China Insights: Keep Calm and Carry On

International equity investors may have taken fright in recent months due to the effects of regulatory crackdowns in China, but looking beneath the surface we find continued opportunities.

Setting the scene

China's government and regulators have initiated a series of crackdowns affecting the supply side across different sectors of the economy, citing consumer protection and a need to ensure levels of competition are maintained as the country continues its move towards becoming a service-based economy driven by consumption.

Additionally, the political framing of the changes is summed up in a government policy objective called "common prosperity".

The recurring slogan is today being used to explain a push to not only narrow yawning gaps in wealth, but generally improve social cohesion. This has led to harder imposition of antitrust regulations, as well as the regulatory hits to sectors such as for-profit online education and video gaming – in both cases citing welfare improvements of children as well as improvements to the wallets of parents.

However, policy decisions elsewhere are also linked to the crackdowns. For example, July this year saw the US government issue advisories to US businesses about reputational and legal risks associated with operating in Hong Kong and Xinjiang.[1]

The same month saw the Chinese government launch a probe into ride-hailing giant Didi, following its listing of securities in the US. This has subsequently been followed by proposals from US securities markets regulator the SEC for additional checks on China-based companies and associated offshore shell companies seeking listings in the US; the checks would demand disclosures on so-called Variable Interest Entities, whether the Chinese government has permitted a US listing, and what risk exists of a delisting under the Holding Foreign Companies Accountable Act.[2]

Sources
[1] U.S. State Department https://www.state.gov/issuance-of-a-hong-kong-business-advisory/ and https://www.state.gov/xinjiang-supply-chain-business-advisory/)
[2] Linklaters https://www.linklaters.com/en/knowledge/publications/alerts-newsletters-and-guides/2021/august/03/sec-requires-chinese-companies-seeking-us-listing-to-make-additional-disclosures1)

Most recently, some USD18 billion was wiped off the value of Macau gambling operators in one day, when on 15 September, the Chinese government announced a regulatory overhaul of yet another sector.[3]

For international investors, then, there are clearly expressed concerns that governments and regulators, whether in China or elsewhere, are raising hurdles to the flow of capital to Chinese businesses. The reaction has been one of pulling money out of the country – or at least thinking about doing so.

On the basis that investors are seeking risk-adjusted reward over the medium to long term, then the changes give rise to a several questions. One is whether the risks of investing in China outweigh the opportunities. Another is whether it is time to rethink allocation to China. However, the question must also be raised as to what opportunities may be going amiss as a result of reducing exposure to Chinese equity.

Known unknowns

Looking through such changes on behalf of underlying investors is precisely what an active fund manager is expected to do.

Hong Kong-based Jane Ye, Senior Portfolio Manager at Sumitomo Mitsui DS Asset Management, says the first issue is to address the element of 'panic' seen among international investors.

To do this requires explaining that there is a reason behind the crackdowns, and if that is better understood, then the investment opportunities may become clearer.

Investors need to do their homework - whether it is new law or even a draft legal text, these need to be read properly and thoroughly.

The decision-making processes of top leaders need to be understood. Here investors need to put changes in context of the long-term horizon that is driving the decisions; thinking about what has happened since last year means they can better begin to understand the government's intentions, Ye suggests.

"The policy priority has shifted from pro-growth to a balance between growth/sustainability," Ye says.

"Sustainability in this context means getting involved in understanding matters such as regulation of the platform economy, social equality targets, supply chain security, and more recently this year data security."

Sources

[3] Reuters https://www.reuters.com/business/macau-kicks-off-public-gaming-consultation-ahead-casino-rebidding-2021-09-15/

Much is ongoing. But research points to differences between recent and past periods of crackdown.

For example, mid-2018 saw e-commerce laws introduced, tying online retailers into additional registration and tax requirements. This was a seen as a measure to protect China's fiscal interests and stakeholders such as counterparties, consumers, employees, and others notes Ye.

Also previously, 2018-19 saw a crackdown when the relevant regulator delayed the process of authorizing new video games titles. The emphasis was on regulatory authority. In contrast, the current crackdown on the video gaming industry emphasizes protecting teenagers' interests, to protect their health. Minors cannot play games on weekdays.

Given differences in reasoning, it is important therefore for investors to read government documents correctly to understand the government's stance correctly. This must be the starting point, Ye stresses. At the end of August, Chinese President Xi Jinping made comments suggesting the country had achieved certain results in the area of antitrust, and that there should be a balance ongoing between regulatory and development objectives.[4]

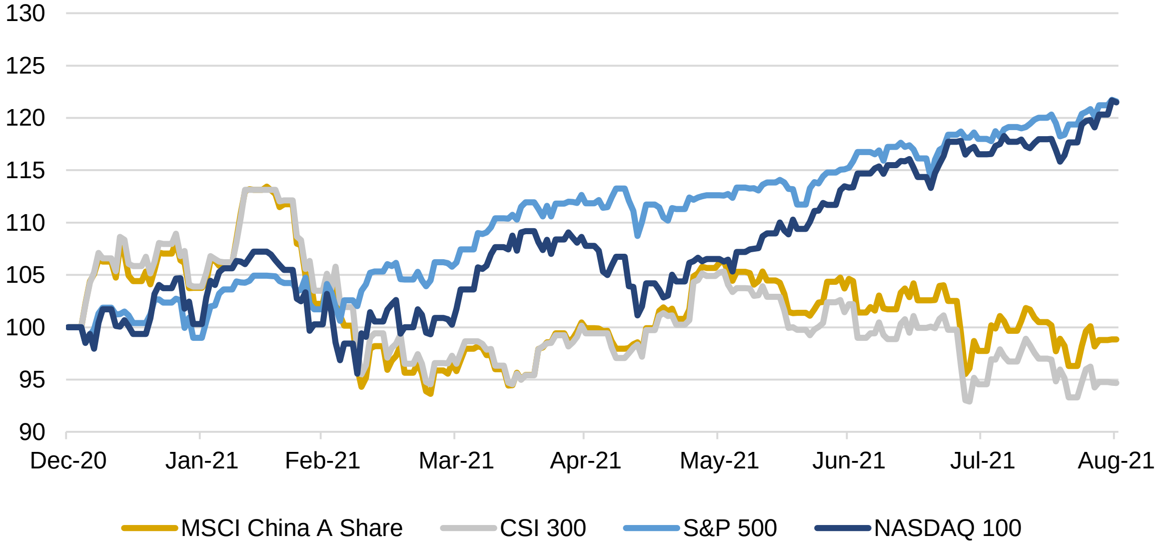
The assessment of such statements is that the country is now closer to a period in which there may be fewer regulatory changes imposed.

"Think back to 2014-early 2015, and the anticorruption period. But by the end of 2016, we had similar comments about things coming to a head."

In 2018, there was a cleanup of shadow banking. Post that period, bank clearing is an area seen as improved.

"So, this type of regulation has clear aims in regards to prosperity," Ye adds.

Policy changes have impacted China equities performance YTD…



Source: Bloomberg as at 31 August 2021. Performance in USD.

Sources
[4] Xinhua (http://www.news.cn/english/2021-08/30/c_1310157993.htm)

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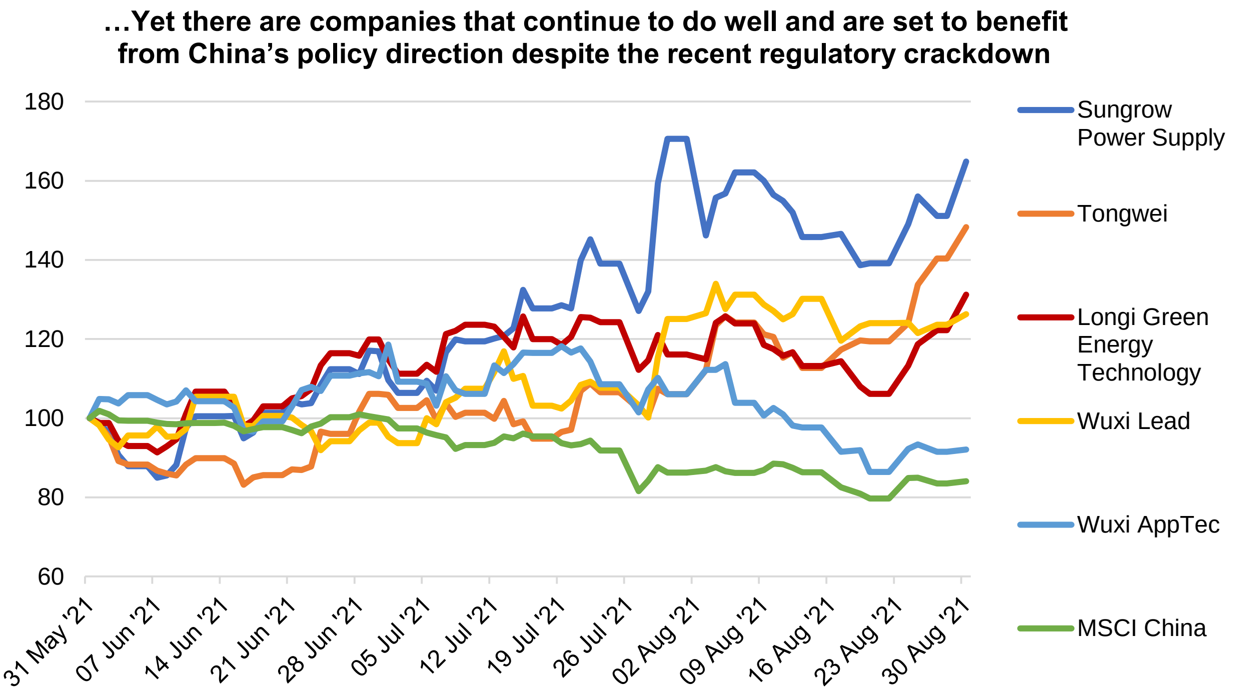

Source: Bloomberg as at 31 August 2021

Supply side focus

Another point to understand is that the crackdowns are very much supply side focused.

Despite some peripheral concerns about government measures dampening the demand side, these are viewed as overblown.The nomenclature being used – common prosperity – itself suggests the government is keen to keep the demand side stimulated, and it has clarified that it does not see this as a zero-sum game; the purpose is to enlarge the middle class, and to ease social anxiety.

Investors should remember that some sectors are immune from this particular round of regulatory changes – regardless of securities selling pressure in the market generally.

And consider what opportunities lie in the blend of antitrust actions combined with changes to e-commerce, where the government intention is more about the behaviour of companies generally rather than picking off individual companies engaged in the platform economy.

Take the case of JD, China's biggest online retailer. Previously, it suffered from restrictive business practices by Alibaba – China's version of Amazon – which limited onboarding of brands. These practices have been targeted by the antitrust push. The result means JD has been able to add new brands for its customers, such as Prada, Este Lauder and Clinic. This is accelerating JD's user base, which is estimated to have jumped from around 13 million to 90 million onboarding per quarter.

Another example is in the area of data security. The Chinese government is looking to a national cloud service facility, which would crowd out private sector suppliers. Investors must thus review the value chain of data security. It means exiting data centre providers whose market has effectively been removed through regulation. However, investors can benefit from increased scrutiny of cybersecurity by increasing exposure to solutions providers in that space.

The market is also missing out on other signals. Securities prices, and P/E multiples, suggest a downbeat mood on consumption. But the government focus on prosperity will have a positive impact on the economy over the medium to long term. There is an opportunity to take advantage of price weakness in the consumer services sector, especially relevant to areas where local demand remains high, such as for high end liquor, battery electric vehicles, travel and tourism, and bottled water.

There is a macro picture to China of course (see boxout). Yet the top-down environment described is one that favours active stockpickers, who retain the ability to assess myriad factors at the micro level influencing investment decisions.

The active benefit

Seeking to identify quality growth company investment opportunities in the Chinese equity markets, Sumitomo Mitsui DS Asset Management applies a framework constituting top-down analysis blended with bottom-up stockpicking.

This objective is to maximise total returns by seeking out quality companies, trading at attractive valuations, and which are in sectors with high growth potential benefitting from long-term mega-trends.

Through proprietary research intended to identify market inefficiencies, analysts will look to factors such as strength of balance sheets, levels of return on equity and levels of product or service differentiation versus competitors. However, reflecting the particular nature of investing in China, the research will also look to corporate governance and the extent to which business development is in line with government policy direction – as already noted above, policy changes can have profound impacts on sectors and companies.

The investment process also applies a negative ESG screen, including carbon footprint and Sustainalytics ESG Risk Rating. ESG is an important consideration for risk control.

Investing in Chinese equity does require different knowledge, as pointed out by Toshiyuki Murai, Portfolio Specialist at Sumitomo Mitsui DS Asset Management.

For example, unlike the US, where the large companies are getting larger, in China, large state-owned enterprises (SOEs) tend not to generate shareholder value, particularly for minority shareholders. Thus, it becomes more important to tap into growth in shareholder value, rather than notice the size of companies. In such an environment, active management is even more important.

For Sumitomo Mitsui DS Asset Management, seeking out companies on this basis means committing staff locally. With six investment professionals in Shanghai and 10 in Hong Kong, there is opportunity to pursue meetings with management and assess levels of confidence beyond reading company reports. It also helps to ensure a voice as a minority shareholder.

To conclude, investors prepared to take an active approach to China are able to select individual stocks and sectors that will continue to prosper regardless of the recent crackdowns, and even find winners within sectors most hit by new regulatory demands.

The macro picture

Patrick Pan, Economist at Sumitomo Mitsui DS Asset Management, adds that while it is true there are macroeconomic downside risks from a crackdown on the property sector, and any associated impact on consumption, elsewhere such risks are seen as more temporary. For example, if Covid cases should rise, the expectation is that Beijing has the capability to control and manage the virus threat, as it has done previously. There are recent examples of provinces having eased control measures, resulting in a relatively quick recovery in their services sectors.

The fundamentals of the Chinese economy remain solid. While there may have been some weakness seen in consumers in July and August, it should also be remembered that incomes have gone through a solid recovery since the previous summer. The national unemployment rate is similar to pre-Covid levels. Pent up consumer demand will recover sooner or later, Pan notes.

Meanwhile, the government retains significant headroom for fiscal and monetary policy. The first half of 2021 saw restraint in infrastructure spending, which could be accelerated, for example. China can cut rates if necessary.

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