Chinese regulation – is it the end of the gravy train?

Since last November and the "postponement" of the Ant Financial listing, one question from investors has stood out: will government regulation from Beijing dampen the profitability of some of China's most successful companies? The damage to share prices has been so hard of late that a number of investors now seem to fear the worst. Didi's recent travails have added to the concern.

Although we are primarily bottom-up stock pickers, we are also 'macro aware' and keep a close eye on the politics. Whilst we try our best to avoid politically sensitive stocks, where we are involved with a company that comes under scrutiny, we are quick to act. New Oriental Education being a good recent example where we sold at $13 (it stands at $6 today); we also exited Alibaba in February at $264 (it is now around $209).

So where next with regulation? We cannot tell you exactly when and where it will bite next or indeed when and where it will be relaxed, but it is worth noting that we have been here before. Tencent was wrapped on the knuckles in 2017 for luring Chinese school children away from their books with its dastardly games; and there was conjecture that Jack Ma's resignation as Chairman of Alibaba in 2018 was the result of regulatory "persuasion". Derating and underperformance certainly followed but the shares recovered as fundamentals reasserted themselves.

Judging when the fundamentals are strong enough to make a recovery is part of our process. Chinese consumers still have strong purchasing power and have become accustomed to many of the goods and services provided by companies which face regulatory scrutiny. For example, education remains one of the highest priorities for Chinese families and there may well come a time when revisiting New Oriental Education and TAL may become a profitable endeavour. We can only do our best on a case-by-case basis.

To those who are seriously worried about the prospect of regulation we would make the following general points:

1. The CCP is faced with a balancing act which has been going on since the 1980s: without the liberalisation of the economy the growth that has enriched the lives of hundreds of millions of Chinese people would not have taken place. Yet at the same time when that liberalisation runs on too fast then a loss of central control may lead to upheaval. This balancing act was rather well summarised in a recent FT article "Between chaos and control" in the Saturday 26th June edition about Cao Siyuan, the official who formulated China's bankruptcy law back in the 1980s (https://www.ft.com/content/6b3a7274-8fac-403e-a385-3f8920f5b369). These laws introduced the concept if only by implication that profitability rather than mere output that was critical if China to become a wealthy post-industrial country. If you missed it, I recommend it as a 5 minute read. It provides a context for Beijing's constant vigil and periodic application of the brakes.

   But the brake pedal is used gingerly. Having achieved a better more comfortable life, the Chinese are not looking back to the agrarian joys of the Cultural Revolution when many were banished to the countryside. Although Meituan, Alibaba and other consumer tech giants may have been fined for antitrust violation, many customers have grown used to the services. The growth of ecommerce will carry on and we expect more than 50% of total retail sales will come from online transactions by 2030 (it is currently about 30%).

2. We have written before about the similarity we see between Beijing's actions over the last year and the anti-trust legislation that began to be introduced in the US at the end of the nineteenth century. It seems self-evident that whilst government regulation cannot be ignored it does not mean the end of corporate success for the best companies. The Morgans, Carnegies, van der Bilts, Rockefellers et al went on making huge profits for years after the Sherman Act in 1890. Some of them are still at it!

   For those that think that is ancient history, just consider Facebook, Apple and Google which have all had the US regulator come knocking. If you had sold these three after they were hit with massive fines then you would have missed a trick.

   Thus, whilst out of Alibaba and several of the other big Chinese names we continue to monitor these companies – many of them will maintain their market leadership and their wide and deep moats notwithstanding the politicians.

So what about the new boys on the block? We believe there is a strong pipeline of first-class businesses too early in their life cycle to attract regulatory opprobrium but just right to offer massive shareholder value.

The gravy train may have slowed but you disembark at you peril.

Performance

Net Performance (USD) as at 30 June 2021	YTD	1 yr	3 yrs	5 yrs	7 yrs	Inception
Aubrey Global Emerging Markets Strategy*	5.1%	46.0%	69.1%	145.1%	138.3%	256.8%
MSCI TR Net Emerging Markets USD (NDUEEGF)	7.5%	40.9%	37.8%	84.5%	53.9%	61.2%

*The above figures have been calculated using a combination of OMGI Fund GBP share class (14Mar12 to 31Mar15) and the AGEM Fund IC2 USD Share Class from 01Apr15 which have been recalculated to simulate USD performance over the same period using GBP to USD FX Daily Spot Rate sourced via Bloomberg. The resultant combined performance is calculated in USD and presented net of management fees and transaction costs. The OMGI Fund GBP performance has been used to simulate the past performance of the AGEM fund because they have both followed the same strategy. However past and simulated performance is not a reliable indicator of future results and you may not get back what you originally invested and investment returns may increase or decrease as a result of currency fluctuations.

Biographies

Camellia Huang | Investment Analyst

Camellia joined Aubrey in November 2020 from Aberdeen Standard Investments where she was an Investment Analyst in Private Markets across their Corporate Finance, Diversified Assets, Infrastructure Equity and Private Equity teams. She began her career in investment management in 2016 at Seven Investment Management in London and then at the Qianhai Equity Exchange in Shenzhen. She holds a Master's degree in Accounting and Finance from the University of Edinburgh. Camellia has lived and studied in both China and Australia and is fluent in Cantonese, Mandarin and Hakka. Camellia holds the CFA Level 1 certificate.

Mark Martyrossian | CEO

Mark has been involved in Asian equities since 1987. He joined Aubrey in 2017 as CEO. He was based in Hong Kong for the 1990s where he spent much of his time working in China.

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