The Recommendations for Chinese Companies Projecting to Listing Overseas

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ABSTRACT

This paper summarizes the experience of Chinese companies overseas listing and examines the risks faced by Chinese companies. As Sino-U.S. relation has strained from 2018, the risks faced by the companies has become complicated. Therefore, the paper offers some recommendations for the companies that project to list overseas in the future. Generally, the company that wants to list overseas is only concerned that the foreign investors do not understand their business model, and thus the company cannot obtain an ideal valuation. However, as Sino-U.S. relation has tightened from 2018, the companies are required to be careful to deal with regulatory pressures posed by both China and the U.S. Therefore, as China has introduced a sci-tech innovation board and Beijing Stock Exchange offering more choices for technology companies without stable profits, for the technology companies owning sensitive data, it is better to give priority to listing in the A-stock market or in Hong Kong stock market to minimize the risk from regulation. In addition, this paper finds that the reason for many overseas listing Chinese companies is because they cannot fulfill the requirements of IPO in China stock market rather than they seek to acquire a premium predicted by the market segmentation hypothesis and the bonding hypothesis.

Keywords: *Overseas listing, Chinese companies, Market segmentation hypothesis, Bonding hypothesis*

1. INTRODUCTION

Since China's reform and opening and entrance of the World Trade Organization (WTO), more and more Chinese companies choose to list overseas, mostly listing in the United States even during the Sino-American trade friction in 2018. Some theories are trying to explain why Chinese companies decide to make greater efforts to go public in an alien stock market than in the domestic market, such as the bonding theory that Chinese firms listing in the US stock market would be rewarded a premium because of its willingness to accept more stringent regulation in the US stock market than in the domestic market. In addition, some technology companies chose to list in the US stock market because they could not fulfill the requirements of IPO in the China stock market. On the one side, in the past few years, American investors have shown more preference for technology companies than Chinese investors. On the other, many Chinese technology companies are invested by American investors through venture capital before IPO, so listing in the US stock market is more conducive to the withdrawal of American investors. However, since the Sino-U.S. relation has become strained from 2018, the risks faced by Chinese companies tending to list in the US has been increased and more complex, especially for technology companies that own sensitive data. Therefore, this paper attempts to give some recommendations for Chinese companies trying to list overseas by investigating the motivations and industries of overseas listing companies.

Many studies believe that companies want to list overseas, especially in the United States, because they can acquire a premium. At first, the premium is mainly explained by the market segmentation hypothesis that the main motivation of overseas listing is to overcome the investment barriers to obtain a lower cost of capital and increased liquidity. Li based his study on the market segmentation hypothesis. Li examined the motivations and consequences of direct overseas listing through a multivalued treatment effects analysis. The study concludes that high-tech firms are inclined to direct overseas list most and firms with high pre-IPO state ownership concentrations tend to directly list in Hong Kong rather than in the U.S., rejecting legal bonding as a motive of overseas listing [1]. Errunza and Miller find that the ability of U.S. investors to span the foreign

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security before cross-listing leads to a significant decrease in the cost of capital from American Depositary Shares (ADRs). The findings support the hypothesis that considerable economic benefits can derive from financial market liberalizations and removing market barriers [2]. Miller examined the impact of dual listing on market value of the companies issuing ADRs. Miller found that dual listing companies typically have positive abnormal returns around the announcement date. In addition, Miller found that firms listing on major U.S. exchanges, such as NYSE or NASDAQ, have larger abnormal returns than those listing on the OTC market, such as 'pink sheets' or PORTAL [3].

Stulz in 1999 doubted the market segmentation hypothesis and laid the foundation of the bonding hypothesis that Chinese firms listing in the US stock market would be paid a premium and thus lower the cost of capital because they choose to list in a high disclosure standard overseas exchange and to obey the strict laws. Zhang and King find that cross-listing firms are motivated by the legal and accounting standards of the foreign markets, more forceful listing requirements, demands for external capital, an expanded shareholder base, and foreign expertise. Doidge et al. find that cross-listed firms that have lower growth opportunities and lower external funding requirements tend to deregister from the U.S. exchange. The fact substantiates the prediction of the bonding theory. However, they do not find any evidence to support the prediction of the loss of competitiveness hypothesis that firms harmed by the Sarbanes-Oxley Act (SOX) were supposed to deregister [4]. However, by surveying private enforcement and public enforcement of securities laws against Chinese cross-listed companies, Clarke challenged the bonding theory. Clarke concludes that the actual bonding effect of cross-listing by Chinese companies cannot be justified [5]. Nonetheless, Karolyi rejected the doubt of the bonding theory by Clarke that public enforcement actions by the SEC are comparatively limited and the penalties are small-scale. Karolyi believes that the penalties for the affected companies are not just from the SEC but also the market in the form of a significantly negative stock price reaction of -6.16% [6].

Some studies use other hypotheses to explain the motivation of overseas listing companies. Doidge et al. provide a theory to explain why firms cross-listed in the U.S. are worth more and why not all firms choose to list in the U.S. The theory believes that most large foreign companies are controlled by large shareholders, so only if the controlling shareholders gain from cross-listing in the U.S. will corporations seek to do so. According to the theory, controlling shareholders choose to focus their efforts on either expropriating as many of the firm's resources as possible from minority shareholders or on increasing those resources by committing to limit their expropriation activities so that the firm can raise capital at a lower cost to capitalize on growth opportunities. Therefore, firms with high growth typically choose to cross-list in the U.S. to get money at a low cost to support their rapid development [7]. Hung et al. find that Chinese state-owned enterprises (SOEs) with strong political connections (i.e., politically connected firms) perform worse than non-connected firms after listing overseas. The paper suggests that managers of connected firms choose to list the firms overseas for private (political) benefits because the managers are more likely to be propagated in political media or promoted to a senior government position after overseas listing than domestic listing [8].

Also, some studies doubt whether there is a premium for overseas listing companies. Sarkissian and Schill investigate the uniqueness of the U.S. foreign listing premium. They compared Tobin's Q ratio of overseas listing firms from a wide cross-section around the world and observed a foreign listing premium in Tobin's Q ratio for many subsamples, not just the U.S. foreign listing subsample. This global comparison rejects the uniqueness of the U.S. foreign listing premium [9]. In addition, Zhang and King (2010) find that after listing, stocks returns are typically negative, and that the overseas listing stocks underperform the market in the post-event window from 3 days to 3 years [10].

As Sino-U.S. relation has strained since 2018, the risks faced by Chinese companies that plan to list overseas have become more complex and the cost has increased. This paper attempts to provide some recommendations for Chinese companies that have a plan of overseas listing. The remainder of the paper is organized as follows. Section 2 summarizes the overseas listing of Chinese companies and sorts out the reasons why they overseas listing. Section 3 describes the risks faced by companies seeking overseas listing. Section 4 presents the recommendations for Chinese companies that project to list overseas, and Section 5 concludes.

2. THE SUMMARIZATION OF OVERSEAS LISTING OF CHINESE COMPANIES

Until November 2021, there have been 387 Chinese companies listing outside of China. As shown by Figure 1, most of them are listed in the US stock exchanges. Some companies choose to trade on the stock markets of other countries, such as the London Stock Exchange and the Singapore Stock Exchange. From 2019 to 2021, even though the political and economic relations between China and the United States has deteriorated, Chinese companies speed up the frequency of listing in the US [11]. During these years, 116 overseas listing Chinese companies have issued new shares in the US, except for four companies listing in the London Stock Exchange and one company in the Singapore Stock Exchange.

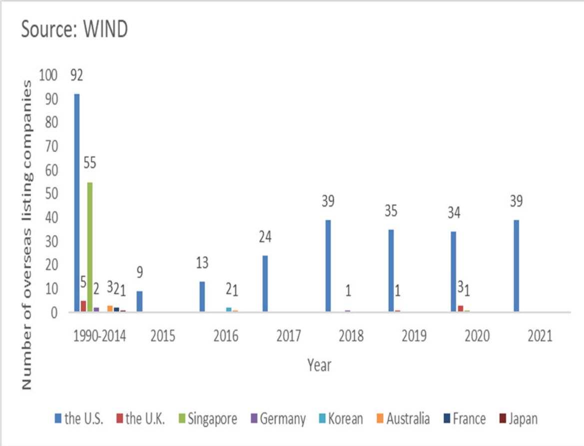

Figure 1 Numbers of overseas listing companies.

As shown by Figure 2, The companies listing overseas are mostly from technology industries, such as Information technology, Medicine etc.

However, if the Hong Kong Stock Exchange is also included in overseas stock exchanges, it must be the favourite one for Chinese companies listing overseas. As of November 2021, there have been 1202 companies from China Inland listed on the Hong Kong Stock Exchange. From 2019 to 2021, 196 companies from China Inland chose to list on the Hong Kong Stock Exchange. Among them, some companies are dual-listed in Hong Kong and the Inland or other countries. The industries of Chinese companies listed in Hong Kong are more widely distributed than those listed in the United States. Chinese companies listed in the US are mostly from technology industries, such as software, internet, and pharmacy industry. To some extent, this phenomenon reflects the preference of US investors.

The companies listed on the Hong Kong Stock Exchange are from almost all industries. However, from 2019 to 2021, the companies from the real estate industry listed in Hong Kong Stock Exchange more than those from other industries. Because the China Securities Regulatory Commission (CSRC) has very strict requirements for the listing of real estate companies, the Hong Kong Stock Exchange is the best choice for these non-technology companies, although due to higher valuation given by inland investors, they all want to go back the A-share market. For example, Wanda Business chose to delist from Hong Kong Stock Exchange to list in the A-share market in 2016. However, after five years of waiting and many efforts, Wanda recently announce that it abandons its listing in the A-share market and choose to back to Hong Kong Stock Exchange.

There are three general reasons why Chinese companies go public overseas. First, some companies cannot list in the A-share market. For example, the CSRC requires companies to list must have stable profits for three years. Some technology companies in the

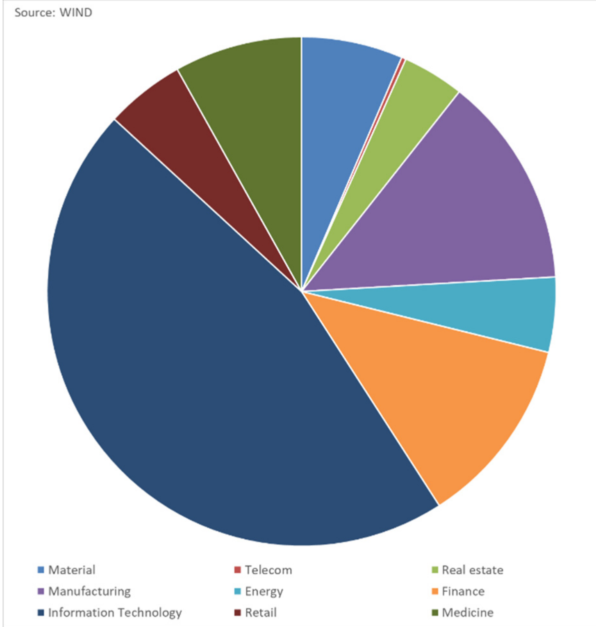

Figure 2 Industries of overseas listing companies.

fast-growth stage, such as Meituan plc., cannot fulfil this requirement. Thus, they have to list overseas. Second, some Chinese companies do their business

internationally, and they require overseas financing channels to support their overseas business. For example, Qingdao Haier Co., Ltd choose to list in the A-share market, Hong Kong Stock Exchange, and Germany's Frankfurt Stock Exchange, so that it can fund its overseas business directly. Third, listing overseas is conducive to the withdrawal of overseas shareholders. The shareholders of some Chinese companies are mainly overseas investors. Thus, listing overseas is a better choice for this type of investor to cash out.

3. RISKS FOR CHINESE COMPANIES PROJECTING TO LISTING OVERSEAS

Typically, companies that want to list on the Hong Kong Stock Exchange have the smallest risk. They only worry about whether international investors have a good understanding of their business. That's a risk faced by all companies listing overseas since they do business in the home market, but their stocks are traded in the foreign market. However, companies that want to list in the US have more complex risks from biliteral regulations. As the relationship between China and the US has become tenser, the risk of Chinese companies listing in the US is increasing. Both governments have put stricter regulations on overseas listing companies since the trade disputes between China and the United States.

On Dec 3, 2020, the House passed the" Holding Foreign Companies Accountable Act" which asks foreign companies to comply better with the audit requirements of the U.S. Public Company Accounting Oversight Board (PCAOB). Although the bill restricts all foreign companies listed in the United States, it was induced by the accounting abuse by Luckin Coffee, a Chinese company that unproperly inflates financial numbers without the usual audit scrutiny required for other American companies. Two key points of the bill have greatly hindered Chinese companies from listing in the United States. First, the bill requires the listing companies to certify that "they are not owned or controlled by a foreign government". Unlike American companies mostly invested by non-governmental organizations, most Chinese companies, such as Alibaba which lists on both NASDAQ and Hong Kong Stock Exchange, would accept the investment of the Chinese Government when they grow enough big. Second, the bill stipulates that the companies would be delisted if PCAOB is unable to inspect the company's audit for consecutive three years. The bill not only brings difficulties to Chinese companies that want to list in the US but also threatens the listed Chinese companies, such as Alibaba, Baidu.

The risk does not just come from one direction. On 10 July 2021, the Cyberspace Administration of China released the "Cyber Security Review Measures (Revised Draft for Solicitation of Comments)" which forces companies that own more than 1 million customers to declare safety reviews. The measure was released right after the IPO of DIDI in NASDAQ, a company that offers transportation services and thus has travel data of hundreds of millions of Chinese. Chinese regulators are angry about DIDI's sneaking listing in the US because they are worried that the confidential data collected by DIDI apps has leaked to the US. Since then, all products of DIDI are required to be off the app store, and new users cannot register. Therefore, after IPO, the stock price of DIDI has gone into free fall. Given this, the U.S. Securities and Exchange Commission (SEC) asks Chinese companies must disclose the risk of the new regulations. These requirements from both sides doubtlessly increase the uncertainty of listing overseas for Chinese companies.

The regulation risk is not only from the tight relationship between China and the US but also from the data regulatory challenges. In the big data era, data collected by overseas listing companies are valued. Therefore, how to regulate the data of cross-listing companies is a problem not only faced by China and the US, but also by all countries. Accordingly, before regulators explore clear data supervision measures, the risk from regulation will be faced by cross-border listed enterprises

4. RECOMMENDATIONS FOR CHINESE COMPANIES PROJECTING TO LISTING OVERSEAS

For companies that want to list overseas, choosing a suitable market to list can reduce the risk of issuance failure and give the company a better valuation. A company may be not popular in the US stock market, and the Price/Earnings ratio, which can reflect the popularity of the company in the market, is lower than other companies in the market, but it may be a sought-after company in Hong Kong Stock Exchange, and therefore it can better exploit the capital market to serve its development. How to choose the suitable market to list depends on many factors, such as the industry in which the company operates, the ownership structure, purpose of financing, or regulatory friendliness, etc.

4.1 The different industries suit for different stock markets

Technology companies, including internet companies such as Alibaba and pharmaceutical enterprises such as BEIGENE, LTD., used to like listing in the US, because investors in the U.S. financial market have a high tolerance for the profitability of high growth enterprises, and these enterprises will get an ideal valuation in the market. However, these technology companies generally have the problem of data and technology disclosure that makes regulators sensitive. Therefore, Chinese regulators have strengthened the review and supervision of such companies with sensitive data to list in the United States. The Apps of DiDi Global Inc., which owns data on the daily travel of hundreds of millions of people in China, have been suspended for over 120 days by the cyberspace regulator of China since its IPO. Thus, more and more Chinese overseas listing companies choose to dual list in the US and Hong Kong, China, such as Alibaba, Baidu, BEIGENE, etc. In addition, the reasons why technology companies prefer to list in the US are becoming less and less important. In 2019, the A-share market has increased the Science and Technology Innovation Board (STAR Market) hosting the Chinese high-growth technology companies which don't have a positive profit. In addition, Shanghai-Hong Kong Stock Connect has increased the capital flow between the Hong Kong stock market and the A-share market, making the share price more reasonable. As Chinese investors have witnessed the high growth of Tencent and Alibaba in past few years, and they are familiar with the products and markets in which technology companies operate, they are inclined to give these technology companies a high PE ratio and pay enough patience to wait for the companies to grow up.

Thus, to avoid the risk of falling into data regulatory review, technology companies are recommended to choose STAR market or Hong Kong Stock Exchange to list.

4.2 Taking Regulatory friendliness into consideration

Most Chinese real estate companies would like to go public in the mainland of China if they can choose because they can be paid a higher price in the A-share market. As of the latest, real estate companies in Hong Kong Stock Exchange typically are given a 1-1.8x Price/Earnings ratio by investors. In comparison, their peers in the A-Share market generally have a 5-6x Price/Earnings ratio. Thus, many real estate companies listed on Hong Kong Stock Exchange want to privatize and go public in the A-share market. For example, on Mar 30, 2016, only after 15 months since IPO, Dalian Wanda Commercial Properties Co., Ltd. (03699. HK) announced that it would launch a privatization invitation and delist from Hong Kong Stock Market. According to Wang Jianlin, the chairman of Wanda's board of directors, the motivation for delisting was that the share price given by the market was too low and far less than the intrinsic value of the company, and Wanda projected to list in the A-share market. However, after five years of preparation and efforts, Wanda finally gave up its plan to list in the A-share market and decided to return to the Hong Kong Stock Exchange, because China Securities Regulatory Commission has delayed the application of listing of Wanda. Not only the listing of Wanda has been delayed, but also the application of reverse takeover of Shenzhen Properties Group, a public real estate company in Shenzhen Stock Exchange, from Evergrande Real Estate has also been delayed for 5 years and Evergrande withdrew the transaction finally. Since 2010, only six real estate companies have successfully listed on the A-share market. Thus, for real estate companies eager for listing and financing, listing in Hong Kong Stock Exchange can reduce more uncertainty, although the share price of companies may be lower than in the A-share market.

5. CONCLUSION

As Sino-U.S. relation has strained from 2018, Chinese companies that project to list overseas face more risks than before, especially for companies owning sensitive data. On Dec 2nd, 2021, DiDi Global Inc. announced that it will delist from the Nasdaq Exchange after a long period of review from the Cyberspace Administration of China. The strained relation has brought many uncertainties for both the companies and the investors. Therefore, the paper tries to offer recommendations for Chinese companies projecting to list overseas.

Although the Sino-U.S. relation has tightened from 2018, the number of Chinese companies that choose to list in the U.S. stock market per year has increased. Most overseas listing Chinese companies chose to list in the Hong Kong stock market and the U.S. stock market. Except seeking the rewarded premium predicted by the bonding theory, Chinese companies choose to list overseas because they cannot fulfill the requirements of IPO in the Chinese stock market. Chinese real estate companies are not liked by both China and the U.S. Securities Regulatory Commission, so they have to choose to list in the Hong Kong stock market with a low valuation. Technology companies without stable profits choose to list in the U.S. stock market with more friendly requirements for technology companies than China stock market.

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