughts intoxicate the brain and drinking largely sobers us again." -Alexander Pope, 1709

In October, I took my first trip to China along with Ensemble Capital analyst Arif Karim. With Rui Ma and Ying-Ying Lu, the hosts of the excellent TechBuzz China podcast, and a dozen of our investor friends (including a number of MOI members) who joined us from the US, Canada, Dubai, London, Singapore, Spain and Mumbai, we visited with 28 corporate executives, industry experts, and government representatives in Beijing, Shanghai, and Hangzhou. From executives at well-known global companies such as Didi, Xiaomi, and Ctrip, to companies less known to western investors such as Qutoutiao, Nio, Bilibili, LexinFintech, MOGU Inc, Club Factory, and Ruhnn, Rui and Ying-Ying gave us an immersive, deep dive into the Chinese business ecosystem.

While Ensemble does not currently have any direct investments in Chinese companies, nor do we plan to make any in the foreseeable future, we think that it no longer cuts it for US or global investors to simply say that China is outside their circle of competence. As investors in global businesses, we know that China's economy and their thriving corporate sector will play an ever-increasing role in our work. So we decided we needed to spend some time there ourselves to augment the research we've conducted from our office computers. In this essay I'll share some of our takeaways from the trip that I hope are relevant to other global investors who do not have deep expertise in China.

For much of the last decade, Ensemble Capital held a large investment in Apple. As the company became big in China, we came to understand that Chinese users spent so much of their online life in WeChat, an app made by Chinese tech giant Tencent, and that they were not nearly as loyal to the iPhone as users in the rest of the world. This was because a Chinese iPhone user could buy the new, cool Android based phone, download WeChat and have all of their content ready to go. While in the past, the iPhone was far ahead of other phone makers, today there is a proliferation of other high end phones and even more advanced concept phones such as the newly released \$3,000 Mi Mix Alpha phone wrapped entirely in screen surface that was on display at Xiaomi during our visit.

Given that WeChat is barely used in the US, it can be hard for US based investors to appreciate the importance of WeChat to the Chinese online experience. Let's just say that in many ways, WeChat and a handful of other apps is the internet in China. With Google not available, Baidu's search results a spammy mix of irrelevant ads, and much of the internet outside of China blocked, the "world wide web" just isn't a terribly important part of the Chinese internet experience.

Looking at our portfolio, about half of our holdings have some sort of intersection with

China. In some cases, it is companies like Tiffany or Starbucks who have material sales into China. Other times it is businesses like Netflix or Google, who do not do business in China, but which possibly could over the long term. And then there are businesses like Mastercard, which after being blocked out of China and watching it become the only country with a non-Mastercard/Visa-based, robust digital payment infrastructure, now finds itself facing possible competition with these Chinese tech/payment giants in emerging markets or even in the US where "we accept Alipay" stickers have started to pop up in some locations.

Many investors don't appreciate the level of latent knowledge they already have about a company or industry before they start researching. For instance, most Americans would know before they even started researching a company like Starbucks that coffee can be bought at lots of different retailers, but the nuanced difference between buying coffee at Starbucks, McDonald's, Dunkin Donuts, Peets or a Third Wave coffee shop is something American investors already understand intuitively. There is even knowledge you don't know that you know. For instance, American office workers don't order coffee for delivery all that often. Why is that? Many American investor may not even be conscious of the fact that this is true in large part because the vast majority of American companies offer free coffee on site to their employees. But this is not true in China and so while it might seem strange to Americans that ordering coffee for delivery is big business in China, the reason has to do with subtle but important cultural differences that are entirely understandable if you take the time to learn about them.

As you read the rest of this essay with our takeaways, don't get the impression that we're experts on China. Our hosts for the trip very much are experts on China and if you are an English speaking investor who wants to expand your circle of competence related to China, we strongly recommend you listen to their excellent TechBuzz China podcast.

If you look back to the quote opening this essay, you'll note that we are acutely aware that a little knowledge can be a dangerous thing if you believe that your little bit of knowledge makes you an expert. But the only way to become an expert is to wade through the early phase of having a little knowledge, recognize that you may have a tendency to get "drunk" on this knowledge and then keep learning more until you come out the other side and are "sober" again.

43% of the revenue of the S&P 500 comes from outside the US. Global markets have become far more correlated to each other as the world has globalized. With the major global economic engines now being China, the US and the EU, it is critically important that all active equity investors recognize that if China is not currently in their circle of competence, it is time to start building that competency now. And while a week long trip won't do the trick, nor will sitting at your desk reading research reports.

While there are of course many, many things large and small to know about China, we came home with more crystalized thoughts about four key themes.

- The rise of local Chinese brands
- Social Commerce vs E-commerce
- The Two Chinas
- The context that allowed for China's rapid growth

## The Rise of Local Chinese Brands

Over the past thirty years, emerging market GDP growth has been faster than US GDP growth. Yet the US stock market has outperformed emerging markets. One important reason for this is that US listed companies have captured a significant portion of non-US economic growth. In the early 1990s, about 24% of S&P 500 revenue came from outside the US, while today that mix stands at 43%. In our own portfolio, the majority of our holdings generate at least some of the demand for their products and services from China and other emerging markets.

In China in particular, the rise in per capita GDP has been astounding. Chinese consumers have used their rising income to purchase more products, with US based companies capturing a significant portion of this growth. Whether it is cars, luxury products, consumer goods, baby formula, or snack food, developed market companies have benefited handsomely from the rise in Chinese consumer spending.

But this easy fuel for growth may be coming to an end, even if China's economy reaccelerates. The fact is that China's locally produced products are rising quickly in quality. While in the past, Chinese consumers allocated a significant portion of new spending to developed market brands due to their significant quality advantage, today Chinese consumers are being presented with quickly improving local brand quality, which is blunting the degree to which Chinese economic growth drives sales of developed market products. The number of examples of this trend we heard about during our trip were numerous.

At Nio, a Chinese electric car company, we got to test drive their new SUV, which from a consumer experience was on par or better than the driving experience of US and European made electric cars (whether Nio can survive financial is a different question). During our visit, a Nio representative talked about how Apple didn't initially have to advertise in China because there was no real high end smartphone competition. But today Apple needs to advertise heavily due to prevalent high end, Chinese made smartphones. But while Apple had a large head start in this regard, Tesla only had about 24 months of being the only quality electric car brand in China, before Nio and others emerged and forced Tesla to start advertising heavily.

Our contact at TalkingData, a third party data intelligence provider, described the way that Chinese made cosmetic brands are exploding in popularity. According to their data, lipstick sales are up an astounding 150% over the last year. But while developed market cosmetic brands may be seeing strong growth in China, they certainly aren't seeing 150% year over year growth because high quality, local cosmetic brands are capturing most of the growth. With the price for a comparable Chinese cosmetic product at about one third of foreign brands, now that quality standards are rising quickly Chinese consumers are allocating more and more of their spending locally.

This idea is true at the concept level, not just the product level. For instance, while you may have read about Costco's huge first day opening of their first store in China, MissFresh is a Chinese grocery shopping concept already thriving in the country. With micro warehouses

located close to consumers and delivery available within 30 to 60 minutes, Costco is entering an already competitive market. Given Chinese households often do not have extra storage space to put away a month worth of bulk purchases from Costco, the MissFresh model may prove to be better suited to the Chinese consumer especially as it is likely they will be able to consistently source high quality local Chinese made products more effectively and efficiently than Costco, at least for some time.

During our visit to Qutoutiao, an online content aggregator, the executive talked about how consumers are rotating to local instead of global brands. In their view, Chinese companies are not nearly as good at marketing as western companies. But today, consumers are learning about locally produced brands via online influencers and what are called Key Opinion Leaders (KOLs). The original distinction between an influencer and a KOL was that an influencer is native to social media, while a KOL is someone who has established expertise offline that they bring to social media, although this distinction has faded over time. As we see with the growing impact of influencers like Kylie Jenner in the US, KOLs are providing a platform to expose Chinese consumers to locally produced brands that they may not have heard of previously. The growing importance of social commerce vs traditional e-commerce is a topic we'll discuss further below, but at this point it is important to recognize that it is the combination of rising local product quality along with a newly emerging way to expose these local products to Chinese consumers that is one of the main reasons for the shift of wallet share to Chinese goods.

What all of this means, is that investors in multinational companies, particularly those selling consumer branded products, should not count on a continuation of solid growth contribution from China. Between a slowdown in total Chinese growth and a mix shift towards the purchase of locally produced goods, it is quite possible that China may cease to be a contributor to growth entirely for many Western consumer product companies.

It is worth noting that one category that was repeatedly cited as not being impacted by this trend was luxury products. Given the extremely long heritage (on the order of 150 years or more in many cases) of many global luxury companies, it isn't possible for a new local Chinese luxury brand with similar heritage to emerge overnight. Therefore, it seems likely that Western luxury products will be relatively immune from the shifts we've described, at least for many years.

### **Social Commerce vs E-Commerce**

While 20 years ago, Chinese companies often followed trends set in the US and Europe, today it is important for western investors to pay attention to business and technology trends that are emerging first in China as leading indicators of what may occur in the US and EU. For instance, while many Americans may look at Amazon Go's cashier-free stores as an innovation, Alibaba's cashier-free Hema stores began being tested over three years ago. Today they are approximately 10 times as many Hema's as there are Amazon Go locations and Hema stores are more varied in their offering with onsite shopping, delivery, freshly prepared food and even live seafood broadly available.

While Western investors are still generally focused on the rise of e-commerce and its

displacement of bricks and mortar retail, the Chinese consumer economy is rotating from e-commerce to social commerce. In a classic e-commerce environment such as Amazon, consumers go to a particular website which is an online version of a store. Whether a “mall” type demand aggregation platform like Amazon.com on which third parties can list items, or a more traditional brand website like Nike.com, e-commerce has been around for over 20 years.

But social commerce on the other hand is a more diffuse model of online retail that does not directly map to offline retail in the same way as e-commerce. For a US example, Kylie Cosmetics exploded in popularity, doing half a billion in revenue in its first two years of existence, through a social commerce strategy. While KylieCosmetics.com is an e-commerce website, it is Kylie Jenner's social media empire that drives sales. Rather than seeking to attract visitors first to an e-commerce website the way that Amazon and other online retailers traditional have, Kylie Cosmetics reaches consumers through social media platforms. Importantly it is not just the Kylie brand's own social platforms driving users to their e-commerce site, but rather a huge network of fans that have created a cross platform brand that is far more multifaceted and dynamic than a simplistic “online store” in the model of Amazon.com.

According to the Internet Society of China, social commerce is expected to be a \$300 billion market in 2019, making up 20% of the country's e-commerce. However, with the segment growing at over 60% a year, it is forecast to reach 30% of e-commerce in 2020.

Social commerce may seem on the surface like a buzz word for e-commerce companies that advertise on social media. But it is far more robust than that. Importantly, social commerce companies are playing a different game than traditional e-commerce. While B2C or “direct to consumer” (DTC) business models characterize most of developed market e-commerce, B2K2C or “business to KOL to consumer” is driving Chinese social commerce. Rather than using digital tools to access customers directly in the e-commerce business model, social commerce companies utilize both digital tools as well as the broad ecosystem of social media users to drive awareness and sales.

At social commerce companies we visited such as Ruhnn and Mogu, the business strategies discussed by the executive teams was fundamentally different from a traditional e-commerce strategy. In both cases, they viewed their job as supporting and facilitating their KOLs rather than being focused primarily on the end consumers (thus the B2K2C rather than B2C business model). One executive at Mogu pointed to JD.com as the traditional Chinese e-commerce company and explained that shopping at JD.com (much like shopping at Amazon.com) is a solitary, not social experience. Since shopping has been a social experience around the globe since far before the rise of the internet, the idea that social commerce is not a fad, but actually a more traditional form of shopping than e-commerce makes a lot of sense to us.

For developed market investors, it is important to recognize that consumer sales in China are not just shifting from offline to online, but from e-commerce to social commerce and that the skill sets and competitive advantages of social commerce success are quite different from traditional e-commerce. And just as importantly, the Chinese experience suggests that

American and European e-commerce companies may be on the verge of shifting from benefiting from a secular tailwind of offline commerce coming online, to a secular headwind from the rise of social commerce.

### **The Two Chinas**

Any American knows that business dynamics and consumer preferences are different if you compare say New York city to Gackle, North Dakota (rated by one online travel guide as the most picturesque and interesting small town in the state). So the idea that there is more than one America or more than one China as it relates to business and consumer analysis should not be surprising. However, the range of business and consumer experience in China is far wider than within developed economies.

Chinese cities are referred to as part of a Tier system. While this system is not official, Tier 1 and 2 cities have massive populations, robust economies and more or less look and feel like developed market. Yet much of the rest of the country is truly an emerging economy with consumers who live an economic experience far removed from that experienced in the US and EU.

During our visit to Shanghai, a city with 22 million people making it bigger than the New York metro area and twice as large as any other US metro area, I was struck by the fact that life there not only did not feel in the least like a developing economy, but rather that it felt like a more advanced economy than those found in most of the developed world. Yet, even venturing to Tier 2 Hangzhou, the location of Alibaba's headquarters, the developing nature of China's economy was apparent.

Depending on how you segment the demographics, between 100 million and 400 million of the 1.4 billion population live within a "developed economy". With approximately 300 million people in the US and 500 million in the EU, it is a fair approximation to say that "developed China" is a very meaningful developed market and of course it is growing faster than the US or EU.

However, there is also "emerging China". In recent years, it has been growth fueled by the emerging parts of the economy that has driven a lot of growth. Yet western investors need to be careful about their circle of competency. Recognizing that there are two Chinas is an important first step in understanding what parts of Chinese business and consumer behavior is within your circle of competence.

As an example, here is a quote from business consultant Andrew Cameron as reported in China Briefing: "A coffee brand in a Tier 1 city like Shanghai does not need to sell the idea of a coffee shop to consumers, as there is already a Starbucks store at every corner of the city. However, the same coffee shop entering a lower-tier city such as Urumqi, may be required to sell the product and *the experience of consuming coffee*, as well as the brand itself."

In both New York and Gackle, North Dakota, Americans understand the experience of consuming coffee. While there is not a Starbucks in Gackle, it is a good assumption that



every resident knows what Starbucks is and has been in one of their stores. But this sort of assumption will take you wildly off course in China.

Western investors need to neither over nor underestimate their ability to gain competence in Chinese business. Developed China is far more like the West than many western investors appreciate, yet most of China is developing and both conscious and unconscious assumptions can be misguided.

When we visited with executives of Ctrip, which until recently was widely understood as the leading online travel company, similar to Booking Holding, I asked why it is that Meituan has grown so much faster and now books more hotel room nights than Ctrip. I knew that Meituan was more focused on smaller cities (developing China) while Ctrip was more focused on affluent customers in big cities (developed China). But I didn't appreciate just how different these markets are.

The executive explained that she had grown up in a Tier 5 city and that this was the sort of market where Meituan was thriving. It makes intuitive sense that the hotel inventory there is quite different than in Beijing or Shanghai. But then she said that many of the hotels booked via Meituan are rented by the hour. The group of western investors in our group froze as from our perspective it appeared that the Ctrip executive had just accused Meituan of facilitating prostitution, since in America this is the connotation of hotels that rent by the hour. But the Ctrip executive went on to explain that in her hometown, most hotel rooms are booked by local people who live there and walk in for a nap or meeting.

These cities generally close down at 8pm. Importantly most people live in homes that are too small to socialize with groups of people. So someone in their 20s who wants to hang out with friends, might rent a hotel room for four hours to play poker in, as there simply isn't room at the home they share with parents and siblings. The older generation may do the same thing when playing Mahjong or hosting an extended family gathering. Whether due to norms around the size of living spaces or for other cultural reasons, the American cultural norm of hosting other people at your house to entertain is simply not prevalent. This leads to more private rooms being available at restaurants, more group sized accommodations, and a differing set of demand dynamics for hotel rooms.

The Ctrip executive went on to explain how different this makes the dynamics of hotel bookings in China. Booking windows are very short with the typical room reserved just three days ahead of time. Even 70% of airline tickets are booked just 5 to 7 days ahead. This is because pricing is not as dynamic in China. The increased price for booking at the last minute is small and the cancellation charge is also small, so there is little incentive to book ahead. 70% of hotel bookings are still offline with 30% being walk in bookings. With hotel occupancy rates in China at just 50% and 60% at peak season, customers can generally negotiate the final price at the front desk.

We came across another example when we visited Club Factory. While a Chinese company, Club Factory is the #3 online marketplace in India after Amazon and Flipkart. Their focus in India is on areas outside of Tier 1 cities. The founder explained that Club Factory provides cash on delivery as an option for customers. While this option is unheard of in the West, it

makes up 70% of Club Factory sales. This was also true in China in the past, but Alibaba has phased it out. Cash on delivery started because consumers didn't have a digital payment method. But now it is hard to break the cultural norm. Consumers in India outside of the Tier 1 cities don't trust online orders yet so they don't want to pay until they have the product in hand. It is also common for people to refuse part of the order after seeing it in person and then only pay for what they keep.

These sorts of fundamentally different competitive and market dynamics in many emerging markets is why many western investors rightly view companies serving these economies as outside their circle of competence.

### **The Context That Allowed for China's Rapid Growth**

One of the attractions of China to investors is the potential for very, very rapid growth. For instance, Alibaba grew by five times from ¥7 billion in revenue in 2010 to ¥35 billion in 2013. It then grew by almost five times again by 2017 and is forecast to have grown by another three times by 2020. This is a 10 year annualized growth rate of 54% meaning Alibaba has 77 times more revenue than it did a decade ago. For comparison, during that same time period Amazon's revenue is forecast to grow by 10x, Alphabet by 5x and Apple by 4.5x.

But while this growth potential is seductive to investors, it also gives pause to investors who worry about Chinese companies rapidly taking market share in the West. As long term shareholders of Mastercard, we're familiar with the media reports that come out each year saying that Alipay is now being accepted in Las Vegas taxis, or New York luxury shops, and that it must be only a matter of time before America flips completely to Chinese payment options.

However, the rapid growth of businesses in China is due just as much to the historically low levels of development as it is to any specialness about Chinese companies themselves. For instance, Alipay and WeChat Pay took off so incredibly quickly and became so dominant, because they were replacing a hugely inefficient cash-based system. Alipay was much, much better than cash and this set the stage for its rapid adoption. But in the US, there is already a robust digital payment system in place. While Alipay may or may not be a better system than Mastercard, at best it is an incremental rather than revolutionary improvement over the existing system in the US.

This is similar to how cell phone adoption in emerging markets has been much faster than in developed markets. This sort of "leapfrogging" of a phase of development occurs when an emerging market does not yet have a legacy infrastructure in place by the time the next way of infrastructure arrives. Many people in emerging economies did not yet have a landline by the time cell phones became widely available and smartphones were available before many people had a home PC. So many people in emerging markets skipped ever having a landline or PC and went straight to a smartphone.

In other words, while rapid growth is easy to associate with rapid development, the rapid growth in emerging markets in certain categories can often be a function of slow historical



development paired with leapfrogging.

Today, people in China use WeChat to pay their utilities, their rent and at vending machines. Why then are so many payments in the West still processed via paper checks or wire transfers (even "online bill pay" is often just digital instructions sent to your bank to print out a check and mail it to the biller)? It is because the systems that enable more efficient payments to billers offer functions that are only incremental improvements beyond the legacy systems that are already in place.

With this context in mind, Alibaba's amazing growth can be seen in the context of the country's poorly developed brick and mortar retail ecosystem. While Amazon hasn't grown as quickly, that is in part due to the very developed pre-existing brick and mortar retail ecosystem in the US. Living in Silicon Valley, I'm a heavy user of Amazon and e-commerce more generally. But there are also a huge number of retail stores just minutes from my house from small local boutiques to big box stores and malls. So while e-commerce is an improvement over brick and mortar in the US, in China the underdeveloped retail ecosystem created a situation where e-commerce offered a leapfrog opportunity.

You can find another example in the hard to believe, but absolutely true fact that China used more cement between 2011 and 2013 than the US used during the 20th century. This is a mind-blowing statistic no matter what context you put it in. But China is nearly ten times larger in terms of population today as the US was on average during the 20th century and the fact that they had a completely emerging economy just a few decades ago means that there was a huge, unmet opportunity to urbanize the country in a short period of time.

What this means from our perspective is that rapid growth of Chinese companies is not due to some mysterious special sauce. But to a pattern that is observable in other countries at other points in history. It is unlikely that Chinese companies that seek to grow outside of China will replicate their rapid growth unless the context of the markets they enter are similarly underdeveloped as China was, and still is in many sectors. On the flip side, Chinese companies entering emerging markets such as India, may have significant advantages over developed market companies entering the same market.

Does this mean that Alipay or WeChat Pay can't compete with Mastercard and Visa in the US? No, not at all. But it does mean you are unlikely to see the sort of massive market share gains WeChat Pay was able to achieve literally overnight in 2014 when the company gamified the digital wallet experience by dropping \$80 million into "red envelopes" for users to send to each other. This led to a tripling of WeChat Payment users from 30 million to 100 million in just a month and to China's mobile payment industry to exceed the size of the US that same year. After 20 million red envelopes of WeChat Pay "cash" were sent in 2014, 3.2 billion such payment transactions were sent the following year, followed by a brain melting 32 billion transactions in 2016.

The bottom line is that the rapid growth potential of the companies serving the Chinese market may be challenging to forecast, but they are understandable. China is not a mysterious place governed by unfathomable market dynamics. Instead, it is a unique place that is neither a more advanced economy that will lead the west, nor an emerging economy

that will simply copy the West. Consumers and businesses in China have opportunities and face risks just like businesses and consumers around the world. But in seeking to understand these issues, investors can grapple directly with the opportunities that may be available in China as well as the competitive risks that Chinese companies may present to Western companies.

So in conclusion, combining our own research from our learnings on the trip, we came away with five key ideas:

- Global investors can no longer accept the idea that China is outside their circle of competence. While your competency may not be high enough to make direct investments in China, it is time to start climbing the learning curve.
- The period of global brands getting pumped up growth from China may be coming to an end. Not so much due to slower growth for the Chinese economy, but due to the rise of high quality local brands.
- While e-commerce will continue to grow quickly in China, pay attention to the rapid shift towards social commerce and how these business models differ from traditional e-commerce. Importantly, be aware that Chinese's move towards social commerce may signal a similar shift is going to come to developed markets over the next decade.
- China is really two markets. A developed market of between 100 and 400 million people and an emerging market with over a billion people.
- When looking at the rapid growth of the Chinese economy and Chinese companies, make note of the unique context in which that growth occurred. It is unlikely that Chinese companies will exhibit similarly rapid growth when they attempt to enter developed markets. "China speed" growth is not a mysterious occurrence; it is an understandable and forecastable outcome of having had an underdeveloped economy paired with the concept of leapfrogging.

No European investor would say that they don't invest in companies that operate in the US because the US system is outside their circle of competence. The same is true of US investors looking at companies serving Europe. At Ensemble, we continue to believe that making direct investments in Chinese companies is likely outside of our circle of competence for the foreseeable future. Yet we also believe strongly that the Chinese economy, Chinese consumers and Chinese businesses will only continue to play an ever growing role in the global system and we're committed to expanding our circle of competence as aggressively as we can.