

Preface

Why China? About 20 years ago, when China's Shanghai Stock Exchange and Shenzhen Stock Exchange were re-opened and newly established in 1990, this would have been the typical question that foreign investors would ask had they been suggested to take a look at these just-born capital markets. Even about 14 years later, when the Shenzhen Stock Exchange introduced its small and medium enterprises board (SME Board) in May of 2004, many continued to hold a skeptical view of the Chinese capital markets, believing it to still be in its infancy.

It was true that, if those skeptics were right, then indeed, why China? From a foreign investor's perspective, China's stock market was still way too "green" in many aspects, especially compared with its counterparts in New York, London, Frankfurt, Tokyo, Singapore, or even Hong Kong which, after its time under the British Commonwealth in twentieth century, was returned to China's jurisdiction in 1997. Among the many shortcomings of China's growing capital market, incomplete and insufficient regulations, ineffective law enforcement, unreliable accounting information and disclosure, and unsustainable business models that were unable to generate sustainable future cash flows deterred the interests of the potential investors from China's capital market.

Even to this day, the improvement of law enforcement and the quality of financial information and disclosure may still appear as an ever-present issue. However, significant progress has undoubtedly been observed on the regulation side, and in the innovation of business models in China in the past two decades. In particular, these business models, developed by companies across all kinds of industries, have fundamentally changed the way that people used to think, look at and evaluate Chinese companies.

There are a number of possible reasons for why these new business models have begun to be developed in the past few decades.

Come to the first is the most straightforward one, which is the volatile economic climate of the last decade and the increased competition in the market place that have inevitably encouraged innovation-driven companies. Not too long ago, as the "workshop of the world," China was feeding the whole world with almost everything people need in their daily life. This was made possible by the support of China's abundant labor forces released continuously from China's rural areas and the no-one-can-beat-it prices on the global market. Taking advantage of its entry into WTO and the overwhelming demand from the world (especially those from

the major developed markets), China was able to reclaim a period of the “shortage era,” when demand was not an issue and producing whatever the world needed at the most competitive pricing was the only game to be played. In those good old days, any business model other than “lowest possible pricing” seemed obsolete.

But every party has its end, and it is true for both China and the world. The highly leveraged consumption model that had helped create the longest expansion period in the USA history since World War II eventually triggered a worldwide financial crisis and the deepest recession since the Great Depression of the 1920s. Meanwhile, China’s export-investment oriented, low-cost labor driven growth model also seemed to come as close as it possibly could to an end. When the first wave of the economic tsunami flooded in, unsurprisingly, it was the companies that had survived for so long on the thread of tiny price margins and a “make a quick buck” philosophy that were the first to get blown aside. At the same time, the companies that were built up on stronger values and unique business models unambiguously stood their ground. Only these companies, those with long-term visions, a focus on long-run brand buildup and strategic business model development became the companies that eventually picked the cherry on the top of the tree.

The second and potentially more pressing reason for business model innovation may have stemmed from Chinese companies need to get financing, which, intrinsically, requires more depth of discussion. As many may know, financing for small and medium sized enterprises (SME) is always a challenging issue, not only in China, but also globally. The difficulties in getting financing for SMEs may result from a number of SMEs’ inherent characteristics, and also of the risks inherited by financing smaller businesses. Just to name a few, these characteristics and risks may include:

- (a) Asymmetric information. The outsiders of a company always know less than the insiders about what actually goes on at a firm. It is not only true for publicly traded large corporations, but also, and especially for SMEs. Either due to cost considerations or protection concerns, SMEs typically disclose less information to the general public than their larger corporate counterparts. As a result, SMEs are typically perceived as enterprises with much higher degrees of uncertainty and risk.
- (b) Non-standardized financial information. In addition to less information released to the general public, the financial information possessed by the SMEs is also less likely to be standardized in a format that is in compliance with the generally accepted accounting principles. Due to limited resources, SMEs usually cannot afford to hire financial professionals to prepare their financial documents, or contract public accounting firms to audit their financial statements. As a consequence, even when SMEs consent to providing their documents, not much of the information can be actually used by financial institutions when they make financing decisions toward SMEs.
- (c) Lack of adequate collateral for bank loans. Because these firms are small, the amount of assets that they can use as collateral for bank loans are typically less. When compared against the financing values that most SMEs request and

need, the collateral they possessed are usually not adequate to meet the requirements of banks.

- (d) Insufficiency of credit records. Commercial banks typically need to use the credit history of their borrowers as an important reference when making financing decisions. However, many SMEs usually don't have any history of borrowing money from banks due to the difficulties in securing bank loans as described above. As a consequence, they are usually rejected for bank loans due to the lack of credit history. Clearly, this creates a vicious cycle. If a SME doesn't have adequate credit history, it won't be able to get credit; if it cannot get credit, it is almost cyclically banned from ever being able to obtain a loan.
- (e) Management flexibility in changing a firm's risk. The classical agency problem normally occurs in large corporations due to the separation of ownership and management. Small businesses usually can avoid this problem because the owner and manager are typically the same person. However, retaining the functionality of ownership and management in one person may increase the flexibility, in both a positive and a negative sense, of the firm's operations. On the one hand, small businesses can change the direction of their businesses or the composition of the firm's assets more easily and rapidly in response to the changes in technology or business conditions. At the same time, however, this flexibility may also increase the uncertainty about the future operations and development of the firm, hence, increasing the firm's risk.
- (f) Lack of economy of scale as a disincentive for financial institutions. From the perspective of the commercial banks, no matter the size of the firm that requests the loans, the bank must input the same amount of effort and procedure to clear that firm for lending; that is, the same application reviews, credit assessment, comprehensive analysis, on-site investigation, and final release of funds, all of which are heavy uses of time and resources. Given the relatively smaller size of loans to SMEs comparing with ones to larger corporations, it is difficult for the commercial banks to achieve the same economy of scale when lending to SMEs. Needless to say, commercial banks, on the whole, prefer larger corporations.

For SMEs, this financing issue is even more severe in China as its economy is still in a transition from a centrally planned regime to a completely market-oriented one. So in addition to the issues that are shared in common with SMEs in developed countries, SMEs in China face the additional burden of even more limited numbers of financial institutions that can legally provide funding to them, which in turn exacerbates the imbalance between demand and supply in the loanable funds market in China. For many years since its inception, the financial industry in China has been so highly regulated that only large, state-owned commercial banks were allowed to be major fund suppliers. Private funds were typically not permitted to directly enter the market. From an economic perspective, under this regime, providing their already limited funds to larger, state-owned (nonfinancial) corporations was clearly a better choice for the large, state-owned commercial banks, considering all the risks and possible returns. As a consequence, many illegal

“shadow loans” with annualized interest rates as high as up to 50 % emerged in some of the more developed areas in China in the recent years,¹ in an attempt to fill the gap in funding supply. And it’s no surprise that these “illegal” financing activities generated tremendous risks and had the potential to trigger financial crises in various forms.

Considering this background, the development of Chinese public equity markets in the past few decades (as benchmarked by the opening of the Shanghai and Shenzhen Stock Exchanges) did in fact provide an important new funding source for SMEs in China. The happy news was that, since 2004, when the SME Board of Shenzhen Stock Exchange established, an increasing number of SME stocks have been listed in both the Shenzhen Stock Exchange’s SME Board and that of the Second Board (Growth Enterprise Board), which was established in 2009. By June 2013, 701 and 355 SME stocks have been listed in these two boards, growing 88 and 13 times, respectively, compared with the numbers from 2004. The total market value also increased from 41.3 billion RMB to about 4.4 trillion RMB during the same period of time, increasing by about 109 times.²

The hard part was that in order to get funds from equity investors, the SMEs that were looking for equity capital must meet the expectations of the equity investors. Because they are making a long-term investment, equity investors focus not only on the historical performance of a firm, they also look at the future cash flows that, together with the inherited risks associated with the companies’ earnings, determines the value of the firm; only a sustainable future cash flow would maximize the wealth of equity shareholders. The question, then, was on what parameters should equity investors judge the future cash flows of these SMEs?

As the age of low cost and low pricing gives way to a different kind of competitive market, generating a sustainable cash flow, on the business side, is now anchored upon well-designed business models and flawless execution. A well-designed business model needs to adequately address all the strategic issues facing the firm for its long-term development, which include, but are not limited to, which industry the firm should be in? What products/services they should produce? What kind of relationships does the firm need to build with its customers, suppliers, and vendors so as to minimize cost or increase profit? And most importantly, what unique business model does the firm need to create to distinguish itself from its closest competitor(s), and how can they highlight their core competencies? In the post-financial crisis era, a well-designed and well executed business model will become the ace that distinguishes the winners from the losers, not only in the goods/services market but in the financial market as well.

In the last 20 years, the question of “why China” has been near completely muted as China’s capital markets gradually improve in value, and the opportunities

¹ Wall Street Journal: <http://online.wsj.com/article/SB10001424052970203914304576626941813821726.html>

² Shenzhen Stock Exchange: <http://www.szse.cn/main/marketdata/>, Sohu Security: <http://stock.sohu.com/20091225/n269197316.shtml>

that Chinese companies can offer have been increasingly revealed on a global scale. During the past 20 years, Chinese capital markets have been re-categorized by many portfolio managers worldwide from a “transitional investment” to a “permanent allocation.” Many top-notch investors such as Warren Buffet, George Soros, and Jim Rogers, and many active private equity funds and investment banking houses such as Bain Capital, Blackstone, Goldman Sachs, and Morgan Stanley, have appeared on the list of Chinese equity investors. It is the Chinese companies with solid, unique business models, among other distinguishing characteristics, that have been hungrily chased by investors both inside and outside China.

Like in the USA, SMEs comprises over 99 % of the total number of Chinese companies.³ The 1,000 or so companies listed in the SME Board and Second Board only represent a very small fraction of the total Chinese companies that need external financing. Without a question, these SMEs that were listed on China’s capital market are among the most elite ones. Who are these “lucky guys” that received funds from China’s competitive capital market, and what did they bring to the table that caused them to be China’s financial markets’ favored stars? Answers to these questions are certainly among some of the most intriguing and sought out to both Chinese and foreign readerships.

The general interest in this issue of China’s SMEs and the capital markets is a result of the huge role that China is expected to play in world economic growth in the forthcoming decades. It is also a result of the highly interconnected and interdependent global market that is now an economic reality. Although the Chinese economy revealed signs for slowdown in the past quarters, its role as one of the most powerful engines for worldwide economic growth in the next decades is still indisputable. Even more unavoidable is China’s ever-growing purchasing power that has been accumulating over the past 30 years by an over 9 % average annual growth rate, and its production and export capacity as “the workshop of the world”. Most importantly, its ambitious urbanization plan from about 50 % as of current to about 75 % in the next 30 years⁴ will alone generate another market the size of the currently existing China market.

As one of the major sources fueling China’s enormous growth engine, the Chinese financial markets and their activity—which cover over 99 % of all Chinese companies—is both a critical and extremely fascinating issue for anyone who may be interested in or impacted by the Chinese market in the coming years.

In particular, institutional and individual investors both inside and outside China should be finding this topic relevant and intriguing. Financial institutions such as security firms, investment banks, private equity funds, venture capitals, commercial banks, other financial intermediaries, and individual investors

³ Zibin Li, President of Chinese SME Association, Xinhua News Net: <http://news.xinhuanet.com/fortune/2010-05>

⁴ Wall Street Journal: <http://online.wsj.com/article/SB10001424052970203735304577166652002366514.html>

including angels could all do well with watching China's financial market closely. Given the interconnected nature of the global financial markets and the complementary nature of different segments/areas of the financial markets, what kinds of Chinese SMEs that can eventually be listed and traded publicly, what stories were brought by the SMEs to convince the market, and what kind of returns for Pre-IPO investors obtained at the exit will be undoubtedly relevant to all these investors, and in turn, will also influence investors' investment decisions at all stages of the target companies' financial growth cycle.

The Chinese SMEs that are looking for public equity funding should also take interest in this topic. The products, the industries, the business models, and the growth potential these listed SMEs promised are solid indicators for what investors prefer and where they are willing to put their money.

Foreign companies, especially foreign SMEs that are looking for external funding from overseas market, are impacted as well. Given the abundant funds available in China's current market and an increased possibility of an opening of an international board in China to list foreign companies, understanding what kinds of Chinese SMEs are already listed would certainly be instructional for them.

Finally, the academia inside and outside China should also take interest, for a number of reasons:

- (a) China's sustainable economic growth in the next decades truly depends upon whether or not China can successfully transfer its growth model from the past 30 years to a new one in the next 30 years, that is, transferring from an investment and export driven way to a domestic consumption driven one, from an environment-damaging, energy-wasting method to an environmentally-friendly and energy-saving one, and, finally, transferring from competing on low labor cost to competing on branding and technology innovation.
- (b) More and more people realize that technology innovation is not a pure "technology" concept, as Joseph Schumpeter indicated decades ago.⁵ Instead, tech innovation is an economic concept that involves in an entire process of research, development, production, marketing, consumption and feedback about an innovation of a product, a service or a business model. As a result, entrepreneurs, instead of scientists and engineers, are the primary participants of the innovation process.
- (c) Since over 99 % of Chinese companies are SMEs, active participation of SMEs will undoubtedly determine the success of technology innovation and the transformation of China's future growth models.
- (d) Given the economic nature of tech innovation, receiving adequate financing will be a determining factor of new innovation development, especially for the tech innovation initiated by SMEs. Consequently, understanding what kinds of SMEs can obtain funds from China's public equity market and how they got

⁵ Schumpeter, J., 2006, *Capitalism, Socialism and Democracy*, New Edition, Routledge, London.

the funding is certainly of significant value in research on the sustainability of China's future growth and design of China's continued reform for the next 30 years.

- (e) Needless to say, China is one of the most powerful engines for today's global economic growth. As a result, the sustainability of global economic growth is highly correlated with the sustainability of China's growth in the forthcoming decades. As many studies about China's business and economy so far only focused on the macro side of the Chinese economy and these aggregate numbers such as the level and growth rate of GDP, inflation, unemployment rate, interest rate, and exchange rate, research on the Chinese economy from micro view and at the level of company, the basic unit of any economy, to analyze the key industries, representative companies, and successful business models that the Chinese firms developed and adopted in operating in today's market place will be an important complement for the knowledge and understanding about Chinese economy.

Therefore, we think this concise book could be a timely publication with significant value for a wide spectrum of readerships either as a reference book or as a guideline in understanding, in gaining knowledge, in research and teaching, and in making business decisions about China and about many other global issues with China connectivity.

Who Gets Funds from China's Capital Market?
A Micro View of China's Economy via Case Studies on
Listed Chinese SMEs

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