Assessing Variable Interest Entity Risk in Your China Portfolio

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Didi defied the government and listed in the U.S. Then, the Chinese education minister abruptly put forth regulations limiting all primary and secondary academic tutoring businesses to nonprofits. So, it's no wonder that social media has brought back the spotlight on VIE (variable interest entity) default risk for a typical China portfolio.

Here is my general assessment:

VIE risk is prevalent and concentrated in offshore Chinese Internet companies, but it probably won't rank among the top three risk factors for the current situation: growth, U.S.-China relations and the impact of China's domestic politics on business regulations.

There is no specific market instrument to assess this risk, but it's likely correlated to the return spread of China tech and the rest of China investment. Recently, there has been widening of this spread, but China tech companies were also taking the most blows in business regulations, thus not necessarily indicating higher VIE risk.

Here is why:

1.What is VIE, and what Chinese laws does it help avoid?

VIE is a structure in which an offshore shell entity, usually in the Caymans, is owned by investors in the U.S. or Hong Kong stock exchanges. This offshore entity has a contractual relationship with the mainland company, but because the relationship is contractual, it is not considered owned. This gets around China's laws that forbid foreign capital in areas like telecommunication and Internet news and media. Because foreign investors own the offshore shell company instead of the actual Chinese company, it creates a layer of risk for investors.

VIE was created to skirt the Chinese law "Special Administrative Measures for Foreign Investment Access (Negative List)." (http://www.gov.cn/fuwu/zhuanti/wstzfmqd.htm) There are 33 rules on this negative list, with the most relevant rules 16 and 17, which forbid foreign capital in Internet news services, publishing, Internet radio and Internet TV (except music). That is why the VIE structure is most prevalent among Chinese tech/Internet companies.

With a VIE structure, a company can also list in Hong Kong or the U.S. without asking China's securities regulator for listing approval. If Didi had delayed and listed in Hong Kong as the government desired, even with the VIE structure, the VIE itself would not have drawn the stern government response.

2.VIE has consistently been in the news since it was pioneered by lawyers in 2000 for U.S.-listed Weibo (the Chinese counterpart of Twitter).

VIE was recognized by GAAP accounting standards, and Moody's assessed VIE default risk as low in 2014. In 2017, the Council of Institutional Investors (CII) sternly warned of this risk and called on the SEC to strengthen disclosure guidance. There are close to 100 Chinese companies listed in the U.S. with a VIE structure and many in Hong Kong. Most well-known Chinese Internet companies, such as Tencent, Alibaba, Pinduoduo, Baidu, JD and NetEase, all operate under a VIE structure. It would be interesting to see what extra VIE disclosures they need to show on annual reports, as they already disclose VIE in their filings to the SEC.

SEC guidance on disclosure could help bring more clarity on which companies are VIEs. Indeed, for people who are immersed in Chinese equities, it is well known that large and prominent Internet companies are under a VIE structure. Most U.S.-listed firms have VIE risk disclosure on their 20F annual report filed with the SEC, but this is on a voluntary disclosure basis. Companies that are only listed in Hong Kong, such as Tencent, have less disclosure , but the SEC doesn't have regulatory power over them. It remains to be seen whether clear guidance from the SEC will translate into guidance changes for the HK exchange.

3.The more China A and H shares that don't use VIE and the fewer the offshore China tech companies like Tencent and Alibaba, the less VIE default risk there is in a China portfolio.

WisdomTree's China ex-State-Owned Enterprises Index has about 30% China A and H shares, plus sectors much broader than China tech; thus, its VIE exposure is high but less than many other China funds. However, almost all Chinese and emerging market Indexes own Tencent and Alibaba. The presence of these two companies alone would show across-the-board VIE risk for many EM and China funds. In the fixed income space, as many debts are also issued by the offshore Cayman entity, the VIE risk is similar to equities.

4.For better or worse, with the VIE structure being so prevalent among offshore listed Chinese equity companies, it has achieved "too big to quickly regulate" status with Chinese regulators.

Chinese regulators aim for stability and control, particularly for the next three years, when China's domestic succession politics will take center stage. Twenty years ago, Internet news and social media were still completely new industries, and Chinese regulators were not confident on how to regulate them.

By now, a set of arrangements and rules are in place whereby the government's Cyberspace Administration works with Internet companies closely, and there is less fear of foreign control. You can even argue the flip side: that the VIE structure gave companies like Tencent somewhat of a loyalty card and "not-really-foreign-owned" label to assuage Chinese regulators.

5.What's the likely long-term future of the VIE structure?

The current VIE structure gets around two sets of rules: the foreign ownership rule and the listing approval rule. To make sure situations like Didi do not happen in the future, China's Cyberspace Administration came out with rules that any company with more than one million users needs to go through a Cyberspace review before listing offshore.

This leaves the foreign ownership rule and VIE structure incompatibility. The government could continue leaving this a grey area, as they did for the last 20 years, tacitly acknowledging VIE structure is indeed not foreign ownership, and thus it does not break Chinese foreign ownership laws. Or it could set a hard cap on foreign ownership and require the VIE structure to be dismantled.

It is common that emerging market countries set a hard cap on ownership of some listed companies. There is one case of a Chinese firm called Baofeng Player, which raised capital under a VIE structure in early venture funding but dismantled that structure when it wanted to list on China's domestic exchange. Its main Chinese entity bought out the offshore entity.

With market cap for VIE-structured firms so large, it is less likely that this would be done abruptly by Chinese regulators who prize stability. In particular, after the education debacle, the education minister was quietly relieved of his duty as party secretary, a de facto face-saving demotion that signaled his complete exit will happen soon. Any other minister who is pondering any type of shock-and-awe regulation now knows there is a career risk.

Conclusion

In summary, the imperfect analogy is that VIE default risk is a bit like China's sovereign default risk. It's always there, and it's higher for an emerging market country like China. It could increase further when domestic and international politics come to prominence. It is also almost unavoidable when it comes to investing in China, unless one wants to go 100% China A shares or avoid any China tech companies. VIE is going to be a favorite social media topic for a long time, as it is prominent and stirs up emotions in both U.S. and China, and it is hard to avoid.