REUTERS

China juices liquidity, and risk, at OTC exchange

SHANGHAI August 22 | By Pete Sweeney

Chinese brokerages will start making markets next week on China's New Third Board, its leading over-the-counter (OTC) exchange but one long derided as a dead-end market populated by small little-known, opaquely managed firms.

The move has revitalized interest and trading volumes have exploded, but analysts warn of significant risk.

Most of the 66 Chinese brokerages so far approved to make markets - a business that requires deep cash reserves and sophisticated risk management skills - have little experience.

Market makers quote both a buy and sell price and guarantee share availability by holding shares themselves in inventory, which requires careful real-time management.

For brokerages it means extra profits, while China's policymakers hope the liberalization will boost liquidity in an exchange that can provide capital for small innovative firms, needed for the next phase of economic expansion.

But, analysts fear that brokerages inexperience coupled with inadequate disclosure by listed companies could led to trouble for an exchange already saddled with image problems.

"Like all OTC markets - including... America's Bulletin Board and Pink Sheets - China's Third Board suffers from inherent fundamental flaws," said Peter Fuhrman, chief executive at China First Capital.

"Liquidity and valuations are persistently low and disclosure is spotty. If it was designed to be a solution to the problem of erratic mainstream IPO policy and approvals on China's main Shenzhen and Shanghai stock exchanges, the Third Board must be judged a major disappointment."

Regardless of critics, trading volumes on the exchange soared almost 700 percent in May when Chinese media first reported the advent of market-makers, ChinaScope Financial data shows. Foreign investors are unable to trade on the exchange.

A Reuters analysis of daily data from the National Equities Exchange and Quotations (NEEQ), which runs the New Third Board, shows that August volumes are set to surpass May's record. Transactions worth 1.16 billion yuan ($188.63 million), as of Aug. 19, were nearly double July's total, while the volume of shares traded has more than tripled month-on-month.

SMALL CAP CELEBRATION

Smaller private companies in China are the country's biggest aggregate employers and generators of GDP, but they have difficulty getting bank loans and even more difficulty getting regulatory approval to list on major markets or issue bonds.

However, while dozens of local governments have created OTC markets to help match companies with investors, the lack of market makers and lack of a clear upgrade path to major exchanges has caused most firms and investors to steer clear.

But that may be about to change.

"The expectation is that the Third Board can be an entree onto the growth enterprise board for select small companies," said Brian Ingram, chief investment manager at Russell Ping An Investment Management.

"If the board does serve that purpose, it's likely to see pretty rapid growth, and the catalyst for that growth is the fact that regulators are allowing brokerage houses to serve as market makers."

Brokerages hope it will boost in profits, something they need badly having struggled since 2010 as investors steadily switched out of Chinese stocks, among the world's worst performers, in favor of housing and high-yielding wealth management products.

SMALL-CAP FEEDING FRENZY

Chinese investors enthusiastically trade small, volatile tickers listed on Shenzhen's ChiNext growth board, so some predict a revitalized OTC board will attract similar speculative interest, further supporting liquidity.

However, sustained interest from both investors and companies depends on whether regulators formally commit to allowing companies on the New Third Board upgrade to ChiNext.

"We're now considering listing on the New Third Board, but we are waiting for policy confirmation that we can upgrade to ChiNext," said Cui Lijun, deputy general manager at robotics firm LEN in Shenzhen.

Similar experiments have disappointed in the past, such as the hard-currency-denominated "B-share" board. Speculators bought B-shares hoping they would ultimately be upgraded to yuan-denominated A-shares, but in the end only a few companies were allowed to transfer, leaving the rest stranded.

CALLS FOR CAUTION

The chequered history of OTC markets in China and abroad, especially with regards to disclosure standards, also has many calling for caution.

In the late 2000s, small Chinese companies began listing on American OTC boards, and some managed to upgrade to major exchanges such as NASDAQ. But many were subsequently found to be riddled with accounting irregularities, causing a swathe of delistings.

Given this history, it is unclear whether regulators want to expand the aggregate OTC market or consolidate it.

Out of all of China's 26 OTC markets, the New Third Board is the only one that companies from anywhere in China can list on, and it will now be the only one where making markets will be allowed.

Some analysts said that this means the government may be elevating the Third Board, so it can then kill off the rest.

But Zhang Yunfeng, the head of Shanghai's rival OTC market, said in an interview published in China's Securities Times on Wednesday that he doesn't feel threatened.

"I'm not optimistic about the market making institution ... if there's not enough base liquidity, market making will have a hard time enabling market performance."

http://www.reuters.com/article/us-china-markets-otc-idUSKBN0GL26920140821