Honey, I shrunk the votes!

This is the first of a series of posts on the day-to-day E, S and G challenges and dilemmas that I encounter as an investor. Naturally, actual listed companies feature as case studies. All opinions in my posts are expressed in a personal capacity and not attributable to my current or any past employer.

This edition focuses on dual/multi-class share structures that confer voting rights disproportionate to the corresponding economic interest. Such structures are frequently employed by founder-led tech companies: Google, Facebook and Alibaba are a few examples. Outside of tech, Berkshire Hathaway is perhaps the best-known issuer of dual-class shares.

Advocates aver that multi-class shares offer investors an opportunity to participate in exciting new businesses while preventing distractions to the founders in the pursuit of their long-term vision. Critics counter that the providers of capital require commensurate accountability and such non-democratic structures shield the founders from ramifications of their own mismanagement.

One such dual-class issuer, GDS Holdings Ltd *(Nasdaq: GDS, HKSE: 9698 HK, Mkt Cap: ~USD17bn)*, recently hooked my attention. The GDS CEO, Mr William Wei Huang, controls 50% of the voting rights with a 5% financial stake. That is by virtue of his owning 100% of the company's Class B shares that have 20x the voting rights of its Class A shares.

Founded in 2001, GDS is the largest developer and operator of hyperscale data centres in China. Through these, it provides infrastructure services to companies in the IT/Internet, financial and telecoms sectors.

GDS' data centre business is highly capital-intensive. It entails large upfront investment in physical infrastructure with expectation of steady returns in subsequent years. To finance its growth, GDS has already raised equity four times since 2016.

1. A USD200mn IPO on NASDAQ in 2016
2. USD329mn additional offering in 2018
3. USD460mn additional offering in 2019
4. USD1.9bn equity issuance in Nov-20 *(while pursuing a secondary listing on HKEX)*

STT GDC, a subsidiary of Temasek-owned ST Telemedia, has been an investor in GDS since 2014. It owns a 33% financial stake, but only 17% of the voting rights.

The presumable rationale for the stark imbalance between ownership and voting rights is that the GDS CEO is the key visionary and therefore that the company is best served by maximizing his control. But with its limited track-record as a listed company, the following thoughts spring to mind:

- In a normal corporate setting, the risk accountability of executive managers is ensured by the owners' control and an ultimate authority to replace them. The latter is missing in this instance. Is this a setting for moral hazard: the incentive to take greater risk when one does not have to bear the full cost of that risk?
- Most Internet-related or IT businesses are funded in the early phases by venture capital and private equity, and an IPO is often the culmination. Thus, not only is capital raising a secondary rationale for the IPO, but subsequent rounds of public equity issuance are also uncommon. Certainly, they are seldom as frequent as GDS' four equity-raises in as many years. Who drives the underlying business here - capital or the key-man?
- As the business matures, the concern of external investors distracting the founder-CEO should be gradually quelled. Certainly, there is no conceivable rationale for the heirs to the CEO's shares to have the same disproportionate control over the company. So, even if the current imbalance is somehow justifiable, shouldn't there be a sunset clause on it say, five- or seven-years into the future?

Two short-sellers - Blue Orca Capital in Jul-18 and J Capital Research in Apr-20 – have variously accused GDS of overstating its financial performance and overpaying for acquisitions from related parties. On both occasions, GDS management promptly and emphatically rebutted the allegations. The

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recent HKEX listing is seen as further evidence of GDS' accounting practices and financials being able to withstand scrutiny.

GDS is currently not a member of any stock index but given its market cap and liquidity, it may be a candidate for inclusion in future. While retail investors and most active money managers have the choice of investing in a stock, passive managers are obliged to buy once it is included in their respective indexes.

Therefore, the tail risks inherent in such a distorted voting structure are worth examining closely. The following are not insinuations but simply possibilities under the current GDS control structure.

Expropriation and leakages. GDS already has had to endure allegations of acquisition of third-party data centre assets at inflated prices, and undisclosed related party transactions where company personnel have been on both sides of the transaction. Despite strong rebuttals by the company, such concerns are unlikely to go away completely.

Eventual disenfranchisement of minority investors. GDS appears set to continue funding its growth with public equity for the next few years. But when the time to harvest a stream of steady cash-flows comes, what if it decides to go private?

A few recent privatization bids spring to mind:

- Tencent-backed 58.com *(WUBA US)*, the largest online-classified company in China, is the first. In mid-2020, a consortium comprising 58.com's CEO and existing PE investors, with tacit support from Tencent, bulldozed an opportunistic, low-valuation privatization through. The minorities were left with no avenue to dissent. In advising minority shareholders, ISS said, "Process that led to buyer's group was *flawed* and the result *questionable*; value offered to holders is *out of sync* with WUBA's historical valuation relative to peers and doesn't provide a control premium to the intrinsic value… there's little apparent downside to voting against a deal".
- Less than two years after an Apr-19 IPO at USD12.5 per ADS, the founders of KOL-incubator Ruhnn Holdings *(RUHN US)*, are privatizing the company at USD3.5 per ADS. The founders controlled 89% of the voting rights with a 44% financial stake, so the privatization, once announced, was a foregone conclusion.
- A story with a partially happy end for the minority investors was GLP *(GLP SP)*, a high-profile logistics infrastructure operator that was privatized in 2017-18 by a consortium led by its CEO. Critically, GIC Singapore held a 37% stake in GLP and was seeking an exit too. That helped ensure that at least a modest privatization premium was paid. In direct contrast, the PE investors and Tencent had stayed on in 58.com, thus directly benefitting from the cheap buy-out of the public investors.

Reading through GDS' public filings, it is not apparent to me if its voting minority (= the economic majority) has the ability to dissent on a buyout valuation if, hypothetically speaking, the CEO decides to take it private.

GDS' ESG reporting, meanwhile, paints a positive picture of it being environmentally conscious and socially responsible. MSCI assigns it an *Average* Corporate Governance as well as Overall rating in a 140-company cohort. Similarly, Sustainalytics rates GDS' Overall and Corporate Governance risk as Medium in an industry group comprising 1,024 companies. The sell-side too, is near unanimous in its approval of GDS: as on date, 23 of 24 coverage analysts have a buy rating.

To conclude, GDS is ultimately a capital-dependent infrastructure leasing business. Its prospects may be promising, but the glaring misalignment between control and financial ownership cannot be justified. A provision to align the voting rights of its Class A and B shares, say in five years, may be a pragmatic solution at this stage: the CEO would get a free pass to implement his vision but with a clear expiry date.

As a disclaimer, this is not a recommendation to buy or sell any security. I do not have any direct or indirect financial interest in GDS, or any other company mentioned in this note.

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