

China's Capital Market Development and Valuation under a Registration-based IPO System

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Abstract. The capital market is an important channel that serves companies with financial needs. On February 17, 2023, China Securities Regulatory Commission (CSRC) officially announced a detailed mechanism and regulations for a registration-based IPO system across the A-share market. This reform marks the shift from the approval-based IPO system in China for many years to a registration-based IPO system. This paper studies and analyzes the features of China's capital market, including the historical development of China's capital market in five stages and the reasons why the same company is valued higher in the A-share market than in other markets. The research also presents forecasts under a registration-based IPO system across the A-share market.

Keywords: China's capital market; Valuation; Registration-based IPO system.

1. Introduction

1.1 Background

On February 1, 2023, the China Securities Regulatory Commission (CSRC) published draft measures and regulations for implementing a registration-based initial public offering (IPO) system for public comment. Two weeks later, on February 17, 2023, CSRC officially announced a detailed mechanism and regulations for a registration-based IPO system across the A-share market. The registration-based IPO system has already been piloted in several mainland stock exchanges' boards, and it will be rolled out to reform China's IPO system from an approval-based system to a registration-based system. Expanding the registration-based IPO mechanism will "give the right of choice to the market" and facilitate listings and corporate fundraising [1, 2].

1.2 Related research

Firstly, Chen and Fu studied the development history of China's capital market and divided the IPO system development in China into five stages, which undergo an administrative approval system, the approval stage, the inquiry system stage, the registration transition stage, and the registration stage. The pilot reform of the registration-based IPO system in the Science of Technology Innovation Board (STAR Market) and Growth Enterprise Market (GEM) brought more opportunities to emerging growth companies and small and medium-sized enterprises [3]. Wu and Fang summarized the development of the Chinese capital market over the past 30 years from regulator-oriented to market-oriented. The Chinese capital market has undergone considerable system, scale, structure, and function reforms. The complete implementation of the registration-based IPO system will deepen China's capital market [4].

Along with the development history of China's capital market, Lu analyzed the regulatory change of China's IPO mechanism considering the background that China piloted a registration-based IPO system in the science and technology innovation board of the Shanghai Stock Exchange (SSE) and ChiNext Board of Shenzhen Stock Exchanges (SZSE). Lu compared the dissimilarities between the approval-based IPO system and the registration-based IPO system from six aspects and concluded that the registration-based IPO system would provide a healthier capital market [5].

Furthermore, Wang started from the historical development of China's IPO system, compared it with United States' dual registration systems, and concluded that the registration-based initial public offering system in China was yet to be developed, in particular, the lack of protection of monitory investors and unstable legal system response to fraud. However, the registration-based initial public

offering system in China still plays a vital role in resource optimization, unleashing the potential of small companies and resolving difficulties in financing [6]. Xiao and Liu introduced the development of China's IPO system and presented the basic principles of a registration-based IPO system are to present complete, fair, and accurate information, and regulators would not simply approve or reject a company's IPO application based on its financial status, business model, etc. Under the registration-based IPO system, the market supply will be increased significantly compared to the approval-based IPO system, meaning more companies will be listed. In addition, the delisting rule will be more strictly followed under the registration-based IPO system, meaning more companies will be delisted voluntarily or involuntarily. Thus, the market will be more critical in the IPO system [7, 8].

In addition, Guo analyzed the information disclosure system for Chinese listed companies with the registration-based IPO reform and concluded that the power of the decision would be moved from regulators to investors, and the information disclosure system would be moved from regulator-oriented to investor-oriented. Multiple forces, such as public accounting firms, investors, and short-selling agencies, should also have a role in the information disclosure mechanism [9].

Moreover, Luo introduced specific impacts of adopting the registration-based IPO system: it would increase the ratio of direct financing, improve the efficiency of issuing stocks, optimize the structure of investors, energize the capital market, boost brokers' revenue, and facilitate the transformation of the broker's business model. Nevertheless, the registration-based IPO system also obligated brokers to improve their abilities in the following aspects: research ability, pricing ability, underwriting ability, risk management ability, and capital sufficiency ability [10]. Leng used Alibaba's IPO in the US as a case study to show how the US-style registration system works. The study reveals that the registration-based IPO system has unique competitive advantages through trial and error. Specifically, the registration-IPO system is quicker from application to public, aims to focus on the quality of information disclosure, gives the power to market itself, and is transparent to the investors [11].

Lastly, Wei introduced the conflicts and countermeasures caused by the complete implementation of the stock registration system from legal and market perspectives. From the legal perspective, the conflict is in the connection of criminal and civil law with securities law, which must be integrated to protect investors. From the market perspective, conflict exists between the authorities and market regulations. Under an approval-based IPO system, the market power will dominate rather than the authority's regulation. The major countermeasures suggested by Wei include: establishing an integrated legislative and regulation system, educating investors, and improving investors' protection system, etc. [12].

1.3 Objectives

This paper aims to study and analyze the features of China's capital market, inclusive of the historical development of China's capital market in five stages, the reasons why the same company is valued higher in the A-share market, and the influences adopting the registration-based IPO system in A-share market. In addition, this paper lays out specific forecasts under the registration-based IPO system in China.

2. The features of China's Capital market

2.1 The development history of China's IPO capital market

Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE) were both established in 1990, which marks when China's stock exchange markets were formed. This was followed by China Securities Regulatory Commission being established in 1992. After 30 years of development, China's IPO capital market may be divided into the following five stages:

The first stage occurred under the administrative approval system from 1990 to 2000. Under the administrative approval system, numerous state-owned companies completed their IPOs. The second stage was the approval system which began in 2001 and lasted until 2004. Under the approval of this

system, securities companies began to play a role in the market and helped companies to reform and complete their IPO process. The third stage was inquiry went from 2005 to 2013. Under this stage, the issuing price of shares was determined by inquiring institutional investors. The fourth stage was the registration transition from 2013 to 2019 when the China Securities Regulatory Commission published numerous documents to promote a registration-based IPO system. The fifth stage is the pilot registration-based system in the STAR market [3].

2.2 The high valuation of the Chinese A-share market

It is well noted that an underlying company's value is different in the A-share market and other markets, such as the HK market and the US market, and typically, the value in the A-share market is the highest. The significant reasons are as follows:

The first factor is the approval-based IPO systems. The Chinese A-share market has been an approval-based IPO system for the last 30 years, while other markets, such as the HK market and the US market, are registration-based IPO systems. The approval-based IPO system is regulator-oriented and has specific hard and fast rules for a company's financial performance, which is difficult for start-up companies to achieve as they have financial needs at that time. In addition, the regulator reviews and judges the qualifications and value of the issuer. The approval-based IPO system leads to low IPO pass rates, which then leads to the high value of the companies if they can gain the regulators' approval. In contrast, the registration-based IPO system is investor-oriented, and the regulator reviews the accurate and fair information submitted by the issuer, with no review or judgment on the qualifications and value of the issuer. So companies can be successfully onboarded if their information is complete, accurate, and fair. The investors and market judge the value of the issuer. Thus, this simple process will lead to a more significant number of issuers on the market. The low IPO pass rate, which is the low supply of issuers and high demand of investors, leads to the company in the A-share market being higher than the value of the same underlying company in other markets.

The second factor is the elevated rate of retail investors. Investors in the stock market consist of retail investors and institutional investors. Retail investors are private individuals who trade stocks based on their emotions and a high spirit of speculation, and they make short-term investment decisions. Institutional investors are usually professional organizations knowledgeable about finance and make reasonably long-term investment decisions based on the business model. The A-share market's retail investor rate is considerably higher than other markets, such as the HK and the US markets, which are dominated by institutional investors. The high rate of retail investors in the A-share market leads to higher volatility and speculation, which also leads to the high value of the A-share market.

The third factor is the market's liquidity premium. Due to the market system and different structures of investors, the A-share market has a high liquidity premium compared to the HK and US markets. First, China's capital account is regulated, and the channels for domestic capital to exchange RMB with the People's Bank of China for foreign currencies to invest abroad are restricted. Second, the RMB still needs to be a widely accepted currency in the international investment market, and direct RMB investment in other markets is impossible. Along with the excessive M2 in the domestic market and the gateway to the foreign market is limited, most of the excessive M2 remains in the domestic capital market. The excessive M2 and limited assets lead to the high liquidity of the A-share market. In contrast, the HK and US markets enjoy a free flow of capital, so accordingly, they would not have high liquidity.

The fourth factor is the net inflow of foreign capital. With the Chinese economy's high-speed expansion, the RMB's internationalization, and a series of favorable regulation policies, foreign capital has taken a long time to become a net inflow to the A-share market. The net inflow of foreign capital indicates that people are confident and positive about the A-share market's development, and thus the value of the A-share market is high.

3. The influence of registration-based IPO system reform

The major influences of registration-based IPO system reform in China are as follows:

The supply end of the A-share market will be increased, and the market value of the issuers in the A-share market will decline accordingly. Under the registration-based IPO system, the success of the IPO depends on the market and investors rather than the regulation's approval. Thus the supply of the market will be booming. The balance of supply and demand will lead to the fair value of the A-share market, unlike the low supply and high demand under the approval-based system. Thus, the broker's business will leap to the next level. As more companies have opportunities to acquire direct finance in the capital market, the broker's business will also grow.

Institutional investors will gradually dominate the market since the registration-based IPO system will not judge the qualification of the issuer; as long as the information disclosure is complete, fair, and accurate, the issuer will be able to obtain direct finance from the investors. This reform will require professional judgment to make reliable investment decisions. Retail investors who invest based on emotion and short-term speculation will soon be replaced by knowledgeable and professional institutional investors.

As the registration-based IPO system is investor-oriented instead of regulator-oriented, associated regulation policies will be issued and implemented to protect investors' interests further. For example, regulations regarding fraudulent financial information disclosure and the class lawsuit against issuers and other associated agencies.

4. The forecast of the registration-based IPO system

Under the registration-based IPO system, the stock price of the issuer will decline gradually. This is due to the increasing supply of issuers in the capital market, and investors will have additional options in the stock market. The supply and demand in the market will create equilibrium, and the high valuation of the stock price of the issuer under the approval-based IPO system will decline gradually to a fair market value.

Secondly, the delisting and stock price falling under the issuing price will become an expected market practice. Under the approval-based IPO system, the delisting rate is extremely low, and the shell of the issuer enjoys a valuation premium regardless of whether the issuer's business is worthless. The registration-based IPO system will help to speed up the whole IPO process, and issuers with better performance will be sought after by investors who enjoy high valuation and liquidity. In contrast, investors will dispose of the issuers with poor performance with the result that the stock price will fall below the original issue price or may even be delisted from the market.

Thirdly, the primary market of securities will be more active. Along with the elevated possibility of IPO success under the registration-based IPO system, the valuation of an issuer will be far higher, which could help reduce the valuation gap between the primary market and the secondary market.

The fourth forecast is the more significant challenge for the whole broker industry. The registration-based IPO system imposes higher industry standards for the broker's industry. Specifically, brokers must be able to wipe out the low-quality issuers and dig out the high-quality issuers to be presented to the market and have a better valuation, underwriting, and risk management skills. Like the low-quality issuers will be delisted from the market, the low-quality brokers will also be delisted from the market or merge with larger and stronger brokers.

5. Conclusion

This paper analyzed and studied China's capital market historical development and the critical reasons that issuers in the A-share market are valued higher than in other markets. The major influences of the registration-based IPO system include the increased supply end in the market that will lead to the gradual decline of issuers' valuation, the broker's business will leap to the next level, and institutional investors will gradually dominate the market. Associated policies and mechanisms

will be rolled out to further protect investors. Forecasts of the registration-based IPO system are that the valuation of the issuers in the A-shared market will decline, delisting and the stock price will fall below the issue price and will become a regular market price, the valuation gap between the primary market and secondary market will be narrow, and low-quality brokers will be delisted or merged by more professional and stronger brokers.

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