Regulatory Risk – What's Past Is Prologue

After a record setting fine for Alibaba, there is still regulatory risk ahead for Chinese internet companies, but that risk should be less severe. With emboldened regulators quicker to signal displeasure, and managements more inclined to react at the first signs of trouble, future problems will not be allowed to fester and grow to the point where radical action is required.

Previously, we noted that the past decade has been a revolving door of government crackdowns for Chinese internet companies, affecting social media, search, P2P finance, education, gaming, online entertainment and now eCommerce and payments/lending. (See *Antitrust with CCP Characteristics*) Alibaba and Ant are just the latest companies to kowtow and grovel so that they may live to fight another day, and they will not be the last; but the threats will likely be more at the margins than existential.

On the whole, the top down "rectification" of structural problems in China's internet industry may be nearly complete. No major sector has gone unscathed and management across the industry has a better feel for what is expected, and should therefore be better equipped to steer clear of the biggest problems. This suggests future regulatory action may be more modest, targeting course correction rather than wholesale change.

While regulation is generally a drag, companies sometimes come out ahead due to the vagaries of unintended consequences. Rules become so onerous that only the largest incumbents have the scale needed to shoulder the burden. In recent memory, the weight of the regulatory burden has helped incumbents consolidate their leadership in education (New Oriental and TAL) and in gaming (NetEase and Tencent). In other cases, such as eCommerce, the crackdown on the market leader creates opportunities for the competition.

With an eye on future threats and opportunities, we look at three main areas of risk for regulatory intervention: antitrust, reform and content.

Antitrust risk

eCommerce: Now that fealty has been sworn, Alibaba can get on with business. It is still one of the *best advertising platforms* for merchants, and owns a highly competitive cloud business. Even under the watchful eye of the regulator, there is plenty to like.

As for JD and VIPS, they may get a wrist slap in future, possibly including fines but with little to no lasting impact on their existing businesses. However, like Alibaba, they will find the regulator is more alert to any potential abuses when they enter new areas.

This is already evident in the latest community group buying craze. In March, the regulator fined several large companies, including Alibaba and Pinduoduo (PDD), for subsidies that led to "deceptive pricing." PDD may also face future risk from its discount-driven model, which has caused some merchants to complain.

Groceries/Community group buy: Once ripe for domination by a couple of players, it is now likely that several companies will coexist, including the usual suspects – Alibaba, JD, and Pinduoduo (see *Survey: China's Online Grocery Market*). Larger companies are no longer able to use heavy subsidies to win market share, which allows smaller rivals, including Miss Fresh and Xingsheng Youxuan, a better opportunity to compete.

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Local services: A duopoly of Meituan and Alibaba. Meituan is the abuser in this relationship – one of the few where Alibaba is an underdog. Meituan is clearly in the discomfort zone, with about 65% market share in food delivery (and higher in smaller, faster growing cities).

There have been numerous complaints about Meituan bullying merchants, in part through its version of "choose one of two." (See *Interviews with Local Merchants*; and *Meals on Wheels*.) This practice is already taboo, as are heavy subsidies, but we expect the government will further pressure Meituan to lower commission rates for food delivery and local services.

Travel: A duopoly of Ctrip and Meituan. Ctrip is safe for now, but only because travel has been ravaged by COVID. Once it recovers, the government will be ever watchful of past practices like *bundling* and efforts to lock in hotels with exclusivity deals (see *More Bundling Headwinds* and *Hotel Wars*).

For its part, Meituan has been an enabler for many low-cost hotels, helping them reach wider audiences at relatively cheap commissions. But it is no longer an underdog in travel and attempts to raise commissions may get more scrutiny than in the past.

Ride hailing: A clear monopoly, with Didi taking more than 80% share. There are lots of small rivals to market leader Didi, but few serious challengers. Hard to see how this changes unless the government wants to break up the company, which seems unlikely unless Didi makes a serious gaffe.

Moreover, Didi is a company capable of potential breakthroughs in homegrown autonomous driving technology, something the government wants to encourage. That takes money, which comes from size.

Search: Baidu was tamed in 2016, after medical ads linked to it were deemed culpable in a person's death. It has since been saddled with restrictions that dictate the volume and nature of its advertising. Though it still controls ~80% of the search market, Baidu is steadily losing share in the overall ad market so future antitrust risk is low (see *China Ad Spending Forecast* and *BIDU: Buyer Beware*).

Reform risk

Payments: The impact of regulatory action is increasingly clear for Ant (see *How Ant Group Became Ant Bank*), but Tencent has yet to say how its payment/credit unit will make the transition to a financial holding company.

Tencent was less aggressive in ramping up its financial products, but the sector was a key future driver so it is hard to sugar coat the ongoing uncertainty for Tencent. The good news is this is a known unknown and should already be reflected in the stock price (see *Consumer Finance Survey, Pt. 1*).

After-school tutoring: The government wants to reduce extreme stress on students by reducing their workloads; parents feel compelled to pile on extra tutoring so their children can eventually ace the dreaded *gaokao*.

We expect to see more reform initiatives as the government struggles to strike the right balance, but as long as the *gaokao* system is in place, there will be strong and steady demand for tutoring companies like New Oriental, TAL and Youdao.

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To date, reform-oriented regulation has driven a cycle of short-term share price declines at EDU and TAL, followed by recoveries as the increased regulatory burden favors the larger, listed incumbents at the expense of smaller competitors.

Online health care: Investing in China's online health care sector seems highly attractive. On the surface, there's enough competition, including Ali Health, JD Health, PingAn Good Doctor, and WeDoctor, and these firms can benefit from long-term growth supported by favorable demographics and the efficiencies that technology introduces to the sector.

However, the reality is that health care is a strategically important sector and thus more highly regulated. And while we believe that certain "tipping points" are close at hand, especially in pharma, the history of stymied reform in this sector suggests that early investors will need patience and fortitude to reap rewards.

Content risk

Video: With huge audiences and a minefield of politically sensitive topics, video will always be risky from a regulatory perspective. iQiyi has had much of its production pipeline stymied by an exceedingly cautious and very censorious regulator for much of the past two years, and this has fueled a decline in paying users since yearend 2019.

The company is starting to get its rhythm back, but that censorship risk is always just around the corner and can ramp up very quickly. Viewers reward creativity and pushing the envelope on new content, but it is an invitation to censorship. On the other hand, safer content risks boring the viewer, and the loss of paying users. iQiyi is walking a tightrope, with billions already tied up in sunk content costs (see *iQiyi Chartbook*).

Newcomer Bilibili also faces risk. Anime, comics and gaming are BILI's lifeblood, but this genre is fraught with risks around sex and violence. Japan is also a key supplier of content, which carries political risk. In particular, the regulator is keen to ensure that BILI's young user base keeps its attention on content that is in the "national interest". All of these risks will rise as Bilibili looks to go more mainstream, doubling users to 400m by 2023.

Gaming: In the past, and in the future, gaming faces multiple risks – political risk because of content sourced from South Korea; moral risk because of young people becoming addicted to violent games; and health risks as the government worries about myopia caused by long hours of gaming.

In the future, political risk remains a factor, especially with Tencent since it still sources popular games from partners in South Korea. The industry has addressed the moral and health risks with better monitoring systems, especially for youth.

The longer approval times now needed for games is a benefit to the incumbents, who have the resources to navigate the process.

Live streaming/short video: A popular format used across eCommerce, entertainment, gaming, dating and education. It is a core product of companies like Kuaishou, Douyin, TME, Momo and YY (recently acquired by Baidu). The problem is it often seeks to leverage sexy women to sell products or services. This is a recipe for regulatory risk (see *Kuaishou: Much More Than Just Short Video*).

Social: The only standalone social firm, Weibo, was brought to heel long ago. However, Weibo is still China's leading gossip and opinion platform, and much like video, it will

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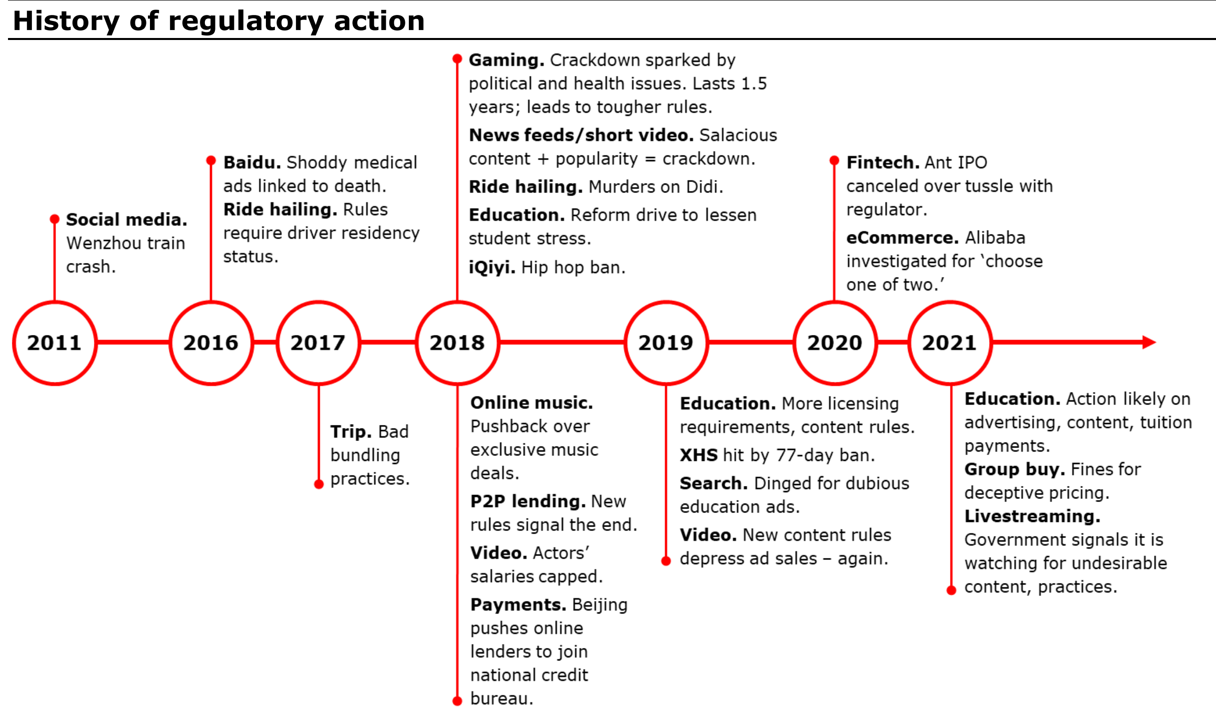
always be closely scrutinized. If any trending topic gets out of hand the regulator will cleanse it. Not much risk here, but also not much reward (see #WorkInProgress).

Figure 1

History of regulatory action



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