An Update on China – August 2021

Key Takeaways

- Emphasis on Local Managers: We have a strong preference to invest with managers who are local to the markets in which they invest as they tend to be more aware of local rules and cultural norms and have better access to information. We have found that these managers are better able to avoid mistakes that foreign investors often make. However, even this local knowledge is not foolproof protection, as we have seen with the recent regulatory changes in the Chinese education sector.

- China's Version of Capitalism: China has embraced certain elements of western-style capitalism, but with an emphasis on greater oversight and control to support broader societal goals including prosperity for all and improved corporate responsibility. Without the proper perspective on the Chinese approach to free markets, western investors can be surprised or confused by market and regulatory dynamics.

- China's Regulatory Posture and Ability to Act: Unlike western democracies, China has the willingness and ability to act quicky to fix problems. Often these abrupt actions surprise investors, and new regulations can have unintended consequences that lead to market volatility.

- Implications Going Forward: Not much has changed. We have always understood the many risks of investing in China and have experienced the consequences of multiple periods of heavy-handed intervention over the last 15 years through our investments in China. We expect the Chinese investing landscape, in both public and private markets, to continue to evolve rapidly, and believe that the Chinese government's guiding principles will remain focused on further opening China's capital markets and becoming an integrated member of the global financial system. However, history has shown that this never happens in a straight line.

Global Investing

Gresham has long held a global view toward investing as an element of maximizing performance and gaining access to a diverse set of return drivers. China has been a significant component of this approach, beginning with our first private investment commitments almost 15 years ago and gradually migrating to the public markets as they have continuously matured.

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- Local Presence: When implementing these non-U.S. investments, we recognize that these jurisdictions have their own rules, both explicit and implicit, making each investment market unique. This is particularly true in emerging markets, including countries such as China, whose rules often seem opaque and difficult to understand to western investors. As a result, we have a strong preference for investing with local talent who better understand these rules and have better information about markets and potential policy changes. This gives them a better chance to avoid mistakes that foreign investors can make. Investing with local managers presents a different type of risk, but one that on balance has proven very successful.

- Volatility Creates Opportunity: The volatility inherent in emerging markets investing is often exacerbated by periodic scares, typically from uninformed or misleading headlines in the western media that cause an overreaction by investors. Embracing this element of investing in these markets is important for remaining invested through periods of significant market decline, so that we and our managers can see through this noise to find opportunities that arise from indiscriminate selling.

China's Regulatory Approach and Market Impact

While embracing the benefits of a free-market economy, China supports a different form of capitalism from the kind typical of western democracies, believing instead that market systems often need more direct guidance and intervention to support broader societal goals.

- Harmonious and Stable Society: The Chinese government's stated goal is to build a harmonious and stable society with progress towards "common prosperity for everyone." Its desire to expand the size of the middle-income group, ensure equitable access to basic public services and minimize the biggest social and financial burdens on Chinese families – primarily housing, education, and healthcare – are often central to their regulatory actions.

- Broader Corporate Responsibilities: China's approach contrasts with the typical western-style free-market goal of simply maximizing profits for companies and their investors. Ironically, at a time when China's actions are often condemned, U.S. interest in broadening corporate responsibility to include social and environmental considerations is increasing.

- Structural Differences in Decision-Making: The Chinese government's structure provides it with what can be an advantage in implementing desired social and economic changes not available to global peers. The Chinese government can implement reforms quickly unlike in a western-style democracy where consensus (or at least a majority) must be built first through rhetoric and cajoling. In China, decisions are often made first, with legislation following as an instrument for execution, a vastly different approach compared to that of the west where laws dictate decision-making.

- Impact of Regulatory Abruptness: One challenge with China's regulatory approach is that changes can be abrupt and significant, often catching investors by surprise, which can lead to indiscriminate selling and market volatility. Further, China's more heavy-handed regulatory approach, while seemingly well-intentioned, can often miss the mark or create unintended consequences.

- Volatility Creates Opportunity: These periods of aggressive intervention typically create opportunities for those investors who can weather the storm and understand regulators' true intentions and therefore the goals of such change. Examples in recent years include:

Company	Sector	Price move (peak to trough)	Months to Recovery	Upside (previous peak to new peak)
Moutai	Spirits	-54%	16	1290%
Hengrui	Biopharma	-40%	8	103%
Netease	Online Gaming	-44%	15	116%
GoerTek	IT Hardware	-62%	8	194%
Yuhua	Higher Education	-58%	14	45%

Source: RisCura Holdings (Pty) Ltd

Bouts of indiscriminate selling typically create pressures on companies beyond the scope of regulation, sometimes leading to stock declines of businesses that are unaffected by the new rules or even those that might benefit from the policies. Once again, having local managers who can properly contextualize and interpret the impact of change has historically proven advantageous in navigating these periods of volatility. We believe the current period is no exception.

Recent Events in China

Our network of local investors provides us with what we believe is often superior information and perspective with far less misinformation than common western sources. This point of view gives us a better foundation on which to make investment decisions. In recent days and weeks, we held numerous discussions with our Chinese and Asian-focused managers to gather their insights and monitor how these managers have performed and re-positioned their portfolios during this volatile period.

Regulation in China historically comes in waves, but current events represent one of the more aggressive periods of regulatory intervention in recent memory. While the western media tend to simplify these various actions under a single meme of Chinese repression, understanding the Chinese government's motivations to "fix" certain problems while unbundling these actions provides insights that help define opportunities. In some cases, the recent changes have caused headwinds for certain sectors (e.g., housing, primary education, finance) and tailwinds for others (e.g., clean energy, healthcare, technology hardware, high-end industrial). The core motivation of these actions remains the same - building a harmonious and stable society with greater self-sufficiency.

As a result of these recent events, Chinese equity markets have fallen victim to indiscriminate selling and large losses. For the month of July, the MSCI China index was down nearly 14% and the local A-Share equity markets were down close to 12%. Like we have seen in the past, most western investors have chosen to sell first and ask questions later.

Big Technology Regulation

The dominant position of many of China's leading technology companies, including Alibaba, Tencent and Meituan, has given rise to concerns around consumer data security, privacy issues and monopolistic behavior. Interestingly, these are the same concerns shared by the U.S. government and its citizens regarding U.S. technology giants such as Google, Facebook and Amazon. While the rhetoric and regulatory actions build slowly in the west, China can act more quickly. This is not the first time China has intervened in this manner.

- In the summer of 2018, Chinese regulators restricted online gaming, causing Tencent's stock to fall ~50% from its peak. The government eventually softened the restrictions with guidance on future business practices. The stock not only recovered but tripled from its trough - until getting hit again from the recent anti-trust scrutiny.
- In November 2020, Ant Financial, the fintech affiliate of Alibaba and one of the two dominant fintech platforms in China, was poised to raise around $35 billion in the world's largest-ever IPO with implied valuation of around $310 billion. The Chinese government abruptly intervened weeks before shares were set to trade in Shanghai and Hong Kong, and the IPO was subsequently halted.
- In July 2021, the app for Didi Chuxing (DIDI), a Chinese ride-hailing giant similar to Uber, was removed from mobile app stores by the Cyber Administration of China because of the company's handling of customer data. While this concern was voiced by the Chinese government before Didi's planned IPO, the company incredibly decided to move forward anyway, and the restrictions ensued. The stock has fallen nearly 40% since its IPO.

U.S.-China Tension and Secured Supply Chains

Over the last few years, tensions between the U.S. and China have risen sharply. The Chinese government continues to reaffirm its commitment toward open markets and integration into the global financial system. However, given recent frictions with the U.S., China is also now determined to reduce its dependence on U.S. and other western nations. In its 14th Five-Year plan (2021-2025) and its Vision 2035 blueprint, China revealed several policy priorities that clarify its goal of increasing self-sufficiency.

- China's Dual Circulation Policy: This policy is intended to expand domestic demand in order to supplement international export demand and seek a hedge against the threat of tariffs and sanctions. China has already become one of the world's largest retail markets, with sales similar to U.S. at approximately $5 trillion. Further supporting China's domestic demand will reduce their economic reliance on exported goods.
- Technological Self-Sufficiency: Instead of just being the largest manufacturer in the world, China wants to migrate upward into advanced manufacturing of high-end and specialized components and is making aggressive investments in R&D in frontier areas like artificial intelligence, quantum computing, integrated circuits, and aerospace technology to achieve its goals. For example, China currently consumes 50-70% of the global semiconductor supply, yet its ability to produce high-end chips is limited, creating weak links in their technology supply chain. However, catching up on high-end semiconductors without U.S.-backed technology is going to take China many years.
- Lessons from Huawei: This vulnerability in semiconductors was exposed when Huawei was cut off from third-party supply by the Trump administration in 2019. At that time, Huawei was the top 5G smartphone brand and the second largest smartphone manufacturer with global market share of 17%, second only to Samsung's 22% and higher than Apple's 11%. As a result of the ban, and in order to keep the business alive, Huawei had to sell its budget handset brand, Honor, and it has been rumored that they may spin-off the company's premium P and Mate brands as well. According to IDC data, Huawei fell out of the Top 5 in global smartphone shipments in Q1 2021.

Societal Considerations

Perhaps the most aggressive of the recent actions relates to the after-school tutoring sector ("AST") which caters to children aged 6-15 in preparation for exams, the most important of which is the college entrance exam. The new restrictions are designed to limit the growing pressure on parents to invest heavily in AST and the hours spent coaching their children just to keep pace with peers. Chinese families, especially many lower- and middle-income families, consider these academic exams an important tool to improve their children's

standing on the social ladder. The government's new restrictions on AST providers prohibit these activities on weekends and school holidays while also forcing these education providers to cut ties with capital markets by becoming not-for-profits.

This change represents a societal decision for China, not a business one. Alleviating the academic competition not only frees up household income for other uses but also provides parents with greater confidence to grow their families, a key government objective since birth rates are on the decline.

The most unsettling aspect of this change for investors is the forced transition to not-for-profit status and the disassociation from capital markets, but we think it reflects the government's determination to limit speculation and backdoor attempts to work around the new policies. Unfortunately, the net result is an effective destruction of the equity value of all these companies that created significant losses in related sectors.

Long-Term Implications

We believe these recent policy actions are consistent with China's longer-term goals and past regulatory actions, but some practical implications are becoming clearer through these events.

Continued Desire for Open Markets and Global Integration

We continue to believe China's stated goal of opening its capital markets and integrating into the global financial system remains in place. As with many examples in the past, China's two-steps-forward, one-step back actions, while intended to be fixes for certain problems, often cause unintended consequences. In support of this view, it appears China did not expect the recent severe market reaction that ensued. To soothe investors' concerns, the China Securities Regulatory Commission's vice chairman Fang Xinghai held a private meeting with major global investment bankers to calm the sentiment shortly after the new restrictions were put in place.

In this call, he emphasized several points:

- Changes to the education industry are a targeted and isolated case that investors should not misinterpret or extrapolate.
- In the future, official policies would be rolled out more steadily to avoid sharp volatility in the markets.
- The crackdown was not aimed at decoupling Sino-U.S. financial markets. Instead, their goal is to ensure long-term sustainable and stable growth in these sectors rather than to squeeze foreign investors or privately-owned businesses.

Historically, when we invest in non-U.S. countries, we attempt to stay away from sectors that the local government deems important. For countries like Russia this includes oil and gas and for China this includes housing and education. We remain mindful of this rule as we invest, but it alone does not always protect us. The surprising action in this case was the retroactive determination that a business model that was detrimental to society after accommodating the growth of that industry for so long.

Profits are Fine; Abusive Monopolistic Behavior is Not

Social well-being and responsibility, while long a stated goal, will become more explicit. Behavior that departs too visibly from the perceived needs of social harmony and the greater political good will not be tolerated. Successful companies will be proactive in aligning interests with government policy.

- For example, Pinduoduo (PDD) positioned itself as an online agricultural platform that connects farmers to buyers to reduce poverty while the company invested heavily on improving agricultural efficiency. At the same time, founder and ex-CEO, Colin Huang, voluntarily resigned in 2020 at the age of 40, before Jack Ma and other first-generation tech tycoons were asked to step down and reduce their public exposure. In his departing memo to investors, Huang said "we envision Pinduoduo to be an organization that creates value for the public rather than being a showoff trophy for a few.
- Relatedly, sectors fulfilling important roles in social responsibility such as finance, real estate, education and healthcare will need to follow the government's strategy instead of being purely guided by profitability. Unfair or unethical practice in pursuit of monetization without respecting social welfare will no longer be tolerated and will be cause for regulatory scrutiny and behaviors that impose systematic risks to society or to specific industries will be regulated.
    - Alibaba was asked to remove an exclusivity clause demanding that merchants not utilize other e-commerce platforms. U.S. and EU regulators are focused on this same issue with Facebook, Amazon, and Google.
    - Ant Financial was effectively an unregulated bank that employed high leverage against its asset base (mostly consumer loans). The company's lending business was estimated to have financial leverage approaching 100x capital, a level that could create systematic financial risk if not addressed.
    - Meituan was prohibited from hiring a delivery workforce without paying minimum wage and providing social insurance.

Onshoring Listed Companies

Going forward, fewer Chinese companies will seek to list in the U.S., and we expect an acceleration of delistings followed by relistings in China or Hong Kong. Over the last few years, the Chinese government has expressed a desire for its national champion companies to remain listed in their home market. This push will be accelerated, as it also avoids oversight and potential vulnerability to the SEC or other U.S. regulatory entities.

- For companies with a dual-share class or a VIE structure, which captures most of our venture-backed companies, an easy next step is to migrate to Hong Kong (H-share) before fully migrating to an onshore mainland exchange (A-share). To accelerate this trend, the Chinese government is mandating that companies hoping to list offshore first receive cyber security review approval, though an exception was made for Hong Kong-listed IPOs.
- Local Chinese markets (A-Shares) are the second largest stock market in the world behind U.S., with over 4,400 listed companies comprising $13 trillion of market cap on Shanghai and Shenzhen stock exchanges. Foreign investors have multiple ways to access China A-share market, such as through a Qualified Foreign Institutional Investor (QFII) or the Hong Kong Stock Connect. Many of our China-focused managers already have access to these markets and, as a result, we are largely indifferent to their listing location.

Concluding Remarks

Investing in China, like with all non-U.S. markets but particularly those in the emerging markets, presents unique challenges that require investors to think about the opportunities and risks differently. Those who apply a western lens to investing in these jurisdictions are prone to local mistakes and panic selling when events transpire that do not fit their existing models. Local managers can often, but not always, mitigate these risks and take advantage of opportunities in these moments of indiscriminate selling.

We expect China's more heavy-handed form of market regulation and intervention to continue as it has in the past. Despite these challenges, we continue to believe that China remains among the most dynamic and attractive investment venues around the world. Among these attractions are the world's second largest consumer market, fast GDP growth overall, ongoing industry rationalization and consolidation and a relative dearth of institutional investors. This unusual combination of attributes gives China what we believe, as we have for over 15 years now, to be unusual investment opportunity and justifying the special efforts necessary to invest in China knowledgeably and productively. Despite the need to deal with different types of risk, our approach to investing in these markets, both public and private, has proven to be beneficial to our clients, even with periods of high volatility and uncertainty like we are currently experiencing. We see China continuing to prosper and grow although in a more controlled manner. Additionally, we continue to believe in China's stated goal of continued integration into global financial markets, it just won't look the way westerner investors have come to expect.

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