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China's evolving regulatory and policy landscape

After the selloff, what next for China equities?

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A spate of regulatory actions across several sectors in China reached a recent crescendo that rattled markets and sent shares tumbling. But some of this selling appears overdone, creating opportunities for investors where long-term growth remains intact and policy impact is neutral – or positive.

Key points

- The recent regulation aims to foster sustainable growth of companies and lower social inequalities.
- Despite policy headwinds in some sectors, China is still on track for decent GDP growth over the next decade, while its middle class should continue to grow and see its purchasing power increase as income gaps are narrowed.
- For long-term value investors, the selloff created good opportunities, especially among companies whose growth trajectories remain intact.
- Areas more aligned with the government's long-term goals include green energy, semiconductors, new infrastructure, electric vehicle supply chains and high-end manufacturing.
- As for sectors facing greater regulatory scrutiny, we tend to look at them from bottom-up, focussing on companies that have more sustainable business models or stronger pricing power.
- FF China Consumer Fund: The long-term objectives of these policies will have positive implications in the form of long term - and more sustainable- catalysts that will support consumption across China

Shares in many Chinese companies sold off sharply in recent sessions, after the publication of harsher-than-expected regulations targeting education companies fuelled fears of deeper policy uncertainties across China's corporate space.

At first glance, the market's shiver is understandable given the severity of regulatory measures that threaten to effectively bring a halt to private tutoring services as a for-profit sector. This came after a year in which Chinese regulators have taken assertive action on data privacy, cyber security, and antimonopoly concerns, among other areas. For some investors, the actions against the tutoring sector raised fears of a worst-case scenario involving a suffocating regulatory clampdown across a broad swath of industries in China. But we think some of these concerns are being overstated, and perspective is needed.

Regulatory intervention in China is nothing new. What is different this time is how specifically the economics of one particular sector were targeted – that of private after-school tutoring for primary and middle school students in core curriculum subjects. The measures came as a surprise but the issues they seek to address are a well-telegraphed national concern in China: how to reduce the financial burdens of parenting to help boost the country's declining birth rate. Education has become widely known in China as one of the "three big mountains" (alongside housing and healthcare) whose spiraling costs in recent years have been a burden for new parents. As such, education, property and healthcare stocks have borne the brunt of recent selloffs.

So too have technology stocks, but we see this as a somewhat separate issue. China's biggest and most dynamic tech and internet companies have come under regulatory scrutiny where their new and fast-evolving business models may have seen them gain huge economic influence amid a regulatory framework that was necessarily evolving in tandem with the industry.

This isn't just the case in China but globally, as shown by recent regulatory action against major tech and internet companies in the US and Europe, for example.

Opportunities emerge

For long-term value investors, the sometimes-indiscriminate selloff in recent days created good opportunities to look for bargains, especially among companies whose growth trajectories remain intact. We believe the overarching aim of recent regulation is to foster sustainable growth and boost social equality. Despite policy headwinds in some sectors, China is still on track for decent GDP growth over the next decade, while its middle class should continue to grow and see its purchasing power increase as income gaps are narrowed.

Interview with Paras Anand -CIO Asia Pacífic- and Victoria Mio -Director for Asian equities-

Q: Is the education sector now uninvestable?

A: The economics of certain parts of China's private education sector have been reset. For example, policymakers now mandate that some areas of tutoring services be not-for-profit. On the other hand, we see dislocation in equity prices, with some education companies trading below their net cash levels. There is no blanket ban on education services and some of these companies are seeking to adapt by changing their business models.

Q: The market has taken the education policy news and extrapolated potential implications to other 'new economy' sectors. Is this a fair assessment?

A: Is this an isolated case for education or a coordinated effort to flatten the playing field across the corporate space? What is clear to us is that improving people's livelihoods and wellbeing is the primary goal. China is seeking to reengineer its economic and social policies to achieve more sustainable growth. The "three big mountains" of education, housing and healthcare have been adding to the financial burdens on families and exacerbating social divides. We've seen increased scrutiny in the internet space, but we think this action is not related to the drive to improve people's living standards that we've seen in education. On the contrary, the internet sector is a provider of social good, for example facilitating commerce throughout the pandemic and broadening financial inclusion through innovation.

Q: What about regulatory action on VIEs, or variable interest entities. Do you see this as likely, or have you any scenario analysis on the potential impact that this could have? Balanced exposure.

A: VIE structures have existed for some two decades in China. We haven't seen anything to suggest a fundamental shift in the status quo has taken place here. Over the years, these structures have facilitated a huge amount of investment and development in some of the Chinese economy's most dynamic sectors. The structure doesn't just apply to foreign listings; the first Chinese Depositary Receipt employing a VIE structure was successfully listed on the Shanghai STAR board last year. Chinese companies with VIE structures have also sought primary or secondary listings in Hong Kong.

Q: Who will win and who will lose as result of recent regulatory measures?

A: In broad terms, China is seeking to achieve more balanced long-term growth and lower social inequalities. Higher quality growth will only offer better investment opportunities. Areas more aligned with the government's long-term goals include green energy, semiconductors, new infrastructure, electric vehicle supply chains and high-end manufacturing. As for sectors facing greater regulatory scrutiny, we tend to look at them from bottom up, focussing on companies that have more sustainable business models or stronger pricing power. The express delivery sector, for example, has leeway to maintain or even raise prices, so as to pay workers reasonable wages. Greater regulations can be a long-term positive in many cases, and we need to look at specific sector dynamics to identify winners and losers.

Q: The property sector is a big part of the Asia and China fixed income space. What are fixed income markets telling us about the impact here?

A: In our view, it's unlikely that China will further tighten property curbs; many stringent measures have already been implemented and additional ones might impact on financial stability. However, the recovery of the sector may be protracted and trading in property bonds may be volatile. For example, the negative reverberations from Evergrande's well publicised recent issues, as well as defaults of smaller players like China Fortune Land, has spread to some other firms in the sector, leading to weaker pricing. Overall, we still see improving fundamentals in the sector, where large players are progressing with their deleveraging plans. A consolidation trend will likely continue in the sector, with small players finding it increasingly hard to grow.

Comments from FF China Consumer Fund portfolio manager, Hyomi Jie

The risk premium for regulatory-exposed sectors will need to move up, so I have been factoring this in across all holdings. With such an increase in risk premium, I'm also currently reviewing various stock opportunities, which have been sold off indiscriminately, as I believe that the fundamental drivers of the China consumption theme remain intact.

Furthermore, if we consider the longer aim of these policies, such as population growth and a more level playing field in regards to competition, this will also have implications as beneficiaries evolve – for example the creation of new businesses, the transition of outbound shopping towards the onshore market and the creation of emerging local brands. Consequently, these are long-term and more sustainable drivers that will support consumption across China.

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