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WHAT'S GOING ON IN CHINA? A DIFFERENT PERSPECTIVE

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July 2021 was an eventful month for investors in China, and China A or China onshore investors experienced a tough time with USD returns for the CSI 300 Total Return Index dropping by -7.5%. Having said that, the CSI 300 had a relatively good month compared to its China offshore peer – the MSCI China Total Return Index, which returned -13.8% – an outperformance of 6.3%. The difference was largely due to the concentrated nature of the MSCI China Index, which has significant exposure to the Chinese technology sector.

The after-school education sector was hit hard during July. This was mostly influenced by new regulatory direction announced by the Chinese regulators. With noise all over conventional media, VIE (variable interest entity) also became a popular term all of a sudden. Many are questioning China as an investment destination and slamming the Chinese government for being an "enemy" of capital. While we understand the emotional reactions of many investors, we see this as an opportunity to both learn about future policy direction and to test the robustness of our investment processes.

In this short update, we aim to summarise recent events in China, with some additional insight into what we've been reading elsewhere.

THE VIE BUSINESS STRUCTURE

Many technology companies in China are classified as value-added telecommunications businesses, and companies under this classification in China can't have majority foreign ownership. An existing legal loophole is used to work around this. Entities are created – often in the Cayman Islands and within China. These involve a series of legal contracts that are signed between a foreign Cayman Island entity, a local Chinese entity, which will be a wholly foreign-owned enterprise (WFOE) and the underlying Chinese business. It provides economic benefits from the underlying Chinese business to the foreign Cayman Island entity, which will have no restrictions on ownership. The downside is that the shareholders of the Cayman Island entity will not have voting rights for the underlying Chinese business, as they technically don't own shares in the underlying Chinese business. This workaround business structure is called a variable interest entity or VIE structure.

CHINESE VIE STRUCTURE RISKS

The main additional risks of the VIE structure in Chinese companies are regulatory and legal in nature. Although the VIE structure is technically legal, it still enables foreign ownership of restricted Chinese companies, which is against the core intention of the restriction on certain Chinese industries.

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HOW LIKELY ARE THE RISKS TO MATERIALISE?

As the regulators have indicated, we believe the "grandfathering" approach will be taken where existing VIE structures will remain, but future IPOs involving the VIE structure will be severely restricted. We believe it's highly unlikely that Chinese regulators will interfere unreasonably with existing VIE structures, as this would ruin China's global reputation as an investment destination with nothing much to gain. After all, it's always been necessary to obtain the unofficial approval of the Chinese regulators before an offshore IPO using a VIE structure could be created. The recent crackdown on after-school education companies related to business practices, rather than the VIE structure itself.

WHY THE SUDDEN SHUTDOWN OF AFTER-SCHOOL EDUCATION COMPANIES?

We believe the reason was to reduce the pressure (and/or misery) of children and young families in China. One of the new rules on after-school classes is that classes must end by 9pm. Think about that for a moment, and consider that it applies to K9 students –aged 15 or younger. Most of these children have extra lessons that continue after 9pm on most week days.

Having spoken to several friends with young children here in Shanghai, it seems the only children that don't typically attend after-school classes beyond 9pm are pre-school – aged 4-5 – and they usually finish by 8:30pm. A recent survey by China Education Paper[1] showed that 92% of parents send their children to extracurricular classes. We suspect the remaining 8% mostly don't due to financial reasons.

In terms of the overall wellbeing of Chinese children and families, we believe the government's intentions are positive, especially if we take a long-term view – which all investors in China (and elsewhere) should be doing. The after-school education sector, whose earnings are often highly dependent on creating extra pressure and stress for Chinese children and families, stands in the way of a balanced and healthy Chinese society.

In addition to the 9pm-curfew for extra lessons, the announced changes include:

- No school subject tutoring on weekends, public holidays and winter/summer school holidays
- No overseas educational classes or classes that go beyond the school curriculum

The following changes will affect investors most:

- Going forward, foreign capital invested in the industry are to be barred via M&A or VIE structures
- School subject tutoring businesses are to be transformed to non-profit organisations (NPOs)

[1] https://www.caixinglobal.com/2021-03-29/cover-story-wheres-the-pressure-on-schoolkids-coming-from-101681656.html

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HOW WERE EXISTING VIE STRUCTURES AFFECTED IN THE AFTER-SCHOOL EDUCATION SECTOR?

We still await detailed steps of policy implementation from the Chinese regulators, but expect the transition of school subject tutoring businesses to NPOs to be the more significant step. If there are no profits, and all business is concentrated in school subject tutoring, then the stocks will be worthless, regardless of shareholding structure. The existing VIE structures themselves have not been impacted yet, but given the changes to the underlying Chinese business dynamics – whether the shareholding structure was direct or via VIE structures – the financial result for investors will be very similar.

WHY DID THE CHINESE GOVERNMENT SUDDENLY INTRODUCE ALL THESE CHANGES?

While the Chinese authorities act extremely efficiently with policy introduction and implementation, these changes were not sudden. Education reform has been on the government's agenda for many years and in March 2021, the NPC and CPPCC (top legislative bodies in China) sent out a clear message for education reform. Therefore, the industry was expecting changes. The regulators held multiple rounds of discussions with top private education firms before the announcement of the new regulations, so these companies had reasonable expectations of what was coming. Investment managers who did their homework should also have expected the change, and managed their portfolio risks accordingly.

HOW WAS PRESCIENT IMPACTED BY THESE CHANGES?

Overall, our exposure to the after-school education sector in the Prescient China Equity Fund was 0.36% before the announcement of regulatory changes. After the announcement, the value of our exposure dropped to 0.16% – effectively an absolute drawdown of -0.20% at its trough. We didn't hold famous names in the sector, such as New Oriental and TAL Education, mainly because:

- The companies don't form part of our CSI 300 benchmark and we very seldomly have off-benchmark holdings
- Both companies were at valuations that we considered too high. Even after the crash (around 90% since the 2021 peak), New Oriental has a forward PE of 8, and TAL Education 15 as at the beginning of August 2021.

We continue to learn from market developments and work with our quantitative models with strict portfolio diversification and risk management processes. July was no doubt a tough month where we experienced negative returns. However, we are encouraged to see our processes working for 2021, and our year-to-date Prescient China Equity Fund alpha sits at 1.1% as at the end of July.

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CAN ONE STILL INVEST IN CHINA WITH THE CURRENT CHINESE GOVERNMENT?

In all likelihood, yes. There's been a lot of negative media noise surrounding China and the Chinese government lately. If we look through the often politically motivated noise, almost all hard data points towards China being a market no investor can ignore. Yes, a series of regulations were introduced across industries. One can be negative and take the cynical view that the government is anti-capital, anti-entrepreneurship and wants absolute control over everything – with no consideration for anyone else. At Prescient, we have a different view: that the government is supportive of innovation and the business environment and friendly towards foreign investors like us, but will step in if the healthy development or wellbeing of ordinary Chinese citizens are being threatened. When the choice had to be made between profits in the after-school education sector or the healthy development of the current generation of Chinese children, the government chose the latter. These interventions are positive for the long-term development of China as a country, and therefore positive for long-term investors like us.

We need to always remember that China is different to South Africa, Europe or the United States. The ability to understand and navigate the local markets here will be key to producing successful investment results. It's easy to blame the Chinese government for poor investment decisions and risk management, but at Prescient, we see these events as learning opportunities to both test and enhance our investment processes.

CHINA ONSHORE OR CHINA OFFSHORE?

We've long been advocates for China A or China Onshore investments. Our China Equity benchmark is the CSI 300 Index, which we believe is a diversified real representation of China. MSCI China, or what we consider China Offshore, is often used by global investment managers. The key differences and reasons why we prefer the CSI 300 are listed in the table below:

MSCI China	CSI 300
Chinese companies listed offshore (outside of Mainland China)	Contains vast majority of listed Chinese companies, better represents overall Chinese economy
High concentration – top 10 around 45% of index	Less concentration – top 10 around 25% of index
Dominated by technology and finance sectors	More diversified index across sectors
Easily accessible by global asset managers	Full access only available to local Chinese managers and foreign QFII license holders – **Prescient holds a QFII license**

The concentration factor had a significant negative impact on the MSCI China Index for July 2021, where the full impact of the sell-off in the technology and the after-school education sectors were felt. While we can't say that the CSI 300 Index will consistently outperform the MSCI China Index going forward, the outperformance has been significant over the past 3 years – cumulatively almost 34% in USD terms.

Sources: Prescient, Bloomberg, 31 July 2021

WHERE TO FROM HERE?

At Prescient China, we'll continue to work hard on the ground for our clients here in Shanghai. China remains more volatile than most major global equity markets, but we see the trend improving as the market matures. We continue to consistently enhance our investment processes and models to ensure their relevance, especially in the current global environment with unprecedented government and central bank interventions. China will likely always be a bit different to other global markets, but that's precisely why we feel it can add value – both in terms of diversification and return enhancement as part of global portfolios.

As we march forward into an unknown future, we'd like to offer a special thank you to our clients who've supported us, and continue to support and trust the Prescient process – especially in these turbulent times. We feel extremely blessed. As always, please get in touch with us directly, or with your local Prescient relationship manager, if we can be of any assistance.

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