What went wrong at watch shop Peace Mark (0304), former associate of Egana (0048)? Webb-site.com shows you the warning signals which analysts missed.

Peace Mark's warning signals

16 September 2008

Soon after *Webb-site.com* put the spotlight on EganaGoldpfeil (Holdings) Ltd (**Egana** 00048) last year, a number of readers wrote to us alleging similar problems at watch shop Peace Mark (Holdings) Limited (**PM**, 00304), which was once an associate of Egana. The e-mails were all anonymous, some allegations were quite specific, but none of them could provide us with hard evidence. So we did not write about it, because we did not have sufficient evidence, and in 10 years, *Webb-site.com* has never been sued, because we go by the facts. Even today, we will not publish many of the allegations. Instead, we passed these concerns on to the regulators on 12-Sep-07. They have investigative powers which we don't. They also have statutory secrecy obligations, so we don't know whether they have investigated.

So unfortunately, we had to stand back and watch as the company imploded, with the stock down 88% from $12.56 at the end of 2007 to $1.50 on 15-Aug-08, and now in provisional liquidation. If it ever resumes trading, you can wave goodbye to most of the other 12%. The company's market value at the end of 2007 was HK$13.09bn (US$1.68bn). The firm also sucked in another HK$1.26bn in a placing at $7.90 organised on 5-Jun-08 by ABN-AMRO and BNP Paribas, two of the three banks which arranged a bridge loan on 1-Feb-08 for the acquisition of Sincere Watch Ltd and for the repayment of other debts.

The results for the year to 31-Mar-08 were announced on 22-Jul-08, showing net profit up 52.3% and fully-diluted EPS up 42.2%. However, if you look more closely at the annual report filed on 30-Jul-08, as well as the history of PM since its 1993 listing, then you will see enough warning signals to have avoided the stock.

Loans to "business associates"

Of the $599.5m of net tangible assets at 31-Mar-08, note 23(a) records "Long term deposits" of **HK$327.8m**. The note says that $136.9m of this "deposit" was made in the year to 31-Mar-07:

> "long term deposits to business associates for joint business development purpose. The business development of this project is under progress and the Directors expected that this amount will be injected into a new joint venture next year."

and then in the year to 31-Mar-08, there were further "deposits" of $191.9m:

> "placed with business associates for the development of a retail chain network in Asia...the Directors expected that the deposits will not be realized within 24 months from the balance sheet date."

None of this was mentioned in the narrative section of the annual report - so we have no idea who the "business associates" are, or what the "business project" in 2007 was, or where the "retail chain network" is or was going to be. Don't be fooled by use of the word "deposit" - these are of course just unsecured loans. They accrue interest at annual prime rate plus 1%, although whether that was actually paid or just accrued is another question. Without adequate explanation in the report, we can only speculate on why these loans were necessary - where did the money go? "Business associates" is also a suspiciously vague term with no legal meaning. What kind of "business associates" were these - customers? joint venture partners? brokers?

Investment in unlisted funds

Then, note 23(c) shows a **HK$40m** investment in an unlisted *"open-ended investment fund managed by professional investment managers"* - but they don't say who. The fund contained mainly *"listed and unlisted equity securities in Greater China market."* It's just the sort of thing that Egana did when it invested in funds managed by the controlling shareholder of Upbest. This investment is in direct contradiction to the statement on page 36 that:

> "Our policy is to deposit surplus cash with creditworthy financial institutions or invest in low risk and liquid instruments."

Loans to share incentive scheme

Another potential hole in the balance sheet is **HK$152m** of loans to the share incentive scheme shown in note 26(a), and explained further in note 36. This scheme, adopted on 20-Apr-07, allowed participants to purchase existing shares in PM at a 5% discount to market price, with a 1-year lock-up. The discount was paid for by PM. Participants could pay in a lump sum or by instalments, with interest, in 24 monthly instalments for employees, or 12 monthly instalments for non-employees.

It is a somewhat unusual form of incentive scheme - the only "incentive" is the 5% discount and the fact that participants can borrow 100% of the purchase cost. In return for that, participants have to lock up their holding for a year (or until the final instalment is paid, if later). More conventional share award schemes do not involve loans - the company pays the full cost of the shares, and hence fewer shares are purchased to provide the same value of award. A good example of this is the scheme at HKEx, which your editor helped devise when he was an INED there.

The PM scheme is not just for employees, but was also open to consultants, professional advisers, suppliers, customers and authorised agents. Suppliers and customers had to have done at least $10m of business with PM.

The discount expenses incurred by PM in the year to 31-Mar-08 were $15.802m, which implies that they bought about $316m of shares for the scheme. Almost all of this was in the second half of the year, as first-half expenses were just $119k, implying purchases of HK$2.4m in the first half and $314m in the second half.

In the previous year, expenses for a similar scheme adopted on 31-Mar-06 were $7.583m (almost all of it in the first six months ending 30-Sep-06), implying purchases of about $152m. The first scheme was adopted on 13-Dec-04.

The current PM scheme is subject to a limit of HK$350m of purchase cost, and together with the previous schemes, it is subject to a limit of 5% of the issued shares. We don't know how many shares were purchased for the scheme or at what prices. Now with the PM shares virtually worthless, how many of the participants are likely to have the means to honour their commitments to purchase these shares and thereby repay the loan?

Share options for non-employees

PM also has a share option scheme which it has used liberally to reward non-employees, including customers, suppliers and professional advisers. On 8-Mar-07 it granted 5-year options to unidentified non-employee(s) to subscribe 41.415m shares at $7.06, vesting in 25% tranches from 8-Sep-07 to 8-Sep-10. However, during the year to 31-Mar-08, PM accelerated the vesting period, allowing 29m options to vest on 8-Apr-07, one month after they were granted, and the remainder split 50% on 8-Sep-07 and 50% on 8-Mar-08. Presumably this amendment was made on or before 8-Apr-07, so it is strange that it wasn't mentioned in the 2007 annual report, published on 12-Jul-07. 29m of the options were indeed exercised in the six months to 30-Sep-07, bringing in $211m. At the time of exercise, the market price was $9.77, giving the holder(s) a gain of $81m. PM did not give any reason for accelerating the vesting period. Perhaps they needed the cash.

Further back, on 19-Dec-05, PM granted 5-year options to non-employees to subscribe 18.75m shares at $2.175 , vesting in 25% tranches from 19-Jun-06 to 19-Jun-09. A quarter of them were exercised in the year to 31-Mar-08 with a gain of $31.3m.

On 23-Aug-02, suppliers and customers were granted 3.5-year options to subscribe 34.5m shares at $0.20, exercisable from 23-Feb-03, which they exercised by 31-Mar-03. The market price at the time of exercise was $0.43-0.44, netting them a gain of $8.1m. By comparison, PM's net profit for the year was $58.2m. In those days, companies did not have to expense the options in their accounts.

At 31-Mar-08, there were 90.71m options (including employee options) outstanding, equivalent to 8.3% of the existing issued shares.

Auditors

PM's auditors are Chu and Chu (no train jokes, please). You probably haven't heard of them, but their past clients may ring a bell or two, if you are a loyal reader of *Webb-site.com*. PM, which last year was a $13bn company, is Chu and Chu's only remaining HK-listed client. PM paid them $7.817m in fees last year, including $4.6m for the audit. They've been auditor of PM since 1996. Our database shows that they have had just 6 other HK-listed clients in past, most of which will be familiar to our long-time readers:

- Upbest Group Ltd (**Upbest**, 0335) - auditor since the IPO on 29-Sep-00, resigned 15-May-06. Upbest featured heavily in our Egana stories last year.
- UBA Investments Ltd (**UBA**, 0768) - auditor since the IPO on 4-Jan-00, resigned 15-May-06. UBA is a closed-end investment company managed by Upbest Assets Management Ltd, owned by Upbest.

- Grand Field Group Holdings Ltd (**Grand Field**, 0115) - appointed 27-Aug-03, resigned 20-Dec-04. See our article Cooking with Gas (4-Mar-04). Several people are facing criminal fraud charges in relation to that case, including the former Chairman, and an executive director of Grand Field as well as the controlling shareholder of Upbest and one of its executive directors.
- Harmony Asset Limited (**Harmony**, 0428) - appointed 17-Dec-03, resigned 29-Dec-06. This is another closed-end investment company, and shares a number of unlisted investments with UBA. At 31-Dec-05 and 31-Mar-06 respectively, Harmony and UBA each owned 26% of Capital Venture Limited, a property investment and money-lending firm incorporated in HK on 3-Dec-96. They also each owned 26% of Chief Finance Limited, a money-lender incorporated in HK on 9-Aug-00, and Harmony and UBA owned 35% and 20% respectively of Fullpower Holdings Ltd, a BVI company which invested in Challengers Auto Services Ltd. UBA has also invested in Harmony and owned 2.6% of it at 31-Mar-08.
- China Golden Development Holdings Ltd (0162) - appointed 19-Mar-03, resigned 28-Feb-06. This company was once known as I-Wood International Holdings Ltd, and featured in our article Wooden Lammas on 19-Feb-01. In the annual report for the year to 30-Jun-02, previous auditors PricewaterhouseCoopers questioned the "propriety" of certain major transactions and the adequacy of disclosures on related party transactions, and qualified their audit report.
- AKuP International Holding Limited (8179) - delisted on 27-Jul-05. The shares were suspended on 4-Feb-04 after the management went missing. That was just after Chu and Chu were appointed as auditors to replace Morison Heng. For the 2002 audit, Morison Heng had disclaimed an opinion on the accounts due to lack of evidence on purported sales and profits, amongst other things. Chu and Chu were obviously prepared to take the 2003 job on, but in the end, they never had to do it, as the management vanished.

History

PM was founded in 1983 by Madam Ho Suk-man (**Madam Ho**), her husband Leung Yung (**Mr Leung**), and Mr Norwood Cheung Chi-keung, as a watch and clock maker based in Wanchai, HK. The factory moved to Tsuen Wan, HK in 1986, and to Shenzhen in 1988. In 1992, they entered a joint venture to establish production in Kunming, Yunnan.

PM was listed on 18-Feb-93, in an IPO sponsored by Standard Chartered Asia Ltd, issuing 40m shares (25% of the enlarged capital) at $1 each together with a 2-year warrant at $1.10 for every 5 shares. After the IPO, Madam Ho, the Vice Chairman, owned 52.5% and Patrick Chau Cham-kwong (**Mr Chau**), the Chairman, owned 15%. As is traditional with HK IPOs, the company just made its profit forecast of $22m for the year to 31-Mar-93, then profits dropped 34% in the following year. There was a 1:1 bonus issue on 20-Sep-93. On 21-Nov-94, PM completed a 1:1 rights issue at $0.20, raising **$64m** gross. In Nov-94, it acquired Mei Ching Products Ltd, a leather goods maker, for $37.8m in cash. For the year to 31-Mar-95, PM booked a loss of $21m.

On 19-Sep-95, PM placed 123m new shares, equivalent to 18.94% of the issued capital, at $0.12 each, raising **$14.8m** gross. Up to this point, PM was an unremarkable small-cap listed watch maker, one of many in HK at the time.

Relationship with Egana

On 16-Dec-95, Egana agreed to buy 30% of PM from Madam Ho for $44.838m, or about HK$0.194 per share, and reducing her stake to 4.96%. The transaction was completed on 28-Dec-95, when Madam Ho resigned from the board. In Aug-96, Egana distributed 11.4% of PM to its shareholders as a dividend. Egana subsequently increased its stake in the market, reaching 20.2% by 30-Sep-96. Chu and Chu were appointed auditors of PM in 1996, replacing Deloitte Touche Tohmatsu.

In Sep-96 PM made a bonus issue of one share and one 2-year warrant for every five shares held, with an exercise price of $0.30. Egana exercised its warrants in Nov-96, injecting $9.38m into PM. PM's accounts for the year to 31-Mar-97 show that it paid $10m for a license and $7.14m for *"technical know-how in connection with product development for the licensed products"* during the year to 31-Mar-97. It is not clear whether this $17.14m was a deal with Egana, which owned 22.8% of PM at 31-Mar-97. Also in that year, PM began investing in the stock market, holding $27.5m of HK-listed shares at the year end, what it later called *"strategic investments"*.

Then on 21-Apr-97 PM launched a massive 2:1 rights issue at $0.10, raising **$192m** gross.

Food import venture with China Paramilitary Police

In Jul-97, PM agreed with North Anhua Group Corp, described as *"the investment arm of the China Paramilitary Police"* and Overseas Treasure Holdings Ltd (whose owners were not identified) to form a joint venture, Overseas Treasure (BVI) Ltd, in which PM owned 51%, to engage *"in the trading of high quality food products"* in PRC cities. It was later disclosed in the Mar-98 report that only 9% was held by North Anhua and 40% by *"a third party food marketing group"*, presumably Overseas Treasure Holdings Ltd. The investment was eventually written off in 2000 (see below). The tenuous justification for this non-core business was that it would help develop distribution chains for PM's timepieces.

Another $42.2m of intangibles - from Egana?

In the year to 31-Mar-98, PM spent another $35.7m on license fees and $6.5m on "deferred expenditure" in connection with product development for the licensed products, a total of $42.2m, more than the $34.2m net profit for the year. The licensors were not identified, although the only brands mentioned in the annual report are leather goods under Ferrano and Dugena, which were both brands owned by Egana. If these were licensed by PM from Egana, then that should have been treated as a connected transaction.

Sale of leather division to Egana

On 31-Mar-99, the last day of its financial year, PM agreed to sell to Egana its leather goods division for $34.8m and a 45% stake in Capricon Co Ltd (**Capricon**), which owned the PM factory, for $20.2m, making a total of $55m. The independent financial adviser was Upbest Securities Co Ltd and it was approved in an SGM on 28-May-99. PM booked a gain of $12.1m on the sale, after writing off deferred expenditure and licenses relating to the business - possibly licences it had acquired from Egana.

Also in the year to 31-Mar-99, PM spent $61.1m on unidentified HK-listed shares, which were worth $48.8m at the year end. No loss was recognised as they were booked as "long term investments". They also held $7.7m of HK-listed shares as short-term investments, reduced from $23.0m a year earlier. PM reported a net profit of $36.4m for the year. Egana owned 24.06% at year-end.

Another $35.5m of intangibles, at least partly from Egana

On 30-Jun-99, PM agreed to pay HK$10m to Egana for the exclusive right to manufacture clocks under the trademarks of Dugena and Pierre Cardin for 4 years. Including this, during the year to 31-Mar-00, PM spent a total of $35m on licenses ($15m) and technical know-how ($20m). The identity of the other licensors was not disclosed. The $35m spent compares with the net profit for the year of just $17.2m. Page 5 of the report mentions investing $20m *"to acquire a remote control technology for the application of a household appliance type remote control in timepieces".*

Also in the year to 31-Mar-00, PM wrote off $33.6m on its food business and $9.6m on its general trading business. They also booked a gain on disposal of listed securities of $18.6m, allowing them to book a net profit for the year of $17.2m.

Failure to obtain approval of connected transactions

Since Egana invested in PM, it was accounting for a substantial portion of PM's sales: 43% in 1997, 15% in 1998 and 40% in the year to Mar-99, mostly timepieces. But PM had never bothered to obtain minority shareholder approval for this. In a circular dated 29-Oct-99 Upbest again acted as independent financial adviser on the continuing trading transactions after PM admitted that it had been in breach of the Listing Rules requiring such approval since 1995. The stock exchange reserved its right to take further action, but didn't.

More licenses

On 28-Apr-00 PM placed 596.5m shares, equivalent to 19.4% of the issued capital through Upbest at par value of $0.10 each, raising $58m. Of that, $34m was spent on licenses in the year to 31-Mar-01. Before the year-end, however, PM disposed of $20m of technical know-how and $46.6m of licenses for $74m, booking a gain of $7.4m. Of the proceeds, $54m was received by year-end and $20m was *"receivable from a company for selling back the remote control technology for watches"* and received after the year-end. They didn't say which company. None of this was explained in the Management Discussion and Analysis in the annual report, so we don't know who the licensors were or what the licenses related to.

Watch patent

In addition, in the year to 31-Mar-01, PM paid $34m for a company (not identified, but probably Nippon Communication Technology Ltd) which had no assets other than a Japanese patent (probably this one) for downloading internet data (or more accurately, setting the time) from personal computers to wrist watches through infra-red communication. The vendor was not identified. The watch patent did not appear in PM's intangible assets at year end, even though they had a valuation from Sallmanns (Far East) Ltd at $32m. Instead, $45.264m of goodwill, including this deal, was written off directly against reserves.

PM also advanced an aggregate of about $39m to a Japanese distributor for "financing the join development of the distribution network in Japan".

In the year to 31-Mar-02 (Note 28(d) of the accounts), PM sold the watch patent company for $34m, satisfied by $34m of "other receivables".

Egana exits PM

On 28-Aug-01, Egana sold 10% of PM to Mr Leung, then Managing Director and husband of co-founder Madam Ho, for $49.8m or about $0.1354 per share, cutting its stake to 6.49%, and its representatives resigned from the board of PM. On 18-Sep-01, Egana sold its 45% stake in Capricon Co Ltd, which owned the PM factory, back to PM for $31.5m, booking a gain of $6.06m. As Egana was no longer a connected person, the transaction was not announced by either side but appears in note 16(f) of Egana's May-05 accounts.

On 25-Jan-02, PM consolidated every 20 shares into 1 share.

On 28-Mar-02, the last working day of the year, PM acquired the Milus brand for $39.208m and its workshop in Bienne, Switzerland, for $2m and then established Milus International S.A.

On 6-Jun-02, PM launched another 2:1 rights issue at $0.18, raising **$66.2m** gross. The issue was underwritten by A-One Investments Ltd (**A-One**), a BVI shell owned 50.45% by Mr Chau and 49.55% by Mr Leung. The issue was only 42.5% subscribed, and as a result, A-One owned 30.17%. Together with the existing holdings of Patrick Chau (10.18%) and Mr Leung (10.00%), they owned 50.35% of PM.

Also in Jun-02, PM obtained a Pierre Cardin watch licence for the China market. Presumably this came from Egana, which acquired the global Pierre Cardin trademark (excluding Argentina, Uruguay, Chile and Japan) in Apr-97.

Capital-hungry

On 30-Mar-04, there was a placing through Cazenove of 93.5m existing shares and a subscription of 126.5m new shares at $1.63 each by A-One and Mr Leung, raising **$206m** gross.

On 20-Jan-06, there was a placing through Cazenove of 90m shares at $3.25 each, raising **$293m** gross.

As mentioned above, there was an accelerated vesting of 29.9m options granted to non-employees in the 6-months to 30-Sep-07, and this raised **$211m**.

Altogether, *Webb-site.com* calculates that from listing in 1993 up to 31-Mar-08, PM has raised gross proceeds of $1,758m (net of buybacks), and paid out $357m in dividends. The capital raised includes $371m of shares issued for Sincere Watch, and the capital and dividend figures both include $36.8m of scrip dividends. And that's before the most recent $1.26bn placing.

Overdue trade payables

Not only does PM carry large amounts of bank debt, but also, mainly as a result of the Sincere Watch acquisition, it has large amounts due to watchmakers. At 31-Mar-08, total trade payables were $1,040m. In note 29 of the accounts, the actual age of the payables isn't stated, because the ageing analysis is relative to the original "due date" - so if they were given 90 days credit, and it is 89 days old, then it is just classified as "not yet due". However, we can see that HK$577m of trade payables were overdue, including $237m overdue by 91-180 days and $208m overdue by more than 180 days.

Of the $1,040m of trade payables, $711m was denominated in Swiss Francs. So you can expect a fair amount of angst at the Swiss luxury watch-makers in any debt restructuring, unless they have security and custody of the inventory. Still, companies like the secretive and probably very profitable Rolex SA, which is owned by a foundation and does not publish its accounts, can probably afford many such failures.

Pledge by A-One

In the announcement of the placing on 5-Jun-08, PM said that Mr Chau, Mr Leung and A-One have separately undertaken to the Placing Agents that:

> "from the date of the Placing Agreement and up to and including the date being three months after the date of the Placing Agreement, they will not...(without the prior written consent of the Placing Agents):
>
> (a) ...pledge...any Shares..."

Less than 3 months later, on 3-Sep-08, PM admitted that A-One has pledged 131,388,889 shares (10.44% of PM) *"for the purposes of certain bonds issued by it"* and that the arranger of the bonds was ABN AMRO Bank, N.V. (**ABN AMRO**). What PM didn't mention is that ABN AMRO was also one of the two Placing Agents in the placing. So surely ABN AMRO, as bond arranger, must have been aware of the pledge and implicitly or explicitly consented to it. So the question arises - when was this pledge made, and why wasn't it disclosed to the public that ABN AMRO had consented to it? Did the other placing agent, BNP Paribas, consent? Or was the pledge already in existence before the placing announcement? In that case, PM was being highly economical with the truth. It is misleading to say that no pledges will be made, when there are already pledges in existence.

Whenever a statement is made about such undertakings or lock-ups, it is incumbent on the company to update the public on any consents given to waive such undertakings. Otherwise, the public is entitled to rely on them.

Brokerage BUY recommendations

On page 46 of its 2008 annual report, the company said:

> "We are proud of having 14 analysts and brokerage firms cover PM with a Buy recommendation. They are ABN AMRO, BNP, Cazenove, China Merchants Securities, Daiwa, DBS, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Kim Eng, Merrill Lynch, UBS and UOB. We sincerely thanks for their support."

Oops! It would be unfair to single out any one of these firms for poor judgement or failure to do their homework.

Organisations in this story

- AKUP INTERNATIONAL HOLDING LIMITED
- CENTURY GINWA RETAIL HOLDINGS LIMITED
- Chu and Chu
- EGANAGOLDPFEIL (HOLDINGS) LIMITED
- GRAND FIELD GROUP HOLDINGS LIMITED
- PEACE MARK (HOLDINGS) LIMITED
- Sincere Watch (Hong Kong) Limited
- Sincere Watch Limited
- UBA INVESTMENTS LIMITED
- UPBEST GROUP LIMITED
