Morgan Stanley
INVESTMENT MANAGEMENT

China Inc.: A Changing Mindset

TALES FROM THE EMERGING WORLD | EMERGING MARKETS EQUITY TEAM | MARCH 2025

AUTHORS

AMAY HATTANGADI
Portfolio Manger, Emerging Markets Equity Team

JERRY PENG
Vice President, Emerging Markets Equity Team

In recent years, investor sentiment toward China has undergone a remarkable transformation, from maximum exposure to a significant scaling back of investments. This change unfolded against a backdrop of slower domestic growth and a complex geopolitical landscape. Yet, we believe current initiatives to improve shareholder returns suggest a new mindset may be on the horizon.

During China's rise as a global manufacturing powerhouse, discussions between investors and Chinese company executives predominantly centered on capacity expansion goals and aggressive revenue growth targets. However, as macroeconomic conditions cooled, the tone of discussions has shifted significantly. Today, the focus is increasingly on companies generating free cash flow, and enhancing shareholder returns through higher dividend payouts and share buybacks. This pivot marks a notable departure from the earlier paradigm and demonstrates, we believe, a more mature approach by Chinese corporate leadership in response to shifting economic conditions. While this transition is especially noticeable in companies with substantial founder ownership or those under pressure from large private equity or strategic investors seeking exits, it reflects a broader move towards prioritizing sustainable shareholder value.

China Value-Up

Comparisons between equity markets in Korea and Japan are inevitable due to their intertwined economic trajectories. From automobiles to electronics, Korean companies have caught up with their Japanese counterparts, and even surpassed them in many high-tech areas. In a previous report (*The Value Up Recipe for Re-Rating Korea*, April 2024), we delved into the Korean government's efforts to implement measures to increase shareholder returns, inspired by Japan's market regulator. While the Korean initiative received much publicity, particularly during their recent legislative elections, similar developments in China have gone relatively unnoticed. Although several economic observers and market forecasters have warned of a prolonged period of subpar returns, drawing parallels between the peaks of Japan's market in 1989 and China's in 2021, we are encouraged to see Chinese corporations transitioning from growth-centric strategies to promoting capital return initiatives.

The Chinese government is actively encouraging a similar "value-up" move especially in their onshore A share market. In April, China's cabinet, the State Council, issued a landmark regulatory guidance, dubbed the "9-point Guideline," on stock market reforms, focusing on initiatives to improve shareholder returns. Subsequently, the Shanghai and Shenzhen stock exchanges implemented revised listing rules. These included setting minimum cash dividend payout requirements and designating companies failing to meet those requirements as "special treatment" stocks as early warning. The exchanges

DISPLAY 1

Concerted Policy Efforts Are Designed To Boost Corporate Value and Investor Returns

DATE	REGULATOR	POLICY/GUIDELINE	RELEVANT POLICY DIRECTIVES
April 2024	State Council (i.e., China's Cabinet)	9-Point Guideline on Capital Market	■ Strengthen regulations, enhance corporate governance, improve investor protection, encourage long-term investment. ■ Enhance market value management by listcos (exchange listed companies). ■ Encourage multiple dividend payments per year; issue warnings to listcos that have no or low dividend payouts. ■ Encourage listcos to reclaim and cancel shares.
April 2024	Stock exchanges	Listing rules amendments	■ Encourage higher capital returns. Designate listcos that do not meet dividend payout/buyback requirements as "Special Treatment" stocks. ■ Require listcos to increase dividend payout frequency (i.e., adopting quarterly or semi-annual dividend payments).
March 2024	China Securities Regulatory Commission (CSRC)	"315" Policy series	■ Require listcos to establish proactive and stable cash dividend payout policy. ■ Urge listcos to raise dividend payout ratios. ■ Encourage listcos to actively buy back shares. Require listcos to put in place share buyback policy in response to short-term share price volatility. ■ Guide listcos to take measures to manage market value and enhance long-term investment attractiveness.
January 2024	State Council	State Council meeting	■ Call for enhancement of listco quality and investment returns ("double enhancement").
December 2023	CSRC	Share buyback rules amendments	■ Streamline procedures to facilitate listco share buybacks. ■ Encourage listcos to establish share buyback policy.
March 2023	SASAC*	Central SOEs performance appraisal	■ Revise KPIs for central SOEs with a focus on earnings quality, ROEs and the ratio of operating cash flow to revenue.
November 2022	CSRC	Three-year action plan for improving the quality of listed companies 2022-2025	■ Enhance listco corporate governance, strengthen the role of independent directors, better accountability of controlling shareholders and board of directors. ■ Improve listco information disclosure, transparency and investor communication. ■ Prosecute accounting fraud and illegal activities; enhance stock de-listing mechanism. ■ Guide listcos to focus on main businesses, lift enterprise value and boost investor returns.
November 2022	CSRC	Annual conference of financial street forum 2022	■ Former CSRC Chairman Yi Huiman announced the concept "valuation system with Chinese characteristics."

Source: Government documents, MSIM. As of April 2024.

* State-owned Assets Supervision and Administration Commission of the State Council.

have urged companies to increase their dividend payment frequency, to be either quarterly or semi-annually, rather than the current annual payments. We believe these steps will create a healthier and more investor-friendly environment.

After three decades of extraordinary growth, China's reversal in fortune has been painful. However, Chinese authorities are making efforts to make the capital markets more resilient in the face of downward pressure on stocks. Earlier this year, the China Securities Regulatory Commission (CSRC) introduced a series of policies, including encouraging listed companies to raise dividend payments and establish formal policies in response to market conditions such as sharp share price declines *(Display 1—Previous Page)*. The measures followed the CSRC's decision late last year to relax regulatory requirements to make it easier for listed companies to conduct share buybacks. China's initiatives to enhance listed companies' quality and performance started in November 2022 with the release of the Three-Year Action Plan which sketched out a comprehensive strategy to improve corporate governance, information disclosure and investor communication. The plan also outlined crackdowns on accounting fraud and other illegal activities. Since then, Beijing has also revamped the key performance metrics for China's unfashionable state-owned enterprises, emphasizing earnings quality, profitability and balance sheet health, rather than sheer size.

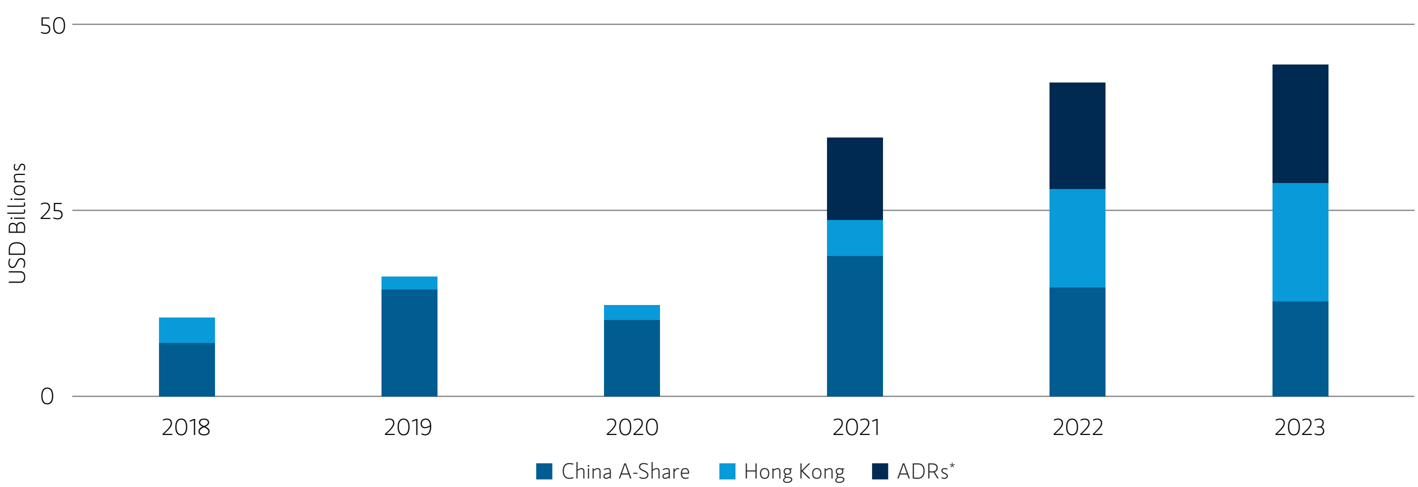
An Expanding Universe of Companies

The drive toward greater shareholder returns started with internet giants, namely Alibaba, Tencent, JD.Com and Trip. Com, which all increased dividends and initiated share repurchases. We think this trend will spread across the Chinese corporate landscape. Shareholder repurchases were initially met with skepticism, seen either as an opportunistic attempt to boost depressed share prices or to facilitate exits for major shareholders. However, these actions are now seen in a different light, as strategic and structural adjustments in response to the changing macro environment in China. This reorientation is likely to benefit select companies that implement generous shareholder payout policies. While these companies might not see the astronomical valuations of mid-2021, at very least the continued de-rating is likely to cease.

Indeed, we have seen a notable surge in share buybacks over the past two years, especially among Hong Kong-listed companies and American Depositary Receipts (ADRs) *(Display 2)*. The uptick would look even more impressive when compared to stock market capitalization, especially considering

DISPLAY 2

Chinese Companies Are Increasing Share Buybacks



Source: Wind, Bloomberg, Company disclosures, BofA Global Research, MSIM. As of 2023. *Incomplete data for ADRs from 2018-2020.

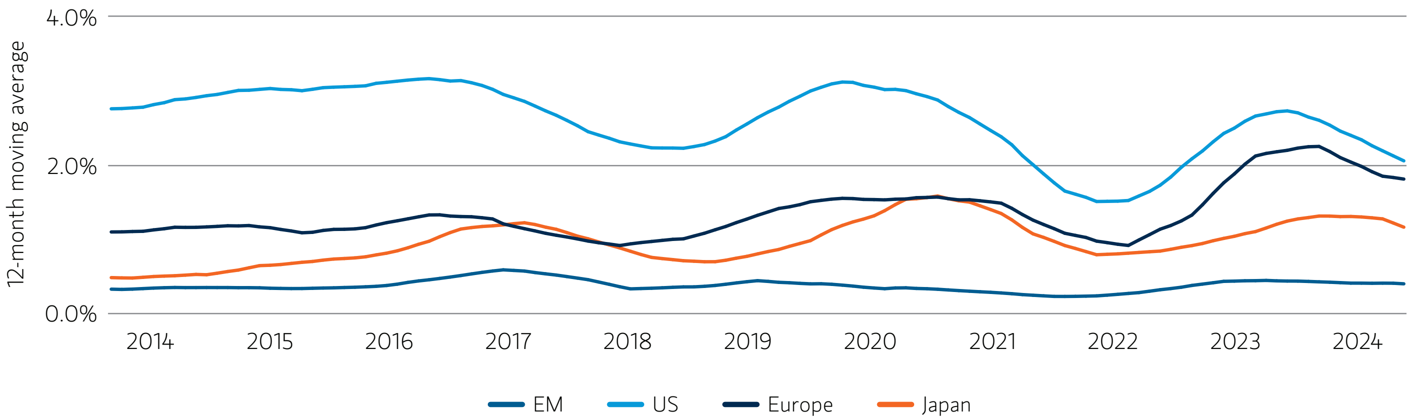
the substantial decline in Chinese stocks since 2021. Historically, emerging markets (EM) have seen considerably lower levels of share buybacks than in developed markets *(Display 3)*, likely reflecting the growth-oriented nature of EMs. Interestingly, however, we now see a clear breakout of China from the rest of EMs in terms of rising share buybacks *(Display 4)*.

We anticipate this momentum to continue in 2024 and beyond. Since Chinese regulators relaxed rules enacted last year, we expect more A-share companies to adopt share buybacks and dividend payouts to enhance shareholder returns. It's worth mentioning that Chinese companies have strong cash flows to support higher payouts, as the country boasts one of the

DISPLAY 3

EM Companies Historically Had Lower Share Buybacks than DM Counterparts

Share buybacks as a percentage of market capitalization

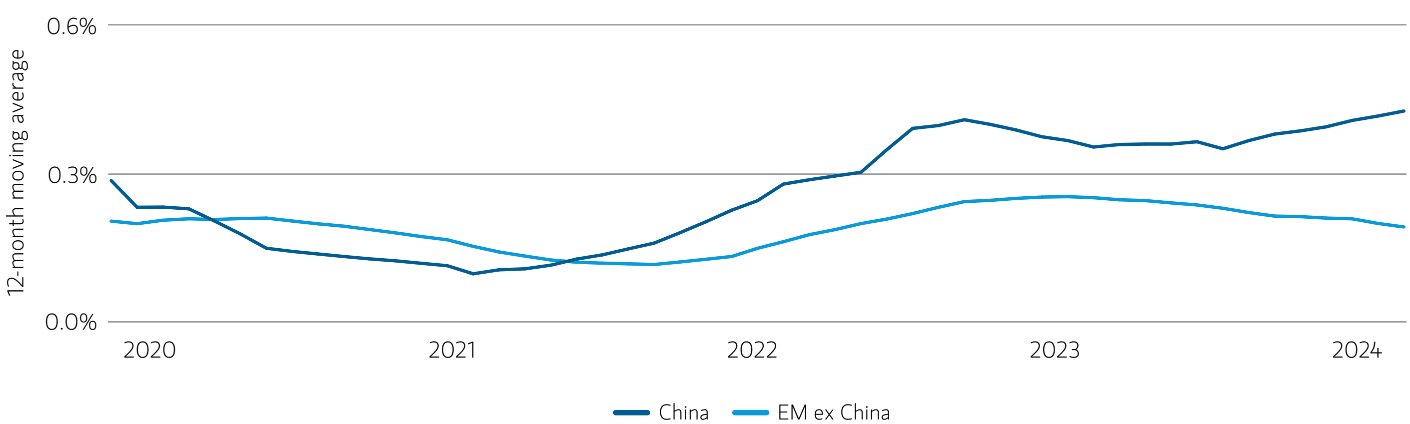


Source: Bloomberg, MSIM. As of March 2024. U.S. data based on the S&P 500 Index. EM, Europe and Japan data based on their respective MSCI country/region indexes. Index definitions can be found in the disclosure section. The indexes do not include any expenses, fees or sales charges, which would lower performance. The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

DISPLAY 4

Share Buybacks in China Are Rising Relative to the Rest of the Emerging Markets

Share buybacks as a percentage of market capitalization



Source: Bloomberg, MSIM. As of March 2024. China and EM ex China data based on their respective MSCI Indexes. Index definitions can be found in the disclosure section. The indexes do not include any expenses, fees or sales charges, which would lower performance. The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

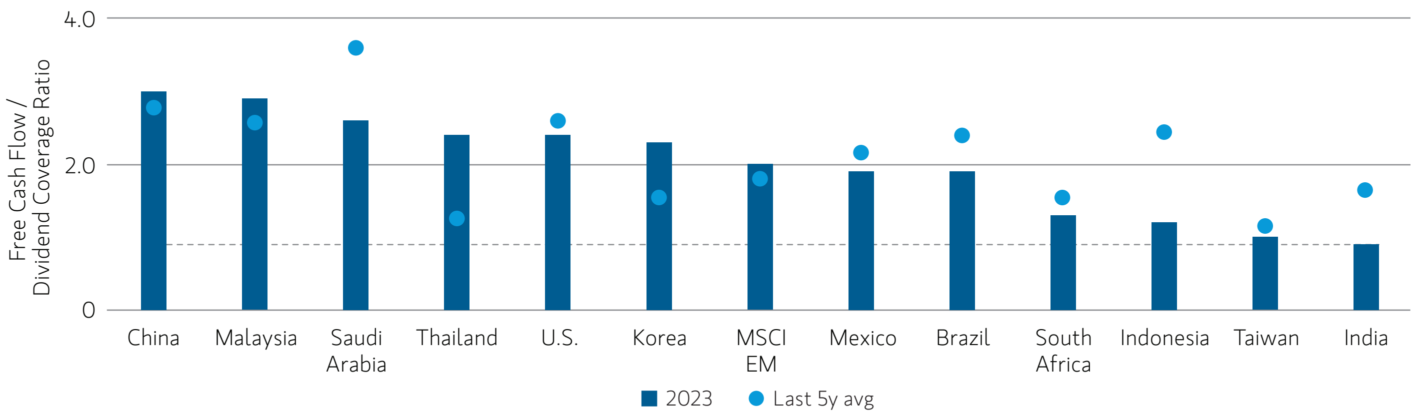
highest free cash flow to dividend coverage ratios in the world *(Display 5)*.

The recent wave of buybacks by Chinese behemoths *(Display 6)* serves different objectives, such as reducing their dominant market presence and shrinking their balance sheets. We hope that China Inc. makes the right decisions keeping in mind the primary goal of boosting long-term shareholder value, as these corporations navigate the complexities of growth, investment and capital returns. As Warren Buffett noted in his recent annual newsletter, "all stock repurchases should be price dependent." Given the current market environment in China, prices seem right for repurchase.

DISPLAY 5

Chinese Listed Companies Have Strong Free Cash Flow To Support Capital Returns

Free Cash Flow / Dividend Coverage



Source: Bloomberg, MSIM. As of December 31, 2023. U.S. data based on the S&P 500 Index. EM data based on their respective MSCI country/region indexes. Index definitions can be found in the disclosure section. The indexes do not include any expenses, fees or sales charges, which would lower performance. The index is unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

DISPLAY 6

Major Companies with Substantial Share Buyback and Capital Return Guidance

COMPANY	INDUSTRY	2023 SHARE BUYBACKS (USD BN)	% MKT CAP	CAPITAL RETURN GUIDANCE
Alibaba	Ecommerce	9.6	4.2%	Additional $25bn share buybacks from 2024 through March 2026. Targets at least 3% in annual reduction in total shares outstanding for the next three fiscal years.
Tencent	Internet	6.2	1.6%	Doubles buybacks to at least HK$100bn (c. $13bn) in 2024. Cash dividend increased 42% in 2023.
AIA	Financials	3.6	3.4%	$10bn share buybacks in three years 2022-2024. May consider further action. Progressive dividends.
KE Holdings	Real Estate	0.7	3.6%	$2bn program from August 2022 to August 2024. Company guides 5% shareholder return in the form of buyback and dividends for 2024.
Baidu	Internet	0.7	1.4%	Up to $5bn initiated in 2023 to end-2025.
NetEase	Internet	0.6	1.1%	Up to $5bn share buybacks in three years 2023-2025. Dividend payout raised to 40% in 2023 from 32% in 2022.
Yum China	Consumers	0.6	2.8%	Plans $1.25bn share buybacks in 2024. Total capital return (dividend + buybacks) of $3bn from 2024-2026.
Vipshop	Ecommerce	0.5	5.6%	$1bn share buyback from 2023 through March 2025. Annual cash dividend policy announced for 2023 (c. US$ 250mn) and onward.
Gree	Consumers	0.4	1.5%	Fourth share buyback program of RMB1.5-3bn in one year through October 2024.
JD.com	Ecommerce	0.4	0.7%	Up to $3bn share buyback over three years through March 2027. Annual cash dividend.
Xiaomi	Technology	0.2	0.5%	More active share buybacks in 2024; more than $230mn buyback in the first two months of 2024.
Trip.com	Consumers	0.2	0.9%	Up to $300mn capital return (buybacks + dividends) in 2024.
Kuaishou	Internet	0.2	0.6%	Up to $513mn (HK$4bn) share buyback in one year from May 2023.

Source: Wind, Bloomberg, Company disclosures, MSIM. As of April 2024. The table shows major listed companies that have a stated policy indicating an ongoing commitment to share buybacks and capital returns.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than the risks generally associated with investments in foreign developed countries. The risks associated with ownership of **real estate and the real estate industry** in general include fluctuations in the value of underlying property, defaults by borrowers or tenants, market saturation, decreases in market rents, interest rates, property taxes, increases in operating expenses and political or regulatory occurrences adversely affecting real estate.

DEFINITIONS

American Depositary Receipts (ADRs) represent an ownership interest in securities of foreign companies and involve many of the same risks as those associated with direct investment in foreign securities, including currency, political, economic and market risks.

INDEX DEFINITIONS

The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy. The **MSCI Brazil Index** is designed to measure the performance of the large and mid cap segments of the Brazilian market. With 68 constituents, the index covers about 85% of the Brazilian equity universe. The **MSCI China Index** captures large and mid-cap representation across China A-shares, B-shares, H-shares, Red-chips and P-chips. It reflects the Mainland China and Hong Kong opportunity set from an international investor's perspective. The **MSCI Emerging Markets Index (EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets. The **MSCI Europe Index** is a free float-adjusted market capitalization index that is designed to measure developed market equity performance in Europe. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends. The **MSCI India Index** is designed to measure the performance of the large and mid cap segments of the Indian market. The **MSCI Indonesia Index** is designed to measure the performance of the large and mid cap segments of the Indonesian market. With 22 constituents, the index covers about 85% of the Indonesian equity universe. The **MSCI Japan Index** is a free-floated adjusted market capitalization weighted index that is designed to track the equity market performance of Japanese securities listed on the Tokyo Stock Exchange, Osaka Stock Exchange, JASDAQ and Nagoya Stock Exchange. The MSCI Japan Index is constructed based on the MSCI Global Investable Market Indices Methodology, targeting a free-float market capitalization coverage of 85%. The **MSCI Korea Index** is designed to measure the performance of the large and mid cap segments of the South Korean market. With 107 constituents, the index covers about 85% of the Korean equity universe. The **MSCI Malaysia Index** is designed to measure the performance of the large and mid cap segments of the Malaysian market. With 32 constituents, the index covers about 85% of the Malaysian equity universe . The **MSCI Mexico Index** is designed to measure the performance of the large and mid cap segments of the Mexican market. With 24 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Mexico. The **MSCI Saudi Arabia Index** is designed to measure the performance of the large and mid-cap segments of the Saudi Arabia market. The **MSCI South Africa Index** is designed to measure the performance of the large and mid cap segments of the South African market. The **MSCI Taiwan Index** is designed to measure the performance of the large and mid cap segments of the Taiwan market. With89 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Taiwan. The **MSCI Thailand Index** is designed to measure the performance of the large and mid cap segments of the Thailand market. With 35 constituents, the index covers about 85% of the Thailand equity universe.

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