TheStreet

# China Stock Battles Destroy Value

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NEW YORK (TheStreet) -- A fierce public debate over the legitimacy of China-based small cap companies is wreaking havoc on share prices and costing unaware investors billions of dollars.

On one side are professional investors who take short positions in stocks. They make money if share prices go down, so, of course, their analysis is almost purely negative, striving to point out what's amiss at the companies they've shorted. On the other side are pros with long positions, who often overflow with optimism in defense of their investments. Frequently there is no neutral arbiter, no balanced and objective view.

**Orient Paper**(ONP) is a good example. Either the company is a fraud, working with obsolete equipment, or it's a nascent industrial giant, destined to grow rapidly as the Chinese economy develops an appetite for paper products; the answer depends on whom you believe, longs or shorts. There are no known regulatory problems or formal charges of fraud against the company; the argument is all opinion on the Internet. The company has roundly rejected the charges of the shorts, and has mounted an energetic defense. Still, controversy has triggered some huge moves in the stock.

In June, before the shorts attacked, Orient Paper stock traded as high as $9.12. In the weeks that followed the first attack, the stock slid steadily, finally bottoming at $4.08 on August 31. As the company's defense has taken hold, the stock has recovered to a degree, holding above $6.00 in recent weeks.

A good many other Chinese reverse-merger companies have been whipsawed by the back-and-forth claims and counterclaims of the shorts and longs in much the say way.

Take **China Sky One Medical**(CSKI). When it became the subject of controversy in the spring of 2009, shares of this maker of traditional Chinese medicines fell 35%, to less than $11. The stock rocketed up at at the end of last year, to more than $25, but has been in steady decline ever since. It trades today at about $7.

**Universal Travel**(UTA), an online travel agency, was attacked by the Australian fund manager John Hempton in September. The company called the charges "unfounded." Its stock lost more 40% of its value between August and October, before recovering later in the fall. It now trades about $6.50, a long way from its all-time high near $17, touched in August 2009.

**China Marine Food**(CMFO), a seafood processor, was publicly criticized by short-side bloggers this past summer. Its shares slid by more than 40% to a low of $3.07 before rallying a bit this fall. Trading recently just above $5, the stock remains well below its all-time peak of $8.44 in January 2010.

"Most people who own these stocks don't go to China, they don't know these companies, they don't speak the language. And so they can be suckered in both long and short," says Peter Siris, a principal at **Guerilla Capital**, which has invested early in many Chinese companies. Siris has often written bullishly about his holdings in a column in the *New York Daily News*.

Where opposing camps of investment pros are issuing reports on a stock that are totally inconsistent -- and both sides have positions in the stock -- investors are apt to wonder whether one side or the other might be trying to manipulate the stock. Until now, individual investors have gotten little help from regulators. Language barriers, legal barriers in China, and the sheer volume of small cap deals have impeded effective regulation.

But that may be changing. Well-informed investment professionals have told the *TheStreet* that the **Securities and Exchange Commission** is now investigating the process that gets many China-based small caps listed on U.S. stock exchanges -- a process called a reverse merger. The agency's growing interest may in part reflect pressure from Congress: In a letter to the SEC in September, the House Finance Committee asked regulators what they were doing to police the auditing of small-cap Chinese companies.

In the case of Orient Paper, the shorts have been led by Carson Block, an attorney from California who has lived in China for years. Block has said that he researched the company and toured its facilities in China because his father was considering an investment in Orient Paper. The father, Bill Block, is an investor in Chinese companies, based in California. His company, W.A.B. Capital, says it maintains an office in Shanghai.

The younger Block says he came to believe that Orient Paper's chairman was probably embezzling funds and that its production lines were so hopelessly antiquated the company had to be lying about paper production. Comparing revenue numbers that the company reported in China to those reported to the U.S. Securities and Exchange Commission, Block has suggested that the company's U.S. filings overstated revenues by a factor of 27.

Carson Block published his charges on the Internet and made such a splash he was soon running a small-stock research shop called Muddy Waters, named not for the bluesman, but for an old Chinese proverb: muddy waters make it easy to catch fish. He now offers his services to institutional investors "on an engagement basis."

Orient Paper and its chairman have defended the company and attacked Block with equal vigor. The company has said Block's charges are false. In a press release issued shortly after the initial Block report, Orient Paper suggested that Block had based his research partly on documents filed by another company, He Bei Oriental Paper Co. Ltd. -- which, Orient Paper said in the release, is a "very small paper manufacturer in Baoding [that] has no direct or indirect relationship."

Not so fast, said Block. In a response published as a press release, he insisted he had the right entity after all. There on the business license, after all, was the signature of the chairman of Orient Paper, Liu Zhenyong.

Two regular contributors to *TheStreet's* sites, Eric Jackson and Rick Pearson, have countered Block's attacks on the company. Jackson and Pearson provide commentary to *TheStreet* as guest contributors, like Op-Ed columnists in major newspapers. *TheStreet* also published Muddy Waters' commentary.

Both Pearson and Block participated in a tour of Orient Paper's production facilities about a year ago, and Pearson later posted a video of the tour. The two sides interpreted what they saw very differently. Pearson's most recent commentary published by *TheStreet* explains that he is still long the stock. Jackson has said he no longer owns Orient Paper shares, but continues to believe that Block's charges are false.

In an attempt to clear its name, the company launched an internal probe of its books under the auspices of its legal counsel, **Loeb & Loeb**, a firm that has represented many Chinese reverse-merger companies. Loeb hired a Big Four accountancy, Deloitte & Touch, to assist in an investigation of Block's allegations. On Nov. 29, the company announced that the investigation had produced a positive report, finding no evidence of fraud.

"Let me make it clear. Deloitte was camped out at their offices for three months!" says Crocker Coulson, Orient Paper's investor-relations representative. Coulson often takes warrants to buy stock in the Chinese companies he represents as payment for his services, though he holds no stake in ONP, he says. "There are almost no Chinese companies that could withstand that level of scrutiny."

Still the crossfire goes on.

"This is a self-serving whitewash," says Larry Rosen, referring to Orient Paper's announcement on the outcome of its investigation. Rosen is a New York lawyer who has built a business as a class-action attorney specializing in shareholder suits against Chinese small-cap companies hit by steep stock-price declines and attendant controversy. He has filed a suit against Orient Paper. "But we'll see," Rosen went on. "I've been proven wrong before. Occasionally it happens. But personally I don't think this press release is worth the bytes it's written with."

Muddy Waters says it stands by its original report.

In many ways, the fracas over Orient Paper is typical of recent controversy in the world of small-cap Chinese stocks, where integrity sometimes seems to be a moving target and analysts can view the same set of facts and draw opposite conclusions.

Longs argue that a good many of the accounting mistakes that have raised havoc for investors were in fact innocent errors, not deliberate misstatements. They say that Chinese executives have recently improved their skills in the area of financial reporting and are now much better able to meet the standards of the U.S. capital markets.

Still, Chinese companies listed in the U.S. tend to have corporate structures reminiscent of Russia's nested dolls, with operating subsidiaries inside holding companies inside holding companies. In that kind of environment, the accounting can get complicated.

Often, the thing that you've bought shares in is a so-called variable-interest entity, or VIE -- which means shareholders own a stake in a contract with the management of the business in China, not a stake in the actual business. Be careful there. Experienced securities lawyers caution that small-cap Chinese companies have an uneven record in regard to such contracts.

Novice investors will want to bear in mind that experienced Wall Street operators are normally "selling their own book." In other words, trying to talk others into buying or selling something they themselves have already bought or sold. In the case of the shorts, they frequently sell borrowed shares before attacking a company, hoping that public attacks will bring down the price and allow them to replace the borrowed shares on the cheap.

Short sellers say they perform a public service when they out fraudulent Chinese companies. They say the longs are at best naive and at worst complicit in foisting shoddy companies upon unsuspecting retail investors in the U.S.

The longs call the shorts predatory manipulators. They charge that the shorts cynically orchestrate "short attacks" to manufacture doubt and torpedo the shares of legitimate companies. They say the shorts have unfairly tarred the entire China sector -- and many solid, growing companies -- with research that is sloppy at best.

Investors will be wise to take commentary from either side with a grain of salt.

Finally, be prepared for turbulence. Orient Paper may prove to be the growth company its backers claim it is, but the stock is still down 30% since the short attacks began. Investors in China need to be ready to ride out that kind of storm.

Eric Jackson, the contributor to *TheStreet* who originally liked Orient Paper, says that individual investors are not well-positioned to understand China-based stocks.

"I'm lucky. I have people on the ground in China. I can go places and find out information," Jackson said. "But what can a retail investor do? They're really relying on the word of the auditor. I think there are auditors ... basically signing off on whatever numbers the company gives them, just to get a fee. And hoping to get referral business from other Chinese companies."

Jackson said he would advise the average investor to stay away from the RTOs.

"If I were giving advice to a friend of mine, I would say avoid it," Jackson said. "I would say: You're not smart enough to sort through what's really going on, so it's probably not worth the risk."

Speaking on behalf of their company, the researchers at Muddy Waters suggested that investors looking at China-based small caps should pay particular attention to assets listed on a company's balance sheet. Where revenues are being fabricated, a company will frequently inflate assets to support the revenue claims, sometimes to a degree that gives a fraud away, the researchers said.

"Finally," the Muddy Waters researchers said, "if it seems too good to be true, it probably is, even in China."

-- *Reported by Scott Eden in New York*