September 17, 2018

Getting Real

Internet Businesses May Be China's Best Key Economic Indicators

- **Seemingly unrelated** Since late summer, China's online giants have seen strong sell-offs, on company-specific events as disparate as gaming approvals (Tencent) and suspicion of criminal activity by the chairman (JD). But there is a commonality: slower growth in China's money supply.
- **The intimate connection** between stimulus and consumption Chinese consumption has been more driven by government stimulus than many investors realize and is also more connected to its inevitable end.
- **Will it last?** Do the problems experienced by China's internet companies, like the economy itself, represent a cyclical or secular decline?

Anne Stevenson-Yang

Tencent may be the most admired company in China, with a dominant position in Chinese online gaming, a staple of portfolios featuring a wide range of businesses around the world, and the very first example anyone mentions when queried about Chinese innovation. As an investment, Tencent has never disappointed: profit has grown every single quarter since 2005—until this year. In Q2, the company reported its first YoY decline in net profit, and the share price suffered dramatically, even disproportionately. Investor expectations that Tencent would enjoy double-digit revenue and profit growth far into the future were deeply wounded.

Tencent blames China's fustily paternalistic gaming regulators for a temporary growth slowdown. New game approvals have been suspended, and there is no clear indication as to when the suspension will end. But several other Chinese internet companies have stumbled on pieces of negative news that are disparate on the surface but may be connected at a deeper level—the arrest of JD.com's chairman in the U.S. on allegations of sexual impropriety, Jack Ma's "succession" or retirement plan at Alibaba, a reporting hiccup at Vipshop, concern about investments at Ctrip, worry about competition from Google at Baidu. But is there a commonality behind the disappointing numbers?

All China's big internet companies have benefited from the great monetary expansion since 2009. Are they bound hand and foot, and are we coming to an end of the era of both rapid monetary expansion and hyper growth of the Internet giants?

Rules of the game

The market generally attributed Tencent's woes to China's paternalistic regulator, which not only forced Tencent to withdraw the popular Monster Hunter, September 17, 2018

Chart 1. Chinese Internet Stock Prices vs. the Nasdaq (yellow), 3 months

Source: Yahoo! Finance

World a week after launch for unspecified content issues but also to pull the poker game Texas Everyday Hold'em for violations of China's restrictions on gambling. New game approvals have also been halted, ostensibly over concern that children's eyesight is being affected by playing too many games.

We asked executives of 10 gaming companies in China what they thought the problem was. Nobody took the "myopia" argument seriously. Here's what they said:

"I think the government's goal is mainly to control public opinion," said a Beijing-based gaming executive. He pointed out that the reputation of the central government has suffered from the recent scandal around counterfeit vaccines, from lax enforcement of income tax laws on movie stars, and other scandals. "They probably want to use these measures to cover up previous problems," he said.

A couple of the respondents speculated that, as investment capital becomes more scarce, China's government wants to direct investment into more productive areas of the economy than gaming. "The whole economy is in decline, and there's too much money invested in gaming," said a Beijing-based executive.

Basically no one takes seriously the ostensible reason for slowing gaming approvals: concern about children's eyesight.

The respondents generally thought that approvals would resume soon, probably in early October. But they were also pessimistic about growth in the industry. Smaller companies were laying off staff. "We've already cut half the staff," said one executive. A manager of one of China's largest gaming companies said, "This will have a great impact on the income and profits of many gaming companies."

Several people expected the new regulatory environment to promote industry consolidation. There is a market in game approvals, which currently cost about ¥300,000 for a casual game, a respondent said, and such approvals will simply become more expensive. "In Xi'an, there are a lot of small companies with just a handful of people," said an interviewee. "This kind of company is very unstable . . . and can easily collapse." He said he did not expect much impact of the new regulatory tightening on large companies.

Several thought the tightened regulatory environment has to do with efforts to crack down on gambling. Tencent gets around gambling restrictions by allowing online poker players to play with virtual tokens, but there are ways to swap the tokens for cash.

"It is related to the elimination of gambling," said a Shenzhen-based executive.

The simplest explanation came from a Chengdu-based executive: "To be honest, I don't know what the reason is. . . . Maybe our industry just has too much freedom, so we need some suppression."

More general woes

It is not only gaming companies, however, that have had trouble sustaining positive results. The arrest of JD.com Chairman Richard Liu on suspicion of sexual impropriety was an occasion for soul searching about how much control investors actually have over the company's management. Vipshop's share price fell when investors noticed that the company stopped reporting active user numbers, suggesting it had no good news to report. Alibaba has suffered margin erosion from consolidation of Cainiao, and, soon after, Jack Ma announced that he will retire from active management in order to engage in charitable activities. His announcement came in a year when he has sold more than $1.5 bln in stock. Ctrip is seeing lower growth and continuing high investment. Baidu's sell-off seems more motivated by concerns about Google returning to China.

> Share price erosion is naturally related to depreciation in the RMB. But that is only part of the issue.

Some details in the measurables are concerning. Amid the regulatory issues, Tencent has quietly shifted from net cash to a net debt position, claiming that $7 bln in investments in Q1 brought about the shift. We have consistently observed that many Chinese companies overstate the value of their investments in order to move overstated profit and resultant phantom cash off their balance sheets. Tencent reports massive cash-generation, and yet Tencent always borrows to fund its numerous acquisitions. Here are comments from Chief Strategy Officer

Chart 2. Baidu's Three-Month Share Price

Source: Yahoo! Finance

James Mitchell from the Q2 call:

"We turned to net debt position in 2018 mainly due to increased strategic M&A investments amounting to US$7 billion in the first quarter. We have moderated the pace of M&A activities in the second quarter, reducing to around US$3 billion net payments. We will continue to review and evaluate the needs in monetizing our investments such as Mobike and Ele.me, which we disclosed recently." (Seeking Alpha transcript)

Big Men

China's Internet giants are all under first-generation management, and the public perception of their success is inseparable from their strongman leaders. Conversely, when there are disclosed financial or ethical failures, the charges do not stick to the company as much as to the founder, Chairman, and CEO. We have seen in the overly exuberant outbound investment of large insurance or property developers blame laid on the top leader, not the company. Contrast that to ethical woes of Wells Fargo, Deutsche Bank, Legg Mason, or United Technologies. When LeEco founder Jia Yueting visibly overreached last year, an entire empire crumbled around him, reaching from content streaming to smart phone manufacturing to new energy vehicles. As China's great Daoist classic, the Daodejing, puts it, "great leaders are hardly known by their subjects." There is a widespread belief by investors that China's model entrepreneurs harbor skills and secrets to which they are not only entitled but that are essential to their success.

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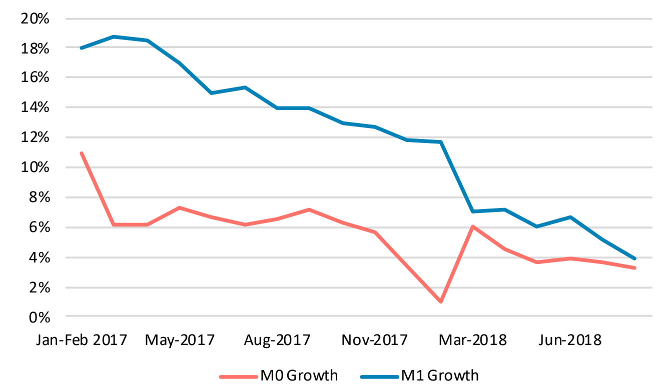
Game rules or the playing field?

Perhaps U.S. investors, so richly rewarded by Chinese internet stocks in 2017, have grown wary and sell shares based on any negative news, and the rule changes at the hands of somewhat opaque shifts in regulator behavior are impactful. But they may be

Chart 3. Money Supply Growth YoY



Source: PBOC

more impactful to investor perceptions than to the actual fundamentals slowing growth. The common ground here is lower money growth.

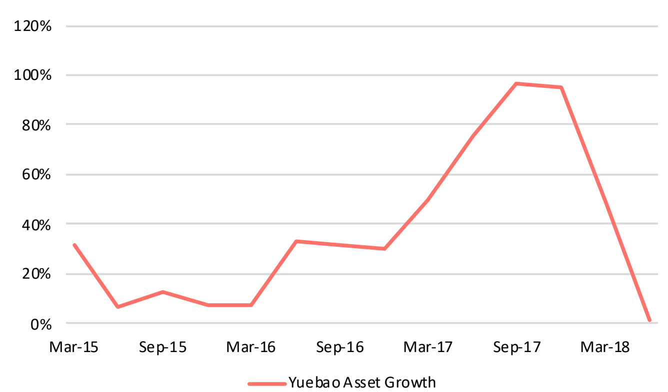
Internet companies are particularly sensitive to the amount of money in circulation, for several reasons. First and foremost, all of the internet companies mentioned above own significant financial-services divisions, and most offer money-market products. They finance their customers and suppliers, offer high-interest loans, sell insurance products, and in many ways profit from the pools of cash they are able to aggregate through these offerings. This is especially true for Alibaba and Tencent, which own China's principal payments tools.

With the monetary expansion and stimulus that was launched in the wake of the global financial crisis, China financial regulators tolerated a vast diversification of financial services, essential to absorbing the liquidity being pumped into the economy. The result of the freedom unleashed was a fast pace of deployment of new and very profitable financial services by the internet giants that far outpaced the ability of regulators to dimension the activity, assess the risks, and effectively regulate it. China is squarely on a path to achieve the highest level of leverage any large economy had even reached.

However robust China's deleveraging activity is or is not, there was no possible way for the established level of stimulus to continue without ruinous outcomes.

The internet companies' finance divisions reflect this slowing. One metric is asset growth for Yuebao, Alibaba's money market offering. Growth has all but stopped since the first quarter of 2018.

Chart 4. Yuebao Asset Growth by Quarter, YoY



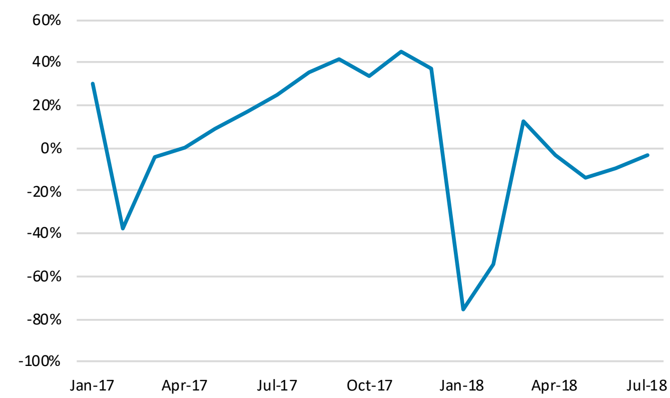
Source: Wind

A secondary way in which money growth affects the internet companies is in the relationship between credit and purchasing behavior. Directly, customers receive credit from the internet companies for their purchases. Indirectly, they simply have more money available when local governments are buying their property, the stock market is trading actively, and infrastructure contracts are flowing liberally. All of this activity is reflected in money growth.

As money growth slows, internet activity is shifting into a lower gear.

Finally, consumer anxiety has risen as a result of a lack of liquidity for speculative real estate investment, failures of many PPP lending entities that

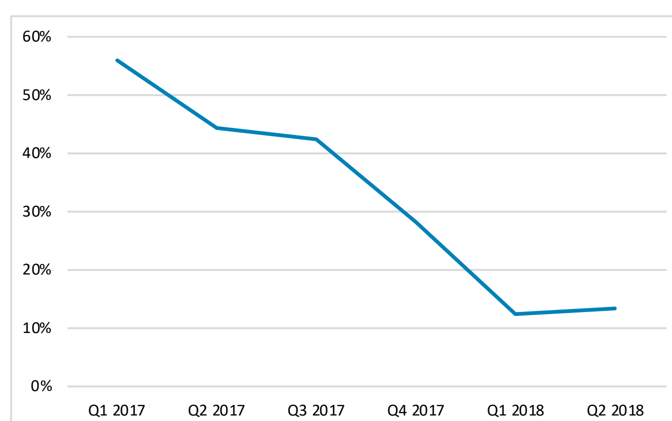
Chart 5. Cumulative Net Increase in Mobile Internet Users



(Dips in January-February are seasonal and relate to the annual New Year's holiday.)
Source: Wind

funded high net worth family income, and similar adjustments under way that are constraining household spending. One month ago, the South China Morning Post wrote, "Chinese households appear to be scaling back their discretionary spending and following a new fashion of minimizing luxury purchases, challenging Beijing's narrative that China's vast domestic market of a billion consumers is ready to open their wallets for better products and services."

Chart 6. Mobile Game Revenue Growth YoY



Source: Wind

Just temporary?

It is worth noting that China's internet companies have realized unprecedented growth in market value since the 2008 global financial crisis. During that same period, China's economy saw massive growth in bank assets but pedestrian growth in consumer staples. Consumption growth has been heavily skewed to luxuries and financial products (housing being a type of financial product in China' economy). These are effects of excess cash pumping into the economy, and pumping in via investment earnings and trading profits, not productivity growth or material wage increases.

China's government now faces the challenge of restraining credit growth without inducing a recession and addressing the high level of income inequality that supports a top-heavy luxury marketplace and makes spending levels fragile. As regulators navigate that difficult passage, money growth (M0-M1) should not be expected to recover past 5%, a far cry from the double digit values of 2016-17.

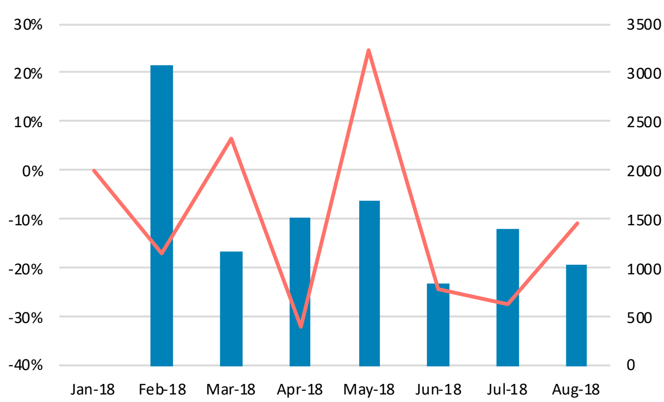
To interpret this as a temporary or cyclical phenomenon, one would have to accept the notion that China can safely return to the high stimulus levels of the last decade. Instead, these trends seem more likely to be pointing toward secular stagnation. This inevitably suggests that the exhilarating days of reliably fast-rising profits from gaming, e-commerce, and online advertising in China are at an end.

Data Matters

Looking for Stimulus

Chinese authorities in the summer promised new stimulus to counteract the trend of declining growth. But the stimulus has really failed to materialize. In July and August, growth in total financing to the real economy continued negative, dropping by 11% YoY in July and 2% YoY in August.

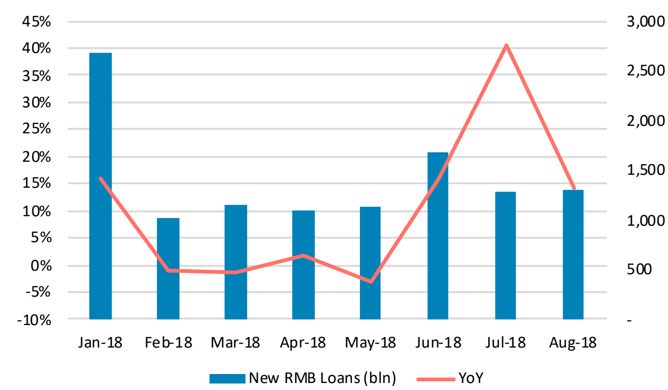
Chart 1. Aggregate Financing to the Real Economy (RMB bln and YoY)



Source: PBOC

The portion of financing that has shown growth is new Renminbi loans, up 41% YoY in July and 14% in August.

Chart 2. New Renminbi Loans (bln RMB and YoY)



Source: PBOC

In other words, banks are taking share from the shadow institutions, as the whole lending establishment becomes more risk-averse.

UPCOMING J CAP EVENTS

September Trips

Finance: What is Happening with the Shadow Banks?

Shanghai, Beijing, Tianjin, Chengdu.

China's government is trying to centralize control over the financial system and direct credit more effectively (and cheaply) through the banks. Will the effort succeed? Are property developers getting loans, and on what terms? What's happening in the money markets? Is there pressure for capital flight? Are assets still inflating? And what about the RMB?

- **Led by Anne Stevenson-Yang, September 24-27**

E-Commerce: Emerging vs Established Players

Shanghai, Hangzhou, Wuhan, Shenzhen.

We will compare established players with new comers like Xiaohongshu, Netease Koala and Miya. Visits to logistics companies, online merchants, and payments companies that can provide insight into growth and margin trends at the listed e-commerce companies.

- **Led by Tim Murray, September 24-27**

October Trips

Infrastructure and Steel: Good and Bad Provinces

Shenyang, Tianjin, Guiyang, Donggaun.

We expected central government tightening of local government spending to slow infrastructure spending in 2018. Now it looks like that tightening is only in "bad" provinces like Tianjin and Liaoning, where we plan to visit Shenyang. "Good" provinces appear to have no break on spending. We will visit Guiyang in Guizhou, which we considered a basket case, and is now being touted as one of the fastest growing provinces due to all the infrastructure that is being built. The central government believes areas like the Pearl River Delta have room for growth. So we will visit struggling Dongguan and the nearby free trade zone of Qianhai to see how these areas are growing. We will visit LGFV, banks, trusts, steel mills and steel traders on this trip.

- **Led by Tim Murray, October 15-18**

Belt and Road Initiative and Macro Economy

Beijing, Urumqi, Horgos, Lanzhou and Shanghai.

Starting in Beijing and finishing in Shanghai we will meet with policy advisors, AMC's, banks, property and construction companies in those locations to get an overview on the macro economy. In between we will go West to see what is happening on the ground with the Belt and Road Intiative (BRI). We will visit Urumqi, capital of Xinjiang Province, to speak with the China Development Bank, visit major logistics infrastructure projects and meet with steel producers to understand the financing and build out of BRI projects. We will then travel to the remote city of Horgos on the boarder of Kazakhstan to see the economic development zone and understand how the BRI is developing trade in the region. On the return to Shanghai will stop in Lanzhou, capital of the poor province of Gansu. Here will take a look at infrastructure projects and meet with bankers and developers to understand how infrastructure is driving growth.

- **Led by Anne Stevenson-Yang, October 29-November 2**

November Trips

Pakistan: the Biggest of the Belt and Road Initiatives

Beijing, Chengdu, Karachi

We will meet with policy banks, government authorities, Chinese companies exporting to Pakistan under the BRI initiative, and Pakistani companies receiving BRI funds to understand how important BRI is to both China and Pakistan.

- **Led by Anne Stevenson-Yang, November 26-30**

December Trips

Payments in India: Paytm, Ebix, Wirecard, Western Union, Moneygram

Mumbai, Delhi, Ahmedabad, Jaipur

We will see companies working to digitize payments in India and understand the economics of the market.

- **Led by Anne Stevenson-Yang, December 3-6**

Please email Brian Emanuelson (brian@jcapitalresearch.com) if you'd like to see a preliminary agenda for any of the listed trips or share with us any trip bespoke ideas you might be thinking about.

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