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The Chinese Regulatory Turmoil - The Sky Is Not Falling

Newsletter for August 2021

The Rediscovery of Chinese Regulatory Risk

Having invested in China professionally for nearly two decades, one is firmly aware of the one cardinal rule that has always remained: China has adopted capitalism but with strong Chinese characteristics. The month of July, when large unexpected regulatory changes were announced in China across various but primarily tech sectors, was a strong reminder of these Chinese characteristics of China's capitalism. This regulatory turmoil has not only impacted most of the portfolios which hold Chinese stocks, but for some it has shaken a few of the core axioms of stock market investing in China. As happens in times of deep uncertainty, all kinds of long-term extrapolations are being made and multi-decade views are being questioned and fundamentally re-examined on the basis of a few months of data points.

Here, we are making a case that "the sky is not falling" for investors in China. Though the regulatory actions look unexpected and have come out of the blue, if you remember that China has "capitalism with Chinese characteristics", the regulatory actions seem more understandable. They are an integral part of the investment process in China.

State Capitalism Versus Purely Market-Driven Capitalism

China has "State Capitalism". Here, unlike in the Western world, the owners of capital are not the prime stakeholders in society. They share space with the state and the Party, which in turn represents the people. In case of increasing tension between capital and state, the rules of the law can be quickly changed. The subtle point to note here is "quickly". Even in Western democracies the laws are changed when capital rubs against the greater good of the people. But this process is slow, deliberated across multiples stakeholders and comes in baby steps. Changes to the tobacco industry, the strengthening headwinds against the fossil fuel sector, ESG-related actions, etc. are all examples of society and state pushing against the wishes of capital owners. But remember, the screws on the Tobacco industry have been tightening slowly for nearly fifty years and protests against environmental degradation for economic gains has been happening for an equally long time, but these industries still exist.

In China, on the other hand, these changes happen much faster. This is because the process is more outcome-oriented than solely beholden to the rule of law. Also, the Chinese political system makes it very easy to change the law book. Whatever the drawbacks of such a system, it can clearly move much faster. Now, if we look at the online education sector, which is the poster boy of sectors hit by this regulatory tightening, the first signs of protests against this sector were only noticed about six months ago. This is all the time it took from the first protest to rendering the sector un-investible, with sector value dropping by nearly 90%. We do admit that this is an extreme case and most regulatory changes are less harsh and made with more deliberation, but such a change would be unthinkable in the Western capitalist system. In our view, the Edtech sector in China was simply made an example of. As the old Chinese saying goes, "Kill the chicken to scare the monkey."

Considering this, one could mistakenly conclude that capitalism has weak roots and followers in China. This could not be further from the truth. One look at China's history and the obvious conclusion is that the few early decades of communist rule where China tried a purely socialist system was a clear aberration. This is a society which has been entrepreneurial for centuries. Whether it is trade through the silk routes, or the diaspora's economic success across Asia and then in the West, this is a society which believes in making money. Also, China's rise and economic success in the past four decades has a strong entrepreneurial and mercantilist underpinning. Hence, the concern often voiced in the last month by some market participants that China is giving up on capitalism is a superficial understanding of what is really happening. Capital in China will always be encouraged to make returns BUT in a form which is consistent with the priorities of the state.

The Current Broad State Priorities

We summarise below what has happened on the regulatory front in China in the past few months and especially in July. The government has been uneasy for some time with a few fundamental risks:

1. **Social risks of increasing inequality:** Over the past ten years, China has seen an exponential rise in the wealth of the top 1%. Currently, China has 626 billionaires, and this number grew a whopping 61% over the last one year. More importantly, if we add the numbers of billionaires in Hong Kong and Macau, the number jumps to 698. This has nearly caught up with the 724 billionaires in the U.S. Other measures like the ratio of disposable income of the top quintile of the urban population to the bottom quintile has also jumped from 4 times in 2002, to 5 times in 2012 and to 6.2 times in 2020. This has created much angst and a lot of the regulation is finally aimed to fixing this trend. This will manifest in multiple ways like the rising share of labour in national profits compared to capital, reduction in monopolistic powers, reduced cost of education, healthcare, childcare, etc.
2. **National Security Risks:** This is becoming an increasing problem as the state seems to be controlling a lesser share of the huge amount of data being generated by various companies, especially in the tech space. This has risks both from the perspective of who gains financially from this invaluable resource and also how this data could compromise national security if in the wrong hands. As some people say: data is the new oil. And the Chinese state wants to control this. The problem is no one knows how and in what form. Also, if data were totally socialised, what would be the value left in giant platforms like Alibaba and Tencent? Hence the anxiety in the market. We believe the actual structure will slowly emerge over the next year and more. But one thing is for sure: the value imputed in these companies because of their ownership of this data is now always going to be questioned.
3. **Financial Risks:** This is one of the reasons to stop the listing of Ant Financial last year. Clearly, the new players in the financial sector had grown below the regulatory radar for too long and now had become too big to fail. This created a dangerous situation for financial stability. Unlike the U.S., China does not have the luxury of flirting with large financial sector risks as it does not have a global reserve currency to bail it out. Also, given the history of misallocation of capital by the organised financial sector in China, the combined risk could be disastrous.
4. **Environmental Risks:** Does anyone remember that it was less than ten years ago that Beijing was considered one of the most polluted cities in the world? Now it has shockingly blue skies and a low level of pollution. China has been on a multiyear campaign to slowly rein back its impact on the environment. This shows up in many ways and will distort demand-supply in multiple industries. 90% of electric city transport buses in the world are in Beijing. China is the largest producer of EV passenger cars in the world by far and is racing further ahead on this front. Closure of polluting factories across sectors like steel, cement, coal, petrochemicals has been going on for years. If not for this, the world would have been flooded with cheap exports of these products from China.

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5. **Geopolitical risks:** On the economic front, this risk primarily manifests in China potentially being barred access to high end commercial products. This could be in technology, healthcare, higher education and in the extreme case even agri-products. Hence China will now pour in resources to increase self-reliance in an increasing number of industries. This disentangling is not good for everyone as we know that globalisation has helped grow the overall economic pie for the world.

The point here is the need for us as investors in China to align ourselves with these objectives. Then the regulatory risks can become regulatory bonanza very quickly.

On a broader note, each of these problems are also being faced by the rest of the world with an equal intensity. It is just that the method of solving them is either smoother, slower or simply postponed. Strangely, China could become the leader in showing the way out of the quagmire capitalism finds itself in in many parts of the Western world.

Conclusion

Though the intensity and speed of the regulatory changes in China were unexpected, the reason they happened is probably justifiable from the Chinese perspective. These regulatory moves will create losers and winners. The idea for investors is to align with the potential winners. Some industries will see the shake out of weaker players, some industries will show better financial returns as less cheap capital is invested there, some will benefit from environmental constraints on competitors, and many will benefit from the government's focus on certain growth sectors. Currently, the market is not able to differentiate the losers, winners and the un-effected. Everything has been sold off as seen in the 15% drop in MSCI China in July. This means there are a lot of relatively cheap stocks in China (unlike in the U.S. where we are at multi-decade peaks). It is the job of investors to pick the right companies in this time of uncertainty. Risks remain as always and will probably be higher for the next year or so as the regulatory landscape slowly settles in China. But we believe that "the sky is not falling."

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