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Q&A with Mirae Asset's Lee on China Tech Regulation

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The following is a Q&A with Phil S. Lee, Head of Equity Research at Mirae Asset Global Investments (Hong Kong) and a Portfolio Manager of the Global X China Innovation ETF (KEJI). To view KEJI's current holdings, visit www.globalxetfs.com/funds/KEJI.

Should investors fear the increased regulatory uncertainty surrounding Chinese tech companies?

Chinese equity markets experienced a meaningful decline in early July, triggered by Beijing's ban of a recent acquisition made by Didi following the ride-hailing company's reported breach in cybersecurity laws. The punishment handed down on Didi is another in a series of government interventions, as efforts to regulate internet platform companies in fintech, e-commerce, food delivery, online education and gaming increase.

Due to this regulatory uncertainty, investors are concerned that China's government may no longer be proponents of growth and tech-innovation. As a consequence, some investors have significantly reduced their holdings in Chinese equities.

While we agree that regulatory uncertainty is bad news for the market, we strongly disagree with the notion that the government is anti-tech or anti-growth, and continue to have high conviction in the government supporting innovative Chinese companies over the long run.

What is the nature of these regulations?

From our perspective, many of the regulations introduced recently are fair and reasonable, reflecting social consensus that is in-line with Chinese values and fostering greater competition and innovation. For instance, echoing the actions against rideshare platforms like Uber and Lyft in the US, regulatory overhang has weighed on food delivery platform Meituan for some time, with speculation that the company may be 'forced' to provide higher salaries or insurance coverage to its delivery riders. Meituan argues that most riders on the platform are temporary workers or hired by 3rd party agencies, meaning that it is not their responsibility to offer certain pay and benefits.

But the company now has 5 million workers, and societal demands for fair treatment of those workers grow louder. From a societal perspective, we believe regulations intended to improve workplace conditions are ultimately the right decision. Food delivery workers experience dangerous and distressing work conditions, while pay is not enough. It may be the right business decision too, as delivery platforms depend on the loyalty of both customers and deliverers to achieve sufficient scale and profitability.

Price-cutting for generic drugs is another area of recent government reform. Over the last three years, through six rounds of nationwide group purchasing auctions, generic drug prices have fallen by 50% or more on average.[1] While lower prices hurt generic drug makers' bottom-lines, it was an area that needed urgent reform. Old generic drugs were too expensive in China and consumed large portions of public medical insurance budgets. Further, it prevented pharmaceutical companies from investing in new drug research and development due to the complacency of generating high returns from generic drugs. Since the government's efforts to cut generic drug prices, there has been an impressive emergence of innovative drugs from Chinese health care companies like Innovent, Henrui, and Junshi.

Antitrust concerns across e-commerce platforms remain top of mind as well, as companies such as Alibaba actively discouraged merchants from selling items on rival platforms. This practice is now banned, which we think is sensible and necessary to ensure fairer competition in the burgeoning theme.

Another sector currently experiencing regulatory overhang is 'After-School Tutoring' (AST). AST has become a cause for concern among middle-class, urban Chinese parents, due to the increased costs of education and the mental burden on children. The latest rumor is that the government will be forced to act by introducing restrictions on AST operating hours. While potentially hurting AST companies' revenues in the short term, these regulations could ultimately set the sector on a more sustainable path forward.

To be sure, Chinese regulatory pressure is not just limited to facilitating improved industry competition, innovation, and alignment with social values. In Didi's case, regulations stemmed from the lingering US-China conflict. At the moment, we are not yet clear how Didi breached cybersecurity laws but according to market speculation, the issue stems from the company possibly sharing data with the US Securities and Exchange Commission, albeit the data could be minor or negligible information for what we know. The Chinese government is very concerned about critical data being leaked to the US via US-listed Chinese companies. Following several years of geopolitical conflict between the US and China, listing in Hong Kong rather than New York has been shown to help avoid these issues.

But it's important to contextualize these regulatory efforts in China, particularly when compared to other emerging markets. Yes, China's government intervenes in the economy and is clearly regulation-heavy, but these efforts largely are designed to prevent one interest group or company from gaining monopolistic powers over its society. Based on our vast experience of investing in emerging markets, we often encounter more malicious cases where vested interest groups, family businesses and conglomerates leverage their size and power to hamper innovations and growth in a country to protect their position. China is different. We welcome positive changes that help to ensure a competitive and sustainable economic environment and believe most of the recent regulatory changes are of this nature.

How do these regulations impact KEJI's positioning?

First, we continue to believe there is plenty of untapped growth opportunity in Chinese equities. A powerful and often effective way to pursue this opportunity is simply to follow the country's economic priorities. China is regulation-heavy, but it's also support-heavy, and the government has a strong track record of supporting businesses that it believes serve China's social needs. These days, social needs include clean air, health care, and technological independence from the US, to name a few.

It's important to note that Chinese society is not just inward-facing; there is a strong perception that exporters are good for society and therefore are highly regarded. There are several innovative opportunities within export-oriented industries such as solar, Electric Vehicle batteries, semiconductors, automation, and AI, that we like to gain exposure to.

Second, we are and should be cautious of mature internet platform companies. If an internet platform already holds a monopolistic position of >60% market share, their business is by its nature a “public utilities” service, comparable to power utility or water utility companies. Key features of “utilities companies” is they should place social service as its priority, rather than shareholder profit. Hence, we believe these internet platforms don’t deserve a high valuation multiple. We do still have an exposure to Alibaba and Tencent, because we believe their valuations are low relative to the market. In contrast, there are several internet companies that trade at extremely high valuation multiples that we actively avoid.

Third, it’s important to note that regulations in China can be cyclical in nature. Why? Heavy regulations tend to create business disruption and hamper employment markets. For example, rumored operating hour restrictions on AST may hurt millions of teachers and relevant workers in the AST industry. Heavy periods of regulation therefore tend to be followed by lighter periods. Currently, we are experiencing one of the most severe regulatory cycles in a decade, which implies a looser period in the near future.

Last, in our view regulation is a short-term pain, but a healthy long-term gain. Despite much discussion on anti-trust action across the world, no other country has successfully reigned in giant corporations. The Chinese government has at least made good on its first step to tackle vested interest groups in its society, while creating an environment for further innovation and more startups in the future, which could ultimately benefit investors.

Overall, we are optimistic on China’s innovation trends and the trajectory of its growth stocks.

Footnotes

1. Source: Reuters, as of 28 December 2020