Asian takeaways

Aussie BBQ bites

For Professional Investors Only | Marketing Communication

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Our latest research trip to Australia confirmed what we already knew: the country is booming. This is despite concerns around high interest rates and their potential impact on domestic consumption, and China's recent economic struggles, as the resource sector's biggest customer.

Indeed, the property market has not seen a notable rates-led pullback, and prices in this sector look resilient, particularly within major urban areas where there are stock shortages. In addition, the employment market is robust. In the context of global economic weakness, Australia seems to be living up to its moniker as 'the lucky country'.

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Things are looking bright for Australia's economy – and for Sydney's skyline.

Of course, like many of Australia's developed market peers, there are indications that the boom is not benefitting all parts of society equally; concerns surrounding a rising cost of living, and property prices becoming increasingly unaffordable, echo those we are seeing across other developed economies.

In Australia, these types of issues are often politicised, and this instance is no different. The Australian Competition and Consumer Commission ("ACCC") is currently investigating the monopolistic conduct of the country's two major supermarket chains, Woolworths and Coles, and is examining their pricing practices. So far, this investigation has resulted in the resignation of long-standing and well-respected Woolworths CEO, Brad Banducci, following an interview on Four Corners, a weekly Australian Broadcasting Corporation current affairs show. The interview was conducted by 'investigative journalist', Angus Griggs, and we believe it was a bit of a hatchet job, with Banducci stumbling through his responses. In Australia, 'tall poppy syndrome' refers to the act of attacking or criticising individuals for their success, and it seems appropriate in this instance.

Checking out the (pricing) competition

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The China relationship

Our visit in early May coincided with a large investment conference held in Sydney, and whilst we met with the supermarket giants and touched on the robustness of the domestic economy, our key takeaways from the conference focused largely on Australia's relationship with China. More specifically, this included the role it can play against the evolving geopolitical backdrop, and in the context of the West's attempts to control the value creation in its energy transition story.

Australia has historically punched above its weight in terms of its relevance to other Asian economies, primarily due to its natural resource supply. It remains the largest exporter of seaborne coal and iron ore to China, as well as being a major exporter of natural gas to the energy short economies of Korea and Japan[1].

The country has attempted to walk the tightrope between the East (specifically China, its largest customer) and West (specifically the U.S., its closest security partner), which over time has led to a strained relationship with the former, particularly under Australia's previous Conservative government of Scott Morrison.

Indeed, Hu Xijin, the bombastic, nationalist editor of the Chinese Communist Party-run *Global Times*, disparagingly referred to Australia as the "chewing gun stuck on the sole of China's shoes" on the back of the country's request for an investigation into the origins of Covid-19[2]. Perhaps tall poppy syndrome is catching...

Looking ahead, there are likely to be more bumps in the road in terms of diplomatic relations, but the current Labour-led, Anthony Albanese government is working to smooth the way with its largest trading partner, and the removal of Covid-era tariffs on Australian wine into China are a step in the right direction.

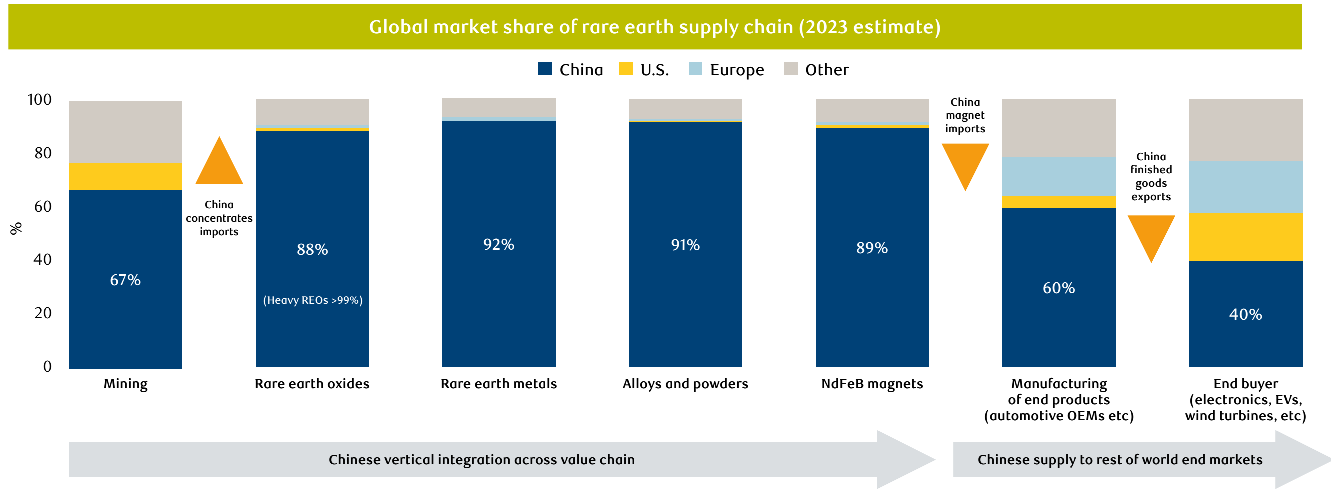
Global decoupling

In recent years, China has dominated the vehicle electrification story (see our piece '*China's clean, green, electric machines*' on page 17 of the Asian Equity ESG Report), largely as a result of the widescale adoption of electric vehicles (EVs) in its expansive domestic market. Now, even the mighty Tesla is feeling the pressure from a wide array of Chinese competitors, recently cutting prices significantly on the back of rising exports to the West from China.

In response to this rising competition, the EU has initiated investigations into unfair practices, such as state subsidies, whilst the U.S. has set punitive import tariffs across direct imports as well as the supply chain. The Inflation Reduction Act ("IRA") adds further focus to the U.S.'s attempts to prevent China from dominating energy transition economics.

1 Reuters, Australian Government, Department of Industry, Science and Resources.
2 China embassy accuses China of 'petty tricks' in coronavirus dispute | Reuters, as at 29 April 2024.

Figure 1: China has strong vertical integration, however raw material imports from other countries help to support supply



Source: Iluka company presentation, as at May 2024.

This situation is not unique to the EV/energy transition space, with the IRA also encouraging onshore semiconductor investments. The recently introduced BIOSECURE Act is another example, aimed at weaning Big Pharma off Chinese contract management and manufacturing organisations in the healthcare sector. However, within the energy transition space we are seeing some interesting subplots.

Critical minerals and rare earths

Rare earths, metallic elements that are key enablers in the energy transition story, are, in actuality, not particularly rare, although their dispersion across the world, and lack of concentration in areas, makes them harder to mine.

China has near total dominance in this space, not because the deposits of rare earths are more concentrated here, but because the country's processing capabilities (for both heavy and light rare earths) are so much more efficient relative to other parts of the world that it has resulted in the abandonment of much of the global capacity outside China. Interestingly, China is not actually fully self-sufficient when it comes to the raw materials, importing from countries such as Myanmar, Madagascar, and even the U.S. (Figure 1). More recently, China has implemented quotas limiting production across producers to help extend its domestic production life.

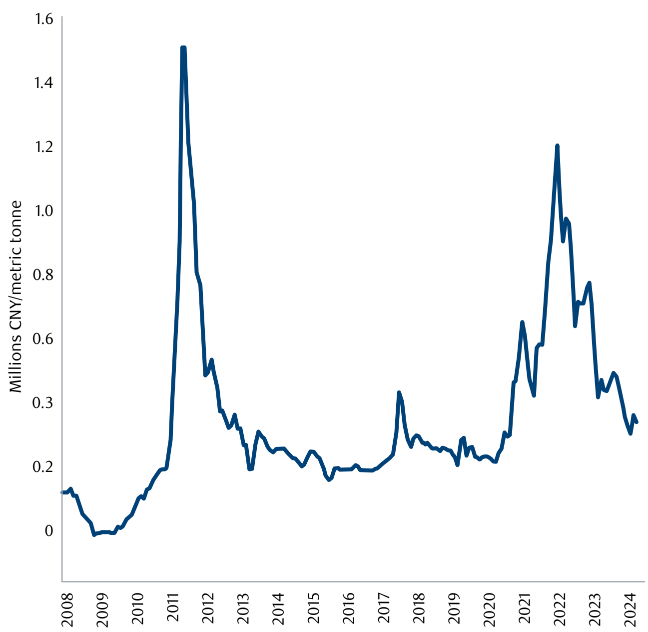
Given the current geopolitical state, it is clear that the western world, led by the U.S., would prefer to look beyond China for its rare earth supply (and indeed its supply of other materials and goods). At present, China has a near monopoly in this area, and the current pricing levels – there is reasonable evidence to suggest that China Inc. has been working hard to ensure that the pricing dynamic remains unattractive to new entrants – make it hard for new entrants in higher cost, 'friendly' nations to invest in such an alternative supply chain (Figure 2).

Indeed, accusations have been levelled that, since China re-organised its rare earths industry in 2021, to create two large industry behemoths (one in each of the light and heavy rare earths spaces), prices have been suppressed and make little economic sense.

Whilst Chinese companies in this level of the supply chain are not making any real economic returns, the value for China Inc. is instead being captured in their forward applications in mechanisms such as permanent magnets, particularly within the EV space. This results in a robust domestic supply chain, helping China to efficiently grow its dominance in this market.

Figure 2: China's rare earths prices pose strong competition to new entrants in higher cost markets

China Neodymium Oxide Market Price Index



Source: Bloomberg, as at 27 May 2024.

In spite of the geopolitical tensions, at present, this strong pricing competition makes it uneconomic for western countries to diversify away from China as a source for rare earths. That said, we are seeing some mining companies outside the region (including Australian company, Iluka) calling for measures such as non-recourse loans to help develop rare earth deposits and build processing capabilities in situ.

There is an opportunity for countries such as Australia here, although in order to convince customers up the supply chain, including both EV and traditional auto original equipment manufacturers (OEMs), to move away from China's low cost resources, we will need to see more from western governments in terms of subsidies, or even mandating non-Chinese supply. Both of these are of course possible, but require strong political will (and a large cheque book) – and would no doubt prove to be those additional 'bumps in the road' for Australia and China's diplomatic relations.

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If we see governments making these moves, China will cry foul, just as it has in the midst of increasing noise surrounding EV tariffs on Chinese exports to the U.S.. The country has blamed these tariffs for the rampant domestic overcapacity in China, protesting that this will negatively impact technological development, as well as international competition within the EV market. More recently, China's trade ministry have weighed in that, in reality, exports to the U.S. account for just a small percentage of China's total car production, questioning the narrative that EV overcapacity in China is flooding overseas markets, as well as the effectiveness of these measures to boost U.S. manufacturing capacity.

Figure 3: Exports make up just a small portion of Chinese EV companies' total revenues

Region (companies)	% of vehicles delivered / revenue overseas
U.S. (GM, Ford)	~50% vehicles delivered overseas
Germany (Volkswagen, Mercedes-Benz, BMW)	~60% vehicles delivered overseas
Japan (Toyota, Suzuki, Honda)	~80% vehicles delivered overseas
Korea (Hyundai, Kia)	~80% vehicles delivered overseas
China (BYD, Geely)	20-30% revenue from overseas

Source: Company filings.

If we look at China relative to markets such as Korea and Japan for example, it does not appear to be over-exporting. By way of example, in 2023 Korean OEM, Kia, and Japanese OEM, Toyota, obtained 65% and 51% of revenue respectively from exports (not including onshore manufacturing capacities in foreign markets)[3]. As illustrated in Figure 3, Chinese companies BYD and Geely derived just 20-30% of revenue mix from exports.

The true situation is likely somewhere in between China and the U.S.'s arguments. There is undoubtedly industry overcapacity in China, but some of this is in the traditional internal combustion engine market, and China's EV space continues to be one of the fastest evolving markets in the global EV transition story.

Looking ahead, it will be interesting to see how this plays out, although we will surely see some continued jousting between China and the western world. As this evolves, nations such as Australia have the opportunity to step up and benefit. However, whilst the country's economy looks robust, the strength of China's shadow means that its ability to play a part in the global green energy transition story will be no mean feat.

[2] Company filings

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