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U.S. China Mining Its Business

Chinese company sets up City of Industry headquarters to raise capital for coal operations back home.

By Joel Russell *Staff Reporter*

U**.S. China Mining** Group Inc. owns mines in Heilongjiang Province, at the extreme northeast corner of China near the Russian and Mongolian borders. It's only U.S. assets are offices in the City of Industry that serve as its headquarters.

So question No. 1: What's it doing here? The answer is surprisingly simple: access to U.S. capital for acquisitions in its home country's booming coal mining industry.

But to execute that plan, the company must overcome obstacles in China, where mining competition is fierce, and in the United States, where U.S. China Mining's over-the-counter stock has been losing value. It doesn't help there are growing concerns about investment fraud involving small Chinese companies.

The company took the first step toward putting its plan into action Jan. 7, when it completed a private placement for $15 million in common stock. The proceeds will complete the rights acquisition and upgrading of a mine in Heilongjiang.

Matt Hayden, a spokesman for U.S. China Mining at San Diego investor relations firm **HC International**, said part of the $15 million also will be used for future acquisitions. In addition, the company has accumulated profits that it plans to invest.

"With over $50 million in cash and a business that generates significant cash flows, the company is well-positioned to capitalize on industry consolidation," Hayden said.

China's coal market has emerged as the largest in the world, consuming more than 3 billion metric tons each year. The International Energy Agency estimates that, in the next 25 years, China will build coal-fired electricity plants with as much capacity as North America, Europe and Japan combined.

A commissioned report on U.S. China Mining prepared by **EquityNet Research** in Sherman Oaks states that China's coal industry mostly consists of tiny mines owned by villages and municipalities. All mines are owned by the government in China, but private companies such as U.S. China Mining can prepay for the right to extract coal.

"China has tens of thousands of small, local coal mines where inefficient management, insufficient investment, outdated equipment and poor safety records prevent the full utilization of coal," the report states. "U.S. China Mining seeks to capitalize on this need (for modernization) by strategically acquiring and consolidating the operations of various mines."

U.S. China Mining paid for

most of its first major acquisition, the rights to the Xing An coal mine, with stock. As a result, the family that owned the mine now controls 42 percent of U.S. China Mining's shares. Mingshu Gong, the family matriarch, is the largest single shareholder with about 5.9 million shares, or 31 percent of total shares outstanding.

Another large stockholder is Chief Executive Hongwen Li, a former provincial mining official, who holds 5.8 percent of outstanding shares. Hayden said U.S. China Mining is specifically headquartered in City of Industry because Li owns a house nearby and lives a portion of the year in California. Li did not respond to repeated requests for an interview.

Digging for Dollars: Trucks at U.S. China Mining's operations at Xing An mine in China's Heilongiang Province.

U.S. China Mining Group Inc. (OTC BB: SGZH.OB)

	Q310	Q309
REVENUE*	$17.9	$9.3
TOTAL LIABILITIES*	12.4	10.5
OPERATING INCOME*	5.3	3.6
NET INCOME*	3.9	2.8
EARNINGS PER SHARE	$0.25	$0.18

* In millions

Summary
BUSINESS: Coal mining and brokering
HEADQUARTERS: City of Industry
CEO: Hongwen Li
MARKET CAP: $70 million
DIVIDEND YIELD: N/A P/E: 8.2

Source: Yahoo Finance

The company also owns the rights to two other Heilongjiang mines. It sells the extracted coal to Chinese power plants, cement producers and wholesalers who sell it for home heating, according to EquityNet.

The largest mine at Xing An shut down early last year so the company could install new equipment to make the mine more efficient and clean. It started up again in September, boosting third quarter earnings.

In addition to coal production, the company also brokers and sorts coal for other mines. The brokerage operation involves transporting coal from other mines on the company's railway cars. The sorting operation involves importing and treating low-grade coal from Mongolia that doesn't comply with Chinese environmental standards, according to EquityNet.

Final 2010 revenue figures have not yet been released, but management guidance indicates U.S. China Mining will have net income of $14.1 million on revenue of $66.5 million. That represents a 44 percent decline in net income compared with 2009. The company has attributed the decline to the closure at Xing An, which hit the stock value hard. Shares trade below $4.50 per share, less than half of their value prior to the closure in November 2009, when the stock was above $11.50. Hayden said the mine should reach full capacity by May.

John Miller, editor of trade

magazine *Asia Miner* in Victoria, Australia, said U.S. China Mining's strategy of buying mines is viable, but the company faces competition from larger rivals with similar strategies. Industrial conglomerates from the United States, Canada, Australia, Indonesia and China are scouring the country in search of good mines. Not all the competition is legal, he added.

"There are so many illegal miners in China that the government is trying to improve conditions by encouraging consolidation and foreign involvement," he said. "Some of these companies in mining and energy are very large and operate on an international scale."

Pacific Rim finance

The company's biggest challenge, though, may be right here at home.

Some Chinese companies that enter U.S. capital markets have a checkered history. Last year, *TheStreet.com* published investigations about fraudulent Chinese investment schemes that use reverse-mergers to get listed on U.S. exchanges without the scrutiny of an initial public offering.

U.S. China Mining, which was not implicated in the investigation, incorporated in Nevada in 2001 and went public through a reverse merger in 2003. It was originally located in Arcadia but moved to Walnut in Northern California in 2005. It relocated to City of Industry in 2008.

A typical example cited by *TheStreet* was China Energy Savings Technology, a maker of energy-efficient lights for streets and commercial buildings. The company, originally called Starway Management, bought a Nevada shell company in 2004 and renamed itself China Energy Savings Technology. In conjunction with the acquisition, about $250 million worth of new stock was issued and given to company insiders, who then bought and sold shares to create the illusion of investor interest. In December 2006, the Securities and Exchange Commission filed fraud charges against the company and the insiders, accusing them of orchestrating a classic pump-and-dump scheme that fleeced investors for at least $25 million.

Hayden maintained that many fraud complaints about Chinese companies come from short sellers who have a financial interest in driving down stock prices.

In response, however, U.S. China Mining is taking steps to establish its legitimacy. The company plans to get listed on a U.S. exchange before the end of the summer, and use its $50-million war chest to acquire significant mining assets. Just this month, its shares moved off the Pink Sheets, where there are no financial reporting requirements, to the Over the Counter Bulletin Board, which requires issuers to file with the SEC.

Veteran L.A. investment banker Lloyd Greif said there may be fraud involving some cross-border companies, but there also is the possibility of great reward for those willing to take some risk.

"Wherever there's growth and money there's the opportunity for fraud," said the chief executive of downtown L.A.-based **Greif & Co.** "You always have to separate the wheat from the chaff. The fact that the company is coming out of a hot market like China doesn't change that."

He recommended investors perform intense due diligence including background checks, a visit to the company's facilities, a review of public filings and a check on the reputation of the company's accounting firm or investment banker.

"Los Angeles is perfectly positioned for this kind of cross-border engagement," Greif said. "There are no major money center banks headquartered in Los Angeles, but we have a number of large venture capital and private equity groups. If companies have a presence in Los Angeles, the money can find them."