Preface

Getting It and Betting It

China is easily the least understood of the world's major economies. Given the mystery that perpetually enshrouded the China of older times to the world outside, this is hardly a new phenomenon. But it is one whose implications grow increasingly consequential with each day that the People's Republic of China (PRC) rises in importance as a modern economic superpower.

Not "getting" China did not matter much for the people beyond its borders during the nearly two millennia in which trade with the lands of the Celestial Empire was conducted by caravans lumbering along the trails of the Silk Road; or when newly industrialized foreign powers could unilaterally dictate terms of commerce with the weakened Chinese states of the late Qing dynasty and warlord-dominated Republican era. After a fiercely independent Communist-led "New China" of the current PRC arose in 1949, its governing ideology pushed the country to recuse itself from international commerce until market-oriented reforms began three decades later.

Since China's pivotal reopening to the outside in 1979, both it and the world beyond have been dramatically changing. China has gone from avoiding foreign trade to becoming the epicenter of a worldwide, integrated manufacturing system. Along the way, it has emerged as a leader in key global industries such as mobile telecommunications, automobiles, and alternative energy. China's demand today for and supply of commodities and natural resources moves world prices. An apocryphal story that used to circulate in the World Beyond China (WBC) not so long ago related that *if all the people in China jumped at the same time, the Earth would be knocked off its axis.* Turned out that the teeming masses of China never needed to jump; they just needed to start producing and consuming enough to genuinely reorient the world in its material economic existence.

In response to this reorientation of our planet's economy, companies from the WBC have beat a path to China to invest their euros, dollars, and yen in order to hitch a ride on what appears to be the unstoppable steamrollering of China's economic juggernaut. People from every corner of the WBC flock to Chinese cities for study or employment, or to strike deals in order to maintain competitiveness in a global market system that effectively revolves around the machinations of a country whose modern existence bears truth to the Chinese name for China: "*zhong guo*" (中国), which literally means "the central nation." This state of affairs has stood out in stark relief throughout the dismal months and years during and after the global financial crisis of 2008–2009, when China's unhesitating economic expansion hummed along as the only major engine for worldwide economic growth.

The WBC has been betting on China, and betting *big*. Because of the sheer size of these wagers—the money, resources, talent, planning, and ambitions at stake—"getting" China in a way that is both meaningful and practically useful has become more important than ever before.

As with any hot topic, the world (both inside and outside of the PRC) lacks not for experts, regardless of whether they can legitimately claim true insights or expertise. Complicating matters, China engenders a plethora of extremes in opposing viewpoints about its true nature, unlike almost any other topic of mainstream business and economics discourse. China bulls see solid fundamentals that point to long-term growth, offering attractive returns for those who buy into the China story. Bears see a country riddled by contradictions and unsustainable drivers that point to a hard landing or a collapse—some predict another version of the implosion that occurred with Japan just as that nation's hard-charging economy seemed poised to take over the world in the early 1990s.

A Prism that Cuts Through the Fog

This book differs from others by suggesting a new prism through which to view key aspects of China's rise, present-day workings, and future prospects in the global economy: stocks. More specifically, it focuses on the stocks of China-operating companies that are listed on the major U.S. stock markets of NASDAQ and the New York Stock Exchange (NYSE).

The reasons for this approach are many. Fundamentally, from an analytical point of view, an enormous advantage lies in the way that detailed and vetted information about Chinese enterprises and the industries in which they operate is available from firms that are listed on U.S. stock markets.

This is partially because of regulatory requirements and stock exchange listing rules concerning timely and robust disclosure. There are market-based inducements for transparency as well. Prevailing financial market sentiment, "the Street," tends to reward with higher valuations those companies that practice high standards of corporate governance. Companies that work to communicate to the public about what management is up to generally benefit from this market tendency. As with any U.S. equity market–traded enterprise, there are multiple incentives for Chinese companies publicly listed in the United States to tell investors and the world at large about what is really happening with these enterprises and, by extension, with China's economy.

The mechanism of interactivity that occurs with Chinese companies trading on U.S. stock exchanges offers diverse benefits. It strengthens Chinese enterprises by providing them with capital investment while exposing them to the discipline and rigors of the U.S. financial system, by far the largest and most liquid in the world. It also allows the WBC to better understand what is actually happening within China and avail itself of opportunities to take stakes in the country's economic growth. Beyond the advantages offered to these market participants, in an intricately interlaced planetary economy whose efficiency depends heavily on robust flows of both information and capital (and in that order), the means by which shares in Chinese enterprises and international information consumers and investors can meet up in U.S. equity markets contributes to the functioning and development of the global market system.

The world's ongoing bet on China's reemergence—following a relatively brief period of comparative decline in that colossal nation's material development during the nineteenth and twentieth centuries after China economically flourished for millennia—as a major world economy finds a unique and influential transaction point in the American equity marketplace.

An Emerging Dynamic

The bet on China that is occurring via the platform of U.S. stock markets, although a fairly recent phenomenon, has been identifiably impacting China and the world beyond in numerous ways:

- The attractive forces of the dynamic are bringing together the world's two largest economies in a far more balanced and economically productive manner than occurs in other dimensions of the financial relationship between China and the United States.
- The watershed event that effectively opened the door for Chinese listings in the United States, the 1997 initial public offering (IPO) on the NYSE of shares in China Mobile (NYSE:CHL), not only proved to China and the outside world what was possible with such stock market listings but also helped underwrite the transformation of the worldwide mobile communications industry.
- Hundreds of China-operating companies have followed since China Mobile's watershed IPO in 1997 to issue shares in U.S. stock markets. Across a range of industries, they have broadened and deepened the PRC economy's exposure to the benefits and demands of what U.S. stock market listings entail.

- The rate of Chinese IPOs in the United States took off when the WBC plunged into a devastating worldwide financial crisis. Just as with China's unrelenting macroeconomic growth during that period, its IPO activity crucially helped stabilize and stimulate global markets as well.
- The deeper and longer-lasting effects of Chinese listings in the United States relate to the increased transparency and accountability that is being brought to Chinese issuers. This facilitates the get-bet transactions of the WBC while it similarly strengthens the Chinese issuers' knowledge of and responsiveness to global market forces.

The latter point is especially critical in what is already known about the dynamism of these listings. The process of building transparency was a lengthy and involved one at China Mobile and its affiliated companies—and not one lacking in extraordinary ironies.

As more and more private Chinese enterprises have gone to market, weaknesses in some of the methods for listing and auditing the firms have come to light. This has brought forward another set of challenges for foreign investors, Chinese issuers, and U.S. and Chinese regulators. The situation has also exposed how *getting things straight* amid all the *betting taking place* still remains a work in progress. Despite these limitations, U.S. stock market–driven information on Chinese companies remains an unrivaled source for publicly available, transparent, rapid, and insightful data about the workings of China Inc. The wagers riding on this new dynamic in global capitalism are not just about money, even if money remains the major motivating factor for placing the bets. The dynamism that propels all the betting is about *a new way of looking at China* and providing *a new way for China to look at the world*.

The Cards in This Deck

The main contents of this book fill seven chapters.

Chapter 1 explores the importance of the U.S.–China equity exchange dynamic from top-down and bottom-up perspectives. It considers the nature of shares that are traded and the companies and industries represented.

Chapter 2 starts off by examining the surge of Chinese IPOs on U.S. markets from 2009 to 2010 and what this has meant for Wall Street. It looks at the companies and industries that played a role in the wave of Chinese issuances along with the contradictory best and worst performances that these stock debuts turned in. It then reviews the sometimes-uneasy market détente that exists between two highly dissimilar economic systems, highlighting some of the populist antitrade tendencies that still resonate within China. Continuing on, it explains the new dimensions of the Sino-American financial relationship borne by Chinese stock issuances, putting the significance of this relationship in the context of selected economic theory and history.

Chapters 3 and 4 are full-length case studies. Chapter 3 discusses the story of China Mobile's birth, rise, and spillover effects as the first major Chinese IPO in America. This is not a typical company-centric case analysis; it is an examination of industrial upgrading and the creation of whole new product categories and marketplaces. If there is any one, singularly compelling illustration of the transcending benefits that come from the U.S.–China equity exchange mechanism, it is China Mobile.

Chapter 4 looks at the unwarranted fear and panic that had come to surround Chinese issuances in U.S. markets by mid-2011 from the example of NASDAQ-traded Spreadtrum Communications (NASDAQ:SPRD). China Mobile demonstrates the rewards that can accrue to those who go long on China; Spreadtrum demonstrates another aspect of this reality by portraying the perils to those who dare go short without good reason. While China Mobile is a major large-cap Chinese stock of around $200 billion in market capitalization, Spreadtrum is a small cap with a market value of approximately $1 billion. The differences in scale provide a degree of balance to the two chapters' side-by-side showcasing of company stories.

Chinese reverse mergers—a type of Chinese stock issuance that became so notorious as to be given its own CRM acronym by the U.S. Public Company Accounting Oversight Board (PCAOB)—are studied in detail throughout Chapter 5. CRMs represent a gray area of the China bet. Many legitimate China-operating enterprises have used the reverse merger process as a low-cost and efficient way to list on NASDAQ or the NYSE. Yet enough had ulterior motives, or suffered from exceedingly poor management, as to become sinkholes for investors. This chapter looks at a sampling of noteworthy CRMs from the role of accountants, short sellers, funds, regulators, commentators, and other market participants and influencers.

Chapter 6 peers into the stock market debacle known as Longtop Financial (PINK:LGFTY), the veritable *Titanic* of the U.S.–China public equity exchange relationship. It considers the extraordinarily negative consequences of Longtop's suspected fraudulent practices and subsequent NYSE delisting. The greatest damage caused by the company's failure has arisen from the way that U.S. and Chinese regulators have scrambled to control fallout without first securing good intergovernmental coordination. Chapter 7 concludes the book by considering the implications of these developments in historical context and how, if not properly managed, the regulatory impasse threatens the continuation of the Sino-American public equity dynamic as the world has come to know and benefit by it.

For those wanting to dig further into the details on those watershed frictions surrounding Chinese listings in the United States, an appendix presents the contents of the administrative subpoena issued by the U.S. Securities and Exchange Commission (SEC) to Longtop's auditor. The subpoena's contents reveal much about regulatory frustrations and differences of approach for how best to enforce transparency and accountability with Chinese listings in the United States.

As noted about the "getting" behind the "betting," the greater social value of U.S.-listed Chinese stocks is the information they convey about an extremely influential but poorly understood economic power. As information products, these stocks' perceived value can be highly subject to the forces of media writ large: company disclosures, government filings, analyst reports, journalist coverage, online blogs, and public sentiments generally.

With exactly this point in mind, while highly opinionated, an overriding objective of *Betting on China* is to present topics as objectively as possible, using transparent and easily verifiable information. Unless otherwise stated, all stock prices and related data have been sourced from information freely available at Google Finance (www.google.com/finance). Readers can just as easily reference other popular and readily accessible financial websites for such information, including Yahoo!

Finance (finance.yahoo.com) or China-based sites like 新浪财经 (Sina Finance, finance.sina.com.cn) and i美股 (imeigu.com, www.imeigu.com). References in the text that deserve citation or are in relation to statistics or other information not generally known are footnoted. Where appropriate, original verbal or textual commentary is extracted to give a fuller voice to varying points of view. This book is an attempt to present facts as much as possible in the original and let readers draw their own conclusions.

As with any iterative, evolving phenomenon, the characteristics of Chinese stocks traded on American stock markets are constantly in flux. This book analyzes the fundamentals of their market presence, the big-picture as well as ground-level factors that contribute to their performance, and the lessons that can be derived. However conditions inevitably change, readers will still be able to apply to the continuously unfolding scene of Chinese listings in America whatever insights they take away from this work.

Ultimately, *Betting on China* is about ways of perceiving the PRC of today and its impact on the world outside. The book's discussion focuses on interaction between China and the United States within the framework of financial economics, specifically equity finance. The implications of these topics stretch far, particularly into fields such as global management, corporate strategy, industrial development, international relations, corporate communications, and public policy. There is much here for anyone interested in China and global affairs, not just those who are active in the world of finance.

The Dealer's Hand

Here, the author lays his cards on the table.

First, to make unambiguously clear a statement of disclosure: During the research, writing, and until at least the initial period surrounding the planned publication of this book, the author did not directly own, nor harbor intention to directly own, any type of equity position—long, short, or otherwise—in the companies that this book discusses.

Betting on China and the sources it cites should by no stretch of the imagination possibly be construed as providing investment advice. *Caveat emptor* applies as much to interpretation of the contents of this book as it would to the purchase of any financial instrument.

As the author previously served as a research fellow at the Milken Institute—an economic think tank whose founder, Michael Milken, has in the past engaged in very high profile disagreements with the SEC and Department of Justice—this might conceivably be perceived as a source of bias by the author against these agencies of the U.S. government. This is certainly not the case. The positions of government organizations such as SEC and the PCAOB, which operates under the SEC's authority, are given ample voice throughout this book. Most of that voice is presented without accompanying criticism of any kind. What critiques the author does make of regulatory actions are offered as constructive remarks that take issue with tactics and strategies, not motives.

In any event, the last word in this book literally goes to the Commission, whose subpoena relating to Longtop Financial is extracted in full in the appendix. Readers—among whom it is hoped will include officials from the SEC and other branches of government in the United States and China—are free to, and in fact *encouraged to*, reach their own conclusions about the author's appraisal of the regulatory actions that are discussed. Those U.S.–China policy missteps and frictions, by the way, should always be thought of as part of the unfolding nature of the dynamic. They, by themselves, are neither "good" nor "bad" but, rather, integral dimensions of the iterative process of exchange. Hopefully, those involved with government policy making will resolve issues in the wake of Longtop and any other problems that might arise in the future so that market participants can stay active in generating gains of trade for themselves and society at large.

Under the auspices of the World Bank, the author has also served as a consultant to Chinese government agencies in the past and might well do so again in the future. This likewise could possibly be construed as biasing the author in another direction, namely, toward favoring Chinese government interests. This also is definitely not the case. The author raises questions about the actions of Chinese regulators, though these comments are more limited in scope. This is not done from a sense of pulling punches but, rather, is a reflection of the reality that in regard to regulating Chinese issuers in the United States, SEC and the PCAOB have (understandably) taken more prominent roles. The higher visibility and market impact of their positions offers up more substance for discussion.

In terms of current influences, after performing a variety of finance-related roles in China (including an earlier, long-since finished advisory position at a foreign fund that made a limited number of small investments into CRM companies), as of the submission of the book's manuscript, the author is consulting a number of NASDAQ- and NYSE-listed Chinese issuers on their investor relations strategies. Such past and present roles might also be viewed as causing the author to take sides with the position of Chinese issuers and insider investors at the expense of the perspective of outside investors. Again, the author does not see such background factors as affecting the balance and accuracy of the book's contents. Perusing the following pages, readers will have a chance to decide for themselves. In any event, none of the U.S.-listed Chinese companies that the author is advising (or has advised) are described in detail within the pages of *Betting on China*.

Summing Up

Concluding this preface with a bit of historical perspective to the frictions that have arisen between U.S. and Chinese officials who yield authority over the China–U.S. public equity pipeline, two Chinese idioms seem apt. The first comes from a classical treatise on Chinese economic and defense strategies, *Discourses on Salt and Iron*, a record and commentary on government policy debates that occurred in 81 BCE (making it a tad older than the contents that went into the New Testament of the Christian Bible). A tenet of governance proffered by *Discourses* is that public officials should "promote righteousness and deemphasize wealth" (*zhongyi qingcai*, 重义轻财).[1] The phrase articulates a traditional Confucian-influenced view that sees financial gain as less important than moral rectitude. Such age-old principles, while not always practiced, remain part of the ethical doctrine of contemporary

Chinese society. This kind of thinking coexists alongside the motto of China's present era: "to get rich is glorious" (*zhifu guangrong*, 致富光荣), a concept that seems similarly adopted by outsiders betting on China's economic growth prospects.

Finding ways to ensure that "getting rich" is still accomplished by "doing right" presents an ongoing challenge for China and its trading partners, one intensified by the interfacing of highly divergent national systems. Nevertheless, the challenge can be met. In the realm of public equity trading, mutually rewarding interactions require supportive markets matched by effective oversight. Winnings need to be justly earned—something that all responsible parties in authority can agree to. The author's greatest hope is that policy makers on both sides of the equation that administer the U.S.–China public exchange mechanism can resolve differences as they arise so that this vital relationship does not merely continue, but thrives.