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China Flexes Regulatory Muscle. What Does That Mean For Investors?

SEPTEMBER 2021

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Snapshot

- China has taken a number of regulatory steps to rein in e-commerce companies and after-school tutoring stocks.
- The government is not expected to cripple e-commerce, but business models at these companies will need to adjust. After-school tutoring is a different story—the industry has been structurally impaired.
- SEI's portfolios remain generally underweight Chinese e-commerce and after-school tutoring stocks.

Titans of e-commerce have become the corporate equivalent of rock stars. These companies (and often their founders) are known all over the world. This fame has invited scrutiny from politicians of all stripes around the globe. Most political figures seem to agree that these online platforms present a host of perceived threats—from concerns about data privacy to disinformation distribution (even if definitions of these threats are wildly varied).

While elected leaders in many countries regularly express concerns about e-commerce companies, little actual action to address them has taken place. In the People's Republic of China (PROC), the situation is different.

More action than talk

The Chinese government has been flexing its regulatory muscle against publically traded social media companies, ride-hailing providers, financial services firms and others. Examples of recent actions taken by the PROC include:

- Limited the number of hours players under age 18 can engage in online gaming as of August 2021.
- Imposed new regulations on companies operating "sharing" business, include ride, home and bike sharing in August 2021.
- Forced for-profit after-school tutoring (AST) companies in July to convert their businesses to non-profit entities.
- Required Tencent (a leading internet technology company) to cancel licensing deals with an array of record labels around the world in July 2021, putting pressure on the company's entertainment businesses.
- Mandated that Ant Group restructure, adhere to more stringent regulations and capital reserve requirements, and sever its relationship with Alipay (a widely adopted digital payment app) in April 2021.
- Fined Alibaba Group (founded by Jack Ma, China's most well-known billionaire) a record $2.75 billion in April 2021 for antitrust violations

- Summoned Ant Group and Tencent to collaborate with China's central bank to develop and distribute a digital yuan (Digital Currency Electronic Payment, or e-CNY)—which was announced in April 2021 in arguably the most prominent state-led move toward digital currencies to date.
- Prevented Ant Group (major financial technology conglomerate and Alibaba affiliate) from following through with its anticipated initial public offering in November 2020.

Social stability over profits

Unlike economies that place a high priority on profits, the PROC operates in a communist system where social stability (maintenance of the status quo) is paramount. Emerging power centers (including corporations) fall under the political and economic primacy of the Chinese Communist Party and are likely to be regulated accordingly.

Some regulations reflect the government's desire to deploy resources. Advances in consumer-oriented technology (such as social media and video games) have highlighted an opportunity to refocus China's best and brightest minds, concentrating their talents on the technologies that will advance the nation's industrial and military strength.

Other regulations are driven by more complex themes. In the fast-growing e-commerce industry with global giants such as Tencent and Alibaba and scores of smaller companies, data security has risen in importance. The PROC wants to protect the vast amount of data that firms gather as they expand their international footprints—particularly those with overseas operations in the U.S. and other nations with strained China relations.

The competitive landscape is another area that the PROC and other governments around the world believe needs to be re-balanced. Access to the global equity market has allowed China's leading companies to pursue market share, often at the expense of profits. This has resulted in the closure of a vast number of medium- and smaller- sized companies—an outcome that, if left unchecked, could potentially undermine social stability.

Lastly, the for-profit AST industry has ballooned into a giant over the past two decades. A small number of people made billions in profits, which added to the social imbalance for hundreds of millions of Chinese citizens—a situation the government found to be intolerable.

The PROC's stated motivation for the crackdown on for-profit AST companies was to protect working-class families. The wealth disparity in China isn't too different from that in the U.S., according to the World Bank's Gini coefficient (a summary measure of income inequality developed by Italian statistician and sociologist Corrado Gini), with the affluent in both countries seeking to give their children advantages not available to the less fortunate. Addressing the disparity supports equality in access to education and reduces stress on children. It also lowers the financial burden associated with raising a child, which not only helps parents but also reflects the government's effort to encourage child birth—and stem the tide of shrinking demographics that could impede the nation's future economic growth.

Why should investors care?

Major Chinese e-commerce companies such as Alibaba, Baidu, Didi and Tencent are big players on the world stage that offer appealing business propositions for investors seeking growth opportunities. Several firms based in China boast outsized weights in the MSCI Emerging Market Index[1], as shown in Exhibit 1.

[1] The MSCI Emerging Markets Index is a free float-adjusted market-capitalization-weighted index designed to measure the performance of global emerging-market equities.

Exhibit 1: Top-10 Constituents of the MSCI Emerging Market Index

Company	Weight (%)
Taiwan Semiconductor	6.38
Alibaba Group Holdings	4.60
Tencent Holdings	4.43
Samsung Electronics	4.07
Meituan	1.25
Naspers	1.25
Vale	1.05
Reliance Industries	0.97
Infosys	0.92
China Construction Bank	0.84

Source: MSCI. As of July 30, 2021.

Government intervention introduces uncertainty, which can result in stock price volatility. For investors with exposure to these stocks, this can lead to declining portfolio values.

These interventions can also lead to less access to Chinese investment opportunities for investors in other countries. As it stands, many Chinese companies are only available to U.S. investors as American Depositary Receipts (ADRs), which are certificates issued by U.S. banks that primarily represent ownership in shares of foreign companies. However, given rising tensions between the U.S. and China—due to their ongoing negotiations about financials disclosure, the obscure legal structure called variable interest entity (VIE) that many Chinese companies use, and China's data-security concerns—there may be a decline in Chinese ADRs over the next few years.

While Chinese companies will still have access to international capital through whichever exchanges host their securities, less of that capital will likely belong to U.S. investors if ADRs do in fact become unavailable.

Over the past year, sanctions introduced by the U.S. government have already promoted this effect. For instance, global index providers S&P Dow Jones Indices and FTSE Russell have removed some Chinese companies from their indexes following a U.S. executive order barring domestic investment in companies with alleged ties to China's military.

Our view

Although the PROC's regulatory intervention has weighed on foreign equity investors, we think it is unlikely that China's economy itself will be severely constrained. China is a huge country with tremendous internal capital upon which to draw.

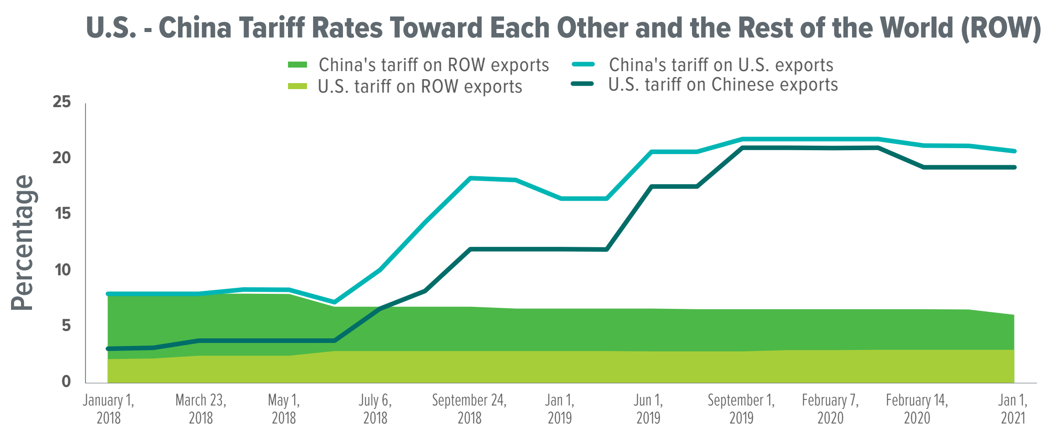
We expect most e-commerce companies will make adjustments to their business models and continue their growth strategies, both domestically and abroad. There is no apparent incentive for the Chinese government to cripple an important industry that employs hundreds of thousands of people and contributes to economic growth. However, in the near future (at least), while regulators sort out the details, we expect to see notably fewer initial public offerings from China's e-commerce industry and potentially slower growth than previously expected.

As for the AST industry, changes will be clearly structural as Chinese President Xi Jinping wants the government to take over control of education as it relates to school-aged children. The companies in this space will be fighting for survival and seeking loopholes in regulations that may still allow them to make profits. They will be further challenged by a lack of access to foreign capital, which had helped propel their growth. In the long-run, unless the government addresses the huge demand for AST, much of the activities may eventually find their way underground.

From a broader perspective, the economic relationship between China and the U.S. will no longer be characterized only by a symbiotic trade structure—in which China's low manufacturing costs (which brought in cash and raised the standard of living) met the seemingly endless demand of U.S. consumers for inexpensive imported goods.

Rhetoric about the China-U.S. trade relationship is vastly different today compared to 2001, when China was admitted to the World Trade Organization and U.S. firms made substantial investments in Chinese factories. Current U.S. President Joe Biden issued new sanctions on China, adding to those imposed by his predecessor; China retaliated once again with its own sanctions, as the business leaders find themselves increasingly focused on supply-chain diversification. Exhibit 2 highlights the changing relationship.

Exhibit 2: U.S.-China Trade on the Rocks



Source: Peterson Institute for International Economics

Source: Peterson Institute for International Economics

The U.S.-China trade relationship now seems characterized by concerns about intellectual property theft, human-rights abuses, and competition over global influence. The EU, Great Britain and Canada have also placed sanctions on China, while Australia and China have imposed tariffs on each other over trade disputes.

Still, China is too big, too efficient and too important a manufacturer for the world to turn its back on. As such, U.S. companies have been placing strong pressure on the Biden administration to eliminate tariffs.

At the margin, we expect to see further diversification of supply chains. We think the U.S. would be wise to bring some semiconductor production back to the United States and to be more self-sufficient regarding personal protective equipment and other critical products. With that said, U.S. firms will continue to operate in China—albeit firmly under China's rules.

China's government, like those in other major economies, is wrestling with proper regulation of fast-growing industries like e-commerce. With a keen eye on maintaining social stability, we will not be surprised if more regulatory changes come in the future. If history is any guide, transparency, or the lack thereof, will always be an issue with investors. The timing and magnitude of changes can be abrupt, as we have witnessed.

The type risk that naturally comes with investing in such an environment is not limited to Chinese equities. Other countries that are less developed carry similar characteristics but have lower profiles since they often represent smaller portions of the equity markets. Therefore, as always, we strongly believe in a diversified investment approach to help mitigate such risks.

Our strategies

We have been underweight Chinese e-commerce and AST stocks for some time due to valuation concerns. These underweights show up in the consumer discretionary and telecommunication services sectors, even though the media often loosely refers to them as technology and education stocks.

Specifically regarding the technology sector, we are biased toward selective companies that specialize in semiconductors, software, and computer hardware because we consider the trade-off between risks and potential returns to be more attractive.

At the country level, our exposure to China is also less than that of the index, primarily through underweight positions in internet-related stocks in consumer discretionary and telecommunication services and a moderate underweight to health care.

The recent regulatory changes in China serve as a reminder that emerging-market stocks can be highly volatile. We have no doubt there will be other shocks in the future. However, the return potential and diversification benefits as a part of global investment strategy remain intact. Through our actively managed, multi-manager approach, we continue to believe we are favorably positioned given the market inefficiencies over the longer term.

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