

July 2, 2010

Yesterday we released a response to ONP's press release stating that we had analyzed the wrong operating subsidiary. An article on TheStreet.com unethically reiterated this claim after we had already disproven it. The English name used to identify the entity is irrelevant in China – the Chinese name is the name that one by which documents are filed at AIC and other PRC government organs. The Chinese name of the entity that we analyzed is 河北省保定市东方造纸有限公司. As we discuss in our report yesterday, this is the same company that is a party to a bilingual loan agreement that ONP filed as an exhibit to its amended 10-Q (http://www.sec.gov/Archives/edgar/data/1358190/000114544310000219/d26110_ex10-5.htm). Thus we stand by all of our conclusions and analysis relating to HBOP.

Vested interests are attempting to distract the market from ONP by focusing attention on the authors of the report. We respond as follows.

Sean Regan's Perspective:

Rick Pearson's story posted on TheStreet.com contains some truths. They're just not relevant to ONP's true situation. The ONP story is about open secrets and an emperor with no clothes.

What surprises me most during my recent introduction to the investment banking / research world is how ill equipped many investors are at gauging production facilities, yet they invest in them anyway. As a production guy, I was dumbfounded Rick couldn't see the same factory I saw in 2 seconds. But after all today's China analysts are a generation raised in Herman Miller ergonomic chairs. Regardless I am shocked that people would stake their reputations on defending the operation I visited on January 5, 2010.

Background

I was brought in as the factory production consultant. I have been going in and out of factory in Asia for about 18 years. I like factories and respect the owners as some of the hardest working people on the face of the earth. Running a factory is tough! Being good at running a factory is even tougher.

Carson and I are good friends and he knows my passion and experience with production facilities. When he had a project with his father, he asked me to consult for them as a factory expert. Basically they would pay my expenses, fly me up and we would take a look. As he was a good friend, I was more than happy to help Carson out.

While at the Hong Qiao Airport waiting to board a flight to Beijing, Carson and I started to browse through the 10-K and 10-Qs. I graduated from business school in 1992, and it had been a while since I looked over such documents. But we sat in that airport for about 8 hours and poured through the documents devouring every page and laughing with coffee and pizza. We couldn't believe what we were reading.

After reading all documents I was eager to get in the factory and see it for my own eyes. That was the day I met Rick Pearson. It was auspicious to find that a reporter for TheStreet.com was there as well. I knew we would get the very best the factory had to offer. In addition, he wanted to film the plant. I cannot remember when I toured a factory with a reporter, much less one with such an esteemed background in finance. It was clear by the number of calls he took and conversations he had many deals going on in China. This factory guy found it all so interesting.

First Impression

After driving for a while, we turned down a narrow country road and drove into what seemed like a village and agricultural area. I instinctively looked for displaced pavement/ bumps on the road and other signs of wear and tear; this is a common sign of heavy traffic and over weight trucks. There were no signs of any sizable logistics operation on the road.

We approached a dilapidated gate and a group of rundown buildings that looked like old storage rooms or dormitories. The gate opened! I was surprised this was the factory.

This is where the divide happens. Two people can walk the same path and see dramatically different things. It must have a lot to do with experience. I never worked for a Wall Street bank, and until the day at the airport, I thought a 10-K was a weekend race. Rick's got that over me. But I do know factories!

The factory I was looking at was unprofessional, unorganized, had low output and produced low quality products. I also felt much of what I did see was staged. No amount jabbing or name calling is going make a real factory appear in the location I visited. The factory I visited, who ever owns or runs it, is incapable of performing to the level ONP reported to investors. Maybe there is another factory. Maybe there is more to it. But it's not on the film Rick made either.

Further Due Diligence

I asked Chairman Liu numerous questions during the factory tour and meeting afterward. These questions covered the production process in detail, and also focused on how ONP could produce and ship the quantities of product it claims.

At the time of the inspection ONP did not have a Chinese website. It claimed to have no contracts for its purported 600 workers. The chairman had no contract. Their

plant and equipment were dilapidated. The asset values reported to the SEC did not match what we witnessed. The ONP asset values are significantly higher than what similar equipment sells for brand new. We later confirmed this with more research, but I could see it in two seconds.

The logistics needed to ship \$102 million of paper products in China did not exist. The steam easily viewed in the video and water on packing tables refutes all claims of a quality paper product. One would not ship good quality production, paper included, uncovered in an open bed truck. The storage of millions of dollars of recycled paper in the open environment is irresponsible at best. And if that paper pile in the back of the plant is worth USD 4,600,000, save your office paper because you may be able to retire on it one day.

From my vantage point there seems to be a grand divide between buying stocks in the USA and understanding a Chinese companies fundamentals; products, people, plant and equipment. On all accounts, ONP fails the due diligence test.

Carson Block's Perspective:

In the following seven pages, I rebut the allegations in Rick Pearson's article. I also address the allegation (which Rick made as well) that our report was a vendetta for ONP turning down a proposal for paid research. We were engaged to perform due diligence for a separate company that was in discussions to provide paid research services to ONP. ONP failed due diligence, and no such proposal was ever made to – nor rejected by – ONP. Muddy Waters, LLC was born of the realization ONP provided us – that there is a gaping need for due diligence in China equity research.

On Rick Pearson's Feature, "Orient Paper: Story Behind 'Fraud' Report

Rick Pearson, Sean Regan, and I are alumni of the University of Southern California. I did not meet Pearson until after I graduated. A former Chinese professor under whom we had each studied introduced us. We met once or twice in Hong Kong in 1998 or 1999, and hadn't spoken again until we met at ONP. Sean had never met Pearson prior to ONP. As Rick wrote, he and I caught up on the way to the factory, talking about the paths our lives had taken from just after graduation, including how he had gone from Deutsche Bank to China microcaps.

We knew that our report would not help Pearson's career or reputation. However, we bore – and still bear – no ill will toward him. Nonetheless, we were surprised that he produced a video in which he's standing in front of clearly antiquated machinery talking about how the stock is a double. No doubt that Pearson is a smart guy with numerous accomplishments, but as Sean writes above, two people with varying experience levels can look at something entirely differently. In the factory, we clearly have the advantage.

I disagree with Pearson's assertions that we didn't ask questions. During the factory tour, Sean was repeatedly stopping to ask detailed questions about the machinery, processes, and chemicals. Chairman Liu was clearly impatient with the questions. Pearson, who was generally keeping up with Chairman Liu's brisk pace, occasionally exhorted us to move along as well. I noticed that Rick frequently interrupted Sean's technical questions or the answers. That partly explains how he got ONP so wrong.

It is true that Sean is not proficient in Chinese, and our interpreter had to translate a good deal of technical speech. Pearson asked his questions in Chinese. I understood his questions, and knew that he was not asking questions that were nearly as technical or detailed as those Sean asked.

Rick may have misinterpreted my silence in response to certain comments he made during the tour. Several times during the tour and in the car on the way back to the station, he exclaimed, "They're printing money!" (I assume he meant it in the legitimate sense.) I was conflicted. I felt the company was a sham and I wanted to help Rick out by telling him so; but, to do so was illogical. He clearly had a relationship with certain people associated with the company. I kept largely silent in response to his comments about the company and his questions as to what I thought. I was in a state of prolonged surprised that he could be so exuberant about this company.

One thing Rick did that really bothered me was shortly after entering the first workshop, he turned to Sean and requested that Sean film him walking around. He already had the camera out, practically in Sean's hand before Sean had the chance to respond. (Sean and I had previously explained to Rick that Sean is a factory expert, and that his role was to conduct technical due diligence in the factory.) Sean took the camera, but fortunately shed it about one minute later by handing it off. Sean was no longer impeded by any recording duties.

It is true that I didn't ask many questions during the visit. Sean was obviously running point on the factory portion. The two-hour lunch with Chairman Liu, his brother, and some other ONP personnel was social. Chairman Liu ordered bai jiu (a potent Chinese spirit). Rick and I actively imbibed with the Chairman at his invitation. Sean and our interpreter did not. Rick sat next to the Chairman and spoke with him a good deal. After the lunch, Sean told me that both Rick and I need to learn Chinese business meal etiquette, such as how to give and receive toasts. He told me he was surprised given the number of Chinese companies Rick sees that he doesn't know social etiquette well.

After lunch, we met at ONP's corporate office. Sean asked a number of questions about production, measuring production, and the products. I had prepared a number of detailed questions before hand about ONP's strategy. (I did not ask many financial questions because as I explain below, our role was due diligence; and, Winston Yen is the person to whom to address financial questions.)

During this meeting, I did not ask all of my questions for two reasons. First, Rick, who was sitting next to the Chairman was effectively monopolizing him much of the time. The other reason is that I was getting surprisingly poor responses to my questions, such as the Chairman's conclusion that ONP has a defensible competitive position merely by virtue of being located in He Bei. He was not concerned by the possibility that margins would be eroded by competitors copying (not unusual in China) this competitive advantage and moving in down the street (except for the fact that ONP's particular street cannot handle major truck traffic).

On Whether Our Report is a Vendetta for ONP Refusing to Pay us \$300,000 for Research

At no time did we, or the company for which we performed due diligence, make a proposal to ONP for compensated research. Nor did ONP reject a proposal from us, or from the company that engaged us to perform due diligence, for compensated research.

My father, William Block, owns W.A.B. Capital LLC ("WAB"), which writes equity research that it distributes to institutional investors. In many cases, it takes management on road shows to meet with institutional investors. In 1999, WAB switched its model from one driven by payments from institutions to one in which the companies compensate it through stock awards or warrants.

I left CIBC World Markets in mid-1999 and went to work with my father at WAB. I worked there full-time for about two years until mid-2001. Since leaving WAB, I have consulted for it on five projects.

In late 2009, my father developed an interest in China microcaps after attending a conference in Florida. It was there that he was first exposed to ONP. He explained his model to some ONP investors at the conference, and they thought that ONP would be a good fit for WAB.

When my father first spoke with me about ONP, I was skeptical. The amount of money it intended to raise to expand its paper factory seemed excessive. I told him to assume that construction expenses would be padded – the question was to what extent. He told me that he was quite impressed with the CFO, Winston Yen. He also said that he had heard Chairman Liu is "different" from other Chinese company bosses in that he doesn't drink, smoke, or chase women.

That was a red flag to me. In my time in China, I've found out that people or things billed as "different" are usually too much "the same." I thought that if the Boy Scout legend turned out to be untrue (which it did – see the social lunch I describe in the previous section), then the fact that this rumor has been created is alarming. It shows a deliberate attempt to game the American investor psyche.

But my father asked me to keep an open mind and meet with him and Mr. Yen in Los Angeles (I had already planned a trip). Between then and the meeting, my father told me that he discussed with Mr. Yen the possibility of doing paid research with a road show for ONP, and that Mr. Yen was interested in it. My father made it clear that any formal proposal would be contingent upon ONP going through due diligence. Mr. Yen stated that he felt compensation of approximately 20,000 shares would be appropriate.

My father of course had in mind that I would conduct the due diligence. He offered me a portion of any economics on the deal. I told my father that I was skeptical and that certain elements of the story sounded shaky. But I agreed that if the company were largely legitimate, there seemed to be a good deal of upside based on the valuation.

My father and I had lunch with Mr. Yen in November 2009. I felt Mr. Yen was sincere, but there were definitely issues with some of his answers to my questions. I tried to delve into the projected construction costs of the factory, asking questions including:

- How many square meters or feet would the factory be?
- What are you assuming is the cost per square meter or foot?
- Have the selected the contractor and how, or how did they intend to?
- What materials will you be building with?
- Will the machinery be domestic or imported?

Mr. Yen generally did not know the answers to these questions because they are very China-side specific. I thought that was reasonable. We then started to discuss the Shuang Xing asset acquisition. He told me that the assets were being acquired from a PRC subsidiary of a Singapore-listed company (I've since been told that other people heard a different story of the transaction). Some of the questions, his answers, and my thoughts are below:

Q: If the margins on this business are so good, why is this company exiting the business?

A: It's not exiting. It's relocating its business to Shandong province.

Q: Why aren't they moving the equipment?

A: It feels its better to buy new equipment in Shandong.

Q: But presumably this is expensive equipment if ONP is paying around \$13 million. How could buying new equipment be more sensible than transporting it?

A: I don't know.

Q: And ONP will be competing with them – right? Why would it make sense to buy new equipment when it's going to be creating a competitor by selling it the existing equipment?

A: I don't know.

Q: This is a new market for you. How will you sell these products?

A: We're going to be hiring the salespeople from the company selling the assets.

Q: Why wouldn't the salespeople have relocated?

A: Some have, but not all of them wanted to

(my thought: so you'll really be competing with the seller – makes no sense.)

Q: So if you're acquiring the assets and hiring the salespeople, why don't you acquire the company instead of the assets? Asset purchases are subject to a significant amount of tax. Registered capital purchases are not.

A: I'm not sure, but actually we already acquired the assets in a way.

Chairman Liu and some other shareholders bought them with their own money and are holding them until we can raise the money to acquire them.

Q: Are the assets currently in operation?

A: No.

(my thought: So the salespeople are just sitting around waiting to be hired?)

Q: At what price did Chairman Liu and the others acquire the assets?

A: I don't know, but we know that the price ONP is going to pay is fair. We had a valuation done on the assets that shows we're purchasing them at a fair price.

Q: Who did the appraisal?

A: A Bao Ding firm – I don't know the name.

(my thought: UH OH!)

Q: Why not use a major firm with an international reputation?

A: I think this firm specializes in valuing this type of asset.

(my thought: Yeah, right.)

Not all sounded bad during this meeting. I believed that there were some internal problems at ONP, but I was open to the possibility that the problems were manageable. I told Mr. Yen that I would handle due diligence for WAB, but that I would bring a manufacturing expert along. I emphasized to Mr. Yen that I would be very thorough and look more closely at the company than anyone else had. I said that I want to see all production lines and the Shuang Xing assets. Finally, I warned him that if Chairman Liu were not comfortable with that level of scrutiny, Mr. Yen should tell my father that ONP is not interested in a deal with WAB.

Mr. Yen soon reverted that ONP is interested in a deal with WAB, and that I was welcome to visit the factory. We made plans to visit on January 4th.

On January 3rd, Sean and I were at Hong Qiao Airport in Shanghai for a number of hours due to the snow in Beijing. This was the first opportunity either of us had to look through the 10-K and recent 10-Qs. As we went through the documents, my jaw dropped a number of times. There were so many red flags, a number of which we covered in our report. By the time we finished our reading, we were convinced the stock was a short.

When we got to Beijing one day late, our mentality had changed from long side due diligence to looking for evidence to build our short case. I had updated my father that there's no way this would be a WAB deal. He was fairly disappointed and played devil's advocate to a lot of the points I made about its inherent problems. In the end, he resigned himself to accepting that the company was not a buy.

The morning we left for Baoding, Sean and I had a spat in the hotel café. I was pouring over my questions, notes, and the filings. I kept trying to discuss the question pattern with Sean, but he wasn't engaging. He was conversing with our interpreter. In an aside, I told him that he needed to get more serious. We exchanged expletives. We then left for the train station.

On the train, Sean explained that it was unlikely one visit to the factory would be enough to build the case. He told me "I've visited over 1,000 factories and run three others. Running a factory is all about control. Guys who run factories are great at controlling people and conditions because they have to be. When you go to a factory, you're on his turf. You won't see what he doesn't want you to see the first time. That's why anytime I qualify a factory, I make at least three visits. They can cover things up, but you look for whether they're covering things up the same way each time. When you notice the differences, you understand what's going on." I calmed down, accepting that we were likely to have to make at least one more trip out to ONP.

After being taken to the factory (with Rick as a surprise fellow passenger), we had a few minutes of small talk with Chairman Liu in his office. Then we walked into the first workshop. The workshop walls were old and worn. But what really got me was the steam everywhere. Chairman Liu was moving quickly, and I was trying to keep up. I was a little disoriented because this was not what I had expected. After we passed the workers at the folding tables, we stopped at the cutting machine for the line. Sean leaned over and said "We got 'em." That was much faster than he'd expected.

The only further communication between ONP and my father or me was on January 6, 2010 when Chairman Liu's assistant emailed me to ask whether I had any follow up questions. I said that we'd like to visit the factory again, but would wait until after the fundraise. (Because of our subsequent document research, that turned out to be unnecessary.) There was no further communication with ONP until this week.

Thus, WAB never made an offer to ONP because ONP failed due diligence. My father felt, and I have to agree, that had WAB made an offer to ONP, it would have been accepted. Certainly that would have been an easier path to getting paid than we took with Muddy Waters, LLC.

On How We Came to Form Muddy Waters, LLC

Sean and I were mildly shocked by Pearson's video and the positive reviews that ONP continued to receive. We've seen this across all industries in China: Westerners wanting a piece of the China pie so badly that they're willing to believe anything. I've had a fairly rare experience here in that I've done business at the multinational level (as an attorney with Jones Day), and then I climbed down into the trenches by opening Mainland's first international standard self storage company.

After some time in the trenches as an entrepreneur here, I came to realize how ivory tower the multinational world (in China) is. My former Chinese colleagues – well educated, progressive, and diligent – are the cream of the crop here. The mistake too many foreign businesspeople make is thinking that the English speaking, relatively polished people they interact with here are representative of China. This myopia is a major factor affecting equity research on Chinese companies.

A number of my closest, dearest friends are Chinese. But the fact is that many of the small companies view analyst meetings as competitions for the money analysts represent. It's often a game where anything goes on the company side. We Westerners are not used to that system. To really understand how this works, you have to get burned on the ground here. With first-hand understanding of how business is conducted in China, you can see a lot more. Just like how a factory expert can identify far more issues than can a novice.

ONP and its attendant hype opened our eyes to the massive need for due diligence in China equity research. Thus, the plan came together in between running our other businesses. We decided that we would form the service and issue an inaugural report on ONP to demonstrate our due diligence capabilities.

There are good Chinese companies listed in the US. We intend to identify and recommend Strong Buys on them. When we do, we think that investors can be assured that these companies have been vetted more thoroughly than anybody else has done. But for the meantime, there are a lot of low quality companies that are being touted and pumped. This touting and pumping is US-driven. Unfortunately, there are those in the US who are complicit – if not orchestrating – these scams. Small China stocks remain caveat emptor for the time being.

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