PRESCIENCE
INVESTMENT GROUP

pre·science (prĕsh'əns)
n. Knowledge of events before they occur; foresight.

Yongye International, Inc. (NASDAQ: YONG)

In this report, we present a number of reasons why investors in Yongye International, Inc. ("YONG" or the "Company") should be especially cautious. We believe that YONG's business activities are riddled with undisclosed related party transactions and that its revenue and profit may be overstated in its filings with the SEC. Further, we urge the NASDAQ and the SEC to look into Yongye's largest sources of revenue in an effort to protect public shareholders and defend the integrity of US financial markets. Our evidence includes:

- In connection with YONG's registration of the recent Morgan Stanley investment with the Securities and Exchange Commission, the SEC forced YONG to disclose the names of its primary customers. An independent source indicates that Yongye is vastly overstating sales to one of its main distributors. **Two of the disclosed key customers appear to be related parties**, **casting doubt over YONG's reported revenue and providing a potential mechanism by which to mislead KPMG, its auditor since 2009.** For this reason we urge NASDAQ and SEC interjection. **We would also note that these three highly dubious customers made up $67 million – or one third of all -- of Yongye's revenue for fiscal year 2010.**
- On May 31, YONG announce that Morgan Stanley would be investing $50mm into the Company via the purchase of convertible preferred stock. The deal is marvelously structured as a win-win for Morgan Stanley. Should YONG violate any number of covenants, Morgan Stanley reserves the right to simply walk away with its capital and earn an IRR of 30%. The structure magnifies losses attributable to common shareholders in the downside scenario, which we view as most likely. **There are several key catalysts that give MS the right to withdraw its investment at a 30% IRR, one of which is if YONG engages in ANY transaction with related parties (see first bullet).**
- Prior reports pertaining to YONG by other analysts -- including the ones here, here, here, here and here -- have done an excellent job documenting potential related party transactions, unusual accounting, the potential siphoning of corporate assets via sham acquisitions, and the destruction of shareholder value through excessive dilution. Management's rebuttals can be found here, here and here.

We estimate fundamental value for YONG is $0.53/share (assuming possibility of any recovery).

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As a cautious investment manager we go to great lengths and commit substantial resources to verifying the claims companies make in their filings with the United States Securities and Exchange Commission (the "SEC"). To date, two of four of the companies we have exposed as engaging in fraudulent behavior have been halted from trading (ABAT and APWR). In addition, the SEC is pursuing a detailed investigation into APWR to determine whether it or any of its personnel violated the federal securities laws.

Consistent in nature with those and other troubled Chinese RTOs we've assessed in the past, a thorough analysis of YONG's accounts and filings reveals numerous red flags, including:

- Declining earnings quality
- Exaggerated claims of product efficacy
- A lack of required disclosure and transparency in spite of well-established US financial market regulations
- Egregious transfers of wealth to undisclosed recipients in the name of strategic acquisitions

Prior reports pertaining to YONG by other analysts -- including the ones here, here, here, here and here -- have done an excellent job documenting potential related party transactions, unusual accounting, the potential siphoning of corporate assets via sham acquisitions, and the destruction of shareholder value through excessive dilution. Management's rebuttals can be found here, here and here.

In this report, we'll shed light on current events and new information recently made public that casts doubt over YONG's reported revenue and provides a potential mechanism by which to mislead its auditor KPMG.

Valuation

Based on a careful assessment of the evidence, we believe Yongye International has historically served as a conduit for transferring wealth from outside investors into the pockets of Company affiliates. Since we believe the Company has no valuable technology or intellectual property and because we are doubtful of its supplier and customer relationships, we are forced to value the Company based on its liquidation value.

In addition, because we believe the Company to be transacting with related parties, we cannot rely on the values of assets and liabilities in its financial reports and assume that, with the exception of PP&E, they offset one another. Our valuation handicaps the value of YONG's PP&E to $17 million, 80% of its Q3 balance sheet value. Adding the value of adjusted PP&E to the $80.5 million YONG reports on its books, less $71.5 million in claims ranking senior to the common equity, divided by the number of share outstanding results in a residual value of $0.53/share.

We estimate fundamental value for YONG is $0.53/share (assuming the possibility of any recovery).

Overview

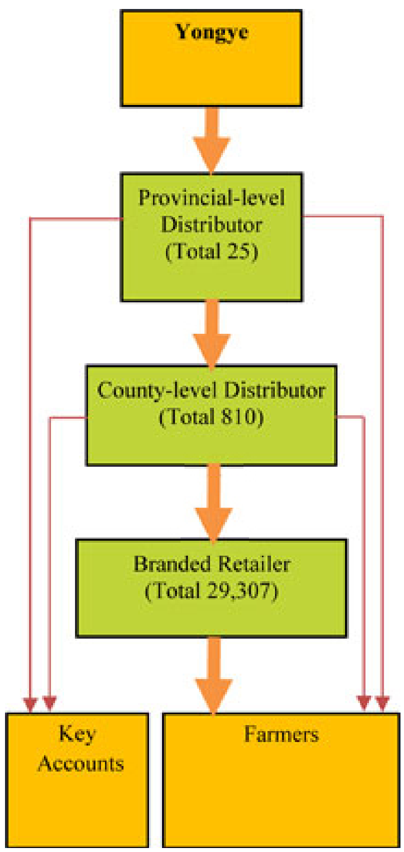
For many investors, Morgan Stanley Private Equity Asia's ("Morgan Stanley") late-May decision to make a $50 million investment in Chinese fertilizer producer Yongye International (YONG) was seen as an all-clear signal. But while Morgan Stanley's investment served as a seeming affirmation of the Company, the investment did not sweep away the allegations made in previous reports that Yongye was engaging in questionable business practices and that some of its financial statements didn't seem to make sense. The SEC had some concerns of its own, sending some sharply worded questions to Yongye regarding its recent filings.

After taking a further look at the SEC's information request and Yongye's replies, our due diligence has uncovered several deeply troubling concerns about the Company's reported operations, including:

- An independent source shows that Yongye is vastly overstating sales to one of its main distributors
- One of Yongye's "independent distributors" appears to be a related party run by a Yongye employee
- Another of Yongye's "independent distributors" appears to in fact be nothing other than Yongye's own corporate-owned and operated Hebei Marketing Center

The SEC Forces YONG's Hand: What Was The Company Hiding?

Yongye sells its products through a distribution model comprised of provincial distributors who purchase its products and sell them through a chain of local distributors whose terminal sales point is either a retail store or a large farm.



Yongye has historically not disclosed the names of its largest provincial-level distributors (i.e. its largest customers), instead labeling them as simply "Customer A", "Customer B" and so on in the Company's SEC filings. Per the 2010 10-k:

For the year ended December 31, 2010			For the year ended December 31, 2009		
Largest Customers	Amount of Sales	% Total Sales	Largest Customers	Amount of Sales	% Total Sales
Customer A	$ 33,173,293	16%	Customer B	$ 29,004,998	30%
Customer B	32,633,201	15%	Customer D	18,534,320	19%
Customer C	20,069,116	9%	Customer A	16,745,156	17%
Customer D	18,578,908	9%	Customer F	9,950,840	10%
Customer E	15,317,393	7%	Customer G	6,038,692	6%
Total	$ 119,771,911	56%	Total	$ 80,274,006	82%

The practice appears to be a clear violation of SEC regulation S-K, Item 101, which requires public companies to disclose significant customers that make up ≥10% of a Company's sales. Yongye was duly criticized for this practice.

In response to criticism, Yongye management issued the following in response:

> *Employing one of the favorite tactics of the short sellers, or those who conspire with them, the Author notes that we do not name our distributors and then suggests that the fact that we seem to be hiding something evidences our bad faith and "might" indicate that there is "a chance" that our distributors are related parties. Our decision not to publicize those names is for competitive reasons, and there is nothing wrong with it. We provide those names to our auditors to be used for their audit procedures on the financial statements. Once again, the facts, not the Author's clever innuendo, are important.*

The SEC seemed to disagree with management's response and forced Yongye's hand, stating the following in its information request: "Please describe to us in detail the nature of your relationship with each of your five major distributors. Tell us how each relationship does not meet the related party criteria outlined in ASC 850-10-20. Include in your description information about each distributor, including whether they have physical facilities or employees. Also tell us what portion of their business you comprise."

Yongye responded with a table listing the names, locations, and percentage of Yongye's products sold as compared with the distributor's total sales. Yongye further warrantied that nothing else was amiss. Among other things, Yongye made the following claims:

- "The distributors are not our affiliates,"
- "We have no equity interests in our distributors nor have we provided any short or long term loans or advances to the distributors. In addition, none of our employees (including our management and their immediate family members) holds any equity interests in our distributors,"
- "None of our employees and their immediate family members are owners of our distributors or related to the distributors' principal owner nor were involved in the initial establishment of the distributors,"
- "We do not control and cannot significantly influence the management or operating policies of our distributors."

Our research finds Yongye's statements to be extremely unlikely to be accurate. In fact, we have found major concerns with at least three of Yongye's five purported main customers (not including the questions raised by other analysts regarding the necessity of the Hebei provincial distributor acquisition – the fourth of Yongye's five main customers). **We would like to also note that these three highly dubious customers made up $67 million – or one third – of all of Yongye's purported revenue for Fiscal Year 2010**.

Name of Distributor	Location	Percentage of our products sold by the distributor to total distributor's sales
Shenzhen Jiuzhoufangyuan Related Party?	Shenzhen, Guangdong	over 50%
Hebei Wansheng (former provincial distributor)	Hebei	No business transactions after July 2010
Jinan Nongxiang	Jinan, Shandong	over 50%
Bameng Jingshirong Overstating Revenues Greatly?	Inner Mongolia	Less than 20%
Shijiazhuang Jichuang Related Party?	Shijiazhuang, Hebei	over 50%

Shenzhen Jiuzhoufangyuan Appears To Be A Related Party To Yongye

Shenzhen Jiuzhoufangyuan (深圳九州方圆科技发展有限公司 or 深圳市九州方圆科技发展有限公司) is supposedly an independent distributor of Yongye's products. However, our research finds that **Shenzhen Jiuzhoufangyuan is operated by the same man, Mr. Dan Shen Hua (沈丹华) who also operates Yongye's Group Marketing Center**. This article from a Chinese newspaper lists Mr. Dan Shen Hua as the general manager of Yongye's South China Marketing Center. However, this description of Shenzhen Jiuzhousfangyuan – Yongye's supposed independent supplier – shows that the distributor's contact person is Mr. Dan Shen Hua, the same as of Yongye's Group Marketing Center.

Furthermore, we would note that the primary business of Shenzhen Jiuzhousfangyuan is in distributing mobile technology products such as MP3 players, cameras, and electronic dictionaries. Please note that this is the exact same business – distributing PDAs and MP3 players – that Yongye engaged in during 2003 before abruptly shifting to fertilizer sales several years later. We believe it is highly likely that Mr. Dan Shen Hua's Shenzhen Jiuzhousfangyuan is a related party to Yongye. In fact, it seems probable that Mr. Dan Shen Hua has worked for Yongye for quite a few years, thus casting the Company's entire response to the SEC into doubt. We don't see how either of the following statements made by Yongye can be true if a long-term Yongye employee runs one of Yongye's largest distributors:

- "None of our employees and their immediate family members are owners of our distributors or related to the distributors' principal owner nor were involved in the initial establishment of the distributors,"
- "We do not control and cannot significantly influence the management or operating policies of our distributors"

Shijiazhuang Jichuang – A Supposed Customer – Appears To Be Yongye's Marketing Center

Yongye claims that Shijiazhuang Jichuang (石家庄冀创方大商贸有限公司简介) is a key customer of the Company. But our research finds that Shijazhuang Jichuang is likely a part of Yongye rather than an independent customer of the Company. For example, we'd note this job advertisement for Shijiazhuang Jichuang. While the job advertisement is ostensibly for Shijazhuang Jichuang – a supposed entity independent of Yongye – when one reads the advertisement, it becomes clear that this is an advertisement to work for Yongye itself.

The advertised job is a finance position to work in helping Yongye with tax issues, accounting, finance, and other related issues. In the job listing, we see that the Company size is listed as 100-499, which seems highly unlikely for a small distributor, and we see that the Company lists itself as part of Yongye and proudly touts the success of Yongye and its ability to get a listing on the Nasdaq stock exchange. Once again, it is hard to believe any claim that Shijiazhuang Jichuang is an independent party when a job listing for Shijiazhuang Jichuang appears to be trying to fill a position in Yongye's Hebei Marketing Center. And of course, if Yongye listed its own marketing center as an independent distributor, this would raise great alarm regarding the trustworthiness of Yongye's SEC filings and the reliability of its revenue claims.

Bameng Jingshirong: Does This Distributor Even Exist At All?

Unlike the previous two listed distributors, where we were able to find the Chinese names of the distributors, we had no such luck with Bameng Jingshirong. In Yongye's SEC letter, the Company chose not to disclose the Chinese names of its entities. Internet searches turn up no sign of this distributor in any way.

However, we have found fairly compelling evidence that Bameng Jingshirong cannot exist – at least not in anything close to the size that Yongye reports it to be. Bameng Jingshirong, which is purportedly Yongye's distributor in Yongye's home province of Inner Mongolia, was supposed to have provided $19 million in revenue to Yongye in 2010.

However, an authoritative list from this year of the largest 100 enterprises in the Inner Mongolia province found no traces of Bameng Jingshirong whatsoever. Yongye Nongfeng Biotechnology, the Chinese subsidiary of Yongye International – placed on the list at #34 with revenues of 1.45 billion RMB ($227 million). However, Bameng Jingshirong is not in the top 100. This is inexplicable if Yongye's SEC response letter is accurate.

In Yongye's letter, the Company claims that Bameng Jingshirong represented $19 million of revenue and that less than 20% of Bameng Jingshirong's sales were of Yongye's products. This means that, at minimum, Bameng Jingshirong had to have sold at least $95 million of products in 2010. This would mean the Company should have reported at least 600 million Yuan of revenue in 2010, which would have easily qualified it for the list of 100 largest Inner Mongolian based enterprises. At the very minimum, the Company should have placed at #52 (where a business with 600 million Yuan of revenue would fall) on the top 100 largest companies. Instead, presumably Bameng Jingshirong was not large enough to even make the list, which would have required only 123 million Yuan ($19 million) of revenue. Yongye appears to be overstating the size of Bameng Jingshirong by at least 4/5ths. And as we stated previously, we could find no proof that Bameng Jingshirong exists in any form whatsoever.

Morgan Stanley's Marvelously-Structured Show Of Confidence

On May 31, Yongye announced that Morgan Stanley would be investing $50 million into the Company via a Series A Convertible Preferred security. Because Yongye had been covered by a shroud of uncertainty, investment in the Company from a premier financial institution like Morgan Stanley felt to equity investors like clean bill of health.

A Bloomberg article followed that painted the picture of Yongye as a battleground stock in the China RTO space, the main characters being Morgan Stanley on the one side and the short selling 'hedge funds' on the other.

In reality, they aren't on opposite sides at all. An examination of the deal structure (see the Securities Purchase Agreement and the Certificate of Designation) indicates that Morgan Stanley was very concerned about the potential downside scenario – the "Fraud Scenario". As a matter of fact we believe that given the possible outcomes, Morgan Stanley's presence is a net negative for common shareholders and has the potential to accelerate the collapse in stock price when the YONG story begins to unfold. The terms of the MS deal are structured such that MS can force early redemption (and be compensated with a 30% IRR) in the occurrence of any of the following events (not to mention many more) if not cured within 90 days:

- The Company is suspended or delisted by the NASDAQ
- Any required financial report is not filed on a timely basis, including the 10-k, audited by a Big 4 auditor with required audit opinions
- **The Company engages in ANY related party transaction (in accordance with the above section, if our assessment is accurate, YONG is in violation of this covenant (Covenant 8.15))**
- **The Company does not obtain, without any additional material consideration, the exploration rights (探矿权) and the mining rights (采矿权) to and the environmental evaluation approval of the lignite coal mine located at Wuchuan county (武川县上秃亥乡枳笈滩风化煤矿) on or prior to December 31, 2011 (Covenant 8.28; Post-Closing Covenant, Section 6).**

Related to the final bullet, Yongye announced on September 6, 2011 that it had obtained an "approval for mineral resource exploration" of the lignite coal mine. Our understanding is that if the Company does not receive the "mining rights" and the "environmental evaluation approval" by December 31, 2011 it will be in violation of this critical covenant as well, another trigger giving Morgan Stanley the right to force early redemption and collect penalty interest on its investment in the form of a 30% compounding annual rate of interest return.

These aren't the only ways that Morgan Stanley wins, of course. Should Yongye survive and continue posting a parabolic rate of earnings growth (which we consider highly unlikely due to the laws of physics), Morgan Stanley will receive a payoff several years down the line in common equity at what is likely to be multiples of the current price. If Yongye's growth slows, falling below 20% in any six rolling quarters, MS has the right to force early redemption and achieve a 20% IRR.

The point is that MS has structured what on the surface appears a win-win, a deal likely made possible by management desperation during a period in which the stock price was plummeting… a win for Morgan Stanley; a loss for common shareholders. We'd like to remind Morgan Stanley, however, that C.V. Starr placed a similarly structured investment in China Mediaexpress (OTC: CCME), only to discover that in actuality there was no cash to walk away with.

Conclusion

Yongye has a history of being on the defensive, and with good reason. Investors and analysts have for the past year or so hurled accusations of fraud at the Company, with its seemingly too good to be true business model and its refusal to disclose the identities of who it's doing business with and who it's transferring tens of millions of dollars to in exchange for assets of dubious quality. The Company has been cloaked in a shroud of opacity, one that has begun unraveling at an accelerated pace as new information comes to the surface and new eyes are drawn to the story.

In light of the sharp questions the SEC pointed at Yongye, we strongly believe that the Company may still be playing fast and loose with the facts as it seeks to present a bullish case to investors. Furthermore, our research into the Company's suppliers indicates that the Company is almost certainly misleading investors about the nature of the Company's relationship with at least three of its supposedly five most important customers. **We would like to again highlight that these three highly dubious customers made up $67 million – or one third – of all of Yongye's purported revenue for Fiscal Year 2010.** If these distributors are something less than what the Company states, Yongye's numbers may be materially different than what has been reported to the SEC. We find Yongye's answer to the SEC's question regarding its largest customers to be straining to credibility, and we urge KPMG to take a long, hard look at Yongye's largest sources of revenue before signing off on the Company's books during the Company's upcoming FY11 audit.

We urge common shareholders to think independently about the Company's prospects. Morgan Stanley holds an advantaged position in the capital structure and has structured a deal that isn't necessarily aligned with common shareholder interests. Further, based on our analysis, it appears Yongye is already in violation of covenant 8.15 of the Securities Purchase Agreement, which if true gives Morgan Stanley the option to walk away with a big 30% IRR payoff, to the detriment of common shareholders.

In summary, we find various parts of Yongye's response to the SEC's questions wholly inadequate, and we have great doubts regarding Yongye's customers and its purported revenues. We urge the SEC and the NASDAQ to take a look at Yongye's largest sources of revenue in an effort to protect public shareholders and defend the integrity of US financial markets.

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