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## China Update – The Implications of Xi’s Power Consolidation

Over the past 15 years, Gresham clients have enjoyed tremendous success with our Chinese investment program, particularly in venture capital. Our general investment thesis over this period rested on a recognition that China’s GDP per capita was reaching an inflection point that was likely to foster a rapid acceleration of consumer wealth creation and spending that would transform their industrial-centric economy to a more balanced, consumer-oriented one. This would necessitate the creation of new businesses and entirely new industries whose addressable market dwarfed that of the U.S. and Western markets combined and whose potential enterprise value was extraordinary. This thesis largely progressed as expected and many would argue that we are still in the early to middle stages of this transition.

Recently, however, the balance of risk and reward has shifted. Western headlines are appropriately focused on increasing political and geopolitical risks and heavy-handed and poorly enacted capital market reforms. The most recent confirmation of this was China’s recently concluded 20th National Party Congress. A few key takeaways include:

- President Xi achieved an unprecedented consolidation of power with his re-election to a third term. While expected, his re-election violates existing policies related to term (2) and age limits (68).
- The powerful seven-member Politburo Standing Committee is now composed entirely of Xi loyalists who possess ideological strength but have limited technical or market expertise.
- As a result of this evolution in the power structure, the balance of so-called “common prosperity” over capital market efficiency and effectiveness is likely to tilt further toward the former while risks of awkwardly introduced regulation and associated consequences have increased.

Some in our China network have recently cited the policy continuity inferred by these events as a positive and in the short run it might be. However, our view must focus on the long-term risks to the foundation of our investment thesis, including advancement of middle-class consumption and capital formation, ongoing market reforms, and the continuation of China’s

integration into the global financial system. To suggest that recent events do anything other than elevate the risks to future investments would be naïve.

## **Increasing Risks**

To better understand Chinese investment risks, it helps to organize around political, geopolitical, and economic uncertainty.

Political Uncertainty: The largest shift in China's risk landscape over the last few years is political. Xi's policies have become increasingly controlling and anti-free market in pursuit of a utopian common prosperity. These policy reforms, while seemingly well intentioned, create worry for Western investors, as the so-called "Chinese path to modernization" is developing in a different direction than the familiar Western systems. The ultimate destination may prove more beneficial for their society, but the outcome is uncertain, and the recent path has been riddled with poor implementation. Investor confidence has been shaken and skepticism abounds on the question of China's commitment to ongoing free market initiatives and global capital market integration.

New policies will continue to clarify the direction, but it will take time. In the near future, we will monitor their zero-Covid policy exit strategy (if any), fiscal stimulus and policy support for their slowing economy and the potential introduction of property and capital gains taxes. Additionally, we can surmise that certain business models, such as large e-commerce platforms that abuse consumer data and for-profit education companies that foster income and achievement disparities, will be less tolerated. All of these factors have already created implications for our investment approach.

Geopolitical Risk: While it is impossible to effectively build a portfolio to protect against global conflict while collecting any measure of acceptable long-term return, it is still worth considering this risk. The failure of the Russian incursion into Ukraine demonstrates the difficulty of physical invasion of a moderately well-supported defender in the modern era. China has been viewed as a semi-silent ally of Russia in this conflict, which appears to be changing China's relationship with the rest of the world and widening existing rifts has also raised concern about activity in the Taiwan Strait. This is in stark contrast to the past few decades during which China's economic miracle was highly reliant on mutually beneficial trading relationships around the world. These growing fractures are consistent with our current view that the world is slowly migrating toward bipolar (China-centric and U.S.-centric) or even tripolar (India-centric) economic and political spheres of influence. The fractious Cold War period, while under completely different circumstances, may provide some parallels to navigating these risks. From an investment perspective, trade, and export-based investment strategies, while never a focus for Gresham, are increasingly difficult to support.

One challenge in evaluating the above risks is that they tend to be exaggerated by Western media in their effort to manufacture villains and controversy to keep ratings high. This doesn't mean there isn't truth in these concerns, but it means we must seek balanced sources of information, importantly including managers on the ground in China. Our network, which has been developed over the last 15 years, is particularly helpful in evaluating these risks. We even traveled to China amid the Covid lockdown and quarantine policy to get first-hand, honest views from local managers. However, no matter the amount or quality of information we gather, clarity will be difficult to achieve. Instead, we must use informed judgment to evaluate whether we are being appropriately compensated for taking these now-elevated risks.

**Chart 1. China's Property Sector Deceleration**

Property sector deceleration is the worst in a decade

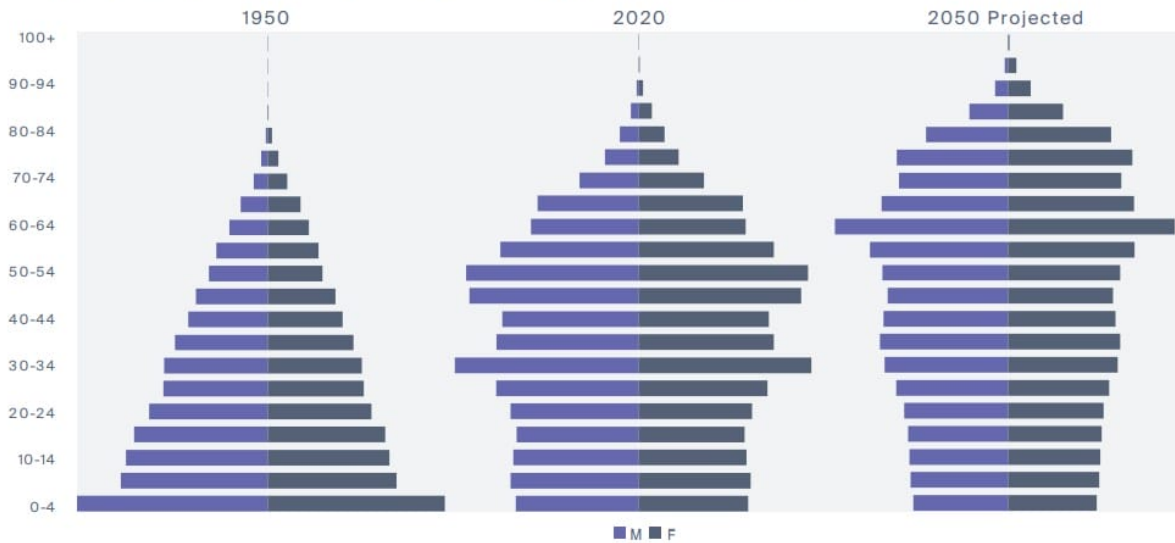


Source: Wind Financial, National Bureau of Statistics of China. As of August 2022

**Domestic Economy:** Political and geopolitical risks are increasing while China's domestic economy is facing numerous headwinds. As shown in Chart 1 on the previous page, the property sector, one of the primary growth engines over the last few decades, is in its worst slump in a decade. New construction has dropped by 45% after the government tightened financing and instituted Covid lockdowns. Additionally, these cyclical headwinds arrive alongside a well-anticipated demographic shift toward an aging population, as shown in Chart 2 on the previous page, that will dramatically shift the ratio of working to non-working citizens. We expect these structural shifts to cap economic growth potential and force resources toward healthcare and retirement support costs.

**Chart 2. China's Population Pyramid**

China's working-age population has already peaked, and aging demographic trend will last for the next few decades



Source: PopulationPyramid.net

## Current Valuations

It appears that much of these risks have been embedded into capital market prices, as the MSCI China index has already declined nearly 60% since February 2021, more than double the decline seen in the U.S. market. As a result, and as shown in Chart 3, the forward price-to-earnings ratio of Chinese equities is approaching 8x, a level roughly half of the S&P 500. Additionally, the price-to-book ratio of Chinese stocks has reached 0.6x, a level not seen in over two decades. The lack of investor support, particularly from Western investors, is notable.

Similarly, fundraising and investment deployment in private markets have both slowed significantly. As shown in Chart 4 on the next page, China VC funds raised \$8.9 billion in the first half of 2022, and when annualized, this total represents a significant year-over-year decline and a much lower level when compared to the past few years. At the same time, the number of new fund launches has seen a similar decline especially when compared to the annual totals since 2015. Second quarter deal activity and volume reached multi-year lows where the decline was particularly acute in larger, later stage investments.

**Chart 3. Forward Price/Earnings daily rate**

The "China discount" in stock valuation



Source: FactSet

## Investment Implications

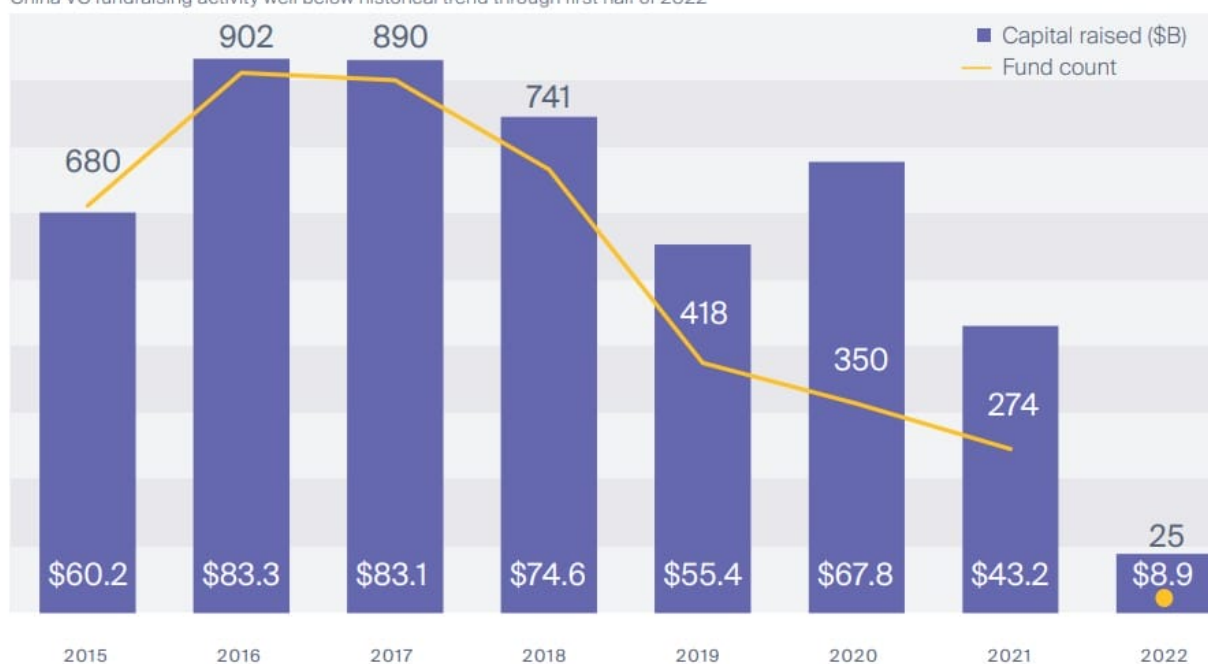
For contrarian investors like Gresham, these types of market declines and fundraising vacuums would typically create a compelling entry point. However, we believe it is telling that we have done very little capital allocation or rebalancing. Western investors' view of China has become so dire that we are increasingly hearing the question, "Is China investable?" We think this question misses the point. We believe there is no such thing as a good or bad (or even an uninvestable) asset, but rather every investment possesses a balance of risks, entry prices and the range of possible outcome that will determine success. For example, few investments would be deemed unsuccessful if investors could enter cost free. Our research suggests future investments in China are no exception and our ongoing evaluation involves balancing increasing risks with wider possible outcomes which, by our metrics, have been somewhat offset by lower entry prices.

It is critical to recognize that China has become increasingly difficult to evaluate and this level of uncertainty deserves recognition. We continue to believe in the long-term upside case for China that is driven by structural growth and increased spending power of middle-class consumers. While the long-term structural growth opportunities may be more clouded than a decade ago due to aging demographics and deglobalization, the Chinese government's investment plan to evolve mobile e-commerce, enterprise digitization, healthcare modernization, hard technology evolution, and independent supply chain development and renewable energy, among many others, may provide some additional support. It is the near-term downside case and the wider dispersion of outcomes that has tilted the risk reward profile for us.

In public markets, we have only added marginally to investments with protected downside and have not yet achieved a level of conviction sufficient to rebalance and maintain our investment levels prior to the recent market decline. There is compelling evidence of businesses trading at attractive levels, but the economic uncertainty and political risk require additional clarity. A cheap business can remain cheap or even get cheaper without capital inflows.

**Chart 4. VC Fundraising Activity**

China VC fundraising activity well below historical trend through first half of 2022



Source: PitchBook. As of June 30, 2022

In private markets, we believe recent regulations have underscored the undesirability of building highly visible businesses and those with large founder personalities. We believe a soft ceiling has been placed on the potential size of businesses, particularly those with access to consumer data or those that are in areas that are important to common prosperity such as education and labor welfare. As a result, we continue to look for opportunities to emphasize earlier stage investments where this ceiling will be less impactful and where we still have a runway for outsized returns. However, these types of structural investment portfolio changes often take a full cycle to realize. As we look forward, to the 2023-2024 investment cycle, it is likely that our ratio of China VC to U.S. VC investment will decline somewhat and become more concentrated into a handful of new and existing relationships that may be well suited for the new environment.

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