COVENANT CAPITAL

28th July 2021

Rethinking Regulation In China

Dear Friends of Covenant Capital,

No doubt you would have read about the ongoing regulation in China and have also seen how stock prices have reacted to this in the last few days. Given the significant pullback that we have seen in both the Hong Kong & Shanghai stock markets, I thought it would be best to shed light on what is currently happening and to also share some of my views on this.

We believe that the current moves that we have seen in non-after school tuition (Non-AST) stocks are extremely driven by sentiment and we have also observed that valuation and fundamentals have overshot tremendously on the downside.

Many of you who have attended our webinars and listen to our presentation on our investment process would know that when it comes to portfolio construction for us, we often emphasize correct position sizing across these 3 factors in any portfolio:

1) % Of exposure of an individual stock
2) % Of exposure of a particular industry
3) % Of exposure at a portfolio level

This is to ensure that we don't see a huge over exposure in a particular stock or industry, something we see time and time again in client's portfolios in private banks, where there is a reoccurrence of a single particular stock in all the various structured notes or FCNs.

Before I share my views on the following topics of:

1) Why the recent regulation on the AST sector?
2) Is regulation good or bad?
3) Are we going to see regulation in other industries in China going forward?
4) Why do we still retain an allocation to large cap Chinese internet stocks?

I would like to first share our firm's views and what we have done in our various portfolios:

- We have no exposure to the AST sector.
- We have reduced our allocations to China internet stocks since March due to regulatory concerns, alongside with growth-value rotation.
- In our Global Equity Portfolio (GEP), we still retain a mid-single digit exposure in the China internet space with a focus on large cap stocks (Tencent, Alibaba, JD.com & Meituan).

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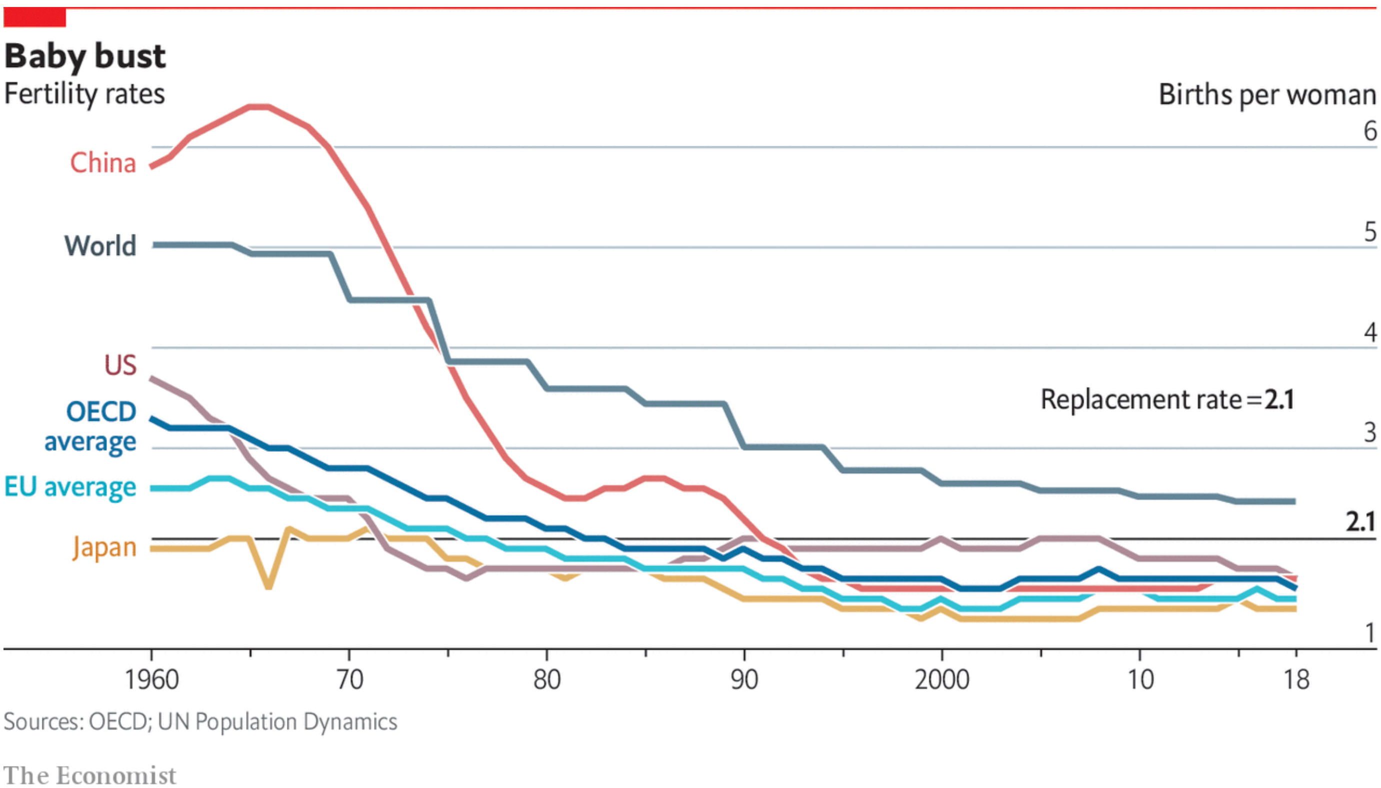
1) Why the recent regulation on the AST sector?



To answer this question, we would first have to look at the birth rates in China. As can be seen in the chart above, China have seen a significant decline in birth rates in their country. This has prompted the Chinese government to announce and introduce their 3-child policy in May 2021, all done in an effort to not only increase the birth rate in China, but also to solve some of the social and economic issues of an ageing population in the future.

So how does a declining birth rate bring about regulatory action in the AST sector? Well, this regulatory clampdown is not new, as the education sector was already in the midst of a regulatory crackdown back in 2018 with regards to fees, student space and operation hours. However, the recent regulatory clampdown we have seen over the last few days is more serious, done on the backdrop of a low and falling birthrate.

The view policymakers have is that the private education sector has played an unwelcome role in exploiting the competitive mindset of parents and have driven education costs extremely high. This has been viewed upon by policymakers as the key factor that discourages families in China from having more children.

Source: Societe Generale & The Economist

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2) Is regulation good or bad?

To determine this, perhaps we can look towards history and towards what some would say the most developed country in the world, America. America went through its own regulatory reforms when Theodore Roosevelt took office in September 1901. This was because it acquired many of the attributes common to industrial nations such as, poor working conditions, great economic disparity, and the political dominance of big business.

To address this, we saw regulations being imposed by the government of the day on the biggest industries such as the railroad industry. Increase scrutiny and regulations saw the dismantling of the Northern Securities Company, a giant railroad company created by a syndicate of wealthy industrialists and financiers. The Elkins Act of 1903 also ended the practice of railroad companies granting shipping rebates to certain companies. The rebates previously allowed big companies to ship goods for much lower rates than small companies could obtain. The Hepburn Act also brought about regulation of the shipping rates on railroads.

Coming back to China, why is regulation necessary? Similar to the American Industrial Revolution, as a country advances and experiences economic success pass a certain point, regulation have to come into play to make the economy more productive and innovative and in order to achieve that, you would need a healthy market environment, one where there is financial system stability, curtailment of monopolistic behavior, and strong data security.

The regulation that we are currently seeing isn't about suppressing the private sector, we know this because we have seen top policymakers take every opportunity to both praise and pledge more support for the private sector's tremendous contributions to the economy, job market and tech advancement. What we are currently seeing is more about clarifying the legal, regulatory and political boundaries for all companies in China. We have also observed that quite a number of the boundaries being drawn were either previously unclear or non-existent.

Regulations can also bring about benefits from an economic perspective of reallocation of financial resources. For example, as a result of the tech clampdown, the relative attractions of investment in capex-intensive sectors such as semiconductors are rising.

Source: Societe Generale & Miller Centre (University Of Virginia)

3) Are we going to see regulation in other industries in China going forward?

Three broad segments: financial de-risking, anti-trust and data security.

Each has a different agency in charge, which means a firm (Alibaba, Didi, etc.) may be investigated simultaneously but independently in different regulatory subjects.

Internet regulation: summary

	FinTech	Antitrust	Data
Main goals	Introduce more stringent capital requirements on FinTech	Protecting the market environment and small business. Also include consumer protection and workers' conditions	Eliminate misuse and misappropriation of personal information; Safeguard national cybersecurity
Example of firms being, or having been, under investigation	Ant, WeBank	Alibaba, Meituan, Didi, Ed Tech firms	Didi, Kanzhun, Full Truck Alliance
Agency in charge	PBoC	State Administration of Market Regulation (SAMR)	Cyberspace Administration of China (CAC)

Source: SG Cross Asset Research

Looking at the three broad segments and regulatory goals of policymakers, we can see that there is a possibility that there will be regulation in other industries. If we were to look at their data/cybersecurity goals, companies which engage in huge data collection such as electric vehicles and digital health companies may be susceptible to tighter scrutiny and increase regulations going forward.

The three China pure EVs makers, NIO, XPeng and Li Auto, are listed in the US . After an extremely strong recovery in June, with share prices rising between 38% and 50%, the three stocks have declined in line with the China internet sector during the month which indicates that markets are starting to price-in this risk.

Digital health stocks are currently experiencing this to a lesser extent, as they are listed in Hong Kong, however, digital health stocks (including JD Health, PingAn Health, Alibaba Health) are also vulnerable due the large amount of sensitive data that these firms are collecting, using and storing.

Source: Societe Generale

4) Why do we still retain an allocation to large cap Chinese Internet Stocks?

- They remain the leaders of their sectors including e-commerce, online entertainment, cloud technology, convenience services and delivery that are crucial to Chinese consumers and social welfare of China.
- E-commerce and online gaming are core businesses of Tencent, Alibaba and JD.com. These sectors were early victims of regulatory crackdown from the China government. Downside has mostly been factored into their earnings downgrade and valuations.
- Valuations are attractive both historically and relative to international peers.
- Tencent and Alibaba have taken actions to comply with new rules and opened their ecosystems to each other.
- Smaller cap stocks might face additional pressure as crackdown broadens to other sectors such as streaming, Fintech and car hailing...
- Earnings (EBITDA) of Alibaba and JD.com have been downgraded -15%/-25.5% respectively from peak.

In the longer term, the probability of **further regulatory shocks will decrease** as new legislation and rules are put in place and the power of regulatory agencies are strengthened.

We also foresee that the pause in the reported planned IPOs such as Bytedance in Hong Kong (the parent company of TikTok, valued at USD180bn) maybe be temporary as regulators have announced that HK IPOs would be exempt from cybersecurity reviews. In the longer term, we may see an acceleration in preference for Chinese firms to list in HK.

Stay Calm, Stay Healthy & God Bless,

Shaun Fonseca | Vice President, Relationship Manager