M1 CAPITAL
INVESTMENT MANAGEMENT

When China sneezes Naspers catches a cold

Commentary June 2021

The JSE gave up ground in June, especially in USD terms as the market declined and the local currency depreciated. This was most likely simply a retracement from accumulated strong returns through the course of the year. For the year-to-date the South African market has returned 16.4% in USD terms, still more than 2x ahead of Emerging Markets but now much closer to developed market returns of 13-15%.

Elsewhere the global Value index also gave up ground relative to global Growth but remains ahead for the year-to-date. The various equity market returns are set out in Table 1 below.

Table 1. South African and global equity returns for June 2021*

	Jun-21	YTD 2021
FTSE/JSE ALSI (ZAR)	-2.4%	13.2%
FTSE/JSE ALSI (USD)	-6.3%	16.4%
MSCI World	1.5%	13.0%
MSCI EM	0.2%	7.4%
MSCI Value	-1.4%	14.7%
MSCI Growth	4.5%	11.1%
S&P 500	2.3%	15.0%
Nasdaq 100	6.4%	13.3%

*Total return indices, Source: Factset

While this commentary is meant to cover the month of June, it often happens that current events at the time of writing overshadow the prior month's developments. This month is no exception. July's SA violence has been well covered and is likely to have lasting impact on confidence and investment in the country. Yet this story was itself superseded in short order in financial markets by regulatory moves in China which caused a sharp decline in the value of various education-focussed listed companies. The market turmoil has reached Tencent, Naspers's largest asset, which of course has direct implications both for our market and for M1 Capital portfolios.

How significant is the Naspers volatility?

The Naspers price movement over the previous 3 years is presented in Chart 1 below.

Chart 1. Naspers 3 year price movement

Source: Factset

While daily consecutives moves in excess of -7% on 26 and 27 July are large and receive media attention, Chart 1 above suggests the price declines are not abnormal. Notwithstanding the more general Naspers price decline of the last few months, the most recent volatility is (so far) not incomparable to that seen at the end of 2018, May 2019 and March 2020. Indeed, probably the best that can be said is that the Naspers share price is periodically subject to bouts of volatility.

A longer term context is further presented in Chart 2 below. The declines seen this week are once again comparable or less than those seen over the entirety of 2018, and also 2016, 2014 etc.

Chart 2. Naspers share price indexed to 100 since inception

Source: Factset

What are the proximate causes of the volatility?

The volatility began in response to several actions by different Chinese regulatory bodies. Regulators suggested private education providers register as non-profit entities effectively closing down the sector. Prior to this an enquiry was conducted into the data security policies of Didi, a recently US-listed ride-sharing company. Most importantly, Tencent which controls more than 80% of China’s music streaming rights was ordered to end exclusive music licensing deals.

Of most concern to international investors has been the banning of the Variable Interest Entity (“VIE”) structure used by Chinese education companies to list offshore. This has cast doubt on the regulatory treatment of the VIE structures used by foreign-listed Chinese companies in general, including Tencent. Foreign investment in the Chinese internet sector is prohibited therefore a particular company’s owners will set up an offshore entity which will list on a foreign exchange and attract foreign capital. The offshore entity then enters into a series of contracts in order to exercise control over Chinese operating companies. Indeed, a foreign shareholder in a Chinese foreign-listed entity has no direct equity ownership of the underlying operating assets. The structure has nevertheless been widely used for some time.

Are the current developments a risk?

Historically mainland-incorporated firms have had to apply for permission to list in Hong Kong or elsewhere, while VIE-structured firms have not been required to do so. This is intended to change with VIE-structured firms likely to be required to seek permission to list offshore henceforth. Most likely these changes have to do with the wider context of the China-US relationship. They will also likely, in turn, however, lead to eventual clarity on the use of VIEs as well.

International investors' greatest protection in this environment appears to be their provision of capital. Should regulators impact foreign ownership interests this would have significant repercussions for any future access to foreign capital by Chinese entities.

An important signal in this respect was the call Chinese regulators held with global investors such as Blackrock, banks including Goldman Sachs and JP Morgan, and Chinese financial groups this Wednesday night. The call sought to provide calm and reassurance. Tencent's share price has since risen 10.3% and Naspers 12.3%.

What risks does Naspers present for an investor?

Naspers may have been South Africa's best-performing asset over many years however it carries associated risk. There is the underlying operating risk related both to Naspers and its underlying investments, including Tencent. There is the Chinese regulatory risk which has become evident now but in reality has existed ever since Naspers made its initial investment in 2001. Finally, and closer to home, there is the benchmark risk which exists due to Naspers's high weight in the ALSI.

How is Naspers treated in M1 Capital portfolios?

Notwithstanding the risks above, Tencent represents the best listed operating asset available for access in South Africa through Naspers. In addition, at current prices, both Tencent and Naspers represent good valuation opportunities. The M1 Capital Equity Prescient Fund has held Naspers for some time at 75% of benchmark weight, therefore sharing in 75% of gains and losses. This means that when Naspers rises, the Fund underperforms slightly relative to the ALSI due to its underweight position. Alternatively when Naspers declines, this adds to outperformance since, again, the Fund is underweight. The Naspers declines have therefore added to relative outperformance during this week of volatility, albeit less so than a fund which does not hold Naspers at all. Barring a material change in circumstances the M1 Capital Equity Prescient Fund will continue to hold Naspers for the foreseeable future.