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What You May Have Missed on the Didi Case

A special report for our investors and advisory clients

Key Takeaways

- **Not a Clampdown but a Catch-up** – China has no intention to suppress Big Tech Firms like Didi, Alibaba or Ant Financial. In Didi's case, the government is trying to catch up on Internet regulation, including personal privacy and data security issues. We view such legislation as necessary and healthy for the industry.
- **No Interest in Causing Disruption** – Didi has over 13 million drivers and 377 million users on its platform, the largest in China. Though taking action against Didi, the government will not risk disrupting the tax-hailing service, which could lead to job losses and public complaints.
- **Not Meant to Turn off U.S. Capital Market Access** – The Didi case is not geared toward denying or restricting U.S. capital market access for Chinese companies. The government also has no prejudice against overseas listed companies. China may still view the China-U.S. investment relations as mutually beneficial.
- **Is the Regulatory Arbitrage Over?** – By generating income from China and raising capital in the U.S., the Chinese ADRs used to enjoy the best of both worlds. There was also minimal regulatory oversight by either U.S. or China. Today, both U.S. and Chinese lawmakers are demanding higher transparency and more accountability from these companies. The legal and compliance challenges will only increase from here.
- **Strategic Shift to Core Technologies…and China A-shares!** – Within China tech, there is likely a strategic shift from technology applications to core technologies. Global investors may also shift their focus from Chinese ADRs to China A-shares. The latter contain more core tech plays such as semiconductor companies.

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Introduction

Recently I was interviewed by CNBC on the regulation of Big Tech in China, apparently related to the Didi event a week earlier. A video clip of the TV interview can be found here:

https://www.youtube.com/watch?v=ix5RYUUuqeY

Didi is an online taxi-hailing company in China, dubbed the "Chinese Uber" (The company actually acquired Uber China in 2016). Chinese authorities launched probes into the company shortly after it was listed in the U.S. More details of the story can be found here:

https://www.cnbc.com/2021/07/02/didi-shares-fall-after-china-announces-cybersecurity-review.html

The Didi event is unfolding right when the China-U.S. relations – including investment relations – are increasingly strained. The story has led to wide speculations and even conspiracy theories about what really happened. Based on foreign media reports, it's tempting to conclude that China is trying to "clamp down" on Big Tech firms, and Didi is the latest casualty.

However, we'd like to provide some "alternative" interpretations…

Not a Clampdown, but a Catch-up

First of all, we don't really view the Didi case as a "clampdown". It's not China's intention to suppress Big Tech firms like Didi, Alibaba or Ant Financial. In fact, China is very much committed to growing the domestic tech sector, as part of its big plan to dominate the global supply chain.

Didi has over 13 million drivers and 377 million users on its platform – the largest in China. The government has no interest in disrupting Didi's services or dismantling the company, at the risk of producing job losses and public complaints.

The government's message to Didi is clear: "Let's take a pause. Something is wrong here". That "something" refers to personal privacy and data security, which China has been trying to catch up on with more regulation.

Remember the Chinese Internet space was largely unregulated before. The government has only been adding regulation in the last few years. For example, China introduced its first Cybersecurity Law in June 2017 – just four years ago. Since then, lawmakers have launched at least two consultations on data security, one of which occurred in May this year and was specifically for vehicle data security.

So the context is that China is moving from almost no regulation on Internet to more regulation. During this transition, the pressure on Chinese Internet firms may seem high, because of the low base or the low expectation of regulation. However, we view such legislation as necessary and healthy for the industry.

China-U.S. Investment Relations

We won't read too much into China-U.S. investment relations from the Didi case. To be clear, the sanction is not geared towards denying or restricting access to the U.S. capital market for Chinese companies (Otherwise Didi wouldn't have gone public in the first place). As mentioned earlier, we think the issue is really about the compliance with local rules and regulations.

Until today, China still views the Chinese and U.S. economies as complementary, more likelihood for cooperation than competition. We also believe there is no inherent conflict between the world's two largest economies. Likewise, the Chinese and U.S. capital markets can also complement each other. And China may still view the China-U.S. investment relations as mutually beneficial.

The fact is that China continues to opens its financial markets to foreigners. Recently Blackrock made the headlines by becoming the first foreign firm to obtain a mutual fund license in China. This is a big deal. And Blackrock is a U.S. company.

The U.S. government however may have a more exclusive view on the investment relations with China. For example, the U.S. financial regulation has turned hostile to Chinese companies (ADRs) since the Trump era.

Implications to Chinese ADRs

The so-called "regulatory arbitrage" of Chinese ADRs may be over. What do we mean by that?

For the longest time, these companies have been exploiting the gaps in Chinese and U.S. regulations, either intentionally or unintentionally. They often enjoyed the best of both worlds, by generating income from the world's fastest growing economy and raising capital in the most efficient manner. There was also minimum regulatory oversight by either U.S. or China.

However, the story is changing. Today both U.S. and Chinese lawmakers are demanding higher transparency and more accountability from the Chinese ADRs. The legal and compliance challenges for will only increase from here. Ultimately it's up to the companies to navigate these challenges and come up with a robust compliance strategy.

Implications to China A-shares

Tech is broad, not just the Internet.

On one hand China is creating more regulation for the Internet. On the other hand, China is stepping up the support for things like semiconductors, artificial intelligence, smart manufacturing, new energy auto and 5G. These are all "core technologies" essential to China's big tech ambition.

It was recently disclosed that Liu He, a Vice Premier and one of the top political leaders of China, has been in charge of developing third generation semiconductors for the country. It shows how serious China is about developing its own technologies.

We are not saying the Internet sector is no longer important. However, within China tech there is likely a strategic shift from technology applications (e.g. Internet) to core technologies (e.g. semiconductors). This is an important structural change.

The Chinese ADRs tend to have more Internet plays like e-commerce and on-line education, while China A-shares have more core technology industries, such as semiconductors, robotics and power batteries (for use in electric vehicles).

Will global investors also shift their focus from Chinese ADRs to China A-shares accordingly? We think so.

Incidentally, we are also seeing record foreign inflows into China A-shares year-to-date. Net buying through China-Hong Kong Stock Connect reached 225 billion (USD 35 billion) as of July 8, 2021. That's well above the whole year of inflows in 2020.

About Us

MegaTrust Investments is an employee-owned, boutique China manager specializing in A-shares (domestic Chinese stocks). The firm was founded in Shanghai, China in October 2007 and launched its first fund - the Yangtze Fund II - in April 2008. The firm and its associate are licensed by the Asset Management Association of China (AMAC) and the Securities & Futures Commission of Hong Kong (SFC) for asset management, targeting only Professional Investors. MegaTrust uses bottom-up research to pick stocks, with a focus on company quality and corporate governance. The firm has approximately $800m of assets under management, with over 13 years of Alpha generation in the Yangtze Funds.

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