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WHY STAR IS CRUCIAL TO CHINA'S CAPITAL MARKET REFORMS

China's capital markets have undergone significant changes since the commencement of the reforms and opening up-policy. The plan to introduce a new Science Technology & Innovation Board (STAR) is yet another show of commitment to deepen and strengthen the country's financial markets to make it an attractive financing option for Chinese enterprises, and one that offers investment opportunities for foreigners.

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China's status as an economic powerhouse and the world's second largest economy is indisputable. For China to continue to grow as a modern market economy, an efficient and stable financial sector is a prerequisite. There have been various measures over the years to vitalise the financial markets such as the Stock Connect, Bond Connect and the inclusion of onshore Chinese A-shares by index builder, MSCI and FTSE.

Still, there have been persistent issues with the Chinese A-share market - high volatilities, overly regulated, inefficient Initial Public Offering (IPO) and exit mechanism, lack of new economy names, etc. To solve these issues, the government has carried out a series of reforms which nevertheless have been proved to be ineffective. The new Science Technology & Innovation Board (STAR), announced first by President Xi at the China International Import Expo, and then further emphasized at the Central Economic Work Conference, represents the central government's determination to deepen the capital market reforms.

More recently, the Vice President, Liu He, head of China Securities Regulatory Commission (CSRC), Yi Huiman, and Shanghai government officials together announced the inception of STAR on June 13th. Officials from Shanghai Stock Exchange further confirmed that the first batch of companies will get listed on STAR within two months.

STAR'S DIFFERENTIATING EDGE VERSUS TRADITIONAL STOCK MARKETS

A relaxation on listing requirement

In terms of financials, there is no longer a need for a three-year track record of positive earnings; in terms of company structure, it allows those structured as variable interest entities (VIEs) or with multi-share classes to get listed. This will help to attract more new economy names to list on the onshore market.

A reform in trading mechanism

Price limits will be expanded from +/-10% to +/-20%, with no limits in the first five trading days. If this goes smoothly, it will serve as a testbed for a potential reform of the trading limits on the traditional boards. On the traditional boards, the current cap on share price fluctuations on the first day of trading is 44% and subsequently 10% a day.

A higher quality stock pool

STAR will adopt a registration-based system in contrast with the lengthy approval-based system on the current boards. The leading underwriters will also have to be the cornerstone investors which will motivate them to bring forward high quality companies. In addition, STAR will run a stricter exit mechanism to maintain a quality stock pool on an ongoing basis.

A transformation of market pricing

While on traditional boards most IPOs are priced with a cap valuation of 23x price-to-earnings, STAR will impose no limit and let the market determine the issuance price instead. The Green-shoe mechanism will also be applied to reduce the price volatility post IPO.

A higher bar for participants

Only institutional investors as well as those retail investors with rich investment experience (>2 years) and certain assets under management (>Rmb500k) are allowed to participate in STAR. This shows regulators' clear intention in reducing volatilities where the strong presence of retail investors on traditional boards is believed to be one source of market ups & downs.

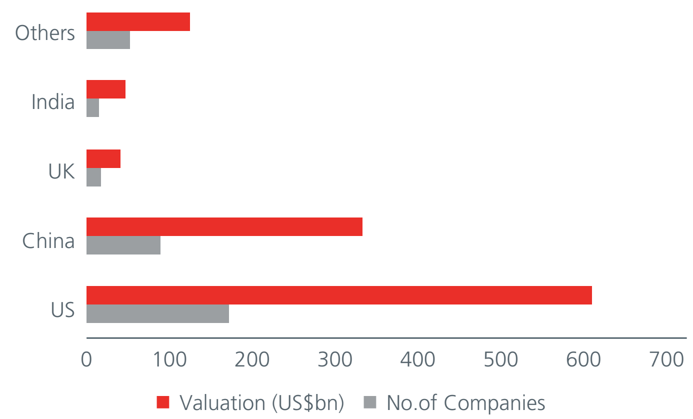
A PLATFORM FOR CHINA'S GROWING NUMBER OF UNICORNS

China has already set a target to become a world leader in artificial intelligence (AI) by 2030[2]. This STAR is thus aimed at attracting and financing innovative companies (those in areas of high-end equipment, biotechnology & health care, IT, new materials, renewable energy, energy saving and environmental protection) that will drive China's future AI competitiveness.

In fact, unicorns[3] and startups are burgeoning in China. According to a research report[4], the global number of unicorns as of May 2019 totaled 346 with the US having a dominant share of 49.7%. This is followed by China, who boasts 89 unicorns (or 25.7% of total). The United Kingdom and India rank third and fourth.

The new STAR will become a platform for such unicorns to list and raise funds at home. Moreover, the latest trade spat with the US and the US curbs on its Chinese technology companies may push Chinese government to extend more support to the domestic high-tech firms, i.e. provide greater access to funding through STAR.

Fig. 1. Global distribution of unicorns by region[4]



ECONOMIC AND INVESTMENT IMPLICATIONS

Due to STAR's national-strategic importance, the Chinese government will do its best to ensure all reforms be carried out in an effective manner. Furthermore, if STAR proves to be successful, some of the reforms/experience (i.e. market pricing, wider trading limits) may be extended to the traditional boards at a later stage.

For corporates, this will mean greater access to funding. It will help to rebalance the economy from an indirect-financing to a direct-financing mode; the gearing ratio of Chinese corporates have been much higher than that of US over the years. In terms of percentage of GDP, however, the non-financial corporate debt of US and China was 143% and 74% respectively as at end of 2018.

For equity investors, these reforms result in a larger investable universe. It will not only attract more global investors into the onshore market but also provide more investment options for onshore institutional investors such as the pension funds and asset managers, to diversify their investments for a better risk-return profile.

Sources: [1]Based on nominal GDP in 2018 [2]Goldman Sachs Global Investment Research, The State Council [3]A unicorn is defined as a start-up worth more than US$1 billion [4]CB-Insights_Global-Unicorn-Club_8 May 2019

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