

Recent antitrust regulations may ultimately strengthen leading Chinese innovators

July 2021

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Justin Leverenz
Chief Investment Officer
Developing Markets Equities



Bhavtosh Vajpayee
Director of Equity Research
Developing Markets Equities



Linda Sun-Mattison
Senior Research Analyst
Developing Markets Equities

Chinese tech: Why regulation could fuel innovation

After surging in 2020, the Chinese internet technology industry has wobbled considerably over the past few months alongside regulatory anxieties. While there remains granular uncertainty about many things in China, my team has strong conviction that recent antitrust regulatory interventions and guidelines will ultimately strengthen leading Chinese innovators by encouraging more rational competitive behaviour.

We also believe that much of the regulatory agenda is being driven by prudent concerns around abusive monopolistic behaviour and reckless competitive engagement. Most importantly, this intervention is set to create clear regulatory guidelines for fintech disrupters to avoid moral hazard and potential systemic financial instability.

China has emerged as arguably the most innovative geography in the world in terms of fintech, e-commerce, and digital entertainment. Much of this is a result of innovation from broad-based, diffused and fair competition. We think US regulators, who are beginning to grapple with similar questions of monopolistic malfeasance, could learn a few things from the evolution of internet regulation in this very vibrant digital economy.

So, what's going on in China internet?

After a sustained bull run in January, emerging market (EM) equities have been hit hard over the past two months by two factors. First, a rebound in the US dollar, which was broadly unexpected. And secondarily a major pullback in China tech stocks, much of which has been driven by growing concerns about regulatory developments in the space.

It is important to emphasize how significant China tech shares have become across the EM universe. Although we have been invested in these companies for more than 15 years, it is only in the past five years that inclusion of China ADRs in the benchmark and the extraordinary industry growth have made these stocks stand out as core investments for nearly all EM equity mandates. Today, the top six China internet companies — Tencent, Alibaba, Meituan, JD, Baidu and Pinduoduo, now account for over 16% of the benchmark MSCI Emerging Markets Index.¹

Although there have been past regulatory interventions in China across sectors, investors began to fret late last year with the postponement of Ant Financial's initial public offering and broader antitrust regulatory fears that this action spawned. Decisive action on Ant, a historically unprecedented fine (and reprimand) imposed on Alibaba, and broader language around inappropriate competitive behaviour have stirred trepidation among investors over the past few months. Simultaneously, this year's USD long-term rate increases and expectations for global reflation have started to impact long duration assets, including tech growth stocks globally.

Around much of the world, social and political consensus has grown that internet platforms have enjoyed a consequence-free environment for far too long, but the nuance, speed and intent of regulatory response varies across regions. This rising chorus for reform should not be news to historians of the monopoly debate over the last century. Every few decades or so, leading businesses of their time have had to agree on a new compact within their temporal social and political context. This time is no different, even if it will be the most consequential regulatory change of the current era, in our view.

The questions that face regulators today comprise the re-definition of certain fundamental boundaries:

- When does an internet ecosystem step over the line from being a catalyst for innovation and empowerment to a tool of extraction and exploitation?
- When does the ownership of risk and reward become unfair between the parties to an internet arrangement?
- When do inventors become rent-seekers? And when do disruptors become the new establishment?
- When does the ownership of data morph into the invasion of privacy?
- When does the self-anointed guardianship of social communication disturb social cohesion and threaten peace?

For answers, look to the East

We believe that regulatory intrusions in China reflect appropriate concerns with potential monopolistic abuse and unique risks to financial stability from digital credit origination from fintech distribution giants like Ant.

In our view, these antitrust regulatory actions will ultimately strengthen both leading Chinese tech innovators (market shares and profitability) and their ecosystems, as they encourage entrepreneurial innovation. And we would expect such prudential regulation to embellish economic development in this period of Chinese economic renaissance. By no means, in our view, do these regulatory interventions mean that China wants to neglect innovation or impose greater state control (or even ownership of) the country's technology giants.

We think China has three advantages to lead the way in regulatory reform around the future of internet.

- Firstly, China has scale, and through scale, a depth and diversity of experience in internet business models. China's top six internet companies enjoy a collective market capitalization of over US\$2 trillion, according to Bloomberg, even as a further spate of listings lies ahead (such as ByteDance and Didi).
- Next, Chinese authorities have shown the capacity to move faster than their Western counterparts. Five instances stand out.

In 2014-15, China cracked down on online gambling. In 2015-16, it curbed the ability of search engines (such as Baidu) to exhibit unverified results on sensitive topics such as medical advice. In 2017-18, China restricted the practices of certain online travel platforms (such as Trip.com) to automatically bundle insurance and other offers with ticket bookings, often to the annoyance of consumers. In late 2020, China (rightly) recognized the asymmetry of risk and reward between the originators of credit (such as Ant Financial) and those who bore the risk (traditional banks). Finally, in 2021, China restricted practices of exclusivity that prevented the ability of merchants to operate on multiple platforms at the same time, while slapping a record US\$2.8 billion penalty on Alibaba for such violations. It also frowned on predatory pricing tactics that large platforms can bear and smaller players cannot.

In recent days, fresh regulatory focus has emerged on Meituan and Tencent. In our view, this is an impressive and consistent report card that stands out versus the hesitant steps of Western governments.

- Thirdly, we contend that Chinese internet has always been more diffused and competitive than its Western counterpart. In China, there has never been a dearth of creative challenge to the established leaders.

In e-commerce, for example, the rise of Pinduoduo and the resilience of JD has erased Alibaba's share of each incremental yuan spent online from 77% in 2017 to 52% in 2020, as per company disclosures and our estimates. In social media, Tencent's share of total time spent online in China fell from 50% to 36% in the same period,² thanks to the rise of short video platforms such as Byte Dance and Kuaishou.

This fertility of entrepreneurial energy should ensure that regulation, while re-arranging the cards, will not damage innovation and progress.



We believe much of the regulatory agenda in China is being driven by prudent concerns around abusive monopolistic behaviour and reckless competitive engagement.

What lies ahead?

We see the future through the following lenses.

1.

“Ecosystem” does not mean exploitation

Internet platforms tend to create “walled gardens.” The economic temptation of becoming gatekeepers to consumer traffic, and to exclude rivals, is too great to resist. This must change. For example, mobile app stores in China (as in the West) continue to charge 30% (sometimes as high as 50%) gatekeeper fees³ on all throughput across all applications in their stores. This hurts smaller developers while providing an unfair and transparent view to app store owners on innovative new ideas.

Social networks, such as those owned by Tencent, wall off rivals such as Alibaba, Baidu and ByteDance, while providing an easy channel for group investee companies (such as Pinduoduo and JD) to reap the rewards of the social traffic. Online platforms differentiate between payment methods, preferring Ant Financial’s Alipay or Tencent’s WeChat Pay, or create friction in user interfaces that push consumers toward a particular choice. There have been allegations of exclusionary practices toward restaurants by Meituan in its core business of food delivery. In our view, all these practices are candidates for regulatory reform.

Not all this change need be disruptive or damaging. For example, opening social media to all might make Tencent’s WeChat even stronger than it is today. Meituan has demonstrated that its leadership in food delivery is hardly dependent on alleged exclusionary practices, but much rather on its excellent ground operations. Pinduoduo and JD may lose their exclusive access to Tencent’s social channels, but we believe their advantages in cost effective, “gamified” shopping (as with Pinduoduo) and fulfilment infrastructure (as with JD) will sustain. To that end, we expect regulatory action to sustain what was well-earned while removing that which was appropriated.



2.

Extraction differs from facilitation

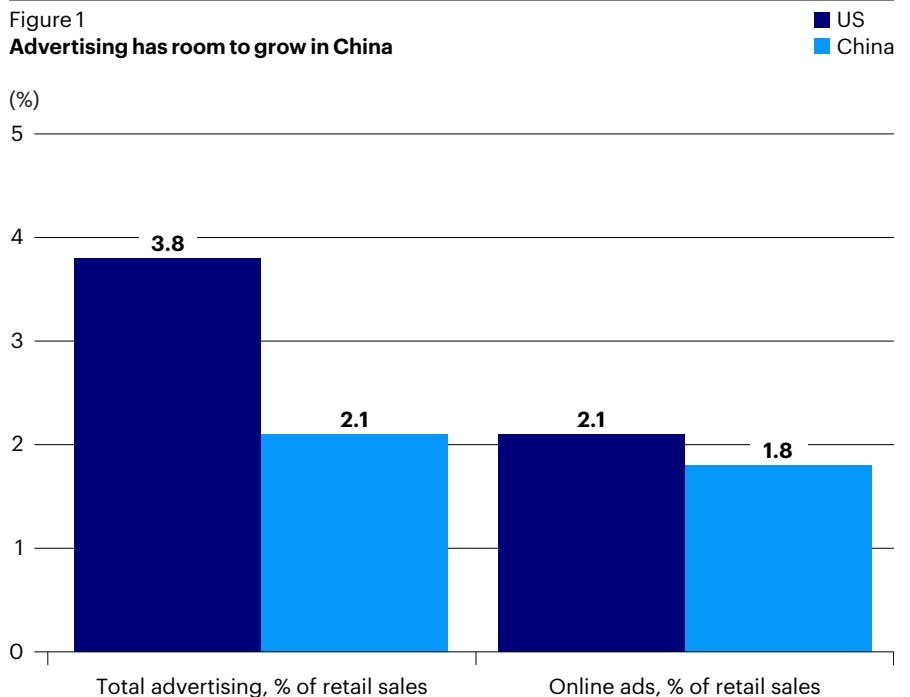
How should internet platforms make money?

Here, we propose a differentiation between extraction and facilitation.

- Extraction is defined by commissions, take rates, operating fees – items of monetization that can be raised on a whim, with little linkage to results. For example, commissions on e-commerce sales, take rates charged to restaurants for food delivery orders, or commissions earned from airlines and hotels for tourist traffic can all be called “extractive.” In our view, it is naive to presume that Meituan’s food delivery commissions will converge from the current high teens to the 25%-30%+ levels seen in Western markets.⁴ Or that an e-commerce platform such as Alibaba’s Tmall can raise its currently disclosed 5% commission arbitrarily. In the future, we would remain sober on our expectations of how much higher these percentages can go.
- Conversely, facilitation should stay unhindered. Every business seeks online expansion via traffic and higher sales. Internet platforms that offer creative ways to facilitate this digitalization will thrive, in our view. We notice that Tencent occupies 36% of all internet time spent in China, but just about 11%-12% of online advertising share.⁵ Meituan is under-monetized on advertising too – under 2% of its food delivery throughput converts to ad dollars,⁶ which is much smaller than global peers. If Alibaba, JD, and Pinduoduo continue to connect sellers to appropriate consumer traffic, there is no reason to expect that advertising-based monetization should not prosper.

We expect those who have nothing new to offer, who are suffering from plateauing consumer engagement and/or weak attribution of ads to actions, will suffer. In this way, regulatory push back to extraction while encouraging facilitation should make internet platforms more creative and consumer friendly. “Earn your keep” ought to be the hand regulations play here.

Indeed, we contend that the advertising industry in China deserves a re-look. While online ad penetration of over 80%⁷ in 2020 is well-flagged as a cause of concern around future industry growth, the fact that China’s overall advertising industry is under-developed does not enjoy the same appreciation. As a share of retail sales, China spent about 2% on advertising in 2020, versus 4% in the US.⁸ When we look at the total revenues of all major internet platforms in China, we notice that less than a quarter of their top-line comes from advertising.⁹ This might imply that the golden era of performance-oriented advertising lies ahead in China. In our view, Tencent and Meituan appear poised to gain, even as Byte Dance, Bilibili and Kuaishou have enormous promise.



Source: Euromonitor and iResearch as of Dec. 31, 2020.

3.

Financial “innovation” cannot come at the cost of systemic stability

For the better part of the last five years, China has focused on the stability of its financial system. It has variously implemented reforms that reduced excessive leverage post the global financial crisis, curbed unsecured consumer lending, pulled back unrestricted peer-to-peer lending, and brought shadow banks to heel. It was only a matter of time before the velocity of unsecured consumer credit originated online by the likes of Ant Financial drew regulatory notice. We believe that this action will prove its merit in the long term.

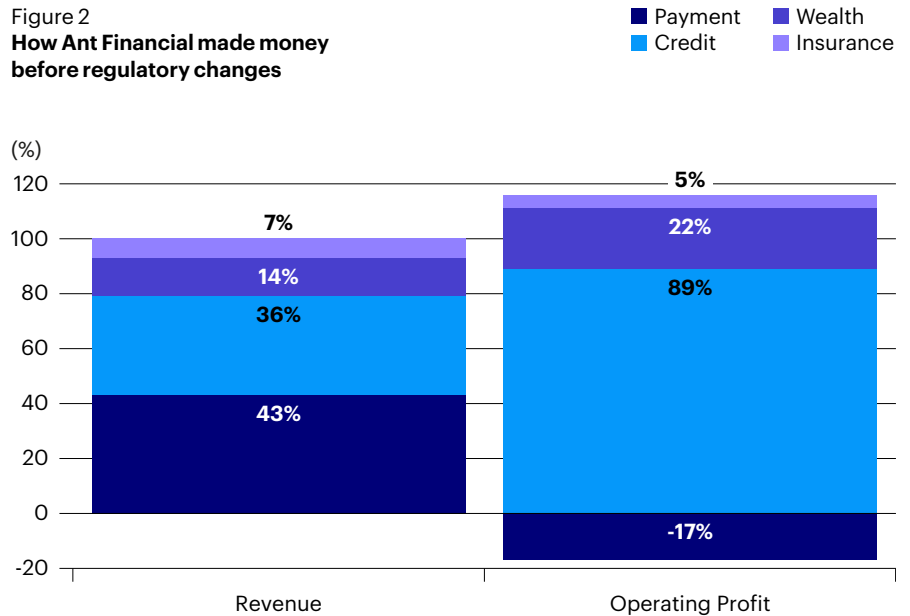
Fintech’s desire to operate in an unregulated zone separated from traditional financial institutions was always a step too far. It ought to be far more beneficial to society when traditional financial institutions also have incentives to digitalize, and when artificial barriers around access to consumer data, traffic, and payment methods (such as multiplicity of non-compatible QR codes) are removed. The move toward a common QR code, data transparency, and the just sharing of risk and reward are all worthy objectives. They remove moral hazard from the system, forcing skin in the game for all players – traditional and online.

And not all of this need be restrictive for fintech players. As traditional institutions gain fair access to online channels, fintech platforms should also be able to expand as digital banks, bearing the same regulatory responsibility as incumbents, while being allowed the freedom to choose their point of scale, market focus and cost structure. To that end, easy money in Chinese fintech is over.

But we also see upsides from fairer pricing of payment transactions, once they stop serving as loss-leading traffic generators for fintech, and predatory pricing practices are curbed. We would expect that to benefit Tencent’s WeChat Pay, which leads in offline payments, but also Alipay as well. The growth of online channels in wealth management and insurance can continue. And credit could grow too – only with more balance sheet involvement and risk sharing on the part of online platforms that generate this credit demand.

Figure 2

How Ant Financial made money before regulatory changes



Source: Company disclosures and Invesco estimates

4.

Data belongs to no one, and everyone

This last bastion of data ownership might prove the thorniest. Data ownership has been framed as a battle for consumer privacy in the West. In China, it will be hard to divorce the debate from the watchful eyes of the Big State.

As a result, we expect this reform to come slower. Early wins might centre around combining online data with offline – building a credit file on consumers of far-reaching granularity and accuracy – and making this framework available to all innovators (as has been attempted in the UK with financial data). Merchants might gain from the removal of arbitrary traffic re-direction practices that sometimes bypass underlying data algorithms and allow platforms to favour one over the other.

The consolidation of data and its availability to new platforms should spur innovation – China has no dearth of talented entrepreneurs willing to try new experiments.

Investing in the evolving regulatory – and competitive – environment

We have been investors in the China internet space for more than a decade and a half, and long-term investors in a clutch of wonderful business. The competitive landscape – and scale of these businesses – has changed dramatically over this period. As we survey the fast transforming landscape of Chinese internet, our focus as investors will need to consistently evolve as we explore real options.

Within the context of Invesco Developing Markets Equity Strategy, Tencent comes out as a most unusual monopolist. In the past, there has been debate around Tencent’s federalist orientation to business, with several minority investments but little active involvement or centralized control of investee companies.

Tencent has never had a membership program to tie its empire together, and it has been distributing traffic via its social platforms with arguably very restricted monetization. It appears that what seemed like missed opportunities or unreasonable hesitancy might have been prescient planning.

Elsewhere, the e-commerce landscape is fast democratizing, and a potentially bruising battle looms between the still-dominant Alibaba and viable challengers Pinduoduo and JD. But this space is seeing more – short video platforms such as Douyin and Kuaishou are aspirants too. And Meituan, and perhaps Didi – both hyper-local businesses – stand a chance of converting newly built grocery channels into distribution pipes for many other categories that sell online. We are wary observers of what we think might be a period of disruptive and unpredictable churn in China’s ecommerce space.

Finally, we believe that heightened regulation in China may counter intuitively function to moderate unsustainable competition and accompanying losses. Policymakers have been reasonably straightforward about their disdain for Silicon Valley-like efforts to wipe out competition through uber-aggressive losses, which leads to either the winners being simply the best-funded players or stressed consolidation leading to monopolies.

More rational competition, coupled with likely greater scrutiny of acquisitions by the leading internet conglomerates, may serve to improve sector profitability. It would not be unrealistic to see some of the marginal businesses of the big players – with associated big losses – being unwound over time.

¹ As of March 31, 2021. The recent IPO of Kuaishou, and impending IPOs from ByteDance, Didi and others, point to further expansion of China internet’s weight in the benchmark index. Portfolio weights in Invesco Developing Markets Fund as of March 31, 2020: Tencent Holdings 6.4%, Alibaba 3.1%, Meituan 1.4%, Pinduoduo 0.9%, Kuaishou 0.9%, Didi 0.6%.

² Source: Questmobile data.

³ Source: Invesco (from our discussions with industry players).

⁴ Take rates can range from 25%-30% (as for GrubHub) to even 40% (in select cities, for Uber Eats), based on company disclosures and media reports.

⁵ Source: Questmobile, iResearch, Disclosed revenues of companies.

⁶ Source: Company disclosures.

⁷ Source: Euromonitor, iResearch.

⁸ Source: Bernstein Research.

⁹ Source: Data collected by Goldman Sachs.

Risk warnings

The value of investments and any income will fluctuate (this may partly be the result of exchange-rate fluctuations) and investors may not get back the full amount invested.

As a large portion of the strategy is invested in less developed countries, you should be prepared to accept significantly large fluctuations in the value of the fund.

The strategy may invest in certain securities listed in China which can involve significant regulatory constraints that may affect the liquidity and/or the investment performance of the strategy.

The strategy invests in a limited number of holdings and is less diversified. This may result in large fluctuations in the value of the strategy.

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