Why bother investing in China?

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The investment philosophy of Ox Capital is to buy champion businesses of the future when valuations are depressed. Typically, reason for the negativity is obvious. Our job, as long-term investors, is to look past short-term disruptions, and determine if the businesses possess strong economic moat which enable them to become champion companies in the future.

From this perspective, Chinese equities are exciting for us. After a three-year bear market, Chinese equites are well-and-truly out of favour. While the Chinese economy is facing multiple headwinds, quality businesses will continue to grow and become champion businesses in coming years. Right now, it is an opportunity to invest and take advantage of the very attractive valuations.

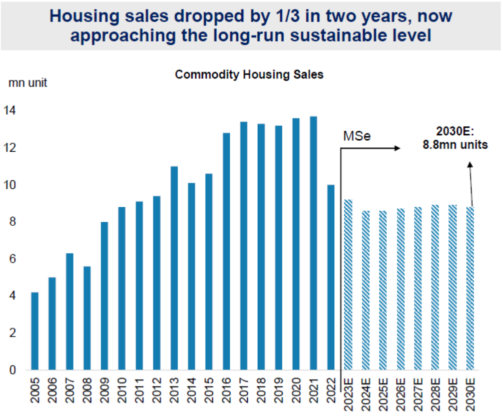
Economic headwinds are well-understood. The economy is reducing its reliance on the property sector for growth. It also has to cope with heightened geopolitical pressure and has spent the last few years purposefully reforming the economy.

In the meantime, we are focussed on strong businesses with solid positions within the country that are still enjoying long term growth. Businesses like Tencent, Tencent Music or Kuaishou, all of which have an abundance of levers to pull by virtue of its dominance in the internet to maintain decent growth rates even in a slower economy.

Let’s go through a few of the issues that has worried investors.

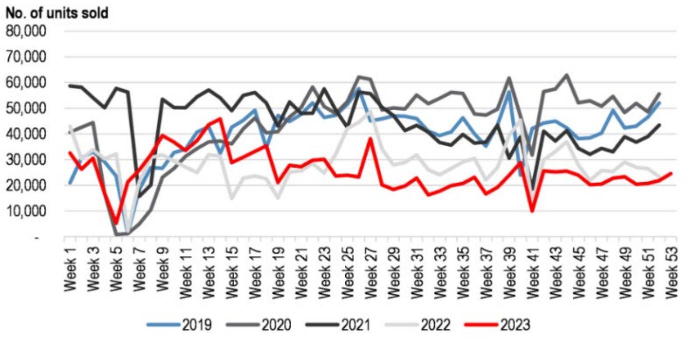
1. The Property Sector

The much talked about property downturn is in fact quite advanced. Sales volumes of new residential properties are down 35-40% from peak sales a few years ago. With loosening of property policies, sales volumes are stabilising. Going forward, given the current backdrop, further decline in volumes is going to have smaller incremental impact on economic activities. According to Morgan Stanley Research, given the significant decline in activities, property investment in China as a percentage of GDP is already lower than that of Korea, Germany, and Japan!



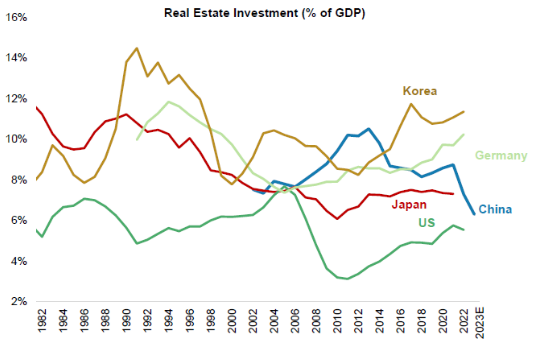
Source: NBS, Morgan Stanley Estimates

Figure 7: 60-city weekly primary sales (excluding outliers) – compared with 2019 / 2020 / 2021/ 2022



Source: CREIS

China's real estate investment/GDP ratio is one of the lowest among major economies



Source: NBS, Morgan Stanley Estimates

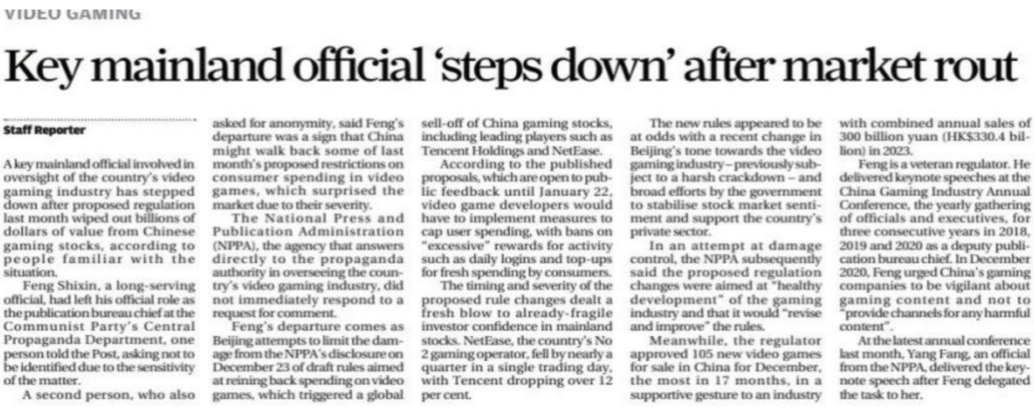
2. Hidden Local Government Debt

Another risk to the economy is the "hidden debt" of the local Governments (also known as local government funding vehicle). Estimates has it totalling USD7 trillion (around 50% of China's economy). While not a small sum, it is manageable, and the magnitude is well-understood by investors and regulators. The regulators are pursuing a combination of austerity, debt restructuring, assumption of debt by the central government and potentially money printing to tackle the problem. These initiatives should gradually work down the problem over time.

3. Government Crackdowns on Certain Private Sectors

Well-known examples of crackdown were on the after-school tuition sector and the internet sector. Firm rules were implemented to curb some of the activities that were deemed dysfunctional by the authorities.

The vibrant private sector has to shoulder the burden of economic growth under guardrails, and the Central Government has little appetite to introduce more tightening measures. The most recent episode involved a government department official having to step down after releasing a consultation paper on additional tightening measures for the video gaming industry.



VIDEO GAMING

Key mainland official 'steps down' after market rout

Staff Reporter

A key mainland official involved in oversight of the country's video gaming industry has stepped down after proposed regulation last month wiped out billions of dollars of value from Chinese gaming stocks, according to people familiar with the situation.

Feng Shixin, a long-serving official, had left his official role as the publication bureau chief at the Communist Party's Central Propaganda Department, one person told the Post, asking not to be identified due to the sensitivity of the matter.

A second person, who also asked for anonymity, said Feng's departure was a sign that China might walk back some of last month's proposed restrictions on consumer spending in video games, which surprised the market due to their severity.

The National Press and Publication Administration (NPPA), the agency that answers directly to the propaganda authority in overseeing the country's video gaming industry, did not immediately respond to a request for comment.

Feng's departure comes as Beijing attempts to limit the damage from the NPPA's disclosure on December 23 of draft rules aimed at reining back spending on video games, which triggered a global sell-off of China gaming stocks, including leading players such as Tencent Holdings and NetEase.

According to the published proposals, which are open to public feedback until January 22, video game developers would have to implement measures to cap user spending, with bans on "excessive" rewards for activity such as daily logins and top-ups for fresh spending by consumers.

The timing and severity of the proposed rule changes dealt a fresh blow to already-fragile investor confidence in mainland stocks. NetEase, the country's No 2 gaming operator, fell by nearly a quarter in a single trading day, with Tencent dropping over 12 per cent.

The new rules appeared to be at odds with a recent change in Beijing's tone towards the video gaming industry – previously subject to a harsh crackdown – and broad efforts by the government to stabilise stock market sentiment and support the country's private sector.

In an attempt at damage control, the NPPA subsequently said the proposed regulation changes were aimed at "healthy development" of the gaming industry and that it would "revise and improve" the rules.

Meanwhile, the regulator approved 105 new video games for sale in China for December, the most in 17 months, in a supportive gesture to an industry with combined annual sales of 300 billion yuan (HK$330.4 billion) in 2023.

Feng is a veteran regulator. He delivered keynote speeches at the China Gaming Industry Annual Conference, the yearly gathering of officials and executives, for three consecutive years in 2018, 2019 and 2020 as a deputy publication bureau chief. In December 2020, Feng urged China's gaming companies to be vigilant about gaming content and not to "provide channels for any harmful content".

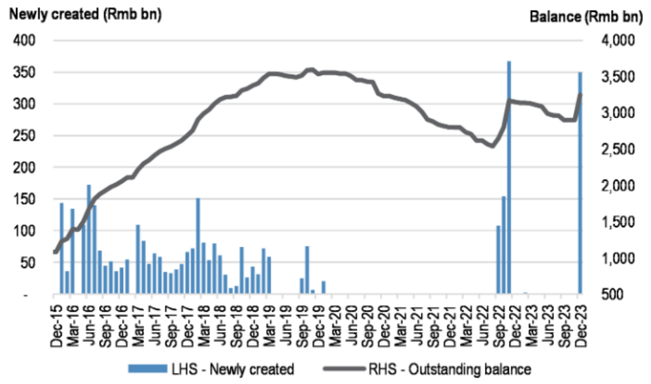
At the latest annual conference last month, Yang Fang, an official from the NPPA, delivered the keynote speech after Feng delegated the task to her.

Source: SCMP

4. Money Printing?

China's version of "money printing" is called pledged supplementary lending (PSL), and it is being tabled. If the magnitude is eventually bigger than investors' expectations, this will be a meaningful impetus for economic growth and cleaning up of the banking system.

Figure 1: China PSL outstanding balance



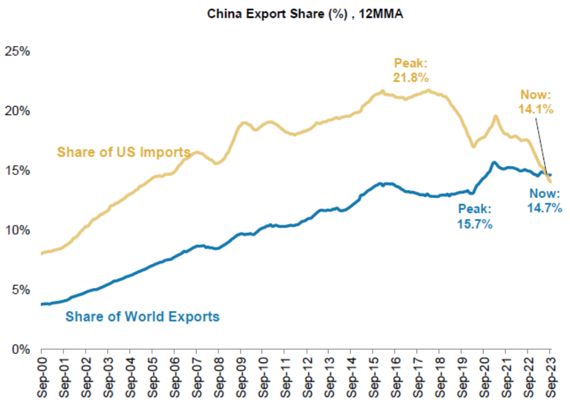
Source: Bloomberg Finance L.P., J.P. Morgan

5. Geopolitical Tension

Geopolitics tension is thawing. The meeting between President Biden and Xi shows the intention from both sides to restore bilateral relations and reducing near-term risk of escalatory confrontation. With the economy a top priority, China is adopting a pragmatic approach to dealing with geopolitical questions.

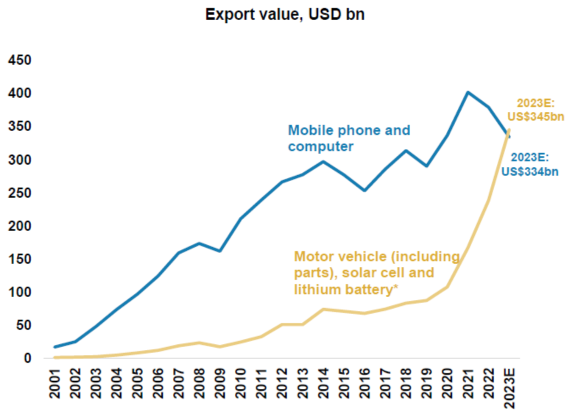
It is likely that continued technological competition will remain. Nevertheless, its manufacturing base remains second-to-none and cost-competitive, China will remain a key part of the global supply chain. New industries such as electric vehicles, renewable energy and automobile have become new drivers for export. China is diversifying exports towards the BRICS countries of the global south and remains the biggest exporter in the world.

China's global export share has remained elevated despite its declining share in the US market



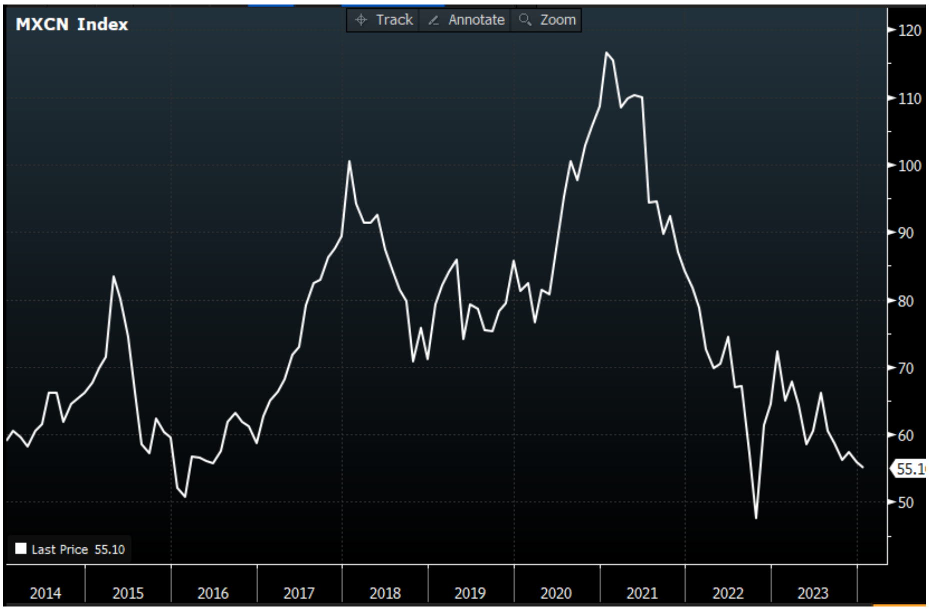
Source: NBS, Morgan Stanley Estimates

Rising competitiveness in China's green supply chain



Source: NBS, Morgan Stanley Estimates

In summary, the problems facing the Chinese economy are manageable. The bright spots are the huge domestic market that continues to grow. Indeed, real income for the consumers is growing, but with the weakness of consumer confidence, excess savings have built up. Improvement in confidence can quickly re-ignite consumer spending. Valuation has come down to a very attractive level, and it behoves long term investors to have an exposure as the economy heals itself over time.



Source: Bloomberg

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