ICT: CHINA

RISK ASSESSMENT: HIGH

HIGHLIGHTS AND OUTLOOK

ICT is one of the most dynamic sectors in the Chinese economy, representing 10% of GDP. The sector is dominated by large private players. This makes the sector very different to other cornerstone industries in China. In addition to the three internet giants (Alibaba, Baidu and Tencent) Chinese companies are global leaders in the areas of telecommunications (Huawei), mobile phone manufacturing (Oppo, Vivo, Xiaomi and ZTE) and home appliance manufacturing (Haier, Gree and Midea).

Despite dynamism in previous years, the sector is subject to some headwinds. Most notably, on July 6, the United States (US) imposed tariffs on USD 34 billion worth of Chinese imports. Many of these products are part of the ICT sector, meaning external demand for these goods is expected to slow down going forwards. We don't exclude the possibility of additional non-tariff measures by the US Department of Commerce on individual Chinese firms, in line with what took place with ZTE in April 2018. This will have a negative spill over on the sector via supply-chain links. Moreover, a more uncertain environment could constraint companies' willingness to do capex investments.

On the supply side, a series of factors related to the technology lifecycle of mobile phones are expected to weigh on the financial performance of some of these companies. In particular, mobile phone vendors and telecommunications have been slow in releasing new generation 5G phones, leaving a saturated market (82% mobile phone penetration) flooded with existing inventory. Pressure on sales and prices will exert downside momentum on profitability and debt servicing capacity. These factors are expected to reverse once new technology kick-starts consumer's replacement cycles.

Strengths

- Benefit of government support under the "Made in China 2025" strategy
- Strong global players
- Good access to / adoption of internet

Weaknesses

- The sector is subject to cyclical headwinds as some technologies mature
- Trade tensions with the US targeting ICT
- Product saturation in some segments

Key Players

- **Huawei:** Largest telecom provider.
- **Oppo, Vivo and Xiaomi:** Largest mobile phone manufacturers by market share.
- **Lenovo** is one of the main global players in several segments, such as mobile phones and computer manufacturing, as well as connected devices
- Internet domestic and international giants: **Alibaba, Baidu and Tencent (or BAT).**
- **Haier, Gree and Midea,** largest home appliance manufacturers by revenues

Source : EU SME Center

Regional Risk Assessments: ICT

ASIA	HIGH
CENTRAL & EAST. EUROPE	MEDIUM
LATIN AMERICA	MEDIUM
M. EAST & TURKEY	HIGH
NORTH AMERICA	MEDIUM
WESTERN EUROPE	MEDIUM

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SUPPLY

A large and crucial part of the global ICT supply chain is located in Asia, with China at its core. Electronics are the single largest product category in Asian trade. Between 2001 and 2016, the value of electronics exports from Asia jumped by 8.2% YoY each year, reaching USD 1700 billion, according to figures by the Hong Kong Trade Development Council (HKTDC). China has become the world's largest electronics producer, with the value of its electronics output reaching USD 700 billion in 2015 (a 38% share of the global market), outstripping the US. China is also the largest electronics export source in Asia, accounting for 40% of the total. More than half of these exports are inter-regional (within Asia), a reflection of increasingly inter-dependent supply chain links.

Mobile phones account for over 60% of total electronics shipments according to figures by the Customs General Administration of China. The sector faces cyclical headwinds, related to the technological lifecycle of mobile phones. In particular, Chinese vendors have been slow to come up with 5G technology. This means they are sitting on large inventories that need to be cleared before the next generation of products can be released. Such an environment could add pressure to profitability and debt servicing. Once available, the deployment of 5G technology will have wide-ranging applications and will boost sales of new generation devices. Until then, supply factors will remain a constraint on the sector.

The ICT sector is expected to continue to benefit from state support under the "Made in China 2025" strategy. The strategy aims to boost China's manufacturing capabilities in order to facilitate a move up global value chains and away from labour intensive industries. Average wages in China have risen by more than 150% between 2008 and 2017, according to the National Bureau of Statistics (NBS). Tapping into higher value added manufacturing is crucial in order for China to avoid falling victim to the middle income trap. This paradigm assumes a "Japanization" of the Chinese economy at a much earlier stage of its industrial development. For the aforementioned reasons, "Made in China 2025" features 70% self-sufficiency targets in critical high-tech segments such as semiconductors, telecommunications and electric vehicles. Such targets are to be achieved through a series of quasi-official fiscal support measures, as well as the creation of a number of funds that tech firms can access in order to facilitate R&D.

DEMAND

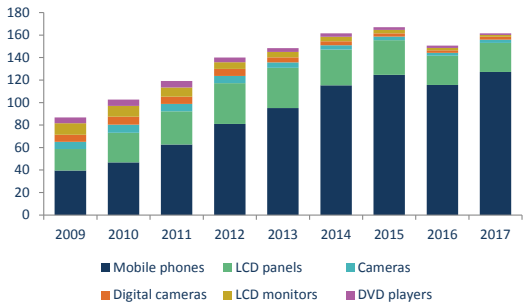
Demand is expected to grow in the long term, favoured by digitalization trends. However, there is saturation in some categories. For example, mobile phone penetration was 82% in 2017 in China, only slightly behind the US at 84%, according to the international association representing mobile phone operators GSMA. The saturation in the Chinese smartphone market is expected to continue into the second half of 2018, as device replacement cycles lengthen. China's rising disposable incomes have allowed consumers to trade up to higher-priced devices, helping its smartphone market to become the largest in the world. However, rising ownership of higher-end devices has also pushed out replacement cycles. In particular, the lack of major hardware updates and a slow rollout of 5G technology will mean that demand for new mobile phones in China will remain sluggish.

Beyond mobile phone shipments, a slowing economy and housing sector are also expected to contribute to restricting demand for electronics and household appliances. Growth is expected to slow to 6.5% in 2018, from 6.9% in 2017, while completed investment in real estate has stagnated around 10% YTD in the first six months of 2018, down from an average of 35% during the height of property investment in 2010. The housing sector is estimated to roughly account for 20% of GDP both directly and indirectly. Decelerating demand in this space will have a negative spill over on dependent sectors such as household appliances and electronics.

On the internet front, the situation might be more favourable. Internet penetration rates were 56% in 2017 according to figures by the China Internet Network Information Centre. While rates in urban areas are much higher (over 70%), there is still substantial room for rural households to increase their access to internet services, which is likely to boost revenues for service providers (BAT) and equipment manufacturers (Lenovo). Online retail sales by value increased by 30% to exceed USD 1 trillion in 2017, making China the largest Ecommerce market in the world.

Finally, external demand for Chinese ICT products may suffer as a result of the ongoing trade dispute between the US and China. On the 6th July, the US began imposing tariffs of up to 25% on USD 34 billion worth of Chinese imports. This will be followed by additional tariffs of USD 16 billion expected on August 23. Approximately 80% of the products subject to 25% tariffs are suspected of benefitting from state support under the "Made in China 2025" strategy, many of which are electronics. The US remains the largest market for these types of goods, so we expect that the impact of higher prices will result in a decline in US demand for Chinese ICT exports. Moreover, the sector remains subject to rising risks on the non-tariff front. For example, on April 16 2018, the US Department of Commerce banned US companies from trading with Chinese electronics manufacturer ZTE as the company was found to be in violation of US sanctions. The ban was later removed but the company posted steep losses for the first half of 2018.

CHINESE EXPORTS OF ELECTRONICS (USD BILLION)



Source: Bloomberg