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"A-Share" Strategy of Chinese Internet Companies

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Abstract

At present, due to the limitation of domestic policies, many internet companies in China have implemented or are seeking overseas capital market.But in recent years, some enterprises have started to choose "A-share" in China.Taking Beijing Baofeng Technology Co.Ltd as an example, this article mainly analyzes the ways of domestic internet companies, especially the ones with the VIE structure, to achieve the strategy of "A-share" and the motivation of it.

Key words: Internet companies; "A-share" strategy; VIE structure; Motivation

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INTRODUCTION

In 2000, Sina, which is a Chinese internet company with VIE structure, went public in America. Since then, this way has been imitated by more and more enterprises and provided an overseas financing channel for some industries which are restricted from foreign investment because of policy issues. But in recent years, many Chinese enterprises have started to dismantle the VIE structure to choose domestic capital market. Shanda Games Ltd (GAME), RONG360, Focus Media and so on, have expressed the desire to be A-share listed companies.

This series of actions of internet companies indicate the change of thinking pattern to a new strategic mode-"A-share" strategy. In short, "A-share" strategy refers to the pattern that an internet enterprise with the VIE structure return to "A-share" market by removing the VIE structure. Under this kind of strategic mode, more and more companies decide to choose the more prosperous capital market to seek higher corporate value rapidly enhance the overall corporate strength (Zhu, Sui, & Tang, 2013). This article takes the case of Beijing Baofeng Technology Co.Ltd as an example to analyze the motivation of "A-share" strategy of internet companies.

1. "A-SHARE"STRATEGY OF BEIJING BAOFENG TECHNOLOGY CO.LTD

1.1 The Establishment and Removal of the VIE Structure

Baofeng Technology is well-known Chinese internet video enterprise. It provides free use of terminal integrated video service through series of software for video users and internet advertising information for business customers. During the process of development, Baofeng Technology has got three rounds of PE financing from 2006 to 2008. In May 2006, the domestic enterprise—KURE Technology, which is the main body of video software development and operations，set up the offshore company-Kuree. In July 2006, Huruan Technology was registered in China and it was a wholly owned subsidiary of Kuree.It was founded to be the domestic controlling platform of the VIE structure. In January 2007, Feng Xin and Wei Chanyuan invested 1.5 million dollars to create the Baofeng-Wang Ji. However, after KURE Technology's capital investment in June 2008, shareholders of Baofeng-Wang Ji turned out to be Feng Xin, Wei Chanyuan and KURE Technology. And they were holding 2.5%, 5%, 92.5% separately. At the same time, Kuree and Huruan Technology signed a series of agreements with KURE and Baofeng-Wang Ji to make sure that Kuree can get the benefits of KURE Technology. Since then, the construction of the VIE structure was completed.

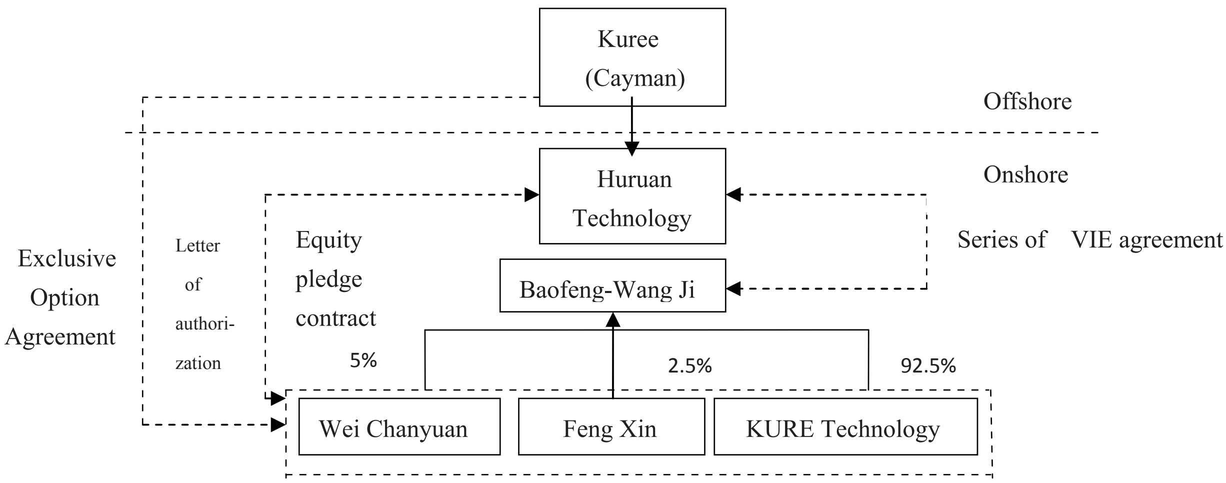

Figure 1
Framework of VIE Structure

Afterwards, Baofeng Technology decided to go to the public in the domestic capital market and started to remove the VIE structure in 2010. In December 2010, Gold Stone Investment and Harmonious Growth Fund bought 100% stake of Huruan Technology from Kuree. Meanwhile, all the VIE agreement was terminated. And then, in July 2011, Kuree paid 41.48 million dollars to repurchase all shares from IDG and Matrix, which are overseas professional investment institutions. After the cancellation of related companies (KURE Technology, Huruan Technology)，the removal of VIE structure was finally accomplished in May 2012.

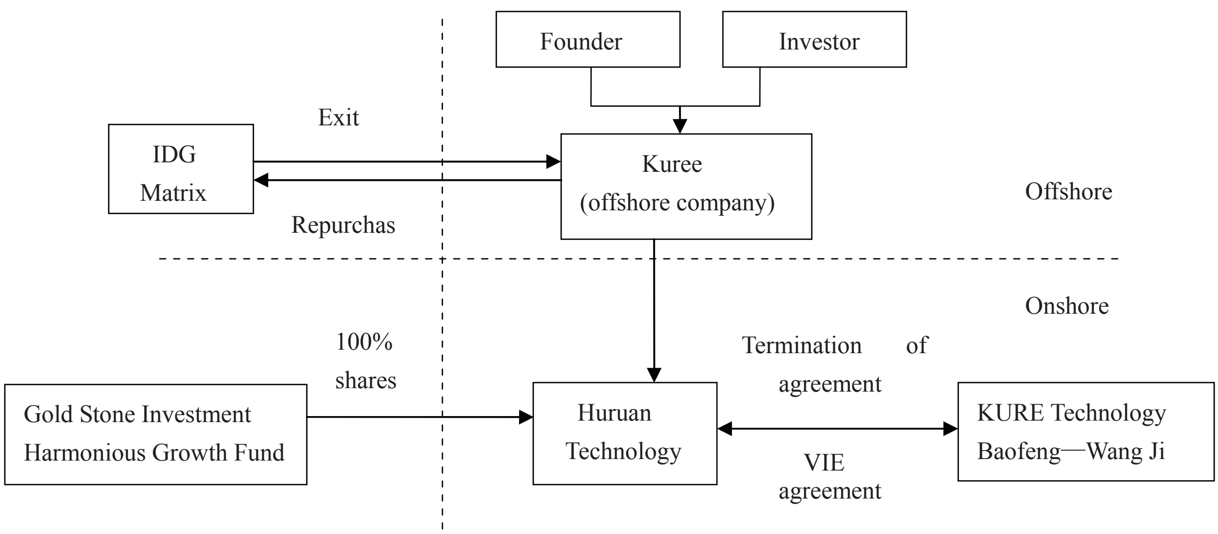

Figure 2
Removal of VIE Structure

1.2 Great Effect of the "A-Share" Strategy of Beijing Baofeng Technology Co.Ltd

1.2.1 Skyrocketing Stock Price

Baofeng Technology is officially listed on China Growth Enterprise Market (GEM) on March 24, 2015 and the issue price was 7.14 yuan per share. While, less than 2 months later, the stock price sharply rose to 229.87 on May 12, 2015 and corporate value has increased to as high as 27.6 billion yuan. There is no double that Baofeng Technology accomplished a miracle of the capital market due to the right choice about the strategy change.

1.2.2 Poor Operating Condition

Stock price rose continuously, while the performance of the first quarter of 2015 was in stark contrast. On April 24, 2015, Baofeng Technology released the first quarter result of 2015: Operating income was 9,2408,800 yuan, up 24.24%, but the net profit attributable to ordinary shareholders of the listed company was 3,208,500 yuan, down 146.72%. The company claimed that the main reason of net profit decline was that virtual reality of business was still in the stages of large-scale investment. So it resulted in an overall loss of the company in the first quarter.

From the point of view of industry, the internet video industry has formed a new market structure since 2012. According to the latest research, more than 70% of this market is occupied by Youku Tudou,Tencent video, iQIYI PPS, Sohu video. So, Baofeng Technology belongs to the second class of this business area. In addition, the company's profit model which still takes the advertising fee as they the main source of income is too single. Considering the fierce competiton in this market, Baofeng Technology is faced with tough problems, such as how to maintain the volume of users and convert the platform edge into earnings.

All in all, in Chinese internet companies rankings, Baofeng Technology is probably only in 200 for both performance and growth. However, the performance of stock price can be described as a miracle and the market value has surpassed Youku which is the largest video website in China. Great success accomplished by such a company will lead us to a deep thinking.

1.2.3 Thinking About the Soared Stock Price

Even though the company fundamentals are not impressed and its industry status is not high enough, Baofeng Technology's stock price in the "A-share" skyrocketed in a short time. There are several reasons for it. First of all, the "A-share" is in a bull market, especially the GEM, which is more bullish. The GEM index has hit the new record again and again under pessimistic expectations. In this background, listing of new shares this year generally gains relatively large increase. Secondly, this year prime minister put forward the concept of "Internet+", which was extremely popular in the capital market.However, most of domestic internet companies were listed overseas. As a scarce internet concept stock in the "A-share" market, Baofeng Technology is easy to be a popular option. Thirdly, the number of total equity of Baofeng Technology is about 120 million, but tradable shares are only 30 million. So, stock prices are more likely to be raised.

2. THINKING OF INTERNET COMPANIES' "A-SHARE" STRATEGY

2.1 Analysis of VIE Structure

VIE structure is also called the "protocol control", because Sina pioneered the use of this mode to realize the indirect overseas listing, so it is also known as the "Sina mode". It has become financing tools of the domestic operating companies which desire to be listed overseas. On the one hand, this way can avoid domestic regulatory policies, on the other hand, it is able to conform to the international "VIE" general rules. It is different from the general equity control mode. There is no direct or indirect equity control relationship between the main body listed overseas and the operating entity. To completely control the domestic operating entity, wholly foreign owned enterprise (WOFE) which is established or controlled by offshore special purpose vehicle (SPV), generally signs a series of agreements with it (Wang, 2015). Overall, VIE structure usually consists of three main operating body, namely domestic business entities, offshore special purpose vehicle and domestic wholly foreign owned enterprise (WFOE).

The agreement involved in VIE structure usually includes strategy consulting contracts, intangible assets lease contracts, equity pledge agreements, stock options, voting agreement and operational control agreements etc.. It gets most of the profits of a domestic enterprise in the form of fees which is from providing for domestic business entity exclusive strategic support, technical support, intellectual property consulting and other advisory services and it achieves indirect control of domestic operating entity through equity pledge and preferred stock.

2.2 New Strategy of Chinese Internet Companies

According to public information, there are more than 200 Chinese companies in the US capital market, which include more than 20 internet companies with the VIE structure listed on Nasdaq, such as Sina, 163, Tencent holdings, 51job, Renren, Baidu. If these internet companies intend to achieve "A-share" strategy and to be one of listed companies, they need to go through the three stages: privatization, the removal of VIE structure and back-door listing or IPO.

As to the removal of VIE structure, its essence is that foreign investment fully withdraws from the industries with restriction from foreign investment. Generally, there are three steps: a) Shareholders of domestic operating entity or RMB investors take over the control of the equity by paying cash to make foreign capital realize profit. b) Terminate entire agreement about debt, revenue, stock dividend between WFOE and domestic operating enterprises. c) Make decision about whether it is necessary to cancel the company overseas.

About the choice between the back-door listing or to the IPO, back-door listing seems to be a better way. First of all, it will take very long time to be a listed company though IPO and possibility of failure will increase in the process of waiting. In order to accelerate the listing process, back-door listings will become the first choice. Secondly, the huge arbitrage space has been witnessed by capital market, which makes many venture capital institutions and shell resource brokers see an opportunity to make profit. Therefore, it can be expected that back-door listing about internet companies will be more frequent in the future.

2.3 The Motivation of Internet Companies' "A-share" Strategy

2.3.1 The Effect of Bull Market

Data shows that, from the beginning of 2015 to May 20, the Dow-Jones Industrial Average and the Nasdaq and the S&P 500 rose less than 10%. And the increase of French CAC40, Germany's DAX, Britain's FTSE100, which are European top three indexes , were only around 20%.

By contrast, the Shanghai composite index got 39% increase and GEM index rose as high as 144% during the same period. And at the same time, there were 862 companies shares which rose more than 100%, accounting for one third of "A-share" listed company. According to statistics, top 50 stocks which got the biggest gains belong to the internet industry. Under the background of national strategy of "Internet +", the performance of the internet companies in the Chinese capital market impressed everyone.

2.3.2 Difference of Internet Companies Valuation in the Different Capital Market

There is huge different value of the Chinese internet companies between the "A-share" and capital market overseas. By April 30, 2015, average p/e ratio of listed companies in Shanghai stock market was about 21.1 times and 57.6 times in Shenzhen stock market. And, the average p/e ratio of GEM reached as high as 104.4 times and the lowest value of internet companies listed on the GEM was 97.24 times. By contrast, the average p/e ratio of internet companies listed on the American capital market was around 40 times.

In addition, there are 14 Chinese internet companies which went public in America though IPO in 2014. And the stock price of 7 companies among them has fallen to the initial issue price. The average decline in the share price of the 14 companies has been 3.1% since 2015, while the Nasdaq index was up 6.1%. These data fully illustrate the different valuation of internet industry, especially the Chinese internet companies.

2.3.3 Chinese Concept Shares Are Unable to Adapt to the Overseas Capital Market

Statistics show that since March 2011, more than 200 Chinese concept shares have been questioned publicly by short-seller in varying degrees. Short selling has been formed a complete industrial chain in America: third-party short-seller, hedge funds, class action lawsuit institution. The common practice is to collect the evidence of Chinese concept shares and publish the adverse report. Then they usually will hire some traders to short the shares of these companies (Liu, 2012). Sadly, this combination always hurts these companies too much. According to data from 2010 to 2012, more than 30 Chinese concept shares suffered all kinds of prosecution and shorting. And some of them ended up with being delisted or bankruptcy.

Research has shown that US-listed Chinese companies enter a market which is not suitable for it. If these companies do not take any action for it is quite likely that they will be under attack by professional short-seller. Moreover, listing fees of 2 million dollars a year, lawsuits of shareholder and potential risks of being delisted will definitely increase the operating risk of enterprises (Chang, 2013). In addition, the enterprise may also fall into vicious circle: Because of the relatively low market value, it will be less attractive to institutional investors and research institutions, which lead to low trading volume and the lower market value. It is no doubt that the combination of low value and attraction to institutional investors will result in financing difficulty.

However, "A-share" market seems to be more moderate. On one hand,，there is the shorting mechanism in Chinese capital market. But for now this mechanism is not mature enough yet. Also, concept of the internet is extremely popular and very few people want to take the risk of shorting. On the other hand, even though the number of claims of listed company has been increasing in recent years，the system of class action lawsuit is not really set up. Therefore, the majority of the companies don't have to worry about the huge claims even for the disclosure of violations or financial fraud.

2.3.4 Support From National Policy

Since 2015, several policies about how to promote the eligible internet companies to "come back" to domestic capital market have been put forward. This is an important signal that surveillance of the listing rules for the internet enterprises will be loosened gradually.

CONCLUSION

This article chooses a very popular topic, which is about if it is necessary for Chinese concept shares "come back" to Chinese capital market—"A-share". And it emphatically analyzes possibility and motivation of internet companies' strategic change.

Successful demonstration effect of Baofeng Technology inspires the internet companies thinking about the strategic change. Many internet companies start to take action to implement the "A-share" strategy. As things stand, wealth effect of the bull market has been fully displayed. High valuations of internet enterprises embody the recognition of the internet and it will increase financing amount for them. Apart from this, "A-share" is a more suitable capital market for Chinese internet companies. Many cases show that most of them can not get used to the operation mechanism of the foreign capital market. At last, gradually loosening policy environment and the reasonable expectation for the registration of the issue of securities will reduce the listing requirement of internet companies.

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