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S-chips not seen regaining favour in Dragon year

Governance issues and shaky Chinese economy put investors in cautious mood

By LYNETTE KHOO

THE seemingly endless string of bad news from the S-chips cluster has hurt hopes of any potential re-rating of S-chips in the near term and investors trapped in the suspended counters of troubled S-chips would probably resolve to stay away from the cluster for the time being.

So, is it still worth investing in S-chips - that make up one-fifth of all listed entities here? Will the year of the dragon usher in good tidings for S-chips or 'dragon chips' as they are otherwise known?

Analysts note that investors should not shun the whole cluster completely as selective stock picking could still yield returns, if liquidity returns in the second half of this year.

But two main factors are still causing investors to stay away from S-chips for now, according to SIAS Research vice-president Roger Tan.

'At the micro-level, there is the consistent loss of confidence in the numbers and governance in S-chips. Investors still see these worrying trends in the recent cases,' he said. 'At the macro-level, we are seeing shaky ground in the Chinese economy. External observers still see a potential of hard-landing for China's economy.

'The macro conditions have to come back first, not just a recovery in Europe but also the economy in the US and more importantly, China needs to show the world that it can bring internal demand up to speed,' he added. 'And of course, the individual companies in Singapore have to show ways to solve their perceived governance issues.'

DMG & Partners Securities analyst Tan Han-Meng noted that some of the larger S-chips have also fallen sharply last year, likely due to exits by institutional investors.

'Accounting irregularities are likely to continue to weigh on valuations this year,' he said. Investors are also more cautious as auditors express their opinions on the companies' financial health during the earnings reporting season.

Using the historical performance of S-chips between 2007 and 2009 as a gauge, he expects S-chips to re-test its historical 0.6 times price-to-book (PB) before delivering better returns in the second half of this year when the impact of more favourable policies in China trickle in.

Last year, S-chips were confronted with tough business conditions with rising labour costs, tighter credit, waning export demand, and a strengthening yuan.

Their stock valuations also took a beating from corporate governance concerns as Sino Techfibre, China Gaoxian, Hongwei Technologies and China Hongxing were added to the list of beleaguered S-chips in the second wave of accounting scandals since the global financial crisis.

Governance issues in Chinese companies took on a global scale when dozens of those listed in the US were hit by fraud allegations from US short-sellers, triggering major losses for investors.

All this has capped research coverage of S-chips last year, while the perceived undervaluation of S-chips continued to fuel privatisations by major shareholders.

'We see good S-chips out there but no matter what they do whether it is paying dividends or showing the market that they have good profits, they have not been well-received by the market,' said Mr Roger Tan.

'I think S-chips need to redesign themselves and redefine themselves so that they can attract the market like they did at the beginning,' he added.

One way to do so is to reduce their financial slack - by issuing dividends and keeping cash to the minimum operating requirement - and raising funds from the market each time an investment opportunity comes along.

This is similar to what Reits (real estate investment trusts) are doing, which Mr Roger Tan deemed a 'well-proven governance approach'.

Auditors note that the audit of cash balances in Chinese companies may continue to be a challenge.

This process is further complicated by different operating procedures at different banks in China, said Foong Daw Ching, a partner at Baker Tilly TFW LLP. But therein lies a silver lining.

'People in China managing corporations or charged with corporate governance are learning or have already learnt to cope with international regulatory requirements,' Mr Foong observed. 'Over time, investors will find that listed entities from China may offer good potential for investment.'

Singapore's regulatory tightening at the pre-listing stage will also provide a better filter, Mr Foong said, adding that this will ensure a better crop of future S-chip listings.

While the easing of economic growth globally and in China could tame cost pressures this year, this could also put a dampener on revenues and credit availability for some S-chips.

Henry Tan, managing director of Nexia TS, noted that credit conditions may worsen for S-chips this year given the deteriorating debt woes in the eurozone.

'We are also particularly concerned with cashflow projection of businesses, in particular, areas of new investments,' he added. 'The collectability of debts will also feature more prominently this year in view of the slower growth of China's economy.'

For investors still keen to invest in S-chips however, Mr Henry Tan suggests that they look into three key areas: dividend track record, low receivables and export-driven businesses; or companies that deal with state-owned customers.

Investors should be alert to red flags such as large cash balance with no dividend track record; and large receivables coupled with large payables, he added. They should also be wary of large advances to suppliers, deposits or other receivables with little explanation; and large inventories for businesses that are not fast-growing. Mr Tan Han-Meng noted that if liquidity returns, investors may want to take a second look at S-chips with larger capitalisation (above $500 million) and higher liquidity (above $1 million daily traded value).

Investors could also look into companies with a supportive industry outlook such as consumer staples and those that can generate positive cashflows consistently without the need for further fund-raising, he added.