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The Big Picture

One of Huawei's newest facilities is the 2,200-acre Ox Horn research and development campus in Dongguan. The research buildings in the collection of 12 "towns" with names like Paris, Verona, and Bruges, are modeled after famous European landmarks. The campus will be part of the company tour program at the upcoming 17th APS China Client Event in May 2023.

THE BRIEFING

Open Borders

China reopened its borders to foreign tourists in mid-March by restoring the issuance of all types of visas. Areas in China that did not require visas prior to the pandemic reverted to visa-free entry, including the southern tourist island of Hainan. Foreigners holding visas issued before 28 Mar 2020 that are still within their validity dates will also be able to enter.

Housing Stabilization

China's housing market shows signs of stabilization, with prices flat or slightly rising in many cities. The average new home price in China's 70 major cities rose 0.1% in February, marking the first monthly increase since May 2021.

Leadership Stability

Beijing reappointed several economic officials for new terms, including Yi Gang as China's central bank governor. The finance and commerce ministers, Liu Kun and Wang Wentao, will also remain in place. Yi and Liu were appointed despite reaching retirement age, which may give investors a greater sense of stability and continuity.

Financial Regulator Consolidation

China is consolidating its financial regulatory authority to oversee banks, insurance companies, securities firms, and other financial institutions. The new authority will replace the current system, to improve oversight of the sector and prevent future financial crises.

China Approves mRNA Vaccine

China has approved its first locally developed mRNA Covid-19 vaccine, developed by CSPC Pharma. The vaccine has shown an efficacy rate of 80.7% in clinical trials, making it one of the most effective Covid-19 vaccines developed in China.

China Mends Saudi-Iranian Ties

Iran and Saudi Arabia agreed to re-establish diplomatic relations in a deal mediated by China. The talks in Beijing covered thorny issues like the war in Yemen and includes vows for each side to respect the other's sovereignty and not interfere in the other's "internal affairs". The rapprochement deal has a two-month window to formally resume diplomatic ties severed seven years ago.

THE WORST IS OVER

By Wong Kok Hoi

Meeting with Founders and CEOs

Over four weeks straddling February and March, I met with founders and CEOs from a dozen listed companies, as well as senior executives from another 10 listcos. I also met with the founders and senior executives from a further six companies that remain privately held. Although each visit was at least two hours, it was the informal interactions, over meals and drinks, that were most insightful because one gets to know their visions for their companies and is also able to look through the windows into their psyches. Many were candid. I share my findings and my observations in this note.

World Cup Soccer

The founders and CEOs I shared meals with had mixed feelings at best towards China's zero-Covid policy, accepting it being a necessity for the Alpha and Beta strains in the first two years, but contending that it was completely unnecessary to persist with it for the Omicron strain.

Some business leaders shared that up to 80%-90% of their factory workers got infected in less than two weeks. Fatalities were few and far between amongst their relatively youthful workforce, but many seniors died. One business leader in Hangzhou told me that the fatality rate was over 50% for those aged over 90 in Hangzhou but added that at that age, they could go anytime. The total casualties remain unknown. One healthcare CEO, however, estimated that between three and four million Chinese citizens probably lost their lives to Covid. Assuming 80%-85% of China's population were infected by Covid, that implies an observed case fatality ratio that is higher than Japan and Australia's 0.2% but shy of the 0.4% in France and Germany, which seems reasonable to me. This and similar anecdotal estimates can neither be verified nor falsified, as no official data of this nature is publicly available.

The lockdowns came at a heavy cost to the economy. But my sense was that the loss of confidence amongst entrepreneurs and consumers was probably the bigger cost. And when the Chinese watched the maskless spectators enjoying the World Cup soccer games at Doha in December, many wondered whether they were living on another planet. At that time, it prompted many to ponder where their country was heading. The final quarter of 2022 was probably the lowest point in recent years for China.

Understanding the Past Regulatory Actions

I believe many investors turned exceedingly bearish after being persuaded by mainstream views that the tough regulatory action against the Internet platform, healthcare, real estate, and education sectors were principally anti-capitalist and anti-entrepreneur, tarring it with the Marxist brush. Unless one understands the Party and the government's policy objectives behind the recent regulatory actions, one cannot build a case for investing in China. Therefore, after this research trip, I feel it is important to repeat some of my views that were expressed in earlier thought pieces.

Few detected the common thread joining these measures into a single resilient gambeson — **the correction of excesses built up over the past 40 years of unbridled laissez-faire capitalism**. The law of the jungle took hold and ruthless Darwinism held sway, where the smart, bold, and connected turned out to be the primary winners. Upright government officials who resisted the allure of amassing riches via corruption, the average citizen without access to capital, and folks without tertiary education were left in the dust. Beijing eventually decided that the excesses would need to be fixed before they led to further social unfairness, unbridled corruption, profound economic distortions and dislocations, systemic risks and eventually social unrest and economic implosion.

Having studied the Japanese property meltdown and the ensuing banking system collapse, some policy makers felt China was treading dangerously close to the footsteps of Japan in the 1980s, particularly in the real estate and banking sectors.

A former Chinese government official who now helms a financial services firm in China shared that insight with me.

Healthcare

Take the healthcare industry as an example. The 2019 rollout of the Chinese government's centralized drug-procurement program, known as Group Purchase Orders (集采), was aimed at ensuring affordable drugs for Chinese citizens. It was not uncommon for drug prices to be cut 80%-90% at the stroke of a pen.

Bad for drug companies but good for consumers.

Education

Turning to After-School Tutoring (AST), President Xi Jinping had actually warned in 2019 that K12 tuition should not be a profit-driven enterprise, but AST companies and their shareholders ignored the warning. Instead, billions of fresh capital poured into listed and unlisted companies, which preyed on parental anxiety and the almost unlimited willingness to spend, in a society where a good education is seen as the passport to much-coveted upward social mobility.

When China's top leaders realized that the bulk of the USD10 billion raised in 2020 by both unlisted and listed EdTech companies was used to poach the top teachers from public schools and to launch marketing blitzes to attract students, they feared the political, economic, and social consequences if nothing was done. Not only would parents end up spending a large part of their savings and income on their child's education, but they also would be disincentivized to have a second child. On top of that, private tutoring after regular school hours on weekdays, as well as on weekends and during school vacations, would inevitably add to a child's stress levels. Some sociologists believe that the high cost of education is a major reason for the declining birth rate in the country. The Party also fears that high AST costs would create a class system where children in rural areas would always be outdone by their wealthy urban counterparts.

Bad for AST investors, but good for parents, their children, and future generations.

Video Games

Similarly, China cracked down on video games in 2021 to address addiction and other negative effects of excessive gaming, limiting the amount of time children and teenagers spend playing. New regulations restricted online gaming for those under 18 years old to only three hours per week, with gameplay limited to specific times during the week. In addition, minors are required to register for online gaming accounts using their real names and identification numbers. The regulations also include restrictions on the content of video games, such as banning games deemed to be too violent.

Bad for video game investors, and good for the youth and maybe even adults.

E-commerce

During the golden period of China's e-commerce platforms from 2014 to 2020, e-commerce companies practically did whatever they wanted. The regulation of antitrust behavior was nascent and murky. Lax labor laws for blue collar workers, especially the delivery staff, allowed e-commerce companies to exploit contract and gig workers, by paying low wages for very long working hours, very little paid annual leave, as well as very minimal to non-existent medical, pension, and other social benefits like housing and so on.

E-commerce companies big and small were able to raise billions of dollars of capital every year to burn during this period, selling products below cost or at very low margins in order to build up their brands and market shares. In 2020, Meituan alone raised USD10 bn to take on rivals of all sizes, in a then-novel retail format called "community group buying" for groceries and fresh produce. Meituan's strategy was to use the new capital raised to kill off its rivals and swiftly take a dominant market share, like what it had done in all its past businesses. Products were sold below cost – for example, a dozen eggs were sold for 1.2 yuan!

To policymakers in Beijing, outselling other community group buying companies, and more importantly decimating mom-and-pop grocery shops, was a waste of precious capital. It does not make the retail industry more efficient.

Many mom-and-pop shops were casualties, fallen by the wayside after such senseless price wars, while many malls were hollowed out. As soon as the giants achieved monopolistic positions, they would increase prices, as manifested in the ride-hailing and food delivery businesses. The strategic intent to build monopolistic power again for future monopolistic profits was not lost on the policy makers. No wonder regulators had acted so decisively.

Regulators have now set the out-of-bounds lines very clearly. They will root out antitrust behavior and violators will be fined heavily, with Alibaba's regulatory woes from 2021 serving as an example. Alibaba's monopolistic practice of forcing retailers to swear off other internet platforms was banned. Selling below cost is now strictly not permitted and blue-collar workers must be provided with adequate medical, pension, and social benefits. These costs now likely account for about 20% of wage costs.

I believe the media got it horribly wrong by asserting that the regulators' actions were targeted at Jack Ma for his infamous speech at the Bund Summit in Shanghai in 2020.

Bad for e-commerce companies, and good for mom-and-pop stores and consumers.

Banks and Developers

The famous "three red lines" policy to deleverage China's developers as well as reduce its banking system's exposure to the real estate sector had an ambitious goal of averting a systemic crisis but it was admittedly carried out too hastily. I was told that China's policy makers heeded the cautionary tale of Japan's property market bust and their resultant zombie banks from three decades ago. The other policy objective is maintaining social stability by ensuring that home prices do not leave the next generation teetering on the edge of penury.

Bad for developers and good for home buyers.

Frying Anchovies

That financial services company chief agreed with the rationale and formulations of most of those policies that I have mentioned here, save for the compressed timeframes of their implementation. Not doing anything to correct the excesses would lead to more economic dislocations and a future systemic crisis. Taking drastic actions to fix them would subject the economy to great stress and shake corporate confidence. Be that as it may, **the risk premium for China equity markets has declined** because excesses have been corrected to quite a large extent and hence the likelihood of a real estate market collapse and an ensuing banking crisis have lessened significantly. No wonder the People's Bank of China (PBOC) can afford to cut the reserve requirement ratio by 25 basis points effective 27 March, against the backdrop of bank runs in the US.

Although the new team under Premier Li Qiang is likely to soften the regulatory touch somewhat, keep in mind that businesses will still have to operate within the rules.

Premier Li Qiang

Little is known about Li Qiang before his appointment as premier — his political ideology, his governance style, et cetera — due largely to his limited publicity press and interactions when he was party secretary of Shanghai, Wenzhou, and Jiangsu province. Confidence in him had been subdued after the Shanghai lockdown but soared after his post "Two Sessions" press conference on 13 March, in which he shared with the nation how he and his new cabinet would manage the economy.

It was therefore no coincidence that the business leaders whom I met with after the Two Sessions turned considerably upbeat about their country's future and business prospects, buoyed by Premier Li Qiang's plan to send "bureaucrats sitting in offices" out to consult people on the front line. They are optimistic about the intention of China's newly appointed premier to bring his down-to-earth work style in Zhejiang province to the country's new government team.

Premier Li Qiang made probably the **most profound statement** in the entire 10-day Two Sessions when he said, "I have worked in regional government for a long time, and I have since learned, **when you sit in the office, all you see is problems, but when you go to the grass roots, you will see solutions**."

"True masters can be found in the grass roots," he said, quoting a Chinese idiom.

"We must send more cadres at all levels to the front line, ask the people what they need and what solutions they have…especially young comrades who have worked in government offices for a long time, they must go deeper into the grass roots and be more down-to-earth."

Chinese business leaders now hope their new premier will focus on actions rather than words, results rather than ideology. This business-oriented Premier's Key Performance Indicator has to be economic performance, and he is well aware that private sector cooperation is key to hitting his economic KPI. Li Qiang is also a rarity among China's political leaders, who typically avoid publicly referencing their hometowns. Li Qiang bucks that trend, openly discussing his deep roots in Wenzhou, a port and industrial city in Zhejiang province that has a millennium-old reputation for being home to pragmatic, savvy businessmen who value results above all.

In contrast, his predecessor Li Keqiang, who was educated at Peking University, and former Vice Premier Liu He, who attended Renmin University as well as Harvard Kennedy School, are seen as carrying a more academic and theoretical slant to policy making.

Importantly, Premier Li Qiang has Xi's trust. They are likely to form a strong partnership. This might be a game-changer for China.

Alpha Baskets

My team and I visited 22 listed companies in seven cities. We picked companies in the semiconductor, factory automation (hardware and software), solar cells, electric vehicle components, aircraft components, AI, satellite topography, cyber security, financial services, property, and healthcare industries. Our research trip's twin objectives were the re-validation of the investment theses for a dozen portfolio stocks, and to look for new investment ideas. At this stage of China's economic development and the challenges faced in its external environment, we believe a portfolio comprising predominantly Structural Alpha stocks in the hardware and software sectors, as well as Economic Alpha stocks, should yield steady alphas. The former is borne out of our belief that China would do as stated repeatedly by government officials and as outlined in detail in the Zhejiang Plan, that is to upgrade its technology and to digitalize the nation. This point was validated again and again during our company visits.

For hardware and software technology stocks, we prefer them to be spread across a myriad of uncorrelated industries — in APS parlance, multiple alpha clusters. We supplement that with Economic Alpha stocks, which had been neglected by growth investors after two years in a bear market.

A big Structural Alpha basket we like is emerging hardware and software technology companies that have successfully caught up with their Western peers. As recently as 3-5 years ago, they were not investable as the gap was still large. Today, they are investable, and hence we have more than 50% of our portfolio in these names. On this trip, we also visited several electric vehicle component companies, including site visits. On the sidelines, I had a private dinner with the founder of a listed EV maker, hosted by our mutual friend. The colossal progress made in just 2-3 years surprised me. An auto analyst told me that the traditional Japanese and the European auto companies are unlikely to catch up, even after they make a full switch. As curiosity got the better of me, I test drove a Chinese EV model and was surprised by the quantum leap in technology and quality. Whilst we are positive on the future of China's EV industry, we are not building any position as yet, because the valuations are too high for our liking. Should we add them to the portfolio in the future, the alphas may not be found in the EV makers but in the component makers — the adjacent alphas.

After two years of a bear market, a number of attractive Economic Alpha stocks have popped up for us. We visited two under-researched leasing companies which we believe are greatly undervalued by the market despite their steady business franchise. China Mobile, our largest Economic Alpha position, is an old position which we continue to like. China Life is another name we like.

In the property market, the "three red lines" have been replaced by "three arrows" but home-buyers are still not biting. Our positive view on the back of policy support turned out to be a tad premature.

Healthcare stocks are more nuanced. Despite the short-term regulatory headwinds that have put pressure on earnings of pharmaceutical manufacturers and the like, the long-term nature of the healthcare industry remains unchanged. Healthcare remains a pillar sector for China and it will not be in the country's interest to stifle innovation in the long term. We have been focused on hospitals, as well as manufacturers of medical disposables and medical devices.

We also have a new alpha basket which we label as Covid recovery alphas. Bei Mo, Venustech, Winning, Moutai, and China Tourism Group Duty Free fall into this category. They were hit particularly hard by the lockdowns last year and should recover strongly this year.

Conclusion

One conclusion we drew from our research trip is that the worst is probably over. That said, economic recovery is likely to be slow as corporate and consumer confidence have not fully recovered. As the external environment turns increasingly uncertain and as the uneven domestic recovery picks up pace, our team of PMs and analysts will spend more time on the ground — looking for solutions and problems.

Wong Kok Hoi is the Founder and CIO of APS Asset Management. He has 42 years of investment experience, including CIO at Cititrust Japan, Senior PM at Citibank HK, and Senior Investment Officer of GIC. He was the recipient of the Monbusho Scholarship in Japan and graduated with a Bachelor of Commerce degree from the Hitotsubashi University (1981). Mr. Wong also completed the Investment Appraisal and Management Program at Harvard University (1990). Mr. Wong is a CFA charter holder.