

China Briefing

China's response to COVID-19 and what comes next

What happened?

As the 2019-Novel Coronavirus Acute Respiratory Disease (COVID-19) sweeps the world, many are examining what China did to respond to the virus. This paper outlines China's actions, the implications of these choices, and what we judge most likely to happen next. It aims to help you invest intelligently by better understanding China.

As of writing, COVID-19 has caused more than 167,000 cases, with more than 6,400 deaths, with the casemix spreading to all regions of the globe excluding Africa. It is natural in an epidemic to search for blame. The Chinese government has, thus far, been the primary victim. That is not totally correct. Understanding COVID-19 is a story of three parts.

In the early period of the virus, the Chinese reaction was swift and effective.

There were early reports of isolated cases, but it was flu season in Wuhan and difficult to see any pattern. On December 29, the local Wuhan Centre for Disease Control (CDC; China has a centralised system whereby all hospital entries are available to a CDC review team) notified its state and federal superiors that there was a suspected outbreak of a SARS-like illness. At the end of the following day, the Wuhan health bureau sent all hospitals in the city an "urgent notification" to report on any possible cases. (It did not, however, declare the disease to be the highest risk (a category 1), nor tell doctors to wear protective clothing or masks.) The next day, an expert team from the central government arrived in Wuhan and took samples for testing. Within a day, they had shut down the most likely source of the virus, a major food market, and it wasn't long before a number of labs around the country managed to isolate the virus from the samples. This isolation normally takes around one month, rather than a couple of days. Finally, on January 5, the World Health Organisation (WHO) was notified and the results were soon posted to open source databases worldwide.

There can be no complaints about any of these actions. They are probably what the WHO had in mind when they fulsomely praised China's response to the epidemic. Xi Jinping, China's leader, made an unprecedented disclosure of the inner workings of the Chinese government, revealing that leaders had met on January 7, and that he had provided requests at that meeting. He would not have made this disclosure if he did not want to be associated with that early period.

What came next has led to strong complaints about Chinese governance.

The Wuhan authorities knew that the epidemic was of grave concern, yet did not notify the public nor begin preparing.

In mid-January, Wuhan city and its higher-level provincial government Hubei each held their most important political meetings of the year. Wuhan media covered these meetings, yet there was only one front-page story on the virus. The Wuhan health ministry made a number of false statements about the illness in its press conferences. It said that there were no new cases when there were, and also told the public that there had been no cases of medical personnel becoming infected, even though doctors were already manifesting symptoms and quarantining themselves. It seems most likely that they were completely occupied by the two political meetings, which took up all government and Party

resources, and killed any air time for public health announcements—thus negligently wasting two vital weeks to prepare for any possible outbreak. For example, they lacked the capacity to test for the virus at the necessary scale, making only 200 test kits per day, and sending early tests off to Beijing for results.

Finally, phase three began, On January 20, Xi Jinping got involved and the vast Chinese bureaucracy kicked into gear, shutting down a whole province. Local governments were told to take any measures necessary. For the past three weeks, we have seen China quarantine various parts of its economy. This method of quarantine is crude, and has never been tried before on such a large scale. Moreover, each area has different rules about quarantine.

This, from a public health perspective, was probably an overreaction: airports and travel ground to a standstill, most of China worked from home (around half of China's citizens were unable to move), and various countries closing their borders to Chinese nationals. It did, however, delay the spread of the disease to other nations.

Today, most of the country, outside the Hubei province that is the epicentre of the virus, is slowly returning back to work. Migrant workers are travelling back to commercial hubs such as Beijing, Shanghai, and Guangzhou and factories have restarted in most areas. But normal life will take a while to return: schools and restaurants remain closed, and many families separated.

Why Chinese tech companies are crucial to China's response to the virus.

Once the crisis began, Chinese technology companies became indispensable. Why?

Technology is the key to China's response to the virus.

The answer lies in the unique nature of China's government and market. China is not so much one government as 3,000 local governments, united by their membership in China's ruling Communist Party. Each of these local governments must have a single person able to be held accountable for whatever happens on their watch; the performance of this individual—and their standing committee, usually made up of 10 to 12 other leaders—is measured on thousands of indicators. Local satraps pick which indicators to focus on. They know that their superiors will take the credit for anything that goes well, and they will take the blame for failures. Occasionally, such as right now, top leaders send out signals so powerful that all local leaders know to drop everything and focus only on that sole objective.

Running China like this, by call-and-response, makes it easier for the top leaders to stay in power. China has five levels of government, and should something go wrong, one can always say that it was caused by a failure to properly heed or follow central instructions. Blame is local, glory national.

But, and this is what makes China different, once the signal goes out from the top, every resource will be used to stop the epidemic. In China inaction is far worse than incompetence. Indeed, the danger now is that the pendulum has swung too far toward overreaction rather than trusting appropriate public health measures. When the call is strong enough, everyone responds, and the fear is that the economy and also the health system will become paralysed. The cure may be worse than the disease. That doesn't matter: China's people want a cure.

Hence why technology companies are essential, as only they are able to sidestep the complicated interactions between thousands of local governments. Rather than everything being passed down, level by level, with one part able to take the blame, technology companies function nationally. They have unique identifiers for all users. These are global variables, whereas the central government has to rely on information taken from thousands upon thousands of bureaux, ministries, local governments etc., because data is collected locally and there is no national storage of information.

In a crisis the government knows that it will need technology companies to achieve its goals. Only they have the reach, speed and capability. Take for example the Alibaba system Health Code, which

was developed by Alibaba's fintech arm Ant Financial. (China made around 50 times more online payments than the United States last year, an indication of how developed its fintech industry is).

Health Code identifies people at risk of COVID-19 by analysing their self-declared health status, travel history and the people they have been in close contact with. It was initially developed in Alibaba's local city, Hangzhou. The city has assigned every resident one of three colors – green, yellow and red – indicating different levels of risk the person poses to public health. People with QR codes colored in red are not allowed to enter public venues such as subway stations, restaurants and shopping malls for at least 14 days. Workers at those places are able to scan the QR code to verify the users' identity. Yellow code holders face similar restrictions, but for seven days.

Compare how simple it is to use Health Code with how difficult it is to achieve the same result using the government. Figure 1 shows how the Chinese state would need to get anything done. They would either have to get the government to work through its many layers (up to four different levels of government all can apply rules); this is marked with a 1. Or it could get the Communist Party to launch a "Patriotic Health Campaign" (this is marked with a 2). Both of these measures rely on significant coordination between multiple levels of government, hospitals, Communist Party bodies, and various other actors. Technology companies on the other hand merely need to use customer data. They ask their users to answer a number of questions, and the information is instantly generated.

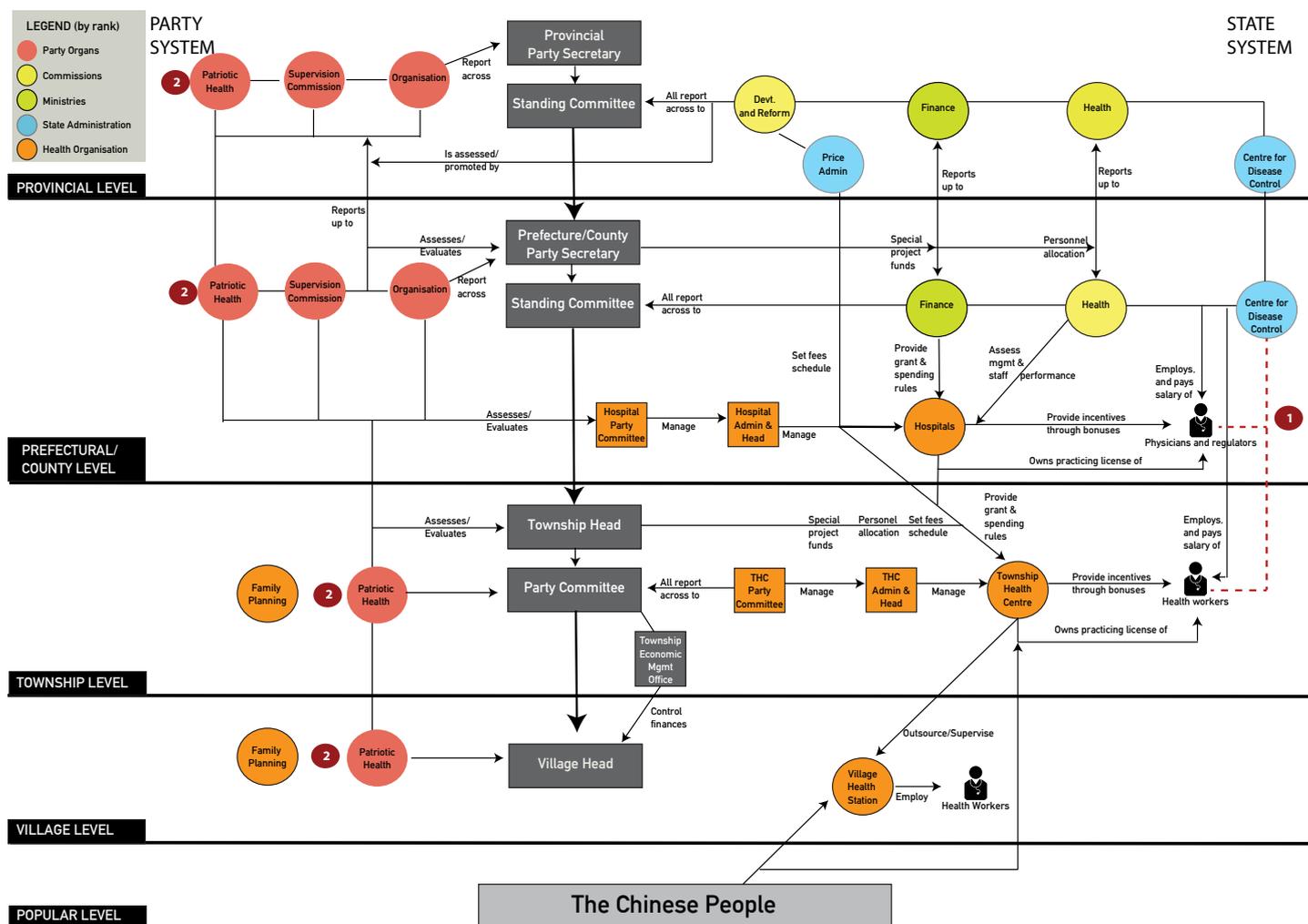


Figure 1: Mapping the Chinese hospital and health regulation system for COVID19

What does this mean for China’s macro-environment?

The epidemic also spawned a wave of articles dubbing it the Chinese leadership’s greatest challenge. That is overblown. The epidemic is unlikely to have a lasting or significant impact on China’s political stability. The greater danger will be in an unwieldy response in the aftermath of the epidemic.

Previous sections have shown that China’s leader Xi Jinping is very unlikely to be blamed for the events up to January 20. He has plenty of material to blame local governments for any failings.

He has, however, taken personal responsibility for the events after the January 20. As a result, the quarantine and its resulting economic and social impacts are a far greater risk to him than the epidemic itself.

Xi has taken two unprecedented actions. Instead of making everything decided by a committee, he has instead put his own name on everything dealing with the virus. In his own words, ‘I chaired a meeting of the Standing Committee of the Political Bureau of the Central Committee of the Communist Party of China. I made all-round arrangements to strengthen the prevention and control of the epidemic. I set up a central leading group to deal with the epidemic.’ He has televised and printed minutes of Politburo Standing Committee meetings, China’s collective leadership body whose deliberations are normally kept secret.

Xi has also short-circuited normal patterns of Chinese life and society. He’s told every local government leader that they must devote their time to the epidemic above all else. Instead of trusting doctors and epidemiological advice, they are instead to use only the word of the Communist Party. This advice is hard to understand from a foreign perspective, but basically they rely on China being divided into “grids”, with special case workers from the Party being assigned to each grid. Case workers do basic primary health care – checking body temperatures, cleaning and disinfecting, screening for illness – and also odd jobs such as manning checkpoints and delivering food.

Xi is betting that the biggest risk to him, and the Party, is being seen as inactive rather than as ineffective. And some of it will indeed be ineffective: more than half of the people diagnosed in Hubei province (that is, most of the cases – see Figure 2 below) are using Traditional Chinese Medicine to treat the symptoms of the Coronavirus, despite no clinical evidence that it is effective.

stability. In the medium-to-long-term, starting 2022, China’s actions now may carry a cost. That is because Xi will be focused on everyone doing what he says. He has sent out many inspectors to ensure that subordinates are working to his rule. This fits Xi’s general style of running the country: a slow, and centralised, method that relies on sending trusted subordinates to assess information on the ground and report back to home base. (In an unusual but revealing metaphor, he once wrote that “making [on-the-ground] inspections and research is like carrying a baby for ten months. Making [policy] decisions is like giving birth.”)

But you can only inspect what is standardised and regularised, and that means having strict plans, metrics, goals, targets, agreed measurements, etc. How can one create such a plan for an epidemic? For its recovery?

It is hard to dispute that the new measures are a stretch. No global public health expert advised locking down the city of Wuhan, or forbidding people to leave their homes even in other cities with very few cases. There has not been such a case of quarantine as a measure of mass public health for centuries (more recently the focus has instead been on using cordon sanitaire, the use of tracking, self-quarantine and then barriers to stop the spread of an infectious disease rather than shutting down a city). These measures smashed the Chinese domestic economy. Figure 3 shows an early example – very few people are leaving their houses at the moment, judging by traffic figures.

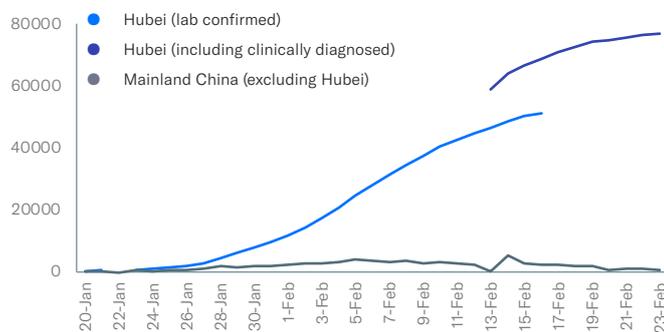


Figure 2: Cases in Hubei versus the rest of China by date declared

Use of Party tools will lead to more popular support than media commentary might lead one to believe. Party members will do all sorts of dirty work, and will be incredibly visible through their red armbands. This is particularly the case at the lower levels (such as townships and counties in Figure 1 above).

So in the short-term, there is unlikely to be an influence on China’s

Average road congestion across 100 cities in China

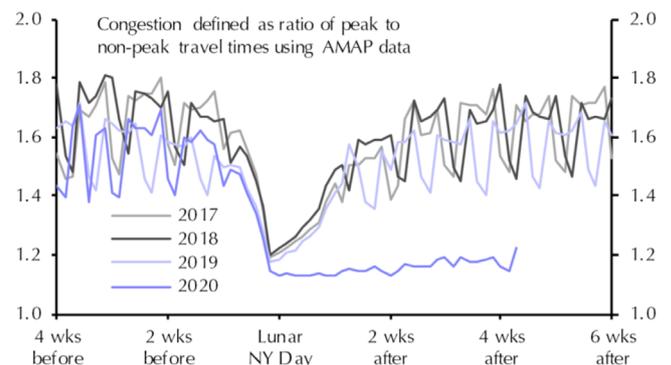


Figure 3: Amount of traffic congestion in China’s 100 largest cities around the Lunar New Year Holiday (Source: Capital Economics)

The week beginning February 24 has seen business begin to return to normal. Companies are banned from restarting work unless they have sufficient masks on hand for employees. Most large companies in the major economic provinces of China are back on deck. But only 30% of small and medium-sized businesses report resuming work. So less than 60% of China’s total output capacity has been restored.

What comes next is predictable: local governments that have money will launch major economic stimulus packages. Beijing city for example has already outlined its plan for 300 new projects this year, promising CNY 252.3bn (around USD 35.9bn) in investment.

The other consequence will be an easier time for multinationals and foreigners. China’s government press conference on its economic recovery plan listed among the government’s immediate priorities a need to “make sure industry-leading foreign companies resume production” and to coordinate efforts to help “major foreign-invested projects”. In times of stress, such as now, FDI becomes even more coveted and essential. Weaker firms perish, investors move away, regulators become more hospitable and it is easier to hire and keep

good staff. Credible foreign investors or entrants are seen as boosting the economy, and policy changes aimed at helping these companies are introduced (such as allowing foreigners to set up their own companies in China after Tiananmen 1989).

Positioning for the long-term

Foreign honeymoon periods only usually lasts for a year or two. China's economy will only continue to grow. This year, 2020, is a particularly significant milestone for China, as it is the deadline for both the government's five-year economic plan and also for the broad goal pursued for two decades of being "well-off". This is defined three ways: ending rural poverty, doubling GDP, and doubling household income (the "two doublings"). China appears certain to meet at least two of these three goals, and is highly likely to meet the third (the doubling of GDP).

To reiterate, China has doubled its household income in a decade. Average disposable income of rural and urban households was CNY 12,520 (USD 1,800) in 2010 and is expected to increase to CNY 26,795 (USD 3,600) at constant prices by the end of 2020. Household income has increased at an annual rate of 7.79 per cent; it is CNY 24,582 (USD 3,500) in real terms in 2019.

This booming consumer market will shift especially to services, education and technology. Especially, it will rely on the digital economy. In China, as shown above, government silos mean that the country is fractured and unable to provide a single unified product. Technology companies are the main winners from these shifts, as they are the only people able to act nationwide. They, and others within China's digital economy, have also been the major winners from the recent COVID-2019 epidemic. Chinese consumers have been staying home throughout the virus, watching videos and listening to music online.

Silverhorn is very well positioned to make the most of these trends. Our co-investment relationship with Tencent is particularly significant.

Tencent shares have risen around USD 18bn since the epidemic began. It is expected to rise yet further when it reports earnings in March, mainly through sales of virtual goods such as armor or weapons in internet games and through advertising. We hold a position in Tencent Music, which is expected to have considerable sales growth in this period.

Tencent has also provided many useful services to China's government and society during the epidemic. The government relies on WeChat, its primary product, to prioritise cases and to inform the public of existing cases of COVID-19. It also relies on WeChat to provide a "report" function for all government employees to tell them when they visit places other than home and office, under the government's declaration of the epidemic as being a warlike situation.

Tencent also has two very well-positioned investments. Medbanks 思派 and MiningLamp 明略数据. Medbanks provides data processing services, specialising in cancer treatments. It matches case files and pathology information with a machine learning model that ingests the latest research. It has more than 50 business development managers, based in all provincial capitals of China, that regularly work and interact with hospitals. This allows it to get around some of the problems of fragmentation noted above. MiningLamp creates data mining software and visualisations that help companies find connections between various matters. It was designed by the son of a policeman who had to deal with grass-roots community problems, and in addition to work with police agencies, it has been used by 40% of China's largest 500 companies.

These two companies together have two possible actions that would aid in responding to the epidemic. They could use their data mapping and visualisation skills to aid in epidemic prevention using the grid management system of the Party. They also can easily develop artificial intelligence drug mapping abilities to trace current anti-virals or other medications that could be rapidly scaled and brought to market.

Glossary of terms

A		L	
AI	Artificial Intelligence	LP	Limited Partner
APAC	Asia Pacific	LTM	Last Twelve Months
API	Application Programming Interface	LTV	Loan to Value Ratio
APJ	Asia Pacific and Japan	M	
APR	Annual Percentage Rate	M&A	Merger and Acquisition
ARPU	Average Revenue Per User	MAUs	Monthly Active Users
ARPPU	Average Revenue Per Paying User	MHE	Mid to High End
ARR	Annual Recurring Revenue	MOIC	Multiple on Invested Capital
ASEAN	Association of Southeast Asian Nations	MoM	Month on Month
ASP	Average Sales Price	MRR	Monthly Recurring Revenue
AUM	Assets Under Management	MSCI	Morgan Stanley Capital International
B		MSME	Micro, Small and Medium Enterprise
B2B	Business to Business	MTD	Month to Date
B2C	Business to Consumer	N	
BOD	Board of Directors	NAV	Net Asset Value
BVI	British Virgin Islands	NPV	Net Present Value
C		O	
C2C	Consumer to Consumer	O2O	Online to Offline
CAGR	Compound Annual Growth Rate	OEM	Original Equipment Manufacturer
CLA	Convertible Loan Agreement	P	
CV	Curriculum Vitae	P&C	Property and Casualty
D		P2P	Peer to Peer
DAUs	Daily Active Users	PARx	Portfolio at Risk more than x days
DACH	Deutschland, Austria & Switzerland	PMS	Property Management System
DD	Due Diligence	Q	
E		QoQ	Quarter on Quarter
EBITDA	Earnings Before Interest, Tax, Amortisation and Depreciation	QTD	Quarter to Date
ECB	European Central Bank	R	
ELN	Equity Linked Notes	R&D	Research & Development
ESOP	Employee Stock Ownership Plan	S	
EU	European Union	SAFE	Simple Agreement for Future Equity
F		SaaS	Software as a Service
FAV	Fair Appraisal Value	SFC	Securities and Futures Commission
FY	Financial Year	SFO	Securities and Futures Ordinance
G		SI	Since Inception
GAAP	Generally Accepted Accounting Principles	SME	Small to Medium Enterprise
GDP	Gross Domestic Product	SOE	State-owned Enterprise
GMV	Gross Merchandise Volume	SPC	Segregated Portfolio Company
GWP	Gross Written Premium	SPV	Special Purpose Vehicle
GP	General Partner	T	
H		TER	Total Expense Ratio
HIBOR	Hong Kong Interbank Offered Rate	TTV	Total Transaction Value
HKMA	Hong Kong Monetary Authority	U	
HR	Human Resources	UCITs	Undertakings for Collective Investment in Transferable Securities
HY	High Yield	V	
I		VIE	Variable Interest Entity
IG	Investment Grade	W	
IPO	Initial Public Offering	X	
IRR	Internal Rate of Return	Y	
IT	Information Technology	YTD	Year to Date
ITD	Inception to Date	YTM	Yield to Maturity
J		YoY	Year on Year
JACI	J.P. Morgan Asia Credit Index Core	Z	
K			
KPI	Key Performance Indicator		

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