Silver Linings Playbook: An Update on the Chinese Company Delisting Saga

HARDING LOEVNER

by Wenting Shen, CFA

Every company, foreign or domestic, that lists on US stock exchanges is required to share underlying records supporting its audited accounts to the US Public Company Accounting Oversight Board (PCAOB) for routine audit inspections. But China's government has not permitted US-listed Chinese companies to comply with this policy, maintaining that some required information impinges on Chinese national security. For 20 years, China—as well as Belgium and France, which took similar positions—were given an unofficial pass.

This is no longer the case. In December 2020, around the same time that US-listed Chinese company Luckin Coffee agreed to pay the US Securities and Exchange Commission (SEC) US$180 million to settle accounting fraud charges, the US government's forbearance ended. Approved with bipartisan support, the Holding Foreign Companies Accountable Act (HFCAA) resolves that any company failing to meet the PCAOB's audit inspection standards for three consecutive years due to restrictions imposed by a foreign government is subject to forced delisting from US exchanges. Given that the HFCAA became effective in 2021, the first delistings of noncompliant companies could begin in 2024; however, Congress is considering an amendment to shorten the timeline to two consecutive years, which, if passed, could trigger delistings as early as 2023.

This past March the SEC ratcheted up the pressure by publishing the names of Chinese companies on track to be pushed off US exchanges. The shares of those companies, as well as those of many other US-listed Chinese companies, tumbled as much as 25% after the announcement. As of June 30, the SEC has identified 153 Chinese companies for delisting—a little under two-thirds of the total of 261 US-listed Chinese firms.

How is this issue likely to play out? I am skeptical that China's government will ever comply with the letter of the HFCAA, which includes a requirement to disclose companies' ties to Communist Party members. On the other hand, conciliatory comments by Chinese policymakers and reports that the two sides have begun discussing the logistics of allowing onsite audit inspections suggest there is room for compromises like those worked out with Belgium and France. In the meantime, since we cannot dismiss the possibility that US regulators will follow through with delisting, we need to consider the potential impact of mass delisting on the structure of China's equity markets and on our portfolio.

Plan Bs

The first Chinese companies listed on US exchanges were state-owned companies in industries such as power generation and oil and gas that debuted as American Depository Receipts (ADRs) on the New York Stock Exchange and NASDAQ in the early 1990s. They listed in the US because, until very recently, raising capital in China was hard. US exchanges offered access to a larger pool of capital, and listing rules were more accommodative to early-stage businesses. Unlike in China, there is no requirement in the US, for example, that companies be profitable before offering shares to the public. Nor is there any rule preventing public companies from issuing multiple share classes with different voting rights—a key inducement for company founders wanting to maintain control over the company without retaining most of the shares.

China's domestic A-share market has grown and become more capital-friendly over the years, but significant restrictions still apply, including limits on how much of a company any single foreign investor may own. For Chinese companies that desire access to foreign capital but want to stay within sovereign China (and not have to worry about national security issues, etc.), listing in Hong Kong has long been another option. Historically, the listing requirements for Hong Kong's Main Board relating to profitability and revenue were also stringent. But over the past few years, as it sought to equalize its footing with other leading global exchanges, Hong Kong relaxed its requirements. For instance, Hong Kong now allows multiple share classes with different voting rights, the same as the US.

Between Hong Kong's liberalizing reforms and the ongoing audit inspection controversy in the US, it is no surprise that more US-listed Chinese companies are now migrating to Hong Kong. In the 18 months since the passage of the HFCCA, over two dozen Chinese companies trading on US exchanges have become dual listed in the US and Hong Kong, joining a dozen that already had dual listings in place. Hong Kong-listed shares are fungible with US-listed ones, so investors can convert their US holdings to the Hong Kong equivalent at any time. Many investors have been doing that, thereby increasing the liquidity of the Hong Kong shares. For example, Alibaba has had a secondary listing in Hong Kong since 2019. As recently as two years ago, only 8% of its shares traded in Hong Kong; by mid-year 2022, more than 30% of them traded in Hong Kong. When its trading volume in Hong Kong surpasses 55%, the company will be eligible (and will eventually be required by the Hong Kong Exchange) to designate Hong Kong as its primary listing, at which point trading in the shares could open to mainland Chinese investors through the Shanghai and Shenzhen Stock Connect program.

On the Bright Side

From our perspective, issuers and investors will ultimately find their own solutions to the delisting threat. If negotiations become deadlocked, the shift in trading activity to Hong Kong should

accelerate. More Hong Kong trading volume means more local, Chinese, and other foreign shareholders who are unconcerned with US rules. The fewer shareholders with a direct reason to worry, the less bearing the delisting issue will have on the share prices. Not all US-listed Chinese companies will be able to follow the path taken by Alibaba and others. Hong Kong's listing requirements, while more relaxed, are still stricter than the US's. But the great majority of the larger listings will convert—including those in our own qualified universe of profitable, high-quality growing businesses.

Today, all the shares in our Chinese Equity portfolio are either Hong Kong shares of dual-listed companies or mainland-listed firms. That brings me to one more impact of the de-listing saga: It appears to have helped catalyze reforms of China's capital markets. Last year saw the launch of the Beijing Stock Exchange, designed to allow small- and mid-sized firms to raise capital more effectively. The Shanghai Exchange's Science and Technology Innovation Board was established the year before with a lower profitability threshold for listed companies. Now the new board has indicated it will move to a registration IPO system that reduces regulators' involvement and shifts compliance responsibility onto the listing companies themselves, cutting IPO lead times from multiple years to a few months. Over time, these reforms should reduce Chinese companies' desire to offer their shares on US exchanges. That, in turn, will help grow the pool of mainland-listed companies, which will benefit our investors.

Despite its growing pains, China's large and growing economy remains home to some of the world's most dynamic businesses irrespective of where they happen to be traded. Regardless of the saga's eventual outcome, we look forward to the day when investors everywhere can focus again on the long-term fundamentals of companies.

Author

Wenting Shen, CFA, is a Portfolio Manager, Chinese Equity (Co-Lead) and Partner at Harding Loevner. View bio online.

Disclosures

This information is as of September 30, 2022 and is subject to change.

For more detailed information regarding particular investment strategies, please visit our website, www.hardingloevner.com. Any statements made by employees of Harding Loevner are solely their own and do not necessarily express or relate to the views or opinions of Harding Loevner.

Any discussion of specific securities is not a recommendation to purchase or sell a particular security. Non-performance based criteria have been used to select the securities identified. It should not be assumed that investment in the securities identified has been or will be profitable. To request a complete list of holdings for the past year, please contact Harding Loevner.

There is no guarantee that any investment strategy will meet its objective. Past performance does not guarantee future results.

