TheStreet

Chinese Stocks: More Trouble Than They're Worth?

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NEW YORK (TheStreet) -- Are accounting blow-ups a fundamental risk of investing in Chinese stocks, or just another unfair reputational knock against the emerging world giant's economic juggernaut?

The latest accounting blow-up involving a Chinese stock occurred on Monday. It concerns not just one, but two affiliated Chinese companies, **Duoyuan Printing**(DYP) and **Duoyuan Global Water**(DGW).

Duoyuan Printing announced a number of changes on Monday that led to the selloff. The chairman announced that the CEO and CFO of the company were being replaced, and the Deloitte Touche Tohmatsu had been fired as auditor after bringing issues to the attention of Duoyuan management which remain unresolved.

Duoyuan Printing was down 54% on Monday, while Duoyuan Global declined by 41%.

Earlier this year, Chineses poultry company **Yuhe International**(YUII) took a market beating after its auditor, Grant Thornton, resigned. Yuhe says it was misunderstanding between the Chinese company and the auditors over provisions of Sarbanes-Oxley that the Chinese management did not understand.

It was guilt by association in the case of Duoyuan Global Water, which shares the same chairman as the printing company.

In lowering its rating on Douyuan Global Water, Piper Jaffray analysts wrote on Monday, "Loss of management credibility in Chinese stocks leads to severe valuation compression. Concerns around internal controls and corporate governance at Duoyuan Printing will add fuel to already high investor concerns around China stocks, and we believe it will impact DGW. China will not go away as an investment theme, and U.S. investors will continue to seek exposure to China's growth, but caution is obviously required when investing in these stocks."

Is it simply, as the management of Yuhe International suggested, that the accounting blow-ups are cases of something being "lost in accounting translation" between Chinese companies and Western auditors?

Chris Purtill, an analyst at Janney Montgomery Scott who covers Duoyuan Water, says the Chinese stocks are a double-edged sword. Some can run-up to frothy multiples after IPOs based on the emerging market growth premium. However, these same stocks can be walloped the second there is the suggestion of any accounting issue, as was the case on Monday with Duoyuan Global Water.

Purtill, who has been at a hold on Duoyuan Global Water since initiating coverage, says that at the point the Duoyuan Global was trading at 33x earnings, the valuation had become so frothy that even if he could have verified every single financial line item from the company, it would have been hard to justify. After Monday, the sword has turned to the other side, with Duoyuan Global's multiple being so low that its actual earnings power may merit another look from investors who can get past the fear of an accounting disaster.

It's not as if the U.S. market is squeaky clean when it comes to the books. Yet even after the notorious 1990s, with Tyco International shareholders paying for Dennis Kozlowski's yacht parties where ice sculptures spewed vodka from private parts, U.S. investors weren't ready to sell U.S. corporations down the river.

The comments from the Piper Jaffray's analysts -- who had been among the Duoyuan Global Water bulls, and took the company public in 2009 -- dodge the issue of whether or not there's substance to the Chinese accounting blow-up issue. Piper Jaffray took down its rating on Duoyuan Global Water to a hold, ultimately saying no more than China wouldn't disappear as an investment theme, but caution is required.

If that's the grand conclusion, then it's no different for Chinese stocks than stocks from any country. Caution is always required, and the human inclination to commit fraud is not something delineated by national borders.

There are some sectors in which Chinese stocks are now staples for investors, such as the renewable energy industry, in particular the Chinese solar stocks. The Chinese solar stocks have given investors some reason to be concerned on the accounting front from time to time. Going back a few years, **LDK Solar**(LDK) had accounting issues that hurt the stock's credibility. **Canadian Solar**(CSIQ) is still in the midst of resolving an investigation by the Securities and Exchange Commission into its accounting practices. **Suntech Power**(STP) still has the lingering issue of sales it has made to an entity owned by its own chairman, an issue over which investors have pleaded for resolution.

Yet to say that caution is required with Chinese solar stocks because they are Chinese stocks -- and as such, are likely to be involved in accounting blow-ups -- isn't exactly scientific law. After all, U.S. solar company **Sun Power**(SPWRA) had to restate 2009 earnings, yet no one assumes that U.S. solar companies require an additional layer of caution do to the risk of accounting blow-ups.

Solar is a good example of the reputational risk that has nagged Chinese firms for many years, and that has proven in at least one major case to be overstated. When Chinese solar firms were still upstarts a few years ago, the knock against them was more or less the standard knock against anything being made in China -- the products weren't reliable.

That case can't be made as easily today against the leading Chinese solar companies, like **Trina Solar**(TSL) or **Yingli Green Energy**(YGE).

In fact, the major solar company involved in the most recent issue related to reliability was U.S. solar giant and industry bellwether **First Solar**(FSLR), which had to take a much larger-than-typical charge for warranty related issues in its last earnings period.

If the U.S. is lagging China in many economic respects, accounting reputation isn't one of them. The U.S. isn't losing ground to China in terms of reliability of products, but China has closed the gap in a sector like solar. Does this mean that the accounting blow-ups that continue to dog Chinese companies are a growing pain soon to be passed, or a fundamental weakness in Chinese stocks that makes them particularly dangerous investments?

The United Steelworkers Union recently lodged a complaint with the federal government that China is not playing fair when it comes to green energy, doling out subsidies to its green energy companies that make the playing field impossible to ever level.

Are investors and Wall Street playing fair with Chinese companies by bringing their accounting issues into the spotlight in a way that suggests it's not corporate malfeasance, but Chinese corporate malfeasance specifically?

Piper Jaffray wasn't pointing the finger in its comments regarding Duoyuan Global Water, but stating a simple fact: loss of management credibility can and will sink a stock.

Indeed, as more and more of the IPO banners draped down the side of the New York Stock Exchange feature the names and logos of Chinese companies, the latest account blow-up involving a China stock raises the question: *Do you have less faith in the credibility of Chinese corporate management than corporate management from Western companies?* Take our poll below to see what the *TheStreet* thinkgs.