“ When do bubbles become black holes? ”

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4 Zen and the art of bicycle finance

SUMMARY: What does China’s ‘bicycle bubble’ reveal about an awakening technological giant? China is in the midst of a bicycle bubble, which is now spilling over into the rest of the world. This bubble tells us a lot about how China is changing internally, and how it is changing the world.

“Here lies a sleeping giant. Let him sleep, for when he wakes up, he will shock the world.”
Napoleon Bonaparte, 1803

China is coming to you

Well, Napoleon might have been slightly premature, but we don't think he was wrong. For an investor it no longer matters whether you want to engage with China as an investment theme or destination, because China is now coming to you. Strange but true, the bicycle offers some insights into this paradigm shift.

What triggered this 'bicycle' line of thought was a bizarre experience on the way to work a month ago. I stumbled bleary-eyed out of my south London house and was confronted by a number of obstacles on my morning walk to the station. These obstacles were bicycles — many, many bicycles — all owned by a start-up called oBike, which offers a 'dockless' bicycle-sharing platform where a member can scan with an app on her smartphone to lock and unlock a bike, which can be picked up and left anywhere. oBike is a Singaporean start-up, but it is an echo of the bike-sharing boom in China.

China has a number of bike-sharing start-ups, of which the two biggest are Mobike and Ofo. These two companies recently raised US$1.3 billion of new funding from investors such as Sequoia Capital, TPG, DST Global, Tencent, Alibaba and Didi Chuxing. Mobike and Ofo have grown rapidly, and now provide 50 million rides per day, have 100 million registered users in 100 cities, and operate a fleet of 12 million bicycles. They are also expanding internationally.

What started as a good idea has, however, begun to cause some significant problems in China's cities. Among these is a huge pile-up of bikes in some areas, bringing a social and institutional backlash against these services.

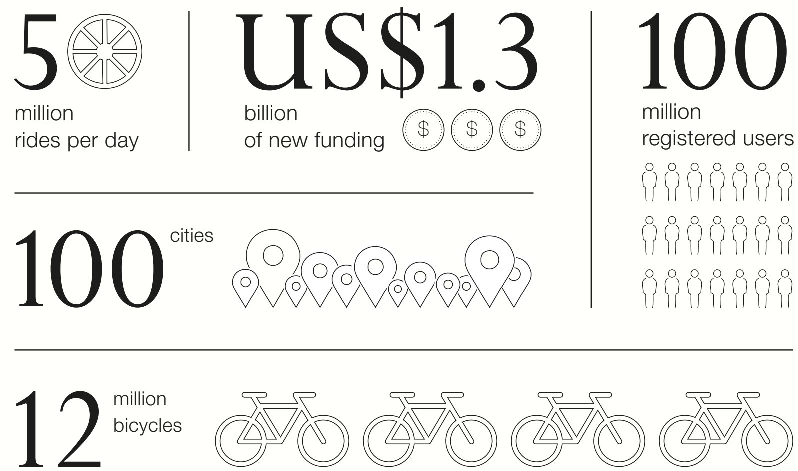
There are also signs that China's enthusiasm for the sharing economy may have gone a little too far. Umbrella-sharing start-up Sharing E Umbrella, which received RMB10 million in start-up funding, provides an example. Similar to the bicycle concept, users can scan a code with their phone to unlock a combination lock that is built into the handle. But there is a flaw in the business model (which might have been foreseeable): there was no penalty for the non-return of an umbrella. Sharing E Umbrella has now lost 300,000 umbrellas. Apparently the founder remains undaunted.

A new technological China is emerging

However, what is interesting about the bicycle-sharing boom in China is what it says about today's China. The market often focuses on 'old China', but there

I want to ride my bicycle

Chinese bike-sharing companies: Mobike and Ofo



is also a 'new China'. This 'new China' is a China of abundant start-up capital, risk-taking start-up and venture-capital investors, dynamic entrepreneurs, and the rapid roll-out of new technological solutions to old problems.

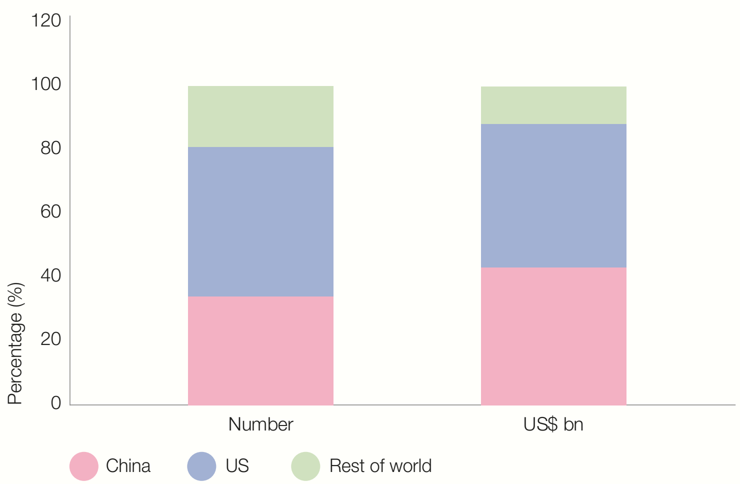
China, it turns out, is quite fortunate to have a relatively undeveloped service economy (fragmented retail, hospitality and distribution industries) and a decrepit state-owned financial services industry (focused on channelling retail deposits to state-owned industry). This has left those industries wide open to digital disruption. The 'walled garden', which is China's internet industry (foreign ownership and competition prohibited), allowed China's internet giants to scale rapidly, drive enormous economies of scale and then build out large and complex ecosystems. The three giants in the garden— Baidu (China's Google), Alibaba (Amazon) and Tencent (Facebook)— known collectively as BAT, have seized their opportunity.

Their success has, in turn, catalysed a storm of innovation, which has been supported, encouraged and funded to a significant extent by China's government. E-commerce in China is roughly double that of the US, with China being by far the biggest global market. Mobile payments in China are 11 times that of the US (US$790 billion versus US$74 billion in 2016). Meituan Dianping is the world's largest online-to-offline platform, which in 2016 sold US$35 billion of services (such as restaurant and cinema bookings, and food delivery) to over 200 million customers. Didi Chuxing (China's version of ride-sharing firm Uber) is five-to-six times the size of Uber in its own domestic market of the US, given the huge size of the Chinese domestic market.

A further competitive advantage for China's internet giants has been a societal lack of concern about data privacy. Perhaps this is a cultural issue, or perhaps China's internet users are less sophisticated than those in the West. More likely, in our view, is that most Chinese internet users assume that their data is effectively quasi-public anyway, given their government's pervasive access to, and control of media, data and information in their society. This means that BAT has virtually unlimited access to vast amounts of data with which to hone its algorithms.

But it's not all about the BAT giants. Remarkably, China now has a third of the world's 'unicorns' (start-ups, typically technology-related or enabled, valued at more than US$1 billion) by number, and a greater percentage by value (see Figure 1).

Figure 1: Global unicorns, June 2016 (Start-ups valued at >US$1bn)

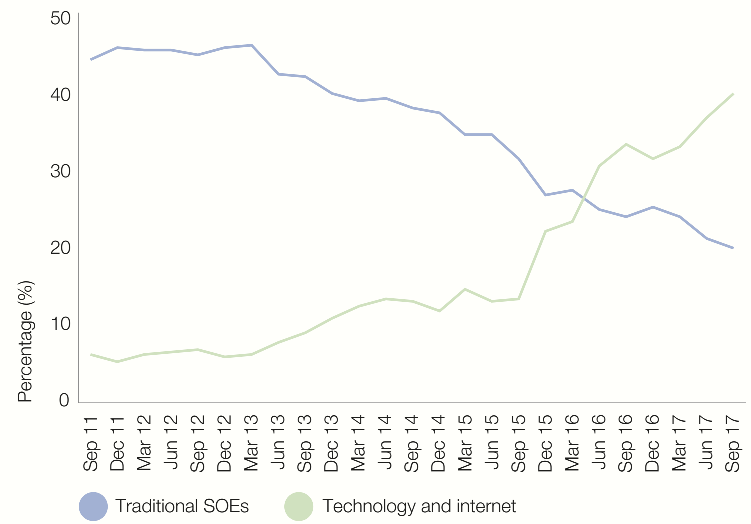


Source: McKinsey Global Institute, 2017

What does this mean for investors?

China is moving fast: 10 years ago its stock market was essentially uninvestable for a global investor, yet in 10 years' time it might be a core part of many global investors' portfolios. In the last six years the traditional state-dominated sectors of banking, energy and materials have declined from 45% of the MSCI China Index to 20%, while the share of technology (almost all private sector, including semiconductors, technology hardware manufacture, software and the internet) has grown from 6% to 40% (see Figure 2).

Figure 2: Changing China — investments in technology have been rising steadily



Source: Investec Asset Management, MSCI, as at 30.09.17

A hedge fund shorting China six years ago was effectively shorting the Chinese government's prowess (or lack of it) in allocating capital (a trade we would have relatively little disagreement with on a long-term view). Whereas a hedge fund being short China today is effectively shorting Chinese hard work, ingenuity and entrepreneurial flair (given the changes in the index) — a very different trade and one which we would disagree with viscerally.