MORGAN CREEK
CAPITAL MANAGEMENT

ALTERNATIVE THINKING ABOUT INVESTMENTS

New China Perspectives

Welcome to the weekly issue of Morgan Creek's ***New China Perspectives****. It is comprised of research from Morgan Creek's China-based investment team together with curated articles of interest. In addition to timely political and economic news covering greater China, Morgan Creek's China team seeks to provide in-depth perspectives on investing in the technology, consumer and healthcare sectors in the region. Our research leverages the "on the ground" insights of our team together with Morgan Creek's decades-long experience in covering the region. Our team are focused, thematic investors primarily covering the technology, consumer, and healthcare sectors and investing in private companies and early-stage managers with deep local expertise. To learn more about our team and investment offerings, please email* chinateam@morgancreekcap.com.

Best Regards,

Mark W. Yusko

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CEO & CIO

NOTES FROM THE BUND[1]

In our last newsletter, we continued a five-week discussion on the recent regulatory changes made by China, and the implications for both China's economy and the broader world economy by discussing the specific plan laid out by the Chinese government. We will continue the discussion this week with a focus on the mindset and intentions of the Chinese government for implementing these changes.

"It doesn't matter if it's a black cat or white cat as long as it catches mice"
Deng Xiaoping

Due to chronic overpopulation for most of China's long history, the Chinese people have always tended towards the pragmatic. This results-oriented mindset underlies its leaders' decision-making process.

Economics 101 teaches us that capitalism is the best mechanism for expanding the overall pie for society, but has two drawbacks: it is not good at distributing the pie; and it is does not consider negative externalities to societies. China's leadership has adopted capitalism to drive the country's development, while intervening intermittently to correct for its blind spots. This approach was coined "Socialism with

Chinese characteristics".

True to its pragmatic roots, new policies were applied by trial and error, or as this approach is called in China, "crossing the river by feeling the stones". The most well-known example was the introduction of capitalism itself in 1979 through the use of special economic zones ("SEZ"). Once the experiment was proven, it was then replicated nationwide. China updated this experiment again in 2013 with a new type of specialized SEZ: free trade zones, which has since successfully mushroomed across the country.

This is the bedrock philosophy behind China's policy introductions – plant many seeds (ideas), discontinue the failures, iterate and rapidly replicate the successes. Many successful companies advocate a similar decision-making approach, like Facebook with its "move fast and break things" motto and Amazon with its "Day 1" dictum.

Mistakes will be made. Facebook flopped with Home (2013) and Amazon with its Fire Phone (2014). China's most recent policy misstep occurred in the coal sector which sparked a domestic energy crisis. While these policies were well-intentioned, the Chinese authorities have had to reverse some pieces of previously attempted energy regulations to cut carbon emissions in the near term.

Detractors of this model label it a "black box". This is not inaccurate – the experimental nature of the regulations implies that it is difficult to quantify successful regulations *ex ante*. This is not to say that regulations are random and without basis: as an example, the authorities have developed a practice of releasing draft regulations to solicit feedback from the public prior to passing a new regulation[2]. However, speed is of the essence in this strategy, with the goal to quickly test new hypotheses and begin iterating towards a practical solution.

This is in stark contrast to alternative political systems, that prioritize building broad consensus which foreign investors may be more accustomed to, requiring lengthier, open floor debates of pros and cons of each piece of regulation prior to passing new policies.

This fundamental difference in regulatory goals explains why China's environment may appear to be more volatile and random compared to its peers in other parts of the world.

Investor outlook on the future direction of China is bifurcated into two camps: the bears, represented by George Soros, essentially argue that China is regressing; the bulls, led by Ray Dalio, argue the opposite. At the heart of the debate is whether recent regulatory actions have shown China's authorities to be anti-capitalist and if so, if China has become uninvestable. While certainly a valid concern from foreign investors, we believe that is not the case.

China's economy was never (and likely will not ever) be fully capitalistic given their view of the constraints of capitalism explained in the section above. China's economy comprises a mix of public and private enterprises, with varying levels of state intervention applied depending on how strategic or sensitive the sectors in question are. Central to China's historic economic success has been the authorities' very visible hand in steering its economy via industrial policies and regulations. Given China's robust economic track record, many western economies, including the US, have now begun to adopt similar practices at home as well. Foreign investors have also thrived within this China framework for decades, profiting from and contributing positively to

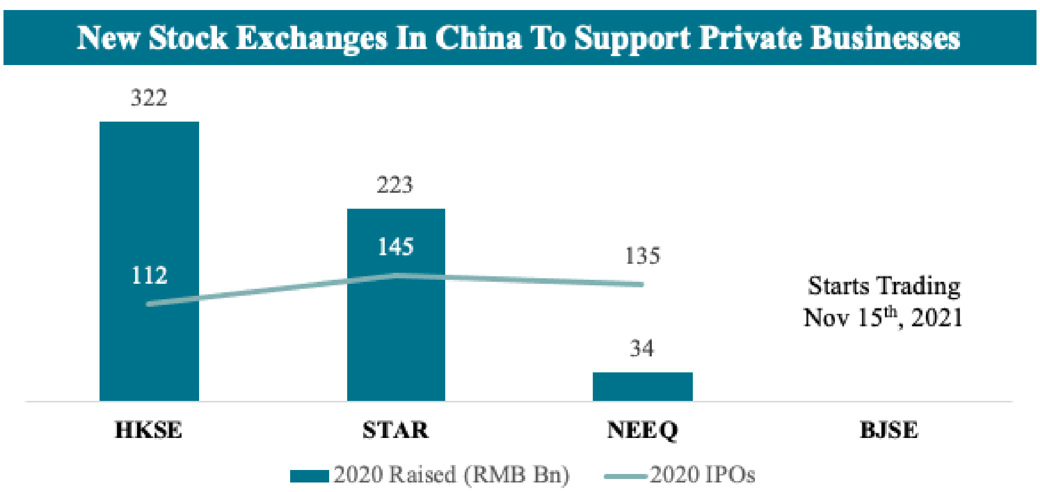
China’s development.

The more important question probably is: why would China (already under such external pressure) choose to reverse course on a model it developed successfully, especially when the model has gained international recognition and is now gradually being emulated across the developed world? The logical answer is that it has not. We will seek to show from recent data points that:

- ***China is not withdrawing from the world.*** In fact, it is accelerating its integration into the global economy, actively seeking participation in a multi-lateral rules-based world order. China signed the RCEP[3], the world’s largest trade deal, in November 2020. It quickly followed up by reaching an agreement with the EU on the CAI[4] in December 2020 and announced its intention to join the CPTPP[5] in September 2021.

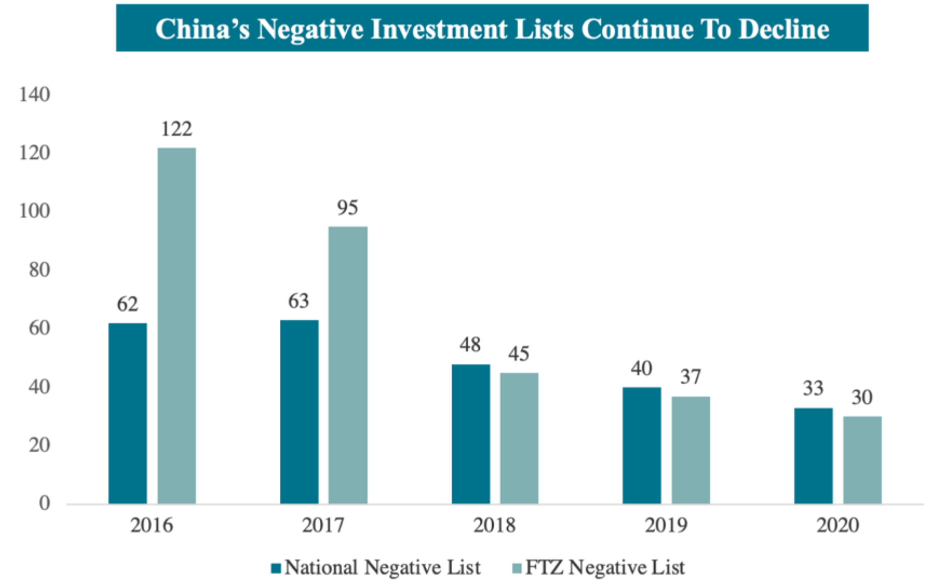
- ***China is not diminishing the role of private enterprise.*** Private businesses play a n important role in China, accounting for 60% of GDP, 80% of urban employment, 44% of total employment. The government periodically proclaims support for private enterprises including tax cuts and stimulus packages for private businesses after the coronavirus pandemic. Critically, the authorities have also opened up new financing channels for private enterprises, including the Biotech chapter on the Hong Kong Stock Exchange, the STAR Board and the recently announced Beijing Stock Exchange.

Figure 1: Capital raised on new bourses[6]



- ***China is not discriminating against foreign investors.*** Besides this discrimination being illegal, which China recently reminded its local governments of, China has been steadily opening up sectors to foreign ownership. The chart below shows the steady decline of China’s prohibited sectors for foreign investment. Following the trend, the authorities promise an even shorter list for 2021.

Figure 2: China’s negative investors list for foreign investors[7]



At the same time, China has also increased foreign ownership percentages in various sectors, for instance allowing Tesla to fully own its Shanghai factory, and recently allowing Morgan Stanley, Goldman Sachs and JP Morgan to fully own their China securities business.

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CHINA NEWS SPOTLIGHT

US-China Fast Track Channel makes it easier for businesspeople and their families to enter China, with caveats: An arrangement to reduce the waiting times for American businesspeople and their families to travel to China has come into effect, according to a major US business group in the country, materializing one of the goals set by the top leaders in November amid geopolitical tensions and Beijing's zero-Covid strategy. *Read more.*

China may delay its much-feared property tax amid price slump in nation's real estate industry: China's property tax could be another casualty of the slump in the housing market, with analysts expecting the government to hold off on expanding trials of the levy because of a real estate-led economic slowdown. *Read more.*

China's NFT market get boosts from the state media and celebrities support: Driven by the overall upward trend market of NFTs globally, NFTs have broke into mainstream in China with a growing number of institutions, venture capitalists and celebrities allocating a percentage of their portfolios to digital assets. *Read more.*

Tencent's WeChat Pay to support digital yuan: Tencent's WeChat Pay started to provide digital yuan as a payment option inside WeChat on January 6, according to a Sina Tech report. *Read more.*

JD.com Introduces Third-party Merchants to Digital RMB System: On Friday, Chinese telecom giant JD.com announced the implementation of third-party access to the digital RMB system on its platform. *Read more.*

Tencent to Acquire Gaming Smartphone Manufacturer Black Shark, Advancing Metaverse Plans: 36Kr was informed on Monday that Tencent plans to acquire Black Shark, a gaming smartphone company. *Read more.*

China's Tianjin tightens control over travel after Omicron cases: The northern Chinese city of Tianjin tightened exit controls and is requiring residents to obtain approval from employers or community authorities before leaving town in an effort to block the spread of the highly transmissible Omicron variant. *Read more.*

As China's Covid-19 test kit orders surge globally, manufacturers are hiring en masse to meet demand: China's manufacturers of Covid-19 testing kits are racing to keep up with surging demand, both domestically and abroad, as the world grapples with a spike in cases caused by the highly infectious Omicron and Delta variants. *Read more.*

Medtronic Announces Approval of the Evolut™ PRO TAVR System in China: Medtronic plc (NYSE:MDT), a global leader in healthcare technology, today announced the National Medical Products Administration (NMPA) has approved the CoreValve™ Evolut™ PRO TAVR system for the treatment of severe aortic stenosis (AS) for symptomatic patients in China who are at high or extreme risk for open heart surgery. *Read more.*

[1] The Bund is a historic waterfront area in central Shanghai, where Morgan Creek's office is located. From the 1860s to the 1930s, it was the rich and powerful center of the foreign establishment in Shanghai, operating as a legally protected treaty port. The picture above is part of the historical waterfront.

[2] Nevertheless, the authorities will still make the final decision on regulations which may or may not incorporate recommendations from the broader public.

[3] The Regional Comprehensive Economic Partnership is a free trade agreement among the Asia-Pacific nations of Australia, Brunei, Cambodia, China, Indonesia, Japan, Laos, Malaysia, Myanmar, New Zealand, the Philippines, Singapore, South Korea, Thailand, and Vietnam.

[4] The EU-China Comprehensive Agreement on Investments is an investment agreement revolving around three main issues: investments, sustainable development, and monitoring and enforcement mechanisms. The agreement requires ratification from the European Parliament before taking effect.

[5] The Comprehensive and Progressive Agreement for Trans-Pacific Partnership is a trade agreement among Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam.

[6] Since inception to H1'21, NEEQ has raised over 529.3B RMB with 11,485 companies; STAR has raised 385.8B RMB with 313 companies and mainland companies in HKSE has raised 7,290.9B HKD with 1,319 companies.

[7] For four years in a row, the two new negative lists have continued to reduce the number of measures limiting access for foreign investment.