Week of 26th July 2021

What's on our mind this week?

The Chinese After-School Tutoring crackdown: What to make of it?

Chinese education companies share prices collapsed on Friday 23rd July in Hong Kong and New York after the text of a new policy document hinting at a sector-wide crackdown started circulating online. TAL Education, which offers after-school tutoring services, led the pack, with its share price plunging over 70% to a six-year low. New Oriental Education, another leading after-school tutoring company dropped by 40% on that day. Both companies lost 95% and 90% of their value since their mid-February peak, respectively.

The document officially released on Saturday 24th July made everything clearer: Devastating measures had been taken to restrict after-school tutoring services in China. From now on, the government will no longer approve new after-school education businesses offering tutoring of core school subjects (music and arts after-school tutoring is out of scope). Tutoring centres can no longer operate on weekends and public holidays, classes can only last 30mn with a 10mn break in-between, and most importantly they all have to turn into non-profit organisations. Raising capital through IPOs on foreign markets, mergers and acquisitions, franchising or using Variable Interest Entity arrangements is now illegal (VIE structures are complicated offshore legal structures designed by smart lawyers two decades ago to circumvent the Chinese law that made illegal any investment by foreign investors in certain strategic areas. Education has always been on that list, alongside media, defense and anything related to the internet).

We understand that many investors were spooked by the new regulation as they were caught by surprise and lost lots of money. Is it really coming out of the blue, as some argued? What is the motivation beyond cracking down a once-100bn USD private industry? Does it increase the overall risk premium of investing in Chinese equities as Chinese policymaking has reportedly become more unpredictable?

The writing has been on the wall for quite some time. Since 6th June 2018 to be precise, when the State Council published a first document in which it criticised in harsh terms the industry as follows: "Some off-campus training institutions have violated the laws of education and the growth and development of young people, and have carried out "exam-oriented" training, which has caused excessive extracurricular burdens on primary and secondary school students, increased the financial burden on families, and destroyed the good education ecology" before listing five pages of drastic measures to reform the industry.

Other official documents were published in 2019, targeting this time online tutoring. Stronger warnings came up in 2021, more specifically on 18th January 2021 when the Central Commission for Discipline Inspection and State Supervision Commission published a three-page notice in which is denounced "vulgar and harmful information on some platforms, advanced and over-standard training, high fees and difficult refunds, excessive marketing and blind expansion, etc., [which] increased the extracurricular burden of students and the financial burden of families."

The last warning to investors came on 18th March 2021 in People's Daily, the official mouthpiece of the Chinese Communist Party which quoted Xi Jinping as having said: "Training chaos can be said to be a stubborn disease that is difficult to manage. On the one hand, parents want their children to be physically and mentally healthy. Have a happy childhood. On the other hand, they want their children not to lose in the starting line of the score competition. Other children have learned so much, why don't we learn? This problem will be solved".

After so many warning signs, the final blow came on 23rd July 2021 in the shape of a State Council official notice. The document that sounded the death knell of the industry was entitled "Opinions on Further Reducing the Work Burden of Students in Compulsory Education and the Burden of Off-campus Training". It concerns all students in compulsory education, typically between the age of six and fifteen, who are enrolled in the mandatory nine-year education cycle (i.e. primary and secondary schooling). As the document title suggests, the new regulation aims to reduce the homework burden for students in school and after school as they attend tutoring classes. The latter was not the only target. Lengthy items were listed in the document regarding what the schools should do, which the market largely ignored as it was more concerned by the fate of the two listed behemoths of the after-school tutoring space, namely TAL and New Oriental Education.

Why is it so critical to reduce the students' burden? And why is there a burden to start with?

GavekalDragonomics had a good description of the matter: "Chinese students' advancement through the education system is almost entirely dependent on their placement in standardized tests. In the recent decade, this has led to a culture of endless homework and test preparation in schools and the widespread use of paid tutoring outside of schools to achieve an edge. China's government noticed this phenomenon and got worried that the grind is turning out legions of dispirited students capable only of rote memorization rather than the creative technologists the nation will need to achieve global leadership. The private tutoring sector has come under particular criticism for thwarting official efforts to reduce the burden of homework in the public school system. If schools relax their requirements, it creates more of an opening for students to use tutoring to get ahead. The widespread use of tutoring also undermines the egalitarian ethos of the nationwide testing system by making it harder for children of poorer families to compete academically with richer ones. According to the official household survey, education has been one of the fastest-growing categories of household spending, rising from 7.5% of the nationwide total in 2013 to 9.5% in 2019."

To tackle this matter is of strategic importance to China's long term economic and social prosperity. As mentioned above, the central government initiated comprehensive sector reforms in 2018. Since then, we have seen new regulations covering both the K12 schools (i.e. primary schools and high schools), whether funded by the government or by private capital, as well as targeting the private sector after-school tutoring sector.

TAL Education had been a long-time capital market darling. At JK Capital we were invested at some point in TAL and New Oriental Education, and we decided to exit our positions in the second half of 2018. We stayed away from the education stocks since then as we know how extremely risky it is to invest in China in a sector that is the target of a government crackdown. We got hurt initially by our decision as TAL's share price doubled between August 2018 and February 2021, but today we do not have any regret.

To us, and to many who closely follow Chinese markets and Chinese news like we do, we knew that tighter regulations were coming targeting the after-school tutoring industry. Admittedly though, we did not foresee the full severity of the plan announced on 23rd July, which essentially shuts down a large and profitable industry. We agree with Gavekal that the 2020 population census which showed that China's fertility rate had fallen far below the level government planners had expected was a trigger for such drastic measures. The government realised that there was no time to waste to reverse the declining fertility rate and the ageing population trend, if even possible. Since the high cost of education is widely identified as one of the burdens that prevent urban families from having more children, the government did not hesitate to take the harshest measures, even if it meant sacrificing an entire industry.

Did this sacrifice increase the risk premium attached to investments in Chinese equities? Are Chinese policymakers 'becoming more unpredictable'? Given the impact on Chinese stock markets over the past few days, the answer to both questions must be 'Yes', even though no policy in China comes out randomly. There is always a trace, a hint, a warning of what to expect, and identifying these signs is what is expected from good China portfolio managers. Any investment made in this country, whether private or public has to be put in perspective of the long term planning of China, which typically ranges from five years to one hundred years as in the case of carbon emission and climate change.

Sources:

http://www.gov.cn/xinwen/2021-07/24/content_5627132.htm
http://www.gov.cn/zhengce/content/2018-08/22/content_5315668.htm
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A crucial step towards China's carbon neutrality goal

Background

As China's latest efforts to drive decarbonisation, the long-awaited national emission trading scheme (ETS) kicked off on July 16th at the Shanghai Environment and Energy Exchange. The grand opening was marked by a deal initiated by SOE giant China Petroleum & Chemical Corp (Sinopec) to purchase 100,000 tons of carbon emission quota from China Resources Group at RMB 52.92/ton.

Since 2011, 8 regional ETSs have been established in major provinces and cities across China as pilot programs to prepare for the launch of the nationwide carbon market. During the pilot phase, structural issues such as isolated markets and government over-intervention have caused huge price disparity (ranging from 10 to 80 RMB/ton) and low market liquidity. Challenges encountered during the pilot phase forced the regulator to postpone the official launch date and reduce its original scope from more than 20 industries to focus only on the power generation industry as it has "more reliable and verifiable data ." Although not as ambitious as the regulator originally planned, the national ETS still covers 2,162 key companies in the power generation industry that accounts for more than 40% of the country's energy-related carbon emissions, making it the largest ETS globally.

Implications

Simply put, carbon quotas or the right to emit carbon are currently allocated to major power generating companies free of charge. The exchange serves as a marketplace where heavy polluters purchase additional quotas from less-polluting companies in order to fulfil their regulatory obligations. At the other end of the trade, cleaner generators sell their excess quotas in exchange for additional income, which they may invest in clean technology to further reduce their emission level. Through this mechanism, as the supply of quota is reduced incrementally which inevitably drives up the price of carbon, all participants are incentivised to reduce their emissions to improve profitability.

The relatively sufficient amount of free quotas has led to a lower demand from polluting companies to buy additional quotas, which in turn results in a low trading price of carbon in China, around RMB 50/ton compared to other markets such as the European Union (EU) around EUR 50/ton. At the current price level, for companies that still largely depend on legacy coal-powered units, the cost of purchasing additional carbon quota is estimated to be between 5% to 25% of their overall production cost . The status quo is expected to change in the coming years as carbon price increases due to reduced quota supply. This is precisely the point of establishing a carbon market to push heavy polluters to accelerate the transformation to cleaner forms of energy or adopt technological innovations such as Carbon Capture, Utilization, and Storage (CCUS) through a market-based mechanism.

Although the short-term implications of the national ETS may seem limited, the national ETS, more importantly, serves as a regulatory infrastructure to regulate other carbon-intensive sectors in China. Other than electricity, it is expected to soon cover seven other industries, including petrochemical, chemical, construction materials, steel, nonferrous metal, papermaking and aviation, allowing the country to effectively regulate the emission activities of its heavy polluters. Through the pilot programs, the above-mentioned industries ended up facing many challenges. Having so many different industries involved created lots of technical issues. Many also found it difficult to absorb the additional cost of carbon. For example, due to the cross-boundary nature of the aviation industry which currently accounts for 2% of the global carbon emissions, measuring and reducing emissions within the sector has proven by the EU ETS's previous attempt to be both technically (specifically for the Monitoring, Reporting and Verification (MRV) system) and politically challenging. As China joins the club to reduce carbon emissions and as the MRV system gradually improves, we may expect multilateral cooperation on carbon trading with a wider industry inclusion to become more promising and viable.

Future outlook

Going forward, the Chinese regulator is expected to leverage more experiences from its international peers to continuously fine-tune and expand its carbon trading scheme. Most importantly, setting the number of quotas within a reasonable range would allow the scheme to effectively facilitate technological innovation and emission reduction measures toward the reduction target, and avoid market crashes, which is what the EU ETS experienced during its initial stage. The current attempt by the EU to include more international and complex businesses such as those within the maritime industry would also be exemplary for the Chinese regulator.

Coupled with a wider industry inclusion, the supply of free quotas is expected to be gradually tightened by the regulator, driving the price up and closer to the international average level. Allowing the entrance of more market participants and structured financial products would further facilitate price discovery, and ultimately support China's goal to achieve carbon neutrality by 2060. Furthermore, as an important supplement mechanism to the mandatory ETS, the voluntary market Certified Emission Reduction (CCER) is expected to reopen to provide more flexibility and incentives to a wider range of market participants.

Notes:

[1] *China's New Carbon Market Inks First Bulk Agreement (caixinglobal.com)*
[2] *生态环境部：全国碳市场选择以发电行业为突破口 有两方面考虑 (baidu.com)*
[3] *Caixin Explains: How China's New Carbon Market Will Work (caixinglobal.com)*

[4] https://m.weekly.caixin.com/m/2021-07-24/101744783.html

[5] 张希良：明年全国碳市场将囊括更多行业_环科频道_财新网 (caixin.com)

[6] *In the first 2005-2007 EU-ETS phase, only three member states had caps that were lower than baseline 2005 emissions levels. This caused a glut on the allowance market - permit prices crashed to a low of €0.03 per ton in December 2007.*

[7] 分析｜新建碳边境、增收排放费范围，欧盟气候新政如何冲击全球_世界频道_财新网 (caixin.com)

[8] *Since March 14, 2017, NDRC temporarily suspended CCER project registration and credit issuance in order to revise the Interim Measures for the Administration of Voluntary Emission Trading of GHG.*