

# 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@morgancreekc.com](mailto:chinateam@morgancreekc.com).*

*Best Regards,*

Handwritten signature of Mark W. Yusko

*Mark W. Yusko*  
CEO & CIO

#### **NOTES FROM THE BUND<sup>1</sup>**

The last 12 months undoubtedly have been one of the most challenging periods for China's economy since Deng's reform and opening, with all manner of headwinds blowing simultaneously:

- Externally, the country has to adapt to an increasingly adversarial relationship with the US
- Internally, China has had to contend with periodic Covid-19 lockdowns and a rapidly evolving regulatory climate

Both investors and entrepreneurs found themselves wrong-footed in this environment, with the former selling down their positions in Chinese companies, leading to peak-to-trough declines of close to 70% over 17 months<sup>2</sup> in US ADRs<sup>3</sup>, for example. However, in these difficult times, more important than investor sentiments around a company's stock price is its management's continued motivation to persist and reinvent itself.

Chinese entrepreneurs may yet find themselves catching up in certain departments, say in technical or managerial skillsets (especially when compared to their peers in the developed west), but one area they can compete among the very best globally is with their ability to embrace rapid change and adversity. This is simply a function of living (and growing up) in an overpopulated country

with scarce resources to go around.

The level of competition in China across every facet of life proves challenging. Some figures can illustrate this for a typical young adult:

- 25 million students apply for 4.4 million university<sup>4</sup> places annually
- 16 million new workers compete for 13 million new jobs<sup>5</sup> (2022)

In business, the odds are equally, if not more, daunting:

- Meituan [3690.HK] emerged as the only local consumer services platform (Alibaba [NYSE:BABA] is currently a distant second) out of the competition between group buy companies, which at the peak [featured over 5,000 competitors](#)
- Even in the domain of biotechnology, where technical (and regulatory – in the form of approval for trials) barriers to entry should limit competition, there were over 12 public companies<sup>6</sup> and numerous start-ups engaged in development of PD-1 inhibitors, where in the US, there were only 3 domestic companies<sup>7</sup> competing in this field

In the next two newsletters, we will explore in greater depth two Chinese businesses, one each that has been the explicit target of adverse internal and external pressures – Huawei and New Oriental. Both companies have had to completely overhaul their businesses to survive, and so far, they appear to be on the path towards recovery. More importantly, the story of these two businesses illustrates the resilience of Chinese entrepreneurs in the face of maximum pressure. We start with New Oriental here.

In an effort to [stem the decline in China's fertility rate](#), which is attributed to the high cost of child rearing (of which education is a main contributor), the Chinese authorities announced sweeping reforms to the education sector. The government directed that firms teaching core curriculums like math, science and history, must be non-profit. The authorities imposed further restrictions on fundraising and business hours (i.e. no teaching during weekends and holidays) as well.

New Oriental [NYSE: EDU], once China's largest education company, had built a network of 118 schools and over 1,600 learning centers over almost three decades. In 2020, EDU enrolled almost 11 million students. 75% of the company's revenue was derived from after-school tutoring and was banned after the regulatory reform. New Oriental's stock, publicly traded since 2006, promptly lost more than 90% of its value over a 7-month period from its peak market capitalization of almost \$33.4 billion<sup>8</sup> on February 2021. While the company was well capitalized with over \$2.7 billion in cash and \$3.4 billion in short term investments at the time, the future never looked more uncertain.

By November 2021, it had [shuttered over 1,500 learning centers](#) and furloughed 60,000 of its 105,000 employees as it saw operating income drop over 80%. However, simply closing the business and admitting defeat was never an option for Yu Minhong, New Oriental's founder. Numerous new business initiatives started. Through January 2021, New Oriental started 89 new companies covering a wide range of businesses including in retail and AI.

One such initiative illustrates the amount of change New Oriental had undergone to ensure its survival: a pivot into selling agricultural products through live streaming. Yu kicked off this new project in December 2021, where he sat in a live streaming studio and [sold agricultural produce](#). His inaugural session was viewed by almost 1.9 million people, and generated RMB 4.9 million in sales.

Since then, New Oriental has co-opted its teachers into this livestreaming initiative and it turns out [selling groceries using English lessons](#) have become viral in China. Data from Bytedance's Douyin research platform showed that more than 1.5 million followers tuned in to New Oriental's live

streaming channel over a recent 3-day interval. The livestreaming teachers sold RMB 19 million of goods in that period, which ranks among the top 10 in GMV<sup>9</sup> compared to all live streamers on Douyin.



*Teacher Dong selling steaks and instructing viewers in English*

Accordingly, New Oriental's stock price has almost doubled in value over the past month (albeit from a low base), and Yu announced more resources will be put into expanding this business line to begin selling educational products and supplies as well.

While it is still too early to declare success in New Oriental's live streaming pivot, the fact that the company has uncovered a new business model which cleverly leverages its differentiated resources (its well-known brand, charismatic and bilingual teachers) in less than a year after the crackdown on education speaks to the resilience of China's entrepreneurs.

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## ***CHINA NEWS SPOTLIGHT***

**China Traders Pile Into Carry Trades While Easy Money Lasts:** Easy liquidity conditions in China are fueling a lucrative carry trade in bonds, with traders betting the gains will be sustained despite signs the central bank is moving toward normalizing monetary policy. China's overnight borrowing rate in the interbank market dropped to 1.17% this week, the lowest since January 2021, widening the spread with the benchmark five-year note to the most in over a year. [Read More.](#)

**China Able to Maintain Stable CPI in Stark Contrast to West - Official:** While major economies such as the US and the EU are grappling with record high inflation, China will see its consumer price index (CPI) remain in a reasonable range, and is capable of attaining its 3-percent

annual target despite the fallout of COVID-19 resurgences and the Russia-Ukraine conflict, a senior Chinese official said on Thursday. Due to soaring international energy and grain prices since the beginning of this year, the US and the EU saw their domestic inflation rates stay above 8 percent in recent months, with the US' CPI rising to a fresh 40-year record of 9.1 percent in June. [Read More.](#)

### **China Central Bank Keeps Medium-term Policy Rate Unchanged for a Sixth Month:**

China's central bank stood pat on its medium-term policy rate for a sixth straight month on Friday, as expected, with investors believing that the bank intends to gradually normalize monetary policy after the easing made during COVID lockdowns. [Read More.](#)

**Xiaomi Handed €3.2m Fine in Italy:** Xiaomi has been fined €3.2 million by Italy's competition authority AGCM for alleged warranty and repair violations. Claims against Xiaomi include that the vendor has refused to carry out repairs it was obliged to perform in the presence of scratches and other minor defects not covered by the warranty. This made "the warranty service subject to the repair of out-of-warranty damage", noted AGCM. [Read More.](#)

**China's Big Tech Companies, from Tencent to ByteDance, Cut back on Strategic Investments as Beijing's Scrutiny Continues:** China's Big Tech companies, from internet giant Tencent Holdings to TikTok owner ByteDance, are paring down their strategic investment units, according to industry sources and publicly available data, in line with efforts to reduce new acquisitions because of Beijing's continued scrutiny of the sector. [Read More.](#)

**BGI Group Units, Illumina Settle U.S. Lawsuits over DNA Sequencing:** Illumina Inc and BGI Group's MGI Tech Co and Complete Genomics have settled U.S. litigation over their rival DNA-sequencing technology, the companies said Thursday. Illumina has agreed to pay \$325 million to end the U.S. litigation, they said, following recent jury verdicts in patent cases in California and Delaware. The settlement also resolves a pending antitrust lawsuit by the BGI affiliates against Illumina in California. [Read More.](#)

**Wuxi-Backed Chinese Biotech Cstone Considers Sale:** Cstone Pharmaceuticals, a Hong Kong-listed biotechnology company focused on developing cancer drugs, is exploring strategic options including a sale of the business, according to people familiar with the matter. The Chinese firm, whose investors include a fund backed by WuXi AppTec Co., is working with Goldman Sachs Group Inc. to help sound out interest from prospective buyers, the people said. It is considering options including the sale of a controlling stake in the company, the people said, asking not to be identified because the matter is private. [Read More.](#)

<sup>1</sup>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.

<sup>2</sup>KWEB index is chosen as the indicator of Chinese companies' performance whose primary business or businesses are in the Internet and Internet-related sectors, the index has fallen from 84.82 in March 2021 to only 28.46 in August 2022.

<sup>3</sup>American depositary receipt (ADR) refers to a negotiable certificate issued by a U.S. depository bank representing a specified number of shares of a foreign company's stock. The ADR trades on U.S. stock markets as any domestic shares would.

<sup>4</sup>Source: National Bureau of Statistics, China's Ministry of Education, Wind database

<sup>5</sup>Source: National Bureau of Statistics, Haitong Securities Research

<sup>6</sup>According to news releases of public companies and other releases from National Medical Products Administration files, the biggest and most competitive 4 companies are Innovent Bio [1801.HK], Beigene [BGNE], Hengrui [600276.SH] and Junshi Bio [1877.HK].

<sup>7</sup>Bristol Myers Squibb [BMY], Merck [MRK], Pfizer [PFE], are from US, while other strong competitors in PD-1 field including AstraZeneca [AZN], Roche [ROG.SIX] etc. are not.

<sup>8</sup>The highest price for New Oriental was \$197 on Feb 16, 2021.

<sup>9</sup>Gross merchandise value (GMV) refers to the volume of goods sold via customer-to-customer or e-commerce platforms. Since retailers may or may not be the producers of the goods they sell, measuring the gross value of all sales provides insight into the company's performance.

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