



Muddy Waters, LLC  
www.muddywatersresearch.com  
info@muddywatersresearch.com  
June 28, 2011

Open Letter to SPRD Chairman re Muddy Waters' Concerns

Dear Chairman Li:

Muddy Waters, LLC has begun researching SPRD, and we have taken a short position in it. (Please see our disclaimer on the last page.) We have identified a number of issues in SPRD's filings, and we believe that there is a high risk of material misstatement in the reported financials since the time of Dr. Ping Wu's resignation. Our concerns are gravest regarding 2010 and 2011 numbers.

We are writing you an open letter so that our concerns and hopefully your responses are transparent to SPRD shareholders. The following letter contains questions relating to many of our areas of concern. Should you send us your response, we are happy to disseminate it.

- I. SPRD reported that revenue increased 229.6% in 2010, after generally being flat in 2007-2009. Can you please explain the sales increase in light of the following 2009 management changes:
  - Founder Ping Wu resigned as CEO in February 2009. According to a July 2010 interview in a respected business publication,<sup>1</sup> Mr. Wu resigned because the board had lost confidence in him. SPRD's sales cycle is four to nine months<sup>2</sup> and the turnaround began almost immediately after Mr. Wu resigned – revenue grew quarter over quarter in Q3 2009 by 136.6%. Therefore, the improved sales pipeline would have been evident under Mr. Wu.
    - Why would the board have lost confidence in Mr. Wu when the sales pipeline was so promising?
  - We note that CFO Richard Wei resigned in April 2009, which was one month before SPRD completed a \$44 million financing.
    - Because it would be unusual to fire a CFO during the financing process, is it fair to assume that he chose to leave?
    - If "yes", why would he have left with such strong sales in the pipeline?

---

<sup>1</sup> [http://news.hexun.com/2010-07-12/124224431\\_3.html](http://news.hexun.com/2010-07-12/124224431_3.html).

<sup>2</sup> SPRD 2010 20-F p. 11.

- II. MediaTek (2454.TW) had approximately 90% of the mainland China mobile handset chip market in 2009. Mobile handset chips are by far its largest revenue source – currently accounting for more than 70% of revenue.<sup>3</sup> Estimates now place MediaTek’s mainland market share at only 70%, with SPRD at 20% (an increase of about 15 percentage points). (It appears that these estimates are based in part on SPRD’s reported numbers.) However, MediaTek reported that its 2010 revenue decreased by 1.4%.

For MediaTek, which relies heavily on mobile handset chips, to have reported a sales decline of only 1.4% while seemingly losing 15 percentage points of market share to SPRD, the mainland China market for mobile handset chips must have grown substantially in 2010.

However, we note that both SPRD and MediaTek faced headwinds as mainland China authorities cracked down in 2010 on gray market handset manufacturers. At the high end of the market, Qualcomm (NASDAQ: QCOM) only grew its 2010 revenue 5.5%.

By how much did SPRD’s mainland China markets (by product type) grow in 2010?

- III. SPRD’s disclosure related to its 2010 revenue is unhelpful and opaque. The 2009 20-F disclosed RF transceiver and baseband semiconductor sales figures. However, the 2010 20-F does not discuss sales of these products. Instead the 2010 20-F discusses the percentage gains for sales of all bundled semiconductors (without ascribing any dollar values).

We take issue with the opaque 2010 disclosure because we believe that issuers should provide “apples to apples” information in successive periods, and the 2010 disclosure is frankly vague and unhelpful.

What were 2010 sales of RF transceivers, baseband semiconductors, and any other products SPRD began selling in 2010?

- IV. SPRD’s lack of any cash income tax payment in 2010 is inconsistent with prior years as well as the PRC’s provisional tax payment requirements. The table below shows SPRD’s pre-tax income, income tax provisions, and cash taxes paid for 2008 – 2010.

(000s)	2008	2009	2010
Pre-tax income	(78,477)	(18,292)	75,324
Income tax provision	201	1,024	8,130
Cash income taxes paid	808	817	-

<sup>3</sup> <http://www.taipeitimes.com/News/biz/archives/2011/04/30/2003502008>

The PRC Enterprise Income Tax law requires that companies pay provisional income tax on a monthly or quarterly basis. Companies must file a provisional tax return within 15 days of the close of the month or quarter along with the provisional payment.

If SPRD generated \$75.3 million in pre-tax profit in 2010, why didn't it make any cash tax payments?

- V. The near simultaneous turnover in 2009 among SPRD's CFO, audit committee, and auditor is troubling. In October 2009, SPRD's CFO, David Wu, resigned after only four months in the role. This was the second CFO in 2009 to resign. In September 2009, audit committee member Ken Lu resigned from the board. In September 2009, Deloitte Touche Tohmatsu was "removed" as auditor, and replaced by another Big Four auditor, PriceWaterhouseCoopers Zhong Tian.

Given that the turnover occurred while SPRD was in the midst of a stunning turnaround, did the resignations and removal have anything to do with discomfort about SPRD's accounting? If not, what were the reasons each resigned (or was removed in the case of Deloitte)?

- VI. We note that the sizes of five balance sheet / cash flow statement accounts grew tremendously in 2010. These accounts are among those that we consider high risk because they are primarily evidenced by paper documentation, rather than their physical presence (as in machinery and equipment). The abundance of paper accounts on the balance sheet was one of the early signs to us that Rino International Corp. was a fraud. It is clear that auditors in China are having significant problems evaluating the veracity of documents.

As discussed infra, we note that 44.8% of SPRD's 2010 year-end inventory is "deferred cost", which means that the inventory has been shipped to customers, but has not yet been booked as revenue. We therefore assume that the auditors did not lay eyes on most (if not all) of the deferred cost inventory.

The cash flow statement accounts that bother us the most because of their unusual sizes in 2010 (compared to earlier years) are shown below – note that all are operating cash flow accounts.

<b>Concerning Operating Cash Flow Accounts</b>			
	2008	2009	2010
Inventories	2,374,962	(17,158,015)	(108,686,598)
Prepayments, other receivables and other CA	(2,883,815)	2,210,729	(13,493,771)
Accounts payable	(14,199,778)	6,032,345	73,285,809
Advances from customers	(907,039)	14,355,732	88,046,631
Accrued expenses and other liabilities	(5,231,311)	7,207,433	21,531,228

As a general matter, can you explain why the size (in absolute value terms) of each of these accounts is much larger than in the past? What processes did the auditors undertake to confirm the sizes of each of these accounts?

- VII. Among the accounts shown in the prior question, we are most concerned about the increases in inventory (especially the deferred cost sub-account) and advances from customers. We believe that having enormous simultaneous increases in advances from customers and deferred costs is implausible.

<b>SPRD Key Balance Sheet Accounts</b>					
	12/31/06	12/31/07	12/31/08	12/31/09	12/31/10
Advances from customers	3,297	1,210	312	14,667	103,068
Days sales	11.2	3.0	1.0	51.0	108.6
Raw materials	2,371	6,467	2,725	3,014	19,341
Work in progress	6,417	4,325	1,654	3,258	10,771
Finished goods	4,829	14,261	9,433	15,126	43,406
<b>Deferred cost</b>	-	-	-	<b>4,144</b>	<b>59,579</b>
Total inventory	13,617	25,053	13,812	25,542	133,097
Turns (based on period end)	4.66x	3.19x	4.93x	2.62x	1.46x

A blogger recently stated that SPRD's new clients are being given up to 90 days to inspect the chips because SPRD is a new supplier,<sup>4</sup> which is the reason for the deferred cost. If SPRD agrees with that assessment, we are a bit perplexed as to how SPRD would maintain good relationships with its existing clients – presumably they would be unhappy with the preferential treatment being given to new clients. We note that MediaTek has no deferred cost account, and thus does not appear to extend this policy. The rationale that new customers want the inspection period because SPRD is a new supplier also strikes us as odd because SPRD and its main competitor MediaTek are fabless semiconductor companies. SPRD's chips are assembled by TSMC. Supplier-specific product defects would therefore be more likely due to design issues than manufacturing, and SPRD's 20-F indicates that clients test the designs before ordering.<sup>5</sup>

Why have each of advances from customers and deferred cost become so significant?

- VIII. We question the wisdom of paying \$32.58 million for a 48.44% stake in MobilePeak, which appears to be a distressed company.

MobilePeak appears to be a distressed company that had an urgent need for liquidity. Rather than completing this acquisition in one step, SPRD

<sup>4</sup> <http://seekingalpha.com/article/276318-spreadtrum-compelling-value-after-broad-chinese-stock-sell-off>

<sup>5</sup> SPRD 2010 20-F, p. 11.

purchased only 48.44% of MobilePeak for \$32.58 million. SPRD disclosed that it “intends to purchase”<sup>6</sup> the remaining equity by the conclusion of Q3. As part of the initial purchase, SPRD loaned MobilePeak money to pay off its convertible bridge loan.

Per the below SAIC financials, MobilePeak generates virtually no revenue, has negative net income, and has negative operating cash flow. Management’s recent comment<sup>7</sup> that it is “too early” to discuss MobilePeak’s customers indicates that MobilePeak’s current revenue is still de minimis.

<b>MobilePeak SAIC Financials</b>			
In million US\$	2007	2008	2009
Revenue	0	0.01	0.3
Gross profit	0	0.01	0.2
Net income	0	-13.2	-3.3
Operating cash flow	-5.1	-4.8	-2.3
Cash used for investments	-0.8	-0.8	-1.2

MobilePeak’s investors include Sequoia, KPCB, and IDG,<sup>8</sup> yet it was evidently left to SPRD to provide liquidity to MobilePeak to repay a loan. Given that MobilePeak’s shareholders chose to sell the company rather than provide it with liquidity, we infer that they doubt its potential. Further, given that SPRD is using cash to fund the purchase rather than shares, we infer that MobilePeak’s shareholders do not see substantial synergies in the transaction.

Is SPRD acquiring MobilePeak in two stages because MobilePeak had an urgent need for liquidity? Why is SPRD acquiring a company that evidently was unable to raise additional funds from its existing investors? Given that SPRD’s previous acquisition of Quorum Systems from large venture capital investors resulted in impairment charges of \$49.8 million (71.1%)<sup>9</sup> within the same year of completing the acquisition, what assurance can you offer that the MobilePeak acquisition will be more successful?

- IX. The increase in ADSes since going public implies that insiders have been selling shares at various times. We note that SPRD recently announced a share buyback of up to \$100 million. Should we expect that shareholder funds will be used to purchase shares that insiders are selling?

<sup>6</sup> [http://www.sec.gov/Archives/edgar/data/1287950/000114420411035005/v225555\\_ex99-1.htm](http://www.sec.gov/Archives/edgar/data/1287950/000114420411035005/v225555_ex99-1.htm)

<sup>7</sup> SPRD June 13, 2011 conference call.

<sup>8</sup> <http://web.archive.org/web/20090629063546/http://www.mobilepeak.com/about.htm#ai2>

<sup>9</sup> Based on the \$55 million cash and \$15 million stock purchase price.

We appreciate your answering our questions, and we believe that SPRD shareholders will also appreciate it. Please address your response to: [info@muddywatersresearch.com](mailto:info@muddywatersresearch.com). For your convenience, the following is a summary of the questions we have asked in this letter.

Best regards,  
Carson Block

1. Per the interview with Mr. Wu, the board lost confidence in him. Why would the board have lost confidence in Mr. Wu when the sales pipeline was so promising?
2. Is it fair to assume that Mr. Wei voluntarily left his position as CFO?
3. If so, why would he have done so one month before completing the financing, and with such a promising sales pipeline?
4. By how much did SPRD's mainland China markets (by product type) grow in 2010?
5. What were 2010 sales of RF transceivers, baseband semiconductors, and any other products SPRD began selling in 2010?
6. If SPRD generated \$75.3 million in pre-tax profit in 2010, why didn't it make any cash tax payments?
7. Given that the turnover in the auditor, audit committee, and CFO position occurred while SPRD was in the midst of a stunning turnaround, did the resignations and removal have anything to do with discomfort about SPRD's accounting?
8. If not, what were the reasons each resigned (or was removed in the case of Deloitte)?
9. As a general matter, can you explain why the size (in absolute value terms) of each of the operating cash flow accounts we highlighted is much larger than in the past?
10. What processes did the auditors undertake to confirm the sizes of each of these accounts?
11. Why have each of advances from customers and deferred cost become so significant?
12. Is SPRD acquiring MobilePeak in two stages because MobilePeak had an urgent need for liquidity?
13. Why is SPRD acquiring a company that evidently was unable to raise additional funds from its existing investors?
14. What assurance can you offer that the MobilePeak acquisition will be more successful than the Quorum Systems acquisition?
15. Should we expect that shareholder funds will be used to purchase shares that insiders are selling?

**Disclaimer:**

**Use of Muddy Waters LLC's research is at your own risk. You should do your own research and due diligence before making any investment decision with respect to**

**securities covered herein. You should assume that as of the publication date of any report or letter, Muddy Waters, LLC (possibly along with or through our members, partners, affiliates, employees, and/or consultants) along with our clients and/or investors has a short position in the stock (and/or options of the stock) covered herein, and therefore stands to realize significant gains in the event that the price of stock declines. Following publication of any report or letter, we intend to continue transacting in the securities covered therein, and we may be long, short, or neutral at any time hereafter regardless of our initial recommendation. This is not an offer to sell or a solicitation of an offer to buy any security, nor shall any security be offered or sold to any person, in any jurisdiction in which such offer would be unlawful under the securities laws of such jurisdiction. Muddy Waters, LLC is not registered as an investment advisor. To the best of our ability and belief, all information contained herein is accurate and reliable, and has been obtained from public sources we believe to be accurate and reliable, and who are not insiders or connected persons of the stock covered herein or who may otherwise owe any fiduciary duty or duty of confidentiality to the issuer. However, such information is presented "as is," without warranty of any kind – whether express or implied. Muddy Waters, LLC makes no representation, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results to be obtained from its use. All expressions of opinion are subject to change without notice, and Muddy Waters, LLC does not undertake to update or supplement this report or any of the information contained herein.**