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ChiNext – The New NASDAQ?

In Poker, the odds of being dealt a hand of a Straight Flush is about 0.0015%, that is, forty possible Straight Flushes over roughly two-point-six million permutations. If you get one of those hands and nobody else does then you take your winnings which works out to be about 4-5 times your capital. Of course one can win with other less impressive hands insofar as your opponents' hands are worse than yours and therefore the odds of a winning hand is one out of the number of total players. Every year about 15 million mainland Chinese commute the ocean via hovercrafts known as TurboJET to Macau to attempt this feat. Now they don't even have to cross the ocean: they can simply go to Shenzhen Stock Exchange and bet on stocks on the ChiNext board. On first day, all 28 new stocks on ChiNext went up between 76%-210% higher than their IPO prices.



What is ChiNext?

ChiNext was launched on 30 October 2009 in Shenzhen Stock Exchange (SZSE) with an objective to provide the opportunities for small, independent, innovative enterprises

with good growth prospects and unique business models to access the capital market. The effort to create a NASDAQ-style board began in 1999 when China's State Council initiated the plan for improving China's capital markets. But the plan was postponed in 2001 when the Internet bubble burst in the US and it was not until May 2004 that the State Council agreed to set up the board and base it in Shenzhen.

A welcome addition to the capital market, ChiNext is the fourth component of China's multi-tier market, which includes the two main boards and SME Board in Shenzhen. While ChiNext and the SME Board have no limitation on legal forms of candidates (i.e. the state-owned enterprise, private enterprise and foreign-funded enterprises can apply for listing), one of the major differences between ChiNext and the SME Board is that the SME Board mainly targets companies that are more mature. ChiNext focuses more on companies in the high-growth stage that significantly rely on innovation. The SME Board was launched in 2004 with IPO qualifications similar to Shenzhen main board, except for the number of issued shares. Companies with less than 100m shares will be issued in SME and those with above 100m shares to be listed on the main board.

To facilitate the listings of SMEs, ChiNext board is designed to be less stringent in terms of listing requirements relative to the SME and the main boards. For example, the profitability, asset and share capital requirements for ChiNext candidates are less stringent compared to the requirements of other boards (refer to Figure 1). It is also interesting to note that the Chinese authorities have paid more attention to corporate governance – a key element for developing the investment industry and capital markets. ChiNext enforces more supervision on its candidates as companies are required to have an established audit committee, where this was not a condition under the SME board.

Figure 1: Requirements Comparison Between ChiNext and SME

| | ChiNext | SME |
|-----------------------------------|--|--|
| Profitability Requirements | <p>Alternative 1:</p> <ul style="list-style-type: none"> Gain profits in the last 2 consecutive years Net profits for the last two years shall be no less than Rmb10 million and shall increase continuously <p>Alternative 2:</p> <ul style="list-style-type: none"> Gain profits in the last year, and the net profits shall be no less than Rmb5 million Business income for the most recent year > Rmb50 million The growth rate >30% in the last two years | <p>Alternative 1:</p> <ul style="list-style-type: none"> Net profits gained in the last 3 fiscal years shall be positive > Rmb30 million (US\$4.4 million) in aggregate Net cash flow gained in the last 3 fiscal years > Rmb50 million in aggregate <p>Alternative 2:</p> <ul style="list-style-type: none"> Business income gained in the last three fiscal years > Rmb300 million in aggregate |
| Assets Requirements | <ul style="list-style-type: none"> ChiNext cancelled the requirements on a proportion of intangible assets Uses net assets instead i.e. the net assets at the end of the last period shall not be less than Rmb20 million, and without uncovered loss. | <p>A proportion of the issuer's intangible assets (excluding its land use right, aquiculture right and mining right) in its net assets at the end of the last period shall be no more than 20% – and there is no uncovered loss.</p> |
| Share Capital Requirements | <p>The total share capital after issuance shall be no less than Rmb30 million</p> | <p>The total share capital before issuance shall be no less than Rmb30 million.</p> |

ChiNext Companies

The launch of ChiNext has attracted substantial interest from many Chinese SMEs from industries ranging from electronics to social services. Although a total of 188 enterprises had applied for listing on ChiNext by October 20, 2009, the first batch of IPOs launched on ChiNext's commencement day consisted of 28 companies. Companies from the machinery, IT, pharmaceuticals and social services industries represent over 80 percent of the first batch of ChiNext-listed companies.

Driven by huge investor appetite, the first batch of ChiNext companies had raised funds in respective amounts that were much higher than anticipated. The 28 companies planned to raise about \$1.0 billion through their IPOs, however, the aggregate proceeds reached \$2.1 billion based on the issue prices of stocks as of December 2009 or an average of US\$75mn (RMB 520mn) per deal.

Figure 2: Percentage Breakdown of Listed Companies by Industry (First Day Launched)

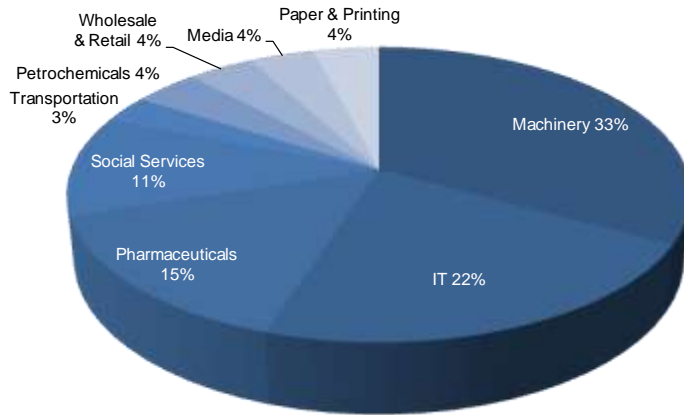


Figure 3: Capital Raised by Sector (As of Dec, 2009)

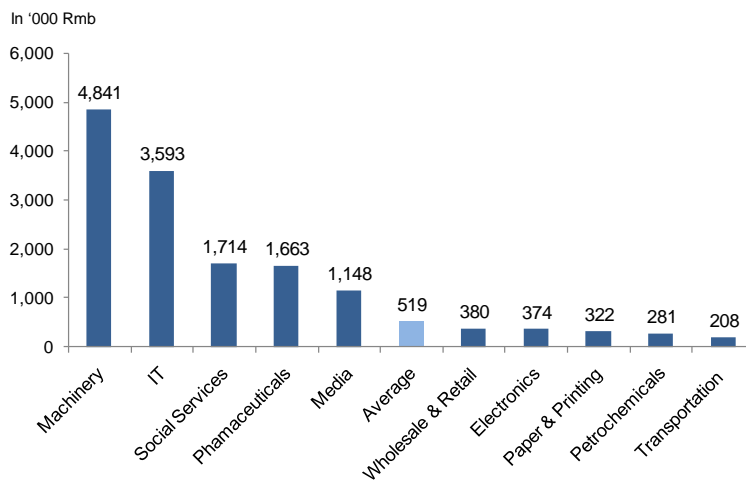


Figure 4: Overview of Largest 5 IPO in ChiNext (As of Dec, 2009)

| Short-Name | % Free Float | Business Type | Company Details | Market Cap bn CNY | 52-wk High/low (CNY) |
|-------------------|--------------|-------------------------|---|-------------------|----------------------|
| HBMC | 20% | Media | A China-based company primarily engaged in producing and distributing movies and TV shows. | 10.6 | 91.80/53.38 |
| Lepu Medical | 8% | Medical Care Products | A high-tech enterprise specialized in research & development, production, sales and service of high-tech medical devices, including those coronary heart diseases treatment related | 23.1 | 86.00/48.76 |
| Geeya | 20% | IT | Engaged in the research and development, production and distribution of software and hardware for digital televisions systems. | 5.2 | 36.90/18.88 |
| TGood Electric | 20% | Machinery | A Chinese-German JV producing transformer substations. | 6.1 | 64.00/35.01 |
| Aier Eye Hospital | 20% | Social Services/Medical | China-based hospital group, holding 15 eye hospitals and 2 ophthalmology institutes | 7.2 | 72.00/42.65 |

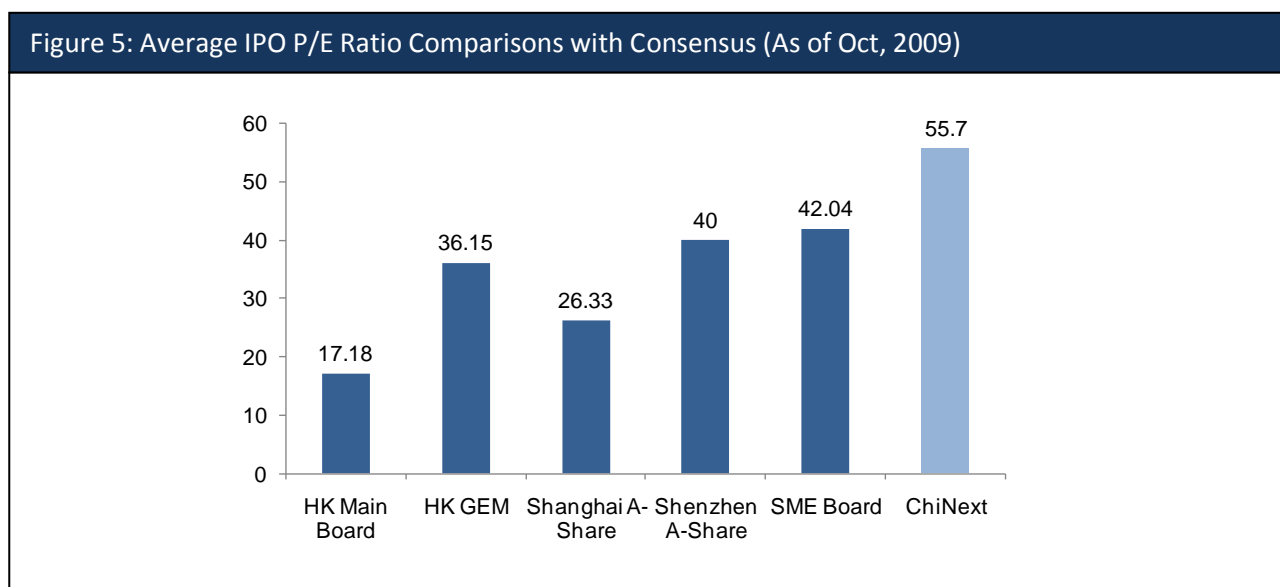
Exit Channel for VC/PE

With lower listing requirements and candidate preferences, ChiNext is a key transitional platform for China's Venture Capital (VC) and Private Equity (PE) funds as it provides another key exit route. Out of 28 first batch ChiNext companies, 23 were reported to be either venture capital or private equity-backed and 4 had received funding from foreign firms. Before the launch of ChiNext, VC/PE funds tended to rely on NASDAQ, NYSE and HKSE for their exit routes. NASDAQ alone currently has 116 Chinese listed companies. The introduction of ChiNext would ultimately encourage the development of domestic VC/PE funds.

A remarkable debut or a risky bet

The attractiveness of ChiNext drew substantial demand from both institutional investors and retail investors. About 252,600 individual investors bought 423 million ChiNext shares on the launch date, representing around 97 percent of the trading volume on the first day of trading on the bourse. The first ChiNext batch companies also attracted investments from 217 mutual funds in the new share subscription process. According to Wind Info, an average ChiNext company attracts investments from 34 funds.

On the launch date, 28 new stocks were traded on average 106 percent higher than their IPO prices. Over the day, all stocks surged ranging from 76 percent up to as much as 210 percents. The average price-earnings ratio for the initial public offering prices was at around 55.70 times, and then was pushed up to around 111 times, much higher than the average of the main bourses like Shanghai Stock Exchange (25 times) and Shenzhen Stock Exchange (37 times).



Large overnight gains of ChiNext stocks have precedents on the Sino alternative exchanges. On the first day launch of the SME Board, stocks rose more than 130 percent on the first trading day. Three months later, the share prices fell by an accumulative of 40 percent from the closing prices on the first trading day. In 1999, the Growth Enterprise Market of Hong Kong Stock Exchange rose at about 100 percent plus on its first trading day but the index fell about 90 percent since 2001 technology stocks plunged.

Some regulations are in place

To curb excessive speculation in the trading of newly listed shares, SZSE has enforced a number of trading rules. First, the suspension rule suspends trading for 30 minutes when stocks move 50 percent from its opening price. The rule further says that if a

company's shares moves 80 percent either way from its opening price, it will be suspended from trading until the final 3 minutes of the session. However, the introduction of the suspension rule did little to prevent the first batch of ChiNext stocks from surging on the launch date.

Another tool to help reduce market volatility is the daily price movement limit which does not apply to the first trading day. The rule specifies that the movements of Chinese A and B shares are only limited to move 10 percent per trading day.

In addition to market suspension mechanisms, SZSE submitted a plan to China Securities Regulatory Commission (CSRC) - effectively the SEC - to improve the mechanism of direct delisting of ChiNext. The goal of direct delisting is to ensure the quality of the listed companies in ChiNext by requiring every listed enterprise meet all the board requirements in order to maintain its listing status. This improvement would help promote the healthy development of the market in the long run.

Conclusion

As an important element in the development of the Chinese capital market, ChiNext is well positioned to attract interest from companies and investors. As of March 2010, there are 58 listed companies and about 191 IPO applications currently under review. However, past phenomenon can serve as a case study for Chinese regulators in a bid to develop ChiNext into a sustainable funding platform for Chinese startups. Since 1962, around 39 nations or regions have launched 75 boards for startups to raise funds. Nevertheless, around half of them were closed due to weak market sentiments and regulatory inconsistencies. It is widely believed that the main reasons for failure of some markets are lowering threshold of market entry, poor supervision and inactive transaction. The excessive speculation on the launching date raised fresh concerns over the long-term sustainability of ChiNext. Remember that in this very same casino, gains could just as well flip to losses. If ChiNext continues to improve its listing regulations, suppress the speculation and manage the volatility level on both primary and secondary markets, ChiNext could very well become the new NASDAQ of China.