Micro to Macro Monthly **BETA**

Today, you're getting the first issue of ***µ2M*** because I see a tremendous opportunity. I found a company with a patented and proprietary technology that solves the biggest problem in the telecommunications industry. The company is already wildly profitable and has revenue growing nearly 100% a year, with a PEG ratio of 1:10. It's positioned to stay the industry standard in one of the fastest expanding markets in history, it has some of the world's largest network providers as its main customers - and it sells for *less than 5 times earnings.*

When the Verizons and AT&T's of the world built their data networks, they laid huge fiber-optic cable pipelines across continents and oceans. They created a massive backbone, and set themselves up to pipe terabits of information from New York City to Jakarta – literally at the speed of light. What they didn't do was plug customers *directly* into that pipeline. If you buy a song from the iTunes store online, that song spends 90% of its time on the shortest part of its journey. It would be like flying from Jakarta to New Jersey on a supersonic jet, and then walking to your hotel in New York City with 100lbs of luggage. I first learned about the "Last Mile" problem when I was studying electrical engineering at NCSU. My professor, the inventor of the plasma screen TV, was explaining the effects of the internet boom at the turn of the millennium. He told me how investment in data companies allowed the big pipelines to be built long before we needed them. He also told me how, before the Last Mile problem was solved, BOOM! The market collapsed.

Flash forward 10 years to the age of ubiquitous mobile smart-phones and high definition TV – the age of 3G and 4G data connectivity. The same problem still exists – only magnified. The only *solution* to the Last Mile problem is to have a wireless access point plugged **directly** into those optical fiber pipelines – and that's what **Telestone Technologies** (NASDAQ:**TSTC**) has been doing for years. Their main customers? The "Big 3" companies with the largest consumer base in the world: **China Unicom**, **China Telecom**, **China Mobile**. They're expanding internationally, too. Among their US customers: **Sprint** and **T-Mobile**.

How They Do It

Telestone operates in what's known as the "access network" sector, meaning they bridge the gap between user devices - cell phones, TV's, computers, etc – and the backbone provider's network - the big 3 in China, or Sprint, Verizon, et al in the US. They have a robust R&D pipeline both for hardware and systems engineering, and boast about $90M of hardware manufacturing capacity - so Telestone is a full solution provider in the access network space.

Right now 40-50% of their revenue comes from the most exciting and fastest growing area of their business – an area that is poised to increase margins and provide them access to new markets in Brazil and the USA. Telestone has developed something called WFDS, a *Wireless Fiber-optic Distribution System*. Mostly, they do building-scale projects, where their equipment provides the access to phone, TV, and the internet through one device. That device physically plugs into a fiber-optic pipeline that joins the major backbone, providing greased-lightning speed for customers, and cost savings for both the network providers and the builders, who no longer have to run cables to every room. One "UAN" (unification access network) plugs into the carrier's backbone and the whole building gets access – but they don't just do buildings. Between 2008 and 2011 the PRC budgeted $70 billion to roll out their 3G Networks in China. Telestone has been working in that space, building and consolidating relationships with the Big 3 providers, and was just awarded a $10 M contract to provide their WFDS technology for the new high-speed rail line between Beijing and Shanghai.

Expanding Outside of China

Telestone's WFDS technology was approved by the United States FCC in September 2009. Right now, international sales account for only 5% of revenue – management expects that to grow to 30% by the end of 2012 as Telestone expands into the US and Brazil, where they already maintain sales offices. The unified access networks they're creating (by supplying TV, internet, and cellular connectivity) with their WFDS solution will continue to grow in China – spurred along by a PRC government mandate and the cash to back that mandate up. Increasingly, though, the technology appeals to foreign companies trying to solve that last-mile problem. This is why they've been able to get contracts from Sprint and T-Mobile in the US, as well as Claro, TIM, and Vivo – Brazil's big 3.

Where the Risks Are

As I see it, there are three main categories of *business* risk for TSTC – competition, capex decreases, and government interference. Telestone may face margin pressure due to competition in their basic equipment business. Also, they are a small company, competing with larger companies that have notable resources. If those companies alter their strategy and attack TSTC's WFDS market it could lead to margin pressure or loss of market share in that space. With regard to capex fears, the original 3G rollout in China was funded via $70 B of PRC government money. That funding has a time-horizon of 2008-2011, and at the end of 2011 the project (and its funding) will be done. Some investors fear this will lead to a decrease in the Big 3's capital expenditure on WFDS installations. I do not, precisely because of overlap with the third risk: government interference. So far, the command economy in China has worked to the great advantage of Telestone – to wit, a share of the $70 billion for the 3G build-out. It looks like over the next few years a mandate to bring TV, Internet, and Telephony networks onto a single framework will benefit WFDS, which is industry standard in China for UAN's. Operating in China does carry its own risks, such as strict regulation of the commercial banking sector, side-by-side existence of state-owned and private companies, and laws or policy to encourage or discourage specific industries. The last of these risks looks to continue working for Telestone's advantage.

Why So Cheap?

Telestone does carry real risk, but recently it's been hit hard by a torrent of manufactured risk as well. The company's volatility alone makes it noticeable – it's traded as low as $1 in March 2009, and as high as $24 a share at the beginning of 2010. Couple that with a recent panic over Chinese reverse-mergers, long DSO's that precipitated a share issue last November, and the accusations of a few unscrupulous bloggers: it's a perfect storm for devaluation.

DSOs or "days sales outstanding," for Telestone are about 360 days, which means it takes TSTC over a year to collect for services rendered. Largely this delay in collection is attributable to the time horizons of the projects, and slow approval by network providers. It's not ideal, but it's a fact of life for TSTC – their customers do network integration approval in two stages – first at the hardware level, which allows Telestone to book the revenue, and then after full network integration – which is only inspected *annually.* Basically, the Big 3 can put off paying, and they do. What these DSO's translate to on a balance sheet is big accounts receivable relative to cash flow. Telestone is growing so rapidly, in fact, that they needed more cash to fund that expansion – DSO's were choking their ability to grow. On November 30, 2010, the company

issued shares at $12 diluting the stock by about 15%, but securing about $20M in much needed cash, and shares plunged from $15 to $10. Presumably to assuage the worry of further dilution, though, they also secured a $44M credit line from the Bank of Beijing.

Recently, some Chinese companies that got listed in the US by “reverse merger,” as Telestone did, have tumbled dramatically. Oriental Paper (ONP) and RINO International Corporation (RINO) are two such companies; they fell by as much as 60% this year in the face of what are, effectively, fraud allegations.

Fraud Allegations (or) Where the Risks *Aren't*

On Jan 11th an anonymous, heretofore unknown blogger on seekingalpha.com known only as "theForensicFactor" smelled blood in the water. Presumably after taking a tidy short position, "tFF" posted a few pages of nefarious, ill-explained commentary alleging that, because they have long DSO's and a divergence between cash flow and accounts receivable, and because they changed auditors in 2010, Telestone is a fraudulent front. The story was anonymously reposted on ZeroHedge.com by the self-styled "Tyler Durden," of *Fight Club* fame. Tyler is also an anonymous blogger, but he has over 300,000 readers. According to *New York* magazine, the blog is working toward "a purifying market crash" culminating in the elimination of big banks altogether. The result of these anonymous postings was, over the course of a couple of hours, a 28% drop in the price of Telestone - wiping some $40MM or so off the market cap of the company.

On the auditor question, it's unclear why TSTC switched from Mazars to a US-based firm, but the following is clear: 1) For FY 2007-2009 Mazars gave them a clean bill of health, and has issued a letter stating there was never any dispute about the legitimacy of TSTC's reporting claims and 2) when the market punished them for changing auditors, Telestone rehired Mazars. Other scary sounding accusations say that TSTC should have much higher liabilities and/or assets on their balance sheet related to real estate. For accounting puposes, though Telestone's offices are held via operating leases. An operating lease records no asset or liability on the financial statements, and the amount paid is expensed as incurred.

Misinformation as Opportunity – What to DO About It

Telestone is a market leader in the fastest growing large economy in the world, and it's well positioned to continue stellar growth and wild profitability. If the dealership wants to sell you their Ferarri for $1, you don't say "the oil and tires need to be changed, and there's a cigarette burn on the upholstery -" you just give the fella a greenback, put the top down, and go for a drive.

I believe estimates by Roth Capital Partners – the firm that agreed to orchestrate the share offering in November - and TSTC's management. Consequently, I think we're in for a huge recovery in share prices. In 2010 income is set to finish around $30M. Revenue will have essentially doubled since 2009. Mazars – a large and well-respected Europe-based auditor – will sign off on the figures. Yesterday, February 9th, The CEO and Chairman, Mr. Han, announced that he's buying back $5M worth of stock with his own money. At current prices, that's about 8% of the total shares available for trading (the float). He already owns over 26% of the company.

I already own shares of TSTC, too: I bought them for about $8 as soon as I'd finished reading the hit job by "Tyler Durden" and associates. Also, due to the huge volatility, premiums on put options for TSTC are astronomical. I sold the February 19 puts with a strike price of $7.50. They were well out of the money at the time I wrote this– but the volatility was so high that I got $0.75 for them. If they expire worthless, I keep the premium for a return of 10% in 20 days (ARR over 500%). Worst case, if the stock miraculously goes below $7.50, I get new shares for $6.75 – a bargain. The options premiums are less now, but still significant. The best course of action I can see now is either acquire TSTC up to $13 or, if you're comfortable with options, sell the March $7.50 puts which now go for about $0.50. They will likely expire worthless and generate about 7% in 36 days (ARR near 100%).

Thanks for reading, and Happy Hunting!

-Griff