SinoTech Energy: Enhanced Oil Recovery or Capital Extraction?

Just like the recently halted Longtop Financial Technologies (LFT), Sinotech Energy Limited (NASDAQ: CTE) is not a Chinese Reverse Merger. It was born in November 2010 via an IPO underwritten by UBS and Lazard Capital Markets, both of whom recently have "buy" ratings on the stock. It also has a "Big 4" auditor, E&Y. However, as we learned from Longtop, pedigree is no substitute for on the ground due diligence. A thorough investigation of CTE (by the same research team holding a 100% accurate and unbroken track record of uncovering fraud at RINO, CGA, CBEH, SCEI and LFT) concludes that CTE, its largest customers and suppliers are likely nothing more than empty shells with little or no sales or income. This report shows:

1. CTE's sole import agent accounting for over $100 million worth of oil drilling equipment orders appears to be an empty shell with no sign of operation, a limited import history and negligible revenue base.
2. CTE's sole chemical supplier appears to be an empty shell, with little or no revenues, a deserted office and no signs of production activity.
3. Likewise, CTE's five largest subcontracting customers, providing the vast majority of CTE's revenues, appear to be shell companies with unverifiable operations and minimal revenues themselves
4. CTE's oil drilling technology is questionable, mispriced and uncompetitive
5. CTE's audited financial statements filed with Chinese Government's State Administration of Industry and Commerce (SAIC) further confirm its negligible business operations
6. CTE's board of directors lacks independence and effective oversight of management, evidenced by undisclosed related party dealings
7. CTE stock is theoretically worth less than $0.63 per share but investors will likely recover nothing

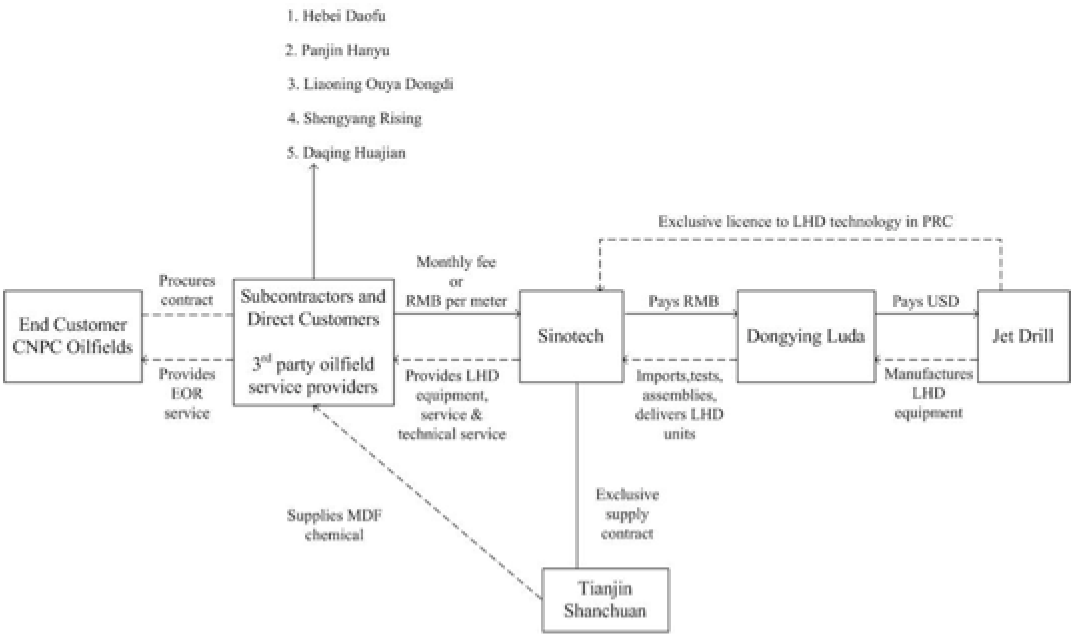
Background

CTE claims to be a leading non-state owned provider of Enhanced Oil Recovery (EOR) services to major oil and gas fields in China with two key recovery techniques: Lateral Hydraulic Drilling (LHD) and Molecular Deposition Film (MDF) chemical oil separation. The LHD service uses high-pressure water jets to drill horizontal holes in multiple directions from an existing vertical well to the surrounding reservoirs in order to increase the quantity of oil and methane gas flow. MDF is a chemical solution that creates an ultra thin film that separates oil from the sand, enabling oil to flow more freely and efficiently to the oil pump.

CTE disclosed that it obtained the exclusive right to use the LHD equipment in China from Jet Drill Well Services, LLC of Texas (Jet Drill), and purchases LHD equipment manufactured by affiliates of Jet Drill through an exclusive import agent, Dongying Luda Petrochemical Equipment Co. Ltd (Dongying Luda). Through Aug 1, 2011, CTE had purchased 16 LHD units through Dongying Luda. In addition, CTE has planned to further increase its fleet of LHD units to 20 by the end of 2011.

CTE acquired the ownership of the underlying patents to the MDF technology from Professor Manglai Gao (高芒来) of China Petroleum University, the original inventor. Pursuant to an exclusive supply agreement, CTE purchases the MDF from Tianjin Shanchuan Petroleum Chemicals Co., Ltd (Tianjin Shanchuan), an entity affiliated with Professor Gao according to CTE's latest 20-F filing.

The performance of MDF and most LHD services are then subcontracted to several 3rd party oilfield service providers (subcontractors). In other words, the subcontractors are responsible for rendering the actual services, collecting fees from end oilfield customers and paying CTE the contractual share of its service fee (usually RMB 2500 per meter drilled for oil wells, RMB 900 per meter drilled for gas well, RMB 300 per ton of oil production from MDF) or alternatively a flat annual fee on a monthly basis. The following diagram illustrates CTE's business model:



The economics of the LHD business plan seems to be exceptionally good with each LHD unit supposedly generating about $7 million of revenue and $3 million of earnings (according to management). With a per unit capital expenditure of $6-7 million per management (consistent with the $6.87 million disclosed in the 20-F), each unit generates 44% annual return on investment and pays back its investment in just a little over two years. As for the MDF business, CTE spent less than $500K to acquire the patents underlying the technology, subcontracts the performance of all MDF contracts and generates close to $20 million in annual revenue with 88% gross margins.

At first glance this is a beautiful business model. Financially, the only issue seems to be that CTE has never generated any positive free cash flow while its capital expenditure budget keeps growing. However, closer scrutiny and several months of fieldwork show CTE appears to operate almost entirely through a network of shell companies with shell suppliers selling to shell customers, despite management's many "demonstrations" of LHD equipment actually being used in the field. Just because management can demonstrate a LHD device in operation does not mean the numbers are real. Given the existence of CTE Chairman's other related businesses outside the public company, we must be mindful of what we see. Ask the following questions:

1. Which company's employees really operated the LHD equipment?
2. Does the LHD equipment really look like something worth over $6.5 million? (Competitors quote similar products for less than 1/10th of that)
3. Who really bought and imported the equipment? CTE or its import agent?
4. Are the customers, suppliers and subcontractors really totally unrelated to CTE as claimed?

First Shell: Import Agent Dongying Luda

CTE's annual report on form 20-F disclosed the following about Dongying Luda:

We purchase our LHD units from Jet Drill through Dongying Luda, which acts as our import agent for the purchase of these units. In addition to import-related services, Dongying Luda provides us with services related to the assembly, testing and fine-tuning of our LHD equipment and sells us ancillary tools and equipment.

Based on the publicly disclosed LHD unit cost of $6.6-$6.87 million, we thus estimate CTE has paid at least $105 million to Dongying Luda to procure 16 LHD units through August 1 2011. In addition, management explained that Dongying Luda, through the port of Dongying, works as import agents for other clients, in addition to Tianjin New Highland (TNH), CTE's operating subsidiary in China. We would thus expect Dongying Luda to be a substantial operation with significant revenues.

Three unusual contradictions immediately stand out:

1) The SAIC filings of Dongying Luda showed 2009 revenue of only RMB 1.3 million and a negligible loss (link to SAIC financials here). 2010 numbers haven't been filed. This is in great contrast to what we were told a technologically advanced importer with multiple clients.
2) It is unclear to us what legitimate benefit CTE may gain from using an import agent when it already has its own license and ability to import, saving considerable money, as can be seen on the Chinese customs website screenshot below:

Readers can verify this by visiting
http://query.customs.gov.cn/HYW2007DataQuery/CompanyQuery.aspx
and entering SinoTech's Chinese name into the first text box (天津新高地科技发展有限公司), and the security code into the second text box.

3) We find it strange CTE's purchase cost per LHD unit is over $6.5 million while a competitor, Radial Drilling Services LLC, selling similar equipment with the identical technology quotes a price of only USD $300-700K (as discussed in the section about Jet Drill below)

Further investigation into Dongying Luda revealed it apparently has no significant operation or business activity at all. Below is a list of the evidence gathered in support of this conclusion:

1) Dongying Luda is unreachable by phone. We attempted to locate the correct phone number of Dongying Luda through various means, including local SAIC registration, telephone directories, Internet search, etc. The only phone number we were able to find goes directly to a fax. In addition, an Internet search using various Chinese search engines yielded next to no public record about this company.

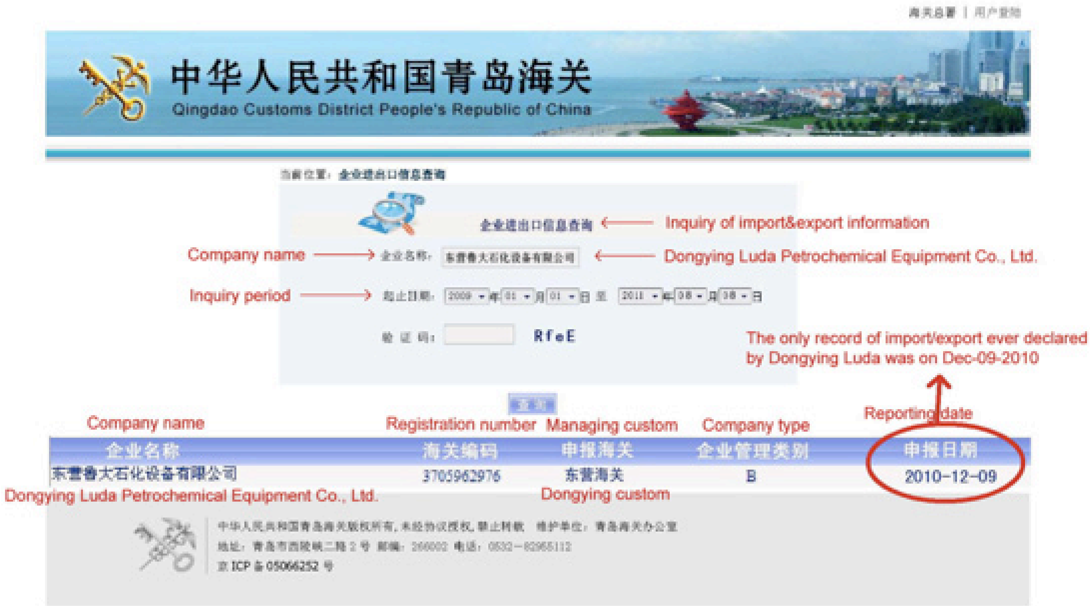
2) CTE's purchases of LHD units through Dongying Luda dated as early as 2007 (link here to Agency Appointment Agreement dated July 1 2007 filed by CTE), are contradicted by official records from the Dongying Municipal Bureau of Commerce (东营市商务局) showing Dongying Luda had no import license prior to August 31 2009.

   Companies in China are required to have a special license before engaging in foreign trade activities. This link (here) and the screenshot below is an official government record, dated Aug 31, 2009, when Dongying Luda was issued its import/export license by the Dongying Municipal Bureau of Commerce. A conversation with the Ms. Han from the Bureau (Tel: +86 546 8318312) also confirmed that Dongying Luda had no import license prior to Aug 31, 2009. How could CTE possibly have purchased LHD units through Dongying Luda back in 2007?

3) Ultimate proof of Dongying Luda's lack of operation – The Official Record from Chinese Customs (中国海关总署) shows Dongying Luda, through June 1, 2011, declared total imports of merely USD**$1,268.46** since receiving its import license on August 31, 2009.

The two screenshots below are the official records of Dongying Luda's importing/exporting activities since 2009, obtained from Qingdao Customs of the PRC Government. As described by the Customs Records, the only record of goods ever imported by Dongying Luda was $1,268.46 worth of "samples" on December 9, 2010.

Picture 1: Only $1,268.46 of imported goods ever declared by Dongying Luda



Picture 2: The details of the Dec 9th 2010 entry.

4) Site visit to Dongying Luda's address revealed no sign of operations

Dongying Luda's registered address is No. 313, 3/F, Area 1, East Meirenyuan, No. 6 Plot, Dongcheng Trade City, Dongying, Shandong Province, 257091 (山东省东营市东城商贸城 6 号地段东美人园一区三层 313 号)

These three characters “东美人” roughly translate to “eastern beautiful woman” (East Meirenyuan). Our investigator took a picture from the street as he approached the building showing these three characters on a sign:

Below is a picture of the main complex housing a building & decoration materials wholesale market:

The East Meirenyuan building is actually a residential apartment. The picture below was taken inside the building. We see these three letters again on the building directory:

At the entrance to the office, we took a picture of the locked door:

An on-duty security guard estimated that the square footage of the rented space is approximately 300 square feet and noted that one person sometimes enters or exits the office. This is not the type of office space we would expect to find for a technologically sophisticated import business having handled over $100 million worth of goods, and it's certainly not a place where industrial equipment could be assembled, tested, or fine-tuned.

In a subsequent conference call to confront management with our concerns, we caught them red-handed trying to cover up the truth of Dongying Luda's lack of importing activities (we recorded the call). The CEO cited CTE's lack of an import license as one of the reasons for using Dongying Luda and insisted to us that Dongying Luda brought in the parts of the LHD units through the port of Dongying since July 2007. The parts are then assembled, tested and fine-tuned in Dongying and then transported to Tianjin. Yet incredibly, the management did not even know the address where Dongying Luda performed the assembly and testing and CTE has been unable to provide this key info in our follow-up communication.

CTE's CEO further explained that Dongying Luda takes the inventory risks of the parts they bought from Jet Drill and sell the assembled unit to CTE for the RMB equivalent amount of the unit cost of $7 million. If this were true, we would expect to see Dongying Luda reporting at least $105 million worth of revenue. The CEO also explained that Dongying Luda provided import services for other large oilfields customers. If that were the case, we would have seen a lot of activity on the official customs records. CTE was unwilling or unable to provide us with proof of Dongying Luda's import records, custom clearance documents and any tariff payment.

The combination of multiple pieces of evidence makes it clear that Dongying Luda has very limited operations and import history. The main purpose of such a shell company is often to funnel money out to trick the auditor. Even though LHD units certainly exist in the field (perhaps imported directly by CTE or its other related entities), it seems unlikely that Dongying Luda imported them. Given the fact that about $105 million was supposedly paid to Dongying Luda for the purchase of the 16 LHD units through August 1, 2011, CTE needs to address where this money really went.

Second Shell - Tianjin Shanchuan, the sole supplier of MDF

The MDF segment contributed $19.4 million of revenue, or 42.8% of sales in 2010. CTE management claims that MDF technology "increases oil recovery from mature wells by displacing the residual oil that adheres to sedimentary rock or sand in the oil reservoir". While the MDF solution is patented, the technique of using soap-like chemicals to improve yield is nothing new. For interested readers, there is a book covering this topic called "Modern Chemical Enhanced Oil Recovery" available at Amazon. We haven't read it, but we suspect few if any of the 648 pages of this book are devoted to technology unique to CTE.

According to its 20-F filing, CTE purchases its MDF under a five-year contract from Tianjin Shanchuan, a chemical manufacturer supposedly affiliated with Professor Manglai Gao:

"We entered into a five-year supply contract with Tianjin Shanchuan, a chemical manufacturer affiliated with Professor Manglai Gao, or Professor Gao, on May 8, 2008 to manufacture and supply our MDF chemicals exclusively for us or parties designated by us. …"

Shockingly during our two separate phone interviews by two different investigators, Professor Gao, denied having any relationship or affiliation with any such entity named Tianjin Shanchuan during our phone interview. In fact, Gao insisted he had never heard of this company even after we spelled its full name and pointed out its detailed address (We recorded this call). A recorded phone conversation can be shared to support what we say here if needed. Gao did confirm that he sold both generations of his MDF patents to CTE, though this was inconsistent with CTE's own disclosure that it purchased only the 2nd generation technology from Gao. We later confirmed through the official State

Intellectual Property Office website that the ownership of 1st generation MDF patents were transferred by Professor Gao to some individuals designated by the CTE, outside of its Tianjin New Highland (TNH) subsidiary.

Our extensive investigation into Tianjin Shanchuan left us with the conclusion that it is likely another shell company without any significant business activities. The main evidence we gathered includes:

1. **Tianjin Shanchuan could not be reached.** Just like Dongying Luda, Tianjin Shanchuan does not have a website, phone number or fax number registered at the local SAIC. Our attempts to reach it obviously failed. There is very little information about this company available through web searching its Chinese name 天津山川石油化工有限公司.
2. **Audited financials by local PRC firms filed with SAIC indicate negligible revenue and operations**. Audited financials from Tianjin SAIC showed a 2009 revenue of merely ¥225,490 (or USD $33k) and a net loss of ¥121,117 (USD $17.8k). Link to Tianjin Shanchuan credit report based on SAIC records can be downloaded (here). Click (here) for original audited financials from official records of the Tianjin State Administration of Industry and Commerce and (here) a translated version.
3. **Site visit to Tianjin Shanchuan's current address found a deserted, empty office with no manufacturing operation.** The official registered address of Tianjin Shanchuan is:

   NO. 309, WANXIANG ROAD, DAGANG, BINHAI NEW DISTRICT,
   TIANJIN, 300273 PR CHINA
   天津市滨海新区大港万象路 309 号

This first picture shows the building address with Chinese characters matching those above (万象路 309):

Stepping back from the address label, we see the full façade of the building:

Looking through the glass, our investigator took the following two pictures:

When challenged to provide the address for Tianjin Shanchuan, CTE management gave us an address identical to the one we visited. On top of that, CTE management arranged a phone conversation between our investigator and Mr. Zhang, the legal representative of Tianjin Shanchuan, who affirmed again that we visited the correct address. Without telling Mr. Zhang we had already photographed his empty office, we asked whether our investigator could visit his office in the next couple of days. Alerted and uncomfortable, Mr. Zhang immediately and said he couldn't meet us because he and his entire staff were out of town on vacation.

The multiple pieces of evidence indicating that Tianjin Shanchuan is nothing more than a shell operation, along with the fact that CTE subcontracts all of its MDF field services to two questionable subcontractors (discussed below), left us with grave concerns about the validity of its reported MDF segment results. Furthermore, why did CTE make such an inaccurate disclosure about Tianjin Shanchuan's affiliation with Professor Gao, a company he clearly has never heard of?

On a conference call between our investigator and CTE management on August 14, 2011, management repeated their story of Tianjin Shanchuan's affiliation with Professor Gao. Management also claimed Tianjin Shanchuan has sold about RMB 30 million worth of MDF solutions to CTE and its two subcontractors annually, however, we have since confirmed from the recently filed official SAIC records that Tianjin Shanchuan reported a calendar year 2010 revenue of zero. As shown in the screenshot below, the explanation given by Tianjin Shanchuan itself in its official filing to the Chinese government for its lack of reported revenue is "Low business volume and high operating costs (业务量低，业务成本)". Click (here) for the original 2010 Annual Joint Inspect Report filed by Tianjin Shanchuan at SAIC.

五、本年度生产经营情况表

Sales

销售（营业）收入	0.0 元	其中：服务营业收入	0.0 元
国内销售额	0.0 元	其中：服务营业额	0.0 元
纳税总额	0.0 元	利润总额	-73330.87 元
亏损额	73330.87 元	净利润	-73330.87 元
资产总额	10480241.8 元	其中：长期投资	0.0 元
负债总额	9141.06 元	其中：长期负债	0.0 元
验资（审计）机构名称	天津市正泰有限责任会计师事务所		
企业经营状况	筹建 X	投产开业 √	停业 X
投产开业日期	2002-12-27		
亏损及非正常生产原因	业务量低，业务成本过高 Low business volume and high operating costs		
是否承包经营管理	X	承包者名称	

Reason for loss or interruption of normal production

Last but not least, we discovered a disturbing coincidence that Tianjin Shanchuan and CTE's Chinese subsidiary, Tianjin New Highland (TNH), both shared the same 2009 PRC auditor (Tianjin Zhengtai CPA Ltd or 天津正泰有限责任会计师事务所) who just happened to sign off on both supposedly unrelated parties' 2009 SAIC audits on the very same day (March 14, 2010)! Click (here) and (here) to download the auditor's report enclosed with CTE's and Tianjin Shanchuan's SAIC financials. We understand this is not any proof to suggest an undisclosed related party relationship but is this really a mere coincidence?

Five More Shells: Direct customers accounting for over 85% of 2010 Sales

The following is the list of significant customers disclosed in CTE's 2010 20-F filing:

	Year ended September 30, 2010			
	Sales $	% of Total Sales	Accounts receivable $	% of Total A/R
Hebei Daofu Oil Exploration Technology Development Ltd.	10,434,521	23.03%	3,885,700	19.31%
Daqing Huajian Petroleum Technology Co., Ltd.	12,614,649	27.84%	6,523,493	32.42%
Panjin Xinglongtai District Hanyu Petroleum Technology Development Company Ltd. ("Panjin Hanyu")	9,034,320	19.94%	2,963,042	14.73%
Liaoning Ouya Dongdi Coalbed Gas Technology Co., Ltd. ("Liaoning Methane")	6,685,067	14.75%	1,965,118	9.77%
Tianjin Botenear Petroleum Projects Limited ("Tianjin Botenear")	4,697,920	10.37%	4,782,400	23.77%

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Four of the direct customers/subcontractors list above accounted for over 85% of CTE's total revenue in FY 2010. With the new contracts signed after September 2010, we expect such concentration to increase in FY2011.

The most puzzling piece of the CTE story, in our opinion, is the significant fee revenue generated from CTE's two largest subcontractors accounting for all MDF sales and a substantial amount of LHD contracts. Hebei Daofu Petroleum Prospecting Technology Development Co Ltd (Hebei Daofu) and Panjin Hanyu Oil Technology Development Co Ltd. (Panjin Hanyu), accounted for 23.03% and 19.94%, respectively, of CTE's FY2010 revenues and should gain further revenue share in FY2011 based on the following paragraph from 20-F:

In December 2010, we modified our agreements with Hebei Daofu and Panjin Hanyu. Under the terms of our modified agreement with Hebei Daofu, we are obliged to supply three LHD units and one testing unit. Hebei Daofu will pay us a fixed annual service fee for each LHD unit of RMB50 million and a fixed annual service fee for each testing unit of RMB2 million. These fees are payable by Hebei Daofu to us on a monthly basis at RMB12.7 million per month. Under the terms of our modified agreement with Panjin Hanyu, we are obliged to supply two LHD units and one testing unit. Panjin Hanyu will pay us a fixed annual service fee for each LHD unit of RMB50 million and a fixed annual service fee for each testing unit of RMB2 million. These fees are payable by Panjin Hanyu to us on a monthly basis at RMB8.5 million per month. Under each of the contracts with Panjin Hanyu and Hebei Daofu, we are responsible for formulating a construction plan for each well, supplying spare parts without charge within a specified quota, repairing equipment annually bearing the expenses, providing technical training and updates and supervising the construction quality on-site.

The modified LHD service contracts provide CTE with monthly, rent-like service revenues totaling about RMB 254 million or USD $39 million for the full year. This revenue stream is largely operational-risk free to CTE as Hebei Daofu and Panjin Hanyu are responsible for the operational aspects, as well as guaranteeing the procurement of a certain number of wells for CTE. In addition to LHD contracts, Hebei Daofu and Panjin Hanyu are contractually obligated under the MDF subcontracts to pay CTE, at least, an annual total of RMB 93.9 million (USD $14.4 million) in service fees. These two subcontracting arrangements alone are expected to generate a minimum of $53.4 million, or 48.5%, of CTE's latest revenue guidance for FY2011.

We set out to verify these relationships expecting to find two well-established oilfield service providers with large revenue bases and deep pockets, given they've agreed to taken on such large financial commitments to CTE. Our findings, once again, disappointed us and revealed another two questionable entities with unverifiable business operations and negligible revenues. Worse, we found Hebei Daofu to be an undisclosed related party entity to CTE.

First of all, SAIC filings show that Hebei Daofu generated only RMB 50k (USD $7.4k) of revenue in 2010 and a small loss (link here for the original electronic records obtained from local SAIC and here for the English version based on SAIC filings). SAIC filings for Panjin Hanyu show a similar RMB 65k (USD $9k) of revenue and a net loss of $14.6k in 2010 (link here for original annual joint inspection report from the local SAIC and here for the translated financials). Second, just like CTE's import agent and MDF supplier, neither company has a website. Nor could we find any meaningful information from Internet searches using their Chinese names. Neither company has official registered phone or fax numbers at the local SAIC.

Site visits support the hypothesis that these companies are non-operational. Hebei Daofu's address is 河北省任丘市西环建材市场 11 号楼北 4 号 or No. 4 Northern No. 11 building, Xihuan Building Material market, Renqiu City, Hebei Province. Our investigator only found a lighting fixture vendor operating out of this address who knew nothing of Hebei Daofu. A picture of the lighting store can be found in the photo below:

Panjin Hanyu's address is 盘锦市□隆台区惠宾街 101 号, or No. 101, Hubin Street, Xinglongtai District, Panjin, Liaoning Province. The first photo is a shot of the front of the building we found:

The next photo shows a closer shot of the sign next to the garage matching the Chinese name of the company (翰宇石油技术开发有限公司);

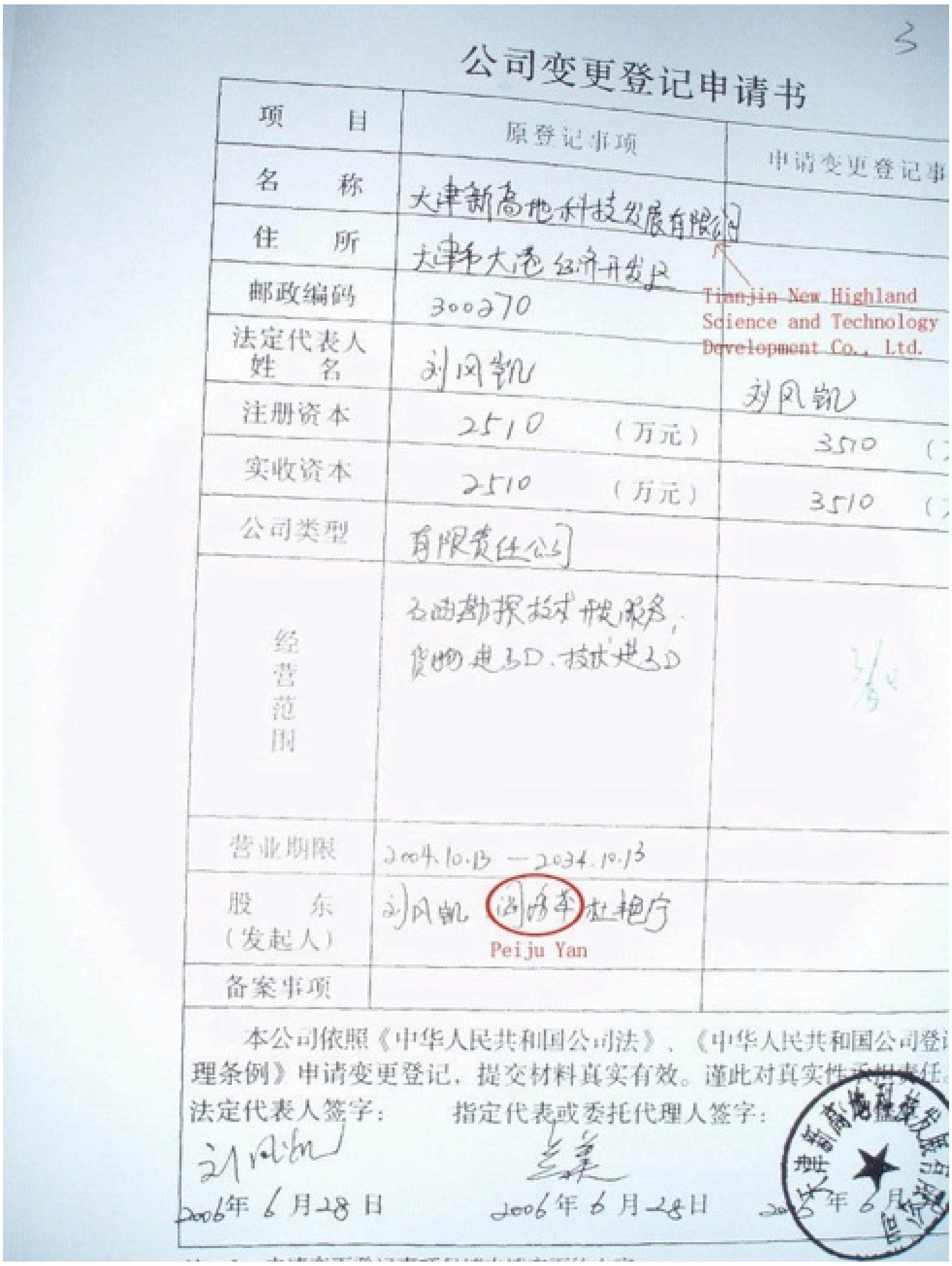
However, despite our ability to find the office, it was locked during normal business hours, and our investigator waited over an hour for anyone to show up (evidenced by the timestamps). It's also worth pointing out that, out of all the other businesses/tenants located at No. 101, Hubin Street, Panjin Hanyu's "office" was the only one without an Air Conditioner exterior unit being installed as shown in the picture above.

Although there is no official business phone number registered for Panjin Hanyu at local SAIC, we did manage to find names and contacts of some individuals designated to handle the registration/renewal of its businesses licenses. One such individual left a local fixed line number leading to a fax machine, as well as a cell phone number from the city of Tianjin (the same city where CTE's head office used to be located).

The most significant evidence of Panjin Hanyu being a shell company is its 2010 balance sheet filed with SAIC (link here). Panjin Hanyu was established in 2006 with a meaningful contribution of RMB 9.6 million of registered capital. However, we could hardly see any meaningful amount assets (cash, inventories, receivables, PP&E) one would expect from an operating business's balance sheet. The major asset on the balance sheet is a large unknown "Other Receivable" in an amount fairly close to the paid-in capital. This indicates the registered capital original funded was later pulled out of the company, most likely, through some type of loan or other advances after the money was used to satisfy the legal capital verification requirement of setting up the company. Judging from the looted balance sheet and lack of earnings, even if Panjin Hanyu is for all practical purposes another shell operation.

Much more disturbing is the fact Hebei Daofu appears to be an undisclosed related party to CTE's Chinese operating subsidiary, Tianjin New Highland (TNH). The following two pictures of official SAIC filings show the names of the three original founding shareholders of TNH (天津新高地科技发展有限公司), one of whom is Peiju Yan (ID #: 13098419741127571X). As shown on the 3rd screenshot below from the official Hebei SAIC website, Peiju Yan is in fact the current 85% shareholder and legal representative of Hebei Daofu.

Picture 1: Initial registration information of TNH from Tianjin SAIC in 2006



公司变更登记申请书

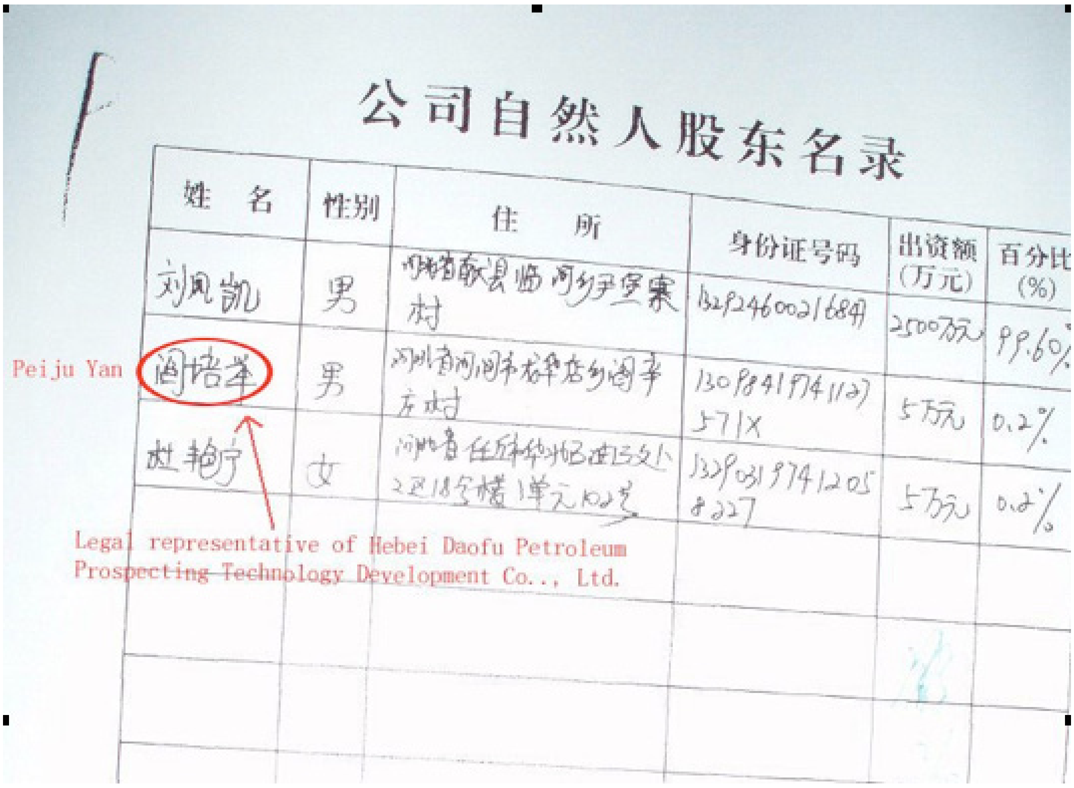
项目	原登记事项	申请变更登记事
名称	天津新高地科技发展有限公司	
住所	天津市大港经济开发区	
邮政编码	300270	
法定代表人姓名	刘风凯	刘风凯
注册资本	2510 （万元）	3510 （
实收资本	2510 （万元）	3510 （
公司类型	有限责任公司	
经营范围	石油勘探技术开发服务；货物进出口、技术进出口	
营业期限	2004.10.13 — 2034.10.13	
股东（发起人）	刘风凯 阎沛举 杜艳宁	
备案事项		

本公司依照《中华人民共和国公司法》、《中华人民共和国公司登记管理条例》申请变更登记，提交材料真实有效。谨此对真实性承担责任。

法定代表人签字： 指定代表或委托代理人签字：

2006年6月28日 2006年6月28日 年6月

Picture 2: Original SAIC filing showing details of three founding shareholders


公司自然人股东名录

姓名	性别	住所	身份证号码	出资额（万元）	百分比（%）
刘凤凯	男	[illegible]	[illegible]	2500万元	99.6%
阎培华	男	[illegible]	[illegible]	5万元	0.2%
杜艳[illegible]	女	[illegible]	[illegible]	5万元	0.2%

Picture 3: Screenshot from official Hebei State Administration of Industry and Commerce website


河北省工商行政管理局 电子政务大厅

河北道福石油勘探技术开发有限公司

注册号	130982000019760		
企业名称	河北道福石油勘探技术开发有限公司 Hebei Daofu Petroleum Prospecting Technology Development Co., Ltd.		
住所	任丘市西环建材市场11号楼北4号		
法定代表人	阎培华 Pei ju Yan	注册资金	5000.0000万元
公司类型	有限责任公司(自然人投资或控股)	登记机关	任丘市工商行政管理局
成立日期	2003-8-18	营业期限	2003-8-18 至
经营范围	石油技术开发、技术咨询、技术服务；五金、交电、纺织品、建材、石油设备及配件、办公用品、汽车配件批发零售＊＊＊		

返回

From what we have seen so far, not only it is highly doubtful that these two entities, with combined revenues of $200k, are not nearly close to be able to pay the contractually obligated $53 million fees to CTE, but the undisclosed past relationship makes us even more suspicious that these leading subcontractors were set up merely for the purpose of supplying phony documents and sales invoices to help CTE pass its audit.

The findings from our investigation of the other 3 major customers follow the same trend: un-locatable or vague street addresses, no way to contact the company, very little information from Internet searches and SAIC filings that indicate shell operations. In addition, the two customers based in Northern

China (Daqing Huajian and Shenyang Rising) were incorporated just over a year ago around March – April 2010. For example, Daqing Huajian was incorporated on March 15 2010, just 2 weeks before it commenced the first LHD contract with CTE based on the 20-F. Together, these 3 customers accounted for 48% of CTE's FY 2010 revenues.

The Liaoning Ouya Dongdi Coalbed Gas Technology Development Co (14.75% of FY 2010 revenue) was visited by two separate investigators on separate days. Both confirmed that the only business present at the registered address is the consignment store on the ground floor of this old residential apartment, as shown in the picture below:

A close up of the sign confirms the address:

Likewise, the Shenyang Rising Methane Technology Service Co., the most recent customer that entered into a LHD service agreement with CTE starting in January 2011, could not be found at its registered address. Instead we found an apartment complex with a healthcare clinic and some other unrelated businesses on its ground floor. Building management has never heard of such company.

The following pictures document our site visit:

The following Table summarizes the results of our on the ground due diligence of the five major clients of CTE:

Customer Name	Liaoning Ouya Dongdi	Shenyang Rising	Daqing Huajian	Heibei Daofu	Panjin Hanyu
Contribution to CTE 2010 Sales	$6,685,067	New contract starting Jan 2011	$12,614,649	$10,434,521	$9,034,320
% of CTE's 2010 Sales	14.75%	$0	27.84%	23.03%	19.94%
2010 Revenue SAIC	$79,764	$148	$0	$7,385.5	$9,601
2009 Revenue SAIC	$0	$0	$0	$11,713	$17,570
Client purchase from CTE / 2010 revenue	8381%	N/A	N/A	141384%	94098%
Official Address	NO. 2, LANE 16, BEILING STREET, HUANGGU DISTRICT, SHENYANG, LIAONING PROVINCE	NO. 64 XINGGONG NORTH ROAD, TIEXI DISTRICT, SHENYANG, LIAONING PROVINCE	TIEREN ECOLOGICAL INDUSTRY DEMONSTRATION PARK, HONGGANG DISTRICT, DAQING CITY, HEILONGJIANG PROVINCE	NO. 4, NORTHERN NO. 11 BUILDING, XIHUAN BUILDING MATERIAL MARKET,RENQIU CITY, HEBEI PROVINCE	NO. 101, HUIBIN STREET, XINGLONGTAI DISTRICT, PANJIN, LIAONING PROVINCE
Attempt to contact	Unable to reach by phone, fax, no website	No website, a cell phone # registered at SAIC leads to some individual in Tianjin city that refused to talk when asked about Shenyang Rising.	No website. No one picks up registered phone # at SAIC.	Unable to reach by phone, fax, no website	Unable to reach by phone, fax, no website
Site Visit Findings	Registered address is at an old apartment building located on one of the oldest residential alleys in Shenyang city. The only business located at the address is a consignment shop that has never heard of Liaoning (Shenyang) Ouya Dongdi. Building security is also not aware of the company.	No. 64 Xinggong North Road is an apartment complex with hundreds of tenants, mostly residential. We called the building management to ask about Shenyang Rising Methane and were told they have never heard of the company.	The Tieren Ecological Industry Demo Park is as large as 410M sqft, even the developed zone is as large as 50-60M sqft. The mgmt office of the industry park confirmed to us that Daqing Huajian has no office or business activity in the park.	The registered current address is within a building material wholesale market with hundreds of vendors. The exact location where Hebei Daofu was supposed be at is occupied by a lighting fixture vendor, who doesn't know Hebei Daofu.	A locked office found during business hours. Investigator stayed on site for over an hour while office remained locked. Local SAIC said the last annual inspection report was filed by some individual who left a local fax number and a cell phone number from Tianjin.

In summary, the story we see unfolding is that shell companies with empty or unidentifiable offices are responsible for the vast majority of all revenues, expenses and capital investments of CTE. The fact that, as admitted by management, CTE has outsourced not only some of the operational duties, but also the collection of payments to these five subonctractors/customers, left us concerned that CTE's major business transactions records, supporting documents and financial invoices shown to the auditor all come from a tightly controlled network of shell companies, one of which appears suspiciously related to CTE itself.

We challenged CTE management to provide us with alternative addresses for these customers and were given four identical (yet vague) addresses to the ones we visited (Daqing Huajian, Liaoning Ouya Dongdi, Shenyang Rising, Panjin Hanyu). Subsequent phone conversations with Liaoning Ouya Dongdi and Panjin Hanyu arranged for us by the management also confirmed we previously visited the correct location. The "new address" for the undisclosed related party Hebei Daofu (任丘市会战大道 6 所 1 信箱) appears to be a post office box.

CTE's audited financials filed with Chinese government support all of the above findings

CTE has one operating subsidiary in the PRC, the Tianjin New Highland Science and Technology Development Co., Ltd. (TNH or 天津新高地科技发展有限公司). As the only PRC based subsidiary, its SAIC filings should closely resemble SEC filings, reporting full revenue, earnings, and similar assets. What we find is a company generating negligible revenue, annual losses, and limited assets including cash and PP&E. As TNH is a foreign invested entity in China, the annual financials submitted to the SAIC are audited. Note that the legal representative of TNH also signed on the front page of its annual joint inspection report, acknowledging his responsibility for the accuracy and truthfulness of the financial information submitted. The original audited financials (B/S, P&L and CFS) of filed by TNH to Tianjin Municipal SAIC can be viewed (here). An English translation of the financials can be viewed (here). In addition, we have further verified the accuracy of the audited financials from SAIC by comparing them to the ones filed with a different government agency, the State Administration of Foreign Exchange (SAFE).

The discrepancies between CTE's PRC and SEC financials, as summarized below, are inexplicably large:

Financial Statement Comparison
Sinotech Energy Limited (CTE)

	2009		
	AIC Filings (CNY '000)	AIC Filings ($ millions)	SEC Filings ($ millions)
Revenue	917	$ 0.134	$ 38.213
COGS	73	$ 0.011	$ 13.830
Net Income	(1,044)	$ (0.153)	$ 18.073
Cash	29,570	$ 4.329	$ 26.171
Receivables	567	$ 0.083	$ 8.619
Current Assets	30,448	$ 4.458	$ 49.648
PP&E	1,008	$ 0.148	$ 13.490
Total Assets	31,483	$ 4.609	$ 95.215
Liabilities	604	$ 0.088	$ 16.289
Shareholder Equity	30,879	$ 4.521	$ 78.926
Average CNY/USD		6.8307	
Ending CNY/USD		6.8259	

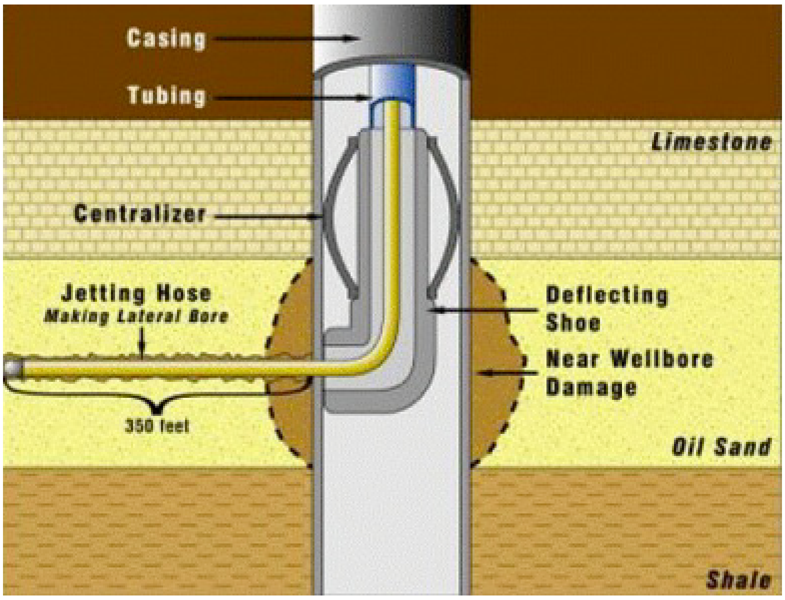
The business presented in the audited financials to the Chinese government is clearly a dramatically smaller company that cannot be explained away as a simple accounting or translational error/difference. Due diligence efforts on CTE's MDF supplier, LHD import agent and direct clients and subcontractors outlined above have indicated to us that the SAIC filings reflect the true state of SinoTech Energy. All evidence support the conclusion that SEC financial statements are unreliable.

Jet Drill's Competitor sells LHD units for less than 1/10th of the price CTE pays

We place no value on CTE's exclusive license to use Jet Drill technology, because we believe CTE's claim of exclusivity and proprietaries of the LHD technology lacks merit. Not only does competing radial drilling exist, but also it exists in China. We are able to identify 3 competitors that offer very similar solutions:

1) Radial Drilling Services Inc
2) Well Enhancement Services LLC
3) Maple Group

Furthermore Jet Drill technology is neither different nor better. Take a look at the websites of both Well Enhancement Services LLC and Shanghai Witsun Jetdrill Enhancement Services Co Ltd, a company that operates lateral water-jet drilling based EOR services in China. Our conversation with Shanghai Witsun confirmed that it purchases its lateral drilling rigs and equipment from Well Enhancement Services and offers the same services as CTE in China. Both competitors even use the IDENTICAL slide explaining the LHD technology used in CTE's 20-F:



This slide is a key obstacle to CTE's claims of exclusivity and uniqueness. Since Well Enhancement Services' website was set up prior to CTE's 20-F filing, Well Enhancement Services could not possibly have plagiarized this slide from CTE's 20-F.

A little history may help investors understand the competitive landscape a bit better. Well Enhancement Services was bought out by Radial Drilling Services (RDS), a company that did similar work in Eastern Europe and Latin America. Before discovering CTE and China, Jet Drill was as a contracted equipment manufacturer for RDS. RDS still operates Jet-Drill rigs in the US, and continues to grow the fleet (although they are no longer sourcing equipment from Jet-Drill). As of today, over 90% of Jet Drill's revenue comes from its biggest customer, CTE. Shanghai Witsun also continues to operate Jet-Drill equipment in China and is growing its fleet.

Maple Group has prepared an informative slide show (link here) comparing their technology to RDS and Jet-Drill, including market share statistics. Investors will find this presentation invaluable. Interestingly, Maple Group stated that with only 2 units in 2009, they already had 11% of global market share (a total 18 units globally). So assuming CTE's reported LHD revenues are true, the market in China today is essentially about the same size of the global market less than 2 years ago! That begs the question that, if the Jet Drill LHD technology is so incredibly profitable, why does it only work well in China? After all, our industry check suggests Jet Drill, up to today, has very minimal business in the US and is not taking any new orders until it upgrades its technology.

RDS is perhaps the largest and most sophisticated player in the radial drilling space, both in the US and abroad, with customers such as Luke Oil, Petrobras, Reposl, Chevron, Chesapeake, Inner Morgan etc. It has recently signed an agreement to start a joint venture with Yantai Jereh Oilfield Services Group (a public company listed in Shanghai under 002353) to offer EOR service in China. We spoke with RDS to learn more about the economics of this business. The most important thing we learned is that **an LHD unit should cost between only $300-700k** depending on "bells and whistles" installed, be it shallow or deep well units. This is approximately the cost of a fire truck, in line with what we would expect, and a far cry from what CTE management claims to pay for an LHD unit through Dongying Luda. We consider RDS's price quote very credible since they used to source the very same units from Jet Drill.

In addition, all three competitors we spoke to (RDS, Well Enhancement Services and Shanghai Witsun) expressed their belief that CTE and Jet Drill are "walking on thin ice" in terms of possible patent infringement. We have no opinion about the merits of competitors' claims but again it seems CTE's LHD technology is far from unique and terribly uncompetitive based on its inflated price. We believe that overpaying for these LHD units is an easy way management can take money out of the company without alerting auditors. This hypothesis is supported by the strong evidence noted earlier in this report that Dongying Luda, the sole import agent of CTE's LHD units, is likely a shell company,

CTE's Board of Directors lacks Independence and effective oversight

As a Cayman Island domiciled foreign issuer CTE is exempted from having a board composed of a majority of independent directors. Nevertheless we're surprised a NASDAQ Global Select Market listed company with over $250 million market cap refuses to hold itself to a higher standard. Only 2 out of the 6 directors on CTE board are, by definition, independent. One of the two is a PRC national who happens to have worked for the same Dagang oilfield with CTE's Chairman in the past. The only apparently independent and qualified director is the audit committee chair Ms. Jing Liu. We question how such a board can properly function in terms of the necessary oversight of company practices and protection of shareholders. Examples of the board's ineffective oversight include competition from related companies and related party dealings, both disclosed and undisclosed as follows:

1. CTE Chairman appears to own a separate entity competing in the same business. As the majority shareholder and Chairman of CTE, Mr. Qingzeng Liu should have no conflict of interest. However, Mr. Liu happens to be the CEO of Singapore listed SKY China Petroleum Services, Ltd (SKY China). The statement in Sinotech's 20-F claiming that SKY China's business does not currently compete with CTE is absolutely false and erroneous. The following is the description for SKY China's business:

SKY China Petroleum Services Ltd, through its subsidiaries, provides petro-engineering solutions to the oil and gas industry in the People's Republic of China. Its technical services segment provides engineering services in extraction of oil. The company's drilling services segment provides technical and mechanical engineering services in the supervision of the use of directional drilling technology for the reworking of old wells. Its extraction of crude oil segment has the operating rights to extract crude oil from the Song Yuan oilfield in Jilin province, the People's Republic of China. The company's rental of drilling rig segment is in the business of leasing drilling rigs to external parties. In addition, it involves in the provision of petroengineering technical services. SKY China Petroleum Services Ltd was founded in 1995 and is based in Tianjin, the People's Republic of China.

In face of the unverifiable sales from current major customers, an even more troubling fact is that a significant portion of CTE's historical revenues also came from SKY China's subsidiary, Dagang Shengkang Petroleum Development Co Ltd (39.7% of FY 2008, 34% of FY 2009 revenues) until its MDF subcontract at Dagang Oilfield was replaced by a new one with the questionable Hebei Daofu in FY2010.

2. **Other possible and undisclosed related party dealings.** As we have proven above, CTE's major supplier, import agent and large direct customers are all likely shell companies with unverifiable operations and negligible revenue. One of these entities, Hebei Daofu, turns out to be controlled and owned by one of the founding shareholders (Peiju Yan) of TNH, CTE's Chinese operating subsidiary. Is the board aware of this undisclosed related party dealing?

On top of this past connection, Hebei Daofu's legal representative Mr. Peiju Yan's PRC ID #13098419741127571X indicates to us that he happens to come from the same town where CTE Chairman Qingzeng Liu is originally from, Cangzhou City in Hebei Province (河北省沧州市).

We could not help but noticing, the shareholders or legal representatives of four other companies we investigated above (Dongying Luda, Tianjin Shanchuan, Panjin Hanyu, Daqing Huajian) are all from the very same town as Chairman Liu. Several individuals' PRC ID were even issued in the very same Xian county (献县) where Mr. Liu came from. Note that a county in China is much smaller than a town. The following table summarizes the shareholders/legal representative information:

Company	People	Name	ID#	身份证归属地	Location of ID issuance
Dongying Luda	Shareholders	Miao Zhijun	132924550604031	河北省沧州市献县	Xian county, Cangzhou city, Hebei Province
		Quan Xinkuan	412932196605181592	河南省 南阳市 桐柏县	Nanyang city, Henan Province
	Legal representative	Miao Zhijun	132924550604031	河北省沧州市献县	Xian county, Cangzhou city, Hebei Province
Heibei Daofu	Shareholders	Yan Peiju	13098419741127571X	河北省沧州市河间市	Hejian town, Cangzhou city, Hebei Province
		Wang Guihu	130922197411282013	河北省沧州市青县	Qing county, Cangzhou city, Hebei Province
	Legal representative	Yan Peiju	13098419741127571X	河北省沧州市河间市	Hejian town, Cangzhou city, Hebei Province
Panjin Hanyu	Shareholders	Du Xiaoping	132924197008028466	河北省沧州市献县	Xian county, Cangzhou city, Hebei Province
		Song Weijie	13092919870706847		Cangzhou city, Hebei Province
	Legal representative	Du Xiaoping	132924197008028466	河北省沧州市献县	Xian county, Cangzhou city, Hebei Province
Tianjin Sanchuan	Shareholders	Geng Chengwei	Missing		
		Zhang Yingyong	13290319691217801X	河北省沧州市任丘市	Renqiu, Cangzhou city, Hebei Province
	Legal representative	Zhang Yingyong	13290319691217801X	河北省沧州市任丘市	Renqiu, Cangzhou city, Hebei Province
Daqing Huajian	Shareholders	Cao Wenxi	12010919650926551X	天津市大港区	Dagang district, Tianjin City
		Zhu Xidi	130929198402038464	河北省沧州市献县	Xian county, Cangzhou city, Hebei Province
	Legal representative	Cao Wenxi	12010919650926551X	天津市大港区	Dagang district, Tianjin City
Sinotech Energy	Chairman	Qingzeng Liu	132903195912096511	河北省沧州市	Cangzhou city, Hebei Province

Since Cangzhou is not a big city, we wonder what are the odds that a total of 3 customers and 2 suppliers of CTE, while supposedly operating in different parts of China all happen to:

a) Be owned/managed by people from the same 2nd tier city from Hebei (five such people came from tiny Xian County (2004 population 570,000)
b) Have a significant percentage, if not all, of its business transactions with a U.S. listed company controlled by another businessman from the same home town
c) Have numerous shell company characteristics mentioned above, i.e. vague/unverifiable street address, un-locatable offices, missing phone numbers, little information from internet search and minimal revenues based on SAIC filings, etc.

It's also worth pointing out that two of the customers (Shenyang Rising and Panjin Hanyu), despite unreachable by fixed line phone numbers, both have cell phone numbers left on records at local SAIC that lead to some unknown individual in Tianjin city, where CTE's main subsidiary (TNH) as well as the Chairman's other related businesses are located. In addition, two supposedly unrelated companies, TNH and Tianjin Shanchuan, also just happen to have used the same local auditor to audit their 2009 SAIC financials signed off on the very same day. Does any of this sound like a legitimate operation?

Conclusion and Valuation – Less than $0.63 per Share

As we learned in the recent collapse of a large number of fraudulent companies operating in China, the typical audit is not as effective as one would expect. As shown in the cases of China MediaExpress (CCME), Longtop Financial Technologies (LFT), China Integrated Energy (CBEH) and Sino-Forest (TRE.TO), even the "Big 4" auditors failed to detect the frauds and were too quick to sign off on fabricated financials. Auditors find it especially difficult to detect fraud in businesses like CTE that have few, or highly overpriced physical assets. Our much closer investigation, however, clearly uncovered a company with a significant mismatch between SEC financial statements and the counterparts filed with Chinese government, with a network of shell companies acting together as a one-stop-shop to provide all business transaction documents, contracts and invoices to the auditor.

On August 12, 2011, we confronted management with our concerns, giving them a chance to challenge our findings. Although management originally stated they were willing to supply necessary documents to prove the existence of the 7 questionable entities, they were unable or unwilling to provide acceptable proof (such as tax declaration forms filed by these 7 entities at local tax bureaus, tax invoices issued by the tax bureaus and proof of tax payments from the financial institutions). We also requested management provide the correct business addresses of the 7 entities for us to verify. After 3 days, we were supplied a list containing five of the same addresses our investigator had previously visited and documented above (Tianjin Shanchuan, Panjin Hanyu, Daqing Huajian, Shenyang Rising and Liaoning Ouya Dongdi), one "new address" that appears to be a post office box (Hebei Daofu) and one new office address for Dongying Luda which we have been unable to visit. Most importantly, more than three days after CTE's CEO first admitted on a recorded call that he was unaware of the address of Donying Luda's LHD assembly facility, we are shocked CTE has still not provided us with this facility's address considering it handles the final assembly and testing of each of CTE's $6.5 million LHD units.

Management instead insisted they could prove the existence of business transactions between these 7 entities and CTE by supplying us with the same documents they gave to the auditor. We were not satisfied with this response, since all such documents are easily fabricated and the auditor, unlike our on the ground investigators, does not have the mandate or ability to scrutinize the operations of CTE's purported customers, suppliers or import agent. **As our research has shown, none of these 7 entities in question appear to be of sufficient size to produce the Sales/Purchases reported by CTE**. The only thing such shell companies are good for producing is mountains of paper based documents to help CTE pass an audit, as we have seen in many other recently collapsed frauds.

Given the likely very troubling implications (i.e. overstatement of revenue, earnings and capex, misappropriation of investors funds etc) based on the findings of our on the ground diligence, we believe the independent members of CTE's Board of Directors should, acting in their fiduciary duties to protect investors, immediately start an investigation and attempt to lock down whatever funds they can secure that are still located in accounts outside the PRC (offshore).

Given the extreme difficulty of recovering funds and assets located within China due to very limited legal recourse available to US investors, we believe the remaining offshore cash is the only value attributable to CTE. Management disclosed on the August 4 earnings call that such cash amounted to $38 million. Therefore we think CTE stock is worth $0.63 per share (with 60.49 million shares outstanding), before subtracting legal costs and based on the assumption that the minority of independent directors convince the majority of the Board to take prompt action to prevent further loss of this cash. Realistically, given the Board's lack of independence and effective oversight discussed above, we believe this cash will be "gone by morning" and expect investors will recover nothing.

NOTE: The authors of this report disclosed to Alfredlittle.com that they are short CTE.