Due diligence in China:
Art, science, and self-defense

Widespread delisting of Chinese companies has investors rethinking due diligence and looking harder for subtle clues that something is amiss.

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It's not often that the credibility of an entire class of companies is called into question at once. The aggregate market capitalization of US-listed Chinese companies[1] fell in 2011 and 2012 by 72 percent—and around one in five was delisted[2]—even as the Nasdaq rose by 12 percent (exhibit). Nor is delisting of Chinese companies purely a US phenomenon: since 2008, around one in ten Chinese companies listed in Singapore has also been delisted or suspended.

The extent of the damage to investor confidence is hard to gauge. The broad decline in market capitalization suggests investors may be tarring even the most transparent and upstanding Chinese companies with the same brush. Now-familiar cases like Longtop Financial Technologies, the China-based software company charged with fraud in 2011, or Sino-Forest, the erstwhile forest-plantation operator that announced plans to liquidate itself last year after allegations of fraud, have left investors with fundamental concerns. These companies had, after all, followed required listing procedures, yet they somehow slipped through the regulatory requirements of the IPO and statutory-reporting processes that might have identified deficiencies. In many cases, the problem was fraud, and often involved false or misleading documentation that would not have been discovered by a regular audit—since such audits primarily rely on documentation supplied by the company itself. Indeed, almost

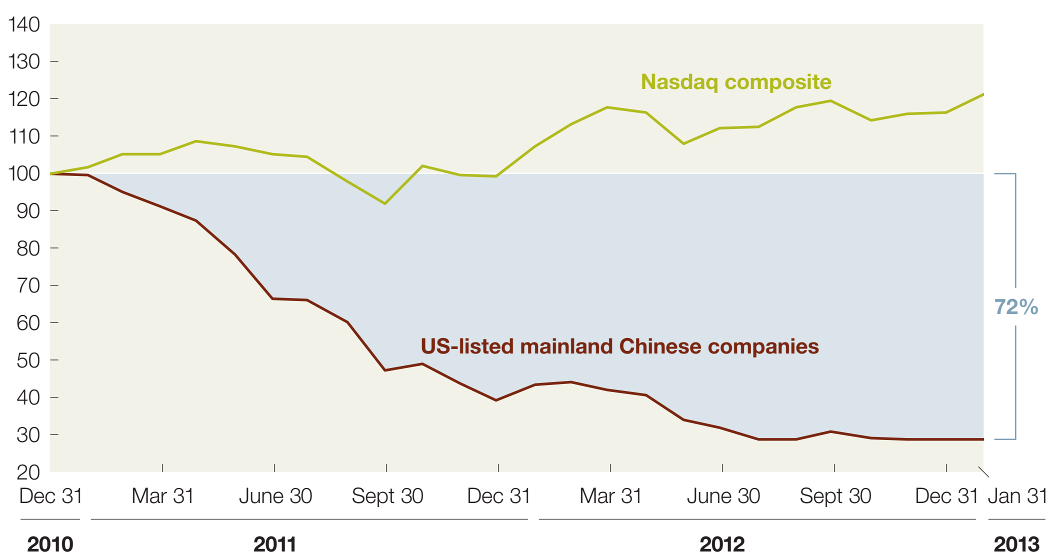
all the companies involved were audited by Big Four firms; most were brought to the market through IPO or reverse takeover by major US investment banks. Past examples have shown that private-equity and strategic investors can miss accounting fraud despite conducting a detailed, professional diligence. Investigative, forensic diligence is important in catching these cases, but it is costly and time-consuming, and not necessarily foolproof.

The problem is surely not limited to Chinese companies, though they are at the center of investor concerns today given the importance of that country's growth and stability to the world economy. It also extends to other countries where transparency is lacking and audit quality is inconsistent. Overcoming investor concerns may mean going back to some investing basics. Diligence is, after all, as much about developing a sense of trust in a company and exercising judgment as it is about finding and checking facts. Financial, portfolio, and corporate investors alike need to revive the habit of looking beyond the usual statutory and regulatory disclosures for less direct indicators of trouble in areas such as the ones discussed in this article: governance, management, financing, market context, and

Exhibit

In recent years, the aggregate market capitalization of US-listed Chinese companies fell dramatically.

TRS index: value on Dec 31, 2010 = 100[1]



[1]TRS index based on median monthly TRS movements for 440 companies from Dec 31, 2010, to Jan 31, 2013.
Source: Bloomberg; Datastream; McKinsey analysis

partnerships. Such indicators are neither conclusive in themselves nor a replacement for other aspects of diligence: exercising judgment isn't just about following a gut feeling. But it can lead to valuable clues that something unpleasant is hiding under the surface, even when everything looks healthy on paper. That makes it especially useful as part of a systematic checklist that investors keep in mind when reviewing diligence results and reflecting on interactions with investee management.

Governance

Corporate governance merits serious attention for a variety of reasons. To start, when it's weak, the floodgates open for unscrupulous management teams. Blatant misappropriation of company resources may be less common than it once was, but it was a factor in some of the companies delisted in the United States recently: in one case, for example, the board chairman transferred ownership of company assets to himself just prior to raising funds from US investors and conspired with the CEO to avoid disclosure.

Governance arrangements also reveal how the top team thinks about its rights and responsibilities. Senior management demonstrates its understanding of them in myriad small and large ways that sometimes serve as early-warning signs. Consider, for example, the many private Chinese companies where a single minority shareholder plays a de facto controlling role. This is not necessarily a problem, but it pays to look closely at how such shareholders view their relationship with the company. Minor things, such as small transactions between the company and the controlling shareholder, can reveal much about shareholders' attitudes toward the company. Do they see it as something to which they have a duty of trust or as an extension of their personal property? Do they understand and respect basic boundaries between company and personal business? Have they gone out of their way to treat minority shareholders fairly during corporate restructurings—something that is easy to avoid doing?

When Chinese companies list their shares on foreign exchanges, particularly in the United States, they need to make sure their corporate-governance infrastructure complies with exchange regulations. The choices made in this process say a lot about management's motivation and about whether there is real intent to improve the company's governance. Have managers made a serious attempt to upgrade their controls and decision-making process? Have there been concrete changes in how top management works and in how it is overseen by the board, or have managers simply made token changes to comply with regulations? Halfhearted governance-compliance efforts may be a leading indicator of deeper problems—even outlandish ones, such as the questions that arose about the very existence of an oil and gas exploration company's operations after it was listed.

Management

A number of delistings of Chinese companies in the United States involved accusations of falsified transaction documents provided for audits. In some cases, the fraud was happening well below top management and even without its direct knowledge, as was alleged at one energy company. The only way to catch these issues directly is through a forensic audit. But investors also need to keep a lookout for warning signs about management that extend beyond the top team and its compliance with governance standards.

How can that be done? A first step for many investors should be examining the bench strength of a company's professional management. It is relatively easy to assemble a senior team that will leave a good impression in a road show. As part of their IPO process, in fact, a number of Chinese midcap companies have fielded compelling leadership teams that included several figureheads brought in recently to add credibility. It's much harder, especially in a market like China where talent is expensive, for executives to build a strong pipeline of competent operational managers with long tenure in the company: that can often take years to develop. Depth of management talent is an indicator of a company that's being built to last—and its absence could signal that a company may have deeper problems.

A mismatch between a company's management capabilities and its growth plans is another potential red flag. If the CFO plans to upgrade the company's financial planning, investors should confirm that the finance team has the size and experience to follow through. If the company plans to expand manufacturing capacity, does it have enough plant managers to run existing facilities as it ramps up new ones? If the company plans to locate manufacturing overseas, does it have general managers who can work in a foreign-language environment? These questions may seem obvious, but too often they go unasked.

The quality of operational management is another area where on-the-ground scrutiny is worthwhile. Good plant discipline is hard to develop and harder to fake, and its absence is typically visible to the trained eye on a single site visit. Even a one-hour walk-through, if used carefully, can provide validation of staffing levels, inventory levels and age, and plant utilization. If a company resists a walk-through, that should sound alarm bells. How good are the company's manufacturing or service operations? Are there good visual-

management systems? Is there evidence of strong health, safety, and environmental and quality systems? Are testing labs in constant use, or does a layer of dust cover the desks? Affirmative answers to questions like these don't necessarily mean a company is trustworthy, but negative ones should be cause for concern.

Financing

Financial management is, in China at least, one of the greatest risk factors. Although proper evaluation is only possible in the context of a full diligence, a company's commercial-banking relationships can offer some indications of whether the conditions exist to facilitate fraud—and these indicators can be assessed quickly and easily through frank discussion with managers. Among the companies delisted in the United States were several that colluded with banks to falsify audit documents, others that took on excessive leverage through sweetheart loans that circumvented banking regulations, and still others that borrowed unnecessarily and then moved the cash out of the company. Investors should ask several questions. Does the company have relationships with multiple banks, or is it reliant on a single one? Are its critical financial relationships with major, well-regarded national banks or smaller, less well-known provincial or municipal ones? How important is the company's business to the bank branch or branches that it works with? None of these factors would prove the existence of financial malfeasance, but they would make malfeasance a lot easier.

Similarly, much can be inferred from the way a company structures and times its loans. Investors should examine whether a company has structured loan facilities and projects to get around restrictions (for instance, breaking a project into sections that are within a loan officer's approval limit). Has capital raising occurred when there were no clear needs—for example, has the company borrowed money when it had ample reported cash on its balance sheet and no major investments under way? Do current patterns of capital raising clearly match its investment plans?

Discovering fraud in these areas through regular audits can be a long process. Well-run Chinese companies are usually keen to provide transparency to investors; reticence is in itself a warning sign. In either case, closer observation of transactional banking relationships and capital raising can give an early indication that something is wrong, without definitively showing what.

Market context

Several of the companies delisted in the United States operated in opaque and protected markets, such as reselling advertising, importing specific fuel or agricultural products into concentrated and highly regulated markets, or operating logistics infrastructure in specific geographies. From an investor's perspective, these episodes reinforce something more fundamental: companies that have competed effectively in open markets are intrinsically more credible than those that function in closed ecosystems.

Of course, many companies operating in protected sectors are reliable and trustworthy and deserving of capital. It can be challenging for investors to reassure themselves of that, though. Further complicating matters is the role that low-cost financing from Chinese banks is alleged to play in some sectors; companies that on the surface seem to be competing vigorously actually may be floating on artificially cheap capital.

For skeptical investors, the other indicators covered in this article can help. Moreover, many Chinese companies are already making the transition to more open competition: consider the country's telecommunications-equipment providers, which have moved from dominating the domestic market to succeeding in international markets, where they must stand on their own without government support. Others, including both private and state-owned enterprises, still face limited natural competition in their domestic market. This is often due to regulation aimed at creating a stable industry structure that government can more easily manage. When policy support is a factor in a company's performance (as was the case in solar-panel manufacturing, where it led to overcapacity), it is usually obvious—and rarely sustainable.

Partnerships

A final reliable sign of corporate trustworthiness is a company's track record with partners. It's reasonable for investors to conclude that a company involved in multiple joint ventures with the same leading multinational partner has survived several rounds of close-up diligence from an experienced operator. It may still have issues, but it was reliable enough to motivate the multinational company to form additional joint ventures rather than turn to other potential partners.

This is not foolproof logic, however. In China, investment restrictions force multinational companies in many industries to work with local joint-venture partners—and some multinationals have clearly gotten partnership decisions wrong. In the infamous high-speed-rail cases, for example, partnerships that multinational companies hoped would help them address the local market turned into disputes over local partners' development of their own technology platforms.

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The spate of delistings in the past two years may, in retrospect, have had some beneficial effects. It has forced many corporate and private-equity investors to increase the depth and detail of their formal due-diligence efforts. It has spurred the growth of what could be termed forensic equity research—conducted by analysts who specialize in reviewing listed companies for potential fraud. Although often disliked by their targets, such analysts provide a valuable balance to traditional equity research. Delistings are also forcing the US Securities and Exchange Commission to look hard at the reliability and acceptability of certain audits, which will most likely result in better standards of practice. Finally, we hope that it will leave investors more cautious about the information on which they rely and more thoughtful and circumspect about how they interpret it.

[1] Based on the 518 companies listed in the United States before January 2012 that were either domiciled in China or domiciled in Hong Kong, with a significant portion of their revenues derived directly from China.
[2] In all, 106 of these companies were delisted over the past two years. More may be implicated by the ongoing US Securities and Exchange Commission investigation into accounting practices.

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