Jonestown Research

Urging Investors Not to Drink the Kool-Aid

Winsway's Denial Digs a Deeper Hole

1733 (HK), Winsway Coking Coal Holdings Ltd.
January 30, 2012

<u>Important disclaimer on last page</u>

- Winsway tried to rebut our accounting analysis by saying that its numbers work because it turns inventory every 2.5 months. In this report, we'll show that this defense makes no sense. In other words, Winsway has no explanation for how its inventory numbers are unable to be reconciled. The only explanation left is that Winsway is cooking its books.

- Winsway's continuing denial that its key supplier, Moveday, isn't a related party is once again not true. Mongolian documents show that named subsidiaries of Moveday in the press release share management and addresses with Winsway, reinforcing that Moveday is an undisclosed related party.

- We expect Winsway's auditor, KPMG, to be looking into these problems as KPMG's global head is now based in Hong Kong.

Before we begin, we should note that Winsway's response pointed out a type-o in our original report. In its critique of Item B of Step 3, we incorrectly labeled one row as "COS (RMB/Ton) Raw" when it should have been "COS (RMB/Ton) Clean". Unfortunately this doesn't change the fact Winsway is cooking its books and committing fraud.

Still Putting the "Invent" Back Into Inventory

Winsway's CFO Jerry Xie held a conference call hosted by Goldman Sachs for the purpose of refuting Jonestown's allegations. One thing Xie consistently repeated was that the inventory value was a fast moving number and that Jonestown could not be correct because the estimates would be too low as the starting base was too high. Xie stated that Winsway turns its inventory quickly – every 2.5 months – and that's why the calculations we performed in our first report using Winsway's numbers make it seem as though Winsway's inventory accounting is off. The problem is that Winsway cannot be turning its inventory that quickly unless it was overstating its yearend inventory value by over 100%.

Through some basic financial analysis, we can see that Xie is either incorrect about inventory turnover, or Winsway overstated its yearend inventory in 2010 (the most recent full year for which we have audited data) by more than 100%. The problem as we see it is that when you're cooking books and making up numbers, things don't make sense (i.e., can't be reconciled). The more Winsway tries to explain itself, the deeper the hole it digs. Xie's discussion of Winsway's inventory turnover is a perfect example of this principle in action.

If Winsway is turning its inventory every 2.5 months, that would mean its annual inventory turnover is 4.8x. (12 months / 2.5 months = 4.8x). However, the numbers Winsway provides in its audited financial statements show that it's only turning inventory 3.1x per year – every 4 months. What is Jerry Xie smoking???

See the calculations below:

Inventory turnover is defined as Cost of Goods Sold divided by Average Inventory[1].

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

$$\text{Average Inventory} = \frac{\text{Beginning inventory} + \text{Ending inventory}}{2}$$

For 2010 Mongolian coal:

Beginning Inventory (or ending for 2009) = 805,372
Ending Inventory = 1,509,355

Average Inventory = 1,157,363

COGS = 3,531,665

Another way of looking at it is: for Jerry Xie to be correct, the actual number for year end 2010 inventory would have to be 666,155. This would imply Winsway is overstating inventory by more than 100% at year end 2010, which is even in excess of Jonestown's estimate.

Jerry Xie's response to the above analysis could be that Winsway experienced a huge surge in demand at the end of 2010, and as a result had a massive inventory build at that time. (This surge would be a major increase in volume because average purchase prices dropped in 2H2010). However analyzing 1H2011 numbers also shows that Xie's statement that Winsway turns its inventory every 2.5 months is clearly wrong.

The 1H2011 numbers show us that Winsway is turning inventory far more slowly than every 2.5 months. Winsway does not disclose COGS on a per product basis in 1H2011, but it states that the gross margin during that time was stable. We can therefore back into a good estimate of 1H2011 COGS. Assuming that gross margin did not change from

[1] http://en.wikipedia.org/wiki/Inventory_turnover

2010 to 1H 2011, we can calculate COGS for Mongolian Coal in 1H2011 as 2,684,861. (The calculation is (1-.304)*3,857,560)[2].

If Jerry Xie were telling the truth, then the company would've sold coal faster and its 1H2011 COGS would have been 3,622,452 – roughly 34% higher than the number we backed into. (The calculation is 1,509,355 * (.5*4.8)).

Now let's come up with a scenario where this would have made sense. At 4.8x per year, a half year is 2.4 cycles. As well, Mongolian volume was disclosed as 3,852,016 tons in 1H 2011, which gives us 1,605,006 tons per "cycle". If the year end 2010 number is one cycle, then the entire cost of the additional 1.4 cycles is (2,684,861 – 1,509,355) or 1,175,506. Divide this by 1.4 and we get the implied COGS for the remaining coal cycles sold in 1H2011, or 839,647.

In order for coal COGS to have been this low, the price of coal would have needed have been far lower than the company reports:

The only possibility for the year end 2010 inventory to have been sold in 2.5 months and the COGS number to still make sense is if the COGS per ton INCLUDING BOTH RAW AND CLEAN plummeted to 523 HKD per ton. This is a full 11% lower than the average purchase price of raw coal in 1H2011. Further, Winsway says the price WENT UP 12.9% INSTEAD. As turning it into clean coal will cost at LEAST 25% losses in washing, that price drop is truly impossible.

Xie also calls out conclusion flawed our assumptions for wash yield saying it is 50% for some grades of coal, more than 85% for other, and that it averages 70%-80%. Jerry, how is 75% a bad estimate for something that ranges 70%-80%? That seems like arguably the BEST possible estimate given the range…

Moveday still Inconsistent

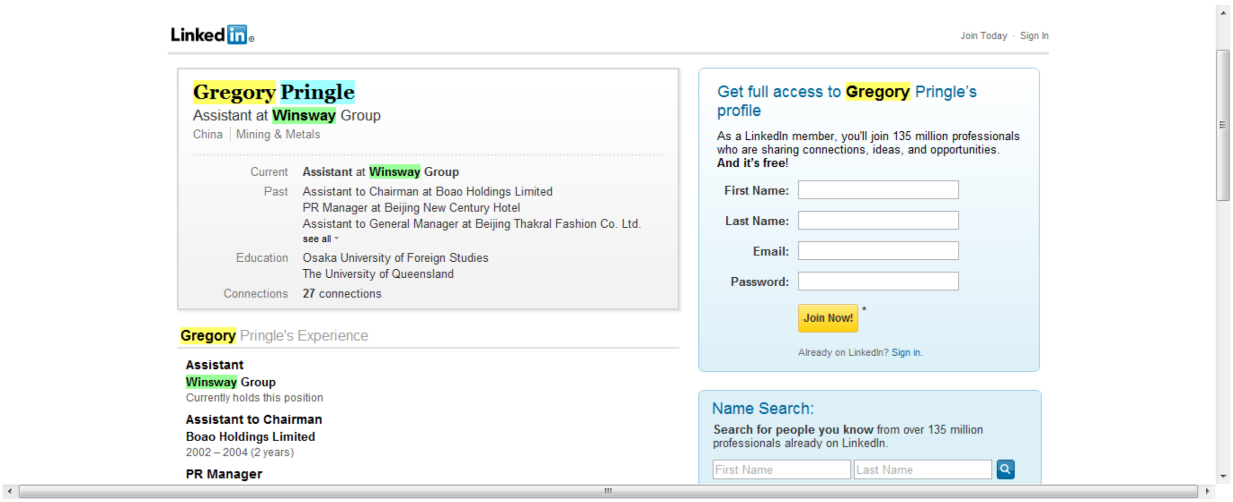
Winsway attempted to refute our charge that Moveday is a related party by naming the following as subsidiaries of Moveday: Mon-Port LLC, Itai Car Co, Ltd, Tavan Tolgoi Shin Co., Ltd, Heroswin LLC and IKH Khuren Khar Co., Ltd. All these companies are in fact partial subsidiaries of Moveday. They are all subsidiaries of Victory Coal Transport (VCT), which is owned by a Singaporean entity called Perfect Crown Pte, which is in turn owned 90% by Moveday and 10% by Mr. Ng Pui Heng, the employee of Winsway previously identified in the Jonestown follow up. This disclosure only points to more possible evidence that Moveday's relationship with Winsway is improper.

When examining VCT, it was found that there was no subsidiary called "Heroswin", but there is a subsidiary engaged in transport called "Heroyesvin". This could be a typo, but it looks like a deliberate attempt to mislead investors because of the link to Heroyesvin.

[2] Gross margin on Mongolian Coal was 30.4% in 2010

Heroyesvin shares an office with Winsway at Sukhbaatar, 1st khoroo, 10 Olympic, and a phone number at 976-11-330638[3].

Winsway and Heroyesvin also have a common director: Gregory Robert Pringle. Appendix A shows Mr. Pringle's relationship with Heroyesvin. Even better is Mr. Pringle's LinkedIn profile – well his previous LinkedIn profile. Mr. Pringle's current LinkedIn profile shows that he's "Independent" (ironic choice of words) at "self-employed" from July 2004 – today. Funny, we wonder when he edited his profile to stop showing this:



Mr. Pringle's prior LinkedIn profile shows him as "Assistant at Winsway Group", yet (as shown in Appendix A) he is also listed as the contact person for Heroyesvin, a VCT subsidiary. Heroyesvin is definitely an (undisclosed – actually denied) related party.

It seems surprising that the one misspelling in the Winsway release leads to a subsidiary that is clearly a connected party. Even so, having this relationship (a common director and shared office) clearly contaminates Moveday as a related party.

Mongolian documents show these five entities only holding approximately 1,000 trucks versus Winsway's claim of over 2,000 on the conference call.

In addition to the YouTube clip we previously posted showing a Hong Kong-based Winsway employee calling Moveday a subsidiary,[4] this is further evidence of being a related party.

[3] See Appendix A

[4] http://www.youtube.com/watch?v=FmOZX-2jzBw

KPMG on the Lookout

Winsway's auditor is KPMG. KPMG's global chairman, Michael Andrew, is based in Hong Kong for the first time ever. He has cited China's growth and the need to focus on "creating a global standard" as a reason to be based in Hong Kong. For $650 you can listen to him speak about it in Hong Kong on February 27th[5]. Given his proximity to the recent news, Mr. Andrew should be looking into this issue very closely. KPMG was the crackerjack firm that managed to identify Olympus's fraud and did not continue to audit the company[6]. Some might say that they should have reported it to the authorities, but we think in this case, Mr. Andrew will err on the side of caution and take a deeper look at Winsway.

We think it is not impossible for KPMG to be "dismissed" as auditor, just as it was with Olympus.

Disclaimer

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[5] http://www.britcham.com/event/captains-industry-luncheon-michael-andrew-chairman-kpmg-international

[6] http://www.bloomberg.com/news/2011-11-25/kpmg-chairman-michael-andrew-says-significant-fraud-evident-at-olympus.html

APPENDIX A – Heroyesvin Information Card

Establishment Card

. TTD: 5018471
2. Name: **Heroyesvin**
3. Application date: 2005.09.16

Company's registration No.: 3501050926012
Taxation office: Chingeltei taxation office
Sum, khoroo: miscellaneous

4. Address:
District: Sukhbaatar
Khoroo: 1st khoroo
Street: Olympic street
Building: Sky Plaza
Number: 10

Phone1: 976-11-330638 Phone2: 976-9978-0110
Fax: 976-11-330571
P.O.Box No.:
E-mail:

5. Registration date: 2005.09.19
6. Type of responsibility: Limited Liability Company

Taxpayer's Classification: Sole Proprietorship

7. Activity:

Condition: 0

Code	Type of activity
602300	Land route transportation service
101000	Coal mining
511001	Commercial procurement

8. Company's total capital (in MNT): 12.000.000.00
9. Type of property: Private
Percentile of government: 0%
10. Establisher:
10.1 Branch:
10.2 other branch organizations
Number of Founders:

Individual				Residential Address	Phone Number	Investment	
Tax Payer's No.:	Surname	Given name	Pass. No.			Amount (tug)	Percent
5466172	Victory Coal Trans corporation Co., Ltd			Sukhbaatar district, Olympic street Jamyan Gun, 14-00	7011-7011	9.600.000.00	80%

12.1. Bank

Code	Bank	Account No.:
050000	Khan Bank /Central/	5009102713
050000	Khan Bank /Central/	5001368942

13. Type of Taxation

Registered date	Name of the individual	Position at the Company

2007.03.21	Wages tax	01010101
2005.12.18	Income tax company	01010201
2012.01.04	VAT domestic service, products	01030101
2011.05.30	Auto transport, transportation tax	04010201

14. Management
Family name: Pringle Surname: Gregory Name: Robert
Passport No.: E 3011253
Registrations No.: AUS 5405219

15. Address
District: Sukhbaatar Phone: 320620 Phone: 324485
Khoroo: 8th
Street: Prime Minister Amar’s Street
Building: Ulaanbaatar Hotel
Door: 501