Analysis of the Problem of the Interest Transfer in the Process of Back-door Listing

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Abstract. Back-door listing could quickly promote the market resources' integrating. Meanwhile, it not only helps the shell resource companies avoid the risk of delisting, but also provides a rapid expansion channel for the back-door companies. The concentration of ownership of listed companies in China leads to the frequent interest transmission of the controlling shareholders after the back-door listing. Based on the Jumpcan Pharmaceutical back-door listing, this paper analyzes the "tunneling" behavior that the major shareholders encroach on the interests of small and medium shareholders by transferring the company property and profits, so as to achieve the interest transmission. Besides, this paper puts forward some suggestions to ameliorate the company's equity structure, strictly supervise the asset appraisal institutions, and improve the pricing mechanism as well as control the dividends of back-door listing etc.

Keywords: Back-door listing, interest transmission, ownership dilution.

1. Introduction

In recent years, with the rapid development of various transaction forms, interest transmission has become an important way for large shareholders to embezzle the assets of small and medium shareholders, and operators to encroach the owners' equity. It has also become one of the main modes that reflect the conflicts between the controlling shareholders and small and medium shareholders. It is the key point of modern corporate managements. In China's characteristic capital market of "emerging + transition", owing to the dominant status of big shareholders, the administrative monopoly of the system for IPO and listing on stock markets and the imperfection of relevant laws and regulations, the situation that the big shareholders take the advantage of their rights of control to infringe the interests of listed companies has been pervasive. On this basis, the revised opinions on "the management measures of momentous assets reorganization of listed companies" issued by the CSRC in 2016 mainly regulated the controlling shareholders' cashing out and speculating in back-door listing. In 2017, detailed regulations on the implementation of private issuing of stock were also issued to regularize the large shareholders' behaviors when they choose to issue stocks at a low level so as to encroach on the interests of small and medium-sized shareholders. While due to the diversity of interest transmission channels and the inherent hysteresis of laws and regulations, the legislation could only alleviate the tunneling behavior of big shareholders to a certain extent, but cannot eradicate this problem.

2. The Background of the Cases

2.1 The Introduction of the Two Parties of Back-Door Listing

2.1.1 The Back-Door Side

Jumpcan Pharmaceutical Group Co., Ltd (hereinafter referred to as Jumpcan Pharmaceutical) was established in Taixing, Jiangsu province in 1994. It is a traditional Chinese medicine manufacturing enterprise with the registered capital of 30 million yuan. It has in total 172 drug approval numbers, and the drugs involved could be classified into 12 categories, including heat-clearing and detoxifying drugs, digestive system drugs, and pediatric drugs. In recent years, thanks to the support of national policies for the traditional Chinese medicine and the popularity of concept of Chinese medicine health care, Jumpcan Pharmaceutical has achieved rapid growth. In 2011 and 2012 China Pharmaceutical Industry Top 100 list jointly issued by the Southern Medicine Economic Research Institute and the

Pharmaceutical Economic Newspaper of the State Food and Drug Administration, Jumpcan Pharmaceutica ranked 34th and 32nd respectively.

2.1.2 The Shell Sources Side

In 1996, Hubei Hongcheng General Machinery Co., LTD. (hereinafter referred to as hongcheng co., LTD.) was established by Hubei Shashi general valve factory with a history of more than 50 years. On January 22, 1997, it was officially registered in Hubei Administration for Industry and Commerce, with a registered capital of 66.308 million yuan. On July 13, 2001, China securities regulatory commission to issue 44,000,000 RMB ordinary shares (A-share) to the public for the first time approved the company, including 40 million new shares and 4 million state-owned shares, with a stock price of 7.80 yuan per share. In addition, it was listed on the Shanghai stock exchange on August 22, 2001.

2.2 Back-door Schemes and Processes

2.2.1 Asset Replacement and Evaluation Plan

Hongcheng co., LTD. would replace all the assets and liabilities owned by it as of May 31, 2013, which is the base date of the proposed assets evaluation, with equivalent part of the injected assets held by Jumpcan Pharmaceutical. The sold-out assets shall be undertaken by the restructuring party or its designated subject.

According to the appraisal report issued by Hubei Zhonglian Commentary Report of Zhonglian Evaluation [2013] No. 05, as of the base date of assets evaluation, the appraisal value of the proposed assets is 603,607,200 yuan. According to the appraisal report [2013] Hu No.368 issued by Yinxin Commentary Report, the appraisal value of the assets to be injected as of the base date of appraisal is 5,600,150,000 yuan. Based on the report of the evaluation authority, the two parties reached an agreement to carry out replacement according to the evaluation scheme. The value-added ratio of Jumpcan Pharmaceuticall is 509.56%, while that of Hongcheng co., LTD. is 29.25%.

Table 1. Asset replacement evaluation scheme

Evaluation object	Evaluation method	Book value	Evaluation value	Value-added ratio
Hongcheng co., LTD.	Asset-based approach	467,003,600 yuan	603,607,200 yuan	29.25%
Jumpcan Pharmaceutical	Income approach	918,720,400 yuan	5,600,150,000 yuan	509.56%

Data sources: Abstract of the major restructuring report of Hongcheng co., LTD. on August 3, 2013

2.2.2 Pricing Method and Price of the Shares in Issue

On August 3, 2013, Hongcheng co., LTD., which had suspended for two months, released the restructuring plan. After the agreement was reached by the two parties, according to pre-arranged planning, Hongcheng co., LTD. intended to purchase the difference between the value of its holding proposed assets above the value of the sold-out assets from Jumpcan Pharmaceutical, namely 4,996,542,800 yuan. The price of the issued shares was the average trading price of Hongcheng co., LTD. on the 20 trading days before the pricing benchmark date, which was 8.18 yuan / share (after the restoration of rights). The number of shares issued was 610,820,000 shares, and the purchasing party undertook that the lock-up period shall be within 36 months from the date of registration to its securities account. The specific distribution target and amount are shown in the table below.

Table 2. Issuing object and amount of Hongcheng co., LTD.

Issuing object	Issuing amount(share)
Jumpcan holding	516,757,360
Cao Longxiang	46,448,458
Zhou Guodi	21,440,299
Huajin Jitian	13,961,698
Hengchuan Investment	12,216,486
Amount in total	610,824,301

Data sources: Abstract of the major restructuring report of Hongcheng co., LTD. on August 3, 2013

2.2.3 Distribution of a Large Amount of Cash Dividend

At the end of 2013, Jumpcan Pharmaceutical conducted the back-door listing and achieved a high proportion of dividend policy in the following three years. In 2014, a cash dividend of 4.0 yuan was distributed for every 10 shares, and a total of 312,581,800 yuan of cash dividends was distributed. In 2015, a cash dividend of 7.00 yuan was distributed for every 10 shares with a perpendicular rise, and a dividend of 547,081,300 yuan was distributed. In 2016, there was a slight increase than the previous dividend scheme, with a cash dividend of 7.30 yuan for every 10 shares, and a cash dividend of 591,025,500 yuan for shareholders.

Table 3. Dividend scheme after back-door listing of Jumpcan Pharmaceutical

Dividend year	Dividend scheme	Date of record	Base date of ex-right
2016	7.3 yuan for every 10 shares	20170427	20170428
2015	7 yuan for every 10 shares	20160419	20160420
2014	4 yuan for every 10 shares	20150403	20150407

2.2.4 Assets Undertaking and Major Shareholders Reduction of Shares

2.2.4.1 Assets Undertaking

On August 3, 2013, Hongcheng stock issued an announcement of major assets reconstructing, which illustrated that the assets to be sold out by the listed company shall be undertaken by the reconstructing party or its designated subject. That is to say, after the replacement of assets was carried out by Jumpcan Pharmaceutical and Hongcheng co., LTD., Jumpcan Pharmaceutical would decide to whom it shall hand over the assets of Hongcheng that was worth 600 million. In December 2013, Hongcheng co., LTD. issued an announcement stating that Jumpcan Pharmaceutical and Hongcheng co., LTD. largest shareholder Hongtai Real Estate had negotiated and reached an agreement on this proposed asset undertaking. Namely, after the completion of the reconstruction, the reconstruction party would transfer the sold-out assets to Hongtai Real Estate for free, or Hongtai Real Estate would directly undertake from Hongcheng co., LTD. according to the actual situation at the time of delivery of the sold-out assets. In order to implement the reconstruction, Hongtai Real Estate established a wholly-owned subsidiary Hubei Hongcheng General Machinery Co., Ltd. with the assets it undertook.

2.2.4.2 Major Shareholders Reduction of Shares

Jumpcan Pharmaceutical, as a typical traditional Chinese medicine manufacturing enterprise, has achieved a total net profit of 3.5 billion yuan and a total capital expenditure of 1.3 billion yuan since its listing. Compared with its own revenue, the cost of the company is not high. Correspondingly, although the company has been listed for only four years, its cumulative dividend has exceeded 1.4 billion yuan. The cost of Jumpcan Pharmaceutical is not so high compared with its revenue, and there is a large amount of capital to pay dividends; however, it has carried out three times of equity financing, including two private placement and one convertible bond, in the four years since its listing. The aggregate accumulative amount raised has reached 3.324 billion yuan. It implements the policy of high dividend at the same time of a large-scale refinancing policy.

Table 4. List of private placements after back-door listing of Jumpcan Pharmaceutical

Issuing date	Issuing object	Number of shares (10,100 shares)	Restricted stock trade period
February 11, 2014	Hwabao turst limited liability company	800.00	12 months
	China life insurance asset management company limited	800.00	12 months
	China merchants funds management company limited	800.00	12 months
	Aegon-industrial fund management company limited	843.00	12 months
May 12, 2016	Golden eagle fund management company limited	2,850,877	12 months
	Anxin fund management company limited	2,850,877	12 months
	Guangfa qianhe investment company limited	4,385,964	12 months
	Guangxi railway development investment fund	2,850,877	12 months
	Southwest securities company limited	2,850,877	12 months
	Penghua fund management company limited	67,519,736	12 months
	China fortune securities company limited	74,860,090	12 months

As a medium-sized listed company with a market value of 30 billion, the daily stock volume of the company is only 33 million shares, with a turnover rate of 0.41%. Such volume of transaction is obviously insufficient for the attractiveness of a large capital. Due to the restrictions on the matching fund raising during the listing of the backdoor, the actual controller of the company, Cao Longxiang family, held 79.86% of shares at the initial stage of listing, and the excessive shareholding ratio of the largest shareholder limited the involvement of institutional funds. In 2014 and 2016, Jumpcan Pharmaceutical carried out two rounds of additional issue. In the two rounds of issuance, the major shareholders did not subscribe, and the shareholding ratio was diluted to 73.77%.

In December 2017, Zhou Guodi, one of the major shareholders of the company who acted in concert, once again announced that she would sell 21.44 million shares of the company, which was 2.65% of the company's total share. This happened after the limited sale period when Zhou Guodi used centralized bidding and block trading to reduce the holding of 2.65% shares.

3. Results Analysis of Jumpcan Pharmaceutical Back-Door Listing

3.1 The Minority Shareholders' Stock Equity is Diluted

The shareholding structure has undergone significant changes, after Hongcheng co., LTD.'s asset replacement, issuance of shares to purchase assets, and the non-public issuing shares to raise matching funds for transaction. Before the transaction, Hongtai Real Estate was the controlling shareholder of Hongcheng co., LTD. After the transaction, Jumpcan Holdings held 68.99% of Hongcheng's total share capital, and the total shareholding ratio of Jumpcan Holdings and its persons acting in concert was 79.69%. Jumpcan Holdings was the controlling shareholder of the company, whereas Cao Longxiang was the actual controller of the company. The equity of small and medium shareholders was diluted from 79.34% to 14.64%. The change of ownership structure is shown in the following table.

Table 5. List of changes of Hongcheng co., LTD. ownership structure after back-door restructuring

Name of shareholder	Before the transaction		Nature of shareholders	After the transaction(before raising matching funds)	
	Number of shares (share)	Proportion (%)		Number of shares (share)	Proportion (%))
Jumpcan shares	-	-	The transaction side	516,757,360	68.99
Cao Longxiang	-	-		46,448,458	6.20
Zhou Guodi	-	-		21,440,299	2.86
Huajin Jitian	-	-		13,961,698	1.86
Hengchuan Investment	-	-		12,216,486	1.63
Hengtai Real Estate	28,549,358	20.66	Original shareholders	28,549,358	3.81
Other public shareholders	109,651,042	79.34		109,651,042	14.64
Amount in total	138,200,400	100.00	Amount in total	749,024,701	100.00

Data sources: According to the arrangement of 2013 Hongcheng Co., Ltd. announcement

3.2 Large Shareholders Benefit from the Rising Stock Price

Figure 1. Change of monthly K chart of Jumpcan Pharmaceutical's stock price before and after back-door listing

As can be visually seen from figure 1, after the release of the back-door restructuring plan on August 3, 2013, the stock price has risen all the way. Before the sale of Hongcheng shells, the performance was sluggish, and the earnings were very little. The stock price was around 8 yuan. Hongcheng co., LTD. has once announced asset restructuring, and the stocks have been suspended. Meanwhile, the company announced the plan to sell the assets of the casting department for 60 million yuan, and planned to issue non-public shares. However, then on December 20, Hongcheng co., LTD. once again announced that during the suspension period, the company demonstrated the non-public offering of shares and believed that the opportunity was not yet mature and decided to cease planning the matter. Small and medium-sized shareholders hoped to improve the company's performance by reconstructing, but it failed. Therefore, Hongcheng co., LTD. immediately fell staying on December 20 after the resumption of trading. It also fell by 9.95% and 7.24% in the following two days.

Although the undistributed profits caused by the poor business performance in the past two years are not many, the total shareholding ratio of social shareholders accounted for 79.34%, which can effectively keep the interests transfer of major shareholders within limits, and the overall funds allocated to small and medium-sized shareholders account for the majority of profits.

After the backdoor listing, Hongcheng co., LTD. carried out asset replacement. After a series of operations, its main business was transformed from the manufacturing of hydraulic machinery and valve manufacturing to the manufacture of Chinese patent medicine. With the country’s favorable policies for the pharmaceutical industry, the new listed company’s operating income increased, and shock prices rose. However, after the shell sale, the small and medium-sized shareholders’ equity of the original Hongcheng co., LTD. was diluted to only 14%. Such a good profit did not greatly improve the interests of minority shareholders, and most of the funds were returned to the pockets of the majority shareholders.

4. Case Enlightenment and Suggestions

4.1 Case Enlightenment

Back-door listing, to some extent, integrates market resources. It not only injects new power into the listed companies that are about to be delisted, saving the company’s operating conditions, but also enables back-door companies to realize capitalization of securities, which expands financing and booms enterprise development. At the same time, back-door listing can activate the transaction of the capital market and promote the maturity and vigorous development of the capital market. In other words, the purpose of selling the shell of Hongcheng co., LTD. is to free the company from the bottleneck period, and to maximize the effectiveness of the business integration of the listed Jumpcan Pharmaceutical, while Jumpcan Pharmaceutical can use the listing of the company to improve its growth, profitability and security. However, subject to the maturity and market sentiment of A-shares, the major shareholders of Jumpcan Pharmaceutical and Hongcheng co., LTD., like some listed companies, shared the benefits brought by the capital market, and at the same time, ignored the interests of small and medium-sized investors, and transferred to their own interests by hidden means. As a result, it is essential to continuously strengthen the capital constraints and market constraints of listed companies.

4.2 Relevant Suggestions

4.2.1 Improving the Company’S Equity Structure

After the back-door listing of Jumpcan Pharmaceutical, the shareholding ratio of the first majority shareholder and its person acting in concert was as high as 79.69%. Other social shareholders could not influence the major resolutions of the listed company. Over time, the participation of small and medium-sized shareholders might be discouraged, which made the major shareholders more “dominant and arbitrary”. Therefore, under the conditions allowed by the market environment, it is of benefit to optimize the equity structure of listed companies and establish a relatively concentrated equity structure, in which the company is jointly controlled by multiple substantial shareholders. In terms of policy, the equity structure of the company dominated by state-owned shares should be changed. A moderately concentrated relatively taking control ownership structure is more conducive to giving full play to the enthusiasm of all parties, so that all parties can share the benefits. It can also to a certain extent impose restrictions on the phenomenon that the benefit transfer of large shareholders encroaches on the interests of minority stockholders.

4.2.2 Strict Management of Asset Assessment Agencies

When it comes to the domestic evaluation agencies, the good and the bad are intermingled, and there is not a completely unified standard in the whole evaluation industry. Different institutions may have different judgments on the same object, and the evaluation methods that they adopt are also different, among which there is no lack of changes in the evaluation methods to create benefits for substantial shareholders. For the assessment results with a relatively high premium rate, the relevant regulatory authorities ought to require the assessment agencies to make a corresponding promise in detail or reissue an assessment report on the authenticity of the assessment results. Once the assessment results are found to be fabricate, the regulatory authorities should severely punish the relevant assessment agencies. In serious cases, the relevant business licenses should be revoked. In addition, the regulatory department may require the evaluation agency to track the financial status of listed companies. If the assessed asset is greatly different from the appraisal in actual operation, the corresponding evaluation agencies can be required to bear jointly liabilities. Such being the case, the independence of the evaluation agency might be increased to a certain degree.

4.2.3 Improving the Pricing and Lottery Mechanism

According to the latest implementation rules of non-public placement issued by the CSRC (China Securities Regulatory Commission) in 2017, the revised implementation rules emphasize much more the binding effects of market pricing. Although the new rules limit the choice of the base date, the 10% discount rule still exists for private placement. The price of private placement refers to the stock price of the 20 trading days before the base date, and it does not exclude substantial shareholders from choosing private placement at a low price or suppressing the stock price for additional issue, so as to achieve the purpose of “less money and more shares”. In this regard, the author suggests that relevant departments are supposed to compare the trend of the company’s stock price with the index when examining and verifying the additional issuance. They might as well cancel the issuance qualification for those who seriously manipulate the stock price.

4.2.4 Controlling the Back-Door Listing Dividends

After the backdoor listing of Jumpcan Pharmaceutical, the dividend per share increased from 0.01 to 0.7, which was far above the industry average, and the major shareholders made a remarkable profit from it. As the substantial shareholders’ shares are still in the lockup period after the back-door listing of the proposed side, they cannot obtain benefits through the secondary stock circulation market. Hence, they tend to use large amounts of cash. They might use the highly concentrated equity to obtain cash. As a result, the regulatory authorities may issue a law restricting the dividend policy of the back-door listing, and formulate the rigid requirements for the cash dividends of the listed companies, under the specific circumstances of the listed companies. Private placement listed companies that meet the requirements for cash dividends should timely disclose information and accept the supervision of the masses of investors.

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