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Share Pledging in China: Funding Listed Firms or Funding Entrepreneurship?

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Webinar Series – Capital Market Development, China & Asia

Dec. 19, 2024

Background: **Financing** via Stock Pledging

- **Main 'participants' of this type of financing activity:**
  - Stock of listed firm: as collateral; firm characteristics/governance
  - The investor/shareholder: where to invest the capital raised from credit resulting from stock pledging? Personal business/listed firm/other firms
  - The 'beneficiary' of the investment capital: listed firm/new startup or other existing firm(s);
  - Credit extension institution: bank, investment bank, trust firm, etc.

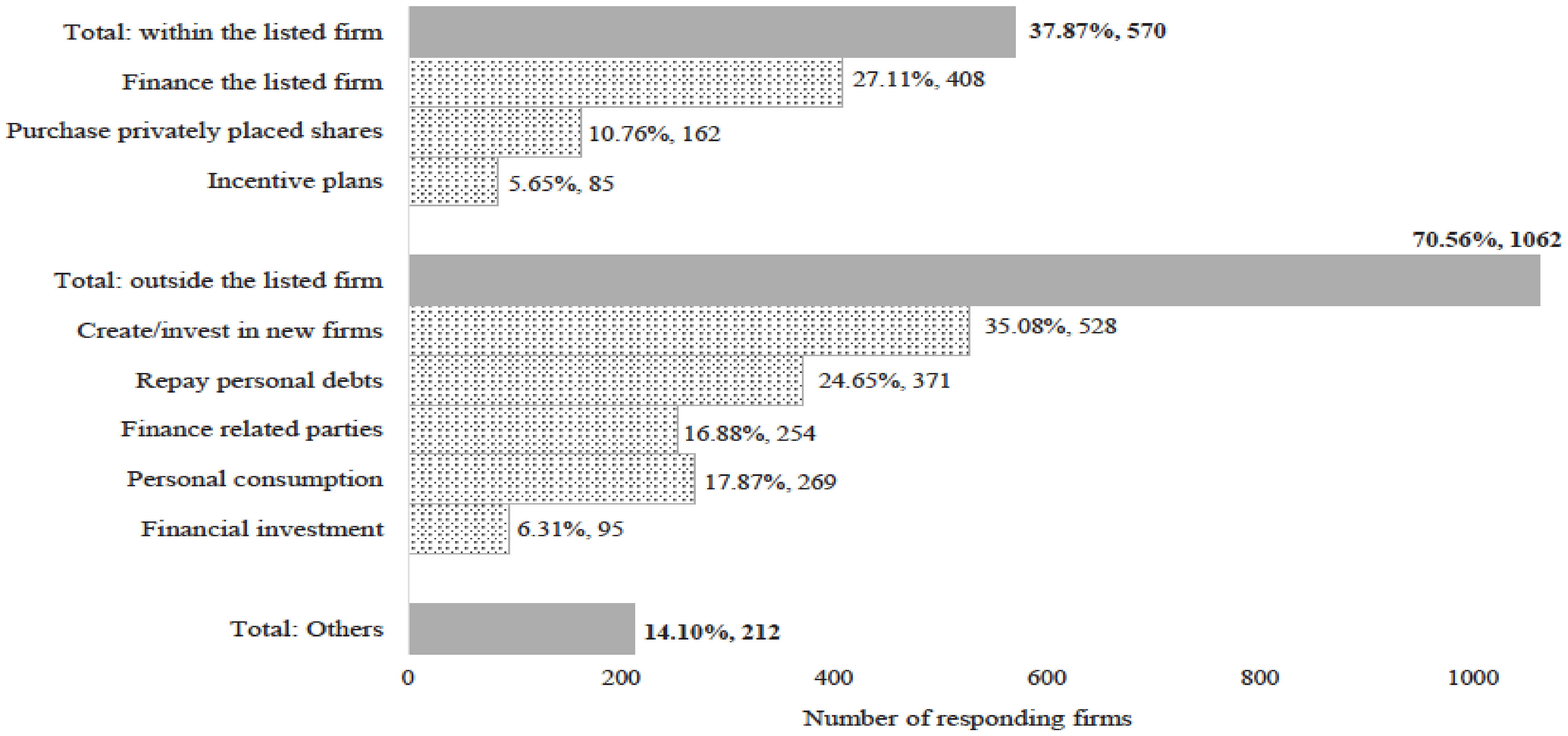
- **What is special about China?**
  - Corporate governance of listed firms: controlling shareholder and related party transactions (RPTs)
  - Funding of entrepreneurial activities: equity capital from SOEs/private sector
  - Debt vs. equity financing: role of banks and bank loans (favoring SOEs)

This Paper

- **Matched data of stockholders' info (investment portfolio) and (new) firms' information at registration (SAIC):**
  - Cleaning up share pledging and fund usage data
  - Time period: **2009 to 2018**; 3 types of shareholders (holding of 5% or more): **individuals** (1500), state owners (903), non-state owners (2107);
  - Key results (Tables 3-6): 1) stock pledging (higher pledging ratio) associated with greater likelihood of investing in new firms (startups), relative to SOE shareholders; 2) attractive targets: startups from "high growth" and "other" (??) industries

- **More tests and results on a robust relationship between the two:**
  - 2013 reform: allowing security firm to enter the pledging market =》 positive effect on individual investors the largest (Table 7)
  - 'Margin call' risk (Table 8); a number of robustness checks.

Comment 1: Large Shareholder's Use of Funds
(survey evidence, Figure A2)



Comment #1 (cont'd): Determinants of Shareholders' Fund Allocation

❑ Large shareholders' investment choices:

- **Table 3**: data from firm disclosure on large (5% or larger) shareholders' use of funds (raised through share pledged loans)
- Better use of survey evidence (of largest shareholder): if info. on (matched firms) is available, can run regressions to better understand *all* possible choices of 'investment portfolios": 1) listed firms and/or other firms; 2) **other personal activities**

❑ A better articulated hypothesis on the goals of fund allocation?

- Optimal investment portfolio that gives the best risk-return combo., with constraints (cost/risk of loans, preferences of the investor)?
- Shareholder characteristics: SOE vs. private firms and individuals; **past investment experience** may be key in explaining new investment (startups)

Comment #2: Funding Startups, What's New?

- **Traditional types of equity financing: VCs, CVC**
  - Overcome information asymmetry, align incentives between investor and entrepreneur and team
  - The role of the state and state capital: rise in importance in recent years
- **Funding by stock pledged loans as a 'hybrid' financing form:**
  - Raising capital thru. collateralized lending => funding cost and other constraints (credit limit); risks from the stock market can "spill over" to the investee firm
  - Examine the **ownership structure** of the investees: who are the **co-investors**?
  - Compare **startups invested by (individual) shareholders** (with capital raised from stock pledged loans) vs. **firms invested by other types of investors** (e.g., an SOE): industry and firm/founder attributes; growth as measured in paid-in capital…

Comment #3: Relationship with the Listed Firm?

- **Hypothesis: the growth of the startup also depends on governance of listed firm (and the role of the large shareholder)**
  - Given the shareholder's past investment experience, the startup can do better if there is 'synergy' with the listed firm (through the shareholder/investor)
  - Can look at RPTs of listed firms, and **rule out 'tunneling' hypothesis** of shareholders' investment into startups

Comment #4: Identification

- **2013 reform: shock on the supply of funds/credit**
  - Large shareholder's investment in new firms probably reflects '**endogenous matching**' between the pair;
  - Need exogenous changes to the investor/firm, or IVs
  - Other shocks to consider: a) conditions in stock market changed in 2018; b) changes in rules of firm registration: "paid-in capital" to "subscription/committed capital" (since 2014)

Summary

- **Interesting data, and a number of interesting results**
- **A more coherent story, with a few more hypotheses:**
  - Centering around largest shareholder's investment in supporting (new) entrepreneurial activities
  - What is unique about this financing and ownership structure?
  - Rule out 'tunneling' hypothesis
- **Need additional identification to pin down:**
  - Endogenous matching between shareholder/investor and startups