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Meeting the Challenges of SME Financing by Accelerating Construction of Multi-layered Capital Markets

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In history, capital markets in developed countries have played a fundamental role in driving economic transitions and cultivating strategic industries.

The 2008 global financial crisis and the aftermath of international market upheavals have had a profound impact upon the global industrial landscape that took shape in the post-World War II era, and every country is striving to compete for the next-generation strategic industries. In a way, we emerging economies are for the first time standing at the same starting line as the developed countries. But how shall we compete with our developed peers? Over the past three decades, all four key strategic industries, namely the PC, telecommunication, internet and bio-pharmaceutical industries were discovered and nurtured by capital markets. That is to say, to a large extent, the competition for future strategic industries between different countries will mainly be decided by the efficiency of their capital markets and the effectiveness of the markets in promoting strategic industries.

Europe emerged as a global power after the industrial revolution by deriving a competitive edge from its first-rate research and development in science and technology, and its advanced capital markets. The same is true of the US, whose rise to world power was accompanied by modern enterprises, remarkable academic institutions and the thriving Wall Street. Interestingly, after the World War II, both the Europe and the US experienced rapid economic recovery and growth for three consecutive decades and then simultaneously fell into economic stagflation. Then the two diverged in their development with the US managing to walk out of the sluggishness of the 1970s and achieve another 30-some years of dramatic growth, propelled by effectively wedding its capital markets and emerging high-tech industries. Europe, on the on the hand, has suffered from relatively low growth ever since. In fact, unlike in the US, financial systems in some European countries are dominated by commercial banks instead of capital markets, and therefore the lack of mechanisms to effectively support and cultivate strategic and new industries has caused the region to gradually lose its competitive edge, especially in recent years with the tide of globalization sweeping the world economy. By the same token, Japan also enjoyed three decades of post-war rapid economic growth, which ended with the 1989 financial crisis. And Japanese economy has never quite recovered in the subsequent two decades up to the present. Japanese Finance Minister Yuuji Yamamoto once said, during his China visit in 2004, that a major defect of the Japanese financial system lies in its underdeveloped capital markets.

The above experiences and lessons of three major economies, Europe, US and Japan, can clearly highlight the decisive roles that efficient capital markets and effective market-oriented resource allocation mechanisms can play in facilitating economic transitions.

Capital markets can provide important support for SME and technological innovations

SMEs, especially technologically innovative ones, are typically characterized by early development stages and small sizes, being financially vulnerable and risky. However, at the same time, historical evidence also illustrated that SMEs can catalyze economic transitions by introducing new business models or industries.

It is natural that SMEs, suffering from their own limited internal capital accumulation, have to resort to external financing to fuel rapid expansion. Whereas bank credit is generally unavailable to SMEs with low-capital and high-risk profiles, capital markets, including equity and bond markets, and broadly private equity and venture capital markets, can provide enterprises and investors with a mechanism to share risks and returns, thus providing a crucial platform for SMEs and technologically innovative enterprises to grow and thrive. The success of the Silicon Valley best exemplifies the advantages of combining high-tech industries and capital markets.

First of all, capital markets provide consecutive financial support to the SMEs and high-tech innovative enterprises in their different development stages, and allow the real winner to emerge; Second, by going public, companies strive to improve their corporate governance, motivate their management and employees by providing incentive structures, and therefore achieve rapid and stable growth. Third, capital markets also furnish SMEs with other social resources including platforms for M&A's, investment banking services and a barometer to gauge market reactions, and thus allow them to form and rapidly expand a competitive edge.

Taking advantage of above-mentioned advantages of capital markets, quite a lot of SMEs and technologically innovative enterprises achieved fast growth. In 1971, when NASDAQ was initially founded, most companies listed on it were small and unknown ones. In 1995, only 24 years later, four of the five companies with the largest capitalizations in the US were NASDAQ-listed companies, including Microsoft and Apple. Recently a hot topic in China is "why can't China give rise to a Steve Jobs?” Mr. Jobs was the undoubted leader of Apple's technological innovations, but capital markets have also played an indispensible role in Apple’s growth, which was born in 1976, went public in 1980, and was later quickly expanded via M&As in the capital markets.

In fact, in recent years, with the opening of the SMEs board and Growth Enterprise Market (GEM), and the rapid development of VC and PE markets in China, capital markets are playing an increasingly important role in facilitating the development of SMEs and nurturing technologically innovative enterprises. We have good reason to believe that with the marriage between capital markets and more and more innovative enterprises all over the countries, China will see its own versions of Apple and Steve Jobs's in the future.

Accelerate construction of multi-layered capital markets to meet the challenges of SMEs and high-tech enterprises development.

Recent years has seen SMEs playing an increasingly important role in China's economy, providing 80% jobs for the whole society. But their financing situation is not optimistic. First, SMEs are generally immature companies with low profit margins at a competitive disadvantage. The relatively higher threshold for bank loans and high costs make it difficult for SMEs to further develop. Second, because of their unstable and risky nature of such enterprises, bank lending is not a readily available financing channel for SEMs. Third, private financing (such as "underground usury") proved to be even more expensive for SMEs than bank loans. Fourth, in the capital markets, the listing threshold is still quite high, and competition for SMEs is fierce. For example, in Zhongguancun Science and Technology Park of Beijing alone, there are more than 1000 companies qualified for listing on GEM. At the same time, PE and VC generally focus on companies in later development stages, creating a high hurdle for companies in earlier stages to get financed.

In April 2011, some SMEs in Wenzhou collapsed because of a break in the chain of financing. In the same city, on one hand, a large number of SMEs are starving for financial support; on the other hand, a lot of private capital of Wenzhou, one of the richest cities in China, is engaged in speculative activities in areas of real estate, coal mining, precious metals, mung beans, cotton, etc. Some private capital even became international "hot money", speculating in overseas real estate markets. The "Wenzhou phenomena" showed that, when social wealth is accumulated to a centain level, the surplus capital would not be able to engine the economic growth without the development of sound financial markets, but instead might cause serious social problems.

So far as the multi-layered capital market structure is concerned, the US boasts 2311 listed companies on the NYSE, 2717 on the NASDAQ, 2386 on the OTCBB, 6199 on the Pink Sheet, and more than sixty thousand in the "grey" market. The whole market resembles a pyramid, which has a relatively stable structure. In contrast, China's capital markets are like an inverted pyramid: there are 1405 listed companies on the main board, 610 on SME board, 258 on GEM, and only 115 on the Zhongguancun share-transfer system(China's OTC market) as of October 2011.

Therefore we should speed up the process of developing multi-layered capital markets, to support the growth of SMEs and technologically innovative enterprises, and to promote building an innovative economy.

To achieve this, first, we need to actively promote the development of the OTC market. We need to learn from the experiences of mature markets, and adopt them to China's specific situations, building an OTC market under unified regulatory framework, to beeter serve SMEs' financing needs.

Second, we need to further expand the SMEs board and GEM. Tailored towards the needs of SEMs, we should improve the IPO, refinancing, delisting and merger & aquisition mechanisms of these two markets, for companies to better grow and thrive. We also need to improve corporate governance and transparency of these companies.

Third, we need to promote the development of venture capital and private equity markets in China, by furnishing relevant policies and regulatory framework, building social credit system, and protecting investors' interests.

Finally, we should accelerate the development of corporate bond market. We need to draw from developed countries' experiences and lessons of high-yield bond market, and develop fixed-income products which can meet the financing need of techonologically innovative enterprises, particularly at their early stages of development.

The development of capital markets is a systematic effort, which involves many economic and social aspects. And the development of the markets is closely related to the interests of many enterprises and investors. The emergence of well-functioning capital markets requires both top-down design and bottom-up collective effort in the entire society. And we should undertake a series of coordinated reform measures. We should strive to improve the quality and efficiency of our regulatory regime to suit the development of a multi-layered market system. We should improve investor-protection mechanisms and enhance investor education, to enable investors to share the fruits of SMEs' growth and China's economic transition. At the same time, we need to establish and improve mechanisms to attract long-term capital into the capital markets, develop institutional investors, and synchronize the development of social security and pension system with that of the capital markets.