Market Facets

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Forced Delisting of Chinese ADRs from US Exchanges – Is a market dislocation coming?

Introduction

Recent actions by China in Hong Kong and rising geopolitical tensions between China and the US have resulted in the US enacting the Holding Foreign Companies Accountable Act ("the Act"). One potential consequence of this Act is the forced delisting of Chinese American Depositary Receipts (ADRs) on US exchanges. This is relevant to index investors as these stocks represent a significant component of the China exposure in most major indices. In this paper, we investigate which companies are impacted, what the options are for these companies if they are forced to delist in the US, and what the market implications of forced delisting might be.

Introduction

China recently proposed a national security law[1] in Hong Kong which sparked protests and condemnation from governments around the world.

In response to recent Chinese government actions, the US administration has outlined a range of measures including the investigation of US listed Chinese companies with unusual practices. Under the new Act, if the US Public Company Accounting Oversight Board (PCAOB) is not able to audit a company for three consecutive years and determine that it is not under foreign control, the company will be delisted from all US Exchanges and any other trading method such as over-the-counter (OTC) trading.

The law is particularly pertinent for Chinese companies as Chinese laws governing the protection of state secrets and national security have been invoked limiting foreign access to China-based audit work papers. Hence there is a conflict between the US and Chinese laws.

To date this has meant that Chinese companies have not been subject to the same level of scrutiny as those from other jurisdictions. The issue is not entirely new and the Chinese

[1] Chinese parliament overwhelming voted to approve the law on 28 May 2020 with legislation expected to enacted by September 2020. https://www.abc.net.au/news/2020-05-27/hong-kong-protests-national-security-law-china-anthem-explainer/12290196

Securities Regulatory Commission (CSRC) has been negotiating with the PCAOB since 2017 to implement some sort of audit oversight. However against the current backdrop of heightened geopolitical tensions, it seems unlikely that either side will back down.

It seems likely that the impact of this legislation will be muted for a number of reasons. Firstly, the three year timeline suggests some room for negotiation between the parties to reach some sort of middle ground enabling the Chinese companies to retain the US listings.

In the worst case scenario, where the Chinese ADRs are required to delist, there are a number of options for them to relist on alternate exchanges. Finally, relisting closer to home will not necessarily mean lower valuations given the likely neutral index impacts and expansion of the potential investor base to include mainland Chinese investors.

Which companies are impacted?

According to PCAOB there are 226 actively traded foreign companies on US exchanges that may be impacted by the Act, of which 186 are China / Hong Kong domiciled. Among these, 20 are already listed on Hong Kong or other exchanges so any delisting impact should be minimal given their shares are fully fungible.

Currently, there are 30 US listed Chinese companies in the MSCI Emerging Markets Index representing 11.4% of the index and 29% of the Index's China exposure. The MSCI All Country World Index contains 30 stocks representing 1.3% of the index. Alibaba, with a weight of 6.9% in the MSCI Emerging Markets Index (and 0.8% in the MSCI All Country World Index), is by far the most significant[2].

Table 1: Top 10 Chinese Companies in the MSCI Emerging Market Index as at 31 May 2020

Company Name	Weight in MSCI EM	Exchange
Alibaba Group Holding Ltd. Sponsored ADR	6.87	NYSE
Tencent Holdings Ltd.	5.79	Hong Kong
China Construction Bank Corporation Class H	1.44	Hong Kong
Ping An Insurance (Group) Company of China, Ltd. Class H	1.05	Hong Kong
China Mobile Limited	0.82	Hong Kong
Industrial and Commercial Bank of China Limited Class H	0.80	Hong Kong
JD.com, Inc. Sponsored ADR Class A	0.76	NASDAQ
Baidu, Inc. Sponsored ADR Class A	0.56	NASDAQ
Bank of China Limited Class H	0.55	Hong Kong

[2] Weights as at 31 May 2020. Source: Factset, MSCI

NetEase, Inc. Sponsored ADR	0.52	NASDAQ

Source: Factset, MSCI

What are the options if they need to delist?

Over the past two years, there have been a number of reforms in the Chinese and Hong Kong stock markets to open up these markets and make it easier for foreign listed ADRs to return.

The most likely option, especially for larger ADRs, is a secondary listing in Hong Kong under new Weighted Voting Rights (WVR) IPO rules introduced in April 2018. This is likely to be feasible for most of the larger ADRs which represent approximately 93% of the Chinese ADR universe and 96% of the MSCI EM Index by market cap[3]. Listing in Hong Kong has the advantage of high liquidity, maintenance of access to foreign capital markets, eligibility for inclusion in Hong Kong indices and expansion of investor base to mainland investors if eligible under the Southbound Connect program[4].

Mainland exchanges are another option following recent reforms by Chinese regulators to make direct listing with red chip structure[5] more practical. One drawback of this option is that foreign exchange restrictions make it hard for existing overseas shareholders to exit their position freely after re-listing in the A-share market, although CSRC is working with SAFE[6] to ease the restrictions.

A final option is listing on the A share market after privatisation and removal of red-chip / Variable Interest Entity (VIE) structure. This option necessitates divestment by foreign investors due to foreign investment restrictions in certain industries. Whilst historically this was the most common way for overseas listed companies to return to the A-share market, it is not expected to be widely pursued now due to cost, complexity and recent regulatory reforms.

What are the possible implications if these companies are forced to delist?

<u>Index Inclusion</u>

Institutional investor positioning is unlikely to be significantly impacted by the forced delisting of these stocks from US exchanges so long as the stocks are relisted on exchanges accessible to them, such as the Hong Kong exchange or the Shanghai and Shenzhen exchanges.

Most major indices used for portfolio management purposes, MSCI, FTSE and S&P, classify companies based on their country of risk rather than country of listing for the purpose of index

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[3] Calculated using analysis conducted by Credit Suisse and presented in their paper “China Market Strategy – Road-mapping the return of Chinese ADRs” 26 May 2020

[4] Southbound eligibility is predicated on the basis of Greater China issuers being granted primary listing status in Hong Kong.

[5] A red-chip company is one where the Chinese government has a considerable stake in the company, and the company does most of its business in China. Red-chip companies are incorporated outside mainland China and listed on the HK Stock Exchange.

[6] State Administration of Foreign Exchange is the Chinese regulatory body governing foreign exchange market activities and managing state foreign exchange reserves.

construction. These companies all currently have a country classification of China and hence are only included in Emerging Markets, Asia Pac or All Country indices. Given most large cap US listed names have established secondary listings on the Hong Kong exchange, announced their intention to establish one or would be eligible to establish one, the index impact is likely to be largely neutral.

Performance Impacts

The impact of the forced delisting on the price of the impacted stocks will be driven, like it always is, by the forces of supply and demand. To assess the performance impact of any forced delisting, it is necessary to consider who the likely buyers and sellers of these securities are and which side is likely to dominate the price action.

However, we can look at the experience of Alibaba's recent secondary listing on the Hong Kong Stock Exchange to assess the likely impact of relisting in Hong Kong. Alibaba submitted its application confidentially to the HKSE before June 2019 for a secondary listing and officially announced the secondary listing plan on 13 November 2019. The secondary listing was well received by investors in both markets with no discernible impact on stock price performance during and after the secondary listing.

Conclusion

US listed Chinese ADRs represent a significant component of the China exposure in most major indices and hence are relevant to investors with an allocation to emerging markets, Asia Pacific markets or China in their portfolios. However, we do not anticipate any major market dislocation to arise as a result of this development due to the recent regulatory reforms that make it easier for these companies to relist on exchanges closer to home, most likely, the Hong Kong Exchange. In fact, most of the largest ADRs led by Alibaba last year, have already taken action or announced their intention to dual list on the Hong Kong Exchange. While we don't expect this development to have any significant market impacts, other developments such as increasing Chinese intervention in Hong Kong may have an impact on market sentiment and we will continue to monitor this going forward.

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