



“Things that look too good to be true usually are.”

— Old Proverb

THIS RESEARCH REPORT EXPRESSES SOLELY OUR OPINIONS. We are short sellers. We are biased. So are long investors. So is CMS. So are the banks that raised money for the Company. If you are invested (either long or short) in CMS, so are you. Just because we are biased does not mean that we are wrong. Use BOC Texas, LLC's research opinions at your own risk. This report and its contents are not intended to be and do not constitute or contain any financial product advice. Investors should seek their own financial, legal and tax advice in respect of any decision regarding any securities discussed herein. You should do your own research and due diligence before making any investment decisions, including with respect to the securities discussed herein. We have a short interest in CMS' stock and therefore stand to realize significant gains in the event that the price of such instrument declines. Please refer to our full disclaimer located on the last page of this report.

COMPANY: China Medical System Holdings Ltd. | HK: 867
INDUSTRY: Pharmaceutical Promotion and Distribution

On February 6, 2020, we published our investment opinion (the “Report”) on China Medical System Holdings Ltd. (HK: 867) (“CMS” or the “Company”) detailing an extensive investigation which indicated that CMS exaggerates its financial performance, inflates profits and conceals that dwindling Company profits are used to privately enrich its chairman. Just over 24 hours later, CMS issued a hasty, incomplete and contradictory response (the “Response”) which barely addressed our Report in any substantive or meaningful way.

In this Rebuttal, we will unpack CMS' nonsense and show why only the most gullible investor would believe the Company's latest obfuscation. CMS' only hope is to convince investors that its financials are true because it has discovered the greatest **tax loophole in the world**, which is not available to any other public company.

Unbelievably, the Company's entire defense rests on its claims that 60% of its profits flow through a Malaysian subsidiary which evidence indicates has no current employees, no office, no customs records of shipping goods, no material IP rights, no operations in Malaysia and **which is not even audited!** Not only does this lone subsidiary supposedly enable CMS to save hundreds of millions in taxes, but **no other public company has discovered this loophole.**

Bullshit. We think that this structure is an obvious fabrication designed to inflate CMS' financial performance. We call on Deloitte to investigate immediately as part of its annual review. How can an auditor sign off on the integrity of the Company's financials without audited financials of its most important subsidiary?

1) The Black Box – Declining PRC Profitability and the Mysterious Malaysian Tax Benefits

In our Report, we highlighted two independent data points, an A-share circular submitted by CMS to Chinese securities regulators (which included audited financials of CMS' PRC subsidiaries) and local regulatory filings, which showed that aggregate net profits at CMS' subsidiaries in the PRC were **49% less than reported from 2016-2018**. We believe such evidence indicates unambiguously that CMS is much less profitable than it claims, and that the Company's exaggeration is only getting worse as CMS struggles under the weight of policy changes in the PRC designed to undermine its business.

In its Response, CMS admits that these filings are **accurate**, but claims that the discrepancy is explained by offshore profits earned by the Company's lone subsidiary in Malaysia. **Indeed, the Company's entire Response is prefaced on the Malaysian black box – a mysterious source of profits and tax savings** which supposedly explains the grave inconsistencies in CMS' financials.

Put simply, CMS' wants investors to believe that it runs 60% of its profits through Malaysia and saves hundreds of millions in taxes even though we think the evidence shows that:

- CMS' Malaysian subsidiary was **not audited**
- CMS has No Malaysian office
- CMS has No current employees in Malaysia
- CMS admits its drugs are **never physically transported via Malaysia**
- CMS has No material IP rights in Malaysia¹
- CMS has No operations in Malaysia
- No other public company knows about this loophole or has been able to replicate it

¹ The Company has reportedly transferred the IP rights for only one commercialized drug to its Malaysian subsidiary, but this drug accounts for only 4% of revenues.

- **Not Audited – Barely Mentioned**

In its Response, CMS describes its Malaysian’s subsidiary as “**crucial**” and claims that this entity conducts the “operation of [its] international business.”² But if Malaysia was so crucial, why wasn’t it ever discussed in the Company’s **thousands** of pages of filings to the capital markets? CMS supposedly generated 60% of its FY 2018 pre-tax profits in the country **yet mentions “Malaysia” only a handful of times in years of disclosures.**

“Crucial” Malaysian Operation was Barely Mentioned in Years of CMS Public Filings

RMB M	Annual Report									
	2018	2017	2016	2015	2014	2013	2012	2011	2010	
Mentions of Malaysian Operations	None	None	None	None	None	None	None	None	None	None
Mentions of Malaysian Office	None	None	None	None	None	None	None	None	None	None
Mentions of Malaysian Employees	None	None	None	None	None	None	None	None	None	None
Mentions of Malaysian Shipments	None	None	None	None	None	None	None	None	None	None
Mentions of Malaysian IP Rights	1*	1*	1*	1*	1*	1*	1*	1*	1*	1*
Total Mentions of Malaysian subsidiary	1†	1†	1†	2‡	2‡	2‡	2‡	2‡	2‡	2‡
Estimated Malaysian Profit	1,196	939	675	875	641	511	299	221	145	
Malaysian Pretax Profits as a % of Total	60%	52%	45%	82%	57%	75%	50%	50%	62%	

Note: * Refers to the IP rights of Augentropfen Stulln Monoeye-drops, which accounts for only 4% of revenues.

† One mention in the income tax section

‡ One mention in the income tax section, one mention in Intangible Assets section related to Stulln eyedrops

Source: CMS Annual Reports

If Malaysia was “crucial” as the Company now insists, why hasn’t CMS ever disclosed even the faintest detail about the transactions or the structure which supposedly enabled the Company to save hundreds of millions or 60% its tax bill by incorporating a lone Malaysian subsidiary?

CMS asks investors to believe it on the grounds that the “Malaysian Company has submitted its 2018 management accounts to the Malaysian financial regulatory.”³ But according to the Company’s prior disclosures, the financial statements of its Malaysian subsidiary are **not even audited!**

We have acted as the auditor of the Company and Sino Talent since its date of incorporation and acted as the auditor of Sky United for the year ended 31 December 2009. No statutory audited financial statements have been prepared for Hunan Pharmapep, Kangzhe Pharmaceutical Technology and Shandong Baoli hao as there were no statutory audit requirements for company under relevant laws and regulations. No statutory audited financial statements have been prepared for those subsidiaries which were incorporated in the British Virgin Islands or Malaysia as they were incorporated in a jurisdiction where there are no statutory audit requirements.

Source: CMS Hong Kong Prospectus, p. 276

In the year of its IPO, Malaysia was just as crucial to the Company’s financials as it is now, supposedly accounting for 62% of the Company’s profits. Yet the Malaysian subsidiary’s accounts were not audited then, and we have no reason to believe they have been audited since.

CMS gives it away in its Response. The Company insists that CMS Pharma “**has submitted its 2018 management accounts**” to the local regulator but curiously never insists or even mentions that such accounts are audited.

If its Malaysian subsidiary is so “crucial” and accounts for 60% of the Company’s reported profits, **why aren’t its financial statements audited?** Are investors really supposed to rely on an unaudited entity as the lynchpin holding together the Company’s web of contradictory disclosures and obfuscations? We believe that the absence of an audit allows the Company to use the Malaysian black box to make up whatever profits it likes, without any independent oversight.

² CMS Response, p. 5.

³ CMS Response, p. 5.

- **No Current Employees or Offices**

CMS' entire Response rests on its claim that the vast "operation of the international business... was undertaken by the Malaysian Company." CMS fails to elaborate, but vaguely insinuates that this involves "**new product investment** and licensing, selection and evaluation of manufacturers, **quality control, supply chain management**, [and] formulation of product promotional strategies."⁴

Rubbish. If CMS' Malaysian subsidiary was generating 60% of the Company's profits because it was undertaking product development, supply chain management and quality control, **then why isn't there any evidence of current employees or offices in Malaysia?**

In the Company's annual report, it discloses ongoing employee benefit and pension obligations in China and Hong Kong because it's an employer in those locations. Yet according to CMS' disclosures, it makes no contributions to Malaysia's pension scheme or government mandated retirement benefit plans.

RETIREMENT BENEFITS SCHEMES

No Mentions of
Malaysian
employees

The employees of the Group's subsidiary in the PRC are members of the state-managed retirement benefit schemes operated by the PRC government. The PRC subsidiaries are required to contribute a certain percentage of their payroll to the retirement benefit schemes to fund the benefits. The only obligation of the Group with respect to the retirement benefit schemes is to make the required contributions under the schemes.

The employees employed in Hong Kong are required to join the Mandatory Provident Fund Scheme (the "MPF Scheme"). Contributions to the MPF Scheme are made in accordance with the statutory limits prescribed by the Mandatory Provident Fund Ordinance of Hong Kong.

During the year, the total expense recognised in the profit or loss for the above schemes amounted to RMB43,052,000 (2017: RMB26,942,000).

Source: CMS 2018 Annual Report

Such contributions are **mandatory** under Malaysian law for employers. Yet in ten years as a public Company, CMS never disclosed any contributions to benefit plans in Malaysia. The absence of any pension obligations in Malaysia, in our opinion, indicates that CMS has no current employees in the country. Otherwise, as an employer, CMS would have to contribute to the government mandated retirement schemes.

Subject to the provisions of section 52, every employee and every employer of a person who is an employee within the meaning of this Act shall be liable to pay monthly contributions on the amount of wages at the rate respectively set out in the Third Schedule.

Section 43(1), EPF Act 1991



Do foreign companies hiring Malaysian citizens need to contribute?

Yes, if the foreign company has registered and is operating in Malaysia.

Source: <https://www.kwsp.gov.my/employer/what-you-need-to-know#Employer>

CMS now claims that its "crucial" Malaysian subsidiary conducts vast and complex international operations but the absence of any pension contributions, **required** for employers under Malaysian law, suggests in our opinion that it has **no current employees in the country.**⁵

Furthermore, CMS' official human resources website advertises for positions in scores of locations in China, but none in Malaysia.

⁴ CMS Response, p. 5.

⁵ In our due diligence, we could only find one person who ever claims to have worked for CMS Pharma, the Malaysian entity, a recent college graduate who started in 2018 but left in 2019.

CMS Pharma not Listed on CMS' Recruiting Website

工作地点:	全部 全国 北京市 东城区 天津市 河北省 石家庄市 唐山市	收起
Job Location	秦皇岛市 邢台市 保定市 张家口市 承德市 沧州市 廊坊市 太原市	
	大同市 阳泉市 长治市 晋城市 朔州市 晋中市 运城市 临汾市	
	吕梁市 内蒙古 呼和浩特市 包头市 乌海市 赤峰市 通辽市	
	巴彦淖尔市 乌兰察布市 阿拉善盟 沈阳市 大连市 鞍山市 本溪市	
	丹东市 锦州市 营口市 阜新市 盘锦市 铁岭市 朝阳市 葫芦岛市	
	四平市 通化市 白山市 延边朝鲜族自治州 大庆市 佳木斯市	
No Recruitment for Malaysia-based Location	牡丹江市 上海市 南京市 无锡市 常州市 苏州市 南通市 盐城市	
	扬州市 镇江市 泰州市 宿迁市 杭州市 宁波市 温州市 嘉兴市	
	湖州市 绍兴市 金华市 衢州市 舟山市 丽水市 合肥市 芜湖市	

Source: LinkedIn; <http://hr.cms.net.cn/search?k=>

Notably, CMS has never claimed any Malaysian employees, which likely explains why CMS failed in its Response to disclose basic details like the headcount of its Malaysian subsidiary. We think it is fanciful to believe that CMS Pharma undertakes vast and complex international business operations out of Malaysia like supply chain management, product development or quality control without any mention over 10 years as a public Company of any staff (or required employer pension contributions) in the country.

In our Report, we noted that we could find no evidence of any office in Malaysia despite our diligent efforts to locate one. In its Response, CMS claimed that it has been “leasing and occupying an independent office for business use.”⁶ But incredibly, **the Company won't even disclose an address which investors could verify.** If CMS has an office in Malaysia, where is it? Why not disclose its address? How many square feet is it? And why has the Company never disclosed it in any previous filings?

In the Company's prospectus, filed in 2010, CMS claimed to generate 62% of its pretax profits in Malaysia, even though it admitted in its prospectus that it **didn't have a Malaysian office at the time.**

In accordance with your instructions for us to value the property interests held by China Medical System Holdings Limited (the “Company”) and its subsidiaries (together referred to as the “Group”) in the People's Republic of China (“the PRC”) and the Hong Kong Special Administrative Region of the PRC (“Hong Kong”) we confirm that we have carried out inspections, made relevant enquiries and obtained such further information as we consider necessary for the purpose of providing you with our opinion of the market value of such property interests as at 30 June 2010 (“date of valuation”) for the purpose of incorporation into the prospectus issued by the Company on the date hereof.

Source: CMS Hong Kong Prospectus, p.360

CMS' has disclosed leased and owned offices in every jurisdiction but Malaysia. If this Malaysian office and operation were so crucial to its business, why never mention it before? And why not disclose its address in the Response?

Ultimately, CMS insists that its “crucial” Malaysian subsidiary conducts vast and complex international business operations, yet there is no evidence of any tangible operations in the country, including any evidence of current employees or office space. Rather, we think the Malaysian black box is a bogus structure designed to facilitate the exaggeration of CMS' financial performance.

- **No Drugs Physically Transported Via Malaysia**

In our Report, we opined that CMS' supposed Malaysian tax benefit was likely bogus because CMS Pharma did not appear in any customs records or databases. If CMS generates offshore profits by shipping drugs through its Malaysian subsidiary, then CMS Pharma should appear on customs records. It doesn't. As we pointed out in our Report, *Malaysia as a country doesn't export enough drugs to China for CMS' claims to be true.*

⁶ CMS Response, p. 4.

CMS' concedes this point. In its Response, CMS claimed that "international trade conducted by the Malaysian Company was genuine and accurate," but **admitted that it imported products** directly to China without "**physically transporting via Malaysia**."⁷

Doesn't CMS claim in its Response that its Malaysian subsidiary conducts "quality control" of its drugs? How does it undertake quality control in Malaysia if the drugs never touch the country?

How gullible are investors supposed to be? Special tax zones like Labuan are set up in order to incentivize local development and commerce out of the economic zone. But CMS claims vast tax benefits and major Malaysian profits without any goods ever touching Malaysia. If it were so easy, why wouldn't everyone do it?

- **No Material IP Rights in Malaysia**

CMS' Response also includes a vague and confusing explanation on certain IP rights which the Company now claims are held by its Malaysian subsidiary. CMS now claims that "by the end of 2018, the Malaysian Company has incurred expenses in intangible asset investments (**including IP rights**) amounting to RMB 2.854 billion."⁸

First, CMS' Response directly contradicts the Company's previous claims. By its own admission, CMS has consistently stated that 99% of the Company's non-current assets, including intangible assets such as **intellectual property and goodwill**, are held in China. **This is black and white.**

The Group primarily operates in the PRC. All revenue from external customers is attributed to the PRC and 99% of non-current assets excluding AFS investments and derivative financial instruments and deferred taxes of the Group are located in the PRC.

Source: CMS 2018 Annual Report

CMS offers an utterly confounding explanation in trying to reconcile its current misrepresentation with its past disclosures. It claims that because intangible assets are somehow "authorized for use" in China and that revenues from the IP assets are generated in China, such IP assets are designated as located in China from an accounting perspective even though they may reside in Malaysia.

This makes no sense. In every disclosure before the Company's hasty and evasive Response, CMS stated unambiguously that 99% of its IP rights and other intangible assets were located in the PRC. How can the Company now claim that such IP rights were actually located in Malaysia? Either the Company's previous disclosures were false, or the Company's Response is false – either way investors have caught the Company red handed with mutually exclusive and contradictory claims.

Indeed, prior to its Response, the Company claimed that it transferred the exclusive rights to **only one of its drugs** to its Malaysian subsidiary.⁹ This was Stulln Eyedrops, which accounted for only 4% of CMS' total revenues from 2014-2018 and does not generate remotely enough revenue to fill the black box. The Company has not, to our knowledge, ever claimed that it transferred any other exclusive licensing rights to its lone Malaysian subsidiary. Why should we believe them now?

More importantly, if acquired intellectual property assets were transferred to CMS Pharma, as the Company now claims, then such assets should be registered offshore. This is how big companies like Apple and Nike have somewhat controversially avoided taxes. Nike [transferred](#) the Swoosh trademark, Uber transferred its app, Allergan transferred its Botox patents, and Facebook transferred its social media technology to offshore shell companies in Bermuda and Grand Cayman. But for this to work, the **IP has to reside offshore.**

We searched the [official Malaysian Intellectual Property Database](#), which reveals that all the trademarks of CMS licensed drugs are registered to the European manufacturers. CMS Pharma is not listed as the owner, representative or agent for any of the drugs.

⁷ CMS Response, p. 5.

⁸ CMS Response, p. 7.

⁹ CMS Pharma also acquired the assets related to Traumakine in 2015, but this drug has yet to be commercialized and thus would not generate any profit or revenue.

Application No.	Denomination	Picture	Owner	Expiry Date	Agent/Local Representative	Application Status
84003843	PLENDIL		ASTRAZENECA AB	21 Aug 2025	Patrick A/L M.G Mirandah	Registered
83/01686	DEANXIT		H.LANDBECK & CO. A/S	15 Dec 2004	SKRINE	Removed
02003039	SALOFALK		DR. FALK PHARMA GMBH	20 Mar 2022	PATRICK MIRANDAH	Registered
02003038	URSOFALK		DR. FALK PHARMA GMBH	20 Mar 2022	PATRICK MIRANDAH	Registered

Source: <https://iponline2u.myipo.gov.my/myipo/www/>

When we searched the Malaysian IP database, CMS Pharma, the Company’s Malaysian subsidiary supposedly responsible for all the offshore profits and tax savings, **did not show up at all.**

Search Criteria

Case Number

Mark to Search (Denomination)

Search Clear Advanced Search

184 Trade Mark(s) **No Matching Records for "CMS Pharma"**

Application No.	Denomination	Picture	Owner	Expiry Date	Agent/Local Representative
00006613	SCHWARZ PHARMA		SCHWARZ PHARMA AG	26 May 2010	Wong Sai Fong ((Deceased))
00008373	APEX PHARMA		Avex Pharmaceuticals Pte Ltd	27 Jun 2020	Bahari Yeow Tien Hong

Source: <https://iponlineext.myipo.gov.my/SPHI/Extra/IP/TM/Obe.aspx?sid=637166413704057962>

Any investors can duplicate the search on the Malaysian IP registry – we found no results for CMS Pharma. If CMS Pharma truly holds IP rights in Malaysia, why aren’t the IP rights registered there?

Also, if the Company generates all of its revenues in China but holds IP rights in Malaysia, then presumably the Company’s Chinese subsidiaries would have to pay licensing fees or royalties to the Malaysian subsidiary. After all, offshore profits should produce offshore cash. Yet CMS claims that 94% of its cash is denominated in RMB at FYE 2018, even though supposedly over 60% of its profits were earned offshore.

As at 31 December 2018, the cash and cash equivalents of the Group were mainly denominated in RMB, with small amount denominated in United States Dollar ("US\$"), Euro ("EUR"), Great Britain Pound ("GBP"), Swiss Franc("CHF") and Hong Kong Dollars ("HK\$").

As at 31 December 2017, the cash and cash equivalents of the Group were mainly denominated in RMB, with small amount denominated in United States Dollar ("US\$"), Euro ("EURO") and Hong Kong Dollars ("HK\$").

RMB M	2016	2017	2018
Great British Pound		1	35
US Dollar	18	2	5
Euro	10	20	4
Swiss Franc		1	3
Hong Kong Dollar	1	2	2
Total disclosed foreign currencies	29	26	49
Cash balance	482	856	815
% of foreign currencies	6%	3%	6%

Source: CMS Annual Report

If the Company earns 60% of its pretax profit in Malaysia, we would expect a much higher proportion of its bank balance to be denominated in foreign currencies. Certainly more than 3-6%. The large cash balance in RMB is consistent with the Company's previous disclosures that 99% of its revenues are earned in China and 99% of its intangible assets are located in China.

CMS' new claim that it holds some IP rights in Malaysia is contradicted by nearly every historical disclosure that the Company made before we pointed out the grave inconsistencies in its reported financials and the bogus nature of its Malaysian tax structure.

- **No One Else Has Discovered the World's Greatest Tax Loophole**

Any investor gullible enough to believe CMS' vague and contradictory claims has a major problem. If it were possible for Chinese companies to save hundreds of millions in taxes each year by incorporating a lone Malaysian subsidiary, wouldn't this practice be widespread?

If CMS' Response is true, the Company has **discovered the world's greatest tax loophole**. In our opinion, evidence shows CMS has no offices, current employees, operations, or material IP in Malaysia. It admits it doesn't ship drugs through Malaysia. If it were so easy to save hundreds of millions in taxes without any material transactions or operations in the special tax zone, why doesn't everyone do it?

We searched for other publicly listed companies that have Labuan-based subsidiaries and found only a handful. Notably, **none of them reported such unusually low effective tax rates as CMS**. If the Company's Response was true, we would expect other publicly listed companies with subsidiaries in the **same tax zone in Malaysia** to also report significant tax savings. But they don't and it's not even close.

Effective Tax Rate	Ticker	2016	2017	2018	Industry
Hilong Holding Ltd.	HK: 1623	28%	27%	35%	Oilfield Services/Equipment
China Aircraft Leasing Group Holdings Ltd.	HK: 1848	28%	27%	18%	Finance/Rental/Leasing
Qisda Corporation	TW: 2352	19%	19%	26%	Computer Peripherals
President Chain Store Corporation	TW: 2912	19%	23%	24%	Food Retail
Delta Electronics, Inc.	TW: 2308	23%	22%	19%	Electronic Equipment/Instruments
Tiberius Acquisition Corp.	TIBR	N/A	N/A	21%	Financial Conglomerates
China Medical System Holdings Ltd.	HK:867	8%	8%	8%	Pharmaceutical Promotion and Distribution

Source: FactSet

Investors should also note the suspicious lack of variance in CMS' effective tax rate. Other public companies with subsidiaries incorporated in the Labuan zone report varying effective tax rates from year to year, which makes sense given the variability of business conditions over time. Yet CMS's effective tax rate remains remarkably the same from year to year, despite changes in its business. We pointed out in our [report](#) on China Metal Recycling, which was subsequently delisted for fraud, that such Madoffian consistency in financial metrics was a major red flag.

Ultimately, the Company's entire defense rests on its claims that 60% of its profits flow through a Malaysian subsidiary which evidence shows has no offices, no current employees, no customs records of shipping goods, no material IP rights, no operations in Malaysia and **which according to the Company's prior disclosures is not even**

audited! Not only does this lone subsidiary supposedly enable CMS to save hundreds of millions in taxes, but investors are led to believe that **no other public company has discovered this loophole.**

We think that this structure is an obvious fabrication designed to inflate CMS' financial performance. We call on Deloitte to investigate immediately as part of its annual review and question how can an auditor sign off on the integrity of the Company's financials without audited financials of CMS' most important subsidiary?

2) The Illusion of Dividends

Despite all the evidence to the contrary, CMS insists that investors can rely on the integrity of its financial statements (which hinge on the integrity of an unaudited subsidiary) because the Company "has been able to maintain and deliver annual dividends at a dividend payout ratio of about 40%."¹⁰

But this doesn't mean anything. Since 2010, CMS and its chairman¹¹ have raised a total of HKD 4.7 billion from equity investors. In the meantime, the total dividend paid out was just HKD 4.2 billion. Of this, HKD 2.3 billion went to the chairman.

HKD M	
Net Proceeds from IPO	895
Share issuance in 2010	12
Share issuance & placing of existing shares in 2015	2,580
Placing of existing shares in 2017	1,224
<hr/>	
Total capital raised from equity investors	4,711
Total dividend paid	4,187
Total dividend paid to chairman	2,251

Source: CMS Annual & Interim Reports

Any investor blindly relying on dividends as a proxy for the integrity of the Company's reported profits should look elsewhere. The money paid out is less than the money raised, meaning such dividends are no evidence whatsoever that CMS is as profitable as it claims.

3) Chinese FDA Records Indicate that CMS Secretly Funds R&D for Chairman

In our Report, we highlighted Chinese corporate and FDA records which indicated that CMS secretly funds research expenses on behalf of a research entity privately owned by the chairman. In its Response, CMS offers meek and non-sensical excuses which contradict the plain reading of black and white corporate records.

For example, CMS claimed in its public filings that the chairman's privately held Kangzhe R&D would continue to bear ongoing clinical trial costs for its compound CMS024. But as we pointed out, Chinese FDA records show that the primary trials are being conducted by CMS subsidiaries, not the chairman's Kangzhe R&D.

In its Response, the Company claims that one of the trials we discovered was "terminated."¹² But this works against CMS, not for it. Because the terminated study was the only one registered to the chairman's private entity.

According to the Chinese FDA database, the other two ongoing trials are conducted by CMS subsidiaries and not the chairman's Kangzhe R&D (as CMS claims).

¹⁰ CMS Response, p. 3.

¹¹ Plus a senior executive.

¹² CMS Response, p. 7.

登记号: CTR20131695	Status: In process 试验状态: 进行中
申办者联系人: 殷远洲	首次公示信息日期: 2014-03-06 First published: 2014-03-06
申办者名称: 益侨(湖南)制药有限公司/ 深圳市康哲药业有限公司/ Applicant: Yiqiao (Hunan) Pharmaceutical Co., Ltd/ Shenzhen Kangzhe Pharmaceutical Co., Ltd	

登记号: CTR20150871	Status: In process 试验状态: 进行中
申办者联系人: 殷远洲	首次公示信息日期: 2015-12-31 First published: 2015-12-31
申办者名称: 益侨(湖南)制药有限公司/ 深圳市康哲药业有限公司/ Applicant: Yiqiao (Hunan) Pharmaceutical Co., Ltd/ Shenzhen Kangzhe Pharmaceutical Co., Ltd	

Source: <http://www.chinadrugtrials.org.cn/eap/clinicaltrials.searchlist>

In the unlikely event that the chairman's private entity was reimbursing the Company's subsidiaries for the costs of the trials, the Company would be required to disclose connected party transactions between CMS and Kangzhe R&D. But it doesn't, indicating that no such reimbursement takes place.

CMS' Response misses broader the point, as it completely ignores the damning evidence in our Report that:

- The chairman's private entity is co-located at CMS' Shenzhen headquarters;
- It uses an @CMS email and the Company's phone number in its registration documents;
- It lists CMS' senior executives as its management team;
- Its only clinical trial in the Chinese FDA database lists a CMS employee (with a CMS email) as its contact person;
- It only reports one employee in its corporate records; and
- It reports minimal operating expenses in its local regulatory filings.

Ultimately, this is overwhelming evidence that the chairman's private entity is simply run out of CMS offices by CMS employees. We think it should be obvious that rather than bearing its own research costs, the chairman's private entity secretly offloads such expenses to the public Company.

4) Rotten Pattern of Self-Dealing with the Chairman

In our Report, we outlined pages and pages of what we consider to be rotten self-dealing between CMS and the chairman's private entities. The Company's Response on these points was **laughable**.

CMS claims that the chairman was the middleman between the Company and its purchase of valuable territorial IP rights from drug companies because he is a nice guy. CMS claims that the chairman buys these rights out of the goodness of his heart, so that the public Company doesn't risk losing money if the prospective drugs or devices fail.

In its Response, CMS claimed that to "avoid incurring uncertain development costs by the [Company] and risks of development failure... the Chairman decided to use his privately-owned company, A&B, to make early-stage investments ... with the aim to assign such product rights to the [Company] without the [Company] having to incur any upfront, registration or sales milestones fees upon achievement of substantial development progress..."¹³

In essence, the chairman claims that he is bearing the risk for the early stage investments through A&B Holdings, and that the Company will only be on the hook if the investments are successfully commercialized.

First, this Response ignores the sequence of events. For example, with respect to CMS' investment in Faron, the chairman only held the territorial IP rights for **11 days before transferring them to the Company**. What could possibly have changed in only 11 days to mitigate the Company's risk? What possible explanation could the chairman reasonably have for buying rights and selling them immediately to CMS if he didn't reap some rotten benefit?

¹³ CMS Response, p. 8.

Second, this Response ignores the facts. The majority of CMS' direct investments have been early stage, when the risk is highest (Acticor, Blueberry, Destiny, Midatech). When CMS has purchased territorial rights through the chairman, such purchases have occurred at a later stage in the development process when risk should be lower (Helius, Neurelis and Faron). This undercuts the Company's Response that the chairman is protecting CMS from losses associated with early stage investments, and leaves investors with no answers (other than the obvious one) of why the Company repeatedly purchases development rights not from the developers but through the chairman.

Third, the Response misses the point entirely. It is not charitable that the chairman invests first through A&B Holdings, because A&B Holdings appears to be run using CMS resources, employees, email addresses and offices. CMS ignores the overwhelming evidence presented in our Report that:

- A&B Holdings is co-located at CMS facilities, lists CMS headquarters as its mailing address and even uses CMS' phone number and @cms email address in its securities filings.
- Local filings show that A&B Holdings' lone Chinese subsidiary only has **one employee** and reported less than RMB 100,000 in operating expenses from 2016 through 2018. Without expenses or employees, there is little chance it conducts any research or investment on its own. Rather, this suggests that its activities are conducted through CMS staff and likely funded, directly or indirectly, by the public Company.
- CMS executives are listed as the contact persons for A&B Holdings in investment contracts with biotech startups, indicating that Company employees are used by the chairman for his private benefit.
- When A&B Holdings nominates someone to the board of a drug development partner, it is typically Peng Huaizheng, whose current LinkedIn profile shows that he is still a senior executive at CMS.



Source: LinkedIn

The chairman does not appear to be running his private entity out of the goodness of his heart. Pages and pages of filings and disclosures show that his supposedly private entity is run through CMS staff, from CMS offices and using CMS resources. It is also critical to note that local filings for the chairman's private entities show almost no employees or operating expenses, confirming that the research and investment undertaken by these privately owned entities is likely done using Company staff and resources.

Of course, CMS completely ignores the thrust of this entire point, likely because such evidence is deeply inconvenient to its weak Response. But we suppose that if investors are gullible enough to believe that a single **unaudited** subsidiary out of Malaysia without any evidence of a real business can account for 60% of CMS' supposed profits, then they will also believe that the chairman acts as a conduit for IP purchases and front-runs CMS' investments out of the goodness of his heart.

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