Alternative Insight

PE ASIA

FOR THE ASIAN PRIVATE EQUITY MARKETS

Buyers beware

The recent fraud allegations relating to Chinese companies listed overseas may force private equity investors to reassess how they buy and seek to influence investee firms

posted - 01 Jul 2011 02:00 GMT Staff Writer

"Transporting the harvested logs would have required over 50,000 trucks driving on two-lane roads winding through the mountains from this remote region, which is far beyond belief [and likely road capacity]."

This skeptical observation was made by Muddy Waters, a Canadian research firm founded by renowned short seller Carson Block, as it delved into claims made by Sino Forest, a Chinese forestry group suspended from trading on the Toronto Stock Exchange in early June as short sellers drove down the firm's share price. The amount of timber the company purported to be selling struck Muddy Waters as unlikely for the practical reasons referred to.

Sino Forest is far from alone in being a Chinese company to suffer a share suspension on overseas exchanges - dozens have suffered the same fate in recent months.

It's not even alone in being a Chinese forestry firm to have experienced this. China Forest Products was also suspended in Toronto while, in Hong Kong, China Forestry was investigated for alleged auditing irregularities.

If the other cases were interesting to private equity firms on a hypothetical level, it was China Forestry that brought alleged fraud within Chinese companies closer to home. The Carlyle Group, through its global growth fund, had invested around $40 million in the firm in 2008 and then a further sum of approximately $15 million the following year. At the time of the stock market suspension, Carlyle was reported to hold a stake of around 11 percent.

Some reports have focused on the vested interests represented by short sellers which can stand to make large profits from share falls. But, while they may be guilty of hyping problems associated with Chinese companies, few would argue that the problems don't exist. "There is a lot of hysteria now and a sense that all Chinese companies are guilty of fraud," says Violet Ho, managing director of China operations at risk consultants Kroll. "In fact some overseas listed Chinese companies have been shining stars, so it's case by case. But fraud is quite prevalent in China."

For the countless private equity firms now operating in China, there may be renewed focus on how to avoid 'irregularities'. This is no easy task. Most private equity investments in the country are in the form of minority stakes, which perhaps come with a board seat attached but where effective influence over the company is limited.

Furthermore, as one market source puts it, "even when you get a board seat, you can still be viewed as an outsider". The source has in mind the kind of scenario where a conversation between the chief executive and chief financial officer is also one between two brothers. Most of the eligible recipients of private equity investment are, after all, family-owned businesses.

Worryingly, this detachment from the beating heart of company decisions means that – post-deal – you could easily fail to identify the inflated sales figures and the customers that may not be all they appear (and may not even exist). More worryingly, you're unlikely to have identified such problems pre-deal, since competition in auctions is so intense that, after a week or two of exclusivity, your chance of striking a deal will pass on to a rival unless you sign up there and then.

Kroll's Ho points out another potential landmine if you fail to conduct proper due diligence: the sometimes questionable track records of management teams. "China is a market with short memories," she says. "Some entrepreneurs who were involved in scandals 10 or 15 years ago have resurrected their reputations. Not much importance is placed on how ethical someone has been in the past."

There are, however, signs of change – from both internal and external forces. For one thing, a new generation of young Chinese finance professionals are bringing into Chinese companies a much better understanding of international capital markets regulation and placing these firms on a better corporate governance footing.

For another, private equity firms today are operating in a different market to the "gold rush" from around 2000 to 2005 where you didn't have to be terribly smart to make good returns – and then raise more funds on the back of those returns. Today there is strong competition, high valuations and pressure from limited partners to keep delivering impressive results. All this helps to ensure that thorough due diligence is given the priority it deserves – thereby minimising the prospect of future shocks.