Causeway China Series: Regulation…or Strangulation?

How Causeway Interprets China's Recent Regulations

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Recent Chinese private sector regulation of companies in the technology and for-profit education sectors triggered a multi-billion dollar sell-off in Chinese equity markets and reignited concerns about the risks of foreign investment in Chinese companies. Some of our clients asked us, how can we get comfortable investing in China with the threat of erratic regulation and unpredictable government policy? Is China anti-capitalist, or anti-foreign capital? Is international panic selling creating investment opportunities?

Causeway portfolio manager Fusheng Li, who leads the firm's Shanghai-based research subsidiary, shares insights on the risks and opportunities stemming from Beijing's private sector regulation.

What is Causeway's take on recent regulation from China?

We think the sensational elements of recent regulatory reform—sudden announcements and sweeping overhauls—distort the underlying reality of China's regulatory progression. Overall, we see these policies as reasonable and long overdue. The Chinese government is implementing consumer, labor, and environmental protections that are longstanding components of many developed economies. Its technology sector antitrust and data privacy concerns are shared by policy makers in the US and Europe, although expressed more unilaterally. Historically, one of the challenges of investing in China has been light levels of regulation across sectors and the variability in how companies complied with regulations. We believe well-established, consistent, and transparent regulations should ultimately lower the risk of investing in China. We also believe the converse: if regulations are arbitrary, or opaque regulations proliferate, then investment risks rise. Importantly, we do not currently believe the recent Chinese regulations are intended to drive away foreign capital.

Where might regulators turn next?

Investors should identify the motivation for regulation. We recognize five regulatory themes:

1. **Regulation to support China's long-term governmental policies:**
    a. Based on prior communications from Beijing regarding the government's long-term goals, we expect regulation designed to promote population growth and common prosperity/social welfare. We also expect government to mitigate systemic risks in the financial system.
    b. We think there are three primary burdens on the Chinese family today: education, housing, and healthcare. Following the draconian restrictions on for-profit education companies, we expect future regulation to be focused on housing and healthcare.
    c. Possible targets of systemic risk mitigation include pensions and social security account management, bank and non-bank lending and consumer credit.

2. **Increased consumer, labor, and environmental protections:**
    a. Consumer: increased scrutiny of product quality of consumer goods and hidden predatory practices in consumer finance. Strict limits on video gaming time for minors may lessen addictions as these young people grow older and boost productivity.
    b. Labor: Reform across industries focused on employer-paid employee benefits. For example, food and express delivery companies may need to begin providing driver benefits.
    c. Environmental: control of heavy pollutants and implementation of carbon quotas.

3. **Targeting anti-competitive behavior:** China introduced antitrust regulation in 2008 but Xi Jinping's government accelerated its implementation. Dominant/monopolistic players in industries that directly touch consumers remain especially vulnerable.

4. **Data ownership/data security:** The government considers user payment data critical public property but currently lacks the technology resources and capability to store and analyze the data. We expect regulation to support the transfer of highly sensitive user data from private to public hands.

5. **US/China competition:** We may see more policies favoring local substitution and promoting China-led research & development.

We are researching all these areas, with an emphasis on those with the greatest ambiguity. As fundamental analysts, our risk analysis is primarily conducted at the individual company and industry level, where we seek to identify companies with attractive value propositions that can earn their profits through fair competition. We consider an individual company within the context of these regulatory themes. We seek to avoid companies we believe have inflated growth and profit margins stemming from what regulators classify as abusive treatment, such as excessive working hours and poor working conditions. Such companies may find themselves facing the headwinds of rising labor and manufacturing costs and other effects of these regulatory goals.

We expect both winners and losers as regulations progress. It is important to recognize some companies—especially scale players—should benefit from increased regulation. For example, stricter carbon emissions standards may spur consolidation in the manufacturing sector and provide advantages to industry leaders. Certain delivery companies already provide welfare benefits to their drivers and will be advantaged when laggard firms must absorb new cost increases.

Is the negative sentiment presenting any buying opportunities?

Beijing's recent regulatory crackdown has weighed heavily on the share prices of large Chinese technology companies with well-capitalized and valuable platforms. We think certain Chinese internet stocks may discount an overly pessimistic future. For our Global Value, International Value, and dedicated China portfolios, we are currently researching several, in our view, high-quality Chinese technology franchises we believe may have sold off and trade below their intrinsic values. We think these franchises should adjust and then thrive. The investment made by Chinese technology giants in areas such as artificial intelligence, autonomous driving, and community group buying have the potential for sizeable shareholder returns. We believe this may be a good time to take advantage of investor pessimism and weak share prices.

Causeway Global and International Value portfolios currently hold two equities with predominantly Chinese economic exposure. We believe these companies are relatively insulated from unanticipated Chinese regulatory risk. One operates in the casino industry in Macau, providing lucrative business, employment, and tax revenues to the Chinese economy. Another is an airport holding company that serves the domestic market in China. Like other Covid-impacted stocks in Causeway client portfolios, we expect a recovery in profitability as travel and leisure activities normalize post-pandemic.

In Causeway Emerging Markets and International Opportunities strategies, China is the largest emerging markets country weight, although the portfolio exposures are currently below-benchmark. For these strategies, Causeway selects emerging markets stocks quantitatively with a fundamental risk overlay. Regulatory risks often fall outside the scope of the quantitative models, so our China research arm is helping our quantitative colleagues assess the risks to Chinese holdings. The largest overweight positions are concentrated in industries outside the current regulatory crosshairs. We maintain exposure to some of China's largest internet stocks, due to their value, growth, and momentum characteristics and our benchmark-relative constraints.

What about the risk of US and Chinese government restrictions on foreign investment in Chinese companies, especially those listed on foreign exchanges?

Nearly 250 American depositary receipts (ADRs) of Chinese companies are listed on three US stock exchanges[1] using "variable interest entities" (VIEs). As tensions between the US and China mount, these listings appear increasingly vulnerable to regulatory actions, including compulsory exchange delisting, from both governments. There are also concerns the US government may restrict its citizens' investments in Chinese company shares listed in Hong Kong (H-shares). We believe a complete financial decoupling of the US from China is unlikely as it does not benefit either party. We take these risks into consideration when accessing Chinese companies on behalf of our clients through a mix of Hong Kong, US (ADR), and mainland China securities.

Final thoughts to share with our clients?

Economic development is a cornerstone for social stability in China and we believe China's economic upgrade will continually present investment opportunities. Despite the jarring recent regulatory actions, we believe China's domestic policy objectives are designed around pragmatic political and economic goals and include the continued opening of its capital markets. Opacity and inconsistency in regulatory actions would likely weigh heavily on investor perception of the risk of investing in China. We must also evaluate the balance of power between private sector leaders and the Communist Party of China, as increasing state ownership would likely erode national prosperity. We staffed our research office in Shanghai to gain proximity to companies, industries, and the all-important regulatory framework. The opportunities for long-term equity investors in China can ultimately outweigh regulatory risks if vetted through diligent research and thorough risk analysis.

[1] U.S.-China Economic and Security Review Commission, May 2021

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