Memo to Titan Clients
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Titan

We've exited New Oriental Education (EDU) and trimmed our China positions

We've exited New Oriental Education & Technology Group Inc. (EDU) and decreased our exposure to China by trimming BABA, BILI, JD, PDD, and TCEHY. We've reallocated cash from these holdings to other international companies within our Offshore portfolio.

Quick take: why we reduced our China exposure

While we remain bullish on many pockets of China's rapidly growing $15T economy, we've decreased our aggregate exposure to the region due to an increasingly active regulatory environment within China's technology and consumer sectors.

Given recent signposts from government officials, we believe the probability of left tail risks across foreign-listed Chinese equities - while still quite low overall - has increased notably vs. just several weeks prior. Accordingly, we are decreasing our net exposure to the region until we observe incremental positive traction on the regulatory front.

Our investment team will be monitoring any upcoming top-down developments within the region carefully, and we'll be regularly reviewing and potentially revising our China allocation following any subsequent developments. Stay tuned.

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On Friday, July 23rd, Chinese education stocks plummeted on media reports that suggested China may ban weekend and holiday after-school tutoring (AST) classes and convert academic tutoring institutions into non-profit organizations.

In our view, those reports—which have since been confirmed by the Ministry of Education—represented a true "left tail" event and a meaningful step up from the event pattern that has impacted the education sector and China's public companies year-to-date.

Source: New Oriental Education & Technology Group Inc.

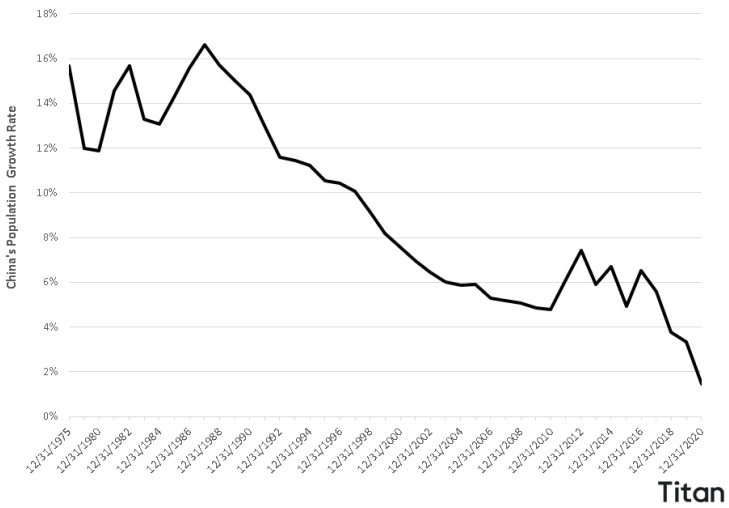
We will note that following the subsequent pullback in Chinese equities, valuations in China are now indeed extremely cheap, and there are additionally several complicating factors that make the regulatory outlook more nuanced than appears on the surface.

But at the end of the day, we believe everything needs to be **weighed probabilistically** against the **key touchstones** of the fundamentals and core thesis drivers. With those core factors in mind, we've decided to exit EDU and revise our net portfolio allocation towards Chinese equities.

Stepping back: Why is the Chinese government focused on the education sector?

As we've discussed in our prior research, China's population growth has decelerated over the last few years, fueling fears that the economy will be dragged down as a result of an aging population.

The Chinese government has taken several different steps to try to address this issue, one of them being regulatory reform over the education sector.



Source: National Bureau of Statistics of China

For context, Chinese society is highly education-focused, and most families invest a significant proportion of their money into ensuring their children are prepared to succeed in China's all-important college entrance exam (the "gaokao").

The stress and cost of preparing for these exams have led some regulators to believe that they may be acting as a hindrance towards the new generations' willingness to have more children.

Interpreting the new regulatory signposts

On Saturday, China's Ministry of Education announced new requirements and restrictions related to China's education system, including:

i.) a ban on weekend and holiday after-school tutoring (AST) classes
ii.) the conversion of academic tutoring institutions into non-profit organizations
iii.) restrictions on foreign ownership in academic AST institutions.

As we noted in our research following the preliminary media reports, these sets of regulatory outcomes were **unexpectedly draconian** and seemed to represent a meaningful reversal from several data points (from both official and unofficial sources) that we observed in the weeks prior to the announcement.

What we found most notable regarding the announced regulations was the new language focused on limiting access to foreign sources of capital. For decades, US investors have held a symbiotic relationship with Chinese markets via ADRs - a type of equity instrument that enabled Chinese companies to access US capital markets and US investors to access Chinese investments.

However, the most recent regulatory developments seem to suggest that local regulators may be increasingly willing to reexamine how it handles this relationship. While regular ebbs and flows in regulatory sentiment have been a defining feature of investing in ADRs since they were first popularized, Friday's announcement struck us as a particularly notable shift upwards in terms of regulatory posturing.

Source: Zhou Qingxian / CNIMAGING

Bridging the event to the portfolio action

As with all investment decisions, the path from fundamental observation to portfolio management decision is not always straightforward.

While heightened regulatory risk has on the one hand reduced one side of the risk/reward equation, valuations have also come in dramatically, creating an up/down setup that could look enticing if examined on a standalone basis.

For example, with EDU in particular, the company is now trading below the value of its cash balance less near-term liabilities, which is truly historic and not something we have observed for a company of this stature and brand value in years. At our exit, EDU was trading at a **87% haircut** to where it traded when we first initiated the position. At those levels, the market is effectively assigning zero run-rate value to the future of the business, even though they could in theory pivot and adapt their model to the new regulatory environment.

While these valuation dynamics look enticing on a standalone basis and create an excellent setup for a potentially sharp reversal following any incremental news that is "better than feared" - we believe **that is far from the guaranteed or statistically expected outcome based on the currently available data**, and importantly, would still not necessarily map to a structurally sufficient improvement in EDU's long-term prospects.

As a result, we have decided to exit our position in EDU. As long-term capital allocators, what matters to us the most is allocating capital to the opportunities that have the **most attractive long-term prospects**, even if it means saying no to some potential near-term opportunities.

Stepping back

As noted in our prior research, the current regulatory landscape could evolve from here in any number of ways. As it stands, we view the latest round of updates as a material signpost that signals a meaningful shift in posturing from regulatory authorities.

However, beyond EDU, our fundamental theses remain intact across our Chinese holdings. We remain bullish on these companies' ability to drive outsized topline and earnings growth over the long-term, and see today's valuations as exceptionally favorable. However, we have nevertheless reduced their net portfolio allocations in order to reflect the recent changes that have occurred on the regulatory front, pending further updates.

Over the coming months, we expect regulatory news flow to be the primary catalyst for price action across most Chinese equities. Our investment team will actively monitor and review any further developments, and we will be reviewing and potentially revising our China allocation on any material changes. To keep up to date with the latest, be sure to stay tuned and activate your notifications in the app.

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