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# **China Integrated Energy's Biodiesel Business: Cause for Concern**

December 2010

## **Introduction**

All around the world, biodiesel is a challenging business with high capital costs, cyclical gross margins and returns on capital. There are limited barriers to entry as production processes to make biodiesel are well understood and can be accomplished by specialty chemical plants of all sizes.

Feedstocks - which can either be food crops, oils from non-edible crops, vegetable oil waste or even used cooking oil - are subject to cost inflation and potential uses in alternative specialty chemical production. For all these reasons, to the best of our knowledge, there are essentially no successful publicly traded biodiesel producers capable of growing sustained equity value.

However, there appears to be a magical place called Shaanxi Province in China where the economics of the biodiesel business are different from everywhere else in the world. In Shaanxi, one biodiesel producer has reportedly been able to produce biodiesel at ever-increasing volumes with eerily consistent 30% gross margins irrespective of market-driven diesel and feedstock prices. This can apparently also be accomplished at extremely low levels of capital investment.

Or so the story goes with China Integrated Energy (Nasdaq: CBEH), a U.S.-traded Chinese company that came public through a reverse merger in 2007. CBEH was featured in a recent Barron's article about the questionable nature of many Chinese reverse mergers. In our opinion, a close examination of CBEH's business claims and both SEC and China's State Administration for Industry and Commerce (SAIC) financial statements leads to significant doubts about whether the company is being accurately represented to U.S. investors. CBEH claims to be a wholesale fuel distributor and gasoline retailer that started an extremely lucrative biodiesel business.

However, CBEH's purported biodiesel gross margin and capital expenditure efficiency is so vastly superior to any other reported biodiesel provider we've analyzed, including those in China, as to merit closer examination. CBEH's financial statements are also audited by a Company based over 8,000 miles away in Boca Raton, FL and cause us to have further concerns about the reliability of their financial reporting.

## **Why are CBEH's Biodiesel Gross Margins Stable In a Cyclical Industry?**

Biodiesel gross margins are largely the function of two variables: biodiesel prices (output price, tied closely to diesel prices) and feedstock costs (input costs). While there is always some plant overhead in fully loaded biodiesel cost of goods sold (COGS), feedstock costs typically account for around 90% of biodiesel COGS.

Thus, when biodiesel prices are high and feedstock prices are low, an acceptable margin can be earned. However, since the production processes for biodiesel are well known and there are alternative uses for biodiesel feedstocks, competition has generally kept biodiesel margins at single digits everywhere in the world, whether the feedstock is pure vegetable oil or the cooking oil thrown out by local fast food restaurants. In the United States, the biodiesel producers that have avoided bankruptcy are marginally

profitable and dependent on government tax subsidies and mandated usage levels, no matter which feedstock they use.

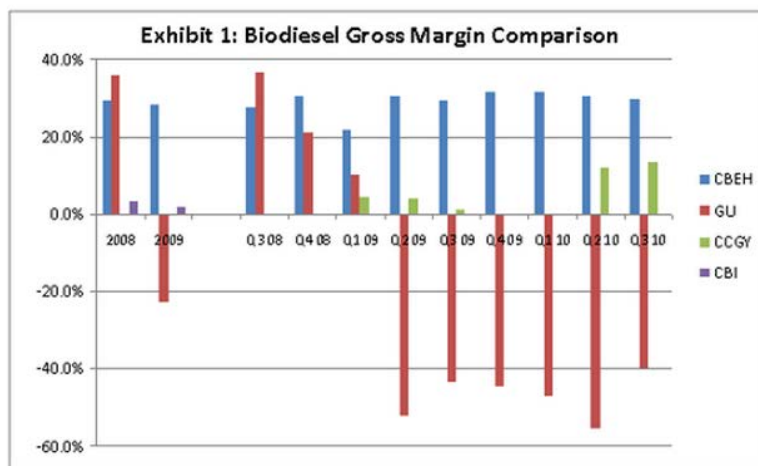
Examining the three other publicly traded Chinese biodiesel producers indicates that the biodiesel business isn't much different in China. Gushan Environmental Energy (NYSE: GU) is listed on the NYSE and claims to be China's largest biodiesel producer, operating biodiesel plants in several provinces. In the first half of 2008 when oil prices were significantly higher, GU was able to earn gross margins in excess of 40%.

However, these gross margins began to rapidly decline as biodiesel prices dropped during the financial crisis, reaching 10% in the first quarter of 2009 and remaining deeply negative since then. The recent negative gross margins are largely the result of unutilized plants shut down due to a tax dispute, but overall cost inflation in China has also pushed up biodiesel feedstock costs. In its SEC filings, GU discloses its selling price per ton of biodiesel and its cost per ton for feedstock.

Even with fully loaded capacity during the quarter ended 6/30/2010, GU's gross margin would be no greater than 10%. The experience of other Chinese biodiesel producers is similar: China Clean Energy (OTC: CCGY) reported 12% biodiesel gross margins for Q2 2010, as compared to 4% for Q2 of 2009. China Biodiesel International (CBI), which was traded on London's AIM until it was bought out for a pittance this year, reported 3% gross margins in 2008 and 2% gross margins in 2009 before accounting for government subsidies. All of this is easily verifiable in GU, CCGY and CBI's financial statements. GU's most recent [6-K](#) quarterly report is particularly enlightening on the subject of feedstock cost inflation.

In contrast, CBEH's gross margins are both unusually high and amazingly consistent, no matter where biodiesel prices are or how far Chinese inflation has pushed up feedstock prices. CBEH consistently reports quarterly biodiesel gross margins within two percentage points of 30%, with the exception of the first quarter of 2009 when the company reported gross margins of a mere 21.6%. This includes the last three quarters of 2009, when competitors GU, CCGY and CBI were reporting single digit gross margins at best. Exhibit 1 shows the remarkable level and consistency of CBEH's gross margins as compared to its peers.

We believe this vividly demonstrates the difference between legitimate commodity-producing companies subject to market forces and one of questionable quality such as CBEH.



Source: SEC and AIM filings.

CBEH claims its large gross margins are the product of two things: its status as a licensed fuel distributor that does not need to use middlemen to distribute its biodiesel and its proprietary processes including usage of the non-edible Chinese prickly ash plant seeds as a feedstock. However, neither of these claims stand up to basic scrutiny or common sense. According to CBEH, very little of its biodiesel is blended into petro diesel and sold at retail; rather, the company primarily sells its biodiesel directly to industrial users. In this link, we can see that CBEH reports that “Eighty percent of the biodiesel we produced was sold to the Tongchuan Huaneng Power Plant and Weihe Power Plant.”

Yet, our research shows that neither plant uses biodiesel as a power source, but instead still depends on traditional coal sources (see [here](#)). The financial filings of GU and CCGY indicate that they also sell their biodiesel directly to industrial users, and are not forced to sacrifice their gross margin by selling to a distributor.

CBEH reports no spending on research and development so it is difficult to believe that it has invented any advantage in a production process as well understood and widely researched as biodiesel. CBEH touts its abundant and adequate supply of Chinese prickly ash, yet we would simply observe that no other biodiesel producer in the world seems to be utilizing the advantages of this free and apparently abundant feedstock. In fact, prickly ash appears to be available here in North America, yet we find no evidence that U.S. biodiesel producers are making use of this supposedly superior feedstock over traditional sources such as corn (see [here](#)).

Seed oils such as rapeseed (canola) are also cultivated for biodiesel, but due to the cost of cultivation, harvesting and extraction, the margins from rapeseed biodiesel are no better and often worse than using used cooking oil or vegetable oil residue. Besides, the company’s most recent presentation indicates that non-edible seed oil only accounted for a minority of its biodiesel production feedstocks. CBEH primarily relies on waste cooking oil and vegetable oil residue, once again just like GU and CCGY.

In fact, in the first two quarters of 2010, CBEH’s gross margin advantage appears to be primarily the result of higher claimed prices per ton of commodity biodiesel sold, \$822 per ton in the most recent quarter vs. \$655 for GU and \$675 for CCGY.

Given the foregoing discussion, what could possibly explain CBEH’s remarkably consistent reported gross margins? One scenario would be that both biodiesel prices and feedstock prices are positively correlated, such that when prices of biodiesel moved in one direction, feedstock costs moved in the same direction and by the same magnitude; this would result in a largely unchanged margin. Another scenario could be CBEH’s ability to hedge its risk to movements in either biodiesel or feedstock costs with a financial derivative or other tactic. Let’s examine these scenarios in greater detail.

There’s every indication that prices of biodiesel in China are subject to market forces linked to the price of oil and diesel in the global economy. By CBEH’s own admission,

*“Our results of operations and financial condition are affected by the selling prices of petroleum and biodiesel fuel products. Prices are subject to and determined by market forces and actions by the PRC government over which we have no control.”*

In China, the prices for petroleum products are primarily influenced by the guidance prices set by the National Development and Reform Commission, or the NDRC. In recent years due to the volatility of world oil prices, the NDRC has acted more regularly to adjust prices. To illustrate, from 2006 to 2008, there were only two oil price adjustments in each year. However, there were eight oil price adjustments in 2009, and two adjustments so far in 2010 (see here).

We think this clearly illustrates that biodiesel prices should have been more variable in recent years, rather than stable and predictable as CBEH's results would lead one to believe. On the other hand, feedstock prices are also subject to market forces outside of CBEH's control, including the general inflation level in China.

In fact, in just one sentence buried on page 23 of CBEH's 10-K, they plainly say that, "The spread between biodiesel prices and feedstock prices has narrowed significantly since September 2008." They go on to say that,

*"Prices for vegetable oil residue, waste cooking oil and non-edible oil seeds, which have historically been our principal feedstocks and comprised approximately 88.3% of total cost of goods sold of our production and sale of biodiesel segment during the year ended December 31, 2009, do not necessarily have a direct price relationship to the price of biodiesel in a particular period."*

If all of these points are true, then how is their biodiesel margin reported for the full year in 2008 nearly identical to the margin reported in the last quarter ended 9/29/10?

The only other explanation would be that CBEH uses financial derivatives to mitigate its market risk or has fixed-price, off-market contracts for both biodiesel output prices and feedstock price of long-term duration. However, we have reviewed all of CBEH's financial filings, and can find no mention of any active hedging program by the company, nor do they report having fixed-price, long-term contracts with either customers or suppliers. Taken as a whole, these findings support our conclusion that CBEH's biodiesel margins could be overstated.

Another more subtle indication that CBEH's biodiesel operations are not exactly what the company claims is the lack of any disclosure regarding the sale of biodiesel by-products. By-products are a natural result of the biodiesel refining process using any feedstock, and a biodiesel refiner is typically left with a substantial amount of residual material after production. For example, Gushan separately discloses its biodiesel by-product sales volume and pricing; the volume ranges from approximately 12-15% of any quarter's volume of biodiesel production and the pricing is considerably lower per ton of output.

Similarly, in CCGY's disclosures, the company describes how it uses its biodiesel "co-products" as feedstocks for other specialty chemical production. In CBEH's filings, unlike Gushan or CCGY, no mention is made of the customers, sales volume or prices for biodiesel by-products. Companies engaged in the messy business of actually producing biodiesel have to deal with fluctuating margins and the disposal of the less attractive remnants of the biodiesel production process. These issues apparently don't affect CBEH in the slightest.

### **Why are CBEH's Plant Capital Expenditures Unusually Low?**

Gross margin is not the only area where CBEH's claimed results are questionable. Let's start by looking at CBEH's original 100,000 tons per year capacity biodiesel plant. According to CBEH's 2009 and 2010 segment

reporting section of their annual report (Exhibit 2), the company only spent \$7.7M in capital expenditures relating to their biodiesel processing segment. CBEH also reports not spending even one single dollar on capital expenditures in 2009. It would be highly unusual for a biodiesel facility to operate for a full year without a single dollar spent on maintenance capital expenditures. Also noteworthy, is the unusual decline in segment assets from \$29m in 2008 to \$16m in 2009.

#### Exhibit 2: Biodiesel Segment Reporting

\$ in millions

	2009	2008	2007
Net Sales	\$55.79	\$50.05	\$4.20
Cost of Goods Sold	\$39.96	--	--
Gross Profit	\$15.83	--	--
Depreciation	--	\$0.88	\$0.08
Interest Expense	--	\$0.02	--
Net income	--	\$14.12	\$0.95
Segment Assets	\$16.40	\$29.08	\$8.89
Capital Expenditure	\$0.00	\$1.10	\$6.66

Source: Company Annual Reports, segment reporting section

At a conversion factor of 307 gallons of biodiesel per ton, CBEH's original 100,000 ton plant equates to \$0.25 in capital costs per yearly gallon of capacity. Much like CBEH's gross margin, this is remarkably better than anyone else we have been able to find in the biodiesel industry. In a survey of other global biodiesel projects, capital costs per gallon of capacity ranged from \$0.65 per gallon on the low end (for a proposed plant in Argentina never actually built) to over \$2.00 per gallon for GU's original biodiesel plants in China. Exhibit 3 details the reported capital costs of CBEH's original plant against its Chinese competitors:

Exhibit 3: Chinese Biodiesel Plant Capital Costs					
Company	Plant	Cost	Tons/Yr	Gallons/Yr	Capital Costs/Gal
China Integrated Energy	Original, Shaanxi	\$7,760,000	100,000	30,700,000	\$0.25
China Integrated Energy	Expansion, Shaanxi	\$15,000,000	50,000	15,350,000	\$0.98
China Clean Energy	Fuqing City, Fujian	\$22,000,000	100,000	30,700,000	\$0.72
Gushan Environmental	Various, 12/31/2009	\$240,000,000	450,000	138,150,000	\$1.74
Gushan Environmental	New Sichuan plant	\$33,300,000	50,000	15,350,000	\$2.17
China Biodiesel Int'l	Original	\$26,327,902	40,000	12,280,000	\$2.14

Source: SEC and AIM filings.

To keep this in perspective, CBEH claimed to earn around \$15M in biodiesel gross profits in both 2008 and 2009 from an investment that supposedly cost less than \$8M. The purported IRR on this project is astronomical, while for every other biodiesel industry participant in the world the payback period for a biodiesel plant is measured in years, not months.

Moreover, CBEH is reporting that their existing plant is located at "Space within the Northwest Fire-resistant Materials Factory" in Exhibit 4. We can't help but wonder how a 100,000 ton /yr biodiesel operation is housed within another factory and what the relationship between biodiesel production and

fire-resistant materials is? This raises substantial doubt in our minds about the form of its actual existence. We will revisit this question shortly.

#### Exhibit 4: Description of Property

Business Segment	Use of Property	Address	Lease Term
Production and Sale of Biodiesel	Biodiesel production facility	Space within the Northwest Fire-resistant Materials Factory, Tongchuan City, Shaanxi Province, China	2006 - 2016

Source: CBEH's Annual Report, page 37

Interestingly enough, the cost of the supposed 50,000 ton capacity expansion that CBEH is working on is actually in line with the capital costs of other biodiesel projects. The company has never explained why it is spending almost twice as much for half the additional capacity.

In October 2010, CBEH [announced](#) they would also acquire a 50,000 ton biodiesel production facility in Chongqing City from Chongqing Tianrun Energy Development Co. for \$16.5M.

Furthermore CBEH states that the Chongqing plant's gross margins of 30% are in-line with its own gross margins, and that the asset would produce \$32M/yr in revenue and \$8m/yr in pre-tax income. This purchase price seems unusually low by our judgment. This asset alone would generate \$16M in just two years on a standalone basis, so why would their owners sell to CBEH at such a low multiple of 2x pre-tax income? Unfortunately, CBEH's press release lacks adequate disclosure to understand fully the exact business rationale for this transaction.

There is no discussion in the press release about any transaction synergies, or commentary from the sellers as to why they executed this transaction with CBEH. By doing our own investigative work, we find a possible explanation. As it turns out, CBEH's competitor Gushan also has a biodiesel plant in the Chongqing region, but shuttered production in April 2009 due to a consumption tax issue with local authorities, and to date has still not resumed the project because it is uneconomic to do so.

Yet, CBEH claims to be able to immediately ramp up production and achieve superior financial goals where others have been unsuccessful. Given these two contradictory facts, we are left to assume that CBEH has not accurately portrayed this plant acquisition to investors.

Gushan Chongqing Plant Discussion is [here](#).

#### Why is CBEH's Auditing Firm in Florida?

CBEH is audited by Sherb & Co. of Boca Raton, Florida. Sherb & Co. seems to specialize in auditing penny stocks and Chinese reverse mergers similar to CBEH. Of 58 current and former Sherb clients we examined in a recent screen, 49 were OTC stocks and only 5 had market capitalizations over \$100M. Median market capitalization was a mere \$10M. CBEH was the largest Sherb client in terms of market capitalization, and indeed almost all of Sherb's clients traded on major exchanges were Chinese reverse merger stocks.

While Sherb lists an office in Beijing, all seven of the partners listed on its website reside in Florida or New York. All of CBEH's audit letters contained in their annual reported have been signed from Boca Raton. It is no wonder that the Public Company Accounting Oversight Board recently [issued](#) a cautionary practice alert regarding the lax standards that many small accounting firms employ when auditing Chinese reverse merger stocks.

It's also noteworthy that Sherb & Co. is the same auditor of China Education Alliance Inc. (NYSE: CEU), yet another Chinese company allegedly misrepresenting its business operations and financials to investors (see [here](#)).

### Why Do SAIC Financials Differ From SEC Financials?

The SEC financial statements of CBEH do not come close to matching the SAIC of its local Chinese operating subsidiary, Xi'an Baorun Industrial Group. For background on SAIC filings, see [this article](#). [Here](#) is a link to the original Chinese financial statements and [here](#) is an English translation. I show a comparison of the most relevant income statement and balance sheet items in Exhibit 5.

Exhibit 5

\$ in millions ✕

	Exhibit 5: SEC vs. SAIC Financials					
	CBEH - SEC		CBEH - SAIC		Over(under)statement	
	2007	2008	2007	2008	2007	2008
Sales	\$87.1	\$216.5	\$58.8	\$148.7	\$28.3	\$67.8
Cost of Sales	77.0	185.9	56.6	146.0	20.4	39.9
Gross Profit	\$10.1	\$30.6	\$2.2	\$2.8	\$7.9	\$27.9
Admin Expenses	\$1.7	\$2.0	\$2.0	\$2.9	(\$0.3)	(\$0.9)
Operating Profit	\$8.3	\$28.5	\$0.0	(\$0.3)	\$8.2	\$28.8
Current Assets	\$35.5	\$78.3	\$13.0	\$24.8	\$22.5	\$53.5
Gross PP&E	\$8.7	\$11.6	\$1.2	\$1.3	\$7.5	\$10.3
Total Fixed Assets	\$8.2	\$16.4	\$2.2	\$2.3	\$6.0	\$14.1

Source: SEC filings, Inter-Credit International. 2007 and 2008 figures converted at 7.60 and 6.95 RMB/USD, respectively

Notice that the overstatement in 2008 revenue is \$68M, roughly consistent with the supposed \$50M in 2008 biodiesel revenue. Notice also that the company only lists \$1.3M in original value of fixed assets before construction in progress vs. \$10.3M in the SEC financial statements- where is the cost of the biodiesel plant PP&E that was supposedly fully operational in 2008? When combined with CBEH's biodiesel segment results, this raises the question of whether much or even any biodiesel is being produced at all.



Biodiesel aside, the gross profits are nowhere near as large as they should be from fuel distribution and retail alone: Baorun disclosed \$1.1M in 2008 gross profits in their SAIC filings while CBEH claimed \$16.1M in gross profit from distribution and retail combined. In 2008 about \$53M of current assets are unaccounted for as well- recall that the large buildup in current assets is where most of the supposed profits went. Putting it together, we believe CBEH has a fuel distribution and retail business that is nowhere near as profitable as they claim, and a much smaller or possibly non-existent biodiesel business.

### **Association with Stock Promoters and Common Director with Orient Paper Inc. (ONP)**

Like many other Chinese reverse mergers, CBEH has been associated with questionable stock promoters. As documented in the previously posted Barron's article, CBEH was taken public with the help of one Meiyi Mary Xia, who started Asia Pacific Securities with convicted Chinese stock fraudster Du Qingsong. After the Barron's article appeared, CBEH released a [press release](#) to distance itself from certain individuals, but admitted they had been instrumental in bringing the company through its reverse merger.

CBEH also shares a director with one of the most notorious alleged Chinese reverse merger frauds, (AMEX: ONP) (see [here](#)). While it has been expunged from CBEH's most recent investor presentation (pdf), Wenbing Christopher Wang has been an ONP director since October 2009. We do not gain further confidence in CBEH given this fact pattern.

### **Conclusion**

We believe that CBEH has much in common with two other alleged Chinese reverse merger frauds, Universal Travel Group (NYSE: UTA) (see [here](#)) and China-Biotics Inc. (Nasdaq: CHBT) (see [here](#)). Like UTA, CBEH has taken an existing business and bolted on an exciting venture that is supposedly generating enormous growth and profits. UTA really does run Chinese package tours, but the online travel booking service driving their stock valuation and supposed profitability appears to be fictitious. From what we can tell CBEH really does distribute fuel and run retail gas stations, albeit not nearly as profitably as they report, but the biodiesel business either does not exist or is materially smaller than they represent.

Similar to CHBT, we believe that CBEH may have misrepresented its existing business in order to raise the money to actually enter the biodiesel business on a grander scale. CHBT took a portion of the money it raised on false pretenses and built a real probiotics plant, which it can now show investors to demonstrate its legitimacy. This month, CBEH hosted investors at its new biodiesel plant expansion. Since unlike its original plant the claimed expenditures on the plant expansion appear reasonable, CBEH will likely be able to show investors a real biodiesel plant.

However, having a real plant doesn't guarantee that CBEH will be able to start earning the kinds of biodiesel profits it claims. The examples of Gushan, China Clean Energy and China Biodiesel International all illustrate the challenges CBEH will face. For all these reasons, we remain cautious on CBEH's business prospects and will continue to closely scrutinize the company's future developments.

Perhaps, our final thoughts are best summarized by the company itself in their own risk disclosure statement to investors:

*“Our limited operating history as a producer and distributor of biodiesel makes it difficult for prospective investors to evaluate our business. Therefore, our operations are subject to all of the risks, challenges, complications and delays frequently encountered in connection with the operation of any new business, as well as those risks that are specific to the biodiesel industry. Investors should evaluate us in light of the problems and uncertainties frequently encountered by companies attempting to develop markets for new products, services, and technologies. Despite best efforts, we may never overcome these obstacles to financial success.”*