Investing in China – caveat emptor?

Understanding Variable Interest Entities

The success that Naspers has enjoyed ever since investing $32-million in Tencent in 2001 – then a relatively small Chinese Internet company – has been the stuff of legend: this single investment has gone up approximately 4 000 times to an overall valuation in excess of $100-billion in less than 20 years, explaining most of the market capitalisation of Naspers (as well as its recent offshoot, Prosus) today.

Some investors may not, however, realise that Naspers doesn't actually own its stake in Tencent directly. Instead, the group enjoys its lucrative exposure to the Chinese business through a structure known as a Variable Interest Entity (VIE). The same is also true for investors in Alibaba, Baidu, Meituan and all other foreign-listed Chinese Internet firms.

In a nutshell, this structure involves setting up two entities: the listed entity as well as the VIE itself. The latter is wholly owned by Chinese citizens, typically the tech firm's founders, and holds the operating licences required to do business in China. Crucially, however, all the VIE's economic benefits are transferred to the listed entity via contractual agreements – effectively sidestepping China's restrictive foreign investment laws (without transferring the "normal" equity or voting rights).

VIEs have questionable legal standing in China and they do not give shareholders the rights typical of direct ownership – as such, they entail a very different level of investment risk. In a column entitled "A legal vulnerability at the heart of China's big Internet firms", *The Economist* magazine described VIEs as "the weakest link" as far back as September 2017, for example.

Most investors take a relatively sanguine view of the situation in the belief that neither Chinese companies nor the country's government will compromise the integrity of VIEs: any serious abuse of the structure will clearly damage China's reputation among international investors.

Rob Vinall, founder of asset manager RV Capital, had this to say about VIEs in a recent newsletter: "The structure is elegant in that it squares the apparent circle of China's insistence on local ownership, Chinese companies' need for capital and foreign expertise, and overseas investors' desire to profit from the growth in Chinese companies' earnings."

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It should, however, be noted that there has been at least one case where VIEs were found to have violated Chinese contract law (just Google the "Alibaba Yahoo spat").

Further, over time it is likely to become increasingly difficult for Beijing to explain to domestic investors why it is that foreigners are deriving most of the economic benefits of China's most dynamic sector; at the very least, investors need to be mindful of this risk.

Notably, VIEs are absent from China's brand-new Foreign Investment Law – legislation indicating that the country is moving to become a more open, rules-based economy. It comes into effect in January 2020 and seeks to level the playing field for foreign investors, while providing certainty on issues such as the protection of intellectual property rights. The devil will be in the detailed implementing rules expected later, but the law is certainly a sign of positive reform.

It would thus appear that investors in Naspers (and/or Prosus) probably don't need to lose too much sleep over their exposure to a somewhat quirky capital structure. It does, however, continue to be a potential risk that one should not lose sight off completely – especially if you happen to have an "index" exposure to the group (or more particularly, an overweight one), given its increasing dominance of the South African equity market over the past few years. ■

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