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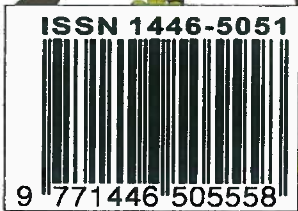
Property Bubble, China Trouble

China Wants New Ties with Australia
Shanghai Disneyland on the Way
Wind Power Cheers up Foreign Investors

Australia..........AUD6.95
Mainland China.......RMB30.00
Hong Kong..........HKD40.00
Other..........USD6.00



Preparing the Chinese company for a successful listing in the USA

By James A. Mercer III

Business ventures are inherently subject to risk, but there are steps that the Chinese operating company can take to increase its chances for a successful listing in the USA. These include proper planning, right team and effective execution.

The Plan

The key to a successful listing begins with an honest appraisal of the operating company with whether its business and personnel are capable of successfully managing the public listing process.

Chinese companies looking to go public must consider the goals that they are attempting to achieve in the public offering process, and whether becoming public will reasonably lead to the accomplishment of those goals. Often the goals are to increase access to capital and to permit the company to make acquisitions with stock rather than cash. If the company doesn't anticipate needing substantial additional capital, or making acquisitions, management should question the reasons for going public. For some companies, their public stock may not have significant investment following, resulting in a stock price that is lower than the intrinsic value. This can result in increased costs of capital, or failure to raise capital when needed.

There are direct costs with being publicly traded, including internal staff who can prepare the SEC filings, investors relations expenses, audit fees, legal fees, and stock exchange listing fees. These fees will aggregate to a $500,000 annually. But there are also indirect costs to being public. Publicly traded companies must disclose their financial results as well as negative events that affect their business. Competitors can use information concerning gross margins, cost structure, profitability and financial resources to disrupt sales and compete more effectively.

The plan must also recognize that the initial listing on an exchange is a step toward the company's goals, but not the endpoint. A listing doesn't guaranty business growth, a large market capitalization, or even the ability for stockholders to sell their shares. A stock price, and hence a company's overall market capitalization is a function of supply and demand for stock. In order to generate demand for the stock, investors must be aware of the company, and have adequate information to make their investment decision. Addressing the public market, making contact with prospective investors, publishing quality financial information is a part of the business process for a public company which must be maintained.

Companies must remember that investors in the public market can effect transactions where they will benefit from an increase or a decrease in the price of the stock. Investors can try to "corner the market" or effect movement in the stock price simply to create an opportunity for profit, regardless of the business fundamentals affecting the company. In the larger public companies, the volume of buyers and sellers, and the market capitalization for the stock reduces the likelihood of this type of manipulation, but it is a real concern for smaller companies. Consequently, the company's operating plan and budget must include investor relations and public relations elements to attract and expand investor interest.

The Team

There are several key internal team members necessary for a successful US listing: a CEO s and a CFO. If not one of these two officers, the company will also need someone with both English language skills and capital markets experience, who can discuss the company's business results and prospects with media, analysts and prospective investors in the USA.

In addition, the Company will need three principal outside consultants: the auditor, the lawyer and the financial advisor.

The Auditor

In order to go public in the USA, the company's financial records must meet international or US financial accounting standards and be auditable. The financial statements that are filed with the SEC in registration statements and periodic reports must be audited or reviewed by an accounting firm that is registered in the USA with the Public Company Accounting Oversight Board (PCAOB). So the Chinese operating company should select an audit firm that is PCAOB registered, or is affiliated with a PCAOB firm.

In addition, selection of an accounting firm should be made on the basis of the quality of their work product, and the quality of their service. A company wants an audit firm that will be responsive and complete its work on time and on budget. However, it is critical that the work be done correctly. Improper accounting may delay the registration process, making the IPO more costly. Accounting mistakes can also significantly impact a company's net income, and whether it meets the listing standards for a par-

ticular stock exchange. Discrepancies that are discovered or occur after a company goes public can result in restatement of past financial statements to correct errors. This generally results in a significant drop in stock price, and often results in lawsuits from investors claiming securities fraud.

The company's accounting records should be reviewed early in the process. If the company's records are not sufficient to audit, the company cannot meet its filing requirements with the SEC. In addition, the historical financial statements need to be scrutinized to determine whether the accounting treatment meets the financial accounting standards. Often companies find during the course of an audit the generally accepted accounting principals require them to change the way they have recognized revenue or accounted for expenses. The results can be significant-a company that generates positive cash flow, may show a net loss on its income statement. That change may determine whether or not the company meets the listing standards to be traded on an exchange.

The Lawyer

The lawyer's principal function is to ensure that filings made with the SEC and other materials released to the investing public meets the SEC's disclosure requirements. The legal advisor will assist in the formation of any holding company structure, including due diligence and drafting of agreements to establish any holding structure. It also reviews the company's material contracts and agreements and ensure that they are described, as necessary, in any SEC filings. US securities laws prohibit misstatement or omission of material information from SEC filings, and the lawyer assists the company in ensuring that its filing are complete and accurate.

Unlike the auditor, there is no specific registration for a lawyer to practice before the SEC. The Chinese operating company will want to select experienced counsel, with knowledge of the SEC filing requirements, and well as experience positioning companies for success. In addition, the underwriter in an IPO generally requires a legal opinion as part of the closing process, and may insist that the company engage a recognized law firm to render this opinion. The lawyer also takes the lead in preparing filings and communicating with the SEC. Effective legal counsel will speed the process for approval, and reduce the possibility that the SEC filings are misleading, and assist the company in communicating effectively with prospective investors.

The Financial Advisor

The financial advisor is the connection between the company and the investors. In an IPO, the financial advisor will act as the lead underwriter, or will assist in the selection of the lead underwriter. The underwriter is the securities broker who arranges the sale of shares from the company to the public investors. The lead underwriter will contract with a number of other broker-dealers to establish an underwriting syndicate for the IPO and select the other underwriters on the basis of whether they can effectively sell an allocation of the stock and on the type of investors that the broker represents. Companies generally seek to establish a mix of retail and institutional investors in an IPO in an effort to create a diverse and liquid trading market for the stock.

Selecting a qualified financial advisor includes: track record for closing deals, experience in China and the company's industry, and record for providing long term support. Companies will want to confirm a financial advisor's track record for closing deals, before signing an engagement which may provide for exclusivity or give the advisor the right to fees on future transactions. Identifying experience in the China market will provide an indication of whether the advisor has contacts with investors seeking to invest in Chinese companies. Experience with other companies in the same industry is helpful for positioning the company, assisting it in highlighting its key operating results to the prospective investor, and differentiating the investment opportunity from others. Finally, evaluating the track record of other companies that the financial adviser has assisted, may help in determining whether the financial advisor supports the companies they represent.

Going Public in the USA.

There are two principal options for going public in the USA:

- File a registration statement with the USA Securities and Exchange Commission, or
- Combine with an existing publicly traded company.

The Traditional IPO

The traditional method for going public is to file a registration statement with the Securities and Exchange Commission (SEC) for an initial public offering of securities to the public. In the IPO process, the company and its outside team work together to identify the underwriter for the offering, negotiate an underwriting agreement, and prepare the registration statement for filing with the SEC.

Once the company has selected the lead underwriter it enters into an underwriting agreement that spells out general terms of the IPO and compensation that the underwriters will receive. The compensation is generally comprised of multiple elements: an underwriting discount (the difference between the price at which the underwriter purchases the shares from the Company and the price at which it sells them to the investing public), warrants to purchase common stock, expense allowance, and right of first refusal to be underwriter on future financing transactions. Underwriting compensation varies depending on the size of an IPO. Total compensation can be as much 13% of the total offering proceeds for very small offerings and as few as 5 or 6% of the total offering proceeds for larger offerings.

Once the underwriting agreement is negotiated, the underwriter is required to submit the proposed compensation package to the Financial Industry Regulatory Agency (FINRA), which is a trade association established by the investment banking community to regulate the industry's activities. FINRA will review the proposed compensation for the IPO transaction, as well as any other compensation from other transactions with the company in the prior six months. If FINRA determines that the overall underwriter compensation is too high, the underwriter will be required to reduce the compensation by decreasing the underwriting discount, decreasing the number of warrants, increasing the exercise price of the warrants, reducing the expense allowance or reducing or eliminating the right of first refusal.

The team also prepares a registration statement for filing the with SEC. The SEC prescribes certain forms of registration statement to be used for this purpose, either a Form S-1 or F-1. SEC regulations specify certain information that must be included in the registration statement: a description of the company, its business, financial position, operating results, management and capital structure. A company with more than $50 million in revenues during the most recent fiscal year is required to provide audited financial statements for its three most recent fiscal years. Companies with under $50 million in revenues are designated Smaller Reporting Companies and are only required to include audits for their two most frequent fiscal years.

Once the team is satisfied that the registration statement is complete, it is filed with the SEC. The SEC will review the disclosure for compliance with its requirements, and accounting staff to review the quality of the financial disclosure and compliance with the applicable accounting standards. The SEC doesn't make qualitative decisions about which companies can go public. It doesn't approve companies on the basis of whether anyone at the SEC believes that the company's business plan will succeed. However, the SEC does insist that companies publicly traded in the US provide disclosure of all material information related to their business, sufficient to allow investors to make an informed investment decision.

The SEC's policy is to try to complete an initial review within 30 days after the initial filing. Then, the SEC will issue a comment letter, detailing areas of the registration statement where the SEC believes the disclosure is inadequate or could be improved. The company, with assistance from its own legal and accounting advisors, then prepares a response letter to the SEC answering any questions that the SEC may have raised. The company also makes changes to the disclosure in its registration statement and files the amended registration statement with the SEC. The SEC staff then reviews the amended registration statement and may submit additional comments or questions to the company. This process can be repeated several times, until the SEC staff are comfortable that the registration statement meets the requirements for full and fair disclosure. This cycle of submitting registration statements to the SEC and responding to comments typically takes between 75 and 150 days to complete.

Once the company and the underwriters are comfortable that the registration statement is substantially complete and the SEC is unlikely to have significant additional comments, the underwriter will distribute a portion of the registration statement to prospective investors. The portion of the registration statement is referred to as the prospectus and contains the information concerning the company. This preliminary prospectus is circulated to solicit interest in purchasing shares in the public offering. The Company management goes on "road shows" with the underwriting syndicate and makes presentations to prospective brokers and institutional investors as part of the pre IPO marketing process. The preliminary prospectus identifies the number of shares to be sold in the IPO and the expected price range, but doesn't include final pricing information.

Once the registration statement has passed the SEC's review, and the underwriting syndicate has completed preliminary marketing of the offering, the company and lead underwriter establish a closing date. The company then requests that the SEC issue an order that the registration statement be declared effective as of the closing date. At the closing of the IPO, the company sells stock to the underwriters and the underwriters in turn sell it to the public stockholders. On effectiveness of the registration statement, the operating company is now publicly traded and required to file periodic reports with the SEC.

The final price of the shares in the IPO is negotiated between the underwriter and the Company, usually the night before or the morning of the IPO. The company and the underwriting syndicate must strike a balance on the offering price. If the company tries to set the price too high, the underwriters will not close the IPO, or the stock price may drop immediately after the IPO because there aren't sufficient investors to purchase shares at the offering price. Conversely if the IPO price is set too low, the company doesn't get the full price per share that it could, and the underwriter isn't getting as large a discount. The company's goal is usually to price the IPO only slightly below the market price. Then the stock is more likely to trade at higher prices following the IPO, creating publicity for the company and for the underwriter because the media considers a stock that trades up as a "successful" IPO. In addition, the investors that purchase the shares in the IPO from the underwriters are

clients of those underwriters. Those clients want the shares trade up after the IPO, as opposed to staying flat or trading down. If the investors in the IPO generate a profit, they are more likely to invest in the company or the underwriter's next financing.

The Reverse Merger

The second alternative for going public is to combine with an existing publicly traded company in a reverse merger transaction. The term "reverse merger" refers to the fact that even through the public company is technically the acquiring company, the operating company is really the survivor of the merger with its management gaining control and its historical financial statements becoming the financial statements for the combined entity after the reverse merger.

In a reverse merger, the operating company enters into an exchange agreement or merger agreement with a public shell--an existing publicly traded company with only nominal assets or operations. These public shells may have been formed specifically for the purpose of combining with an operating company, or may have started as operating companies, whose business has failed. The national stock exchanges in the USA will delist companies that have ceased business operations. Consequently, public shells are most commonly found on the OTC Bulletin Board or the Pink Sheets.

There are a number of finders that specialize in identifying and selling public shells. The purchase price for acquiring a public shell is generally comprised of cash and some amount of shares that will be retained by the trading company's existing stockholders. The price depends upon whether the public shell is listed on the OTC Bulletin Board or the Pink Sheets, any costs necessary to bring the shell into compliance with SEC filing requirements, and whether or not the public shell may have contingent liabilities that would impact the Chinese operating company after the reverse merger.

Once a public shell has been identified, the public shell and the Chinese operating company enter into an agreement to effect the reverse merger. The agreement provides for the stockholders of the operating company to transfer all or substantially all of the shares of the operating company to the public company. In exchange, the public shell company issues shares of its stock to the stockholders of the operating company. As a result, the stockholders of the Chinese operating company own a majority of the public company, and the public company owns the operating company as a subsidiary.

The public shell company is required to file a report on Form 8-K with the SEC when it enters into an agreement for a reverse merger transaction. It must file another report when the public company completes the reverse merger transaction. This second report is required to contain substantially all of the information contained in a registration statement, inc ing a description of the new operating company, its busin financial position, operating results, management and ca structure. The 8-K must also include audited financial st ments for the Chinese operating company. Once the rev merger transaction is complete, the operating company control of the public company and immediately has ong public reporting requirements. The SEC doesn't have to prove the reverse merger or the form of 8-K.

Each approach has its advantages and disadvantages. IPO process is designed to raise capital for the company provide an active market following the IPO. The process ates a diverse shareholder base, who have purchased shar the same price. The IPO itself may be picked up by the m and draw attention to the company. However, an IPO req the company secure an underwriter for the offering, is consuming, and there is no certainty that the transaction close. Even after an underwriter is secured, the registra process with the SEC takes 75 to 150 days or even longe the end of that time, market conditions can change, or the derwriter may determine that it is not willing to price the at a price the company will accept.

The reverse merger can be done in 30 to 60 days if company has completed audited financial statements. It is less costly than a traditional IPO and the outcome is n certain-the company doesn't have to wait for the SEC tc prove a registration statement or for the underwriter to lin prospective purchasers. The downside to the reverse merg that it alone doesn't raise any capital for the company, u the public shell has cash as part of the transaction, and t doesn't develop the diversified shareholder base to creat active trading market. In the reverse merger, the shares are publicly traded are those that are outstanding at the of the reverse merger transaction. This generally repre less than 10% of the company's stock after the transa and is held by investors who acquired shares in a public or an operating company that failed. They did not inve the company's business, and it is difficult to gauge what behavior will be after the reverse merger. Therefore, panies that effect a reverse merger often follow it up w financing transaction, either a p placement or registered offerin increase capital to the company to increase the number of shar the public float, and increase inv interest in the company. CBF

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