THE ‘SHORTS’ WHO POPPED A CHINA BUBBLE

From disparate corners of the world they alleged fraud at U.S.-listed Chinese companies, bringing many to their knees.

BY DANIEL BASES, RYAN VLASTELICA, CLARE BALDWIN AND MARK BENDEICH
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THEY ARE A RAG-TAG bunch, often working from home or tiny offices scattered round the world, from rural Texas to Beverly Hills and a suburb near Australia’s Bondi Beach.

Some have never even been to China; most don’t speak or read Chinese. And yet in the past nine months, this small group of “short sellers” has published research exposing accounting fraud at a series of Chinese companies listed in the United States and Canada, and made as yet unproven allegations against a whole bunch more.

As a result they have scuttled a once hot sub-sector of the American capital markets.

In a number of cases they claim to have made a killing by shorting those stocks - placing a bet that the shares would fall in value - before publishing the research. They insist they operate independently but are clearly influenced by one another’s ideas and tactics.

Altogether, they have been the catalyst that has wiped more than $21 billion off the market value of Chinese companies listed in North America. The sell-off has led to big losses for some very prominent investors, including hedge fund manager John Paulson and former AIG CEO Maurice “Hank” Greenberg.

In the aftermath, a series of companies have been delisted by U.S. exchanges, auditors have quit at a number of others, investors are filing class action lawsuits, and the U.S. Securities and Exchange Commission is pursuing investigations.

To their supporters, the short sellers are doing the regulators’ work for them by exposing fraud. They argue that many of these companies, which are often legally domiciled in offshore havens such as the Cayman Islands, should never have been allowed to list in America in the first place.

To their detractors, the short sellers have leveraged a handful of correct calls on accounting shenanigans into a campaign that has tainted many legitimate Chinese companies. Some accuse them of conspiring with big hedge funds to take short positions before they publish their research.

Many have jumped into the Chinese short selling game; Reuters has identified the five below as among the most prominent players.
CARSON BLOCK

AGE: 35
LOCATIONS: Hong Kong and the U.S. West Coast
WEBSITE: www.muddywatersresearch.com

Carson Block has been punching above his weight in China, judging by the impact of the reports issued by his firm, where he is the only full-time employee.

Toronto-listed Chinese timber company Sino-Forest Corp, perhaps the largest target for short-sellers, has lost more than 60 percent of its value, or more than $2.5 billion, since Block accused the company of a massive fraud in early June.

His published research has also sparked plunges in shares of the following companies: Orient Paper, RINO International, China MediaExpress and Duoyuan Global Water. He also issued an open letter to the CEO of Spreadtrum Communications, citing concerns about its financial reports, though the stock has recovered from an initial dive.

About $1.7 billion has been wiped off of the aggregate market value of these U.S.-listed companies since the reports from his firm, whose name stems from the Chinese proverb, “Muddy waters make it easy to catch fish.”

Before starting Muddy Waters, Block ran a Shanghai-based self-storage company called “Love Box Storage.” He previously worked as an attorney at Jones Day in Shanghai and as an adjunct professor at Chicago-Kent College of Law. His lack of a Wall Street track record has been questioned by his critics. Block, who still owns Love Box but isn’t involved in day-to-day operations, says these experiences “gave me a trench level view of business in China” where he “learned about the good, the bad and the ugly.”

Block says his interest in shorting Chinese stocks came after his father, Bill, president of W.A.B. Capital – which introduces small, public Chinese companies to institutional investors - asked him to examine Orient Paper for a possible investment on the long side.

The report brought a great deal of attention to Muddy Waters, and Block received tips for new companies to focus on. Orient Paper said an internal probe didn’t find any fraud, but in March it said it would re-audit its fiscal 2008 results. The stock trades well below pre-report levels.

“We realized the company was a complete fraud, and I assumed there were other likely frauds out there,” Carson Block said. “I didn’t have a business plan in mind when I set up Muddy Waters and wrote the report; I just figured I’d see what happened next.”

Block’s firm currently only takes short positions, bets that a stock will fall in price, though Block has said he may go long in the future. He declined to disclose how much the firm has in assets under management.

Block says his success has made him and his wife a target for threats. He recently moved his main base to the West Coast – though he won’t say exactly where – from Hong Kong. Block had already increased security measures, including removing the Muddy Waters phone number from its website. (The firm used to list a false address to increase its camouflage, a move that drew brickbats from its critics.) “I felt that the sort of attention I was getting wasn’t the kind we want,” he said.

JOHN HEMPTON

AGE: 44
LOCATION: Sydney, Australia
WEBSITE: http://brontecapital.blogspot.com/

John Hempton looks more like the public servant he used to be rather than the millionaire hedge-fund manager he has become, dressed in an olive cable-knit sweater over collared shirt and tie, jeans, docksiders and large, round spectacles.

He is reading a book on his Kindle at a beachside cafe near his home in Bronte, an affluent seaside suburb on Sydney’s eastern shore. He had cycled from his home on a hybrid electric bike. His wife drives a 14-year-old car. An economics graduate, he started his career in Australia’s treasury department trying to unravel tax-avoidance schemes.

“I really do understand fraud and esoteric accounting issues, and strangely enough that comes from my days at Treasury,” he said. “I was given all the gnarly avoidance problems … I cut my teeth on stuff that was deliberately complex and a little nasty. It was a good place to learn how nasty accounting works.”

Hempton said he had “semi-retired” at the age of 39, after making a personal fortune on the flotation of fund management firm Platinum Asset Management, where he was a junior partner and analyst covering financial, media and utilities stocks. He says he once managed A$20 billion (US$21.15 billion) in

WEBSItE: www.muddywatersresearch.com

Sino-Forest: the big short

Canada's Sino-Forest is the largest of the Chinese accounting scandals

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<tr>
<th>Month</th>
<th>Event Description</th>
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<tr>
<td>June</td>
<td>Hedge fund manager John Paulson sells entire stake; shares hit 52-week low</td>
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<tr>
<td>July</td>
<td>S&amp;P cuts Sino-Forest rating</td>
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<tr>
<td>Aug 20</td>
<td>Singapore-based fund Mandolin announces big stake, shares rebound</td>
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Source: Thomson Reuters

WEBSItE: http://brontecapital.blogspot.com/
He started his new career by writing a blog on his favorite topic: the sickness at the heart of international banks.

Hempton then struck up a partnership with an old friend, Simon Maher, formerly the head of an Australian utility. They formed Bronte Capital with a small office near the famous Bondi Beach, and initially managed their own money.

After spotting his first alleged China fraud - Universal Travel Group - Hempton says there was no turning back.

“They are so obvious that this is like shooting fish in a barrel. It’s not going to remain that way. We are already finding it’s tougher to find them in the U.S., and the ones that are really obvious are already mostly exposed. We are looking a little in Hong Kong now.”

He has written on a series of Chinese stocks that have blown up: Universal Travel Group, China Agritech, Longtop Financial Technologies, and China Media Express.

“Do we do this, that is, shorting Chinese stocks, all the time? No. But here we have seen a bundle of names with a market cap in the $300 million to $400 million range. There were so many of them, stupid frauds that were easy to see,” Hempton said.

JOHN BIRD
AGE: 62
LOCATION: MANOR, TEXAS
WEBSITE: www.waldomushman.com

John Bird does not speak Chinese, has never been to China and expresses little interest in going. Instead, he makes his bets against Chinese small-cap stocks from his 130-acre home in the Texas countryside outside of Austin where he lives with his wife of nearly 40 years and a dozen Arabian horses.

Despite his lack of direct knowledge of China, Bird is confident there is widespread fraud, and said recently that for those shorting Chinese stocks, “this is harvest time”.

“A little under a third of Bird’s active portfolio is in short positions. He said he began shorting Chinese stocks in 2009 after seeing a note from veteran short seller Manuel Asensio saying that drugs company China Sky One Medical Inc might have problems.

China Sky, which he started to look at in spring 2009, is one of his most notable positions. He has sued the company’s auditor for not acting on information that China Sky’s financials might contain errors.

“It’s not a matter of whether they are fraudulent companies, it’s just a matter of who they are cheating,” Bird told a conference in June. As a joke, he passed out a children’s’ toy - a Chinese finger trap -- to everyone in the audience. The trick of the toy is that it’s easy to put your fingers into the trap’s woven cylinder but it’s much more difficult to pull them out.

Bird is long on some oil, gas and pipeline stocks but said he never goes long on Chinese companies. At 62, the white-haired investor has had years of financial experience - and his share of flops.

Public filings show several state tax liens and state tax lien releases against properties Bird owned in Texas. He describes the liens as “collateral damage” to his mid-1980s bankruptcy that came about because of a property bust.

Bird declines to describe the nature of the businesses he was associated with. Public records show companies with names like “Wishlist”, “Magnetic Clone” and “Golden Fried Chicken of America”. He says he was a “junior league venture capitalist” who gave money to people with good ideas.

Bird and other investors have been urging the SEC to compare reports filed with the
Andrew Left has come a long way from the late 1990’s IPO boom, later switching to shorting the stocks after another infraction, the NFA says.

Left departed after 9 months, in March 1995 by the National Futures Association for failure to supervise employees engaged in fraudulent practices. Left was sanctioned by the NFA as part of a wider probe into the firm. The firm was closed down in December 2008 after another infraction, the NFA says.

Left devoted himself to the late 1990’s IPO boom, later switching to shorting the stocks at a friend’s suggestion. “It was like a friggin’ light bulb went off in my head,” he said.

About 10 years ago he started writing about his research on a website called Stocklemon, later renamed Citron Research.

Pretty much the main theme of Citron is to encourage investors to use their brains. Don’t listen to an analyst all the time. Don’t listen to the company. Does it make sense to you? Do your homework. And that is pretty much it,” he said.

Left says he does not sell his research nor work for a hedge fund. He describes himself as an independent investor, not just a short-seller.

He’s written about Chinese reverse takeover stocks for the last four years, though he’s never been to China except for a couple of days in Hong Kong a decade ago.

“Lately the action has been in China…. Two years from now I doubt I’ll be writing about Chinese stocks anymore;” he said.

In the meantime, he’s hired a Chinese-speaking finance PhD. student from UCLA, to translate, read documents and make phone calls. He also hires investigators in China.

Of his Chinese positions, his biggest loser was New Oriental Education. “I wrote about it, shorted it and realized I was wrong, so I got out very quickly. It is up 100 percent since then,” he said.

Left, who grew up in a Detroit suburb, won’t discuss his net worth, saying only that he lives “in a nice house” in Beverly Hills.

Dressed in grey golf pants, white shirt and sockless sneakers, Left was recently in New York meeting hedge funds to talk about how they missed the dubious business practices at these U.S.-listed Chinese companies.

On the China-related shares, he published on a number of companies, including China-Biotics, China MediaExpress Holdings, Deer Consumer Products, Longtop Financial Technologies and Harbin Electric.

Harbin was hit after his reports on the viability of a loan agreement for a pending buyout. Shares recovered following his report, yet it still trades well below the $24 buyout offer price. He hasn’t backed away from his position on Harbin, he said.

He says his best trade wasn’t a short position and had nothing to do with China. At the depths of the market downturn in April 2009 he went long U.S. banks.

“It was the end of the world and I decided to take my daughter to Disneyland... The world was going to hell on CNBC and I’m waiting on line, not even for a ride,” he said.

Seeing how crowded Disney was convinced him the economy wasn’t so terrible. He returned home and covered his short bets, then went long by shorting the ProShares UltraShort Financials ETF -- a leveraged short play on financial stocks.

“(I) loaded up on things like that and just held on. Thank you Disneyland!”

Rick Pearson is one China specialist who actually knows the country: He studied finance and Mandarin at the University of Southern California and began traveling to China in the early 1990s, spending six years there all told.

He says he his familiarity with the country has been a double-edged sword: It helped him gain access to factories and management, but the closeness may have made him too credulous.

The former Deutsche Bank convertible
bonds banker, who is currently living in Beijing, says he lost a lot of money on long positions in Chinese stocks. He won’t say exactly how much, but described his long position in Orient Paper Inc as particularly “painful.”

He was long when Muddy Waters released a report on the company. He then bought more shares because he thought the report was wrong only to see the stock plunge further.

After that experience, Pearson grew more critical of Chinese companies and disclosed short positions in China-Biotics, China ShenZhou Mining, Gulf Resources, Harbin Electric and Longtop Financial in an occasional column he writes for TheStreet.com.

Pearson said in June he began to realize that some Chinese stocks were “a giant Ponzi scheme.” Still, Pearson resists being grouped with other shorts, arguing he would rather be long Chinese stocks and expressing concern that the moniker will impede his access in China. He says he thinks the China small-cap short trade may be close to an end as a viable strategy. “There’s too many stocks whose share prices are already too low. There’s too many stocks that have already been attacked by people. In my opinion it doesn’t necessarily make a lot of sense to go shorting a $3 stock.”

Pearson recently got out of all of his investments - he had some long positions in Chinese Internet stocks – because of concerns about the U.S. debt ceiling debate. His intelligence-gathering methods are varied: taking people for coffee or karaoke, ferreting out executives’ cell phone numbers, contacting sales representatives through Chinese e-commerce site Alibaba, and coming back to visit factories at unscheduled times. Pearson also counts employees and the number of vehicles in parking lots, looks at the age and condition of factory equipment and contacts customers and checks information in SEC filings with a company’s China staff.

Pearson said he does not work with other investors, but he does occasionally keep in touch. One of the things that he says he learned from Texas-based short seller John Bird is the importance of filings with the Chinese authorities. When Pearson showed up to meet Bird for what he said was the first time in Los Angeles in June, he came wearing a T-shirt that stated, “John Bird was right.”

(Reporting by Daniel Bases, Ryan Vlastelica and Clare Baldwin in New York; Mark Bendeich in Sydney; Editing by David Gaffen, Martin Howell)