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ALTERNATIVE THINKING ABOUT INVESTMENTS

New China Perspectives

Welcome to the latest issue of Morgan Creek's ***New China Perspectives****. This issue is comprised of research from Morgan Creek's China-based investment team together with curated articles of interest. In addition to timely political and economic news covering greater China, Morgan Creek's China team seeks to provide in-depth perspectives on investing in the technology, consumer and healthcare sectors in the region. Our research leverages the "on the ground" insights of our team together with Morgan Creek's decades-long experience in covering the region. To learn more about our team and investment offerings, please email chinateam@morgancreekcap.com.*

Best Regards,

Mark W. Yusko

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NOTES FROM THE BUND[1]

This is the second installment of our newsletter discussing the education crackdown which happened in China in 2021. In our prior newsletter, we analyzed the negative impact the overheated education sector has brought to the Chinese society and capital markets.

China's series of education curbs were a short-term response to halt the effects of unrestrained capitalism from exacerbating the challenges in its society. This regulation occurred at the height of the competitive education market frenzy described in the prior newsletter where certain education companies used marketing strategies that preyed on the anxiety of parents, placing a huge burden on families to "keep up with the Joneses" by committing resources (time and money) to prepare for exams. This competitive environment ultimately resulted in many demoralized youth deciding to "lie flat"[2], and delaying marriage and having children. [3]

While China's controls succeeded in stemming the escalation of the symptoms, it did not solve the root of the problem. At the core of the issue is hyper competition in China – that is, too many people competing over extremely limited resources.

Parents, rightfully so, want the best for their children. The commonly accepted path is to get into the best universities in China. China is approaching this issue simultaneously by increasing supply and reducing demand to find a new equilibrium.

China has achieved the former by surpassing the US on a major ranking of the world's best universities[4] for the first time. It had 338 universities ranking in the top 2,000 globally by US News & World, compared to 280 US universities. The challenge for graduates today though is education inflation. There is no dearth of Chinese university graduates (more than 11 million new graduates annually) and almost one in every three of China's youths between 20-24 years old possess a university degree.[5] Indeed, it is no longer sufficient just to have a university degree to stand out – one needs a degree from the top universities (top decile) of China to do so. However, mathematically speaking, even as China succeeds in increasing the overall quality of its universities relative to other nations, domestically students will continue to compete for spots in the top branded local universities like Tsinghua (founded 1911), Peking (1898), Fudan (1905) and Jiaotong (1896). These educational institutions have built their brand recognition for over a century, Even if China increases the number of universities, it is unlikely to be able to completely solve this problem in this manner.

That said, by increasing the supply of universities, China is also increasing the number of university graduates: China is expected to graduate 11.6 million graduates this year, a record high.[6] Given that the Chinese economy is undergoing a great transition (which we wrote about in the April 21st newsletter), it may be unable to generate enough jobs that satisfy the expectations of this highly educated workforce.

The authorities are trying to address this issue by diverting more of the college-bound students towards vocational training. Students who are less competitive under the test-oriented system can receive practical training which can help them secure a job. This is common in developed countries, including Germany, where more than half[7] of the college-bound high school student population goes to vocational programs. In China however, there remains a social stigma attached to technical training. Chinese authorities have vowed to increase the quality of vocational schools and hope to change societal perceptions over time by improving the social status of technicians. In 2019, the State Council allocated 100 billion yuan for vocational upskilling and vowed to expand vocational college enrollment by 1 million to cultivate talent of various professional skills.[8]To support this, China is trying to maintain robust demand for the mass working class.

China had previously accepted the development path of the US – that is, from agrarian to manufacturing to services as being the natural and appropriate path for a developed economy. To that end, the authorities allowed the consumer internet companies essentially to develop with very little interference[9] in the early days, giving rise to the consumer platform giants today. In the beginning, when competition was fierce amongst different platforms, the masses benefitted from additional channels to market their wares. For example, Taobao helped usher in an era of prosperity for rural villages with the rise of mom and pop operations employing millions of people across the country[10]; Meituan and Eleme helped created a new gig economy of over 7 million delivery personnel[11], etc.

However, as these platforms gradually gained dominance in their respective sectors, they began to squeeze their suppliers/workers for more profit: Taobao merchants were compelled to enter into "forced exclusivity" contracts[12], Meituan delivery personnel were forced to register as "independent contractors" enabling them to avoid employee responsibilities.[13] A recognition grew that these companies might not necessarily contribute to the common good of society.

Indeed, post the Global Financial Crisis and the implosion of Wall Street, China has appeared to shift its economy towards the German model of development, consulting German experts while writing its anti-monopoly laws.[14] It also began to appreciate its manufacturing sector, coupled with its large centralized state-owned banking sector which supports it, in a new light: Germany has shown that it is possible to become a developed country while maintaining a robust industrial core. This new stance seems to be evident in Beijing's latest five year economic plan unveiled in 2021, which held no target for the consumption share of economy, but pledged to keep the country's manufacturing component stable at 25% of GDP.

Today it appears manufacturing is once again recognized even in the developed world as an important industry with de-industrialized major economies all scrambling to reshore production. A recent McKinsey article referenced the sector as being the backbone of economic development, necessary to foster sustainable, inclusive growth.[15] More specifically, manufacturing is vital to stimulate internal consumption as it builds the foundation of a strong domestic working class consumer base. A Singaporean government study conducted in 2013 stated that every 100 manufacturing sector jobs created were associated with 27 new service positions, while 100 service jobs only contributed 3 to the manufacturing sector.[16] Moreover, it is believed that manufacturing jobs may provide the highest wages for a group of people who would otherwise have received the lowest on service positions.[17]

China is also committing significant resources to upgrade its economy and complete its transition to create the new economy jobs that highly educated youths aspire to, some of these measures which we discussed in prior newsletters. However, these are monumental challenges many countries, not just China are facing, and will need time to adequately address.

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CHINA NEWS SPOTLIGHT

China Halves Stamp Duty on Stock Trades to Boost Flagging Market: China halved the stamp duty on stock trading effective Monday in the latest attempt to boost the struggling market as a recovery sputters in the world's second-biggest economy. The finance ministry said in a brief statement on Sunday it was reducing the 0.1% duty on stock trades "in order to invigorate the capital market and boost investor confidence". *Read More.*

Didi Sells Smart Car Arm to Xpeng in Retreat from EV Industry: Xpeng Inc.'s shares soared after it agreed to buy Didi Global Inc.'s smart-car development arm in a deal that both eliminates a potential competitor in the crowded electric-vehicle market and gives it a tech-savvy partner in a new venture. The HK$5.84 billion ($744 million) all-stock deal will see Didi emerge with a 3.25% stake in Xpeng, according to an exchange filing Monday. *Read More.*

Huawei Reportedly Building 'Secret' Semiconductor Fabs: Huawei is building a network of secret semiconductor fabs in China, according to recent media reports. Or maybe it isn't. The Semiconductor Industry Association reportedly informed its members that Huawei has acquired two existing plants and is building three more. It has also received some $30 billion in government subsidies to help. The move into chip fabrication makes sense for Huawei, given its difficulty selling networking gear and its government's desire to build more chips at home. According to Bloomberg, though, the fabs would enable "a shadow manufacturing network that would let the blacklisted company skirt US sanctions and further the nation's technology ambitions." *Read More.*

EV Maker BYD Buys Jabil's China Manufacturing Business for $2.2 Billion: Chinese automaker BYD (002594.SZ) said on Monday its electronics unit has struck a deal with U.S.-based manufacturer Jabil Inc (JBL.N) to buy its mobile electronics manufacturing business in China for 15.8 billion yuan ($2.2 billion). The deal will expand BYD Electronic's (BE) (0285.HK) customer base, product portfolio and its smartphone components business as it looks to capture Jabil's potential growth in the sector. *Read More.*

Idorsia and Simcere Enter into a Licensing Agreement for Daridorexant in China: Idorsia Ltd (SIX: IDIA, "Idorsia"), specialized in the discovery, development and commercialization of small molecules to transform the horizon of therapeutic options, and Simcere Pharmaceutical Group Ltd (2096.HK, "Simcere"), an innovation and R&D-driven pharmaceutical company, announced today that they have entered into an exclusive licensing agreement for Idorsia's daridorexant in China. *Read More.*

I-Mab Closes One of China's Biggest-ever Biotech Fundraisings: China's I-Mab Biopharma just raised a massive $220 million in a third-round fundraising that once again reveals the growing strength of the country's emerging biotech sector. The Shanghai-based company—which grew out of the merger between Third Venture Biopharma and Tasgen Biotech last year—says it plans to plow the cash back into its pipeline of preclinical and clinical-stage antibody drugs for cancer and autoimmune disorders. It's had no difficulty raising cash to fund its endeavors, having completed a $150 million series B round in March 2017. *Read More.*

Dizal's Sunvozertinib Approved by China NMPA with Potential for Best-in-class Therapy in NSCLC with EGFR Exon20ins Mutations: Dizal today announced that sunvozertinib has been approved by the National Medical Products Administration (NMPA) of China for the treatment of adult patients with locally advanced or metastatic non-small cell lung cancer (NSCLC) with epidermal growth factor receptor (EGFR) exon 20 insertion (Exon20ins) mutations, whose disease has progressed on or after platinum-based chemotherapy. Sunvozertinib, with its superior efficacy and safety profile, is the first and only Category-I Innovative Drug in China for the treatment of lung cancer that has been granted breakthrough therapy designations from both the NMPA and the FDA. *Read More.*

[1] The Bund is a historic waterfront area in central Shanghai, where Morgan Creek's office is located. From the 1860s to the 1930s, it was the rich and powerful center of the foreign establishment in Shanghai, operating as a legally protected treaty port. The picture above is part of the historical waterfront.

[2] "Lying flat" is a Chinese neologism describing a personal rejection of societal pressures to overwork and over-achieve.

[3] Young Chinese put kids, marriage on back burner at record rate as cost pressures and Covid overwhelm | South China Morning Post (scmp.com)

[4] China tops U.S. for first time in this ranking of world's 'best' universities - MarketWatch

[5] Source: National Statistic Bureau

[6] China looks to create more jobs amid record number of graduates - Global Times

[7] The German Vocational Training System: An Overview - Federal Foreign Office (germany.info)

[8] China moves to improve salaries of high-skilled technicians - CGTN

[9] MGI_China_e tailing_Full_report_March_2013.pdf (mckinsey.com)

[10] The Alibaba Effect: How China's eBay Transformed Village Economics : Goats and Soda : NPR

[11] In China, delivery workers struggle against a rigged system – The China Project

[12] What is 'forced exclusivity'? And why did it get Alibaba fined? · TechNode

[13] Food delivery giants Ele.me and Meituan promise to stop treating delivery workers like disposable garbage. Sort of. – The China Project

[14] China Economy Policy: Economists look to German model to explain China's crackdowns, ET BFSI (indiatimes.com)

[15] Want to drive inclusive economic growth? Start with manufacturing | McKinsey

[16] Manufacturing And Services In Singapore's Economy: Twin Engines Of Growth And Their Asymmetric Dependencies (mti.gov.sg)

[17] https://www.brookings.edu/wp-content/uploads/2016/06/0222_manufacturing_helper_krueger_wial.pdf