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"Our view"

KPMG China, Deal Advisory

The New 3rd Board: a boon to the Chinese OTC market

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OTC (over-the-counter) market players in China seemed to have had a new lease of life in the country in recent years with the advent of the 'New 3rd Board', which – despite the widely reported recent volatility in stocks – has grown in leaps and bounds over the past few years.

The New 3rd Board, launched in 2009, serves as a national share transfer system for small and mid-size businesses to transfer shares and raise funds, marking a considerable expansion of China's OTC market. The board complements the main boards (SHSE & SZSE), the SME board and the ChiNext board, and is seen as an easier financing channel with low costs, simple listing procedures and a short application period for start-ups not qualified for listing on major exchanges.

Over the past year, the New 3rd Board has been increasingly acting as a potential target pool amid the growing number of strategic acquisitions in the market, especially when other private companies are considered less transparent. With an ever-greater array of sectors and industries being a part of offerings listed on the board, options open to investors – particularly A-share-listed enterprises – seem to be ripening in terms of potential M&A, regardless of motive whether product expansion or strategic transformation.

In 2014, 15 companies in total de-listed from the New 3rd Board as they were taken private; 11 of these were involved in M&A[1]. For example, in October 2014, Zhuhai Orbita Control Engineering Co., Ltd. (SZSE:300053) – a high-tech R&D, design and manufacturer enterprise – announced acquisition of a 100% stake in the New 3rd Board-listed GuangDong Poya Information and Technology Co., Ltd. (NTB:430708) – a provider of security and protection solutions and systems – via cash and new share issuance. The rationale behind the deal was to enrich Orbita's current products and services and to realize potential synergies[2].

However, New 3rd Board listed players have gradually been attaining their own financial power – a process incumbent both on the degree of liquidity in the market and on the sentiment of 'market makers', who are increasingly registering as traders on the New 3rd Board. With the increasing financial independence, a large number of listed companies have started considering proactive extensional M&A rather than waiting to be acquired.

New share issuance plus cash – a strategy typically followed by A-share listed companies – has also started working for the New 3rd Board companies. For instance, Dodoca Inc. (NTB:430177), a New 3rd Board-listed mobile social marketing software company, announced this February an agreement with Weiba Info Technology, which provides web-based enterprise marketing services in China and for Tencent's WeChat mobile messaging app. Dodoca spent CNY80 million (via new share issuance and cash) to acquire a 100% stake in Weiba, a deal that would help Dodoca improve its market competitiveness.[3]

The board's value in May 2015 had reached CNY1.7 trillion[4] (CNY988 billion as at Aug. 30)[5] from CNY800 million 2 years ago[6], while average P/E ratio grew to 60.9x in May[7] (34.8x as at Aug. 28)[8] – seductive levels for SMEs contemplating a listing. However, we've recently seen some inbound investors to China finding that target companies are using the New 3rd Board in negotiation tactics, using the board's multiples as a valuation benchmark. In some cases, these companies have been found running parallel processes (trade sale and listing), which can typically drag the deal out or trigger added hurdles.

Nonetheless, in our view, given the limited liquidity and low trading volumes, multiples on the New 3rd Board are most likely not representative or sustain-able. While mutual benefits in terms of synergies are certainly possible, we are advising clients (inbound to China) to emphasize the above and other potential limitations of this board – such as lock-up periods restricting cash outs – in their deal negotiations when persuading owners that joining an MNC might be a better option in the long term.

1.Fifteen Companies delisted on the New Third Board in 2014, (Jan.16.2015), *Qianzhan. com;* 2. Orbita Acquires Poya with Obvious Synergies, (Oct.24.2014), *Fz.ce.cn*; 3. Dodoca Announced Acquirements of Weiba, (Feb.03.2015), *Kuaixun.stcn.com*; 4.New Third Board has crossed the CNY1.7 trillion line, (May.21.2015), *Securities Daily*; 5. Xin San Ban Weekly News, (Sep.1.2015), Cnfol.com; 6. New Third Board to face tighter scrutiny, (May.9.2015), *China Daily*. 7. New Third Board's average PE ratio reached 60.9x, (May.27.2015), *China Venture*. 8. CSC Group Raised Fund, (Aug.31.2015), 0033.com;

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