BUYERS BEWARE

Investors must distinguish between the good, bad and ugly, before investing in overseas-listed Chinese companies By Peter Humphrey

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Little more than a year ago, almost no one wanted to read or publish articles about the farce of some Chinese overseas stock listings.

At a chamber of commerce event in Beijing in early 2010, I outlined how numerous obscure Chinese companies were sneaking onto overseas stock exchanges and defrauding shareholders. While fraudulent Chinese stock listings had grave implications for the reputation of mainland companies, it was the first time someone had spoken publicly about the issue. Indeed, a month later another chamber of commerce in Shanghai refused to host such a talk, afraid of upsetting some imagined power-that-be.

My speech attracted quite a big audience in Beijing. But while I was networking, I realized many people were not there to learn how to avoid fraud – half of them were there to learn how to commit it. Plenty of the scam merchants who bring such murky listings to foreign stock exchanges – dodgy lawyers, "investment bankers" and shady due diligence outfits – were in attendance. They were only able to carry on their game for a few more months before the tide began to turn against them.

A year later, the landscape has shifted dramatically. A string of Chinese firms listed on NASDAQ, Amex and the New York Stock Exchange have imploded in fraud scandals after being shown to have cooked their books, faked sales, stolen assets and pocketed capital that was raised on US markets. The latest of such companies, Longtop Financial Technology, caught out in late May, is the largest thus far by market capitalization (US$1 billion) to be exposed as a fraud.

The unraveling of these crooked firms resulted from efforts to expose the scams by private investigators, research houses, hedge funds, Wall Street newsletters, and finally – rather late and timidly – the mainstream press.

The US Securities and Exchange Commission (SEC) is finally hot on the trail, chasing a raft of guilty Chinese companies. Most of these gained access to US investors through a practice called a reverse merger, in which a closely-held firm becomes public by purchasing an already-listed shell company. About 350 Chinese companies have listed in this way since 2004, with a total capitalization of more than US$100 billion. By some assessments, at least one-third of them had fraudulent roots and underpinnings. Many still await exposure.

Questions arise

One company that has come under question is China Green Agriculture, a NYSE-listed fertilizer maker in Shaanxi province. Concerns emerged that the company was either producing extremely expensive vegetables, or that it had overstated revenues and earnings. The SEC announced in January that it had launched an informal inquiry into the company. Auditors eventually admitted that China Green Agriculture did not "maintain effective controls" to ensure the accuracy of financial statements.

In another example, China Integrated Energy, a NASDAQ-listed producer of biodiesel, was reporting spectacular profits from a facility that recycles used cooking oil, and also a forest of pepper-seed trees that is used to make eco-friendly fuel. However, its stock plunged after an investigation commissioned by a skeptical overseas investor showed the only traffic in and out of the company's main plant in four months were visiting US investors. Shareholders filed a class-action lawsuit against China Integrated Energy in April for misrepresentation of products and funds.

Rino International Corp, a manufacturer of water treatment equipment, has been under a cloud since mid-2010 for producing fraudulent financial documents, inflating the size of its operations and workforce, and fabricating client contracts. In December 2010, Rino was delisted from NASDAQ to over-the-counter markets. The company's woes continued, however, culminating with the mass resignation of its remaining independent directors and auditors in March 2011.

Rumors about implausible margins at Longtop, a NYSE-listed US$1 billion market cap financial software firm, began bubbling to the surface in early 2011. Muckrakers also reported that Longtop had an undisclosed relationship with a staffing company and a sordid history of scandal at its top levels of management, but the company stoically refuted the charges. In May, Deloitte abruptly resigned as the company's auditor, accusing Longtop of fake bank accounts, missing cash and deliberate deception. Not to be outdone, the CFO also resigned, and the SEC opened yet another investigation.

Avoiding scams

Scam merchants are still lining up similar Chinese companies for listing, but the present atmosphere in the US will make it more difficult. Serious people with reputations worth protecting have begun to realize they need to avoid these deals.

Solving this problem is not rocket science. It requires common-sense due diligence. But when companies are rigging financial statements with the help of window dressers from boutique investment banks and accounting firms nobody has ever heard of, due diligence must go beyond the balance sheet. Investors need to understand the background, track record, reputation and business practices of a company. Peel the onion by physically checking on-the-ground operations and customer and supplier bases – then assess whether it matches the rosy financial data they report.

Investors and other interested parties should conduct due diligence by asking the right questions. If it seems too good to be true, it probably is. First, find out the real origins of the company. Are there any other companies behind it, or hidden hands? Is there any history of scandal, or skeletons in the cupboard?

Secondly, determine the sources of its original capital and assets. Has the company misappropriated state assets or earned seed capital from crime? Who were the original shareholders, and what is their status now? Were they disenfranchised through illegal means or unethical sleight of hand?

Look at the company's decision makers, directors and shareholders. Are their identities genuine? What citizenships do they use when registering a business? Is there anything in their background, reputation or business practices that make them an unsuitable business partner? Do they have close associates, relatives, cronies or proxies involved in the business?

Carefully examine the company's sales. Is the firm just making up numbers, like other Chinese businesses that have imploded recently? Do the numbers add up? What do regulators on both sides of the ocean say about the firm? Does the company tell the same story to regulators in both countries, or does the story vary dramatically depending on the audience?

Another useful resource is internet chat rooms. When analyzing a company, look out for hostility and negative comments – then ask, what's the reason behind it?

At the same time, understand the company's products and what it does in the market. Are there many complaints in the public realm about their products and their practices? Have complaints been resolved or have they been covered up?

Such questions must be part of the due diligence process. Investigators can find answers through on-the-ground inquiries and thorough research into Chinese regulatory filings and other records. This is perhaps the only way for investors and interested parties to distinguish between the good, bad and ugly Chinese firms being put on parade for a public listing. E

TURNING TIDE: Chinese companies trading in North America have come under increased scrutiny this year