

Chaoda Modern Agriculture (682 HK)'s Early Signs of Fraudulence

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1 Corporate Governance

Event Group	What Happened	When	Coy's Comment			Why This May Be a Sign of Fraud					
3 Auditors Resigned	PwC resigns	Jun 2003	Due to fee dispute (Baker Tilly joined CCIF as joint auditor in Jun 2005)			Competition among auditors ensures fair pricing and fees are agreed on before assignment Authority's view on fee dispute: SEHK ¹ and SFC ¹ raised concerns with HKICPA ¹ that auditors have been relying on fee disputes to disguise real reasons for resignation Diff in fees insufficient to justify loss in mkt cap of HK\$200m 2 days after PwC's resignation - Auditor fees still up by RMB0.5m from 2002 to 2004 and only down by RMB0.4m from 2006 to 2008.					
	Baker Tilly Int. and CCIF CPA Ltd. resigns	Jun 2007									
	Auditor Fees (RMB m)	2002	2003	2004	2005	2006	2007	2008			
	Annual Amt (pg in AR)	2.4 (44)	4.2 (50)	2.9 (57)	4.1 (52)	4.5 (65)	3.8 (64)	4.1 (71)			
	Audit Fee/SG&A (%)	1.5	1.8	1	1.2	1	0.6	0.5			
5 Senior Mgt Resigns	Independent director, Wong Kong Chi (WKC)	Sep 2003	No reason given			Timing: WKC resigned 3 mths after PwC and during preparation of FY2003 AR (Annual report); GW resigned during preparation of FY2005 AR					
	Chui Na Lai (CNL), exec. director, co-founder, CEO's spouse	Sep 2004	Due to health reasons			Reputation: WKC is ACCA member and mgt's silence adds to the suspicion Shortly after resig'n: CH - became agricultural consultant (no records on further studies) GW - became CFO of Acorn Int'l (despite cited personal problems)					
	Independent director, Chen Hang (CH)	Jul 2005	Due to further studies			Currently senior mgt in Le Gaga: CNL – Chairwoman (joined Jul 2010), CH – VP of Ops (joined 2008), GW – Independent Director (since Oct 2010) ²					
	CFO Gordon Wang(GW)	Sep 2005	Due to personal reasons			Pay rise: from RMB0.7m to RMB3.3m wks before Chui's resignation					
	Corp Secretary, Susanna Ching (SC)	Dec 2006	Currently in Admin Appeals Board for HK Govt			Asset transfer: Chui transferred her entire stake in Kailey Investment ³ to CEO, Mr. Kwok Chui's pay rise, asset transfer and current job does not seem to suggest health problems					
Significant Related Party Transactions	Fujian Fertilizer, FF (Fujian Chaoda Agricultural Produce Trading Co) is owned by Chaoda's CEO, Kwok	2001-2010	Exclusive agreement is to ensure stable supply of quality fertilizer			FF is the only supplier to Chaoda vs. most companies which contract 10-20 suppliers FF sets the price based on what it can sell to other entities (2010AR) - This agreement is rare in the agri industry: easy to manipulate & difficult to trace volume - Overpriced fertilizer: Chaoda quoted RMB1500/MT vs. peers' RMB700–1300/MT. ⁴ SAIC ⁵ docs show: FF has no biz ops & assets consist almost entirely of receivables 2009: FF reports RMB700m in sales with just RMB11,599 of fixed assets Indicator of where the profits are: Kwok's stake in Chaoda ↓ vs. his stake in FF ↑					
											FY2001
	Purchases of fertilisers in RMB m (AR pg no.)	52 (pg61)	106 (pg64)	136 (pg72)	175 (pg80)	215 (pg76)	300 (pg96)	376 (pg95)	530 (pg102)	661 (pg115)	678(pg106)
	Purchases/COGS (%)	29	35	28	28	29	33	31	34	33	28
	49% stake in Asian Citrus (AC) acquired by Chaoda - AC consists of a neglected plantation with low yielding trees	Jul 2001	The acquisition offers Chaoda an opportunity to invest in the growth of a modern orange farm			Not really an investment opportunity: Previously Pepsi Co had handed AC's orange farm to local govt for free after conducting analysis, concluding that the development involves high investm't and risk; Chaoda had a massive write-down of RMB162m (>50% of net assets); Chaoda's ROE is much higher than AC's. More for the benefit of chairman: Large fertiliser purchases (RMB238m over 9yrs) from FF due to AC's neglected farmland; Chaoda claims it grows all its produce, however, AC disclosed (listing doc) that Chaoda purchased orange amounting to RMB69,000, 11,000 in 2002 & 2003.					

2 Cash Flow Statement – Over-financing in Capital Markets

Chaoda's growth model (approx 2-2.5yrs to evaluate, plan, lease, cultivate and harvest the land) should allow mgt to est. its financial position and capital requirement in advance. Yet the co engaged in the below-mentioned sudden capital raises and raised over RMB7.3bn (≈US\$1.1bn) since its IPO

Date	What They Say	What They Do				Net Cash
		Date	Amt Raised	Via	Other Details	
NA ¹	Failure to raise capital will not impact growth rate Highest in co's history: 38% revenue growth in 2007 (The year in which investment in 2004 would have been realised)	Jun 2004	RMB1bn (failed)	Proposed bonds	Planned amt to raise ≈ FY2004 net income	RMB359m (2004 H1)
Oct 2008	Use internal funds for expansion of 100,000mu ^b of farmland (it had 494,800mu then) It has enough cash to redeem convertible bonds (CB) worth RMB1.37bn due May 2009	Feb 2009 (4mths later)	RMB341m	Gypsy Swap	Insider trading. Exec directors, Kuang Qiao and Ip Chi Ming, sold their entire holding of 3.2m and 0.7m shs before announcement	RMB398m (2009 H1)
Mar 2009	Sufficient internal resources to pay CB and high yield bonds while maintaining growth rate	Jun 2009 (3mths later)	RMB1.5bn	Shr placem't	Insider trading. Ip Chi Ming sold 80,000 of his 90,000shs 2wks before announcement	RMB398m (2009 H1)
Mar 2010	Enough cash on hand and from ops to finance growth even after retiring high yield bonds	Aug 2010 (5mths later)	RMB2.4bn	Bonds, shr, options	-	RMB2bn (2010 H2)
NA ¹	Cited market conditions for its failure to raise funds	Apr 2011	RMB1.3bn (failed)	Proposed notes	-	RMB2.8bn (2011 H1)

3 Balance Sheet – Inflated Capex

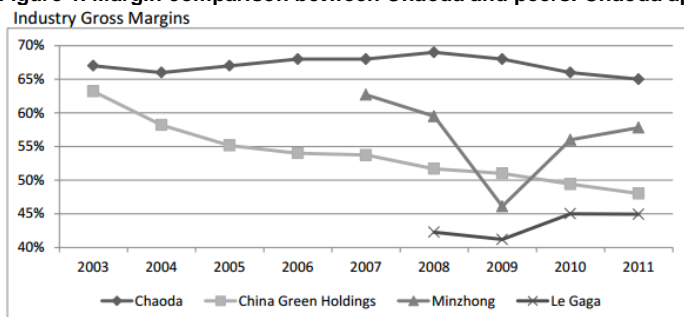
Spent RMB9bn on capex (irrigation, greenhouses, buildings & machinery) since IPO. Present expected spending: RMB28,000/mu (peers quoted RMB13,000 to 20,000/mu)

	Plantation area (mu)	Cumulative Capex since Inception (RMB bn)	Capex per mu	Analysis: 36% higher capex per mu than peers	Greenhouse Coverage ⁸	Analysis
Chaoda	664,225	9.1	13,705	Chaoda spends much more than its peers. Yet: Peers follow similar growth strategy; Cost base is mostly historical; Relative size of Chaoda vs. peers can't justify the relative capex; It is a competitive industry.	7%	Chaoda has less green house coverage than its peers which should cost more. This is contrary to its higher unit capex.
Minzhong	27,981	0.2	8,519		10%	
China Green	92,700	1.1	11,590		12%	

4 Income Statement – Profit Smoothing

Where?	Analysis on margins
Chaoda's gross margins against industry peers – See Figure 1 below.	Higher and more consistent than industry peers. Its largest YoY change was 3% points (from 2009 to 2010). Conclusion: Chaoda's margins are improbable as they make Chaoda appear as if it is unaffected by supply, demand, quality issues or natural disasters

Figure 1. Margin comparison between Chaoda and peers. Chaoda appears to be immune from margin volatility.



Source: Company reports

5 Other Fraudulent Acts – Branding

Entity Involved	Details of Entity and its Involvement	Signs of Fraud
Highly ranked by World Brand Lab (WBL)	Branding consultancy which could have received fees for upping Chaoda's rank: ranking up from No. 220 in 2004 to No. 82 in 2011. Subsidiary of WEG (see next item)	- No marketing experts contacted by AA have heard of WBL - Using "whois" registry search revealed that WBL's website was created by a college student in 2006. However, Chaoda cited its ranking in 2004 which is even before the website's creation. WBL's unclear ranking methodology: comparison of annual rankings shows that companies can disappear and appear out of nowhere in the space over 1yr's time. WBL's ranking uses two group of companies. 1 st group are genuinely valuable coys like PetroChina to boost legitimacy & offered other places to 2 nd group of coy who pay WBL. WBL claimed that: its team includes experts from Harvard, MIT, Yale, Oxford etc. Amongst WBL's consultants and experts, some claimed to have worked with WBL, some claimed to just gave speeches at WBL conferences and some have spoken to WBL but no idea who's WBL and why WBL posted their pictures. Robert Mundell: Chairman of WEG and WBL but HSD may have used him as a figurehead ⁹ WBL assigns Chaoda a brand value of RMB12.3bn, more than Chaoda's market cap.
World Executive Group (WEG)	Holding company of WBL Registered in Nov 2002 with Hai Sen Ding (HSD) as CEO and founder of WBL and WEG	Low website traffic. Website has extremely low traffic (not even registered on Alexa statistics ¹⁰) - Coy's registered address is a dorm room in MIT but recent info shows that is has offices in HK and NY However: its HK office turned out to be a "virtual office" ¹¹ and the property mgr of its NY office had never heard of WBL or WEG, but the address was leased to Nation Online (see next item).
Nation Online	Website registered under HSD	This is just one of 1,000 domains registered under HSD, many of which are poorly constructed or non-operational. One of the websites, bosslink, plagiarised a logo from E*Trade

6 Valuation of Chaoda

Method	Valuation Components	Liquidation Value
NAV	Land ownership: leased from farmers	No claim on land yet liable for L/T contracts with farmers Bulk of its L/T assets is infrastructures that are tied up with land (e.g. irrigation systems) which will also be lost without landownership.
	Corp Structure: Often a mistake, it's a P chip stock ¹² that is not recognised in China as a nat'l enterprise. Chaoda consists of many interlinked PRC and offshore BVI entities	Guarantors of CB are all BVI entities so it's nearly impossible for CB holders to collect cash balance shown in its balance sheet. BVI entities are not required to disclose ownership structure or financial position ¹³
	Asian Citrus (the only confirmed stake): Interest has down from 49% to 13.4%. AC is plagued by insider trading, related party trxn, discrepancy in listing docs.	According to mkt prices, stake in AC is worth HK\$870m (HK\$0.57/sh) No value will be left if mgt continues to sell the stake
DDM	Annual div of 5% of net income ≈ HK\$0.06/sh	Share price = HK\$0.60 (Assuming 0% growth and 10% discount)

Note: 1 SEHK: Stock Exchange of Hong Kong Limited, SFC: Securities and Futures Commission, HKICPA: Hong Kong Institute of Certified Public Accountants. 2 http://www.legaga.com.hk/html/about_bod.php#7, <http://freerealttime.brand.edgar-online.com/> 3 Kailey Investment Ltd is a holding company by which Mr. Kwok holds ownership in Chaoda. By transferring her stake to Mr. Kwok, Chui removed her direct interest with Chaoda. 4 Price quoted by industry peers is for very high quality organic fertiliser with shipping costs included. 5 Businesses operating in China must provide financial statements to the State Administration for Industry and Commerce (SAIC). 6 1mu=1/15 hectare, 7 NA = Not available. 8 Greenhouses can triple the yields of open fields and produce higher quality products but incur costs of about 4 times higher than open fields. 9 Mundell is a Nobel Laureate who helped set up the euro currency. Several credible sources confirmed him as Chairman, but Mundell could not be reached for verification by AA team on his involvement with WBL & WEG. 10 A website founded in Apr 1996 containing a wide database of statistics on websites (<http://www.alexa.com/company>). 11 A service which helps to create an impression of a physical office. Includes a fake secretary, PO Box, phone no, access to conf rm, etc. 12 P chip: Chinese companies listed in HK and incorporated in Cayman Island, Bermuda & British Virgin Islands. 13 Source: <http://www.offshorebvi.com/bvi-offshore-companies.php>