Corporate scandals risk big blow to China stocks

Concerns raised over quality of foreign listings, especially those from China

Adding to the already poor interest in SGX-listed Chinese stocks or S-shares with the Chinese markets slump, a crisis of confidence emanating from the China tainted milk saga and recent corporate scandals is threatening to cause a more serious blow.

A string of bad news on S-share companies broke out last week. The market was shocked when China Printing & Dyeing turned a trading halt into a trading suspension after announcing that its CEO and deputy CEO had gone missing. The suspension also came amid rumours that its parent company had gone bankrupt.

FerroChina also hit the headlines for being the first listed company here on record to fall victim to the current credit crunch. It defaulted on some 706 million yuan ($1152 million) of loans after banks cut the credit lines, prompting analysts to suspend coverage on the stock.

There were also others – Tianjin Zhong Xin Pharmaceutical Group and New Lakeside – that filed adjustments to their previous financial statements, flagging potential issues in the accounting quality.

Such developments have sent fresh jitters over the quality of Chinese listings here.

Assoc Prof Mak Yuen Teen, co-director of Corporate Governance and Financial Reporting Centre at NUS says: “We have to think about the quality of foreign listings coming to Singapore especially if they are coming from China.

“Do we get to pick the best of the companies?” he asks.

Dr Mak believes the China tainted milk problem that broke out last month has ramifications beyond food-related companies. “People will start asking questions on confidence in dealing with Chinese-related companies,” he says.

The “made-in-China” brand has long been a source of controversy as concerns shift from lead painted toys to toxic pet foods, seafood, toothpaste, and now milk.

Among the S-shares, ice cream maker Youcan, raw milk producer China Milk, and producer of liquid milk and milk powder China Dairy have been directly hit as their products have been taken off the shelves in a recall by the Agri-food and Veterinary Authority of Singapore.

But analysts caution against mixing the good with the bad, as failures of governance and accounting irregularities are not confined to Chinese companies. Local firms and large global names are not immune, as reflected in cases like Worldcom and Enron.

PrimePartners research manager Lim Kong Soon says while quality problems in China are real, they should not be stretched to represent all products from China.

The fact that China is now the largest manufacturer for many products and as the world’s factory, the probability of products’ default, and hence the risk of being sensationalised in the press, are much higher,” he adds. Nonetheless, it is a norm to discount S-shares further to take into account country risk and execution risk.

The sell-off in S-shares has sent many counters to new lows, with the Prime Partners China Index and FTSE ST China Index at their all-time lows last Friday and a year-to-date slump of 75 per cent and 76 per cent respectively.

According to PrimePartners’ estimates, the total average earnings of S-shares for the first half grew more than 20 per cent from a year ago. But governance issues are probably clouding out this fundamental point, analysts say.

The perceived higher risks, coupled with the slowdown in the Chinese economy and in turn corporate earnings next year, may keep valuations at depressed levels in the near-term.

A lot of S-shares are at ridiculous valuations, after pricing in a slowdown for this year and earnings growth for 2009. We are still seeing some companies trading between 2 to 3 times 2009 PE,” DMG & Partners Securities analyst Heng Tong Jin observes.

Even as issues of ethics and corporate governance linger on, Mr Heng sees it as “trade off for the high returns when investors are able to catch it.”

He believes that surprise analyst visits to S-share companies in China may help detect issues otherwise left uncovered.

In a recent report by JP Morgan, the latter screened S-shares with a market cap of over US$200 million, and found that 13 out of 21 stocks, or 62 per cent of them, triggered various warning bells. Among the issues raised were poor financial discipline such as hoarding cash instead of paying off debts, lack of disclosure, and resignation of key managers, directors or auditors.

For Chinese companies to restore investor confidence, Dr Mak says they should improve the quality of their management, find good independent directors, and manage their cashflow well.

Many Chinese companies have confided good business performance with good corporate governance, he adds. He recounts a conversation he had with the head of a S-share company, who lamented that his company was not winning corporate governance awards despite its strong profits and share performance.

“I had to explain to him that just because you have good short-term stock price performance, that does not imply that your corporate governance is good.”