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September 30, 2013

Montage IPO–Are The U.S. Markets Re-Opening To Chinese Companies?

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The U.S. capital markets—the largest in the world—have been all but closed to Chinese companies for more than two years. The successful IPO of Montage Technology, and e-commerce giant Alibaba's announcement that it will seek a U.S. listing, may signal the long-awaited re-opening of the U.S. capital markets to Chinese companies. There are also lessons learned.

Pillsbury recently represented the underwriters, led by Deutsche Bank Securities, Barclays and Stifel, in the successful $150 million IPO of Chinese semiconductor company Montage Technology Group Limited (NASDAQ:MONT) (www.montage-tech.com). This is encouraging news for Chinese companies watching the international capital markets. There are also some clear lessons learned from this IPO.

The Closing of the Markets

Between 2004 and 2010, more than 300 Chinese companies went public in the United States, many of them middle-market enterprises, across a range of industries. A large percentage of them are now gone, taking themselves private, delisting, or simply going dark. A small but significant minority are embroiled in SEC investigations and stockholder litigation. As a consequence, the U.S. markets have been all but closed to Chinese companies for more than two years.

The fundamental drivers have not changed, though. China is still jammed with high-growth companies that need capital. Among other reasons, the Shanghai stock exchange has been closed to new listings for over a year. Likewise, the Shenzhen exchange has suffered from near-fatal volatility. As a result, debt is increasingly difficult to raise in China. And PRC companies need capital.

Chinese companies can look to Hong Kong and sometimes to Europe for listings. But the U.S. capital markets remain by far the largest and deepest in the world—especially for companies in the high-value world of technology, new media, and life sciences. There is a tremendous pent-up demand. Are U.S. investors willing to buy?

Attributes of Successful Companies

Montage Technology is a Shanghai-based fabless provider of analog and mixed-signal semiconductor solutions aimed at the home entertainment and cloud computing markets. Obviously it was able to make a compelling business case and had a strong growth story. But so do many other Chinese companies that have not been able to convince international investment banks to underwrite an offering. What made Montage different?

As the saying goes, to someone with a hammer, everything looks like a nail. So as lawyers, we may be biased. But based on our experience representing more than 30 Chinese companies traded publicly in the U.S., we have some thoughts on what makes a Chinese company attractive in the U.S. markets—despite the recent history of accounting and other problems.

Corporate Leadership

To reach international sources of capital, a company's leadership also needs to be international, at least in outlook and experience. The rocket-like path of the Chinese economy has propelled many PRC companies into the global capital markets, in some cases before management is ready. International investors want to see:

- Top management—the Chairman or the CEO—who can present the company and its story to international investment banks; it adds credibility if top management has international schooling or training;
- Financial management which has international experience operating under U.S. GAAP or IFRS (International Financial Reporting Standards) ; international training or schooling is a big plus and CPA credentials are even better;
- A board of directors which includes solid, credible outside directors who have the skills and experience to understand the operations of a purely Chinese operating company;
- An audit committee which is truly independent and not a rubber stamp;
- Stability—investment banks do not like to see rapid turnover at the top of a company they are asked to take public, and,
- A management team and board of directors which is accessible and comprehensible to an investment community which may not understand China or speak Chinese.

Corporate Governance

Corporate governance covers a broad range of internal systems and processes, from board meetings to board committees to investor relations. Good corporate governance means paying attention to corporate recordkeeping, board committees and board meetings, documentation of key decisions, avoiding interested-director and related-party transactions without clear independent scrutiny, and a host of other matters.

International venture capital or private equity backing, obtained while the company was still private, often gives international bankers a sense of confidence. These types of private investors understand what the public equity capital markets will demand. It is in their clear self-interest to get the company ready for a listing, including in the area of corporate governance. Having them on board before approaching a public offering is often a big advantage.

Some Chinese companies went public using the much-maligned "reverse merger" route. Many of them are no longer with us. Those that are have survived the crucible of SEC reporting, short-sellers, and market scrutiny. Their governance procedures have a better chance of standing up to the heightened scrutiny of top-tier investment banks.

Strong External Auditors and Accounting Issues

The bulge bracket investment banks sometimes seem to have a (well-deserved) love affair with the Big Four accounting firms. While our experience indicates that not all successful Chinese IPOs have used the Big Four, they certainly have used one of the Big Ten. The market is still smarting from what it sees as "push-over" auditing firms, and new aspirants to the market must be ready to show their auditors are independent, experienced in China, and credible to an international investment community.

There are some other accounting-related issues that can increase, or decrease, chances for a successful listing. A history of related-party transactions is sure to draw scrutiny if not outright skepticism. Any mismatch between reported financials and the reports filed with the PRC tax and corporate authorities will be a huge red flag to investors; this is more common than it should be and must be avoided.

Many companies, and all Internet companies, use a contractual or "variable interest entity" (VIE) structure in China in order to comply with PRC foreign investment laws. These structures are sound but can be misused. As part of the listing process, a Chinese company must be prepared to show compliance with the legal arrangements constituting the VIE structure, as well as a history of putting in place practical safeguards against misuse.

Finally, given the recent focus in both the PRC and the U.S. on illegal payments and solid anti-corruption procedures, which address employee behavior, vendor activities and internal accounting, and which have actually been complied with, lends great credibility to a U.S. listing.

Transparency

The U.S. markets are designed to work on the principle of transparency and equal access to information. Although this principle sometimes seems to be honored in the breach, in the context of an IPO it is critical. How can a Chinese company establish its credentials in this area?

- Strong independent board members—a company which has outside directors who have industry recognition and a reputation for independence.

- Public filings—many Chinese companies now are pursuing listings in the U.S. as "foreign private issuers" or FPIs. This means that the listing vehicle is not a U.S. company. Generally a holding company in the British Virgin Islands, the Cayman Islands, or elsewhere is used. With some investors the use of an offshore vehicle alone stimulates concerns. However, an FPI which takes advantage of its right not to file quarterly financial reports with the SEC and make other filings which are mandatory for U.S.-based issuers, is just asking for questions. It is a strong signal to the market of a company's intention to be transparent for it to voluntarily comply with all the reporting requirements applicable to U.S.-based public companies. And, with the new JOBS Act, complying fully with SEC reporting requirements applicable to U.S. issuers is easier for smaller and emerging growth companies.

- Analyst coverage—post-IPO coverage from respected market analysts helps put careful research on the company into the public conversation; a lack of coverage can signal unwillingness or inability to provide the level of information demanded by international markets.

- Investor relations—a competent and active investor relations program makes the company and its information accessible to U.S. investors and can help build trust in the marketplace.

Are the Markets Re-Opening for Chinese Companies?

The successful IPO of Montage Technology is a welcome sign to Chinese businesses that have been shut out of the U.S. for what seems like forever. So is the recent announcement by e-commerce giant Alibaba that it will seek a listing in the U.S. rather than Hong Kong.

Both these developments are also a signal of the maturation of the market for PRC enterprises. The days of fast money, driven by hedge funds and reverse mergers, are gone and will not return. What is emerging instead is a rational, mature capital market opportunity for Chinese companies that, in exchange for international capital, are willing to be full participants in the international investing marketplace.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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