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Analysis: Investors drop China broadly; shun big names, IPOs

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By Ryan Vlastelica

NEW YORK (Reuters) - For U.S. investors wanting direct exposure to Chinese stocks, there appear to be fewer and fewer safe places to enter.

Huge numbers of Chinese shares traded in the United States have sold off recently following a rash of accounting scandals. The scandals have prompted attention from regulators and brokers, and has some of the auditors involved facing legal action.

With even some investor favorites pressured, some are turning to U.S. companies with deep exposure to China to play its growth story, or waiting for a bottom in Chinese names seen as more stable.

The selloff continued on Friday, with shares dropping broadly. Industry bellwethers haven't escaped the recent flight from China even though the criticism has been on stocks traded on U.S. exchanges through reverse mergers.

Beijing-based Internet giant Baidu Inc has slumped 18 percent since the start of May while New Oriental Education & Technology Group is down almost 19 percent.

Baidu shed 1.2 percent on Friday to $121.69. New Oriental fell 3.4 percent to $101.20 and PetroChina, one of the biggest Chinese companies by market cap, lost 2.7 percent to $137.41.

Even IPOs, often seen as a measure of investor risk appetite and which debut with a higher level of scrutiny than reverse mergers, have come under the spotlight, adding to the flight away from Chinese stocks.

"People hear that there isn't the greatest transparency in China, and (the recent scandals) validate those existing fears," said Alec Young, equity strategist at S&P Equity Research in New York, adding that the controversy was hitting names unconnected to the concerns.

"If you drive through a bad neighborhood, you're going to lock your doors to be safe, but if you see something outside the windows you're going to be even more freaked out," he said.

U.S. listings of China-based IPO companies had attracted buyers with their above-average returns. But after the recent sell-off, their shine has faded.

In the first quarter of 2011, U.S.-listed Chinese IPO companies posted an average 30-day profit of 15.1 percent compared with an average 30-day profit of 10.4 percent for all U.S. IPOs.

In the second quarter, however, huge losses have plagued newly listed Chinese ADRs. Data through the close of U.S. markets on Wednesday show an average drop of 24.7 percent in the first 30 days of trading. All U.S. IPOs are up an average of just under 7 percent on the same basis.

"Investors are scared of having another Longtop Financial or another Duoyuan Global Water," said Josef Schuster, founder of Chicago-based IPO investment firm IPOX Schuster LLC., referring to two shares that have drawn intense criticism from analysts. Both have fallen sharply and haven't traded for weeks.

The heightened attention came after short seller Muddy Waters accused Sino-Forest of fraud on June 3. Analysts joined the timber company in defending the stock, which slumped more than 70 percent since the allegations.

Sino-Forest is only the latest named in a series of accusations this past year, with some charges proving accurate, leading to delistings and massive stock drops.

"It's possible that (accusations of fraud) could get broad-based, and that will scare people regardless of how strong the economy is," said Yu-Dee Chang, chief trader of ACE Investments in McLean, Virginia. "That's why you're seeing all these better-known and better-quality stocks like Baidu getting hit along with the others."

Chang forecast further downside in the near-term but is starting to look for places to add positions in beaten-down shares. "Internal demand is still pretty strong," he said.

The Chinese economy's growth rate has slowed lately, contributing to the broader weakness. Recent data showed factory growth in the country expanding at its lowest pace in at least nine months, while trade data on Friday also showed weakness.

With China still considered one of the world's growth engines, there is still investor interest in getting exposure to the expansion. But the scandals and Chinese government's policy of tightening to curb inflation are pushing investors to seek alternatives.

"There's no doubt that Asia is going to be a great investment, despite some bumps, but we're not going directly into China," said Matt McCormick, a money manager at Cincinnati-based Bahl & Gaynor Inc. "We like names like Procter & Gamble and McDonald's, which have revenue exposure to China and will benefit from the growth there but aren't directly exposed."

The scandals, along with bearish macroeconomic trends, "have all added up," he said.

(Additional reporting by Clare Baldwin; Editing by Leslie Adler)