DECEMBER 2013

CORPORATE FINANCE PRACTICE

How they fell: The collapse of Chinese cross-border listings

As the China–US IPO pipeline restarts, recent history offers lessons for companies, investors, and regulators.

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Amid the frenzy around Twitter's $1.8 billion IPO on November 7, it would have been easy to miss a pair of small Chinese IPOs in New York a week earlier. Qunar, the Chinese travel-booking service, raised $167 million on November 1, with share prices rising 89 percent above the initial offering. The day before, 58.com—a Chinese version of Craigslist—raised $187 million, exceeding the initial offering by 47 percent.

Do these IPOs—and three others this year—mark a broader return of Chinese cross-border listings in the United States? It's too early to tell; after all, Qunar's listing was the second from a reputable company in a well-understood industry.[1] And 58.com fit neatly into the sweet spot of US tech-industry analysts. These are among the first major Chinese listings in the United States after more than 100 Chinese companies were delisted or suspended from trading on the New York Stock Exchange in 2011 and 2012 as a result of fraud and accounting scandals. The fallout of that episode, which destroyed more than $40 billion in value, continues to reverberate through the investment community and in subsequent lawsuits.

Cross-border listings play an increasingly important and valuable role for companies and investors in an ever-more-global economy—and they do promote the mobility of capital, competition between exchanges, and greater strategic flexibility for companies. But if they are picking up again, understanding the episode and its lessons is important for both executives and investors if we are to avoid a repeat.

The story behind the story

Many observers at the time viewed the massive loss of value as a simple story: the companies never should have listed in the United States in the first place, and investors were drunk on China's vigorous growth during the early years of the new millennium.

The real story was more complex. Primary responsibility falls on the companies whose malfeasance precipitated such a strong reaction from investors. Yet in many ways, the process also got ahead of itself: companies and their managers were ill prepared to meet the expectations of foreign markets, and the infrastructure was unprepared to supervise cross-border listings adequately. Even in the 1990s, such listings were mostly limited to a few accidents of corporate history, where a company had roots in more than one region. As the stock exchanges consolidated and sought global scale, companies found themselves able to choose overseas exchanges based on the characteristics of the market, the availability of capital, and the sophistication of investors. Regulators were—and still are—structurally incapable of enforcing policy across borders. And investors themselves were unaware of the fragility and weakness of their protections in cross-border listings.

Three waves of listings

When Chinese companies began to list in the United States, they came in three waves between 1990 and 2010. The first arrived in the 1990s, after privatization and at the direction of Chinese regulators, who recognized that the largest and most prestigious Chinese companies would benefit from the capital and governance standards that nascent domestic markets could not provide. Their hope was that listing in Hong Kong or New York would compel the companies' transition from government departments into fully functional corporations—by forming boards, imposing corporate-governance standards, and creating management infrastructure for statutory reporting, for example. New York at the time was the most highly regarded listing location, with the highest governance standards, and it conferred a stature befitting the companies to be listed.

The second wave of listings included more state-owned giants, as well as an increasing number of private companies, many from China's burgeoning technology sector, including Baidu, Tencent, and Youku. These companies felt that US

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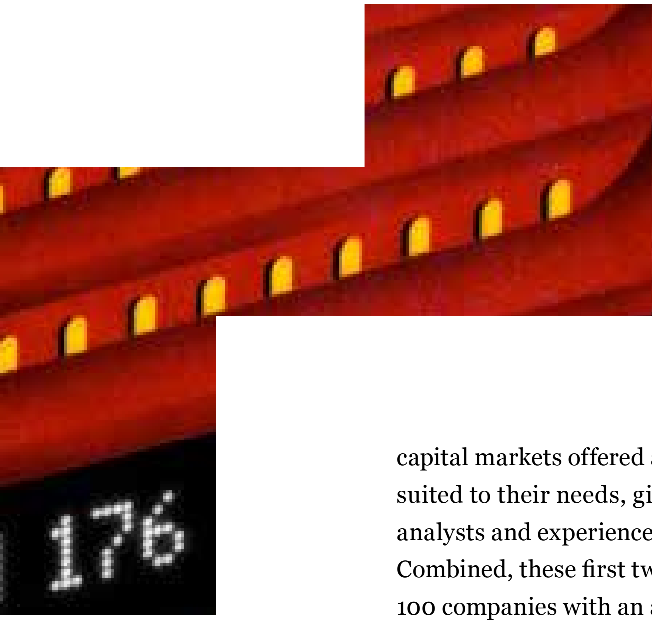


capital markets offered an environment best suited to their needs, given their concentration of analysts and experience with technology listings. Combined, these first two waves comprised around 100 companies with an average market capitalization of $24 billion as of 2013, representing 48 percent of the total value of Chinese companies listed in New York.

The third wave of listings was larger by number—around 500 companies—though the companies themselves were much smaller, with an average market cap of less than $5 billion. Unable or unwilling to compete for capital in the domestic stock markets with the larger private and state-owned enterprises, many of them looked instead to New York. There, they found ready access to US capital markets and investors who had grown comfortable with US-listed Chinese companies and had considerable appetite for the China growth story.

New York also still held the prestige and brand that had attracted the first wave of listings—and now there was an infrastructure in place to support these IPOs. All major US law firms and banks had a presence in China, as did a group of smaller advisory firms specializing in reverse-merger listings, where an unlisted company acquires a shell that is already listed and registered with the US Securities and Exchange Commission (SEC), bypassing the more rigorous scrutiny of a standard IPO. These tended to be much smaller: as the crisis hit, companies listed by reverse merger had an average market capitalization of only $68 million and represented less than 1 percent of total market capitalization of all New York–listed Chinese companies. As it would turn out, this 1 percent would cause a disproportionate amount of trouble.

The turning point

By early 2011, a series of scandals had developed around companies from the latest wave of listings. Many involved fraud with features that presented particular problems for investors. Almost all involved misrepresentations in financial reporting that would have been missed by a standard audit. Many involved falsification of the underlying documents on which audits relied, particularly commercial banks' transaction records. This could be detected by a fraud audit or detailed hands-on due diligence, but these are only conducted by exception.[2] And while fraud in the most egregious cases was more visible, such as false claims about customers or manufacturing facilities, it was not common for investors to perform this kind of diligence.[3]

Many of the scandals involved companies that had listed by reverse merger. By June, the SEC had issued an investor bulletin discussing the risks of reverse mergers,[4] citing six enforcement actions taken in the preceding months, all against Chinese companies. A mere three months later, the median New York–listed Chinese firm had already lost two-thirds of its value.

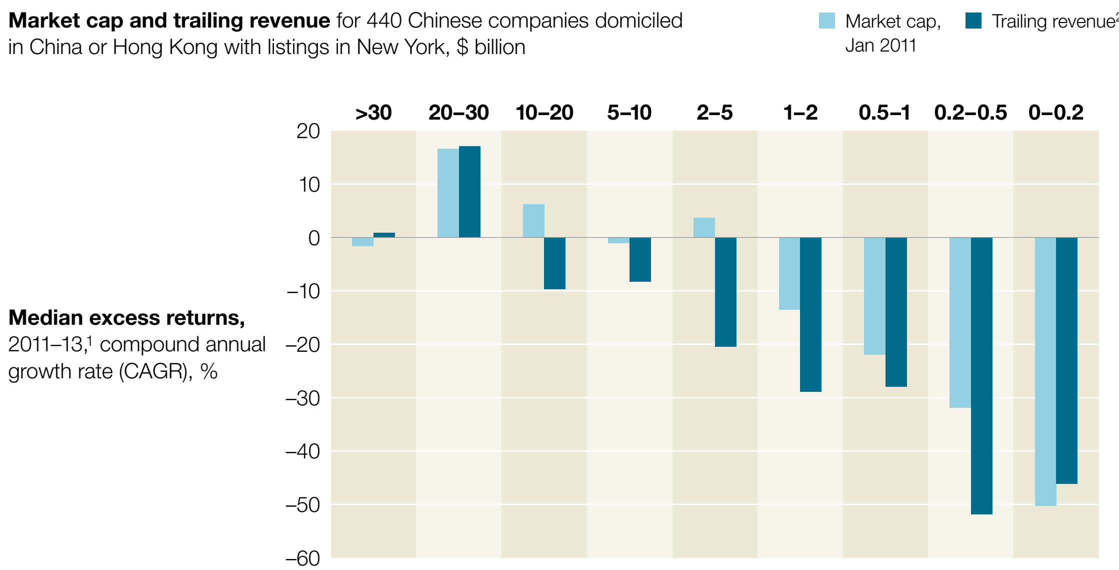
The market reacts

Many market observers—as well as the companies themselves—viewed the sell-off as an indiscriminate backlash by the market against any and all Chinese companies. In reality it

Exhibit

Shareholder returns fell less for large companies than smaller ones.

Market cap and trailing revenue for 440 Chinese companies domiciled in China or Hong Kong with listings in New York, $ billion



[1]CAGR excess return (total returns to shareholders) vis-à-vis returns of relevant sector index for Jan 2011 to Jan 2013.
[2]Latest available trailing 12-month revenue as of Jan 2013.

Source: Bloomberg; Thomson Reuters Datastream; McKinsey analysis

was anything but. Investors clearly distinguished between small and midcap companies—those with market capitalization below $200 million—and the larger, better-established ones, with market capitalization over $20 billion. Indeed, while median small and midcap companies underperformed the S&P 500 by 40 percent between 2011 and 2013, the median large-cap company *outperformed* the index by around 15 percent (exhibit).

Beyond size, other systematic factors such as industry or geographic revenue mix played almost no role in the change in valuations. Moreover, a number of companies performed significantly better or worse than their size would suggest, as investors differentiated among them based on concrete company-specific news, such as major acquisitions, credit downgrades, new-product launches, or patent approvals. In effect, the market decided that the size and reputation of the major companies was the only currency they would accept.

Chinese companies listed on other foreign exchanges were not immune. In spite of the preference for New York listings, many had also listed elsewhere. Of the 160 Chinese companies listed in Singapore, for example, nearly one in ten was delisted between 2011 and 2013, collectively valued at $27 billion, or around 5 percent of the exchange's capitalization.

Hong Kong was a notable exception. Mainland Chinese companies there represented 42 percent of the exchange's total capitalization, with an aggregate market capitalization of $1.1 trillion.[5] Yet the decline in Hong Kong's "red chips" was only 40 percent as big as that for US-listed mainland companies.[6] Why? First, reverse-merger listings are relatively uncommon there, with only one in the past five years, and so most companies go through the heightened scrutiny of an IPO. Second, the city's securities industry—including its brokerage, equity analysis, accounting, legal, and banking sectors—developed around listings from mainland China and has decades of experience in them. The investment community also has a much stronger network there and is better able than the US investment community to spot leading indicators of problems.

Regulators step in

Regulatory protections failed to prevent this crisis from happening, and once it happened, they failed to remedy it—though through no fault of their own. While the exchanges in question promptly suspended companies' listings when evidence of fraud emerged, US securities regulators could not themselves take action against the companies or their executives, whose assets were typically in mainland China. Suits against them would end up in Chinese court, where judgments would be hard to enforce.

Instead, regulators focused on the advisers who allegedly misled US investors—auditors in Hong Kong and the United States. Here, too, their hands were tied. Like most countries, China restricts provision of professional services to companies incorporated and licensed locally, which typically means that US-listed Chinese companies are audited by the Chinese subsidiaries of the Big Four US audit firms. These subsidiaries are licensed and supervised by the Chinese, not by a US-based accounting-oversight board whose authority doesn't extend to foreign audit firms. These subsidiaries resisted releasing their working papers for audits on delisted companies, maintaining that they were covered by China's extremely broad state-secrets laws.[7]

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They also asserted that Chinese regulators—who have long resisted any form of supervision by foreign regulators—instructed them not to cooperate and that doing so would invite severe criminal penalties.

In July 2013, China's regulators offered to release audit working papers to the SEC on a case-by-case basis. This is an improvement, but it's a small one. It enables the SEC to prosecute long after the event—and only after negotiating to get the materials it needs. It does not give the SEC any automatic rights to inspect the auditors' work, to take action against them without regulators' support, or to take effective legal action against the companies or their officers.

Companies react

In the aftermath, few companies saw their valuations recover quickly, despite efforts to convince investors of their honesty. Some tried to bolster their share prices with more frequent, more comprehensive investor communications, but no amount of communicating could assuage the market's wariness. Others explored bringing in a credible new strategic investor whose extensive diligence, managers hoped, would demonstrate reliability. One such deal was successful—Pearson's acquisition of Global Education and Technology—but other strategic investors remained largely aloof. Still others opted for take-private deals, announcing or completing 27 of them in 2012 and 12 through November 2013—though most were led by second-tier private-equity firms.

Comments from the Chinese executives of delisted companies are revealing. Even before the sell-off, many Chinese executives we spoke to felt US investors didn't understand them—they were too distant to fully grasp China's risks and opportunities. Others felt US investors' analysis was too colored by their familiarity with mature companies in the same sectors at home, where the drivers of growth and profitability were often radically different. After the sell-off, most also felt that, in retrospect, they as a group had been poorly prepared for listing in New York to begin with.[8] Many professed to have had little awareness of the regulatory burden it would carry or the challenges of investor relations in the face of a crisis.

Although most of the people we spoke to said their companies had no immediate need for fresh capital, all planned eventually to relist—preferably in China, either on Shanghai's A-share market or in Hong Kong if they needed foreign capital. This preference was partly economic, but they also felt that investors and analysts there would better understand and be able to value them. Many also expressed a desire to participate more closely in their home market and to see their successes enrich local investors rather than to be at the mercy of foreign investors.

Lessons learned

For such listings to work, there needs to be a regulatory framework that provides transparency and protects investors, a professional-services ecosystem that provides effective quality control for listings, and an investor base with the knowledge and capabilities to understand the businesses properly. If regulators and investors are serious about avoiding similar crises in the future—involving companies from China or elsewhere—there are several lessons to learn.

An equity market is more than just an exchange. Investors rely on a broad ecosystem of professional advisers, equity analysts, brokers, and regulators who perform quality control on the companies that list there. The dangers come when the ecosystem takes on issues that it is not prepared to evaluate. In the major global equity markets, investors take the high standards of this ecosystem for granted, when in fact relying on audited financials and company representations is insufficient in many markets.

The companies involved in this case happened to be Chinese, but the elements that led to fraud there are visible in many other emerging markets, as well as in some developed ones. The lack of quality control is especially concerning with regard to companies originally listed by reverse merger, since this route to market continues to be used. Indeed, on US exchanges, there have been nearly as many reverse mergers per year involving companies after January 2011 as in the preceding five years. That there were far fewer Chinese companies should give investors little reassurance. They need to be aware of the shortcomings of reporting and find ways to fill the gaps, whether through informal channels or through analysts doing investigative diligence.

Gaps in regulatory supervision must be closed. The SEC doesn't face a problem just with Chinese audit firms but potentially with any audit firm outside its regulatory purview. And the SEC is not the only regulatory agency facing this problem, since every other major capital market could face the same experience, particularly given the growing competition among stock exchanges.

To close the gap between US and Chinese regulations satisfactorily, the countries' two regulatory agencies must collaborate; both sides urgently need this to happen. The solution offered by the Chinese regulators falls far short of genuine cross-jurisdiction cooperation and to date has not been fully tested. Hence US investors are still forced to take on faith the content of audit reports, and neither they nor regulators have timely mechanisms to take action against frauds.

A company's choice of listing location must be more thoughtful. It's a strategic decision that most companies will only make once. They and their advisers must be less driven by emotive factors and prestige and more by economics and an appropriate fit between issuer and location. Although the top-tier equity markets are increasingly similar on liquidity, costs, and valuations, significant differences remain in specialization and ability to understand different types of companies. Just as expertise in mainland Chinese companies is disproportionately concentrated in Hong Kong, for example, Toronto has a concentration of experts in junior miners, London in large resource companies, and the United States in technology companies. US markets are still comfortable with larger and better-known Chinese companies, many of which are significant on a global level, but they are not confident with smaller, less-well-known ones, and valuations reflect this.

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Cross-border listings will continue to be valuable for companies, investors, and exchanges alike. The lesson of the Chinese delisting debacle is that each must be more circumspect in their approach and take concrete steps to avoid a repeat.

[1] Qunar's parent company, Baidu, has been listed in New York for several years and is extensively covered by US equity analysts.

[2] For a more detailed review of this, see David Cogman, "Due diligence in China: Art, science, and self-defense," *McKinsey Quarterly*, July 2013, mckinsey.com.

[3] These events spawned a small industry of analysts and investigators that do this kind of research: it is increasingly becoming a standard feature of diligence in China, even for public-market investors.

[4] See *Investor Bulletin: Reverse Mergers,* US Securities and Exchange Commission, June 9, 2011, sec.gov.

[5] H-shares—the Hong Kong listing of mainland-incorporated companies—account for around 21 percent of Hong Kong Stock Exchange capitalization. The red chips, or overseas-incorporated companies controlled by state-owned enterprises, account for an additional 20 percent.

[6] Calculated from median decline in P/E ratios in Hong Kong red chips versus US-listed Chinese companies.

[7] China's state-secrets laws cover an extremely broad range of economic information: this includes, for instance, the financial reports for key state-owned companies. While these laws tend to be used only for genuine secrets—nonpublic information with national-security implications—some have been prosecuted for releasing less sensitive information.

[8] The majority of delisted companies were, for legal reasons, unable to comment on their situation, and those still trading in the US were similarly unable to discuss their future plans openly.

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