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By: Michelle Toh

China still needs Wall Street. A rare agreement with the US is proof

Hong Kong (CNN Business)A new deal between the United States and China aims to draw a line under one of the biggest disputes in global business: how Chinese companies listed on Wall Street should be audited.

Last Friday, regulators from both sides announced an agreement that would allow US officials to inspect the audit papers of those firms, satisfying a long-running demand stateside and bringing relief to businesses and investors in each country.
The breakthrough means that for now, more than 160 Chinese companies may have dodged the immediate threat of being kicked off the world's biggest stock market. Regulators appear to be wasting no time in testing the new deal. Reuters reported Wednesday that US officials had chosen Alibaba, Yum China and other companies for a first round of inspections beginning next month, citing unidentified sources. The firms did not immediately respond to a request for comment.

But officials warn that the arrangement is just the first step forward on an issue that remains delicate, suggesting these Chinese companies aren't out of the woods until access is secured and a broader agreement is finalized. Experts also say it's unlikely to lead to a quick resolution of other flashpoints in US-China business relations.

What's happening?

The agreement allows US regulators to inspect and investigate registered accounting firms in mainland China and Hong Kong that audit the books of Chinese companies.

The deal is the most comprehensive of its kind ever reached between the United States and China, according to the US Public Company Accounting Oversight Board. US inspectors are expected to travel to China and Hong Kong to start on-site inspections, likely "by mid September," according to Gary Gensler, chairman of the US Securities and Exchange Commission (SEC).

"Reaching an agreement on these pilot inspections was the key test of whether the two sides could finalize a broader deal that would avoid the eventual delisting of Chinese firms from US exchanges," Lauren Gloudeman, director of China at Eurasia Group, told CNN Business.

Drew Bernstein, co-chairman of Marcum Asia CPAs, an accounting firm, auditor and adviser for Asian companies looking to enter US markets, also believes the first big hurdle has been cleared.

"China has made it clear that they believe that enabling some of its companies to continue to access the US capital markets is in China's interests, and regulators have made some significant concessions to get to a deal," he said.

Who's affected?

The long list of companies at risk includes some of China's top tech giants, Alibaba (BABA), Baidu (BIDU), and JD.com (JD).

US regulations stipulate that firms that do not comply with requests to fully open their books will be barred from trading in the United States in early 2024. That deadline, however, could be moved up.

And the pressure has ramped up significantly in recent months: This year, the SEC has added more Chinese companies to its list of entities that could face expulsion, while US lawmakers have increased calls to give those businesses an ultimatum.

China had previously been hesitant to let overseas regulators inspect its accounting firms, citing security concerns. The tension has already led some Chinese companies to retreat from US markets.

Just this month, five state-owned companies opted to leave the New York Stock Exchange, citing low turnover and high costs. The voluntary delistings were made by China Life Insurance, PetroChina, Sinopec, Aluminum Corporation of China and Sinopec Shanghai Petrochemical.

Others are trying to keep their options open.

Alibaba — perhaps the most well-known Chinese company amongst Western investors — in July outlined plans to upgrade its Hong Kong listing to primary status, which it expects to take place by the end of this year.

The company, whose shares have traded on the New York Stock Exchange since 2014, hopes to hold dual primary listings once the change is complete.

Hong Kong has emerged as a popular venue for companies looking to ease concerns over getting booted off Wall Street.

"As it takes time for the cooperation [on the new deal] to materialize, the delisting risk of US-listed Chinese stocks cannot be fully alleviated in the short term," according to analysts at Bocom International, the investment banking arm of Bank of Communications.

Dual primary or secondary listings in Hong Kong would likely remain "an attractive choice" for now, they wrote in a report on Monday.

Why does this matter?

Besides forcing companies to rethink their game plans, the situation has already contributed to a slowdown in share issues.

US initial public offerings by Chinese companies have slumped significantly, with eight primary listings so far this year compared to 37 in the same period last year, according to data provider Dealogic.

The value of those deals has also shrunk massively. So far in 2022, companies have raised just $332 million through IPOs on US markets, down from nearly $13 billion a year ago, Dealogic data shows.

Other factors are driving the slowdown, including the market slump that has created an overall dreary IPO market affecting companies of all kinds.
For some Chinese players, there has also been anxiety about a regulatory crackdown.

Over the past year, Didi, China's biggest ride-hailing firm, has become a cautionary tale. The company went public in New York last year, and later delisted after getting caught in the crackdown at home.

But there could be a rebound in Chinese share issues, if the US Congress sees evidence that China is sticking with the audit deal.

"In our experience, Chinese management teams remain highly interested and motivated to list in the US, given the relatively streamlined listing process," Bernstein said.

"So if the IPO market recovers next year, we would expect a surge of new Chinese listings in 2023."

Will the deal work?

Analysts remain cautious over whether the new audit deal will put companies in the clear.

Goldman Sachs analysts believe there is still a roughly 50% chance of Chinese shares getting delisted.

Last week, the SEC chief also warned that companies still faced ejection if their papers could not be accessed by US authorities.

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Confirmation of the upcoming inspections "makes it very likely — a 90% probability — that the two sides finalize a broad agreement on inspections by the end of the year or soon after," Eurasia experts wrote in a report.

"The lead US regulator will not go [to] the trouble of traveling to Hong Kong if it lacks confidence in China's commitment to a deal."

Xiaomeng Lu, director of geo-technology at Eurasia, said that Beijing could still order more state-owned enterprises to delist preemptively, "because these firms manage information deemed sensitive to national security."

China may choose to take that route, "rather than be subject to annual inspections," her team wrote in a report.

Will this help the United States and China get along better?

Despite the progress made, the world's top two superpowers are expected to remain at odds on other issues.

"Though the agreement is a constructive signal broadly, it does not have much feed-through to the broader bilateral relationship," Gloudeman, Eurasia's China director, said.

"It is hard to see a reset on the horizon, with intensifying geopolitical flashpoints like the disconnect on Taiwan policy and China's relationship with Russia. Upcoming election cycles in Taiwan and in the US risk further deterioration of the bilateral relationship."

Bernstein, the accounting executive, said the deal pointed to the limits of decoupling, even as ties fray.

"The US-China relationship reminds me of conflict-ridden relationships where at the end of the day, they realize they can't afford to get divorced," he said.