

Reform with Chinese characteristics

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This week marks 35 years since a key moment in the history of modern China, the Tiananmen Square incident in Beijing. Following the death of ousted Chinese Communist Party (CCP) secretary Hu Yaobang in April of 1989, large-scale protests, initially led by university students, called for democratic, social, and economic reforms. After declaring martial law in May, events culminated on the evening of 3 June, as military forces advanced into Tiananmen Square, ending in a devastating loss of civilian lives. The event was poignantly captured through the image of a lone demonstrator who stood facing oncoming tanks as they rolled into the Square.

The events of Tiananmen Square saw economic reform stagnate as the CCP looked to cement its political authority across China, however, progress reignited in 1992 when China's then-leader Deng Xiaoping toured the country's special economic zones, which had been created in the early 1980s as part of the CCP's economic reforms. What followed was a significant downsizing in the role that China's state-owned enterprises (SOE) played in the economy, which in turn unleashed a previously state-owned workforce into private entrepreneurship, driving economic growth. The State-owned Assets Supervision and Administration Commission of the State Council (SASAC) was established in 2003 to oversee SOEs, acting as a mechanism for the CCP to allocate state capital and today it is one of the largest economic entities in the world.

While SOE reform is not a new phenomenon, changes appear to have gathered pace over the last 18 months, beginning with the 'Three-Year Action Plan' in November 2022, which set out a strategy to improve corporate governance and communications. Revised key performance indicators for central SOEs were introduced by SASAC in March last year, including a focus on return on equity and cash flow generation. With over 200 million Chinese retail investors investing in domestic equities, the CCP is acutely aware that improved financial performance for listed SOEs is not only beneficial to the state (through increased distributions) but also essential to keeping the country's emerging middle-class content, particularly in light of the ailing property market which has become less attractive as a vehicle for wealth creation.

A number of policy directives have also been introduced by regulators this year, partially in response to the heightened market volatility across Chinese equity markets. In March, the China Securities Regulatory Commission outlined the 315 Policy series, which encouraged listed companies to raise dividend payout ratios and create share buyback policies. This led to the Shenzhen and Shanghai stock exchanges amending listing rules in April, designating those listed companies that failed to meet payout and buyback requirements as 'Special Treatment' stocks. Finally, a '9 Point Guideline' by the State Council was also introduced in April, which strengthens regulations to improve investor protection, along with further warnings to those companies with no or low dividend payouts.

All of the above are positive developments for investors in China, but selectivity is key. Under the tenure of Xi Jinping, market-led reform is making way for state-driven policy, with this reversal perhaps most widely reported in Western media through the fallout across the technology and private education spaces. Even for listed state-linked enterprises, preference is given to those aligned with local and central government. This can include access to cheaper financing and favoured subsidy allocation. Those SOEs operating within economic and socially important segments that are implementing sensible strategies to improve financial performance are seeing increased interest from active fund managers that we speak to as part of our fund research efforts.

Central SOE and SOE linked companies have often been viewed as un-investable by many institutional asset managers. The tide of negativity towards Chinese equities may be beginning to turn, and SOEs find themselves in a sweet spot amongst a market which has been very out of favour over the last two years. Clouds certainly remain, not least in today's geopolitical landscape and China's relationship with the West. However, a combination of low valuations, improved profitability and a focus on shareholder returns are often the ingredients for an attractive investment opportunity.



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