Making Sense of the Sell-Off, Then Rally in Chinese ADRs

Concerns about delistings on U.S. exchanges appear to be overblown.

March 2022

The U.S. Securities and Exchange Commission's (SEC) demand for detailed audit documents from U.S.-listed Chinese firms recently contributed to a wave of selling in their American Depositary Receipts (ADRs) amid worries these firms could be delisted. But we feel the panic around this event was excessive and that the current rebound in Chinese ADRs is justified.

For one thing, the U.S. government has been open in its actions. The Holding Foreign Companies Accountable Act (HFCAA) was passed at the end of 2020 and requires that the SEC ban companies from trading in the U.S. if the Public Company Accounting Oversight Board (PCAOB), the federal audit watchdog overseen by the SEC, is unable to inspect their audits for three consecutive years. The recent news that the SEC identified five companies at risk of such a ban in 2024 shouldn't come as a big surprise.

Meanwhile, Beijing has shown a willingness to help these companies comply with the auditing requirements. The PCAOB and the China Securities Regulatory Commission (CSRC) are working together to address these issues. Hong Kong Exchange (HKEX) authorities are also facilitating an easier homecoming for those companies that would like to list in Hong Kong. Both developments should help reassure investors.

The concerns over the ADRs have added to a number of questions that have hovered over Chinese stocks recently. That includes rising COVID-19 cases, geopolitical tensions, China's focus on deleveraging, regulations, and slowing growth. The result has been a significant swing in equity markets, moving from the largest sell-off in Chinese stocks since 2008 to a more recent surge that was the largest two-day climb in Chinese stocks in more than 20 years.

We expect more names to be added to the initial list of five companies—BeiGene, Yum China, Zai Lab, ACM Research, and Hutchmed China—that the PCAOB identified. However, many Chinese companies with ADRs have already secured secondary listings in Hong Kong, with the Hong Kong Exchange having loosened its listing requirements to accommodate the demand from ADRs for a secondary listing or dual listing. Ahead of the 2024 deadline, companies like Yum China have already completed a Hong Kong share listing. This means their shares could continue trading even if they were delisted from U.S. markets.

The process of converting holdings from ADRs to HKEX shares is quite simple and quick. Investors can typically instruct the custodian to convert ADRs into Hong Kong shares without restrictions. The depositary will be canceled, and the

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custodian will deliver the Hong Kong shares to the investor with the entire process taking about two business days electronically and involving a reasonable cost. This should help minimize any impact on these securities.

Trading Liquidity Boost

While investors are concerned about trading liquidity in Hong Kong being lower relative to the U.S. market, we believe this could change in the future as volumes are expected to pick up with an increasing number of investors converting their ADR holdings into HKEX-listed shares. Although a portion of institutional investors holding ADRs may not be able to trade in Hong Kong, this could be compensated by increased flows from mainland Chinese investors who can buy dual- and primary-listed companies in Hong Kong via the Southbound Stock Connect scheme.

Mainland Chinese companies interested in raising funds overseas have used the variable interest entities (VIE) structure to circumvent a law under which Beijing prohibits direct foreign investment in certain industries. Recently, such structures have come under renewed scrutiny after China issued new guidelines for the platform economy.

The VIE structure is, in fact, not a focus of the HFCAA. If the CSRC approves a Hong Kong listing of a company with the VIE structure in the coming few months, this can be viewed as an implicit approval of VIE structures by the market.

Comfortable With ADR Exposure

T. Rowe Price strategies that have invested in ADRs have done so primarily due to the deeper pools of liquidity in the U.S. markets. We remain comfortable with our holdings as these companies are either dual listed or are open to listing in Hong Kong. We also don't think the developments with the ADR regulations alter our investment theses, which are rooted in company fundamentals and in-depth analysis.

It is important to remember that Chinese ADR stocks will not be delisted immediately. The HFCAA requires companies to comply to auditing standards within three years of being put on notice by the SEC, as has happened to the first five companies to be named. This is more than enough time for companies to set up a secondary—or even a primary—listing on another exchange. Since many Chinese ADRs already have a secondary listing, we think there is a low likelihood that their shares will ever become untradeable.

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