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# Thoughts on China Opportunities From an Active Risk Management Perspective


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Recent regulatory changes by authorities in China and the United States have raised concerns around investing in Chinese companies. In light of these concerns, we feel it important to detail how MFS approaches China opportunities from an active risk management perspective.

The assessment of these risks has long been a part of our bottom-up research process, and we regularly analyze them at the stock, sector and portfolio levels. While some of the risks are well known and reported on — such as the variable interest entity (VIE) structure used by many offshore listed Chinese companies — our approach is to assess a broad range of upside and downside risks, including extreme outcomes, to optimize the tradeoff between risk and reward. As with any country, we thoroughly examine each investment opportunity in China from the perspective of long-term sustainability, paying particular attention to government regulation and corporate governance.

Recent developments in the Chinese regulatory environment make this a good time for an update, although, as we note in more detail below, many of the risk factors we see are not unique to China. We acknowledge that some of these risks are difficult to predict and could potentially have a significant impact on individual sectors or companies. However, in the context of a portfolio construction process that seeks to optimize risk/reward, we still see merit in understanding the drivers of regulatory change — which are often logical when placed in their political context and are likely to be seen elsewhere. Our mandate is not to avoid risk but to carefully weigh its materiality in relation to our long-term investment thesis.

## Promoting specific behaviors, not regulating companies

Our belief is that China is trying to encourage specific behaviors and not target specific companies or shareholders. Many of the recent developments seem reasonable when examined individually and are a direct result of the Chinese government's focus on reducing income inequality, protecting consumers and small and medium-sized enterprises and reversing demographic headwinds. In fact, we think we could see a similar evolution of regulatory risk beyond China.

## Sectors in focus

Over the past year, we have seen an uptick in Chinese regulatory reforms in the antitrust arena and in the regulation of e-commerce marketplaces and payment platforms.

China's intent appears to be like those of regulators elsewhere, who are focused on reining in anti-competitive practices among some of the technology giants. Below are some examples of recent regulations that we have been analyzing to understand their impacts on specific industries and sectors. Thus far, except for in the education sector and Ant Financial, the regulatory changes have not had a major impact on the companies.

**Mergers and acquisitions** In recent months, regulators have insisted on the submission of mergers and acquisitions for review and they have also doled out many fines for previously unsubmitted M&A transactions, though penalties, to date, have been modest.

**E-commerce marketplace** are coming under increasing scrutiny, with authorities banning marketplaces from demanding exclusivity. The ban has increased the ability of small and medium sized companies to expand their market share, while ending exclusivity should be a negative for incumbent platforms due to increased competition. Additionally, regulators have barred the practice of differential pricing based on purchasing behavior.

**Payment platforms** face new rules that prohibit them from facilitating unsecured loans without directly bearing a substantial portion of the credit risk. This, combined with the requirement that certain government licenses be obtained, led to the cancelation of the initial public offering by Ant Financial in late 2020.

**Cybersecurity** Recent weeks have seen an uptick in the regulation of Internet companies, particularly in the area of cybersecurity, where the focus is on the collection and management of private information. These regulations were accompanied by the announcement of an investigation of ride-hailing company Didi's use and collection of data shortly after its New York IPO. We view these regulations as similar in nature to the European Union's Global Data Privacy Regulation (GDPR).

**Gig economy** Regulations recently put in place to protect the interests of workers in the gig economy — particularly food delivery workers — will likely lead to increased costs for Meituan and Alibaba's ele.me. Similar concerns have been expressed about companies in the US that provide delivery and taxi-like services.

**After-school tutoring** Particularly hard hit has been the after-school tutoring industry, as China's government has introduced new regulations aimed at reducing the cost of child rearing at a time when the country faces a challenging demographic profile after decades of its one-child policy.

## The variable interest entity

Another area of focus, with both Chinese and US regulators signaling concerns, has been the use of the variable interest entity structure. The framework has been used for the past two decades. It was designed to circumvent Chinese foreign investment restrictions in specific industries. Any arrangement that is designed to avoid a regulation is an obvious red flag, and MFS has consistently incorporated this risk into our investment analysis. Given increasing levels of scrutiny, we think it timely to summarize the VIE structure, and to outline how we differentiate between companies that use it.

A VIE combines an entity in China that faces restrictions on foreign ownership with a separate entity that is incorporated offshore (typically in the Cayman Islands, Bermuda or Hong Kong) under which the ownership of the domestic entity is attributed to the foreign entity via a contractual agreement that passes economic interest to the foreign entity with the legal ownership staying in China.

The concept of economic pass-through while maintaining separate ownership is not unique to Chinese VIEs. It is often used in joint ventures and has been used in several global industries that face foreign capital controls, such as airlines and mining. There are, however, obvious risks when sidestepping restrictions through the use of a clever legal construct, as regulators can tighten rules, either prospectively or even retrospectively.

To compound the risk, the non-China entity is often incorporated in jurisdictions with weak minority shareholder protections. The risks around minority shareholder protections are not unique to VIEs, but the combination of weak legal ownership (via a contract as opposed to title) and a jurisdiction without robust minority protections has increased the scope for abuse, which can extend from unfair related-company transactions to the misappropriation of the underlying assets within the domestic entity at the expense of the shareholders in the offshore entity.

While the original VIE concept was created to circumvent foreign ownership controls, some of these controls have since been partially deregulated. One example is the introduction of the Stock Connect program that allows foreigners to invest in companies listed on the Shanghai and Shenzhen exchanges (known as A-shares) via a link with the Hong Kong Stock Exchange. In addition, a set of new Foreign Investment Laws was implemented in 2020 that enhanced regulatory transparency and liberalized controls on certain sectors, indicating a commitment by China to further open up its capital markets.

Once again, this is something that needs to be analyzed on a case-by-case basis, as there are sectors in China where foreign ownership remains regulated and for which the use of a VIE structure could be prohibited through tighter application of underlying controls. For its part, the China Securities Regulatory Commission (CSRC) has indicated that it is “taking measures to promote orderly development of certain industries,” indirectly indicating, in our view, that their main objective is to tighten oversight in sensitive sectors. Once more, we are also seeing similar regulatory oversight moves in sensitive sectors, such as technology monopolies, in other jurisdictions.

Across the Pacific, US regulators have signaled their own concerns regarding Chinese companies using the VIE structure to list on US exchanges via American Depository Receipts (ADRs). In December 2020, the Holding Foreign Companies Accountable Act was signed into law in the United States. It prohibits overseas companies from listing securities in the US if they fail to meet Public Company Accounting Oversight Board (PCAOB) requirements for three consecutive years, such as allowing full inspections in China or the review of audit documentation. In our view, this will likely lead to more companies de-listing in the US and re-listing on the Hong Kong exchange, which will have implications for US funds that limit offshore exposure to ADR listings only. According to UBS, VIE-related US listings are worth over US$1.6 trillion, as of 9 August 2021.

Importantly, from our perspective, not all VIEs share the same risk profile, and VIE risk is often not our greatest concern since we have found that there is no clear correlation between the structure of the VIE and actual corporate governance and alignment with minority investors.

Our approach has been to assess the risks attached to each VIE by looking at the track record of the management team and where cash balances are held (within the VIE or the listed entity). We have also mapped the various licenses back to VIE owners and have used these maps to engage with companies on regulatory risk. This process has helped us identify potentially riskier relationships and VIE structures. Ultimately, when making long-term investment decisions, it is our role to assess these factors, along with other fundamental business and ESG risks.

## Active risk management is paramount

As we said at the outset, our approach is not to avoid the risks inherent in investing in China — we see similar challenges across the investible universe — but to carefully weigh them in order to judge whether they are material to our investment thesis. Many of the factors discussed are not unique to China but rather challenges that investors face broadly. It is our belief that a thorough research process can help identify and quantify risks. It can also help construct portfolios that provide exposure to companies that create value over the longer term while optimizing and diversifying the risks taken.