

## China Bans Gaming

*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 are affected by our economy. I'm your host Mike Disabato and we have two stories for you this week. The first is about a video game ban in the largest video game market in the world. And then we discuss with gusto, the corporate governance news around the market. Thanks as always for joining us, stay tuned.

Video games have become epic, stories with Pulitzer Prize winning dialogue, design more suitable for a box office movie than something your kid plays after school and music created by some of the top musicians of our time. Playing them is like participating in the story, becoming the maligned antihero trying to claw their way back to retribution or the astronaut searching a foreign solar system for lost civilization. They are beautiful, there is no doubt in that. But there are also addictive, first person shooter games for example, can employ casino like tactics to keep their players enraptured and there have been highly publicized deaths surrounding video games in Asia after teenagers played certain games for 40 hours straight. Whether video games are bad for you or not is a debate that has been raging for some time, and I don't particularly care to have it on this podcast.

But there has been a growing concern by regulators and companies around younger players and their time spent on screens. China, one of the world's biggest video game markets has throughout the years implemented a number of regulations that try to curb what they see as a public health problem equal to what they called recently spiritual opium, that was retracted immediately when it was put out. And this week, the National Press and Publication Administration, China's online watchdog issued a regulation that kids under 18 in China will only be able to play video games for one hour a day and only on Friday, Saturday and Sunday. This comes after a 2019 ruling that banned kids in China from playing after 10:00 PM and only allowed them to play 90 minutes a day, except on holidays they got three hours. They also curtailed kids in game transactions.

Why is this such a big deal? Well, there are about 740 million Chinese gamers in 2021. That's bigger than the entire populations of the US, Japan, Germany, France and UK combined, and its domestic market is worth more than 45 billion US dollars a year in revenue and the industry has become huge players in the media and entertainment market. In the U S for example, 64% of adults play video games and 72% of teenagers play video games according

to Pew Research. It's a hobby that crosses class, gender and racial lines, everyone plays. So if society, the S in ESG if you will, begins to believe that the industry is nothing but another addictive product, then companies may have to reckon with such backlash. But first, to discuss what this new regulation in China does to the major video game companies in the region like Tencent and NetEase, I called my colleague Siyu Liu who covers the media and entertainment industry for us and has been watching the story for some time.

Siyu Liu:

For Tencent and other major players in the market such as NetEase the biggest burden is that they will have to... so, the regulations are just guidelines for companies. So, the burdens on the companies to follow through, to make sure to add protective measures, to add mechanisms, alerts, whatever they can figure out to make sure that they're compliant with the regulation to prevent underage gaming.

Mike Disabato:

In China, it's not like these companies are pushing back on this regulation, Tencent came out and said that this law was a good move as did other Chinese domiciles companies such as NetEase. The market didn't really agree and shares in the Chinese video game companies fell in early trading. But the companies genuinely seem unconcerned, and that may be because when it comes to revenue for video games, the big moneymakers are now not the box sales, but in-game purchases of virtual items, I'm talking different avatars and skills and privileges or other end game consumables, features of functionality that you have to buy in order to play, and minors don't really spend all that much money, for one thing, kids are broke and even their modest incomes available to the companies have been curtailed in China in 2018 and 2019 as the government limited in-game purchases by those 18 and younger.

Siyu Liu:

But according to the most recent financial report from 2021 Q2, the underage and here underage is below 16 from their disclosure is about 2.6% among their gaming revenues. It's relatively small compared to the rest of the segments, but I think from a regulatory reputation or public scrutiny perspective, they definitely have a lot of challenges ahead of time.

Mike Disabato:

And you can see this by what the companies are now doing in response to this regulation and the regulations previous, they're trying to shift that reputational risk onto the parents of kids that are playing too much. For example, Tencent, the company we've been talking to in response to this regulation and the regulations previous, they've set up what's called the Parental Guardian Platform that allows parents to screen their kids and ensure that they're not playing too many video games, NetEase set up something similar where parents can reach out to online game monitors and say, "My kids are playing too much, can you remove their IP address." It's like the companies are saying, "Look, the problem aren't guns, the problem is gun education so, parents need to educate their kids on how to use a gun."

Siyu Liu:

The industry has been there for a while, right? And for the larger ones that we see such as Nintendo or Electronic Arts, none of them really proactively admitting the addictiveness of video games. They really just put the responsibility on parents for underage user's prevention, but we see that companies whenever there is... Electronics Arts had a controversy in one of their games that involved loot boxes, which is considered gambling feature. But they were also being very defensive about it. There's the lawsuit still ongoing, they probably got penalties but that's it. So, the whole industry is definitely not proactive, very reactive in terms of these social responsibilities. So, it will probably need to come from regulations or from active engagement on these topics.

Mike Disabato:

Regulations are coming because this is definitely an industry wide problem. China does have the most restrictive regulation out there sure. But, all over the world, there is more concern around the addictive qualities of video games and regulations and lawsuits are being brought against these companies. For example, South Korea had this 2011 Youth Protection Revision Act, would stop those under the age of 16 from playing after midnight, that was a recently abolished. The UK and the United States had to try and curb what Siyu was talking about there, these things called loot boxes and they're video game in game sealed mystery boxes and you can earn them sometimes through playing or you can earn them by playing money and you open them up and you get a random collection of items. And they've been seen as being the similar to gambling for your mind, kids are getting addicted to them.

And even the World Health Organization has gotten into the discussion. In May 2019, it classified gaming addiction as a mental health condition named gaming disorder, and member nations are expected to adopt public health approaches to introduce treatments and preventative measures starting in 2022. So, the problems might just be beginning, but largely video game companies as Siyu said, haven't really been proactive in trying to calm this onslaught and they might not do anything until they're forced by people like investors, but do investors actually care about this? Well, to answer that question, I called up Joseph Williams a colleague of mine that deals with our company screens, which are tools investors can use when they don't want a company with a certain revenue generation in their portfolio and I asked him whether he has seen investor concern around video games?

Joseph Williams:

I absolutely think so. We actually now have a screen under our adult entertainment for instance theme, that captures companies that are involved with explicit content in video games and we've also received requests from investors around either loot boxes, which are an interesting invention of the video game industry and then also around just general mature content, violence and so forth.

Mike Disabato:

Now, mature content has definitely been a thing on people's mind for a long, long time that's why we got the mature ratings set on video games. But Joseph also talked about the fact that

investors have been looking to engage more on maybe the addictive properties of video games. The one hindrance to this though, is that it's difficult to know which games actually have addictive properties because, when a company puts out a new game, it's hard to tell if it's just a beautiful story that's as addictive as a good book is or a good movie or if it's a game that preys on the impulsive young mind that hasn't yet developed an adult impulse control.

Joseph Williams:

The reason why we haven't expanded our offering is because it's very difficult for us to parse out what a game includes and there's a lot of different requests around, we want to restrict games with loot boxes. Well, we'd have to go and play each one of those games or do research on each game that the publisher actually puts out there in order to determine that. Another example, we want to restrict games that that show gratuitous violence. Well, what's the definition of gratuitous violence? That's difficult to depart. So, that's really one of the main reasons why we haven't built out the screens in more detail but, if we do continue to see this interest and this pressure, I would say that we will need to provide at least some additional level of granularity in relation to video games.

Mike Disabato:

You might be thinking, well, who cares about the video game industry? This is a little kid or younger adult situation but, the video game industry at this point in 2021 is a behemoth, it's bigger than movies at this point and it sucks other industries into its orbit. YouTube and Twitch generate revenue from video game streamers. Esports is now a billion-dollar industry that is growing about 15% per year. Discourse a popular communication channel for gamers is looking to broaden itself and compete with the likes of WeChat and WhatsApp. There are now shows and movies with tie end to video games, the oddest being The Angry Birds Movie. And speaking of Angry Birds, phone giants like Apple are pushing into the video game industry as well. In fact, Apple is actually being sued by Epic the maker of the popular video game Fortnite, for allegedly using its control of mobile operating systems to stymie competition.

So what does that all mean? It means this industry is sprawling, but that doesn't mean there can't be investor and consumer backlash or companies don't do enough to promote the more positive things about their games, storytelling, education and empathy building exercises for example. And if they only focus on the things that make them a lot of money, but turn their industry into a pariah and cause parents to worry about the soft malleable minds of their children, then these companies might be in trouble. And the reason I think that is because, full disclosure here, I play video games and a lot of my cohort plays video games. So, when they turn into parents, they will have a much better understanding of what these video games are about, how to limit their kids from playing them and how to be worried about what might happen if they play them too much and it might cause a problem for video game companies in the future.

All right, this week we're going to do a big finish type ending for this episode on the various governance moves happening around this week in the investment world. Shout out to Pardon

the Interruption on ESPN for doing this always, and I've got my very own old man interlocutor and all round brilliant person, Ric Marshall to help me with this. So, Ric, here's the first one, Monro a massive auto services and tire centers company has an extreme version of unequal voting rights for its shareholders. Any resolution approved by common shareholders must also be approved by a 60% majority of its class C shareholders and right now, the last remaining class C shareholder was a man named Peter Solomon who's an 81-year-old investment banker who has served as director of Monro for 37 years. Despite holding shares representing only 2% of Monro's outstanding equity, Mr. Solomon effectively controls the company in that he can unilaterally veto any item put before a shareholder vote. What happens Ric when a man has all this power?

Ric Marshall:

Well, actually Mike, this really isn't all that uncommon. We we've talked about this before. There are quite a few companies out there in virtually every market where control is held by single individual. We see it especially among founder firms and especially among high-tech companies, but we see it all over the place. What makes this situation so unusual I think is the means of control, which gives Solomon absolute total control, even though he only holds about 2% of the outstanding equity that's exceptional. I think what makes it even more interesting though is as an investment story is his age, at 81 and the length of service that he's had at the company's 37 years of involvement and let's remember that this is in a company that's in an industry, the automotive industry whose future can hardly be considered a slam dunk strategically.

Mike Disabato:

Right. So, MicroStrategy a software giant that is the largest us corporate investor in Bitcoin is among the 2% of the MSCI USA index, that's just index we have of the top companies in the US but nothing to worry about there, with no female directors as of August 2021. Do you think this will last out?

Ric Marshall:

Well, this is also a really small board with five members currently. So in theory, at least it shouldn't be all that difficult for them to diversify. They'd add some female directors. The real question here from my perspective is probably not so much a matter of will they diversify, but rather what happens when they do, what will a diversified board mean to a company like MicroStrategy which has some other interesting features like heavy investment in Bitcoin for example, how will diversification of the board change this company? It's coming, but what will that mean for MicroStrategy investors?

Mike Disabato:

They tried it a couple of times but both female directors left. So, WH Group Limited a large Chinese pork producer that also owns a number of American pork operations. So, it's 81-year-old chairman stepped down recently after his son was ousted as deputy chairman and company vice president, after he punched a door and banged his head and punched the glass

cabinet in a dispute with his father. Does this family fuel drama put WH Group in operational jeopardy?

Ric Marshall:

Unfortunately we see these family-based dramas all too often. It's a common feature of family firms. Sometimes they work things out, but just as often these situations signal the beginning of a major transition for the company. Despite its size, this could be a company where the family firm operation, the family firm governance has seen its end and this will transition ultimately into a more typical widely held company. Well, let's not forget that great many of today's largest widely held companies started out as founder firms then transitioned into family firms and ultimately became the widely held firms that we know today. This is just the essence of the ownership journey for a lot of companies.

Mike Disabato:

It's True. It also reminds me of Succession, which I think is coming back in a month I'm very excited for that. Last one and another family drama, Molson Coors the beer making giant behind Coors beers is jointly controlled by the Molson family in Montreal, Quebec and the Coors family of Golden Colorado in the US. Do you think this cross border marriage will continue to work?

Ric Marshall:

Completely different situation here, it's like night and day. This kind of cross border two family managed situation is really quite rare and exceptional. But so far it's worked really, really well and the risks that we saw often arise like we're seeing at WH Group, have been completely absent. I think we'd have to say that the Molson family and the Coors family working together collaboratively have managed those risks in a very appropriate and effective way. This is a study in what family firm governance can be.

Mike Disabato:

That's it for the week. I want to thank Siyu and Joseph and Ric for joining me to discuss this week's news with an ESG twist. I want to thank you so much for listening, I always appreciate it. Don't forget to rate and review us wherever you get your podcasts and of course subscribe so you can hear us every week. Have a great rest of the week and I'll talk to you soon.

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