BARRON'S

Curdled Expectations

By Neil A. Martin

1,457 words
17 December 2007
Barron's
48
English

More than 100 Chinese companies have gained instant stock-market listings in the U.S. since 2000 via so-called reverse mergers. Typically the Chinese entity merges with a publicly traded U.S. shell company, thus eliminating the need to file a prospectus, launch an initial public offering or otherwise pass regulatory muster. While the motivation behind such transactions may be as legitimate as a desire to save time and money, critics note that lax regulation has often gonehand in hand with price manipulation and other deceits.

Likely to give more fuel to opponents of such mergers are American Dairy's disclosures last week that it has dismissed its independent accounting firm, Oklahoma-based Murrell Hall McIntosh; withdrawn its 2007 revenue and profit guidance; and is the subject of an informal Securities and Exchange Commission probe. The San Marino, Calif.-based company, whose Chinese subsidiary, Feihe Dairy, produces milk powder for infant formula as well as soybean products, also said it will hire a new accountant to re-audit its results for 2004 through 2006, calling into question the veracity of its reported numbers in those years, a span in which earnings grew about 143% and revenue 228%. American Dairy's shares plummeted 12% to 14 on the week, but the stock, which was trading near 26 just two months ago, could fall more in coming months.

Unknown to many investors, at least until recently, the SEC began questioning the independence of Henny Wee, the company's Hong Kong-based auditor, as early as 2005, owing to Wee's involvement with a company that advised and owned a stake in American Dairy. The agency notified American Dairy (ticker: ADY) in this year's third quarter that it was the subject of an informal investigation. Barron's recently has been asking Wee and American Dairy CEO Leng You Bin similar questions, but hasn't received many answers.

The Chicago hedge-fund company Citadel loaned American Dairy $80 million last summer to pay off loans and finance a much-needed expansion, with the stipulation that Leng replace Murrell Hall by next May with a large, multinational accounting firm such as Ernst & Young. Questions about the independence of American Dairy's audits could complicate the company's quest for additional funds, which it will need to fend off deep-pocketed competitors such as Nestle (NESN.Switzerland) and Wyeth (WYE) as it seeks to expand to China's larger cities.

Founded by the Chinese government in 1962, American Dairy was privatized in 1997 under Leng. In 2003 its U.S. arm merged with a Utah shell, Lazarus Industries, and renamed itself American Dairy. Its shares traded on the OTC bulletin board before moving to NYSE Arca, an electronic exchange; Leng, who controls 63% of the company, told Barron's he hopes the stock soon will be trading on the New York Stock Exchange.

In theory, at least, American Dairy's prospects should be bright. Based on Chinese astrology, 2007 is the Year of the Golden Pig, considered an especially fortuitous time for couples to have babies. Indeed, China's hospitals have been packed with expectant parents this year, and total births are likely to top 20 million before the lunar year ends Feb. 6, more than 25% above the country's average number of births per year. With a partial nod to the Pig year's impact, the company raised its '07 sales guidance last month to $160 million, about 30% above '06 results, and said operating income would jump 50%, to $30 million. Last week it with withdrew that forecast and said it is cooperating with the SEC.

Murrell Hall became American Dairy's accountant after the reverse merger. With no offices in China, it turned to Wee, a Malaysian-born Chinese based in Hong Kong, to assist in auditing the company's financials. In public correspondence released last summer, the SEC noted that certain American Dairy filings listed Wee as both the company's auditor and a principal in Belmont Capital Group, which provided capital-raising and consulting services to American Dairy prior to its public listing in '03, and later bought 8% of its shares. The agency disclosed it had written letters to American Dairy in December '05 and January '06, questioning its auditor's independence.

In response, Wee told the SEC he owned 51% of Belmont until June '02, but sold his stake to Tracy Wan, a former employee of his auditing firm and former business partner in Belmont, and that he no longer was involved with the firm. Yet he continued to share office space with Wan. According Hong Kong real-estate records obtained by Barron's, Wee in fact owned 80% of Belmont in the early 2000s; from April '02 to January '06, the firm was controlled by two entities in the British Virgin Islands, the records show, before passing clearly to Wan's control.

Wee also told the SEC that he leased part of his office to Belmont after June '02, and in an e-mail response to Barron's admitted he and Wan each owned 25% of a third company, Questpro Holdings, the owner of the office. Wee and Wan worked together not only on American Dairy's reverse merger but that of China Precision Steel (CPSL), which Murrell Hall engaged Wee to audit before resigning as the company's auditor in October.

In a Dec. 6 e-mail responding to Barron's queries, Wee said his firm "ceased to provide any form of service" to American Dairy after the second quarter. He also confirmed that he doesn't read Chinese, noting his staff translates documents for him. The next day a Murrell executive confirmed his firm no longer was on the job, and wouldn't be auditing the company's fourth-quarter results. Four days later American Dairy announced it had dismissed Murrell Hall "effective immediately," and that the company was under investigation.

"Who can say what surprises might be in store for investors?" says Todd Fernandez, senior research analyst with the proxy-advisory firm Glass Lewis. "Not only did American Dairy keep word of the SEC investigation away from investors since the last quarter, but it also failed to mention it was aware of such concerns as far back as as 2005, when the SEC began a review" of an S-1 regulatory filing by the company.

In a statement, American Dairy said it believes the SEC's primary focus is on the independence of Murrell Hall and Wee, not the company's business operations or management. It does not expect the re-audit to "necessitate material adjustments" to historical results. But the next auditor will have its work cut out, given new questions raised by American Dairy's third-quarter filing.

On Nov. 15 the company reported preliminary results for the September quarter, but announced it would delay filing the requisite 10-Q report with the SEC. Four days later it filed the document, which indicated, among other things, that third-quarter gross profits were $19 million, not the $24.6 million previously reported. Leng attributed the difference to "intercompany eliminations, which we did not take into account at the time."

Another red flag in the 10-Q was a quarter-to-quarter drop of 17% in the company's distribution expenses, even as capital expenditures more than doubled to $25 million, versus $12 million in the first half. Several hedge-fund analysts have suggested American Dairy may be capitalizing expenses, but a company spokesman says advertising expenses "fluctuated considerably between Q2 and Q3," and that such capital expenditures "are not out of the ordinary considering ADY's significant investment in capacity expansion and new revenue opportunities."

Notwithstanding its accounting issues, American Dairy's biggest problem may be its business prospects. Its growth model is predicated on competing in the high-margin powdered-milk business in China's so-called Tier 1 cities such as Shanghai, Shenzhen and Beijing -- markets that are dominated by foreign multinationals. The company's Flying Crane brand is a major name in smaller and mid-sized markets but barely is visible in the nation's largest cities.

Moving uptown, so to speak, will require deep pockets, which American Dairy probably doesn't have. Those who may have profited most from the company's endeavors are the folks who rode the stock up from the low single digits to this year's mid-20s -- and sold before it fell. As investors in some Chinese reverse mergers have learned, the mergers aren't the only things that reverse.

Document B000000020071215e3ch0000d

