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June 18, 2011

## Key partner casts doubt on Sino-Forest claim

By MARK MacKINNON AND ANDY HOFFMAN  
 From Saturday's Globe and Mail

*Globe inquiry finds irregularities in timber company's disclosure;  
 Chinese forestry officials open probe*

Embattled Sino-Forest Corp. TRE-T, once Canada's biggest publicly-traded timber company, appears to have substantially overstated the size and value of its forestry holdings in China's Yunnan province, according to figures provided by senior forestry officials and a key business partner there.

During two weeks of on-the-ground reporting that included interviews with Chinese government officials, forestry experts, local business operators and brokers, The Globe and Mail uncovered a number of glaring inconsistencies that raise doubts about the company's public statements regarding the value

of the assets that lie at the centre of the company's core business

of buying and selling Chinese timber rights.

Once a stock market favourite, Sino-Forest has had a spectacular fall since a short seller's report, published June 2, alleged that the company engaged in large-scale fraud and is inflating the value of its timber assets. The shares are down 82 per cent since the release of that report, written by Carson Block of Muddy Waters LLC, representing a paper loss of \$3.7-billion to investors in little more than two weeks.



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The company has denied all wrongdoing and the board of directors formed a committee to probe the allegations raised by Muddy Waters. The investigation is expected to last months and has begun with representatives from PricewaterhouseCoopers checking Sino-Forest's bank accounts to verify the more than \$1-billion (U.S.) the company says it holds in cash at Chinese banks and other financial institutions.

The Globe's investigation raises particularly hard questions about a key agreement in March, 2007, that Sino-Forest says gave it the right to buy timber rights for up to 200,000 hectares of forest in Yunnan over a 10-year period for between \$700-million (U.S.) and \$1.4-billion. The trees were to be bought through a series of agreements with an entity called Gengma Dai and Wa Tribes Autonomous Region Forestry Co. Ltd., also known as Gengma Forestry.

The company says it has fulfilled virtually all of the agreement with Gengma and now owns more than 200,000 hectares in Yunnan.

But officials with Gengma Forestry, including the chairman, dispute the company's account of the deal, telling The Globe and Mail that the actual numbers are much smaller.

Xie Hongting, the chairman of Gengma Forestry, said in an interview that the transactions carried out so far by Sino-Forest amounted to less than 14,000 hectares.

Asked how many deals Gengma had conducted with Sino-Forest, Mr. Xie said: "I've told you that we sold them almost 200,000 mu." (Mu is a Chinese unit of land measurement; 15 mu equals one hectare.)

Mr. Xie's account corroborates the assertions of senior forestry officials in the province. Speaking on condition of anonymity, these officials challenged the company's statements that it controls more than 200,000 hectares of Yunnan trees, and said they are now investigating.

In a written response to questions from The Globe, Sino-Forest said it stands by its public statements regarding its Yunnan holdings. The company said it has purchased about 13,300 hectares of "forestry assets and leased land" directly from Gengma Forestry, and another 180,000 hectares of "forestry assets only" from other sellers, using Gengma as a purchasing agent.

"The agreement has not been yet fulfilled as we have not completed the purchase of 200,000 hectares," the company said.

That statement from Sino-Forest appears to contradict its own publicly filed financial reports. In its first quarter 2011 report, the company said that "under the master agreement entered in March 2007 to acquire 200,000 hectares of plantation trees over a 10-year period in Yunnan, the Company has actually acquired 230,200 hectares of plantation trees for \$1,193,459,000 as at March 31, 2011."

The company's 2010 annual information form filed with regulators earlier this year said that as of December 31, 2010, Sino-Forest had "acquired approximately 190,300 hectares of plantation trees for \$925.9-million (U.S.) under the terms of the master agreement."

The Globe's investigation of the company's dealings and holdings in Yunnan points to inconsistencies in the company's accounting of its timber rights and raises broader questions about its business practices.

In dispute is just how much the company really controls of the dense oak, pine and birch forests that cover the rippling mountains of southern Yunnan, which is close to China's border with Myanmar.

Sino-Forest's core business consists of buying timber assets in China, holding these plantations for two or three years as they appreciate in value, and then selling them at a profit. Sino-Forest also has a log trading business. Combined, these operations account for about 95 per cent of the company's current revenue. Sino-Forest also plants trees for harvest, but these holdings are not expected to generate revenues for five or six years.

Its corporate structure has opened Sino-Forest up to criticism that it is too opaque. The company has scores of subsidiaries in China and offshore locations such as the British Virgin Islands. It has refused to disclose the names or locations of the customers who buy its standing timber, saying it doesn't want to reveal the identity of its customers for competitive reasons.

Non-state-owned forests in China are usually collectively owned by village councils on behalf of their residents, or in some cases belong to individual households. The trees and their produce can be bought, but the land can only be leased.

As of the end of 2010, the company claimed control of about 800,000 hectares of trees in nine Chinese provinces plus New Zealand. Its operation in Yunnan province, in addition to being its largest, is also the one for which it has made additional disclosures recently in an attempt to defuse the allegations made in the Muddy Waters report.

So far, however, it has disclosed purchase agreements as well as forest and woodland rights certificates for about 7,000 hectares of forest in Yunnan. The company has not disclosed significant documentation regarding its forestry holdings in other provinces.

To find Gengma Forestry, Sino-Forest's local partner in the so-called "Yunnan master agreement" - the 2007 deal said to be worth as much as \$1.4-billion - you have to duck down an alleyway behind the drugstore on the main street of this nondescript trading city, then up a dusty cement staircase.

On the landing is the litter-strewn office with an open door and a window protected by metal bars. Despite signing a deal with Sino-Forest that should guarantee a windfall, the company has clearly fallen on hard times. "Our relations with [Sino-Forest] were not totally good. They talked about a lot of things, but in the end it was hard to get money from them," said Zhang Ling, Gengma Forestry's office manager.

Ms. Zhang said the company was approached by Sino-Panel, a Sino-Forest subsidiary, out of the blue in 2006 - "they said they found us over the Internet" - but that they hadn't heard anything from the company in recent years. She said Gengma Forestry felt it had made a bad deal on the forests it sold. "We sold it for 30 yuan per mu (per year). Now the price is soaring because the hype around timber is very high."

When The Globe asked Sino-Forest why a Gengma official offered a different account of the 2007 deal, the company said it stood by its statements on the transaction and suggested Gengma's chairman should be contacted. "We don't know who you spoke to, but we continue to be in touch and have a good relationship with the Chairman, Xie Hongting," the company said in an e-mail. Mr. Xie's office address and local phone number were both included. When The

Globe contacted Mr. Xie, he contradicted Sino-Forest's account that it has bought about 200,000 hectares of forest through the Yunnan master agreement.

With four years of the master agreement deal already elapsed, Mr. Xie said Sino-Forest has followed through on deals that give them long-term leases, which are usually for three or four decades, for timber rights on "almost" 200,000 mu of timber through Gengma, or about 13,300 hectares - not the 200,000 hectares the company claims to have acquired.

At the same time as the company announced the Gengma Forestry deal in 2007, it also announced the sale of \$200-million (U.S.) in new shares to a group of investors led by Temasek Holdings, Singapore's massive sovereign wealth fund, to help □ pay for the timber deal - one of a series of equity and debt financings Sino-Forest has completed over the past decade to fund its huge growth.

While Gengma Forestry officials question Sino-Forest's account of the 2007 deal, local land brokers said it would be difficult to find 200,000 hectares of quality land leases to complete that agreement.

"Most of the land with good trees around Gengma is all sold out. Only lesser land is still available to buyers now," said Zhang Fuyin, a broker who said he sold 10,000 mu of timber in the area to Sino-Panel, a Sino-Forest subsidiary, several years ago. The deal with Gengma Forestry says the timber purchases will take place in "Lincang city and its surrounding areas," a likely reference to Lincang county, of which Gengma is the geographical heart.

Senior forestry officials in the province challenged the company's assertion that it controls about 200,000 hectares of forest in the region. Speaking on condition they not be identified, they said their records showed Sino-Forest manages far less than that and said the Yunnan Forestry Bureau would begin an investigation aimed at determining the company's true holdings.

In addition to the questions about Sino-Forest's disclosures on the size of its holdings, forestry officials, as well as local timber brokers who spoke to The Globe raised questions regarding the value Sino-Forest attributes to its Yunnan assets.

"It's very hard for anyone to say what the value of their property is," said one forestry official, adding that forested land in Yunnan needed to be evaluated by a special body jointly appointed by the Forestry Bureau and the Ministry of Finance. Sino-Forest has not requested such an official valuation of its land, he said. "(The valuation) must have two chops (official seals) and two forestry resource evaluation experts and two licensed evaluators... . Even I can't just go there and give it a value."

In an e-mail response to The Globe and Mail, Sino-Forest replied that because they own the trees, rather than the land, their holdings would not be registered with the provincial forestry bureau.

"As a matter of course, when we purchase trees only, we obtain a confirmation of our ownership from the local county or city Forestry Bureau for the local area in which we purchase, not the provincial Forestry Bureau. Sino Forest's ownership of its forestry assets in the Yunnan province is voluntarily documented in each case by the local or city Forestry Bureaus, not at the provincial Forestry Bureau level. As a result, officials at the provincial Yunnan Forestry Bureau would not have an official record about Sino-Forest's local forestry assets."

Born from a reverse takeover of a shell company trading on the Alberta Stock Exchange in 1994, Sino-Forest grew to a market capitalization of more than \$6-

billion. Its largest shareholder is Paulson & Co., run by John Paulson, who is among the world's best-known hedge fund managers and whose flagship fund owns 14 per cent of Sino-Forest's shares, according to regulatory filings.

Before the Muddy Waters report was published, seven out of seven Canadian equity analysts who covered Sino-Forest rated the company a buy.

*With reporting by freelance writer Carolynne Wheeler in Beijing.*

## FOREST GROWTH

March 23, 2007: Sino-Forest announces a deal to acquire 200,000 hectares of standing timber in Yunnan province over a 10-year period for \$700-million (U.S.) to \$1.4-billion. The company says it will acquire the trees through "purchase agreements" with Gengma Dai and Wa Tribes Autonomous Forestry Co. Ltd. (Gengma Forestry).

At the same time, the company says it will sell \$200-million in new shares to investors, with most of that going to Temasek Holdings, Singapore's sovereign wealth fund.

Dec. 31, 2007: By this date, Sino-Forest had acquired 10,438 hectares for \$88.1-million under the Gengma deal, according to company disclosures.

2008: Sino-Forest acquires 64,562 hectares of Yunnan forest under the Gengma deal, according to company documents, for a total of 75,000 hectares purchased.

2009: Further acquisitions bring Sino-Forest's total purchases under the Gengma deal to 109,100 hectares, at a cost of more than \$500-million.

2010: Sino-Forest has its busiest year yet in Yunnan, acquiring another 81,200 hectares through Gengma. As of Dec. 31, 2010, it had bought 190,300 hectares of Yunnan trees via the deal, for \$925.9-million.

June 2, 2011: An obscure research firm, Muddy Waters LLC, alleges that Sino-Forest has overstated purchases from the Gengma agreement by \$800-million.

*Source: Company documents*

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