A China Expert's Views on How to Invest in U.S. Listed China Based Companies

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Due to China's explosive GDP growth of 9% per year for the last 30 years, some of the world's fastest growing companies are naturally based in China, many of which belong in the micro and small cap space due to their smaller sizes.

Over the past 16 years, our firm New York Global Group ("NYGG" www.nyggroup.com) has been advising China based corporate clients with their strategic growth. NYGG is a China and New York based corporate advisor with a large bilingual staff consisting of accounting and financial experts. Since NYGG established its Beijing office in 1998, the firm has efficiently executed more than 200 projects in China. NYGG staff speaks the Chinese language and knows the Chinese culture.

With access to significant investment capital, NYGG performs extensive due diligence on prospective clients. Despite a very large deal flow, less than 2% of all China based companies reviewed by NYGG have passed the firm's client review process. Several of those that have been rejected by NYGG still have found their way into the U.S. public markets through other sources. Almost all of the rejected companies have resulted in various problems for investors. In the ever-evolving China space, NYGG's local presence in China continuously provides the firm with the latest intelligence on Chinese companies. In addition, NYGG possesses in-depth knowledge regarding the background of nearly all U.S. stock exchange listed China based companies.

U.S. Listed China Based Companies Represent Less Than 3% of All Listings on the Reputable NASDAQ and the NYSE

Few people may realize that in the first half of 2010, over 190 Chinese companies became public on China's Shenzhen Stock Exchange after raising a total of US$30 billion in capital, the highest amount in the world for growth companies. Within the Shenzhen Stock Exchange is China's one year old NASDAQ-styled ChiNext Board, which serves high growth micro cap companies. The ChiNext has listed more than 100 new companies and these listings are currently trading at an average P/E multiple of 64 times (*on average, these listed companies reported 48% increase in net income for the first half of 2010.*) Many of these small cap Chinese names on the ChiNext have successfully raised astonishing amounts of capital from Chinese investors – often hundreds of millions of U.S. dollars each in highly oversubscribed offerings.

Meanwhile, the nearly 200 China based companies listed on the NYSE and the NASDAQ have demonstrated similar earnings growth patterns, however their shares are trading on average P/E multiple of only 7 times.

Why do Chinese companies even bother to list their shares on a U.S. stock exchange then? This article addresses the seemingly puzzling question with insights drawn from facts, discussions with hundreds of Chinese management teams, and NYGG's own on the ground experience as China experts over the last decade.

Many Chinese Companies Prefer to List on Domestic Chinese Stock Exchanges

The U.S. capital markets present challenges for many China based companies due to differences in language, culture, and regulation. Many larger China based companies with longer operating history choose to list on China's domestic exchanges. Recently, the world's largest China related corporate finance deals and public listings have taken place in Shanghai and in Hong Kong, representing a significant loss of revenues and opportunities for both U.S. investment banks and U.S. stock exchanges trying to compete globally. Presently, many Chinese domestic investment banks are strong and powerful. Armed with healthier balance sheets and billions of U.S. dollars in capital, they are competing effectively and globally with U.S. investment institutions.

China's Domestic Listing Inefficiencies Drive Chinese Companies toward U.S. Listing

Of the hundreds of corporate CEOs in China whom NYGG staff has visited with that run highly profitable businesses, many have expressed strong interest in accessing public markets in China. However, China's two stock exchanges cannot accommodate all of the demand. For smaller private companies, the recently opened ChiNext Board provides a compelling venue. However, there is already a tremendous backlog of several hundred companies waiting in line. In addition, listing requirements include years of highly burdensome preparatory work that even upon fulfilling do not guarantee a successful listing.

Naturally, market forces lead these high growth Chinese companies to seek listings outside of China, with the U.S., Hong Kong and Singapore as their primary destinations due to these markets' highly efficient, sponsor-driven public listing process.

Chinese companies decide to list in the U.S. due to the founding principles of a free market economy in the United States, less government intervention in private enterprises, and global reputation of its well regarded stock exchanges such as the NYSE and the NASDAQ. In return, U.S. investors can invest in China based, high growth companies with their shares listed on the familiar U.S. stock exchanges, a win-win for both issuers and investors.

“Survival of the Fastest” – Going Public in the U.S. via the Reverse Merger Route

China’s economic growth has created a uniquely competitive domestic market for goods and services. For fast-growing Chinese businesses, it is critical to raise equity financing to be used as working capital in order to gain market share and to increase plant capacity and drive down unit cost. Oftentimes, the driver for continued growth lies in a business’ ability to afford to buy more inventories and accommodate larger accounts receivable. Hence, a company that raises capital quickly often gains a first mover advantage by utilizing capital strength to leapfrog its competitors. Simply put, survival of the fittest has become synonymous with survival of the fastest. Thus, the reverse merger route is always resoundingly appropriate for accomplishing financial objectives in a swift and secure manner, allowing management to focus on operating a profitable business. For these exact reasons, it is not a coincidence that many U.S. listed China based companies choose to become public in this manner - it makes common sense as well as great economic sense.

Reverse Merger versus IPO

There is nothing good or bad about a reverse merger or an IPO. These are simply two ways to become public companies. These two approaches are certainly not unique just to the U.S. markets. They are used on any stock exchange in the world. An IPO involves creating a public entity by selling new shares to the general public through underwriting brokerage firms. A reverse merger involves acquiring an already public company, thereby replacing its spot on the stock exchange - a process that is typically concurrent or followed by a capital raise in the form of a private placement of securities with accredited investors. Both methods accomplish the same end result: a public company that successfully raises capital through equity offerings.

Reverse Merger Is a Main Stream Wall Street Product – Warren Buffett’s Berkshire Hathaway Has Done It

Readers may not know that plenty of world class companies have become publicly listed via the reverse merger process, including Berkshire Hathaway Inc., Texas Instruments Inc., Occidental Petroleum Corp., Tandy Corp. (RadioShack), The New York Stock Exchange and many others. More specifically, over 50% of the 119 China-based companies that are currently listed on the NASDAQ have become public via reverse mergers, so have many listings on the NYSE. Warren Buffett’s Berkshire Hathaway has created tremendous shareholder value over the years. Clearly, one must look at a company’s fundamental performance rather than its method of becoming public.

Another popular and well accepted mechanism for Wall Street to raise money for companies is what is commonly known as a SPAC (Special Purpose Acquisition Company). A SPAC is a publicly traded “shell company” with cash sitting on its balance sheet and is actively seeking to acquire an operating company. A SPAC transaction is a reverse merger transaction. Major bulge bracket Wall Street firms often underwrite deals that create these SPACs, raising tens or hundreds of millions of dollars for a shell company that has nothing but cash in it.

Why Do So Many High Growth Companies Stay Away From the IPO Approach?

An IPO can take a full year or more to complete, plus millions of dollars in legal, accounting and other costs. Aside from the prohibitive costs for smaller companies, many of the larger investment banks on Wall Street have no interest in underwriting IPOs that raise less than $100 million. An IPO can also be a high risk venture for a company since the underwriters often cancel scheduled IPO offerings under unfavorable market conditions, leaving an already capital starved company with high expenses while raising no capital at all. Plenty of growth companies in the U.S. have gone out of business due to their inability to complete IPOs. In the long run, companies with consistent earnings growth, honest management and good corporate governance practices tend to do well, regardless of how they became public initially.

Are Reverse Mergers Being Unfairly Targeted by Sensational Reporting?
Fact: Reverse Merger + Capital Raise = IPO

Over the past 12 years, the U.S. Securities and Exchange Commission has taken a number of regulatory actions to protect investors from underhanded practices in both the small IPO and reverse merger markets in order to give the investing public full disclosure. In fact, from a public disclosure point of view and from a legal perspective, the exact same set of SEC documents is used during a capital raise through either a reverse merger or an IPO. Each method of going public requires that a Form S-1 registration statement be filed with the SEC, and are subject to the same review by the SEC staff. Almost all China based companies listed on a U.S. stock exchange through a reverse merger have gone through the SEC review process in an S-1 filing.

NYGG's Clients' Shares Are Broadly Held by Long Term Institutional Investors

All of the China based companies that NYGG has worked with in the last decade have successfully raised equity financing through high quality underwriters and have gone through SEC reviews. Such high quality and consistency is further evidenced in the large percentage of NYGG's client company shares being held by highly reputable long term institutional investors such as Fidelity, Wellington, Janus, Vanguard and many others. Over time, it is NYGG's experience that institutional investors focus on the fundamental business of a company and do not care about whether a company has become public via a reverse merger or an IPO. It is certainly foolish for anyone to downplay the level of sophistication and research capability among some of the largest mutual funds in the world. Their trust in these Chinese companies is evidenced by their purchase of substantial shares in the same U.S. listed China names that NYGG has worked with. Quality companies attract quality investors and vice versa. Many of NYGG's clients are of high quality in terms of earnings growth and corporate governance.

Investing in China is All About Gaining Exposure to Its Growth

According to the All-China Federation of Industry and Commerce, a government entity, there are currently more than 60 million registered businesses in China. Based on NYGG's proprietary research, there are over 80,000 businesses in China that generate more than US$0.5 million in net income per year. Many China based companies are highly profitable, making them highly sought after by global investment banks. Many U.S. investment banks have regarded winning Chinese companies' banking mandates the significant sources of their banking revenues.

Goldman Sachs: U.S. Investment Assets are Underexposed to China

In the last decade, NYGG has witnessed China's rapid ascend into the second largest economy and one of the fastest growing economies in the world. Despite such growth, less than 4% of U.S. managed investment assets have any exposure to China's growth. This is a paltry amount compared to those invested in slower growing and mature markets such as Europe or Japan. Goldman Sachs recently stated that U.S. investment assets are severely under-exposed to China. Fidelity International has recently expressed similar views, as well as other global minded and sophisticated institutional investors.

On the Ground Due Diligence is Imperative for Investing in Any Company

Every year, NYGG staff visits with hundreds of Chinese companies. Although there are impressive growth stories behind many of them, NYGG chooses not to work with 99% of the opportunities that the firm encounters. The reasons can range from the fact that a company's management team has unrealistic expectations, the return on invested capital is poor or we discover fraud. Since NYGG has extensive local staff in China, NYGG can quickly identify an issue in the same cultural and language environment as the Chinese management. In addition, NYGG focuses on management's understanding of corporate governance and public reporting obligations. NYGG has always found that successful U.S. listed China based corporate clients have a strong desire to gain access to international markets and can compete effectively as transparent public companies with strong corporate governance. They are not just another Chinese manufacturer that competes solely based on price.

NYGG Performs 7 to 11 Months of Due Diligence on A Potential China Client

Due to NYGG's language and cultural familiarities with Chinese companies, NYGG has some of the most comprehensive and stringent due diligence processes and requirements for screening China based companies. NYGG conducts on the ground due diligence and forensic accounting that lasts on average between 7 and 11 months. NYGG lives by the motto of "Trust, but verify." NYGG's in-house English-Chinese bilingual CPAs and financial analysts spend months analyzing customer receipts, inventory, production capacity, and performing extensive channel checks. For more than a decade, NYGG has developed valuable insights and extensive China relationships to help unearth red flags.

NYGG cares about quality, not quantity. As an equity investor, NYGG invests its own funds into client companies along with other institutional investors. NYGG has vested interest to make sure its clients are credible in all respects.

Gaining True Understanding of China Requires Extensive China Presence

Understanding China's 5,000 year history as well as the people and culture requires speaking the Chinese language and gaining significant cultural experiences. Short trips to China or performing desktop research alone will not turn an individual into an expert on China and is far from sufficient when trying to reach well-informed investment decisions. Thus, NYGG encourages investors and journalists to visit China, perform their own due diligence, and experience the vibrant growth first hand. Facts, not speculation or fear, are important elements of successful investing.

U.S. Listed, China Based Companies Represent Compelling Value to U.S. Investors

At single digit earnings multiples, many of these U.S. listed China names are high growth companies trading at severe discounts to their peers in China, despite their significant earnings power. For U.S. stock exchanges, these China based companies add to the necessary diversity of their listed companies. For U.S. investors, such high quality, China based companies present compelling opportunities from a valuation perspective. Investors can profit from China's rapid economic growth directly and in their own "backyard" – through companies listed on the NYSE or the NASDAQ. These U.S. listed China based names follow the same familiar SEC disclosure requirements and reporting regulations as U.S. companies, and allow U.S. investors to examine the company in their own English language rather than learning to speak or write the Chinese language. It makes great sense for U.S. investors to invest in quality China based companies listed on U.S. stock exchanges.

Bilateral and economic relationships between the U.S. and China are important to investors. It is time for both U.S. and Chinese investors to learn the facts about each of these two great nations. During this learning process, focusing on the realities and building an accurate base of knowledge rather than depending on sensational reporting that builds fear and unnecessary barriers between friends will result in better economic and cultural understanding.

About the Author:

Mr. Benjamin Wey is the President and a founding partner of New York Global Group ("NYGG"), a leading middle market advisory firm on Wall Street specialized in executing China related transactions. With more than 80 professionals between New York and Beijing, NYGG has been advising China based corporate clients with their strategic growth in the past 16 years. With access to more than US$500 million of investment capital, NYGG is a leading source of high quality deal flow for investment banks and institutional investors worldwide. A bilingual Chinese American, Mr. Wey possesses extensive international business experience, broad business contacts, and cultural familiarity as an expert on China. In 2006, Mr. Wey was awarded the Golden Key to the city of Suning, in China's Hebei Province, for his leadership in establishing a 120-student elementary school benefiting underprivileged kids in rural farming communities and orphans. Mr. Wey came to the United States in his teenage years on a full academic scholarship. Mr. Wey has a Bachelor's degree in Management and an MBA in finance. Mr. Wey is a Visiting Professor of Finance at Shanghai University of Finance and Economics as well as China University of Petroleum.

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