

Week of 9th November 2020

What's on our mind this week?

Addressing the elephant in the room – The Ant

On 3rd November 2020, Chinese regulators suspended the A share listing of Ant Group on the STAR board at the eleventh hour when it was about to be listed. On the same day, the Hong Kong stock exchange announced the suspension of Ant Group's concurrent H share listing. The last minute cancellation of the largest IPO to ever take place around the world was a decision that only the very top of the Chinese government could have made given that trillions of RMB had already been committed and paid by investors, both in China and outside of China and that it was an extremely high profile IPO that had put China under the spotlight. All boxes had been ticked by the company during the IPO preparation. There had not been any oversight by regulators, sponsors, underwriters, lawyers etc. The due diligence was properly undertaken. This is not a botched IPO leading to a blame game exercise. It is much bigger than that.

The decision to cancel the IPO we believe was triggered by a speech made by Jack Ma at a conference in Shanghai on 24th October during which he characterized the Chinese banking system (and for that matter all banking systems in the world) as one that is outdated, that stifles innovation and that is in need of a profound transformation. What is more startling is that Jack Ma's remarks came after Vice President Wang Qishan, a Xi confidante called for a balance between innovation and strong regulations to prevent financial risks. According to him, the traditional way of lending that is based on collateralization of assets needs to be replaced by a system based on big data and artificial intelligence. This is Ant's business model.

The existing size of Ant's lending activities coupled with Jack Ma's open willingness to revamp the Chinese banking sector, if not to replace it, all of a sudden appeared as being a threat to China's banking system, and therefore as a threat to China's financial stability. It is very likely that when it made its decision, China's leadership had in mind the 2007 subprime crisis in the US that almost triggered the implosion of the US banking system had it not been for the US government and the Fed's decision to take extraordinary measures that, nevertheless, triggered a global crisis.

China's leadership, on the back of the wake-up call it had, decided at the last minute to take systemic, and we would argue courageous measures that, if anything (a) show where authority resides, (b) bring Ant under a greater scrutiny of PBoC and CBIRC regulations, which it was not previously, and (c) amend lending rules by requiring that Ant keep on its books 30% of the loans it gives out, versus 2% at present, which is a profound change to Ant's business model as it will force Ant to operate as a traditional bank, which is precisely what Jack Ma wanted to escape from to implement his vision.

We believe this has great implications as banks and financial institutions are believed to be too comfortable with Ant facilitating the loans while Ant has no skin in the game with no downside risk. This could have potentially developed systemic issues with respect to credit quality over time. By involving Ant's balance sheet significantly in the credit underwriting process going forward, the government has addressed this potential systemic risk.

Cancelling the IPO was the logical consequence as the change of business model is likely going to have a material impact on the future growth of the company, its return on equity, and the valuation given by the market. The Chinese leadership took the view that these changes had to be done before any pain was inflicted on hundreds of millions of retail investors who would have had reasons to blame the government for a post-IPO change of the rules. Of course, this wake-up call could have and should have happened long before the IPO process was launched last July. "Better late than never" was probably the conclusion reached by China's leadership which we believe is understandable given the stakes involved.

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