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## Short CBAK. CBAK is insolvent

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Normally I try to shy away from very low priced stocks, however in the case of China BAK Battery (CBAK), it is a company which I have been quite familiar with for years while living in China. I am very well informed about the company's complete insolvency as well as the unusual rise in its share price. Due to its insolvency, China Bak's worth is in fact negative, far below zero. So it seems quite likely that the share price will soon react appropriately to this fact in the near term.

For those who are interested in the full details I have, as always, provided a very thorough and well substantiated explanation below. However for those who simply want a quick overview, I provide the following summary:

### Summary

China BAK is quite visibly very deeply insolvent. Although the company has not released a 10Q filing since June, we can see that by now China BAK is now down to just \$4 million in cash and has \$170 million in short term debt and payables which are now due imminently. Interest alone is now running \$1 million per month. In fact, the company is now selling its remaining products at below cost in order to pay the banks. However, given that over \$4 million of inventory had been written off as obsolete in the previous 9 months, it is unclear how long even this can continue.

Following its 5th NASDAQ delisting notice and at a share price of \$0.30, the company took several urgent steps (including a 1:5 reverse split and appointing a questionable new director) to remain listed in the US.

Prior to "regaining compliance with NASDAQ listing standards", the shares typically traded around just \$20,000 per day. The day after regaining compliance with the NASDAQ, a sudden inflow of new trading volume (around \$2,000,000) helped to push the share price to nearly \$3.00 in just a few days, but then the volume dropped off and the buying pressure failed. In looking at this sudden surge in price and volume, it is instructive to look at the options which are currently outstanding on the stock. The company has 3.1 million stock options outstanding with an average exercise price of \$3.59, and if the stock cannot briefly exceed this level, then these options would simply become worthless in the event of a delisting or formal insolvency. In addition, the Chinese banks, who are owed over \$140 million in near term debt, now hold as collateral the shares of Chairman Xiangqian Li, who owns 30% of the company. A continued US listing is beneficial to the Chinese banks as it is the only way they can sell their collateral shares on such a large percentage of the company.

As a result, there could be significant downward pressure coming from these sources. Unfortunately, as is often the case, some smaller US investors jumped into the stock hoping to catch a quick momentum ride upward without understanding what is coming.

### Detailed Analysis and Explanation

By November 2012, China BAK's market cap had shrunk to just \$15 million, slightly above the \$13 million it appeared to have in cash as of the June quarter when it last put out a 10Q. Unfortunately, [China BAK has over \\$170 million of bank loans and payables](#) that are coming due within just the **next few weeks**

**and months** and interest expense alone is running over \$1 million per month.

Although we are now in December, China BAK has still not submitted any filings for the September quarter, but we can see from the June quarter (its last filing) that the [net loss for that quarter alone](#) had exceeded \$27 million and that it was consuming nearly [\\$4 million in cash per quarter](#).

So by now China BAK has at most \$4 million in cash, [insufficient to even make the interest payments](#) on its \$170 million of near term obligations, much less the principle. The debts are all short term and are coming due in the coming weeks and months.

If China BAK ends up filing another quarterly report, its insolvency will become quite plain to see on paper and we will see that the cash is effectively all gone, as is the company.

In addition, from its filings, we can see that the banks are now firmly in charge, and that they are forcing China BAK to sell whatever products it has at **below cost** in order to repay any portion of its debts that can possibly be recovered. It is impossible for them to be repaid in full, however they are clearly trying to get what they can, while they still can.

Yet we can also see that write-downs of obsolete products exceeded \$4 million for the previous 9 months, so the ability for the banks to recover additional funds is questionable.

This selling below cost observation can be clearly illustrated from the fact that in the two most recent quarters, China BAK's revenue was as much as [10% less than the cost](#) to previously manufacture those goods. The other way to express this is as a [negative gross margin of around 11%](#), as shown in its SEC filings. In short, every time China BAK makes a sale it is losing substantially more money. However it is clear from the company's financial condition that this is the only way to get any money at all back to the banks.

Also of importance is the fact that the banks now [have as collateral the shares held by Chairman Li](#), who owns about 30% of the company. So once they are finished collecting their cash, they will almost certainly begin selling the shares of the company to recover any additional money they can get, because there is no possibility of China BAK repaying them anything in any other way. [Looking back 5 years, China BAK has never made a profit](#) and it is now selling its products at below cost, so it clearly has absolutely no ability to generate any cash whatsoever to repay the banks. Even if the Chinese banks sell their shares at 5-10 cents, which will not amount to much, getting any amount is better than getting nothing and Chinese banks are obviously not in the business of owning the US listed shares of insolvent reverse mergers for any reason.

The auditor is an audit firm known as "PKF" which has the dubious distinction of having all of its China based clients having fallen to well below \$1.00 or otherwise been delisted due to fraud, as shown below. Aside from China BAK, PKF's current China client list is as follows:

Ticker	Name	Price	Mcap
CHGS	China Gengsheng	\$0.41	\$11m
CNBI	China BCT Pharmacy	\$0.25	\$9m
	THT Heat Transfer		
THTI	Tech	\$0.94	\$15m
XNYH	Xinyinhai Technology	\$0.01	\$70k

PKF had [previously been the auditor of record](#) for Wonder Automotive (WATG), Orsus Xelent Technologies (ORSX) and China Expert Technology (CXTI), however each of those companies was delisted due to fraud and PKF is no longer auditing them. A [descriptive lawsuit of this](#) makes for some interesting reading for those who have the time.

As [described on its website](#), PKF isn't actually an accounting "firm", rather it is a "Global Network of Independent Accounting Firms" which anyone can join. In fact, for those who are looking to get into the auditing Chinese companies game, [PKF has even provided an easy online form](#) which can be filled out under the heading "JOIN US". The bar for becoming a PKF "auditor" therefore does not appear to be set at an exceedingly high level.

My only point is that no one should be surprised that the auditor hasn't warned investors of this insolvency, because in the case of PKF we don't even know who the real auditor is, only that someone has signed up under the PKF banner to provide audit services.

The NASDAQ has been trying to be a bit more proactive than the auditor and in October China BAK received its [5th NASDAQ delisting notice](#).

In August, the [CFO, Treasurer and Secretary resigned](#) and a [director and member of the audit committee also resigned](#). These resignations, along with the share price trading as low as \$0.30 caused the company to (once again) be out of compliance with NASDAQ listing standards and be subject to delisting.

To remedy the situation and avoid a delisting to the pink sheets, China BAK took a number of urgent steps.

Obviously a reverse split was necessary, so China BAK did a 1:5, taking the share price up from \$0.30 to a notional level of \$1.50, even though (obviously) the value of the company did not change

China BAK also appointed Xiangqian Li to assume the role of CFO, which is notable because it means that [Mr. Li simultaneously fills all of the roles](#) of President, CEO, Chairman of the Board and, now, CFO for CBAK. With only one person filling all of the senior management roles and without a Treasurer or Secretary, one wonders who else is left at this company.

To quickly fix the director vacancy and prevent an immediate delisting, China BAK initially [appointed Jonathan Christopher Paugh](#) as a director and also as chairman of not one, but two board committees. As it turns out, [Mr. Paugh is the son of Charlene Budd](#), who is head of the audit committee, so the [NASDAQ forced him to resign in October 2012](#), just 3 few weeks after his appointment. Mr. Paugh is still an associate at a Texas law firm with no prior experience as a company board member or in China.

At this time, the NASDAQ issued its [5th delisting notice to China BAK](#).

After Ms. Budd's son was forced to resign, China BAK was still undeterred, and [quickly appointed Martha Agee](#) to fill the role. As it turns out, Ms. Agee works with Ms. Budd. Both are teachers in the same department at a small Christian college in Waco, TX named Baylor College.

As we can see online [from resume of Ms. Agee](#) and the [resume of Ms. Budd](#), neither has ever listed any prior board experience on their resumes nor have they posted any experience in China. But fortunately they do teach on business related topics at the small Christian college.

We can also see from Baylor's [posted schedule for Ms. Agee](#) that she is teaching a full load of classes this semester during weekdays, so it seems quite unlikely that she would have been able to make her first trip to China to conduct due diligence before accepting this board role just 2 weeks ago. But given the urgency of the need to fill the director seat to satisfy the NASDAQ, the phone call to Ms. Agee would no doubt be fast and easy. Or perhaps Ms. Budd just popped in to the office next door to mention it in person.

Ms. Agee continues to get [rave reviews from students](#) at the small Christian college in Waco, TX. All students reviewing her give her 5 stars without exception and seem very happy about the ["easy 100%" scores](#) that can be achieved on the quizzes where the answers are in the back of the book. As shown in the reviews, generous extra credit and points for attendance make her "the best teacher at Baylor". Obviously one would hope that Ms. Agee applies much stricter standards to management of a small Chinese reverse merger now that she has accepted her first board role in a public company.

Since China BAK is now visibly insolvent and is facing imminent delisting from the NASDAQ, one might now wonder why China BAK even continues to make an effort to stay listed on the US capital markets. It also makes one wonder why the share price has risen so dramatically in the past 2 weeks.

As shown below, over the past few years, [China BAK has granted an excessive number of stock options](#) mostly to Chairman Li, now totaling over 3.1 million shares, with a weighted average strike price of \$3.59. The table below summarizes the number of options which are currently outstanding and exercisable. Note: the table below only includes those options which are currently exercisable, but in fact there are substantially more out there.

	# of options	Strike Price
1	360,000	\$4.30
2	1,250,000	\$4.18
3	605,000	\$3.29
4	841,600	\$2.81

<b>5</b>	37,500	\$2.43
<b>6</b>	53,600	\$1.28
<b>7</b>		
	<b>Total</b>	<b>Wtd Avg.</b>
	3,147,700	\$3.59

Upon delisting, there is no realistic chance of these options ever becoming in the money.

As a final aside, the company's financial statements continue to exhibit some unusual inconsistencies. Given the magnitude of the findings above, these details are likely not worth much additional attention, however I note them just for completeness.

Despite having \$170 million of bank debt and payables, a cash balance (back in June) of just \$13 million, negative cash flow of \$4 million per quarter, interest expense of over \$1 million per month, along with losing money on every sale made, [China BAK has continued to](#) tell investors that:

*We believe that our current cash and cash equivalents and anticipated cash flow from operations will be sufficient to meet our anticipated cash needs, including our cash needs for working capital and capital expenditures for at least the next 12 months.*

Quite obviously China BAK is entitled to "believe" anything they please, however given the obvious insolvency of the company, this statement comes across as a being not entirely genuine.

China BAK also notes that:

*Typically, banks will require borrowers to maintain deposits of approximately 10% to 100% of the outstanding loan balances and bills payable.*

For China BAK this would amount to at least \$17 million of pledges. China BAK currently shows exactly \$13 million in cash and \$4.6 million in pledged deposits, coincidentally amounting to \$17.6 million. So it is unclear to me if the \$13 million is actually unpledged cash or if it should be (and in fact, is) being held in pledged deposits (making it unusable to China BAK). As per China BAK's disclosure, the pledge requirement on 100% of its cash would be a bare minimum requirement for Chinese banks with which it does business. And in fact, if China BAK did actually have more cash, we would (based on the banking guidance provided by China BAK) expect to see even larger amounts of cash held back as pledged reserves.

And as a final note, China BAK tells us that:

*To help us finance and expand our operations, we had access to \$219.6 million in short-term credit facilities and \$23.6 million in long-term credit facilities as of [June 30, 2012](#). As of [June 30, 2012](#), the principal outstanding amounts included short-term bank loans of \$146.3 million under credit facilities and long-term bank loans of \$23.4 million maturing in over one year, and bills payable of \$66.2 million under credit facilities, leaving \$40.5 million of short-term funds available under our credit facilities for additional cash needs.*

Despite the fairly obvious math problems in that paragraph, one might be tempted to assume that China BAK could still potentially borrow another \$40.5 million even despite its current insolvency.

However, a detailed read of the individual terms of each of these loans from each of these banks reveals that this cash is not actually obtainable due to the terms they contain. As shown in their filings and on the balance sheet, China BAK is now rolling its loans such that the longer term loans are becoming shorter term loans, and as of late November, much of the additional capacity they had referred to has already expired.

This disclosure runs 5 pages, so I will not repeat it all here, however interested readers can refer to pages [8-12 of the recent 10Q](#).

## **Conclusion**

So quite clearly, China BAK is utterly insolvent. On paper, the value of this company isn't just "zero", it is actually deeply negative due to the massive debt load that the company has racked up over many substantial loss making years. Although the banks may be able to realize some minimal recovery value on their loans, there is clearly no scenario whatsoever in which shareholders can ever receive anything from China BAK. The recent surge in the stock, represents the last opportunity to sell this stock at any reasonable price and with any reasonable volume, so it is an opportunity that should be jumped on as quickly as possible before it evaporates.