

SME Financing: From Market Failure to Network Externalities

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STOCK EXCHANGE



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SMEs are the backbones of real economy

**Chinese
SMEs
account for**



- **SMEs account for 99% of the total number of all companies registered and are cornerstones for economic growth and social well-being.**

Hungry SMEs in China

- Bank lending serves more than 90 percent of large enterprises, but only less than **20 percent** of SMEs
- The real-term lending rate for small and medium-sized enterprises are about **15 percent** at the moment, according to China Association of SMEs.
- SMEs' private lending amounted to **RMB 3 trillion (USD 492 billion)** in 2013.

Key challenges

- Information asymmetry
- Market failure for SME financing market
- Enhance public service for SME financing

Multi-tiered Market Structure

- SZSE's Multi-tiered Market Structure

Main Board

- Established on 1 Dec., 1990
- 480 Blue-chip companies

SME Board

- Established on 17 May, 2004
- 723 High-quality SMEs

ChiNext Market

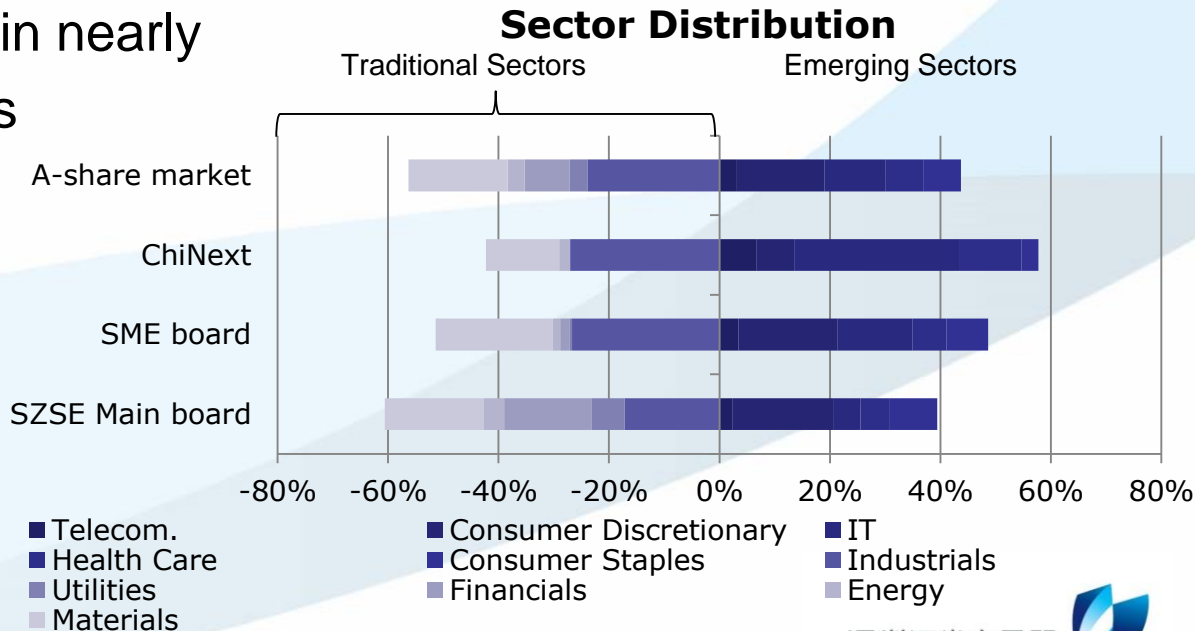
- Established on 30 Oct., 2009
- 392 Emerging and high-technology enterprises

SME Board and ChiNext have raised USD 167 billion for 1,109 SMEs and innovative start-ups.

Data as of 15 Sep., 2014

Widening Sectorial and Geographical Coverage

- There are altogether 532 listed companies on SZSE that are in strategic emerging industries, accounting for 33.08% of all the SZSE-listed companies.
- Private sector accounts for **81%** of all listed companies on SME Board and **95%** of the ChiNext market
- **93%** of issuers on ChiNext and **74%** on SME Board are certified high-tech enterprises.
- SZSE-listed SMEs located in nearly **120** municipalities and cities across China.



The SZSE Supports Green Industries and Sustainable Development

- The SZSE supports environmental, alternative energy and new materials companies.
- More than 50 green companies are listed on the SZSE.
- Social Responsibilities Index to promote environmentally sensitive practices.
- The SZSE has established a special fund to restore deserts in Inner Mongolia. The project has attracted wide participation by financial institutions and companies.



The SZSE Supports Agricultural Industries

- The SZSE collaborated with *Yangling Modern Agricultural Pilot Zone* in 2012 to foster hi-tech high-value-added agricultural issuers.
- The SZSE had listed 53 issuers in agriculture, husbandry, fish farming and food processing by the end of 2012.
- The capital market facilitates the transition of agricultural businesses into high value-added, modern enterprises.

➤ *Leading Companies in the Agricultural Sector:*



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Information Disclosure to Bridge Asymmetry

- The exchange, as a platform of information disclosure, enhances visibility of SME issuers.
- The SZSE took the lead in adopting XBRL (extensible business reporting language) to streamline information dissemination.
- The SZSE provides free trading data and information to investors.
- The SZSE organizes regular investor relations events for investors to meet executives for face-to-face communication.
- Dedicated website provides all related information to investors free of charge and enables interactive communication between investors and listed companies.

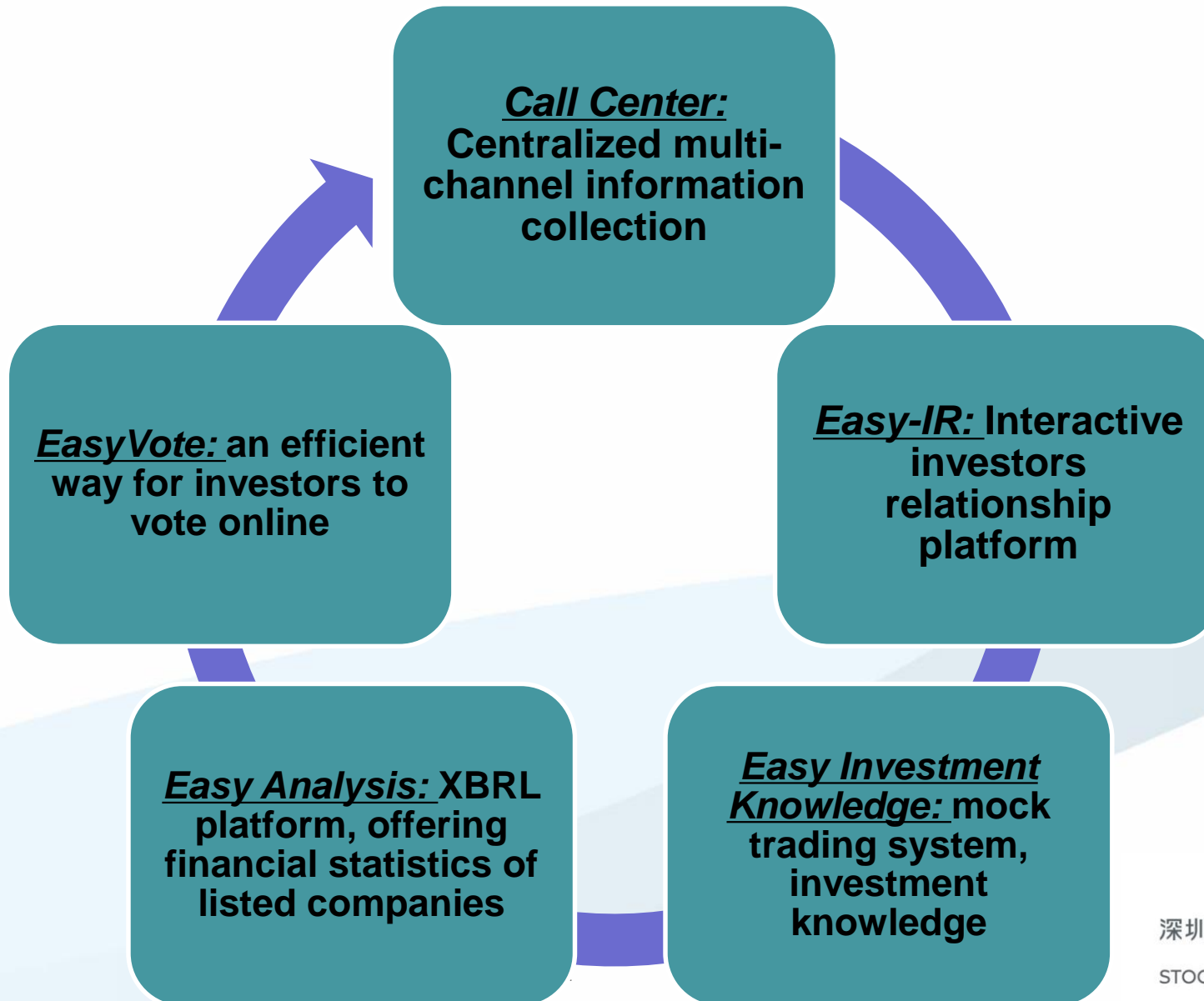
Enhancing Information Access

- SZSE launched its *Easy-IR (Investor Relationship)* platform in 2010, a micro-blogging platform (like Facebook) to facilitate communication between investors and listed companies.
- SZSE developed the *Easy-IK (Investment Knowledge)* in 2013, which incorporated investment knowledge into online games. Through games, tests and simulated investment, investors know better of their own risk preference, and thus employ rational investment strategies.



Enhancing Information Access

Easy-IK, Easy-IR, Easy Analysis, EasyVote and Call Center!



Information Disclosure to Bridge Asymmetry

- Working with banks by sharing issuer candidate information to help banks identify suitable SME loan clients
- Helping banks design lifecycle financing service for SMEs.
- Encouraging standard disclosure of financial information and proper corporate governance by SMEs.

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Network Externalities-Expanding Market Coverage

- In May 2014, the CSRC lowered the listing threshold for the ChiNext Market. Companies meeting one of the two standards can now list on ChiNext Market:
 - ✓ (1) profitable in the past two consecutive years with accumulated profit above RMB 10 million (US\$ 1.6 million); or
 - ✓ (2) profitable in the past year (**regardless of the size of profitability**), with total revenue above RMB 50 million (US\$ 8.1 million).

Network Externalities-Expanding Market Coverage

- In July 2014, the CSRC decided to allow internet and hi-tech companies that are **not-yet-profitable** to list on the ChiNext Market after being quoted for one year on the NEEQ(New Third Board), the national OTC trading platform. A sub-segment will be created under ChiNext for these innovative startups.



Network Externalities-SME Private Placement Bonds

- Merits of SME Private Placement Bonds:
 - *Lower issuance threshold, lower financing cost (vs. bank loans)*
 - *Filing-based issuance system, approval within 10 working days*
 - *Non-standard product design, more freedom in utilization of proceeds*
- By the end of August, 2014, 325 companies have filed their issuance documents and 253 companies have completed their issuance, raising a total amount of RMB 26.6 billion with a weighted average coupon rate of 9.18%, saving about 40% cost compared with bank loans.

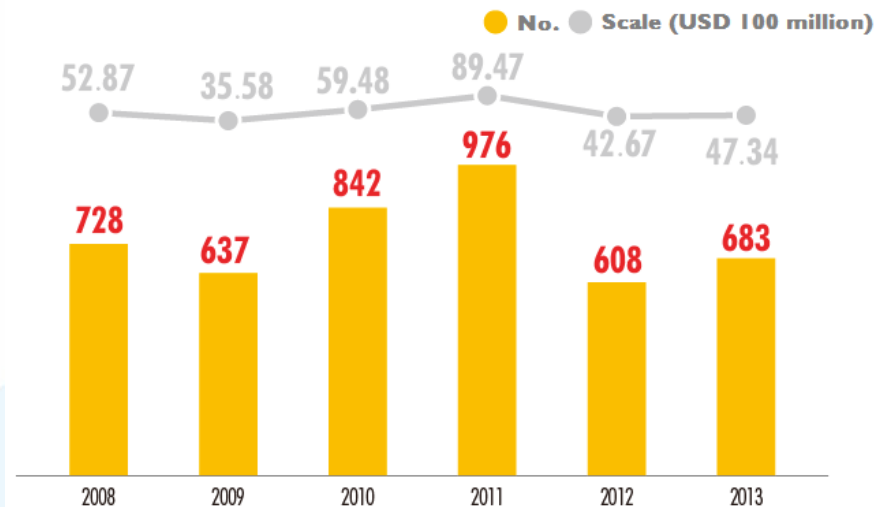
Network Externalities-Listing Local Banks

- To speed up the healthy growth of SMEs, one of the effective methods is to promote the development of small and medium-sized financial institutions, including rural commercial banks, urban commercial banks and micro-lending companies.
- At the moment, China has 45 rural commercial banks and 145 urban commercial banks. But only 3 urban commercial banks are now listed on the Shenzhen and Shanghai exchanges.
- SZSE advocates the listing of rural and urban commercial banks. In June 2014, 11 rural and urban commercial banks published their preliminary IPO prospectus.
- Through entering the capital market, they can raise funds to shore up their capital bases and remove the bottlenecks in serving SMEs.

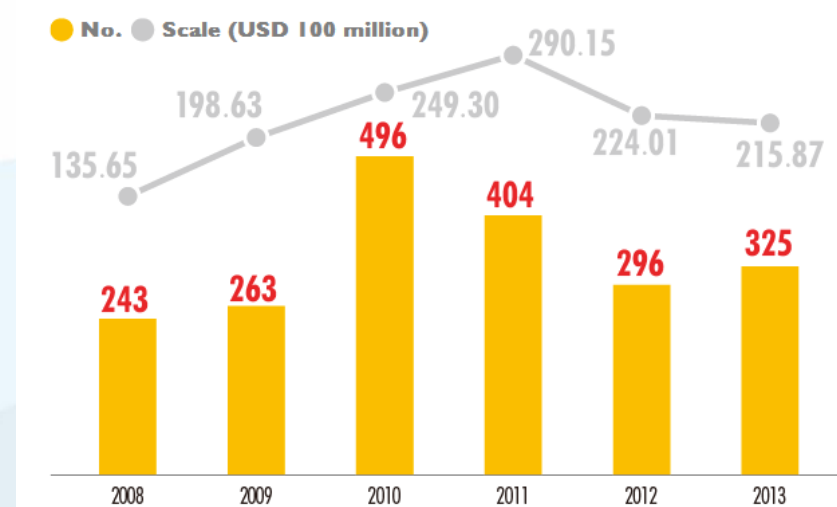
Network Externalities: Galvanizing Investment

- By the middle of 2013, there were more than 6,000 VC/PE firms in China, with USD 170 billion available for investment.
- More than 300 listed companies on the SZSE are backed by venture capital.

Number and Amount of Venture Capital Investments

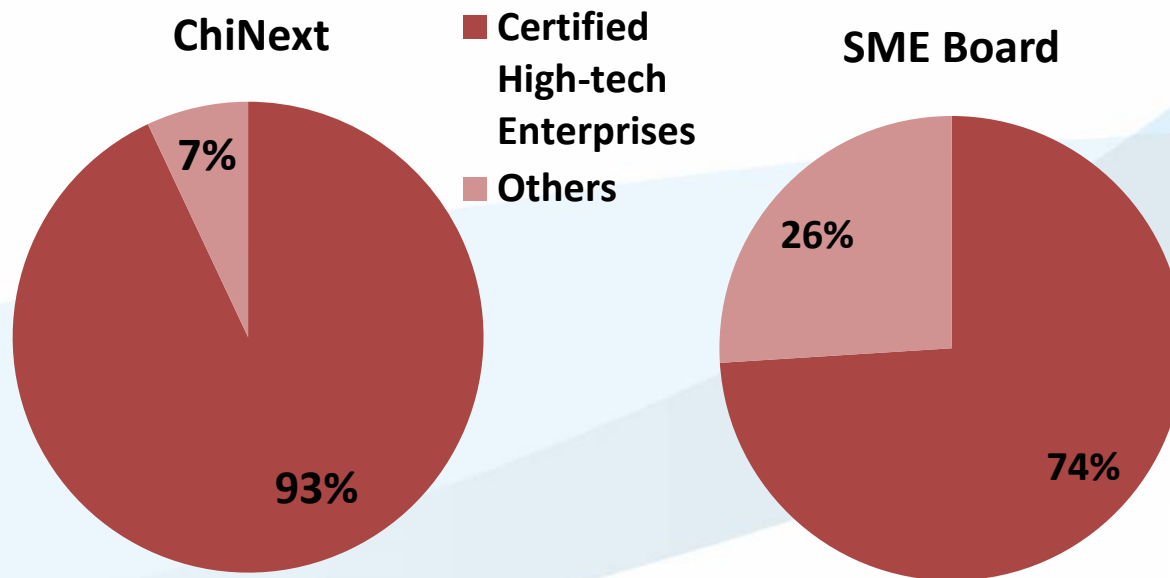


Number and Scale of Private Equity Investments



Network Externalities: Galvanizing Investment

- According to Zero2IPO, in the first half of 2014, 60 of all 99 domestic IPOs are backed by VC/PE. The return for VC/PE investments is 11.71 times.
- The capital market completes the circle of innovation by linking industrial demands with investment funds.



Network externalities: Connecting Markets

- Given China's huge geographic expanse, the SZSE has partnered with local equity or asset transfer markets to build local capital platforms.
- With concentrated information, corporate equity and investors, local capital platforms reduce market friction, enhance corporate visibility and facilitate trading.
- Local capital platforms facilitate long-term financing for small and micro-sized firms, which contributes to economic growth and job creation in the region.

Network externalities: Connecting Markets

- In January 2013, the *National Equities Exchange and Quotations, NEEQ*, was launched, with SZSE as one of its major shareholders.
- The NEEQ mainly targets at non-listed public companies. Companies quoted on NEEQ can directly apply to list on a stock exchange once they meet the listing standards. In August 2014, 1,100 companies are being quoted on NEEQ, increasing almost 210% compared with the number at the end of 2013.
- Regional equity trading centers are known as the “Fourth Board”. And they were incorporated into China’s multi-tiered capital market system in April, 2014.
- SZSE holds a 10% stake in QHEE and also invests in regional equity trading centers in Chongqing, Wuhan, Beijing, and Shandong.



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Network Externalities: Supporting Intermediaries

- As the Chinese capital market has a short history of just 24 years, intermediary services have a lot to be desired.
- The SZSE offers a suite of live and televised training programs and discussion seminars to enhance intermediaries' professional knowledge and qualification.



- The SZSE facilitates knowledge-sharing among financial intermediaries.

Network Externalities: Serving Intermediaries

- SZSE offers training on wealth management for frontline employees from brokerage firms and asset management companies. Major topics included policy interpretation, wealth management, product development, investor suitability and risk management.



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Network externalities: Serving Intermediaries

- The SZSE supports intermediaries by offering M&A advisory services.
- The SZSE promotes M&A activities involving listed SMEs to facilitate efficient allocation of capital resources. For example, China's pharmaceutical industry is heavily fragmented, with more than 6,000 firms competing against each other. Consolidation in the industry helps larger firms achieve economies of scale with heavy investment in R&D.
- Financial intermediary services can be very helpful in promoting M&As in the industry.

Network Externalities: Serving Intermediaries

- With proper supervision, intermediaries bring front-line supervision and guidance to listed companies and investors.
- The exchange works with financial intermediaries in the following aspects:
 - assessing new products, services and supervisory rules to reduce transaction costs and facilitate capital market activities;
 - offering incentives for intermediaries to develop services in western China;

Externalities: Success Story -

■ Small Business Lending Backed by ABS: Case Study of Alibaba

□ Background Introduction

- Alibaba, China's e-commerce giant
- Spill-over effects from its e-commerce platform to micro-loan services
- Aliloan leverages Alibaba's extensive trading data to track customer trade.
- Latest data shows that Alibaba, as china's largest online sales platform, has attracted more than 85 million active retailers and 279 million active customers, and more than 11 billion trades has been conducted in 2013.

□ How it Works

- Small and micro-sized businesses as underlying assets
- Distribution of interest to investors.
- Proceeds raised by the ABS are used to finance further micro-loans.
- The ABS are designed to roll over repaid loans to purchase new small-loan assets.

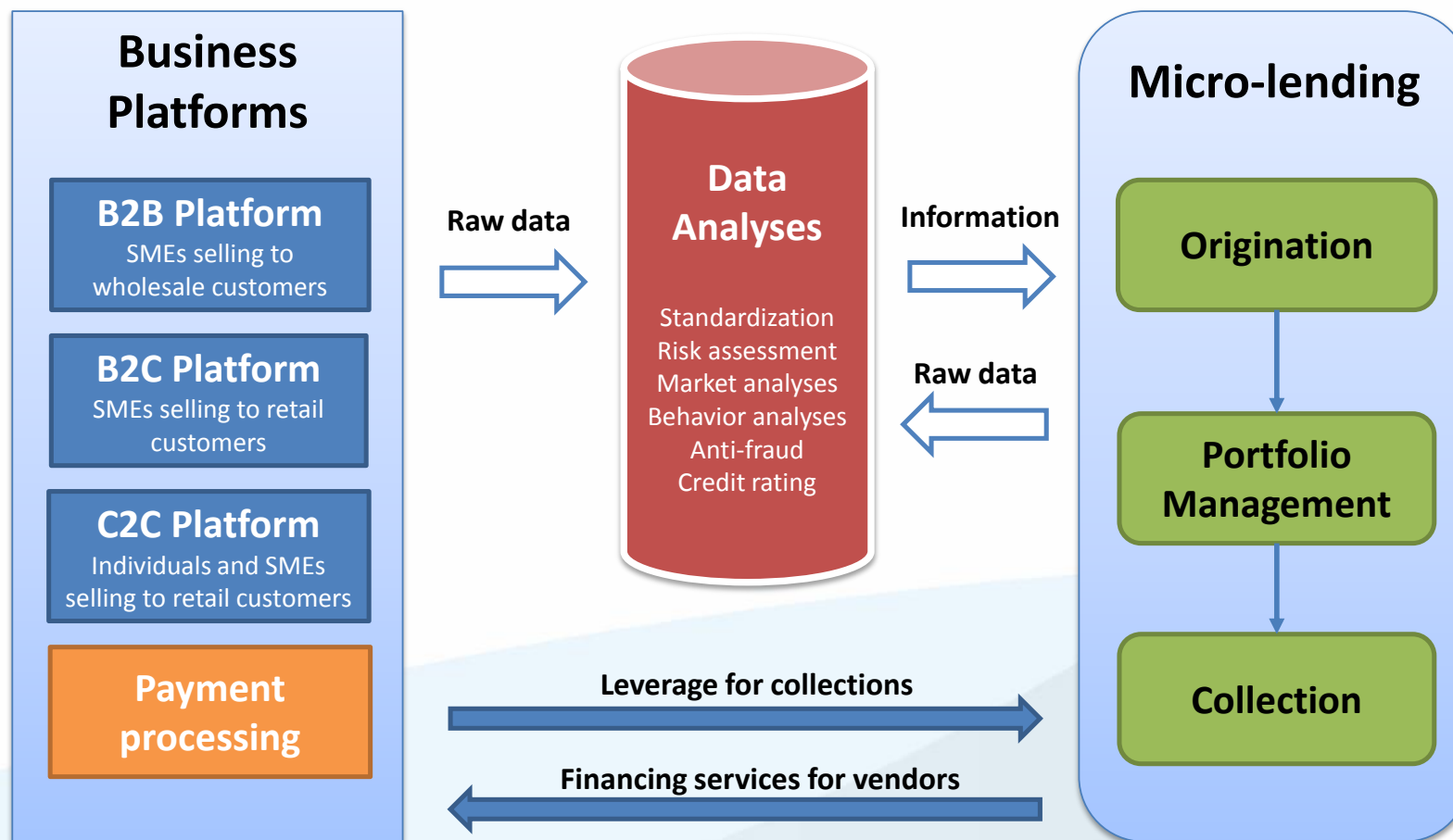
□ First Micro-loan ABS Product

- Alibaba has agreed to share online trade data with banks to help SMEs gain recognized credit history.**



Externalities: Success Story -

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Working with Government to define market

- Working with government to promote SME listing.
- Government plays role in defining property rights.
 - Land ownership
 - Corporate origin and Evolution.
- Risk Compensation
 - Subsidy for Intermediaries
 - Incentive policies for listing

Supervision: Protecting Investors

➤ **Case Study One: Investor Compensation**

- ChiNext-listed Wanfu Biotechnology (WFB) falsified financial information in IPO prospectus in 2011.
- The sponsor, auditor and legal firm involved were censured for negligence of duty.
- Gong Yongfu, chairman of WFB, was arrested for criminal charges.
- PAS offered a fund of RMB 300 million for compensating investors before court proceedings.
- The SZSE developed Internet-based system for compensation claim and processing.

Supervision: Protecting Investors

➤ **Case Study Two: Investor Compensation**

- ChiNext-listed Hirisun Technology Inc. was charged with accounting irregularities by the CSRC.
- Before the CSRC completes its investigation, controlling shareholders of Hirisun decided to compensate investors.
- This is the first case of early settlement out of court by controlling shareholders.

➤ **Key Takeaways:**

- Deterring potential violators
- Alert for intermediaries to exercise due diligence and integrity.
- Investors' interests are safeguarded and so is market integrity.
- Avoiding unnecessary market fluctuations

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Summary

- The exchange serves as a platform for interaction among issuers, investors and financial intermediaries.
- The exchange maintains the fairness and integrity of the market.
- The exchange can maximize its positive network externalities in supporting real economy, encouraging social investment, fostering innovation and entrepreneurship.
- The exchange can mobilize social resources and government support to help grow the SME sector.

Thank You!

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