JCAP

China Primary Insight

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Commentary

Selling a Dream

Fabulous Frauds

- The market still values Chinese "concept" IPOs. Ambitious frauds tend to use the same strategies: scientific-sounding language, uncheckable metrics, and references to a vast but completely unmeasured and unmeasurable market.
- Even large businesses—like Alibaba—can be guilty of selling a dream and being sloppy on specifics. Beware the mystery of the East.
- As the queue for A share IPOs gets longer, Chinese companies will be looking to the U.S. market for 2017 floats. But the Chinese economy is only worsening, and growth stories should be placed under careful scrutiny.
- As is common everywhere in the world, investors look for user base numbers and revenue growth as key metrics and appear to be tolerant of bottom-line losses. Chinese players on global capital markets really appreciate this.

Anne Stevenson Yang

Foreign investor infatuation with Chinese investment schemes has clearly receded, and Chinese companies have to work harder to raise capital. One can almost get nostalgic for the truly imaginative company ideas that got to market in the headier days of 2009-12. Some Chinese IPOs from that era of endless stimulus and bigger-than-life numbers presented soaring fantasy business ideas that make frauds like Tyco look just, well, plain. But today, we have to admire the adaptations some Chinese listcos and prospective IPOs have made to the tougher capital market environment.

The older, less skeptical environment hosted such companies as THT Heat Transfers Technology, which manufactures "plate heat exchangers and various related products;" Tianyin Pharmaceutical, which makes "stimulated egg powder" for veterinary applications, Shiner International, which makes "biaxially oriented polypropylene (BOPP) tobacco film," and three different companies making organic fertilizer. Companies in Chinese Traditional Medicine have been especially popular, since even their applications generally refer to incomprehensible benefits like "improving qi." There is "Dog, Where," a pet travel service, and Sweet Pea Square Dance online instruction. There are sites providing search for tutors, homework assistance, and DIY baby food recipes.

Many currently traded companies adored by investors still share characteristics of these ambitious concept companies of the past. To command truly high valuations, companies need at least a few of: an unfamiliar product or service that can be described only in scientific-sounding language, an addressable market that investors are assured they are culturally incapable of understanding but are told is vast, and specific-sounding metrics that have no comparables outside China or even in China's own past. When it's

a technology company, it's important to use the word "disruptive."

Another part of the presentation is a rapid series of investment rounds with rapidly escalating "market" valuations. It is not uncommon to have four or five rounds of private-venture investment in an 18-24 month period, driving the calculated value of some companies that are barely operating to hundreds of millions of dollars. Sometimes the investors are visibly original angels, taking now very small shares at far higher costs. Sometimes they are other "local" companies with obscure ownership that cannot be confirmed as unrelated to the earlier investors. These rounds are always publicized as widely as possible.

Rocket Science

One of the businesses I really hope exists is Kuangchi Science, listed in Hong Kong as 0439 and valued at more than 100 times earnings. Worth HKD 18 bln, the company in 2015 had HKD 76 mln in revenue. It makes materials for cloaking devices on space ships and says it builds flying apparatuses for space tourism. The company's Australia subsidiary, Martin Jetpack, makes large backpacks equipped with downward-facing rockets that you strap to your back to make you fly. Here is a Youtube video. It's just like being in a GI Joe comic book ca 1980. The original company was "Solar Ship," which reverse-merged into a paper company.

Kuangchi describes its business this way:

> "The Group focuses on the research and development of a variety of disruptive space technologies flying at different altitudes, as well as the provision of comprehensive in-depth space services. The Group's products are combined with metamaterial technologies and are widely used for wide-area internet-of-things networking, optical remote sensing and telemetry, internet access, smart big data collection, innovative smart cities, private network and backbone communications, smart observations, emergency rescue, transportation and space tourism, etc."

Front page of the annual report of Kuangchi Science

Mysterious scientific language more easily attracts money. China Agritech, formerly listed on NASDAQ as CAGC, reported that it had developed "fertilizer nanotechnology." China Medical Technologies Inc. in its prospectus describes "ECLIA" technologies without explaining the acronym. "Our ECLIA system, which consists of reagent kits and an ECLIA analyzer, is an IVD system based on enhanced chemiluminescence immunoassay technology." Pseudo-technical language is a tell. If you can't understand it, maybe it doesn't mean anything

Mysterious scientific language more easily attracts money.

Especially useful in the latest IPOs are terms like "big data" and the general use of the word "platform" instead of "product." For example, Kandi, which makes electric cars, prefers to say it is developing a platform for selling cars rather than to report actually selling cars. Like many automobile manufacturers, Kandi is claiming a transformation into a mobility service provider. Management shows considerable resourcefulness in making this prospect exciting:

> ". . . [W] e believe there is an opportunity for

a new business model. Kandi has been advocating, and through the Service Company, as defined below, implemented the "Micro Public Transportation" ("MPT") program, which provides a shared pure EV transportation platform to urban residents."

The Inscrutable Third Tier

One of the most durable strategies for obtaining an excessively high valuation is to claim superior cultural access to a market that the group of investors cannot understand, because they are too distant geographically, culturally, and educationally from the target. Mazu Alliance (MZU ASX), unfortunately no longer traded as the company did not pay its listing fees, is dedicated to the worship of a goddess called Mazu who, they say, has a cult in Fujian Province in China. Mazu, a goddess for the seafaring, gained some prominence during the first Taiwan straits crisis in 1954-55, when the Mainland and Taiwan struggled over coastal islands, one of which was Matsu, named after her. An aura of special power still is found there. But like St. Christopher, she has been demoted in modern Chinese life.

When listed, the company was building "Mazu city," a complex of seven temples, and managed the "Wushi Palace of Queen of Heaven temple." Today, few Chinese people from outside the Xiamen region have heard of the goddess Mazu, though there are undoubtedly at least a few hundred elderly farmers in Fujian Province who worship her. Mazu exemplifies the attraction of mystery, of the management team that with confidence can present an otherwise inaccessible market to reverent outsiders. "Mazu is a goddess of the sea with over 200 million followers today from both the Buddhist and Taoist religions," the prospectus explained. . . . Religious tourism is driven by people's devotion to their favoured saint or deity. Pilgrimage is a phenomenon common to many of the world's religious beliefs, and is well entrenched amongst worshippers of Mazu. Religious tourism is comprised of both devotees of the faith, as well as general tourists that travel for vacation and

From the Mazu Alliance prospectus

recreational reasons."

Mazu was one of the many Chinese companies that persuaded its investors that it had captured a large, native-Chinese market residing somewhere in the interior of the continent that foreign investors living overseas had little ability to understand without the guidance of the Mazu management team.

In addition to offering sales to customers who were completely unknown to the investment world, Mazu provided serious-sounding but unverifiable data. The Goddess Mazu enjoyed "continuous belief for over 1,000 years" and a "well-established global community of Mazu worshippers of over 200 million believers. Some sources support the estimate of more than 380 million believers today." There are 13,000 Buddhist temples in China, the prospectus says with dubious relevance, 1,500 Taoist temples, 30,000 Islamic mosques, and 16,000 Christian churches.

The Game Game

Like Mazu, Giant Interactive, the gaming company, told investors that they could not possibly understand the free-spending ways of customers in "low-tier cities." Some of the high-value players of the

MMORPGs residing in these rustic areas, they reported, spent as much as USD 1 mln over several years of play just to buy virtual goods in the game. "You don't understand," IR would say. "Players in third-tier cities are just crazy." Giant is a gaming company in more ways than one.

For the builders of temples, promoters of pilgrimages, and gaming companies raking in mountains of profit from third-tier city gamers, the blizzard of unaudited statistics with unclear relevance to the business can be blinding. It may remind a few readers of Alibaba and its Gross Merchandise Value (GMV), a vaguely bounded measure of online sales and other transactions originally intended to impress. That number, now bloated to astronomical levels as a product of huge annual growth rates, has destroyed its own credibility and become an embarrassment, calling into question all related growth numbers. Alibaba is gamely shading it and has determined that it will report GMV only twice a year, in the 20-F and at "Singles Day" on November 11. The SEC has pointed out that GMV does not correlate with BABA revenue or profit, leaving investors to wonder what it does correlate with, if anything. Like the billion customers that used to be invoked by any Western company justifying an investment in China, GMV was there as a symbol, to impress with sheer, incomprehensible size and growth rates.

Niches

Another useful strategy of ambitious companies seeking investor credibility is to uncover or invent a previously unknown niche market. One successful practitioner of this art, now delisted, was Yuhe International. Yuhe raised chickens for a single day starting from when the eggs hatched. Yuhe would then sell "day-old broilers" to chicken farms. Before it delisted, Yuhe reported that it had capacity to raise more than 3 million chicks.

There are also products so obscure that there can be no comparable company to provide a reality check on margins or size of market. China Cord Blood was among the first companies to offer umbilical cord blood storage. China Biotics sold "live microbial food supplements." HQ Sustainable Maritime makes beauty products made from tilapia.

Tilapia-based beauty may seem implausible but only because of its narrow scope. Before Longtop Financial, no one had heard of "core banking platforms," but Longtop persuaded investors that this was a very real and very valuable technology. There continues to be a parade of financial service companies that offer everything from vague credit card management services to "lover's insurance," totally new niche markets on their way to being certain buys for at least a billion new consumers.

In the Eyes of the Beholder

Prior to reforms in China, factory wages in the major cities ranged from 30 yuan to 115 yuan a month, wage scales were utterly flat, and individuals were criticized for owning anything that everyone else did not own. There is no private wealth in China older than 35 years, yet now some massive fortunes have been accumulated. Until the global financial crisis, wealth creation rode the wave of China's huge productivity gains in manufacturing and miraculous export success. Property developers built useful commercial and residential facilities to keep up with the increasing financial might of a growing China.

Since the global financial crisis and the launch of broad stimulus programs, wealth creation has turned entirely on financial products, leverage, and capital gains. This has provided a rich culture for get-rich promoters, and indeed many families have reaped substantial rewards from soaring real estate prices, equity prices, and commodity prices. But less than a decade ago, this appetite for quick capital gains led investors into a kind of fantasy land, where the potential returns on an investment had little to do with an actual performance record or even performance potential of a business. Some businesses, like prop-

erty developers, found themselves with large cash holdings or unlimited access to debt and explored ways of building alluring start-ups in media, health-care, technology, and education, rather than physical buildings, to lure in public investment.

China's entire world of equity investment departed from value investment and charged ahead in the belief that there would always be a greater fool. In the domestic market, constant large liquidity investments by the government enabled this to continue with steady growth. It is now reaching a watershed moment. Ditto for markets abroad. To the reader, it is doubtless apparent where the greater fools were to be found once Chinese enterprises began regularly to access global capital markets, first in front-door IPOs, then in reverse mergers, and now in a number of innovative channels, like structured M&A deals.

It seems that in the investment business, dumb can sometimes be smarter.

UPCOMING J CAP EVENTS

February Trips

Online Travel

Eastern and Southern China. We will visit Ctrip, Alitrip, Meituan, 58 Tongcheng, and other online travel companies plus hotel groups and airlines in four cities in China to learn about the growth in online travel and the relative prospects for the industry contenders.

- **Led by Jeff Dorr, February 20-23**

March Trips

Spring Steel Demand

Four cities, northern, southern, and western China. Infrastructure spending, construction demand, "supply side reform", the property market.

- **Led by Tim Murray, March 13-16**

Will China Save the Cruise Business?

Shanghai, Guangzhou, Beijing, and Tianjin. We will visit agents selling cruises for Royal Caribbean, Carnival, Norwegian, and smaller lines to learn about sales and pricing trends, the importance of gambling and duty-free revenues, planned capacity, and expected growth from China.

- **Led by Qin Shengxian, March 15-17**

Copper and Aluminum Demand and Supply

Four cities, central, northern, and western China. Demand for copper and aluminium going into the peak season.

- **Led by Tim Murray, March 20-23.**

The Politburo in 2017

Beijing, Shenzhen, Hong Kong. What may happen in politics in 2017.

- **Led by Anne Stevenson-Yang, March 27-30.**

Please email Brian Emanuelson (brian@jcapitalresearch.com) if you'd like to see a preliminary agenda for any of the listed trips or share with us any trip bespoke ideas you might be thinking about.

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