MY TWO CENTS

Regulatory Risks in China: Sorting Signal From Noise

PORTFOLIO MANAGER

Viewpoints

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Regulation of Chinese companies is here to stay. Although increased regulation may add to near-term volatility in equities, it will likely be a long-term net positive for investors. In part, a more robust regulatory framework simply reflects China's maturing markets. While this is capitalism with Chinese characteristics—China is obviously still a communist state—the country embraces capitalism to drive innovation and improve productivity. Successful companies are expected to give back to society, and Chinese regulators are expected to remind companies of that social contract.

With a bullish view on innovative small companies in China, I take regulatory risks very seriously. However, by considering regulatory trends across China through a more balanced lens, I find it easier to parse the signal from the noise within China's financial markets. I believe regulatory risk is another reason active security selection remains key—investment managers can strive to find companies outside of regulatory crossfire through a comprehensive and thoughtful due diligence process.

Regulatory Risks Outweigh Macro Risks in China

Regulatory risks matter more to equity investment in China than macro risks. China's policymakers have enough monetary and fiscal policy tools in their arsenal to help smooth out any blips in their economic cycles. Accordingly, I maintain a sharp focus on identifying and avoiding regulatory risks via a consistent and disciplined investment framework and process. In my experience, smaller companies tend to be more vigilant about risks, as regulatory fines and penalties have the potential to put a small company out of business. Spending time with up-and-coming entrepreneurs generates helpful insights, particularly when it comes to regulatory risks. With a more sensitive compass at hand for spotting regulatory risks, my research team and I seek companies that may benefit, rather than be harmed, by regulatory trends. Smaller companies, especially those in newer industries that are helping to solve China's relevant problems, are more likely to have constructive, collaborative relationships with regulators.

In the Headlines: Antitrust, Data Privacy and VIE's

Antitrust regulation in China seeks to create a more level playing field for businesses, which ultimately helps to promote market growth and healthy competition. Areas facing increased regulation include education, fintech and transportation services. Parts of e-commerce, particularly large e-commerce platforms with significant market share, have also captured the attention of regulators. Our universe of small- and mid-cap companies tends to have less

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regulatory scrutiny because companies of that size are not yet perceived to have monopolistic power. Chinese regulators are likely to conduct an ongoing review across all sectors of the economy over time to break up monopolies. These regulatory reviews are designed to foster the next generation of innovation.

Turning to data privacy, Chinese regulators are paying more attention to companies listing abroad. This risk was triggered in recent months by top-down factors (most notably, geopolitical tensions between the US and China) as well as bottom-up challenges (such as Chinese companies who did not get the full blessing of regulators before initiating their foreign listings). The benefit of this review is to help the newer generation of China's Internet users protect their data online. Regulators update data privacy guardrails as needed to ensure that consumers don't fall into predatory practices of companies that may have a data advantage. Data privacy reviews may have a short-term impact on fundraising for Chinese companies, delaying their ability to become publicly listed. However, our fundamental belief is that great companies will find capital, even it if takes a little longer than initially planned. The Artisan China Post-Venture Strategy has the capacity to invest in great companies onshore, offshore, in public markets and in private markets.

Another topic making news headlines are VIEs (Variable Interest Entities). I see any potential regulatory risks among VIEs as company- and industry-specific, rather than related to the investment structure itself. The VIE structure, which allows Chinese companies to list on both domestic and foreign exchanges, has been around for decades. At the end of the second quarter of 2021, VIEs accounted for all Chinese ADRs in the MSCI China Index, as well as a healthy portion of the Hong Kong-listed H shares within the index. Headlines and speculation around VIEs flare every couple of years, but I don't foresee any immediate changes to the VIE structure itself.

Capital Efficiency: The Superpower of Small Companies

Small companies are used to sudden disruptions in capital flows. Accordingly, the most successful small companies in China are very capital efficient and can navigate short-term funding gaps by optimizing internal resources quickly. Because small companies never know where the next round of funding might come from, they tend to take a nimble approach to navigating delays in fundraising and public listings. After two decades of investing in China, I've learned the importance of finding companies with strong balance sheets that can fund their own growth until the next stage in their development.

Small companies have the potential to shine amid periods of market volatility because they generally have the best experience at doing the most with less capital. In our current environment, it could take longer for private companies to go public, but I am very confident in our portfolio companies because they tend to have healthy balance sheets. In the near term, Chinese regulators will take more time to review foreign listings across areas of focus, including data security. Over the long term, Chinese companies are likely to come back to the US market when the conditions are right.

The Role of Due Diligence and Active Management

Through our active approach to security selection, we seek to avoid companies that may be harmed by regulatory risk. Small companies need to be very forward-looking in terms of upcoming regulations to survive and grow. Accordingly, I look for companies that have embedded these potential risks into their product and service planning processes. Our longstanding relationships with small company management teams is a proprietary source of alpha for the Artisan China Post-Venture Strategy.

Small companies in China have the potential to provide investors with attractive, noncorrelated returns, which are increasingly hard to come by in an interconnected world. I believe it takes specialized on-the-ground fundamental due diligence to fully vet small companies in China's fast-paced, highly dynamic economy. By looking for companies tackling and solving big problems for China's enormous middle class, our research team seeks companies with the potential to become the large-caps of tomorrow.

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