Pitfalls, Perils and Possibilities for Investing in Asia: A Fund Manager’s Perspective

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I Don’t Know What I Don’t Know
Framework: Focus on China

- Investor rights and corporate governance are a “hot topic”
- The real issues—what happens when things go wrong
- Avoiding perils and pitfalls
- China versus the developed world
What Are the Real Issues For Investors in Asia?

- Land rights (or lack of thereof)
- Foreign ownership
- Sloppy accounting or outright fraud
- Disadvantages to minority investors

Source: CLSA Asia-Pacific Markets
History of Land Reform in China

1949

- 90% of population farmers
- Peasants have full, private ownership rights to land

1956

- Owned by collective farms and communes

1978

- Return of individual household use rights to land

Present

Source: CLSA Asia-Pacific Markets
Foreign Ownership is Restricted in “Strategic” Industries

- Art, Sports and Entertainment (Media, Internet)
- Telecommunications
- Farming, Forestry, Animal Husbandry & Fishery
- Mining and Quarrying
- Beverages
- Medical and Pharmaceutical Products
- Electric Machinery and Equipment Manufacture
- Production and Supply of Power, Gas and Water
- Education

Challenging Ownership Structures

Variable Interest Entity (VIE)

Source: Cadwalader, Wickersham & Taft
The VIE Structure is Common, But Not Riskless

- VIEs are commonly used by Chinese companies listing in the U.S.

- Despite how common they are, VIE structures have risks
  - As an investor, your only asset is a contract
  - Chinese government has never said they’re ok
  - Haven’t been subject to legal tests

*If VIEs aren’t enforceable under Chinese law, what are they worth?*
Case Study
Sloppy Accounting or Fraud?

Both lead to value destruction

- Chinese companies fall into three broad categories:
  - **Red chips (State owned enterprises listed onshore)**—perhaps more difficult to get a group of party members to collude?
  - **Family owned businesses listed onshore**—collusion within the same family makes fraud easier, but same jurisdiction, language, makes cross checks possible
  - **Family owned businesses listed offshore**—perhaps most prone given family ties make collusion simpler to carry out. Various jurisdictions, language barriers make it more difficult for cross references

- Ultimately, we have to conduct adequate due diligence to determine whether risks and reward are justified

Source: Kroll and CLSA
Cross-holding Ownership Structures in Asia

*Minority shareholders are often disadvantaged*

- The eight largest conglomerates in the region exercise control over 25% of all listed companies
- The top 22 control one-third of all listed companies
Economic Stake ≠ Control Rights

Ownership stake

- 50%
- 40%
- 30%

A owns only 6% of D

Control rights

- Majority
- Blocking Minority
- 30%

A effectively controls all of D
Recovery Given Default

Average recovery of 40% is in line with U.S. recoveries

Source: Goldman Sachs
Working Capital Inconsistencies are the Best Indicators of Financial Stress

- Fluctuations and inconsistencies in working capital levels are often leading indicators of financial distress
- Most bond indentures do not restrict expenditures on inventory and working capital (not a form of restricted payments), giving managers greater discretion in using company cash
- Large inventory purchases or increases in trade receivables
- Capex commitments can also trigger a cash shortfall
Best Practices If We Suspect a Problem

- **Act with speed**
  - Start taking action as soon as problems emerge

- **Know your fellow creditors**
  - Vulture investors
  - Entry price matters

- **Press for change of legal representative**
  - A company’s legal representative has all the power
  - He/she may refuse to cooperate with offshore equity holders

- **Appeal to a higher court**
  - Controlling shareholders of most Chinese companies have local political influence

- **Negotiate upfront**
Conclusion

- Investor rights and corporate governance are different
- Asking the right questions is key
- Perils and pitfalls equal opportunity
- Empirical research shows defaults and recovery experience in China is consistent with that of the U.S. experience