BARRON'S

Handcuffing Shareholders

January 28, 2008
By Leslie P. Norton

Some of last year's brightest U.S. initial stock offerings were made in China. Despite the market's sharp correction, the five largest, listed on the facing page, remain 14% higher on average than their offering prices, underscoring their popularity with investors.

But a closer look at these offerings suggests investors should temper their enthusiasm. A study by RateFinancials, a respected New York firm that usually rates the financial reporting of big U.S. companies, found that on measures like quality of earnings, accounting and corporate governance, the Chinese companies don't measure up. RateFinancials, set up by two former investment bankers at the time of Enron's collapse in 2002, confines itself to publicly available documents filed with the Securities & Exchange Commission.

"The results are quite striking," says Victor Germack, co-founder and president of RateFinancials. "And these are from the documents of record, because Regulation FD says they have to reveal public information through their filings. This is what investors rely on, not puff pieces from the company." Although some acknowledged problems mostly due to rapid growth, the Chinese companies all disputed RateFinancial's findings.

The five are Giant Interactive (ticker: GA), a Shanghai-based online-game provider; LDK Solar (LDK) of Xinyu City, Jiangxi Province, which makes solar wafers; Shenzhen-based China Nepstar Chain Drugstore (NPD); solar-cell maker Yingli Green Energy (YGE) of Baoding, China; and seed-company Agria (GRO) of Beijing. They were the five largest Chinese IPOs by deal size last year on the New York Stock Exchange.

Barron's readers know LDK Solar. It was hit with shareholder lawsuits and an SEC query as a result of evidence of questionable inventory disclosed by its former controller to Barron's ("China's Solar Boom Loses Its Luster," Oct. 8, 2007) and others. LDK's own inventory investigation gave the company a clean bill of health.

Germack isn't questioning the accuracy of all the numbers. What he says is that the companies' filings reveal myriad shortcomings, including very short operating histories, multiple company-holding structures and concentrated ownership. The companies also have engaged in many related-party transactions. And they operate in regulatory environments like the Cayman Islands and China "that have historically had issues with law enforceability," says Germack.

Governance is poor. The companies don't have to file proxy statements because the SEC deems them foreign-private issuers, or "controlled companies." As a result, RateFinancials says, information about governance and compensation is incomplete and inadequately disclosed. At Agria, for example, RateFinancials sees "poor governance due to the lack of complete separation of the Chairman and CEO positions, lack of sufficient independence of the board, presence of anti-takeover provisions in the articles and memorandum of association, material weakness in the financial reporting system, indefinite terms for directors and related-party transactions."

Giant Interactive's disclosure is limited because the company doesn't have to file a proxy. Germack ticks off his other governance concerns: "A non-independent chairman who is also the controlling shareholder, a staggered board, more than two board insiders, material internal control deficiencies, related party transactions."

The majority of these companies' stock is in very few hands. Consider Nepstar, which says in its prospectus that post-offering, founder and chairman Zhang Si Min would still own 52% of the stock through a British Virgin Islands holding company. "This concentration of ownership may discourage, delay or prevent a change in control of our company, which could deprive you of an opportunity to receive a premium for your [American Depositary Shares] as part of a sale of our company and may reduce the price of our ADSs," the prospectus states.

RateFinancials found "evidence of quality of earnings weaknesses" at all the companies, including big increases in receivables, negative operating and free-cashflows, significant amounts of deferred revenues, major prepayments and sizable long-term commitments to suppliers.

The analysis firm rates companies on a scale of one to 40, with 40 the best, based on quality of earnings, accounting policies, governance, footnotes and management discussions. The five IPOs scored just 13.1. Their average quality of earnings was 5.1 points out of 20 possible points, their accounting merited two points out of five, and governance an abysmal 0.8 points out of five.

As a matter of context, RateFinancials reviewed 70 firms' financial statements last year, including the Chinese companies', for institutional investors. The overall average score was 16.4, or higher than the Chinese companies' average. (All the scores tend to be low, since these assignments usually focus on companies where there's some question about accounting, quality of earnings and governance.)

Predictably, the companies didn't like the results. Several pointed out that these risks were adequately disclosed in their filings. In a statement to Barron's, Yingli noted that revenue, earnings and EPS had all grown over the past three quarters and that the company posted "truly significant" growth in a few years. RateFinancials spotted a jump in Yingli's net receivables as a percent of revenues; Yingli responded that it was "effectively managing" its receivables. And a June 2007 earnings misstatement, it said, was related to a one-time currency gain and didn't reflect core business.

Agria, in a statement, said it "is not familiar with RateFinancials or its qualifications. However, these are not new issues as they were fully disclosed in the company's IPO prospectus. The company is presently working to address these issues. For example, as measure of independence, there are two co-CEOs, and one co-CEO is separate from the chairman." Agria said its "management and board" are "committed to shareholder transparency as an NYSE-listed public company."

Giant Interactive noted in a written reply that, as a foreign private issuer, it isn't subject to U.S. proxy rules; it's required only to file communications mailed to shareholders as mandated by Cayman Islands law. It defended its staggered board as "a common anti-takeover defense," and said that its directors are mostly independent and that its related-party transactions occurred when it was still a private company. It added that it was aware of internal-control deficiencies — "many of which reflect the effect of rapid growth in a short period" — and is trying to address them by, among other things, creating an internal-control department and hiring a new chief financial officer.

Nepstar, meanwhile, said that founder and Chairman Zhang's "controlling shareholder role at the moment is to the benefit of the small shareholders rather than to the damage of them" because of his government connections and strategic expertise. Jack Lai, LDK's chief financial officer, responded that "if a company has no infrastructure and no vision, no planning or execution, how can it accomplish this kind of growth? Our objective is to be the No. 1 solar-wafer company in the world. In three years, we could have a shot at No. 1."

Possibly, but LDK and other newly public Chinese companies will need continued shareholder support to reach their ambitious goals.