

# China's Education Company Crackdown and Harassment at Activision

*Featuring:*

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Mike Disabato:

What's up everyone and welcome to the weekly edition of ESG Now, where we cover how the environment, our society and corporate governance effects and are affected by our economy. I'm your host, Mike Disabato. And we have two stories for you this week. First we discuss what is going on with Chinese education companies as Beijing cracks down on profits. Then we have a hot take on the sexual harassment controversy at video game company, Activision Blizzard. Thanks as always for joining us, stay tuned. In China, the competition for the best schools is fierce. If you want to get into a good college, you have to do really well on the National College Entrance examination. And for middle school or high school, you have similar entrance exams that in part can determine a child's future early on. In some instances, 600 youngsters are competing for one spot at a prestigious school.

Mike Disabato:

That's compared to an average of around 20 to one in the UK. So, preparation begins well before the exams begin. And parents are under pressure to provide their aspiring scholars with as much help as they can get. The parental desire and student angst has allowed for the creation of private education companies. Those that provide after-school tutoring, assistant programs and test prep. Tutoring prep companies have become a massive industry in China, which has the largest education system in the world with 260 million students. The sector grew from around 40 billion US dollars in 2011, to around a hundred billion today with many companies issuing IPO's on foreign exchanges. This has meant that the companies have attracted a lot of foreign investors, which then calls the Chinese government to enact various regulations at one point, limiting the amount of foreign investment allowed in its private education sector. Still the sector continued to grow unabated.

Mike Disabato:

That is until about a week ago when it was revealed that for various reasons which include education affordability and a looming population decline, Beijing would force private sector education companies in China to list themselves as non-profits. Effectively banning companies from making a profit from teaching school curriculum. That caused near 60% drop

in company valuation on the NASDAQ stock exchange and a massive debate began about profits, education and private capital. You may remember back in March, we actually covered this issue when it was becoming even more apparent that there were some structural complications in the sector. But today we are going to discuss the decline in much greater detail from a local standpoint, a market standpoint, and from an impact investor standpoint. That's because education is part of the UN sustainable development goals. Number four, to be exact. And it means it's also part of the social impact investment ecosystem.

Mike Disabato:

So, we're going to discuss what it means for a social impact company to be profitable near the end this episode. But to start us off, I called up my research colleague Xiaoshu Wang, who is actually from China and works out of our Beijing office. And she even has children and is starting to think about what the future of education is going to look like for them. So, she was a great person to talk to about and see what she thought about this new regulation. And she started off by telling me, letting me know how popular these companies have become, and not just for college kids, but for high school kids and for middle school children as well.

Xiaoshu Wang:

Almost more than 50% middle school and those of primary school students, they are taking some kinds of those tutoring courses after school. And in particular, in tier one city like Beijing and Shanghai, it's very common a student spend more than 10 hours a week in those tutoring programs and funds on those tutoring programs could also come up to 30 or 40% of a normal, say, middle class family's salary level. And in some cases, even a parent, one of the parent need to full-time accompanied by the child to take all those courses. And there is also some of criticize and I would say content they provide to students. Some case, they kind of hurry child to learn the main course beyond normal learning rate.

Mike Disabato:

Let's quickly recap what you're saying there. The cost of private tutoring programs can account for 30 to 40% of a family's budget, a number I used by the way to calculate the maximum amount of rent I can spend monthly. They require a lot of time spent by both young students and sometimes parents. And they create unreal expectations with their curriculum. By the way Xiaoshu told me that there is a new adage that her neighborhood has adopted because of how these companies have begun teaching English. And it translates roughly to, you might have learned enough English to be American, but not to be Chinese. So, if everyone realizes how impractical this is, why are enrollment rates so high around China? Well, the problem is, and this is in part what caused the Chinese government to crack down on the companies is prestigious schools are using these companies as a way to rank students and get the best of their schools. There are schools all over China that anyone can enroll in, but then others are much more selective and use whatever process they can to weed out some of the lesser achieving individuals.

Xiaoshu Wang:

For some of the students they do want pick smarter child or high quality students. They're not allowed by the policy to do so. So, they leverage those obviously out of school systems to ranking students and help them to selecting and recommend high quality students, everything under the table. And all the parents, they also need to try all means to figure out through all kinds of message channel, to figure out which class, if I get in, I could be recommended or whether there is a secret contest, the tutoring program they are organizing. So, if my child win any prize in this contest, I can be enrolled. So, it's totally untransparent.

Mike Disabato:

It's kind of a pay for play system. Those that have access are both better prepared for exams and have a better chance of getting on lists that would allow them to do better in the future or so it would seem. And what parent doesn't want that for their child? Because of the system, as we noted before, the industry boomed. For example, the largest publicly traded education company in China by market cap, TAL Education, has about 45,000 employees and runs 990 teaching centers in 102 cities. Let's compare that to Goldman Sachs. One of the largest investment firms in the world. It has about 40,000 employees, but with this size came exposure and with exposure came party scrutiny. And that scrutiny first came to the scene in 2019, when the party acted against foreign education companies effectively banning them from operating in China. Then there were only domestic companies left to operate.

Mike Disabato:

The issue appeared again early in 2021, during two conferences in March where the party raised concerns over how the education companies were operating and marketing their services. We put out a report in March saying that it was likely more restrictive regulation that was coming down the pike. And here we are. What is unique about all this is that the Chinese government is basically saying that profitability in these critical sectors is as much of a threat to its smooth operations as any short of foreign influence. So, to understand what these actions mean all in context, I called up Miranda Carr, who has covered the Chinese market for some time and asked her to make sense of all of this.

Miranda Carr:

You are seeing a trend now in China. So, obviously a lot of the companies in China are state-owned enterprises. So, there you have a strong element of government control and abiding by the appropriate regulations, but it's been the private sector and lots of these private companies who are previously quite sort of entrepreneurial, relatively unregulated, but now the tech companies and the including the online education companies have become really big and powerful players in China's corporate landscape, but also in its economy. And also how it relates to the population is large. So, the concern from the regulatory side about their activities, how they react in terms of dealing with the regulation. Crucial issues like the privacy and data of the users, these are all elements where when the companies were either smaller or they weren't such big, important part of the economy.

Miranda Carr:

Then a lot of it was overlooked, but now they're so strategically important that they will be facing a lot more regulatory pressure. So, companies that are following the more responsible business lines, not taking too sort of an aggressive stance in terms of maybe the marketing or the privacy and data, and actually abiding very strictly by the regulation is going to have to be, and that's a key factor that investors are going to have to consider when they're looking at private companies much more. So, then when previously the concern has been about the, maybe this on the SOE side, what the state influences. But now I think the concern, how you deal with the private companies and what regulation they're facing is the big challenge at the moment.

Mike Disabato:

There's a challenge of regulation as Miranda just noted. And there's also the challenge of company intent. Investible education companies are often put into portfolios that would cater to impact investors. Those that are a bit more resolute in their desire to invest in companies that provide a beneficial social or environmental impact alongside a financial one. But those two objectives can come into conflict, as we are seeing right now. People are getting more access to education, but as Xiaoshu told us, it has created a pay for play system. So, when does an education company become something different than a vessel for positive social impact? And is perhaps affordability the better metric for impact than profit? To find out, I asked our impact investing specialist, Olga Emelianova for her opinion on the matter.

Olga Emelianova:

The access to basic needs and basic services is something that the global impact investors are trying to solve. So, in that case, it would be access to medicine to healthcare, to education, to housing. So, in kind of figuring out whether there is a need for social impact investing, we need to understand, is there a problem. And I think in case of China if you're looking to general statistics in terms of access to education, graduation rates, enrollment statistic, literacy rates, I think China is actually doing quite well. Based on the world bank data and the UNDB. The numbers are pretty good. So, maybe the first impression is that maybe there is no problem. There is no real space for the impact investors to move to China, but the situation changes when you start looking into more granular data when it's more regional spread.

Olga Emelianova:

And when the look into the statistics by the difference between urban areas, for example, in the rural areas, it's drastic. I've been looking into some of the numbers from World Bank just before we talked and for the secondary high school education and academic degrees, there's such a big gap between the percentage of the graduations, where in rural areas, it's really marginal, it's like two, 3% graduation rate compared to over 50 in the urban areas. So, there is certainly some of the gap regionally, where there are some demographics that remain under served. So, that indicates that yes, there is a problem and there is a need for that impact investing.

Mike Disabato:

So, there is a legitimate need in China to not only excel at school, but to get the resources necessary to achieve a positive education that can help benefit anyone's life. And maybe that is how these companies could have staved off some of the regulatory burden. Show that they are not only helping those with means, but they're also helping those that are outside of the system. So, how might a company do that? How might a company provide a service to a group that isn't really in the position to pay? And the question really, is profitability antithetical to the idea of social impact? And what I mean is, can a company provide services to the poor, if it requires the poor to pay? That doesn't seem like a good business model or even one that makes sense. Well, for many companies that we consider socially impactful, it isn't about the product you provide. It's about the programs you can help fund.

Olga Emelianova:

It's through issuance of bonds or loans, or designating ring fences and some specific project is addressing the social needs and providing it with the equality in mind and the affordability in mind. So, it's very specific ring fenced mechanisms that we are looking at from the impact perspective. I don't think you can apply it on a company level and say like, all right, if you're for profitable then you don't have any positive impacts. Because you may be both. The professional companies, the ones that are providing those professional services or products whether it's housing, whether it's education, whether it's health care they have to distribute the profit.

Olga Emelianova:

They have to distribute the money that they get, maybe in some regions to support the programs and others. And I think that really kind of connects very well to the area of healthcare and pharmaceuticals, where we have giants, pharmaceutical giants, they are very much for profit, but they are also the ones who are supporting most of the programs on the source markets, providing the pro bono services or discounted products and adjusting to the local needs.

Mike Disabato:

So, I have a confession for you all. During the pandemic, I got semi addicted to a video game called Call of Duty Warzone that was developed by a company called Activision Blizzard. And I wasn't alone in this addiction, by the way, there were 6 million after its release on March 10th, 2020. That number grew to 50 million by April and a year later, there are over a hundred million players. To the joy of my loved ones, I no longer sit up until all hours playing the game, but there is no denying that it has been hugely successful for Activision Blizzard. But now the spotlight is being put on the company in a different way. The problem began last week when the California Department of Fair Housing and Employment filed a charge lawsuit against Activision Blizzard that alleged sexual discrimination, harassment, and retaliation at the company. The company claimed the lawsuit is meritless and irresponsible.

Mike Disabato:

And according to reporting by Robert Schrier, Bloomberg more than 2000 employees have signed a letter calling the company's responses to the lawsuit, [inaudible 00:15:38] and insulting. And they've asked the executive sponsor Francis Townsend of the ABK Employee Women's Network to step down for her comments after the lawsuit. As of this recording, thousands of employees have walked off the job at Activision. The CEO has issued a public apology, and some customers are calling for a boycott of all Activision products until the situation is dealt with. To discuss this issue further. I called up Meggin Eastman who has researched diversity, equity and inclusion at companies for some time. So, Meggin, give me your [inaudible 00:16:11] take on this. What is going on at Activision?

Meggin Thwing Eastman:

Sure, Mike, so there's a couple of different threads to pull on here. It's not just about diversity or the status of women at the company, though, that's the crux of the lawsuit and the protests that we've seen. It's also about the tone from the top and what that says about how management thinks about the people who make the company's product. And what this looks like at least is some pretty short-sighted ways of thinking about the talent. And so if I'm an investor looking at this, I might be wondering, what else do I not know about Activision Blizzard's human capital and just how badly might that be eroding value.

Mike Disabato:

So, what started all this was that California Department of Fair Employment and Housing lawsuit that was filed on July 20th, but that's a bit unusual for that department to actually file that lawsuit. And it pretends some difficult times ahead for Activision, correct?

Meggin Thwing Eastman:

Yeah, because that's definitely the other piece of this here. So, there's the part about Activision Blizzard, but then there's this question about the whole rest of the industry. So, yeah, the California Department of Fair Employment and Housing is the one that's behind this lawsuit and they don't file a lot of their own lawsuits. They're the place that employees would go to issue a complaint and basically be given permission to pursue that complaint against a company, but they don't file very many of their own. And so the involvement of this department is already a pretty significant indicator that it thinks that there's a strong case in the allegations. And actually the department's director said explicitly and publicly that they litigate where they think they'll be able to help remedy systemic problems and where the litigation can serve as a precedent with a pretty explicit goal of having a wider impact beyond the case itself.

Meggin Thwing Eastman:

So, that definitely tells you something about how this Department of Fair Employment and Housing is viewing the allegations around Activision. And we already know that the software industry, especially in California, has come under heat over the last several years, for lack of diversity, for failure to nurture and promote women, for discriminatory behavior, sexual harassment. I mean, recall the Google walkout in 2018, for example, that was centered around

the Me Too movement. And then there's the video game industry, which is a part of the software industry, as far as the companies that make the games and gaming culture more widely has developed a certain reputation for misogyny. If you think about the Gamergate controversy a few years back as being probably the most publicly visible example of that.

Meggin Thwing Eastman:

And so I would absolutely read the filing of this lawsuit as a shot across the bow for other companies in the industry. And if I'm invested in some of those companies, or I'm thinking about investing in some of those companies, that means I'm looking at potentially heightened risk of litigation. And I might want to be asking management a few pointed questions about this, if I can, or at least digging for some more information, because even if a company doesn't get sued, this whole thing still raises questions about talent management and long-term value and the treatment of workers and ability to recruit and retain, and basically get the most value out of the talent you have.

Mike Disabato:

And that's it for the week. I wanted to thank Xiaoshu, Miranda, Olga, and Meggin for talking to me about this week's news with an ESG twist. I wanted to thank you so much for listening. Don't forget to rate and review us wherever you get your podcasts. And of course, if you want to, do subscribe. Talk to you next week and have a good weekend.

Mike Disabato:

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