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The overseas listing puzzle: Post-IPO performance of Chinese stocks and ADRs in the U.S. market

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ABSTRACT

The “China concepts stock” in the U.S. has attracted a great deal of attention among international investors due to the fast growth in Chinese economy. This paper examines the aftermarket performance and the motivations to list in the U.S. for Chinese firms over 1993–2010 by considering the great impact of split-share structure reform in China. We find that the Chinese firms in the U.S. generally underperform the benchmark and industry peers in the post-IPO period of 3 years. The Chinese cross-listing ADRs show superior performance relative to the single-listings in the long run. It seems that more stringent listing requirements and accounting standards help to improve the corporate governance and operating performance of the Chinese firms. The evidence also supports that the Chinese issuers are motivated to cross-list in the U.S. due to over-investment incentives, leverage effects or free-cash-flow signaling, which is consistent with agency theory and signaling hypothesis.

1. Introduction

The “China concepts stock” in the U.S. market has attracted a great deal of attention among international investors due to the fast growth in Chinese economy. The “China concepts stock” is a set of stock issued by companies whose assets or earnings have significant activities in Mainland China. Investments in these stocks are considered as one of the purest investment plays on China’s long-term economic growth outside of foreign direct investment. Claessens et al. (2006) document that a

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country with better economic fundamentals such as higher growth opportunities and income level is associated with more internationalization of the firms including listing, trading and capital raising in international exchanges. Since 1993, increasing numbers of Chinese firms have cross-listed in the U.S. market, and many international investors buy shares in these companies in order to participate in the spectacular growth of the Chinese economy (Cheung et al., 2009). As of 2011, 243 Chinese firms have listed in the U.S. in the form of initial public offerings (IPOs) and American Depository Receipts (ADRs), and the market share of Chinese firms accounts for 73.33% of the market share among all the foreign listings in the U.S. market (Ritter, 2011). Initially, a majority of the Chinese firms were traded in the U.S. in the form of ADRs and served as a vehicle to signal the quality of state owned enterprises (SOEs).[1] According to the logic of the Chinese government—"Let the most beautiful daughter marry first", the Chinese ADRs are selected by the government or dominated by SOEs and their issuances are primarily determined by political relations, not by the firms' desire to find growth opportunities or expand foreign sales (Hung et al., 2008). Thus, the Chinese ADRs typically have more professional boards of directors, use greater accounting conservatism, and exhibit higher investment efficiency than their domestic counterparts. In addition, Chinese companies traditionally have separate, restricted share classes for domestic residents and foreigners.[2] Very few studies have examined the difference between domestic shares and foreign shares issued by Chinese firms. For example, Eun and Huang (2007) show that Chinese investors value local A-shares more highly if the firm has corresponding B- and H-shares available to foreign investors. Yang and Lau (2006) document that there are differences between Chinese firms listed as H-shares in Hong Kong and ADRs in the U.S., and they suggest that the Hong Kong market may offer a better information environment for Chinese firms compared to the U.S. market. Fernald and Rogers (2002) document that the foreign shares were sold intentionally low with deep discounts to attract global investors, and these shares are identical other than who is allowed to own them, but foreigners have generally paid only about one-quarter the price paid by domestic residents.

The "China concepts stock" has faced great challenges since a split-share structure reform occurred in China and many overseas-listed Chinese companies have tainted by fraud scandals in recent years. Due to historical reasons, a large amount of non-tradable shares exist in Chinese stock market and this causes severe agency problems. Starting from 2005, the CSRC launched a split-share structure reform aimed at eliminating all non-tradable shares and transferring non-tradable shares into tradable shares. This mandatory institutional change has resulted in significant changes in the IPO issuance and firm liquidity, and the domestic Chinese markets for new issuances were frozen in 2005. Since then, a remarkable increase in overseas listings has been observed as more and more Chinese firms seek to cross-list in the U.S. exchanges. However, many of these companies seek to list in the U.S. through reverse mergers or backdoor IPO listings. According to the Public Company Accounting Oversight Board (PCAOB), more than 150 Chinese companies have backdoored their way onto the U.S. since 2006 by using old shells of listed U.S. companies (the total market capitalization of such firms is over 12.8 billion U.S. dollars in 2010). Because these types of listings become public by merging with the U.S. publicly traded shell companies without the regulatory rigors involved in a traditional IPO, many of them are found to be less regulated or have been accused of fraud or shoddy accounting. This attracted a great deal of attention from the U.S. Securities and Exchange Commission (SEC) and the SEC started investigating them as well as the network of U.S. auditors and public relations firms who marketed such companies to the U.S. market. As a result, many international investors suffered huge losses and encountered difficulties in understanding the value and institutional features of these Chinese firms.

[1] Mr. Daojong Zhou, the former chairman of the China Securities Regulatory Commission (CSRC) talked to the CEOs of foreign listed firms and said: "Overseas-listed companies are all outstanding enterprises that are representatives of their respective industries to an extent. I hope you can also be the models of listed companies. The behavior of an overseas-listed company is not only the company's own business, it relates to our country's image of reform and openness (May 26, 1995, CSRC web news)."

[2] There are five types of Chinese shares: (1) government shares, which are held by the State Assets Management Bureau (SAMB); (2) legal entity shares (or C shares), which are held by other state-owned enterprises; (3) employee shares, which are held by managers and employees; (4) ordinary domestic individual shares (or A-shares), which can be purchased only by Chinese citizens on the Shanghai (SHSE) or the Shenzhen (SZSE) stock exchange; and (5) foreign shares, which can be purchased only by foreign investors in Mainland China (B-share), in Hong Kong (H-share), or in the U.S. (N-share). The first three types of shares are not tradable in the official exchanges, although employee shares are allowed to be listed three years after the IPO.