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The Value of Long-Term Investing

Investment Insight

CHINA'S 'COMMON PROSPERITY': UNDERSTANDING THE BACKGROUND, IMPLICATIONS AND OPPORTUNITIES FOR TECHNOLOGY, CONSUMER AND LUXURY COMPANIES

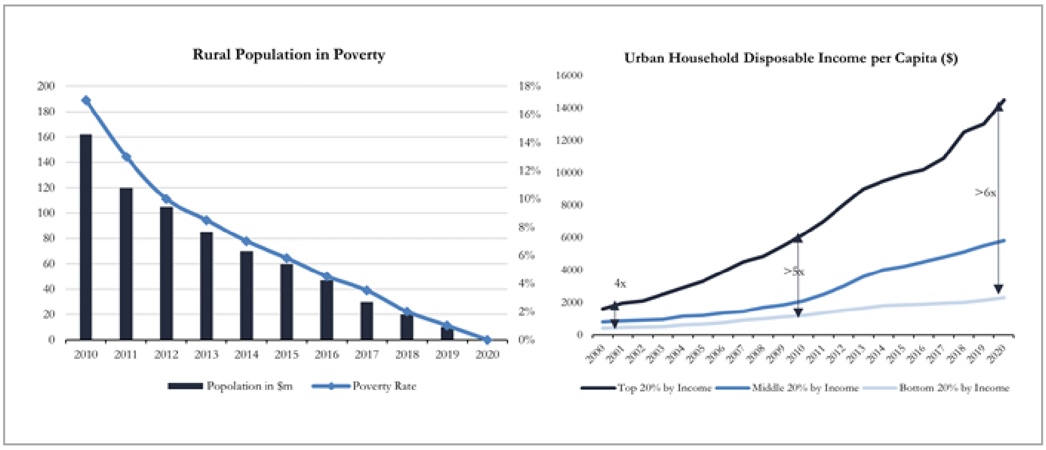
"We should build a world of common prosperity through win–win co-operation."

President Xi Jinping addressing the United Nations, 2017

Since the 1970s China has lifted nearly a billion people out of poverty, the biggest reduction in poverty that the world has ever seen. China now has the second-largest consumer economy in the world and is a major market for global consumer and luxury companies. It has all but eliminated extreme poverty but income and wealth inequality remain high.

Towards the end of August, consumer and luxury companies with exposure to China saw a significant sell-off. *LVMH*, the global leader in luxury, was down 12%. The moves came on the back of Chinese government initiatives to combat economic inequality and redistribute income and wealth over the next five years. Coming at a moment when President Xi is expected to serve a third term in office, it has reminded investors of the government's previous anti-corruption campaign and has raised concerns about a similar government crackdown.

It is important to recognise, however, that the initiatives are grounded in policy outlined as part of the government's five-year plan approved by the National People's Congress in March 2021. Far from coming 'out of nowhere', the overall policy goals have been clear and have been subject to detailed planning and analysis. It is important to focus on the way they are now being implemented across industries. The surprise is not in the initiatives themselves but in the market reaction. Since 2000, the gap in disposable income between top quintile income and low quintile income households has widened significantly. It now stands at over six times, as the graph below indicates. For political, economic and social reasons, the Chinese government has decided to take measures to reduce income inequality over the coming years and to promote what it calls 'common prosperity'.



J. Stern & Co
4 Carlton Gardens
London SW1Y 5AA
United Kingdom

Tel: +44 20 3478 1800
Fax: +44 20 3478 1799
info@jsternco.com
www.jsternco.com

The goals of the plan to create 'common prosperity' are to address income inequality, narrow the income gap between rich and poor, and ward off potential social instability. These reforms are important for the Chinese economy, and over the long term should also be of benefit to us as investors in luxury brands.

How common prosperity could be achieved, and why

Given the potential impacts of the policy, it is important to understand what the Chinese government means by 'common prosperity' and how and why it intends to pursue it. Below we have included a summary table setting out the key policy aims and how they will be tackled.

	GOALS	POLICY FOCUS
Social Risks	**Tech giants:** To tackle social inequality	Take up responsibility of flexible workers Ban monopolistic behaviour with disregard for social welfare
	Education: To ease parents' burden associated with children's education	Increase Public School resources, vocational training Ban profit-oriented after-school tutoring
	Housing: To meet living demands of urban residents	Property Rental Market Prohibit housing speculation, over-leveraged developers
	Healthcare: To improve care and reduce medical costs	Innovative drugs and R&D of medical technology Reduce generic drug prices
	Insurance & Pension: To reduce households' precautionary savings	Develop commercial Insurance (medical and retirement) Ban speculative activity, discourage short term products
National Security Risks	**ADR & Overseas Listings:** To reduce national security risks such as overseas listings of data-rich companies, enhancing monitoring of data flows	Promote Mainland HK listing, data & algorithms stored in China Ban overseas listings of data rich tech firms
	Semiconductors: To be self sufficient	Develop China-designed chips, next-gen technology such as 5/6G, ioT, quantum networks and blockchain
	Software: To strengthen cybersecurity	Establish leading cybersecurity players with big exposure to the public sector
Financial Risks	**Fintech:** To curb regulatory arbitrage and reduce the risks of financial debt	Proper oversight on leverage constraints & capital requirements, data usage Reduce Risk from high leverage, low capital and product concentration
	Capital Flows: To promote RMB decentralization	Orderly increase of two-way flows Ban on speculative capital flows
Environmental Risks	**Decarbonization:** To reach peak emissions by 2030 and be carbon neutral by 2060	Develop clean energy, smart grid, electrification, green financing Discourage "brown assets"

The Chinese government will shift its governance priorities towards balancing growth and sustainability and will seek to tackle social inequality and security through a major regulatory reset. We have already seen the government taking action in areas like technology and education, offshore holding companies and overseas IPOs.

The government has identified social welfare, taxes, charity and inclusive education as means to achieve this shift in society and to increase middle-income households' share of the economy. This is different to the approach China has taken over the past 40 years of economic reform, during which 'socialism with Chinese characteristics' was about setting growth and wealth generation on their own course, with regulations and the taxation framework operating in the background.

Of course, real and perceived inequality of income and wealth, but also of opportunity and prospects for achieving a better life, is a global issue that is one of the great challenges of our time. Popular pressure is increasing on governments in the US, Europe and elsewhere to reduce inequality, whether through elections or other means. Seen from this perspective, Xi Jinping's equality initiatives to address regional, urban/rural and income gaps have much in common conceptually with Boris Johnson's calls for a levelling up between north and south in the UK by channelling taxpayers' money to initiatives in education, social care and innovation.

Beijing also clarified that the word 'common' in 'common prosperity' does not mean 'absolute equal'. It does not intend to reverse its previous successful approach and risk stifling innovation and entrepreneurial spirit or stop competitive or market-based incentives altogether.

The measures to be implemented are intended to enhance the social safety net and narrow inequality. Many are standard practice for government funding and should be seen as part of China's ongoing political, economic and social development. China has consumption tax levied on only five categories of products and does not yet have many other forms of taxes, in particular on property, savings and other wealth. For example, the government is assessing how to gradually introduce property tax, and pilot schemes are being run already. China also does not have a separate capital gains tax that distinguishes capital gains from income and it does not have an inheritance tax.

Other measures include wage increases linked to economic growth and inflation in order to rebalance workers' share of the economy. The government is evaluating the introduction of enhanced social security programmes for subsistence allowance, shelter, education, medical treatment and care for the elderly. Corporate profit share could also be lowered through increases in corporate or other taxes, and incentives could be provided for firms and high-income individuals to support charity.

Zhejiang province is one of China's most prosperous provinces and also the home of Alibaba, one of China's biggest companies. It is therefore not surprising that the region has been chosen to run a pilot scheme for reaching 'common prosperity'. The government has set guidelines for the scheme that aim to address the three key development gaps: the regional gap, the urban/rural gap and the income gap.

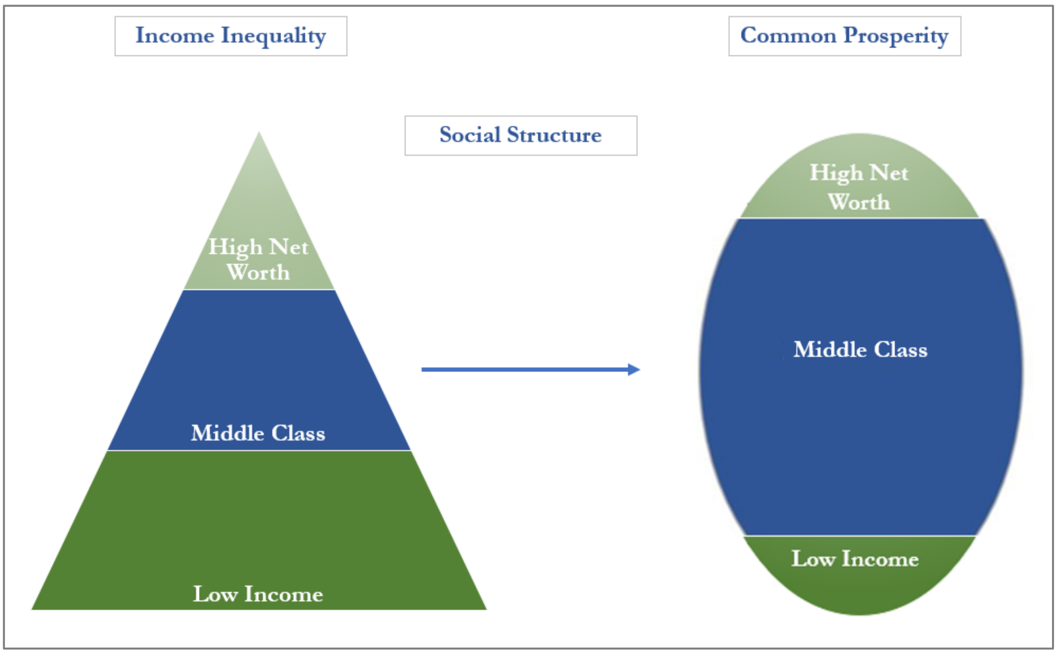
On 19 July, Zhejiang released its own detailed plan of the pilot scheme. A central pillar of Zhejiang's plan is the creation of an 'olive-shaped' social structure with a large middle class and fewer people who are very rich or very poor. The hope is that this will put middle-income households at the core of society and alleviate expenditure pressure on education, healthcare, housing, care for the elderly and childcare.

The plan proposes 52 tasks and goals relating to income, employment, housing, education and public health in the province and sets out several clear and specific targets for 2025, including:

- The annual per capita disposable income of all residents in Zhejiang is to reach RMB 75,000 (it was RMB 52,400 in 2020).
- The urban/rural income ratio is to be less than 1.9x (compared to 2.0x for Zhejiang and 2.6x nationwide in 2020).
- Payment for labour will account for more than 50% of GDP.
- The share of households with annual disposable income of RMB 100,000–500,000 (the income level at which middle class is defined) is to reach 80%.
- The urbanisation rate of the population of Zhejiang will reach 75% (it was 72% in 2020).

– The enrolment rate in higher education is to be more than 70%.

– Children are to receive 15.5 years of education on average.



Reaction of technology companies

In the US and Europe, digital transformation and the disruption it has brought in many sectors has had significant benefits but has also been a factor in rising real and perceived inequality. The structural change to industries like retail, media, transportation, travel and hospitality has fundamentally changed these industries, many of which are among the biggest sources of employment. It has forced companies and employees to adapt and change, to invest and to acquire new skills. Importantly it has also contributed to the change in working practice to shorter, more flexible, but also more uncertain employment. Governments have struggled to keep up with these changes both in terms of broader policies but also in terms of tax and regulation. Basic business issues like the treatment of labour forces, wage inequality and appropriate corporate tax are important issues that need to be addressed, while more digital-specific issues like privacy, data security and social media regulation also highlight the need for further discourse and regulation in the sector. These issues clearly vary greatly between technology sectors, companies and countries. Some will be addressed by companies in response to commercial and consumer pressure but others can only be resolved by governments through policies and regulations.

In China, several of the largest technology companies have already responded to the government's calls for common prosperity by announcing initiatives of their own. Take Tencent, for example: on 18 August, Tencent announced it will invest another RMB 50 billion (approximately USD 7 billion) in promoting common prosperity by focusing on low-income and rural communities, concentrating on areas such as education and healthcare. This is on top of the RMB 50 billion already pledged by the company. Alibaba, following in Tencent's footsteps, also announced an RMB 100 billion (approximately USD 15.5 billion) programme over five years to support common prosperity initiatives.

In another scheme DiDi, often referred to as China's Uber, is addressing workers' rights by helping its workforce to establish a union. Other companies have also been encouraged to take similar actions to support the government's common prosperity programmes. Indeed, over 70 companies have already publicly pledged their support.

Implications for the consumer and luxury companies

As regards the effect on the consumption of luxury goods, this latest scheme is quite different from the 2012–2016 anti-corruption campaign, when the government cracked down on the gifting of luxury goods to public officials as well as on conspicuous consumption. That crackdown reset the base for luxury goods consumption to underlying consumer demand, which has since grown strongly over the past several years.

LVMH store in Beijing. Source: Unsplash

Today China's middle class is both bigger and richer, and encompasses over a third of luxury goods consumption in the world, and most of the sector's growth. Over the next decade China wants to double the number of middle-class citizens from the 400 million recorded in 2020 to 800 million by 2030. China defines the middle class as those with an annual disposable income of RMB 100,000–500,000 or USD 15,000–75,000 comparable to average incomes in the US and in Europe. As these Chinese middle-class consumers continue to prosper they will step up to the common definition of mass-affluent consumers, with incomes of USD 75,000 or over and assets of USD 100,000 to 1 million. This increase in middle-class, mass-affluent consumers over the next ten years will be a positive for the luxury sector and a major growth driver for luxury consumption.

Availability of aspirational consumer goods for those with disposable income is one of the measures of prosperity. That is why we think that middle-class consumption is not only compatible with common prosperity but an integral part. Government policies over the past several years point to its support for middle-class consumption. These policies have included a reduction on the import duty paid on luxury goods, establishing a new duty-free shopping zone on Hainan Island, a cut in VAT and raising shoppers' annual duty-free allowance.

Opportunities from the luxury sector sell-off

We think that the market sell-off in the luxury sector following the government's wealth redistribution comments was overdone. Past experience has shown us that this type of market reaction to potential regulatory risks tends to create a buying opportunity. Of course, higher taxes may decrease disposable income for top-end consumers, who may constrain their purchases of luxury. However, these effects have proven to be temporary. The biggest opportunity, however, will be a much bigger pool of new middle-class and mass-affluent consumers who previously did not have enough income to buy luxury. Over the long term we therefore think that the net effect of common prosperity will mostly be positive.

Today, most luxury products are aspirational discretionary goods for middle-class and mass-affluent consumers rather than being reserved for high-net-worth individuals only. The consumption of luxury is not just limited to products like Bulgari's or Van Cleef's high-end jewellery or *Hermès*' Kelly handbags, which can cost tens of thousands of dollars or more and require middle-class consumers to save up for years before buying them. Luxury also encompasses affordable luxury items like skincare product Advanced Night Repair Serum from *Estée Lauder*, or designer fragrances by Giorgio Armani, or *L'Oréal's* Valentino. Middle-class consumers are spoilt with choices that could suit all wallets.

Luxury is so compelling because consumers are prepared to pay more for the 'real thing', be that buying Louis Vuitton handbags, Tiffany's engagement rings, or Ray-Ban or Oakley sunglasses from EssilorLuxottica. For example, last month Estée Lauder reported its full-year results, and the company said that it had not seen any slowdown in product sales in China, with its stock price reacting positively to the news. Similarly, in early September spirits producer Pernod Ricard reported 44% growth in China for the last financial year, and that there is no sign of this trend slowing. With the consumption of Western spirits in China only accounting for 1–2% of total spirits volume, the growth potential is enormous.

Source: Unsplash

The most prestigious luxury brands like Hermes and Louis Vuitton never go on sale. China's common prosperity goals are to achieve rising, more broadly distributed income, and deliver opportunity, access and prosperity for a greater number of people. If it succeeds in doubling the middle class to 800 million by 2030, it will create the largest pool of consumers in the world. It means that our long-term investment thesis for consumer and luxury is not only very much intact but will become even more compelling, and any volatility is a rare opportunity to buy some of the world's leading consumer and luxury companies at a discount.

Zhixin Shu, CFA
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