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Reasons, Impacts, and Implications of the Delisting Wave of Mainland Chinese Enterprises Listed in U.S. Stock Markets

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Since 2011, a series of Mainland Chinese enterprises listed in U.S. exchanges have been suspended, delisted, privatized, or reverted to over-the-counter transactions. This phenomenon attracted wide-spread media attention, and the companies involved include Xinhua Sports and Entertainment, Shanda Interactive Entertainment, FunTalk, Jiangbo Medicine Group, China Security Surveillance Technology, and Shandong Yuhe Group. This paper analyzes the reasons and impacts of the delisting wave as well as its implications on Hong Kong's IPO capacities and the consolidation of the city's status as an international financial center.

The variety of factors that triggered the delisting wave

Since mainland enterprises started going public in overseas markets in early 1990's, the U.S. has been a main destination. There have been four episodes of IPO booms in America (see Table 1), with Internet companies such as Renren, NetQin, Jiayuan.com, and Qihu 360 Technology going public in the first half of 2011. The turning point was the second half of last year, when an increasing number of Chinese companies were delisted or privatized due to fraud litigations and short-selling pressure from institutional investors. According to Wind, 46 mainland enterprises listed in the U.S., or 17.9% of the total (see Table 2), have been delisted. In addition, data from Roth Capital Partners, Dealogic, and Thomson Reuters suggest that privatization by management, strategic buyers, and individual investors amounted to US$3.5 billion and that US$ 4.3 billion of potential deals are in the pipeline (compared with almost zero in 2010). In contrast, Chinese companies raised only US$2.2 billion in U.S. IPO's in 2011, representing an annual decline of 40%. This unprecedented wave of delisting appeared to be due to market conditions, inherent flaws of the listed entities, and speculation.

Table 1: Four episodes of IPO booms in America

Year	Representative companies	Remarks	
2000	Sina, Sohu, NetEase	Marked the beginning of the "Internet + China" concept in the U.S.	
		Number of IPO companies	Funds raised (in US$B)
2004	Shanda, The9	11	0.803
2007	Giant, LDK, Nepstar, Yingli	29	5.695
2010	Dangdang, Youku	34	3.6

Source: SEC, China Finance Online, BOCHK Research

Table 2: Chinese enterprises exiting the U.S. in 2011

	Number of companies	Percentage (%)
Delisted firms	46	17.9
Forced delisting	28	10.89
Privatization	6	
OTC transaction	1	
Bankruptcy	1	
Suspension	6	
Share price less than US$1	43	16.73
Share price less than US$2	92	35.8

Source: Wind, China Finance Online, BOCHK Research

Chinese-concept stocks entered a downward trend as China's economic growth slowed down. Since the second half of last year, as the European and American debt crises worsened and China's growth decelerated, problems related to local government debts, shadow banking, and SME's have become more severe. In equity markets in the mainland and Hong Kong last year, the Shanghai composite declined 21.68% while the Hang Seng index lost 20.0% (the Hang Seng China enterprises index dropped 21.7%). In the U.S. markets, the NASDAQ China index had declined 38% by the end of December from its peak. The USX China index lost 27% for the whole year, with 93% of Chinese companies in the red. In addition to investor concerns about China's slowing growth, the "China concept" might have created a bubble that would lead to corrections. (In general, American IPO's currently boast a PE of 15 times, yet 40% of IPO's of Chinese companies sport a PE of over 15 times.) On one hand, the rules of U.S. exchanges stipulate that companies with a share price below US$1 for 30 consecutive trading days would be delisted. On October 28th, 2011, China.com, the first U.S. listed Chinese Internet company, filed for bankruptcy after 12 years as a public entity. On the other hand, the decline in share prices and relatively low valuation (the market cap of some companies decreased by 70%-80%) raised the funding cost of companies, and some of them chose to exit the markets voluntarily. On November 22nd,2011, Shanda Interactive Entertainment announced that its parent company would spend US$2.3 billion to buy back the shares on the market, ending its 8-year journey as a public company.

Corporate finance irregularities could be the trigger of delisting. Many companies that did not meet Chinese IPO requirements went public in the U.S. through shell companies because they were attracted by the low barriers to entry (no requirements of two years of profitability), reasonable costs (usually less than US$1 million of total expenses), efficiency (going public takes as little as 5-6 months), and success rates as high as 99%. Some companies, to varying extents, exaggerated financial results for M&A activities or were repackaged by intermediaries. In June, 2010, the SEC sued China Yuchai International for reporting false profit figures and violation of federal securities law. Since the beginning of 2012, Heli Electronics Corp, China Changjiang Mining New Energy, and Rino International have been suspended by the SEC because they either provided false information or failed to report the removal of existing auditors. As a result, corporate finance misconducts have triggered a herd mentality where Chinese enterprises listed in the U.S. as a group are facing a credibility crisis. In 2011, the SEC published a list of 170 companies that went public via shell entities, with the majority being mainland enterprises.

Intermediaries ratcheted up their "sell China" calls. In the U.S., accounting firms, investment banks, law firms, and PR companies have formed a whole system where they investigate problems of public companies, publish their findings, short sell these companies, disseminate such information in the capital markets, file litigations, and close their trades after prices have plunged. Rough estimates suggest that 70% of Chinese companies with alleged corporate finance irregularities suffered from misconduct on the part of auditors that caused misrepresentation of financial information on IPO prospectuses. Moreover, by the end of November last year, 67 Chinese companies listed in the U.S. had been questioned by a third party. For instance, in November, 2011, Muddy Waters published an 80-page report that attacked Focus Media, accusing the company of exaggerating results, selling company assets cheaply, and insider trading. The share price of Focus Media plunged 40% immediately, and US$1.5 billion evaporated from its market cap. In addition, another company issued three reports in a row that targeted Qihu 360 Technology. In July, 2011, one rating agency jumped on the "sell China" bandwagon and issued a report that claimed that Chinese companies have "widespread weaknesses" in corporate governance and consequently have to live with a higher-than-normal probability of fraud accusations.

Chinese companies face greater exiting pressure due to differences in rules and culture as well as lack of cooperation between regulators. First of all, most Chinese companies adopt the IFRS accounting standard, while GAAP remains the widely accepted rule in the U.S. The difference in accounting standards may result in inconsistent figures for net asset value, net income, and profit margins. As a result, the chances of reporting inaccurate corporate finance information would increase. Secondly, due to cultural differences between China and the U.S., it would be difficult for American fund managers and investors to understand the true fiscal conditions of mainland companies. Because of lack of guidelines about going public via shell companies, little self discipline on the part of intermediaries, and insufficient government regulation, rumors produced by research firms, media tabloids, and hedge funds would be easily believed. Furthermore, since 2004 the Public Company Accounting Oversight Board (PCAOB) has sought cooperation with China Securities Regulatory Commission to perform checks on audit firms. However, there has been little real progress, and the PCAOB is thus unable to oversee Chinese auditors, creating cross-border regulatory loopholes.

I have some explanation for Chinese companies exiting U.S. exchanges. **First of all, very few companies were**

forced to leave due to credibility issues. The number of dishonest companies as a percentage of total listed Chinese entities is not significantly higher than that of companies from other nations, so one need not overreact. According to DataExplorer, there were 1238 public companies on the NASDAQ between 2003 and 2007, while a total of 1248 companies exited the market during that period of time. **Second, exits could be considered as a strategy to get out of the woods.** According to Roth Capital Partners, U.S. listed Chinese companies with market caps of over US$1 billion recorded an average annual gain of 35%, whereas those with market caps of below US$500 million endured annual looses of 20%, crystallizing the polarization. Most of the companies threatened by the latest delisting wave were private companies and SME's. Shanda Interactive Entertainment's exit, as mentioned above, signaled the company's discontent about being undervalued. The exit would help it lower funding costs and consider opportunities in other markets.

Impacts of Chinese companies leaving the U.S. stock markets

On one hand, the international image of Chinese companies has been negatively affected by the fact that 46 companies exited from the U.S. market. The rational judgment of global investors might become clouded if this trend continued. On the other hand, the delisting wave may to some extent mitigate the long-existing problem of Chinese companies going public with deficiencies and force them to improve corporate governance, strengthen auditing and disclosure of corporate finance information, and conforming to international operating standards.

Market environments would be unlikely to improve in the short run. On December 28,2011, China Century Dragon Media won a class action lawsuit against shareholders and thus arrested the decline in its share prices. However, the overall market sentiment suggests that "sell China" voices still have an audience. A good number of lawsuits are being heard, and "China concept" stocks continue to underperform. The Bloomberg Chinese Reverse Mergers Index tracking the performances of 80 Chinese companies which have completed reverse mergers declined 57.32% compared with the same period last year, while the S&P500 and NASDAQ lost only 3%. Since last year, a number of companies, including Xunlei Technology, cloudary.com.cn, Lashou, and Vancl, have pulled their IPO plans in the U.S., which reflects the negative impact of the credibility crisis. Furthermore, American investors do not understand Chinese companies well, and institutional research coverage remains sparse. Communication between Chinese companies and American investors is unlikely to improve in the short term.

Tougher regulation in the U.S. increases the difficulties for Chinese companies going public. "Easy IPO, tough regulation" is an important reason why many Chinese companies failed to remain public. To comply with rules, companies listed in the U.S. must disclose financial information at least five times a year and will be monitored by the SEC, the exchanges, auditing and law agencies, the media, and individual investors. There is a high probability of class action lawsuits, and losses in the courtroom entails paying large amounts of fines. In November, 2011, the SEC approved measures by the three major exchanges to strengthen regulation of reverse mergers (see Table 3). The barrier to going public via shell companies will be raised, and the costs of complying with regulations will increase, lowering the incentives for Chinese enterprises to go public in the U.S. Of the 14 Chinese companies that went public in the U.S. in 2011, 12 dipped below their IPO prices, with BCD Semiconductor Manufacturing and Qihu 360 Technology being the only exceptions.

Table 3: SEC-approved measures to raise the barriers to going public via shell companies (November 10, 2011)

The prospective company shall have been traded over the counter or on exchanges regulated by the U.S. or foreign countries for more than one year.
The prospective company shall submit information documents on shell company related transactions.
The prospective company shall submit audited report for at least one fiscal year.
The shares of the prospective company shall trade above US$4 on at least 30 trading days during the 60 trading-day period between IPO application and approval.
The exchange on which the company is traded must be a formal one.

Implications of the delisting wave for Hong Kong

Hong Kong listed firms have also felt the pressure from the problems being exposed in the U.S. In fact, in mid 2011 some Chinese firms listed in Hong Kong endured heavy selling pressure, which triggered market panic. The delisting wave in the U.S. offers warning signals for the regulation of mainland enterprises listed in Hong Kong. However, as Chinese enterprises find it more difficult to go public in the U.S. and the market environment worsens, they will look for other overseas markets to meet their huge financing needs as a result of China's industrialization, urbanization, and modernization. Hong Kong will become more important as an overseas financing platform for mainland enterprises.

Diverging IPO trends will help Hong Kong maintain its position as a top fund raising center. Since the financial crisis, global economic growth and the center of development have increasingly shifted to the East. Hong Kong is unique in that it boasts seamless cultural integration between the East and the West as well as superior systems. As a result, Hong Kong can help both mainland enterprises to realize their international strategies and international investors to share the benefits of China 's economic growth. According to Dealogic, last year, the size of IPO's in Shanghai, Shenzhen, and Hong Kong combined reached US$73 billion, double that of NYSE and NASDAQ. According to Ernst & Young, stock exchanges in Greater China account for 46% of global IPO's and remain leaders in the market. The latest data from HKEX reveal that total IPO's amounted to HK$258.912 billion in 2011, making Hong Kong the top IPO destination for three years in a row. Therefore, some financially sound and mature enterprises involved in the delisting wave in the U.S. may consider going public in Hong Kong and thus help replenish Hong Kong's IPO pipeline.

Hong Kong should strengthen its advantages in servicing mainland enterprises. Compared to the U.S., Hong Kong investors are more familiar with mainland enterprises. Hong Kong's biggest advantage lies in its system that offers a range of services by lawyers, accountants, auditors, and analysts (see Table 4). For instance, when it comes to reverse mergers, Hong Kong has tougher regulations than the U.S., with higher shell company costs but lower compliance expenses after going public. Furthermore, thanks to the twelfth five-year plan and the implementation of CEPA, Hong Kong and the mainland's financial markets have had greater interaction in such areas as product development, financial regulation, and business communication. As technical hurdles are eliminated, more mainland enterprises, especially the non-state owned ones, will receive improved services should they choose to be listed in Hong Kong.

Table 4: Comparison between the Hong Kong and U.S. markets for Chinese IPO's

IPO place	Hong Kong	The U.S.
IPO expenses	HK$0.15-0.65 million	About US$1.5 million
Time required	About 7 months	At least 1 year
Market awareness	Relatively strong	Relatively weak
Shell company cost	About HK$50 million (main board)	US$0.2-0.4 million
Main advantages	Proximity of language and geography; market promotion ample liquidity; a variety of funding avenues; strong market awareness	Deep markets; a varietyof funding higher PE ratios and turnover
Main disadvantages	Smaller markets; lower PE ratios and turnover	Differences in geography, culture, and laws; limited market awareness, high IPO expenses

Source: SEC, HKEX, BOCHK Research

Overall, many quality mainland enterprises are still waiting to go public in Hong Kong, and the delisting wave in the U.S. might have provided Hong Kong with an opportunity to attract more IPO's from mainland companies. By improving sales promotions, strengthening cooperation with the Mainland, and fine-tuning the funding arrangements of RMB IPO's, Hong Kong will be able to consolidate its position as the main destination for mainland enterprises and continue to move forward as an international financial center.

主要經濟指標(Key Economic Indicators)

一. 本地生產總值 GDP	**2009**	**2010**	**2011/Q2**	**2011/Q3**
總量(億元) GDP ($100 Million)	16,223	17,354	4,361	4,642
升幅(%) Change (%)	−2.7	7	5.3	4.3
二. 對外貿易 External Trade	**2009**	**2010**	**2011/11**	**2011/1-11**
外貿總值(億元) Total trade ($100 Million)				
港產品出口 Domestic exports	577	695	51	610
轉口 Re-exports	24,113	29,615	2,734	30,049
總出口 Total exports	24,691	30,310	2,786	30,658
進口 Total Imports	26,924	33,648	3,227	34,443
貿易差額 Trade balance	−2,233	−3,338	−441	−3,785
年增長率(%) YOY Growth (%)				
港產品出口 Domestic exports	−36.4	20.4	−19	-3.4
轉口 Re-exports	−11.8	22.8	2.5	10.7
總出口 Total exports	−12.6	22.8	2	10.4
進口 Imports	−11	25	8.8	12.2
三. 消費物價 Consumer Price				
綜合消費物價升幅 (%) Change in Composite CPI (%)	0.5	2.4	5.7	5.2
四. 樓宇買賣 Sale & Purchase of Building Units				
合約宗數(宗) No. of agreements	133,962	162,739	5,982	103,217
年升幅(%) Change (%)	18.2	21.5	-62.5	−31.6
五. 勞動就業 Employment	**2009**	**2010**	**2011/9-11**	**2011/10-12**
失業人數(萬人) Unemployed (ten thousands)	19.7	15.9	12.1	11.6
失業率(%) Unemployment rate (%)	5.4	4.3	3.4	3.3
就業不足率(%) Underemployment rate (%)	2.3	2	1.5	1.4
六. 零售市場 Retail Market	**2009**	**2010**	**2011/11**	**2011/1-11**
零售額升幅(%) Change in value of total sales (%)	0.6	18.3	23.5	25.0
零售量升幅(%) Change in volume of total sales (%)	−0.8	15.5	16.9	18.6
七. 訪港遊客 Visitors				
總人數(萬人次) arrivals (ten thousands)	2,959	3,603	355	3,777
年升幅 (%) Change (%)	0.3	21.8	16.4	16.3
八. 金融市場 Financial Market	**2009**	**2010**	**2011/10**	**2011/11**
港幣匯價 (US$100 = HK$) H.K. Dollar Exchange Rate (US$100 = HK$)	775.55	777.45	776.75	778.75
貨幣供應量升幅(%) change in Money Supply (%)				
M1	39.6	12.8	0.4	8.4
M2	5.3	8.1	8.4	12.5
M3	5.2	8	8.4	12.4
存款升幅 (%) Change in deposits (%)				
總存款 Total deposits	5.3	7.5	6	9.9
港元存款 In HK$	11.2	7.2	-5.5	2.1
外幣存款 In foreign currency	−0.6	7.9	20.2	18.8
放款升幅 (%) Change in loans & advances (%)				
總放款 Total loans & advances	0.1	28.6	20.4	23.5
當地放款 use in HK	−1.4	24	11.3	14.2
海外放款 use outside HK	7.2	48.3	57.3	60
貿易有關放款 Trade financing	−6.2	56.5	40	36
最優惠貸款利率(%) Best lending rate (%)	5.0000	5.0000	5.0000	5.0000
恆生指數Hang Seng index	21,873	23,035	19,865	17,989