Feihe International's Rough Financial Position

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“We never want to rely on the kindness of strangers in order to meet tomorrow’s obligations.”
~ Warren Buffett

Synopsis

ADY has serious financial problems. The company is heavily indebted, yet has a history of producing negative cash flow and no immediate prospects for operating improvements. It is highly questionable whether or not ADY should be considered a going concern. ADY is relying on the kindness of its PRC bankers to remain alive at the moment, but with huge near term payment commitments, this kindness will be tested. In order to survive long term, I believe ADY will need to raise at least an additional $100m in equity capital.

Yet, ADY is a Chinese RTO that has already burned through three other private equity funds’ money, has negative cash flow, has no proper CFO, and after over five years as a public company in the USA (including a stretch of approximately one year where it did not file statements) in its latest 10-K reports that it still did not maintain effective internal control over financial reporting. In this current environment for Chinese RTOs, an equity raise would be difficult and the pricing horrible. The early redemption by Sequoia in February and the departure of the CFO in November last year complete the story and confirm that insiders have known for a while that it is time to get out. I believe existing investors in ADY risk either insolvency or a massive dilution in their holdings.

Overview and History of ADY

ADY is a producer and distributor of infant formula, milk powder, soybean, rice and walnut products in the PRC. Its main product is infant formula, which accounts for approximately 2/3 of its sales and most of its gross profit. ADY is a small player in the infant formula market with approximately 3.6% market share (reference from Roth Capital's March 22nd report). The company operates a capital intensive business in the highly competitive infant formula industry.

ADY was one of the first Chinese reverse mergers, and began trading in the USA in 2005. Since then it has had dilutive convertible bond issuances from Pike Capital in 2006 and Citadel in 2007, followed by a redeemable equity issuance to Sequoia in 2009, which was mainly used to repay Citadel. The company had its brief moment in the sun following the melamine scandal in September 2008, as it was one of the only Chinese brands that did not have melamine in its infant formula (see link here).

That event caused sales to spike temporarily, but ADY was not able to hold on to its market share gains, as multinational brands surged in popularity and larger Chinese brands fought to regain their market share. In spite of declining sales, ADY kept on its expansion path, spending significant funds on sales and marketing, trying to expand into Tier 1 cities where its brand has no following, as well as growing its production base and building its own dairy farms. Through its failed marketing campaigns and failed expansion, the company significantly overextended itself. Additionally, the company recently agreed to repurchase Sequoia's shares, putting additional financial strain on the company.

Dependent on the Kindness of Strangers

ADY is in a rough position financial position. The charts below show the current financial situation of the company:

USD MM	2008	2009	2010
Sales	193.2	271.1	257.1
Gross Profit	76.0	130.7	103.3
EBIT	6.5	3.3	-29.6
EBITDA	11.8	11.8	-16.6
Less: Net Capex	35.3	89.6	40.6
EBITDA - Capex	-23.5	-77.8	-57.2
Addback: Loss on Sale of Cows	0.3	1.7	10.2
Proxy Cash Flow	-23.2	-76.1	-47.0

BALANCE SHEET	12/31/10
Short Term Debt	69.3
Current Portion of LTD	9.8
Sequoia Repayments (due in 2011)	48.7
Capex Payables (all short term)	31.2
Total Short Term Debt	159.0
Long Term Debt	28.6
Sequoia Repayment (due in 2012)	16.4
Total Long Term Debt	45.0
Total Debt	204.0
Less: Cash and Equivalents	-17.7
Net Debt	186.3

ADY has $186m in debt, but has generated negative cash flow for the last three years. From my previous experience in leverage lending and leveraged buyouts, I know that this is the financial picture of a company on the brink. In order to comfortably service $186m of debt, ADY would need EBITDA of approximately $60m, a figure it has never come close to achieving. ADY has given net income guidance of $22-24m for 2011, of which $10m is from tax subsidies, so real net income guidance is only $12-14m, which implies nowhere near enough cash flow to service this level of debt.

I have followed this company since 2008 (and was long for a portion of 2008 and 2009) and have never seen it make its numbers, so I have no reason to believe that it will meet these figures either. ADY's 2011 net income projection is predicated on sales growth to $290m even though ADY intends to cut marketing and consolidate points of sale, which sounds like an unlikely combination. The bank analyst reports published last month all expressed doubts on these projections and said they believe ADY needs to raise substantial equity financing.

In ADY's annual report published on December 31, 2010 shown here, Deloitte Touche Tohmatsu wrote,

> …the Company's losses from operations and deficiency of net current assets *raise substantial doubt about its ability to continue as a going concern*.

On the risk factors in the same annual report, ADY states,

> As of and for the year ended December 31, 2010, we had net loss of approximately $9.9m and deficiency of net current assets of approximately $59.3m, with short term loans of approximately $68.8m that mature in the next 12 months and redeemable common stock of $63m expected to be redeemed in the upcoming fiscal year. While we believe we will be able to refinance much of our short-term bank loans when they become due and that our cash generated from operations, along with existing cash and our ability to draw down on unutilized credit lines will be sufficient to fund our expected cash flow requirements for at least the next 12 months, *our belief may be mistaken*.

ADY put on a brave face in its latest earnings call, claiming it would draw down unutilized credit lines. But ADY is clearly relying on the kindness of its PRC bankers and understating its short term indebtedness in its statement. The entire Sequoia repayment of $65.1m (the last payment is due March 2012) and the capex payable of $31.2m together are $96.3m, so if they indeed have another $100m of credit available (which I doubt), they would need to use all of it.

Since ADY has already stretched its working capital and still has negative cash flow, if it drew down the rest of its lines, it would have no breathing room at all, and would run into bankruptcy. In addition, ADY will need funding for working capital, if it indeed is going to increase sales, and also funding for its uncompleted capex projects.

Insider Already Know the Game is Up

On February 2, 2011 the company announced a plan (shown here) to redeem Sequoia's shares for $63 million plus interest in four equal installments with the first installment beginning on March 31st, 2011 and the last on March 31st, 2012. The redemption price was $24 per share plus interest. Sequoia's original agreement allowed it to have its shares redeemed on the third anniversary from its investment (i.e. August 27th, 2012) at a price of $31.20 per share if the average closing price of ADY's stock for the fifteen trading days prior to the third anniversary was less than $39 per share. For the longest time I could not figure out why ADY agreed to redeem Sequoia's shares early. Why would ADY agree to a contract which it had no ability to pay and why would Sequoia agree to a contract which gives it substantially less money that it would otherwise receive?

In its agreement with ADY, Sequoia placed a clause which allowed it to block any subsequent equity financing done by ADY at a price lower than $24 per share (see Page 31 of the September 10Q here). I think ADY's management knows the stock will not hit the $24 level again, so it had to agree to buy out Sequoia early in order to do a subsequent equity raise. Probably there was a game of brinkmanship. ADY knew it had to raise money and Sequoia knew that without a further huge equity raise, ADY would go bankrupt so Sequoia made a concession on price in order to get its money back. There is no other plausible conclusion as far as I can tell. This tells me both ADY and Sequoia know that ADY needs a lot of money - badly.

An additional insider also knew it was time to hit the door. Jonathan Chou, the former CFO, resigned on November 16, 2010 (see filing here), exactly one week after the 10Q was filed. According to the 2009 annual report shown here, Chou had received options in 2009 worth $1.1 million. Why would Jonathan walk away from his options at ADY? My assumption is he knew they were not worth anything, and he knew the company was on shaky financial footing. Since that time Lin Hua, the Vice Chairman has been the acting CFO. The company announced on November 16th as well that it had formed a search committee to find a new CFO. Yet, amazingly, over four months later, ADY has still not found a new CFO. This is a terrible sign, and a clear indication that any CFO candidate they have approached has gotten word that the company is weak financially and should be avoided.

Summary

ADY has a capital intensive business in a very competitive industry. As a small and marginal player in its space, it has struggled to compete and maintain profitability, generating consistent negative cash flows. The company has seen its market share decline from over 7% after the melamine crisis in late 2008 to approximately 3.6% today in spite of massive marketing and capex expansion efforts, which have in turn left the company in a perilous financial position.

The financials demonstrate that the company is heavily indebted with significant short term financial liabilities. The company's auditors have strong reservations about whether or not the company is a going concern. In addition, the exit of Sequoia and the CFO indicate that insiders with substantial knowledge of the business know it is time to get out. ADY needs to raise at least $100m of equity capital, but an equity raise will be difficult for a company with its track record and RTO pedigree. I believe shareholders in ADY face either insolvency or massive dilution.

Disclosure: I am short ADY.