Jonestown Research

Urging Investors Not to Drink the Kool-Aid

Fraud Alert: 1733 (HK), Winsway Coking Coal Holdings Ltd.
January 19, 2011

Important disclaimer on last page

For the following reasons, we assert that Winsway has material misstatements in its reported numbers that amount to securities fraud:

- Winsway's balance sheet inventory values cannot be reconciled with the tons of coal inventories that should be on the balance sheet. This is a clear sign Winsway is cooking its books – in other words, committing fraud. We estimate that Winsway's inventory is overstated by about HK$1 billion as of H1 2011.

- Official China import data shows volumes far lower than those Winsway reports.

- Winsway's key transportation provider (and beneficiary of a $40 million loan from Winsway), Moveday, is actually an undisclosed related party. Jonestown Research will soon release video evidence showing this.

  Even worse, Moveday appears to be a shell company. It has no evidence of due establishment in Mongolia, it has no registration card (record), and has never filed to pay taxes. The industry sources we spoke to have never heard Moveday's name, which would be extremely unusual if Moveday really were operating at the scale Winsway claims. Therefore we think that the described operations of this vendor is largely – if not completely – fictitious.

- Winsway's investor presentations contradict its prospectus with respect to its import process. We believe that Winsway presents this different picture because a) it believes that most investors don't read the prospectus (unfortunately this assumption would likely be correct) and b) the presentation version makes a strange business model seem direct and easy to understand.

- Winsway's fraud should not be a surprise. The "Moody Waters" report gave Winsway 11 red flags. The highest number of red flags Moody's gave was 12. Sino-Forest only had 7 red flags.

- Through this fraud, Winsway has raised approximately one billion USD. Winsway is planning to use US$600 million of this capital to finance the planned acquisition of 60% of Toronto-listed Grande Cache Coal (GCE-TO). Both the Hong Kong Stock Exchange and the Ontario Securities Commission must approve this acquisition.

  We urge the Hong Kong Exchange and Canadian regulators to look closely at Winsway to insure its closing doesn't negatively impact Winsway investors. Rather, we believe that Winsway's funds should be returned to its bond (US$500 million) and equity investors. Further, we believe denying this acquisition is likely to protect Canadian jobs and interests. Both of these interests greatly outweigh the interests of the risk arbitrage funds that have piled into GCE in recent weeks.

Intro to Winsway

Winsway (SEHK ticker 1733) is a coal trading and transport company headquartered in Hong Kong. The company claims to buy raw coal in Mongolia, bring it to China where it is washed, and then sell the cleaned coal to Chinese steel mills. In addition, the company engages in the seaborne trading of hard coal sourced globally from mines and other traders.

We have thoroughly examined Winsway, and believe the company is committing fraud with respect to falsified financial statements and misrepresentations regarding related parties. The scale of its business may be much smaller than it claims.

INVENT–ory

Winsway's reported inventory numbers make clear that the company is cooking its books. The flaws are evident in both its Mongolian coal and seaborne trading businesses. The balance sheet inventory numbers (converted into tons) cannot be squared with the amount of tons you calculate would be in inventory using the average purchase prices and volumes Winsway provides in its prospectus. We estimate that Winsway's inventory is overstated by about HK$1 billion as of H1 2011.

As of June 30, 2010, Winsway's reported raw and cleaned coal inventory is 59.1% too high. At the same point, Winsway's reported hard coal inventory is 33.4% too low. Below you can see the discrepancies in each period. Winsway is clearly committing fraud.

	31/12/2007	31/12/2008	31/12/2009	30/6/2010
Ending Tons Raw and Raw Equivalent (from Cleaned Coal) per Balance Sheet	595,211	673,388	1,683,877	1,892,154
Ending Tons Raw and Raw Equivalent (from Cleaned Coal) per Reconciliation	515,529	556,066	1,588,116	1,189,600
Discrepancy	**79,682**	**117,322**	**95,761**	**702,554**
Discrepancy as a % of Balance Sheet Tonnage	**15.5%**	**21.1%**	**6.0%**	**59.1%**
Ending Tons Hard Coal per Balance Sheet	-	-	336,901	277,377
Ending Tons Hard Coal per Reconciliation	-	-	428,291	416,745
Discrepancy	**-**	**-**	**(91,390)**	**(139,368)**
Discrepancy as a % of Balance Sheet Tonnage	**0.0%**	**0.0%**	**-21.3%**	**-33.4%**

We do not say "fraud" lightly. Two accounting experts – one is a well-respected professor, the other is a "Big Four" auditor – expressed similar opinions. Each accounting expert confirmed that using the disclosed inventory notes in financial reports, the financial statements are clearly fraudulent with respect to inventory. As we discuss later in this report, this book cooking is enabled by the business of buying and selling to the same counterparty, Moveday, which is an undisclosed related party of Winsway's.

To do this analysis, you have to first calculate the inventory in tons as of January 1, 2007. Next you have to reconcile the inventory tonnage in each period by taking the beginning inventory balance, adding coal purchases and subtracting coal sales. It's very important to note that in 2008 Winsway began selling cleaned coal. Cleaned coal is raw coal that Winsway "washes" (processes). Since cleaned coal comes from raw coal, it can – and must for these purposes – be converted back into its equivalent amount in raw coal. You make this adjustment using Winsway's "wash rate" of 75%. Third, you convert the balance sheet values into tons using Winsway's disclosed per ton COS. Finally, you compare the tons from each set of calculations. There are major discrepancies. We will walk you through the calculations below.

First a few caveats. We are aware that FIFO accounting can result in some discrepancies between the methods we used. However the discrepancies are too large to result from FIFO timing issues. The conversion from cleaned coal COS / ton into its raw coal equivalent by using the 75% wash rate isn't exact. However the information Winsway discloses in its prospectus on the composition of its COS make clear that any difference is immaterial. The numbers you produce through reconciliation are so far off the balance sheet-based tonnage that it's clear Winsway has a problem.

We based our analysis on the IPO prospectus because it has more detailed information than the periodic filings. To do this analysis you need to keep in mind 7 variables:

- the RMB values of coal inventory (prospectus p. 49), the 2007 increase in inventories from the cash flow statement (prospectus p. I-15),
- the number of tons of coal sold by type (prospectus p. 222), the number of tons of hard and raw coal purchased (prospectus p. 223),
- the COS / ton by coal type (prospectus p. 223),
- the ending value by coal type (prospectus p. I-49), and
- the cleaned coal wash rate of 75% (disclosed in conversations between the company and investors).

Step 1: Calculate 2007 Beginning Tons of Inventory on the Balance Sheet

	31/12/2007
A. Ending Raw Coal Value (RMB) per p. I-49	169,040,000
COS (RMB) / Ton per p. 223	284
Ending Raw Coal (Tons)	595,211
B. RMB Increase in Inventories from Cash Flow Statement (p. I-15)	143,388,000
COS (RMB) / Ton per p. 223	284
Net Increase in Raw Coal Inventories (Tons)	504,887
C. Ending Raw Coal (Tons)	595,211
- Net Increase in Raw Coal Inventories (Tons)	504,887
2007 Beginning Raw Coal Inventory (Tons)	**90,324**

As shown above the beginning raw coal inventory in 2007 was 90,324 tons. You'll need this number to do the reconciliation. Keep in mind that in 2007, Winsway only bought and sold raw coal – there were no other types of coal in its inventory.

Winsway values inventory at cost of sales, meaning the value includes transportation, processing, staff, depreciation, customs charges, and other expenses. These expenses should be reflected in the value of each ton of coal on Winsway's books.

Step 2: Reconcile Inventory Tonnage from 1/1/2007 - 30/6/2010

	31/12/2007	31/12/2008	31/12/2009	30/6/2010
A. Cleaned Coal Sold (Tons) per p. 222	-	657,895	1,796,081	1,551,157
Adjust to Raw Coal Equivalent at 75% Wash Rate	**-**	**877,193**	**2,394,775**	**2,068,209**
B. Raw Coal Sold (Tons) per p. 222	539,789	350,260	344,811	697,070
Raw Coal and Raw Coal Equivalent Sold (Tons)	**539,789**	**1,227,453**	**2,739,586**	**2,765,279**
C. Beginning Raw Coal and Equivalents Balance (Tons)	90,324	515,529	556,066	1,588,116
+ Raw Coal Purchases (Tons) per p. 223	964,994	1,267,990	3,771,636	2,366,763
- Raw Coal Sold (Tons, Including Equivalent Amount)	539,789	1,227,453	2,739,586	2,765,279
Ending Raw Coal and Equivalents Balance (Tons)	**515,529**	**556,066**	**1,588,116**	**1,189,600**
D. Beginning Hard Coal Balance (Tons)	-	-	-	428,291
+ Hard Coal Purchases (Tons) per p. 223	-	-	3,361,228	1,995,687
- Hard Coal Sold (Tons) per p. 222	-	-	2,932,937	2,007,233
Ending Hard Coal Balance (Tons)	**-**	**-**	**428,291**	**416,745**

Cleaned coal comes from raw coal. Winsway's wash rate is 75%, which means that for every 4 tons of coal it cleans, it'll have 3 tons of cleaned coal. As you'll see, you need to adjust the clean coal sold back into raw coal for the reconciliation. You do this by dividing the tons of cleaned coal by 75% to find out how much raw coal was purchased. From now on, you'll largely have to look at the raw equivalent of the cleaned coal together with the raw coal.

Step 3: Calculate the Ending Tons of from the Balance Sheet

	31/12/2007	31/12/2008	31/12/2009	30/6/2010
A. Ending Value Raw (RMB) per p. I-49	169,040,000	170,120,000	487,049,000	460,299,000
COS (RMB / Ton) Raw per p. 223	284	407	401	327
Ending Balance (Tons) Raw	**595,211**	**417,985**	**1,214,586**	**1,407,642**
B. Ending Value Cleaned (RMB) per p. I-49	-	117,613,000	222,092,000	237,653,000
COS (RMB / Ton) Raw per p. 223	-	614	631	654
COS (RMB / Ton) Raw Equivalent for Cleaned - @ 75% Wash Rate	-	461	473	491
Ending Balance (Tons) Raw Equivalent	**-**	**255,403**	**469,291**	**484,512**
C. Ending Value Hard (RMB) per p. I-49	-	-	285,018,000	290,414,000
COS (RMB / Ton) Hard per p. 223	-	-	846	1,047
Ending Balance (Tons) Hard	**-**	**-**	**336,901**	**277,377**

The tons above are derived from the notes to the financial statements (p. I-49) and supposedly represent the inventory amounts on the balance sheet.

Step 4: Compare the Ending Tons from Balance Sheet (Step 3) to Ending Tons from Reconciliation (Step 2)

	31/12/2007	31/12/2008	31/12/2009	30/6/2010
Ending Balance (Tons) Raw & Equivalent from Balance Sheet (Step 3)	595,211	673,388	1,683,877	1,892,154
Ending Balance (Tons) Raw & Equivalent from Reconciliation (Step 2)	515,529	556,066	1,588,116	1,189,600
Discrepancy	**79,682**	**117,322**	**95,761**	**702,554**
Discrepancy as % of Reconciliation Tonnage	**15.5%**	**21.1%**	**6.0%**	**59.1%**
Ending Balance (Tons) Hard from Balance Sheet (Step 3)	-	-	336,901	277,377
Ending Balance (Tons) Hard from Reconciliation (Step 2)	-	-	428,291	416,745
Discrepancy	**-**	**-**	**(91,390)**	**(139,368)**
Discrepancy as % of Reconciliation Tonnage	**0.0%**	**0.0%**	**-21.3%**	**-33.4%**

Therein lies the problem! The tons implied by the balance sheet are far different than the tons you get through reconciliation.

It's important to come back to the principle that financial statements just describe a series of activities and transactions. Inventory is simple, and Winsway's inventory should be simple to analyze. You take the amount you begin the year with, add how much you bought and subtract how much you sold. The inventory you see should be what's left. Winsway buys raw coal in Mongolia, sells some of it still raw, and then washes the rest in China. Once washed, the inventory becomes cleaned coking coal. The cleaned coking coal is then sold to Chinese steel mills. The reconciliation should get you fairly close to the balance sheet numbers…if the books are genuine.

Given that Winsway uses cost of sales to value inventory[1], we can just use some simple math on the first half 2011 inventory numbers versus year end 2010 to see the discrepancy[2]:

Winsway reports 3,622,786 tons of coal bought, and it reports 3,852,016 tons of coal sold. Historically, approximately 70% of the coal it sells is cleaned coal – so to sell 2,696,400 (70% of 3.852mil) of cleaned coal you would need 3,592,200 of raw coal. Winsway would also have sold 1,155,600 of raw coal for a total "raw equivalent" of sold coal to be 4,747,800. It had 3,622,786 (amount bought) minus 4,747,800 (amount sold) = -1,125,014 (that they took from inventory). In any way you look at it, inventory shrunk – it sold more than it bought. How would it be possible then for inventory values to RISE by 20%?

The only possible reason is that the "cost of sales" went up significantly and with significant purchases at high prices, increasing the value of inventory. However, cost of sales only rose by 13% in the first half of 2011. So – prices were up 13%, quantity was down by approximately 1 million tons, yet inventory *increases* by 20%? **The overstatement is approximately 1 BILLION Hong Kong Dollars in 1H 2011!**

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1 Prospectus page 218: Inventories are carried at the lower of cost and net realizable value. Cost is calculated using the weighted average cost formula and comprises all costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present locations and condition."

2 http://www.winsway.com/attachment/20110905180201001273095_en.pdf

We don't know what Winsway's actual revenue is. However, it's quite likely that its profits are much lower than it claims. Based on our research and speaking with traders and competitors, margins in coal trading should not be higher than approximately 100 RMB per ton. Considering Winsway claims to have made a spread as high at 635 RMB per ton (roughly 50% gross margin) for what is a pure trading business, we find its claimed margins unlikely.

By overstating inventory, Winsway has an excuse for the lack of cash. When you claim to be making more money than you actually are, there is going to be cash missing. When the auditor looks for cash, you have to show something in its place. Winsway is partially plugging this hole by claiming it spent the cash on inventory. By overstating inventory consistently, it sustains the ability to report falsely high margins.

Undisclosed Related (Counter)Parties – The Sino-Forest of Coal Trading

How Winsway does business depends on if you ask the company or if you read the prospectus. Page 246 of the Prospectus describes a business which is nonsensical. The Prospectus describes a convoluted process of buying and selling coal. We are unaware of any publicly-traded companies of Winsway's claimed size that use a similar process:

Step 1: Winsway offshore entity buys coal from a supplier in Mongolia. (Winsway leads investors to believe it buys directly from the mine when the supplier is actually Moveday, the middle man that is actually a related party to Winsway.)

Step 2: Winsway offshore sells the coal to an import agent, with the agent supposedly taking delivery on the Mongolian side of the border.

Step 3: The import agent moves it across the border, and then Winsway PRC buys the same coal back from the import agent on the PRC side of the border.

Step 4: Winsway PRC sells to customer.

First, Winsway has an import license according to PRC coal import data. We also know this because official China import records show that it imports coal in its own name as coal imports are highly regulated– just in much smaller quantities than Winsway claims in its filings to import. Chinese import data shows total coal imported of 2.8 million tons versus claims of 3.6 million tons. This is an overstatement of 30%. (Clearly it wouldn't make sense for Winsway to pay an import company fees to import the coal.) Further, our checks found Winsway employees working at the border terminal in Mongolia, sending coal directly to its employees on the PRC side of the border.

When management speaks to investors though, it that it uses import agents – it's as though management forgot what its prospectus says. We guess management changes the story because the prospectus description is so unlikely. The key is whether Winsway's auditor believes the prospectus description.

Similar to Sino-Forest's "authorized intermediaries" (AIs) version 1.0[3], using a series of unregulated offshore paper transactions (especially unnecessary ones like selling to an import agent only buy it back form him immediately) is a very easy way to siphon funds out of the company or falsify sales that never occurred. Selling coal to an importer (especially when unnecessary) and then immediately buying it back enables fraud by allowing the company to easily manufacture sales, payables, and receivables. Such a complicated transaction structure is a clear red flag that fraud might be occurring.

The motivation for management to misrepresent the business is that it accomplishes two main goals: 1) providing a pure paper framework for reporting revenues and profit to auditors and 2) describing a business more complex and having much larger scale than a pure trader, which would give it a much lower multiple. The use of import agents is clear when reviewing company reports, yet the company does not describe these parties at all in discussions with investors – at times saying import agents are used for "less than 5% of sales volume" according to investor relations.

Because we cannot be certain of the total declared usage of import agents to their auditors, we cannot be sure what percentage of reported revenue is being falsified, but given that import data shows 2.8 million tons imported in the first half of 2011 (the last period for which we have disclosed data from the company), and declared tons is 3.6 million, we can estimate the exaggeration is approximately 28% or at least 50mm US dollars just using average purchase prices of raw coal. Again, we think the overstatement of profits is much larger given the hard-to-believe gross margin Winsway claims.

The Missing Transporter – The Moveday Myth

Winsway claims to primarily rely on one transporter, a company called Moveday[4]. It appears that Moveday is actually a shell company, and it is an undisclosed related party to Winsway. Our investigators have found no evidence of due establishment of Moveday in Mongolia. To the contrary, it has no registration card, and has never filed for taxes. Moveday is incorporated in the BVI, which has become known as a haven for poor corporate governance – especially for Chinese companies. Regardless, we expect that Winsway's auditors have seen numerous transfers of cash (for offshore transactions of course) to Moveday.

The Moveday Myth is told by analysts and Winsway. Supposedly Moveday is a large transportation company ("one of the largest in Mongolia" according to Winsway). In reality, Moveday appears to have been exclusively funded by Winsway (via a 40 million USD unsecured loan) and then granted the exclusive right to buy low from the mine and sell high to Winsway. Winsway insists that Moveday is an independent third party, but video evidence confirms it is not. We will release the video evidence soon.

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3 See Muddy Waters' Sino-Forest report pages 9-11. www.muddywatersresarch.com

4 See Winsway's prospectus, which mentions Moveday 78 times by name and calls it an "Independent Third Party".

We set out to find the mysterious Moveday through field work in Mongolia. As hard as we tried, no one we spoke to in the coal or transportation industry knew who Moveday is. All we got was another myth: everyone had heard of a company that buys low and sells high to Winsway, but nobody knew anything more about it. Numerous coal traders are aware that Winsway supposedly uses a company called Moveday to do their trucking, but not one of them has met with or transacted with Moveday.

This begs the question: Who moves the coal? Winsway low level employees in Mongolia pointed to a company called “Sanhe”. Sanhe is Inner Mongolia Urad Zhongqi Sanhe Energy Development Company5. We found some Sanhe trucks moving Winsway coal in Mongolia. Sanhe used to be part of Winsway but was divested on March 31, 2009 according to the IPO prospectus. It is owned by two individuals – it is therefore not a subsidiary of Moveday. Sanhe’s shareholders are Dong Guoxan and Sun Hongzhou. Mr. Sun is a Winsway employee and works for the company’s PRC subsidiary Erjinaqi Haotong.

If Sanhe, a company owned by a Winsway employee, is actually moving all the coal for Winsway, then what is Moveday being paid to do? We know Winsway is buying Coal from several mines, but we also know they are paying Sanhe to move it – Sanhe’s drivers do not appear to be volunteering, so why does Winsway pay Moveday?

A delivery man with a hidden camera was sent to the Winsway office at Cheung Kong center in Hong Kong with a delivery for Moveday. When he asked the employees for a Moveday signature and “chop” (this is the equivalent of an official seal a company in HK uses to do business) he was told that Moveday is in fact a Winsway subsidiary and that Winsway had the ability to sign for Moveday. This is the video that we will release once we finish disguising the identity of the people in the film (for privacy reasons).

Regardless of whether Winsway legally owns Moveday, all evidence points to a strange and improper relationship. With employees doing business for both companies (clearly low level staff in HK were familiar enough to call it a subsidiary) out of the same office, this is a relationship that deserves a closer look.

In the Prospectus, there is a description of the relationship between Winsway, Sanhe and Moveday. Apparently Winsway needed both companies to truck coal, so it gave cash to Moveday and trucks to Sanhe. Considering all evidence shows Sanhe is the company actually doing the moving, it sounds like Moveday just pocketed the cash.

Canadian authorities must fully investigate the existence of Moveday, its operations, and payments made to Moveday by Winsway prior to any approval.

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5 Winsway bond prospectus page F-55.

Macau-nting

We were wondering where the company could have learned to be so creative with its books. “This is some of the most dubious accounting we have seen outside of Macau” we thought to ourselves. We thought too soon. According to the section titled “Procurement of Services” on page 186, all book-keeping and document processing services for the company were handled by the Macau office of a company owned by the chairman. This shows terrible internal controls. In August of 2010, in preparation for the IPO, the company finally decided to put the function in house, but still chose to locate that office in Macau.

For those that are not familiar with Macau, it is famous in Asia for being a center of money laundering, handling everything from exchanges of money for North Korean arms deals to corrupt money from China. Transactions via Macau are typically considered suspect and it is well known that this is an ideal destination if one wanted to falsify financial transactions. In December of 2009, the American Consulate in Hong Kong claimed Macau’s success is due to “encouraging money laundering”[6].

Investment Canada Act and Grande Cache Coal Ramifications

We suggest the Hong Kong Exchange review this transaction to insure that fraudulently obtained funds are not used to purchase Grande Cache. Canadian regulators also have cause to be concerned about transaction.

Part 4 of the investment act requires that the acquirer develop resources and contribute to the Canadian economy via jobs, infrastructure, intellectual property, etc… We firmly believe that a fraudulent company acquiring a prized asset for the purposes of having something “real” in a sea of fraud is directly contradictory to the spirit of this act.

A fraudulent company will not contribute meaningfully in terms of jobs; the company is run for the benefit of the fraudster promoters. Winsway possesses no special engineering or technical prowess that would be considered beneficial for the Canadian economy. Lastly, it is unlikely that Winsway will exploit the resource to its potential; fraudsters are more likely to sit on the asset until the right moment arises for them to strip it from the company.

Perhaps the most important thing to mention is that the fraud has now been exposed. If the purchase is allowed, the creditors of Winsway will seek to maximize returns and seize the Grande Cache assets. It is likely that workers will suffer via lost pensions, layoffs, or just normal downsizing as creditors seek to maximize their recovery. It is even possible that the Grande Cache assets will be split apart and re-sold to competitors thereby consolidating the industry and hurting consumers. Until Winsway is fully investigated, it is in the best interest of Canadians for the government to block this acquisition.

6 *The Economist*, December 09, 2011

Responsibility of Grande Cache Coal Directors

Canadian law classifies creditors as stakeholders. This includes Grande Caches creditors. The directors are putting them at risk of having to stand in line with the creditors of a fraudulent Chinese company if they allow the transaction to take place. Creating losses for Canadian creditors can only do damage to the Canadian economy. The borrowings of Grande Cache are mainly capital leases secured by equipment and buildings. The creditors are American and Canadian institutions that will suffer once Winsway's fraud is fully punished.

Clearly, the responsible thing to do is for the directors to halt the transaction immediately. Canadian markets have already suffered substantially from China-based fraud, and further contamination from the Canadian economy via the Chinese fraud effect is something the directors should work hard to avoid.

Disclaimer

Jonestown Research is short the securities of Winsway and Grande Cache Coal Corp. We have every reason to want the securities to go down in price because we'll make money when they do so. After we publish this report, we may short more, cover, or trade in any manner we see fit. Jonestown Research isn't registered in any jurisdiction as an investment advisor, broker, or anybody who'd need a license to discuss investments. This isn't an offer to buy or sell securities. Use Jonestown Research at your own risk, and we absolutely implore you to do your own due diligence. While we make significant efforts to ensure our research is accurate, we cannot give any assurance that it is. Nothing in this report came from "insiders" or consists of material non-public information.