Dear Patrons,

Someone asked me recently what investment lessons I've learned researching Chinese companies and working in China over the last 12 years. I share them below.

12 INVESTING LESSONS FROM CHINA

LESSONS SPECIFIC TO COMPANIES

(1) Unfocused. Western investors are used to singularly focused companies. In China, you'll come across some companies engaged in many different businesses.

- I first came across this when researching Three Gorges and saw they aren't just in the hydroelectricity business; they also had an advertising and billboard business.
- A more recent example: Jinchuan Group "makes and explores nickel and other metals ... the company also offers beauty and cosmetics, media, property investment, property development and financial services." (hmm...)

(2) Higher debt loads. Chinese firms tend to have more debt/leverage on their balance sheets, though this isn't the case for the capital light tech companies.

- My understanding: In the past and arguably still the case today, Chinese investors typically want to know what their return would be before they made an investment. Equity investing doesn't work that way. This meant debt-like financing was preferred.
- There's even a Chinese term for Equity-like debt structures: 名股实债 literally translated "name equity, really debt". These structures are prevalent in Wealth Management Products and 理财 products
- Many entrepreneurs financed their growth with borrowing, either from personal networks or the banking/non-banking system.

(3) Volatility. If you are investing in Chinese markets, you will most likely encounter higher levels of volatility. Bring a strong stomach.

(4) VIE - Variable Interest Entity. While researching Chinese companies, you will eventually run across a VIE structure. In US GAAP VIEs are a form of off-balance sheet accounting. In China whole companies are held in this structure.

- It was developed to allow foreign capital into restricted industries by allowing a Chinese founder or partners to own an onshore entity which then has a contractual relationship with a foreign owned entity, usually granting them access to the cash flows of the business.
- Lots of coverage of VIEs, they were called a legal vulnerability, the SEC has investigated them, even the death of VIEs was called.
- VIEs have neither been explicitly approved or prohibited by China's regulators. Why? Probably because either decision would be worse for China.
  - For China VIEs are great, foreign capital is allowed in, but given no direct ownership. This capital is risked to fuel innovation, competition and ultimately improve people's lives and society.
  - For the investors, they get exposure to those restricted industries and, if it works out, get liquidity on international markets (now even China's new STAR exchange is accepting them).
- Insomuch as restricted access is part of the US-China tensions, VIEs could be a part of that.

GENERAL LESSONS

(5) ADRs - American Depository Receipts. (a.k.a. ADS – American Depository Shares) There are additional costs to owning ADRs. The costs are often incurred when the company pays dividends or if you wish to convert them to ordinary (non-ADR) shares. The details on these costs will be in the Company's annual report.

(6) Competition. Western investors may be surprised by the level of competition in China.

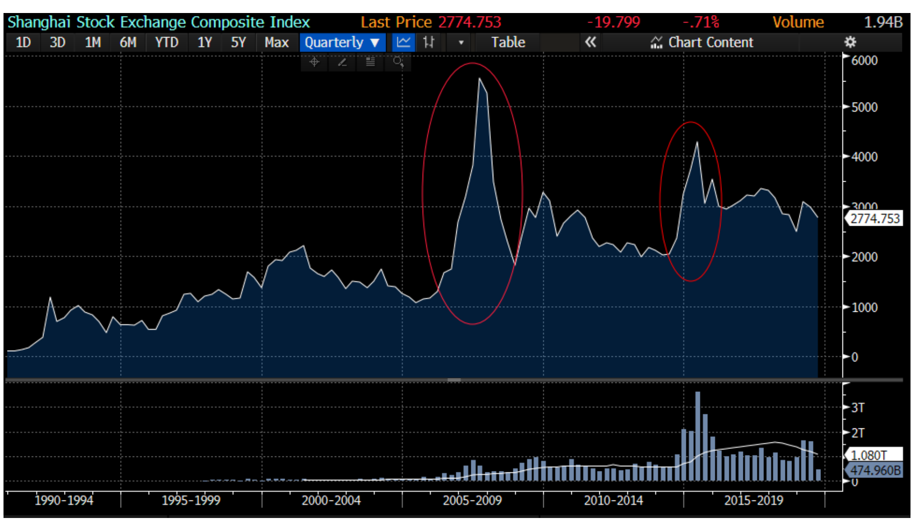
1. SMEs, startups - fiercely competitive which can lead to rampant value destruction.
   - From what I hear, it's not unusual for VCs to hear an idea and go fund it with a founder of their choice.
   - Competitors may beat you to market with an idea or be right behind you, whereas in other markets you may get a 1-year head start before others catch on.
   - Examples: shared bikes, ride hailing apps, streets with stores selling the same thing with similar-sounding names
2. Large Privates - winners who break ahead and get ever larger also develop regulation risk.
   - Monopolies and oligopolies don't enjoy the same market dominance in China as they do in the West.
   - Examples: gaming giants, mobile payment giants, large conglomerates (HNA / Wanda Anbang)

(7) Fast paced innovation. Driven in part by competition & in part by the incredible market opportunity, the pace of innovation is extremely fast.

- With many new industries' paths already blazed in other countries, initial idea isn't a secret.
- Companies must innovate faster to differentiate themselves.
- Example: mobile payments, WeWork Now, super apps, mini-programs, fintech

(8) The "Hot New Thing". When a mania gets going in China, investors need to be careful. I distinctly remember taxi cab drivers with phones on their dash displaying stock prices in 2014-2015, a classic warning sign.

- Sometimes CEOs pursue goals simply because other CEOs are pursuing them (related to #1 and #6).
  - Examples: local services, premium video content, short video
- China's stock market experienced two large manias in the last 15 years. See chart below: Shanghai Composite, 2006-2007 and 2015



(9) Regulation / role of regulator. China's regulators have almost parental tendencies (e.g. concern online gaming causes myopia in children) and tend to favor the consumer over industry players, sometimes even punishing whole industries or specific players that get too powerful.

- The regulator in China tends to be hands-off to nascent industries, even supportive. (Good for innovation, related to #7)
- But if the industry grows too large or specific players get too powerful, regulators step in and disrupt them.
- In P2P lending, regulators stayed hands off and the industry was allowed to grow to massive heights. Then things turned sour, Ezubao was found to have faked $7.6 billion of loans on its platform. Regulators then came in with harsh regulations that the industry is still struggling with today.
    - Examples: peer-to-peer lending, consumer lending, online advertising, real estate development, shadow banking/WMPs, mobile payments now with DCEP

(10) Restricted & Prohibited Industries, sometimes referred to as "restricted access". These industries are either not open to foreign investment/ownership or ownership is limited to below 50% in an onshore Joint Venture. (Without these restrictions, there wouldn't be #4 VIEs)

- Some of these industries are issues in current US-China relations.
- Examples: telecommunication, ship building, rare earths, radio and TV production, book publishing, internet news, tobacco, manufacturing of automobiles (whole list)

(11) Consumer preferences can change quickly.

- China is experiencing evolution in consumer preferences at a faster pace than other countries, this leads to 'leap-frogging' where consumers skip the PC and go directly to mobile smartphones.

(12) Demographics & regional differences. Don't expect a company who has focused on T1 cities to easily gain traction in other regions.

- Tier 1 & 2 city consumers tastes can be vastly different than Tier 3, 4, 5.
- I personally thought online media & entertainment would bridge the chasm, but vast differences in consumer preferences still exist. We now see short-video apps that cater to one over the other.

Thank you for your support. What have you learned investing in China? Let us know in the comments on this post or email me to start a dialogue at james@hullx.com

Yours truly,
James Hull

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