The Quoted Companies Alliance

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A New Beginning for Chinese Issuers on AIM

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Current State of Play

In October 2004, when China Wonder celebrated its landmark flotation as the first Chinese company listed on AIM, investors were encouraged by a 153% surge in the company's shares on the second day of dealings. The China heat had begun with the number of new Chinese company IPOs on AIM reaching 32 during 2006 to the total number of China companies on AIM currently at 60 and dwindling. Four years after the magnificent Chinese debut, the current state of play reveals a change of sentiment. With only five Chinese IPOs on AIM in the first three quarters of 2008, a negative return of 16.2% for AIM China Index in the first half of 2008 , the de-listing of Jarlway, Financial Payment System and GruppeM, the suspension of CEC Unet, and the unexplained disappearance of the Chairman of Canton Property Investment and CEO of ZTC Telecommunications, the question must be asked – is AIM still suitable for Chinese issuers?

The flexible regulatory regime of AIM had attracted many small and medium-sized private companies in China. These companies would otherwise have had difficulties in capital raising due to the restrictions on borrowing from China's commercial banks or in satisfying the legal requirements for a domestic or Hong Kong listing (e.g. being unable to demonstrate the required track record period). AIM became the obvious choice for these young and fast-growing Chinese companies. However, the exchange's flexibility and its self-regulating structure in fact presented significant challenges for Chinese issuers and investors.

Communication

A significant portion of the problem appears to have arisen from insufficient communication. From the pre-admission stage, the Chinese issuers often suffered from the culture shock arising from working with foreign Nomads, financial advisers, accountants, lawyers and western investors. Nomads, being regulated by the AIM Nomad Rules, are responsible for assessing the appropriateness of a company for listing on AIM and ensuring that the issuers fulfil their continuing obligations under AIM Rules. Chinese issuers have had to appreciate that Nomads are effectively performing the regulatory compliance function, and it is an education process for the Chinese issuers to understand the essence and the principles set out in the rather thin AIM Rules. Views and practice can often vary from Nomad to Nomad. In our view, communication between Chinese issuers and its advisers plays a very significant role in terms of achieving a successful admission and complying with post-IPO ongoing obligations.

The concept of "listing" has often been misunderstood by Chinese issuers. For some Chinese issuers, achieving a successful IPO is perceived as the end of the transaction and as a result, they have failed to invest sufficient time and money to maintain a good, transparent and regular communication channel with their investors. One of the consequences of poor communication is that investors have seen a lack of liquidity – this has been described as "a lurking problem yet to be solved for AIM" . This is likely to have been one of the key drivers for ReneSola, now the one of large AIM-listed Chinese companies, to have sought a dual-listing on NYSE for a higher valuation and enhanced liquidity. It appears that many AIM-listed Chinese companies have not been able to maintain investors' appetite due to lack of communication.

Corporate Governance

Good communication comes from a well-functioning corporate governance system. Nomads typically require Chinese issuers to adopt the Quoted Companies Alliance Corporate Governance Guidelines for AIM Companies 2005 ("QCA Guidelines") as its corporate governance standard upon admission. For historic and cultural reasons, corporate governance is not a concept well-understood or practiced by many domestic Chinese companies. In 2006 corporate governance was enshrined in the new Company Law for domestic private companies, although prior to the introduction of the Company Law, corporate governance requirements were applicable to public companies only. The key operating subsidiaries of many AIM-listed Chinese issuers are privately-owned companies that simply are not familiar with corporate governance. Whilst the QCA Guidelines may work well with western companies that have better corporate governance systems in place, they may not be the most suitable for Chinese issuers, and in fact, the stricter Combined Code may even be a better choice with its clearer guidance for these foreign companies.

Board Composition

Good communication among the entire board is vital. Often, Nomads will insist on (and investors will expect) UK representation on the board of Chinese issuers. Hence, it is not uncommon to see non-executive board members of a Chinese issuer based in two or more geographic locations. Directors based outside of China often find it difficult to communicate with executive board members in China or are not informed by the company of material information as often as they should be. As a result, the function of UK representation in the form of independent non-executive directors ("NEDs") in the decision-making process is somewhat diminished, and the effectiveness and quality of the board's collective decisions can often be challenging. These will undoubtedly cause serious damage to the company's public image and investors' confidence.

The board of a Chinese issuer is generally composed of the founding Chinese executive directors ("EDs"), a CFO and the NEDs. Amongst these, the role of a CFO is particularly important. Whether he or she had started with the company from the beginning or has only been appointed upon admission, a CFO must possess the right financial management and accounting experience and qualification with a successful track record and should be someone who understands the company's operations well, so that he can efficiently communicate with the outside world (particularly western investors). Internally, a CFO can act as the bridge between the NEDs and EDs to ensure good internal communication. Chinese issuers should appreciate the importance and value (and corresponding remuneration) of the CFO. Better internal communication would only lead to better performing board and eventually benefit the company and its shareholders as a whole.

Future

In our view, the above difficulties are manageable and can be controlled, if they are addressed properly from the outset of the IPO. Professional advisers are key in addressing these issues and helping the Chinese issuers to better prepare themselves. It is therefore important to engage a team of professional advisers with solid understanding of both Western and Chinese cultures, rather than relying on inexperienced financial intermediates. For the right Chinese companies to come to AIM, good due diligence must be carried out by bankers, accountants, lawyers and industry experts.

The current turmoil experienced by Chinese issuers can be viewed as little more than a natural cleansing process by which the weak and unsuitable listed companies are weeded out of the system. The same applies to all AIM companies irrespective of sector or geography. For the remaining companies, it is probably a good time to restructure to enhance shareholder value, for example by means of capital return, and re-strategize by improving corporate governance and optimising board composition. With the above issues appropriately addressed, quality Chinese companies already listed on AIM or looking to list will see a new beginning and ride out this storm in a stronger position.

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