China – Governance and Regulatory Risks to the Fore

The recent "China rout" reflected a raft of government announcements/edicts across a range of sectors that have the potential to severely impact growth and profitability on a sustained basis. Current valuations to us suggest that the downside risks on China are still material if there are no systemic improvements in China's policy settings and overall corporate governance.

This article has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Mark ets Fund.

The factor that drove the Emerging Markets index down so much last month was China (which has a near 40% index weighting). The MSCI China Index fell a whopping -14%, reflecting the sharp fall in China H shares (-13.4%) and Chinese listed equities in the US.

Indeed, the correction was led by US listed China education companies, which sank -75% over July and US/HK listed China internet heavy weights, such as Baidu (-20%), Tencent (-18%), Alibaba (-15%) and JD.com (-12%). Chinese banks, which fell on average -15% over June, dropped another -5% over July. If this was not enough, the MSCI China Real Estate index fell -23% over the past month reflecting ongoing concerns over solvency of the sector.

In short, the "China rout" reflected a raft of government announcements/edicts across a range of sectors (especially internet communications and education) that have the potential to severely impact their growth and profitability on a sustained basis. This combined with the systemic debt problems which are now starting to bubble to the surface (especially in the property sector), accentuated the collapse.

These adjustments by the government intensified over July and forced investors to reassess the over-arching equity risk premium for investing in China. It seems the likelihood of the Chinese government potentially interfering in "any" private enterprise and permanently damaging its ability to create shareholder value – especially for foreign investors - has clearly increased in the eyes of the market.

We have long had zero exposure to the Chinese internet and education sectors as we have been uncomfortable with the VIE ownership structure from a governance perspective. We have also viewed the risks of regulatory interference in these sectors as intolerable – given how important they are economically and socially in China, and the government's desire to exert tight control over such areas.

Foreign ownership of these sectors has never been permitted according to the letter of the law in China, and the workaround has been for companies to employ the variable interest entity (VIE) ownership structure.

A VIE enables foreign investors to invest in restricted sectors in China via a legally dubious structure which has never been formally endorsed by Beijing. In several cases where the Chinese counterparties have broken the VIE agreements, foreign investors have been left high and dry in the Chinese courts due to the illegal status of the VIE structure. High profile incidents include Yahoo! having Alipay snatched from it by Jack Ma, and the Gigamedia, FAB Universal, and Chinachem court cases all favouring the local parties in VIE disputes.

Investing in a company where we do not have clearly defined ownership rights, and where a foreign government could suddenly, or arbitrarily deem our shares to be worthless, is not a risk worth taking in our view.

There have been significant developments in the past few months, which have been highlighted in the below timeline (see Exhibit 1) from Bloomberg in relation to the sharp fall in the Golden Dragon China Index. Note: The MSCI Golden Dragon Index captures the equity market performance of large and mid-cap China securities (H shares, B shares, Red-Chips and P-Chips) as well as securities classified in Hong Kong and Taiwan.

Exhibit 1: Major Chinese regulatory developments since mid-2020

Source: NASDAQ Golden Dragon China Index via Bloomberg

Most recently, on 3 August 2021, Tencent fell -6% after Chinese media called online games "spiritual opium".

Index risks highlighted

The shares of those companies, most impacted by the above events have fallen sharply. After Chinese outlawed for-profit school tutoring, Chinese education companies collapsed in July – Gaotu Techedu (-79%), TAL (-76%), New Oriental (-74%) – in one month alone. These companies are all down at least 90% from their highs earlier this year, and the latter two have lost their position as top 40 index constituents.

Index heavyweights have fallen precipitously from their highs: Alibaba (-38%), Tencent (-37%), Meituan (-48%) etc. We believe this is clear evidence that investors were under-estimating the governance and regulatory risks of investing in these sectors. We see risks that these companies could trade on even more depressed/lower multiples going forward.

The weighting of the Chinese internet and education companies in the MSCI EM index has fallen from around 18.5% at the start of 2021 to 14.5% today. With their large index weights, we believe their downside has been exacerbated by forced ETF and index-related selling.

There could still be further long-only and hedge fund selling in these names to come, and it is not impossible that we could see some extreme 'Archegos style' volatility in individual names. Further, some indexes could delete some of these companies as we move closer to the 2024 deadline for the Holding Foreign Companies Accountable Act, which will likely result in most of the 248 Chinese ADRs being delisted from US exchanges (see more below).

VIE risks now in focus

Other investors, we believe, are starting to wake up to the risks around VIEs. Bloomberg recently highlighted the disclosures in DiDi's IPO prospectus:

"There are substantial uncertainties regarding the interpretation and application of current or future PRC laws and regulations," said Didi's prospectus, about the VIE structure. And if anything changed, it said, "the relevant governmental authorities would have broad discretion in dealing with such violation, including, without limitation: …revoking the business licenses and/or operating licenses of our PRC entities; … [or] requiring us to restructure our ownership structure or operations, including terminating the contractual arrangements with our VIEs."

This is quite jaw-dropping when you read it for the first time. But similar language and warnings are contained in the prospectuses or annual reports of all US-listed Chinese companies which operate in restricted sectors and thus have VIEs – see extract from Alibaba on the RHS.

VIE risks clearly highlighted in Alibaba's annual report

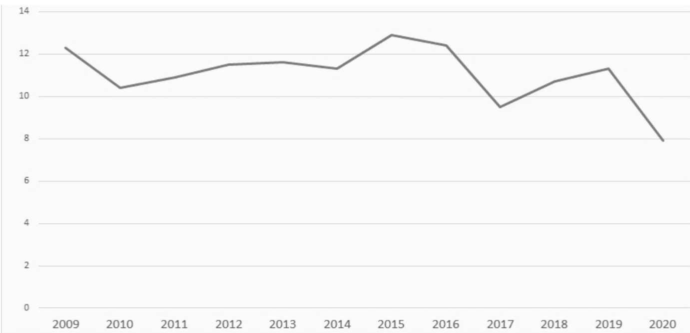
If we or any of our variable interest entities are found to be in violation of any existing or future PRC laws, rules or regulations, or fail to obtain or maintain any of the required permits or approvals, the relevant PRC regulatory authorities would have broad discretion to take action in dealing with these violations or failures, including revoking the business and operating licenses of our PRC subsidiaries or the variable interest entities, requiring us to discontinue or restrict our operations, restricting our right to collect revenue, blocking one or more of our websites, requiring us to restructure our operations or taking other regulatory or enforcement actions against us. The imposition of any of these measures could result in a material adverse effect on our ability to conduct all or any portion of our business operations. In addition, it is unclear what impact the PRC government actions would have on us and on our ability to consolidate the financial results of any of our variable interest entities in our consolidated financial statements, if the PRC government authorities were to find our legal structure and contractual arrangements to be in violation of PRC laws, rules and regulations.

Source: Alibaba Annual Report 2020

We have also heard from Chinese accounting/VIE experts that getting money out of the VIE structure is very difficult without incurring punitive tax rates (as high as 70%). This may explain why companies with this ownership structure continue to raise capital offshore to fund expansion and have never paid substantial dividends.

For example, Tencent's dividend payout has averaged 11% over the past decade and fell to 8% last year – see Exhibit 2. This is despite it having 'cash and cash equivalents' in excess of $20bn in each of the last four years (and $35bn in 2020). This issue may necessitate an adjustment in how these companies are valued going forward.

Exhibit 2: Tencent Dividend Payout Ratio (%) (2009-2020)



Source: Bloomberg

What's next?

It is hard to predict what will happen to the sector over the next few months, and anyone who tells you otherwise is kidding themselves.

Many thought the regulatory blitz was finished in the last week of July, but we have seen further announcements in August to date. It is possible that the regulatory crackdown could subside in the coming weeks, especially if China gets concerned that the impacts are spilling over into the domestic economy and individual livelihoods.

US regulatory developments also remain fluid. The US has already proposed to move forward by one year the deadline for the delisting of Chinese companies from US exchanges if they do not comply with PCAOB audits. Closer to this deadline, we expect the sector could face more uncertainty and volatility when it dawns on investors that this is actually happening. This is of course barring a last-minute U-turn from US authorities, but this looks unlikely at this stage.

If/when the US delistings finally happen, we believe investors will be forced to scrutinise these companies even more closely, and ask – how can I invest in a company that doesn't submit itself to US audits (amongst addressing other governance shortcomings)?

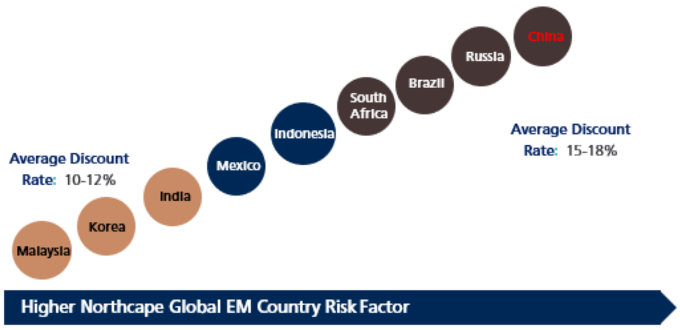
Northcape has had a long-standing zero exposure to the Chinese internet space given our concerns on governance and regulation. Recent events have further reinforced our decision to maintain our sustained high discount rate for China which reflects our sovereign risk concerns (spanning economic, political, and governance) of investing in the Chinese market. As such, we have a structural underweight to China, and zero exposure to China A-shares.

A point to ponder – if a government can unilaterally declare that entire sectors can no longer be profit-making, and ultimately wants to control capital allocation across the economy, then why have a stock market at all?

China equity risk premium reassessed

We sense the market is starting to come around to our way of thinking on China, based on the recent correction. However average valuations in China (MSCI Golden Dragon China Index trailing P/E is 20X) – still do not take account of the risks based on our assessment. As Exhibit 3 illustration shows under our sovereign risk modelling, China has one the highest equity risk premiums (approaching 18%). This level is well above its 10-year bond yield of 2.8%, which might suggest an equity cost of capital of 8-10% to the casual observer/uninformed investor. This is clearly a level that profoundly understates the risk of investing in the country in our view.

Exhibit 3: Northcape EM Sovereign Discount Rankings



Current valuations to us suggest that the downside risks on China are still material if there are no systemic improvements in China's policy settings and overall corporate governance. Specifically, the markets risk premium on China has the potential to deteriorate, seeing P/Es fall even further.

Again, this highlights the dangers of a passive equity investment in EM, whereby investing in an index tracking strategy by default provides near 40% exposure to the China risk. By the same token, this is a positive testament to investing in an active, highly selective investment strategy for the EM equity asset class, which can price the China risk, and have the appropriate portfolio weighting.

*The **Warakirri Global Emerging Markets Fund** is long only, low turnover (30-50% p.a.) and selective. As such it will hold between 20-40 stocks of Emerging Market businesses with clear opportunities for growth.*

For more information, please contact us on 1300 927 254 or visit warakirri.com.au