China Tech Crackdown, a short-term pain for the new growth phase?

The crackdown on the China Tech sector and ongoing concerns of delisting in the US markets has caused Chinese equities to fall significantly since its February peak this year. Investors have been left confused and panicked especially as the media continues to increase coverage on the crackdown. In this article, we will share the backstory, deep-dive into the actual details of what transpired during this crackdown and, and finally our views.

Timeline of the China crackdown on tech

Late 2020 - China halted Ant Financial's IPO and started a crackdown on the tech sector. Soon, all eyes fell on the China Fintech sector as it has remained an "unchecked" sector for the longest time.

Early 2021 - The crackdown expanded to tech companies

- Alibaba was fined for unfair monopolistic practice of restricting their merchants from doing business with other platforms.

- Tencent was fined for allowing sexually exploitive content of minors. Tencent Music was fined and ordered to end its exclusive music licensing deals. Merger with the popular live streaming platform, Douyu and Huya was blocked

- JD.com, Meituan, and Pinduoduo were scrutinized on their practices of exploiting the rights of consumers and merchants

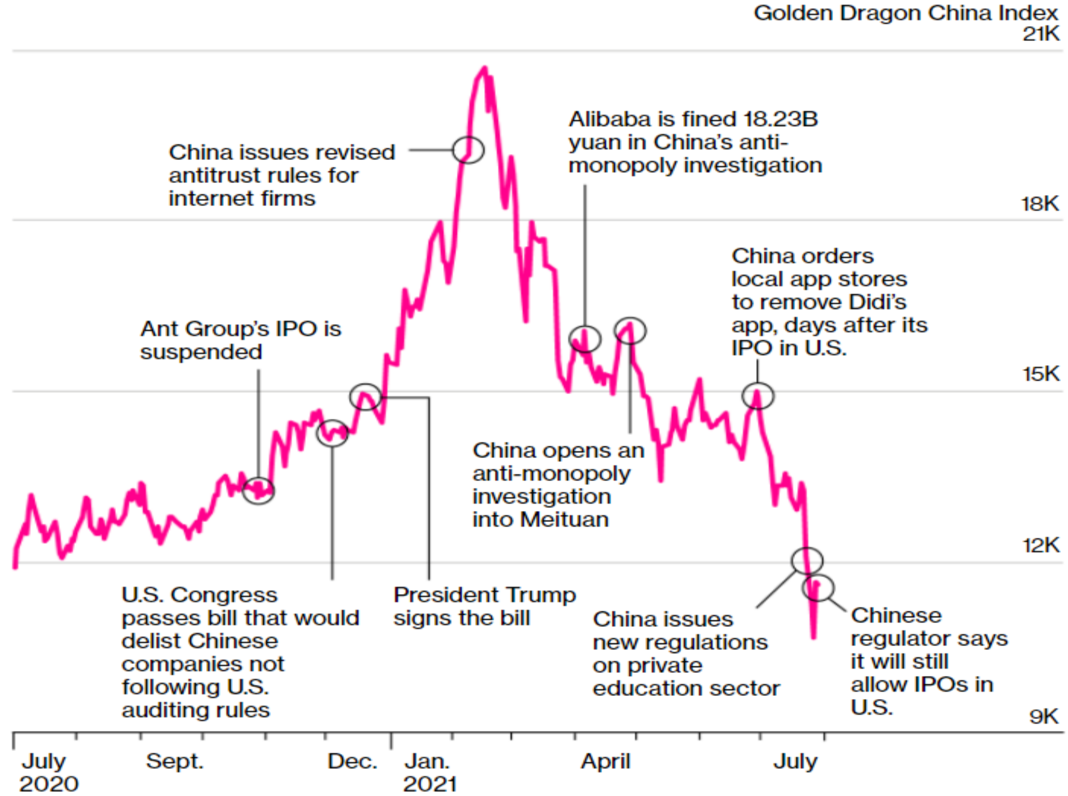
May 2021 - Local authorities in Sichuan Province halted Bitcoin mining in the region, shutting over 90% of its Bitcoin mining capacity

June 2021 - Crackdown on Didi following their IPO in NYSE. Didi's apps were suspended for illegal user data collection and violation of the data protection regulations

July 2021 - Crackdown on Edutech sector. Companies offering school curriculum courses or lessons might be made not-for-profit organisations. This is a big blow to the Chinese education business.

Tech Trauma

A crackdown from regulators has hammered China's tech stocks

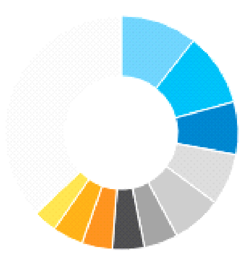


Source: NASDAQ Golden Dragon China Index via Bloomberg

The Consequence

Kraneshare CSI China Internet ETF (KWEB) which tracks overseas-listed Chinese share of internet-sector companies has fallen over 50% since the peak in February to August this year.

KWEB Top 10 Holdings [View All]



Alibaba Group Ho...	10.60%	NetEase, Inc. Spo...	4.71%
Tencent Holdings ...	10.12%	Baidu Inc Sponso...	4.44%
JD.com, Inc. Spon...	7.30%	Bilibili, Inc. Spons...	4.22%
Pinduoduo, Inc. S...	7.14%	Trip.com Group L...	4.22%
Meituan Class B	6.93%	Kuaishou Technol...	3.25%
		Total Top 10 Weig...	62.93%

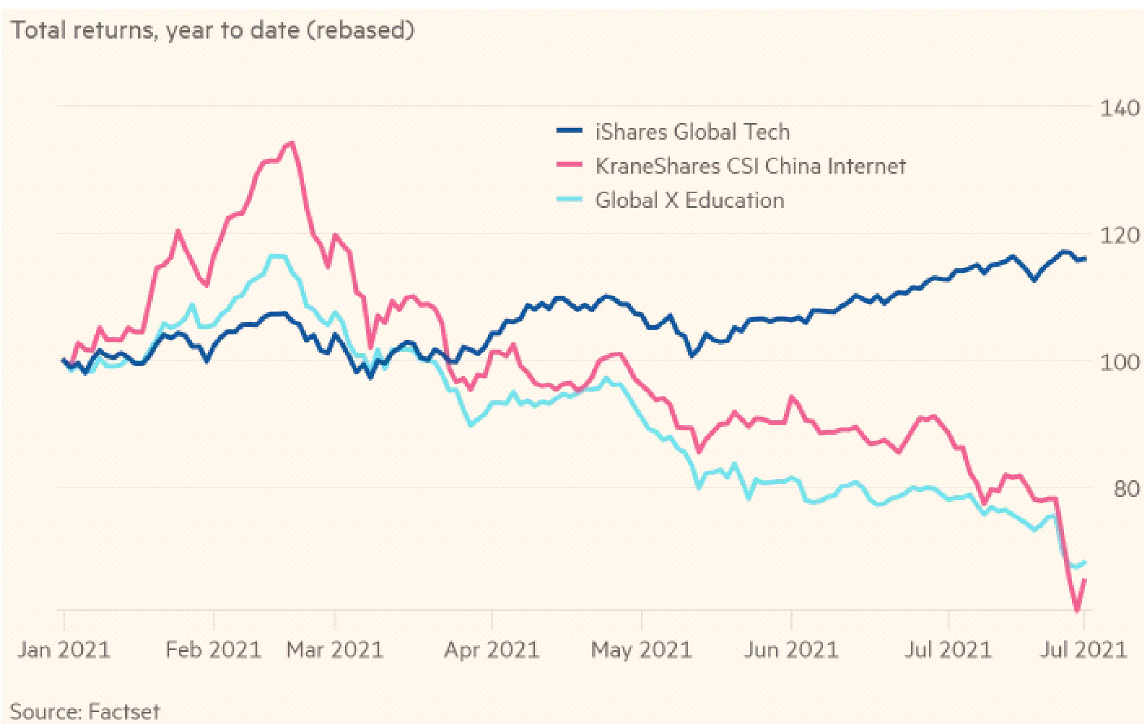
Source: https://www.etf.com/KWEB

Global X Education ETF (EDUT) tracks the global companies providing products and services facilitating education, which happens to have large exposure in the Chinese Edutech sector has fallen more than 40% since the peak in February to August this year.

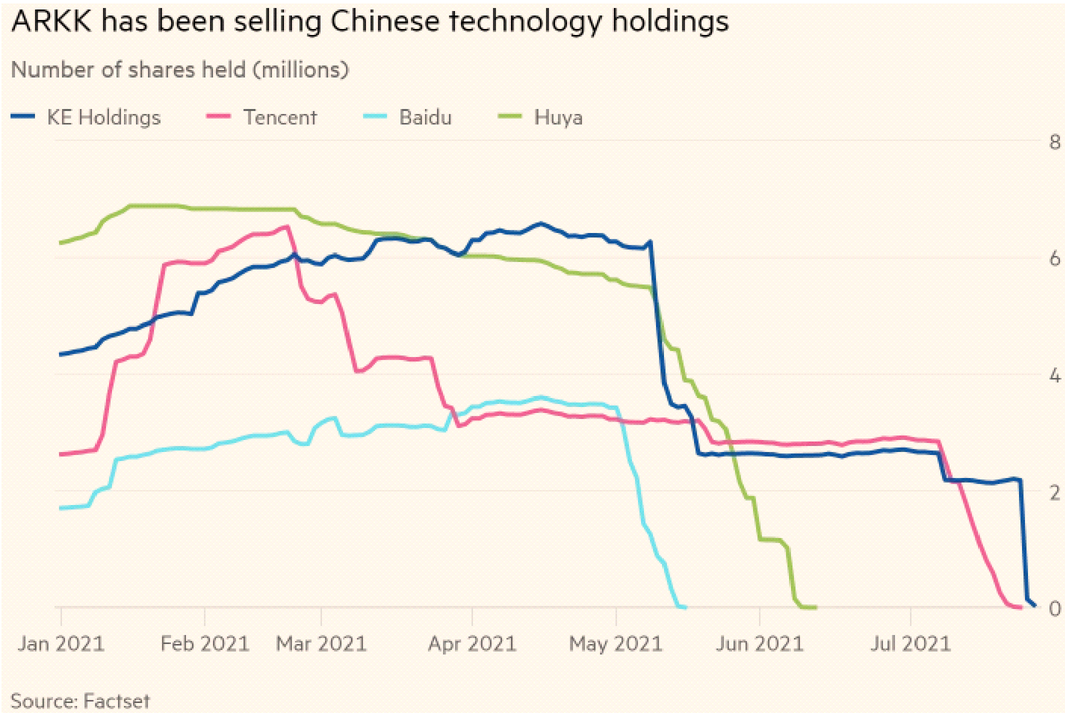
EDUT Top 10 Holdings [View All]

Chegg, Inc.	14.37%
Bright Horizons Family Solutions, Inc.	10.46%
Pearson PLC	9.98%
Zoom Video Communications, Inc. Class A	8.30%
IDP Education Ltd.	7.27%
RingCentral, Inc. Class A	5.38%
2U, Inc.	3.76%
Bandwidth Inc. Class A	3.51%
John Wiley & Sons, Inc. Class A	3.28%
8x8, Inc.	3.20%
Total Top 10 Weighting	69.51%

Source: https://www.etf.com/EDUT#fit



Actively managed ETF, Ark Invest has sold off nearly all its Chinese stocks over a period of 3 months from May to August, reducing its exposure to the lowest since inception.



Deep-diving China's tech crackdown

Before figuring out how we can turn this into an investment opportunity, it is important to understand the why.

Investing in China can be rewarding yet punishing at the same time if one does not understand the "Chinese way of doing things". In an authoritarian state, the government has more control over the private sector. The Chinese Communist Party (CCP) will always put its national interest above the private sector's growth.

China's Five-Year Plan provides a key indication for assessment on how Beijing intends to lead the Chinese economy in the next 5 years. The major themes include:

- Prioritizing the quality of growth rather than the quantity of growth
- Building China into a self-reliant technological and manufacturing powerhouse
- Accelerating the drive towards a low-carbon economy to help achieve the 2030/2060 climate goals
- Achieving "common prosperity" through new rural revitalization strategies
- Moving ahead with gradual liberalization of the business environment
- Elevating China's leadership role in regional and global economic governance
- Managing great-power rivalry with the United States

Source: https://www.hkstrategies.com/en/chinas-14th-five-year-plan-2021-2025-report/

The key focuses of the five year plan is a clear indication for businesses and investors that the CCP is more plans to place more emphasis on improving its social development while economic development takes a backseat for now.

Time to buy the dip? Or is it too early?

As there is still no indication of the regulatory crackdown, investing in the tech sector at this current juncture could result in a high risk of catching falling knives. On the flipside, the attractive valuation and rapid growth of these China Tech companies may strike as a good bargain to long-term investors. The sell-off of some tech stocks were not a result of any fundamental changes, but rather investor sentiment, which could change again in a flash. First, we must understand the short and long-term impact of the crackdown. Here are 3 fundamental factors you may want to consider if you decide to buy the dip:

1. Will policy changes cause structural change to business's model?
2. Companies' valuation
3. Companies' growth

Crackdown on Anti-Trust and unfair competition in the cyberspace

In the short term, new regulations will hurt the businesses of tech giants like Tencent, Alibaba, and Meituan Dianping. In the long term however, the regulations help to create a healthy competitive environment for smaller players, in turn driving innovation into the industry. Dominant companies have huge market share and their moat will remain wide for many years to come.

The financial health of major tech companies (Tencent, Alibaba) remains robust and our views on the adjusted valuation may suggest that the companies might be significantly undervalued.

Crackdown on violation of data collection and data security in the cyberspace

In the digital economy, data is the new oil. Protecting national data and personal data cannot be taken lightly. The short-term pain for Chinese companies to secure data and improving their cybersecurity will eventually prevent an irrevocable disaster in the future.

Didi Chuxing has the largest market share in the ride-hailing business in China and it is likely to maintain its market share for a long time. However, its ride-hailing business remains non-profitable even after so many years. Unlike Uber and Grab which have successfully created their own food delivery channel, with Meituan Dianping's widely established position in China, Didi may have difficulty branching out to food delivery.

Mandate for Edutech and private tutoring businesses to register as non-profit organisations

This is a major blow to the Edutech sector as it will completely disrupt their business model. Extra-curricular tutoring companies are also not allowed to be publicly listed. The future of the Edutech companies and private tutoring business is uncertain.

	Tencent, Alibaba	Didi Chuxing	TAL, Gaotu
Will policy changes cause structural change to business's model?	Do not cause structural change to the business model	Do not cause structural change to the business model	May cause significant structural change to business model
Companies' valuation	May be significantly undervalued after the correction	May not be significantly undervalued	Uncertain due to significant change in fundamentals of the business
Companies' growth	Have high growth potential in the digital economy	Business model may not have wide moat	Uncertain due to significant changes in fundamentals of the business

While investing in China market can be rewarding (if you have done your due diligence), regulatory risk will always remain a huge concern for investors. Therefore, is it important to ensure proper diversification into different sectors and other major economies while keeping close track of your allocation to avoid over-exposure in any one sector.

Three ways to invest in China Stocks

Direct Investment through the stock exchange

- Investing directly into China A-share through the Shanghai-Hong Kong Stock Connect with UOB Kayhian
- Invest indirectly into H-Shares as most of the China tech giants are also listed in the Hong Kong Stock Exchange
- Invest through Chinese American Depositary Receipts (ADR)* in the US Stock Exchange

ADR – Investors are not buying shares of China-based operating company but instead buying shares of a shell company issuer that maintain service agreements with the associated operating company. There might be a risk (low probability) of Chinese stocks being delisted from the US Market and the ADRs may be worth zero.

Investment through Exchange-Traded Funds (ETF)

- Passive way of investing in a basket of Chinese stocks without having to pick the stocks

  - Listed on SGX - Lion-OCBC Securities Hang Seng Tech ETF (HST) tracks the performance of the 30 largest Tech-themed companies listed in Hong Kong https://portal.iocbc.com/iwov-resources/sg/ocbc/ospl/PDF/LGI_HST_ETF_Brochure_EN_20210309.pdf

  - Listed on HKEX - CSOP Hang Seng Tech ETF (3033) tracks the performance of 30 top technology or innovative companies listed in Hong Kong https://csop.onlineminisite.com/hstech/index_en.html

  - Listed in NYSE - KraneShares CSI China Internet ETF (KWEB) tracks the performance of Chinese share of Internet-sector companies https://kraneshares.com/resources/factsheet/2021_07_31_kweb_factsheet.pdf

Investment through Unit Trust

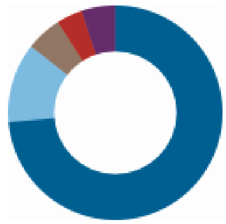
- A passive way of investing where the funds invest selectively based on their mandate and investment strategy, which aims to fulfil the stated investment objective of the fund.

  - **Fidelity China Innovation fund** invests primarily in equity securities of companies that are linked to the theme of innovation, digitization, and artificial intelligence. As of 30 Jun data, the fund has a total of 17% allocation for its top 3 holdings; Tencent, Alibaba, and Meituan. Hence, the fund fell more than 19% in the past 3 months.

Top 10 Positions (%)

Company	Sector	Fund	Index
ALIBABA GROUP HOLDING LTD	Consumer Discretionary	5.6	8.4
TENCENT HLDGS LTD	Communication Services	5.1	8.1
TAIWAN SEMICONDUCTOR MFG CO LTD	Information Technology	4.2	0.0
CIMC ENRIC HOLDINGS LTD	Industrials	3.5	0.0
WUXI APPTEC CO LTD	Health Care	3.0	0.6
MEITUAN	Consumer Discretionary	3.0	2.3
GLOBAL UNICHIP CORP	Information Technology	3.0	0.0
HUTCHISON CHINA MEDITECH LTD	Health Care	2.9	0.1
MEDIATEK INC	Information Technology	2.8	0.0
ZAI LAB LTD	Health Care	2.7	0.2

Geographic Exposure (%)



	Fund	Index
China	73.6	99.5
Taiwan	12.0	0.0
Hong Kong	5.4	0.5
Korea (South)	3.9	0.0
Cash*	5.1	

Sector Exposure (%)

	Fund	Index
Information Technology	30.9	10.0
Health Care	23.2	9.5
Consumer Discretionary	14.9	24.0
Industrials	11.5	8.7
Communication Services	7.6	11.8
Materials	3.5	6.0
Financials	3.3	14.9
Utilities	0.0	2.3
Real Estate	0.0	2.9
Consumer Staples	0.0	8.4
Energy	0.0	1.5
Cash*	5.1	

Certain unclassified items (such as non-equity investments and index futures/options) are excluded. *Cash refers to any residual cash exposure that is not invested in shares or via derivatives

Source: Fidelity China Innovation Fund - Aug 2021

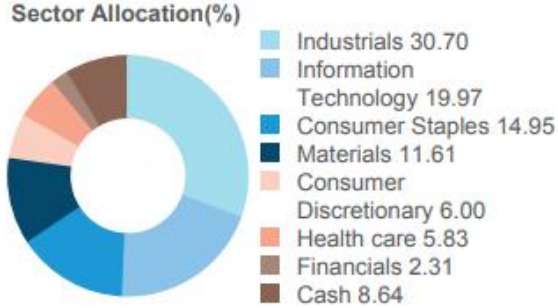
- **United China A-share Innovation Fund** invests primarily in A-Shares of companies listed in the PRC which are beneficiaries of technology, innovation and, trends. The fund performed relatively well as it has lesser exposure to the tech giants. The domestic shares also benefits from MSCI inclusion as it plans to gradually increase A-share weightings in their indices.

Top 10 Holdings(%)

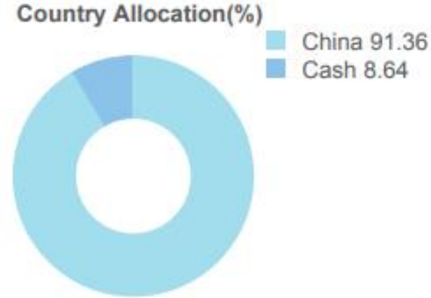
EVE ENERGY CO LTD	8.47	CONTEMPORARY AMPEREX TECHNOLOG	4.28
SHENZHEN INOVANCE TECHNOLOGY C	6.89	SHANGHAI LIANGXIN ELECTRICAL C	3.97
LONGI GREEN ENERGY TECHNOLOGY	5.80	GINLONG TECHNOLOGIES CO LTD	3.78
GUANGZHOU TINCI MATERIALS TECH	5.41	CHANGZHOU XINGYU AUTOMOTIVE LI	3.66
KWEICHOW MOUTAI CO LTD	4.53	HANGZHOU HIKVISION DIGITAL TEC	3.49

Portfolio Characteristics

Sector Allocation(%)



Country Allocation(%)



Source: United China A-share Innovation Fund - Aug 2021

- **JPMorgan China A-Share Opportunities Fund** invests primarily in China companies. The fund is diversified across 8 main sectors, providing protection to investors worried on the short-term regulatory crackdown. Its largest allocation of 19.3% is in the industrials sector which is positioned to prosper as the wider economy recovers from the coronovirus-led recession.

Holdings

TOP 10	Sector	% of assets
LONGI Green Energy Technology	Industrials	4,0
China Merchants Bank	Financials	3,7
Wuliangye Yibin	Consumer Staples	3,6
Kweichow Moutai	Consumer Staples	3,4
Ping An Insurance	Financials	2,9
CATL	Industrials	2,7
Ping An Bank	Financials	2,5
Yunnan Energy New Material	Materials	2,5
Tongwei	Industrials	2,3
Jiangsu Hengrui Medicine	Health Care	2,3

REGIONS (%)		Compared to benchmark
China	99,0	-1,0
Cash	1,0	+1,0

SECTORS (%)		Compared to benchmark
Information Technology	21,8	+8,4
Industrials	21,3	+6,4
Consumer Staples	15,3	+1,7
Health Care	13,0	+2,2
Financials	10,9	-13,6
Consumer Discretionary	9,6	+0,6
Materials	6,4	-2,4
Telecommunication Services	0,7	-1,4
Utilities	0,0	-1,8
Energy	0,0	-1,1
Cash	1,0	+1,0

Source: JPM China A-Share Opportunities Fund – Aug 2021

The onslaught began in November 2020 when the largest China's Fintech Company, Ant Group was suspended from its public listing. It is expected that the regulators will continue to implement more controls over the tech sector in line with its 14th 5-year plan, shifting away from quantitative growth-focus to quality socio-economic development. Investors should be aware that the volatility is likely to remain high in the near-term, and they should invest only if they are convinced with the long-term growth potential of China's Tech sector.

All data as of 15 August 2021