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China web finance craze sows confusion and risk

By Robyn Mak February 19, 2016

The author is a Reuters Breakingviews columnist. The opinions expressed are her own.

China's internet finance craze is piling on confusion and risk. Web giants, insurance groups and even the country's top taxi app are pushing into the fast-growing sector. But competition is fierce, and investors have little way to judge which business models are viable.

As China's 650 million web users increasingly turn to their smartphones for shopping, payments and even investing, the country's state-controlled banks are struggling to keep up. This has spawned a host of start-ups that seek to lure customers by promising greater convenience and more attractive returns. The outstanding balance of Chinese internet finance products – including peer-to-peer lending and online investment funds –hit 4.6 trillion yuan ($700 billion) by September last year, according to Nomura. P2P lending volumes alone more than quadrupled in 2015.

Private giants have already emerged. Ant Financial, controlled by Alibaba boss Jack Ma, spans nine different businesses from money market funds to credit scoring and recently raised new equity at a $45 billion valuation. Its crown jewel, Alipay, dominates China's online payments market, which reached an estimated 11.8 trillion yuan ($1.8 trillion) last year, iResearch estimates.

Lufax, which was set up by insurance giant Ping An and is now valued at $18.5 billion, operates an online marketplace for everything from crowdfunding to life insurance plans. It is also China's largest peer-to-peer lender with a loan balance of 32 billion yuan at the end of December, according to Nomura.

Then there is Zhong An, China's first online-only insurer which is backed by the bosses of Alibaba, Ping An and social media and gaming company Tencent. The three-year old venture, which was recently valued at $8 billion, is limbering up for an initial public offering.

Margins are thin, though. Alipay takes a cut of up to 1.2 percent on online merchants' transactions, and as little as 0.6 percent for small businesses. Compare that with U.S.-listed PayPal, which last year generated revenue of $9.2 billion on transactions worth $282 billion – implying an average fee of 3.3 percent.

Even so, massive scale can still make for big businesses. Though Alipay doesn't disclose any information about its finances, let's say its average fee is 1 percent. Its 50 percent share of China's online payments market would imply almost 59 billion yuan of annual revenue. Apply Paypal's 16 percent operating margin and China's 15 percent tax rate for tech companies, and Alipay's earnings would have reached 8 billion yuan last year. On a Paypal-style earnings multiple of 36, Alipay alone would be worth $44 billion.

Competitors are piling in, however. Apple this week launched its Apple Pay service in China, in partnership with state-owned credit card processor UnionPay and many of the country's biggest banks. Samsung is set to follow suit. Even ride-hailing startup Didi Kuaidi is joining the craze.

China's home-grown rival to Uber announced last month that it will team up with China Merchants Bank to offer credit card payments and auto financing.

Selling wealth management products via the internet is even more opaque. Analysts at Nomura reckon money market funds account for most of the products distributed online, with assets under management hitting 2.2 trillion yuan at the end of last year. But yields have been steadily falling: Ant's leading Yu'e Bao fund now offers an annualized yield of just 2.7 percent, down from more than 6 percent at the start of 2014, and little better than most bank savings accounts. Platforms like Lufax are increasingly branching out to offer securitized products.

Then there's regulatory uncertainty. Chinese authorities have tolerated more start-ups than their counterparts in the West. But a number of high-profile failures look set to trigger a crackdown. The recent collapse of a $7.6 billion Ponzi scheme run by a peer-to-peer lender has added to pressure to finalise regulations for the troubled P2P sector. Beijing will probably shift to regulating online wealth and asset managers next.

Growing demand for consumer finance and sclerotic state-owned banks will keep valuations soaring. Early backers of Zhong An, Ant and Lufax can take comfort in the size and scale the three already have established. But beyond that, China's web finance sector remains a black box for investors.