RISCURA

Regulation of Chinese Technology Companies

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1 Introduction

Concerns over Chinese regulation turned from nervousness to fear in late July when drastic reforms regarding education companies were passed. After-school tutoring is a popular industry in China (as parents seek to give their children the most comprehensive education possible) but the state has now taken a dim view of this because the resulting pressure on students is considered socially undesirable. After-school education companies in China now need to become non-profit and they can no longer list on public markets. It had a significant negative impact on the market capitalisation of almost all related education companies and led to an indiscriminate price correction across all sectors although technology companies were worst affected. Losses in Chinese tech and education stocks since February 2021 have exceeded $1 trillion, according to Bloomberg. At the time of writing this thoughtpiece, we are seeing some stability returning to Chinese stock markets.

We were already noting regulatory concerns in China some time before these developments – indeed we have mentioned them in our newsletters. Only a few weeks ago Didi (the Uber of China) was put under an investigation a day after listing on Nasdaq, together with another two companies, for alleged data privacy violations. As a result, a number of other highly anticipated IPOs were postponed.

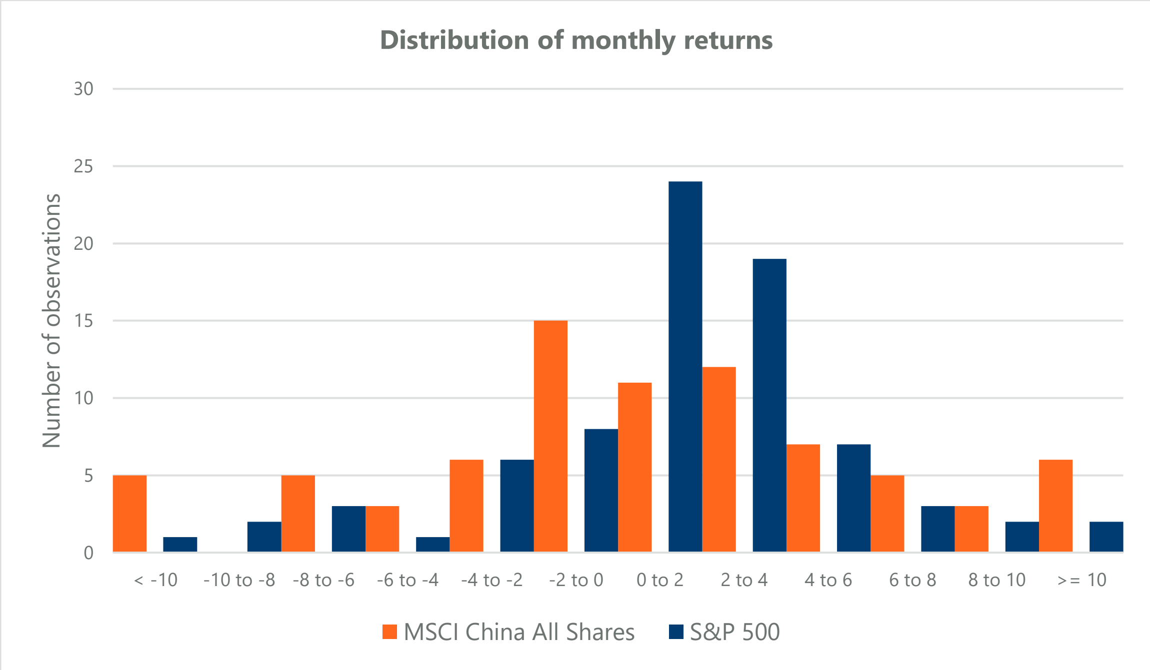
Regular China market watchers will have seen frequent “signposting” in the weeks approaching the regulatory changes in education to warn investors of what was coming. Almost all our managers had significantly reduced their allocations to education resulting in a net underweight to the internet sector across our portfolios and with very little aggregate exposure to education stocks. We can also confirm that the OOCF is performing roughly in line with the benchmark.

What is unfortunate is how China has scaled up its regulatory scrutiny across a number of sectors simultaneously, and over a short period of time. Whilst many of them are linked to the government’s objective of improving social equality they have different reasons and implications. Media articles mixing all these issues and concluding that China has returned to its “anti-capitalist ways” is something that we see every five to six years. As Ray Dalio of Bridgewater recalls in his latest letter, he has witnessed this before whether it was during the market manipulation of 2015 or the Chinese currency plunge in 2015-16. Every time foreign investors interpreted this as policymakers turning away from capital markets. Whilst all this time, he has observed steady and fast development of capital markets, entrepreneurship, and openness to investment foreign investors.

In order to properly understand the developments it is important to separately address the changes and the intentions behind them. However, before doing this we would like to remind our investors that this is a market where outsized monthly drawdowns resulting from exogenous events are common and create attractive investment opportunities for the skilled investors.

2 Regulatory fear creates volatility

The Chinese markets tend to experience high volatility. Since Jan 2015, there have been 5 months returning worse than -10%. All saw strong recoveries in the following 2-3 months. As shown in the chart below, the China market exhibits a much more “fat-tailed” distribution of returns than the US market over the period of Jan 2015 to Jun 2021. (“Fat tailed” means there are relatively more occurrences of very low or very high returns). Positive and negative extreme events also seem to cluster together - i.e. sharp drawdowns are followed by equally sharp recoveries.



Source: eVestment

Many sectors have experienced volatility around regulatory fear in the past – white liquor in 2013, gaming and generic drugs in 2018 just to name a few, but the best companies in these sectors have continued to make new highs in share price ever since. More lately the regulatory fear has also come from US regulation of US-listed Chinese companies. The short-lived and extreme swings usually give skilful managers the opportunity to rebalance their portfolios and buy into good companies at more attractive prices.

The following table shows the share prices of some of China's market leaders and how their share prices fell due to exogenous factors, often related to a fear of regulation, and their recoveries after. The most dramatic and famous one is Moutai, a premium liquor company, that lost half of its market capitalisation during the anti-corruption crackdown in 2012/3 but recovered the loss and is up over 1000% since.

Company	Sector	Price move (peak to trough)	Months to Recovery	Upside (previous peak to new peak)
Moutai	Spirit	-54%	16	1290%
Hengrui	Biopharma	-40%	8	103%
Netease	Online gaming	-44%	15	116%
GoerTek	IT hardware	-62%	8	194%
Yuhua	Higher education	-58%	14	45%

We have described many times that a key contributing factor to volatility and inefficiency in China is the high retail investor representation. Yet sometimes global institutional investors are no better than retail investors as they do not fully understand what is happening on the ground, especially when it comes to political and regulatory developments. This often leads to serious misjudgement or overreaction.

In recent days, global funds continued to sell out of Chinese stocks while local managers have started buying the dip. This phenomenon reminds us of late 2018 where global managers reduced exposure to Chinese hardware tech, such as Goertek, as the Sino-US trade war was escalating, while local managers took the other side of the trade. Those stocks rebounded and made new highs after reporting strong earnings growth in the subsequent quarters. This time around Tencent, a poster child for the Chinese internet, is now trading at a forward price/earnings (P/E) multiple of below 20 times, which is lower than the 22.5 times P/E of the entire S&P 500.

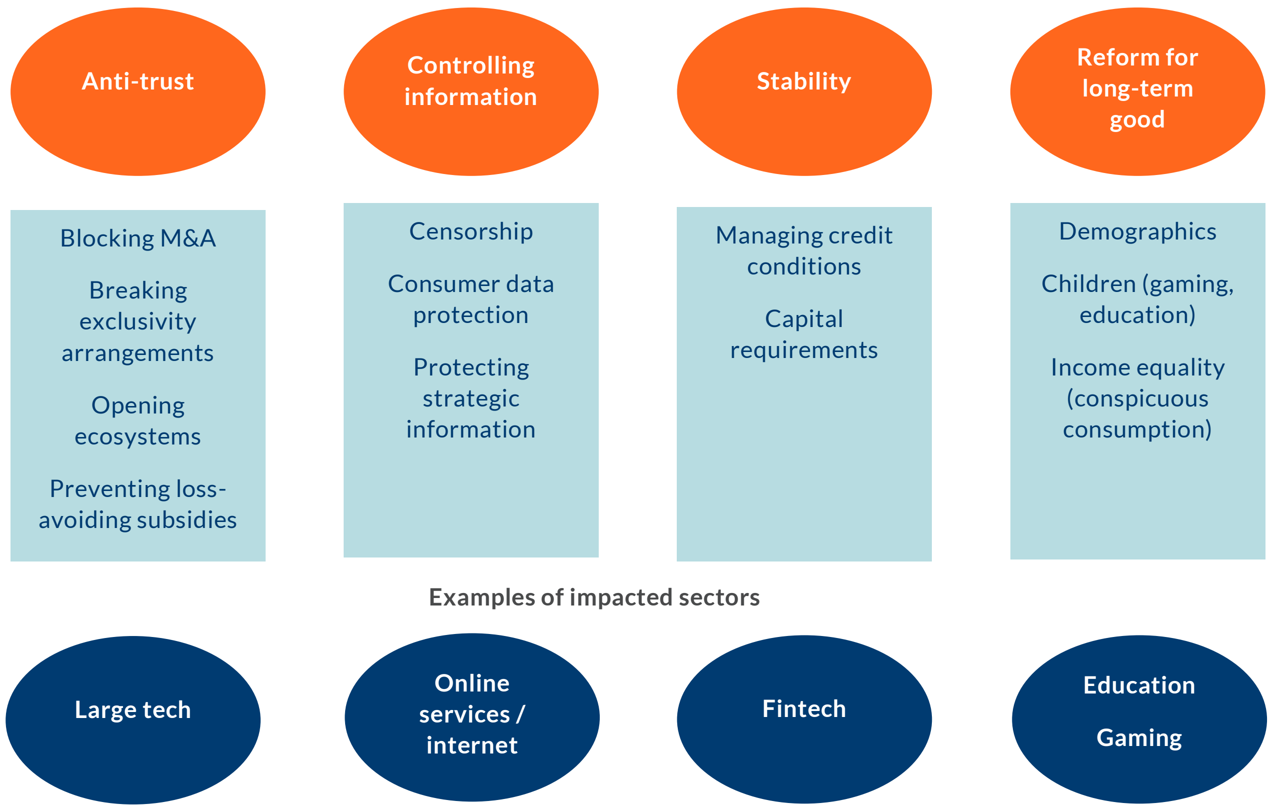
Time will tell who has made the right decision!

3 State capitalist system

It is very important to understand that China is a state capitalist system. Whilst capitalist policies encouraging entrepreneurship, innovation and pursuit of wealth creation have created one of the world's leading economies we must not forget that the main objective of the communist party is to serve the interests of the people. It still has large parts of its population living in relative poverty and its existence is dependent on having a happy population. Therefore, capitalism cannot compromise social objectives as it had started to do lately.

Regulation in sectors like banking or internet has fallen behind the rapid rise of corporate China over recent years. In reality the same has happened in developed markets with respect to anti-trust behaviour exhibited by the likes of Alphabet and Amazon, data privacy issues, fake news and technology. The Chinese policymakers are taking actions that are actually much needed elsewhere. Meanwhile sectors like education have always been specific areas of focus for the State.

There is wave of regulation coming through in China to address these issues that can be categorised into four broad areas:



Source Fairtree, RisCura

It is important to understand and respect the State's social objectives and all skilful managers must pay close attention to their implications when investing in China. There is consensus among the managers we work with that the environment will be tougher than usual given the breadth of ongoing reforms. While they are aligned with China's social objectives, different initiatives across multiple sectors at the same time is coincidental.

Almost everyone was surprised by the severity of the new regulation regarding education. Turning an established profit-making industry to non-profit overnight is no doubt very drastic. It is understandably alarming to a capitalist world that prizes a free market. Although China's authoritarian regime allows swift implementation of policy, the government usually seeks public consultation and communicates the issues with stakeholders in advance. New rules are sometimes tested out in pilot cities before embarking on nationwide implementation. Yet this time around, the government did not communicate clearly nor have a transitory plan and thus caught the market off guard.

Such uncertainty needs to be properly accounted for as a risk factor. Therefore, Chinese tech should trade at a discount compared to its global peers, but the big question is by how much.

The costs of not respecting China's social objectives are high and not only for the investors. Many of our managers believe that policy makers are losing patience with "ignorant capitalist entrepreneurs". Whilst most well-run companies are very sensitive to state requirements there have been a few that have been less respectful. Jack Ma, founder of Alibaba and one of China's richest (and most flamboyant) people, is one recent example where the state has taken exception and clamped down on his activities. We are told that the management of Didi were warned multiple times to address the subject of data security before listing. An attempt to reform the education sector in 2018 was largely ignored and the sector only became greedier. The government is also weary that the rich are not doing enough to help the poor. This is a further risk that needs to be monitored.

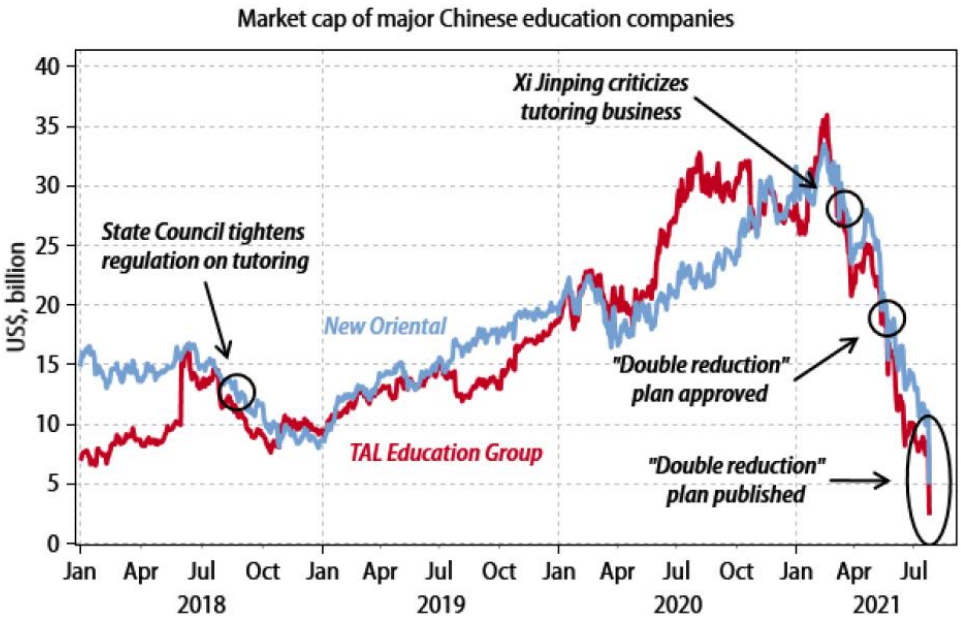
On the plus side, regulation can bring tailwinds as well as headwinds. Sectors like semiconductor and clean energy have been enjoying supportive policies from the government and attracting lots of private capital. A significant portion of investment manager outperformance in China can be attributed to understanding the opportunities and risks that result from regulation.

The next sections will address the recent regulatory activities in more detail before we turn to the subject of VIE structures and risks to foreign investors.

4 Tech sector regulation and the emphasis on social good

4.1 Education sector

On July 23rd, China's regulators announced a set of reforms for the education sector, banning curriculum-based private tutoring firms from seeking profits, from raising new capital or from public listing. Share prices of the three largest players New Oriental Education, TAL Education and Gaotu Techedu fell 54%, 71% and 63% respectively on the day. Since rumours and market discussions started earlier this year, these stocks have fallen more than 90% as the chart below shows:



Source: Gavekal Research, Macrobond

After-school tutoring has been a fast-growing sector in China in recent years, attracting a large amount of capital from the private and public markets. In preparation for the college entrance exam, a rising number of families pay for their children to receive (expensive) tutoring outside of school hours. At the peak the sector was worth over $100 billion, and many early investors had benefited from its rapid development.

However, many social problems are also created. First there is inequality since only the middle and upper class can afford the costs. Many see it as bad competition as money spent does not lead to quality education but only to cramming and anxiety. Children of all ages are affected and there are also stories of students who are burnt out even before they reach high school. Furthermore, many companies have been using aggressive advertising campaigns aimed at parents to create a feeling of guilt. This clearly does not meet the government's objective of a harmonious and healthy development of society. Furthermore, the government believes competition for education is directly contributing to families' reluctance to have children.

The new rules are designed to decrease workloads for students and financial strain on parents, in order to help promote social equality and perhaps indirectly boost the birth rate. As one of our managers put it, this is "an ESG package from the Chinese government in an effort to make China a fairer society and a more sustainable economy that benefit the broader Chinese population".

Similar clampdowns have happened before to other sectors such as online gaming, generic drugs and real estate, each time for social welfare reasons.

Knowing the policy objective and the government's determination, most local managers had either exited or significantly reduced exposure to the education sector ahead of the announcement. International managers were probably less well positioned.

The future of the listed education companies is unclear at this point. The regulatory scrutiny is mostly aimed at the K12 sector and severest for K10. These companies also have other business areas, and many have very little debt and cash surpluses. Furthermore, we know that our fund managers' children are still receiving lessons from these companies as we speak. The most optimistic view we have heard is that the implementation of the new regulation may be subject to interpretation– i.e. could "non-profit" be interpreted as "affordable"? The new regulation has not instructed existing companies to de-list. The urgency of the reform was to stop a number of new listings of companies in this sector who are known to use aggressive marketing tactics.

Our fund managers are watching from the sidelines although we have seen trading activity in these stocks from both international investment managers and some well-known investors in China.

4.2 Didi and the importance of data security

Just days after the company listed in the US, the Chinese cybersecurity regulator launched an investigation into Didi Global and banned new user registrations, citing serious violations of laws and regulations in collecting and using personal information. Shares of Didi's stock have fallen 35% since then.

As the dominant ride hailing app and one of the largest tech platforms in China, Didi has over 350 million active users and a large amount of user, map and traffic data. The company knows when and where everyone is going. It also runs an offshore artificial intelligence lab in Silicon Valley for autonomous driving and predictive algorithms research. It is not surprising that the Chinese government wants to regulate companies like Didi in the way they collect and use data and where they keep it. In May this year, Tesla announced it would build a data centre in China to house all data generated by local owners to meet China's legal requirements. Globally, we have seen increasing scrutiny on information security given the importance of data to the public interest and national security.

It was also reported that the company management ignored the authorities' suggestion to delay its IPO amid concerns over cross-border data transfer and sensitive timing of the Chinese Communist Party's 100th anniversary. We believe Didi attracted stronger regulatory actions due to company-specific reasons.

All companies holding data for more than 1 million users must be approved by the Cyberspace Administration of China before they list on the Nasdaq. This is direct reciprocation of the US administration demanding more information from Chinese companies listing in the USA. China, understandably, doesn't want sensitive data ending up in American hands. This means that not all companies will be allowed to list on the Nasdaq and need to consider alternative exchanges such as Hong Kong or the Star Board in Shanghai. While this may impact their ability to raise capital (or the cost of doing so), it does not remove it altogether; it merely forces them to look locally instead of to the USA.

With respect to postponed IPOs since the Didi debacle, the venture specialists who own these companies have told us that the regulators are requesting them to address the data security review before listing but have not objected for their plans to list on the Nasdaq as such.

4.3 Internet and playing catch-up on anti-trust and social responsibility

We have discussed anti-trust matters within the internet sector in previous letters. China has allowed its internet industry to develop with few restrictions and is now catching up with regulation aimed at large technology companies. After regulatory intervention, e-commerce giants have now started to allow merchants to sell on multiple platforms and payment companies such as Alipay and WePay have shifted towards an open architecture. This is all good news for healthy competition and benefits the broader internet sector.

Meanwhile the welfare of the flexible workers of the gig economy has also come into the fore just like in the USA and UK. Meituan, the leading food delivery app, is under direct regulatory scrutiny for workers' rights and benefits. This is no different to similar concerns regarding Uber and Deliveroo in the UK although perhaps far more concerning in a communist country!

The days of unlimited expansion, unrestricted acquisitions and abuse of monopoly power, along with privacy violations, seem about to end.

5 VIE structure and overseas IPOs

Let's take a look at Variable Interest Entity (VIE) structures, a favourite subject of China sceptics. As a reminder, Chinese companies in certain restricted sectors are not allowed to have foreign investors. To overcome this, many technology companies have listed overseas using Variable Interest Entities. These structures provide financial interest in companies without a legal ownership (such as voting rights or a legal claim to assets). While not directly comparable, there are some parallels with non-voting or deferred shares issued by companies in many other countries. There are trillions of dollars of market cap under VIE structures globally. However, they have two drawbacks.

Firstly, offshore investors may lose control of the domestic company to its founder or management. Perhaps the most famous example of this is when Jack Ma spun out Ant Financial from Alibaba Group at the expense of foreign owners including Yahoo. Saying that governance of many large technology companies is questionable globally with founders often holding a majority of voting rights through complex control structures - whether it's Naspers in South Africa or the founder led technology companies in the USA. We have argued previously that evaluating the integrity of management and controlling shareholders is the most important consideration when investing in emerging markets. A bad apple will exploit investors with or without a VIE structure.

The second drawback of VIE structures is that Chinese policymakers have never explicitly approved them or discussed them in the Foreign Investment Law. China sceptics have always referred to VIE structures as a risk that the communists can nationalise these companies at any time. This concern has come to the fore again when the Chinese government explicitly referred to these when it said that education companies can no longer list through VIE structures. This has led to a return of the question of legitimacy of VIEs. Saying that, any retrospective action regarding VIE structures would be a globally systemic event with significant risks to worldwide economies including China.

What seems clear is that there will be greater scrutiny of which companies can list through VIEs. However, we should see this as a positive as it finally addresses one of the biggest concerns of foreign investors. Whilst not all companies may be able to use this structure, once clarified there will be legitimacy for those that do. This is a natural progression of the reform of Chinese capital markets.

We have seen some global commentators claim that Chinese companies will no longer list in the USA or that the VIE window is now closed. We disagree. Having consulted many venture capitalists who are driving IPOs we understand that there are no plans to give up on ambitions to list on the Nasdaq nor are they aware of any reasons why they will not be allowed to do so. However, they tell us that they expect more clarity in the coming weeks and there will be delays to listings. This is not only due to greater scrutiny from the Chinese side but also in the USA where the SEC has banned further listings until they issue new disclosure requirements. The China Securities Regulatory Commission has responded by saying that they will cooperate with their American counterpart and remain committed to advancing reform, opening up and reiterated that they have no objections to overseas listings.

One venture capitalist asked us why any government would turn down foreign investment. Whilst there is clear preference for listing on the Chinese mainland or in Hong Kong, foreign investment obtained through Nasdaq listings is an important driver for growth and innovation in China. However, geopolitics will create greater red tape on both sides. From the US perspective, it will be a great shame for the Nasdaq to lose its dominance to competitors in China or Europe.

6 Bringing it all together

Chinese markets have seen incredible volatility in recent weeks but none of this is unprecedented and is part and parcel of investing in markets that remain driven by retail investors and prone to overreaction from international shareholders. This creates significant investment opportunities for skilled managers. As we have repeatedly said, this is not a market for passive investors. The same applies now with the indiscriminate sell-off over the last week of companies that are exposed to increased regulation but at the same time others for no reason beyond that they “are Chinese”. Valuation multiples of growth companies have dropped across the board. Many of our managers are busy repurchasing shares of great businesses that they had only recently sold for valuation reasons.

Investors must always respect the social objectives of the Chinese state capitalist system. This creates significant risks in companies that need to be avoided but also tailwinds for others when policies encourage innovation and development.

Saying that, Chinese policymakers are behind on regulation and seem to have decided to catch up across multiple sectors all at once. It is safe to assume from their actions in education that they are prepared to be stern if required. This will need to be watched carefully and it has never been more important to have a specialist who knows what they are doing.

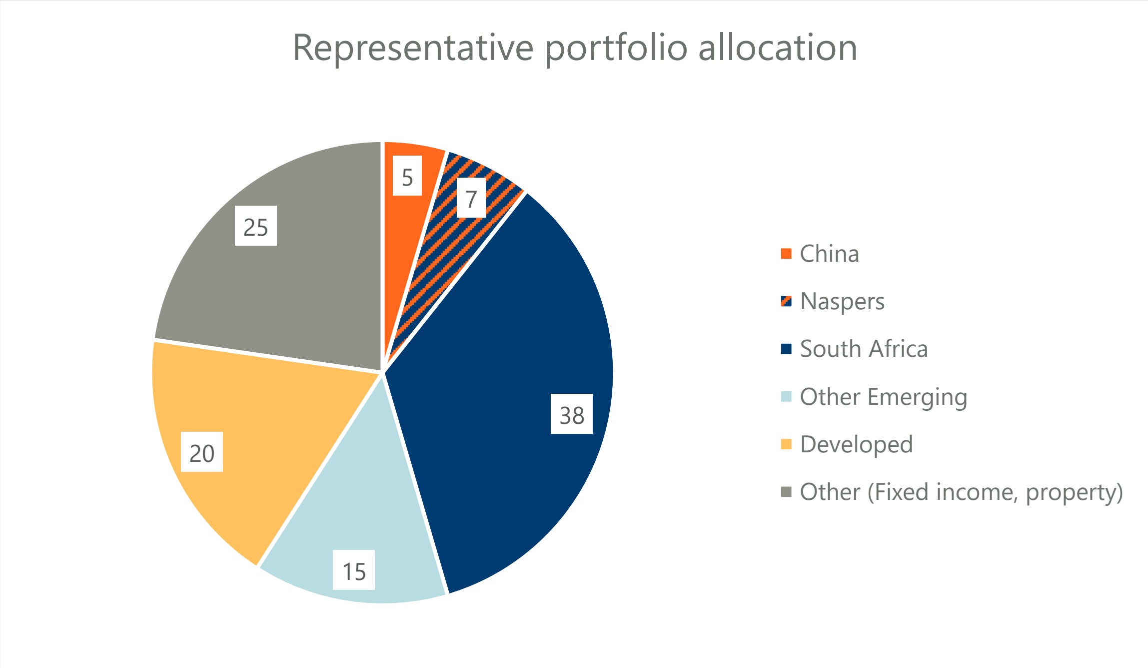
This brings us to the need for specialist Chinese managers. China is the world’s second largest stock market with thousands of fast-growing companies. Whilst it is too large to ignore it also requires a skillset that very few global equity managers and only some global emerging market managers have. China requires dedicated specialists who really know what is happening on the ground.

Next is the subject of diversification. We should not apply the same principles in China as we apply to developed markets. China is not a market where concentrated portfolios are better. Firstly, it means that an investor misses out the widest growth opportunity set given the multiple drivers of growth and secondly it exposes the investor to “black swan” events that happen in China more frequently than elsewhere. As one of our best managers once told us, he learnt the importance of diversification when he saw his 20% investment in Moutai collapse when the Chinese anti-corruption campaign started in 2012. It was an exogenous event that he could not have foreseen. Even though the company later prospered, it resulted in significant short-term drawdowns for the manager. This is why we strongly argue for investing across multiple managers specialising in different sectors. For our pooled strategies we have more than 10. This diversification has helped our investors withstand trade wars, Covid-19 and now this regulatory crackdown whilst enjoying high returns relative to the market indices.

7 China exposure in context for Southern African investors

7.1 How much and by what means?

For a representative Southern African portfolio or strategic target the China allocation would be around 5% of the total portfolio through pooled China exposure, plus an additional 6-7% indirectly via Naspers/Tencent (based on RisCura estimates).

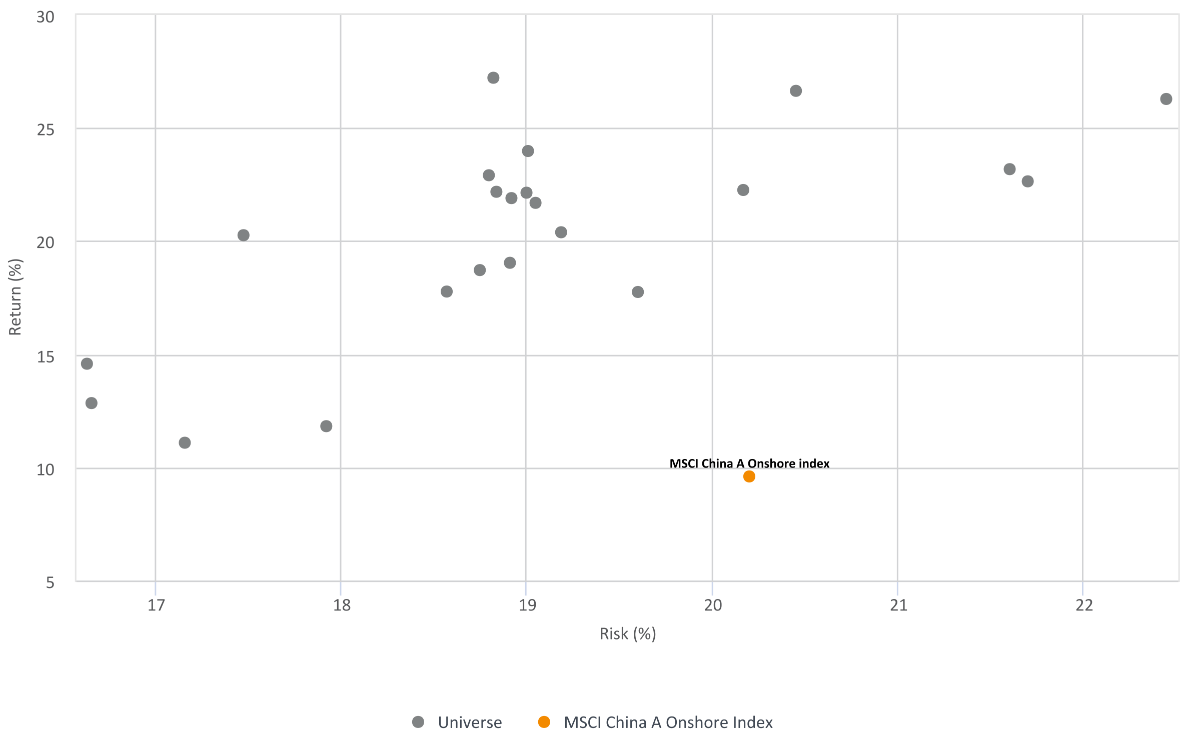


Tencent has been one of the stocks considerably impacted by the regulatory crackdown (it's music business for example being ordered to stop exclusive distribution deals as well as the regulator banning Tencent's proposed merger of China's 2 top videogaming sites). As a result, Tencent's share price has declined by over 40% since its peak in February 2021. By contrast, more diversified China exposure, such as the MSCI China index or the (mainland) MSCI China A index saw declines of between 15-25% over the same period. Active managers have fared even better. This demonstrates once again the benefit of a diversified approach, especially in a country like China where (largely due to the actions of trend-driven retail investors), market volatility is inherently higher. Investors who are concerned about future volatility would therefore benefit from replacing single-stock exposure with a multi-sector, multi-manager alternative.

7.2 Active or passive?

We have argued previously that China is unsuitable for passive investment and this recent episode gives a good working example. The significant presence of retail investors, typically under-informed and price trend-following, creates outsized volatility in the market and at the same time opportunities for skilful managers. As a result, in China, active managers have long track records of outperformance. This is shown in the chart below where most managers deliver returns above the index, and frequently at lower levels of volatility.

60 Months Scatter for the Period Ended 30 June 2021



Risk and returns greater than or equal to 12 months are annualised. Report currency = ZAR

7.3 Conclusion

China continues to represent good opportunities for long-term investors. The market is huge with over 4000 companies, domestic growth remains robust (even if less strong than in previous years) and skilful managers continue to deliver outperformance. The regulatory crackdown has reminded us of the benefits of a diversified exposure, together with the value of having local specialists who are likely to understand regulatory themes and messages somewhat better than global investors.