

[Short Ideas](#) | [Consumer](#) | [China](#)

900,000 Reasons To Sell Feihe

Sep. 17, 2012 8:07 AM ET

by: ClearwaterBay

Asymmetric information has allowed Feihe International (NYSE:[ADY](#)) over the years to mislead U.S. investors while its tainted products are heavily denounced by Chinese consumer groups and its reputation is spiraling out of control. In our [initial report](#) on ADY, we examined the forceful industry trends and ADY's strategic and operational ineptitude that have led to ADY's imminent business and financial crisis. In this article, we will uncover why the Chinese consumers are not buying ADY's flagrant advertisements, and that the U.S. investors have been blindsided by ADY's continuous cover-up on its tainted dairy products.

Consumer Fraud

Some unscrupulous Chinese companies use language, geographic, and culture barriers to their advantage and paint a picture to the U.S. investors that's totally the opposite from the reality in the local Chinese market. While ADY's operational and financial metrics are rapidly deteriorating, ADY's management has been touting their dairy products as untainted, giving the U.S. investors a sliver of hope that somehow this "pureness" can be monetized in a growing market. Through years of management's countless road shows, conference calls and public releases, ADY has been lying to the U.S. investors by inculcating a pristine image of itself in a tainted marshland of Chinese domestic infant formula - unscathed and above its peers. However, the truth is totally the opposite -- on the other side of the world, the Chinese consumers and media have spoken loudly against ADY's consumer fraud. Consumer complaint cases against ADY have skyrocketed in the past two years in China. This recent article from Sina.com.cn ([NASDAQ:SINA](#)) [exposes](#) ADY of false product advertisement and its worsening tainted milk powder problems.

"Trust Gate" - Feihe Milk Scandal Exposed By Chinese Media

(The links below are the original Chinese articles; [translator](#) here.)

"Trust Gate" [[China Dairy](#), [Universal Family](#), [Phoenix New Media](#) (NYSE:[FENG](#))] is the term used extensively by the Chinese media starting in late 2010 to describe ADY's unethical and illegal practice of selling tainted dairy products, conducting illegal marketing practices and falsely advertising on its product quality. There have been mountains of

evidence against ADY from the Chinese dairy consumers to Chinese national and regional media to Chinese consumer associations. ADY's tainted dairy products and unethical marketing practice problems are extensive. Here are just few examples: ADY continued to use milk from its dairy cows after they were infected with [infectious diseases](#), reported by whistleblower ADY workers to Legal Weekend and republished in Sohu (NASDAQ:[SOHU](#)) on November 2011; ADY's infant formula causes [severe diarrhea](#) in babies and its packaging does not have the mandatory QS mark that denotes Quality Safety after proper processing and quality inspection.; [rice worms](#) found in ADY's rice powder products; ADY's repeated [illegal marketing](#) and sales activities reported by Chinese consumer association; [falsifying manufacturing](#) dates exposed by ADY's regional chief sales representative; giving away [expired dairy](#) products during marketing promotions (also read our previous article on how ADY uses product giveaways to inflate its gross margins).

One Chinese investigative reporter who exposed ADY of its Trust Gate problems mentioned that in 2010 when he did an Internet search with the Chinese key words 飞鹤奶粉"Feihe milk powder" and 投诉"consumer complaint/lawsuit" on the Chinese search engine Baidu (NASDAQ:[BIDU](#)) he found about [190,000](#) related articles. This week we did an exact same search on Baidu, and Feihe consumer complaint/lawsuit related articles have reached 908,000!

We expect ADY Trust Gate to worsen as ADY loses additional control over milk supply after it was forced to sell its dairy farms. Even in the short term with ADY expecting to receive raw milk from these dairy farms as consideration of the sale, the purchasers of these dairy farms are local financial buyers -- versus legitimate industry players like Yili Dairy, Nestle SA ([OTCPK:NSRGY](#)), and Beingmate; all three major players now have operations in ADY's home turf of Heilongjiang -- and have even less operational experience and control on quality than ADY did. Couple this continuous fall in quality control and ADY's decreasing cash reserve for cover-ups (see below), and we would expect more media expose and consumer complaints against ADY, expecting the Feihe brand to be a "1,000,000+ consumer-complaint wonder" on Baidu in the not-too-distant future.

The Trust Gate Cover Up

To cover up the mounting product quality cases, ADY resorted to many unethical business tactics, including: promised to test the tainted products by examiners but [never did](#); allows consumers to exchange for an upgraded product line on the condition that only if all of the tainted ADY products are returned to ADY; uses political and [economic pressure](#) to force investigative reporters to cancel their expose on ADY's defective products in the media,

etc. Even before ADY's current dire business and financial situation, some Chinese media have already predicted ADY's downfall and named ADY to be the [next Sanlu](#) -- the notorious Chinese dairy company that was forced into bankruptcy due to its tainted milk problems. Media mentioned the fact that both Sanlu and ADY have tainted milk problems and both used very similar deceptive business practices, including tainted product cover-ups, to which Sanlu eventually had to admit.

Despite ADY had spent major advertising dollars on its Feihe brand for many years, the brand never took off because the Chinese consumers can get real time information over the traditional and new media about the serious quality issues surrounding ADY. The typical one-child Chinese parents do lot of online and offline research before picking the infant formula for their infants. ADY's growing mountain of consumer complaints on its product quality has totally destroyed Feihe's credibility in the mind of Chinese consumers, leading ADY to lose market share in 1H 2012 to both the international dairy brands and domestic brands despite continuous heavy marketing, as we showed in our first report.

In addition to the regular cover-ups, ADY tried to damage-control its brands by de-emphasizing its flagship Feihe brand and make up new sub-brands like AstroBaby in attempt to detract consumers' attention from the negative image of the Feihe brand. However, it's too little, too late, and not enough cash for ADY. A recent Chinese brand analysis calls ADY's overall brand image as [chaotic](#). Despite ADY's claim of growing its high-end, high-margin milk products, they have not led to ADY's overall sales growth in 1H12 and more importantly, these profits never flow through to its bottom line or even to its operating income line, as we have shown in our previous article.

The Cockroach Effect: Consumer Fraud Spills Over to Financial Fraud

It is unfortunate that this dichotomy of the "Mr. Clean" image in the U.S. capital market and the "Trust Gate" scandal in the Chinese local market went on for so long and that the U.S. investors were misled by ADY's cover-up of its ongoing product quality problems. While ADY's Trust Gate scandals and cover-ups permeate the Chinese consumer market, it is highly likely its financial statements are also tainted as we have begun to probe in our previous article. We have just notified the U.S. regulators and the SEC regarding ADY's material misrepresentation of facts and accounting irregularities and PCAOB, regarding ADY problematic financial statements and current auditor's possible negligence in audit procedures, including the mandatory analytical reviews. We also provided additional documentation to both the SEC and PCAOB, comparing the huge discrepancies between ADY's SEC financial filings and its PRC's SAIC and SAT official reports that ADY would need to reconcile dating back to fiscal year 2008.

Four Pillars of Growth Crumbling

During its heyday, ADY boasted of an integrated business model, a big war chest, product quality, and brand equity. All four pillars are now crumbling. Just within last three years, over [400 of the 1,176](#) domestic dairy companies have been shut down in China primarily due to their inability to control upstream resources. Successful upstream ownership is the only way for Chinese dairy companies to [survive](#), and the Big 3 dairy players are making [massive investments](#) in dairy farms in China. Unfortunately, ADY has tried but could not successfully operate an upstream operation. The combination of upstream inadequacy, scanty cash, tainted products, and brand degradation qualifies ADY to be on the chopping block for the next wave of unqualified Chinese dairy companies.

As the house of Feihe falls U.S. investors do not want to be the last one holding ADY shares. [Mario Gabelli](#) has sold out his ADY positions. The chief architect of ADY's RTO and capital market, ADY's [vice-chairman and CFO](#) has sold most of his ADY ownership over the years and has only 15,000 shares remaining. The vestige of Chinese milk powder companies in the public company cemetery -- Emerald Dairy* ([OTC:EMDY](#)), Rodobo International* ([OTC:RDBO](#)), and Yayi International ([OTC:YYINE](#))- should serve as a reminder to everyone that justice will be served to unscrupulous RTO companies like ADY.

We will share more info in later reports. In the meantime, the 900,000 articles on ADY's Trust Gate should provide real insights on the gravity of ADY's imminent business calamity.

*Note: Emerald Dairy and Rodobo International both are milk power companies from ADY's hometown of Heilongjiang province. These two companies were actually in better financial conditions than ADY is now (e.g. cash and working capital ratio) when they were banished to the Pink Sheet. Their shares last traded at 10 cents and 20 cents, respectively.

Disclosure: I am short [ADY](#). I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.