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Investing in China in Light of Recent Regulatory Actions

Michael Kass, Portfolio Manager
Baron Emerging Markets Fund, Baron New Asia Fund, and Baron International Growth Fund

The Chinese government's regulatory actions aimed largely at different facets of the technology sector have shaken investor sentiment toward a range of Chinese assets in recent months. The moves come as Chinese policymakers embark on redefining the role of private enterprise to better align these companies and industries with the government's goals of prosperity, sustainability, and stability.

It is important to consider what is happening in China today in context. Recent regulatory reviews and mandates are the culmination of many months of deliberation and signaling. These announcements were timed to roll out almost coincident with the celebration of the 100-year anniversary of Communist Party rule a few weeks prior and in part represent the political process of President Xi preparing for next year's Party Congress where he will push to overcome term limits and cement the status of Mao/Deng Ziaoping and perhaps even continue in power for life.

1. ***Everything happening in China today should be considered as part of President Xi demonstrating to his allies and opposition that he is delivering on Communist Party goals/priorities more effectively than his predecessors and is thus worthy of exalted status.***

   - The Party, under Xi's leadership has set out three principal goals:
     1. continuing to lift millions out of poverty and into the middle class
     2. improving China's environmental trajectory and putting the country on a sustainable course
     3. enhancing the social, political, and financial/economic stability of the country
   - Xi and the Party believe that if they are not advancing these priorities, the Party's leadership and power will eventually become vulnerable. Xi is generally perceived as making solid progress and delivering on the first two objectives, while the jury is out on the third.

2. ***The current rash of regulatory tightening can be seen nearly entirely in the context of Xi's effort to shore up the third plank.***

   - The Party believes that social stability, and its own legitimacy, in part requires a change in what has been a significant widening of the wealth gap in China.
   - In recent polling, middle class and down families cited the most significant sources of pressure to be:
     1. the cost of education/tutoring/test prep. According to some reports this cost can comprise over 20% of disposable income.

2. the high cost of housing
3. uncertainty around the cost of health care

- The cost of education/tutoring (and housing) are also cited as limiting family formation and preventing the birthrate from increasing after the repeal of the one-child law.
- Education/testing was recently hit hard[1] because it was viewed as a uniquely responsible for existing social instability and pressure on rank-and-file citizens while not a concern for the wealthy class.
- The tutoring, property, and health care industries are most likely to be impacted by regulatory modifications in our view, though we should state that health care pricing has been under pressure for several years now and the current trend of pricing pressure, offset by healthy consolidation, innovation, and a broader government funding/social safety net should continue.
- We are comfortable with our quality health care investments in China. We do not own education or housing stocks in China at this time.

3. ***A second major manifestation of the drive for greater "stability" (and control/oversight) in China is the new emphasis on data security/cybersecurity.***
    - China's titans of digitization (Alibaba/ANT, Tencent, Meituan, JD, Pinduoduo, Didi, Baidu, Bytedance, etc.) control massive amounts of data – consumer data, credit data, mapping/location data, transportation/logistics data – all of which the Party considers strategic to China's national security.
    - China sees cybersecurity as a global issue and is alarmed that local Chinese companies invest a fraction of the amount of global peers in data/cybersecurity (by some estimates). There are new regulatory bodies (now with teeth) developing guidelines for "digital" businesses to follow – but they are not fully crystallized. This was one of the reasons that Didi was punished for disregarding regulator requests to defer its IPO.[2]
    - We do not think data/cybersecurity requirements will have a material impact on business models or profitability of the China tech/internet sector, but companies will be required to implement adequate security measures.

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[1] On July 24, 2021, China's government issued new regulations that drastically limit for-profit tutoring services and prohibit foreign investment in Chinese private education companies. The new rules restrict both tutoring services and the profits they generate. They limit online lessons to 30-minute sessions; impose a tutoring curfew of 9 p.m.; and prohibit instruction during weekends, holidays, and school breaks. Companies that offer private instruction in core subjects will have to register as nonprofits and will no longer be able to raise investment capital through IPOs or advertise their programs.

[2] Didi Global is a China-based ride hailing app. Days after Didi's June 30, 2021, market debut on the NYSE, the Cyberspace Administration of China launched an investigation into the company and asked it to stop registering new users, citing national security and the public interest. The regulator also said it would remove the mobile apps operated by Didi from app stores.

4. ***The Party also believes that if allowed to continue unaddressed, the "disorderly expansion of capital" (largely by the digitization leaders) will ultimately threaten the Party's control and stability*.**

   - The party's view is that for the past 10 to 15 years, the titans of digitization have benefited from "state protection" in the form of walling out Amazon/Google/Facebook, etc. This was very good for China's economy/consumers, for its productivity/innovation, and for its small businesses/merchants.
   - But now, the scale and scope of these companies and the data they leverage is considered a source of vulnerability – these companies have become too powerful and too integral to the lives of China's citizens.
   - Further, these companies are now seen increasingly as "rent-seeking" institutions, using their data and monopoly/duopoly status to further their own corporate interests potentially at the expense of their consumers/counterparties/merchants/workers/other constituents. This concern led to the formation of the "anti-monopoly commission," which is another major source of investor uncertainty. As is the case in the U.S., dominant Chinese internet platforms that leverage monopoly-type power at the expense of counterparties are under review and may face revisions. The mechanism to remedy simply works very differently in China than in the U.S.

5. ***On the other side of this divide are the industries and companies that are considered a part of the solution*.**

   - These companies and industries in general form our "China value-added" theme. These are industries and companies that can help enhance China's stability and security by moving towards self-sufficiency in the key intellectual capital-based industries such as semiconductors, software, pharma/biotech, EV/renewable energy, automation/robotics, etc.
   - These companies will grow and prosper at the expense of Western multinationals that have dominated the profits of such industries in China for the past two decades, in our view.
   - These companies are also beneficiaries of China's objectives and initiatives and form a core component of both Baron Emerging Markets Fund and Baron New Asia Fund.

6. ***Foreign investors/VIEs/ADRs***

   - VIEs (Variable Interest Entity) are the legal/structural mechanism to allow foreign investors to have confidence in investing in China-based companies from a governance perspective. The VIE structure safeguards the economic benefits of ownership given that only local/mainland entities can maintain actual control of the assets.
   - VIEs are not going away, and Chinese authorities just stated they remain comfortable with the VIE structure – but VIE review will help slow the "disorderly expansion of capital" and can act as a means to coerce more listings and capital investment to migrate from the U.S. to H.K. and mainland markets.
   - China authorities want to see more mainland institutions/retail investors participating in and benefiting from the value creation by local Chinese companies as there is frustration that the majority of gains of the past 10 to 15 years have accrued to U.S. and international investors and institutions.

- We believe that Chinese authorities will use the VIE approval process and cyber/data security reviews to both “slow the disorderly expansion of capital” and encourage more companies to list in the H.K. and mainland markets rather than in the U.S.
- There is an ongoing accounting dispute between the U.S. and China with regard to U.S.-listed China ADRs (American Depository Receipts), which is another catalyst for listings to migrate to Hong Kong/China.
- There have been recent rumors that the U.S. may “prohibit” investment in China equities, which we believe is indicative of the level of fear and panic in recent days. This would very likely be unviable. Prohibiting investment in new IPOs could be possible, but with an estimated $500 billion of U.S. investor capital in China equities via U.S. ADRs, Hong Kong, and mainland A share listings, a forced repatriation would likely trigger a major global financial and economic shock and would materially harm the interests of those U.S. institutions and retail investors.

7. ***Having started early this year (late last year in the case of Alibaba/ANT), we believe the impact of China’s shifting regulatory landscape is largely already priced into markets**.*

- While a capitulation often involves an overshoot, we may see new lows, and would at least expect some form of a retest of recent lows in coming weeks as more details around the regulatory details roll out. But we do believe investors, and particularly international/global investors without a particular mandate to invest in EM/China equities, are capitulating on the uncertainty regarding such changes before more transparency arrives.
- We believe it is likely that China-related equities will recover, perhaps significantly, as more regulatory clarity emerges, even if, as we expect, there are more specific/targeted adverse impacts. China’s reliance on private sector capital and innovation will remain intact.

A **variable interest entity (VIE)** refers to a legal business structure in which an investor has a controlling interest despite not having a majority of voting rights. The term **American depositary receipt (ADR)** refers to a negotiable certificate issued by a U.S. depositary bank representing a specified number of shares—usually one share—of a foreign company's stock.

Regulatory Authority, Inc. (FINRA).