Bronte Capital

The sometimes eccentric views of John Hempton

Thursday, April 25, 2019

Anzac Day

It is ANZAC Day morning and I can't sleep quite right. I am going to the Dawn Service - but it isn't the same without Alice.

Alice was a war-widow who looked after me as a child, and I looked after a little in old age.

In memory, here is a post from 2009, the last time I went to the remembrance parade with Alice.

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The original ANZACs were the Australian and New Zealand Army Corps. They landed on 25 April 1915 at Galipoli in the Dardenelles for what was to become a protracted and punishing military defeat.

Australians (and New Zealanders) still commemorate Anzac Day as their national day of remembrance and with numerous dawn services, remembrance parades followed by war stories, stories about the (great) grandkids and drinking with your mates. It's a day that is both sombre and joyous, reverential and light-hearted. We remember our dead in a peculiarly Australian fashion.

Today I was privileged to go to the ceremony with Alice. Alice looked after me as a child and I return the favour in her old age.

Alice served as a nurse in the Second World War. Her first husband served in Palestine, Tobruk and possibly El Alamein – but paid with his life at the true battle for Australia – at Kokoda. (The reason I am not sure he fought at El Alamein is timeline. He may have been at El Alamein and he was certainly in Egypt but the main battle was fought at El Alamein in late 1942 and the Kokoda battles were already happening by then.)

Alice's family sacrifice did not end there – her second husband had what I suspect were continued psychological problems after New Guinea. Alice's son (Richard) served in Vietnam. (It is possible however that Alice's second husband fought at El Alamein - and she confuses which battles they fought in.)

I pushed Alice in her wheelchair at the Legacy War Widows Service in Sydney. The ranks of World War II War Widows are getting thinner – and Alice may have been amongst the oldest. She is the youngest (and one of only two surviving) of more than a dozen children. Being the youngest of many her father was not young when she was born – and – possibly uniquely – she was wearing her father's Boer War medals. The medals proudly were issued under Queen Victoria and Edward VII and showed their heads – reminding us that Australia has always fought under the auspices of the British Crown.

The ceremony was short and moving – and whilst I was pushing a wheelchair I did not feel that I belonged in the march. Other people had sacrificed much and I was a beneficiary not a victim. Still many tears were shed.

It was about an hour till the main march went through. Richard disappeared to march with his Vietnam buddies. I was left chatting with a bunch of mostly spritely women in their 80s whose husbands had died when they were 18-20. Most did not remarry though one did and the second husband died in the Korean War.

Their husbands mostly died in campaigns against the Japanese after fighting the Germans. The woman who sat next to me told me her husband served on HMAS Australia and was killed by a kamikaze at the Battle of the Coral Sea. I was surprised as I did not know that kamikazes had been used as early as the Battle of the Coral Sea (1942). Moreover it did not gel with her age as she was 18 married and pregnant when the war ended (1945) so it was unlikely that he was killed in 1942. But HMAS Australia was the victim of a kamikaze – possibly the first kamikaze and there were many

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A note on humor

I find Americans sometimes do not get a British or Australian sense of humor.

If something on this blog makes you really angry I suggest you read Swift's *Modest Proposal*... you will find the link here.

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dead. The date of that attack (January 1945) matched the age of her child. Not to quibble. She bought up a very well adjusted child as a very young widow – and she never remarried. It does talk however to how inaccurate memory is – even of very important things. Her mixed up memory matched Alice's doubt about which husband (if any) fought at El Alamein.

The march itself was charming, lighthearted, sad and poignant. And most of those things all at once.

It was led by a group of horses in full nineteenth century military regalia. After a decent interval came a man with a wheelie bin and a shovel who – to cheers from the crowd – cleaned up the horse dung.

Then came a riderless horse called Galant in lieu of any surviving veterans from the Boer War. Another riderless horse represented the First World War which was dated 1914-1918. Flags representing all Australian divisions that fought in that war were carried by serving military officers.

There was no horse and no other representation for Australia's (minor) involvement in the Russian Civil War (1919). Australia played a very small role in that war – and there were few Australian dead – but the parade did not honour them. The Australians fought in British units – though – according to this minor history at the Australian War Memorial web site Australia did send naval ships for reconnaissance.

After a decent interval came a formal precession led by Professor Marie Bashir. Marie Bashir is the Governor of New South Wales – and hence the representative of Her Majesty the Queen of Australia. Governor Bashir is I think 78 years old – but my spritely war-widow companions thought she looked young and fantastic.

Then came a large number of divisions of Second World War veterans. Some were carried in taxis, some in military vehicles, some in wheel chairs – but most marched. A few dropped out of the march to flirt with the war widows which I found hilarious and the widows found flattering. Many saluted as they went past us.

The women tended to look a little better than the men (which is not atypical amongst 85 year olds). Most colourful were the women who served in field hospitals who were dressed to the nines and all wearing gleaming (and elegant) white gloves. Interspersed were marching bands mostly provided by various high schools including my high school. My old high school (Sydney High) is an academically selective school with a history of taking the upwardly mobile children of the latest generation of immigrants. In the days that Jim Wolfenson went there it was full of Jews and other children of Eastern European refugees. It now is the children of Indians and Middle Eastern Muslims as well as South East Asians. The band filled me with hope for Australia – and the racial mix of the students in it differed dramatically from the all-white Second World War returned soldiers.

The troops went past largely in order of the campaigns they fought. Most of the campaigns I knew Australians were involved in – but there were groups that fought with Americans and other services (usually in specialised roles) that I did not know about. One example were the Polar Bears – a naval group covering arctic supply lines.

There were contingents from Korea, the Malaya Emergency and extensive Vietnam Veterans. There were small groups from the first Gulf War, East Timor, Iraq and Afghanistan.

Finally there were groups representing allies we fought with in various wars. There were for instance a small group of Dutch soldiers who were assigned to Australian Divisions after Dunkirk. There were Americans (mostly from Vietnam), Ghurkhas and other assorted South Asians. The largest group were Vietnamese who fought for the South and later settled in Australia as refugees.

To me though one of the most moving parts of the whole parade happened by fluke. We tried to find a bathroom for Alice – and a woman who worked for Legacy led us to a disabled toilet. Legacy is a charity for families of war dead – and it was Legacy who had organised the War Widows special ceremony. They have a group for the children of war dead – and – for the first time – she had organised them a place in the parade. They were led by a military truck and in the back was their oldest member – a son of a soldier who died in the Great War – and their youngest member – a son of a soldier who died in Afghanistan. I would not have understood the significance of that baby had I not met the organiser.

And whilst I am sad for the child – if I judge it by the children of the war widows I sat with then the boy will turn out OK, and in sixty five years he will still be honouring his father's sacrifice.

John

PS. I have to repeat one of the comments.

> My mother was raised in an orphanage in Brisbane run by Legacy. As far as I know, she doesn't go to A.N.Z.A.C. Day parades, but does go to the Dawn Service. The "Legacy Kids"/orphans have their own get-togethers. Every August for the past 26 years, the orphans have a re-union on the birthday of the woman who ran the orphanage. She was a Legacy employee who had lost her husband on the Kokoda Track. One of her brothers was a Rat of Tobrook (9th Division) and El Alemein veteran, who later lost an arm at Milne Bay in Papua New Guinea. Another of her brothers is buried in France, killed while flying for the RAF. After her husband died, she lost her only child. She later gave back by running the orphanage for Legacy. She touched hundreds of orphan's lives. They never forgot her. She was also my Godmother.
>
> My Grandfather was killed in Sydney during WWII while serving in the Australian Army. My mother has never visited his grave - its just too painful, even after all these years. My father has an uncle buried in northern France, a casualty of WWI's Battle of the Somme. No one from our family has ever visited his grave to pay our respects. There are many families like ours in Australia with similar stories to tell.
>
> Lest We Forget.

PPS. I have been a little perplexed by the stories told by the War Widows. They are sometimes embellished, sometimes the stories are compressed. I gather Alice's first husband fought with the 7th division. He could not have fought at El Alamein as he would have been in New Guinea by that time. Here is a history from the 7th's website. Almost all of what Alice told me (and the medals she wore) are consistent with this history - though she mixes her two husband's campaigns up.

> The 7th Division left Australia in October 1940 for the Middle East. Over the next two months, the 7th was concentrated in Palestine. It was slotted for a move to Greece to help in the defence against Axis invasion, but instead moved into defensive positions in the Western Desert. Parts of the Division under the command of Maj General Allen crossed into Syria and fought a hard won victory in the campaign against the Vichy French . 18th Brigade excelled itself as part of the defence of Tobruk.   With Japanese invasion of Australia imminent, the Division was recalled home. Elements of the Division (2/3rd Machine Gun Battalion, 2/2 Pioneer Battalion, 2/2 CCS,2/6 Fld Pk Coy and 105 Gen Tpt Coy)were diverted to Java. They fought a defensive campaign against overwhelming Japanese odds and were only forced to surrender after an early capitulation by the Dutch forces there.
>
> The Division moved to New Guinea and established headquarters in Port Moresby. The timely arrival of the Division in New Guinea helped to halt the Japanese advance.. 21st Brigade fought a bitter campaign of attrition on the Kokoda Track,until replaced by 25th Brigade who slowly forced the Japanese northwards. 18th Brigade and other Australian units inflicted the first decisive defeat of the Japanese on land in World War 11 at Milne Bay and then at Buna and Sananandа in January 1943.   21st Brigade and the militia 39tth Battalion won a costly victory at Gona in December 1942.   George Vasey took over command of the Division in October 1942, until his death in a plane crash in 1945. Major General Milford then took over command until the end of the war.   In 1943, the Division was airlifted from Port Moresby to Nadzab in the Markham Valley. After an advance on Lae, the Markham and Ramu Valleys were soon swept clear of Japanese troops. A bloody campaign in the mountains of the Finisterre Ranges followed.

Posted by John Hempton at 3:16 AM   No comments: Links to this post

Saturday, April 20, 2019

Mattel: Buybacks, Barbie and dead babies

I used to be of the view that suggested that buybacks were just another way of distributing to shareholders - a bit like dividends, selectively applied.

You could turn a buyback into a dividend by selling your own shares in precisely the proportion that the company bought shares back. Then your percentage ownership was unchanged and you would have (in cash) your share of the monies that the company distributed to its owners.

I used to think that. But it isn't quite true because companies can impair themselves with buybacks in ways that you just couldn't with dividends. Few companies support paying dividends at 2x underlying cash generation. But debt funded buybacks of this size are alas fairly common.

Debt funded buybacks, applied to their illogical limit, will corrupt you, and turn you into a gebbeth - inhabited by the debt (and its evils) you have allowed into your body.

First however I need to recount a parable about how leverage corrupts morality.

Valeant and the price of Syprine

Syprine is an old drug, out of patent for years that is a treatment for Wilsons disease. Wilsons disease is a disorder where copper builds up in your blood eventually killing you. If you take Syprine you lead a symptom-free normal life.

There are a few thousand people with Wilsons disease in the United States and as it was a minor disorder there was a single supplier of Syprine.

Valeant bought this single supplier. They cranked the price to $400,000 for a years supply and took every asset of every sufferer they could find.

Pay up or die.

Valeant instituted a patient subsidy program so that they could crank the prices to levels that no patient could afford and then drop the price (through the subsidy) to a level where they could strip every asset of every sufferer. They found precisely how much a Wilson's disease sufferer had, and they took the lot.

Valeant bought up all the raw-material suppliers for the drug so no alternative supply could make it the market. They either bought up or intimidated all the veterinary suppliers of Syprine so that veterinary supplies couldn't be diverted. Horses get Wilsons disease too but a few (hundred) dead horses were the collateral damage in Valeant's plan to extract huge rents from an old-and-out-patent drug.

Eventually this got to a Congressional hearing and Bill Ackman (the activist investor then on the board of directors of Valeant) promised to go to a director meeting and get Valeant to drop their prices on Syprine.

But Valeant didn't drop its price despite the promises of its (then) largest shareholder, because if they had dropped their prices on Syprine they would not have been able to pay their debt.

Normal people do not tell Congress they will do something and then do the exact opposite. But add in enough debt and decent people will become evil.

That is what happened with Syprine and Valeant.

In the Valeant case the debt came from buying pharmaceutical companies at very high prices. But in the case I am going to show you (Mattel) the leverage can just come from buying back stock.

And the lesson for management teams is if you buy back enough stock at the wrong price you too can become evil.

But let's start with what went wrong with Mattel.

Mattel, a toy story

Toys are not an easy business. They have a competitor: computer games. Once upon a time if you looked at Mattel it broke down into girls toys and boys toys. Girls toys meant Barbie. Boys toys meant Matchbox (cars) and Hot Wheels.

These were evergreen, growing sales year after year, decade after decade.

Then along came computer games. And boys toys in particular were hit badly. Once upon a time you could sell a Matchbox car to a nine year old. Nowadays the competition is Mario Kart, and frankly Mario Kart is more exciting.

These days the only people who buy Matchbox cars are 3 years olds and creepy 45 year old men.

It is not as if you can't grow a toy company - but the focus is generally younger and younger. Spin Master grew a large (listed) toy company from nowhere on the success of Hatchimals. A fairly large unlisted toy company was built on the success of Shopkins and other toys aimed at younger children.

With a savvy enough social media strategy you could even make a success of some traditional boys toys. Nerf is an amazing success at least in part based on a craze for making astonishingly violent Nerf War videos and showing them to legions of fans on YouTube.

But that was Hasbro. Mattel was devoid of such success.

And Mattel had some failures too. The most notable one was American Girl an iconic up-market branded doll which Mattel took downmarket (stocking in Toys R Us) and blew up the cachet of the brand.

Once upon a time you could go with your precious daughter to an American Girl shop and have her clothed and her hair cut to match the doll. It was quite the experience. Stocking in mass market shops destroyed this.

What Mattel did have however was buybacks. Lots and lots of buybacks and they kept the earnings per share on a pleasant enough path.

Mattel's buybacks

The extraordinary buyback binge undertaken by Mattel is best seen in their cashflow statement. If you want the full version I have prepared Mattel's accounts for over 20 years, standardised and as presented (courtesy of the wonderful CapitalIQ.com).

Here however is the key summary of the last few years of this binge:

Year	Buybacks ($M)
2010	447
2011	524
2012	67
2013	493
2014	177

The buybacks (plus ordinary dividends) were way in excess of available cash generated and Mattel accumulated a lot of debt.

The credit rating is now firmly in "junk" territory and is trading (slightly) distressed. The debt trades in the low 90s.

There are now no buybacks now or dividends as cash flow has evaporated.

It is hard to imagine that Mattel, owners of such staples as Barbie, could get itself so knotted, but net debt is now over $2.2 billion. And when there hasn't been a lick of operating cash flow for two years that becomes difficult.

And even Barbie is a little problematic these days. Comparing Barbie to other dolls on Amazon reveals a lack of pricing power. Indeed it seems the only place with pricing power is the collectables market (and with Barbie that means really creepy forty five year old men).

Why I am short Mattel

I am short Mattel based on seemingly dysfunctional management and too much debt. I regarded these in part as flip sides of the same problem. Too much debt meant that Mattel found it hard to take risks, to invent new toys, to hire and nurture the talent that keeps a toy company fresh.

Debt meant that Mattel had to "milk" brands, prioritising short-term cash for stock repurchase and eventually for interest payments. This led to cashing the iconic American Girl brand in for a short-term sugar hit when it was stocked in Toys R Us.

I knew management were dysfunctional. Churn in the c-suite proves it. But recent stories leave me reeling. Mattel have morphed into a truly evil company. One that kills babies.

Dead babies

The recent big news was that Mattel has recalled the Fisher-Price's Rock 'n Play sleeper. The story is well told in the New York Times.

Here is the key quote:

> When Fisher-Price agreed last week to recall all 4.7 million Rock 'n Plays on the market, it said it was not at fault for the more than 30 infant deaths the Consumer Product Safety Commission had linked to the sleeper.
>
> Instead, the company said the reported deaths stemmed from the sleeper's being "used contrary to safety warnings and instructions" to buckle babies in with the harness and avoid putting other items in the sleeper. (The safety commission advises that it should not be used once children reach 3 months or show signs of being able to roll over.)

I want you to understand how twisted this is. The company knew babies were dying in this sleeper. But the company wasn't at fault - it was the parents who used the sleeper in ways that seem obvious if contrary to instructions.

The New York Times demonstrate that the ways people used the sleeper were consistent with Mattel's advertising/promotions but whatever.

Parents bought this thing and their babies died.

And it wasn't one death. One death is an accident. At the second death you are probably wondering *"is this a product design issue"*. At the third death if you are not having serious doubts then you probably lacking basic human morality.

But this was over thirty deaths.

That is thirty families that held funerals for their baby.

I don't know what you say to parent number 17 whose child died well after it was patently obvious that this thing was killing babies.

One day I guess we will find out what Mattel will say to a jury.

But this is a moral failure truly extraordinary for a company whose key staff have to love children, understand children and design things to make children happy.

Understanding children and designing and marketing things to make children happy

But from what I hear that isn't what Mattel is about any more. Their management were once from fast moving consumer goods companies (really attuned to milking brands).

Now they are Silicon Valley/social media types (which Hasbro has shown with Nerf might be better), but they seem too focused on selling their existing characters to Hollywood.

But Hatchimals (to pick a success from Spin Master) was a toy aimed at young children designed by someone with flair and a deep empathy with the young children who are the target market.

An empathy and an understanding that seems lacking at Mattel.

The morality of short-selling

I am a short-seller, and sometimes I am betting things fail when I really hope (for society) that they survive.

I am short a very small amount of Tesla and strangely I hope I lose on that bet. Elon Musk has demonstrated that electric cars can be better than internal combustion engines. He has improved the world. I think his finances are a mess and he has other problems. But deep down I hope he succeeds. I feel slightly dirty betting against what is fundamentally a good thing.

And I felt a little dirty betting against Barbie too. After all what is wrong with a toy company?

But there is plenty wrong with this toy company. It kills babies. It fails the basic test of a toy company.

And it will probably go bust too. And it will be deserved. The world will be a better place when the toy company which doesn't love children and doesn't design things to make them happy finally fails.

And maybe the next deadly toy won't stay on the market quite as long. And there will be less grieving parents because this thing has finally filed chapter 11.

I truly hope so.

John

Posted by John Hempton at 6:15 PM 6 comments: Links to this post

Monday, April 1, 2019

Visa, Mastercard, Huawei and spying

In the days before smart-phones if I wanted to develop a ubiquitous mechanism of spying on people I would probably start with an electronic payment system that tracked everything that people bought and where.

This is not an original thought - and there is a reason why Visa and Mastercard cannot crack the Chinese market.

But the Chinese government and its (compromised or stupid) proxies in the West tell us we should open ourselves to Huawei (which provides a much better mechanism for spying).

I would normally bet that wouldn't happen - but given the quality of Western political leadership these days nothing much would surprise me.

Just making an obvious observation that I have not seen elsewhere.

John

Posted by John Hempton at 9:39 PM 9 comments: Links to this post

Thursday, February 7, 2019

A quick note on the resignations at the top of National Australia Bank

The Chairman (Dr Henry) and the CEO (Andrew Thorburn) of National Australia Bank have just resigned following criticism by the Australian Banking Royal Commissioner.

I do not know Andrew Thorburn, but I know Dr Ken Henry well and am proud to count him as a friend.

In February 2016 Jonathan Tepper (of the English research firm Variant Perception) and I spent a week traipsing around the outer suburbs of Sydney checking out property developers, mortgage brokers and even some bank branches.

It was dead easy to find widespread evidence of mortgage fraud. It was pervasive - fraud was the way of doing business. Jonathan Tepper wrote it up in a now infamous report on the state of the Australian property market.

Jonathan Tepper was widely mocked in the Australian press when our findings were published.

However the findings we had were confirmed by the evidence put before the recent Royal Commission.

For the record we found that all four Australian banks were problematic but that National Australia Bank was the least bad of a bad lot.

I went to have a chat with Dr Henry who took our findings seriously and began the (admittedly difficult) task of improving the National Australia Bank.

He was open about the difficulties in doing so, open about the incentives both within the bank and outside the bank and was cognoscente how difficult this was going to be. But he started.

I am not trying to defend National Australia Bank. It was the best of a (very) bad lot. But it was still not very good and Dr Henry started the task of making it directionally better.

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Anyway come the Royal Commission Dr Henry talked to the Commission in a frank and open way about the problems. It was Dr Henry being Dr Henry: honest, competent, and realistic.

It came off badly. I remember the grilling he got from the Royal Commission and understood what was happening. It was clear that what was required from the Royal Commission was kowtow, rather than honest frank discussion. Dr Henry looked bad even though he was probably the single most reliable and honest witness the banks put up.

The Royal Commissioner made specific findings against Dr Henry and Andrew Thornburn. This surprised me because on my research National Australia Bank was the best of a bad lot, both in absolute level of moral decay and in direction.

The Royal Commissioner I believe misinterpreted the relative honesty of National Australia Bank.

Direct criticism was made of Dr Henry and Andrew Thornburn and today they resigned.

I am not sure that any Australian banker deserved to come out of the Royal Commission unscathed, but in a relative sense injustice has been done. The most honest party at the Royal Commission has paid with their career for their honesty.

I don't think Kenneth Hayne (the Commissioner) has done the country or the cause of banking reform a good job. And that is a pity.

John Hempton

A post script is warranted: one of the key conversations I had with Dr Henry I had in the presence of Rob Shears from Valor Private Wealth.

Rob is a financial planner and a friend of mine.

He has regularly (and appropriately anonymised) told me of the financial condition of prospective clients, many of whom are loaded with inappropriate mortgages on (sometimes multiple) investment properties.

He is a very good window on bad bank underwriting.

Anyway he was in the room when I had a phone conversation.

Today he tweeted this:

> One of our clients friends is a bank manager of a NAB branch. Within 48 hours of the phone call you made to Ken a few years ago (I was in your office at the time) there were significant restrictions put on certain investor loans immediately. Ken is honest and competent.

I was unaware at the speed at which NAB acted when reliably informed of bad practices. But it confirms my impression of how NAB (and NAB alone) took our report seriously.

Posted by John Hempton at 8:44 PM 7 comments: Links to this post

Monday, January 14, 2019

The Myth of Capitalism: Monopolies and the Death of Competition. Jonathan Tepper and Denise Hearn. A review...

The Myth of Capitalism is a polemic about the reduction in competition in many industries in the US. And it starts in an entirely appropriate place.

Dr Dao - a doctor with patients to serve the next day - was "selected" by United Airlines to be removed from an overbooked plane.

As he had patients to tend the next day he did not think he should leave the plane. So the airline sent thugs to bash him up and forcibly removed him.

The video (truly sickening) went viral. But the airline did not apologise. The problem it seems was caused by customer intransigence.

They apologised after what Tepper and Hearn think was true public revolt, but what I think was more likely the realistic threat to ban United Airlines from China because of the racial undertones underlying that incident.

If a "normal" company sent thugs to brutalise its customers it would go out of business. But United went from strength to strength.

The reason the authors assert was that United has so much market power you have no choice to fly them anyway - and by demonstrating they had the power to kick your teeth in they also demonstrated that they had the power to raise prices. The stock went up pretty sharply in the end.

Oligopoly - extreme market power - not only makes airlines super-profitable. It gives them the licence to behave like complete jerks.

But what is true of airlines is true of industry after industry in the United States. Hospital mergers have left many towns with one or two hospitals. Health insurance is consolidated to the point where in most states there is only one or two realistic choices. Even the chicken-farming industry is consolidated to the point where the relatively unskilled and non-technical industry makes super-normal profits. Tepper and Hearn have assembled many other examples.

Two other assertions lace this book. Firstly - and somewhat controversially - the authors assert that low levels of competition lead to low levels of innovation (and hence lower levels of economic growth). This is controversial because Silicon Valley produces companies with very little competition (Google for example) that are clearly innovative.

The second assertion is that companies with market power use their power both ways - firstly to raise prices to customers, but just as importantly to squeeze suppliers, especially employees.

Oligopoly and innovation

Peter Thiel (one of the anti-heroes of this book) has long argued that market power and super-normal profits are the goal of innovation and that innovative firms innovate to keep the good times rolling. And indeed this is part of the model of Silicon Valley. Thiel's receives consistent support from economists who receive sponsorship/grants/work from monopolists. Tepper suggests that these economists might be compared to prostitutes - except that would be grossly unfair to prostitutes.

I am going to add my two-bits worth here. Thiel is almost certainly right in Silicon Valley. Innovation is both the source of and funded by high-levels of market power.

But Thiel is wrong in much of the world. I live in Australia - the land of oligopolies. The Sydney business community is possibly the most conservative business community that size in the world. If you are a businessman here your job is to (largely) to milk the excessive market power that your business has in what is a small and isolated market. Disruption is to be feared and discouraged because it is a threat to the gravy train. This differs a lot from Thiel's world - but I suspect that in many industries oligopolists are innovation phobic.

Oligopoly and suppliers

Perhaps the biggest contribution this book makes to the policy debate is to examine how market power is used to squeeze suppliers and not just customers. This is - in the authors view - why in this cycle wages have not risen as the economy comes close to full employment. They just think that monopsony employers squeeze wages. They do because of market power - and because of unfair clauses in employment contracts like non-compete clauses. There is an argument for non-compete clauses where staff could walk with intellectual property - but the book notes widespread non-compete clauses in the fast food industry. *A non-compete for flipping burgers is just a mechanism that allows employers to suppress wages*.

Tepper and Hearn note that wage growth is slower in areas with few employment choices (especially areas with just one large employer in town). The rural-urban wage divide in America is - the author argue - exacerbated by this.

When you interview Trump voters in rural areas about why they voted for Trump they often state that they think the system is rigged against them. Tepper and Hearn argue that is because the system really is rigged against them.

Low prices and oligopoly

There is a form of American industry that doesn't try to raise prices. Amazon, Costco and above all WalMart are the key example.

Walmart for years used to talk in their conference calls about all the cost savings they were implementing. And analysts would want to put those cost savings into their model as earnings. Walmart would disabuse you of this. Cost savings are passed to customers.

By doing this Walmart squeezed competitors until in many places it is the only local supplier of note. But it did this by the pro-market tactic of lower prices.

This doesn't look supportive of the Tepper/Hearn thesis - except that they argue that Walmart and Amazon (but to a much lesser extent Costco) then use the considerable market power they accrue to squeeze their suppliers (especially their workers). Walmart famously pays low wages. Amazon uses veritable armies of lowly paid contractors.

Market power gives licence to corporate management to behave like jerks, whether it be kicking in the teeth of their customers (United Airways) or paying their workers poverty wages (Walmart).

The Costco counter-example

Costco is almost the only company in this book that comes off well. Sure they win by having lower prices - but they also win by having well paid and happier workers (and much lower staff turnover). Costco management are not jerks. And in that they provide a decent counterexample to management described throughout this book.

But even Costco squeezes suppliers. This example is recent and not in the book. Costco is entering the business of breeding chickens for meat - and it is doing it in a spectacularly large way. Obviously this is not core business. But they came up against the chicken meat oligopoly (discussed in the book) and Costco thought they would win by disrupting their oligopolistic suppliers.

An angry book is not much use to me

Tepper and Hearn have written an angry book. It is angry at the regulators that have allowed non-competitive mergers to happen. It is angry at politicians and lobbyists in the pocket of supernormally profitable corporations.

The solution to the problem in capitalism according to the authors is more capitalism. They want more entrepreneurism, less barriers to entry in companies but also they want regulators to view skeptically (and stop) anti-competitive mergers. They endorse measures against tech companies that stop them leveraging monopolies on one sector into monopolies in another sector. They would have endorsed the break-up of Microsoft into an operating system company and an applications company.

They provide a reasonable agenda for a market-friendly politician or regulator who believes in competition and doesn't want to be on the lobbyist tit.

All well and good but I have no use for their anger. I am not a regulator or a lobbyist or a politician. And there are plenty of other things in the world to be angry about.

But that doesn't mean I regret reading the book. I don't. I am a hedge fund manager and my job is to make money for my clients.

And the simple question I ask about a book like this is "will it help me make money for my clients".

In this case the answer is yes.

It gave me a few direct clues on how to make money. But I am not going to tell you those. Read the book.

But it also gave me some useful analytical tools which I will use fairly regularly. That I demonstrate by example.

French fries and (economic) freedom

Lamb Weston - the world's biggest marker of french fries is a minor obsession of mine. Margins have crept up and are now over 17 percent. If you go back 20 years (well before the company was spun out of Conagra) the company business faced gluts and made losses.

Profitability has been rising for years. Operating margins are now two thirds of Apple. But Apple do cool sophisticated and expensive stuff for those margins. Lamb Weston processes and distributes potatoes.

The business used to be cyclic. There is an article in the New York Times in 1997 about about a glut laying waste to the industry.

But it doesn't look like that now - and it hasn't for years.

The market values Lamb Weston at 3.4 times sales. [Ratio is (net debt + market cap)/revenue.]

By contrast Apple - a company that has huge market power and very fat margins - is valued at 2.9 times sales.

To me this looks absurd. The market values wholesale sales of french fries considerably higher than it values Apple's sales.

Apple does a huge amount for its sales. They develop and manufacture sophisticated and groovy devices with sophisticated software. They have redefined corporate cool. And they smell hyper-profitable.

Except that buying potatoes cutting them into french fries, par cooking them, freezing them and distributing them to fast-food chains is valued more highly by the market. (Again my measure is EV to sales but this is true by most measures...)

And it is not as if french fries are high growth either. They grow low single digit - and there are good reasons (mostly health) as to why that should slow too.

I have to ask myself why shouldn't I short Lamb Weston. Surely competition is going to rip those margins lower at some point.

Tepper and Hearn provide one explanation as to why I should not put on the obvious trade - oligopoly.

And it is pretty clear that they are right. French fries is a super-profitable business.

In conference calls Lamb Weston signal extremely modest expansions in capacity. It is like the many companies who signal in conference calls that they are happy with their market share. *They are of course signalling that they are not interested in a price war*.

Of course an oligopoly is vulnerable if someone well funded wants to enter the industry. And in a country with true economic freedom that shouldn't he hard. There isn't anything spectacularly technical about making french fries.

That the margin has stayed this high (and indeed grown) is a signal of a lack of economic freedom. Nobody seems able or willing to break the french fry oligopoly - and that has to be in some sense political.

We shouldn't call them "freedom fries". May I propose "economic oppression fries". It seems more accurate.

The politics of the french fry oligopoly

French fries it seems are absurdly profitable. The return on assets is in the teens (which seems kind-of-good in this low return world). Margins keep rising and yet there is no obvious emerging competition.

It may be a good investment even though it looks pretty expensive. But if competition comes Lamb Weston could be a terrible stock.

There has been plenty of consolidation in this industry. Sure many of the mergers shouldn't have been approved by regulators - but they were - and the industry has become oligopolistic.

But this is not a complicated industry - it is not obvious why competition doesn't come.

Bluntly I really don't have a clue what keeps the competition out.

It could be regulation (and captured regulators). It might be the farmers don't want further entries.

Whatever there is not much policy ground for lowering the cost of french fries. They don't exactly meet public health objectives.

Tepper and Hearn would argue that the oligopoly is used to suppress payments to suppliers - and the main supplier here are Idaho farmers. Usually they would be pretty good at lobbying. But there is another possibility - which is that the oligopoly is super-strong - and some of the excess profits are used to pay over-market prices to the farmers and maybe the farmers have (in their own interest) chosen to lock up the industry with regulation (and lobbying).

This is the sort of thing that is never spelled out in the accounts. After all if the company makes its profits by screwing the public it isn't going to tell you. [Unless they are United Airways who are just jerks.]

So without a detailed knowledge of the politics of rural Idaho I can't really analyse this situation. But hey - after reading this rather good book I know the questions to ask.

If anyone is really familiar with this oligopoly (particularly any potato farmers) I would really love to talk to you.

Till then I will just try to find another interesting book to read.

John

Posted by John Hempton at 11:28 PM 22 comments: Links to this post

Wednesday, November 28, 2018

Afterpay: a regulator view

The Australian Securities regulator (ASIC) has come out with a long review of buy-now-pay later arrangements in which it has decided to ~~do nothing~~ monitor the companies going forward.

This is perceived by some as very bullish for Afterpay. The stock is up fairly hard as I write this.

Afterpay (ASX:APT) is the big player in this industry and a cult stock and cult product amongst Australian millennials. There are several other players and ASIC's study covered six of them.

ASIC does not have a reputation as an aggressive regulator so that they are monitoring the company going forward is the expected result.

But the ASIC report (available here) does give some insight into Afterpay.

Here are a few extracts:

First an example of underwriting:

> **Case study 1: Debts on top of further debts**
>
> Vicki was in her early 20s and a mother to three preschool-aged children. She was unemployed but received Centrelink payments.
>
> Vicki had multiple payday loan debts totalling $4,000 and a $9,000 car loan. Vicki also had a $1,000 debt to Certegy Ezi-Pay that had been referred to a debt collector and several telecommunications and utility debts.
>
> Vicki explained that she then incurred a $740 debt to Afterpay to buy goods at a butcher and several clothing stores

Note that Afterpay is the last lender here and lent after a previous debt had been referred to a debt collector.

And another underwriting example:

> **Case study 3: Sold goods that the consumer didn't need**
>
> John received a carer's pension. He was cold-called by a merchant who sold him a solar power system financed through Certegy Ezi-Pay. John said he did not have a job at the time and the salesperson said that he would write down John's last job. 18 months later, he owed over $6,100. John also owed over $7,000 on a loan and $3,000 in other debt.
>
> John said he started using Afterpay in early 2018 and now owes them $960. He said he doesn't recall being asked about his expenses when he signed up for this arrangement.

Note again Afterpay is the last lender.

And another underwriting example:

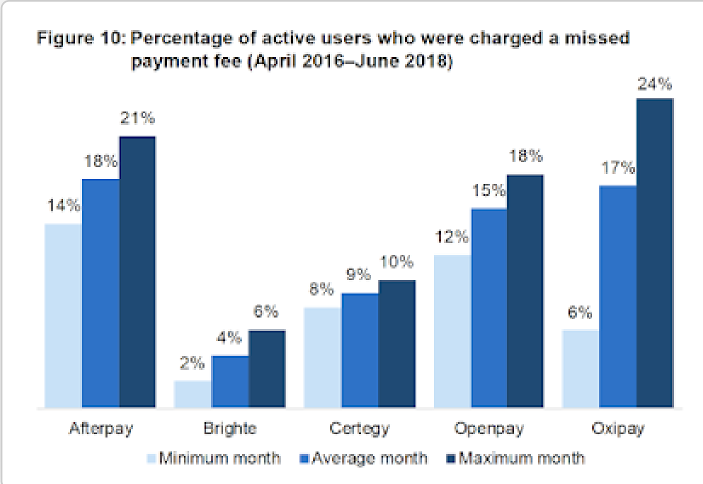
> **Case study 4: No inquiries about the consumer's financial position**
>
> Ben was unemployed, received a disability support pension, and lived with his father who assisted him as a carer. Ben said he had a shopping addiction.
>
> Ben reported feeling overwhelmed with debt. He had a $5,000 credit card debt, and he was able to accrue a $1,500 debt with Afterpay, and a $1,000 debt with zipMoney.

In this case Afterpay lent after the consumer was clearly in trouble. But they may not have been the last lender.

Afterpay - the worst lender in the group

Afterpay is considered the gold standard in this sector. It has the most highly valued stock. I have asked several bulls and they all tell me how much better Afterpay is than the competition.

But ASIC have the numbers. Here is a graph of the percentage of Afterpay customers who incur a late fee versus the competition. **It sure looks like Afterpay has the worst credit quality.**



All I can say is that ASIC have helped out researching a controversial stock.

John

Posted by John Hempton at 11:03 AM   8 comments: Links to this post

Monday, October 15, 2018

Schadenfreude: reposting a 2011 post on Sears

I posted on Sears in 2011.

They finally filed bankruptcy.

I am surprised it took that long.

Here though is the post again. It reads okay.

We have been short Sears Holdings, publicly, albeit in small quantity. Being summer in Australia I did not even look at the market for the last couple of days - but got into work for some congratulatory emails as Sears stock is off very hard on an announcement of truly awful sales, the closure of 100 to 120 stores and $1.6 to $2.4 billion of non-cash charges. (More about the charges later on.)

I look pretty smart putting a Sears short on in November - and kudos is gratefully accepted but undeserved. I was short Sears at my old firm when the Eddie Lambert controlled K-Mart took them out for considerably more than they were worth. It was not the only time that happened to me

- but multiple stabs don't dull the pain. I would gladly swap kudos for a refund of my then clients' money.*

The premise for owning Sears was property liquidation. The company owned many of its sites - sometimes on book at low historic values reflecting the company's long and once glorious history. Eddie Lambert and his merry-men were going to extract that value through selective store closures and super-profitable liquidation. Sears was an awful retailer (there was little doubt about that) but it was - they thought - a good property play.

My view: owning Sears as a property play is a demonstration of the arrogance and breathtaking naivete of much that passes on Wall Street. Sears Holdings has over 300 thousand employees. I don't know how you successfully liquidate a business integrated with that many lives. I don't know of anyone who has ever successfully liquidated a business with that many employees.** I am not sure it can be done and it certainly can't be done by someone with my skill-set (highly analytical, ability to spy value or value traps but no people management skill and not much tact).

The idea that Sears was going to be managed/liquidated by a bunch of hedge fund guys (people like me) well - that was comical.

Just to stress the point for my fund manager friends who read accounts and have my skills (but like me are often disconnected from the businesses they invest in) I will state the obvious. The employees are living breathing people and as you pull the business apart the way you treat those people and how they think about you (and behave towards you) are critical to any value you extract in liquidation. Someone has to look these people in the eye and tell them they don't have a job. And someone has to pick-and-choose which people to fire and which to retain. And they have to do this without destroying much of the value extracted along the way. They have to liquidate the firm in such a way that the value accrues to the liquidators and not to the people who are being screwed.

I don't care what you think of the morality of that. The reality of that is that it was always going to be hard - possibly very hard.***

We are about to find out how hard. Sears is going to close 100 to 120 stores (it is vague about the number) and fire many employees. But they have not worked out which employees or even which stores. Not to sound ghoulish - but my guess is that this is going to be considerably harder than the "Sears spokesman" makes it sound. And if they can't do 120 stores without trouble then the original Sears liquidation premise was insane. This is a case of Wall Street fantasy meeting reality: eventually reality wins.

The charges and reality

The large (non-cash!) charges deserve mention. This is from the Sears release:

> [We Sears] expect that we will record in the fourth quarter a non-cash charge related to a valuation allowance on certain deferred tax assets of $1.6 to $1.8 billion

You know what that means. It means that you should not expect to earn that profit in the future. It is the admission from the Eddie Lambert controlled Sears that the fantasy is over.

The reality is unchanged: when you think of the 1950s you think of Sears. Sears was (in Main Street reality) irrelevant a decade ago. The Wall Street fantasy took a little longer to end.

John

*(**A note about Schadenfreude.**) The take-over of the old Sears by the Eddie Lambert controlled K-Mart was the second worst day of my career. The worst day was when Fred Goodwin's Royal Bank of Scotland purchased Charter One Financial. When I started the blog one of the main goals was to spell out just how atrocious Sir Fred Goodwin (the then CEO of Royal Bank of Scotland) was. The fourth post on this blog was the beginning of my "Sir Fred Goodwin death watch". I enjoyed watching him and his bank come apart. But I should not have enjoyed it. Schadenfreude is not an attractive personality characteristic and the collapse of RBS has caused real pain to a lot of innocent parties. And a Schadenfreudegasm - well that just strikes me as unreasonably indulgent. After all my clients lost money - and I should and would but cannot swap any pleasure I had for a refund of their losses.

This time though I am just accepting the Schadenfreude. My client are making money and I have no reason to feel guilty about that. Moreover I don't have to fire those employees. Unlike Royal Bank of Scotland (which Sir Fred destroyed) Sears employees were doomed anyway.

**. It is worth mentioning the GM example. GM was salvaged through bankruptcy with a couple of hundred thousand employees. But those employees were particularly trapped, the shareholders were wiped out and the Government contributed considerable money. That is what a "successful" transition for a business with that many employees looks like.

***. (Politics, employees and realism). I am a bleeding heart left-winger and naturally feel a little paternalistic to the employees being fired. However you don't need to be a bleeding heart lefty to agree with my analysis. A realist will tell that when you have 300 thousand employees your relation to them is going to be critical in running your business. Employees are "stakeholders" even if your only (moral) criteria is "shareholder value". Realism over politics is a better basis for investment.

Posted by John Hempton at 10:00 PM 3 comments: Links to this post

Monday, October 1, 2018

The last day of the quarter (Tesla edition)

Hedge fund managers who actively trade to produce profit specifically on the last day of the quarter should be treated with scorn. They are marking their book and that is bullshit.

It doesn't mean that it doesn't happen. Just treat it with the contempt it deserves.

Companies that do things to produce results on the last day of the quarter should be treated with similar scorn. Channel stuffing, shifting expenses into the next quarter and other forms of abuse lay there.

I am completely staggered by an SEC filing by Tesla today detailing an email by Elon Musk to staff. I will quote in full:

> EX-99.1 2 tsla-ex991_6.htm EX-99.1
> Exhibit 99.1
>
> The following e-mail was sent by Elon Musk to all employees of Tesla, Inc. on September 30, 2018.
>
> We are very close to achieving profitability and proving the naysayers wrong, but, to be certain, we must execute really well tomorrow (Sunday).
>
> If we go all out tomorrow, we will achieve an epic victory beyond all expectations.
>
> Go Tesla!!!
>
> Thanks for all your hard work,
> Elon

If this were a drug company I would call fraud. Channel stuffing is just too easy.

But this is a car company and channel stuffing doesn't work so well.

I am wondering (comments please) on just what Tesla could possibly be doing on a Sunday, the last day of the month, to produce the result Elon desires?

John

and hat-tip to Jaguar Analytics for pointing out the filing...

Posted by John Hempton at 10:38 PM 27 comments: Links to this post

Monday, September 17, 2018

Crypto Pot Stock

There is a point in the cycle when it is impossible to separate comedy from stock promotion.

Examples in the past:

- China Agritech (a fraudulent organic fertiliser company) once stated their product involved nano-honeycomb embedding technology and microelement deep complexing. Organic fertiliser of course equals manure. So this was some high-tech shit.
- SEFE Inc (which has also gone to zero) told us they could generate electricity for the grid from the phenomena of atmospheric corona discharge by a proprietary collection element held in the air by a balloon.

But now the promotes are crypto and marijuana. So I give you this from a genuine promotional email. I could not make this up. Needless to say I do not recommend buying this stock.

ATTBF Is The ONLY Cannabis-Crypto Stock
YOU Need To Watch On Monday!
Dear Fellow Traders,

My New “Crypto Pot Stock” Alert for Monday is: ATTBF

ATTBF Joins The Crypto Revolution!!!

‘Cannabis + Crypto.’ The two single HOTTEST Sectors of the Market right now.

ATTBF is now merging the two together, and the windfall could be tremendous.

On Feb 1, the company announced the Acquisition of a 49% Stake in CannaNUMUS Blockchain Inc. - developers of a cryptocurrency which will represent the performance of a suite of portfolio cannabis companies.

“With a 49% equity stake in this blockchain platform, Abattis could see a significant upside from any CannaNUMUS liquidity event, including a reverse take-over of CannaNUMUS or an ICO,”

Yes, there are already Marijuana-based CryptoCurrencies. And while none are especially noteworthy, it's worth mentioning that CANN(CannabisCoin) has seen 20,000%+ GAINS and now boasts a $5.5 MIL Market Cap, POT (PotCoin) has seen 3,300%+ GAINS and enjoys a $35 MIL Market Cap, and THC (HempCoin) has seen a monsterous 114,000%+ Gain with a $28 MIL Market Cap!

Needless to say, ATTBF is in good company!

John

Posted by John Hempton at 5:59 PM 7 comments: Links to this post

Wednesday, September 5, 2018

Thinking aloud about China Biologic Products

There are stocks which you never get right - and where the facts and history is just so ambiguous that you don't think you will ever get them right.

China Biologic Products (Nasdaq:CBPO) is one of those that leave me perplexed. It is a blood processor in China with a strange political and arguably unsavoury past followed by years of spectacular performance and a few failed takeover bids.

I am short. And I think now I have probably made a little money - but hardly enough to justify the stress I have gone through. And after all this time I am still far from sure what the underlying reality is.

So I will lay out what I know and what I think I know.

The creation of China Biologic Products and the arrest and imprisonment of Dr Du

Australia has a long history in blood processing to provide antivenoms and technical blood products and has produced a global-giant product in this space - CSL. Dr Du was a Melbourne based Chinese heart and lung surgeon with good knowledge of this technology who moved to China to start a blood processing business which was by repute not very large, but modestly successful.

It didn't end well for Dr Du. He was arrested and charged with embezzling a couple million yuan from the company (the accuser was his business partner) and the business was stripped from him. He spent six years in prison. You can find an abbreviated version of the story here.

There is some evidence that these charges were trumped up. And they were not over a lot of money in the scheme of things. The amount of money was USD360 thousand. *This is not how a giant and successful business usually changes hands*.

The reverse merger of China Biologic Products

China Biologic Products came to market by the most suspect of methods - a reverse merger - at the height of the China reverse merger frauds. The material here looks really damming. Here is the first 10-K filing by the company as a Chinese company.

> China Biologic Products, Inc. was originally incorporated on December 20, 1989 under the laws of the State of Texas as Shepherd Food Equipment, Inc. On November 20, 2000, Shepherd Food Equipment, Inc. changed its corporate name to Shepherd Food Equipment, Inc. Acquisition Corp., or Shepherd. Shepherd is the survivor of a May 28, 2003, merger between Shepherd and GRC Holdings, Inc. or GRC. In the merger, the company adopted the Articles of Incorporation and By- Laws of GRC and changed its corporate name to GRC Holdings, Inc. On January 10, 2007, a Plan of Conversion became effective pursuant to which GRC was converted into a Delaware corporation and changed its name to China Biologic Products, Inc...
>
> On July 19, 2006, we completed a reverse acquisition with Logic Express, whereby we issued to the stockholders of Logic Express, 18,484,715 shares of our common stock in exchange for 100% of the issued and outstanding shares of capital stock of Logic Express and its majority- owned Chinese operating subsidiary, Shandong Taibang. As a result of the reverse acquisition, Logic Express became our 100% owned subsidiary and the former shareholders of Logic Express became our controlling shareholders with 96.1% of our common stock. Shandong Taibang became our 82.76%- owned indirect subsidiary and is the operating company for all of our commercial operations. Shandong Taibang, is a sino-foreign joint venture company established on October 23, 2002 with a registered capital of RMB80 million (approximately $10.3 million). Upon the closing of the reverse acquisition, Timothy P. Halter, our sole director prior to the reverse acquisition, submitted his resignation letter pursuant to which he resigned from all offices he held and from his position as our director, effective immediately. Siu Ling Chan and Lin Ling Li were appointed as our directors at the closing of the reverse acquisition. In addition, our executive officer was replaced by the Logic Express executive officers named herein at the closing of the reverse acquisition.

There is a fair bit to unpack here. The listing was a standard enough reverse merger into Shepherd Food Equipment Acquisition Corp. You would like to find something out about them but they were an utterly delinquent filer. SEC filings don't exist.

And the core business wasn't China Biologic Products (that name came later). It was Shandong Taibang. Moreover they only owned after the merger 82.76 percent of it. The other 17.24 percent was owned by an undisclosed party. That party will be explored later in this note.

Finally the vendor of the shell was Timothy P. Halter. He was ground zero for literally dozens of disastrous Chinese reverse mergers as per this 2011 Reuters article.

The entity actually reverse merged into China Biologic Products was called Logic Express, a British Virgin Islands Company. I do not know how Logic Express acquired Shandong Taibang. The deal happened on 19 July 2006.

We know a little more about Logic Express now than when this deal happened because of the leak of the Panama Papers. Here is the link to Logic Express in the Panama Papers. Logic Express was registered on 6 Jan 2006, just over six months before it went public and originally had only two shareholders. These were Chan Siu Ling and Li Lin Ling. Three more shareholders signed up on 11 July 2006 - a mere 8 days before the company was listed.

These shareholders were granted 18,484,715 worth about $1.8 billion dollars at current price. And remember what they owned was 83 percent of Shandong Taibang - founded only in 2002 and with registered capital of about USD10 million.

The two shareholders prior to the reverse merger

The Panama Papers list only two shareholders of Logic Express from inception. They are Chan Siu Ling and Li Lin Ling. Who are they? Well let's get back to them later.

The reverse merger press release

There was a press release to announce the reverse merger. You can find the original at this link, but here it is almost in its entirety:

> SHANDONG, China--(BUSINESS WIRE)--July 20, 2006--Shandong Missile Biologic Products Co. Ltd. ("Shandong Biologic"), announced today the closing of a reverse merger transaction with GRC Holdings, Inc. (OTCPK:GRCG) ("GRC") and the closing of an equity placement by GRC and certain of its controlling stockholders raising $8.1 million in aggregate gross proceeds. Shandong Biologic is a biopharmaceutical company principally engaged in the research, production and manufacturing of human plasma-based pharmaceutical products in the People's Republic of China ("China"). GRC is a publicly-held, non-operating company with headquarters in Argyle, Texas that is in the process of changing its name to China Biologic Products, Inc.
>
> The reverse merger transaction involved a stock exchange with the stockholders of Logic Express Limited, a British Virgin Islands company ("Logic Express"), the 82.76% owner of Shandong Biologic. Upon closing of the exchange transaction , Logic Express became a wholly-owned subsidiary of GRC and the former shareholders of Logic Express acquired approximately 96% of GRC's issued and outstanding common stock immediately prior to the financing transaction described below.
>
> In connection with the change in ownership of GRC, Ms. Katherine Loh, Ms. Lin Ling Li and Ms. Siu Ling Chan were appointed to the Board of Directors of GRC, Mr. Michael Li was appointed as its Chief Executive Officer and Mr. Peter Yeung was appointed as its Chief Financial Officer.
>
> Immediately following the exchange transaction, a private placement of shares of common stock closed involving the issuance by GRC of 2,200,000 shares of its common stock at a purchase price of $1.895 per share and warrants to purchase 1,070,000 shares of common stock at an exercise price of $2.8425 per share. In addition, two of the controlling shareholders, Siu Ling Chan and Lin Ling Li (the "Selling Shareholders"), sold an aggregate of 2,080,000 shares of GRC common stock at a price of $1.895 per share to the investors including Pinnacle China Fund, L.P., who acted as lead investor in the private placement. Lane Capital Markets acted as exclusive placement agent and financial advisor and received warrants to purchase 214,000 shares of common stock at an exercise price of $2.8425 per share. As a result of the forgoing transactions, the investors collectively hold approximately 20% of GRC's issued and outstanding common stock immediately after the completion of the private placement but before the exercise of the warrants.
>
> Gross proceeds from the investors amounted to approximately $8.1 million. Part of the proceeds to GRC will be used to meet a $3.3 million capital contribution requirement that Logic Express has in Shandong Biologic. The proceeds being received by the Selling Shareholders will be placed into escrow until registration of the capital contribution with the PRC authorities is complete and, upon release, will be used primarily to repay indebtedness owed to Shandong Biologic. In the event such registration is not completed by July 31, 2006, the proceeds will be refunded to the investors and the shares purchased returned to the Selling Shareholders.
> As part of the private placement transaction, the Selling Shareholders have placed an aggregate of 4,280,000 shares of common stock into escrow. If the audited consolidated financial statements of GRC do not reflect at least $4,819,500 of after-tax net income or $5,823,465 of after-tax net income before minority interest for the fiscal year ending December 31, 2006, one-half of the escrow shares will be distributed on a pro rata basis to the investors. If the audited consolidated financial statements of GRC do not reflect at least $8,302,000 of after-tax net income or $10,031,416 of after-tax net income before minority interest for the fiscal year ending December 31, 2007, the second-half of the escrow shares will be distributed on a pro rata basis to the investors. If GRC has met the applicable threshold, the appropriate number of escrow shares shall

> be returned to the Selling Shareholders. GRC estimates the 2006 and 2007 revenues, on a consolidated basis, to be approximately $22 million and $36 million, respectively. The Company emphasizes that the foregoing revenue estimates constitute forward-looking statements, and actual results may be materially different from those expressed herein.

Again it is worth unpacking details here.

The reverse merger target was in Argyle Texas. This isn't exactly a big place. The population is a couple of thousand. It is however where the above mentioned Timothy Halter has his ranch and many of his other reverse mergers hailed from. The company traded before (and after) this transaction on the Pink Sheets.

Peter Yeung (who first turned up as a shareholder only 8 days before the reverse merger transaction) is the foundation Chief Financial Officer. But whoever Peter Yeung is he did not stay as Chief Financial Officer very long. The first 10-Q for China Biologic Products refers to Stanley Wong as Chief Financial Officer. I have tried to find out what happened to him. The best I have found is that he is Canadian educated and he handled the reverse merger as per this Bloomberg link.

The Bloomberg link also states that Peter Yeung is also known as Wai Keung Yeung. An Albert Yeung (also sometimes Wai Keung Yeung) reappears on the board in 2012 as an independent shareholder even though the lineage appears to be as a director of the pre-reverse merger BVI company.

Also in this transaction the company issued 2,200,000 shares of its common stock at a purchase price of $1.895 per share and warrants to purchase 1,070,000 shares of common stock at an exercise price of $2.8425 per share. The insiders also sold 2,080,000 shares of GRC common stock at a price of $1.895. (With the shares at about $90 that does not look like a great insider sale!)

The only named investor was Pinnacle China Fund. That is Barry Kitt's outfit. Mr Kitt is a controversial figure from the world of Chinese reverse mergers as this old Barrons piece shows. However in this case Mr Kitt's shares would be up a few hundred million dollars. Perhaps he is a great investor after all.

The final thing is that the reverse merger agreement contained a collateralised guarantee that the published accounts will show at least a certain amount of profit - at least $10 million before minority interests. Remember that the capital base of Shandong Biologic was prior only about $10 million. These are big guarantees. But they were met. However the whole thing seems a little irrational. If China Biologic could really earn that much why were insiders selling their own shares to Barry Kitt's group? I couldn't explain it.

My being puzzled

China Biologic Products looked like a classic 2011 period Chinese reverse merger promotion. There are some of the same players as many of the entities that failed during that period.

But there was one big difference. A deciding difference. And that was the business founded by Dr Du. I sounded out several people who knew Dr Du. One was a journalist who followed the story. One was a former official of the (Australian) Department of Foreign Affairs who had paid consular visits to Dr Du when he was an Australian in a Chinese prison.

All of these people described Dr Du as legitimate and the business he operated as a real and valuable operation. *This differed from some of the more egregious 2011 era Chinese reverse mergers because there was something there*.

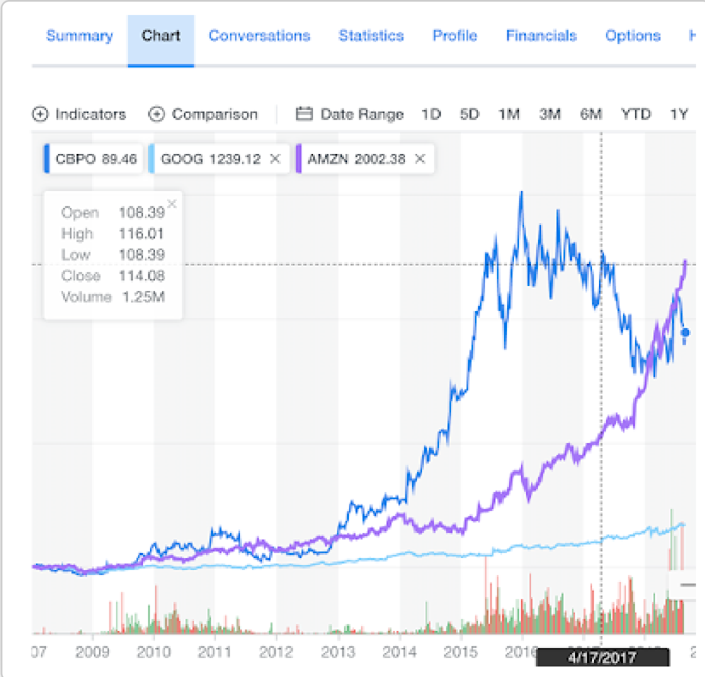
We were short it in those days. And we covered. And thank the Dear Lord we did because the stock is up over 10x since we covered.

It was always a possibility that some real Chinese companies chose to list into defunct pink-sheet shells and wind up being a fantastic business. And I guess this was that.

The recommendations I got for Dr Du and his business were universally good. This may well be a truly good business that came to the market in an unusual way.

Just how good?

Well to say China Biologic Products did well is to understate it. Here it is graphed against Google and Amazon as far back as Yahoo! has the data.



You see that - it is almost as good as Amazon, and was way better early-on. And both of those make Google look like a stock for losers. (As I own Google and not Amazon or China Biologic I am suitably chastened.)

Whatever: it is an astonishing performance.

And it is a performance reflected in the accounts. They are frankly amazing. Here are the accounts downloaded from CapitalIQ. According to the accounts this has generated substantial net cash every year and capital expenditures have never exceeded $50 million. **This company has grown like a weed and has never appeared to need external money**. On the accounts this is an amazingly good business.

The company did a few acquisitions to increase their footprint but in aggregate there were not many.

The company generated plenty of cash - but it did not pay dividends or buy back stock. Indeed they issued stock. As of the last balance sheet they were sitting on $366 million in cash and securities mostly representing past profits. Remember very little cash was ever actually deployed in this business.

Along the way there were repeated transactions with PW Medtech - a fairly illiquid Hong Kong listed company who seems to me to be functionally a related party. PW Medtech owns 5.5 million CBPO shares which is considerably more than its market cap. It has also - according to accounts and press releases received considerable cash. Marc Chan owns over a quarter of PW Medtech and 7 percent of CBPO. He may not technically be a controlling person - but he clearly has a large position. He never appears on any board though he is seemingly a Hong Kong resident operating through several BVI companies such as Parfield International.

Executives and associated people

It is hard to find career details for executives of this company - but here are a few that I have puzzled over.

Stanley Wong

The first 10-Q names Stanley Wong as CEO. You can find his LinkedIn page here. I have kept an archive of it here. The LinkedIn CVs states his role was "listing work". However he was there for ten months. He has been a director of a few companies that worked and a few that didn't. CapitalIQ for instance lists him as a former director of Blockchain Group (HK:0364). That didn't work.

Tung Lam

The first 10-K the company lists Tung Lam as the chief executive of the operating subsidiary:

Tung Lam. Mr. Lam has been the Chief Executive Officer of our operating subsidiary, Shandong Taibang, since October 2003, and is responsible for the entire operation. Prior to joining the Company, Mr. Lam served, from November 1999 to August 2003, as the vice president of Fujian Province Fei Yue Group, where he was in charge of management investment.

It also states that:

> Ms. Siu Ling Chan is the wife of Mr. Tung Lam.

You will remember her as one of the shareholders of Logic Express prior to its reverse merger. I am trying to establish if she is related to Marc Chan from PW Medtech - but have made no progress.

The 10-K also gives a CV for Ms Chan.

> Siu Ling Chan. Ms. Chan has been our director since July 19, 2006. She has been our chairwoman since January 1, 2007 and served as our CEO from January 2007 to March 2007. Ms. Chan is also currently a director of our subsidiary Logic Express. She was also appointed as the director of Shandong Taibang in April 2006. Prior to joining us, Ms. Chan worked from 1991 to 2005, as an administrator at the Fujian Academy of Social Sciences, and from 1989 to 1991 as a statistician at the Fujian Pingtan Economy Committee. She received her diploma in Statistics from Xiamen University in 1989 and a diploma in management from the Fujian Party Committee School in 2004.

The important detail is that she was educated at a Party School. These are finishing schools for elite Communist Party cadres.

In 2010 China Biologic responded to on-line claims that it was a criminal fraud. The company set up a special committee to investigate and they in turn selected O'Melveny & Myers LLP to advise them. The Special Committee report is summarised in an SEC filing which you can find here. The Special Committee squibbed on the issues associated with Tung Lam. To quote:

> Allegations Regarding Identity of Tung Lam – With respect to the allegation that Mr. Tung Lam, the Chief Executive Officer of one of the Company's primary operating subsidiaries, Shandong Taibang, and spouse of Mrs. Siu Ling Chan, the Company's board chair, was previously known as Mr. Lin Ziping and was imprisoned for smuggling in China, the Special Committee found evidence supporting Mr. Lam's denial of the allegation, as well as conflicting evidence with respect to this claim. As a result, the Special Committee concluded that it could neither confirm nor exclude the allegation.

Ze Qin Lin

The special committee did not squib on the husband of the other original shareholder of Logic Express. Here is what they have to say:

> Allegations Regarding Ze Qin Lin – With respect to the allegations that Mr. Ze Qin Lin, the husband of current CBPO director Ms. Lin Ling Li, is a former associate of Mr. Tung Lam and was imprisoned in China in connection with the same smuggling activities, the Special Committee found support for the allegation that Mr. Ze Qin Lin was sentenced to imprisonment in China in connection with smuggling offenses of Fuzhou Bonded Zone Western Industrial, Ltd.

In fairness China Biologic also has other directors and officers whose CVs seem entirely appropriate. Many are hard to trace but that is probably my unfamiliarity with the Chinese sources.

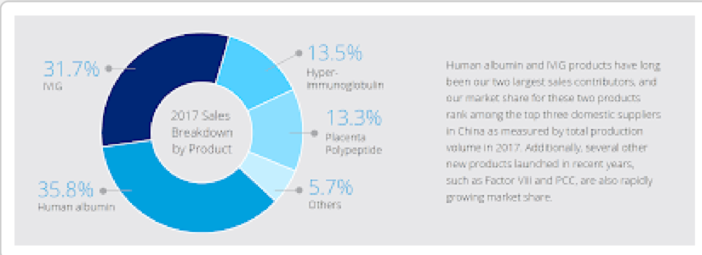
The simple product list

One of the interesting things about this company is how far and fast it has grown despite an extremely limited product set none of which are patent protected and all of which have extensive competition. There are only nine products sold in different dose forms as per this extract from the last annual report.

> We have a strong product portfolio covering over 20 different dosage forms of plasma products across nine categories, and one chemical drug, placenta polypeptide. All of our plasma products and the placenta polypeptide product are prescription medicines administered in the form of injections. Our principal products are human albumin and immunoglobulin for intravenous injection, or IVIG. Albumin has been used for almost 50 years to treat critically ill patients by assisting the maintenance of adequate blood

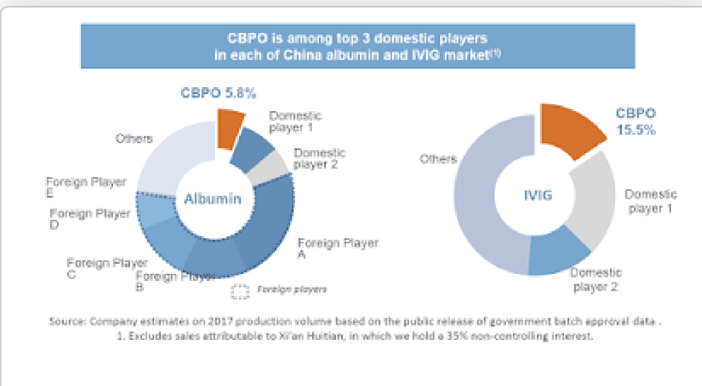
volume and pressure. IVIG is used for certain disease prevention and treatment by enhancing specific immunity. These products use human plasma as their principal raw material. Sales of human albumin products represented approximately 35.8%%, 39.2% and 37.6% of our total sales for 2017, 2016 and 2015, respectively. Sales of IVIG products represented approximately 31.7%, 34.6% and 42.2% of our total sales for 2017, 2016 and 2015, respectively.

The breakdown of sales is given in the following chart:



Human albumin - their biggest product - is the most widely produced blood fraction in the world. Intravenous immunoglobulin (IVIg) is also very widely produced. The same can be said of all nine products - things like Rabies antibodies (which regular readers will know I have had).

The last corporate presentation also makes clear that the company has a low market share - singled digit in most products. Here is the key slide.



In human albumen, their biggest product, the market share is below 6 percent.

Ignoring this company

I shorted this company in 2011 along with a bundle of Chinese reverse mergers. The aggregate trade was great - but this stock went up and I covered. I am not a sucker for endless pain.

Moreover I heard pretty good things about the business Dr Du established. And so what I had was:

a) evidence from people who knew the founder that this was a good business
b) a path to market associated with a raft of corporate failures and shareholder losses
c) world beating high levels of profitability despite low market share in commodity products
d) reams of related party transactions (especially if you regard PW Medtech as related).

All of this makes for something that interests a short-seller but I wasn't going to put my neck on the line and short a stock that was performing like Amazon without stronger evidence and a catalyst.

So I passed. I just kept a watching interest. But the right position was in my opinion to be flat. (In retrospect I should have been long - but the rectrospectoscope is 20/20.)

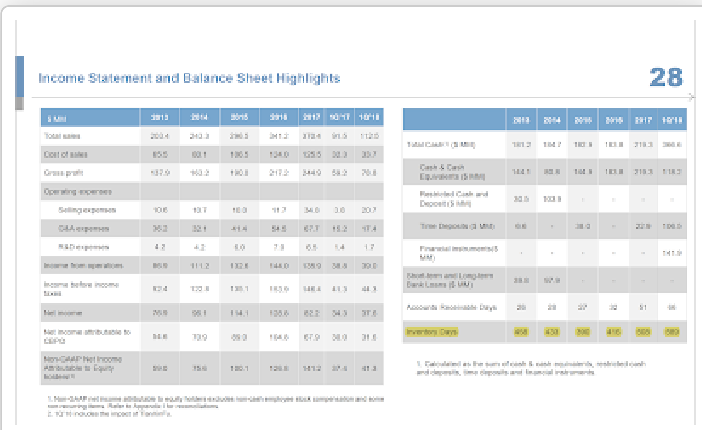
Inventories: the odd part of the accounts

There was one anomaly in the accounts - one that I kept coming back to. This company seems to have too much inventory. This is particularly pronounced in the company's latest presentation.

The presentation continuously points to supply shortages for plasma and blood products. For example take this slide which I have highlighted.

	Plasma Companies	Other Pharma Companies	Commentary
Regulatory Control	☑		China's plasma-derived products market is highly regulated by the government
Supply / Demand	☑		Significant supply shortage favors leading plasma players
Historical Pricing	☑		Prices for most plasma products have remained steady whereas the average price of many pharma products has been in decline
Domestic Competition	☑		28 active plasma product manufacturers in China vs. thousands of pharmaceutical companies
Foreign Competition	☑		Currently only albumin and recombinant factor VIII are open to imports
Sales and Distribution	☑		Compared with pharmaceutical companies, the plasma industry in China is a seller's market
Growth Visibility	☑		Growth among plasma manufacturers is primarily driven by the supply/demand imbalance

Despite repeated comments by the company of shortages the inventory days are large and growing. This slide from the same presentation shows inventory days at 589. And it is not as if there is a complicated set of products which need to be held. There are only nine products and a range of doses. Again I have highlighted the key section.



$ MM	2013	2014	2015	2016	2017	1Q'17	1Q'18
Total sales	203.4	243.3	296.5	341.2	373.4	91.5	112.5
Cost of sales	65.5	80.1	105.5	124.0	125.5	32.3	33.7
Gross profit	137.9	163.2	190.8	217.2	244.9	59.2	78.8
Operating expenses							
Selling expenses	10.6	13.7	16.3	11.7	34.6	3.6	20.7
G&A expenses	36.2	32.1	41.4	54.5	67.7	15.2	17.4
R&D expenses	4.2	4.2	6.0	7.8	6.5	1.4	1.7
Income from operations	86.9	111.2	132.8	144.0	135.9	38.8	39.8
Income before income taxes	92.4	122.8	139.1	153.9	146.4	41.3	44.3
Net income	76.9	98.1	114.1	125.6	82.2	34.3	37.6
Net income attributable to CBPO	54.6	73.9	85.3	104.6	67.9	30.0	31.6
Non-GAAP Net Income Attributable to Equity holders[1]	59.0	75.6	100.1	126.8	141.2	37.4	41.3

1. Non-GAAP net income attributable to equity holders excludes non-cash employee stock compensation and some non-recurring items. Refer to Appendix I for reconciliations.
2. 1Q'18 includes the impact of Tianfin.

	2013	2014	2015	2016	2017	1Q'18
Total Cash[1] ($ MM)	181.2	184.7	182.8	183.8	219.3	366.6
Cash & Cash Equivalents ($ MM)	144.1	80.8	144.8	183.8	219.3	118.2
Restricted Cash and Deposit ($ MM)	30.5	103.9	-	-	-	-
Time Deposits ($ MM)	6.6	-	38.0	-	22.8	106.5
Financial Instruments($ MM)	-	-	-	-	-	141.9
Short-term and Long-term Bank Loans ($ MM)	39.8	97.9	-	-	-	-
Accounts Receivable Days	20	28	27	32	51	66
Inventory Days	458	433	390	416	565	589

1. Calculated as the sum of cash & cash equivalents, restricted cash and deposits, time deposits and financial instruments.

Blood products have large inventories. You need a store for emergency, and the time, for instance, for all the tests to come back also adds to the number of inventory days. The two biggest blood processing companies (CSL, Grifols) have between 230 and 260 days inventory.

China Biologic has an extra year or it sitting around.

Some of the Chinese companies have more inventory than this - but none has close to China Biologic.

- Shanghai RAAS Blood Products Co (listed as a large competitor) has 197 days as of 30 June 2018,
- Hualan Biological Engineering has 425 days as of 30 June 2018,
- Shenzhen Weiguang Biological Products also has 425 days as of 31 December 2017
- Boya Bio-pharmaceutical Group has 229 days as of as of 30 June 2018

I have identified private companies in the space too - and all have less inventory days than China Biologic. You can find our source list here. However we count CBPO has anomalously large inventory.

I presume it is in fridges and well preserved or otherwise it would stink.

Whatever. It is hard to reconcile all those excess inventory days with the repeated claims of shortages of product.

The takeover bid and overbid and eventual share placement

Eventually the company received a go-private bid and an overbid. The first bid was from CITIC which is the government controlled Chinese private equity firm. CITIC is "Princeling Central" - the place where the children of the most powerful cadres wield their stuff.

Here was the bid. Note that it is non-binding and subject to due diligence.

> BEIJING, June 19, 2018 /PRNewswire/ -- China Biologic Products Holdings, Inc. (NASDAQ : CBPO) ("CBPO" or the "Company"), a leading fully integrated plasma-based biopharmaceutical company in China, today announced that its board of directors (the "Board") has received an unsolicited, preliminary non-binding proposal letter from CCRE Holdings Limited, a wholly owned subsidiary of CITIC Capital Holdings Limited (together with its affiliates, "CITIC"), pursuant to which CITIC proposes to acquire all of the outstanding shares of the Company not already owned by CITIC for US$110 in cash per share...
>
> The Board cautions the Company's shareholders and others considering trading in the Company's securities that the Board is reviewing and evaluating CITIC's proposal and no decisions have been made with respect to the Company's response to the proposal. There can be no assurance that any definitive offer will be made, that any agreement will be executed or that this or any other transaction will be approved or consummated. The Company does not undertake any obligation to provide any updates with respect to this or any other transaction, except as required under applicable law.

So I am still completely unsure about China Biologic Products. It may be one of the greatest companies ever (as the accounts indicate) but I can't dismiss the possibility that it is a residual Chinese reverse merger stock promote that did not fall apart around 2011. I know there is a business there - and probably a good business there - the one founded by Dr Du. But that this business has massively outperformed Google seems to me a stretch.

Anyway - I thought now I get a cheap look. CITIC would get to due diligence on this company and would find out. If they did they would either:

(a) buy it and I would lose my spread or
(b) walk away, sell their stake (possibly aggressively) and I would make some coin.

I genuinely had no idea of the outcome - but I thought the risk-reward was favourable so I put on the short.

I got a little lucky. There was a vaccine scandal in China after I put the position on. One of the tainted products was rabies antibodies - a direct competitor to China Biologic. At a minimum fairly heavy regulation is coming. Xi commented extensively and was clearly angry. And when the Supremo is angry with blood products and vaccines a risk averse organisation like CITIC buying in seemed unlikely.

Here are a few Xi quotes - as per the South China Morning Post...

> "The violations by Changchun Changsheng Bio-technology are serious and appalling," state broadcaster CCTV quoted Xi as saying...
>
> Xi also ordered the authorities to use severe punishment "to cure the chronic disease [of corruption] and scratch poison from one's bones".
>
> He told the authorities to resolutely "improve the supervision of vaccines and guard the bottom line of safety in order to safeguard public interest and social security".

I just did not think the deal would close. And for that matter nor did the market as the spread widened.

Then China Biologic received an overbid...

> BEIJING--(BUSINESS WIRE)-- A consortium composed of Mr. David (Xiaoying) Gao, GL Capital Group, Bank of China Group Investment Limited and CDH Investments (the "Consortium") today announced it has made a non-binding proposal to acquire all of the outstanding common shares of China Biologic Products Holdings, Inc. ("China Biologic" or the "Company") (NASDAQ: CBPO), that are not already held by the Consortium, for US$118.00 per share in an all-cash transaction valued at approximately US$3.9 billion. The proposal was conveyed on August 17, 2018 in a letter to China Biologic's Board of Directors.

> The Consortium's proposal represents an approximate 30% premium to China Biologic's closing share price on August 16, 2018, and an approximate 40% premium to the Company's closing price on June 8, 2018, the last trading day before CITIC Capital's proposal to acquire the Company for US$110.00 per share was conveyed. Commenting on its offer, the Consortium stated: "Our proposal delivers immediate and attractive value to China Biologic's shareholders and provides the Company the ideal partners to support its future growth. As a private company, China Biologic will have the additional operational flexibility and financial support to build on its successful track record as China's leading plasma player while navigating the current challenges facing the country's biopharma industry."
>
> "Our compelling proposal benefits all of China Biologic's stakeholders and we want to work collaboratively with the Board to complete a transaction in an efficient and expeditious manner. We also want to partner with the current management team as we take the Company forward."
>
> The Consortium has received from Goldman Sachs (Asia) L.L.C. ("Goldman Sachs") a non-binding letter indicating that, subject to the assumptions, terms and conditions in the letter and such other matters as Goldman Sachs considers relevant, Goldman Sachs is, as of the date of the letter, highly confident that as sole lead arranger, sole bookrunner and sole syndication agent, the structuring and syndication of a senior secured debt financing could be accomplished by Goldman Sachs as part of the financing for the acquisition described therein.
>
> Goldman Sachs is acting as financial advisor to the Consortium, Skadden, Arps, Slate, Meagher & Flom LLP is acting as its U.S. legal advisor, and Conyers, Dill & Pearman is acting as its Cayman Islands legal advisor.

At this point I thought I was probably toast. David Gao is a former CEO of the company and so presumably knows what he is buying. His CV is plausible though it contains blemishes. The most notable blemish is that he was on the board of ChinaCast Education - a reverse merger stock that collapsed with admitted fraud. Moreover Goldman Sachs was highly confident that this could be financed.

I simply couldn't see how I could win. But then I was puzzled because the vaccine scandal in China was growing. I could not see how the deal made sense with a wave of re-regulation coming at them.

Whatever. I was let off the hook. China Biologic rejected both bids without due diligence and took money from a consortium to finance their future growth. Here is the press release.

> BEIJING, Aug. 24, 2018 /PRNewswire/ -- China Biologic Products Holdings, Inc. (NASDAQ: CBPO) ("China Biologic" or the "Company"), a leading fully integrated plasma-based biopharmaceutical company in China, today announced that the Company's board of directors (the "Board") has received a letter dated August 23, 2018 from CITIC Capital MB Investment Limited, an affiliate of CITIC Capital Holdings Limited ("CITIC"), withdrawing its preliminary non-binding proposal dated June 11, 2018, with immediate effect. The Company further announced that the Board has unanimously decided to reject the previously announced preliminary non-binding proposal dated August 17, 2018 from the consortium (the "Consortium") consisting of Feng Tai Global Limited, a company beneficially owned by Mr. David (Xiaoying) Gao, the former Chairman and CEO of the Company, GL Sandrose Investment L.P., World Investments Limited and CDH Utopia Limited.
>
> After careful review of the Consortium's proposal, the Board has unanimously determined that it is not in the best interests of the Company and its shareholders as it did not reflect the intrinsic value of the Company and would abrogate the shareholders' opportunity to enjoy the long-term return from the Company's execution of its business strategy of growing into a leading global biopharmaceutical company.
>
> In addition, the Company announced that it has entered into definitive agreements (the "Share Purchase Agreements") for the issuance and sale of an aggregate of 5,850,000 ordinary shares of the Company, which represents 14.9% of the enlarged share capital post the issuance and is expected to raise gross proceeds of approximately US$590 million. The Company intends to use such proceeds to support its business expansion plan and strategic acquisitions. Under the Share Purchase Agreements, Centurium Capital Management Ltd. ("Centurium"), CITIC, Hillhouse Capital Management, Ltd. ("Hillhouse"), each via its respective investment vehicle(s), and PW Medtech Group Limited ("PWM", and together with Centurium, CITIC and Hillhouse, the "Investors") will subscribe for and purchase 3,050,000, 1,000,000, 1,000,000 and 800,000, respectively,

newly issued ordinary shares of the Company at a per share purchase price of US$100.90, representing the closing price per share as quoted by the NASDAQ Global Market on August 23, 2018, and a premium of 2.5% and 7.9%, respectively, over the Company's 30 and 90 trading day volume weighted average price as quoted by the NASDAQ Global Market through August 23, 2018.

The release is a doozy. The company is rejecting the offer from the previous CEO. CITIC is withdrawing its offer and they are issuing 5.85 million shares to raise $590 million from a group of respectable investors.

The big buyer is PW Medtech - and it is really hard to understand how they subscribe to this. PW Medtech has a market cap of USD320 million and it is buying over $300 million worth of stock. Their accounts show 90 million yuan of cash. That doesn't come close to paying for this. And - as observed - they and their controller - the difficult to track Marc Chan - are already massively overweight China Biologic.

The other buyers are CITIC and Hillhoue. Hillhouse is only in for $80 million which to them is a drop-in-the-ocean. I know some senior people at Hillhouse. I had lunch with them once. But they haven't answered my emails. *I am really keen to find out what they see in this company that I have missed*.

But at the end of this I am just perplexed. Yeah I am staying short. I don't see how all this works. But then again Dr Du did - by repute - found a pretty decent business so anything is possible.

Dear readers I would love your thoughts. And if someone with a contrary view on the stock wants to contact me I am keen. Hillhouse presumably believes the extraordinary growth this company has had can continue. I would love to chat to them.

Till then yours in puzzlement. Oh, and I remain short, but less short than when the takeover was in full swing.

John

Posted by John Hempton at 10:05 AM 9 comments: Links to this post

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