

Finding Value Among Chinese Reverse Mergers

Summary

- Capitulation selling in Chinese Reverse Mergers
- This opens a window of opportunity for bargain hunting, as many CRMs are now selling cheaply
- *Strategy:* Buy a basket of these CRMs; add on strength

Chinese Reverse Merger Stocks Walloped

"People are always asking me where the outlook is good, but that's the wrong question. The right question is: Where is the outlook most miserable?"

- John Templeton

Few sectors are as negative as North American-listed Chinese stocks right now - particularly, the US-listed **Chinese reverse mergers (CRM)**.

A reverse merger is a non-traditional way of attaining the listed status. The strategy is simple: A private operating company is merged with a shell public company so that the private firm becomes a public entity without an IPO. This method is favoured by many Chinese firms because the process is less rigorous, cheaper, and quicker. The last few years saw a number of such Chinese reverse mergers (CRMs) in the States, partly due to the strong investor demand.

But following the revelations of a number of fraudulent CRMs, the entire CRM sector collapsed. The **Bloomberg Chinese Reverse Mergers Index**, for example, plunged 60% since December last year (Figure 1). John Paulson, for example, lost **half a billion dollars** in **Sino Forest**, the Chinese timber firm (Figure 2). Understandably, many investors are now adopting the "sell first, ask later" strategy. In a nutshell, the following reasons prompted investors to flee the sector:

1. **Fraud** - China Media Express and Sino Forest are two well-known Chinese firms that saw their dodgy operations and questionable profits come to light. And they, as investors discovered, are not alone. A number of Chinese securities in America have been suspended in 2011 over the resignation of auditors and key management. This casts doubt on the entire CRM sector.
2. **Intensified Selling** - There is a concerted shorting effort to drive the sector lower. Research firms are issuing well-timed reports that questioned the integrity of Chinese financial data. The **rise in short interests** of Chinese stocks clearly points to significant bearish bets.
3. **Fears of Chinese Hard Landing** - Talks of a Chinese hard landing abound (Figure 3). As the Chinese credit growth slows, many investors anticipate the Chinese economic miracle to vanish. This increased selling of the CRM sector.

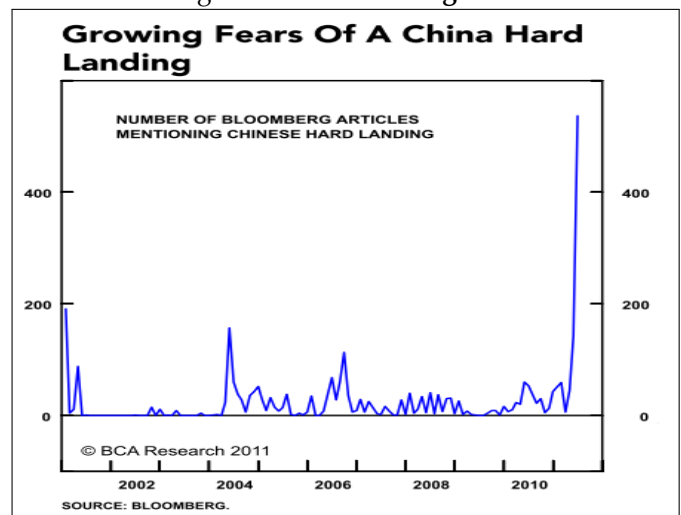
Figure 1: CRM Sector Down 60% In 6 Months



Figure 2: Sino Forest (TRE CN) Collapsed!



Figure 3: Hard Landing Fears!



Finding Potential Value In The Sector

While I am sure there are many rotten apples within the Chinese reverse merger sector, it is my hypothesis that not all RMs are bad. Some will be successful - eventually. The current indiscriminate selling paints the picture that all Chinese RMs are poison for investors - and they should be avoided under *any* circumstances. I disagree, remembering this old Wall Street adage: *"There are no bad bonds, only bad prices."*

To find out if any of these beaten down securities offer good value, I examine a number of Chinese RMs on the US exchanges.

First, I define the universe according to this **Bloomberg Chinese Reverse Mergers List**. There are 83 stocks in this list. I then crossed out stocks that were suspended at the time of research.

Second, I scanned this list of stocks - through Bloomberg - for their fundamental results. In particular, I pay attention to the following items:

1. Cash levels
2. Total Liabilities
3. Market Capitalisation
4. Revenue Trends
5. P/E ratios
6. Free Cash Flow

In particular, I focussed on CRMs that have (1) Good cash balances; (2) Low debt levels; and (3) Reasonable profitability.

Candidates

In total, I picked 10 interesting CRM stocks that suggest value. Their average price declines this year is a dismal 52%, and the average Price-Earnings ratio is an unexpensive 3.5 (see Table below and Tables next page).

Table 1: A Snapshot Of Cheap Chinese Reverse Mergers (CRMs)

Stocks	YTD (%)	M.Cap (\$m)	PE Ratio
China Sky One Medical (CSKI US)	-68.72	36.93	1.25
China North East Petroleum (NEP US)	-43.58	115.23	3.10
SmartHeat Inc (HEAT US)	-75.95	49.02	2.40
China Nutrifruit (CNGL US)	-33.69	68.29	3.14
Tianyin Pharmaceutical (TPU US)	-47.06	42.33	2.77
China Marine Food Group (CMFO US)	-49.44	81.02	3.55
SkyPeople Fruit Juice (SPU US)	-42.37	68.86	2.55
ChinaNet Online Holdings (CNET US)	-67.77	25.64	1.97
Cogo Group (COGO US)	-39.66	192.10	13.02
China Botanic Pharmaceutical (CBP US)	-52.79	34.63	1.39
Average	-52.10	71.41	3.51

All these CRMs appear to have ample cash balances. For example, **China Sky One Medical**, whose Market Cap is a tiny \$37 million, but has Cash of \$43 million while its Total Liabilities is only \$8.2 million. In other words, it is selling for less than its cash in the bank!

Another CRM, **SmartHeat**, has a Market Cap of \$49 million, but has Cash of \$56.8 million and Total Liabilities of \$21.9 million. Its Current Assets of \$152 million is three times its market cap. On paper, the firm looks perfectly solvent.

China Nutrifruit is equally interesting. It has a Market Cap of \$68 million, Cash of \$43.5 million and Total Liabilities of \$7.7 million. Its revenue trend is bullish.

However, one may argue that the above statistics are crude and cannot determine whether a firm will survive. True. While these stats are inconclusive, they can serve as a good starting point for further investigation.

Another worrying issue is that these fundamental information may be incorrect, as a number of CRMs are known to cook their books and engage in deceptive practices. Again, I would stress conducting more research on these firms - like browsing their 8-K filings, annual reports, and management reports etc - to determine the veracity of these numbers. Investing is all about taking calculated risk; doing more research on these stocks may improve the odds of successful results.

Conclusion And Tactics

Panic selling of Chinese Reverse Merger stocks is reaching climactic. Investor sentiment on the sector is as bearish as the bank stocks in December 2008. Trust in this sector had completely evaporated.

Driven to exceedingly low levels, I suspect a lot of the bad news are already priced in. Any good news in the sector may cause a positive re-rating of the sector. The risk-reward favours a buy.

Given the immense uncertainties surrounding the sector, I would buy a basket of Chinese RMs. This way, it reduces the portfolio risk. For entry points, I would buy into stocks that have defined technical support levels. The reason for this is to avoid stocks that are still downtrending. Another bullish technical signal is an upward dynamic that suggests selling exhaustion.

All in all, I hope this brief note may spur readers to investigate the sector further. I know initiating a contrarian bet is not easy, hence it is only fitting that I end this note in the encouraging words of the legendary contrarian John Templeton:

"To buy when others are despondently selling and to sell when others are avidly buying requires the greatest of fortitude and pays the greatest ultimate reward."

Table 2: Some Fundamental Statistics Of Chinese Reverse Mergers (CRMs)

Stock	M.Cap (\$m)	Cash (\$m)	Total Liabilities(\$m)	Current Assets(\$m)	PE Ratio	FCF/Share
China Sky One Medical (CSKI US)	36.93	43.12	8.21	65.63	1.25	0.53
China North East Petroleum (NEP US)	115.23	60.97	27.97	85.55	3.10	0.44
SmartHeat Inc (HEAT US)	49.02	56.81	21.93	151.61	2.40	-0.42
China Nutrifruit (CNGL US)	68.29	43.54	7.74	62.70	3.14	0.78
Tianyin Pharmaceutical (TPU US)	42.33	27.01	7.48	39.54	2.77	-0.50
China Marine Food Group (CMFO US)	81.02	15.56	9.42	74.19	3.55	0.68
SkyPeople Fruit Juice (SPU US)	68.86	49.35	24.01	102.63	2.55	0.52
ChinaNet Online Holdings (CNET US)	25.64	15.59	6.29	32.77	1.97	0.22
Cogo Group (COGO US)	192.10	106.01	93.13	310.15	13.02	0.26
China Botanic Pharmaceutical (CBP US)	34.63	27.83	3.39	50.52	1.39	0.40
Average					3.51	

Table 3: Year-to-Date Performances And Short Interest

	YTD (%)	Float (m)	Short Interest(m)	Percent Shorted	Employees	Auditor
China Sky One Medical (CSKI US)	-68.72	10.29	1.81	17.6	2279	MSCM LLP
China North East Petroleum (NEP US)	-43.58	20.87	1.74	8.3	715	Baker Tilly
SmartHeat Inc (HEAT US)	-75.95	24.98	1.63	6.5	776	Goldman Parks Kurland Mohidin
China Nutrifruit (CNGL US)	-33.69	5.36	0.095	1.8	516	HLB Hodgson Impey Cheng
Tianyin Pharmaceutical (TPU US)	-47.06	19.62	0.02	0.1	1365	Patrizio Zhao
China Marine Food Group (CMFO US)	-49.44	17.48	1.26	7.2	972	BDO China
SkyPeople Fruit Juice (SPU US)	-42.37	24.22	1.28	5.3	358	BDO
ChinaNet Online Holdings (CNET US)	-67.77	7.37	0.02	0.3	295	Bernstein Pinchuk
Cogo Group (COGO US)	-39.66	23.24	0.69	3.0	560	KPMG
China Botanic Pharmaceutical (CBP US)	-52.79	8.98	0.05	0.5	66	MSCM LLP
Average	-52.10					

Figure 4: China Sky One Medical



Figure 5: China North East Petroleum



Figure 6: SmartHeat Inc



Figure 10: SkyPeople Fruit Juice



Figure 7: China Nutrifruit



Figure 11: ChinaNet Online Holdings



Figure 8: Tianyin Pharmaceutical



Figure 12: Cogo Group



Figure 9: China Marine Food Group



Figure 13: China Botanic Pharmaceutical



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