

ChiNext promises big things for VC in China

The Shenzhen-based exchange has had a mixed opening, but provides a much needed exit route for investors in China's smaller TMT-focused companies.

Ten years in the making, the Shenzhen-based ChiNext exchange, otherwise known as the 'Growth Enterprise Market' (GEM), has been heralded as a breakthrough for China's population of smaller, technology-focused companies.

It should also be a key development for China's venture capital industry, providing it with a much-needed domestic exit route. In fact, of the initial 28 companies which began trading on 30 October, research from Chinese private equity data provider *Zero2IPO* shows that 23 were venture capital- or private equity-backed. Four of these companies had received funding from foreign firms.

"Previously for most TMT-related companies, the more popular listing venues were NASDAQ and NYSE and more recently the HKSE," commented Laure Wang, co-founder of Hong Kong-based fund of funds manager Asia Alternatives. "The new GEM board provides yet another potential exit venue, further strengthening one of the critical foundations for the development of a venture capital ecosystem."

Applicants for GEM board listing are required to have at least RMB30 million worth of stock capital – much lower than the minimum RMB50 million needed to list on Shenzhen's SME board. Likewise, GEM board applicants must have been profitable for two fiscal years prior to listing, with net profits of at least RMB10 million. On the SME board, the requirements are three years and profits of at least RMB30 million.

The news is good for China's smaller companies, which are often overlooked when it comes to domestic funding routes in China, despite the (ever-growing) importance of the TMT sector to the country. According to Central Bank figures cited in the *Wall Street Journal*, small and midsize companies only received \$1.3 trillion of the loans made by Chinese banks in the year to September 2009, despite representing 60 percent of the country's output.

And with China fast-becoming the home of technology, ChiNext should serve as another weapon in China's arsenal against other key venture capital markets.

"Within the US venture ecosystem, listings for venture companies have become more difficult or less attractive with Sarbanes-Oxley costs and complexity as well as a shrinking of the investment banks, leaving many stocks "orphaned" from research coverage," continued Wang. "This is one area where Chinese

venture companies are showing comparative advantage – more venues to list, high investor appetite for fast-growing companies and a relatively smaller pool of existing public TMT companies when compared to the US universe, which provides scarcity value."

But, of course, as with all new markets, there is an element of caution needed before success can be declared. And with China, where the presence of "hot money" and the regulatory environment are always concerns, extra caution is needed. As Wang pointed out, aftermarket trading and performance, disclosures and transparency and the ability to demonstrate

a complete cycle of full realizations by venture capital investors all need to be watched carefully.

The first few days of trading did little to ease any fears of speculative trading. Only ten of the 28 stocks listed had an IPO P/E ratio below 50 times. In fact, the average IPO P/E ratio was 56.6 times, which, compared with an average IPO P/E ratio of 25 times in China's A-share market, and 40 times on the Shenzhen SME board, caused some to warn of over-heating.

30 October saw the first 28 stocks begin trading at an opening price on average 76.5 percent higher than their issue price. The day saw all 28 stocks surge, with gains ranging from 76 percent to 210 percent. However, the second day of trading saw the share price of 20 of the 28 stocks drop the maximum 10 percent allowed under the ChiNext regulations. Not the most moderate of beginnings, although trading was holding up at the time of going to press.

There are also concerns this new market may encourage companies to list before they are truly ready.

Said Andrew Rickman, chairman of UK-based angel investor Rockley Group, which launched a joint venture with Shandong High-Tech Investment Corporation in May: "I worry this new market will attract small companies perhaps in the way that the AIM market in London has, where they're too young and too early to be exposed to the public markets and can get stranded."

However, he stressed that ultimately anything that contributed to the development of China's domestic venture capital and private equity industry "has got to be a good thing".

And that finally is the point: as a further step towards enabling China's VC and PE industries to become self-sufficient, ie being able to raise money, invest and exit within the country, ChiNext has the potential to be a pretty fundamental one. ●



High P/E ratios on ChiNext caused some to warn of over-heating