

05.06.2024

## View From the Ground – An Update on China

*Our team recently returned from one of our regular trips to China and we wanted to provide an update on recent market events and observations from the ground.*

Over the past decade, discussions around investing in China have grown increasingly complex and, at times, contentious, especially since 2021. The investment landscape has been deeply influenced by geopolitical tensions, including the US-China trade disputes, restrictions on Western semiconductors, sanctions targeting specific Chinese corporations, and the potential for conflict in the Taiwan Strait. Moreover, China's dedication to market liberalization seems to have faltered, marked by a government-led regulatory clampdown across vital sectors that include real estate, internet services, and for-profit education. This situation was further aggravated by the stringent Covid lockdown measures. Consequently, the confidence of both international and domestic investors has taken a significant hit, resulting in a pronounced downturn in the Chinese stock market, with a roughly 47% drop from its highest point. Specifically, internet companies have seen a staggering \$2 trillion evaporate from their market valuation since early 2021. Faced with these challenges, numerous investors have chosen to retract their investments which has signaled growing skepticism towards the Chinese market.

For many investors, including our professional peers, investing in China has become a binary decision for those concerned with headline and political risks. It's a reasonable decision to simply avoid China-related investments where practical. However, as investors, we are compelled to avoid such binary characterizations and attempt to understand the challenges and opportunities at a deeper level, leading to a probabilistic view of risk and reward. In this article, we attempt to provide:

- An understanding of why investors' experience in what has become the second largest public equity market in the world has been so disappointing
- Observations from our recent on-the-ground experiences about the current state of China and the Chinese consumer;
- Possible sources of optimism or at least reasons for the market finding its footing;
- A few themes our managers have identified as tailwinds for specific stock price appreciation;
- An update on Gresham's approach to investing in this volatile market.

### **A Retrospective on Chinese Equities**

Throughout the careers of many current investors, China has been seen as a beacon of immense growth potential, often regarded as the world's most promising growth narrative. Indeed, China's economy has soared, becoming the second largest globally, yet the performance of Chinese equities has been underwhelming. Over the past three decades, the

MSCI China Index has yielded a mere 0.5% annually in U.S. dollar terms. Moreover, this period has been characterized by significant volatility, with sharp rallies and severe declines. For investors limited to passive engagement through liquid market indices, the experience has been notably frustrating, embodying the adage that “the economy does not reflect the stock market.”

At first glance, it might appear that China has offered scant investment value. Yet, it’s crucial to recognize that during this time Chinese equity markets have ascended to become the world’s second-largest stock market by capitalization, swelling from under \$1 trillion in 2003 to more than \$14 trillion today. The divergence between index performance and market capitalization growth raises questions. This can be attributed to two main factors. Firstly, the hypercompetitive nature of the Chinese market has led companies to frequently issue equity to support their growth ambitions, which dilutes the value for existing investors and can destroy the value for those who do not prevail in the competitive landscape. Secondly, the historical composition of Chinese equity market indices has leaned heavily towards State-Owned Enterprises (“SOEs”), which prioritize social objectives over the interests of minority shareholders. Consequently, these indices have often represented businesses with subpar management and governance, with little emphasis on shareholder value. It’s therefore unsurprising that passive investment in Chinese indices has been less than fruitful.

Our experience underscores this observation. When we first explored investment opportunities in China nearly two decades ago, it was clear that many companies poised to capitalize on China’s remarkable growth and the rise of the world’s largest middle class were not listed on public markets. Consequently, our attention shifted toward venture capital where these burgeoning enterprises were taking shape. It necessitated patience and a substantial evolution within the capital markets before we started to allocate significant investments into Chinese public markets. Even at that juncture, and consistent with our current approach, our strategy was to pinpoint a select few managers capable of identifying a limited number of specific opportunities.

## **China Today**

Despite the maturation of public markets, investing in China has been challenging recently. Geopolitical tensions and policy errors have deterred foreign investors, while the post-Covid economic rebound has fallen short of expectations. This situation has led to widespread investor frustration and skepticism, casting doubts on China’s commitment to a market-driven economy. Moreover, the anticipation of historically low China GDP growth targets at 5.3%—a reflection of the downturn in the real estate sector and lackluster governmental stimulus measures—has further soured investor sentiment. The government seems reluctant to fire its historical “stimulus cannon,” and its current strategy aims for a shift from short-term, real estate and fixed-asset investment-driven stimulus, to fostering ‘quality growth’ through advancements in high-end manufacturing and the technology supply chain. This pivotal transition, expected to moderate GDP growth rates in the near term, indicates a slow but deliberate move toward sustainable development. This may be positive in the long run,

but it is not helping to bolster current investment sentiment.

This recalibration of China's growth trajectory and its heightened risk profile have resulted in lower market valuation multiples. We approach this situation with more than healthy skepticism. The pertinent question for us is whether the market's pricing accurately reflects the severity of these challenges. Our extensive engagement in the region—comprising four trips in the past year and numerous hours of dialogue with local managers—has provided us with a grounded perspective.

Despite the macroeconomic concerns, the vibrancy of cities like Shenzhen, Shanghai, and Beijing persists, with business activities displaying resilience. Crucially, our managers' portfolio companies stand out for what they believe to be superior business quality and promising growth prospects beyond the subdued general economic forecasts. Further, recent market declines have provided an opportunity to rotate into these companies at very attractive prices.

### **Reasons for Optimism?**

#### *Valuations are Attractive*

In the wake of a significant market downturn, Chinese equity markets are now sitting at historically low valuations. When paired with sell-side analysts' forecasts of 10% to 15% earnings growth for the next year, the Chinese stock market emerges as one of the most appealingly valued and fundamentally robust regions worldwide. Take Alibaba as an example: the internet behemoth is trading at a 5x P/E ratio when you adjust for cash and marketable securities held on its balance sheet. Additionally, the company recently issued a \$1/share cash dividend and ramped up its stock buyback program from \$25 billion to \$40 billion, representing over 20% of its approximately \$180 billion market capitalization. Tencent, in a similar vein, has initiated a \$12.8 billion stock buyback plan alongside a 40% dividend increase.

#### *Is Sentiment Bottoming?*

Based on our discussions with investors, there's a growing sense that sentiment is beginning to stabilize. The last two years have seen accelerated outflows of foreign capital due to lackluster market performance and the issues noted above, but as valuations become more attractive, domestic investment flows have shown signs of revival. Additionally, the increasing divergence in stock performance based on corporate fundamentals suggests that intrinsic business strengths are starting to overshadow broader negative sentiment. Although timing market turning points is notoriously challenging and valuation isn't always a reliable short-term indicator, we believe it often serves as a solid basis for predicting long-term returns for those focused on fundamentals.

#### *Government and Regulatory Support*

Recognizing the somewhat self-inflicted decline in market sentiment, the Chinese government and financial regulators have implemented measures to lend support. This includes easing key interest rates and reserve requirements to boost lending, alongside issuing directives aimed at bolstering equity prices. Actions such as direct equity purchases by the “National Team” and the appointment of a new Chairman for the China Securities Regulatory Commission are designed to offer support to Chinese equities. More crucially, long-term initiatives aimed at SOEs profitability and capital management signal a commitment by the government to stabilize public market performance, offering investors a level of reassurance and the prospect of improved shareholder alignment.

## **Manager Themes**

China is a large and complicated opportunity that tends to be aggregated into a single narrative to suit a particular story, but it’s also a more complex and nuanced story that doesn’t fit neatly into a box. Our focus has always been on capturing the tailwinds of an emerging middle class and their increasing discretionary spending. This will not change. The opportunities within this evolution in Chinese society are always changing and several specific themes emerged from our recent due diligence trips.

### *SOE Reform and an Emphasis on Shareholder Value*

In November 2022, the China Securities Regulatory Commission (CSRC) emphasized the development of a “capital market with Chinese characteristics,” urging SOEs to enhance their focus on capital market performance. This directive has led central SOEs to implement measures such as higher dividend payouts and a focus on key financial metrics , such as net profit, operating profit margin, labor productivity, R&D investment, and asset liability ratios. These initiatives signal a shift towards aligning more closely with minority shareholder interests—a trend that is gaining momentum across Chinese corporates, particularly within SOEs.

Mirroring the strategies of their Western counterparts, numerous Chinese companies are now prioritizing shareholder returns and opting for share buybacks and dividends over domestic project investments. This shift in strategy is especially compelling given the low starting valuations, making the direct return of cash an attractive proposition. Collectively, these moves toward SOE reform and an emphasis on shareholder value mark a significant shift in the operational and strategic ethos of Chinese enterprises, indicating a maturing perspective on capital allocation and shareholder engagement.

### *Refocus on Domestic Consumer Brands*

Emerging from China’s stringent Covid lockdowns, economic growth has moderated, leading

to a marked shift in consumer behavior. The transition from investment in real estate to the pursuit of quality products and services that offer genuine value and positive experiences is becoming more pronounced. This change is particularly evident among the middle class, whose consumption patterns are evolving significantly. While there's a noticeable consumption downgrade, with luxury brands facing various challenges, a pronounced pivot toward domestic brands is underway, often at the expense of leading Western names such as Tesla and Nike. This shift underscores a growing preference for home-grown brands that resonate more closely with local tastes, values, and economic realities. That will allow these leading local consumer companies to emerge in an enviable position within the competitive landscape.

## **Gresham's Approach**

At the heart of our investment due diligence process lies a foundational principle: the value of in-person visits to managers and grounding our assessments in concrete facts and firsthand observations. While we cannot predict the future, our extensive field research strengthens our conviction that future opportunities will arise in the Chinese public markets and the balance of risk and reward have begun shifting. However, we continue to refine our approach to better navigate the increasingly volatile market landscape.

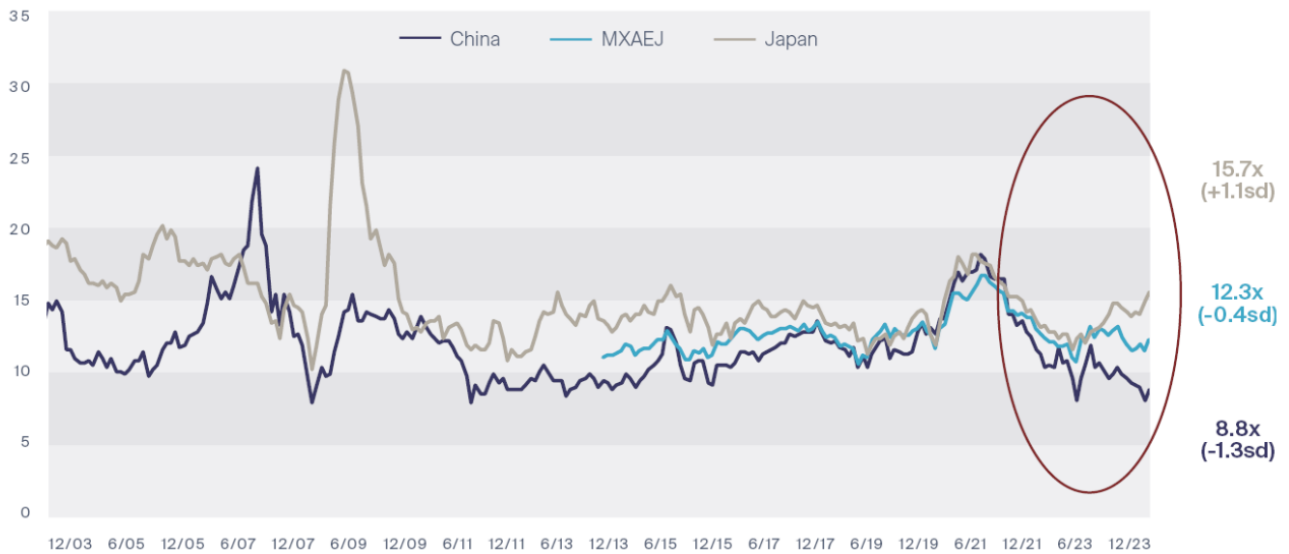
## **Concluding Thoughts**

While we retain a more optimistic long-term outlook for investing in a concentrated portfolio of Chinese equities, we are presently maintaining a similar allocation to global capital market index weightings as we conduct further due diligence. However, within our exposure we have strategically reallocated capital towards Pan-Asia investment mandates that offer the flexibility to invest across the region but may lean into China when our managers find attractive opportunities. This shift aligns with the evolving "China Plus One" supply chain strategy adopted by numerous multinational companies, opening burgeoning investment prospects in Southeast Asia, Japan, and India. While we continue to value the in-depth analysis and extensive networks of country-specific specialists, we're also mindful of the need to mitigate the volatility risks associated with a concentrated focus on any single country, particularly China.

We are also prioritizing managers who possess a versatile toolkit for investing across the capital structure of individual companies and can dynamically adjust their market exposure. This approach increases manager-specific risk, but it also ensures that our exposure in China is targeted rather than reliant on the performance of broad equity benchmarks. We continue to value smaller, more nimble managers capable of uncovering under-the-radar opportunities where market volatility provides attractive entry opportunities.

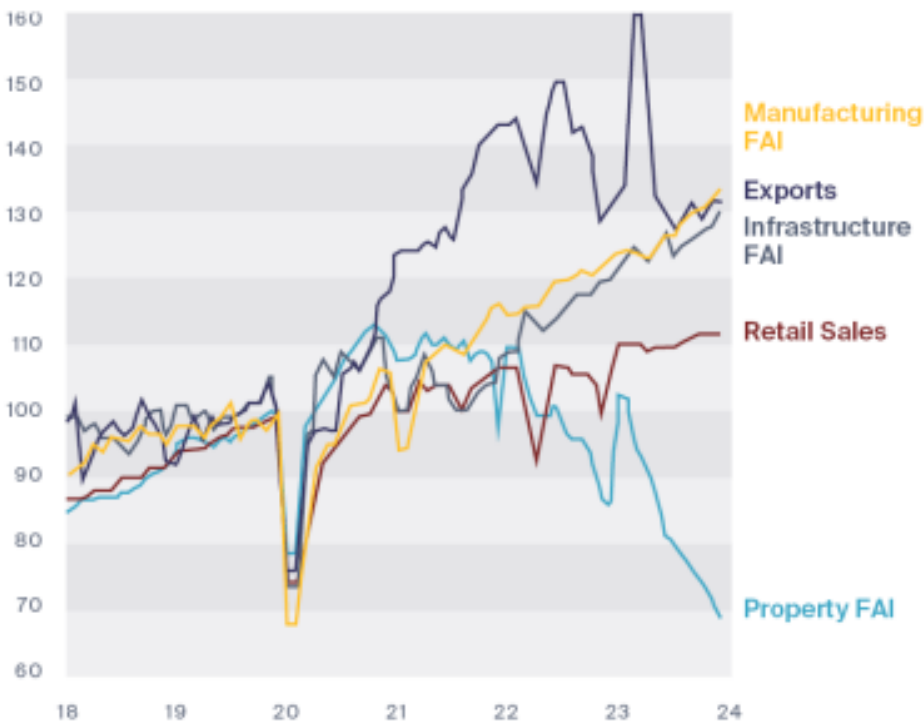
**China equity valuations are near historical trough levels**

12m fP/E (x)



Source: Goldman Sachs  
As of Feb 29, 2024

**Ex property sector, the Chinese economy continues to grow at a moderate pace**



Dec 2019 = 100  
Seasonally adjusted levels  
Source: Marquarie

*The statements made in this article are the opinion of Gresham Partners and were developed from market research and data. Nothing in this article is intended to nor should be implied to be intended as any offer or solicitation for the purchase of securities or investments. No representation or warranty expressed or implied is made as to the accuracy or completeness of the information contained herein. Nothing contained herein should be relied upon as a promise or representation of future performance or as being intended to be investment*

*advice.*

*\*Approximate AUM and client families as of 12/31/23*



Gresham Partners LLC

May 6, 2024

Copyright © 2026 Gresham Partners LLC. All rights reserved.

May not be reproduced or distributed without permission.