The Big Read **Chinese economy**

How Xi Jinping is reshaping China's capital markets

The pipeline for IPOs increasingly reflects technological competition with the west and the heavy influence of the state

Hudson Lockett in Hong Kong 17 HOURS AGO

When Xi Jinping revealed his first big policy manifesto after taking the helm of China's Communist party, he electrified the world of global finance with a call for state-owned enterprises to step back and let markets play a "decisive" role in the world's second-largest economy.

Analysts at Goldman Sachs hailed the slate of policy priorities, released in late 2013, as a "bold economic reform agenda" with a "pro-market stance" that would curb government intervention and rein in entrenched state-run businesses.

But in the years that followed, waves of volatility in Chinese stocks and currency, the threat of financial disruption from upstart tech tycoons and fears offshore listings could breach data security only served to bolster the case among policymakers that if markets are to play a "decisive role", then the role of the party must be more decisive still.

"[China's leaders] think they know better than the market and many of [their] actions have done real damage to it and to the economy," said Weijian Shan, one of China's most seasoned and successful financiers, during a recorded video meeting with brokers held during the depths of Shanghai's punishing Covid-19 lockdown. Shan added his Asia-focused private equity group PAG, which manages more than $50bn, had diversified away from China.

The unusually sharp criticism from Shan, long a vocal defender of Beijing, came at a critical time for the country's capital markets. A regulatory crackdown in China has lopped roughly $2tn off the market value of listed tech groups over the past 12 months as Xi has railed against the "disorderly expansion of capital".

In place of the open markets he talked about a decade ago, the environment for raising capital that has emerged in China is increasingly shaped by Xi's broader strategic priorities — one that is focused on technologies considered central to economic competition with the west, directed by the state and tinged with suspicion about outside influences.

The shift reflects how foreign investor influence is fading as Beijing pushes forward with efforts to mould China's equity capital markets into an assembly line that marshals private funding towards policy goals, with the ultimate aim of producing a new generation of national champions across strategic sectors.

A worker locks a gate at a residential complex in Shanghai, where lockdown is so harsh that it has raised the prospect of a second recession in China since the beginning of the pandemic © Hector Retamal/AFP/Getty Images

To that end, the state is expanding its presence up and down the country's IPO pipeline. Over the past decade, so-called government guidance funds have raised more than $900bn to ensure enough early funding flows to companies from favoured industries such as high-end manufacturing, renewables and biotech. Additionally, policymakers have pushed through reforms to grant swifter listings as soon as such companies are ready to go public.

For Xi, funding China's transformation into a global centre of high-tech innovation is central to national defence. In a speech published last year in the country's top journal of Communist party theory, he warned that "only by grasping key core technologies in our own hands can we fundamentally guarantee national economic security, national defence security and other securities".

"Investors are doing a reset," said Kiki Yang, co-head of Bain & Company's Asia-Pacific private equity practice. Gone are the days of disruptive start-ups burning through foreign backers' cash to scale up for an initial public offering in New York or Hong Kong. "As a fund, we need to think about the sectors that can actually benefit from a policy perspective," she added. "A lot of the bigger deals are [being] done by the government-led funds, at least in the last year or so."

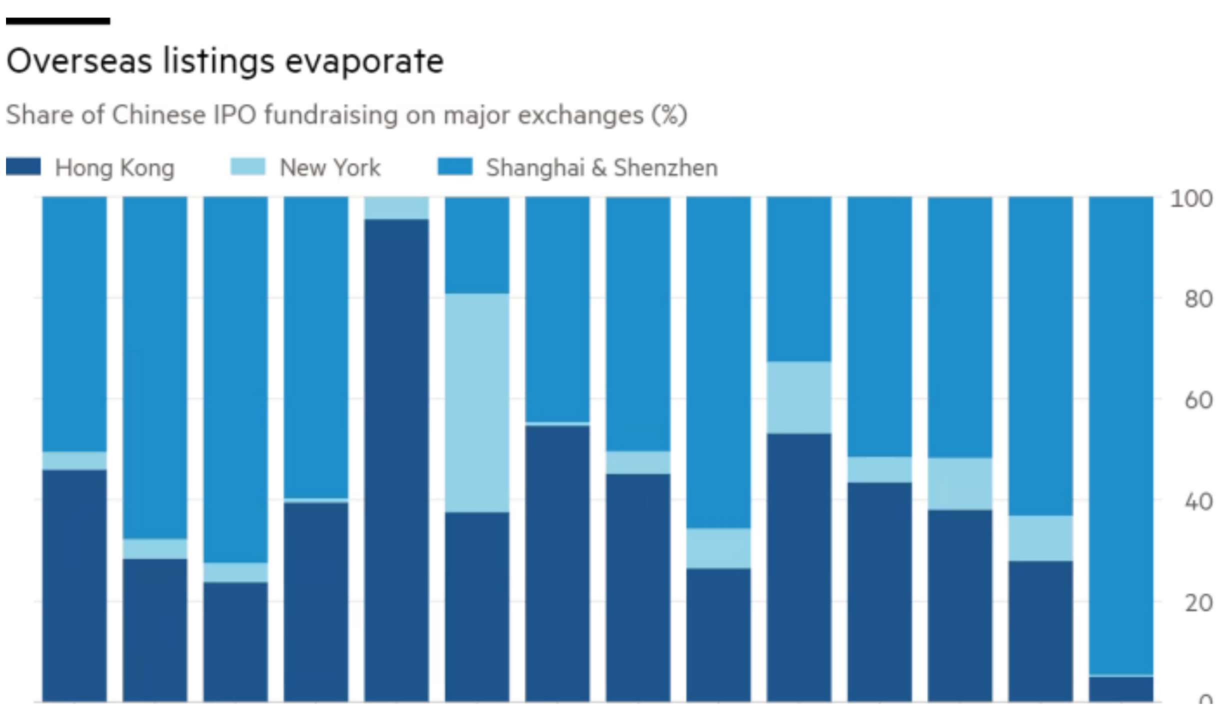
That is a far cry from a decade ago, when China's start-up scene was flush with cash from private overseas investors including Sequoia and SoftBank, whose early backing for the likes of Alibaba and Tencent helped foster innovative apps and payment platforms that reshaped the Chinese economy.

Fraser Howie, an independent expert on Chinese finance, said the country's leaders "don't consider platform and internet companies as genuinely innovative. They want microchips, quantum computing, genetics, real tangible things as opposed to cyber space."

Howie said US sanctions imposed on Chinese semiconductor and telecoms equipment makers and blowback in Europe over Beijing's refusal to condemn Russia for the invasion of Ukraine have pushed the party-state to funnel more money to sectors it believes are vital to safeguarding national security and China's economic ascent. "Xi Jinping is clearly dictating it," Howie added. "The question is how successful he'll be."

Investors left out in the cold

Xi's first big IPO intervention came in November 2020, when regulators scrapped what would have been the record $37bn listing of Ant, the fast-growing fintech group owned by billionaire Alibaba founder Jack Ma. But the broader regulatory crackdown on the tech sector began in earnest almost 12 months ago, shortly after ride-sharing app Didi Chuxing listed in New York despite warnings from Chinese regulators over data security concerns.



2022 figures cover year to date
Source: Dealogic
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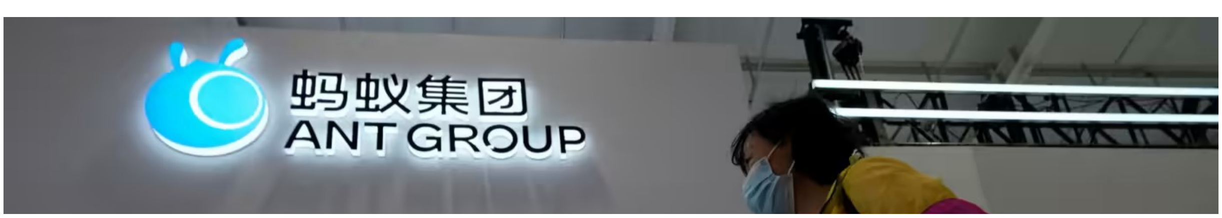
That prompted a halt to almost all offshore IPOs to allow regulators to finalise new foreign listings rules for companies with large amounts of user data. At the same time, tensions flared over Beijing’s refusal to grant US regulators full access to the audit reports of Chinese companies trading on Wall Street, raising the spectre of forced delistings and questions over whether selling shares in New York will be worth the trouble.

“The US is proving to be very, very difficult,” says the head of Asia equity capital markets syndicate at one Wall Street investment bank. The person added that there was “no doubt” that more Chinese IPOs would go to Hong Kong once Beijing allowed offshore listings to resume, but different types of companies would dominate deal flow.

“These very techy, platform, data-sensitive names are just hard to invest in,” the banker said. “The flip side is, if you bring a company [to market] that’s doing renewable energy in China, everybody knows that is a business model the government’s going to encourage.”

No one knows when offshore IPOs will return in full force. Data from Dealogic show 95 per cent of the $35bn in IPO fundraising by Chinese companies this year has been amassed in domestic markets, where state-run investment banks such as CICC and Citic Securities dominate deals and new share sales require regulators’ sign-off.

As a result, most listings now go to either Shanghai or Shenzhen, and few expect this to change any time soon. “What you’ve seen in the first quarter gives you a pretty good idea of what the rest of the year is going to look like,” said one veteran IPO lawyer with an international group based in Hong Kong. That would keep foreign investors largely shut out of Chinese IPOs, while top Wall Street banks such as Goldman Sachs and Morgan Stanley will miss out on Hong Kong and New York listings, which have delivered billions of dollars of annual fees in recent years.



Xi Jinping's first intervention in a big IPO came in 2020, when regulators scrapped the $37bn listing of Ant, owned by Jack Ma © Ng Han Guan/AP

In addition to curtailing access to global equity markets, the past 12 months have hastened changes further up the deals pipeline, where regulatory action and state-backed investment are having an impact on which companies receive the funding from venture capital and private equity groups needed to scale up for an IPO.

"Everyone knows how tough it is this year," said Yang, at Bain. She estimated the level of undeployed funds held by Asia-focused investors rose to a record $650bn in 2021 as dealmaking in China was hit by investor concerns over geopolitical tensions with the US and tighter regulation.

But she added that while funding plummeted in the second half of last year for some segments of tech historically favoured by private equity, others, such as semiconductors, shot higher thanks in large part to government-led funds.

'Tonnes of capital will be wasted'

The scope and ambition of government guidance funds have also grown substantially during Xi's tenure. These public-private investment funds, set up by or for government agencies, carry a dual mandate of furthering Beijing's policy aims and delivering financial returns.

Since the start of 2013, about 1,800 government guidance funds have raised more than Rmb6tn ($900bn) to invest in strategic sectors and have already received approval from regulators to bring in more than double that amount, according to estimates from independent research group Zero2IPO.

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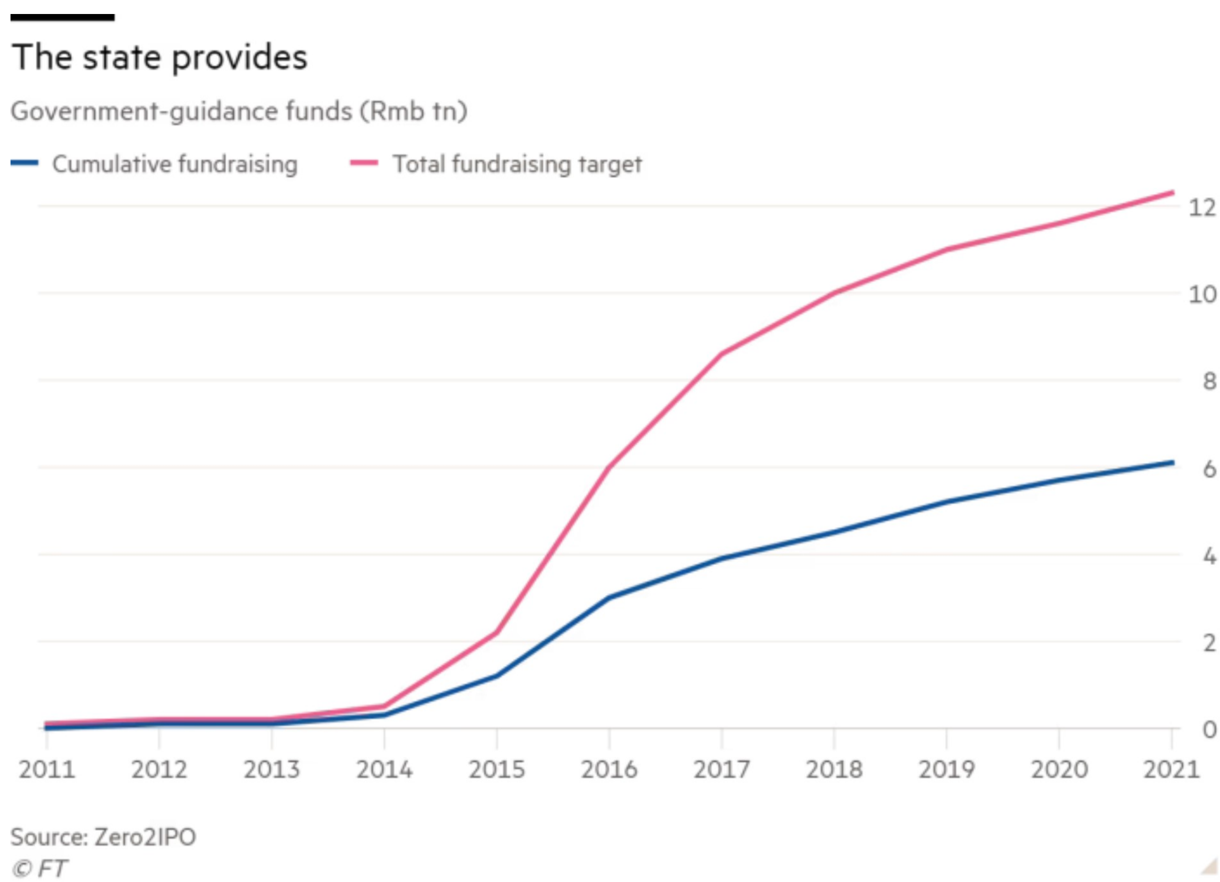
Figures from investment data provider Preqin show the share of China-focused private equity and venture capital fundraising going to state-led funds has risen from about 2-3 per cent prior to Xi coming to power to more than a third in recent years. Bain estimated about 40 per cent of the more than $86bn raised by foreign and domestic China-focused funds last year went to these state-backed funds.

“The vast majority of funding into Chinese VCs is from the government,” says William Bao Bean, a general partner at global venture capital firm SOSV. He said that while “the smart money in China has traditionally been global capital”, investing has become much more difficult over the past four years as government controls have grown more stringent.



The resulting shift in funding has produced more IPOs by companies from what Beijing has designated “strategic emerging industries” including electric vehicle manufacturers, biotechnology, renewable energy, artificial intelligence, semiconductors and other high-end equipment manufacturing.

In 2020, such listings accounted for more than half the value of equity fundraising in China for the first time and last year raised a record haul of Rmb735bn, according to Gavekal Dragonomics, a Beijing-based consultancy.

Thomas Gatley, an analyst at Gavekal, said China's equity capital markets had entered a new phase in which Beijing's vision increasingly dictated where domestic and international capital was willing to invest: "The outright losing of the US market and the increased peril of investing in anything not on the government's menu, that's the inflection point."

Investment opportunities in Chinese stocks will become more concentrated in either the kinds of high-end manufacturers and AI companies needed to protect China from the impact of US sanctions or the renewable energy and electric vehicle companies the leadership considers central to the future of the global economy. "That's the bet you're now making as a foreign investor into China," Gatley said.

Yet some observers questioned whether this bold, purpose-driven vision for China's equity capital markets would work — among the reasons being the party's growing affinity for top-down planning that ignores market signals.

"Tonnes of that capital will be wasted," Gatley said, "either by companies that don't do very well or some form of fraud."

Market pushback and 'inefficient' funds

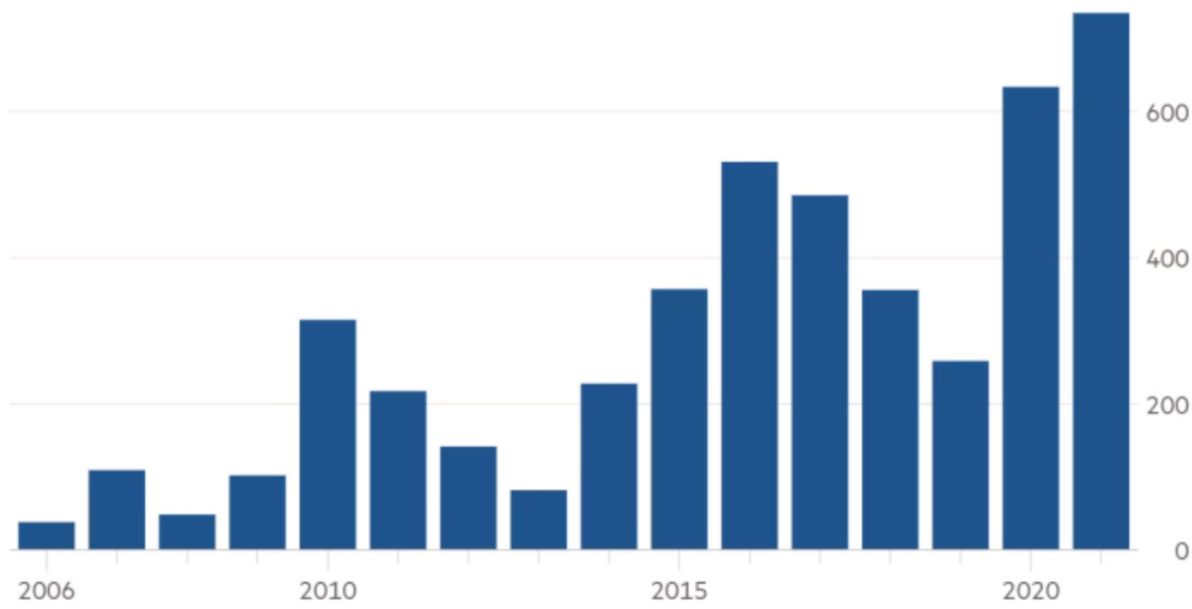
Markets are already demonstrating how official approval does not guarantee a successful IPO, even on Shanghai's science and technology-focused Star Market, a specialised board of the city's stock exchange that was launched in 2019 under the personal imprimatur of Xi.

Since 2020, the Star 50 index of the board's largest and most liquid stocks has shed a quarter of its value, badly lagging behind the broader market. This year, the value of 40 per cent of the 66 companies that have listed on Star has fallen on their first day of trading, according to figures from financial data provider Wind.

This has prompted regulators to ask whether investment banks should be required to ensure a certain number of the IPOs they deliver do not immediately fall, according to Chinese media. In a recent speech, Fang Xinghai, vice-chair of China's securities regulator, appealed to bankers to "please lower the price a little" if they thought shares would drop on day one.

Funds flow to strategic sectors

Onshore equity fundraising by strategic emerging industries (Rmb bn)



Source: Gavekal Dragonomics
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Analysts have argued that the listings process in China is already so tied up in regulations that investment banks have limited influence over how IPOs are priced. And Star is such an important prestige project that officials have begun laboriously scrutinising listings applications to ensure they conform to official expectations of what qualifies as a "proper" IPO.

This has created a listings backlog so long that numerous companies — many of which had sought to list on Star because it was supposed to avoid such bureaucratic gatekeeping — have given up, with almost 160 applications officially cancelled since the board's 2019 launch and still more withdrawn or suspended.

Douglas Arner, a law professor and financial regulation expert at the University of Hong Kong, said that although Xi's term began with a push for more market-driven reform, subsequent moves had either mitigated or completely undone those changes in order to put the state firmly back in charge.

"You're faced with, often, incoherence," he said. "The end result is that there is a lot of uncertainty and a lot of systems aren't working that well."

That is reflected by government guidance funds which, despite their impressive scale, have delivered mixed results. An analysis published in 2020 by the Center for Security and Emerging Technology at Georgetown University found many such funds were "poorly conceived and implemented, and that the mechanism as a whole is often inefficient".

inefficient”.

Li Qiang, left, Shanghai’s Communist party chief, and Yi Huiman, right, chair of China Securities Regulatory Commission, strike a gong to launch the Star Market in Shanghai in 2019 © Chinatopix/AP

Yet the study’s authors added that the funds were “unquestionably helping mobilise money and other resources for new businesses and emerging technologies” and concluded they “should not be casually dismissed”.

Acting in self-defence

China’s provinces have long served as testing grounds for policies to foster business, commerce and innovation. But analysts worry that Xi’s government is sabotaging the policies of previous leaders who allowed that freedom.

China’s powerful State Council, or cabinet, codified this top-down vision for the country’s development in late March with a sweeping policy statement titled “Accelerating the Construction of a Large and Unified National Market”.

Guided by the lodestar of Xi Jinping Thought — the president’s political philosophy — the document promises “staunch support for the creation of a high-quality market system and high-level socialist market economy” and vows to ensure it is a “sustainable historical process”.

Bruce Pang, head of research at investment bank China Renaissance, said this dense thicket of party jargon pointed to a growing desire for Chinese provinces to march in lockstep with Beijing.

Much of this drive, he said, was built around an expectation China could soon be forced to become far more self-reliant if hawkish sentiment already prominent in Washington took hold in London and Brussels.

"Beijing is urging all levels of officials to focus on internal and domestic markets," Pang said. "They're not saying we're closing the door [to global investors]. They're saying if anyone else closes the door for us, we have to be well equipped and prepared."

Xi's favoured stocks lag behind the broader market

Equity benchmarks (indexed to 100)

Source: Bloomberg
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If Xi succeeds in reshaping China's IPO pipeline to fit this strategic vision, it will entangle the country's listed companies — and thus its stock market as a whole — ever more tightly with Communist party objectives such that western governments may ultimately decide to cut off investment flows.

The Asia head at one UK asset manager said he expected US financial institutions to lobby furiously against any new restrictions in Washington on holding Chinese equities, but added: "Is it possible it could swing that way? Yes." Such restrictions would inevitably impact European investment houses that want to keep their US clients, the person added, saying: "And we do rather like American investors."

Should Washington throttle American investment flows to sectors vital to Beijing's plans for technological dominance, it could threaten decades of work by Chinese policymakers to coax global investors into the country's gradually opening onshore markets.

"The access problem — 'can I buy Chinese stocks' — has been solved," said Howie, pointing to the more than Rmb3tn worth of mainland Chinese equities the country's central bank estimates are now held by foreign investors. "But that's come at a time where . . . there could well be a capital backlash internationally for Chinese stocks, because to simply be investing in China is almost immoral."