BAILLIE GIFFORD | Global Stewardship

Global Stewardship – monthly bulletin

July 2021

An update on China

Events in China have been the focus for many investors over the past month, as the state has intensified and widened its regulatory crackdown on some privately listed companies.

This is not a new phenomenon: those with long memories will recall that the search engine Baidu faced scrutiny over its marketing of healthcare products back in 2016 and Tencent's video gaming business was affected in 2019 as the government imposed limits on when children could play online. In November 2020, Ant Financial was forced to cancel its public share offering due to a last-minute intervention by the authorities, and its parent company Alibaba was further impacted by the introduction of draft anti-trust guidelines. More recently, shares in the ride-hailing company Didi Chuxing, which only debuted on the US stock exchange in June, fell sharply following an announcement that China plans to tighten its rules on companies listing overseas. And, most dramatically, the stock prices of Chinese private tutoring firms have collapsed after a suggestion that government intervention would effectively prevent such firms from making profits.

As of the end of June 2021, Global Stewardship portfolios had 6.5 per cent invested in Chinese companies (based on a representative portfolio) spread across five holdings, all technology-related: online retailers Alibaba and JD.com, gaming and social media group Tencent, food delivery service Meituan, and search engine Baidu. For the avoidance of doubt, Global Stewardship does not own the aforementioned Didi, neither does it have any exposure to the private education companies.

Although the case for holding these five firms differs company by company, it would be fair to summarise that each is an innovative, entrepreneurial business, with strong positions in fast-growing areas of a fast-growing economy. The Environmental, Social and Governance (ESG) case for each is similarly nuanced, but we are confident that all five will be beneficial for the Chinese society over the long term. For example, in a recent review of Tencent we noted the positive impact of the company's social network services in enabling efficient communications while its payments arm is helping to widen access to finance.

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But recent events require us to step back from our usual focus on stock specifics and reappraise the wider investment implications of China's regulatory clampdown. We should warn that this is a rapidly-developing issue and that we run the risk of our comments being out of date by the time they reach you. That said, our current view remains largely in line with our longer-term thinking. Essentially, we believe there is a cyclical element to Chinese regulation. After a number of years of (relative) laissez-faire, the Chinese state is now pushing back against private companies, seeking to reassert a greater level of control.

It seems reasonably clear that companies which had been perceived to be ignoring the warnings of regulators (Ant and Didi for example) have been punished as a result. This is to be expected, and we want our holdings to work with the authorities over time in order to succeed as businesses in the context of the needs of the broader Chinese society. In addition, as we have previously noted we believe that greater oversight of, and restrictions on, fast-moving technology firms should be anticipated, both in China and abroad. Moreover, this is – on balance – a positive development. For example, regulation of the Chinese ecommerce sector is focused on creating a level playing field for consumers, merchants and employees. As responsible investors it is hard to argue against such ambitions.

We could go on – for example on the geopolitical component of China's desire for more of its firms to list on domestic exchanges rather than in the US – but in the interest of brevity we should close by attempting to answer perhaps the key question for investors: will increased government intervention lead to a sustained valuation discount on Chinese stocks? In the long run, we believe the answer is no: as outlined above this is cyclical reassertion of authority. When judged on their revenues and earnings potential, our Chinese holdings remain among the best growth opportunities available to us. In the short run, however, there has clearly been an impact on share prices and hence on the portfolio's performance. We discussed this during July in our regular monthly portfolio meeting and decided to take advantage of the volatility by making small additions to Alibaba, JD.com and Meituan.

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CM16723 Global Stewardship Monthly Bulletin Jul 2021 IC 1021
Ref: 12205 10004190