NORTHCAPE
CAPITAL

Global Emerging Markets

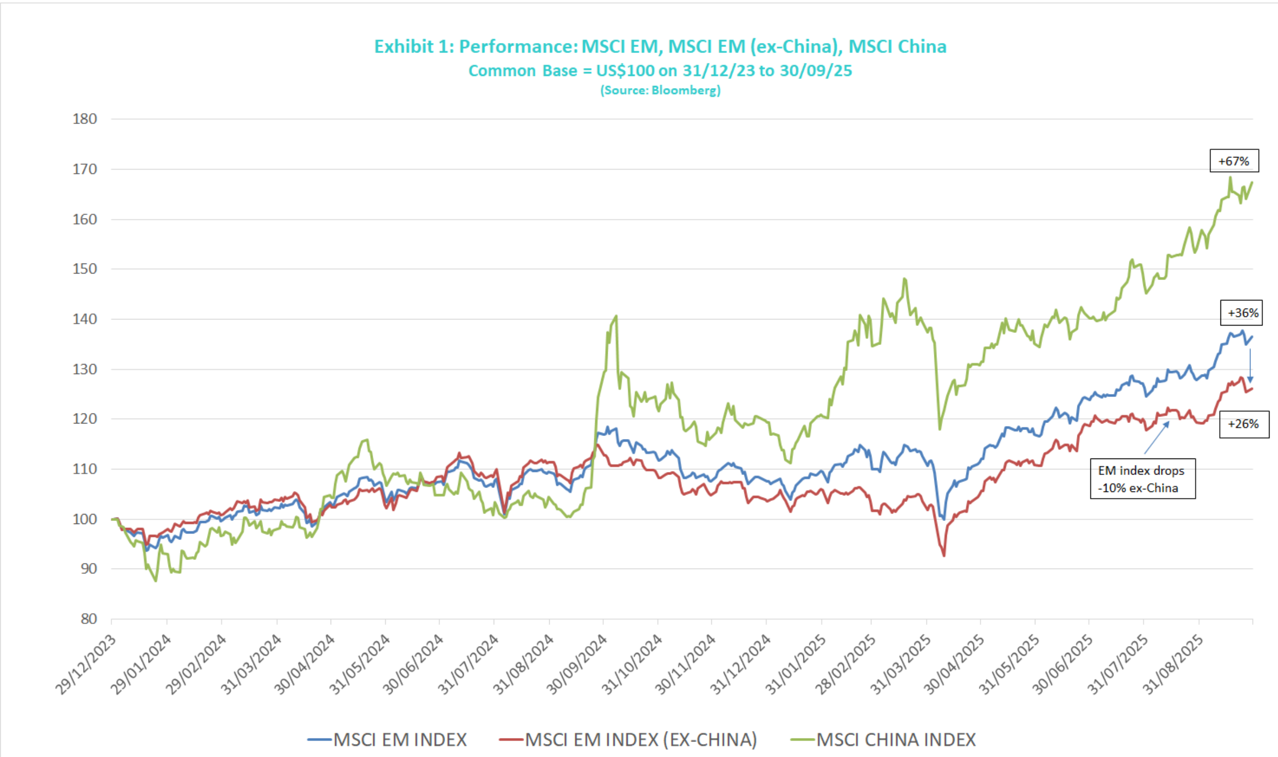
Risk in the China Rally…

In this report we dig deep into the drivers of China's stock market rally since December 2023 and assess the direction from here by analysing return on capital trends from a diverse selection of companies. We believe the index's return on capital is set to remain poor and we therefore remain deeply underweight China. We continue to prefer EM opportunities where returns on capital are much higher, industry overcapacity is not an issue, and companies (and banks) allocate capital with shareholders in mind, like Mexico, India, South Korea and Taiwan.

The China MSCI EM US$ index is up +67% since 31 December 2023 to 30 September 2025, which is considerably more than MSCI EM Index of +36% over the same timeframe. Given its high index weighting China has had a sizeable impact on the overall EM equity asset class over the past 21 months – indeed, if we were to strip China out, the overall EM index return drops -10% percentage points to +26% (see Exhibit 1).

What's been driving the MSCI China Index?

It has not been a broad-based rally, rather it has been quite narrow, not unlike the impact of the 'Magnificent Seven' on the S&P 500 over a similar time frame. Like the US, the top performing stocks for China in terms of contribution are all in the Technology sector: Alibaba, Tencent, Xiaomi, PDD Holdings, and NetEase. These five stocks alone account for a 32% weight in the MSCI China Index and are up +73% on average in 2025 YTD. This group has been led by the largest stock in the China index, Alibaba up +120% YTD.



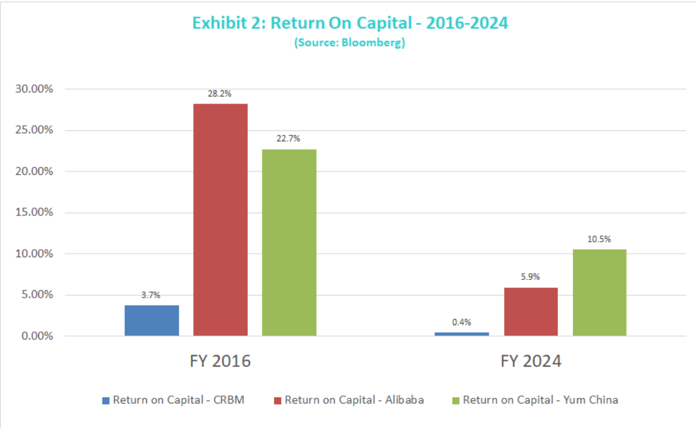
Excluding these five stocks the MSCI China Index would be up +24% YTD, almost 50% lower. These five tech stocks appear to be at the centre of the AI 'feeding frenzy' in China and hence are catching a lot of media attention. An interesting point to note is the fact that China and Hong Kong stock markets have been driven by a massive amount of retail buying and ETF flows on the AI investment theme. According to HSBC, equity mutual fund issuances in China have surged 132% year on year in 2025, a sign there is a lot 'hot money' chasing the momentum of AI linked stocks driven by FOMO (fear of missing out). China's retail investors now account for a whopping 90% of daily stock exchange trading in Shanghai. This is in stark contrast to several major markets where the trading is driven by institutional activity, for instance, retail investors account for about 20%-25% of trade volumes on the New York Stock Exchange. China's high retail stock market participation creates significant risks of a market correction.

In our view, for China's equity market to keep rising it would require the fundamentals of its listed corporates to materially improve. This would be manifested in a sustained improvement in China's return on capital for its listed companies.

To examine the outlook for China's corporate return on capital, we look at the returns for three companies that address different sectors. We can then gauge from this diverse sample how the return on capital is tracking more broadly in China. Plus gain some insight into the outlook for China's equity market by analysing the return on capital direction of these companies going forward. The three stocks are:

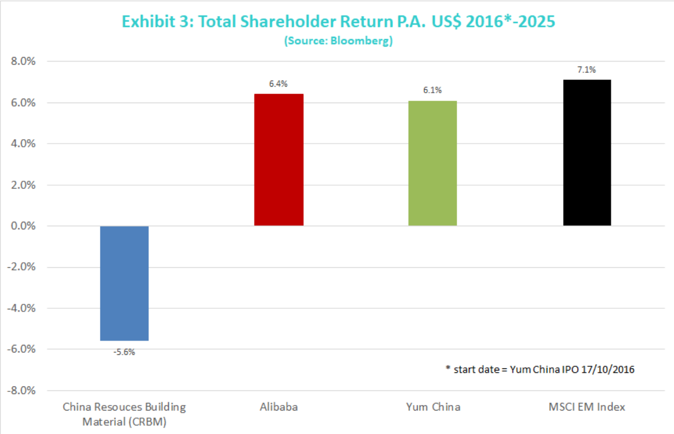
1. **Alibaba** (e-commerce, data centres, AI)
2. **Yum China** (restaurants)
3. **China Resources Building Materials** – CRBM (cement)

First, if we look at the return on capital of these three companies from 2016 to 2024, we can see that it has fallen significantly in all cases, with CRBM approaching zero in FY 2024 (see Exhibit 2).



The simple reason for the decline in return on capital of these businesses has been the large increase in investment (capex) over the past decade, resulting in excess capacity across all three of these industries. Given companies in China are limited in their ability to restructure (rationalise their cost base), as this would create unemployment and potential social unrest, such excess capacity has resulted in widespread price deflation and lower margins (hence lower returns on capital).

Moreover, if we look at the investment return of these companies over the past ten years, it has not been great (see Exhibit 3). CRBM's has had a negative annual return of -5% p.a., and despite the strong rally over the past 18 months, both Alibaba and Yum China have underperformed the EM index over the 2016-2025 period.



To assess China's future return on capital prospects, we note the following for each company in turn:

Alibaba

When ChatGPT exploded onto the scene in late 2022, the response in China was swift. The central government designated AI infrastructure as a national priority, urging local governments to quickly accelerate the development of so-called smart computing centres, a term coined to describe AI-focused data centres. Over 500 projects were announced with many private companies partnering with local government to construct these large data centre facilities. According to press reports many of these data centres now operate at less than 20% capacity.

The low-capacity utilisation would dictate that China stops building new data centres. However, it seems Alibaba has been pressured by China's government to undertake a massive phase of investment which will see its capex rise nearly fourfold, from US$4 billion in 2024, to $15 billion per annum over 2025-2027 (this capex has created negative cashflows, and rising debt levels). The capex will largely be used to build even more enormous data centres to house the expected booming demand for AI servers in China. Alibaba will also be required to acquire computer chips from local Chinese (and largely unproven) semiconductor foundries. China's data centre industry, already fraught with massive over capacity, is about to get worse.

We note the Alibaba Chairmans' (Joe Tsai) comments at an investment conference in Hong Kong in March 2025 are quite concerning: "I start to see the beginning of some kind of bubble," Tsai told delegates. Some of the envisioned projects commenced raising funds without having secured "uptake" agreements, he added. "I start to get worried when people are building data centres on spec. There are a number of people coming up, funds coming out, to raise billions or millions of capital…"

Alibaba's management (and many sell side analysts) have subsequently qualified the Chairman's comments saying that Alibaba's data centres host the latest server technologies and are therefore potentially not impacted by the overcapacity of legacy technologies in China. A good counter point to note - we believe investors need to consider the risk that the idle, older data centre capacity is updated (repurposed) with newer technologies and the fact that server demand could slow if the AI returns are lower than expected. Even if returns are lower, we also think there is a good chance that Alibaba will be forced (by the government) to keep spending on AI data centres to assist in achieving national GDP growth targets. As such, we think the prospect of an enduring improvement in Alibaba's return on capital is a risky assumption.

It should be remembered, like the railroad and internet booms, seminal technological shifts are never easy. They always start with a very large misallocation of capital, followed by a watershed industry rationalisation from which the winners emerge many years later. The current AI boom in China has the hallmarks of this.

Yum China

Yum China owns and operates restaurants trading in China under KFC and Pizza Hut banners, and over the past ten years has added 10,000 units, growing to 17,000 restaurants.

However, over 2016-2024 sales per store have declined from US$900,000 to US$690,000 (-24% drop), and EBITDA per store has fallen from US$139,000k to US$100,000 (-30% drop). This has led to a large drop in Yum China's return in capital from 22.7% in 2016 to 10.5% in 2024. To increase restaurant utilisation rates Yum China has also entered the home delivery space for Pizza Hut and KFC competing against other food retailers and quick-service restaurants.

Despite the grim outlook, Yum China is committed to adding 1,500-1800 restaurants per annum (8-10% more each year), which points to the potential in our view for returns on capital to decline further, especially given the constrained consumer and weak demographics of China. Yum China is already starting to reduce prices, increase promotional deals to attract traffic to its restaurants, and we suspect its menu price deflation will become more severe in the years ahead, negatively impacting margins.

We also note that in 2025 a very fierce food delivery price war erupted, which reflects food retailers and take out restaurant groups (like KFC and Pizza Hut) quest to gain sales volumes from home deliveries at the expense of margins, and returns on capital. Yum China needs to reduce its footprint by closing low return stores to reflect the new reality of its marketplace. However, given the political imperative not to close businesses, Yum China keeps opening more new restaurants at a very rapid pace. This all points to a much weaker return on capital to shareholders in the future, and a lower share price.

China Resources Building Materials (CRBM)

In light of the massive expansion in China's cement production capacity (and weak property market), cement industry capacity utilisation has fallen from around 80% in 2020 to about 45% in 2025. As such average cement prices have fallen 20% to about US$60 per ton over this time frame.

Given this paradigm, CRBM's net profit has crashed from US$1.0 billion in 2018 to just US$29 million in 2024, whilst its net debt levels have increased massively from US$26 million in 2018 to US$1.8 billion in 2024. Its return on capital has slumped to a mere 0.5% in 2024. Any rational banking system would probably see financing pulled from CRBM and force an asset base restructuring (i.e. excess capacity removed – certainly not increased).

However, the financial system in China functions on lending no matter what the risk is to drive GDP growth. This has led to a vast array of "zombie" companies like CRBM, stuck in low/negative return industries, but accumulating increased debt year after year. This has led to China's banking system being potentially riddled with bad debts from such zombie companies when they are eventually restructured, and loans written off. However, we do not foresee any restructuring soon. To get back to 80% capacity utilisation would require about 30-40% of China's cement capacity to be shut down or removed, which is not going to occur under the current political system, given the big negative ramifications for the economy, financial system and social stability.

Accordingly, we continue to see CRBM's debt levels rising, with depressed pricing, margins and returns on capital, thereby sustaining poor returns to shareholders.

While we have focused on three companies in this section, we note for the broader China market over 2016 to present:

- Return on Capital has fallen from 4.9% to 4%
- Net debt/EBITDA has increased from 1.2x to 3.9x
- MSCI China has returned 4.4% CAGR versus the MSCI EM index's 5.7%

Summary

China's stock market has had a strong rally over the past 21 months, and especially this year. It seems this bounce has been fuelled by hot money chasing the AI investment theme and is dominated by retail investors with a high focus on short-term share price trading, rather than considering long-term shareholder value drivers. The examples of Alibaba, Yum China, and CRBM show three diverse companies operating in industries plagued with over capacity/deflation requiring material output rationalisation. However, this seems impossible under the current political system in China, due to risks to social stability from a deep recession, and high unemployment. Indeed, these companies are continuing to increase capacity and increase debt levels when the price signals and return data suggest they should not.

This all infers that the basis for a sustained rally in China's equity market is simply not there in our view. Further, as the hot money recedes, the underlying fundamentals will take hold (again), giving rise to another market relapse, most likely the fifth in the past twenty years (see Exhibit 4).

Moreover, looking at our three examples, it is easy to understand why the MSCI China Index's return on capital over the past twenty years has fallen from 11.6% in 2005 to 4.0% in 2024 (see Exhibit 4 again), and speaks to why this index (apart from the odd retail buying spree) has not performed on a sustained basis. As our three examples show from a bottom-up perspective, the index's return on capital in our view is set to remain poor, indeed risks exist that it will head even lower than the current 4% under current business practices. We therefore remain deeply underweight China, and continue to prefer Mexico, India, South Korea and Taiwan as EM opportunities where returns on capital are much higher, industry overcapacity is not an issue, and companies (and banks) allocate capital with shareholders in mind.

Finally, a much better way to invest in the AI technological shift is through the leading global semiconductor companies (TSMC, SK Hynix, and Samsung Electronics) which we own. They are the real "picks and shovels" of the industry. These companies compared to China's AI companies are operating with world's best technologies, strong capital discipline, generally good governance, and very strong balance sheets.

Exhibit 4: MSCI China Index US$ (LHS) V China Market Return On Capital (RHS) 2005-2025
(Source: Bloomberg)

For more information, please contact our distribution team:

Katie Orsini
Client Director

p: +61 2 8234 3629
e: katie.orsini@northcape.com.au

Wendy Hammond
Client Manager

p: +61 2 2 8234 3638
e: wendy.hammond@northcape.com.au

Eliza Clarke
Client Manager

p: +61 2 2 8234 3606
e: eliza.clarke@northcape.com.au

Northcape Capital

Sydney
Level 24, 45 Clarence
Street Sydney NSW 2000
Australia
P: +61 2 8234 3600

Melbourne
Level 18, 90 Collins Street
Melbourne VIC 3000
Australia
P: +61 3 8626 8000

ABN: 53 106 390 247
AFSL: 281767

www.northcape.com.au