INVESTING IN CHINA

Janus Henderson
INVESTORS

Signals and Smokescreens

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Signals and Smokescreens

Source: iStock

'PEARLS DON'T JUST LIE ON THE SHORELINE; YOU MUST DIVE IN THE OCEAN TO FIND THEM.'

Success only comes through greater effort – Chinese proverb

As China transitions from being a 'participant' in globalisation into a 'shaper,' investors are looking to the region for its exciting opportunities. China's growth story offers strong potential; but investors can be deterred by risks arising from the differences between Chinese corporate governance compared to more established markets.

To help inform investors about risk in China, Janus Henderson presents this wide-ranging educational series – China investing: Signals and Smokescreens. This is based on an in-depth study of China stocks that underwent periods of intense financial stress in recent years. Based on the outcome of whether the stock price collapsed or survived, the study identifies a set of pre-existing signals and common characteristics that can potentially help global investors understand and identify China-specific risks going forward.

Tread carefully

While many Chinese stocks have performed extremely well in the last decade, there have been a number of high profile failures, often associated with governance issues. Understanding the relationships between companies and their stakeholders – particularly the State – is critical in assessing governance-related risks. For global investors, viewing opportunities within the unique context of China is essential, and this study reveals scenarios that would be unlikely in more established markets. Examples include:

- An independent director, who was accused of negligence for failing to detect malfeasance, argued that he should not be punished because he 'always regarded an independent directorship as an honorary title', 'knew nothing about the operation of the company' and 'did not have the ability to understand the accounting sheets'.
- A chief financial officer who tendered his resignation after the board had 'denied him sufficient access to the financial records'.
- A company that made a public announcement on NASDAQ that its chief executive had fired the external auditors half way through the audit because they had asked to see the bank statements, a request that was deemed to be 'overly broad'.
- A board of directors which, on arriving at the office building in order to retake control over their operations, were water-cannoned by the local Chinese management team.

'Signals and smokescreens'

Building on its expertise in investing in Chinese companies, and Asian equities generally, Janus Henderson has undertaken the 'Signals and Smokescreens' study by analysing publically available information from companies that underwent periods of intense financial stress in recent years. Some of these companies failed while others survived. From this study, certain red flags emerged as indicators of potential risk; and also green flags that could indicate a certain robustness that enables a company to weather the storm.

Signals and Smokescreens (cont.)

The purpose of the study is to share knowledge and help global investors gain a better understanding of risk and corporate culture in China. Written in partnership with author Tim Clissold, an expert on business in China, the study explores the Chinese corporate mind-set and ownership structures that help determine whether minority investors in the public markets get their fair share of the fruits of corporate success.

Janus Henderson believes it is imperative to invest with a proper understanding of the risks and implications in all markets and that, in keeping with the proverb above, there are pearls to be found in China, but only through diligent analysis and risk assessment. The study will be released as a series of modules and include insight from our Asian equity investment managers.

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Implications for investors

"China's development into a key player on the world stage has been dramatic and, for investors, its importance is only going to grow in the years ahead. The difference in how companies are run in China, however, makes it essential to look behind the numbers. There are key differences in board structures, corporate governance, the relationship management has with individual investors and whether companies are acting in shareholders' best interests. This study seeks to help provide a context for investing in China and provide insight into the risks beyond the numbers."

Mike Kerley
Director of Pan-Asian Equities and Portfolio Manager at Janus Henderson Investors

"The business environment in China is still quite young and this has consequences. Its high growth, entrepreneurial companies are often still driven by the founder and these individuals by their nature are often incredibly focused, driven, independent and prepared to take risk. This tends to be coupled with relatively weak governance, with the tradition of having a strong board and external audits still fairly new, and the regulatory framework is also in its infancy compared to the US. This means that there are definitely exciting opportunities but equally there are significant risks that it is essential investors are cognisant of."

Tim Clissold
China author and businessman

Chinese economy = larger than the US (in purchasing power parity terms)

Alibaba (Chinese internet stock) = largest IPO in history in 2014

More than US$30bn losses from China-based reverse takeover frauds in 2011

200+ Chinese A share companies to join MSCI EM Index in June 2018

2,228% rise in market capitalisation of the MSCI China since 2000*

*Source: Bloomberg, 1/1/2000 to 31/12/2017 in US$ terms

THE CHINESE GROWTH STORY AT A GLANCE

Source: iStock

Rationale and methodology: risk, with Chinese characteristics

Source: iStock

'CROWS FIRST SENSE A RISING WIND, ANTS FIRST SENSE A FLOOD.'

Those familiar with their surroundings are most likely to foresee danger – Chinese proverb

Why is there a need for the study?

China's size, its early stage of development, international ambitions and relatively high levels of corporate debt mean that the country needs vast amounts of development capital for many decades to come. Meanwhile the Chinese government has been consistent in its policy of 'opening-up' and moving towards global trading norms. Thus, China both desires and needs a sustained inflow of foreign equity capital for its continuing economic development.

China's need to attract foreign investment in the global equities markets has at times been hindered by high profile failures in domestic stocks, which has tainted investor confidence. Most of these failures derived from problems in Chinese governance, but they were magnified by the difficulties many global investors face in analysing risk in China. An improvement in the ability of global investors to assess risk has the potential to improve investment returns and increase China's ability to attract capital. Thus better knowledge provides the prospect of a mutually reinforcing cycle.

What's different about China?

It is only in the past few decades that China has emerged from a prolonged period of chaos caused by invasion and civil war, and China has only relatively recently reclaimed the ability to act coherently as a nation. This transformation in the capabilities of the Chinese state has coincided with globalisation, a one-off event based on the ideas of free market economics, and dramatic changes in technology. Many observers conflate these two phenomena and attribute China's extraordinary growth to its adoption of Western economics; but this does not stand up to deeper analysis. For two thousand years, the Chinese economy has relied on a complex interplay between government strategy, state-owned actors and a highly entrepreneurial private sector; it is no different today.

China's long traditions and continuous civilisation have produced a governance regime that is, in important ways, different from those more familiar to global investors. One example is the 'chop'-system, which has endured since the Han Dynasty two thousand years ago. In China, corporate action requires the affixing of a company seal, or 'chop' to contracts and other key documents. The 'chop' must be registered with Chinese authorities and anyone controlling the 'chop' has wide powers to deal with the company's assets and its affairs as they wish. The board of directors of a company deprived of its chop is rendered entirely unable to take corporate action, make statutory filings or defend itself against legal action. Thus the physical possession of the 'chop' confers rights and powers that would be unrecognisable in a Western context.

All companies in China are also required to appoint a 'Legal Representative', which must be a person appointed as the custodian of the corporate 'chop', and who has the sole right to enter into binding contracts on behalf of a company. Thus for a company to take effective corporate action, documents must be both affixed with the company's chop and signed by the legal representative registered with the relevant authorities.

This chop system, coupled with the overriding power of the Legal Representative, has often created a situation in China where, if a board loses control of the chop or faces an uncooperative legal representative, shareholders' rights can be completely abrogated. Strict adherence to this governance structure is such that, in certain cases reviewed as part of the study, the board of directors of the company was unable to register valid resolutions to dismiss their own Legal Representatives or take other corporate actions, because the outgoing legal representatives refused to sign and affix the chop on their own dismissal documents with local authorities, effectively holding the company to ransom. Moreover, there have been countless attempts by foreign directors to use the court systems to force disgruntled legal representatives to return a company 'chop', none of which have ever been successful.

Rationale and methodology: risk, with Chinese characteristics (cont.)

The role of the State in equity markets

On a macro-level, the stock markets in China are used as a tool for the State to realise its strategic aims; thus they are not as market driven as in the West and are subject to two specific controls that are absent from the Western model.

Firstly, the government regulates the markets closely by controlling the flow of companies that are allowed to list both on the domestic markets and the global stock exchanges. Important state-owned enterprises that contribute to the realisation of government development strategy will find it much easier to access both the international equity markets and domestic debt. Consequently, the domestic equity markets, while providing an important source of wealth for Chinese investors, are essentially an instrument for realising national strategy and this strongly influences the way they are governed and regulated.

Secondly, the participation of foreign investors in China's economy is strictly regulated by the Ministry of Commerce, which publishes an extensive list of prohibited areas where foreign investment is restricted or excluded entirely. Certain large Chinese companies have nevertheless circumvented these restrictions through contractual structures called Variable Interest Entities, which may present investors with an additional layer of risk.

On a micro-level, another example of the role of the State in Chinese governance is its deep involvement in the transfer and registration of share ownership. In China, a company's 'business licence' is the definitive proof of ownership of shares. It is issued by the relevant branch of the State Administration for Industry and Commerce (SAIC) and not, as in the case of a share certificate, by the company itself. This means that the State plays an integral role in all transfers of equity and one cannot, at will, buy and sell equity stakes in People's Republic of China (PRC) entities, without the approval of the Chinese government.

Purpose of the study

Given the inclusion of Chinese domestic 'A-shares' into the MSCI World Index, due-diligence on China stocks is more important than ever for global investors. The different legal and corporate structures and the different governance environment demand that, when analysing Chinese equities, the investment process should be tailored to the reality of the risk environment; and that means placing corporate governance at the heart of risk assessment.

The most important factor for investors to understand is the real intentions in the mind of the controlling shareholder. This is because, in practice, minority public investors have quite weak protection. There are basically two types of business that raise public equity; the first consists of state-owned enterprises (SOEs), and the second are privately owned. For the SOEs, the controlling shareholder is the State and it is important to recognise that it views its long-term strategy as more important than short-term financial gain, although this can sometimes benefit investors. The second type of company is privately held and, due to the historical development of China's economy, all private businesses were established in the last 25 years; therefore, these companies tend to be dominated by their original founders, who are often highly entrepreneurial risk-takers. It is therefore critical to look for signals that might reveal the real intention in the minds of the founder group.

The core purpose of this study is therefore to equip investors with a framework that can enable them to understand the fundamental question:

How can we properly assess the alignment of interests between the controlling shareholders and the minority public investors?

Scope/methodology

Building on Janus Henderson's decades of experience of investing in Chinese equities, we have conducted case study analyses on more than 60 Chinese companies with securities listed on the global stock markets, particularly NASDAQ and the Hong Kong Stock Exchange. We looked at companies that endured periods of intense financial stress, such as during a short attack. A short attack is where market participants take a large short position, compressing the stock price, and, if possible, putting the company into bankruptcy. We then examined publically disclosed information available prior to the short attack and identified characteristics of each company's corporate governance that appeared to determine the eventual outcome.

Where the short attack resulted in substantial destruction of shareholder value, we identified a series of commonly reoccurring indicators of risk, or 'red flags'. Where the share price weathered the storm and the company went on to prosper, we identified a series of positive attributes, or 'green flags'. Certain patterns emerged from the data. The intention is that by sharing the results of the study, investors will be better informed as to the risks associated with investing in China.

The flags described in the study should be considered holistically and we aim only to paint a more nuanced picture of the interplay of the various factors that contribute to the state of a particular company's governance. We do not assert any causal link between flags and outcomes, as this approach would be overly simplistic given the intricacies of the Chinese economy and governance structure. Instead, the study seeks to explore areas of governance that we found to be prone to greater risk in China. For each of these areas, key questions are posed that we believe investors should consider when analysing a particular opportunity. We also ask our investment teams for comment on how they weigh the particular risk and opportunity.

'Signals and Smokescreens' will include modules covering:

- Financial ratios
- Board oversight
- Related party transactions
- Material transactions
- External oversight
- Stakeholder relations
- Variable interest entities

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China investing: Module 1 – financial ratios

Source: iStock

'EVEN A TOWER A HUNDRED YARDS TALL, STILL HAS FOUNDATIONS ON EARTH.'

Don't suspend disbelief in extraordinary circumstances; everything should have a basis in reality – Chinese proverb

Given the high-growth environment of China's economy, certain companies have been experiencing rapid expansion on a scale not evident in the West and this is expected to continue in the medium term. A result of this is that investors are sometimes inclined to accept figures that appear 'too good to be true' as a result of their desire to ride the wave of China's growing success. However, this suspension of disbelief sometimes means investors refrain from assessing whether changes on a given Chinese company's financial statements stand up to reason.

The starting point for all of the 'Signals and Smokescreens' case studies has been an analytical review of the balance sheet, cash flow and profit/loss of the Chinese companies in our data set that were subjected to a short attack*. This helped us to look for signs of anomalies in the reporting on the underlying business and for indications that the controlling shareholder(s) might have manipulated the accounts in an effort to inflate the share price which, in turn, could have provided the short sellers with a reason to initiate coverage.

The purpose of this review was not to identify cases of manipulation 'after-the-fact', but to determine whether key financial ratios, in conjunction with a thorough examination of the company's governance and other external factors, might have made it possible for investors to anticipate turbulence in the share price and thus avoid losses.

Beyond the numbers

As is the case in more mature markets, in our view some form of quantitative screening should be the starting point of the investment process in Chinese equities. However, in light of the high-growth nature of China's emerging market, more importance needs to be placed on contextualising and cross-checking a company's financial statements in order to determine their veracity.

Evidence of any outliers or inconsistencies in financial figures and ratios should act as a strong prompt to look 'beyond the numbers' into a given company's governance and internal controls to identify the real causes of anomalies.

Moreover, a comparison of a company's financial statements with external factors, such as global industry norms or relationships with suppliers and customers, can help to highlight cases where reported profits and growth are just not credible.

Key figures and ratios

We examined absolute changes in values, such as rapid increases in receivables days or short-term debt, in addition to relative changes, such as widening divergence between net income and cash flow. Some of the key figures and ratios that we found particularly useful in evaluating a given company's financial position included the following:

- **Increasing receivables days**
  This could suggest aggressive revenue recognition and/or an inability to collect funds from customers, which is a common problem in China;
- **Inventory days**
  Rapid increases might indicate that sales growth is slowing, whereas rapid decreases could indicate the flooding of distribution channels, which might not reflect actual sales by distributors;

*In a short attack, firms conduct extensive desk analysis and on-the-ground due diligence of a listed company that they suspect of being either fraudulent or of manipulating their share price. After gathering their evidence, these firms take large short positions before publically releasing negative reports on the company in question in an effort to depress its share price and profit from their short positions.

China investing: Module 1 – financial ratios (cont.)

- **Large increases in asset growth**
  Some companies occasionally use intense M&A activity over short periods as an opportunity to book large gains, particularly in intangible assets such as goodwill or assets evidenced by paper documentation rather than physical existence;
- **Increases in short-term debt**
  This might indicate that a company is struggling to generate free cash flow from operations;
- **Increases in deferred assets**
  This can indicate an attempt to manipulate profits by delaying the recognition of costs;
- **Increases in margins**
  Large jumps in margins can indicate that a company might be understating its expenses or overstating its revenue and profit;
- **Increasing divergence between net income and cash flow**
  This could suggest, among others things, delays in receiving cash settlement for sales already booked, aggressive recognition of revenue or the flooding of distribution channels to maximise profit;
- **Increasing divergence between cash holdings and interest income**
  If there is a negative correlation between cash holdings and interest income, or if interest income is inordinately small, this can suggest that a company has exaggerated its cash holdings;
- **Divergence between depreciation and fixed assets**
  Falling depreciation relative to fixed assets can indicate the exaggeration of the useful life of assets.

Financial ratios – risks in practice

The above examples are by no means exhaustive but by looking at the these figures and ratios, amongst others, we found some rather striking warning signals in the financial statements of foreign-listed Chinese companies, which strongly indicated aggressive application of accounting standards in order to drive up share prices or, in the most egregious cases, to manufacture the results:

- **Inaccurate imports**
  A scrap metal recycling company that was reporting revenue growth and outputs of processed recycled metal that far exceeded its nearest competitor, despite the fact that its capital expenditure was comparatively low. In trying to determine the plausibility of these numbers we noticed that, in order for the company to actually be producing its reported output, it would have had to have been importing more scrap metal in a single month than the Chinese Ministry of Environmental Protection permitted in a whole year. This information was readily available from the Chinese internet and suggested that many of the company's figures had been fabricated.
- **Manipulated margins**
  A mining company that manufactured and distributed coking coal with EBITDA margins of between 60%-68%, which were stratospheric in comparison with those of its fellow industry peers, which ranged from anywhere between 10% to 45%. Moreover, these margins remained eerily consistent despite the company operating in a cyclical industry in the middle of a recession. For example, in one year, the EBITDA margin increased despite its sales declining 6%, its production costs per ton increasing by 13% and its average selling price declining by 18%. Thus the reported results could not possibly be squared with any objective reality.
- **Soaring shares**
  A manufacturer of capital equipment for the production of photovoltaic cells used in solar panels, which claimed gross margins of 85% and 55% profit-before-tax margins, figures which were vastly superior from its competing capex equipment manufacturers in China. Further investigation revealed ballooning 'days-in-receivables' from a customer under common management. This strongly implied that the management was manipulating margins and effectively funding the privately-held, onshore related party with publicly raised cash from shareholders of the listed entity. These events coincided with an increase in the listed company's share price of 600% in a single year. Not long after this information was disclosed in the annual report, the stock price suffered a decline of 47% and trading was suspended after the Securities and Futures Commission launched an investigation. At the date of writing three years later, the shares remain suspended.
- **Trees that fell themselves**
  A forestry company which claimed to harvest over one million metric tons of woodchips in a given year, but which only had just over US$200,000 of depreciating fixed assets, as the balance was still 'under construction'. Further inspection showed that the only fixed assets which were depreciating were vehicles; this logging company had no logging equipment. There was another forestry company which saw vast increases in its revenues and net income over multiple accounting periods without anything like a proportionate increase in its capex spending, thus implying that the company was somehow able to double its logging capacity without investing in more logging equipment. Further inspection of the profit and loss account revealed that almost all of the company's profits had been derived from arbitrary revaluations of forestry assets rather than the sale of timber.
- **Inverse correlations**
  A Chinese valve manufacturer claimed that their margins were directly related to their R&D spending. However, the company then reported significant decreases in research & development spending from an already miniscule 0.3% to 0.1% of revenues in the same year as they posted increases in margins from 6.4% to 24.5%.
- **Dubious assets**
  A leading Chinese e-commerce business showed that the level of intangible non-current assets held in the balance sheet had grown from around 25% of net assets to almost 60% in the first three years after the initial public offering (IPO). Most of these increases derived from write-ups in goodwill during an intense acquisition spree plus revaluations of 'investments in equity investees,' despite these investees showing consistent losses and with book values that no longer accurately reflected their market value. This company has a corporate structure with over 500 hundred subsidiaries, which in turn raises the risk of misstatements remaining undetected by the external auditors.

Green flag indicators and balance

We found that there was a clear correlation between companies with strong governance and balance sheets comprised mainly of well described, recognisable tangible assets where certain key ratios and figures appeared rational and consistent with similar businesses outside China. Or, where they were inconsistent, there were plausible and independently verifiable reasons provided to believe that such inconsistency was genuine. So for example, if the identification of a red flag consisted in the divergence between fixed assets and depreciation, the corresponding green flag could be the company providing verifiable evidence that the fixed assets had only recently been purchased and were therefore at the early stages of their useful lives. Alternatively, if a red flag consisted in a rapid increase in inventory in a company whose products are paid for at the point of sale, the corresponding green flag might consist in the company demonstrating that it operates in a seasonal industry and that it is more economical to focus on production in the low season in order to allocate funds to distribution when the demand is higher.

This being said, even where the numbers appear to stack up, it is important to maintain a sceptical approach to uncover further reasons to believe that those figures accurately portray the true state of the underlying business.

Investment team perspectives

"Although the numbers are always a good starting point for making an informed and successful investment decision they must be analysed in conjunction with a full understanding of the industry in which the company operates. Behind the numbers may lay an opportunity or a risk – only in-depth analysis will determine which it is for investors."

Mike Kerley
Director of Pan-Asian Equities and Portfolio Manager

Summary

The table below shows the flags that were most instructive in our analysis.

Red flags	Green flags
Increasing receivables days – this could suggest aggressive revenue recognition and/or an inability to collect funds from customers.	Explained increasing receivables days – a positive if reflective of industry trends or a change in customer mix that alters payment terms.
Abnormal inventory days - rapid increases might indicate that sales growth is slowing; rapid decreases could indicate the flooding of distribution channels, which might not reflect actual sales by distributors.	Key ratios and figures that appear rational and consistent with similar businesses, reflect seasonal trends or mark a change of strategy that is clearly articulated by management.
Large increases in asset growth – some companies occasionally use intense M&A activity over short periods as an opportunity to book large gains or mask organic shortfalls.	Well-articulated acquisition or expansion strategy, which enhances the company's growth prospects.
Increases in short-term debt – this might indicate that a company is struggling to generate free cash flow from operations;	Explainable increases in short-term debt – could be in conjunction with rising receivables and increased inventories
Changes in margins that don't reflect industry trends – this could suggest a deferral or understatement of costs or an overstatement of revenue.	Economies of scale and gains in efficiency could result in industry-leading profitability
Divergence between net income and cash flow could suggest problems with cash collection or aggressive recognition of sales.	Slower than average cash collection may well be a sector norm but should be seen alongside the ability of management to mitigate the effect.

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China investing:
Module 2 – board oversight

Source: iStock

'A FOX MAY PREACH RELIGION, BUT IT STILL INTENDS TO STEAL CHICKENS.'

Judge intentions by actions, not words – Chinese proverb

In all markets, good corporate governance starts with the board of directors. In China, however, there are a number of indicators to look out for when evaluating governance and the board's composition often provides an insight into the mind of a company's ultimate controlling shareholder. In our review of over 50 companies in the 'Signals and Smokescreens' study, over three quarters exhibited red flags that might indicate poor alignment between the interests of the controlling shareholders and minority public investors.

Transitioning from planned economy to market economy

China is experiencing a transition from a planned economy to one in which market forces play a much greater role. Consequently, companies that have developed in the nascent private sector have relatively short histories and consequently share ownership often remains concentrated in the hands of the founding management team.

For example, in one public company we reviewed, block ownership by the controlling shareholder was over 80% of the issued share capital. Given the total control that flows from this degree of ownership, minority investors need strong reassurance that the controlling shareholders will always act in the interest of all shareholders. The purpose of this section of the study is to help investors interpret, using publically available information, the mindset of a company's ultimate controller and their attitude to strong governance and internal controls.

Board construction

The 'Signals and Smokescreens' study found consistent key indicators that help investors assess the real intentions of the controlling shareholders as they construct the boards of public companies. Some companies have a diversity of experienced directors that shows a real desire to implement the proper governance standards and internal controls that are needed to build shareholder value over the longer term. Others are stacked with insiders who lack the interest or authority to protect the rights and interests of minority shareholders, and this may indicate a short-term desire from the controlling shareholders to take as much value out of the company as possible.

Warning signals

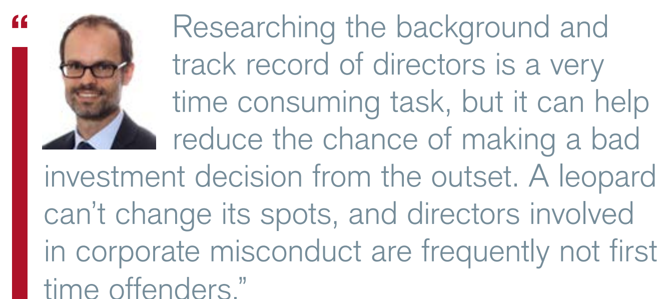
Examples of companies with signs that controlling shareholders are not prioritising the long-term interests of all of the shareholders included situations where the boards had some of the following characteristics:

- **Family-firsters** – some company boards are dominated by family members of the founding management team; one consisted of two brothers, plus their brother-in-law, with no experienced independent directors. In another case of a quoted Hong Kong company, the chairman appointed her 21-year old son as an independent director. There are also plenty of examples where family-run companies have genuinely independent, competent non-executive directors and this gives a high degree of comfort that the founders want to do the right thing and build value over the longer term for the benefit of all shareholders.
- **Vase-directors** – this term refers to appointments that are more decorative than functional, often consisting of esteemed scholars and learned academics, who have little or no corporate or business experience and are thus unlikely to detect and prevent governance failures. In one particularly high-profile fraud, after one of the non-executive directors was fined for his failure to intervene, he protested publically that he should not be punished because he 'always regarded the independent directorship as an honorary title,' 'knew nothing about the operation of the company' and 'did not have the ability to understand the accounting sheets'. The appointment of such 'vases' implies that the controlling shareholders are keen to avoid proper scrutiny on behalf of minority shareholders.
- **Musical chairmen** – sometimes there is an astonishingly high turnover of directors and executive staff. This is by far the most prevalent red flag observed in underperforming or fraudulent Chinese companies. Multiple resignations of board members or dismissal of executives indicates tensions at a management and board level and suggests that individuals could be leaving as a result of discomfort relating to its operations and/or financial reporting. One company we reviewed saw five chairmen in the space of three years, whereas another saw 9 resignations from the board within a period of one year.
- **Impulsive strategists** – other companies have chairmen who impulsively make up business strategy as they go along, implying that there is no proper internal review process by a competent board. Examples include a quoted business that manufactured LED lighting in southern China, which suddenly acquired a second tier French football club. The chairman of the company, interviewed after the announcement, said in a somewhat unguarded moment that he had initially been against the acquisition because he "didn't know anything about the football business," but changed his mind because "President Xi wants to promote football in China so it's a good relationship crossover."
- **Un-Chinese characters** – appointment of a director or CFO who has no experience in China, no presence in China or who cannot read Chinese characters. This type of appointment has been made at numerous high-profile cases of major fraud in Chinese companies where management took advantage of the information asymmetry this presented, using it as an opportunity to pull the wool over the eyes of foreign directors and, in particular, CFOs who could not read Chinese. There is no reason why shareholders should not ask the directors and management at the AGM whether or not they can read Chinese, but this very rarely happens.

Investment team perspectives

"In China analysing the board of directors is a particularly important insight into the culture and professionalism of a company. This is particularly important in China where strong leaders, family businesses and high levels of related party transactions are common."

Charlie Awdry
China equities investment manager



"Researching the background and track record of directors is a very time consuming task, but it can help reduce the chance of making a bad investment decision from the outset. A leopard can't change its spots, and directors involved in corporate misconduct are frequently not first time offenders."

Antony Marsden
Head of Governance and Responsible Investments

- **Prior record** – reputation is often the best judge of a person's character and competence. It is therefore very revealing of the intentions of controlling shareholders when they appoint individuals to the board who have either been intimately involved in or associated with corporate scandals. In an examination of one NYSE-listed company, we found that the controlling shareholder had appointed an individual as director and chairman of the audit committee who had previously been the CFO of a NASDAQ-listed company that collapsed spectacularly after allegations of fraud, wiping out over US$1 billion in shareholder value. This would have been revealed by a rudimentary desk-analysis of the internet.

Positive attributes

On a positive note, we have found Chinese stocks that performed robustly under conditions of financial stress, such as a short-attack*, where a diverse and properly experienced Board was able to 'circle the wagons' and mount a prompt, coherent and decisive response for the protection of shareholder value.

We particularly noted one Chinese software company that suffered a sustained short attack, but eventually emerged from the ordeal with its stock price intact. The board consisted, not only of the core controlling management team, but also highly experienced corporate veterans from a variety of business backgrounds, including the former head of the Asian operations of a major investment bank and a representative of a large US-based institutional investor that had a substantial stock holding and remained firm. The inclusion of this level of expertise demonstrated that the controlling shareholders had not only appointed directors committed to the long-term success of the company, but who also had reputations to lose and would therefore be vigilant in enforcing good governance. We found this to be a clear sign that the controlling shareholders viewed their interests as aligned with those of minority shareholders because it implied that they both had nothing to hide and were willing to prove it.

Summary

The key question here is:

What signs are present to help investors understand the mindset of the individuals who ultimately control the company and to assess the proper alignment of the interests of all shareholders through good governance?

The table below shows the flags that were most instructive in our analysis.

Red flags	Green flags
'Vase-directors'	Appointment of directors with a wealth of relevant experience where it is clear what they will bring to the table
Family members on board	Appointment of directors with the right experience that unquestionably demonstrates competence.
Foreigners on the board who don't speak Mandarin, or split management with, say, key management personnel or directors in the US and operational management in China.	Foreign directors with experience/careers in China. Directors who can both understand the Chinese mind-set but bring a different perspective.
High turnover in management/ directors, especially the CFOs.	Relatively stable Board and management team, indicating that insiders are not uncomfortable with the company's activities
Directors or executives associated with past scandals or with poor reputations	Appointment of directors with 'reputations to lose'

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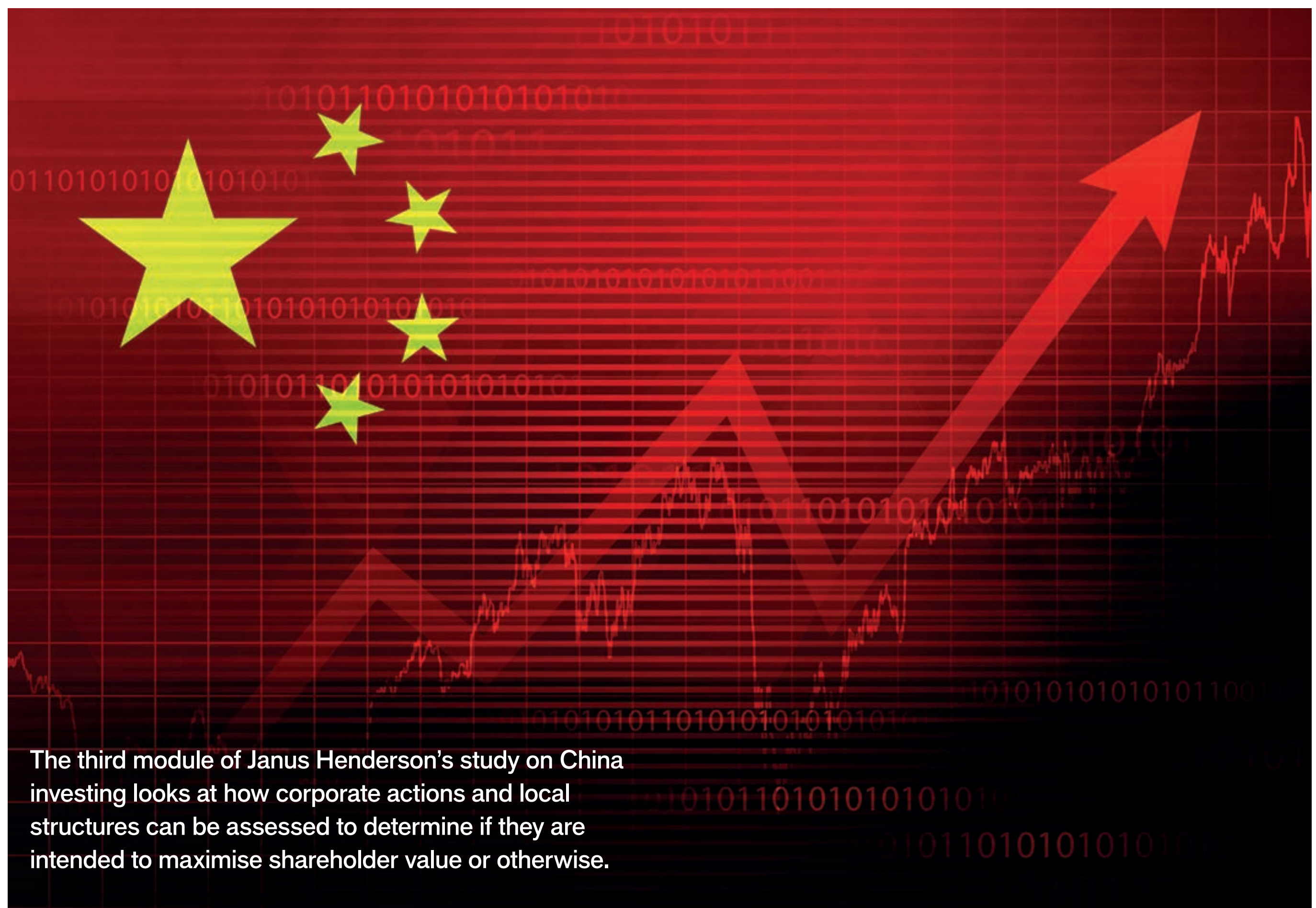
China investing:
Module 3 – material and related-party transactions



The third module of Janus Henderson's study on China investing looks at how corporate actions and local structures can be assessed to determine if they are intended to maximise shareholder value or otherwise.

Source: iStock

'THE FIRST FAVOUR IS A FAVOUR, THE SECOND AN OBLIGATION.'

The ties that bind may be less clear than you think – Chinese proverb

Our core focus in the 'Signals and Smokescreens' series is to educate investors in identifying factors relating to the internal structures and external relations of Chinese companies. This can help to reveal the true intentions of a company's controlling shareholders. While it is crucial for investors to be cognisant of these factors in making fully-informed decisions about investing in Chinese equities, it goes without saying that a crucial part of the investment process ultimately depends on the flow and circulation of money; where is it coming from and where is it going?

China's ongoing and rapid transition from a planned economy to a hybrid system where market forces play a major role means that regulations have not yet had time to develop to the levels of international norms. This means that Chinese companies wishing to list domestically face an arduous listing process that is tightly controlled by multiple government agencies, resulting in low approval rates that are subject to minute fluctuations in government policy. In order to avoid these hurdles, many Chinese companies opt to list on foreign exchanges, which can generate added prestige and larger amounts of capital. Although, in the vast majority of cases, this arrangement has benefited both foreign investors and the Chinese controlling shareholders, it nonetheless creates a potential risk. Proceeds from the listing can potentially be extracted onshore from the listed entity under the guise of value-generating material transactions where there are fewer impediments to these funds being misused.

Moreover, though transactions with related businesses can be problematic for companies in all jurisdictions, related-party transactions (RPTs) can be particularly challenging in China. This is because China's business culture has been developed over centuries through reliance on trust built through deep personal business relationships – or '*guanxi*' – rather than written contracts negotiated at 'arm's-length.'

Disadvantaging investors

The two cultural and regulatory factors explained above result in much weaker protection for minority public shareholders against material and RPTs taking place at non-market valuations. Thus they warrant close scrutiny and targeted analysis by investors as they assess opportunities in China. The 'Signals and Smokescreens' study has examined more than 50 Chinese companies, and material transactions that disadvantaged the minority shareholders were found in over half of these cases – approximately a third of those were between related parties. Additionally, many of the companies examined lacked transparency in their corporate structure, which raised the risk of misuse of shareholders' funds through these transactions.

Here we describe factors that investors should consider when evaluating whether material transactions were intended to benefit

the related parties involved or the whole of the shareholder group. Through our analysis, we have come across several cases where the transfer of an asset to a publicly quoted company was obviously completed at a non-market value; others were more subtle, but equally dangerous.

Material transactions – risks in practice

Some of the examples of material and RPTs that were detrimental to shareholder value that we encountered include:

- **Spider's web**
  The most important sign of potential risk – and one that can be easily identified – is the partial listing of just a fraction of a much larger, complex and interconnected China business under common control. In these sorts of structures, it is essentially impossible to verify independently whether transactions between the onshore entities and the offshore listed company have been negotiated at 'arm's-length.' One example disclosed in the Chairman's Statement less than a year prior to its suspension from a major stock exchange was that '*38% of our sales in the year were transactions to independent third parties*', which by implication means that the remaining 62% were not. In another case, a company was able to book fictitious forestry assets through 'authorised intermediaries' who were actually acting in concert with the listed company's management. These situations are not so difficult to detect as they often involve the acquisition of capital assets without a corresponding cash payment. In both cases, the listed company was experiencing ballooning receivables from the related parties, who were essentially using the listed company as a bank. If there is no transparently rational reason for keeping substantial parts of an overall business out of a listed company, investors should be wary.

- **Lack of independence by valuers**
  We noticed one Hong Kong-listed entity that purchased property development rights on the Chinese mainland from companies owned by the chairman of the listed company. The net asset value of the acquired entities was only slightly above HK$1 billion, however, the purchase consideration paid was over HK$5.5 billion. The transaction was supported by a report from a foreign valuer, who was different from the one that had been engaged in the past. The new valuation company was itself experiencing financial stress at the time and its holding company went into administration a few months after the deal completed. Given the materiality and conflict of interest regarding this transaction, the valuation may not have been truly independent and might have been used deceptively by the chairman to justify an artificial purchase price at the expense of the minority public shareholders.

- **Placements for personal gain**
  A series of discounted equity placements were made by a Hong Kong-quoted company to outside companies owned by its own chairman. This resulted in mass resignations from the board and the chairman owning a huge majority of the quoted company. The chairman then sold the placements into the market at substantial premiums, netting a personal fortune of US$1.2 billion. These transactions all took place within a few years.

- **Keeping it in the family**
  We noticed a NASDAQ-quoted China stock that disclosed an acquisition for US$15.3 million. Several months later, in a separate disclosure, it became apparent that the vendor of the acquired business had itself only purchased it a month beforehand, and that the price paid by the vendor was US$6.1 million. The unreasonable capital gain in such a short time is cause enough for suspicion, but a third disclosure revealed later that the vendor company that enjoyed the gain was owned by the wife of a controlling shareholder in the NASDAQ purchaser. It also stated that '*the contract did not cover indemnification regarding the improper payments to foreign government officials by employees of the target company.*' The suspicious nature of the transaction could have been revealed by a desk-analysis of the original seller, whose identity had been disclosed, and whose US-quoted business had sold its Chinese subsidiary due to the discovery of illegal payments.

- **Unexplained pricing differences**
  The management of a NASDAQ-listed cable television and GPS equipment manufacturer prepaying for the equivalent amount of office space on the third and fourth floors of the same unfinished building. According to the notes to the financial statements, the third floor had been purchased for US$1.7 million and an identical space directly above on the fourth floor had been purchased for US$8.1 million. A brief search on the Chinese internet showed that both of these prices were above market rate, implying that the discrepancy may have been due to the payment of kickbacks.

- **Self-dealing**
  In 2014 a Hong Kong-listed producer of natural gas in China announced it had agreed to purchase two of its parent company's wholly-owned entities situated in North America for a total purchase consideration of US$200 million. The issue was that the controlling shareholders of the Hong Kong-listed entity were also controlling shareholders of the parent entity and that both of the acquired North American subsidiaries were making significant net losses.

Natural evolution, intentions and foresight

In the US, the Securities and Exchange Commission was established more than eighty years ago, whereas in China, the comparable regulator, the China Securities Regulatory Commission, was empowered by the China Securities Law that was enacted less than twenty years ago. As mentioned above, this means that the regulatory oversight regarding material and related-party transactions is much less developed in China than in more mature markets. However, it must be stressed that this does not mean that the presence of highly material or RPTs necessarily signifies nefarious activities. These transactions are essential to the functioning of many businesses. As China's market continues to evolve, these sorts of transactions in the form of capital expenditure, mergers and acquisitions and changes in block ownership are to be expected and are, in many cases, vital to the long-term viability of companies.

Notwithstanding all of the above, our focus here has been on interpreting information surrounding material and related-party transactions to provide insight as to whether the transactions were intended to maximise shareholder value, not whether or not they actually do. For instance, in the above example of the discrepancy in purchase considerations for two floors of office space in the same building, real-estate prices might have subsequently sky-rocketed. Nevertheless, we can use the unexplained discrepancy in the price paid for essentially identical assets to understand the management's intention at the time. In this case, the stock price collapsed about a year later due to issues that arose regarding the company's auditors. By examining the property transaction and reaching the correct conclusions about the management's real intentions in seeking foreign investment in the first place, global investors would have been able to avoid a loss.

China investing:
Module 3 – material and related-party transactions (cont.)

Key considerations

What are the main corporate actions and structures in China that facilitate the misappropriation of shareholders' funds, and how can it be determined whether these actions and structures are intended to maximise shareholder value?

The table below shows the flags that were most instructive in our analysis of companies.

Red flags	Green flags
A corporate structure where the listed entity is a small cog in a much larger machine, leading to numerous RPTs between related subsidiaries which can easily be manipulated.	Simple and transparent corporate structure with management clearly articulating the methodology and basis for related-party transactions
Use of shareholders' funds to purchase subsidiaries in which management hold stakes or personally benefit and where it is almost impossible to determine whether these are at 'arm's length.'	Clearly defined reasoning for the assets being acquired and the benefit to minority shareholders.
Transactions involving capital assets that result in ballooning receivables.	Clear business rationale and transparent disclosure of the need to structure the capital transactions in the way chosen.
Excessive use of SPVs/SPEs (special purpose vehicle/ special purpose entity), creating a complex corporate web with multiple RPTs between subsidiaries.	Low related customer concentration (ie. majority of sales are to independent parties).
Share trading or decreasing management stakes that are not proportionate to share dilution.	Material transactions should be ratified by an experienced board with no personal financial interest in the transactions.
Purchase of loss-making or non-revenue generating entities.	Material transactions only occur when ratified by an experienced board where there is clear evidence of adequate financing from a solvent balance sheet.

Investment team perspective

"Material and related-party transactions are a regular part of corporate life in China and are common in both the state and private sectors. It is imperative to understand the nature of these transactions, the value at which they are undertaken, and whether they are in the best interests of minority shareholders in order to make an informed investment decision."

Mike Kerley
Director of Pan-Asian Equities and Portfolio Manager

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China investing:
Module 4 – external oversight

Source: iStock

In the fourth module of Janus Henderson's study on China investing, we examine the capacity and independence of external auditors that investors should consider when reviewing published financial statements.

'A WISE ONE MAY CHECK A THOUSAND TIMES, BUT THERE'LL STILL BE AT LEAST ONE ERROR'

No one can be completely free from error – Chinese proverb

So far, the 'Signals and Smokescreens' series has focused on an analysis of internal governance; but as the proverb shrewdly observes, no one is infallible and mistakes can inevitably occur. While this risk is addressed in the West through the appointment of independent auditors and advisors, the practice of appointing an external auditor began only very recently in China. Moreover, the industry is heavily regulated by the state, which can compromise independence.

Certified Public Accounting firms (CPAs) have only existed in China since the 1980s; until 1998, the Chinese government required all CPA firms to be formed by government bodies or government-controlled institutions such as universities. Currently, CPA firms are regulated by the Chinese Institute of Certified Public Accountants, which is controlled by the Ministry of Finance. When they were first allowed into China in the 1990s, it was compulsory for the international 'Big-Four' accounting firms to operate through joint ventures with local accounting outfits. Foreign auditors are still required to be managed and controlled by local Chinese nationals and there are limits on the numbers of foreign partners. Additionally, Chinese regulations strictly prohibit auditors from surrendering their audit papers to foreign regulators, such as the US Securities and Exchange Commission (SEC) or the Public Company Accounting Oversight Board, even in cases involving a Chinese business listed on an overseas stock market.

These two factors – namely, the relatively recent practise of using an external auditor at all, and the heavy restrictions on the ability for foreign auditors to operate in China – can both lead to a potential dilution in the rigour of oversight by company auditors and also risk compromising their independence.

Competence and independence

When considering the audit of the financial statements of Chinese-quoted companies, we need to assess the reliability of the auditor by looking more closely at certain indicators. In our analysis of more than 50 companies through the course of this study, just under half exhibited warning signals related to the external audit function.

We will present some factors related to the capacity and independence of external auditors that investors should consider when reviewing published financial statements. Through our analysis, we observed some clear patterns between defects in external oversight and Chinese stock failure.

China investing: Module 4 – external oversight (cont.)

External oversight risk in practise

Here are some of the warning signs of problems relating to aspects of a company's external oversight that we encountered:

- **Rotating auditors**
  High turnover in auditors in a short space of time is an indicator of potential problems. For example, we encountered one Alternative Investment Market (AIM) listed company that had four different auditors in the same number of years. This is a clear signal that the audit cannot be completed to satisfactory standards. The change in auditor could be due to dismissal or voluntary resignation. In both cases the reasons should be evaluated carefully, as can be shown in the following examples.

- **Resignation**
  We noticed one case where the auditor resigned because 'management prevented them from performing adequate audit procedures on the cash at bank.' Contrary to the situation in the West, where bank statements are taken as reliable third party audit evidence, the manipulation of bank statements, in concert with bank staff, is a notorious method of falsifying accounts in China. Consequently, auditors often undertake enhanced procedures. In this case, the management refused to allow the auditors to visit the bank and they therefore resigned. This type of event should be taken very seriously by investors but, in this case, an investor noticed that the market capitalisation of the company was lower than the net cash balances and bought US$12 million of the stock, losing all of it shortly afterwards. This was presumably due to not having reviewed the public disclosure of the reasons for the auditor's resignation or ignoring it. It is of the utmost importance to satisfy oneself that the reasons for any resignations of auditing firms do not indicate problems and to assess the impact on the reliability of the financial statements.

- **Dismissal**
  In another case, we noticed that the auditor of a NASDAQ quoted Chinese company had been summarily sacked after it asked to review the company's bank statements. This absurd position taken by the Chinese Chief Executive Officer (CEO), with the excuse that the audit procedure was 'too broad,' led to several resignations from the board of directors and the collapse of the stock price. This might have been difficult to predict in advance, but more alert investors would have noticed that the same individual was the CEO of another NASDAQ company with the same brand name and, if they had promptly divested from that company as well, they would have avoided heavy losses that occurred when similar problems emerged in the second company.

- **Unreasonably low fee**
  External auditors are often considered an unnecessary bureaucratic nuisance by Chinese businesses because there has never been a perception that an audit can add value to the investment process. We have seen cases where the fee is so low that there is no possibility of performing adequate fieldwork. For example, one internationally recognised firm of auditors was paid £16,500 to audit a multi-site New York Stock Exchange (NYSE) listed company with revenues of over US$130 million. The only possible way that they could complete the audit would be to rely on outsourcing to a local Chinese CPA firm, which would probably have compromised quality.

- **Capacity and competence**
  We have seen cases where quoted companies have appointed very small auditors, which have a history of scandal or a very obvious lack of any experience in China. One US-listed Chinese company hired an auditor whose website boasted that they were the 'audit alternative for listed companies' but had no other listed clients on their website. In another case, a NASDAQ-quoted company appointed a firm of accountants based in Florida that had two audit partners and no presence at all in China.

- **Outsourcing**
  Foreign audit firms sometimes outsource the audit fieldwork in China to a local firm. For instance, the notes to the financial statements in one quoted company stated that 'more than 50% of the audit staff are employees of the auditor,' thus implying that a significant number were not, even though this was a well-known international firm of accountants. This raises the risk that audit staff have not been trained to international standards. Another listed company's audit partners had not signed off on a single annual audit from China, implying that their work was outsourced to unknown firms.

Valuations

A secondary area of external oversight that we considered was the use of external experts in assessing the carry value of material assets. Although the examples above include rather blatant attempts to avoid proper scrutiny of financial statements, we have also found some publically-listed Chinese companies with significant problems caused by expert valuations. In one example, a foreign-listed Chinese company had been involved in the development of forestry assets for harvesting and sale in China. The company's shares were suspended from trading on the Hong Kong Stock Exchange and their auditor, one of the 'Big Four', later resigned over concerns about accounting irregularities in the group's records. The company was subsequently delisted.

The company's annual reports from the reporting periods prior to the delisting displayed warning signals prior to the share suspension. The financial statements revealed that almost all of the previous three years' profits had resulted from large revaluations of forestry assets rather than revenue derived from the sale of timber. Further investigation showed that these valuations had been prepared by a small forestry consultant based in New Zealand. This firm was paid the equivalent of £3 million, which was highly material to the consultancy, to conduct specialist valuations of forestry assets in China, a task for which the firm lacked any previous experience and did not have the capacity to conduct adequate on-the-ground surveys. This should have raised questions about the capability and independence of the consultant, since the entire three years' profits derived from their valuation work.

Caveat

In summary, while it is an oversimplification to say that the appointment of a top auditing or valuation firm implies a clean bill of corporate health, nevertheless, the willingness of a management team to appoint competent auditors exhibits the mindset that should reassure investors that the financial statements have been prepared conscientiously.

Key considerations

How can it be determined whether a company is taking every reasonable step necessary to ensure that the information disclosed in the audited financial statements reflects a true and fair view of its state of affairs?

The table below illustrates some key flags that we found most instructive in our analysis of Chinese companies.

Red flags	Green flags
Appointment of an obscure auditor.	Appointment of a 'Big-Four' auditor.
Turnover in auditors within short time frame.	Retention of auditor or a credible reason for the change.
Audit fees that are incommensurate with the company's scale; increases in revenue without proportionate increase in audit fee.	Audit fees that are commensurate with the company's size and the work to be undertaken.
Outsourcing of audit work to onshore firms.	Audit opinion confirms that work was not outsourced and performed by well-trained employees.
Appointment of small valuation firms without presence in China/requisite experience; doubts can be raised regarding independence.	Appointment of experienced valuation firms with experience in China and preferably with global credibility.

Investment team perspectives

"In addition to the global issue of managing potential conflicts of interest, the domestic auditing profession in China is fragmented and suffers from overcapacity. Foreign joint ventures are highly regulated, therefore, monitoring the action of auditors and how management interacts with them is an important consideration in the due diligence process when it comes to investing in Chinese companies."

Charlie Awdry
China equities investment manager

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