

Dealmaker's Long Trip Through China RTO

Scott Eden

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Not only can water float a boat, it can sink it also. -- Chinese proverb

NEW YORK ([TheStreet](#)) -- Richard Heckmann still remembers the exhilarating wave of applause that rose and broke over him from the trading floor of the **New York Stock Exchange** when he rang the opening bell to celebrate a major acquisition in China.

It was May 2008, and he shared the stage with his new partner, a man he knew as Xu Hong Bin, founder of a company called **China Water & Drinks**. Three days earlier, Heckmann's company -- already listed on the NYSE -- had agreed to acquire China Water for more than a half billion dollars in cash and stock.

Less than a year later, Heckmann would tell the world he had been swindled, that China Water was mostly a fiction and that "Xu Hong Bin" was an alias used to conceal a criminal record. Xu has denied those charges. He is suing Heckmann in Delaware Chancery Court, claiming that Heckman owes him millions of shares of stock.

Heckmann has thus joined the growing number of investors who believe they've been cheated by a special class of Chinese company, one that gains access to U.S. capital markets via a reverse merger and then -- the victims say -- lies about business operations to jack up its stock price, frequently channeling fat profits to principals and early investors, while setting late-comers up for a nasty fall.

In recent months there have been so many allegations of fraud along these lines the **Securities and Exchange Commission** has gone on the offensive. Sources involved in the RTO business have told *TheStreet* that SEC attorneys are seeking information about the international network of highly skilled promoters, investment bankers, auditors, lawyers and early-stage investors who shape and energize the reverse-merger deal flow, launching one stock after another into the U.S. equities markets. The SEC has declined to comment.

A review by analysts at *TheStreet* showed that investors in the U.S. have suffered losses in excess of \$34 billion in RTO and similar China-based stocks. That total adds up all the market-cap losses for 150 stocks that appear to have been used to bring Chinese companies to U.S. exchanges. The list of 150 included stocks hurt by association with allegations of fraud as well as those directly implicated. Losses were measured from a stock's peak price at any time over the past five years to its present price.

Heckmann's story demonstrates that even experienced investment professionals have been flummoxed.

At 67, Heckmann is based in Palm Desert, California, in an office building on Frank Sinatra Drive. His specialty is the roll-up: the building of a big company through the feverish acquisition of smaller ones that share a focus. His pay day comes when the roll-up is sold to a major corporation for a heroic sum.



Richard Heckmann

Heckmann made his first millions while still in his 30s, with a roll-up in the field of medical devices. In 1990, he began consolidating hundreds of local water-purification plants into what would become **U.S. Filter**. Nine years later, he sold that company to **Vivendi** for \$8 billion. He then took control of **K2**, the ski-equipment company, and used it to Hoover up a slew of sporting-goods brands, until he had something he could sell to **Jarden(JAH)** for \$1.2 billion.

All of which is to say that Heckmann didn't fall off any truck. He stepped down from a Gulfstream.

"I can't believe they got me," he says.

By the time he formed his special purpose acquisition corporation, or SPAC, in 2007, Heckmann was enraptured with the investment idea that has captivated the rest of capitalism: the vast, rapidly growing markets of China. It doesn't take a Warren Buffett to understand the macroeconomic fact of China's 1.5 billion people and the double-digit GDP growth year after year. The lure is ancient. Ever since Marco Polo journeyed overland from Venice in the 13th century, Westerners have sought to crack open and exploit the vast commercial potential of the Middle Kingdom.

Even now, Heckmann rhapsodizes.

"It's *such* an electric place! There's *so* much growth. It is so obvious what's going to happen there."

Heckmann saw the potential of a nation with an average per capita income of \$4,300 -- "imagine what happens to that economy when they get a middle class!" He says his first visits floored him, the infrastructure in the big cities so spotless, efficient and high-tech it looked sci-fi. The frenetic pace, the go-get-em energy of the people, China as the most explosive wealth creator since the end of feudalism. Miss out and you lose.

The same pitch is heard from a lot of Chinese stock promoters, repeated in deal after deal.

"We believe China's economic growth is poised to outpace that of the rest of the world for the foreseeable future and believe U.S.-listed Chinese stocks present one of the most compelling ways to participate in this trend," said Mark Tobin, co-director of research at **Roth Capital**, in a press release regarding Roth's "Fifth Annual China Tour" last April.

It was Byron Roth, CEO of Roth Capital, who brought Heckmann and Xu Hong Bin together. Heckmann was ripe for the approach. He had used his new special purpose acquisition corporation, called **Heckmann Corp.(HEK)**, to raise some \$400 million on the American Stock Exchange, telling investors the money would be used for acquisitions. His enthusiasm had brought former U.S. Vice President Dan Quayle to the company's board, along with famed football coach Lou Holtz.

Byron Roth -- native Iowan, son of a Mennonite farmer -- is a key figure in the world of Chinese small caps. His firm has underwritten public stock offerings and arranged PIPE financings (private investment in public equity) for dozens of reverse merger companies, prospectuses and SEC records show. The firm has a solid reputation in the investment business but has caught plenty of criticism in connection with China stocks. If there were league tables for reverse merger deals, Roth Capital would be close to the top, along with **Rodman & Renshaw(RODM)**, **Brean Murray Carret**, **Global Hunter**, **Maxim Group** and **Piper Jaffray(PJC)**, a firm that occasionally handles the larger offerings.

According to Roth Capital's Web site, the firm has done \$2.9 billion in China-oriented deals since 2003. The firm's office in Shanghai actively prospects for companies with good growth stories. Back at headquarters in Newport Beach, Roth's bankers and brokers build financial backing packages with private placements of stock among trusted investors. Later, when the time is right, they underwrite new equity issues to the investing public. Often, some early holders have the chance to exit with big profits after the public enters, *TheStreet's* review of the sector showed.

Among the early investors in China Water, Roth had some powerful allies. The first was **Pinnacle Advisors** of Plano, Texas, founded by Barry Kitt. Pinnacle frequently operates in tandem with Roth on reverse merger deals. The two companies have close ties. Kitt has sent his son and daughter to work in Roth's office in Shanghai. Pinnacle too regularly prospects for promising companies in China. Among investment pros focused on China -- dozens of them spoke to *TheStreet* for this series -- Kitt is known as the grand master of the China-based reverse merger.

Kitt declined to comment about China Water when contacted by *TheStreet*.

Certainly Kitt has deep experience. He helped engineer one of the first China-based RTO deals in 2005. That company was called **China BAK Battery(CBAK)**. In that instance, Roth later helped arrange PIPE deals with Kitt and others, company filings with the SEC show. Like many other RTO companies, China Battery has failed to live up to advance billing. The stock peaked at about \$12.50 10 months after the reverse merger and now trades at around \$2.

The reverse merger for China Water was completed in May 2007. Several weeks later, Pinnacle took the lead in providing \$30 million in capital in return for 22.4 million shares. In January 2008, Roth arranged another round of funding -- this time \$50 million -- from a group led by **Goldman Sachs(GS)**. Both deals are described in SEC filings and a prospectus later issued by Heckmann Corp. Goldman declined to comment.

Heckmann says that Pinnacle, Roth and Goldman Sachs all did their own due diligence on China Water & Drinks. He absolves Roth Capital, Pinnacle, and Goldman Sachs. "If I thought for a second they knew anything, I'd be all over them. I'm not a guy who's gonna sue people I believe to be innocent," he says.

For his part, Byron Roth is philosophical about his friend's travails.

"It just got through us," Roth says of his own firm's due diligence efforts. "It appears that China Water was a very sophisticated fraud that passed not only our due diligence filters, but also those of the other qualified professionals involved."

Barely a month after the \$50 million round of financing with Goldman, Roth was introducing Richard Heckmann to Xu Hong Bin. Company filings with the SEC show that the introduction came in late February 2008, at Roth's annual "Orange County Conference," a lush affair at the Ritz-Carlton in Laguna Beach, featuring serious panels by day and serious parties by night. The rapper Snoop Dog performed at the conference in 2006, Ludacris the next year, Billy Idol in 2010. One Roth party in New York had the *New York Post* buzzing about scantily clad Asian models, each painted with the ticker symbol of a company whose shares Roth had underwritten.

By early May 2008, Heckmann and his staff were in Hong Kong, negotiating a deal with Xu.

Heckmann himself took pains to ensure the operations were legitimate. He says he deployed a team of **Credit Suisse(CS)** bankers in Hong Kong, where they spent five months -- up until the deal's closing in November 2008 -- investigating every aspect of China Water. The lead banker was a native Chinese, educated at the University of Chicago, Heckmann says. He says the team checked and double-checked receivables, hundreds of them, in person and by phone, exercising a degree of care beyond anything Heckmann had previously done.

Heckmann recalls how, together with investigators, he toured and retoured the company's eight bottling plants -- clean, state-of-the-art facilities with conveyer belts churning, and so many trucks in transit to and from the loading bays there was an air of a chaos, everything in motion 24-7. China Water's single biggest customer, **Coca-Cola(KO)**, confirmed its receivables to Heckmann himself. So did the second-biggest customer, the Taiwanese food conglomerate **Uni-President**.

"Even in hindsight," Heckmann says, "I don't know what else we could have done."

When an agreement was struck in May 2008, the investors who had joined Pinnacle in the China Water PIPE deals -- acquiring shares for \$1.34 -- had the opportunity to sell their shares for \$5 each, with the promise of another \$3.80 or so per share in cash and/or stock if the company hit certain performance targets, Heckmann's filings with the SEC show. Their return would have been 273% in a little more than a year. But all of those investors chose to take stock from Heckmann instead, multiple sources have said.

By the time Heckmann completed his assessment of China Water's operations in the fall of 2008, the global financial crisis was at a fever pitch and prices for commercial assets were plunging. Consequently, Heckmann was able to convince Xu to renegotiate. Heckmann says that, in the end, Xu cut the purchase price of China Water by \$120 million and agreed to take most of that in the form of stock, changes that proved critical to Heckmann later.

According to Heckmann, the first sign of trouble came a month after the closing. That's when Heckmann noticed a revenue slide. It seemed that China Water's customers were reluctant to pay their bills. But this could easily be explained. The world's economies had gone into recession. Even the People's Republic had found it necessary to launch an enormous stimulus plan. Plus, end-of-year delays in payments are common, throughout the business world. Come December, companies want to show cash on their balance sheets, so they hold back.

"It was troubling," Heckmann says of the slide, "but it didn't tell me anything."

The most disturbing signal came in early 2009. Heckmann had installed at China Water a new COO and new CFO. The new COO was bilingual, native Chinese, with experience as a Coca-Cola bottling executive in China. Heckmann had wanted him to act as Xu's lieutenant, providing critical support for Xu, as Xu didn't speak English, and had needed a translator to interact with his American backers. Heckmann says he was shocked when Xu shut the COO out of all operations meetings.

TheStreet contacted Xu's lawyer, Israel Dahan, who is with Cadwalader Wickersham & Taft, one of the oldest law firms on Wall Street -- and Dahan declined to make Xu available for comment.

When confronted, Xu was polite but inflexible, Heckmann says. Xu resigned on March 13, 2009, a Friday. Thirteen days later, Heckmann's nightmare began in earnest.

China Water & Drinks was itself a roll-up, still active in acquiring smaller companies, a strategy Heckmann had planned to continue. One deal was in process when Heckmann acquired the company. Heckmann believed that China Water had agreed to pay \$13.9 million for a bottled-water plant in Harbin, a city in northeast China. He recalls that, to his great surprise, he got a call in the middle of the night at his home in Palm Desert. He says the new CFO told him over the phone that the owner of the Harbin plant had agreed to sell for -- not \$13.9 million -- but \$2 million.

Heckmann got on a plane to Hong Kong.

When revenues continued to slide, Heckmann's team started calling customers, he says. He sent receivables to collection agencies. He says the agencies reported back that a lot of China Water's customers appeared to be fictions. Phone numbers had been disconnected. Offices appeared to be non-existent.

When his new company wrote those receivables off, its stock tanked, losing two-thirds of its value before bottoming at \$3.40. It now trades around \$4.80.

Heckmann says that the paper trail on the revenues led his team to an office within an office Xu had maintained in Shenzhen, a mainland city adjoining Hong Kong. He says that, using a staff of around 20 there, Xu had inflated revenue by "round-tripping" product shipments with cronies. Heckmann charges that China Water routinely sent products to warehouses maintained by Xu's business associates, agreeing to buy the products back eventually. In reality, the sales were phony, Heckmann says. Xu has denied this in papers filed with the Delaware Chancery Court.

Heckmann now relates all of that to comments he had heard earlier from accountants at **Ernst & Young**. The accountants had been hired to consult on tax issues related to the deal. He says they told him that the company's payments of value-added tax had been much less than expected -- the tax is 17% of the purchase price of products, to be collected and passed along to the state by the seller.

According to Heckmann, China Water's executives had explained the tax discrepancy with a line of reasoning heard from other Chinese executives under similar circumstances. Executives with China-based companies commonly explain that payment of the full value added tax, on time, is unrealistic. To pay on time would kill their profits. The implication is that, in China, dodging taxes is as acculturated as gambling. No one, whether business or individual, is fully on the up-and-up when it comes to taxes, the executives say. This explanation has been a factor in several stock blow-ups mentioned to *TheStreet* by investment professionals familiar with the RTO business.

Heckmann says that, "in an abundance of caution," he demanded that China Water set aside millions of dollars as a reserve, in case taxes were owed.

Only later, as the revenue story unraveled, did he realize he had reserved millions to pay taxes on revenues that didn't exist, Heckmann says.

Heckmann recalls that he spent most of 2009 and 2010 in a state of high anxiety, frantically working to salvage what he could.

"I had nights and nights and nights where I laid there staring at the ceiling saying: What could we have done differently? How could you be this stupid?" he says. "But it's not that I was stupid. When I look somebody in the eye, and he tells me something, and he's an executive, I tend to believe him -- or at least believe there's some great basis to what he says, not that he's just telling me what I want to hear."

Heckmann and Xu are now ensnarled in a complex legal battle in Delaware, with Xu claiming that Heckmann owes him millions in locked-up stock and Heckmann claiming that Xu defrauded him. Xu's lawyers at Cadwalader Wickersham & Taft claim that, even if the charges of fraud were true -- Xu denies them -- Xu would be entitled to the stock, under the terms of a severance contract signed by Heckmann.

Heckmann's side has said that, if they win, the shares in dispute -- now counted as outstanding shares -- will be canceled. Heckmann has claimed in court papers that Xu Hong Bin is a phony name for a man with a criminal record in China. Court filings lack detail on that claim.

Meantime, Heckmann says his new company is growing. There were some real customers, including Coca-Cola, and those accounts are going well, Heckmann says. The company has been buoyed by the continuing boom in China, and Heckmann believes the investors who trusted his instincts will do well, in the end.

But he now takes a dim view of reverse mergers -- "I wouldn't trust one of them," he says -- and advises caution on Chinese companies generally.

"If someone lies to you in the U.S., you can get him. If someone lies to you in China, you can't," he says. "I've lost my confidence that I can figure it out."

-- Reported by Scott Eden in New York