

Short-Seller Cuts Through China Red Tape

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NEW YORK ([TheStreet](#)) -- Over the last year and a half, John Bird has been accused of forgery and stock manipulation, spent more than \$100,000 on legal costs and hired a cadre of private detectives in Shanghai -- all in the course of exploring the murky world of small-cap Chinese stocks listed on U.S. exchanges.

Bird's wife, Jenny, says all the cloak-and-dagger stuff makes her worry that men with hoods and masks will come for them in the middle of the night. "You've been watching too many Sopranos," her husband replies.

Bird's humor belies his real concern about the dark dealings he is intent on revealing. Those dealings involve a particular category of Chinese small-caps -- the reverse takeover, or RTO, companies.

Seen in the best possible light, RTOs represent a back-door way to get a Chinese company listed on a U.S. stock exchange; the process -- perfectly legal -- bypasses the scrutiny normally applied to an initial public offering or the listing of American depositary receipts, by merging the Chinese company into a shell company that is already publicly traded in the U.S. On the other hand, extreme skeptics see RTOs as a pump-and-dump racket on an intercontinental scale.

Bird's investigative exploits began innocently enough. A retired entrepreneur and small businessman in Austin, Texas, he started looking into Chinese companies as a kind of retirement diversion, only to become obsessed with a paper trail he regards as evidence of fraud.

He is mostly a short investor in China stocks. In other words, he sells shares that he has borrowed, hoping he can replace them with shares purchased in the future at a lower price. If the price goes down, he makes money. Exposing bad news about companies can accelerate a share decline and make his strategy pay off. That's one of the reasons he has amassed thousands of pages of documents in support of his short positions and has published the ones he considers most revealing on a Web site he set up, www.waldomushman.com.

Among long investors in Chinese stocks -- those who own shares and profit from increases in the share price -- Bird and his ilk are reviled. Over the past few years, longs and shorts have engaged in a kind of propaganda war over RTOs. Big money is at stake as the two sides battle to sway public opinion and shift stock prices their way. That's where the threats and charges against Bird have come from.

Today, Bird sees the world of Chinese small-caps as a kind of no-man's land, where dishonest executives can submit misleading statements to U.S. regulators without fear of punishment on either side of the Pacific. Individual investors are vulnerable and in most cases unaware of the special dangers associated with RTOs, he says.

He found inspiration for his work in the spring of 2009, when he came upon research by Manuel Asensio. Asensio is now managing partner of Mill Rock Investment Advisors, a firm that espouses a balanced approach to investments, but he is perhaps best known as the vocal short seller who runs asensio.com, a Web site that speaks of a "unique combination of proprietary trading and public advocacy of its positions."

Asensio was then boring into a small-cap called **China Sky One Medical (CSKI)**. Based in Harbin City, in northeastern China, the company had merged into a U.S. shell in 2006 and had uplisted to the **Nasdaq** in 2008, **SEC** records show. The company described itself as a purveyor of ancient Chinese homeopathic remedies updated for modern consumers.

In several notes published on his Web site, Asensio had attacked China Sky One Medical's products, a cornucopia of curatives and diagnostic tests: dental ulcer sprays, cough-suppression suppositories, anti-depression "granules," magnetic hemorrhoid ointments, and myopia-correcting eye drops. The product line described on the company's web site also includes Angelica Nourishing Blood Syrup, for the treatment of "irregular menses" and "postpartum blood deficiency," and Jieyinling Lotion for Private Parts, for the treatment of "cervical erosion, gonorrhea, syphilis, and so on."

The skepticism rooted in Bird's own trench-level business experience kicked into overdrive. He soon found himself reading China Sky One's annual report filed with the SEC, its 2008 10-K.

Bird looks at financial documents with a nuts-and-bolts perspective. Early experience in the real estate business taught him the value of thorough credit checks. In the theater business -- he says he once owned a string of cineplexes in and around Austin -- he learned a bit about marketing and promotion. "We did popcorn and jujube beans and soda pop by the gallon," Bird recalls of his work in theaters. "I know a little bit about high-margin garbage."

Initially, he focused on the numbers relating to inventory turns -- the ratio of sales to average inventory for a given period. Figures in the 10-K indicated that China Sky One's inventory turns for the year came in at about 50. Put another way, the company was saying that sales were so strong -- and manufacturing operations so efficient -- it could have exhausted its entire inventory of raw materials and finished products every seven or eight days.

Bird related those numbers to the popcorn stands in his theaters.

"The very nature of the game requires having a large inventory. How can they get by with nominal inventory?" Bird asks rhetorically, recalling his thoughts as he read the 10-K. "We used to get popcorn delivered to us every three days and we couldn't manage to run those kinds of numbers. If you believe in numbers, if you believe in the sanctity of addition, you end up coming to these inescapable conclusions."

China Sky One declined to comment for this story.

Bird says he then decided he needed to see a credit report on China Sky One Medical. Phone calls and emails to credit bureaus in London and India led him to a Beijing-based agency called Inter-Credit. The agency agreed to send him credit reports via email. When Bird figured out that Inter-Credit was getting much of its information from China's State Administration for Industry & Commerce, the SAIC, he started going directly to the source, he says.

The SAIC has no real equivalent in the U.S. It is a massive bureaucratic omnium gatherum, encompassing some of the duties performed in the U.S. by the Securities and Exchange Commission, the Federal Trade Commission, the Financial Industry Regulation Authority, the Internal Revenue Service, the Food and Drug Administration, a bunch of other agencies and, to top it off, the secretaries of each of the 50 states. It reaches down to the municipal and even village level. It requires an annual financial return from every registered business. In short, the SAIC has a lot of information.

"It was like a kid-in-a-candy store sort of thing," Bird says of his experience with the SAIC. "I started willy-nilly ordering and asking the credit bureau to send me everything they could get."

Bird says he amassed more than 1,000 pages -- most of it in Chinese -- then hired translators to produce English versions. He says the material confirmed his suspicions about China Sky One. The key, from Bird's point of view, was a glaring inconsistency between the income numbers that the company was reporting to U.S. authorities and corresponding or related numbers reported to China's SAIC.

China Sky One Medical had said publicly that most of its operations were executed by subsidiaries in China. Documents made public by Bird -- says he obtained them from the SAIC -- show that those subsidiaries reported revenues totaling about \$3.2 million for 2008. To the SEC, the company reported total revenue for the same year at \$91.8 million.

There was more. China Sky One's SEC filings indicate that in 2007, the company purchased materials from a major supplier, Harbin Yongheng Printing Ltd, in the amount of \$1.75 million. Documents obtained from China by Bird indicate that Harbin Yongheng's total sales for 2007 were only about \$1 million.

"If I believe these are accurate records, then I now have a very good indication of what the true nature of this business is, and it's nothing like what they're telling U.S. investors," Bird says.

Armed with that information, Bird decided to bet against China Sky One Medical by shorting the stock. During the summer of 2009, he borrowed a hefty chunk of China Sky One Medical shares -- he won't say how many--and sold them for about \$15 a share, he says.

In support of that move, Bird set up waldomushman.com to distribute particularly damaging documents publicly. The name of the site is an homage to actor Steve McQueen, who used the alias Waldo Mushman to conceal his true identity when entering motocross races. By way of explanation, Bird relates that McQueen fell victim to medical quacks in Mexico before dying of

cancer there in 1980. A kind of mission statement on the site makes it clear that Bird believes he's fighting against fraudulence.

Shortly after Bird posted China Sky One Medical's SAIC documents on his Web site, he took his information to the SEC. Company executives soon conceded in a public statement that Bird was right, and that the company's filings were in fact inconsistent. The only defense offered was that records filed with the SAIC aren't meant as an accurate picture of a company's total operations, or understood that way in China, but rather are commonly understood to be accurate only in respect to paid-in capital and ownership. Paid-in capital refers to the amount shareholders have invested.

A little less than a year later, in August, the company disclosed that the SEC had started a formal investigation focusing on accounting issues. Recently, China Sky One Medical announced disappointing revenue projections, explaining that suppliers were withdrawing to avoid entanglement with the SEC. The stock was selling for \$16 a share in August 2009, when Bird first posted the SAIC documents. It's now at \$8.

When *TheStreet* sought further information regarding SAIC filings from the SAIC, the agency didn't respond. Crocker Coulson, who handles investor relations for China Sky One Medical, offered a comment about SAIC documents from his own perspective.

"They're absolutely worthless as a signpost as to whether a company is a fraud," Coulson said.

Several investment professionals involved with RTOs on the long side -- among them Benjamin Wey, head of New York Global Group -- have suggested that discrepancies between financials statements filed with the SAIC in China and the SEC in U.S. are accountable to concern over tax payments, particularly China's value added tax, which amounts to 17% on most commercial transactions. The experts say that Chinese companies underestimate revenues in statements to the SAIC -- or delay the filing of accurate statements -- to hold their taxes down.

The notion that SAIC filings are largely meaningless finds little support among some experts. The Shanghai-born-and-raised Gerry Wang, CEO of a containership company in Vancouver, says his extensive network of friends and colleagues in China view accuracy in SAIC filings as an imperative.

And Peter Humphrey, a forensic accountant and corporate due diligence investigator in China, puts it bluntly: "The apologists for the fraudsters in the U.S. like to downplay the importance of SAIC filings because doing so serves their purposes."

Bird's own review found many cases where SAIC filings *do* match SEC records, in particular for Chinese companies that went public in Hong Kong or in the U.S. through direct IPOs, as well as those that trade in the United States through issuance of American depositary receipts. As an example, he mentions **Solarfun Power(SOLFI)**, a manufacturer of solar panels that went public in the U.S. in 2006. Bird says Solarfun's filings with the SEC matched filings with the SAIC down to the last digit.

Bird says he concluded that the RTO companies were special, in a bad way. While more than a few prominent shorts are quick to suggest that they are on the side of the angels in their campaigns against RTOs, Bird is down to earth about his own motivations.

"I'm not a do-gooder at heart," he says. "Sure it's nice to have that as a mantle to carry around with you. But if you get paid for it on top of that -- and get paid extraordinarily well -- well, then it takes on a great deal of fun."

-- Reported by Scott Eden in New York