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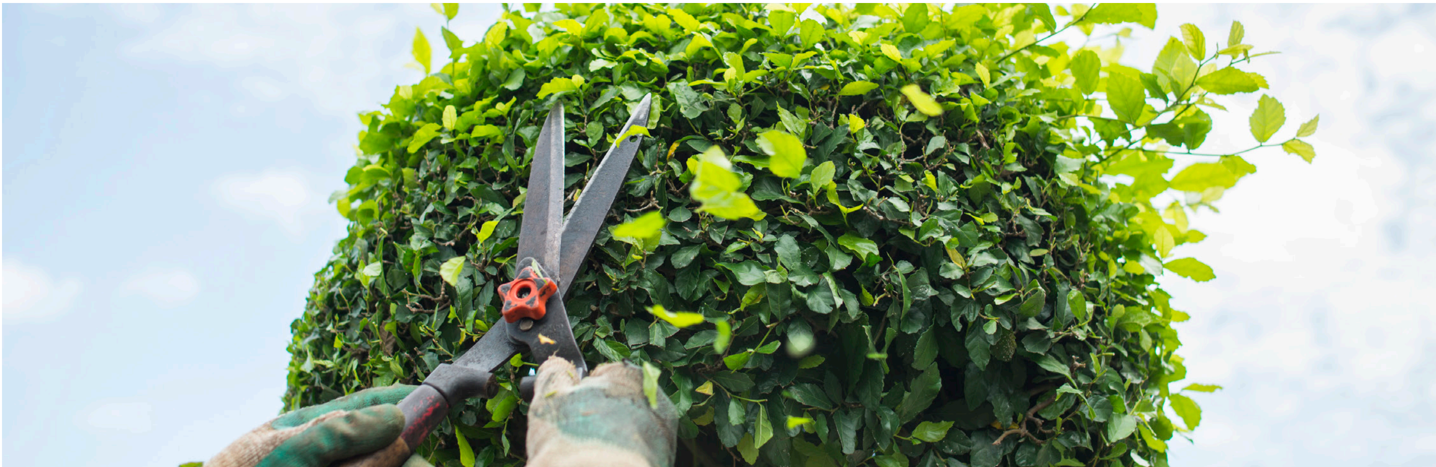

Understanding China's approach to ESG

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Policies to reduce inequality, remove monopolistic measures and improve employee welfare are positive, although the Chinese government's tools may be blunter than some. China expects the result to be more sustainable and higher quality growth which should still present attractive long-term opportunities, although understanding the government's ESG priorities will help in identifying the winners and losers.

The Chinese government rewrote the script on China's fast growing after-school tutoring industry with its latest measures to restrict grade nine (K-9) after school tutoring hours, as well as the tuition companies' capital market and dividend activities. The announcement of the "none-for profit" clause mentioned in the measures indicates that the companies are not allowed to pay out dividends but must reinvest any profits, rather than not being allowed to make any profits at all. The news wiped billions of dollars of market capitalisation from the sector's three largest education companies.

The measures aim to ensure that students are getting enough rest and looked to reduce household spending on education. If successful, these factors could potentially help reverse or slow China's declining birth rate. Importantly, there is also the desire to reduce inequality in the system. Poorer households were less able to afford these after-school sessions and seem disadvantaged in the quest for the higher grades needed to enter China's top schools.

The tighter regulations on the after-school tutoring industry follow China's increasing scrutiny on the financial and technology sectors in the last couple of months. After Alibaba's subsidiary Ant Group's IPO was cancelled in December 2020, the Chinese authorities fined the ecommerce giant a record USD2.8 bn in April for abuse of its market dominance. The authorities also ordered 34 leading Chinese tech companies to fix anti-competitive practices and ensure open ecosystems. Food delivery platforms were also not spared when President Xi recently called for greater consideration for the welfare of delivery drivers, as well as those of couriers and truck drivers.

Which sector will be next to come under the Chinese government's regulatory radar? How does one invest in a market where the regulatory risks appear higher than most? Is the Chinese equity market still investible?

Policies to reduce inequality, remove monopolistic measures and improve employee welfare are ultimately positive. Viewed from a different lens, they represent the "S" within ESG, which global investors have increasingly focused on post the COVID-19 pandemic. That said, while most developed market governments would have probably adopted a more consultative and transitory approach, the tools which the Chinese government wields are blunter and have more immediate impact. This is perhaps China's style of ESG.

We believe that the Chinese equity market remains investible although it would require a deep understanding of the Chinese government's ideology and priorities, as well as a highly active approach to investing. We wrote earlier this year, that an understanding of China's policy leanings is key to investing in its stock market, more so than other markets. China's intention to reform the after-school tutoring sector was flagged earlier in the lead up to the National People's Congress in March, although the finalised measures were probably harsher than most expected. Nevertheless, China's unique policy making process, where the strategic priorities of the government and the initiatives to implement those priorities are tabled every five years, makes it critical for investors to understand policy leanings and incorporate the potential implications into their portfolios. Experience helps, as does having research and investment teams on the ground. Having a diversified portfolio across both new and old economy stocks is also prudent.

The Chinese economy is the second largest in the world and ongoing reforms should help to drive more sustainable, higher quality growth. The Chinese equity markets will present attractive long-term opportunities for investors who have the expertise to navigate China's internal challenges and priorities, amidst lingering external tensions. For long term investors, we believe that the five themes which we identified earlier – 1) Advanced manufacturing 2) Increasing technological self-reliance and innovation 3) Raising domestic consumption (Dual Circulation Policy) 4) Boosting urbanisation and 5) Accelerating green development will have important implications for portfolios. And as the latest episode teaches us, understanding the ESG priorities that matters to the Chinese government will be key in identifying the winners and losers within these themes.

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