# Chinese Government Officials Confirm HRBN and DEER Committed Multi-Million Dollar Land Fraud -- Time for U.S. Regulators to Act

Harbin Electric (NASDAQ: HRBN) and Deer Consumer Products (NASDAQ: DEER) stocks should both be halted from trading until their managements restate their financials to correct egregiously exaggerated prices they claim they paid for recent land use rights purchases. In the case of HRBN, management claims they paid $23 million cash as of June 30th, 2011 as a deposit on $38 million of land use rights priced at 500,000 RMB per Mu, double the government's offering price. This $23 million prepayment was in fact never made. In the case of DEER, management reported paying $37 million to purchase land use rights but failed to disclose receipt of $21 million in rebates. Our report today provides concrete evidence consisting of multiple recorded phone calls, on site visits and emails with government officials proving beyond any doubt that HRBN and DEER are both guilty of conducting very similar fraudulent land use rights purchase schemes to steal money from their shareholders. HRBN's auditor, Frazer Frost, failed to respond to our attempt to share our findings last week. DEER's management has repeatedly refused to address our findings and tried unsuccessfully for several months to conceal the truth. This morning we handed over all our evidence to officials at NASDAQ and the SEC prior to publishing this report. We are hopeful regulators will halt HRBN and DEER until their financials are restated to reflect reality, in the same manner as PUDA and CTE were immediately halted after we published our findings (here) and (here). Last week PUDA's independent investigation committee in fact confirmed (here) all of our findings and the stock, delisted to the Pink Sheets, to date fell over 90% from its highs. In this report we prove that HRBN and DEER's land frauds are just as brazen as the fraud conducted by PUDA and CTE and thus deserve the same fate.

**Background**

Since 1989 China has established over 120 economic development zones to manage the conversion of farmland to industrial land that is flattened, accessible and connected to necessary utilities (made "shovel ready") for industrial buyers. The central government sets minimum selling prices for development zone land use rights according to the grade of the land. A list of minimum land use purchase prices published by the central government's Ministry of Land and Resources ("MLR") is available (here). For example, the MLR grades the Wuhu Economic and Technological Development Area (or "WEDA") as "Grade 6" having a minimum 227,000 RMB per Mu (or Chinese acre) purchase price. That price is roughly equivalent to $217,000 per acre, a very steep price for land in a rural area outside the city. To sell land at such high prices the local governments that stand to benefit from the taxes (a portion of corporate income tax and VAT) and jobs created by the industrial users of the land are often willing to offer steep discounts in the form of cash rebates, tax breaks and other performance based incentives to lure buyers. The local government is especially eager to court well known foreign invested enterprises such as those traded on the U.S. NASDAQ exchange. Thus it is very common for a company to buy land use rights below the government's minimum price in the less developed regions. For example, $30 million of land use rights could easily translate into a net price of $20 million (with the $10 million rebate paid to the account of the buyer's choice within seven days of closing) provided certain reasonable conditions are met.

The motivation of the local government to discount the land use rights makes perfect sense. But, unfortunately, sometimes corruption enters the exchange. Local officials routinely negotiate and prepare the official purchase agreement stating more or less whatever the buyer wants its auditors, investors and lenders to see. A secret "supplemental" agreement between the buyer and the development zone sets forth the lower real price, discounts and other incentives. Cash rebates can be transferred to any account specified in the supplementary agreement. This is a very basic and well-known land use rights exploitation that with bad intentions can be used to divert large amounts of investors' money.

### HRBN's Fraudulent $23 Million Land-Use Rights Prepayment

In its form 10-Q filed on August 9, 2011 (here), Harbin Electric (HRBN) disclosed the following land purchase and payment activities by its subsidiary Xi'an Tech Full Simo Motor Co Ltd ("Tech Full" or "Simo Motor"):

> *On June 10, 2011, Simo Motor entered into a land use agreement (the "Simo Land Use Agreement") with Xi'an Lintong Tourism and Business Development Management Commission ("Xi'an Lintong") with respect to Simo Motor's use of 500 Chinese Mu of land (approximately 82.4 acres or 333,500 square meters) located at Daixin Industrial Development Zone in Xi'an Lintong (the "New Site"). Pursuant to the Simo Land Use Agreement, the New Site will be used for construction of a new manufacturing facility that will produce electric equipment and machinery and related products as part of a capacity expansion project at Xi'an Simo. The term of the Simo Land Use Agreement is 50 years and the aggregate amount that Simo Motor shall pay to Xi'an Lintong is approximately $38.8 million (RMB 250 million). The Company made a pre-payment of $23.0 million (RMB 150 million) as of June 30, 2011 and will pay in full upon receipt of the land use license to be issued by the government.*

The payment appears on HRBN's Cash Flow Statement for the 6 months ended June 30 2011, where $23,208,049 was disclosed as "Payment for advances on intangible assets", as shown below:

| | | |
|---|---|---|
| Taxes payable | 2,325,131 | 719,344 |
| Net cash provided by operating activities | 18,429,317 | 49,138,164 |
| | | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Payment for advances on intangible assets | (23,208,049) | - |
| Payment for advances on equipment purchases | (5,692,232) | (10,386,470) |
| Purchase of intangible assets | (10,634) | (110,507) |
| Purchase of plant and equipment | (3,604,343) | (1,637,564) |
| Disposal of plant and equipment | 77,931 | 90,892 |
| Additions to construction-in-progress | (8,444,793) | (28,558,099) |
| Payment to original shareholders for acquisition | - | (27,946,571) |
| Payment to acquire noncontrolling interests | - | (26,550,890) |
| Deconsolidation of cash held in disposed subdivisions | - | (602,948) |
| Proceeds from sale of controlling interests in subsidiaries | - | 718,781 |
| Net cash used in investing activities | (40,882,120) | (94,983,376) |

Based on the $38.8 million or 250 RMB million total purchase price disclosed by HRBN, we calculate the price per Mu of land is 500,000 RMB. However, through a series of in person and phone conversations with Ms. Xiaorong Wang, whose title is Deputy Director of the

Investment Promotion Department (招商部) of Xi'an Lintong Tourism and Business Development Zone Management Commission ("Xi'an Lintong"), we confirmed that **as of August 31, 2011:**

1) HRBN has not signed any formal land use rights purchase agreement or even agreed on a final land price per Mu, contradicting HRBN's 10-Q disclosure that it entered into a land use agreement on June 10, 2011.
2) HRBN has exaggerated the true cost of the land use rights by at least 92%
3) Xi'an Lintong did not receive the $23 million prepayment HRBN reported it made as of June 30th. Where did this $23 million go?

In order to verify the land purchase transaction and the reported price, our investigators recorded three separate conversations with Ms. Wang. The investigators approached Ms. Wang as representatives of a U.S. listed electric motor manufacturer interested in buying land similar to HRBN's requirements. We then inquired about HRBN's land use rights price and purchase details.

When asked about the price of the land within the Daixin Industrial Development Zone, Ms. Wang repeatedly stated that the actual price should be no more than 260,000 RMB per Mu on each of our three conversations. According to the MLR, the minimum land use purchase price in this "Grade 10" Zone is 112,000 RMB per Mu. All land sold is in a condition that is ready for immediate construction with no additional improvement required. Ms. Wang described 260,000 RMB per Mu as "… a packaged, all-in price, which means for this price we (Xi'an Lintong) will take care of the application, administrative procedure related to the land ownership and make sure you get your land use rights certificate with your company's name on it". Ms. Wang explained that upon further negotiation the land-use rights sale price could be discounted for buyers that are publicly listed companies.

When asked specifically about the land use purchase of HRBN's Tech Full subsidiary, Ms. Wang explained that "Tech Full, their case is still being negotiated. They will have to wait till their Chairman gets back to make a decision." Ms. Wang further explained "we actually haven't reached the point of talking about the price with them." Although not recorded on tape, Ms. Wang made it clear to us when we met in person that no formal land purchase agreement had been signed between Tech Full and Xi'an Lintong. The failure to reach a formal agreement was due to changes in the size of the 500 Mu land parcel caused by the changes to the Zone's own development plan plus the fact that HRBN Chairman Tianfu Yang had been away and thus unable to make a final decision on the purchase. As for the price Tech Full might ultimately pay, Ms. Wang repeatedly stated it would be no more than 260,000 RMB per Mu, adding:

> *"…I can tell you this because we are very transparent about how we operate here. It's not like we give secret differential treatment to this company or that company. It's all quite transparent. So for a company like Tech Full Motor (泰富电机), I can tell you for sure that they will get some discount, if they decide to move here. I don't need to hide this. So I can directly tell you they will*

*definitely get some discount. As for the amount of discount, it is to be determined by a later meeting of our leaders."*

**Lastly, when we confronted Ms. Wang regarding the $23 million prepayment HRBN claimed to make as of June 30th, she paused for over 4 seconds before responding and then stated: "Tech Full? Prepayment?"**

On Thursday, September 1st, the day after our third call with Ms. Wang, we approached HRBN's auditor, Frazer Frost, offering to share all our evidence. We made two phone calls to Dean Yamagata, the partner in charge of auditing HRBN, and left messages with his receptionist. He did not call back, so we called a third time that day and told his receptionist it was extremely urgent and she put us right through to him. We explained to Dean that we wanted to share evidence of serious irregularities in HRBN's 10-Q requiring confidential treatment and he replied that he needed to talk to his partners to confirm if they wanted to proceed. Late that afternoon we received a call back from Brian Tunnelle, who identified himself as the partner in charge of quality control. We explained we needed their immediate cooperation by the end of the day. The next day we left Brian two voicemails demanding a response. It has been over four days and Frazer Frost has never responded. However, we are certain Frazer Frost tipped off management to our findings because, miraculously, on September 5th we received a threatening phone call from an "investor" who threatened to "take action" against us if we published anything negative about HRBN. We recorded a copy of the call for regulators. Additional proof that Frazer Frost tipped off management about our report is HRBN's double press releases early this morning (here and here) reaffirming management's confidence in the buyout and encouraging investors to avoid lending their shares to short sellers and to not be "distracted by what the Company believes are illusory, spurious, and unfounded claims and scare tactics." Does this sound like smart advice?

**Conclusion**

HRBN's independent directors should launch an immediate investigation into the fraudulent land-use rights purchase and phony $23 million prepayment disclosed in its second quarter 10-Q. One question everyone should immediately ask is why did HRBN's management loot the company for $23 million on the last day of the second quarter, in the midst of constant public debate over the validity of management's $445.5 million leveraged buyout? How can we trust that management is taking the company private in October when they are stealing money from the company in June? What did HRBN management do with this money? HRBN's independent directors should follow the example of PUDA and put a halt to the proposed buyout until HRBN's historical financials are restated and management is held responsible for their actions.

Click (here) to listen to the 1st conversation recorded on August 26th 2011 in the office of Xi'an Lintong Tourism and Business Development Zone Management Commission. Click (here) for a transcript of the recorded conversation. Click (here) for pictures from our visit to the Development Zone office, as well as a copy of Ms. Wang's business card and the Zone's brochure.

Click (here) to listen to the 2nd conversation recorded on August 30, 2011 over the phone with Ms. Wang from Xi'an Lintong. Click (here) for the transcript. Note that during this call Ms. Wang sent us an email (copy here) providing us the application form for admission to zone.

Click (here) to listen to the 3rd conversation with Ms. Wang recorded on August 31, 2011 over the phone. Click (here) for the transcript.

## DEER's Disappearing $21 Million Land-Use Rights Rebate

According to the Anhui Province Land & Mining Market Portal (here) recent comparable land use rights sales show an average price paid of 244,208 RMB per Mu, compared to the 329,669 RMB per Mu price DEER reported it paid in its SEC filings, a difference of 35%. The average price paid for the two most directly comparable transactions involved similar sized land on the same street (开发区东区淮河路西侧) in the same month was only 226,442 RMB, a difference of 45.6%. A spreadsheet of the comparable land sales can be downloaded (here).

**More importantly, we discovered that, as is common practice in China, a large portion of the purchase price was rebated by WEDA as a subsidy so that the actual cost of land use rights was no more than 100,000 RMB per Mu. We proved this in a series of recorded telephone and email communications (outlined below) with multiple staff at the WEDA Investment Promotion Bureau. We conclude DEER overstated its land use purchase price by 3.3X, far more than the 45.6% indicated by the comparable sales.**

To determine the real cost of land use rights in WEDA, we approached the Bureau as a household appliance manufacturer interested in building a manufacturing plant similar to DEER. A Bureau director, Mr. Zhuang, explained that the listed price (from the MLR) for land in the new zone where DEER invested is 227,000 RMB per Mu, "but the real price your company pays normally shouldn't exceed 100,000 RMB per Mu." Mr. Zhuang affirmed, "Any typical company gets this 100,000 per Mu price. For certain exceptionally good companies, their prices are even lower than 100,000." In subsequent email communications, the Bureau again confirmed that the actual cost of the land use rights is 100,000 RMB per Mu. A transcript of our first recorded call on June 24th with the Mr. Zhuang can be found (here) and a recording of the call can be found (here). A translated email record can be found (here).

Mr. Zhuang went on to explain that 227,000 RMB per Mu is the minimum price set by the central government's MLR and must appear in the sales contract. If desired, the contracted price could be set higher with the help of WEDA during the land auction process. The land auction itself is influenced by WEDA so that the purchaser always wins the land at the agreed upon contract price. The price can be whatever amount the purchaser wants to show on its books, as long as the price is at least equal to or greater than the 227,000 RMB per Mu minimum price set by the national government. **We asked the Bureau point blank whether we could inflate the purchase price to boost our assets on our balance sheet. Mr. Zhuang chuckled and clearly responded, "That's fine. If you have the need, we can cooperate with each other."** A transcript of our second recorded call on June 27th with Mr. Zhuang can be found (here) and a recording can be found (here). Two more bureau staff, Mr. Li and Ms. Shi, also confirmed the actual price of 100k RMB per Mu (120k for more recent transactions) and rebate arrangement via recorded calls and emails. Transcripts of our recorded calls with Li are available (here and here) and Shi (here) with recordings with Li (here and here) and Shi (here). An email from Mr. Li can be found (here). An email from Ms. Shi can be found (here).

**Regardless of the contracted price, the Bureau repeatedly assured us that WEDA always signs a supplemental financial subsidy agreement with the purchaser rebating the excess paid so that the actual price paid works out to no more than 100,000 RMB per Mu. The full amount of the subsidy is normally rebated within 7 business days to any account specified in the supplemental contract. In DEER's case we calculate the rebate was 210,000 RMB per Mu multiplied by 660 Mu divided by 6.60 RMB/$ = $21 million. DEER has not disclosed the receipt of this large rebate nor booked any receivable. Where did this money go?**

DEER's only excuse to date is that the bid process resulted in an unusually high auction price for its land use rights. DEER convinced Global Hunter Securities analyst Joe Giamichael to explain in his research report dated April 14th (link here) that:

> …the company acquired the land use rights through a bid process in which there were multiple parties (which could not be disclosed) but can somewhat explain the premium paid on a per Mu basis relative to other publicly posted transactions.

DEER also accompanied Joe Giamichael to meet Wuhu officials who lied to Joe about the terms of the transaction. In contrast, in both our second and fourth calls with the Bureau, two different representatives explained that the "public" auction process is only procedural in nature. We were told that in reality, it is "impossible to have a second bidder" due to the WEDA's imposition of eligibility requirements that preclude other bidders. This is a common practice in China. Both Mr. Zhuang and Mr. Li from the Bureau assured us that a situation in which multiple bidders pushed up the auction price has never happened. A transcript of our first recorded call on July 6th with Mr. Li from can be found (here) with a recording (here).

One common misunderstanding by the US investment community about the industrial land sales in China and also a common fallacy used by a lot of companies to justify inflated land sales is the excuse of the sale being at "auction". However, as it is commonly understood in

China, the auctions of industrial land are merely "procedural" in nature and are operated with the help of local governments and development zones. To help the industrial buyer secure a particular piece of the land at the previously promised price, the local governments usually, through the local Land & Resources Bureaus, set in place a number of very restrictive eligibility requirements for participating in the auction, in order to ensure that only one bidder participates in the final auction. Not surprisingly, when asked about the possibility of other parties bidding on the same piece of land and pushing the auction price higher, the two WEDA officials responded as follows:

In our first recorded phone conversation on June 24, 2011 (here), Mr. Zhuang stated to us "Because we can play with ("操作") the land auction process and put in place some conditions/requirements, to make sure you're the only one bidding when the public auction takes place, so there's no other party bidding and pushing the listed price higher."

Last but not least, common sense says that if the prices of the industrial land were really determined by a true bid/auction process then why would development zone officials repeatedly quote us a fixed, all-inclusive price right away over the phone? There is simply no excuse for any company ever claiming it paid higher than the prices quoted by the development zone officials. The following conversation was recorded on the phone call with WEDA staff Mr. Li on July 6 2011 (link here):

Investigator: One problem I just realized is, now that the land sales have to go through a public auction process. So if our land is listed up there (for bid), is it possible some other party will see this and become very interested in this piece of land, so…at last it could affect my listed auction price?

Mr. Li: That is not going to happen. We have advantages in terms of restrictions, including what industry they (the bidders) are in…etc. This (auction process) is tailored to your specific situations and conditions. It's impossible to have others participating. Not possible.

Investigator: So in the words, you will set in some eligibility requirements and restrictions accordingly, so at last…

Mr. Li: Correct, it's entirely set based on your specific conditions so it's impossible to have a second bidder. We have so many companies here. The issue you raised has never happened to any one of them.

During this call Mr. Li also affirmed that the rebate on the land purchase would be paid out in a lump sum within 7 days to the account of the buyer's choice.

Investigator: One more issue to confirm with you. You just talked about the thing about land purchase cost payment. Because this is such a large amount of cash inflow, so you need to take it into account in my financial model. So the rebate funds you mentioned earlier, it will be returned within 7 days, correct?

Mr. Li: Yes. We will definitely lay it out (in the contract), the normal time it takes for the subsidy funds to be paid back is set up like this: once the land purchase price is fully paid, we will have the subsidy in place within 7 business days.

Investigator: So it's returned in a lump sum payment.

Mr. Li: Definitely.

Investigator: So it's going to be returned to the company that purchased the land?

Mr. Li: Hm Yes. You, you can do it in two ways. One way (it can be returned) is to the agreement signing company, or it can be the account of the subsidiary you set up in Wuhu.

Investigator: Okay. In other words, I set up a company in Wuhu to buy the land, so rebate funds will be paid to this Wuhu company's account?

Mr. Li: Yes. Anyway, this can be discussed. It can be paid to either your parent company's account or the account of your new subsidiary here (in Wuhu).

Investigator: Oh, paying to the parent company means, our parent in Guangdong?

Mr. Li: Yes. When you sign the agreement, you surely do it under the parent company's name. After signing the agreement, you set up the subsidiary here.

Investigator: Um, Yes.

Mr. Li: This can also be discussed. According to your situation, your company's specifics, this…should be no problem. This should be no different no matter if it was paid to whichever company's account.

Li thus confirmed that the rebate could be paid to any account of the buyer's choice. Since no auditor could ever discover the secret rebate paid out under a secret supplemental agreement to a secret account, DEER's independent directors need to act aggressively to demand WEDA disclose where the $21 million was sent. Who from DEER is responsible for the theft of this money?

## Why is there still no sign of any construction activity at DEER's 660 Mu project a year after the first parcel was purchased?

DEER bought the land use rights to the first 435 Mu parcel on July 2nd 2010. The Bureau staff was helpful to point out that the original investment agreement with DEER (never disclosed by DEER as far as we can tell) specified the first phase of the project (a 10 million unit production line) would be completed by July 2011 (government news report can be found here to support this). Nearly one year later, the Bureau director, Mr. Zhuang, angrily explained to us "Deer Electric has issues and hasn't even started the construction as of now!" Mr. Zhuang went on to state that if DEER "doesn't do anything soon, we will kick it out for sure." Later in the conversation, Mr. Zhuang elaborated:

> Deer Electric back then claimed they're some NASDAQ listed company. They invested using USD… Now it's been more than a year, there's not any sign of activity here. We, actually, have quite a problem with them. If they don't start soon, this land is surely going to be taken back. They've occupied quite a large piece of land. [A transcript of our third recorded call with Mr. Zhuang can be found (here) and a recording of the call can be found (here)]

As a follow up to our calls and emails, on Monday July 4th our investigator visited DEER's 660 Mu expansion project in WEDA. There was absolutely no sign of any construction activity or equipment on the site. There was no sign of anyone at the vacant prefab temporary worker housing and project oversight structures on the site. Did all the workers ride the construction equipment off the site celebrating Independence Day? All the land appeared undisturbed and covered in weeds. Bureau staff explained that for all projects WEDA pays for the leveling of the ground and the access road. Other than the rented temporary structures, DEER appears to have paid for nothing at all, despite showing a considerable amount of construction in progress on its balance sheet. The frustration expressed by the bureau staff is thus completely justified. A collection of photographs from our visit documenting the lack of construction activity can be found (here).

Finally, keep in mind that we have repeatedly questioned why DEER needed this expansion in the first place. Recall DEER has large excess production capacity at its existing plant. The whole project, like other unnecessary capacity expansion projects in other companies before it, seems deceptive and abusive of shareholders.

**We hope regulators will review all this evidence and force DEER to admit the true cost (after rebates of $21 million) of its $37 million land purchase. Why is there no meaningful construction progress in the last year? Where did the $21 million go?**

## Conclusion

The evidence we presented in this report is solid proof that both HRBN and DEER defrauded their investors of a combined $44 million via fraudulent land use rights purchases. As a result, both companies' historical financials as previously filed are false. The independent directors of both companies should immediately launch investigations into these transactions. HRBN's contentious management led buyout should be put on hold until its financials are restated. Swift action is paramount since management will be quick to try to cover up the truth while continuing to pump their stock. In fact we already have proof that DEER tried to cover up the findings of our previous report.

Following our March report on DEER (link here), in which we first exposed DEER's fraud, DEER falsely claimed in a lawsuit (link here) that Mr. Liu from WEDA did not exist and that therefore our allegations were false. DEER's preposterous claim that Liu does not exist was easily refuted when one of our investigators recorded a follow-up call on June 9th with Mr. Liu (link here for the recording of the call and here for a transcript). Our investigator then phoned the Investment Services Center on June 9th and spoke to an employee who acknowledged Mr. Liu worked there. Then the investigator spoke directly with Mr. Liu, who recalled speaking to the investigator in the past and confirmed he worked at the Center since 2005. DEER failed in its effort to conceal its fraud. We are certain DEER and HRBN will both quickly try to silence the government officials we interviewed in this report. DEER and HRBN will also surely try to convince the officials' bosses to contradict their stories. But considering the overwhelming evidence we shared in this report we are hopeful DEER and HRBN's land frauds can no longer be concealed. DEER and HRBN have finally been busted. Independent directors, auditors and regulators must act now.

**Disclosure:** Contributors to this report are short HRBN and DEER