SME Financial Services in China:

Institutional Framework and Emerging Opportunities

SMEs are the backbone of China's economy but are under-served

In China, SMEs accounted for 60% of GDP and 80% of employment but they accounted for less than 40% of total bank loans. Aside from banks, SMEs have few other sources of finance. Risk management is commercial banks' primary concern, such that loan approval usually takes at least 1 month which certainly cannot fulfill the timely funding requirement of SMEs. Further, most types of loan products such as cashflow lending and unsecured lending are still in premature stage. SME's difficulties are especially great during periods of liquidity tightening when bank head offices allocate lending quotas to the politically powerful state-owned enterprise sector in preference to SMEs.

Rapid growth in the non-bank financing sector creates opportunities

We estimated that the CAGR for new loan from non-bank channels grew at 32.8% during 2008-2012, far exceeding new RMB bank loan growth of 13.7%. This is due to the government's promuglation of new regulations on non-bank financing institutions. As a result, the sector grew rapidly, for example, small loan companies experienced 98% and 51% growth in loan during 2011 and 2012, and finance leasing companies recorded 40% growth in receivabes during 2011. We believe that the industry is in its infancy and will grow substantially, but the industry is still quite fragmented with yet non-existence of national players.

The SME financing sector has begun to receive policy support

Over the past 10 years, the central government has rolled out numerous policy document encouraging SME lending and clarifying the legal status of non-bank financing institutions. SME financing issues are also high on policy makers' agenda. Local governments are also taking initiatives in nuturing SMEs, such as providng guarantee to SME loans extended by banks and non-bank financing institutions. Also, some provinces have also relaxed certain restrictions on non-bank financing institutions which are originally required under the central government's regulations. Further, policies are getting friendlier to foreign institutions (by allowing 100% foreign ownership) and indeed the government has realized that overseas experience is needed to push the industry forward.

Significant opportunity as well as risks

Considering their ability to meet SME demand and likely policy changes, we forecast that the small loan industry will grow the fastest among those subsectors, followed by financial leasing, pawn loan, and loan guaranty. We expect industry growth rates to range from 17-30% CAGR from 2012-16, significantly higher than the expected growth of 10.5% for commercial bank loan.

There are great opportunities in this sector which only started in recent years. Industry players need to understand fully the financing demand of SME, develop diversified financing source, and build a robust risk management and bad debt disposal systems. However, there are also risks in this sector, such as regulation changes which may impact those players operating on grey areas. Risk of bad debts could be a concern as SMEs are regarded as pro-cyclical, though we will show that it is controllable and bad debts as a whole is improving.

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Executive Summary

This report provides an overview of China's SMEs, the institutional framework of their financing channels, the underlying trends of those financing channels and the significant opportunities in the SME centric non-bank financing sector.

SMEs have been the key driver and contributor of China's economic growth, employment, and innovation in the past decades. However, the financing bottleneck for SMEs was manifested under the government's tightening measures since 2010. Thus, both the central and local governments have been rolling out numerous measures to facilitate the financing channels of SMEs. These have created the non-bank financing sector for SMEs, which is new in China. In the context of China's financial sector reform and development, non-bank finance a current high priority sector and will likely see continued growth, reform and innovation over the next five years.

This sector is new and growing quickly due to: 1) rapid development of SMEs and their immense financing needs; 2) structural bureaucracy and conservatism of commercial banks in satisfying SMEs; 3) central and local government support; 4) fragmented industry and absence of national players. We think the industry will experience significant growth and changes in the next 5 years.

We forecast that the non-bank channels for SMEs (small loan, pawn and finance leasing) will take up 5.5% of total social finance in 2016, up from the estimated level of 3.2%in 2012. Small loan, finance leasing, pawn, loan guarantee, and entrusted loan will grow at 29.7%, 28.5%, 21.7% and 13.0% CAGR from 2012-16, generally higher than total and SME bank loan growth of 10.5% and 17.5% respectively during the period.

The significant growth of the industry will reward players which have developed good sources of financing, diligent risk management and network of bad assets disposal. All these require deep understanding of SME needs, institutional platforms, local situations, and policy trends.

Macro trend: SMEs in China and the Financing Gap

This section provides an overview of SMEs, their financing channels and their macro development trends.

SMEs (broadly defined as those with annual sales below RMB300mn or employees below 300), accounted for 60% of China's GDP, and they will become increasingly important over time as a driver to a domestic-lead economy. However, China's bank-centric financial system has structural limits incompatible with SMEs' demand for flexible finance leading to a huge SME financing gap.

The government has been supportive to SMEs in various fronts which we think will lead to a secular industry growth in the next decade. Since non-bank financing channel has an irreplaceable role over SMEs' lifecycle, we believe this will enjoy a stellar growth as well.

Definition of SMEs in China

To better design policies that can address SME needs, the Ministry of Industry and Information Technology (MIIT) published definitions on SMEs which are followed by other policy institutes including the People's Bank of China (PBOC). In 2011, when the financing problem of SMEs was the most acute, MIIT redesigned the definition of SMEs in preparation for new SME policies. In general, the threshold for SMEs was lowered in spite of China's huge economic achievement during 2003-2011. Furthermore, a new category, "micro enterprise", was defined, signaling the government's intention to support this grass-roots segment of the economy.

Exhibit 1.: Definition of SMEs by MIIT (for major industries), China

Industry	Entreprise		2003	2011
Industrials	Mid	Employees	300-2000	300-1000
		Annual sales	RMB30mn-300mn	RMB20mn-400mn
		Total assets	RMB40mn-400mn	n/a
	Small	Employees	<300	20-300
		Annual sales	<RMB30mn	RMB3mn-20mn
		Total assets	<RMB40mn	n/a
	Micro	Employees	n/a	<20
		Annual sales	n/a	<RMB3mn
		Total assets	n/a	n/a
Retail	Mid	Employees	100-500	50-300
		Annual sales	RMB10mn-150mn	RMB5mn-200mn
	Small	Employees	<100	10-50
		Annual sales	<RMB10mn	RMB1mn-50mn
	Micro	Employees	n/a	<10
		Annual sales	n/a	<RMB1mn
IT	Mid	Employees	100-30	100-300
		Annual sales	RMB30mn-300mn	RMB10mn-100mn
	Small	Employees	<100	10-100
		Annual sales	<RMB30mn	RMB0.5mn-10mn
	Micro	Employees	n/a	<10
		Annual sales	n/a	<RMB0.5mn

Source: MIIT, CIRL

Definition of SMEs varies from industry to industry. But **in general, China defines SMEs as enterprises with annual sales below RMB300mn or employees below 300.** The cutoff level is slightly higher than the standard generally used for international comparison, which defines SMEs are any firms with employees below 250. The EU, for example, is closer to such general standard:

Exhibit 2.: Definition of SMEs by the European Union

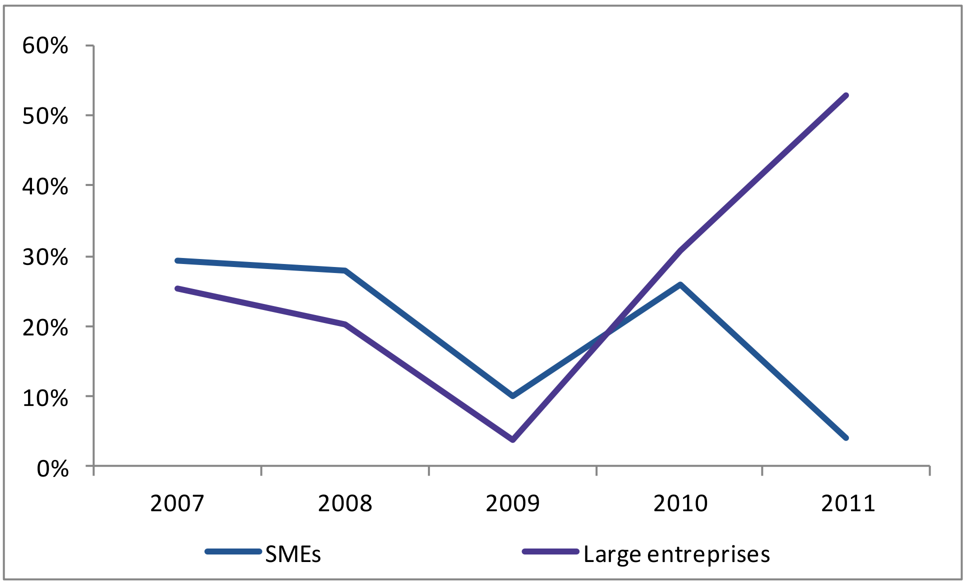
Entreprise	Employees	Sales	or	Total assets
Medium-sized	< 250	≤ € 50 m		≤ € 43 m
Small	< 50	≤ € 10 m		≤ € 10 m
Micro	< 10	≤ € 2 m		≤ € 2 m

Source:TheEU Commission, CIRL

SMEs are backbone of the economy but under-funded

SMEs are the backbone of China's economic growth. In terms of industrial output, SMEs outgrew large enterprises in 2006-2009. They were the key drivers of China's economy until 2010 when the economy was substantially distorted by the RMB4 trillion stimulus package which exhausted social resources on infrastructure and real estate projects diverting funds away from SMEs. SMEs were further suffocated in 2011 when liquidity was tightened. Faced with limited capacity, banks favored loans to SOEs and large corporate instead of loans to SMEs (as the authority to approval loan was returned to banks' headquarters).

Exhibit 3.:Growth of industrial value added



Source: WIND, CIRL

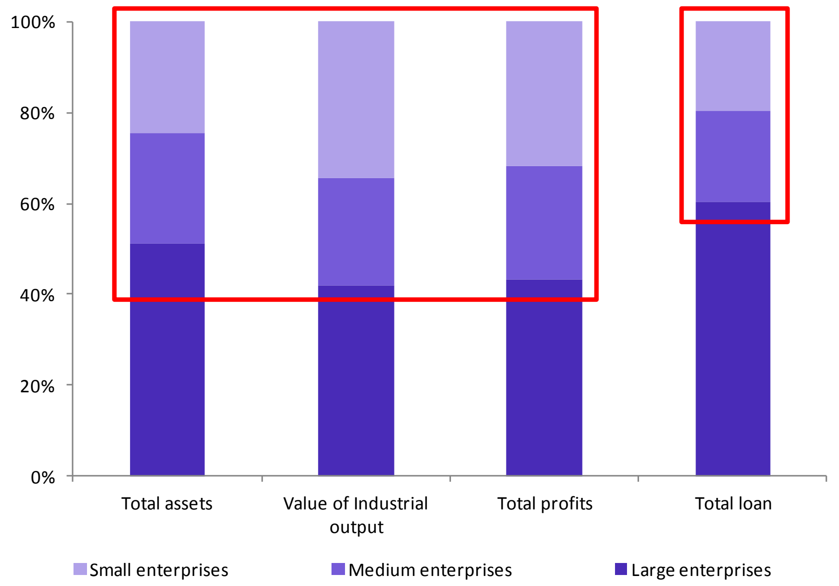
They generate about 60% of the country's GDP, 50% of overall tax and create near80% of employment.

Furthermore, SMEs have become a major force in pushing forward China's science and technology innovation. According to the Ministery of Industry and Information

Technology (MIIT), SMEs account for 65% of the country's all invention patents, 75% of corporate innovations and 80% of new product developments. In Beijing, for example, SMEs contributed 57% of business revenue in 2008 but spent 71% of the total R&D expenses in the city.

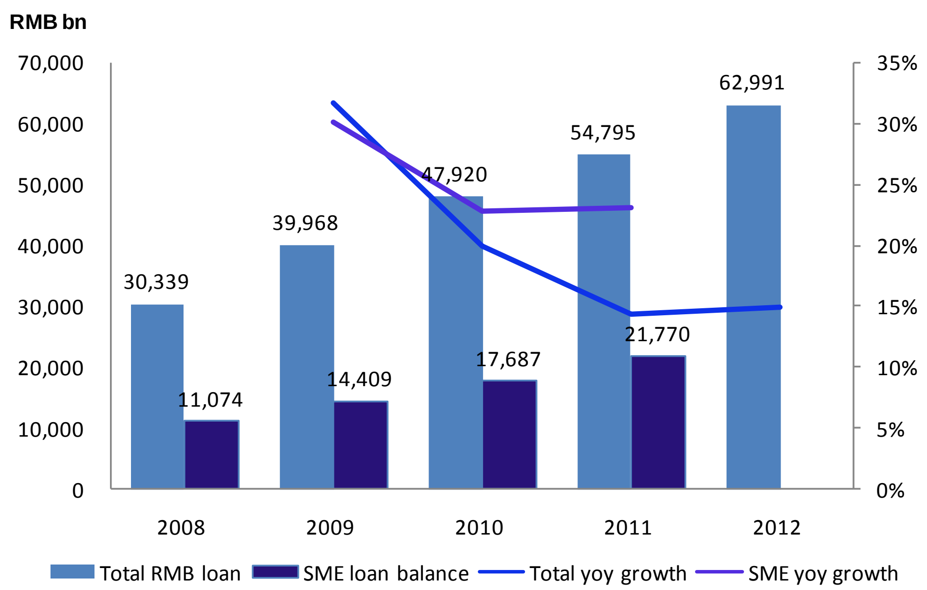
Despite the important role of SMEs, they receive only 39% of China's total commercial bank loans.

Exhibit 4.: SMEs contribution to China's economy and total loan SMEs obtained (2011)



Source: WIND, CIRL

Exhibit 5.: Total RMB loan vs. SME loan



Source: PBOC, CIRL

SMEs lead domestic transformation of economy

China's government officials intend to change the economy from export-led to domestic-led, in search for a balanced growth across regions and working classes. Boosting domestic consumptions is a way-out for China's overflowed saving which led to assets bubble. Indeed, consumption became the chief driving force of economic growth since the turn of 2012 when investment and exports slowed.

SMEs are the core players in the consumption and services, of which companies are generally in smaller size. In MIIT's definition of SMEs in the retail industry, for example, refer to companies employ less than 300 people, much smaller than manufacturing which defines SMEs as having staff size less than 1000.The retail industry is the driving force behind the vigilant consumption expenditure, which consistently grew by over 14% in past 10 years. The importance of boosting domestic demand is reiterated in the latest policy address by Wen Jiabao during the Conference of People's Congress. Thus, SMEs will continue to experience a secular growth amid China's economic transformation, in our view.

Lifecycle and finance requirements of SMEs

SMEs of same stage of development do share common problems and financing needs. In general, enterprises of Startups and Growth stage are SMEs (including micro enterprises) with annual sales below RMB300mn, in China context. However, those SMEs are barred from some major forms of financing such as public stock issuance and bond finance.

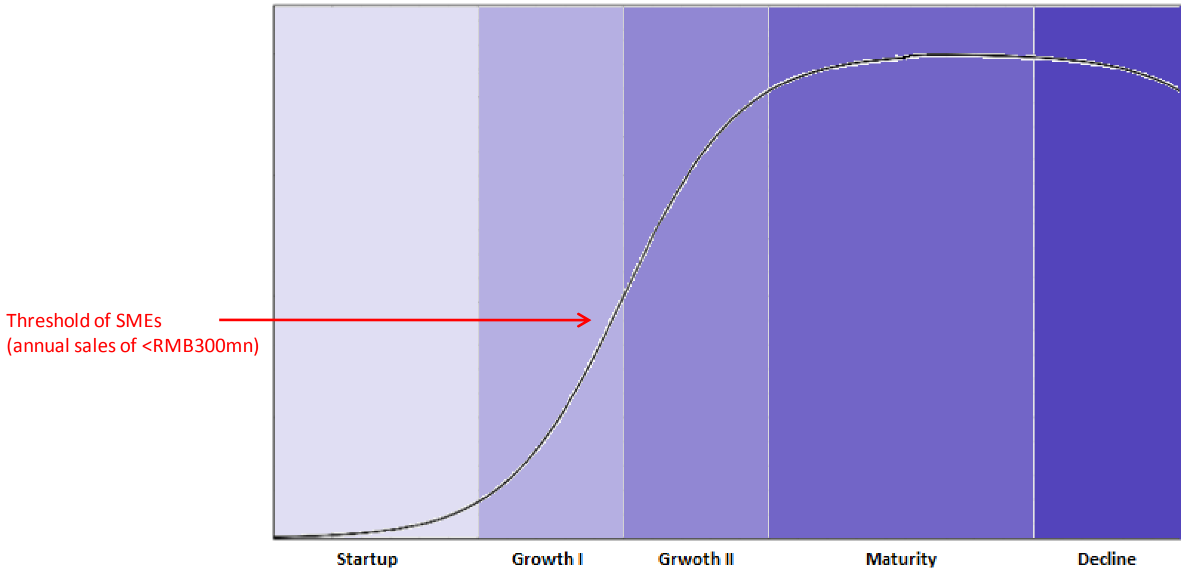
1. **Startups** are usually micro enterprises which face problems such as stability of customer base, undercapitalization, insufficient number of staff etc. Since owners' resources are the major source of fund, the types of finance they need is probably personal loan.

2. In the stage of **"Growth I"**, the enterprise has developed a sound customer base and business model, thus they need further financings to fuel the business growth which are mainly short term finance including trade credit and revolving bank loan for working capital needs. Lacking in fixed assets they may also need modern forms of financing including cash flow finance and finance leasing

3. **"Growth II"** stage represents a period of rapid expansion with significant capital expenditure. This is usually after a company obtained stable customer base on a sustainable business model with attractive growth opportunities. Usually, enterprises in this stage are ready to raise fund from external investors (or even getting listed).

4. In **“Maturity”** and **“Decline”** stage, most financing needs are of operational needs instead of that for long term capital investment, since long term growth is limited by this stage.

Exhibit 6.:Lifecycle of China SMEs



Stage	Startup	Growth I	Growth II	Maturity	Decline
Problems	Undercapitalization	Liquidity	Financing gap of LT investment	Lack of new investment projects	
	Insufficient staff	Lack of credit record		Maintaining return of investment	
	Lack of credit record				
Source of fund neede	Owners' resources	Owners' resources	Owners' resources		
	Personal loan from non-bank institutions	Retained profits	Retained profits	Retained profits	
		Trade credit	Trade credit	Trade credit	
		Bank loans of personal guarantee	Unsecured loans and overdrafts	Unsecured loans and overdrafts	
	New forms of finance not widely provided to Chinese SMEs	Hire purchase and leasing	Hire purchase and leasing	Hire purchase and leasing	
		Private equity investment	Private equity fund	Private equity fund	
		Cashflow finance	Cashflow finance	Cashflow finance	
		Mezzanine Finance	Mezzanine Finance	Mezzanine Finance	
		Personal loan from non-bank institutions	Long term corporate loan	Long term corporate loan	
			Public equity issuance	Public equity issuance	
			Bond issuance	Bond issuance	

Source: PBOC, CIRL

The majority of SMEs are at “Startup” or “Growth I” stages, so they are not eligible for public listing or bond issuance. Most commercial banks in China only provide collateral-based lending (i.e. against real estate or land). The weak asset base of SMEs and their flexibility nature made them in thirst for modern ways of finance such as cashflow finance and leasing, which are not widely available in China.

SME’s finance not catered by banks

SMEs financing needs are “small, urgent and frequent”, because of their rapid growth and relatively weak liquidity management. They depend for survival and growth on timely, although usually small, cash injections.

Exhibit 7.:SMEs’ financing needs not satisfied by commercial banks		
Financing needs	**Situation**	**Banks' limitation in satisfying such needs**
Working capital	Production expenses for a confirmed order	Loan approval process is complicated and lengthy
Bridging loan	Extension of a certain loan	Banks require repayment in full before approving a new loan
Deposits for tender	To show capable for taking up a project	Banks require business plan and operation rights before grantinga loan
Tax expenses	Tax can’t be made due to cash flow problems	Tax payment seldom an allowable loan purpose by China banks

Source:CIRL

Limitations on banks as SME lenders

Commercial banks are closely monitored by the CBRC and PBOC because they accept public deposits. To limit risks for savers, they are required to apply strict risk management principles and rigorous loan approval processes. As a result, lenders and borrowers have to go through tedious and time-consuming procedures. Subject to quarterly loan quotas by the CBRC and with closely monitored non-performing loan and other operating ratios (e.g. loan-to-deposit ratio, capital adequacy rato and etc), they are unable to provide flexible financing solutions needed by SMEs.

Barriers of bank financing for SMEs include:

1. **Evaluation of business nature, loan usage, registered capital and credit history -** companies without credit history find it hard to obtain the first batch of credit as banks tend to favour SOEs or local government-backed companies. For SMEs, it is almost impossible to obtain unsecured finance from commercial banks;

2. **Lengthy and complicated credit approval –** banks’ loan approval can take more than one month versus one to seven days for pawn loan companies and small loan companies. Given their smaller capital base, SMEs usually need urgent short-term funds. Non-bank financing institutions focus on the quality of collateral, which is a more objective criteria than business profitability. Non-bank financing institutions are also less concernon repayment sources, which further shortens the evaluation time;

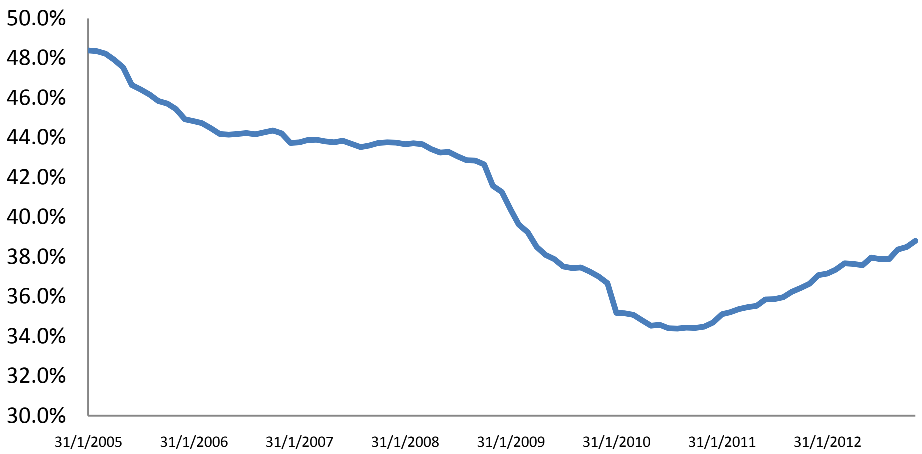
3. **Prudent and rigid policies –** regulators make it difficult for banks to offer flexible products, such as unsecured lending and short-term bridge loans. For SME loans, commercial banks accepts only real estate collaterals, and they almost do not provide loans based on business cashflow or inventories. Therefore, SMEs without real estate collateral can hardly obtain working capital loan. Furthermore, banks provide limited personal unsecured loans; if any, it is usually in the form of credit card loans, which are small and difficult to be obtained by self-employed small business owners who do not have stable income proof;

4. **Government policy preferences dictate loan allocation** – companies in industries not currently favoured by the government (e.g. property development and energy-intensive manufacturing) find it very difficult to obtain credit. Also, banks are penalized for failing to comply with new loan quotas assigned by the CBRC;

5. **No automatic loan renewal mechanism -** typically, debtors have to repay the loan and re-apply once the loan expires ("先還後貸"). This creates strong demand for bridging loans, which resembles timely approval and flexible repayment terms;

6. **Reluctance to provide short-term financing -** due to complicated loan approval procedures, banks tend to shy away from short-term loans. The proportion of such loans extended to private enterprises has been steadily declining especially during economic downturn.

Exhibit 8.:Proportion of short-term loan to commercial banks' total RMB loan



Source: PBOC, CIRL

Exhibit 9.: Commercial banks vs. non-bank financing institutions

	Non-bank financing institutions	Banks
Regulator	MOFCOM, local Bureau of Financial Work	CBRC
Loan type	Pawn loan, small loan, entrusted loan, financial leasing	Retail loan, corporate loan
Objectives	Prevent loan losses Smooth foreclosure Efficient approval process	Prevent delinquency Capital management (against risk) NIM management (against funding cost)
Risk management	Collateral protection	Client's borrowing/banking record Understanding of funding use Evaluation of business Collateral protection
Policy factors affecting loan business	Nil	Government policies (industries prefered by the state) Monetary policy (loan quota imposed by CBRC)
Preferred clients	SMEs with solid assets	SOEs
Usual time required for loan approval	2-7 days except financial leasing	1 month or more
Duration of loan	Below 6 months except financial leasing	1 year or longer

Source: CIRL

RMB10 trillion Financing Gap: Huge funding demand not satisfied

It was surveyed that in various major cities, SMEs on average could only obtain 10%-25% of the total loan they need. Some local governments have published their conservative estimates for “Financing Gap” of SMEs in their respective regions, i.e. loan demand not satisfied by commercial banks. For example, Guangdong, Shandong and Sichuan reported SME Financing Gap of at least RMB1 trillion, RMB400 bn and RMB200 bn respectively.

With refernce to various Financing Gap estimates reported by local governments and academic institutes, as well as the total asset base and borrowing ability of SMEs, we estimate that China’s total Financing Gap of SMEs amounted to RMB10 trillion in 2011. This is significant compared to the commercial bank’s new loan to SMEs of RMB4 trillion during 2011.

Government policy: Past and the future

This sector provides an overview of the government's policies for the SME sector. The increasing government encouragement, as well as the SME sector's rapid development underpin the rapid emergence of the non-bank financing sector. In our view, industry regulations are evolving, which will provide more opportunities to some players (e.g. large players, foreign investors, and those with modern and systemic management) and less to others (e.g. those operate on grey area practices).

History of SME oriented policies

The non-bank financing industry is relatively new in China. Before the financial crisis in 2008-09, there were only two predominant channels for SMEs to obtain external finance: Middle sized or small banks, and underground lending. There were a large number of guarantee companies at that time but they were highly unregulated and allegedly participated in illegal business such as accepting deposits and providing direct-lending. The problem of SME financing was addressed by policies during 2008-09 and further emphasized when SMEs liquidity was further squeezed amid liquidity tightening during 2010-11. Regulations on varies types of non-bank financing institutions were promulgated and implemented in during the past few years.

Exhibit 10.:Promulgation of SME supportive policies

Year	Law / Regulation	Highlights
Jun 2002	Law of the PRC on Promotion of SMEs 中小企業促進法	"to encourage the development of SMEs as backbone of economic growth" "to establish supportive funds to spur SMEs growth" "to encourage the loan guarantee services for SMEs"
Feb 2005	The Pawning Measures 典當管理辦法	Allowing pawn loans to be backed by real-estate collaterals, such that pawn loan providers are able to provide block funding to SMEs
Jan 2007	Measures for the Administration of Lease Financing Companies 金融租賃公司管理辦法	Lowered registered capital required for the finance leasing license Pave way for SMEs' equipment finance
May 2008	Guiding Opinions on the Pilot Operation of Small-lending Companies 小額貸款公司試點指導意見	Formalizing institution framework for unsecured finance "To encourage rural and micro entreprises lending"
Mar 2010	Interim Measures for the Admin. Of Financial Guarantee Companies 融資性擔保公司管理暫行辦法	To legitimize loan guarantee business for the supporting of SME finance
May 2010	Opinion on the encouragement of private investment 國務院關於鼓勵和引導民間投資健康發展的若干意見	"to reinforce the support for the financing of private investment" "to improve the loan guarantee service system for SMEs"
May 2011	Notice of CBRC on Supporting Commercial Banks in Further Improving Financial Services for Small- and Micro-sized enterprises 中國銀監會關於支持商業銀行進一步改進小企業金融服務的通知	Allow to exclude small enterprise loan with an amount <Rmb 5 mn when calculating the 75% cap of loan-to-deposit ratio
Oct 2011	Supplementary Notice of CBRC on Supporting Commercial Banks in Further Improving Financial Services for Small- and Micro-sized Enterprises 中國銀監會關於支持商業銀行進一步改進小型微型企業金融服務的補充通知	Target to keep small and micro-enterprise loan growth above overall loan growth and the increase in small and micro-enterprise loan amount higher than

Source: MOFCOM, CBRC, PBOC, CIRL

Policies vary geographically but some by local governments are relaxing

Although regulations of non-bank financing institution are promulgated by agencies of the central government (i.e. CBRC, MOFCOM), the authorities who take up the overall surveillance are the Financial Affairs Office under local government and local subsidiaries MOFCOM. Regulations of each city are slightly different. For example, according to the national regulation, the maximum loan allowed to single borrower for small loan companies is 5% of the registered capital, but the relevant ratio is 3% under Beijing's local regulation announced in Jan-2009.

On the other hand, some regions have been relaxing regulations on non-bank financing institutions, for small loan companies in particular. The national regulation promulgated in 2008 stated that small loan companies may obtain loan for not more than 50% of their registered capital. We have seen a relaxation by some provinces so far: For example, the local government of Zhejiang announced that all small loan companies may raise borrowing up to 100% of registered capital; Hoinai announced in Aug-2012 that small loan companies (subject to a good rating) may at maximum obtain loan equal to 200% of their registered capital.

Government policies – the road ahead

After establishing regulations on each segment of the non-bank financing industry, we believe the government will continuously fine-tune those regulations and roll out focused policies. Apart from supporting SMEs, the government also intends to bring underground finance back under surveillance by formalizing alternative finance institutions such as small loan companies and pawn loan companies, in our view. The evolution of government policies should reflect this intention. Also, we will likely see more initiatives to help the financing of those institutions.

Below sets out some initiatives that the government is working / will likely start working on:

1. **Higher leverage for certain non-bank financing institutions.** So far, there are only a few provinces which allow small loan companies to obtain borrowing fund more than 50% of registered capital. Currently the ratio for small loan companies is even lower than for pawn loan companies. Also the government may take more active role in encouraging commercial banks to provide additional fund to non-bank financing institutions (whether equity or direct lending), such that their corporate governance and risk management can be further improved.

2. **Relaxing restrictions on shareholding.** For small loan companies, the regulation announced in 2008 stated that single individual or corporate shareholders of small loan companies should not hold stake more than 10%. This has led to a lot of proxy holdings intended to circumvent the shareholding regulation. Since 2010, some local governments have raised this percentage, such as Shangdong, Chongqing and Shanghai (to 25-30%).

3. **Relaxing restrictions on interest rate:** Current maximum interest rate allowed is 4 times the PBOC rate (i.e. currently 6% x 4 = 24%). Due to the strong demand, the active interest rate is usually higher than that, after taking into account "administrative fee" charged which is effectively part of the interest. We believe a reasonable relaxation of this would bring more transparent and flexible pricing to segregate good and bad borrowers. Note that the maximum interest rate allowed for money-lenders in Hong Kong (equivalent to small loan companies in China) is 60%, and for pawnbrokers is ~42% per annum, which are far higher than that in mainland China.

4. **Breeding national leaders.** Many non-bank financing institutions are operating in local scale. Even a few of them manage to expand outside the city / province, each location runs on its own capital and management with little synergy on risk diversification and liquidity management. We believe the government would take initiatives to address the future emergence of cross-province non-bank financing institutions. For example, the government may allow pooling of capital base of all branches under the group company, in order to enhance their capital efficiency.

5. **Opening to foreign institutions.** Currently, the segment of small loan companies has the most foreign-participation. Pawn loan companies, if owned by foreign institutions, are mostly on Variable Interest Entity (VIE) structure. There is no restriction on foreign ownership of those institutions but due to the lack of precedent and for smooth application process, VIE structure is usually used for the acquisition and establishment of foreign ownership. Examples are Credit China (8207.HK) and Goldbond (172.HK) which own their pawn business in China via VIE structure. We see more clarification in this aspect in the future.

6. **Further, capital injection for foreign-owned entity usually needs more than 3 months.** To save the time and hassle, currently they use channels such as finance leasing or even RQFLP which are legitimate channels of to injection overseas fund. There is room for formal channels for foreign institutions to inject capital fund to their licenses in China.

7. **More clarifications on innovative financial products.** There are a few "re-guarantee companies" emerged in major provinces, such as Beijing and Jiangsu, which undertake guaranteed loan of SMEs from guarantee companies. These work like reinsurance companies in the insurance sector. The largest company of this kind is the Jiangsu Credit Reguarantee Group, which has capital of RMB3.15bn by end-2011 and undertook reguarantee amount of RMB3.17bn during 2011. They help guarantee companies to diversify risk but some of them also directly engage financial guarantee business with end-borrowers. Formal policy clarification is needed to delineate their scopes and risk undertakings.

SME Financing Institutions in China

This section and the sections following provide an introduction to various bank & non-bank financing channels relevant to SMEs. They each perform their own historical background and financial functions.

Bank financing channels for SMEs

In China, around half of the total social finance is provided by commercial banks and policy banks, which are mostly government-owned. Under policy mandate, they are currently encouraged to extend loans to SMEs. Numerous initiatives and new products were rolled out to capture the high growth of SME financing demand. SME loans extended by commercial banks grew 25.3% CAGR during 2008-2011 vs. total loan 21.8%. In spite of that, the acute financing problems of SMEs are still unsolved.

Policy banks, however, lack retail branches and found it hard to provide lending directly to SMEs. They sometimes rely on non-bank financing channels to accomplish their policy mandate.

Non-bank financing channels for SMEs

The non-bank financing industry in China is relatively new. Although pawnbrokers have been in existence for hundreds of years, it was not until 2005 that legal framework was established to allow pawn loans to be backed by real-estate collateral, opening an important financing channel for SMEs. To cater the rapid growth of SMEs, various types of non-bank financing channels emerged in recent years:

1. **Loan-guarantee companies -** intermediates between banks and borrowers acting as guarantors of the loan and, in case of default, bear the credit loss. They deposit a minimum 10% of the guaranteed amount in the bank allowing borrowers to obtain funds which otherwise may not be available to them.

2. **Small loan companies -** provide unsecured small loans (including microfinance) and collateral-based loans to individuals and SMEs.Their local expertise and limited coverage (they can operate only within their district) help to minimize risks. They have higher risk tolerance than commercial banks as they are not allowed to accept deposits. Each loan is not allowed to exceed 5% of registered capital (subject to local regulations) and its size (~RMB100k – unsecured, ~RMB1.5mn - secured by real estate) depends on loan type.

3. **Pawn loan companies -** short-term lending (i.e. under 6 months with loans usually below RMB10mn) on easily transferable collaterals. Unlike banks, they

are primarily concerned with collateral quality rather than borrowers' repayment ability. This enables them to provide timely financing solutions to SMEs.

4. **Finance leasing companies -** equipment-based financing. They take the ownership of the equipment and thanks to their insight into the equipment resale market they serve SMEs with manageable risks. Finance leasing offers a convenient long-term (>3 years) financing option for fixed asset investment since SMEs are usually unable to obtain loans for terms exceeding 1 year.

5. **Entrusted loans -** a legitimate lending and borrowing channel among companies via banks. The lender deposits funds at its entrusted bank, which then provides funding to the assigned customer. The service does not require a financial licence. The entrusted loan channel allowspawn loan companies to circumvent capital and customer exposure restrictions and provide funds to companies which fail to meet banks' credit requirements

Exhibit 11.:Major bank & non-bank SME financing channels

	Commercial banks	Non-banking SME financing channels				
	Major commercial banks	**Loan guarantee**	**Small loan**	**Pawn loan**	**Finance leasing**	**Entrusted loan**
		Insurer of bank loan	**Unsecured finance for investment and consumption**	**Short-term finance for emergeny**	**Long-term finance for investment**	**Flexible form of lending**
Maximum leverage ratio	RWA ~10x of capital base	10x of equity	1.5x of registered capital	2x of registered capital	10x of equity	no limit
Geographic flexibility	Nationalwide	Nationalwide	Within approved district	Hard to expand outside home province	Nationalwide	Nationalwide
Time required for processing	Long	Longer, as bank remains the fund provider	Shortest	Shortest	Long, as fixed assets needed to be revaluated	Short
Largest limitation	Prolonged risk management proceedure Inflexible products Subject to central bank's monetary policy	Consumes banks' lending quota	Lowest leverage possibility; Cap on max loan to individual customer (3-5%)	Cap on leverage ratio and cap on max loan to individual customer (25%)	Costly for short-term lending Requires industry expertise	Requires close relationship with banks
Special features		Flexible and therefore high business turnover	Unsecured lending; Upgradable to county bank		Long-term loan; Easy to obtain bank finance	No license needed
Loan duration?	6 mths - 1 year for SMEs	Short & Long term	Short-term (<6 months)	Short-term (<6 months)	Long-term (>1 year)	Short & Long term
Collateral required?	Yes	Yes	No	Yes	Yes	Yes
Urgency for loan?	Least urgent	Less urgent	Urgent	Urgent	Least urgent	Less urgent
Loan amount?	Large	Large	Small	Large	Large	Large
Suitability for:	Large size of long term financing for those with good credit record	Project finance and those wish to establish good credit record with banks	Diversified consumer finance	Short-term, secured, mid-sized loan for urgent needs	Equipment finance	Large size of short-to-med term financing

Source:CIRL

Banks as SME lenders

Institutional profile

Both commercial banks and policy banks are regulated and, to some extent, state-owned. They are mandated to accomplish loan growth targets set by the government, including that on SME loan. Their institutional setup and constraints in achieving their mandate are very different.

1. **Commercial banks:** There are 5 state-owned national banks in China, 12 joint-stock banks, and 144 city commercial banks. All major national banks are governed by both market and state policies, which include loan quota, favoured and non-favoured industry, as well as SME lending. Competition is not very intense, given that bank loan is still a predominant source of financing in China. Also, there is little price competition given interest floor in place.

2. **Policy banks:** They are 100% owned by the State Council and are mandated to fulfil a list of policy objectives including the promotion of SMEs. Policy banks include Export-Import Bank (Exim), the Agricultural Development Bank (ADB) and the China Development Bank (CDB) each has its own distinct function and responsibility. The policy banks were charged with promoting and financing the construction of infrastructure, promoting exportation and food productions. Now, those policy banks are running in commercialized way. Among them, CDB is probably the most active in supporting SME finance.

Business model

1. **Commercial banks:** It was not until the recent 2-3 years that most commercial banks in China set up a functional unit for SMEs. Before this, SME business either fell into corporate unit or personal finance unit. SME loans were usually evaluated with the same criteria and process as for large corporate, which normally takes 1-2 months for new loan to be approved. Some smaller banks such as China Minsheng Bank and China Merchants Bank have long established units specialized in local SMEs via branches and relationship manager. To some degree, they accept innovative financing solutions such as cashflow finance and equipment finance. These are followed by other major banks in recent years as SME loan became the top of policy agenda. This business is, however, less lucrative and cost efficient comparing to serving large clients.

2. **Policy banks:** Unlike commercial banks, policy banks have limited branches. For instance, CDB currently only has 52 offices national-wide to provide loan to infrastructure projects and various sectors encouraged by the government, including SMEs. Lacking in mature local network, policy banks also support

SMEs via non-bank finance channels. For example, CDB arranged a syndicate loan of RMB6 bn for Far East Horizon (3360.HK), a major independent finance leasing company, for a term of three years. This kind of long-term funding is essential to match the duration of leasing contracts but is difficult to obtain from commercial banks. As such, policy banks are able to fulfill their SME responsibilities.

Risks and constraints

1. **Commercial banks:** The business of SME lending requires a high level of entrepreneurial mind which is not always found in banks' staff. On the other hand, discretion power of local managers could lead to cronyism and corruption which hurt banks' asset quality. Further, banks are good at traditional risk management but relatively weak in managing risks on collaterals other than real estates, e.g. equipment, basic materials and company shares. They also lack channels in disposing foreclosed collaterals.

2. **Policy banks:** The lack of local network seriously constraints policy banks to be a real SME lenders. Usually, they rely on local partners who may not go through the full process in evaluating and monitoring SME loan.

Outlook

1. **Commercial banks:** SME remains the business segment that consistently recorded higher-than-average growth. In view of the huge Financing Gap of SMEs fore-mentioned, SMEs will continue to be an important contributor to commercial banks' overall loan growth.

   We forecast SME loan of commercial banks will grow 17.5% CAGR from 2012 to 2016, vs. 10.5% of overall loan.

   It is true that loan approval became quicker and easier for SMEs who have (and have clean) borrowing records, under which loan approval can be as fast as within 24 hours. Yet for SMEs or individuals to obtain the first loan from banks should still require a 15-day approval period, which is too long for SMEs who need flexible and urgent finance.

3. **Policy banks:** Among the few policy banks,CDB is the most involved in terms of SME lending.The policy bank had SME loan balance of RMB1.55 trillion by end-2011, up 55% from the level of end-2009. Yet it was only equivalent to 7.1%

of the total RMB21.8 trillion SME loan. We think this would hardly turn into an important funding channel for SME since SME lending is so different from other focuses of policy banks. Also, when its SME portfolio is scaling up, it is hard for them to engage new good local partners to build up a high quality SME portfolio.

Commercial banks &non-bank financing institutions are complementary instead of competitors

Due to commercial banks' limitation in meeting SME's needs, they are largely in different market segments from non-bank financing institutions. For example, some SMEs are entirely "unbanked" as they have no collatizable assets under the individual and company ownership. Some SMEs do obtain loan from banks yet they may still need urgent working capital fund and bridge fund which would take much longer time for banks' process. As such banks are not competiting head-on with non-bank financing institutions such as pawn loan and small loan providers.

Commercial banks and non-bank financing institutions need not compete with each other: In fact they usually refer busineses to each others. Below are some examples of cooperation between banks (commercial banks and policy banks) and non-bank financing institutions:

1. **Business referral:** According to Credit China (8207.HK) which is a listed pawn loan and entrusted loan provider, ~25% of business are referred from commercial banks, which are the borrowing needs that are not possible to be provided by banks (e.g. insufficient credit records, urgency requirement etc.). On the other hand, it may sometimes refer clients to commercial banks and earn the referral fee (consultancy fee).

   Commercial bank welcome business referrals from close partners as this helps selecting creditable customers (usually SMEs) and containing credit risk (by obtaining external guarantee).

2. **Loan product development:** Huaxia Bank, a mid-sized commercial bank based in Beijing, launched a product called "Buyout Rally Loan" (買斷型接力貸). In the first phrase, small loan companies provide loan to small or mirco entreprises that are also approved by Huaxia Bank. In the second phrase, Huaxia Bank buys back the loan from the small loan companies. The loan could also be backed up by guarantee companies. The maximum duration and amount are 18 months and RMB20mn, respectively. This product is an attempt to shorten the time that borrowers receive the loan, and simulateously solves the funding problem

(especially long term funding) faced by small loan companies[1].

3. **Funding support:** China Development Bank (CDB), one of the most important policy bank in China with total assets exceeed RMB6 trillion, has signed cooperative agreement with the Financial Affairs Office of Guangdong province, local government of Guizhou and the Association of Small Loan Companies of Anhui province. Under this agreement, CDB would provide loan to local small loan companies under the guarantor of local government or small loan companies association. During 2012, small loan companies in Guangdong province alone received RMB2bn loan from the CDB, according to Xinhua News[2].

[1] See: http://www.hxb.com.cn/chinese/sme/index1.jsp?cid2=1259208806116014l&cid3=13250585852550107
[2] See: http://big5.xinhuanet.com/gate/big5/news.xinhuanet.com/2012-11/26/c_113806215.htm

Financial guarantee to enhance SME lending

Institutional profile

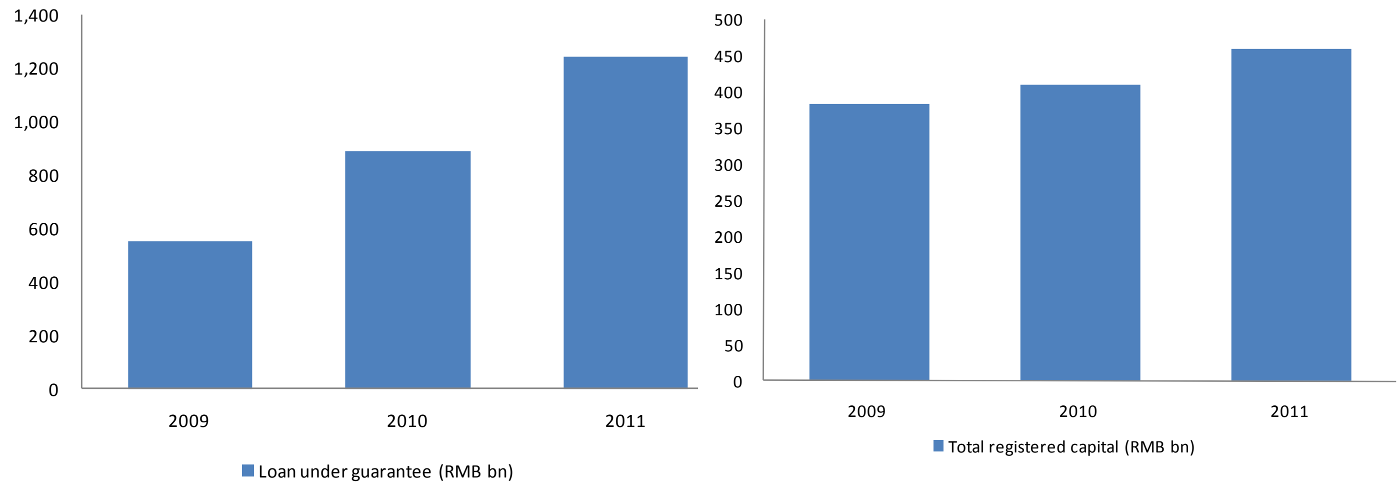
Financial guarantee companies offer repayment guarantee to less credit-worthy borrowers, or those without credit recorded to qualify for bank loans. They do not offer loan themselves, but provide commercial banks deposits of 10% of the total guaranteed loan and often obtain counter-guarantee from borrowers. As such, it helps some borrowers to obtain the valuable credit record for accessing further bank loans in the future. Since guarantee companies bear the default risks, they are incentivized to monitor and detect the default risks therefore help lowering risks to commercial banks. For commercial banks, the arrangement with guarantee companies helps them achieve its mandate on SME loans. Therefore, guarantee companies offer a win-win scenario for SMEs and banks. They are regulated by the China Banking Regulatory Commission.

History and milestones

Before 1997, all guarantee companies were state-owned. Since 1998, local governments are authorized to grant guarantee licenses to private companies. The period of 1998-2004 marked a high growth of private guarantee companies in China. Without a clear regulation and surveillance, there were no standard risk management practice, and many industry players also took part in direct investment business or even acquired deposit and provide lending on their own which is not allowed under the license. A large scale industry consolidation was completed in 2011 when industry players re-applied their licenses from local governments. Weak or non-compliant companies were forced out.

After the industry consolidation, loan guarantee companies generally follow better practice and thus many financial institutions have started cooperating with them. The loan guarantee industry experienced tremendous growth in recent years. Loan balance under guarantee more than doubled to RMB1,247 bn as at end-2011 from RMB555 bn as at end-2009.

Exhibit 12.:Balance of loan under guarantee and registered capital of guarantee companies

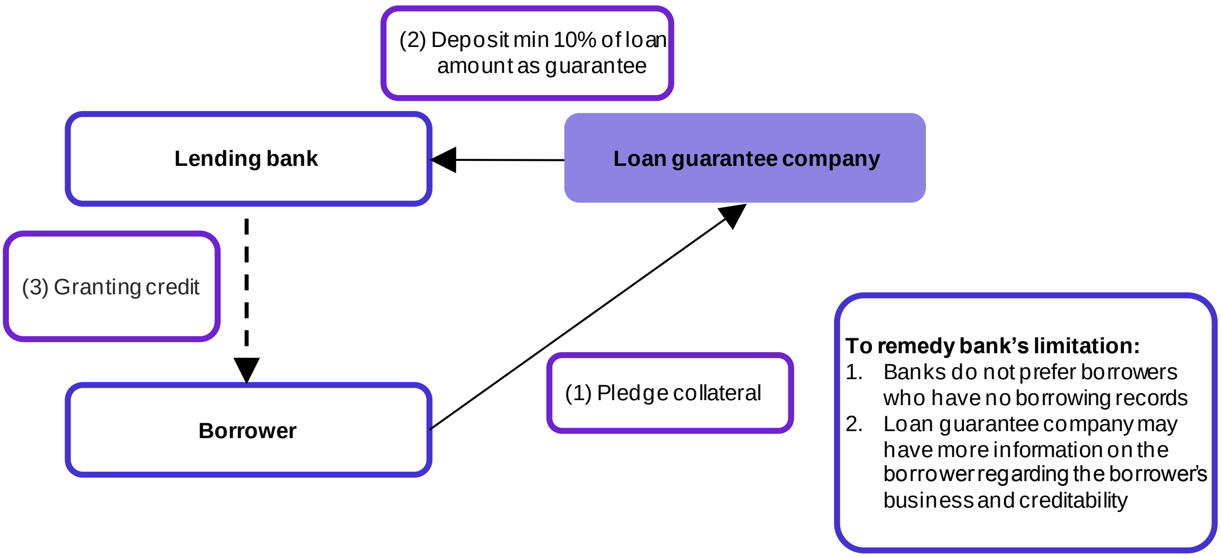


Source: CBRC, CIRL

Business model

In the event of loan default, loan guarantee companies bear the liabilities to commercial banks. In return, they normally charge 2-5% guarantee fee per annum from the borrowers. There is no cap on the charge of guarantee fee, but this appears to be low compared with interest charged by pawn or small loan companies. Guarantee companies, however, can enjoy leverage from endorsing a total amount of loans up to 10x of its deposit. As a result, they can earn an annual rate of 20-50% on their capital in theory, under maximum leverage.

Exhibit 13.: Business model of guarantee companies



Source: CIRL

Competitive landscape

The loan guarantee industry is competitive in the sense that there were 8,402 in China as at end-2011, up from 6,030 a year earlier. They are allowed to conduct business nationwide. Their individual strength hinges in their relationship and track record with commercial banks, as well as connection with local SMEs. It is essential to have a large pool of customers because of the low fee relative to guaranteed amount.

Risks

Although commission fee is relatively low compared to the guaranteed principal (normally 3-5%), loan guarantee companies bear the default risk of the whole amount of guaranteed principal. The amount deposited to the commercial bank could be as low as 10%, such that loan guarantee companies may not have the financial resources to honor the guarantee contract should the loan default. Although they may seek “counter-guarantee” collateral from borrowers, the foreclosure and sale do take time.

As mentioned, many industry players also involve in direct investment business or even acquired deposit and provide lending on their own which is not allowed under the license.

Outlook

The outlook of this sector should be encouraging given that banks are encouraged by state policies to extend loans from SMEs, and guarantee companies introduce them customers of manageable risks. Besides, commercial banks tend to acquire SMEs clients to mitigate the narrowing interest spreads. This is favourable to the loan guarantee industry. However, potential investors need to be cautious on tightening regulations such as increase in share capital requirement, malpractices and government’s intention in consolidating the industry. Since commercial banks are involved heavily in the business of loan guarantee, the government may tighten regulations if they impact the stability of the banking system.

The size of loan guarantee industry, in terms of loan balance under guarantee, will increase 17.8% CAGR from 2012 to 2016, we expect, accounting for 6% of total SME loan

Institutional Framework: Small loan companies

Institutional profile

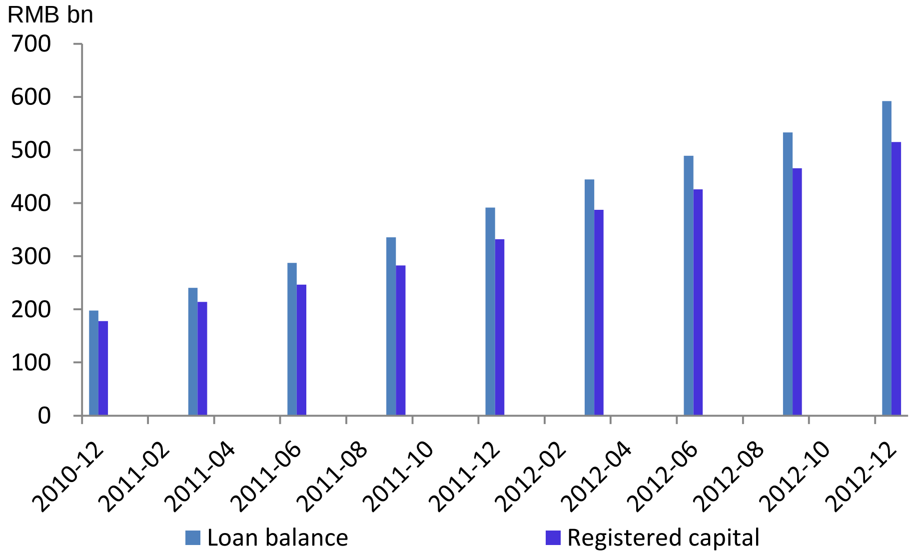
Small-loan company provide unsecured loan to individuals and SME owners. In general, loan amounts average at RMB30,000 - 100,000 depending on borrowers income level. As such, it is essential to have large group of customers.

By regulation, small loan companies are not required to obtain collateral, unlike pawn loan companies.Their maximum loan to a single borrower is capped at 5% of the company's registered capital (compared with 25% for pawn loan companies), subject to further local regulations, and usually does not exceed RMB1.5mn. This forces them to diversify their portfolio, in contrast to pawn loan companies who usually extend credit toonly a few SMEs. They are regulated by Financial Affairs Office of local governments, which report to the China Banking Regulatory Commission and the People's Bank of China.

History and milestones

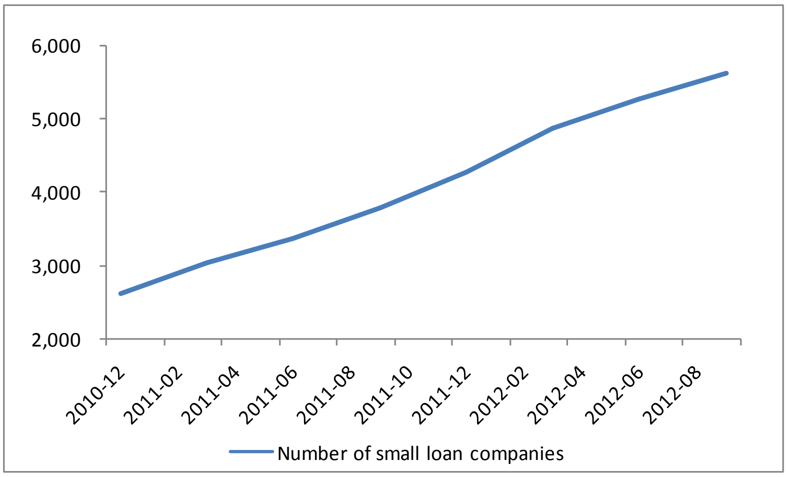
China started formally licensing small loan companies in 2008, after they have established some pilot companies in 5 provinces in China in 2005. The sector experienced a year of explosive growth in 2011 when the credit was tightin commercial banks. During 2011, there were 1,668 new small loan companies established in China , represented 64% growth in the total number. By end-Sep 2012, the country had 5,629 operators with loans totaling RMB533bn, 170% up from end-2010.

Exhibit 14.:Total loan balance and paid-up capital of small loan companies in China



Source: WIND, CIRL

Exhibit 15.:Total number of small loan companies in China



Source: Wind, CIRL

Small loan companies are part of government drive to stimulate small rural and agricultural businesses. After two consecutive years of earnings, securing a commercial bank as their largest shareholder and active involvement in the county lending business, they can apply for a county bank licence and accept public deposits, a fast track to rapid and sustainable growth.

Exhibit 16.:Small loan companies milestones

2010	Chongqing piloted to grant small loan companies access to the PBOC online credit system
2009	CBRC issued the Interim Provisions on Restructuring Small Loan Companies into Village Banks. Main entry requirement includes: - Consecutive operation for at least 3 years; - The proportion of agriculture-related loans shall be higher than 60% in the recent 4 quarters; - Licensed domestic banks must have a 20% minimum ownership of the village bank; individual non-financial institution investors can have up to 10% of the remaining shares.
2008	Private capital were allowed to set up small loan companies on a trial basis according to the Guideline on Small Loan Companies Pilot Scheme issued by PBOC and CBRC in May
2005	Small loan companies sprouted in China in 2005 with the establishment of 7 pilot companies in 5 provinces in China

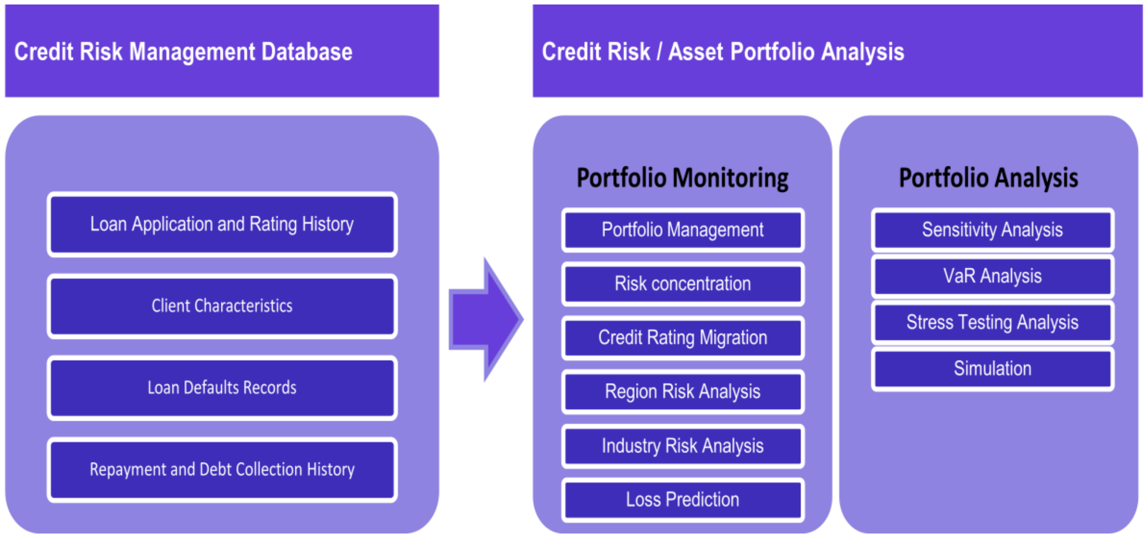
Source:CIRL

Business model

Free from the collateral requirement, small loan companies can offer flexible financing solutions to individuals or proprietary business owners. Apart from unsecured loan, some small loan companies also provide innovative loan productsto SMEs, such as loan being pledged by receivables, inventory or equity.

Their maximum interest rate is four times the six-month PBOC benchmark lending rate (5.6% x 4 = 22.4%) and with administration and consulting fees, the effective rate edges close to that of pawn loans (30-40%). Small loan companies are not required to take collaterals but some companies do require collateral protections in the same way like pawn loans.

Exhibit 17.:Scientific risk management adopted by overseas small loan companies



Source: World Bank, CIRL

SMEs remain the largest customer group of small lending companies in China. Although the CBRC regulation states that loan to a single borrower should not be more than 5% of small loan companies' registered capital, there is no restriction on the maximum dollar value that can be granted to an individual. It was reported PBOC officials disclosed in a forum that loans exceeding RMB500,000 accounted for 86% of the total, while only 1.9% is below RMB50,000. Out of the total 5,629 small lending companies in China as of September 2012, the average registered capital is RMB83mn, such that the maximum amount of loan allowed under the regulation is averaged at RMB4mn.

Competitive landscape

The small loan industry is not as competitive as loan guarantee. There were 5,629 small loan companies as of September 2012, but they only face limited local competition as each license restricts the region that one can operate in, therefore theycompete with only a few players in the region.

China's small loan companies are similar to foreign microfinance operators. Attracted by the prospect of an upgrade to a county bank (村鎮銀行), foreign investors are setting up small loan companies as their foot in the door of China's lending business. Thus, this segment is the most invested by foreigners among all the subsectors in the non-bank financing industry.

Below shows examples of foreign invested small loan companies

Exhibit 18.:Example of foreign invested small loan companies

Small loan company	Chinese Name	City/Province	Parent company	Year of Est.
Citibank Rural Finance	花旗小額貸款公司	Hubei, Dalian	Citibank (US)	2008
HSBC Rural Finance	匯豐小額貸款公司	Hunan	HSBC (UK)	2010
Fullerton Credit	富登小額貸款公司	Chengdu, Chongqing, Wuhan	Temasek (Singapore)	2011
Promise	普羅米斯小額貸款有限公司	Shenyang	SMBC Consumer Finance (Japan)	2011
Berich	百裕小額貸款有限責任公司	Nanning	Berich (Hong Kong)	2012
AEON	永旺小額貸款有限公司	Tianjin	AEON (Japan)	2012

Source: DBS Vickers, CIRL

Risks

The small loan industry is a balance between risk and return. On one hand, the return is usually lower than pawn loan industry as part of their business are derived from local consumer finance, on which interest rate is normally lower than real estate-collaterized SME loan. Since each loan are of small size, the administrative cost for the given amount of loan portfolio is relatively high.

On the other hand, the risk should be lower given a scientific way of management, since loan portfolio is supposed to be well-diversified among different customers (though still there could be certain risk of geographicaly concentration). Regulatory risk is relatively less, as the relevent regulation framework is largely mature compared with loan guarantee business, although there are still some common malpractice such as illegal deposit taking. By regulation, they are less leveraged compared with guarantee companies and pawn companies, therefore they would cause little financial burden to commercial banks thus they should face less adverse regulatory changes.

Outlook

We think the outlook of this sector is the most encouraging in the sense that they are likely to receive positive policy support given the government’s priorities in boosting consumption, SME finance and rural finance. Some regional governments have lifted up the allowed maximum bank borrowing for small loan companies. Also, the conditions of the transformation to rural banks could be relaxed in the future, offering a potential way to obtain the valuable banking license. The industry growth will come from both influx of new players and rising average loan balance per company.

The size of small loan industry, in terms of total loan balance, will increase 29.7% CAGR from 2012 to 2016, we expect, accounting for 1.7% of total RMB bank loan by 2016, up from 0.9% at the end of 2012.

Institutional Framework: Pawn loan companies

Institutional profile

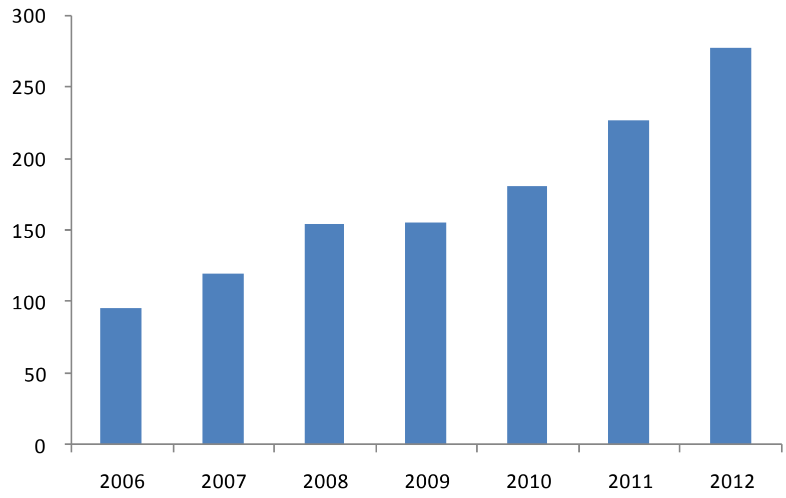
Pawn loan companies offer collateral-backed short-term (fewer than 6 months) loans for bridging loans, working capital etc. They offer swift loan approval (2-7 days vs. over a month for banks) thanks to their focus on the quality and reselling value of the collateral rather than borrowers' cashflow and history.

The industry is old and simple, compared with other alternative finance sectors, but it is smaller in terms of registered capital and amount of loan. By end-2011, there were 5,237 pawn loan companies in China but total registered capital was only RMB70bn (RMB13mn per company) vs. small loan companies of 4,282 nationwide with total registered capital of RMB332bn (average of RMB77mn per company). Pawn loan companies had averaged loan at RMB11mn, vs. small loan company's RMB91mn.

History and milestones

Pawnshops emerged in modern China in 1987. Popular collateral included jewelry, watches, artwork, etc. The country had only 1,300 pawnshops in 2005 when the Ministry of Finance and the Ministry of Public Security jointly issued the "Pawning Measures" allowing pawnshops to accept real estate as collateral. By June 2012, China had 6,078 registered pawn companies. During the first half of 2012, the industry has disbursed total pawn loan of RMB148bn. On average, the industry grew at 19.5% during 2006-2012, on the basis of total amount of pawn loan disbursed (accumulated loan during the year).

Exhibit 19.:Total amount of pawn loan disbursed during the year (in billion RMB)



Source: MOFCOM, CIRL

Exhibit 20.: History of China's pawn loan industry

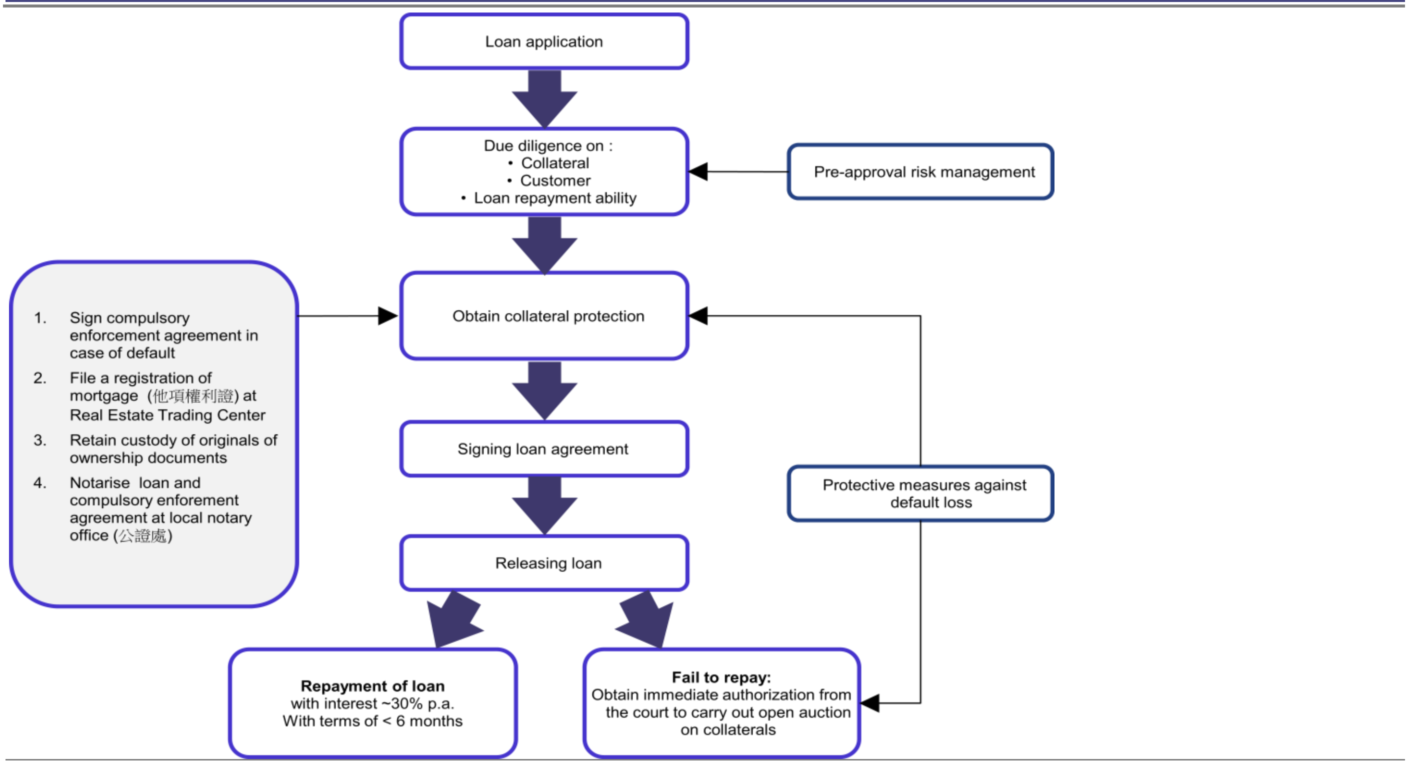
2011	MOFCOM issued a draft of revised Pawn Meausures for public consultation. The new measure proposed to raise The minimum registered capital to RMB5 mn from RMB3 mn and raise The minimum register capital for Real estate pawn companies to RMB10 mn from RMB5 mn.
2005	MOFCOM and Ministry of Public Security jointly promulgated the Pawn Measures The new measures raised entry requirement on registered capital The new meausres also lowered the monthly interest rate cap - Real estate pawn: reduced from 3% to 2.7% - Personal property pawn: reduced from 4.5% to 4.2%
2003	MOFCOM took over the role of overseeing the pawn loan industry as SETC was abolished.
2000-2003	State Economic and Trade Commission (SETC) took over the role of overseeing the pawn loan industy Pawn industry were re-classified as non-financial industry SETC expanded pawn loan business scope to real estate pawn loan and allowed pawn companies to borrow from banks with a maxium amount not exceeding their registered capital.
1996	PBOC took charge of the pawn industry, issued the Interim Measures for Pawn Industry Management Pawn industry were classified as non-bank financial industry
1987	The first pawn company established after pawn business being banned for decades in China, marking the revival of China's pawn industry

Source: MOFCOM, CIRL

Business model

We believe that most pawn loan companies in China are family-run pawnbrokers conducting the traditional pawn business on personal belongings (e.g. jewelry, watches, gold etc.). Since 2005, real estate backed pawn loan have been prevalent for major pawn loan companies. They obtain certificates of registered mortgages from the Real Estate Registry for real estate collateral assets, demand notarized enforceable court execution orders from borrowers and retain ownership documents until the loan is fully repaid. Sometimes sales & purchase agreements on the collateral are signed, allowing the pawn loan lender claim the ownership in case of default.

Exhibit 21.:Pawn loan – the business model and risk management



Source: CIRL

Under the Pawning Measures, loan extended to a single borrower should not exceed 25% of registered capital. Real estate backed pawn loans are usually conducted via entrusted loan channel, under which the loan company deposits funds at its entrusted bank, which then provides funding to the assigned customer. The service does not require a financial license. Entrusted loans allow pawn loan companies to circumvent capital and customer exposure restrictions and provide funds to companies which fail to meet banks' credit requirements

Pawn loan companies earn lucrative interest and commission fee income. According to China's "Pawning Measures", pawn loan companies' interest should not exceed the PBOC six-month benchmark lending rate (currently 5.6% p.a.) and commission fees 2.7% per month for real estate collateral and 2.4% per month for financial assets. The actual interest and commission fee on pawn loans is 30-40%, compared with interest charged by commercial banks on SME loans (currently around 10%) and "underground lending" (40-60% according to official PBOC release, could be as high as 180%).

Competitive landscape

There were 6,078 pawn loan companies in China as at Jun-2012, increased from 4,433 and 5,237 as at end-2010 andend-2011 respectively. Although the growth is rapid, competition is not intense, reasons are: 1) Most old industry players are family-run conducting the traditional pawn business on personal belongings; 2) they are localized due to license restriction on conducting cross-provincial business; 3) large market demand especially in recent years as monetary condition is tight. Credit China (8207.HK), which is running the major real estate pawn loan company in China, expressed that they approve only one out of 10 loan applications.

Risks

This sector is relatively low risk compared to loan guarantee business as there are risk-limiting measures deployed by pawn loan companies: For example, they usually require easily transferable collateral, with real estate as the most common form of collateral. Independent appraisals and site visits are sometimes necessary during due diligence. Some pawn companies accept antiques or precious metals, having identified potential buyers in case of default. Top industry players are usually able to sell collateral within 2-3 months from loan default.

Exhibit 22.: Pawn loan – Clauses on lending agreements that allows mandatory sale of collateral upon default

第 XX 条：强制执行公证

本合同应办妥赋予强制执行效力公证，在此乙方承诺在其不履行或不完全履行本合同义务或/及与当票相关的义务时，乙方、抵押房地产的共有人或/及乙方其他财产的共有人愿意接受依法强制执行。强制执行标的为本合同第三条所述的、至实际清偿之日止乙方应履行的本金及各种利息、综合管理费、违约金及实现债权和抵押权的其他费用。强制执行的范围不仅及于抵押房地产，而且也及于乙方的其他财产。因办理公证产生的所有费用均由乙方承担。在此情况下，甲乙双方在此共同拍定由 XX 进行抵押房地产的拍卖事宜，并指定 XX 评估公司对抵押房地产进行评估。

Source:Credit China, CIRL

The biggest regulatory risk in this segment is the legitimacy of entrusted loan. While entrusted loan as a whole would not be banned, the CBRC may impose restriction for banks in accepting entrusted loan businesses, which would limit the maximum amount of pawn loan that can be provided.

Outlook

The outlook of this pawn loan industry in China should be positive and stable throughout economic cycle.

Given the stated hurdle in obtaining bank loan by SMEs and individuals, pawn loan is easily their last resort. Even in mature economies, their pawn loan markets still grow at handsome pace. For example, the balance of pawn loan in Hong Kong grew 6.2% CAGR during 2007-2011 and that in US grew 8.2% during the same period.

Pawn loan companies have the tradition of being prudent in risk management, therefore is likely to grow in a rather stable way compared to loan guarantee and small loan industry.

The size of pawn loan industry, in terms of total loan granted in the year, will increase 21.7% CAGR from 2012 to 2016, we expect, accounting for 0.76% of total RMB bank loan in the year, up from 0.52% in 2012.

Institutional Framework: Finance leasing companies

Institutional profile

Finance leasing companies offer equipment-based long-term finance, as banks are unwilling to offer loan of more than one year term to SMEs.

Under finance leasing, it is production equipment, not real estate as in pawn loan finance, is used as collateral. The lessor becomes the legal owner of the equipment for the lease period, with the right to take over the asset if payment is in default.

Most clients of finance leasing companies are also clients of commercial banks. Banks do not provide finance leasing services directly because they lack expertise in industrial equipment and prefer real estate (with its readily identifiable value) as collateral. Thus, finance leasing offers SMEs long-term finance (> 1 year loan), usually unobtainable from banks, which is essential for their long-term investment decisions, especially for non-property assets such as equipment.

History and milestones

Finance leasing was introduced in China in 1980s to provide funding for the import of advanced equipment and technologies. The sector experienced a period of stagnation in the 1990s due to industry and regulatory restructuring, but recorded a strong growth in the last decade due to government encouragement. Following China's accession to the WTO, various Sino-foreign JVs of finance leasing companies were setup. In 2004, the MOFCOM released a circular to encourage domestic-invested finance leasing companies; and in 2008, the government further declared a positive stance towards developing this industry. During 2008-2012, total leasing balance grew at a rapid rate of 89% CAGR.

Exhibit 23.:History of China's finance leasing industry

2007	Commercial banks were allowed to directly set up finance leasing companies
2005	MOFCOM permitted the establishment of wholly foreign-owned finance leasing companies.
1999-2000	Regulations and accounting rules on finance leasing were gradually established and served as cornerstones for the industry to recover
1989-1999	The leasing industry stagnated due to industrial and regulatory
1981-1988	Finance leasing was introduced to China and experienced fast development

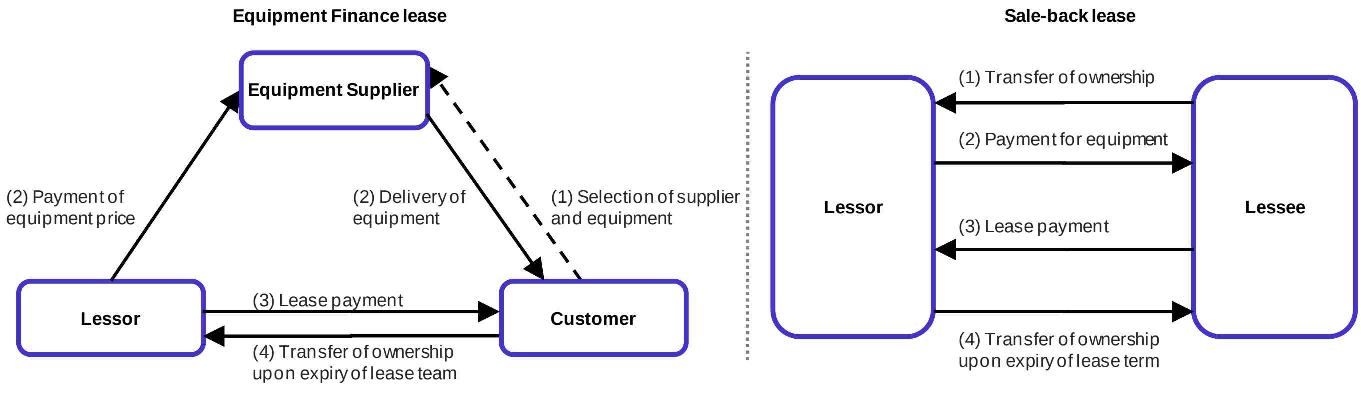
Source: CIRL

Business model

"Equipment finance lease" and "sale-back lease" are two primary forms of finance leasing. In a direct lease, the leasing provider buysspecified equipment from a supplier and leases it to thecustomer. In a sale-back lease, thecustomer sells existing equipment to the leasing provider,who in turn leases the same asset to the customer.

SME owners can convert machinery and equipment, which banks may not readily take as collateral, into liquidity if desired.

Exhibit 24.:Two types of finance leasing



Source: CIRL

In comparison to pawn loan finance, finance leasing uses production equipment as collateral, rather than real estate collateral. Also, during the lease period, the leasing company is the legal owner of the equipment, with the right to take over the asset if payment is in default.

Other major differences between finance leasing companies and pawn loan companies:

Exhibit 25.:Comparing between two types of collateral-based non-bank lending

	Finance leasing	Pawn loan
Loan purpose	Long-term finance for investment	Short-term finance for emergeny
Regulatory authority	MOFCOM (for foreign invested ones and non banks owned) CBRC (for bank-owned)	MOFCOM
Minimum registered capital	US10mn (foreign-owned)	Rmb5mn (property pawn loan)
Loan duration	3-5 years	within 6 months
Annual interest rate	6-15%	25-35%
Total number (end-2011)	258	5237

Source: PBOC, MOFCOM, CIRL

The lessor is the legal owner of the equipment for the lease period, with the right to take over the asset if payment is in default, finance leasing business requires in-depth technology and market knowledge (especially the second-hand market) of the productive equipment, therefore most of them adopt industry a focus strategy.

The strong industry focus enables finance leasing companies to provide value-added services. For example, Minsheng Leasing (under the ownership of Minsheng Bank, 1988.HK) also offers aircraft procurement, management and maintenance, as well as aircraft disposal. Far East Horizon (3360.HK), adopted an industry focused business model and specializing in seven industries: healthcare, education, infrastructure, construction, printing, shipping, machinery and textile. Thus, non-interest income from providing services such as procurement and disposal of equipment, introducing customers, and equipment trading accounted for 37% of its income in 2011.

Competitive landscape

The finance leasing industry is least competitive, in our view, the number of players is rapidly increasing. There were about 260 financing leasing companies in China as of end-2011, including 18 bank-affiliated companies, 66 captive leasing companies, 180 independent leasing companies. The total number of company nearly doubled from 128 in 2008, and most major banks have setup their own bank-affiliated leasing companies.

In spite of the surge of players in this industry, we think competition is not very intense due to high knowledge requirement in the business and thus different focus pursued by each industry player:

1. **Bank affiliated lessors:** Established by banks, under the initiative of expanding product and customer mix, while enjoy a looser regulation than banks (i.e. receivables exempting from the loan-to-deposit rule applicable to bank loans)

2. **Captive lessors:** Setup by equipment manufacturers, to provide funding to their customers

3. **Independent lessors:** Generally have lower level of registered capital and narrower funding, thus focus more on SMEs. They are subject to more favourable leverage ratio than bank affiliated lessors

Exhibit 26.:Comparison of 3 types of leasing companies

	Bank affiliated lessor	Captive lessor	Independent lessor
Regulator	CBRC	MOFCOM	MOFCOM
Parent Company	Commercial banks or other financial institutions	Equipment manufacturers	Non-financial institutions or equipment manufacturers
Underlying leasing assets	Aircraft, vessel, large-scale equipment	Equipment produced by parent company	Small-to-medium scale equipment
Funding sources	Interbank market, Financial bond, Shareholder deposit, Bank loan	Bank loan	Bank loan
Leverage	Net asset / Risk-weighted asset > 8%	Asset / Equity < 10	Asset / Equity < 10

Source: CERC, MOFCOM, China Leasing Association, Companies, DBS Vickers, CIRL

Captive finance leasing companies are directly associated with certain equipment manufacturers to help finance product sales of their group companies, as such they are not interested gaining leasing contracts on equipment manufactured by others; on the other hand, bank-affiliated companies usually focus in mega-size contracts on equipment such as aircraft, ships and etc. Therefore, the vast SME leasing market is yet to be explored.

Risks

Asset quality is the biggest risk in this sector, in our view. Scrap value of leasing equipment depends primary on its physical condition and market situation of the output it produces. Productive equipment is easily depreciated and obsolete, such that the leasing company may have to write off the loan balance entirely should the lessee fails to honor the repayment obligation.

Regulation risk is minimal in this sector, as industry players are generally large and disciplined.

Outlook

Outlook for the finance leasing industry is bright. It is emerging as a popular option for capital-intensive businesses. The penetration is low, however. Finance leasing accounts for only 3% of China's equipment purchase activities (>10% in developed economies).The net receivables surged at a CAGR of 207% in 2006-2011, compared with loan growth of 20% in the period. Despite the high growth in recent years, the penetration remained much lower than developed countries:

Exhibit 27.:Growth of leasing contracts balance

Rmb bn	2006	2007	2008	2009	2010	2011	Jun 2012	CAGR 06-11
Balance of financial leasing contracts	8	24	155	370	700	930	1,280	
yoy growth %*		200.0%	545.8%	138.7%	89.2%	32.9%	37.6%	158.9%
Balance of Rmb loan (Rmb bn)	22,529	26,169	30,339	39,968	47,920	54,795	59,642	
yoy growth %*		16.2%	15.9%	31.7%	19.9%	14.3%	8.8%	19.5%

Source: PBOC, Wind, CIRL

Exhibit 28.: Growth of leasing contracts and market penetration

Ranking	Country	Annual volume (US$ bn)	Growth in 2010 (%)	Market penetration (%)
1	US	193.9	12	17.1
2	China	63.7	50	3.8
3	Germany	52.5	6.3	14.3
4	Japan	50.8	-6.6	6.3
5	France	30.9	7.3	10.5

Source: CERC, MOFCOM, China Leasing Association, Companies, CIRL

The size of finance leasing industry, in terms of total loan balance at year-end, will increase 28.5% CAGR from 2012 to 2016, we expect, such that the leasing balance at the end of the period presents 5% of GDP and 4.7% of total fixed assets investment during the year, up from 2.4% and 3.4% respectively in 2012.

Entrusted loan channel for lending between companies

Institutional profile

Entrusted loan is not a formal institution, but an official channel for any non-bank institution to provide loan to another company via bank. In the case of non-bank financial institutions, entrusted loan allows those institutions to circumvent loan size restrictions so as to provide funds to SMEs which fail to meet banks' credit requirements.

History and milestone

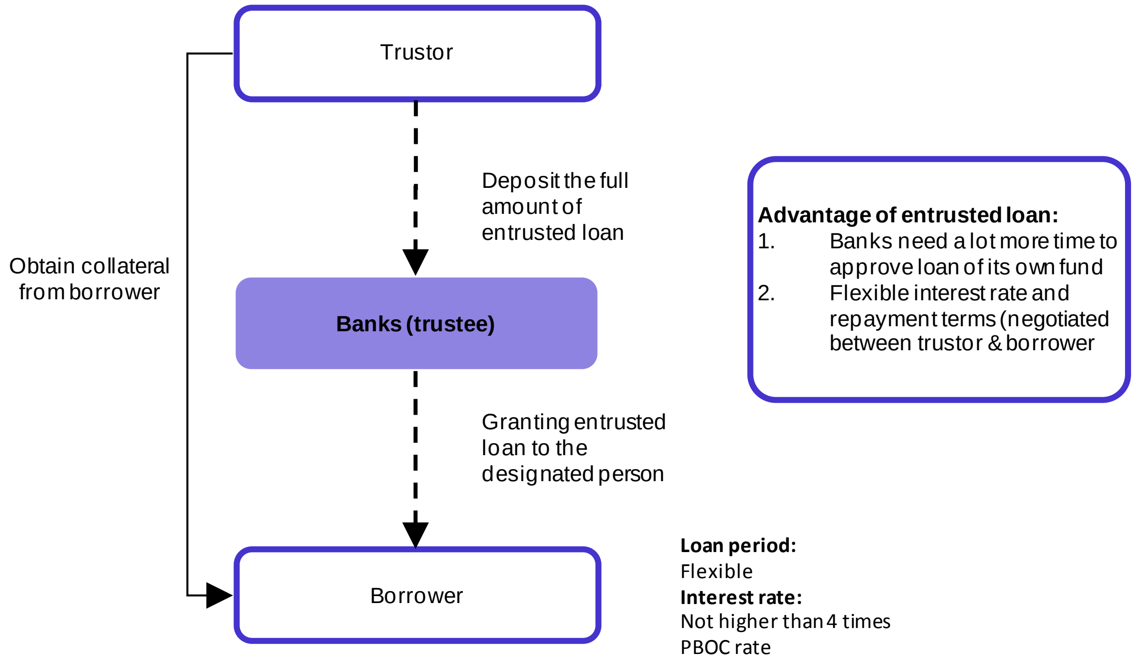
Entrusted loan did not receive much attention before 2009, when the amount of new entrusted loan accounted for 3.3% of total social finance in that year. However, it boomed in 2011 when banking liquidity was tight. Reasons are that: 1) entrusted loan is not calculated under the loan quota of internal bank policy; 2) entrusted loan simultaneously come with deposits and would not deteriorate loan-to-deposit ratio; 3) much loan was extended to those restricted industries (e.g. property development, metal and steel) that face difficulties in obtaining loan from banks in traditional channel. Thus entrusted loan became a popular channel for many pawn loan and small loan companies to disburse their loan to SMEs.

There is no particular regulation governing this lending activity, except that it is subject to be a ruling in 1991 which caps any legally enforceable lending rate at 4x of PBOC's benchmark rate and forbids interest compounding.

Business model

This is a form of inter-company lending achieved through an entrusted loan arrangement, with bank as intermediary. This is a form of agency business to banks. Banks provide capital to a borrower specified by the trustor, who deposits the same amount with the bank. The bank collects principal and interest on the trustor's behalf and does not bear any risk of default. The bank receives a fixed agency fee and interest charged by the trustor should be within four times of the relevant PBOC benchmark rate. Effectively, this is indirect lending and borrowing among corporations, which the government seeks to monitor by requiring it to be conducted through the banking system.

Exhibit 29.:Workflow of entrust loans



Source: CIRL

Many non-bank financing institutions use entrusted loan as a channel to avoid the regulatory cap on loan size allowed under their licenses. For example, the total loan balance allowed under pawn license is two times their registered capital, and new operators (within a year of registration) can lend only up to the amount of their net assets. Also, the maximum loan to single borrower under pawn license is 25% of registered capital, and for small loan license is 5%. Some loans for medium-sized enterprise could be up to RMB10-20mn which easily exceeds the maximum amount allowed under the license and therefore they should be done via the entrusted loan channel.

Entrusted loans give them flexibility to get around these thresholds. Commercial banks can provide entrusted loans to borrowers as specified by the lender, who also provides the lending funds and assumes the risk of default. There is no limit on the amount and duration of entrusted loans.

However, it needs additional time (a few days at least) for banks to process, and the banking charges is around 1%.

Risks

This form of financing is subject to a fairly high regulatory risk. It is essentially a form of shadow banking which is not formally regulated by any regulatory body. Currently entrusted loan is a means for pawn loan companies to circumvent registered capital's restriction. Some guarantee companies, who are not allowed to provide loan under regulation, even conduct entrusted loan business and therefore attracted a close watch by the regulator. The CBRC may impose restriction for banks in accepting entrusted loan businesses, including those on maturity, industry and interest rate. On the other hand, the CBRC has already forbidden loan guarantee companies to provide entrusted loan via commercial banks.

Outlook

There is strong demand for entrust loan financing, thanks to huge SME funding demand and banks' inadequacy in serving them. However, we expect the relevant authorities such as CBRC will announce measures to regulate entrusted loan activities. The growth rate of entrust loan coming forward should be slightly higher than commercial banks' overall loan growth, but lower than other SME financing channels as other channels become mature.

We expect the size of entrusted loan, in terms of total loan balance at year-end, will increase 13.0% CAGR from 2012 to 2016, we expect, such that it will account for 10% of total social finance in 2016, down from 15.6% in 2012 and fall to the similar level in 2009.

Regional development

This section aims to show that the development of non-bank financing sectors in provincial level is largely driven by local policies and the activeness of provincial government in pushing the development. We argue that GDP level does not imply the relative development of non-bank financing sector in a province.

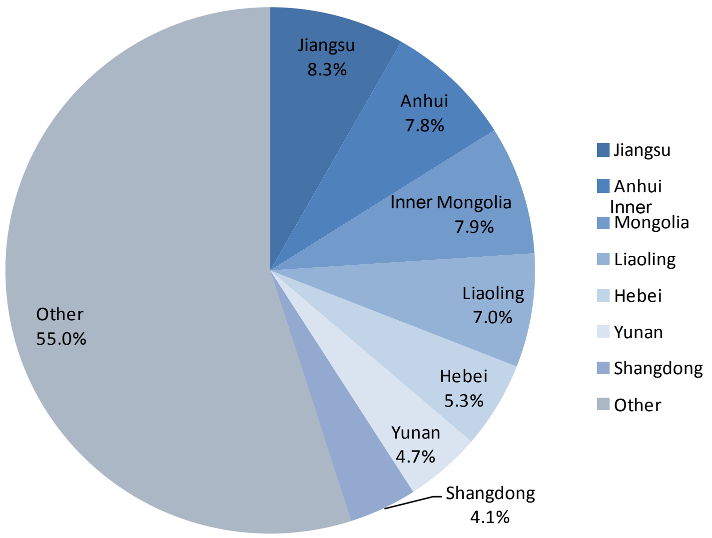
Overview of regional development in non-bank financing channels

Although the central government has decided the framework and regulations for various kinds of non-bank financing institutions, the actual regulation and supportive policies depend on the local government in each region. Also, the enterprise demography in each region also determines development of those institutions. We here conclude a few points on regional development by using statistics of the most widely available, which is on the small loan company industry. We found the below phenomenon:

1. Some provinces implement policies conductive to SME finance, therefore result in more advanced development of small loan companies, e.g. Jiangsu, Inner Mongolia

2. Small loan companies grew rapidly in some provinces in past few years, such that the top five provinces inhabited 35% of China's total number of small loan companies. Those provinces are Jiangsu, Anhui, Inner Mongolia and Liaoning. Their number of small loan companies as proportion to the country is higher than their economic significance.

Exhibit 30.: Distribution of small loan companies in China (by Sep 2012)



Source: WIND, CIRL

3. Affluent provinces usually have bigger size of loan per small loan company, such as Zhejiang, Fujian and Jiangsu.

4. There are certain regions that are advanced in economic development and SME inhabitation, but their non-bank financing industry are not very developed, such as Guangdong.

Regional development: Jiangsu

1. **Economic and SME profile:** Jiangsu has one of the largest SME clusters in the eastern provinces. It hosts many of the most competitive SME clusters including electronics in Nanjing, silk in Yancheng, and auto-parts in Zhenjiang. Some advanced industries are also thriving, such as software in Hangzhou and communication equipment in Fuyang.

2. **Institutional development:** The non-bank financing industry in Jiangsu is relatively developed. Jiangsu has the largest number of small loan companies, thanks to the progress during 2011-2012. Jiangsu only had 194 small loan companies as of end-2010 but grew to 465 by Sep-2012, at the rate of 140%. The province's total loan balance under small loan companies as of Sep-2012 stood at RMB101 bn, rose by 46% yoy and accounted for 19% of the country's total, though its GDP only accounted for 10% of China.

   The pawn loan industry in the province was not as big (hosted 369 pawn loan companies vs. 6078 of China's total), but they are more developed compared to other regions. The average registered capital was RMB23mn as of June-2012, significantly higher than RMB1.3mn of national total by end-2011. SMEs and sole-proprietorship, instead of individuals, are major clients of pawn loan companies in the region. Sophisticated items such as real estates, listed shares and raw materials are the major types of collaterals.

3. **Government policies:** Jiangsu's local government carries out conductive policies towards non-bank financing industry. One example is the policy promulgated in 2010 which reduced tax for small loan companies involved in certain kinds of loan. Also, the largest province-level guarantee company was setup by the government in Jiangsu to backup and bridge local guarantee companies and all SME lenders.

Regional development: Guangdong

1. **Economic and SME profile:** The SME clusters in Guangdong were developed in the earlier period of China's opening to foreign investments. The eastern part of Guangdong province (Guangzhou, Dongguan, Huizhou and part of Shenzhen) focus on IT and communication systems, and the western part (Zhuhai, Zhongshan, and Jiangmen) focus on the electrical and mechanical sectors. There are also some SME clusters which are globally significant, such as the apparel industry in Dongguan and aluminum products in Fushan. At the core hub of the Pearl River Delta, SMEs in Guangdong have formed industry value chains with global competitiveness on cost and technology.

2. **Institutional development:** Despite the importance the SME sector and apparent need for their financings, the SME financings in Guangdong province is relative not maturely developed. For example, Guangdong is largest province in terms of GDP, accounting for 11% of the national total (and 8% larger than the 2nd Jiangsu). But ithad small loan receivables of only Rmb24bn as of Sep-2012,one-quarter of Jiangsu's and was only 5% of the national total. The Guangdong's pawn loan receivables were also around 5% of China's total, much less than the province's economic significance.

3. **Government policies:**The local government is relatively prudent in approving small loan and pawn loan licenses. The first small loan license was granted in 2009, which is after most of other provinces. As of Sep-2012, the province only had 219 small loan companies, represented less than 4% of national total.

Regional development: Chongqing

1. **Economic and SME profile:** Chongqing situates in middle-west of China. It is a water, land and air transportation hub with well-established infrastructures and energy supply. Chongqing is one of the traditional industrial centers in China, which was known for its machinery, metallurgy, textiles food and chemicals. Its GDP growth in 2012 ranked the second among all provinces in China.

   Over 99% of the total companies in Chongqing are SMEs contribute 41.3% of the local GDP. High-tech products comprised of 22.7% of the total output value of these SMEs. The Chongqing government intends to nurture the high-tech industry by encouraging SME finance. According to the guidance from SMEs IT committee, several of investment and financing channels in R&D investments are guided to achieve a 20% annual growth rate during the 12th FYP, 90% of which should come from private finance. Chongqing, having a large SME sector and a proactive government, is positioned as a centre for SME financings in the western part of China.

2. **Institutional development:**The non-bank financing industry in Chongqing is thriving. Although its GDP is only 2% of national total, its balance of small loan companies was close to 5% of China. The financial guarantee industry in Chongqing is also blossoming. The guaranteed principal grew nearly 100% annually in 2011 and 2012, with only 137 guarantee companies by Mar-2012 compared to > 6000 nationally. Among them, some are strong players and have already expanded outside Chongqing. Hanhua Guarantee, for example, is based in Chongqing but has already obtained financial guarantee licenses in 12 other cities and provinces such as Beijing and Jiangsu. The province welcomes investment and fully ownership of small loan companies by foreign institutions. For example Temasek and Credit China (8207.HK) has obtained small loan license in Chongqing as the first step in penetrating into the inner China.

3. **Government policies:** The Chongqing government has been proactively aiding SMEs. It encourages the setup of new small loan companies, especially by foreign and reputable entities. Temasek, for example, was granted a small loan license in Chongqing in 2011. Besides, the local government is also proactive in lining up financings for small loan companies such as to provide them additional fund for expansion.

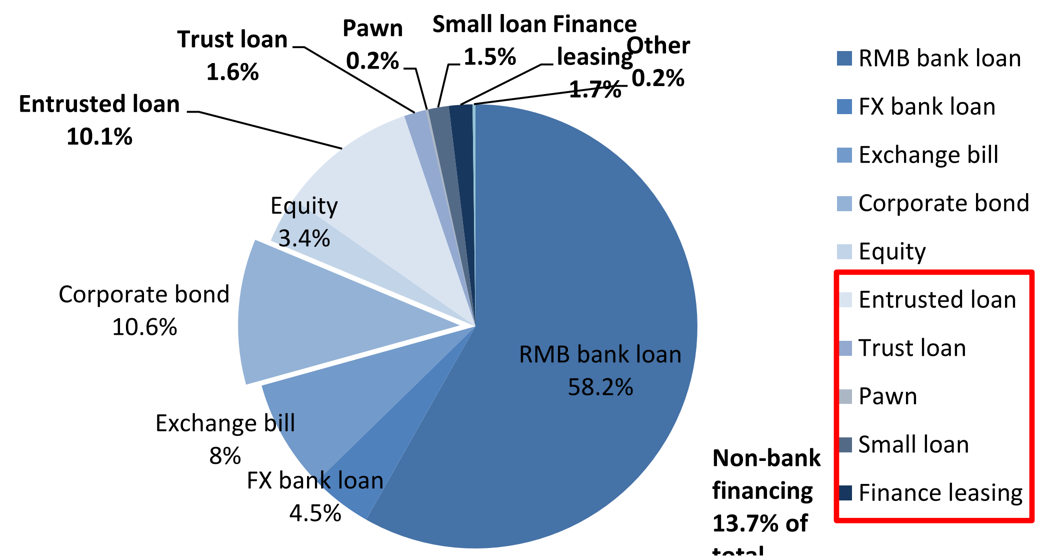
Forward looking: Opportunities and risks

This section aims to provide our view on the size of non-bank finance sector in China, and also its growth, opportunities and risks to investors. We will also offer a forecast of growth rate for each subsector of those financing channels for 2012-2016, in regard to their institutional characteristics and current development. While SME loan extended by commercial banks will continue to grow a higher pace than average, that of non-bank channels will likely outperform, in our view. Regulatory risk is the chief risk to concern, followed by NPL. This sector will likely provide huge opportunities to investors who follow a robust risk management and fully understand the regulatory trend.

Small but growing size of non-bank financing in China

Non-bank financing channels include entrusted loan, pawn loan, small loan, finance leasing[3]. Note that not all of them are exclusive for SMEs. Entrusted loan, for example, is also a common channel of lending among large enterprises. Nevertheless, we estimated that the CAGR for new loan from the above non-bank channels grew at 32.8% during 2008-2012, far exceeding new RMB bank loan growth of 13.7% and total social finance of 22.6% during the period.

Exhibit 31.: Total social financing by channels (2011)



Source: WIND, PBOC, MOFCOM, CIRL

Note: Reported figures for bank loans, exchange bill, corporate bond, equity, trust loan; estimated figures for pawn, small loan and finance leasing; social finance under pawn and small loan channel could be underestimated due to quick turnaround during the period

The total size of non-bank financing has been increasing and reached 13.7% of total social financing in 2011, we estimate. The jump during 2011 was mainly due to

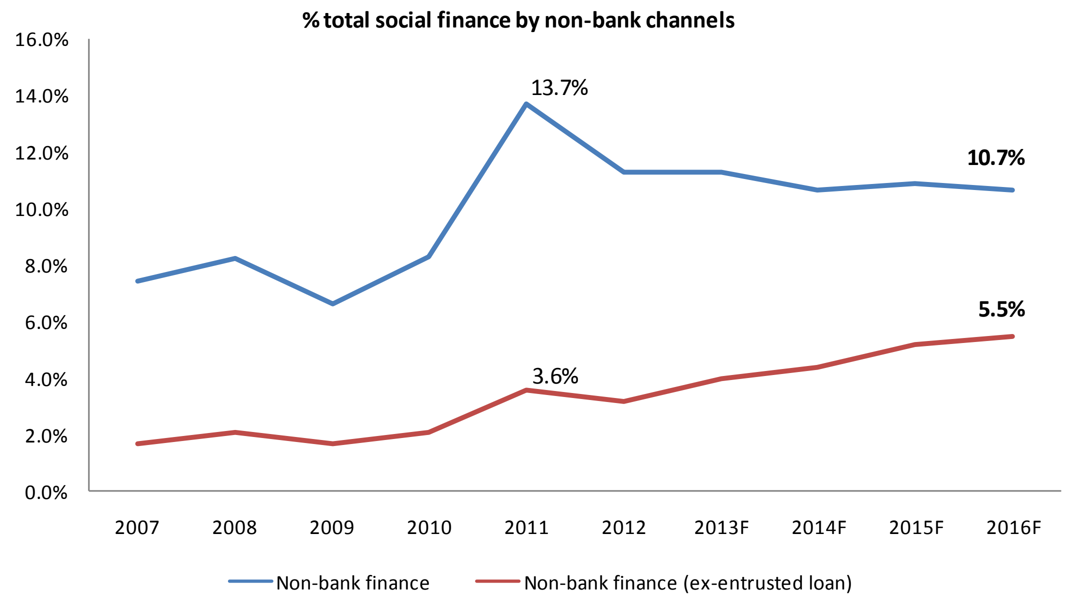
[3] Although bond, equity and trust loan are literately not a source of bank financing, we exclude here as we focus mainly on those relevant to SMEs

increase in entrusted loan under government's restriction on lending to property developers.

Recall that we have estimated there were funding gap of at least Rmb10 trillion for SMEs as of end-2011, which will grow in tandem with size of SMEs. This provides a huge room for non-bank financing channels which provided new finance of merely RMB1.8 trillion during 2011. Excluding entrusted loan, the sector provided only RMB0.5 trillion or 3.6% of total social finance.

We forecast that the non-bank channels for SMEs (small loan, pawn and finance leasing, entrust loan excluded) will take up 5.5% of total social finance in 2016, up from the estimated level of 3.2% in 2012. On the other hand, we expect entrusted loan may face certain regulatory pressure and therefore will see a smaller proportion coming forward.

Exhibit 32.: The proportion of social finance by non-bank channels *



Source: CIRL

** Note: Mainly comprises of entrusted loan, small loan, pawn loan, finance leasing. Calculated by deducting bank loans, exchange bill, bond, equity and trust loan from the total social financing figure, since they are less relevant to SMEs*

Growth forecast for sub-sectors

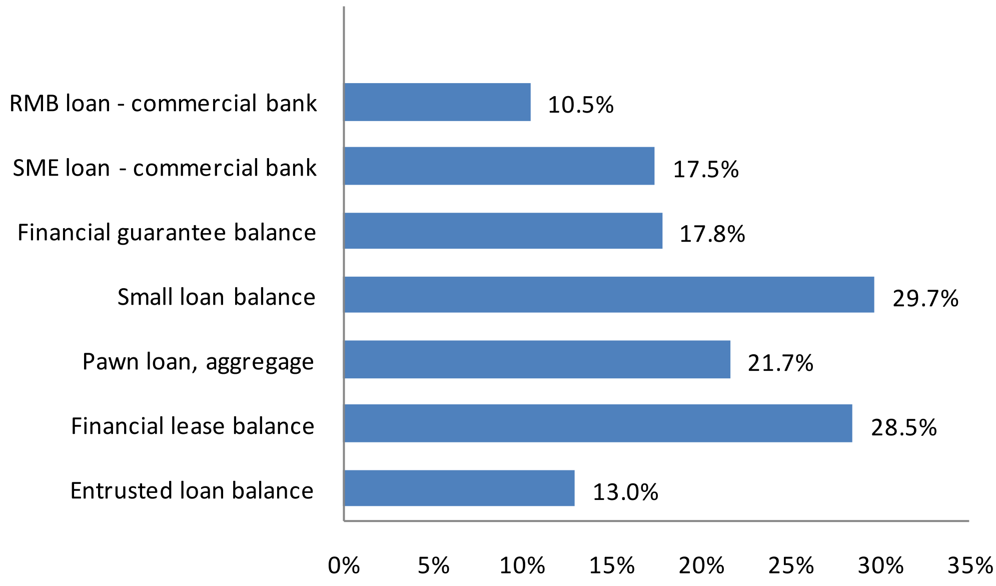
We believe the non-bank SME financing sector will achieve growth rate higher than overall RMB bank loan as well as SME loan by commercial banks. The top growth subsector, according to our forecast, is the small loan industry, with loan balance to grow by 29.7% CAGR from 2012-16.

Thanks to the low penetration rate and the relatively mature regulation in place, we expect the finance leasing industry will grow at 28.5%, the second fastest among all financing subsectors.

The pawn loan industry will have the aggregate balance increased by 21.7% during the period, we expect. The total size of small loan and pawn loan is expected to reach 2.5% of total RMB loan balance of commercial banks, up from merely 1.4% as at end-2012. This is still lower than other mature markets like Hong Kong, of which the combination of money lenders' loan (similar to small loan in China) and pawn loan together was equivalent to 4.3% of Hong Kong's total bank loan at end-2011.

Entrusted loan will still likely to outgrow China's overall loan growth, thanks for strong growth of SME loan. However, we expect the strong role of entrust loan will be diminished, as other non-bank financing channels are getting more well-developed, thus more loan will be provided under institutionalized platforms (e.g. small loan & pawn loan). For example, the average register capital of small loan and pawn loan companies have been increasing, which allows them provide larger amount of each loan to customers. Further, future regulation changes will likely lift the maximum leverage ratio for small loan companies. The entrusted loan channel, on the other hand, will be subject to tighter regulation, we expect.

Exhibit 33.: Expected annual growth rate of subsectors from 2012 to 2016



Source: CIRL

Key success factors

Although there are different frameworks of non-bank financing, most companies operate on multi-platforms: Possibly pawn license plus small loan, or small loan plus financial guarantee. No matter what the license or business model is, all successful ones are SME-centric, with the aim to provide flexible financing solution not available from commercial banks. Below are successful factors based on our interviews with various listed companies participated in the industry:

1. **SME-centric:** Commercial banks are constrained by its regulation and internal process that sometimes they are not in the best capacity to serve SMEs. SMEs are the first market segment that non-bank financing institutions ought to explore due to the large loan amount they usually require. Relatively, lending to SMEs is less costly than consumer individuals in terms on approval cost per dollar of loan. After all, there is clear demand for SME loan but not yet for consumer loan. As such, onesuccessful factor is their connection with local SMEs and ability to provide flexible solution to them.

2. **Financing:** Non-bank financing institutions have limited source of fund. Although they are allowed to take up leverage (borrow as much as 100% of their capital, for pawn loan companies for example), in reality most of them could hardly obtain bank loan. For example Goldbond (172.HK) and Credit China (8207.HK) are HK-listed with considerable track record, but they were only able to obtain minimal borrowing from banks. However, Credit China managed to issue two RMB bond in Hong Kong during 2011 and 2012, at coupon rate of 9% and 11% respectively, totaling RMB300mn. Nevertheless, UA Finance, under SHK Financials (86.HK) managed to obtain credit facilities of RMB3-4bn from commercial banks in China.

3. **Risk management:** For secured loan, appraisal collateral value and keeping a reasonable loan-to-value is important. For unsecured loan, diversification is the key. Some SME lenders are familiar with companies along the local supply-chain, such that any potential default can be early detected.

4. **Bad debt disposal:**SME lending is high risk in general. It is essential to be able to dispose collaterals of bad debts efficiently with low cost. The failure of which may lead to loan loss and inefficient fund usage. Credit China (8207.HK) has agreement with a shareholder which promised purchase of debts and collaterals if borrowers fail to pay back. Due to its low loan-to-value ratio implemented, there is still lucrative margin for the shareholder when bad debt is purchased and subsequently resold.

Grey areas, improper practices, and potential policy risks

The non-bank financing industry is still in infant stage. It is still loosely regulated. Apart from accepting deposits which are heavily cracked down by the authorities, there are some grey areas and improper practices:

1. **Charging above the interest rate cap:** Current maximum interest rate allowed is 4 times the PBOC rate (i.e. currently 5.6% x 4 = 22.4%). Usually lenders charge higher interest rate at the name of administrative fee. For example, Credit China (8207.HK) expressed that their monthly effective rate is around 3.5% which is close to 40% annually. Some may also deduct interest fee upfront, which is not allowed under the regulation.

2. **Extending loan above limits** There are regulatory limits regarding total loan relative to registered capital, i.e. two times under pawn loan companies and 1.5 time under small loan companies. When exceed the limit, many industry players may provide entrust loan to customers via related companies and obtain collaterals in the same way as pawn loan. While essentially this is pawn loaning business, it become outside the balance sheet of pawn loan companies. Also, small loan companies may use the same way to circumvent regulatory cap on single-party loan (i.e. loan to single borrower not more than 5% of registered capital).

3. **Improper sale of foreclosed collaterals:** According to the relevant regulation on pawn loan activities, foreclosed collaterals should be sold via public auction, and any amount exceeds the loan balance should be paid back to the borrower. In reality, some pawn loan companies only invite a few connected parties to those auctions and thus selling prices are usually low.

   There are chances that regulatory changes may adversely impact the business of non-bank lending: For example, the CBRC may restrict entrust loan activities, or MOFCOM may strictly require pawn shop to lend within 2 times of registered capital. However, we are in the view that the chance for an aggressive clampdown is slim:

1. Entrusted loan have been in practice since 2000 and so far there is no policy debate on significant revision;

2. Non-bank financing institutions received much policy support especially in local level after SME’s liquidity crunch in 2010, we do not see an urgent need for industry consolidation except some degree needed in the financial guarantee industry

3. Currently, the urgent need for policy address should be trust loan (loan provided by trust companies, which are of large amount and most often goes to property development projects or local government financing platforms) and credit risk from wealth management products sold to the public.

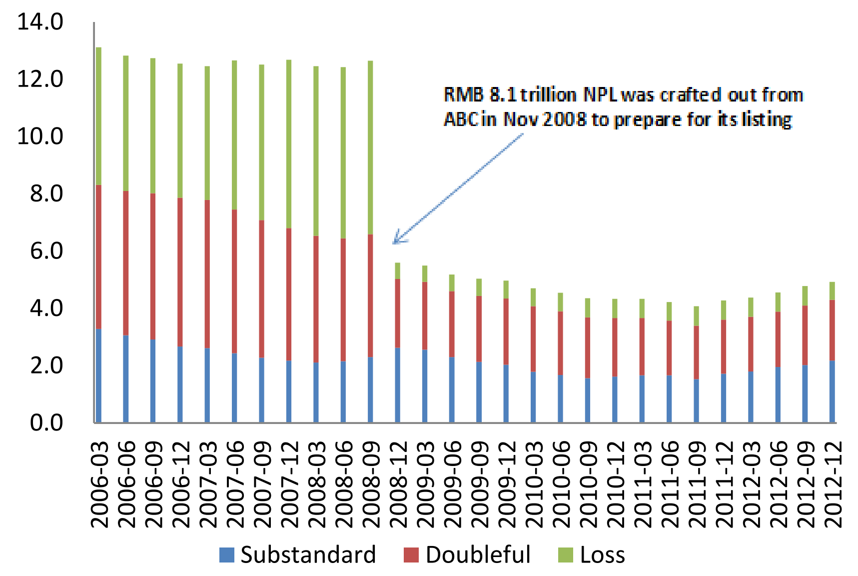
Risks of bad debt

1. **Deterioration of the property market:** The non-bank financing industry is sensitive to cycles and government policies of the property market. A considerable portion of their loans are granted to low-tier developers who have limited access to the official loan market. In addition, collaterals are usually real estates. Fortunately, major participants in the industry we interviewed stress the importance of keeping a low loan-to-value ratio, maximum at 40-50%.

2. **Widespread default of SMEs:** SMEs are more prone to internal and external economic cycles, and banks prefer to lend to large enterprises during economic downturn when credit risk is high. However, usually SMEs would choose to payback costly loans than bank loans which are of lower interest. Furthermore, collaterals are usually resold with deep discount in the case of default, such that SMEs would try to avoid by any mean. In most cases, when SMEs obtain new loan from banks, they choose to first pay off non-bank borrowings. Thus, many non-bank financing institutions expressed to us that their loan quality also depends on banks liquidity condition.

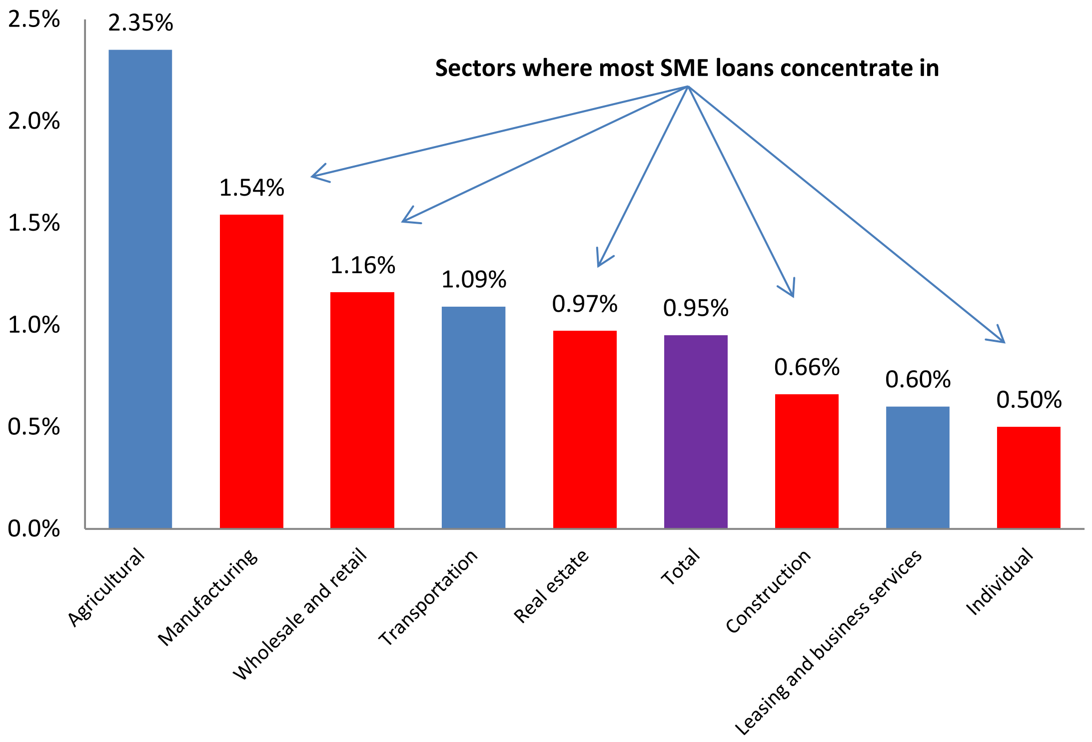
3. **NPLs of commercial banks seem stable across the cycles:** Let alone the craft-out of NPL from Agriculture Bank of China, NPLs in China are stable across the cycle. It is, however, showing a sign of uptrend in recent quarters. Looking at the breakdown, the sector of highest NPL seems to be agriculture and manufacturing. SMEs which form the major customers of non-bank financing institutions are usually belong to the subgroup of manufacturing, wholesale and retail, real estate and individual.

Exhibit 34.: NPL trend since 2006 (in RMB trillion)



Source: PBOC, CIRL

Exhibit 35.: NPL breakdown by sectors (Dec-2011)



Source: PBOC, CIRL

Appendix: Listed comparables

Credit China (8207.HK)

1. **Shanghai-based SME lender:** Listed in 2010, Credit China was the first non-bank financing institution went for listing in Hong Kong. It is based in Shanghai and focuses in SMEs with average loan size around RMB5-8mn.

2. **Most lending provided via entrusted loan channel:** Credit China's pawn loan license in Shanghai has registered capital of RMB100mn, which can provide maximum single loan of RMB25mn loan and total loan of RMB200mn. Focusing in real estate collateralized SME loans, most loan provided to customers are conducted via entrusted loan channel. Credit China expressed that ~25% of business are referred from banks, in which clients are in need of urgent fund that banks are not able to immediately satisfy.

3. **Relatively robust risk management:** Credit China accepts only real estate collaterals in the heart of the Shanghai and Chongqing city. According to the company experience, it is able to resell foreclosed real estate collaterals within 2-3 month, and historically recorded no loan loss. It strictly maintains a loan-to-value ratio of no more than 40%, which provides sufficient cushion for property price fluctuations.

4. **Managed to refinance via equity and bond:**It managed to raise new equity fund of approximately HK$160mn and HK$190mn in Jun-2011 and Dec-2012 respectively, through its listed platform. Moreover, it has also raised RMB offshore bond of RMB100mn, RMB200mn and RMB50mn in Sep-2011, Sep-2012 and Dec-2012 respectively. It helped the company to grow its loan portfolio from RMB303mn by end-2010 to RMB797 by Jun-2012.

Goldbond (172.HK)

1. **Hong Kong's first listed pawn loan provider**: It acquired a pawn loan business in 2004 and subsequently transformed from a security brokerage into a finance provider and extended its business into financial guarantee and finance leasing. In October 2011, Hony Capital, the largest private equity fund in China, invested in the pawn and financial guarantee subsidiaries of Goldbond. Currently, Goldbond owns 40% of the pawn and financial guarantee business and 100% of the finance leasing and small loan business.

2. **Extensive network, diversified business:** Through its associates and subsidiaries, Goldbond operates in varies 2nd-tier cities such as Wuhan, Changsha, Chongqing, Chengdu and Hangzhou. Apart from local pawn loans on

personal belongings, it also provides vehicle mortgage, unsecured lending, private equity lending, property development loan, finance leasing and financial guarantee. Yet, its loan portfolio is still highly concentrated in a few large-sum loans.

3. **Concern on loan quality and risk management:** Goldbond's has participated in several block loans that turned out to be past due and impaired. A loan of RMB100mn was granted to a Wuhan borrower in 2010 and turned out past due for longer than 6 months and the company encountered difficulties in selling the collaterized land right. Another case occurred in 2011 when a HK$60mn property development loan in Zhuhai became defaulted. Furthermore, we notice that certain loans were granted directly by the listed company instead of via its licensed financing subsidies. By March 2011 when the company last report its fully consolidated balance sheet, 43% of the total HK$1.1bn loan were past due and not impaired (afterwards part of its business became associates).

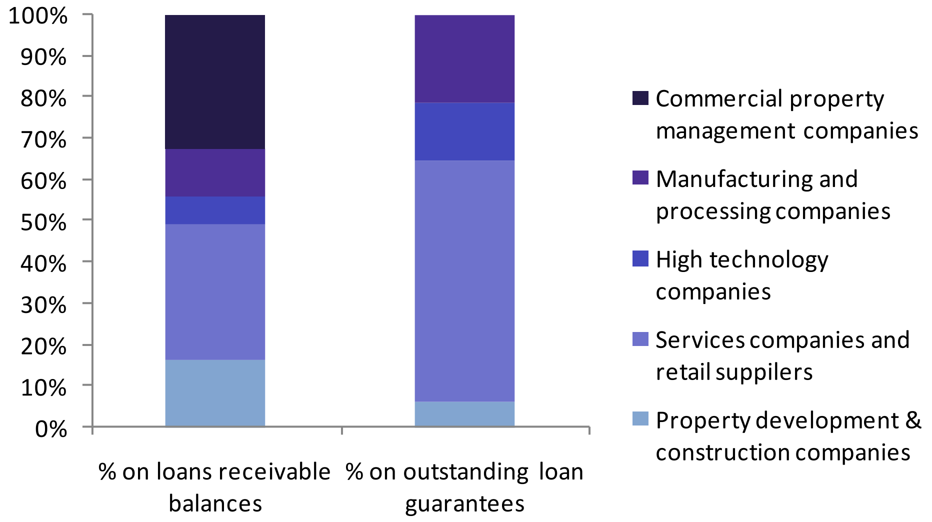
4. **Settling in low ROE:** Goldbond's ROE was 9% in FY10 (year-ended March), 5% in FY11 and negative in FY12 (stripping off the one-off gain in assets sale). Also, Goldbond has lent HK$570mn (by end-Sep 2012) to its 40%-owned associated company, majority of which earns only 3-5% fixed interest per annum. Despite having a long track record of listing, the low valuation of Goldbond can be attributed to the inefficient usage of fund and subdued holding structure.

China Financial Services (605.HK)

1. **Beijing-based pawn loan and guarantee company:** China Financial Services (CFS) previously focus in the retailing business with more than 170 convenience stores in Beijing. It bought pawn loan and guarantee companies from its shareholders in 2011. It had loan receivables and guaranteed balance equivalent to HK$1bn and HK$71mn respectively by end-2012.

2. **SME focused, leveraging on its retail expertise:** The small loan company is located near Zhongguanchuan (中關村) which is the top technology industrial zone in Beijing. CFS aims to provide loan to SMEs in that region which are mostly startups with little banks borrowing record. It also provide working capital loan and financial guarantee services to retail industry by leveraging on its vast convenience store network in the city.

Exhibit 36.: NPL breakdown by sectors (Jun-2012)



Source: Company, CIRL

3. **Collaterals may face liquidity problem in selling off:** Unlike Credit China, CFS accepts wide range of collaterals such as quadrangle (四合院, the traditional Beijing house), raw materials and antique. Intrinsic value is hard to identify and the company may face difficulties in reselling. Though management expressed they have expertise in those products, the company needs time to demonstrate its risk management capacity. Further, its policy on maximum loan-to-value ratio is 60%, higher than 50% that Credit China upholds.

Far East Horizon (3360.HK)

1. **A major independent finance leasing company focused in 7 industries:**Listed in March 2011, Far East Horizon (FEH) is the second largest independent finance leasing company in China (2010), focusing in 7 industries: Healthcare, education, construction, printing, shipping, machinery and textiles.

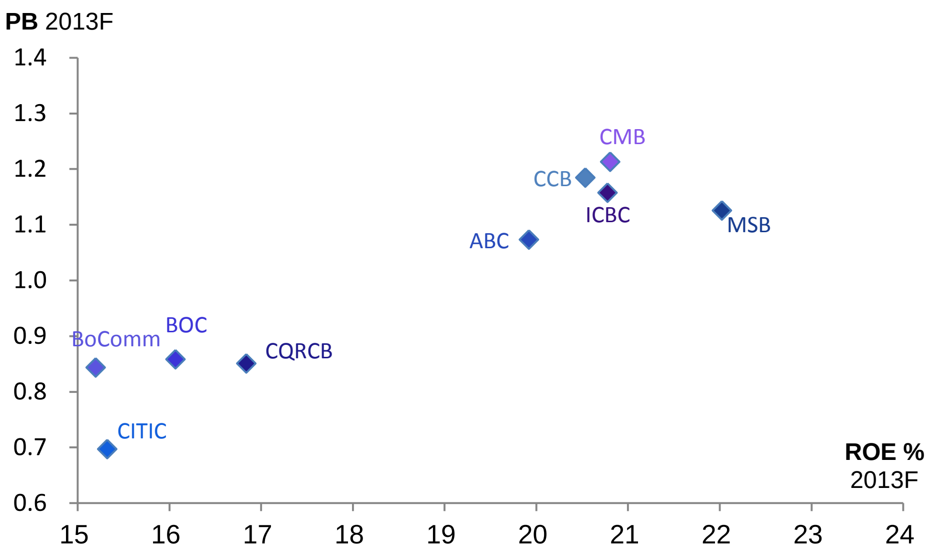
2. **Sizable value-added service to earn non-interest income and differentiate from banks:** FEH has over 100 stuffs in each industry focus and half of them are industry specialist prior to joining the company. This distinguishes from the practice of other financial institutions that segregate departments by product (i.e. retail vs. commercial banking).They are not only “relationship managers” but also industry specialists. Since finance leasing involves equipment purchases, staff must be familiar with the market and functions of each component and attend exhibitions to establish industry networks. As a result, each team is familiar with the value chain of its industry and provides value-added services to SMEs. Non-interest income from providing services such asprocurement and disposal of equipment, introducing customers, and equipment trading accounted for 37% of its income in 2011.

3. **Diversified source of funding:**FEH has strong funding base, which is an advantage compared to other non-bank lending institutions. It is one of the first leasing companies in China accessed to the bond market. In May 2012, it issued a 3-year bond of RMB1.25bn at annual interest rate of 3.9%, lower than the PBOC 3-year benchmark lending rate of 4.15% at that time. It also secured syndicate loan led by China Development Bank who utilizes FEH as a channel to fulfill their SME mandate.

Valuation approaches

1. **ROE and PB approach is the fundamental factor for relatively mature financial institutions:** Taking reference from China banks, valuation is positively related to their respective ROE. This is on the rationale that banks derive their income from loan portfolio, which is restricted by the capital base. The better ability to earn from equity, the higher valuation a bank should deserve.

Exhibit 37.: China banks: PB vs. ROE (2013F)



Source: Bloomberg, CIRL

Note: Closing price as of 29 April 2013

2. **PE approach as the second approach to derive valuation:**For financing institutionswithout leveraging or not yet fully utilized the financial resources, the PE approach is an attempt to factor-in both the existing earning ability as well as the projected growth. If earning can be significantly enhanced without injecting extra equity, or if those companies derive much income from non-interest sources which are unrelated to loan book, PE approach seems to be a preferred way.

3. **Difference in valuation explained.** Far East Horizon (3360.HK) is better valued with PB approach, as its loan growth is restricted by the size of its equity (leverage ratio of finance leasing company must not be higher than 10x), and it has strong source of borrowing to support its loan growth. Although it has superior ROE and ROA, it is trading at relatively low PB possibility due to the recent offloading of shares by its major shareholder (i.e. ChinaChem) which resulted in investors' concerns on the continuality of funding and business support from the shareholder.

   Smaller players who have good strengths could command a higher valuation. For example, Credit China (8207.HK)is a niche player in the SME loan market in Shanghai. It has proven good internal system to contain credit risks and a certain track record after its listing in Hong Kong. Goldbond (172.HK), however, has low ROE and poor risk management record. Therefore, it is trading at a low valuation in terms of PB.

Exhibit 38.: China lending financials valuation

	bloomberg code	Mkt Cap (HKD mn)	Price (HKD)	PER (x) FY11A	PER (x) FY12A	PER (x) FY13E	P/B (x) FY11A	P/B (x) FY12A	P/B (x) FY13E	ROE (%) FY12A	ROA (%) FY12A
Company name											
FAR EAST HORIZON	3360 HK	17,219	5.23	10.2	8.7	7.1	1.3	1.1	1.0	17.1	2.9
SUN HUNG KAI CO	86 HK	11,618	5.45	11.2	10.5	8.8	1.0	0.8	0.8	8.8	4.4
CREDIT CHINA HOL	8207 HK	1,696	0.71	8.5	-	6.9	1.8	1.6	1.4	27.3	15.5
CHINA FINANCIAL	605 HK	1,972	0.64	11.2	-	9.1	3.0	-	1.0	5.0	N/A
GOLDBOND GROUP H	172 HK	769	0.28	11.9	-	-	0.5	-	-	4.6	N/A
FLYING FINANCIAL	8030 HK	541	0.53	9.3	-	-	2.5	-	-	28.8	N/A
Average				**10.6**	**9.6**	**8.0**	**1.5**	**1.2**	**1.1**	**12.6**	**7.6**
IND & COMM BK-H	1398 HK	1,810,880	5.42	7.5	6.5	6.0	1.6	1.4	1.2	23.4	1.4
CHINA CONST BA-H	939 HK	1,606,865	6.45	7.9	6.7	6.2	1.6	1.4	1.2	22.4	1.5
CHINA MERCH BK-H	3968 HK	333,471	16.16	8.0	6.6	6.3	1.7	1.4	1.2	24.2	1.4
BANK OF CHINA-H	3988 HK	1,006,809	3.59	6.6	6.1	5.6	1.1	1.0	0.9	18.2	1.1
AGRICULTURAL-H	1288 HK	1,107,921	3.64	8.0	6.4	5.8	1.5	1.2	1.1	20.5	1.2
BANK OF COMMUN-H	3328 HK	442,407	6.10	6.2	5.9	5.9	1.1	1.0	0.8	20.5	1.1
CHINA CITIC BK-H	998 HK	235,242	4.28	75.1	4.8	4.8	19.9	0.8	0.7	20.9	1.1
CHINA MINSHENG-H	1988 HK	335,868	9.79	171.7	6.0	5.5	45.5	1.3	1.1	23.9	1.4
CHONGQING RURA-H	3618 HK	38,874	4.18	7.5	6.1	5.4	1.1	1.0	0.9	16.9	1.4
Average				**7.4**	**6.1**	**5.7**	**1.4**	**1.2**	**1.0**	**21.2**	**1.3**

Source: Bloomberg, CIRL

Note: Closing price as of 29 April 2013

Analyst Certification

I, Antony Cheng, Research Director of Cinda International Research Ltd., hereby certify that all of the views expressed in this report accurately reflect our personal views about the subject company or companies and its or their securities. I also certify that no part of our compensation was / were, is / are or will be directly or indirectly, related to the specific recommendations or views expressed in this report / note.

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