

Note: You should assume we have a short position in FMCN as of this report – prior to reading this report see important disclaimer on the last page (page 9).

FMCN: Reiterating Strong Sell
Muddy Waters, LLC
February 9, 2012

**Muddy Waters was Right about FMCN’s LCD Network Overstatement;
Independent Verification Counted Cardboard Posters Instead of LCDs**
Weak Attempt at Jedi Mind Trick Exposed

In our November 21, 2011 report on FMCN, we accused management of fraudulently overstating the size of its LCD Network. FMCN had previously defined the LCD Network as a “network of flat-panel television displays.” FMCN first vehemently denied our charges that it overstated the LCD Network size, and then independently “verified” that its previously reported number of 185,174 LCD Network displays was correct.

However, over 30,500 of those “verified” displays are not LCD televisions at all – rather, they are mere cardboard posters. Not only does this mean that FMCN management was brazenly lying to investors in the wake of our report, but the lies sharply call into question the veracity of FMCN’s reported financials. We estimate that each LCD television generates monthly revenue seven times that of a cardboard poster.

Separately, on November 29, 2011 we pointed out that FMCN had previously grossly lied about the size of its movie theater advertising network. FMCN’s recent attempt to explain away that lie is almost as ridiculous as its conflation of cardboard with LCDs.

The implication for investors is that if the inputs to the financials (network sizes) are lies, then why wouldn’t the outputs (revenue and profit) also be lies? As the old saying goes, “garbage in, garbage out.”

Muddy Waters was Right All Along

Independent “verification” proves Muddy Waters was correct when we concluded FMCN lied about the size of its LCD Commercial Display Network. In order for FMCN to meet its disclosed numbers, it had to include approximately 30,500 **cardboard posters** in its LCD display network count. In other words, per FMCN’s own verified data, over 15% of FMCN’s LCD network consists not of LCDs – but of cardboard.

FMCN’s prior disclosures on its network make no allowance for cardboard displays. FMCN wrote the following in its 2007, 2008, 2009, and 2010 20-Fs:

“Our LCD display network, which refers to our network of flat-panel television displays placed...”¹

¹ 2010 20-F pp. 38-9, 2009 20-F p. 36, 2008 20-F p. 35, 2007 20-F p.33.

FMCN has made it unambiguous that “LCD” means Liquid Crystal – not Light Cardboard – Display. At least that was the case before Muddy Waters exposed FMCN’s fraud.

(Based on strong evidence Muddy Waters still believes FMCN separately double counted another 32,500 Digital 2.0 displays from the poster frame segment as “LCD 2.0 Digital Picture Screens” under the LCD Network segment in order to get to its “verified” number.)

We reiterate. In order to rebut Muddy Waters’s conclusion that FMCN overstated the size of its LCD Commercial Display Network, FMCN had to include 30,500 of the cardboard objects shown in the below picture (from FMCN’s website):



Therefore, even putting aside the issue of whether FMCN double-counted some (actual) LCDs, FMCN overstated the size of its LCD Commercial Display Network. Muddy Waters was correct from the beginning.

FMCN attempted to pull a Jedi mind trick by referring to the roughly 30,500 cardboard posters as “LCD 1.0 picture frame devices.” It strikes us that only a management with a significant degree of contempt for its shareholders would attempt to pass off a piece of cardboard as an LCD television. However, this is the same management that:

- told investors its movie theater network was 17.6x the number of movie theaters in existence in China. (We discuss management’s almost-as-ridiculous justification for this lie infra.)
- traded in and out of Allyes, causing substantial losses to shareholders while generating tens of millions in profit for insiders and their friends (explaining that such insider gains were necessary to incentivize management, including soon-to-join members).

- claimed to have acquired six SMS advertising companies that it in fact did not.²
- Took Olympus style acquisition write downs of \$1.1 billion on \$1.6 billion in acquisitions.

FMCN's management either believes that investors are stupid, or that its Jedi powers are overwhelming.

Muddy Waters was 100% correct that FMCN deliberately overstated the size of its LCD network. In FMCN's responses to our reports, FMCN management has purposely deceived shareholders and analysts by including cardboard posters in the LCD count. We intend to bring this outrage to the attention of the SEC, but in the meantime we suggest FMCN now describe this network in its filings and communications as the "LCD and Cardboard Display Network."

Hidden in Plain Sight – How FMCN Used Cardboard Posters to Make its LCD Number

Remember when we asked whether independent verification in China is better than toilet paper?³ FMCN has provided its own resounding response of "NO!"

On January 6th, 2012 FMCN announced that Ipsos Marketing Company completed a full count of FMCN's LCD display network, and that FMCN currently has 185,174 displays in the network.⁴

The problem is that 30,542 of these LCD displays aren't LCDs at all – they're just simple cardboard posters. FMCN ludicrously labeled these posters "LCD 1.0 picture frame devices" in five of its responses to our first report.⁵ In addition to cardboard having no meaningful characteristics in common with an LCD,⁶ a cardboard poster can hardly be called a "device."

² FMCN claimed to have acquired parties to VIE agreements with these handset advertisers, but for numerous reasons outlined in our November 21st report, this explanation does not hold water.

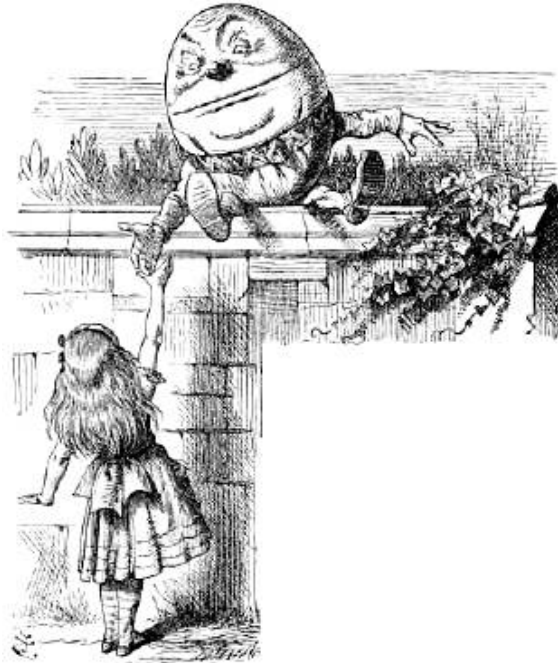
³ MW December 9, 2011 report reiterating Strong Sell on FMCN.

⁴ <http://ir.focusmedia.cn/phoenix.zhtml?c=190067&p=irol-newsArticle&ID=1645519&highlight=>

⁵ 2011: November 22 & 29, December 14 & 22; January 6, 2012.

⁶ It's arguably noteworthy that both contain carbon atoms.

“When I use a word” Humpty Dumpty said, in rather a scornful tone, “it means just what I choose it to mean – neither more nor less.”



On January 6, 2012, FMCN filed the 2nd amendment to its 2010 20-F. In the amendment, FMCN discusses the inclusion of the “LCD 1.0 picture frame devices” in its LCD network size count. FMCN then tells us in the amended 20-F that these are really just cardboard posters. There are numerous references to this surprising fact throughout the filing, but the most telling is:

Advertisements on our poster frame network and LCD 1.0 picture frame devices on our LCD display network consist of full-color glossy advertising posters designed and provided by our advertising clients.⁸

Note that in the above disclosure, FMCN is stating that the “LCD display network” contains cardboard posters. In other words, FMCN has valmorphanized⁹ cardboard into LCD. Who does that????!!!

FMCN’s excuse for why it gets to call cardboard by the name “LCD” is similarly laughable. FMCN claims it used the cardboard posters instead of LCDs in these 30,500 locations because adequate power to run LCD televisions was unavailable.¹⁰ (Interestingly this problem only occurs in the well-developed Tier 2 cities of Tianjin,

⁷ Humpty Dumpty quote and illustration from Carroll, Lewis *Through the Looking Glass* (1872).

⁸ 2nd Amended 2010 20-F, filed January 20, 2012, p. 46.

⁹ <http://www.urbandictionary.com/define.php?term=valmorification>

¹⁰ 2nd Amended 2010 20-F, filed January 20, 2012, p. 42, and see FMCN November 29, 2011 press release

Kunming, and Shijiazhuang,¹¹ which have a combined population of 29.4 million¹²) Because these posters were installed by the LCD division, which really, really wanted to put TVs in there but (goshdarnit!) wasn't able to, FMCN think it's justifiable to label the posters "LCD 1.0" "devices" and include them in the LCD network count.

FMCN missed its opportunity to make clear that it had cardboard posters in its LCD count prior to:

- calling Muddy Waters's conclusion that FMCN overstates its LCD Network size "unfounded",¹³
- spending shareholder money on two "verifications" of its LCD network size when management knew that at least 30,500 of the "LCDs" were really cardboard, and thus contradicted FMCN's own well-established definition of "LCD", and
- threatening to sue Muddy Waters.¹⁴

Putting the above behavior aside, FMCN's purported reason for installing cardboard posters instead of LCD TVs (lack of adequate power) is obviously yet another lie.

A 17-inch LCD consumes peak power of approximately 20 watts.¹⁵ A typical elevator will draw upward of 50,000 watts during operation.¹⁶ (20 watts is 0.04% of 50,000 watts.) Moreover, even a tiny elevator (5' x 5') would require a 40-watt light bulb to light its interior.¹⁷ **How on God's great earth could FMCN not find adequate power for an LCD television in either the elevator or elevator lobby? Are these posters in mine shafts?**

It is unreasonable to believe that FMCN's LCD division, with its expertise honed from installing and maintaining over 100,000 real LCDs, could not find power sources for 30,500 LCDs in three Tier 2 cities. The real reason FMCN counted 30,500 cardboard posters in the LCD network is that Muddy Waters caught the company with its pants down, and management is now trying to lie its way out of trouble.

So yes, when an independent report (supposedly) verifying the size of a flat-panel television network includes over 30,500 cardboard posters in its count, the report's contents are as valueless as non-commercial excrement. Excrement, along with a study concluding FMCN didn't overstate its network size, is better contained in soft colorless toilet paper.

¹¹ <http://ir.focusmedia.cn/phoenix.zhtml?c=190067&p=irol-newsArticle&ID=1634311&highlight=>

¹² www.wikipedia.org

¹³ <http://ir.focusmedia.cn/phoenix.zhtml?c=190067&p=irol-newsArticle&ID=1632858&highlight=>

¹⁴ See FMCN's January 6th and 9th press releases explaining that its acquisition of a ginseng farm was nothing more than a (dodgy) tax shelter.

¹⁵ http://support.lenovo.com/en_US/product-and-parts/detail.page?&LegacyDocID=MIGR-71930

¹⁶ <http://www.thyssenkruppelevator.com/downloads/10KTechGuide.pdf>

¹⁷ Assuming a lighting requirement of 15 lumens / sq. ft. (375 lumens), one would need a General Electric A15 incandescent 40-watt light bulb, which produces 415 lumens.

We believe that the post-MW report conflation of cardboard with LCD amounts to securities fraud and a violation of GAAP segment reporting principles (carried over from SFAS 131) – we see no Humpty Dumpty defense available under 10(b)-5. In any event, those points are for Deloitte, the SEC, and courts hearing investor class actions to ultimately decide.

Movie Theater Count – A Coverup Almost as Ridiculous

On November 29, 2011, we showed that FMCN in 2007 and 2008 20-F filings claimed to have 27,164 movie theaters in its network when the potential size of the market (per government statistics) was only 1,545 theaters. In other words, FMCN claimed to have market share of 1,758.2%.

Here is how FMCN worded (emphasis added) its obviously false movie theater count disclosure in 2008:

The cost of revenue for our movie theater and traditional outdoor billboard network increased 101% from \$28.5 million in 2007 to \$57.3 million in 2008. The increase is primarily attributable to: . . . 3) increased leasing costs associated with time we rent on movie theater screens as a result of an increase in the number of theaters we lease in our network from 10,930 in 2007 to 27,164 in 2008.

Following our exposure of this lie, here is management’s tortured attempt to explain it away:

Prior to 2009, we calculated the size of its movie theater network by calculating the number of screens on which each of its advertisers had purchased advertising and then summing the screen count for each advertiser to produce an aggregate number of screens.¹⁸

Per this revisionist definition, management wants investors to believe that FMCN previously defined “theater” as $\Sigma(\text{customers} \times \text{screens purchased})$.¹⁹ Oh but there would be so many questions unanswered if this were true! For instance, would there be a new “theater” each time a customer re-purchased time on the same screen; or, is each “theater” all customer-buys on that screen, and if so, over what period?

Management offered this explanation because they twice assumed investors are stupid – first when FMCN claimed to have 27,164 theaters, and then when management thought it could redefine the plain English meaning of “theater.” Chairman Jiang, investors aren’t that stupid – if you occasionally took some buy-side investors’ questions on the earnings worship calls, you’d probably know that.²⁰

¹⁸ 2nd Amended 2010 20-F, filed January 20, 2012, p. 43.

¹⁹ We’re not 100% sure we understand how FMCN purports to have calculated “theaters” – trying to figure the equation out is a bit like trying to determine the GPS coordinates for Narnia.

²⁰ As we pointed out on p. 18 of our November 21, 2011 report, FMCN has not taken any buy-side questions since its Q1 2007 call.

What These Lies Mean for Investors' Money

Since our initial report, we've heard some investors and analysts downplay the significance of these lies,²¹ and instead dissemble by focusing on the great numbers FMCN is reporting. However, because the lies about the number of LCD televisions and movie theaters in the network were used to support growth in reported revenues and profits, one has to wonder whether reported numbers are real. This is particularly true because we estimate that the average LCD television generates monthly revenue seven times that of a cardboard poster. Why would FMCN lie about the inputs to the numbers without also lying about the outputs?

Our concern about whether FMCN's core business numbers are accurate is most acute because FMCN's LCD and cardboard display network business is opaque in the two areas that matter most – advertisement ASPs and location lease costs.

FMCN's LCD and cardboard display network business model is highly opaque on the revenue side. FMCN's rate card is irrelevant to the revenues that FMCN generates because most customers receive a substantial discount from the rate card. The problem is that it is impossible to independently determine the discount levels.

In the course of our research, we determined that the minimum discount offered to customers for Tier 1 advertisements is approximately 65% off the rate card. We believe that there are customers that receive Tier 1 ad discounts of more than 90% off the rate card. Further, we found that the discounts on Tier 2 ads are greater than those of Tier 1. We also found that most Tier 3 and 4 ads are usually free.

There is no way to independently determine the weighted average discount by tier. It is therefore impossible to independently determine FMCN's ASP. You have to take management at its word. We don't.

The screen location lease costs vary widely, and it is impossible to independently verify FMCN's reporting of these numbers. In our research of location costs in Shanghai Class A office buildings, we found that FMCN pays anywhere from approximately \$50 (RMB 300) per screen per month to \$1,500 (RMB 10,000) per screen per month. Presumably the screens in residential buildings cost less, but we found it difficult to develop a reliable blended estimate. Because screen location lease costs can vary by orders of magnitude between similar locations, they cannot be independently verified. Thus, you have to take management at its word. Again, we don't.

²¹ We heard one second hand account of a conversation between an investor and an analyst with a major bank. We were told that during the conversation, the analyst claimed to have previously noted that the theater count was implausible, yet the analyst never became concerned about FMCN as a result.

This management has demonstrated time and again that it should not be taken at its word. Further, the over the top nature of these lies paints the picture of a management who views its investors and analysts as gullible and worthy of contempt. We believe that the opacity of FMCN's business model offers far too great of an opportunity for this management, with its demonstrated track record of lying and self-dealing, to play games with the numbers.

Acknowledgement

While we were satisfied that FMCN was double-counting the LCD 2.0 Digital Picture Screens to make its reported LCD network screen count, we had not caught FMCN's admission that it needed to count over 30,500 cardboard posters in order to make its number. (The key information was largely buried in the recently filed 2nd amendment to FMCN's 2010 20-F.)

The credit for this observation belongs to published author and Seeking Alpha contributor Matt Berry. (Interestingly, Mr. Berry's book is a guide to righteous behavior. We have expressed a copy of Mr. Berry's book to Chairman Jiang.)²²

In an article published on February 6th, Mr. Berry called FMCN out on the LCD screens and the ridiculous explanation the company offered for its movie theater lie. We were impressed by both Mr. Berry's analysis and use of sarcasm – particularly in equating FMCN's conflation of cardboard and LCDs to conflating Ferraris and bicycles. Mr. Berry, our hat is off to you.

WARNING: A printout of this Report is not a CRT Display

²² Mr. Berry authored *The Mechanics of Virtue: A Cynic's Guide to Righteous Behavior*, CreateSpace (Dec. 2009).

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