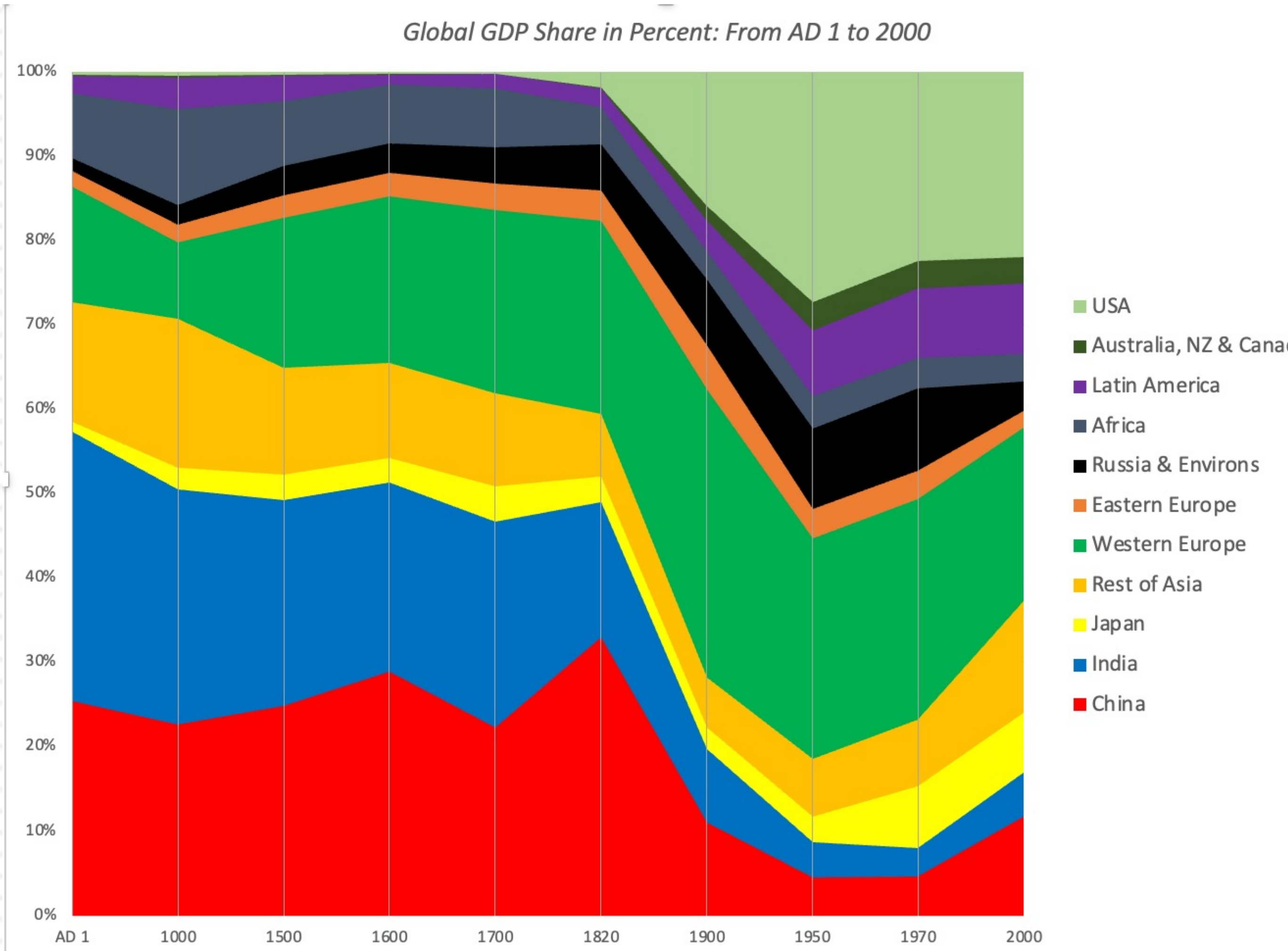
THE CHINESE TECH CRACKDOWN: CONTROL BEATS GROWTH

Governments and Company Value

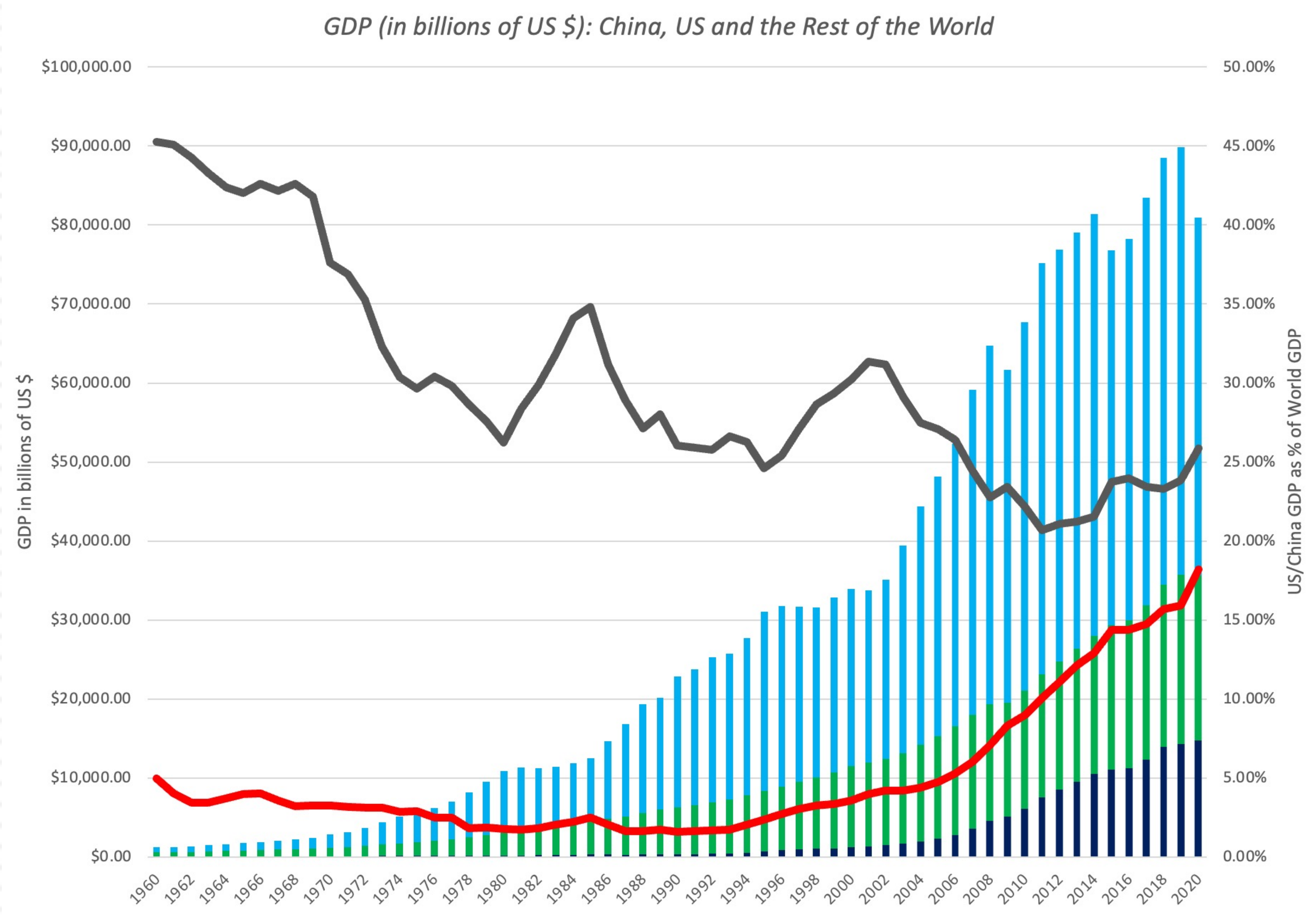
The Chinese Tech Crackdown!

- For the last two decades, China has been the dominant story in the global economy and capital markets, as the country's immense growth and concurrent infrastructure investments have sustained commodity prices and altered the balance of world economic power.
- That growth has come with the recognition that in almost every venture in China, public or private, the Chinese government is not just a factor, but the key player determining the venture's success and failure.
  - Afraid of being shut out of the biggest, growth market in the world, businesses operating in the country accepted limits and constraints that they would fight in almost every other part of the world.
  - In the last year or so, Chinese tech companies, including shining stars like Alibaba, Tencent and Didi have woken up to this recognition, and investors have had to quickly readjust their expectations for these companies.

China’s Place in the Global Economy: A Really Long Term Perspective



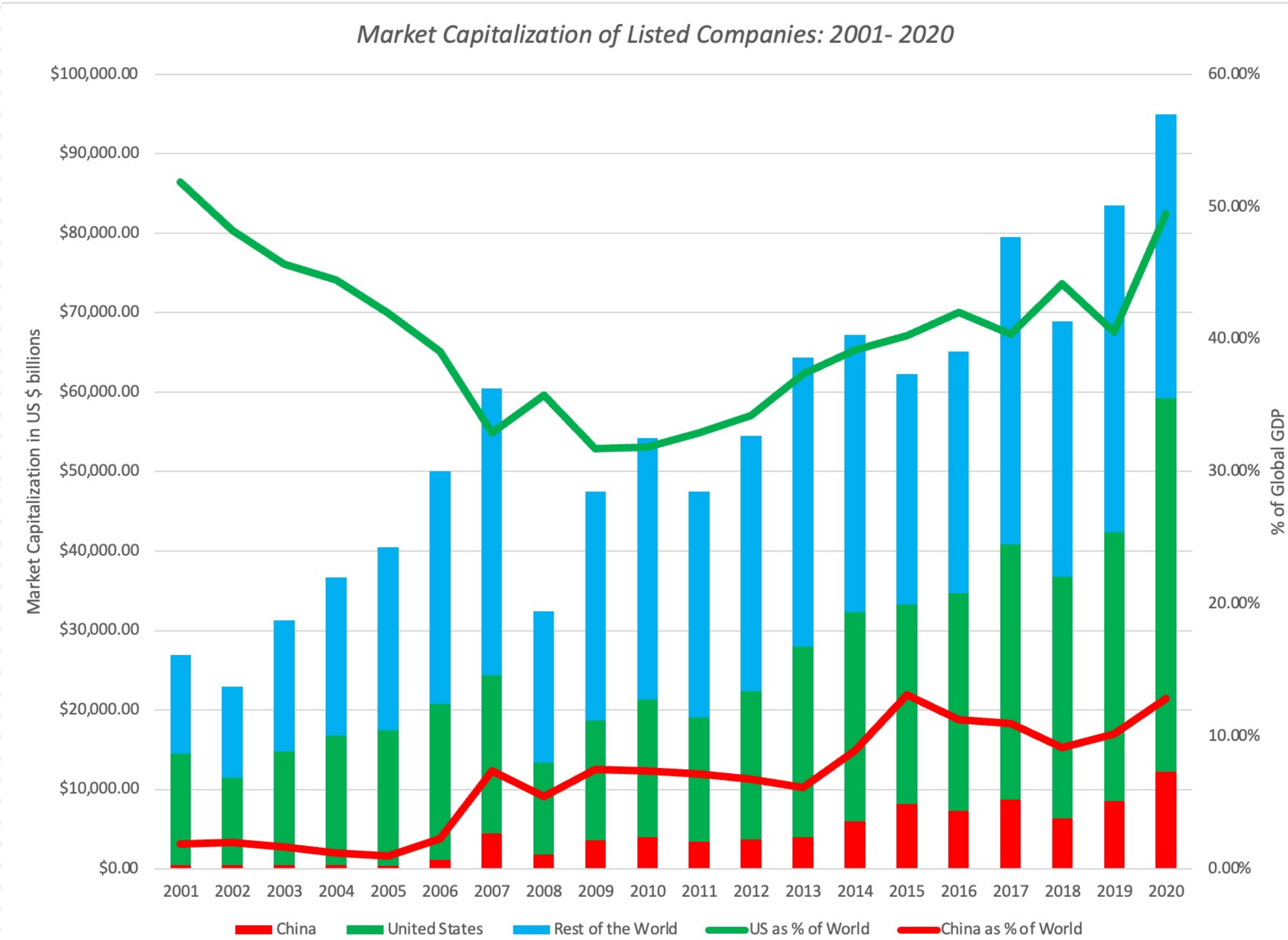
And more recently…



China carries the world: The Last Decade

Period	Change in World GDP	Change in China GDP	China's share of Global Growth	World GDP CAGR	World without China GDP CAGR
1961-1970	$1,654.65	$32.89	1.99%	10.16%	9.25%
1971-1980	$8,046.05	$98.55	1.22%	14.34%	14.51%
1981-1990	$11,602.06	$164.99	1.42%	7.70%	7.72%
1991-2000	$11,018.07	$850.49	7.72%	4.01%	3.79%
2001-2010	$33,766.11	$4,875.82	14.44%	7.15%	6.54%
2011-2020	$13,229.40	$8,635.57	65.28%	1.80%	0.72%

The Rise of Chinese Financial Markets



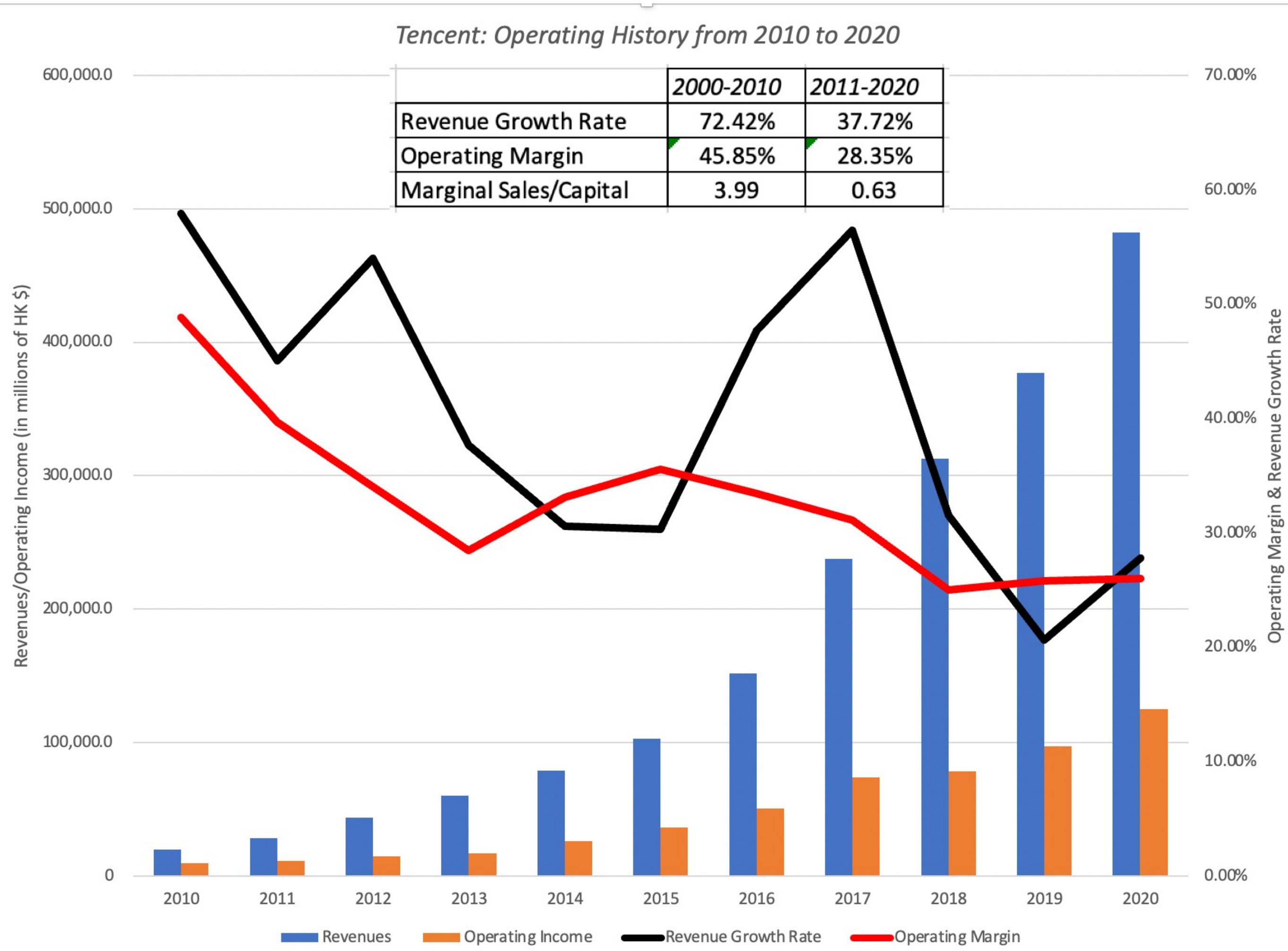
The Surge of Tech

On December 31, 2010		On December 31, 2020	
Company Name	**Market Capitalization**	**Company Name**	**Market Capitalization**
PetroChina Company Limited (SEHK:857)	$ 303,127	Tencent Holdings Limited (SEHK:700)	$ 692,741
Industrial and Commercial Bank of China Limited (SEHK:1398)	$ 233,284	Alibaba Group Holding Limited (NYSE:BABA)	$ 630,959
China Construction Bank Corporation (SEHK:939)	$ 222,265	Kweichow Moutai Co., Ltd. (SHSE:600519)	$ 384,444
Bank of China Limited (SEHK:3988)	$ 139,886	Industrial and Commercial Bank of China Limited (SEHK:1398)	$ 262,381
Agricultural Bank of China Limited (SEHK:1288)	$ 134,949	Ping An Insurance (Group) Company of China, Ltd. (SEHK:2318)	$ 234,644
China Petroleum & Chemical Corporation (SEHK:386)	$ 101,539	Meituan (SEHK:3690)	$ 223,571
China Life Insurance Company Limited (SEHK:2628)	$ 97,667	Pinduoduo Inc. (NasdaqGS:PDD)	$ 217,881
China Shenhua Energy Company Limited (SEHK:1088)	$ 76,058	China Construction Bank Corporation (SEHK:939)	$ 191,867
Ping An Insurance (Group) Company of China, Ltd. (SEHK:2318)	$ 72,719	Wuliangye Yibin Co.,Ltd. (SZSE:000858)	$ 173,521
Bank of Communications Co., Ltd. (SEHK:3328)	$ 51,434	China Merchants Bank Co., Ltd. (SHSE:600036)	$ 167,886
China Merchants Bank Co., Ltd. (SHSE:600036)	$ 44,194	Agricultural Bank of China Limited (SEHK:1288)	$ 164,803
Tencent Holdings Limited (SEHK:700)	$ 39,648	China Life Insurance Company Limited (SEHK:2628)	$ 138,860
Baidu, Inc. (NasdaqGS:BIDU)	$ 33,624	JD.com, Inc. (NasdaqGS:JD)	$ 136,234
China Pacific Insurance (Group) Co., Ltd. (SHSE:601601)	$ 31,448	Bank of China Limited (SEHK:3988)	$ 131,242
China CITIC Bank Corporation Limited (SEHK:998)	$ 29,247	Contemporary Amperex Technology Co., Limited (SZSE:300750)	$ 125,280

The Chinese Tech Decade

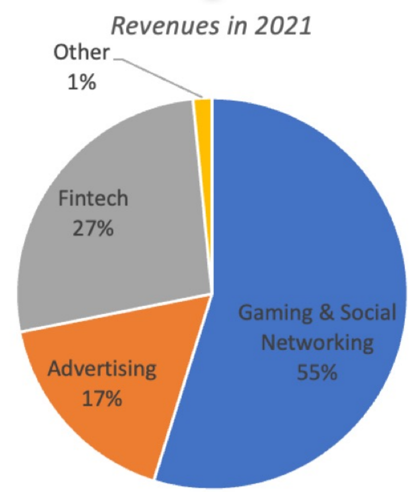
- The rise of technology as an economic force and market driver is not unique to China. After all, the FANGAM stocks (Facebook, Amazon, Netflix, Google, Apple and Microsoft) were the engine that drove market capitalizations in the US for the last decade, with COVID super charging their rise in 2020.
- There is an advantage to taking a deeper look at some of the biggest winners in the business, not only to understand why they succeeded, but also to get insights into whether they can sustain that success in the future.
  - It is for that reason that I will focus on four Chinese tech companies (Tencent, Alibaba, JD.com and Didi) for the rest of this post, the first three because they make the top fifteen list, in terms of market capitalization in China, and the last because of its high profile IPO, just a few weeks ago.

Tencent Operating History

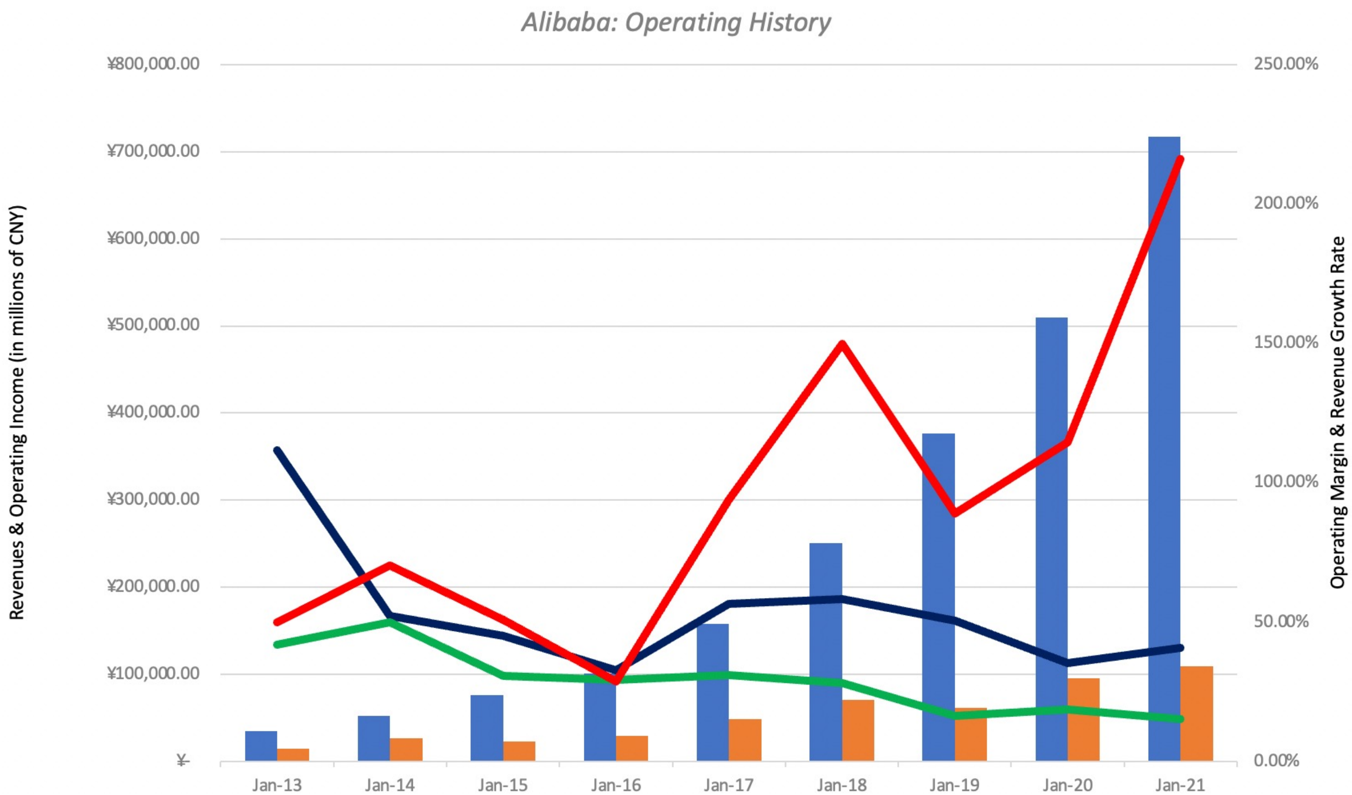


	2000-2010	*2011-2020*
Revenue Growth Rate	72.42%	37.72%
Operating Margin	45.85%	28.35%
Marginal Sales/Capital	3.99	0.63

Business: Tencent is is almost every aspect of online business in China, but its core is built around video gaming and social networking, , supplemented by a dominant fintech (WeChat & WeBank) segment, business services (including Tencent cloud) and online advertising.

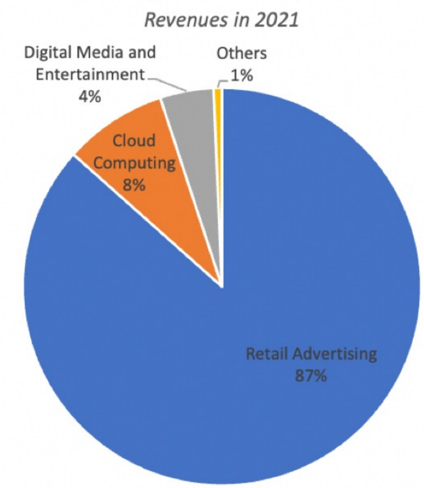


Alibaba: Operating History

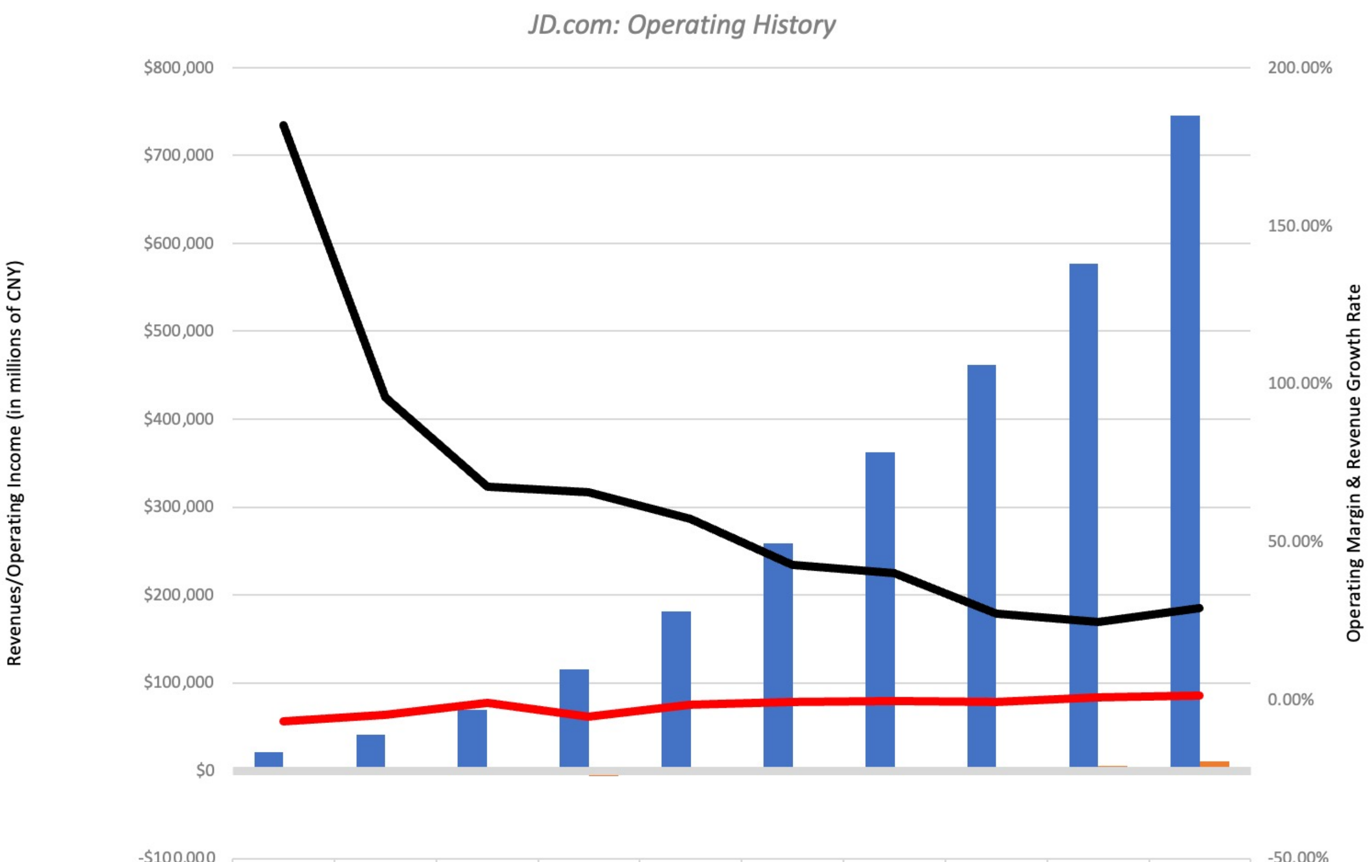


	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21
Revenues	¥34,517.00	¥52,504.00	¥76,204.00	¥101,143.00	¥158,273.00	¥250,266.00	¥376,844.00	¥509,711.00	¥717,289.00
Operating Income	¥14,413.00	¥26,233.00	¥23,310.00	¥29,557.00	¥48,912.00	¥70,609.00	¥61,606.00	¥95,534.00	¥109,594.00
Revenue Growth Rate	111.76%	52.11%	45.14%	32.73%	56.48%	58.12%	50.58%	35.26%	40.72%
Operating Margin	41.76%	49.96%	30.59%	29.22%	30.90%	28.21%	16.35%	18.74%	15.28%
Chg Sales/Chg Inv Cap	0.5	0.70	0.51	0.29	0.94	1.50	0.89	1.14	2.16

Business: Alibaba provides the platforms (TaoBao and Tmall) through which much of online retail traffic in China flows, collecting a slice of transactions that occur on them. It owns a piece of Ant Financial (previously called AliPay) that operates in the payment processing space (and is owned and controlled by Jack Ma, Alibaba's founder).

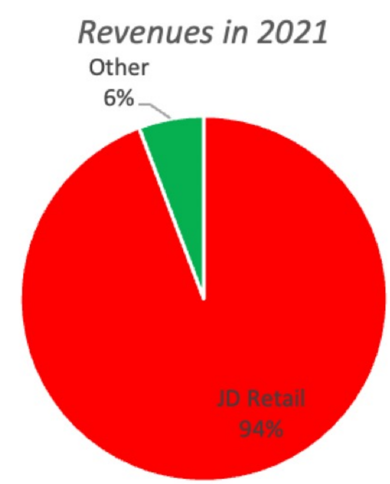


JD.com: Operating History

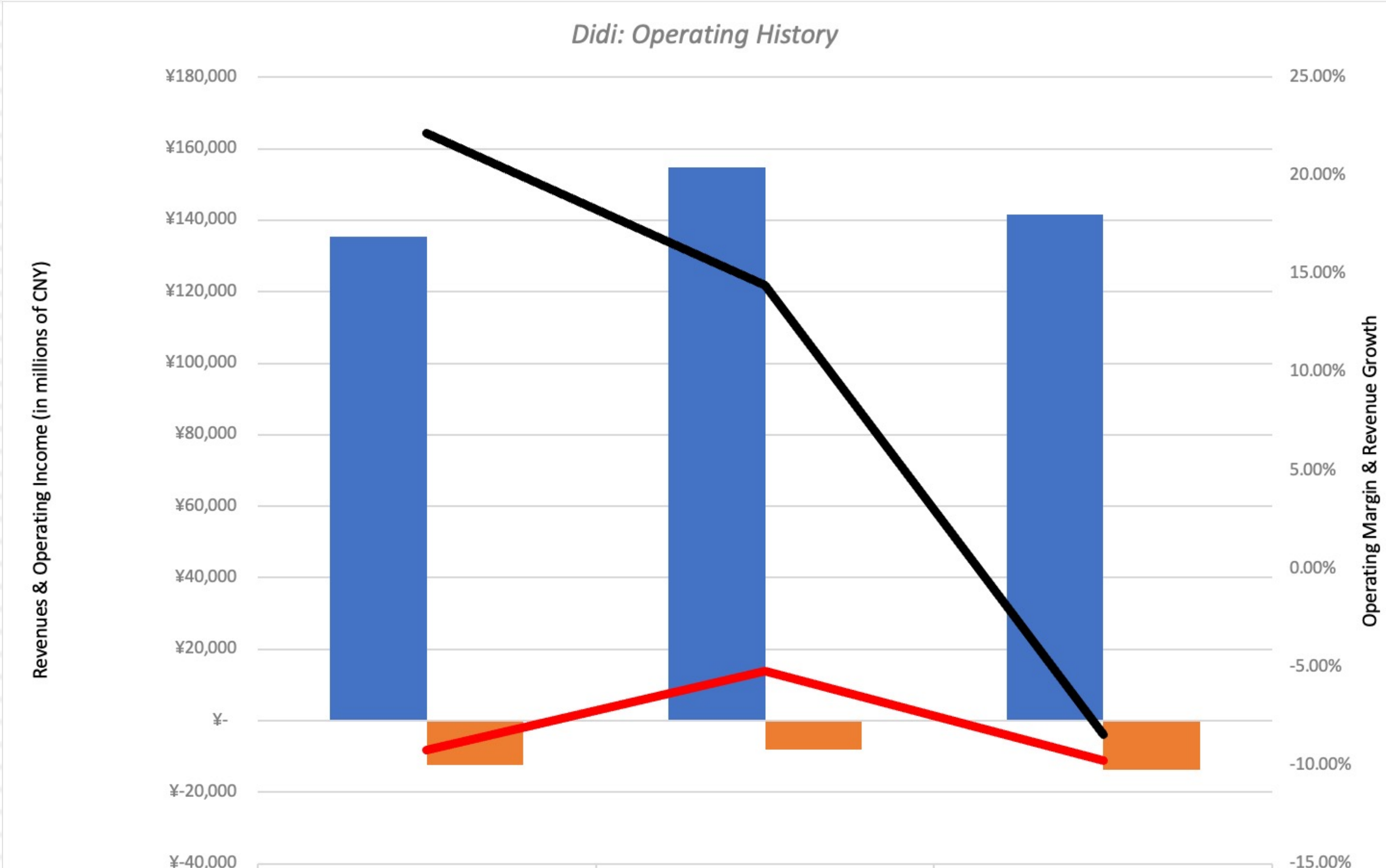


	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenues	$21,129	$41,381	$69,340	$115,002	$181,042	$258,290	$362,332	$462,020	$576,888	$745,802
Operating Income	-$1,404	-$1,951	-$579	-$5,802	-$2,608	-$1,252	-$836	-$2,597	$5,110	$10,694
Revenue Growth Rate	181.72%	95.85%	67.57%	65.85%	57.42%	42.67%	40.28%	27.51%	24.86%	29.28%
Operating Margin	-6.64%	-4.72%	-0.83%	-5.05%	-1.44%	-0.48%	-0.23%	-0.56%	0.89%	1.43%

Business: JD.com is an online retail company. It has followed the Amazon model of going for a higher market share of the Chinese retail market, settling for low or even negative operating margins along the way.

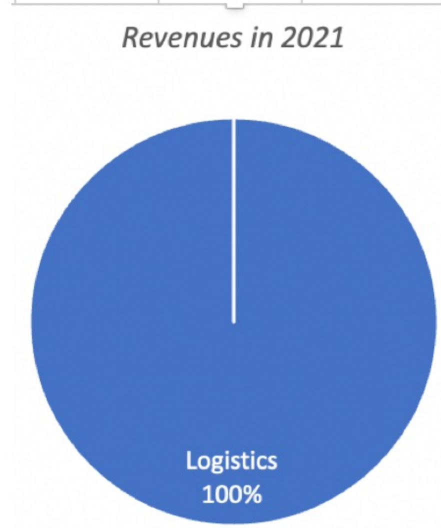


Didi: Operating History



	2018	2019	2020
Revenues	¥135,288	¥154,786	¥141,736
Operating Income	¥-12,443	¥-8,013	¥-13,788
Revenue Growth Rate	22.15%	14.41%	-8.43%
Operating Margin	-9.20%	-5.18%	-9.73%

Business: After its acquisition of Uber China, Didi is the dominant Chinese ride-sharing company, generating the bulk of its revenues from the car service business, with forays into the food delivery business. Over its life, the company has lost money and burned through cash, before going public in 2021.



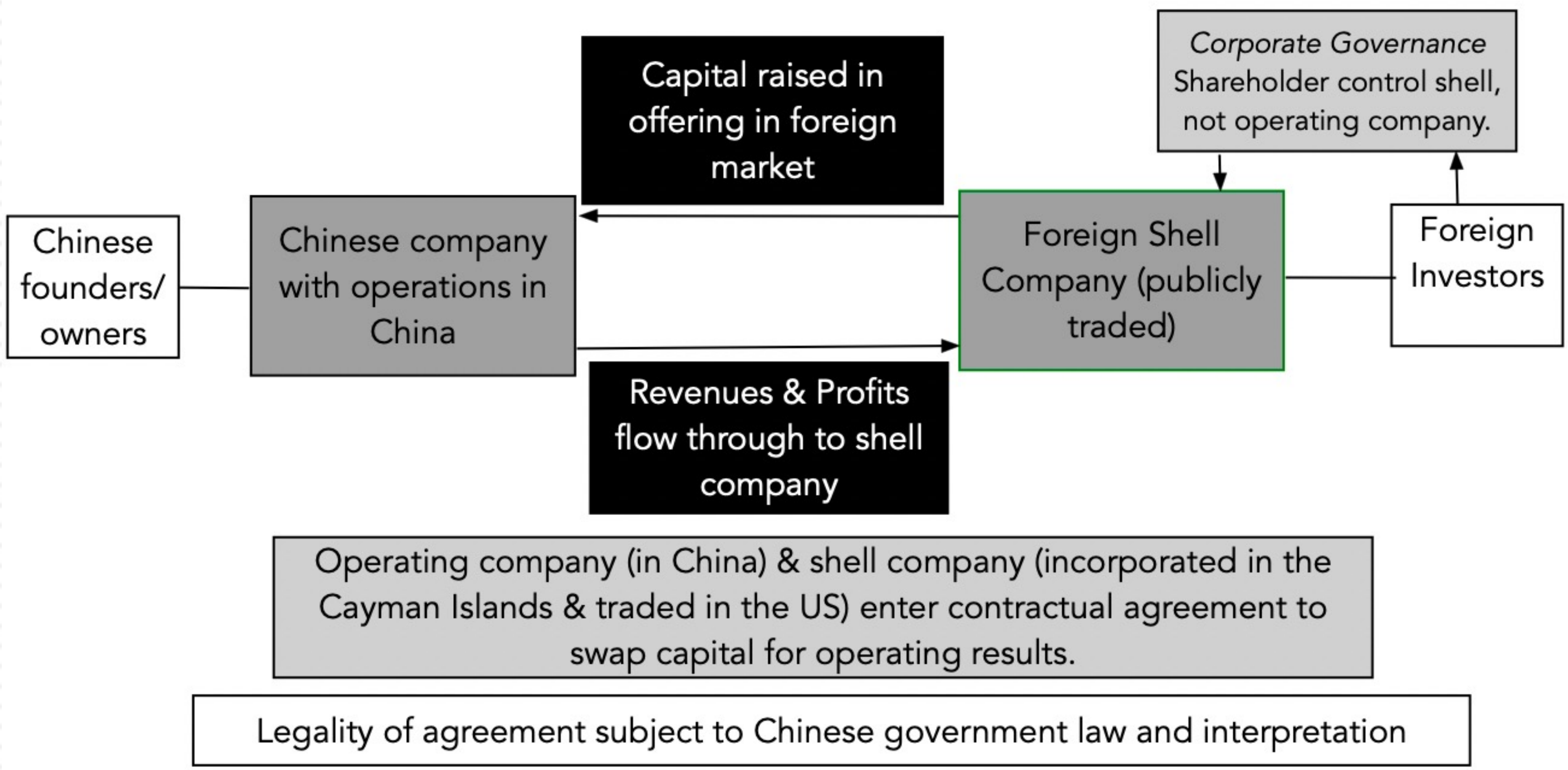
1. Big Markets (Squared)

- Big Market Squared: China was the engine that drove global growth over the last decade, and with that growth has come a surge in buying power for Chinese consumers. Companies that are positioned to take advantage of this growth, whether domestic or foreign, have been rewarded by investors with higher market capitalizations. With tech companies that are disrupting conventional businesses, there is an added allure of growth occurring at the expense of the status quo. You could argue that this combination (of China and disruption) creates growth stories on steroid, as investors load on dreams of one big market (from disruption) on top of another (China).
- As with any steroid-driven story, there are downsides.
  - Investors often over-estimate the possibility of success in big markets, because they fail to factor in new entrants and competition fully.
  - The size of the Chinese market, in conjunction with local dominance, has also meant that Chinese tech companies prioritize domestic market growth, simply because it is easier. Clearly, global ambitions notwithstanding, Chinese tech companies have remained overwhelmingly Chinese.

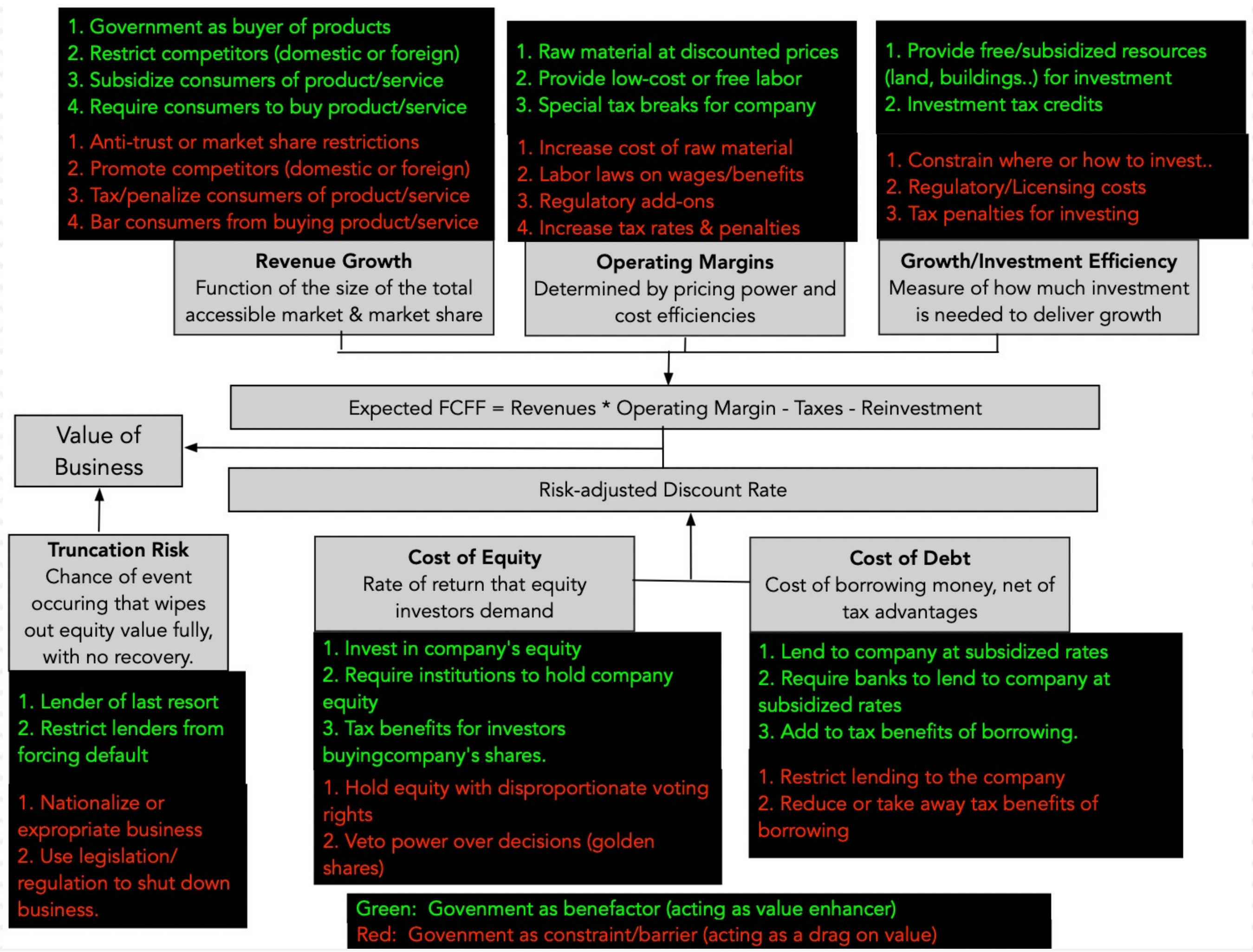
2. Attuned to the Chinese Consumer

- Note that these companies were very much part of the pack, competing with foreign and domestic players, just a decade or two ago, but have managed to separate themselves from the rest, in the years since.
- While there are many factors that may have contributed, one in particular stands out. Rather than copying what successful US tech companies were doing to gain market share and profitability, these companies tailored their business models and product offerings to the Chinese market, adapting to what Chinese consumers cared about and wanted.
  - In my IPO post on Alibaba, I argued that the reason it was able to vanquish eBay and more established competitors was because it created what the Economist called the "world's greatest bazaar" and a payment mechanism for Chinese consumers felt comfortable using online.
  - Tencent not only built a gaming platform specifically focused on Chinese consumers, but was well ahead of its US tech competitors in building the world's leading social media platform in WeChat.
  - Didi was conceived as a cab-hailing company in 2012, but it too tailored its services to the local characteristics of the Chinese market, acquired its main domestic rival in Kuadi Dache in 2015, and forced Uber to capitulate and sell its Chinese segment in 2017.

3. Corporate Governance Nightmares



4. Beijing as (mostly) benevolent partner



With superpowers!

- Bigger, quicker and more permanent: Chinese government can not only change the competitive balance and game more decisively than its democratic counterparts, where making laws involves trade offs and bargains, but also make the changes more permanent, since regime change is not in the cards (at least the official ones).
- With no checks & balances? Government rules and regulations, in most economies have to run a gauntlet of legal challenges, before becoming law, in a system where the judiciary can over ride or set aside government actions.
- Growth versus Control: Sensible investors have always understood this power, and tried to price them in, but for much of the last decade that has led them to bid up Chinese companies, on the assumption that Beijing would tilt the playing field in favor of domestic companies, at the expense of foreign competitors, and that the governments' push for more economic growth would make it more likely to be an ally, rather than an adversary, to companies. That calculation, though, does miss the other quality that the Chinese government has always valued, which is control, and the tussle between the two (growth and control), in my view, explains much of the crackdown on Chinese tech.

Valuing Chinese Tech Companies

	Government Threat		*Government as benefactor*	*Government as Net Negative*	*Government as Adversary*
Tencent	Fined company $1.5 billion for violating anti-trust law, by not disclosing acquisitions. Also restricted game playing by young users on weekdays.	Revenue Growth (yrs 1-5)	20.00%	15.00%	10.00%
		Target Margin	28.29%	25.00%	20.00%
		Cost of Capital	5.85%	5.85%	5.85%
		Value per share	HK$ 713.76	HK$ 512.83	HK$ 352.47
HK$ 471.80		% Under or Over Valued	-33.90%	-8.00%	33.86%
Alibaba	Fined company $2.75 billion for "abusing market position" and violating anti-trust laws. Also stopped Ant Financial (Alipay) from IPO in 2020.	Revenue Growth (yrs 1-5)	25.00%	20.00%	15.00%
		Target Margin	14.67%	12.00%	9.00%
		Cost of Capital	7.79%	7.79%	7.79%
		Value per share	¥ 1,766.63	¥ 1,204.44	¥ 808.69
¥ 1,051.06		% Under or Over Valued	-40.50%	-12.73%	29.97%
JD.com	Fined for misreporting prices and offering false promotions (on its retail site). Regulations increasing on heathcare & financial service arms.	Revenue Growth (yrs 1-5)	30.00%	25.00%	20.00%
		Target Margin	4.00%	3.50%	3.00%
		Cost of Capital	9.45%	9.45%	9.45%
		Value per share	¥ 672.92	¥ 479.33	¥ 352.78
¥ 489.26		% Under or Over Valued	-27.29%	2.07%	38.69%
Didi	Citing violations of consumer privacy, regulators asked Didi to stop accepting new users and pay fines for not disclosing acquisitions.	Revenue Growth (yrs 1-5)	40.00%	30.00%	20.00%
		Target Margin	12.00%	8.00%	4.00%
		Cost of Capital	9.51%	9.51%	0.00%
		Failure Probability	10.00%	15.00%	25.00%
		Value per share	¥ 173.15	¥ 50.62	¥ 0.27
¥ 52.47		% Under or Over Valued	-69.70%	3.65%	19333.33%

Acting on the valuations!

- I would remove Didi and JD.com from the mix, largely because they are closer to fairly valued, than under valued. In fact, I would argue that looking at Didi's still to be worked out business model, and the huge consequences of government action or inaction, it is closer to being an option than a conventional valuation in equity.
- With Alibaba and Tencent, both of which are under valued in my base case (government as a net negative), I have three choices:
  - Buy both Alibaba and Tencent, and hope that the "government as adversary" scenario does not play out for either.
  - Buy one of the two, based upon not just the valuation but also the rest of the company, including corporate governance and structure
  - Buy neither, because you believe that the "government as adversary" scenario is more likely than the "government as benefactor"

My Tencent Pick(s)

- I am not inclined to double down on betting on how the Chinese government will behave in the future, and will pick only one of these stocks.
- I would pick Tencent over Alibaba for three reasons.
  - The first is that Tencent is a more rounded company in terms of being in multiple businesses, and I do think that the WeChat platform, like the Facebook platform, adds a premium to their valuation.
  - The second is that I prefer buying Tencent on the Hong Kong stock exchange to buying Alibaba's Cayman Islands shell company on the New York Stock Exchange.
  - The third is that while I admire Jack Ma as an entrepreneur, I am believe that personality-driven companies have an added layer of risk, since that personality can draw attention and fire.

Tencent Investment Choices

- With my Tencent investment, I faced a secondary choice of investing directly in Tencent or indirectly buying shares in Naspers, a South African holding company.
- If you are puzzled about why Naspers enters the equation, the company acquired 46.5% of Tencent in return for a $32 million VC investment in 2001, and as Tencent surged in market capitalization, Naspers has become a proxy for the stock, with 80% or more of its value coming from its Tencent holdings.
  - The one difference is that the market is discounting the holding by 20-30%, in Naspers hands, reflecting concerns about taxes due and corporate governance at Naspers.
  - That discount seems immune to almost every attempt by Naspers to make it disappear; Naspers spun off a Dutch entity, Prosus, and endowed it with a portion of the holding, in an attempt to eliminate the discount, but the discount persists, albeit a little smaller.
- I decided that the potential upside of hoping that the discount narrows over time is exceeded by the downside of creating a layer between me and my Tencent investment.

Conclusion

- In valuation, we seldom consider the explicit effects of government policy and regulations on company value.
  - The rationale that is offered is either that the government's capacities to add and detract from value offset each other or that the current numbers for the company (growth, margin etc.) already incorporate the government effect.
  - While this is defensible, when government policy is stable, it breaks down when governments deviate from the script, and behave differently that they have in the past.
- With Chinese tech companies, long used to the Chinese government being an ally in their search for growth and profits, the last year has been a rude awakening to a new reality of an activist and punitive version.
  - I believe that notwithstanding claims from Beijing that this latest crackdown is about protecting consumer privacy and increasing competition, it is more about the government exercising control over both companies and data.
  - I also believe that the adjustment in market prices that we have seen in Chinese tech companies is reflecting the fear that investors now have that the government will act as a constraint rather than an accelerate on future growth and profitability.
  - As markets recalibrate prices to reflect the new reality, there are opportunities for solid returns in this space, and I hope to one of the beneficiaries!