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CHINA REGULATION: FROM TECH TO EDUCATION - OUR VIEWS

1. What are your views on China education regulation (following the announcement on 24 July)

Zhikai: On Saturday 24 July, China imposed stricter regulations on China's education sector, including re-classifying tutoring companies as having "non-profit" status. The State Council officially released the Double Reduction (2R) policy. As a result, China education stocks plunged, and broader sentiment towards Chinese stocks (including large-cap internet names) took a hit.

According to this notice, the document claims that the following measures will be introduced:

1) After-school tutoring (AST) for K9 students during weekends/holidays is not allowed
2) The government will not approve new ASTs, while existing ASTs that provide academic tutoring for K9 students (students up to 14-15 years of age) should be converted to "non-profit" status
3) Listed companies will no longer be allowed to raise capital via stock markets to invest in businesses that teach curriculum subjects. Tutoring companies that teach curriculum subjects can no longer accept foreign investment, which could include capital from the offshore registered entities of Chinese firms
4) Foreign capital is not allowed to be used to buy shares in academic ASTs, not even via VIE (Variable Interest Entity, for example American Depositary Receipts (ADRs) listed in the US), mergers & acquisitions, or custodians
5) AST advertising is also banned.

David: Unlike previous regulations, this policy, if carried out based on the wording in the document, will spell the end of the AST sector. This was extremely surprising to the market and to us. Only a few days earlier, the local education bureau in Guangzhou put out a regulation guideline that was more in line with our thinking, such as tightening the licensing, ensuring high quality teaching, reinforcing some regulations on after-school programmes, etc. There were no measures as drastic as the latest announcement released by the central government on 24 July.

When defining previous regulations in this sector, the regulator systematically consulted the leading companies, allowing them to do business properly as long as they followed the government's long-term direction. The latest round of regulation is clearly pointing in another direction, mostly relating to concerns over social equality and demographics. In our view, such measures are unlikely to be effective since actual demand will likely encourage underground services such as informal one-to-one classes, and these are likely to become a more expensive and lower quality alternative. Leading players in the after-school tutoring sector may be expected to transform themselves into other businesses, if they want to keep their business afloat - e.g., day-care operators, outsourced after-school service providers for governments / schools to reach more adult students.

2. What do your investment teams see in the regulatory landscape ahead?

David & Zhikai: Education technology had emerged as one of the biggest investment plays in China in recent years.
There are uncertainties surrounding this sector, but with the new regulation, it is certain that the government is serious about reducing AST activities for K9 students, as well as regulating AST operators.

The new top priorities on the government's agenda (at least for the next six months) are:

1) Social equality
2) Demographics (low birth rate)
3) National security (China wants to make sure that Chinese data collection does not fall into the US hands).

The intensifying local regulatory scrutiny is one of the reasons for the reversal, not only in education but also in China tech-related market capitalisation. It is worth noting that the regulations the government has announced (e.g. anti-trust, fintech / capital markets, data security and social equality) are consistent with the authorities' objectives of promoting efficient, fair growth, containing systemic risks as well as preventing a disorderly expansion of capital.

Regulatory tightening is not new in China as it also occurred in 2016 and in 2018. Antitrust investigations usually lasted 11 months on average. Most importantly, this tech-related regulatory tightening is a global phenomenon and is not specific to China. For example, in the US, a number of leading US social network and e-commerce platform companies face regulatory scrutiny as well.

China's digital economy accounts for about 40% of the country's GDP. China's tech/internet sector represents about 40% of the weight of the MSCI China index, which underscores its importance to China's growth prospects at both the macroeconomic and equity market levels. These targeted companies participate in the drive towards the government's long-term objectives focused on technology, consumption and efficiency, which were highlighted as key economic priorities in the latest 14th Five-Year Plan.

In a nutshell, the Chinese government does not aim to destroy these targeted sectors as the innovative companies in them will continue to be the growth drivers of China's economy. It is thus important to remain very selective in our investment approach. After the dust has settled, some companies will have a harder time, while others will emerge stronger amid these regulatory uncertainties.

3. What other sectors could potentially be targeted by the Chinese government?

David & Zhikai: Social equality, demographics and national security will likely become the core drivers of further regulations. In particular, large internet names may be under further scrutiny (e.g., the launch of e-CNY may further undermine leading e-payment players such as Alipay and Tenpay).

It is unlikely that the tightening of property sectors will be loosened any time soon, mostly due to high debt levels, potential social unrest resulting from increasingly expensive housing as well as the ever-higher cost of raising children.

We believe that sectors closely related to gig workers (e.g. express delivery, food delivery, solo car and truck drivers) as well as companies that provide basic social infrastructure are likely to be subject to higher risks (e.g. healthcare internet platform, consumable medical device / equipment, etc.).

4. Is now the right entry point to add Chinese equity allocation or the dust has yet to settled?

David: In our view, regulation has always been part of China's economic landscape. We may use this correction to build new positions and top up our investment in high conviction names. Asset allocation is a tougher question as we rarely try to time the market.

The long-term argument remains intact, but we foresee a potential reshuffle in terms of asset allocation:

- A series of regulations had already put the market on high alert, and the latest piece of news in the education sector could almost be regarded as the last straw.
- Social equality, ageing demographics and national security will become the top priorities in the authorities' agenda and it is these that could see further government actions.
- China's recovery has peaked (albeit that it can still be sustained for longer) and the US economy is rebounding strongly.

5. How are your China equities and Asian equities portfolios positioned to weather the storm?

David: We took the hit and completely sold out our after-school tutoring positions in BNP Paribas China Equity (we were previously overweight by 70bp in this sub-sector, as of 30 June 2021). We believe that our other positions are less at risk in terms of China's key priorities (social equality, demographics and national security). Even so, we will review all our portfolio names to assess any further risks.

That being said, the overall shape of our China equity portfolio has not changed. Before the regulatory announcement, the AST weight in the portfolio was relatively small (given the overweight in AST sector by only 70bp). Furthermore, we already have an underweight exposure to the internet names in our portfolio.

After this painful transition and stricter regulations, we believe that the leaders across many sectors should probably benefit from this regulatory transition as it will become much harder for new competitors to enter. We remain focused on our pure bottom-up approach and our stock-specific high conviction names, which are in line with the long-term structural trends in China. We believe in these sustainable investment opportunities in China, particularly in the sectors that are benefiting from the three specific structural trends:

1. **Technology & innovation**: China's economic transformation and tech advancement is supported by the size of the domestic market, higher R&D spending and a vast talent pool. Innovation also goes beyond technology (hardware and software, etc.). The tech boom is not only benefiting the new economy sectors but also helping traditional industrial and manufacturing sectors. We see opportunities in the fields of capital goods, tech and industrial upgrading.

2. **Consumption upgrading**: We see significant growth opportunities for leading companies in sectors such as insurance. We see many domestic winners now emerging as multinational corporates, thanks to rising household incomes, low household debt and more diversified consumer profiles. This will likely only accelerate in the next five to ten years.

3. **Industry consolidation**: This is being driven by regulatory tightening on new capacities, environmental cost pressures, higher financing costs and the upgrading of industrial structure. Rather than just looking at revenue, companies need to focus more on R&D, productivity and costs. Those with progressive mindsets will likely increasingly pull ahead of the competition and drive consolidation. Examples include the machinery and new economy sectors.

We believe these investment themes will stand the test of time regardless of external factors such as Covid-19 or the escalation in the trade tensions between the US and China. These themes are guiding stars for our stock selections in our long-term portfolio strategy.

Zhikai: We also took the hit and sold out our after-school tutoring position completely in BNP Paribas Asia ex-Japan Equity (we were previously overweight in one position by 70bp in this sub-sector, as of 30 June 2021). We also slightly trimmed some positions in China (e.g. internet names) due to the potential policy tightening. We are reviewing all our names to assess any further risks.

The overall shape of our Asia ex-Japan equity portfolio has not changed. The portfolio is already underweight Chinese names and overweight Hong Kong, South Korea and Indonesia. Our portfolio remains largely unchanged as the Asian Equities team focuses on structural trends and strong business models and high-quality companies with low debt that can generate sustainable returns with sound or improving Environmental Social and Governance (ESG) profiles.

1. **Consumption: Turnaround & e-commerce**: In Asian consumer staples, we identify specific stocks with attractive potential (e.g., turnaround situations), as well as reliable operators with a proven multi-year ability to perform well. In China, our team favours names offering margin turnaround potential (from the restructuring of distribution and/or brand repositioning). We also target companies with a long runway of double-digit sales growth in areas such as online travel, sports and electronic appliances. That being said, we are mindful of valuations, and look for companies with earnings growth prospects in which we have a solid conviction.

2. **Technology: All about pricing power:** Since end-2020, semiconductor and component supply shortages and price hikes are impacting the supply chain. A number of companies in the global supply chain have avoided adding capacity since the start of the Sino-US trade tensions in 2018. Meanwhile, social distancing, work-from-home and 5G development have increased the demand for IT equipment and products. We expect the semiconductor industry to grow at a low-double-digit level in 2021. As a result of the demand and supply mismatch, pricing power has returned in Integrated Circuits (IC) foundries, display panels, dynamic random-access memory and passive components. In our view, a number of companies in Taiwan and South Korea should benefit from this. Our team favours companies with solid pricing power to benefit from supply tightness in these areas.

3. **Financials: Towards further consolidation**
   In 2021, Asian banks will see their debt repayment burden rise as the policy of postponing loan repayments will likely expire. Banks' non-performing loan ratios are likely to creep up but they have made major provisions in anticipation of a worst-case scenario. With their top lines rebounding from better loan growth outlook and their margins stabilising, Asian banks are well positioned to show good earnings recovery in 2021, in our view. We still favour financial companies that are well placed to continue to expand their market share and grow earnings superior to of their peers. While we are typically wary when banks quickly outpace their peers, we see a unique situation wherein the industry looks set to consolidate in favour of strong players.

6. What are your view & latest portfolio position in China Tech / ADRs in your Asian portfolio?

Zhikai: The Chinese regulators are turning their focus towards e-commerce and internet companies (with the agreement of the political leadership). This likely means that the light regulatory environment, especially for companies of a significant size and/or involved in sensitive sectors, is over. This is an uncertain period as the regulatory measures are hard to calibrate given the opaque policy goals. We believe the Chinese regulators want to rein in what was previously an under-regulated environment to prevent market abuse and improve regulatory oversight. What is clear – and unnerving for investors – is that the regulators no longer place capital raising as their top priority (e.g. Ant Financial IPO cancellation, the regulatory measures against Didi post listing). It is also clear that compliance and regulatory related costs will increase for e-commerce and internet names.

That said, we also believe that the regulators do not intend to crush these companies or impose confiscatory penalties, as illustrated by the recent fines imposed on the companies (all very manageable and in most cases (except for Alibaba) essentially token fines). These companies are at the forefront of technology adaptation, economic growth and, perhaps most importantly, the broadening of economic benefits to the masses. In our view, the regulators understand this, as it will be impossible for the state to replicate the business models and further increase economic participation without these companies. We also note that in the latest 5-year plan, technology and global expansion were emphasised as priorities for the government's development plan.

We believe that expectations also played a role in the stock price reactions as the market originally expected many tightening measures to ease after the Chinese government celebrated its 100th anniversary on 1 July. The surprise came after Didi's IPO in the US when the Chinese government actually stepped up its control after the celebration, leading to the selloff.

In our portfolio BNP Paribas Asia ex-Japan Equity, we only hold Alibaba, Tencent and Meituan.

- We cut Tencent to underweight in March (from >2% overweight at the beginning of 2021) after the regulatory issues related to Alibaba in December 2020. But we brought it back to an overweight in May when we thought most of the issues were settled and after Alibaba was fined USD 2.8 billion post the probe in April 2021. We slightly trimmed the position to neutral.
- We also took Alibaba back to an overweight after the announcement that Ant Financial was re-organising itself into a financial holding company.
- We are slightly underweight Meituan and are waiting for the results on the anti-monopoly investigation to be completed.

All three companies have said they will do whatever the government asks them to do. In the case of Alibaba, its founder Jack Ma made a speech last December that upset the authorities. However, he (and Alibaba) was later very cooperative and accepted the huge fine. Alibaba also promised to use all its profit this fiscal year to invest and help merchants to grow their businesses on the platform. Its subsidiary, Ant Financial, will restructure its business to fulfil the requirements listed by the authority. Tencent had stated in previous earnings announcements that it will use its investment gain to invest in areas including basic science, education innovation, rural revitalisation, carbon neutrality, food/energy/water provision, assisting with public emergencies, technology for senior citizens and public welfare. Meituan's founder has injected 57.3 million shares of Meituan (~USD 2 billion) into a charity fund to help those in need.

We are planning to 'watch and wait' through this turbulence and believe most of the negative news has already been priced in, although there may still be some other companies in this field that may become subject to further actions by the regulators.

7. What about the other equity investment teams at BNP Paribas AM – did they bring any changes to their Chinese allocation in their portfolios?

Pamela Woo: In our BNP Paribas Consumer Innovators fund, we had a small exposure to Chinese education stocks via a position in TAL education (18 bp as of 30 June). We have been increasingly wary of the potential for further regulation in the industry and finally exited the holding after the announcement on 24 July. One of the themes in our portfolio is the evolving role of the Millennial in China's gradual transition to a more consumer-oriented economy, so we continue to maintain exposure to the Chinese consumer, but we no longer have any exposure to the AST industry.

Pamela Hegarty: In our BNP Paribas Disruptive Technology, we slightly overweight Tencent and Alibaba which are two of the most transformative companies within the Chinese market. Similar to some of our US holdings in mega-cap platform companies, we have balanced our high conviction level in their enduring competitive advantages with increased risk as targets for regulatory oversight.

With China operating on a more centrally planned economic model, we must be constantly cognizant of potential regulatory risks on the horizon and incorporate that ever-present potential into our level of conviction and position sizing. At this stage, we are still evaluating the possibility for further downside or even an opportunity provided by market overreaction in some cases. We have no immediate plans to alter position sizes, but that may change in the near future as we continue to assess the situation. Each of these companies held in our portfolios have demonstrated strong competitive advantages leading to sustainable growth, which is aligned with the core tenets of our investment philosophy. It seems likely that harsh regulation in the case of ASTs has permanently and considerably altered the economic viability of those businesses, but the fundamental risks for large tech and e-commerce platforms are far less definitive

The above-mentioned stocks are for illustrative purpose only and does not constitute any investment advice or recommendation. Past performance is not indicative of future performance. ADRs: American Depositary Receipts.

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