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A VIEW FROM ASIA – CHINA SPECIAL

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Consternation – a feeling of anxiety or dismay, typically at something unexpected.

Sina Corporation (well, its lawyers) pioneered the concept of the Variable Interest Company (VIE) as a means to list Sina's shares on the New York Stock Exchange. The first Chinese internet company to do so in 2001, it set the stage for a flood of IPOs and capital raisings by Chinese companies from US capital markets.

It was an ingenious legal 'contract'. Quoting from Bloomberg news: *"It enabled Chinese companies to sidestep restrictions on foreign investment in sensitive sectors including the Internet industry. The structure allows a Chinese firm to transfer profits to an offshore entity -- registered in places like the Cayman Islands or the British Virgin Islands - with shares that foreign investors can then own."*

Those were the heady days of globalisation, marked by China's entry into the World Trade Organization (WTO). The internet was in its infancy while Asian economies were struggling from the aftermath of the financial crisis of 1997-98 (a time when I had no desire to know about treatments for thinning hair - note to younger self, that was important). As that decade progressed, one catchphrase became increasingly popular: 'economic decoupling'. Most economic forecasters and market participants (myself included) hoped or predicted the imminent cutting of the umbilical cord that joined Asia to the West. Suffice to say, that moment of decoupling is upon us; the contours are vastly different from what we envisaged.

Churchill's characterisation of the Soviet Union in October 1939 as "a riddle wrapped in a mystery inside an enigma" is an apt description of the VIE structure.

Quoting Matt Levine at Bloomberg (everyone should read his work):

"So I have a soft spot for Chinese VIEs. The idea is that, under Chinese law, it is somewhere between "complicated" and "forbidden" for foreigners to own certain big important Chinese tech companies. This is a problem for those companies if they want to raise capital from foreign investors and list their stocks on foreign stock exchanges. But there is a solution. "Ownership" of a company is a complicated notion, a vague jumble of rights to elect directors, approve mergers, and claim a residual interest in the company's cash flows. You could break those things up and sell them separately. Write a profit-sharing contract that says "A will pay B all of A's profits after expenses for the next 100 years, renewable at B's option," and hey that's a residual claim on cash flows. (Or something vaguer: "A will pay B an annual consulting fee that B decides in its total discretion based on the economic value of the relationship," etc.; not technically a residual claim but what else is it?) "B will provide management services to A and A will follow B's instructions," hey that's basically control. "B will have the right to appoint a majority of A's board of directors," put it in a contract, it's not actually stock ownership. Etc. Write some contracts that, bundled together, look like ownership, but aren't ownership.

With Chinese companies, this sort of thing is generally called a "variable interest entity." You set up a company in the Cayman Islands that can be owned by anyone. The Caymans company enters into a series of contracts with the local Chinese company, giving it, not ownership, but certain carefully curated economic interests and control rights over the Chinese company. Then you list the Caymans company in the U.S., and people buy its stock, and they sort of pretend that they're buying stock in the Chinese company — they sort of pretend that the Chinese company is a subsidiary of the Caymans holding company — even though really they're only buying an empty shell that has certain contractual relationships with the Chinese company.

Cross-currents for technology stocks

In my opinion, there are several cross-currents affecting Chinese technology businesses and stocks.

Firstly, a regime change under President Xi. The Chinese leader has articulated more forcefully than most that the Chinese Communist Party (CCP) is supreme. Jack Ma found out to his detriment when he made a speech in which he was critical of regulators. Besides – and this is acknowledged off the record by people in the know – a large shareholding in Ant Financial is owned by the Shanghai faction (those considered close to ex-President Jiang Zemin), a political rival of the current administration.

Secondly, there is the clear ideological battle line drawn under President Trump's administration in 2018. Yet, there is a twist. I do not think it is a clear-cut ideological contest between capitalism (the US) and communism (China); the CCP is a Marxist-Leninist party that uses the tools of capitalism effectively. This ideological divide is more about superpower rivalry, and we happen to have a label attached to it.

The third cross-current is the real source of the current predicament for governments: data. Its collection, usage and security are now arranged around national boundaries. Any industry considered a national priority or subject to national security is now wrapped in data nationalism. Accounting oversight, rightfully demanded by US Congress through the Public Company Accounting Oversight Board, for US-listed securities flies in the face of data nationalism.

To the drawing board

What does this all mean for us? The Chinese authorities are currently re-examining rules around listing outside China's stock exchanges. A news report yesterday suggested *"once amended the rules would require firm structures using the VIE model to seek approval before going public in Hong Kong or the US."*

Since 2018 I have considered any Chinese ADRs as risky for exactly this eventuality. Hence, in the past two and a half years, I have chosen to own stocks listed either on the Hong Kong or the Shanghai/Shenzhen stock exchanges. I have a large underweight position in China, partly due to valuations, partly because of increased regulatory risks and partly on account of the tightening macro environment.

Following this week's events, I have to wait and judge whether Hong Kong-listed firms are likely to be dealt with as heavy-handedly as any US listed stocks. Rationally speaking, that should not be the case – the Chinese mainland now completely controls Hong Kong – but geopolitics and national security concerns can trump rationality.

The other big risk revolves around data and business models. Unlike the US, where technology behemoths operate within loosely defined spheres of influence (Facebook vs. Amazon vs. Microsoft vs. Google), that is not the case in China. Every large company and upstart challenger wants to encroach upon and compete against incumbents, using not just data but aggressive cash burn and sometimes harsh competitive tactics (monopolising users or suppliers via threats).

Moats matter

This, then, requires a return to first principles on our part, to understand what is the genuine competitive moat for a business. Further, to analyse whether that moat is now threatened by Chinese government's imposition of national security priorities. This is not going to be easy. Yet my fortune in positioning the portfolio with a large underweight in China allows me some breathing space. Markets by definition are fickle and move from euphoria to panic, as we currently observe. I welcome that wholeheartedly. Consternation concentrates the mind.

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JOHCM Asia Ex Japan Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	30.06.21	30.06.20	30.06.19	30.06.18	30.06.17
A USD Class	56.71	6.37	-0.68	-3.98	20.00
Benchmark	39.62	1.61	-0.47	9.93	26.83
Relative return	12.24	4.68	-0.21	-12.65	-5.39

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg, NAV of Share Class A in USD, net income reinvested, net of fees as at 30 June 2021. The A USD Class was launched on 30 September 2011. Benchmark: MSCI AC Asia ex Japan NR (12pm adjusted). Performance of other share classes may vary and is available on request.