Previous Page

# One Heckuva Cheap Stock

http://www.fool.com/investing/international/2009/03/18/one-heckuva-cheap-stock.aspx

Tim Hanson
March 18, 2009

Would you pay nine times earnings to buy shares of a company growing 48% annually? What about six times earnings for a company growing by 55%? How about four times for a company growing at *nearly 80% per year*?

*Are* there any companies out there that actually look this cheap?

Yes, but I'd guess that you have no interest in owning them.

**Of course, you claim you like cheap stocks**
The problem? These three companies are Chinese, and each has given American investors pretty good reasons to be skeptical. The first is **China Fire & Security**, which has been announcing new contracts left and right to install fire safety systems in power and industrial plants in China. However, it also came public via a questionable reverse merger, and its management team was featured in an unflattering light on Sharesleuth.com. The company's recent 10-K also revealed two material accounting process weaknesses that need to be corrected.

The second is **American Oriental Bioengineering**, which has been growing like gangbusters by using Western capital to consolidate the traditional-medicines business in China. Yet many Americans are skeptical that these herbal remedies work. And despite AOB's impressive track record, they're also skeptical of the company's serial acquisitions, since it, too, came public via a reverse merger and once paid a stock promoter to hype its stock. In fact, when an 8-K released last month revealed that the company spent $70 million to purchase a building in Beijing, the stock dropped more than 20%.

The third company referenced above is **China Security & Surveillance Technology**, another serial acquirer in China that suffers from a name and business line (supplying cameras for China's Safe City Initiative) that has American investors thinking the firm helps perpetuate oppressive totalitarianism.

**All is not cut and dried**
While each of these companies offers a compelling price and an enormous growth opportunity, on the heels of the **Satyam** accounting scandal, it's difficult for American investors to be comfortable with foreign companies that may not offer the same level of transparency as their U.S. counterparts. That explains why U.S. companies that grew more than 30% last year are trading at substantial premiums:

| Company | TTM Revenue Growth | P/E |
|---|---|---|
| **Intuitive Surgical** (Nasdaq: ISRG) | 46% | 20 |
| **Blue Coat Systems** (Nasdaq: BCSI) | 54% | 56 |
| **Bankrate** (Nasdaq: RATE) | 75% | 20 |
| **Mobile Mini** (Nasdaq: MINI) | 31% | 14 |
| **DG FastChannel** (Nasdaq: DGIT) | 61% | 20 |

| | | |
|---|---|---|
| **comScore** (Nasdaq: SCOR) | 35% | 11 |
| **Ebix** (Nasdaq: EBIX) | 75% | 11 |

Data from Capital IQ, a division of Standard & Poor's.

The fact is, many American investors feel uncomfortable with the prospect of investing in a company that they can't visit, that makes products they can't check out for themselves, and which is run by a management team that may not speak our language.

If that's you, you're missing out on some fantastic opportunities and some extraordinarily cheap valuations. But before we get to that, let's revisit the AOB 8-K that spurred a 20% sell-off from which the stock still hasn't recovered.

**Here's how it went down**
At 5 p.m. ET on Jan. 9, AOB filed an 8-K announcing that it had completed a $70 million acquisition of "buildings occupying 14,615 square meters of office space on 22,008 square meters of land ... in the New Economic & Technology Development Zone in Beijing." The company further noted in the filing that it "intends to use the properties as a Convention and Training Center."

Soon thereafter, **Piper Jaffray** downgraded the stock, saying, "We feel the investment is a significant deviation from the intended use of capitals, which is to acquire pharmaceutical companies in China. ... As such, we see the management's decision as disappointing," and investors started selling.

**But was it warranted?**
Now, there are certainly some negative aspects to AOB's announcement.

First, it made a major acquisition, investing more than 40% of its balance sheet, without issuing a press release to investors. Second, buying a convention center doesn't seem to fit with AOB's goal of becoming a top-five pharmaceutical company in China. Third, paying $445 per square foot of office space in a real estate downturn is expensive.

Since the market was already on edge about Satyam's attempt to mask a $1 billion cash shortfall on its balance sheet with an acquisition, AOB was not given the benefit of the doubt here.

**AOB got that message**
Fast-forward to the following Friday, when the company issued a press release explaining that the building "is a long-term investment in AOBO which builds out our multi-functional headquarters and centralizes our management in Beijing, while deepening our presence in a very important development region focused on attracting leading pharmaceutical companies."

The company further noted, "While we have not always elaborated on our motivations at the time, due to economic, competitive and other reasons, we consistently and effectively have navigated China's complex economic and competitive landscape, and have created significant shareholder value in the process. We believe this property purchase is no departure from AOBO's proven past."

This "trust us" argument may not hold water with American investors, given that many of us are predisposed -- for good reason, in many cases -- to be skeptical of all things Chinese. But AOB does have a solid operating track record, and it has consistently reaped shareholder value from its acquisitions.

**What could be the benefits here?**
Moreover, the company could garner some benefits from this move. For example, a permanent office building in Beijing helps the company prove to the government of China that it is, in fact, a domestic

Chinese company.

That may sound silly. But until now, in the eyes of the PRC government, AOB has been nothing more than a foreign capital corporation that leased some space in Shenzhen and was buying Chinese assets. While this was fine when the Chinese economy was humming along, the country's current slowdown has prompted its government to focus on supporting domestic consumption and domestic job creators.

In order to continue to benefit from reduced tax rates and be given the opportunity to acquire Chinese state-owned enterprises (SOEs), access capital from state-run Chinese banks, and benefit from the country's domestic stimulus plan, AOB likely needed to show that it was a major *Chinese* pharmaceutical maker. Buying top office space in Beijing does that.

**Summing up**
This is not to say that the AOB acquisition is cut and dried. The property acquisition price still looks expensive, and if we believe that AOB will get benefits from having a permanent Beijing office, we need to keep checking up on the company to make sure those benefits are realized.

Not coincidentally, however, the company announced a few million dollars' worth of savings the next Tuesday, when it revealed that all of its subsidiaries would now benefit from China's reduced 15% high-technology tax rate. (The company had previously paid a blended rate closer to 20%.) While there's no clear cause-and-effect relationship here, it never hurts to have a good relationship with the government.

When it comes to investing in China, there will be communication problems, there may be transparency issues, and there are business norms that may make Western investors initially uncomfortable. But remember, these companies are trading at absurdly cheap levels relative to their growth prospects. The opportunities in China are so tantalizing that it's worth the effort to learn more about them, and to invest in a diversified basket of carefully chosen opportunities.

**Find those opportunities**
At *Motley Fool Global Gains*, we travel regularly to China to meet with management teams and investors in the country to closely vet all of our potential ideas. After all, the reason that the market will sell you a 55% grower for six times earnings is because it's uncomfortable. If you can get comfortable with owning that stock, you stand to make a lot of money.



*This article was first published on Jan. 15, 2009. It has been updated.*

*Tim Hanson is co-advisor of* Motley Fool Global Gains*. He owns shares of AOB and China Fire. AOB and China Fire are* Global Gains *picks. AOB is also a* Motley Fool Hidden Gems *recommendation. Intuitive Surgical, Bankrate, and Ebix are* Rule Breakers *selections. Mobile Mini is a* Stock Advisor *pick. The Motley Fool owns shares of AOB. The Fool's disclosure policy is written in plain English.*