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What's Wrong With Chinese IPOs?

Another wave of Chinese IPOs is hitting the US equity market, but this time many US investors are staying dry. The reasons for this growing aversion are several, but paramount among them are evidence of actual fraud at a handful of companies, skepticism about business models and growth rates, inadequate financial controls and opaque financial disclosures. As a result, Chinese IPOs have been one of the worst performing groups in the US IPO market, which furthers investor avoidance of the sector. If an investor bought every Chinese IPO since 2008, the average return through mid June would have been a -24% loss, compared to a 25% gain on the average non-Chinese IPO.

Historical Activity and Performance of US Listed China IPOs 2008-2011

	2008	2009	2010	2011 YTD	2008-2011
US Listed China IPOs	4	12	41	11	68
% of US Total	12.9%	19.0%	26.6%	15.5%	21.1%
Total Return	-49.6%	-25.6%	-20.5%	-23.2%	-23.5%
US Listed IPOs (ex China)	27	51	113	63	254
% of US Total	87.1%	81.0%	73.4%	85.1%	78.9%
Total Return	25.7%	40.7%	26.5%	8.5%	24.8%

Source: Renaissance Capital LLC (www.RenaissanceCapital.com)

Total return measured as offer price to 6/17/11 close.

Includes IPOs with an initial market capitalization of more than \$50 million.

The ongoing fraud investigations of Longtop Financial (NYSE: LFT), Duoyuan Global Water (NYSE: DGW) and other Chinese issuers coupled with the Securities and Exchange Commission's suspensions of trading in some Chinese "reverse merger" US shell companies have caused investors to be suspicious of all Chinese IPOs. Despite these problems, issuance activity of Chinese companies in the US has continued unabated since 2009.

Early Chinese IPOs

To understand why this is happening to the initial public offerings of entrepreneurial companies from one of the largest and fastest growing countries in the world, it is helpful to review how Chinese IPOs have evolved. Back in the 1990s when nascent Chinese Communist capitalists first tested the US IPO market, the companies raising money were old-line manufacturing companies, utilities and infrastructure plays. Bicycle makers, for example. Towards the end of the decade Chinese issuance in the US was dominated by strategic state privatizations, most notably of China Telecom (NYSE:

CHA), China Unicom (NYSE: CHU), China Petroleum (NYSE: SNP) and PetroChina (NYSE: PTR). Although these IPOs were initially lapped up by investors starved for a public way to play China, many did poorly because they were not managed to developed markets' standards of public companies.

Then, the character of Chinese issuance changed entirely. Starting in 2005 with the initial public offering of search engine Baidu (NASDAQ: BIDU), Chinese IPOs represented innovative and growing companies that reflected China's emergence from a developing economy to a broad-based, post-modern society. During this period, Chinese IPOs included: Ctrip.com (NASDAQ: CTRP), a leading online travel portal; Home Inns (NASDAQ: HMIN), an inexpensive hotel chain; New Oriental Education (NYSE: EDU), a chain of English language schools; and Mindray Medical (NYSE:MR), a maker of high quality medical equipment.

By this time, China had become a dominant manufacturer in strategically important industries. Solar panels in particular. The PRC flexed its muscle with large numbers of Chinese solar manufacturer IPOs during this period, including Suntech Power (NYSE: STP), LDK Solar (NYSE: LDK) and Trina Solar (NYSE: TSL). US investors fell over themselves to get stock and the prices of the shares of these companies, regardless of quality or underlying fundamentals, soared.

Current IPO Market for Chinese IPOs

As Chinese IPOs proliferated, the Chinese government discovered the Hong Kong Stock Exchange as an alternative to the New York Stock Exchange and the NASDAQ. This served two purposes: it showed the US government that the PRC did not need the US capital markets to raise vast amounts of money and it provided a convenient way for the government to dispose of government privatizations in which US investors had limited interest. US institutional investors are more amenable to risk assets. Thus, slow growing Chinese IPOs head to Hong Kong; growth companies embark for New York.

Leaving aside the scandal-ridden Longtop and other outright frauds, too many constituents of recent vintages of Chinese IPOs share undesirable investment characteristics that reflect the opportunism of Chinese entrepreneurs and a lingering misperception that US investors are so eager to get in on China Inc. that they disregard basic investment standards. Such is not the case, as is demonstrated by the recent difficult debuts and disappointing performance of US-listed Chinese IPOs.

Problems with US-listed Chinese IPOs

The problems of Chinese issuers are many. A number of recent Chinese IPOs have moved forward with poorly described business plans that portray the company as something it is not, or not yet. Some omitted key government policy changes

that would restrict the number of products the company could sell. Other tactics make it difficult for prospectus readers to make period to period comparisons of key metrics.

Financial sloppiness, including estimated revenues, extremely high receivables and skimpy analysis of financial performance abound. A number of Chinese companies had only recently hired a Chief Financial Officer and supporting staff. Perhaps this is motivated by unwillingness to add an experienced and expensive English-speaking CFO to overhead, but it is inexcusable. Until recently some companies also used second and third tier auditors. Several issuers also had obviously quickly cobbled together businesses that had no history of operational integration. The mistrust of Chinese IPOs has been aggravated by recent auditor resignations.

The mistrust appears mutual. Several of the Chinese managements have shown arrogance towards prospective US investors, by pointing out, for example, that Chinese car buyers prefer European models to a roomful of US investors. When answering questions, key executives routinely gloss over specific concerns about their business models or recent trends. To some extent, the attitude of not wanting to admit weakness is cultural and understandable. However, being a publicly traded company is a privilege, not a right and prospective US investors are entirely legitimate in demanding full disclosure, candor and confidence that in the future information will be disclosed in a timely and appropriate manner.

To be sure, some of the Chinese IPOs understand and accept the concept of full and fair disclosure as the foundation of public markets. The businesses are clearly defined and well-described. Growth is organic, meets an unmet need and has been well executed. Valuation rationales are not supported by unlikely assumptions of vastly accelerating revenues and fattening margins. The key executives have relevant experience and have reasonable tenures at the company. Financial statements are clear, fully explained and audited by a major international firm.

China Must Solve its IPO Problems

When China first began tapping the IPO market twenty years ago, the People's Republic of China was in the driver's seat, offering investors only what the PRC wanted to sell. Today, it is the potential purchasers who are delineating the standards for the types of businesses, valuation and disclosure under which they are willing to invest. While the US SEC can tighten its regulatory purview, the ultimate responsibility for complete and accurate disclosure lies with company management and others involved in preparation for an IPO. In the end, if prospective Chinese IPOs learn the tough lessons of today's flawed IPOs and the PRC steps up its regulatory and audit oversight, China will produce many well-run, innovative companies deserving of public investment.

About Renaissance Capital

Founded in 1991 and headquartered in Greenwich, CT, Renaissance Capital is a global IPO investment advisor providing institutional research, investment management and indexing services. The Firm's research services consist of providing fundamental analysis and global IPO market analytics to the top institutional buyers of IPOs. Renaissance Capital also provides IPO-focused investment management services to individual investors through the [Global IPO Plus Fund](#) (symbol: IPOSX), a mutual fund with a \$5,000 minimum account size, and to institutional investors through separately managed accounts. The Firm maintains the [FTSE Renaissance IPO Index Series](#) (Bloomberg symbols: IPOS, IPOSC, IPOST, IPOAPX, IPOHKT), which serve as a benchmark of IPO performance and are used as the basis for ETF products. For more information, visit our website www.renaissancecapital.com.

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