My Two Cents
Assigning Multiples to Chinese Equities

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The Artisan China Post-Venture Strategy focuses on disruptive, fast-compounding companies. Key investment themes we follow today include innovative health care, millennial consumers and opportunities for technology leapfrogging. During a recent webcast, we received many questions from investors, including how to account for unquantifiable risks in China and how to assign multiples to Chinese stocks amid recent regulatory announcements and heightened volatility. Here are some replies.

How do you account for unquantifiable risks associated with investing in China from a fundamental and valuation standpoint?

Unquantifiable risks could include factors such as environmental risks, geopolitical tensions, and economic surprises. We have seen all of these in China, just this year. Flooding in Hubei Province caused significant damage and displacement. US-China trade tensions continued to simmer, with US senators introducing legislation to further regulate ADRs. And the Delta Variant dampened consumer sentiment, while impeding both local and international travel.

In the context of the Artisan China Post-Venture Strategy, we strive to tackle these unquantifiable risks on two different fronts. The first front is through portfolio diversification. We deliberately limit our exposure to any single sector or industry to avoid sector concentration risks. We also regularly compare the inter-correlation of our portfolio holdings, looking to build a portfolio of securities with low correlations.

The second way we tackle these risks, as the question implies, is through fundamental research and an acute awareness of valuation. In our fundamental research process, we consider a worst-case or "bear-case" scenario, including scenarios that would cause a company to go out of business. Our bear-case scenarios include natural disasters, as well as any unexpected turns in geopolitics.

How do you put a multiple on a company in China when the government comes out each day with a new regulation?

Multiples tend to reflect investors' confidence levels in various market outcomes. All things being equal, higher multiples may reflect investors' belief that a positive long-term outcome is more likely. While it may seem counterintuitive, we find China's regulatory framework very helpful in our process for establishing target valuations of individual companies because the government clearly articulates and sets policies to achieve long-term goals.

In our experience, China's policymakers tend to broadcast their concerns and points of view well ahead of implementing new guidelines, so we believe it is important for active managers investing in China to thoroughly read and understand the government's publicly available consultation papers. We try to avoid companies and industries caught in regulators' crosshairs. These companies tend to be larger incumbents and/or companies that may be perceived to offer little additional gains in terms of long-term social benefits.

For the Artisan China Post-Venture Strategy, we typically focus on companies in an early stage of growth. Many companies that can be found in innovative sectors are aligned with the government's forward-looking policies. Furthermore, we may research a company for several years before we form an opinion on its long-term prospects. During those years, we consider regulatory risks and study the government's consultation papers to identify potential areas of regulatory concern.

What are the biggest risks under the new regulatory framework? And what is the difference this time vs. the regulatory environment if there is any?

There has been a high concentration of regulatory noise this year because of the transition between five-year plans. 2021 is the first year of the newest five-year plan. On a long-term view, we see a continuity of public policy. China remains focused on areas that are likely to present challenges to economic growth. These challenges include an aging population, the need to provide affordable health care at scale through a single-payer system, and the need to develop greater technology independence.

In the near term, we believe industry incumbents likely face the biggest risks under the new regulatory framework. Areas such as e-commerce are already very well developed, so policymakers may prefer to steer human capital and financial capital away from these incumbents and towards industries where innovation contributes to the social good. Industries that may potentially benefit from the regulatory framework include those that can help improve workforce productivity through software, automation, or robotics. In addition, companies focused on innovative health care therapies may stand to benefit as well.

The notion of 'common prosperity' has been extensively featured in media reports. How significant is 'common prosperity' and income inequality in China's policy framework?

According to analysis by the Paris School of Economics, the top 10% of households in China own about two-thirds of the country's wealth—roughly the same degree of economic inequality as the US. While China has genuine challenges around economic inequality, we believe the phrase 'common prosperity' may signal something broader than just income. We believe 'common prosperity' is a philosophy that attempts to include all citizens in China's social fabric, such as the ability to find work, own a home and start a family. In our view, Chinese policymakers are not trying to give everyone the same level of income; rather they are trying to give more people a better quality of life.

Do the current regulatory changes and encouragement of competition reduce the ability to find companies with moats? For example, we have seen the erosion of these moats recently with the Chinese tech giants.

There is an important difference between a competitive moat and an outright monopoly. A moat means that the company is competing to innovate, enjoys a relatively level playing field and is winning new business by offering the best products. A monopoly means that a company is unfairly squeezing other competitors out of the running. In our view, there are many companies in sectors with attractive competitive moats in China today. We like to see moats that are built out of intellectual property, superior customer service models and/or superior products. Key investment themes we are following include the millennial consumer in China, innovative health care and opportunities for technology leapfrogging.

How do you see the risks of the Chinese government nationalizing certain companies such as making Alibaba an SOE?

In our view, China is a state-run economy but does not want to be a state-owned economy. China needs innovation and capital from the private sector to achieve its long-term goals. Broadly speaking, we see the risks of the Chinese government nationalizing certain companies as low.

Were there any surprises in recent census data? What are the likely impacts of future policymaking on domestic Chinese small-cap companies and what should investors be prepared for?

China's population is currently projected to peak around the year 2030 and could potentially fall by half over the remainder of the century, according to projections by The Lancet, a medical journal. We believe that fact was already well known by policymakers. The surprise in China's latest census data was that government efforts to encourage higher birth rates had not gained traction.

China started to relax its single-child policy around 2013. By 2021, policymakers were encouraging families to have up to three children to help prevent population decline, but birth rates remain low. Encouraging families to have more children is a complex proposition. Key inputs include housing affordability, education costs, general health care costs and the cost of elder care.

As these issues relate to small companies, we believe the government continues to understand that small and medium-size businesses are China's economic backbone. While there were many regulatory announcements this year, we see the policy and market environments as being broadly supportive for small and medium-size businesses.

The government has announced more loans to small and medium-size businesses. In addition, through our bottom-up research process we continue to see organic activity on the ground that indicates small companies are finding it easier to get funding.

Given that China's birth rate is not likely to increase, how would weakening demand support innovation, in your opinion?

As China's population ages, we've seen a shift in spending patterns. Millennials, those roughly age 25 to 40, are reshaping consumption. This age group typically spends more than it saves. Especially in the younger end of this cohort, people are marrying, starting families and forming new households. Millennials may also be caring for aging parents.

Broadly speaking, we believe consumers are looking for solutions that help improve time management and ease the burdens of managing the household. We also see that Chinese millennials often favor domestic brands and prefer companies that understand local needs. Declining birth rates also means a reduction in the labor force. We think this trend will spur innovation in areas such as robotics, warehouse automation and work productivity software.

Turning to semiconductors, what is your opinion about high valuations vs future potential growth? Are we due for a correction once the global semiconductor shortage begins to ease?

Semiconductors have historically been thought of as a cyclical sector, along with commodities such as oil, natural gas and coal. With cyclical sectors, we see that when there is too much supply, the market tends to correct for a couple of months. With the growth of a digital economy globally, we believe that the market for semiconductors is becoming less cyclical and more structural. In our view, we are slowly beginning to see more long-term investors come into the mix and smooth out some of the dips in the market.

Because of this shift from cyclical to structural, we believe investors cannot use historical methods of valuation. When there is a shift in the pattern of growth, there also needs to be a corresponding shift in the valuation. We are still at the beginning stages of the transition from cyclical to structural. Over the long run, we expect that valuations for semiconductor companies may be able to re-rate at a higher level, enjoying more stable growth and higher multiples. China currently imports around 80% of its semiconductors, so its semiconductor industry can experience growth on several different fronts.

One aspect that we like about the semiconductor industry is that it has very long supply chains, multiplying the opportunities for growth. We are particularly interested in companies that are helping to develop next-generation semiconductor materials, as well as fabless integrated circuit design companies. Almost everywhere we look in the Chinese economy, there is significant demand for semiconductors. This includes electric vehicles, 5G mobile network, consumer electronics and industrials.

Will the proposed Beijing stock exchange expand investment opportunities for foreign investors? How will it fit in with the two existing onshore exchanges in Shanghai and Shenzhen?

As the overall size of China's domestic stock market grows, so will access for foreign investors. The planned Beijing exchange is meant for small and medium enterprises. Many of these have historically traded on the over-the-counter boards, where liquidity is very low. The new exchange should provide greater liquidity for small and medium businesses. The Shanghai and Shenzhen exchanges are often very focused on health care and technology companies. We expect the new Beijing exchange to be broader and more balanced in its sector exposure.

China welcomes foreign investors and needs global capital to spur additional growth and development. The opening of China's capital markets to foreign investors has been gradual and we expect it will continue to progress at a thoughtful, measured pace. To gain access to China's financial markets, foreign investors typically need to work with an asset manager that has a license to trade local securities. This license is known as a qualified foreign institutional investor, or QFII, license. Artisan Partners has a QFII license and continues to expand its on-the-ground presence in Asia.

Are Chinese ADRs investable?

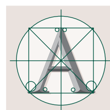
We expect that ADRs will go through a period of increased disclosure requirements, as well as a period of valuation discovery from foreign investors. We think the ADRs are investable, but we also expect some additional headline risk in the coming years. We expect that more Chinese companies may continue to come to the US market over time, but there has been a slowdown more recently due to regulatory scrutiny. Many companies that currently issue ADRs through the NYSE have also sought to diversify their listing exposure by also listing through the HKEX.

Where do you see opportunities in China's equity markets?

China today is facing some significant long-term challenges, including an aging population, growing health care demands and the need to develop technology independence. Policymakers need to steer both human capital and financial capital toward private-sector businesses

that can help address these large, unmet needs in the marketplace. With regard to China's aging population, we closely observe the habits and preferences of millennial consumers, who are now the driving force for spending. Millennials may be more interested in spending money on experiences, such as dining in restaurants and creating memories with family and friends, rather than accumulating more possessions. In terms of innovative health care, we are researching and investing in companies that provide next-generation therapies, including areas such as oncology, heart disease and metabolic diseases. Turning to opportunities for technology leapfrogging, key themes we seek to capture in our portfolio construction include semiconductors, software and hardware and clean energy.

China's equity markets are often volatile over the short-term, but we believe that volatility may create opportunities for active managers with regional expertise. Investing with a long-term view, we are typically looking for companies that can fund their own growth and ride out any short-term bumps in the markets. China's economic growth is more of a marathon than a sprint. When we think about a marathon runner, she may occasionally need to stop for water. There will be disruptions along the way. But there are many drivers of economic growth in China. Our focus remains on innovative industries, which we believe are likely to become much bigger over time. With an emphasis on early-stage public and late-stage private equities, we seek to foster the next generation of global innovators based in China.



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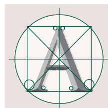
A R T I S A N  P A R T N E R S