

Usana: You **DO NOT** Have the Right to Remain Silent

Introduction / Background (NASDAQ:USNA)

Macro-trends: Revenue and margin squeeze in the direct distributor “potions and lotions” industry:

Multi-Level Marketing companies are making headlines lately, as they all delicately walk the lines of legality of their business models. These companies stray increasingly into boundary-pushing "risky business" because most all of them are exhibiting telltale signs of market saturation in the US and developed countries. Inevitably, as their "independent distributors / sales associates" realize that the vast majority at the bottom of the "downstream" will never make any money, these sales pyramid companies are flogged until they saturate their markets, at which point growth atrophies. One obvious symptom is excessive churn rates among distributors. As the number of genuinely profitable resellers plateaus, 90% of new recruits lose money, and sales growth fades.

In the US and Europe, revenue growth rates for all the MLM companies are now down to single digits at best. Meanwhile, distributor counts in these regions are actually shrinking across the industry, despite the high unemployment numbers that might attract idle members of the workforce to try their hand at direct sales.

In their thirst for growth, these companies naturally have set their sights on exploiting Asia and the Pacific Rim and ultimately China to postpone the inevitable multiple compression, and keep their stock prices inflated as long as possible. Compelled by market's insatiable demand for growth, they are forced to keep demonstrating those growing-to-the-sky uptrending charts, even though the quality and therefore sustainability of their business is increasingly suspect.

This is why China is now of such a crucial importance to these companies. Grass-roots entrepreneurship is still a new theme within the Chinese culture, and the social pressure to develop personal wealth so as to achieve family economic security is enormous.

All these companies face the same problem: they craft complex over-the-rainbow commission schemes to compensate their "independent distributors", which inevitably place a huge incentive on recruiting new distributors. Newly recruited distributors always find themselves obligated to maintain minimum order amounts to maintain their eligibility for commissions. Often this results in “subscription” commitments to buy inventory, which pile up in basements and garages. And of course,

the companies can't possibly be expected to track the revenue from sales which are legitimately consumed by non-distributors, can they?

In [prior articles in Citron Reports](#), as well as a recent [Fortune Magazine article](#), NuSkin's multi-level scheme in China has been exposed. But as bad as NuSkin's exploitation in China has been, Usana's is even further beyond the bounds of legality.

But MLM's and pyramid compensation schemes are strictly illegal in China.

When it comes to China, there's one insurmountable problem: Multi-Level Marketing companies and their pyramid compensation schemes are completely illegal in mainland China. The MLM companies resort to one version of hanky-panky or another to show outscale growth rates from within China, which they add into their results to maintain their multiples. But they're all short on details about how they actually accomplish it operationally. Below are a couple of examples of curious analysts' attempts to gain "clarity" about China revenues.

USANA: Can Investors Count on Management for Disclosure?

US-domiciled MLM businesses like Usana have adopted various strategies to set up "legitimate" operations to provide camouflage for their mischief in China. Usana paid heavily (over 4x revenues) to acquire [a small baby products](#) company in order to obtain a coveted "direct sales" license in China. (**Note:** these licenses do not permit any sort of multi-level compensation pyramids, just direct commissions to salespersons for bona fide consumer sales.)

But commissioned direct sales of these products cannot possibly support levels of gross revenues and profits necessary to move the needle for the company. Instead, it has temporarily provided "cover" while it established a pyramid sales operation in Mainland China using Hong Kong banks.

For Usana management, at what point are they obligated to start disclosing the real risks of trying to do business there?

It is Citron's opinion that the bright line is when **material events** occur. **Like when Usana distributors are arrested and fined? Or when the SAIC, an official Chinese government agency, advises internet posters that being an Usana distributor is illegal?**

Let's examine the gap between management's statements and reality here. Citron recalls only a few prior companies of interest where management's answers are so far from reality – and the consequences have always been devastating.



What Usana Management states (and leaves unsaid) about its business in China:

Q & A from 2nd quarter, 2011 conference call (first question):

[John San Marco](#) - Janney Montgomery Scott LLC

Do you know what the percentage of your Hong Kong associates that are actually Chinese nationals? Do you know what that percentage is, by any chance?

[David Wentz](#) - Chief Executive Officer

No, we do not.

[John San Marco](#) - Janney Montgomery Scott LLC

Okay. I mean ballpark? I mean it's pretty -- is it substantial? Or you can't even render a guess? A ballpark guess?

[David Wentz](#) - Chief Executive Officer

We definitely have a number of people who are building in Hong Kong. **We do not have a percentage or have a number that we could point to with any accuracy.** [\[Link ...\]](#)

OK, summer 2011 is ancient history, right? So now, fast forward 15 months to the first question, 3rd quarter 2012 USNA conference call. Surely these guys have had plenty of time to get their mainland China story figured out for public consumption by now, right? But ... nope:

Q & A from 3rd quarter, 2012 conference call:

[Timothy S. Ramey - D.A. Davidson & Co., Research Division](#)

I may have missed it and I know you had strong results in Greater China, but **would you mind giving us a little granularity over what happened with mainland versus Hong Kong?** Because that's kind of been a source of interesting shifts in sales in previous periods?

[G. Douglas Hekking - Chief Financial Officer](#)

We saw north of 20% growth in each of those markets and also strong growth in Taiwan. So we continue to see **growth overall in the Greater China region.**

[Timothy S. Ramey - D.A. Davidson & Co., Research Division](#)

Can you give us **a little more specificity** than just the north of 20%. I mean, I think you're up, what, 27% overall?

[G. Douglas Hekking - Chief Financial Officer](#)

Yes. We see that the mainland China outpacing the rest of the markets. But like I said, **we're running essentially as one region now** and we kind of look at it as one, but...

[Timothy S. Ramey - D.A. Davidson & Co., Research Division](#)

Great. Okay. And would you say the same for -- I mean obviously, a big increase in recruitment as well. Does that track kind of the sales pattern?

[G. Douglas Hekking - Chief Financial Officer](#)

Yes. The active customer accounts that you see are well-correlated in the Greater China region. Absolutely.

The company has had 15 months since then to tell investors what is really going on in China with regard to Usana's business prospects. They haven't said a word about any of the numerous material events that imperil Usana's China operations. This provides the background in which Citron reports what Usana is really doing in Mainland China.

So what's Really Going On with Usana's business in China?

1) 🍋 Citron presents official SAIC responses to inquiries about Usana products in China:

Two explicit question and answer exchanges on the Chinese SAIC cases where inquiries about the selling business and the products are answered in no uncertain terms:

The screenshot shows the SAIC public opinion platform interface. The header includes the SAIC logo and the text "中华人民共和国国家工商行政管理总局" (State Administration For Industry & Commerce of the People's Republic of China) and "公众留言" (Public Opinion). The date is 2012年10月7日 星期日. There are navigation links for "留言查看", "留言须知", and "常见问题解答".

用户登录

用户名:
密码:
[登录](#) [注册](#)

我要留言
我的留言

留言查询

留言编号:
关键词:
标题:
留言类型: 请选择留言类型
回复部门: 请选择
开始时间: 2009年 1月 1日
结束时间: 2011年 1月 1日
[搜索](#)

公众留言回复

- 内资企业登记管理
- 外商投资企业登记管理
- 商标注册
- 打击传销与规范直销
- 消费者权益保护
- 农贸市场监管
- 网络商品交易
- 个体工商户登记管理

留言标题: 请问一下这个USANA公司产品是否合法?

- 留言编号: 17007 留言类型: 打击传销与规范直销
- 留言内容: 最近想购买usana中文名字叫做优莎娜的保健品,但是必须要注册会员,我想问一下这个公司产品和服务是不是传销?合不合法?
- 留言回复: 谢谢留言。
- 回复部门: 直销监督管理局 时间: 2011-12-09

留言标题: usana (优莎娜)在网上销售是否为非法传销

- 留言编号: 15405 留言类型: 打击传销与规范直销
- 留言内容: 尊敬的工商总局领导:你们好! usana (优莎娜)产品是美国的一家公司生产的产品,国内有人加入,请问这种在网上销售是否为非法传销?或是为国家所允许的,敬望你们指教。我...
- 留言回复: 谢谢留言。
- 回复部门: 直销监督管理局 时间: 2011-11-17

Translation:

Question 1: I'm planning to purchase USANA products, Chinese name “优沙娜”, but I have to register as a member first. I'd like to ask whether the product and service from the Company is legal and does it involve MLM?

Response from Direct Selling Monitor and Management Agency:

USANA is involved in MLM. Please provide further information to local Industry and Commerce Agency and police authority with further details including the specific neighborhood, name and address of the personnel involved and detailed location of such meetings to facilitate our efforts to clamp down on such activities.

Question 2: Hello, USANA products are manufactured by an American company and a lot of people are involved in China. I'd like to ask whether selling such product online is illegal or is it permitted by the government. I look forward to your response.

Response from Direct Selling Monitor and Management Agency:

This Company is involved in Multi-level Marketing and currently, a number of local SAIC and police authorities have initiated criminal investigation on such cases. For more details, please contact local SAIC and police authorities.

If you know China, you know that when this kind of language is published, it's not just "random speculation".

2) 🟡🟡 Recent law enforcement mobilization against pyramid schemes

[总局首页](#) | 2012年10月29日 星期一

中华人民共和国国家工商行政管理总局 直销监督管理局
State Administration For Industry & Commerce of the People's Republic of China Direct Selling Regulation Bureau

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工商总局联合公安部等12部门召开打击传销工作情况通报会

SAIC joint Ministry of Public Security and other 12 departments held against pyramid schemes briefings

SAIC has a joint Ministry of Public Security, the Central Propaganda Department, the Central Committee for Comprehensive Management Office, the Supreme People's Court, Supreme People's Procuratorate, the State Internet Information Office, the Ministry of Commerce, Ministry of Education, the Ministry of the People's Bank, the State Bureau for Letters and Calls 12 departments briefing held against pyramid schemes work. The State Administration for Industry and Commerce, the Ministry of Public Security is responsible for working since last year to crack down on pyramid schemes and MLM crimes special action to crack down on this year have been informed participants in other sectors respective participation or tie against pyramid schemes work.

...

#5: Further increase the degree of propaganda efforts, especially around major [MLM] cases investigated, so that the people are fully aware of the danger and deception of MLM. All levels [i.e. national and local] of the Administration of Industry and Commerce and Ministry of Public Security should focus on propaganda in key areas and populations and educate people in-depth to establish the correct ideas on morality and how to get rich; and by issuing alerts and warnings, they should expose the criminal nature and deceptive tricks of MLM to improve the people's ability to recognize [MLM], planting the idea of "reject MLM, stay away from MLM" in people's heads and hearts.

...

... Six major policy and organizational steps to beef up enforcement of anti-pyramid, Network Marketing and MLM activities ..

Date: August 20, 2012
[LINK : <http://zxjg.saic.gov.cn/mrktwcms/directsale/workingact/html/2045.htm>]

New SAIC publication of enforcement against pyramid scheme organizers

<http://www.cqn.com.cn/news/cjpd/623918.html>

(**Note:** Even using Google Translate, the meaning of these links is clear.)

Below is a selection of recent stories on MLM law enforcement activities from across China:

<http://b2b.netsun.com/detail--6061980.html>
<http://roll.sohu.com/20121012/n354735631.shtml>
<http://www.hinews.cn/news/system/2012/10/10/015035827.shtml>
<http://px.jxnews.com.cn/system/2012/10/10/012133734.shtml>
<http://news.163.com/12/1011/07/8DH55LUF00014AEE.html>
http://www.tianjinwe.com/tianjin/tbbd/201210/t20121009_6503831.html
<http://finance.ifeng.com/roll/20121009/7122200.shtml>
<http://news.sina.com.cn/o/2012-10-03/014925295523.shtml>

Now: Appearing on a TV Near a Billion Usana Customers

And specifically, this TV News segment should really be of concern to investors:

<http://www.t-d.tv/2012/09/29/VIDE1348885122947185.shtml>

First, note the date: **Sept 29, 2012**. TV news report on a recent encounter with a salesman visiting Mr. Shen's family, promoting Usana's nutritional products. The packaged product does **not** carry serialized licensing number, is **not** registered with the Chinese equivalent of the FDA, and is **not** labeled and does **not** provide instructions in Chinese; all of which are conditions which render such product sales illegal in China.

The interviewee further observes that the product contains common ingredients which are available from other popular domestic products at lower cost.

3) 🟡🟡🟡 **Recent Law Enforcement actions against USANA reps: already on record:**

Enforcement of anti-MLM laws is regional in China. We are already seeing proof that Usana reps are being apprehended and put out of business, with income disgorgement and fines.

Why hasn't the company disclosed these as risk factors?



Jiajiang County, Leshan City Administration for Industry and Commerce Administrative punishment hearing

"...Yang Xiuqin engaged in a criminal investigation by the Council of the Network MLM's case...through the purchase USANAhealth food registration USANA USANA Member Member No. 3237815...

USANA company claiming to be based on the sales of nutritional and skin care products company, with offices in Hong Kong: USANA Hong Kong Limited the company website<http://www.usana.com> . Its business model: the purchase of 150 points for the first time in the company's website, plus a \$ 300 membership fee...

Article VII of the behavior of this Ordinance, introduced, trick, or coercing others to participate in pyramid schemes by the administrative department for industry and commerce shall be ordered to stop the illegal confiscation of illegal property confiscate the illegal income, a fine of up to 50 million of 10 million yuan ; constitutes a crime, be held criminally responsible.

"provisions, Council proposed Your punishment is as follows:

An order to stop illegal;

Two, confiscate the illegal income 9047.04 \$ (RMB 7350.72 \$)

Second, a fine of \$ 150,000 .

Date: July 4, 2012 [LINK : http://www.jjaic.org/E_ReadNews.asp?NewsID=860]



Ji Jiang County, Leshan City Administration for Industry and Commerce Administrative punishment hearing

"...introducing others to obtain illegal benefits USANA behavior violation prohibiting pyramid schemes "article 7, paragraph (b), and paragraph (c)..."

Council intends to penalties imposed on the parties as follows:

An order to stop illegal [activities] ;

Second, confiscate the illegal income 9922.56 Hong Kong dollars (equivalent to 8062.08 yuan);

Second, a fine of 150,000 yuan .

Date: July 6, 2012

[LINK : http://www.jjaic.org/E_ReadNews.asp?NewsID=862]

Citron asks:

Where is Usana's disclosure of these material events?

Citron's answer:

Don't count on the company or analysts to provide investors critical information on this topic until it's too late.

4) 🍋🍋🍋🍋 Investigation reveals Usana managers actively participating in creating illegal pyramid compensation scheme to circumvent China's anti-MLM laws:

What Citron did:

To uncover how the scheme works, Citron's investigators signed up as Usana reps to penetrate the Usana pyramid.

What Citron found:

Prospective Usana reps from mainland China travel to Hong Kong, where they are instructed by Usana reps on how to **illegally open Hong Kong Bank Accounts**, using a proxy address, and to direct the illegal pyramid compensation so it circumvents China's anti-pyramid scheme laws.

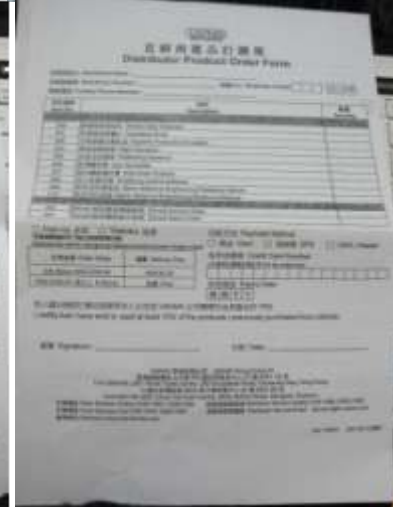
And this is not just a rogue phenomenon at the far fringes of the business operation. What makes this so bad is it proves that not only is Usana operating illegally in China, the company is abetting Chinese citizens in breaking the law .

Bring on the evidence.

Who is Ada Chai?

Our operative traveled to Hong Kong and met with Ada Chai herself on June 27, 2012. Clearly Ada is a big stone in the Usana pyramid.





[Link to full size images of this photo and document set.](#)

[Link to images of China Merchants Bank Dinner and Lecture.](#)

Ada explains in great detail how to use her own (Ada's) Hong Kong address, how to open a Hong Kong Bank account, how to use Ada's address for downlines recruited in Mainland China, and how Ada will open their bank accounts at the same bank so they can get paid. And of course how Ada would expect some type of gift in exchange for helping to open these accounts.

Our contact attempted to open a bank account at the Bank of China, but was refused when she disclosed that the purpose of the account was to facilitate Usana business. She was informed by the bank lobby manager that "Many Mainlanders do business with Usana, and they all use China Merchants Bank," and referred her there to open an account.

Ada Chai offers to take our contact to open a bank account at China Merchants Bank. Then back to Usana's headquarters to complete her "Auto-Pay/auto-Deposit Agreement" with her new Hong Kong bank account number, and then out to dinner! Ada explicitly explains the reason to use her (Ada's) address, not her own, is that there is no Usana in Mainland China; therefore she needs to sign up as a Usana distributor with a Hong Kong identity.

There was other disturbing advice given as well; such as to avoid shipping fees, someone could pick up her order from Usana to mail her the products for less than half what Usana would charge for small orders. (Hello! Anybody think this violates China's import laws?)

Here's his business card:



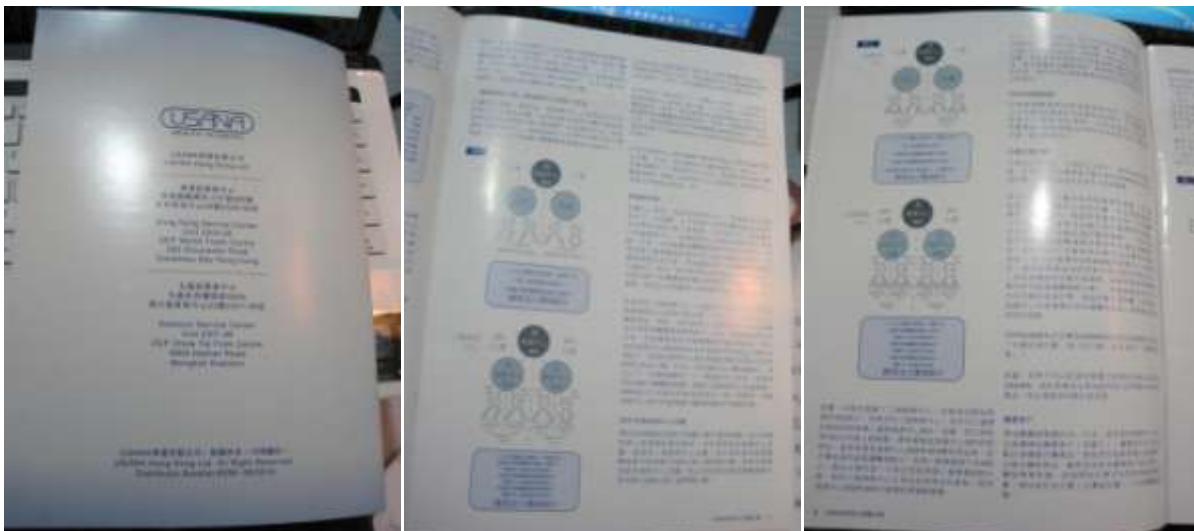
824	Online Business Tool (4 weeks) (in
Delivery Fee (count on each single order)	
Order Value	Delivery Fee
Below HK \$5,000	HK \$80.00
HK \$5,000 & Above	Free

Our contact asked Ada again if she would be allowed to sign up distributors in Mainland China. Ada told her yes, she would be able to, but there would be a few problems. And every problem has a solution. Both the main obstacles were a Hong Kong address and a Hong Kong bank account, and Ada knows how to handle both of these.

Here's the starter kit our contact purchased at the end of her visit:



In fact, our contact obtained images of the complete Usana Distributors Manual, in Chinese and English, which spells out Usana's entire compensation scheme. Our contact was advised by Ada Chai (and is recorded) that **everything** in the book about downlines and pay structures applies to her prospective sales activities of Usana products in Mainland China.



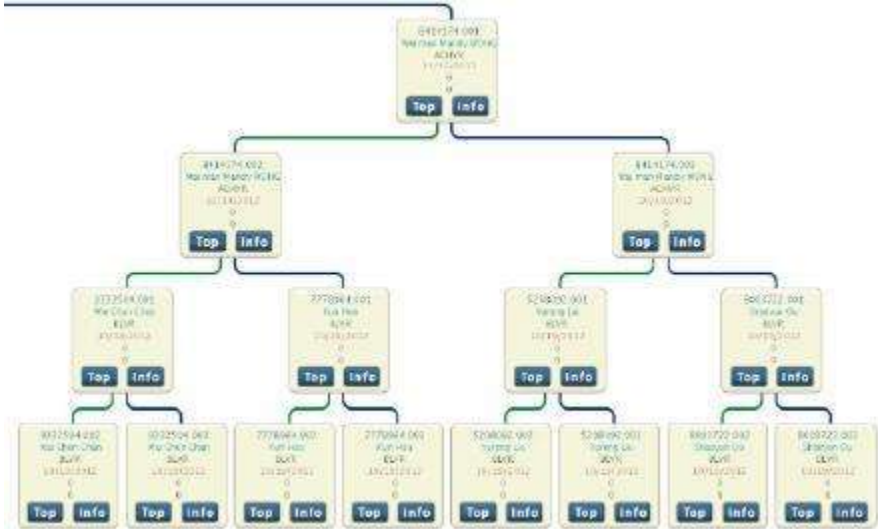


[Link to the complete set of images for this Manual](#)

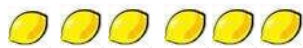
5) 🟡🟡🟡🟡🟡 Recent updates: HK Bank Account with false address leads to directly to establishing illegal downline sales rep in Mainland China: Entire scheme is structured to circumvent PRC's anti-MLM laws.

Our research didn't end with this preliminary visit, however. In fact, the contact proceeded to follow the instructions as given, open the requisite HK bank account, and become a Usana rep. With the explicit understanding that she was going to recruit a downstream in mainland China, she proceeded to do just that; and as a bonus, obtained additional downlines given to her by Ada Chai. (common practice because of limitations on the number of direct downline "slots" in the Usana compensation scheme.

The left side of this tree represents the operative's recruited downline; those on the right (shown here) are reps added by Ada Chai and are unknown to the researcher. (A graphic of the complete tree is linked below.)



[Link to the complete downline tree for the researcher in Usana's system.](#)



Conclusion:

The obtained evidence presented here unequivocally supports the conclusion that Usana is blatantly operating an MLM pyramid in China, and this activity is endemic -- not the fringe behavior of a few rogue distributors. This activity stretches far beyond the cover provided by the nascent baby products company which Usana purchased for the purpose of obtaining a direct sales license in China.

From a regulatory perspective, U. S. investors have to ask how long this scheme can be used to buttress the company's claims of double-digit top and bottom line growth. At worst, management is lying about all this. But at a minimum, **they aren't disclosing the real risks** of their business to investors or the SEC.

When we see distributors being arrested, and when the company's representatives teaching people how to evade Chinese laws, they are willfully abetting the laws of a sovereign country.

So how can Usana claim sustainability for its strategy in China? How can analysts hang a generous P/E multiple on growth generated this way, while encouraging investors to buy the stock up to unsupportable price targets? Are investors simply left to speculate about the risks in Usana's ability to "influence" public officials to keep the game going? (Of course, all bribes made by employees of US companies to gain business in foreign countries are **explicitly illegal** under the [Federal Foreign Corrupt Practices Act.](#))

Risk Factor:

If in fact the Chinese Government is going to give a free pass to Usana and Nu Skin in order to prove Citron wrong ... then the writer of this article is going to run for Governor of Utah.