SCOK's Failed Coalmine Consolidation and Questionable Financials

SinoCoking and Coke Chemical Industries (NASDAQ: SCOK) listed on NASDAQ in February 2010 through a reverse merger. SCOK subsequently raised $44 million through a private placement that closed on March 11th, 2010. Today's report shows:

> **SCOK's Mine Consolidation is Just a Dream. The reality is that SCOK was never appointed as a coalmine consolidator by the Henan government. Regulations Prevent SCOK and its Subsidiaries from Owning or Operating Mines.**
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> **As a Result, Majority Ownership of SCOK's Mines Must be Transferred to a State-Owned Consolidator. Future Income from SCOK's Mines Cannot Be Consolidated into its Operating Results**
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> **Where is the coal? Video Surveillance and Government Documents Indicate the Hongchang Mine is Not Producing Any Coal, Contradicting Management's Current Claims**
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> **SCOK's Planned 900,000 ton New Coking Plant was Just a Hole in the Ground on May 16th 2011 When the CEO Told Investors on a Conference Call the Plant would be Completed the Following Month**

Mine Consolidation is Just a Dream

On October 4, 2010 SCOK announced its fiscal year 2010 financial results (link here) and provided background information, explaining how their Hongchang mine in Baofeng county had been shut down since late June 2010 by the Henan Provincial government due to the government's plans to consolidate the small mines in the industry:

> "The Company's Baofeng mine, along with all other mines with annual production capacity between 150,000 and 300,000, has temporarily stopped production since late June 2010 due to the Henan Province authorities' consolidation plan. Under the consolidation plan, mining companies below an aggregated one million metric ton annual production threshold need to be consolidated to reach such capacity by March 31, 2011. As the only private mining company in Pingdingshan to be granted consolidator status, SinoCoking is in active discussions with 20 private mining companies that collectively represent 3 million metric tons of combined annual capacity and will complete an additional 4 acquisitions before the March 31st deadline, and 9 in total by the end of the fiscal 2011…"

Of key concern is SCOK's statement is management's claim SCOK was **"the only private mining company in Pingdingshan to be granted consolidator status".**

On August 17, 2010, SCOK announced it entered into agreements to acquire 60% equity interests in two Pingdingshan, Henan based coalmines (Shuangrui coal mine and Xingsheng coal mine). SCOK Chairman Mr. Jianhua Lv stated, **"we will continue to leverage our status as a coalmine consolidator in Henan province"** in its press release (here). At this point, investors in SCOK's $44 million private placement must have felt pleased with SCOK's progress as the only private official coalmine consolidator.

The reality is that SCOK was never appointed as a coalmine consolidator by the Henan government.

We obtained two government documents related to mine consolidation in the Pingdingshan area dated March 8, 2010 and May 4, 2010 that can be downloaded (here) and (here) with English translations (here) and (here). The March 8th document is an announcement from the Pingdingshan municipal government regarding the coalmine consolidation in the Pingdingshan area. It outlines the details, method and timeline of the consolidation of the smaller mines. The May 4th document announces that there shall be only two consolidators in the Pingdingshan area: Chinese State-owned China Pingmei Shenma Group ("China Pingmei") and Henan Province Coal Seam Gas Development and Utilization Co., Ltd ("Henan Coal Seam Gas"). The coalmine consolidation will proceed in three stages concluding April 31st, 2011. **Importantly, the announcement states that consolidators must have more than 51% of the equity ownership of each target coalmine.**

SCOK's Hongchang coalmine has an annual capacity of 150k tons (SCOK claims it mined 132,449 tons of raw coal from its Hongchang coal mine in fiscal 2011 in its 10-K filing here) so it falls into the category of "small and medium" size local mines with capacity between 150k tons to 300k tons. Hence control and at least 51% of the equity of the Hongchang mine must be acquired by one of the two appointed consolidators.

So the truth is exactly the opposite of what SCOK's management claimed. SCOK was never an official consolidator and its Hongchang coal mine must be acquired by one of the two official state-owned consolidators, who must, according to the regulations acquire at least 51% ownership. This effectively puts SCOK out of the coal mining business. The state-owned consolidator will assume all operations.

In the May 4th, 2010 document the government coalmine consolidation team lists all the coalmines that should be acquired by China Pingmei. The list includes SCOK's Hongchang coalmine as well as the Xingsheng coalmine and Shuangrui coalmine. This directly contradicts SCOK Chairman Mr. Jianhua Lv's August 17th, 2010 press release (noted above) stating that SCOK had entered into agreements and paid deposits to acquire the Xingsheng and Shuangrui coalmines.

At this point the true history of SCOK is starting to sound a little like PUDA. It gets worse.

In order to avoid having its Hongchang coalmine acquired by China Pingmei, SCOK tried to partner with the other official consolidator Henan Coal Seam Gas. SCOK set up a company called Henan Zhonghong Energy Investment Co., Ltd. ("Zhonghong Investment") in December 2010 according to its 10-Q filing (here). Zhonghong Investment would then set up a JV with

Henan Coal Seam Gas to consolidate the proposed mine acquisitions. The equity interests in Zhonghong are actually held by three individuals on Hongli's behalf adding control risk to the proposed structure. Why would SCOK use three nominees to hold the equity in this major investment? Surprisingly SCOK's Chairman Lv is not one of the three nominees. On May 2, 2011 SCOK announced (here) the new JV with Henan Coal Seam Gas received its business license. The new JV is called Henan Hongyuan Coal Seam Gas Engineering Technology Co., Ltd. ("Hongyuan CSG") and will carry out SCOK's coal mine acquisitions. Interestingly, SCOK mentioned Hongyuan CSG will "assume management of and responsibility for all mining safety issues at Hongchang mine as well." This is a false statement since according to the government mandate Henan Coal Seam Gas must consolidate the Hongchang mine. We obtained a document dated February 18, 2011 (link here and translation here) from the office of the Henan coalmine consolidation team stating that the consolidator for SCOK's Hongchang coalmine is Henan Coal Seam Gas (replacing from China Pingmei).

We assume SCOK was fully aware of the relevant regulations, yet SCOK has repeatedly stated it will have the controlling ownership in these coal acquisitions. As recently as its prospectus filed November 22nd, 2010 (here) as well as the 10-Q filed November 15th 2010 (here), SCOK stated:

> "The Company intends to acquire a controlling stake in selected private mine-owning companies using cash, its common stock, or a combination of both as consideration for these acquisitions."

After its November 22nd 2010 prospectus SCOK mysteriously stopped using the words "controlling stake" when discussing its acquisition plans.

For example, in the 10-Q filed May 16th, 2011 SCOK simply states that:

> "We intend to complete all such acquisitions through Hongyuan CSG, our joint-venture with the state-owned Henan Coal Seam Gas"

We obtained the official government ownership record of the Hongyuan CSG JV (here). It shows Henan Coal Seam Gas owns 51% of the Hongyuan CSG JV while SCOK's subsidiary Zhonghong Investments Co., Ltd. owns the other minority 49% position, a fact SCOK failed to disclose. The Hongyuan CSG JV was established on April 28th, 2011. Since SCOK only holds a minority interest in the new JV, if SCOK transfers the equity ownership of the Shuangrui, Xinsheng and Shunli mines it acquired to the new JV then SCOK would be no longer be able to consolidate the financials of these coalmines. SCOK would only be able to report its 49% investment in the Hongyuan CSG JV as a long-term investment on its balance sheet and the income would be reported as investment income. Disturbingly, SCOK and its public shareholders will not directly control the 49% of Hongyuan CSG JV. Is SCOK another PUDA time bomb?

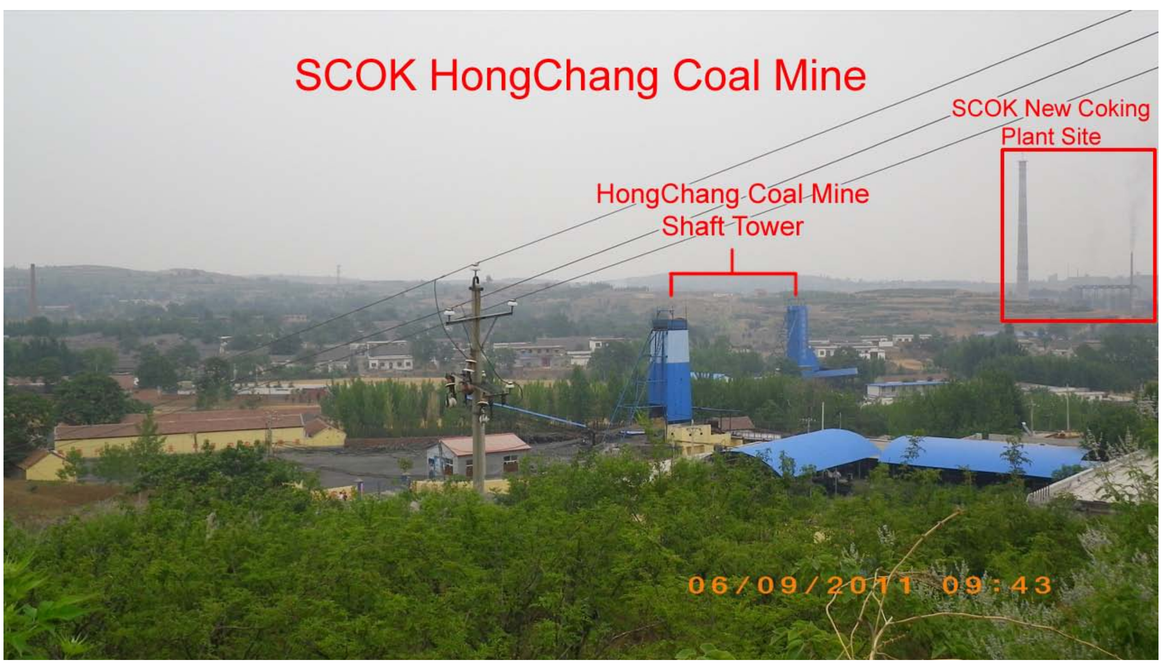
In its 2011 10-K filed September 13th, 2011, management for the first time noted that SCOK, through Zhonghong Investments only owns 49% of the Hongyuan CSG JV. SCOK made no attempt to explain the implications of losing control of its coalmines. SCOK investors were left on their own to figure it out.

Clearly, Henan Coal Seam Gas will become a major player in mine consolidation. SCOK at best will be a small minority investor in this venture. In early 2011, Henan Coal Seam Gas set up a billion RMB fund with CITIC (the same CITIC that PUDA Chairman Ming Zhao secretly borrowed $530 million from) to finance the consolidation of small coalmines in Henan according to this article (here with PDF here). No matter how SCOK's management tries to spin the story, as a minority investor in Henan Coal Seam Gas's coalmine consolidation projects the public investors of SCOK seem destined to lose.

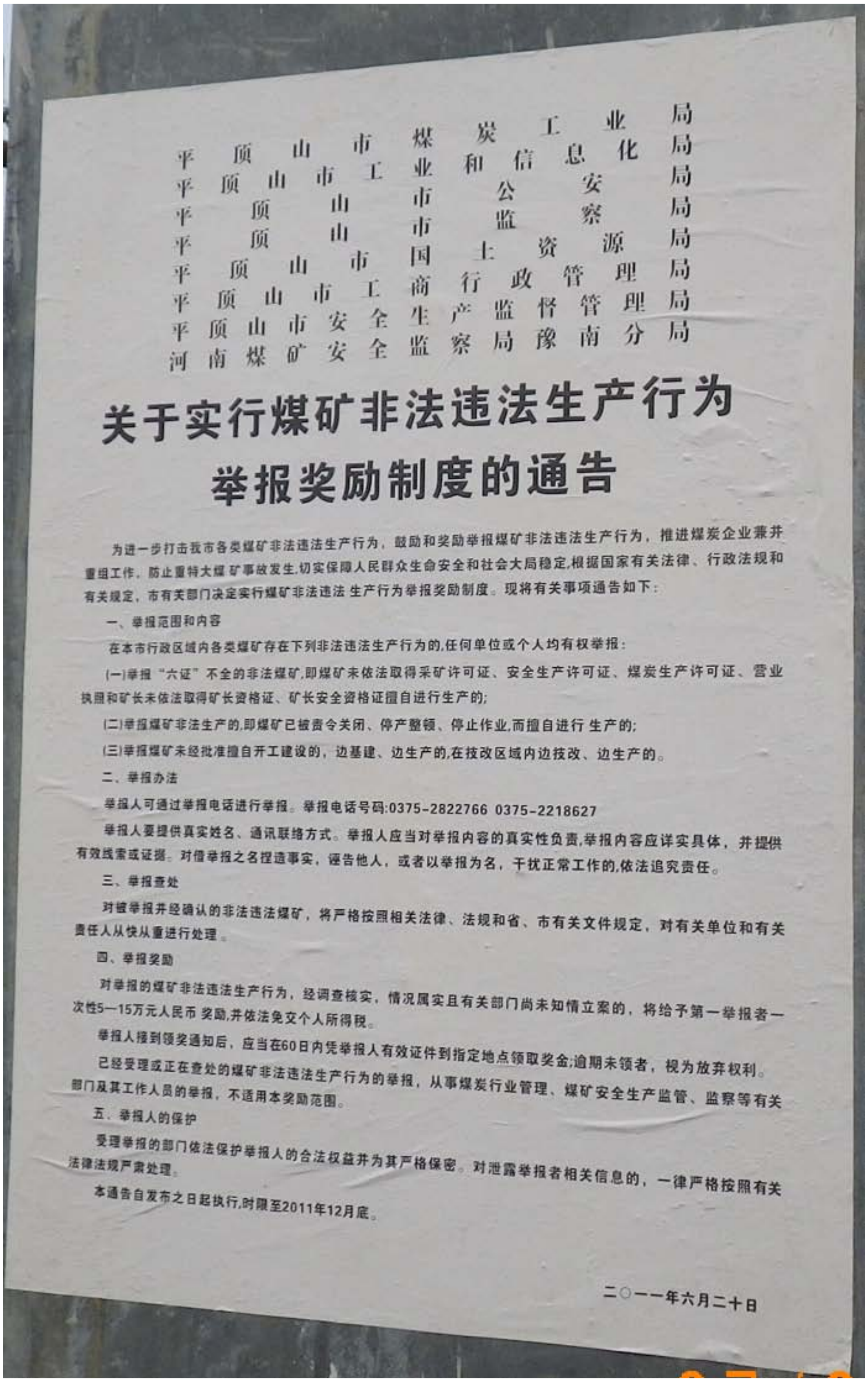
Where is the coal? Video Surveillance and Government Documents Indicate the Hongchang Mine is Not Producing Any Coal

SCOK states in its 10-Q filing (here) that after its Hongchang mine was shut down in late June 2010, it was "allowed to resume operations in late 2010, albeit at only 50% capacity." According to its SEC filings, SCOK claims that since the Hongchang mine resumed mining in late 2010 it produced 132,449 tons of raw coal by June 30th, 2011, the end of SCOK fiscal year.

However, the March 8th, 2010 government document referenced earlier in this report states clearly that no coalmine is allowed to resume production in the Pingdingshan area until the mine consolidation and safety inspection process has been completed. Until then, any mining activity is illegal. Investigators from the International Financial Research & Analysis Group (www.ifragroup.com/services) visited SCOK's Hongchang coalmine to conduct video surveillance since late May. Here is the overview picture of Hongchang coal mine:



The investigators took a photo of a big warning sign dated June 20, 2011 posted on behalf of eight local authorities next to the gate of the Hongchang coal mine. The warning sign states: "Anyone will get a big monetary reward (50k RMB to 150k RMB) for reporting illegal mining activity in the area":



The bounty is effective until the end of the 2011. A complete translation of the warning sign is available (here). We have no idea how SCOK could produce 132,449 tons of raw coal between late 2010 and June 30th, 2011 as claimed since its Hongchang mine clearly continues to be shut down.

Furthermore, surveillance videos uploaded here (SCOK Vimeo Channel) show absolutely no production activity at the Hongchang coalmine for the past three months. There is no visible pile of coal, no trucks delivering coal and no other production activities. Occasionally a few workers appear but they seem only to be either securing or maintaining the mine. Recently the investigators reported that one of two mineshaft towers was taken down.

We have no idea where SCOK got its coal considering (1) most of the mines in Pingdingshan area remain shut down due to the provincial wide mine consolidation and safety inspection and (2) From December 2010 to at least June 30th, 2011 SCOK has been unable to purchase coal from Zhengzhou Coal Industry Group due to its inability to supply sufficient coal commodities. (At June 30th Zhengzhou Coal had still failed to refund $1.87 million in coal prepayments to SCOK.)

To conclude this section, we'd like to point out that without any apparent mining of high margin raw coal and with limited access to coal from other sources that SCOK management was still somehow able to report it increased operating income in fiscal 2011 to $23,497,198 from $19,620,505 in 2010. Dream on!

SCOK's Planned 900,000 ton New Coking Plant was Just a Hole in the Ground on May 16th 2011 When the CEO Told Investors on a Conference Call the Plant would be Completed the Following Month

As recently as SCOK's 10-Q filing on May 16th, 2011 (here) on page 48 the new coking plant "Construction is expected to be completed by the end of June 2011, and production immediately thereafter." The CEO even mentioned on the May 16, 2011 earnings conference call that the trial production would start at the end of June (link here). Our investigators visited SCOK's new coking plant construction site on June 9th to check on the progress. Clearly from the photo below it does not look like the plant will be completed for a long time:

Compared to the hole in the ground to the "stock" photo from SCOK's PPT:

It is not surprise in SCOK's latest investor presentation (here) the management changed the timeline of the completion to the end of 2011. Doubtful as well.

Conclusion

Management falsely promised investors they would use the $44 million capital raised in March 2010 to build a larger and more advanced coking facility and acquire local coalmines as the only privately owned consolidator mandated by the provincial government. More than 18 months have passed and none of the expansion plans have been completed. Meanwhile SCOK continues reporting increasing profits from its coal businesses. However, much of these profits are clearly contradicted by the fact that virtually all coalmines in the area, including

SCOK's only "producing" coalmine appears to be completely shut down according to government documentation and video surveillance records.

Disclosure: Contributors to this report are short SCOK.