

## **One Billion Chinese People Can't Be Wrong: ONP is a Fraud**

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As of the time of publication, 90.7% of respondents to an online poll conducted by Sina.com. (Nasdaq: SINA) believe that ONP is committing fraud.

(<http://survey.finance.sina.com.cn/result/48540.html>)

The poll follows the publication of an article by the 21<sup>st</sup> Century Business Herald ("21CBH"), which is one of China's most respected business publications. The article details 21CBH's own investigation into the claims Muddy Waters, LLC raised. The article, which has been republished on Sina.com and Sohu.com (Nasdaq: SOHU), appears here in Chinese on Sina.com:

<http://finance.sina.com.cn/chanjing/gsnews/20100722/04168341604.shtml>

We provide an in-house translation of the article herein. 21CBH's investigation uncovered the following:

- According to a tax bureau insider, the AIC financials ONP provided to investors in response to Muddy Waters LLC's allegations overstate HBOP's profit and taxes paid by close to 400%. This may now be fraud on the PRC side as well.
- HBOP's largest supplier, Dongfang Trading Co. Ltd., is a shell company that has virtually no recorded revenue the past two years. This company was founded by Chairman Liu and Li Chen. Mr. Li was a director of ONP until 2009. Dongfang Trading's address is the same as ONP's primary plant. The article pointed out that ONP has never disclosed that its purchases from Dongfang Trading are related party transactions.

Our thoughts are that having a supplier that is a captive shell company makes it easier to produce documents that would fool the auditors. Moreover, we could never understand why a company as large as ONP claims to be would purchase from a trading company, thereby giving up approximately 10% in margin.

- Chairman Liu's response to the reporter's information about HBOP having overstated its profits and taxes per the tax bureau's information was to disclose that HBOP has a Beijing subsidiary that has agreements with other companies to receive revenue. Chairman Liu claimed that he is the Legal Representative of this subsidiary. The reporter was unable to find the company in the registry in Beijing. Nor was he able to find any company in Beijing that lists Chairman Liu as the legal representative. As one of our followers wrote to us "One lie needs 1,000 more to cover up."
- "Many" paper industry experts told the reporter that ONP's claimed inventory turnover is well above what is usual.

- A senior official of China's Paper Manufacturing Association stated that ONP's claims about the capacity of the corrugating medium line it has ordered are in "no way" accurate. Note that we recently discovered that ONP had switched to a different type of machine (without disclosure) in response to our initial analysis. This further supports our thesis that significant amounts of money will be misappropriated in this purchase.
- The reporter spoke with one of ONP's new 2009 customers, which is one of the Top Three. The customer's own annual revenue is close to the amount that ONP claims it purchased in 2009. As we discussed in our initial report, a customer's revenue would be at least two times what it purchases from ONP (if not more). The company representative partially corroborated that conclusion by stating its first half purchases from ONP were approximately 25% of the annual volume that ONP claimed for the year.
- The reporter confirms that Muddy Waters, LLC did indeed investigate the correct entity.

*Muddy Waters LLC Translation of the 21<sup>st</sup> Century Business Herald Article*

**An Investigation into the Financial Mysteries of AMEX-Listed Orient Paper**

Authors: Yi Peng and Wang Kang

The elderly people of Xushui NanYing Village in Hebei have heard that ONP's boss Liu Zhen Yong went to the US at the beginning of the year to ring the bell; and because of that, this paper manufacturing factory located amongst the fields west of the village will soon strike it rich.

A sign with the declaration "The paper manufacturing plant shall expand by an area of more than 1,000 mu" (approximately 717 million sq. ft.) displayed outside the production plant gave the villagers a more intuitive insight. On 21 July, Liu Zhen Yong told this reporter "Getting listed will allow the Company to develop at rocket-like speed."

However, the listing of the Company has brought him trouble, at least for now. It all started with a report published on 28 June by an American research firm "Muddy Waters LLC" (henceforth referred to as MW).

The report claimed that ONP is suspected of exaggerating its profit levels in the past three years and is also suspected of forging its total asset values, inventory turnover and also key customer information. ONP swiftly rebutted MW. According to Chinese media reports, "ONP once refused the purchase of MW's report for which they asked US\$300,000." Both companies have been at a war of words on multiple occasions ever since.

After the report was published, on 30 June, ONP's stock price dropped greatly. As of 20 July, ONP's stock price has continued to fall, with the share price ending at US\$5.26 that day with a fall of 7.07%.

The paper manufacturing firm that is established by Liu Zhen Yong was reverse merged on March 2007 onto the US OTCBB market. In December 2009, it was allowed to trade on the AMEX, and this man hailing from Liu Zhuang of Xu Shui County, Liu Zhen Yong, rang the closing bell that day in January 2010.

This reporter travelled onsite to investigate ONP's operation facilities in China. After verifying with representatives from the Company, I discovered that there are many dubious points of contention regarding ONP's actual operating income and their related transactions. There exists a gap between the company's actual tax situation and the figures provided by the listed company. Their main supplier and the Company have not disclosed that their transactions are related party transactions, and this main supplier has had almost no revenue for several years.

### **Profit Mystery: "Most taxes paid in Beijing"**

In Hebei Province, Xushui County, south of the city, about three kilometers down a village-town highway is one of the main manufacturing plants of ONP. In 1996, Liu Zhen Yong registered Hebei Baoding Orient Paper Milling Co., Ltd (henceforth referred to as HBOP). Before this, Liu once worked in a printing factory for seven years, and the company's listing information provided also stated that in the late 1980s, he was the Deputy Director of a Liu Zhuang Cast Iron Factory.

After this in 2000 and 2002, the company separately signed land agreements with villages neighboring its main plant (Wu Ji Village & Nan He Shou Ying Village) to acquire an additional 40 mu (approximately 290,000 sq. ft.) of land nearby the land occupied by the original printing factory. This area of land is now the company's main manufacturing area. In addition, according to Liu Zhen Yong himself, "The company has built 80 mu (approximately 580,000 sq. ft.) of production facilities," in the industrial area of the county along Ju Li Road.

In the report published by MW, when two of their researchers visited the factory on 5 January 2010 this year, they ascertained that the factory's machines are "old and poorly maintained" and released photos of the manufacturing equipment they took. After seeing the photos, a person working in the paper manufacturing industry remarked to this reporter that the manufacturing conditions in the photos are similar to the operating conditions seen in the paper manufacturing factories of the early 1990s.

In sharp contrast to this, ONP reported in their past two years annual reports that the Company's revenue is around US\$65.2 million and US\$102 million. According to MW's report, this is overstating the actual revenue by more than 27 times and 40

times, respectively. AMEX has strict regulations regarding past three years profits for listed companies.

In the Company's materials, ONP claimed that He Bei Bao Ding Oriental Paper Milling Co. Ltd. ("HBOP") is its operating subsidiary firm in China, and is responsible for the company's main manufacturing business. "HBOP's financial reports also encompass those of other subsidiaries." Therefore, HBOP's profits and tax situations are the key to determining whether ONP falsified its results.

However, evidence given by both sides has resulted in the matter being shrouded in mystery. MW's researcher has provided this reporter with a photocopy of the business information chopped with the proprietary seal of Xushui County Bureau of Administration of Industry and Commerce ("AIC") as proof that the investigated target was really HBOP. According to the information provided, the company's 2008 revenue stands only at 16.32 million yuan (US\$2.4 million).

But according to the AIC archived financial reports that ONP released, its 2008 revenue stands at 452 million yuan (US\$66.2 million), which is close to the figures reported by the listed company. To my knowledge, this business information is provided by companies themselves for the purpose of statistics and archiving with the AIC.

This reporter has gleaned from a tax bureau insider that HBOP's actual financial situation has a considerable gap from what is reported by the listed company. Further, in a Xushui County Government Economic Development Report released in 2008, HBOP's "profits and taxes" that year from Jan-Oct stands at 22 million yuan (US\$3.2 million). The term "profits and taxes" encompasses the company's net profits and the tax paid (MW Comment: this is likely pre-tax income plus VAT taxes paid on revenue). However, according to the AIC information provided by the firm after the scandal broke, the corporate income tax paid in the four quarters that year alone is over 20 million yuan (US\$2.9 million) and the net profits exceed 60 million yuan (US\$8.8 million).

When asked about the discrepancies between the tax figures provided by the operating company and the listed company, Liu Zhen Yong explained over the phone, "The sales of the company's products are largely conducted by another subsidiary company located in Beijing." In the same phone call, Liu Zhen Yong shared the fact that the company's products are now manufactured mainly in six places, apart from the two factories belonging to Orient HBOP, the rest are dispersed in various districts and counties of Baoding City, and "even though the company does not own any shares in those companies, there is an agreement to receive shares of their profits."

If such a unique network of relationships indeed exists, then the nexus lies in a company called "Beijing Orient Paper Sales Company." According to Liu, the legal representative of that company is he himself, and it is registered in Beijing's

Chaoyang district. It conducts sales for the products produced by the abovementioned six major manufacturing areas, and helps HBOP accrue some of the profits from the other manufacturers. As such, “The majority of the company’s taxes naturally is paid in Beijing. In August, the Beijing company will even hold an event.” Liu said.

After hearing him speak, it would seem that we could put the matter to rest.

However, when this reporter checked the information network provided by the Beijing AIC, there is no company registered with the aforementioned name, nor is there any company in the registry that even has the term “Orient Paper” in its name. (MW Comment: the same two Chinese characters represent “Orient” and “Oriental”.) When checking legal representatives registered with the name “Liu Zhen Yong”, there are no corresponding records of the supposed company either.

### **Business Mysteries: Equipment, Inventory and their “10 Major Clients”**

Even more business operational details are put to the test.

MW suspects that ONP exaggerated its production capabilities corrugating medium paper line that it is buying. According to MW’s report, they have spoken to an anonymous factory worker in the factory producing the line, and he has revealed that the best machine in the factory is only capable of producing 150,000 tons of product annually, at prices of around US\$4.4 million.

On 1 July, ONP responded saying that the corrugating medium paper manufacturing production line purchased by the company is capable of producing 367,000 tons of product. This equipment produced at the Henan supplier is valued at US\$27.8 million and is used to manufacture 5.6 meters wide, 120g / square meter corrugating medium paper.

According to figures released by ONP, this machine can produce 1,200 meters of the above-described product per minute. MW however thinks that the actual figures should fall within the more reasonable range of 500-600 meters per minute.

Both parties have uncompromisingly held fast to their views on the pricing and production capability. This is because it concerns the figures reported by the listed company regarding its assessment of its fixed assets and their figures on its operation performance.

A provincial level branch leader of China’s Paper Manufacturing Association told this reporter, “Using current existing domestic production equipment, if it were to produce 1,200 meters of corrugating medium paper per minute and keeping it at 5.6 meters wide, there is no way that a thickness of 120g / square meter can be achieved. It is more likely to be at a thickness of 90g / square meters or less.”

At the same time, the exceedingly high inventory turnover rates quoted in ONP's financial statements differ from the rates more commonly observed within the industry. According to MW's reference of their financial reports, ONP's 2009 inventory turnover rate was as high as 16.85, which means the firm is able to clear out a batch of finished goods and half-finished goods in less than one month. This is in contrast to the "general industry cycle of two to three months, unless they are manufacturing cash notes, medical paper or other special use paper," as many paper manufacturing industry experts revealed to this reporter.

For example, the "competitors" listed in ONP's financial reports, Shan Dong Chen Ming and Nine Dragons inventory turnover rate that year are 4.29 and 7.67 respectively only.

In addition, in ONP's financial reports, their Top 10 Customers in 2008 and 2009 are also largely different. Of the 10 major customers that made the list in 2008, only two made the list again in 2009. As such, MW's report suspects that falsifications have been made. Checking against information made public, the report's claim that "the total revenues announced by some companies are too close to the transaction figures announced by ONP" rings true.

This reporter has made special effort to find out more about one of the companies that newly made the major customer list in 2009 (within the Top Three). This enterprise has publicly announced revenue of about 40 million yuan (US\$5.9 million) in the most recent year, but in ONP's financial report, their transaction with the company is almost close to the 40 million yuan (US\$5.9 million) figure. "I can only say that we did cooperate with ONP, and from what I can recall, the first half of the year we had transactions amounting to about 10 million yuan," (US\$1.5 million) the representative from this firm told the reporter.

### **"The Biggest Raw Material Supplier"**

In the upstream chain, this reporter discovered that a company named "Xushui County Dongfang Trading Co. Ltd" (henceforth termed Dongfang Trading Co. Ltd), according to ONP's financial report, this company, with a (Chinese) name similar to the Company's, has been ONP's largest raw materials supplier since 2006.

In the three years from 2007 through 2009, this company's supplier share is at levels of 53%, 50% and 37%, respectively.

Information shows that this company was established in 2001, registered at Xushui County AIC, and its main business is waste material collection. In the application information provided in the early stages of start-up, the company registration address contained five houses located in "Xushui County Nan He Shou Ying Village West", and it also comes with lease contracts signed with the village committee.

This company's initial registered capital was 500,000 yuan (\$60,500 at the time), with two shareholders. The first shareholder was Liu Zhen Yong, the second was Li Chen. Li Chen once was a Director of ONP but resigned from the post in 2009. In ONP's published documents, his drawn salary from ONP was US\$4,826 in 2008 and US\$4,093 in 2009. Li Chen now holds 201,164 ONP shares, which is 1.1% of shares offered.

Not long after Dongfang Trading Co. Ltd was registered, the legal representation was transferred from Li Chen to a man named Li Jian Jun and equity rose to 500,000 yuan. From what this reporter understands, Li Jian Jun is a native of Xushui. Also, Dongfang Trading Co. Ltd and the HBOP factory address are in the same place in Nan He Shou Ying Village.

"Dongfang Trading Co. Ltd in the most recent two years almost doesn't have any revenue," the aforementioned tax bureau insider informed me, "It's just like a shell company."

"My ownership was withdrawn in 2004," Liu Zhen Yong responded. During our conversation he did not elaborate much, throwing out utterances such as "Li Jian Jun comes from Beijing", "This is a Beijing company", and "Apart from this company, we have suppliers from other places such as Beijing."

With regards to these troubles caused by the company's listing, he firmly believes that "Some people have ulterior motives."

According to the AIC information, even before the three-year financial review to get listed on AMEX, Liu Zhen Yong's paper manufacturing plant has announced close to 100 million yuan (US\$15 million) output value for several years running, and is recognized by the government as a "key enterprise", an honor that is bestowed only upon enterprises with taxes of more than one million yuan (US\$150,000). For many years, this enterprise is considered a famous "high energy consumer" enterprise in that region.

ONP announced on 20 July that they have already hired an American law firm to work closely with the independent audit committee announced on the 16<sup>th</sup>, to jointly review this incident caused by Muddy Waters.

**As of the publication date of this report, Muddy Waters, LLC (possibly along with or through our members, employees, and / or consultants) has a short position in the stock (and / or options of the stock) covered herein, and therefore stands to realize significant gains in the event that the price of the stock declines. Following publication of this report, we intend to continue transacting in the securities covered herein, and we may be long, short, or neutral at any time hereafter.**

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