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## Cease and Desist on Delist-Relist

Taking U.S.-listed Chinese companies private is the latest bad idea to sweep the private-equity world.

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Foreign private-equity firms have a history of running into trouble in China. Generally consigned to buying minority stakes instead of the traditional buy-out-and-turn-around model they mastered back home, several big-name firms have become collateral damage in various corporate fraud sagas. Yet now some PE investors look set to jump into what could be the worst China investment move of all: the "delist-relist" deal.

The theory is simple. Hundreds of Chinese companies have gained listings in the U.S. via reverse takeovers, injecting all of their assets into a dormant shell company with shares traded on NASDAQ, AMEX or, more commonly, over-the-counter. Only then do the Chinese firms discover the enormous compliance costs associated with being listed in America, not to mention the low valuations for U.S.-traded shares relative to what a Chinese company could pull from equity markets back in China.

Enter PE investors to buy out the American shareholders, delist in the U.S., and then cash out by relisting in China. Several such deals have already been hatched, including one by Bain Capital to spend \$100 million taking private NASDAQ-listed China Fire & Security Group; two deals orchestrated by Hong Kong-based Abax Capital, the planned buyouts of NASDAQ-listed Harbin Electric and Fushi Copperweld for more than \$700 million; and Fortress Group's financing to

take Funtalk Holdings' private. Conversations with market participants suggest quite a few other PE firms are now actively looking at such transactions.

Yet while the superficial appeal is clear, the risks are enormous and unmanageable, and have the potential to mortally wound any PE firm that tries.

The first problem relates to the aspect that most excites PE firms about delist-relist deals: the low share price in the U.S. The assumption generally is that this is simply bad luck. Many Chinese companies ended up trading over-the-counter or at low valuations on NASDAQ as a result of their reverse mergers. Share prices stay depressed, the theory goes, because American investors don't understand the company's business or trust its accounting.

That may be too generous to the Chinese executives. Those managers were foolish to have done a reverse merger in the first place. One can infer the boss has little knowledge of capital markets and took few sensible precautions before pulling the trigger on the backdoor listing that has probably cost the firm at least \$1 million in fees to complete and ongoing regulatory compliance. An "undervalued asset" in the control of someone misguided enough to go public this way may not be undervalued after all.

Next, there are the complexities of taking a company private. For instance, class-action lawsuits have become fairly common in any kind of merger or acquisition deal in the U.S., with minority shareholders often disputing the valuation. With Chinese companies, distance, differences in accounting rules, and unusual corporate structures are likely to lead to bigger disputes over what a company is actually worth.

As if all that weren't bad enough, it is far from certain that these Chinese companies, once taken private, will be able to relist in China. Any proposed initial offering in China must gain the approval of the China Securities Regulatory Commission. There is a low chance of success. No one knows the exact numbers, but from my own conversations with Chinese regulators, it seems likely that only 10%-15% of the more than 150 companies per month that applied to list last year gained listings. Companies whose U.S. listings failed will almost certainly suffer a serious

stigma in the CSRC's eyes. PE firms could end up owning firms that are delisted in the U.S. and unlistable in China.

Making a failed investment is usually permissible in the PE industry. Making a negligent investment is not. The risks in these deals are both so large and so uncontrollable that if a deal were to go wrong, the PE firm would be vulnerable to a lawsuit by its limited partners for breach of fiduciary duty. Such a lawsuit, or even the credible threat of one, would likely put the PE firm out of business by making it impossible for the firm to raise money. In other words, PE firms that do delist-relist deals may be taking an existential risk.

Why, then, are PE firms considering these deals? Because they appear easy. The target company is usually already trading on the U.S. stock market, and so has a lot of disclosure materials available. Investing in private Chinese companies, by contrast, is almost always a long, arduous and costly slog requiring extensive due diligence. Delist-relist seems like an easy way in, especially for smaller, less experienced PE firms.

By some counts, America's largest export to China is now trash and scrap for recycling. These delist-relist deals have a similar underlying logic, that PE firms can turn American muck into brass in China. But that's a big and very dangerous gamble. The only people certain to do well out of these deals are U.S. investors who sell out now at a small premium in the "take private" part of the deal.

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