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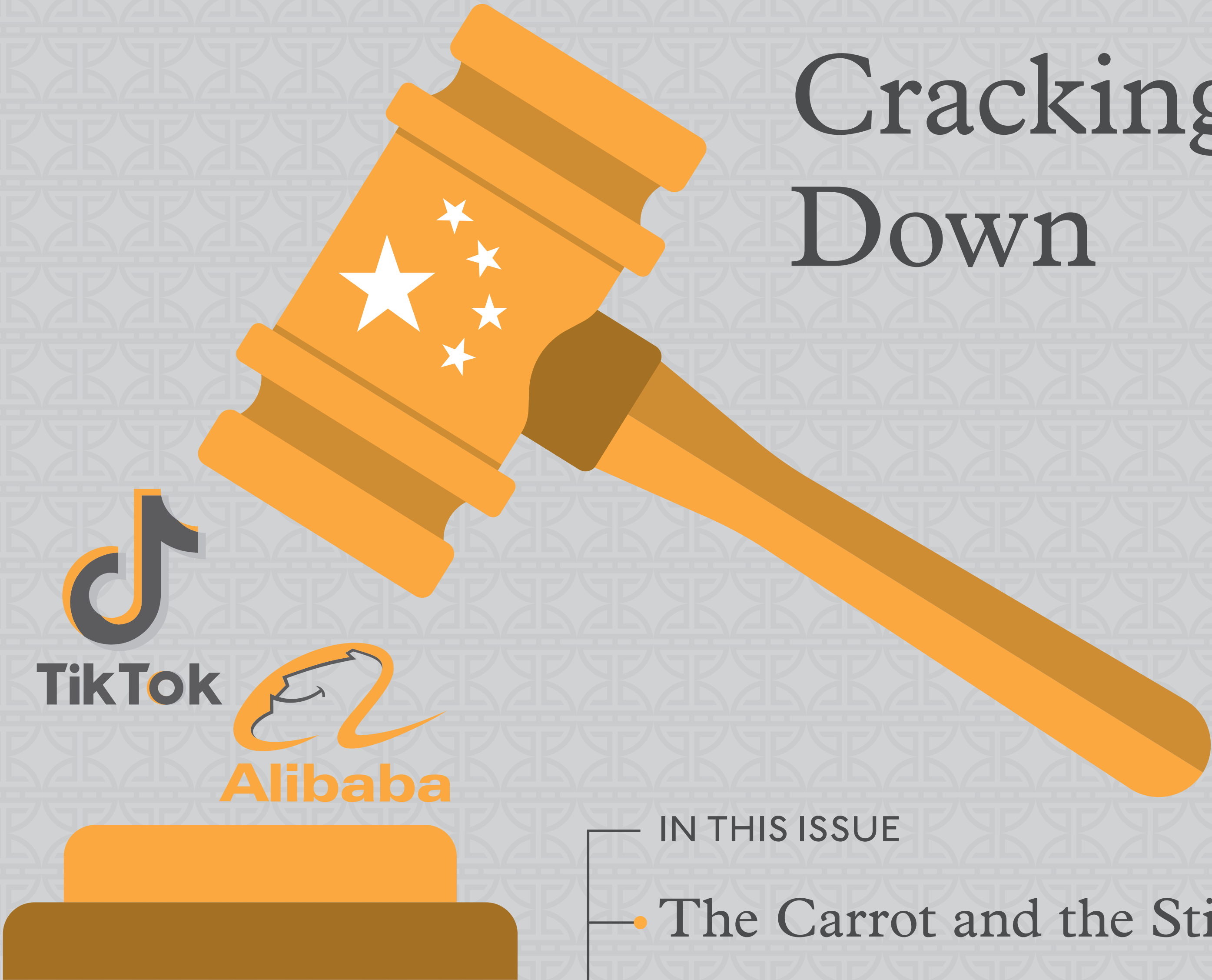
Cracking Down



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CRACKING DOWN

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If the past few months have shown us anything, it is that China's autocratic intervention can be deployed at the drop of a hat. Its most successful 'free-market' enterprises are no longer immune from state control, and investors were startled as President Xi Jinpin announced a flurry of regulatory actions against the country's 'technology Titans'. While it is not unusual to witness the Chinese government engage in an assault on capitalism, the swift and unexpected announcements appeared to upset financial markets in their lack of forewarning.

There have now been over 50 responses to regulatory offences by a number of firms, ranging from anti-trust abuse to data violations (**See: The Chinese Way**). Most notable are the region's greatest success stories being quashed: Ant Group's US$37bn initial public offering was suspended just days ahead of its listing; Tencent was ordered to end exclusive music licensing deals; and, more recently, the ride hailing app Didi was ejected from app stores just days after its listing in New York.

While surely Mr Xi has little appetite for stamping out prosperity, the attack has wiped around US$1tn from stock markets. On the contrary, his goal seems to centre around shaping the industry before it becomes uncontrollable and misaligned with state ambitions. Lowering the barriers to entry and ensuring the industry's wealth is shared amongst small and large businesses is surely a good thing. After all, the country's Western counterparts demonstrate the Technology sector's tendency to consolidate into monopolistic behemoths. Though, perhaps the knee-jerk response was not the best policy, and to maintain investment (particularly from overseas investors), he will have to tread more carefully in future. Expectations must be set, and the boundaries need to be clearer.

Indeed, the Technology industry seems to have snuck up on leaders. In the absence of any robust regulation, firms have capitalised on their network effects to grow at a rate of knots. Didi, like Uber, has fast become one of a small set of taxi firms in the gig economy. The more users and partners (aka drivers) it gains, the more attractive the product becomes to new users. The app now has more users than there are Americans. Though there are some that, for now, have avoided the firm hand of the Chinese State: social media platform ByteDance has seen its user base grow exponentially in the last few years (**See: The Carrot and the Stick**).

While all this has created anxiety in investors, it also presents an opportunity. China's economic growth prospects remain some of the strongest in the world. First out of the pandemic and on the right side of inflation (**See: Chinese Inflation: The *Other* Story**), the country is poised to resume its rapid economic expansion plans. It also remains underserved as a consumer-led economy; household consumption represents a mere 39% of Chinese GDP, whereas in America this is almost 70%. If nothing else, this is an ideal environment to build new brands in the world's second-largest economy.

STOCK FOCUS

THE CARROT AND THE STICK:
CAN TIKTOK'S PARENT COMPANY BYTEDANCE BE THE SUCCESS STORY OF CAREFUL COMPLIANCE WITH CHINA'S COMMUNIST PARTY?

Amongst the recent furore over China's regulatory pressure on some of its largest corporations there is a sense of quiet optimism around one Chinese tech giant, ByteDance.

If the name is not instantly recognisable, the group's social media giant TikTok certainly will be. National lockdowns and more time to spend scrolling through viral videos have expanded TikTok's user base far beyond the teenage generation, with advanced artificial intelligence techniques providing a revolutionary algorithm to keep users scrolling, consistently recommending video content tailored specifically to the tastes of each individual.

The addictive nature of viral content and the broadening appeal to a wide range of demographics saw downloads rocket throughout all age groups during 2020, and by December it was reported the app had been downloaded a staggering 2.6 billion times. By February 2021, it was estimated there were 1.1 billion active users of TikTok every month, with each user spending an average of 52 minutes per day on the app across eight browsing sessions. Perhaps more worryingly for behavioural psychologists, a new study recently revealed that younger people aged four to fifteen spend an average of 80 minutes per day on the platform. This number of eyeballs focusing in on one platform of course brings immensely lucrative advertisement opportunity as tailored adverts are placed strategically between videos, encouraging brands to pay up to US$200,000 to promote a hashtag. Moreover, creators of popular videos are now being rewarded with bumper pay packets through the TikTok creator fund; 20-year-old influencer Addison Rae reportedly took home over US$5m during 2020.

In addition to TikTok, the ByteDance group owns two further social media platforms: Douyin which is essentially a Chinese form of TikTok, and TouTiao (Headlines) which provides a tailored aggregated news feed to millions of users across China. However, it was the group's US operations in TikTok that sparked security concerns with previous American President Donald Trump. After one of the first platforms developed by ByteDance, Neihan Duanzi, was permanently shut down in 2018 for hosting improper content, senior executives announced that the group would give preference to Chinese Communist Party (CCP) members in its hiring and established an internal CCP Committee to serve party members amongst its employees. The group has also reportedly formed strategic partnerships with the Chinese Ministry of Public Security in order to contribute to the ministry's public relations efforts.

As a result of the Trump administration's intention to ban TikTok during the summer of 2020, ByteDance engaged in talks with potential buyers and agreed to sell its US operations in TikTok to technology giant Oracle. However, as the American Presidency transitioned to Joe Biden, the deal was put on pause to assess whether the threat of the US 'ban' on TikTok would remain under a new administration. It has since become clear that the Biden administration has reviewed the situation and does not appear to be in favour of such a ban, thus the deal with Oracle has been abandoned.

With the group no longer at risk of break-up, senior executives within ByteDance have reportedly been eyeing up an initial public offering (IPO) on the Hong Kong Stock Exchange. The group appear to be treading very carefully through a tumultuous political climate for Chinese companies, appearing to stay on the right side of China's Communist Party and its regulators. Following a meeting with officials to discuss cyber security earlier this year, in which executives from China's ride-hailing app Didi Chuxing were also said to be present, ByteDance delayed IPO plans in order to provide regulators with more detail on how they process information. Didi, on the other hand, went ahead with a US$4bn listing on the New York Stock Exchange in June, only to be banned from China's app stores a few days later and subject to a fresh investigation into rule violations. Furthermore, founder Zhang Yiming, estimated to have amassed a US$44.5bn fortune from his success in ByteDance, stepped away from his role as Chief Executive in spring. Although claiming his departure from the role was due to his dislike of managing people and his preference for "solitary activities like… daydreaming", it seems clear the move is a nod of compliance towards a government highly sceptical of ultra-high net worth CEOs, the recent disappearance of former Alibaba chief Jack Ma perhaps firing a clear message.

It seems, therefore, that TikTok's parent group have an obvious intention to work with, not against, Xi Jinping and the CCP. As recently as 5th August, ByteDance reacted to the CCP's change in policy towards online tutoring websites by announcing a shift in its education division away from school age children in favour of adult-only tuition, closing down its Gogokid platform which allowed foreigners to teach English to China's children. The group continues to adapt and make sacrifices in order to avoid the ferocious force that is Chinese regulation, a skill that is beginning to set it apart from the other tech giants of China.

Coupled with this apparent ability to please regulators, underlying fundamentals are impressive. During 2020, ByteDance doubled total revenue to US$34bn, and was estimated to be worth upwards of US$250bn based on private stock trades. China-based publication 36kr estimates an even greater valuation of over US$400bn. The group continues to develop key revenue streams too, with a new division named BytePlus beginning to sell components of the software behind TikTok's addictive algorithm to companies outside China, along with elements of its market-leading video effect software and computer vision technology.

"During 2020, ByteDance doubled total revenue to US$34bn, and was estimated to be worth upwards of US$250bn based on private stock trades...."

The 15th century Ming treasure voyages in China are often used to explain the 'carrot and stick' metaphor; the fearsome fleet of the Ming dynasty being the 'stick' while lucrative access to Chinese trade the 'carrot'. Six centuries on, the country's current government has shown its willingness to strike with the stick of regulation but has yet to dangle the carrot of compensation for companies who look to comply with its political intentions. The smart move for China's ruling party would therefore be to encourage a successful public floatation of ByteDance, and use that as an example of what smart cooperation with authority can award. ■

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INSIGHT

THE CHINESE WAY

A flurry of anti-trust fines and significant shifts in regulation have hit the Chinese market in recent months, all but decimating the private education sector and leaving investors worried that the Communist Party could wield its sharp sword over any of China's business sectors.

In April of this year, Alibaba was hit with a US$2.8bn fine due to 'anti-competitive practices against merchants using its e-commerce platform' sending its stock down over 29% from its late-October highs. While shares initially rallied on a lower than expected fine, they have since traded downwards further, alongside other Chinese internet stocks such as Tencent and Meituan, on worries that the government could force a tighter regulatory grip.

Such fears were later confirmed, not across the tech industry but the private education sector, with shares of US-listed TAL Education Group falling over 93% since February this year. The government saw such companies embedding themselves into the Chinese school curriculum and increasing the pressure that children faced at a young age. The new regulations, classifying private education companies as non-profits, shows the power that the Communist Party has over the population and the country's business environment, again highlighting that they are more than happy to make a splash as a show of force.

Clearly there will be key implications going forward as a direct result of both the regulations and the stark investor response. While China has no plans to stop US listings of Chinese companies, to help shield themselves from potential problems many Chinese companies that were initially looking to list in the US have started to consider a potential pivot over to the Hong Kong market. We would, therefore, expect the vast majority to now choose either Hong Kong or Shanghai as their listing location.

Chart 1 – TAL Education Group shares over five years

Source: Factset

In recent weeks the Chinese securities regulator hosted a meeting with large multi-national banks and financial institutions to stress that the country still wishes to remain open to foreign investment and has no intention to de-couple the China-global capital markets relationship. While investors surely welcomed the news, many will be hoping for substantially improved communication with financial markets. The regulator has realised the importance of better communication, given the shock reaction markets had to the education crackdown and, while policymakers are likely to place foreign investors at the bottom of their priority list, we would hope and expect to see greater prior warning.

As many will know, investing in any emerging market economy carries with it substantially higher risks. The political and economic uncertainties, coupled with a lack of disclosure from companies and a poorer understanding of the local market, exacerbate the risks associated with countries in the growth stage of their economic development cycle. Given such factors, exposure towards China across cautious portfolios should be low, meaning that the specific risks the region presents are limited to a small portion of the portfolio.

However, given the returns within China over the past two years, many had simply forgotten the risks and focused primarily on the impressive performance offered by exciting companies. The recent regulations, then, were a stark reminder and, in many ways, will help investors to better evaluate China's positioning within their portfolios. Recent events, however, have not been outside the realm of what many might have expected, given the Communist Party's power and ruthless application of values and regulations. To put it simply, to invest in the China growth story, it has to be done on the strict terms set out by the government, over which individuals have little to no sway. This is something Western investors have not yet experienced, at least to this extent, but it is a key characteristic of investing in the region that they will have to get comfortable with, one way or another.

While the recent regulations have proved frustrating and worth keeping a close eye on, they do not take away from the overall long-term growth story that the country has to offer - there are still a plethora of highly innovative and fast-growing companies ripe for investment.

The regulations were, after all, implemented with good intentions. The private tuition industry in China was placing undue stress on children at a young age and essentially creating an extra hoop within the education system that parents had to jump through if they wanted their children to perform well and attend top universities. Such qualms were raised by the Communist Party last year, but, given that Western investors are predominantly used to either regulation that takes many years to come to fruition or for it to fall through completely (look at big tech regulation in the US), the swift implementation by the government was shocking.

Going forward, regulation analysis will form a key stage in the investment process from the perspective of both fund managers and investors. Fund managers especially will have to both forecast which sectors are prone to governmental regulation and actively manage the regulatory risk within portfolios. Therefore, comprehensive reviews and trust will have to be built over time with active managers to ensure they are effectively implementing procedures to combat regulatory risk and the impact it has on their views and holdings going forward. ■

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TOPIC OF THE MONTH

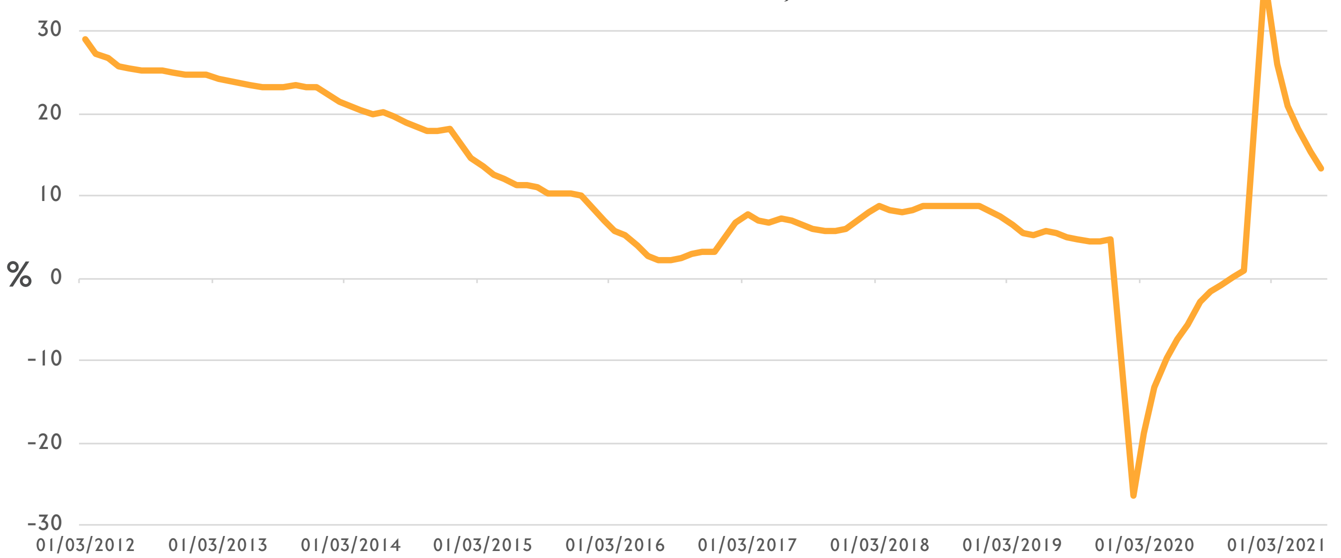
CHINESE INFLATION: THE OTHER STORY

Talk of any country's economic miracle and the conversation inevitably centres around its growth. But, just as important to the miracle story is growth's irritating cousin, inflation, which latches itself to growth and tries to follow it around. Inflation is a general rise in the price of goods and services and measures a loss of purchasing power. To truly grow, an economy needs to grow at a rate that outpaces inflation - this is known as 'real growth'. As investors seek shelter from rising inflationary pressures worldwide, China looks to stand apart from the pack, but we look to see if this environment is changing, and what that means for inflation?

In China, the preferred measure of inflation is the CPI, or consumer price index, which measures the average rise in prices as paid by consumers across the economy. The National Bureau of Statistics collects this data through various weightings of 'baskets' of goods and services, of which the weightings aren't disclosed. An example is pork; as a staple of the Chinese diet, it is believed to be the most heavily weighted product, with food, tobacco and alcohol accounting for approximately 30%. Real growth in the country is running high, with CPI and economic growth running at 1.3% and 8.8% respectively in May - can China sustain this trend?

China is a large manufacturing economy, which makes it susceptible to commodities. The moniker 'Factory of the World' evokes images of roaring coal-fired smokestacks belching into the sky, but rising tensions with, and a coal embargo on, Australia has caused them to sputter. Coal inventories are declining and prices rising as companies scramble to source new suppliers. A strong rally in oil and steel prices have demonstrated manufacturers' exposure to these commodities' volatility. The producer price index (PPI) measures cost inflation for producers, and jumped to 9% in May, led by a 34.3% price rise in the oil and metals sectors, and though PPI's effect on CPI is muted, it still trickles through. More broadly for consumers, natural disasters have affected food prices as storms rock its top wheat growing areas, and fears of a resurgent African Swine Fever have caused farmers to slaughter their pigs – collapsing pork prices by 65% in the process.

ACCUMULATED GROWTH OF PRIVATE FAI, PERCENT - CHINA



Source: Factset

Yet growth doesn't always cause inflation. By increasing productivity – that's output, per worker, per hour – a country can produce more goods and services at the same cost, or the same number of goods and services at a lower cost. Good investment is often an effective way of doing this, and investment as a proportion of GDP was 44% in 2020, but still lower than in the past. China's productivity grew at 15.5% p.a. between 1995 and 2013, but may be experiencing diminishing returns since that figure fell to an average of 5.7% p.a. from 2014 to 2018. Since its economy is still only 30% as productive as advanced economies such as the US and Germany, this appears premature and could mark an acceleration in inflation. It's important to note that this growth is still impressive; in the same 2014 to 2018 period US productivity growth hovered between 1% and 2%.

"As investors we must be wary of the underlying assumptions we make. The CPI index in China is often accused of underrepresenting price pressures, due to an underweighting of housing costs."

This productivity puzzle could be compounded by a shifting regulatory regimen, with a clampdown on the highly innovative technology and education sectors – Chinese technology is worth about US$4tn – potentially stifling future innovation and, by extension, productivity. Though such inflation could be argued as necessary, China's anti-monopoly agency has approximately 50 staff and is relatively inexperienced. Such a small team has scope for large errors which could increase business costs and translate into higher prices for consumers, while many regulations inadvertently entrench incumbents and reduce competition, further increasing prices.

Inflation indices try to be representative of the economy and, at 25% of GDP, the Chinese real estate market is a significant contributor to inflation. The property market in coastal regions is experiencing soaring prices, where cities have forced developers to sell properties to first time buyers, selecting by lottery. Despite the Hukou system preventing unregistered citizens (of which there are many) from entering these lotteries, odds to win can be as low as 1/60.

China is a tale of two property markets. The government builds housing that lies empty in inland regions, causing excess supply and reducing housing cos; a town in northern China was selling homes for less than the cost of a square metre in Shanghai. This isn't an issue the Communist Party is happy to let lie, though. New commuter towns are being constructed outside its biggest cities with improved public services and easier Hukou registration. Strict regulation has curbed price growth, and the party has real estate firmly in its sights, understanding affordable housing to be an important lever of maintaining social stability – and its power.

Inflation is influenced by factors domestic and external, and a crisis in global shipping intuitively threatens to disrupt demand for Chinese goods. Yet a voracious appetite for exports has defied intuition, with exports to the EU and US rising 35.9% and 42.6% respectively year-on-year. Meanwhile, the renminbi has remained strong in spite of headwinds - a strong currency reduces the competitiveness of exports while reducing the relative cost of imports, which is ultimately usually reductive to inflation.

In a new focus on self-sufficiency, the party is driving new investments in advanced technologies such as chips. Growing national champions to compete with incumbents will be costly, involving vast sums of investment and decades of patience. If, in the pursuit of economic self-sufficiency, the government compels firms to buy Chinese, they will likely be buying chips of an inferior quality for a higher price – increasing costs, and inflation, while potentially harming productivity.

As investors we must be wary of the underlying assumptions we make. The CPI index in China is often accused of underrepresenting price pressures, due to an underweighting of housing costs. Moreover, in an opaque political system that measures performance by economic metrics, officials have an incentive to place a thumb on the scales.

China's inflation story has been one suppressed by rapidly growing productivity, developing into an economy surprisingly resilient to volatile commodities. Yet its future appears less simple as the government runs out of low hanging productivity gains to pick. Although a sign the country isn't immune to runaway prices, China's real estate market is an early indicator of its willingness to act in the pursuit of sustainable price growth. In a world where the regime claims adroit economic policy as a font of legitimacy, expect inflation to be kept under its watchful eye. ■

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