Asia Weekly China's Coming IPO Reform

May 2, 2015

by Hardy Zhu

of Matthews Asia

As China has moved toward a more market-based economy, the government has relinquished much regulatory power and simplified its many administrative procedures. With a portion of China's domestic A-share market made accessible to international investors, people have turned their attention to much-anticipated equity market IPO reforms in China.

Currently, IPO approvals sit with a regulatory body called the Chinese Securities Regulatory Commission (CSRC), and it dictates what firms are eligible to be listed (including such aspects as profitability requirement) as well as the pricing of new shares; for example, an IPO cannot be priced higher than certain price-to-earnings multiples. The drawback of this system is that the Chinese domestic equity market has excluded many great companies that were initially unprofitable but held high growth potential. And artificially suppressed valuations for new share sales can make secondary trading more volatile.

Like many mature markets, China will adopt the so-called "registration" system. The rationale is that the government should not be eligible to make decisions on whether a particular firm is allowed to be listed on public markets or on how the IPO should be priced. The CSRC will only make sure the IPO application meets all necessary disclosure rules, and should leave pricing matters to the market to decide. Profitability requirements will also be eliminated.

The core of this change is that the regulator will not pass judgment on the investment value of the listing company but instead shift the supervisory focus to the secondary market. There are a few benefits from this change: Firstly, as it eliminates the "human factor" from the regulator in terms of determination of IPO eligibility, and improves information transparency, it helps reduce chances of unfairness and corruption.

Secondly, the new mechanism will pave the way for smaller-sized and more innovative companies to access the capital market, satisfying varying risk appetites of investors. By lowering the listing bar, it should help stimulate entrepreneurship.

Thirdly, the new system will hold a listing's deal sponsor and issuing firms more accountable over the authenticity of their application—including financials. Both parties should exert more due diligence considering the risk of later being delisted. Meanwhile, since it's up to investors to determine the value of an IPO, they will strive to improve their investment capabilities, especially for many retail investors who dominate the A-share market. With a more reasonable pricing, the newly listed stocks may not see such drastic movements during its initial trading period which can help reduce market volatility.

As with many reforms in China, I expect this to be a gradual process. Although the regulator is determined to carry out these changes this year, I still expect some kind of "window guidance" from the government on the volume and speed of IPO approvals. But certainly, we believe, China is on the right path.

Hardy Zhu
Research Analyst
Matthews Asia
