



“The Markets Need More Skeptics”

- [The Economist on Wirecard](#)

*THIS RESEARCH REPORT EXPRESSES SOLELY OUR OPINIONS. We are short sellers. We are biased. So are long investors. So is Feihe. So are the banks that raised money for the Company. If you are invested (either long or short) in Feihe, so are you. Just because we are biased does not mean that we are wrong. Use BOC Texas, LLC's research opinions at your own risk. This report and its contents are not intended to be and do not constitute or contain any financial product advice. Investors should seek their own financial, legal and tax advice in respect of any decision regarding any securities discussed herein. You should do your own research and due diligence before making any investment decisions, including with respect to the securities discussed herein. We have a short interest in Feihe's stock and therefore stand to realize significant gains in the event that the price of such instrument declines. Please refer to our full disclaimer located on the last page of this report.*

COMPANY: China Feihe Ltd | HK: 6186  
INDUSTRY: Infant Milk Formula

PRICE (AS OF CLOSE  
7/7/20)

**HKD 15.82**

MARKET CAP

**HKD 141 BILLION**

30 DAY AVG VOLUME

**42 M SHARES**

BLUE ORCA VALUATION

**HKD 5.67**

China Feihe Ltd. (HK: 6186) (“Feihe” or the “Company”) claims to be a hyper-profitable and fast-growing infant milk formula (IMF) producer in China. A failed US-listed reverse merger, Feihe went private in 2013 following a series of auditor dismissals and accusations of misconduct. Its stock price collapsed, and its business foundered. Yet away from the scrutiny of auditors and the market, Feihe remerged in a 2019 Hong Kong IPO claiming a near miraculous change of fortunes.

**In 2019, Feihe reported EBITDA and net income margins higher than Apple, Tencent and Alibaba.** All while supposedly growing at a 54% CAGR from 2017-2019. It supposedly achieved such remarkable performance selling the same products to the same customers in the same market as when the Company was a failed reverse merger.

We think Feihe's story has more in common with Wirecard and Luckin Coffee than Apple or Tencent.

In this report, we present multiple independent data points which, in our opinion, indicate that Feihe overstates IMF revenues, understates billions in operating costs such as advertising and labor expenses, understates headcount by as much as 10x, and materially inflates profitability.

Notably, Feihe recognizes revenue when it hands products to its logistics providers, which Feihe repeatedly insists are independent third parties. But our investigation indicates that Feihe's primary logistics company, which claims to transport most if not all of its products, is run by a Feihe employee and operates as part of the Company. We believe that this is fatal to Feihe's credibility, and to the integrity of its financials.

**If we add back our estimate of undisclosed labor and advertising expenses and adjust revenues to reflect independent retail sales data, we question whether Feihe is even profitable.** We therefore value the Company on an EV/adjusted sales multiple. Even at a 5x EV/adjusted sales multiple, which is double the multiple of other Chinese IMF producers, we value Feihe at HKD 5.67 per share.

- 1. Revenue Inflation Via Undisclosed Related Party Logistics Company.** Feihe primarily sells infant milk formula to distributors but recognizes revenues when its products are “handed over to logistics service providers,” which the Company insists are all independent third parties. However, site visits and PRC corporate records indicate that Feihe's primary logistics company, which claims to transport most if not all of Feihe's IMF products out of its factories, is managed by a Feihe employee. Accordingly, we believe that **Feihe is recognizing revenue when it passes products to a logistics firm which is part of Feihe.** In our opinion, this is devastating to the credibility of Feihe's financial statements and creates an obvious mechanism to inflate sales.
- 2. Nielsen and Ministry of Commerce Data Suggest Feihe Overstates Revenues.** Two credible, independent data sets tracking retail sales in China indicate that Feihe's revenues are substantially less than the Company claims. Notably, although the data sets are produced independently, both the Nielsen data and the Ministry of Commerce data suggest, in our opinion, that Feihe's actual revenues are 49% less than reported by the Company in 2018-2019.

- a. **Nielsen’s IMF Retail Sales Data Suggests Feihe Overstates Revenues.** In its 2019 Prospectus, the Company reported that its infant milk formula (“IMF”) products generated all-channel **retail sales** of RMB 17.9 billion in 2018. Yet according to the Nielsen data, collected at the point-of-sale and **without reference to Company disclosures**, offline retail sales of Feihe’s IMF products were only RMB 5.9 billion in 2018. Taking into account Nielsen’s coverage ratio, this data set indicates that **Feihe’s revenues were 49% lower than reported to investors in its prospectus.**
  - b. **Ministry of Commerce Sales Data Also Suggests Feihe Overstates its IMF Revenues.** China’s Ministry of Commerce (“MoC”) collects and analyzes data on IMF retail sales through supermarkets, hypermarkets and convenience stores (the “Modern Trade” channel). Given the Company’s ratio of sales through this channel, the MoC data indicates that Feihe’s total IMF revenues were only RMB 4.6 billion in 2018, and RMB 6.5 billion in 2019. By our calculation, **the MoC data indicates that Feihe’s revenues were 49% less than reported in 2018-2019.**
  - c. **Frost & Sullivan Inexplicably Doubled the Size of China’s IMF Market.** Naïve investors may push back on independent data sets like Nielsen on the basis that Frost & Sullivan’s “research” corroborates the Company’s claims. But this would be foolish. First, Frost & Sullivan’s credibility is less than zero after being used in the prospectuses of notable frauds like Luckin Coffee (US: LK) and Tianhe (HK: 1619). Its research is also wildly inconsistent. Feihe hired Frost & Sullivan for both its recent 2019 prospectus and its prospectus from its aborted 2017 Hong Kong IPO. Inexplicably, Frost & Sullivan’s estimate of historical IMF retail sales in China for the same years (2014-2016) **were twice as high** in the 2019 Prospectus as in the 2017 document. Such dramatic and obvious inconsistencies between the prospectuses undermine the credibility of the research. We suspect that Frost & Sullivan had to retroactively double the size of the IMF market in the 2019 Prospectus because otherwise, Feihe’s purported market share would appear ludicrous.
3. **Feihe Understates Billions in Operating Expenses.** Multiple independent data points indicate that Feihe incurs billions more in operating costs than the Company admits in its filings. In our opinion, such undisclosed expenses indicate that Feihe is considerably less profitable than it claims.
- a. **Hidden Staffing Costs and Headcount Understated by 10x.** Feihe claimed in its prospectus to only have 5,422 full-time employees. We think this is a lie. In May 2020 interview, Feihe’s chairman unambiguously bragged that the Company employed 50,000 sales representatives, indicating that the Company is massively understating its true headcount. This matters because several court cases state that Feihe pays its sales representatives **directly**, meaning their costs should be reflected on Feihe’s income statement. At the wages advertised by Feihe on online job postings, we estimate that Feihe incurs at least RMB 925 million in undisclosed labor costs from its underreported headcount.
    - i. **Feihe a Strange Outlier vs Peers in Reported Salary Costs.** This understated headcount likely explains why Feihe is a major outlier when comparing its salary expenses to other IMF producers in China. In 2019, Feihe’s Hong Kong-listed IMF peers spent an average of 11% of revenues on salary expenses, whereas Feihe claimed to spend only 4% of revenues. Taking its financials at face value, Feihe is an inexplicable outlier. If we flip the calculation, Feihe reported an average salary of only RMB 99,095 per employee in 2019, 43% less than the average salary reported by its Chinese peers. We doubt that Feihe could grow rapidly by paying its employees an average salary 43 % less than its competitors. Rather, in our opinion, the likely explanation for such contradictory figures is that Feihe materially understates its labor costs.
  - b. **Understated Advertising Expenses.** Unusually for a fast-growing consumer product, Feihe claimed in its prospectus that its advertising expenses declined 11% in 1H 2019 (YoY). Yet overwhelming independent evidence suggests that Feihe’s advertising spending grew exponentially in 2019. In Q1 2019, Feihe became the number one advertiser on CCTV, reportedly increasing spending 309% YoY on China’s most important network. Other data shows a similar trend. CTR Market Research, a joint venture with the state-owned China International Television Corporation (an SOE), reported that, **on TV commercials alone**, Feihe’s spending increased **517% in 2019**. Using Feihe’s reported 2018 advertising expenses as a baseline, if we apply the

growth rate in advertising spending across channels reported by independent media tracking sources, we estimate that Feihe's actual advertising spending was at least **RMB 765 million more than reported in 2019**.

- 4. Ghost Factory and Questionable Tax Refunds.** Eight days after Feihe's IPO, GMT research issued a note questioning many of the "fraud-like" characteristics of Feihe's financials. Feihe's primary [rebuttal](#) to GMT was the contention that its financials were trustworthy because its subsidiaries paid billions in PRC taxes in 2018-2019. If the taxes were true, so the argument went, Feihe's financials were true. Yet look closer and this defense falls apart. Part of Feihe's so called tax defense rests on its subsidiary Feihe Tailai, which supposedly generated billions in revenues and paid hundreds of millions in taxes. The problem is that by Feihe's own admission, the Tailai factory **was still under construction** and did not produce any product during the track record period. Local records show it did not receive a license to produce formula until 2020. **We doubt that Feihe Tailai could generate billions of revenues and pay hundreds of millions in taxes in 2018-2019 while its only factory was still under construction.** In our view, Feihe Tailai shows that subsidiary level taxes don't exonerate Feihe at all. Rather, it is compounding evidence undermining the authenticity of Feihe's financials.
- 5. Feihe Overstates Billions in Capital Expenditures.** Companies inflating profitability must inflate capital expenditures or other balance sheet line items to wash fake profits. In this case, evidence indicates that Feihe overstates billions in capital expenditures, in some cases by reporting that the Company is undertaking facility expansion projects which were already completed **before its IPO**.

  - a. Kedong Expansion Already Complete.** Feihe claimed in its 2019 Prospectus that it planned to invest a further RMB 431 million to expand its capacity in Kedong from 12,000 to 52,000 tons-per-year. In its 2019 Prospectus, Feihe claimed that the expansion was only 19% complete. Yet incredibly, Feihe's prior prospectus from its aborted 2017 Hong Kong IPO stated that the **same Kedong expansion** was finished in 2018. To corroborate this timeline, we found [numerous](#) press releases from the local Qiqihar government [announcing](#) that the project was [complete](#) by 2018, well before the IPO. Put simply, Feihe claimed that it would be investing hundreds of millions in capital expenditures in a project which it previously admitted was already complete. **We found similar discrepancies with other proposed Feihe production facilities.** In our opinion, Feihe misled investors about future capital expenditures to conceal underreported operating expenses.
  - b. Flagship Kingston Facility.** In its 2019 Prospectus, Feihe claimed that it would invest C\$ 330 million to build a new plant in Kingston, Canada. Yet in December 2019, the builder of the Kingston facility, the Graham Group, [announced](#) that it completed and delivered "**on time and on budget... a C\$ 208.8 million plant** to ... Feihe International, after almost two years of construction." Put simply, the builder's completion announcement stated that the facility cost 37% less than Feihe claimed. The builder's lower investment figure is corroborated by other Canadian media and [government](#) announcements, all of which, in our opinion, indicate that Feihe materially exaggerated its reported capital investment in the Kingston facility.
- 6. Major Audit Red Flags.** Of Feihe's seven PRC subsidiaries which engage in the sale of milk powder, five were **not audited by any firm in preparation for the IPO**, despite their critical importance to the integrity of Feihe's financial disclosures. Worse still, Feihe's key sales subsidiary was audited not by E&Y (or its local affiliates), but a local Heilongjiang accounting firm with a questionable reputation and which had recently been [censured](#) by local advisory authorities for low quality. Any investor relying on an auditor as a gatekeeper to prevent the Company from misrepresenting its financial statements can take no comfort from Feihe. Even after Feihe went public, none of its Chinese subsidiaries were audited by Ernst & Young or its affiliates.
- 7. The Original China Hustle.** A failed reverse merger, Feihe traded under the curious moniker "American Dairy" (US: ADY) as a US-listed company for 10 years. Although it initially soared, Feihe's stock plummeted when it was revealed that the Company's assistant auditor was also its stock [promoter](#). When Feihe belatedly disclosed an SEC [investigation](#), Feihe's primary auditor departed. **Feihe then restated historical financials, admitting**

that its net income had been overstated in one year by 29%. Feihe [churned](#) through 4 auditors in its final years, a telltale sign of corporate rot. Feihe limped along, dogged by [allegations](#) that it was fabricating its financial performance. Investor confidence was shattered, and Feihe's share price collapsed, never to recover. In 2013, it went private, its tail firmly between its legs.

8. **Same Business – Different Result?** Selling the same products in the same market to the same customers, Feihe was a failure as a US-listed reverse merger. Yet away from the scrutiny and oversight of regulators, auditors and investors, Feihe supposedly experienced a dramatic change of fortune.
  - a. **Booming Revenues.** As a US-listed company, Feihe's revenues were declining. As a private company leading up to its 2019 Hong Kong IPO, Feihe was supposedly the fastest growing major IMF company in the world, reporting a CAGR of 54% in revenues from 2017-2019.
  - b. **Expanding Margins.** Companies growing rapidly typically do not simultaneously expand margins. Not Feihe. In its last six years as a US public company, Feihe struggled to consistently earn a profit. In 2019, Feihe reported 42% operating margins and 29% net margins, far above any foreign or domestic company selling IMF products in China.
  - c. **Better Business than Apple and Microsoft?** To put Feihe's reported performance in context, its growth and profitability is a major outlier compared to other Chinese and global IMF producers. Absurdly, Feihe reports the same EBITDA and net margins as Microsoft (US: MSFT), and better EBITDA and net margins than Apple (US: AAPL), Tencent (HK: 700) and Alibaba (HK: 9988).
9. **Curious Case of YST.** Adding to the puzzle of Feihe's immediate and miraculously turn of fortunes, the financials of its near-exclusive fresh milk supplier (and quasi-related party) have collapsed. Feihe purchases between 78-96% of its fresh milk from Hong Kong listed YuanShengTai Dairy Farm Limited ("[YST](#)") (HK:1431). YST was originally owned by Feihe's chairman. Today, Feihe claims that YST is no longer a related party. But evidence suggests otherwise. On the [website](#) of an investment platform called Max Wealth, owned in part by Leng Youbin, Feihe's chairman brags that he not only runs Feihe but is also the actual controller of YST.
  - a. **Fortunes Inexplicably Not Linked.** YST is Feihe's most important and largest supplier. Feihe is YST's largest customer (60% of revenues). Given their mutual interdependence and close ties, YST and Feihe's fortunes should be intertwined. But they diverged considerably. Feihe's revenues skyrocketed, but YST's revenues are flat. Feihe's margins ballooned. But YST's margins plummeted. In 2016, Feihe and YST generated the same amount of cash flow from operations. Since then, YST's cash flows are flat while Feihe's increased **39x** in the next three years. This only enhances our suspicion that Feihe secretly (or not so secretly) controls YST, pushing losses and costs on its supplier to make its own business appear far more profitable than it really is.

## VALUATION

In this report, we present multiple independent data points which suggest in our opinion that Feihe overstates IMF revenues, understates operating costs such as advertising and labor expenses, understates headcount by 10x, and materially inflates profitability.

In 2019, Feihe reported EBITDA and net income margins higher than Apple, Tencent and Alibaba. All while supposedly growing at a 54% CAGR from 2017-2019. It supposedly achieved such remarkable performance selling the same products to the same customers in the same market as when the Company was a failed reverse merger, taken private for a pittance and dogged by allegations of fraud. Feihe's supposed miracle is all the more suspicious because of the stark underperformance of its exclusive and quasi-related party fresh milk supplier, YST.

We think Feihe's story has more in common with Wirecard and Luckin Coffee than Apple or Tencent.

Feihe recognizes revenue when it hands products to its logistics provider, which Feihe repeatedly insists is an independent third party. But our investigation indicates that Ruixinda Logistics, which claims to transport all or almost all of Feihe's IMF products, is run by a Feihe employee and operates as part of the Company.

This is catastrophic for the integrity of Feihe's financial statements, as it means the Company has free reign to recognize revenues by handing product to a logistics firm which is secretly part of Feihe.

Evidence also indicates, in our opinion, that Feihe is materially underreporting operating costs. Feihe reported 5,422 employees in its prospectus, but as recently as May 2020 its chairman has [bragged](#) to employing 50,000. Accordingly, we add back what we conservatively estimate to be at least RMB 925 million in understated labor expenses.

We also believe that Feihe understates advertising costs. Feihe claimed in its most recent prospectus that ad spending declined in the first half of 2019, but independent data shows that Feihe's TV spending increased 517% on TV commercials alone in 2019.

We understand that Feihe likely receives a discount on its increased purchasing volume, but we highly doubt that its ad spending could decline in a year when independent data shows that its advertising spending increased across all channels by 286%. Even if we assume that Feihe receives a further 60% discount on its additional advertising, we estimate that the Company's advertising spending was at least RMB 765 million more than reported in 2019.

If we only adjust for what we believe to be Feihe's understated advertising expenses and labor costs, at its current multiple, we value Feihe down 35%. But this is only half the story, as we believe there is overwhelming evidence that Feihe also inflates revenues, likely facilitated by recognizing revenue whenever it hands off its IMF products to an undisclosed related party logistics company. Based on our review of Nielsen and Ministry of Commerce data, we calculate that Feihe exaggerates its IMF sales by as much as 49%.

**If we add back our estimate of undisclosed labor and advertising expenses and adjust revenues to reflect independent retail sales data, we question whether Feihe's business is even profitable.**

RMB M		2019
Reported total revenue		13,722
Reported IMF revenue		12,538
Est. IMF revenue overstatement	-49%	(6,095)
Reported IMF blended gross margin		72%
Est. IMF gross profit overstatement		(4,414)
Reported total gross profit		9,610
Adjusted total gross profit		5,195
Reported expenses and other income		(3,927)
Est. understated labor costs		(925)
Est. understated advertising expenses		(765)
<b>Adjusted profit before tax</b>		<b>(421)</b>

Source: Feihe Public Filings, Blue Orca Calculation

This [tracks](#) with the statements of Feihe's former director, who says that its growth has been fueled by high spending on staff. As Feihe continues to try and capture market share in Tier 1 and Tier 2 cities, where its products are not as popular, we believe it will be forced to maintain or increase its spending on sales staff and marketing. Put simply, we have no reason to expect Feihe to become profitable going forward.

Because we believe Feihe's business is likely unprofitable, we value the Company on an EV to sales multiple. We recognize in our valuation that even by our calculation, Feihe is still growing and is likely a leading domestic player. Accordingly, we assign a 5x EV/sales multiple to the Company, which is **double** the median multiple of its peers.

Company	Ticker	FY19 Sales	EV	EV/Sales
Yili	600887-CN	90,223	205,808	2.3 x
Mengniu	2319-HK	79,030	116,335	1.5 x
H&H	1112-HK	10,925	24,528	2.2 x
Beingmate	002570-CN	2,785	7,717	2.8 x
Average				2.2 x
Median				2.3 x
<b>Feihe</b>	<b>6186-HK</b>	<b>13,722</b>	<b>120,314</b>	<b>8.8 x</b>

Source: Factset, Companies' Public Filings

Given that the overall IMF market in China is shrinking, we think such a multiple is extremely charitable.

RMB M	2019
Reported total revenue	13,722
Reported IMF revenue	12,538
IMF revenue inflation %	-49%
Adjustment: IMF revenue overstatement	(6,095)
Adjusted Feihe total revenue	7,626
Adjusted EV/sales multiple	5.0 x
Adjusted EV	38,132
+ Cash	12,768
- Total Debt	4,996
	45,904
Outstanding shares	8,933
Valuation (RMB)	5.14
<b>Valuation (HKD)</b>	<b>5.67</b>
<b>Last traded price</b>	<b>15.82</b>
<b>Downside</b>	<b>-64%</b>

Source: Feihe Public Filings, Blue Orca Calculation

At a 5x EV/adjusted sales multiple; we value Feihe at HKD 5.67 per share.

## REVENUE INFLATION VIA UNDISCLOSED RELATED PARTY LOGISTICS COMPANY

Feihe's supposed revenue growth has been nothing short of miraculous. Selling the same products in the same market to the same customers, Feihe was a failure as a US-listed reverse merger. Yet away from the scrutiny and oversight of regulators, auditors and investors, Feihe's revenue supposedly grew at a 54% CAGR from 2017-2019.

In our opinion, there is a growing body of evidence that Feihe's revenues are inflated. As we highlight in this report, we believe there is a stark inconsistency between Feihe's reported revenues and independent data from the Ministry of Commerce and Nielsen tracking retail sales of IMF products in China. We suspect that this discrepancy is driven by channel stuffing using an undisclosed related party logistics company.

Feihe primarily sells IMF products to distributors but recognizes revenues when its products are "handed over to logistics service providers."

In general, we enter into standard distribution agreements with our distributors and maintain a buyer and seller relationship with them. We recognize revenue when our products are handed over to logistics service providers, at which time the control of such products is transferred to distributors. Major terms of our standard distribution agreements include:

*Source: Feihe Prospectus, p. 192*

Because the Company records revenues when the cans are loaded onto trucks at its facilities, Feihe claims to use only "independent third-party logistics service providers." This claim is critical to the integrity of Feihe's financial statements.

During the Track Record Period, we outsourced substantially all of our logistics needs to Independent Third Party logistics companies. We believe outsourcing logistics allows us to reduce capital investment and the risk of liability for transportation accidents, delivery delays or losses. Our products are delivered by enclosed-body trucks. We select our logistics service providers based on thorough and regular review of their price and service quality, including risk control, accuracy and timeliness. We regularly work with over 20 logistics service providers, many of whom we have developed stable relationships with. We usually enter into standardized logistics agreements with one-year term. Under the

*Source: Feihe Prospectus, p. 233*

The risk of channel stuffing and revenue inflation is overwhelming if Feihe can recognize sales simply by transferring finished products to a logistics firm secretly controlled by the Company. That is likely why Feihe repeatedly insists that it "**outsources substantially all of its logistics needs to independent third-party logistics companies.**"

But our due diligence suggests that this claim is false.

We believe that Feihe's primary logistics company, which claims to transport most if not all of Feihe's IMF products out of its facilities, is an undisclosed related party secretly managed by the Company's employees.

When investigators visited Feihe's production facilities to conduct due diligence on the Company in spring 2020, they noticed and took photos of a number of Feihe trucks parked at a nearby logistics company, Kedong Ruixinda Logistics Co. Ltd. ("Ruixinda Logistics").

Investigators contacted Ruixinda Logistics, which stated that it has 200 delivery trucks and **undertakes most, if not all**, of the transportation work for Feihe. The logistics firm claimed that it primarily transported milk powder from Feihe facilities in northeastern China to warehouses in other parts of the country. Notably, when investigators asked, a Ruixinda Logistics employee claimed that the logistics firm was part of the Feihe group.



Source: Investigator Site Visits, May 2020

Ruixinda Logistics claims to be part of the Feihe group, occupying an important role as the primary logistics company for transporting Feihe's IMF products in northeastern China.

This is corroborated by a recent government press release. In March 2020, a news release from the Heilongjiang government stated that Ruixinda Logistics transports IMF products produced by Feihe's primary operating subsidiary, Heilongjiang Feihe Dairy ("Feihe HLJ").

According to the press release, Ruixinda Logistics delivered most, if not all, of the Company's IMF products. This involves picking up products from all of Feihe's production facilities, including plants in Kedong, Gannan, Tailai, Longjiang and Jilin Zhenlai.

针对承担黑龙江飞鹤乳业公司生产产品（奶粉）配送运输的瑞信达物流有限公司车辆数量多，地点分散，运输范围

Given the large number of vehicles of Ruixinda Logistics, which undertook the distribution and transportation of products (milk powder) produced by Heilongjiang Feihe Dairy (Feihe HLJ) ...

2月29日，齐齐哈尔路政处组成了调研小组实地对该公司进行了调研，面对面与该公司的相关负责人进行了交流；对该企业的运输车辆及相关手续进行了实地考察。调研组现场了解到，瑞信达物流有限公司有运输车辆数量为200台左右，运输车辆为6轴货车，几何尺寸超限，每次出车需要按照国家相关政策要求办理《超限车辆运输通行证》。由于

车辆运输行驶范围包括飞鹤乳业克东基地、龙江基地、甘南基地、齐齐哈尔基地、泰来基地、吉林省镇赉基地，生产的成品奶粉要运送到上海仓、天津仓、苏州仓、郑州仓、西安仓、成都仓、哈尔滨仓等地，每次运输分散办理许可都

(Ruixinda Logistics) transportation range includes Feihe Dairy's Kedong plant, Longjiang plant, Gannan plant, Qiqihar plant, Tailai plant, and Jilin Zhenlai plant. It delivers IMF products to warehouses in Shanghai, Tianjin, Suzhou, Zhenzhou, Xi'an, Changdu, and Harbin.

建立一车一电子档案，与路政处建立局域平台，通过平台录入的车辆信息获得相关要件，再利用网络传递审批要件，完成审批流程。这种流程不仅在疫情防控期间让企业少跑路、甚至不跑腿，就能轻松办理《超限车辆运输通行证》，

也可以一直沿用，得到了该企业高度赞同。据统计，疫情期间齐齐哈尔路政处为企业保驾护航，1月27日至3月10日，共发出运输车辆通行证850台次，运送婴儿奶粉22137吨，保障了全国婴幼儿口粮的供应。

According to statistics, Qiqihar Road Administration Office escorted the company (Ruixinda Logistics) during the epidemic. From January 27 to March 10, a total of 850 transport vehicle passes were issued and 22,137 tonnes of infant milk formula were delivered, which guaranteed IMF supply across the country.

Source: [http://www.hljjt.gov.cn/z\\_sglzglij/sllzgli\\_gzdt/2020/03/7896.html](http://www.hljjt.gov.cn/z_sglzglij/sllzgli_gzdt/2020/03/7896.html)

\*Feihe's public filings do not mention Qiqihar plant, so the stated tonnage is not Feihe's production volume.

The government press release, the site visits and our independent investigation all indicate that Ruixinda Logistics is the primary logistics firm serving the Company, meaning that Feihe recognizes revenue when it hands products to the firm.

*Logistics.* Once payment has been received from a distributor, we will engage Independent Third Party logistics service providers to deliver our products to designated warehouses that exclusively store our products. We recognize revenue on sales to distributors when the products are handed over to logistics service providers. Delivery costs are included in the selling price of our products. We closely monitor the inventory level of our distributors who are required to follow the first in first out policy. Distributors' warehouses must comply with relevant environmental, safety and hygiene standards set by us.

Source: *Feihe 2017 Prospectus*

The integrity of Feihe's financial statements therefore relies on the Company's claim that Ruixinda Logistics is an independent third party. We think not.

First, when investigators inquired, a Ruixinda Logistics employee stated that it was part of the Feihe group. This is corroborated by PRC corporate records, which show that Ruixinda Logistics' current executive director and legal representative is Xie Dehe, who appears to be Feihe employee.

企查查 Qcc.com 全国企业信用查询系统 官方备案企业征信机构 克东瑞信达物流有限公司 Ruixinda Logistics 应用 APP下载 续费VIP 企业套餐 个人中心

基本信息 26 法律诉讼 7 经营状况 12 经营风险 3 企业发展 7 知识产权 0 新闻公告 2 历史信息 17

Legal Rep 法定代表人 解德河 Xie Dehe 经营状态 存续 (在营、开业、在册) 成立日期 2013-06-06

主要人员 2 (查看更多5条 历史高管)

序号	姓名	职务	持股比例	最终受益股份
1	解德河 Xie Dehe	执行董事兼总经理	-	-
2	程子丽	监事	-	-

Source: [https://www.qcc.com/firm\\_b2c776628322e8161e65a59bc4b330e7.html](https://www.qcc.com/firm_b2c776628322e8161e65a59bc4b330e7.html)

Xie Dehe is also listed as the executive director and general manager of Qiqihar Jinhe YuanShengTai Tourism Farm Co., Ltd, which until recently was known as Qiqihar Feihe ShengTai Farming ("Feihe Farming").<sup>1</sup>

齐齐哈尔锦鹤原生态观光牧场有限公司 我要认证 Qiqihar Jinhe YuanShengTai Tourism Farm (Feihe Farming)

存续 曾用名 齐齐哈尔飞鹤生态养殖有限公司 Former name: Qiqihar Feihe ShengTai Farming

电话: 0454-46611593 邮箱: 466115934@qq.com 地址: 黑龙江省齐齐哈尔市铁锋区扎龙镇边屯村

工商信息 查看工商官网快照 (查看更多历史工商信息)

Legal Rep 法定代表人 解德河 Xie Dehe 经营状态 存续 (在营、开业、在册) 成立日期 2014-10-27

Source: [https://www.qcc.com/firm\\_f2de923a6a024f7b42109100251f2efe.html#base](https://www.qcc.com/firm_f2de923a6a024f7b42109100251f2efe.html#base)

<sup>1</sup> Jinhe YST changed its name from Feihe ShengTai Farming to Qiqihar Jinhe YuanShengTai Tourism Farm Co., Ltd in April 2018.

## 齐齐哈尔锦鹤原生态观光牧场有限公司

我要认证

Qiqihar Jinhe YuanShengTai Tourism Farm (Feihe Farming)

主要人员 2 (查看更多2条 历史高管)

序号	姓名	职务	持股比例	最终受益股份
1	解德河 Xie Dehe 大股东 实际控制人 最终受益人 关联7家企业 >	Executive Director and General Manger 执行董事兼总经理	100%	100.00%
2	朱天龙 Zhu Tianlong 关联11家企业 >	监事 Supervisor	-	-

 Source: [https://www.qcc.com/firm\\_f2de923a6a024f7b42109100251f2efe.html#base](https://www.qcc.com/firm_f2de923a6a024f7b42109100251f2efe.html#base)

PRC corporate records show that Feihe Farming's supervisor is Zhu Tianlong 朱天龙, who is also a shareholder and an employee of Feihe.

On June 18, 2019, exercising of DIF Share Options under the First DIF Share Option Scheme by the following holders was approved by the board of directors of DIF Holding: Mr. Lu Guang (盧光) (an employee of the Group, through Dream Lantern) (50,000), Mr. Zhu Tianlong (朱天龍) (an employee of the Group, through Blessedness Cipher) (25,000) and Dasheng Limited (933,000). On the same date, the following holders of DIF Share Options under the Second DIF Share Option Scheme exercised their DIF Share Options: Mr. Leng (through Garland Glory) (50,000), Mr. Liu Hua (through LH Financial) (200,000), Mr. Cai Fanliang (through Adroit Shipping) (100,000), Mr. Liu Shenghui (through LSH Investment)

Source: Feihe Prospectus, p. 146

As advised by our PRC Legal Advisers, as of the Latest Practicable Date, Mr. Leng, Mr. Liu Hua, Mr. Liu Shenghui, Mr. Cai Fangliang, Ms. Leng Shuang, Mr. Liu Yaohua, Ms. Zhu Hongli, Ms. Ma Ju, Ms. Lin Lan, Mr. Li Chen, Mr. Lu Guang and Mr. Zhu Tianlong, being the relevant beneficial shareholders of the Company and who, to the best of our knowledge, being PRC nationals, had completed the registration under the Circular 37.

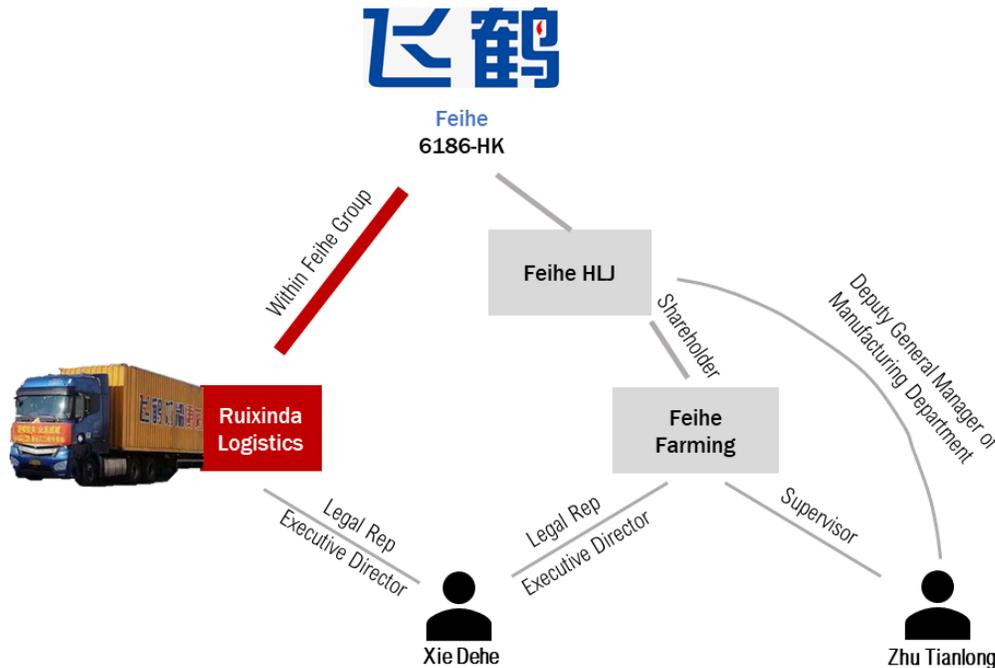
Source: Feihe Prospectus, p. 148

Feihe Farming's 2019 annual filings state that it is owned by the Company's primary operating subsidiary, Feihe HLJ.

2019 Annual Report		2019年度报告		有0条修改记录		填报时间: 2020年04月03日	
企业年报信息由该企业提供, 企业对其年报信息的真实性、合法性负责				Reported Date: April 3, 2020			
<b>基本信息</b> <ul style="list-style-type: none"> <li>统一社会信用代码/注册号: 912302043085864318</li> <li>企业通信地址: 齐齐哈尔市铁锋区扎龙镇边屯村</li> <li>企业联系电话: 6107720</li> <li>从业人数: 企业选择不公示</li> <li>企业经营状态: 开业</li> <li>是否有投资信息或购买其他公司股权: 否</li> <li>是否对外提供担保担保信息: 否</li> <li>企业主营业务活动: 服务业</li> </ul>				<b>Company Name: Qiqihar Jinhe YST Tourism Farm (Feihe Farming)</b> <ul style="list-style-type: none"> <li>企业名称: 齐齐哈尔锦鹤原生态观光牧场有限公司</li> <li>邮政编码: 161000</li> <li>企业电子邮箱: 466115934@qq.com</li> <li>其中女性从业人数: 9人</li> <li>企业控股情况: 企业选择不公示</li> <li>是否有网站或网店: 否</li> <li>有限责任公司本年度是否发生股东股权转让: 否</li> </ul>			
<b>股东及出资</b> Shareholder		Registered Capital		Subscription Date			
序号	股东	认缴出资额(万元)	认缴出资时间	认缴出资方式	实缴出资额(万元)	实缴出资时间	实缴出资方式
1	黑龙江飞鹤乳业有限公司	300	2015年05月29日	货币	300	2015年05月29日	货币
Feihe HLJ		RMB 3 M	May 29, 2015				

 Source: [National Enterprise Credit Information Publicity System](#)

Such records show that Ruixinda Logistics, a supposedly independent third party, is run by a Feihe employee who is also the executive director and general manager of another Feihe entity, Feihe Farming.



Evidence suggests that Feihe Farming remains important to the Company. As of July 2020, Feihe’s procurement website **contains an active link** with instructions for suppliers on how to invoice the Company for deliveries.

The screenshot shows the Feihe e-procurement platform interface. The navigation bar includes: 首页 (Home), 采购公告 (Procurement Notices), 中标公告 (Bidding Notices), and 服务指南 (Service Guide). The main content area displays a list of notices under the heading "重要公告" (Important Notices). One notice is highlighted with a red box:

标题	日期
问卷调查-供应链金融生态圈	2019-03-04
供应商对账业务对接人通知	2019-02-18
付款业务变更通知	2018-12-26
龙江开票信息变更	2018-10-31
关于做好增值税税率调整工作的通知	2018-04-18
飞鹤采购部组织架构调整通知	2018-03-19
2018年飞鹤乳业融资贷款通知	2018-01-02
变更管理通知函	2016-03-18
【2016年度采购合同在平台上更新】	2016-03-10
关于婴幼儿配方乳粉食品安全追溯信息通知	2016-01-25
关于供应商原辅材料变更需要提前告知的函	2015-11-23
<b>飞鹤乳业供应商开具增值税说明</b>	<b>2015-10-28</b>
关于供应商平台需上传资质的公告	2015-07-31
系统设置密码要求	2015-06-26
使用本系统前请阅读本通告	2015-05-15

The highlighted notice is titled "飞鹤乳业供应商开具增值税说明" (Feihe Dairy's Suppliers VAT instruction) and is dated 2015-10-28. A red arrow points to this notice with the text "VAT instruction to Feihe Dairy's Suppliers".

Source: <http://pm.feihe.com/custom/GroupNewsList.aspx?GroupId=157>

三、**开发票信息:** Invoice Instruction:1. **发货地址:** 飞鹤乳业克东分公司 (乳品公司, 液态奶厂)

开票信息如下:

企业名称: 黑龙江飞鹤乳业有限公司

税 号: 230230736928960

地 址: 黑龙江省齐齐哈尔市克东县克东镇庆祥街

开 户 行: 克东县农业发展银行

帐 号: 20323023000100000052451

电 话: 0452-4312257

邮 编: 164800

Delivery Address: Feihe Dairy Kedong Branch  
(Dairy company, liquid milk factory)

Issue invoice to: Feihe HLJ

2. **发货地址:** 飞鹤乳业食品分公司 (克东米粉厂)

开票信息如下:

企业名称: 黑龙江飞鹤食品有限公司

税号: 230230769207131

地址: 克东县克东镇庆祥街

电话: 0452-4312511

开户行: 工商银行克东支行

帐号: 0902034909221052943

邮编: 164800

3. **发货地址:** 飞鹤乳业观光牧场 (齐齐哈尔)

开票信息如下:

企业名称: 齐齐哈尔飞鹤生态养殖有限公司

税号: 230204308586431

Delivery Address: Feihe Dairy Tourism Farm (Qiqihar)

Issue invoice to: **Feihe Farming**

Feihe Dairy Procurement Department

October 28, 2015

飞鹤乳业采购部

2015年10月28日

Source: <http://pm.feihe.com/custom/News/ViewNews.aspx?id=170>

For deliveries to one of Feihe's facilities, the Company instructs suppliers to invoice Feihe Farming, underscoring its continued importance to the Company. Yet Feihe Farming is represented and managed by the same individual who represents and manages Ruixinda Logistics, which we believe is overwhelming evidence that the logistics firm is part of Feihe.

There is also evidence to suggest that Feihe itself considers Ruixinda Logistics to be part of the Company. In February 2020, Feihe [put out](#) a press release stating that its logistics department deployed 117 trucks to deliver IMF.

## 先人一步, 飞鹤打响疫期待供货保卫战!

2020-02-07 Feb 7, 2020

2020年初, 疫情爆发

独属春节的热闹和喜庆在几天之内, 迅速沉寂下来。

无数声音开始发酵, 医学专家、新闻媒体、各地政府通过各种手段和渠道告诫所有人“别出门, 外面很危险”。

然而, 却有人坚定地选择“逆行而上”, 从郑州、苏州、信阳、黄石、到西安……

8天5城, 飞鹤物流部负责人邢万军和他的团队, 从大年初二开始一直在路上。他们制造着安静得不太寻常的城市里为数不多的“噪音”, 为的是中国亿万宝宝口粮。

“若有战, 召必回, 战必胜”

为了确保疫情期间备货充足, 大年初二, 飞鹤乳业着手部署“疫情供货保卫战”, 作为久经一线的物流部负责人邢万军立刻沟通基地紧急调配出了117辆运输车装货; 同时号召员工提前返岗、沟通承运商、印刷标语、调配库存、联系仓库……在数不清的沟通和电话中, 战斗打响了!

Source: <https://www.feihe.com/a/701.html>

It is notable that the head of Feihe's logistics department would announce his deployment of 117 delivery trucks, which look like they belong to Ruixinda Logistics. This directly contradicts Feihe's 2019 Prospectus, in which Feihe claimed that in order to reduce capital investments and limit liability, it **outsources** substantially all of its IMF products to independent third-party logistics companies. Such statements make sense, however, in the context of all the evidence showing that Ruixinda Logistics is part of Feihe.

This is consistent with other news articles, which state that Ruixinda Logistics is part of the Feihe group, and even refer to it as Feihe Dairy Ruixinda Logistics.

“护航”我们在行动

朱长江 北黑分公司宝泉收费站 3/18

宝泉收费站面对疫情启动联合执法机制，对飞鹤乳业瑞信达物流公司货柜车（多为挂靠车辆）加以扶持，该企业担负着疫情防控应急物资和民生保供运输任务，因疫情期间无法提供超限许可要件，为保障疫情防控应急物资和民生保供运输，站领导积极联系克东县路政所协调办理有关超限运输通行证的事宜，并将此事汇报给齐齐哈尔分公司王勇总经理。

Facing the epidemic situation, Baoquan toll station launched a joint law enforcement mechanism to support Feihe Dairy Ruixinda Logistics' container trucks



Source: [https://mp.weixin.qq.com/s/wK3x2U9PiLgk4m1z\\_vPt7A](https://mp.weixin.qq.com/s/wK3x2U9PiLgk4m1z_vPt7A)

We believe that there is overwhelming evidence to suggest that far from an independent third party, Feihe's primary logistics firm is clearly part of Feihe.

Because the Company recognizes revenue not upon delivery to distributors but when the products are handed off to its logistics firm, it creates an obvious mechanism to inflate sales. That is likely why Feihe repeatedly insisted in its 2019 Prospectus that it outsources all of its logistics only to independent third parties. But our investigation of Ruixinda Logistics suggests that this claim is false, with devastating effect for the credibility of the Company's financials.

In our opinion, this undermines the integrity of Feihe's reported revenues and provides critical supporting evidence for other sections of the report suggesting that the Company overstates its sales.

## NIELSEN AND GOVERNMENT SALES DATA SUGGEST REVENUE OVERSTATEMENT

Two credible, independent data sets tracking retail sales in China indicate that Feihe's revenues are substantially less than the Company claims.

### 1. Nielsen's IMF Retail Sales Data Suggests Feihe Overstates Revenues

In its 2019 Prospectus, the Company reported that its infant milk formula ("IMF") products generated all-channel **retail sales** of RMB 17.9 billion in 2018.<sup>2</sup> However, Nielsen's point-of-sale data suggests that Feihe's revenues are materially lower than the Company claims.

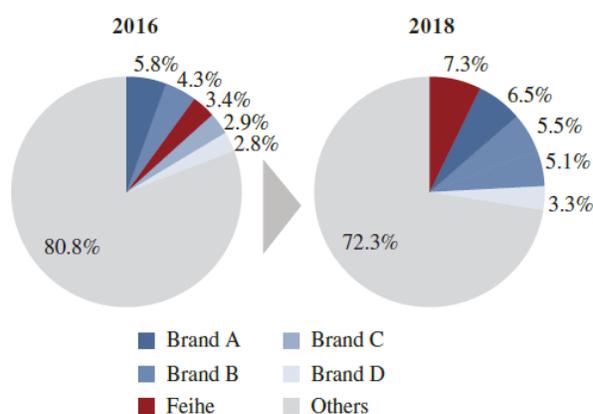
RMB M	2018
China IMF retail market size	245,000
Feihe market share	7.3%
<b>Reported Feihe IMF retail sales value</b>	<b>17,885</b>

Source: 2019 Feihe Prospectus, p. 107, p. 113

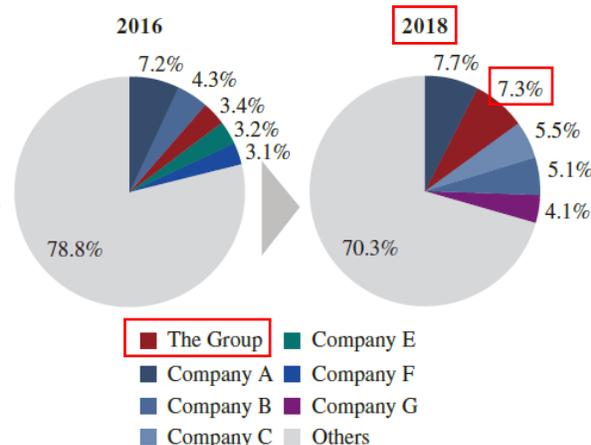
The infant milk formula market in China represents infant milk formula products sold by domestic and international brands in China, excluding cross-border purchases by Chinese consumers. According to the F&S Report, the retail sales value of China's infant milk formula market increased from RMB160.5 billion in 2014 to RMB245.0 billion in 2018, representing a CAGR of 11.2%. After reaching a

Source: 2019 Feihe Prospectus, p. 107

Market Share of Brands in Infant Milk Formula Market (China)



Market Share of Players in Infant Milk Formula Market (China)



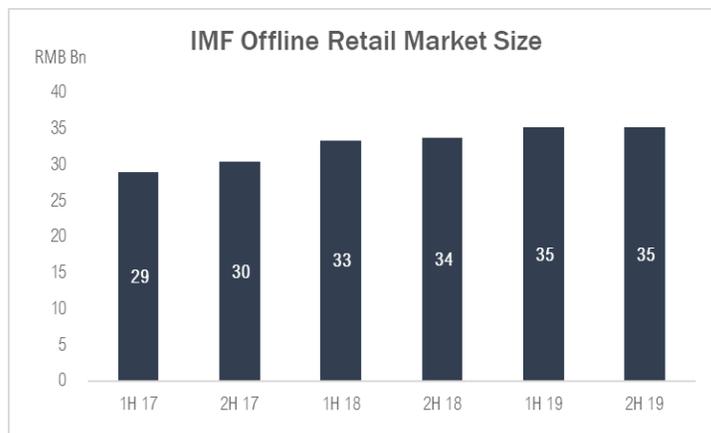
Note: The Group's retail sales value is calculated based on the Group's audit data.

Source: Frost & Sullivan

Source: 2019 Feihe Prospectus, p. 113.

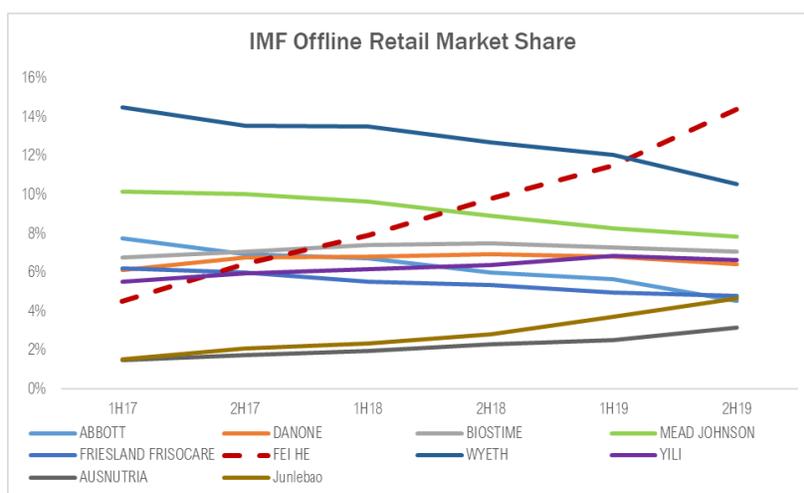
Nielsen, the global market research firm, collects IMF sales data from surveying both modern trade channels (supermarkets, hypermarkets and convenience stores) and maternity and baby stores ("MBS"). By collecting data at the point-of-sale, **without reference to Company disclosures**, Nielsen produces monthly estimates of the total amount of offline IMF sales in China.

<sup>2</sup> The total reported retail sales of Feihe's IMF products (RMB 17.9 billion) should not be confused with Feihe's reported IMF revenues (RMB 9.2 billion) for 2018. Feihe's 2019 Prospectus indicates a 67% retail markup (excluding the impact of VAT).



Source: Nielsen Data as Summarized by Goldman Sachs

This data is so credible that Goldman Sachs publishes a bimonthly report summarizing Nielsen’s estimates of offline IMF sales in China, including the market share of major brands.



Source: Nielsen Data as Summarized by Goldman Sachs

According to the Nielsen data, summarized by Goldman Sachs, Feihe’s offline IMF retail sales were only RMB 5.9 billion in 2018. This retail sales figure is far lower than the figure reported in the Company’s prospectus.

**Nielsen Data on Feihe Offline Retail Sales**

RMB M	2018
Nielsen Tracked Retail sales of Feihe IMF via Modern Trade	1,627
Nielsen Tracked Retail sales of Feihe IMF via Maternity Store	4,312
<b>Offline retail sales value of Feihe IMF</b>	<b>5,938</b>

Source: Nielsen Data as Summarized by Goldman Sachs

We asked Nielsen directly about the coverage of their IMF retail sales data, and they stated that their data set covers 82% of offline sales in China.

"82% of FMCG sales within our defined universe" Does this mean that Nielson collect the sales data from 82% of the stores in all cities and towns in 20 provinces of China and 4 municipalities? What is the margin of error?

Within the geographic area (excluding the village), we estimate that the sales that we report is around 82% of total FMCG sales. For the remaining 18% of sales, is from the channel that we do not cover.

Source: Email Correspondence with Nielson

## DEFINE THE UNIVERSE - GEOGRAPHICAL COVERAGE

NATIONAL (CITY + TOWN) PANEL

• About 45% of nation's landmass

• The retail sales of consumer goods from the geographic regions that RI covers is 82% (excluding Village) of the total mainland China (source: National Statistic Bureau, 2017 Year book)

Source: Nielsen

Note: RI means "retail index"

To account for sales in small rural villages, which are likely *de minimis*, we assume a Nielsen coverage ratio of 75% in our calculation. Assuming this coverage ratio, we calculate that Feihe's total retail sales were only RMB 8.9 billion in 2018, which was 50% less than reported to investors in the Company's prospectus.

RMB M	2018
Nielsen Tracked Retail sales of Feihe IMF via Modern Trade	1,627
Nielsen Tracked Retail sales of Feihe IMF via Maternity Store	4,312
Offline retail sales value of Feihe IMF	5,938
% of offline IMF sales	89%
Retail sales of Feihe IMF	6,682
Nielsen coverage ratio	75%
<b>Feihe IMF Retail sales based on Nielsen data</b>	<b>8,910</b>
<b>Reported Feihe IMF Retail Sales</b>	<b>17,885</b>
<b>Difference %</b>	<b>-50%</b>

Source: Feihe Prospectus, Nielsen, Blue Orca Calculation

In its 2019 Prospectus, Feihe claimed that its IMF products generated all-channel retail sales of RMB 17.9 billion in 2018. Yet Nielsen data suggests that Feihe's actual retail sales were 50% less than this reported figure. This discrepancy persists when we compare the Nielsen data to Feihe's reported revenues.

### a) Nielsen's IMF Retail Sales Data Also Does Not Reconcile with Reported Revenue

Feihe reported that its IMF revenues were RMB 9.2 billion and RMB 12.5 billion in 2018 and 2019, respectively. Yet according to the Nielsen data, summarized by Goldman Sachs, Feihe's offline IMF **retail** sales were only RMB 5.9 billion in 2018 and RMB 9.1 billion in 2019. Again, these sales figures are far lower than should be the case if Feihe's reported revenues are true.

#### Nielsen Data on Feihe Offline Retail Sales

RMB M	2018	2019
Retail sales of Feihe IMF via Modern Trade	1,627	1,952
Retail sales of Feihe IMF via Maternity Store	4,312	7,162
<b>Offline retail sales value of Feihe IMF</b>	<b>5,938</b>	<b>9,114</b>

Source: Nielsen Data as Summarized by Goldman Sachs

To compare Feihe's reported revenues to the Nielsen retail sales data, we need Feihe's promotional policy, the percentage of the Company's offline sales and the retail markup for offline products. Feihe disclosed that its offline sales represented 89% and 91% of its dairy revenue in 2018 and 2019, respectively.

RMB M	2018	2019
Reported IMF revenue	9,199	12,538
% of offline sales	89%	91%
<b>Reported offline IMF revenue</b>	<b>8,175</b>	<b>11,447</b>

Source: Feihe Public Filings

Feihe's reported retail sales in its 2019 Prospectus suggested a retail markup percentage of 67%.

RMB M	2018
Reported Feihe IMF revenue w/ VAT	10,702
Reported Feihe IMF retail sales value	17,885
<b>Implied Retail Markup %</b>	<b>67%</b>

Source: Feihe Prospectus

Note: The weighted average VAT rate was 16.3% in 2018

We also need to adjust the retail sales data for Feihe's long running promotions, through which it gives distributors free products. In a recent investor call, the Company confirmed that it ran a promotional policy of buy 6 get 1 free for Astrobaby products in 2018 and 2019.<sup>3</sup> That means for every 7 cans purchased by consumers, Feihe only generated revenues from 6 of them. In other words, when 7 cans are sold to end customers and the transaction is captured by Nielsen, only 86% of the transaction value should be attributed to Feihe's revenue.

### Feihe's Promotional Policy: Buy 6 Get 1 Free

Q: 最高端的超级星飞帆的促销情况及价格趋势?

A: 2016年星飞帆买3送1, 2018年买6送一, 去年11月继续收紧为买7送1, 未来可能会变为打9折的方式。从渠道上看, 主要的三个渠道是线上渠道、线下传统渠道(如沃尔

Answer (Feihe): The promotional policy of Astrobaby was buy 3 get 1 free in 2016 and buy 6 get 1 free in 2018. It changed to buy 7 get 1 free in November last year (2019)

播等活动的销售计算做线下, 因为直播中客户留言下单由经销商及门店跟进发货; 另外, 很多母婴店都有自己的APP及微信会员系统, 比如通过微信联系门店送货并支付, 特别是疫情中这种销售模式增长很快。

Source: Feihe Investor Call on May 13, 2020

Lastly, in the Company's favor we also adjust the Nielsen data to account for inventory held by its distributors and retailers. Feihe primarily sells to distributors, so there is a timing difference between when Feihe sells its products to distributors and when retailers sell the products to end customers. According to its prospectus, Feihe's distributors keep two months of inventory on hand.

To prevent stock accumulation, we regularly monitor the inventory levels of our customers, and generally maintain an inventory to sales ratio of approximately two, reflecting a healthy inventory level in our industry, according to the F&S Report. We also have a barcode scanning function in place, in which we are able to track our products and receive automatically-generated information on our customer's inventory levels, thereby reducing our labor costs and the risk of human error in gathering such

Source: Feihe 2019 Prospectus, p. 163

In a recent investor call, Feihe's management claimed that its distributors' and retailers' inventory levels were each 1.5 months in 2019.

<sup>3</sup> For simplicity, our calculation assumes the same buy 6 get 1 free policy across all Feihe product lines, which is overly conservative given that Feihe reportedly offers better promotional policies (such as buy 4 get 1 free) for non-Astrobaby IMF products.

Q:4-5 月销售情况？终端动销情况，渠道库存水平？

A:公司第一季度增长不低于 30%，但全年包括 4-5 月没有业绩指引，公司有 2018-2023 年五年目标，2023 年中国婴幼儿奶粉市场市占率 30%。公司 2019 年年末经销商平均库存达 1.5 倍，目前以及未来维持这一水平。

The Company's distributors' inventory level was 1.5 times at the end of 2019

Q: 公司终端是否有压货情况？库存周转率水平？

Q: Is there channel stuffing situation at Feihe's retailers? What is the inventory turnover level?

A: 19 年初平均库存水平 1.6 倍，19 年末平均库存水平 1.5

倍，不存在压货情况，得益于扫码系统，严格管理经销商库存，杜绝经销商压货情况。

A: (Retailers) inventory level was 1.6 months at the beginning of 2019 and 1.5 months at the end of 2019.

Source: Feihe's Investor Call Summary (May 2020)

Therefore, we multiply the Nielsen tracked retail sales in December by 3.5 to calculate distributors' and retailers' ending inventory. As distributors and retailers already had inventory at the beginning of the year, only the increase of inventory in the channel should be reflected in the calculation.

Knowing the retail markup and Feihe's ratio of online-to-offline sales, we can use the Nielsen retail data to calculate Feihe's implied revenues. As discussed above, we assume Nielsen's coverage ratio is 75%. Assuming this coverage ratio, we calculate that Feihe's actual offline IMF revenues were only RMB 4 billion in 2018, and only RMB 6 billion in 2019, which was 52% and 46% less than reported to investors for those years.

RMB M	2017	2018	2019	2018 - 2019 Cumulative
Feihe IMF offline retail sales value captured by Nielsen (a)	3,564	5,938	9,114	15,053
Estimated distributors' and retailers' inventory impact				
Estimated retail sales of December	361	575	903	
Distributors' and retailers' inventory level (months)	3.5	3.5	3.5	
Estimated distributors' and retailers' inventory	1,262	2,011	3,162	
Estimated increase in distributors' and retailers' inventory (b)		749	1,151	1,900
Adjusted Feihe IMF offline retail sales value (c=a+b)		6,688	10,265	16,953
% coverage ratio		75%	75%	75%
Calculated Feihe IMF total offline retail sales value		8,917	13,686	22,604
VAT %		16%	14%	
		7,665	12,032	19,697
Retail Markup %		67%	67%	67%
Feihe IMF wholesale value		4,587	7,188	11,774
Buy 6 get 1 discount %		14%	14%	14%
Estimated Feihe offline revenue		3,931	6,161	10,092
Feihe reported offline revenue		8,175	11,447	19,622
<b>Difference</b>		<b>-52%</b>	<b>-46%</b>	<b>-49%</b>

Source: Feihe's Public Filings, Nielsen Data as Summarized by Goldman Sachs, Blue Orca Calculation

We suspect that Feihe is aware that the Nielsen data undermines its reported revenue figures, because it is noticeably not mentioned in the Company's 582-page 2019 Prospectus. In its listing document, Feihe only mentions Nielsen once when it brags that it ranked second in China's IMF market.

consumption growth. Through dedicating resources to our sales and marketing efforts, we have established high customer loyalty, evident through recent brand research conducted by Nielsen, which indicated that as of 2018, Feihe ranked first in terms of purchase intention and most frequently purchased brand among domestic brands and ranked second in the overall infant milk formula market in China. We believe the strong brand recognition we have gained in these cities has led to our competitive advantage over other domestic and international brands, such as the first infant milk formula domestic brand in mind and strong association as the brand that is "More Suitable for Chinese Babies" (更適合中國寶寶). As a

*Source: Feihe Prospectus, p. 161*

We think this is a tip off. Feihe refers to the Nielsen study only with respect to market share, which indicates that the Company is aware of the data. If that is the case, why does Feihe exclusively rely on Frost & Sullivan in its 2019 Prospectus when the Nielsen data is far more credible?

In our opinion, the explanation is obvious: whereas Frost & Sullivan merely relied on the Company's reported figures, the Nielsen data contradicts Feihe's reported revenues. But notably, Nielsen is not the only independent data set which suggests that the Company is materially overstating its revenues.

## 2. Ministry of Commerce Sales Data Also Suggests that Feihe Overstates its IMF Revenues

China's Ministry of Commerce ("MoC") collects and analyzes data on IMF retail sales through supermarkets, hypermarkets and convenience stores (the "Modern Trade" channel). The data set includes IMF retail sales broken out by brand and average retail price. The MoC generates this data set by sampling Modern Trade stores in China, which it uses to calculate total IMF sales across the PRC by brand through this channel. The Chinese government collects and uses this data, meaning investors should be able to rely on it.

[China International Capital Corporation](#) ("CICC") (3908.HK), one of China's leading investment banks, regularly publishes summaries of this data. Although this data does not include sales through the MBS channel (maternity and baby stores), it does provide a credible estimate of retail sales through hypermarkets, supermarkets and grocery stores which can be used to calculate an IMF producer's overall revenues.

According to the MoC data, retail sales of Feihe's IMF products through the Modern Trade channel were RMB 1.9 billion in 2018, and RMB 2.2 billion in 2019.

The MoC data indicates that Feihe's actual revenues are much smaller than the Company claims. To convert Feihe's retail sales through this channel (as measured by the MoC) to the Company's total revenues, we need two inputs: the retail markup percentage and the ratio of the Company's sales through this Modern Trade channel.

For the retail markup percentage, we compare Feihe's reported ASP to the average retail sales price of Feihe products provided by the MoC. This government data set indicates an average retail markup of roughly 30%, which based on our interviews with distributors, is likely a conservative estimate.

RMB/kg	2018	1H 19
Feihe reported ASP	175	179
Feihe reported ASP w/VAT	203	204
Retail ASP from MoC Modern Trade data	265	262
<b>Retail Markup%</b>	<b>30%</b>	<b>28%</b>

*Source: Feihe Prospectus, MoC Modern Trade data, Blue Orca Calculation*

IMF retail sales channels are generally divided into three categories: MBS, Modern Trade, and e-commerce platforms. Feihe disclosed that its online sales channel represented 11% of its dairy revenue in 2018 and 9% in 2019.

Estimates vary for the ratio of Feihe's sales through the Modern Trade channel but sell side analysts estimate around 20%. Notably, this is corroborated by the Nielsen data, which shows that the Modern Trade channel (hypermarkets, supermarkets, and grocery stores) contributed 24% of Feihe's IMF revenue in 2018, and 20% in 2019.

#### Feihe IMF Revenue by Sales Channel

% of IMF revenue	2018	2019
Modern trade	65%	72%
<b>MBS channel</b>	<b>24%</b>	<b>20%</b>
Offline IMF revenue	89%	91%
Online IMF revenue	11%	9%
Total	100%	100%

Source: Feihe Prospectus, Nielsen Data as Summarized by Goldman Sachs

The MoC data states that retail sales for Feihe branded products through the Modern Trade channel were only RMB 1.9 billion and 2.2 billion in 2018 and 2019, respectively. Given the percentage of sales through this channel, and after adjusting the calculation for the impact of free products and inventory in the channel, the MoC data indicates that Feihe's total IMF revenues were only RMB 4.6 billion in 2018, and RMB 6.5 billion in 2019.

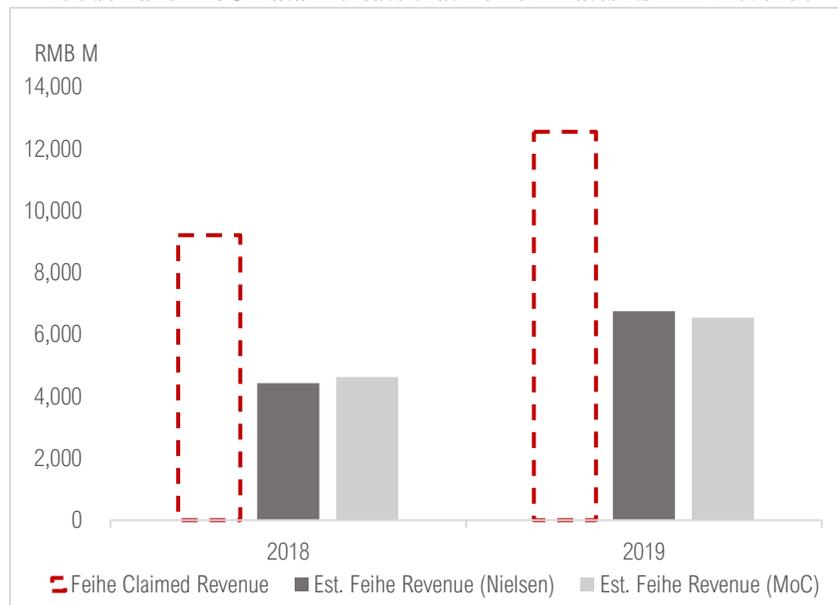
#### Revenue Overstatement Implied by Ministry of Commerce Data

RMB M	2017	2018	2019	2018-2019 Cumulative
MoC tracked Feihe IMF retail sales (Modern Trade) (a)	1,441	1,920	2,182	4,102
Estimated impact of distributors' and retailers' inventory				
Retail sales of December tracked by MoC	164	185	184	
Distributors' and retailers' inventory level (months)	3.5	3.5	3.5	
Estimated distributor's and retailers' inventory	574	647	643	
Increase in distributors' and retailers' inventory (b)		73	(4)	
Calculated Feihe IMF Modern Trade retail sales value (c=a+b)		1,993	2,177	4,170
VAT %	17%	16%	14%	
Feihe IMF retail sales excl. VAT		1,713	1,914	3,627
Estimated markup %		30%	28%	29%
Estimated Feihe sales via Modern Trade		1,313	1,491	2,804
% of Feihe IMF sold via Modern Trade		24%	20%	22%
		5,394	7,626	13,021
Adjustment: Buy 6 get 1 free discount %		14%	14%	14%
Estimated Feihe IMF revenue based on MoC data		4,624	6,537	11,161
Reported Feihe IMF revenue		9,199	12,538	21,737
<b>Difference %</b>		<b>-50%</b>	<b>-48%</b>	<b>-49%</b>

Source: Feihe Prospectus, MoC Modern Trade data, Blue Orca Calculation

By our calculation, **the MoC data indicates that Feihe's sales were 49% less than reported in 2018-2019.** Notably, this MoC data is consistent with the Nielsen data, even though they are produced independently. Both suggest a 49% sales overstatement by the Company in 2018-2019.

### Nielsen and MoC Data Indicate that Feihe Inflates its IMF Revenue



Source: Blue Orca Calculation of Nielsen and MoC data

### 3. Frost & Sullivan Inexplicably Doubled the Size of China's IMF Market

Much like Luckin Coffee (US: LK) and Tianhe (HK: 1619), Feihe relies on Frost & Sullivan, which it cites ubiquitously in its 2019 Prospectus, to support the Company's purported sales figures. Indeed, it is likely that some naïve investors may push back on independent data sets like Nielsen on the basis that the Frost & Sullivan "research" corroborates the Company's claims. But this would be foolish.

First, Frost & Sullivan has been used by so many recent frauds that its research is no longer reliable. Take the most egregious recent example, Luckin Coffee. Luckin's [prospectus](#) relied heavily on Frost & Sullivan to give its reported revenues and meteoric growth some credibility.

#### Overview

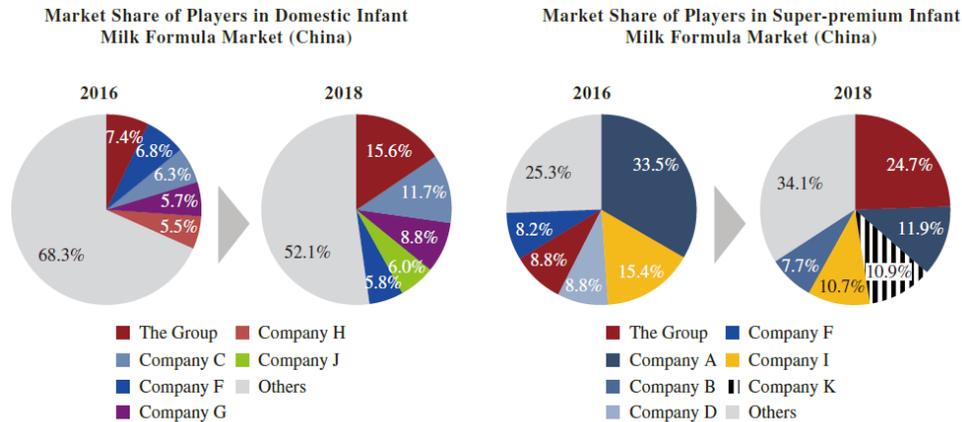
We are China's second largest and fastest-growing coffee network, in terms of number of stores and cups of coffee sold, according to the Frost & Sullivan Report. We have pioneered a technology-driven new retail model to provide coffee and other products with high quality, high affordability and high convenience to our customers. We believe that our disruptive model has fulfilled the large unmet demand for coffee and driven its mass market consumption in China, while allowing us to achieve significant scale and growth since our inception.

Source: [Luckin Coffee Prospectus](#), p. 1.

Even the opening line of Luckin's prospectus stated, "we are China's second largest and fastest-growing coffee network, in terms of number of stores and cups of coffee sold, according to the Frost & Sullivan Report." As we know now, most of Luckin's sales [were fabricated](#).<sup>4</sup>

Second, as Feihe admits in its 2019 Prospectus, Frost & Sullivan's retail sales estimates **are calculated using Feihe's self-reported revenues**. Far from being an independent check on the Company's claims, Frost & Sullivan is merely renting its name to give the imprimatur of authority to Feihe's self-reported numbers.

<sup>4</sup> To be clear, we are not suggesting that Frost & Sullivan is any way complicit in Luckin Coffee's fraud or any other misrepresentation by a company touting its research. Just that its research is compiled using their clients self-reported figures, meaning its market research for the Company's IPO is only as credible as the Company's claims.



Note: The Group's retail sales value is calculated based on the Group's audit data.

Source: Frost & Sullivan

Source: Feihe 2019 Prospectus, p. 113.

Frost & Sullivan relies on self-reported sales data provided by Feihe to estimate Feihe's retail sales and market share, whereas Nielsen's figures are derived from electronic point-of-sale data (checkout scanners) from all Chinese offline channels. The Nielsen data is therefore, in our view, a far more credible estimate of Feihe's true sales figures.

Historically, Nielsen data has proved a far more credible gauge of sales than the self-reported revenues of listed companies. In 2013, we [alerted the market](#) to another children's consumer products company, *Prince Frog* (HK: 1259), in which Nielsen data indicated that actual sales were far lower than Prince Frog claimed. At the time, many sell-side analysts dismissed this discrepancy and instead relied on Euromonitor's study, which like Frost & Sullivan's work for Feihe, was sourced directly from the company. Prince Frog subsequently collapsed and is now a penny stock. The Nielsen data proved correct for Prince Frog, and we think it will prove correct for Feihe as well.

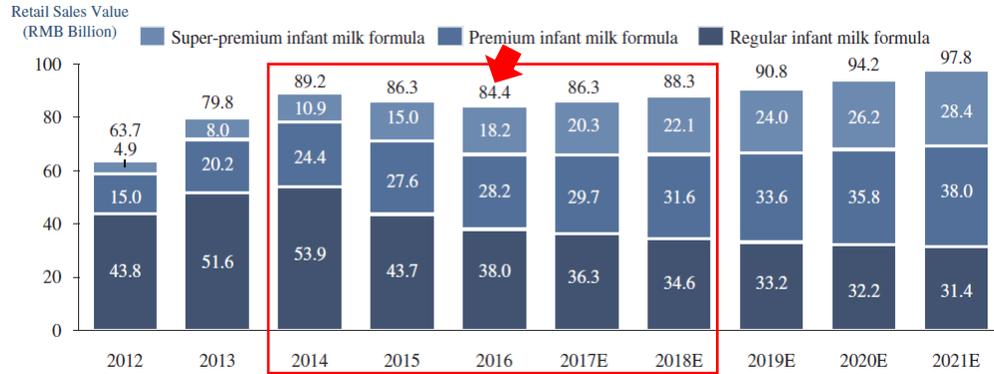
Third, Frost & Sullivan wildly contradicts itself. Feihe [tried](#) to go public in Hong Kong in 2017 but withdrew its IPO after limited interest. Feihe hired Frost & Sullivan in both 2017 and 2019 to provide supporting market research for its listing documents, including the size of the IMF market in China and the competitive landscape.

However, comparing both prospectuses, Frost & Sullivan inexplicably doubled the size of the *historical IMF market* from the first prospectus to the second. In Feihe's 2017 prospectus, Frost & Sullivan's research stated that China's IMF market size was RMB 89.2 billion in 2014 and [shrank](#) to RMB 84.4 billion in 2016.

#### *Size of the Infant Formula Market in China*

The infant formula market in China represents infant formula products sold by domestic and international brands in China, excluding cross-border purchases by Chinese consumers. The retail sales value of China's infant formula market increased from RMB63.7 billion in 2012 to RMB84.4 billion in 2016, representing a CAGR of 7.3%. After reaching a high of RMB89.3 billion in 2014, with relatively high growth since 2012, the retail sales value of the infant formula market in China decreased slightly in 2015 and 2016 primarily due to declines in birth rates and an increase in cross-border purchases by Chinese consumers. Going forward, China's infant formula market is expected to grow at a CAGR of

Source: Feihe 2017 Prospectus

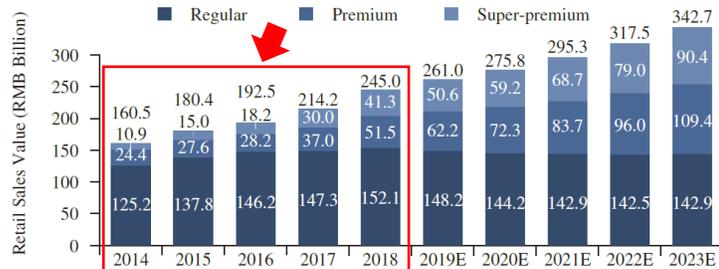


Source: Feihe 2017 Prospectus

This trend was obviously negative, as Frost & Sullivan’s original research showed that IMF retail sales in China were declining and had declined for two consecutive years from 2014 to 2016.

Yet, in Feihe’s 2019 prospectus, Frost & Sullivan inexplicably **doubled** the size of China’s IMF market. In the 2019 Prospectus, Frost & Sullivan reported that IMF retail sales in China were RMB 160.5 billion in 2014, which supposedly **grew** to RMB 192.5 billion in 2016.

	CAGR 14-18	CAGR 18-23E
Total	11.2%	6.9%
Super-premium	39.5%	16.9%
Premium	20.5%	16.3%
Regular	5.0%	-1.2%



Source: Frost & Sullivan

Source: 2019 Prospectus, p. 109

These were historical numbers, not projections or estimates. The value of retail IMF sales in China for 2014-2016 should not have changed between the 2017 Prospectus and the 2019 Prospectus. Yet Frost & Sullivan’s estimate of IMF retail sales for the same years (2014-2016) **were twice as high** in the 2019 Prospectus as in the 2017 document.

Even the trend was different. In the 2017 Prospectus, Frost & Sullivan reported that retail IMF sales in China **declined from 2014 to 2016**. Yet in the 2019 Prospectus, Frost & Sullivan reported that retail IMF sales in China grew during that same period (2014-2016), which directly contradicts its previous research.

We think there are two conclusions from this comparison. First, such dramatic and obvious inconsistencies between the prospectuses should make it obvious that Frost & Sullivan’s “research” supporting Feihe’s claims is not reliable.

Second, we suspect that Frost & Sullivan retroactively had to double the size of the IMF market in China because otherwise, Feihe’s implied market share would appear ludicrous. If we calculate Feihe’s 2018 market share using Frost & Sullivan’s *original* estimate for the size of the market from the first prospectus, the Company’s market share would be 20.3% of the 2018 IMF market in China, and 46.2% of the super-premium market.

RMB M	Total IMF		Super-premium	
	2016	2018	2016	2018
China IMF retail market size - 2019 prospectus	192,500	245,000	18,200	41,300
Feihe market share - 2019 prospectus	3.4%	7.3%	8.8%	24.7%
Feihe IMF retail sales value	6,545	17,885	1,602	10,201
China IMF retail market size - 2017 prospectus	84,400	88,300	18,200	22,100
<b>Implied Feihe market share - market size in 2017 prospectus</b>	<b>7.8%</b>	<b>20.3%</b>	<b>8.8%</b>	<b>46.2%</b>

*Note: The 2018 market size disclosed in Feihe's 2017 prospectus is estimated.*

*Source: Feihe Prospectuses, Blue Orca Calculation*

Feihe does not have a 20.3% market share. This would be an obvious lie. Our speculation is that in order to reconcile this inexplicable market share with Feihe's reported revenues, Frost & Sullivan simply doubled the size of the market.

We believe that independent data sets from Nielsen and the Ministry of Commerce are far more credible. Rather than affirming the Company claims, in our opinion, these data sets suggest that Feihe's actual revenues were 49% less than reported in the years prior to its IPO.

## FEIHE UNDERSTATES BILLIONS IN OPERATING EXPENSES

Multiple independent data points indicate that Feihe incurs billions more in operating costs than the Company admits in its filings. In our opinion, such undisclosed expenses indicate that Feihe is considerably less profitable than it claims, which directly undercuts the bull case for its lofty trading valuation.

### 1) Hidden Staffing Costs and Headcount Understated by 10x

In its 2019 Prospectus, Feihe claimed to have only 5,422 full-time employees, with just 3,130 in sales and marketing.

As of June 30, 2019, we had 5,422 full-time employees. Generally, we enter into labor contracts with our employees. We did not have any dispatched labor as of the Latest Practicable Date. As of the Latest Practicable Date, most of our employees were located in China. The following table sets forth the number of our employees by function as of June 30, 2019:

	Number of employees
Sales and marketing	3,130
Production	1,499
Quality control	312
Administrative	316
Finance	81
Research and development	63
Management	21
<b>Total</b>	<b>5,422</b>

Source: Feihe Prospectus, p. 243

Yet in a May 2020 interview, Feihe's chairman unambiguously said that the Company employed 50,000 sales representatives. In the interview, which any investor can [watch](#), the chairman discusses the merits and costs of "hiring" these employees. This flagrantly contradicts Feihe's claim in its 2019 Prospectus to only have 5,422 employees.



Now we have 50,000 of sales representatives and nutrition consultants. You think we **hire these 50,000 people** just to sell products? These 50,000 people provide knowledge... So, people don't think these are costs? **These are costs.**

Source: <https://finance.sina.com.cn/onehour/2020-05-15/doc-iirczymk1746780.shtml>

This tracks with other pre-IPO [statements](#) in which Feihe’s chairman routinely bragged that the Company had tens of thousands of employees. Such statements directly contradict the Company’s 2019 IPO prospectus, and indicate that the Company is massively understating its true headcount.

On a March 2020 investor call,<sup>5</sup> Feihe’s executive director and president Cai Fangliang corroborated Leng’s claims and stated that the Company has over 50,000 sales representatives.

On the call, Feihe’s president tried to reconcile the Company’s previous claims with his bold proclamation of a giant salesforce by stating that the Company does not need to recognize costs from these representatives as such costs are “already reflected in its sales prices.” He seems to be arguing that even though admittedly “these reps are managed by [Feihe],” it does not need to disclose them in its 2019 Prospectus or recognize their costs on its financials because Feihe does not pay these employees directly. Rather, he asserts that their costs are somehow “factored” into the product price. We think this is false.

[Several](#) court cases [state](#) that Feihe **pays its sales representatives directly**. A 2019 employment lawsuit between a Feihe distributor and its employee indicates that Feihe pays at least the base salary of its sales representatives, meaning their costs should be reflected on Feihe’s income statement.

Last year, an individual, Yang Luanjiao sued her former employer, also a Feihe distributor, over a wage dispute. According to the court, the distribution contract stipulated that the base salary of the sales representative was borne by Feihe, whereas the commission and bonus of the sales representative were borne by the distributor Yingzifang. The court document states that Yang worked at Yingzifang from December 2009 to October 2018 and that Feihe transferred RMB 800 to RMB 1,000 to Yang’s card every month.

### 2019 Legal Document Stated Feihe Paid Sales Representative’s Base Salary

#### 本院查明

本院经审理查明如下：原告永州市零陵区婴姿坊双牌停车场店系经营者李建中个人经营的个体工商户。2009年12月6日至2018年10月15日，被告应聘在李建中经营的贝因美、婴姿坊连锁店担任副店长一职。在被告工作期间，被告接受原告的经营者李建中的指派，分别在不同的分店轮流工作。被告按月支付原告工资，工资由底薪加提成组成，每月平均工资为2500元左右。原、被告双方未签订书面劳动合同，原告

From December 6, 2009 to October 15, 2018, the defendant worked as deputy store manager of Beingmate and Yingzifang chain stores that were operated by Li Jianzhong.

另查明，李建中经营的婴姿坊连锁店是飞鹤乳业公司的经销商。经销合同约定：导购人员基本工资由飞鹤乳业公司承担，导购员提成和奖金由婴姿坊店承担。飞鹤乳业公司的所有导购人员只能销售飞鹤乳业公司所生产的产品。飞鹤乳业公司每月有转入800至1000元不等的基本工资到被告卡中，但被告卡中的钱，全部由原告的经营者李建中与其妻子邓丽取走。

In addition, it was found that the Yingzifang chain operated by Li Jianzhong was a distributor of Feihe Dairy Company. The distribution contract stipulates that the base salary of sales representative shall be borne by Feihe Dairy Company, and the commission and bonus of the sales representative shall be borne by Yingzifang.... Feihe Dairy Company transferred base wages ranging from RMB 800 to RMB 1,000 to the defendant’s card every month....

Source: [https://www.qcc.com/wenshuDetail\\_com\\_a2aeab8164e820e08cce510a4731cb5a.html](https://www.qcc.com/wenshuDetail_com_a2aeab8164e820e08cce510a4731cb5a.html)

This court case indicates that even though they are officially employed by distributors, Feihe directly pays at least the base salary of many sales representatives. So rather than somehow factor the costs of such sales representatives into the price of its product, as Feihe’s president claimed, direct payments to sales representatives should be recognized as expenses on the Company’s income statement.

Such costs are material. We found multiple job posts in which Feihe recruited full-time sales representatives on an average monthly salary of RMB 2,551.

<sup>5</sup> Feihe management call hosted by UBS, March 26, 2020.

**Full-time Sales Representative Monthly Base Salary**

Date	City	Province	Hiring Company	Base Salary	Source
8/8/2017	Nanning	Guangxi	Feihe	1,350	<a href="#">Link</a>
2018	Unknow	Unknow	Feihe	2,410	<a href="#">Link</a>
2018	Unknow	Unknow	Feihe	1,254	<a href="#">Link</a>
2018	Yongzhou	Hunan	Feihe	900	<a href="#">Link</a>
4/25/2018	Tai'an	Shangdong	Feihe	2,500	<a href="#">Link</a>
12/21/2018	Huangchuan	Henan	Feihe	4,000	<a href="#">Link</a>
2/14/2019	Tangshan	Hebei	Feihe	3,500	<a href="#">Link</a>
2/28/2019	Leshan	Sichuan	Feihe	1,550	<a href="#">Link</a>
6/24/2019	Anshan	Liaoning	Feihe	3,000	<a href="#">Link</a>
9/5/2019	Handan	Hebei	Feihe	2,000	<a href="#">Link</a>
3/25/2020	Hengshui	Hebei	Feihe	1,250	<a href="#">Link</a>
4/11/2020	Qinhuangdao	Hebei	Feihe	2,000	<a href="#">Link</a>
Current	Foshan	Guangdong	Feihe	4,500	<a href="#">Link</a>
Current	Kunming	Yunnan	Feihe	5,500	<a href="#">Link</a>
<b>Average</b>				<b>2,551</b>	

Note: We include only base salary if specified

The screenshot shows the BOSS Zhipin interface for Feihe Group. The company profile is verified (indicated by an orange sign). The 'Hot Jobs' section lists several positions, with 'Sales Representative' (导购促销员) highlighted in a red box, showing a salary of 4-5K. The company information section is also highlighted, showing 'Feihe HLJ' (黑龙江飞鹤乳业有限公司).

Source: <https://www.zhipin.com/gongsi/ce87773ce5fad7a61nJy3tW8.html?ka=job-comintroduce>  
 Note: The orange sign next to Feihe's name means this account is [verified](#) by the posting company.

The screenshot shows a job posting for Feihe Milk Powder. The title is 'Feihe奶粉招聘导购员若干和活动助理'. The salary is listed as 3000-5000元/月 (RMB 3,000 to RMB 5,000 per month). The company is Feihe HLJ (黑龙江飞鹤乳业有限公司). The posting date is December 21, 2018.

Source: <http://www.hc376.com/post/zhaopin/6405369x.html>

Although the amount and structure vary by region, job postings indicate that the expected compensation for many part-time sales representatives is roughly RMB 250 per week.<sup>6</sup> At the wages advertised by Feihe, we estimate that

<sup>6</sup> Several job posts recruiting for Feihe ([here](#), [here](#), [here](#) and [here](#)) [advertise](#) that the expected base compensation for Feihe's part-time sales representative is around RMB 92 per day. Three of the five job posts stated that part-time sales representatives only worked on Saturdays and Sundays. The remaining two posts did not specify workdays. For our calculation, we therefore assumed the cost to Feihe for such part-time reps would be RMB 250 per week, assuming each worked 2.7 days.

the cost of 51,500 undisclosed full and part-time sales representatives would be at least RMB 925 million to the Company in 2019.

Sales Representative	Headcount March 2020	Base Compensation (RMB/month)	Base Salary (RMB M/year)
Full-time	16,500	2,551	505
Part-time	35,000	1,000	420
<b>Total</b>	<b>51,500</b>		<b>925</b>

Source: Feihe Disclosures; Blue Orca Estimate

Note: The number of full time and part time sales representatives was disclosed by Feihe's president on a March 2020 investor call

At advertised wages, we estimate that Feihe likely understated staffing costs by at least RMB 925 million last year. This has a material effect on Feihe's valuation.

This also likely explains why Feihe is a major outlier when comparing its salary expenses to other IMF producers in China. In 2019, Feihe's Hong Kong-listed IMF peers spent an average of 11% of revenues on salary expenses, whereas Feihe reportedly spent only 4% of revenues.

#### Peer Comparison: % of Salary Expenses to Revenue

	2014	2015	2016	2017	2018	2019
Ausnutria	10.9%	11.9%	12.1%	11.3%	11.5%	12.6%
Yashili	12.4%	13.6%	20.3%	18.5%	15.7%	13.6%
Mengniu	5.7%	6.3%	7.5%	7.8%	8.1%	7.9%
<b>Average</b>	<b>9.7%</b>	<b>10.6%</b>	<b>13.3%</b>	<b>12.5%</b>	<b>11.8%</b>	<b>11.4%</b>
<b>Feihe</b>	<b>3.8%</b>	<b>4.8%</b>	<b>4.8%</b>	<b>3.7%</b>	<b>3.0%</b>	<b>3.8%</b>

Source: Companies Public Filings

Feihe is a massive outlier when comparing its reported salary expenses to other IMF producers. Either the Company has grown revenues rapidly by spending less than its peers on sales and marketing employees, or Feihe is materially understating its labor costs. Given that Feihe has been caught understating headcount by 10x, we think it is obviously the latter.

If we flip the calculation, Feihe reported an average salary of only RMB 99,095 per employee in 2019, 43% less than the average salary reported by its Hong Kong-listed IMF peers.

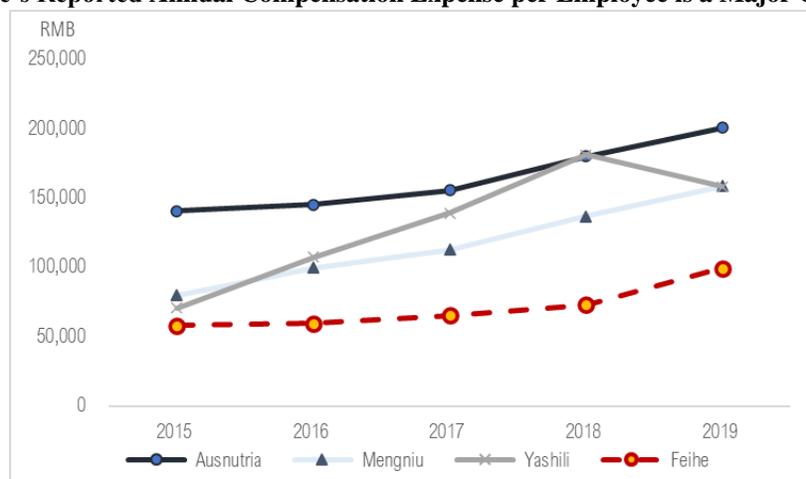
#### Average Annual Salary per Employee (in RMB)

RMB	2015	2016	2017	2018	2019
Ausnutria	140,629	145,227	155,545	179,788	200,609
Mengniu	79,581	99,682	112,680	136,692	158,505
Yashili	70,480	107,119	138,818	181,119	158,090
Average	96,897	117,343	135,681	165,866	172,401
Feihe	57,775	59,319	65,215	72,981	99,095
<b>Difference</b>	<b>-40%</b>	<b>-49%</b>	<b>-52%</b>	<b>-56%</b>	<b>-43%</b>

Source: Companies Public Filings<sup>7</sup>

<sup>7</sup> For our calculation, we assume that Feihe's headcount was 3,000 before 2017. Feihe only disclosed its headcount in May 2017 and 1H 2019, so we took the average of these two figures as its headcount in 2018. Mengniu and Ausnutria includes directors' and chief executive's remuneration in their total salary expenses, but the numbers are less than 1% of total salary expense.

### Feihe's Reported Annual Compensation Expense per Employee is a Major Outlier



Source: Companies Annual Reports

We find the same result if we compare Feihe to IMF companies listed on the mainland stock exchanges, for which disclosure rules are different.<sup>8</sup> Based on the Company's disclosures, Feihe's salary expenses for its sales and marketing staff were less than 3% of its revenue.<sup>9</sup> By comparison, Feihe's Chinese listed peers Yili and Beingmate spent 6% of their revenue on sales staff's salaries, **more than double Feihe's reported expenses.**

#### % Salesperson Salary to Revenue Comparison

	2017	2018	1H 2019
Yili	4.3%	4.6%	5.0%
Beingmate	9.3%	7.9%	7.2%
<b>Average</b>	<b>6.8%</b>	<b>6.2%</b>	<b>6.1%</b>
<b>Feihe</b>	<b>2.2%</b>	<b>2.9%</b>	<b>2.8%</b>

Source: Companies Public Filings

We doubt that Feihe could achieve its reported growth or revenues without aggressive spending and hiring. Just the opposite. Sell-side analysts and even Feihe's previous independent director both attribute Feihe's reported growth to its aggressive spending on sales and marketing staff.

For example, a Cinda Securities research report published in June 2019 summarized the major IMF players' strategies for selling in lower tier cities. The report stated that Feihe sent 15,000 salespeople to promote its products in maternity and baby stores in the third and fourth-tier cities.

<sup>8</sup> Chinese listed companies provide the staff number by function and the respective salary expenses. Therefore, we can calculate the average salary per sales employee.

<sup>9</sup> With 3,130 full-time employees in sales and marketing, Feihe reported that its staff salary and bonus in its selling and distribution expenses were RMB 297 million in 2018, and RMB 163 million in 1H 2019.



表 3 海外与国品牌在三四线城市竞争战略梳理

品牌	类型	市场份额	竞争战略
惠氏	国外品牌	17%	启赋作为超高端产品主打一、二线市场，SMA 珍蕴作为高端产品主打三、四线市场，目标 5% 份额
美赞臣	国外品牌	9.4%	今年 6 月，美赞臣与京东达成战略合作，借力京东强大的物流运输能力，将产品往三四线城市卖
菲仕兰	国外品牌	-	早在 2016 年，菲仕兰就与辉山合作推出婴幼儿奶粉品牌“子母”，重点发力三、四线市场
君乐宝	国内品牌	-	在线上线下开展各种母婴知识培训、产品冲调培训活动，以期抓住宝妈们的心
飞鹤	Feihe 国内品牌	6.7%	地推优势，飞鹤派出了一支 3000 人的消费者教育团队和 12000 名导购队伍，深入三四线城市各个母婴店“帮忙卖货”
贝因美	国内品牌	2.5%	聚焦大单品粉爱+系列，代理国际大品牌突围高端市场。建立门店管控档案，追溯产品来源同时更好的维护下游客户。
澳优	国内品牌	1.5%	佳贝艾特与百年品牌海普诺凯 1897 打开一、二线市场，能力多、美纳多稳住三四线市场的基础上提升份额

Promoter advantage: Feihe sent a team of 3,000 consumer education personnel and 12,000 sales representatives to the maternity and baby stores in the third-tier and fourth-tier cities to “help sell products”.

Source: [http://pdf.dfcfw.com/pdf/H3\\_AP201906101334273429\\_1.pdf](http://pdf.dfcfw.com/pdf/H3_AP201906101334273429_1.pdf)

In November 2019, Song Liang, the Company’s previous independent director, stated that Feihe grew its revenue by aggressively expanding its sales teams in third and fourth-tier cities, and rewarded this large staff with a generous incentive system. As a result, he said, Feihe’s labor costs were higher than other IMF producers.

对此，乳业分析师宋亮表示：“过去几年间，飞鹤依靠在三四线城市建立庞大的地推团队以及对销售人员的激励机制，拉动了销售额增长，尤其是在人口稠密的河南、山东等地，销售规模从过去的五六亿元做到了20亿元，这也导致飞鹤的人力成本整体偏高。”

Dairy industry analyst, Song Liang, said that: “In the past few years, Feihe has relied on the establishment of a large local sales team in third- and fourth-tier cities and an incentive system for sales personnel to drive sales growth, especially in densely populated areas such as Henan and Shandong. Sales revenue grew from RMB 500 ~ 600 million to RMB 2 billion, which also led to Feihe’s overall higher labor costs.”

Source: <https://baijiahao.baidu.com/s?id=1651163029512877903&wfr=spider&for=pc>

Mr. SONG Liang (宋亮), aged 38, has been an independent non-executive Director since [•] 2017. Mr. Song has served as a senior analyst in Beijing Aisen Information Consultancy Limited\* (北京埃森信息諮詢有限公司) since March 2014. Before that, he served as an agricultural and sideline product analyst of the Distribution Productivity Promotion Center of China Commerce (中商流通生產力促進中心) from July 2006 to March 2014. He has also been a non-executive director of Beijing Lijialiying Infant and Child Supplies Co., Ltd. (北京麗家麗嬰婴童用品股份有限公司) since October 2015.

Source: Feihe 2017 Prospectus

Feihe’s own former independent director admitted that Feihe grew sales through higher labor costs, yet Feihe’s financials do not reflect such costs. Rather, on a relative basis, Feihe claims to spend far less than other Chinese IMF producers on labor. We think this is obviously false.

Feihe reported 5,422 employees in its 2019 Prospectus, and salary expenses which were a major outlier when compared to other IMF companies operating in China. Yet its chairman has repeatedly and recently bragged to the media that Feihe employs over 50,000. Court cases and job postings make it clear that Feihe manages this staff and pays many of these sales representatives directly. We believe that these labor expenses are not currently reflected as costs on Feihe’s income statement, but they should be.

## 2) Understated Advertising Expenses

In addition to significantly underreporting labor costs, we think Feihe has also been understating advertising expenses. In its 2019 Prospectus, Feihe reported that it spent RMB 484 million on advertising expenses in the first half of 2018. Curiously for a supposedly fast-growing consumer product, Feihe claimed that its advertising expenses decreased by 11% to only RMB 430 million in 1H 2019.

	For the year ended December 31,						For the six months ended June 30,			
	2016		2017		2018		2018		2019	
	(In thousands of RMB, except percentages)									
	(unaudited)									
Advertising expenses	487,819	35.6%	833,188	39.0%	1,166,958	31.9%	484,353	34.7%	430,083	27.7%
Promotional expenses	311,300	22.7%	407,797	19.1%	607,938	16.6%	269,884	19.3%	382,789	24.6%
Offline events expenses	233,420	17.0%	440,965	20.6%	864,956	23.6%	199,643	14.3%	154,084	9.9%

Source: Feihe 2019 Prospectus, p. 294

Feihe claimed that revenues grew by 32% in 2019. We would expect, like most consumer products, that such growth is driven by a commensurate investment in marketing. Yet Feihe claimed in its 2019 Prospectus that advertising spending declined 11% in the first half of 2019.

We think this is patently false, as overwhelming evidence shows that Feihe drastically increased its advertising spending in 2019.

For example, CCTV is China's most important TV network, and its commercial slots are expensive. In Q1 2019, Feihe was the number one advertiser on CCTV in China, increasing its spending by 309% over Q1 2018.

### 2019 Q1 Top 10 Advertising Spender by TV Channel Category

#### 2019年第一季度各级电视频道广告花费TOP10品牌及增幅

中央台	CCTV	省级卫视	省级地面台	省会城市台
飞鹤 Feihe	309%	德芙 106%	成博士 New	雅诗兰黛 118%
小罐	7%	士力架 156%	养无极 -43%	云南昆明 >1000%
君乐宝	68%	温尔罐 >1000%	陈李济 -42%	天地和 6%
足力健	-7%	益达 32%	雅诗兰黛 113%	兰蔻 -9%
蒙牛 Mengniu	181%	伊利 -6%	伊利 -7%	功夫掌门 New
同溢堂	88%	王老吉 -38%	鸿茅 -80%	欧莱雅 -56%
伊利 Yili	51%	兰蔻 10%	兰蔻 25%	2019首届南京国际皮革裘皮博览会 New
鲁花	12%	旺旺 -42%	康师傅 469%	立白 >1000%
华为	12%	康师傅 188%	葛洪 -56%	固升 604%
8848	12%	达利 New	百威 62%	费列罗 -6%

Source: <http://www.cnad.com/show/525/299353.html>

We question how Feihe's advertising spending could have declined in a quarter in which spending on CCTV increased 309%. Other data shows a similar trend.

CTR Market Research ("CTR"), a joint venture with the state-owned China International Television Corporation (an SOE), tracks and periodically publishes advertising purchasing data, including detailed rankings of advertising spending on television commercials by Chinese consumer brands. Although CTR does not track all of the Company's advertising expenses, it does provide directionally valuable data for increases or decreases in advertising spending through television, broadcast and print media.

This independent data shows that **on TV commercials alone**, Feihe's spending increased **333% in the first four months of 2019, compared to the same period the year before**.

2019 January to April Top 20 Advertising Spender (Brand) (RMB 100M)

2019年1-4月投放TOP20品牌 (亿元)								
排名	行业	大品牌	2018年1-4月		2019年1-4月		增量	增幅
1	药品	养无极	Jan'18 to	54.9	Jan'19 to	47.3	-7.6	-14%
2	药品	同溢堂	Apr'18	71.8	Apr'19	43.2	-28.6	-40%
3	药品	陈李济		62.6		39.5	-23.0	-37%
4	药品	鹤洪		76.8		38.1	-38.7	-50%
5	药品	成博士		0.0		35.4	35.4	新增客户
6	饮料	伊利		32.5		32.3	-0.2	-1%
7	家居用品	天地和	RMB 3.25 B	84.5	RMB 3.23 B	30.6	-53.9	-64%
8	化妆品/浴室用品	兰蔻		30.5		29.6	-0.9	-3%
9	食品	德芙		18.8		29.2	10.5	56%
10	饮料	君乐宝		9.2		27.9	18.7	203%
11	家居用品	优活		0.0		26.9	26.9	新增客户
12	酒精类饮品	鸿茅		110.1		23.9	-86.2	-78%
13	衣着	温尔曼		7.1		22.7	15.6	220%
14	食品	士力架		13.9		22.5	8.6	61%
15	衣着	足力健		18.1		21.9	3.8	21%
16	食品	康师傅		6.7		20.8	14.1	212%
17	化妆品/浴室用品	蕾诗兰黛		16.2		20.7	4.5	28%
18	化妆品/浴室用品	欧莱雅		26.5		19.7	-6.8	-26%
19	饮料	飞鹤		4.5		19.5	15.0	330%
20	衣着	Feihe		RMB 450 M		RMB 1.95 B	18.2	新增客户

数据来源: CTR, 电视, 不含杂类大项, 2018.1.1-2019.4.30, 刊例价 Source: CTR, TV, excluding others, January 1, 2018 to April 30, 2019, official rates

Source: <http://dy.163.com/v2/article/detail/EFVELT6Q05171F4N.html>

CTR's advertising expense figures are based on official rates, so like all buyers, Feihe receives significant discounts to the sticker price. The discount to official rates varies widely depending on when and where the commercial appears, and includes variables such as viewership, channel, prime time and other variables. This makes it difficult to estimate Feihe's actual spending based on the official rates. But there should be directional consistency.

Notably, the CTR data is consistent with the advertising spending trends disclosed by other public companies. For example, in the list above, CTR's data shows that Yili's advertising spending was flat year over year. This is consistent with Yili's reported advertising spending, which stayed at RMB 4 billion in 2018 and 2019.

来自知情人士的消息, **伊利集团 (Yili)** 已经于日前召集媒介购买业务比稿, 并邀请多家 4A媒介代理公司参加。

据悉, 本次伊利的比稿将分成三个标——电视与平面媒体购买、户外媒体购买、数字媒体购买。伊利集团每年的媒介总花费估计在40亿人民币左右。

It is reported that this time Yili's draft will be divided into three categories: TV and print media purchase, outdoor media purchase, digital media purchase. Yili Group's total annual media cost is estimated to be around RMB 4 billion every year.

Source: <http://www.madisonboom.com/2019/01/21/yili-on-hunt-for-its-media-business/>

The CTR data is consistent with the disclosed spending of the Company's competitor, Yili. But not for Feihe. Feihe's television commercial spending grew **333%** in the first four months of 2019, yet Feihe claimed that its advertising spending declined over that same period.

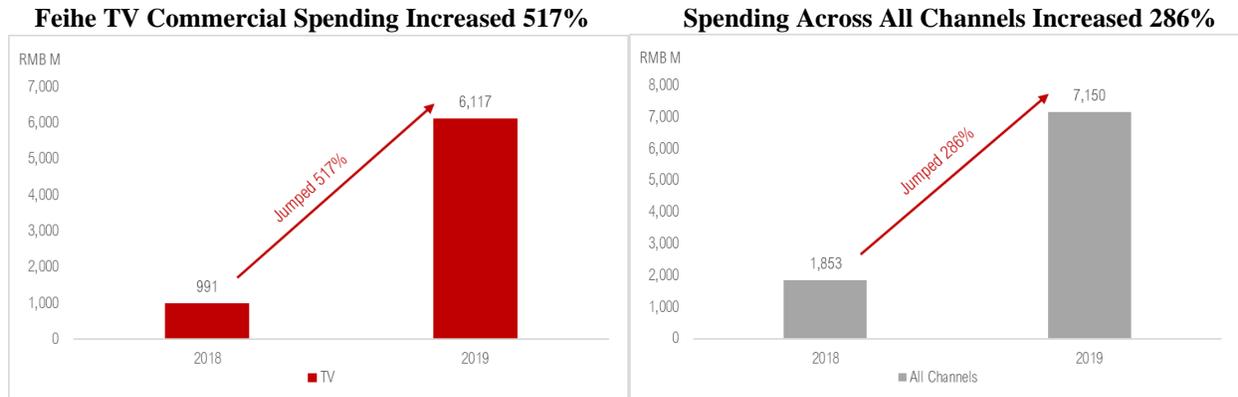
Feihe's aggressive spending on television advertising continued into the second half of 2019, likely in preparation for the Company's IPO. According to another published report, **Feihe's TV commercial volume grew 385.6% in November 2019**, compared to the same month the previous year.

饮料行业11月份在电视媒体头部行业中增幅最大，达到46.2%。从品类看，婴幼儿奶粉、茶、原奶的广告投放量较多，广告花费同比上涨282.0%、33.1%、37.4%。婴幼儿奶粉品类中，惠氏和美赞臣的广告刊例花费增幅均超过10倍，飞鹤在电视广告投放量同比上涨385.6%。茶类别中，小罐和天天清依旧占据投放量榜单前两位但投放总量有所下滑，龙润的广告花费上涨较多，对饮料行业在电视媒体的增长有正向拉动作用。

Feihe's TV advertising volume grew 385.6% as compared to the same period last year

Source: <http://www.ctrchina.cn/insightView.asp?id=3626>

We reviewed the full year CTR data, which shows that Feihe increased its advertising spending on TV commercials by 517% in 2019 and increased its total advertising spending across all channels by 286% in 2019.



Source: CTR (Feihe Advertising Spending at Official Rates)

CTR tracks companies' advertising spending on TV, radio, and outdoor media, but does not track TV show sponsorships or offline campaigns. Accordingly, CTR data does not include a significant portion of Feihe's total advertising spending.

For example, Feihe conducted several new large-scale advertising campaigns leading up to its 2019 IPO, including buying out space in a Beijing subway station and on a popular high-speed train. This advertising space is expensive.

**Feihe New Media Campaign in 2019**



Source: [Shanghai Light Show](#), [Feihe Bullet Train](#), [Beijing Subway Station](#)

How could Feihe's ad spending have declined year-over-year, as it claimed, when in 2019 it launched so many new high-profile offline campaigns?

Type of Advertisements	2018	2019
CCTV Ads Collaboration	CCTV National Brand Project	CCTV Parent-Child Brand Project
Offline Ads Campaign	Beijing Subway Station (small scale)	Feihe Branded Bullet Train Lighting Show in Shanghai Beijing CBD Parent-child space Beijing Subway Station Large Scale Outdoor Poster Ads
Exclusive Sponsorship of CCTV Documentary		Aerial China S2 (航拍中国) Bond with China (中国缘)
Integrated Media Campaign		Feihe Origin Campaign (溯源之旅)
Celebrity Endorsement	Zhang Ziyi (Brand Ambassador)	Zhang Ziyi (Brand Ambassador)
Sponsorship of TV Shows	知否知否应是绿肥红瘦 如懿传	知否知否应是绿肥红瘦 破冰行动
Offline Sponsorship		China Fashion Week Fairytale Town 《小骑手!冲啊》线下选拔赛 萌娃运动会
Sponsorship of Variety Shows	我就是演员 (第一季特约) 新鲜育儿观第一季 隔代育儿(独家冠名) 无敌小鹿儿歌篇 (小鹤icon)	小骑手!冲啊 (独家冠名) 新鲜育儿观第二季 吴晓波年终秀 (首席战略合作伙伴)

Source: Survey of Major Advertising Campaigns and Sponsorships

The Company sponsored more TV shows and launched more campaigns in 2019, likely to boost sales and notoriety in preparation for its November IPO. This included prominent advertising blitzes in high cost space such as Beijing's subway station and high-speed trains. We doubt that the Company's ad spending could have decreased as it claimed.

Rather, independent evidence indicates that spending increased drastically in 2019. Using Feihe's reported 2018 advertising spending as a baseline, we apply the 286% growth rate in spending reported by independent media tracking sources like CTR. Even assuming that Feihe receives an additional 60% discount on its higher volume, we estimate that Feihe actual advertising expenses were at least **RMB 765 million more than reported in 2019**.

RMB M	2018	2019
Feihe advertising expenses	1,167	1,036
Growth %		-11%
CTR tracked advertising spending growth %		286%
Assumed Volume discount		60%
Estimated advertising expenses		1,801
<b>Difference</b>		<b>(765)</b>
<b>Difference %</b>		<b>-42%</b>

Source: Blue Orca Calculation

We cross checked our estimate with an advertising expert, who has years of experience working with major IMF manufacturers. The expert provided a detailed estimate of Feihe's advertising spending in 2019, broken out by campaign and media platform. His estimate was consistent with our analysis.

RMB M	2019
TV	700
Focus media	200
Digital media	170
Outdoor campaigns (Feihe Branded HSR, Shanghai light show, etc.)	200
Radio, celebrity endorsement, building billboard, PR, etc.	300
[Program sponsorship]	150
<b>Feihe advertising expenses</b>	<b>1,720</b>

*Source: Interview with Advertising Expert*

*\*The expert did not mention program sponsorship, which we estimate the costs are RMB 150 million.*

In short, Feihe's cost structure appears substantially more onerous than it discloses to investors, meaning its business is likely much less profitable than it claims.

### 3) Underreported Expenses Indicate Operating Profit 35% less than Reported to Investors

Combining Feihe's undisclosed advertising expenses and underreported labor costs, we believe that Feihe incurred at least RMB 1.7 billion more in operating costs than it disclosed to investors in 2019.

RMB M	2019
Reported revenue	13,722
Reported gross profit	9,610
Operating expenses	4,761
Operating profit	4,848
Estimated undisclosed labor costs	(925)
Estimated undisclosed advertising expenses	(765)
<b>Adjusted operating profit</b>	<b>3,159</b>
<b>Difference %</b>	<b>-35%</b>

*Source: Blue Orca Calculation*

Such expenses have a material impact on Feihe's profitability. We calculate that even if investors believe Feihe's reported revenue figures (which we think are inflated), such undisclosed costs indicate that the Company's profitability was at least 35% less than reported in 2019.

## GHOST FACTORY AND QUESTIONABLE TAX REFUNDS

Eight days after Feihe's IPO, GMT research issued a note questioning many of the "fraud-like" characteristics of Feihe's financials. Feihe's primary rebuttal to GMT was the contention that its financials were trustworthy because its subsidiaries paid PRC taxes of RMB 2.0 billion in 2018 and RMB 1.4 billion in the first six months of 2019. If the taxes were true, so the argument went, Feihe's financials were true.

**Tax payment certificates:** The Company has requested and obtained the tax payment certificates (the "Tax Payment Certificates") from Qiqihar Taxation Bureau and Zhenlai County Taxation Bureau of the PRC State Administration of Taxation, which confirm that the tax payments (such as corporate income tax and turnover tax) made in accordance with applicable PRC laws and regulations by the Company's principal subsidiaries located in the PRC for 2018 and the six months ended 30 June 2019 amounted to approximately RMB2.0 billion and RMB1.4 billion, respectively. In addition, the Company's subsidiaries in Qiqihar in aggregate are grade A taxpayers who contribute the largest amount of tax payment in the city. The Group's tax payment certificates also reflect the Group's operating scale and conditions.

Source: <https://www1.hkexnews.hk/listedco/listconews/sehk/2019/1122/2019112200953.pdf>

First, tax payments do not necessarily prove revenues or profits are real. PRC regulators recently reported that Luckin Coffee paid taxes on its fabricated revenues. In this case, when we dig deeper, local taxes do not exonerate Feihe at all. Rather, in our opinion, it is compounding evidence undermining the authenticity of Feihe's financials.

### a) Ghost Factory Revenues

In our opinion, Feihe's purported tax payments and local filings are fabricated to mislead investors because they include substantial revenues and tax payments from a ghost factory which Feihe admits was not even open during the track record period.

According to Feihe's disclosures to investors, Feihe (Tailai) Dairy ("Feihe Tailai") is a wholly owned manufacturing subsidiary which owns and operates the Tailai plant.

Name of subsidiaries	Date and place of incorporation	Amount of initial registered capital/authorized share capital/authorized capital stock	Immediate shareholder/ equity-holder and equity interest attributable to our Group	Reason for the establishment
Feihe Tailai	July 25, 2016, PRC	RMB500 million	Feihe HLJ, 100%	Operation of the Tailai Plant

- (6) The construction of the Tailai Plant is still in the planning stage, it is expected that the construction of the Tailai Plant will be completed by the end of 2019.

Source: Feihe 2017 Prospectus

### CORPORATE AND GROUP INFORMATION (Continued)

Name	Place of incorporation/ registration and business	Issued ordinary/ registered share capital	Percentage of equity attributable to the Company		Principal activities
			Direct	Indirect	
Feihe (Tailai) Dairy Products Co., Ltd (飛鶴(泰來)乳品有限公司) <sup>11</sup>	The PRC/ Mainland China	RMB500,000,000	-	100	Manufacture of milk powder

Source: Feihe 2019 Annual Report

According to Feihe's 2019 Prospectus, the Company was still in the process of building a new 20,000-tonne Tailai goat milk powder facility at the time of the IPO. Feihe stated that the total investment for the Tailai plant was RMB

400 million, and that it expected to incur RMB 133 million in future expenditures to complete the facility (33% of total), **which the Company expected to finish in the second half of 2019.**

#### Tailai Plant

We invested in the construction of a Tailai Plant, located in Tailai county, Heilongjiang province, for the production of goat milk infant formula and goat milk powder products. As of the Latest Practicable Date, Tailai Plant was in the course of trial production. On June 21, 2017, we procured land in Tailai county for our Tailai Plant and commenced construction in August 2017. See “– Properties – Owned Properties – PRC.” Upon completion in the second half of 2019, the Tailai Plant is expected to have a designed annual production capacity of 20,000 tonnes. The total estimated capital expenditure for our Tailai Plant is approximately RMB400.0 million, of which RMB267.2 million was incurred as of June 30, 2019 and we expect to fund the remaining capital expenditure by internal funding.

Source: *Feihe 2019 Prospectus*, p. 216

Notably, Feihe did not **report any production from the Tailai plant in its prospectus**, which makes sense considering the factory was still under construction.

The following table sets forth the designed annual production capacity, actual production volume and utilization rate of our production facilities for the periods indicated:

Facility	Product type	For the years ended December 31,									For the six months ended June 30,		
		2016			2017			2018			2019		
		Designed annual production capacity <sup>(1)</sup> tonnes	Actual production volume <sup>(2)</sup> tonnes	Utilization rate <sup>(3)</sup> %	Designed annual production capacity <sup>(1)</sup> tonnes	Actual production volume <sup>(2)</sup> tonnes	Utilization rate <sup>(3)</sup> %	Designed annual production capacity <sup>(1)</sup> tonnes	Actual production volume <sup>(2)</sup> tonnes	Utilization rate <sup>(3)</sup> %	Designed annual production capacity <sup>(1)</sup> tonnes	Actual production volume <sup>(2)</sup> tonnes	Utilization rate <sup>(3)</sup> %
Kedong Plant	Infant milk formula products; adult milk powder	12,000.0	8,995.3	75.0	12,000.0	8,711.0	72.6	12,000.0	11,690.8	97.4	12,000.0	2,921.5	48.7
Gannan Plant	Infant milk formula products; adult milk powder	39,000.0	16,434.0	42.1	39,000.0	26,080.0	66.9	45,600.0	29,802.6	65.4	45,600.0	18,173.3	79.7
Longjiang Plant	Infant milk formula products; adult milk powder	21,000.0	15,451.0	73.6	21,000.0	19,606.4	93.4	28,000.0	25,112.4	89.7	28,000.0	14,044.9	100.3
Feihe Zhenlai Plant	Infant milk formula products; adult milk powder	6,000.0	2,763.0	46.1	6,000.0	3,190.0	53.2	7,200.0	7,206.8	100.1	7,200.0	3,358.0	93.3
Baiquan Plant <sup>(4)</sup>	Adult milk powder	-	-	-	-	-	-	7,200.0	1,824.5	101.4	7,200.0	3,158.4	87.7
Total		78,000.0	43,643.3	56.0 <sup>(5)</sup>	78,000.0	57,587.4	73.8 <sup>(5)</sup>	100,000.0 <sup>(7)</sup>	75,637.1	75.6 <sup>(5)</sup>	100,000.0 <sup>(7)</sup>	41,656.1	83.3
Kedong Plant <sup>(6)</sup>	Liquid milk products	8,800.0	6,856.1	77.9	8,800.0	6,067.8	69.0	8,800.0	5,842.6	66.4	8,800.0	3,518.9	80.0
Baiquan Plant <sup>(4)(6)</sup>	Soybean powder	5,400.0	1,041.0	38.6	5,400.0	1,308.3	24.2	5,400.0	-	-	5,400.0	-	-

Source: *2019 Feihe Prospectus*, p. 212

**To state the obvious, if the Tailai factory was still being built, then it should not have generated any revenues. But Feihe’s local filings show the opposite.**

We reviewed the local credit reports containing the SAIC financials for Feihe Tailai, the manufacturing subsidiary whose only facility is the Tailai plant. According to local filings, Feihe Tailai recorded revenues of RMB 1.3 billion in 2018 and RMB 1.7 billion in 2019.

#### Profit and Loss Statement (Unit: Thousand Yuan):

	2019	2018
Sales	1,680,970	1,280,110
Less: Cost of sales	1,363,267	1,043,495
Sales taxes and additional	6,481	4,827
Other business profit	81,416	56,352

Source: *Feihe Tailai Credit Report*

In addition, SAIC filings show that Feihe Tailai supposedly paid hundreds of millions of taxes generated from this reported revenue.

RMB M	2016	2017	2018	2019
Total operating Revenue	337	472	1,280	1,681
<b>Total tax payment</b>	<b>3</b>	<b>57</b>	<b>135</b>	<b>n/a</b>

Source: Feihe Tailai SAIC Filings and Credit Report

How could a manufacturing subsidiary generate billions in revenues and supposedly pay hundreds of millions in taxes if the facility was not in operation? Press releases state that the Tailai plant only obtained the permit of produce IMF in February 2020.

**新华网 黑龙江**

## 黑龙江：疫情之下，审批跑出“加速度”

2020年02月22日 15:31:24 来源： 新华网

为提高办事效率，国家市场监督管理总局和黑龙江省特事特办：2月17日，飞鹤（泰来）乳品有限公司配方注册申请和飞鹤（甘南）乳品有限公司星飞帆产品升级配方注册申请顺利通过了国家市场监督管理总局批准；2月18日，黑龙江省市场监督管理局核发了飞鹤（泰来）乳品有限公司的食品生产许可证……一路绿灯，疫情期间，审批竟跑出了“加速

February 18, the Heilongjiang Provincial Market Supervision Administration issued the food production permit to Feihe (Tailai) Dairy.

Source: [http://hlj.xinhuanet.com/klj/2020-02/22/c\\_138808498.htm](http://hlj.xinhuanet.com/klj/2020-02/22/c_138808498.htm)

The Tailai plant was not even licensed until 2020 to produce IMF. And Feihe admits that it did not produce any product during the pre-IPO track record period. **So we doubt that Feihe Tailai could generate billions of revenues and pay hundreds of millions in taxes in 2018-2019 without producing infant milk formula.**

Other details suggest that local financials (and related purported tax payments) are likely fabricated to cover Feihe's tracks. For example, PRC records indicate that Feihe Tailai's paid-in capital was zero when the facility was being built.<sup>10</sup> Yet, with zero paid in capital and an incomplete plant, Feihe still claimed that this entity had a massive business.

Local financials also show that Feihe Tailai's fixed assets *declined* from 2018 to 2019, a strange development given that the Tailai plant was supposedly under construction during this time. Usually, when a subsidiary builds its **only production facility**, fixed assets increase. But not in this case.

<sup>10</sup> Feihe Tailai 2019 Annual Filings.

### Feihe Tailai PP&E Decreased while Building its Plant

Balance Sheet (Unit: Thousand Yuan):

	2019	2018
Cash & bank	141,621	192,219
Accounts receivable	71,807	99,130
Advances to payment	31,432	45,384
Other receivables	54,443	55,109
Inventory	132,814	169,856
Other current assets	8,658	15,258
Total current assets	440,775	576,956
Fixed assets	88,237	127,739
Other non-current assets	14,829	24,855
Total non-current assets	103,066	152,594

Source: Feihe Tailai Credit Report

Feihe Tailai's production history not only indicates that Feihe's reported tax payments and local filings are bogus, but also casts doubt on the Company's consolidated financials disclosed to investors in its prospectus.

Feihe claimed that RMB 1.1 billion of its group-level profits in 2018-2019 were from government tax credits, which the Company classified as "other income" on the income statement of its consolidated financials.

Feihe claims that this 'other income' is primarily derived from government grants, which it receives as **tax refunds for selling milk powder**.

government grants recognized during the same years or period. A description of the government grants and a summary of the major terms of the relevant agreements are set forth below:

- **Amount.** Our PRC operating subsidiaries shall receive cash subsidies generally ranging from 20% to 40% of VAT and enterprise income taxes paid and, in certain agreements, 100% of other local taxes paid;

Source: Feihe 2019 Prospectus, p. 291

A major portion of such other income was reported by Feihe Tailai. But how could such tax refunds be authentic when the factory was not even in production?

RMB M	2018	2019
Feihe reported other income	556	977
Government grants		
Assets	17	2
Income	395	724
Feihe Tailai SAIC other income	168	408
<b>% of reported other income</b>	<b>30%</b>	<b>42%</b>

Source: Feihe Public Filings, Feihe Tailai Credit Report

In our view, Feihe Tailai shows that taxes and local financials do not exonerate Feihe at all. Rather, it is compounding evidence undermining the authenticity of Feihe's reported revenues, profits, income, grants, refunds, and taxes. We think Feihe's financials are not credible, given such a prominent example of revenues, profits and taxes from a ghost facility that was not even completed.

## FEIHE OVERSTATES BILLIONS IN CAPITAL EXPENDITURES

Companies underreporting operating expenses face a problem: a cash hole on the balance sheet which needs to be plugged. Thus, many companies inflating profitability must inflate capital expenditures or other balance sheet line items to wash fake profits. In this case, we think evidence indicates that Feihe overstates capital expenditures, in some cases by reporting that it is undertaking facility expansion projects which were actually completed *before the IPO*.

In its 2019 Prospectus, Feihe claimed that it had five production facilities with a total capacity of 100,000 tonnes; and that it intended to spend billions to add an additional 151,000 tonnes of capacity.

significant amount of time, typically requiring a minimum of two years from plant design to completion of construction and the commencement of trial production. Our newly-constructed and expanded production facilities are expected to experience a three-year ramp-up period before reaching their full designed annual production capacities. Based on the plans for our planned production facilities as disclosed below, we expect to increase our designed annual production capacity by 151,000 tonnes, when we complete the ramp-up of such facilities to their full designed annual production capacities.

Source: *Feihe 2019 Prospectus*, p. 215

In total, Feihe's 2019 Prospectus outlined billions in future capital investments to expand its capacity at its formula production facilities.

RMB M	Disclosed Completion Date	Capex Overstatement
Kedong plant 克东厂房	1H 2020	431
Kingston plant	1H 2020	578
Jilin plant 吉林厂房	1H 2020	269
<b>Total</b>		<b>1,278</b>

Source: *Feihe Prospectus, Blue Orca Estimate*

There is just one problem. Evidence from local government announcements and Chinese media indicate that either Feihe overstated its investment in such projects or that a large portion of this “future” capacity expansion was already complete **before the IPO**.<sup>11</sup>

### a. Kedong Expansion Project (overstated future capex of RMB 431 million)

Feihe stated in its 2019 Prospectus that its Kedong plant had a capacity of 12,000 tonnes and declared an intention to expand capacity at this facility to 52,000 tonnes by 2020. The Company announced that the project would cost RMB 530 million and that construction began in October 2018. As of 1H 2019, the Company claimed to have only invested RMB 99 million, meaning it would invest a further RMB 431 million to complete the Kedong expansion project.

#### *Expansion of Kedong Plant*

We commenced expansion of our Kedong Plant in October 2018 by adding a new production line with an increase in designed annual production capacity from 12,000 tonnes to 52,000 tonnes. We expect to have a designed annual production capacity of 32,000 tonnes in the first year of commencing operations, 40,000 tonnes in the second year and the full designed annual production capacity of 52,000 in the third year. As of the Latest Practicable Date, the expansion of Kedong Plant was still in progress. We expect to complete the construction of the new production line in the first half of 2020. During the construction period, the current operations at the Kedong Plant were not affected. The total estimated capital expenditure for the expansion of our Kedong Plant is approximately RMB530.0 million, of which RMB98.9 million was incurred as of June 30, 2019 and we expect to fund the remaining capital expenditure by internal funding.

Source: *Feihe 2019 Prospectus*, p. 216

<sup>11</sup> In this section, when we discuss pre and post IPO, we mean “after the latest practicable date” as defined in the Prospectus, which was October 22, 2019.

In its 2019 Prospectus, Feihe claimed that it started construction in 2018 and only 19% of the project was complete.

Yet incredibly, Feihe's prior prospectus from its aborted 2017 Hong Kong IPO stated that construction of the Kedong expansion was commenced and completed well before the timeline outlined later in the Company's 2019 Prospectus. According to the 2017 Prospectus, the Company stated that it began the Kedong plant expansion in 2015 and expected to complete the project in early 2018. This is clearly the same project.

#### *Expansion of Kedong Plant*

We commenced expansion of our Kedong Plant in May 2015 by adding a new production line with an increase in designed annual production capacity from 12,000 tonnes to 50,000 tonnes. As of the Latest Practicable Date, we had completed the project design and feasibility study and commenced construction. We expect to commence operations of the new production line by early 2018. During the construction period, we do not expect that current operations at the Kedong Plant will be affected. The total estimated capital expenditure for the expansion of our Kedong Plant is approximately RMB300.0 million, of which RMB67.1 million was incurred as of December 31, 2016 and we expect to fund the remaining RMB232.9 million using cash from operations.

*Source: Feihe 2017 Prospectus*

Consistent with the 2017 Prospectus, local government and media reported that the expansion started in November 2015 and was completed by 2018.

Kedong is a county under the jurisdiction of Qiqihar City. In June 2015, the Qiqihar government put out a press release stating that Feihe decided to construct a 50,000 tonne IMF production plant in Kedong. The plant has a gross floor area of 30,500 sqm, which matches the Company's disclosures. The government's announcement stated that construction would begin in 2015.



### 飞鹤年产五万吨配方乳粉智能化生产项目奠基

Upload Date: June 8, 2015

上传日期: 2015-06-08

来源: 市信息中心

6日上午, 鹤山脚下彩虹门高耸林立、气球条幅迎风飘扬, 呈现出一片火红的场面。飞鹤乳业年产5万吨配方乳粉智能化生产项目奠基仪式在克东县蒲峪路工业园区内隆重举行。

市领导张贵海、李洪国出席奠基仪式。

据介绍, 为进一步增强企业产品市场竞争力, 飞鹤乳业决定在飞鹤克东老厂区内新建年产5万吨配方乳粉智能化生产项目, 建设期为2015—2016年。项目计划总投资5亿元, 占地面积5.2万平方米, 建筑面积3.05万平方米, 主要建设主车间1座、库房2座、综合楼1座及附属配套工程, 新上生产线9条。项目达产达效后, 可将克东及其周边飞鹤牧场生产的鲜奶全部实现就地加工, 预计年生产配方乳粉5万吨, 实现销售收入55亿元, 税金5亿元, 安置就业283人。

Feihe Dairy decided to construct a new 50,000 tonnes IMF smart manufacturing plant. The construction period is 2015 to 2016. The estimated investment is RMB 500 million. The plant's site area is 52,000 sqm and the building area is 30,500 sqm.

The plant is expected to produce 50,000 tonnes of IMF a year.

*Source: [http://www.qqhr.gov.cn/News\\_showNews.action?messagekey=102880](http://www.qqhr.gov.cn/News_showNews.action?messagekey=102880)*

The local government also provided updates on Feihe's Kedong project. In November 2017, the Kedong government put out a [press release](#) stating that Feihe already invested RMB 300 million in its Kedong plant and that the facility

was undergoing interior decoration and equipment installation. The government announced that the plant would **begin trial production in November 2017**.

In August 2018, two months before Feihe claims to have started the Kedong expansion in its 2019 Prospectus, a press release on the Qiqihar government website announced that the new 50,000 tonnes production line **was already open and had been in production since the end of 2017!**<sup>12</sup>

今年上半年，全县地区生产总值实现16.9亿元，增长18.4%；公共财政预算收入实现2.5亿元，增长73.2%；规上工业增加值9.9亿元，增长43.9%，以上三项增幅在全市九县均排名第一。

现代畜牧业长足发展 **Feihe Dairy IMF smart production project cost RMB 500 million and was in production at the end of last year (2017).**

走进克东县飞鹤乳业智能化配方乳粉生产车间，只见规模宏大的现代化生产线有序运转，一罐罐优质配方奶粉从这里生产出来。工厂负责人介绍，**飞鹤乳业配方乳粉智能化生产项目总投资5亿元，于去年年底投产**，整条生产线采用机器人操作，企业实现了生产信息化、自动化、智能化，走上了高速发展轨道。

Source: [Government Announcement, August 2018](#)

In November 2018, another press release from the Qiqihar government showed a picture of the 50,000 tonnes production line at Feihe's Kedong plant in action. The announcement stated proudly that the new facility was already in operation.

齐齐哈尔市人民政府 WWW.QQHR.GOV.CN		政务公开		网上办事		互动交流		走进鹤城	
索引号	20181102-161459	分类	工业、交通;市信息中心;图说新闻;						
发布机构	市信息中心	发文日期	2018-11-02	Date of release: November 2, 2018					
名称	克东县飞鹤乳业实现销售收入55亿元								

### 克东县飞鹤乳业实现销售收入55亿元

信息来源：市信息中心



这是克东县飞鹤乳业5万吨无尘智能化生产线，随着传送带不断运转，一罐罐奶粉正在贴标打包装箱，发往各地。据了解，克东县飞鹤乳业总投资5亿元建设的奶粉智能化生产项目，每天可打包100多吨奶粉，年可生产包装奶粉5万吨，实现销售收入55亿元。

This is Feihe's 50,000 tonnes dust-free smart production line in Kedong County. As the conveyor belt keeps running, cans of milk powder are being labeled, packaged, and sent to various places. It is understood that the smart milk powder production project, which Feihe Dairy invested RMB 500 million to build, can package more than 100 tonnes of milk powder per day. It can produce and package 50,000 tonnes of milk powder per year ...

Source: [http://www.qqhr.gov.cn/News\\_showGkmlNews.action?messagekey=161459](http://www.qqhr.gov.cn/News_showGkmlNews.action?messagekey=161459)

<sup>12</sup> We know this is the same project, because Feihe reported in its 2019 Prospectus that the building area of its Kedong plant was 30,599.9 sqm, which matches with the area mentioned in government's press releases. Accordingly, we are confident that the Kedong plant mentioned in the local government announcements is the same Kedong plant described in Feihe's 2019 Prospectus.

In its 2019 Prospectus, Feihe claimed it intended to invest a further RMB 431 million in the Kedong expansion, which the Company stated would be complete by 2020. **At the time, Feihe claimed that the expansion was only 19% complete.** Yet announcements from the local Kedong government, corroborated by Feihe's prior disclosures in its 2017 Prospectus, indicate that the project was already complete in 2018, well before the IPO.<sup>13</sup>

In our opinion, Feihe misled investors about future capital expenditures as a way to conceal underreported operating expenses. As discussed in this report, there is voluminous evidence to suggest that Feihe understates advertising, staffing and other expenses, and that the Company is far less profitable than the Company claims. By overstating capital expenditures, we believe that Feihe is able to conceal undisclosed operating expenses.

#### b. Kingston Plant (overstated capex of RMB 578 million)

We also question Feihe's claims regarding the construction of its new facility in Canada. In its 2019 Prospectus, Feihe claimed that the total capital expenditure to build its Kingston plant would be C\$ 330 million.

We commenced construction of this facility in the fourth quarter of 2017 and expect to complete construction and commence production in the first half of 2020. For details of the material licenses and permits necessary for our operations in Canada, see “– Licenses and Permits – Canadian Operations.” The total estimated capital expenditure for our **Kingston Plant is approximately C\$330.0 million** (equivalent to approximately RMB1,711.7 million), of which C\$278.9 million (equivalent to approximately RMB1,446.6 million) was incurred as of June 30, 2019. We expect to fund the remaining capital expenditures by internal funding.

Source: *Feihe Prospectus*, p. 215

There is direct evidence to suggest Feihe is exaggerating its total investment in the Kingston plant. In December 2019, the builder of the Kingston facility, the Graham Group, [announced](#) that it completed, “**on time and on budget... a C\$ 208.8 million plant** to Canada Royal Milk, a division of China-based Feihe International, after almost two years of construction.”

### Graham finishes new **\$208.8M infant formula plant** in Kingston, Ont. on time, on budget

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December 10, 2019 by On-Site Staff



An overview of the new manufacturing facility in Kingston, Ont. PHOTO: Graham

A new infant formula manufacturing facility in Kingston, Ont. is complete on time and on budget.

Graham Group Ltd. said Dec. 2 it has handed over the \$208.8 million plant to Canada Royal Milk, a division of China-based Feihe International, after almost two years of construction.

Source: *On-Site Canadian Construction Magazine*

<sup>13</sup> This expansion from 12,000 tonnes per year capacity to 50,000 tonnes per year capacity at the Kedong plant, should not be confused with another, currently ongoing project at the Kedong plant. The further expansion, currently under construction, will add another 40,000 tonnes to bring the total capacity of the Kedong facility to 90,000 tons per year.

Put simply, the builder reported that the facility cost C\$ 208.8 million, 37% less than Feihe reported in its 2019 Prospectus.

It is also notable that the builder specifically highlighted that the facility was built “on time and on budget,” because the budgeted amount was far lower than the amount Feihe later claimed to have invested in the project.

In Feihe’s 2017 Prospectus, the Company stated that the capital expenditures for the facility would be C\$ 225 million, not C\$330 million, as Feihe later claimed.

#### *Kingston Plant*

We plan to invest in a goat milk and cow milk infant formula production facility in Kingston, Ontario. We believe the strategic location of this project will enable us to develop our overseas business. In October 2016, we entered into a strategic cooperation agreement with the Canadian Dairy Commission, pursuant to which the Canadian Dairy Commission agreed to provide support for our project, supply cow milk and facilitate our construction of the Kingston Plant. Our Kingston Plant will feature a research and development facility as well as incorporate smart manufacturing technologies using cloud computing and big data to manage the exacting and complex process of infant formula production. We plan to install one production line each for cow milk infant formula products and goat milk infant formula products, each with an expected designed annual production capacity of 20,000 tonnes. We expect to commence construction of this facility in the third quarter of 2017 and commence operations in 2019. The total estimated capital expenditure for our Kingston Plant is approximately C\$225.0 million (equivalent to approximately RMB1,134.3 million). We did not incur any capital expenditure with respect to this project during the Track Record Period. We plan to finance this project by allocating approximately 40%, or HK\$1,285.1 million of the net proceeds from the Global Offering, and using bank borrowings and cash from operations.

*Source: Feihe 2017 Prospectus*

The Canadian builder confirmed that the project was delivered on budget, meaning such initial estimates are likely a reliable indicator of total investment. Furthermore, local Canadian development authorities published a deck on the project confirming that the total investment for Kingston facility was only C\$225 million.



**Project Highlights**

- **\$225 million investment**
- 320,000 square foot facility
- World class intelligent manufacturing facility
- Canada's first & only wet infant formula facility
- North America's first & only goat milk infant formula facility
- One of the largest Foreign Direct Investment Projects in Canada for job creation
- 200 to 250 new full-time direct jobs
- 1,200 to 1,500 indirect jobs
- **Facility design includes 2 separate production lines: 1 for cow dairy and 1 for goat dairy**
- Multi-phase project
  - Phase I: Infant formula production with cow dairy
  - Phase II: Infant formula production with goat dairy
  - Phase III: Addition of nutra-ceutical products and/or distribution

*Source: Feihe Canadian Project Presentation from Kingston Economic Development Corporation*

Together with the completion announcement by the builder, this evidence indicates, in our opinion, that Feihe materially exaggerated its reported capital investment in the Kingston facility.<sup>14</sup>

<sup>14</sup> In addition, Feihe [received](#) a C\$ 24 million grant from Ontario’s Ministry of Economic Development and Growth in November, 2017. Hence, the total investment from Feihe would be even lower than the reported figure.

### c. Jilin Plant (overstated future capex of RMB 269 million)

In its 2019 Prospectus, Feihe claimed to be in the midst of building a new 20,000-tonne facility in Zhenlai, Jilin, which it expected to open in 2020. Feihe reported that the project would cost RMB 400 million, with at least RMB 269 million in expected future capital expenditures to complete the project.

#### *Jilin Plant*

We invested in the construction of a Jilin Plant, located in Zhenlai county, Jilin province, for the production of infant milk formula products. As of the Latest Practicable Date, Jilin Plant was still under construction. Upon completion in the first half of 2020, the Jilin Plant is expected to have a designed annual production capacity of 20,000 tonnes. The total estimated capital expenditure for Jilin Plant is approximately RMB400.0 million, of which RMB131.0 million was incurred as of June 30, 2019 and we expect to fund the remaining capital expenditure by internal funding.

Source: [Feihe 2019 Prospectus, p. 216](#)

According to Feihe's 2019 Prospectus, it had only incurred 33% of the projected cost of building the Jilin facility. Yet local media reported that the construction of Jilin plant was completed by November 2019, meaning most if not all of the cost associated with the project should already have been incurred at the time of the IPO.

飞鹤(镇赉)乳品有限公司于2007年入住镇赉经济开发区, 2018年启动了二期飞鹤(镇赉)乳品加工项目建设, 在各项措施的保驾护航下, 该项目于2019年11月基本建成, 正式调试出粉。根据项目实际情况与《镇赉县人民政府办公室关于做好企业复工和节后错峰返

In 2018, the construction of the second phase of Feihe (Zhenlai) dairy processing project started. Under the escort of various measures, the project was basically completed in November 2019, and officially commissioned to produce powder.

据了解, 该项目总投资约4亿元, 占地面积8万平方米, 建筑面积2.2万平方米。项目全部建成达产后, 将实现全智能化生产, 日处理鲜奶500吨, 年可处理鲜奶15万吨, 加工生产婴幼儿奶粉2万吨。预计实现年销售收入60 亿元左右, 实现税金9亿元, 提供就业岗位约300个。

It is understood that the project cost around RMB 400 million... IMF production capacity of 20,000 tonnes.

Source: <http://news.cnjiwang.com/jlxwdt/sn/202003/3076415.html>

This is corroborated by other government announcements stating that most of construction took place in 2018, long before Feihe's IPO.



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Posted Date: August 22, 2018



字号:

#### 飞鹤（镇赉）乳品加工项目建设稳步推进

Feihe (Zhenlai) dairy processing project, with a total investment budget of RMB 400 million ..., has been under construction since April 25. The construction period is from 2018 to 2019... Currently, the civil foundation construction of the project has been completed, and the main body is under expedited construction.

飞鹤（镇赉）乳品加工项目, 计划总投资约4亿元, 占地面积8万平方米, 建筑面积2.1万平方米, 于4月25日开工建设, 建设期为2018年至2019年, 项目按照食药行业GMP标准设计, 建设10万级国际标准化净化车间。目前, 该项目土建基础施工已经完成, 主题施工正在紧张建设中。同时, 各个设备厂家已确定, 待土建施工条件满足后随时进场。

Source: [Government Announcement, August 2018](#)

Feihe claimed in its 2019 Prospectus the Jilin plant would be completed in 2020 after an additional RMB 269 million of investment, 67% of the total project investment. Yet local government announcements and media reports suggest that the plant was already complete and in trial production by the time of the IPO, suggesting that such future capital expenditures were likely suspect.

Why fabricate capital expenditures? We believe that Feihe's business is substantially less profitable than it claims, meaning the Company has to concoct or inflate capital expenses to conceal operating costs. We also believe that the Company's revenues are substantially smaller than it claims. Announcing future investments for projects that were already completed provides a convenient cash outflow to conceal inflated sales and profitability.

In total, either by announcing future capital investment in projects which appear to already have been complete, or simply overstating the investment amount of the Kingston facility, we believe that Feihe overstated at least RMB 1.3 billion in capital expenditures.

RMB M	Disclosed Completion Date	Capex Overstatement
Kedong plant 克东厂房	1H 2020	431
Kingston plant	1H 2020	578
Jilin plant 吉林厂房	1H 2020	269
<b>Total</b>		<b>1,278</b>

*Source: Feihe Prospectus, Blue Orca Estimate*

## MAJOR AUDIT RED FLAGS

When GMT questioned its financials, Feihe [fell](#) back on the old excuse that its financial statements are trustworthy because they are audited by an independent big four accounting firm, Ernst & Young. But this is not the case. Incredibly, Feihe went public without any audit whatsoever of many subsidiaries, which should undermine investor confidence in the integrity of the Company's questionable financials. Even after Feihe went public, [none](#) of its PRC subsidiaries were audited by Ernst & Young or its affiliates.

Of the 28 subsidiaries listed in the Company's 2019 Prospectus, only eight were audited. Six of those eight were not audited by Ernst & Young, but by small local PRC firms, one of which was recently reprimanded by accounting oversight authorities.

No	Name	Incorporation Date	2017 Prospectus	2019 Prospectus	Principal activities
1	Flying Crane International, Inc.	31-Dec-85	Not audited	Not audited	Investment holding
2	Feihe International	23-Dec-14	Not audited	Not audited	Inactive
3	Feihe China Nutrition (Hong Kong) Limited	23-Dec-14	Ernst & Young	Ernst & Young	Investment holding and provision of management services
4	Feihe China Nutrition Company	15-Jan-02	Not audited	Not audited	Inactive
5	Heilongjiang Platinum Commerce Co. Ltd	13-May-15	Not audited	Not audited	Investment holding
6	Feihe International (HK) Limited	22-Apr-14	Ernst & Young	Ernst & Young	Investment holding and provision of management services
7	Heilongjiang Platinum Holding Limited	28-May-15	Not audited	Not audited	Inactive
8	Heilongjiang Platinum International Limited	30-Nov-15	Not audited	Not audited	Inactive
9	Vitamin World International Company Limited	06-Mar-18		Not audited	Investment holding
10	Vitamin World USA	13-Dec-17		Not audited	Sale of vitamin products
11	Vitamin World (China) Limited	23-Mar-18		Not audited	Investment holding
12	Vitamin World (Hong Kong) Limited	23-Mar-18		Not audited	Inactive
13	Canada Kingston Dairy	31-Oct-16	Not audited	Not audited	Inactive
14	Canada Royal Milk ULC	31-Oct-16	Not audited	Not audited	Inactive
15	Heilongjiang Feihe Dairy Products (Feihe HLJ)	21-Aug-96	Heilongjiang Anlian	Heilongjiang Anlian	Manufacture and sale of milk powder
16	Beijing Feihe Biotechnology Scientific and Commercial (FKA:Beijing Flying Crane Biotech Co., Ltd)	08-Jun-04	Not audited	Not audited	Sale of milk powder
17	Feihe (Gannan) Dairy Products	22-Mar-06	Heilongjiang Zhongqi	Heilongjiang Zhongqi	Manufacture of milk powder
18	Feihe (Longjiang) Dairy Products	27-Sep-13	Heilongjiang Zhongqi	Heilongjiang Zhongqi	Manufacture of milk powder
19	Jilin Feihe Alfbeta Dairy Co (Feihe Zhenlai)	04-Nov-13	Not audited	Jilin Quanxing	Manufacture of milk powder
20	Meiweishi (Beijing) Health Management	04-Aug-18		Not audited	Inactive
21	Heilongjiang ShangHeGu Nutraceutical Food	18-Aug-15	Not audited	Heilongjiang Anlian	Manufacture of soybean and sale of food products and soy beverages
22	Feihe (Tailai) Dairy Products	25-Jul-16	Not audited	Not audited	Manufacture /sale of milk powder
23	Heilongjian Feihe E-commerce	09-May-16	Not audited	Not audited	Sale of milk powder
24	Feihe (Jilin) Dairy Products	05-Jun-17		Jilin Quanxing	Sale of milk powder
25	Canada Royal Milk (Hong Kong) Limited	21-Jun-19		Not audited	Inactive
26	Feihe Group Limited	15-Mar-19		Not audited	Inactive
27	Feihe (Harbin) Dairy Co., Ltd	24-Apr-19		Not audited	Sale of milk powder
28	Royal Milk (Harbin) Food Nutrition Technology Company Limited	16-Jul-19		Not audited	Sale of milk powder

Source: Feihe Prospectuses

Feihe reported only seven PRC entities which engage in the sale of milk powder. None of these key subsidiaries were audited by EY. **Five were not audited by any firm, despite their critical importance to the integrity of Feihe's financial disclosures.**

Beijing Feihe Biotechnology Scientific and Commercial Co., Ltd (北京飛鶴生物科技股份有限公司) <sup>#1</sup>	The PRC/ Mainland China 8 June 2004	RMB10,000,000	–	100	Sale of milk powder
Feihe (Tailai) Dairy Products Co., Ltd (飛鶴(泰來)乳品有限公司) <sup>#1</sup>	The PRC/ Mainland China 25 July 2016	RMB500,000,000	–	100	Sale of milk powder
Heilongjiang Feihe Electronic Commerce Co., Ltd (黑龍江飛鶴電子商務有限公司) <sup>#1</sup>	The PRC/ Mainland China 9 May 2016	RMB10,000,000	–	100	Sale of milk powder
Feihe (Harbin) Dairy Co., Ltd (飛鶴(哈爾濱)乳品有限公司) <sup>#1</sup>	The PRC/ Mainland China 24 April 2019	US\$50,000,000	–	100	Sales of milk powder
Royal Milk (Harbin) Food Nutrition Technology Company Limited (皇家妙克(哈爾濱)食品營養科技有限公司) <sup>#1</sup>	The PRC/ Mainland China 16 July 2019	RMB10,000,000	–	100	Sales of milk powder

<sup>1</sup> No audited financial statements have been prepared for these entities as they were either newly incorporated or incorporated in jurisdictions which do not have any statutory audit requirements.

Source: Feihe Prospectus

Feihe argued that five sales entities did not have audited financials because they “were either newly incorporated or incorporated in jurisdictions which do not have any statutory audit requirements.”

However, Feihe's 2019 Prospectus was published in October 2019 and three of these entities were incorporated at least two years prior. In addition, Feihe's other PRC subsidiaries have audited financial statements. If other PRC entities were audited, we question why these entities would be exempt? We think the reason is obvious: unaudited subsidiaries can easily be used to fabricate the Company's financial performance.

The financial statements of Feihe's other two sales subsidiaries were audited, but not by EY. Rather, they were audited by local firms, one of which has a highly dubious reputation. Feihe's largest subsidiary, Heilongjiang Feihe Dairy was audited by Heilongjiang Anlian Accounting Firm (“Anlian”), an accounting firm which was recently been censured in China for its low quality.

Heilongjiang Feihe Dairy Products Co., Ltd (黑龍江飛鶴乳業有限公司) <sup>#2</sup>	The PRC/ Mainland China 21 August 1996	US\$45,000,000	–	100	Manufacture and sale of milk powder
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<sup>2</sup> The statutory financial statements for the years ended 31 December 2016, 2017 and 2018 prepared under PRC GAAP were audited by 黑龍江安聯會計師事務所有限公司, certified public accountants registered in the PRC.

Source: Feihe Prospectus

In January 2019, the Accounting Management Bureau of the Heilongjiang Department of Finance published the results of its review of recent audit reports prepared by local accounting firms in the province. It found deficiencies at 24 accounting firms, including the local branch of Anlian which presumably audits Company subsidiary Heilongjiang Feihe Dairy.

黑龙江省财政厅会计管理局  
HEI LONG JIANG SHENG CAI ZHENG TING KUI JI GUAN LI JU

The Accounting Management Bureau of Department of Finance in Heilongjiang

发布时间: 2019年01月21日 Date of Release: January 21, 2019

限期整改24家

These 24 firms need to make rectification within a time limit

1. 黑龙江嘉信会计师事务所有限公司及注册会计师万连生、赵学刚、王一焜
2. 哈尔滨文天会计师事务所及注册会计师关宗华、赵爱军
3. 黑龙江兴安会计师事务所有限公司及注册会计师王慧臣、李桂勤、杨永超、王春英
4. 黑龙江至诚会计师事务所有限责任公司及注册会计师: 王莉兰、王玉香、毕研娟
5. 黑龙江慧达会计师事务所有限公司及注册会计师: 冯连娣、王福珍
6. 黑龙江安联会计师事务所有限公司鸡东分所 Heilongjiang Anlian Accounting Firm Kedong Branch
7. 黑龙江东联会计师事务所有限公司鸡东分公司

Source: <http://www.ljkjw.gov.cn/content-info.aspx?id=1976>

Although it did not specify which firm was guilty of which transgression, the supervisory board censured the listed firms (including Anlian) for a basket of deficiencies, including for the failure to properly establish and implement control systems, the failure to properly review firms under audit, and the failure to obtain sufficient evidence in an audit.

## 二、检查发现的主要问题 Key issues found through inspection

通过检查，全省大部分会计师事务所能够较好执行执业准则，防范职业风险意识明显增强，执业质量正在逐步提高。但同时发现，部分事务所对质量控制体系的建立和执行重视不够，内部质量控制制度尚不健全且实施不到位，审计项目质量复核制度形同虚设；风险导向审计流于形式，审计计划工作缺乏有效性，存在审计风险评估程序、总体审计策略和具体审计计划不完备，缺乏准确的职业判断；未能按照中国注册会计师执业准则要求执业，审计程序执行不到位，部分事务所存在为减少审计成本而不按审计准则规定执行必要的审计程序，在未获取充分、适当的审计证据的情况下出具审计报告，存在重要审计程序实施不足和审计取证不充分等问题；部分注册会计师知识老化，现行审计准则、会计准则以及新修订的会计相关法规制度等知识更新缓慢、专业胜任能力严重不足；部分事务所合伙人（股东）不参与事务所经营管理，注册会计师不出具报告或允许他人以本人名义出具报告，挂名职业问题严重；部分事务所合伙人（股东）、执业注册会计师年龄偏大，应用现行审计准则能力不足，执业质量难以保证，个别事务所执业注册会计师年龄在75至80周岁间，执业风险隐患极高；个别事务所合伙人（股东）人数不足，未能达到办所条件，但仍继续执业；个别事务所在工商部门办理设立分所营业执照，但并未按规定取得执业资格证书；部分事务所日常管理不到位，人员交接不完备，监管部门下达年度行政监督检查工作无从落实；部分事务所在财政部门的备案信息与在市场监管部门的备案信息不一致、未按规定进行业务报备，基本信息和业务信息不完整，主动报备意识不足等问题突显。

Translation: Deficient firms did not pay enough attention to the establishment and implementation of the quality control system which remains insufficient, and the quality review system for audit projects is useless; the risk-based audit is not thorough, and the audit planning is inefficient. The assessment procedures, overall audit strategy and specific audit plan are incomplete, lacking accurate professional judgment. Certain firms failed to practice in accordance with China Standards on Auditing and Quality Control with proper audit procedures in place. Some firms do not follow the audit standards and reduce necessary procedures for cost-cutting purposes; audit reports are issued without obtaining sufficient and appropriate audit evidence. Some public accountants, who update knowledge about current accounting standards and amendments too slow, are no longer competent for the position. Some partners (shareholders) of certain firms do not participate in the management of the firm. CPAs do not issue reports or allow others to issue on their behalf. Some of the partners (shareholders) and certified public accountants of the practice are too old to apply the current auditing standards, which makes it difficult to guarantee the quality of their practice. High risks are observed in the work performed by accountants between the ages of 75 and 80. The number of partners (shareholders) in individual firms is not enough to meet requirements, but these firms continue to operate. Some firms open new branches without obtaining the license. Some firms have deficiencies in day-to-day operations and personnel management, so that the annual administrative supervision and inspection work issued by the regulatory authority cannot be implemented. The filing information in the financial department are inconsistent with records sent to the oversight board. Problems such as failure to submit filings in accordance with regulations, incomplete information and documentation, and inadequate awareness of proactive filing have become prominent.

Source: <http://www.lkjw.gov.cn/content-info.aspx?id=1976>

This was not the only sign of trouble at the small accounting firm which was responsible for one of the **only audits** of a Feihe subsidiary selling milk powder prior to the Company's IPO.

In December 2019, the Heilongjiang Institute of Certified Accountants Association revoked the registration of eight Anlian CPAs due to poor assurance quality.

Circular on the Assurance Quality Inspection Results of Certified Public Accounting Firms in Heilongjiang Province in 2019

### 关于2019年全省注册会计师事务所执业质量检查情况及处理结果的通报

时间: 2019-12-03 16:18:12 浏览次数: 373

Date: December 3, 2019

# 黑龙江省注册会计师协会文件

(三) 撤销黑龙江容大会计师事务所有限公司吴芝福、滕淑桂，黑龙江禹实会计师事务所有限责任公司张志玉、刘飞南，黑龙江天健会计师事务所有限公司薛义，齐齐哈尔大成会计师事务所乔巍、宁淑芹，黑龙江安联会计师事务所有限公司克东分公司刘本溪、李寿举，黑龙江安联会计师事务所有限公司泰来分公司张冠智、焦桂兰，黑龙江安联会计师事务所有限公司甘南分公司谭会兰、杨明贵，黑龙江安联会计师事务所有限公司讷河分公司魏德荣、赵士弟，齐齐哈尔盈会计师事务所韩东玲，黑龙江昊华会计师事务所有限责任公司贾进财、赵玉理，黑龙江中港会计师事务所有限责任公司谭学东、满世俊，哈尔滨华通会计师事务所有限责任公司王基隆、刘泽渭，哈尔滨前进会计师事务所有限责任公司尚海燕、赵海蓉，黑龙江盘古会计师事务所有限公司牟瑶、王哲人、聂志、王戎，黑龙江龙顺达会计师事务所有限责任公司李迎玖、郑元福，哈尔滨华强会计师事务所张殿国、张亚芬，肇东市万鑫会计师事务所（普通合伙）马俊英、蔡景林、叶秉衡，黑龙江思齐会计师事务所有限公司郭文斌、陈淑云，黑龙江葆沃会计师事务所有限公司杨修奎，哈尔滨方圆会计师事务所有限责任公司张传群、李雪玲，哈尔滨天德会计师事务所杜朝辉，哈尔滨嘉润会计师事务所有限公司曹枫、佟绍新、郭兆英，黑龙江兴安会计师事务所有限公司王慧臣、周世杰，黑龙江龙誉会计师事务所有限公司翟建华，大庆铭利会计师事务所孙庆龙，大庆诚信信强会计师事务所有限公司王秀芸，大庆和鑫会计师事务所王德礼，黑龙江中垦德明会计师事务所有限公司张明志，黑龙江建业会计师事务所有限责任公司林英爱、刘丽华等53名注册会计师的注册。

Revoke the registrations of these 53 CPAs, including... Liu Benxi and Li Shouju at Anlian Kedong branch, Zhang Guanzhi and Jiao Guilun at Anlian Tailai branch, Tan Huilan and Yang Minggui at Anlian Gannan branch, Wei Derong and Zhao Shidi at Anlian Nahe branch ...

Source: <http://www.hljicpa.org.cn/index.php?m=content&c=index&a=show&catid=44&id=895>

Anlian only [had](#) 22 registered CPAs in October 2019, so it was not a big firm. Based on the revocation circular, the body recommended to revoke the registration of eight CPAs in December that year, a substantial loss.

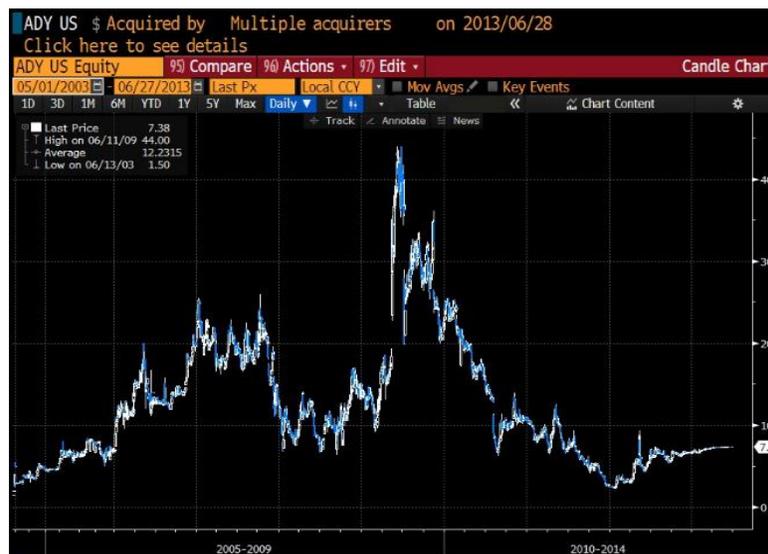
It is absurd that a Company with a market capitalization of over USD 18 billion went public without auditing the financial statements of many key sales subsidiaries. Worse still, its primary sales subsidiary was audited not by E&Y, but by a local auditor with a bad reputation which had recently been censured by accounting authorities. Any investor relying on an auditor as a gatekeeper to prevent the Company from misrepresenting its financial statements can take no comfort from Feihe.

## THE ORIGINAL CHINA HUSTLE

In May 2003, Feihe [became](#) one of the first Chinese companies to execute a reverse merger onto the U.S. stock markets. Trading under the curiously selected name “American Dairy” (Ticker: ADY), the Company moved from the pink sheets through the Archipelago Exchange into an outright listing on NYSE.

Although its stock price initially soared on Feihe’s claims of robust growth and expanding margins, Feihe’s share price collapsed under the scrutiny of regulators, investigative journalists, and investors.

In December 2007, the Company [belatedly revealed](#) that it was subject to an SEC investigation regarding the independence (or lack thereof) of its auditor. For its first years as a publicly traded company, Feihe was audited in part by an accountant in Hong Kong who raised capital for the Company and [purchased](#) 8% of its shares. Put simply, one of Feihe’s stock promoters was also auditing its books.



Source: Bloomberg

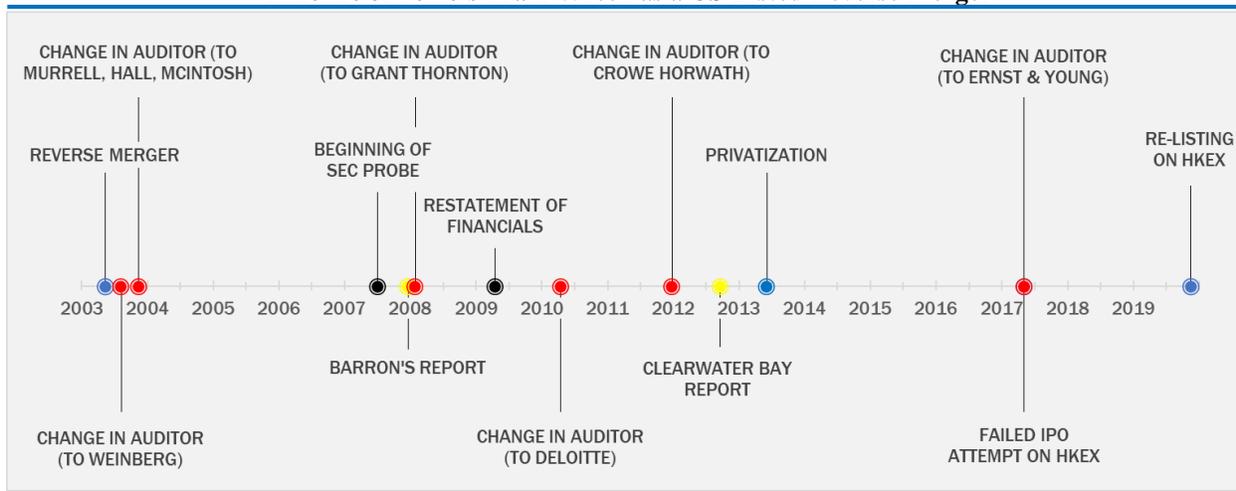
When news of the SEC investigation broke, Feihe’s American auditor [resigned](#)<sup>15</sup> and the Company withdrew its revenue and profit guidance. Barrons then published a lengthy investigative [piece](#) questioning Feihe’s financials and the integrity of Company executives who would permit one of its stock promoters to moonlight as its auditor. The Barrons piece also raised questions as to whether Feihe concealed the SEC investigation from investors.

Following the [dismissal](#) of its auditor, Feihe [restated](#) historical financials, admitting that its net income had been overstated in one year by 29%. Investor confidence was shattered, and Feihe’s share price collapsed, never to recover.

Feihe limped along, dogged by [allegations](#) that it was fabricating its financial performance and lying to investors about its products and its business. Investors even [sent](#) US regulators evidence allegedly showing a material discrepancy between Feihe’s US financials and its SAIC filings, suggesting that like many reverse mergers, Feihe was simply lying to the capital markets about its revenues and profits. Feihe [churned](#) through 5 auditors in 10 years as a US-listed company, a telltale sign of corporate rot.

<sup>15</sup> Or was dismissed, according to Feihe. Following the scandal, Feihe claimed that it had no knowledge that Henny Wee, a consultant and promoter of Company stock, was also involved in the audit. Feihe blamed and sued its primary auditor, MHM, alleging breach of duty. For its part, MHM [denied](#) that it was at fault, and blamed Feihe for hiring the conflicted stock promoter to do audit fieldwork. The suit was dismissed at an early stage of the litigation process, without any adjudication on the merits. Both the Company and its accountant blamed each other. The facts are murky, although we question how a company could not notice that its consultant and promoter was also assisting the audit team or conducting audit fieldwork?

**Timeline of Feihe’s Train Wreck as a US-Listed Reverse Merger**



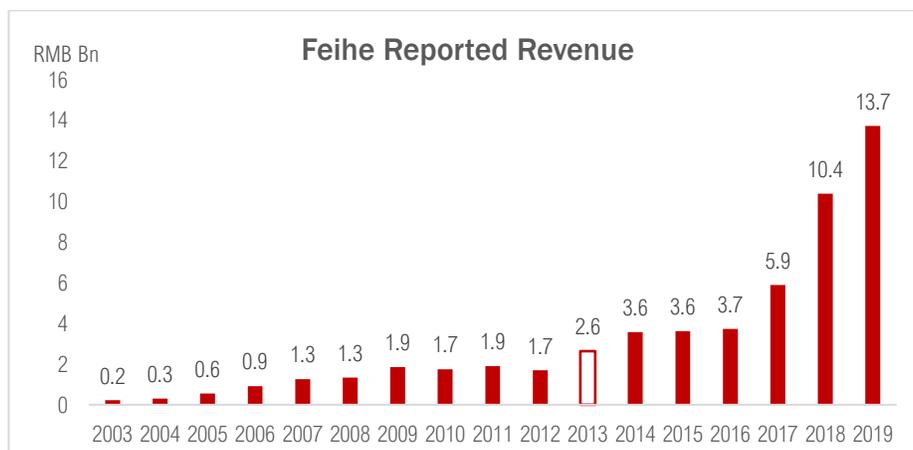
Source: Feihe SEC and Hong Kong filings

In 2013, following the collapse of its stock price and dogged by allegations of misconduct, Feihe went private. The Company delisted, its tail firmly between its legs.

**An Unlikely, Immediate and Miraculous Turnaround**

As a private company without the scrutiny of the capital markets or oversight of auditors, Feihe engaged in what appears to be one of the most miraculous and immediate turnarounds in corporate history.

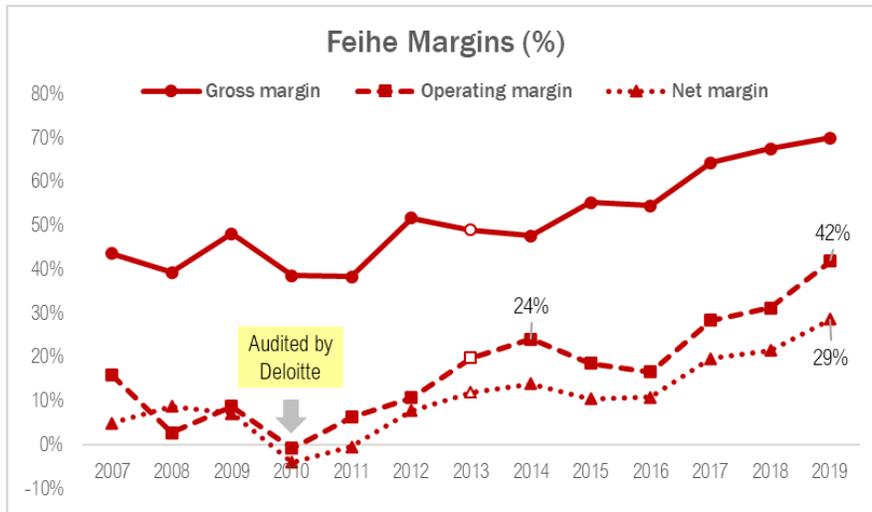
Feihe reported tepid growth as a US listed company, with sales essentially declining from 2009 to 2012. Yet, despite selling the same products to the same customers in the same market, Feihe’s revenues mysteriously exploded. In its first full year as a private business (2014), its revenues supposedly doubled. Growth then plateaued. But just in time for its recent IPO in Hong Kong, Feihe experienced a dramatic and unprecedented surge, reporting that sales supposedly tripled between 2016-2019.



Source: Feihe SEC and Hong Kong filings

Note: 2013 figures are estimated as the midpoint between 2012 (US filings) and 2014 (HK filings)

Companies growing rapidly typically do not simultaneously expand margins. Yet Feihe’s profitability also experienced an unlikely and immediate renaissance upon going private. In its last five years as a publicly traded company in the US, Feihe’s operating margins never broke 11%. Over many years, it barely earned an operating profit. Yet just two years later, Feihe’s operating margins supposedly jumped to 24%. This explosion continued, and Feihe’s reported operating margins topped 42% in 2019.



Source: Feihe SEC and Hong Kong filings

Note: 2013 figures are estimated as the midpoint between 2012 (US filings) and 2014 (HK filings)

In the six years before it went private, Feihe never reported a net margin higher than 10%. Interestingly, in 2010, the only year Feihe was audited by a Big Four auditor (Deloitte), its net margins fell to **negative -4%**. Yet somehow in 2019, Feihe reported 29% net margins.

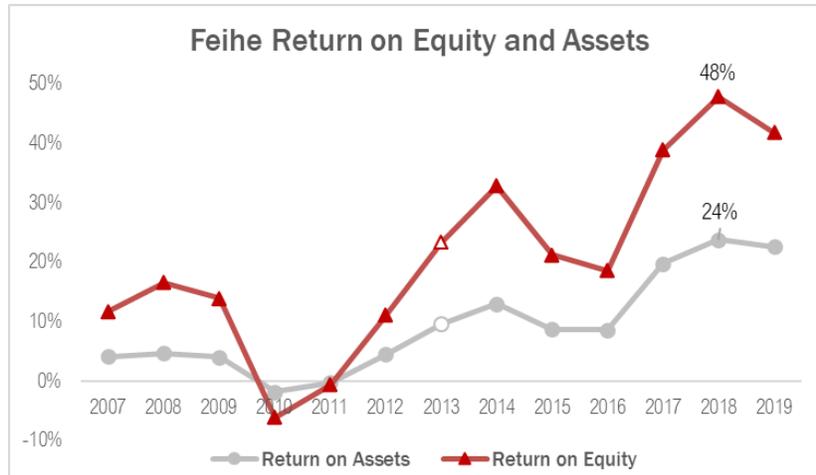
What makes Feihe’s recent profitability and revenue growth all the more suspicious is that the business today is not materially different than the one which struggled to break even in 10 years as a US-listed company.

Feihe was selling the same products when it was a US reverse merger, including its flagship product Astrobaby, which the Company [launched](#) in May 2010. It is also managed today by the same officers who helmed the Company when it was dogged by allegations of misconduct as a US reverse merger.

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	
CEO & Chairman	Leng Youbin																		
CFO	Liu Hua																		
VP of Finance	Liu Shenhui																		
President	Cai Fangliang																		
Governance issues:																			
Changes in auditor	█					█		█	█									█	
Restated financials		█	█	█	█														
SEC probe					█	█	█	█	█										

Source: Feihe SEC and Hong Kong filings

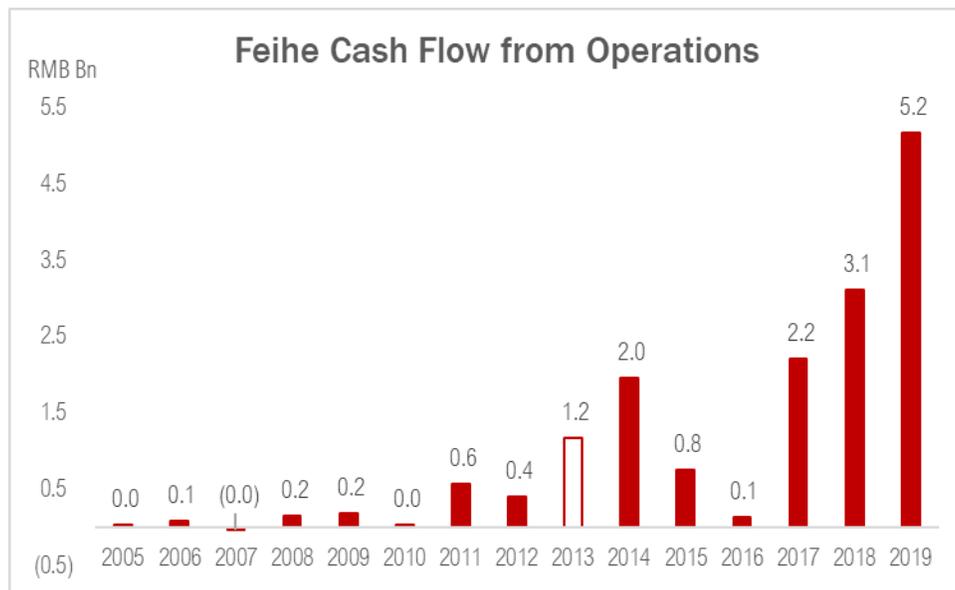
After announcing it was subject to an SEC investigation, Feihe’s return on assets decreased and became negative in 2010. Yet in the interim between its US delisting and its Hong Kong IPO, Feihe’s return on assets (ROA) spiked to 24%, despite supposedly minimal capital investment during this time. Feihe’s return on equity (ROE) reached 48%, a level of performance achieved only by the world’s best companies.



Source: Feihe SEC and Hong Kong filings

Notably, despite such incredible profitability and growth, Feihe’s cash generation has been mysteriously inconsistent. The Company’s cash flows from operations supposedly jumped from an average of RMB 179 million per year as a US-listed company, to RMB 2 billion in its first full year as a private business.

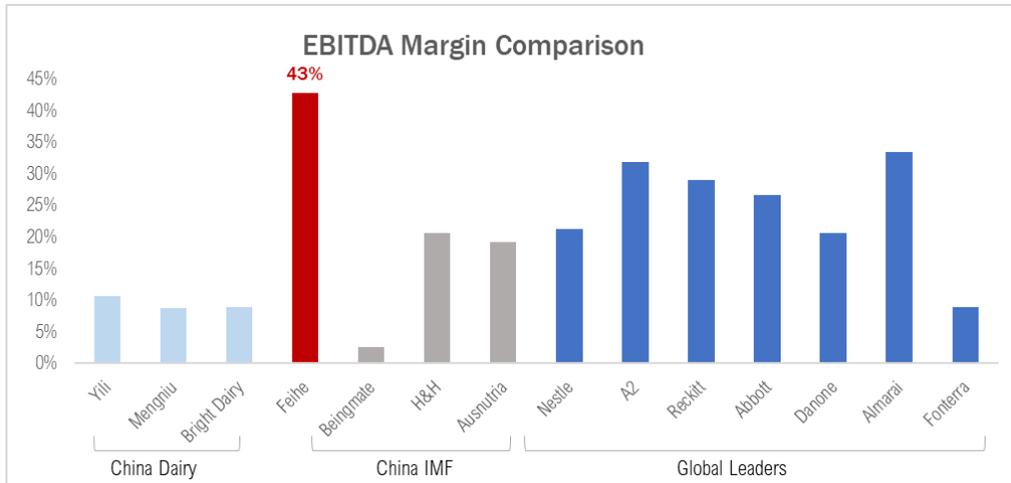
Cash flows from operations then declined for two consecutive years until they rebounded hard to unprecedented heights in 2019, convenient timing for Feihe’s recent IPO.



Source: Feihe SEC and Hong Kong filings

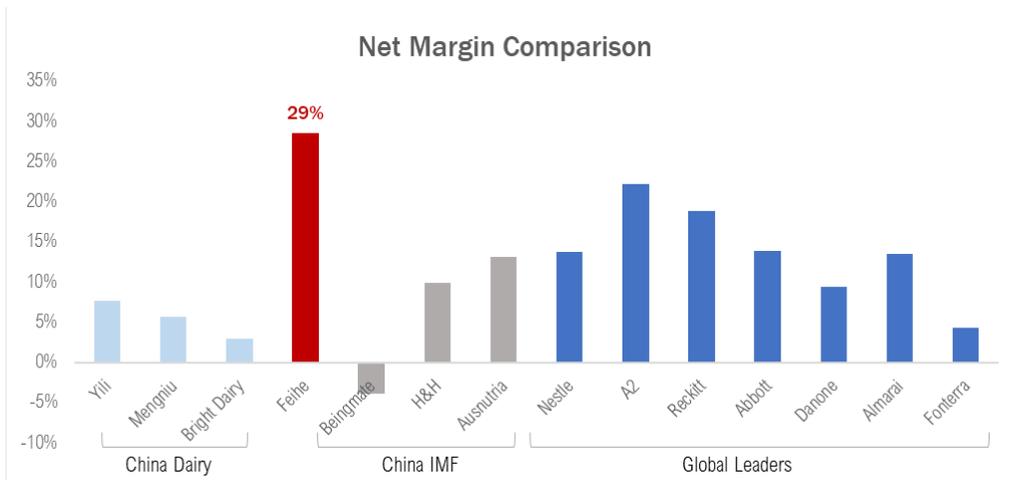
**Better Business than Apple and Microsoft?**

To put Feihe’s reported performance in context, its growth and profitability is a major outlier compared to its Chinese and global peers. Feihe reported EBITDA margin of 43% in FY 2019, wildly above any other Chinese or global IMF or dairy companies.



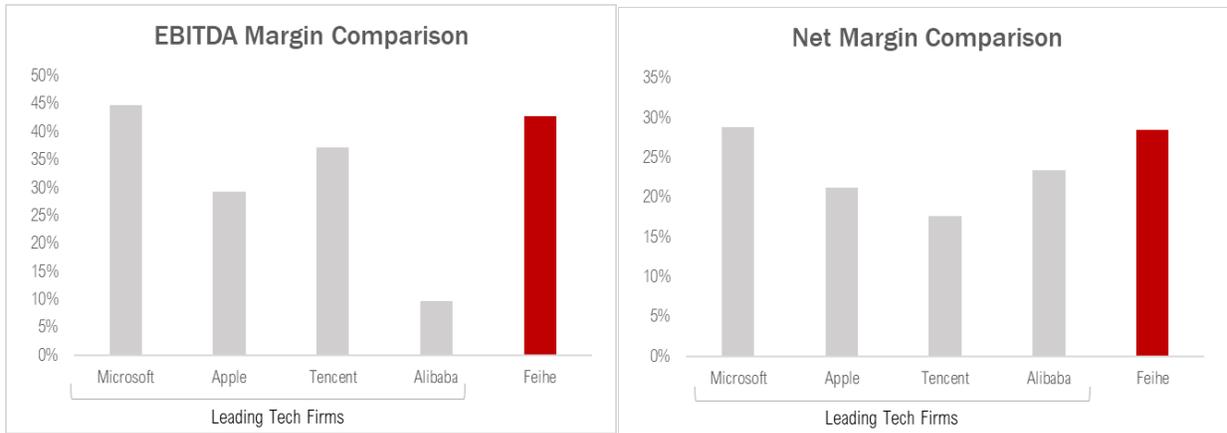
Source: Bloomberg

On net margins, Feihe’s performance is even more of an outlier. In a year when many dairy and IMF producers struggled to hit 10% in net profits, Feihe reported net margins of almost 30% !



Source: Bloomberg

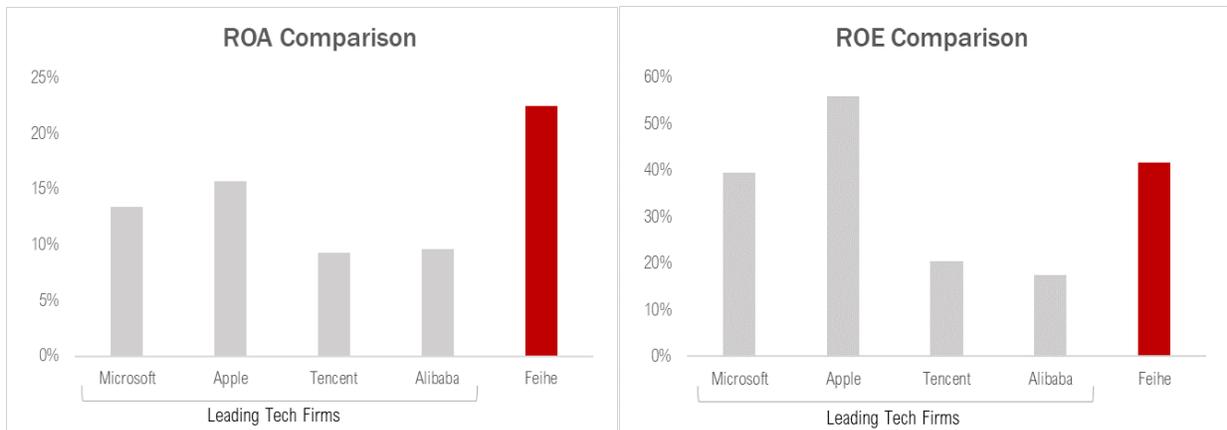
To put into context just how absurd Feihe’s reported performance has become, Feihe reports the same EBITDA and net margins as Microsoft (US: MSFT), and **better EBITDA and net margins than Apple (US: AAPL), Tencent (HK: 700) and Alibaba (HK: 9988).**



Source: Bloomberg

How could a failed US reverse merger, with old products and a management dogged by past allegations of fraud, generate more profitability than Apple, Tencent and Alibaba?

Measured by a return on assets or equity, Feihe supposedly is a more efficient allocator of capital and investment than the world’s leading technology companies. All while experiencing supposedly fantastic revenue growth selling old brands in a heavily competitive and fractured market.



Source: Bloomberg

Such claims, in our opinion, are ludicrous. There are two conclusions from such reported performance: either Feihe has created the world’s best business or it is grossly misrepresenting its financial performance. We think it is obviously the latter.

## THE CURIOUS CASE OF YST

Adding to the puzzle of Feihe's immediate and miraculously turn of fortunes, the financials of its near-exclusive fresh milk supplier (and quasi-related party) have collapsed.

When the Company was struggling in 2011, Feihe [shocked](#) US investors by spinning out its two dairy farms in Kedong and Gannan to Hong Kong listed (HK: 1431) YuanShengTai Dairy Farm Limited ("YST"). The nature of the relationship has always been subject to controversy.

Feihe admitted in early securities filings that Heilongjiang Feihe Yuanshengtai ("YST Heilongjiang") was directly owned by its chairman, Leng You-Bin.<sup>16</sup>

### (2) Due from/to related companies

Mr. Leng You-Bin is the Chairman, Chief Executive Officer, President, and General Manager of the Group. During the years ended December 31, 2008 and 2007, the Group sold goods to companies owned by close family members of Mr. Leng You-Bin, including one company, [Heilongjiang Feihe Yuanshengtai Co., Ltd directly owned by Mr. Leng You-Bin, on an arm's length basis](#).

Source: [Feihe 2008 10-K, p. F-19](#)

In 2011, Feihe took investors by surprise when it announced the sale of its two dairy farms to YST for RMB 849 million.<sup>17</sup> YST's prospectus [stated](#) that 11 of the first 12 registered equity holders of YST Heilongjiang were Feihe employees, raising suspicions that Feihe sold its valuable dairy farms to itself to escape US creditors. But the Company claimed that its employees, including its chairman, no longer had any interest in YST at the time of the deal.

The deal smelled rotten. Feihe [sold](#) two valuable assets to a buyer which was until very recently directly owned by its chairman, before conveniently announcing that the Company was going private. Furthermore, YST only paid a small part of the consideration in cash. For the rest, YST agreed to pay off the acquisition of its farms in non-cash installments of fresh milk to Feihe for the next 4 years.<sup>18</sup>

Essentially, Feihe sold its key assets and financed the buyer's purchase, an overly generous deal for a company so closely related. Following the spinoff, Feihe even agreed to guarantee YST's bank loans, up to RMB 402.5 million.<sup>19</sup>

In recent years, YST remains Feihe's most critical supplier, from which it purchases 78-96% of its fresh milk in any given year.

Year	2014	2015	2016	2017	2018	2019
% of total fresh milk purchased from YST	96%	78%	80%	80%	86%	n/a
% of YST's revenues generated from Feihe	52%	43%	44%	53%	69%	60%

Source: *Feihe and YST's Hong Kong filings*

*\*The percentages are calculated by the disclosed absolute figures*

Feihe is equally critical to YST, serving as its largest customer and accounting for 60% of YST's revenues in 2019.

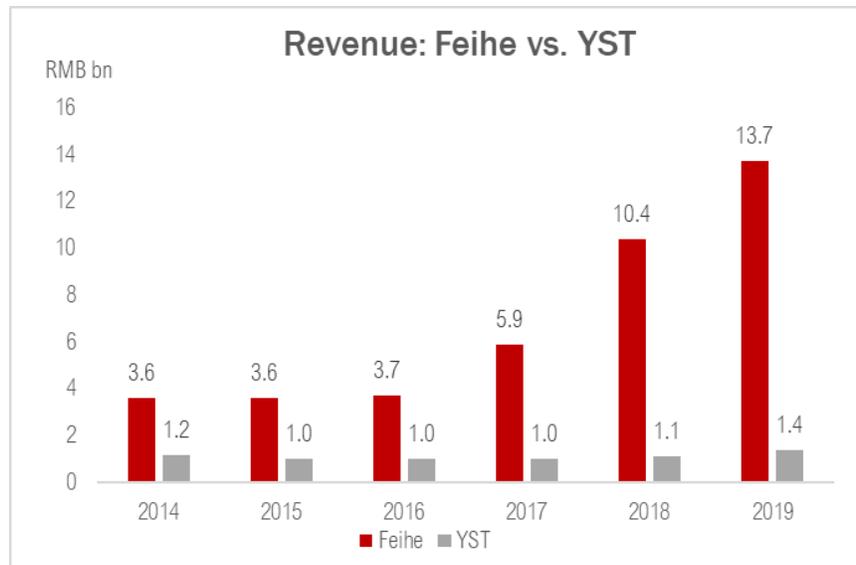
Given their mutual interdependence, one would think that YST and Feihe's fortunes would be intertwined. But they have diverged considerably. Despite being its near-exclusive supplier, and being run by former Feihe employees, YST's revenues have stagnated.

<sup>16</sup> YST Heilongjiang is now known as Heilongjiang Kedong Ruixinda YuanShengTai Dairy Farming Joint Stock, one of YST's main subsidiaries.

<sup>17</sup> Feihe SEC filings stated that the buyer is Haerbin City Ruixinda Investment Company, whose legal name is [is](#) Harbin Ruixinda Dairy Farming, a wholly owned subsidiary of YST.

<sup>18</sup> Feihe 2017 Prospectus, p. 118.

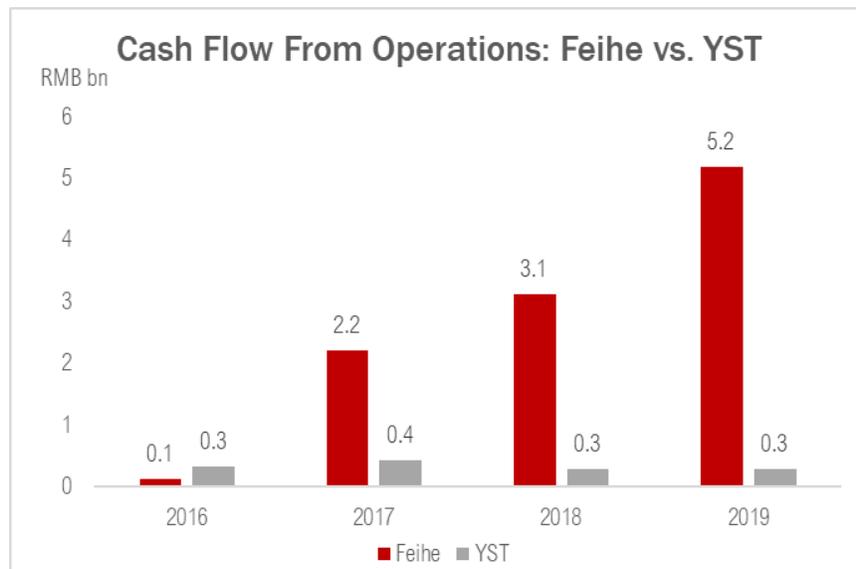
<sup>19</sup> Feihe 2017 Prospectus, p. 119.



*Source: Feihe and YST's Hong Kong filings*

This raises a quandary. Given that the price of fresh milk declined only slightly over this period, how did Feihe grow revenues so rapidly while revenues of its largest and near-exclusive related party supplier stagnated?

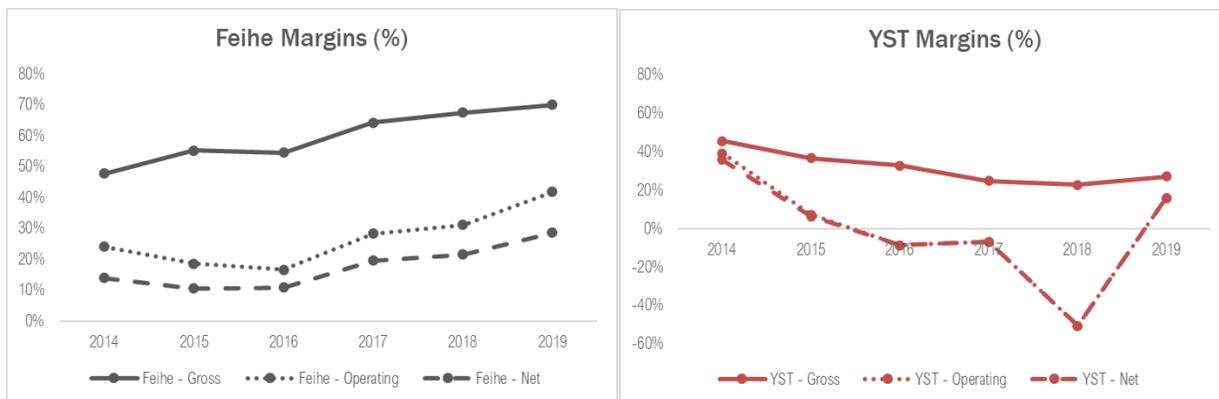
Their respective cash generation was also suspiciously inconsistent. In 2016, both Feihe and YST reported **almost the same amount of cash flows from operations**. Yet YST's cash flows from operations stagnated, while Feihe's increased **39x** in the next three years.



*Source: Feihe and YST's Hong Kong filings*

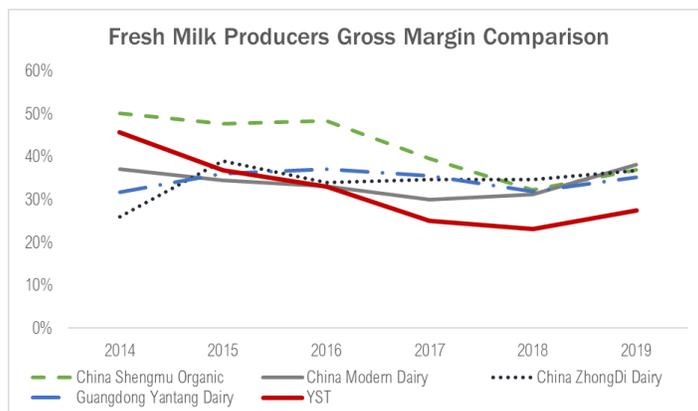
The largest divergence was in profitability. In its first year as a private business, Feihe generated lower margins than YST. YST should have benefited from Feihe's explosive success. Yet YST's margins plummeted. YST reported negative net and operating margins 2016-2018, culminating with a brutal 2018 in which net margins plummeted.<sup>20</sup>

<sup>20</sup> This was in part due to the write down of a facility which the government unexpectedly closed for regulatory reasons.



Source: Feihe and YST's Hong Kong filings

Relative to other dairy farms in China, YST's gross margins went from the second highest among its peers to the lowest, right around the time Feihe prepared for its IPO.



Source: Companies Public Filings

This only enhances our suspicion of Feihe's supposed economic miracle. Why didn't its near-exclusive supplier, and quasi related party benefit from Feihe's roaring success? The fortunes of the two companies should be intertwined, so why did they diverge so considerably in recent years?

One suspicion is that Feihe secretly (or not so secretly) controls YST, pushing losses and costs on its supplier to make its own business appear far more profitable than it really is.

Feihe claims that the two companies are independent, and that neither the Company nor its management team own or control YST. But independent evidence, in our opinion, suggests otherwise. On the website of an investment platform called Max Wealth, owned in part by Feihe's chairman Leng Youbin, he brags that he not only runs Feihe but is also the actual controller of YST.

**麦客财富股东介绍: 冷友斌 先生**

Max Wealth's Shareholder Introduction: Leng Youbin

卓越的企业领导人, 热心捐助社会, 受到当地政府和社会的一致称赞

**担任职务**

Positio

飞鹤乳业董事长

原生态牧业(HK.01431)实际控制人

Feihe Dairy's chairman  
Actual controller of YST  
(1431.HK)**个人简介**

冷友斌先生自1985年参加工作以来, 一直从事乳业的研发、生产及销售管理工作, 有着丰富的行业管理经验, 并获得多项国家级的研发成果和专利。曾先后被评为黑龙江农垦总局优秀杰出青年、齐齐哈尔市劳动模范、黑龙江省质量管理先进个人、中国乳业十大科技人物等称号。2003年率企业挂牌纳斯达克, 成为国内首家美国上市的乳品企业; 2005年飞鹤乳业已成功登陆纽约证券交易所。



Source: <http://www.mkcaifu.com/index.php?m=content&c=index&a=lists&catid=76#content>

It makes sense that Feihe controls YST. Feihe's chairman started YST. Feihe then started YST's dairy businesses by spinning out its farms. Feihe also inexplicably guaranteed YST's borrowings. YST was managed by former Feihe employees and sells near the majority of its fresh milk to Feihe. To boot, Feihe's chairman brags online that he controls both companies.

Not only does this directly contradict Feihe's claims that YST is separate but only adds to our suspicions that Feihe secretly dumps losses on its related-party supplier.

## VALUATION

In this report, we present multiple independent data points which suggest in our opinion that Feihe overstates IMF revenues, understates operating costs such as advertising and labor expenses, understates headcount by 10x, and materially inflates profitability.

In 2019, Feihe reported EBITDA and net income margins higher than Apple, Tencent and Alibaba. All while supposedly growing at a 54% CAGR from 2017-2019. It supposedly achieved such remarkable performance selling the same products to the same customers in the same market as when the Company was a failed reverse merger, taken private for a pittance and dogged by allegations of fraud. Feihe's supposed miracle is all the more suspicious because of the stark underperformance of its exclusive and quasi-related party fresh milk supplier, YST.

We think Feihe's story has more in common with Wirecard and Luckin Coffee than Apple or Tencent.

Feihe recognizes revenue when it hands products to its logistics provider, which Feihe repeatedly insists is an independent third party. But our investigation indicates that Ruixinda Logistics, which claims to transport all or almost all of Feihe's IMF products, is run by a Feihe employee and operates as part of the Company.

This is catastrophic for the integrity of Feihe's financial statements, as it means the Company has free reign to recognize revenues by handing product to a logistics firm which is secretly part of Feihe.

Evidence also indicates, in our opinion, that Feihe is materially underreporting operating costs. Feihe reported 5,422 employees in its prospectus, but as recently as May 2020 its chairman has [bragged](#) to employing 50,000. Accordingly, we add back what we conservatively estimate to be at least RMB 925 million in understated labor expenses.

We also believe that Feihe understates advertising costs. Feihe claimed in its most recent prospectus that ad spending declined in the first half of 2019, but independent data shows that Feihe's TV spending increased 517% on TV commercials alone in 2019.

We understand that Feihe likely receives a discount on its increased purchasing volume, but we highly doubt that its ad spending could decline in a year when independent data shows that its advertising spending increased across all channels by 286%. Even if we assume that Feihe receives a further 60% discount on its additional advertising, we estimate that the Company's advertising spending was at least RMB 765 million more than reported in 2019.

If we only adjust for what we believe to be Feihe's understated advertising expenses and labor costs, at its current multiple, we value Feihe down 35%. But this is only half the story, as we believe there is overwhelming evidence that Feihe also inflates revenues, likely facilitated by recognizing revenue whenever it hands off its IMF products to an undisclosed related party logistics company. Based on our review of Nielsen and Ministry of Commerce data, we calculate that Feihe exaggerates its IMF sales by as much as 49%.

**If we add back our estimate of undisclosed labor and advertising expenses and adjust revenues to reflect independent retail sales data, we question whether Feihe's business is even profitable.**

RMB M		2019
Reported total revenue		13,722
Reported IMF revenue		12,538
Est. IMF revenue overstatement	-49%	(6,095)
Reported IMF blended gross margin		72%
Est. IMF gross profit overstatement		(4,414)
Reported total gross profit		9,610
Adjusted total gross profit		5,195
Reported expenses and other income		(3,927)
Est. understated labor costs		(925)
Est. understated advertising expenses		(765)
<b>Adjusted profit before tax</b>		<b>(421)</b>

Source: Feihe Public Filings, Blue Orca Calculation

This [tracks](#) with the statements of Feihe's former director, who says that its growth has been fueled by high spending on staff. As Feihe continues to try and capture market share in Tier 1 and Tier 2 cities, where its products are not as popular, we believe it will be forced to maintain or increase its spending on sales staff and marketing. Put simply, we have no reason to expect Feihe to become profitable going forward.

Because we believe Feihe's business is likely unprofitable, we value the Company on an EV to sales multiple. We recognize in our valuation that even by our calculation, Feihe is still growing and is likely a leading domestic player. Accordingly, we assign a 5x EV/sales multiple to the Company, which is **double** the median multiple of its peers.

Company	Ticker	FY19 Sales	EV	EV/Sales
Yili	600887-CN	90,223	205,808	2.3 x
Mengniu	2319-HK	79,030	116,335	1.5 x
H&H	1112-HK	10,925	24,528	2.2 x
Beingmate	002570-CN	2,785	7,717	2.8 x
Average				2.2 x
Median				2.3 x
<b>Feihe</b>	<b>6186-HK</b>	<b>13,722</b>	<b>120,314</b>	<b>8.8 x</b>

Source: Factset, Companies' Public Filings

Given that the overall IMF market in China is shrinking, we think such a multiple is extremely charitable.

RMB M	2019
Reported total revenue	13,722
Reported IMF revenue	12,538
IMF revenue inflation %	-49%
Adjustment: IMF revenue overstatement	(6,095)
Adjusted Feihe total revenue	7,626
Adjusted EV/sales multiple	5.0 x
Adjusted EV	38,132
+ Cash	12,768
- Total Debt	4,996
	45,904
Outstanding shares	8,933
Valuation (RMB)	5.14
<b>Valuation (HKD)</b>	<b>5.67</b>
<b>Last traded price</b>	<b>15.82</b>
<b>Downside</b>	<b>-64%</b>

Source: Feihe Public Filings, Blue Orca Calculation

At a 5x EV/adjusted sales multiple; we value Feihe at HKD 5.67 per share.

**DISCLAIMER**

*We are short sellers. We are biased. So are long investors. So is Feihe. So are the banks that raised money for the Company. If you are invested (either long or short) in Feihe, so are you. Just because we are biased does not mean that we are wrong. We, like everyone else, are entitled to our opinions and to the right to express such opinions in a public forum. We believe that the publication of our opinions about the public companies we research is in the public interest.*

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