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Z-Insight: The First Anniversary of ChiNext-Fever Cooling Down

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Since ChiNext formally landed Shenzhen Stock Exchange on October 30, 2009, till the closing on October 22, 2010, there have been totally 130 companies listed on the ChiNext of the Shenzhen Stock Exchange with a total market capitalization of RMB 559,973,758,747.00 and a circulating market capitalization of RMB 125,956,676,061.00. The average P/E is 68.05 times, 29.2% higher than the average P/E of 52.65 times on SMEB, and 87.1% higher than average P/E of 36.37 times on SZSE.

After the listing of the first batch of 28 com panies, various criticisms on ChiNext can be heard. People with positive attitude view it as a short cut of financing for high-growth small and medium-sized companies; those with negative attitude view it as a tool for senior management of companies to make a quick buck and win profit and for VC/PE institutions to heighten the market valuation; and people with wait-and-see attitude view that it is over-hot and the time of sharp plunge after climbing high is difficult to predict. Is ChiNext Aladdin's magic lamp for people to get rich overnight? Or it is a Pandora's Box that brings the market more speculative opportunities and uncertain factors? At the time of the first anniversary of ChiNext, Zero2IPO Research Center, as a famous venture capital and private equity research institution in the Great China region,

Table 1 Quarter-on-quarter Comparison of IPOs on ChiNext in Q4'09-Q3'10

Quarter	Financing Amt. (US$M)	Growth Rate	No. of IPOs	Growth Rate	Average Financing Amt. (US$M)	IPO P/E	Average First-day Return[1]
Q4'09	2,988.13	-	36	-	83.00	62.18	93.2%
Q1'10	2,943.44	1.5%	29	-19.4%	101.50	76.40	32.5%
Q2'10	3,752.07	27.5%	25	-13.8%	150.08	65.19	29.9%
Q3'10	3,425.56	8.7%	32	28.0%	107.05	58.89	54.5%

Source: Zero2IPO Research Center

Table 2 Quarter-on-quarter Comparison of IPO P/E[2] on China Markets in Q4'09-Q3'10

Quarter	Shanghai Stock Market	Shenzhen Stock Market	
		SMEB	ChiNext
Q4'09	49.27	51.67	62.18
Q1'10	39.64	55.26	76.40
Q2'10	40.22	53.20	65.19
Q3'10	23.42	49.74	58.89

Source: Zero2IPO Research Center

[1] Average first day return = (closing price of the first day-issuing price) /issuing price.

[2] IPO P/E=issuing price per share/net earning per share of the last period.

conducted observations and analysis on the following as pects based on VC/PE-backed IPO on ChiNext in terms of return on investment (ROI) and risk evaluation .

ChiNext companies are over valued, high P/E might not last long

From the first batch of application, companies, institutions and individual investors all held unprecedented passion for IPOs on ChiNext. Whatsoever the number of listed companies rapidly exceeds 100, or the average IPO P/E it brings, all of these are stunning.

AS of the closing on October 22, 2010, total number of listed companies on ChiNext of the Shenzhen Stock Exchange reached 130 with a total market capitalization of RMB559,973,758,747.00 and a circulating market capitalization of RMB125,956,676,061.00. The average P/E is 68.05 times, 29.2% higher than the P/E of 52.65 times of SMEB and 87.1% higher than the P/E of 36.37 times of Shenzhen main board. Compared with other foreign GEB markets, P/E of ChiNext is still very high: at the time of closing on October 22, 2010, P/E of London AIM market was 60.07; at the time of closing of September 30, 2010, P/E of HKGEM was 33.11[3] .

Huge amount of capital is invested in ChiNext companies, VC/PE institutions are at the forefront

Undoubtedly, from the very beginning of its opening, ChiNext continuously encountered overheating investment for VC/PE institutions which are often criticized. Because high P/E brings high return which is coveted by many investors, from Q4'09, VC/PE institutions are very active in the participation in IPOs on ChiNext. Of the 130 companies currently listed on ChiNext, 73 companies are backed by VC/PE, accounting for 56.2% of the total. Behind the 73 companies, there are totally 150 VC/PE institutions: including 28 PE institutions with a financing amount of RMB799.00M; 122 VC institutions with a financing amount of RMB1.88B.

As an emerging market which is just starting, ChiNext gives VC/PE institutions a broad room to put their expertise to good use; while the feature of pursuing "new" and "hot" issues on China stock market for a long time pushed the rate of return to as high as 93.2% on the first day of issuance of ChiNext as expected, while the remain-high P/E and average return on book value[4] allow VC/PE to make windfall profits from investment on ChiNext. According to statistics by Zero2IPO Research Center, from the Q4'09 to the third quarter of 2010, 80%-90% of exits by VC were via

Table 3 Quarter-on-quarter Comparison of VC/PE-backed IPOs on China Markets in Q4'09-Q3'10

Quarter	SSE		SMEB		ChiNext	
	No. of IPOs	% of Total	No. of IPOs	% of Total	No. of IPOs	% of Total
Q4'09	0	0.0%	25	83.3%	25	69.4%
Q1'10	3	30.0%	14	26.9%	15	51.7%
Q2'10	1	100.0%	20	34.5%	12	48.0%
Q3'10	1	16.7%	17	37.0%	16	50.0%

Note: 5 VC/PE-backed IPOs were launched successfully on ChiNext from September 30 to October 22.
Source: Zero2IPO Research Center

[3] Due to difference in disclosing date, data on the same date is unavailable. Hence, all data provided herein is the latest as of the closing date of the report, for reference only.
[4] Average return on book value = (Issue price*shares held-investment amount)/investment amount

Table 4 Average EPS of Listed Companies on ChiNext in Q3'10[7]

	Up	Down	Equal
Number	41	76	8
% of Total	32.8%	60.8%	6.4%
Average Growth Rate YoY	101.5%[8]	-40.8%	0.0%

Source: Zero2IPO Research Center

IPO, while the proportion for PE is above 90%, and IPO on ChiNext has been an important exit option.

If Summer comes, can Winter be far behind?

Firstly, the over-high P/E illustrates that the overall valuation of ChiNext has deviated from its actual value, while the over-valued portion is the bubble of the market during the process of crazy pursuing. Certainly, for companies listed on ChiNext, because it is difficult to quantitatively predict the growth level of these companies' future earning, growth and innovation are reasons for them to enjoy a high P/E. However, even if we take into account of "growth" and select the currently prevailing PEG[5] as the evaluation indicator to inter-verify with P/E, the valuation of ChiNext has deviated from its normal range. Calculating based on the growth rate of 30%[6] of "growth rate of operating revenue of recent two years shall not be less than 30%" in the definition of ChiNext by Shenzhen Stock Exchange, PEG=68.05/30=2.27, pursuant to the rational pricing level of PEG=1 (at this time growth rate of ChiNext will reach 70.0%), overall valuation of ChiNext is still on the high end. What's more, 30.0% past growth level of operating revenue can not be the rational prediction of future trend, growth level of operating revenue might be amplified. In fact, from the semi year reports and Q3 reports of some companies we can see that, their profitability level is not satisfactory.

Secondly, from the average first day return after the listing on ChiNext over the past year, we can see that, after the 93.2% of ultra-high average first day return in Q4'09, the return in the following three quarters reverted to normal level, and in Q2'10 and Q3'10 the return was even be lower than SMEB, which reflects the current status of A share market of our country: institutions and individual investors like to pursue "new" issuers. On the one hand, the quick passion allows senior management of listed companies to get rich overnight; on the other hand, the stock market is sure to adjust back after the rising momentum is exhausted. At the early days when SMEB was launched, it was also boosted to very high on the first day, but it suffered cold soon after and the value of most stocks could not support such a high market capitalization. In the trading days afterwards, it suffered a lot in losses, and it had been even two years for some stocks to pick up their prices. For the ChiNext in the beginning period which will not avoid declining after long time of prosperity, the decline of first day return in the following quarters indicates the tend that the market will finally return to be rational.

Thirdly, from perspective of the average return on book value of VA/PE-backed Chinese IPOs on global markets, the return on investment of 6.56 times on the ChiNext in Q3'10 was the lowest level among four quarters after its launching, only 28.1% of the rate of return in Q2'10.

Investigating the reasons of the drop of average return on book value, the author believes

[5] PEG=(P/E)/growth rate

[6] In fact currently the growth rate of EPS of the Q3 disclosed by ChiNext companies is only 8.5%, including the special data of EPS increase rate of 1600.0% of Huayi Bros; if eliminating this data, the growth rate will be -4.3%.

[7] As at October 28,2010, there were totally 125 ChiNext companies who disclosed Q3 results.

[8] Because Huayi Bros' average EPS growth rate is 1600.0% which heightens the overall data, after eliminating this ultra-high growth rate, the average growth rate is 64.0%.

Table 5 Quarter-on-quarter Comparison of First-day Return on China Markets in Q4'09-Q3'10

Quarter	Shanghai Stock Market	Shenzhen Stock Market	
		SMEB	ChiNext
Q4'09	37.3%	68.7%	93.2%
Q1'10	19.6%	47.1%	32.5%
Q2'10	24.3%	37.0%	29.9%
Q3'10	22.6%	53.5%	54.5%

Source: Zero2IPO Research Center

Table 6 Average Return on Book Value of VC/PE-backed Chinese IPOs on Global Markets in Q4'09-Q3'10

IPO Locality		Q4'09	Q1'10	Q2'10	Q3'10
Domestic Markets	SSE	-	4.46	4.05	9.99
	SMEB	17.06	11.84	16.89	9.58
	ChiNext	7.48	10.10	23.31	6.56
	Average	**10.52**	**10.60**	**18.93**	**8.16**
Overseas Markets	NYSE	1.81	5.04	1.22	18.93
	NASDAQ	1.71	2.07	2.35	3.13
	HKMB	2.88	2.19	2.90	2.66
	SGX (main board)	2.00	2.94	2.94	-
	FWB	1.63	1.81	-	-
	Average	**2.56**	**2.85**	**3.90**	**9.13**

Source: Zero2IPO Research Center

this is the result affected by two influencing factors: Issue price and actual paid price per share at the time of capital injection by VC/PE[9]. Firstly, the IPO P/E in Q3 was 58.89, the lowest of one year. The drop of IPO P/E illustrates that the issue price is becoming more reasonable than that in the previous three quarters. However, when checking the data disclosed by ChiNext, the author found that, till Q2, P/E of circulating shares of ChiNext is always as high as about 60 times. If the IPO P/E of primary market in Q3 is not affected by circulating P/E of the secondary market, the incentive might be that the price enquiry reform of ChiNext which is widely concerned is imminent[10] to control problems which investors care about such as high P/E, high pricing and high oversubscription. It showed that, in Q3, issue price of new shares has taken the lead and IPO P/E has dropped about 10 percent than that of Q2 on ChiNext. The lowering of issue price is a performance of returning rational, and also a precursor that the market will gradually return.

On the other hand, investment cost of institutions is increasing, which will be demonstrated in the actual paid price per share at the time of capital injection. According to data of Zero2IPO Research Center, in H1'10, institutions were very active in financing, but with less investments. As of the Q3'10, VC/PE totally invested in 601 companies with a total investment amount of US$6.89 billion, which can be converted into RMB46.00B; VC/PE totally raised and completed 112 funds with capital raised of US$28.40B, which can be converted into RMB190.00B. In other words, it is easy to raise capital but difficult to invest. This can also be seen from the serious oversubscription phenomenon at the time of listing of ChiNext companies: according to Zero2IPO Research Center's incomplete statistics, as of Q3'10, public average oversubscription of listed compa-

[9] Shares held are kept unchanged, average book return on investment =(issuing price*shares held -investment amount)/investment amount =(issuing price/actual price per share paid)-1

[10] Before issuing this report, CSRC announced that reform of new share issuance of SMEB and ChiNext of the second stage will be implemented as of November 1, 2010.

nies in ChiNext is 161.54 times, which illustrates that there are a lot of extra capitals to invest in ChiNext companies and there is excess liquidity for invested companies. Because ChiNext market has irresistible high P/E for various institutions, which makes it usual for several institutions to appreciate one company under the circumstance of limited good projects, not only the competition among VC/PE is intense, market valuation of ChiNext is also further driven high. Due to increased cost of institutions' participation, investment return of institutions will be very limited given IPO P/E does not reach a certain high.

In addition, the investment risk of ChiNext is needless to say. According to CAPM model in finance, calculating the fluctuation rate between ChiNext index from June 1, 2010 to October 22, 2010[11] and Shenzhen Composite Index through linear regress[12], we can derive that, Beta of ChiNext index to Shenzhen Composite Index is 1.20, Alpha is -0.89. These parameters indicate that ChiNext has more fluctuation than Shenzhen market and bring more systematic risks. Meanwhile, its extra return in relation to risk-free return is lower than extra return of Shenzhen Composite Index. With the increasing maturing of ChiNext, risks will be clearer with the fluctuation.

[11] June 1, 2010 is the starting date on which Shenzhen Stock Exchange announced ChiNext index, because the floating of the early stage of ChiNext is not stable, early period data will not be taken as the evidence of index evaluation.

[12] Risk free interest rate standard will be based on SHIBOR and converted on a basis of 365 days per year. Goodness of fit R2 of CAPM model is 0.70.

One-year lock-up period is expiring, what shall VC/PE do

We return our topic to the expiring of lock-up period. After entering the Q2'10, discussion about share release of 27 companies of the first batch companies listed on ChiNext ("Bode Energy Equipment" promised that its shareholders would not reduce shares in three years) is prevalent. The announcing of the lowest average return on book value in history of ChiNext in Q3'10 also add worries on the concern of the market on releasing. Admittedly, the releasing day indicates that a watershed of ChiNext market is coming. However, it is still unknown how much impact the watershed will have on the market.

Released shares of the first batch of 27 ChiNext companies are about 1.194 billion shares with a total market capitalization of over RMB30.00B, involving 20 companies backed by 32 VC/PE institutions with shareholding proportion from 0.5% to 15.0%, and total financing amount reaches RMB657,628,721.00 with RMB18,267,464.00 for each institution on average. Because institutions that inject capital in ChiNext companies are mainly VCs, compared with later period investment, VC's investment strategies focus more on initial stage, that is to say, when lock-up period comes, most VCs have completed their missions and can sell their shareholding to exit. Under the LP model, taking IPO as the exit option, GPs and LPs could share their investment fruits only after selling shares. Due to the special constraints of lock-up period of ChiNext, the exit period of making profit has been postponed for one year, once the shares they hold are released, VCs will have no choice but to exit as soon as possible. Furthermore, according to principles of economics, when most investors in the market simultaneously have the same expectation over the market trend, the actual trend of the market will comply with this expectation; currently the situation of ChiNext is very dangerous, it is not difficult to imagine that most institutions will cash out immediately.

In July 2010, as three companies including Shandong Uroica Automatic Equipments, Ningbo Shuanglin Auto Parts and Chengdu Goldtel Electronical Technology publishing prospectus, total number of ChiNext listed companies reached 100, only less than nine months after the opening of ChiNext; to the contrast, from Zhejiang NHU Company on June 25 2004 to Xinjiang Tiankang Animal Science Bio-technology on December 26, 2006, the process of SMEB from 1 to 100 took two and a half years. Where ChiNext will go, and how will VC/PE adjust their investment strategies, all the suspense are left to the fourth quarter of 2010, let's wait and see.

109 Chinese Companies Listed in Q3'10 with Financing Amount Accounting for 79.7% of the Total Worldwide

Released by Zero2IPO Research Center

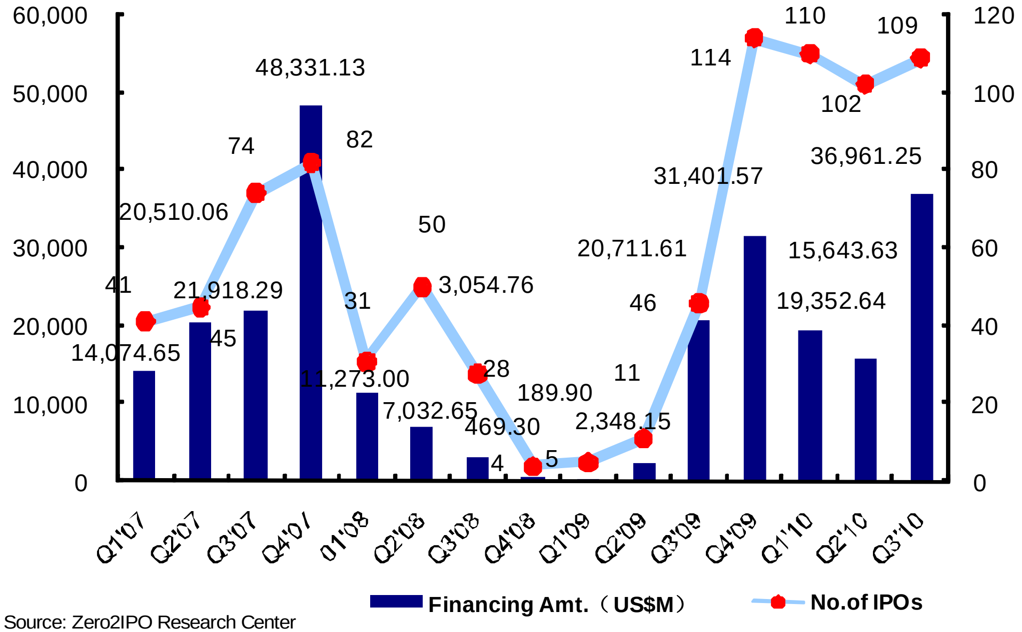
In Q3'10, in 13 overseas markets and 3 domestic markets Zero2ipo Research Center concerned, totally 165 companies were listed in which up to 109 Chinese companies were listed in domestic and overseas markets, about twice of other countries' total IPOs. Total financing amount of the Chinese listed companies reached US$36.961B, accounting for 79.7% of total global financing, with US$339M in average.

Table 1 Distribution of Domestic IPOs in Q3'10 by Enterprise Type

Enterprise Type	Financing Amt. (US$M)	% of Total	No. of IPOs	% of Total	Average Financing Amt. (US$M)
Chinese Enterprise	36,961.25	79.7%	109	66.1%	339.09
Other Enterprise	9,428.94	20.3%	56	33.9%	168.37
Total	**46,390.19**	**100.0%**	**165**	**100.0%**	**281.15**

Source: Zero2IPO Research Center

Chart 1 Quarter-on-quarter Comparison of Domestic and Overseas IPOs of Chinese Enterprises between Q1'07–Q3'10



Source: Zero2IPO Research Center

It is revealed in the China Enterprises IPO Annual Report Q3'10 published by Zero2ipo Research Center, a famous venture capital and private equity research institution in Great China, that in 13 overseas markets and 3 domestic markets, global IPO transactions in Q3'10 continued the general trend of last two quarters. On the one hand, transactions were still active with a total of 165 companies listed globally, all but the same as 167 and 165 IPOs in Q1 and Q2; on the other hand, the financing amount was US$46.39B in total or US$281.00M on average, both increased by 28.3% QoQ.

165 Companies Listed Globally; Chinese Companies Took the Lead

In Q3, totally 165 companies got listed globally, basically the same as 167 and 165 IPOs in Q1 and Q2; on the other hand, the total global financing amount was US$46.39B, with a financing amount of US$281.00M for each in average. The prevailing role of Chinese companies in global IPO market is still unshakable, totally 109 companies were listed in domestic and overseas markets, about two times of total IPOs of other countries; in Q3, the total financing amount of Chinese companies was as high as US$36.96B, accounting for 79.7% of total global financing amount, or an average one of US $339.00M.

In Q3, the boom derived from the listings of Chinese companies persisted. Both the number of IPOs and financing amount were at an all-time high. In Q3, totally 109 Chinese companies were listed in domestic and overseas markets, an increase of 63 companies, with a annual growth rate of 136.96%; financing amount was as high as US $36.96B, a Y-o-Y growth of 78.5%.

As for market distribution, among 109 Chinese companies, there were 25 ones listed in various overseas markets with a total financing amount of US$12.85B, the number of listings increased by 7 YoY with a combined financing amount increasing 94.7% YoY; domestic capital markets were in the limelight and attracted 84 companies getting listed with a financing amount of US $24.11B, the number of listings increased by 56 from the same period of 2009 to contribute another US$10.07B.

The Number of Overseas Listings and Financing Amount Surged up Q-o-Q and Y-o-Y; Overseas IPOs Concentrated in Certain Markets and Industries.

In Q3, the European debt crisis has been taking its toll, all countries faced the pressure of inflation and the investment prospect looked dim. While the recently released data from the US revealed that its economy and market have been on the mend, especially for the US stock market after this September. The month has witnessed an unprecedented bullish stock market in the US ever since the year of 1939. Hence, new share issuance in various countries was till very active, in this quarter totally 25 Chinese companies were listed in five overseas markets with a total financing amount of US$12.85B. In a Q-o-Q comparison, the number of listings of Chinese enterprises in overseas markets registered an upsurge of 7 with more financing amount involved, namely up 8.52 times. Compared with the same period of the previous years, Chinese companies'overseas listings soared to catch eyeballs worldwide.

The main reasons behind the surging financing amount lie in the IPO of Agricultural Bank of China in HKMB on July 16, 2010, which contributed a financing amount of US $10.48B, 81.5% of the total financing amount of overseas listings of Chinese companies. After reducing this IPO, the total financing amount of other companies was only slightly higher than that of Q2, basically the same as Q1, although the number of listing companies increased a bit.

As for market distribution, 25 Chinese companies'overseas IPOs concentrated in some markets, such as HKMB, NASDAQ and NYSE, particularly in HKMB. To be specific, 15 companies chose to get listed in HKMB with

Table 2 Distribution of Domestic IPOs in Q3'10 by Region

Region	Financing Amt. （US$M）	% of Total	No. of IPOs	% of Total	Average Financing Amt. （US$M）