



## THE CURIOUS CASE OF HARBIN ELECTRIC

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Much ink has been spilled over the controversy surrounding Harbin Electric (Nasdaq: HRBN). Ostensibly billed as a Mainland, China manufacturer of linear, industrial and specialty motors, Harbin is virtually one of the last-standing Chinese RTOs (reverse takeover) still trading in the double digits with a healthy market cap (last price, \$16.50, or \$518 million).

Beginning last fall with the downfall of RINO International (RINO.pk) and culminating in an almost daily perp walk of small cap Chinese RTO earlier this year, dozens of high-visibility, well-covered Chinese RTOs were exposed as frauds. The level of duplicity ranged from outright fantasies (China-Biotics (CHBT.pk) comes to mind as an especially colorful one) to mind-bogglingly complex corporate charades designed to loot shareholder assets (think secret loans and side-pocket agreements, ala Puda Coal (PUDA.pk) to run of the mill restatements (Fuqi International anyone?). While only two reached into the billions, Longtop Financial (LGFTY.pk) and Sino-Forest (SNOFF.pk), most of these charades were pulled off with the idea of looting low-end, eight figure sums from unsuspecting US-based investors.

What do all of these frauds have in common? The bald impudence of drumming up profitable financials out of thin air – in short, cloaking niche businesses, old factories, small operations, in the guise of large, well-oiled, highly efficient profit machines. The schemes were aided by armies of accountants, lawyers and ordinary clerks, at worst willing to cooperate actively, or at best willing to turn a blind eye to concocting outright lies. With the language barrier for ordinary Americans coupled with the 6,000 mile difference between New York City and Beijing, the average investor just could not comprehend that these frauds were out-and-out concoctions of crap. Without realizing that these Chinese businessmen lacked a strong cultural aversion to lying, the desire to make a “killing” in Chinese growth stocks ensured an endless stream of willing buyers to pony up billions in primary stock offerings for purportedly cheaply valued, high growth potential deals, peddled by the likes of Roth Capital, Rodman & Renchaw, etc.

Investors, like herds, ultimately respond to stimuli. When said investors start getting stung with 90%+ losses upon owning a fraudulent security, behavior changes. Over a period of months the herd panicked, stampeding out of all RTOs that were tainted by anything Chinese. A scan of those securities that still trade today turn up symbols



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by the handful, trading in \$1, \$2 & \$5 price tags, with most carrying market-caps well below \$100m.

Yet Harbin stands at \$16 and change, almost exactly where it was quoted in the beginning of September 2010 before all the carnage took place. Its' not for lack of detractors – over the past 90 days numerous short-sellers have picked over Harbin's operations and financials, providing evidence beyond a reasonable doubt that at the very least Harbin is being untruthful with its' investors as to its size, scope and profitability of its' business.

The latest to bring out the evidence this morning is Alfred Little. A noted Chinese short seller, Alfred meticulously documents conversations his investigator has with the Chinese official in charge of land sales in Xi'an, proving beyond a reasonable doubt (in my mind) that Harbin lied in its most recent 10-Q filing regarding a purported multi-million dollar land purchase.

For many quarters Harbin had been reporting usually large profit margins and net income. Yet its cash flow has historically been negative – leading it to borrow copious sums of money from an assortment of Chinese State-owned banks. If you believed the profits were fictitious where could Harbin have been hiding the cash? According to Little they pulled a page out of Sino-Forest's playbook and plunked down a \$23 million deposit on a \$38.8 million land purchase, purportedly to house a giant new factory in the outskirts of Xi'an. (Read the full report [here](#))

When you put out deceitful financials and report fictitious profits, you must account for the cash somewhere. Amongst the Chinese RTO frauds, there have historically been two approaches. Some of the frauds would report continuously building cash piles (Longtop Financial is a prime example of this strategy) over many quarters. The downside to this approach is you must continuously string accountants along with fictitious bank statements, while in theory said auditors should be able to uncover such fraud by simply contacting the right people at the bank to confirm or deny your statements.

A better way to pull off the fraud is to hide the profits in purchases of fake assets. It a lot harder for an auditor to discover that the factory you've built for \$75 million only cost you \$15 and change. The story gets even more opaque when you claim tracts of land at valuations that at face value sound legit. While the whole story hasn't come out on Sino-Forest, that seems to have been the modus operandi in place over there. And



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if Little's work is to be believed, that is exactly what has occurred at Harbin Electric.

In Harbin's 10-Q the land purchase is described as follows:

On June 10, 2011, Simo Motor entered into a land use agreement (the "Simo Land Use Agreement") with Xi'an Lintong Tourism and Business Development Management Commission ("Xi'an Lintong") with respect to Simo Motor's use of 500 Chinese Mu of land (approximately 82.4 acres or 333,500 square meters) located at Daixin Industrial Development Zone in Xi'an Lintong (the "New Site"). Pursuant to the Simo Land Use Agreement, the New Site will be used for construction of a new manufacturing facility that will produce electric equipment and machinery and related products as part of a capacity expansion project at Xi'an Simo. The term of the Simo Land Use Agreement is 50 years and the aggregate amount that Simo Motor shall pay to Xi'an Lintong is approximately \$38.8 million (RMB 250 million). The Company made a pre-payment of \$23.0 million (RMB 150 million) as of June 30, 2011 and will pay in full upon receipt of the land use license to be issued by the government.

At the time Harbin filed its 10-Q this land purchase stood out like a sore thumb. The 10-Q reveals cash flow from operations for the quarter of \$18.4 million. Therefore the purchase of land is certainly material. Yet Harbin never disclosed this purchase to its investors in any press release and chose to dump it within the footnotes to its' financial statements.

Would a legitimate firm hide the fact it plunked down its entire quarterly net cash flow to begin the largest expansion in the company's history? Could a land purchase of \$38.8 million, plus untold tens of millions of additional dollar to build out the factory and equipment be justified in what is ultimately a low end low margin business? Wouldn't shareholders prefer the company deploy that capital to pay a dividend or repurchase stock, especially when the stock is trading at a significant discount to the \$24 buyout price?

Alfred Little has been personally responsible for the trading halts of Puda Coal and SinoTech Energy (CTE). Citron Research directly uncovered China MediaExpress, China-Biotics and Longtop Financial, amongst others.

The company, meanwhile, hides the largest organic expansion in the company's history within Note 10 of its financial footnotes.

Who would you believe?