

# Chinese Equities and Corporate Governance Issues

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Poor corporate governance and/or fraud occur in all countries, both in developed and emerging markets. Global investors have lost a great deal of money in previous high-profile stock market scams. Notable frauds in the past 25 years include ZZZZ Best Inc. (1986), Centennial Technologies Inc. (1996), Bre-X Minerals (1997), Enron (2001), WorldCom (2002), Tyco International (2002), HealthSouth (2003), and Bernie Madoff (2008).

Within the universe of Chinese equities, lax corporate governance standards and/or fraud has been a major theme this year, highlighted by dozens of North American-listed companies whose share prices have plunged due to inadequate accounting principles and financial reporting, among other things. One Toronto-listed firm, Sino-Forest (TRE CN), saw nearly 80% of its value wiped out in a matter of days following fraud allegations by Muddy Waters Research and it is reported that John Paulson suffered a loss of more than US\$500 million. The most notorious fraud cases have involved reverse mergers in North America, although other incidents have occurred to a lesser extent on other exchanges where Chinese companies are listed.

## Made in China — Packaged for Foreign Investors

In the December 1999 issue of *The Gloom, Boom & Doom Report* I wrote that China's private sector had just been given an official stamp of approval by the Communist government earlier that year at the 9th National People's Congress. That landmark event was very important because the private sector was emerging as an important alternative to the state sector as an engine for growth and employment. Although the private sector finally got "equal treatment", Beijing continues to have

a strong bias of allocating capital to the state sector (via equity, debt, and bank loans) instead of the private sector. New listings on China's domestic exchanges in Shanghai and Shenzhen have pre-dominantly been reserved for state-owned enterprises, although this changed somewhat in June 2010 with the launch of a dedicated new trading platform in Shenzhen to support growing venture enterprises.

Without adequate fund-raising channels on the mainland, private firms in China have been forced to seek funds from overseas stock markets starting around 2000. The Chinese government actually allowed and encouraged private enterprises to list on stock markets all over the world as part of an experiment. Competition over the years for listings has been very keen and today you can find hundreds, if not thousands, of Chinese companies listed on numerous exchanges globally. Hong Kong has been the top pick among entrepreneurs given its

proximity and prestige factor. Many small and relatively large well-connected private enterprises have for years found a welcome home here to raise equity capital to grow their businesses. Some companies chose Singapore where the listing requirements are more lenient. We estimate that there are now approximately 6,300 companies listed worldwide that we consider greater China-related stocks (including Taiwan), and approximately two-thirds of these are listed outside of the mainland. We expect this number to increase more than 30% in three years to a staggering 8,300 companies. (See [Table 2], showing the investment universe of greater China-related equities.)

## The Rise and Fall of the Chinese Reverse Merger

Hundreds of Chinese companies have listed in the US via reverse mergers (also known as backdoor listings) since 2005. In this process and with the help of an unregulated advisor/

Table 2 Greater China-related Equities Investment Universe

	October 2011	October 2014
Hong Kong Main Board – including H shares and Red Chips	1,359	1,752
Hong Kong Growth Enterprise Market	60	85
Shanghai A-Share	905	1,230
Shanghai B-Share	53	53
Shenzhen A-Share	1,338	1,760
Shenzhen B-Share	53	53
Taiwan Main Board	743	830
Taiwan Gre Tai Exchange	573	680
Singapore	324	465
Other Asia	312	450
US & Canada	480	730
London	75	124
Other Europe	42	88
Total	6,317	8,300

Source: Pacific Sun estimates

promoter, a private Chinese company merges with a U.S. publicly traded shell company, many of which are found on less regulated exchanges such as the Pink Sheets, the OTC Bulletin Board or NYSE Amex. This allows the company to become public without the scrutiny of a proper initial public offering. The group then takes private investments from early-stage investors and sometimes it moves on to bigger US exchanges. Once there, it sells more shares allowing the founders and early stage investors to cash out. Niche investment banks that have been active the past few years at this later fund-raising stage include Roth Capital, Rodman & Renshaw, and Brean Murray, among others.

The depth and quality of American equity markets has been ideal for young companies to raise capital from institutional and retail investors by way of reverse mergers in addition to the more traditional IPO route. Two other means of raising capital, namely PIPEs (Private Investments in Public Equity) and SPACs (Specified Purpose Acquisition Companies), were also popular until a few years ago, but still remain viable, high-risk fund-raising alternatives.

Problems that arise from the reverse merger model are rooted at the early stage of development. Unregulated advisors/promoters are given a high degree of leeway to basically “create” a new company with sometimes questionable operating businesses. To illustrate and in an extreme case, a promoter persuades Company A to list in the US via a shell company and in doing so persuades it to compensate him/her with shares (often free) and/or options. The promoter proceeds to complete the necessary documentation. In addition the advisor/promoter packages the business, creates an interesting new name — say China Super Duper Energy (you get the picture) — and produces state-of-the-art marketing materials inclusive of overly bullish and often unrealistic financial projections. Once the company’s reverse merger process is completed,

the promoter will also, either directly or through an investor relations firm (sometimes inter-related), e-mail blast prospective investors with press releases with often meaningless information, in order to hype up the company, much like a pump and dump operation. Early shareholders then exit as new investors buy shares. The unregulated advisor/promoter thus has a huge undertaking in the entire reverse merger process, although their role is not required to be included in corporate filings.

Over the past year, dozens of small Chinese companies listed in the US and Canada have been accused by their auditors and short sellers of having lied to investors and misrepresented the true extent of their businesses. As a result, tens of billions of dollars in market capitalization have been erased as companies have had auditors resign and shares delisted. While some Chinese companies and deal promoters have reaped handsome gains, foreign investors, both institutional and retail, have gotten killed. The Bloomberg Chinese Reverse Mergers Index is down 60% year to date and 70% from its high in January 2010. (See [Figure 11], showing the Bloomberg Chinese Reverse Mergers Index, which tracks Chinese-based companies that trade on US exchanges following reverse mergers.)

Companies that have suffered with inadequate corporate governance controls and/or frauds include Agria Corp. (GRO US), Yuhe International (YUHE US), Sinotech Energy (CTE US), ShengdaTech (SDTHQ US), Duoyuan Printing (DYNP US), China-Biotics (CHBT US), China Sky One Medical (CSKI US), Jiangbo Pharmaceutical (JGBO US), and Rino International (RINO US). Shares in Sino-Forest remain suspended as Canadian regulators investigate whether company executives have misrepresented revenue in public filings and kept bogus accounts.

Facing an outcry from investors, the SEC has this year begun looking at some of these companies as well as their network of auditors and middleman who marketed them to the public. The SEC has been hampered by a lack of cooperation from regulators in China. In August 2010 a *Barron’s* study on Chinese reverse mergers found that “these companies fall between the cracks of market regulation”. Basically many parties, not just the advisors/promoters, are to blame for the meteoric rise and epic collapse of the Chinese reverse merger bubble.

Deals from one particular Shanghai/Southern California-based advisor/promoter all seemed to follow the same pattern, namely the shares

Figure 11 **Bloomberg Chinese Reverse Mergers Index, 2009 to the Present**



Source: Bloomberg

lose almost all of their value and become worthless penny stocks. Previous deals included Legend Media (LEGE US), Perfectenergy (PFGY US), Pure Biofuels (PBOF US), and Stratos Renewable Corp. (SRNW US). Other deals include VLOV (VLOV US), China Green Materials (CAGM US), NF Energy Savings Corp. (NFEC US), Nutrastar (NUIN US), and Weikang Biotech (WKBT US).

Companies that have raised funds via the proper IPO route have also had serious corporate governance issues. Shares of NYSE-listed software company Longtop, which has an impressive list of major institutional investors thanks to a couple of fund offerings since 2007 led by Goldman Sachs, Deutsche Bank, and Morgan Stanley, have plummeted 99% since May after accusations by its auditor of “very serious defects”, including faking its bank accounts.

The negative sentiment has even hurt the normally buoyant internet-related stocks, such as China’s leading search engine Baidu.com (BIDU US) and Sina (SINA US), the operator of the country’s Twitter-like messaging service. Shares of these companies corrected 30–50% during the last two weeks in September over concerns that Chinese regulators were considering amending the “variable interest entities” structure which uses a series of contractual agreements to allow an offshore holding company owned by foreign investors to effectively run a business inside China, according to *The Asian Wall Street Journal*. This structure is used by most US-listed Chinese companies.

### **Fraudulent Chinese Companies Listed in Asia**

A handful of Chinese companies listed on Asian stock markets have also had their fair share of corporate governance and fraud issues, albeit to a lesser degree. Many cases have seemingly occurred in Singapore given the island nation’s aggressive pursuit of Chinese companies and relatively easier listing requirements. Companies that have had issues include China Aviation Oil (CAO

SP), Sunshine Holdings (SUNS SP), China Milk (CMILK SP), and Sino-Environment Technology Group (SINE SP). In 2008, Sino-Environment sold US\$109 million worth of convertible bonds with the help of Morgan Stanley to a group of well-known lenders. Its share price fell over 90% in the next year, while the company not only defaulted on its bonds but was put under investigation by the Monetary Authority of Singapore, after the company’s auditors Price Waterhouse Coopers said they could not verify the whereabouts of approximately US\$85 million of the company’s cash. Shares in Sino-Environment were subsequently suspended from trading in September 2009 and delisted.

In Hong Kong, fraud has also occurred. As I wrote in the August 2003 issue of *The Gloom, Boom & Doom Report*, a company called Euro-Asia was one of the highest-profile corruption cases. The former chairman, Yang Bin, was eventually arrested and sentenced to 18 years in prison for serious commercial crimes. Listed in July 2001, investors lost all of their money by the end of 2002. It was found that his company “was experiencing serious financial difficulties, much of which was related to his large array of unlisted businesses in China.... The company had exaggerated its revenue 21-fold for the four years to listing and it had RMB2.1 billion in income between 1998 and 2001 but tax authorities found it was less than RMB100 million.”

A more recent potential fraud company involves Chaoda (682 HK). On September 26 a company called Anonymous Analytics (www.anonanalytics.com) issued a scathing, yet well-documented report entitled “Chaoda Modern Agriculture — 11 Years of Deceit and Corporate Fraud”. In the report the anonymous publishers detail how Chaoda “has an extensive history of deceiving investors and shareholders” and that “since the IPO there were several resignations of auditors, executives, and directors”. It went on to add that the company went through “several

rounds of financing ... because Chaoda is overstating its cash balance, exaggerating its revenue, and falsifying its financial statements”. Other misdeeds were mentioned. It is alleged that Chairman Kwok Ho was using a company majority owned by him called Fujian Fertilizer as the exclusive manufacturer and supplier of fertilizer to Chaoda, and that this was a front to siphon money Chaoda had raised over the years.

Other notable and possibly fraudulent companies listed in Hong Kong, both proven and pending, include Tack Fat Holdings (928 HK), Zhongwang (1333 HK), China Forestry (930 HK), Real Gold Mining (246 HK), and Sino-Forest subsidiary Greenheart Group (94 HK). US private equity group Carlyle is the biggest foreign investor in China Forestry, an operator of mainland plantations whose shares have been suspended since January 2011 after its CEO was arrested for embezzlement. Real Gold’s shares were suspended from trading in May after the *South China Morning Post* reported that the miner had filed one set of accounts with the Hong Kong Stock Exchange and a different one with China’s central government. Its auditor resigned on October 13. Citibank assisted on three share placements for the company since February 2009.

### **As Contrarian As It Gets**

For many investors, Chinese equities are a no go. One friend who has invested in Chinese stocks for years (mainly in US-listed companies) commented to me a couple of months ago that he “will never invest in a Chinese company again and neither will any of my friends”. Naturally, his stance is quite understandable given the pain many investors have suffered because of malpractice. However, put into proper context, could the high-profile shenanigans regarding fraudulent behavior be a buy signal for investors to invest in Chinese small and mid cap stocks? After all, the overall universe of investible securities is growing quickly and, as pointed out earlier, there will likely

be more than 8,000 greater China-related companies listed worldwide in the next three years. Taiwan will have approximately 1,500 of those listed companies by that time and, by most accounts, corporate governance standards of Taiwanese companies are excellent, they pay dividends, and many of them have extremely profitable operations on the mainland.

The markets seem to be pricing in a very worst-case scenario for Chinese small and mid cap stocks. However, investors should note that not all of the fraud allegations are true and/or may be overstated. In fact, after Moody's Investors Service produced a red flag report in July that warned investors about accounting and governance risks at dozens of small Chinese companies, many of the companies came back and correctly proved that some of the details were factually incorrect. In addition, it has become a bit of a fad to produce a negative research report with an aim to profit from a short position on a Chinese company (this may become a bubble itself) and people that do such activities may have short investment careers.

The majority of Chinese companies listed overseas are fundamentally sound, even if they sometimes fall short of US disclosure and corporate governance standards. Also, with the improving oversight by regulators there are reasons to believe that the quality of investible companies will increase going forward. When dealing with reverse merger companies, it is highly recommended that the use, involvement, and details of advisors/promoters be disclosed in corporate filings and that they are required to become regulated, even if their head office is in China.

The Chinese government also realizes that it needs to do more to

support its many millions of entrepreneurs and emerging enterprises, as they are the future of China's economy. Recent measures taken by Beijing to help cash-strapped private businesses are a positive sign, as witnessed in some parts of eastern China when the State Council unveiled tax breaks and financial support for small businesses. The announcement followed a visit by Premier Wen Jiabao to Wenzhou city in Zhejiang province amid reports of surging bankruptcies among private companies unable to repay debt to so-called underground lenders.

### **Chinese Equity Market Cycles — Fast and Furious**

There have been five major market cycles since I moved to Asia in January 1990. Each time the major Chinese indices nearly halved on average and it took about 12-1/2 months for markets to recover to previous levels. The five major cycles included China's major austerity program (1993-1994), the Hong Kong handover hangover/Asian crisis double whammy (1997-1998), the bursting of the global technology bubble (2001-2002), SARS (2003), and the global financial crisis (2008-2009).

The sixth major market cycle may already be in the works as a result of a possible double dip global recession and European sovereign debt issues. Major Chinese indices are down around 30% since they last hit highs at the end of 2010. However, share prices of greater China-related small and mid cap stocks have already corrected between 50-75% since that time.

In my 20 or so years of living and investing in greater China, pessimism is probably at its highest level; and partially as a consequence, extreme value has emerged. Exposed frauds are

exposing excellent investment opportunities in other companies that operate in similar sectors. Take the case of Chaoda. Since that company listed in January 2000 we have been suspicious of the company's good standing due to corporate governance concerns and constant fund-raising exercises. However, we were able to take advantage of the situation by buying a similar company on the cheap called China Green Holdings (904 HK) at its IPO in January 2004 at HK\$1.28 and selling a large amount of shares in May 2008 at over HK\$10, a gain of more than 7x over four years.

The prolonged sell down of greater China-related small and mid cap stocks because of corporate governance concerns and external global macro issues has pushed down valuations to extremely low levels. Our short list of 100 greater China-related stocks now trade at about 5x next year's earnings, are projected to grow 30% CAGR three years forward, and pay a yield of about 5%. There may be some more downside in the next few months as China's economy is expected to slow; but from a contrarian's view, getting exposure sooner rather than later to this growing, emerging asset class may be a shrewd investment decision. We are on the lookout for companies that are geared to the Chinese consumer, that pay dividends, that have good corporate governance practices, and whose insiders are net buyers of shares.

#### **Pacific Sun Greater China Equities Fund**

The Pacific Sun Greater China Equities Fund invests primarily in Asia-listed greater China-related small and mid cap stocks and is now available for professional investors. For further information, please contact Pacific Sun Advisors' Founder and CEO Andy Mantel at [andymantel@pacificsun.com.hk](mailto:andymantel@pacificsun.com.hk).

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