



Buyer beware

Andrew Shinn, vice president, sales and development at SunGard Astec Analytics, examines the challenging world of hard-to-borrow Chinese stocks

ANALYSIS

As investors seemingly stumble over themselves to ensure that they are adequately represented in the biggest potential market in the world, it appears that the 'caveat emptor' approach is often ignored.

While it has become clear that asking questions and undertaking due diligence are imperative when buying and selling Chinese stocks, it is difficult to get good information about many small-cap Chinese companies. In addition, the nature of reverse takeovers pose added risks to investors and legitimate Chinese companies alike.

Fraud allegations

One of the most expensive stocks on SunGard Astec's Lending Pit recently has been China Media Express (NASDAQ: CCME). The company installs LCD televisions on buses that run between mid-sized cities in China. CCME sells advertising to generate revenue and provides much of the entertainment content as well. CCME has shown outstanding revenue growth over the past few years. The only problem is that some investors, including Citron Research, are accusing the company of being a fraud.

After Citron Research released its report on January 31, CCME's share price declined from \$18 to \$13. Borrowing activity in Lending Pit, however, started to increase well before January 31. From January 19 through January 31, CCME's borrowing cost quintupled from 650 bps to 3,400 bps.

This is not the first time that a Chinese company has been accused of fraud. RINO International (NASDAQ: RINO), which makes products for Chinese steel producers, was also accused of fraud by Muddy Waters, a fund that was short

the stock. One of the fund's allegations was that some of RINO's customers were fake. The allegations were eventually proven true when the CEO of RINO admitted that two of its customers did not exist. In addition, the CEO admitted that RINO's financial statements going back to 2008 contained significant material errors.

Likewise, China Education Alliance (NYSE: CEU) fell sharply after a hedge fund released a negative report. The hedge fund, Kerrisdale Capital, hired a private investigator to visit CEU's offices and training centers in China and determined that CEU's business was not legitimate. In addition to empty classrooms, the hedge fund demonstrated how it was impossible for potential customers to purchase educational materials on CEU's websites.

On the other hand, some companies fight back. When Muddy Waters issued another series of reports claiming that Orient Paper (AMEX: ONP) was engaged in fraudulent activity, ONP issued follow-up reports from auditors claiming that it had not overstated revenue. ONP was also helped by some US shareholders who were involved in defending the company against Muddy Waters' allegations. One investor, Rick Pearson, posted video from a visit to one of ONP's factories and it seems that ONP has regained investors' confidence for now. But delving into the world of some of these small-cap Chinese companies demonstrates how difficult it is to get good information.

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The risks of Chinese reverse takeovers

In a reverse takeover, a foreign company will purchase a domestically-listed company in order to gain access to domestic capital markets. Because there is a long wait to get listed on the Chinese stock exchanges, Chinese companies have been completing reverse takeovers of US-listed companies for some time now. The US-listed companies have few, if any, assets and are targets solely because of their stock ticker. Once the Chinese company merges with the US-listed firm, the Chinese company makes sure to include the word "China" in the new company name and proceeds to raise additional equity. Compared to an initial public offering, complet-

ing a reverse takeover enables a Chinese company to gain access to the US capital markets with minimal disclosure.

While reverse takeovers provide benefits to Chinese companies, they pose risks to investors and to those competently-run Chinese companies that suddenly find themselves targets of negative research reports. However, the risks to investors and companies alike can be dismissed under the 'buyer beware' warning, in which the purchaser assumes the risks. Those Chinese companies that decided to come to America did so with eyes open.

Investors also face risks because of the lack of available information. For example, it is difficult for an investor to determine whether CCME's televisions are installed, working correctly and outperforming the competition on bus routes between mid-sized cities in China. Likewise, when hedge funds allege that televisions are not actually installed, there is no way to confirm the allegations without actually visiting China.

In response to Kerrisdale's report on CEU, the company held a conference call to deny the claims of fraud. However, one analyst said that CEU should do more to defend itself, and suggested that CEU post photos and addresses of all of its facilities. (It is indeed shocking that investors would invest in a company that did not even disclose the address of its facilities.)

Often, investors do not need to visit a company's factories in China to perform due diligence. One of the most damning allegations against CEU was its amazing success in relation to its competitors, such as DL, CEDU and CAST, that had much lower revenue growth. If a company is posting exceptional growth but cannot provide a sound explanation for it, then the growth may be too good to be true.

Another red flag for investors involves statements filed with China's Administration for Industry and Commerce that do not match documents provided to the United States' Securities and Exchange Commission (SEC). Then again, how many Western investors are able to decipher Chinese documents?

This raises the point that those who are purchasing shares of Chinese reverse takeover companies are not investors - they are speculators. Therefore, these speculators should not protest when hedge funds conduct due diligence and issue negative reports. Unfortunately, many long investors protest vigorously to regulatory agencies and claim that hedge funds are manipulating the market with their negative reports.

The impact on securities lending

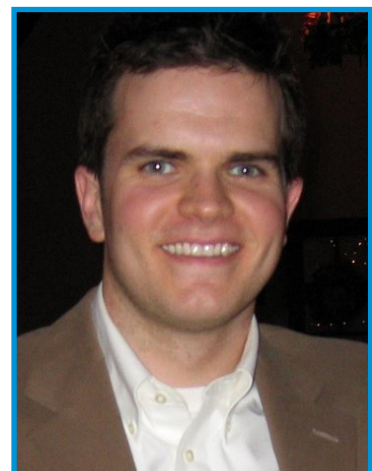
Participants in securities lending benefit from the revenue gained by lending shares of these small-cap Chinese companies. But fraudulent companies benefit neither securities lending nor the entire capital markets system.

The securities lending industry could also benefit if small investors were able to take both sides of a trade. As a result, there would be a healthy debate about the business models of these Chinese companies since there would be small investors on the short side as well as the long side. Then regulatory agencies such as the SEC would not be deluged by complaints every time a hedge fund published a negative research report. Instead, long and short retail investors would be thankful for such research reports. If an investor changed his mind, he could act accordingly.

Small investors should be more careful when buying shares of Chinese reverse takeover stocks

To balance the scales, small investors need to be able to express short sentiment more easily. Currently, it is nearly impossible for a small investor to short sell a stock that is hard-to-borrow. Assuming the share price is above \$5, investors can purchase put options, but options force investors to lock in a time horizon for their trade.

Since there is no easy answer, small investors or speculators should be more careful when buying shares of Chinese reverse-takeover stocks. On the other hand, with the collective punishment that many Chinese reverse takeover stocks have taken in the face of the recent fraud allegations, there are undoubtedly some undervalued stocks available if investors are able to actually conduct due diligence. **SLT**



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