CHINA TECH - A TOP-DOWN VIEW

Q&A ON RISKS HANGING OVER CHINESE TECHNOLOGY STOCKS

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SUMMARY

Chinese stocks are facing headwinds from both sides of the Pacific. The United States have been pushing regulation that directly targets Chinese firms listed in the US and may lead to their delisting, while China is actively enforcing tough new regulation on the technology sector. The consequence has been a ~30% drop in the price of Chinese ADRs (mostly US-listed Chinese tech firms) since February 2021.

- **Q1: What is the size of the US-listed Chinese equities market?**
  There are currently about 250 Chinese firms listed in the US with a total market capitalisation of USD 1.7trn. American Depositary Receipts (ADRs) account for a very large majority of these listings.

- **Q2: What is the Holding Foreign Companies Accountable Act (HFCAA) and why does it matter for Chinese firms?**
  HFCAA prohibits the securities of a company from being listed on US exchanges if the company has failed to comply with the Public Company Accounting Oversight Board's audits for three years in a row. In effect, HFCAA could result in the delisting of Chinese companies' stocks listed in the US.

- **Q3: What is Executive Order #13959?**
  Executive Order #13959 essentially bars US persons from investing in any security of companies deemed to be related to Chinese military activities. There are currently 59 entities identified as such.

- **Q4: How serious is the delisting risk and what can Chinese firms do about it?**
  The risk of delisting from US exchanges is real, especially for firms closely tied to the Chinese military or government. Also, HFCAA could also lead to a delisting of most US-listed Chinese stocks. Those with an alternate listing in Hong Kong are best protected.

- **Q5: What happens to an ADR in case of delisting?**
  A delisting usually leads to a termination of the ADR program, whereby holders typically receive the corresponding local shares, or cash in some cases. Investors however stand a liquidity risk in case the programme is not terminated, of if the corresponding local shares are not exchange-traded.

- **Q6: Why is the Chinese government cracking down on tech firms?**
  The Chinese authorities have recently intensified their scrutiny of the tech industry in order to curb monopolistic behaviour, adapt regulation to the digital economy, and ensure proper collection and use of personal data, especially when cross-border flows are involved.

- **Q7: What are Variable Interest Entities (VIEs) and why do they matter?**
  This ubiquitous legal structure has historically allowed Chinese firms, particularly tech firms, to circumvent domestic restrictions on foreign investment in certain industries. Chinese authorities are increasingly clamping down on this regulatory loophole.

- **Q8: Are US listings over for Chinese tech companies?**
  US listings for Chinese firms have been dealt a severe blow, though not a mortal one. US issuance is set to be muted for the rest of this year, probably to the benefit of Hong-Kong.

- **Q9: Are Chinese tech stocks still investable?**
  We remain positive on Chinese tech over the long-term but acknowledge that patience is needed as Chinese companies adapt to the new regulations. While the regulatory overhang is likely to persist until the end of this year, resumption of strong earnings growth should lead to an eventual re-rating.

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Question 1: What is the size of the US-listed Chinese equities market?

There are currently about 250 Chinese firms listed in the US for a total market capitalisation of USD1.7 trn. The top three listed firms account for around 50% of this market capitalisation and the top 10 for about 70%.

Listings consist of American Depositary Receipts (ADRs) and a small amount of common stocks. While imprecise, investors generally refer to US-listed Chinese stocks as "Chinese ADRs" because this category represents the overwhelming majority (~97%) of market capitalisation.

Question 2: What is the Holding Foreign Companies Accountable Act (HFCAA) and why does it matter for Chinese firms?

HFCAA was signed into law by Donald Trump on 18 December 2020. It prohibits securities of a company from being listed on any US securities exchange (or even traded over the counter) if the company has failed to comply with the Public Company Accounting Oversight Board's (PCAOB) audits for three years in a row. The act also requires public companies to disclose whether they are owned or controlled by a foreign government, with some clauses specifically referring to the Chinese Communist Party.

The act highlights the growing incompatibility between Chinese securities law and US legislation. Whereas auditors of US-listed companies are required to present detailed documentation on their audits to the PCAOB, China's new securities law, which was revised in March 2020, specifically prevents auditing firms operating in China and Hong Kong from providing such documentation without approval from the Chinese authorities

HFCAA therefore increases the risk that US-listed Chinese companies will be forced to delist. As things stand, the US PCAOB cannot inspect their audit records, hence opening the possibility for the Securities and Exchange Commission (SEC) to withdraw their listing for non-compliance in three years' time.

Note that the US Senate recently passed the Accelerating Holding Foreign Companies Accountable Act, which would reduce the number of non-compliance years to two instead of three and extend the act to companies using audit firms in Taiwan or Singapore. While this is not yet law, it nonetheless shows American lawmakers' willingness to enforce stricter control over Chinese listings in the US.

Question 3: What is Executive Order #13959?

On 12 November 2020, President Trump signed Executive Order #13959, essentially barring US persons from investing in the securities (or their derivatives) of companies included in a list of 'Communist Chinese Military Companies' (CCMC) maintained by the US Department of Defense. The list, which contained 31 companies in November 2021, was subsequently amended to include 45 names in January 2021.

The order gives US investors 60 to 365 days to divest their holdings in any company included in this list. US stock exchanges and index providers have been scrambling to

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adapt. For instance, MSCI decided to remove 13 Chinese securities from its Global Investable Market Indexes on 5 January 2021. The New York Stock Exchange (NYSE) initiated the delisting process for three telecom companies, then cancelled the delisting at one stage, before going back to the original plan.

Executive Order #13959 was amended on 3 June 2021 by the Biden administration to provide a stronger legal footing for investment restrictions, as several Chinese companies had successfully challenged their inclusion in the CCMC list. The scope of targeted companies as defined in the new executive order (EU #14032) was also enlarged to encompass companies "operating in the defense or surveillance technology sector of the Chinese economy". Responsibility for maintaining the list, which now contains 59 entities, was transferred to the Treasury department. The actual investment restrictions for US investors remain unchanged.

Question 4: How serious is the delisting risk and what can Chinese firms do about it?

The risk of delisting from US exchanges is real for Chinese companies, in particular those exhibiting close links with the military or the government (which are specifically targeted by Executive Order #13959 as amended, or the US Entity list).

For those potentially impacted by HFCAA, there is still a chance that Chinese regulators strike an agreement with the SEC and the PCAOB before the deadline is hit. In a recently published document, China's State Council mentioned the need for a constructive approach to cross-border regulation cooperation, perhaps hinting at a willingness to cooperate with the Americans.

Chinese firms can offset the risk of de-listing in the US. The simplest and smoothest way is to apply for a secondary listing in Hong Kong, although such listing is subject to a set of requirements, notably regarding market capitalisation and/or revenues. Companies seeking a listing in Hong-Kong also need to show two years of "good regulatory compliance" and be deemed "innovative companies" (although a recent consultation contemplates waiving this criterion).

Those ineligible for a secondary listing in Hong Kong could also consider re-listing in mainland China. Shenzhen's ChiNext or Shanghai's STAR board would be natural destinations given their innovation tilt and relatively loose requirements (registration-based, pre-earnings firms accepted, accessible to companies registered outside mainland China, VIE[1] and WVR[2] structures permissible). However, international investors would have only limited access, since only a subset of A-shares is accessible through StockConnect.

Listing on Shanghai or Shenzhen's other boards (Main Board, SME Board) is also an option, but this would come at the expense of more stringent requirements, particularly on financial maturity or VIE and WVR structures).

[1] Variable Interest Entities allow Chinese domestic companies to attract foreign direct capital and circumvent legal restrictions that exist to invest in certain industries. In essence, foreign investors have no actual claim on the domestic company, but instead participate in the ownership of a Special Purpose Vehicle (SPV) that has a series of contractual agreements for profit sharing.
[2] WVR stands for Weighted Voting Rights

Note that the 'heavy-weight' ADRs included in major indexes have either already put in place, or would be eligible for, secondary listings in Hong Kong. Alibaba, Yum China, Netease, Baidu and JD.com have already secured secondary listings there, while Pinduoduo and TAL Education, to name a few, would also theoretically be eligible.

Overall, we estimate that more than 90% of US-listed Chinese companies (on a market-capitalisation weighted basis) currently included in MSCI indices would be eligible for a secondary listing in Hong Kong by the time the earliest HFCAA de-listing kicks in.

Furthermore, exchanges in mainland China and Hong Kong have materially loosened listing requirements in recent years, in an effort to lure Chinese companies back home. For instance, Shanghai's STAR board and Shenzhen's ChiNext have both introduced registration-based IPO systems (as opposed to application-based ones), and the Hong-Kong stock exchange now accepts weighted voting rights (in contrast with the previous *"one share one vote"* principle). It is therefore clear that China is preparing the ground for its most innovative companies to list domestically should they want or need to.

Question 5: What happens to an ADR in case of delisting?

American Depositary Receipts (ADRs) are US-traded security instruments that represent the shares of a foreign company listed in another jurisdiction. They allow US investors to access foreign markets without having to open foreign brokerage accounts or bother about currencies (ADRs are denominated in US dollars).

ADRs are typically created by US banks which acquire shares of companies in another country, deposit them at a local bank, and then issue an equivalent value on the US market as ADRs. Note that ADRs can be either sponsored, if there is an agreement between the issuing company and the US bank, or non-sponsored. Only the former can be listed on stock exchanges.

Should an ADR be delisted (e.g. because it has been deemed non-compliant with PCAOB three years in a row), the ADR programme is usually terminated by the US depositary bank. In this case, ADR holders are offered to receive the corresponding local shares or, in some cases, a cash amount. However, if the program is not terminated, of if the corresponding local shares are not exchange-traded, investors in the ADRs become exposed to a significant liquidity risk as they may struggle to trade their securities.

Generally speaking, investors who bought the ADRs of firms that also have their shares listed in Hong-Kong are best protected against the risk of a US delisting, although forced selling and market stress around the delisting decision may nonetheless impact prices.

Question 6: Why is the Chinese government cracking down on tech firms?

In our view, there are at least three main reasons behind the Chinese government's regulatory actions against big domestic internet-based companies.

First, as in many other countries, the Chinese government is concerned about Big Techs' monopolistic and/or anti-competitive business practices. This is especially problematic in the information technology sector because of strong network effects that result in 'winner-takes-all'. Some internet platform companies, because of their size and close-to-exclusive access to end users, possess enormous market power over potential competitors.

Second, due to the very nature of innovation, regulations are often failing to keep up with the services provided by technology companies. For example, online credit and the other digital services offered by fintech companies combined new technology with features offered by traditional financial service companies. The lack of regulation on such activities could, the authorities fear, expose the economy to new systemic risks.

Third, the Chinese authorities are concerned about the collection and protection of personal data and potential across-border transfer of such data. User-data collection lies at the heart of most technology companies' business models but raises serious questions about people's privacy as well as national security concerns should foreign powers manage to access this data.

But why now?

Perhaps because some Chinese tech companies have grown too big to ignore. At time of writing, e-commerce accounted for more than 30% of Chinese total retail sales. We estimate online sales could amount to Rmb13.5 trn in 2021 (roughly USD2.1 trn, or over 12% of China's expected 2021 GDP), with the bulk of transactions conducted through a handful of major platforms using one of two dominant e-payment systems. The size of China's online credit business by some major fintech players has also risen to a level that could cause significant financial turmoil if things go sour.

In addition, strategic competition with the US means that national security (including economic and financial security) has risen sharply up the list of China's priorities. This is evident from the prominence given to national security in the Chinese government's latest Five-Year Plan.

In our view, the purpose of regulating the technology companies is not to curb their growth per se, but instead to ensure they are aligned with national interests as defined by Beijing. Given the enormous importance assumed by some technology firms, what we have seen so far likely is just the beginning of a major regulatory push that could last for some time.

Question 7: What are Variable Interest Entities (VIEs) and why do they matter?

The VIE structure allows Chinese domestic companies to attract foreign direct capital and circumvent legal restrictions to invest in certain industries. The structure is essentially composed of two parts:

- The VIE per se, which is a special purpose vehicle incorporated in China and owned by Chinese individuals,
- A wholly foreign owned entity (WFOE) also incorporated in China, which is typically owned by a Cayman Islands public company, itself owned by foreign investors. Note that WFOEs are conventionally used by multinationals to conduct business in China.

The parts of the business that are restricted to foreign ownership are put into the VIE, with the remainder hosted by the WFOE. Thanks to specific accounting rules and contracts between the WFOE and the VIE that mimic control and economic interest of direct ownership, both entities can be consolidated. This makes owning shares of the Cayman Islands company almost equivalent to owning the Chinese entities directly.

Since its inception, the VIE structure has become the preferred method for listing companies operating in the "new economy" such as internet platforms, education, e-commerce or electric vehicles. While very common on US exchanges, this type of structure can also be found in firms listed in Hong Kong, Toronto or London.

Given the ubiquity of the VIE structure and the legal ambiguities that come with it, the validity of the setup going forward must be monitored closely. While many have called for the end of the structure many times, it rather seems that Chinese authorities are now acknowledging the setup but are also increasingly making sure that it is brought back into the mainland's regulatory framework.

For instance, China's State Council's anti-monopoly committee issued new guidelines covering VIEs for the first time in February 2021, allowing regulators to issue anti-competition penalties such as the one that was imposed on Alibaba. In addition, the updated cybersecurity law now encompasses a very large definition of 'critical information infrastructure operators', thus facilitating regulatory reviews like the one to which the taxi ride-hailing giant Didi Chuxing was subjected recently.

In parallel, the China Security Regulatory Commission is leading efforts to revise the 1994 rules on overseas listings, potentially requiring prior regulatory approval for any Chinese listing abroad, including VIEs. The Cyberspace Administration of China has also proposed fresh rules banning companies with more than one million users from listing overseas without security clearance.

Question 8: Are US listings over for Chinese tech companies?

While it is too early to declare the US-listing route over for Chinese companies, it is true that the list of headwinds is growing by the day.

On the US side, regulatory bodies are clearly pressing ahead with the implementation of the HFCAA, increasing the risk of de-listing should no compromise be found between China and the PCAOB on auditing issues. In addition, the ongoing crackdown of Chinese authorities on tech companies coupled with the opening of an investigation into Didi Chuxing just days after its New York listing – which logically sent its stock tumbling – may have curbed the enthusiasm of US investors for Chinese stocks. Fresh news of a major crackdown on after-school tutoring firms, the most prominent of which are listed in the US, can only reinforce this trend.

On the Chinese side, the flurry of regulatory efforts to tighten the noose around overseas listings and the significant loosening of listing criteria in recent years (both on mainland and Hong Kong stock exchanges) clearly indicate that Hong Kong is meant to become the favoured overseas listing place for Chinese firms.

US markets remain attractive for thanks to the depth of capital that can be tapped, looser listing requirements and generally higher valuations compared to HK or mainland China. This explains why, despite regulatory uncertainty, 2021 has been a very strong for equity issuance on US markets by Chinese firms so far (~USD18 bn have been issued year-to-date, compared to ~USD11 bn on average for a full year since 2010).

But the Didi shock seems to have turned the tide, at least for the rest of this year, with a large number of listing candidates considering a potential pivot to Hong Kong instead. The longer-term impact is more uncertain and will depend on how regulations evolve in both the US and China.

Question 9: Are Chinese tech stocks still investable?

Valuations for Chinese tech stocks are currently at five-year lows, meaning that the various headwinds they are facing are likely already priced in. Regulatory overhangs typically last nine to 12 months, as happened when there was a crackdown on the gaming industry in 2018. In other terms, negative news flow could keep prices range bound in the near term. There is undoubtedly a contagion effect to be considered as Chinese internet companies exist within an interdependent ecosystem. For instance, apps providing goods and services also rely on payments and advertising.

We remain positive on the Chinese tech sector over the long term but acknowledge that patience will be needed as Chinese internet companies comply with the new regulatory environment. Yet we expect them to keep delivering on earnings, which should drive an eventual re-rating. While Chinese authorities perceive a strong rationale for reining in Big Tech at this stage, they are also well aware that it remains a strong engine of growth for China in the long run.

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