Reflections

July 2021

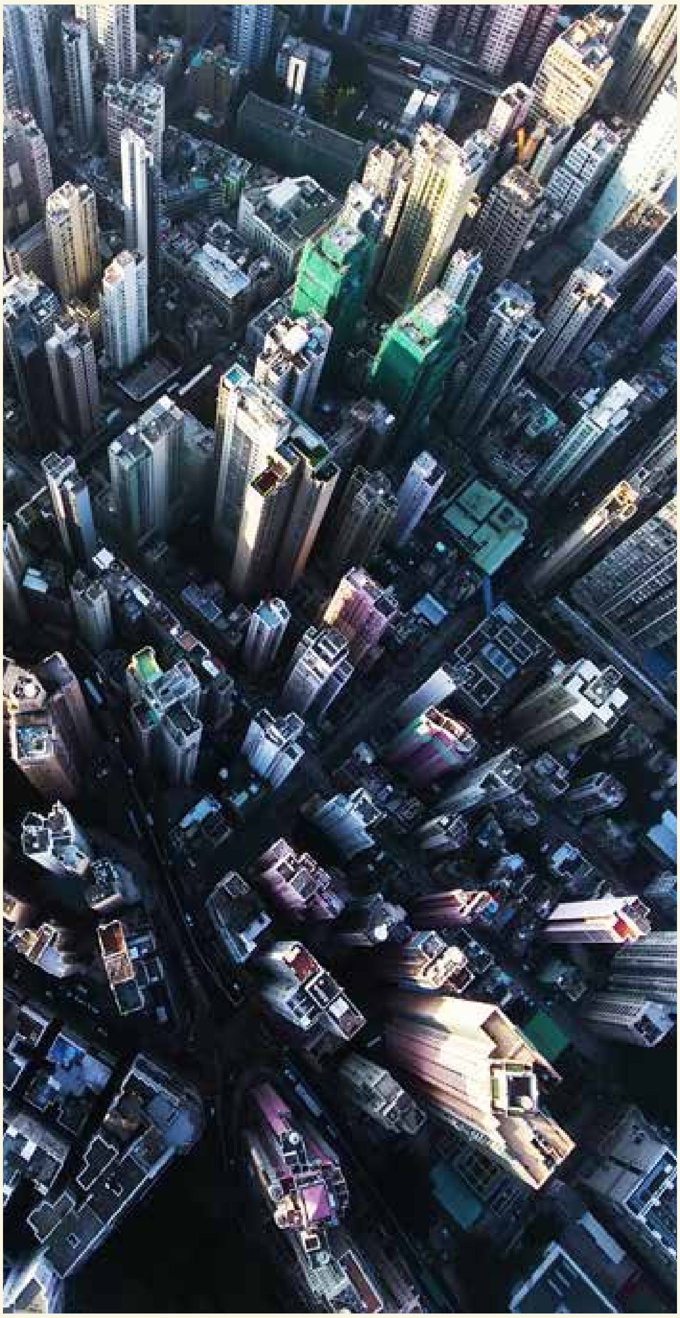
The political and regulatory backdrop in China (and elsewhere!) has always ebbed and flowed. Our approach to identifying which companies will have the best chance of transformational growth over the next five to 10 years is, as always, based on bottom-up fundamental analysis – and this remains the case even as the regulatory backdrop evolves.

Our experience in China has been that the regulatory issues are usually about the balance between societal stability on the one hand, and technological innovation for prosperity on the other. Alignment of both clearly matters to the state. At times innovation might run ahead of stability, or vice versa, so regulation is used to restore balance.

We believe it is important to draw a distinction between matters of national security, data privacy and antitrust regulations, as opposed to the politics of listing. There are both push and pull factors associated with the listing venue of choice. China wants its companies to list on domestic exchanges as this aligns with its long-term ambition to shift the balance of global liquidity and capital market traffic, while the US's hard line on audit data currently means Chinese ADRs may have a limited lifespan. This is consistent with our view of the broad direction of travel over the past few years. In the first instance we would expect to see a growing number of secondary listings from US ADRs in Hong Kong.

If Chinese companies opt to list in China rather than the ADR route, we're well positioned as a firm to manage this – thanks in part to our Hong Kong-based dealing desk, our Shanghai research office, and our experience investing in HK lines and China A Shares. Within the LTGG portfolio there are 10 Chinese names, eight of these are held as ADRs. Many have dual listing status and we are considering switching to the Hong Kong line where possible. This is a straightforward process – executing the right to have the shares exchanged – and has minimal cost. For those holdings without local listings we have engaged to ensure they are managing the situation and have plans in place.

Perhaps the more important analysis, certainly to us, is assessing whether the companies in which we invest are well positioned to navigate regulatory developments. We therefore consider how material such developments may be in the context of our investment thesis for each individual company. We have been here before with Baidu and healthcare advertising, Tencent and the gaming approval suspension and more recently with Ant Financial.



Very often we find that the companies in which we invest are in fact well-aligned with the interests of the state. Regulation of the ecommerce sector, for example, has been more focused on creating a level playing field for consumers, merchants, and employees. This probably enhances the long-term opportunity. Chinese growth is driven by small and medium-sized enterprises (SMEs) and the big platforms found within the LTGG portfolio enable these SMEs.

More recent regulation centred around education reform is perhaps something new. So why focus on this sector? The Chinese government was shocked by the recent census that showed the country was aging faster than expected. This was met with a relaxation of the one child policy. The new three child policy was greeted on social media by 'I can barely afford one child, let alone three'.

Three of the largest costs to Chinese families are education, housing and healthcare. Consequently, it is likely that these three sectors may be in the firing line to raise birth rates. The three names therefore more in focus for LTGG are TAL Education, KE Holdings and BeiGene.

Given the desire to reduce education costs there is some surprise that TAL has been affected by the regulatory drive given one of its avowed aims is to lower education costs by using technology. Our worst-case scenario based on the current proposals is that TAL's revenues and profits reset at about half of their previous levels which would be more than accounted for by the recent share price fall. We are due to meet management in early August and will be conducting a full 10Q review.

On housing, KE Holdings has been subject to rumours, but in fact this company has done more to establish industry standards in the real estate market than any other. So, despite short-term volatility, we believe the long-term outlook remains positive. Within healthcare, regulation over the past five years has been updated to encourage innovation and we don't believe regulators will change course meaning innovating companies such as BeiGene should be fine, whereas generics companies may be vulnerable to greater price controls.

We continue to monitor and engage with LTGG companies as we calibrate our probability-adjusted upside scenarios for your Chinese holdings, and we will be pleased to provide further updates in due course. In terms of tone in the team at this point though, we are quite likely to be embracing opportunities to add to holdings where their share prices have become disconnected from their fundamentals.

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