GOVERNANCE IN CHINA

RISK OR OPPORTUNITY?

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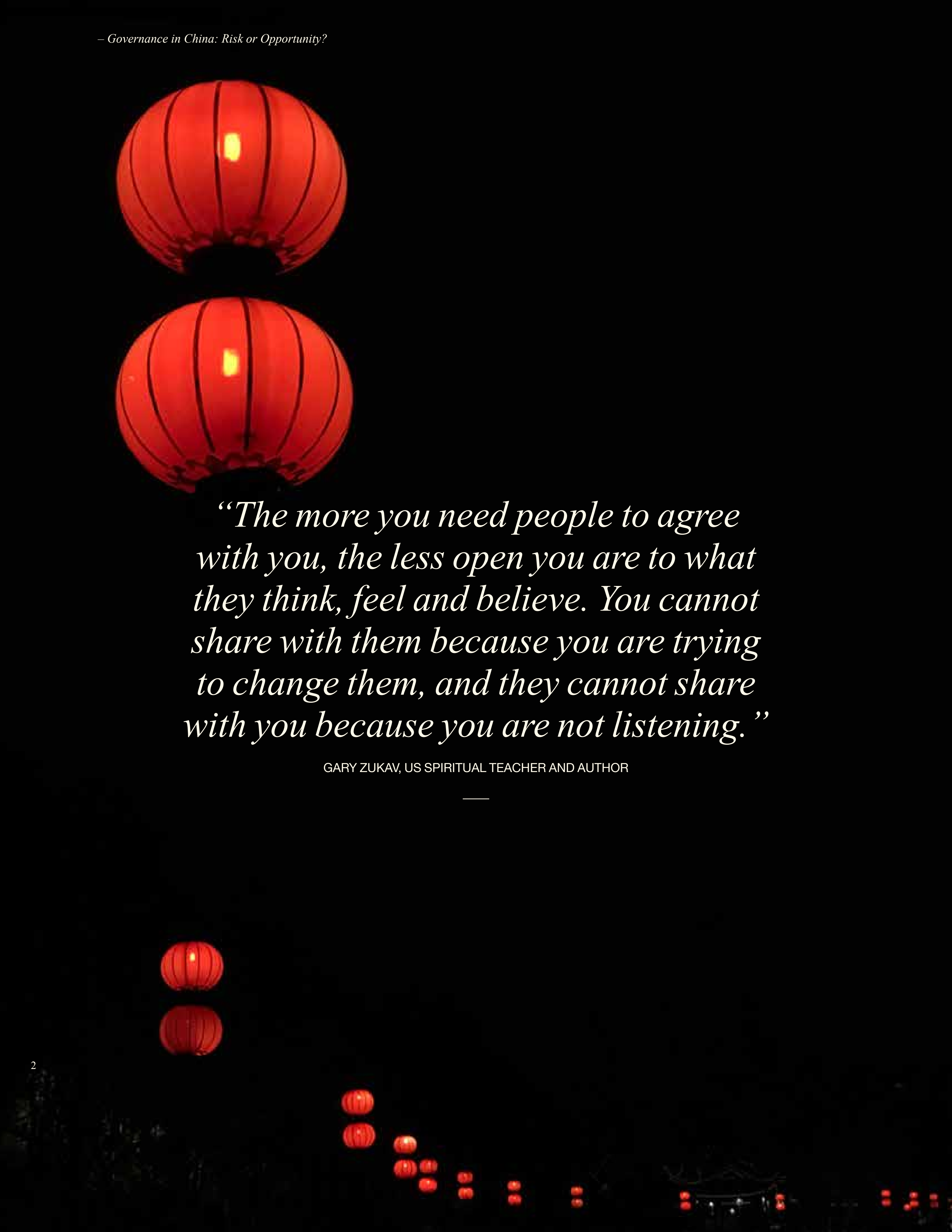
GOVERNANCE IN CHINA: RISK OR OPPORTUNITY?

BY BEN BUCKLER

The excitement of a large, relatively unknown and under-owned Chinese stock market is catching on. Global investors are increasingly comfortable with Chinese companies and the country's A-share market. The last decade has brought many innovative, growing Chinese businesses to international markets. In more recent years, reform of China's domestic markets has further increased the opportunity set, especially since MSCI included onshore stocks in its benchmarks. But while foreign holdings of Chinese A-shares have roughly doubled over the last two years, China's domestic markets still have far less foreign participation than virtually any other emerging market.

Spotting opportunities in China takes familiarity with the markets' idiosyncrasies – and its risks. In assessing these, understanding corporate governance matters.

Being good long-term owners and stewards of companies, on behalf of our clients, requires a deeper understanding of ownership structures, the quality of management and its alignment with shareholders' interests. This is a core component of every research report for every company we analyse in every part of the world. In this respect, China is no different.



"The more you need people to agree with you, the less open you are to what they think, feel and believe. You cannot share with them because you are trying to change them, and they cannot share with you because you are not listening."

GARY ZUKAV, US SPIRITUAL TEACHER AND AUTHOR

GOVERNANCE IN CHINA – TAKE IT FROM THE TOP

China's autocratic politics allow for a long-term vision that few in the Western world could countenance. Most Western timeframes have to do with short-term elections, rapid-fire news bites and quarterly earnings cycles. Democratic countries struggling to work out who will be in power next month or next year, will struggle to rival President Xi Jinping's 'Vision for 2049' for example, an action plan taking them up to the centenary of the People's Republic of China.

Understanding governance in China takes an understanding of this political, social and economic backdrop, and of how the next 30 years may matter far more than the last 30.

China's economy is the foundation of party power. It has leveraged its economic strength by engaging with the world and is now returning to the original ideological vision of the Chinese Communist Party (CCP), one which returns the country to its historical place at the centre of the world.

The Chinese government is now hoping to engineer a fundamental shift in the economy from manufacturing-led growth to innovation-led growth over a very short time-frame. This shift in focus from the speed of growth to the quality of growth should also align with many governance and sustainability principles, especially those around efficiency and environmental protection. Yet heavy-handed government intervention in supposedly free and efficient markets is often viewed suspiciously outside China. Top-down development policies have driven phenomenal growth in recent decades, but this can be a double-edged sword. It is often seen to come at the expense of civil society, the rights of the private sector and of academic freedom.

Policies encouraging innovation can come with generous fiscal and financial rewards, but this often incentivises non-specialist state-owned enterprises to try to compete for funds. Production can take off quickly, but cheap and substandard products can crowd out genuine innovators. A healthy scepticism of official growth rates, apparent competitive advantages and the sustainability of returns is needed.

The outside world may not always agree with the CCP's approach, yet few would doubt its impact on China's economic development, and thus on the wider world. In governance terms, the challenge is dealing with the rapid speed of change. The greatest of those changes may still lie ahead.

MODERN CORPORATE GOVERNANCE

Modern corporate governance in China is closely linked to the rapid evolution of its capital markets. Many Chinese companies are listed on overseas exchanges, predominantly in the US and Hong Kong, where they are subject to a wide range of disclosure requirements, governance and sustainability included.

The A-share market brings added challenges to corporate governance. Domestic stock markets opened in Shanghai and Shenzhen in 1990 and private companies have only been permitted to list from 2000 onwards. In China, as for many emerging markets, the concepts of responsibility and sustainability are often at a much earlier stage of development than elsewhere. Without strong demand from domestic investors, management teams of A-share companies have had limited incentives to consider governance and sustainability either strategically or operationally.

The Chinese markets have grown fast, resulting in a wide variety of governance practices from companies with lower levels of awareness of environmental, social and governance standards relative to developed market counterparts.

Disclosure, especially around environmental and social issues, is sporadic. Top-down policy makers provide guidance, but we are yet to see a coherent, comprehensive and standardised regulatory framework defining and integrating the three components of ESG (environmental, social and governance).

If, however, we see all differences as risks, we may be blinded to opportunities. In the last five years, China's domestic equity markets have seen a burst of internationalisation, marked by inclusion in MSCI's indices and increased amounts of foreign investment. One of the hurdles to inclusion was governance practices which are improving, if from a low base. The experience of Chinese companies listed outside China is likely to help onshore regulators as they plan the next steps for Chinese governance. Greater regulatory guidance from policy makers will provide more transparency and ability to better evaluate the ESG performance at a company and industry level. Greater participation by global investors will further shine a light on governance and sustainability expectations and should continue to drive corporates in a positive direction.

GOVERNANCE CHALLENGES

In China as in every country, good and bad governance practices exist. Understanding a company's operating environment is critical, regardless of what part of the world it operates in. It is far too easy to make misleading generalisations about China. Such assertions often focus on risks at the expense of the opportunities and can be a lazy response to differences in culture, political context and economic development.

Although things are developing fast, foreign investors must acknowledge the lower starting point for A-share companies. In China attention must be paid to other considerations:

— **Language and communication:** many A-share companies only report in mandarin.

— **Corporate Access:** access to companies can be difficult. Getting to meet the right senior-level person, such as a director or executive, can be even more challenging.

— **Investor relations (IR):** few A-share companies meet Western standards of professional IR.

— **Ticking boxes:** Corporate Governance is often seen just as a compliance exercise.

— **Alignment:** the interests of government owners and minority shareholders can diverge.

— **Lack of understanding:** there can be gaps in awareness of corporate governance and ESG principles.

— **Pledged shares:** a common practice in China where owners use their equity as collateral to secure loans. The shadow-banking crackdown has forced more down this route.

— **Human rights:** China often sees reduced personal freedom as the price of security.

Engaging in management discussions around governance and sustainability is not easy in China, structurally or culturally. Few investors hold shares long enough to vote them, and apathy is added by the perception that voting against the government is pointless or disloyal. The emergence of investor relations functions, reporting in English and the growth of foreign investment banks have all resulted from the growing internationalisation of the Chinese market. Yet for domestic managers, the Chinese idiom that 'the bird that pops its head up gets shot' remains a bar to difficult conversations with companies, including ones around governance and sustainability.

The phrase 枪打出头鸟 *[qiāng dǎ chū tóu niǎo] means 'the bird that pops its head up gets shot' in Mandarin.*

BLURRED LINES: STATE-OWNED VS PRIVATELY-OWNED COMPANIES

"China is a 12 trillion dollar authoritarian super-architect with global geopolitical objectives."

CHINA'S VISION OF VICTORY, JONATHAN WARD, 2019

In China every individual and every entity is ultimately beholden to the Party and to the State. The relationship between government and society is obviously very different from that of Western societies. Understanding corporate governance in China requires a deeper understanding of state influence at a corporate level. This is true of both publicly and privately-owned companies. Loyalty is a cost of doing business. In return, the Party acknowledges that the 'great rejuvenation' requires entrepreneurs and private businesses. The case study of Alibaba, in the appendix, is an interesting example in this context.

The relationship between the government and corporations is particularly evident in the A-share market, where listing rules require that all companies set up internal Communist Party organisations and that large firms have a CCP-appointed board member.

Unlike most countries, state-owned enterprises (SOEs) dominate the market. SOEs, under the strict definition of a majority central or local state owner, make up approximately 40 per cent of the A share market cap. Many also have overseas listings. These tend to be concentrated in capital intensive industries (energy, telecoms, transport, finance).

A by-product of this structure in China is that the A-share market has low correlations to global equities. The State is a long-term owner that won't trade its stake based on increased volatility or a market sell-off.

However, there are particular governance challenges associated with these companies. Broadly speaking:

- SOEs may often be directed to invest in support of national goals.
- State assets, alongside their managers, are regularly reshuffled.
- Management typically comprises senior party officials, not business people. Incentives are different.
- Parent and subsidiary relationships can add complexity.

But by focusing too much on the role of the state, we risk missing the opportunity. Outsiders who can't see beyond one-party authoritarian rule can miss out by failing to appreciate how dynamic, innovative and capable some companies in this market are. In some instances, this may also be true of SOEs with superior access to labour, land and capital.

Perhaps more than for many other countries, the balance between government power, the business community and society must be viewed in shades of grey rather than black and white. It is not always easy drawing a clear line between private-sector companies and state-controlled ones.

Private companies can also be leaned on to support national goals and large state projects. Figuring out which investments are coerced, and which are solid opportunities is not easy. But while it may pay to be cynical at times, the West is often in danger of mischaracterising what it sees, by interpreting it in its own terms.

For example, early 2019 saw scare stories emerge that Beijing was attacking private enterprises. This was seemingly based on a misinterpretation of prudent steps by financial regulators to curtail systemic risk. The moves were widely mischaracterised in the Western media as a ploy to increase state control over private firms. In fact, viewed over the longer term, a crackdown on shadow banking, growing levels of regulation and Xi Jinping's outspoken support should be seen as good for the economy and beneficial to leading companies.

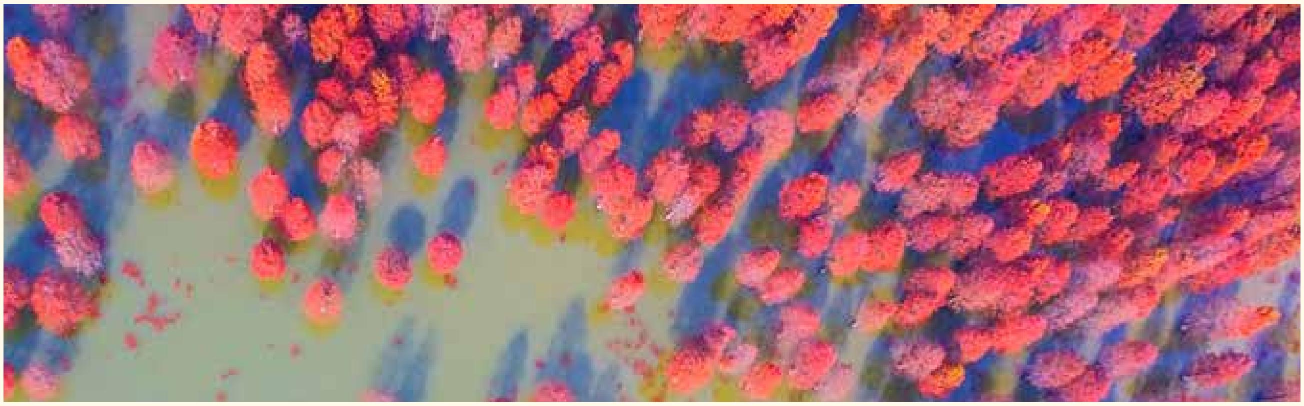
These challenges provide an interesting window through which to appraise a passive approach to investing in China. It makes the approach we take when assessing all companies' governance structures even more relevant. It is vital to consider governance structures on a company-by-company basis.

OUR APPROACH

At Baillie Gifford, we are looking to provide patient capital to companies to whom thinking about corporate governance is not merely a compliance requirement, but a tool for enhancing long-term performance. Our partnership structure is a big advantage here.

We are often told by investee companies that our approach is very different. We aren’t looking for next quarter’s numbers or news-flow catalysts of share price movement in coming weeks. We ask questions about management alignment; about incentives, about long-term strategic vision, about competitive positioning and its sustainability over years not months.

In China, not only can this seem unusual to corporates, but in many instances it has proven helpful in building relationships with management teams who value the input of an unusually engaged, long-term supportive investor. This has helped us lead governance discussions, and in the cases of Alibaba and Ping An Insurance, has led to our being asked for input into their sustainability reports.



There are nuances in how our investment teams analyse companies' governance structures and the potential growth opportunities. However, all of them think deeply about governance and management quality.

- The opening of a research office in Shanghai will further deepen our analysis and understanding of China and of A-share companies, both as potential holdings but also as competitors, suppliers and customers to businesses held on behalf of our clients elsewhere. The speed of change and the scale of the potential opportunities will lead to disruption that will cause winners and losers.
- At a company level, reporting requirements and regulations are largely similar to other markets. Overseas listed Chinese companies conform to the standards of their listing market. For A-share companies, there is very little difference between Chinese and international accounting standards. The main challenge in the domestic market comes from communication. Reports are typically in Mandarin, there is limited corporate access, most companies don't hold results briefings and consensus numbers are unreliable. In recent years however, the impact of foreign investors on governance and disclosure has grown and we should expect this to continue as the market institutionalises over time. We have three advantages in this area:
  - A growing number of Mandarin speakers within Baillie Gifford.
  - Meeting opportunities with management – a broader set of relationships facilitated by our presence in Shanghai.
  - Third party analysis - we have a 10-year relationship with an independent consultant for on-the-ground forensic research and due diligence.
- Our independent research partner provides reports on Chinese companies':
  - Ownership structure
  - Management quality
  - Competitiveness and market position
  - Red flags - areas for deeper research and consideration
- We apply exactly the same fundamental framework in our research to China as to other countries. This is augmented by an additional due diligence checklist where required.
- Proxy voting
  - Although the impact of voting at a company's AGM will be distinctly limited with the high percentage of retail shareholders, high turnover, and State interest, we vote all shares where we have voting rights. This could be deemed wasted energy or effort at present, but it should stand us in good stead as we look to build relationships with management teams in the years ahead.

BY FOCUSING TOO MUCH ON THE ROLE OF THE STATE, WE RISK MISSING THE OPPORTUNITY.

CONCLUSION

Baillie Gifford's approach is designed to ensure we know the risks while being able to take advantage of the opportunities. Rigorous fundamental analysis allows an understanding of the social, political and economic environment for each investment.

There are over 5,000 Chinese companies listed on exchanges around the world. Fundamental analysis and an active approach to stock picking is critical. Our job is to focus on quality and long-term growth. Doing so requires a deep understanding of governance and sustainability. A focus on good governance is a tool to mitigate the risk of getting Chinese companies wrong. Importantly however, it also helps us discover where the best opportunities lie, and to single out the companies whose governance practices are best aligned to our relentless goal of long-term returns.

ALIBABA CASE STUDY

We have often found that founder-run companies operate in a way that is aligned to the interests of long-term investors. In contrast to popular conspiracy theories around the departure of Jack Ma at Alibaba, we see the transition of power to the next generation of stewards as an inspirational example of long-term company management. This all revolves around the Alibaba Partnership which formalised the collective decision making and reduced key person risk.

Private companies often require a symbiotic relationship with the state. Although Alibaba is a private company set up without Beijing's support, it quickly became the national ecommerce champion and then much more. The government helped Alibaba protect its business by hindering eBay and Amazon's development until Alibaba was strong enough to stand on its own. The deal between the government and Alibaba has always been clear. The government acknowledges that state-run companies cannot undertake the types of internet businesses run by Alibaba and social media and gaming giant Tencent. Alibaba is seen as a partner and a key asset to help the government in its desire to shift the economy from being manufacturing and export-based to being consumer and service-based. The government cannot plausibly build similar SOE internet firms. It needs private internet companies, who are allowed to exist as long as they play ball. They self-censor their content, do not challenge the government and comply with official requests.

Now that Alibaba has become so big and powerful, it undertakes some of the functions of a state enterprise. It shares its users' data with the government. According to some sources, Alibaba has designed an app that is required for use by all the party's 90 million members, providing updates on Xi's daily activities, copies of his speeches and assigns credit points to users who log in daily. The Party knows in real time whether members are using the app or not. Alibaba is seen as a solution provider for the government, on hand when the Party needs to push a message to the masses.

Perhaps the area that Alibaba is most likely to cross swords with the government is in its financial arm, Ant Financial. This offshoot has stepped into an old-economy business – lending – previously dominated by SOEs, although it is helping to modernise the old world. To date, Alibaba has responded quickly to written regulations and unwritten policy prescriptions. The government has no reason to view Alibaba as a threat.

Jack Ma.

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