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China investors angry at mud-slinging

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The production line is a whirring mass of rollers, wheels and pipes, monitored by men at computer panels. Forklifts zip about a storeroom carrying vast rolls of paperboard. This is the factory of Orient Paper, a US-listed company that Muddy Waters, the short seller, attacked two years ago as a virtually worthless fraud.

Orient Paper was the first of the eight companies targeted so far by Carson Block, whose Muddy Waters outfit shot to prominence in 2011 when its claims of fraud felled Sino-Forest, a Toronto-listed Chinese forestry company that once had a $4bn market value. Since then, Mr Block's reputation has become so established that his views are headline news and often send targets' share prices plunging.

"There are no companies on which we have written where we have made mistakes," Mr Block told the Financial Times. "We really dig into these companies."

His seven reports on Chinese companies have all alleged fraud. But not all of his targets have collapsed, nor has wrongdoing always been proved. That has angered investors and managers whose businesses suffer lingering suspicion.

"From an emotional standpoint, you not only want to sue the shorts but do something worse like break their legs," says Drew Bernstein, co-managing partner of Marcum Bernstein & Pinchuk, a US auditor with a Chinese practice and chairman of Orient Paper's audit committee.

"There's a big leap between a company that willingly misrepresents its numbers and companies that make bad decisions. Shorts would like to obscure that difference," he adds.

Mr Block's reports have raised a deep question about whether investors knew what they were getting when buying into Chinese companies. Yet the fact that some companies remain active, even thriving, long after being targeted by Mr Block gives rise to the opposite question: are short sellers sometimes just as likely to get it wrong in their quest for profit?

In Orient Paper's case, Mr Block in June 2010 challenged the use of almost $28m that the company said it had paid for a new production line for corrugating medium paperboard.

The report stated: "We believe it is more likely that there have not been (nor will there ever be) any such equipment purchases; and thus almost the entire amount of money has been misappropriated."

This month, the FT visited the company's factory in Xushui, a quiet town about a two hour's drive from Beijing. Without advance warning, an FT reporter tried to walk on to the grounds. After being detained for 15 minutes by a security guard, Orient Paper granted access.

In the storeroom, rolls of paperboard - the weights marked on them reaching 1,200kg - were stacked three or four high. Forklifts were moving some to a flatbed truck. Next door, puffs of steam were rising from the corrugated medium production line, which ran for about 220 metres, the length of two football fields. It appeared to conform to the company's public disclosures.

Muddy Waters' most recent target is Olam, a Singapore commodities trader, which has fought back more vigorously than his previous victims, launching a libel action in Singapore.

Short sellers are notoriously secretive about their positions, which often involve shares, debt and derivatives, and even more reticent about their profits.

At Olam, shares on loan jumped this year from about 5 per cent in May to a peak of more than 13 per cent in late November, according to Markit Securities Finance. By that time, the cost to borrow was very high, about 7-9 per cent on an annual basis, according to market participants. Were someone to have built a short position of 5 per cent of Olam's outstanding stock worth a notional S$200m ($165m) from mid-November, when Muddy Waters launched his attack, and to have closed it out by December 10, they would have made a profit of about S$25m.

Short sellers operate in various ways. Many work behind the scenes, either encouraging journalists to ask questions or writing letters to auditors and regulators in the hope that any action they take will produce the desired results.

"Carson does good research, he's a hard worker," says Andrew Left, who has been writing about what he sees as fraudulent and overhyped stocks since 2001, most recently as Citron Research. "Just because stocks don't go down right away, sometimes people want to discount your work."

Not all China short sellers began with the intention of bringing down companies. Dan David of GeoInvesting, a research website, profited from the wave of enthusiasm for Chinese companies in 2009, and initially wanted to prove Mr Block and his fellow shorts wrong.

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On looking more closely into Chinese companies, Mr David raised issues he found with managers and bankers, but received little interest. At that point he decided to go short himself, but says he still sees exposing wrongdoing as a duty. He respects the work of Muddy Waters but notes the firm is now only after profitable big game. "He won't go after stocks starting at three or four dollars. A fraud is a fraud."

In July, Muddy Waters turned its attention to China's booming education industry. It alleged that New Oriental Education and Technology Group, the country's largest private sector training company, was using accounting tricks to inflate its profits. Muddy Waters concluded: "It is probable EDU [the New Oriental ticker symbol] will restate earnings, and probable that Deloitte [its auditor] will resign."

Almost six months on, US-listed New Oriental has not restated its earnings, Deloitte has not resigned - and the company's shares are now about a third higher than they were when Mr Block published his attack.

Business at its schools is humming. On a recent evening, hundreds of young students filed into a Beijing-based training centre for after-school classes, receiving extra tuition in English, maths, even Marxist theory - anything to give them an edge in the hyper-competitive Chinese education system.

Muddy Waters said New Oriental was selling franchise rights but then counting all the franchisee's revenues and students as its own. Louis Hsieh, chief financial officer of New Oriental, says Mr Block had misrepresented its business model by focusing on one small subsidiary brand and extrapolating to the entire company.

"You must take a huge leap of faith to buy what he says but he makes it sound so convincing, the way he writes it in such a harsh tone," he says.

Many Muddy Waters reports dwell on the differences between audited accounts and company filings to China's State Administration of Industry and Commerce, which are often incomplete and are not vetted by auditors.

The Chinese filings are in effect business registrations and companies have historically seen little reason to help their competitors by filing detailed information.

Orient Paper has had a harder time than New Oriental. Its share price is still languishing almost 80 per cent below its level before the Muddy Waters report. It announced a probable settlement of its Muddy Waters-related shareholder lawsuits in June, two years after the initial attack, for $2m.

Part of the power of the Muddy Waters report came from its photographs of the Orient Paper factory's shoddy equipment next to pictures of its competitors' gleaming facilities. The dated machinery is still housed in one section of the factory, but it is being phased out.

"This is how [investing] is supposed to work," Mr Bernstein says. "You go into a healthy business that's undercapitalised and you capitalise them so they can take advantage of an opportunity. The company did exactly that. It doesn't look like a US factory, but neither does the town it's in look like a US one."