



Identify fraud through financial statements



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Today's agenda



- Ten red flags:
 1. Operating cash flow < net profit
 2. Excessive operating margins
 3. High accounts receivables
 4. High inventories
 5. Low effective tax rate
 6. Excessive M&A
 7. Key metrics on a per-unit basis out of line
 8. High corporate bond yield
 9. Low interest income from cash
 10. Rising share count
- Case study: Mega Expo Holdings (now renamed NOVA Group)
- Recommended books
- Asian Century Stocks



I. Operating cash flow lower than net profit

- **Cash flow from operations (CFO)** is lower than the sum of net profit + depreciation and amortisation
- **Why? Something is sucking up cash:**
 - Accounts receivables
 - Inventories
 - Non-cash gains & losses
 - Capitalisation of R&D
- **Dig deeper** into that line item:
 - If accounts receivable or gains, check revenue recognition policies & related party transactions
 - If inventories, check aging of inventory

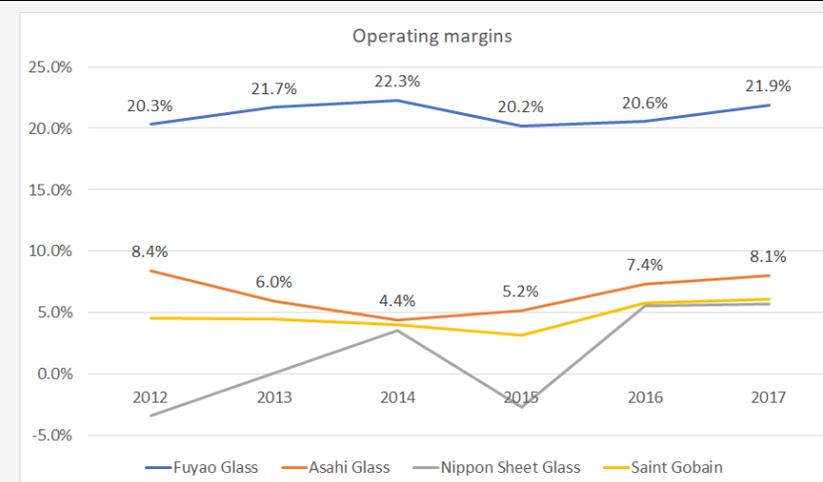
	Note	2012 RMB'000	2011 RMB'000
Operating activities			
Profit for the year		944,556	5,439,287
Adjustments for:			
Depreciation	8(c)	49,508	29,913
Net finance expenses	8(b)	592,376	457,240
Loss on disposal of property and equipment	7	251	47
Profit on disposal of investment properties	6	(10,234)	(6,512)
Net gain on liquidation of subsidiaries	7	(22,609)	(8,762)
Change in fair value of investment properties	16	(2,162,772)	(6,867,322)
Income tax	9	538,243	1,987,110
Operating profit before changes in working capital			
Decrease/(increase) in bank deposits		145,235	(184,083)
Decrease/(increase) in trade and other receivables		309,888	(638,605)
Increase in trade and other payables		22,462	189,448
(Increase)/decrease in inventories		(711,800)	824,757
Income tax paid	25(a)	(198,635)	(203,267)
Net cash (used in)/generated from operating activities			
		(503,531)	1,019,251

Renhe Commercial Holdings 2012 annual report



2. Excessive operating margins

- **Operating margins** way above peers?
 - For a commodity product?
 - Does the company have pricing power?
 - Is there a moat or comparative advantage?
 - Depreciation policies more aggressive than peers?
 - Capitalising software expenses or R&D?
- Check related party transactions to see whether there's any potential cycling of cash.
- **Recycling of cash** = payments to related parties which then become fake customers that generate new revenue
- Such recycling can be spotted through acquisitions of subsidiaries or acquisitions of deposits



Fuyao Glass's operating margins vs its peers

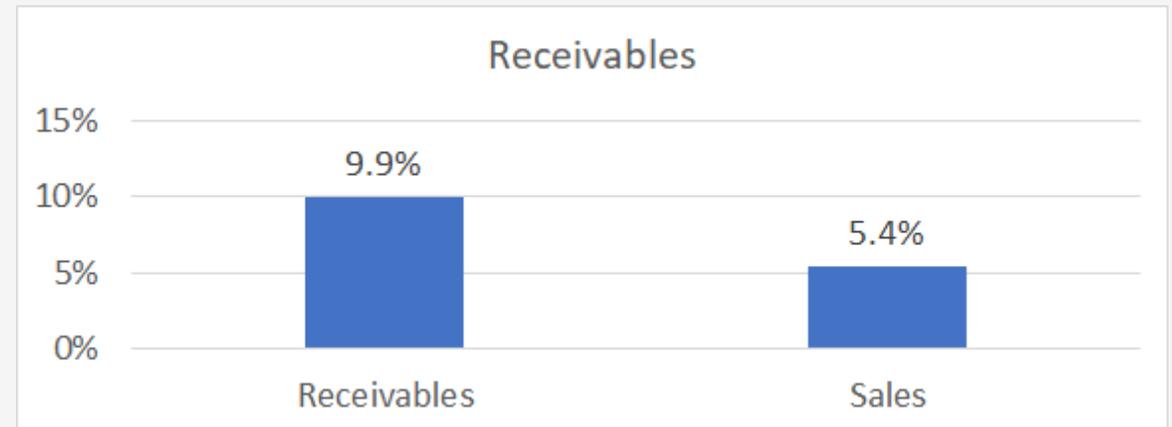
Related party transactions	2015	2016
Revenue	30,138	53,722
COGS	24,668	43,880
Sales of complete knock-down kit	11,133	23,859
Purchase of complete build-up units	11,661	24,620
Purchase of automobile parts	4,601	9,071
Total purchases	16,262	33,690
Related party as % of revenue	37%	44%
Related party as % of COGS	66%	77%

Geely related party transactions



3. High accounts receivables

- High **accounts receivable days** (avg accounts receivables / revenues * 365) compared to peers
- Company is not getting paid by its customers
- **Long-term receivables** particularly problematic
- Acceleration in accounts receivable growth means loosening of credit standards
- Company might be recognising revenue prematurely
- Review the “**Revenue recognition**” section in “Significant accounting policies” section of the financial statements
- Revenue recognition meet the key four criteria?
- Try to identify customer who isn't paying



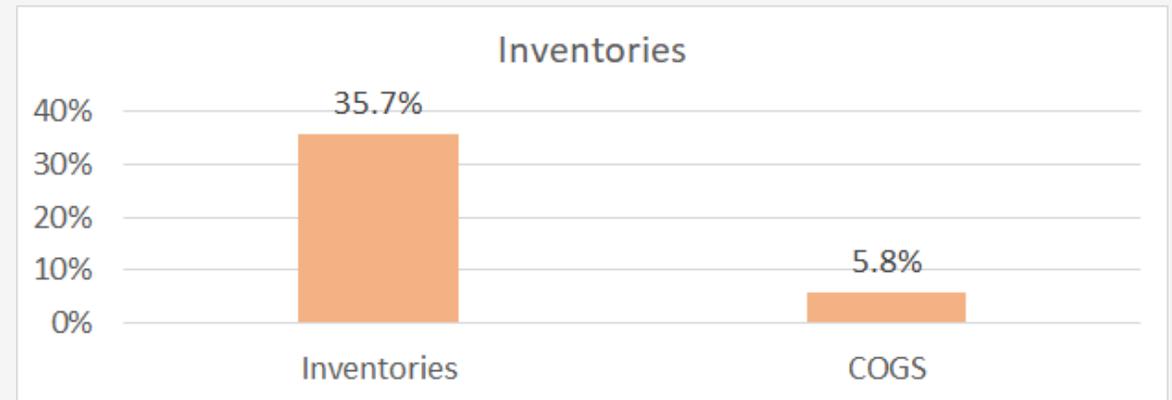
Lenovo's 2018 growth in sales vs receivables

- Revenue is typically recognized when:
1. Persuasive evidence of an arrangement
 2. Delivery has occurred
 3. Price fixed or determinable
 4. Collectability reasonably assured



4. High inventories

- **Inventory days** = $(365 * \text{inventory} / \text{COGS})$
- Are the inventory days higher than those of their peers?
- Is inventory is rising faster than cost of goods sold (COGS)?
- Focus on **finished product inventory**:
 - A rise in raw materials could just reflect movements in commodity prices
 - A rise in work-in-progress inventory could reflect optimism about the future
- High inventory growth, **possible explanations**:
 - Demand is weaker than expected
 - Manipulation of earnings by inflating end-of-period inventory levels



Lenovo's inventory growth vs the growth in COGS



5. Low effective tax rate

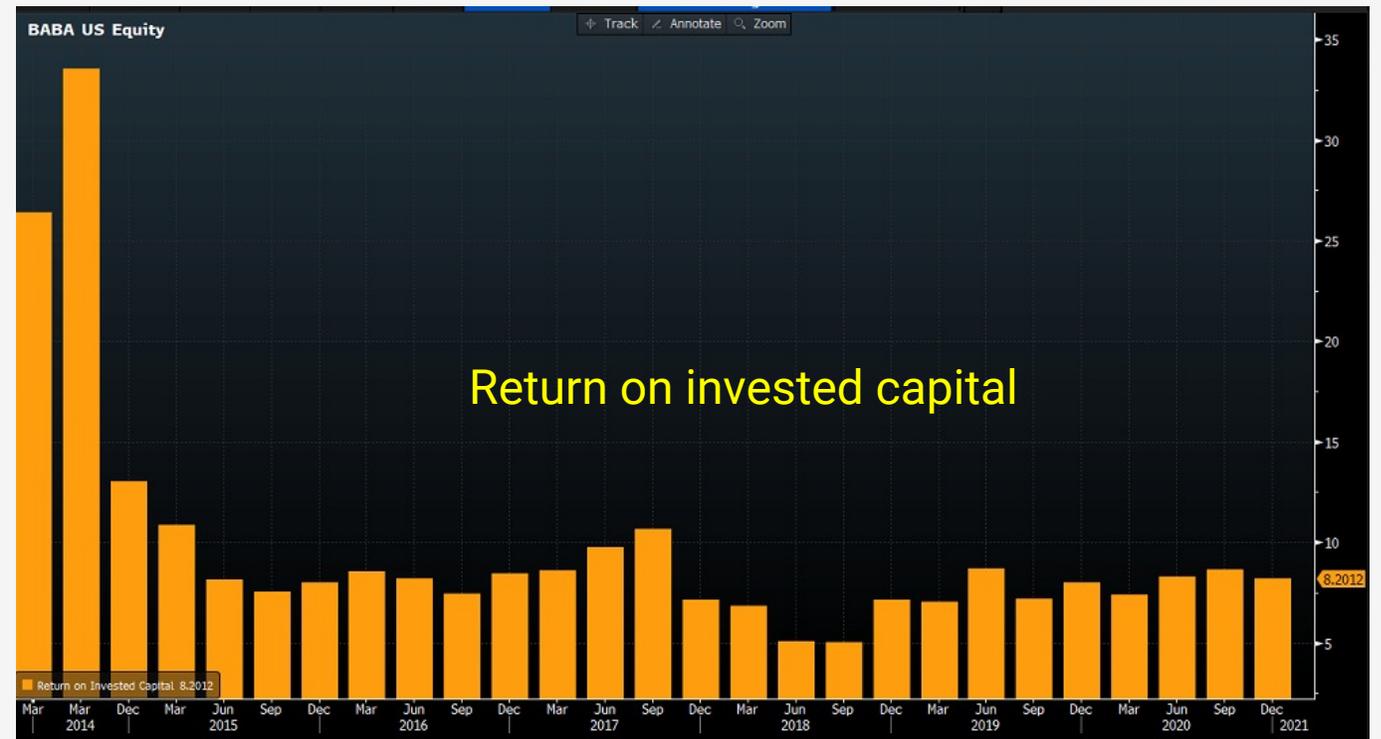
- Is the **effective tax rate** = (tax expense / pretax income) **lower than the statutory tax rate**?
- Check in footnotes for an explanation:
 - Enjoying special tax incentives?
 - Taxable income (as assessed by the tax authorities) lower than reported profits
- Double-check with **tax actually paid** in the cash flow statement

Profit before income tax	9	3,173,858	3,657,076
Income tax expense	10	(178)	(244)
Profit for the year		3,173,680	3,656,832



6. Excessive M&A

- Problems with recurring M&A?
 - They **might overpay**, so check multiples paid
 - Hiding costs through acquisition, e.g. "**outsourcing of R&D**" (c.f. Valeant)
 - Funnelling money out through **related parties**
- Check:
 - Growth in balance sheet
 - ROIC over time
 - Goodwill vs shareholders' equity
- Potential write-downs of R&D? If never written down, discount earnings



Source: Bloomberg



7. Key metrics on a per-unit basis wildly out of line

- Break down the business into its key building blocks: e.g. sales volume, employees, outlets
- **Compare accounting items to those blocks**
- For example:
 - Property, plant & equipment (PP&E) / revenue vs peers
 - PP&E / hotel room
 - Revenue/employee
- Are they lying about the number of employees, the number of hotel rooms, etc.?
- Could a sister company be shouldering part of the company's expenses?

	Net PP&E (ex. Building) per hotel room	% difference
<i>RMB</i>		
Huazhu Self-Operated Hotels (Reported Min.)	54,502	
Huazhu Self-Operated Hotels (Credit Reports)	24,283	124.4%
Cosolidated from Huazhu Secretly Owned Off-Book Hotels (Credit Reports)	4,599	1,085.0%
Independent Franchisees (Credit Reports)	11,460	375.6%
Shanghai Jinjiang (Reported)	33,373	63.3%
BTG Hotels (Reported)	29,246	86.4%

Net PP&E/room in Bonitas Research's report on Huazhu



8. High corporate bond yield

- Fixed income investors are smarter
- Check bond pricing data on Bloomberg, bondsupermart or Cbonds
- If borrow cost > 10%, good luck avoiding the treadmill to bankruptcy
- High borrow cost is worrying. Are creditors seeing:
 - **Hidden debt?**
 - **Aggressive accounting?**



Source: Bloomberg



9. Low interest income from cash

- Bank statements can be faked and cash may not be there
- **Effective interest on cash =**
Calculate interest received / average cash balance
- Compare with typical deposit rate in that currency
- Potential explanation:
 - **Cash doesn't exist**
 - **Cash transferred to company** on 31 December 2022 to improve the optics

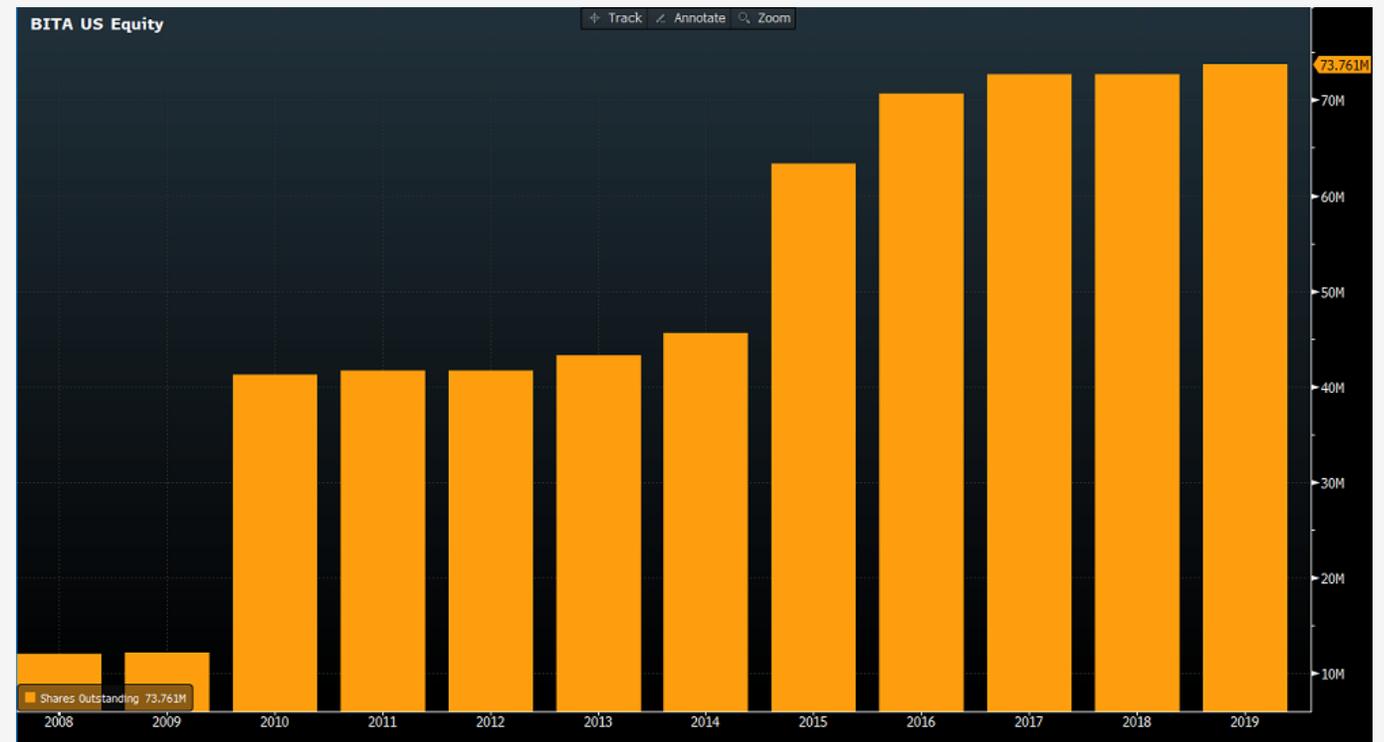
	Notes	2017 RMB'000	2016 RMB'000
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchases of items of other property, plant and equipment		(67,105)	(273,845)
Proceeds from disposal of items of other property, plant and equipment		1,393	9
Purchases of other intangible assets		(1,323)	(5,174)
Acquisition of subsidiaries		(3,360)	(2,050)
Disposal of subsidiaries	36	—	(3,662)
Disposal of investments in redeemable preference shares	20	371,365	—
Acquisition of an associate	35	—	(26,410)
Interest received		33,622	18,227

CAR Inc's cash flow from investing activities



10. Rising share count

- **Avoid recurring dilution**, especially in undervalued companies
- Issuing new shares could be done to:
 - Build empires justifying higher pay
 - To fund shortfalls of cash
 - As acquisition currency
- Pull up the chart of the company's share count over time to spot dilution
- If rising, then announced buybacks should be taken with a grain of salt
- Minority-friendly management teams do not dilute public investors



Source: Bloomberg

Case study: Mega Expo (1360 HK), now known as "NOVA Group"



- Hong Kong-listed **event organiser** providing consulting services to bars, selling entertainment equipment to them, supplying them with alcohol and helping them recruit DJs.
- The business has had **amazing growth** since a number of key subsidiaries in Shanghai and Shenzhen were set up in 2017
- Part of the company's growth came from a series of **seven acquisitions** in less than two years, financed through the capital markets
- Mega Expo's CEO was a former member of a prominent Chinese boy band turned entrepreneur



Mega Expo 1/5: Unreasonable operating margin + normal tax rate



- Mega Expo's operating margin in FY2019 was 38%, far above peers such as Pico Far East
- The fact that revenue doubled is by itself a red flag, given the constraints of hiring talent and financing working capital needed for such growth
- Since Mega Expo was essentially a subcontractor, there's no reason why it would enjoy margins above say 10%
- The effective rate of 15% is normal – the company actually paid real tax in Hong Kong

Income statement

	Notes	2019 HK\$'000	2018 HK\$'000
Revenue	7	576,120	254,051
Cost of sales		(192,810)	(137,787)
Gross profit		383,310	116,264
Other income	8	16,574	1,814
Other gains and losses	9	1,244	28,619
Net loss on financial assets at fair value through profit or loss	9	(30,009)	(23,974)
Net (loss)/gain on change in fair value of contingent consideration payables		(23,255)	43,433
Selling expenses		(19,068)	(12,570)
Administrative expenses		(110,301)	(40,209)
Operating profit		218,495	113,377
Finance costs	10	(22,665)	(237)
Profit before tax	9	195,830	113,140
Taxation	11	(88,514)	(22,435)
Profit for the year		107,316	90,705
Other comprehensive income/(expense)			
<i>Items that may be subsequently reclassified to profit or loss:</i>			
Exchange differences on translation of foreign operations		(12,328)	(3,907)
Release of exchange reserve upon deregistration of a subsidiary		-	169
Total comprehensive income for the year		94,988	86,967

OPM = 38% (arrow pointing from Revenue to Operating Profit)

Effective tax rate = 15% (arrow pointing from Profit before tax to Taxation)

Mega Expo 2/5: Massive goodwill + receivable growth



- Mega Expo's goodwill balance of HK\$332 million suggests significant acquisitions above book
- For what it's worth, the goodwill/equity ratio was
- The company doesn't have many other assets, except receivables
- Receivables grew +336% in FY2019, way faster than the revenue growth of +127%. It looks like Mega Expo wasn't getting paid for its services.
- The accounts receivable days against FY2019 revenues was 303 days – a huge red flag. Normally, customers will pay you within 90 days.
- In 2018, Mega Expo issued an unsecured corporate bond with an effective interest rate of 10.2%, suggesting limited confidence in their creditworthiness (footnote 31).

Balance sheet

	Notes	2019 HK\$'000	2018 HK\$'000
Non-current assets			
Property, plant and equipment	15	4,738	5,980
Intangible assets	16	14,252	22,511
<u>Goodwill</u>	17	332,417	290,982
Financial assets at fair value through profit or loss	24	7,977	13,430
Interest in an associate	18	–	12
Prepayment and deposits	23	16,062	1,703
Deferred tax assets	20	1,465	5,525
		376,911	340,143
Current assets			
Inventories		2,159	3,400
<u>Trade receivables</u>	21	171,327	109,793
<u>Factoring receivables</u>	22	307,557	–
Prepayments, deposits and other receivables	23	52,275	14,954
Financial assets at fair value through profit or loss	24	48,887	3,355
Income tax receivables		2,089	231
Cash and cash equivalents	25	212,951	171,175
		797,245	302,908
Current liabilities			
Trade payables	26	26,445	9,604
Receipts in advance	27	2,528	2,810
Contract liabilities	28	13,210	–
Accruals, deposits received and other payables	29	33,129	43,909
Contingent consideration payables	30	83,061	45,979
Income tax payables		26,655	11,845
		185,028	114,147
Net current assets		612,217	188,761
Total assets less current liabilities		989,128	528,904

Tons of goodwill

Massive growth in receivables

Assets +83%

Mega Expo 3/5: Lack of cash flows due to accounts receivables



- Two red flags:
 - Negative operating cash flow for two years straight
 - Pretax profit way higher than cash flow from operations
- The primary culprit is a massive increase in receivables, which means the company never got paid for its revenues
- Was the revenue real? Or just fabricated?

Cash flow statement

	Notes	2019 HK\$'000	2018 HK\$'000
OPERATING ACTIVITIES			
Profit before tax		195,830	113,140
Adjustments for:			
Depreciation of property, plant and equipment	15	3,157	3,325
Amortisation of intangible assets	16	7,314	7,388
Gain on disposal of property, plant and equipment	9	-	(10)
Gain on disposal of intangible asset	9	(15)	-
Write off of property, plant and equipment	9	19	13
Net loss on financial assets at fair value through profit or loss	9	30,009	23,974
Dividend income	9	-	(160)
Financing income		(31,698)	-
Interest income	9	(738)	(1,886)
Interest expenses	10	22,665	237
Net loss/(gain) on change in fair value of contingent consideration payables	30	23,255	(43,433)
Net gain on disposal of subsidiaries	9	-	(14,180)
Loss on deregistration of a subsidiary	9	-	169
Equity-settled share-based payment expenses	9	57,404	6,202
Reversal of impairment loss on other receivable	9	-	(11,500)
Waiver of amount due from an associate	9	21	-
Operating cash flows before movement in working capital		307,223	83,279
Increase in amounts due from an associate		(9)	(4)
Decrease/(increase) in inventories		1,113	(3,451)
Increase in trade receivables		(66,522)	(94,403)
Increase in factoring receivables		(310,879)	-
(Increase)/decrease in prepayments, deposits and other receivables		(52,071)	23,505
Increase in trade payables		17,411	4,106
Increase/(decrease) in receipts in advance		2,555	(25,503)
Decrease in contract liabilities		(10,224)	-
Increase in accruals, deposits received and other payables		12,589	8,601
Cash used in operations		(98,814)	(3,870)
Tax paid		(70,327)	(15,267)
Financing interest received		30,398	-
Net cash used in operating activities		(138,743)	(19,137)

Receivables

Weak cash flow

Mega Expo 4/5: Acquisition of subsidiaries + no interest on cash



- Acquisitions of subsidiaries & acquisition of an unlisted investment fund raises a red flag for me
- Were the payments to related parties?
- That would explain the high margins, i.e. would imply a recycling of cash through related parties
- Effective deposit rate = $0.738/192.1 = 0.2\%$ low for a mainland Chinese business

Cash flow statement

Notes	2019 HK\$'000	2018 HK\$'000
INVESTING ACTIVITIES		
Dividend income	-	160
Interest received	738	1,886
<u>Payment for acquisition of subsidiaries</u>	<u>(39,460)</u>	<u>(17,521)</u>
Purchase of property, plant and equipment	(1,966)	(106)
Proceeds from disposal of property, plant and equipment	167	499
Proceeds from disposal of intangible asset	115	-
Acquisition of listed equity securities	-	(19,200)
<u>Acquisition of unlisted investment fund</u>	<u>(30,000)</u>	<u>-</u>
Proceed from disposal of listed equity securities	-	20,145
Acquisition of unlisted fund	-	(10,082)
Proceed from disposal of unlisted fund	-	9,923
Proceeds from disposal of subsidiaries	-	51,722
Net cash (used in)/generated from investing activities	(70,406)	37,426
FINANCING ACTIVITIES		
Dividends paid to owners of the Company	(14,542)	-
Interest paid	(29,415)	(3)
Net proceeds from placing of shares	-	100,327
Net proceeds from issue of corporate bonds	298,510	2,580
Net cash generated from financing activities	254,553	102,904
NET INCREASE IN CASH AND CASH EQUIVALENTS		
Cash and cash equivalents at the beginning of the year	171,175	54,583
Effect of foreign currency exchange rate changes	(3,628)	(4,601)
CASH AND CASH EQUIVALENTS AT THE END OF THE YEAR	212,951	171,175

No interest income?

Recycling of cash

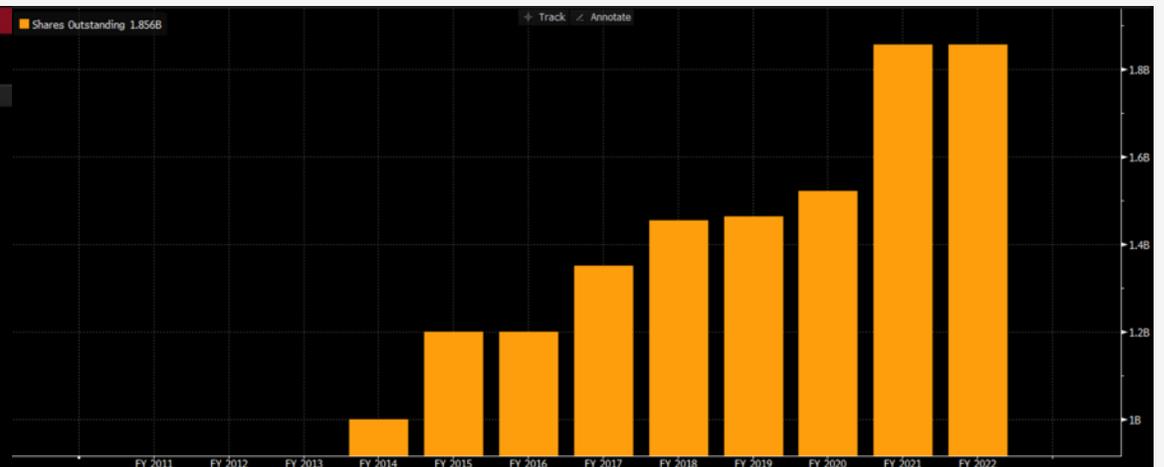
Mega Expo 5/5: Rising share count due to M&A and share issues



M&A and share issues

Effective	Action Type	Ticker / ID	Summary
01/20/23	Equity Offering	1360 HK	INTL Equity Offering: ADDL
11/19/20	Divestiture	1360 HK	Unit: Mega Exhibition International Ltd, Seller: NOVA Group Holdings Ltd
08/20/20	Equity Offering	1360 HK	INTL Equity Offering: ADDL
03/08/18	Equity Offering	1360 HK	INTL Equity Offering: ADDL
11/24/17	Acquisition	1360 HK	Target: Cheer Sino Investment Holdings Ltd, Sought: 100.00%
07/10/17	Divestiture	1360 HK	Unit: Up Huge Corp Ltd, Seller: NOVA Group Holdings Ltd
05/26/17	Equity Offering	1360 HK	INTL Equity Offering: ADDL
04/09/17	Acquisition	1360 HK	Target: Fortune Selection Ltd, Sought: 100.00%
03/03/17	Acquisition	1360 HK	Target: Sparkle Mass Ltd, Sought: 100.00%
12/23/16	Equity Offering	1360 HK	INTL Equity Offering: ADDL
05/06/16	Acquisition	1360 HK	TERMINATED - Target: Treasure Spy Ltd, Sought: 100.00%
01/21/16	Acquisition	1360 HK	Target: Almighty Captain Ltd, Sought: 51.00%
06/01/15	Equity Offering	1360 HK	INTL Equity Offering: ADDL
04/21/15	Divestiture	1360 HK	Unit: Idea Trade Ltd, Seller: NOVA Group Holdings Ltd
11/20/14	Equity Offering	1360 HK	INTL Equity Offering: ADDL
11/06/13	Equity Offering	1360 HK	INTL Equity Offering: IPO

Shares outstanding



Blue Orca's allegations against Mega Expo



1. **Dubious acquisitions:** The seven acquisitions funded by the capital markets were mostly empty shells with no revenues, no assets and no track record.
2. **Related party revenues:** 95% of revenues came from undisclosed related parties, particularly dodgy entertainment group "Noah's Ark", which owned bars and KTVs in Shanghai and elsewhere.
3. **No operating footprint:** Blue Orca was unable to find any evidence of operations at Mega Expo's key subsidiaries, only an employee with an e-mail address belonging to "Noah's Ark".
4. **Non-standard advisers:** The appraiser and auditor behind Mega Expo had been behind some of Hong Kong's largest frauds.
5. **High valuation:** The valuation of 22x Price/Book and 13.3x Price/Sales was far above listed peers such as Pico Far East.



"Truth is Stranger than Fiction."
- Mark Twain

THIS RESEARCH REPORT EXPRESSES SOLELY OUR OPINIONS. We are short sellers. We are biased. So are long investors. So is Mega Expo. So are the banks that raised money for the Company. If you are invested (either long or short) in Mega Expo, 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. Because this document has been prepared without consideration of any specific clients' investment objectives, financial situation or needs, and no information in this report should be construed as recommending or suggesting an investment strategy. 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 Mega Expo'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: Mega Expo Holdings Ltd. | HK: 1360
INDUSTRY: Exhibition and Entertainment

PRICE (AS OF CLOSE 5/8/2019) HKD 4.20	Mega Expo Holdings Ltd (HK: 1360) ("Mega Expo" or the "Company") is a Hong Kong listed event organizer whose share price has mysteriously appreciated over 300% despite limited disclosures as to how it actually makes money. Its shares inexplicably trade at over 13.3x sales and 22x book, a valuation reminiscent of Hong Kong's most notorious stock manipulations.
MARKET CAP: HKD 6.1 BILLION	Since 2017, Mega Expo has spent an aggregate of HKD 470 million on seven acquisitions. With its core exhibition business unprofitable and shrinking, Mega Expo financed these acquisitions through the capital markets by issuing equity at a massive discount to its share price and selling corporate bonds at interest rates near or above 10%.
30 DAY AVG VOLUME: 15.9 MM SHARES	Despite raising debt at punitive interest rates and diluting shareholders, the Company has little to show for these purchases. Most of Mega Expo's acquisition targets were either empty shells or newly formed businesses with no revenues, minimal to no assets, and no track record of operating a business. Many of the acquired entities do not even have operating WeChat accounts or websites, even though the target entities are supposedly in the businesses of marketing, brand consulting, or event planning. In our opinion, these were mostly sham transactions designed to loot money from the public company.
BLUE ORCA VALUATION: HKD 0.00	Almost all Mega Expo's sham transactions over the last two years involved the acquisition of assets or businesses previously owned by or connected to the Noah's Ark Group, a shadowy syndicate which Chinese law enforcement and media have linked to prostitution through its network of affiliated bars, clubs and KTVs. The picture below was allegedly taken at the White Horse Club in Shanghai, a club for male escorts linked by Chinese media to the Noah's Ark Group. Unbelievably, we found evidence that Mega Expo's current subsidiary (and recent acquisition) provides services for this notorious brothel.



Source: http://www.sohu.com/a/291718548_442092

In effect, we believe that Mega Expo has undergone a stealth reverse merger, and that shadowy networks with ties to criminal enterprises such as prostitution now control the public company. We estimate that 95% of Mega Expo's CY 2018 revenues were derived from businesses acquired from or connected to the Noah's Ark Group. Even Mega Expo's new CEO, a former member of a prominent Chinese boy band, was plucked from an entity previously controlled by the Noah's Ark Group.

To facilitate this scheme, Mega Expo retained the same appraisal firm that valued a sham acquisition for Tech Pro Technology (HK: 3823) ("Tech Pro"); a notorious Hong Kong fraud we exposed in 2016. After its auditor resigned, Mega Expo also retained an auditor whose only other major client is the notorious China Ding Yi Feng (HK: 0612) ("China DYE"). China DYE's shares were recently suspended and its assets frozen by the Securities and Futures Commission amid accusations of stock manipulation and fraud.

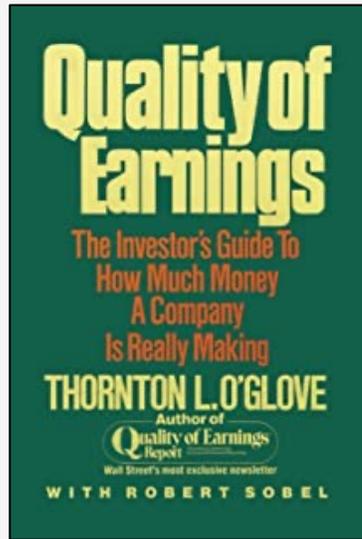
Like Tech Pro and China DYE, we believe that Mega Expo is an obvious fraud, that its equity is worth HKD 0.00, and that trading of its stock should be halted to protect future investors and hopefully provide a modicum of recovery for shareholders and creditors.

Mega Expo's share price slumped 97% since Blue Orca's report



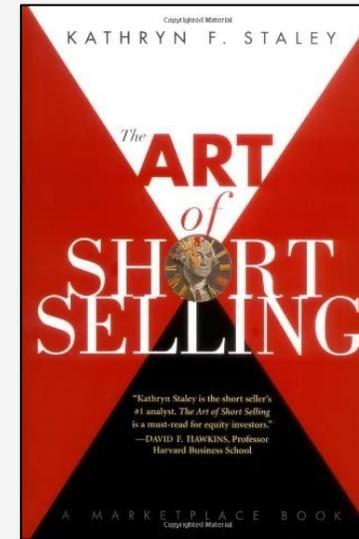
Source: Bloomberg

Recommended books



Quality of Earnings by Thornton L. O'Glove (1987)

- Learn to detect earnings manipulation.
- Helps you adjust earnings to what they would have been if it wasn't for the manipulation taking place.



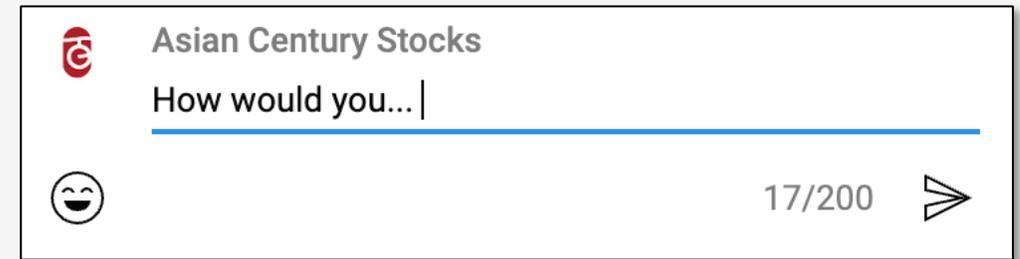
The Art of Short Selling by Kathryn F. Staley (1996)

- The best book ever written on short-selling.
- How short-sellers apply financial analysis to find targets and trade the stocks on the way down.



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