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NOW STREAMING: A VOLATILE  
CHINESE TECH STOCK

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## Abstract

### Now Streaming: A Volatile Chinese Tech Stock

iQiyi offers video streaming services, a superfluous good with demand highly dependent on a country's economic conditions. In order to forecast this demand, a macroeconomic analysis for China was performed. That analysis found that the economic growth exhibited in past years was essential for the success of products such as iQiyi's. It also found that in 2019 economic conditions and consumer confidence deteriorated, mainly because of the trade war with the U.S. Despite a deal being reached between the two countries, the issues between them are extremely complex and tension should resurface in 2020.

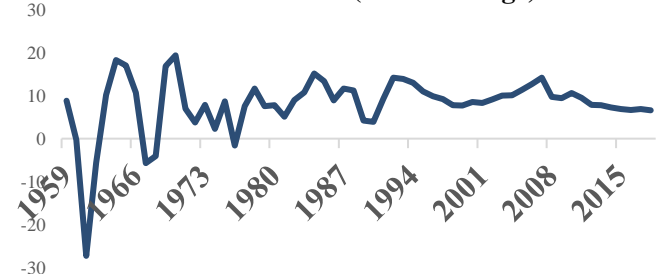
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## China Macroeconomic Analysis

Far from a first necessity good, a streaming subscription is still seen as a luxury to many segments of society. Since it is such a cyclical service, it is essential to understand the surrounding macroeconomic conditions in order to forecast the future demand for the services offered by iQiyi. The People's Republic of China (PRC) is the most populous country in the World. With a population of 1,395.38 million, access to its markets is one of the most desirable rights around the globe, since the millions of potential consumers have the power of multiplying sales for any company with this privilege. There is one main obstacle however, the country's ruling political party. The Communist Party of China (CPC) determines that the State is responsible for organizing, planning and regulating virtually all aspects of the life of its citizens and companies, making the existence of competition very difficult. This creates a "regulatory wall" around the country's precious markets. Although no official statistics have been released regarding this matter for several years, a recent World Bank study<sup>1</sup> estimated that, in 2017, the share of state owned enterprises in China's GDP was between 23 and 28% and that these companies were responsible for employing between 5% and 16% of the workforce. Such a large public sector usually means that a country would be an economic laggard, but the Chinese economy has been able to not only subsist but thrive, posting double digit GDP growth percentages consistently during this century. This feat hasn't been accomplished since 2012

**1. China GDP Growth Rate (In Percentage)**



however and GDP growth has been decelerating for a few years with the 2019 print

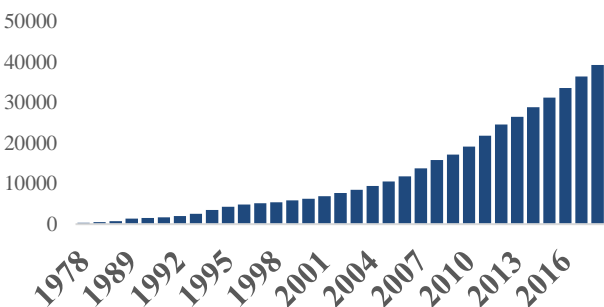
<sup>1</sup> World Bank. 2019. "How Much Do State-Owned Enterprises Contribute to China's GDP and Employment?" Accessed January 3. <http://documents.worldbank.org/curated/en/449701565248091726/pdf/How-Much-Do-State-Owned-Enterprises-Contribute-to-China-s-GDP-and-Employment.pdf>. (World Bank 2019)

expected to be around the 6.6% level.

Since 2002, the country hasn't posted an unemployment rate print higher than 4.3%, and in the third quarter of this year it reached the value of 3.61%. This number points to a buoyant labor market and, as expected, average wages have been growing at a rampant pace reaching 82,461 RMB per year (approximately 10,600€) from 37,147 RMB in 2010 (approximately 4,800€) an increase of over 120% that demonstrates the vastly improving economic conditions that the country has been experiencing in the last decades, making it possible for the demand of a service such as the one offered by iQiyi to exist.

Another important factor affecting the potential demand for iQiyi services is related with Chinese consumers, its confidence and its consumption capacity. In theory, if consumers have a higher share of income to spend in non-essential

## 2. China Disposable Income (In RMB)



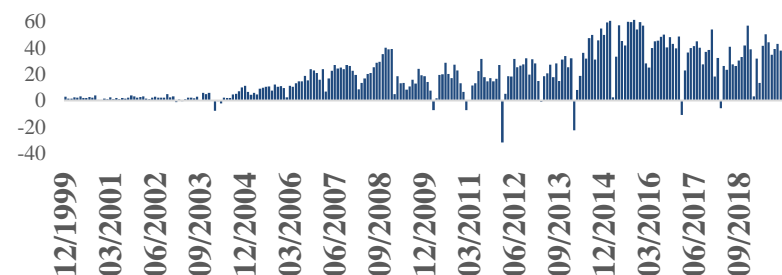
consumption (i.e. higher disposable income), services such as the one offered by iQiyi should see a surge in demand. In fact, by looking at the annual disposable income per capita of Chinese urban households we realize that, as before, this figure has been rising

consistently, reaching the value of 39,251 RMB for the year of 2018, an increase of 8% year-over-year and an increase of 105% since 2010. The path taken by this particular statistic confirms what was previously shown by the average wage's figures: that the economic development felt in the country has allowed the Chinese consumer to gain purchasing power benefitting numerous services and products that would've previously seen as superfluous. Retail sales on the other side have been slowing considerably during the year of 2019, reaching the lowest year-over-year growth since 2003 (7.2% in April). Regarding consumer confidence, China's

consumer confidence index had a bumpy ride in 2019. Reaching the highest level for the year in February, it decreased until its lowest point in August before surging late in the year on the back of renewed optimism regarding a possible trade deal. The slowing of consumer spending growth taken together with the lower consumer confidence levels seems to confirm iQiyi management assertions regarding the weakening macroeconomics conditions China is facing. With this said four reasons seem to be behind the weakening of Chinese consumers confidence.

The first reason is the decline in production. In fact, by observing the country’s official PMI (Purchasing Managers’ Index) we can see that it has been declining since March of 2019 (until a November surge brought it back close to that level), pointing to softening conditions on the productive side of the economy. The second reason is a severe decline in exports (falling more than 20% year-over-year in February and staying in negative territory for most of the year), caused in great part by the increasing trade tensions felt around the globe. China was particularly affected by these tensions since the U.S. started a trade war with the country in 2018. It did so by setting tariffs on Chinese goods and enacting other trade barriers

### 3. China Trade Balance (In Billions of USD)



as a way of forcing the country to address what the U.S claims are “unfair trade practices”. These include a persistent and growing trade balance surplus (it hasn’t been in negative

territory since March of 2018 when it reached the level of -5.794 billion USD, and reaching a value as high as 56.8 billion USD in December of the same year), the theft of intellectual property and forced transfer of American technology as well as the involvement of the government in the economy by subsidizing private

companies as well as directly financing state-owned enterprises that unfairly compete with its international counterparts. The third possible reason for the decline in consumer confidence is related with the debt level exhibited by the Chinese economy. In fact, according to the Institute of International Finance China's total corporate, household and government debt rose to 303% of GDP in the first quarter of 2019<sup>2</sup>. A key gauge of the financial leeway available in the country's economy, it is clear that, at this level, there isn't much room to maneuver, especially considering that the total debt stock of over 40 trillion USD corresponds to approximately 15% of the World's total debt. On the other side, the indebtedness of the country seems to be starting to take a toll on the real economy demonstrated by a survey conducted by China's central bank that showed that urban residents are increasingly choosing to deposit their money in the bank as opposed to spending or investing it. Moreover, in another sign of the high leverage of the economy, the country saw a record level of over 130 billion RMB in corporate bonds default in 2019. Finally, it is important to mention the increase in inflation level felt during the last year. Starting at a level of 1.7% in January, the CPI rose 4.5% year-over-year in November, providing another sign of the increasing costs consumers faced and contributing in a meaningful way to the decrease in consumer confidence felt in 2019.

Overall the Chinese economy had a slower year especially if we think about the pace set by the country in the beginning of the century (and even during this decade). Consumer spending seemed to decelerate in 2019, caused by the decrease in manufacturing and exports, which were in its turn caused in great part by the trade war with the U.S. However, in December, the Chinese government confirmed

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<sup>2</sup> Reuters. 2019. "China's debt tops 300% of GDP, now 15% of global total: IIF." Accessed January 3. <https://www.reuters.com/article/us-china-economy-debt/chinas-debt-tops-300-of-gdp-now-15-of-global-total-iif-idUSKCN1UD0KD>. (Reuters 2019)

that the two countries had reached an agreement on a “Phase One Deal”, holding off the raise of the planned tariffs for just two days later. To many market participants this deal was inevitable, since the tariffs proposed for December 15 would’ve had a devastating effect for both countries, and a preliminary deal seemed to be in the best interest of the two parties. But more than that, and despite the apparent euphoria felt in the stock market following this announcement, this deal was just a steppingstone in the direction of solving the underlying issues that caused the tensions in the first place. In fact, this deal covered only parts of the American grievances with its Chinese counterparts, and some of the problems raised by the American side (such as the subsidization and government interference in Chinese companies) are structural characteristics of the Chinese economy, and it might not be in the country’s best interest to ever change them. As such, and considering the difficulties behind the negotiations of this “Phase One Deal”, it is very likely that tensions between the two countries increase again in the future, and that the Chinese side only took this deal because it encompassed only minor issues and it allowed the country to avoid what would’ve been the seriously damaging December tariffs. As such, we forecast that during the first months of 2020 we’ll see improved economic conditions and consumer confidence in China, which should have a positive effect on iQiyi subscriber growth as well as advertising revenue. However, as the year progresses and the cracks in the relations between the two countries reappear (caused by the hard stance the U.S. president will likely have in an election year and the possibility that the Chinese side will fail to meet the previously agreed upon commitments), the trade tensions will become a drag on the economy and it will continue on the downward path it took in 2019.<sup>i</sup>

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<sup>i</sup> All the statistics and graphics were sourced from the Bloomberg terminal.