Manulife Investment Management

Investment Note

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Targeted regulatory policies are a strain on investors' nerves and the broader Chinese equity market. In this investment note, Kai Kong Chay, Senior Portfolio Manager, Greater China Equities, provides an update on how these developments are affecting key sectors and explains why investors should identify and focus on opportunities that take advantage of policy tailwinds.

Navigating the regulatory environment for China equities

The latest pullback in China's stock market raises a question – is market volatility the old, new, or recurring "normal"? In the past few weeks, select industries and sectors have faced tighter regulatory policies, which has resulted in a sharp sell-off among certain sectors.

However, sector-focused regulatory and policy changes are not unusual for emerging markets like China. In the past, risk-off and indiscriminate sell-offs often created mispricing opportunities for long-term investors. For example, in 2018, the video gaming sector went through a major review cycle and suspended approvals of game licenses[1]. Policy-wise, the roll-out of a centralised bulk procurement program for generic drugs in late 2018 also caused a correction in pharmaceutical stocks and in the wider healthcare sector. Below are our summarised thoughts on the key recent events.

Recent events and the implications

- **Education**

Concerning the recent sell-off of after-school tutoring (AST) stocks in China[2], the key implications of the new policy released on July 24 include: 1) The mandatory conversion of K-12 (kindergarten through 12th grade) subject-tutoring firms to non-profit institutions. 2) Foreign capital investments in academic tutoring institutions are prohibited. This includes VIE structures (variable interest entity, i.e., the offshore listing structure).

The scope of the official policy released was more significant than what we and the market had expected. With limited visibility on the future earnings profile, the fundamentals of the AST sector had to be re-assessed and expectations to be reset.

Given the subsequent sector-wide sell-off, it's worth pointing out that the new policies are specific to tutorial schools. The aim being to protect the students' well-being. However, tertiary and vocational training companies have been subjected indiscriminately to a sector-wide sell-off which now present mispricing opportunities.

Indeed, tertiary education and vocational training are key areas for Chinese policy makers to enhance the skill set of its labor force, alongside the country's agenda to move up the value chain to innovation-led manufacturing and economic activities. China has set its goal of a higher education enrolment rate to reach 60% by 2025 (51% in 2019, 54% in 2020) and is making progress[3]. In 2021, the number of enrollments to Gaokao (university entry exam) reached a record high of 10.78 million with lots of unmet demand for higher education. Since 2018,

[1] SCMP, 8 August 2018, "The State Administration of Radio and Television, which is in charge of monitoring games and other entertainment content, has not given licenses to any new games since March 28".

[2] On 24 July 2021, the "Opinions on Reducing Homework Burden and After-school Tutoring Burden of Students in the Compulsory Education Stage" (aka "Double Reduction" policy) was officially released by Chinese government.

[3] Ministry of Education of the People's Republic of China, 31 March 2021. 教育部：到 2025 年，高等教育毛入学率力争提升到 60% - 中华人民共和国教育部政府门户网站 (moe.gov.cn)

regulations for commercial “for-profit” tertiary education has been revisited. The policy on operations and M&A activities for tertiary education (i.e. the Implementation Rules for the Law for Promoting Private Education) was released in May 2021 after nearly three years of consultation[4]. The objective of the regulatory revamp was to promote the development and increase supply of quality private tertiary education. As the regulatory revamp was just concluded, we do not foresee further policy announcement on the tertiary education segment while regulated M&A activities have continued since May.

- **Property management services**

Regulation notice was issued to property management services on 23 July and had triggered policy concerns[5]. The notice emphasised on tightening control regarding inappropriate activities such as failing to provide services in accordance with the standard contract and failing to disclose pricing rationale. While the controls on regulation notice are not new measures, the sector has been under pressure.

One point to remember is that property management is one of the sectors which the government intends to support under the 14th Five Year plan. As the industry consolidates, the sector is expected to grow and quality sector leaders could gain market share at the expense of smaller and unlisted peers. Our positive view on the investment opportunities in this sector is further supported by the enlarged revenue pool from community value-added services. In addition, the valuation of the high-quality companies in the sector are now more attractive after the recent sharp correction.

- **Cybersecurity and anti-trust review**

The Cyberspace Administration of China (CAC) announced a cybersecurity inspection on certain ride-hailing platforms in early July soon after the IPOs of a few concerned companies in the US. In fact, the “Measures for Cybersecurity Review” with the aim to ensure the security of critical information infrastructure and safeguard national security, has already been in effect since June 2020. Platform operators are now expected to act as gatekeepers to protect personal information.

As data security issues and privacy-related regulations have emerged in China, the regulators are keeping a watchful eye on the collection, application, and security of data, following global regulatory initiatives to protect data privacy[6]. Given its importance, we believe the current tightened regulatory environment on cybersecurity matters may stay for longer. We also expect more self-inspections, proactive rectifications and internal controls from key players. The financial implications of these measures are yet to be defined.

Regarding antitrust investigations, we’ve been seeing some positive developments after a record fine was imposed on a leading player for monopolistic practices in April. Subsequently in mid-July, most of the internet players summoned (33 in total) are reported to have signed anti-monopoly self-regulatory conventions[7] and pledged to gradually open up their platforms to promote fair competition.

Outlook

While staying mindful of regulatory headwinds, we suggest investors not to overlook policy tailwinds on certain favourable sectors that are supported by government policies. To name a few, renewable energy can bode well under the sustainability initiatives of China. Industrial automation, manufacturing upgrade and semiconductor supply chain self-sufficiency are also on the top of the Chinese government’s agenda.

- **Renewable energy supply chain**

We are positive on the renewable energy sector especially those in the supply chain of solar energy, which we see strong medium-term growth potential driven by the government’s goal to reach carbon

[4] On 14 May 2021, the People’s Republic of China (PRC) State Council announced the Implementation Rules for the Law for Promoting Private Education (“Education Sector Implementation Rules”).
[5] Ministry of Housing and Urban-Rural Development of the People’s Republic of China, 23 July 2021. 中华人民共和国住房和城乡建设部 - 住房和城乡建设部等 8 部门关于持续整治
规范房地产市场秩序的通知 (mohurd.gov.cn)
[6] The implementation of General Data Protection Regulation (GPDR) in Europe in 2018.
[7] Finance.sina.com.cn, 14 July 2021.

neutrality by 2060[8]. In fact, solar power in China has achieved grid parity and could generate sustainable returns without government subsidies. We also like growth-oriented commodities such as lithium that are used for battery production. Battery and energy storage are used not only for China's electric vehicle adoption but also in our view are critical in the wider renewable energy application context.

- **Healthcare innovation**

For companies in innovation, we have been positive on biopharmaceuticals in oncology drug development. The investment team also sees attractive opportunities in contractual research organisations (CRO) which enjoy solid demand from both local and global biotech companies. We're positive on specialised medical services providers such as assisted fertility which can benefit from China's third-child policy push.

Conclusion

Despite policy headwinds, we believe the Chinese government aims to keep its key sectors in check, but not to curb their development while encouraging innovation. Beyond the near-term volatility, we believe China's fundamental, structural growth story remains intact. As China continues to elevate its economic composition, policy makers will continue to push ahead with corporate governance and sector-specific policy reforms, ensuring growth is managed and can navigate through a sustainable trajectory.

[8] China pledges to be "carbon neutral" by 2060, Financial Times, 23 September 2020.

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