In Case You Missed It: CSOP's Weekly China Wrap Up

Slower May M2 growth signals progress in deleveraging campaign, though New Loans up

China reported several noteworthy data points in May:

1. Money Supply M2 growth of 9.6% YoY; below consensus estimates and April figures[1]
2. RMB 1060 billion in Aggregate Financing; below consensus estimates and April figures[2]
3. RMB 1.1 trillion in New Loans; above consensus estimates and April figures

Deconstructing the results

The People's Bank of China (PBOC) attributed the M2 decline to reduction of systemic leverage via successful implementation of their desired 'prudent and neutral' monetary policy. So far this year, the PBOC has used open market operations to drain RMB 775 billion from the system, helping moderate the money supply while driving up funding costs. Although the PBOC has reversed course on several instances when conditions became too tight, they released a statement emphasizing that slower M2 growth will be the 'new normal' moving forward.

The slowing M2 growth is not the full story, however. The expansion of New Loans implies that the central bank is willing to maintain liquidity through traditional bank credit. Given that Aggregate Financing--which includes both bank and non-bank loans--shrank in May, it appears that the decline in non-bank loans offset the growth in bank credit. In other words, the PBOC is purposefully trying to squeeze funding from the shadow banking system back to regulated bank lending.

Recent policy decisions mirror this conclusion. So far in 2017, authorities have tightened regulation on over-leveraged players out of concern for the exploding shadow banking situation. The restrictions on brokerage pool businesses panicked market players, sending bond yields above the bank lending rate of equivalent maturity. As a result, China's net corporate financing has nosedived and local companies without access to banks are struggling to issue new bonds to rollover existing debt. Given the increasing cost of financing and the growing government tolerance for default, pessimists expect these trends to culminate in a wave of bond defaults.

China's banks to cease distribution of Anbang insurance products after Chairman taken into custody

Following regulatory instruction to cut ties with the insurance giant, six Chinese banks have reportedly ceased distributing Anbang Group products. Anbang has been in the spotlight this week after the company announced that Chairman Wu Xiaohui would step down from his position for "personal reasons." Local Chinese media reported that Wu was in police custody, though China's government has remained mum on the issue.

Anbang Group: A Brief History of the Trouble

Anbang Group launched in 2004 with USD 60 million of capital and, over the next decade, grew into a sprawling global behemoth with AUM exceeding USD 240 billion.[3,4] Wu Xiaohui is largely responsible for the success story. As the husband of the late supreme leader Deng Xiaoping's granddaughter, he deftly leveraged his connections and hard-charging personality to drive Anbang's swift rise.

In the past several years, Anbang borrowed RMB cheaply by issuing high-yielding wealth management products they claimed were insurance policies. To deliver the promised exorbitant returns, they invested product sale proceeds in high-yielding corporate bonds and real assets, embarking on a purchasing spree to scoop up banks, real estate firms, and traditional medicine manufacturers. Although Mainland authorities prohibit insurance companies from concentrating more than 15% of assets overseas, 60% of Anbang's portfolio is invested in foreign markets, according to the company's fiscal report.

Why crack down?

Wu is the latest high-flying financier caught up in Xi's anti-corruption dragnet, as policy makers frantically attempt to clamp down on systemic risk and slow outflows. Regulators initially focused their attention on Anbang in May, issuing rules that banned the highly-leveraged company from launching new products. The recent prohibitions on bank sales intend to further slow Anbang's growth. Given that almost 90% of the firm's products are sold through banks, the measures have had their intended result.

The takeaways?

Several things can be learned from the Anbang saga. One, the government is indicating that insurance companies must cease behaving like private equity firms and return to their conservative roots. The freewheeling acquisitions tolerated under the recently-ousted chairman of the China Insurance Regulatory Commission are no longer a viable business model. Two, the Anbang case provides yet another example that China's billionaires and top regulators no longer have a free pass. The government is proffering a new pecking order. They will readily quarantine insurance giants and protect banks in the instance that the former begin to teeter.

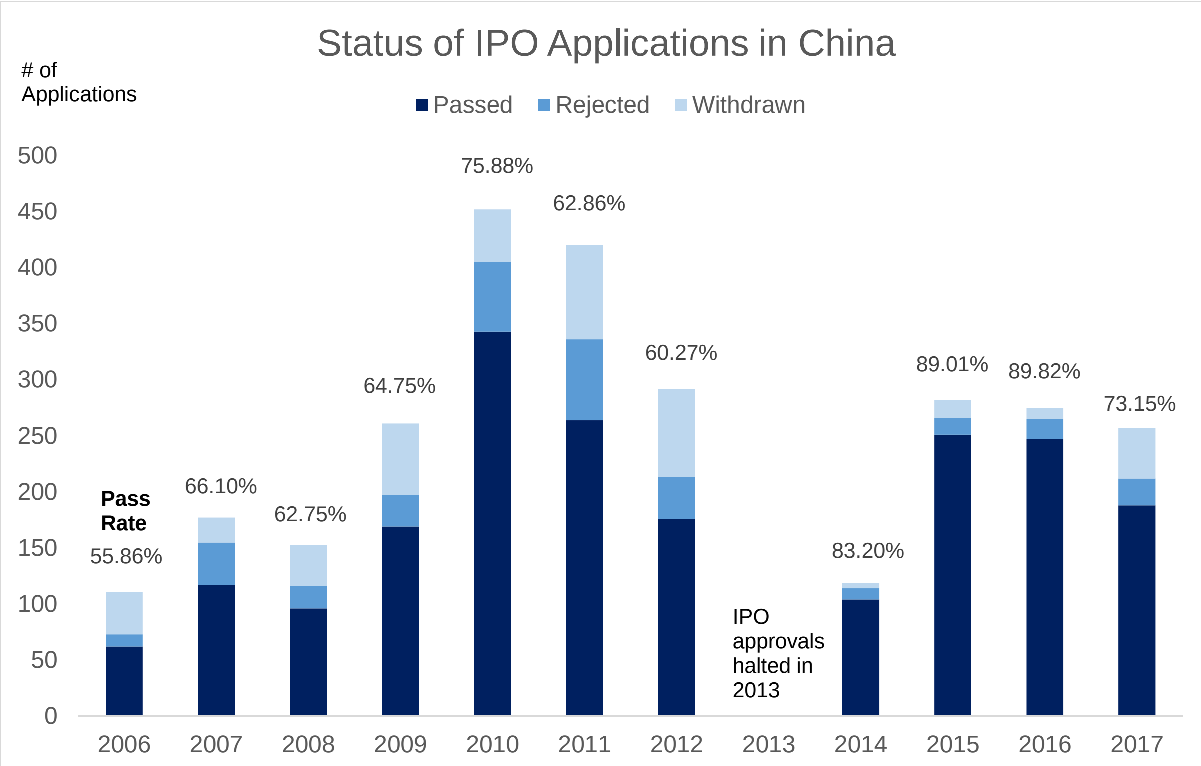
China's Securities Regulator rejects IPO applications at highest rate since 2013

The China Securities Regulatory Commission has rejected initial public offering (IPO) applications at the highest rate since 2013, when the securities watchdog halted IPO approvals for over a year. Regulators are stepping up their scrutiny, spurning companies with suspect business operations, inconsistent accounting, irregular transactions, precarious earnings, and/or falsified statements.

Why so many rejections?

So far this year, China's onshore A-share market has lagged both its Hong Kong-listed peers and the US market. China's investors and media often blame the weak market on the flood of IPOs; almost as many applications have been submitted so far in 2017 as were submitted in all of 2016. Regulators have paused IPO approval as a way to increase the quality of listed companies and boost investor confidence.

The new hardline is part of a larger shift from an approval-based to a registration-based IPO registration process. Under the current approval-based system, authorities largely decide listing prices, valuation caps, and registration pace. On the contrary, the registration-based system would give companies more flexibility on the pricing and timing of their IPOs. However, some onlookers believe that the IPO reform process is largely beside the point. They posit that without an efficient mechanism for short-selling or a legitimate delisting process, it is impossible for the market to function properly and punish "bad" IPOs and fraudulent companies.



Source: China Securities Regulatory Commission, as of May 19, 2017
Note: Even though the pass rate is the lowest in recent years, total expected approvals in 2017 are still likely to exceed previous years'.

Vanke battle ends with Evergrande transferring shares to Shenzhen Metro at RMB 7 bn loss

Evergrande Group (3333 HK), China's second largest property developer, announced it would transfer all holdings of rival Vanke (000002 CH) to Shenzhen Metro Corporation at RMB 18.80 per share. As Evergrande originally purchased the stock at an average RMB 23.35 per share, the company lost an estimated RMB 7.07 billion on the transaction. After the transfer, Shenzhen Metro will be Vanke's largest shareholder, owning 29.38% of the listed company's outstanding shares.

The Battle Royale: A Timeline

The deal represents the end of an unprecedented year-long power struggle to take control of Vanke. The timeline below highlights the most important events.

> December 2015: Baoneng Group became Vanke's largest shareholder after accumulating 25.4% of outstanding shares, a buildup it began in July 2015. Baoneng funded the purchase through subsidiary Forsea Life's insurance policy sales, an innovative strategy that exploited loopholes in China's insurance and securities regulations. Baoneng's strategy soon drew copycats. Evergrande Insurance and Anbang Insurance too began buying Vanke stock in the secondary market.
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> March 2016: To fight off the attackers, Vanke management invited state-owned white knight Shenzhen Metro to inject assets to dilute Baoneng's control. Vanke management was worried that Baoneng's poor credit would negatively impact the company's financing cost. However, China Resources Group, the prior largest shareholder, nixed the idea, concerned about the dilution to its ownership stake.

July 2016: China's securities regulator told Vanke management and shareholders to resolve their dispute, saying their behavior was disturbing market stability.

November 2016: Evergrande continued its buying spree, coming to own 14.07% of Vanke's A-Shares.

April 2017: China's government ousted the chairman of China Insurance Regulatory Commission. Also reprimanded both Baoneng and Evergrande on using insurance proceeds to fund attempted Vanke buyouts.

June 2017: Through shuttle diplomacy, the government pressured Evergrande into transferring its position to state-owned Shenzhen Metro Group.

Why did Evergrande take the loss?

Some onlookers speculated that Evergrande was willing to give up its Vanke stake in exchange for government approval for a back-door listing in on the Shenzhen Stock Exchange—a long-coveted prize.

Lawmakers weigh whether to strengthen CFIUS, potentially forbidding China for acquiring US high tech

Republican Senators are weighing whether to strengthen the role of the Committee on Foreign Investment in the United States (CFIUS), the group responsible for evaluating whether foreign companies can invest in US firms seen as vital to national security. Lawmakers have expressed particular concern over China's interest in Artificial Intelligence, fearing the country will leverage the technology to compete with the US militarily or economically.

Why the concern?

Artificial intelligence (AI) has recently captured the public imagination, especially after AlphaGo's highly publicized victory over human counterparts. China has made no secret of its ambition to become dominant in the field, evidenced by Midea's high-profile purchase of German robotics manufacturer Kuka and Baidu's merger with US computer vision firm xPerception.

Indeed, the United States remains China's top destination for foreign direct investment. In 2016, China invested USD 45.6 billion in the country, a figure that has already reached USD 22 billion in the first five months of 2017. Since 2012, 29 investors from Mainland China have invested in US Artificial Intelligence companies, according to research firm CB Insights.

The Nays

The role of CFIUS is a rare bipartisan consensus in today's hostile political climate. The current debate continues Obama's legacy, during which CFIUS blocked Chinese companies from acquiring high-end chip makers on several occasions. Still, there remain a few dissenters. Some onlookers believe that the overeager administrative control is no better than China's state-control model, undermining the free market spirits so valued in the United States. Others warn that the CFIUS measures will trigger retaliation from China, halting inbound investment from US companies seeking to enter the growing market.

Notes:

1. M2: M2 is a measure of the money supply that includes highly liquid assets and all physical currency
2. RMB: Renminbi, the official currency of the People's Republic of China
3. USD: US Dollar, the official currency of the United States in America
4. AUM: Assets under management