Brandes' View on Heightened Regulatory Risk of Chinese Companies

Over the past few months, investors have been inundated with news about regulatory tightening across various industries in China. While the risk of government intervention in Chinese companies is not new, many market participants have been taken aback by the speed and extent of the recent regulatory moves, renewing concerns about how far the government can go in exerting its influence on a company's operations. Most recently, the potential collapse of real estate developer China Evergrande Group added fuel to the fire. Chinese stocks fell 18.1% in the third quarter of 2021, representing one of the worst-performing countries within the MSCI Emerging Markets Index.[1]

Brandes' stance is one of caution—and evaluation. We are cognizant of the potential impacts of the regulations on individual companies and believe select China-based businesses remain attractive for the long term.

The Situation

What catalyzed the recent spate of regulations by the Chinese government?

In terms of timing, the second half of 2021 marks a period in which China's policymakers can afford to shift its focus from economic growth—as it is likely to be relatively strong—to the regulatory environment for its corporate sector. Through the new regulations, the government has emphasized its goal of "common prosperity" and seeks to defend the broader population's interests against big businesses, wealthy entrepreneurs, and foreign capital. The common reform objectives include the pursuit of economic and social stability, as well as the strengthening of national security.

Do the regulations mainly target large companies in specific industries?

There is definitely an element of not wanting to breed large, monopolistic businesses that are too big to fail, too big to regulate or too big to obey. That said, the regulatory tightening is not confined to just several large companies, but rather spans several industries, most prominently education and technology.

CHINA'S REGULATORY TIGHTENING: NOT AN INDISCRIMINATE CRACKDOWN

Segment	Policy Goal	Encouraged Practices	Discouraged Practices
EDUCATION	Ensure fairness & inclusiveness	Public school education, vocational training	Profit-oriented afterschool training
TECHNOLOGY	Promote corporate social responsibility	Greater responsibility for employee and consumer welfare	Monopolistic behavior with no regard for social welfare
FINTECH	Curb regulatory arbitrage and financial stability risks	Regulated & licensed business with proper oversight on data usage	Unlicensed operators with high leverage and product/credit concentration risks

Source: Morgan Stanley Research.

How about foreign investments? Will China strongly curb overseas listings to further limit foreign ownership?

There has been an increasing scrutiny—both from Chinese and U.S. regulators—over variable interest entity (VIE) structure, which has enabled many large Chinese companies to raise capital overseas while circumventing Chinese government's limitations on foreign investments.

VIE structure can pose as a double-edged sword for China: on one hand, it allows its companies to potentially benefit from foreign investments that they need to grow; on the other hand, it complicates its efforts to limit foreign involvement in sectors deemed domestically sensitive (e.g., those with national security exposure). Chinese companies listed in the U.S. under a VIE structure have also been getting more attention from U.S. regulators in the last couple of years, with an emphasis on accounting oversight.

There are two sides to the VIE risk:

1. China-led regulation: There is a risk that China bans VIEs and forces these companies to delist from U.S. exchanges. In our opinion, there is little likelihood of this happening as it would put many companies out of business and likely be extremely detrimental for the Chinese economy and capital markets. The regulatory crackdown is not about banning VIEs; instead, it focuses on data-rich companies (e.g., internet platform firms) and how to prevent them from listing overseas without being compliant with Chinese data security concerns. Longer term, China's stance appears to be that it does not want overseas-listed companies to be used by foreign governments as leverage. As such, it may increase pressure on Chinese companies, especially those that are data-rich, to list in Hong Kong or the mainland stock exchanges.
2. U.S.-led regulation: In 2020, President Trump issued executive orders sanctioning U.S.-based investors' activity in Chinese companies with Chinese military involvement. He also signed the Holding Foreign Companies Accountable (HFCA) Act to further pressure U.S.-listed Chinese companies to provide more disclosure and transparency (companies have until 2024 to work through the accounting oversight issues). In our opinion, it is unlikely that U.S. regulators will ban ADRs (American depositary receipts) completely as it will put U.S. investors at a disadvantage. Such a move won't be very effective in preventing large, viable businesses such as Alibaba from accessing capital markets either. It will just drive that access to Hong Kong or China's A-share markets.

Recently, Evergrande made headlines as it is facing a major debt crisis that can potentially push the company into bankruptcy. What is Brandes' view on the situation and the potential spillover effect?

In our view, Evergrande's situation highlights some issues plaguing the Chinese banking, real estate and insurance industries that we've been wary of for years.

Real estate development has been a key engine of China's growth and commodity demand. Over 13% of China's 2019 GDP (gross domestic product) comes from real estate investments (compared to 5% for the U.S.), with residential building representing the majority of those investments. That percentage is a lot bigger if we include the construction industry, which is naturally related to the real estate market.[2] Currently, property demand in China, especially residential, appears to be in a cyclical decline. This has resulted in financial challenges for property developers, in particular those that are highly indebted such as Evergrande.

The root of Evergrande's trouble is excessive leverage. The company has been using short-term financing and cash flows from property presales to expand land acquisition and construction activity, essentially creating a maturity mismatch between liabilities and investments. Our base-case assumption is that the Evergrande restructuring is working towards a managed default in which lenders give time for non-core assets to be monetized and projects can be completed on time. The government may have to step in to facilitate asset sales and loosen credit to homebuyers and project companies to prevent further systemic risk. However, we do not see the government relaxing their tightening stance on highly indebted property developers too much, as they still want to send a clear signal to rein in excesses in the sector. We think that the risk premium for Chinese companies, especially in sectors closely connected to property development, may need to be reassessed as a result of the latest developments.

Impact on Brandes

What is Brandes' exposure to China?

We have positions in Chinese companies in various strategies, and our holdings are diversified in terms of industry and type of ownership (i.e., private vs. state-owned enterprise). Recently, we conducted regulatory reviews on our Chinese holdings that we believe are most sensitive to regulatory risk, and took corrective measures as needed. We do not have a meaningful exposure to companies affected by U.S. sanctions.

Does Brandes have any allocation to Chinese banks or real estate businesses?

We do not have any direct exposure to banks or real estate firms in China. Our Emerging Markets Equity Strategy has long been materially underweight Chinese financials and real estate companies relative to its benchmark (MSCI Emerging Markets Index) due to our concern about the cyclical risk, which we feel had been overlooked by many, and the over-leveraged nature of many players in the sectors, as brought to the forefront by the Evergrande's situation.

How are you handling VIEs and the associated risks in Brandes' portfolios?

The ADR de-listing risk for our holdings is mitigated, in our view, by owning stocks with multiple listings (Hong Kong or A-shares). We generally prefer to own Hong Kong-listed or A shares and seek to avoid Chinese companies with only ADR listings. In our opinion, companies with only ADR listings present greater risk as they may be forced to de-list from U.S. exchanges without a fungible Hong Kong-listed security to convert into.

Outlook

How has the recent regulatory tightening affected the attractiveness of Chinese stocks going forward?

As long-term investors, we remain calm and focused, and do not think panic selling across the board is prudent. On the contrary, we believe the price correction of Chinese stocks represents an opportunity to selectively add to our China exposure. Keep in mind that over the longer term, Chinese companies have delivered attractive returns, with MSCI China returning 8.9% annually for the 10 years ended 9/30/21 vs. 6.5% for the MSCI Emerging Markets Index.[3] This being said, we remain very careful in our stock selection and the aggregate exposure to China in our Emerging Markets Equity Strategy continues to be significantly lower than that of the MSCI Emerging Markets Index (23.4% vs. 34.0% as of 9/30/21).[4]

It is not uncommon that political uncertainties contribute to heightened volatility and negative asset flows in an emerging market (for example, selloff of Russian equities in 2014 and Brazilian stocks in 2015[5]). In our experience of navigating the ups and downs of emerging markets equities, the culmination of these types of conditions can provide opportunities for a discerning, valuation-oriented investor.

[1] Source: MSCI via FactSet as of 9/30/21. Past performance is not a guarantee of future results. Please note that all indices are unmanaged and are not available for direct investment.

[2] Source: National Bureau of Economic Research Working Paper "Peak China Housing" by Rogoff, Yang; published August 2020.

[3] Source: MSCI via FactSet 9/30/11 to 9/30/21.

[4] Source: Brandes, MSCI as of 9/30/21.

[5] For the 1-yr ended 12/31/14, Russian equities within MSCI EM declined 45.9%; for the 1-yr ended 12/31/15, Brazilian equities within MSCI EM declined 41.8% (U.S. dollar terms). Source: MSCI via FactSet.

The MSCI Emerging Markets Index with net dividends captures large and mid cap representation of emerging market countries. **The MSCI China Index** with net dividends measures equity market performance in China.