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New Third Board Expansion around the Corner; New Source of Profit Emerges

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Over-the-Counter (OTC)[1] market has long been a major part of the international multi-layered capital market framework. For the improvement of the construction of China's multi-layered capital market, advancing the third board market will be an inevitable trend. In particular, with the launch of the ChiNext in Oct. 2009 that marked the emergence of China's second-board market, the multi-layered structure in China's capital market has come into shape; at the work conference on the regulation over securities and futures held not long ago, Shang Fulin, Chairman of the China Securities Regulatory Commission (CSRC), explicitly specified that expanding the scope of the pilot project implemented in Zhongguancun and building an uniformly regulated OTC market shall top the agenda of the CSRC this year while he also sounded a bugle call for the increasingly intense "expansion of the new third board market". The launch of the "two sessions" resulted in extremely high market expectation for the timetable concerning official kickoff of the "expansion of new third board market". At this time, Zero2IPO Research Center, a famous VC and PE research institution in Greater China, forecasted the development opportunities brought by the "new third board market" and plans to work out the Special Research Report on Investment Opportunities in "New Third Board Market Expansion" in the near term, which will offer the all-sided analysis on the value growth area for state-level high-tech zones, intermediaries and VC/PE institutions brought by the "expansion of the new third board market" and explore the development mode and prospect of the expanded new third board market.

Rotation between the old and new third board markets in the past decade

In 2000, the CSRC led the establishment of agency share transfer system as an OTC system among some securities companies, which was the "third board" or "old third board" we call today. The launch of third board market aimed at solving the problem involved in the share transfer by the companies exiting from the main board market and the companies listed in STAQ and NET systems (the two net systems). Statistics showed that by the end of 2010, there were 50 stocks, including 42 exiting from the main board market and eight listed on the two net systems, in the old third board, with the codes all being "400". However, the old third board failed to grow bigger because of its poor liquidity, varied corporate qualifications and inactive trading.

On March 16, 2006, Beijing Zhongguancun Science Park set up the agency share transfer system as a pilot project upon approval from the CSRC, enabling the unlisted joint-stock limited companies in the park to use the system for share quotation and transfer, which was the "new third board" widely known today. Though both are subordinate to the third board market for share trading of unlisted companies, the new third board shows features quite different from the old third board: The listed companies in the new third board are all high-tech companies that rely on the development of Zhongguancun Science Park and boast remarkably optimized qualifications; the objects of trading change to some extent as only institutional

[1] OTC refers to the securities trading markets outside securities exchanges. Generally, there are no concentrated and uniform trading system and venue; trading is enabled by such means as telephone and electronic quotation system and the securities trading of unlisted companies takes the dominant position.

investors are allowed to participate in the trading of shares in the new third board besides the natural shareholders who gain shares through such channels as private placement and the investors recognized by the Securities Association of China.

The new third board offers another way for SME financing as a powerful incubator

Compared with the main board and ChiNext, the new third board features a lower threshold for listing, as there are few restrictions on profitability, except for such necessary conditions as prominent prime operating business, complete corporate governance structure and standardized operation. Therefore, the new third board somewhat incorporates the features of an incubator and can offer financial support to the small and medium-sized high-tech companies at their early

[2] Note: In case that a limited liability company is completely transformed into a joint-stake limited company based on its previous book value of net assets, the duration can be calculated from the date of establishing the limited liability company.

Table 1 Comparison of Listing Condition of New Third Board Market, ChiNext and Main Board

Project	New Third Board Market	ChiNext	Main Board
Subject Qualification	Unlisted joint-stock company	Lawfully established and existing Joint-stock limited company	Lawfully established and existing Joint-stock limited company
Operation	Above 2 years [2]	Above 3 years	Above 3 years
Profitability Requirement	With lasting operational capacity	Making profits for 2 consecutive years to gain the accumulated net proceed no less than RMB10M and growing continuously; or making profit in the previous year to secure the accumulated net proceed no less than RMB5M and operational revenue no less than RMB50; or gaining operational revenue growth rate no less than 30% in the past 2 years.	With the accumulated net profit in the latest fiscal years above RMB30M
Asset Requirement	Unlimited	With the net asset valuation in the last phrase no less than RMB20M and without unrecovered loss	With the proportion of intangible asset (Without including land use right, water surface aquaculture right and mining right) to net asset in the last phrase not more than 20%
Equity Requirement	Unlimited	With total equity no less than RMB30M after the issuance	With the total equity no less than RMB30M after the issuance
Core Business	With prominent core business	Without major changes in the past 2 years	Without major changes in the past 3 years
Actual Controller	Unlimited	Without major changes in the past 2 years	Without major changes in the past 3 years
Board Member and the Management	Unlimited	Without major changes in the past 2 years	Without major changes in the past 3 years
Growth and Innovation Capacity	Hi-tech enterprises in Zhongguancun Science Park	High-tech and high-growth enterprises in new economic, new services, clean energy, new materials and new agricultural industries	Unlimited
Investor	Investors with risk identifying and resistance capacity	Investors with above 2 years of experiences	Unlimited
Regular Information Disclosure Report	Annual and interim reports	Annual, interim and quarterly reports	Annual, interim and quarterly reports
Filing or Examination and Approval	Filing system	Examination and approval system	Examination and approval system

Source: Zero2IPO Research Center

stage. The new third board will be an ideal channel of financing for the high-tech companies that are still toddlers in the industry.

High-tech parks compete with each other for pilot projects; securities companies cannot wait for the chance

Because the expansion of the new third board market can bring the companies in pilot parks smooth, convenient and direct channels of financing, nearly half of the 83 state-level high-tech parks nationwide competitively applied to local securities bureaus and offices of financial affairs for pilot projects and set up work groups, providing tenant companies with preferential policies in succession and the "seed companies" with listing tutorship. The expansion is intended to cover about 20 high-tech parks and the competition among the high-tech parks with total output value and more "seed companies" will thus be particularly intense.

As for securities companies, the expansion of third board market also indicates new potential profits. According to the Measures on the Quotation and Transfer of Shares on the Unlisted Joint-stock Limited Companies in Zhongguancun Science Park through Agency Share Transfer System of Securities Companies (Interim), an unlisted company must entrust a chief securities company as its recommended chief securities company and recommend it to the Securities Association of China when it is listed in the agency system. Therefore, the companies in the parks have extreme dependence upon chief securities companies if they want to go trading on the new third board.

According to Zero2IPO Research Center, there are 44 securities companies qualified as chief securities companies in the new third board, including both long-standing ones like Shenyin & Wanguo Securities and Guotai Junan Securities and the emerging forces that make vigorous expansion in ChiNext like Ping An Securities, Guosen Securities and Huatai United Securities. In terms of the number and amount of domestic IPO underwriting in recent years, the securities landscape at home has undergone subtle changes, as the small and medium-sized securities companies represented by Ping An Securities and Guosen Securities achieved development in IPO underwriting and sponsoring businesses on SMEB and ChiNext and were more vigorous than such powerful rivals as CICC. As SME financing business keeps expanding and improving, domestic securities landscape face restructuring at any time. Meanwhile, the opportunity resulted from the expansion of the new third board may further speed up the pace of small and medium-sized securities companies towards becoming those of the first-rank.

Although the CSRC hasn't given clear reply to the question whether the market maker rule will

Table 2 List of Securities Companies in New Third Board Market

Shenyin & Wanguo Securities	Guotai Junan Securities	Guosen Securities	Changjiang Securities	China Galaxy Securities	Bohai Securities
Haitong Securities	GF Securities	China Merchants Securities	Everbright Securities	Huatai Securities	Citic Securities
Donghai Securities	Guoyuan Securities	Orient Securities	Ping An Securities	BOCI Securities	Shanghai Securities
Western Securities	China Jianyin Investment Securities	Hongyuan Securities	Nanjing Securities	Qilu Securities	Shanxi Securities
Northeast Securities	Sealand Securities	Soochow Securities	China Securities	Central China Securities	Goldstate Securities
Huaxi Securities	Southwest Securities	Great Wall Securities	Huatai United Securities	Zheshang Securities	Daton Securities
Minsheng Securities	Guodu Securities	Cinda Securities	Golden Sun Securities	Essence Securities	Dongxing Securities
Wanlian Securities	Guolian Securities				

Source: Zero2IPO Research Center

be introduced into the new third board, the market is well positioned for that. Under the market maker rule, securities companies can act as franchised traders, or market makers, to keep offering bilateral quotations in the market and accept investors' requirements on purchase or sales at a certain price. The market maker rule will offer more liquidity in the market, so as to make up for the insufficient liquidity since the launch of the new third board and reduce market fluctuations. Once the market maker rule is adopted, securities companies will be offered new room for development, i.e. gaining yields through difference between purchasing and selling prices. But we must stay alert against the fact that the regulation over market maker rule is crucial, as market makers need to instantly obtain a great deal of information about both buyers and sellers and have advantages during share trading. Once the regulation is loose, the rights of securities companies could be expanded or abused in a limitless manner and thus disturb normal market transaction orders.

Exit channel may be widened while VC/PE makes immediate response

Standing on the wave of the "expansion of the new third board", the interest-driven VC/PE institutions were the first to discover the new source of benefits. In recent two years, three third board companies, including Join-Cheer Software, BEILU Pharmaceutical and iReal, have gotten listed on SMEB and ChiNext through IPOs for public financing; in particular, the exits of BVCC and IPV Capital from BEILU Pharmaceutical and the withdrawal of SDIC High-tech Investment and TusPark Ventures from iReal benefited the exiting institutions a lot. The said three successful cases chartered a new course for the exits of VC/PE institutions. Generally speaking, VC/PE institutions pay lower cost when injecting funds in third board companies and will obtain great returns once the invested companies get listed through IPOs. Moreover, as the VC/PC market competition grows white-hot and the grab for excellent companies among institutions becomes increasingly intense, the emergence of the new third board undoubtedly offers new room for the PE market with adequate capital.

According to the incomplete statistics by Zero2IPO Research Center, 14 companies in Zhongguancun's agency share transfer system reported the approval of resolution by their shareholders' meetings to initiate IPO plans at a proper time, including 11 companies that intend to go trading on ChiNext. Transferring the venue trading of the new third board companies funded by VC/PE institutions to Shanghai and Shenzhen stock markets through IPOs can serve as a new exit channel for VC/PE institutions. Because the third board market is presently part of the OTC market and not a public market, the new third board companies must experience the complete process that includes IPO application, review, approval by the CSRC and listing like any other companies if they intend to issue shares publicly. The desire of new third board companies for getting listed on the main board and ChiNext through IPOs requires an accelerated pace in the construction of stock listing transfer mechanism following the expansion of the new third board, i.e. whether the CSRC can provide a "green channel" to the companies in the parks that have been traded in the new third board market by the simplification of IPO process.

We can expect that as the mechanism for the new third board market grows increasingly mature, the market capacity expands and liquidity increases, the new third board itself and even the future OTC market can both be viewed as independent exit channels, thus making China's capital market more diversified and multi-layered. ■

Note: Securities Trading Automated Quotations System (STAQ system) and the NET system developed by China Securities Trading System Corporation Ltd. were two electronic quotation systems operated nationwide in the early 1990s and a trial for establishing the OTC market. They gave rise to a securities trading market landscape featuring "two exchanges and two nets" ("Two exchanges": Shanghai and Shenzhen stock exchanges; "Two nets": STAQ and NET). But due to multiple factors, STAO and NET transaction systems didn't grow strong and the operation of both systems stopped on Sep. 9, 1999.

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