

A VIEW FROM ASIA



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- Chinese regulators stepped in to suspend Ant Financial's highly anticipated IPO a couple of days prior to its listing in November
- While the immediate negative sentiment will wash out over time, Samir takes a look at the broader implications for China's stock market and his portfolio

JOHCM Asia ex Japan Fund

Contumacy: stubborn refusal to obey or comply with authority, especially disobedience to a court order or summons.

A shocker

My remit is not politics. Yet everything is politics nowadays. Look no further than the suspension of the highly anticipated IPO of Ant Financial (AF). That it happened after attracting US\$3 trillion in demand, and a couple of days prior to its listing, is unprecedented. None of us is privy to the actual reasons, but we could try connecting the dots.

There is little doubt in my mind that the decision was taken either by, or after conferring with, President Xi Jinping. Perhaps intervention from the government was to be expected. Ten days before it happened, Alibaba founder Jack Ma took to a conference stage in Shanghai to deliver a stinging rebuke of regulations that according to him "stifled innovation". The company soon came in for a deluge of criticism on Chinese state media. Commentators faulted Ant for straying from its core payments business and called out Big Tech generally for misleading users to consume beyond their means. Guo Wuping, head of consumer protection at the China Banking and Insurance Regulatory Commission, said fintech companies used their market power to set exorbitant fees. There are some wild conspiracy theories floating around as to the timing of the IPO suspension. One of them (and in no way do I endorse or verify this) was that the IPO shed light on the existing shareholders (and some very large prospective ones) of AF, allowing the authorities to go after those branded as corrupt or not in sync with the regime's thinking.

An elegant solution...

Starting out as a convenient solution (an escrow account for buyers and sellers reluctant to trust each other on Alibaba's Taobao platform), Ant grew into a behemoth in the financial industry. There were several drivers of this success. Notable amongst them were an innate entrepreneurial and technological bent of mind; a blank slate to disrupt staid companies; and a superior service which provided convenience and cheaper costs for users. Over just 15 years, Ant established a foothold across almost all sub sectors of finance.

Providing access to financial services for the marginalised in society, democratisation of credit, and connecting rural parts of the country to a technologically sophisticated online commerce system were national priorities, too. It is no exaggeration to state that the payments, logistics and ecommerce industry in China is the most modern in the world. Recently there was a discussion paper on curbing the monopoly power of large technology firms. In my opinion, apart from data privacy (which is a nebulous concept in China), there is no aspect of business immune to the brutality of market-based competition. If you need any proof, witness the rise of ByteDance or Pinduoduo, which have become immensely successful platforms in their own right, despite the perceived monopoly of Alibaba and Tencent.

...leads to undesirable outcomes

Yet the same technology and connectivity leads to severe excesses. Technology delivers convenience but can quickly morph into an addiction. Complaints abound on the harmful effects of social media and the time devoted to online games. In

finance the ill effects could be as harmful for the economically vulnerable. Simple one-click access to loans can be useful in times of need, help small businesses get access to credit once considered impossible, yet lending taken to extremes can be detrimental. In China, the phenomenon of peer-to-peer lending took off in 2012/13. Ultimately, that unbridled boom in unsecured credit by lending platforms were snuffed out by 2018. There were no rules in an emerging industry. Cheap capital and gung-ho attitudes resulted in a mushrooming of lending platforms. Each tried to raise deposits at high cost and lent money with gay abandon, claiming their sophisticated systems could calibrate risks. That, as it turned out, was not the case.

A bit different

AF was not in the same bucket as P2P platforms. Initially it expanded from payments to providing easy access to money market funds and investments for active users of Alipay. With vast amounts of aggregate data on spending and investing patterns, it created a credit scoring system and expanded into lending. It too is a platform, connecting those with deposits or savings and borrowers in need of funds. Its systems are sophisticated. All publicly disclosed metrics on risk and loss ratios in the IPO prospectus prove that it had good granular data and risk management abilities. Yet its scale differentiated AF. Not just its absolute scale but also the rate of growth of loans through their system was staggering. In 2020, despite Covid-19 (or maybe because of it), loans grew close to 50% year-on-year. Therein lies the problem. AF has good systems and risk management but virtually none of the risk of bad debts. When those risks arrive, banks will own them, not AF.

To draw a parallel, compare the post-bubble Japanese banks. Several rural and agricultural banks in Japan had increasing deposits but few profitable lending opportunities. In a low rate, low margin environment, they increased risks by famously buying collateralised debt obligations and collateralised loan obligations in the early 2000s. It did not end well for them. Somewhat similar are the rural and state-owned banks in China. With their old economy customers struggling, profitable lending opportunities had shrunk. They do not have the sophistication or the ability to build a retail bank. Up steps AF offering banks a mechanism to increase loan yields by lending to customers on AF's platform from the farm to the coast. The only catch? AF kept a third of the margins and none of the risk of non-performing loans (NPLs). Sure, as of now, AF's risk management is good. Yet no country has avoided downturns and the ensuing problems of rapid unsecured lending.

A desirable move with broader implications

That is why, in my opinion, the regulator stepped in to force AF to change its business model. AF will now be a quasi-finance firm not a pure technology firm. Under new regulations, AF will need to co-lend 30% of every loan, provision for potential NPLs and build capital buffers similar to other financial institutions. It is safe to say the valuation of AF will be 30-40% lower than at IPO. Finance firms are valued differently than tech firms. Additionally, its staggering growth will flatten. All in all, the move to impose these new regulations was prudent. We can debate the timing of the suspension, yet there would be criticism no matter when the regulators imposed new rules. Individual investors were protected

from losing money and larger investors would have been critical about the arbitrariness post facto.

This move has broader implications for China's stock market. The immediate negative sentiment will wash out over time. The authorities are suggesting a diametrically opposite approach to the economy to the one taken in 2008/09. Back then, the stimulus spigots accompanied frenzied lending. The wanton loans, the white elephant projects, the overbuilding in property and rise in general indebtedness is surely a lesson too recent to forget. If so, there is a ripple effect on the economy with slower but hopefully better quality of growth. Recent unwillingness by the People's Bank of China (PBOC) or the central government to bail out regional state-owned enterprises defaulting on bonds is another subtle hint. China's 10-year government bond yield, at 3.3%, is close to mid-2019 levels. Free liquidity (growth in money supply adjusted for growth in nominal GDP) is falling. All these are additional pointers of caution in the near term on China's stock market.

After a blistering rise from the lows of March 2020, valuations for several firms are well above historical trends. That was the primary reason driving me to reduce exposure to China's "A" share market in the past two months. The macroeconomic factors I describe above are likely to induce more caution. I have also reduced our holdings in Alibaba, recognising the changed business metrics for AF. The underlying business remains good, yet valuations are fair. For the portfolio overall, as the chatter around a rotation to value gathers momentum, that tilt is somewhat reflected through the changes over the past couple of months.

JOHCM Asia Ex Japan Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	30.11.20	30.11.19	30.11.18	30.11.17	30.11.16
A USD Class	35.13	11.60	-21.47	25.90	6.70
Benchmark	25.56	8.13	-9.87	35.17	7.22
Relative return	7.62	3.20	-12.88	-6.86	-0.49

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg, NAV of Share Class A in USD, net income reinvested, net of fees as at 30 November 2020. The A USD Class was launched on 30 September 2011. Benchmark: MSCI AC Asia ex Japan NR (12pm adjusted). Performance of other share classes may vary and is available on request.

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