Guosen Expert Series:
Accounting and Regulatory Challenges to VIEs in China

A massive migration of US listed Chinese companies to HK?

Alibaba’s (Not Listed) long-awaited IPO has put the VIE (Variable Interest Entity) structure, which is commonly used by Chinese internet companies listed overseas, in the limelight again. Prof. Paul Gillis, speaker of our latest Expert Series, believes that China could eventually allow mainland companies in restricted areas, such as internet and media, to directly list aboard, which will make the VIE structure obsolete and substantially reduce the risks associated with investing in these companies. However, in another area of his concern, the cross-border auditing entanglement between the US regulator, the Hong Kong regulator, the Big-Four accounting firms and the Chinese government may not have a smooth ending and, in the worst case scenario, could lead to a massive migration of US-listed Chinese internet companies into Hong Kong and HKEx (388 HK, Not Rated) may be one of the few that would be happy seeing this disruptive event happening. Internet stocks listed in Hong Kong may also benefit from this migration should a re-rating occur in the sector in Hong Kong, which consists of, with the exception of Tencent (700 HK, Not Rated), mainly small Chinese internet players. According to Bloomberg, the sector’s median 12-month forward PE in Hong Kong is below 20x while that of major US-listed Internet companies is about 30x.

Investing in companies with VIE akin to investing in derivatives

With much fanfare, Alibaba kicked start its long-awaited IPO. In our latest Expert Series, Professor Paul Gillis of Guanghua School of Management of Peking University highlighted the key risks and issues with the Variable Interest Entity (VIE) structure, which is widely used in overseas-listed internet companies in China, including IPO candidate Alibaba, to circumvent regulatory restrictions on foreign-ownership in these companies. The absence of legitimate ownership by foreign investors in the VIE and issues related to the continuity of the crucial agreements between the VIE and the WFOE are some of the major risks highlighted by Prof. Gillis, who puts investing in companies with VIE structure akin to investing in derivatives, not equity.

China’s relaxation of foreign-ownership restrictions will be the best outcome

While there are ways to reduce risks to foreign investors in a VIE structure and, in the views of Prof. Gillis, Alibaba’s structure is already one of the best in the market in terms of reducing such risks. However, the risks cannot be completely removed. He believes that China could eventually allow mainland companies in restricted areas, such as internet and media, to directly list aboard, which will make the VIE structure obsolete and substantially reduce the risks associated with investments in these industries although investing in equities is never risk free.

Disruption may still come from battles on cross-border auditing

Professor Gillis also discussed the entanglement of the US SEC, the Big-Four accounting firms, Hong Kong SFC and the Chinese government in cross-border auditing issues, which may potentially become a full-blown crisis and lead to the closure of the US equity market to mainland companies and the massive migration of those that are listed there moving to Hong Kong. Should this happen, HKEx (388 HK, Not Rated) will be one of the few major beneficiaries. Hong Kong-listed internet players may also benefit from the migration should this accompany the sector in Hong Kong, which is trading at discount to major US-listed peers. Nevertheless, the US and China may still prefer a less solution through negotiation and one such window may be available in early July when the next meeting for the US/China Strateg Dialogue is held.

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See the last page of this report for important disclosures
Investing in companies with VIE akin to investing in derivatives

What is Variable Interest Entity (VIE)?
The long-awaited Alibaba (Not Listed) IPO is structured using VIE, which is a way that allows foreign investors to gain exposure to Chinese companies that are operating in sectors restricted to foreign investors. It is a commonly-used structure by Chinese internet companies listed offshore. The VIE structure allows foreign investors to share economic benefits of the VIE through many contracts made between the VIE, which holds the assets restricted to foreigners (e.g. an internet license) and a WFOE (wholly foreign owned enterprise), which is controlled by an offshore holding company, which may or may not be listed. As a result of the contractual arrangements, the offshore holding company would be able to consolidate the financials of the VIE into the group’s overall financial statements. In addition, the PRC founders pledge their shares in the VIE to the WFOE and grant option to the holding company and WFOE to transfer their shareholding in the VIE to any designee at any time, or alternatively to convert the VIE into a WFOE when PRC regulations and laws permit. It is essentially a different concept from a direct ownership of the assets in question.

The emergence of VIE
Sina.com (SINA US, Not Rated) was the first company used the VIE structure back in 2000, in response to the PRC regulatory restrictions on foreign investment in the media business, which include internet content, in China. Foreign ownership restrictions are applicable in certain sectors such as telecoms, banking & insurance as well as the media related companies, which include internet companies. The VIE structure is a way to workaround foreign ownership restrictions. Following the successful listing of Sina, this structure was adopted by other internet companies like Sohu (SOHU US, Not Rated) and NetEase (NTES US, Not Rated) and became the de-facto structure for Chinese internet companies seeking overseas listing although such structure is also used by Chinese companies in other industries.

Why investors are concerned about VIE structure
The submission of IPO application of Alibaba has reignited questions about the legality and enforceability of the VIE structure, largely attributed to the dispute between Alibaba Group and Yahoo Inc. (YHOO US, Not Rated) in 2011 regarding Alipay, an affiliated third party online payment service provider of Alibaba. Alipay was spun off from Alibaba and restructured to a domestic operating entity without foreign ownership. Two major shareholders of Alibaba, namely Yahoo and Softbank (9984 JP, Not Rated), claimed that they were not notified about the restructuring and the decision was not approved by the board. Mr. Jack Ma, the founder of Alibaba and the legal owner of the VIE, arranged the spin-off and said Alipay would have risked not getting license under the new regulatory framework rolled out by the PBoC. The dispute was later settled with an agreement that Alipay would pay Alibaba royalties for software service and 49.9% of its consolidated pre-tax income and continue to service Taobao and other group businesses under preferential terms. In addition, Alibaba will be paid at least USD 2 billion and a maximum of USD 6 billion if Alipay went public or monetized through any other means.

VIE contracts with the WFOE may not be legally enforceable
One of the biggest risks of the VIE structure is that some of the contracts between the VIE and the WFOE may not be legally enforceable in China since the foreign-owned WFOE may be restricted from conducting the business undertake by the VIE, which is almost always the case or the structure would not be used in the first place. A recent example happened in 2010 when the board of GigaMedia (GIGM US, Not Rated) intended to remove Wang Ji, the founder as well as the owner of the VIE, from his position as head of China operation but failed. Wang did not cooperate and the Board of GigaMedia filed a series of lawsuits against Wang but failed as the Chinese court ruled that the VIE agreements are not legally enforceable. The dispute was later ended with GigaMedia selling its investment for good. There is also the risk of continuity of the VIE as it is usually the business’ founder who owns the VIE and the death of whom may result in problem as the person inherent the estate may have quite different thoughts about the business.

How the risk is mitigated?
While the VIE structure is of very high risk to investors, it remains the only viable solution to Chinese companies with foreign ownership restriction getting overseas listing. There are companies to address investors’ concerns over such risk. Prof. Gillis believes that Baidu (BIDU US, I Alibaba are actually doing well in terms of mitigating the risk. Both companies allocate operational asset in the WFOE and only retain the business licenses, which tend to be foreign-ownership restriction, and limited operating assets in the VIEs. This has reduced the valuable assets of the business should there be any problem with the contracts between WFOE.
Rating agency Moody’s recently issued an announcement on May 27th addressed the issue of the VIE structure of Baidu and Tencent (700 HK, Not Rated), and believed the risks are “manageable, given the companies’ ownership structure, control of cash flow and long track record of using the VIE structure”. Moody’s believed the separation of ownership of the operating license and asset will greatly mitigate the risk since the VIE is holding the licenses though, it cannot operate the business without the hard and soft assets like trademarks, technology and intellectual-property rights.

**VIE will like to prevail until China changes the rules**

While the VIE structure is highly risky and Prof. Gillis puts it akin to derivatives, it remains the most commonly used structure by Chinese companies with foreign-ownership restriction and, until the Chinese government changes the rules, e.g. relaxing foreign-ownership restrictions on some of these industries, we believe that this structure will continue to prevail despite on-going investors concerns.

**The Cross-border auditing entanglement**

**US, China and HK are locked in a cross-border auditing battle .....**

Major audit firms have been locked in battles related to cross-border auditing in China. On the US front, the Big-Four have been sanctioned in a 112-page ruling which bans them from auditing US-listed firms for six months. The Sarbanes-Oxley Act and PCAOB Rules require that an audit firm must be registered with PCAOB to prepare or issue, or play a substantial role in the preparation or furnishing of, an audit report with respect to any US issuer. The PCAOB defines “substantial role” as an auditor who performs “the majority of audit procedures with respect to a subsidiary or component of any issuer the assets or revenues of which constitute 20% or more of the consolidated assets or revenues of such issuer necessary for the principal accountant to issue an audit report on the issuer. The Big-Four failed to comply with the requirements in many of their audit works for US-listed Chinese companies. In Hong Kong, the SFC took Ernst & Young to court when the latter did not provide work papers related to a former IPO candidate as E&Y is restricted to do so by China’s state secrecy laws. To complicate matter further, China has recently put forward proposal that ban foreign auditors to do audit works for mainland companies and requiring them to outsource the work to their mainland affiliates.

**... and may end with massive migration of US-listed Chinese companies to Hong Kong**

According to Prof. Gillis, if there is no compromise to the US ruling and China’s proposal comes into effect, it could potentially become a serious issue as not only the US-listed Chinese companies will be affected, many of the MNCs with major Chinese exposure will also be influenced, such as Coca-Cola (KO US, Not Rated), McDonald’s (MCD US, Not Rated) and GSK Plc (GSK US, Not Rated). One likely modification would be the exclusion of the MNC. The effective date of the ban may also be postponed to buy more time for a less disruptive solution. In the worst case, where the ban becomes permanent, Prof. Gillis believes that it will result in a massive migration of US-listed Chinese companies to Hong Kong for listing. But this requires the HKEx to change the rules and allow listing companies with dual share classes, which is common to many US-listed Chinese companies. However, this may not be undesirable to the Chinese government, which may prefer these large internet companies move their listing to China’s turf. The internet sector in the Hong Kong market may also benefit from the migration of many large Chinese internet companies to the local market should this result in a re-rating of sector locally. According to Bloomberg, the median 12-month forward PE of the HK internet sector is below 20x while that of major US-listed internet companies is about 30x. However, a Hong Kong-listing will not resolve all issues as demonstrated by the SFC v. E&Y case, which is a conflict between upholding the rule of law locally and compliance with the State Secrecy Law.

**Negotiation may still be the preferred way for a less disruptive outcome**

While the worst-case scenario may not be entirely undesirable, as we pointed out above, both China and the US governments may still prefer a less disruptive solution through negotiation. One such window of opportunity, according to Prof. Gillis, may present in early July, when the US/China Strategic & Economic Dialogue is convened. While this meeting usually covers a broad range of high-level issues, delegation this time may include officials from the PCAOB and SEC to facilitate the negotiation of the cross-border auditing issue.
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