Thornhill Capital

August 2011 Due Diligence Newsletter

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Due Diligence on Chinese companies – don't apply if you're not Chinese

Due diligence on Chinese companies is not easy or for those with high blood pressure. I equate it to an iceberg where most of the issues are below the surface and unseen. No one knows how large the iceberg is below the waterline, we just know it's massive and there. The question is how do you find out exactly what's below the surface?

Analyzing what's below the surface is not a simple task. As with conducting due diligence on companies in other countries, adaptability and flexibility to the unique requirements of that country are essential. Nowhere is that more evident than in China. The combination of differences in accounting, the existence of several sets of financial books, related party transactions, lack of internal controls, and a host of other issues make due diligence in China challenging.

Since 2001, Foreign Direct Investment (FDI) into China has averaged $25 billion annually, with $35 billion coming into China in 2010. Although the FDI has increased during this period, the due diligence supporting these investments has proved, for the most part, inconsistent. This inconsistency is manifested in the widely varied expertise of those that conduct the due diligence.

Many investors choose to do their own due diligence. For some that works well. They have a well-qualified staff of Chinese professionals with an extensive knowledge of Chinese companies and instinctively know which areas they should focus on when conducting their due diligence. But a great majority of investors lack these skills. The learning curve in knowing what to look for in the books and records, operations, and other areas of the company is very steep. Only the use of an experienced Chinese due diligence staff can ferret out the issues that lie below the surface of the water. Due diligence by a Chinese forensic accounting team is not only advantageous, prior to making an investment or forming a joint venture with a Chinese company, it's critical.

There are two prerequisites for successfully performing due diligence on Chinese companies. The First prerequisite is to conduct your due diligence only if you have a person who is fluent in Mandarin and can read Chinese. This person should also be Chinese rather than someone who has learned to read and write the language. Having the documents translated, and going through an interpreter, just doesn't work. The sheer number of documents, and an understanding of those documents gained from speaking with management and staff, necessitates this fluency. Understanding the culture and the way things are done is essential in piecing together the facts necessary for your due diligence. This involves more than being knowledgeable in accounting or business. It involves immersing yourself in the culture and having a core understanding of why things are done the way they are. You grow up in China, you get it. You grow up in the US, you don't. If you're not Chinese, don't try to do due diligence on a Chinese company.

A second prerequisite is that the person performing the due diligence should have work experience within a Chinese company. The reason so many audit and accounting firms have problems with Chinese companies is that many of the staff have little or no practical work experience within Chinese companies. They may be good auditors and accountants, but unless you've worked in a Chinese company (not an accounting firm) and know the intricacies of Chinese business practices, you're unlikely to get much below the surface of the iceberg. Conversely, professionals who have worked in Chinese companies and know the day to day functions of accounting and finance

and operations are more likely to uncover deficiencies. Understanding the documentation associated with a business is an acquired skill. So much of what you see may not be true or accurate. If you've worked in a Chinese company you know this. You know where the skeletons are likely hidden because you've buried the bodies for previous employers. It's not uncommon for a Chinese company to construct documentation to support their vision of the company with respect to taxes, permits, revenue and earnings, and a host of other issues. Chinese business practices are, as with everything else in China, unique. Local knowledge is essential. Having past business experience in a Chinese company is critical.

Preparation for your due diligence should begin before you visit the company. I recommend preparing a checklist as this will allow you to conduct an in-depth review of the company and lessen the possibility that something will be overlooked. There can be so many distractions as you review data, check facts, and speak with employees that it's easy to miss something unless you're working off a checklist. Although this checklist is primarily the same for most private or public companies, it should be modified after review of the corporate documentation to include areas of interest specific to the company you're evaluating.

For a public company, research public documentation and become thoroughly familiar with the company prior to your visit. If you're able, speak with vendors and customers and see what they have to say about the company.

For a private company, send the Chairman a list of requested documents, along with tables and schedules that you'd like him to complete and return prior to your arrival.

Getting this information before you visit the company will not only help ensure that you don't overlook relevant information, it will also save time and allow you to focus your due diligence as a result of the documentation you receive.

It's also a good idea to look at blogs and other information on the company that may be available on the internet. Although you may find much of this information to be inaccurate or incomplete, there's usually some measure of truth found within. Add any adverse information contained in the blogs to your checklist. Either way you'll need to validate or disprove these allegations.

One of the areas that you'll examine in your due diligence is the company's bank statements. Oftentimes I'll see a Chinese company hand our staff a printout of their bank statements only to see it handed back. The reason it's handed back is that many times bank statements received from the company are forged, a product of the company's computer rather than the bank's. The forgeries are usually quite good and contain an exact replica of the bank's chop on the bank statements.

There's a number of reasons for the company to give you falsified bank statements, and none of them good. The most common reason is that the company's version of the bank statement supports the falsified books and records of the company. If they want you to believe the company has the revenue and earnings they've represented, as well as "prove" to you that they've wired their required tax payment to the government, then the bank statement handed to you by the company will reflect this falsehood. The company may also hand you a fictitious bank statement because they've so co-mingled personal and corporate cash that the company becomes un-auditable. The bank statements presented to you will, of course, be perfect. Bank deposits will match payments received by the company with no indication of other outside funds being deposited or withdrawn. You always want to go to the bank and ask for a local print-out.

When we think of due diligence, we're usually thinking a one way street. We're thinking of our due diligence on a Chinese company. However, the reverse is also true. Increasingly, Chinese companies are investing globally, and the Chinese government is actively encouraging this. In March, 2011 China's National Development and Reform Commission (NDRC) established that resource related overseas investments below $300 million, and non-resource-related investments below $100 million, don't need its approval. Because of this, cash-rich Chinese companies are looking to expand beyond their traditional domestic market.

Chinese companies are experiencing increasing domestic competition and are looking to overseas markets for companies, which are oftentimes more technologically advanced and selling at attractive prices. Acquisitions in a foreign country often offer a more cost effective method of entering an established market, while at the same time providing a greater degree of profitability than the company is attaining domestically.

The Chinese have similar difficulties in performing due diligence on U.S. companies. To a large extent, they simply don't understand how our businesses operate, particularly with regard to regulatory compliance and federal and state standards. It's as foreign to them as Chinese local and provincial law is to us. Just as we experience cultural, legal, and regulatory issues in our due diligence of Chinese companies, so too have Chinese companies experienced similar issues with their due diligence. Just as the two prerequisites mentioned earlier specify what's needed to successfully conduct due diligence in China, so too are these same prerequisites applicable to what's needed to successfully conduct due diligence outside of China.

Determining the composition of the iceberg below the waterline is not only possible, but highly probable if you use the proper methodology. Once you know what's below the surface you can make an informed investment decision. Competent due diligence will show you what you have, providing you the necessary data to make an informed decision.

Preparing a Chinese client for the rigors of the audit process

The first major undertaking when a company has committed to go public is preparation for two years of US GAAP audit. Most Chinese companies will have already been through a Chinese "audit" for purposes of bank loan compliance or tax filings. I put this term in quotes because a Chinese audit is only independent and objective in theory. Like many independent services that we take for granted as autonomous and reliable in the financial industry in the U.S. when performed by experts – such as asset valuations, bank confirmations, and audit reports, to name a few – Chinese audits are usually not worth the paper they are printed on. They may look nice, with a Chinese CPA firm's logo on the cover, neatly organized statements, and pages of footnotes, but there is usually little resemblance to reality in the numbers.

Generally, the Chinese audit firm will come to the company for a day or two, recalculate the company's management accounts, maybe look at a few invoices, and issue their audit report. There is an understanding between companies and the audit firms that the company has material unreported sales, or the company is claiming ownership of assets that it does not really own to bolster its borrowing power, or whatever other

deception benefits them – but that's just doing business in China. As long as they pay the Chinese audit firm, a company can pretty much publish audited results reflecting whatever fits its purposes.

So when a company decides that it is going public in the US, the first major hurdle to clear is preparing Chinese management, especially financial management, for the thorough examination that they are about to undergo. Chinese financial managers are generally of the mindset that the auditor asks for the financials and a small number of documents, the auditor accepts the information at face value, and the job is done. Even a year or two ago, before the many restatements and accounting frauds of Chinese companies were exposed, auditors were much more lenient and the process of preparing for and completing a US GAAP audit was far beyond anything a Chinese accounting staff had ever done. Today, with the PCAOB warning its member firms to crack down on Chinese audits, the SEC performing full reviews of almost every Chinese client, and both organizations meeting with Chinese government officials to attempt to give them the right to directly investigate Chinese companies, the environment is far more difficult.

At the outset of an engagement, we typically provide the company's financial management with a few basic guidelines and warnings to prepare them:

1. Prepare to be intruded – One of the basic principles of an audit is that the auditors should review each transaction with "professional skepticism." With the recent audit troubles in China, firms have taken this to a whole new level. Chinese financial managers are used to auditors who take every response at face value, and do not drill down or question inconsistencies. It can be quite a shock when a US firm comes to town, even with Chinese speaking staff, and question every answer given. US audit firms all employ or contract with Chinese nationals, and those auditors understand all of the tricks of the Chinese trade. So it is usually easy for auditors to identify where the problems are, and they're not shy about asking the company outright when they suspect creative accounting. In Chinese culture this often causes problems if the financial manager is not given the chance to "save face" and he is trapped into admitting inconsistencies. Similarly, Chinese managers may be offended by the auditors' requirement to verify information with a third party. For

example, the company may provide a bank statement to the auditors, which includes the bank chop for verification. The auditors will disregard the bank statement and require that the company take them to the bank so the bank manager can print the statement in front of them. The financial manager will often take this request as an insult to his integrity. On more than one occasion the direct confrontational approach used by the US auditors has caused our client companies to demand that the auditors be dismissed (even when the auditors were right). While firing the auditors was never actually the end result, the pain and hassle of stroking egos and educating the client in the middle of the audit is much worse than preparing them upfront.

2. Hire more staff – In most cases, we have found that Chinese CEO's are reluctant to spend any of their own money on the public process, no matter how small the amount. Usually a bridge loan is taken and held in escrow in the US and any expenses not covered by that loan will not be paid. This includes something as trivial as hiring an extra couple of staff accountants to help with the workload. The problem is further exacerbated by the fact that the CEO often does not want to hire new accountants because he has the current staff "trained" in a particular type of irregular accounting. But there is a lot of grunt work involved in preparing for an audit, including such things as rebuilding inventory records or cash transactions for up to several years. Most Chinese companies are barely staffed well enough to prepare internal financial reports and file their tax returns on time, meaning there is no way they can complete an initial two-year audit in a timely fashion, and definitely no way they can file quarterly reports in the required 45-day timeframe after going public. If additional staff members are not brought on the result will be a longer audit process and delayed funding at the outset with and possible late filings and a delisting once public.

3. Ask for help – most US auditing principles are vastly different from Chinese methods. Usually, the company's financial staff does not understand why they are required to perform a certain task. Just as often, the staff auditor does not understand what they are asking for or why. Auditors are notorious for asking for every schedule and document in existence, even if they are only required to sample test a small portion. They would rather err on the side of over-testing to limit their liability. However, since Chinese financial management doesn't understand US

auditing procedures, they do not know when a request seems a little strange. This is where they should rely on the audit management team, which consists of Chinese speaking US GAAP experts hired by the Company to assist with the audit process, or the US CFO (if the company has not engaged these professionals at the outset of the going public process, ignore these guidelines as it is unlikely the company will ever complete its audit). If a request seems too burdensome or a little strange, the company should involve the US professionals to challenge the audit manager or partner. In my experience, nearly all audit requests that seem irrational usually are, and the issue can be solved with more reasonable alternative procedures. But it takes an expert on the audit process advocating for the company to get that done, otherwise the auditors will walk all over the company. That may result in a bulkier audit file, but it will also increase the audit cost and the time to completion.

If the company goes into the audit with the expectation that it is going to be a marathon, and not a sprint, the entire process will be easier for all parties involved. Not that it will be easy, because a real audit is never a simple process, no matter the industry, audit firm, or country. But if the company's financial department and US GAAP experts work in concert and each do their part, the audit will be completed in the fastest manner possible. After going through the most difficult part, the initial two-year audit, the team will be much better prepared to successfully meet their post-public filing requirements.

Special Edition:
The China Small Cap Blood Bath
Equals Opportunity

By Larry Isen -- EmergingChinaStocks.com

The China Small Cap Bloodbath

The first half of 2011 was pretty darn ugly in the China small cap sector. It was a bloodbath akin to the last 6 or 7 I have lived through.

I've been professionally involved in the markets one way or another since early 1987. I've somehow survived the October of '87 crash, the Asian Contagion, the Demise of the Dot-Coms, 911, Enronitis, and the Real Estate/Sub Prime market meltdown.

Of them all, the recent 2008 market melt down was by far the scariest as it seemed it was possible for our entire financial system to collapse. This was a once in a millennium event, so it was kind of nice to get out of the way early in the 21st century.

This crash and all the crashes that have come before have a lot in common, but at the same time were each unique in their own way. Bubbles and Crashes go way back in history.

Jonathan's Coffee House in London is credited by many as being the first formal stock exchange. In London of 1690 there were at least 100 stocks actively traded, and brokers would gather at Jonathan's to trade the physical shares. Jonathan was the first to post a daily list of prices. When Jonathan's shop burned down in 1748, it was the end of an era, but led to the building of the first London Stock Exchange.

The first stock market bubble, which started at Jonathan's, burst in September of 1720. Shares of the South Sea Company rose from 140lbs all the way to nearly 1,000 lbs in the summer, but collapsed back to 200 lbs by October.

Since that time irrational markets have been inflating and deflating constantly, fueled by the human emotions of fear and greed.

And, speaking of fear and greed- the fear side of the equation has dominated the China based small cap sector in the first half of 2011. Those who did their homework made the profits of a lifetime in just six short months. From my perspective, I'm glad it happened. Despite having been mistakenly on the long side, I'm an admirer of the markets working thanks to the efforts of those who were temporarily smarter than I was.

However, as with all crashes, there is opportunity. One of the greatest investors of all time, J. Paul Getty, summarized it perfectly when he said

"Buy when everyone else is selling and hold until everyone else is buying. That's not just a catchy slogan. It's the very essence of successful investing".

There's a lot of risk associated with staying on the sidelines. One lesson comes from the uniquely American treasure **Mark Twain** who tells the story of the frog who burned his bottom while sitting on a hot stove.

The frog learned his lesson, and would never sit on that hot stove again. Eventually, the frog froze to death. That's a story about risk.

I don't plan to freeze to death. I believe there is now a lot of money to be made in this sector.

The Great Bargains of History

I'm now shopping for bargains. There are only brief periods in time where one can accumulate companies with 30% to 50% top and bottom line growth at 2 to 5x their trailing earnings. These kinds of opportunities don't come along too often. Here's some case studies to consider:

1. In 1984 to venerable Disney Co, that had traded in the $30 range over the previous few years, hit a low of $.73 per share. Disney was close to going out of business. The management brought in Eisner and his team who purchased other media companies like ABC which allowed the company to integrate its brands. The stock went back to $41. Not bad if you bought under $1.
2. In 2002 (the heart of the Dot-Coms turning into Dot-Bombs), Yahoo! traded as low as $4.05 after peaking at $108 two years earlier. At the time, the stock had more cash per share than its price. Three years later the stock was $43- that was of course before Google came along and changed the Search landscape. You could look at Amazon, Akamai, Cisco, and many others in the same time frame.
3. How about Jack-in-the-Box in 1993 when the company had customers die from eating meat tainted with E. coli bacteria. The stock traded down to $2.06, but the company survived the publicity, and made a high of $37 in 2007. Not bad.
4. Apple Computer was probably one of the greatest bargains in history. Apple was trading at $3.28 in 1997 despite having a book value of $6. Microsoft's domination of the PC market at that time was really hurting their business, and large

shareholders were calling for a liquidation cash out. Management, led by Steve Jobs, decided to transform Apple into a digital entertainment powerhouse, and the rest is history.

There's four examples of opportunities to make fortunes when Wall Street and the Wall Street media hated those stocks.

Consider an even more current story. In early 2009 my neighbors bought Apple at under $100 (now $360) and Ford at $1.70 (now $13.50) when everyone hated equities-especially the media. Why? Simply because they had just purchased a new Ford Flex and really liked the car, and they used a great many Apple products and loved them.

At the time you couldn't find one talking head on CNBC to suggest any equity was worth owning, but that's when you'll make the most money if you make the right move.

This Time It's Different, But It's Always the Same

> *"If I had 8 hours to chop down a tree, I'd spend six sharpening my axe"*
> *Abraham Lincoln*

One of the common characteristics of the complete wash out of a market sector is the loud voices assaulting us from every direction shouting clearly that no stock in the sector will ever come back. In the case of the China small caps, the loud voices are screaming everything is fraudulent, and the entire sector is dead forever.

Not likely.

I'm amused almost every day when I read from numerous sources that any Chinese company who's a "Reverse Merger" is a fraud.

This is patently ridiculous. It is true that the path to becoming a public company in the US is far easier with a reverse merger. Less review is done at the front end by less qualified merchant banking types, so you're likely to have a higher incidence of problems.

When a company has been publicly traded for 3 to 5 years and done multiple financings and registration statements during that time, its origins are no longer of any importance. It's like saying Warren Buffet is a poor investor because he didn't get a Harvard MBA.

And, speaking of Warren Buffet- did you know Berkshire Hathaway has its roots as a reverse merger, along with the NY Stock Exchange?

Fraud is fraud and you will find it with the most pedigreed company on the NYSE (see Enron), and the smallest China company you never heard of.

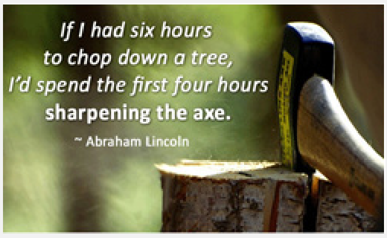
As I look over the carnage in this sector I see opportunity. This melt down is a bit different, but it's always the same.

It's different because you can't trust the SEC filings or the audited numbers coming out of these companies- much akin to the Enron/Worldcom disasters in the early 2000's out of which came an atrocious piece of legislation known as Sarbanes Oxley.

When you think about it, this is a less daunting challenge than buyers of Disney or Apple had to face at the bottom. In those cases, you needed faith the company would turn around.

In the case of China small caps, all you need to do is identify the companies that aren't publishing fraudulent numbers. Their business doesn't need to improve. They just have to be honest.

Sounds simple, but not quite that easy. In searching for a good way to "sharpen my due diligence axe" I came upon the answer at a conference in NY earlier this year.



Alan Refkin and his Thornhill Capital / China 360 team have become my sharp axe, and I expect to chop some huge profits out of this sector on the long side.

I have learned more about China fraud from Alan than I have from reading every Muddy Waters report they have published.

There are hundreds of great China based growth companies trading with US listings. Some of them are committing fraud. The majority have probably already been uncovered by short sellers.

In order to confirm a China based company is not committing fraud, the company simply has to cooperate with an internal investigation implemented by the folks at China 360.

It's not a re audit of the company's books. Primarily, the review focuses on confirmation the company's China government filings correspond closely the SEC filings.

The most important filing is the VAT (Value Added Tax) return- the equivalent of our Federal Tax return.

In China, you don't mess with the Central government. If a Chinese company files and pays its taxes, you can be 99% sure those are the real numbers. The penalties for cheating the Central government are too severe.

Hence, my belief I can find some nuggets of gold in this vast river of China small caps. I just have to lift the right rocks with gold underneath.

Investigations are underway funded by yours truly. If you want to follow the outcomes and know which stocks I'm recommending, simply subscribe at www.emergingchinastocks.com. I'll find those nuggets of gold for you.

Warmest Regards,

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