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**Company:**

New Oriental Education & Technology  
Group (NYSE: EDU)

**Industry:**

Education

**Recommendation:**

Strong Sell

**Report Date:**

July 18, 2012

**Price:**

\$14.62

**Market Cap:**

2.26 billion

**Float:**

117.1 million

**Avg Volume:**

1.14 million

- EDU has reported 392% revenue growth since going public! The revenue growth has been built on store growth of 338% during this time.<sup>2</sup> EDU tells investors that its entire store network is company-owned, but this is a lie. As recently as last month, EDU president and CFO Louis Hsieh adamantly denied that EDU has any franchisees. This report shows Hsieh's statements are patently false – EDU has numerous franchisees. However, these franchisees are not a hidden bonus for investors. Rather, they are part of a substantial fraud in EDU's accounts.
- It is virtually certain that EDU uses the upfront franchise and other fees to inflate its cash balances in order to receive unqualified audit opinions from its auditor.
- EDU's Beijing operation (which is approximately 35% of EDU's reported revenue) has prepared financial statements for 2009 – 2011 are fraudulent. EDU has submitted these financial statements to its domestic regulator, the Civil Affairs Bureau ("CAB"). It is probable that EDU used these same financials in the preparation of its U.S. filings.
- EDU's corporate structure is far more problematic than just a weak VIE. The schools that conduct its operations are ultimately state property. We question how EDU can consolidate them.
- We believe that as a result of our exposure of these problems with EDU's reporting, EDU will restate historical results – likely significantly; and, that its auditor will resign.

Calculation based on RMB revenue, and excludes currency fluctuations.  
Store count number includes schools and learning centers; it excludes book stores.

## **Magna Cum Fraude**

We rate EDU a Strong Sell because it is probable that EDU will have a significant restatement, and that its auditor will resign.

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### **Franchising: The CFO Doth Protest Too Much, Methinks<sup>3</sup>**

"A lie ain't a side of a story. It's just a lie."  
- The Wire, season 5 episode 8<sup>4</sup>

In the following excerpt of a June 2012 conversation, EDU president and CFO Louis Hsieh is either lying or demonstrating that he is being lied to. As we show in this report, it is indisputable that EDU has an extensive franchising operation. It is virtually certain that EDU has been consolidating the financials of its franchisees into its own financials.

We encourage investors to listen to the recording of this conversation at <http://www.muddywatersresearch.com/watch-the-video-edu>.

Q: "Do you franchise any of your stores?"

Hsieh: "No. No. Our biggest asset, the reason our moat is so large is cause of our brand name. We will protect that. [inaudible] We own everything."

Q: "So the four hundred and thirty learning centers..."

Hsieh: "We own all of them."

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<sup>1</sup> Calculation based on RMB revenue, and excludes currency fluctuations.

<sup>2</sup> Store count number includes schools and learning centers; it excludes book stores.

<sup>3</sup> Props to Shakespeare for the original line in Hamlet Act III, Scene II "The lady doth protest too much, methinks."

<sup>4</sup> <http://en.wikipedia.org/wiki/Clarifications>

Q: “How many? I’m sorry.”

Hsieh: “It’s six hundred and fifty.”

Q: “Learning centers and schools? It’s a mix?”

Hsieh: “Yeah. Over six hundred. About six hundred and fifty. We own everything.”

Q: “A hundred percent fully-owned?”

Hsieh: “Yes.”

Q: “I see. And do you have any arrangements, in terms of, you know, capital, capex, or cost sharing, or profit sharing, or any type of cooperation?”

Hsieh: “No.”

Q: “With others?”

Hsieh: “Nope. All ours. We’ve grown completely organically. We owe nobody.

Q: “Purely organic, a hundred percent owned by New Oriental?”

Hsieh: “Correct. Absolutely correct. That’s how we control the quality.”

## Introduction

New Oriental Education & Technology Group Inc. (“EDU”) is lying to shareholders about its store growth and financial performance. As is typical of many of the frauds we have witnessed in China, how EDU actually conducts its business differs materially from what it tells investors. Inside China, EDU has an extensive and long-standing franchising operation. We know this because we have listened to discussions between EDU and a potential franchisee. Outside China, EDU’s president / CFO Louis Hsieh vehemently denies the existence of any franchising or financial sharing arrangements whatsoever.

We have evidence that EDU’s franchising operation covers dozens of cities, including its original Tier 1 markets, and that the franchising includes both POP Kids and traditional format stores. However, EDU has never disclosed any information related to franchising. It is virtually certain that EDU uses the front-end weighted franchise fees it receives to game its cash balance confirmation during its audit. It is also virtually certain that EDU consolidates its franchisees’ results as though they were EDU’s own. This has a number of other implications for numbers reported since going public in September 2006, including:

- 37.0% revenue CAGR built on 29.1% store count CAGR from FY2006 to FY2011.
- Capital expenditures since going public of approximately \$104 million.
- 19.5% enrollment CAGR.
- 41.0% teacher and 39.8% non-teacher employee count CAGRs.