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**Company:**
Sino-Forest Corporation
(TRE.TO, OTC: SNOFF)

**Industry:**
Forestry

**Recommendation:**
Strong Sell

**Estimated Value:**
< $1.00

**Report Date:**
June 2, 2011

**Price:**
$18.21

**Market Cap:**
4.2 billion

**Float:**
4 billion

**Avg Volume:**
1.4 million

- Like Madoff, TRE is one of the rare frauds that is committed by an established institution. In TRE's case, its early start as an RTO fraud, luck, and deft navigation enabled it to grow into an institution whose "quality management" consistently delivered on earnings growth.
- TRE, which was probably conceived as another short-lived Canadian-listed resources pump and dump, was aggressively committing fraud since its RTO in 1995.
- The foundation of TRE's fraud is its convoluted structure whereby it runs most of its revenues through "authorized intermediaries" ("AI"). AIs supposedly process TRE's tax payments, which ensures that TRE leaves its auditors far less of a paper trail.
- On the other side of its books, TRE massively exaggerates its assets. We present smoking gun evidence that TRE overstated its Yunnan timber investments by approximately $900 million.
- TRE relies on Jakko Poyry to produce reports that give it legitimacy. TRE provides fraudulent data to Poyry, which produces reports that do nothing to ensure that TRE is legitimate.
- TRE's capital raising is a multi-billion dollar ponzi scheme, and accompanied by substantial theft.

## Introduction

As Bernard Madoff reminds us, when an established institution commits fraud, the fraud can become stratospheric in size. Sino-Forest Corp. ("TRE") is such an established institutional fraud, becoming massive due to its early start, luck, and deft navigation. At nearly seven billion dollars in enterprise value, it will now end.

TRE started humbly – as a fraudulent company going public on the Toronto Venture Exchange via reverse takeover ("RTO"). Sixteen years later, Muddy Waters would be exposing its US-listed imitators – companies such as RINO, DGW, ONP, and CCME. It seems impossible that a Chinese RTO coming public in 2010 could ever get to where TRE did. But for many years, TRE sat barely noticed on the Toronto exchange. It was committing fraud from the very beginning; but, there were not enough similar frauds to raise investors' awareness.

Then in 2003, it changed its business model – moving to a level beyond standard capex schemes that most China frauds run. Its new model, purchasing trees, gave it limitless room for growing its fraudulent balance sheet and vacuuming up money from the capital markets. At the same time, China was becoming a major investment theme. TRE became more sophisticated – engaging Jakko Poyry to write valuation reports, all the while giving Poyry manipulated data and restricting its scope of work. Thus more and more investors are drawn into TRE's fraud every year as it falsifies timber investments and manipulates Poyry further. At some point, TRE became an institution – a seasoned stock with "quality management" that consistently grew earnings over more than a decade.

Were Muddy Waters not to have come along, it is likely that this fraud could have continued for a few more years and billions of dollars more. Solving this fraud was not easy. In order to conduct our research, we utilized a team of 10 persons who dedicated most to all of their time over two months to analyzing TRE. The team included professionals who focus on China from the disciplines of accounting, law, finance, and manufacturing. Our team read over 10,000 pages of documents in Chinese pertaining to the company. We deployed professional investigators to five cities. We retained four law firms as outside counsel to assist with our analysis. We are confident that we have brought more expertise, time, and money to bear in analyzing TRE than has any investor or bank – by a substantial margin.

## Executive Summary

Sino-Forest Corp (TSE: TRE) is the granddaddy of China RTO frauds. It has always been a fraud – reporting excellent results from one of its early joint ventures – even though, because of TRE's default on its investment obligations, the JV never went into operation. TRE just lied.

The foundation of TRE's fraud is a convoluted structure whereby it claims to run most of its revenues through "authorized intermediaries" ("AI"). AIs are supposedly timber trader customers who purportedly pay much of TRE's value added and income taxes. At the same time, these AIs allow TRE a gross margin of 55% on standing timber merely for TRE having speculated on trees. The sole purpose of this structure is to fabricate sales transactions while having an excuse for not having the VAT invoices that are the mainstay of China audit work. If TRE really were processing over one billion dollars in sales through AIs, TRE and the AIs would be in serious legal trouble. No legitimate public company would take such risks – particularly because this structure has zero upside.

TRE avoids disclosing the identities of all but one of its AIs "for competitive reasons." The one AI we know it has disclosed (at a credit analyst event in April 2011) is actually a connected party – to both TRE and one of its agents. Despite TRE's opacity on the revenue side, we have overwhelming evidence that the $231.1 million in Yunnan province timber TRE claimed to sell is largely fabricated. Such amount exceeds TRE's real timber holdings in Yunnan province. It exceeds the applicable harvesting quotas by six times. Transporting the harvested logs would have required over 50,000 trucks driving on two-lane roads winding through the mountains from this remote region, which is far beyond belief (and likely road capacity).

On the other side of the books, TRE massively exaggerates its assets. TRE significantly falsifies its investments in plantation fiber (trees). It purports to have purchased $2.891 billion in standing timber under master agreements since 2006. We have smoking gun evidence from Yunnan province that it overstated its purchases there by over $800 million. Of the five agents we have been able to identify (TRE does not provide Chinese names), Yunnan appears to have the only legitimate agent. The other agents have histories and connections to TRE that make it obvious they did not purchase billions of dollars in timber for TRE. Further, the other agents appear to be laundering money for TRE – moving large amounts of money to an undisclosed subsidiary of TRE and a trading company that TRE does business with. We also see clear evidence that TRE has falsified its books – Chinese government records make clear that TRE would have had a capital hole of $377 million to $922 million if it were making the investments it claims.

TRE then feeds the fraudulent data to Poyry, while allowing Poyry access to only 0.3% of its purported timber holdings. TRE touts the valuation reports as evidence of its credibility. One fresh example occurred at TRE's annual general meeting on May 30, 2011. At the meeting, CFO David Horsley emphasized to the shareholders in attendance that Poyry teams spend "six personal weeks" in the field for the valuations. On a June 1, 2011 telephone call with analysts to discuss the Poyry report, Poyry clarified that four men spent six days in the field, which the Company calculates is approximately six man-weeks.[1] Fortunately, it appears that in 2011 Poyry is becoming somewhat cautious about TRE using its name to bilk investors out of billions of dollars, and it has accordingly restricted how TRE may use the report.

TRE's claims to be "transparent" are interesting. Its offshore structure, which utilizes at least 20 British Virgin Island entities, is an unjustifiable black hole.

Auditors are far less effective in detecting fraud than most investors assume they are. The problem is that fraudsters are willing to forge documents. We show a suspicious letter from HSBC that was written on behalf of one of TRE's main subsidiaries, Sino-Wood Partners. We submitted this document to HSBC's department of fraud risk.

Another issue with auditors detecting fraud is that when the auditors are based in Canada, and the fraud is in China, the auditors are far less versed in the games fraudsters can play in China. As CCME and LFT show, even China offices of "Big Four" auditors have a number of issues detecting fraud. For most of its time as a public company, TRE's auditors have been Ernst & Young out of Canada. In TRE's case, the auditor problem morphs into another significant issue – that of TRE's poor corporate governance. TRE's board of directors appears to be the retirement plan for former Ernst & Young partners, and its audit committee members all fail PRC political,

[1] Muddy Waters is proud to say that by this methodology, we spent two man-years researching TRE and preparing this report.

industry, and cultural knowledge tests.[2] A favorite trick of Chinese RTO frauds is to gain credibility by putting Westerners without Chinese skills or background into management or onto the board. TRE probably pioneered the practice.

No fraud is complete without the payoff. Its constant capital raising is a multi-billion dollar ponzi scheme. We see some evidence of how TRE is stealing the hundreds of millions of dollars that have entered the PRC. Its financial tunnels include an undisclosed subsidiary that seems to act as a magnet for payments from many of TRE's disclosed PRC subsidiaries and the agents that purportedly purchase timber for TRE.

## Valuation

Because TRE has $2.1 billion in debt outstanding, which we believe exceeds the potential recovery, we value its equity at less than $1.00 per share.

### Sino Forest Equity and Debt Estimated Values

Sino-Forest has raised a total $3.05 billion from the capital markets. The capital structure consists of $1.892 Billion of bonds outstanding[3], Senior Secured Bank Loans of $207 million ($154.0 million from the Dec 31, 2010 financials and a new CNY 350 mil term facility. This makes debt outstanding $2.100 Billion.

In addition, it has raised $989 million of equity in shares sales going back to May 2004. Due to the SAIC filings, we know that a maximum of $1.2 Billion of cash has been injected onshore.

The Company also has a 63% stake in its listed subsidiary Greenheart Group, however, because we have concerns about this company, we do not factor it into our valuation.

The equity/credit analysis valuation analysis is very difficult as a result of the inability to rely on the audited financials and our belief that the company has far fewer assets than it reports. In order to value the equity and the credit, one has to assume one of two scenarios, both of which assume an injection amount of $1.2 Billion into China:

[2] TRE Management Information Circular, May 11, 2011, pp. 32-33

[3]

| Issuer | Cpn | Maturity | Amt Out(M) | Curr | Mty Type |
|---|---|---|---|---|---|
| Sino-Forest Corp | 9.125 | 08/17/11 | 87,670 | USD | BULLET |
| Sino-Forest Corp | 5 | 08/01/13 | 345,000 | USD | CONVERTIBLE |
| Sino-Forest Corp | 10.25 | 07/28/14 | 399,517 | USD | BULLET |
| Sino-Forest Corp | 4.25 | 12/15/16 | 460,000 | USD | CONVERTIBLE |
| Sino-Forest Corp | 6.25 | 10/21/17 | 600,000 | USD | CALLABLE |

Scenario 1: Assets in China are accessible to creditors and shareholders

If the assets in China were accessible, the first thing that creditors would have to do would be sell the small forestry assets that the company has and attempt to recover any cash balances. Given the propensity for theft, we will be liberal and assume that the recovery from asset sales and cash seizures is 50% of the amount injected – roughly $600 million. $50 million would be used to pay back the onshore RMB denominated debt. The rest would then need to be repatriated via a capital reduction process with SAFE, the Chinese capital account regulator. At an absolute minimum, the cost of offshoring this money would be around 15%, giving us a total recovery bull case of $467 million.

The offshore cash is not simply calculated by subtracted cash raised from cash moved into China. Management has been liberal with cash compensation. As well, they have spent $54 million on their Greenheart stake, $30 million in a consent payment for a bond exchange, and $7 million paying off Ms. Chen on the Homix purchase. If the convoluted BVI structure has yet to be used for theft, then the offshore cash balance could be as high as $1.5 Billion (Non-injected cash minus management compensation minus offshore acquisitions).

This gives us an asset base of $1.967 Billion in the best case, which we believe to be unlikely. Versus the current outstanding offshore debt of $1.893 Billion, the "real" best case net asset value is around $92 million. Divided by the current number of shares outstanding – 245 million - that leaves a share value of approximately C$0.38 at current exchange rates.

Scenario 2: Onshore Recovery of Zero.

Due to the time involved to actually change the legal representatives and liquidate collateral onshore, all the while chasing the cash balances and coordinating with authorities, historical precedent should show that there is little that can be done with onshore assets.

Using the above bull case of offshore assets, we estimate recovery for bondholders would be approximately 80 cents on the dollar, with a value of zero for the stock. Assuming that distressed investors target a 15% IRR (again, this would be extremely generous for a distressed Chinese credit), the absolute maximum an investor should be willing to pay for the credit is around 69 cents on the dollar. The recovery could be higher if less money was put into China.

Our belief is that the true recovery would be far lower, but without the aid of law enforcement, we will never really know how much money is there or where it went.

## I. TRE Was Always a Fraud.[4]

TRE was engaged in aggressive fraud from the time it went public. Between 1994 and 1996, it generated between 65% to 77% of its reported revenues from an equity joint venture[5] with the Leizhou Forestry Bureau. All of these numbers were fabricated. In reality, TRE breached its commitment to contribute equity capital to the EJV. TRE's conduct so incensed the Leizhou

[4] Appendix A5 – Chinese and English translations available.
[5] China has two classifications of Sino-Foreign joint ventures: equity joint ventures ('EJV") and cooperating joint ventures ("CJV"). The main difference is that in an EJV, profits and assets (upon winding up) are distributed in proportion to the parties' equity holdings. In a CJV, the parties may contract to divide the economics disproportionately to their equity interests.

Forestry Bureau that it filed with the Zhanjiang City Foreign and Economic Relations and Trade Commission ("COFTEC") a letter containing numerous grievances. We show this letter and a translation in Appendix A5. This letter and the rest of the EJV's SAIC file make clear that the EJV never achieved the any operation remotely close to that envisioned by the partners or described by TRE in its annual reports. Moreover, the Forestry Bureau accuses TRE of misappropriating cash through improper transactions.

In its 1997 annual report, TRE claims that its Heyuan and Guangxi CJV partners took over the (fictitious) wood chip business from the Leizhou EJV – even growing it by 193% that year. Considering the base year (1996) revenue was zero, we believe investors should assume that 1997 results from the CJVs were shy of $16.1 million TRE reported.[6]

TRE's penultimate fraudulent act in Leizhou was to claim that the Leizhou Forestry Bureau reimbursed TRE $12.43 million between 1999 and 2003 through a series of payments consisting of logs. This claim that the Forestry Bureau owed TRE in excess of $10 million dollars was a gross exaggeration of the facts and contradicts the EJV's SAIC file, improperly adding $12.43 to TRE's shareholders' equity. This type of phantom transaction would become the blueprint for TRE's massive fraud.

There was another critical outgrowth from the Leizhou EJV. Upon termination, TRE converted the company to a wholly foreign-owned enterprise ("WFOE"). The WFOE's business scope[7] included "producing and selling wood products." TRE wound this company down in December 2003. This is the same year it began telling investors that it used AIs to handle its sales because it was not licensed to sell woodchips and wood based products domestically.[8] In other words, TRE wound down a business that was licensed to sell wood chips; yet, at the same time was stating that it was forced to use AIs because none of its companies were licensed to sell woodchips in the domestic market. At that time, the Leizhou WFOE could have utilized this business to take over and carry out the proprietary sales of the wood chip and processed wood business. Essentially because TRE learned that it could successfully lie about operating a factory with a party known to shareholders, it went two steps further – lying about operating a trading business with a party unknown to shareholders.

## Leizhou EJV – The Ghost of Ventures Past

The Leizhou EJV, the Zhanjiang Leizhou Eucalyptus Resources Development Co. Ltd., came into being on January 29th, 1994. TRE subscribed to 53% of the equity, which was to total $10 million, and the total investment was established at $25 million. TRE's obligation was straightforward; it would contribute 53% of the investment in cash ($5.3 million) in phases. It was to inject 15% of the registered capital within three months of incorporation, and its portion of the balance of the registered capital within two years. It paid in one million dollars, which left a balance of $4.3 million. The Forestry Bureau was to contribute forest assets of 3,533 ha (note that this greatly contradicts TRE's Canadian filings, which state 20,000 ha), and other assets.[9] The articles of association show that the newly formed entity was created for the specific purposes of:

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[6] Annual Reports 1997 p. 21, 1998 p. 25
[7] Leizhou WFOE business certificate April 12, 2000 See Appendix A10
[8] 2003 Annual Information, p. 22
[9] Leizhou EJV, Articles of Association, 1993 See Appendix A2

> "Managing forests, wood processing, the production of wood products and wood chemical products, and establishing a production facility with an annual production capacity of 50,000 $m^3$ of Micro Density Fiber Board (MDF), managing a base of 120,000 mu (8,000 ha) of which the forest annual utilization would be 8,000 $m^3$."[10]

The application included a detailed feasibility study for the MDF board production factory including financial analysis, market studies, and production plans totaling over sixty pages. Leizhou Forestry Bureau's expectation was that the factory would generate profit, provide value-added manufacturing jobs, and introduce new technology and management knowhow. The articles also reveal a plan for the Leizhou Forest Bureau to make additional land available for harvesting and replanting that would total 8,000 ha (including the original 3,533 ha). This concept formed the basis of TRE's "phasing-in" program and was also utilized to inflate TRE's forest rights claims. However, the EJV never achieved "normal operations", and neither the plans for the manufacturing facility, nor any additional land utilization or forest acquisitions were executed. The signature of TRE's president, K.K. Poon on the amended articles evidences this fact.[11]

The EJV's 1995 PRC Capital Verification Report (contained in the SAIC file) showed that the JV lost $1.1 million (RMB 8,709,107).[12] The audit report also shows inventory of only $1,100 (RMB 9,000), which is hardly the level required to support an operation making weekly shipments of woodchips of approximately $400,000, as claimed by TRE.[13] By mid-1995, TRE had still not injected the balance of investment. The Forestry Bureau solicited the local COFTEC[14] to send a formal notification reminding TRE of its obligation. By the time the contribution deadline arrived in January 1996, the TRE management team was incommunicado.[15] After the Jan 29, 1996 deadline lapsed, Allen Chan and Chan Shixing failed to respond to formal letters. They also skipped a Board meeting called to resolve the issues.[16]

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[10] Id.
[11] Leizhou WFOE Amended Articles of Association, Appendix A3.
[12] 1995 Annual Audit Report
[13] In 1995, p. 13 of TRE's annual report claimed that TRE shipped out 204.2 BDMT of wood chips at an average price of $103/BDMT. This equals $21,032,600 USD, or approximately $420,652 per week based on a fifty week year.
[14] Zhanjiang City Foreign and Economic Relations and Trade Commission.
[15] Leizhou Forestry Bureau, Letter Requesting Termination of the EJV See Appendix A5.
[16] Leizhou Forestry Bureau, Letter Requesting Termination of the EJV See Appendix A5.

However, in Canadian filings, the Leizhou EJV was white hot. TRE disclosed the following information regarding the EJV.

| Calculated Leizhou EJV Annual Sales According to Avg. Price and Qty in BDMT Reported by TRE | | | |
|---|---|---|---|
| Year | BDMT (Thousands) | Average price (USD/m³) | Amount (Thousands USD) |
| 1994 | 156.3 | 85 | $ 13,286 |
| 1995 | 204.2 | 103 | $ 21,033 |
| 1996 | 212.5 | 102 | $ 21,675 |
| 1997 | 45 | 98 | $ 4,410 |
| Total | 618 | | $ 60,403 |

Source: 1994 ~ 1997 Annual Reports

TRE took a bit of a victory lap in its 1996 Annual Report, when it congratulated itself on the Leizhou EJV completing three years of profitable operations.[17] Moreover, the Company even claimed that the Leizhou EJV carried out $412,000 of research and development that year.[18] According to TRE, it was floating its partner (rather than the other way around) for $15.0 million:

> "The $14,992,000 due from the LFB [Leizhou Forestry Bureau] represents cash collected from the sale of wood chips on behalf of the Leizhou EJV. As originally agreed to by Sino-Wood, the cash was being retained by the LFB to fund the ongoing plantation costs of the Leizhou EJV incurred by the LFB."[19]

In 1998, the Leizhou Forestry Bureau finally lost its patience and submitted a letter to COFTEC containing numerous grievances, and requesting that the EJV be terminated.[20] In addition to grievances related to the failure to inject capital and develop the MDF board factory as planned, the Forestry Bureau accused TRE of improperly removing money and making payments to a third party with which the EJV had not done business:

> "After paying one million dollars, the foreign party not only failed to fully fund the company, but also approved in its own name the gradual withdrawal of funds in the amount of RMB 4,141,045.02 RMB [approximately $500,000], from the paid in capital provided by the company for the Joint Venture, among which $270,000 USD was paid out to the Huadu Baixing Wood Products Factory (花都市百兴木制品厂)，which has had no business relationship with the joint venture at all. This amount of money equals 47.6% of the money [TRE's] paid in capital. Although our side has almost entirely paid in the capital to which we subscribed (all but 0.9% of the subscription total), because of the limited contribution from the foreign party, and its withdrawal of a huge amount of money from among those funds it contributed, it is impossible to put into practice the project that the joint venture aimed to construct or set up and the intended production and business operation activities. This is because the funding has been insufficient and the

[17] 1996 Annual Report, p.22
[18] 1996 Annual Information, p. 8
[19] 1996 Annual Report, p. 20
[20] Leizhou Forestry Bureau, Letter Requesting Termination of the EJV, Appendix A5.

foreign party did not contribute the majority of the equity to which it subscribed. The joint venture therefore is merely a shell, existing in name only." [21]

In additional to phenomenally inflating the sales of woodchips from the EJV, TRE planted the seeds for a new mechanism that would propel its near infinite NAV growth, and enable it to create billion dollar forest accounts out of thin air. In the 1996 Annual Information Form, and that of previous years, TRE claims that the Leizhou JV had already "phased in" 20,000 ha of plantation lands from the Forestry Bureau. [22]

However, the Articles of Association clearly stipulate that if the project requires capitalization beyond $25 million USD total investment, then the foreign partner would contribute additional cash, and the Chinese partner would make additional in-kind contributions in the form of land use rights and forest assets.[23] Since the project was never fully capitalized, there was no need for the Chinese partner to make additional in-kind contributions, and therefore no new forest assets would have been added to the venture. Additionally, the 8,000 ha, were discussed in the Articles only in the section pertaining to the long range planning for the company. Those sections of the Articles defining the parties' respective capital contributions specifically state 3,533 ha (53,000 mu) as the Leizhou Forest Bureau's contribution.[24] In short, no additional contribution under a "phase –in" plan took place.

In addition to deducing that a scorned government EJV partner would not unilaterally contribute additional forest assets to support a manufacturing facility that had never been constructed, there is documentary proof that since inception, no significant increases in assets occurred. The EJV's PRC audit reports from 1995 and 1997 show no change in the intangible assets, under which heading forest assets are classified.[25] Had an additional 16,500 Ha been phased into the EJV, intangible assets would have increased by approximately RMB 86 million.[26]

In 1998, the two parties agreed to wind up the EJV. In the separation agreement, the parties agreed that the Forestry Bureau would receive all of the assets the Forestry Bureau originally contributed, and TRE would keep the entity and look for a new partner.[27]

Interestingly, in its 1997 annual report TRE described the agreement to terminate the EJV as entitling it to $12.4 million worth of assets from the LFB. TRE stated that it would in lieu receive payment over three years in the form of 730,440 m3 of standing timber the Forestry Bureau owned.[28]

Four years later, the 2003 Annual Report includes a claim that the Company completed its recovery of open receivables from the Leizhou Forest Bureau with a final collection in the amount of $10.2 million in the form of standing timber.[29] It is hard enough to collect on a debt

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[21] Id.
[22] 1996 Annual Information, p. 5
[23] Leizhou EJV, Articles of Incorporation, 1993, p. 3 Appendix A2.
[24] Leizhou EJV, Articles of Incorporation, 1993, p. 2 Appendix A2.
[25] The 1997 audit report breaks out the forest rights as being valued at RMB 18,454,766. Appendix A9.
[26] The 1997 audit report itemizes the forest assets at a value of RMB 18,454,766, which equates to a total of 5,223 Rmb/Ha. A net increase of 16,467 Ha therefore should result in a net increase of 86,016,029 rmb. Appendix A9.
[27] Board Resolution, Leizhou Resources Development Company, June 3, 1998 See Appendix A6.
[28] 1997 Annual Report
[29] 2003 Annual Report, p. 34, 40

when the debtor really owes you money. It is substantially harder when you are really the debtor, and the counterparty is a government agency.

| Leizhou WFOE<br>A/R Collections from Leizhou FB | | |
|---|---|---|
| Year | Amount ('000 USD) | |
| 1999 | $ | 1,125.00 |
| 2000 | $ | 1,063.00 |
| 2001 | $ | - |
| 2002 | $ | - |
| 2003 | $ | 10,242.00 |

Source: TRE Annual Reports

After the exit of the Leizhou Forest Bureau, the Company did not locate a new joint venture partner. In May of 1999, TRE converted the EJV into a Wholly Foreign-Owned Enterprise ("WFOE"). In April of 2000, the WFOE's new scope of business, which included producing and selling wood products, was formally approved.[30]

However, after receiving approval to reduce the size WFOE's remaining required capital contribution to only $1.4 million,[31] TRE still failed to do so for another three years.[32] In October of 2003, TRE finally wound down the Leizhou WFOE (without having contributed the additional capital). The application for deregistration was made on Oct 28, 2003 and approved by the Guangdong Zhanjiang COFTEC on November 4, 2003.[33] The key point to note is that in the 2003 Annual Report, TRE began disclosing that it needed to conduct business through authorized intermediaries due to lack of proper licensing, while failing to disclose that in the fourth quarter of the year, it was winding down an existing WFOE that had the business scope to do the business.[34]

<u>How to Succeed in Business Without Really Trying (by Finding AIs)</u>

TRE's initial AI model was that it purported to buy logs, turn them into woodchips, and then sell them to customers. TRE disclosed in 2003 that it had been engaging in this model via its Heyuan and Guangxi CJVs. (TRE makes shameless use of the corporate memory hole.)

This model appears to be a tortured attempt to create an accounting event for TRE even though it risked no capital and moved no physical goods. (TRE would later make this look less tortured by creating a third party to the transactions, the agent, which probably made its auditors feel better.)

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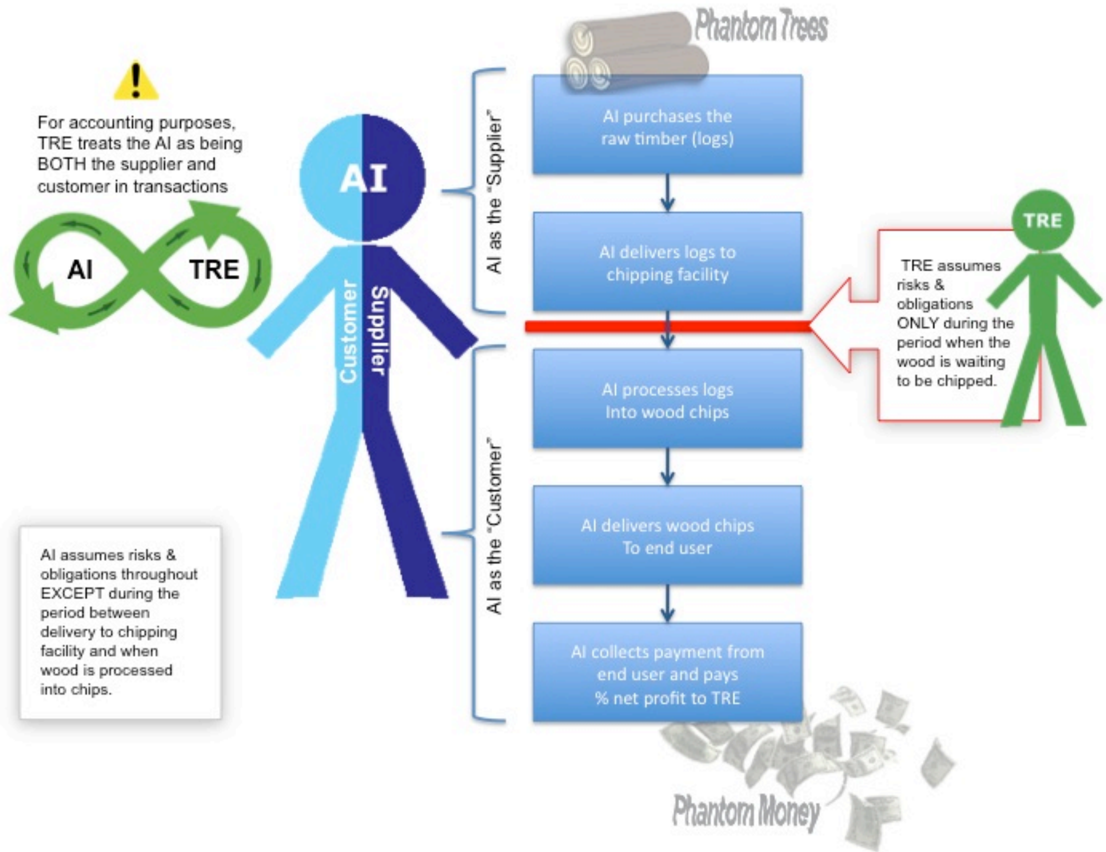
[30] Board Resolution, Dec 1, 1999; Wholly Foreign Owner Enterprise Change of Registration Approval, April 12, 2000. Appendix A10.
[31] Leizhou WFOE Application for Deregistration, Oct 28, 2003 Appendix A8; Zhanjiang COFTEC Approval for Reduction in Registered Capital, Dec 28, 1999. See Appendix A7
[32] 2000 Annual Information, p. 26
[33] Application for Deregistration of a Foreign Invested Enterprise, Guangdong State Administration for Industry and Commerce, Oct. 28, 2003 See Appendix A8.
[34] 2003 Annual Information, p. 22

According to the description in its 2006 annual information of how these transactions worked, TRE (through the magic of AIs) booked revenue and profit, but

- did not commit capital to purchase the logs,
- did not enter into contracts to purchase the logs from suppliers,
- did not take title to the logs,
- did not at any time store (let alone view) the logs,
- did not commit capital to process the logs into wood chips,
- did not contract to process the logs into wood chips,
- did not market the wood chips,
- did not enter into contracts to sell the wood chips, and
- did not receive cash from the parties purchasing the wood chips.

Instead it "agreed to reimburse the costs of the AI, including the cost of the purchase of raw timber, and to pay both a processing fee and management fee…" However, "…all of [the aforementioned fees] are deducted from the sales proceeds of the wood chips." In other words, TRE would not pay any money because the AI would be "reimbursed" when it sold the chips.

In order to make these transactions into accounting quasi-reality, TRE assumed "all risks and obligations relating to the raw timber once it arrives at the premises of the AI until it is processed into wood chips, except for any loss arising as a result of the AI's default." As the same filing specifies, the AI assumed the risks and obligations of the timber at all other times – from the time it is purchased until title passed to the customer. The below diagram illustrates the purported transactions:




Essentially, TRE's assumed risk was that a meteor would destroy the wood while at the AI's facility (assuming that the contracts lacked force majeure clauses). For this invaluable service, the AI paid TRE a fee on a "net basis after withholding of applicable taxes by the AI." In other words, there was no tax documentation that can be used to confirm whether TRE actually received any money in this way.

Believing that TRE actually generated substantial revenue this way strikes us as akin to believing in the power of diving rods to find precious metals. However, TRE was able to apply the same principles to a model that allowed it to raise billions of dollars more. The model is dealing in standing timber.

**II. "AI" Really Means "Artificial Intermediary"**

The structure of using anonymous parties that purportedly purchase from TRE without requiring TRE to generate VAT invoices allows TRE to invent sales figures without fear of being exposed by tax bureau records. Given that TRE has mostly been audited by accountants based in Canada, using this structure to commit fraud takes more audacity than skill. If TRE really is using an AI structure, shareholders should demand management be replaced immediately because TRE is running substantial and unnecessary legal risks. We are convinced that this model does not really exist though, so no board meeting to discuss the illegalities of the AI structure is yet necessary. As far as we are aware, TRE has disclosed the identity of only one AI, which happened at a recent credit analyst event in China. However, this purported AI's general manager, Lei Guangyu, is part of a web of shadow players spanning the AI, an agent, TRE, and Greenheart. He and the AI are closely related to TRE.

TRE May be a Great Supplier, but How Much Prison Time Would the AIs be Willing to do for TRE?

In a legitimate public company, management would be summarily dismissed for using TRE's AI structure, if it had not already been arrested. This model would violate fiduciary duties, and because it is so blatantly illegal in the PRC, would probably be beyond the scope of D&O coverage. Furthermore, it would be difficult for TRE to find a counterparty willing to work with it in this model in size. The size of the transactions is so large that the AI management would possibly be committing offenses that could land them lifetime prison sentences.

On the other hand, the cure for the problems is simple. TRE, which already has over 60 wholly-owned companies in the PRC, could buy and sell timber through new or existing WFOEs (wholly foreign-owned enterprises). It could pay its own VAT and enterprise income tax ("EIT"). This is what practically every other foreign investor with at least $100,000 in its pocket does.

It is illegal for foreign companies to engage in domestic (i.e., non-import / export) business in the PRC without having incorporated a local subsidiary to carry out the business. The PRC deems profits generated by foreign companies doing domestic business without a domestic subsidiary to be illegal. The prior two years of illegal profits are subject to confiscation. Therefore, if TRE were really using this structure for its BVI subsidiaries, they would be risking confiscation of the prior two years of their profits.

As foreign enterprises conducting domestic business in China, TRE's BVI entities would still be subject to the PRC corporate income tax. TRE's failure to pay corporate income tax for its profits generated in China would subject TRE to penalties more severe than those disclosed. The penalties (on top of the unpaid tax) would be 50% to 500% of the unpaid tax. There is no statute of limitations that would prevent the tax bureau from recovering all of TRE's unpaid taxes with per day surcharges and penalties.

Because of TRE's disclosed contingent tax liability of $156.9 million, it is clear that TRE's entities conducting a sizable portion of its business (whether foreign or domestic) are not paying taxes themselves under their own tax registration. Nor are the AI acting in a legal manner merely as tax payment agents that pay tax to the tax bureau in TRE's name. While such a situation would be critical for any company with sizable China operations, because TRE is free cash flow negative, such penalty would endanger TRE's solvency. Regardless, this is not what TRE is really doing. It is lying about selling such large volumes of timber to the AIs.

TRE would have numerous problems with the AIs trying to pay TRE's value added tax ("VAT"). Entering names other than the seller of the good on a VAT invoice is a tax crime. The penalty for VAT invoice-related crimes on large VAT amounts can be a lifetime prison sentence for managers of companies engaged in this behavior. We assume that many of these VAT payments would be in excess of the threshold to trigger such penalty; therefore, the managements of the AI would be risking the sentences in these transactions. It is difficult to understand how TRE generates a 55% gross margin from the AI on standing timber sales all the while risking their lives. TRE does not appear to add that much value.

TRE and the AIs' chances of getting away with the scheme would be low. The PRC banking system has controls in place for anti-money laundering purposes. The tax bureau is part of this platform. We consulted an attorney who is an expert in tax, foreign exchange, and banking matters. The attorney advised us that it is highly unlikely that TRE could have such large amounts of RMB sloshing around the banking system without corresponding VAT documentation. Note also as discussed infra in The Capital Hole, TRE's BVI companies would be unable to open up RMB bank accounts.

Because the AIs are not importing this timber, they would not have customs invoices, and would not be able to convert RMB into foreign currency and pay TRE offshore. While it is possible that the AIs could pay TRE offshore from the AIs' existing offshore accounts, with over one billion dollars in payments being made annually, the AIs would likely be left with unmanageable foreign currency / RMB imbalances. Therefore, the banking system and foreign exchange controls would likely have long ago ended TRE's AI business – in an unpleasant way.

*Everybody's All-Intermediary: Lei Guangyu*

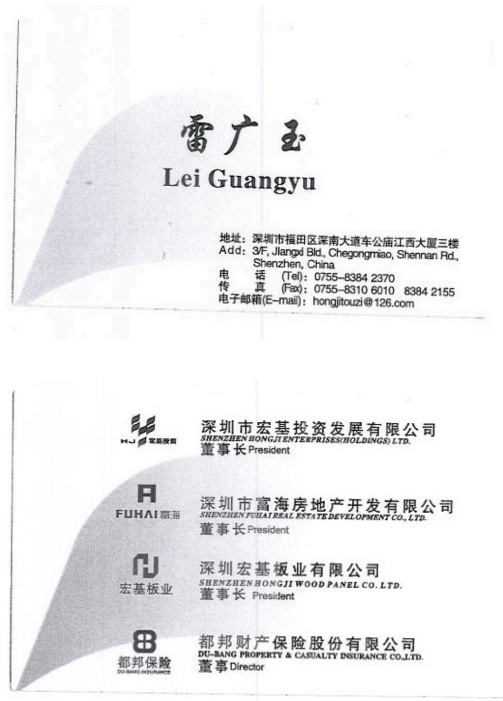
To our knowledge, TRE has only unveiled one AI to investors. In April 2011, TRE introduced credit analysts to Lei Guangyu, who is the president of Shenzhen Hongji Enterprises (Holdings) Ltd. ("Hongji"). Both Lei and Hongji are related to TRE. At the time that TRE sold its 12.73% stake in Greenheart Resources Holdings Ltd. to Omnicorp, Lei Guangyu was the signatory for two BVI entities, Fortune Universe Ltd. and Spirit Land Ltd., which held a combined 7.41% of Greenheart. The 2007 audit report from one of TRE's subsidiaries, Heyuan Jiahe Forestry Development Co. Ltd. ("Jiahe"), lists an account payable to Hongji for approximately $400,000 (RMB 2.7 million) as a related party transaction. According to the audit report, Hongji's relationship to Jiahe is that they are both subsidiaries of the same parent. See Appendix BB1.

Hongji is engaged in irregular transactions with TRE. One of TRE's key PRC subsidiaries, Sino-Forest (China) Investments Co. Ltd. had an account payable of $4.2 million (RMB 35 million) to Hongji at the end of 2005. This is a large amount of money in the context of TRE's onshore transactions that we have been able to see. Further, it shows a flow of funds opposite of what should occur (i.e., AI to TRE).

We sent a field agent to Hongji's headquarters in Shenzhen. It has a subsidiary called Gaoyao Hongji Panel Co. Ltd.. The legal representative of this company Wang You Wang is the signatory on a lease contract for the factory belonging to Guangdong Jiayao Wood Development Co., Ltd., one of TRE's key subsidiaries. Gaoyao Hongji also appears to be the "arms length" purchaser of $30 million in machinery from TRE's Guangdong Jiayao on March 31, 2009. However, the owner of the company that leased the factory from TRE is a TRE and agent executive, Lam Hon Chiu. (We discuss more about Mr. Lam in TRE's Dodgy Timber Agents.) We are not sure what to make of this transaction, but it does not appear to be arms length to us.

As an aside, it appears that Hongji does not buy domestic timber from TRE. According to the person with whom we met at headquarters, Hongji primarily deals in timber imported from Russia and South America.

Below is Lei Guangyu's business card.




**III. Gengma, Yunnan: Illegal Logging or Fraud? Timber Sales are Beyond PRC Quota**

According to TRE's 2010 Management's Discussion and Analysis, the Company sold $507.9 million of Standing Timber, of which 45.5% ($231.1 million) of the sales were derived from broadleaf trees in Yunnan at an average price of 102 RMB/m³. This equates to 2,265,000 m³ of broad leaf timber in the form of "large logs".[35] In TRE's 2010 Annual Information Form, its claimed yield for broad leaf is between 105 to 210 cubic meters per hectare, which means that approximately between 10,800 ha (hectares) and 21,600 ha would be required for this sale. However, the 2009 Poyry report noted a regulation prohibiting clear cutting of these forests and revised the yield downwards by 50%:[36]

> Poyry has this year become aware that, under current regulations, this crop type cannot be clear-felled, but must be selectively logged, with only up to 50% of the volume allowed to be removed. Poyry has consequently adjusted the yield table for the broadleaf crop type, from 181 m³/ha to 90 m³/ha to reflect this constraint.[37]

At a maximum of 90 cubic meters per hectare, at least 25,000 ha would be required for this sale. That is the equivalent of approximately 96 square miles, or one and one half the total area of

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[35] In the June 2, 2011 Poyry/Sino-Forest joint conference call, the Poyry consultant further specified that the high price for the Yunnan broad leaf of $102/m³ was for "large logs"
[36] Sino-Forest Corporation, Valuation of China Forest Crop Assets As at 31 December 2009, Final Report, pp. 15 and A5-3. http://www.sinoforest.com/filings.asp
[37] Sino-Forest Corporation, Valuation of China Forest Crop Assets As at 31 December 2009, Final Report, pp. 15 and A5-3. http://www.sinoforest.com/filings.asp

Washington D.C. The volume required under either yield calculation is enormous and in excess of both TRE's contracted holdings as well as the Lincang region's local quota.

First, as described in detail in section IV of this report, TRE's contracted holdings in Yunnan are in Lincang City and amount to only 20,000 ha (300,000 mu, 15 mu = 1 ha), not the 200,000 ha claimed by the Company.[38] The 25,000 ha equates to 375,000 mu of forest land.[39] This 375,000 mu needed for the transaction is 75,000 mu in excess of its total contracted holdings and also ignores any previous depletions made in the years 2009 or 2008.

Second, the forest area required for harvest exceeds the total area available in the Lincang region under the annual quota of both 2010 and 2011 combined. In China, forest harvests have been strictly controlled through a quota system since 2001, with quotas established in the Five-Year Plans. The Provincial Forestry Bureaus proposes the quotas to the National Forestry Bureau and the State Council, which have approval responsibility. The Provincial Forestry Bureau then allocates quotas to the local forestry bureaus. Using the maximum yield estimated by Poyry of $90m^3/ha$, the minimum harvest area of 25,000 ha required to complete this sale by far exceeds the permitted logging quota for the Lincang City (which includes Gengma county) where the Company's operations and land holdings are located.[40] Our local field work in Lincang and Gengma, our calls to the Lincang and Gengma Forestry Bureaus, and open source research all confirm that this alleged sale of 2,265,000 $m^3$ of Yunnan broadleaf exceed the full available quota for natural forest (the classification for hardwood broadleaf) of not just the year 2010, or the two years of 2010 and 2011 combined, but all of 2010, 2011, 2012, 2012, 2014, and all of 2015! Our field agents contact the Lincang Forestry Bureau for re-confirmation of this fact, and the section chief there confirmed that the full years quota for each of 2009, 2010, and 2011 was 376,000 $m^3$.[41]

| | |
|---|---|
| Yunnan Lincang City Region Annual Quota for Natural Forest ('10 & '11) | 376,000 $m^3$ |
| Years of Quota Req'd to Meet 2010Harvest From 2,265,664 ($m^3$) | 6.02 years |

**How Much Forest Did Sino-Forest Forest if Sino-Forest Could Forest Forest?**

Even if TRE's was able to simultaneous arrange unite a network of provincial traders in five surrounding regions, including from major competitors with both forests and local mills and plants, such as Yunnan Jinggu, Taixing Forestry, and Shanshui Forestry, around the common goal of filling TRE's order, there remain enormous bureaucratic and logistical obstacles. all of which could only be achieved through an miracle of political, labor, and logistics worthy of the last Great Chairman, Chairman Mao.

Assuming for a second, that all of the requisite plantation rights, logging permits, and transportation permits were properly secured, the actual task of logging still would need to be completed. The 2009 Poyry report explained that the typical harvesting practice in China as labor-intensive. This is especially so because of the required selective logging required for Yunnan broad leaf. Poyry states that, "Trees are typically felled by axe or handsaw, cut to length

[38] See Lincang City, Reply Regarding the Request for Approval D3 (English)
[39] Chinese land is typically measured in Mu (亩). 1 hectacre (ha) = 15 mu.
[40] Muddy Waters field research, and Lincang City Forestry Dept., Lincang Quota, See Appendix C1
[41] Muddy Waters field research, and Lincang City Forestry Dept., Lincang Quota, See Appendix C1

in the forest and then carried to the roadside by hand."[42] Additionally, Poyry found that logging broadleaf in Yunnan would be more expensive than any other region in China because of the mountainous terrain and the distances required for carriage of logs to a truckable road.[43] In the few of the Company's plots that Poyry visited in Yunnan in 2009, its forest description notes frequently indicate that the plots which had the best trees with "good form" or "higher stocking and standing volume" were either in places that were "remote", "several km from the nearest navigable road," or with "slopes [that are] steep up to 35 degrees" making the harvest all the more arduous.[44]

To understand the sheer magnitude of the task involved, it is important to understand that Yunnan is a remote, rugged, mountain province that rises from the mountainous border areas of Burma and Laos all the way into the Tibetan Himalayas. Lincang itself is 92% mountainous, with two peaks over 3,000 meters (9,000 ft.), Lincang Snow Mountain and Yongde Snow Mountain, and its southern border drops down to the banks of the Lancang river (headwaters of the Mekong) in a progressive sequence of mountains and valleys.[45] In this rugged geography even the less mountainous, or "hilly" areas, would make for a difficult harvest. The prospect of harvesting any sizeable quantity of logs by hand would be daunting, magnifying the inefficiency exponentially. This brings us to another major hard constraint in this supply chain: logistics.

If by some miraculous feat of human labor, the Company's army of farmers was able to selectively harvest the 2.2 million cubic meters of logs, there is the issue of actually transporting all of the wood. The roads through the mountains are dangerous, with switchbacks, steep precipices, and even no guard rails in the more remote mountain sections; roads leading into the agricultural areas are of a lower quality and often unpaved.[46] During the rainy season, which lasts from May to October, travel by road is further complicated by mud and occasional landslides. According to a local wood trader in Gengma city, Yunnan, the typical load for a small truck is about 20m$^3$ and a large truck is 30 m$^3$. Even if TRE was able to load up all of its trucks with 25 m$^3$ and 35 m$^3$ of logs per load, somewhere between 65,000 to 90,000 truckloads would have been required to make the journey to nearest rail station 200 km (120 miles) away, assuming no losses of trucks or logs while navigating the precipices and hairpin turns.[47]

In short, unless this sale of 2.2 million cubic meters of broad leaf timber from Yunnan was fulfilled illegally (in excess of quota and without all of the requisite permits) and accomplished with an army of Chinese farmers and shipped out via a secret under-ground train tunnel running below the mountains, it either never happened or was grossly over-inflated.

### IV. TRE's $800 Million Yunnan Scam Shows Timber Holdings are Forged

TRE claims to have purchased, under various master purchase agreements since 2006, timber costing $2.891 billion. Smoking gun evidence shows that TRE overstated purchases from the

[42] 2009 Poyry report, p. 21 http://www.sinoforest.com/filings.asp
[43] 2009 Poyry report, p. 22 http://www.sinoforest.com/filings.asp
[44] 2009, Poyry report, pp. A3-3 to A3-7. http://www.sinoforest.com/filings.asp
[45] Muddy Waters Research field work in Lincang and Gengma. For more information on Lincang city and the surrounding regions see: http://www.yunnanadventure.com/YunnanGuide/Lincang-Travel-Guide.html, http://www.seeyunnan.net/view.asp?id=224
[46] Blog: http://uselesstree.typepad.com/useless_tree/2011/04/dazhai-yunnan.html
[47] Muddy Waters Research Reports by FM and team.

Yunnan agent, Gengma Dai and Wa Tribes Autonomous Region Forestry Co. Ltd.[48] (also known as Gengma Forestry Co. Ltd. – see Appendix D1), which appears to be a legitimate agent, by approximately $800 million.

The value of purchases made under Yunnan master agreement is overstated by approximately $800 million. TRE announced in March 2007 that it had entered into a master agreement to purchase up to 200,000 hectares of plantation trees in Lincang City, Yunnan Province.[49] (Note that Gengma County is a sub-division of Lincang City.)

The SAIC file for TRE's Yunnan entity, Sino-Panel (Gengma) Co. Ltd. and the Lincang City Forest Bureau's 2008 – 2010 Work Completion Reports contain the following documents, which we used to understand the real terms of the Yunnan master agreement:

1) the Approval Letter by the Lincang City Commercial and Business Bureau (临商发《2007》68号) (Appendix D2)
2) the Approval Letter by Lincang City Development and Reform Commission (临发改经贸发《2007》234号) (Appendix D3)
3) the Lincang City's Forest Bureau 2008 Work Completion Report Summary and 2009 Work Leads (临林发［2009］1号) (Appendix D4)
4) the Lincang City's Forest Bureau 2009 Work Completion Report Summary and 2010 Work Leads (临林发［2010］1号) (Appendix D5)
5）the Lincang City Forest Bureau's 2010 Half Year Work Completion Report and Planning for the Second Half. (Appendix D6)

[48] This is the agent that TRE refers to as the Gengma Dai and Wa Tribes Autonomous Region Forestry Company in its March 2007 announcement of the master agreement.
[49] See Sino-Forest website.

The approval letters state that TRE has entered into an agreement to acquire 6,667 ha (300,000 mu) of forest plantation in Lincang City. TRE acquired 75,000 mu in 2007 from Gengma Forestry Co. Ltd. The Yunnan agent told us that after TRE completed this purchase, it helped TRE acquire another 13,333 ha (200,000 mu) in the nearby Lincang counties of Mengding and Cangyuan. Below is a photo of the agent's office that our field agent took.

Lest there be any doubt that the approvals omitted the other 160,000 ha that TRE claims is covered under the agreement, information about the local economy and forest industry make it clear that TRE did not enter into agreements to acquire such a large amount of forest, and at such a high per unit price.

The 2008 Work Completion Report states that Lincang City's forest industry output was approximately $380 million (RMB 2.6 billion). The report also states that the forestry business received only $32 million in foreign investment in 2008. TRE would have represented 80% of the forestry GDP for the entire city – let alone county. It would have invested approximately substantially more than the city reports in foreign investment in the industry. (Again, their main operation is in Gengma county, which is a sub-division of the city.) In the 2009 Report, the industry output reached approximately $440 million for the entire city. More interestingly, the report states that the city only issued forest rights concessions of 267 ha (4,000 mu) for the year. The 2010 semi-annual report states that as of 2010, Lincang City had issued forest rights concessions of 45,526 ha, valued at approximately $50 million. From these numbers, we can see that TRE is overstating the per hectare cost by about four times. Below is the calculation based on Lincang City's numbers:

$50 million / 45,526 ha = $1,098 per ha

vs.

TRE's claimed purchase price of $4,865 per ha.

The sheer scale of TRE's claims regarding its Lincang City, Yunnan transaction contradict reality. The Bureau of Statistics of Lincang stated the GDP of Lincang City was $3.1 billion in 2010 (Appendix D7). This contract alone would have caused local GDP to grow to four billion dollars, making Lincang the next Shenzhen in terms of growth rate.

From our fieldwork, we were told that Gengma County's 2010 total GDP was only $475 million. If TRE were to be believed, it would have been the vast majority of the entire economy of the county.

Further, we made calls to a local wood product manufacturer that appears to be one of the larger such companies in the area. He is familiar with TRE, and stated that he believes TRE purchased about 150,000 mu of plantation forest, which is in line with the documents we obtained. We spoke with a local official at the Gengma County Forestry Bureau who stated that TRE purchased 50,000 to 60,000 mu of forest. This range is a decent bit lower than the amount stated in the documents. The constant throughout is that the measurement unit is mu (again 6.7% of a hectare).

By all indications, the Yunnan agent is a legitimate agent. At least it is the only agent with a relevant scope of business. Its scope of business includes "wood and wood product purchasing, processing, and sales；forestry and forestry-related product planting, purchasing, processing, and sales; specialized economic forestry and wood project development and construction…" ("木材及木材制品收购、加工、销售；林业及林下产品种植、收购、加工、销售；特种经济林木及制品德基地建设和项目开发…")

## V. TRE's Dodgy Timber Agents

*Four Other Agents are Highly Unlikely to Have Sold the $2.9 Billion TRE Claims to Have Bought*

Four other agents are highly unlikely to have sold anything close to TRE's claim of a combined $2.9 billion. These agents, which would be among the largest private businesses in their locales, generally operated out of apartments while purportedly each doing annual revenue in the hundreds of millions from TRE alone. Two of these agents are managed by a senior TRE executive, Lam Hon Chiu.

TRE does not disclose the Chinese translations of its agents' names. We obtained the Chinese names from PRC audit reports (contained in the SAIC files) of various TRE subsidiaries. We show the various audit report pages with the agents' names in Appendix E1. We did not obtain the Hunan agent's SAIC file in time for this report, and we did not find the Chinese name for the Guizhou agent.

Guangxi agent: Zhanjiang Bo Hu Wood Co. Ltd. (湛江博虎木业有限公司)

TRE claims to have entered into a master agreement in December 2007 under which (as of December 31, 2010) it has purchased 150,000 ha of plantation for $646.6 million. We are skeptical for the following reasons:

- Bo Hu was incorporated only one month before TRE entered into this massive contract. See the business license in Appendix E2.
- Bo Hu was thinly capitalized at the time of entering into the agreement – its registered capital was only $135,000 (RMB one million) at the time. Obviously Bo Hu was not extending any credit to TRE for the tens of millions of dollars in timber purchases it was likely making at a given time.
- Bo Hu's scope of business does not include anything related to forest agency (unlike the Yunnan agent supra). Its scope of business at the time of purportedly entering into the agreement was "wood products, plywood, glues, paper products, and decoration material (木制品，胶合板，胶水，纸制品，装饰材料). Bo Hu did not add attempt to anything relevant to forest agency until September 23, 2008. See the application to change the scope of business in Appendix E2.
- Bo Hu is incorporated in Guangdong province, and would likely have substantial tax issues operating in Guangxi province (due to incessant competition among tax authorities in China). Further, all companies dealing with wood products must have a wood product permit issued by the forestry bureaus within the provincial jurisdiction. Bo Hu's license is for Guangdong – not Guangxi. See Appendix E3.
- While purportedly generating hundreds of millions of dollars in annual revenue, Bo Hu's office was in an apartment building in this apartment complex from August 2008 through sometime in 2009:


*How many $200 million companies are in this apartment complex?*

Bo Hu's current office is now in a proper office building, but the high level of security is unusual. On the ground floor, our researcher was stopped by security guards who seemed very cautious and alert. They questioned our researcher regarding why he was there. He was only permitted to enter the building after convincing the guards he had an appointment with Bo Hu's vice president of sales, Mr. Xu. There was yet another security guard stationed outside Bo Hu's office door on the second floor. This type of security around an office of this size is highly irregular in China.

- We spoke with a Mr. Xu, who is the vice president of sales for Bo Hu. He is certain that Bo Hu does not deal in Guangxi plantations. Mr. Xu did say however that Bo Hu is a customer of Sino-Panel (one of TRE's subsidiaries), and has been buying plywood from it since summer 2010 in volumes less than $1.5 million annually.

- Bo Hu's audit report shows that it has made substantial payments to TRE entities, including an undisclosed subsidiary. (See Appendix E4 & E5.) As we discuss infra in Glimpses of How TRE Steals the Money, we believe that some of these entities may be tunnels through which TRE steals investor funds.

- Bo Hu's 2008 audit report shows revenue of approximately $37,000 (RMB 250,189) – for the sake of clarity, that is thirty-seven thousand dollars. See Appendix E6. It is inconceivable to us that Bo Hu would be able to understate its revenue by over $200 million (or 99.9%) – at over $200 million in annual revenue, Bo Hu would be one of the larger privately-owned businesses in Zhanjiang. It would not be able to avoid booking so much revenue, in which case the revenue in the audit report would reflect much larger amounts.

**Fujian Agent**

- Zhangzhou Lu Sheng Forestry Development Company Limited (漳州绿盛林业发展有限公司) was incorporated on Nov. 19, 2007 (Appendix E7), just nine months before TRE entered an approximately one billion dollar (RMB seven billion) master contract with it.

- The registered capital was only $78,000 (RMB 550,000) (Appendix E7).

- The registered address was at Floor 1, No. 7 Xibian Hongyang New Village (Orchid Garden), Shan Cheng Village, Nanjing County (南靖县山城镇溪边宏洋新村（兰花园）7 号 1 层) until November 29, 2010 (Appendix E10). This address is the personal residential address of Mr. Wang Rui Mei (Appendix E8), who is also listed on the SAIC filings to be the legal representative, executive director, supervisor, and manager of the company (Appendix E11).

**Image 10 No 7 Orchid Garden**

- A copy of the master agreement signed by TRE and Zhangzhou Lusheng was found in the Sino-Panel (Fujian)'s SAIC files (Appendix E9a-E9g). It is a contract with a total of seven pages with no terms regarding liability – it seems to be an unlikely billion dollar contract. Interestingly, the contract stated that as of the time signing the contact Lusheng has already been authorized by the owners of 200,000 Ha of the forests in Fujian to act on their behalf. However, Lusheng did not have any wood or forestry related license at the time it entered into the contract.

- We sent a team of field agents to visit Zhangzhou Lusheng in Fujian. Our agents located the new registered address at 5th Floor, Jiamao Honey Industry, No 362 Construction Road, Shancheng Town, Nanjing County (南靖县山城建设路 362 号嘉贸峰业大厦 5 楼)。


嘉贸蜂业
JIA MAO FENG YE
中国平安人寿保险
中国平安人寿保险
南靖嘉贸蜂业蜂产品经营部
电话:0596-7820136


Field enquiries confirmed that Zhangzhou Lusheng operates at the address on the 5th floor. There are four desks in Zhangzhou Lusheng's office, which appeared to be approximately 180 m2 with 5-6 employees in the office at the time of visit. This implies that Lusheng has an extremely efficient computer system (given that it processes so much money and so many payments with a small staff).

- Our researcher paid a visit to the Nanjing County Forestry Bureau and spoke with the Unit Head Mr. Ma there. Mr. Ma claimed that he has not heard about Zhangzhou Lusheng nor has he heard of Wang Rui Mei.

Jiangxi Zhonggan

- This agent is a related party. The legal representative and President of this company is TRE executive vice president, Lam Hong Chiu.

- Jiangxi Zhonggan Industrial Development Company Ltd ("Zhonggan")江西中赣实业发展有限公司 was incorporated on January 28, 2009 just five months before TRE entered into an approximately $700 million contract on June 16, 2009. See the business license in Appendix BB2.

    - Yun County Electronic Paper (云县电子报), an online newspaper operated by the Yun County local government (中共云县委云县人民政府主办), published an article naming Lam Hon Chiu as the general manager of Hong Kong Sino-Panel Company who has visited Yun County with government officials on July 23rd, 2010. http://61.166.10.99:8011/Qnews.asp?ID=5340&QID=1837 (Appendix E12)

    - Dongkou County Hunan, an online article published on Dongkou County government website stated that on Feburary 5, 2007, the county government met with the top management of Canadian Sino-Forest Group including Chairman Allen Chan (陈德源), VP Ye Han Xiang (叶翰祥) and VP Lam Hon Chiu (林汉钊)at Changsha discussing the possibility of investment in Dongkou County. http://dongkou.mofcom.gov.cn/column/print.shtml?/zhongyaozt/200707/20070704898019 (Appendix E13)

    - Qiqihaer City Heilongjiang, an online article published on June 20, 2006 on the Qiqihaer city's government website stated that the Qiqihaer government official met with the VP of Sino-wood (Asia) Limited Lam Hon Chiu (林汉钊) on their trip to Hong Kong to discuss investment in Qiqihaer City. http://www.qqhrmofcom.gov.cn/index.php3?file=detail.php3&kdir=2200134&nowdir=2030157&id=830707&detail=1 (Appendix E14)

    - On one of the company listing website http://www.bldg-materials.com.hk/master.php?keyword=1854 listed Lam Hon Chiu as the Senior Manager of Sino-Panel (Asia) Limited. (Appendix E15)

    Jiangxi Zhonggan is clearly a related party related party.

- Jiangxi Zhonggan is a joint-venture incorporated by Hong Kong China Square Industrial Ltd. 香港中国坊实业有限公司 (China Square) and Nanchang Tongdasheng Industrial Company Ltd. 南昌市通达盛实业有限公司 (Tongdasheng) with a total register capital of USD 5 million with USD 4 million by China Square and USD 1 million by Tongdasheng.

- China Square is a company registered in both Hong Kong and BVI with Lam Hon Chiu as its legal representative, it seems to be a shadow actor on TRE's behalf to setup undisclosed but related subsidiaries in China.
- By looking at the SAIC file of Jiangxi Zhonggan's Chinese partner Nanchang Tongdasheng, we don't see any reason for its existence except that TRE needs a Chinese name to legally register a joint venture as its agent in Jiangxi. Tongdasheng was incorporated November 3rd, 2006, with a registered capital of 500,000 RMB. The registered address is a fishing village near Nanchang city 南昌市西湖区桃花镇渔业村. The business scope is Domestic Trading 国内贸易 (Appendix E16). According to the 2009 Annual Check Report in the SAIC files that the revenue of Tongdasheng for 2009 is USD 14,909.84 (RMB 104,368.93) with a net profit of USD 326.58 (RMB 2,286.07). It is nearly impossible for such a company to invest on its own with USD 1 million to setup Jiangxi Zhonggan with China Square unless someone else is "funding" the amount.
- Below is photos of the registered address of Nanchang Tongdasheng.
- 


The 2008 and 2009 Jiangxi Zhonggang's audit report shows numerous large transactions between the Company, TRE, and other parties. However, none of these transaction is forestry related.

## VI. The Capital Hole

Chinese government records show a capital hole that makes claimed timber purchases impossible.

China imposes capital controls that ensure there are records of significant movements of foreign currency into China. From TRE's PRC company SAIC files, it is clear that TRE's cash needs in China outstrip the capital it has contributed to its China operations by at least $377 million, and possibly quite more. China's capital controls prevent TRE from funding its operations from outside of the PRC by purchasing trees through payment of foreign currency.

When an existing PRC company wants to bring foreign currency into China as investment in the business, it applies to the Ministry of Commerce, the State Administration of Foreign Exchange, and the State Administration of Industry and Commerce ("SAIC"). Once the authorities approve the application, the company may bring in the approved amount of foreign currency. When an investor forms a new foreign-owned company, it must specify foreign currency it will invest.

The authorities will review the entire establishment application, including the portion requesting the right to bring foreign currency into China.[50]

A given company's SAIC file shows records current within a few months of all applications for injecting equity capital. Further, PRC law requires equity capital injections to be verified by PRC licensed accountants. The amount of debt a company can borrow is limited by law, and SAIC records reflect the amount of money that a company is approved to borrow from offshore. However, debt injections are not recorded in SAIC files. We totaled up all of TRE's actual equity injections and approved debt injections (again, the debt capital is not verified, but we gave TRE the benefit of the doubt), and the amount of capital that went into TRE's PRC operations is only $1.213 billion since 1994. Its investments were $1.7 billion larger than its operating cash flow during this period. (Note that these figures also exclude the need for operating cash.) Therefore, TRE has a capital hole of $377 million to $922 million. It could not have purchased the trees it claims to have.

| (USD millions) | |
|---|---|
| OCF | 3,308 |
| CapEx - Disposals | 5,058 |
| Total ST Borrowings incl. Repayments | 160 |
| Onshore Capital Need | 1,590 |
| Capital Contributed - High | 1,213 |
| Capital Contributed - Low | 668 |
| **Onshore Cash Hole - Low** | **377** |
| **Onshore Cash Hole - High** | **922** |

*Cash flow numbers from Bloomberg. To be conservative, we assumed that all short-term borrowings were onshore.*

TRE could not have funded its business with foreign currency. If TRE were going to pay the supplier in foreign currency, it would be illegal unless the goods sold were for export. Because the investments are not for export out of the PRC, the sellers would not be able to obtain customs declarations. Large amounts of foreign currency hitting the sellers' bank accounts without accompanying customs declarations would be quite risky for the sellers just on a one-time basis – such a transaction could lead to inability to convert the currency, and issues with the customs and tax bureaus. We do not believe that TRE found suppliers willing to engage in transactions with such large risks throughout its 16-year reporting history. Therefore TRE could not have made these investments by paying the sellers in foreign currency in the PRC.

TRE's agents under the master purchase agreements are thinly capitalized (see infra TRE's Dodgy Timber Agents). They could not have each funded hundreds of millions of dollars in undocumented currency swaps done through offshore bank accounts.

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[50] For more on how China's currency controls work, see Collins, Robert and Block, Carson "Doing Business in China for Dummies" (Wiley 2007), chapter 9.

TRE's only means of funding these investments would have been by injecting investment capital into its own PRC companies, which it did not do in sufficient amounts. Therefore, TRE's claimed investments and revenues are fraudulent.

## VII. TRE's Manipulation of Poyry Reports

TRE's abuse of Poyry's name is well-illustrated by a recent statement that TRE CFO David Horsley made at the annual shareholders' meeting on May 30, 2011 that Poyry teams spend "four to six personal weeks" in the field evaluating TRE's holdings. On a June 1, 2011 call the statement was clarified to mean that a team of four people each spends six days in the field, so that the total approximates six man-weeks of work. (Amusingly reminiscent of Bill Clinton's "I did not have sexual relations" comment.)

Since 2003 Poyry (Beijing) and its Shanghai branch have been engaged to conduct reviews of TRE's operations and value its assets; however, Poyry's purpose is only to estimate the market value of the forest assets based on information provided by TRE, and not to perform due diligence or confirm the ownership of the forest areas.[51] In numerous locations throughout the reports, Poyry adds disclaimers, stating:

- Poyry has not viewed any of the contracts relating to forest land-use rights, cutting rights, or forest asset purchases [52]
- It is important to understand that this is not a confirmation of forest ownership, but rather a verification of the mapped and recorded areas of stocker forest.[53]

However, despite a generally favorable report, Poyry nevertheless cannot hold back a degree of astonishment at TRE's unusual trading practices, describing in the reports opening paragraphs that TRE's forest holdings are "dynamic" (emphasis provided by Poyry).[54] Poyry states, "Unlike most forest owners and managers, Sino-Forest actively trades in forests. Each year the company both sells and buys forests, and accordingly the composition of the forest estate changes much more than for a business that is simply managing and harvesting a more static resource."[55] This fact greatly complicates its inspection and valuation process as "the composition of Sino-Forest's estate can change quite significantly from one year to the next."[56]

Certainly such dynamic trading complicates inspection and verification activities, as it is tantamount to a giant shell game. With a maximum of only 53% of existing 2008 forest being carried over into 2009,[57] it is easy to disclaim any specific accusation of lack of forest rights ownership in any given plot or region.

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[51] Conference call, June 1, 2011, Poyry valuation discussion.
[52] 2009 Poyry, Sino-Forest Corporation Valuation of China Forest Assets as at 31 December 2009, Final Report, 23 April 2010 Rev. 03, p. iv http://www.sinoforest.com/filings.asp
[53] 2009 Poyry, p. 12
[54] Poyry, Sino-Forest Corporation Valuation of China Forest Assets as at 31 December 2009, Final Report, 23 April 2010 Rev. 03, p. vi & 8
[55] Poyry, Sino-Forest Corporation Valuation of China Forest Assets as at 31 December 2009, Final Report, 23 April 2010 Rev. 03, p. vi & 8
[56] Poyry, Sino-Forest Corporation Valuation of China Forest Assets as at 31 December 2009, Final Report, 23 April 2010 Rev. 03, p. 8
[57] 2009 Poyry report, Valuation of China Forest Crop Assets As at 31 December 2009, 23 April 2010, Rev 03, www.sinoforest.com/filing.asp, p. 8

In introducing its methodology for assessing risk into the discount rate calculation, 2009 Poyry explains that the valuation of forest crop assets faces challenges, including:

- The reliability of forest descriptions
- The accuracy of yield prediction
- Achieving high growth rates in a consistent manner[58]

The Poyry report explains that its review of forest land holdings consisted of selecting 66 cluster maps that represented only 1,611 ha of forest, or only about 0.3% of TRE's claimed 491,000 ha.[59] During the June 1, 2011 conference call, Poyry revealed that the figure for the 2010 assessment was only 0.1% of estate holdings due to the substantial increases in newly acquired plantations. Poyry further reveals that current yield tables for these forests have not been properly established.[60] Poyry has performed some field studies and collected sample data from various plots, but its statistical analysis comes with the caveat that "in comparison with most other forests, the large Sino-Forest estate is significantly under-sampled for growth and yield purposes."[61] In short, due to the poor quality of data and documentation on the forest plot, until there is an opportunity to both verify the forest's physical characteristics and use satellite imagery on all forest claims, that the sample sizes are too small to establish significance. Poyry and all investors then can only take TRE at its word that the remaining 99.9% of its purported holdings are accurate in terms of their size, yield, and composition.

Do You Think a 2.5% Risk Premium on TRE's Discount Rate for WACC Seems a Little Low?

Poyry's 2009 report includes an appendix detailing the calculation method for the discount rate, WACC, and CAPM; wherein the consultant, Dr. Mardsen, from the University of Auckland's Dept. of Accounting and Finance of the School of Business, provides details on formulas used to value a generic forest asset in the China. Dr. Mardsen repeatedly emphasizes the need to keep in mind the additional risk associated with developing markets, such as capital controls, political instability, corruption, poor accounting and managerial controls, an uncertain legal framework and lack of protection of investor property rights; and factor a premium onto the discount rate of the cost of capital, stating: [62]

> In China and in emerging markets the level of corporate governance may vary significantly between companies. Corporate governance is important as it provides mechanisms whereby outside investors can protect themselves against expropriation by insiders. Corporate governance can impact on the risks that outside investors may face in respect of any expropriation of assets. These factors together with the size and other market frictions may warrant an adjustment to the cash flow expectations and/or an

[58] Poyry, Sino-Forest Corporation Valuation of China Forest Assets as at 31 December 2009, Final Report, 23 April 2010 Rev. 03, p. 55
[59] Poyry, Sino-Forest Corporation Valuation of China Forest Assets as at 31 December 2009, Final Report, 23 April 2010 Rev. 03, p. 11
[60] Poyry, Sino-Forest Corporation Valuation of China Forest Assets as at 31 December 2009, Final Report, 23 April 2010 Rev. 03, p. 17
[61] Poyry, Sino-Forest Corporation Valuation of China Forest Assets as at 31 December 2009, Final Report, 23 April 2010 Rev. 03, p. 17
[62] 2009 Poyry Report Appendix: Uniservices, Investment Appraisal for Forest Investment in China, 5 Jan 2010. P. 5

> increment to the cost of capital for the forest if investors' property rights are not clearly defined. Where control is not obtained a minority discount and / or illiquidity discount many apply. [63]

Dr. Marsden calculates the real pre-corporate tax WACC range of between 7.1% to 12.8%. Poyry then selected the current 8.5% to 9.0% discount rates in New Zeeland and adds a 2.5% to 3.0% resulting in a discount rate of 11.5%, providing for the 2006 pre-tax cash flow valuation of TRE's assets at $2,297.5 million USD as of December 31, 2010.[64] But, Dr. Marsden closes with a note and a warning:

> If significant corporate governance and agency cost issues between insides and outside investors arise (e.g. from <u>lack of transparency</u>, possible <u>risk of expropriation of assets</u>, <u>restrictions of remittance of profits</u>, or <u>exchange rate control</u>), the use of cost of capital at the upper end of our range may be warranted.[65]

It begs the question; if evidence of systemic and comprehensive fraud and illegal activity is discovered in the Company from inception, throughout its operating history, and into the present, by how much would the discount rate need to be adjusted?

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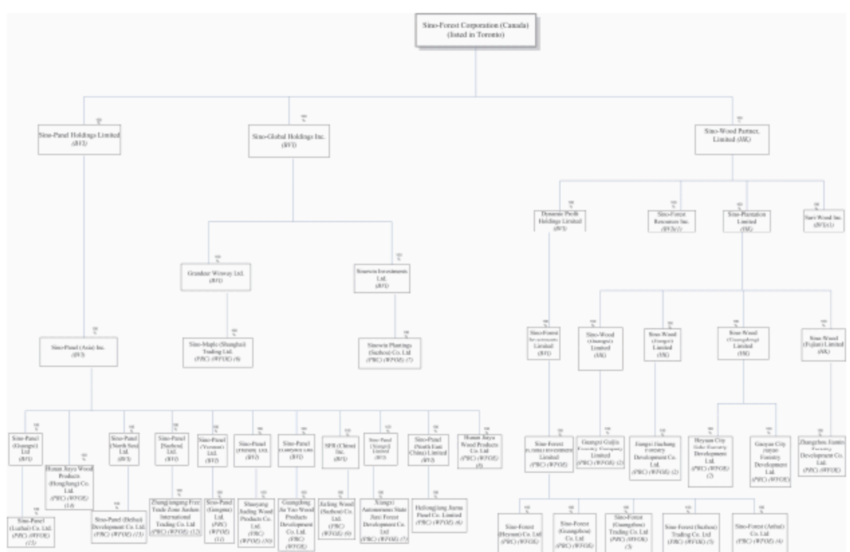
[63] 2009 Poyry, P. 4, 5

[64] 2009 Poyry, p. vi; 58; 2009 Poyry Report Appendix: Uniservices, Investment Appraisal for Forest Investment in China, 5 Jan 2010. P. 23.

[65] 2009 Poyry Report Appendix: Uniservices, Investment Appraisal for Forest Investment in China, 5 Jan 2010. P. 23

## VIII. Egregiously Complex and Opaque Offshore Structure

In TRE's 2010 annual information form, it discloses that it has at least 20 British Virgin Island ("BVI") entities. As a recent South China Morning Post article points out, BVI is the favorite domicile of Chinese seeking opacity. There is no public shareholder registry, and there are no requirements to file tax returns. TRE no longer discloses its organizational chart, but the last one it made available in an annual information statement is from 2007 – see below. This structure is highly opaque, and in our view, unnecessary for legitimate business purposes. It is not a tax-optimized structure either due to direct ownership of PRC entities by BVI subsidiaries. (Dividends remitted to Hong Kong holding companies are taxed at a lower rate than dividends to BVI owners.) We therefore pose the following question to TRE's management (given its emphasis on its transparency): "Why have you structured the business in this way?"



## IX. Suspicious Bank Document

Suspicious Bank Document.

The following bank letter appears to be written on behalf of Sino-Wood Partners, Ltd. We found it in incorporation applications in the SAIC files for four of Mandra's entities. TRE, which now owns 100% of Mandra, was a founding shareholder of Mandra with a 15% stake. Sino-Wood was the entity that was reverse merged into the public shell to make TRE a public company. It had been expected to IPO in 2003, but the IPO was unexpectedly canceled.

HSBC

PRIVATE & CONFIDENTIAL

Ref:

CMB TSD Division B

Relevant Approval Authorities and Administration Authorities for Industry & Commerce

1 February 2005

Dear Sirs

Re:MANDRA FORESTRY ANHUI LIMITED

At the request of Sino-Wood Bartners,Limited(the "Company"),we have pleasure in advising that the Company has maintained an active and satisfactorily conducted current account with us.General banking facilities to the extent of HKD medium eight figures have been granted to the Company on an unsecured basis. For the past twelve months, we have haneled their import/export bills business with satisfactory results.We consider the Company is good for normal business engagement.

The aforesaidinformationis given in strict comfidence and without any responsibility,howsoever arising,on the part of the Bank or any of its officers.

Yours faithfully

Regina Lee
Relationship Manager

c.c. Mandra Forestry Anhui Limited

The Hongkong and Shanghai Banking Corporation Limited
Tsim Sha Tsui District Commercial Banking Centre:
10/F HSBC Building Tsim Sha Tsui, 82 Nathan Road, Kowloon, Hong Kong
Tel: 2733 9111 Fax: (852) 2721 7648

## X. Shoddy Corporate Governance

Internally, TREs fraud was enabled by poor corporate governance. The corporate governance issues include the following:

- TRE's board appears to be the retirement plan for partners of its auditor, Ernst & Young. It currently has five directors on its board from E&Y. We believe that such a clubby atmosphere can dull the auditors' ability to perceive problems.
- We are bothered by senior management's practice of paying its salary via fees to a consulting firm – this is inappropriate for a public company with a multi-billion dollar market capitalization. More disturbing is senior management's C$12 million buyout of its own shares in subsidiary with investor funds. (The subsidiary's planned 2003 IPO was unexpectedly canceled.)
- TRE failed to disclose a 2003 petition to wind it up at the listed company level.
- TRE has failed its internal control test. The 2010 failure is due to senior management personally handling settlement of accounts receivable and accounts payable. This is particularly troublesome because the notes to TRE's financial statements appear to state that the majority of TRE's receivables from its accounts receivable are paid by TRE's AIs to TREs agents to pay off timber purchases. If our reading is accurate, then a substantial portion of TRE's purported revenue would not even be expected to hit its bank account, thereby making the fraud substantially easier to carry out.

## XI. Glimpses of How TRE Steals the Money

- From reviewing TRE and the "Agent's'" annual inspection and audit reports from the SAIC files, it seems that the agents mainly serve as a tunnel to move money for TRE.
- These agents generally report little to no revenue or profit, and pay little to no tax. However, they have balance sheets orders of magnitude the sizes of their revenues. The balance sheets mainly consist of receivables from TRE entities, and disturbingly, payables to TRE entities.
- Both Yunnan and Guangxi agents are sending a large amount of money to TRE's undisclosed subsidiary, Huaihua City Yuda Wood Co. Ltd. This subsidiary is based in Huaihua City, Hunan Province, which we suspect is the nerve center for TRE's illicit activities. We tried mightily to obtain SAIC files for TRE's four subsidiaries and the Hunan agent, but we were only able to obtain minimal information (such as shareholdings) after much effort. This is highly unusual.
- Payments to farmers and collectives for forest are noticeably scarce in the financial statements of the agents.
- The following tables shows the finances of three agents for 2008 and 2009

| **2008** | Zhanjiang Bohu<br>湛江博虎 | Jiangxi Zhonggan<br>江西中赣 | Gengma Forestry<br>耿马林业 |
|---|---|---|---|
| Revenue | ¥250,188.59 | ¥0.00 | ¥161,944.45 |
| Tax Paid | ¥16,280.71 | ¥0.00 | ¥545,651.87 |
| Profit | (¥707,828.30) | (¥473,604.40) | (¥1,730,241.89) |
| Total Assets (Year End) | ¥328,764,932.35 | ¥78,342,694.60 | ¥127,590,736.52 |
| Total Debts (Year End) | ¥328,478,921.42 | ¥44,400,000.00 | ¥122,287,992.44 |

| 2009 | Zhanjiang Bohu 湛江博虎 | Jiangxi Zhonggan 江西中赣 | Gengma Forestry 耿马林业 |
|---|---|---|---|
| Revenue | | ¥58,516,200.00 | ¥455,400.00 |
| Tax Paid | | ¥0.00 | ¥122,757.00 |
| Profit | Not Available | ¥42,528,626.48 | (¥1,199,609.00) |
| Total Assets (Year End) | | ¥619,731,395.86 | ¥121,465,482.00 |
| Total Debts (Year End) | | ¥543,260,074.78 | ¥120,338,833.00 |

Bohu's 2008 Transactions (TRE entities are highlighted) (Appendix E4 and E5)

**Bohu 2008**

| **Prepayments Made** | | |
|---|---|---|
| Shaoyang Jiading (TRE) | 邵阳嘉鼎 | ¥49,871,398.63 |
| Hunan Jiayu (TRE) | 湖南嘉裕 | ¥24,202,808.06 |
| Xiangxi Jiaxi (TRE) | 湘西嘉熙 | ¥30,925,793.41 |
| | | **¥105,000,000.10** |

| **Other Account Receivable** | | |
|---|---|---|
| Sino-Panel (TRE) | 嘉汉板业 | ¥38,661,000.00 |
| Guangxi Dacheng | 广西大成 | ¥15,000,000.00 |
| Xuwen Hengdong | 徐闻恒东 | ¥7,610,000.00 |
| Guangxi Bohu | 广西博虎 | ¥3,200,000.00 |
| Beihai Real Estate | 北海房地产 | ¥27,813,100.00 |
| Zhanjiang Tianxiang | 湛江天翔 | ¥25,450,000.00 |
| Zhanjiang Tianlun | 湛江天伦 | ¥19,000,000.00 |
| Leizhou Bangsheng | 雷州邦盛 | ¥40,000,000.00 |
| Leizhou Hengfu | 雷州恒福 | ¥1,897,777.11 |
| Other | 其它 | ¥1,009,563.51 |
| | | **¥179,641,440.62** |

| **Other Account Payable** | | |
|---|---|---|
| Sino-Panel（China） | 嘉汉板业（中国） | ¥53,158,409.50 |
| Sino-Panel (Sanjiang) | 嘉汉板业（三江） | ¥31,297,786.00 |
| Sino-Panel (Luzhai) | 嘉汉板业（鹿寨） | ¥29,399,999.97 |
| Sino-Panel (Hezhou) | 嘉汉板业（贺州） | ¥79,000,000.00 |
| Huaihua Yuda | 怀化裕达 | ¥134,900,000.00 |
| Guangxi Bobai Forestry | 广西博白林场 | ¥2.09 |
| | | **¥327,756,197.56** |

From the above table, Bohu has made three prepayments to TRE's subsidiaries totaling RMB 105 million. This flow of funds contradicts the disclosed nature of the parties' relationship. Further, with such low registered capital and poor operating results, it is difficult to understand how Bohu's balance sheet is this large.

Bohu has an account payable of RMB 327.8 million to six companies. Four of the six companies are Sino-Panel Subsidiaries. The fifth company Huaihua Yuda is an undisclosed TRE subsidiary that has been receiving massive amounts of money from TRE's subsidiaries. The last company listed is Guangxi Bobai Forestry, which is supposed to be a partner forestry company in Guangxi; however, but the amount owed RMB 2.09 ($0.30) pales in comparison.

Jiangxi Zhonggan (an undisclosed related party) plays the same games. Its 2009 audit report shows that it had received a prepayment of RMB 448.6 million from Sino Panel China (Investment) Company Ltd. In the same year, it made a prepayment of RMB 212.0 million to Harbin Oubangde Economic and Trading Co. Ltd., a trading company in Harbin, whose business has nothing to do with acquiring forests in Jiangxi Province. According to the audit report, Jiangxi Zhonggang has dealt with more trading companies than forestry companies. (Appendix K3 and K4)

The same is true for Gengma Forestry (a mostly legitimate agent). Its revenue has been declining since it entered into the master agreement with TRE. The revenue was RMB 3.6 million in 2007, and declined to RMB 160,000 RMB in 2008 and RMB 455,400 in 2009. The assets and debts are 787 times 2008 revenue, and 266 times 2009 revenue. Although it really does broker forests, it appears to be helping TRE in some way beside acquiring forest.

TRE has a significant undisclosed subsidiary, Huaihua Yuda Wood Company Ltd. (怀化裕达木业有限公司). Huaihua Yuda has taken massive amount from TRE's subsidiaries, but its existence was never disclosed. In 2007, Huaihua Yuda received a prepayment of RMB 92.0 million from Sino Panel (Hezhou) and another payment of RMB 81.0 million from Sino Panel (Gengma). (Appendix K5 and K6) According to our research from two government websites, Huaihua Yuda is a subsidiary of TRE.

## XII. The Multi-Billion Dollar Ponzi Scheme

Sino Forest to date has raised over $3.05 billion from the capital markets and has not paid a cent back from free cash flow, nor has it paid a dividend.

Sino-Forest raises capital in increasingly larger amounts, which is effectively a Ponzi scheme. TRE raises cash from the financial markets, purportedly buys forestry assets, which are then valued at a significantly higher level by Poyry (which takes TRE's word on the size and scope of the acquisition at face value), leading to a higher reported net asset value which acts as the support or collateral for an even larger capital raise. The first investor relies upon the new capital to generate the return, thereby fitting a classic Ponzi scheme definition.

It is a fairly standard capital markets transaction to complete a new financing of an asset that has increased in value. In isolation, this conceptually would not be a Ponzi scheme. However, a series of financings almost wholly reliant upon a series of unreliable reports covering the asset values of a company that has been free cash flow negative for 16 straight years should raise some red flags. In order to understand how this cycle has managed to continue for such a long period of time, it is important to understand two key issues: the manipulation of Jakko Poyry's valuation reports, and the way the TRE uses these reports to convince new investors to finance them.

With the exception of an incentive payment of $30 million to exchange an existing bond into a longer dated one, TRE has never returned any capital to shareholders despite so many financings. Because of the nature of the company, TRE must continue to spend in order to survive. Without an acquisition pipeline, TRE cannot justify raising capital from new investors. Without new investors, it cannot repay old investors, and would fall apart.

As expected, TRE is still talking about a large acquisition pipeline for 2011.