# GLAUCUS RESEARCH GROUP

All that is required for evil to triumph is for good men to do nothing — *Edmund Burke*



COMPANY:

## SHOUGANG FUSHAN RESOURCES GROUP LIMITED | HK 0639

INDUSTRY: Coal Mining

**Recommendation:**
Strong Sell

**Daily Volume:**
38mm
(most recent 10-day average)

**Market Cap:**
HK$14 billion

**Price:**
HK$2.66
As of Market Close 4/10

**Underwriters:**
BOCI Asia, Morgan Stanley, Deutsche Bank AG, Credit Suisse

**Auditor:**
BDO Limited Hong Kong

We believe that Shougang Fushan Resources Group Limited (HK: 0639) ("Fushan"), a 2008 effective reverse merger trading on the Hong Kong stock exchange, has misrepresented its business and financial position to investors and that, as was the case with Chaoda Modern Agriculture (HK: 0682), regulators will halt trading of Fushan's stock on account of such impropriety.

For a brief video summarizing the major conclusions of this report, please click here or visit our website at www.glaucusresearch.com

**1. Overpayment for a Major Acquisition from Insiders.** Comparable acquisition data indicates that Fushan significantly overpaid for the coal mines that it acquired from company insider Xing LiBin ("Mr. Xing") for HK$ 10.5 billion[1]. By our calculations, Fushan acquired the mines for RMB 97 per tonne of the stated coal reserves, when its competitors acquired other similarly-sized, primary-coking coal mines (in the same or neighboring province) for between RMB 11 and RMB 16 per tonne of reserves. This indicates that Fushan overpaid by roughly HK$ 8 billion.

**2. Pump and Dump.** Fushan's long-time Chairman Wong Lik Ping ("Chairman Wong") and his cohort, Mr. Xing, each sold the vast majority of their respective company shares within 18 months of the reverse merger. Chairman Wong grossed HK$ 4.5 billion and Mr. Xing grossed HK$ 4 billion as Fushan's stock soared on the strength of suspiciously high margins.

a. **We believe Fushan's EBITDA margins are fabricated** because they are head and shoulders above those of its domestic and international peers and they display Madoffian consistency.

b. **Suspiciously Low Costs.** Fushan's cost of goods as a percentage of sales is 3500 basis points lower than that of its Chinese and international coking coal comps. We believe that, much like the Longtop scandal, insiders have embellished Fushan's performance by moving costs off of its books. Specifically, we suspect undisclosed related-party transactions with Mr. Xing, who controls 12 area coal mines, 8 of which are within 15 miles of Fushan's operations.

c. **Ridiculous ASPs.** Despite selling a commodity, Fushan justifies above-market prices (in this case as high as 20%) because its product is different. In 2008, one related party customer single-handedly boosted overall post-merger sales and pre-tax income by 10% and 21%, respectively, by buying an enormous amount of coal at a 72% premium to prices paid by other customers.

**3. Undisclosed Related Party Transactions.** Fushan made HK$ 375 million in purportedly charitable donations (17% of its 2009 EBIT) to the Liulin Provincial Government for the construction of public schools. We believe that this was no charitable donation; rather evidence suggests that the money went to an elite, for-profit school owned by Mr. Xing.

**4. Musical Chairmen.** Fushan has churned through 5 chairmen in the last 3 years. Since 2009, no chairman has signed off more than once on the company's annual audited financials, suggesting that they may have fled rather than risk being tarnished by an accounting scandal at the company.

**5. Weak Auditor.** Fushan's auditor, BDO Limited Hong Kong, has a checkered history of representing other publicly listed Chinese companies which have committed or have fallen under suspicion of committing fraud.

**6. Valuation.** We believe Fushan is worth no more than HK$ 0.91 per share, which is the private market value of its mines based on a generous multiple of 29x its estimated reserves as of Q1 2012. This figure includes Fushan's minority stakes in Mt. Gibson (MGX) and APAC (1104 HK) at a 20% liquidity discount. We gave no credit to net cash of HK$ 0.69 per share given the brazen nature of the Fushan fraud and the difficulty of recovering against entrenched and powerful insiders in China's corrupt judicial system.

[1] All figures in this report are presented in Hong Kong Dollars unless otherwise specified.

# Disclaimer

*We are short sellers. We are biased. So are long investors. So is the company. So are the banks that raised money for the company. If you are invested (either long or short) in Fushan, so are you. Just because we are biased does not mean we are wrong.*

*You are reading a short-biased research report. Obviously, we will make money if the price of Fushan's stock declines. You can publicly access any piece of evidence cited in this report or that we relied on to write this report. Think critically about our report and do your own homework before making any investment decision.*

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# Introduction

Shougang Fushan Resources Group Limited ("**Fushan**" or the "**company**") is a mining company that produces and sells coking coal. The company, which went public on the Hong Kong Stock Exchange ("**HKEX**") via an effective reverse merger, owns and operates three coal mines in northern China (Shanxi Province).

It is our opinion that Fushan is a pump-and-dump scheme that serves as a vehicle to transfer wealth from shareholders to wealthy, powerful and connected insiders. The company boasts margins that are nearly double almost all other publicly traded domestic or international coking coal miners. This is not credible. We believe that insiders have exaggerated the performance of the company by inflating sales figures and moving costs off Fushan's books through disclosed and undisclosed related-party transactions. As the price of Fushan's shares skyrocketed on the strength of dubious production figures and out-of-this-world performance, insiders aggressively **sold their respective stakes in the company**.

We also believe that Fushan has inappropriately transferred shareholders money to investors by more direct means. We present evidence that Fushan purchased coal mines from insiders at price-to-reserve multiples significantly higher than what independent third parties paid for similar mines in the same region during the same time period. We also believe that Fushan has violated securities laws by diverting company funds to for-profit schools owned by a major shareholder under the guise of charitable donations.

But to understand the story it is necessary to identify the primary beneficiaries of these illicit transactions.

# The Men Behind the Curtain

For those investors similarly impressed by Fushan, its uber-impressive profits and magical growth story, we would like to introduce former Fushan Chairman Wong Lik Ping ("**Chairman Wong**") and Forbes 400 Chinese billionaire Xing LiBin ("**Mr. Xing**").

Chairman Wong served as the chairman of Fushan from 2001-2009, during which time the company struggled as a middling jewelry business.

By contrast, Mr. Xing was then one of China's richest men and owner of Shanxi Lasen Energy ("**Lasen Energy**"), a massive privately-held conglomerate with interests in coal mining, electricity, cement, hotels, agriculture and education.

Chairman Wong and Mr. Xing came together in 2008 to orchestrate the reverse merger that created the company in its current form, making billions for both men in the process. This is their story.

Wong Lik Ping (left), Shougang's Chairman from 2001-2009 and minority owner of Fortune Dragon Group. Mr. Xing (right) is famous for his quote "money is not a sin.[2]" He was the majority shareholder of Fortune Dragon Group and the primary beneficiary of Fushan's acquisition.

[2] http://baike.baidu.com/view/834542.htm

# Fushan Overpays for Acquisitions

On July 25, 2008, Fushan consummated a $HK 10.5 billion acquisition of an 82% interest in three coal mines (the "**3 Mines**"), purchased from Fortune Dragon Group ("**Fortune Dragon Group**"), a company owned by Mr. Xing and Chairman Wong. Fushan paid the owners of Fortune Dragon Group **HK$ 4.86 billion in cash (cash raised throughout the prior year in anticipation of the acquisition) and HK$ 5.67 billion in new shares issued by the public company**.

This HK$ 10.5 billion transaction transformed Fushan overnight from a floundering jewelry company into a Chinese mining behemoth (measured solely by market capitalization). But evidence suggests that the company significantly overpaid for old, provincial mines, thus illicitly enriching Chairman Wong, Mr. Xing and their cohorts at the expense of shareholders.

From Fushan's public filings, we have assembled the following information on this transformative acquisition and the value of the acquired mines. The following chart presents the gospel according to the company:

3 MINES PURCHASE PRICE CALCULATION[3]
('000,000)

| | |
|---|---|
| Reserves (mm tonnes) | 142 |
| EV/Reserves Ratio | 97.0x |
| Total Enterprise Value of the 3 Mines (RMB) | ¥13,808 |
| Total Net Debt (RMB) | ¥(2,234) |
| Total Equity Value of the 3 Mines (RMB) | ¥11,574 |
| % Ownership Acquired | 82% |
| Value of the Acquired Equity (RMB) | ¥9,458 |
| VALUE OF THE ACQUIRED EQUITY (HK $) | $10,530 |

The conventional metric for evaluating a coal mine acquisition is the ratio of the purchase price of the mine's implied total enterprise value to the amount of such mine's proven and probable reserves. For the Fushan's 2008 acquisition, according to our calculations the implied total enterprise value of the 3 Mines (before subtracting net debt) was 13.8 billion RMB, or 97 times the amount of proven and probable coal reserves of the 3 Mines.

In order to assess the reasonableness of the purchase price paid by Fushan, we retained China Coal Resources, a subsidiary of Fenwei Energy Consulting Co, to provide data on acquisitions of other private coal mines in the same geographic region and during months leading up to the announcement of the Fushan acquisition. China Coal Resources is China's premier consultancy in the coal and coke industry, employing a staff of over 360 professionals.

Without revealing the purpose of our inquiry, we asked China Coal Resources for a table of comparable transactions, including the estimated reserves and production data for coking coal mines acquired in the same region (Shanxi province and neighboring provinces) in 2007 and 2008. In Appendix I we have included the complete mergers and acquisitions comparables table for the 2007-2008 period that we obtained from our independent, third party consultants.



[3] See Appendix III

## APPLES TO APPLES

According to China Coal Resources' coal classification chart (and coal quality data provided by the company), Fushan's coal falls into the category of bituminous #25 coal (see Appendix II), which falls into the broader group of **primary coking coal**. To put it in context, of the 14 sub-categories of coking coal, Fushan's appears fifth best in terms of quality. In the universe of Chinese metallurgic coal, Fushan's coal is slightly above average, but nevertheless is an undifferentiated commodity that must compete with higher and lower quality coking varieties and contemporary substitutes such as pulverized coal (PCI).

In the table below we compare Fushan's acquisition of the 3 Mines with other acquisitions of '**primary coking coal**' mines in the Shanxi and neighboring provinces during the same time period. This ensures that we are comparing apples-to-apples and giving the company the benefit of the doubt for the quality of the coal that it purports to mine. Even with these generous assumptions, the data suggests an unmistakable conclusion: that Fushan vastly overpaid for the 3 Mines.

COMPARABLE ACQUISITIONS

| MINE LOCATION | ACQUISITION DATE | IMPLIED ENTERPRISE VALUE (RMB MM) | COAL RESERVES (MM TONNES) | COAL TYPE | EV/RSV |
|---|---|---|---|---|---|
| Linfen, Shanxi | May 07 | 600 | 50 | Primary Coking | 12.0x |
| Tiayuan, Shanxi | Oct 07 | 882 | 78 | Primary Coking | 11.3x |
| Zhengzhou, Henan | Dec 07 | 275 | 18 | Primary Coking | 15.3x |
| Zhengzhou, Henan | Dec 07 | 225 | 14 | Primary Coking | 16.1x |
| Jinzhong, Shanxi | Apr 08 | 480 | 32 | Primary Coking | 15.0x |
| AVG OF M&A COMPS | | | 38 | | 13.9X |
| FUSHAN S THREE MINES | JAN 08 | 13,808 | 142 | PRIMARY COKING | 97.0X |

Fushan acquired the 3 Mines from an insider for RMB 97.0 times (per tonne) of the amount of reserves. By comparison, its competitors bought coal mines of similar size, in the same area, during the same time period, producing a comparable grade of coking coal, for an average multiple of RMB 13.9 times (per tonne) of reserves.

If investors applied the valuation metric of comparable transactions (13.9x reserves) to the 3 Mines acquired by Fushan from its rich and powerful benefactors in 2008, **the total debt on the books of the 3 Mines would have exceeded the value of the mines. In other words, it appears that Chairman Wong, Mr. Xing and their cohorts sold investors a net liability for over HK$ 10.5 billion.**

3 MINES PURCHASE PRICE CALCULATION[4]

| ('000,000) | ACTUAL TRANSACTION | FAIR VALUE |
|---|---|---|
| Reserves (mm tonnes) | 142 | 142 |
| EV/Reserves Ratio | 97.0x | 13.9x |
| Total Enterprise Value of the 3 Mines (RMB) | ¥13,808 | ¥1,983 |
| Total Net Debt (RMB) | (2,234) | (2,234) |
| Total Equity Value of the 3 Mines (RMB) | ¥11,574 | (¥251) |
| % Ownership Acquired | 82% | 82% |
| Value of the Acquired Equity (RMB) | ¥9,458 | (¥205) |
| VALUE OF THE ACQUIRED EQUITY (HK $) | $10,530 | ($228) |

By this metric, it appears that Fushan overpaid Mr. Xing and his cohorts by over **HK$ 10.5 billion** for the 3 Mines.[5] Worse still, the company's valuation of the 3 Mines relied on highly suspicious production figures for the 3 Mines spoon-fed to the company by none other than the seller.

[4] See Appendix III

[5] For the purposes of this valuation calculation, we ignored $1.1 billion in intercompany loans. Net debt for 3 mines as of 4/30/2008 (the Valuation Date).

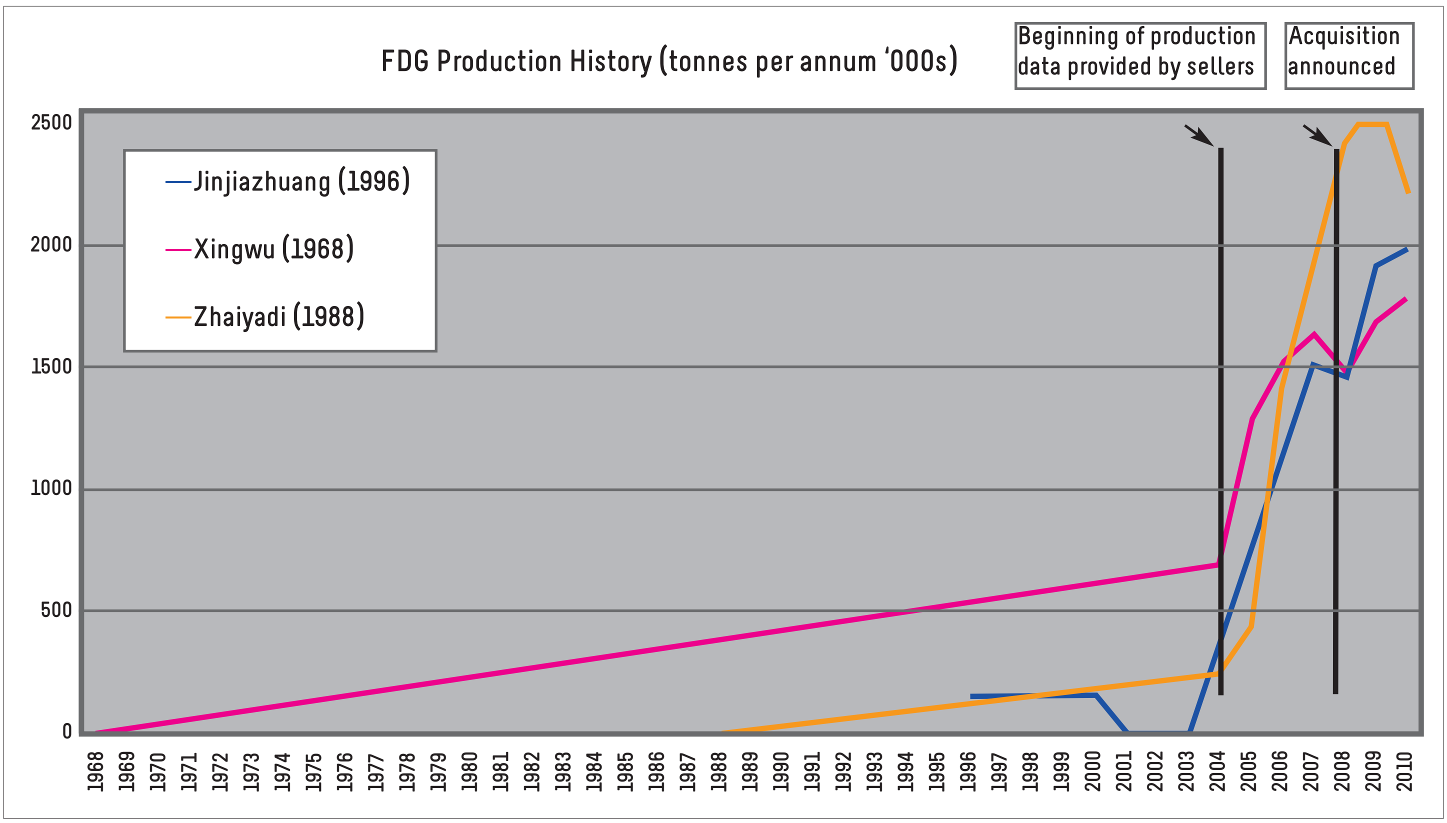
# Dubious Production Data

A host of further evidence supports the notion that Fushan massively overpaid for the 3 Mines, thereby enriching insiders to the detriment of shareholders.

## EMPEROR'S NEW CLOTHES

In July 2008, Fushan paid HK$4.9 billion in cash (HK$4 billion of which was raised in the capital markets from investors immediately prior to the acquisition) and issued 1.26 billion new shares valued at HK$5.7 billion (thus diluting existing shareholders) to acquire the 3 Mines. Fushan tapped the capital markets to raise money for the acquisition by pointing to dubious production figures at the 3 Mines. Such production figures **are not remotely credible and appear not to have been independently verified.**

The following graph shows production data provided in Fushan's public filings. Suspiciously, production at each of the 3 Mines jumped meteorically just prior to their acquisition by Fushan. The exponential growth of the 3 Mines just prior to their acquisition by the company is simply not credible for three reasons: the mines were already mature at the time production spiked, the mines were located in a popular coal mining region, making it unlikely that they could have escaped unnoticed for a significant period of time, **and headcount at the 3 Mines did not appear to increase between 2005-2007, a period that saw 4 acquisitions and a miraculous explosion of productivity.**




Linear production estimates shown for Xingwu and Zhaiyadi prior to 2004. Production data for Jinjiazhuang from 1996 to 2000 refers to capacity, not output.

## FROM ZERO TO HERO

At the time of the acquisition, the 3 Mines were, on average, already **decades into production** (each was established in 1968, 1988, and 1996, respectively). Despite it being highly unlikely that Fortune Dragon Group could so quickly and easily ramp up output, in the four years prior to the acquisition, production at the 3 Mines purportedly exploded. The production history of the Jinjiazhuang and Zhaiyadi mines, in particular, merits close scrutiny.

Fushan's public filings only included pre-2004 production figures for the Jinjiazhuang mine ("Jinjiazhuang"). According to the technical report provided by the company, from 1996 to 2001, Jinjiazhuang's production maxed out at 150,000 tonnes of coal per year. Then, from 2001 to 2003, **the Jinjiazhuang Mine was mothballed for three years**. Needless to say, Jinjiazhuang did not seem a likely candidate for a booming mining operation.

But, according to production figures provided by Fortune Dragon Group, Jinjiazhuang went from idleness to spectacular profitability in a short time. Production appears to have increased by 900% in the five years prior to Jinjiazhuang's sale to Fushan.

900%. At an old mine. The "growth" at the Zhaiyadi mine is similarly unbelievable; it rocketed up 860% in the four years prior to the acquisition.

| MINE PRODUCTION | 2002 PRODUCTION | PRE-2004 CAPACITY | 2004 PRODUCTION | 2008 PRODUCTION | % INCREASE | |
|---|---|---|---|---|---|---|
| Jinjiazhuang | 0 | 150,000 | 400,000 | 1,500,000 | 900% | (5 years) |
| Xingwu | NA | NA | 700,000 | 1,500,000 | 114% | (4 years) |
| Zhaiyadi | NA | NA | 250,000 | 2,400,000 | 860% | (4 years) |

Fushan's oldest mine is Xingwu (originally opened in 1968, when Lyndon Johnson was president of the United States). After taking 36 years to reach 700,000 tons of coal, production more than doubled in the four-year period prior to the sale of the mine to the company. Apparently, this mine took four decades to reach the inflection point in its growth curve.

Note that acquisitions cannot explain the exponential growth of production at the 3 Mines. In December 2006, the Fortune Dragon Group absorbed four smaller mines into its existing mining operations. But prior to such acquisition, the 3 Mines had purportedly recorded 3 years of suspiciously amazing growth.

## HIDING UNDER EVERYONE'S NOSE?

Fortune Dragon Group's mines were not tucked away in a remote or under-mined region. Just the opposite. Shanxi province alone accounts for 55.4% of China's coking coal reserves.[6] According to the company's 2009 annual report, the 3 Mines are "located within the Lishi-Liulin mining area of Hedong coalfield, one of China's key reserve areas for high-quality hard coking coal." Given the number (and density) of coal mines in the area, we find it unlikely that the assets capable of such a quick and easy jump in production remained under the radar for, on average, 24 years since they began commercial production.

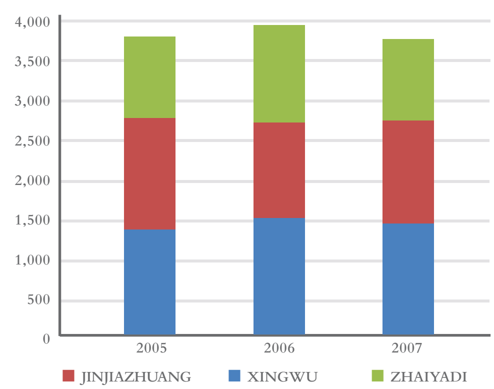
## EMPLOYEE-FREE GROWTH

Perhaps most suspiciously, production at the 3 Mines skyrocketed even though the Fortune Dragon Group did not add any net employees. Despite boosting output by 102% between 2005 and 2007, Fortune Dragon Group's headcount actually shrunk. How did fewer employees produce more than twice the amount of coal considering that labor is a major cost of goods for Chinese coal mines?

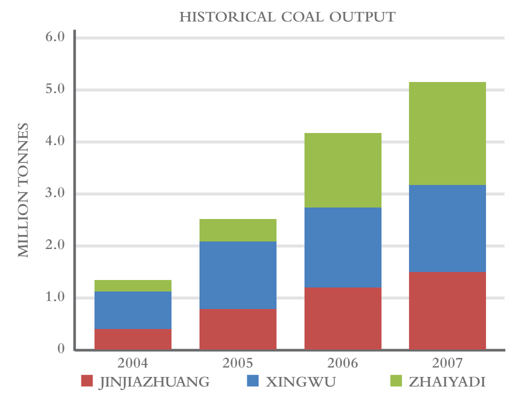
[6] BNP Shougang Fushan Equity Research Report, February 7, 2012.

Below we have graphed the headcount at the 3 Mines from 2005 through 2007 and juxtaposed it with a graph on the right showing the meteoric rise in production at the 3 Mines during the same period.[7]

**Fortune Dragon Employee Count**




**Fortune Dragon Coal Output**




We believe that the above graphs provide compelling evidence that Fushan defrauded shareholders by lying about the productivity of the 3 Mines. We find it absurd that a company could increase production so dramatically at old mines without increasing headcount. In fact, headcount *decreased from 2006-2007*, a period during which, according to Fushan, production increased by almost 25%, and Fortune Dragon Group purportedly spent $HK 1 billion to acquire four smaller mines from Mr. Xing's wife. This is simply not believable.

## RUBBER STAMPS

A savvy investor might object to our conclusion on the grounds that the company hired two independent consultants, a mining expert and an appraiser, to bless the 3 Mines acquisition. But on closer inspection, such independent evaluations are no more than rubber stamps of data provided by the sellers.

The company hired John T. Boyd, an independent mining consulting firm, to review the reserve estimates and production figures of the 3 Mines and prepare a technical report of its findings (the "**Boyd Report**"). Strangely, the Boyd Report relies almost exclusively on estimates of reserves and historical production data at the 3 Mines provided by Mr. Xing's Fushan Dragon Group (referred to as FDG in Boyd's report):

> "The basis of our work was historical operating and other source data provided principally by FDG …**the primary source of information (written and verbal) relied upon by BOYD in preparing this ITR was provided by FDG**…**in preparing this report, we have relied upon reserve, operating, and other data as provided by FDG**…the accuracy of the results and conclusions of this report are reliant on the accuracy of information provided. **We have made no attempt to verify the technical and geological information presented in the reference material documents** and ***assume*** **it has been prepared by competent engineers and geologists**…nor do we represent any of our findings include matters of a legal or accounting nature."

In other words, the Boyd Report relied almost exclusively on data provided by Fortune Dragon Group and its owners (Mr. Xing and Chairman Wong), which is a grave conflict of interest that undermines any comfort investors can take from the allegedly independent evaluation.

The company also hired Greater China Appraisal Limited Tse Wai Leung to provide an independent valuation of the transaction (the "**Greater China Appraisal**"). Yet the Greater China Appraisal, like authors of the Boyd Report, relied upon figures provided by Mr. Xing:



[7] Shougang Fushan reverse merger prospectus. Available at http://www.hkexnews.hk/listedco/listconews/sehk/2008/0625/LTN20080625008.pdf.

> "**We have not carried out detailed site measurement to verify the correctness of the mining areas** of the Coal Mine but have ***assumed*** **that the areas shown in the legal documents provided to us are correct.**"

Put simply, the company bought three old mines and justified the acquisition to shareholders based on dubious production figures provided by Chairman Wong and Mr. Xing, the primary beneficiaries of the transaction. Such production figures appear not to have been independently verified by the consultants and appraisers brought in to evaluate the acquisition.

# Fushan Pumps, Insiders Dump

The objective of a pump and dump scheme is to talk up the share price through misleading financial performance so that insiders may dispose of their shares after other investors take the bait.

The chart below shows that Mr. Xing and Chairman Wong dumped 90% of their interest in the company within 18 months of the 3 Mines transaction. We estimate that Mr. Xing grossed **HK$ 4.0 billion** and Chairman Wong grossed **HK$ 4.5 billion**.

MR. XING

| DATE | NOTES | SHARES OWNED (NET OF SHORT POSITION) | NET SHARES SOLD[1] | % OF POSITION DIVESTED | ESTIMATED AVG. STOCK PRICE[2] | ESTIMATED GROSS PROCEEDS ($ HK)[3] |
|---|---|---|---|---|---|---|
| 7/25/08 | Acquisition Date | 669,546,536[4] | | | | |
| 9/22/09 | Acq + 14 mths | 557,896,536[5] | (111,650,000) | 17% | $3.28 | 366,212,000 |
| 12/31/09 | Acq + 17 mths | 7,940,536[6] | (549,956,000) | 82% | 6.56 | 3,607,711,360 |
| TOTAL | Acq + 17 mths | 7,940,536 | (661,606,000) | 99% | | 3,973,923,360 |

CHAIRMAN WONG

| DATE | NOTES | SHARES OWNED (NET OF SHORT POSITION) | NET SHARES SOLD[1] | % OF POSITION DIVESTED | ESTIMATED AVG. STOCK PRICE[2] | ESTIMATED GROSS PROCEEDS ($ HK)[3] |
|---|---|---|---|---|---|---|
| 7/25/08 | Acquisition Date | 1,413,741,900[4] | | | | |
| 2/10/09 | Acq + 7 mths | 873,171,900[7] | (540,570,000) | 38% | $2.18 | 1,178,442,600 |
| 9/22/09 | Acq + 14 mths | 673,171,900[5] | (200,000,000) | 14% | 3.30 | 660,000,000 |
| 12/31/09 | Acq + 17 mths | 378,671,900[8] | (294,500,000) | 21% | 6.20 | 1,825,900,000 |
| 6/30/11 | Acq + 35 mths | 239,346,900[9] | (139,325,000) | 10% | 5.80 | 808,085,000 |
| TOTAL | Acq + 35 mths | 239,346,900 | (1,174,395,000) | 83% | | 4,472,427,600 |

[1] Net share reduction from previous date.

[2] Estimated average stock price between ownership reporting dates.

[3] Estimated gross proceeds = net shares sold * estimated average stock price.

[4] Source: Company Filing A, page 2.

[5] Source: Company Filing C, page 7.

[6] Source: Company Filing D, pages 44–45. Long position of 428mm shares (incl 423mm with Firstwealth Hldgs Ltd.) less short position of 420mm shares.

[7] Source: Company Filing B, page 2.

[8] Source: Company Filing D, pages 41–42. Long position of 588mm shares (incl 399mm with China Merit Ltd.) less short position of 210mm shares.

[9] Source: Company Filing E, pages 46–47. Long position of 418mm shares (incl 296mm with China Merit Ltd.) less short position of 178mm shares.

| Relevant Fushan Filing | Link | Page(s) |
|---|---|---|
| A | http://www.hkexnews.hk/listedco/listconews/sehk/2008/0725/LTN20080725258.pdf | 2 |
| B | http://www.hkexnews.hk/listedco/listconews/sehk/2009/0210/LTN20090210380.pdf | 2 |
| C | http://www.hkexnews.hk/listedco/listconews/sehk/2009/0923/LTN20090923008.pdf | 7 |
| D | http://www.hkexnews.hk/listedco/listconews/sehk/2010/0428/LTN20100428932.pdf | 41–42, 44–45 |
| E | http://www.hkexnews.hk/listedco/listconews/sehk/2011/0907/LTN20110907301.pdf | 46–47 |

Upon the consummation of the reverse merger, Mr. Xing received a 15% stake in the company (670 million shares) and Chairman Wong's ownership stake stood at 31% (1.4 billion shares). When the markets saw Fushan's outstanding performance and the price of the company's stock soared, Chairman Wong and Mr. Xing sold out.

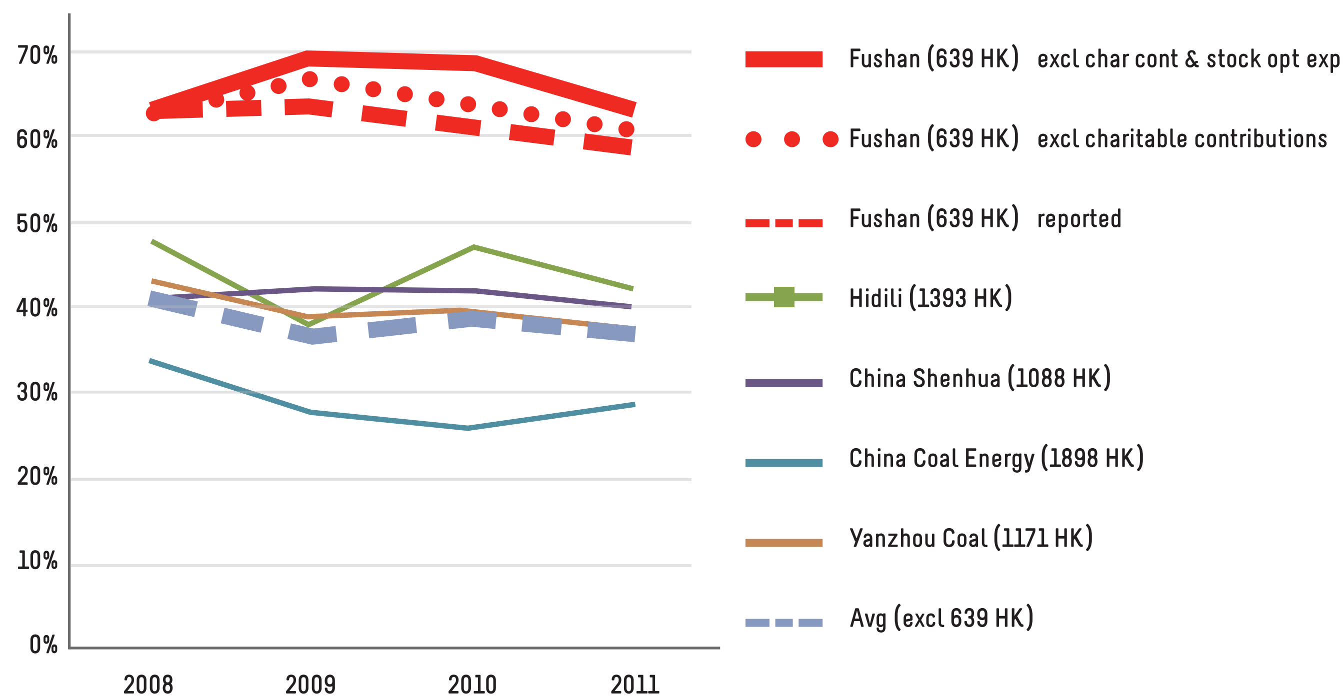
# Ridiculous Margins

A common denominator of Chinese reverse mergers that have collapsed under allegations of fraud is that their performance appears too good to be true. The play book is simple. Fraudsters hide costs through off-books transactions with related parties in order to inflate margins and pump up their stock price. Once the stock price soars on the wind of amazing profitability, insiders sell. Longtop Financial (NYSE: LFT) was the paradigmatic example of this scheme.

We believe that Fushan's insiders have perpetrated a similar deception. Compared to other coal mining companies, Fushan's financial performance is simply incredible. The company's EBITDA and EBIT margins easily trounce its HKEX and A-share coal competitors, which, for the most part, are much larger, vertically integrated, and more experienced organizations.

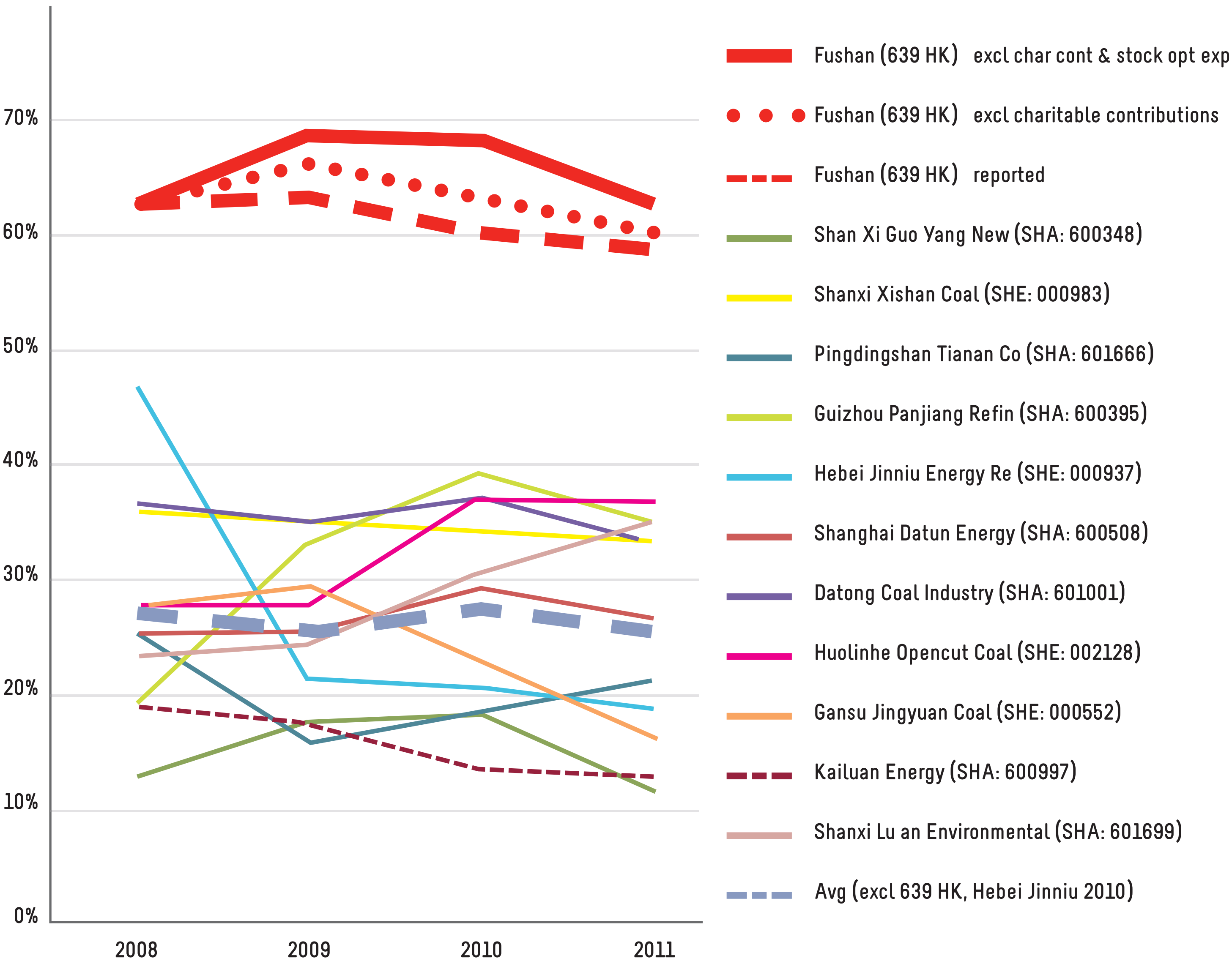
Fushan's financial performance is so far superior to its competitors that it leaves only two choices: either it has revolutionized the coal mining business or the company is fabricating its financial statements.

H-SHARE COMPS (EBITDA MARGIN)[8]




[8] Margins adjusted to exclude non-recurring items.

A-SHARE COMPS (EBITDA MARGIN)[9]



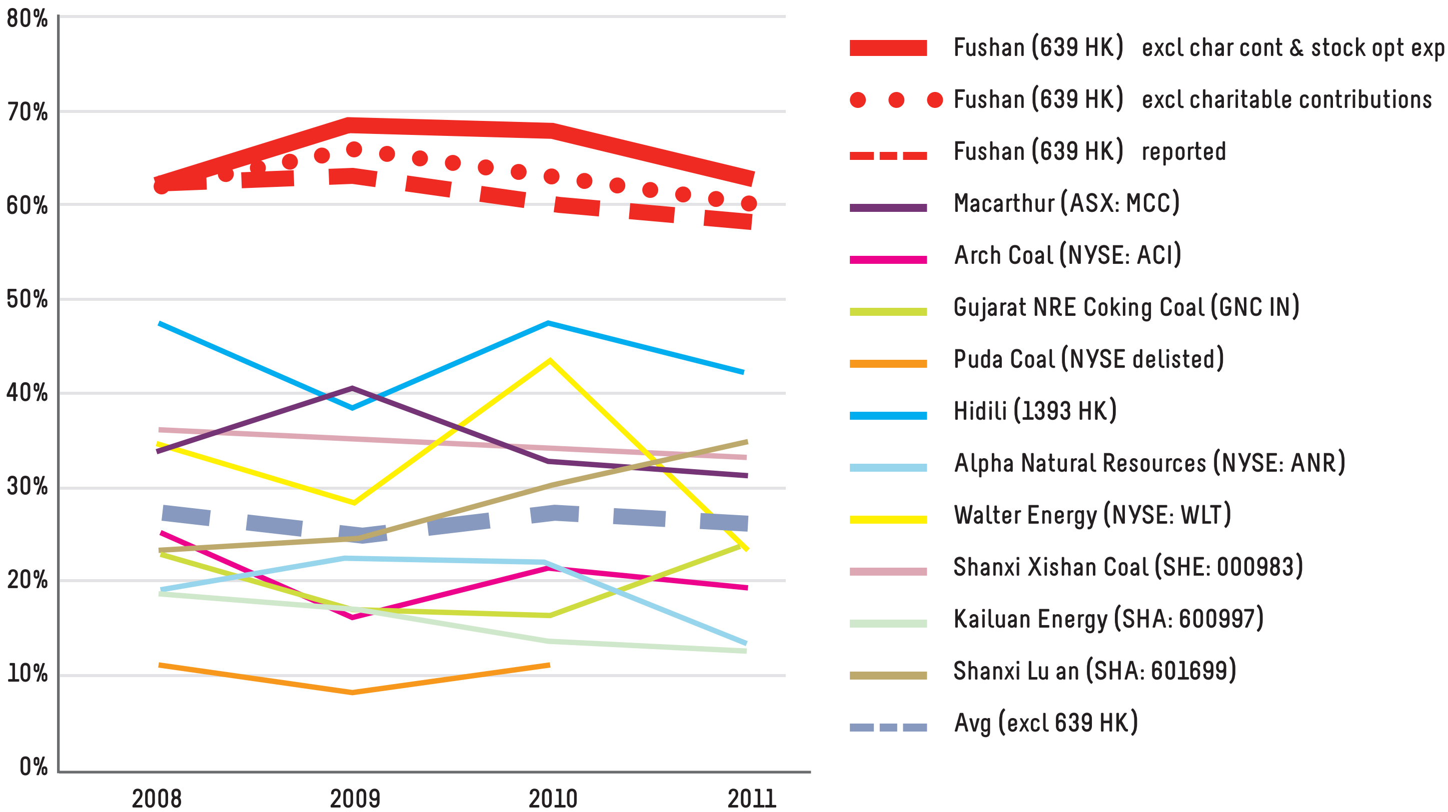

It is highly unlikely that Fushan is the most efficient and best-managed coal mine in the world, as its global and Chinese competitors should benefit from economies of scale. Fushan produces coal from three old and provincial mines. Yet it manages to generate better EBITDA margins than companies with much larger mines. Either Fushan is the most efficient and best-managed coal company in the world or it is a fraud. We think the answer is obvious.

For those that would argue that Fushan's margins can be explained by its focus on high quality, and therefore, high priced coal, we present the following chart comparing Fushan to other Chinese and leading international coking coal companies, which focus almost exclusively on high priced coal. Again, Fushan's margins seem a work of fiction.



[9] Margins adjusted to exclude non-recurring items.

GLOBAL METALLURGIC (COKING) COAL COMPS – EBITDA MARGINS[10]




The peer group we assembled in the above chart is made up of pure coking coal companies operating in Shanxi (Shanxi Lu'an, Shanxi Xishan), a neighboring province in China (Kailuan Energy), Southern China (Hidili) and in other parts of the world, such as North America, Australia, and India.

Fushan cannot argue that cheaper labor can account for the discrepancy because in our comparison we included local competitors hiring from the same labor force. In addition, several of the above companies are industry leaders for metallurgic coal, with vastly greater purchasing power, technology, and management skills. Yet their margins still average 3500 basis points below those of Fushan. This fails the smell test.

## MADOFFIAN CONSISTENCY

One of the hallmark features of Bernie Madoff's Ponzi scheme was that he consistently produced exceptional monthly returns despite wild swings in the market. The consistency of Fushan's margins bears a striking resemblance to Madoff's returns: notice in the above chart how margins for Fushan's peers fluctuate during the doom and gloom of the great recession (2008-2010). Yet Fushan's margins appear immune to the cyclicality in coal prices during the same time period.

To the contrary, in 2009, Fushan's adjusted EBITDA margin (excluding stock option expense and charitable contributions) increased 724 basis points despite:

- its average selling price for raw coal *declining* by 18%,
- its sales *declining* 6% on an annualized basis,
- its production cost per tonne *increasing* by 13%, and
- the reported loss of the company's most profitable customer who accounted for 31% of sales in the prior year.

Virtually all of its competitors suffered during this period. How was Fushan immune? Fushan, like Madoff, has a track record remarkable for both its excellence and its strange consistency.



[10] Margins adjusted to exclude non-recurring items.

# Oh What An Awful Web We Weave...

If we dig deeper into Fushan's remarkable margins, we find that Fushan's performance is driven by curiously high average selling prices ("ASPs") for a commodity and an unreasonably low cost structure.

## COAL 101

Coal is found in continuous seams that stretch out over vast geographical areas, like an underground river. Below is a picture of a coal seam (the thick black lines) which stretches across the countryside.

It is particularly important to understand how coal seams affect the market price of coal. Each seam produces coal with different characteristics. But, and this is crucial, **coal characteristics generally do not significantly vary within a seam at a similar access point**. Thus, exchanges, companies and traders typically set a spot price for coal by the seam and nearest city of origin.

Fushan primarily mines seams #4 and #9 within five miles of Liulin. Coal from seams #4 and #9 from the greater Liulin area are traded at prices set by the Liulin coal market.

How is Fushan more profitable than other coal companies? Part of the reason is that it sells Liulin #4 and #9 coal at **premium to the market prices for coal mined from the exact same seam.** According to BNP's recent research report, from 2009-2011, Fushan sold its Liulin #4 coal at a **19% premium** to the Liulin #4 benchmark price, while the company's #9 clean coal sells at a 10% premium to the Liulin #9 benchmark.

Coal is a commodity (or so we thought). How can Fushan's coal sell at a significant premium to the **same coal mined from the same seams?** The whole point of setting a spot price for coal from each seam is that buyers and sellers can quickly and easily exchange the commodity without having to determine the unique characteristics of each lot. The notion that Fushan could sell its #4 coal for almost a 20% premium to the spot price of #4 coal is absurd.

## RELATED PARTY ASPS

This begs the deeper question: who would pay a premium to the spot price for a commodity?
The answer: a related party who, as a major shareholder, directly benefits from Fushan's financial performance.

In 2008, Mr. Xing's conglomerate bought raw coking coal from Fushan at 72% above the price paid by other customers. [11]
The following table summarizes the transaction.



[11] http://www.hkexnews.hk/listedco/listconews/sehk/2008/1125/LTN20081125099.pdf

RAW COKING COAL TRANSACTIONS (7/25/2008 THROUGH 10/20/2008)

| Buyer | Transaction Value (RMB mms excl VAT) | Coal Volume (tonnes) | Price[1] (RMB/tonne) |
|---|---|---|---|
| Mr. Xing | 345.8[2] | 376,285[2] | 919.0 |
| Other Customers | 812.1[3] | 1,523,715[4] | 533.0 |
| Related Party Premium | | | 72% |

Source: http://www.hkexnews.hk/listedco/listconews/sehk/2008/1125/LTN20081125072.pdf ("2008 Caps Revision").

[1]Transaction value divided by tonnes of coal purchased.

[2]Sum of actual raw coal purchases by Party D (Mr. Xing and his associates) as per page 8 of the 2008 Caps Revision.

[3]Calculated as follows.

| | | Source |
|---|---|---|
| Raw coal sales – 2008 (HK$ mms) | 1,315.8 | 2008 annual report, page 74 |
| Exchange rate | 0.88 | |
| Raw coal sales – 2008 (RMB mms) | 1,157.9 | |
| Less: sales to Mr. Xing (RMB mms) | 345.8 | (from above) |
| Raw coal sales to other customers – 2008 (RMB mms) | 812.1 | |

[4]Calculated as follows.

| | | Source |
|---|---|---|
| Sales volume of raw coking coal – 2008 (tonnes) | 1,900,000 | 2009 annual report, page 21 |
| Less: coal sold to Mr. Xing between 7/25/2008 and 10/20/2008 | 376,285 | (from above) |
| Raw coal sold to other customers (tonnes) | 1,523,715 | |

In 2008, Mr. Xing's related party premium for one 3-month period singlehandedly boosted Fushan's 2008 sales and pre-tax net income by 10% and 21%, respectively.[12] Mr. Xing's decision to buy raw coal from Fushan at a hefty premium came immediately after the reverse merger and just prior to the time when Mr. Xing and Chairman Wong dumped virtually all their shares. While this transaction was disclosed to investors, we think it should be noted that coal washing is a razor thin margin business, making it unlikely that Mr. Xing could afford to overpay for raw coal and still make a profit, and that it seems incredibly unlikely that Mr. Xing would ever buy raw coking coal from a third party, much less for a 72% premium, given that he owns 12 coal mines in the same area, 8 of which are within 15 miles of Fushan's operations.

It is also worth noting that since 2008, Fushan's board has maintained huge mandates for related party coal transactions with Mr. Xing and director Shi (who also owns competing coal mines in the area), and 27% shareholder Shougang parent (whose employees comprise nearly half of the board). Board-approved transaction caps allow these parties to purchase coal for more than twice the price that Fushan commands with other customers. We believe that these arrangements provide a significant opportunity to related parties to manipulate the share price of Fushan by artificially boosting ASPs.

In our opinion, the notion that Fushan sells a commodity at a large premium to a related party is dubious. We suspect that such transactions take place at market prices but that Fushan marks up the price on the invoice in order to boost its margins. Make no mistake that insiders reap a massive benefit from such actions: outstanding margins boost Fushan's stock price, allowing insiders to enrich themselves on the sale of the company's shares.

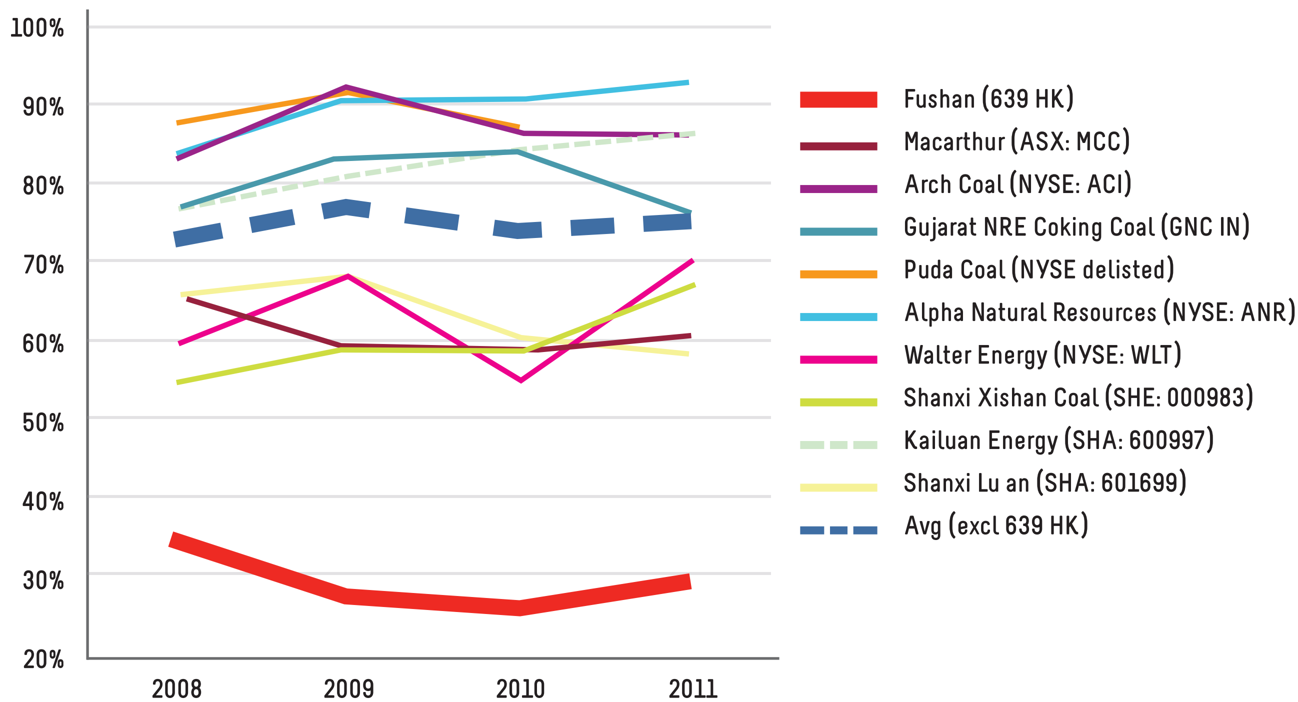
## LONGTOP 2.0

In addition to reporting unrealistically high ASPs, Fushan achieves world-beating margins because its costs, as a percentage of revenue, are so much lower than its domestic and international competitors' margins.

The graph below compares Fushan's cost of goods sold as a percentage of sales against its pure coking peers. This chart is truly remarkable because it shows Fushan allegedly mines a commodity at gross margins that would be the envy of a software monopoly.

[12] http://www.hkexnews.hk/listedco/listconews/sehk/2008/1125/LTN20081125099.pdf

## GLOBAL METALLURGIC (COKING) COAL COMPS – COGS AS % OF SALES




The above graph suggests that Fushan has revolutionized the coal industry. It has discovered a way to mine coal so much more cheaply than its competitors that it seems like magic. Notice that cheap labor costs or geographic anomalies do not explain the difference: Fushan's costs are ridiculously lower than domestic peers, including coal companies mining in the same province (Shanxi Lu'an, Shanxi Xishan).

In this way, Fushan reminds us of Longtop Financial, a US-listed Chinese company which collapsed after Citron Research and Bronte Capital publicly accused it of committing fraud. Like Fushan, Longtop boasted absurdly high margins relative to its competitors.

Longtop was able to artificially inflate its margins through hidden related party transactions: Longtop's insiders shifted its labor costs off the company's books to an undisclosed related party, making Longtop's performance stunning by comparison to its competitors. We believe that something similar may be happening with Fushan.

## PROXIMITY TO RELATED PARTY COMPETITORS

Mr. Xing, through his conglomerate Lasen Energy, owns **twelve competing coal mines near Fushan's coal mines, eight of which are within 15 miles of Fushan's operations**. On the following page, we have prepared a simple map showing the close proximity of Fushan's coal mines to Mr. Xing's coal mines.

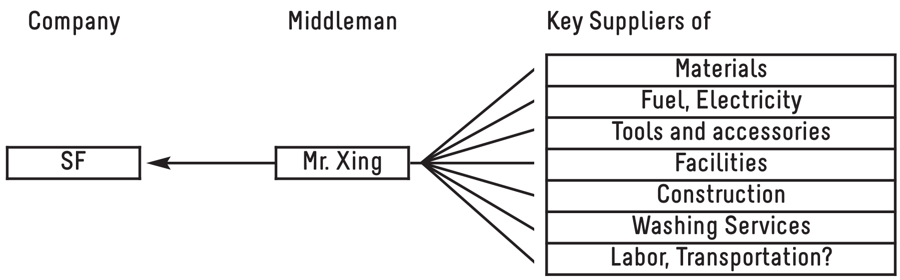
Approximate
coal mine locations - Google Maps


PROXIMITY

Most of Mr. Xing's mines are within a 15 minute drive of Fushan mines. We believe that this allowed Mr. Xing to funnel artificial EBITDA through Fushan so that he and Mr. Wong could dump their remaining stakes at the very top of Fushan's trading range (late 2009).

A closer look at Fushan's business reveals that Mr. Xing is one of the company's top suppliers for a number of non-coal inputs such as tools, accessories, facilities rental, construction contracts, and possibly other common cost of goods sold items like labor and transportation.

We find it odd that one of the most cost-efficient coal mines in the world has a middle man between itself and many of its key inputs. We believe Mr. Xing's Lasen Energy is moving costs for these services off-books, which has helped Fushan earn gross margins as high as 74% and adjusted EBITDA margins as high as 69%.




Also of interest is the unique structure of the supply contracts between Mr. Xing's Lasen Energy and Fushan. As the following excerpt shows, the price of materials supplied to the company by Mr. Xing is determined not based on the market price of the materials or services supplied, but on the price that Mr. Xing has charged other entities for similar materials or services.

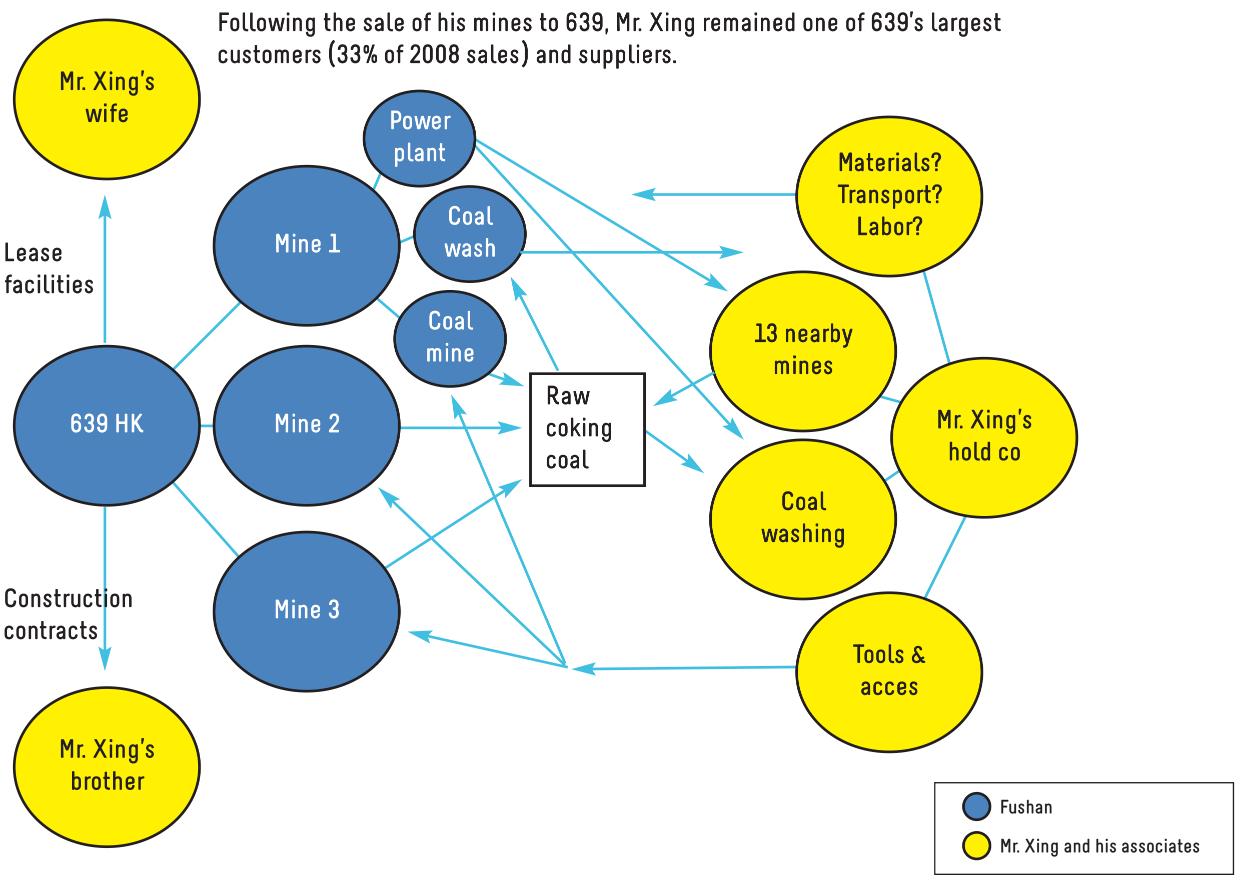
> placed by the purchaser from time to time. The unit price of the raw coking coal, accessories and small tools payable by the purchaser to supplier will be no less favourable than the unit price offered to the purchaser by independent suppliers for the same type of raw coking coal, accessories and small tools. Such unit price benchmarks shall be

Any investor in Chaoda is, to their great regret, already familiar with just such a contractual arrangement (Chaoda, halted after allegations of fraud, had a similarly dubious contract with its chairman which was highlighted in the whistle-blowing piece circulated by Anonymous).

This contractual structure allows Mr. Xing to charge Fushan any price he wants, provided he can show that he charged such price to another customer. It is basically a blank check for Mr. Xing to make up whatever price he likes.

But we believe that Mr. Xing is rather clever. Rather than overcharge Fushan for materials and services, we suspect that he **undercharges Fushan (at least on paper)**, thereby allowing the company to boast spectacular margins and thus bolstering the price of his stock. It is essentially the same strategy as Longtop and Chaoda: use related party transactions to shift costs off the books of the publicly listed company, thus making the publicly listed company's performance appear spectacular and sending its stock price through the stratosphere.

The number of related party transactions between Fushan and Mr. Xing and his family are head-spinning, so we put it in visual format to show investors just how tangled a web Mr. Xing has woven around the company.




Given that Fushan's margins are much higher than its competitors, investors should be deeply suspicious at the tangled web of related party transactions between the company and insiders.

The proximity of Mr. Xing's other coal mines, the fact that Fushan relies on Mr. Xing as both a major supplier and customer, and the relationship between Fushan and Mr. Xing's family all present an ideal opportunity to falsify Fushan's margins. It would be near impossible for anyone to verify Fushan's claimed production and sales figures given how easy it would be to move costs off of the company's books.

We believe that Fushan has moved significant costs off its books to Mr. Xing's other companies, allowing it to earn margins 2000 bps to 3000 bps above their HK, A-share, and global peers – margins that also showed almost no signs of cyclicality in the 2007-2011 period.

In short, we believe Fushan fraudulently exaggerated its margins to pump up the price of its stock, which later allowed insiders Mr. Xing and Chairman Wong to dump virtually all of their shares. We believe that the charade continues today so that the company can raise money for another dubious acquisition.

# Fushan Diverts Money Earmarked for Charity

Under the guise of making a HK$ 375 million charitable contribution to public elementary schools, evidence indicates that Fushan diverted the money to a **for-profit school** owned and operated by Mr. Xing's conglomerate.

According to the 2009 Annual Report of Fushan, "[i]n the light of the considerable profit that we have earned, the Group decided to give back to the society through **donations to charities**. Last year, under the request of the relevant Mainland government authority, the Group joined hands with other coal enterprises in Liulin County, Shanxi Province **to commit ourselves for donation for the construction of modern schools and provision of educational facilities** in the region which cover a total land area of 1,000 mu. The annual donation made by the Group between 2009 and 2011 is RMB110 million, a total donation of RMB330 million [roughly HK$ 375 million]."

While we applaud the notion of a major corporation giving back to the community, as we will see, Fushan's contributions hardly qualify as charitable. **Rather, it appears that the donations went to a for-profit school owned by Mr. Xing**.

Below we show two pictures side by side. On the left we show an excerpt from the company's 2009 Annual Report showing a blueprint of a school to which the purportedly charitable monies were donated. On the right we show a picture from the website of one of Mr. Xing's private, for-profit schools. They are clearly the same school.

SHOUGANG RESOURCES 2009 ANNUAL REPORT


Fushan International Energy Group Limited

**Management Discussion and Analysis**

**BUSINESS REVIEW** *(continued)*

**Financial Review** *(continued)*

**Other Operating Expenses**

During the year, other operating expenses were approximately HK$269 million, representing an increase of approximately HK$225 million or approximately 5.1 times as compared with approximately HK$44 million in 2008. The increase was a result of the full year of operating results of the three premier coking coal mines in 2009, having impairment of trade receivables of HK$32 million and charitable donation of HK$125 million made by the Group to the Liulin Provincial Government for the construction of modern schools and provision of education facilities in 2009.

Blueprint of school under construction

**Finance Costs**

During the year, finance costs were approximately HK$125 million, representing an increase of approximately HK$34 million or approximately 37% as compared with approximately HK$91 million in 2008. The increase in finance costs was due to the full year of interest expense from the borrowings of HK$1,110 million in 2008 which was solely for used to finance part of the consideration for the 2008 Acquisition. During the year, HK$17 million borrowing costs were capitalized in the construction in progress.

**Net Transaction Loss Arising from Acquisition of Available-For-Sale Financial Assets**

The Company suffered a one-off non-cash transaction gain of HK$54 million and a one-off non-cash transaction loss of HK$275 million arising from the acquisition of Mount Gibson shares under the First Agreement (as defined below under "**Increase in shareholding by Substantial Shareholders**") and from the acquisition of APAC shares under the Second Agreement (as defined below under "**Increase in shareholding by Substantial Shareholders**"), as a result of having net transaction loss of HK$221 million. Details of the net transaction loss are set out in the below under "**Material Investments and Acquisitions**".

**Income Tax Expense**

During the year, income tax expense was approximately HK$428 million, of which approximately HK$146 million representing the provision of withholding tax on the dividend declared from the three coking coal mines in accordance with the tax regulations in the PRC. The three coking coal mines are entitled to 50% relief on the income tax from 2008 to 2010, thus the income tax rate of the three coking coal mines is 12.5% from 2008 to 2010.

**Owner's Attributable Profit**

By reason of the foregoing, the profit attributable to the Owners in the year were approximately HK$1,126 million, representing an increase of approximately HK$558 million or 98% as compared with approximately HK$568 million in 2008.

**Increase in shareholding by Substantial Shareholders**

On 9 February 2009, Mr. Wong Lik Ping ("Mr. Wong"), a shareholder and executive director of the Company, and China Merit Limited, a company wholly-owned by Mr. Wong, entered into the share sale agreement ("Share Sale Agreement") with Excel Bond Investments Limited ("Excel Bond"), a wholly-owned subsidiary of Shougang Concord International Enterprises Company Limited ("Shougang International"), pursuant to which 12.05% of the Company's share capital at the completion date of the Share Sale Agreement was sold to Excel Bond.

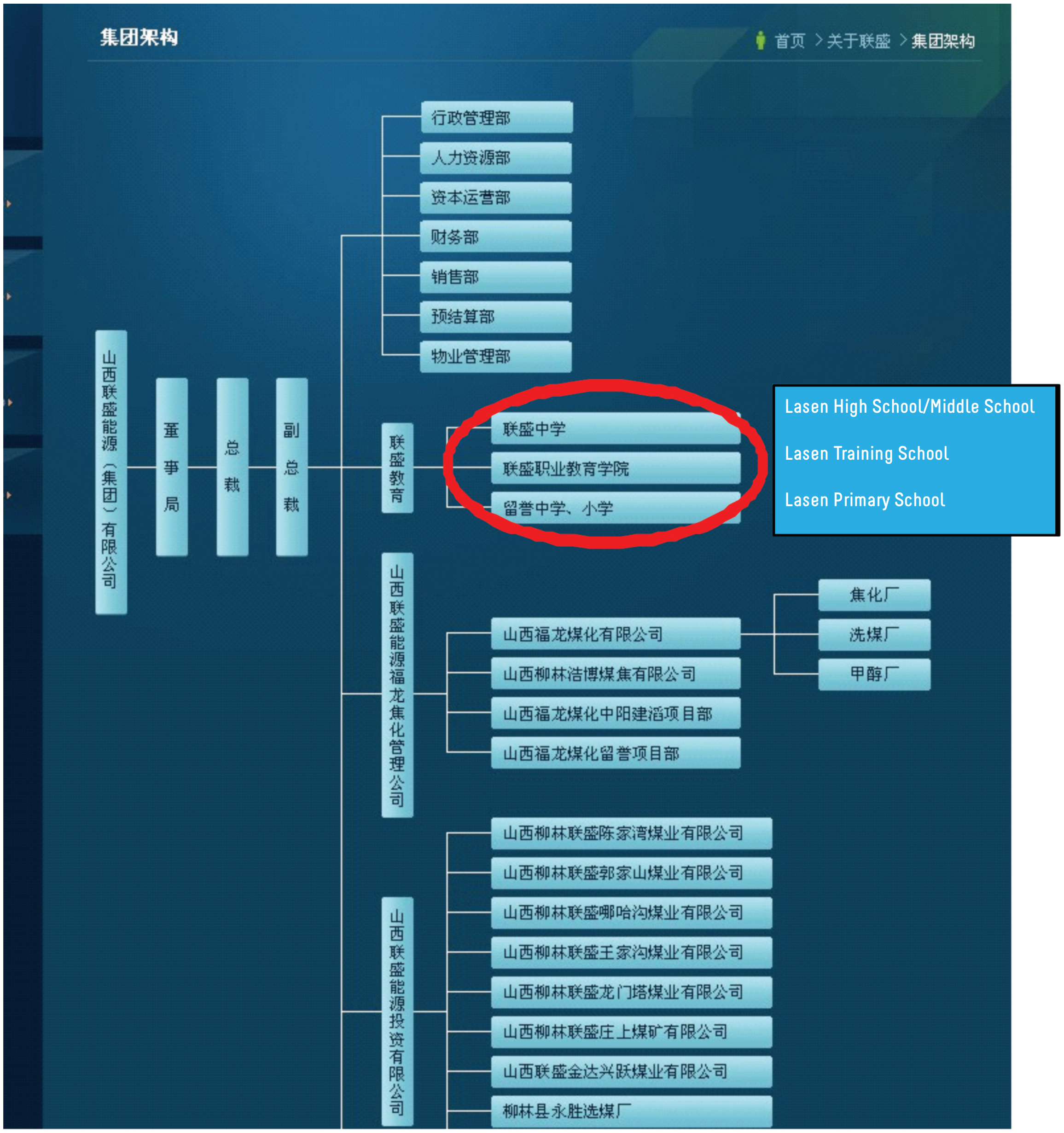
Annual Report 2009 23

WEBSITE OF MR. XING'S[13] FOR-PROFIT SCHOOL

[13] This picture of the for-profit school was taken down from Lasen Energy's website in early 2012. We saved screen shots of this photo and others, which are available in Appendix IV.

The website[14] of Mr. Xing's holding company, Shanxi Lasen Energy ("**Lasen Energy**") states that Mr. Xing owns **three for-profit schools**: Lasen High School Middle School, Lasen Training School and Liuyu Primary School.

These schools are highlighted in red on the screenshot of Lasen Energy's organization chart shown below.






[14] http://www.sxlasen.com (service unavailable as of 4/10/2012). Homepage archive as of 2011 available at web.archive.org/web/20110208071006/http://www.sxlasen.com/.

From the same website (article translation below) we learn that although the schools receive government subsidies, they are privately-owned, for-profit entities:

教育 首页 集团业务 产业板块

联盛中学

时间: 2011-01-06 19:05:31 点击率: 637

联盛中学是由柳林县政府和联盛能源有限公司共同创办的一所"民办公助"体制的封闭式全日制完全中学。

学校现有教职工311名，其中161名专任教师全部以高中6—8万元、初中4—6万元的年薪在全国聘用。学校现有在校生2776名，校园占地面积7万余平方米，现有60个教室的教学楼一座，可

Translati on: "thdLasen School is a 'privately-held, government-sponsored' school, jointly founded by Liulin County local government and Lasen Energy Co., Ltd. (Mr. Xing's Holding Company)"

According to our Chinese attorneys, such privately-held schools receive government subsidies but remit any operating profit (or a percentage thereof) to their private shareholders. In China, such schools are exclusive and costly. Mr. Xing's schools charge a hefty tuition and are structured to remit a profit to his private conglomerate. What is the connection to Fushan?

The first of Lasen Energy's three listed schools, Lasen High School/Middle School, is an elite, for-profit high school as can be confirmed through its website (www.sxls.net). Within that website, there are pictures of elaborate buildings currently under construction (available in Appendix IV), one of which **is the same exact picture from Fushan's 2009 Annual Report**. The evidence indicates that, rather than making a charitable contribution, Fushan shareholders are funding the expensive capital investments in a school, for which a Fushan insider will be collecting the return on investment.

At best, Fushan has violated securities laws by failing to disclose this related party transaction. At worst, this is textbook fraud: using money raised from investors through the capital markets to secretly boost the profitability of businesses owned by insiders.

Fushan recently announced plans to double down on school charity[15], committing further payments of $HK 244 million per year between 2012 and 2014.



[15] www.hkexnews.hk/listedco/listconews/sehk/2012/0322/LTN20120322770.pdf; page 25, note 18(c).

# Who Will Be The Chairman When The Music Stops?

Fushan has had five different chairmen in the last three years.[16] We believe that the high turnover at the chairman position indicates that the end game is near: no one wants to be sitting at the head of the table when the music stops.

| DATES | TENURE | NAME |
|---|---|---|
| October 20, 2011 – present | 6 months | Shaofeng Li |
| May 10, 2010 – October 20, 2011 | 17 months | Pingsheng Wang |
| January 5, 2010 – May 10, 2010 | 4 months | Qinghai Wang |
| March 13, 2009 – January 5, 2010 | 9 months | Zhong Cao |
| September 14, 2001 – March 13, 2009 | 8 years | Wong Lik Ping |

The position of chairman of a public company is a highly coveted position, and for good reason. Serving as the chairman of a public company is a well-compensated and prestigious position, so it is highly unusual to find a public company where its chairmen quit so frequently and so soon after being hired.

The short tenure of Fushan's recent chairman is therefore noteworthy and suspicious. Since Chairman Wong, no chairman has signed off more than once on the company's annual audited financials, suggesting that they may have fled rather than risk being tarnished by an accounting scandal at the company.

# Adventures in Auditing

Fushan's auditor is BDO Limited Hong Kong ("**BDO**"), an accounting firm which has a track record of signing off on the financial statements of companies which committed fraud or are currently being accused of committing fraud. BDO's record speaks for itself.

BDO audited China Expert Technology ("**CXTI**"), a notorious U.S.-listed Chinese fraud. CXTI's shares soared to $7.00 on the strength of spectacular financial results. But CXTI was a hoax. The company did not exist and its financials were conjured from thin air. The CEO and CFO subsequently disappeared and CXTI ceased to file financial statements, wiping out its investors. CXTI's shares are now almost worthless. How could investors have confidence in an auditor that signed off on a company that did not exist?

BDO Limited's less-than-sterling record does not end with CXTI. BDO Limited is the auditor of China Biotics ("**CHBT**"), Orient Paper ("**ONP**") and Gulf Resources ("**GURE**"), all of which have been the subject of whistle-blowing investigations in the last twelve months.

| BDO'S RECORD | | |
|---|---|---|
| TICKER | COMMENTS | INVESTOR RETURNS |
| CHBT.PK | Citron Research presented a detailed report accusing CHBT of fraud. | Currently trading on the pink sheets at $1.70. At the time of Citron's report, traded around $14.00 per share. |
| ONP | Muddy Waters presented a detailed report accusing ONP of fraud. | Currently trading around $4.00, down from a high of $15.00. |
| GURE | In April 2011, Glaucus Research presented a detailed report, available here, outlining various improprieties at GURE. | Currently trading around $2.00 per share down from a high of $13.00. |
| CXTI | CXTI was a hoax. A blatantly fraudulent company. | Delisted. |

BDO Limited has accumulated a roster of clients that, in the last year alone, have seen the value of their shares drop precipitously as a result of accusations of fraud.

[16] http://www.shougang-resources.com.hk/attachment/2009031317554917_en.pdf; http://www.shougang-resources.com.hk/attachment/2010010520435917_en.pdf; http://www.shougang-resources.com.hk/attachment/201005071332010092979_en.pdf; http://www.irasia.com/listco/hk/shougangresources/announcement/a80678-e_639_changeofdirectors.pdf

This track record may not come as a surprise, considering that BDO Limited Hong Kong is not regulated by the PCAOB. Many Chinese auditors, under pressure to please clients, often refrain from conducting deep due diligence, ignore suspicious numbers, and make favorable assumptions on their clients behalf. Without the risk of censure or punishment, given that they do not answer to any U.S. regulatory body, the carrot of substantial fees can lead Chinese auditors to prioritize client retention over accurate disclosure and a thorough investigation.

We have no idea whether BDO has been misled by the company or it is complicit in what we believe to be an ongoing scam. But we are certain that BDO's track record suggests that its status as Fushan's auditor should not give any investor comfort that it can serve as a bulwark against fraud.

# Valuation

If we value Fushan's business as a multiple of the reserves remaining in the company's three coal mines, then we can calculate a reasonable value of the shares as follows:

| FAIR VALUE OF 3 MINES TODAY | | |
|---|---|---|
| | | per share |
| Reserves–3/31/2012 (est mm tonnes) | 117 | |
| Multiple–most recent CCR M&A comps | 29x | |
| TEV–100% (mms RMB) | ¥3,385 | |
| TEV–100% (mms HK $) | HK$4,170 | |
| % Ownership | 82% | |
| TEV–Fushan (mms HK $) | HK$3,408 | HK$0.63 |
| Mt. Gibson stake (20% discount) (MGX AU) | $1,222 | $0.23 |
| APAC stake (20% discount) (1104 HK) | $272 | $0.05 |
| EQUITY VALUE | HK$4901 | HK$0.91 |
| | | |
| Shares Outstanding (mms) | 5,378 | |

Fushan claims to have HK$ 0.69 per share in net cash and cash equivalents. In light of the evidence presented in this report, which in our opinion shows fabricated sales, off-the-books expenses, and defrauding shareholders of billions of dollars, we doubt that the company's stated cash balance actually exists. For those investors confident in BDO Limited's ability to count cash and verify sales invoices in China, Deloitte's experience with Longtop shows that even top-tier auditors are easily fooled by fake cash balances.

We therefore value the company at **HK$ 0.91 per share**, which consists of the salvage value of its three mines (HK$ 0.63 per share) assuming a generous 29x multiple of reserves as reflected in CCR's most recent 2010 M&A comps (see Appendix V) plus HK$ 0.28 per share for Fushan's minority stakes in Mt. Gibson (MGX AU) and APAC Resources (1104 HK) at a 20% liquidity discount. Even this estimate may be too sanguine.

Given the difficulty of recovering money against fraudsters in China's judicial system, we believe that equity holders would be fortunate to recover anything if the company collapses under regulatory scrutiny. Chinese courts are notoriously corrupt, arbitrary and protective of local businesses and industry. Notions of judicial independence do not apply. As a result, for foreign investors such as Fushan's equity holders, we suspect that litigating against a powerful and wealthy local Chinese businessman in a Chinese court would be a Sisyphean task.

Further hindering any prospect of recovery is that Fushan's puppet master is one of the richest men in China and the Vice Chairman of CPPCC, Liulin County. Along with his vast wealth, Fushan's insiders have a surplus of relationships and connections with government and state-owned enterprises, which magnify his influence over judicial outcomes.

In light of the difficulty of recovering any cash from entrenched insiders through China's judicial system, after paying off debt holders, we believe that there will be nothing left to pay equity holders, making Fushan's equity essentially worthless. But to be generous, we are placing a price target of **HK$ 0.91 on Fushan's shares**.

## APPENDIX I: COMPARABLE COAL TRANSACTIONS – 2007/2008

China Coal Resource

### Tranaction Information of China Coal Mines

| Time | Area | Share(%) | Purchase Price （RMB,million Yuan） | Reserves (1,000 tons) | Output （1000 tons /y） | Coal type |
|---|---|---|---|---|---|---|
| Mar. 2007 | Lvliang, Shanxi | 100 | 320 | 43,000 | 600 | 1/3 coking coal |
| May. 2007 | Linfen, Shanxi | 100 | 600 | 50,000 | 450 | Primary Coking Coal |
| Jun.2007 | Jincheng, Shanxi | 100 | 320 | 60,000 | 450 | Anthracite |
| Oct.2007 | Tiayuan, Shanxi | 51 | 450 | 78,000 | 900 | Primary Coking Coal |
| Nov.2007 | Fukang, Xinjiang | 100 | 180 | 130,000 | 1,200 | Thermal Coal |
| Nov.2007 | Fukang, Xinjiang | 100 | 1100 | 130,000 | 900 | Gas-Fat Coal |
| Dec.2007 | Zhengzhou, Henan | 80 | 220 | 18,000 | 450 | Primary Coking Coal |
| Dec.2007 | Zhengzhou, Henan | 80 | 180 | 14,000 | 300 | Primary Coking Coal |
| Jan.2008 | Changzhi, Shanxi | 100 | 80 | 12,000 | 150 | Thermal Coal |
| Jan. 2008 | Changzhi, Shanxi | 100 | 360 | 36,000 | 60 | Lean Coal |
| Mar.2008 | Shuozhou, Shanxi | 90 | 480 | 110,000 | 1,200 | Thermal Coal |
| Apr.2008 | Jinzhong, Shanxi | 100 | 480 | 32,000 | 450 | Primary Coking Coal |
| Oct.2008 | Erdos, Inner Mongolia | 100 | 180 | 98,000 | 900 | Thermal Coal |

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## APPENDIX II - COAL QUALITY

According to Appendix VIII of the prospectus, Fushan's primary seams provide JM and SM quality coal.

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### Chinese Classification of Coal

| | | Symbol | No. | Specification | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | $V_{daf}$ | $G_{R.I}$ | Y (mm) | B (%) | $P_M$ (%) | $H_{daf}$ (%) | $Q_{gr,maf}$ (MJ/kg) |
| Anthracite | 1# | $WY_1$ | 01 | ≤3.5 | | | | | ≤2 | |
| | 2# | $WY_2$ | 02 | >3.5~6.5 | | | | | >2~3 | |
| | 3# | $WY_3$ | 03 | >6.5~10 | | | | | >3 | |
| Bituminous | Meagre | PM | 11 | >10～20 | ≤5 | | | | | |
| | Meagre lean | PS | 12 | >10～20 | >5～20 | | | | | |
| | Lean coal | SM | 13 | >10～20 | >20~50 | | | | | |
| | | | 14 | | >50~65 | | | | | |
| | Primary coking | JM | 15 | >10～20 | >65 | ≤25 | (≤150) | | | |
| | | | 24 | >20~28 | >50~65 | | | | | |
| | | | 25 | | >65 | ≤25 | ≤150 | | | |
| | 1/3 | 1/3JM | 35 | >28~37 | >65 | ≤25 | (≤220) | | | |
| | Fat coal | FM | 16 | >10~20 | (>85) | >25 | (>150) | | | |
| | | | 26 | >20~28 | | | (>150) | | | |
| | | | 36 | >28~37 | | | (>220) | | | |
| | Gas fat | QF | 46 | >37 | (>85) | >25 | (>220) | | | |
| | Gas coal | QM | 34 | >28~37 | >50~65 | | | | | |
| | | | 43 | >37 | >35~50 | | | | | |
| | | | 44 | | >50~65 | | | | | |
| | | | 45 | | >65 | ≤25 | (≤220) | | | |

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| | | Symbol | No. | $V_{daf}$ | $G_{R.I}$ | Y (mm) | B (%) | $P_M$ (%) | $H_{daf}$ (%) | $Q_{gr,maf}$ (MJ/kg) |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1/2 Medium-caking | 1/2ZN | 23 | >20~28 | >30~50 | | | | | |
| | | | 33 | >28~37 | | | | | | |
| | Weak-caking | RN | 22 | >20~28 | >5~30 | | | | | |
| | | | 32 | >28~37 | | | | | | |
| | Non-caking | BN | 21 | >20~28 | ≤5 | | | | | |
| | | | 31 | >28~37 | | | | | | |
| | Long-flame | CY | 41 | >37 | ≤5 | | | >50 | | |
| | | | 42 | | >5~35 | | | | | |
| Lignite | 1# | $HM_1$ | 51 | >37 | | | | ≤30 | | ≤24 |
| | 2# | $HM_2$ | 52 | | | | | >30~50 | | |

**Note: In accordance with China's national coal classification standards,**

**Anthracite** (yellow)

**Thermal coal** (blue)

**Coking coal** (orange)

## APPENDIX III - 3 MINES PURCHASE PRICE CALCULATION

| ('000,000) | ACTUAL TRANSACTION | FAIR VALUE[1] |
|---|---|---|
| Reserves (mm tonnes) [2] | 142.35 | 142.35 |
| EV/Reserves Ratio | 97.0x | 13.9x |
| Total Enterprise Value of the 3 Mines | ¥13,808 | ¥1,983 |
| Total Net Debt [3] | 2,234 | 2,234 |
| | | |
| Total Equity Value of the 3 Mines | ¥11,574 | (¥251) |
| | | |
| % Ownership Acquired [4] | 82% | 82% |
| Value of the Acquired Equity (RMB) [5] | ¥9,458 | (¥205) |
| VALUE OF THE ACQUIRED EQUITY (HK $) [6] | $10,530 | ($228) |

Source: Fushan "Acquisition Prospectus" dated 6/25/2008 http://www.hkexnews.hk/listedco/listconews/sehk/2008/0625/LTN20080625008.pdf

[1] Fair Value defined as average of acquisition comparables on Enterprise Value per tonne of proven and probable reserves basis. The 13.9x multiple is the average of CCR s 2007/2008 comparable transactions for primary coking coal.

[2] Fushan's proven and probable reserves as of 12/31/2007 per the BOYD Technical Report on page VIII 24 of the Acquisition Prospectus.

[3] Per page VII 15 of the Acquisition Prospectus; net debt equals total liabilities less cash and equivalents as of 4/30/2008 Valuation Date.

[4] Weighted average economic ownership of Fushan's 3 mines based on page VII 18 of the Acquisition Prospectus.

[5] Exchange rate of HK$1 to RMB 0.8981 was used per page VII 13 of Acquisition Prospectus.

[6] Total equity consideration per page 9 of Acquisition Prospectus; Intercompany sale loans of $1 billion ignored for valuation purposes.

**Undisclosed Related Party Transactions**
The website archive for Mr. Xing's for profit school contained 10 pages of specific illustrations. The second illustration on page 8 of 10 matches that on page 23 of Fushan's 2009 annual report.

首页 学校概况 校园新闻 师资力量 名师导学 心理殿堂 学生天地 家长学校 下载中心 教学文类 访客留言 高级搜索 年级之星 电子期刊

联盛中学 学校文章 学校概况 详细

## 新校园规划

发布时间:2009-5-29 22:29:01 作者: 来源: 阅读：8445 评论：26

新校园规划图—部分建筑物设计图展示


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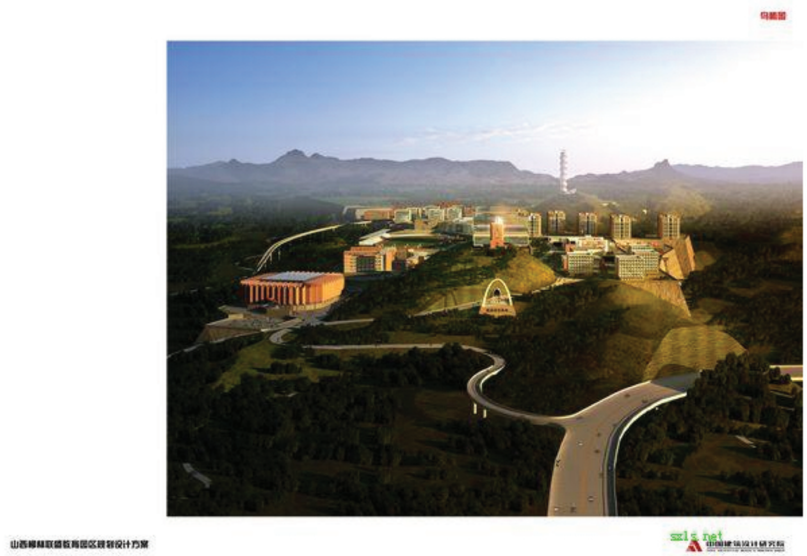

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Per page 23 of Fushan's 2009 annual report, Fushan's charitable donations went to this for profit school, which belongs to Mr. Xing.

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## APPENDIX V - CCR 2010 M&A COMPS

| MINE LOCATION | ACQUISITION DATE | ENTERPRISE VALUE (RMB MM) | COAL RESERVES (MM TOMES) | COAL TYPE | EV/RSV |
|---|---|---|---|---|---|
| Jinzhong, Shanxi | Mar 10 | 1,230 | 49 | Primary Coking | 25.1x |
| Lvliang, Shanxi | Jun 10 | 2,420 | 70 | Primary Coking | 34.6x |
| Linfen, Shanxi | Jun 10 | 1,320 | 63 | Primary Coking | 26.2x |
| Lvliang, Shanxi | Aug 10 | 660 | 43 | Primary Coking | 30.1x |
| Linfen, Shanxi | Jan 10 | 670 | 44 | Primary Coking | 29.9x |
| AVG OF M&A COMPS | | | 54 | | 29.2X |

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### Tranaction Information of China Coal Mines

| Time | Area | Share (%) | Purchase Price （RMB, million Yuan） | Reserves (1,000 tons) | Output （1000 tons /y） | Coal type |
|---|---|---|---|---|---|---|
| Jan. 2010 | Qingxu, Shanxi | 100 | 2,160 | 90,000 | 1,200 | Lean coal |
| Mar. 2010 | Gujiao, Shanxi | 51 | 690 | 45,000 | 900 | Fat coal |
| Mar. 2010 | Jinzhong, Shanxi | 100 | 1,230 | 49,000 | 900 | Coking coal |
| Jun. 2010 | Lvliang, Shanxi | 100 | 2,420 | 70,000 | 1,200 | Coking coal |
| Jun. 2010 | linfen, Shanxi | 80 | 1,320 | 63,000 | 1,200 | Coking coal |
| Aug. 2010 | Lvliang, Shanxi | 51 | 660 | 43,000 | 900 | Coking coal |
| Sep. 2010 | Lvliang, Shanxi | 51 | 560 | 46,000 | 900 | 1/3 Coking coal |
| Sep. 2010 | Jinzhong, Shanxi | 51 | 970 | 57,000 | 1,200 | Fat coal |
| Sep. 2010 | Jinzhong, Shanxi | 51 | 410 | 32,000 | 600 | Gas coal |
| Jan. 2011 | linfen, Shanxi | 51 | 670 | 44,000 | 600 | Coking coal |

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