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snapshot

FLEECY CLOUDS: THE FUTURE AND THE PAST OF IPOS IN MAINLAND CHINA

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Mainland China's capital markets are not entirely akin to their Western counterparts: the regulator of the two stock exchanges (the Chinese Securities Regulatory Commission, or CSRC) is directly affiliated with the government; the main players are state-owned enterprises (SOEs) rather than private corporations; and political and economic stability are prioritized over the liberalization of market forces. Recently, the connection between politics and financial markets has been under global scrutiny due to the blockage of the IPO of Ant Group, magnate Jack Ma's fintech giant, by Chinese elites fearing an excessive risk of volatility.

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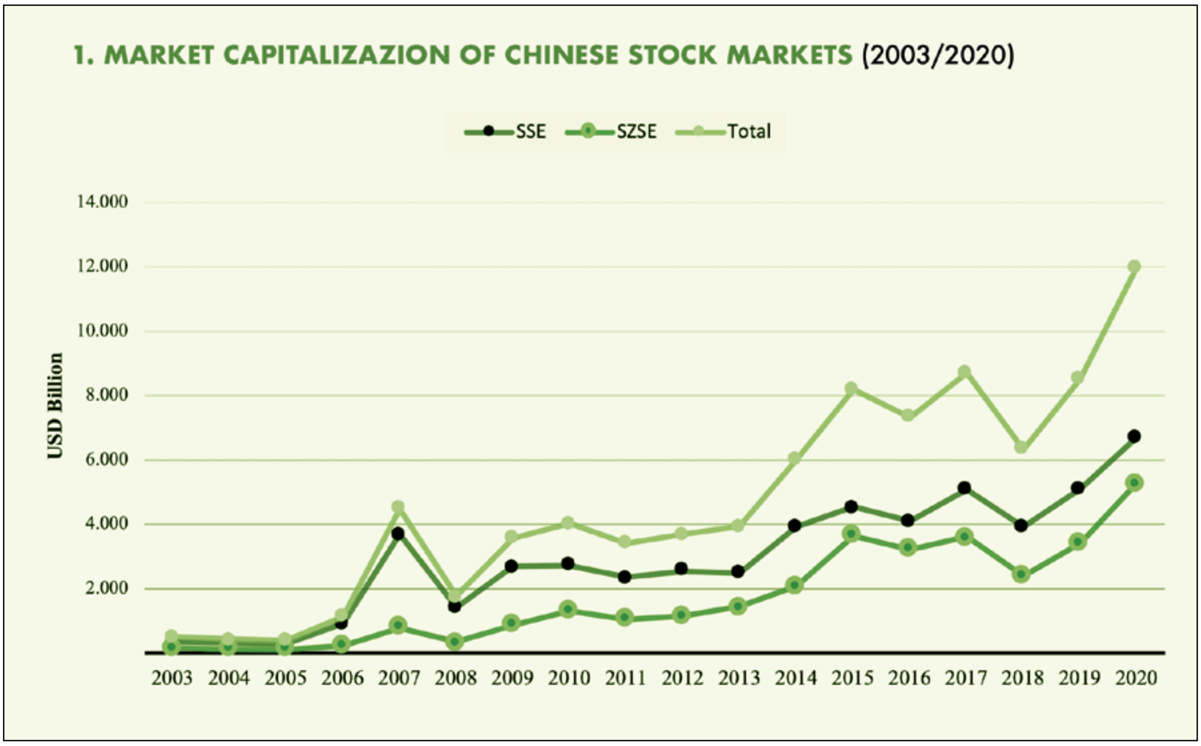
Such a decision should not be regarded as a major policy change, but rather as a reinforcement of the status quo: the mainland stock markets were both created in 1990 to bottle up the chaos that characterized the eighties, a decade marked by a lack of regulation of the sector and by decentralization. Since then, the IPO market has been closed a total of eight times by the CSRC, and thus the halting of Ant's listing is more noteworthy for its size and abruptness than for its novelty. The grip of the Chinese Communist Party (CCP) on mainland financial markets has varied in intensity over the years but has never faded away.

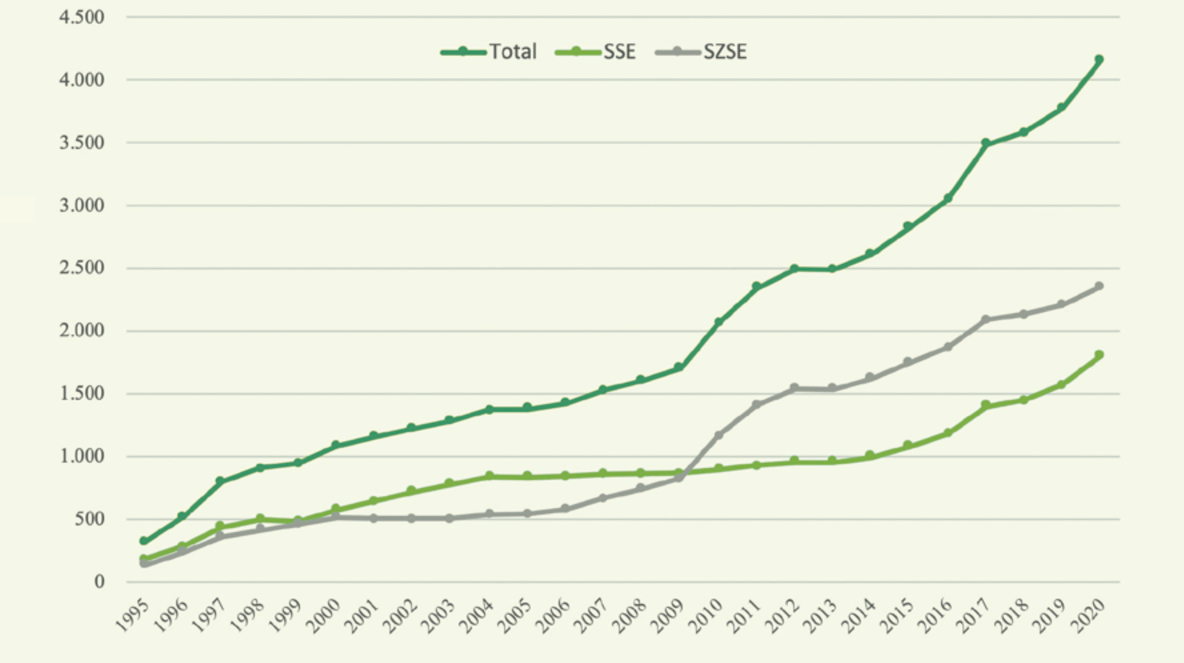


World Federation of Exchanges, Shanghai Stock Exchange (SSE), Shenzhen Stock Exchange (SZSE). Own elaboration. Year-end data, converted to US dollars end-of-year exchange rates.

While the political aspect of Chinese finance is currently attracting widespread attention, it is but one side of the coin. To try to predict what kind of future awaits, we will analyse recent developments in the context of a larger, and ongoing, process of reforms. From 1990 to 2020, the Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE), the two central equity markets, grew in size at an astonishing rate. The number of total listed firms on mainland exchanges increased from 323 in 1995 to 4,156 as of January 2021; the overall market capitalization[1] of the SSE and SZSE combined rose from USD 512 billion in 2003 to almost USD 12 trillion at the end of December 2020. Gradual internal reforms, a constant feature of Chinese policymaking since Deng Xiaoping's ascent to power, have accompanied this unprecedented growth. One of the most controversial issues to regulate, for Chinese elites and the CSRC, has been that of the IPO process, a mechanism that is in perpetual evolution and that has ramifications for mainland China's financial markets as a whole.

[1] The 'market capitalization' of a stock market is obtained by multiplying the number of shares that trade on the exchanges by their current prices.

2. NUMBER OF LISTED FIRMS ON STOCK EXCHANGES (1995/2020)



World Federation of Exchanges, Shanghai Stock Exchange (SSE), Shenzhen Stock Exchange (SZSE). Own elaboration.

The evolution of the IPO process in mainland China

Between 1993 and 2000, IPO procedures in the SSE and SZSE were based on an annual quota system, with the latter being predetermined by the central government. Local administrators had to gather information and propose territorial companies as candidates for listing on the Chinese stock exchanges based on their performance. The national regulator would then decide, bearing in mind the centrally established quotas, which of the firms proposed by local governments would be allowed to undertake IPOs; the pricing was based on price to earnings (P/E) ratios,[2] and the CSRC did not allow the value to exceed 15. This system was useful as an initial instrument for market development in China, which lacked an advanced legal framework regulating IPOs. It also provided some incentives and competition among provincial administrators, which would in theory be pushed to select the most profitable enterprises as candidates for listing.

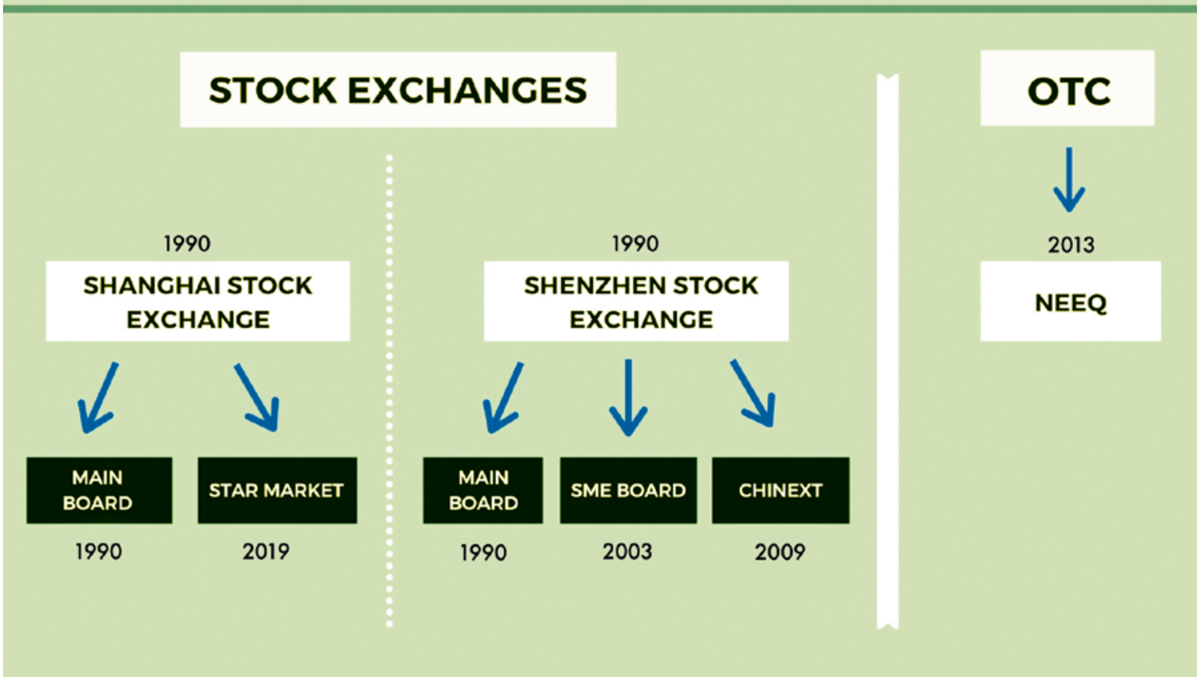
[2] The P/E ratio divides the market value per share of a company by its 'earnings per share' (net profit/number of shares outstanding). The higher the P/E ratio, the more investors are willing to pay for the same amount of earnings per share.

However, the procedure was inherently flawed: the conflict of interest was blatant, as local governments were both shareholders of territorial firms and the entities in charge of recommending them for listing on national exchanges. Quotas were abandoned in favour of a 'sponsor system' after China joined the WTO in 2001, an event that served as a push for market-oriented reforms. The new scheme was formalized by the third plenary session of the 16th Central Committee of the Communist Party of China in 2003. A sponsor, generally an investment bank, accompanies a firm in the process of going public both 'ex ante' and 'ex post': prior to the IPO, it is in charge of monitoring the corporate governance and financial health of the enterprise; after the procedure is concluded, it must keep on overseeing the finances of the interested firm. The CSRC regulates the sponsors operating in the markets, and remains the ultimate authority over who gains access to the stock exchanges. The institution has also relaxed control over IPO pricing based on P/E ratios, but reserves the right to intervene in the case of excessive swings.

The IPO process and the structure of mainland stock exchanges

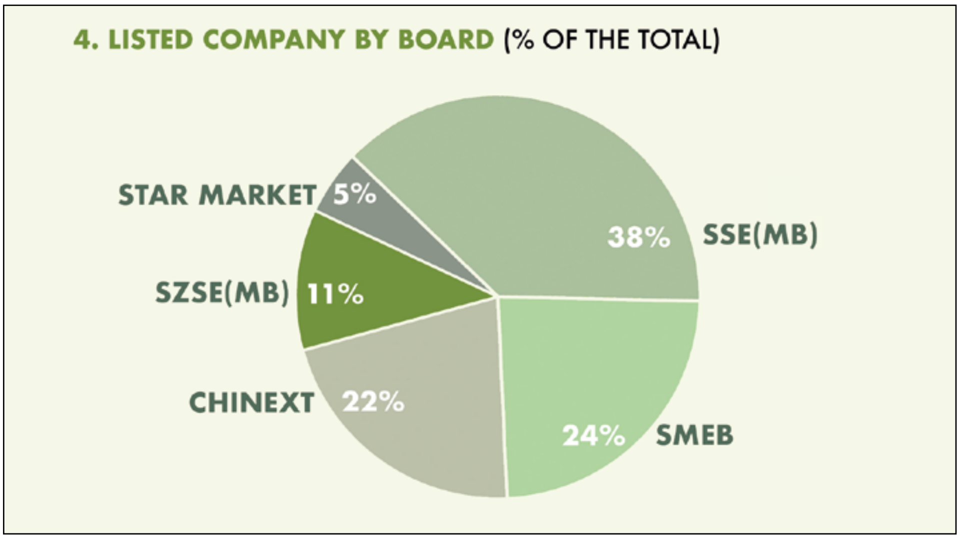
The IPO process in China presents various unique characteristics, and is troublesome in numerous ways: the selection of companies to be listed is influenced by the CSRC and is therefore not based purely on economic performance; the listing requisites on the main boards are quite strict and are based on historical data rather than value; the erratic attitude displayed by the CSRC in IPO policies often results in a 'waiting room' of firms aiming to go public; and private or smaller corporations experience difficulties when trying to access credit. Furthermore, leading academics have cited the interference of national regulators in the IPO mechanisms as one of the main contributing factors to poor overall Chinese stock market performances.

3. CHINESE STOCK MARKET STRUCTURE



Own elaboration. In parallel with the two central exchanges, a 'National Equities Exchange and Quotations' (NEEQ) over-the-counter (OTC) market was created in 2013.
It mainly functions as an incubator for official boards on the exchanges, such as the ChiNext.

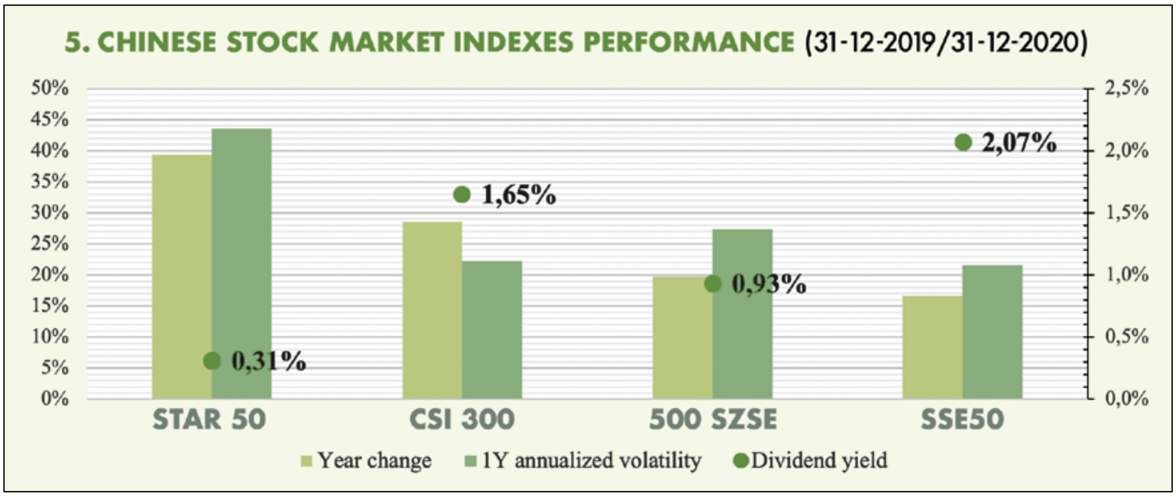
The CSRC is aware of these issues, and the reform of the IPO process has been rather high on its (very broad) list of priorities over the last two decades; the gradual establishment of markets with lower listing requirements than the main boards, namely the Small and Medium-sized Enterprise Board, or SMEB in 2003 and the ChiNext in 2009, was proof of the institution's commitment. The SMEB's aim was to provide financing for SMEs as an alternative to the Shenzhen main board, which was mainly reserved for larger corporations, while the ChiNext focuses on SMEs with high growth potential. The foundation in 2019 of the Science and Technology Innovation Board (also known as the 'STAR Market') which now runs in parallel with the main board in the SSE, is the most recent step taken by the regulator to promote market forces. The STAR Market hosts 5% (216) of the overall listed companies, and has a total capitalization of around USD 508 billion as of January 2021.



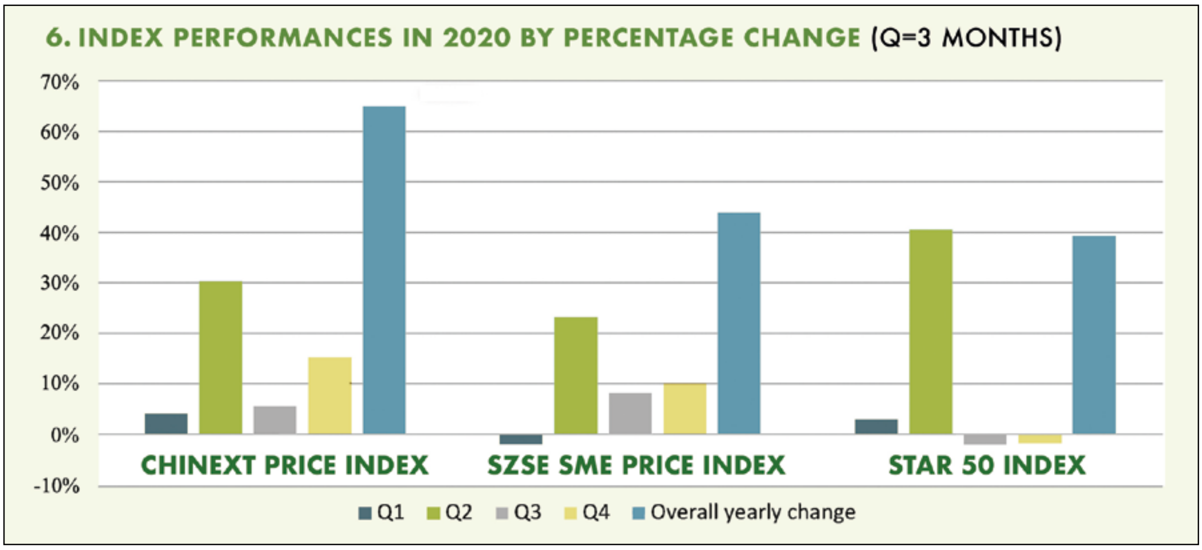
Shanghai Stock Exchange (SSE), Shenzhen Stock Exchange (SZSE). Own elaboration.

This approach represents a qualitative change from prior experiments and is a courageous step for the CSRC and the CCP to undertake. Previously, other mainland boards did not allow the filing of IPOs by firms who had unrecovered losses or were yet to generate profits; this led to the flight of numerous local high-tech companies to the Hong Kong Stock Exchange, the Nasdaq or the New York Stock Exchange (NYSE). In contrast, the STAR Market has offered from the day of its foundation a 'registration-based system' with an IPO pricing that is entirely based on market dynamics: this allows greater room for high-tech companies, which often lack a strong history of profitability but display high potential for growth. The success of the board, even in a year as troublesome as 2020, pushed the CSRC to implement a registration-based system on the ChiNext as well, from 27 April 2020,[3] prompting competition over which board can attract the most promising companies. Figure 5 details the performances of some of the main stock indexes in China: the STAR Market distinguished itself as having a high positive percentage change over the year (39.3%), while also displaying higher volatility and low dividend yield (as can be expected from a high-tech-focused board). Figure 6 compares the performances of the STAR Market, ChiNext and the SMEB from 31 December 2019 to 31 December 2020, highlighting trimestral percentage change in the relative indexes: the COVID-19 crisis had an impact on Chinese markets as well as global markets, but the positive year-end value for these three boards is undeniable.

[3] The SZSE official website:. Last accessed: 10 January 2020.



Chinese Securities Index Co., Shanghai Stock Exchange (SSE), Shenzhen Stock Exchange (SZSE). Own elaboration. The STAR 50 Index follows the fifty largest companies with the most liquid stocks on the STAR Market; the CSI 300 Index measures the most liquid stocks of the largest companies on both the SSE and the SZSE; the 500 SZSE Component Index follows the stock of the top 250 SZSE firms; and the SSE 50 Index follows the stock of the largest SSE companies. The left axis refers to annual growth percentage and the right axis to yield percentage.



Chinese Securities Index Co., Shanghai Stock Exchange (SSE), Shenzhen Stock Exchange (SZSE).
Own elaboration. The impact of the COVID-19 crisis is seen especially in Q1; the following three months show a rapid recovery. Year-end changes on the previous year are substantial for all three boards.
The ChiNext Price Index closed at +65%, while the SZSE SME Price Index registered a 43.9% increase.

Ant Group's business model and Jack Ma

7. ANT GROUP IN NUMBERS

1 Billion+ YEARLY ACTIVE USERS ON ALIPAY	**80 Million+** MONTHLY MERCHANT USERS ON ALIPAY
$17.5 Trillion+ TOTAL PAYMENT VOLUME IN MAINLAND CHINA (YEARLY)	**711 Million+** MONTHLY ACTIVE USERS ON ALIPAY
2,000 PARTNER FINANCIAL INSTITUTIONS	**200+** COUNTRIES THAT SUPPORT PAYMENT WITH ALIPAY

Ant Group prospectus published for the Hong Kong Stock Exchange IPO. Data updated to 30 June 2020. Own elaboration.

As the STAR Market offered a supportive environment, Ant Group saw the opportunity for a dual listing in mainland China and on the Hong Kong Stock Exchange, in what would have been the largest IPO ever recorded, with over USD 35 billion in funds raised. The process was abruptly halted by Chinese elites on 3 November, with sinologists and economists trying to interpret the reasons behind such a seemingly rushed decision. Two main motivations contributed to the blockage. The first is the business model of Ant Group itself, which presented a direct challenge to conventional banking and investment practices; the second is of a political nature. The origins of the company are to be found in 2004. At the time, Taobao, the immense online store managed by e-commerce behemoth Alibaba, did not offer a trustworthy method of payment for potential buyers and sellers, leading to mistrust among its users. Thus, the mobile payment platform Alipay was created by the company to facilitate exchanges: it was to function like a clearing house for a stock market, holding the buyer's money in escrow[4] until confirmation of delivery of goods was sent, minimizing risk. The experiment was so successful that it turned into a nationwide phenomenon: the platform became an affiliated company of Alibaba in 2011, only to rebrand itself as Ant Financial Services Group in 2014, and then Ant Group in June of 2020. Nowadays, the functions of Alipay are ubiquitous, with individuals, corporations and financial institutions alike having access to a wide array of services.

[4] **If something is held 'in escrow', it means that it cannot legally be released until certain conditions are met.**

At the same time, Ant has become an intermediary in the credit supply for small consumers and businesses, categories that are normally disregarded by conventional banks. The company, through its state-of-the-art algorithms, assesses the reliability of the borrowers and originates the loans, then transfers them to partner banks, which are the final capital providers. Ant charges a fee for its services but does not carry the risk of the operation (it only provides 2% of the total loan); this risk rests entirely on the shoulders of the banking sector and individuals. Analysts have compared such a business model to the mechanisms that prompted the 2008 US mortgage crisis.[5] National regulators were quite fearful of the consequences of such a system, and scrutinized Ant's actions over the last year, especially in the second half of 2020. However, after a one-week delay of Ant's IPO from 14 October due to investigations into conflict of interest, the CSRC gave permission for the domestic public offering on 21 October regardless of the possible dangers. The IPO valuation skyrocketed, as expected, with the listing being 872 times[6] oversubscribed[7]; what was not expected was the issuance by the government of the ruling that 'any loan-providing small business' should contribute capital of no less than 30% of the total loan.[8] The draft of the document was finished on 2 November, and it was published on 3 November on the government's official website, the same day as Ant's IPO was blocked. If Ant were to comply with these rules, its entire business model would be greatly undermined: the market value of the company would plummet from that of a high-potential fintech group to that of a traditional bank. What drove the CCP to react so strongly?

[5] George Calhoun, ***Why China stopped the Ant Group's IPO (Part 2): Ant's dangerous business model***, **Forbes, 16 November 2020.**

[6] **Reuters, *Ant Group's Shanghai retail book for $34.4 bln listing 872 times oversubscribed*, 29 October 2020.**

[7] **Oversubscription of an IPO happens when the demand far outweighs the supply of issued shares. If an IPO is 'oversubscribed 872 times', it means the demand is 872 times the value of shares available. This inevitably leads to higher prices or a further release in securities, resulting in more capital being raised for the company.**

[8] **The Government of China's official website,** 中国银保监会 中国人民银行关于《网络小额贷款业务管理暂行办法（征求意见稿）》公开征求意见的公告, **roughly translatable as 'Interim measures for the administration of online small loans (draft for solicitation of comments), public announcement for soliciting comment', article 15, subparagraph 3, 3 November 2020.**

The answer is the political challenge that Jack Ma dared to pose to national regulators, and to the CCP itself. On 24 October 2020, this majority holder of Ant Group delivered a speech, rich in metaphor but quite explicit in meaning, at a financial convention in Shanghai. Jack Ma,[9] once a champion of the People's Republic of China (PRC), infamously lamented the inexistence of a proper Chinese financial system and asked for a change in policymaking to favour the forces of innovation while letting go of the fear of instability. This initiated an arm-wrestling match between Chinese elites and the entrepreneur, culminating in a tense meeting between Ma and some of China's top financial officials on 2 November. That same evening, an article with the title *Don't speak thoughtlessly, don't do as you please, people can't act on their free will* was posted on state-run press agency Xinhua's official WeChat account. The column, while never mentioning Jack Ma directly, was accompanied by a painting titled *Fleecy Clouds*, depicting a horse-shaped cloud in a blue sky: the message was clearly directed at the magnate, whose name in Chinese is Ma Yun – literally, 'horse' and 'cloud'. Ant Group's IPO was officially blocked the following day. Since then, investors worldwide have been wondering what will become of China's stock exchanges, and whether market-oriented reforms are destined to continue or will suffer a setback.

[9] **For more information on Jack Ma's role in the company, refer to Ant Group's application form for the IPO on the Hong Kong Stock Exchange, p.131.**

Mainland China's IPOs and the international system

It is likely that Ant's IPO will not be withdrawn indefinitely but will be reproposed under new conditions in the future. What most matters is to understand both internal and international dynamics when discussing the Chinese reality. In October 2020, the fifth plenary session of the 19th Central Committee of the Communist Party of China adopted the CCP Central Committee's proposal for the delineation of the 14th Five-Year Plan (2021–2025): one of its most discussed aspects is the incorporation of the concept of 'dual circulation' into its guidelines. In this framework, 'domestic circulation' (internal economic activities) and 'outer circulation' (China's economic links with the outside world) will reinforce each other to strengthen economic development. However, the declared objective of such a strategy is to reduce the role of international trade in the PRC's economy and strengthen domestic markets; thus, Beijing may become more 'inward-looking' amidst the COVID-19-induced global economic crisis.

It is also vital to remember that the foundation of the STAR Market in July 2019, along with the decision to create a more welcoming environment for IPOs of domestic companies, came at a time of trade war between the US and China. It is apparent that the CCP is pushing for 'red chip' companies – Chinese-incorporated companies listed overseas – to come back to the SSE and SZSE, since fears exist of a decoupling between the PRC and the US. Such 'homecoming listings' could be favoured by the choice of the Securities and Exchange Commission (SEC) to delist Chinese companies traded on the NYSE or the Nasdaq. In addition, the new Chinese Securities Law, which came in force on March 1 2020, seems to signal a strong will on the CCP's part to systemically reform the IPO process to create a market-based system; nevertheless, the continuous commitment to enforce such measures will be the crucial element to assess the progress of market-oriented reforms in China. The evolution of relations with the US will also contribute to the PRC's policymaking. The newly inaugurated president of the US, Joe Biden, seems to prefer the promotion of positive relationships with the PRC, but he will soon be faced with epoch-defining strategical decisions, from both a political and an economic perspective.

To conclude, this snapshot suggests that researchers and practitioners should not necessarily focus on the failure of Ant Group's IPO, but rather on contextualizing the matter so that historical and systematic tendencies are highlighted. In the PRC, political dynamics will always prevail over market forces, but market forces will be fostered as long as economic stability is not put in danger. In that case, new regulations intended to curb instability will arise. The reform process will be gradual, its speed may vary over time, and the CCP will remain in control: whoever tries to 'proceed at their own speed', and become a formidable force in the process, must follow the Party's rules or else be forgotten.

THE AUTHOR

Alessandro Bonfratello graduated in international affairs from the University of Turin. He worked at the Consulate General of Italy in Hong Kong and earned a double degree from the Beijing Foreign Studies University. His research focuses on China's capital markets and available access routes for international investors.