



PRESCIENCE POINT
RESEARCH GROUP



China Gerui Advanced Materials Group
NASDAQ: CHOP

“Red Flags Pertaining to China Gerui”

Recommendation: Strong Sell

October 2011

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I. Executive Summary

In this report, we present a number of reasons why investors in China Gerui Advanced Materials Group, Ltd. (CHOP) (or the “company”), as well as its auditor and the SEC, should be especially cautious. We believe that the company’s revenue and profit may be overstated in its filings with the Securities and Exchange Commission.

Our analysis has many parallels and has led us to the same conclusions as that pertaining to A-Power Energy Generation Systems (APWR). (APWR’s auditor subsequently resigned and trading was halted by the NASDAQ; APWR is currently under investigation by the SEC.)

A summary of our key concerns include:

- Impossible economics -- CHOP claims to be an extraordinarily profitable company with industry leading margins. But there is nothing extraordinary about what it does: much like an oil refinery, it converts one commodity good into another. An analysis of directly comparable companies and liquid commodity markets pricing for both CHOP’s raw materials and finished goods reveals evidence indicative of a business likely inflating its profit margins.
- Past SAIC filings indicate the company is likely generating the rather ordinary profits one would expect from a business of this type, and one in line with similar manufacturers of cold-rolled steel.
- Common ties -- From July 2007 to October 2008, CHOP’s current CFO Edward Meng served as the part-time and then full-time CFO of A-Power Energy Generation Systems, prior to an abrupt dismissal.

II. Company Overview – Impossible Economics

China Gerui Advanced Materials Group, Ltd. converts hot-rolled steel into cold-rolled steel. Cold rolling steel is a value added process that makes steel stronger, effectively by forcing the atoms into uncomfortable positions. To produce steel sheets, hot-rolling can reduce sheet thickness much more quickly than cold-rolling. That being said, cold-rolling is not a technologically complicated process, and the equipment is readily available to anyone willing to invest in a production facility.

"It's like somebody telling you they just drove over here at 600 miles per hour. It's not going to happen."

--- John Bird (the godfather of Chinese fraud exposés)

China Gerui Advanced Materials Group does not manufacture advanced materials. They take a commodity product, hot-rolled steel, and produce another commodity product, cold-rolled steel. Over the past three years, CHOP’s gross profit has been growing while margins have been stable at around 30%. These steady margins appear doubtful when comparing CHOP’s revenue and COGS to hot- and cold-rolled steel market prices.

Liquid markets exist for both of these products, and pricing data is readily available specifically in local Chinese markets. Pricing data can easily be tracked by accessing a Bloomberg terminal. Prices across China for hot-rolled steel can be seen under “CDSPHRAV Index”, and cold-rolled steel can be seen under “CDSPCRAV Index”. The price of the type of steel products CHOP produces varies depending on thickness, hardness and quality, but the indices provide a good benchmark for industry pricing.

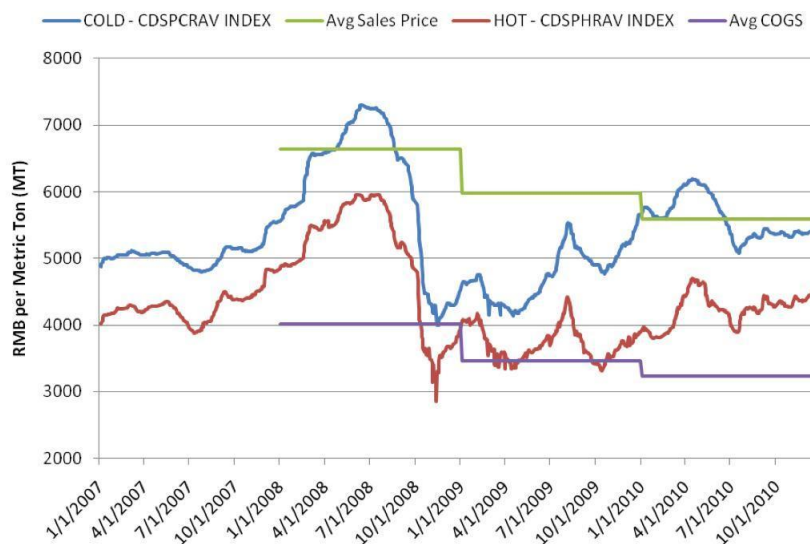


The below chart exhibits the spread between hot and cold rolled steel prices:



Because CHOP is a foreign private issuer it is not required to issue quarterly reports or proxy statements; but working off its reported average annual COGS and revenue per ton numbers and comparing them to prices prevailing in the market reveals startling discrepancies.

Comparison of CHOP to Market



The chart above demonstrates that CHOP's average sales and COGS metrics either do not mesh with market realities or do not fit with management's claims.

In 2010, CHOP claims to have paid less for hot-rolled steel than it traded for in the prior two years! In the company's 2010 annual report, management attributes margin growth to "a larger decrease in raw material prices, on a percentage basis, as compared to the decrease in average selling price." This does not match up with the reported numbers for the market

where prices were increasing throughout the year. Even competitors such as China Precision Steel experienced an increase in raw material costs. CHOP's raw material cost was decreasing.

In 2009, CHOP claimed to have sold cold-rolled steel at an average price the market index never even achieved during that year. Is it that the high ASP can be explained by the value-added chromium plating operation? No, as this production line, capable of plating 50k tons, did not come online until the 4th quarter of 2009. Furthermore, according to a management conference call, the chromium plating process increases the value of cold-rolled steel by ~25%. Being that chromium-plated steel makes up 20% of Gerui's finished goods, it wouldn't have been enough to explain the major discrepancy demonstrated in the chart.

In 2008, CHOP claims to have sold goods at near peak prices and purchased raw materials at near trough prices. Perhaps if CHOP stored raw material inventory when prices were low, and liquidated finished goods inventory when prices were high, these numbers could be explained. But since the company also claims an extraordinarily high inventory turnover (discussed further below) and since management claims to purchase raw materials only when a firm order has been placed, the numbers in this context appear impossible.

These year-in-year-out anomalies are inexplicable, and further digging solidifies our belief that CHOP's SEC filings represent a company that is too good to be true.

Note the following inconsistencies from CHOP's SEC filings. Management claims to have ended 2010 with only 250k tons of "cold rolling steel processing production capacity" and 50k tons of "chromium coating capacity", as can be seen on page 31 of the most recent 20-F:

Our cold rolling steel processing production capacity as of December 31, 2010 was approximately 250,000 metric tons per annum and our chromium coating capacity was approximately 50,000 metric tons per annum. We plan to expand our overall steel processing manufacturing capacity to 500,000 metric tons by 2012. We also intend to add new production lines and higher value-added products, such as plated products to improve our profit margin.

However, management also claims that "sales volume" increased to 299.8k tons as can be seen on page 36 here:

Our revenue is generated from sales of our cold-rolled steel products. Our revenue increased \$35.0 million, or 16.0%, to \$253.9 million in 2010 from \$218.9 million in 2009. During the year ended December 31, 2010, our sales volume was up by 20.0% to 299.8 metric tons from 249.9 metric tons last year. However, our average selling price was down from \$876 per metric ton during 2009 to \$847 per metric ton during 2010 as a result of our strategic decision to increase capacity utilization and sales volume to generate greater revenue growth in 2010, which was partially offset by overall price reductions based on product and market demand.

Confused readers might suggest that the actual output for the year was only 250k tons, implying that management added its 50k tons of chromium plating to the 250 cold-rolled capacity to reach a 300k total. We're confident that 300k tons is the actual weight of material produced (despite the fact management claims 250k tons of capacity) because management explicitly claims "average selling price was down from \$876 per metric ton during 2009 to \$847 per metric ton during 2010". 299k tons sold at \$847 per ton matches the \$253 million of revenue reported in 2010.

We pride ourselves on the depth of our research and seek out attractive investment opportunities that jive with common sense. We tend to steer clear or short companies that repeatedly "accomplish the impossible". The fact that CHOP claims to produce 300k tons of steel with only 250k tons of capacity is just one more oddity for auditors, the SEC, and investors to think about. And there are others.



III. SAIC Filings

Businesses that operate in China file their financial statements with the State Administration for Industry and Commerce. These statements are an excellent place to start piecing together the truth. One would expect reputable Chinese companies to submit financial statements to the SAIC that resemble those published in the US.

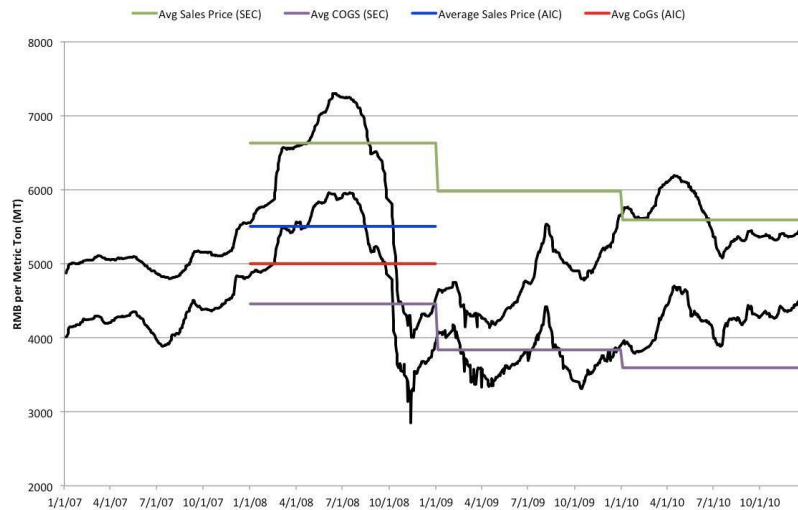
The AIC filings for CHOP go back a number of years. In 2009, its AIC filings do indeed match its SEC filings. As investors in some of the most notorious frauds – Longtop Financial and Sino Forest – have come to find out, matching statements do not necessarily equate to a clean bill of health.

It has been well-established, however, that nonmatching financials are a blaring red flag. CHOP’s 2007 and 2008 financials do not match. And interestingly, while the prices CHOP claims to have transacted at for its raw materials and finished goods appear disjointed from market prices and trends, its AIC numbers appear in line with market realities.

Comparison of SAIC financials to SEC financials (\$ in mms USD)				
	2007		2008	
	AIC	SEC	AIC	SEC
Income Statement				
Revenue	\$ 117.0	\$ 139.6	\$ 159.8	\$ 196.3
COGS	\$ (104.4)	\$ (100.6)	\$ (145.1)	\$ (142.4)
Gross Profit	\$ 12.6	\$ 39.1	\$ 14.7	\$ 53.9
Net Income	\$ 6.2	\$ 23.7	\$ 6.9	\$ 35.5
Balance Sheet				
Cash and Equivalents	\$ 16.5	\$ 19.4	\$ 23.5	\$ 67.3
Accounts Receivable	\$ 0.5	\$ 10.2	\$ 1.1	\$ 10.3
Inventory	\$ 11.9	\$ 8.7	\$ 17.3	\$ 3.6
Total Current Assets	\$ 40.7	\$ 74.7	\$ 55.3	\$ 94.0
PP&E	\$ 23.1	\$ 15.8	\$ 35.8	\$ 19.9
Other Long-Term Assets	\$ 11.5	\$ 1.3	\$ 12.1	\$ 1.4
Total Assets	\$ 75.4	\$ 91.8	\$ 103.2	\$ 115.4
Debt	\$ 33.1	\$ 37.8	\$ 56.0	\$ 57.6
Common Equity	\$ 39.3	\$ 17.4	\$ 44.8	\$ 12.5

The below chart shows how the 2008 AIC data matches up with the Bloomberg market indices compared with data from CHOP’s SEC filings:

AIC vs SEC Price Comparison



The AIC filings report a reasonable average sales price and a reasonable price paid for raw materials given prevailing market conditions. They indicate that CHOP bought hot-rolled steel for an average price of 4,996 RMB/ton, and sold cold-rolled steel for an ASP of 5,502 RMB/ton. This compares to average market prices during 2008 of 5,014 and 6,066 RMB/ton for hot and cold-rolled steel respectively.

Based on market conditions, the AIC numbers appear more reliable than those claimed in CHOP’s 2008 filings with the Securities and Exchange Commission. The discrepancies are so large that they cannot be explained away as mere accounting errors. If indeed the past AIC filings represent CHOP’s true business, its 2008 net income was overstated by 80.6%!

IV. Financial Statements and Company Comparison

Not surprisingly, China Gerui’s financial statements also don’t resemble those of other cold-rolled steel manufacturers, strengthening the case that it is inflating its profit margins. CHOP reports unreasonably high margins, RoIC, and inventory turnover.

In the table below, we compare CHOP to two comparable competitors, China Precision Steel (CPSL) and Sutor Technology Group (SUTR).

China Precision Steel, Inc. is a Chinese steel processing company engaged in the manufacturing and selling of precision cold-rolled steel products. CPSL produces a cold-rolled steel product that is of similar thickness as CHOP, but can produce strips that are much wider. Its specialty precision products are used in the manufacture of automobile parts and components, steel roofing, plane friction discs, appliances, food packaging materials, saw blades, textile needles and microelectronics.

Sutor Technology Group Ltd. is a Chinese manufacturer of fine finished steel products. Its business segments are broader than CHOP, but they also produce cold-rolled steel. Its products are sold primarily to solar energy, appliances, automobile, construction, infrastructure, medical equipment and water resource industries. Its customers are located in China and export markets like Europe, Middle East, South America and Hong Kong.

Financial Analysis: Cross-Sectional Industry Analysis
China Gerui Advanced Materials Group Limited (NASDAQ: CHOP)
As of 24 June 2011

All Numbers in USD Item	2010			2009		
	CHOP	CSPL	SUTR	CHOP	CSPL	SUTR
Revenue	253,866,337	110,453,947	478,690,000	218,902,632	76,281,621	429,750,000
COGS	177,869,648	100,146,924	445,880,000	153,095,354	68,549,426	393,450,000
Purchases	178,913,045	112,394,052	441,900,000	155,499,921	67,009,409	386,290,000
Gross Profit	75,996,689	10,310,000	32,810,000	65,807,278	7,730,000	36,310,000
Operating Income	66,949,876	6,810,000	18,380,000	60,314,717	(210,000)	26,150,000
Net Income	47,083,424	5,590,000	11,330,000	43,448,278	(410,000)	18,680,000
Current Assets	227,914,726	117,781,872	219,160,000	146,638,445	84,031,751	234,210,000
Current Liabilities	161,191,730	48,445,127	314,500,000	146,638,445	42,805,652	153,070,000
Avg Inventory	6,480,579	22,398,634	42,170,000	4,756,597	17,045,079	47,740,000
Avg Receivables	4,447,635	32,369,840	11,510,000	7,556,454	29,461,954	9,190,000
Avg Trade Payables	5,134,321	8,548,176	32,065,000	6,478,652	9,595,000	23,090,000
Avg Working Capital	33,361,498	55,281,422	90,910,000	19,952,481	59,065,000	72,025,000
Avg Total Assets	256,676,690	178,515,000	303,335,000	149,863,106	164,475,000	305,515,000
Avg Shareholders Equity	127,427,430	123,850,000	164,570,000	49,791,633	120,455,000	145,530,000
# of Days in Period	365	365	365	365	365	365

Performance Ratios

Δ Net Income (y/a/y)	8%	N/A	-39%			
Gross Profit Margins	30%	9%	7%	30%	10%	8%
Net Profit Margin	19%	5%	2%	20%	-1%	4%
Return on Assets	26%	4%	6%	40%	0%	9%

Activity Ratios

Inventory Turnover	27.4x	4.5x	10.6x	32.2x	4.0x	8.2x
Day Of Inventory On Hand	13.3	81.6	34.5	11.3	90.8	44.3
Receivables Turnover	57.1x	3.4x	41.6x	29.0x	2.6x	46.8x
Days of Sales Outstanding	6.4	107.0	8.8	12.6	141.0	7.8
Payable Turnover	34.8x	13.1x	13.8x	24.0x	7.0x	16.7x
Days of Payable	10.5	27.8	26.5	15.2	52.3	21.8
Working Capital Turnover	7.6x	2.0x	5.3x	11.0x	1.3x	6.0x

DuPont Analysis

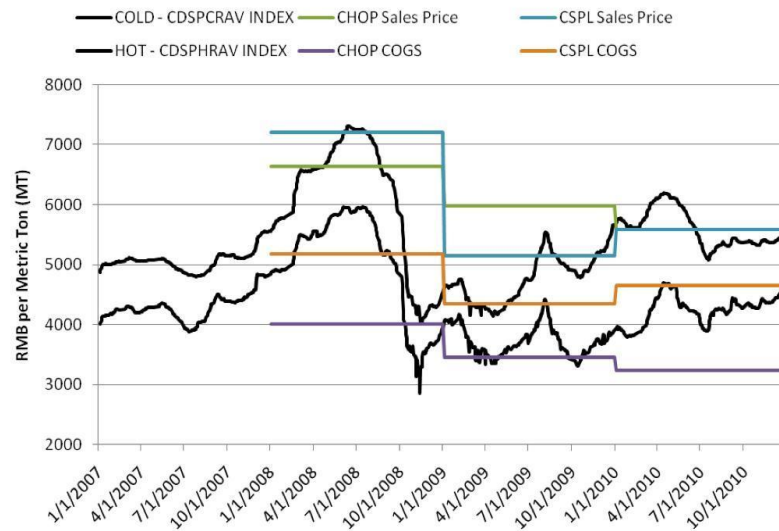
Net Profit Margin	19%	5%	2%	20%	-1%	4%
Asset Turnover	1.0x	0.6x	1.6x	1.5x	0.5x	1.4x
Leverage	2.0x	1.4x	1.8x	3.0x	1.4x	2.1x
ROE	37%	5%	7%	87%	0%	13%

CHOP's reported financial performance was extraordinary in light of its comps over the past two years. Its gross margins are 3x higher than its competitors, which reported gross margins typical of other firms in the industry globally (7-10%). CHOP reportedly turns over its inventory 27.4x per year, while its comps turn over their inventory only 4 – 10x per year. CHOP's credit and collection systems are also very different from the competitors as they collect receivables much faster and pay their suppliers much faster. This efficiency, if real, may suggest CHOP is engaged more in trading of materials than production of a complex higher margin product.

CHOP's business, as reported in the financial statements above, defies economic common sense for a business claiming to do what CHOP does. Comparing CPSL's reported average sales prices and COGS numbers to the Bloomberg data provided above shows a company operating more in line with economic reality than CHOP:



Comparison of CHOP and CSPL to Market



This chart shows that CPSL has reported narrower margins than CHOP every year. It also shows that CPSL is paying market rates or higher for raw materials, and selling finished products at around market rates. What's also interesting is that when prices were rising in 2010, CPSL reported higher prices for hot and cold-rolled steel; on the other hand, CHOP appears to have become completely unhinged from reality, reporting lower prices for both. This departure also seems to defy economic sense.

V. CHOP and APWR – Common Connection

Edward Meng was named CFO of CHOP on October 19, 2009. Prior to joining CHOP, Meng worked as the CFO of A-Power Energy Generation Systems, another company we investigated and whose financials we determined likely could not be relied upon. Our analysis can be found [here](#).

Following our investigation into that company, the following transpired:

- Several board members announced their resignations
- APWR's auditor (MSCM LLC) resigned, announcing that it had refused to sign off on the company's financial position
- NASDAQ stock exchange halted all trading in APWR stock
- CFO Peter Mak stepped down
- The SEC initiated an investigation into whether the Company or any of its personnel violated the federal securities laws.
- The investigation is ongoing.

We're not certain whether Edward Meng had a hand in any potential shenanigans at APWR, but APWR's CEO made the following statement in the press release announcing Edward Meng's termination in October 2008:



“He has played a critical role in the transition of A-Power to a US public company, in the growth of our core distributed generation business, and in the startup of our wind turbine production business.”

We suggest making reference to our analysis for an assessment of APWR’s core and wind turbine businesses.

Meng was terminated from his position at APWR after it was determined he’d violated another employers Code of Conduct – he was accused of 2-timing that company.

“A-Power Energy Generation Systems, Ltd. (“A-Power”), announced today that its Audit Committee has completed an internal review that confirmed assertions made by NASDAQ relating to the omission of certain biographical information of Edward Meng that had not been disclosed in various filings prior to July 2008, and which was corrected in the Company's 20-F filing on July 11, 2008. The assertions were prompted by a NASDAQ notification to the company of a letter written to NASDAQ from Mr. Meng's former employer. The letter stated that Mr. Meng had breached that company's Code of Conduct by being employed by that company on a full-time basis while at the same time being employed by A-Power as its part time CFO.”

This didn’t deter CHOP from deciding Meng would be a good cultural fit.

VI. Conclusion

CHOP isn’t doing anything extraordinary: It refines one commodity product into another, like scores of other companies. An analysis of CHOP’s reported financials against those of comparable companies and liquid commodity markets, however, exposes a company either operating outside the normal bounds of economics or one inflating its financial statements. We believe that it’s the latter.

Our suspicions are strengthened by our analysis of the company’s SAIC filings and striking similarities with our assessment of A-Power Energy Generation Systems, a company that was halted from trading by the NASDAQ and that is currently under investigation by the SEC.

We hope that investors who own CHOP and those considering buying shares at what appears to be a fundamentally cheap valuation familiarize themselves with the risks that we have addressed. We also hope that the SEC and CHOP’s auditor UHY Vocation HK CPA Ltd. take necessary precautions in protecting investors. We encourage UHY to carefully analyze the evidence that we have provided, in order to ensure that CHOP is accurately reflecting its financial position.