China Briefing

Ant crushed?

Executive summary

1. *The recent Ant decision is not a kneejerk reaction to a speech but rather a salvo in a long-running regulatory fight, which spans not only finance but also anti-trust.*
2. *While Ma and Ant lost this battle, they have considerable advantages for the long-term war; even if Ant is treated as a finance not a tech firm, it will still be formidable.*
3. *The final outcome is bad for Ma, Ant and their bankers, yet unlikely to harm investors. China's financial system should expect a flood of foreign money.*

Ants famously can withstand pressures up to 5000 times their own weight. One would imagine that Ant Financial founder Jack Ma—the entrepreneur who built the USD 700+ billion Alibaba Group, Ant's parent company—felt a similar burden recently. Ant's dual Hong Kong and Shanghai IPO, set to be the world's largest yet, was scheduled for Thursday last week. But just two days prior to this, the Shanghai Stock Exchange announced that they had suspended Ant's listing. Later, an Exchange spokesman told an interviewer that this delay was due to Ant's "hurried" push to IPO. But was it? And will it happen again? In this briefing we outline the structural dynamics behind the suspension, and what we think will happen next.

Mad at Ma

The simplest theory for Ant's suspension is that Jack Ma himself needed to be reined in.

The "blame Ma" idea came from a speech that he gave to a high-powered Shanghai finance summit on 24 October. Ma began by saying "I'm retired. If you think what I'm saying is crazy, just pretend you didn't hear it", going on to say that "systemic risk" was not China's main problem and that the global Basel Accords are an "old people's club". So China's biggest risk is that it "lacks a financial ecosystem" and that its banks are like "pawn shops", some so big that they were not allowed to fail. "As the Chinese like to say, if you borrow 100,000 yuan from the bank, you are a bit scared; if you borrow a million yuan, both you and the bank are a little nervous; but if you take a 1 billion yuan loan, you are not scared at all, the bank is". Regulation, he argued, was standing in the way of solving problems with technology.

Reuters quoted that "Several senior financial regulatory officials were furious at Ma's criticism ... one source characterising the speech as a "punch in their faces". Foreign media reported a flood of regulatory action. The cabinet office of China's government compiled a report on public sentiment about Ma's speech and submitted it to senior leaders including President Xi Jinping. Reuters reported that "top Chinese leaders then became more involved and asked for a thorough investigation of the company's business activities, which eventually led to the halting of the world's biggest IPO".

Ma was punished 2 November, 8 days after his speech, dragged in to see regulators with two other members of the Ant board. On the same day, Beijing issued draft rules on online micro lending, curtailing some of Ant's consumer credit businesses. And the next day came the big shock: the Shanghai Stock Exchange suspended Ant's listing on its Star board, citing Monday's meeting and subsequent regulatory changes. Ant then said in a filing it would suspend its Hong Kong IPO as well.

Blaming Jack Ma is simple and easy. Characters make stories. And Jack Ma is a great story. His rag to riches yarn inspires millions. He's also extraordinarily charismatic (the author was once nearly crushed by a group of 20 students jostling for a selfie with him). So in the aftermath of the surprising suspension, most of the rumors centered on his actions, including a recent duet with a famous Hong Kong chanteuse, his wearing of imperial robes (albeit in blue rather than vermillion), his rock star status... the list went on.

But Ant was punished; not Ma himself. China has shown no hesitation going after wealthy and powerful individuals, regardless of the companies they may run. Xiao Jianhua, for example, was an extremely well-connected tycoon living in the Hong Kong Four Seasons on a Canadian passport until he was taken by Chinese officials in 2016. If Beijing had a problem with Jack Ma rather than Ant, they are far more likely to focus their ire on him directly.

Rather, Ma misjudged. He staked his cards on a game of regulatory poker. He pitched Ant as a technology company that worked on finance, rather than as a financial services provider. This makes sense when you are listing; tech firms are worth more. But Ant holds more financial licences than any other financial institution. This is a long-running saga. When financial regulators dealt with this problem six years ago, trying to get rid of the now-ubiquitous QR code, Ma reportedly used his connections with the central government to get what he wanted. The second time has not proven to be the charm.

No matter how fresh Ma's comments may seem—and trashing your regulators in front of two of the eight most powerful people in the country, as he did in his speech, is an unusual way of making friends and influencing people—they appear more reacting to events rather than driving them. That is because Ant was facing a far more difficult regulatory environment than its July IPO prospectus outlined.

Revenge of the Regulators

Ant's most recent suspension is not the first time they have had regulators step on their toes. They were forced to exit both the credit assessment and money management business due to fears about financial risk and about privacy. And, more broadly, as a former Chinese central bank governor put it: "if the private sector wants to participate in providing financial infrastructure, it must have "public spirit"... the willingness to serve the public interest, which means the company will not use the privilege and advantage gained from the infrastructure it provides to seek profit.

So the Chinese state has a number of regulatory aims for Ant, all of which co-exist. Financial regulators want stability, a goal often overlapping with state-owned banks desire for the status quo to continue. China's leaders want economic growth and for credit to be available to China's dynamic private sector. These multiple conflicting goals can, on occasion be used for regulatory arbitrage.

In early September, Ant was provided notice of new regulations that would require any company owning more than two financial businesses to register as a financial holding company. Under these rules, Ant could not fully claim to be a technology company. These rules were foreseen. Proposed in 2019, they were acknowledged in the Ant prospectus. Ant said that they planned to register such a financial holding company.

This was just one of a range of activities. The Wall Street Journal reported also seeing a private notice sent to commercial banks "warning them about the risks of making loans in partnership with third-party institutions... banks should not be outsourcing their loan underwriting and risk controls". Another set of regulations were also released limiting how much asset-backed securities that could be issued by microlenders.

All of these regulations went straight to the heart of Ant's success. Ant currently has two micro-lending firms, Huabei and Jiabei, that contribute 40% of its revenue. Neither of these currently have consumer finance licences. They take loans from banks, usually small banks or private banks, and issue asset-backed securities (ABS) in the market. This capital provided small unsecured loans to about 500 million people over the past year at, academic estimates put it, 15% interest annualised. The leverage was 100 times the original bank loans.

Ant's business model rises and falls on how much it must set aside. Currently, when Ant partners with banks to make loans, the lenders provide the funding and bear the risk of defaults, while Ant collects fees for facilitating the transactions and bringing the clients. If Ant is unable to make loans in partnership with others, then it will need to keep 30% of the capital on its books, as per draft rules unveiled on Monday (before the Ant IPO was suspended). Ant only takes about 2% of loans on its own balance sheet. The rest comes from third parties or, as discussed above, is bundled as securities and sold on. Ant currently has the equivalent of USD 321 billion in credit balance outstanding to consumers and small businesses. If Ant were to follow the draft rules issued by the central bank regulator on Monday, they would have to set aside 95 billion yuan in capital, or 2.7 times the current capital for its two micro-lending arms, according to Jefferies estimates.

None of this battle is new. It comes in the wake of a long-running squabble between the tech giants and the state as to who should be allowed to assess creditworthiness. However, regulations such as those discussed above usually take around one year to draft. So why did Ma misstep?

Most probably, he underestimated the power of the regulators. The last time he had this fight and won, in 2014, he relied on the fact that China's banking regulators do not have direct channels to the top like he does. Financial regulation in China remains a long way from decision making. China's central banker does not sit on the committee of the 25 most powerful people in the land. Its financial and insurance regulator do not have a clear person in charge, instead splitting responsibilities across two people, one of whose meetings are not made public.

But in 2016-17 China made clear that it wanted to strengthen banking regulations. Xi Jinping made financial risk one of his "three critical battles". It set up a special Financial Stability and Development Committee, put Xi Jinping's trusted lieutenant in charge, and gave it a direct reporting line to the government. Coordination improved. Ma's run around the outside of the regulators proved less successful. Figure One overleaf describes. The khaki lines, new committee and new regulators were all new additions, made after the last stoush between Alibaba and financial regulators.

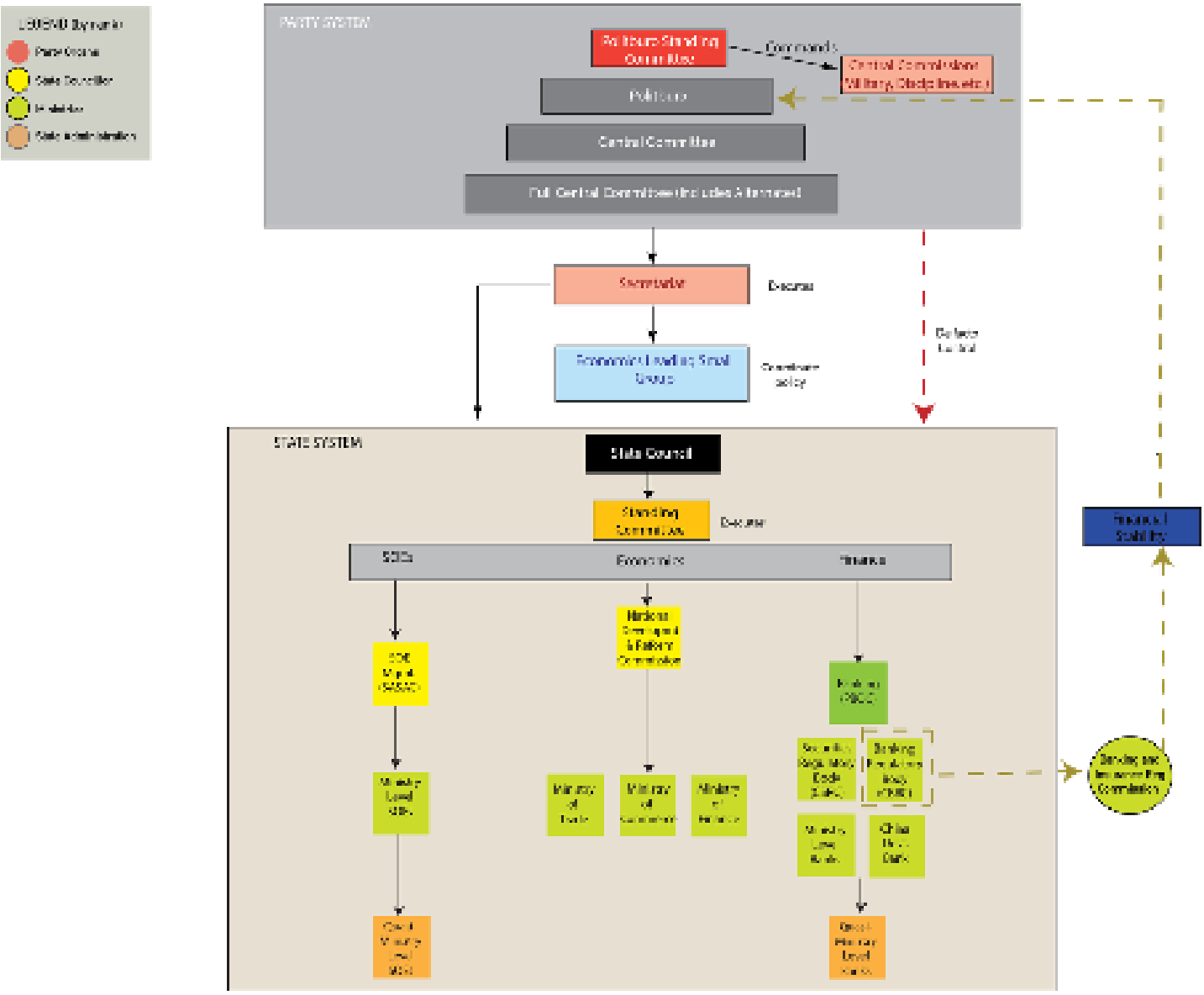

Figure One: China's economic and financial regulatory system, central level

Indeed, it was the new Financial Stability committee, headed by Xi's trusted interlocutor Liu He, that responded to Ma's speech. Liu spoke on 31 October, before Ant's suspension, calling for "proper supervision to effectively manage risks while also encouraging innovation". Publications backed by the central bank also printed editorials criticising Ma's speech, similar to their last fight. Unlike the last time, the People's Daily, the official newspaper of China's leaders that acts as a kind of newsletter letting the world know what they think, republished the central bank editorials.

Also different from 2014 was that Ant was trying to go public. Ant's IPO was oversubscribed by some 873 times. Tens of thousands of households took out loans to buy Ant shares. Should the IPO have succeeded, and then the financial regulations bit, then these mom and pop investors would have lost money. Moreover, the government would have lost policy flexibility; once listed, the genie could not be put back in the bottle, even for Alibaba.

Given this, one can put themselves in Ma's shoes here: while regulatory risk existed, he had trumped it before. And dealmakers from Citigroup, JP Morgan, Morgan Stanley, and CICC (China International Capital Corporation), who would have made an estimated USD 400mn from the float, knew that a technology company would be more popular than a financial services company (telling brokerages that their internet and technology analysts should cover the deal, rather than financial services analysts). Given this, he probably thought why not roll the dice and keep talking about Ant as a tech company?

The end of the battle, not the war

The People's Daily commentary on Ant's listing said that it was suspended to "safeguard the rights and interests of financial consumers and investors, and for the long-term healthy development of the financial market." It is this idea of long-term healthy development that we see as more critical to Ant's future prospects, greater than the impact of this suspension.

Undoubtedly, Ant will now become a very different company in structure and in balance sheet. Its regulatory environment will appear more like that of a financial services provider and less of a tech company. Its growth will slow. Its market valuation will decrease.

But amid the froth, the state needs Ant. Why? Because Ant makes products, and creates marketplaces. Ma's speech was right: China's big four state banks are not designed for tech innovations. These banking behemoths have a 58 percent share of loans and an even higher share, 61.5 of deposits. These deposits can be used to loan to state firms, and these loans are a much greater proportion of total lending than small unsecured loans such as those offered by Ant. There are few incentives to innovate.

China's regulators may want to reduce their risk, but it's not clear that China's bankers want to loan. Bloomberg's Ren Shuli writes for example "it's been so difficult for small businesses to obtain bank credit in the last decade that they have become hard wired not to invest for the future. Here's the latest tidbit of evidence: In the third quarter, even as China's economy recovered and 86% of 300 smaller manufacturers CLSA spoke to became profitable, most remained wary. A record-breaking 59% of their capital expenses went into mere 'regular maintenance,' the brokerage found."

Ant talks to these businesses. It leads. For small businesses or consumers who do not have access to credit, it created its own bank (as did a number of other tech giants). This follows a "3-1-0" rule: you apply in three minutes, get approved in one second, and have zero human interaction. The delinquency rates are between 1-2%, although they have crept up over 2 this year. Such a low rate for a robo-approval process is staggering.

Figure Two: How Ant sees its business model

Ant, however, was built for Alibaba itself and has incredible infrastructure. Take payments. While PayPal processed USD 712 billion in 2019, Alipay saw USD 17 trillion stream through its pipelines in Mainland China alone.

The 'intelligent decision making system' in Figure Two is very impressive. As Ant notes, it forms a loop with all of AliPay's many other products that helps make better and better decisions, due to AliPay's extraordinary data access across many areas of one's life. According to their prospectus, they "assess their creditworthiness on an ongoing basis and dynamically adjust credit approval process and limits." What is unspoken but undeniable is that Ant's greatest weapon is the threat of cutting off access to AliPay. It is hard to underestimate how valuable access to AliPay is to one's daily life. Figure Three below shows all of the things that can be done through AliPay. One's life can and is lived just on AliPay (or on its great rival, WeChat). The threat of losing this lifeline provides a strong enforcement threat.

Figure Three: All Ant all-over—how Alipay is at the heart of daily life

China's need to embrace efficient credit provision, and Ant's competitive advantage both mean that in the long run, it is hard to see any competitor other than Tencent (makers of WeChat). We think Ant knows that. In a statement after its IPO was suspended, Ant pledged to "embrace regulation." Ant will need to apply for new licenses for its credit business to fully comply with regulators and be regulated as an entity under financial holding company rules. At present only 4 firms qualify.

That is because regulating China's microfinance industry will help Ant. China currently has several hundred companies, and they have around USD 135bn of outstanding loans; that itself is a reduction from several thousand only a couple of years ago. There are only 250 licensed microcredit firms. These firms will now have their loans capped and will need to keep at least 30% of loans "jointly issued" with commercial banks on their balance sheet.

Ant, however, will be given 12 months to comply with these new rules. It will have a first mover advantage, in addition to having the process knowledge already of how to build up a credit ecosystem (Figure Four overleaf shows how complicated this is). Possible e-commerce rivals such as Pinduoduo will face significant barriers to entry, and far greater scrutiny as they attempt to catch up to Ant.

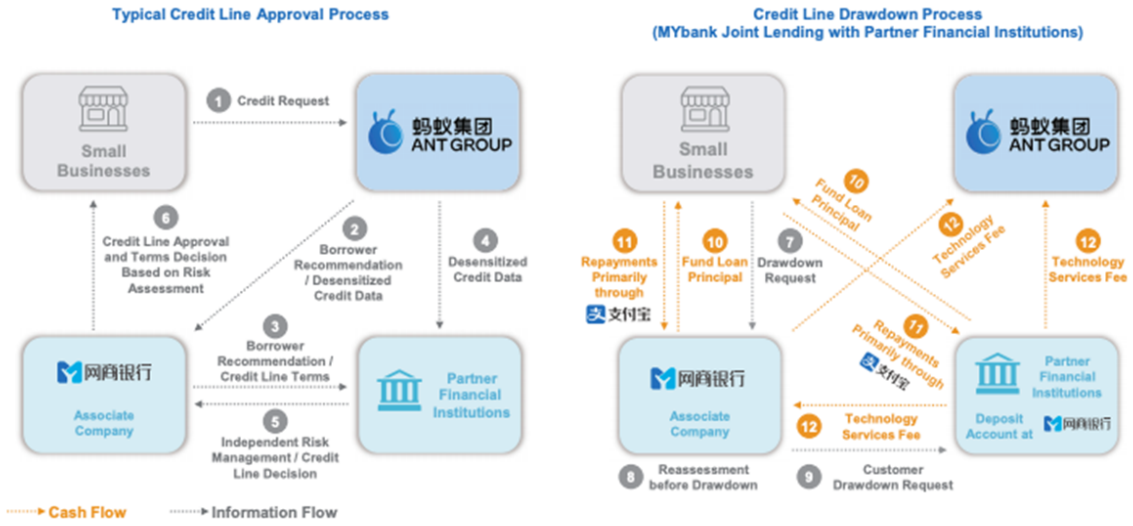

Figure Four: The Ant credit line ecosystem

What comes next?

This delay is unlikely to be fatal to Ant going public; it shall probably re-list in the future. Many mega IPOs, including those of companies such as Aramco and Facebook that are similar size to Ant, have shaky starts. And Ant itself was carved out of Alibaba's own IPO: so one can see a similar future whereby the insurtech, fintech and payments parts are each split into their own business and given their own IPO.

Rather, as this week's antitrust draft rules make clear, Ant is just one part of the constant ebb and flow between tech giants needing to show regulators their "public spirit" and also gain yet more share of China's ferociously competitive market.

Probably the more direct impact will be on China's exploding TMT ecosystem. Although Ant likes to emphasise its role in expanding access to credit among small businesses, in fact much of its lending business is in unsecured consumer credit. If small loans become harder to access then e-commerce (including the booming livestreaming industry) and gaming, the cash cow of its rival Tencent, are also likely to be affected. Tencent itself is also likely to push Ant. In the wake of Tuesday's shock decision Tencent quickly issued a statement on how they fully supported the new regulations. Its WeChat Pay function is even more ubiquitous than AliPay, and its mergers and acquisitions team yet more active. (Note that Silverhorn has written a number of briefings already on Tencent and its role in Chinese society and finance based on our participation in Tencent's partnership funds; these are available upon request).

China's tech giant duopoly is in this way rather stable: Alibaba and Tencent both have very good products, strong network and platform effects and high profit margins in financial services provision. They threaten the big banks, and indirectly some well-connected elites, who need access to capital. If either became a monopoly, they would be likely to be smashed. But while they have each other—and can set prices and develop ecosystems with that in mind—China's market remains incredibly lucrative.

The next faultline is about the management of data. Both Alibaba and Tencent, and their spinoffs Ant and WeChat Pay, hold vast amounts of user information. To the government, this needs to be carefully managed and regulated. A senior regulator warned in an official editorial against "fintech companies abusing their hegemonic position", saying that they should use data to help people rather than serve their own interests. This is particularly the case under China's new Civil Code, covered in our July Silverhorn Briefing.

This data privacy issue will possibly worsen for Alibaba and Tencent when they go outside China's borders. The Bank for International Settlements has previously warned about how big tech can become major cross-border payment systems, arguing that regulators should hold them subject to the same strict regulations that apply to banks. (This may explain Ma's anti-Basel broadside). But data privacy issues, especially with regards to fears of China, could hinder expansion throughout the rest of the world. What may occur is that the Chinese model or technology is used, and often by Chinese companies, but localised in place, such as Southeast Asia.

Finally, in the wake of the Ant decision there has come a lot of talk about China's overall financial market development and attractiveness to foreigners or institutional investors. We see China as being in a sweet spot right now. Its bonds have a much higher yield than US treasuries. Its domestic innovation push is a boon for tech companies, many of which are listed in Hong Kong or US exchanges. The implementation of the new QFII rules just last week basically means that "access" is no longer the problem when it comes to China. Literally any foreign fund manager can get money in, and more importantly get money out of China. And so there is about USD 900bn invested by foreigners in Chinese equities and bonds at the moment. That is a big number, but it is well below what would be expected for an economy of China's size and development.

Perhaps then we can leave the last word to the speaker who followed Jack Ma at the financial forum, Ray Dalio, who argued that global investors need to have "a significant portion" of their portfolios in Chinese assets. We don't see the Ant postponement squashing that.

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