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BARRON'S

Beware This Chinese Export

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Smaller Chinese companies have found an easier way to gain a coveted U.S. stock market listing without an IPO. So how have their investors done?

IN CHINA, IF YOU WANT YOUR BUSINESS LISTED on an American stock exchange, you may find yourself talking to Du Qingsong. His electronics company was among the first to reach Nasdaq back in 1997. From the city of Xi'an, the end of the ancient Silk Road in central China, Du has put together half a dozen of the country's latest arrivals on the Nasdaq and the New York Stock Exchange. Yet it's hard to find him in their securities filings or even at his office, located in a room inside the headquarters of his son's beef company. That could be because Du was banned from stock-market activity, after drawing a four-year jail term for a 1999 fraud conviction.

Like their American counterparts, China's biggest businesses raise capital through underwritten initial public offerings. But in the past few years, hundreds of mid-market entities have gotten U.S. listings through a back-door maneuver known as a "reverse takeover"—in which an active Chinese business merges into a dormant American shell corporation that was registered for public trading. So Chinese medical-device vendor Winner Group merged into the shell of Las Vegas Resorts; tire maker Zhongsen International merged into Rub A Dub Soap. The stocks rarely surpass $1 billion in market capitalization, but their collective presence is substantial. More than 350 of these deals have been done in recent years, reaching, at their peaks, a combined capitalization of more than $50 billion.

The lure for American investors is the wondrous growth of China's economy and the ascent of such benchmarks as the Halter USX CHINA Index, which rose more than 60% last year. But most reverse-merger stocks have proven to be a poor way to ride China's boom. Today, the market cap of these stocks has shrunk to $20 billion, a 60% drop.

A Barron's study of the most seasoned 158 China reverse mergers shows that in the first three years of each stock's trading, the median among them underperformed the Halter Index by a dismal 75% (see the chart, Relatively Lousy). The Halter index is composed of U.S.-listed Chinese companies, ranging from the American depositary shares of well-known names like Internet giant Baidu.com (ticker: BIDU) and telecom power China Mobile (CHL) to small-cap reverse mergers. The median of those China reverse mergers lagged behind the Russell 2000 index of small-cap stocks by 66%. The billions in reverse-merger losses were shouldered by Chinese entrepreneurs, who thought they were raising capital the American way—and by American investors, who thought they were buying a piece of China's prosperity.

Reasons for the stocks' disappointing performance aren't hard to find. The group has been a minefield of revenue disappointments and earnings restatements. Financial filings the companies make with the Securities and Exchange Commission often diverge from those filed with the Chinese government—by drastic amounts. Investor and analyst visits to corporate facilities in China reveal operations smaller and less impressive than shown in U.S. presentations. The companies too often select auditors who have previously signed off on the financials of companies that turned out to be busts. Some companies' securities filings don't disclose the involvement of promoters in China or the U.S., who—like Du Qingsong—have disquieting track records in the stock market.

These companies fall between the cracks of market regulation. The SEC's enforcement staff can't subpoena evidence of any fraudulent activities in China, and Chinese regulators have little incentive to monitor shares sold only in the U.S. Many reverse-merged companies admit in prospectuses that they haven't gotten required approvals under China's financial regulations. Yet the convoluted structures devised by lawyers in China and the U.S. have kept the companies out of trouble, says Mitchell Nussbaum, a lawyer with Loeb & Loeb who's arranged dozens of reverse mergers. But satisfying each country's legal requirements doesn't make the companies' shares good investments.

The Public Company Accounting Oversight Board, established under the Sarbanes-Oxley Act to police auditors, recently warned against lax auditing of U.S.-listed Chinese businesses. The PCAOB plans to ask Congress to lift restrictions on the disclosure of its disciplinary proceedings against accountants. China is one of several nations that won't let the PCAOB inspect the local auditors used by U.S.-listed companies.

AS WITH THE MANUFACTURED GOODS that China exports to the U.S., there's an established supply chain for Chinese reverse mergers. At the Chinese end, promoters like Du Qingsong scout out businesses that are viable candidates for reverse mergers. Some of the companies are reorganized around their most profitable parts. These are then merged in share exchanges with American shells that are frequently provided by U.S. firms that deal in penny stocks. The Big Board or Nasdaq collect listing fees. Capital is injected by hedge funds, who in return get cheap shares in a private placement. The hedge funds often also get substantial say over the new U.S. company's hiring of key financial personnel. Among the active and well-known investment banks in these deals are Roth Capital, Rodman & Renshaw and William Blair. Bankers fete the companies at investor conferences; one even featured former President George W. Bush as keynote speaker. This week, as it happens, Roth Capital is hosting its annual gathering of reverse-takeover companies at Hawaii's Grand Wailea Resort.

Only a handful of reverse takeovers have made it from China to a listing on the most prominent U.S. exchange, the NYSE. One of them is China Green Agriculture (CGA), which produces fertilizer and operates greenhouses. In late 2007, the predecessor to China Green reverse-merged with Discovery Technologies, the dormant shell of a Mexican-restaurant operator whose stock had fallen to less than a penny a share. The deal was already complex. Before merging into Discovery, China Green's predecessor first merged into a New Jersey corporation controlled by Yinshing David To. To was a Chinese citizen who also goes by the names ShingHoi To and Du Chenghai. His father is Du Qingsong.

After surviving China's Cultural Revolution, Du Qingsong rose in the 1980s to become general manager of Sha'anxi province's largest fertilizer factory. Provincial officials then sent him to run a floundering maker of TV-tube components in Xi'an City. Du revitalized the state-owned enterprise and, by 1997, one of its units was listed on China's Shenzhen Stock Exchange. In September of that year, Du took two other subsidiaries of the state business onto Nasdaq, raising $42 million in one of the exchange's first China listings. But the Nasdaq stock, Asia Electronics Holding Co., went into a tailspin when Du disappeared in the summer of 1998.

He'd been arrested. Newspaper reports speculated that Du was the victim of a power struggle between his political patrons in Xi'an and their rivals. In 1999, a local court found Du guilty of "fraudulent investment schemes" and sent him to prison. China's securities regulators also barred Du from China's stock markets and any management role in a listed company. Nasdaq delisted Asia Electronics after its shares fell to pennies. At a subsequent corruption trial of the Xi'an branch chief of China's securities regulator, evidence showed that Du had given the branch chief 5,000 shares of his company before its Shenzhen Exchange listing. The regulator got a 12-year sentence after a bribery conviction.

Du, now 64, agreed to speak with Barron's when we called him. (Xia Ming, a China expert and political scientist at City University of New York, translated.) But, asked about run-ins with the Chinese government, Du cancelled the interview. He communicated with us, instead, by e-mail. His jail sentence, he wrote, was the result of politics. "After their investigation, they found nothing," said Du. "The court made the decision simply for the sake of a conviction." As for the alleged bribery of a securities regulator, Du said in the e-mail that government officials sometimes took shares meant for employees. "I merely acquiesced without objection," he said. "I only met him once. I never had any relationship with him."

Once the fertilizer company China Green became a U.S. stock in December of 2007, its SEC filings show that Du's son, whose New Jersey company had merged with it, controlled 38% of its shares. He later turned most of the stake over to China Green's chief executive, Li Tao, under the terms of an agreement worked out with the company's hedge-fund investors. Du's son retained 3%. "We always take cash for our consulting service," Du Qingsong wrote to Barron's , explaining the arrangement . "Of course, if the consulting service is for a listing, we also take some percentage of shares."

China Green says Du was not involved in founding or organizing the company, "directly or indirectly," nor did he receive any stock.

Du hands out an expensive-looking marketing brochure for his consulting firm AiDi Investment, with pictures of him alongside "directors" who its says include a partner of the well-known law firm Proskauer. The law firm says its partners have no relationship with Du. Many of the photos also feature an American stockbroker, Meiyi Mary Xia, who started a brokerage firm called Asia Pacific Securities with Du just before he was arrested in 1998. Her home is the address used for AiDi's American office and for the China Green shareholdings of Du's son. When the diesel-fuel producer China Integrated Energy (CBEH) did a reverse merger in October 2007, about 90% of its stock was held for a time by Xia. Her husband, Lawrence Xiao Xia Pan, was Nasdaq's chief China representative from 2005 to 2007. When asked about Du, Xia said, "I don't work with him any more," and hung up.

In scouting for reverse-takeover candidates, Du Qingsong has plenty of competitors.

One is Kit Tsui, who has helped deliver some of China's most volatile reverse takeover stocks, like the chemical supplier Gulf Resources (GFRE) and the cardboard maker Orient Paper (ONP). The two stocks rocketed from pennies a share to about 15 bucks around year end, ballooning the value of shares held by Tsui through entities like Max Time Enterprises. But trouble seems to haunt Tsui's deals. The company that first brought him to Nasdaq—a telephone manufacturer he'd started in the 1990s by the name of Industries International—had its main business forced into bankruptcy by Chinese authorities in 2004, and its auditor alleged that the company misreported related-party deals with Tsui. Tsui subsequently stepped down.

In June, the Amex-listed shares of Orient Paper plunged to 5 when a pair of investment researchers published a report declaring the company a fraud. The Hong Kong-based analysts, whose firm is Muddy Waters Research, said in their report that they visited Orient Paper's factory in January and found it idle and dilapidated. They calculated that the company's SEC filings overstated the value of its assets some ten-fold. Revenues were overstated 40-fold, the researchers estimated. They've shorted the company's stock. Muddy Waters said last week it stands by its conclusions.

Company spokesman Crocker Coulson said Orient Paper would have no comment, pending a board-commissioned internal investigation of the Muddy Waters allegations by the company's lawyer, Loeb & Loeb's Mitchell Nussbaum, who also declined comment. A money manager who spoke with company officials says they blame Tsui for the alleged irregularities. Barron's left messages at Tsui's offices in Beijing, Shenzhen and Shanghai. We heard nothing back. We also visited the address of Tsui's firms, China Finance and China U.S. Strategy, in New York, near Rockefeller Center, but building attendants said the floor was vacant.

One of the most controversial promoters of Chinese reverse takeovers, Benjamin Wey, continues to find work. Wey'shistory of suspension and censure by Nasdaq and state securities regulators has been amply reported, including a Barron's story ("AgFeed Trips on Its Way to the Trough," May 19, 2008). Since our piece describing Wey's work for the hog farmer AgFeed Industries (FEED), the company has missed production targets and its shares have slumped from 15 to below 2.50. The company could not respond to queries by presstime. In an interview last year with the English-language newspaper China Daily, officials of his New York Global Group investment bank claimed that 15% of the Chinese companies on Nasdaq were its clients. The firm has offices in Beijing and at 40 Wall Street in New

York. On its Website (www.nyggroup.com), Wey's firm brags of alliances with four city governments and China's central bank. With hedge-fund operator Michael D. Witter—grandson of the brokerage founder Dean Witter—Wey last year announced plans to raise $300 million to invest in China companies. Neither Wey nor Witter responded to Barron's queries.

Kitchen-appliance maker Deer Consumer Products (DEER) doesn't mention Wey in its securities filings. But the Chinese language version of Wey's Website shows him flying with Deer's management in a private jet on the night before the pricing of a $75 million secondary offering underwritten by William Blair and BMO Capital Markets. Wey's latest success story is CleanTech Innovations (EVCP), a maker of windmill towers whose shares tripled to $9.50 shortly after a July private placement led by William Blair. At that price, the stock trades for 220 times last year's earnings.

THE REVERSE TAKEOVER of a China company usually coincides with a private placement of its shares with hedge funds. For instance, in the reverse merger of China Green in December 2007, hedge funds and other investors bought $20.5 million of the new company's stock. Among the frequent participants in such deals are Pinnacle Adviser's Barry Kitt, Barron Capital's Andrew B. Worden and Guerilla Capital's Peter Siris, who's talked about his Chinese stock holdings with this magazine.

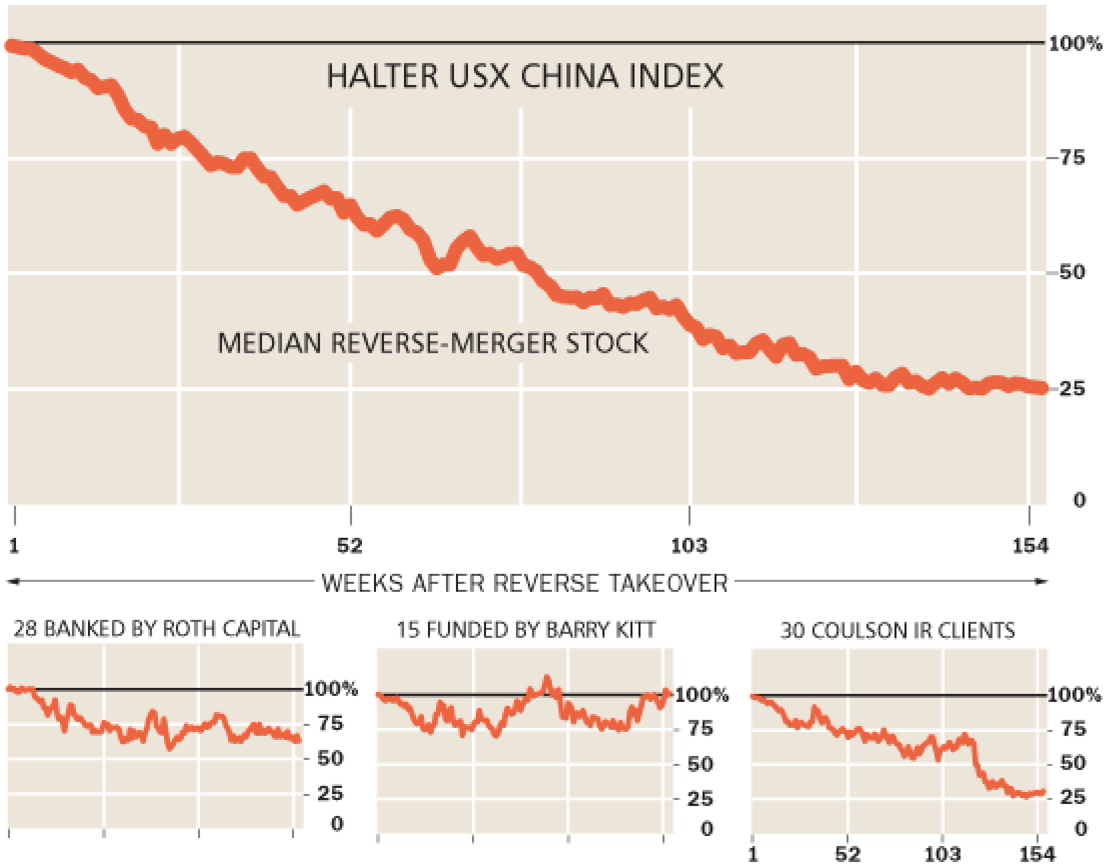
Plano, Texas-based Kitt has invested in dozens of China reverse mergers—often taking the lead position in the private placement. When executives of China Green, the fertilizer company that had initially merged with the company controlled by Du Qingsong's son, rang the opening bell at their NYSE listing in April, Kitt was beside them on the balcony. In the reception that followed, Kitt thanked China Green for letting him invest. Kitt refused an interview and after he received e-mailed questions, our messages were blocked from his e-mail system.

As with most private placements of public equities—otherwise known as PIPEs—the investing public should think twice before following PIPE investors.

To test whether particular funds' participation augered well for investors, Barron's studied the performance of hedge funds' Chinese PIPE deals the same way we did all the Chinese reverse mergers. We analyzed data from Morningstar and Bloomberg using the statistics routines of the open-source project Rmetrics (www.rmetrics.org), which many Wall Street firms utilize. One of Rmetrics' developers, Yohan Chalabi, a Ph.D. student at the Swiss Federal Institute of Technology, helped write our computer scripts. We compared each stock's return, from the date of its reverse-merger announcement, against a benchmark's return for the corresponding period. Because the stocks all had different merger dates, this approach (known as an "event study") helps control for varying market environments. Then we looked at the median return for the group under examination (see charts, Relatively Lousy). Of the reverse mergers where Pinnacle was a PIPE investor, there were 23 stocks with at least one year of returns. Over that stretch, the post-merger return of those stocks slightly lagged behind that of the Halter Index, as it did for the 15 stocks in Kitt's PIPE portfolio that had three-year returns.

Relatively Lousy

From 2003, Barron's compared the cumulative return of 349 Chinese reverse-merger stocks against the Halter USX China Index starting from the merger announcement. The red line, below, is the Halter-relative return of the median of the 158 reverse mergers with three years of data. At the bottom, Halter-relative returns of reverse mergers banked by Roth Capital, or funded by Barry Kitt, or advised by Crocker Coulson.



Sources: Bloomberg; Morningstar; the R/Rmetrics Projects

Investors would be well advised to steer clear of stocks like those in the PIPE deals involving Andrew B. Worden's Barron Capital. Of those China stocks, 11 had at least a year's worth of returns and their median lagged behind the Halter Index by 30%. For the seven stocks with three years of returns, the median fell short of the Halter Index by over 75%. The Barron Website features testimonials by the chief executives of Orient Paper and SkyPeople Fruit Juice (SPU) thanking Worden for his support. The Website invites companies to let him introduce them to lawyers and accountants who can help them go public. It boasts of his 20 years analyzing and investing in public and private companies, yet neglects to mention that during that span he pled guilty in a 1995 prosecution for wire fraud and settled an SEC civil suit that alleged he'd opened dozens of accounts and then stiffed brokers on losing trades. Worden didn't return calls or e-mails.

Buried in the exhibits of many reverse-takeover filings are agreements that often give hedge funds like Worden's and Kitt's extraordinary sway over the fledgling companies. In exchange for their PIPE financings, the funds get approval power over a company's choice of auditor, investor-relations firm and chief financial officer. One of the most frequently stipulated IR firms is CCG Investor Relations, which boasted last year that its "core group" of 15 clients had gained an average of 412% after listing on the Nasdaq or the Amex. CCG founder Crocker Coulson told Barron's that China offers "the most exciting economy and companies in the world." He has set up two blind-pool companies to invest in Chinese businesses.

But a longer term analysis of Coulson's client list shows performance that doesn't come close to his selective sample. As shown in the nearby chart, the median return among the 30 CCG reverse-merger clients with at least three years of trading history underperformed the Halter index by a whopping 70%, since their mergers. Coulson commented that these companies had only benefitted from CCG's services for a portion of their history as U.S. listings.

Hedge funds would seem to want to ensure that their portfolio companies hire only the sharpest auditors. Yet one after another of the reverse-merger companies hire the same small firms that certified the financials of companies that came to grief.

Dozens have hired Frazer Frost, the successor firm to Moore Stephens Wurth Frazer & Torbet. Moore Stephens, a Los Angeles auditor, gave clean audit opinions in 2004-05 to China Energy Savings Technology. Doubts about the balance sheet caused the SEC to suspend trading in 2006 and eventually file a fraud suit against the company, which is now defunct. The PCAOB found no deficiencies when it made its regular inspection of Frazer Frost and the firm's Asian-services partner, Susan Woo, notes that she and her colleagues go to China themselves to examine and audit clients. "We are the guard to the public and we have a responsibility," she says.

Accounting problems have recently surfaced at a couple of Frazer Frost's China clients. Even the investment banker of China Natural Gas (CHNG) consigned the stock to a Sell rating a couple weeks ago after the company admitted that its March balance sheet had failed to reflect a large bank loan from February. RINO International (RINO), a Frazer Frost client that makes equipment for sewers, has had three auditors and four CFOs in the past four years, while restating its financials twice. "Every company has some deficiencies in internal controls," says Woo. "These are newly public companies."

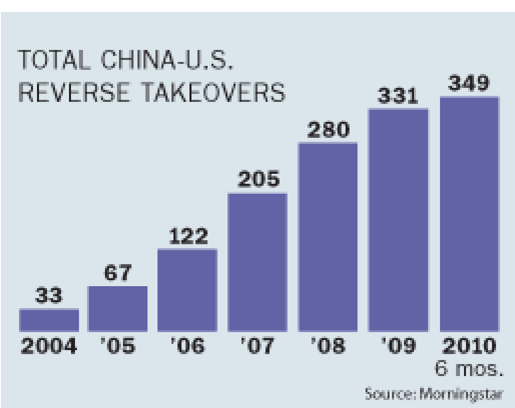
Another popular auditing pick is Kabani & Co., a small Los Angeles firm that the PCAOB found deficient in a routine inspection in 2008. Kabani audited Bodisen Biotech, one of the earliest China blowups. Bodisen's shares ran up to 19 with the help of commercials on CNBC, then tanked to 47 cents when the Amex suspended the stock in 2007 over the company's misleading disclosure of its relationship with Benjamin Wey's New York Global Group. Kabani has audited a number of Wey's other promotions and now audits China Green. Partner Hamid Kabani did not respond to requests for an interview.

As the "auditor of auditors," the PCAOB has sounded an alarm over the auditing of overseas businesses. A July 12 practice alert noted with concern that 40 accounting firms with five or fewer partners had rendered opinions on companies with China-based operations. "We take these practice alerts very seriously," says Greg Scates, the agency's deputy chief auditor.

AT THE END OF THE reverse-merger supply chain are the U.S. bankers, which include Roth Capital, Rodman & Renshaw and William Blair, among others.

Journey to the West

In all about 350 China companies have merged their way to the U.S. markets since 2003.



The pre-eminent banker for China reverse mergers is Roth, the Newport Beach, Calif., firm whose promotional materials say that it pioneered the practice of PIPE financing and has helped raise more than $2.8 billion for 67 U.S.-listed Chinese companies. Roth works closely with hedge funds like Kitt's Pinnacle. Indeed, Kitt's son is an investment banker in Roth's Shanghai office.

The broker's analysts were caught flat-footed by the problems of banking clients like Orient Paper and China Natural Gas, cutting ratings and price targets after the shares had already slumped.

Questions have also begun to be raised by investors about banking client China Green. In SEC filings the company reported revenues of $23 million for 2008, but in its tax filings in Xi'an it reported less than $8 million. "CGA's financial statements are accurate," said chief executive Li Tao, in an e-mail. "Legitimate reasons exist for why [China's State Administration for Industry and Commerce's] reported financial statements do not match those numbers filed with the SEC."

Roth Chairman and CEO Byron Roth declined an interview, but in an e-mail said: "We take the due diligence process very seriously and perform extensive due diligence." Asked about the promoters Du Qingsong, Kit Tsui and Benjamin Wey, Roth wrote: "None has had any role in connection with any offering we have completed."

When asked how Roth's banking clients had performed as investments, the brokerage chief said the 70 China stocks that his analysts follow were up 120% in 2009 and down about 15% through early August. That didn't quite answer the question, so we ran the numbers ourselves.

Of the 28 Roth client companies with at least three years of trading post-merger, the median among them underperformed the Halter Index by one third over a three-year period. By comparison, the Roth client companies roughly matched the returns of the Russell 2000. Roth isn't alone as a banker for China reverse-mergers, of course. Running a similar three-year analysis of Rodman & Renshaw's banking clients, we found the 12 companies with three years' of post-merger returns performed some 70% worse than the Halter Index. Rodman's Chief Executive Edward Rubin says his bank focused on China in a big way in 2009, after most of these stocks had been reverse-merged and—he claims—abandoned by their original bankers.

The reverse-merger industry gathers in Hawaii this week at a Roth conference—a venue equally favored by China stock touts and by the sector's short sellers. The rest of us should probably stay home.

Research for this story was provided by Sam Fellman, Jolene Paternoster and Wyatt Smith.

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