

Research on Shorting Mechanism and China Concept Stock Enterprises

-- Based on the Analysis of Focus Media and Anta Sports

Luyue Fan^{1, a, *}

¹Beijing Jiaotong University, Weihai, Shandong 264200, China

^aCorresponding Author's Email: 19725004@bjtu.edu.cn

Abstract: Since 2010, Chinese companies listed overseas have been frequently shorted. By issuing short-selling reports, short-selling agencies investigate and question the operations, information disclosure, and internal governance of these companies. These short-selling reports have accelerated the exposure of corporate problems and caught investors' attention. However, not all of the Chinese stock companies which have been short-sold have their share prices plummeting and never recovered since then. In the long run, there are still Chinese stock companies that are hardly influenced. For this study, two Chinese stock companies, Focus Media and Anta Sports, are selected, which have been shorted by muddy water institutions while have different market reactions. For comparison, the event research method is used to analyze the impact of short-selling events on their stock price changes, and reasons for which their reactions are different are discussed. Faced with opportunities and challenges, China Concept Stock companies should be prepared well, strictly abide by local laws and regulations, and conduct self-examination in a timely manner. Once a short-selling agency investigates and issues a targeted report, companies should respond quickly and be vigilant about the threatening parts in the report, so as to strive for stable development in the financing market.

Keywords: Short selling mechanism, China concept stocks, Information disclosure, Confidence crisis.

1. Introduction

The incident of Luckin Coffee being shorted by Muddy Waters has once again attracted the attention of investors. After the scandal broke, Jay Clayton, chairman of the U.S. Securities and Exchange Commission, said in an interview that because of information disclosure issues, investors should not put money into the stocks of Chinese companies listed in the United States when they adjust their portfolios recently." The survival of Chinese concept stocks appears to be under threat. Short-selling institutions use information obtained from field research, multi-party interviews, and official documents to find out the contradictions between them and the information disclosed in the company's annual report, thereby proving the possibility of fraud in the company. These short-selling reports have accelerated the exposure of corporate problems. Once the Chinese concept stocks are shorted by institutions, they may face the risk of stock prices plummeting, becoming penny stocks, or even suspension and delisting. In order to study the reactions of different companies after being shorted, Focus Media and Anta Sports are selected for comparative analysis. Both Focus Media and Anta Sports have been shorted by a well-known institution, Muddy Waters. However, the short-selling reports on these two Chinese stock companies have completely different impacts. Focus Media's share price plummeted, and its market value evaporated rapidly. Finally, it chose to delist and backdoor a secondary listing in mainland China. After the Muddy Waters Agency released five short-selling reports on Anta, the stock price of Anta Sports has not been greatly affected. It is still active in the Hong Kong stock market, and the stock price has increased significantly. The purpose of this article is to compare the stock price changes of these two Chinese companies listed in capital markets outside mainland

China after they suffered short selling, and use the event study method to analyze the parts of short selling reports that need to be vigilant, and discuss a high-quality way of survival of overseas listed Chinese companies in a market full of challenges and opportunities.

2. Situation of China Concept Stock in the Capital Market

Due to the rapid growth of China, the "Chinese concept stocks" in the United States have attracted great attention from international investors. On December 3, the US "Foreign Company Accountability Act" was officially implemented, and Chinese stocks plummeted collectively again. In recent years, relevant U.S. authorities have repeatedly warned that Chinese concept stocks in the United States have risks such as insufficient disclosure, accounting fraud, corruption, low privatization prices, and loose regulatory standards in the place of registration[1]. Based on the economic performance of Chinese concept stocks since 2021, China concept stocks are becoming high-risk in the background of the increasingly complex Sino-US game. At the same time, some Chinese-funded enterprises have frequently encountered problems such as insufficient information disclosure and loose regulatory standards in the place of registration, which has led to the dilemma of being collectively shorted, group lawsuits, and even claims in the US and Chinese concept stocks in recent years. Due to certain differences between China and the United States on the supervision of Chinese concept stocks, the United States is likely to use regulatory tools to curb financing of Chinese concept stocks in US. The US securities regulators have long advocated for independent enforcement activities in China and inspections of Chinese accounting firms in accordance

with their domestic laws. For the sake of sovereign security, China advocates that the United States needs to rely on the regulatory enforcement activities of Chinese securities regulators, or that the two sides negotiate and conduct joint inspections. In terms of performance, stricter listing requirements and accounting standards may help improve corporate governance and operating performance of Chinese companies[2]. It seems that the frequency of short-selling of Chinese concept stocks in overseas markets has increased, and many short-selling institutions have focused on Chinese concept stocks. Overseas Chinese concept stocks suffered from a stock price crash and an integrity crisis. Not only Chinese concept stocks are varying-quality, but also there are issues like accounting fraud, questioned business models, and the potential moral hazard of VIE and other corporate-level reasons[3]. Moreover, there are also external factors such as economic slowdown, collective hunting of short interest chains, and China-US cross-border regulatory loopholes that influence the development of Chinese concept stocks. In response to the phenomenon, at the end of 2021, Chinese regulatory authorities issued the "Administrative Regulations on the Overseas Issuance and Listing of Securities by Domestic Enterprises (Draft for Comment)" and the "Administrative Measures for the Recordation of Overseas Issuance and Listing of Securities by Domestic Enterprises (Draft for Comment)", aimed at promoting domestic enterprises to use overseas capital markets in compliance with laws and regulations to achieve standardized and healthy development[4].

3. Case Background Analysis

3.1. Focus Media Case Background

Focus Media was born in 2003 and created an elevator media advertising model. Its business scope covers simulcast screens, frame posters, smart screens and pre-screening advertisements in theaters. In 2005, Focus Media became the first Chinese advertising media stock listed on Nasdaq in the United States, and was included in the Nasdaq 100 Index in 2007. On November 21, 2011, Muddy Waters released an analysis report on Focus Media. According to the report, Focus Media obviously exaggerated the number of LCD network displays and paid high prices to acquire companies. Since Focus Media's IPO, insiders have sold at least \$1.7 billion worth of stock, accounting for two-thirds of Focus Media's market value. Due to these possible insider trading, fraud, selling shareholders' assets at a low price and other issues, Muddy Waters has given it a strong selling investment recommendation. This caused the stock price of Focus Media to plummet on the Nasdaq, as low as 39.49%, and its market value has shrunk severely. After the incident, a journalist from the China Economic Times called Focus Media's Shanghai headquarters on November 22, and then received an email from Focus Media, which responded to the "Muddy Waters" question. Focus Media believes that Muddy Water does not learn about Focus's business, and has not included digital poster screens in the entire system when investigating. But at the same time, Focus Media also admitted the failure of some acquisitions. On November 22, its stock price rebounded while there is still a great gap from before the incident. Finally, Focus Media was delisted from Nasdaq in May 2013 for US\$3.545 billion.

3.2. Anta Sports Case Background

The Anta brand was founded in 1991, and Anta Sporting Goods Co., Ltd. was listed on the main board of the Hong Kong Stock Exchange in 2007. Anta Sports provides professional sporting goods to the market in China, including sports shoes, apparel and accessories. On July 8, 2019, Muddy Waters released a report accusing Anta Sports of controlling dealers. In this report, Muddy Waters' main allegation is that Anta inflates profits by shifting fees to dealers. On July 9, Anta issued an announcement to refute Muddy Waters' short selling, emphasizing the independence of its distributors. In terms of financial data, Anta emphasized that there is no sharing of management costs between the company and its distributors. In terms of personnel, Anta emphasizes that distributors have financial and human resource management functions independent of the company. Anta said its distributors were at their own risk and stressed their independence. Then, Muddy Waters released a second report, questioning Anta Sports' transfer of listed company assets at a low price. In response to the report, Anta responded again, calling it an unfounded guess. The board of directors of Anta strongly denies the allegations in the report regarding the related transactions of the Group, believes that the allegations are inaccurate and misleading, and the report contains factual errors, misleading statements and unfounded speculations. Then, Muddy Water disclosed three more short-selling reports against Anta, accusing Anta of having problems in the relationship with FILA and controlling independent suppliers. However, after five short-selling reports and two clarification announcements were issued one after another, Anta's stock price recovered after falling. From the perspective of long-term stock price changes, this short-selling incident did not cause many waves. Before Muddy Waters, Anta had been frequently shorted by other short-selling institutions. Since it was properly resolved, it did not influence much.

4. Market Reaction Analysis

The case study will use the event study method, which is to study the relationship between the event and the stock price fluctuation according to the change of abnormal return rates. This study adopts the short-term event research method and selects the market model to estimate the expected stock return. The three assumptions required to use this method are that financial markets are efficient, the events studied are not anticipated by the market, and there are no mixing effects of other events during the estimate window.

4.1. Case Study of Focus Media

Take November 21, 2011, as the event day when Muddy Waters shorted Focus Media. Excluding trading suspension days and market closing days, the event window period is 2 days before and after the event day. Build the market model, $ER_i = \alpha_i + \beta_i * R_m + \varepsilon$. Among them, ER_i is the dependent variable, which is the expected return rate of Focus Media stock. R_m is the explanatory variable and is represented by the Nasdaq index. The above data can be obtained from publicly disclosed information on the American stock exchange. α is the intercept term, β is the regression coefficient of the stock return on the market return index, and ε is the random disturbance term. Using Eviews10 software, as Table 1 shown, the model was regressed by the least squares method, $\alpha_i = -0.0004$, $\beta_i = 1.5375$. The model can be

used to calculate the expected return of the company's stock during the event window.

Table 1. Focus Media Regression Analysis

Dependent Variable: Firm Return				
Method: Least Squares				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
Market Return	1.5375	0.1944	7.9086	0.0000
α	-0.0004	0.0039	-0.0919	0.9269
R-squared	0.3872	Mean dependent var		-0.0004
Adjusted R-squared	0.3810	S.D. dependent var		0.0498
S.E. of regression	0.0392	Akaike info criterion		-3.6202
Sum squared resid	0.1522	Schwarz criterion		-3.5684
Log likelihood	184.8206	Hannan-Quinn criter.		-3.5992
F-statistic	62.5460	Durbin-Watson stat		1.4457
Prob(F-statistic)	0.0000			

After obtaining the expected return rates of Focus Media's stock, calculate the difference between it and the company's actual stock return rate during the event window period to obtain abnormal return rates and cumulative abnormal returns.

According to the data in Table 2, on November 23, 2011, the last day of the window, the cumulative abnormal return was -14.65%. It can be seen that the short-selling incident did have a negative impact on Focus Media's stock price.

Table 2. Abnormal Return and Cumulative Abnormal Return of Focus Media

Date	AR	CAR
2011/11/17	1.91%	1.91%
2011/11/18	1.83%	3.73%
2011/11/21	-36.50%	-32.77%
2011/11/22	14.86%	-17.91%
2011/11/23	3.26%	-14.65%

4.2. Case Study of Anta Sports

Similarly, taking July 8, 2019 as the event day when Muddy Waters shorted Anta Sports, the model is $ER_i = \alpha_i + \beta_i R_m + \epsilon$. R_m is the explanatory variable, and the Hang Seng Index of

the Hong Kong stock market is selected. The above data can be obtained from the information publicly disclosed on the Hong Kong Stock Exchange. Through regression analysis, $\alpha_i = 0.0032$ and $\beta_i = 1.2009$ can be obtained as Table 3 shown.

Table 3. Anta Sports Regression Analysis

Dependent Variable: Firm Return				
Method: Least Squares				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
Market Return	1.2009	0.2315	5.1875	0.0000
α	0.0032	0.0021	1.4897	0.1395
R-squared	0.2137	Mean dependent var		0.0041
Adjusted R-squared	0.2058	S.D. dependent var		0.0239
S.E. of regression	0.0213	Akaike info criterion		-4.8438
Sum squared resid	0.0448	Schwarz criterion		-4.7920
Log likelihood	246.6104	Hannan-Quinn criter.		-4.8228
F-statistic	26.9103	Durbin-Watson stat		2.4029
Prob(F-statistic)	0.0000			

On July 8, 2019, the abnormal return reached the lowest point at -5.79% according to Table 4. Short-term market analysis results show that Anta Sports' stock price was indeed negatively affected by the short-selling report issued by the

Muddy Waters Agency, but the impact was significantly less than that of Focus Media. After the event, share price returns gradually returned to normal levels.

Table 4. Abnormal Return and Cumulative Abnormal Return of Anta Sports

Date	AR	CAR
2019/7/4	0.75%	0.75%
2019/7/5	-0.50%	0.25%
2019/7/8	-5.79%	-5.54%
2019/7/9	0.79%	-4.75%
2019/7/10	-1.77%	-6.51%

5. Market Reaction Comparison

After being shorted by the well-known institution, Muddy Waters, Focus Media and Anta Sports seem to have different market reactions. Although both of their stock prices have been negatively affected in the short term, it is clear that Focus Media has been influenced more significantly, with its stock price plummeting and its market value shrinking. In the long run, the two have embarked on completely different development paths. Although Focus Media's share price rebounded the day after the short-selling incident, its market value was still seriously undervalued in the long run. When it was delisted from Nasdaq, the company's market value was \$3.545 billion. After two years of privatization and backdoor listing, the company's total share capital was 4.116 billion yuan and its market value was 190.4 billion yuan. Anta's share price has soared, rising from HK\$51.25 per share on the day of the incident to more than HK\$80 per share today, and the return on equity has also reached 21.50%. One of the reasons for the difference in the follow-up development of the two companies is that the focus of the short-selling reports on them is different. The short-selling report on Focus Media focuses on possible insider trading, selling shareholders' assets at low prices, and other issues, which are actually related to the interests of investors. The report for Anta Sports is about the relationship between dealers, suppliers, and sub-brands in its operation process, and does not involve core business capabilities and investor relations. On the other hand, Anta's safe passage of this short-selling storm may also be related to its positioning in the market. The CIO of Muddy Waters, Carson Block, once stated that institutional investors will screen out many companies for investment due to the need for asset allocation and considering the scale and liquidity of Chinese listed companies, Anta may be an appropriate choice. The reason why Anta's stock price has also been hit in the short term in the short term may be that investors are worried about its stock price changes. When the problem in the short-selling report has not been confirmed, investors may sell their holdings out of concern that the stock price may fall instead of holding shares and wait. However, the selling behavior itself may also lead to a drop in stock prices. Generally, in the long-term market reaction, the negative impact of this panic is almost negligible.

6. Conclusion

After being shorted by Muddy Waters, there have been different market reactions for Focus Media and Anta Sports. Focus Media's stock price plummeted and was finally delisted, while Anta Sports' ROE in 2020 was 21.50%, and its stock price has grown from HK\$51.25 on the event day to more than HK\$80. According to the content of the short-selling report, it can be found that the doubts against Focus Media is more fatal, involving issues such as insider trading, fraud, and selling shareholders' assets at low prices. The short-selling report on Anta Sports mainly pointed out its problems with dealers and independent suppliers, and the short-selling was not successful. Although Muddy Waters, as a well-known short-selling agency, did have a negative impact on Anta's stock price after shorting it, in the long run, the company's ROE is still high and the stock price has grown significantly. In the long run, not all short-sold companies have been hit. Stocks with great operation situation and development potential can still maintain steady growth in stock prices. Faced with many short-selling institutions, Chinese concept stock companies should standardize their operations, improve the company information disclosure system, and not give them opportunities to take advantage. Once a short-selling agency issues reports on them, companies should respond quickly, conduct self-examination in time, and be vigilant about the threatening parts of the report to ensure that they can develop soundly in overseas markets, rise to challenges and seize opportunities.

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