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Perspective from
Franklin Templeton Emerging Markets Equity

SOCIALISM WITH CHINESE CHARACTERISTICS: UNDERSTANDING CHINA'S POLICYMAKING

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China is in the middle of a tightening regulatory cycle, which has elevated stock market volatility. These events have underscored our longstanding view on Chinese equities: it is a unique asset class that follows China's regulatory cycles more than its economic cycles, which points to the need to invest in companies on the right side of policy change.

Regulatory cycles have been a feature of China's development, and they have not impeded its phenomenal progress over the years. To a large extent, they reflect the course adjustments that officials undertook to balance economic growth with social harmony—an approach broadly characterized as "socialism with Chinese characteristics."

Government interventions are not specific to China. Many of the issues it is trying to address, ranging from social inequality to corporate monopolies, are similar to those that have drawn regulatory action in the West. What makes China different tends to be its manner of policy execution. Geopolitical tensions have added urgency to parts of its agenda.

Against this backdrop, we examine the strategic goals that have shaped China's latest regulatory moves. We also discuss our investment approach in light of the still-evolving policy environment. We highlight three main takeaways.

- China is committed to becoming a "modern socialist country" achieving quality, equitable and sustainable development. This is the underlying thread uniting its regulatory actions under these broad objectives: common prosperity, national security, an orderly expansion of capital, financial stability and environmental sustainability.
- Investors should seek companies that could benefit from policy tailwinds, while avoiding those that look vulnerable to policy headwinds. Being selective is key. Regulations can affect companies within the same industry differently, and we are rigorous about

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evaluating individual companies' alignment with China's strategic agenda. Our analysts on the ground combine top-down perspectives with bottom-up insights to piece together an extensive view of a complex investment landscape.

- Chinese equities remain investable. In our view, to steer clear of China because of regulatory concerns is to give up potentially compelling exposures to numerous fast-growing quality companies. Although regulatory scrutiny is an inherent risk, we monitor it closely and factor it into our research and portfolio management processes.

THE ROLE OF THE CHINESE STATE

Sweeping regulatory changes across China have shaken market sentiment lately. Tighter scrutiny of anti-competitive behavior, data security and gaming in the internet industry, a clampdown on for-profit after-school tutoring (AST) and curbs on property sector leverage are among actions that have heightened investors' perception of policy risks.

We have long viewed government policies as a key driver of Chinese equities given the far-reaching impact that policies can have on China's economy, industries and stock market liquidity. Measures encouraging growth or consolidation in certain industries have reshaped their lifecycles. High-end liquor (baijiu), peer-to-peer lending and gaming are examples of areas that encountered periods of slowdown in the past decade as officials took aim at unchecked growth or other perceived problems.

Put differently, we believe Chinese equities are a unique asset class that follows China's regulatory cycles more than its economic cycles. In that context, the recent policy shifts bear watching. Yet, we also see no reason for investors to avoid the asset class altogether. Regulatory cycles are not uncommon in China, nor have they derailed its remarkable progress over the years. And the country remains open for business—officials have sought to ease market concerns around their latest regulatory campaign.

Regulatory cycles largely reflect the hand of the Communist Party of China (CCP) in trying to balance economic growth with social stability. Underpinning the party's legitimacy is its pledge to raise living standards for the masses and limit inequality, embodied in its guiding philosophy "socialism with Chinese characteristics." Over the years, the party has opened up the economy, while intervening in areas that it deems out of step with its vision or detrimental to consumers, workers and other stakeholders in society. We expect this philosophy to continue directing China's development ahead.

To be sure, government interventions are not specific to China. Many of the issues it is grappling with, including social inequality, corporate monopolies and data security, resemble challenges that have sparked regulatory pushback in the West. That said, China's manner of policy implementation tends to be different. The CCP's wide control enables it to tighten its grip with a speed and decisiveness that are typically absent in most liberal democratic systems. Less-than-transparent policymaking and communication in China can sometimes unsettle markets. And in some instances in the past, nascent industries found room to experiment and grow in the absence of established regulatory frameworks, before officials stepped in with tighter rules as they felt the need arose.

LOOKING THROUGH A MODERN SOCIALIST LENS

China's recent regulatory moves are broadly consistent with its decades-long development model. But several other factors, not least the CCP's 100th anniversary this year, may have strengthened the government's resolve to tackle certain imbalances and burnish its credentials.

Having achieved its first centenary goal of making China "moderately prosperous," the CCP is now working toward its second centenary goal of building a "modern socialist country." The new ambition is evident in China's 14th Five-Year Plan (2021-2025)—a blueprint for its economic and social development in the coming years. Unlike previous plans that revealed a growth-at-all-costs mindset, the latest plan emphasizes higher-quality development that is also more equitable and sustainable, with common prosperity, environmental protection and other themes gaining prominence.

Unchanged from previous five-year plans is China's focus on innovation, technology and consumption. It remains eager to strengthen its manufacturing capabilities and achieve self-sufficiency in key technologies, especially amid supply-chain disruptions and geopolitical disputes. Boosting domestic demand is also of strategic importance as the country looks to enhance its overall economic resilience.

We see five main strategic priorities driving China's recent regulatory reset. Several motivations can combine to bring about a particular policy move.

1) **Common prosperity:** The government is keen to narrow income gaps and have more people benefit from economic growth. For several years, meeting the urban population's housing needs and containing property speculation have been on officials' radar. Housing, education and health care are widely known as the "three big mountains," where high prices have driven up living costs and crowded out other forms of consumption. Separately, measures to improve the welfare of lower-income and less-advantaged groups have affected industries such as food delivery. Recent guidelines around social security coverage for food delivery riders are an example.

2) **National security:** Wide-ranging issues linked to data protection, technology independence, national sovereignty, social stability and birth rates fall under this category. We think that US-China tensions have especially sensitized China to the importance of securing its data, technology and geographical integrity. The government's crackdown on US-listed ride-hailing group Didi Global likely centered on the company's vast holding of consumer data and fears that US regulators could access it through audits. Meanwhile, other internet platforms also possess troves of consumer data and wide influence over public opinion through social media, raising officials' concerns.

3) **Orderly expansion of capital:** The government is cautious about the aggressive expansion of certain companies within or beyond their industries, and the risks this could pose for the wider economy. In the internet industry, the rapid growth of large platforms in recent years has undergirded their strong bargaining power over merchants, scale advantages over smaller competitors and ability to burn cash to gain market share. Such trends have prompted the rollout of anti-monopoly measures and other rules to ensure the industry's sustainable growth.

4) **Financial stability:** This has been China's longstanding priority, due in part to the amount of debt in the economy. Deleveraging the real estate sector in an orderly fashion has been a focus area in the past few years, given the sector's importance to the economy and the need to avert broader systemic risks. Measures include a "three red lines" policy introduced in 2020 to limit property developers' borrowings.[1] Elsewhere, officials have stepped up their oversight of financial technology (fintech) providers as their swift rise triggered unease around their data and lending practices, consumer leverage and the potential disruption to the overall financial sector. In late 2020, regulators halted an initial public offering by Ant Group, the fintech arm of Alibaba Group.

5) **Environmental sustainability:** China's ambitious targets to reach peak carbon emissions by 2030 and carbon neutrality by 2060 are key prongs of its vision to improve its living environment. In general, we expect the government to support industries contributing to decarbonization, while tightening rules for high-emission industries.

From a broader perspective, we think that China's regulatory approach has become more principle-based rather than rule-based—it appears ready to modify its rules to accommodate its longer-term goals. The result is higher policy uncertainty, which makes it all the more crucial for investors to track the government's strategic agenda and identify companies that appear to be on the right side of policy change.

THE SEARCH FOR WINNERS AND LOSERS

Navigating China's evolving policy environment calls for rigorous research and stock selection. Importantly, regulations do not affect companies within the same industry equally. We seek to understand which businesses could benefit from policy tailwinds or grate against policy headwinds, and how the changes could affect their valuations.

Company fundamentals make a difference. Strong management teams, resilient business models and an adaptability to change stand out to us as key qualities that should cushion companies against policy uncertainty. Notwithstanding the initial share-price volatility that can hit some companies facing a regulatory squeeze, history proves that well-managed businesses can adapt and subsequently thrive.

Gaming ban reshapes industry

Between 2018 and 2019, China introduced restrictions on gaming to combat what it thought was inappropriate content, as well as rising levels of myopia and gaming addiction among the country's youth. Shares of game developers, including leading companies such as Tencent and NetEase, corrected in response.

Officials froze game license approvals for around eight months, and some games had to go through modifications before release. Tencent, for example, changed the storyline of Peacekeeper Elite from survival shooting to peacekeeping and censored blood in the game. In addition, the authorities restricted individuals under the age of 18 from playing online games between certain times and capped their spending on in-game purchases.

The licensing suspension slowed the revenue growth of the gaming industry, even though it did not affect existing game titles. Many small and medium-sized game developers struggled to generate cash without new game releases. The period, though challenging, resulted in market consolidation—Tencent and NetEase took market share from smaller studios. The subsequent lifting of the suspension enabled the gaming industry to resume growth, and Tencent's and NetEase's shares rebounded.

The industry has come under renewed pressure in recent months after China further limited gaming hours for minors. News of a delay in game approvals followed—reportedly due to stricter regulatory reviews of content and other areas. We expect the industry to weather the latest scrutiny, considering the extensive regulatory changes that had already taken place, along with companies' proactive compliance to the government's directives.

To analyze policies and relate them to individual companies require a deep understanding of China's distinct dynamics and an ear to the ground—reasons for our investment in a domestic research presence. Our local analysts, who speak the language and are embedded in the culture, are a rich source of top-down and bottom-up insights that together offer a comprehensive view of the investment landscape. We share our perspectives on select industries below.

Education

The government's overhaul of AST for school-going children demonstrates its desire to reduce the educational burden on families amidst China's slowing birth rate. This ties in with its common prosperity and national security objectives. The restrictions on for-profit activities, operating hours, foreign investments through variable interest entities (VIEs) and other areas of the AST industry have made the existing business model for most AST companies unviable or uncertain from our standpoint.

However, investors should not mistake these rules for a crackdown on the entire private education industry. The government has offered policy support for higher education providers running universities and vocational colleges as it seeks to upgrade its workforce and move its economy up the value chain.

Internet

Although the government has introduced several restrictions in the internet industry, we do not think it intends to hinder the market's overall innovation and growth. Rather, we believe it aims to foster the industry's sustainable development for the benefit of not just companies' shareholders, but also their consumers, employees and other stakeholders in the longer term.

We find most leading internet platforms are aligned with the government's pursuit of common prosperity through their significant contributions to China's economic growth, efficiency and employment level. We also see their cloud and other information infrastructures laying the foundation for China's technology development. In our view, these companies' business models remain valid. We believe that they can adjust to the new regulations and continue creating value through services that offer better user experiences and efficiencies.

Even as new rules imply higher risk premia for shares of certain internet companies, heavier cost structures and some pressure on earnings power, we consider the overall impact to be largely operational—not existential. We see no obvious alternative to the existing digital economy, and we expect the internet industry to resume its growth after the heightened regulatory scrutiny, albeit at a slower pace than before. From another point of view, the creation of a more level playing field could bring more business opportunities to small- and medium-sized internet players ahead.

Semiconductors

Notwithstanding more guardrails for the internet industry, China has continued to prioritize the development of core technologies in areas such as semiconductors and artificial intelligence (AI). US sanctions cutting off its access to high-end semiconductors have only dialed up its resolve to achieve self-sufficiency in this area, and it has pumped heavy investments into memory and logic foundries.

Spotlight on VIEs

China's ban on foreign investments in the AST industry through VIEs has raised questions around VIEs' future. These concerns have also weighed on investor sentiment toward some of the largest Chinese internet companies listed through VIEs.

VIEs offer a way for Chinese firms in certain key industries to sidestep government restrictions on direct foreign investments and raise funds overseas. Put simply, under a typical VIE structure, investors own shares in a shell company that relies on contractual arrangements to obtain economic benefits from a China-based company. The shell company does not own equity in the China-based company but relies on the contracts to gain economic interests in the latter. Although VIEs have existed for around two decades and are well-known to Chinese officials, the authorities have not explicitly recognized or denied the compliance of this structure.

We view VIE risk as primarily part of the political risk from investing in China. At this stage, VIE risk in the internet industry is not a major concern for us, given the clear alignment that we see between the industry and the government's strategic priorities of common prosperity and technology independence. On a broader level, we think that China remains open to foreign capital and has no intention to drive foreign investors away from its companies. China's securities regulator also indicated that the AST restrictions were targeted, and that the VIE structure remains important to Chinese markets.

Beyond VIEs, Chinese American depositary receipts (ADRs) have been under the spotlight. The United States recently took steps to force the delisting of Chinese companies from US stock exchanges if they fail to comply with US auditing standards and other requirements. We expect more Chinese ADRs to seek listings in other markets such as Hong Kong, as we have seen with the secondary listings of companies such as Alibaba and JD.com. Moreover, the Chinese ADR market is far from representative of the much larger Chinese equity universe.

In general, we favor local Chinese listings where they are available, and where liquidity and other conditions allow. We continue to monitor regulatory developments in these areas and incorporate them into our risk assessments.

At the same time, China is pressing ahead with the digitalization of its traditional industries using big data, AI and automation—all of which would require semiconductors. We expect growing domestic chip demand, coupled with increasing import substitution, to benefit certain local semiconductor players.

Renewable energy and electric vehicle (EV) supply chains

We see China's decarbonization push creating growth opportunities for companies participating in renewable energy production. A large part of China's carbon emissions comes from power generation, which makes the transformation of its energy mix critical. In our view, companies in the solar energy supply chain, ranging from polysilicon producers to solar module makers, could benefit.

EVs also play a part in China's decarbonization journey. EV demand has risen significantly, with the country aiming for EVs to make up 20% of new car sales by 2025.[2] We see investment opportunities in the EV supply chain, which include EV makers and producers of EV battery components such as electrolytes.

As decarbonization gains pace globally, renewable energy and EV-related companies in China are likely to see growing structural demand for their products not just domestically, but also overseas. The European Union, for example, plans to slash its carbon emissions by 55% from 1990 levels by 2030.[3]

HARNESSING INFORMATION AS AN ADVANTAGE

China's regulatory environment can be complicated to navigate, but policy uncertainties should not deter investors from Chinese equities altogether. Those who avoid the asset class are likely to miss out on potentially compelling opportunities, as we have seen in fast-growing quality companies, especially in areas linked to innovation, technology and consumption. China has also become an integral part of the broader emerging market investment universe, which makes the country all the harder to ignore.

We view regulatory uncertainty as an inherent risk when it comes to investing in China, to be carefully monitored and integrated into our research and portfolio management processes. We believe that our research-driven approach is particularly suited for China's inefficient markets, where some segments remain overlooked and offer mispricing opportunities that well-informed investors can exploit. Drawing upon policy and company insights from our analysts on the ground, as well as the combined experience of our global investment team, we have continued to find longer-term investment opportunities at valuations we consider to be attractive.

Our global research footprint has been an added strength when it comes to evaluating and advocating sustainability issues in China. As a whole, China's environmental, social and governance (ESG) practices have room to improve, even though we have seen changes head in the right direction. The government's recent push for mandatory ESG reporting, coupled with its carbon neutrality pledge, should help accelerate progress. We think that our familiarity with international ESG standards, global investor expectations and China's operating environment position us for constructive engagements with Chinese companies on sustainability. This also paves the way for potential collaborations to improve ESG practices that might not just help share prices, but also benefit other stakeholders in society.

OPPORTUNITIES THAT OUTLIVE HEADLINES

In short, Chinese equities remain investable. We believe that the market is more policy-driven than economy-driven, which makes it critical to understand which companies could be aligned with, resilient against or vulnerable to regulatory changes. As China pursues common prosperity, national security and other goals in the next leg of its growth, our experience in combining fundamental analysis with top-down views to generate high-conviction investment ideas is likely to come into play even more than before.

We can expect regulatory cycles in the future as China steers the economy toward modern socialism. Policy scrutiny could fall on different industries depending on the government's strategic priorities. This points to the ongoing need to monitor regulatory risks and incorporate them into research and portfolio management.

Investors who choose to avoid Chinese equities because of these top-down concerns potentially run a different risk—that of passing over bottom-up opportunities that we find compelling. Instead, we think investors should recognize the realities of investing in China and position their portfolios in companies that appear in line with the government's strategic goals.

Endnotes

1. In August 2020, the People's Bank of China (PBOC) and the Ministry of Housing announced new guidelines to encourage developers to deleverage. The rules set limits for three financial ratios that determine a developer's future borrowing growth rate. For developers who meet all three limits (coded green), annual borrowing growth is capped at 15%. Developers who breach all three limits (coded red) face zero growth in total borrowing.
2. Source: CNBC, "China's electric car leaders predict new energy vehicles will dominate the local market by 2030," June 15, 2021.
3. Source: BBC, "Climate change: EU to cut CO2 emissions by 55% by 2030," April 21, 2021.

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