Chinese clampdown

Lorenzo La Posta, Senior investment analyst, Momentum global investment management, London

COVER spoke to Lorenzo La Posta, Senior investment analyst, Momentum global investment management, London about the recent regulatory challenges to Chinese tech stocks.

COVER: *Can you give us some background on what is currently happening with regards to Chinese stocks?

Lorenzo La Posta: To give you a short overview, since November last year the financial regulators have been issuing newer and newer rules that touched mainly the internet and consumer sectors. Mostly, those new changes took place in the e-commerce space, online gaming, private education and ride sharing. This series of regulatory changes has spooked markets to some extent.

Up to the end of last year, the Chinese equity market had been the best performing over what has been a terrible year for financial markets. But things have changed a bit, markets have been worried about these regulatory changes and investor sentiment has fallen under pressure. If you look at the main equity indices today, you'll see that the broader China index is down 15% from its peak in February, and the technology sub sector is down 30 to 40%. But what has happened in China really?

There have been a few announcements on upcoming regulations aimed at improving matters such as clients' privacy, data sharing, anti-competitive behaviours and workers welfare, so nothing inappropriate or unusual. Actually, something that was probably overdue for a massive sectors such as the internet in China.

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To give you some detail, the online gaming industry has been regulated to force kids to stop at maximum three hours of online gaming per day, which you think sounds a lot, but there was a serious problem with kids spending entire days playing online games. In the ride sharing industry, there have been changes trying to protect the workers welfare, as we have seen in the West, with our own Uber and the likes.

So, really, China has just seen a series of regulations aimed at improving the social welfare and improving the conditions of new industries that are now play a key role in the society. But that looked bad in the investors's eyes. Regulation is not always investor friendly, obviously, because investors like high margins, investors like free markets where you can just grow unregulated. But societies don't like it, societiesy needs rules to be in a better shape.

That determined some repricing, let's say, of the bigger names in the Chinese internet and e-commerce sectors such as Alibaba, Tencent or, Meituan and it has put the entire sector under pressure and, to some extent, also the entire stock market.

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COVER: It does look like it's aimed at tech stocks. But the way that you describe it now and talk about it now, seems like it's more of a general, almost relook at making sure that the companies are on track in terms of what the strategy of the government is, with regards to workers and people's wellbeing. So it's not necessarily aimed at tech stocks as such?

Lorenzo La Posta: The latest regulation, that we have seen in the last 9-10 months, has been very specific around the internet, e-commerce, private education and online gaming sectors. Investors' sentiment was hit everywhere, simply because markets perceived it not as a regulation of a new sector, but rather as an attack to the private sector and to capitalism. It is not my position to determine which one it is really, because it is in the government's hands~~.~~, but perhaps it is a bit of both.

Yes, it is true that the regulation has mostly focused on technology and maybe it's been so because technology, or rather the internet and e-commerce, are the new sectors in China and they are highly important. They have grown massively, playing an important role for the population. So, obviously, the Chinese government is focusing on those areas for now. Regulation is not a new thing, in 2018 they cleaned up the coal and steel sector and regulated the peer-to-peer lending businesses. Regulation is a natural part of evolving societies.

But this time around, the way these things have happened, makes me think that China is pursuing not only a strong capital market, but also a strong society and its following, ultimately, the party's agenda. But China wants foreign capital, they need foreign capital to grow. So ultimately, I don't think this is an attack to the private sector itself. They don't want to break it. They don't want to disrupt it. They just want it to be different and more beneficial to their social welfare.

COVER: So it seems almost like it is just business as usual, when it comes to investing in Chinese stocks?

Lorenzo La Posta: Well, business as usual is a bit of a simplification, because the Chinese government has not been fully transparent, it has been quite opaque in their communication. So, even if this is business as usual, it is something you need to keep a close eye on. I'm not saying you should just accept increasing regulation. If anything, you should really put a lot of thought in what stocks you are buying in the Chinese market. It is my suggestion to always be very thorough whenever you think about investing. Go into details, ask the right questions and, right now, the question I'd ponder, as a Chinese equity buyer is not only "is this stock attractive from an earnings and/or valuation perspective?", but also "is this stock beneficial for the social welfare?".

Interestingly, I've read an article mentioning that the words "common prosperity" have been mentioned 65 times so far this year in official statements. That tells you a lot, that tells you the government is not just trying to push free markets, but it's trying to push a stronger society. If a company is perceived to be going against it, then it's a company that is at risk of being regulated away. Think about private education, it was a very strong market and those businesses were posting great margins, showing fantastic grow, but suddenly, the government realized that was not good for society, that was just good for investors' pockets.

Those private education businesses were putting additional costs onto families trying to raise children, they were putting additional pressure on children, and they were disrupting the state-run education system. The government didn't like it; they didn't think that was beneficial and so they stopped it. So, whenever you buy stocks, whenever you think about what sectors, what specific names to go into, just wonder if it's useful for the society or if it's just a pure, capitalistic interest that you're buying into.

COVER: Where we, as the West so to speak, have been complaining about Chinese companies not always being as well regulated as in the West, when it comes to employee relationships, and treatment, etc. Now that we are feeling the clamp down a little bit, maybe it's challenging for our thinking.

Lorenzo La Post: It was surprising, probably, but I see it as an overdue advancement in a huge equity market. They have something like 5000 listed stocks. They are a massive economy, similar to the United States. They are by far the largest middle class in the world. I read the number was something like 1.2 billion people deemed to be middle class by 2025. This is impressive and it's a huge opportunity set.

Regulation is something that might simply be needed, to make it a bit more stable, a bit more comfortable, from an external perspective as well.