RESOURCEWORLD magazine
INVESTMENT OPPORTUNITIES AND NEWS

Is China's credit worse than Greece's and Spain's?

In the wake of the global economic meltdown of 2008, the European Union has been suffering from a slow-moving but unwavering crisis that has underscored the flaws behind the common currency, the euro. The euro zone crisis has toppled governments, sent a number of countries into a second recession and exposed deep rifts between regions. It has threatened the continent's six decades of progress toward gradual unification; Europe teeters between a breakup of the euro and stronger measures that would create tighter fiscal and political ties.

If you ask investors what the number one macro issue plaguing the world economy today is, they would point to the euro zone crisis. However, there are an alarming number of economists that now feel China's credit situation is far worse. There is clear evidence, with individual companies in China, that their accounting practices are horrible. A growing number of Chinese companies listed on US stock exchanges have faced accusations of accounting fraud.

While securities fraud is nothing new, the levels seen in the past 12 months are of extreme concern with the Sino Forest scandal being the most publicized. While over 20 US-listed Chinese companies have been de-listed or halted, so far in the last year, a number of others have been hit by the resignation of their auditors. Another rash of fraudulent accounting will now finally force the Public Company Accounting Oversight Board to inspect the works of Chinese accounting firms auditing US public companies. Strangely enough, the PCAOB, which was created in the wake of the Enron accounting scandal, is presently barred by Chinese securities regulators from doing so. What are they trying to hide?

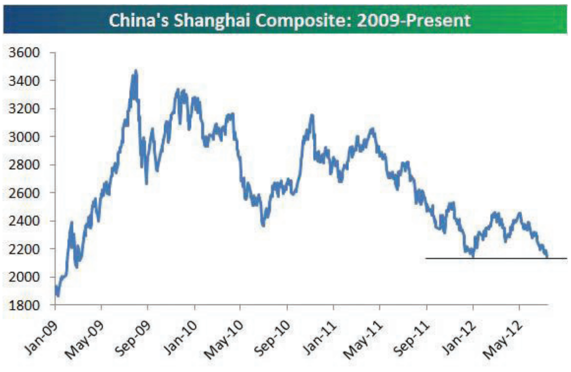
How did so many apparently toxic Chinese companies come to trade on the US stock market – thought to be one of the most tightly regulated? It turns out that many problem companies have listed by means of reverse merger. Chinese companies looking to get into North America can take one of two paths: submitting a formal application, or employing the strategy of a reverse merger. In a reverse merger, a private company buys a public shell company which no longer operates, but which is listed on an exchange. The private company then sells its shares on the exchange through the approvals granted to the previously listed company.

How did so many apparently toxic Chinese companies come to trade on the US stock market – thought to be one of the most tightly regulated? It turns out that many problem companies have listed by means of reverse merger.

Reverse mergers are arguably less demanding than going through a formal listing application, as the process is exposed to less scrutiny. Where the shell is an SEC-registered company, the private acquirer is not required to undergo an expensive and time consuming review by state and federal regulators; this process has already been completed by the public company. The process is also less costly. Where underwriting costs for an IPO often reach 7% to 12% of the total price of offered stock, the price for purchasing a shell company is generally around $50,000 to $500,000. Another benefit is that reverse mergers are less time consuming with a completion timeline of 6-8 weeks provided you have qualified professionals doing the work. The speed and lack of scrutiny involved in the process, however, makes reverse mergers much more susceptible to fraud. According to the PCAOB, over 150 Chinese companies, worth $12.8 billion, have entered US markets in this way since 2007, with only 50 filing IPOs. In June 2011, the SEC warned investors against investing with Chinese firms listing via reverse mergers. Recently, the Hong Kong Securities and Futures Commission (SEFC) published a report on the role of investment banks in IPOs detailing examples of poor due diligence, inadequate disclosure and insufficient scrutiny of potentially illicit operations.

Recently, what is leading the trend down is large cap Chinese names that have had an earnings warning i.e. "upcoming quarterly income to be less than expected." As we write this, China's main stock market index, the Shanghai Composite, fell another 1.74% to a new 2012 low. As shown in the chart, it's make or break time for Chinese stocks.

The Shanghai is currently trading right at its prior lows from 2011. If this level breaks, it will be a nightmare from a technical per-



spective. With the index already down 38.12% from its highs in August 2009, Chinese investors are not looking forward to another technical breakdown. On the flip side, if the Shanghai Composite holds here it could represent a short term buy signal.

In summary, with so many concerns in Europe and the US, we must ask ourselves how bad the situation might be in other markets, particularly those close to China. The evidence of faulty accounting practices is alarming to say the least and with the Asian markets on the brink of a major technical breakdown, it's time to pay attention and take caution. ■

Dennis Hoesgen and Eric Hoesgen are Senior Investment Advisors with Hoesgen Investment Partners (HIP) at Canaccord Wealth Management, a division of Canaccord Genuity Corp, Member-Canadian Investor Protection Fund. The information contained in this article is drawn from sources believed to be reliable, but the accuracy and completeness of the information is not guaranteed, nor in providing it does HIP, Canaccord Genuity Corp, or its subsidiaries, or affiliated companies, assume any liability. This information is current as of the date appearing in this article, we do not assume any obligation to update the information or advise on further developments relating to these securities. This report should not be considered personal investment advice or a solicitation to buy or sell securities. Canaccord Genuity and holdings of its respective directors, officers and employees and their associations, from time to time may buy or sell any securities mentioned herein. The views expressed are those of the authors and not necessarily those of Canaccord. Eric Hoesgen and Dennis Hoesgen can be reached at 604-643-7705 or HIP@Canaccord.com.