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# ZST Digital Networks: Deceptive Business, Bad Investment

November 3, 2010

## Situation Overview

ZST Digital Networks (OTCPK:ZSTN) came public in October 2009 and raised $25 million by offering 3.1m shares at $8 per share. The offering was led by Rodman & Renshaw and Westpark Capital, two ubiquitous underwriters in the market for bringing Chinese companies public in the U.S. through reverse takeovers (RTOs).

There are plenty of recent examples of why investors should be highly skeptical of purchasing shares in these Chinese RTO companies. Many lack transparency, internal controls, exaggerate their financial performance and assets, have weak governance, and in some cases are outright frauds. Look no further than China-Biotics (OTCQB:CHBT), Orient Paper (ONP), Douyuan Printing (DYP), China New Borun (BORN), China Marine Food Group (OTCPK:CMFO), Fuqi Int'l (OTCPK:FUQI), and China Northeast Petroleum (NEP) as cautionary examples.

Upon a close examination of ZSTN's business, financial model, and governance we are highly skeptical that their business exists in the manner it is being portrayed to U.S. investors, and believe ZSTN is a business of dubious practices and investment merits. Our main concern is their depiction to U.S. investors of a business generating superior sales and earnings growth without any cash flow generation. Furthermore, their financial model appears to favor customers, suppliers, and business partners at the expense of shareholders. We also provide hard evidence through a comparison of their SAIC financials to their SEC filings that indicate gross misrepresentation of their financial condition.

## What Is ZST Digital's Business?

The company claims to derive revenues principally from sale of products related to cable TV program distribution systems which include digital cable TV network equipments and IPTV set-top boxes. The company also recently entered the GPS market and sells devices, and GPS installation and subscription services. At present, ZSTN's main clients are broadcasting TV bureaus and cable network operators serving various cities and counties in the Henan Province.

## Red Flag #1: Unusual Financial Model Reporting Strong Sales and EPS Strength Without any Real Cash Flow Growth

Focusing first on their income statement, ZSTN is reporting that its sales have grown from $28m in 2007 to over $100m in 2009. The company does not disclose units sold or average sales prices (ASPs) per unit. This lack of transparency makes it difficult to reconcile total sales, but by cross referencing various pieces of information from company filings, many inconsistencies and question marks appear. To illustrate, ZSTN reports that its main products are IPTV set top boxes (STB), which accounted for 56% of its total revenues in 2008 amounting to $31m of IPTV product sales.

Furthermore, according to slide 8 on their recently filed September 2010 investor presentation (see here), ZSTN says the 2008 market for its IPTV product is 2 million households, and that it has 62.5% of the market. This implies company sales of approximately 1.25 million units. As previously discussed, ZSTN does not disclose its ASP, however, by checking various pricing sources in China we can estimate a range of $50 - $150 per STB. This allows us to imply a range of how many units they are actually selling. The discrepancy in unit sales is quite startling and illustrated below:

| | | | | | |
|---|---|---|---|---|---|
| Assumed Price per IPTV Set Top Box (1) | $50.00 | $75.00 | $100.00 | $125.00 | $150.00 |
| ZST's 2008 Reported IPTV Revenues | $31,041,259 | $31,041,259 | $31,041,259 | $31,041,259 | $31,041,259 |
| **Implied Units Sold** | **620,825** | **413,883** | **310,413** | **248,330** | **206,942** |
| Estimated Units Sold from Investor Presentation | 1,250,000 | 1,250,000 | 1,250,000 | 1,250,000 | 1,250,000 |
| Variance | (629,175) | (836,117) | (939,587) | (1,001,670) | (1,043,058) |

| **IPTV Unit Sales Estimate from Investor Presentation (2)** | |
|---|---|
| Size of Henan Province IPTV Market | 2,000,000 |
| % of share ZST | 62.5% |
| **Estimated ZST unit sales** | **1,250,000** |

| **ZST's IPTV Revenues (3)** | |
|---|---|
| 2008 Total ZST Revenues | $55,430,819 |
| % of Revenues from IPTVs | 56% |
| **Total IPTV Revenues** | **$31,041,259** |

(1) See various product comparisons for IPTV STBs in China
http://www.alibaba.com/product-gs/279758996/IPTV_set_top_box.html
http://www.alibaba.com/product-gs/316536140/iptv_set_top_box_800.html
http://www.alibaba.com/product-gs/240996866/IPTV_SET_TOP_BOX_IPTV_STB.html
(2) As reported in ZST's Sept 2010 investor presentation for 2008; slide 8.
(3) As reported in 2009 10-K; pages 7 and 37.

Sales, general and administrative (SG&A) and R&D expenses also seem highly unusual for a technology company growing as fast as ZSTN claims. Selling expense is among the lowest we've seen for any growth company in our experience. ZSTN's selling expense margin was a minuscule 0.01% (1 basis point) in 2007 and has grown to 0.6% (60 basis points) in the LTM 6/30/10 period. In other words, ZSTN spent a mere $30,000 to generate $28m in revenues in 2007 and is now only spending $670,000 in selling expense for $105m of revenues. It begs the question; do ZSTN's products just sell themselves?

G&A expenses are also unusually low for a business of this size. We've heard the argument that wages and operating costs are low in China; however, how low is low? According to the proxy statement, the CEO of this $100m operation only makes $15,000/year. Likewise, R&D spending is typically the life blood for a technology-based company; yet, ZSTN reports that it spent nothing on R&D expense in 2008.

To get a better sense of just how unusual ZSTN's reported SG&A and R&D figures are, we have benchmarked them against a range of other Chinese publicly listed technology companies. To our amazement, ZSTN not only is reporting superior revenue growth in our sample set, but also the highest sales per employee at $500,000, all while having both the lowest SG&A and R&D margins.

$ in millions except per employee figures

| Company: | Cogo Group | UTStarcom | China Tech Faith Wireless | China Digital TV Corp | China Info Security | ZST Digital Network |
|---|---|---|---|---|---|---|
| Ticker: | COGO | UTSI | CNTF | STV | CNIT | ZSTN |
| Business Description: | Customized module design solutions focusing on the digital media, telecom equipment and industrial business markets | Provider of Internet Protocol ("IP")-based network solutions including the integration and support services to telecom operators | China-based original developed products (ODP) provider focused on the design and development of handsets and finished products | Provider of CA systems to China's digital television market, allowing networks to manage content delivery | Solution provider of digital security, geographic, and hospital information systems in China | Supplier of digital and optical network equipment to cable system operators in the Henan Province of China |
| **H1 2010** | | | | | | |
| Revenues | $172.50 | $154.00 | $126.00 | $33.30 | $58.80 | $50.09 |
| SG&A Expense | $11.40 | $51.35 | $9.01 | $6.90 | $5.70 | $1.94 |
| *% margin* | *6.6%* | *33.3%* | *7.2%* | *20.7%* | *9.7%* | *3.9%* |
| R&D Expense | $5.10 | $19.10 | $6.20 | $4.70 | $1.13 | $0.33 |
| *% margin* | *3.0%* | *12.4%* | *4.9%* | *14.1%* | *1.9%* | *0.7%* |
| Reported Employees | 485 | 2400 | 518 | 504 | 1439 | 100 |
| 2007-2009 Sales CAGR | 14% | -60% | -21% | 1% | 83% | 86% |
| Revenue per employee | $355,670 | $64,167 | $243,243 | $66,071 | $40,862 | $500,930 |
| SG&A per employee | $23,505 | $21,396 | $17,394 | $13,690 | $3,961 | $19,360 |

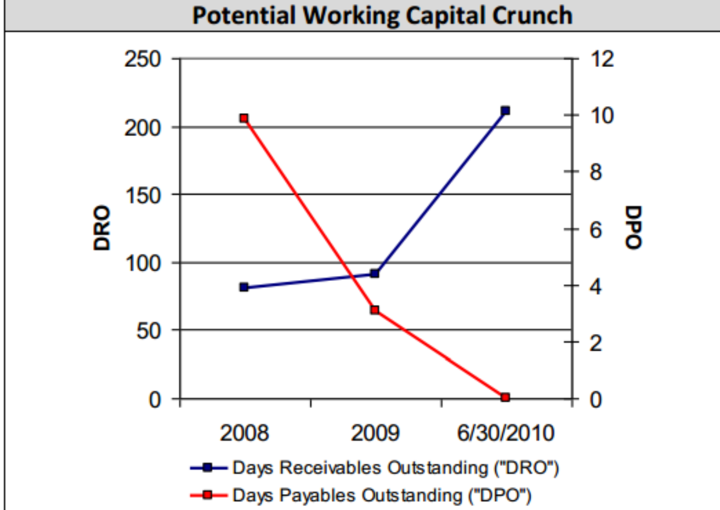
Source: Public company filings

## Unusual Financials vs. Peers

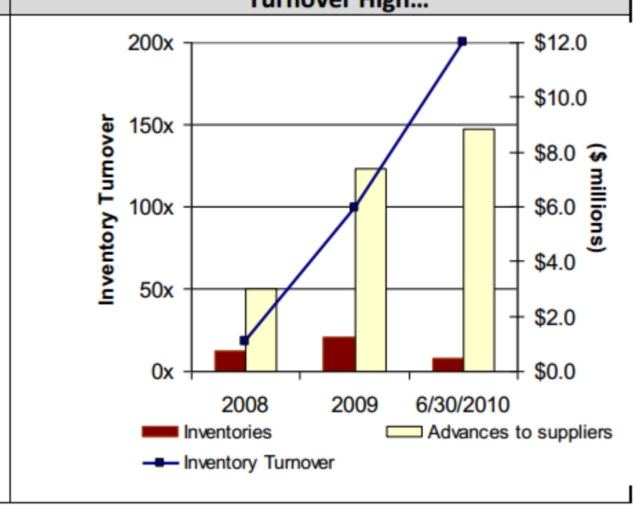
Not surprisingly, given the reported cost structure and sales growth, ZSTN is also reporting strong EPS growth of $0.49 in 2007 to $1.30 for the LTM 6/31/10 period. However, as we'll explore next, the earnings quality, as measure by actual cash flow, is very low. By looking at the all-important cash flow statement, the true story of ZSTN is revealed. Over the LTM 6/31/10 period, the company's cash from operations was -$4.1 million. Factoring in capital expenditures, free cash flow was -$5.4 million.

Turning our attention to the balance sheet reveals the mystery behind ZSTN's lack of cash flow. For a company that claims to be capital and operating efficient, the balance sheet tells the opposite story. The current assets of the company are comprised mainly of cash, accounts receivables, and advances to suppliers.

**Alarming Trend of DRO Rising and DPO Falling Signals a Potential Working Capital Crunch**




**Inventories Mysteriously Low and Inventory Turnover High...**




Source: Company Financials

On the supplier side, ZSTN reports 3 key suppliers accounting for over 30% of their purchases. While it's hard to gauge the solvency/credibility of these suppliers, any mishap with one of these counterparties could cause significant problems for ZSTN in collecting the cash. ZSTN appears to freely advance them large amounts of cash, and pay their invoices quickly. ZSTN reported almost no accounts payable outstanding at the end of the quarter, yet approximately $7.4 million in advances to suppliers. In our experience, we've not seen any company manage working capital so inefficiently.

Perhaps the greatest mystery of all in ZSTN's balance sheet is the question of its inventory (or lack thereof). As of the last quarter, ZSTN carried only $0.50 million of inventory on hand, and has not carried more than $1.50 million of inventory in the last 12 months. Yet, they manage to report over $105 million of sales; this equates to an astronomical inventory turnover ratio of ~200x! The company says they subcontract all manufacturing on a turnkey basis, with suppliers delivering fully assembled and tested products based on their proprietary designs. This model they say allows them to have significantly reduced capital requirements. We still don't understand how they avoid taking the inventory onto the balance sheet since they ultimately contract with their customers and take the risk of unsold inventory.

If ZSTN does not have to take inventory on to their balance sheet, then what exact function does the company play in this industry? As illustrated earlier, they definitely do not appear to be a leading edge technology development company, since they spend almost nothing on R&D. Furthermore, the company relies on only 1 patent in their business. As disclosed in their filings, CEO Zhong Bo has legal ownership of just one patent in China that they rely on in the operation of their business. On January 9, 2009, they entered into a patent license agreement with him for the right to use the patent.

The foregoing discussion merely begs the question: "What does ZSTN do?" It appears they are just passing orders from customers to suppliers and acting as a distributor. If they are purely a distributor, then their margins and inventory turnover ratio is remarkable in comparison to leading multi-billion dollar U.S. technology product distributors.

As the table below illustrates, profit margins average around 1.5% vs. ZSTN's reported 12.4% and inventory turnover ratios are closer to 12x as opposed to ~200x.

**Comparison of ZSTN's Margins and Inventory Turnover Ratio to US Technology Products Distributors**
$ in millions

| Company: | Ingram Micro | Arrow Electronics | Avenet | ZST Digital Network |
|---|---|---|---|---|
| Ticker: | IM | ARW | AVT | ZSTN |
| Business Description: | IT wholesale distributor, providing sales, marketing and logistics services for the global IT industry. Ingram distributes and markets technology products worldwide | Provider of products, services and solutions to industrial and commercial users of electronic components and enterprise computing solutions. Arrow serves over 900 suppliers and over 125,000 OEMs | Industrial distributor of electronic components, enterprise computer and storage products and embedded subsystems. | Supplier of digital and optical network equipment to cable system operators in the Henan Province of China |
| LTM Sales | $32,440 | $16,720 | $19,160 | $109.1 |
| LTM EBITDA | $503 | $640 | $711 | $19.1 |
| *% margin* | *1.6%* | *3.8%* | *3.7%* | *17.6%* |
| LTM Net Income | $287 | $279 | $410 | $13.5 |
| *% margin* | *0.9%* | *1.7%* | *2.1%* | *12.4%* |
| Average Inventory (1) | $2,250 | $1,583 | $1,612 | $0.5 |
| Inventory Turnover (2) | 14.4x | 10.6x | 11.9x | 199.7x |

(1) Average inventory of 2Q'10 and 2Q'09
(2) LTM Sales / Average Inventory
Source: Public company filings

ZSTN's financial model appears to favor all its constituents except their shareholders. As illustrated, since raising money from investors last year, ZSTN has continued to grow its outstanding accounts receivables and advances to suppliers, while reducing accounts payable to almost nothing. Moreover, as we'll explore later, it appears that cash is being siphoned from the company by management to other outside entities. In return, shareholders are being rewarded with reports of ever increasing sales and net income, but no evidence of growth in cash generation.

**ZST Digital Networks (ZSTN) Financial Summary**

| $ in millions | 2007 | 2008 | 2009 | 6 months Ended 6/30/09 | 6 months Ended 6/30/10 | LTM 6/30/2010 |
|---|---|---|---|---|---|---|
| Cable TV Equipment | $28.72 | $55.43 | $99.31 | $41.44 | $41.31 | $99.18 |
| GPS Devices | $0.00 | $0.00 | $0.00 | $0.00 | $6.68 | $6.68 |
| **Total Product Sales** | $28.72 | $55.43 | $99.31 | $41.44 | $47.99 | $105.86 |
| GPS Services | $0.00 | $0.00 | $0.00 | $0.00 | $2.10 | $2.10 |
| Other Services | $0.00 | $0.00 | $1.09 | $0.00 | $0.00 | $1.09 |
| **Total Services** | $0.00 | $0.00 | $1.09 | $0.00 | $2.10 | $3.19 |
| **Total Sales** | $28.70 | $55.40 | $100.40 | $41.44 | $50.09 | $109.05 |
| *% growth* | *413%* | *93%* | *81%* | -- | *21%* | -- |
| Cost of Goods Sold | $23.20 | $45.60 | $83.30 | $34.90 | $37.60 | $86.00 |
| Gross Profit | $5.50 | $9.80 | $17.10 | $6.54 | $12.49 | $23.05 |
| *% margin* | *19.2%* | *17.7%* | *17.0%* | *15.8%* | *24.9%* | *21.1%* |
| Research and Development | $0.09 | $0.00 | $0.22 | $0.00 | $0.33 | $0.55 |
| *% margin* | *0.3%* | *0.0%* | *0.2%* | *0.0%* | *0.7%* | *0.5%* |
| Sales Expense | $0.00 | $0.15 | $0.36 | $0.07 | $0.38 | $0.67 |
| *% margin* | *0.01%* | *0.3%* | *0.4%* | *0.2%* | *0.8%* | *0.6%* |
| G&A | $0.72 | $1.00 | $1.80 | $0.47 | $1.56 | $2.89 |
| % margin | *2.5%* | *1.8%* | *1.8%* | *1.1%* | *3.1%* | *2.7%* |
| **Total SG&A** | $0.72 | $1.15 | $2.16 | $0.54 | $1.94 | $3.56 |
| *% margin* | *2.5%* | *2.1%* | *2.2%* | *1.3%* | *3.9%* | *3.3%* |
| Operating Income (EBIT) | $5.50 | $9.80 | $14.02 | $5.30 | $10.10 | $18.82 |
| D&A | $0.00 | $0.00 | $0.10 | $0.09 | $0.23 | $0.24 |
| Stock Comp | $0.00 | $0.00 | $0.00 | $0.00 | $0.08 | $0.08 |
| **Adjusted EBITDA** | $5.50 | $9.80 | $14.12 | $5.39 | $10.41 | $19.15 |
| % margin | *19%* | *18%* | *14%* | *13%* | *21%* | *18%* |
| **EPS** | $0.49 | $1.04 | $1.16 | $0.48 | $0.62 | $1.30 |
| % growth | -- | *112%* | *12%* | -- | *29%* | -- |
| Cash from Ops. | ($7.60) | $3.30 | ($8.65) | ($0.90) | $3.60 | ($4.15) |
| Capex | $0.04 | $0.00 | ($0.50) | ($0.78) | ($1.60) | ($1.32) |
| **Free Cash Flow** | ($7.56) | $3.30 | ($9.15) | ($1.68) | $2.00 | ($5.47) |
| **Current Assets on Balance Sheet** | | | | | | |
| Cash | $1.12 | $1.13 | $13.63 | $20.78 | $15.78 | |
| Inventories | $5.49 | $0.78 | $1.25 | $0.89 | $0.50 | |
| Accounts Receivable | $9.42 | $12.32 | $24.89 | $18.14 | $28.94 | |
| Advances to Suppliers | $0.00 | $3.02 | $7.40 | $7.59 | $8.85 | |
| Advance to Employee | $0.77 | $0.01 | $0.00 | $0.01 | $0.00 | |
| Pre-Paid Expenses | $0.01 | $0.01 | $1.06 | $1.02 | $1.04 | |
| **Total Current Assets** | $16.81 | $17.27 | $48.22 | $48.43 | $55.11 | |
| **% of Current Assets** | | | | | | |
| Cash | 7% | 7% | 28% | 43% | 29% | |
| Inventories | 33% | 4% | 3% | 2% | 1% | |
| Accounts Receivable | 56% | 71% | 52% | 37% | 53% | |
| Advances to Suppliers | 0% | 18% | 15% | 16% | 16% | |
| Advance to Employee | 5% | 0% | 0% | 0% | 0% | |
| Pre-Paid Expenses | 0% | 0% | 2% | 2% | 2% | |
| **Total Current Assets** | 100% | 100% | 100% | 100% | 100% | |
| Accounts Payable | $3.02 | $1.23 | $0.70 | $6.86 | $0.00 | |
| **Ratios** | | | | | | |
| Inventory Turnover (1) | NA | 17.69x | 99.41x | NA | 199.73x | |
| Days Payable Outstanding | 47.5 | 9.8 | 3.1 | 71.7 | 0.0 | |
| Days Receivables Ratio | 119.8 | 81.2 | 90.5 | 159.8 | 210.9 | |

(1) Sales / Average Inventory

**Red Flag #2: 3 Auditors in 3 Years**

ZSTN has changed its accountant/auditor a remarkable three times in only three years. This fact is plainly disclosed by the company in its proxy statement (see page 6 here). While not an indication of wrong-doing, this repeated change should serve, at the very least, as a major red flag for any potential investor. ZSTN recently appointed BDO China Li Xin Da Hua CPA Co., Ltd. to be their auditor in April 2010.

In FY09 they had Kempisty as their auditor and in 2008 they had AJ. Robbins, PC. It's noteworthy that ZSTN's first two auditors, AJ Robbins and Kempisty, are both U.S. based accountants with no presence in China, or apparent expertise with Chinese companies noted on their websites.

**Red Flag #3: Inexperienced CFO Running a Publicly Listed Company; Earnings Already Restated Once**

John Chen was appointed CFO in October 2009. According to his biography, he does not have the requisite experience typically seen for CFOs of publicly listed technology companies. He previously served as a banker with Brean Murray and Global Hunter Securities (prolific underwriters of RTOs), neither of which had any previous business relationship with ZSTN. Mr Chen is a medical doctor by training, does not have a CPA or similar accounting degree, and no apparent technology or cable product industry experience. Furthermore, under his tenure as CFO the company has already had to restate earnings once (see here).

**Red Flag #4: No Indications that ZSTN's Core IPTV Products Are Available to Purchased Anywhere**

Given the forgoing discussion of ZSTN's impossibly remarkable financials, we turn our attention back again to their products. Starting with their IPTV set top boxes, we searched the internet looking for more information and outlets to purchase their products. Our search for their 'branded' ZST products resulted in absolutely nothing. We also searched by their local name "Zhengzhou Shengyang Technology."

We've provided the following links for the reader to verify our claims.

See the company's website here. The website will be probably either 1) be blocked by your browser due to concerns over malware; or 2) be completely unavailable.

Industry sources for IPTV STB manufacturers yield no results for ZST's 'branded' products:

http://www.verimatrix.com/partners/set_top_box_vendors.php

http://www.itvdictionary.com/stb.html

http://www.iptvmagazine.com/iptvmagazine_directory_ip_stb.html



http://www.iptv-industry.com/cl/iptvsettopboxcompanies.htm

http://www.birds-eye.net/directory/companies/?sector=IPTV_STB

http://www.china.manufacturers.globalsources.com/

http://www.alibaba.com/products/zhengzhou_shengyang_technology/CN----Henan------------_1-CN,.html

Furthermore, in the company's annual report, they claim that they have well established distribution channels and regularly attend trade fairs for electronic products to promote themselves (page 6, 10K). A quick check of the fairs they mention, provide no indication they've attended any of the recent fairs:

Hong Kong Electronics Fair (here)

CES Las Vegas (here)

China Hi-Tech Fair (here)

**Red Flag #5: Questionable New Business Line of GPS Products and Services**

In late 2009, the company purchased certain 'technical know-how' related to the GPS business for $190,136 (yes under $200,000 thousand). ZSTN says that since Q4'09, they began providing GPS location and tracking services to third parties, mainly automobile dealers and plan to participate in the GPS service provider business by establishing a partnership with China Unicom (CHU), a wireless network provider.

By the first 6 months of 2010, ZSTN is already reporting to be selling $6.6m of GPS products with a 21% gross margin and $2.1m of GPS services with a 97% reported gross margin. It seems almost improbable that within 6 months ZSTN has established an entirely new business in which they have no prior experience, and are generating almost $3.5m of gross margin. If our math is correct, that's an astounding 3,582% annualized IRR on their investment!

The company has provided very limited disclosure as to how they have achieved these remarkable results, but what is disclosed shows sizable contradictions. To illustrate, the reported GPS products and services revenues totaling almost $8.8 million diverges from their most recent discussion of the business in their September 2010 investor presentation. As slide 9 clearly indicates, ZSTN has captured only 3 contracts with product sales totaling only $2.1 million and service fees totaling only $273,000 (see here).

Many questions about this new GPS business remain unanswered. For example: 1) Who sold them the technical know-how? 2) Who did they hire to help support the tremendous growth of the business? 3) Who are the customers? 4) How does this strategically fit with their other businesses? 5) Why are GPS products such a hot growth area when they've been commercially available already for many years around the world?

What is very clear, in our opinion, is that ZSTN's core IPTV set-top box business, if it really exists, is under pressure and will not grow at the same rate that it's currently being presented. The move into a seemingly unrelated GPS products and services is a development investors should view defensively.

**Red Flag #6: ZSTN Is Vastly Understating Its Competition**

In their 10-K, ZSTN names only Motorola (MOT), Cisco (CSCO), and Pace as competitors. However, upon some simple fact checking, one quickly realizes that ZSTN doesn't make a single mention of any China-based competition! Absent are ZTE, Huawei, UTStarcom, and a host of other significant players in the Chinese market. We find it curious and highly unlikely that ZSTN thinks that it doesn't compete against any of these much larger local competitors. Oddly enough, by reviewing Pace's business you see that they don't even have much of a presence in Asia/China and don't describe China as being a core market for their products. If China were a great growth story for Pace, we think they'd at least mention it in their annual report.

See China IPTV market research here.

See Pace's annual report, lacking any mention of China being a core market for their business, here.

**Red Flag #7: Corporate Governance and Shareholder Structure Major Concern**

The last proxy reveals that Zhong Bo, the Chairmen and CEO, owns almost 43% of the stock and can wield the entire decision making power over the company. No director owns a single share in the company, and the CFO is the only other member of the executive team owning shares (an insignificant 25,000 shares to be precise). There's virtually no institutional support for the stock other than the largely unknown underwriter Westpark Capital who retained 6% of the stock offering.

The CEO is the father of Zhong Lin, the Chief Operating Officer, and also a director of the company. Mr. Bo was kind enough to give his son Mr. Lin a $285,000 retention bonus if he remains continuously employed with the company for a period of 24 months. We note that no other members of management have been awarded such generous retention bonuses. (See the Retention Agreement From Father to Son here.)

Larger, and more mysterious, possible misappropriation of shareholder funds are being funneled through outside 'business development' service providers. To illustrate, in December 2009 ZSTN agreed to pay $1.55 million to Finance Access, Inc. for "consulting, business development and professional services." Another two mysterious payments of $0.50 million and $0.75 million were made in October 2009 to both Fabulous Worldwide Limited and Practical Worldwide Limited, respectively, for providing "business development services."

We have not been able to find information on any of these three companies to validate their existence. What is clear is that after almost 1 year since these payments were made, ZSTN has not made a single announcement of any business relationships resulting from these engagements.

Finance Access Inc. Contract (here)

Fabulous Worldwide Contract (here)

Practical Worldwide Limited Contract (here)

We are skeptical that ZSTN shareholders got either "practical" or "fabulous" services for these payments. To put into perspective the magnitude of these three payments, totaling over $2.0 million, they are more than 4.4x bigger than ZSTN has spent on research and development for its products in that past 4 years!

**Red Flag #8: SEC vs. SAIC Filing Comparison Shows Alarming Discrepancies**

Perhaps the linchpin for our analysis is a comparison of what ZSTN is reporting to China's State Administration for Industry and Commerce (SAIC) vs. what the company is reporting to the SEC and US investors; we've presented them side-by-side for ease of comparison. The results are astounding and provide further evidence that ZSTN's business appears not to be accurately portrayed to US investors. For those readers not familiar with SAIC filing considerations and why they matter, an excellent discussion is contained here.

**SAIC vs. SEC Financial Comparison**

**ZSTN's 2008 SAIC vs. SEC Reported Financials**

| Income Statement | SEC | SAIC |
|---|---|---|
| Sales | $55,431,000 | $20,941 |
| Cosf of Goods Sold | $45,594,000 | $0 |
| SG&A | $1,006,000 | $56,513 |
| Interest Expense | $339,000 | $102,596 |
| Net Income | $6,109,000 | ($132,695) |
| **Balance Sheet** | | |
| Cash | $1,134,954 | $81,056 |
| Receivables | $12,322,099 | $3,136,833 |
| Inventory | $775,185 | $186,133 |
| Fixed Assets (PP&E) | $34,148 | $407,904 |
| Short-Term Debt | $3,931,991 | $5,856,288 |
| Total Liabilities | $8,321,409 | $6,288,486 |
| Shareholders' Equity | $8,982,920 | $1,547,469 |
| Total Assets | $17,304,329 | $7,835,955 |

The original SAIC Chinese and English translation versions are publicly available here:

**Conclusion: ZSTN Should Be Viewed Extremely Cautiously as an Investment**

We have illustrated more than a few questionable items to consider before investing in ZSTN. We are highly skeptical that their business exists in the manner it is being portrayed to U.S. investors. In our opinion, the financial profile, governance and share structure have major deficiencies. While, the stock valuation "looks cheap" on traditional valuation metrics like Price/Earnings, EV/EBITDA, and EV/Sales, there are clearly many reasons why.

The main concern is the lack of cash generation of this business, and a financial model that appears to favor customers, suppliers, and creditors at the expense of shareholders. The most alarming evidence we have indicating the potential misrepresentation of their business is the big discrepancy between SAIC and SEC financials showing extreme overstatement of revenues, profits, and assets. Furthermore, having had three auditors in three years, gives us grave concern for the reliability of the financials. We've seen numerous blow-ups recently in the Chinese RTO space. ZSTN fits the mold of another RTO that is a time bomb waiting to explode.