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Leapfrogging the IPO gridlock: Chinese companies get a taste for reverse takeovers

HONG KONG | By Elzio Barreto

Investors look at an electronic board showing stock information at a brokerage house in Shanghai, China, April 21, 2016.
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Chinese firms looking to jump a massive queue of companies seeking to do initial public offerings (IPOs) and start trading their shares on the Shanghai or Shenzhen markets are increasingly going through the backdoor by taking control of companies that already have coveted listing status.

The fashion for so-called reverse takeovers is seeing some unlikely combinations, such as a mobile game developer getting listed through a shoe company and a pharmaceutical distributor tying up with a brewer. In such deals, a listed company buys a bigger privately-held company through a share exchange that gives the private company's shareholders control of the merged entity.

Companies in the IPO queue, and those advising them, had hoped China would shift to a faster registration-based system for stock market flotations from the current approval regime this March. But the new securities regulator said it would take time to draft the new rules, leaving 762 companies lined up seeking to do IPOs and many of them concerned that the process could take years.

This is prompting companies to consider acquiring listed entities whose businesses are often very modest or deteriorating in a bid to gain quick market access.

"It's a sign of companies' complete lack of confidence in their ability to calculate how long they would have to wait to get a primary IPO listing in China. It's absolutely unknowable at this stage," said Peter Fuhrman, CEO of China-focused investment bank China First Capital.

BIG PREMIUMS

These deals are proving lucrative for investors in the companies being acquired - often at sizable premiums to their stock market value - but they also raise governance concerns as those getting backdoor listings do not get the same scrutiny they would face in a formal IPO.

Reverse takeovers also bring back memories of a series of accounting scandals in 2011-2012 involving Chinese firms that gained access to U.S. markets through those transactions. The U.S. Securities and Exchange Commission suspended trading and revoked the registration of some companies, with more than 100 of them delisted or suspended from trading at the New York Stock Exchange over the two-year period because of fraud and accounting issues, according to a McKinsey & Co report.

In a public bulletin in June 2011, the SEC warned investors that “many companies either fail or struggle to remain viable following a reverse merger,” and noted there had been “instances of fraud and other abuses involving reverse merger companies.”

The regulator later approved tougher standards for reverse mergers at both the NYSE and Nasdaq exchanges.

Some other markets, including Hong Kong and Australia, also tightened and clarified rules on backdoor listings to prevent similar problems.

"The main concern with backdoor listings is...that they are often easier than IPOs and companies do not have to go through the IPO application process and accompanying scrutiny," said Jamie Allen, secretary general of the Asian Corporate Governance Association.

An average of 10 companies a month were granted approval to list on the two Chinese exchanges this year and at that rate the backlog will take nearly six-and-a-half years to clear.

The China Securities Regulatory Commission (CSRC), the markets' regulator, did not respond to a request for comment. Chinese companies have carried out $20.6 billion worth of reverse mergers so far this year, including a $2.7 billion deal by Alibaba-backed logistics company YTO Express in late March to merge with a Shanghai-listed clothing maker.

That's higher than the $19 billion of deals over the same period last year and comes after a record $66.9 billion of backdoor listing activity in all of 2015, which was also spurred by a temporary shutdown of the IPO market in China, Thomson Reuters data showed. By comparison, volumes were $46.5 billion in 2014 and $27.4 billion in 2013.

Digital advertising company Focus Media, which delisted from the Nasdaq in 2013, relisted in Shenzhen in a $7.2 billion backdoor listing in December, the biggest ever such deal.

Chinese tycoon Wang Jianlin's Dalian Wanda Commercial Properties may also seek a backdoor listing on the Shanghai stock exchange if it does not get regulatory approval to launch a planned IPO there soon, according to two people with knowledge of the matter.

Most of the deals have happened with concurrent secondary offerings to raise new funds for the merged companies.

WILLING TO WAIT

A China listing can come with a big bump in valuation. Companies listed on Shenzhen's ChiNext board for high-tech and fast growing companies trade at an average price-to-earnings ratio of 70 times, compared with 13.4 times in Shanghai, where China's largest state-owned firms are listed, 9.3 times in Hong Kong and 20.3 at the Nasdaq.

The price in shares of Focus Media's 'shell' target Hedy Holdings have nearly doubled in value since the companies announced in August the reverse merger that allowed Focus Media to list in Shenzhen. Shares in Kingnet Network Co Ltd have soared 154 percent since April 2015, when Taiya Shoes made a bid for the mobile game developer.

Still, some companies that only recently entered the China IPO queue are willing to wait.

"We are not sure how long (until) we can get listed, but we understand that a lot of companies are applying for IPO and may need to wait for a long time," said an investor relations officer at Jiangsu Heshili New Material, which produces materials used for fiber optic cables and filed to go public in Shenzhen in March.

MAY NOT BE CHEAPER

Reverse takeovers can sometimes be more expensive than IPOs. An IPO can cost a lot in advisory fees and work with lawyers and auditors to get a company's accounts and controls in shape to pass muster with regulators and exchanges. But with a takeover, there are also advisory fees and a lot of those same auditor and legal fees once the deal is completed – plus there is the cost of taking control of the listed company at a premium to its share price.

Indeed, the flurry of deals is pushing the price of shell companies in China through the roof, making reverse mergers only practical for sizeable companies. There were 33 reverse mergers involving Chinese companies in 2015, putting the average deal size at about $2 billion, with the average price more than doubling to $4.1 billion so far in 2016, according to Thomson Reuters data.

"If you're the nervous investors that took Focus Media private for a couple of billion in the U.S., if you're a delivery company and you need money to buy airplanes, you can't wait for two, three or five years," Fuhrman said, in reference to the way in which being listed allows companies to raise funds more easily – whether for investments or to let shareholders cash out.

"You gotta suck it up and pay the money."

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