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Ant Financial's Aggressive Strategy

Ant's Over-leveraged Funding Structure

*"Ant Financial has got just enough bullets to cause a small-scale financial crisis."
Economist with a State Owned Bank.*

- **Growing Market Share.** Ant Financial has quickly taken market share from traditional banks, trust companies and other financial firms. Eventually, the regulators may reduce Ant's consumer lending business to prevent losses by the bigger banks.
- **Undercapitalized "Bank."** We estimate that Ant's outstanding credit stands at 49x Ant Cash Now's registered capital. This 2% capital adequacy ratio is far below the CBRC 8% requirement for commercial banks.
- **Little Oversight.** Ant Financial has lending data for Ant Credit Pay as it utilizes a "virtual credit card" and tracks user purchases. However, there is little data on Ant Cash Now's loans issued directly to users. This raises red flags about potential defaults.
- **Main Driver Behind Securitization.** In 3Q 17, Alibaba and its finance units accounted for 82% of consumer credit ABS. This is a significant concentration of risk.

Summary

Ant Financial operates through two businesses, Ant Credit Pay, which is a "virtual" credit card customers use to buy goods through Alibaba's online platforms, and Ant Cash Now, which provides loans in cash issued directly to users who pay in installments with interest. The capital is supplied primarily through securitized loans sold to wealthy investors. We believe there are several significant risks to the business:

- **Awkward Scalability.** Ant Now's loans, because they are in cash, are untraceable, so the default rate data used for Ant Credit Pay transactions are not available. This makes the scalability and control of Ant Cash Now's business much more difficult.
- **High Leverage.** In order to scale the business, Ant Cash Now has created a high level of leverage through securitized loans. Currently, total outstanding credit, including off-balance sheet items, are estimated at nearly 49 times Ant Cash Now's registered capital, far above the regulated limit of 2.3x.

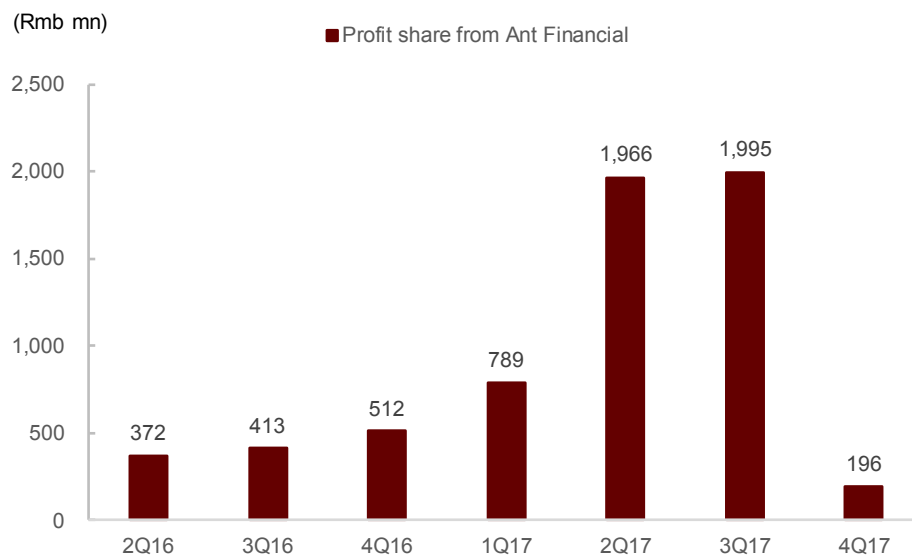
Ant Financial's Rapid Growth

1. Background

Ant Financial was officially founded in October 2014, spun out of Alipay, Alibaba's mobile payments company. In the past few years, Ant has expanded beyond payment services to include wealth management, financing, insurance and a credit score business. Prior to February 2015, Alibaba booked SME loans' interest in its revenue and received a 49.9% profit sharing of Alipay. Since then, Alibaba has booked 37.5% of Ant Financial's pretax income in its other income under the category of royalty and software technology service fees.

According to Alibaba's quarterly reports, in calendar year 2017 profit contributed by Ant Financial was Rmb4.946bn. Due to tightening regulation and a payment subsidy war, in the fourth quarter the profit share from Ant Financial dropped significantly to Rmb196mn (US\$30mn), the lowest level since it turned profitable in 2Q16.

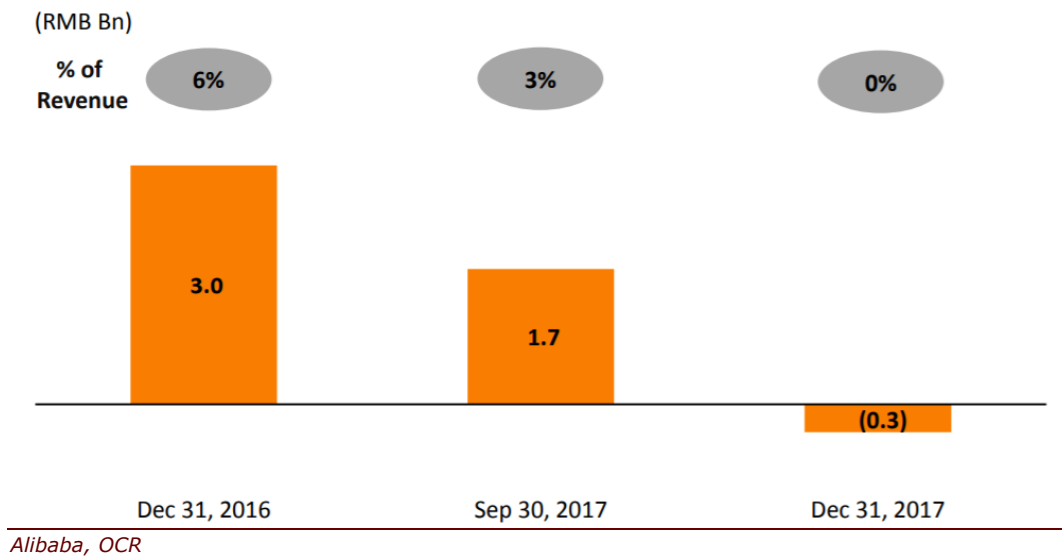
Figure 1: Profit share from Ant Financial dropped significantly in 4Q17



Alibaba, OCR

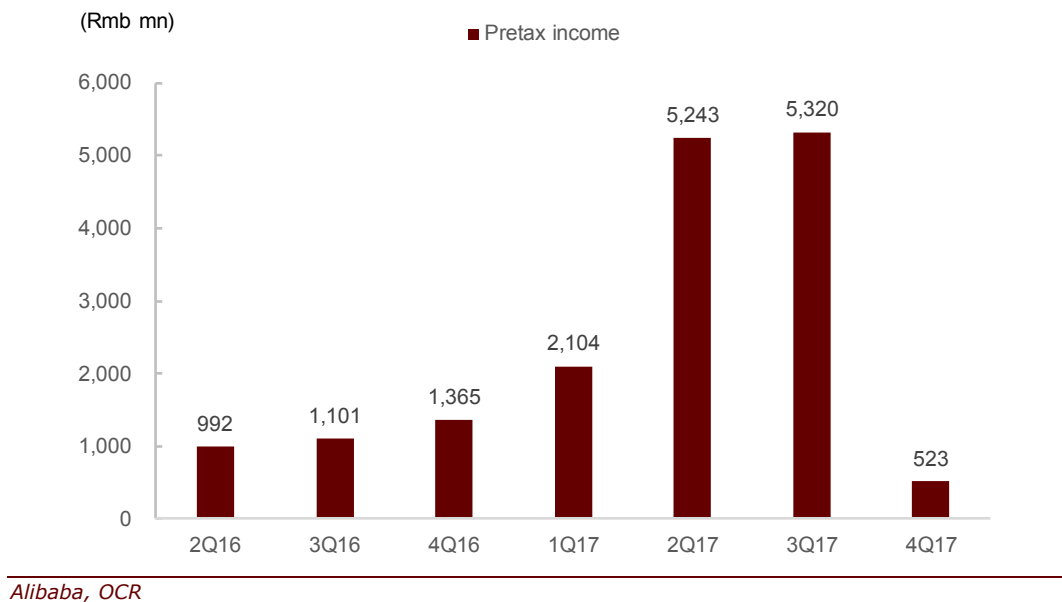
As a result, Alibaba incurred a loss on "other income" of Rmb348mn (US\$54mn) in the quarter ended December 31, 2017, compared to other income of Rmb3bn in the same quarter of 2016.

Figure 2: Alibaba's other income (loss), net



Assuming 37.5% share proportion of pretax income, Ant Financial achieved ~Rmb13.2bn pretax profit in 2017, though 4Q only accounted for 4% of the full-year number.

Figure 3: Ant Financial's Pretax income



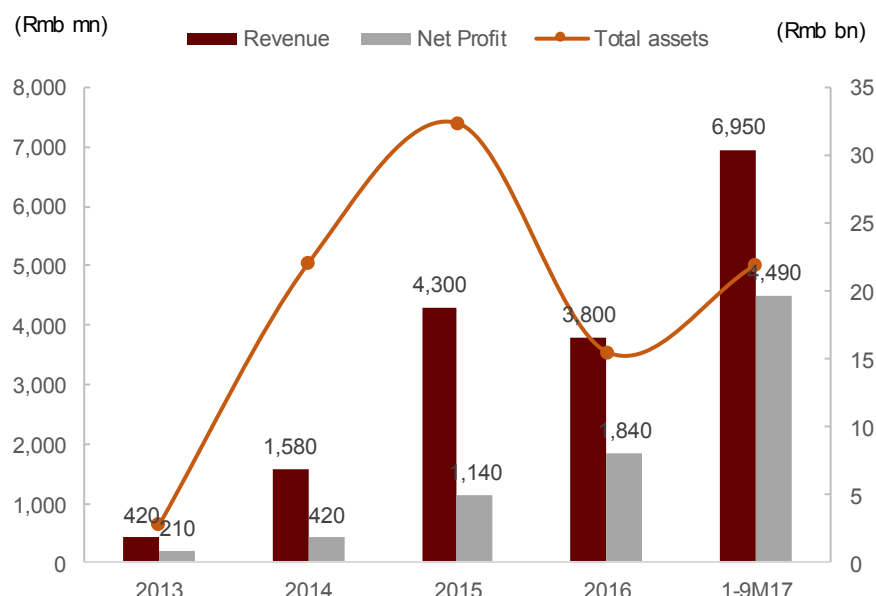
Alibaba explained in its financial report that “the decline was mainly due to Ant’s aggressive user growth plan, which increased expenses in return for substantial additions in new users for Alipay Wallet.” However, **we believe the major impediment to profit growth occurred in its most profitable business -- consumer finance.**

Ant Financial Challenges the Traditional Banks in Consumer Finance

Installment loans (Ant Credit Pay) and cash loans (Ant Cash Now), together comprise Ant's consumer finance business. They are operated by Chongqing Ant Business Micro Credit Co., and Chongqing Ant Shangcheng Small Loans Co., Ltd., formerly Chongqing Alibaba Small Loan Co., Ltd.

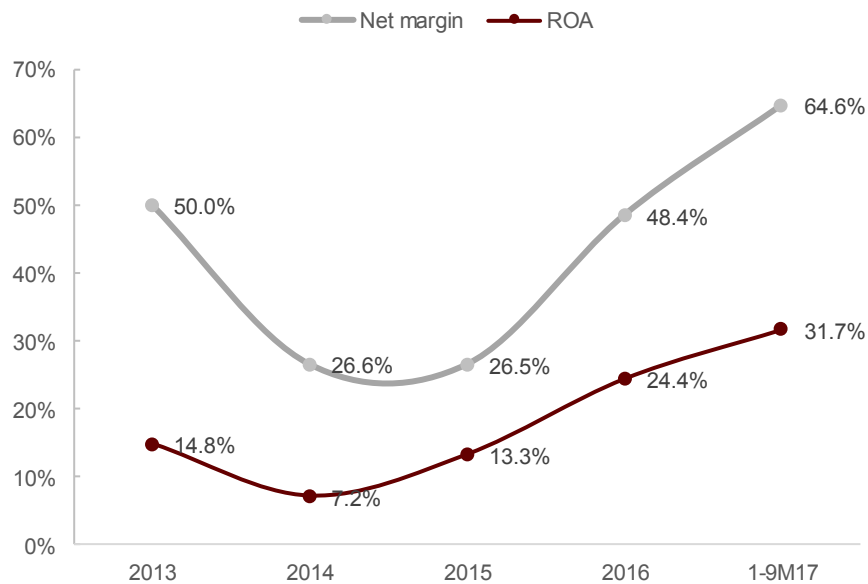
According to First Consumer Finance, over the past five years Ant Cash Now (including both Chongqing Ant Shangcheng Small Loans Co. Ltd.) recorded strong growth in both revenue and net profit. By the end of 3Q17, its revenue and net profit reached Rmb6.95bn and Rmb4.49bn, respectively. Total assets grew at a much slower pace from Rmb2.8bn in 2013 to Rmb21.9bn as end of 3Q17. However, the company's profitability largely improved in terms of net margin and ROA during the same period. Net margin and ROA increased by approximately 15ppt and 17ppt during the same period.

Figure 4: Strong growth of Ant Cash Now



Source: First Consumer Finance, OCR

Figure 5: Continuously improving profitability

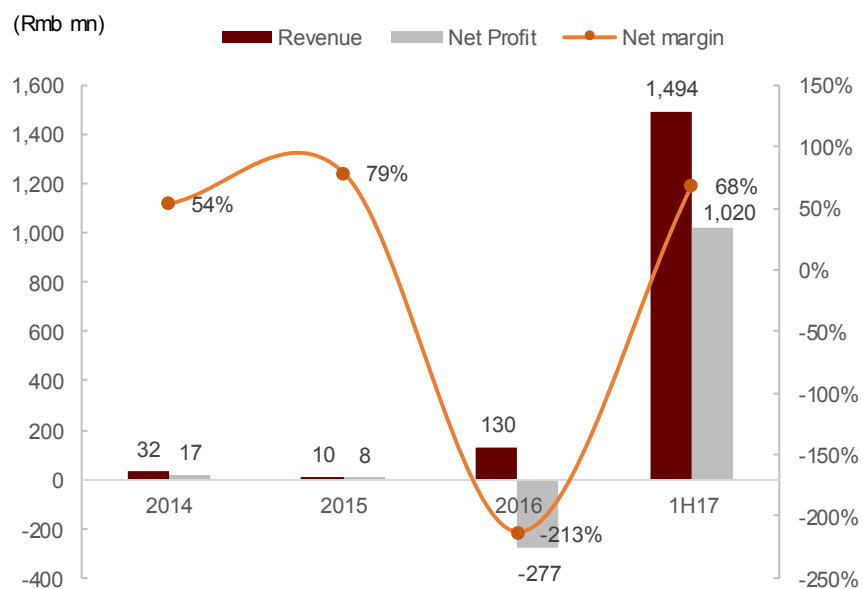


Source: First Consumer Finance, OCR

Rising Debt Could Challenge Ant's Business

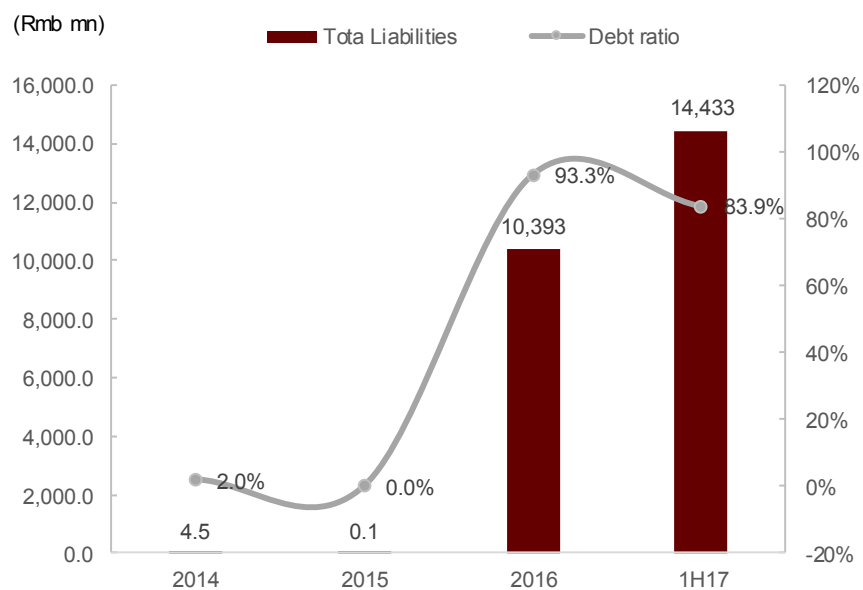
The scale of Chongqing Ant Business Micro Credit Co., which operates Ant Credit Pay, is relatively small. After incurring a loss of Rmb277mn, in 1H17 the company earned Rmb1.5bn in revenue and Rmb1bn in net profit, implying a net margin of 68%. Meanwhile, total assets of Ant Credit Pay grew from only Rmb223mn in 2014 to Rmb17.2bn by the end of 1H17, comparable to that of Ant Cash Now. In contrast, Ant Credit Pay's ROA has been limited, only in the mid-single-digits, 5.9% at the end of 1H17. However, total liabilities surged from Rmb4.5mn to Rmb14.4bn, suggesting a debt ratio of 83.9%. According to the media reports, the company's NPL ratio and delinquency rate are 1.29% and 1.83%, respectively.

Figure 6: Ant Credit Pay's Business is relatively small



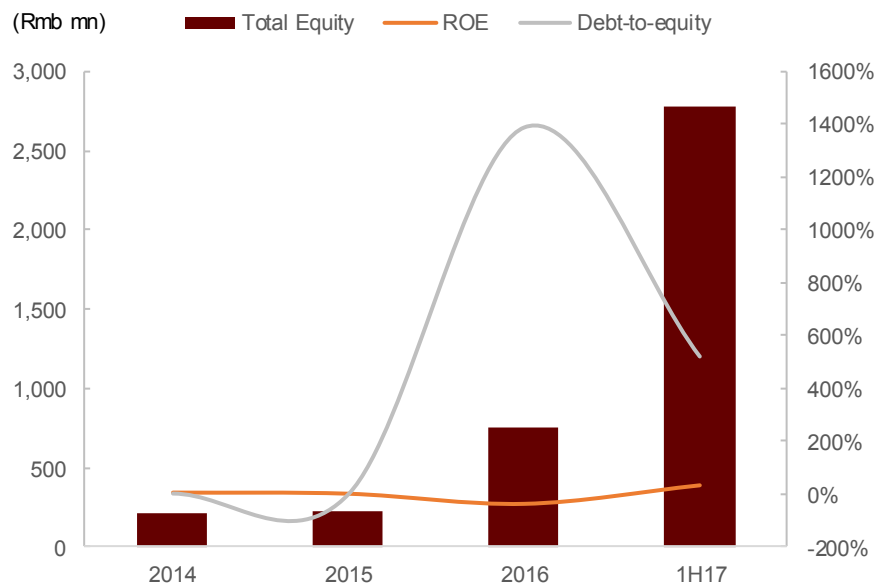
Source: First Consumer Finance, OCR

Figure 7: However, Total liabilities surged along with the company's debt ratio



Source: First Consumer Finance, OCR

Figure 8: Implied total equity and ROE & Debt-to-equity levels



Source: First Consumer Finance, OCR

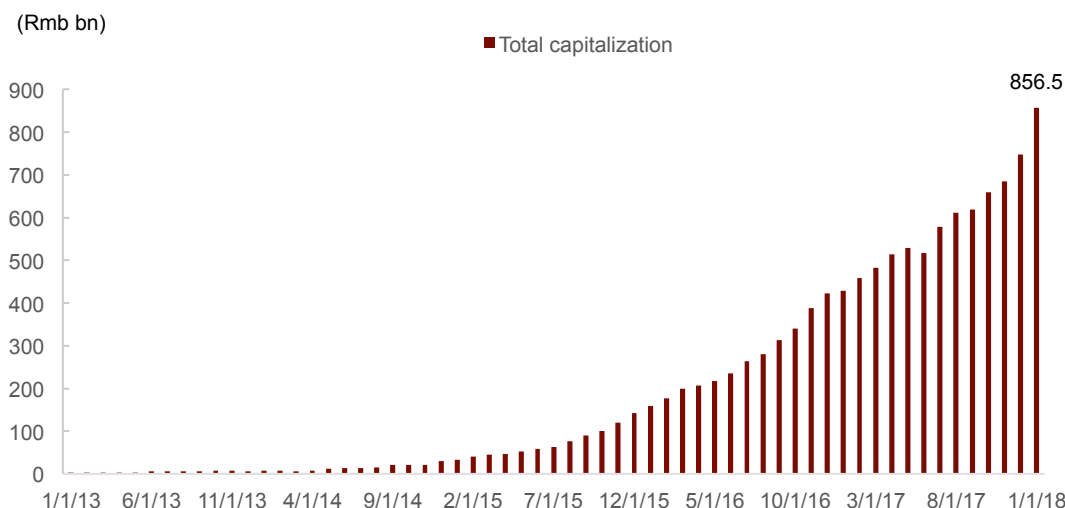
Based on our interviews, Ant Financial is estimated to make ~Rmb8bn in net profit in 2017 through its consumer finance business (Ant Cash Now & Ant Credit Pay). That business is under increasing pressure due to tightening regulations. For instance, its recent issuance of asset backed securities (ABS) was on hold due to high leverage ratios, which are higher than regulated levels.

We believe the biggest underlying risk lies with Ant Cash Now rather than Ant Credit Pay. Ant Credit Pay has relatively low risks, because it is a virtual credit card issued for users to pay in Tmall, Taobao and other third-party platforms operated by Alibaba. For each transaction, money is transferred directly from Ant Financial to merchants' Alipay account. As long as the principal can be paid before the due date, there's no interest charge. Payment by installment is also available. In contrast, Ant Cash Now is a business based on cash loans issued by Ant Financial directly to users who make installment repayment with interest. Rather than make the payment under specific guidelines, Ant Cash Now's users can withdraw the money directly from their Alipay wallet. Therefore, *it is difficult for Ant Financial to verify or monitor the loan once the money leaves its balance sheet.*

High leverage is one of the biggest risks for Ant Cash Now. That's because securitization (through Asset Backed Securities, or ABS) has been Ant Financial's major funding source. According to the Asset Management Association of China, Alibaba launched 118 consumer credit ABS for a total amount of Rmb275bn, which accounted for 82% of total issuance for the first nine months of 3Q17. Another 8%, namely, Rmb27.7bn, was contributed by 27 ABS issued by JD.com. In other words, Alibaba, together with JD.com, drove the rapid growth of China's corporate securitization market. For instance, total capitalization of registered ABS at the China Securities Depository and Clearing Corporation (CSDC) over the past five years recorded high growth, up from the single billions to Rmb856.5bn at the

end of January 2018. “Among them, consumer credit related ABS is believed to be the largest product category, which accounted for more than 60% total outstanding balance of corporate ABS,” said a senior banker in Beijing.

Figure 9: Growth of China’s ABS market



Source: CSDC, OCR

Based on our interviews, the cost of capital through securitization for Ant Cash Now is estimated to be around 6%. Currently, total outstanding credit, including off-balance sheet items, are estimated at nearly 49 times Ant Cash Now’s registered capital, far above the regulated limit of 2.3x.

In addition, Ant Financial **accelerated** its issuance of ABS last August, September and October. For instance, monthly ABS issuance amounted to ~Rmb24bn last October due to “expectation for tightening regulations” and “peak seasons such as Double 11, Christmas and New Year,” according to an interview with an employee at Tebon Securities, which is the main firm responsible for Alibaba’s ABS issuance. Regulatory pressure has been the culprit. “We’re not surprised to see it accelerated the latest issuance of Ant Cash Now ABS up to a total level of Rmb4 billion, due to increasing regulatory pressure,” the employee noted.

However, what has caught the PBoC’s attention was not only the large amount of off-balance-sheet loans, but the significant profits earned from less-educated young people in lower tier cities. “Taking advantage of its sister relationship with Taobao and Alipay, Ant Financial has quickly taken market share from traditional banks, trust companies and its peers, in the highly lucrative consumer finance business, who indirectly assist commercial banks to lend money. And this is in conflict with regulators’ goal to balance each party’s interests,” said an economist at Shanghai’s prestigious Fudan University.

Indeed, Ant Cash Now’s net profit in the first three quarters of 2017 exceeded the profit of many other small city and commercial banks such as the Bank of

Hangzhou, the Bank of Guiyang, and the Bank of Changshu. In addition, Ant Cash Now topped all other listed banks in terms of its net margin of 64.7%, along with its quite high YoY growth of both revenue and net profit.

Figure 10: 1-9M17 Operating Results of Major Chinese financial institutions

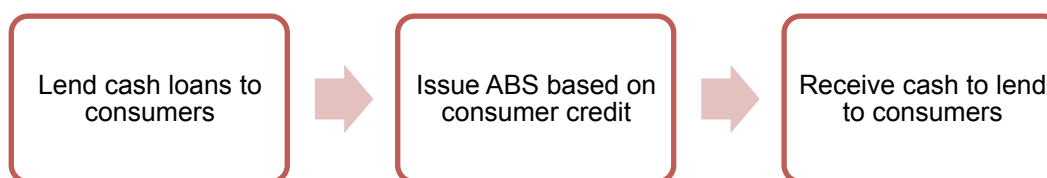
Bank	1-9M17 Total Revenue (Rmb bn)	YoY(%)	1-9M17 Net Profit (Rmb bn)	YoY(%)	Net margin (%)
ICBC	535.8	3.5%	229.1	2.5%	42.8%
Construction Bank	472.0	-0.1%	202.3	3.9%	42.9%
Agricultural Bank	408.4	5.8%	160.1	3.9%	39.2%
BOC	364.1	1.4%	155.5	2.4%	42.7%
China Merchants Bank	165.7	3.4%	59.2	13.0%	35.7%
Bank of Communication	149.7	1.6%	54.8	3.5%	36.6%
Industrial Bank	103.0	-13.2%	47.5	7.3%	46.1%
SPD Bank	124.8	3.2%	42.4	3.1%	34.0%
China Minsheng Bank	105.9	-9.0%	41.1	3.1%	38.8%
Citic Bank	115.3	0.0%	34.9	0.8%	30.3%
China Everbright Bank	68.8	-2.8%	25.5	4.1%	37.0%
Ping An Bank	79.8	-2.6%	19.2	2.3%	24.0%
Bank of Beijing	38.8	6.9%	15.6	3.9%	40.3%
Huaxia Bank	50.1	5.2%	14.3	-2.5%	28.6%
Bank of Shanghai	24.4	-7.5%	11.6	6.5%	47.7%
Bank of Jiangsu	25.6	7.5%	9.3	11.6%	36.3%
Bank of Nanjing	18.6	-11.8%	7.5	16.8%	40.5%
Bank of Ningbo	18.6	3.5%	7.4	16.2%	39.7%
Ant Cash Now	6.9	190.8%	4.5	193.5%	64.7%
Bank of Hangzhou	10.2	-4.8%	3.7	10.3%	35.9%
Bank of Guiyang	9.0	27.1%	3.2	18.9%	35.9%
Bank of Changshu	3.6	11.4%	0.9	16.7%	26.0%
Bank of Wuxi	2.1	12.4%	0.8	10.4%	36.0%
Bank of Wujiang	2.1	18.4%	0.6	9.2%	30.4%
Bank of Zhangjia Gang	1.8	5.1%	0.6	6.6%	30.3%
Bank of Jiangyin	1.8	-3.9%	0.5	-3.2%	28.2%

Source: Wind, OCR

This may be what prompted the PBOC to enact new rules. In April 2018, the PBOC was scheduled to increase the reserve fund requirements for online payment platforms, including Ant's Alipay, to 50% from 20%. The bank also proposed transaction limits on QR code payments. Securities regulator CSRC has also called on money market funds such as Yu'E Bao to set aside 0.5% of net assets to cover bad debts.

Ant Financial's "Infinite Loop" Fundraising Model
In fact, we're more concerned about the "infinite loop" of Ant Cash Now's fund raising machine – borrowing from private investors to lend to private consumers. Without proper size limits and strict implementation of capital adequacy ratio requirements, Ant Cash Now's leverage can be infinitely amplified – with the associated high risks.

Figure 11: The "infinite loop" of Ant Cash Pay's cash loan business



Source: Company Data, OCR

A Bank Without the Regulations

According to our interviews, Ant Financials' outstanding balance of consumption loans has reached Rmb600bn. The daily borrowing amount per user is Rmb700 and Rmb3,000 for Ant Credit Pay and Ant Cash Now, respectively. This makes it similar to an ordinary bank – without bank regulations. According to an economist at one of the Big Four Chinese state banks, “We see Ant Financial as a complete banking system as its issuance scale of consumption loans and the number of users are multiples of the world’s largest banks.”

He noted that in 2017 Ant Financial attracted 100mn new clients, which grew its customer base to 500mn. This large size would explain why Ant Financial is on the radar of the Chinese regulators.

If we assume a 5% default rate compared with the 1.7% rate disclosed by Ant Financial’s Executive Chairwoman, Lucy Peng, in a recent talk at the Qiantang River forum, approximately Rmb30bn in ABS capital could be at risk. It’s unlikely that Ant Cash Now is able to track the use of its funds loaned out. In other words, “Ant Financial has got just enough bullets to cause a small-scale financial crisis,” the bank economist noted.

Figure 12: Overview of the consumption loan balance of the major Chinese commercial banks

Bank	Balance as end of 1H17 (Rmb bn)	Addition in 1H17	YTD Growth as end of 1H17
Ant Financial*	600	300	100%
China Everbright Bank	372	54	17.0%
Ping An Bank	277		N/A
ICBC	260	13	5.3%
Agricultural Bank of China	164	11	7.3%
Construction Bank	158	83	110.7%
China Merchant's Bank	84	20	31.2%
Bank of Haerbin	80	10	14.7%
Bank of Jiangsu	61		N/A

Source: Company Data, OCR ; Note : Consumption loan balance for Ant Financial is an estimate based on our interviewees

Low Cost Model Under Threat

Although Ant Financial injected nearly Rmb8.2bn into Ant Cash Now and Ant

Credit Pay to justify its current financing scale and leverage ratio as well as terminate several high-risk Ant Cash Now accounts, we believe Ant's ability to fund its business through nearly "zero-costs" is about to change.

- 1) The first likely change is to introduce other funding sources such as banks, trust companies and P2P companies, similar to online competitor Qudian's business model. According to Qudian's prospectus, more than half of its funding has come from institutional investors such as P2P, traditional banks and trust companies.
- 2) The second way is to leverage continuous ABS issuance from Ant Credit Pay. In recent months, Ant Financial raised the scale of ABS issuance for Ant Credit Pay from Rmb1.5bn to Rmb4bn.
- 3) The third way is to transfer its cash loan business to Alibaba's Mybank.

Conclusion

In our view, Ant Financial is counting on an IPO to continue to fund its over-scale consumer finance business. However, it might be good news for investors if the deal is postponed due to a new debate on the legitimacy of Ant Cash Now.

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