



BEIJING BAOFENG TECHNOLOGY

Recommendation: Short

Written By: Michael Gorton

Disclosure

I currently have no position in any of the stocks mentioned in this report

Some documents may contain errors due to the translation from Chinese to English

Market price at the close of the market on June 10th was used for Beijing Baofeng Technology, Co due to the trading halt



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Company: Beijing Baofeng Technology, Co.
Stock Number: 300431:CH
Recommendation: Short
Price Per Share: 307.56 CNY
Stock Exchange: Shenzhen



Source: Bloomberg

Background

Beijing Baofeng Technology Co Ltd is an internet company that provides video and audio entertainment services. They do this by operating multiple softwares such as storm PC, storm wireless application, and BFVCenter video browser. In addition, they have a video converter and have recently launched a virtual reality headset. The video entertainment services are provided for free, but the firm generates the majority of their revenues from advertising (free + advertising business model). There are over 200 million active users per month and more than 50 million daily active users according to the company's CEO.

IPO

Baofeng went public on the Shenzhen Stock Exchange on March 24th at a price of 7.14 yuan (\$1.14) per share. The Flotation was oversubscribed by almost 300 times and the stock price increased 30 trading sessions in a row following the IPO date. The current price is ¥307.56 per share, 43 times higher than it was on the day it went public. As of June 10th, trading has been halted due to the pending disclosure of an important issue.

Founder/Chairman: Feng Xin

Feng Xin graduated from the Hefei Industrial University School of Management. He previously held positions at Kingsoft and Yahoo China before he went on to found Baofeng Technology. As of April 2015, he owned 25.5 million shares (21.3%) of Storm Technology stock that is worth about 7.82 billion yuan (\$1.25 billion).

Valuation

	Market Cap (millions)	P/S	P/B	P/E
Baofeng (USD)	\$ 5,942.00	74.3	96.5	654
Youku Todou (USD)	\$ 5,755.00	7.8	2.6	Loss
Leshi Internet (USD)	\$ 19,640.00	15.3	37.2	325.8
Tencent (USD)	\$ 189,428.00	14	13.3	47.9
Baidu (USD)	\$ 72,915.00	8.7	8.3	34.7
Google (USD)	\$ 374,112.00	5.6	3.4	27.2
Industry Average	\$ 10,598.00	6.8	4.1	33.4

Source: Morningstar; Data provided by Bloomberg for Baofeng (TTM)
Note: Market cap converted for Baofeng and Leshi at CNY:USD exchange rate of .161

Company	Price/Revenue	Price/Earnings	Price/ Book Value
AOL (1999)	29x	179x	45x
Amazon.com (1999)	14x	Loss	88x
Yahoo! (1999)	148x	1,425x	69x
Baofeng (2015)*	96x	880x	128x

Source: 1999 Fairfax Chairmen letter; Market Cap of 36.9 billion CNY and financial data at the end of 12/2014 was used for Baofeng

Catalysts/Risks

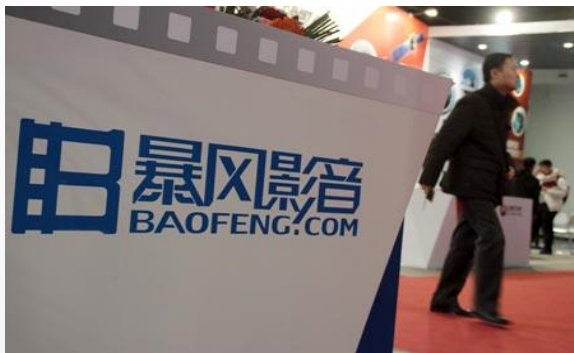
<u>Catalysts</u>	<u>Risks</u>
Central Bank stops its loose monetary policy	Euphoric investor sentiment continues
Recession	Central Bank continues its loose monetary policy
Regulation	No lock up period coming up
Investors realize the overvaluation	
Earnings miss	
Copyright infringement	

Conclusion

The trading halt in Baofeng's stock has put a lot of uncertainty in a short position. There hasn't been much explanation for the trading halt except that it is pending the disclosure of an important issue, but it could be due to regulators investigating potential stock manipulation. New rules have also been proposed to limit margin requirements. This can affect the ability to borrow shares to execute a short position. Despite these obstacles, I still feel that Beijing Baofeng Tech (300431:CH) is a very intriguing short position due to the overly optimistic assumptions that the market is discounting into the price. The TTM P/E is 654, TTM P/S is 74, and TTM P/B is 97; all multiples are at similar levels to what some of the most overvalued tech companies of 1999-2000 were trading at. The high assumptions that are assumed into the price have led me to the conclusion that if trading continues, a short position is very intriguing at this level.

Background

- Beijing Baofeng Technology Co Ltd is an internet company that provides video and audio entertainment services. They do this by operating multiple softwares such as storm PC, storm wireless application, and BFVCenter video browser. In addition, they have a video converter and they recently launched a virtual reality headset. The video entertainment services are provided for free, but the firm generates the majority of their revenues from advertising (free + advertising business model). There are over 200 million active users per month and more than 50 million daily active users according to the company's CEO.



Source: Wantchinatimes.com



Source: Android.tgbus.com

Background

- Sector: Technology
- Industry: Software
- Sub Industry: Application Software
- Headquarter Address: 13F, Shouheng Technology Mansion



Source: Google Maps

No. 51 Xueyuan Road
Haidian District
BEIJING, BEJ 100191
China

- Number of Employees: 660

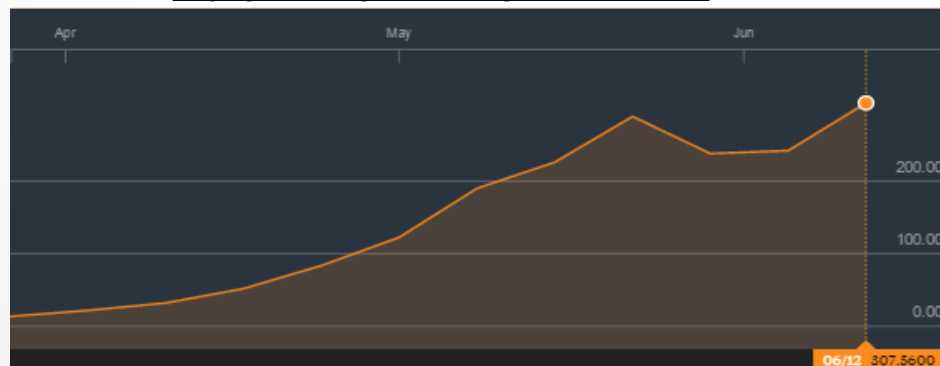
Stock Information

- Stock Exchange: Shenzhen
- Stock Number: 300431:CH
- Price Per Share: 307.56 CNY
- Shares Outstanding: 120,000,000
- Market Cap: 36,907,200,000 CNY
-

IPO

- Went public on the Shenzhen Stock Exchange on March 24th at a price of 7.14 yuan (\$1.14) per share
- Flotation was oversubscribed by almost 300 times
- Stock price increased 30 trading sessions in a row following the IPO date
- Price has soared 43 times since the IPO date
- Trading has been halted as of June 10th due to the pending disclosure of an important issue
- This important issue may be related to regulators investigating if there has been stock manipulation occurring

Beijing Baofeng Technology IPO – 6/10/15



Beijing Baofeng Technology Co Ltd

+ Watchlist

300431:CH SHENZHEN

Trading has been halted for 300431:CH

↑ **307.56** CNY **27.96**
10.00%

As of 03:00:31 ET on 06/10/2015.

Sources: Bloomberg

Key Executives

- Chairman/President: Feng Xin
- Chief Operating Officer: Cui Tianlong
- Vice President: Wei Chanyuan
- Vice President: Qu Jingyuan

Feng Xin graduated from Hefei Industrial University School of Management. He previously held positions at Kingsoft and Yahoo China before he went on to found Baofeng Technology. As of April 2015, he owned 25.5 million shares (21.3%) of Storm Technology stock that is worth about 7.82 billion yuan (\$1.25 billion).



Chairman Feng Xin; Source: Baidu

Top 10 Shareholders

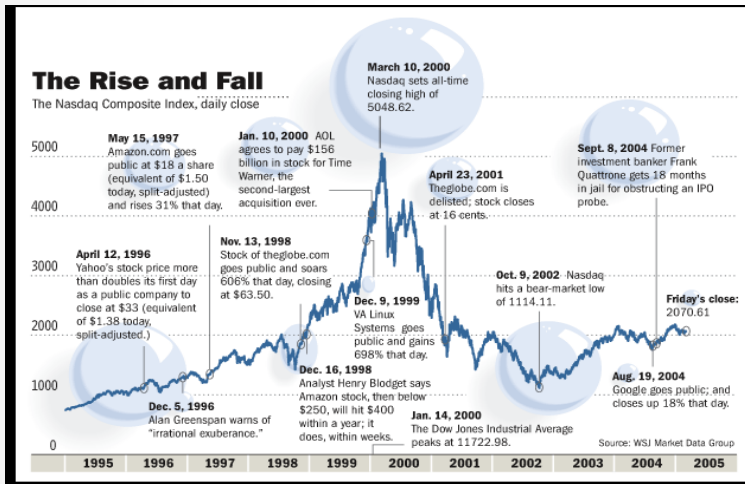
- Feng Xin owns 21.3% of the total shares
- Top 10 shareholders own 53.6% of total shares

Name of Shareholder	Total Capital Ratio	Number of Shares
Feng Xin	21.30%	25,556,490.00
Beijing Harmonious Growth Investment Center	8.17%	9,800,010.00
Investment Advisory Co.,	4.35%	5,219,190.00
Tianjin Wu Tong equity investment fund	3.48%	4,175,370.00
Huawei Investment Holdings	2.91%	3,496,860.00
Cai Wensheng	2.80%	3,356,820.00
Jiang Weiqiang	2.80%	3,356,730.00
Controlled Growth Equity Investment Fund partnership	2.72%	3,269,610.00
Beijing Litai Prudential Investment Center	2.61%	3,131,550.00
Hangzhou Changlang equity investment partnership	2.46%	2,951,730.00

Source: 2015 Baofeng First Quarter Report

NASDAQ Bubble

- Baofeng sells at similar nosebleed multiples to the most popular tech stocks right before the NASDAQ bubble popped



Source: <http://www.thebubblebubble.com>

“There is no investment idea so good that it can't be ruined by a too high entry price. And there are few things that can't be attractive investments if bought at a low-enough price. When investors forget these simple truths, they tend to get into trouble.”

- Howard Marks “Everyone Knows” Memo, 4/26/2007

Company	Price/Revenue	Price/Earnings	Price/ Book Value
AOL (1999)	29x	179x	45x
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Baofeng (2015)*	96x	880x	128x

Source: 1999 Fairfax Chairman letter

*Market Cap of 36.9 billion CNY and financial data at the end of 12/2014 was used

Company	Ticker	12/31/1999	4/14/2000	% Chg 12/31/99 to 4/14/00
Amazon	AMZN	76	47	-38
AOL	AOL	76	55	-28
Yahoo!	YHOO	216	116	-46

Source: Howard Marks' 5/1/00 "Irrational Exuberance" Memo

NASDAQ Bubble

- Baofeng's Market Cap/Revenue multiple trades at a similar level to Go2Net and exceeds DoubleClick's multiple shortly before the peak of the Dot Com Bubble
- Their gain has exceeded all of the overvalued "junior" tech issues that Prem Watsa highlighted in his 1999 chairman letter in less than 3 months
- It's 4 times higher than DoubleClick's gain!

Company (1999)	Market Cap (USD, Millions)	Revenue (USD, Millions)	Market Cap/Revenue	Loss (USD, Millions)	Price gain in 1999
DoubleClick	10,700	258	41	56	1037%
Go2Net	2,400	22	109	1	884%
InfoSpace.com	21,700	37	586	10	1023%
Red Hat	10,300	25	412	18	655%
VerticalNet	8,000	21	381	53	925%
Company (2015)	Market Cap (CNY)	Revenue (CNY)	Market Cap/Revenue	Profit	Price gain since IPO in March 2015
Baofeng	36.9 billion	386 million	96	42 million	4200%

Source: 1999 Company data was provided from the 1999 Fairfax Chairman Letter

Competitors

Some Competitors:

1. Youku Tudou
2. Leshi Internet
3. Tencent
4. Baidu
5. Google

Baofeng mentions the competitive nature of the industry in a required stock market announcement that resulted because of abnormal fluctuations in its stock

The company once again reminded investors to focus on the following risk factors for the company:

1, falling profits and even the risk of loss

After the listing, we continue to focus on independent research and development of video technology and product applications, continuous improvement User experience. The future of the company still plans to continue to increase investment of resources and network bandwidth copyright to respond

An increasingly competitive industry trends; on the other hand the company still needs to increase sales staff,

Increasing sales incentives, expand sales channels and strengthen institutional cooperation and other third-party market a variety of ways to increase sales Sale of efforts to maintain and enhance the delivery scale advertisers to promote the company's continued development of new platform products.

Therefore, the company's future video content costs and leasing costs of bandwidth, marketing expenses are expected to remain in High level.

If the future of the industry environment appears, adverse changes in the company operating conditions, the company's future revenue growth Growth continued to slow down or speed may cost more than revenue growth, will lead the company's business Industry profit, net profit (before deducting non-recurring gains and losses lower) compared with the 2014 loss and even the presence of a Now the risk of loss.

Source: Baofeng Stock Market Announcement of Abnormal Fluctuation

Relative Valuation

- Baofeng's relative valuation exceeded all of its competitors based on Price to Sales, Price to Book, and Price to Earnings ratios

	Market Cap (USD, millions)	P/S	P/B	P/E
Baofeng	\$5,942.00	74.3	96.5	654
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Industry Average	\$10,598.00	6.8	4.1	33.4

Source: Data provided by Bloomberg for Baofeng and Leshi Internet; Morninstar for the industry and every other company
Note: Market cap converted for Baofeng and Leshi at CNY:USD exchange rate of .161

Intrinsic Valuation

- Using a 15% discount rate, the current market capitalization **assumes 2014 net profit will grow at 75%** for the next 5 years and **the multiple for net profit in 2020 will be 101**

Assumption

- Growth Rate = 75%
- Discount Rate = 15%
- Chinese 10 year Bond Rate for Terminal Year = 3.67% (6/17/15)
- 5 year model
-

Intrinsic Valuation

Growth	0.75
Discount rate	0.15
Chinese 10 yr Bond	0.0367

All values are in millions except rates and multiples

	Reported	Projected with 75% Growth Rate					TV
	2014	2015	2016	2017	2018	2019	2020
Net Profit	¥42.00	¥73.50	¥128.63	¥225.09	¥393.91	¥689.35	¥714.65
Discount Rate		0.870	0.756	0.658	0.572	0.497	
Discounted Net Profit		¥63.91	¥97.26	¥148.00	¥225.22	¥342.73	

Total Discounted Net Profit	¥877.13
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TV (2020) Net Profit	¥714.65
Multiple	101
Terminal Value	¥72,179.52
Discount Rate	0.497
Discounted TV	¥35,885.98

Sum of Discounted NP and TV	¥36,763.10
Shares Outstanding (millions)	120.00

Price per share	¥306.36
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Discount rate, growth rate, and multiple assumptions are arbitrary, and can certainly be adjusted. The main purpose was to get a sense of what assumptions the market was making for this company. **The growth rate and multiple that Baofeng is discounting into its price are way too high since they don't put enough emphasis on competition, macro-factors, litigation, or anything that can possibly go wrong.**

Catalysts

- Central Bank stops its loose monetary policy
- Recession
- Regulation
- Investors realize the overvaluation
- Earnings miss
- Copyright Infringement

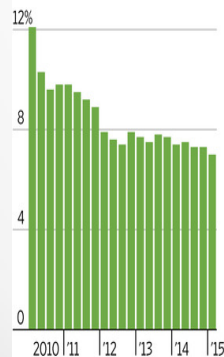
Central Bank

- China has cut interest rates three times in seven months
- Rate cuts have led to surging Chinese stock markets, large amounts of newly opened brokerage accounts, and an increase in margin trading
- According to a May 4, 2015 Barron's cover story, "China's Raging Bull", investors on the Chinese mainland recently opened new stock market accounts at a rate of 4.1 million a week; up 70,000 a year ago
- Margin balances have increased from 300 billion yuan 17 months ago to 1.6 trillion yuan
- Baofeng's speculative run has been a result of all this Central Bank activity, but will end if the Central Bank decides to become more aggressive in monetary policy

Wakeup Calls

As growth has slowed...

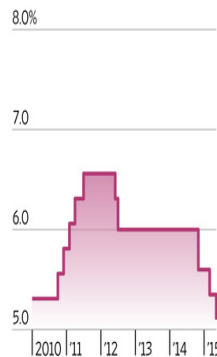
Annual change in quarterly gross domestic product



Sources: CEIC Data; National Bureau of Statistics

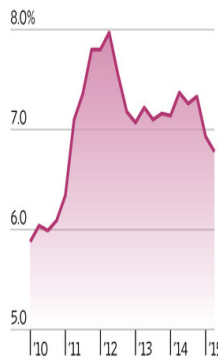
...China has cut lending rates...

Monthly one-year benchmark lending rate



...but loan costs remain high.

Quarterly weighted average lending rate for general loans



THE WALL STREET JOURNAL.

Chinese brokerage accounts are opening up like crazy



Recession

- Although there is no way of knowing for sure when a recession will exactly occur, they are inevitable
- A recession will put an end to the speculative frenzy occurring in the Chinese stock markets just as did for the U.S. stock markets in 2000
- China's economy has started to slow down already with GDP for the first quarter of 2015 at 7%, its slowest quarter since Q3 of 2009



Source: Financial Times

“[Boom-Bust] Those two words say it all. If you have a boom, eventually you’ll have a bust. And the further the boom goes, the worse the bust is likely to be. If there’s no boom, on the other hand, there needn’t be a bust.”

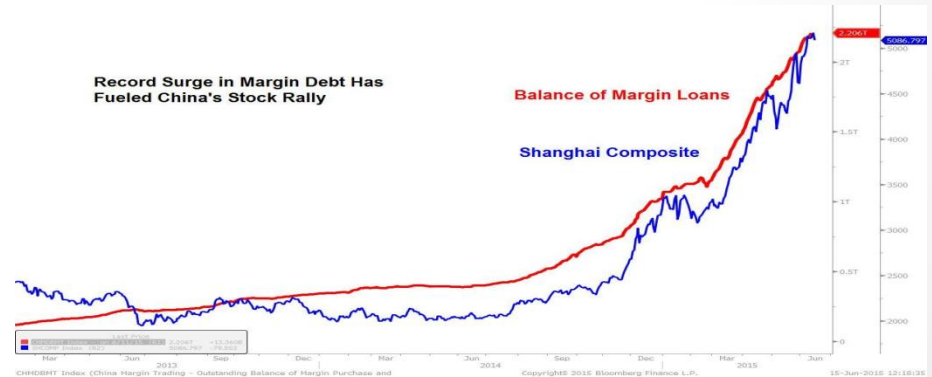
– Howard Marks, September 19, 2008 “Nobody Knows” Memo

Regulation

- At present, there is no ceiling on how much margin an investor can take on
- There have been numerous ads targeted to investors to take on more leverage such as the one below that reads, "Give You Lots More Stock Trading Capital; Gives You Lots More Profit Opportunity; You Trade Stocks, I Give You Money, Profit Is Yours; Also Provide Capital For Overseas Futures and H-Shares; Expand Your Capital 1 to 10 Times; Professional Service"
- China's security regulator released draft rules on June 12th to cap a brokerage's trading and short selling business at four times its net capital
- According to Bloomberg, three brokerage firms – Changjiang Securities, GF Securities, and Haitong Securities – announced an increase in margin requirements from 60% to 80%
- Higher margin requirements will most likely end or at least slow down the speculation that has been occurring since higher amounts of equity will be required to fund trades



Source: <http://investinginchinesestocks.blogspot.com/>



Source: Bloomberg

Investors Realize the Overvaluation

- Baofeng's stock price has increased 4200% since its IPO in March
- Its price to book, price to earnings, and price to sales multiples are all similar to some of the most over valued tech stocks at the end of 1999, right before the tech bubble burst
- Using a 5 year model, I estimate that net profits would have to grow by 75% to justify the current price
- This catalyst is based on human psychology, and seems to almost always take the longest to come to fruition



Investors Realize the Overvaluation

- According to the Shenzhen Stock Exchange rules, a large deviation in price over a short time period can cause a company to issue a warning to investors
- There have been 7 announcements of “abnormal fluctuations in stock trading and risk warnings” on their website so far

Investor Relations

Stock Market Announcements
Reports
Investment
Advisory

Stock Market Announcement

Storm Technology: Abnormal fluctuations in stock trading and risk war...	Download
Storm Technology: Mirror Storm on shares of the company Beijing Scie...	Download
Storm Technology: The second session of the Board sixth Earnings Rele...	Download
Storm Technology: Abnormal fluctuations in stock trading and risk war...	Download
Storm Technology: Abnormal fluctuations in stock trading and risk war...	Download
Storm Technology: Abnormal fluctuations in stock trading and risk war...	Download
Storm Technology: Abnormal fluctuations in stock trading and risk war...	Download
Storm Technology: IPO and listing on the GEM Listing announcement	Download

1 2 3 4 5 6 7

Source: Baofeng.com

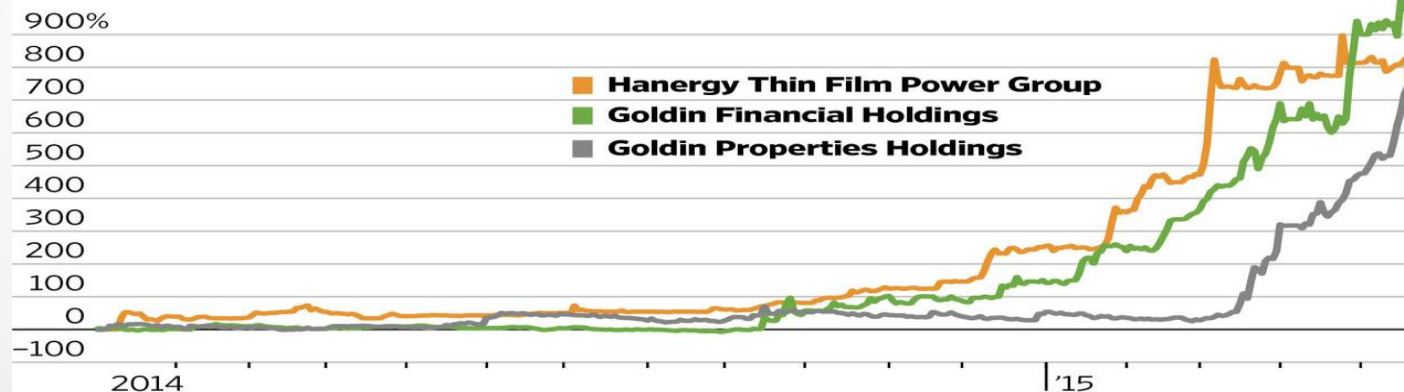
Investors Realize the Overvaluation

- Hanergy Thin Film Power and Goldin saw their stock plunge after soaring over 400% from the end of 2014 to April 2015
- The rise in price made their founders overnight billionaires just like Xin Feng
- Hanergy's stock plunged 47% in May. Almost \$19 billion in market value was wiped out in 24 minutes
- Goldin's stock plunged about 60%

Race to the Top, and Back

The share prices of Hanergy Thin Film, Goldin Financial and Goldin Properties all soared like eagles before dropping like rocks.

Percentage change from beginning of 2014



Source: FactSet

THE WALL STREET JOURNAL.

Investors Realize the Overvaluation

- The Wall St. Journal, Bloomberg, and many other media outlets have picked up on the large price rise in Baofeng's stock just as they did with Hanergy and Goldin
- This may be the tipping point in what looks to be an inevitable crash for Baofeng's stock
- Chinese market regulators likely picked up on the volatility in Hanergy and Goldin shares, which could be another reason that trading was halted

Earnings Miss

- Companies that have had large run ups in price become very sensitive to earnings misses
- Earning misses bring expectations back down to earth since investors realize those high growth rates that were previously projected, may just not be obtainable after all
- According to the table below, the highest forecast for 2017 annual net profit is estimated to be 127 million
- Even if Baofeng achieves the highest estimate of 127 million annual net profit, their P/E multiple is still excessive at 290
- This estimate is a 44% annual growth rate from 2014 annual net profit of 42 million
- This clearly doesn't factor in the headwinds that they have already been facing such as competition, copyright infringement, and a 1Q 15 loss of 3.2 million
- If they earn the highest estimate for 2015 annual net profit of 66 million, their P/E would be 559
- According to Bloomberg, Baofeng reports 2nd quarter earnings on 7/31/15

Summary - forecast annual earnings per share

Unit: yuan

Year	Number of agencies forecast	Min	Means	Maximum	Industry average
2015	7	0.30	0.44	0.55	0.44
2016	7	0.38	0.62	0.78	0.61
2017	5	0.47	0.83	1.06	0.79

Summary - Annual net profit forecast

Unit: 100 million

Year	Number of agencies forecast	Min	Means	Maximum	Industry average
2015	7	0.36	0.53	0.66	6.22
2016	7	0.45	0.74	0.94	7.87
2017	5	0.56	1.00	1.27	9.35

Source: <http://stock.zdcj.net>

Copyright Infringement

- Leshi Internet accused Baofeng of copyright infringement on May 14, 2015
- Baofeng has had similar lawsuits in the past
- According to Baofeng's prospectus, there have been about 100 copyright litigations that were concluded through settlement or mediation since 2011.
- Baofeng had to pay 3.312 million yuan as a result
- There were 17 additional lawsuits that were pending at the time of the prospectus
- Baofeng lost 28 of the copyright infringement cases and had to pay about a million yuan

Source: Steve Mollman; 5/15/15 Quartz Article "A copyright lawsuit has finally stopped the crazy stock market streak of Beijing Baofeng Technology"

Copyright Infringement

Issuer selection and cooperation platform video sites are known within the industry, and obtained a master of Radio Authorities permission licenser video sites. From the date of January 1, 2011 until the signing of this prospectus, Issuer due to aggregation platform included as a co-defendant Litigation, including cases in which proceedings have been closed 253, of which 71 to withdraw from the plaintiff and the issuer need not assume financial responsibility; 48 cases have been in consultation with the Copyright supplier partnerships resolved; 103 cases closed by way of conciliation or mediation, the issuer total sum Payment of copyright compensation costs 3,312,650 yuan (including 1 closed with a reconciliation from not purchasing the respondent compensation costs); 28 From the issuer against the issuer to pay the total cost of 1,045,375 yuan compensation for copyright, three cases in favor of the issuer, or He dismissed the plaintiff. Such action and responsibility without a significant impact on the issuer's business. Eye Before, the issuer of the cooperative agreement with the majority of the partners in the agreement, the partners need to ensure their video content with the Play legitimate rights and comply with national regulations, if the issues playing video content partners copyright flaws exist, Or does not comply with the relevant regulatory provisions of the State leaving the issuer being chased rights of third parties or government authorities Accountability and is therefore suffer the loss of the issuer shall be borne partners. At the same time, the Issuer will also further increase

Source: Page 1-1-60 of Prospectus

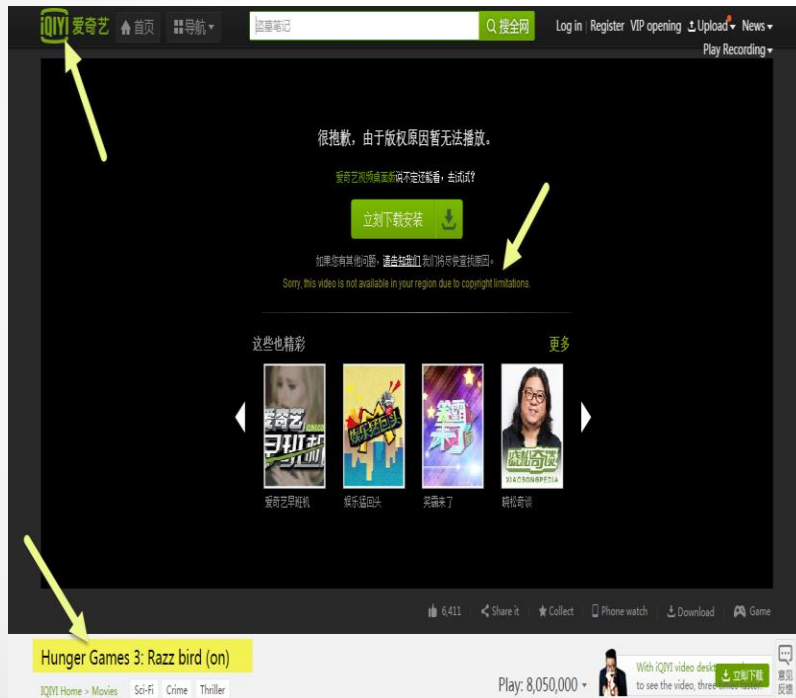
Copyright Infringement

- The bottom left image shows the American movie Homefront starring Jason Statham. The full movie can be viewed on Baofeng's website
- The bottom right image shows a 3 minute behind the scenes making of the new Jurassic Park movie, Jurassic World
- Copyright Infringement lawsuits will force Baofeng to remove entertainment content that brings lots of traffic to its website (left image) and replace it with more movie trailers and behind the scenes "making" videos (bottom right)
- Less traffic will ultimately result in less ad revenue, which Baofeng relies heavily on



Copyright Infringement

- Competitors have moved quicker than Baofeng at removing content that violates copyright laws



Source: iqiyi.com (6/13/15)



Source: Baofeng.com (6/13/15)

Risks

- Euphoric investor sentiment continues
- Central bank continues to keep loose monetary policy
- No lock up period (restricted share) expiration any time soon

Euphoric Investor Sentiment Continues

- Markets can continue to be irrational due to desires to get rich quick
- The recent 4200% gain for Baofeng in less than 3 months proves this
- Here are some recent quotes I came across that show the difficulty it can be to short a company in a bull market:
- “‘I don’t think any macro indicators or growth could explain today’s enthusiasm. It’s a bull run without growth’ – Lu Wenjie, UBS’s China equity strategist in Shanghai.”
– WSJ “Bulls Are Running in China’s Market” James T. Areddy
- “‘The higher the stock prices are, the more people are buying them,’ said Gao Haibao, a 58 year-old electrician who says he has dabbled in stocks since 1990.”
– WSJ “Bulls Are Running in China’s Market” James T. Areddy
- According to an article on May 22, 2015 from weekinchina.com, Guangfa Securities opined in a report that, “Everyone knows there is a bubble, but everyone wants to make quick money trading on market momentum”

Central Bank

- As previously stated, China's Central Bank has cut interest rates three times in seven months leading to a surge in stock market indexes, new brokerage accounts, and an increase in margin trading
- A continuation of loose monetary policy will continue to fuel speculative activity
- China's money supply (M1) grew from ¥5,000 in 2001 to ¥35,000 in 2013



Next Lock-up Period Isn't Until March 2016

- 25% of the shares were issued on March 24, 2015 in an IPO
- 48% of the shares are restricted until 3/24/2016
- The remaining 27% of the shares are restricted until March 26, 2018
- The lack of an upcoming lock-up period won't result in insiders dumping shares onto the market at least for another year

In Billions	As of April 2015
Total Shares	12
Total A Shares	12
A shares in Circulation	3
Restricted A Shares	9

Ban Date	Lifted number of shares (Billions)	Lifted shares of the total capital
3/24/2016	5.791	48%
3/26/2018	3.208	27%
3/24/2015	3	25%

Sources: <http://stock.zdcj.net>

Conclusion

- The trading halt on Baofeng's stock has put a lot of uncertainty in a short position
- There hasn't been much explanation for the trading halt except that it is pending the disclosure of an important issue. There is no stock market announcement on Baofeng's website, but it could be due to the possibility of price manipulation. After all, more than a hundred stocks on the Shenzhen Exchange have seen their shares rise more than 500% this year in addition to Baofeng's large gain. (1)
- New rules aimed at limiting margin requirements can affect the ability to borrow shares to execute a short position
- Despite these obstacles, I still feel that Beijing Baofeng Tech (300431:CH) is a very intriguing short position due to the overly optimistic assumptions that the market is discounting into the price
- TTM P/E is 654, TTM P/S is 74, and TTM P/B is 97
- The valuation is consistent with the high flying tech companies right before their valuations collapsed in 2000
- Some of these tech companies of the late 90's have had and continue to have a major impact on the consumer and the economy. Baofeng can have a positive impact over the long term as well, but it's more than likely that it will experience a price correction first
- If or once trading continues, a short position can be very intriguing at this very optimistic price level

(1) The New Yorker "Eastern Exchanges" James Surowiecki