Weekly Geopolitical Report

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An Ant Problem

Although the U.S. elections were the major story during the first week of November, another notable, but somewhat overshadowed, event did occur, namely, when Chinese regulators forced Ant Group to suspend its initial public offering. Ant Group, an affiliated firm of Alibaba Group (BABA, USD 294.04), was preparing to launch an IPO. The listing, estimated to be $37 billion, would have been the largest IPO in financial market history. The new stock was to be listed on the Shanghai and Hong Kong exchanges, shunning New York and London. Investors flocked to the expected new issue, leading to a massive oversubscription of 870x, or $2.8 trillion. The IPO attracted preorders from investors as broad as sovereign wealth funds to individual investors. Many of those small investors borrowed money to purchase shares. There were rumors that some Hong Kong broker/dealers were allowing investors to borrow up to 20x their initial stake.

Given these conditions, the decision to pull the IPO was surprising. In this report, we will offer background on Ant Group. We will discuss the concerns of regulators and examine the motivations for such a controversial and potentially damaging decision. This decision will likely undermine foreign investor confidence in China's regulatory regime and impact Beijing's attempt to woo investors into China and internationalize its currency. As always, we will close with market ramifications.

Ant Group

As previously mentioned, Ant Group is a company affiliated with Alibaba Group. It was previously known as Ant Financial. Ant Group owns Alipay, China's largest digital payment platform. It is used by 80 million merchants and has one billion subscribers. Perhaps the way to think about the company is that it didn't start out to be a financial firm. Instead, Ant Group developed organically to support the retail activity of Alibaba. Ant Group facilitates $17 trillion a year in transactions. As it assisted Alibaba's customers in making purchases, it found that it needed to expedite transactions between buyers and sellers on its platform. In 2004, Ant's financial services were first developed out of this need. Soon after, Alibaba's holding of escrow funds for purchases evolved into Yu'e Bao, which is now a $173 billion money market fund with 650 million members. Its loans to consumers and small businesses were $314 billion at the end of Q2. Its credit business has two loan wings, *Huabei*, which acts like a credit extension for purchases, and *Jiebei*, which provides small loans. Over the past 12 months, these two services combined had 500 million users. Most of these personal loans are capped at $300. But, in the rural interior, this amount may exceed a month's income. With a maximum interest rate of 15%, this sort of lending begins to have the look and feel of payday lending in the U.S. It may not be enough to threaten the financial system, but it could become a political problem given how many users it has. Although investors were unnerved by the decision to pull the IPO, many applauded the move, viewing Ant Group as something of a predatory lender.

Part of the reason Ant Group grew so quickly is that China is underbanked. About 460 million people, or about 47% of the population older than 15 years old, lack formal bank credit histories. The Chinese banking system is heavily regulated, and the largest banks tend to transact mostly with state-owned enterprises (SOEs). As Alibaba discovered 16 years ago, average Chinese citizens were unable to easily use the banking system to borrow money or make transactions.

As Ant Group has grown, regulators have had a wary eye on its activities. There are two reasons behind this concern. First, the rapid growth on both sides of the financial balance sheet creates the potential for risk. Money market funds are runnable—in other words, if investors panic and withdraw their funds at once, there is the potential that depositor funds could be lost. In addition, it is unclear what holdings are on the asset side of the fund's balance sheet. In the West, money market funds tend to hold short-term sovereign and highly rated corporate paper. In China, it is not clear if such assets are available. But, in a run, assets have to be liquidated quickly and this may not be possible given the level of development of China's financial system.

Second, with regulation, there is usually an element of regulatory capture. This term expresses the fact that, over time, the regulator tends to come under the sway of the regulated. Often, employment opportunities can be limited in an industry and the next job opportunity for a regulator is within the industry they regulated. This gives regulators an incentive to cooperate with the firms they regulate. Second, the data needed to regulate a firm usually comes from that industry; an adversarial relationship may make it hard to acquire information. Regulatory capture can lead a regulator to champion the goals of the firms they regulate, especially against disruption.

It would make sense for Chinese banks to try to undermine Ant Group's growth and the most effective way to accomplish this outcome would be to force the company to be treated as a bank, not as a technology firm. From the regulators' viewpoint, the ever-growing size of Ant Group does pose a risk to the financial system. Still, given that the IPO coming to market was a record, it seems rather radical to suspend the sale. So, how did this happen?

The Confrontation

Banking regulators have been concerned about Ant Group for some time. But, given the size of the firm and the stature of Jack Ma, the co-founder of Alibaba and Ant, we suspect that conversations were ongoing but in the background.

All that changed after Ma gave a speech in late October where he strongly criticized regulators. He accused them of "regulating an airport using train station rules" and described the Basel accords as "an old people's club." These comments did not sit well with regulators. It should be noted that the meeting's headline speaker was Wang Qishan, a close ally of General Secretary Xi. Wang spearheaded Xi's anticorruption campaign in his first term. Ma was clearly going up against highly placed members of the Chinese Communist Party (CPC). Wang's speech centered on the need to maintain financial market stability.

Open confrontation with state officials is rare in China, mostly because when it does happen the state generally wins. Thus, it remains a mystery why Ma decided that confronting regulators in an open forum was a good idea. There are several theories as to why this occurred:

1. It is possible Ma was a victim of internal government infighting. It is not at all unusual for regulators to have differing ideas on the path of regulation. Ma may have been assured that his position had support within the government and thus he was safe to confront officials. Ma may have been the "tip of the spear" in an internal fight and the faction wanting easier regulations lost.
2. It would also fit that Ma simply overplayed his hand. U.S. tech entrepreneurs are famous for "moving fast and breaking things." Ma's history with Alibaba and Ant Group would fit this pattern. When faced with an obstacle, he has moved to create solutions. Starting Ant Group to facilitate transactions was a bold step; fostering it to create a massive money market fund fits the pattern as well. His personal history "favors the bold." What he may have misunderstood is that Alibaba and Ant have gotten so large that when such firms take aggressive steps, it has significant ramifications and creates systemic risks.
3. Ma may have been desperate and was hoping for "an appeal to the emperor." In Chinese history, there is an element of making appeals to the head of state when one feels aggrieved by local officials. Regulators were making it clear they wanted to regulate Ant Group as a financial firm instead of a technology firm. Ma knew that regulating Ant Group in this fashion would reduce the value of the firm and thus he was resisting that outcome. He may have concluded that he was going to lose the regulatory fight if he stayed quiet, so he opted for a public demonstration, hoping the leadership was on his side and would overrule provincial financial regulators. If this was his motivation, it was a serious miscalculation; reports indicate that General Secretary Xi made the decision to pull the IPO.

Of the three, we suspect the third option is the most likely. It is true that technology entrepreneurs everywhere tend to run roughshod over regulators. In the U.S., tech mergers have skirted the borders of antitrust violations and the ride-sharing industry essentially ignores local licensing regulations on livery and state labor laws. In some respects, regulators were giving Ma something of a pass to allow the IPO to move forward. And, in Ma's defense, regulatory risks were mentioned in the prospectus. Nevertheless, given the degree of demand for the IPO, it is clear that these risks did not deter investors. At the same time, it is more likely Ma knew the regulatory regime was about to change so he was "working the refs" to get a better deal. Perhaps, in the end, he will.

The Reaction

After Ma's remarks, regulators moved swiftly, "inviting" the CEO and several of his corporate officers to a meeting. Although the official statement suggested the gathering was merely "regulatory interviews," reports suggest Ma faced a "*yuetan*," or a dressing down, from regulators.

Although the proximate event was Ma's speech, in reality, regulators were growing increasingly uncomfortable with Ant Group's leverage and reach. It simply may have been a matter of time before Ant Group was going to face financial regulation instead of tech regulation. Ma's speech simply triggered a reaction that was likely going to occur at some point.

What now?
There are several questions that need to be answered—if and when will the IPO occur and what will be the new price? We do expect the IPO to occur but it will likely take several months. However, the value of the firm will likely be significantly less than expected from the initial offering.

In order to encourage credit quality, Chinese banks usually retain at least 30% of their loans on their balance sheets. Ant Group holds about 2%; it sells most of the loans back to the banks and borrows deposits from banks to make the loans. It also charges a 2.5% fee for each loan it arranges. Because it only holds a small amount of loans on its balance sheet, it has less incentive to press for strong credit quality and has every incentive to expand lending. This 2% level is a form of leverage, improving Ant Group's profitability. If Ant Group is forced to hold only 20% (although 30% is more likely) on its balance sheet, analysts estimate its valuation could fall by 45% to 50%. It is estimated that Ant Group's P/E multiple was around 48x; if it is regulated as a bank, the multiple would be more in the range of 12x. It is clear that the regulatory framework for Ant Group will change and it will have an adverse impact on its valuation.

Ramifications
Although we doubt the decision to halt the Ant Group IPO was planned in advance, the fact that the Xi administration was willing to do so at such a late date is a strong signal about the priorities of the Chinese government. The IPO would have been the largest in financial market history, larger than Saudi Aramco (222, SAR 35.35). The Ant Group issue was wildly oversubscribed. It was to be listed on two Chinese exchanges, excluding London and New York. On every level, it was a major win for China, a sign that it was in the "major leagues" of finance. For a country that has been trying to lift its financial status with aspirations of its currency competing for reserve status, this IPO was a step in that direction.

Although regulators were clearly and legitimately concerned about Ant Group's risk to the financial system, no one in the government was willing to step in and require changes at the company before the IPO was approved. Given the high expectations that surrounded the sale, the decision to pull the offering makes Beijing appear petty and unreliable. Investors of all sizes had participated in the presale; brokers are now having to return funds to small investors.

And yet, despite the bad faith it projects, the fact that Chinese officials were willing to accept this loss of face suggests that a more important goal had to be met. That goal is that the CPC is dominant and cannot be questioned. As the Ant Group debacle unfolds, other major Chinese tech firms have seen their equities tumble on fears they may be Beijing's next target.

Xi's government has a history of bringing the wealthy to heel. Xaio Jianhua, who ran the Tomorrow Group, was seized in Hong Kong in 2017 and emerged this summer to say he was working with the government to unwind his company. Wu Xaiohui, who married the granddaughter of Deng Xiaoping, led Anbang Group, an insurance company with assets held around the world. Anbang ran afoul of Beijing and Wu is serving an 18-year prison sentence for fraud. Ren Zhiqiang, another property developer, was sentenced to an identical prison term; although the charges were tied to corruption, his arrest coincided with his criticism of the Xi government's handling of the pandemic, calling President Xi a "clown."

The common theme in all these arrests is that the Xi government will not tolerate entrepreneurs being critical of the CPC government or becoming too powerful in the eyes of Chinese leaders.[1] It doesn't matter how rich or powerful, or even the impact on markets or world opinion of adverse actions, there is no protection from the CPC. Jack Ma's error was engaging in public criticism, but his stature has made him a target as well. The CPC under Xi will not tolerate dissent or anyone forgetting that the ultimate power in China is the communist party.

There is a clear signal being sent and it is a cautionary tale for investors—the CPC is paramount and will not hesitate to intervene in markets if it feels its interests are being threatened, regardless of the costs. This situation presents a problem for investors. China is the world's second largest economy. The country's equities dominate the emerging market equity indices. It has a massive impact on commodity prices. The U.S. and Chinese economies are deeply entwined; even a U.S. domestic equity portfolio would likely be touched by China. China's level of foreign reserves gives it influence in the U.S. Treasury market.

Completely avoiding China in investing is difficult and may not be practical. Accordingly, this means investors must manage the risks surrounding the attitude and behavior of the Xi regime. That doesn't necessarily mean kowtowing to everything China and the CPC says, but it also means understanding that anything potentially negative for the CPC will have ramifications; investors should be aware of this balance. For example, Canada's arrest of Meng Wanzhou, the CFO of Huawei (002502, CNY, 2.92), has led to a deterioration in Canadian/Chinese relations. Australian criticism of China's attempt to influence Australian legislation and Canberra's call for an investigation of the origins of COVID-19 have led to retaliatory measures from Beijing, from restrictions on commodity sales to the ouster of journalists. So far, the actions taken against Australia are more symbolic than effective, but China is expressing its displeasure.

So, what should investors do? If completely avoiding China isn't practical, then careful monitoring and diversification are the best alternatives. We don't anticipate a change in China's behavior, and we do expect its impact on the world economy will remain significant. At the same time, the Ant Group event is a clear sign that China is willing to inflict harm on financial markets and its reputation to protect the position of the CPC. For investors in China, *Caveat emptor*!

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[1] For example, recent changes to China's antitrust policy have adversely affected some technology Chinese equities.