



GLAUCUS RESEARCH GROUP

All that is required for evil to triumph is for good men to do nothing — Edmund Burke

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COMPANY:

CHINA MEDICAL TECHNOLOGIES, INC. | NASDAQ: CMED

INDUSTRY: Medical Devices and Equipment

Recommendation:
Strong Sell

Avg. 3 Mo. Volume:
~350,000
Shares/day

Market Cap:
\$86.7 mm

Price:
\$3.32

As of Market Close 12/2/11

Underwriters:
UBS

Auditor:

PricewaterhouseCoopers
Zhong Tian CPAs Limited
Company, Beijing,
China WC

IPO:
August 2005

- We believe that CMED has defrauded investors and that it is the next Longtop Financial (LFT) or Universal Travel Group (UTA).
- CMED paid \$28 million for an acquisition from a seller who we believe was secretly related to CMED's chairman. Evidence also shows that CMED radically overpaid for the acquisition: a few months before selling the company to CMED, a company controlled by parties related to CMED insiders bought out minority shareholders at prices suggesting that the business was worth \$5-\$8 million, not the \$28 million paid by CMED for the acquisition. In our opinion, CMED's chairman orchestrated an acquisition to embezzle roughly \$20-\$23 million from the public company.
- CMED sold its primary business segment, responsible for the majority of the firm's sales since inception, to the chairman at less than 2x trailing EBITDA. We believe that this suspicious looking transaction was designed to cover up that the Chinese FDA was about to (or already had) suspended CMED's permit to sell HIFU products, thus rendering CMED's core business segment worthless almost overnight.
- Despite a purportedly profitable business, CMED is a serial capital raiser and has not generated free cash flow for most of its history. The company has spent twice as much on "investing activities" as it has purportedly generated from operations, so much like a typical Chinese fraud, it relies on debt or equity financing as its primary source of cash generation.
- CMED's balance sheet presents numerous highly suspicious red flags. CMED's receivables account for a much higher percentage of net revenues than its Chinese competitors and its Day Sales Outstanding are on average 141.9 days longer than a leading Chinese competitor, despite the fact that both companies sell similar products to similarly situated customers.
- In 2009, an anonymous letter to the audit committee accused senior management of committing fraud with respect to the company's financials and its acquisitions. After an investigation by the audit committee, CMED's auditor, KPMG, resigned.
- **Valuation:** As of September 30, 2011, CMED has \$413 million of debt outstanding, the holders of which would take priority over shareholders. Given the difficulty of recovering money against alleged fraudsters under China's corrupt and arbitrary judicial system, we believe that debt holders can at best hope to recover \$0.10 - \$0.20 on the dollar, putting the value of the equity at **\$0.00**.

Our Due Diligence Process

Glaucus Research Group California, LLC (“Glaucus Research”) engaged a team of 13 independent consultants (located both in China and the United States) with expertise in law, finance, medicine and accounting to examine CMED and the Chinese medical device sector over the last 12 weeks. Our consultants reviewed and analyzed the company’s SAIC filings, conference call transcripts, press releases and SEC filings.

Glaucus Research Group has disseminated independent research on U.S. listed Chinese companies for the past nine months. Our track record speaks for itself. For example, the New York Stock Exchange delisted the subject of our first report, Universal Travel Group (UTA), within weeks after we released our report alleging that UTA had defrauded investors.

We believe that in light of the evidence presented in this report, CMED’s independent directors have a fiduciary duty to conduct an independent investigation into the company. We also believe that PWC, CMED’s auditor, has a duty to investigate the evidence identified in our report when conducting the audit of the company for the fiscal year 2012.

Why CMED?

CMED is a medical device company that manufactures and markets immunodiagnostic and molecular diagnostic products for the detection of various cancers, diseases, and disorders, as well as companion diagnostic tests for targeted cancer drugs.

A few weeks ago an anonymous short seller posted a [blog entry](#) on GeoInvesting’s website alleging that CMED committed fraud by, among other things, overpaying for acquisitions from undisclosed related parties. We here at Glaucus Research follow the U.S.-listed Chinese space closely, so we were naturally curious. We decided to investigate the allegations of fraud.¹ Here is what we found.

We believe that the evidence supports the anonymous blogger’s allegations that CMED committed fraud by overpaying for an acquisition from an entity that appears to be secretly related to CMED’s founder, CEO and chairman. Although we could not verify all of the claims by the anonymous blogger, there are a host of other red flags to support the notion that CMED is the next Longtop (LFT) or Universal Travel (UTA).

Valuation

CMED claims to have \$206 million in cash and roughly \$413 million in debt (valued at par). In light of the recently uncovered evidence, we believe that such debt could be worth at most \$0.50 on the dollar (cash/debt ratio), but probably far less. Given the difficulty of recovering money against fraudsters in China’s corrupt judicial system, we believe that debt holders would be fortunate to recover \$0.10-\$0.20 on the dollar. Chinese courts are notoriously corrupt, arbitrary and protective of local businesses and industry. Notions of judicial independence do not apply. As a result, for foreign investors such as CMED’s debt holders, we suspect that litigating against a powerful local Chinese businessman in a Chinese court would be a Sisyphean task. Further hindering any prospect of recovery are any relationships CMED’s chairman may have with the local government or state owned enterprises, which would only magnify his influence over the judicial system.

Even if we are mistaken about the difficulty of recovering any cash, after paying off debt holders, there will be nothing left to pay off equity holders, **making CMED’s equity essentially worthless.**

¹ We have no affiliation with the author of the anonymous blog piece. However, upon noticing the allegations we contacted the author through the Geoinvesting message board to ask him about his research. He would only tell us that he was based in China but would not send us any evidence supporting his claims.

The Fraudulent Acquisition of BBE

We have found evidence in publicly available SAIC filings which, in our opinion, shows that CMED committed fraud by overpaying for an acquisition that was owned by a party secretly related to its chairman.

On November 26, 2007, CMED **announced** the acquisition of Beijing Bio-Ekon Biotechnology Co., Ltd. (“**BBE**”) from an allegedly independent third party for \$28.8 million, consideration to be paid in cash.


But according to publicly available filings in China, (a) the alleged ‘independent third-party seller’ is a party closely related to CMED’s founder, chairman and CEO, **Wu Xiaodong** (“**Chairman Wu**”) and (b) BBE was worth far less than the \$28 million CMED paid to acquire it. The evidence supports the allegation that Chairman Wu used a complex web of international shell companies and closely related lackeys to embezzle between \$20 and \$23 million from CMED’s investors.

COPS AND ROBBERS

Since the formation of BBE, publicly available SAIC filings show that the largest shareholder of the entity was a company named Beijing Yimin Weikang Technologies Co., Ltd. (The “**Chinese Front Company**”). The founder, chief executive and legal representative of the Chinese Front Company was none other than the former executive assistant to CMED’s Chairman Wu.

The resume below (English translation on the right side) shows that Shujun Chen (who we will refer to as the “**Cop**” because he is a former Beijing police officer) served as the “Assistant to the General Manager” of a privately-held company, Beijing Chengxuan Economic and Trade Co., Ltd. for almost three years. SAIC filings show that Chairman Wu was the Executive Director, legal representative and **General Manager** of the same entity. Chairman Wu and his wife were also **the two primary shareholders** of that entity.

法定代表人(分支机构负责人、个人独资企业投资人、执行合伙企业事务的合伙人)登记表

企业名称	北京益民卫康科技有限公司		
姓名	陈蜀军	性别	男
证件名称及号码	432922197702041714	国籍	中国
户籍登记住址	湖南省岳阳县水车岭乡五洲村 1号		
个人简历			
	起止年月	单位	职务
	95-1987	石塘咀镇派出所	警员
	1988-2001	北京益民卫康科技有限公司	任总经理助理
	2001.01-2008.12	北京益民卫康科技有限公司	任副总经理
注：应自具有完全民事行为能力之日起至今，并不得间断。 证明该任职人员具有完全民事行为能力，产生程序符合有关法律、法规和章程的规定，经任命(委派)出任企业法定代表人(负责人)。			
			盖章(签字) 年 月 日

1. 企业分支机构应在“盖章(签字)”处加盖企业公章；个人独资企业分支机构应在“盖章(签字)”处由投资人签字；合伙企业及其分支机构由全体合伙人在“盖章(签字)”处签字；其它类型企业不填。
 2. 本表不够填的，可复印续填。

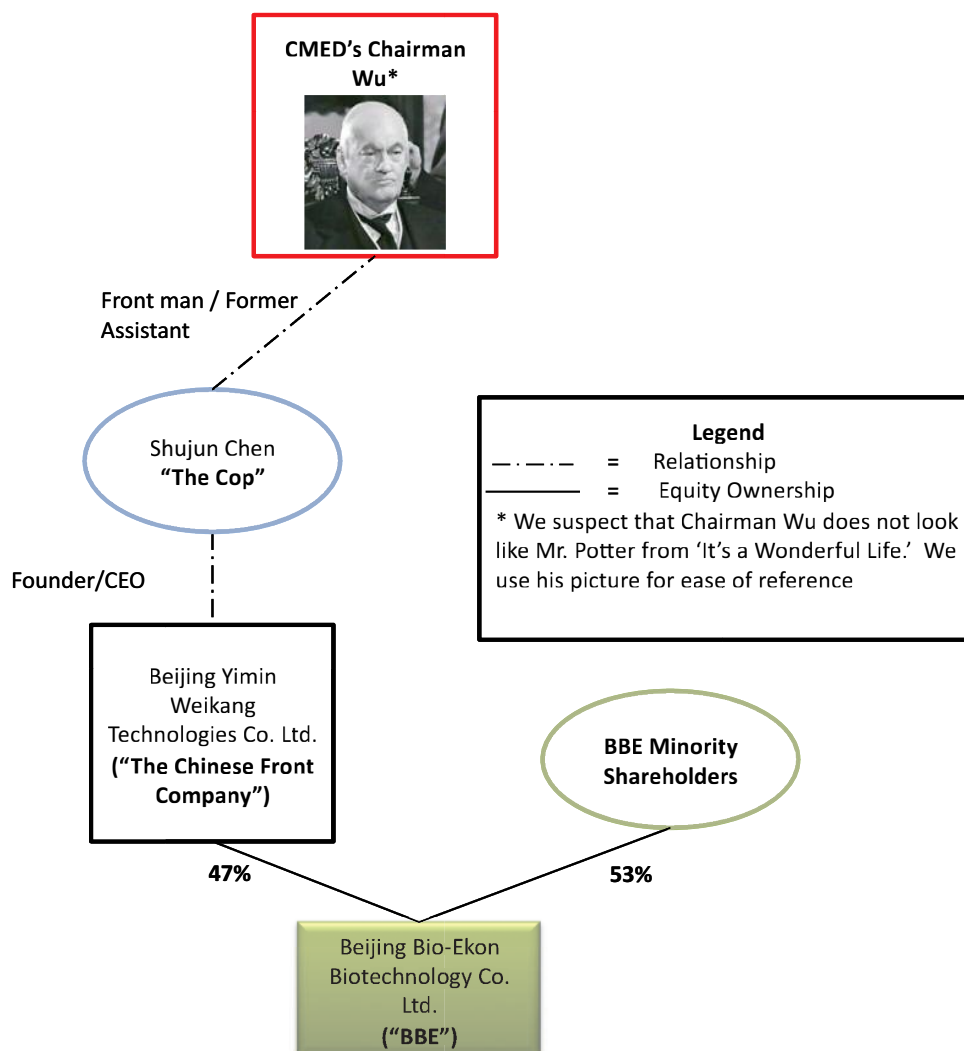
Registration Form of Legal Representative

(Branch manager, Investor of individual proprietorship enterprise or Partner who executes partnership affairs)

Company name	Beijing Yimin Weikang Technology Co., Ltd.			Photo
Name	Shujun Chen	Gender	Male	
ID Number	432922197702041714	Nationality	China	
Registered permanent address	Suite 1, Xinpu Village, Shuling Township, Dongan County, Hunan Province			
Personal CV				
Notes: Start from the date when the person has complete civil capacity without gap.	Time	Company	Title	
	Jul. 1995-Jul. 1998	Beijing Brigade of Armed Police Corps, doing communication work		
	Aug. 1998-Mar. 2001	Beijing Chengxuan Economics and Trade Company, Ltd.	General Manager Assistant	
	Apr. 2001-Dec. 2003	Beijing Qinglong Lake Technology and Trade Co., Ltd.	Vice General Manager	

The resume also shows that other than his experience as an executive assistant to Chairman Wu, the Cop had very little in the way of business experience. Connecting the dots, it appears that Chairman Wu had his former executive assistant serve as his front man for the Chinese Front Company, which was the primary shareholder of BBE.

In order to follow the complex web of multi-jurisdictional related party transactions, on the next page we have included the first in a series of slides.



MINORITY SHAREHOLDERS BE GONE!

After Chairman Wu took CMED public on U.S. capital markets, the Chinese Front Company (controlled by Chairman Wu's former assistant) bought out the other minority shareholders of BBE for \$0.16 - \$0.23 per share in separate transactions, each taking place between January and March of 2007.² These transactions indicate that the value of BBE was \$5-\$8 million, not even close to the \$28 million that CMED paid a few months later to acquire the business.

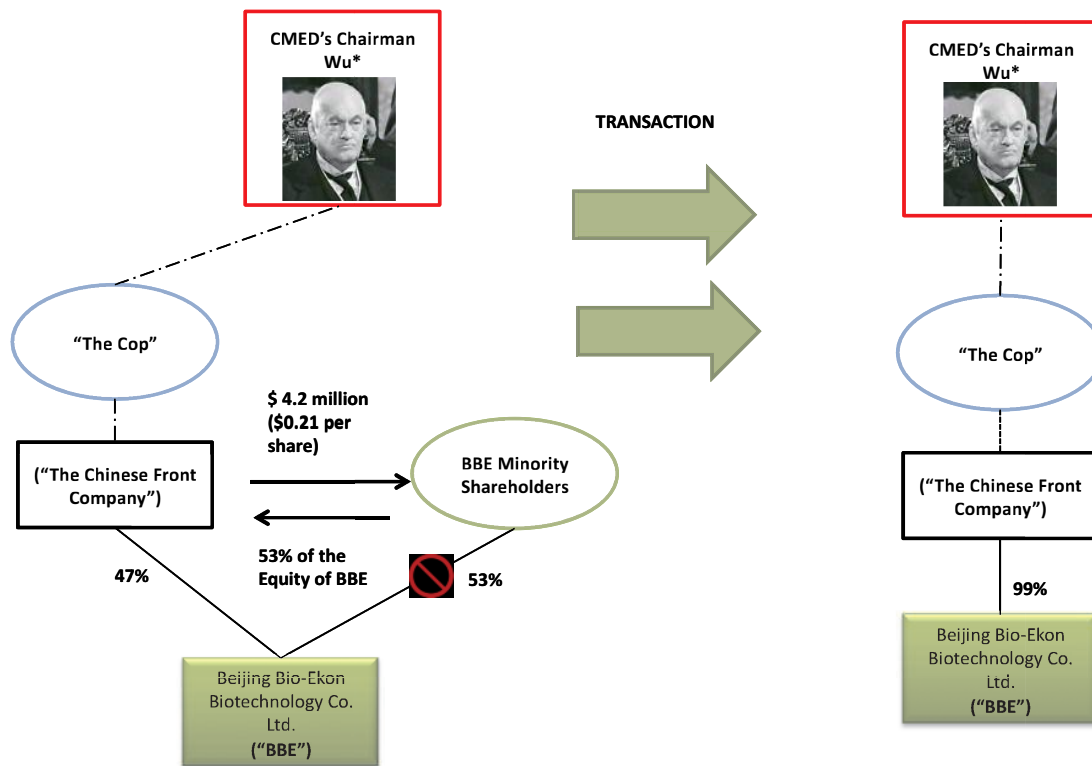
Below we calculated the weighted average price for the acquisition of BBE shares by the Chinese Front Company from minority shareholders and compared it to the price per share eventually paid by CMED.

COMPARISON OF PRICES PAID FOR SHARES OF BBE (USD\$)	TRANSACTION DATE	PRICE PER SHARE	IMPLIED VALUATION OF THE COMPANY
Minority Shareholder Sale Price	Jan. - March 2007	\$0.21	\$7,769,834
CMED Acquisition Price	Nov. 2007	\$0.78	\$28,800,000
Difference	8 - 10 months	271%	\$21,030,166

² For a full description of these transactions, please see the table in Appendix A and the SAIC filings we provided in a separate zip file available on our website.

We believe that Chairman Wu was using the Chinese Front Company to buy out the other minority shareholders of BBE in anticipation of selling BBE to CMED for a substantially inflated price. Thus, we believe that the share prices paid to other minority shareholders in January through March of 2007, which puts the value of BBE between \$5 - \$8 million, are a much closer approximation of the value of the company than the price CMED eventually paid for the acquisition. See below.

MINORITY SHAREHOLDERS BE GONE!

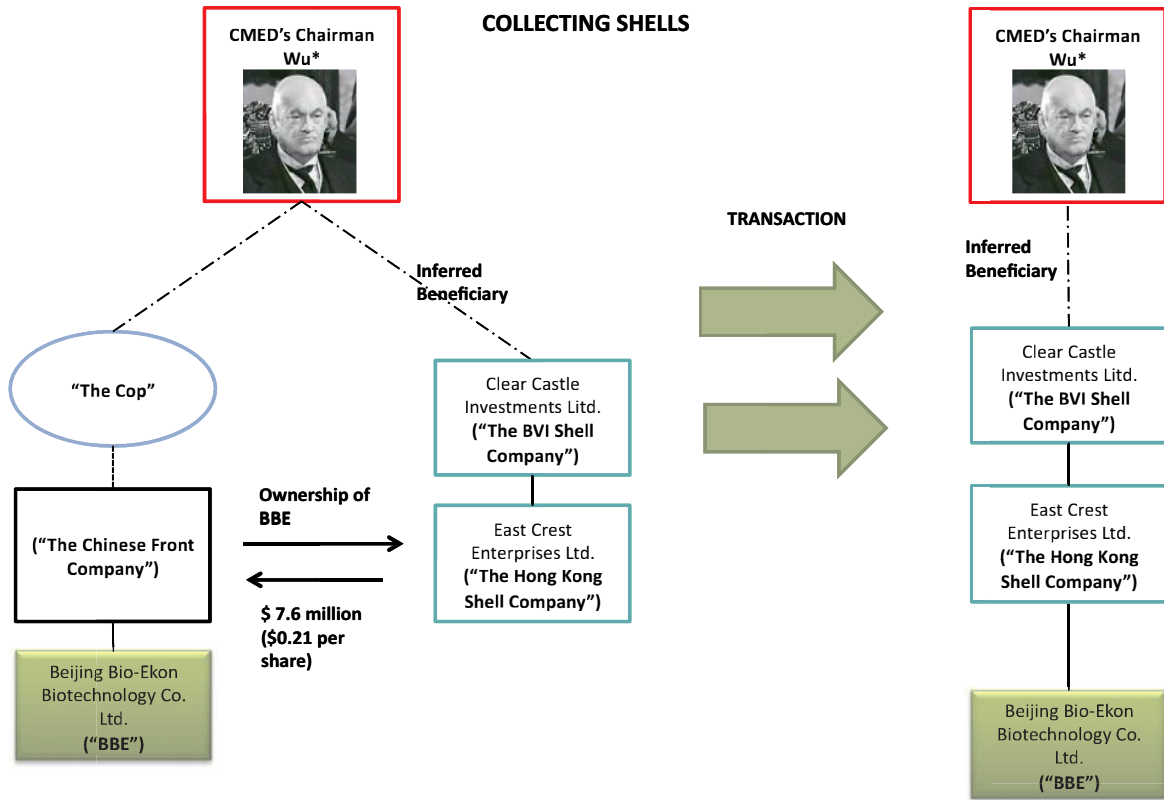


COLLECTING SHELLS

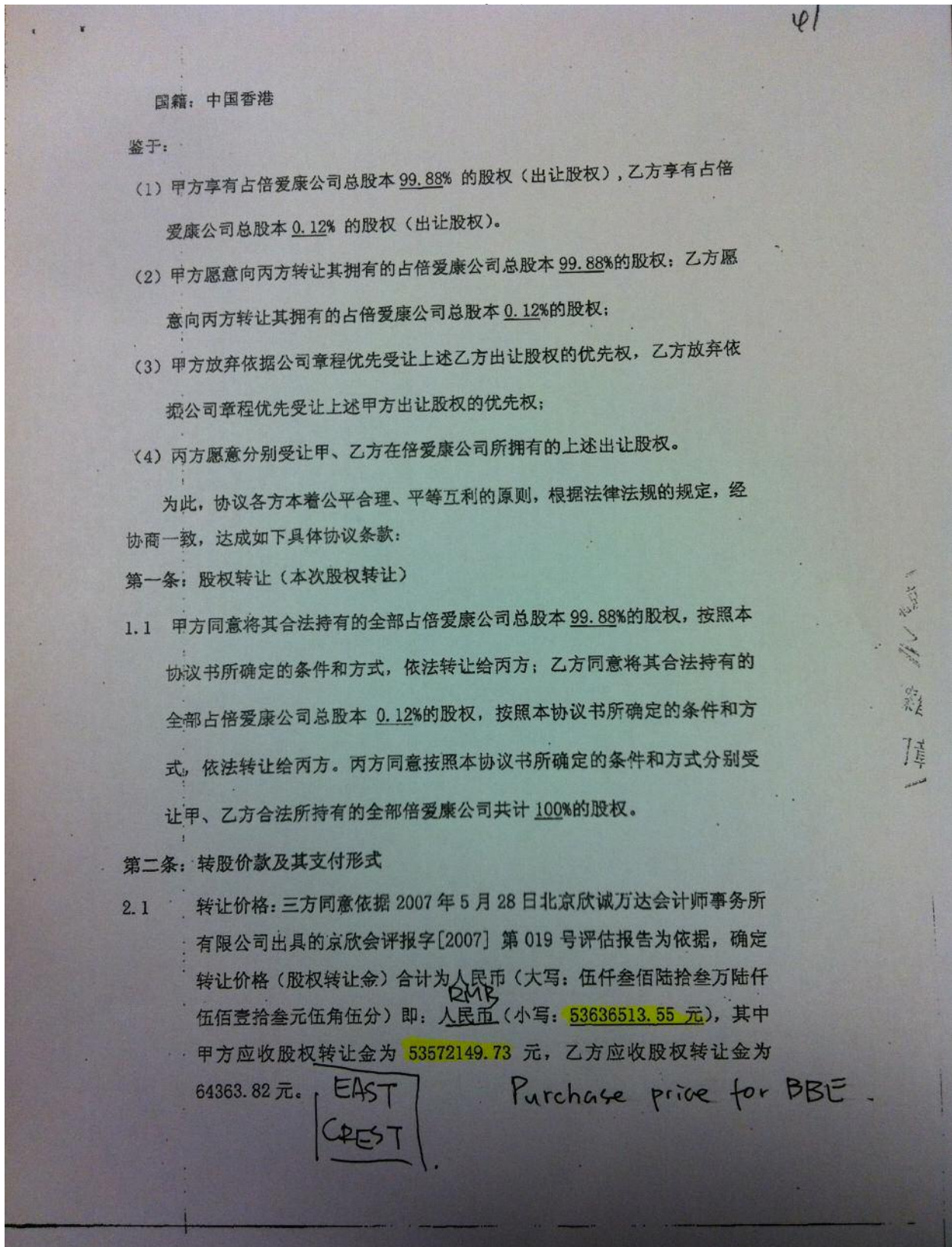
After buying out his minority partners, we believe that Chairman Wu controlled BBE through his Chinese Front Company. But this was not ideal, because any direct sale of the BBE business from the Chinese Front Company to CMED could easily be traced back to Chairman Wu through publicly available SAIC filings.

To circumvent the transparency of such a transaction, we suspect that in May of 2007, Chairman Wu had the Chinese Front Company sell BBE to a Hong Kong shell company called East Crest Enterprises Limited (the **Hong Kong Shell Company**). The Hong Kong Shell Company was, as our chosen nomenclature would suggest, nothing more than an empty shell. It had (and has) only 10,000 HK\$ in registered share capital and is owned by Clear Castle Investments Limited, a BVI entity (the **BVI Shell Company**).

The advantage of transferring BBE to the Hong Kong Shell Company (which was owned by the BVI Shell Company) is that the financials of privately-held Hong Kong and BVI companies are not publicly available. So, both Hong Kong and especially the BVI are **ideal jurisdictions to hide the identity of the beneficiaries of large cash payments**. We believe that CMED's Chairman Wu was the ultimate beneficiary of the BVI shell company.



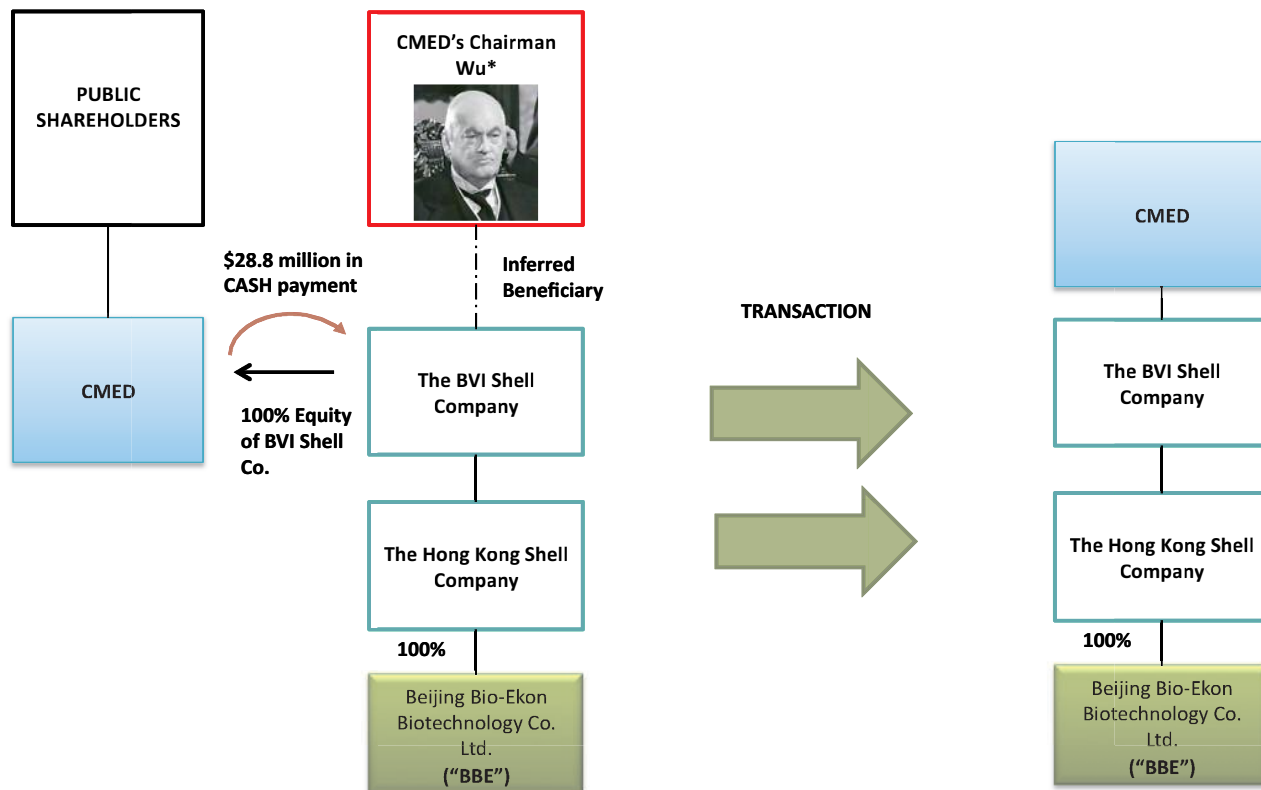
In May of 2007, just five months before CMED acquired BBE, we believe that Chairman Wu had his Chinese Front Company transfer BBE to his Hong Kong Shell Company for an **aggregate consideration of \$7.6 million**. Again, note that the purchase price is similar to the valuation put on the company by minority shareholders, and is substantially less than the \$28.8 million CMED paid to acquire BBE just a few months later. Here is the SAIC excerpt showing the transaction.



THE STING

After all of the pieces were in place, all that remained was to execute the final move. In November of 2007, a matter of months after three independent transactions established the value of BBE at a range of \$5.5 – \$8.4 million, CMED paid a whopping \$28.8 million for the company (\$0.78 per share).

THE STING



Other evidence supports the conclusion that CMED significantly overpaid for BBE. Notably, CMED failed to provide BBE’s income statement or balance sheet for the periods prior to the acquisition. Why? Probably because, according to SAIC filings, in the fiscal year prior to being acquired by CMED, BBE generated only **\$4 million in total sales** and lost over \$3.3 million in net income.

BBE SAIC FILINGS				
USD (CALENDAR YEAR END)	2006	2007	2008	2009
INCOME STATEMENT				
Gross Sales	\$4,246,790	\$3,921,612	\$2,897,589	\$2,466,990
Gross Profit	\$0	(\$3,306,220)	(\$233,452)	(\$801,797)
Net Profit/(Loss)	\$211,127	(\$3,306,220)	(\$233,452)	(\$801,797)
BALANCE SHEET				
Total Assets	\$9,581,598	\$6,117,204	\$6,348,260	\$5,500,984
Total Liabilities	\$2,577,746	\$2,304,807	\$2,769,315	\$2,705,021
Total Stockholders Equity	\$7,003,709	\$3,812,397	\$3,578,944	\$2,795,963

While not dispositive, we believe the meager sales and the paucity of assets on the balance sheet provide supporting evidence to what the previous section already showed: CMED paid way too much for BBE.

The allegation that Chairman Wu was the ultimate beneficiary of the \$28 million payment by the company to acquire BBE is supported by the fact that CMED **deliberately concealed the identity of the seller(s) of BBE**.

Suspiciously, CMED was silent on the identity of the seller in the [Form 6-K](#) announcing the acquisition. The company put out a detailed press release describing BBE's business, but conveniently left out any mention of the counterparty to the transaction.

In the [Form 20-F](#) for the FY 2007, CMED stated that it acquired BBE from Finnea International Limited (“**Finnea**”). We now know from BBE's SAIC filings that no entity named Finnea ever owned BBE. Suspiciously, CMED did not give any jurisdiction of incorporation for Finnea. Nor did we find any reference to Finnea when conducting Baidu and Google searches. We can find no evidence that Finnea ever existed.³ We believe that the company made up Finnea to distract investigators from the real beneficiary, Chairman Wu, who cashed in through his alphabet soup of global dummy corporations and front men.

We may not have been the only ones to notice the caper. On November 19, 2007, shortly before the company announced the BBE acquisition, Cole Carpenter, an independent director and member of CMED's audit committee, [resigned](#). While we acknowledge that the timing may be purely coincidence, we find it suspicious that a member of the audit committee resigned on the eve of a transaction wreaking of impropriety.

In conclusion, the chain of custody supports the allegations of fraud. Here is how we suspect the transaction played out. Chairman Wu set up a company in the name of his personal assistant (the Chinese Front Company), which owned a significant stake in BBE. He then bought out the minority shareholders in BBE at prices suggesting the company was worth \$5 – \$8 million. Once in control of the entity, he needed to cover his tracks. So he then transferred BBE from the Chinese Front Company to the Hong Kong Shell Company, which was controlled by the BVI Shell Company. This would allow all of the proceeds of the sale to flow directly to the BVI Shell Company, which sat in a jurisdiction where **no one could discover who got the cash from the sale**. Chairman Wu then had CMED buy the asset for \$28 million, thus embezzling anywhere from \$20 to \$23 million from U.S. capital markets.

Note that in the 18 months before the BBE acquisition, CMED successfully executed an IPO and a secondary equity offering and issued convertible debt. In the Chinese RTO space, we have seen many examples of companies diverting cash raised from capital markets by overpaying for acquisitions from parties related to insiders. In our opinion, CMED followed this playbook to the letter.

The HIFU Hustle

One of our immutable rules of investing in China: if you notice something incredibly shady that would not pass a smell test for a U.S.-based firm, do not dismiss it simply because ‘it's China.’ When we put CMED under the microscope, we noticed another transaction that we doubt any American public company could get away with.

In December of 2008, [CMED sold](#) its primary business segment to Chengxuan International, Ltd., a company owned by Chairman Wu, CMED's founder, chairman and CEO, for \$53.5 million.⁴ The sale of the HIFU business was no spinoff of a minor asset. Rather, according to the company's [IPO filings](#), CMED's “primary product [was] the HIFU therapy system.” The price was also startling: CMED sold its primary business segment to the chairman/CEO at less than 2x the EBITDA of the prior fiscal year.

We think that this transaction was an elaborate ruse. In our opinion, the purpose of the hasty and strange sale of CMED's primary business to its chairman was to **conceal** that the business segment was worthless (or soon to be worthless) because the Chinese government was going to (or had) terminated CMED's right to sell HIFU products.

Instead of disclosing the true value of the HIFU business to investors, which would have undoubtedly damaged the price of CMED's stock, CMED concealed key negative developments in order to keep its stock price high, enabling it to raise roughly \$240 million in high-yield debt from capital markets before dumping the purportedly valuable asset at a fire-sale price.

Supporting evidence for our line of reasoning include the facts that: (a) CMED's permit to sell HIFU products expired on January 25, 2007, two years before the sale of the HIFU business, and was not renewed thereafter, (b) the company did not disclose the ‘independent’ evaluation supposedly conducted at the time of the sale or the identity of the ‘independent’ evaluator who allegedly valued the business, (c) the HIFU business was still purportedly profitable and accounted for the majority of the company's net revenue over the previous four years, (d) Chairman Wu paid less than 2x EBITDA for the business and (e) the entity that purportedly bought the business could not legally do business in China.

³ Further, in its Form 20-F from fiscal year 2007, CMED's structure [chart shows](#) that BBE is directly owned by CMED ECLIA Diagnostics Limited. Yet [just one year later](#), CMED's Form 20-F shows that BBE is directly owned by East Crest and Clear Castle. Why would CMED deceive investors at the time of the acquisition as to the identity of sellers?

⁴ To be clear, CMED disclosed at the time of the transaction that it was selling its HIFU business to Chairman Wu.

THE REGULATORY GUILLOTINE

Publicly available [filings on the website](#) of the State Food and Drug Administration of China (“SFDA” or “Chinese FDA”) (shown below) state that CMED’s permit to sell HIFU products **expired on January 25, 2007**, and was not renewed thereafter.

(JPEG Image, 772x535 pixels)

<https://mail.google.com/mail/?ui=2&ik=ba66467f4e&view=att&th=13...>

国产器械		返回
生产场所		Modified Company Name
附件		
生产企业名称	由原“北京源德生物医学工程股份有限公司”变更为“北京源德生物医学工程有限公司”。生产企业注册	
备注 地址	由“北京经济技术开发区中和街4号”变更为“北京经济技术开发区永昌北路24号1号楼”；原注册号为“国药管械(准)字2003第3230044号”变更为“国药管械(准)字2003第3230044(更)”。原注册证自发证之日起作废。	
注册号	国药管械(准)字2003第3230044号(更)	Registration Number
生产单位	北京源德生物医学工程有限公司	
地址	北京经济技术开发区永昌北路24号1号楼	Address
邮编		
产品名称	高能聚焦超声肿瘤治疗机	
产品标准	YZB/国 0042-2002《FEP-BY系列高能聚焦超声肿瘤治疗机》	
产品性能结构及组成	由控制台、电源柜、治疗床三部分组成。治疗床包括功率超声辐射器、超定位系统、位移系统、水路系统及相关驱动电路。控制台分为超影像系统、手动控制操作系统及计算机系统。电源柜包括整机主电源开关与功率超声辐射驱动电路等部分。超声换能器电源输出波形为正弦波，频率为1.1MHz±15%；焦点处最大声强值不小于1000W/cm ² 。辐射区域：径向不大于3mm，轴向不大于10mm。	
有效期	2007.01.25	Expiration Date
批准日期	2003.01.25	Date Granted
产品适用范围	用于临床乳腺肿瘤、四肢及表浅组织肿瘤或骨肉瘤、肝脏(左叶)、肾脏及盆腔实体肿瘤的局部姑息性灭活治疗。	
规格型号	FEP-BY02	
变更日期	2005.05.20	Modification Date

返回

The timeline is simple. CMED's permit to sell HIFU products expired on January 25, 2007. The permit was not renewed. CMED divested the HIFU business roughly **700 days later**. What happened during the missing 700 days? Was CMED selling HIFU products illegally? Did the SFDA notify CMED that its permit would not be renewed? Admittedly, we can only speculate based on the circumstantial evidence.

According to our Chinese counsel, CMED would have been permitted to sell HIFU products even after the expiration of its permit if its application for renewal was pending before the SFDA. Our Chinese attorneys told us that the SFDA normally processes permit renewal applications in *90 days*, although because of a backlog in 2007-2008, it would have been *possible* for CMED's renewal application to be stuck in limbo for much longer (even up to 2 years). It is our opinion that if the SFDA typically takes 90 days to renew an application, it is unlikely that it took 700 days to review CMED's HIFU submission.

Even giving CMED the benefit of the doubt, we believe that CMED had **good reason to believe that its permit would not be renewed**, but **failed to disclose this material risk to investors**. Why? Because CMED tells us so.

On the company's first conference call following the sale of the HIFU business, CMED's management team stated that the "Chinese FDA is getting more strict approving [HIFU] of therapeutic equipment. And they are putting more strict regulations when they approve this kind of therapeutic equipment. So this also affects the prospects of the HIFU business."

CMED's executive continued (grammatical errors in the original transcript): "[i]n the past we get our original approval for HIFU business, for HIFU system, the SFDA approve a very broad range of indication, including so that can enable us to treat tumors in different parts of the body. **Now the regulation requires us to submit the clinical cases for each single indications**. This makes it very hard to get this broad approval as before, so that we have to narrow the treatment range and that end result will push us, force us to either lower the selling price of the HIFU system or **postpone the sale of HIFU system to hospitals**, because it is very hard for us to provide so many clinical cases in **such short notice**."

Essentially CMED claimed to have been **taken by surprise** by new SFDA regulations requiring more clinical trials in conjunction with the sale of the HIFU products. Thus it rushed to divest the HIFU business. But is it credible that such regulations **came out of nowhere with no grace period**? We do not have any expertise, so we retained a prominent Chinese law firm to tell us the answer.

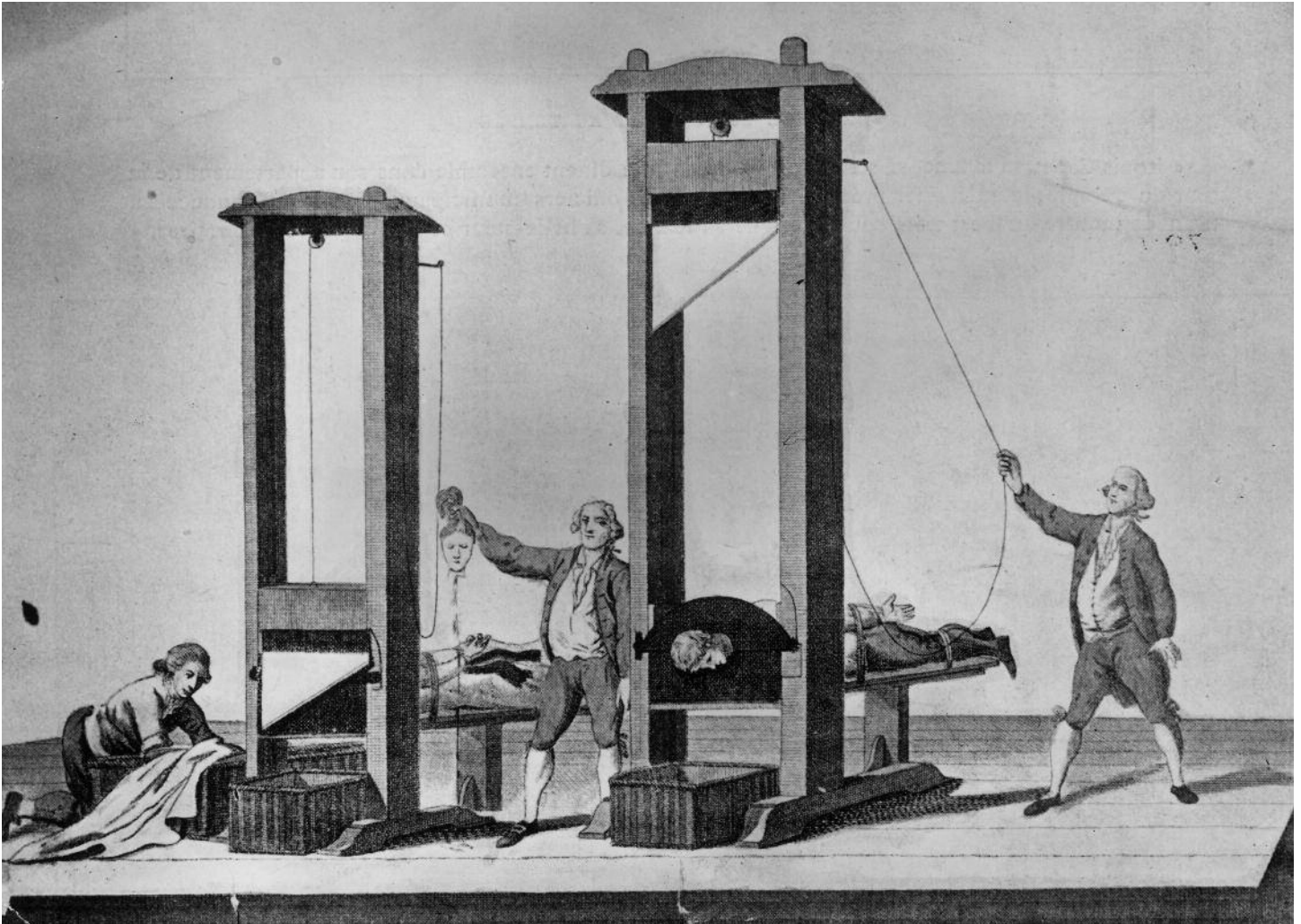
According to our attorneys in China, the SFDA promulgated several new regulations in **2004 and 2005** which (just as CMED said) required stricter criteria for the approval of medical device products, including regulations requiring more clinical trials. In other words, while CMED's management appears to have told the truth about China's changing legal landscape, management may have not been **truthful about timing**. The new regulations to which CMED's officer referred were passed in 2004-2005, almost **three to four years before** the sale of the HIFU business.

It therefore appears disingenuous for CMED to argue that it was caught by surprise in **Fall-Winter of 2008** by new and more stringent SFDA regulations, which required further clinical study for CMED's HIFU products, when such regulations were adopted in **2004-2005**. After all, CMED's Chinese competitors in the HIFU market appear not to have been disrupted by the new regulations during that timeframe. Do not believe us? Browse around on the websites or the filings for Chongqing Haifu (HIFU) Technology Co., Ltd or Shanghai A&S Science Technology Development Co., Ltd., both of which sold and continued to sell HIFU products without a hitch throughout the same period.

Here is the rub.

If CMED's management knew about the new SFDA regulations since 2004–2005, they would have also known that when their permit to sell HIFU products expired in January of 2007, it was in jeopardy of not being renewed. CMED's management would most likely have known that they had not performed the required clinical trials to keep selling HIFU products. Without regulatory approval, CMED could not sell HIFU products to Chinese hospitals. **Thus, as soon as the SFDA rejected CMED's renewal application, the HIFU business would become worthless overnight.**

In effect, CMED's core business dangled precariously under the threat of a regulatory guillotine.



We believe that the real reason behind the hasty sale of the business to the chairman in December of 2008 was that the Chinese FDA was about to reject (or had rejected) CMED's application to renew its HIFU permit. With a regulatory guillotine poised treacherously overhead (or possibly dropped), it is our suspicion that CMED arranged a hasty sale of the business to the chairman instead of disclosing to investors that the SFDA was about to (or had) shut down its primary product segment. Why else would a company sell such a profitable cornerstone business?

SELLING THE CROWN JEWEL

Support for the notion that the government was about to (or had) crack(ed) down on CMED's HIFU business is that **it did not make sense for CMED to sell such a purportedly profitable core business**. After all, the HIFU business accounted for a majority of the company's net revenue over the four years prior to the divestiture.

SEGMENT INFORMATION	FY 2005	FY 2006	FY 2007	FY 2008	4-YR TOTAL
Percentage of Net Revenue					
HIFU Rev. %	81.5%	66.4%	60.6%	40.2%	54.8%
ECLIA Rev. %	18.5%	33.6%	39.4%	41.6%	37.1%
MD Rev. %	0.0%	0.0%	0.0%	18.2%	8.1%

Prior to the divestiture, the HIFU segment accounted for almost 55% of the company's total net revenue over the previous four fiscal years. Further, although growth of the HIFU business had slowed, the *reported* gross margins on HIFU products were still an impressive 72.6%. We pulled the data in the table below from CMED's public filings.

SEGMENT INFORMATION	FY 2006	FY 2007	FY 2008
HIFU % Gross Margin	70.5%	71.7%	72.6%
ECLIA % Gross Margin	69.9%	73.2%	72.9%
MD % Gross Margin			14.7%
% Gross Margin	70.3%	72.3%	62.2%
HIFU % YoY Net Rev. Growth	39.3%	34.2%	11.1%
ECLIA % YoY Net Rev. Growth	210.1%	72.6%	76.5%

As the above chart shows, prior to the divestiture, although growth had slowed, the HIFU segment's gross margins (72.6%) were still significantly above the industry average in the Chinese medical device market (51%).⁵ If the HIFU business was still quite profitable and operating at spectacular gross margins relative to CMED's Chinese competitors, why divest it?

An even better question: why divest the business **for so cheap a price?**

BUY HIGH, SELL LOW?

Not only did CMED sell its primary business to its founder/chairman/CEO but it sold the business at a remarkably low price. In the fiscal year prior to the sale, the HIFU business was generating gross margins of 72.6% and a FY 2008 EBITDA of \$32.6 million.

HIFU BUSINESS SEGMENT	FY 2006	FY 2007	FY 2008
TTM EBITDA	\$18,951,524	\$28,500,385	\$32,620,417

CMED sold its primary business segment to the chairman/CEO for an aggregate consideration of \$53 million, a price less than 2x EBITDA for the previous FY.⁶ Again, why sell such a profitable business at such a low price to a related party?

⁵ Deutsche Bank: China Healthcare: Sustainable Growth Ahead; a buy/sellside's perspective. August 25, 2010.

⁶ Even more odd, the sale of its primary business came out of nowhere. On the company's Q1 2008 conference call, taking place on August 4, 2008 (four months before the divestiture), the company announced that "Q1 revenues from the sales of our HIFU systems increased 11.6% year-over-year." The company went on to project that "HIFU revenues will have a positive contribution to the company, positive growth in our HIFU business, which include the whole HIFU business that means domestic and overseas opportunity."

COVER UP

On the company's first conference call following the sale of the HIFU business, CMED's management team tried to justify the suspicious divestiture by reporting that almost immediately after the sale of the HIFU business to the chairman, **sales for the HIFU business dropped sharply 76% year-over-year. Essentially, according to the company, the HIFU business died overnight, immediately after CMED sold it.**

CMED's Vice President Feng Zhu explained that the decline of HIFU sales was driven "mainly because of the economic downturn." He continued that CMED's customers, many of whom finance their purchase of CMED's HIFU diagnostic products on credit, could not finance such purchases in a tightening credit market in China. He concluded: "so we actually predict[ed] this kind of slowdown and its part of the reason we decide to sell our HIFU business."

Stop to consider this ludicrous explanation: CMED wants investors/regulators/auditors to believe that it sold the only part of its business that was vulnerable to the risk of an economic slowdown **to its own Chairman** immediately prior to the downturn. This does not make sense for a number of reasons.

First, the economic downturn was already in full swing by the time CMED consummated the divestiture. Bear Stearns collapsed in March of 2008. Asian markets descended into panic in the middle of 2008. Lehman precipitated the collapse of U.S. markets in September of 2008. Throughout that **entire period until December 2008**, the **HIFU business appears to have been generating healthy net income and an industry-beating gross margin of 72.4%.**

Second, CMED sold its HIFU products to the same hospitals and dealers to which it also sold products from its other business segments. If tightening credit for such customers accounted for a drop in sales by 76% year-over-year, then why were CMED's other business segments (ECLIA; FISH) not affected? Third, it seems a stretch for CMED executives to claim that they sold the HIFU business in anticipation of the global economic downturn coming (and its second and third order impacts on CMED's customers) but its Chairman and CEO, who purchased the HIFU business, did not.

In other words, the explanation that the economic downturn precipitated the sale of the HIFU business sounds like it fell straight down from a bull's backside.

THE PHANTOM INDEPENDENT EVALUATION

The suspicion that the sale of the HIFU business was to cover up shenanigans (in our opinion, most likely a looming or incipient regulatory crackdown) is compounded by the lack of any independent oversight of the sale.

Although CMED [protested](#) that it “engaged a qualified and reputable international firm to carry out an independent valuation of the HIFU Business,” it disclosed neither the report **nor even the identity of the independent evaluator**.

If the independent evaluator was indeed a reputable international firm, why would CMED not disclose the firm’s identity? The identity of a reputable firm would give shareholders and prospective investors comfort that a global brand stood behind an independent evaluation of the HIFU business. We suspect that the only reason CMED did not disclose the identity of the evaluator was because the firm was neither highly reputable nor truly independent. That is, if indeed they ever actually retained an independent evaluator.

BUSINESS WAS WORTHLESS... AND THEY KNEW IT!

An additional suspicious detail is that CMED purportedly sold the HIFU business to Chengxuan International Limited, a [BVI entity](#). Why is this unusual?

If the ‘sale’ of the HIFU business was legitimate, CMED should have sold the business to a Chinese subsidiary of the BVI entity because BVI entities are not permitted to sell medical products manufactured in China to Chinese hospitals. The buyer of the CMED business, Chengxuan International Limited, appears to have been a BVI **holding company that could not actually sell HIFU products in China**. This makes the whole transaction look like a sham.

Why arrange a transaction with a BVI entity that could not take delivery of a working business? The **primary benefit of selling the business to a BVI entity is that, because of strict privacy laws in the BVI, any payments to or from Chengxuan International Limited would be kept secret**.

A FINAL WRINKLE

One final question must be bothering the careful investor: if the HIFU business was indeed worthless, why would CMED’s Chairman Wu agree to pay cash to CMED in exchange for an allegedly worthless HIFU business?

First, consider the function of the company in this scenario. If indeed CMED was (and is) a massive fraud, Chairman Wu’s main goal would have been to keep the stock price of the public company as high as possible to enable him and other insiders to tap capital markets and defraud U.S. investors of money.

Therefore Chairman Wu would have tried his utmost to prevent the circulation of any bad news about the company. If the Chinese SFDA barred CMED from selling its primary product, then CMED’s stock price would have undoubtedly suffered (probably badly). Rather than weather the storm of negative publicity and the decline in stock price if Chinese regulators halted CMED’s primary business segment, the easy solution from Chairman Wu’s perspective was just to ‘buy’ the business.

Second, we have no evidence that Chairman Wu actually paid cash to CMED for the HIFU business. Again, the primary benefit to purchasing the HIFU business through a BVI entity would be that **no investor or regulator could verify that such an entity ever paid any cash for the acquisition**. The drawback, of course, is that the BVI entity cannot sell HIFU products, but if regulators are shutting it down anyway, no big deal.

The story took one more surreal turn. After the sale of the HIFU business, Chairman Wu threatened to sue CMED because the SFDA did not approve the renewal of the permit to sell HIFU products. A clever investor may ask: why would Chairman Wu ever threaten to sue the company if he wanted to divert negative attention from CMED and the transaction?

We believe that this suit was a cleverly disguised attempt by Chairman Wu to **justify the low sale price of the business**. After all, most reasonable investors would be scratching their heads wondering why CMED sold such a purportedly profitable business to its chairman at so cheap a price. They may even think that the chairman defrauded the company by acquiring a great business at less than 2x EBITDA.

But by threatening to sue the company (and never actually following through on the threats), Chairman Wu makes it seem like **he got screwed** and CMED's shareholders actually came out on top. What better way to convince investors that they got a good price on a related party divestiture than to **beat your chest and say that you got the short end of the stick.**

We are not so easily fooled, primarily because the lawsuit makes no sense. Chairman Wu alleged that CMED screwed him. He complained that CMED sold him a worthless business that could not pass regulatory muster. But as founder, CEO and chairman of CMED, Chairman Wu would surely have been intimately familiar with the HIFU business. Chairman Wu was basically alleging that he screwed himself, which we find unlikely, at least in the financial context.

Also, he only threatened to sue. He never followed through, which makes his threats look more like they were meant to divert attention from the low sale price of the HIFU business.

CONNECTING THE DOTS

In sum, it is our opinion that the hasty divestiture of CMED's HIFU business was an attempt to cover up the fact that a regulatory guillotine had rendered (or was about to render) the business nearly worthless. In case you missed it, here are the (rather unbelievable) facts.

FACT 1: CMED IPOs in the U.S. on the strength of its HIFU business.

FACT 2: From its IPO date, CMED tells its investors that the sale of HIFU products is a growing and super-profitable business.

FACT 3: In January of 2007, CMED's permit to sell HIFU products expires. Despite new regulations that would appear to jeopardize the renewal of its permit, **CMED's management team does not tell investors of any such risks.**

FACT 4: In August of 2008, CMED raises \$240 million from the capital markets of August 2008 by issuing high yield debt. It does not mention in its bond prospectus that there is a material risk that the Chinese SFDA will not renew its HIFU permit.

FACT 5: In December of 2008, 700 days after permit expiration and out of blue, CMED sells its supposedly super-profitable core business segment to its chairman at what looks to be a bargain-basement price.

FACT 6: CMED sold the HIFU business to a BVI holding company that could not operate the HIFU business or sell products in China, but this ensured that **any payments to or from the BVI buyer would be secret from investors and regulators.**

FACT 7: CMED has failed to disclose either the 'independent evaluation' of HIFU or even the identity of the firm that supposedly conducted an 'independent evaluation.'

At best, it appears that CMED failed to disclose to investors the material risk that the Chinese FDA would reject its permit to sell HIFU products. At worst it appears a hasty, ill-conceived and **deliberately deceptive cover up** by management.

Where is the Free Cash?

CMED shares many other characteristics with Chinese companies that have been delisted on account of fraud. Despite its purported profitability, CMED is a serial capital raiser and has not generated free cash for most of its history.

USD	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	SUM
Net cash generated from operating activities	\$23,844,571	\$51,571,286	\$66,190,571	\$70,108,286	\$39,982,429	\$32,025,143	\$283,722,286
Net cash used in investing activities	(\$19,539,714)	(\$126,350,714)	(\$118,793,000)	(\$209,599,286)	(\$102,217,429)	\$13,452,714	(\$563,047,429)
CFO + CFI	\$4,304,857	(\$74,779,429)	(\$52,602,429)	(\$139,491,000)	(\$62,235,000)	\$45,477,857	(\$279,325,143)
Net cash generated from/(used in) financing activities	\$114,919,714	\$124,507,714	(\$12,307,000)	\$250,185,286	\$29,294,429	(\$428,571)	\$506,171,571

This table says it all. Despite a purportedly profitable business, CMED does not organically generate free cash flow. Rather, it relies on debt or equity financing for cash flow.

The reason is that throughout most of the company's history, the amount of cash that the company has used in investing activities (primarily acquisitions) has exceeded, in most years by a large margin, cash purportedly generated from operations.

The totals are staggering. CMED has raised \$500 million from the capital markets and "invested" over \$563 million in acquisitions or capital expenditures. In the last six years, net cash used in investing more than doubled net cash generated from operations.

For a business as purportedly profitable as CMED, its primary source of cash is selling debt or issuing equity to the capital markets, which should make any investor familiar with the U.S.-listed Chinese space to run for the hills.

A Good Way to Hide Fake Sales

Companies committing fraud often inflate receivables as a way to hide fictitious sales figures. Here the glove fits nicely as CMED's accounts receivable are enormous and out of line with its competitors.

CMED has two product segments: (x) immunodiagnostic products (ECLIA), which CMED sells through third party distributors and (y) molecular diagnostic products (FISH/SPR-HPV), which CMED sells directly to small to medium-size hospitals.

Notably, CMED's competitor, Mindray Medical (MR), sells medical devices to the same customers (distributors and small/medium size hospitals). Despite a similar customer base, CMED's accounts receivable are suspiciously large.

	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010	AVG.
Accounts Receivable as a % of Net Revenues						
MINDRAY	7.0%	9.8%	16.4%	17.9%	20.3%	14.3%
CMED	41.9%	93.6%	52.9%	41.3%	42.0%	54.3%
Difference	4.9x	8.6x	2.2x	1.3x	1.1x	2.8x
Receivables Turnover						
MINDRAY	17.05	13.94	9.24	6.25	5.49	10.4
CMED	2.4	1.2	2.2	2.6	2.2	2.1
Difference	7.1x	11.6x	4.1x	2.4x	2.5x	5.5x
Day Sales Outstanding						
MINDRAY	21.41	26.19	39.51	58.44	66.51	42.41
CMED	152.9	302.7	163.9	139.1	163.1	184.4
Difference (In # of Days)	131.5	276.5	124.4	80.7	96.6	141.9

Over the past 5 years, CMED's receivables accounted for a significantly greater percentage of net revenues compared to MR. Also, CMED's Day Sales Outstanding show that MR's customers pay their bills on average **142** days faster than MR.

Note that MR's international sales cannot account for the difference. According to MR's SEC filings, the increase in MR's DSOs from 2008 to 2009/2010 was because international sales began to account for a significant proportion of its net revenues, and according to the company, "international customers generally have longer credit terms than our China-based customers." When MR was selling medical devices to Chinese distributors and small/medium size hospitals, which are CMED's customers, MR's DSOs were **even lower**.

Since the end of the Company's last fiscal year, CMED's receivables look even worse. According to Deutsche Bank's November 2011 report on the company, CMED's DSOs were an astonishing 230 days as of the last quarter. Not only is this a 57% increase year over year, but comparatively, MR's customers pay up 162 days faster than CMED's customers.

The bottom line? Receivables are an easy way for management to hide exaggerated revenues on the balance sheet. Given that CMED supposedly generates a healthy net income but very little free cash flow (see previous section), unusually high accounts receivable stand out as a significant accounting red flag and, in our opinion, suggest that the company is vastly exaggerating its sales and net income.

Un-Intellectual Property

CMED's balance sheet contains another glaring red flag. As demonstrated by the chart below, 60% of the total assets on CMED's balance sheet are composed of 'intangible assets' in the form of unpatented technology, the value of which are determined by management.

CMED'S INTANGIBLE ASSETS FYE 3/31, RMB (THOUSANDS)	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
Total Intangible Assets	224,744	1,565,362	1,541,793	3,487,474	3,285,190	2,973,358
Unpatented Technology	174,681	1,504,917	1,485,844	3,437,836	3,245,561	2,943,624
Non Compete Agreements	40,513	51,514	45,653	38,881	30,084	21,142
Patented Technology	9,550	8,931	8,311	7,691	7,071	6,719
Customer Relationships	0	0	1,985	1,851	1,716	1,582
Assembled Workforce	0	0	0	1,215	758	291
Total Assets	1,375,841	3,192,228	2,931,804	5,783,176	4,909,069	4,948,062
% of Unpatented Technology	13%	47%	51%	59%	66%	59%

As this table shows, the majority of the intangible assets listed on CMED's balance sheet are unpatented technology and technical know-how which were obtained in the FISH/SPR acquisition. According to the company, "the fair values of our identifiable intangible assets [i.e., the unpatented technology] were determined by management with the assistance of independent appraisers..."

Management's valuation of this technology is questionable, given that the technical know-how is not protected intellectual property.

It is also highly questionable that, as always with CMED, the company does not disclose the identity of 'independent appraisers' conducting purportedly independent valuations of the company's intangible assets. Nor do they make available to investors the independent valuation reports.

The fact that CMED's balance sheet is so heavily weighted toward unpatented technology, the value of which is determined by management, is a major red flag.

Uncredible Margins

Given that CMED's medical devices are not based on technology that is patent-protected, we would expect mediocre gross and operating margins when compared with industry competitors.

Yet according to CMED's SEC financials, the company's margins significantly outperform its competitors. CMED has reported gross margins, operating income margins and net income margins that are **spectacular when compared with the industry average for Chinese medical device companies.**⁷

MEDICAL DEVICE MARKET	CHINESE MEDICAL DEVICE MANUFACTURERS INDUSTRY AVG.	CMED (FY)		
		2008 FY	2009 FY	2010 FY
	2009			
Gross Margin	51.4%	71.1%	85.3%	82.3%
Operating Income Margin	25.0%	57.4%	70.6%	53.2%
Net Income Margin	21.5%	54.5%	68.2%	50.4%

CMED sells commoditized products based on technology that is not protected by a patent (see discussion above of CMED's unpatented intangible assets). In addition, because of CMED's small size (relative to competitors), it should have less leverage to negotiate better premiums with distributors and small/medium-size hospitals.

Yet CMED's SEC financials show exactly the opposite: its **gross margins, operating margins and net income margins are so spectacular that they defy credibility.** In our experience, if margins look too good to be true, they probably are.

Other Insiders Notice Something Rotten

In April 2009, CMED's audit committee received an anonymous letter alleging that the company's senior management was engaged in accounting fraud in connection with the company's acquisitions of FISH and SPR and its divestiture of the HIFU business, as well as its revenues. The audit committee (consisting of three independent directors) initiated an investigation and retained a prestigious American law firm (Paul Weiss) and an independent forensic accountant (AlixPartners) to examine the accusations.

On July 30, 2009, CMED announced that the law firm and forensic accountants had completed their investigations and reported to the audit committee "that the investigation has not identified evidence to support the allegations made in the anonymous letter." So far so good, you might say.

But not so fast. Notably, CMED did not make available to the public the results of the investigation, including findings of the audit committee or any findings, reports or conclusions of the investigating law firm or forensic accountants.

We suspect that the result must not have been positive because after "completion" of the internal investigation by the audit committee, KPMG, CMED's auditor since going public in 2005, resigned. The timing of KPMG's resignation is inherently suspicious, as the accounting firm stepped down after completion of the investigation and during CMED's annual audit. PWC replaced KPMG and has audited the company's financials since August of 2009.

Other Related Party Transactions

CMED, it seems, only transacts with companies owned or controlled by its CEO/chairman.

In February of 2004, CMED entered into a purchase agreement with Beijing Weixiao for the purchase of a building that is currently used as the company's offices, manufacturing facilities and research and development center for RMB64.8 million (U.S.\$7.8 million), of which, the prepayment of RMB60.0 million (U.S.\$7.2 million) was made in March of 2003 and the remaining RMB4.8 million (U.S.\$0.6 million) was paid in April of 2004.

Prior to going public, CMED also acquired its ECLIA/immunodiagnostic business from Beijing Weixiao Biological Technology Development Co., Ltd ("Beijing Weixiao"), a company owned by CMED's Chairman Wu, for \$30.2 million in August of 2004, one month prior to the launch of the ECLIA system to the market.

⁷ Deutsche Bank: China Healthcare: Sustainable Growth Ahead; a buy/sellside's perspective. August 25, 2010.

According to the company, \$12 million of the proceeds from the initial public offering went to pay Beijing Weixiao and Chairman Wu for the acquisition of the ECLIA/immunodiagnostic business.

The company disclosed both related party transactions. But given the preponderance of the evidence that CMED has abused transactions with its chairman to either defraud or deceive shareholders, we believe that the purchase of a \$7.8 million building and a \$30.2 million unproven ECLIA business both warrant suspicion.

Disclaimer

We are short sellers. We are biased. So are long investors. So is the company. So are the banks that raised money for the company. If you are invested (either long or short) in CMED, so are you. Just because we are biased does not mean we are wrong.

You are reading a short-biased research report. Obviously, we will make money if the price of CMED's stock declines. You can publicly access any piece of evidence cited in this report or that we relied on to write this report. Think critically about our report and do your own homework before making any investment decision.

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APPENDIX A

	DATE	BUYER	SELLER	SHARES	PRICE/SHARE (USD)	TOTAL AMOUNT PAID (USD)	IMPLIED VALUATION OF THE COMPANY (USD)	REF:BBE SAIC PAGE
The Chinese Front Company Buys Out Minority Shareholders	1/8/07	Chinese Front Company (北京益民卫康科技有限公司- Yimin)	Minority Shareholder (北京市丰台区综合投资有限公司)	3,699,070	\$0.17	\$646,283	\$6,462,829	728-737
	1/24/07	Chinese Front Company (北京益民卫康科技有限公司- Yimin)	Minority Shareholder (刘岩华 Yanhua Liu)	739,814	\$0.16	\$116,256	\$5,812,824	722-727
	3/8/07	Chinese Front Company (北京益民卫康科技有限公司- Yimin)	Minority Shareholder (武汉华工创业投资有限责任公司)	15,099,482	\$0.23	\$3,451,310	\$8,455,016	544-549
	3/13/07	商少宏 Shaohong Shang	Minority Shareholder (仲琦 Qi Zhong)	44,874	\$0.16	\$7,051	\$5,812,824	550-555
BBE is Transferred from the Chinese Front Company to the Hong Kong Shell Company	5/30/07	Hong Kong Shell Company (东峰企业有限公司 East Crest)	Chinese Front Company (北京益民卫康科技有限公司- Yimin)	36,945,825	\$0.21	\$7,653,164	\$7,662,459	623-628
	5/30/07	Hong Kong Shell Company (东峰企业有限公司 East Crest)	商少宏 Shaohong Shang	44,874	\$0.20	\$9,194	\$7,579,516	623-628
CMED Buys BBE	11/26/07	CMED	Hong Kong Shell Company (东峰企业有限公司 East Crest)	36,990,699	\$0.78	\$28,800,000	\$28,800,000	SEC Filings