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Takeaways from Our China Regulatory Webinar

A special report for our investors and advisory clients

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Key Takeaways

- **What Surprised Us the Most** – The severity of the crackdown on private education, and the uncertain timing of regulatory enforcement in China
- **What's Next** – The on-going regulatory scrutiny covers a wide range of issues and impact several industries not just Big Tech, such as Health Care, Real Estate, Financials and certain segments of Consumption.
- **Keyword: Security** – Despite the multitude of regulatory issues, security is an overriding theme that connects the various dots. For example, cybersecurity is one form of "security". Technology self-sufficiency is for national security. Narrowing the wealth gap is about social security. Deleveraging the economy is to ensure financial security. And climate change is about environment safety…
- **Don't Waste Time Predicting Regulations** – It may be futile trying to predict the specific regulation and the enforcement timing. It's also not our job to critique or influence government policy. Our main responsibility is towards the investors, protecting their interest and managing the investment risk, assuming that the Chinese regulatory environment is not something we can predict or control.
- **Focus on Corporate Governance** – OECD defines governance as a set of relationships between a company's management, its board, its shareholders and other stakeholders – which include governments and regulators. Bottom-up governance research is how we view and manage the regulatory risk in China. An important aspect of our research is on the "regulatory effectiveness" of Chinese companies.
- **Proactively Managing the Regulatory Risk** – In terms of regulatory effectiveness, one thing to look for is an acute sense of the legal and regulatory issues, and a proactive attitude toward regulatory compliance. The best companies actively engage the regulators, the shareholders and other stakeholders on hot-button issues, before they turn into real

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regulatory risks. This is as opposed to just waiting for things to happen.

- **Valuation Limits on Big Tech** – It may be too early to tell the investment implications from the current regulatory events. We believe increasing regulation is the new norm for Big Tech in China. This should last for years, not months. If so, there will be a valuation limit on Chinese Internet stocks, similar to that in the domestic pharmaceutical industry.

Below are key takeaways from our recent webinar "A Bottom-up Analysis of the Regulatory Risk in China", held for investors on August 31.

The webinar was organized by MegaTrust Investments, with Dr. Dequan Wang of Governance Solutions Group (GSG) as a guest speaker. Dr. Wang is an experienced legal, regulatory and governance expert in China. More information about him and his firm can be found at the following link:

https://gsg.hk/en/firm/

Readers may also want to check out my previous articles on this topic:

https://www.linkedin.com/pulse/key-investment-issues-related-recent-regulatory-events-qi-wang-cfa/

https://www.linkedin.com/pulse/what-you-may-have-missed-didi-case-qi-wang-cfa/

WORLD | ASIA | CHINA

China Passes One of the World's Strictest Data-Privacy Laws

China's once-freewheeling internet faces new rules protecting personal data, as the world's largest online population awakens to privacy concerns

UPCOMING EVENTS

Sep 9 2021 — 2:00 PM - 2:30 PM EDT — Community Conversations: How Sept. 11th Changed Us

Sep 14 2021 — 12:30 PM - 2:00 PM EDT — The Future Of Transportation

Sep 27 2021 — 11:00 AM - 7:00 PM EDT — Women In The Workplace Forum

Source: wsj.com

What Surprisued Us the Most

In hindsight, there are few surprises from the recent regulatory events in China. For the past six years, the government is vigorously trying to catch up on Internet-related regulation, including the National Security Law and the

revised Advertisement Law in 2015, the Cybersecurity Law in 2016, the E-Commerce Law in 2018, and the Personal Information Protection Law passed just weeks ago – which Wall Street Journal calls "the world's strictest data privacy law". By now it shouldn't be a surprise to anyone that China is serious about reforming the Big Tech Internet industry, and wants to increase the regulation.

However, there are at least two things that surprised us:

First is the severity of the crackdown on private education. We always knew that the education sector is problematic, in terms of the business model and corporate governance etc. However, we didn't expect such harsh measures by the government, making all private school businesses illegal in China (not illegal to run, but illegal to make profits from).

Second, the timing of the regulatory enforcements. For example, China's Anti-monopoly Law was passed in 2007 and came into effect in 2008. However we only saw meaningful applications to the Internet sector this year. Why is there a 14-year lag? Maybe the Chinese Internet players weren't big enough back then? Do regulators need time to move up the learning curve? Are there any other considerations? The answer is not exactly clear.

Likewise, the regulation for after-school tutoring (cram schools) was announced in 2018, while the enforcement only began this year. The timing of the regulatory enforcement is where we'd like more guidance and transparency from the government.

What's Next?

What other sectors could be affected by the on-going regulatory tightening?

The current regulatory scrutiny covers a wide range of issues, which impact several sectors not just Big Tech, such as Real Estate, Health Care, Financials and certain segments of Consumption.

There is a long list of regulatory issues at hand: anti-monopoly, cybersecurity, data security (including vehicle data), personal privacy, on-line marketing practices, technology self-sufficiency, environmental impact, income inequity, the wealth gap, cost of living, labor issues (e.g. employee benefits) and others like sexual harassment in the workplace.

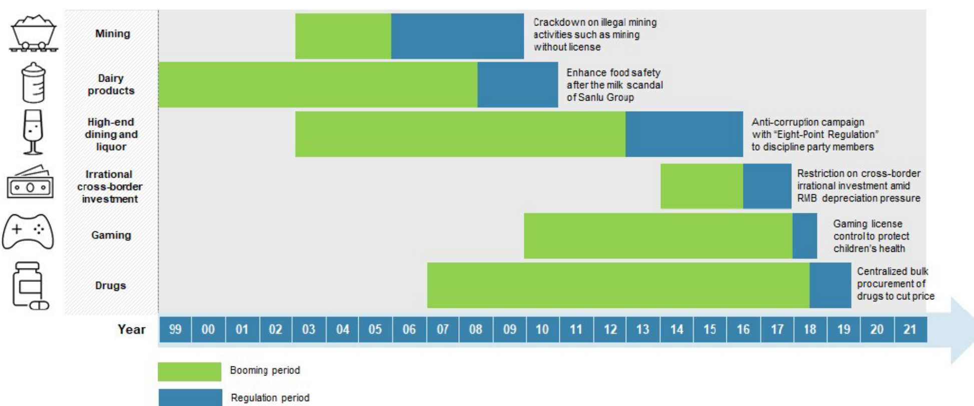
Note that China is not alone in pursuing some of these regulatory agendas, like controlling Big Tech, protecting personal privacy and dealing with climate change. In many cases, China is simply trying to play catch-up with the rest of the world.

Key Word: Security

How can we possibly understand and manage such complex issues? We suggest investors view through the lens of "security" as a common thread. The word "security" appeared exactly 66 times in China's Five Year Plan (2021-2025), which was announced in late 2020. To stay in power, the Chinese government need stability and security. We think nearly all regulatory issues today fall under this overriding theme.

Cybersecurity or data security is one form of "security". Technology self-sufficiency is for national security. Controlling the cost of living, reducing income inequity, narrowing the wealth gap and increasing employee benefits are about social security. Deleveraging the economy is to ensure financial security. Climate change is about environment safety, and so on.

China's Regulatory Cycle



Source: Morgan Stanley.

How Bad Can Things Get?

We'd like to reiterate it's not the government's intention to nationalize, break up or restructure the Big Tech Internet firms, or any other sectors or companies under the spotlight (except education).

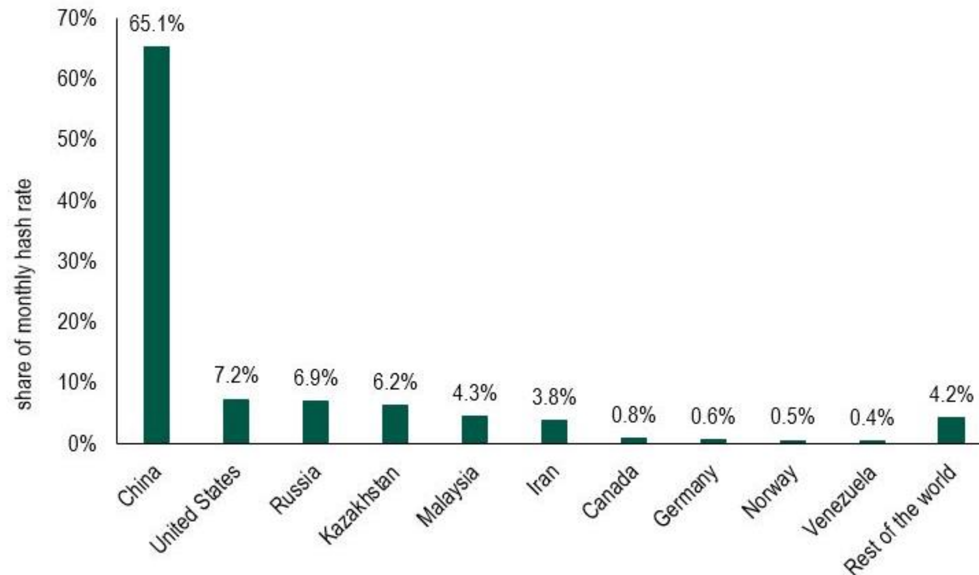
In Didi's case, the company has over 14 million drivers and close to 280 million users (riders) on its platform – the largest taxi-hailing app in China. There would be major (negative) ramifications in terms of service disruption, unemployment and public outcry, if Didi were forced to shut down overnight. This is not what the government would like to see, consistent with the theme of "security".

Both speakers (Qi Wang and Dequan Wang) agree that government's remedy is to change the corporate behavior of Big Tech rather than restructure the whole industry (behavioral as opposed to structural).

More Financial Regulation?

So far most of the regulatory pressure is from the industry regulators. For example, the Ministry of Transport for Didi, the State Administration of Market Regulation on Tencent, and the Ministry of Education on TAL. What about the financial regulators? Can we expect more tightening there as well?

Bitcoin Mining Hash Rate (April 2020)



The financial regulators – like the China Securities Regulatory Commission (CSRC) – are involved in some of the recent "crackdowns". In fact, some investigations are conducted jointly by multiple government agencies, including the financial regulators. China likely views capital market regulation as another leverage in changing the corporate behaviour of companies concerned.

The financial regulatory agenda is not just to limit the growth of Big Tech. This need to be viewed in the broader context of financial market opening and reform, improving the quality of listed companies, and creating a healthier environment for both domestic and foreign investors… Some of the financial regulations may seem unfriendly to the market at first, but they should result in win-win situations over the long term – for both companies and shareholders.

Interestingly, many Chinese Big Tech companies begin to resemble financial firms. Some are already offering financial services directly. Others may be holding large financial assets as a result of their business operations.

For example, a leading bike-sharing platform is now likened to a bank, due to

the large “deposits” taken from millions of customers as collaterals. It’s a real challenge for the financial regulators to understand and control these new forms of financial risk.

What About Corprote Governance?

OECD defines governance as a set of relationships between a company’s management, its board, its shareholders and other stakeholders – which include governments and regulators. An important aspect here is also the “transactional relationship”, which involves dealing with disclosure and authority (compliance). So, is there a corporate governance angle in the recent regulatory events in China? Absolutely.

In fact, bottom-up governance research is how we view and manage the regulatory risk in China.

(1) As mentioned earlier, it is rather difficult to forecast the nature and the timing of regulatory changes in China.

(2) Also, we don’t think it’s our job to critique or influence government policy. It’s simply not what a fund manager does. Our main responsibility is towards the investors, protecting their interest and managing the investment risk, assuming that the regulatory environment is not something we can predict or control.

(3) Our focus has always been on companies, not regulators. What we found is that corporate governance does make a difference in the recent regulatory events.

Our view was echoed by Dr. Wang, who said governance is “essentially balancing the interests of the company’s various stakeholders”, including the government. Incidentally, regulatory risk control or “regulatory effectiveness” is a key indicator in both MegaTrust and GSG governance research models.

What to Look For in Regulatory Effectiveness

So how do we evaluate the regulatory effectiveness of Chinese companies?

The first and foremost is an acute sense of the legal and regulatory issues, and a proactive attitude towards regulatory compliance. Good compliance is not just about ticking all the boxes. In China, there are often no boxes to tick, especially with brand new, innovative, technology-driven businesses.

However, no regulation doesn’t mean companies can do whatever they want. They need to identify the hot-button issues and potential regulatory risks as much as possible. It’s also good practice to actively communicate with and even educate the regulators on new technologies and upcoming issues.

Unfortunately too many Chinese companies choose to ignore these issues, take shortcuts, or try to capitalize on the regulatory loopholes… until the crackdown happens of course.

We think the Chinese securities brokerage industry does a good job of cooperating with the regulators. For example, cross-border trading was a major regulatory challenge in China, due to the capital control and foreign ownership limits etc. The brokerage industry voluntarily communicated with their regulators on these issues, and one brokerage firm actually came up with the original idea of Stock Connect. This is now a highly successful program allowing foreigners to trade China A-shares easily through Hong Kong.

Almost all regulatory issues entail some kind of conflict of interest. Even if a company fails to resolve this conflict of interest, at least it should be open and honest about it, not hiding it. If necessary, the company should address the conflict to the various stakeholders, especially the shareholders.

In the education sector, there is a major conflict of interest between the basic education service (K12) and the profit-seeking motive of a listed company. This is a fundamental problem that need to be addressed. However, none of the education companies have spoken openly about it. Based on our research, there wasn't sufficient honesty and integrity in facing this conflict of interest, and helping investors understand the potential regulatory risk.

As mentioned before, the regulatory risk in education did not emerge overnight. In fact, there has been a "regulatory storm" in the Chinese education sector for the last two years. However, for one of the leading education firms, there was no mentioning of any regulatory risk during the earnings conference call for the past eight quarters. This is not only disappointing, but also a possible breach of the management's fiduciary duty to the company's shareholders.

Valuation Boundaries for Big Tech

What is the investment implication to Chinese Internet from the on-going regulatory scrutiny?

Ideally we'd like to match each new regulation to key items on the company's financial statement line by line – which we are trying to do. However, we are still amidst the current regulatory cycle, and things are still happening as we speak. The situation is quite fluid, and there may be too many moving targets.

As for the specific regulation, we think data privacy will have a bigger, longer-lasting impact on Internet companies, rather than say, the imposed limits on on-line gaming or marketing practices to children. Gaming generates significant revenues, but it's just one segment of the Internet business model.

Data privacy on the other hand will severely limit the Internet platform's ability to cross sell. Any restrictions on cross-selling will impact almost the entirety of the Internet business model…

This leads an interesting question: Where is the (business) limit for Chinese Big Tech Internet platforms?

Well, before the current wave of regulation, there was almost no limit. Big Tech could get into almost any business with relative ease. This is also why there was almost no valuation cap on these companies. Granted, some of the companies have been growing at a high rate for a long time. 100x PE multiple? No problem. Why not 200x? Or 300x? Sky was the limit.

We believe more regulation is the new norm, which should last for years not months. If so, there will likely be a limit on the growth of Big Tech, and therefore some kind of valuation cap.

The best example is the Chinese pharmaceutical industry, which has been heavily regulated, and face new regulations every 12-18 months. The pharmaceutical industry is quite accustomed to regulatory cycles, and investors also trade these stocks accordingly. For example, A-share listed Hengrui Medicine (600276.SH) has been trading between 50-100x PE in the last ten years, and Hong Kong listed CSPC (1093.HK) is consistently between 20-50x PE in the last decade. The upper limit on valuation is mainly from regulatory risk, in our view.

Viewing Challenges As Opportunities

There has been some controversy over how China handles the regulatory tightening lately. There is also a related debate on whether the Chinese stock market is investable because of the uncertain regulatory risk. Both sides have their arguments and we will not go into details here.

We suggest global investors take an "alternative" view, and get back to the basics of why investing in emerging markets or China in the first place. Growth is often the No. 1 reason. Then think about the root cause of this growth… which often stems from some kind of problems: lack of infrastructure, substandard living conditions, a large but inexperienced workforce, inefficient markets, poor corporate governance and opaque legal systems etc.

The same set of problems that scare off some investors may lead to growth opportunities and viable business models for others, and ultimately contribute to the success of emerging market investing. Nothing is perfect even in developed markets like the U.S., yet great companies and smart investors tend to view challenges as opportunities.

The valuation range of regulated industries in China including now Big Tech presents an interesting opportunity to buy great companies at reasonable or cheap prices.

Our Quality Framework Focused on Governance

Source: MegaTrust.

About Us

MegaTrust Investments is an employee-owned, boutique China manager specializing in A-shares (domestic Chinese stocks). The firm was founded in Shanghai, China in October 2007 and launched its first fund - the Yangtze Fund II - in April 2008. The firm and its associate are licensed by the Asset Management Association of China (AMAC) and the Securities & Futures Commission of Hong Kong (SFC) for asset management, targeting only Professional Investors. MegaTrust uses bottom-up research to pick stocks, with a focus on company quality and corporate governance. The firm has approximately $800m of assets under management, with over 13 years of Alpha generation in the Yangtze Funds.

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