RISCURA

China in April

China Newsletter

May 2021

More information?

riscura.com

Chinese corporates recorded strong Q1 results with aggregate net profit growth of over 20% compared to the same period in 2019, translating into a compound annual growth rate of over 10% in the past two years.

China in April

In April, amid a global equity rebound, US markets reached record highs on the back of dovish signals from the Fed and optimism over economies reopening thanks to the COVID-19 vaccine rollout in the US and the UK.

Chinese equities were also in positive territory, with the MSCI China and MSCI China A Onshore indices up 1.4% and 4% respectively, although they lagged behind the MSCI ACWI's 4.4%. Materials, Healthcare and companies in the electric vehicle supply chain performed the best, while Real Estate, Energy and Industrials underperformed.

The underperformance of China markets versus global markets year-to-date comes on the back of strong outperformance in 2020. Given this, as well as expectations of policy tightening and rising regulatory scrutiny for many sectors in China including internet and education, a pause is not unexpected.

After the price correction in February and March, we think the margin of safety for long-term investors has increased compared to the beginning of the year.

On the economic front, Chinese corporates recorded strong Q1 results with aggregate net profit growth of over 20% compared to the same period in 2019, translating into a compound annual growth rate of over 10% in the past two years. Retail sales growth accelerated in March from the first two months.

Some 102 million domestic tourists travelled during the Qingming "Ancestors Day" holidays in early April, equivalent to 95% of the pre-COVID-19 level.

SF Holding, a company owned by many of our managers, reported earnings missing the consensus and subsequently saw a 20% pullback in its share price. SF Holding is a delivery and logistics company operating across China.

The market was concerned about slower growth of the express delivery business due to competition, a large capex programme and the upfront costs of new business expansion.

Our manager disagrees with the market. They support SF's front-loaded investment to strengthen the company's industry leading position and they expect SF to maintain a revenue growth rate of over 25% in the coming years.

Education sector under regulatory scrutiny

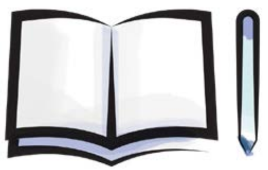
The education sector has been highly successful over recent years but is now coming under significant regulatory scrutiny. At their peaks in February this year, Tal Education, New Oriental Education ("EDU") and GSX Techedu, the three most prominent stocks in this sector, were up by 9.7x, 5.5x and 11.3x, respectively, over the last five years. However, TAL and EDU's share prices have halved and GSX's has fallen almost 90% since then.

China's State Administration for Market Regulation has several concerns. It brought greater supervision on pricing and governance some years back although there still have been numerous violations. Fines were issued, including to all of the leading providers in this sector. The government's primary concern is related to social issues such as reducing family costs and overly pressurising young students.

We have seen this story play multiple times in other sectors. Initially the share prices of the entire sector derate significantly. However, eventually, the best quality companies benefit as competition is reduced when unsustainable business practices are shut down.

We saw this in 2018 in the healthcare sector when the regulator introduced rules to clamp down on generic drug pricing. Since its bottom in 2019, Hengrui, the leading Chinese biotechnology company, has enjoyed a share price appreciation of over 70%. Most of the shareholders in TAL believe the same

We saw this in 2018 in *the healthcare sector* when the regulator introduced rules to clamp down on generic drug pricing. Since its bottom in 2019, Hengrui, the leading Chinese biotechnology company, has enjoyed a share price appreciation of over 70%.



Most of the shareholders in TAL believe the same will happen in *Education* – the industry leaders will come out of this stronger.

will happen in Education – i.e. industry leaders will come out of this stronger. Whilst better companies should focus on a curriculum and service to customers, they have struggled with pricing pressure given the fierce competition. There have been numerous Financial Times articles about how the Chinese online education sector is not sustainable given that many pay substantial sums to acquire customers. The key will be to identify the winners.

TAL is a company that is held quite widely, ranging across global managers and Chinese specialists. Interestingly, this investment opportunity was identified very early on with many global managers holding it since its Initial Public Offering. Many of the managers' children learn English at TAL. It is quite common for it to be 10% or more in portfolios.

Whilst we like managers with high conviction, performance over shorter periods can be rocky. We do not consider this problematic and have commented previously that we believe diversification across complementary fund managers with different focus areas is critical in China for this very reason. Risk of regulation, geopolitics and market sentiment brings significant volatility even to the best companies.

About RisCura

RisCura is a purpose-driven global investment firm that offers a wide-range of services across the investment industry. We offer investors unique insights and guidance to help shape the future world we all want to live in whilst still achieving and exceeding financial goals for its clients. With a focus on emerging and frontier markets, RisCura has pioneered research of investment managers in mainland China for over ten years and has helped clients to allocate over $1bn into the region.