

## IR Strategy Series

### Navigating the Waters of China Reverse Mergers

The China reverse merger space is currently under enormous scrutiny and investor uncertainty following a number of highly publicized accounting restatements and allegations of fraud. We are now in a highly contradictory situation where companies generating earnings growth of 40%-50% are trading at only 5 or 6 times forward earnings and 1 to 2 times book value, well below the multiples typically associated with growth companies.

Today, almost any Chinese company can be a target of a well organized short attack and subject to class action law suits, SEC and independent investigations. Frustrated with low valuations, some Chinese companies are exploring options such as going private and relisting on the A-Share or Hong Kong markets. Private equity funds are now on the prowl to buy out undervalued companies. Baring Private Equity and Goldman Sachs recently teamed up to snap up the public shares of NASDAQ-listed Harbin Electric at a 20 percent premium to its trading price in a \$750 million deal. Several other such deals are reputedly in discussion stages, showing that the big money recognizes the value of Chinese small caps.

At the same time, China has become the largest source of new international listings on US exchanges. Plus, Fortune Magazine's list of the 100 Fastest Growing Companies for 2010 contains almost a dozen Chinese companies.

What will it take for US investors get comfortable investing in these companies? What can Chinese companies do to set themselves apart?

Given the potential growth opportunities offered by Chinese companies, investor confidence will eventually return, but expect much higher levels of due diligence. Those companies that work to enhance financial reporting, embrace corporate governance best practices and engage in transparent shareholder communications will be prepared for the next stage of growth once the dust settles.

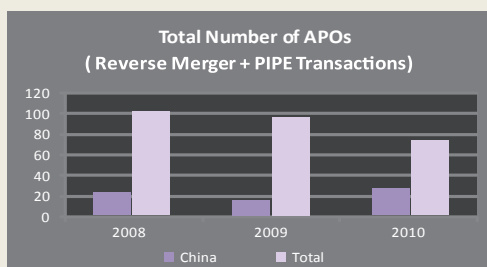
## Reverse Mergers and China

After the dot com bubble in 2000, the IPO market all but disappeared for smaller companies. These companies were forced to find alternative means of going public and raising capital, such as reverse mergers. In a reverse merger, a private company purchases control of a public company, also known as a "shell" company because it has little or no day-to-day operations. The private company then merges into the shell and becomes a public company in its own right. Reverse mergers are frequently combined with private investment in public equity (PIPE) financings, commonly referred to as alternative public offerings (APO®).<sup>1</sup>

APO transactions have a number of advantages over traditional IPOs, the most important of which are time and expense. Most reverse mergers that include a financing can be completed in as little as three months with fees of under \$1 million. In contrast, an IPO can take up to a year and cost several million dollars to complete. In recent years, the number of investors willing to participate in PIPE financings in connection with reverse mergers has increased. Plus, the Securities and Exchange Commission has legitimized reverse mergers as a method of going public. These factors have resulted in a growing number of smaller companies going public via an APO transaction.<sup>2</sup>

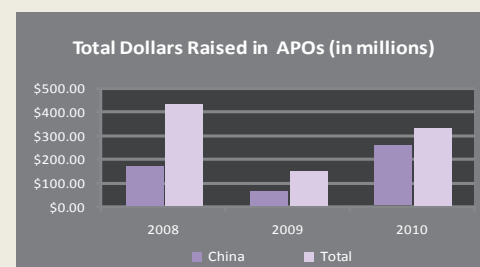
APO transactions are particularly well suited to rapidly growing, Chinese companies seeking quick access to the capital markets at a reasonable cost. The number of Chinese companies going public via an APO transaction has been increasing in recent years. Almost half of the US listed China or Hong Kong based companies currently listed on the NYSE, NASDAQ or NYSE Amex exchanges went public via a reverse merger. So far in 2010, more than 40% of APO transactions were Chinese companies (Figure 1). More importantly, Chinese companies raised in excess of \$260 million in capital, representing more than 80% of the total capital raised in these transactions (Figure 2).

**Figure 1:**



Source: Dealflow Media Inc. 2010 figures through September 2010.

**Figure 2:**



Source: Dealflow Media Inc. 2010 figures through September 2010.

## Why List in the US?

Given the time, effort and expense required to list in the US, why would a Chinese company even bother to list here, rather than Shanghai or Shenzhen where companies trade at much higher valuations?

China's domestic equity markets remain primitive on many levels. An A-share listing for a private company is subject to a waiting list of many years and relies heavily on guanxi, or government connections for approval. The newly established ChiNext market is also suffering from backlog issues. More importantly, China's A-share market lacks a functioning follow-on or secondary market. As a result, Chinese companies chose to list on outside markets such as the US, Hong Kong or Singapore.

China is a rapidly growing economy, and those companies with access to capital can leapfrog the competition. By listing in the US, Chinese companies can quickly build scale in their businesses, outpace their competitors, and pursue domestic or overseas acquisitions. A U.S. listing also demonstrates that the Chinese company has committed to international standards of financial reporting, product quality, and management. As a result, multinational customers may be more comfortable signing contracts, acquisition targets may be more comfortable accepting shares, and local officials may be more generous with land grants, licenses, R&D grants and the other forms of government support available in China. That being said, the currently depressed valuation levels in the US are causing some companies to consider a Hong Kong listing as a viable alternative.

## Performance of Chinese Reverse Merger Companies

Many factors impact the success of a company, including the successful execution of its business plan, growth strategy and strong financial performance. However, there is no denying that listing on a senior exchange provides many benefits. Exchange listed companies are more liquid, have larger market capitalizations, trade at higher multiples and find it easier to raise capital to expand their businesses or make acquisitions than their counterparts quoted on the OTC Bulletin Board.

Since entering the China market in 2005, CCG has worked with more 70 Chinese companies that went public via a reverse merger. Analyzing the performance of the companies we worked with, we found that the 36 companies that transitioned to a senior exchange had average performance of 45.3% since going public via an APO transaction, outperforming the Halter China Index by 23.2%.<sup>3</sup>

Why don't all Chinese reverse merger companies upgrade to a senior exchange? In short, it involves a lot of time, effort and expense. Companies must meet financial and operational requirements and institute corporate governance practices such as an independent board, establish committees and adopt a code of ethics. They must also meet share price, market value and float requirements and have a minimum number of shareholders. Finally, the cost of upgrading and listing on a senior exchange can be significant, especially for cash starved, high growth companies.

## Key Investor Concerns with China Reverse Mergers

Investing in Chinese stocks come with additional risks, including economic and political risks, difficulty in obtaining reliable information on the company and limitations in enforcing legal action against company executives. Investors understand and accept these risks, which are reflected in a higher risk premium for Chinese companies despite their attractive long term growth rates. There are, however, a number of other factors that impact valuation that are completely within the company's control. It is critical for management to listen to and understand the concerns that investors air on non-deal road shows, on earnings conference calls or at investment conferences. Below is a discussion of some frequent concerns related to China reverse merger companies and some strategies for management teams address them.

### Can I trust the numbers?

Because Chinese reverse merger companies are attractive investments due to their profitable and growing businesses, the integrity of the financial statements is of the utmost importance to investors. A few highly publicized allegations of fraud in the China reverse merger space have brought this issue to the forefront. Even unsubstantiated rumors can cause massive panic and sell offs of as much as 30% to 40% in a single day of trading. In this environment, it is tempting

to paint the entire China reverse merger space with the same brush. Here are steps management teams can take to differentiate their firms:

- **Engage an auditor appropriate to the scale of the business** - Frequently, the first question that investors ask when looking at a Chinese reverse merger company is “who is your auditor?” In fact, many funds expect every Chinese company they invest in to use a “Big Four” audit firm. While this may not be realistic for smaller companies, it is critical to choose an auditor that has adequate staffing and expertise to provide a comprehensive audit for a PRC-based company. Checking the latest inspection by the Public Company Accounting Oversight Board (PCAOB) can be a good place to start in making this evaluation. Please note that some audit firms based in China and Hong Kong are exempt from PCAOB inspections, which can contribute to investor concerns. Management teams should be prepared to explain their choice of auditors when meeting with investors.
- **Engage an English speaking CFO experienced in US GAAP accounting** - Investing in a high caliber Chief Financial Officer helps instill confidence in the company, the management team and the financial results. A highly qualified CFO with a strong background in US GAAP accounting can reduce the risk of late filings and accounting restatements. This type of CFO is able to build credibility and interact easily with US investors at investment conferences, on earnings calls and on non-deal road shows.

Unfortunately, this is an area where many Chinese reverse merger companies miss the mark. Some hire relatively inexperienced, non-English speaking CFOs in an effort to keep costs down. Others select CFOs that are fluent in English but have limited US GAAP and IFRS accounting experience, who are not a good cultural fit for the management team, are located in a different city or country from the company’s operations or have limited access to the rest of the senior management team. This frequently results in a frustrated CFO who feels like an outsider, and contributes to high levels of turnover in the CFO position. Chinese reverse merger companies should spend the time and resources required to hire a highly qualified, English speaking Chief Financial Officer who is also a good cultural fit for the company.

- **Invest in internal accounting systems and staff** - In order to successfully transition to working with a larger audit firm, management will need an appropriate level of staff that is highly trained in US GAAP accounting and internal controls. Engaging a larger audit firm first to provide consulting advice on strengthening internal controls can be a productive way to make sure that the company is prepared to successfully upgrade to a “Big Four” audit firm, identify and resolve any material weaknesses. A stable and highly qualified financial team will provide investors with a higher degree of confidence in the company's financial reports.

- **SEC filings are consistent with Chinese government agency filings** - Given the amount of attention focused on filings with the Chinese government agencies such as the State Administration for Industry and Commerce (SAIC) and State Administration of Taxation (SAT), it behooves management teams to verify that these filings are materially consistent with reported financials in their SEC filings. While there can be legitimate reasons for differences, such as accruals under US GAAP vs. Chinese GAAP, very large variances may be seen as a sign that reported financials are overstated. Many investors have begun reviewing these reports as part of their due diligence process.

## Corporate Governance

Corporate governance is the framework of checks and balances through which a company minimizes and manages the conflicting interests between insiders and external shareholders.<sup>4</sup> Unfortunately, corporate governance is one of the most challenging areas for Chinese management teams to come to terms with. In fact, many Chinese companies listed in the US have a long way to go in order to receive high marks from corporate governance ratings companies such as ISS, Standard & Poor's or The Corporate Library. However, there are a number of areas where Chinese companies can embrace corporate governance best practices distinguish their firms:

- **Embrace international norms of corporate governance and decision making** - Many Chinese reverse merger companies have a principal stockholder who in some cases owns upwards of 50% of the outstanding shares. The principal stockholder is quite frequently the founder of the company, CEO and Chairman of the Board of Directors. While this typically results in lower agency costs, the case with Chinese reverse merger companies is slightly different because the Chairman/CEO is often accustomed to making strategic decisions with minimal formal processes or checks and balances. One of the greatest challenges for Chinese companies that list overseas is to adapt to international norms of governance and decision making without losing the entrepreneurial vision that was instrumental to their success.
- **Succession planning** - Many of China's leading public companies are headed by relatively young, entrepreneurial executives who have been instrumental in the success of their companies. While succession planning may be the farthest issue from the CEO's mind, this is an important issue to investors. Companies that can demonstrate there is a plan in place to ensure a smooth transition in the event of a change at the top levels of management will ease investor concerns.
- **Appoint highly qualified independent directors** - Independent directors provide an outside perspective and help ensure that companies are acting in the best interest of shareholders. For this reason, it is critical to appoint independent directors that have experience in the company's industry, the capital markets, accounting, securities law, corporate disclosure or sales and marketing. Selection of a highly qualified audit committee chairman is of utmost importance because the audit committee oversees the accuracy and reliability of the financial information reported by the Company. Appointing young or inexperienced independent directors with unimpressive backgrounds in an effort to minimize costs

is frowned upon by investors. Likewise, appointing directors who serve on dozens of boards raises questions as to how much oversight they are able to provide to the company. In today's environment, many investors want Chinese companies to engage independent board members who are U.S. citizens due to their legal exposure.

- **Empower the board** - Board members have a duty to make decisions based on what ultimately is best for the long-term interest of shareholders. An effective and empowered board has the following characteristics: a majority of independent directors, relevant experience, authority to hire external experts without management's intervention or approval, and access to accurate information about the company's financial and operating position.<sup>5</sup> An empowered board provides investors with confidence that there is a high level of oversight, and companies that embrace best practices in this area are more highly regarded than those who do not.

## Carefully Consider the Implications of Equity Financings

Given heightened concerns about dilution, any offering with an equity component should have a very well defined use of proceeds that will result in increased earnings per share. Management teams should consult with their investment bankers regarding the timeline and structure of any planned equity offering, and consider whether alternative means can be used to fund planned acquisitions or capital expenditures.

## Be Prepared to Answer Questions About Related Party Transactions

Transfers of real estate, intercompany loans, related party suppliers or customers are all receiving heightened investor attention. Management should expect investors to perform increased levels of due diligence on these transactions and be prepared to explain how these transactions are in the best interest of shareholders, rather than the related party. Investors often investigate company policies regarding related party transactions with management, board members or other related individuals as part of their due diligence.<sup>6</sup>

## Corporate Structure

One issue that affects all Chinese companies, reverse mergers and IPOs alike, are concerns regarding complex corporate structures. The Chinese government has enacted a number of laws regarding foreign investment in the assets of Chinese companies, such as restricting and prohibiting foreign investments in industries that are deemed vital to the Chinese economy, such as telecommunications and online commerce.<sup>7</sup> Historically, Chinese companies wanting to access the international markets went public through a "round trip" investment in which they transformed themselves into offshore holding companies, typically headquartered in the British Virgin Islands, which then acquired the Chinese onshore business.

In 2006, the Chinese government enforced what is commonly referred to as “Circular 10”, a group of regulations which require government approval for these types of round trip investments. Since government approval is extremely difficult to obtain, a number of alternative corporate structures were been developed that fall outside the scope of Circular 10. Two of the most popular are the Variable Interest Entity (VIE) and the Slow Walk.<sup>8</sup>

For investors who are unfamiliar with the regulatory context, these corporate structures appear unnecessarily complex and risky. Therefore, management teams need to be well versed in these issues and be able to clearly explain the reasons behind their corporate structures to investors.

## **Under Attack: What to Do if You Are the Target of a Short Seller**

Short sellers prey on fear. They make a number of allegations based on data from seemingly reliable sources and use it to raise questions regarding the trustworthiness of the target’s operations, financial results or management team. This causes a flurry of panic and investors head for the doors, afraid that the allegations may be true and that they will lose all of their investment if they don’t get out now. Class action lawsuits soon follow, and a company can find itself in the midst of a crisis in a matter of days. While management is unlikely to reverse the damage to the stock price overnight, it can take steps to mitigate investor fears and help reduce the impact and duration of a short attack.

The best approach is to move quickly and develop an integrated, strategic crisis communications plan. The best place to begin is with an “all-hands” meeting that includes the management team, independent directors, legal counsel and the investor relations manager or outside investor relations firm. At the meeting, the company will determine the appropriate level of response based on input from its advisors, the nature of the short attack, the specific allegations and the market response. Some companies prefer not to engage with the short sellers while others pursue a comprehensive and aggressive response.

Some techniques that companies can utilize in the short term to make their companies less susceptible to short sellers include:

- Utilize proprietary data to identify which broker dealers have illegal naked short positions and urge them to cover those positions
- Conduct outreach to major shareholders to encourage them to remove their shares from margin accounts, thereby reducing the number of shares available to short
- Issue an active stream of press releases that communicate the latest operational developments and financial data, refute the claims of short sellers and explain changes the company is making in response to the allegations of short sellers
- Institute a share repurchase program or pay a dividend - these actions require an analysis of the costs and benefits of using cash in this manner and must be approved by the board of directors.

Other elements of an effective and well rounded crisis communications plan include:

- Proactive outreach to large institutional investors and sell side analysts
- Timely response to investor inquiries. Preparing a detailed list of FAQs is critical to ensure responses to all investors are consistent
- Special investor conference calls to address concerns and answer questions
- Designate a media spokesperson and refer all media requests to the spokesperson
- Internal communications - brief all employees on the situation via an in-person meeting, internal conference call, or email communication, reinforce “no media” policy, develop FAQs for employees to refer to when responding to inquiries from customers or suppliers
- Investor days/factory tours
- Corporate videos - especially useful for companies who are located in remote areas

The most important issue is the action the company takes in resolving any problems or issues that come out of the short attack and how it communicates those actions to its shareholders. Companies that proactively seek to remediate problems can win back investor confidence over time. This may involve amending language in SEC filings, restating financial statements, making changes to the management team and adhering to the recommendations of the Board following the outcome of an internal investigation. Those companies that fail to do so will face additional selling pressure and may face legal and regulatory action.

## Conclusion

The current uncertainty regarding China reverse merger stocks will most likely lead to higher standards across the board for Chinese companies, as part of an evolution that has occurred over the past several years. Companies that are prepared to “raise their game” by proactively addressing investor concerns are likely to fare much better and ultimately emerge as the winners as the phase of the market corrects, and investors are once again drawn to the tremendous growth opportunities in China.

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CCG Investor Relations is a leading national investor relations agency providing a full range of investor relations services to publicly held corporations, as well as privately held corporations intending to go public.

<sup>1</sup> David N. Feldman and Steven Dresner, *Reverse Mergers: And Other Alternatives to Traditional IPOs* (New York: Bloomberg Press 2009)

<sup>2</sup> Feldman and Dresner

<sup>3</sup> Return is calculated using the closing price of first active trade following the close of the reverse merger through September 13, 2010.

<sup>4</sup> CFA Institute Centre for Financial Market Integrity, *The Corporate Governance of Listed Companies: A Manual for Investors* (Charlottesville, CFA Institute 2009)

<sup>5</sup> CFA Institute Centre for Financial Market Integrity

<sup>6</sup> CFA Institute Centre for Financial Market Integrity

<sup>7</sup> For more information, see the "Catalog for the Guidance of Foreign Investment Industries" (effective Apr. 1, 2002), <http://www.fdi.gov.cn/ltlaw/lawinfodisp.jsp?id=ABC0000000000004228&apld=1>.

<sup>8</sup> For more information, see: Thomas M. Shoesmith and Woon-Wa Siu, Pillsbury Winthrop, *Financing High Growth Chinese Companies After "Circular 10"*, China Rising Newsletter Volume 1, Issue 2 April 2009 and Simon Luk, Winston & Straun, LLP, *Certain Recent Entrepreneurial Responses to China's Mergers & Acquisitions Rules* <http://www.winston.com/siteFiles/Publications/D251D3BADFE41705F62637CD143EEDA3.pdf>

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