IPOS IN CHINA: CHALLENGES AND OPPORTUNITIES FOR COMPANIES AND INVESTORS

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ABSTRACT

China's economy is gaining significant importance in the global economy and local companies have been entering the Chinese stock market. This trend is only going to increase over the next years and the subject will certainly gain importance in the business and academic world. (Ernst & Young Global IPO trends report, 2011) This paper analyzes the performance of Chinese IPOs in the first day of trading and what mechanisms and tactics were in place in the past five years that allowed firms to perform the way they did. Moreover, the paper will also present changes that have recently occurred or are likely to occur in the near future that are going to change stock performance in the first day of trading in the next years. It will end highlighting strategic perspectives for companies pursuing an IPO in China.

RESUMO

A economia da China está ganhando importância significativa na economia global e as empresas locais têm entrado no mercado de ações chinês. Esta tendência só vai aumentar nos próximos anos e o tema vai certamente ganhar importância no mundo empresarial e acadêmico. (Ernst & Young Global IPO relatório tendências, 2011) Este artigo analisa o desempenho dos IPOs chineses no primeiro dia de negociação e quais os mecanismos e táticas estavam no local nos últimos cinco anos que as empresas autorizadas a realizar da forma como fizeram. Além disso, o documento também vai apresentar mudanças que têm ocorrido recentemente ou são susceptíveis de ocorrer no futuro próximo, que vão mudar o desempenho das ações no primeiro dia de negociação nos próximos anos. Ela vai acabar destacando perspectivas estratégicas para as empresas que prossigam um IPO na China.

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Introduction

With the inauguration of the Shanghai and Shenzhen stock exchange, a new chapter in China's impressive economic story was written. Today, the Shanghai stock exchange is the 5th largest exchange in the world and investors around the globe are eager to invest in China's booming economy. One reason for that trend is China's outstanding IPO performance over the last years.

With an average underpricing of 137%, China's IPO market clearly outperforms other countries'. Indeed, other emerging countries like Brazil or India just show underpricing performance of 34% and 82% and are lagging behind the soon-to-be largest economy in the world. Although the abnormal initial return of China's IPOs decreased since 2007 and IPO companies tend to underperform over the long term, IPOs in China are still a hot topic among investors.

Since November 2002, when the Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors was released, foreign investors are able to invest in China's stock market via A shares. As a result, the IPO market has gotten an additional push forward. However, the Chinese IPO market is complicated. The China Securities Regulatory Commission (CSRC) regulates securities, international parties are involved in the IPO process and an entire set of requirements are necessary for companies conducting an IPO.

Nevertheless, all this cannot describe China's outstanding IPO performance in the last years. This paper gives explanations that go beyond standard theories and focus on China's unique regulatory structure, weak standards for accounting and poor corporate governance as the major drivers of extreme IPO underpricing in China.

Relevant milestones in China's stock market

China's stock market inaugurated in the early 90s

In the early 90s China's stock market was officially born. On December 19th 1990 China's first securities exchange, The Shanghai Stock Exchange (SSE), inaugurated with only 30 bonds and 8 stocks available to trade. Today, Shanghai Stock Exchange is the world's 5th largest stock market by market capitalization at US$2.7 trillion as of Dec 2010. However, unlike the Hong Kong Stock Exchange, the Shanghai Stock Exchange is still not entirely open to foreign investors due to tight capital account controls exercised by the Chinese authorities.

Later on July 3rd 1991 The Shenzhen Stock Exchange (SZSE) started its operation and Chinas two major stock exchanges were born. In November 1991, almost one year after China's first security exchange inaugurated, Electronic Vacuum Devices Co., was the first company which went public in B-shares. The stock market movement was, for someone surprisingly, also supported by officials. In January 1992 Deng Xiao-Ping expressed an official speech to recognize the values of stock markets to an economy. In retrospect the speech promoted and helped to accelerate the development and growth of China's stock markets, which are today a major engine for China's economy (see the following chapters). In January 1992, late Chinese leader Deng Xiaoping visited the Shenzhen Stock Exchange (SZSE) and said, "Our experiments in Shanghai and Shenzhen have been successful. So it seems that some capitalist products could also apply in a socialist society."

Independent regulatory units are installed after fraudulent practices

On August 10th 1992 thousands of people, were unable to buy stocks and protested against fraudulent practices. Paper work which was necessary to conduct a purchase was hold by government officials to their own benefits driven by supply shortages. After investigations from the government, which proofed the claim to be true, China suspended IPOs for one year. Later on and as a consequence of these events, China's main regulatory unit, China Securities Regulatory Commission (CSRC) was founded and established. Its main objective is to act as an independent unit which regulates securities affairs. Overall the CSRC is an institution of the State Council of the People's Republic of China (PRC), with ministry-level rank. It is the main securities regulator of the PRC.

China's stock market is gaining momentum in the mid-90s

With the beginning of 1993 China's stock market is gaining momentum. In August 1993 the first mutual fund went public on Shanghai stock exchange and one month later, the first hostile takeover took place. The Shenzhen-listed China Bao'an Group Co. Ltd. (Bao'an) started secretly acquiring stocks from Shanghai Yanzhong Industrial Co. Ltd. (Yanzhong) on the secondary market. Although Yanzhong protested against the takeover, the CSRC confirmed that the takeover was a market behavior and the shares purchased by Bao'an were valid. An additional sign of a market oriented behavior. One year later, in August 1994 Huaneng, firm listed on China's stock exchange was the first Chinese company which went public on the New York Stock Exchange.

However, not only positive events impacted China’s stock exchanges in the 90s. On February 23, 1995 the darkest day in China’s securities history happened, when the 327 T-bond incident happened. Later in December 1996, as a consequence of strong unforeseen up- and downward movements of stock prices, a limitation of stock price movement was put into place. Furthermore in the same year, a People daily comment about stock manipulations influenced a plummet in the stock market.

Laws and reforms are shaping the market in the late-90s

In December 1998, the Securities Law of the People's Republic of China was endorsed by the National People's Congress, and came into effect on July 1, 1999. China's Securities Law is the nation's first comprehensive securities legislation. The law grants CSRC to implement a centralized and unified regulation of the nationwide securities market in order to ensure their lawful operation.

Later in November 2002 one of the major steps in China’s young stock exchange history took place. The People's Bank of China and the CSRC released the Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors also known as QFII. Basically QFII qualifies foreign institutional investors to invest in A-shares and give them therefore the option to invest in China’s stock market.

In April 2005 a major capital structure reform started. Before that, stock shares were categorized into fluid and non-fluid shares. Around two-third of shares were non-fluid shares, which produced a problem of corporate governance. Management comprised of shareholders with non-fluid shares had no incentives to manage a firm accordingly as shareholders could not sell shares. Therefore profits from rising share prices were not possible. After the capital structure reform, which replaced non-fluid shares into fluid ones, the corporate governance problem was improved. However, non-fluid shares released inevitably produced a lot of sell-outs from non-fluid shareholders and negatively affects fluid shareholders. In return, shareholders are financially compensated by non-fluid shareholders under central government’s pressure.

Another major event took place in June 2007 when the qualified regulation act was installed. Qualified Domestic Institutional, better known as QDII, is a scheme relating to the capital market. It allows Chinese domestic investors to invest in oversea markets if certain conditions are fulfilled. This was a further sign of an opening process in China’s stock market.

On October 30th 2009 ChiNext, a capital market for small and medium size firms was founded. Main objective was to provide financing to technology and innovation-driven startup companies. Initially, over 28 companies went public and rose over 100% - a success of a new developed market. Today ChiNext holds the larger number of IPOs within mainland China.

On April 2010, after several years of preparation, the first stock index future in China was introduced. The China Securities Index 300 futures give investors the first time ever the chance to profit also from declining stock prices. The first time short selling mechanism in China's stock market was possible.

Later in July 2010 the Agricultural Bank of China went public, which was the largest IPO in China's history. However the stock market in China stays challenging as the first failed IPO in history showed. In June 2011 Baling Technology failed in the IPO, which represent the first IPO failure in China history.

Current structure and regulatory framework

China has two major stock exchanges

China mainland has two stock exchanges: the Shanghai Stock Exchange and the Shenzhen Stock Exchange. The later one has two different listing platforms which are the SME Board and the Growth Enterprise Board (ChiNext). All of them target different customers:

Shanghai Stock Exchange (SSE) is the world's 5th largest Stock Exchange by market capitalization with US$ 2.7 trillion as of 2010. In order to be listed in the SSE enterprise's issuance must be approved by the Council Securities Management Department and comply with regulations set by the Securities Law of the People's Republic of China and Company Law of the People's Republic of China. In particular, companies applying for the listing in the SSE must meet the following requirements: (Shanghai Stock Exchange, 2011)

- Total share capital before issuance over Rmb30 million
- Enterprises must operate profitable in the last 3 years
- Number of shareholders with holdings over Rmb1,000 need to be at least 1,000 people
- Publicly offered shares must be more than 25% of the company share capital. For companies with a market capitalization over Rmb400 million the requirement of free float gets reduced to 15%
- Enterprises must not have committed any major illegality or false accounting records for the last 3 years

Shenzhen Stock Exchange is the second largest stock exchange in China. The market capitalization of the enterprises listed on the Shenzhen Stock Exchange was about US$1.3 trillion in 2010. It has two different listing platforms: (Li, 2010)

a) SME Board: targets Small-and-Medium sized companies, which are mature or will soon be mature. The funds raised by the issuer shall be used for its primary businesses in principle
b) Growth Enterprise Board (ChiNext): targets companies that are still in the growth stage with a clear innovative focus. The ChiNext focus on companies with the following features: high technology, fast growth, new business models, new energies and new services.

Neither the SME Board nor ChiNext has limitations on ownership. State-owned enterprises, private enterprises and foreign-funded enterprises can apply for listing on the Shenzhen Stock Exchange. The companies applying for listing must have been operative for the last three years.

The requirements to be listed in the ChiNext are considerably lower and are the following:

- Profitability requirements: The SME requires issuers to satisfy one of the following conditions: (i) positive net profits in the last three fiscal years amounting Rmb30 Million in aggregate; (ii) positive net cash flows in the last three fiscal years amounting Rmb50 Million in aggregate; or (iii) business income in the last three fiscal years amounting Rmb300 million in aggregate. In contrast the ChiNext has lower profitability standards: (i) the company should have growing profitability for the last two years and net profits should not be less than Rmb10 million, or (ii) the company should had profits in the last years amounting at least Rmb5 million while having achieved Rmb50 million in business income with a growth rate of more than 30% in the last year.
- Asset requirements: ChiNext has lower asset requirements compared to the SME Board. The Chinext requires the companies being listed to have net assets over Rmb20 million in the last period. The SME Board uses a proportion of intangible assets listing approach with a requirement of intangible assets to be no more than 20% of total assets.

- Share capital requirements: SME requires total share capital amounting at least Rmb30 million before issuance while the ChiNext requires total share capital above Rmb30 million after the issuance.

China Securities Regulatory Commission is the main regulator

The main regulator for companies going public in China is the China Securities Regulatory Commission (CSRC). In order for the issuance to be approved, a CSRC-approved Sponsor must apply on behalf of the company pursuing the IPO while at the same time needs to conduct due diligence on the listing application and make recommendations on the readiness of the company to pursue the offering. (Equity, 2010)

Another special feature of listing in China is that before a company can qualify to submit its application the CSRC must undergo a period of tutorship where the company will learn about the requirements and best practices of becoming a listed company. In that period the company that wants to go public should improve its corporate governance procedures. Once the CSRC grants the approval the company has 6 months to undertake the equity issuance. After this time the approval document lapses and a new fresh approval must be obtained again.

After the approval from the CSRC the preliminary pricing assessment, which is divided into preliminary assessment and cumulative pricing assessment, takes place. The preliminary pricing assessment is designed to determine the strike range of the issue while the offer price is determined using a cumulative calculation of tending offers. Many times in the Shenzhen Stock Exchange the preliminary pricing assessment is the only tool used to define the offering price. After the strike range and offering price have been fixed, the company needs to fill the CSRC documentation and make a public note on the issuance available.

Several parties are involved in a typical IPO process

In order to go public in China companies have to hire the following parties, which are all involved in the IPO process:

- Underwriter: the company hires a lead underwriter that will be responsible for the underwriting of the issuance. The underwriter costs are the main cost incurred in the process of going public. The underwriting fees in China generally range between 1,5% and 3% of the offering size. Factors affecting the underwriting discount or fee are the size, complexity or efforts needed for a successful underwriting. The main players in the equity underwriting arena in China are the foreign banks Morgan Stanley and

Goldman Sachs as well as the Mainland Chinese players ICBC, CICC and CITIC Securities. Due to the ascend of the Shenzhen SME Exchange, other smaller players like Ping An Securities are rising in the table leagues. (The Stars Of China: Banks, 2011)

- Legal counsel: another critical party in the underwriting process is the legal counsel firm. It is the party in charge of preparing all the legal documents that will be submitted to the CSRC and the negotiation of the underwriting agreement.
- Accounting firm: accounting firms to audit the financial statements and prepare the final documents that are submitted to the CSRC.

A typical IPO in China takes about one year

The whole process of going public takes approximately one year in China mainland. In the following chart there is a timetable of the listing process for both Chinese stock exchanges. (Equity, 2010)

Shanghai/Shenzhen Stock Exchange IPO Timetable
The following table summarizes the general timetable for listing.

	Period	Responsibility
Tutorship period	365 days (1 year)	Sponsor and the IPO company
Listing material preparation by company and other professional firms	60-120 days (2-4 months)	Sponsor, Legal Counsel, Accountants, and the IPO company
Examination and approval by CSRC	121-210 days (within 3 months after the receipt of the securities listing application)	CSRC
Answering comments and revision of the prospectus	211-240 days (1 month)	Sponsor, Legal Counsel, Accountants, and the IPO company
CSRC approval	241-300 days (within 6 months after the receipt of the securities listing application)	CSRC

Different types of stocks are available on China's stock exchanges

On Chinese Stock Exchange companies can issue different types of stocks – A shares and B shares

- A shares are priced in the local Renminbi Yuan currency. Initially trading A shares was restricted to domestic investors only but after the reforms implemented in December 2002 foreign investors are now allowed with limitations to buy A shares. In order to do so the foreign investor needs to be certified as a Qualified Foreign Institutional Investor (QFII). As per 2010 the government of China had approved the certification to 98 foreign institutional investors. The QFII program has a US$30 billion quota on the amount that can be traded by those foreign institutional investors.

- B shares are quoted in US dollars and are available to both domestic and foreign investors. Currently the Regulatory Boards are studying the merger of both kinds of shares.

There is a third kind of stocks available in the market, so called H shares. Those shares refer to shares of companies incorporated in Mainland China but listed and traded in the Hong Kong Stock Exchange. Often, companies float their shares simultaneously in the Hong Kong Stock Exchange and in the Shanghai or Shenzhen Stock Exchange. Prices discrepancies between both shares are common, although. A shares usually trade at a premium over H shares as the government of the People's Republic of China restricts mainland Chinese people from investing abroad.

In addition there are N shares. N Shares refers to Chinese companies listed on the NYSE, NASDAQ, or the American Stock Exchange. They may or may not be incorporated in China, but they have their main business operations in mainland China.

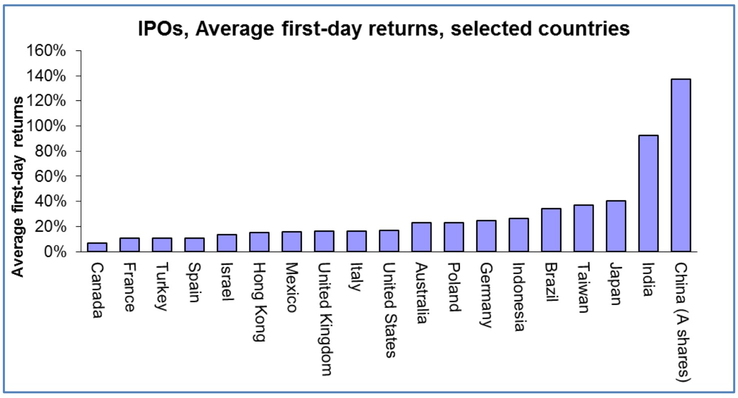
IPOs in China in a nutshell

Average return on China's IPOs is outstanding compared to other countries

Data on IPO performance in different countries, compiled by Professor Jay R. Ritter, highlights the unusually high first day returns in mainland China. With an average underpricing of 137% vs. only 16.2% in the United Kingdom or 16.8% in the United States (Ritter P. , 2010), IPOs in China are outstanding. China's IPO underpricing appear extremely high even when compared to other emerging economies, such as Indonesia (26.3%), South Africa (32.7%) and Brazil (34.4%).

It is interesting to note that the extreme underpricing only affects A-shares traded on mainland exchanges. Chinese companies listing B-shares, H-shares and N-shares do not experience such drastic underpricing. Traditional IPO underpricing theories which focus on information asymmetry and reputation effects for the underwriting banks cannot really explain the degree of underpricing seen in the Chinese mainland markets (see also the following chapter).

Figure 1: IPOs, Average first day returns, Source: (Ritter P. J., November 2011)



Review of China's IPO financials show high average abroad the board

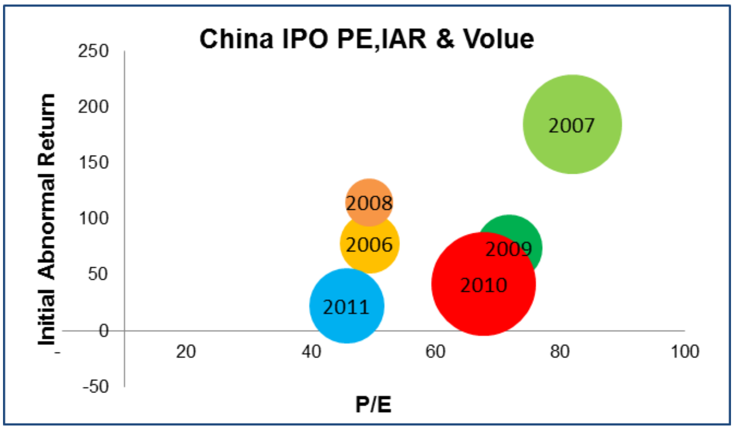
From 2006 to October 2011, the average P/E ratio of China IPOs is 61 with a high of 82 in 2007 and a low of 46 in 2011. The average abnormal initial return is 86% with 185% as a high and 22% as a low During the same period, the market average return is 33% with 127% as high in 2006 and -65% as low in 2008. Someone can see that P/E as well as index returns show high volatility.

Figure 2: IPO data from 2006 to 2011, Source: (Wind Information)

Year	IPO P/E	IPO Abnormal Initinal Return %	IPO Volume Billion USD	Indext Return %
2006	49	78	26	127
2007	82	185	72	94
2008	49	115	17	-65
2009	72	74	33	74
2010	68	42	79	-13
2011	46	22	41	-16
Average	61	86	45	33

This bubble graph in Figure 3 shows that for the IPO market in 2007, both the P/E ratio and IAR (Initial Abnormal Return) are higher than on other years, whereas the bubble size represents the IPO volume. In 2006, 2008 and 2011, the PE levels are very close to each other and ranged from 45 to 50. In addition, the bubble size represents the IPO volume.

Figure 3: China's IPO market over the last years, Source: (Wind Information)



In addition China's IPO volume was about 3 times the volume of the US, and if we include the HK market, Greater China's IPO volume was about 3.6 times the one of the US. China's influence in the global capital market is therefore much bigger than it first appears. We also took the IPO volume as an index of new company formation and privatizations in one country to show China's position in the global capital market. The unprecedented scale of China's IPOs definitely implied the global corporate landscape is in a change and will probably never be the same again.

China's IPO abnormal initial return decreased since 2007

From 2006 to 2011, China's stock market demonstrated a much more volatile behavior than before. Based on public information, the yearly volatility of Shanghai and Shenzhen stock market was 44.76% and 47.50%. Most of the time IPO AIR is much higher than index return while volatility is lower. This in addition makes IPOs an attractive investment opportunity and often preferable to just buying market indexes. In 2007, IPO AIR is almost twice of market return. For the year of 2008, 2010 and the first ten months of 2011, the market return were negative 65%, 13% and 16% while the IPO AIR were positive 115%, 42% and 22%. In the year 2009, the two returns are almost of the same level. All together the graph clearly shows two things: First, IPO AIR is in most years higher than index return. Second, IPO AIR decreased since 2007 dramatically from 185 in 2007 to 22 in 2011.

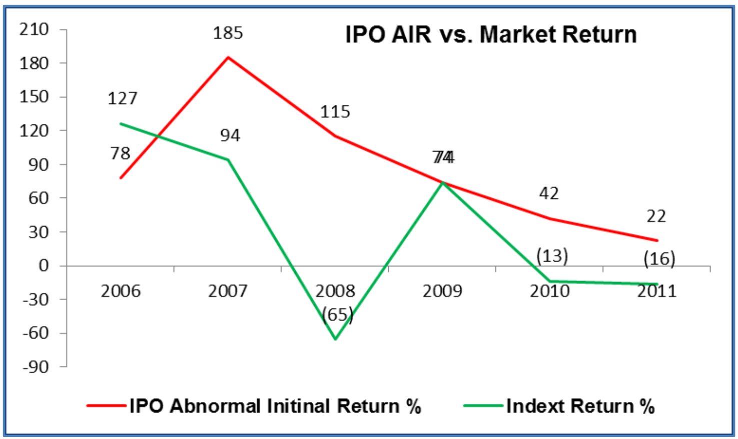
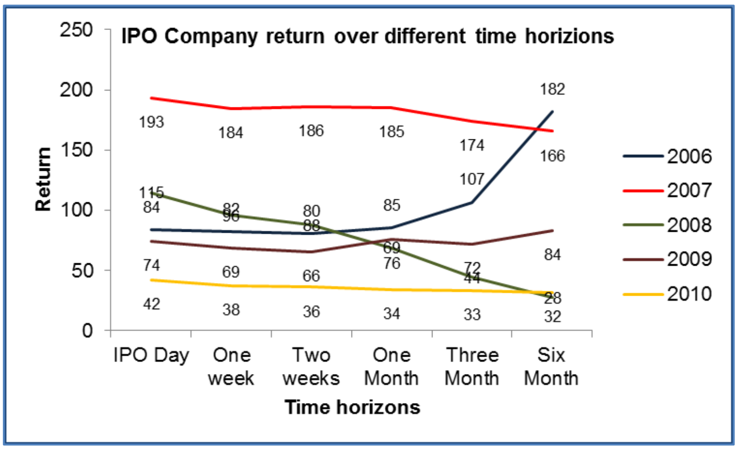


Figure 4: IPO AIR vs. Market Return, Source: (Wind Information)

IPO companies tend to underperform over long term

Another interesting phenomenon in China IPOs is the tendency to underperformance in the long term. Ritter (1991) was one of the first who proposed this problem. He also found out that IPO under performance was more obvious for companies, which went public during periods of high IPO activities. Usually these researches looked back at IPO companies' performance for 3 to 5 years. Because of the limitation of data, we just included the return of those companies which went public from 2006 to 2010 over 5 different time horizons in our analysis.

Figure 5: IPO company return over different time horizons, Source: (Wind Information)

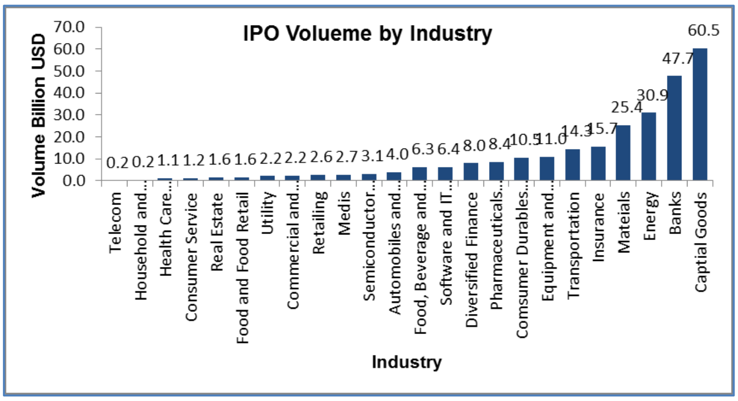


The graph shows that companies issued in 2008 did show a very obvious return declining trend. We think this is mainly because of the unfavorable market situation at that time. For the years 2007, 2009 and 2010, the curves are quite flat with slight upward as well as downward movements. For the year 2006, the curve is upward leading. Altogether, we can see that dependent on the year of the IPO, long term return tends to stay flat or even downward sloping. Over the long-term IPO companies tend to underperform.

Financial industries have highest IPO Dollar volume

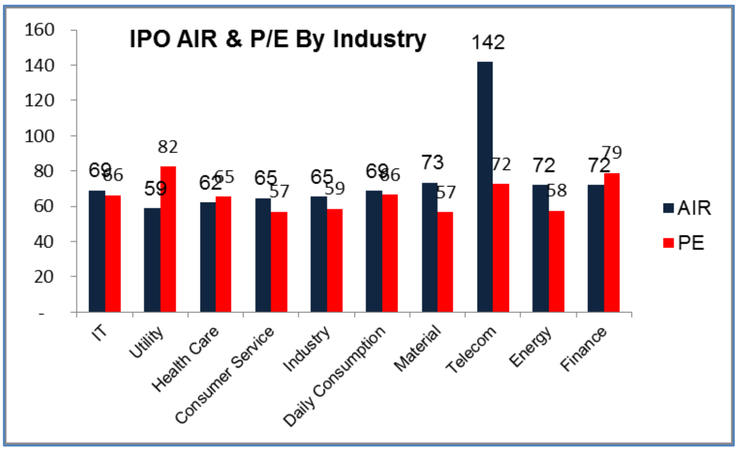
From 2006 to November 2011, the top five IPO industries by dollar volume are capital goods, banks, energy, material and insurance. For the same period the telecom industry had the highest abnormal initial return compared to other 9 industries.

Figure 6: IPO volume by industry, Source: (Wind Information)



In addition we didn't see obvious material differences among industry PE ratios as can be seen in Figure 7. PE ratios range in all industries between 57 and 82 and are consistent with abnormal initial return.

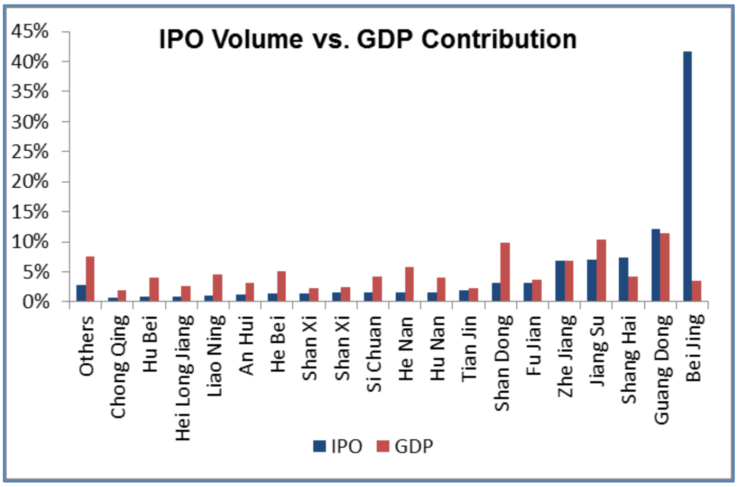
Figure 7: IPO AIR & P/E by industry, Source: (Wind Information)



IPO activities in China are clearly concentrated in major cities

Figure 8 shows that there is severe unbalance between IPO volume percentage and GDP contribution for different provinces especially for Beijing. In 2010, 41.67% of all raised capital flew to firms registered in Beijing while Beijing only contributed 3.52% GDP for the year of 2010. This can be explained by the fact that most big public companies in China are state owned companies with headquarters in Beijing. For example, in 2010 the Agricultural Bank of China went public in the mid of 2010, fetching the world's ever largest IPO. ABC raising a total of $22.1 billion in both Shanghai and Hong Kong stock market. And because ABC's head office was in Beijing and the group went to public as a single company, its IPO volume was treated as Beijing's IPO volume while GDP contribution calculation from ABC is based on different province location of the ABC's branches all over China.

Figure 8: IPO volume vs. GDP contribution, Source: (Wind Information)



Why IPOs in China are different

Regulatory and structural explanations for China A-share underpricing

Standard theories relating to IPO underpricing are insufficient to explain the degree of underpricing in China A-shares. As a result, researches from all over the world have put forward alternative theories to explain this phenomenon. (Jie, June 2009), (Megginson, Extreme Underpricing: Determinants of Chinese IPO Initial Returns, November 2005), (Megginson, Regulatory Underpricing: Determinants of Chinese Extreme IPO Returns, March 2007), (Wang, 2006). Most alternative theories focus on China's unique regulatory structure, weak standards for accounting and poor corporate governance as the drivers of extreme IPO underpricing.

IPO activity in China has been dominated by the privatization of large Chinese State Owned Enterprises (SOE), while the IPO activity for smaller enterprises or entirely private firms has played a smaller role. The Chinese government views IPO activity as part of its investment and capital formation goals set forth as part of its five year plans. As such, IPO activity is driven by political considerations as much as by capital markets. Every year, Chinese regulators set targets for investment, including sub-targets for regions and industries, and then invite companies to seek capital through an IPO. While targets are set by regulators, they are not formally disclosed and aren't known outside of the policy setting bodies. Each year, IPO demand exceeds the allocated capital raising quotas, leading to long waiting periods for companies looking to go public. Since different targets exist for different industries and regions, the waiting period may wary depending on the company, with some enterprises being able to list quickly while others wait many years for a chance at being listed. Corruption and unclear, non-transparent decision making further complicate matters, making it nearly impossible to know when a specific company will be given the right to do an IPO.

Historically, the pricing of IPOs in China has been set by regulators and based on earnings multiples (P/E). Until 1999, regulators set a pricing cap on the IPO's P/E ratio of 20, which greatly underpriced the shares relative to prices prevailing in the secondary market. Since then, regulators have been liberalizing pricing and introducing more flexibility, but the IPO pricing process still remains far from transparent. In the West, investment banks working on an IPO seek investors through a roadshow process, during which they explain the story and prospects of the company, and gauge investor interest. The investment banks can then adjust the IPO pricing based on investor feedback to price the IPO as close as possible to the demand level investors have expressed. No such mechanism exists in China, and no market / investor feedback is allowed to impact the IPO pricing. This leads to more conservative underwriting and pricing of new issues.

There is often a very long delay between IPO offerings in China and the listing of shares for trading. This delay results from the regulatory process in China, with authorities limiting the number of IPOs coming to market and trying to balance the growth and investment flows to different regions of the country. The delay between subscribing to an IPO and committing capital to actual listing can take several months and in some cases years. In addition, investors must commit capital equal to the amount of shares they wish to subscribe, even though in the end they are likely to receive a very small allocation due to vast IPO oversubscription. In other words, investors must commit a large amount of capital, for an unknown period of time, and wait for that capital to be returned after the shares have begun trading and being allocated a tiny percentage of the desired IPO amount. A result, only huge returns on the IPO allocations received can justify the long delays and capital commitments needed.

Finally, a number of China specific factors relating to information and control asymmetry help the underpricing of IPOs. First, accounting standards in China remain lax and less trustworthy than in many Western markets, leading investors to be suspicious and demand higher returns from new companies coming to market. Secondly, the initial public offerings in China tend to be minority share issuances which still leave the government as the majority shareholder. This means, that will the company is being privatized, the public shareholders are unlikely to be able to exercise much influence on the company's board. This gives rise to a corporate governance discount, as investors are buying an economic interest in the company, but without much voting or management control power. Thirdly, in cases where companies are controlled by powerful insiders, the long period between IPO share subscription and public listing has given insiders the opportunity to steal assets from the company during this time period. After the company releases its financial statements and receives investor's money but before its shares are listed for public trading, there is an incentive for insiders to remove key assets from the company's books and transfer them to other entities they may control. This risk is referred to in the academic literature on China IPOs as "tunneling risk" and is another factor driving the large discounts seen on Chinese IPOs. Finally, China remains a country if a closed capital account, meaning it is very difficult for the ordinary Chinese to transfer money and invest abroad. As a result, Chinese investment options are limited to bank deposits, domestic bonds, domestic equities and real estate. With bank deposit paying interest rates below inflation, bonds illiquid, and real estate purchase made ever more difficult by the Chinese government concerned about a bubble, Chinese equities (A-shares) remain as one of the only investment outlets for the ordinary Chinese. This helps to explain huge amounts of speculation in the stock market, IPO oversubscription and very large first day returns.

China companies raise funds on alternative markets

Chines companies today can raise equity financing in a variety of markets. While the focus of this paper is on the Chinese mainland A-shares market, important alternatives exist in the form of the Hong Kong Stock Exchange (HKSE) as well as the New York Stock Exchange (NYSE). Finally, there has been a recent spike in US listing of Chinese companies via reverse-merge IPOs – a dynamic that warrants attention.

While the Shanghai stock market today is the 5th largest in the world by capitalization, it is important to note that many Chinese companies are seeking a listing outside of mainland China. NYSE has attracted the business of such giants as China Life Insurance (LFC) and China Mobile (CHL), while ICBC (1398) and Ping an Insurance (2318) both went public on the HKSE. Most interestingly, the two largest IPOs of recent years, Agricultural Bank of

China (1288) and AIA Group (1299) both chose Hong Kong not Shanghai for their IPOs. By doing so, the companies are signaling that while China's mainland exchanges may be growing, large companies looking for significant liquidity and funding, still chose more mature markets such as Hong Kong. The lower degree of underpricing found in Hong Kong means companies are able to raise more money than they would if they listed on the Chinese mainland, and could be a factor explaining by large Chinese companies still prefer to IPO in non-Mainland markets.

Reverse-merger IPOs as unique vehicle

In addition to the mega IPOs of companies such as Agricultural Bank of China, recent years have seen a dramatic increase in so called reverse-merger IPOs of many Chinese companies seeking capital. A reverse-merger IPO is considered a simpler and cheaper way of going public, allowing many small companies to circumvent the compliance and roadshow necessary with a traditional IPO. In a reverse-merger transaction, a publicly listed "shell company" with little or no operating assets is first registered with the SEC via an S-1 registration. Such listing generally takes place in the over-the-counter or pink-sheets markets. Next, the publicly listed company acquires a privately held company, with the shareholders of the private firm exchanging their shares for those of the public firm. The assets and directors of the surviving company are almost solely that of the former private firm. Finally, the public entity can issue additional shares to raise capital.

There are numerous US companies offering advice on going public via reverse-merger IPOs. While, nothing about the process is specific to China, Chinese companies have dominated the US reverse-merge IPO statistics in recent years, with consultancy firms specifically setup to cater to Chinese clients. A quick search on Google, reveals such companies as "Go Public Institute – Public Shells for Reverse Mergers" (http://www.gopublic.com), "Dynasty Resources", (http://www.dynastyresources.net/corporate-finance.html), "Going Public Experts" (http://www.goingpublicexperts.com/), "Williams Securities Law Firm" (http://www.gopublicdirect.com), "How2GoPublic.Com" (http://www.how2gopublic.com). When contacted, one of the firms claimed they could complete a reverse merger IPO process for a total of $40,000 USD. Further research reveals the clients of the above companies and the S-1 filling they have made with the U.S Securities and Exchange Commission (SEC). All the companies we have found were exclusively Chinese, had little assets, and consisted primarily of insiders looking to sell shares in their businesses. Examples of companies recently filing S-1 documents, along with information highlighting the business of each company, are presented in the table A in the appendix.

The business prospects, financial accounting standards and corporate governance of many of these companies appear weak. Similarly, the reputability of the US law firms working on these reverse-merger transactions appears seriously doubtful. In fact, a significant number of such firms have been delisted, sued by shareholder and are being investigated by the SEC (Delfeld, 2011). Due to the amount of reverse-merger IPO activity, the SEC has also considered imposing additional rules and checks for companies seeking a reverse-merger, while a recent SEC announcement (SEC, 2010) has said that reverse-merger IPO companies are prone to “fraud and other abuses” while many of the companies may “either fail or struggle to remain viable.”

Implications for future IPOs in China

What (and what not) to expect for the upcoming years

Looking to the future is always a challenging exercise. When it comes to the Chinese context, it is even harder because the country is growing so fast and the government tends to be efficient to give quick responses to market issues. In the past five years, stock markets observed impressive first-day returns over IPOs in China. This phenomenon happened due to a set of structures, regulations and incentives that were in place at that particular moment. Thinking ahead for the next upcoming years, it is important to understand what might change and what kind of impact the change is likely to produce on IPOs’ first-day returns.

<u>Market structure</u>: On a macro perspective, there are no significant expected changes in the market structure for IPOs over the next years. There are still many large SOEs that can benefit from raising capital through IPOs and these companies are very likely to receive preference by regulators to be listed. These companies are already big players in their respective markets and are very likely to follow China’s overall economic growth, hence presenting attractive opportunities for investors.

Although improving over the years, these companies still present the same problems that existed in the recent past years which were part of the reason for underpriced IPOs (weak accounting, poor corporate governance, lack of transparency, etc.).

<u>Regulations</u>: There are many questions investors have nowadays that are in the government’s agenda. Will there be a relaxation on foreign investment rules? Are the A and B shares going

to be unified? While the answer for these and other questions are highly expected, it is hard to precise when the government is likely to address them (not to mention a larger issue that is the Renminbi convertibility).

Chinese government is currently trying to push companies to make their initial offerings more in mainland China then in Hong Kong (last year Hong Kong had the largest volume of IPO by market capitalization and in 2011 the trend is to remain number one), but both Shenzhen's and Shanghai's pipeline are full and it is up to regulators to maneuver over the companies that will be listed.

A new initiative that is in going to take place in the Shanghai stock market is the "International Board", which will allow international companies to be listed in that stock exchange, providing local investors with new investment options (major multinationals operating in China are expected to be the first ones in the International Board).

Apart from that, there are efforts to make the Chinese stock market follow more international rules and it is expected that IPOs in China will eventually be organized through a registration-based system like in the US or Europe, but there is no clear deadline for this to happen.

<u>Incentives</u>: there are two different angles to analyze incentives: the government / company owner and the public perspective.

The largest IPOs are normally SOEs and since the government usually remains with a large part of its shares in the company, a high first-day valorization/ return is welcomed.

From the public's perspective, as stated before in this paper, there are currently not that many interesting investment alternatives and the IPOs seem like a good opportunity. Since demand is far greater than supply and most people cannot buy the stock at its initial price (there are quotas and a lottery scheme most of times is used).

China is likely to keep the trend of increasing the IPO market (by market capitalizations, not necessarily by number of IPOs), it is possible that the public will have more chance to access initial prices. The International Board in Shanghai will also help to increase supply of investment opportunities for the general public.

Other than the three main aspects presented (structures, regulations and incentives), it is possible to argue that the market is simply getting more mature (evolving over a learning curve). While that is highly debatable, data show that in 2010 and 2011 first day returns were, on average, lower than the previous years. The debate lies on whether this was really a maturing evolution or simply reflects the on-going global economic crisis. Since there is a cap on foreign investments for A shares, making supply lower than demand, the global crisis is probably not a major driver of China IPO's lower first-day returns recently.

Very recently, Guo Shuqing was nominated the new chairman of CSRC. He has ambitious plans to develop China's capital markets, making it more competitive and more on pair with its western peers. His proposal is to build a comprehensive bond financing platform and promote innovation on financial services. Moreover, he promises to have "zero tolerance" on inside trading, assuring more transparency in the marketplace. Whether he will succeed or not, it is up for the future to tell us, but one thing is for sure: China is pushing its capital markets towards Western rules and dynamics.

Considering market structure, regulations, incentives and evolution on a learning curve, we do not expect to see first-day returns reaching European standards, but there is a market evolution in place and it is very unlikely that China's stock market is going to see those abnormal returns that occurred in the past years in the future. What is more likely to happen is for the market to keep the 2010/2011 trend with returns averaging between 20% and 40%.

Conclusion

China openness to a market-driven economy is a recent process and the country managed to change drastically over the past decades. Profound changes happened in Chinese society as well as in the economy, and the stock market was no exception for that.

Just like the country as a whole, China's stock market is still in its way to become a sophisticated marketplace. The government runs the transition slowly and through the past decades, local investors were able to profit from the market's imperfections.

China is going irreversibly towards a Western style of stock exchange regulation and dynamics. It will increase investors' confidence hence increasing the flow of money into China, but it will also make the initial IPO returns lower. But the path to this future is tortuous and will take years. While China is not there yet, the days of 100% (or more) profit in one day are over and the average expected initial return is decreasing, but investors are still able to profit from above average IPOs first-day return.

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