Spruce Point Capital Management

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The Fantasy World of Camelot Information Systems

Camelot Information Systems	**Research Summary**
Ticker: CIS **Exchange**: NYSE **Price**: $9.00 **52wk High**: $28.18 **52wk Low**: $8.32 **Avg. Volume**: 605,000 **Diluted ADS o/s**: 48.7m **Market Cap**: $438m **Cash**: $134m **Debt**: $12m **Ent. Value**: $316m **Conclusion**: Strong Sell **Price Target**: $3.75	➢ **A closer look into Camelot Information Systems ("CIS") and their position in the Chinese Information Technology industry reveals numerous question marks investors should consider** ➢ **We will explore a number of concerns with CIS including:** **1) Unusually high revenue per employee, matched only by the alleged fraud Longtop Financial** **2) Abnormally low SG&A margins, but exceptionally high total wage cost per employee, yet evidence suggesting high employee dissatisfaction** **3) Lack of industry recognition from competitors, independent research firms, and industry trade organizations** **4) Pursuing an aggressive acquisition strategy, and paying big premiums for businesses of questionable quality with limited disclosure** **5) Cash management strategy appearing at odds with financial objectives** **6) Significant and material accounting weaknesses** ➢ **Based on our independent research, we conclude CIS is a strong sell and believe a fair value for the share price to be $3.75**

Introduction

Camelot is the most famous castle and court associated with the legendary King Arthur. It's in Camelot where stories of romance, bravery, nobility and chivalry have captured the imagination of readers and historians for hundreds of years. Yet, most scholars today would agree that Camelot is purely fictional, and its precise location has never been determined.

Perhaps, the story of Camelot is a cautionary tale for today's investor romance for the shares of Camelot Information Systems (NYSE: CIS). Camelot is a provider of business solutions and IT services to corporations and financial institutions in mainland China, Taiwan, Hong Kong, and Japan through a network of 28 regional and local subsidiaries. Over the years, Camelot has been actively expanding its service offerings through acquisitions and investments in developing solutions and establishing strategic partnerships with leading international IT product providers.

CIS is one of a handful of Chinese IT service providers to come public in the United States in the past few years. Among its peers are recently listed Chinese IT service providers such as VanceInfo Technologies (NYSE: VIT), HiSoft Technology Int'l (Nasdaq: HSFT), iSoftStone Holdings (NYSE: ISS) and the alleged fraud, Longtop Financial (NYSE: LFT).

CIS's Financial Model Shows Unusually High Revenues Per Employee

At the heart of every service business, is the talented pool of professionals to work with clients in delivering solutions to their most challenging IT projects. It is no wonder that China has emerged as a burgeoning country for the outsourcing of technologically challenging work. It is estimated that China produced 5 million college graduates per year with nearly 700,000 engineers. The cost savings of utilizing this vast Chinese talent pool have been estimated at between 50 – 70% versus a comparable US IT service provider.[1] The industry growth and profitability within China has created an intense warfare for employee talent for companies to gain a competitive edge. In fact, among every financial filing we analyzed, this was listed as a top business risk factor facing the Chinese IT service industry. To illustrate, we have included excerpts on this matter from a few industry participants:

"*Our business involves the delivery of professional services and is highly labor-intensive. Our ability to execute current and future projects and to obtain new customers depends largely on our ability to attract, train, motivate and retain highly skilled personnel, particularly project managers, independent consultants, project leaders and domain experts. We believe that there is significant demand for those personnel. The loss of a significant number of our professionals or the inability to attract, hire, develop, train and retain additional skilled personnel may materially and adversely affect our ability to manage, staff and successfully complete our existing projects and obtain new projects. Increasing competition for these individuals may also significantly increase our labor costs, which may materially and adversely affect our profit margins and results of operations*."

-- Camelot Information Systems, 2010 Annual Report

[1] Chinasourcing.com industry trade association

"Our attrition rates were 17.7%, 12.8% and 19.8% per annum in 2008, 2009 and 2010, respectively. We may encounter higher attrition rates in the future, particularly if China continues to experience strong economic growth. There is significant competition in China for skilled personnel, especially experienced middle and senior level management, with the skills necessary to perform the services we offer to our clients."

-- iSoftStone, 2010 Annual Report

"The attrition rate among our employees who have worked for us for at least six months were 18.8%, 13.8% and 14.6% for 2008, 2009 and 2010, respectively… In addition, we may face increasing difficulties recruiting the talent we need to staff our outsourcing facilities in less developed cities in China with lower average wages and living standards."

-- HiSoft, 2010 Annual Report

"The average turnover rate of the Group through 2010 was 12.3% which was lower than the sector average level. Despite that the costs of human resources have increased continuously in recent years, the Group was still able to increase earnings capability constantly through the continuous increase in the scale of business income and a series of cost and performance management measures..."

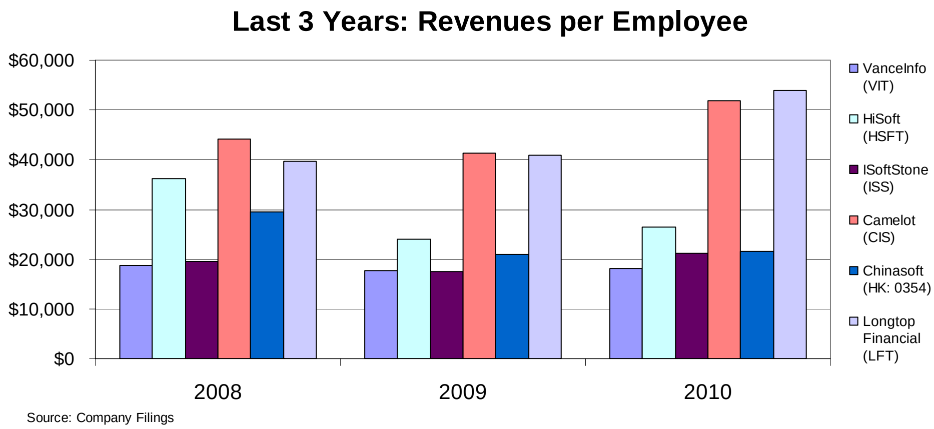
-- Chinasoft, 2010 Annual Report

The most notable omission in CIS's disclosure on the competitiveness for employee talent is the topic of the attrition rate. Is it possible that CIS somehow has a more productive, loyal and satisfied employee workforce than the rest of its competitors? Let's explore this question in further detail.

The first red flag that caught our attention is CIS's unusually high revenue output per employee. As the chart and table below indicates, CIS is an extreme outlier compared with its peers, but matched only by Longtop Financial, an alleged fraud that was exposed by Citron Research:

Longtop Financial Report
http://www.citronresearch.com/index.php/2011/04/26/citron-reports-on-longtop-financial-nyselft/

Among the set of companies with approximately $200m in annual revenue, CIS is reporting nearly twice the average revenue per employee and has the fewest employees in the peer group. This trend has remained consistent for the past few years and is illustrated in the chart below.



CIS's revenue per employee is matched only by Longtop Financial

We looked at CIS's overall business profile to see if we could explain this dramatic difference. As illustrated in the tables below, CIS's revenue and customer mix is not materially different from its competitors. For example, CIS's top ten customer revenue concentration and percentage of revenues from fixed-price contracts is comparable to its peer group. CIS also serves some of the same global, price sensitive customers such as IBM, Lenovo and Hitachi as its competitors. These facts make it highly unlikely that CIS is capable of generating an equal amount of revenue, with nearly half the workforce of the competition. Accounting for ~30% of revenues, IBM is CIS's largest customer and attributable to a contract to establish a delivery center to provide enterprise application services exclusively for IBM's customers. It is noteworthy that IBM recently renewed this contract with CIS in May 2011, but omitted a key clause that gave IBM a call option to purchase CIS's Delivery Company at net asset value plus a percentage of cumulative revenues. It may be inferred from this omission that IBM no longer sees value in acquiring this business from CIS, for whatever reason. The materiality of the IBM contract to CIS also underscores a unique risk facing CIS; IBM can terminate the contract at any time if certain conditions are met. CIS may also face termination if they are found to be competing with overlapping customers, a real risk we will explore when we discuss CIS's recent acquisitions.

Later in this report, we will also call into question the idea that CIS's employee workforce is somehow more experienced and higher-skilled, which allows them to charge a premium for their services.

	VanceInfo (VIT)	HiSoft (HSFT)	ISoftStone (ISS)	Camelot (CIS)	Chinasoft (HK: 0354)	Group Average
FY 2010 Revenues	$211.5	$146.5	$197.0	$192.8	$236.9	$196.9
FY 2010 Employees	11,646	5,521	9,285	3,718	10,940	8,222
Revenues per Employee	$18,161	$26,535	$21,214	$51,856	$21,651	$27,883
2007-2010 Revenue CAGR	50.0%	32.4%	75.6%	55.4%	26.4%	48.0%
% Revenue from Top 10 clients	66.5%	56.8%	54.3%	61.7%	57.2%	59.3%
Fixed-price contract revenue	36.9%	17.4%	58.8%	48.6%	57.0%	43.7%
Key Clients:	Microsoft	Microsoft	Microsoft	IBM	Microsoft	
	IBM	UBS	IBM	Hitachi	IBM	
	Lenovo		Huawei	Lenovo	GE	
	Huawei		Bank of China	State Grid	NEC	
	Tibco		UBS	China Const. Bank	Hitachi	

Source: Financial Filings

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FY 2010 Sales Breakdown	VanceInfo (VIT)	HiSoft (HSFT)	ISoftStone (ISS)	Camelot (CIS)
Sales by Industry				
Financial Services	11%	24%	17%	36%
Technology	33%	63%	33%	11%
Communications	43%	--	38%	4%
Other Industries	13%	13%	11%	49%
Total	100%	100%	100%	100%
Sales by Segment				
R&D Services	62%			
Enterprise Solutions	9%			
App. Development/Maintenance	21%			
QA and Testing	6%			
Total IT Services	36%			
Other Solutions and Services	2%			
Infrastructure Tech. Solutions		52%		
R&D Services		48%		
Application Development/Maintenance			31%	
R&D Services			34%	
Infrastructure and Software Services			3%	
Total IT Services			68%	
Consulting and Solution services			28%	
Business Process Outsourcing			4%	
Financial industry services				34%
Enterprise application services				66%

Source: Company Filings

CIS's largest segment appears to be enterprise application services, a business that primarily focuses on SAP-based ERP services in two forms (i) packaged software services and (ii) software development and maintenance services. They provide services for systems ranging from traditional ERP systems, such as those offered by SAP and Oracle, to new dimension applications, such as customer relationship management, business intelligence, supply chain management, integration tools and manufacturing supply execution. From the links below, it becomes clear that CIS competes broadly against all its peers in this business segment, and does not appear to offer anything unique that places them at a strong competitive advantage in this business.

iSoftStone Enterprise Solutions w/ SAP and Oracle

http://www.isoftstone.com/en/itservices/erpservices.htm

VanceInfo Enterprise Solutions w/ SAP and Oracle

http://www.vanceinfo.com/en/outsourcing/EnterpriseSolution

http://www.vanceinfo.com/en/solutions/OracleEBS

http://www.vanceinfo.com/en/solutions/SAP

HiSoft Enterprise Solutions w/ SAP and Oracle

http://www.hisoft.com/offerings/enterprise-application-services

The analysis also reveals that CIS's largest industry single group is financial services. This business primarily consists of system software support and maintenance, application software development and implementation services as well as consulting services in the financial industry, principally for banks and insurance companies. While all of these peers also provide solutions to the financial service sector, there are two public Chinese IT companies that exclusively work in this industry and they are Longtop Financial (NYSE: LFT) and Yucheng Technologies (Nasdaq: YTEC). Upon reviewing their disclosure on their competitive landscape, neither company even mentions CIS.

Yucheng's March 2010 investor presentation on slide 9 shows a good competitive landscape overview of the Chinese financial technology market. The slide was produced with the help of an independent IDC report, and presumably the Company's own market knowledge. While showing the industry is fragmented, it is clear that neither Yucheng nor IDC considers CIS to be a materially important industry participant. Given the size of CIS's reported financial service revenues of $67m in relation to Yucheng's reported revenues of $61m, we find this to be a noteworthy result.

http://www.sec.gov/Archives/edgar/data/1356462/000114420410012102/v176719_6-k.htm

Longtop Financial's last Annual Report also fails to mention CIS:

"*We also face competition from well-funded international platform providers, such as Accenture and IBM, domestic IT solution providers for the financial services industry, such as Digital China Holdings Limited, Yucheng Technologies Limited, Global InfoTech Group, Sinosoft, and other targeted solutions providers in certain market segments in which we operate*"

The omission of CIS is not just limited from competitors' viewpoints. For example, a recently released, independent research report on the state of the Chinese banking solutions market in March 2011 fails to indentify CIS as a meaningful participant in the industry; however, they do note both Yucheng and Longtop:

http://www.businesswire.com/news/home/20110323005101/en/Research-Markets-Core-Banking-Solutions-Market-China

Furthermore, industry trade organizations such China Sourcing (http://en.chinasourcing.org.cn/index.jsp) do not reference CIS as an industry participant. However, peers such as iSoftStone, HiSoft, Longtop, VanceInfo, and Chinasoft are all recognized independently among their list of "The Top 10 Leading Service Providers." Meanwhile, CIS is not even listed among "The Top 100 Growing Service Providers." The International Association of Outsourcing Professionals (IAOP) also compiles a list of the top 100 global outsourcing corporations and omits CIS, but names all of the same competitors listed above (http://www.iaop.org/content/23/152/2040/). Lastly, CIS is also absent from the China Global Services Alliance (http://www.chinagsa.org/members).

Given that CIS is very comparable in terms of revenue size, reported growth rate, and business/industry mix, we find these consistent omissions by both peers and independent sources to be a cautionary sign.

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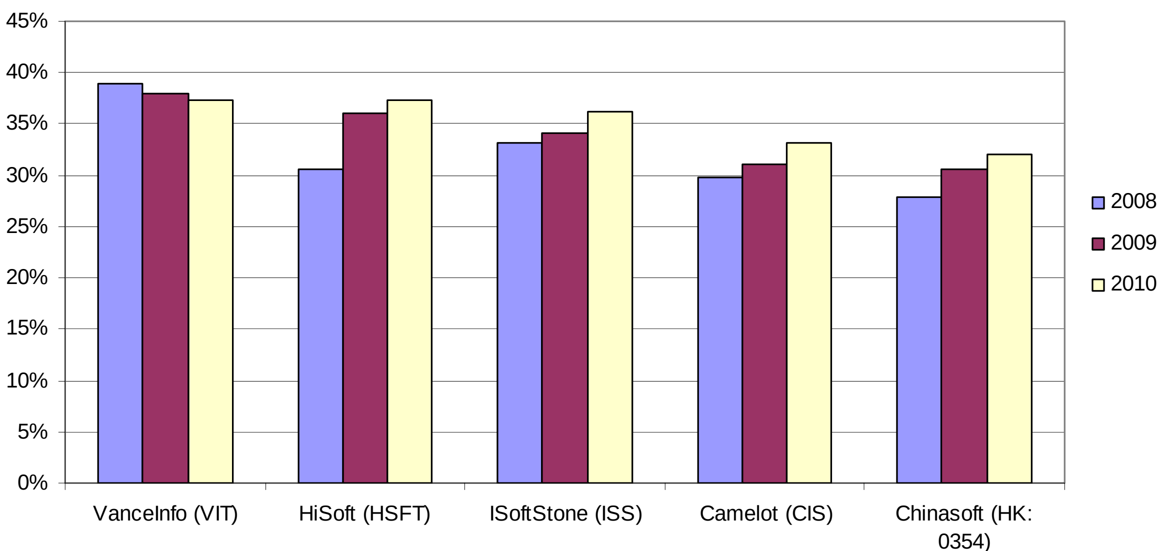
CIS's Cost Structure Also Appears Inconsistent

We have established that CIS reports extraordinary revenue productivity for a workforce that is claiming similar services, to similar clients, in similar industries to many of its peers. Now let's take a closer look at their reported cost structure.

The gross margins over the past three years are illustrated below:



Source: Company financials, excludes share comp. and intangible amort.

Gross margin is impacted by cost of revenues for IT service companies, which mainly consists of outsourcing costs, compensation and benefit expenses (including share-based compensation expenses), travel expenses and material costs.

A deeper dive into the cost of revenues yields some interesting observations; In particular, we note that CIS's compensation costs are primarily outsourcing costs, and that total wage expenses as a percentage of total cost of revenues is materially lower for CIS than its peers. From this perspective, it appears that CIS is acting more like a staffing and placement operation, rather than a Company with deep technical knowledge and capable of achieving premium prices for its services as they suggest. CIS's trend of outsourcing has accelerated in recent years, whereas its peers that disclose outsourcing costs have scaled back this practice.

Cost Components as a % of Total Cost of Revenues

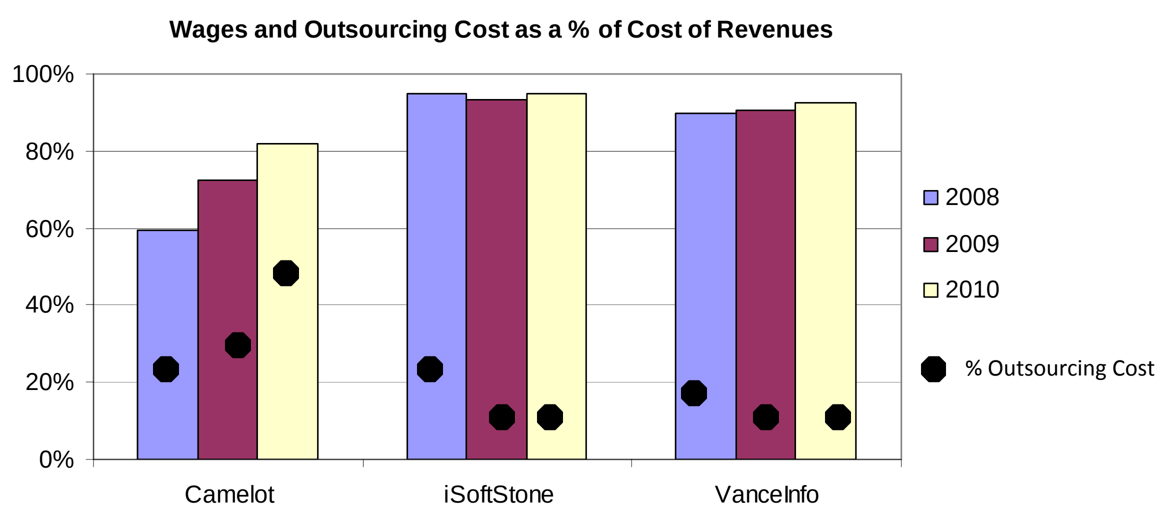
Camelot Info. Systems	2008	2009	2010
Compensation and benefits	32%	36%	30%
Outsourcing Costs	28%	36%	52%
Total comp+outsource	60%	72%	82%
Travel Expense	26%	15%	9%
Materials	14%	9%	7%
Other	1%	4%	4%
Share comp. expense	0%	0%	0%
Amortization	-1%	-1%	-1%
Total	100%	100%	100%

VanceInfo	2008	2009	2010
Salary and compensation	73%	78%	81%
Subcontracting costs	17%	13%	12%
Total comp+outsource	90%	90%	93%
Travel costs	5%	5%	4%
Other costs	6%	5%	4%
Share comp. expense	0%	0%	0%
Total	100%	100%	100%

iSoftStone	2008	2009	2010
Salary and compensation	71%	78%	81%
Subcontracting costs	24%	16%	14%
Total comp+outsource	95%	93%	95%
Rental	3%	3%	3%
Travel and transportation	3%	2%	3%
D&A	2%	1%	2%
Other	2%	2%	3%
Gov't subsidies	-3%	-2%	-5%
Share comp. expense	0%	0%	0%
Amortization	-1%	0%	0%
Total	100%	100%	100%

Source: Company financials

The point is illustrated clearer in the chart below. While the trend for higher wage costs as a percentage of total revenue costs is rising, the differential gap to peers is certainly striking, as is the increasing cost component of outsourced labor.



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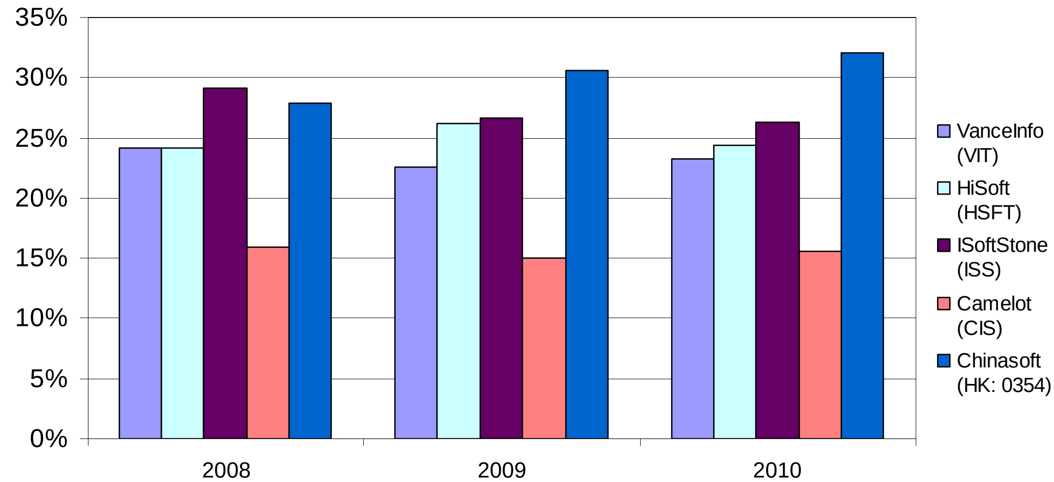
Furthermore, a closer look at selling, general and administrative expenses also highlights some important observations: CIS has consistently reported the lowest SG&A expense margin in the industry.



CIS has unusually low and stable SG&A margin for a growth company

Source: Company financials, excludes share comp. and intangible

CIS's SG&A margin has remained constant while it has been increasing industry-wide to support growth and general cost inflation. Recall that CIS has been reporting revenue growth consistent with the industry, so steady margins implies their cost structure is also growing at approximately the same rate. While plausible, this is very unlikely, especially in light of CIS's acquisition spree and need to integrate disparate business operations. Many in the industry have also been indicating the increase in wage pressure due to the war for talent and overall cost inflation in China. This is best illustrated by some relevant disclosures:

"*Our most significant costs are the salaries and other compensation expenses for our professionals and other employees. Wage costs for professionals in China are lower than those in more developed countries and India. However, because of rapid economic growth, increased productivity levels, and increased competition for skilled employees in China, wages for highly skilled employees in China, in particular middle- and senior-level managers, are increasing at a faster rate than in the past. We may need to increase the levels of employee compensation more rapidly than in the past to remain competitive in attracting and retaining the quality and number of employees that our business requires*"

-- iSoftStone, Annual Report

"Wage costs for professionals in China are lower than comparable wage costs in more developed countries and India. However, the wage costs in China's IT services industry may increase at a faster rate than in the past. In the long term, wage increases may make us less competitive unless we are able to increase the efficiency and productivity of our professionals as well as the prices we can charge for our services. Increases in wage costs, may reduce our profit margins."

-- VanceInfo, Annual Report

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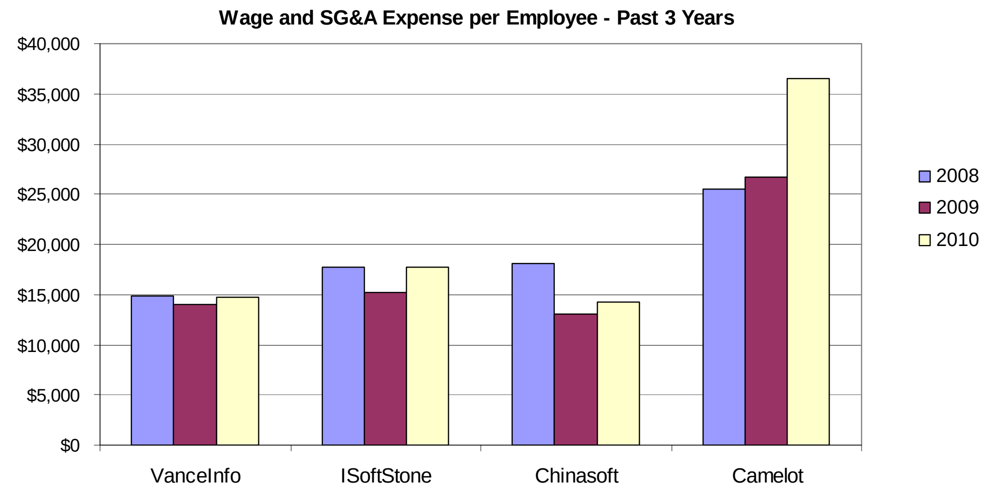
If we look closer at total wages (including outsourcing costs) and SG&A expenses per employee, we again find CIS to be an extreme outlier in its industry. The higher cost trend accelerated in 2010 as CIS's wages cost grew by 80%, yet their stated employee growth was only 20%.



Source: Company Filings
Note: Exludes share comp and amortization expenses

CIS spent more than double the industry average on wages and SG&A expense per employee than industry peers in 2010

A View Into CIS from its Employees

<u>LinkedIn</u>

LinkedIn provides a valuable window inside a company. Technology professionals by their nature are technology savvy, and tend to embrace the LinkedIn platform. Therefore, we find it incredibly striking that CIS has virtually no employees registered on LinkedIn:

Company	Employees on LinkedIn	Followers
Neusoft	964	1190
VanceInfo	757	901
HiSoft	704	937
ISoftStone	480	628
Chinasoft Int'l	243	251
Longtop Financial	243	271
Dimension InfoTech (1)	14	17
Camelot Information Systems	12	19

(1) Recently acquired by CIS in Jan 2011
Source: LinkedIn.com, Aug 1, 2011

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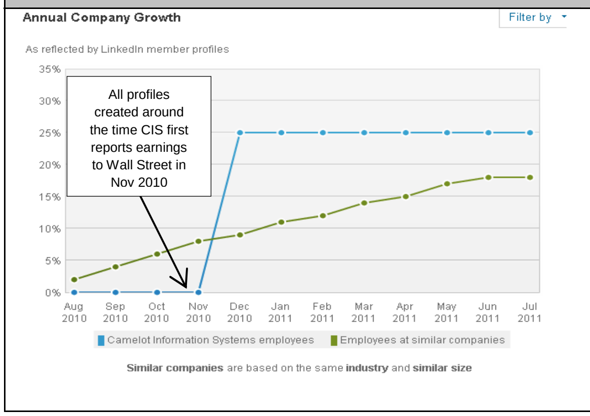
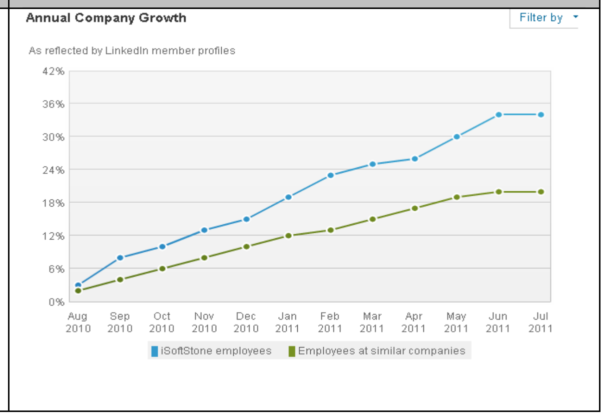
In fact, the user statistics indicate that almost all CIS employee profiles were created on LinkedIn shortly after going public and not a single employee has joined the site thereafter. For comparison purposes, each of CIS's competitors has shown steady growth in employee profiles on LinkedIn.

Camelot Information Systems

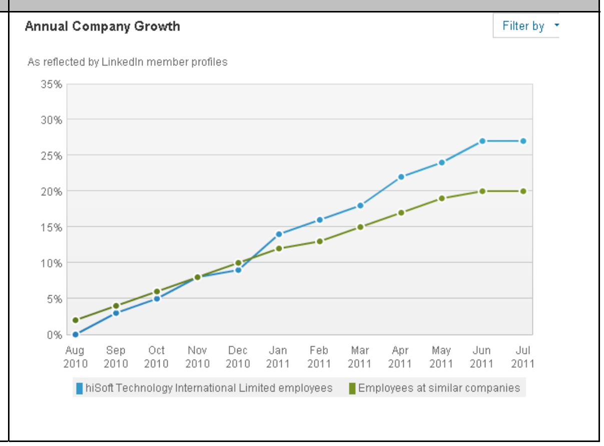


iSoftStone



VanceInfo Technology

HiSoft Technology



Source: LinkedIn

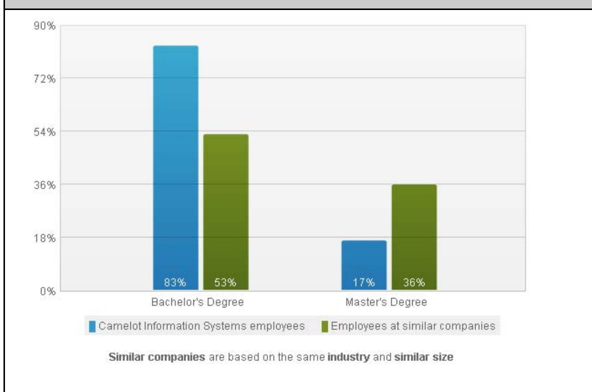
LinkedIn also allows us to examine management's claims that the experience and knowledge of their workforce is related to their ability to achieve superior pricing on contract terms. LinkedIn compiles statistics from its members that analyze both the education and work experience level for a given company and compares it with the average for the industry.

The charts below indicate that CIS's workforce, albeit on a limited sample set, has greater percentage of workers with bachelor's degrees (lower % of master's degrees) than the industry. Furthermore, their workforce tends to be less experienced with nearly one third of employees having less than 5 years professional experience. Their IBM contract does tie prices to the experience level of its employees as indicated in Annex B of their agreement:

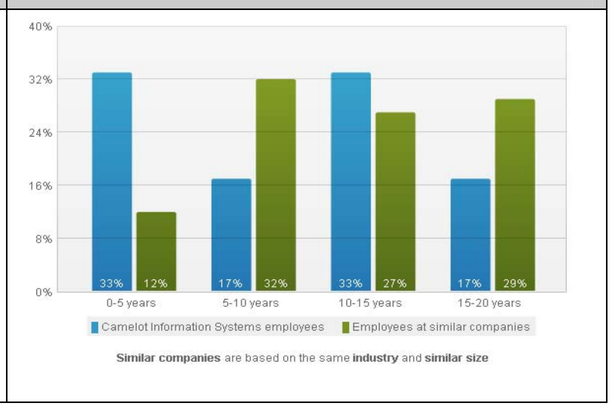
http://www.sec.gov/Archives/edgar/data/1487295/000134100411001272/ex4-9.htm

These results, cast further doubt on management's claims that they are able to achieve higher revenues per employee than their competition.

Highest Degree Obtained: CIS vs. Industry



Years Work Experience: CIS vs. Industry



Reference Links:

Camelot Information Systems
http://www.linkedin.com/company/camelot-information-systems/statistics

VanceInfo
http://www.linkedin.com/company/vanceinfo_2/statistics

HiSoft Technology
http://www.linkedin.com/company/hisoft-technology-international-limited/statistics

ISoftStone
http://www.linkedin.com/company/isoftstone/statistics

7Yes.com (Chinese version of Glassdoor.com)

If we are to take the Company's claims at face value, employees are supposed to be highly productive as indicated by the extreme measure of revenue per employee. Furthermore, we would expect employees to be satisfied with their compensation given that CIS is spending nearly twice the amount of money per employee on wages than its industry competitors.

Unfortunately, we find a contradictory view to these claims thanks to a Chinese career social networking website called 7yes.com. This website is analogous to the U.S. website called Glassdoor.com, which provides employee reviews and feedback on companies. Below are recent excerpts from the site. We did not simply pick or chose negative posts; all of the posts, dating back to 2005 to the present, had scathing comments, particularly on the topic of HR recruitment, pay, and career opportunities.

接到这家公司,一直催着要给签合同，说不去了公司报道 居然威胁我，以后找工作别想混了

"I received the offer from the company, who pushed for a contract. I told them I was not able to join, but the recruiter threatened me that I would not be able to look for the next job if I refuse."

确实是烂。有认识的朋友，离开后竟然半个多月工资都不给的。垃圾。

"It is really bad. I know a friend owed half a month salary after leaving. Garbage."

垃圾外包公司，福利差，没奖金，没补助，离职还扣发两个月工资。

"Garbage outsourcing company. Poor benefits. No bonus. No subsidy. Got taken off two month salary after resignation."

公司走了好多人啊，流水似的，在那里的还不赶紧跳啊？

"Many people left like water. Those who are still there had better leave soon."

公司很多职位又枯燥又没发展，去了就是耽误自己

"Many boring positions without a future. Waste your opportunity if you go there."

柯莱特确实很烂, 知法犯法, 快点倒闭! 我2011年4月份的工资,到现在6月份还不发. 还见一帮托

"Camelot is truly awful. They break the laws. Go bankrupt soon! They did not give me my April salary even in June (now). They are a bunch of cyber-junkies (those who get paid for pumping)"

公司很多职位又枯燥又没发展，去了就是耽误自己

"Many boring positions without a future. You will waste your opportunity if you go there."

Reference Link: http://7yes.com/group/bewwwnote/gid/6330

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Questionable Acquisitions are Generating CIS's Growth

CIS has completed over 9 acquisitions in the past few years as part of its growth strategy, yet offers investors very limited disclosure on these deals. Below we take a closer look at 4 of the acquisitions recently completed and have highlighted areas of interest in grey.

Observations:

1) Unusually high goodwill and intangibles representing 75-100% of the acquisition price
2) Companies acquired have limited to no property, plant and equipment value
3) Companies acquired have limited contract backlog value and are being amortized in most cases over just 1 year
4) Stock issued in most cases valued at under $6.00/ADS

It's not uncommon for technology companies to be asset light business models, with much of the value comprised of employees, relationships, tech "know-how," and brand value. Nonetheless, we find the high goodwill and intangibles, low PP&E and limited value attributed to contract backlog concerning. To illustrate, we point to the recent acquisition of Beijing Tansun Software Technology Co., Ltd. According to the Company's website (http://www.tansun.com.cn/list.php?fid=41&), they've been in business for 10 years and have over 600 employees. At their stated $1m PP&E level, that equates to less than $1,700 per employee which seems incredibly low by any measure. The contract backlog value of $580,000 also doesn't seem large enough to justify a fully employed workforce of 600 people.

Unfortunately, due to limited disclosure, we are not able to analyze the revenue and profitability for any of CIS's acquisitions on an individual basis. Furthermore, the Company has not even communicated these acquisitions to shareholders through press release announcements. For example, the most recent acquisition of Dimension InfoTech Ltd. in January 2011, CIS's first transaction since coming public in 2010, wasn't announced to shareholders. The deal was quietly included as a note in the Company's annual report. It's not hard to understand why CIS might not want to draw attention to this deal. For starters, Dimension shareholders received 4.4 million shares at $18.54/ADS; a healthy discount to the trading price for CIS stock, which averaged $25.00/ADS for the month of Jan 2011, and the 3 month trailing price average of $21.90/ADS. More importantly, the Dimension acquisition potentially places CIS in direction competition with IBM, their largest customer. As can be seen on the following link (http://www.sap.com/china/partners/consult/index.epx), Dimension InfoTech is a certified SAP consulting partner. However, according to CIS's technical service agreement with IBM, they agreed to a non-compete clause for SAP consulting services, that if violated, could result in a termination of their IBM contract.

Section 16.0, Non Compete
http://www.sec.gov/Archives/edgar/data/1487295/000134100411001272/ex4-9.htm)

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CIS's Recent Acquisitions

Dimension InfoTech, January 2011 ($ in millions)		Wtd. Avg. Useful Life
Cash	$1.51	
Term deposits	0.30	
Accounts receivable	3.59	
Other current assets	1.02	
Property and equipment	0.15	
Intangible assets		
Trade name	$2.20	Indefinite
Contract backlogs	0.64	1 year
Customer relationships	0.73	5 years
Non-Compete Agreement	0.78	3 years
Total Intangibles	$4.35	
Goodwill	6.51	
Fair Value of Assets Acquired	$17.43	
Current liabilities	($2.28)	
Bank Borrowings	0.00	
Deferred tax liabilities	(0.65)	
Fair Value of Liabilities	($2.93)	
Purchase Price	$14.50	
Goodwill and Intangibles / Purchase Price	**75%**	
Financed by:		
Cash	$4.00	
Stock	$5.34	
Ordinary Shares Issued	1.15	
Stock Price	$4.63	
ADS Equivalent Price	$18.54	
Fair Value of Earnout	$5.15	
Total Financing	**$14.50**	

Tansun, Dec 2009 ($ in millions)		Wtd. Avg. Useful Life
Cash	$1.84	
Restricted Cash	0.00	
Accounts receivable	3.54	
Other current assets	0.71	
Property and equipment	1.09	
Intangible assets		
Trade name	$3.02	Indefinite
Contract backlogs	0.58	3.5 yeas
Customer relationships	2.58	4 Years
Completed Technology	3.60	
Total Intangibles	$9.79	
Goodwill	8.72	
Fair Value of Assets Acquired	$25.68	
Current liabilities	($3.98)	
Bank Borrowings	(1.80)	
Deferred tax liabilities	(1.38)	
Fair Value of Liabilities	($7.16)	
Purchase Price	$18.52	
Goodwill and Intangibles / Purchase Price	**100%**	
Financed by:		
Cash	$8.79	
Stock	$5.78	
Shares Issued	3.93	
Stock Price	$1.47	
ADS Equivalent Price	$5.88	
Fair Value of Earnout	$3.97	
Total Financing	**$18.52**	

Source: Company filings.

Beijing Yinfeng Tech, April 2008 ($ in millions)			Wtd. Avg. Useful Life
Cash		$0.57	
Accounts receivable		0.55	
Other current assets		0.04	
Property and equipment		0.10	
Intangible assets:			
Trade name		$0.33	Indefinite
Contract backlogs		0.12	1 year
Customer relationships		2.35	5 years
Completed technology		0.25	5 years
Total Intangibles		$3.05	
Goodwill		9.66	
Fair Value of Assets Acquired		$13.98	
Current liabilities		($1.09)	
Deferred tax liabilities		(0.29)	
Fair Value of Liabilities		($1.38)	
Purchase Price		$12.60	
Goodwill and Intangibles / Purchase Price		**100%**	
Financed by:			
Cash		$8.16	
Stock			
Shares Issued	Sep-09	1	
Stock Price		$1.22	
ADS Equivalent Price		$4.88	
Shares Issued	May-10	2.20	
Stock Price		$1.47	
ADS Equivalent Price		$5.88	
Total Financing		**$12.60**	

Source: Company filings.

Red River Valley, February 2008 ($ in millions)			Wtd. Avg. Useful Life
Cash		$0.96	
Accounts receivable		2.02	
Other current assets		0.78	
Property and equipment		0.12	
Intangible assets:			
Trade name		$1.34	Indefinite
Contract backlogs		0.07	1 year
Customer relationships		1.24	3 years
Completed technology		0.53	10 years
Total Intangibles		$3.17	
Goodwill		5.81	
Fair Value of Assets Acquired		$12.86	
Current liabilities		($1.72)	
Deferred tax liabilities		(0.19)	
Fair Value of Liabilities		($1.91)	
Purchase Price(1)		$10.95	
Goodwill and Intangibles / Purchase Price		**82%**	
Financed by:			
Cash		$5.20	
Stock		$2.05	
Shares Issued	May-10	1.8	
Stock Price		$1.14	
ADS Equivalent Price		$4.56	
Total Financing		**$7.25**	

Deal term was amended. $8m deferred payment was settled with $1.5m in cash and 1.8m shares @ $1.14.

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CIS's Balance Sheet Is Notably Weak

The impact of CIS's acquisitions is evident when comparing its balance sheet among its peers. CIS has unusually high goodwill and intangibles, and low property, plant and equipment among its assets. High days sales outstanding and payables also indicate delays in paying and receiving cash.

FY 2010 Balance Sheet $ in millions	VanceInfo VIT	HiSoft HSFT	ISoftStone ISS	Camelot CIS
Current Assets				
Cash and Investments (1)	$181.5	$170.2	$184.0	$147.4
Accts. Receivables				
Billed	$27.1	$35.9	$26.7	$43.1
Unbilled	60.3	11.6	77.6	63.0
Allowance	(2.0)	(3.7)	(2.3)	(0.4)
Accts. Receivable, Net	**$85.4**	**$43.8**	**$101.9**	**$105.7**
Inventories	0.0	0.0	0.0	1.6
Prepaid Expenses/Other Assets	4.9	4.1	7.8	11.4
Deferred Income Tax Asset	2.4	0.3	1.1	1.0
Loan Receivable	0.0	2.5	2.5	0.0
Deferred Costs	0.0	0.0	0.0	0.0
Total Current Assets	**$274.2**	**$220.9**	**$297.4**	**$267.2**
Goodwill	$28.1	$18.6	$19.4	$41.2
Intangible Assets	6.8	4.5	5.6	26.6
Property, Plant, Equipment	20.3	9.8	17.9	4.7
Pre-paid rent	2.4	0.0	0.0	1.5
Long-term Investments	1.7	0.0	0.4	0.0
Prepaid Land Rights	18.0	0.0	0.0	0.0
Deferred Income Tax Asset	0.0	0.5	0.5	0.2
Other Assets	0.0	0.8	1.9	0.1
Total Assets	**$351.6**	**$255.1**	**$343.0**	**$341.5**
Current Liabilities				
Short-term Loans	$3.0	$40.0	$37.3	$11.6
Convertible Notes	0.0	0.0	29.4	0.0
Accounts Payable	0.8	2.3	12.9	18.6
Accrued Expenses	36.4	28.1	24.1	19.1
Acquisition Payables	0.0	0.0	3.6	15.6
Income Tax Payable	7.7	5.3	1.7	9.6
Deferred Revenue	1.3	0.0	5.7	5.6
Gov't Grant	0.0	2.9	0.0	0.0
Other Current Liabilities	0.5	0.0	1.0	0.0
Total Current Liabilities	**$49.7**	**$78.5**	**$115.7**	**$80.0**
Long-term borrowings	0.0	0.0	0.0	0.4
Deferred Income Tax	1.2	0.6	1.2	4.3
Unrecognized Tax Benefit	0.0	1.0	0.0	0.0
Other liabilities	1.3	0.0	0.0	1.1
Acquisition Payables	3.3	0.0	0.7	2.3
Total Liabilities	**$55.5**	**$80.1**	**$117.6**	**$88.2**
As of % of Assets				
Cash and Investments (1)	66%	77%	62%	55%
Property, Plant, Equipment	6%	4%	5%	1%
Goodwill & Intangibles	10%	9%	7%	20%
Accounts Receivable	31%	20%	34%	40%
As of % of Liabilities				
Accounts Payable	1%	3%	11%	21%
Acquisition Payables	6%	0%	4%	20%
Days Sales Outstanding	147	109	189	200
Days Payable Outstanding	2	9	38	53

(1) Includes restricted cash
Source: Company annual reports

Metrics shaded indicate the weakest balance sheet among peers

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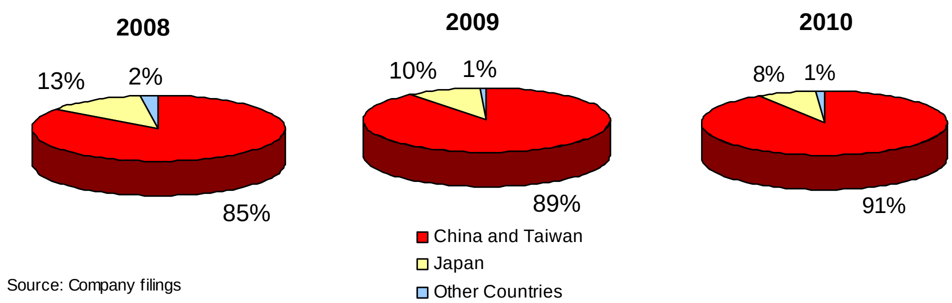
Cash Management Strategy at Odds with Capital Requirements

The Chinese IT industry has grown over the years not only by serving its own domestic clients' needs, but also by expanding to serve a global client base looking to tap into its cheap, and abundant workforce with localized knowledge. However, not every company in the industry has experienced the same international growth pattern. For example, CIS has seen little change in its overall business mix of revenues from customers outside of China and Taiwan. Their strategy has been to grow organically in China and Asia, but also through acquisitions as illustrated earlier.

The following pie charts indicate that China and Taiwan have become a greater proportion of CIS's revenue mix on the past three years.

CIS's Historical Revenues By Customer Origination



Source: Company filings

For comparison, we can see that Camelot has the highest proportion of Chinese and Taiwanese sales, and, therefore the lowest proportion of sales to the U.S. among its peer group.

FY 2010 Revenue by Customer Location

Location	VanceInfo	HiSoft	iSoftStone	Camelot (1)
China	45.1%	8.6%	55.2%	91.1%
US	33.6%	54.1%	25.2%	0.0%
Europe	15.2%	9.3%	9.0%	0.0%
Japan	4.7%	23.0%	10.3%	7.7%
Other	1.4%	5.0%	0.3%	1.2%
Total	100.0%	100.0%	100.0%	100.0%

(1) Reported as PRC and Taiwan
Source: Company filings

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CIS discusses the effect of its geographic business mix on its foreign currency exposure and reporting in its financial filings:

"A majority of our net revenues and a significant majority of our expenses are denominated in Renminbi, the legal currency of China .. For the year ended 2010, our net revenues denominated in Renminbi, New Taiwan Dollar, Japanese Yen and other currencies accounted for 83.4%,7.8%,7.6% and 1.2% respectively, of total net revenues."

--Camelot Information Systems, Annual Report

As illustrated, it does not appear that CIS has material economic exposure to the U.S. Dollar other than "translation risk." This is further supported by the fact that CIS does not have any operating subsidiaries in the United States as indicated here:

http://www.sec.gov/Archives/edgar/data/1487295/000095012310061173/h03859exv21w1.htm

CIS's business entities with functional currency of RMB, Yen, NT$ and HK$ translate their operating results and financial position into the U.S. dollar, the Company's reporting currency. Translation adjustments are reported as cumulative translation adjustments and are shown as a separate component of other comprehensive income. These translations are book entries only and do not require the physical movement of currencies.

Given the foregoing discussion, we turn our attention to the location of CIS's cash accounts. A detailed comparison of cash management practices for industry peers is provided in the table below.

Cash Balance by Location - March 31, 2011
$ in millions

Location	VanceInfo	%	HiSoft	%	iSoftStone	%	Camelot	%
US	$0.8	1%	$3.0	2%	$2.4	2%	$86.9	73%
China	$73.2	50%	$117.6	92%	$155.1	96%	$26.5	22%
Hong Kong	$60.5	41%	$1.2	1%	$1.1	1%	$0.1	0%
Taiwan	$0.2	0%	$0.0	0%	$0.2	0%	$3.9	3%
London	$11.1	8%	$0.0	0%	$0.0	0%	$0.0	0%
Japan	$0.6	0%	$4.7	4%	$2.4	1%	$1.4	1%
Other	$0.1	0%	$1.9	1%	$0.0	0%	$0.1	0%
Total Cash	$146.4	100%	$128.3	100%	$161.3	100%	$118.9	100%

Reference Links:

Camelot Information Services
http://www.sec.gov/Archives/edgar/data/1487295/000134100411001248/camelot_6k.htm

VanceInfo
http://www.sec.gov/Archives/edgar/data/1417961/000095012311055683/c18270exv99w1.htm

HiSoft
http://www.sec.gov/Archives/edgar/data/1493639/000110465911031564/a11-13206_1ex99d1.htm

iSoftStone
http://www.sec.gov/Archives/edgar/data/1500308/000119312511155690/d6k.htm

The analysis indicates that CIS keeps a majority of its cash in a U.S. bank account with Citibank. Given our understanding that CIS has limited business in U.S. dollars, and no U.S. operating subsidiaries, this appears unusual and out-of-line with industry practice. By comparison, its peers report sales to U.S. customers of between 25% – 55% of revenues, yet keep only minimum cash balances in the U.S.

All foreign exchange transactions involving RMB must take place through the People's Bank of China or other institutions authorized to trade. RMB is freely convertible only to the extent of current account items. For FX transactions under capital account items, such as making inbound and outbound direct investment, borrowing foreign loans, and repatriation of investments, prior approval of, or registration with, the State Administration on Foreign Exchange ("SAFE") or its local branches is required.

CIS raised money in its IPO for working capital and general corporate purposes, as well as funding possible future strategic acquisitions. Keeping funds in the U.S. appears at odds with CIS's financial needs and objectives: 1) US$ yields are unattractive vs. RMB; the U.S. dollar is depreciating against the RMB 2) Working capital needs are in RMB 3) Acquisitions have predominately been in Asia/China 4) RMB foreign exchange capital controls make keeping funds outside of China less liquid.

Internal Controls Casts Doubt on Reliability of Financials

By its own recognition, CIS has a "significant deficiency" over its internal controls for the financial reporting period ending December 31, 2010. The significant deficiency identified primarily relates to a lack of continuing professional training on U.S. GAAP and SEC regulation and rules for key accounting personnel. Furthermore, CIS had a "material weakness," which is a more severe issue, for the FY 2009 period and prior to going public. The material weaknesses identified primarily related to: (i) lack of a comprehensive accounting policies and procedures manual in accordance with U.S. GAAP accessible to accounting personnel to ensure that accounting policies and procedures are followed; and (ii) lack of dedicated resources to take responsibility for finance and accounting functions and the preparation of financial statements in compliance with U.S. GAAP.

Who is overseeing the finance and accounting function at CIS?

CIS's current CFO is Mr. Gordon Lau. According to his published biography, Mr. Lau served as the CFO of BJB Career Education Company Limited (a company that failed to go public with Goldman and Credit Suisse underwriting it in Dec 2010 due to "market conditions," a period when dozens of Chinese companies came public in the US), and as the CFO of Xinhua Finance Limited, a financial information company listed on the Tokyo Stock Exchange. Certain readers may recall that Xinhua Finance also used to trade here in the U.S. on the Nasdaq under the ticker XFML, but was eventually delisted. Three former executives of Xinhua Finance are currently facing fraud charges and are set to go to trial (http://www.bbc.co.uk/news/business-13356791). Mr. Lau was not implicated in the alleged fraud, but given the connection to the XFML and the foregoing statements on internal control weaknesses, we believe our cautionary stance on CIS's financial disclosures are warranted.

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Conclusion and Price Target

Our analysis has highlighted numerous concerns with CIS's business model. While providing similar services in similar industries to its peers, CIS reports significantly higher revenues and costs per employee. Are we to conclude that CIS offers unique services, achieves premium pricing, and has a highly productive and well-paid workforce? To the contrary, we find compelling evidence that employees are dissatisfied in a number of areas including recruitment, pay, and the quality of career opportunities. Unlike its peers that report significant employee turnover, CIS does not, so we wonder if CIS is intentionally concealing troubles with retaining employees, or just a staffing company cloaked as an IT services specialist? We also illustrated that employees are nearly absent from LinkedIn, a popular and global career website. This observation makes us wonder: Is CIS's business growing as fast as they are disclosing? One thing that is growing is the Company's pace of acquisitions. We present evidence that indicates CIS is paying extreme premiums for business that appear to have little in operating assets and contract backlogs, funded with stock at a large discount to its current value. We also find evidence of an unusual cash management strategy at odds with industry practice and the Company's own financial needs. For a company that has acknowledged material weaknesses in its financial reporting, we are extremely cautious and conclude Camelot's stock value may be closer to fantasy than reality.

Price Target

Given our concerns about the quality of Camelot's business, and the reliability of its financial statements, we believe the stock should trade between a range of $2.50 - $5.00 per ADS, where the low end is cash value and high end is the average implied share price of Camelot's stock issued for recent acquisitions. Therefore, our target price is the midpoint of our range or $3.75 per ADS.

Chinese IT Trading Comparables
($ in millions, except per share figures)

Name	Ticker	Stock Price 8/11/2011	% of 52-wk High	Ent. Value	Estimated Revenue Growth	LTM EBITDA Margin	P / E LTM	P / E 2011E	Enterprise Value / LTM EBITDA	Enterprise Value / Revenue LTM	Enterprise Value / Revenue 2011E	Tangible Value / Share	Net Cash / Share
VanceInfo	VIT	$17.67	43.0%	$643	24.1%	19.3%	21.5x	18.4x	14.8x	2.9x	2.3x	$5.78	$3.73
iSoftStone	ISS	$11.01	48.7%	$540	27.0%	13.5%	137.6x	20.4x	18.6x	2.5x	2.0x	$3.89	$2.07
HiSoft	HSFT	$10.64	31.3%	$249	14.4%	10.8%	23.0x	13.6x	14.5x	1.6x	1.4x	$4.87	$2.79
Chinasoft	HKG:0354	$0.36	93.6%	$573	18.9%	14.2%	NM	70.0x	17.1x	2.4x	2.0x	$0.02	$0.03
				Max	27.0%	19.3%	137.6x	70.0x	18.6x	2.9x	2.3x	$5.78	$3.73
				Average	21.1%	14.4%	60.7x	30.6x	16.2x	2.3x	1.9x	$3.64	$2.15
				Min	14.4%	10.8%	21.5x	13.6x	14.5x	1.6x	1.4x	$0.02	$0.03
Camelot	CIS	$9.12	32.4%	$322	22.3%	15.0%	45.6x	10.5x	10.2x	1.5x	1.2x	$3.80	$2.51

Source: Company filings; forward estimates based on First Call mean estimates.

Value of Camelot's Share Price Implied From Recent Acquisitions

Date	Acquisition	Implied ADS Price
2/1/2008	Red River Valley	$4.56
4/1/2008	VLife	$4.88
4/1/2008	Yinfeng	$5.38
7/1/2008	Harmonation	$4.56
7/1/2009	Agree	$5.00
12/30/2009	Tansun	$5.88
	Average:	**$5.04**

Source: Company filings