feature

Corporate governance is key to Chinese investments

Good corporate governance is important for Chinese companies in order to regain the trust of investors following recent bad publicity. Frank Lewis is an experienced non-executive director who has been involved with Chinese companies for five years and he has thoughts on how they should approach this requirement.

Chinese investments are out of favour with many investors thanks to the disappointing performance of many quoted Chinese companies and bad publicity about the accounting and corporate governance of others.

A number of Chinese companies have left AIM in recent years. Some, such as solar cells manufacturer Jetion, have felt that the quotation was not worth the cost in terms of money and management time. Many of the companies that chose to cancel their AIM quotation did not raise the cash they expected to when they joined AIM and this meant that they got off to a bad start. Others, such as cement supplier West China Cement, have moved to other markets. West China Cement switched to the Hong Kong Stock Exchange and it did not believe it was worth maintaining two quotations.

It is not just Chinese companies on AIM that have done badly and failed to come up to modern corporate governance standards.

In fact, many of the worst examples have been quoted on the US and Canadian markets. One of the most recent scandals has concerned TSX-listed Chinese forestry company Sino-Forest Corp, which has been accused of misrepresenting its assets. This is a company that was once worth more than $6bn.

Ernst & Young has resigned as auditors and the Toronto Stock Exchange intends to delist Sino-Forest on 9 May because of its "failure to meet the continued listing requirements of the exchange".

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Scepticism

Both institutional and private investors are concerned about Chinese companies. They have been bombarded with bad publicity about the companies and the allegedly inaccurate financial information published by some of them. There is scepticism about whether accounts are really true and whether the assets exist in some cases.

Even some of the Chinese companies that have a good track record have been hit by bad publicity. Oranges producer Asian Citrus has always been careful to keep the London market informed and management regularly visits the UK to meet investors and the media. Its association with an investor involved in other scandals has not helped.

Governance

Frank Lewis is an experienced non-executive director who believes that good corporate governance is vital and this is even more important for Chinese companies given their recent history. He has been chairman or non-executive director of a number of AIM companies including three Chinese companies. He is currently chairman of Asia Ceramics and a non-executive director of China Africa Resources.

China Africa Resources was set up by AIM-quoted Weatherly International and East China Mineral Exploration and Development Bureau to develop the Berg Aukas lead, zinc, vanadium project in Northern Namibia. In the longer term, the company may buy other assets from its shareholders.

Asia Ceramics distributes ceramic wall and floor tiles, sanitary ware and other home improvement products to the domestic Chinese market. Asia Ceramics is based in Foshan City, Guangdong Province in China. Foshan is the eleventh largest city in China and the focus of the Chinese ceramics industry.

Not all of Lewis' companies have had a straightforward history. His other Chinese company directorship was of mobile phone manufacturer ZTC Telecommunications. Chaohui (aka Charles) Huang, the boss and major shareholder of ZTC, disappeared at the beginning of November 2008 and the local authorities sealed the factory. The operations were shut and Lewis sorted out the company, which was renamed China Evoline. It looked for a suitable reverse takeover target but failed to find one and was wound up.

Culture

Lewis argues that Chinese businessmen suffer "a big culture shock" when they realise the extent of the information they have to provide when they float their company, as well feature

as the ongoing information they need to provide about the business.

However, Lewis says that it is a two-way street and UK advisers and investors need to respect and understand Chinese culture.

It is important that at least some of the directors speak English and it also helps if they have worked in the West and understand the business culture.

Chinese companies need to understand that the suitability of the directors has to be investigated and there need to be competent and independent non-executive directors on the board. This is good for investors but it is also good for the company because these non-executive directors can provide input to the business.

"The concept of independent non-executive directors is not normally initially appreciated by the executive directors, and neither is what value they can add to the progress and credibility of the company", argues Lewis. It is also important that there is at least one UK-based non-executive. "They need to appreciate that these independent directors will have to communicate with advisers, as well as shareholders in certain circumstances, and ensure good corporate governance. This would generally be different to the way Chinese companies normally operate."

"Non-executive directors who have experience of working with Chinese companies can appreciate the concerns and issues of the directors because of the cultural issues and lack of experience of UK listed companies, and can help remove the concerns in a respectful way. Experienced non-executive directors can also assist with the learning curve of how listed companies should operate in the UK, communicate with advisers and deal with issues like price-sensitive information", says Lewis.

Lewis can speak from experience, having been involved with Chinese companies for five years. "My personal experience is that generally one has to earn the respect and trust of your Chinese colleagues on the board, and when there is mutual respect they will take advice on running a listed company in the UK and comply with the rules including corporate governance."

"It is very important for companies wishing to do an IPO to appreciate that the IPO is only the beginning and not the end of the process in terms of success and making money for shareholders," adds Lewis.

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New issues

Despite the bad publicity and the fact that many investors are not interested in Chinese companies at the moment there are still ones that are floating on AIM.

China-focused integrated mining services group Rare Earths Global managed to attract investors because rare earth metals have a high profile at the moment because of their scarcity and the fact that most of the current supply is from China. The company raised £5.52m, net of costs of £880,000, at 247p a share in order to provide working capital.

Ivor Shrago is the chairman of Rare Earths Global and he has legal and investment experience in the UK and Hong Kong. He has been a director of other Chinese companies on AIM, including PAQ International, which chose to drop its AIM quotation.

The latest Chinese company to join AIM is sportswear brand owner Naibu Global International. Naibu raised £6m at 124p a share but £1.65m of this went on flotation costs. Naibu initially planned to raise up to £50m at the same share price.

Naibu has three non-executive directors who each have experience in the UK and Asia. Giles Elliott is a former chief executive of UK broker Bridgewell and fellow non-executive Stephen Cheung also worked at the broker. However, there is no independent chairman. Co-founder and 46.75% shareholder Huoyan Lin is executive chairman. Elliott is the only other director with a shareholding.

Liquidity

One of the ways that many AIM companies do not help themselves is that they have too narrow a shareholder base and Chinese companies can be some of the worst offenders. Seven shareholders still own more than 90% of Naidu, while Rare Earths Global's chief executive, Simon Ong, owns 77% of the company.

Of course, there is no requirement for any free float on AIM but companies need to understand that just because they can float with very limited liquidity it does not mean that it is a good idea.

The rapid rise and subsequent slump in the share price of Dongfang Shipbuilding showed how volatile a share price can be when there is a limited number of shares available to trade. It undoubtedly meant that the share price reached heights that it would not have done had there been a more liquid market. There was a precipitous share price decline when shipbuilding contracts failed to materialise. Northland subsequently resigned as nominated adviser and the shares were suspended.

The quadrupling of the Rare Earths Group share price in the fortnight following its flotation has been exacerbated by the tightly held share base.

Chinese companies can still float on AIM but there need to be examples of good long-term performance to regain the interest of some investors. Short-term price leaps are not the way to do this.