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CHINA: THE LANDSCAPE HAS CHANGED

Key points

- China's deployment of a growing range of tools across its policy arsenal highlights the sharp pivot that has taken place from the 'To get rich is glorious' era of Deng Xiaoping to the 'Common Prosperity' epoch being pursued in earnest by its current leader, Xi Jinping.
- Starting almost a year ago, policymakers within China began more proactively addressing perceived shortcomings – such as the power of technology platforms, growing income inequality, and the fraying of the Chinese social fabric – that have emerged amidst the nation's rapid development.
- The difficult choices Chinese policymakers have made suggest to us that the investment lens through which global investors evaluate opportunities in China has changed and the strategies deployed towards investing in the Middle Kingdom need to adapt accordingly.
- In the 'To get rich is glorious' era, aligning with Chinese government policy areas proved rewarding as policy was willing to cede monopoly/oligopoly power and profits in exchange for speed in achieving development goals.
- In the 'Common Prosperity' era, we suspect development goals will likely not be sacrificed. Instead, unofficial costs of 'winning' the race to lead key growth segments now come with the prospect of a redistribution of a portion of rents as the industry matures or a sharing of unexpected social costs as they emerge.
- For investors, this suggests that a stock picking approach in earlier stage favoured sectors will be needed to capture returns in the acceleration phase of growth before potential growing social burdens emerge. It also suggests, that growth rates in mature, though still 'favoured' sectors may see profitability come under pressure over time.

Global Investment Committee

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Gradually…then Suddenly: The evolution of the start of the 'Common Prosperity Era'

Many will cite the suspension of the Ant Group IPO in November, 2020 as kicking off the crackdown on China's 'Big Tech' companies and presaging the July, 2021 crackdowns across a wider range of industries.

However, the regulatory foundations for these moves can be traced back to the enacting of China's Anti-Monopoly legislation in 2008 and subsequently, in 2016 China's Cybersecurity Law which focused on not only ensuring network security but also to 'safeguard(ing) cyberspace sovereignty…and the societal public interest'.

Politically, the foundation was laid as early as 2012 when then President Hu Jintao made "Common Prosperity" a fundamental principle of socialism with Chinese characteristics, stressing the need to narrow income gaps and promote rural development to safeguard China's long-term goals.

Admittedly, with aggressive enforcement and political focus only coming many years later, this speaks to the gradual and then, more sudden approach often taken by Chinese policymakers as the balance between developmental goals and wider social costs tips unfavourably.

A Timeline: Building up to the 'Common Prosperity Era'

Year	Month	Type	Detail
2008	August	Anti-Trust	Anti-Monopoly Law implemented
2012	November	Political	Common Prosperity' made a political objective
2016	November	Data Security	Cybersecurity Law enacted
2018	October	Social	First Online Gaming curbs announced
2020	June	Social	Livestreaming companies censured
	November	Anti-Trust	Internet Anti-Monopoly rules announced
	November	Fin'l Stability	Ant Group IPO Suspended
	December	Anti-Trust	Anti-Trust probe of Alibaba begins
2021	February	Anti-Trust	Exclusivity restrictions announced on internet platforms
	March	Social	Tutoring regulations proposed
	March	Social	China warns again 'disorderly expansion of capital'
	April	Data Security	Data regulations on vehicles announced
	April	Social	Online education limits announced
	May	Social	Tuition limits on online education announced
	June	Data Security	Data Security Law enacted
	July	Social	Local minimum wages ordered for delivery cos.
	July	Social	Ban on for profit tutoring

Sources: SupChina.com, Bloomberg Financial L.P. and UBP

Indeed, while the initiatives by China's policymakers have been characterised as a move to regulate 'Big Tech' companies, Carlos Casanova, UBP's Senior Economist in Asia rightly highlights that the actions span multiple dimensions and objectives (please see Asia Macro: How to Think about tighter regulation, August 2021).

The high profile actions against online giant, Alibaba, while originally framed as a personality conflict between Alibaba founder Jack Ma and Chinese President Xi Jinping, can more properly be framed as, at least initially a financial stability issue in light of the rapid growth of Alibaba's consumer lending subsidiary, Ant Group.

As seen in other economies, rapid change in the financial sector has the potential to create financial system instability, a challenge which China has frequently grappled with in its own history. Such moves – trading rapid development in key sectors against a shifting risk of future financial system instability – has been a delicate balancing act by Chinese policymakers going back to the 1980s.

However, what now appears clear is that the reaction function of Chinese authorities has shifted from this narrow, linear trade-off.

Instead, it now appears that a recognition has emerged that the developmental benefits of the rapid growth of platform companies within China have now crossed a threshold in terms of social and potentially long-term economic cost that requires more active intervention in the near term and a different regulatory foundation in the medium term.

While anti-monopoly efforts have been an accelerating tool of enforcement, more recently, data security restrictions are coming into focus. Just as anti-monopoly efforts began gradually before 'suddenly' accelerating, similar moves on the data security front should no longer be a surprise moving forward. Indeed, tighter data security measures may not only serve as consumer protection as well as having national security purposes, but they may also serve to limit foreign players by constraining their ability to leverage offshore economies of scale in the domestic Chinese market and allow emerging domestic players to continue to develop and thrive.

Beyond this, it is also apparent that the measures taken to date are increasingly being pursued not only with the consumer in mind, as seen in the online education sector. More recently, moves to ensure minimum wage compliance in the delivery platform realm speak to the wider social costs that burgeoning platforms are imposing on the overall economy and the new regulatory backdrop to distribute these costs more equitably.

The shift towards a not-for-profit online education sector from the burgeoning for-profit segment highlights that these social burdens may increasingly be borne by corporates themselves in the near term until they or perhaps upstart competitors are able to adapt their business models to take into account these increasingly important, non-cash costs.

So, while the original reaction function of trading off future growth and development objectives against the prospect of future financial system instability will remain in place, costs including social welfare and income inequality look set to become a greater part of the policy discussion as the regulatory landscape continues to shift looking forward.

The China Investment Approach: Looking Back…

With the wider regulatory toolkit available to Chinese policymakers combined with this evolving reaction function, the approach that has been successful for investors seeking to participate in China's growth trajectory in recent decades is likely to be changing as well.

A successful approach to investing in China since its opening up to the world in the late-1980s has been one that aligned investors with broader Chinese policy priorities outlined in China's periodic Five-Year Plans.

Indeed, detailed declarations from China's Communist Party have helped investors navigate China's transformation from a developing export powerhouse in the late-1980s and early-1990s to its infrastructure focus through the turn of the century.

With the 21st century seeing a pivot of priorities towards services, consumption and higher value-added sectors, investors were rewarded for shifting allocations as legacy priorities lagged these new, favoured segments that would bring the Chinese economy forward.

That backdrop enabled investors to stand alongside policymakers to capitalise upon growth amongst, in many cases, chosen local champions until developmental policy objectives were achieved often leading to waning growth momentum in those segments.

Less well understood is that one of the key costs of this development approach was a fragile banking system and an over-reliance on real estate in the local economy. As a result, as development in targeted areas accelerated too rapidly, threats to overall financial system stability grew resulting in China's regular intervention into the banking system and property markets.

Despite this, this targeted high growth strategy has enabled Chinese equities to outpace their US counterparts since the turn of the century – even taking into account the moribund Chinese returns seen over the past decade as well as the dramatic weakness seen year-to-date.

The China Investment Approach: …Looking Ahead

Having benefitted from spectacular growth, policymakers now appear to acknowledge the associated social costs which have apparently reached a tipping point for China as a whole.

These externalities – from environmental costs to social inequality and in some cases, questionable governance – have been viewed in the past as acceptable costs in pursuit of development targets outlined in its Five-Year Plans.

Looking ahead, however, the 'Common Prosperity Era' pursues a new industrial/social framework that appears to seek to redistribute these costs more broadly. Indeed, as recent announcements indicate, it appears that the corporate sector and the wealthy – who have benefitted from the previous development framework – will increasingly bear a greater share of mitigating the public costs created in many cases by the exercise of market power encouraged by the previous development strategy.

As seen in the case of delivery services, those paying low wages to delivery drivers are now being 'encouraged' to meet minimum wage standards and provide basic health insurance coverage, forcing either a pass through of increased costs – or as seen in the online education segment, the restraint of pricing power to keep prices to customers under control.

In addition, we have seen anecdotal reports of large companies and their founders "voluntarily" making substantial charitable pledges in support of social causes.

While such pledges are not uncommon among Western companies, the scale of the commitments made in recent weeks pales in comparison. Tencent Holdings committed CNY100 billion (US$16 billion) to clean energy, education, and efforts to revitalise villages. The amount totals close to 60% of 2020 net profit and 40% of end-2020 balance sheet cash though a more modest 2.6% of current market capitalisation.

With the potential for rising wage costs, more constrained pricing power, as well as an increased corporate social burden, the prospect that the persistent margin pressure Chinese corporates have experienced since the turn of the century might accelerate looms on the horizon.

Multi-decade margin pressure may rise for Chinese corporates looking ahead

Sources: MSCI, Bloomberg Financial L.P. and UBP

With corporate leverage near historic highs (which has offset the impact of margin compression on corporate returns in recent years), investors may need to rely on more efficient asset utilisation trends in high growth segments that remain under the gaze of China's increasingly aggressive regulators to drive corporate returns looking ahead.

Put another way, in the past, investors could identify opportunities by targeting industry leaders in favoured segments and capitalise upon the policy induced growth phase of the sector to secure attractive returns.

Looking ahead, investors risk that as the growth phase matures, a growing burden of social costs may emerge and undermine longer-term returns.

Recognising this constraint on its overall growth objectives, it appears that China will pursue a new industrial-social model that will increasingly rely on the emergence of small, innovative firms that work in parallel with larger, regulated firms and platforms in segments deemed socially sensitive or strategically important, somewhat akin to the Singapore's listed Government Linked Corporations (GLCs).

In addition, China will likely require ongoing restructuring and reform to mitigate its historical over-reliance on real estate investment and its financial system will need to pivot away from a reliance on property and legacy State-Owned Enterprise lending and in favour of supporting the development of small and medium-sized firms both via lending and non-lending activities. This will be challenging to achieve in the short term in the absence of interest rate reform and a commitment to removing implicit guarantees.

As a result, recognising the turbulence that ongoing restructuring and reform might bring to equities and credit in both the banking system and real estate segment, two approaches may be helpful in addressing this changing landscape.

First, investors can seek to invest at an earlier stage of the growth cycle (admittedly in segments still aligned with the broader developmental framework outlined in the 14th Five-Year Plan). Though a riskier approach as industry leadership may not yet be crystallised and may require a longer investment time horizon, such an approach may allow investors to capture the acceleration phase of the a sector's growth cycle more fully before potential social costs emerge.

In addition, investors will need to look increasingly to management and business models which are able to extract shareholder value, less from the prospect of exercising pricing power or leveraging industry dominance, but instead by delivering efficient asset utilisation to deliver strong returns to shareholders as well as broader constituents alike.

Investors to turn to stock selection and incorporate A-share opportunities into their China allocations

For investors, the uncertainty surrounding this shifting regulatory backdrop has left the broader MSCI China Index still only pricing more of a modest cyclical slowdown in the overall growth trajectory of large Chinese corporates rather than a structural change in the profitability prospects looking forward medium term.

In contrast, Alibaba, the e-commerce giant against whom regulatory actions visibly kicked off the transition to the Common Prosperity Era has seen its valuations fall below the 20x earnings level for the first time in its history suggesting that markets are pricing a more sustained change in its profitability or growth prospects looking ahead.

This highlights our contention that stock selection will grow in importance relative to theme or sector selection looking longer-term. Cyclical opportunities will undoubtedly continue to present themselves, but the growing importance of the management component in driving returns to meet not only shareholder obligations but also responsibilities to employees and communities as well should become an increasingly important distinguishing characteristic.

As a result, passive investors in China should instead look to active solutions to adapt to this new landscape, especially for those focused on Hong Kong-listed H-share and international indices which are dominated by large and increasingly mature players which may bear the brunt of the costs of transition to this new framework.

Moreover, a focus on companies and sectors at an earlier stage of the growth cycle may make domestically-listed A-share opportunities a more fertile hunting ground for investors looking ahead. So, to exploit these earlier stage opportunities fully, investors in the China space will likely need to incorporate a greater blend of both domestically-listed A-share as well as more accessible, HK or globally listed opportunities within their China allocations.

Looking at sectors, seven strategic technological areas identified in China's 14th Five-Year plan may provide such early-stage opportunities for investors including:

1. artificial intelligence;
2. quantum computing;
3. integrated circuits and semiconductors;
4. neuroscience;
5. genomics and biotechnology;
6. clinical medicine and health; and
7. deep space, earth, sea and polar exploration.

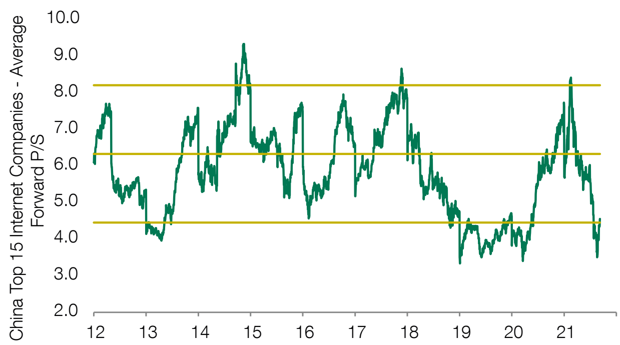
The early stage of development in these technologies and the likelihood of state participation reinforce our view that stock selection will become increasingly important.

For investors seeking a shorter investment horizon, the focus on restricting monopolies and promoting social fairness could benefit second-tier players in still-fast growing sectors like e-commerce and streaming entertainment.

Opportunities may continue to exist in earlier stage internet companies that have long growth runways, such as those targeting younger generation users (>18) or latched on to structural trends like video-based consumption. While regulations will likely result in slower growth and lower margins for market leaders, positive demographic tailwinds may continue to drive those with strong barriers to entry.

Indeed, with the broader internet space trading at cyclically low price-to-sales ratios, earlier stage names may be in a position to avoid more sustained compression in profitability than more established market leaders in more mature segments.

Valuations are becoming attractive for earlier stage Chinese internet companies with long growth runways



Sources: Bloomberg Financial L.P. and UBP

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