Court File No. CV-17-587463-00CL

***ONTARIO***
**SUPERIOR COURT OF JUSTICE**
**COMMERCIAL LIST**

B E T W E E N:

THE CATALYST CAPITAL GROUP INC. and
CALLIDUS CAPITAL CORPORATION

Plaintiffs

- and -

WEST FACE CAPITAL INC., GREGORY BOLAND, M5V ADVISORS INC. C.O.B. ANSON GROUP CANADA, ADMIRALTY ADVISORS LLC, FRIGATE VENTURES LP, ANSON INVESTMENTS LP, ANSON CAPITAL LP, ANSON INVESTMENTS MASTER FUND LP, AIMF GP, ANSON CATALYST MASTER FUND LP, ACF GP, MOEZ KASSAM, ADAM SPEARS, SUNNY PURI, CLARITYSPRING INC., NATHAN ANDERSON, BRUCE LANGSTAFF, ROB COPELAND, KEVIN BAUMANN, JEFFREY MCFARLANE, DARRYL LEVITT, RICHARD MOLYNEUX, GERALD DUHAMEL, GEORGE WESLEY VOORHEIS, BRUCE LIVESEY and JOHN DOES #4-10

Defendants

**SUPPLEMENTARY WRITTEN SUBMISSIONS OF THE DEFENDANTS, NATHAN ANDERSON AND CLARITYSPRING INC.**

**APPENDIX "A": REPORTS ON HINDENBURG RESEARCH WEBSITE**

**(MOTION RETURNABLE DECEMBER 16, 2020)**

**DATE: JANUARY 20, 2021**

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# TAB 1

# Kandi: How This China-Based NASDAQ-Listed Company Used Fake Sales, EV Hype to Nab $160 Million From U.S. Investors

Published on November 30, 2020



## (NASDAQ:KNDI)

- Today we reveal what we believe to be a brazen scheme by China-based, NASDAQ-listed Kandi Technologies Group to falsify revenue using fake sales to undisclosed affiliates.
- Our investigation included extensive on-the-ground inspection at Kandi's factories and customer locations in China, interviews with over a dozen former employees and business partners, and review of numerous litigation documents and international public records.
- We unmasked Kandi's "unnamed" top customers and found that almost 64% of Kandi's last twelve months (LTM) sales have been to undisclosed related parties.
- The company's largest customer, representing ~55% of last twelve months (LTM) sales, shares a phone number with a Kandi subsidiary, and shared an executive with Kandi.
- We visited the "customer". It is based in a tiny building right next to Kandi's factory with a

sign indicating that it's a Kandi company. The same building housed another entity used by Kandi as part of a separate fake sales scheme to collect illegitimate subsidies from the Chinese government, for which it was fined and sanctioned.

- Kandi's second largest customer, representing ~9% of LTM sales, was once wholly owned by the company. Its website still integrates the Kandi logo with the customer name. Export records show that 91% of the U.S. exports by the "customer" went to undisclosed related party entities based out of Kandi's U.S. headquarters and warehouses.
- To support this, we have photographic evidence of one such Kandi "customer's" inventory sitting in Kandi's own warehouse.
- Kandi's financials corroborate our concerns. The company has consistently booked revenue it cannot collect, a classic hallmark of fake revenue. Its Days Sales Outstanding (DSO) a common measure of revenue collection, was 278 days in the previous quarter, about 5.6x worse than its closest auto peer.
- Kandi's top financial ranks have been a revolving door; another key sign of accounting irregularities. The company has had 3 auditors in the past 5 years, and 4 Chief Financial Officers in the past 4 years.
- Kandi's current auditor, Marcum, was just handed a 3-year ban from auditing Chinese companies by the Public Company Accounting Oversight Board (PCAOB). Rather than firing the auditor, Kandi just reported its intention to renew the engagement.
- Kandi's latest issues are part of a long-running pattern, rather than an isolated incident. The architects of Kandi's original go-public transaction were charged with fraud by the SEC in 2014 for, among other things, engaging in a scheme with Kandi's (still) Chairman/CEO to artificially inflate its stock price.
- In 2016, Kandi's long-serving prior auditor was ejected from the industry by the PCAOB specifically for failure to catch obvious signs of fraud at Kandi, including misappropriation by company management and undisclosed related party transactions.
- Kandi's latest pitch to investors is focused on an imminent U.S. launch. We show that Kandi has been "launching" in the U.S. for 12 years. Its first U.S. vehicles were imported illegally and seized by customs. A former distribution partner said every single car that eventually made it into the country broke.
- Kandi has a reputation in China for poor quality vehicles and failing to honor service warranties. The company has reported no domestic EV sales for years outside of its minority stake in a joint venture. We expect its U.S. efforts will continue to sputter.
- We also review Kandi's partnership with a Chinese rideshare company, which it has repeatedly claimed could lead to up to 300,000 EV sales. We show that the rideshare partner's app is mostly vaporware; it has almost no users and isn't even ranked among China's top 50 rideshare apps.
- Lastly, we address the company's much-touted battery swap program, which is preliminary and hopelessly behind peers, including Kandi's own partner Geely. Without a meaningful number of cars on the road Kandi's battery swap efforts simply don't make sense.
- Kandi raised $160 million from U.S. investors this month alone. All told, we think Kandi has engaged in a major fake revenue scheme, hyping its story to U.S. investors, in order to take advantage of regulatory gaps enabling China-based companies to siphon cash from

U.S. capital markets with impunity.

*Initial Disclosure: After extensive research, we have taken a short position in shares of Kandi Technologies. This report represents our opinion, and we encourage every reader to do their own due diligence. Please see our full disclaimer at the bottom of the report.*

## *Introduction: Electric Vehicle Euphoria*

Many investors have come to the realization that electric vehicles are the future of the auto industry. In rational times, such investors might express this view by picking companies that are best-of-breed; the likely industry winners.

But this is 2020, so instead, a psychotic flood of speculative capital has lifted all companies in the sector, regardless of quality.

Readers of this piece are likely familiar with our views on Nikola, the electric vehicle brainchild of Trevor Milton, a man who has forever enshrined "gravity" in the list of zero-emission energy sources (perhaps the company's only genuine innovation to date). [1]

Many investors avoided Nikola due to its speculative status as a pre-revenue newcomer. Some of these investors may have instead found Kandi, seeing it as a revenue generating EV manufacturer with a long history.

## *Background: Basics on the Business*

Before we dive into the specifics, let's review the basics.

Kandi went public in the U.S. in mid-2007 via reverse merger onto the Over the Counter ("OTC") market. It then uplisted and has traded on the NASDAQ since March 2008. [Pg. 14] The company has been run since its inception as a public company by Xiaoming Hu (胡晓明) who serves as Chairman, CEO & President. [Pg. 33]

Historically, the company manufactured and sold ATVs, go-karts, and electric vehicles. Currently, Kandi's main focus is electric cars and related parts.

Kandi has announced several initiatives that are key to its business case (which we will review thoroughly):

1. The "U.S. Launch" of Kandi's small, low-cost electric cars;
2. China's domestic rideshare market, which Kandi hopes to significantly participate in; and
3. The company's battery swap technology, which it has indicated will be spun off and taken public in Shanghai

The company's market cap has expanded to over $1 billion as of this writing, trading ~$13.62 per share, more than 6x its 52-week lows. The company has raised $160 million from U.S. public market investors this month alone. [ 1,2]

# *Part I: Kandi's Extensive History of Fraud Allegations*

Investors in Kandi seem largely unaware of the company's history of credible fraud allegations during its tenure as a public company.

## *2014: The Architects of Kandi's Reverse Merger Deal to Go Public Were Charged With Fraud by the SEC For, Among Other Things, Engaging in A Scheme With Kandi's Chairman/CEO To Artificially Inflate Its Stock Price*

According to an SEC complaint, Kandi was taken public on the OTC by a group of individuals that engaged in multiple market manipulation schemes. [ Pg. 3]

The architects of the scheme were charged with fraud by the SEC in 2014.


**U.S. SECURITIES AND EXCHANGE COMMISSION**

**Litigation Release No. 22986 / May 7, 2014**

***Securities and Exchange Commission v. S. Paul Kelley, et al.*, Civil Action No. 2:14-cv-2827 (D. N.J., filed May 5, 2013)**

**SEC Charges Toronto-Based Consultant and Four Others with Multiple Chinese Reverse Merger Schemes**

The complaint included allegations that the individuals had engaged in a fraudulent scheme to inflate the price and volume of Kandi. [ Pg. 43] According to SEC prosecutors, the scheme was concocted with the help of Kandi's CEO:

**F. Tazbaz, Lockhart, and Becker Orchestrated a Scheme to Defraud Through Manipulative Trading in a Third Chinese Issuer, Kandi Technologies**

132. From approximately April 2009 through at least December 2010, Tazbaz, Lockhart, and Becker orchestrated a scheme to defraud investors of a third Chinese issuer, Kandi Technologies Group Inc., primarily through manipulative trading in Kandi's stock.

133. The manipulative trading was done with scienter. In addition, the manipulative trading was done for the purposes of creating a false or misleading appearance of an active market in the stock and inducing the stock's sale or purchase by others.

134. Kandi was listed on NASDAQ on March 18, 2008, and was trading as high as $6.82 per share in April 2008. However, by the end of 2008, Kandi's stock price had dropped to less than $1.00.

135. Tazbaz and Lockhart held large positions in Kandi's securities that they sought to liquidate.

136. In approximately September 2009, Tazbaz and Lockhart traveled to China to meet with Kandi's CEO. In that meeting, Kandi's CEO reached an oral agreement with Tazbaz and Lockhart as follows:

a. Kandi agreed to provide Tazbaz and Lockhart with 350,000 additional shares of Kandi;

b. Despite Kandi's prior oral agreement that the Kelley Group would cover certain expenses related to maintaining Kandi's public listing for the first two years after going public, Kandi agreed to cover certain additional of its own post-public expenses;

c. In exchange, Tazbaz and Lockhart agreed to pay U.S. stock promoters to tout Kandi; and

d. Tazbaz and Lockhart further agreed to orchestrate U.S. stock promoters to manipulate the trading of Kandi stock to increase its price to at least $3 per share within three months.

The individuals settled the charges in December 2019. Despite the Chairman/CEO of Kandi being identified as playing a critical role in a conspiracy to manipulate his own stock, neither he nor the company were ever charged by the SEC.

## *2016: Kandi's Long-Serving Auditor Had Its Registration Revoked by the Public Company Accounting Oversight Board ("PCAOB") Specifically for Failing to Catch Obvious Signs of Fraud at Kandi*

Kandi's auditor for most of its publicly traded existence was Albert Wong & Co. ("AWC"), a small auditor based in Hong Kong. AWC served as Kandi's auditor from mid-2009 until its dismissal in April 2016.

A month after its dismissal, in May 2016, the PCAOB issued an order revoking AWC's registration, fining it $10,000 and barring its principals from associating with any registered public accounting firm due to its failure to catch obvious signs of fraud at Kandi.

PCAOB
Public Company Accounting Oversight Board

1666 K Street, N.W.
Washington, DC 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-0757
www.pcaobus.org

ORDER INSTITUTING DISCIPLINARY PROCEEDINGS, MAKING FINDINGS, AND IMPOSING SANCTIONS

*In the Matter of AWC (CPA) Limited, WONG Chi Wai, CPA, and WONG Fei Cheung, CPA,*

*Respondents.*

PCAOB Release No. 105-2016-016

May 18, 2016

The order focused on AWC's audit failures relating to Kandi, mentioning the company by name 151 times.

The PCAOB found, among other failures, that AWC failed to implement procedures designed to provide reasonable assurance of detecting material fraud or illegal acts. [ Pg. 4]

**C. Summary**

7. This matter concerns Respondents' violations of PCAOB rules and standards in connection with the issuance of audit reports on the consolidated financial statements of Kandi Technologies Group, Inc. ("Kandi" or the "Company") for the years ended December 31, 2010, 2011, and 2012. As detailed below, Respondents, among other things, failed repeatedly to exercise due professional care and professional skepticism, to obtain sufficient appropriate audit evidence with respect to financial statement assertions, to include procedures designed to provide reasonable assurance of detecting fraud or illegal acts that would have a direct and material effect on the determination of financial statement amounts, and to prepare and maintain adequate audit documentation.

## *The PCAOB Report Went Into Detail About Obvious Signs of Theft by Kandi's Chairman/CEO And Undisclosed Related Party Transactions*

The PCAOB found that AWC failed to take issue with Kandi's Chairman and at least one Kandi finance employee (referred to as "Cashier") **reporting cash held in their personal accounts as belonging to the business. The auditors simply included the cash held in personal accounts in the company's reported cash balance.**

The effect of this was likely a reporting of an inflated cash balance while direct evidence of misappropriation was ignored. Per the report:

> 25. Kandi management represented to Respondents that the $3.0 million temporarily held by the Cashier in her personal account was at the request of Kandi's bank. However, for all of the cash and restricted cash balances held in the personal accounts of the Cashier and Chairman, Respondents failed to consider management's rationale of having Company funds held in the personal bank accounts of the Cashier and Chairman, and whether the stated business rationale (or lack thereof) suggested that the transaction may have been entered into to engage in fraudulent financial reporting or conceal the misappropriation of assets.[24]
>
> 26. At no time during the Kandi 2010 Audit did Respondents consider whether the cash amounts reported as restricted and held in the Chairman's personal accounts represented personal loans from Kandi that might constitute illegal acts, or for which disclosure would have been required as related party transactions. As a result,

The PCAOB report referred to Kandi's responses as "evasive" [Pg. 12] and repeatedly called into question the reliability of its representations and integrity. [Pgs. 8-9, 13]

## *The PCAOB Report Went into Further Detail About Obvious Undisclosed Related Party Transactions At Kandi, Including Those Relating to Kandi USA*

The report also suggested that **management made adjustments to disguise recognition of related party revenue**

> *"**Respondents failed to assess the risk of fraud related to these last-minute adjustments** to reflect the Kandi USA revenue as being from Dingji, **including whether these adjustments were motivated by management's desire to conceal Kandi's transactions with Kandi USA in order to avoid related party disclosures**" [Pgs. 12-13]*

Note that elsewhere in this report, we have detailed specific and obvious signs that Kandi is still engaging in extensive undisclosed-related party transactions through its U.S. operations.

Despite the PCAOB barring AWC and its principals from auditing public companies for failing to identify clear signs of fraud at Kandi, domestic regulators have not brought any enforcement

action against Kandi.

## *2016: The Chinese Government Announced That Kandi Had Been Involved in a Scheme Through its Joint Venture to Obtain Illegitimate EV Subsidies Through the Use of Sham Sales to Related Parties*

In 2013, the Chinese government announced large subsidies to producers of electric vehicles. That same year, Kandi and Chinese EV manufacturer Geely established a joint venture to produce electric vehicles.

According to Chinese media, the joint venture generated subsidies through a scheme involving buying and selling to/from related parties.

The gist of the scheme was as follows: China provided subsidies to both to producers and purchasers of electric vehicles. Kandi gained one subsidy through its manufacturing joint venture with Geely, then sold the cars to a related party entity that purported to be in the rental/car sharing business, collecting the other.

The scheme worked because Kandi's cars were so cheap. The cost to build the vehicles was actually less than the subsidies, so Kandi just needed to build as many cheap cars as possible to cash in on the government money.

In 2016-2017, media reported on the results of a Chinese government investigation which found that Kandi and its JV partner (among others) had thousands of idled vehicles and was involved in fraudulently obtaining state subsidies.

As a result, Kandi's JV partner was fined and Kandi was forced to write off $3.3 million in subsidies.

In 2019, media stumbled across a car lot where thousands of Kandi cars were apparently sitting unused and had been deteriorating for years, believed to be part of the same scheme.

AC 汽车行业关注 autochat.com.cn

**Cheating? A huge shared car cemetery, almost all low-end electric vehicles made in shoddy way**

2019-03-24 12 : 32Source : Automotive industry pays attention to Jianhong

(Pictured: A car cemetery filled with thousands of unused Kandi vehicles. Source )

## *2017: Kandi Restated Its Financials to Account for Previously Undisclosed Related-Party Deals and Promised to Mend its Ways*

On March 7, 2017, the company acknowledged in an SEC filing that in response to questions from the SEC's Division of Corporate Finance, it needed to restate its historical financials to "separately identify certain related party accounts" and make "corrections to the classification of notes receivable and notes payable in the Company's statements of cash flow".

The filing stated that investors should not rely on its financial reporting "or any earnings releases or other communications" from 2014-2016.

The same filing disclosed that Kandi's accounting may have material weaknesses and that the

PCAOB revoked the registration of its prior auditor due to deficiencies.

# *Part II: We Think Most of Kandi's Sales Are Fabricated*

Kandi was not charged by regulators for any undisclosed self-dealing, despite extensive historical evidence suggesting a pervasive pattern.

Part of the issue, we think, is that U.S. regulators have limited access to audit and regulatory information from China, leaving them hamstrung in their overseas enforcement efforts.

In 2017, the company promised to do better going forward, but given the lack of regulatory oversight and consequences: *why would it?*

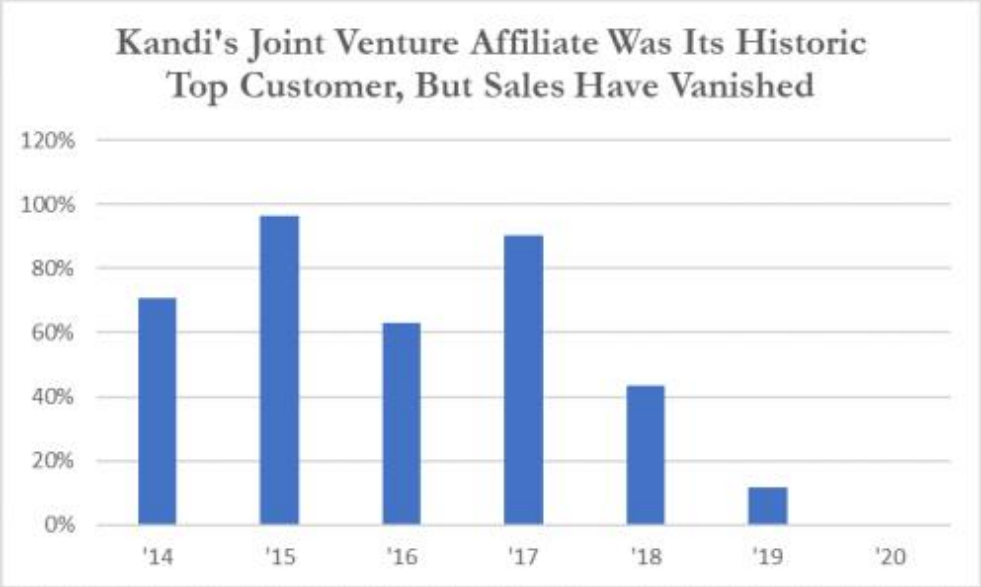
## *Background: Kandi's Top "Customer" From 2014-2017, Representing 63% -97% of its Sales, Was its Joint Venture Partner*

## *But Following the Subsidy Scandal, Sales to the JV Partner Evaporated*

Since 2014, Kandi's reported EV sales had been driven by its joint venture with domestic auto manufacturer Geely. [2] [Pg. 11] But Kandi's sales to its JV partner declined sharply by the end of 2018 following revelations of a Chinese subsidy scandal and subsequent subsidy policy adjustments.

Through its overgenerous subsidies, the Chinese government inadvertently acted as a dedicated "buyer" of Kandi's cars (many of which ended up just rusting in a parking lot, as shown above). Without the subsidy scheme run through its joint venture entity, Kandi needed legitimate buyers for its products.

In Q1 2019, Kandi acknowledged on its quarterly investor call that it didn't sell any EV products due to a "transitional period". Kandi's financials show that its proportion of sales to its joint venture rapidly declined and have essentially vanished in 2020.




(Source: SEC filings)

This is corroborated by Chinese media sources, which reported that the company sold zero vehicles domestically in 2019 and early 2020. [ 1,2,3]

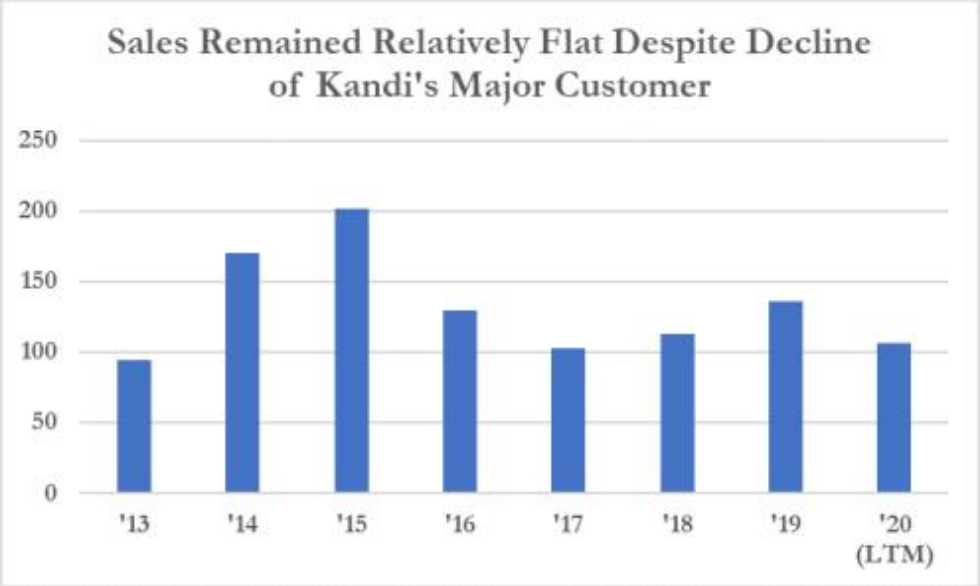
Kandi's joint venture with Geely was originally 50/50, but Geely bought most of Kandi's stake in 2019, leaving Kandi with 22%. The entity is now focused on manufacturing an electric SUV called the Maple 30X. Given Kandi's lack of reported revenues from the affiliate, it is unclear what current role, if any, Kandi plays in its manufacturing.

## *Despite the Virtual Elimination of Kandi's Major Customer, Kandi's Revenue Somehow Remained Stable… With the Help of Two Unnamed Mystery Customers*

Usually sales *drop* when a firm suddenly loses its business from a customer comprising 63%-97% of sales.

Incredibly, that has not been the case with Kandi. Its sales actually rose slightly following the

2018 decline of its top customer, then leveled off.




(Source: SEC filings)

## *Kandi Redacts the Names of its New Top "Customers" Which Have Accounted for Almost 64% of Last Twelve Months (LTM) Sales*

Two unnamed customers have played a big role in plugging up the sales "hole" left behind by the decline of Kandi's JV. Kandi redacts the name of these key customers on its financials, referring to them as "Customer A" and "Customer B".


(Source: Kandi's SEC filings)

## *We Have Identified the Names of Kandi's Top Customers*

Prior to September 2019, Kandi disclosed the names of its top customers. Here is an example from June 2019:

| Major Customers | June 30, 2019 | June 30, 2018 |
|---|---|---|
| Jinhua Chaoneng Automobile Sales Co. Ltd. | 36% | 36% |
| Zhejiang Kuke Sports Technology Co., Ltd. | 27% | 4% |
| Kandi Electric Vehicles Group Co., Ltd. and its subsidiaries | 17% | 29%(1) |

As of September 2019, the company began redacting the names of its top customers, except for the name of its related party joint venture partner:

| Major Customers | September 30, 2019 | September 30, 2018 | S |
|---|---|---|---|
| Customer A | 30% | 24% | |
| Customer B | 30% | 4% | |
| Kandi Electric Vehicles Group Co., Ltd. and its subsidiaries (related party) | 15% | 61% | |
| Customer D | 10% | - | |

The remaining customers, according to Kandi's disclosures, are sales to unrelated party customers.

We were able to identify Kandi's top customers by connecting the dots between the percentage of sales associated with each customer in the prior periods when the names were unredacted.

For example, customer concentration disclosures from June 2020 referenced the customer concentration numbers from the prior year (when the names were unredacted). [ Pg. 10, Pg. 17]

| Major Customers | June 30, 2020 | June 30, 2019 |
|---|---|---|
| Customer A | 57% | 36% |
| Customer B | 15% | 27% |

| Major Customers | June 30, 2019 | June 30, 2018 |
|---|---|---|
| Jinhua Chaoneng Automobile Sales Co. Ltd. | 36% | 36% |
| Zhejiang Kuke Sports Technology Co., Ltd. | 27% | 4% |

Once unmasked, we examined the customer relationships more closely and found alarmingly close ties to Kandi.

## *Kandi's New Top Customer, Accounting for 55% of LTM Sales, Shares a Phone Number with a Kandi Subsidiary*

According to Chinese corporate records available through corporate records service QCC, key customer Jinhua Chaoneng Automobile Sales ( 金华市超能汽车销售有限公司) shares its phone number with a 100% Kandi-owned subsidiary.

Here is Jinhua's corporate record, with its phone number highlighted, including an indication that it shares the number with three other entities:


The second name on the list of shared numbers is Zhejiang Kangdi Intelligent Power Exchange Technology Co., Ltd. (浙江康迪智能换电科技有限公司), which is 100% owned by Kandi .

同电话企业

0579-82239276

| 序号 | 企业名称 | 法定代表人 | 注册资本 | 成立日期 | 经营状态 |
|---|---|---|---|---|---|
| 1 | 金华市超能汽车销售有限公司 | 胡毅恒 | 100万元人民币 | 2011-05-17 | 存续 |
| 2 | 浙江康迪智能脱电科技有限公司 | 王新伙 | 2000万元人民币 | 2015-03-06 | 存续 |
| 3 | 金华市宝翔进出口有限公司 | 凌经纬 | 200万元人民币 | 2011-07-12 | 存续 |

We called the number to see which (if any) company the phone number belonged to. This was the conversation (which we recorded):

**HER**: Hello

**US**: Hello. Are you Jinhua Chaoneng?

**HER**: No

**US**: What company are you?

**HER**: Who are you?

**US**: I'm looking for Jinhua Chaoneng and had this number

**HER:** They moved away many years ago

**US**: Oh, then are you Kandi?

**HER**: Who are you?

**US**: I'm looking for these companies. I want to check if this phone number belongs to Chaoneng or Kandi or who?

*(HANGS UP)*

## *We Visited the Address of the Customer and Found Them Based in a Small Building <u>Adjacent to a Kandi Factory</u>*

# *The "Customer" Had Kandi's Name in Its Signage, Indicating That it is Part of Kandi*

The addresses of the 2 companies are also almost identical, per the same corporate records. Both are based at plots "G-01-03 and G-02-01" in an industrial park in Jinhua City, per QCC records.

First, we viewed the customer address using Baidu maps . It shows a Kandi factory:


(Source: Baidu Maps)

Then, we sent an investigator to the industrial park several months ago in order to confirm ourselves:


(Source: Hindenburg investigator, Summer 2020)

We asked the security guard working the Kandi gate about Chaoneng (the customer) and he had never heard of them.

However, we found a small building adjacent to the factory with a sign that named the purported customer as "Jinhua **Kandi Electric Vehicle**Chaoneng".

(Source: Hindenburg investigator, Summer 2020)

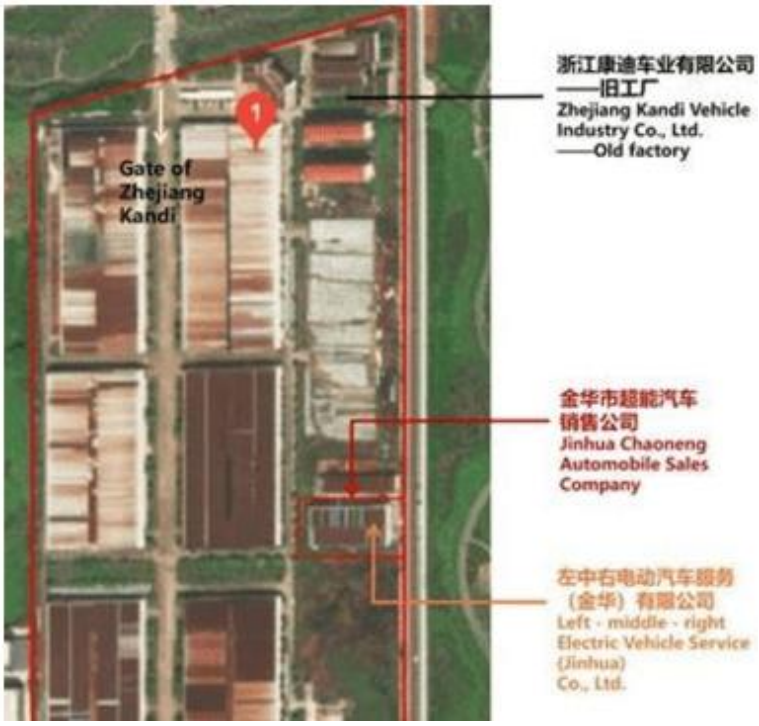
## *The "Customer" Address Matched the Address of the Key Undisclosed Related Party Entity Involved Kandi's Earlier Fake Sales/Subsidy Scheme*

As noted above, the Chinese government had previously sanctioned Kandi and its JV partner over a scheme to collect illegitimate government subsidy payments through fake EV sales.

The entity used to generate the fake sales in that scheme was named " Left Middle Right, Co. Ltd" (浙江左中右电动汽车服务有限公司), and is based out of the exact same small building as Kandi's new top "customer".


(Source: Hindenburg investigator, Summer 2020)

Here is an overhead view of the Kandi factory and its purported customer/subsidy scheme entities.




Kandi appears to simply be recycling its old fake sales playbook (except this time the target is U.S. investors rather than the Chinese government.)

## *Kandi's New Top Customer Shared an Executive with Kandi, Further Evidencing Close Ties Between the Two Companies*

Further evidencing a long connection, a 2010 article detailed how an individual named Hu Yiheng, a Kandi employee, held a senior position at Kandi acting as "办主任" or "Office Director".

Hu YiHeng [3] is the name of Chaoneng's legal representative since June 17, 2013 and is also a 30% shareholder of Chaoneng, per corporate records through QCC.com:

| | | | | |
|---|---|---|---|---|
| 12 | 2013-06-17 | 法定代表人(负责人、董事长、首席代表)变更<br>带有*标记的为法定代表人 | 朱世贵 | 胡毅恒* |
| 14 | 2011-06-21 | 投资人(股权)变更<br>带有*标记的为法定代表人 | 姓名:宋富元;出资额:30;百分比:30%【退出】<br>姓名:徐朝建;出资额:70;百分比:70%【退出】 | 姓名:朱世贵;出资额:70;百分比:70%【新增】<br>姓名:胡毅恒*;出资额:30;百分比:30%【新增】 |

In short, Kandi's largest "customer" is (a) based at a Kandi factory; (b) shares a phone number with a Kandi subsidiary; (c) integrates Kandi into its own signage; (d) is based in the same building as another entity involved in a fake sale scheme for Kandi; and (e) shares or shared a key executive with Kandi.

We do not think sales to this entity are legitimate.

## *Kandi's Second Largest Customer, Named "Kuke", Accounts for 9% of LTM Sales. It Was Previously Wholly Owned by Kandi And Still Has an Unusually Tight Relationship*

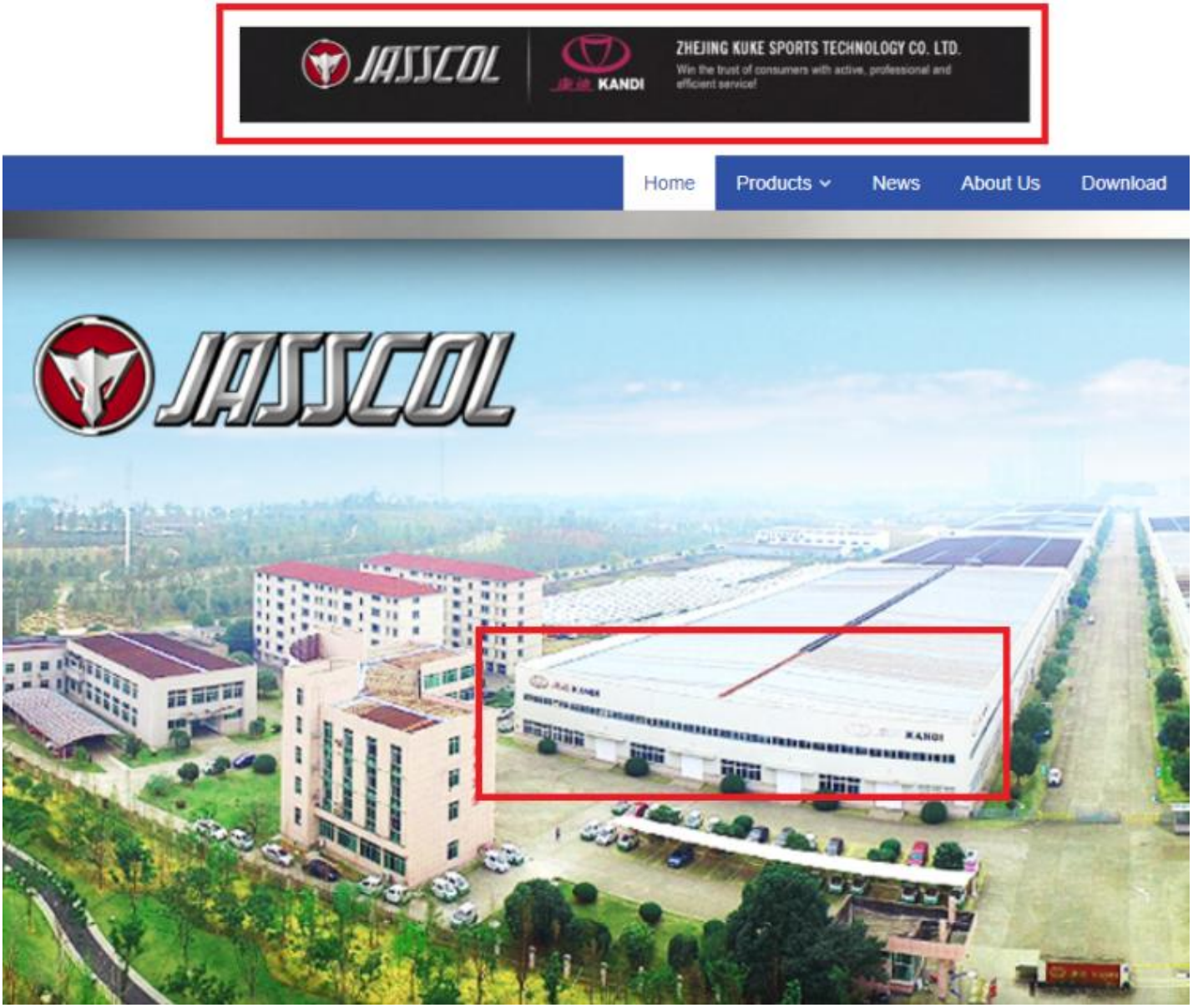
Kandi's 2nd largest customer is Zhejiang Kuke Sports Technology Co., Ltd. (浙江酷客运动科技有限公司) ("Kuke"). The customer accounted for 11% of last quarter's sales and 9% of Kandi's LTM sales.

In an obvious link between the two entities, we found that Kandi *previously owned* Kuke up until 2008, right around the time of Kandi's IPO, when it was sold to 2 private individuals.

| | | | | |
|---|---|---|---|---|
| 26 | 2008-02-05 | 投资人(股权)变更 | 企业名称:浙江康迪车业有限公司;出资额:500;百分比:100%;法人性质:法人股东【退出】 | 姓名:邮剑锋;出资额:150;百分比:30%【新增】<br>姓名:吕二娃;出资额:350;百分比:70%【新增】 |

In fact, corporate records on QCC.com **still refer to the company as being a part of Kandi**


Kuke's website still shows close ties to Kandi. The homepage features a large image of Kandi's factory, and the company's logo integrates Kandi with its corporate name. The site also features the brand name "Jasscol", which is a registered trademark *owned by Kandi* [Pg. 5]


JASSCOL
KANDI
ZHEJING KUKE SPORTS TECHNOLOGY CO. LTD.
Win the trust of consumers with active, professional and efficient service!
Home
Products
News
About Us
Download
JASSCOL
KANDI

(Source: Kukesport.com , accessed 11/25/2020)

## *Export Records Show ~91% Of Kuke's U.S. Exports Have Gone to Three Entities Based Out of Kandi America's Addresses*

## *In Other Words, Kuke is "Buying" From Kandi Then Selling Right Back to Obvious Undisclosed Related Parties of Kandi*

Kuke's website indicates that exports to North America comprise the vast majority of its business.

ABOUT US

Company Name:
ZHEJIANG KUKE SPORTS TECHNOLOGY CO., LTD

Business Type:
Manufacturer

Year Established:
2001

Total Employees:
51-100

Total Annual Revenue:
5 million US dollars- 10 million USD

Export Percentage:
71% - 80%

Major markets and proportions:
North America 70% , South America 5% , Eastern Europe 1% , Southeast Asia 4% , Africa 1% , Oceania 1% , Mid East 2% , Eastern Asia 4% , Western Europe 1% , Central America 5% , Northern Europe 1% , Southern Europe 1% , South Asia 1% , Domestic Market 3%

(Source: KukeSport About Us Web Page)

We reviewed export records through data aggregator Import Genius. Using the earliest records available, dating back to October 2017, we found that over 90.9% of Kuke's exports to

the U.S. by weight went to three entities:

(1) Massimo Motor Sports LLC

(2) Lil Pick Up Inc.; and

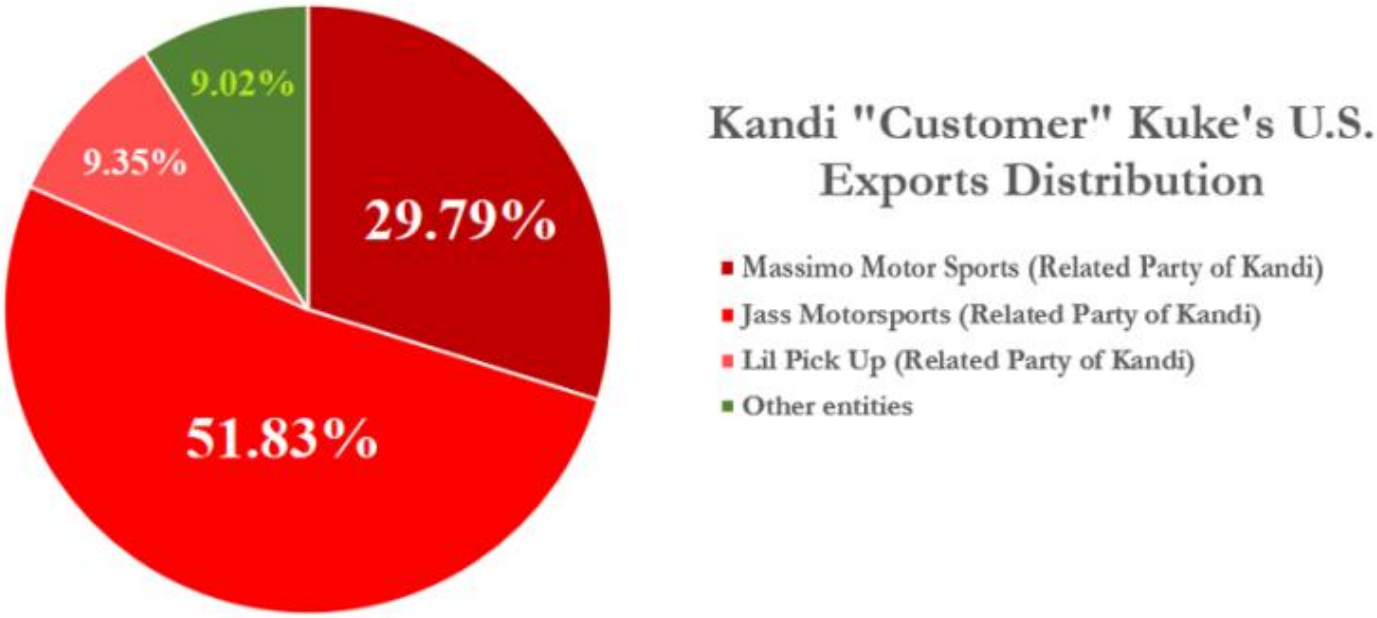
(3) Jass Motorsports Inc.

Here is a sample of the records, showing Kuke shipping to Massimo, Lil Pick Up, and Jass:

| PRODUCT DESCRIPTION | CONSIGNEE | SHIPPER | ARRIVAL DATE | WEIGHT (LB) |
|---|---|---|---|---|
| GO KART | JASS MOTORSPORTS INC. | ZHEJIANG KUKE SPORTS | 02/15/2018 | 22176 |
| GO KART | JASS MOTORSPORTS INC. | ZHEJIANG KUKE SPORTS | 02/15/2018 | 22968 |
| GO KART | JASS MOTORSPORTS INC. | ZHEJIANG KUKE SPORTS | 02/11/2018 | 22968 |
| ATV ATV | LIL PICK UP, INC. | ZHEJIANG KUKE SPORTS | 04/04/2019 | 44814 |
| ATV | LIL PICK UP, INC. | ZHEJIANG KUKE SPORTS | 03/18/2019 | 25894 |
| ATV ATV | LIL PICK UP, INC. | ZHEJIANG KUKE SPORTS | 03/13/2019 | 43725 |
| LOW SPEED VEHICLE L | MASSIMO MOTOR SPORTS | ZHEJIANG KUKE SPORTS | 11/23/2020 | 69498 |
| LOW SPEED VEHICLE L | MASSIMO MOTOR SPORTS | ZHEJIANG KUKE SPORTS | 11/23/2020 | 46332 |
| LOW SPEED VEHICLE L | MASSIMO MOTOR SPORTS | ZHEJIANG KUKE SPORTS | 11/23/2020 | 69498 |
| LOW SPEED VEHICLE E | MASSIMO MOTOR SPORTS | ZHEJIANG KUKE SPORTS | 11/17/2020 | 71229 |
| LOW SPEED VEHICLE L | MASSIMO MOTOR SPORTS | ZHEJIANG KUKE SPORTS | 11/17/2020 | 70022 |
| LOW SPEED VEHICLE L | MASSIMO MOTOR SPORTS | ZHEJIANG KUKE SPORTS | 11/17/2020 | 69498 |
| LOW SPEED VEHICLE E | MASSIMO MOTOR SPORTS | ZHEJIANG KUKE SPORTS | 11/17/2020 | 23925 |
| LOW SPEED VEHICLE L | MASSIMO MOTOR SPORTS | ZHEJIANG KUKE SPORTS | 11/10/2020 | 49104 |

(Source: ImportGenius export records)

As we will show momentarily, state corporate records and litigation documents reveal that Massimo, Jass and Lil Pick Up are based out of addresses associated with Kandi America, making them clear related parties.




## *30% of Kuke's Historical Exports Were to Massimo Motor Sports LLC, An Entity Based Out of Kandi America's Headquarters and Owned by the Founder and Manager of Kandi America*

Massimo Motor Sports is based out of Kandi's U.S. headquarters in Texas and is owned by David (Jianxun) Shan, a founder and current manager of Kandi's U.S. subsidiary.

Here are Massimo's corporate records showing the address matching Kandi's U.S. headquarters:

05-102 (Rev.9-15/33)

**Texas Franchise Tax Public Information Report**

*To be filed by Corporations, Limited Liability Companies (LLC), Limited Partnerships (LP), Professional Associations (PA) and Financial Institutions*

Tcode 13196 Franchise

| Taxpayer number | Report year |
|---|---|
| 3 2 0 3 9 8 1 6 1 0 6 | 2 0 1 8 |

| | |
|---|---|
| Taxpayer name | MASSIMO MOTOR SPORTS LLC |
| Mailing address | 3101 W MILLER RD |
| City | GARLAND |
| State | TX |
| ZIP code plus 4 | 75041 |

KANDI

**USA Headquarters**
**3101 W Miller Rd, Garland, TX 75041**

**General Questions**
info@kandiamerica.com

(Source: Texas Corporate Records and Kandi America website )

## *After Buying Kandi Product's Through Kandi's "Customer", Massimo Motor Sports Then Sells Products Right Back to Kandi.*

## *Massimo, An Undisclosed Related-Party Entity of Kandi America, Is Therefore Both a Top Customer and a Top Supplier Of/To Kandi.*

## *We View This as a Brazen, Clear Circular Sales (i.e. Fake Revenue) Scheme*

Once Massimo receives product from Kandi's key "customer" Kuke, who does it sell its products to? Evidence shows that one of Massimo's key customers… is Kandi.

Kandi began redacting the names of its suppliers in late 2019. Using the same trick we used to unredact its customer names, we see that Massimo has been Kandi's "Supplier C", representing 25% of Kandi's purchases in the first six months of 2020, and 15% in the same 2019 period.

| Major Suppliers | Six Months Ended June 30, 2020 | Six Months Ended June 30, 2019 |
|---|---|---|
| Zhejiang Kandi Supply Chain Management Co., Ltd. | 59% | 48% |
| Supplier C | 25% | 15% |

| | Purchases | |
|---|---|---|
| Major Suppliers | Six Months Ended June 30, 2019 | Six Months Ended June 30, 2018 |
| Zhejiang Kandi Supply Chain Management Co., Ltd. | 48% | |
| Massimo Motor Sports, LLC | 15% | |

To recap, Kandi sells to top "customer" Kuke à which then exports to Massimo (based out of Kandi's U.S. headquarters) à then Massimo sells products right back to Kandi.

## *52% of Kuke's Historical Exports Were to Jass Motorsports Inc., An Entity That Shared an Executive With Kandi and Was Based Out of the Exact Same Address As a Branch of Kandi USA*

Moving right along, Kandi's "customer" Kuke also exports to an entity called Jass Motorsports.

Jass Motorsports' incorporation documents list a Rancho Cucamonga, California address that matches the address previously listed for a branch of Kandi USA. Both entities shared an executive officer as well.

Jass Motorsports, Inc.

The name and address in the State of California of this corporation's initial agent service of process is:

XIAOHUI ZHANG
10955 ARROW ROUTE, STE 101
RANCHO CUCAMONGA, CA 91730

IV

The initial street address in the State of California of this corporation is:

10955 ARROW ROUTE, STE 101
RANCHO CUCAMONGA, CA 91730

KANDI USA, INC. BRANCH

| | |
|---|---|
| Company Number | 2011060100233 |
| Status | Active |
| Incorporation Date | 31 May 2011 (over 9 years ago) |
| Company Type | Foreign For-Profit Corporation |
| Jurisdiction | Indiana (US) |
| Branch | Branch of KANDI USA, INC. (California (US)) |
| Registered Address | 10955 ARROW RT, STE 101, RANCHO CUCAMONGA, CA 91730 United States |
| Directors / Officers | PACIFIC REGISTERED AGENTS, INC, agent<br>Wangyuan Hu, president<br>Xiaohui Zhang, secretary |

(Pictured: Jass Motorsports and Kandi USA Corporate records via California Corporate Records and OpenCorporates )

## *9% of Kuke's Historical Exports Went to Lil Pick Up, Inc., An Entity That Also Leases Warehouse Space at Kandi America's Headquarters*

## *We Have Photographic Evidence Showing Lil Pick Up Inventory Sitting in Kandi America's Warehouse, Covered with a Tarp*

Export records show that Kuke also regularly exports to Lil Pick Up, a company run by Renfeng Wang, who appears to share a business relationship with Kandi America Founder & Manager David Shan. [1,2,3]

Recent litigation records revealed that Lil Pick Up, LLC rents space at 3101 West Miller Road in Garland Texas, the headquarters for Kandi America. [Pg. 8]

The records even include a picture of Lil Pick Up inventory sitting in the warehouse covered with a tarp, dated from July of this year.

(Pictured: Inventory owned by Lil Pick Up Inc., a supposed Kandi customer, covered in a tarp at Kandi's U.S. headquarters, dated July 17, 2020, per litigation records [Pg. 9])

## *Kandi Has Consistently Booked Revenue That it Can't Collect, A Classic Sign of Fake Revenue.*

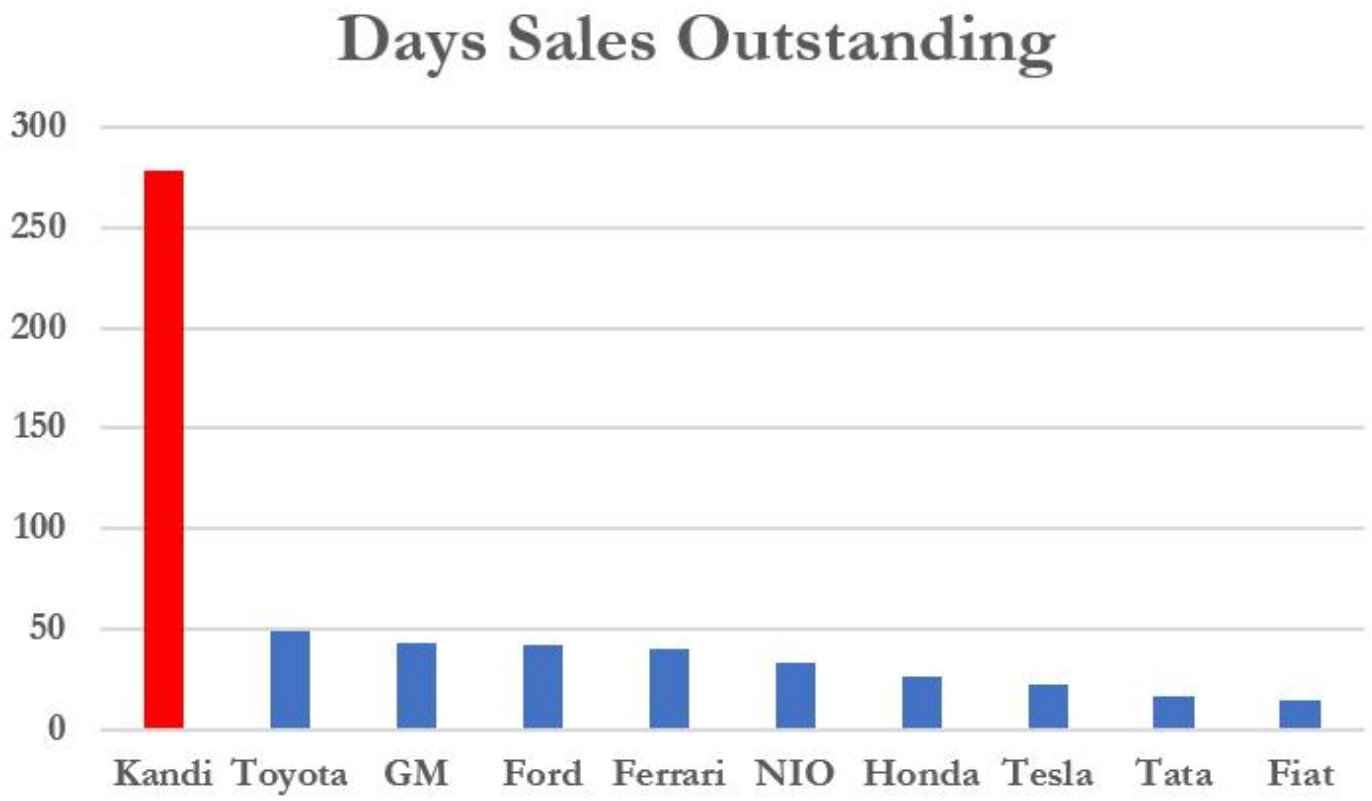
## *Kandi Had 278 Days of Sales Outstanding—5.6x Higher Than its Closest Competitor.*

Kandi's financial statements support our findings.

When most companies sell a product, they eventually collect the revenue and convert it into cash. This is especially true in the auto industry where cars are usually financed or paid for on the spot, before they are driven off the lots at dealerships.

Kandi seems to sell plenty of product, but then appears to have an incredibly difficult time collecting and converting it into cash.

The key measure of revenue collection is days sales outstanding ("DSO"), which measures the average days it takes to convert accounts receivable into cash. Kandi's DSO in the previous June quarter was 278 days, 5.6x its closest auto manufacturing competitor, making it an outrageous outlier.

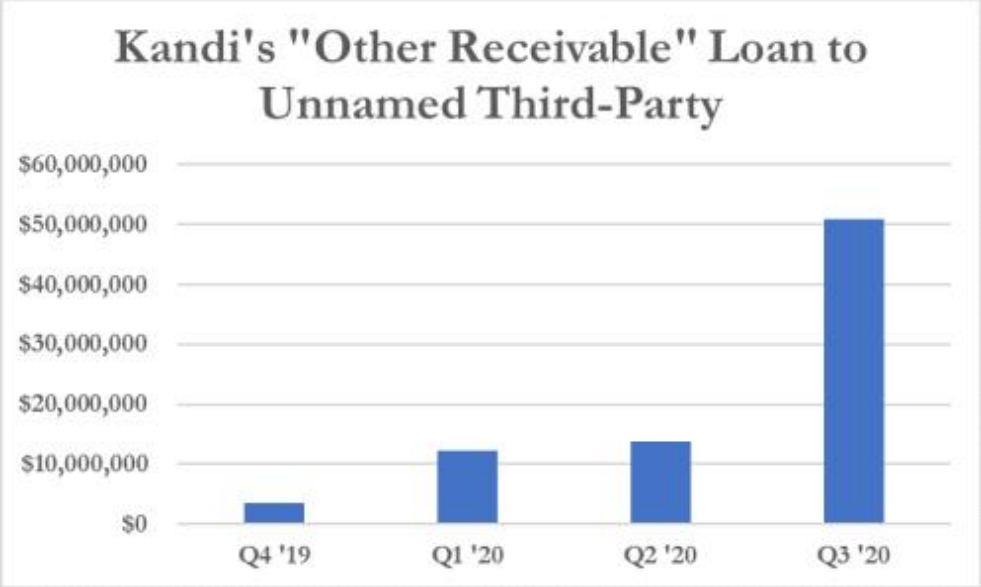



(Source: Author calculations based on SEC filings)

The company has attempted to justify its revenue collection failure by stating that its credit terms are "typically 180 to 360 days after delivery." [ Pg. 27] This doesn't add up—very few industries allow customers to pay a year after they've received a product, and as seen above, automobiles clearly aren't one of them.

In Kandi's most recent September quarter, its trade receivables balance declined, but a new category of unusual receivable that has ballooned in its place. Kandi recorded a ~$51 million "loan to third party" as an "other receivable" in the most recent quarter, up from $13.7 million in the prior quarter.

This mystery loan did not seem to exist a year ago.




(Source: Kandi's SEC filings)

Most businesses generating $106 million in LTM revenue don't suddenly loan $51 million to unnamed third parties without explanation. Once again, these major balance sheet irregularities are hallmarks of fake revenue. When factoring in the new mystery receivable, Kandi's DSO in its most recent quarter is a whopping 429 days.

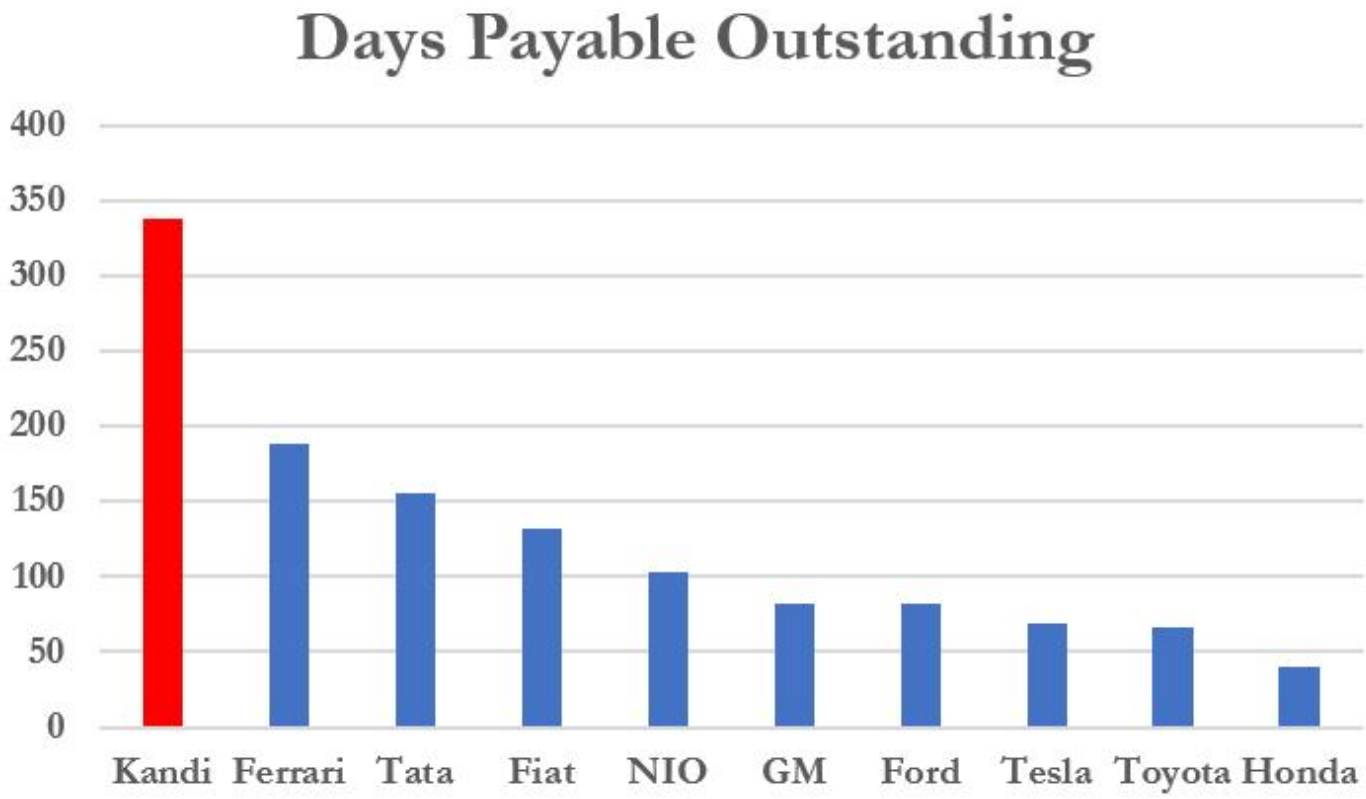
## *Kandi's Payables Are Similarly Outrageously High at 338 Days Outstanding—1.8x Its Closest Competitor.*

## *Are Suppliers Awarding Kandi the Most Generous Payment Terms in the Industry—Or Are Circular Sales Resulting in Fake Payables Along with Fake Receivables?*

Typically, large, established market participants can demand better terms for amounts owed to suppliers due to their size and financial strength. Kandi is a fraction of the size of its larger auto peers and is generally a cash burning enterprise.

Despite this, Kandi's financials indicate that its payment terms with suppliers are the most generous in the industry. Its Days Payables Outstanding ("DPO") in the prior June quarter was 338 days, almost a full year.

That is 1.8x its closest auto manufacturing competitor, again making Kandi a clear outlier within its industry.




(Source: Author calculations based on SEC filings)

Why might this be the case? Another hallmark of fake revenue is when companies have large unexplained payables alongside large unexplained receivables.

Companies engaging in circular sales schemes may sell and later repurchase its own product, such as appears to be the case with Kandi and its relationship with Massimo, which we have shown above to be both an undisclosed related-party customer AND supplier of Kandi's products.

The result of all this is the generation of fake revenue, fake earnings, and fake receivables/payables from/to the undisclosed related entities.

Some readers might be wondering—isn't this all the sort of thing auditors are supposed to catch?

## *Kandi Has Had 3 Auditors in the Past 5 Years and Has Regularly Reported Weaknesses in Its Financial Controls*

Frequent changes with a company's auditor are another red flag for accounting issues.

Kandi has taken this red flag to another level. As described above, Kandi's long-serving auditor Albert Wong & Co. was ejected from the industry following its well documented failures to catch clear signs of fraud at Kandi. The firm was dismissed as Kandi's auditor in April 2016 and was replaced by BDO.

**2016**: In BDO's first year as Kandi's auditor, it identified 5 *entire categories* of material accounting weaknesses. These included material weaknesses in its disclosure of related party transactions. [Pg. 45]

**2017**: Kandi reported that it had instituted a plan to "remediate" the material weaknesses in its internal controls over financial reporting. [Pg. F-3] BDO's audit opinion for the year said that the weaknesses had "not yet been fully remediated" as of the end of 2017. [Pg. F-3]

**2018**: BDO issued a clean audit opinion, [Pg. F-3] but then was subsequently replaced in October 2019 after BDO and the company "mutually elected not to continue the engagement". BDO was replaced with Marcum Bernstein & Pinchuk, marking Kandi's 3rd auditor in under 5 years.

So, how are things going with Marcum so far?

## *Two Months Ago, Kandi's Current Auditor Marcum Was Handed a 3 Year Ban From Auditing Chinese Companies by the Public Company Accounting Oversight Board Due To Violating Audit Standards*

Kandi's current choice of auditor comes as no surprise. Marcum had already been disciplined and sanctioned by the PCAOB in 2019 violating rules on independence:

# PCAOB Sanctions Two Firms and One Individual for Auditor Independence Violations

Washington, Sep. 10, 2019

The Public Company Accounting Oversight Board today announced the settlement of disciplinary proceedings against **Marcum LLP** and **Marcum Bernstein & Pinchuk LLP**, as well as **Alfonse Gregory Giugliano, CPA**. This is the first time the Board has: (1) sanctioned a registered public accounting firm for publicly advocating its audit clients as investment opportunities—a violation of auditor independence requirements; (2) sanctioned an annually inspected firm's head of independence for substantially contributing to the firm's independence violations; and (3) mandated the retention of an independent consultant.

The 2019 order sanctioned Marcum in connection with its "China Best Ideas Investment Conference", where it "endeavored to create a perception that the China Conference was an event featuring companies—some of which were Marcum issuer audit clients—that were high-quality investment opportunities".

In September 2020, Marcum was handed a three year ban on auditing Chinese companies as a result of violating PCAOB rules and auditing standards.

MARCUM LLP

# PCAOB prohibits Marcum from doing China audits

By Michael Cohn October 02, 2020, 4:10 p.m. EDT 3 Min Read

The Public Company Accounting Oversight Board has imposed a $250,000 penalty on Marcum LLP and its Marcum Bernstein Pinchuk unit over audits of Chinese companies and prohibited the firm from auditing clients in China for three years.

Upon seeing this news, a reputable company would have likely fired Marcum immediately so as to disassociate from its soiled reputation. But on November 17th, six weeks after the PCAOB prohibition announcement, Kandi filed proxy documents seeking to reappoint Marcum as its auditor for the year.

## *It Hasn't Just Been Auditors That Have Been A Revolving Door: Kandi Has Had 4 CFOs Over the Past 4 Years, Another Major Red Flag*

Kandi's Chairman/CEO has maintained his position since inception, but the company's top accounting rank has seen extensive turnover.

**2016:** In November, Kandi's CFO Wang Chen resigned and was replaced with Mei Bing.

**2019:** In January, Mei Bing resigned as CFO for "personal reasons" and was replaced with interim CFO Zhu Xiaoying.

**2020:** In May, Kandi appointed Jehn Ming (Alan) Lim as CFO, who is currently serving in the role, after Zhu Xiaoying was said to have "completed her responsibilities" as interim CFO.

## *Kandi's New CFO: Prior Work History Included Working at (i) An Accounting Firm Ejected by the PCAOB and (ii) an Affiliate of Kandi's Current Auditor*

Of the two recent firms Kandi's newly-appointed CFO worked at, one had its registration revoked by the PCAOB and the other is affiliated with Kandi's auditor.

According to his biography in SEC filings, Kandi's CFO worked at accounting firm Stonefield Josephson from 2006 to 2008. The firm later merged with Marcum, Kandi's new auditor through its Chinese joint venture.

Lim later served at Kabani & Company from 2008 to 2012, per his biography in SEC filings. (He left this out of his LinkedIn profile for understandable reasons.)

Kabani had its registration revoked after PCAOB inspectors found a "wide-spread and resource-intensive effort" to alter documents in audit files in order to pass inspection in 2008:

PCAOB
Public Company Accounting Oversight Board

1666 K Street, N.W.
Washington, DC 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8435
www.pcaobus.org

**PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD**

| | |
|---|---|
| *In the Matter of Kabani & Co., Inc.,*<br>*Hamid Kabani, CPA,*<br>*Michael Deutchman, CPA,*<br>*and Karim Khan Muhammad, CPA,*<br><br>Respondents | PCAOB File No. 105-2012-002<br><br>**ORDER SUMMARILY AFFIRMING FINDINGS OF CERTAIN VIOLATIONS AND IMPOSITION OF SANCTIONS FOR THOSE VIOLATIONS**<br><br>January 22, 2015 |

**I. Introduction**

On April 22, 2014, the hearing officer issued an amended initial decision in this disciplinary proceeding, finding that the registered public accounting firm Kabani & Co., Inc., and three associated persons of the firm, Hamid Kabani, Michael Deutchman, and Karim Khan Muhammad, participated in a "wide-spread and resource-intensive effort" over several weeks in 2008 to alter documents in the audit files of three issuers in an attempt "to deceive PCAOB inspectors in an upcoming inspection about the deficiencies in the Firm's audit work papers." The decision found that Kabani's and Deutchman's misconduct was "intentional and knowing," and Khan's was "knowing, intentional, or at least reckless." The decision concluded that respondents thereby violated PCAOB Rule

# *Part III: Kandi Has Been "Launching" in the U.S. for 12 Years. We Expect its Efforts Will Continue to Sputter*

Investors of late have been drawn to Kandi's much-touted "U.S. launch". The pitch by Kandi is that it aims to provide a low-cost electric vehicle that is attractive to value-oriented U.S. consumers.

Typically, companies expand to new markets after they have developed a strong presence in their domestic markets. Not the case with Kandi. The company operates in China, the largest EV market in the world, yet Kandi has reported a grand total of zero domestic Chinese EV automobile sales since the end of 2018. [ Pg. 24, Pg. 32, Pg. 28, Pg. 22]

We spoke with several former employees of Kandi America to learn what is going on. We were told that the latest "launch" is nothing new. For years, the company has failed to deliver the number of cars and failed to sign up the number of dealerships necessary to succeed. Several referred to Kandi's U.S. efforts as "smoke and mirrors" and openly speculated that it could be a strategy to lift its stock price.

# *Kandi "Launched" in the U.S. in 2008. Its First Batch of Cars Were Seized by U.S. Customs After Being Imported Illegally. The Launch Failed*

New investors in Kandi may not realize that the company has attempted to launch in the U.S. multiple times over the past 12 years. Each attempt has sputtered.

Kandi began seeking to expand its presence to the U.S. as early as 2006. [ Pg. 4] By late 2008/early 2009, the company introduced the "Coco" to the U.S. market, a golf cart-like vehicle that could reach maximum speeds of about 25 mph, but was intended for street use.

One major problem emerged: the initial vehicles had been imported illegally. Customs officials identified that Kandi and its distributor had misclassified the vehicles as ATVs. The EPA intervened , fined Kandi $40,000, and ordered the company to destroy or export the vehicles back out of the country.

**U.S. ENVIRONMENTAL PROTECTION AGENCY**
**WASHINGTON, D.C.**

| | | |
|---|---|---|
| In the Matter of: | ) | |
| | ) | ADMINISTRATIVE |
| | ) | SETTLEMENT AGREEMENT |
| Solus International Corporation and | ) | AED/MSEB-7809 |
| Kandi USA, Inc., | ) | |
| | ) | |
| Respondents. | ) | |

The company eventually sorted out the problem and, in 2008, a smattering of U.S. dealerships attempted to sell the car, as shown in this example video :


Federal and state tax credits made the car as cheap as $865 for Oklahoma residents . (Joe Exotic from the popular Netflix series Tiger King, an Oklahoma resident, purchased a Coco .) But the company eventually stopped reporting sales of the Coco after 2012 and the car quietly disappeared from the market.

## *We Asked Kandi's 2008 U.S. Distribution Partner About the Vehicles: "They Didn't Run, Every Single One Broke"*

To learn what happened with the company's original U.S. launch, we spoke with a founding partner of Kandi's U.S. importer and distributor for its 2008 Coco release.:

> *"We brought in our first 200 vehicles and had nothing but problems. They didn't run, **every single one broke**.The prototype was excellent but when they started shipping these vehicles nothing but problems. Engines weren't working, batteries were burning up."*

> *"I had three big distributors that took in the first allotment of cars. I had them set up to buy 2,000 vehicles in the first year from Kandi. We had the documentation but from what I understood they forged it, they faked it……Customs got them and said if you don't get these cars out of the US then you're going to be fined and they will be destroyed."*

We asked how many of Kandi's cars had issues when they finally made it into the country:

> *"Every single one…I'm a salesman and I was running round the country like a mechanic. I was flying all around the country trying to fix these things and it just got to the point 'I'm out, I can't do this anymore… I left because I the whole process was horrible, too secretive, a lot of side deals I didn't know about. I said you guys handle it, I'm out."*

## *Kandi Tried to Launch U.S. Operations Again in 2018, But Plans Were Delayed*

After the failure of the "Coco", Kandi planned another U.S. launch in 2018.

Kandi bought a U.S. company in early 2018 known for sales of ATVs and recreational vehicles, then renamed it Kandi America. In June 2018, Kandi formally announced its expansion into the U.S. market, starting with 3 prototype vehicles. (A Model K22 and 2 Model EX3s.)

In August, Kandi held a launch event to showcase its cars to dealers in the hopes of developing a distribution network. We spoke with a former employee who worked for the company at the time, who told us:

> *"They had a press release at a hotel in Frisco and they set up the cars in a nice display room and Chamber of Commerce folks from Garland came and there was all this big to-do. And I thought great it's going to happen* ***But from that point, no cars and no nothing. Nothing ever showed up and nothing ever happened".***

We asked if any dealers signed up:

> *"No not to my knowledge.* ***To my knowledge we never had anybody to invest and go forward with that. And luckily so, because they still wouldn't have any vehicles to sell****"*

On a conference call at the time, Kandi's Chairman/CEO had alluded to U.S. sales kicking off near the end of 2018, but that didn't pan out.

## *Kandi Tried a U.S. Launch Again in 2019, But Those Plans Were Again Delayed*

In January 2019, Kandi's Chairman/CEO told Bloomberg in an interview that the company planned to ship cars to the U.S. that year.

In February 2019, Kandi announced the National Highway Traffic Safety Administration ("NHTSA") had "approved" its two electric vehicle models, claiming:

> *"The NHTSA approval is an assurance that Kandi's two EV models conform to NHTSA standards and are registered in the U.S."*

The stock soared over 40% on news of the government approval. Yet, despite the claims, we found that the NHTSA doesn't actually *approve* cars. Instead, manufacturers self-certify. Per the NHTSA spokesperson we contacted (emphasis added):

> *"By Federal law all vehicles sold in the U.S. must be certified* ***by the manufacturer*** *as meeting all applicable Federal Motor Vehicle Safety Standards (FMVSS).* ***NHTSA does not certify vehicles prior to sale – doing so is the manufacturer's responsibility.."***

In either case, investors likely expected the news would lead to an imminent U.S. sales ramp. That didn't happen.

## *Kandi's Latest 2020 U.S. Launch Efforts Appear to Be Delayed*

## *Former Kandi America Employee: "If You Never Produce the Product Then It's Just Smoke And Mirrors… ".*

In July 2020, Kandi once again announced the "formal launch" of its vehicles in the U.S., and held a virtual launch event in August to re-introduce the cars.

So far, several reviewers have tested the cars, and several dozen vehicles are sitting in the company's Texas lot. The company received EPA certification for its vehicles this month,

clearing the path to potentially sell vehicles.

Kandi targeted deliveries by year-end , but the company now expects to begin deliveries in early 2021, according to a recent reviewer that spoke with the company.

The company seems to be struggling to find dealer distributors. A November 23, 2020, Barron's article identified only one authorized Kandi EV dealer, a Denver pharmacist who approached the company about purchasing an EV and then decided he wanted to invest $30,000 to open his own dealership.

We spoke with a former employee this month who keeps in touch with Kandi. They described how the company has continuously struggled to bring in enough cars and to find dealers to sell them:

> *"I was talking to a gentleman there (at Kandi America) the other day and he said 'still trying to get the cars here'..**what's crazy is we're almost in 2021 and I was there in 2017, waiting and waiting and we're still waiting and still in exact same holding pattern**..*
>
> *"...**if you never produce the product then it's just smoke and mirrors as far as I'm concerned."***

## *Kandi's Chairman/CEO Expressed Uncertainty on Its U.S. Launch "The U.S. Market Is Not Familiar with Our Products"*

## *Kandi is Recognized in China However, and Has a Reputation for Poor Quality*

Kandi's own Chairman/CEO didn't seem to have much confidence in the reception of its cars in the U.S. market, expressing uncertainty in a recent Barron's interview :

> *"We are not very certain about it," he says. "The U.S. market is not familiar with our products."*

Domestically in China, Kandi is somewhat known, but not for the right reasons.

Multiple Chinese media outlets reported that historical customers had batteries fail after mere days, while other customers complained that the company refused to honor warranties after various product failures. [1,2,3,4]

## *Two Years Ago, Angry Kandi Customers Held a Protest at Kandi's Headquarters, Complaining About Shoddy Vehicles and the Company's Failure to Honor Its Service Warranties*

A December 2018 news article reported that more than 10 buyers of Kandi's EVs held a protest at its headquarters in Hangzhou because Kandi refused to provide after-sales service, despite having warranties.

Protesters brought banners to Kandi's headquarters, which read:

> *"**The quality of Kandi EVs is severely below standard**; Kandi cheated the government for subsidies and defrauded customers; we want our rights exerted, the manufacturer [Kandi] needs to take responsibility for after-sales service".*


(Pictured: Angry Chinese Kandi consumers protesting the company's poor quality products and failure to honor warranties at Kandi's China headquarters. Source )

We believe this may be one reason why the company has reported no domestic auto sales in China in the past several years.

## *Despite the Lack of Vehicle Sales to U.S. Customers, Kandi Appears to Be Booking Sales of Its U.S. Vehicles Through an Undisclosed Related Party Anyway*

Oddly, the company appears to be booking sales from its auto exports to the U.S. despite acknowledging that sales to U.S. customers have not yet begun. [ Pg. 16]

Kandi has reported $878,000 in EV Product (i.e. vehicle) sales since Q4 2018, all of which have been exports from the company's Hainan factory, per Kandi's SEC filings. [ Pg. 24, Pg. 32, Pg. 28, Pg. 22]

The company has not announced entering any new markets aside from the U.S., so we can

presume that all of the export sales are to the U.S. So how is the company booking years of revenue from sales that haven't happened?

Normally, companies that manufacture products will ship the products to its foreign subsidiary then sell the products to end users. Not the case with Kandi apparently.

We checked import records through ImportGenius and found that Kandi's Hainan factory has been shipping cars to Massimo Motor Sports LLC. This same entity turned up in the section above about Kandi's undisclosed related-party customer relationships.

| Product Description | Consignee | Shipper | Arrival Date | Gross Weight (LB) |
|---|---|---|---|---|
| K27 ELECTRIC CAR SOFTWARE K27 | MASSIMO MOTOR SPORTS LLC | KANGDI ELECTRIC VEHICLE HAINAN | 2020-09-13 | 22,308 |
| K27 ELECTRIC CAR K27 ELECTRIC | MASSIMO MOTOR SPORTS LLC | KANGDI ELECTRIC VEHICLE HAINAN | 2020-08-31 | 30,140 |
| LITHIUM-ION RECHARGEABLE BATT | MASSIMO MOTOR SPORTS LLC | KANGDI ELECTRIC VEHICLE HAINAN | 2020-08-30 | 25,300 |
| K27 ELECTRIC CAR K27 ELECTRIC | MASSIMO MOTOR SPORTS LLC | KANGDI ELECTRIC VEHICLE HAINAN | 2020-08-16 | 22,946 |
| K27 ELECTRIC CAR K27 ELECTRIC | MASSIMO MOTOR SPORTS LLC | KANGDI ELECTRIC VEHICLE HAINAN | 2020-08-16 | 15,092 |
| K23 ELECTRIC CAR | MASSIMO MOTOR SPORTS | KANGDI ELECTRIC VEHICLE HAINAN | 2020-02-07 | 9,847 |
| K23 ELECTRIC CAR | MASSIMO MOTOR SPORTS | KANGDI ELECTRIC VEHICLE HAINAN | 2020-01-30 | 9,847 |
| K23 ELECTRIC CAR K23 ELECTRIC | MASSIMO MOTOR SPORTS | KANGDI ELECTRIC VEHICLE HAINAN | 2020-01-30 | 19,694 |
| K27 ELECTRIC CAR | MASSIMO MOTOR SPORTS LLC | KANGDI ELECTRIC VEHICLE HAINAN | 2020-01-21 | 7,462 |
| K23 ELECTRIC CAR LITHIUM ION PC | MASSIMO MOTOR SPORTS LLC | KANGDI ELECTRIC VEHICLE HAINAN | 2020-01-15 | 26,400 |

(Source: ImportGenius)

As a reminder, Massimo Motor Sports is based out of the Kandi USA headquarters in Texas and is owned by David (Jianxun) Shan, a founder and current manager of Kandi's U.S. subsidiary.

In sum, Kandi appears to be booking illegitimate U.S. sales to an undisclosed related party before formal U.S. customer sales have even begun.

# *Part IV: Kandi's Rideshare and Battery Swap Initiatives*

In addition to Kandi's much-anticipated U.S. launch, the company has repeatedly touted plans to (a) sell up to 300,000 vehicles domestically through a rideshare partner; and (b) roll out domestic quick battery swap stations to make EV charging fast and efficient.

Investors have viewed both endeavors with excitement, but a quick review shows both ventures are either devoid of substance or hopelessly behind competitors.

## *Kandi's Rideshare Partner Ruibo Has Virtually No Presence in a Market Already Dominated by Didi And Other Rideshare Apps*

In January 2019, Kandi announced an agreement to join forces with rideshare company Ruibo to deliver 300,000 cars to the Chinese rideshare market in 5 years.

The company has repeatedly indicated that it may deliver hundreds of thousands of EVs to the venture in the coming years, an exciting prospect for investors. ( 1,2,3,4)

Progress has been slow. Kandi formally established the rideshare joint venture with Ruibo in October of this year .

China's rideshare market is huge, but much like the U.S., it is controlled by top players. In the U.S., the market is dominated by Uber and Lyft. In China, ~90% of the market by revenue is dominated by Didi, ( 1,2) with the next closest competitor commanding only about 4%.

Kandi has chosen to partner with Ruibo, a company that doesn't even appear on lists of the top 77 or top 50 rideshare apps in China.

On China's most popular app stores like Huawei and Xiaomi we see that Ruibo's downloads barely even register. [4]

## Kandi Partner Ruibo Vs. China's Top Rideshare Apps

| | | Huawei Total Downloads | Xiaomi Total Downloads |
|---|---|---|---|
| Didi | 滴滴出行 | 3,200,000,000 | 1,243,370,855 |
| Dida Chuxing | 嘀嗒出行 | 300,000,000 | 110,000,000 |
| Shenzhou Zhuanche | 神州专车 | 200,000,000 | 20,739,917 |
| Caocao Chuxing | 曹操出行 | 100,000,000 | 44,906,981 |
| Shouqi Chuxing | 首汽约车 | 77,940,000 | 32,347,474 |
| T3 Chuxing | T3出行 | 20,780,000 | 6,036,284 |
| Didi ShunfengChe | 滴滴顺风 | 18,680,000 | 8,821,414 |
| Hengdao Chuxing | 享道出行 | 7,890,000 | 4,001,924 |
| Dongfeng Chuxing | 东风出行 | 3,890,000 | 1,913,386 |
| Ruibo (Yitu Chuxing) | 逸乘出行 | 10,000 | 760 |

We had a local consultant test Ruibo in major cities Beijing, Hangzhou, Jinhua and Xiamen. The app failed to find a driver each time. Here is a video of our investigator attempting (and failing) to hail a ride in Hangzhou, where Ruibo is headquartered, during normal daytime hours.


(Pictured: One of multiple Ruibo ride requests in Hangzhou that failed. Click for brief video )

We reached out to customer service for help. The rep suggested we try to hail a ride through a separate app called Gaode Maps, which is an aggregator of multiple platforms (i.e. Didi, Ruibo, and other rideshare apps). In other words, they suggested we use a competitor.

We followed up by asking if the platform had really been launched yet and received no reply.

On Kandi's most recent Q3 2020 investor call , CFO Alan Lim was asked about the 300,000 rideshare vehicle estimate and essentially walked the claim back, referring to the number as really just a conceptual goal:

> *"(It) is rather an idea of the program but not entirely or necessarily means that there will for sure put 300,000 EVs to the market. So how many EVs will be supplied to the market at the end of the program?* ***We are not 100% sure. But the so-called 300,000 is sort of like a slogan or an idea".***

We conclude that Ruibo is mostly vaporware, with slim to no shot at competing in China's intensely competitive rideshare market.

## *Kandi's Battery Swap Program Is Well Behind Competitors Such As Nio, BJEV, And Even Its Own Partner Geely*

China's domestic electric vehicle industry has heavily invested in battery swap stations in order to minimize charging wait times. Major EV manufacturers that dwarf Kandi in size and scale are well along the path.

Manufacturer NIO, for example, has already completed its one millionth battery swap and had – at the end of last year – swap stations in 51 cities, including Beijing, Shanghai and Guangzhou.

Manufacturer BJEV has also secured a broad footprint with 160 stations across the nation. Alibaba backed Xpeng Motors launched a battery leasing service in September 2020. Kandi's partner Geely also has a competing service , having launched its first battery swap station in October 2020 with plans to expand aggressively.

Kandi has thrust itself into this competitive part of the market as well. In January 2018, Kandi acquired battery swap technology company Jinhua An Kao ("An Kao") for approximately $4 million in cash and ~2.96 million shares (valued at $20.7 million at the time). Currently the

company has one pilot charging station .

## *Kandi Lacks Enough Vehicles on the Road for a Battery Swap Program to Make Sense*

As detailed above, Kandi has reported no domestic sales of EVs in the past several years outside of its minority stake in an affiliate entity with Geely.

The company is manufacturing model K23s in its Hainan facility for inventory, though until recently it lacked a sales certificate to be able to sell the cars itself, according to former employees we interviewed.

Despite a lack of cars on the road needing battery swaps, Kandi announced on November 2, 2020, that it aims to list its battery swap subsidiary on Shanghai's STAR Exchange and it has already engaged CITIC to help it IPO. We do not envision this being a successful endeavor.

## *We Have 25 Questions for Kandi's Management*

Through the course of our research we contacted the company asking several questions about its financials and product initiatives. We received no response, so here are the questions that we think investors deserve the answers to:

1. SEC prosecutors alleged in a complaint that Kandi's Chairman/CEO participated in a scheme to inflate the price of its stock, along with several individuals that took Kandi public as part of its original reverse-merger IPO. How do you respond to these allegations?
2. Kandi's long-serving auditor, Albert Wong & Co., was ejected from the industry by the Public Company Accounting Oversight Board ("PCAOB") over its failure to detect clear evidence of misappropriation by senior management of Kandi, along with undisclosed related-party transactions. Has management ever responded to these allegations? If not, how do you respond now?
3. In 2019, Chinese media located a car lot with thousands of Kandi vehicles apparently sitting unused and deteriorating. Were these cars manufactured as part of the well-publicized subsidy scheme? What is your explanation?
4. Kandi has reported no sales to its JV/affiliate with Geely in recent quarters. What role does Kandi have, if any, in the manufacturing and sales of the Maple 30x?
5. Despite the evaporation of revenue through the JV with Geely, Kandi's revenue remained relatively flat due to the dramatic increase of sales to "Customer A" and "Customer B" (i.e. Jinhua Chaoneng Automobile Sales Co. Ltd. and Zhejiang Kuke Sports Technology Co., Ltd.) What products are you selling to these entities, and how do you explain the sudden uptick

in sales to them?

6. Why does Kandi's top customer (Chaoneng) representing 55% of LTM sales, share a phone number with your subsidiary? Why is it based at the same address as your own factory, and with signage indicating it is a Kandi company?
7. Kandi's second largest customer (Kuke) represented almost 9% of LTM sales. But export records show that ~91% of Kuke's U.S. exports go directly to entities based at Kandi's U.S. warehouse locations. How do you explain this?
8. One of Kuke's export entities, Massimo Motor Sports, is owned by David (Jianxun) Shan, founder and manager of Kandi's U.S. subsidiary. How do you explain Kandi's product sales to this obviously undisclosed related party entity?
9. Kandi's filings show that Massimo sells product right back to Kandi; it has been reported as supplier of up to 25% of Kandi's goods in recent periods. How do you explain these apparently circular sales?
10. Why is Kandi's Days Sales Outstanding (DSO) 5x-6x higher than peers? Will you name the counterparties to these uncollected receivables?
11. In its most recent quarter, Kandi reported a "loan to third party" of ~$51 million as an "other receivable." This is a massive loan, yet Kandi has not disclosed the borrower, despite its obligations to disclose material loans. Who is the borrower?
12. Why is Kandi's Days Payable Outstanding (DPO) almost 2x higher than your closest peer, and over 3x higher than the median? What are the names of Kandi's top suppliers?
13. Kandi has had 3 auditors in the past 5 years. Why the revolving door?
14. Kandi has had 4 CFOs in the past 4 years. Why the revolving door?
15. Kandi's current auditor, Marcum, was recently handed a 3-year ban from auditing Chinese companies from the PCAOB. Will Kandi continue to attempt to reappoint Marcum as its auditor, as indicated by your recent proxy filing, or will the company choose a credible auditor?
16. We spoke with a former distribution partner that worked on the company's 2008 U.S. launch. They said the prototype vehicles worked well, but every single customer vehicle broke down. How can consumers be sure that quality has improved?
17. Why has Kandi not reported any domestic sales outside of the Geely JV in the past several years? A former employee we spoke with said Kandi did not even have a sales license up until late this year. What happened? What is standing in the way of restarting domestic EV sales?
18. How is it possible that Kandi has booked EV Product sales to the U.S. for several years when EV Product sales to U.S. consumers haven't even begun, per the company's own admissions?
19. An auto reviewer recently reported that the company now aims for a Q1 2021 launch in the U.S. Are sales to U.S. customers delayed once again?
20. Export records show that Kandi has shipped its Hainan EV Products not to Kandi, but to undisclosed related party Massimo Motor Sports. Has Kandi been recording the shipments of EV products to this entity as sales?
21. David (Jianxun) Shan is founder and manager of your U.S. subsidiary. Shan controls an entity called Miller Creek Holdings which owns the Kandi America headquarters. Kandi leases the facility from Miller Creek, yet does not record the lease payments as related-

party transactions. Why not, given the company's obligations to disclose all related party transactions?

22. How do you expect to sell 300,000 vehicles through your relationship with rideshare app Ruibo when Ruibo has virtually no users in a market already dominated by Didi (along with dozens of other competitors)?
23. How do you expect your battery swap program to generate any interest when Kandi has virtually no vehicles on the road in China to swap batteries into?
24. From 2014-2018, Kandi reported that ~75%-83.5% of EV Parts sales consisted of battery packs. The company stopped reporting the percentage. What percentage of EV Parts sales from 2019 and onward were battery packs?
25. Litigation records show that Kandi previously purchased batteries from Jiangsu Tianpeng Battery Co., Ltd (江苏天鹏电源有限公司), and the company recently announced a deal with CBAK Energy for its batteries. Does Kandi manufacture its own battery cells, modules, and packs, or does it simply resell them from others?

# *Conclusion: How Does A Company Like Kandi Keep Getting Away With It?*

Many investors assume that auditors and regulators protect investors from fraud. Such trusting, well-meaning investors might wonder: How does a company like Kandi trade on a premier U.S. exchange without any regulatory consequence when:

Kandi was brought public by a promoter charged with fraud by the SEC over allegations of conspiring with the (still) Chairman/CEO to manipulate its stock price.
Kandi was fined by the EPA for illegally importing its very first shipment of vehicles into the country.
Kandi's long-serving auditor was ejected from the industry over its failure to catch obvious signs of extensive fraud at the company, and its latest auditor has been banned from auditing Chinese companies by the PCAOB.
Kandi was sanctioned by the Chinese regulators (but not U.S. regulators) for a scheme to generate false sales through undisclosed related party transactions in order to collect illegitimate subsidies.
Kandi admitted that its financials were false due to a failure to recognize related party transactions, and had to restate 3 years of financials.
Kandi displays obvious hallmarks of fake revenue including a key "unrelated" customer based at its own address sharing its own phone number, having massive uncollected sales, and serial CFO/auditor turnover.

In the end, many Kandi investors won't read this report, or will simply dismiss our findings outright because we are betting against the company.

The company will likely issue some sort of press release declaring everything we say false and misleading, as they always do, while ignoring all or the vast majority of the questions we've raised. They may throw in a legal threat and a token share buyback/insider purchase for good measure.

Some investors will believe management blindly—after all, these are executives at a large, public company trading on the well-respected NASDAQ exchange.

Such investors won't realize that virtually all of this report was constructed from public records, and they can simply click through the hyperlinks we've provided to recreate most of our thesis in about an hour.

If regulators do decide to pursue a case, they will likely be stonewalled by the Chinese government, and may just throw their hands up in the end—because what's the point of running a challenging international investigation just to win a default judgement that can't be collected from overseas defendants anyway?

If a regulatory action does occur, it often takes 3-5 years, because 5 years is typically the statute of limitations for cases of fraud, and regulators like to investigate near the deadline before making a decision on whether to prosecute.

In the interim, many investors will view the lack of a regulatory enforcement as a vindication of the company. And a company like Kandi only needs to fool some of the people all of the time. The company has raised $160 million from U.S. capital markets in November 2020 alone, and we have no doubt it will attempt to perpetually sell stock.

And for us, we'll keep calling it out as we see it. Best of luck to all.

## *Disclosure: We are short shares of Kandi Technologies (NASDAQ:KNDI)*

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[1] We are still very much short Nikola. For readers inclined to maintain social distance during the pandemic we recommend visiting Nikola's under construction "factory" which, after 4 months, appears to still be a large, empty plot of land in the middle of the Arizona desert.

[2] Unlike Kandi's other sales, these were fully disclosed as being related party sales, whereby Kandi would contribute EV parts to the venture, and the JV would complete assembly of the vehicles.

[3] Hu YiHeng shares a surname with the Chairman/CEO of Kandi, but we were unable to determine whether there is also a familial relationship.

[4] Note that these metrics include all downloads on every device through the history of the app, explaining how the download metrics (for Didi specifically) have managed to dwarf the population of China over time.

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# TAB 2

# Loop Industries: Former Employees and Plastics Experts Blow The Whistle On This "Recycled" Smoke And Mirrors Show

Published on October 13, 2020



## (NASDAQ:LOOP)

- Loop Industries has never generated revenue, yet calls itself a technology innovator with a "proven" solution that is "leading the sustainable plastic revolution". Our research indicates that Loop is smoke and mirrors with no viable technology.
- As part of our investigation, we interviewed former employees, competitors, industry experts, and company partners. We also reviewed extensive company documentation and litigation records.
- Former employees revealed that Loop operated two labs: one reserved for the company's

two twenty-something lead scientist brothers and their father, where incredible results were achieved, and a separate lab where rank-and-file employees were unable to replicate the supposedly breakthrough results.

- The two brothers who act as lead scientists for Loop and who co-invented Loop's recycling process appear to have no post-graduate education in chemistry and list no work experience other than Loop.
- A former Loop employee told us that Loop's scientists, under pressure from CEO Daniel Solomita, were tacitly encouraged to lie about the results of the company's process internally. We have obtained internal documents and photographs to support their claims.
- Loop focuses on recycling a common form of plastic called "PET". According to a former employee, Loop's previous claims of breaking PET down to its base chemicals at a recovery rate of 100% were "technically and industrially impossible". The same employee told us the company's claims of producing "industrial grade purity" base chemicals from PET were false.
- According to litigation records, Loop's CEO, Daniel Solomita hired a convict, who had previously pled guilty to stock manipulation, to help raise Loop's startup capital. That convict introduced Solomita to another convict who facilitated Loop's first investment.
- Solomita has no apparent formal science education but has a history of stock promotion at another publicly traded company that subsequently imploded.
- Executives from a division of key partner Thyssenkrupp, who Loop entered into a "global alliance agreement" with in December 2018, told us their partnership is on "indefinite" hold and that Loop "underestimated" both costs and complexities of its process.
- We contacted Loop's other partners, including Coca-Cola and PepsiCo, most of whom refused to divulge whether any plastic had been recycled as part of their partnerships with Loop. Comments from Danone, owner of the Evian brand, suggested it had not bought any PET from Loop thus far. We suspect these partnerships have gone nowhere.
- Loop's JV with PET and chemical company Indorama, promoted frequently over the last two years as an imminent revenue stream, is "still being finalized", according to an employee, despite being announced in 2018. An Indorama employee told us no production has taken place thus far.
- We expect Loop will never generate any meaningful revenue. With a market cap of ~$515 million, we see 100% downside to Loop once it burns through its ~$48 million in balance sheet cash.
- We have submitted our findings to regulators.

*Initial Disclosure: After extensive research, we have taken a short position in shares of Loop Industries. For members of the media who wish to independently corroborate our work please contact us for introductions to whistleblowers and other sources on condition that their anonymity is maintained unless they explicitly agree to go on-record. This report represents our opinion, and we encourage every reader to do their own due diligence. Please see our full disclaimer at the bottom of the report.*

## *Background: The Biggest Problem and the Biggest Opportunity in Plastics Recycling*

Every year, about 27 million tons of plastic waste winds up in landfills, creating a major problem for the environment as well as for the plastic industry.

Low-cost recycling is the answer to these problems and the biggest challenge in the recycling industry has been PET plastic – the cheap, clear, lightweight plastic often used in drink bottles and other food and beverage packaging.

(Pictured: PET plastic, commonly found in drink bottles. Photo Credit: Phys.org )

Traditional PET recycling methods require heat and pressure to break down and re-shape plastic, which is costly. New "advanced recycling" techniques aim to minimize the use of heat and pressure by breaking down plastic with chemicals, but thus far these methods have proven expensive and inefficient.

There are an estimated 70 million metric tons of PET plastic generated annually, representing a massive global problem and, conversely, a major opportunity for whoever can solve the problem. [Pg. 8]

## *Enter Loop Industries, Which Has Essentially Claimed to Have Found the Holy Grail of Plastics Recycling—An Inexpensive, Efficient, Profitable Process For Recycling*

# *The World's Most Ubiquitous Plastic*

Loop Industries (NASDAQ:LOOP), headquartered in Quebec, claims to have found the answer.

Loop refers to itself as a technology company whose "mission is to accelerate the world's shift toward sustainable PET plastic and polyester fiber and away from our dependence on fossil fuels."

The company was incorporated in Nevada on October 23, 2014 and went public through a reverse merger in June 2015. [ Pg. 8]

Loop has claimed to have developed a patented and proprietary technology that breaks down PET plastic:

> *"of any color, transparency or condition, including waste PET plastic recovered from the ocean that has been degraded by the sun and salt, to its base building blocks (monomers)" [Pg. 6]*

Even more incredibly, the company claims to have achieved these breakthroughs after setting up a laboratory using "products purchased from the local hardware store" [ *translated from French*][1].

In its most recent October 2020 investor presentation , Loop calls its process "proven" and says that its facilities are expected to have a "margin profile which notably exceeds competing recycling technologies, with EBITDA margins 40%." [ Pg. 3] Its website, as of October 11, 2020, says that Loop is "radically transforming how plastic is produced".

In other words, the company claims to have discovered how to turn worthless trash into pure gold, a feat that multi-billion chemical companies such as DuPont, Dow Chemical, and 3M have been unable to achieve on a large scale despite years of efforts.

Loop's investor base has been encouraged by both its breakthrough claims and a slew of partnerships that have lent credence to its technology. These partnerships include some of the biggest firms that generate plastic waste worldwide: Coca-Cola, PepsiCo and Danone to name a few.

# *Reality Check: Former Employees, Plastics Experts and Competitors Blow The Whistle On "Liar" Scientists, Faked Results, Rudimentary Technology And Hollow Partnerships*

As we will show, Loop's claimed breakthroughs in PET plastic recycling are fiction. Our investigation into Loop, spanning 6 months, has included speaking with multiple former employees, company partners, polymer/plastic experts, and competitors.

Our investigation points to one conclusion: **in the words of a former Loop employee**, we simply **don't really think they have the technology".**

Former employees painted a picture of a chaotic company, whose lead scientists are twenty-something "liars", with no relevant work experience other than Loop, that were able to achieve "impossible" results in a secret second lab that rank-and-file employees weren't allowed to access.

Loop's supposed proprietary process is a black box that has not shown itself to be more efficient or cost effective than comparable solutions, contrary to the company's claims, according to former employees and outside experts.

Loop's CEO, who has no specific educational background in chemistry, sought out the help of several convicts to put together Loop's startup capital, according to litigation records. Loop's management has a track record of taking investors on a ride with sweet sounding public company stories that have ended in catastrophic losses.

Loop's partnerships have gone almost nowhere. The company announced a key joint venture in 2018 to build a facility with well-respected PET and chemical company Indorama, but two years later the terms of the deal have yet to even be finalized. Other major consumer plastic brands were unable to confirm to us that their partnerships with Loop had progressed.

Experts we spoke with raised serious questions about the company's ability to make its "unparalleled purity" end product, as claimed, at large scales with any cost efficiency. They said Loop is focused on a decades-old problem and there is nothing new or revolutionary about the idea of breaking down PET in the fashion Loop is claiming.

All told, we think Loop is just a smoke-and-mirror show masquerading as a technological

leader.

# *Part I: Background on Loop's Key People*

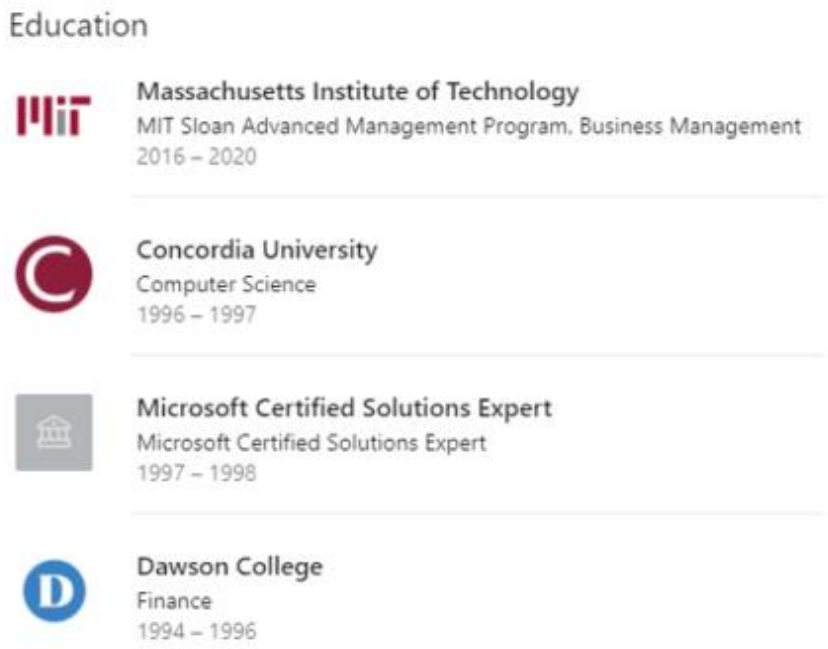
## *Loop's CEO Daniel Solomita: No Educational Background In Chemistry and A History of Stock Promotion*

Some of the largest chemical companies in the world are working with their teams of top scientists to solve the plastic sustainability problem.

Major multi-billion dollar corporations like Dow, DuPont and Eastman Chemical have committed to deploying their combined teams of tens of thousands of employees to help create a circular economy for plastic and waste. [1,2,3]

Given Loop's claimed breakthroughs, one might similarly expect top scientists at the helm. Instead, we found that Daniel Solomita, Loop's CEO, has no apparent formal education in chemistry or polymers.

Solomita's education, according to his LinkedIn and SEC biography includes 2 years studying Finance at Dawson College and 1 year studying computer science at Concordia University. He also cites attendance at an MIT management program during his tenure at Loop.




(Source: Daniel Solomita LinkedIn)

His LinkedIn does not include any science or chemistry-related work experience, other than Loop, but for 4 years he spent doing "Business developpment [sic]" at SMH Recycling.

In Solomita's official SEC biography he lists being a director and President of Dragon Polymers – a "recycler of industrial polymers through landfill remediation" that focused on PET – in April 2012 [also see: Pg.20].

The former stock of Dragon is now listed as a "shell" on OTC Markets and trades 99.9% off its highs. [Pg.2] The spikes at the beginning of the stock chart show portions of Solomita's tenure at Dragon, which had previously been named Blue Gold Beverages.


Both Blue Gold and Dragon Polymers were pushed by stock promoters like xplosivestocks.com and outlets like "Penny Stock Rumor".

## Summary

| | |
|---|---|
| Start time: | 8:30 AM |
| Start date: | November 29, 2012 |
| Symbol: | DRAG |
| Company: | Dragon Polymers Inc. |
| Stock promoter: | "Penny Stock Rumour" |
| Campaign ID: | 5919 |

## Dragon Polymers Inc.

| | | |
|---|---|---|
| Employees: | 4 | |
| Year of incorporation: | 2008 | |
| Market capitalization: | $215,039 | *(as of July 25, 2013)* |
| Business description: | Scrap and waste materials | |
| Website: | - | |

[Source: OTC Dynamics ]

According to Dragon Polymers' 2014 annual report [ Pg. 12], the company changed its name on October 12, 2014 and impaired its recycling assets because it had "no hopes of future revenue from the recycling operations." [2]

Two weeks later, on October 23, 2014, Solomita incorporated Loop Holdings. [ Pg. 13]

It seems Loop was born out of the business concept that Solomita's former company impaired to $0.

Considering this, **it doesn't come as a surprise to us that Loop has never turned a profit, never generated a single dollar in revenue, and has never generated any cash from operations.**

## *Loop's Origins: CEO Solomita Engaged a Convict Who Pled Guilty to Securities Fraud to Help Raise Loop's Early Capital*

## *That Convict Introduced Solomita to Another Convict (Who Had Pled Guilty to Wire Fraud and Securities Fraud) Who Helped Facilitate the Company's First $80,000 Investment*

One might think that a company with breakthrough technology in plastic recycling would have attracted major chemical companies or well-known VC firms as early investors. Firms like Eastman Chemical, Kleiner Perkins, and Blackrock are all actively involved in plastics recycling.

Instead, according to a lawsuit filed in 2017 in the Superior Court of California (Case No. BC648640), Loop turned to an individual previously convicted of securities fraud, Henry Lorin, to help raise its early outside capital.

> Furthermore, Responding Party and Plaintiff Henry Lorin initiated several business relationships for Defendant Daniel Solomita, on behalf of himself and the surviving entity of the reverse merger involving First American Group and Holdings, which includes Lance Bauerlein—a close friend of Responding Party whom he had done business with in the past—Scott Sieck, John Denzer, Michael Franklin, Norman Olshansky, Bob Gartzman, Harold Sahlem, Bruce Fogel,

(Source: Lorin v. Loop exhibits page 50)

The lawsuit against Loop and Solomita was filed by Lorin, who had "initiated several business relationships" for Solomita, according to the exhibits. Lorin previously "pled guilty in the Southern District of New York to conspiring to manipulate the prices" of certain securities and was found to have given false testimony to the Securities and Exchange Commission.

# Guilty Plea In Stock Case

By Reuters

A former stock promoter pleaded guilty on Friday to conspiring to break mail and wire fraud laws and to obstructing a Government investigation of possible stock manipulation by officials of the defunct Haas Securities Corporation.

Henry Lorin, 47 years old, of New York City, pleaded guilty to two counts of conspiracy and obstruction. He faces a maximum sentence of 10 years in prison and a $500,000 fine.

Mr. Lorin was accused of conspiring with Eugene Laff, the former chairman of Haas, and Stanley Aslanian Jr., the brokerage firm's former president, to manipulate the prices of three over-the-counter stocks. Mr. Lorin also admitted that he gave false testimony to the Securities and Exchange Commission in July 1987.

(Source: New York Times, Monday, April 17, 1989)

The same documents state that Lorin introduced Solomita to another individual, Lance Bauerlein, who helped raise the first $80,000 for Loop.

Tony Meti, Michael Boychuk, and their ongoing business relationships with Donald Danks and Jonathan Destler. In March 2014, Responding Party introduced Mr. Solomita to Lance Bauerlein. Mr. Bauerlein's contact helped raise the first $80,000 for Holdings in November 2014. On or about January 20, 2015, Responding Party traveled to Florida with Daniel Solomita to introduce Mr. Solomita to Scott Sieck, John Denzer, and Michael Franklin. On or about February 27, 2015,

[Source: Lorin v. Loop exhibits Pg. 200]

Bauerlein was indicted criminally in June 2013 and later pleaded guilty to wire fraud and securities fraud in 2015. He was also charged by the SEC over agreeing to "engage in manipulative and deceptive securities transactions".

UNITED STATES DISTRICT COURT

Eastern District of Pennsylvania

UNITED STATES OF AMERICA
v.
LANCE BAUERLEIN

**JUDGMENT IN A CRIMINAL CASE**

Case Number: DPAE2:13CR000320-001

USM Number: #71422-066

Maria Antoinette Pedraza, Esquire
Defendant's Attorney

**THE DEFENDANT:**

☒ pleaded guilty to count(s) One and Two of an Information.

☐ pleaded nolo contendere to count(s) _____ which was accepted by the court.

☐ was found guilty on count(s) _____ after a plea of not guilty.

The defendant is adjudicated guilty of these offenses:

| Title & Section | Nature of Offense | Offense Ended | Count |
|---|---|---|---|
| 18:1343, 1349 | Wire fraud. | 10/31/2008 | 1 |
| 15:78j(b) and 78ff | Securities fraud. | 10/31/2008 | 2 |

Bauerlein was also barred by the NASD and fined $90,000 and ordered to disgorge $280,000 decades earlier for engaging in "private securities transactions at unfair prices".

## *Loop Co-Founder Donald Danks Has A History Of Allegations Of "Misleading Statements", "Unlawful Business Practices", and Leaking Material Non-Public Information*

Loop's co-founder Donald Danks, who reportedly helped Solomita start Loop in 2014, has a checkered past of his own.

Danks previously served as Chairman and CEO of iMergent.

According to a 2007 article in the Brisbane Times, iMergent was subject to a slew of allegations of misleading statements, unlawful business practices, violations of the Business Opportunity Fraud act and wrongfully enticing customers.

brisbane times

## iMergent's history of legal woes

By Shannon Molloy
March 13, 2007 – 10.00am

iMergent, the company behind website business ComTrainers and others, has been the subject of legal challenges and international criticism over its sales methods and business practices.

On top of those allegations, Danks was accused by Barron's of leaking material non-public information about his company's revenue numbers.

BARRON'S

Over the past few weeks, *Barron's* has learned, iMergent's CEO, Donald L. Danks, has told select individual and institutional investors that the company's fiscal third-quarter earnings will be over 50% higher than the estimate of 39-to-41 cents a share set by the one analyst who follows the company. That translates into about 60 cents a share, versus 29 cents in the comparable 2006 period.

Some people apparently have gotten the good word already. On a tape recording of a conversation heard by *Barron's*, a voice that sounds like Danks' is heard telling an investor about the earnings, adding that "net dollar contracts written," which is the way the company reports its revenue, will be around $50 million, versus $26 million.

(Source: Barron's )

Danks served as a Director of Loop from June 29, 2015,until June 28, 2018. He continues to actively promote Loop on social media, re-tweeting Loop tweets as recently as September 2020 and a reposting a LinkedIn post in August 2020.

## *Loop's Current Process Was Invented By Two Brothers in Their Twenties With No Work Experience Other Than Loop And No Post-Graduate Education In Chemistry or*

# *Polymers*

One might consider a CEO with a history of stock promotion and an early association with multiple individuals convicted of securities-related fraud to be a red flag.

But putting that aside for the moment, it isn't completely impossible for an unlikely/unsavory cast of characters to somehow attract a scientist that manages to identify new breakthroughs.

So, who is the talent behind the process that Loop claims could help reshape the multi-billion dollar plastics industry?

The company's current (Generation II) process was invented and patented by two brothers in their 20s, Adel and Fares Essaddam, who have no apparent post-graduate studies in chemistry or polymers or any work experience other than Loop. Adel started at Loop just *months* after completing his diploma and Fares started working for Loop while still attending university.

## **Scientific Research** Leadership

**ADEL ESSADDAM**
*Lead Scientist*

- Co-inventor of Loop Industries' second generation (GEN II) depolymerization technology
- Recipient of a 3-year technical degree in Composite Materials Transformation from CÉGEP St-Jérôme and trained in Natural Sciences in parallel.
- Joined Loop Industries in 2016 as Laboratory Assistant and was promoted to Research Scientist in 2017. As Lead Scientist since 2018, Mr. Essaddam leads the research, lab and mini-pilot teams and ensures Loop remains at the forefront of chemical recycling innovation and oversees process optimization to drive down cost and support the commercial scale-up of the technology.

**FARES ESSADDAM**
*Technology Lead*

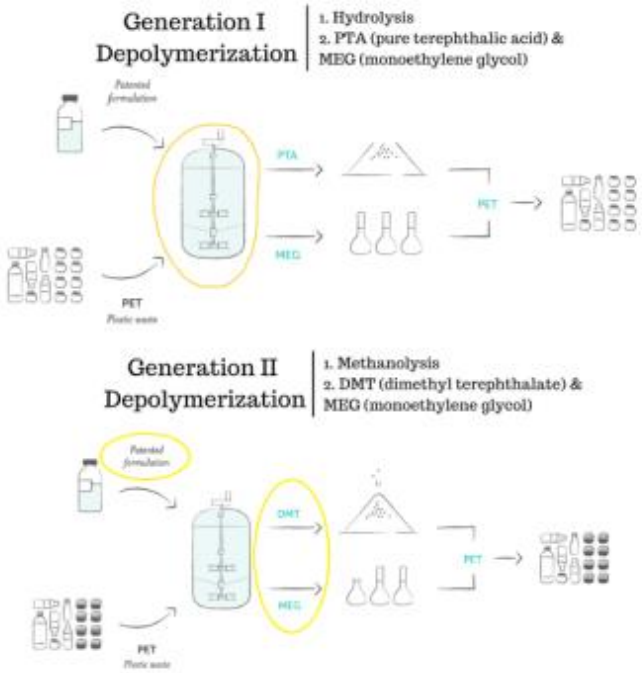
- Co-inventor of Loop Industries' second generation (GEN II) depolymerization technology
- Having an educational background in Biochemistry, Mr. Essaddam joined Loop Industries in 2015 as Laboratory and Research Assistant and was promoted to Research Scientist in 2017, where he focused on ensuring the economic and industrial feasibility of the Loop process, as well as purifying and synthesizing the material sent to Loop's partners.
- In his current role as Technology Lead since 2020, Mr. Essaddam is responsible for liaising between the laboratory and engineering teams to ensure data and limitation compliance, assisting the laboratory team in preparing for complex material manipulations and working on improving Loop's process. He also leads support activities as the pilot plant level in order to respect laboratory and engineering criteria.

(Source: Loop October 2020 Presentation Page 30 )

Adel is Loop's "Lead Scientist", according to the company's October 2020 investor presentation . According to Adel's LinkedIn page , he has a technical diploma in composite materials transformation from CEGEP de Saint Jér me and has no other work experience aside from Loop. He finished his education in 2015 and started at Loop in January 2016, according to his LinkedIn.

Adel's brother Fares is the company's "Technology Lead". Fares also lists no other work experience on his LinkedIn page other than Loop. His education at Universite d'Ottawa took place between 2014 and 2018 and he started as an analyst at Loop in May 2015, working at the company for 3 years while in school, according to the LinkedIn bio.

Their dad's patent formed the basis of the company's GEN I process, which has now become defunct in favor of the company's new GEN II process. [3] [Pg. 8]




(Source: Seeking Alpha , LOOP's Website , explanations and emphasis added.)

When we asked a former employee about the Essaddam brothers and how their process was perceived by others at Loop, we were told:

> *"**They learned most of the stuff from the dad and they were lying the same way as the dad** They wanted to make sure to get results."*

# *Part II: Former Employees Speak Out*

## *Former Loop Employee: "The Chemists Behind the Technology Are Liars"*

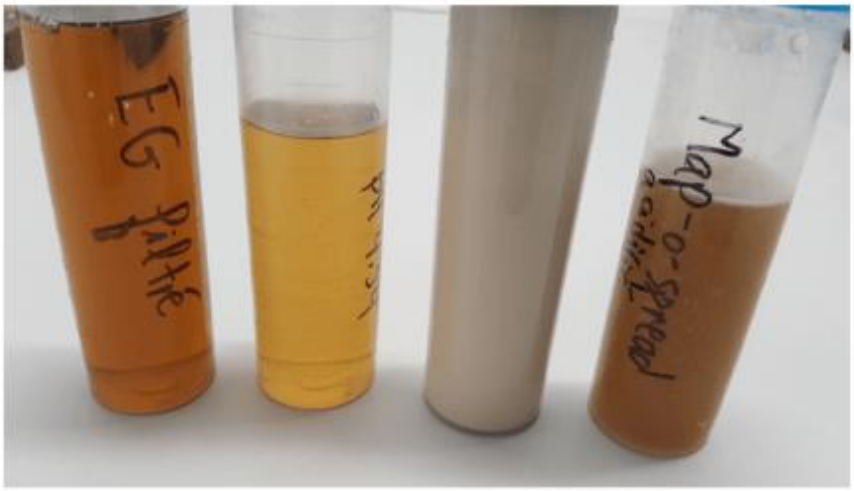
## *Former Loop Employee: "I've Seen False Numbers. I've Seen 'I Want This Sample, Give Me This Result. I Don't Want To See Anything Else. I Want To See This Result'."*

After speaking to former Loop employees, we believe we understand the dysfunctional dynamics at play within the company.

When asked how it was possible that the chemists and experts we interviewed (whose opinions are detailed later in this report) didn't see a way for Loop's process to be cost efficient, but that Loop did, they told us:

> *"**The main problem was that the chemists behind Solomita's technology are liars. They made him hear what he wanted to hear.** I was working on the purification of the MEG and I was not successful at all. I worked on that for [redacted] and it was a painful recovery because some of the dyes were staying in the MEG (PET base chemical monoethylene glycol) and there was no way to remove them. I tried many, many things and I was not successful at all."*

A former employee provided us with these photographs of the dirty MEG:




When we asked how Loop dealt with the difficulties of proving their process internally, they told us they had seen false numbers being used internally:

> *"I've seen false numbers… I've seen 'I want this sample… Give me this result. I don't*

> *want to see anything else; I want to see this result.'"*

The employee described an intimidating tone at the top, referring to CEO Daniel Solomita:

> *"If you don't do what he expects you to do, not fast enough, or if the results are not good enough, he gets angry and he can yell at you for hours and hours and hours. Yeah. I've seen one of his worst frustrations, he yelled at two people for three hours, non-stop."*

When asked about Solomita and whether he would demand certain results, a second employee told us:

> *"There's just facts and there's chemistry and there's certain things you can't like—* ***even if you want something to happen, you're not going to get a resolution.*** *It has to come from a scientific point of view in order to find resolution.* ***You can't just throw money at it, or just have a fit or something. You can't direct the molecules to behave the way you want them to like you would, for an example, an employee showing bad behavior."***

## *Two Former Loop Employees: The Company Has Two Labs. One For The Essaddam Family And One For "All The Other People".*

## *Former Employee: "When It Was Time to Talk About Results, They Were Hiding Things And Bypassing Us To Go Present Results To The Boss"*

Based on what we were told by former employees, it seems like the 'miracle' results and successes that were being produced at Loop came out of a separate lab for the Essaddam family that had been sequestered from other Loop employees.

Two former employees confirmed the existence of separate labs to us. The first said:

> ***"When I was there, there was two labs. One of them was for the Essaddam***

> ***family. And one of them other was for all the other people. We would not see what they were doing.*** *It was in the same building; it was one on the second floor and one on the first floor. We could go into the lab but at some point, it was dangerous because they had an explosion in their lab from toxic fumes since they were doing so many crazy things in there. We would never go in there. I was trying to avoid it as much as possible."*

The first also told us about suspicious results that were coming out of the Essaddams' lab and how the family separated themselves from the rest of the company's scientists:

> *"They were friendly but at some point,* ***when it was time to talk about results, they were hiding things and bypassing us to go present results to the boss.*** *So, they would present their results and not ours. They had two faces. They had their father in the background for everything so they would discuss everything as a family. I'm sure like every day they would probably discuss that at the family dinner. I have a couple of other friends that left because they couldn't stand it anymore."*

> *"There was always a group saying 'they did this again…' 'They brought samples and wouldn't tell them what it was' and 'when we gave results, they weren't happy about it…'"*

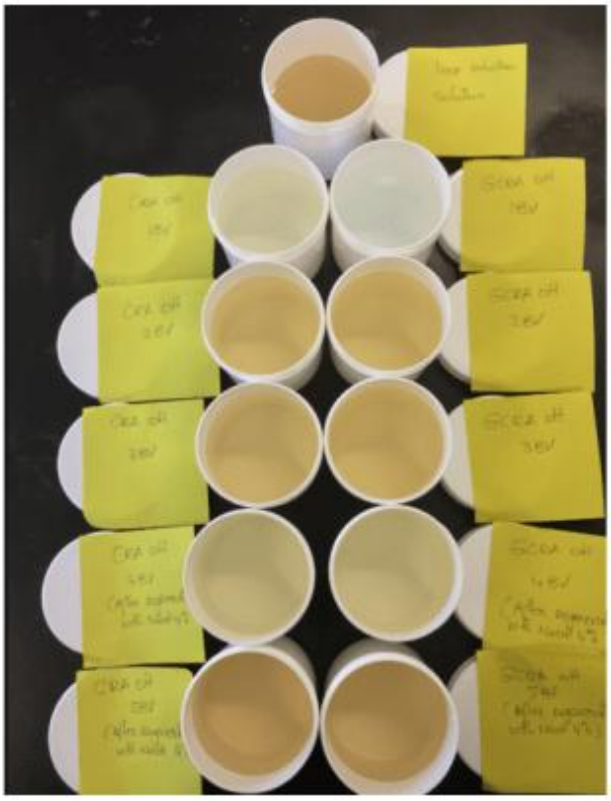
## *Solomita Claimed the Process Needed to Remain Secret—Even Within the Company—to Avoid Leaking it to Competitors*

The second former employee confirmed that the father and two sons worked in an R&D lab while the other employees worked in a second lab, which analyzed samples received from the R&D lab.

> *"One of them was more like the analytical lab, which then needed to test the results.* ***And then the actual R D and process was more from the other lab.*** *The one with the gentleman and the two boys [Essaddam and his sons]."*

The analytical group would receive samples from the R&D lab, then work on the purification

process and analyze the results. We received pictures and details of this analysis. For example, these photographs show tests to remove metals in the solution prior to a process called PTA precipitation:



(Pictured: photos from internal Loop testing to remove impurities)

We were also told that the problem was that the process being used in the R&D lab was not shared with the other lab – it was kept secret even within the company – supposedly because Solomita was worried that it would be leaked to competitors.

The second employee explained that processes in the R&D lab weren't documented well enough for the analytical lab to know how the results were being achieved:

> *"In chemistry you get taught you have to follow a protocol. You have to write everything. You write what you do and you do what you write. You make a clear and explicit action plan beforehand. That's something that you learn formally. That's something you need to implement in your mentality."*

> *"Ultimately if you have your QC (quality control) that comes and tells you 'Hey this is a really good batch, keep tweaking on these parameters', you need to be able to know 'OK what did I do exactly to get this particular sample. **And I feel like there's where there was a little bit of gap. If it wasn't perfectly documented, then you don't know how you got this really good sample.**"*

## *Former Employee: The Results Coming Out of the Secret Lab Were, At Times, Blatantly Impossible*

The first former employee recounted to us how results coming out of the Essaddam lab were sometimes simply "impossible". For example, in one case they claimed the process produced more solution than was initially put in. (Analogous to somehow turning 1 gallon of input into 2 gallons of output.) The employee concluded:

> *"I was not getting along with the Essaddam family. **I am a very honest person, a chemist who respects the code of ethics. In my point of view, a lie and falsifying results is not acceptable. I was not shy to say it.***

> ***When a chem came from the lab into a meeting and said 'I got it, I was successful', I would say it's impossible, you got more than what you sampled in the initial solution that you treated.** They would say 'no that's not true.'"*

## *Loop Claimed That the Base Chemicals It Created Were Of "Industrial Grade Purity"*

## *A Former Employee Refuted This, Saying One Of The Base Chemicals Was "Not Even Isolated At The Time" And Was "Still Mixed With Dyes, Water and Solid Wastes"*

Over three years ago, Loop was already claiming to have been able to create PET plastic building blocks that were of specifications needed for industrial use. This conveyed to investors that the process was consistently creating a viable end product.

In the company's May 30, 2017, annual report, it describes its PET base chemicals (PTA and MEG monomers) as of "industrial grade purity":

> *"Our depolymerized PET has been tested in third-party laboratory settings…and we have concluded that* ***the TA and MEG are of industrial grade purity, meaning they are suitable for use in commercial beverage bottles.*** *[Pg. 5]*

But when we asked a former employee about these claims, they told us that not only wasn't the output of industrial grade purity but the process was failing.

The MEG "was not even isolated at that time," the former employee told us. It was "still mixed with dyes, water and solid wastes."

The former employee also told us they "never saw any test report from an outside lab or manufacturer". They believed Loop's partner, Indorama, had used some base chemicals produced at a lab to create some bottles and that they may have been the "third party source" relating to these claims.

## *Loop Claimed It Was Able to Break PET Into Base Chemicals At A Recovery Rate "Of 100% "*

## *Former Loop Employee: This Is Technically and Industrially "Impossible"*

In the company's June 15, 2016, annual report , it claimed to be breaking PET down into base chemicals at a recovery rate of "100%". [ Pg. 8]

> ***" ur proprietary technology breaks down polyethylene yerephthalate ET" into its base chemicals, purified terephthalic acid TA" and ethylene glycol EG" , at a recovery rate of 100%."***

We spoke to a former employee that worked at Loop around the time of this claim, who told us the claim of a 100% recovery was "technically impossible" and "industrially impossible".

They also told us that "yields were not even repeatably over 90% at the lab scale" in October 2016, nearly 4 months after the company had already claimed a 100% recovery rate in public filings.

A polymer expert we interviewed, who has had no contact with the former employee, told us that a reclaim of 100% of PTA (purified terephthalic acid) and EG (ethylene glycol) base chemicals from PET is "impossible". The expert also said that even "over 90%" would be "a stretch."

## *Former Loop Employee: "I Don't Think That [Loop's Gen II] Process Will Be Successful. Actually, I Don't Really Think They Have the Technology."*

Speaking about Loop's new Generation II process we were told that it "wasn't easier" than the earlier problem-ridden Generation I process:

> *"When I was there, they were producing PET and the contaminants had to be very low. We were successful every ten batches maybe, because there was always a contaminant that was way too high. We were trying to purify and repurify. Sometimes we'd purify a batch 4, 5, 6 times. On a material level it's impossible to be successful and make money off of that. You'd have to send a batch back to reprocess because it's full of contaminants—you can't make money off of that."*

Despite Loop's claims of a "revolutionary" process and "disrupting" the plastics industry, [4] the former employee told us they didn't think the Gen II process would be successful, nor did they think that the company even has the technology it claims:

> ***"There were so many issues with the process that we left it alone and we started a new process, but it wasn't easier I don't think that it will be successful. Actually, I don't really think they have the technology. That would be my conclusion."***

## *Loop's Own Patents Seem To Contradict The Company's Claims About Yields, Purity and Lack Of Heat and Pressure In Its Process*

In Loop's October 2020 investor presentation , it emphasizes its "patent protected" technology. Instead of proving the value of the company's intellectual property, the company's patents and related applications instead seem to stand at odds with company disclosures and, in some

cases, *appear to disprove some of the company's own statements.*

The company has two patent families; one relating to its now defunct GEN I process and another related to its GEN II process. [ Pg.5] The patents relating to the GEN II process [ 1, 2, 3] look to be Adel and Fares Essaddam brothers' only patents. The main differences between the GEN II patents relate to the catalysts that the company is using to break down PET.

An expert chemist we consulted for this report called the GEN II patents "very similar" to the GEN I patent , which Loop CEO Daniel Solomita purchased in 2014 for $445,050 and has since written off Loop's balance sheet. [ Pg. F-15, F-16]

The company's GEN II patents are replete with examples of adding both heat and pressure to Loop's process. [5]

These revelations appear at odds with the company's previous claims of breaking down PET "under normal atmospheric pressure and at room temperature" (likely referring to GEN I, from Q2 2017 10-Q) and claims made as recently as May 2019 (while describing the GEN II process), where on Loop's website, in which the company says its process uses "zero energy input" and that this is **why the technology is revolutionary".**


(Source: Wayback Machine, Loop Industries website from May 3, 2019[6])

Heat and pressure both require energy input, and thereby can substantially increase costs.

The GEN II patents also offer a glance into the company's cherry-picked base chemical yields

after breaking down PET. The results that the company admits to in its patents appear to be far worse than the "unparalleled" and "100% recovery" claims Loop has made in the past.

The data is cherrypicked for each base chemical, as well. For example, in this GEN II patent application [ Pg. 22], data is presented in two different ways for each of the two base chemicals produced from the process, DMT and MEG.

The company chooses to show MEG yield after distillation, but not DMT yield ***after distillation.*** For MEG, it shows yield after only *one* distillation. Ergo, this makes it impossible to determine the purity of the final product based on the data provided; and certainly difficult to prove "unparalleled purity" after the multiple distillations that are likely necessary, our expert confirmed to us.

Additionally, a former employee informed us that the company's MEG yield was being reported in the GEN II patent in a way that exaggerated the effectiveness of Loop's process. [7] **Even the inflated numbers do not qualify the process as high yielding, giving a false impression of the importance of the patent, the former employee said.**

# *Part III: Loop's Hollow Partnerships*

Key to the investment thesis in Loop is its lineup of partnerships with major plastics-related corporations around the globe.

We connected with Loop's partners and found the deals showed few signs of progress and mostly amounted to hollow press releases. Such empty partnerships are common in Environmental, Social and Governance ("ESG") companies, providing major corporations an opportunity to "greenwash" or give the appearance that they are taking steps to help the environment, while doing very little to actually engage.

## *Loop's Former Chief Growth Officer Used His Rolodex to Secure Partnerships With L'Oreal, Coca-Cola, PepsiCo And Other Major Corporations.*

## *But These Partnerships Appear to Have Stalled. Loop's Partners Would Not Disclose If They Had Recycled Any Plastic with Loop – Except One That Indicated It Had Received Nothing.*

Just like other questionable companies of days past that have used various partnerships to project legitimacy, we think Loop is running a similar playbook.

In an October 2020 investor presentation, Loop touts its partnerships with companies like L'Oreal, Coca-Cola and PepsiCo.

We inquired with the above partners on the amount of plastic they processed in conjunction with Loop and were given vague answers, boilerplate responses or directed back to Loop.

For example, after emailing Coca-Cola European Partners for comment, we were diverted to an outside PR firm, Blurred London. After 13 days and several follow up emails, we received the following non-committal response:

> *"**Loop is one of many technology providers** working on developing efficient processes and alongside our bottling partners across the globe, **the Company continues to evaluate several solutions to accelerate commercialization** in support of a circular economy for our packaging and our World Without Waste goals."*

Danone, owner of the world-famous Evian water brand, unveiled its recycled PET bottle in July 2020, saying it had been two years "in the making". But none of the plastic or recycled resin came from Loop, even though the companies have a partnership agreement.

Responding via an outside PR company, Freuds, Evian said: "When Loop's production site is operational, Evian will be one of the first brands purchasing LOOP PET to be produced."

Loop currently has no operational production site in Europe or elsewhere – hence we view the statement as a roundabout admission that no Loop plastic has been used in the Evian bottle.

## *Loop's Former Chief Growth Officer Told Us Multinational Partners Make Bets "On All Kinds Of Things" And Take "One or Two Years" To Do Rigorous Process Due Diligence After A Partnership Is Announced*

We spoke with Loop's former Chief Growth Officer, Nelson Switzer, (who has since resigned). Switzer indicated to us he had used his contacts from his former job as Chief Sustainability

Officer of Nestle Waters to help entice some large names into partnerships [8]:

> *"As a former chief sustainability officer for one of the world's largest CPGs ("consumer packaged goods") I had and still have a very extensive network with other CPGs around the world and that was a big part of it."*

During our conversation with Switzer, he also seemed to confirm to us that larger corporations are fairly loose on signing vague sustainability or environmental partnerships:

> ***"They'll make these bets on all kinds of things whether its new technology or new enterprises or otherwise."***

Switzer also explained that turning such partnerships into production deals can take "one or two years" of due-diligence:

> *"…**some of those things took one, or two years or more to qualify an additive or new type of plastic and there's lot of reasons for it**in order to even consider that material into a production line we would have to make sure what the potential impact is on our production line. Is it going to contaminate anything? Do we have to worry about it?"*

Switzer would not tell us whether Loop's products were tested by multinationals (Pepsico, Coca-Cola, L'Oreal etc.) after announcing agreements, nor would he answer questions as to whether or not he stood alongside the production line and watched the process work.

## *Former Loop Employee: Partners "Couldn't See The Entire Process. They Had To Believe The Results We Were Giving Them."*

A former employee of Loop told us that they didn't think the potential partners could see Loop's process from start to finish before entering into their partnerships:

> *"Danone spent an entire week with us. They wanted to see the process from the*

> *beginning to end…It was taking almost 2 weeks to finish a batch. So, they couldn't see the entire process. They had to believe in the results we were giving them."*

Loop hasn't disclosed a partnership with a major consumer brand name since Switzer resigned last May.

On September 28, 2020, Loop announced it had hired Sheila Morin as the company's Chief Marketing Officer. Morin previously worked for both L'Oreal and Danone, two Loop partners, in the past.

## *Indorama Joint Venture: Announced By Loop In 2018 With An Expected Start Date Of Q1 2020 – Yet Indorama Tells Us The Project Is "Still Being Finalized"*

One of the biggest partnerships the company touts is its joint venture with established global polyethylene manufacturer Indorama.

The 50-50 JV wasannounced on September 24, 2018. Both Loop and Indorama put $500,000 cash into the venture in April 2019. The company announced that the JV would have "an exclusive world-wide license to use Loop's technology to produce 100% sustainably produced PET resin and polyester fiber with plans to begin commercial production in Q1 2020."

Indorama was apparently so excited at the time that they suggested that Loop's CEO should win a Nobel Prize, according to a 2019 article (*translated from French*) [9]:

> *"Mr Solomita recalls the reaction of Indorama's main financier when the duo introduced him to their new technology: "He said to me: 'if what you are saying is true, you deserve a Nobel Prize!'"*

That excitement seems to have worn off. Now, both Loop and Indorama have indicated that the JV terms have not even been finalized, almost 2 years after the announcement. Loop's most recent 10-Q, filed in October 2020 says:

> ***"Discussions on the joint venture structure and financing are on-going."***

## *Indorama Exec 1: "The Project Is Still Being Finalized"*

We reached out to Indorama to try to learn whether *any* work had been done to advance the project over the last two years.

Indorama's SVP of Corporate Communications and Sustainability emailed us in mid-July saying they "cannot comment except to say [they] are actively pursuing partnership with Loop", then said immediately afterward **the project is still being finalized".**

## *Indorama Exec 2: "Right Now, We Don't Have Any Production"*

We were also able to reach Sanjay Mehta, Chief Technology Officer in the Business Recycling Group for Indorama Ventures at the Spartanburg Plant in mid-August 2020:

> *"JV is in continuation mode and we continue to move forward and decide for the next quarter, how things are shaping relating to Covid and how the market is…So we are very cautiously watching it and then we are going to make a call next quarter…"*

He declined to say whether the Spartanburg plant had been retrofitted with any of the equipment needed for the Loop process. When we asked him if there was any production using Loop's technology now, Mehta commented:

> ***Right now we don't have any production, that I can say.*** *But I don't want to give any more detail at this stage."*

## *Recently Announced Partnerships Seem to be Shifting Focus From Indorama*

On September 3, 2020, Loop put out a press release announcing it had entered into an agreement to engage two outside firms called Chemtex and Invista Performance Technologies, the technology licensing arm of Invista, a major global producer of polymers and fiber.

The agreement is to help Loop develop its manufacturing processes, instead of collaborating with its longtime partners in Indorama, which has decades of experience in polymer

manufacturing.

The company further appeared to be shifting focus from Indorama by recently entering into a "strategic partnership" with SUEZ, a *traditional mechanical* plastic recycler, to build Loop's first "Infinite Loop" facility.

Given Indorama's supposed close relationship to Loop, we can't help but wonder why *Indorama* isn't developing these facilities and – if it *was* offered the chance – why it passed on the opportunity. The commissioning of Loop's new facility is projected for 2023, though like the Indorama joint venture, we doubt it comes to fruition.

Unlike Indorama, which is a chemical company with longstanding experience in end-to-end production of PET polymers, Suez is better known for sorting and managing waste streams and mechanically converting those into recyclable PET pellets.

A plastics industry source, with knowledge of Loop's partnerships, told us:

> *"The competence of Suez makes sense because you have a partner dealing with the front end, the entire collecting, sorting, washing as a pre-treatment of what then what goes into depolymerization. But what is lacking, and the announcement is silent, is who will be the producer? Who will bring in the expertise for the entire production of depolymerization and polymerization again? Whether it is not Indorama or is Indorama – it's silent on that question."*

## *Loop Partner Thyssenkrupp: Contract With Loop Is "Basically" On "Indefinite" Hold Due To Indorama Partnership Going "Silent"*

On December 19, 2018, Loop entered into a "Global Alliance Agreement" with the industrial solutions division of ~$3 billion German multi-national engineering and steel company Thyssenkrupp. The press release boasted that the agreement with that division, called Uhde Inventa-Fischer GmbH, would be a "strategic alliance expected to shape the future of PET and Polyester manufacturing".

The companies had planned to "license the respective technologies developed by Loop and thyssenkrupp Industrial Solutions to manufacturing partners in geographical regions around the world" by rolling out a "Waste To Resin" solution that would help companies achieve their

goals of using 100% sustainable PET and polyester.

On October 12, 2020, we spoke to two senior executives at Uhde Inventa-Fischer GmbH.

We asked how they would characterize the state of Thyssenkrupp's contract with Loop and were told by one senior executive that it was "on hold" and contingent on whether or not Loop moves forward with its Indorama partnership:

> *"It's depending on whether there will be a first project or not (with Indorama). If there's no first project there's no path forward…It's basically on hold. The contract is on hold and is silent on whether Indorama will further collaborate with Loop."*

A second executive at Uhde Inventa-Fischer GmbH confirmed this to us, stating:

> *"At the moment this (contract) is more or less for an indefinite time on hold. There was a project on-going with Loop but cooperation stopped maybe three months ago for the project with Indorama and since then according to my knowledge there is no further cooperation on-going and no further cooperation is planned."*

The second executive also told us that Thyssenkrupp was supposed to be involved, to some degree, in the Indorama partnership, but that it's "not happening at the moment":

> *"For the contract between Loop and Indorama I don't know. That's between them. But for our part we delivered the basic but there's no further contract between us and Loop. At one time we talked about being involved in the detail but it's not happening for the moment."*

## *Drinkfinity: A Short-Lived And Questionable Partnership With PepsiCo That Already Appears To Be On Its Last Legs*

Another partnership that showed early promise appears to be on its way out.

In February 2017, the company signed a service agreement with Drinkfinity, a subsidiary of Pepsi, to provide customers with mailing envelopes so they can recycle their Drinkfinity pods.

[S-A, Pg. 1]

**A former employee told us of the program that one of the elements of the pods is an aluminum foil, which could never be recovered by Loop's process, being a metal"**

> *"In fact, in our tests, final PTA was highly contaminated by aluminum and was hard to remove being soluble in water like the PTA and insoluble in the solvents used to depolymerize the PET."*

As one article pointed out in 2018:

> *"The bags in which LOOP asks customers to send their empty Drinkfinity pods in are made from LDPE (low-density polyethylene) plastic, which LOOP's technology* ***cannot recycle*** *– thereby appearing to place Loop in violation of their own agreement to recycle the packaging."*

A Seeking Alpha author ordered and scanned a shipping label for the Drinkfinity partnership. The label included in the article showed the pods were being mailed to St. Albans, Vermont.


(Source: 2018 Seeking Alpha article details on Drinkfinity)

The 7 Champlain Commons address on Loop's mailing label corresponds to the red box shown here:

(Source: Google Maps , accessed 8/4/2020)


(Source: Google Maps , accessed 8/4/2020)

Photographs from a visit to the St. Albans site during September of 2019 showed a number of Loop's Drinkfinity packages sitting in a couple of 55-gallon barrel drums:



(Pictured: On-site visit showing Loop Drinkfinity pods sitting in barrels)

To us, packaging a pod in non-recyclable LDPE, shipping it through the mail, only to drive it another 66 miles to Montreal doesn't seem like a great use of resources – nor does it sound friendly to the environment.

## *Drinkfinity Partner: "I Don't Know How Long Our Part In This Will Last… It's Not Particularly Lucrative… We Don't Make Sh*t Doing It."*

We contacted the businesses listed at the St. Albans address this year and learned that the Drinkfinity packages were being mailed to D&M Spools Prep, a recycling company. When reached for comment, D&M confirmed they were the middleman for receiving these pods in the U.S. and that the pods were then shipped to Montreal.

A D&M employee told us they were "currently under contract to send [the pods] back to Loop Industries in Canada", adding "I know very little about what happens to the pods when they leave here."

The employee told us that they had gone up to visit Loop in the hopes of entering into an agreement with them (outside of the Drinkfinity middle-man deal) but, after several months of waiting, learned that Loop wasn't able to process D&M's PET scraps:

> *"**What their part is, I really have no idea.** The way we got to know them (Loop) is we deal with PET – a lot of PET scraps. We had gone up to visit this company and they could supposedly turn it back into a liquid form – some sort of way. **We sent them samples of our stuff and there was too many contaminants in it for them to be able to do it so we never really did anything with them.**"*

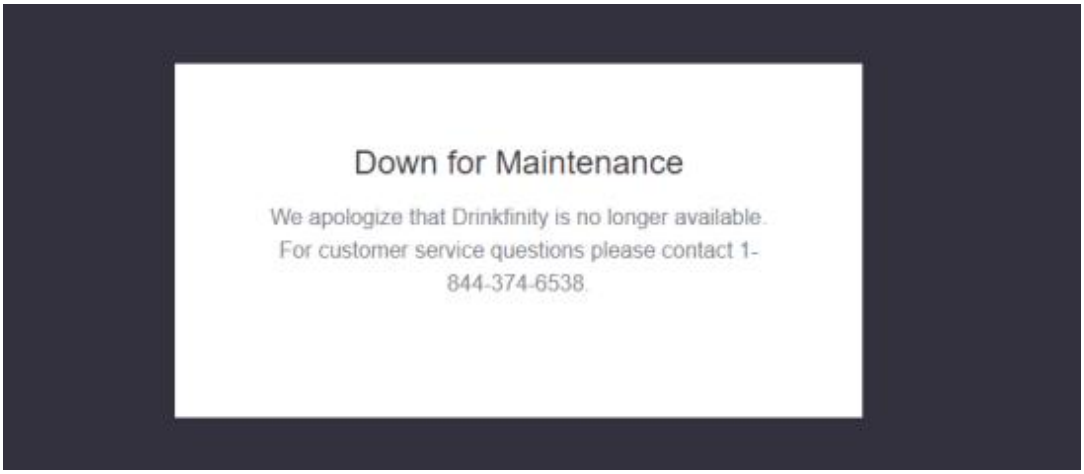
We asked if they were able to verify Loop's process. They told us they were not and that it was "more of a meet-and-greet":

> *"We weren't allowed in – I don't know if they had a laboratory set up. I don't even know if we were on the actual site where they did it. **It was a very small complex we went to. It was basically more just offices. It was more of just a meet-and-greet**"*

Offering us their final thoughts on the partnership with Loop, they said:

> *"I don't know how long our part in this is going to last. I don't know if we'll re-up. It's not particularly lucrative for us. **We don't make sh*t doing it."***

It looks as though neither Pepsi, nor Loop, have kept up with the program. Drinkfinity's (former) website at www.drinkfinity.com now just offers this message:




(Source: Drinkfinity.com, accessed 10/7/2020)

# *Part IV: Experts and Industry Participants Weigh In*

## *In a Highly Unusual Move, The Company Hasn't Published Any Of Its Recovery Rates Or Purity Standards Since 2017, Before It Began its Flagship Generation II Process.*

In Loop's October 2020 investor presentation, it refers to its technology as "proven" and claims that its end product is of "unparalleled purity".


Many leading plastics companies (and startup companies in various scientific disciplines)

publish peer reviewed studies or white papers that detail their advancements in the field. Contrary to that practice, we were unable to find a single peer reviewed study or white paper in any scholarly journal describing Loop's process.

For comparison, French competitor Carbios published a study in *Nature* in April 2020 showing their small-batch study, after a 10-hour reaction time, recovered 90% of base plastic building blocks (monomers). Carbios is part of an official consortium between L'Oreal, Pepsico, Nestle Waters, and other major brands.

## *Our 30-Year Polymers Expert Consultant Called The Lack of Publications "Suspect"*

We reached out to one expert in polymers/plastics with 30 years' experience who has worked as a chemist for over three decades, holds several patents and has specific experience working with advanced methods of plastic recycling.

One of the things he asked us for was analytics on Loop's process. But Loop doesn't appear to have reported purity standards or recovery rates for its process since February 2017 – something that our chemist found baffling:

> *"It should be very straight forward. The analytical is the 'proof' of a process.* ***Anything short of complete analytical support of a process should be suspect.*** *The 'secret sauce' has no effect on the resultant analytical results of the products. Why won't they share the process vs. analytical?* ***I think I know why***

## *30-Year Expert In Polymers: Loop's Gen II Process Isn't New, Isn't Simple Or Easy, Isn't Profitable And Involves Technology That Already Exists*

The same 30-year expert told us that the company's GEN II process involves technology that has existed for decades and is well known in the industry. He told us that when PET was first developed in 1941, then marketed by DuPont in 1951, scientists would have already "had a firm understanding of the properties" of the plastic. He said that rigorous testing leading up to the first bottle patent in 1973 meant the industry likely had a "thorough" understanding of hydrolysis and solvent resistance by then.

He noted that he did not see any type of special catalyst or trade secret in the patent that

would preclude somebody else from doing the exact same thing that Loop is doing.

He said of Loop's process:

> *"…the chemistry is there and has been there.* ***Implying that it is  new' and implying that it is  simple  easy,' and profitable as a standalone process, just isn't true****"*

## *Second Expert Consultant With 45 Years' Experience: Loop's Type Of Process Is "Very Well Known"*

We also reached out to a second expert who has decades of experience with plastics and has worked in a number of positions in the industry, including as a project scientist for a company that merged with a $40 billion chemical company.

The second expert told us:

> *"I would concur with that opinion.* ***He is right in saying it's very well-known processing*** *Big companies like Coca Cola and so forth have been doing this for a number of years – depolymerizing.*
>
> *But the purity of the materials they are working with originally is kind of high. They're just recycling their own materials. But to get all the gunk out of there – with caps and paper – it's kind of like a laborious process and has to come about pretty quickly before you even get to this point (depolymerization)."*

During a discussion about how base chemicals could be reformed into usable PET plastic, we asked the second expert whether or not it would be a tough field to just break into for a new player, given the massive scale and already existing best practices in the industry by the major chemical companies:

> *"That's correct. Boy you said it right there. I concur with that 100%. Yes, best practices – and many of those best practices are trade secrets as well."*

## *Loop Competitor: "We Could Not See Any Big Difference"*

## *From Loop and What Was Already Known in The Field Of Chemical Decomposition Of PET*

We also reached out to a C-suite employee of a competitor for help on understanding how the advanced recycling field views Loop. We were offered a similar take to what our chemist told us, that Loop's process is relatively well known:

> *"We started to pay attention (and) the first point to us was that the patent itself was not very detailed in the way things were done.* ***We could not see any big difference away from what was already well known in the field of chemical decomposition of ET."***

## *30-Year Expert In Polymers: Loop's Process For Breaking Down PET Plastic Is "Basic Stuff", But Its Purification Process Is A Black Box*

A polymer expert we spoke to told us that Loop's processes for breaking down PET plastic are already well known, but that purifying the broken down plastic is the difficult step. He called this step in Loop's process a "black box".

What baffled him most was how the company could get from broken down PET plastic to usable, purified PET chemical building blocks again. He told us:

> *"I haven't seen any references as to how Loop is refining the products to a usable form. Typically, processes such as distillation are used to refine, but that depends on the analytical results."*

He also told us that he believed this information has been omitted specifically because the process likely *isn't* viable. He referred to Loop's process as "basic stuff" and told us:

> ***The detailed information for either process is readily available to anyone***
> *No 'secret catalyst' or 'patented formulation' additive is required. I do not know if any of the specific chemical pathways fall under someone's current patent though. Wouldn't think so.* ***It's basic stuff."***

We asked our chemist about the company's statement that their "proprietary technology breaks down PET into its base chemicals, Purified Terephthalic Acid (PTA) and Mono Ethylene Glycol (MEG), at a recovery rate of over 90% and under normal atmospheric pressure and at room temperature". [ Pg. 6]

He told us that products created after breaking down the PET aren't pure at that stage and need to be purified further to make the purified and usable end-product the company touts:

> ***the products' are not pure. They really can't be used unless pure.*** *The statement is kind of misleading, in my opinion. While 90% conversion sounds good, it really isn't. Polymerization is tricky. Contamination is really bad."*

Loop's recent agreement with Chemtex and Invista, announced on September 3, 2020, indicates further to us that Loop has not shored up all parts of its process. Rather, it signals that the company is seeking help with purification and repolymerization. A former Loop employee, when asked about the agreement, confirmed it was likely because Loop needed help with this portion of its process.

## *45-Year Expert In Polymers/Plastics: "The Chemical Industry Has Been Working On [Re-Polymerization] For 50 Years"*

Our second expert agreed that the purification portion of the process is where any secret sauce would be, and Loop hadn't demonstrated any advancements. He concurred that this was the most challenging part of the process, telling us:

> *"The chemical industry has been working on this for 50 years. Or more. And they've put together very efficient processes in order to make the pure PET polymer."*

## *Loop Competitor: Purification Of Polymers Was The Key Question With Loop & The Sudden Switch To Gen II Was "Very Weird"*

The competitor that we spoke to echoed the concerns of our chemist, telling us that purification of polymers was paramount and that the company's sudden switch from Gen I to Gen II was "very weird".

The competitor told us:

> " ***ur question was how are they going to deal with this the moment that they purify the polymers****and they must guarantee some food grade PET at the end, because that was the original purpose."*

Speaking about the switch from Generation I to Generation II, the same competitor said:

> *"**If today our CE came to us and told us you know what we're going to change our reactions in terms of the impact, the reactor itself, but mostly the purification, what I would say is Are you crazy Are we restarting everything from scratch "***

He continued:

> " ***ou are changing your impact on your business model. To us on the outside to us it sounded very weird."***

## *Loop Competitor Confirms: Separation Of Dyes Is "Hardest Part" Of The Process*

The same competitor confirmed what our chemist and former employees had already told us; that purification and the separation of dyes was the crux of the process:

> *"**Because the separation from the dyes and the organic element that are inside the ET waste and potentially dissolve in liquid is the most challenging part**. It is where you have to start inserting some catalyst which is actually what most of our competitors tried to do, or in the case of Ionica they used some magnetic nanoparticles. **But if you use a catalyst then you start to see chemical elements appearing in the final ET after you have depolymerized and this is where you get troubles with the purification"***

A former employee provided us with the details regarding Loop's attempts to try and wash the

PET with either water, P4 (dichloromethane) or both and the potential to reuse P4 without purifying it. The goal was to see if washing PET with used P4 could remove some dyes and make the final purification of MEG easier.

"No success," we were told by the employee. "It was impossible to separate the different layers and recover the non-depolymerized PET."



(Pictured  Preliminary tests taken place at Loop attempting to remove dyes and colors from raw material prior to the complete depolymerization process.)

## *30-Year Expert In Polymers: "I Don't See How You Could Make Any Money Or Save Any Money" Using Loop's Process. "It's A Scam In That Sense".*

We also inquired with our first expert as to why everybody in the plastics industry was not utilizing Loop's process if it was as revolutionary as the company claimed. He responded:

> ***Everyone isn't doing it because I don't see how you could make any money or save any money in doing it."***

He concluded, upon his overview of the company's Gen II process information that was available on the company's website, by telling us:

> *"It appears to me that they took a very complex process, significantly simplified it, omitted a lot of serious stuff, and only mentioned the favorable highlights.* ***I would say it's a scam' in that sense."***

## *Loop Competitor: We Heard Rumors "Something May Not Be Working" At Loop. Their Credibility as A Competitor Is "Much Lower Than It Was 2-3 Years Ago".*

One of Loop's competitors also told us that they were no longer worried about Loop as a competitor and that industry rumors were indicating to them that something may be amiss. They told us:

> *"With Loop, it's sort of another world. We never met them in person, just secondhand speech. But to us, it's not at the same level of competition that we thought it was….*
>
> *If you sum all the things with the fluctuations of the stock value, of the contradictory information that we are provided in the quarterly reviews. Also copy and pasting of sentences in some press releases from other companies* ***All of these to us was a symptom of something going on behind the scenes that was not completely understandable to us."***

## *Plastic Recycling Partner Of $35 Billion Dow: "…I Never Heard Of These Guys Ever. Nobody Has Ever Talked To Me About Their Technology."*

To better understand whether Loop has had a meaningful impact on the recycling industry,

and whether or not they are truly "on the radar" of large multi-national corporations, we reached out to large conglomerates to ask their opinion of Loop.

We were able to reach Rick Perez, CEO of Avangard Innovative, Houston, whose company announced a partnership with $35 billion market cap Dow in 2020, supplying post-consumer plastic film pellets to Dow.

He told us he had "never heard" of Loop and that "nobody has ever talked to [him] about [Loop's] technology":

> *"You need a team of people who know what they're doing. I don't know them (Loop). I never heard of them. Never been aware of any brand owner or converter (that has talked about them) and we move in the largest and biggest scale in the world and I never heard of these guys ever. Nobody has ever talked to me about their technology."*

When we described Loop's process to him, he seemed uninspired:

> *"If you built the polymer then you can break it back down. I don't consider that recycling. You bring it back to raw materials and put it back together again from the molecules. What is its carbon footprint…Are you really creating something environmentally friendly or just bringing a different process to the waste stream?"*

## *Executive At Loop Partner Thyssenkrupp: Loop "Underestimated" Costs And "Underestimated" Process After Breaking Down PET To Its Base Chemicals*

One senior executive we spoke to at Thyssenkrupp's industrial division, when asked if he was familiar with Loop's process, admitted to us they had "seen the weaknesses" in Loop's process and alluded to cost being the "crucial point" on whether or not Loop's process is viable:

> *"We got certain understanding (of Loop's technology) by working on the development of a potential first integrated plant and have some insight there and a certain understanding of the potential of the technology and of certain ways to go and certain time and developments needed. We've also seen the weaknesses. I believe it's*

*more a matter of how economical such a technology at the end of day is. I would say you will always find a technical solution potentially. But what is the OPEX and CAPEX price for it? That's the crucial point…"*

A second executive told us that "the cooperation with Loop was very difficult" and that is why they stopped their Global Alliance agreement. He also said:

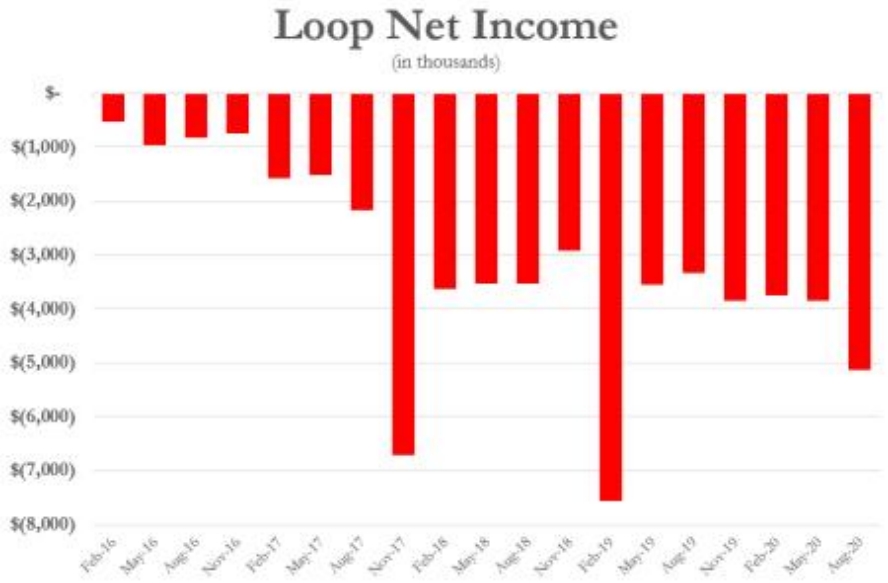
> ***The technology is available but they underestimated the cost I would say.*** *when they say it's a profitable process, then going into the detailed figures it turns out it might be profitable* ***but there's a long way to go. And then there was a personal character thing which made things difficult."***

The second executive also confirmed to us that the purification portion of Loop's process and the isolation of the base chemicals were stages in the process Loop had "underestimated":

> *"The depolymerization definitely worked. The enzymes they're using worked fine. But once you have a depolymerized solution then you need some kind of cleaning of that solution. You need to separate what the depolymerization process is giving you. It's the separation they underestimated. It's not their core business.* ***They say they're just focusing on depolymerization but the necessary cleaning steps of the solution were underestimated."***

## *Loop Has Never Generated Revenue And Warns Investors It May Never Achieve Or Maintain Profitability*

Loop has never generated revenue **and has an accumulated deficit of 62.3 million.**[Pg. F-1] It has a history of widening net losses that leave us little faith that the company will ever generate income on its bottom line (or produce meaningful top line revenue, for that matter).




(Source: FactSet)

Loop has about $48 million in cash, given its balance last quarter and including a recent secondary offering . With a quarterly burn rate of about $5 million and planned capital expenditures for its production facility, we expect the company will need to raise more equity in order to advance its plans, should it ever choose to do so.

## *Conclusion And 15 Questions We Believe Management Should Answer*

We think Loop's claimed breakthroughs, which represent the entirety of its business prospects, simply don't exist.

We also think investors in Loop deserve answers to the following questions:

1. Was Daniel Solomita aware that Henry Lorin was a convict who had pled guilty to securities fraud charges when he was engaged to help raise early capital for Loop?
2. If so, why did you hire a convict to help with your early capital raising efforts?
3. Were you aware that Lance Bauerlein was under an active indictment for criminal securities fraud charges when you met with him to help facilitate Loop's initial $80,000 investment?
4. Did you expect that appointing two inexperienced individuals in their twenties with no post-graduate education in the sciences would yield a revolutionary breakthrough in the field of plastics recycling?
5. According to several former employees, the R&D lab run by the Essaddams was producing results that couldn't be replicated outside of their lab. How do you respond?

6. Why does the company have two distinct labs? Is it best practice to limit access of the company's scientists to a lab where major breakthroughs are said to be occurring?
7. Loop's competitors have published advancements and findings in scientific journals. Can Loop point us toward any relevant publications? If not, why has Loop not done this, despite all of the company's claimed breakthroughs?
8. When Loop claimed in 2017 that it was able to break down PET to its monomers at industrial grade purity, had MEG been ***consistently and successfully*** isolated at the time? Former employees state that it was mixed with dyes, water, and solid wastes. How do you respond?
9. In 2016, Loop claimed to break down PET at a recovery rate of 100%. A polymer expert with over three decades of experience and former employees have described this recovery rate as "impossible". How do you respond?
10. Can you ***quantify exactly*** how much plastic Loop has recycled in conjunction with L'Oreal, Coca-Cola, and Danone since the announcement of these partnerships? Has there been any offtake from these companies, and if so, how much?
11. Have L'Oreal, Coca-Cola, Pepsi, and Danone actually seen the entire Gen II process work from start to finish, using actual post-consumer waste PET?
12. Why has it taken over 2 years to finalize terms of the joint venture with Indorama? Further, why did the company recently engage new partners instead of furthering its cooperation with Indorama?
13. What is the status of the Drinkfinity partnership, given that the website doesn't even appear to function?
14. Why were Drinkfinity bags made with LDPE when Loop can't recycle that plastic?
15. We understand the company's patents deal with depolymerization, but we also know these methods to be relatively well known already. Does the company have a patent on any specific **purification** methods that can be proven to purify PET monomers in way that exceeds the industry's current best practices at an industrial scale?

We look forward to Loop's answers to all of the above questions.

## *Disclosure: We are short shares of Loop Industries (NASDAQ:LOOP)*

## *Legal Disclaimer*

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[1] " l'époque, l'ingénieur et un partenaire, le chimiste Hatem Essaddam, ont construit un laboratoire de fortune, fabriqué avec des **produits achet s la quincaillerie locale** dans le but d'y faire des expériences. Ils espéraient développer une nouvelle technologie pour recycler le plastique de type PET (polyéthyl ne téréphtalate), utilisé dans la fabrication de bouteilles de plastique."

[2] "On October 12th, 2014, the Company had a change in the management. The new management changed the name of the Company to Hitec Corp on November 4th, 2014. The new management decided that it is not generating sufficient revenue and has no hopes of future revenue from the recycling operations and impaired the asset of $600,000."

[3] "The Company has determined that it have [sic] no intent of commercializing the GEN I technology." [ Pg. F-16]

[4] Loop's website on October 12, 2020: "Disrupt traditional plastic and fiber manufacturing" and "Why our technology is revolutionary"

[5] See WO2020/002999 here . Addition of heat to portions of Loop's process can be found in

numerous examples, such as lines [0015], [0033], [0034], [0036], [00114], et al. Use of pressure can be found in line [00148] in the previously linked example and line [0136] in the company's US patent here .

[6] The company's website, as of October 11, 2020 now says "Our depolymerization process achieves this **using low heat** and **no pressure**" and calls the company's technology "low-energy".

[7] The former employee told us: "Usually you report a yield according to the theoretical amount the depolymerization should generate, not based on what you found in your reactor after the reaction. So it means that the true yields are even lower than the ones listed…"

[8] Additionally, his LinkedIn states he: "(I) Led sales & marketing to successfully secure multi-year agreements with PepsiCo, Coca-Cola, L'Oreal, Nestle Waters, L'Occitane and other global consumer packaged goods companies – selling Loop's total planned production capacity. (I) Developed supply chain pipeline of waste PET to satisfy the feedstock requirements for Loop's total planned production capacity."

[9] "M. Solomita se souvient de la réaction du principal financier d'Indorama, lorsque le duo lui a présenté sa nouvelle technologie: Il m'a dit: "si ce que vous dites est vrai, vous méritez un prix Nobel!"»"

# TAB 3

# We View Nikola's Response As a Tacit Admission of Securities Fraud

Published on September 15, 2020



Last week, we issued a report that presented extensive evidence of a litany of material false statements made by Nikola's Founder and Executive Chairman, Trevor Milton.

We included 53 questions at the end of our report that we believe shareholders deserve answers to. The company promised a full point-by-point rebuttal, but then only responded to 10 of our questions.

Of those 10 responses, the company debunked nothing. Instead it either confirmed or sidestepped virtually everything we wrote about, and in some cases raised new unanswered questions.

## *Nikola Failed to Address 43 of our 53 Questions. Of Those It Touched On, It Largely Confirmed Our Findings or Raised New Questions*

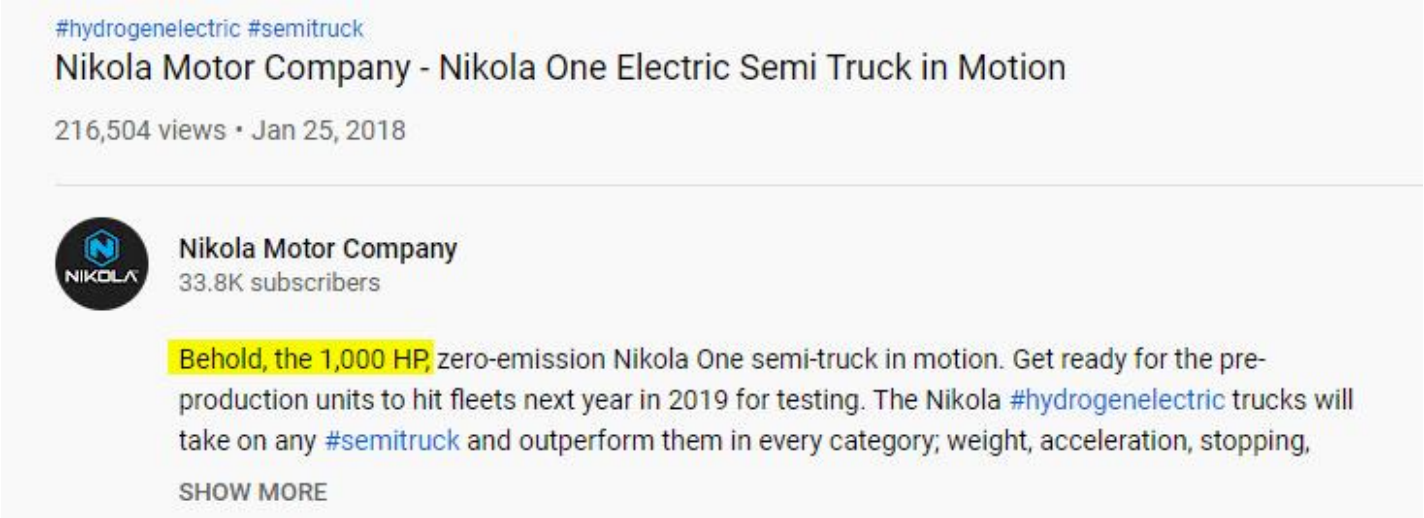
## *Nikola Admitted That Its Deceptive "Nikola One in Motion" Video Was, In Fact, Video of The Semi-Truck Simply Rolling Down A Hill.*

## *The Company Says It Never Claimed the Truck Was Powering Itself, Despite Deceptive Editing and Claims That it Had "1,000 HP" With "Sports Performance"*

In our report, we explained how the company released a video called "Nikola One in Motion", which made it seem that its Nikola One semi-truck was traveling under its own power at a high rate of speed. Angles in the video were edited to make it appear as though the semi was moving on a roadway that was flat, or even uphill.

In Monday's response, the company acknowledged that its vehicle was not functioning under its own power, and instead, was apparently simply showcasing the power of gravity. It claimed that using the term "in motion" dispelled the deceptive nature of the video.

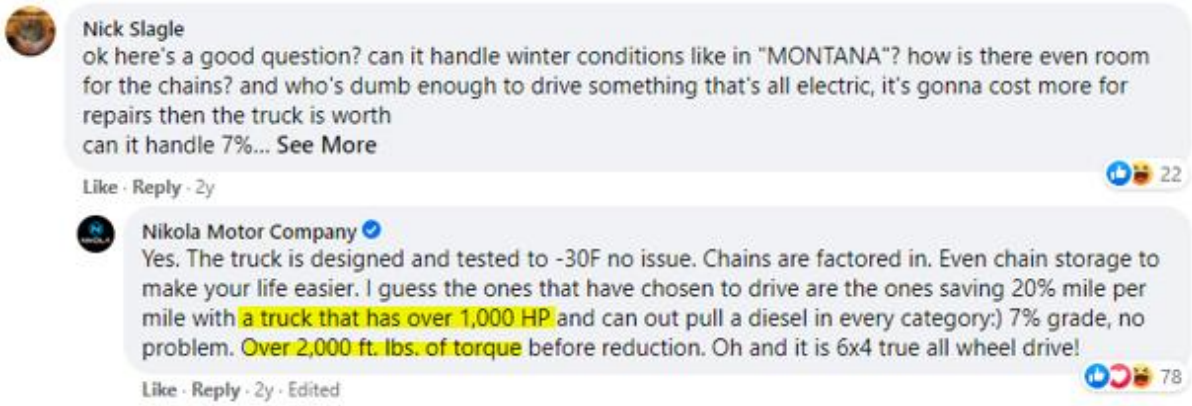
We disagree. Beyond common sense, the company referred to the Nikola One as " **the 1,000 H** , zero-emission Nikola One semi-truck" in the description of its video. Obviously, the truck can't have 1,000 horsepower or even 1 horsepower if it doesn't power itself.



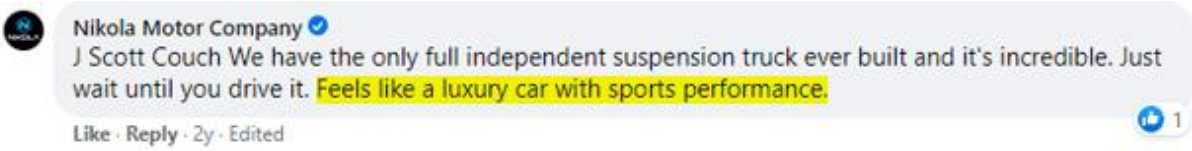

On January 25, 2018, Nikola posted the same video to its corporate Facebook page.

Underneath the video are a series of comments that were answered by Nikola's verified corporate Facebook account.

In response to inquiries about the video, the company confirmed the Nikola One had "over 1,000 HP" and "over 2,000 ft. lbs. of torque" and can handle a "7% grade, no problem". Readers would have likely interpreted this as an ability to climb *up* a 7% grade hill, not roll *down* a very steep hill.




The company also told one person: "…wait until you drive it. **eels like a luxury car with sports performance."**




Given the public statements Nikola was making at the time, we view the company's new admission that the Nikola One was not powered on its own in the video as a tacit admission of securities fraud.

## *Nikola Claims the Nikola One Semi Was Not A "Pusher" Because It Was Designed To Move Under Its Own Power Train. It Then Admits the Truck Didn't Ever Move Using Its Own Power Train.*

## *Reminder: Nikola and Trevor Referred to The Nikola One As "Fully Functional", "Fully Built", "A Real Truck" And "Not A Pusher" At Least 6 Times Between October 2016 and December 2016*

As we wrote, in December 2016, the company falsely claimed at Nikola World, on video, that the Nikola One "fully functions and works…this is a real truck—this is not a pusher." It later admitted that it was NOT fully functional to Bloomberg.

Nikola's response yesterday completely failed to address Trevor's false statements claiming that the truck "fully functions and works".

Instead, the heavily-lawyered language clumsily attempted to redefine the term "pusher", suggesting that because Nikola *hoped* its non-functional vehicle would work *someday*, that it therefore wasn't a pusher at the time.

We appreciate that Nikola's new law firm, Kirkland & Ellis, tried to do their best with what they had to work with. However, Trevor later helpfully defined the term "pusher" on video while emphatically denying that the truck fit his own definition:

> ***"This isn't just a pusher like a lot of vehicles that they unveil that are just vehicles that don't actually function. This is a fully functioning vehicle which is really incredible."***

With that definition in mind, we offer a reminder that Nikola and Trevor reassured investors that the Nikola One semi worked at least 6 times:

- Nikola called the truck "functioning" and "fully built" on Twitter on October 16, 2016.
- At the December 1, 2016 launch event, Trevor says: "This thing fully functions and works, which is really incredible."
- He also said "We will have a chain on the seats to prevent people from coming and just for the safety. I don't want someone to end up doing something and driving this truck off the stage."
- Later at the same event, he insisted 3 times that the truck was real, stating "know it's real", "you're going to see this is a real truck" and "this is not a pusher".
- Trevor again said, in a video dated December 2, 2016: "this isn't just a pusher" and "this is a fully functioning vehicle"

Given Nikola's admission that the truck seen in the video was not fully functioning, the above were all clearly statements that misled investors. In other words, these were outright lies.

## *Our Report: Former Employees Told Us No Further Work*

# *Continued On The Nikola One After 2016 Even Though The Company Was Still Publicly Claiming In 2018 That the Nikola One Would Soon be Ready*

Referring to the "Nikola One in Motion" video, a company tweet in June 2018 stated that "pre-production units (would) hit fleets in 2019 for testing" which was false. Former employees told us that no further work continued on the Nikola One after the 2016 demonstration.


Note that a former employee indicated to us that work on the Nikola One was abandoned immediately after the initial reveal, in December 2016.

Yesterday, Nikola stated that "it ultimately decided not to invest additional resources into completing the process to make the Nikola One drive on its own propulsion", seemingly validating our findings.

Nikola's decision to ultimately halt investment is not the issue; the company's failure to acknowledge that it had halted investment while telling investors work continued is the

problem, and represents another clear case of making knowingly misleading statements.

## *Our Report: Nikola And Trevor Hyped A Letter of Intent to Acquire Battery Technology Company ZapGo. The Tech Turned Out To Be Vaporware. After Nikola Realized This, They Continued To Hype It Anyway*

## *Nikola's Response: It Wasn't ZapGo We Were Hyping. The Game Changing Battery Tech is Part of a Secret R&D Agreement We Can't Provide Any Details On. Also, We Are Using GM's Battery Technology for Some Reason*

In our report, we pointed out that Nikola had introduced the Nikola battery "prototype cell" and called it "game changing battery technology" in November 2019. Trevor Milton also hyped it as technology that would make "diesel trucks obsolete for good" on Twitter on November 18, 2019.

The company originally called it "game-changing" and "the biggest advancement we have seen in the battery world." In Nikola's response from yesterday, however, the technology is now only described as "potential battery technology advancements".

Our report noted that the letter of intent with ZapGo was signed within 2 days of a tweet teasing the press release on the battery technology. The press release then *referenced* the Letter of Intent, stating:

> *"Nikola **entered into a letter of intent** to acquire a world-class battery engineering team."*

ZapGo was later accused by Nikola of fraud, false representations, and failure to disclose that its President had been indicted for tax fraud.

Nikola's own lawsuit indicated that it was made aware of these issues on December 5, 2019, and we noted that Trevor continued to hype the company's battery technology into February 2020.

Nikola formally terminated the agreement on February 26, 2020 and appears not to have

publicly discussed the situation since, until yesterday.

Now, Nikola has responded that Trevor's statements regarding the company's battery technology were related to "an ongoing confidential R&D partnership with a leading academic institution".

It goes without saying that funding academic research is not the same thing as acquiring a team of engineers, as the original "game changing" announcement indicated.

The newly referenced academic partnership appears to have been first talked about in August 2020 in this YouTube video, where Milton says about Nikola's battery technology: "It's tied to a university that had developed the technology. And we essentially ended up licensing all of it and helping them fund it all the way through."

We asked Nikola to ***provide dated agreements and documents*** that support that the supposed secret partnership had been ongoing *prior to* the company's mid-November 2019 press release.

We asked:

> *"Which university were you working with on the battery technology, how much did you fund them with, and exactly what have you developed in conjunction with them thus far? Will you post the agreement for all to see?"*

Instead we are met with more vague answers. The company's response provided no details about the confidential R&D relationship that supposedly involves advanced battery technology, and no indication of when it began.

## *Our Report: Trevor Claimed to Have Reduced the Cost of Hydrogen By 81% Relative To Peers And Was Producing 1,000 kg of Hydrogen Per Day At Nikola's Headquarters*

## *Nikola's Response Confirmed That None of this Happened: "Nikola Continues to Believe that its Planned Hydrogen Station Network… Will Provide Key Competitive Advantages."*

At Nikola World in December 2019 Trevor claimed on video that Nikola was producing 1,000 kilograms of hydrogen a day on site at his Phoenix headquarters:

> ***"In America we've already got the largest hydrogen station in the western hemisphere at our headquarters. Can produce over 1,000 kilograms a day on site."***

Subsequent to Nikola World, Trevor reiterated in several public interviews that he achieved significant breakthroughs in hydrogen production.

In an August 2020 interview with Fox Business News, when asked about the company's hydrogen, Trevor says:

> *"We saw an opportunity to bring the cost of hydrogen down going zero-emission and putting it on parity with diesel, and it's the first time in history that's been able to be done,* ***so it went from about 16 kg and we are down now below . kg***

In another interview on July 17, 2020, on the TeslaCharts podcast, Trevor claimed Nikola has been able to "chop the cost of hydrogen from $16/kg down to – we're down below $3/kg on our hydrogen now." [1] [11:34].

Trevor's claims followed a years-long pattern of hyping Nikola's non-existent hydrogen network, including this comment from 2018 in response to the Facebook video of its "Nikola One In Motion", publicly assuring readers that the company had 8 hydrogen stations "going up right now":


As acknowledged by the company's statement Monday, **it has no hydrogen network**, and simply hopes to have one in the future. This once again strikes us as a tacit admission of securities fraud.

## *Our Report: Trevor Milton Falsely Claimed In 2020 That Five Nikola Tre Trucks Were "Coming Off The Assembly Line Right Now"*

## *Bloomberg Corroborates: The Assembly Line Isn't Finished*

## *Nikola's Response Tacks A Year and A Half Onto Trevor's Publicly Disclosed "Right Now" Achievement, Saying It Doesn't Expect the Tre Until Q4 2021*

Our research highlighted statements made by Trevor in July 2020 that 5 Nikola Tre trucks were coming off an assembly line in Germany. We showed in our report that none of the trucks had been completed and that *the assembly line itself* had not been completed.

Bloomberg has since confirmed our work, writing :

> *"**Those statements were a mischaracterization of Nikola and Iveco's progress in Ulm**, according to two people familiar with the matter. **The assembly line is still under construction and not yet operational or building prototypes**, the people said. There are prototypes being built by hand in a workshop, one of the people said."*

On Friday, in response to our report, Trevor tweeted pictures of unfinished Nikola Tre trucks in a work area that is clearly not an assembly line.

In its response on Monday morning, Nikola stated:

> *"five trucks are currently being built and commissioned in Ulm, Germany, and are pre-production builds"*

This confirmed our original report, including comments quoted by a Bosch spokesman, indicating the trucks were still not completed and had not rolled off an assembly line in July. Nikola then stated that it expects the Tre to be "ready for production and available to customers by the fourth quarter of 2021."

We view this, once again, as an admission that Trevor's statement to investors in July was patently false. Not only were completed trucks not rolling off an assembly line, but an assembly line hadn't even been constructed. The trucks remain uncompleted.

## *Our Report: Nikola's Order Book Is Fluff, Including A ~$3.5 Billion Order From A Company With Only $1.3 Million In Cash*

## *Nikola's Response: We Have an Order From A Different Company, That We Hope To Begin Deliveries On In Three Years*

In our report we pointed out that the company's order book appeared to be filled with fluff, including non-committal orders and orders where potential customers like Anheuser Busch have multiple 'outs'.

We showed that U.S. Xpress reportedly accounts for a third of its reservations, representing ~$3.5 billion in orders, yet U.S. Xpress had only $1.3 million in cash on hand last quarter.

Monday morning, the company failed to address the issue and simply reiterated that it had an order from another company, Republic Services, that it hopes to begin deliveries on three years from now.

We view this as an admission that the company's order book was, in fact, filled with fluff.

## *Our Report: The Company's Unveiling of Its NZT Off-Road Vehicle Deceptively Presented a Mock-Up As if It Was Market-Ready. Following the "Unveiling" the Project Was Then Outsourced for Redesign.*

## *Nikola Responded By Re-Wording Our Statements Then Declaring The Reworded Statements to be False*

In our report, we described the 'unveiling' of the company's NZT off-road vehicle at Nikola World in 2019. At the event, Trevor described the product as a *fait accompli* of its design team, saying it "rivals some of the best automotive engineering in the world".

We reported that the model was actually not completed, and that weeks later, Nikola scrapped the design and quietly outsourced the redesign to a company called Stellar Strategy.

In response, Nikola ***reworded our statements*** regarding the company's NZT off-road vehicle in order to claim those pretend statements were false.

Nikola inaccurately stated that we claimed the NZT "***program"*** was scrapped after the Nikola World 2019 event. In fact, we clearly stated that the program continued, but that the ***design*** was outsourced to a third party called Stellar Strategy LLC.

## Our report:

Within weeks of the event, Nikola management scrapped the design for the NZT because the model was not manufacturable as visualized on stage, according to the former employee.

The company now faced "a massive redesign" before it could bring the NZT to market, they said.

Despite regularly claiming to develop almost everything in-house, Nikola quietly outsourced the NZT redesign to a small company called Stellar Strategy LLC. Stellar is staffed by former executives of Polaris, a well-known producer of off-road vehicles who had advised Nikola on the open cabin version.

## Nikola's Response:

- **Short Seller Alleges NZT Program Was Scrapped after Unveiling:** The program remains underway. The first NZT enclosed cab display model is sitting in Nikola's showroom at its headquarters. The Company has since spent millions of dollars preparing the NZT enclosed cab version for production using both internal and external resources. More to come at Nikola World 2020.

  *These allegations by the short seller are false and misleading, and designed to manipulate the market to profit from a manufactured decline in Nikola's stock price.*

Nikola failed to refute our point that it presented (yet again) a non-functional "mock-up" of the NZT at Nikola World. We believe this represents a tacit admission that it's NZT "reveal" was a farce.

The company also failed to mention Stellar Strategy in its rebuttal despite our specific question asking about the relationship, which we believe underscores its inability to design and innovate internally.

## *Our Report: Why Would Trevor Appoint His Brother As "Director of Hydrogen Production/Infrastructure" Given He Had No Apparent Experience in Hydrogen Technology?*

## *Nikola's Response: Travis Milton Ran A Construction Business*

In our report, we noted that Trevor Milton appointed his younger brother Travis to a position

that required scientific expertise. We asked:

> *"Why did you appoint your brother Travis as "Director of Hydrogen Production/Infrastructure"? What experience does he have in hydrogen research and production?"*

We further asked:

> *"What would you say are Travis' key contributions to Nikola's alleged breakthrough advancements in hydrogen production?"*

The company responded on Monday by claiming that Travis is qualified for this high-level scientific position because he previously worked in construction:

> *"Travis Milton previously owned and operated his own construction company preparing him for hydrogen station infrastructure and buildouts."*

When faced with the same question, in a since-deleted Instagram rant addressing the question (we have a copy), Trevor stated:

> *"Why do you give a shit? Go start your own company—hire your own employees!"*

Our questions to the company concerned Travis' contributions to Nikola's claimed hydrogen breakthroughs, and his experience with the significant technical and scientific challenges of hydrogen production, storage and delivery.  Those questions remain completely unanswered.

## *Our Report: Trevor Claimed On Video That Nikola's Inverters Were Developed In House And That OEMs Were Asking To Use Them. In The Same Video He Is Showcasing An Inverter Manufactured By Cascadia With Masking Tape Covering Its Label.*

## *Nikola's Response: Admits This is True, Then Deflects by*

## *Vaguely Stating That the Company Has Been "Working on Its Own Inverters For Quite Some Time"*

In our report, we pointed out that Trevor, on video, claimed that Nikola made its own inverters in-house, along with all the e-axle design and other key components.

In the same video, Trevor shows off an inverter that we discovered is actually manufactured by Cascadia, with a piece of masking tape on the label that concealed who really made it.

The company **once again admitted the claims in our report to be true**, and walked back its claims that these inverters were Nikola's proprietary intellectual property by vaguely stating that it is "working on" its own inverter:

> *"Nikola has been designing, engineering and working on its own inverters for quite some time."*

The company's CEO, Mark Russell, further walked back the company's claims to have vast proprietary technology when pressed by reporters from the Financial Times on Friday:

> *"Asked about Mr. Milton's claim to have all the 'core' technology for its vehicles, Mr. Russell* ***described the company as an 'integrator', stitching together the many elements of its vehicles from a complex supply chain.***

Russell's admission clearly corroborates our own findings, and directly contradicts Trevor's repeated claims of Nikola having vast proprietary intellectual property.

The company's response on Monday morning declared that "at no time did Nikola state that the inverter on the prototype truck shown in the video was the Company's." But of course it ignores the fact that there is video proof, narrated by Milton himself:

> *"We do all the e-axle design in house. All the gears, the gear reductions. The thermal the cooling. Even the controls that go with it.* ***And, also, the inverters as well. All inverters on the Nikola truck are probably some of the most advanced software systems that I know of anywhere in the automotive world. Why do I***

> ***know that It's because other EMs are asking us to use it."***

Why would OEMs be asking to use an inverter that hadn't even been developed? Furthermore, Trevor actually points to the supposed "in-house" inverter in question in the video:

Pictured: Trevor Milton's finger, while he narrates a "Behind the Scenes" video, pointing at a Cascadia Inverter with masking tape over its label, about 15 minutes before proclaiming Nikola makes all its own inverters.

Once again, the company admitted our findings were correct.

Now, rather than defending its previous false claims to have developed revolutionary proprietary technology for use in its vehicles and prototypes, Nikola now vaguely claims to be working on it.

## *Our Report Presented Evidence That Trevor Misled Potential Investors in a Predecessor Entity by Inflating a $16 Million Deal with Trucking Company Swift Into a $300 Million Deal.*

## *Nikola Claims the Deal Could Have Been $250 Million With Options.*

## *Swift Didn't Exercise Those Options And, Instead, Sued dHybrid Over Misrepresentations With its Original $16 Million Deal.*

In our report, we pointed out one of Trevor Milton's early business ventures, called dHybrid, closed on a $16 million contract with Swift Transportation before being sued by Swift over allegations of providing it with trucks that didn't work and of misappropriating capital for personal use.

Nikola writes off this portion of our report by inexplicably claiming that the agreement "has no connection with or association to Nikola." This ignores the fact that Trevor Milton was dHybrid's founder, as well as Nikola's founder, former CEO, major shareholder and current Executive Chairman.

Nikola also points out that that Swift Transportation had options to make future purchases from dHybrid for $250 million.

We showed a slide from an investor presentation claiming the contract to be $300 million, a clear inflation, by the company's own standard:


In reality, nowhere near $250 million changed hands, however. Swift sued dHybrid after an investment of about $2 million, alleging that the dHybrid trucks didn't work and that officers of dHybrid misappropriated capital for personal use.

# *Nikola Failed to Address 43 of Our 53 Questions*

## *Their Silence on These Questions Speak Volumes*

At the bottom of our original report, we offered Nikola 53 questions it could answer to clear the air for investors, the market and its stakeholders alike. Instead of answering them, Nikola only touched on 10 of them.

Despite claiming to have found "dozens" of inaccuracies with our report, Nikola's response essentially validated **all** of the issues we raised. Below are the questions Nikola did not even attempt to address:

1. Before suddenly pivoting to fuel cells, you claimed that your Compressed Natural Gas (CNG) technology was "10-15 years ahead of any other OEM in fuel efficiencies, MPG, and emissions". Why did you suddenly abandon this supposedly revolutionary technology rather than sell it for billions of dollars?

Nikola's response: **N NE**

2. You claimed that Nikola's headquarters has 3.5 MW of solar panels on the roof, yet later media reports and pictures of the roof show they don't exist. Where did they go?

Nikola's response: **N NE**

3. You claimed Nikola owned its own natural gas wells, then re-affirmed that you "still have them" when later asked what happened to them. Can you provide any documentation proving Nikola owns/owned natural gas wells?

Nikola's response: **N NE**

4. In 2018 you were sued by your former CFO. What were the allegations in the complaint, which is now sealed?

Nikola's response: **N NE**

5. What OEMs have asked to use "your" inverters in their products, as Trevor claimed on video?

Nikola's response: **N NE**

6. You appointed your brother Travis as "Director of Hydrogen Production/Infrastructure". What experience does he have in hydrogen research and production?"

Nikola's response: **N NE**

7. What would you say are Travis' key contributions to Nikola's alleged breakthrough advancements in hydrogen production?

Nikola's response: **N NE**

8. After the Bloomberg piece, you claimed on Twitter that there was a table with truck gears and components sitting in front of the audience for all to see. The event was extensively documented—can you present evidence that such a table existed in plain view for the entire audience?

Nikola's response: **N NE**

9. Do you think a table with gears sitting somewhere would in any way invalidate your claims at the time that the truck "fully functions" when it was later shown that it didn't?

Nikola's response: **N NE**

10. After lambasting Bloomberg's reporter publicly, calling him a "deceiver" and saying he should be fired, you then promised the full audio of the interview with Bloomberg would be released. Why haven't you released it yet?

Nikola's response: **N NE**

11. Do you think it's wise to threaten to sue journalists for getting a story totally correct?

Nikola's response: **N NE**

12. In August 2016, you claimed "**Nikola has engineered the holy grail of the trucking industry**", pivoting to hydrogen from natural gas. Now that you have acknowledged the Nikola One wasn't fully "engineered" at the time of the statement or the December show, do you wish to retract this press release in full?

Nikola's response: **N NE**

13. Did the Nikola One truck have hydrogen turbines or Brayton CNG turbines at the time of the demonstration in December? Was the fueling system hydrogen or CNG?

Nikola's response: **N NE**

14. Why did you say just two weeks before Nikola's sudden "pivot" to hydrogen that "CNG is the way to go" on Twitter if you were imminently planning to announce a switch?

Nikola's response: **N NE**

15. Did you have an artist come in and stencil "H2" and "Zero Emission Hydrogen Electric" on the side of the Nikola One despite the truck having natural gas components installed?

Nikola's response: **N NE**

16. Do you still consider the Nikola One to have been "fully functioning" despite needing to snake an electricity cord up through the stage in order to power the otherwise completely non-working vehicle?

Nikola's response: **N NE**

17. Which Nikola employees knew about the "plan" for the Nikola One in Motion video and which ones participated in creating it? Did those include Kevin Lynk, your Chief Engineer?

Nikola's response: **N NE**

18. At the time, did you think pre-production units of the Nikola One would just magically produce themselves?

Nikola's response: **N NE**

19. According to you, Nikola designs most things in-house. Did you outsource the redesign of the NZT to Stellar Strategy?

Nikola's response: **N NE**

20. In October 2019, you teased a major battery breakthrough 2 days before signing a letter of intent with ZapGo. You then announced that you had revolutionized the battery industry, before realizing that it was vaporware and ultimately suing the company. Why didn't you correct the press release or update your investors on the status of the deal, which had fallen apart?

Nikola's response: **N NE**

21. In December 2019, Jason Roycht, your VP of Technology Development, realized that ZapGo's President had been indicted for fraud. He raised alarms about the company's relationship with Porsche, which he determined was overstated. Why did you hype the battery tech in February on Twitter despite already knowing of all these issues?

Nikola's response: **N NE**

22. You formally terminated the agreement for the apparent "game changing battery technology" from ZapGo on February 26th, 2020. It is now 6 months later. Have you ever publicly acknowledged that this major deal fell apart?

Nikola's response: **N NE** (until yesterday, apparently.)

23. In August 2020 when specifically questioned about the deal by a Tesla fan, why didn't you take the opportunity to let people know that it had fallen through?

Nikola's response: **N NE**

24. You claimed in an interview to have succeeded at cutting the cost of hydrogen by ~81% from peers, stating "we're down below $3/kg on our hydrogen now". How much hydrogen has Nikola produced at this price, if any?

Nikola's response: **N NE**

25. At Nikola World 2019 you claimed on video to be producing 1,000 kg of hydrogen per day at your headquarters. When pressed by a reporter, you later admitted that you produce no hydrogen. Did you lie about producing hydrogen on camera to the entire audience at Nikola World?

Nikola's response: **N NE**

26. Why did you post a video saying the Nikola Two had gone from 0-60mph in under 5 seconds when anyone with a stopwatch can see that it took at least 10 seconds?

Nikola's response: **N NE**

27. Following the 0-60 video you promised to post a professional version of the video, saying it was just being edited. But you never did. Why? Does the Nikola Two have as much power as you've claimed it has?

Nikola's response: **N NE**

28. In the TeslaCharts podcast at the 40:20 minute mark you said regarding hydrogen stations: "we're gobbling up the best locations right now". Yet your latest quarterly report showed no real estate assets aside from your current headquarters. Where exactly are these locations that you have been "gobbling up"? How many have you purchased already?

Nikola's response: **N NE**

29. What is the hold up with your Coolidge facility construction? Have plans been submitted yet and permits been received? Why is there virtually no sign of progress ?

Nikola's response: **N NE**

30. Why do you spend so much time on social media fighting your "haters" and threatening former employees with litigation over NDA enforcement? Don't you have a factory to build and products to produce?

Nikola's response: **N NE**

31. Did you have your service personnel traverse the country to conceal potentially fatal defects with dHybrid's product to close the deal with Worthington, as alleged by one of your former employees on recorded audio?

Nikola's response: **N NE**

32. What was the rationale for Worthington's later impairment of dHybrid and the write-off of $1.5 million in warranty expenses ?

Nikola's response: **N NE**

33. In May 2015, you represented in a legally binding contract with EVdrive to have "new and valuable proprietary turbine technology". Months later, emails showed you were in discussions with Brayton to purchase their turbines. Did you have any "new and valuable turbine technology" at the time you represented having it?

Nikola's response: **N NE**

34. If so, what was it, and why did you then need to buy turbine technology from Brayton?

Nikola's response: **N NE**

35. When you sold your St. George Security & Alarms company in an $300,000 deal, your business partner, who said he had a 50/50 deal with you, only received ~$100,000, according to him. Did you get more than him despite having a 50/50 arrangement?

Nikola's response: **N NE**

36. The buyer of the alarm business said you misled him and that customer contracts and other deals fell through post-sale. What happened?

Nikola's response: **N NE**

37. How much did you make when you sold the alarm business a second time? How much of those proceeds did your apparent "50/50" business partner receive?

Nikola's response: **N NE**

38. You claimed that uPillar.com had 80 million monthly active users and that you had beat Amazon to the shopping cart, despite launching in 2009. A former employee called the 80 million number "absurd", and media articles at the time describe the page views far lower. What evidence can you show that you had that number of page views?

Nikola's response: **N NE**

39. Do you realize the internet shopping cart was invented 15 years earlier, in 1994?

Nikola's response: **N NE**

40. Swift filed a lawsuit against your company dHybrid in mid-2012, alleging, among other things, that you had used its investment for personal use. Can you produce bank records showing how you used dHybrid funds? Did you divert funds to uPillar.com?

Nikola's response: **N NE**

41. Did you claim to sPower that you had finished the dHybrid system and then misrepresent its results to them, as alleged in their lawsuit ?

Nikola's response: **N NE**

42. When you launched dHybrid Systems in 2012, why did you claim in marketing materials to have started the business in 2011?

Nikola's response: **N NE**

43. Have you ever deceived anyone?

Nikola's response: **N NE**

# *Conclusion: Nikola's Response Had Holes Big Enough to Roll a Truck Through. We Remain Short Shares of Nikola Corp*

## *Legal Disclaimer*

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# TAB 4

# Nikola: How to Parlay An Ocean of Lies Into a Partnership With the Largest Auto OEM in America

Published on September 10, 2020



*(NASDAQ:NKLA)*

- Today, we reveal why we believe Nikola is an intricate fraud built on dozens of lies over the course of its Founder and Executive Chairman Trevor Milton's career.
- We have gathered extensive evidence—including recorded phone calls, text messages, private emails and behind-the-scenes photographs—detailing dozens of false statements by Nikola Founder Trevor Milton. We have never seen this level of deception at a public company, especially of this size.
- Trevor has managed to parlay these false statements made over the course of a decade into a ~$20 billion public company. He has inked partnerships with some of the top auto companies in the world, all desperate to catch up to Tesla and to harness the EV wave.
- We examine how Nikola got its early start and show how Trevor misled partners into

signing agreements by falsely claiming to have extensive proprietary technology.

- We reveal how, in the face of growing skepticism over the functionality of its truck, Nikola staged a video called "Nikola One in Motion" which showed the semi-truck cruising on a road at a high rate of speed. Our investigation of the site and text messages from a former employee reveal that the video was an elaborate ruse—Nikola had the truck towed to the top of a hill on a remote stretch of road and simply filmed it rolling down the hill.
- In October 2019, Nikola announced it would revolutionize the battery industry. This was to be done through a pending acquisition, but the deal fell through when Nikola realized (a) the technology was vaporware and (b) the President of the battery company had been indicted months earlier over allegations that he conned NASA by using his expense account to procure numerous prostitutes.
- Nikola has never walked back claims relating to its battery technology. Instead, Trevor continued to publicly hype the technology even after becoming aware of the above issues. The revolutionary battery technology never existed – now, Nikola plans to use GM's battery technology instead.
- A spokesman for Volvo spin-off Powercell AB, a hydrogen fuel cell technology company that formerly partnered with Nikola, called Nikola's battery and hydrogen fuel cell claims "hot air".
- In addition to now using GM's battery technology, Nikola seeks to use the automaker's production and fuel cell capabilities. Nikola seems to be bringing nothing to the partnership but concept designs, their brand name and up to $700 million they will be paying GM for costs related to production.
- Inexpensive hydrogen is fundamental to the success of Nikola's business model. Trevor has claimed in a presentation to hundreds of people and in multiple interviews to have succeeded at cutting the cost of hydrogen by ~81% compared to peers and to *already be producing hydrogen* Nikola has not produced hydrogen at this price or at *any* price as he later admitted when pressed by media.
- Trevor has appointed his brother, Travis, as "Director of Hydrogen Production/Infrastructure" to oversee this critical part of the business. Travis's prior experience looks to have largely consisted of pouring concrete driveways and doing subcontractor work on home renovations in Hawaii.
- Claims of owning energy producing assets is not new for Nikola. Trevor claimed that Nikola's headquarters has 3.5 megawatts of solar panels on its roof producing energy. Aerial photos of the roof and later media reports show that the supposed panels don't exist.
- At one point Nikola claimed to own its own natural gas wells. There is no evidence in company filings to support this. The claims were eventually quietly removed from Nikola's website.
- Trevor claims Nikola designs all key components in house, but they appear to simply be buying or licensing them from third-parties. One example: we found that Nikola actually buys inverters from a company called Cascadia. In a video showing off its "in-house" inverters, Nikola concealed the Cascadia label with a piece of masking tape.
- In a July 2020 podcast, Trevor said of Nikola's "Tre" truck: "We have five of them coming off the assembly line right now in Ulm Germany." A spokesperson for Bosch, the

manufacturing partner building the trucks, confirmed this month that they haven't made any trucks yet.

- The company's Nikola One "reveal" was a total farce. We corroborate Bloomberg's earlier work debunking Trevor's claims regarding its semi-truck that "this thing fully functions and works…this is a real truck" and provide new evidence.
- We present behind-the-scenes photos showing that Nikola had an electricity cable snaked up from underneath the stage into the truck in order to falsely claim the Nikola One's electrical systems fully functioned.
- We learned through emails and interviews with former partners that Trevor had an artist stencil "H2" and "Zero Emission Hydrogen Electric" on the side of the Nikola One despite it having no hydrogen capabilities whatsoever; it was built with natural gas components.
- We also present evidence that subsequent "reveals" were fictitious. In 2019, Nikola revealed a "next generation" version of its off-road vehicle. We learned that it was scrapped within weeks of the unveiling due to manufacturing challenges. The redesign work was then quietly outsourced.
- Nikola's much-touted multi-billion dollar order book is filled with fluff. U.S. Xpress reportedly accounts for a third of its reservations, representing ~$3.5 billion in orders. U.S. Xpress had only $1.3 million in cash on hand last quarter.
- Nikola's key partners and backers have been cashing out aggressively. Worthington, Bosch and ValueAct have all sold shares. Worthington sold $237 million shares over a 2-day span in July and another $250 million in August. We think they know exactly what type of company Nikola is, and we expect that as Nikola's GM "partnership" boosts the stock price, key holders will continue to exit.
- We think Trevor Milton, through dozens of outright lies, was able to form partnerships with some of the largest legacy auto companies in the world in their desperation to catch up to Tesla's EV leadership status.
- Trevor has ensured he is not going down with the ship. He cashed out $70 million around the IPO and amended his share lock-up from 1-year to 180 days. If he is fired, his equity awards immediately vest and he is entitled to collect $20 million over two years. Milton has laid the groundwork to extract hundreds of millions from Nikola years before ever delivering on his promises.
- Every now and then a story comes around that exposes how little the "experts" really know. Theranos inked partnerships with Walgreens, Safeway, and Cleveland Clinic and staffed its board with luminaries. We think Nikola's partners did not do their homework.

*Initial Disclosure: After extensive research, we have taken a short position in shares of Nikola Corp. This report represents our opinion, and we encourage every reader to do their own due diligence. Please see our full disclaimer at the bottom of the report.*

# *Background: A Relentless Tesla Rally Pressured General Motors and Other Legacy*

# *Automakers to Catch Up*

The underlying narrative for the electric vehicle market in 2020 has undoubtedly been Tesla's relentless rally, which recently culminated in the company being valued with a market cap of over $400 billion at its peak—more than time-tested names like GM, Ford, Daimler and Fiat – *combined.*

Unlike Nikola, Tesla develops extensive proprietary technology, which cuts many traditional automakers and suppliers out of its picture. The astronomical rise in Tesla's valuation has pressured other auto companies, like General Motors, to unlock similar value from the ongoing EV wave. In August 2020, analysts from Deutsche Bank and Morgan Stanley pressed General Motors to spin off its electric vehicle business, stating that such a move dedicated to EV could be worth "up to $100 billion".

"Nothing is off the table," GM CEO Mary Barra said at the time, appeasing analysts and winning a price target boost from Morgan Stanley shortly thereafter.

# *Background: GM Temporarily Staves Off Pressure From Analysts And Stakeholders By Entering Into A Strategic Partnership with Nikola*

On the morning of September 8, 2020, Nikola announced a strategic manufacturing partnership with General Motors, sending shares of both companies sharply higher.

For many, the deal was viewed as long-awaited validation for Nikola, which to date has mainly presented little but prototypes, renderings and a heap of promises. After all, General Motors is one of the largest, multinational auto manufacturers on the planet and has been in business for over 100 years. It has reach into every major auto market, including the U.S., Europe and China.

Economically, GM gets $2 billion in stock (an 11% stake) in Nikola for non-cash contributions such as engineering and validating a truck for Nikola, $700 million in expense reimbursements, supply contracts and 80% of the EV credits, along with a host of 'outs'. GM can begin selling shares before a single truck rolls off the line. Essentially, it's a free call option in a "sexy" EV story for General Motors.

But why sign with Nikola at all? GM's CEO was asked on the day of the announcement what technology GM would get out of the deal. She couldn't name a single thing.

The real "value" for GM seems to be branding. We believe the legacy automaker simply seeks to latch General Motors' storied name onto Nikola's charismatic Founder and Executive Chairman, Trevor Milton. Trevor is perceived by many as a forward-thinking, fresh, visionary entrepreneur capable of rivaling Elon Musk's allure.

But in GM's attempt to keep up with Elon Musk, who did they just get into bed with?

# *Introduction: Who is Trevor Milton?*

"I never deceived anyone!"—Nikola Executive Chairman Trevor Milton

What is the difference between a visionary selling a daring view of the future and a con artist?

Tech founders are often accused of being overly rosy with their projections. Supporters credit such founders as having bold, forward-thinking plans while detractors accuse them of knowingly selling unrealistic promises.

While such debates among optimists and pessimists are common, most everyone can agree that there is a difference between being overly optimistic about the future and outright lying.

Credibility is important for any management team, but this is especially true of a company like Nikola that has virtually no revenue and no shippable product. Given Nikola's market cap as of this writing, the company is a ~$20 billion promise of what it can achieve in the future.

And Trevor Milton is as "key man" as it gets. Per Nikola's filings:

> *"Mr. Milton is the source of many, if not most, of the ideas and execution driving Nikola" [Pg. 45].*

In Trevor's post-Q2 CNBC interview, he said he let Nikola's CEO and CFO handle the earnings call because he " *wanted them to feel like they have a voice in the company*" (Aug 5th CNBC, 3:34)

What follows is a deep dive on the origins of Nikola Corp. and its founder Trevor Milton.

What we found is that, for over a decade, instead of developing his own capabilities, Trevor has established an undeniable track record of taking from others and claiming technology as his own. He has quietly used off-the-shelf products from third-parties while loudly claiming to have vast proprietary technology.

Trevor would then leverage what he had and repeatedly mislead customers, partners, and investors in order to build his credibility and take his concept to the next level.

This pattern of behavior continues to this day, now with billions of dollars on the line and with Nikola tied to some of the largest auto companies in the world.

Our work for this report involved speaking with multiple whistleblowers, business partners, and former employees as well as reviewing extensive internal documentation from Trevor's ventures leading up to Nikola, including emails, text messages, recorded conversations and behind-the-scenes photographs.

Based on our findings, we believe Nikola is an intricate fraud built on dozens of lies over the course of its founder Trevor Milton's career, which he has parlayed into a $20 billion cloud of smoke and partnerships with some of the top auto companies in the world.

# *Part I: Trevor Milton's Career Path Leading Up to Nikola*

## *November 2009: Trevor Milton Launches dHybrid, Inc. with a Partner, Kicking off his EV Trucking Journey. It Ended in Litigation With Allegations of Misappropriation and False Promises*

After dropping out of college , Trevor Milton started an alarm sales company in Utah called St. George Security and Alarm. He eventually exited the business for $300,000. Our interview with its buyer indicated that Trevor overpromised, resulting in a total loss for the initial acquirer. We also interviewed Trevor's "50/50" business partner who indicated he was led to believe the exit was much smaller, saying he ultimately received only $100,000 for his "50%".

Following the alarm business exit, Trevor launched an online classified ads website that sold used cars, called uPillar.com, which eventually failed. (For more on both of these early businesses, see the Appendix at the end of this report.)

Following those two early pursuits, Trevor's initial foray into alternative energy vehicles was a company called dHybrid, Inc. Trevor joined forces with an engineer named Mike Shrout who had developed compressed natural gas (CNG) conversion technology for diesel engines. Shrout was to bring the technical expertise to the venture while Trevor would bring his business experience.

## *It Got Off to a Good Start: dHybrid Entered into Agreement with Major Trucking Company Swift to Convert Up to 800 Trucks, a Contract Valued at $16 Million*

Shortly after launching dHybrid, Trevor contacted Jerry Moyes, CEO of Swift Transportation to market dHybrid's conversion technology, according to a source familiar with the company. The team demonstrated the technology on a converted pickup truck to Moyes at Swift's Phoenix facility.

Moyes was apparently impressed with the demo and Swift eventually signed a development agreement, paying $2 million for a 9% stake in dHybrid, as well as extending a $322,000 loan to the company. The agreement, which we located through litigation records, called for the conversion of an initial 10 trucks for testing with a commitment to convert 800 trucks thereafter.

## *Swift Later Sued, Alleging the Company Delivered Only 5 Trucks That Didn't Work and That dHybrid's Officers Misappropriated Capital for Personal Use*

The deal immediately hit roadblocks, as dHybrid failed to deliver on its agreement. Swift filed a lawsuit in mid-2012. A subsequent amended complaint alleged that only 5 trucks had been delivered instead of the promised 10, that the performance of the trucks didn't to live up to the

initial promises, and that capital had been misappropriated by dHybrid's officers.

**DHYBRID BREACHES THE FUEL AGREEMENT**

16. After the parties executed the Fuel Agreement, dHybrid failed to meet its obligations under the Agreement.

17. Pursuant to Section 4 of the Fuel Agreement, dHybrid was to install ten dHybrid Systems for testing on Swift's vehicles.

18. Contrary to the express terms of the Fuel Agreement, dHybrid provided and installed only five dHybrid Systems for testing on Swift's vehicles.

19. After dHybrid provided and installed the five dHybrid Systems on Swift's vehicles, Swift operated said vehicles for ninety (90) days as a testing period.

20. During the testing period, Swift experienced engine issues with the dHybrid Systems and discovered that the dHybrid Systems did not in fact possess the technical efficiencies or capabilities as represented by dHybrid.

21. Further, despite representing that it would apply the Advance Payment towards "research, installation, and development of the Technology," upon information or belief, dHybrid did not use all of the $2,000,000.00 Advance Payment for "research, installation, and development of the Technology."

22. Upon information and belief, dHybrid applied portions of the $2,000,000.00 Advance Payment for its and/or its officers' or directors' personal use and/or other purposes unrelated to the Technology, the dHybrid Systems, or the Fuel Agreement.

## *In the Lead-Up to the Lawsuit, Trevor Reached out to New Investors Claiming the Swift Contract Was Worth $250-$300 Million*

## *Reality: We Have the Contract. It Was Only $16 Million*

As dHybrid's $2 million in startup capital was running out, Trevor reached out to new investors, making bold claims about the size of the Swift contract and how well the technology was performing.

This includes an email to Anthony Burns, the former CEO of Ryder Systems, shown below. In the email, Trevor makes several claims that appear to be outright fabrications, based on litigation records and conversations with a former business partner:

1. "So far we are saving Swift 38% on their fuel bill." At the time, the Swift data showed savings of no higher than 24%.
2. "We have logged over half a million miles of data pulling 80,000 pound loads." These numbers were apparently similarly inflated.
3. **We have signed a 2 0 million dollar plus contract with Swift"** The contract was **only for 16 million**, as per Swift's lawsuit, and as corroborated by our source familiar with the agreement.

**From:** "Trevor Milton" <trevor@dhybrid.com>
**To:** [redacted]
**Cc:** [redacted]
**Sent:** Thu, Dec 8, 2011 at 22:23
**Subject:** dhybrid - [redacted]

Anthony,

[redacted] is a great friend of mine and is helping me out on this project. dhybrid is a company that takes existing diesel engines, or new diesel engines, and turns them into hybrid vehicles running on CNG (Natural Gas) and diesel at the same time. Our technology swaps about 70% of the diesel which is $4.00 per gallon and replaces it with CNG which is $1.27-$2.00 per gallon. Run out of CNG, no problem, the system reverts from burning both fuels at the same time, back to stock pure diesel only until you fill up with CNG again so the blend can continue.

We have signed a $250 Million dollar plus contract with Swift transportation to outfit their fleet with our product. So far, we are saving Swift 38% on their fuel bill! Thats about a year and half ROI for any application. Those are their numbers! We have logged over a half a million miles of data pulling 80,000 pound loads. Our system is able to completely control the trucks timing, injection, turbo, etc to ensure a perfect burn and meet emission standards.

When replacing that much diesel with clean natural gas, your emissions dramatically drop. We have exemptions from both EPA and ARB for our testing and are in the process of full certifications with both government entities.

There are two areas where you could really help us out.

1- Introducing us to Ryder Systems or possibly Caterpillar.. I would love to take a group of Ryder vehicles and turn them into hybrids for a pilot program. Run them, and let Ryder analyze the savings and emissions. Then, convert all of Ryder's fleet in the long run. Caterpillar has worked with Clean Air Power

In another dHybrid investor presentation we reviewed, one slide cites the Swift contract as being $300 million, triggered when EPA certification is achieved:


But once again, per the Swift lawsuit, we see clearly that the contract value was only $16 million. [Pg. 10]

**AGREEMENT**

1. Purchase Price; Advance Payment. The above recitals are hereby incorporated by reference. Subject to the terms and conditions set forth in this Agreement, Seller agrees to sell and Buyer agrees to purchase and install, the dHybrid System on Eight Hundred (800) of Buyer's diesel-powered vehicles at a price of Twenty Thousand and No/100 Dollars ($20,000.00) per vehicle for a total price of Sixteen Million and No/100 Dollars ($16,000,000.00) (the "Purchase Price"). Each truck shall be outfitted with up to one hundred (100) Gas Gallon Equivalent CNG storage per vehicle. Immediately upon execution of this Agreement by the Parties hereto, Buyer shall pay to Seller a non-refundable payment of Two Million and No/100 Dollars ($2,000,000.00), in commercially available funds (the "Advance Payment"). The Advance Payment shall be applied toward the Purchase Price. Buyer acknowledges that the Advance Payment shall be used for research, installation, and development of the Technology, third party agreements and deposits, and is therefore non-refundable. The remaining amount of the Purchase Price shall be paid by Buyer as specified in Section 6 below. In the event that Seller offers dHybrid Systems for sale to any other person or entity during the term of this Agreement for a price lower than the Purchase Price, then the Purchase Price as defined herein shall automatically be amended to equal that lower price for purchases by Buyer hereunder.

## *Following the Swift Litigation, dHybrid Sought a Buyout But the Deal Ended in More Litigation, With the Buyer Alleging dHybrid Made Numerous Misrepresentations About its Capabilities*

In dire financial straits, Trevor sought to negotiate a buyout with a company called Sustainable

Power Group LLC ("sPower") based in Salt Lake City, Utah.

The parties entered into negotiations and signed a term sheet in May 2012, but only one month later in June, sPower exercised the termination clause and backed out of the agreement **citing significant misrepresentations during their due diligence process.**

Shortly after, when dHybrid disputed sPower's findings, sPower filed a lawsuit alleging:

1. **dHybrid had not, as represented, completed development of the dHybrid System.**

- dHybrid had not begun the EPA certification process as dHybrid had claimed.
- **dHybrid had been mispresenting results obtained from the five Swift diesel semi-trucks that were using the dHybrid System.** Specifically, sPower discovered that dHybrid materially misrepresented the fuel-blend ratios achieved by these diesel trucks.
- **dHybrid had falsely represented the fuel-cost savings** achieved by Swift as a result of using the dHybrid System.
- dHybrid was often having trouble interpreting data it received from Swift's drivers. Rather than seek clarification or perform more detailed test runs with the dHybrid Systems, dHybrid elected to fill in the gaps in the data with assumptions it created.

# *2012: Trevor Pitched Investors on His Team, Including an Experienced CTO—But the Named Individual Was Never dHybrid's CTO*

In the Spring of 2012, with dHybrid under pressure to raise additional capital, Trevor prepared a presentation for the Park City Angels, a venture capital group in Salt Lake City. In that presentation, Trevor falsely claimed that the company had an experienced Chief Technology Officer.

The presentation, which we reviewed, contains a slide listing dHybrid's management team. The CTO is the only individual in the group identified by his initials: "S.S." rather than his full name.

The CTO's employment and educational background, however, including a MS degree from the University of Michigan and work experience at General Motors and Parker Hannifin, matched

that of dHybrid contractor Steve Scott .

# Management Team

- Trevor Milton – Founder & CEO
  - Successful serial entrepreneur. Founded and sold SGS Alarms. Founded classified site upillar.com.
- William Milton – Vice President of Operations
  - Operations Manager at Union Pacific Railroad and industrial development in Las Vegas. BS degrees in accounting and psychology from Brigham Young University
- Tony Allen – Chief Legal Counsel
  - Former in-house Legal Counsel for ProPay, Inc., one of the largest merchant processors in the country. BS degree from Brigham Young University and JD/MBA degrees from University of California/Berkley
- S.S. – Chief Technology Officer
  - Attained twelve years of automotive systems engineering and product development experience at General Motors, Mercury Marine and Parker Hannifin. BS and MS from Univ. of Michigan
- Timothy Hunt – Implementation Consultant
  - CEO of Go Natural CNG managing entry into Class 8 trucking market

dHybrid ENERGY UNCOVERED

4/13/2012 Management Team 14

An individual familiar with dHybrid's operations said that Scott never held the position of CTO. He had only worked on various proof-of-concept projects for dHybrid as an outside consultant.

## *2012: With dHybrid Mired in Litigation, Trevor Started a New Company With his Dad, Choosing a Very Similar Name, dHybrid Systems*

## *Trevor Then Falsely Claimed to Prospective Partners That 'dHybrid' Had Been in*

# *Operation for Years*

With dHybrid mired in litigation and a suspended state of existence, Trevor and his father Bill Milton launched dHybrid Systems, LLC in October 2012. The new company quickly resumed its focus on CNG fueling systems except Trevor and his father now owned the entity, leaving Trevor's former partners with nothing.

With the similar name of dHybrid Systems, Trevor was able to suggest to prospective clients, partners and investors that the new company was a continuation of dHybrid and its years of experience and achievements.

We reviewed an example of such marketing materials that falsely suggested dHybrid *Systems* began in 2011, when in fact the entity had been formed in October 2012.

**THE DHYBRID DIFFERENCE**

dHybrid started out building hybrid technologies for heavy duty vehicles and entered the natural gas fuel system market in 2011. After being asked by dealers from all across the country to offer an alternative to the existing fuel system providers, dHybrid took the step and began engineering the most advanced fuel system on the market with technology never before seen in the heavy duty natural gas industry.

d·HYBRID SYSTEMS

Here are the incorporation records for comparison:

Date: 10/30/2012
Receipt Number: 4084696
Amount Paid: $145.00

EXPEDITE

RECEIVED
OCT 30 2012
Utah Div. of Corp. & Comm. Code

**ARTICLES OF ORGANIZATION**

**OF**

**dHybrid Systems, LLC**

The undersigned, acting pursuant to the Utah Limited Liability Company Act (the "Act"), adopts the following Articles of Organization for the purpose of organizing a Utah limited liability company (the "Company").

1. **Name** The Company's name is **dHybrid Systems, LLC**.

2. **Term.** The Company will continue until dissolved by law or as provided in the Company's operating agreement.

3. **Purpose**. The Company's purposes are (a) to develop, install, market, sell, dedicated compressed natural gas and liquefied natural gas fuel systems ; and (b) to engage in any other lawful activity for which a limited liability company may be organized under the Act. The Company may take any action incidental and conducive to the furtherance of those purposes.

## *2014: dHybridSystems Was Then Acquired by Worthington—A Successful Exit… For Trevor*

## *We Learned from a Former Employee (In a Recorded Call) That dHybrid Concealed Potentially Fatal Product Issues from Worthington In Order to Get the Deal Done*

By 2014, Trevor had found a buyer for his new company, industrial manufacturing heavyweight Worthington Industries (NYSE:WOR). Worthington paid $15.9 million for a 79.59% stake in the entity, valuing the entire company at $19.9 million. [ Pg. 15]

On October 20, 2014, we acquired a 79.59% ownership interest in dHybrid Systems, LLC ("dHybrid"), a leader in compressed natural gas ("CNG") systems for large trucks. The remaining 20.41% was retained by a founding member. The total purchase price was $15.9 million, which includes contingent consideration with an estimated fair value of $4.0 million. The acquired business became part of our Pressure Cylinders operating segment upon closing.

In recent interviews, Trevor has overstated the exit value. In a 2019 interview with Trucks.com, for example, he claimed that his $15.9 million exit was for "much more than $20 million".

TRUCKS.com Search

*Some of your suppliers have invested, and you personally invested funds from the reported $20 million sale of dHybrid Systems, your previous company, in Nikola. Who else is in?*

It sold for much more than $20 million, and the buyer, Worthington Industries, is a very large shareholder in our company. But most investors have asked us not to identify them. There are lot of complications, where companies don't want competitors to know they are invested, or financial institutions want to keep it quiet.

Getting back to the deal at the time, it appears Trevor overpromised on the capabilities of the technology and its effectiveness in the field.

In recorded conversations, former employees of dHybrid Systems admitted to traversing the country in a mad dash to patch up dHybrid's broken systems as best possible, concealing the issues from Worthington so that the deal could close. Per the conversation [ click for audio ]:

- "I helped design and develop and **fix all these repairs that Worthington didn't know about**. But I was in the field **making repairs so that they wouldn't find out about it."**
- "These back-of-cab units were actually falling off of the trash trucks, like, breaking off. They were shearing the damn frickin' frames and then coming off, like nearly friggin' causing deaths."
- "**I was the guy in the field making sure Worthington didn't find out. If they had found out that would have ruined the deal**."

The company in question was Waste Pro. Here is a picture of one of its trucks converted for CNG from dHybrid.


# *Using Worthington's Credibility, Trevor Then Apparently Made False Claims About Nikola's "Proprietary" Technology in Order to Induce Partners to Work with Him*

According to former employees of EVDrive, they signed with Trevor based not only on his supposed leadership role at Worthington but also on a belief that Nikola (named Bluegentech at the time) had advanced proprietary turbine technology that would make for a good fit with their own technology.

Trevor represented that he had proprietary turbine technology in a contract signed with EVDrive in May 2015, which we've procured a copy of:

## DEVELOPMENT AGREEMENT

This DEVELOPMENT AGREEMENT (this "*Agreement*") is made and entered into effective as of the **5th day of May, 2015** (the "*Effective Date*"), by and between Bluegentech, LLC, a Utah limited liability company ("*Bluegentech*"), and EVDrive Inc., a Wyoming corporation ("*EVDrive*").

## RECITALS

WHEREAS, Bluegentech intends to integrate a new and valuable proprietary turbine technology ("*Bluegentech Turbine*") into a turbine powered electric semi-truck that is all-wheel drive;

The agreement reiterated that the turbine was "Bluegentech's proprietary turbine system".

## SCHEDULE A

## DEFINITIONS

1. "*Affiliate*" or "*Affiliates*" of a Person means any other Person that directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with, such Person. The term "control" (including the terms "controlled by" and "under common control with") means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a Person, whether through the ownership of voting securities, by contract or otherwise.

2. "*Agreement*" means this Development Agreement and all schedules attached hereto or documents expressly incorporated into this Development Agreement by reference.

3. "*Bluegentech*" menas Bluegentech, LLC, a Utah limited liability company.

4. "*Bluegentech Turbine*" means Bluegentech's proprietary turbine system including Bluegentech's Property, including any related technologies or products jointly developed by the Parties pursuant to this Agreement to be used with the Bluegentech Turbine.

**But that appears to have been false as well**Two months after Bluegentech represented to

EVDrive that it owned proprietary turbine technology, Trevor's entity was in negotiations with another company called Brayton Energy to purchase their turbines. Once again, we have the email record to prove this.

The turbine purchases were stated to be on behalf of Worthington, which Trevor was working with at the time:

On Jul 24, 2015 2:05 PM, [redacted]@braytonenergy.com> wrote:
>
> [redacted]
>
> Here is our preliminary schedule of the turbine engine range extender design, build, lab qualification test at Brayton, and delivery to Worthington.
>
> The critical path item on testing is the new high speed alternator. The effort is already underway with E+A, we can certainly work with them to see if they can expedite the project.
>
> We are projecting that we will need the battery and rectifier by 2/1 for the lab qualification testing at Brayton.

Does this correspond with your delivery schedule?
>
> Most of our other subassemblies will be ready before the end of the year which will allow for us to begin building the test rig up.
>
> We anticipate there will be ~ 2 months of testing in the lab for commissioning, debugging, and system tuning.

Then a few weeks of performance testing, finally shipping to Worthington at the end of April for installation in the truck assembly.
>
> Let me know you thoughts, we can focus resources on the longer lead items to expedite the whole program.

Do you have a Gantt chart you could send us?
>
> [redacted]
>
> Mechanical Engineer
>
>
> 75B Lafayette Road
>
> Hampton, NH 03842

Trevor leveraged his Worthington role, in addition to claims of having proprietary technology to draw in partners that could collectively help piece together parts needed for Nikola's first EV truck.

As we will show later, the claims of having "proprietary" technology that is actually someone else's product appear to be an ongoing phenomenon with Trevor to this very day.

# *December 2015: Worthington Promptly Wrote Down the Value of dHybrid Assets*

About a year after the deal, Worthington identified problems with the dHybrid Systems acquisition and recorded a $2.3 million impairment related to the acquisition in Q4 2015. [Pg. 53] The company further recorded a $1.5 million warranty-related expense relating to dHybrid in 2016. [Pg. 3]

As we detail in the Appendix to this report, Worthington had a deep relationship with Nikola, which it now appears to be attempting to downplay and distance itself from. At one point, Nikola was a subsidiary of Worthington and the close relationship gave Trevor enough credibility to cobble together several early partnerships.

# *Part II: Nikola*

## *2016: After Cobbling Together Truck Parts with Deceptively Constructed Partnership Agreements, Nikola Announced it Would Revolutionize Transportation*

Bluegentech then became Nikola, and Trevor continued to line up supplier deals in an attempt to get the pieces together to assemble the company's first truck with third-party parts.

According to former employees and partners working on the Nikola One, the company's first proposed semi-truck, progress was slow. Nevertheless on May 9th 2016, Nikola came out of 'stealth mode', announcing that it had developed a product that would revolutionize the field of transportation.


The press release vowed to unveil the Nikola One in December, committing the company to an aggressive deadline.

## *December 2016: The Big Nikola One Reveal —"This Truck is By Far the Most State of The Art Truck Ever Built in History… This Thing*

# *Fully Functions and Works… This is a Real Truck—This is Not a Pusher"*

# *Reality: It Was Not A Real Truck And Was, In Fact, A Pusher*

By the end of the year, Nikola was poised to reveal its revolutionary new truck, the Nikola One. In the months leading up to the presentation, a user asked Nikola whether the truck would be a "design unveiling or a functional prototype". Nikola confirmed that it would be a "functioning" and "fully built truck at event".


At multiple points during a video recording of Trevor's presentation at the launch event on December 1, 2016, Trevor can be heard making it crystal clear that the Nikola One was a fully functioning truck:

At the 17:30 mark:

> *"You'll see it up on the screens–they're fully functioning screens. Really incredible. We will have a chain on the seats to prevent people from coming in just for the safety.* ***I don't want someone to end up doing something and driving this truck off the stage****…so we're going to try to keep people from driving off.* ***But this thing fully functions and works, which is really incredible****"*

Trevor then closed the presentation by insisting 3 times that the truck was real, at the 39:00 mark:

> *"* ***or every doubter out there that said there's no way this is true. How can that be possible We've done it****It's my pleasure to actually let you guys enjoy the night, see the truck,* ***know it's real****, touch it, feel how sturdy it is.* ***ou're going to see that this is a real truck. This is not a pusher****Thank you so much everyone!"*

For anyone unsure what a "pusher" is, Trevor actually clarified in another video at the event and *again* reiterated that the truck was fully functioning and complete in response to an interviewer's question:

> *Q: "So how long have you been working on this because this is a fully functioning truck right?*

> *Trevor: "Yeah"*

> *Q: "So how long have you guys been working on this?*

> *Trevor: "Years in secrecy. It's been very hard. Some of the people found out about us over the last 4 or 5 months as we announced in the lead-up to this big event, but it took years and years to get here.* ***This isn't just a pusher like a lot of vehicles that they unveil that are just vehicles that don't actually function. This is a fully functional vehicle which is really incredible ou can go through. We can***

> ***change out whatever they want, all the temperatures. I mean this is a fully functioning vehicle it's not just a pusher. That's what they call it in the automotive world they just push and it doesn't move."***

It turns out it was a pusher.

## *Bloomberg Later Identified That the Truck Was NOT Completed.*

## *Trevor Responded by Admitting This, Then Claimed He NEVER Said it Was Completed (Despite Video Clearly Contradicting Him).*

## *He Then Threatened to Sue Bloomberg*

In June of this year, Bloomberg published a piece highlighting that, contrary to Trevor's claims, the truck was not complete and was missing components.

**Bloomberg**

Hyperdrive

**Nikola Founder Exaggerated the Capability of His Debut Truck**

By Edward Ludlow
June 17, 2020, 3:29 PM EDT
*Updated on June 17, 2020, 3:38 PM EDT*

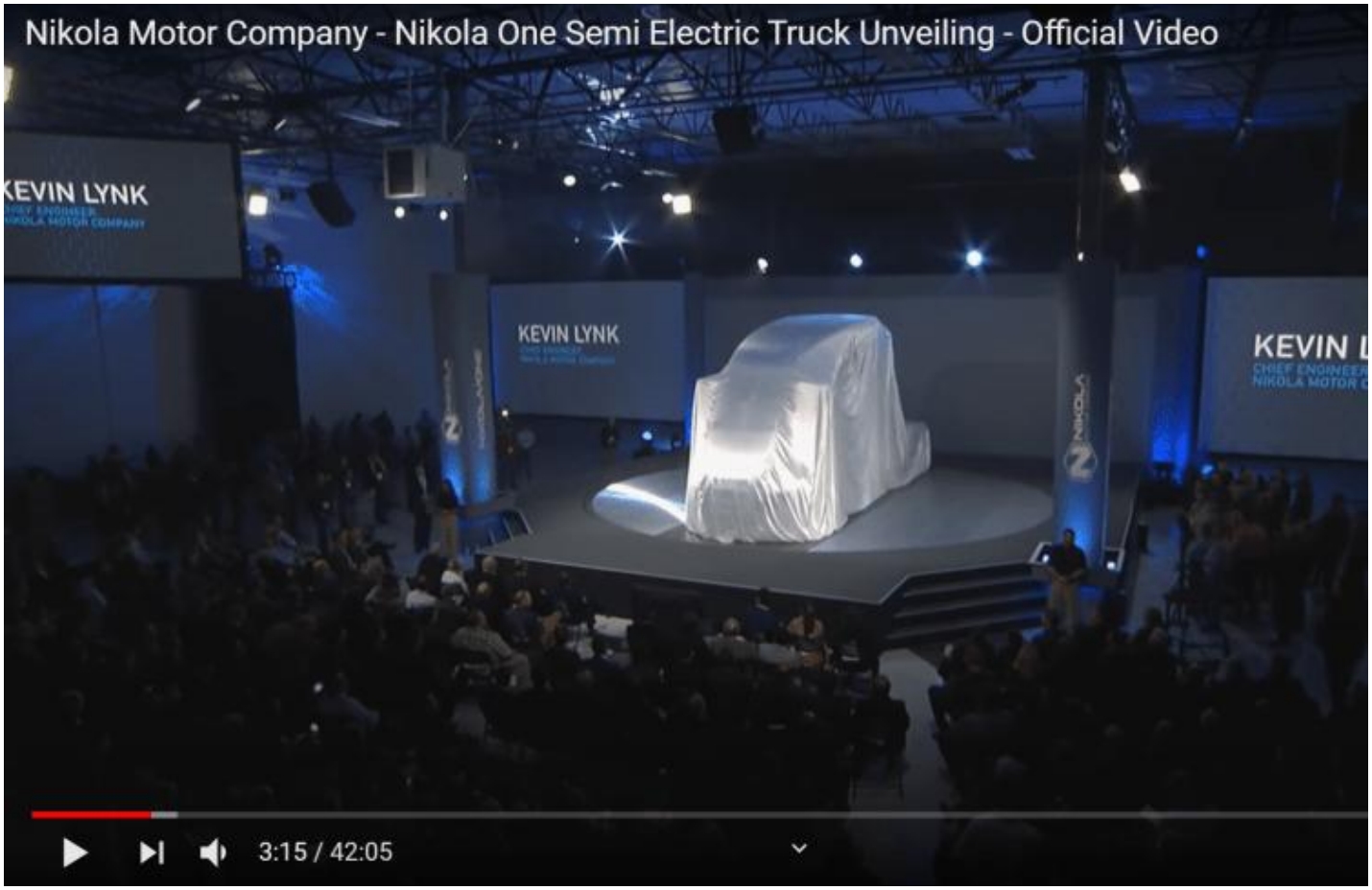
- The Nikola One revealed in 2016 was inoperable, missing parts
- 'I never deceived anyone,' Trevor Milton says in an interview

In response, Trevor blasted the reporter on Twitter and immediately vowed to sue, claiming that everyone knew the truck wasn't operable and that the parts were sitting right on the table in front of the audience the whole time:


It was a bold retort. But it was completely invalidated by Trevor's own words – **multiple times** – including on video at the event and in Tweets leading up to it.

In the video of the event , we saw no such table with truck gears and components clearly visible to all. Instead, the seating went right up to the stage except for a small table with a computer monitor up front:

[Click here to see video of Trevor's repeated false statements ]

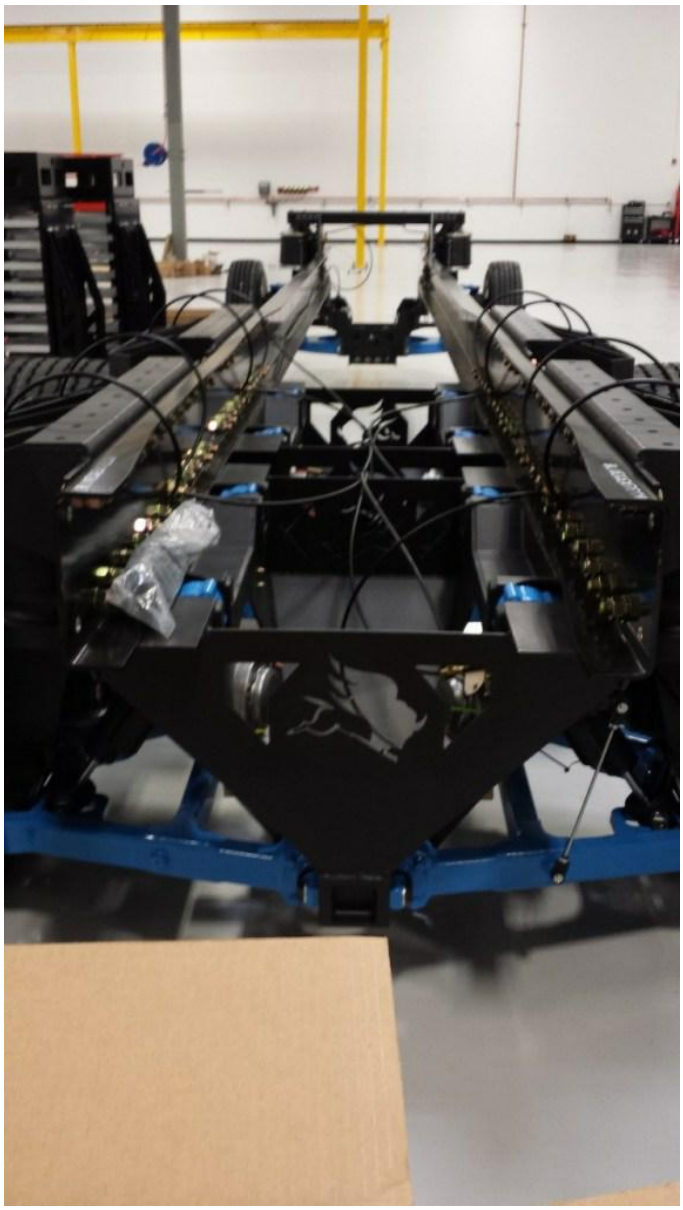



In either case—if there was a table with gears (somewhere), we fail to see how that in any way corrects Trevor's repeated false claims during the presentation that the truck was fully functional.

## *Bloomberg Was Right. The Reveal Was a Farce. More Evidence Corroborates the Bloomberg Piece and Furthers Their Allegations*

We have behind-the-scenes photos and other evidence showing just how incomplete the Nikola One was at the time of the 2016 reveal.

In late August, just 3 months before the show, Nikola's "truck" consisted largely of frame rails with wheels mounted to its Meritor suspension.



(Source: Individual who worked on the Nikola One "Truck" in Late August 2016)

Other components had not yet arrived, including the e-axles, the turbine, the natural gas fueling system, and the body — according to a source who worked on the job. The factory was not even set up for production. Workers were running to the hardware store to pick up basic parts, according to the source.

# *August 2016 (4 Months Before the Show): Nikola Claimed to Have Engineered "The Holy Grail" Of Hydrogen Technology For Trucking, Despite No Apparent Evidence it Had Even Begun Development*

Amidst all this, the company abandoned its supposedly revolutionary compressed natural gas (CNG) technology with no explanation. At the beginning of August, Nikola abruptly announced that it had pivoted from a (CNG) turbine range extender to a hydrogen fuel cell range extender.

The press release claimed that the technology had *already* been engineered successfully.


The press release boasted that this achievement was the *holy grail of trucking*

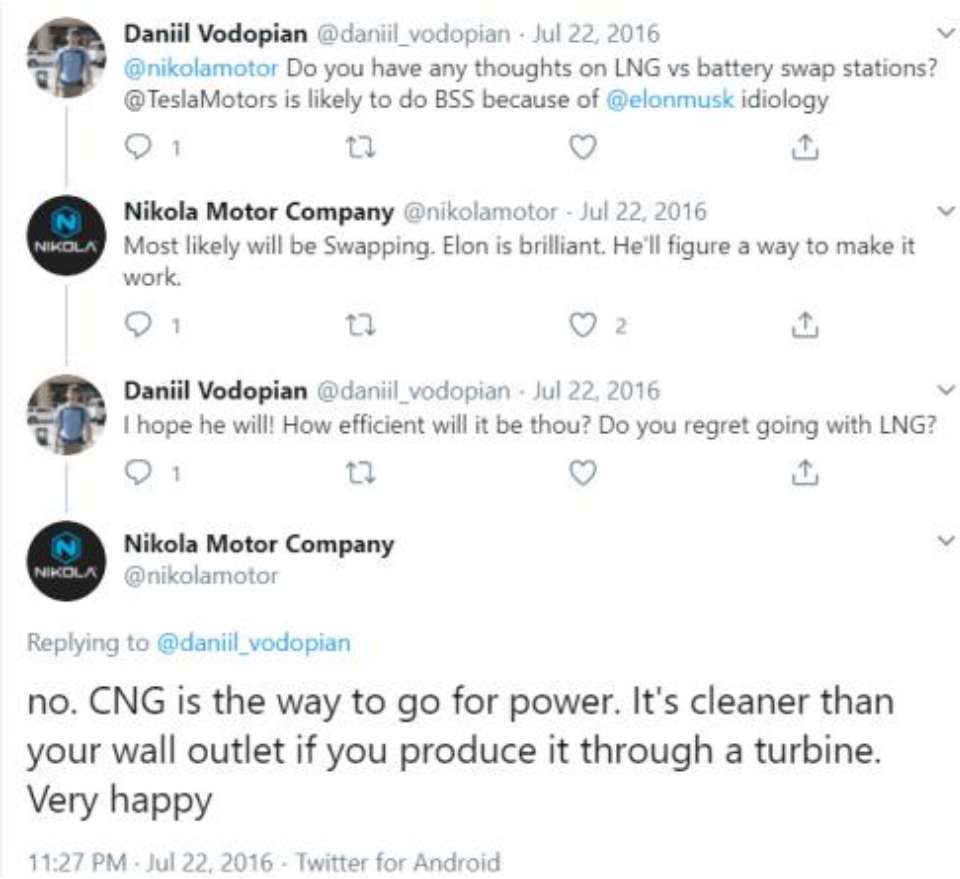
> *"**Nikola has engineered the holy grail of the trucking industry.** We are not aware of any zero emission truck in the world that can haul 80,000 pounds more than 1,000 miles and do it without stopping. The Nikola One requires only 15 minutes of downtime before heading out for the next 1,000 miles."*

**Despite these claims, there was no in-house hydrogen capabilities and no hydrogen partners were brought on board**, according to former partners working in the lead-up to the show. The announcement **was a shock to even those involved with the company** according to our sources.

In May 2016, 3 months prior to the hydrogen "pivot", the company announced it had begun taking reservations for the *natural-gas-powered* Nikola One, which it claimed to have already

"engineered, developed, and is finalizing assembly." It even promised purchasers free compressed natural gas fuel.


Less than *two weeks* prior to the announcement that Nikola had engineered a revolutionary hydrogen solution, the Nikola Twitter account reinforced that its focus was still on CNG (compressed natural gas), not hydrogen. "CNG is the way to go" it said:



Months earlier Trevor had boasted in public interviews of its natural gas capabilities, stating :

> *"Our technology is 10-15 years ahead of any other OEM in fuel efficiencies, MPG and emissions"*

It is unclear why Nikola decided to suddenly abandon its supposed 10-15 year advantage in natural gas.

Yet despite the "pivot" to hydrogen, the prototype being built continued to be focused on natural gas, according to those involved. The truck presented at the show had natural gas turbines installed, according to our sources.

## *Trevor Had "H2" Stenciled on the Truck Despite the Truck Apparently Having Zero Hydrogen Capabilities*

As it turns out, building a zero-emission hydrogen truck is rather difficult. However, merely stenciling "H2" and " Zero Emission Hydrogen Electric " on the side of a non-functioning truck is much easier.

**Trevor had H2 stenciled on the side of the Nikola ne despite the reality that the Nikola ne contained a turbine designed for natural gas and absolutely zero hydrogen technology whatsoever**, according to our sources.

A video of the event showing the stencil-work can be seen here :


Nikola Motor Company - Nikola One Semi Electric Truck Unveiling - Official Video
NIKOLA ONE
U.S. XPRESS
NIKOLA ONE
32:46 / 42:05


NIKOLA ONE
H2 ZERO EMISSION
HYDROGEN ELECTRIC

By November, one month before the show, a team from Brayton arrived with natural gas turbines, according to sources involved in the preparation. Since the turbines would be deep in the truck tucked against the battery, no one would be able to be see that there was no generator plugged into it and that it didn't, in fact, run on hydrogen. The fueling system was natural gas only.

## *"Get Exposed Wiring Looking as Nice as It Can": Emails Make Apparent the Last-Minute Rush to Make the Nikola One Look as Good as Possible in the Weeks Leading Up to the Show*

As the show got closer, ambitions were reduced, and it was clear that everyone wanted to just make things look as good as possible for the presentation. We have reviewed emails that corroborate this, instructing workers to "get exposed wiring looking as nice as it can" and other last-minute touch-ups:

[redacted] Mon, Nov 14, 2016, 5:51 AM

to Dane, Bob, paul[redacted] Trevor, Morgan

Folks,

Hope everyone enjoyed their weekends. Items from my side related to the next few weeks.

1. This Week
   a. We should all be on the same page here.
   b. Has to be looked at as the last week to work on chassis items which have to function for the show
      i. DC/DC Box Contactors in Front High Voltage Distribution Box
      ii. Power Steering Contactors in Front High Voltage Distribution Box
      iii. 12V DC/DC Converter in DC/DC Box
   c. I personally do not see value in running the 12V DC and AC loads for the show from the high voltage battery.
   d. If this is something folks want to do then the chassis wiring for the DC/AC inverter and Current Ways Chargers needs to be ran as well.
   e. I plan to focus on the SW related to the 12V DC/DC Converter and Sevcon content related to the Power Steering Pump this week.
   f. I am coming into SLC tomorrow morning.
   g. Morgan is supporting the Rex activity.
   h. Dane needs to focus only on wiring this week.
2. Next Week
   a. I do not plan to come to SLC next week.
   b. This has been a very tough decision as I want to support the project and team to the best of my abilities but I made no commitment to travel on Thanksgiving.
   c. With the body builders onsite next week I perceive the focus to be on cab wiring and the "dry" high and low voltage connections for the rear gearboxes.
   d. These are items which Dane and Morgan have been leading and I feel a plan can be put in place to support them properly.
   e. It is because of this that the Power Steering System will be my top priority this week. Of course this requires the power steering subsystem to be installed within the next two-to-three days
   f. I will follow up with Kevin Lynk on this.
3. Week of the Show
   a. I plan on being in SLC the 27th through the 30th to assist in final details.
   b. Get exposed wiring looking as nice as it can.
   c. Confirm proper operation of the interior electronics desired for the show.

Bob, Paul and Dane. Let's sync up over phone when the three of you are in the office and have a chance to talk this morning.

Take Care,

[redacted]

Most everything needed to be installed before the body arrived, so things were put in and buttoned up as well as they could be. The e-axles were installed without motor cores or gears

and were installed empty on the "truck" by mid-November.

The body arrived in late November, and the team from N2A Motors, which makes custom car bodies, got it installed on Thanksgiving. This was roughly a week before the show and just days before the truck needed to be pulled onto the stage, which was being built on the other side of the factory.

Once the truck was winched up onto the stage, an artist stenciled "US Xpress" onto the cab and "H2" prominently on various parts of the vehicle.

## *The Truck Could Not Power Itself, Let Alone Drive, So an Electric Cable Was Snaked up Through the Stage.*

## *Trevor: The Truck is "Fully Functioning"*

According to a source who worked on the project, and as is visible in this photograph, a cable was snaked up from under the stage through the floor of the cab to power the cabin screens.


Additionally, mockups of the infotainment pages were loaded onto the in-cabin displays.

In an attempt to underscore the functionality of the truck, Trevor put the focus on the only part of it that was turned on– **the screens that were powered by the cable under the stage.** But the screens, which had been loaded the day before with largely static webpages, according to our source, were reluctant to respond to his efforts.


The statements made by Trevor don't strike us as optimistic "forward looking" statements. They were not exaggerations. **They were simply bald-faced lies.**

In January 2017, following the event, the company raised capital as part of its Series A round. [Pg. F-26] It also signed partnerships in the months to come with companies like major

automotive supplier Bosch as well as fuel cell and hydrogen partners.

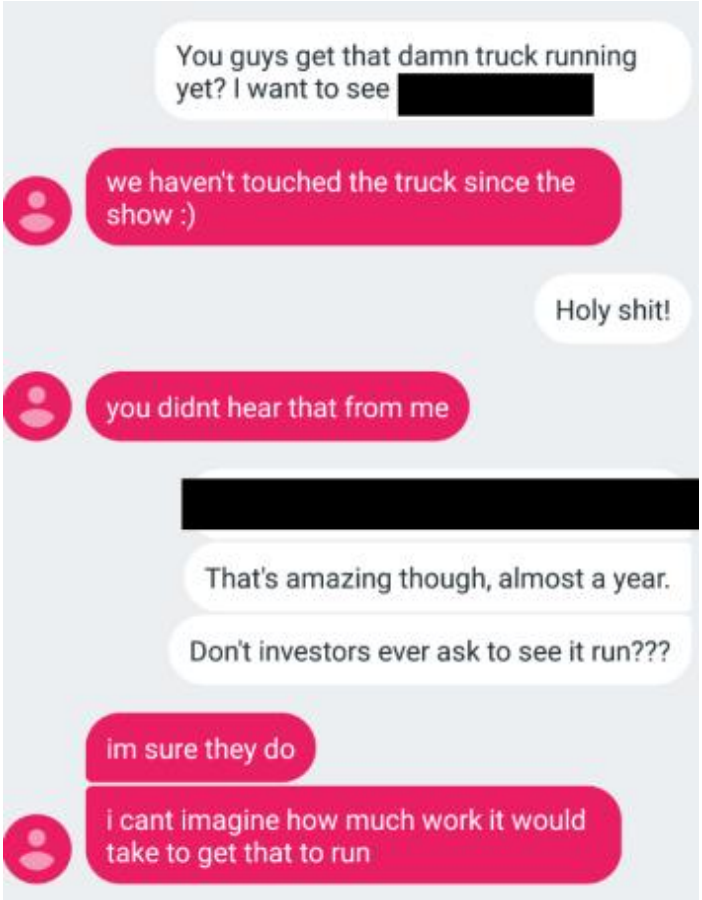
Presumably, the misleading representations made at the event helped fuel these new deals. Subsequently, CNH International jumped in with both an investment and agreement to aid in the manufacturing .

## *Following the Show, The Company Abandoned Development of the Nikola One, According to Text Messages from a Former Employee, Having Apparently Already Served its Purpose to Draw in Credible Partners and Investment Capital*

To the surprise of people involved in the Nikola One project, **development work on the truck did not continue after the show.**

It appears the prototype had already served its purpose: giving the company the legitimacy it needed to raise more investment and court larger partners that would be able to build them an actual working model from start to finish.

It was not considered necessary to actually back up the false claims that had been made on the stage. Below is a text exchange with a former employee who corroborated this (in red).




(Source: Text conversation with former employee. Redacted small portions to protect identity of sources.)

## *2018: In Order to Continue the Appearance of Progress, Nikola Posted a YouTube Video of Its Nikola One "In Motion" on the Road.*

## *Text Messages from a Former Employee Reveal the Truck Was Simply Filmed Rolling Down a Big Hill.*

As time passed and the hype from the December 2016 show faded with no major updates, skepticism began to mount about the Nikola One.

As shown above, no plans were in place to finish development of the Nikola One. Bosch, which had partnered with Nikola following the show, was still quite some time away from delivering working prototypes of Nikola's next development.

To remedy this 'hype gap', Nikola teased a tweet on October 6 th 2017 about an upcoming video:


The first video, which was finally released in January, was for major auto parts manufacturer Phillips, and showed a short clip of the Nikola One easing to a stop sign.

But the main event was another video, entitled "Nikola One in Motion" released the next day on Nikola's corporate YouTube account and promoted on social media, garnering 230,000 views on Facebook alone. This video appeared to show the truck driving on a level road at a high rate of speed.


The video generated a tremendous amount of buzz and excitement about the pre-production units to be released the following year (which never happened).

But according to a former employee who spoke with Nikola Chief Engineer Kevin Lynk , **the video was simply the result of Nikola towing the truck to the top of a hill and rolling it down.**

yeah
Aug 16 12:08pm

the truck commercial was done [redacted]
Aug 16 12:08pm

they were planning it before [redacted]
Aug 16 12:08pm

and i asked kevin how it was going to work and he said they would tow it to the top of a super low grade hill and let it roll
Aug 16 12:09pm

(Text messages with former employee. Note slight redactions to protect source identity)

The deception involved in the production of this video appears to have been elaborate. The company scouted a remote section of road on the Mormon Trail just to the south of Grantsville, Utah, which we have since located.

This section of road is lightly used and features a 2-mile-long perfectly straight stretch with a consistent 3 percent grade–plenty of length and enough of a slope to get a motorless truck rolling.

(Source: Google Maps )

There were no features in the shot that would betray the slope, so the camera could be positioned at an angle that would make the road appear fairly level, or at times, even uphill :


## *We Rolled A Vehicle in Neutral Down the Same Hill. We Reached a Top Speed of 56mph and Rolled for ~2.1 Miles*

An investigator sent to the exact site used by Nikola for their video tested the hill in an SUV by parking the vehicle at the top, then rolling from neutral. He was able to hit a top speed of 56 mph and rolled for approximately 2.1 miles.

(Pictured: Investigator vehicle parked at the top of the hill [license plate redacted] and rolling down the hill)

## *The Media Took the Bait, Calling it 'Road Testing'. Nikola Then Featured the Video for Arizona Governor Doug Ducey When Announcing Its New Manufacturing Facility*

## *Ducey: "This is a HUGE Announcement"*

Although the company didn't specifically say the truck was moving *under its own power*, it was the clear implication. And the video had the desired results, with industry publications describing the footage as 'road testing':


Another article described the truck as "cruising" when it was, in fact, just rolling down a hill.

The next week, Nikola held a ceremony to celebrate its deal to launch a manufacturing facility in Arizona, featuring the "Nikola One In Motion" video at the ceremony.

Immediately after playing the video for the audience, Arizona governor Doug Ducey exclaimed:

> *"Today, I'm proud to announce, that Nikola Motor Company, is coming to Arizona.* ***This is a HUGE announcement****This is a manufacturing headquarters of hydrogen electric semi-trucks that will be moving to our state."*

# *April 2019: Nikola "Unveiled" a Next Generation Version of NZT Off-Road Vehicle*

# *The Design Was Quietly Scrapped Within Weeks of the Unveiling Due to Manufacturing Challenges*

At the 2019 Nikola World event, Trevor introduced the company's luxury version of its off-road vehicle, the NZT. In a video of the event , Trevor can be seen praising the work that had gone into the design. He described how the vehicle was "fully enclosed," offered "luxury" design, and had "full HVAC, heating and air conditioning, the first one of its kind in the market."


At the 22:22 mark Trevor gushed over the engineering:

> *"When we unveil this, pay close attention to the workmanship. The interior, the exterior* ***. It rivals some of the best automotive engineering in the world.*** *This is on an off-road vehicle.* ***This is a moment that people from around the world have been waiting for."***

Curiously, the new generation closed cabin version of the vehicle was vastly different from the open cabin version, which was set up on a track at the event for test drives. A video from the site showed the open version:


In fact, the closed cabin version was only a "mock up," and lacked some of the luxury features Trevor described on stage, such as the A/C, which could not be accommodated behind the

dashboard, according to a former employee.

Within weeks of the event, Nikola management scrapped the design for the NZT because the model was not manufacturable as visualized on stage, according to the former employee.

The company now faced "a massive redesign" before it could bring the NZT to market, they said.

Despite regularly claiming to develop almost everything in-house, Nikola quietly outsourced the NZT redesign to a small company called Stellar Strategy LLC . Stellar is staffed by former executives of Polaris , a well-known producer of off-road vehicles who had advised Nikola on the open cabin version.

# *April 2019: Trevor Claimed on Video That Nikola's Headquarters Was Completely Off the Grid, with 3.5 Megawatts of Solar Installed on Its Roof*

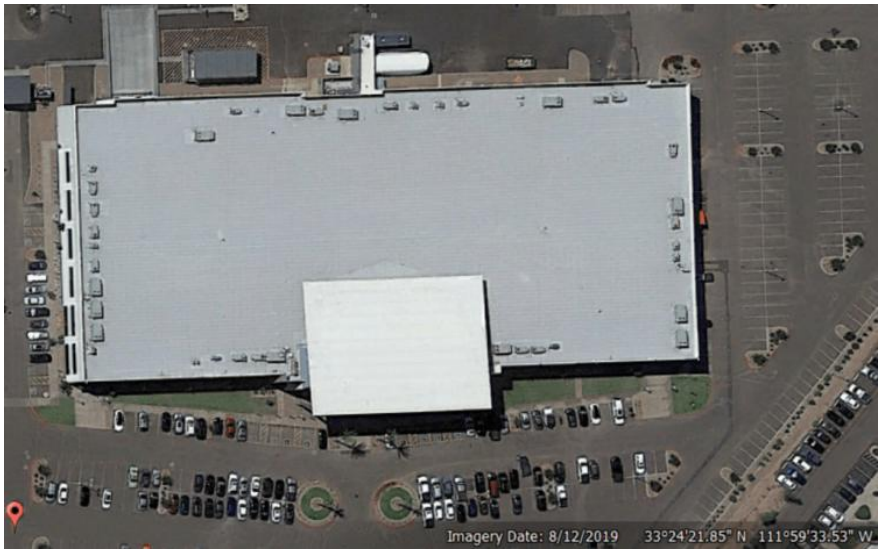
# *Reality: There Were No Solar Panels. The Lack of Panels Is Corroborated by Local Media and Subsequent Pictures*

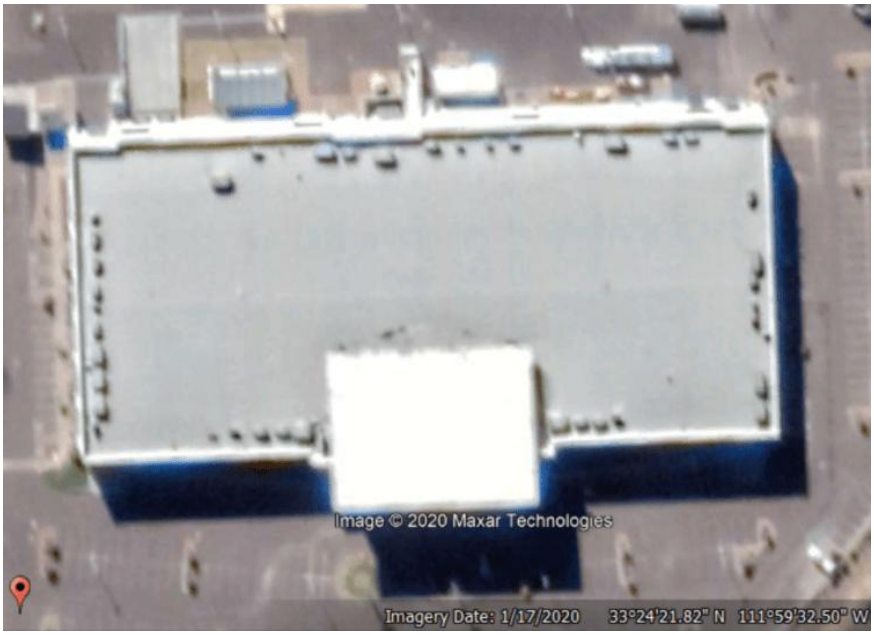
Trevor has claimed that Nikola has an off-the-grid headquarters with 3.5 megawatts of solar on its roof, a large installation. In an April 2019 pitch, for example, at the 10:03 mark, he states:

> *"We have the only off-grid headquarters that we know of, completely off of hydrogen, battery, and solar.* ***We have 3. megawatts of solar up on the roof producing about 18 megawatts of energy a day in our headquarters****, and we're storing 10,000 kilograms of hydrogen and using fuel cells as energy backup and batteries as energy sources as well. Our company is truly one of the most innovative companies in the world!"*

Despite this claim, an article in June 2019 in BizJournals stated that the company had yet to install any solar panels on its roof.

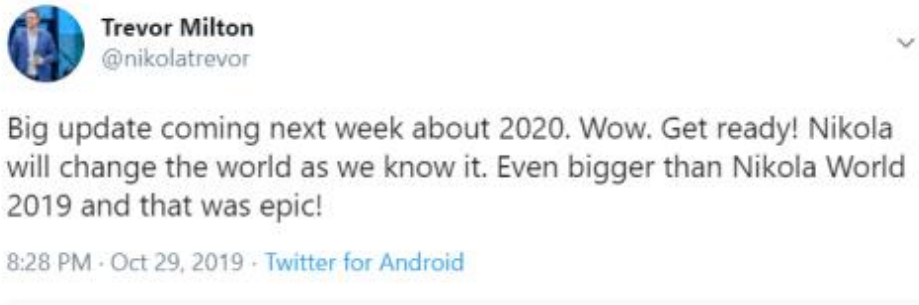
We pulled satellite pictures of Nikola's headquarters (4141 E Broadway Road Phoenix, AZ) from Google Earth Pro and found that all subsequent overhead views (dated August 2019 and January 2020) showed no sign of solar panels on the roof either:



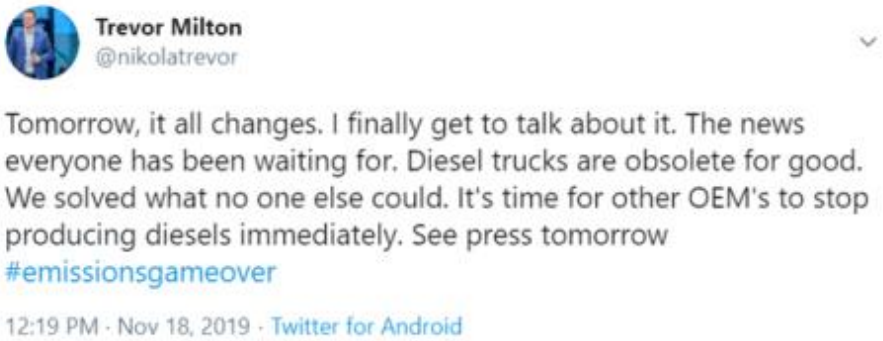

## *November 2019: Nikola Announces the Nikola Battery "Prototype Cell", Calling It "Game Changing Battery Technology"*

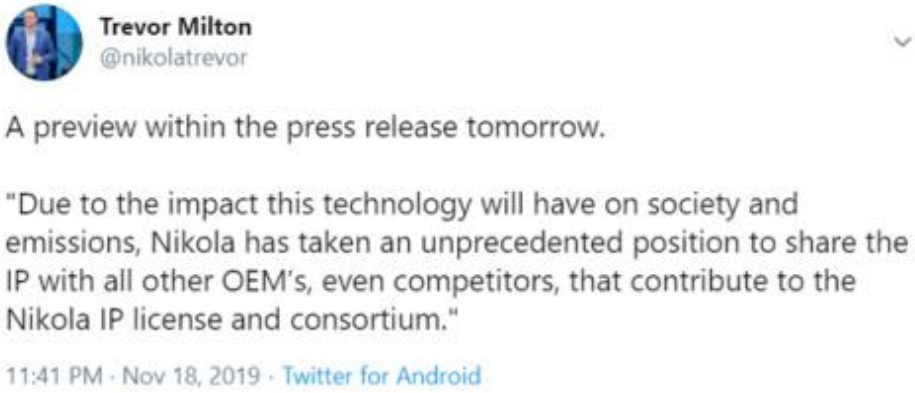
In late October 2019, Trevor began teasing on twitter that Nikola was going to change the world with an upcoming announcement that was bigger than anything he had announced in the past:




It would later become clear that the above teaser tweet was issued 2 days before the company signed a Letter of Intent to acquire a battery technology company.

In mid-November, Trevor issued several more tweets, generating excitement and anticipation for the mystery reveal:



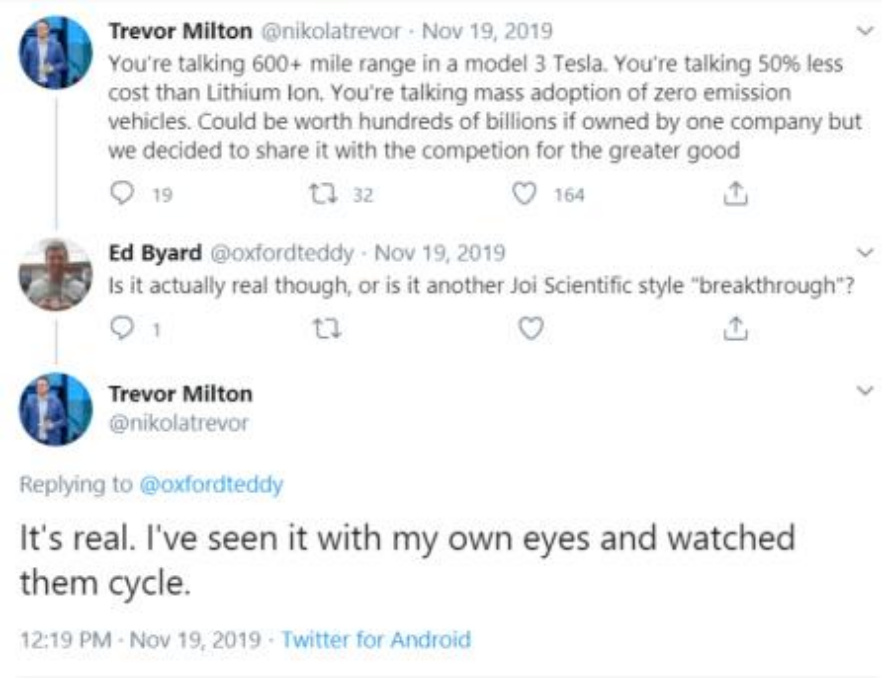

Finally, on November 19, 2019, the very day after Nikola began private negotiations to go public, [Pg. 81] Nikola announced that it had solved one of the greatest challenges facing sustainable energy; a high-density battery.


Nikola certainly didn't undersell the purported achievement:

> *"**This is the biggest advancement we have seen in the battery world**," said Trevor Milton, CEO, Nikola Motor Company. **We are not talking about small improvements – we are talking about doubling your cell phone battery capacity. We are talking about doubling the range of BEVs and hydrogen-electric vehicles around the world.**"*

Trevor continued to tout the battery technology to his Twitter following, claiming he had seen the cell perform with his own eyes, and promised a major demonstration at Nikola world 2020.

**He estimated the value of the new technology to be worth *hundreds of billions*.** As we later learned, Nikola had signed a letter of intent to acquire the technology **for only 6. million**, which would have made this the most accretive acquisition in history:




As with past claims, the public representations differed significantly from the private reality.

The battery announcement made reference to a letter of intent to acquire a battery company, though it did not name the company or reveal the letter. We found the name of the company in litigation records.

## *Nikola Intended to Acquire the Battery Tech, But After the Grand Announcement, Soon Learned it Was Vaporware.*

## *Furthermore, Nikola Learned the President of the Battery Company it Intended to Acquire Had Been Indicted Months Earlier After Using His NASA Expense Account to Hire Numerous Prostitutes*

In March 2020, Nikola sued the battery company, named ZapGo Ltd., alleging fraud, false representations, and failure to disclose that the President of ZapGo had been indicted months earlier for tax fraud.

Had anyone at Nikola merely Googled the President of ZapGo, Charles Resnick, they would have found that 6 months earlier Resnick made national news for allegedly conning NASA through a scheme to use his expense account to hire numerous prostitutes. Resnick pled guilty in January 2020.

Sections

The Washington Post
*Democracy Dies in Darkness*

Science

**A man conned his NASA-funded lab into paying for trips to see prostitutes and escorts, feds say**

Nikola's complaint against ZapGo describes how after entering into a Letter of Intent to acquire the company, and after it had already invested $2.2 million into the company, Nikola realized ZapGo's claims were highly questionable.

The complaint also made clear that Nikola, through its VP of Technology Development Jason Roycht, learned about the tax fraud issue and false claims made by ZapGo as early as December 2019:

8. As Roycht was learning about ZapGo, he discovered on 5 December 2019 that Resnick has been indicted for tax fraud for submitting receipts for prostitutes as business expenses. Roycht told Tim Walder and Stephen Voller, who claimed they did not know about Resnick's fraudulent actions.

9. Roycht continued to learn more about ZapGo. ZapGo claimed that it had a deal with Porsche to provide charging stations at Porsche dealerships. While in the UK visiting ZapGo, and at the invitation of Stephen Voller, Roycht met with Porsche in the United Kingdom together with Stephen and Charles to confirm ZapGo's story and the status of the opportunity at Porsche where it became evident that ZapGo did not have a realistic plan to provide Porsche with energy storage solutions.

## *Despite Learning About the Issues with the Battery Tech in December 2019, TrevorWas Still Hyping the Tech in February 2020*

Despite the issues with ZapGo, Trevor didn't see any reason to stop touting the battery

technology via his Twitter account :


Nikola formally terminated the agreement on February 26, 2020 and appears to not have publicly discussed the situation since. The November 19, 2019, Nikola press release has not been rescinded or corrected, and investors likely believe the "game changing" battery technology still exists.

It never did.

## *Powercell AB Spokesman's Comments on Nikola's Battery (And Hydrogen Fuel Cell) Technology: "Hot Air"*

In 2017, Nikola signed a deal appointing Sweden's Powercell AB as its primary supplier of hydrogen fuel cell stacks. Powercell was an investor spin-out from Volvo , one of the world's largest truck and industrial vehicle makers.

Bosch and Powercell had been completing tests on Nikola's behalf. But in early April 2019, Powercell issued a statement announcing it was ending its agreement with Nikola saying the business terms were "totally unacceptable".

Just days later, Nikola partner Bosch unveiled a $56.5 million licensing deal , with additional

royalties, with Powercell for its S3 fuel cell stacks.

Referring to the breakdown of the deal with Nikola after more than two years of tests, Powercell spokesman Marten Wikforss told us by phone from Sweden this month:

> *"As you can tell from the press release, the terms we were presented for our cooperation with Nikola were, as we stated, unacceptable. So we communicated that and in response, they said 'we're out of the game'"*

> *"What they communicated when they said they weren't going to use our parts and fuel cells was initially that they were going to launch their own fuel cells and it would be so much better or whatever.* ***It was a lot of hot air coming from them Then you didn't hear anything from them. And then all of a sudden they were going to launch a new revolutionizing lithium-ion battery system too. And I haven't heard anything about their own fuel cell system and I haven't heard anything about their revolutionary battery either"***

He said, however, that there were no restrictions on Powercell's licensing deal with Bosch and that Bosch could provide batteries to Nikola even though their direct deal had collapsed.

> *"We're providing to Bosch and it's up to them if they want to supply to companies like Nikola. We haven't banned sales to certain clients. They're free to operate and sell their product."*

## *When Subsequently Pressed on the Battery Acquisition by Tesla Fans, Trevor Dodged the Question Then Changed the Story Completely*

## *Now, an Unnamed University Is Supposedly Developing the Technology*

When skeptical Tesla fans visited Nikola in August of this year, Trevor had a conversation about

battery cell technology . First, he claimed to be working on cells that eliminate all toxic materials, saying he's been working with **companies** to bring the tech to market:

> *"**We've essentially worked with some battery companies to bring those cells to market.**"*

The questioner then asked:

> *"Is this tied to that company you acquired and announced earlier this year…?"*

Trevor initially said he was working with "battery companies", but when the Tesla fan brought up the deal for the company that Trevor (but not the questioner) knew had failed, he then suddenly changed course and said it was related not to a company, but to an unnamed university:

> *"No, it's not actually. It's tied to a university that had developed the technology. And we essentially ended up licensing all of it and helping them fund it all the way through."*

Note that Nikola does have a deal with universities to develop *fuel* cells, but we found no indication that it has anything to do with *battery* cell technology. We found no record of any such licensing deal in its filings.

Following the discussion of the unnamed university, Trevor then downplayed the possibility of a breakthrough, despite his previous claims to have achieved the breakthrough in November 2019:

> *"I hate cell development. **Likelihood of success is like hitting the lottery, you know So, it's very unlikely you're gonna develop a cell that'll work.** So, they did really good work, they had showed that they had thousands of cells that were already being cycled that were not failing. So, we came in and we helped fund 'em. We helped provide 'em funding for equipment that they needed. They furthered the development and now we're going to be showing off cells at Nikola World, **we hope.**"*

The conversation about universities developing the battery tech took place a mere two weeks ago, but now, the company has announced that it will be using GM's proprietary battery technology.

We're confident Nikola's battery technology simply never existed, yet has now managed to trade that empty promise for GM's actual capabilities.

## *June 2020: After Years of Deception, Nikola Goes Public—A Massive Monetization Event That Added Billions of Dollars of Liquidity and Value from Unknowing Public Market Participants*

Nikola went public via a reverse merger on June 4th via a special purpose acquisition company.

Shares of Nikola spiked, largely on the backs of retail investor euphoria. Many inexperienced investors were learning about the company for the first time and, seeing a long list of impressive claims, believed that they were getting in on the ground floor of the next Tesla.

Overnight, Trevor became a multi-billionaire and a minor social media celebrity. A host of news articles came out comparing him to Elon Musk.

## *But Being Public Also Brought Criticism. Trevor Quickly Becomes Obsessed with Short Sellers, Critical Journalists, and Other "Haters"*

We at Hindenburg take pride in reporting on companies that try to silence criticism with intimidation. A functioning market requires diverging views and opinions in order for investors to be able to make informed decisions.

We also believe that companies engaging in such practices are vastly more likely to have something to hide. In one recent example, MiMedx Group sued its critics, only to be charged criminally with fraud two years later.

Most public company leaders focus on developing their products and their business. But upon going public, Trevor almost immediately took to lashing out at short sellers and threatening journalists with litigation for writing critical articles:

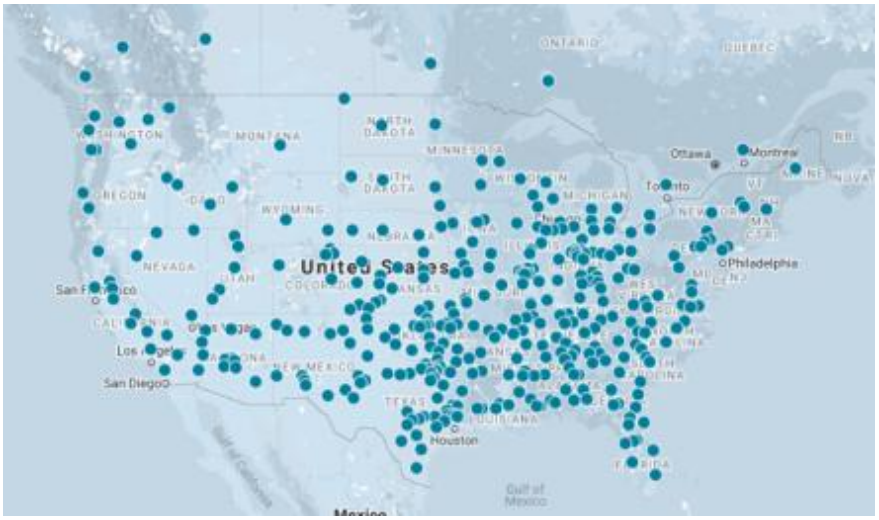



## *2020: Trevor Claimed Nikola Produces Hydrogen for Under $3/kg, ~81% Cheaper Than the Rest of The World, Representing a Major Breakthrough*

The high cost of hydrogen, among other issues, has prevented it from becoming a mainstream fuel source for alternative energy vehicles. The high price tag results from both the cost to isolate hydrogen and the cost of building production facilities/transmission.

Low-cost hydrogen production is critical to Nikola's financial viability, as Nikola's hydrogen long haul truck sales would rely on a working network of hydrogen stations. Nikola's much anticipated fuel cell pickup truck's existence also hinges on a hydrogen station roll out.

As part of its hydrogen strategy, Nikola says it is planning on building 700 hydrogen stations across the US, with further plans to expand worldwide.




(Source: Nikola's website )

Per the company's latest quarterly report:

> ***"This planned construction of hydrogen stations is essential to persuading customers to pay a higher premium for our trucks"*** *[Pg. 41]*

To build these stations, Nikola announced in a June 2020 press release that it would be purchasing components from Norway-based Nel ASA.

At Nikola World in December 2019 Trevor claimed on video to a large audience to already be producing 1,000 kilograms of hydrogen a day on site at his Phoenix headquarters:

> ***"In America we've already got the largest hydrogen station in the western hemisphere at our headquarters. Can produce over 1,000 kilograms a day on site."***

Subsequent to Nikola world, Trevor reiterated in several public interviews to have already solved this major world problem, describing Nikola as having achieved breakthroughs in hydrogen production.

In an August 2020 interview with Fox Business News, when asked about hydrogen, Trevor says:

> *"We saw an opportunity to bring the cost of hydrogen down going zero-emission and putting it on parity with diesel, and it's the first time in history that's been able to be done,* ***so it went from about 16 kg and we are down now below 3 kg*** *and there's a lot of reasons for that, but the main one is standardization of a hydrogen station worldwide has allowed us to drive that cost down dramatically.* ***We tell people we're an energy technology*** *company that happens to build really cool vehicles."*

In another interview on July 17, 2020, on the TeslaCharts podcast, Trevor claimed Nikola has been able to "chop the cost of hydrogen from $16/kg down to – we're down below $3/kg on our hydrogen now."[1] [11:34]. This would mark an astonishing 81.25% reduction in the cost of hydrogen.

When challenged again about Nikola's hydrogen production cost by the TeslaCharts podcast host [25:00], Trevor repeats the question, compliments the host on asking the question, claims he has "so much experience" with answering the question, says he "knows the stuff better than anyone he has ever encountered" and says he has spent "7 years" driving the cost of hydrogen down.

But he then admits that many of the "changes" in the hydrogen world he has seen are "not so much on the technology side" and that Nikola has "seen maybe a 5% or 10% increase in efficiency across the board" in hydrogen technology. But that's "not what changes the world," Trevor says.

After providing an anecdote about his father, and offering some other sidetrack discussion, **he then admits that Nikola's entire answer to bringing down the cost was to simply standardize a hydrogen station**. "The standardization of the hydrogen station was the most important aspect," Trevor says.

Such standardization would clearly bring costs down, but Nikola already claimed to have accomplished the feat without having a single *production* facility of its own.

# *When Pressed on the Subject in July 2020, Trevor Acknowledged Nikola Produces No Hydrogen at All. The Claims Made at Nikola World and In Multiple Interviews Were, Once Again, Completely Fictitious*

In a subsequent interview on July, 2020, when pressed about hydrogen production, Trevor acknowledged producing no hydrogen at all:

**Trevor:**

> ***The station is designed to store and pump about 1,000 kg's per day. Electrolyzers are going in now and should be operational with zero emission solar production by Nikola World 2020. We have 2. megawatts of solar going up now at the facility. The station functions now, but we do not sell it to the public.***"

*Interviewer:*

> " ***K, so for the record: ou're currently producing no hydrogen*** *but you're planning to produce 1 metric ton/day using 100% solar energy by the end of the year? What are you going to use it for by then?"*

**Trevor:**

> ***The permitting process of producing hydrogen takes much longer than storing and pumping it. We spent the last year building the largest hydrogen station in the western world in hoenix, AZ at our H . Now we will spend the next months installing the hydrogen production Electrolyzers, ower Electronics, Thermal, Etc. into that station."***

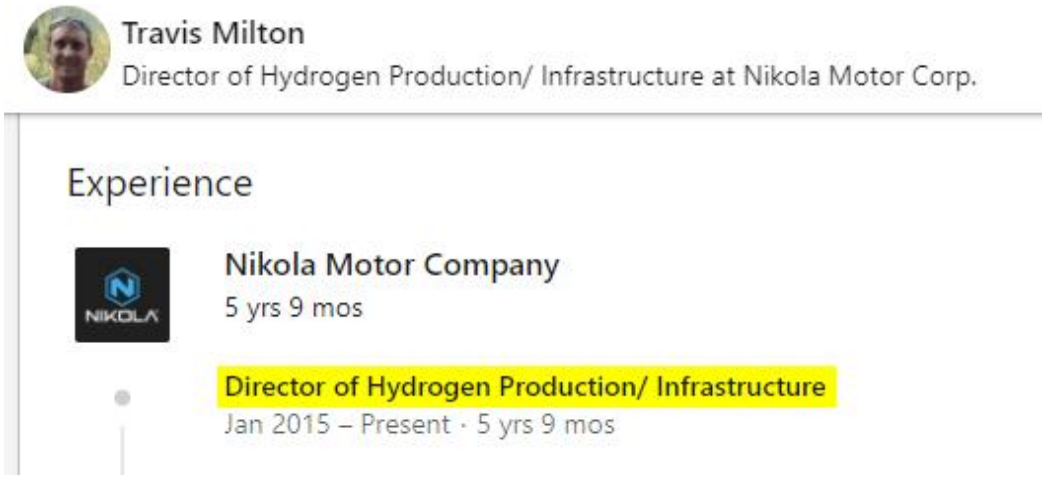
We found the admission to be unsurprising when we learned who was in charge of Nikola's efforts to develop and roll out its supposedly revolutionary hydrogen production capabilities.

# *Nikola's Director of Hydrogen Production /Infrastructure Is Trevor Milton's Brother, Who Worked Paving Driveways in Hawaii Prior To Joining at Nikola*

Given the complicated nature of hydrogen, we wanted to look closer into the resumes of who Nikola has put in charge of such a critical and dangerous aspect of their business.

We expected to find that Nikola had hired a world-renowned scientist to lead its revolutionary hydrogen efforts. Instead, it appears Nikola has appointed Trevor Milton's brother, Travis, as the Director of Hydrogen Production/Infrastructure.

Travis has held his title at Nikola for over 5 years, beginning January 2015, according to his LinkedIn.

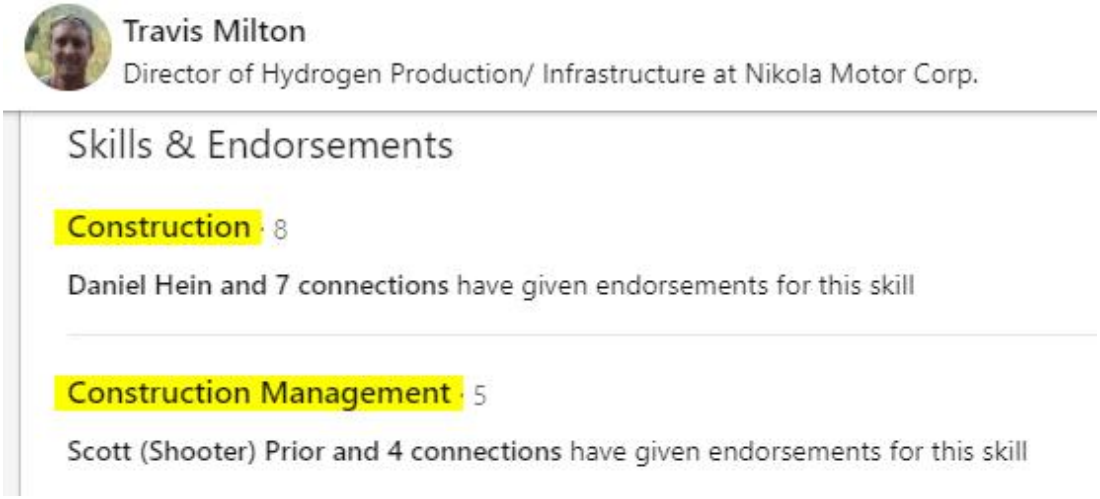



(Source: Travis Milton LinkedIn )

Interestingly, he seems to have landed in this crucial position the same month he finished his last job, where his LinkedIn lists him as "President" of "Self-Employed" in Maui, Hawaii.


(Source: Travis Milton LinkedIn )

We found a number of endorsements for construction work from individuals in Maui, Hawaii.




(Source: Travis Milton LinkedIn )

Eventually, we found a website that highlighted Travis' work pouring concrete and building a barn as a subcontractor in Maui.

(Source: Travis Milton, Flatwork and Framing, Maui )

*"**Mr. Milton poured two long and challenging driveways** (one driveway was the world's steepest), and extensive walkways with elaborate embossed Hawaiian leaves," the website says.*

(Source: Travis Milton, Flatwork and Framing, Maui )

Another picture from the site feature's Travis's work applying epoxy flakes to a staircase:

(Pictured : Travis Milton applying epoxy flakes to staircase in Hawaii prior to joining Nikola and allegedly revolutionizing the hydrogen fuel industry)

We're not sure how this work prepped Travis for a key role in solving one of the world's greatest scientific challenges, but he appears to have been handsomely rewarded for his discoveries.

Trevor has given Travis, along with other family members of Trevor and select early employees, **stock worth over 110 million as of this writing.**[Pg. 116]

One source we spoke with, who previously worked with Travis, described him as not having a formal role and as someone Trevor "kept around" if they "needed someone to hold a rope, or something like that" while they were working on vehicles.

## *Nikola's Head of Infrastructure*

# *Development, In Charge Of "Leading Development" Of Nikola's 700 Hydrogen Station Network, Is the Former CEO And General Manager of a Golf Club In Idaho*

Also central to the company's hydrogen station initiative is Nikola's "Head of Infrastructure Development".

Once again, we might anticipate that the rollout of Nikola's coast-to-coast hydrogen production network would be managed by an individual with an extensive background in both science as well as large infrastructure developments.

For this task, the company chose Dale Prows, who is described at the 13:20 mark in a video produced for investors ahead of the company going public, as "one of our hydrogen experts."

Prows joined Nikola after spending almost 4 years as CEO and General Manager at a residential golf course in Idaho.


(Source: Dale Prows LinkedIn )

**CEO and General Manager**
Huntsman Springs, Inc.
Dec 2014 – Jul 2018 · 3 yrs 8 mos
Driggs, Idaho

Led the development strategy and operations of a beautiful private residential golf club and spa in the shadows of the Grand Teton peaks in Driggs Idaho.

(Source: Dale Prows LinkedIn )

(Source: Huntsman Springs Golf Course )

Prows, along with Travis Milton, are apparently going to spearhead building the world's first network of 700 hydrogen *production* and fueling stations.

## *Trevor: "We've Assembled One of the Best Teams in the World"*

## *Nikola's Chief Engineer: A Background Largely in Software Development and Pinball Machine Repair*

Trevor regularly touts bringing in top talent from all over the world. Key to that team is Nikola's Chief Engineer, Kevin Lynk .

Trevor credits Kevin with designing all of the company's e-axle, a complex task for one vehicle let alone Nikola's proposed suite of vehicles. At 8:43 in the following video, Trevor details all the elements of Nikola's e-axle's as developed by Lynk:

> *"All the e-axles at Nikola were developed by Kevin… (These include) rotor, stator, cooling, thermal, gears, and sometimes inverters."*

(Note that the e-axles appear to be mostly developed by Bosch .) We reviewed Kevin's biography on LinkedIn and found that prior to Nikola, he worked for 7 months designing oilfield products using CAD software, 3.5 years in software development, and prior to that spent 9 months repairing pinball machines.

Here is the rest of his resume after college and before Nikola, per his Linkedin :

**Mechanical Engineer**
Profire Energy
Sep 2014 – Mar 2015 · 7 mos
Lindon, Utah

- Designed, analyzed, and documented innovative oilfield technology products using SolidWorks and Composer as part of a research and development team.
- Performed initial implementation and ongoing administration of SolidWorks EPDM, Product Data Management (PDM) system for control and automation of CAD files through ...see more

**Applications Engineer**
GoEngineer
Apr 2011 – Sep 2014 · 3 yrs 6 mos
Greater Salt Lake City Area

Demonstrated and taught a suite of Engineering software surrounding SolidWorks.

Performed customer technical support for SolidWorks, solving problems in nearly every aspect of the program.

**Arcade Restoration and Repair Technician**
Pinball Machine Repair
Aug 2010 – Apr 2011 · 9 mos
Park City, UT

Restored and repaired antique to modern pinball machines, slot machines, juke boxes, and arcade games for high end customers.

## *Trevor Milton in 2020: We Make All Our Inverters In-House*

## *Reality: Nikola Buys Inverters from a Third-Party Supplier. A July Video Shows the Inverter, but the Label of the Manufacturer*

# *is Covered with Masking Tape*

After the critical Bloomberg article , it seemed there was an undercurrent of skepticism that Trevor became obsessed with countering.

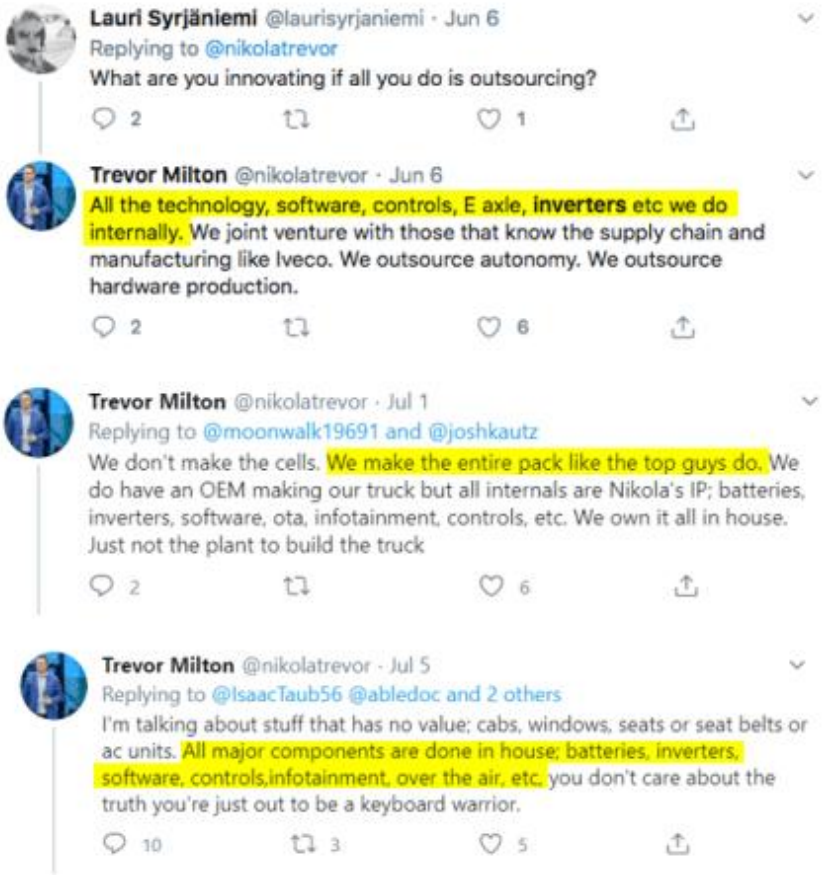
Nikola had always made claims that its components were developed in-house, dating back to Nikola's first press release on May 9, 2016:

> *"The **majority** of the semi-trucks components **are being developed by Nikola**"*

Yet these claims never seemed to make sense. As we have already shown, Nikola's early history was that of a company loudly claiming to have vast proprietary technology while quietly signing partnership agreements with third-party suppliers.

The chorus of doubts among Nikola's "haters" grew louder after it became a public company.

When people would ask skeptically what Nikola had ever actually developed, Trevor would respond with a list of components such as batteries and inverters made in-house. See examples, here , here and here :




Trevor later attempted to counter skeptics by showing videos of the two prototype trucks that had been built with partner Bosch, suggesting that this somehow disproved the allegation that the earlier truck he built had never been finished.

In one such video, on July 14th, 2020, Trevor walks viewers through the Powertrain for the Nikola Two. At the 29:30 mark Trevor begins describing the in-house inverters and how other OEMs are asking to use Nikola's proprietary inverter tech:

> *"We do all the e-axle design in house. All the gears, the gear reductions. The thermal the cooling. Even the controls that go with it.**And, also, the inverters as well. All inverters on the Nikola truck are probably some of the most advanced software systems that I know of anywhere in the automotive world.** Why do I know that? It's because other OEMs are asking us to use it."*

At the 7:02 mark, we can see the inverters up close. There is a relatively inconspicuous green piece of masking tape on the component:


Here it is up close:

The inverter is not proprietary to Nikola. Cascadia Motion, a small company in Portland, offers

such inverters off the shelf . The tape is covering the label which would normally show the product description and other specifications that make clear who built the component:


We texted a sales engineer for Cascadia and asked if the model was available to the public or if it was a customer specific model, and they confirmed that it was for sale to the public.

This follows the same pattern. Nikola has regularly used off-the-shelf products from third parties, while claiming to have vast internal proprietary technology and to "design" all the products itself. It then partners with companies that actually have the components Nikola claimed to have already developed internally.

## *July 2020: Trevor on the Nikola "Tre" Truck: "We Have 5 of Them Coming Off the Assembly Line Right Now"*

# *Bosch Spokesperson In September: We Don't Have Any Yet*

In February 2020 , a deal was unveiled to produce the Nikola Tre in Europe on an Iveco S-way platform and using Bosch electronics.


(Pictured: Inveco S-Way vs. the planned Nikola Tre)

Nikola had said it would be ready to show off the Tre at the Hannover IAA trade Fair this September, the most prestigious in Europe.

In a July 2020 podcast , (39 minute mark) Trevor gave the impression it was all systems go – at least on the initial BEV model:

> *"We have the most advanced battery electric truck in the world. We have a truck coming into production right now with 720 kwh the largest battery we know of on a truck anywhere in the world coming into production.* ***We have five of them coming off the assembly line right now in Ulm Germany.*** *They'll enter production end of next year-ish, somewhere around there."*

But in a phone interview on Sept. 9, Bosch said not so.

Thorsten Schoenfeld, spokesman for Bosch's electro-mobility unit at headquarters in Germany said this:

> *"No they are not ready yet. I don't know exactly the year but we're working on it."*

When asked what exactly the Nikola-Iveco-Bosch partnership had planned to show at the Hannover trade fair – now canceled due to Covid-19, Schoenfeld said:

> *"We would have shown different innovations and a kind of truck but not a real truck but a showcase."*

## *July 2020: Nikola Posts Video of Nikola Two Going "0-60 in Under 5 Seconds"*

## *Reality: The Vehicle Was Already Rolling When the Video Started and it Still Took Over 10 Seconds*

Following the Nikola One "demonstration", the company was successful in raising capital and bringing on a number of legitimate partners. Automotive supply heavyweight Bosch agreed to work with Nikola in September 2017 , and, by all reports, largely built its Nikola Two prototype trucks.

In a tweet , Trevor posted a video claiming to showcase the Nikola Two prototype's acceleration capabilities:


The video begins with the truck already rolling. By just using a basic stopwatch, we can see that it takes over 10 seconds between the start and Trevor exclaiming "there it is" on the video. The speedometer is not visible, and we obviously have no ability to see what is actually powering the truck.

[Click here to see the video, with a stopwatch ]

In response to questions about the veracity of the video ( 1,2), Trevor promised that professional video would soon follow, but we have seen no such update.


Overall, information has been sparse on the Nikola Two. Last month, several Tesla fans toured the Nikola facility and rode in the prototypes, with some reporting that they were surprised the EV truck was so loud . Apparently, the AC had been turned on full blast, which kept the riders

cool from the Arizona heat but also fueled skepticism.

There have been several videos of the prototypes built by Bosch being driven around parking lots (1,2) and at unknown speeds carrying unknown-sized loads in stylized videos, but once again, investors and partners are left in the dark about what Nikola really has.

# *Nikola's Former CFO Left and Sued the Company. The Entire Docket is Sealed—But A Month After the Lawsuit Nikola Suddenly Announced it Had Refunded All Truck Deposits.*

# *Did They Ever Really Exist?*

In March 2018, Nikola's former Chief Financial Officer Jonathan Spira filed a lawsuit against the company, with Nikola countersuing several months later.

A sudden change in CFO is often a red flag. A CFO that departs while suing the company obviously is an even bigger red flag. Both cases were eventually dismissed. The allegations remain unclear, and it is unclear whether they were dismissed as part of a settlement.

Prior to the lawsuit by its CFO, Nikola claimed to have 7,000 pre-orders ***with deposits***, a total potential value of $2.3 billion for its proposed electric truck. Industry watchers viewed the numbers with skepticism at the time. Per CleanTechnica:

> *"Despite reportedly taking $10.5 million in reservation deposits (across ~7,000 preorders), the Nikola Motor Company has completely backed away from its plans to offer a battery-electric Nikola One semi-truck, according to recent reports."*

> *"…Bad news for those who put down reservations (**if the reservation figures were accurate/true**)".*

A month after the lawsuit was filed, Nikola suddenly announced via Twitter that it was refunding all deposits


Industry blog Green Car Reports described the move to refund deposits with confusion:

> *"The point of refunding the deposits remains somewhat unclear, however, even if Nikola is flush with orders and cash. Customers that have sent the company money have skin in the game, meaning they're more likely to follow through with their purchases at the end of the day."*

# *Nikola's Order Book: More Fluff Than Substance*

As of the latest quarter, Nikola reported 14,000 cancelable reservations for its trucks. [ Pg. 35]

The most high-profile reservation regularly discussed is Anheuser Busch's contract for 800 trucks. The agreement provides significant outs however, allowing Budweiser to cancel (i) anytime with 1-year notice (ii) if a 90-day road test doesn't perform up to expectations; or (iii) if the products aren't delivered at all.

At the time of the Anheuser Busch deal, Ryder was to perform all servicing , but that relationship has since ended .

Nikola has also publicized its deal with Arizona trash company Republic Services, with an order for 2,500 refuse trucks based on the Nikola Tre. Those appear to be for battery electric vehicles not hydrogen-powered models. Nikola stated the refuse trucks would be supplied from the Nikola factory at Coolidge, which has barely begun.

The rest of the "reservation" book seems non-committal. In investment bank Cowen's initiation

of coverage report for Nikola, it noted:

> *"U.S. Xpress makes up more than one-third of the 14,600 reservations on hand"*

Were U.S. Xpress to complete such an order it would amount to ~$3.5 billion in value. But as of its last quarterly report, U.S. Xpress had only $1.3 *million* in cash on hand. [ Pg. 3] There is no realistic way that the company could possibly order the number of trucks it has "reserved".

Having a large order book sounds great but having buyers both willing and credibly *able* to pay is another matter entirely.

# *Nikola's Fixation with NDAs, Secrecy, and Legal Intimidation*

Often, the two most glaring red flags that something is amiss at a company are (a) an obsession with secrecy and (b) the constant threat of legal action or retaliation against anyone who speaks out.

Companies typically use a common justification for such paranoia—they've found the holy grail of something and they must take all measures to prevent competitors from finding out about it.

Often, in these cases, the real secret is that there really isn't much behind the curtain at all.

During our research, we reached out to multiple former Nikola employees. We were told by one that Nikola had issued a legal warning to all former employees to intimidate them into not discussing the company.

Recently, several Tesla fans visited Nikola and were required to sign NDAs.

We even reached out to the actors in a Nikola commercial showing the Nikola One "in motion" (see section above). We found that the actors had been required to sign NDAs. What proprietary secrets could an actor standing next to a truck possibly learn that require them to be muzzled?

# *At One Point, Nikola Claimed to Own its Own Natural Gas Wells*

# *Yet Now, All Mentions of These Supposedly Owned Wells are Gone. We Found No Mention of Nikola Ever Owning Natural Gas Wells in its SEC Filings*

Nikola's claim to own its own energy sources (like its fictitious hydrogen production operation) is not particularly new. At various points in its history, Nikola has claimed to own natural gas wells, despite no evidence we could identify suggesting this was the case.

For example, the Internet Archive shows Nikola's bold claims of being able to "guarantee" cheap fuel for its prospective customers because it actually *owned* natural gas wells.

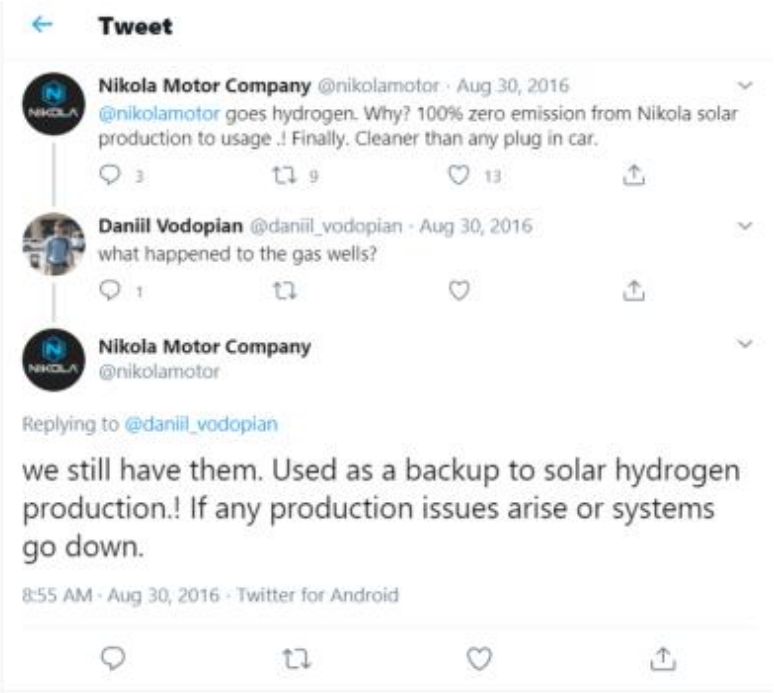

HOW CAN YOU GUARANTEE $1.50 PER GALLON FUEL THEREAFTER?

At Nikola Motor Company, we've decided to invest in American energy. Nikola owns the rights to its own natural gas wells. Along with the Nikola One fleet that transports the natural gas from the wells to the stations. With 7 wells on a single property, Nikola can pump out millions of gallons of clean natural gas each day. Nikola plans on having more than 5 well sites for redundancy throughout the United States. Complete vertical integration removes market uncertainties and allows Nikola Motor to control its own prices and keep them that way for Nikola customers. Nikola bypasses all the gas companies, liquifies the gas on site, then delivers it to the station through its fleet of electric trucks.

Fuel Price Security

With Nikola Motor, the trucking industry's largest variable expense (fuel) is now fixed, predictable, manageable, affordable and guaranteed.

One astute follower of the company asked about the "gas wells" to which the Nikola corporate account stated "we still have them." If that was ever the case, where were they and where did they go? Why weren't they mentioned as an asset in the company's prospectus ?




# *Trevor: Has Previously Said "I Don't Back Down" In the Face of Criticism*

# *Prove it: Here Are 53 Questions—Let's See How Many He Backs Down from Answering*

Trevor has succeeded at intimidating many with threats of litigation. As we've said many times before, we welcome such threats. We find that litigious executives often have the most to hide. Sometimes executives will *only* answer probing questions under oath (if ever).

But on the off chance we are just flat out wrong about absolutely *everything*, here is Trevor's opportunity to prove it. These are the specific questions we think investors in Nikola and, largely, investors in Trevor deserve the answers to:

1. Did you have your service personnel traverse the country to conceal potentially fatal defects with dHybrid's product to close the deal with Worthington, as alleged by one of your former employees on recorded audio?
2. What was the rationale for Worthington's later impairment of dHybrid and the write-off of $1.5 million in warranty expenses ?
3. In May 2015, you represented in a legally binding contract with EVdrive to have "new and valuable proprietary turbine technology". Months later, emails showed you were in discussions with Brayton to purchase their turbines. Did you have any "new and valuable turbine technology" at the time you represented having it?
4. If so, what was it, and why did you then need to buy turbine technology from Brayton?

5. Before suddenly pivoting to fuel cells, you claimed that your Compressed Natural Gas (CNG) technology was "10-15 years ahead of any other OEM in fuel efficiencies, MPG, and emissions". Why did you suddenly abandon this supposedly revolutionary technology rather than sell it for billions of dollars?
6. In December 2016, you claimed at Nikola World, on video, that the Nikola One "fully functions and works…this is a real truck—this is not a pusher." You later admitted that it was NOT fully functional to Bloomberg. Did you brazenly lie, or was this just a series of multiple honest mistakes?
7. After the Bloomberg piece, you claimed on Twitter that there was a table with truck gears and components sitting in front of the audience for all to see. The event was extensively documented—can you present evidence that such a table existed in plain view for the entire audience?
8. Do you think a table with gears sitting somewhere would in any way invalidate your claims at the time that the truck fully functioned?
9. After lambasting Bloomberg's reporter publicly, calling him a "deceiver" and saying he should be fired, you then promised the full audio of the interview with Bloomberg would be released. Why haven't you released it yet?
10. Do you think it's wise to threaten to sue journalists for getting a story totally correct?
11. In August 2016, you claimed "**Nikola has engineered the holy grail of the trucking industry**", pivoting to hydrogen from natural gas. Now that you have acknowledged the Nikola One wasn't fully "engineered" at the time of the statement or the December show, do you wish to retract this press release in full?
12. Did the Nikola One truck have hydrogen turbines or Brayton CNG turbines at the time of the demonstration in December? Was the fueling system hydrogen or CNG?
13. Why did you say just two weeks before Nikola's sudden "pivot" to hydrogen that "CNG is the way to go" on Twitter if you were imminently planning to announce a switch?
14. Did you have an artist come in and stencil "H2" and "Zero Emission Hydrogen Electric" on the side of the Nikola One despite the truck having natural gas components installed?
15. Do you still consider the Nikola One to have been "fully functioning" despite needing to snake an electricity cord up through the stage in order to power the otherwise completely non-working vehicle?
16. For the "Nikola One in Motion" video, will you confirm that you towed the non-functioning truck to the top of a hill and just filmed it rolling down?
17. Which Nikola employees knew about the "plan" for the Nikola One in Motion video and which ones participated in creating it? Did those include Kevin Lynk, your Chief Engineer?
18. When you released the above video, the Nikola Twitter account said, "Pre-production units to hit fleets in 2019 for testing". Former employees state that no work continued on the Nikola One. What work did you ever complete on the Nikola One after the show?
19. At the time, did you think pre-production units of the Nikola One would just magically produce themselves?
20. When you " unveiled " the NZT in April 2019 you praised the vehicle and its engineering, yet a former employee described it as only a "mock up" and said you scrapped the design after the show due to a need for a "massive re-design". How do you respond?
21. According to you, Nikola designs most things in-house. Did you outsource the redesign of

the NZT to Stellar Strategy?

22. You claimed that Nikola's headquarters has 3.5 MW of solar panels on the roof, yet later media reports and pictures of the roof show they don't exist. Where did they go?
23. In October 2019, you teased a major battery breakthrough 2 days before signing a letter of intent with ZapGo. You then announced that you had revolutionized the battery industry, before realizing that it was vaporware and ultimately suing the company. Why didn't you correct the press release or update your investors on the status of the deal, which had fallen apart?
24. In December 2019, Jason Roycht, your VP of Technology Development, realized that ZapGo's President had been indicted for fraud. He raised alarms about the company's relationship with Porsche, which he determined was overstated. Why did you hype the battery tech in February on Twitter despite already knowing of all these issues?
25. You formally terminated the agreement for the apparent "game changing battery technology" from ZapGo on February 26th, 2020. It is now 6 months later. Have you ever publicly acknowledged that this major deal fell apart?
26. In August 2020 when specifically questioned about the deal by a Tesla fan, why didn't you take the opportunity to let people know that it had fallen through?
27. You instead told the questioner that you had a deal with an unnamed university relating to their battery technology and that Nikola had funded the research. Which university were you working with on the battery technology, how much did you fund them with, and exactly what have you developed in conjunction with them thus far? Will you post the agreement for all to see?
28. You claimed in an interview to have succeeded at cutting the cost of hydrogen by ~81% from peers, stating "we're down below $3/kg on our hydrogen now". How much hydrogen has Nikola produced at this price, if any?
29. At Nikola World 2019 you claimed on video to be producing 1,000 kg of hydrogen per day at your headquarters. When pressed by a reporter, you later admitted that you produce no hydrogen. Did you lie about producing hydrogen on camera to the entire audience at Nikola World?
30. Why did you appoint your brother Travis as "Director of Hydrogen Production/Infrastructure"? What experience does he have in hydrogen research and production?
31. What would you say are Travis' key contributions to Nikola's alleged breakthrough advancements in hydrogen production?
32. What led you to select Dale Prows, whose previous employment consisted of managing a golf course, to be the "Head of Infrastructure Development"?
33. Do you really develop all your inverters in-house or do you buy them from Cascadia?
34. Why did you put a piece of tape over the Cascadia label when you were presenting your supposed "in-house" inverter on video?
35. What OEMs have asked to use "your" inverters in their products?
36. Why did you post a video saying the Nikola Two had gone from 0-60mph in under 5 seconds when anyone with a stopwatch can see that it took at least 10 seconds?
37. Following the 0-60 video you promised to post a professional version of the video, saying it was just being edited. But you never did. Why? Does the Nikola Two have as much power

as you've claimed it has?

38. In the TeslaCharts podcast at the 40:20 minute mark you said regarding hydrogen stations: "we're gobbling up the best locations right now". Yet your latest quarterly report showed no real estate assets aside from your current headquarters. Where exactly are these locations that you have been "gobbling up"? How many have you purchased already?
39. What is the hold up with your Coolidge facility construction? Have plans been submitted yet and permits been received? Why is there virtually no sign of progress ?
40. Why do you spend so much time on social media fighting your "haters" and threatening former employees with litigation over NDA enforcement? Don't you have a factory to build and products to produce?
41. When you sold your St. George Security & Alarms company in an $300,000 deal, your business partner, who said he had a 50/50 deal with you, only received ~$100,000, according to him. Did you get more than him despite having a 50/50 arrangement?
42. The buyer of the alarm business said you misled him and that customer contracts and other deals fell through post-sale. What happened?
43. How much did you make when you sold the alarm business a second time? How much of those proceeds did your apparent "50/50" business partner receive?
44. You claimed that uPillar.com had 80 million monthly active users and that you had beat Amazon to the shopping cart, despite launching in 2009. A former employee called the 80 million number "absurd", and media articles at the time describe the page views far lower. What evidence can you show that you had that number of page views?
45. Do you realize the internet shopping cart was invented 15 years earlier, in 1994?
46. Swift filed a lawsuit against your company dHybrid in mid-2012, alleging, among other things, that you had used its investment for personal use. Can you produce bank records showing how you used dHybrid funds? Did you divert funds to uPillar.com?
47. When you reached out to Ryder Systems about an investment in dHybrid in 2011, you said that the Swift contract was for $250 million, when the actual agreement only shows it was $16 million. Why the large discrepancy?
48. In another dHybrid presentation, you claimed the Swift contract was for $300 million. What evidence can you present that shows your Swift contract was for $250-$300 million, and not the $16 million in the actual agreement?
49. Did you claim to sPower that you had finished the dHybrid system and then misrepresent its results to them, as alleged in their lawsuit ?
50. When you launched dHybrid Systems in 2012, why did you claim in marketing materials to have started the business in 2011?
51. In 2018 you were sued by your former CFO. What were the allegations in the complaint, which is now sealed?
52. You claimed Nikola owned its own natural gas wells, then re-affirmed that you "still have them" when later asked what happened to them. Can you provide any documentation proving Nikola owns/owned natural gas wells?
53. Have you ever deceived anyone?

# *Our Conclusion: Nikola is a Massive Fraud Constructed on Dozens of Lies*

Sometimes people misspeak by accident. No one has a perfect memory, and we all occasionally get things wrong.

But what we have witnessed at Nikola, and specifically from Trevor Milton, is a pattern of well-planned and deliberate acts of deception ranging from (a) the staging of non-working products as if fully functional, wrapped in numerous lies about capabilities that don't exist; (b) the staging of misleading videos, which require extensive premeditation, planning and execution; (c) material lies about capabilities, partnerships and products that simply do not exist at all, on video and often in front of entire rooms full of people; and (d) a culture of secrecy and intimidation that to this point has largely kept it all under wraps.

We think Trevor Milton is incapable of telling the truth. We believe he lies like most people breathe. It is natural for him, and our extensive review of his history suggests it has been this way throughout his entire business career.

Every now and then a story comes around that exposes how little the "experts" really know. Theranos had inked partnerships with Walgreens, Safeway, and Cleveland Clinic and had staffed its board with luminaries. Madoff raised billions in capital from sophisticated investors across the globe.

The remarkable thing about Nikola's story is not that someone like Trevor Milton exists, but that he has managed to parlay his stories and lies into deals with some of the best manufacturers and partners in the world by claiming to own vast proprietary technology and having successfully built revolutionary products that simply didn't exist.

He transformed these deceptions and false promises into an empire that at one point was valued at $34 billion, larger than Ford and Fiat Chrysler . He's signed deals with GM, Anheuser Busch, Bosch, Worthington, and a slew of significant automotive players. He received investment from Fidelity and ValueAct, among other name-brand institutions.

We truly think Nikola is both a sign of the times and a story for the ages.

# Appendix: Additional Backstory

## 2005: Trevor's First Business—A Local Security Company, Where He Apparently Burned Parties on Both Sides of a Deal

Trevor's business career began when he was in his early twenties and opened a company that sold security systems door-to-door in St. George, Utah. Trevor described the resulting early success in an interview : "I built that company up and within about a year or two I had sold it for almost two million dollars, and I thought I was on top of the world."

The company, called St. George Security and Alarms, was registered in 2004, according to the Utah Secretary of State website. Two years later, Trevor and a business partner sold the company for a payment of $300,000 up front and monthly payments of around $5,000 that brought the total purchase price of the business to $850,000, according to the buyer, who we interviewed.

The buyer told us that he realized soon after purchasing the business that it was not as Trevor had portrayed it; pending contracts fell through and it turned out that customers had been overpromised during the door-to-door sales process. The buyer put the business back to Trevor, as the purchase agreement allowed, and took a complete loss of $300,000. Trevor then re-sold the business a second time to another company in Salt Lake for an unknown sum, he said.

Notably, when we contacted Trevor's business partner, he said he received about $100,000 from the sale – about what he put into the business – and that it was news to him that the buyer agreed to pay more than the initial upfront payment or that the business had been sold a second time. He also said that if Trevor sold the business for $2 million then Trevor owes him $900,000.

It's unclear whether Trevor actually became a millionaire two years after founding his first business, but he had already allegedly burned a business partner and the acquirer of that business.

## July 2009: Trevor Launched uPillar.com, a

# *Website He Claimed Had 80 Million Monthly Active Users, Invented the Online Shopping Cart and Was Beating Amazon*

# *Former Employee: 80 Million Users Claim is "Absurd". uPillar Was a Failed Craigslist/eBay Clone and The Shopping Cart Was Invented in 1994*

Trevor's account of his rise in the business world follows the "$2 million" alarm company sale with claims he reinveste d the money from the alarm company into uPillar.com, a website he launched in July 2009. The site offered free classified ads and monetized by charging car dealers to sell used cars online.


(Pictured: Scan of Trevor Milton uPillar business card from former employee)

These days in interviews, Trevor describes uPillar as a rapidly growing company that was beating Amazon and eBay :

> *"[It was] way ahead of its time actually…we were beating Amazon at what they were doing.*
>
> *We had the first ever shopping cart in history. No one else had ever developed a*

*shopping cart to buy 50 items from 50 different sellers, checkout at one time…the first group in the world to really do that. We beat Amazon, we beat eBay…"*

*"Ultimately* ***we would have ended up being Amazon*** *but we were in Utah and at the time Utah had no clue what investment was around the internet. So, we just grew too fast and that was a lesson for me at that time was not to grow too fast."*

In a recent interview with Forbes , Trevor claimed uPillar had 80 million monthly users. Websites at the time describe uPillar as "only reporting on average around 200k monthly visits" and as spending big on advertising to get a temporary bump , then watching its usage subsequently tank.

We spoke with a former employee who called the claim of 80 million monthly users "absurd". They said of the site:

*"Much of our time was spent approving classified postings. We were always able to keep up with it, with only a few of us approving them." (Because of the low traffic).*

*"Many of the ads were posted by scammers from overseas, so we constantly rooted those out by identifying I.P. addresses."*

*"The website failed to deliver a product to rival eBay. Our mass uploader feature was supposed to be able to compete with eBay, and we were trying to deliver it to customers before eBay raised its listing fees, but we weren't able to. Many users weren't able to move their storefronts from eBay, because our website couldn't facilitate the mass product info. Users were stuck using eBay."*

The former employee also told us:

*"Amazon was not talked about a competitor…eBay and Autotrader were."*

For reference, uPillar launched in 2009 . It did not have the first shopping cart, and it was not beating Amazon. The first online shopping carts were used in 1994 , the same year Amazon was founded . By then, Google had processed almost 800 billion searches , and the iPhone had been

in existence for 2 years. Amazon had existed for 15 years and reported over $4.6 billion in general eCommerce sales excluding books.

# *Disclosure: We are short shares of Nikola Corp (NASDAQ:NKLA)*

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[1] Additional sources [ 1,2] put the cost of hydrogen production for vehicles at $16.63/kg and $16.51/kg. Costs are coming down. A 2011 DoE report states that at $4/kg hydrogen would reach parity with fossil fuels. Recent reports by industry sources, including the Hydrogen

Council and Shell and by investment groups including Goldman Sachs and Kepler Cheuvreux, envision hydrogen coming down 50% over the next 5-10 years. That all being said, it hasn't happened yet, and Nikola appears to have done nothing to advance the process despite its claims to have already achieved breakthrough levels.

# TAB 5

# GrowGeneration: This Latest Euphoric Retail Stock Has The Brightest Management Red Flags We've Ever Seen—70% Downside

Published on August 21, 2020



- GrowGen is a roll-up of small mom and pop gardening shops. With the whole industry getting a financial temporary benefit from COVID-19, its stock has surged almost 108% in a week on the back of strong quarterly sales and retail investor enthusiasm.
- GrowGeneration's management team is one of the most questionable we have ever seen at a public company. Top executives have extensive ties to alleged pump & dump schemes, organized crime and various acts of fraud.
- President & Co-Founder Michael Salaman was alleged by the FTC to have engaged in scheme to sell consumer credit card information without authorization. He has an extensive career in penny stock failures alongside his father, Abraham Salaman, a twice-convicted fraudster with ties to the mob.

- At Michael Salaman's last public company, Skinny Nutritional Corp, he selected a CFO who had previously spent 3 years in prison for bank fraud. A key shareholder/landlord, known as "the Godfather of payday lending" was later sentenced to 14 years in prison in a massive racketeering case.
- All the Skinny Nutritional Corp directors resigned amidst securities fraud allegations and complaints that management failed to provide the board with basic financial information. The company eventually filed for bankruptcy.
- GrowGen CEO & Co-Founder Darren Lampert is a securities lawyer turned penny stock broker. Lampert spent the former half of his career defending several boiler room brokerages, including individuals with deep ties to the mob, and the second half operating at brokerages including several that came under scrutiny from regulators or prosecutors.
- For example, CEO Lampert has personal and business ties to Robert Cattogio, who was sentenced to 12 years in prison in 2001 in what the government at the time dubbed "the largest securities fraud ever prosecuted".
- CEO Lampert later worked at several questionable trading operations including Hold Brothers (expelled by FINRA) and Incremental Capital (founders were arrested for insider trading).
- GrowGen CFO Monty Lamirato has previously been sanctioned by the SEC over allegations of professional misconduct. He had a history of working for failing penny stock companies prior to joining GrowGen.
- GrowGen's auditor Plante & Moran was reported to have missed major fraud at one of its key clients. Its latest PCAOB inspection report detailed a laundry list of audit failures and some of the firm's clients consist of failing OTC companies.
- Purely on a fundamental/valuation basis, without the alarming warning signs above, we see 60% downside to shares of the company. The company trades at an extremely rich 60.5x adjusted estimated 2020 EBITDA and over 6.1x estimated 2020 sales.
- Management seems to agree with our valuation assessment. The company completed a financing at $5.60 per share, reflecting a 70% discount to current levels.
- Insiders and key holders, including the CEO, President & Co-Founder, and private equity backers have sold stock aggressively this year in the $4-$8 range.

*Initial Disclosure: After extensive research, we have taken a short position in shares of GrowGeneration. This report represents our opinion, and we encourage every reader to do their own due diligence. Please see our full disclaimer at the bottom of the report.*

## *Basics on the Business: An Acquirer & Operator of Grow Shops with A Stock That Has Recently Caught Fire Among Retail Investors*

GrowGeneration Corp. is an operator of grow shops, which provide gardening supplies to both individuals and businesses focused largely on the cannabis niche.

The company was incorporated in Colorado in 2014 and subsequently acquired four existing hydroponic supply stores. [ Pg. 1] It grew from there and now owns 28 locations with plans to continue acquiring and integrating new shops. The company uplisted to the NASDAQ in December 2019.

## *The Good News: Gardening Is One of the Few Brick & Mortar Businesses That Have Experienced a COVID Tailwind. Our Channel Checks Found That Sales at GrowGen's Stores Have Indeed Increased Substantially But Some Caution May be Warranted*

Starting with the good news, GrowGen reported an impressive quarter, showing year-over-year same-store-sales growth of 49% and strong revenue growth.

The gardening business has experienced a wave of renewed interest due to lockdown and isolation measures resulting from the global pandemic. We called all the stores in the locations where the company says it's posting biggest growth in order to perform channel checks:

- A manager in West Lansing Michigan told us "we've been pretty much booming…the biggest challenge is getting people to wear their masks but otherwise its going pretty smooth for our industry."

- An assistant manager in Livonia, Michigan told us: "Actually it's kind of crazy 'cuz since the beginning (of coronavirus) business went up, we've been significantly busier than we've ever been before."

- A manager in the Brewer Maine location told us "I would say we're up probably 40 percent. I guess that will drop off toward the winter."

All the store managers and employees we spoke with provided similar positive feedback, confirming that business has increased substantially since COVID.

## *The Stock Has Run Well Past the Numbers: We See 60% Downside Purely on a Valuation Basis and Prior to our Findings on Management Detailed Below*

The tailwinds have fueled an already surging stock. GrowGen's stock has surged almost 108% in a week, helped by the quarterly numbers coupled with media appearances by a management

team that has been active about telling the company's story.

The stock now trades at over 60.5x adjusted estimated 2020 EBITDA and over 6.1x estimated 2020 sales.

We see 60% downside reflecting purely a rationalized valuation for the following reasons:

- The stock is priced absurdly rich even under a best-case scenario. This is clearly driven by retail momentum & euphoria.
- The COVID surge is not likely to be permanent. As the pandemic eases and people get back to work, we expect growth will ease.

Management appears to agree with us. On June 30th, less than two months ago, the company issued stock at $5.60 per share, a 70% discount to current levels. The initial deal was announced on June 10th and shortly thereafter GrowGen requested an exemption from the SEC to accelerate its registration to complete the financing. ( On June 26th)

We can also take guidance from insiders and key holders including the CEO, President & Co-Founder, and private equity backers whom have sold aggressively this year in the $4-8 range (56-78% discount to current levels) for total proceeds of ~$14 million and a meaningful portion of their holdings. (Source: FactSet)

We note some caution on their growth by acquisition strategy here as although the company is tucking in one 'mom and pops' after another, it appears that social media reviews of stores deteriorate after acquisition.

Nonetheless, bulls would likely argue that the business is positioned well to consolidate its industry niche and grow into its numbers with the backing of strong management.

And that brings us to what we view as the overriding problem with GrowGeneration.

# *GrowGeneration's Management Team Is Poison: An Extensive History of Ties to Organized Crime, Penny Stock Bankruptcies and Failures, Fraud Allegations and Regulatory Infractions*

In the remainder of the report, we examine GrowGeneration's key management and board and show why we think that while the company has an interesting business model, the investment should be avoided at all costs.


## *Part I: President & Co-Founder Michael Salaman—Extensive Ties to Organized Crime, Fraud Charges by the FTC And A Career of Controversial Penny Stock Failures*

Michael Salaman is credited on GrowGeneration's website as being one of two company co-founders.

(GrowGeneration Co-Founder & President Michael Salaman)

We did a thorough review of Salaman's background and found that he has a storied career that includes, among other things:

- Extensive business dealings with his father Abe Salaman, a twice-convicted stock fraudster with ties to the mafia.
- Operating multiple now-bankrupt or defunct penny stocks that failed amid controversy.
- Allegations of fraud by the FTC.
- Allegations of fraud by shareholders and improprieties by the board of his previous public company.
- Association with the "Godfather of Payday Lending", who is serving 14 years in prison after being found guilty of a massive racketeering scam.

## *Skinny Nutritional: A Public Company Run into the Ground by Michael Salaman*

## *Bad Sign: The Company's CFO Had Previously Served 3 Years in Jail for Bank Fraud. Salaman Hired Him Anyway*

Prior to starting GrowGeneration, Salaman was CEO and founder of Skinny Nutritional, which sold fruit-flavored, zero calorie water.

The company started in 2000 and traded on the pink sheets, experiencing a rocky path to eventual bankruptcy in 2013. One harbinger of the company's eventual ruin could have been Salaman's selection of a CFO, an individual that had previously served 3 years in jail for bank fraud.

That CFO, Donald McDonald, had prior overlapping work experience with Salaman. They both worked at infomercial maker National Media Corp, another penny stock that failed following the

fraud charges against Salaman and others brought by the FTC (detailed further below).

The overlapping work history indicates to us that Salaman was familiar with McDonald's imprisonment, but hired him anyway. Below is an excerpt from a media article on the subject:

The Philadelphia Inquirer

## Skinny Water's uphill run

by Joseph N. DiStefano, Posted: August 26, 2010

.....

Salaman and McDonald have long business resumes. McDonald, a Villanova graduate and the oldest son of a prominent Philadelphia doctor, worked for infomercial maker National Media Corp. in the 1980s and early 1990s, and was also head of direct marketing at nude-movie distributor Spice Direct Entertainment Co., among other jobs. In 1982, he was convicted of bank fraud against another former employer, Beneficial Savings Bank, and spent three years in the federal prison in Allenwood, Pa. Federal securities law doesn't require him to list that on company filings because it's been more than 10 years. "It was a long time ago," McDonald told me. Sasso's firm represented the bank at the trial.

### *Skinny Nutritional's Key Shareholder and Landlord, Known as "The Godfather of Payday Lending", Was Later Sentenced to 14 Years in Prison Over a Major Racketeering Scheme*

### *Michael Salaman is Still Friends with the "Godfather" on Facebook*

In addition to selecting a convicted felon as CFO, Skinny Nutritional made an unusual choice for its landlord. SEC filings show it leased office space from Hallinan Capital, run by Charles Hallinan. [Pg. F-36] Hallinan also owned a 5.3% stake in the firm, making him a key shareholder. [Pg. 46]

Hallinan was sentenced to 14 years in prison in 2018 and stripped of $64 million after a jury found he was the mastermind behind a major racketeering scheme to defraud borrowers through his payday loan empire. He was found guilty on 17 counts including fraud and international money laundering.

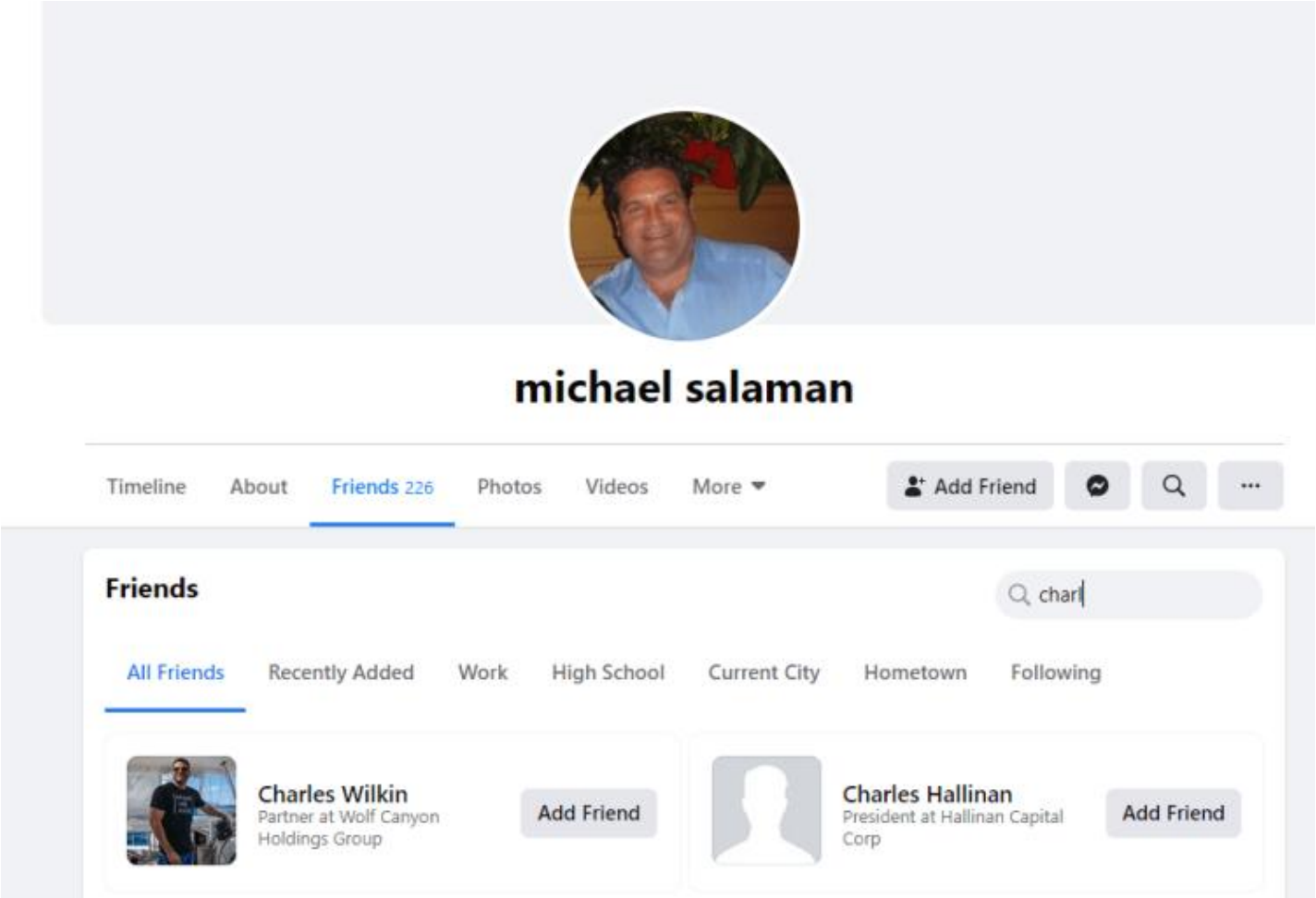
Local media dubbed him the " Godfather of payday lending ".

The Philadelphia Inquirer

# Federal jury finds Main Line payday lender Hallinan guilty of racketeering conspiracy

by Jeremy Roebuck, Posted: November 27, 2017

In case there is question of whether it was merely a relationship of landlord and tenant, Michael Salaman's Facebook account (which we expect may soon become private) lists Hallinan as a friend:




*Skinny Nutritional Declared Bankruptcy Following Mass Director Resignations Over (a) Failure to Provide Financials and (b) Undisclosed Lawsuits Alleging Securities Fraud, Among Other Issues*

In 2013, all board members except for Salaman resigned amidst securities fraud allegations and allegations that management had failed to provide board members with basic information to perform their oversight roles.

The three resignation letters were scathing. See one resignation letter below:

zuckerman | honickman

January 17, 2013

Mr. Michael Salaman, CEO
Skinny Nutritional Corp
1100 East Hector Street
Suite #391
Conshohocken, PA 19428

Dear Michael,

This will confirm that I am today resigning from my position as a member of the Board of Directors, and any related committees and/or duties, of Skinny Nutritional Corporation ( the "Company"), effective immediately.

I am doing so because I do not have confidence that I am being kept informed of facts and events that involve the Company, and bear directly on my responsibilities as a Director of the Company. Specifically and by way of example, it was only well after the fact that I was told that (i) the Company's D & O insurance coverage had been allowed to lapse for non-payment of premium, and (ii) a lawsuit had been filed against the Company in July, 2012 alleging fraud, misrepresentation and unfair trade practices in connection with the plaintiff's purchase of the Company's shares. I am greatly concerned that there may have been other critical facts and circumstances in the past, and may be others in the future, which will also not be brought to my attention in a timely fashion, if at all.

Please convey my best wishes to the Board for the future success of the Company.

Sincerely
/s/ Michael Zuckerman
Michael Zuckerman

A second board member wrote the following in their resignation letter :

> *"Although it has been clear for some time* ***that the Company has not been willing to freely provide to Board members i basic, essential, financial, production and sales information, and ii forecasting for internal and investor purposes,*** *I had remained patient, hoping that these institutional problems would be addressed, due to the repeated assurances from management that the solutions being suggested by various Directors would be put into place. Ultimately, I have had to recognize that, for whatever the reasons,* ***the Company will not correct these serious problems****"*

A third board member wrote the following in their resignation letter :

> *"This has been a difficult decision for me, as I have been working hard for quite some time to improve the Company's (i) ability and willingness to provide basic, essential, financial, production and sales information to the Board, and (ii) forecasting for internal and investor purposes. Among the various ways I tried to resolve these institutional problems, I brought in a former CFO at MBNA at my own expense to work with the Company, but ultimately was forced to recognize that, despite repeated assurances from management that the suggested solutions and inter-company communications were necessary, appropriate and would be implemented,* ***the Company was unwilling to correct these serious problems"***

Unsurprisingly, Skinny Nutritional's serious problems landed it in Chapter 11 bankruptcy shortly thereafter.

Case 13-13972-jkf Doc 219 Filed 01/15/14 Entered 01/15/14 14:35:52 Desc Main
Document Page 1 of 198

**IN THE UNITED STATES BANKRUPTCY COURT**
**FOR THE EASTERN DISTRICT OF PENNSYLVANIA**

| | | |
|---|---|---|
| In re: | ) | Chapter 11 |
| | ) | |
| Skinny Nutritional Corp., | ) | Case No. 13-13972 (JKF) |
| | ) | |
| Debtor. | ) | **Related to Docket No. 168** |
| | ) | |

To reiterate, Salaman hired a CFO with a questionable background and the company failed after the company failed to provide financials to its own board– this is not a nuance to ignore given that Salaman has a key role at GrowGen both on the management team and the board .

## *Michael Salaman's Early Investment Career Involved Acquiring/Running Penny Stock Shells with Father Abe Salaman*

## *Abe is a Twice-Convicted Fraudster with Extensive Ties to Organized Crime*

The sins of a father aren't always attributable to a son. But as we will show, Michael's father has an extensive background in fraud, and Michael's business dealings with his father have been deeply intertwined.

Abe Salaman has been convicted of fraud twice. The first involved a guilty plea in the 1970's to an indictment alleging he helped rig the price of a stock on the Philadelphia exchange.

In the early 90's, a company Abe Salaman worked for, National Media, had accused him of insider trading. In 1992, a jury found in Salaman's favor in that case. Son Michael was working at the same company during this period, according to his SEC biography which placed him at National Media from 1985-1993. [ Pg. 22]

Abe Salaman's second conviction came as part of a wide-sweeping probe into organized crime on Wall Street around 2000. According to the New York Times, a pre-dawn raid involving nearly 100 federal agents arrested 11 people charged in the stock scheme.

Those arrested included the brother of famous mafia hitman Sammy Gravano, a captain in the Bonnano crime family, and two members of the Russian mafia. The scheme involved multiple pump and dump stock frauds, which collectively roped in thousands of victims.

The New York Times

## 19 Charged in Stock Scheme Tied to Mob

By Alan Feuer

March 3, 2000

The scheme was straight out of a Hollywood pitch meeting, the authorities said: "Goodfellas" meets "Boiler Room." For nearly three years, they explained, a cadre of stockbrokers cheated unsuspecting investors out of $40 million -- with the support and muscle of the New York mob.

Michael Salaman's father, Abe Salaman, was indicted on three counts of racketeering conspiracy and securities fraud, according to court records and media reports. He pleaded guilty in 2001.

*Michael Salaman: Previously Charged by the FTC Over Selling Credit Card Numbers as Part of a Telemarketing Scheme at a Company Vice-Chaired by his*

*Father*

According to Salaman's biography filed with the SEC, he began his career as VP of business development for National Media Corp, an infomercial marketing company. [ Pg. 22] His father Abraham Salaman had served as Vice Chairman of the board of the same company during part of Michael's employment and was later accused of insider trading in stock of the company, as referenced above.

In 1996, Michael Salaman, along with others and the company, were charged by the FTC with victimizing 2,682 consumers across the nation as part of a telemarketing scheme in which the defendants allegedly trafficked consumers' credit card numbers without their consent.Below are excerpts from the FTC release on the charges .

FEDERAL TRADE COMMISSION
PROTECTING AMERICA'S CONSUMERS

Contact | Stay Co

## 2,682 Victims of Credit Card Number Trafficking Scheme To Get Partial Refunds

April 2, 1996

FOR RELEASE

The Federal Trade Commission announced today that it has distributed funds out of a $292,500 redress account to 2,682 consumers across the nation who were victimized as part of a telemarketing scheme in which the defendants allegedly were trafficking in consumers' credit card numbers. According to the FTC, the victims had agreed only to use a 3D camera on a free-trial basis, but the defendants already knew the consumers' credit card numbers and each of the consumers' accounts was charged without their knowledge or authorization. The FTC obtained a

.....

The FTC first announced the case in December 1994, when it filed both a complaint detailing alleged law violations and a settlement of those charges in federal district court. The FTC's complaint names Capital Club of North America, Inc.; Philip A. Herman Marketing Consultants, Inc.; List Marketing Management, Inc.; Subscription Services, Inc.; National Media Corporation; Media Arts Publications, Ltd.; Business Publications, Inc.; GLS Direct, Inc.; NIS of South Jersey, Inc. (both the New Jersey and Florida corporations); Philip A. Herman; Michael Salaman; Ross Housley and Rocco Petrucelli. The defendants do business primarily out of New Jersey and Pennsylvania.

Later in 2001, National Media Corp filed for bankruptcy following a name change.

*Michael Salaman's Slew of Questionable Deals with Father Abe, Resulting in Numerous Penny Stock Failures*

Salaman and father Abe went on a spree of deals throughout the 1990's and 2000's that regularly ended in ruin for shareholders.

**American Interactive Media AIME" : A Company Run by Michael Salaman With the uiet Backing of His ather, Which Cratered and Deregistered its Securities ollowing a Stock romotion Run**

According to Michael Salaman's biography filed with the SEC, following his stint at National Media Corp, he then started a digital media company called American Interactive Media, Inc. ("AIME"). Pg. 22] Michael's name shows up on the company's SEC filings, but father Abraham Salaman masked his ownership in the enterprise through an entity called Mountain Ranch Partners.

SEC filings show that the Mountain Ranch entity, with its unstated owners, received discounted shares and warrants in the company through a private offering. [ Pg. 41]

shares of Common Stock at an exercise price of $3.52 per share. AIME also issued warrants to Mountain Ranch Partners for the purchase of 500,000 shares of Common Stock at an exercise price of $1. The Preferred Stock and the warrants were sold in a private offering pursuant to an exemption under Section 4(2) of the Securities Act. Each share of Preferred Stock has a stated value of $315 and a liquidation value of $1,000. The holder of the Preferred Stock is entitled to an 8% annual cash dividend, which dividend

41

According to New Jersey corporate records , Mountain Ranch Partners was controlled by Abe Salaman.

C-124P 7/03

New Jersey Division of Revenue

**Certificate Of Withdrawal**
For Use by Foreign Profit Corporations
(NJSA 14A:13-8)

DPP RECEIVED JUN 08 2009

BY: _____

0100901747

1. Name of Corporation: Mountain Ranch Partners, Inc
2. Corporation Number: 0100-9017-47
3. Incorporated under the laws of: Colorado
4. The corporation is not transacting business activities in New Jersey.
5. The corporation hereby surrenders its authority to transact business activities in New Jersey.
6. The address to which the Treasurer, State of New Jersey may mail a copy of any process against the Corporation that may be served is: Corporation Service Company
   Street and postal designation: 830 Bear Tavern Rd
   City: W. Trenton State: NJ Zip Code: 08628
7. Date of Adoption: 5-1-06

Signature: Abraham Salaman Pres Date: 2/20/09
(Must be Chairman of the Board, President or Vice President)

Type Name and Title:
Abraham Salaman, President

We saw no disclosure stating that Mountain Ranch was a related party. According to a New York Post article , now available in web archives, Abe hired a Florida penny stock promoter to hype shares in the company, which subsequently cratered.

SEC records show that AIME later had its securities registration revoked after failing to file timely periodic reports.

**Americas Shopping Mall: Michael and Abe Were Both Involved in this Near Total Investment Loss and a Scandal that Resulted in Connecticut's State Treasurer Requesting a ederal robe**

In 1999 Abe Salaman also turned up alongside son Michael in a scandal that drew the scrutiny of the Treasurer of Connecticut. Approximately $9 million in state pension money was invested

into a company called Americas Shopping Mall as both Michael and his father, along with other stockholders, registered to sell their stakes.

The investment ultimately went bust, resulting in Connecticut's State Treasurer requesting a Federal probe into the suspicious connections.

**Neurocorp: Another Salaman Shell Company Involving Michael and Abe That Later Collapsed**

Around 1996, Abe Salaman took a company public called Neurocorp that eventually ran treatment centers for people with dementia, schizophrenia, depression, and other mental health disorders. [Pg. 38]

Michael also held a stake in the business, along with two brothers. [Pg. 20, Pg. 38]

**The entity appears to be defunct**: as its last SEC filing is a notice that it's annual report would be late, followed by nothing.

Collectively, the extensive ties between Michael Salaman and numerous penny stock failures and individuals associated with fraud should be alarming, given his role in GrowGen's management and the board.

## *Part II: CEO & Co-Founder Darren Lampert's Professional and Personal Dealings with Individuals Associated With Organized Crime and Sanctioned Brokerage Firms*

Darren Lampert has been GrowGen's Chief Executive Officer and a Director of the company since its founding in 2014.

Lampert is an attorney by trade. According to the company's most recent 10-K, Lampert "began his career in 1986 as a founding member of the law firm of Lampert and Lampert (1986-1999), where he concentrated on securities litigation, NASD [now FINRA] compliance and arbitration and corporate finance matters."

His bio in the annual report also discloses that he "has represented clients in actions and investigations brought before government agencies and self-regulatory bodies."

What his bio doesn't note, however, is that as an attorney and as a broker, he has a long history of involvement with individuals associated with organized crime and penny stock boiler rooms.

### *Lampert's Time at Hold Brothers Between 2005 and 2007 Has Been Omitted From His GRWG And LinkedIn Biographies. We Think We Know Why.*

GrowGen's bio for Lampert details his time before 2005 and after 2007, stating:

> *"…15 years working as a portfolio manager and proprietary trader at Schonfeld Securities (1999-2005), Schottenfeld Group (2007) and Incremental Capital (2008-2010)." Pg. 22]*

Absent from Lampert's bio in GrowGen's annual report (but visible on his FINRA Broker Check record) is his time working at Hold Brothers Online Investment Services between 2005 and 2007.

Lampert's LinkedIn also fails to mention his time at Hold Brothers and conflicts with his official bio, stating that he was at Schonfeld Securities through January 2007. His FINRA Broker Check file says he was only at Schonfeld Securities through 2004 – a three-year difference.

FINRA now lists Hold Brothers as having been "expelled" in November 2012.


Prior to that, Hold Brothers was a firm that was **censured and fined 3. million for manipulative trading activities, anti-money laundering AML , and other violations,"** according to a September 2012 FINRA press release :

News Release

September 25, 2012
Michelle Ong (202) 728-8464
Nancy Condon (202) 728-8379


# FINRA Joins Exchanges and the SEC in Fining Hold Brothers More Than $5.9 Million for Manipulative Trading, Anti-Money Laundering, and Other Violations

The press release notes that:

> *"Between Jan. 1, 2009 through Dec. 31, 2011, Hold Brothers' largest account and an affiliate were day-trading firms wholly owned and funded by Hold Brothers' principals" and that these entities "engaged traders and trading groups in various foreign countries, primarily China, to trade its capital."*

These foreign entities "used sponsored access relationships with Hold Brothers to connect to U.S. securities exchanges to manipulate the prices of multiple securities" including "hundreds of instances where the foreign day traders used spoofing and layering activities to induce the trading algorithms of unwitting market participants to provide the traders with favorable execution pricing that would not otherwise have been available to them in the absence of the day traders' illicit spoofing and layering activities."

## *Lampert's Time at Hanover & Company, Circa 2002, a Brokerage Firm With Extensive Ties to the Mob*

Hold Brothers is not the only portion of Lampert's work history that appears to have been omitted from his GrowGen and Linkedin biographies. Both also fail to mention his time at Hanover & Company.

**A bankruptcy case filed in March 2002 revealed that Lampert was an attorney for Hanover Company, a brokerage firm that had extensive ties to the mob.**

The defendant in the case, Anthony Siclari, "testified that Darren Lampert, attorney for

Hanover, prepared the loan documentation" for a transaction highlighted in the lawsuit.

Siclari was a former account holder at Hanover and "profited from Hanover fraudulent activity," the case reads, "and then engaged in transactions to take those gains out of his Hanover account, both for his own benefit and to pass them on to Hanover personnel or Hanover itself."

Siclari's account was alleged to have been the "beneficiary of violations of securities laws perpetrated by Hanover officials — most significantly, Robert Catoggio, ("Catoggio"), the trader for Mr. Siclari's account and Mr. Siclari's friend since boyhood, who pleaded guilty to securities fraud."

In 1997, Catoggio had been arrested for conspiring to manipulate the market alongside two other individuals, one of whom, Louis Malpeso was alleged to be an associate of the Colombo Crime Family.

Then, in 1999, Catoggio was charged as part of a group of 85 individuals for a "Mob Connected" $100 million stock scam. He was, at the time, already serving 18 months in prison for another stock fraud scheme.

Alongside Catoggio, Hanover was run by Roy Ageloff, who was "already infamous on Wall Street for running high-pressure boiler rooms that touted obscure stock offerings," according to a 2017 Variety article :

> *"In July 1996, Fortune called Hanover a 'lowlife brokerage firm,' and noted that the FBI was looking into questionable IPOs," the article reads.*

According to the article , Catoggio allegedly funnelled money to the Genovese crime family and that Ageloff was sent to prison in 2001:

> *"Ageloff and his associates were indicted in June 1999, and accused of swindling investors out of $150 million in a series of 'pump and dump' schemes" and "prosecutors alleged that Catoggio funneled millions of dollars in proceeds to a captain in the Genovese crime family, whose stepson was one of the brokers who pleaded guilty. Ageloff pleaded guilty in 2000 and was sent to a medium-security prison in Florida in 2001."*

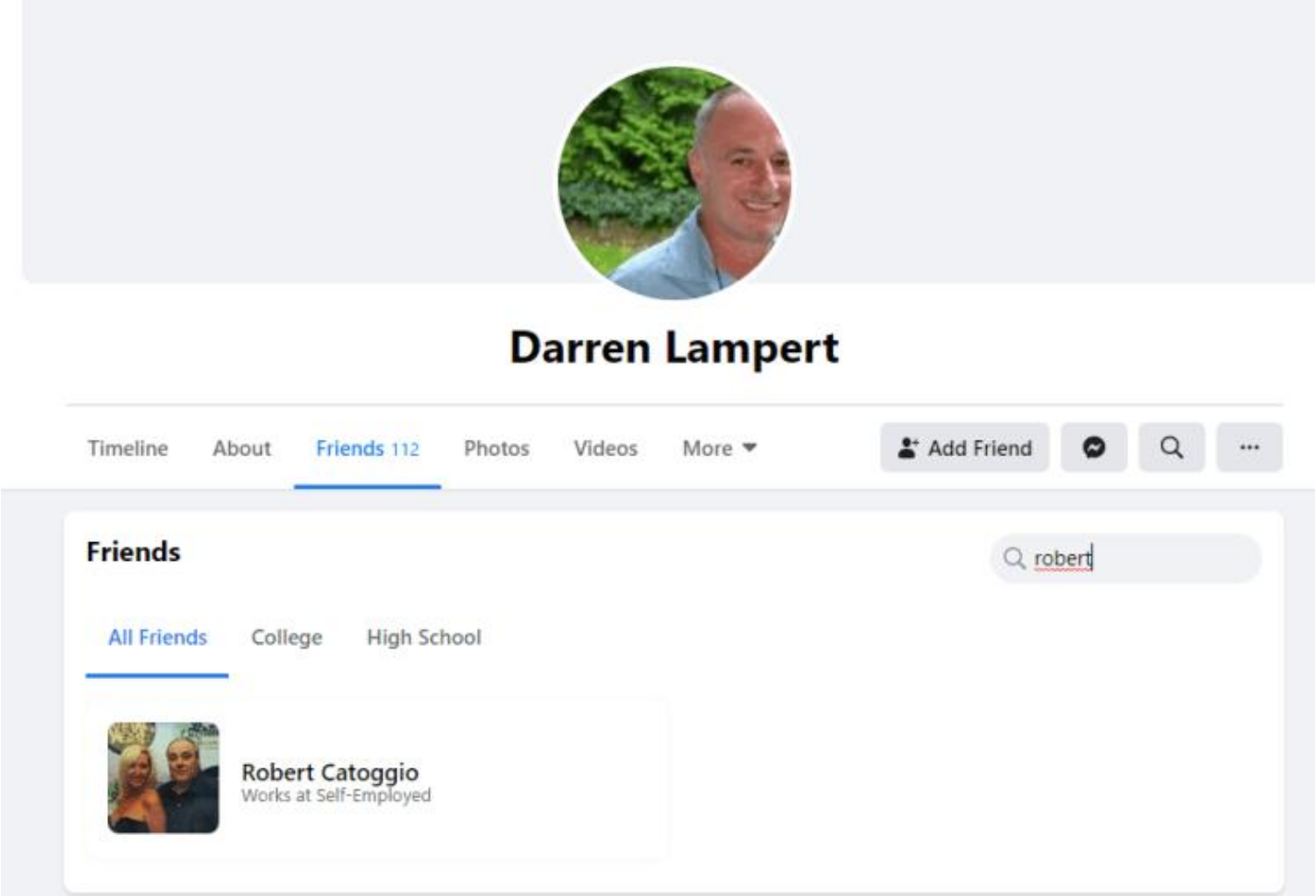
*Lampert's Ties with Convicted Mob-Associated Stock Fraudster Robert Catoggio Appear to Continue to this Day*

*The CEO and the Catoggios are Facebook Friends. In April This Year Lampert "Liked" a Photo of Ronald Catoggio's Homemade Pasta*

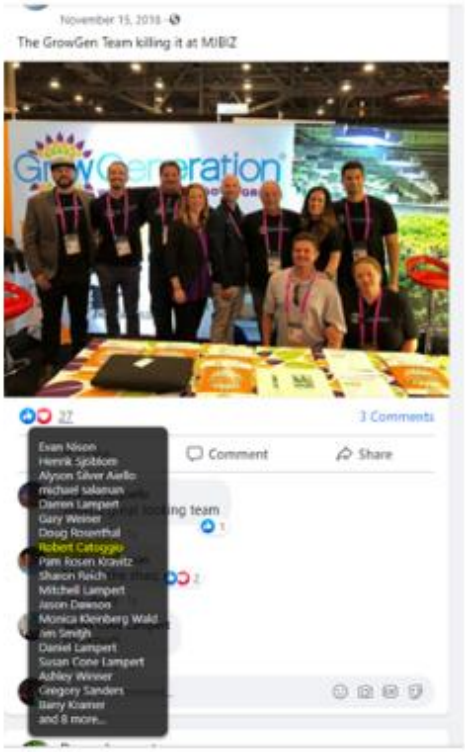
We wondered exactly how deep Lampert's ties with Catoggio run. We figured that if they had a purely business relationship as peers at Hanover, both would have likely moved on once the brokerage firm imploded.

After examining Darren Lampert's social media posts, it appears their relationship is still relatively close.

For starters, on his Facebook profile, Lampert is friends with Robert Catoggio.



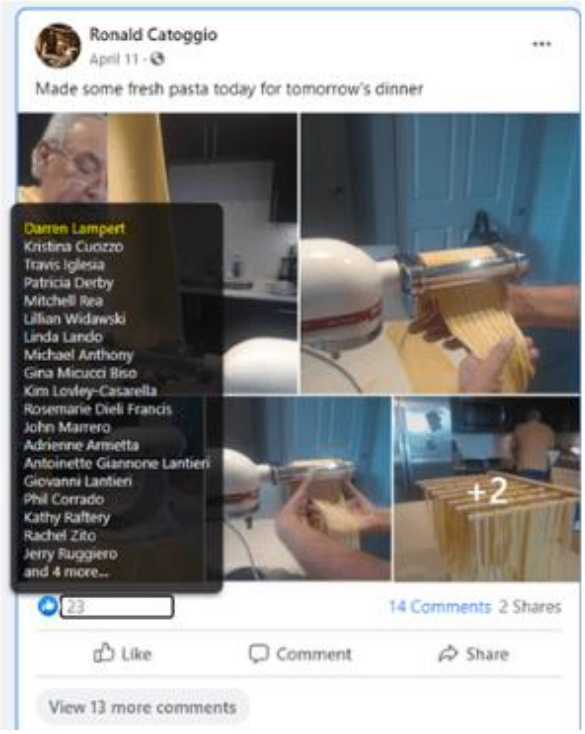

Robert Catoggio has also engaged with Darren over the years (Darren's profile is private so his posts are sparse). The last post we could find where Robert engaged with Darren is from November 2018. It is a picture of the GrowGeneration team.




Robert Catoggio is also connected with Mitchell Lampert, Darren's brother and GrowGen's legal counsel, on Facebook.

Lastly, Darren is connected to Ronald Catoggio, also named as a defendant alongside Roy Ageloff and Robert, who is believed to be a relative.

As of April 11, 2020 of this year, Darren Lampert liked that Ronald Catoggio was making some fresh pasta for dinner:




### *Lampert Also Spent Time at Incremental Capital, Whose Founders Were Arrested as Part of the Sweeping Insider Trading Probe That Took Down Raj Rajaratnam*

Lampert's bio also notes that between 2008 and 2010, he worked at Incremental Capital in an unspecified role. Incremental Capital was a company founded in 2008 by the Goffer Brothers, who were part of a group arrested in 2009 as part of the infamous Raj Rajaratnam insider trading probe:

> *"The men were arrested and charged in November 2009, weeks after Rajaratnam's arrest in an investigation that extensively used FBI phone taps for the first time in an insider trading probe. Up to 60 recordings could be played at the trial."*

REUTERS

Zvi Goffer, one of the seven defendants in the Galleon insider trading case, leaves the Manhattan Federal Court after his arraignment in New York February 2, 2010. REUTERS/Jessica Rinaldi

The Goffer brothers were also "accused of bribing two lawyers at the prominent law firm Ropes & Gray with tens of thousands of dollars for secret information on takeover targets."

Zvi Goffer went on to be a trader at Galleon Group, the firm founded in 1997 by Raj Rajartnam that was closed in October 2009 after an insider trading scandal that led to Rajaratnam being sentenced to 11 years in prison.

Zvi was found guilty on 14 counts of conspiracy and securities fraud and was sentenced to 10 years in prison. He was also ordered to forfeit $10 million.

## *Lampert Had A History of Defending Boiler Rooms And Stock Scams At His Law Practice*

During Lampert's time as an attorney, he took on multiple cases involving boiler rooms and mob-associated individuals, which raises troubling questions in light of the above.

In Bondi v. Blinder-Robinson, et al, filed 5/3/1989 in New York Western District Court (6:1989cv00530), Lampert represented Blinder-Robinson and Co.

Blinder-Robinson was a penny stock brokerage firm that was charged by the SEC for overcharging its investors by more than $20 million over the course of 21 months. The company "marked up prices as high as 140 percent on penny stocks when selling them to investors."

Ultimately, the SEC "suspended Blinder Robinson from trading in penny stocks for 45 days and from underwriting such offerings for two years".

Lampert's father, Irwin Lampert – who was also former CFO of GrowGen, also appears to have been involved in Blinder Robinson.

He was originally named on the SEC's complaint against the company:

> *"In addition to Blinder-Robinson and Blinder, the SEC originally named the following corporations and individuals as defendants in this action: American Leisure, Cavanagh Communities Corp., Scope, Inc., Nathan S. Jacobson,* ***Irwin S. Lampert,*** *Joseph Klein, and Leon Joseph. These defendants all have entered into consent decrees with the SEC, and no longer are active parties in this litigation"*

His father was described as being close to the firm's founder and worked as counsel for the firm:

> *"Irwin Lampert, an attorney, has had a close personal relationship with Meyer Blinder since they met in Florida in 1972. Mr. Lampert was counsel for Blinder and Blinder-Robinson in an earlier securities case."*

Blinder, who was dubbed by media as the "Penny Stock King", had been sentenced to 46 months in prison in a fraud case.

## *All in the Family: Darren Lampert's Brother Mitchell, Who Serves as GrowGen's Legal Counsel, Also Has A History of Working With Boiler Rooms*

Darren Lampert's brother, Mitchell, with whom he worked with at Lampert and Lampert, also has a history of defending companies alleged to be penny stock boiler rooms.

Mitchell Lampert now works at Robinson  Cole, is listed as GrowGeneration Corp's counsel of record on the company website :


Interestingly, Mitchell's biography also doesn't mention his former firm "Lampert and Lampert" by name. Rather, it vaguely says "prior to joining Robinson  Cole, he was a partner in a mid-sized New York City-based law firm."

Previously, Mitchell Lampert was listed as defense counsel for Wellshire Securities when it was sued by the Securities and Exchange Commission in March of 1990.

According to the New York Times, "The S.E.C. charged that since July 1988, the 'normal business' of Wellshire has been to operate 'as a penny-stock 'boiler room," selling speculative over-the-counter securities of unseasoned companies to the investing public through the use of various abusive sales practices."

# S.E.C. Charges Brokerage Used 'Boiler Room' Tactics

By DIANA B. HENRIQUES

In a case that offers a wealth of detail about how penny-stock "boiler rooms" operate, the Securities and Exchange Commission filed suit yesterday against a New York brokerage house, accusing it of having used fraud, lies and fictional analysts' reports to sell high-risk stocks by telephone to investors across the country.

The civil complaint, filed in Federal District Court by the New York regional office of the S.E.C., names Wellshire Securities of New York; its president, Robert E. Cohen of Bedford, N.Y.; its executive vice president, Carol Martino of New York; a broker, Joseph Jenkins Jr. of Brooklyn, and two former employees.

In an unusual move, the complaint also named as defendants the officers of two small public companies, Ventura Inc. of Needham, Mass., and Environmental Landfills, of Harriman, N.Y., whose shares were sold by Wellshire. The complaint charges that Robert Beck and Richard Sands, both officers of Ventura, and Paul V. Winters Jr., chairman of Environmental Landfills, issued or endorsed misleading press releases and brokerage reports about their companies.

The S.E.C. charged that since July 1988, the "normal business" of Wellshire has been to operate "as a penny-stock 'boiler room,' selling speculative over-the-counter securities of unseasoned companies to the investing public through the use of various abusive sales practices."

According to the complaint, Wellshire began in June 1988 to hire novice brokers who were given no formal training or supervision. The complaint said the brokers made 100 to 400 unsolicited telephone calls a day, seeking buyers for the firm's speculative "house stocks," on which they earned very high commissions.

The S.E.C. is asking that the defendants be forced to give up any profits made on the stocks to compen-

Continued on Page D2

The article continued:

> *"Mitchell Lampert, the lawyer for the brokerage firm and its two top executives, said, 'Our position is that nothing has been done wrong by Wellshire or Mr. Cohen and Ms. Martino.'"*

On Sunday, September 23, 1990, the New York Times published a follow up piece on Wellshire called "The Scam Goes On".

INVESTING

# The Scam Goes On

*A Government crackdown has driven penny stock operators to invent new disguises.*

By Diana B. Henriques

DR. ENRICO S. MANGO, A LONG ISLAND ORthopedic surgeon, was growing suspicious of his stockbrokers at Wellshire Securities, a low-budget brokerage house based in New York City. During the spring of 1989, he had bought penny stocks — shares of companies too small to be listed on a stock exchange — recommended by a Wellshire broker and lost money on them. But that July, Dr. Mango bought again: 20,000 shares of Ventura, a fledgling leasing company based in Needham, Mass., at $1.50 a share.

After weeks of abbreviated phone calls, undelivered confirmation orders, vague answers and unfulfilled promises, Dr. Mango began to record his conversations with Wellshire brokers, including Edward D. Braverman. On Aug. 11, the surgeon taped the following exchange:

MANGO: So where do we stand then?

BRAVERMAN: Your 20,000 Ventura is trading at 3, and the stock is poised for its significant move.

MANGO: Before . . . it was going on 3¼, and about a week ago I thought it was 3½. Wasn't it up a bit before that?

BRAVERMAN: Yeah, it's been trading around, you know. [The broker explains that a lot of people had dumped the stock but Wellshire itself is still buying.]

MANGO: When do you think that something is going to happen with it?

BRAVERMAN: I think we're going to get a move now. Right now, in fact, it's being listed on the Vancouver this evening. [Braverman mollifies Mango with the promise that the stock price will now be publicly reported.] From Monday on, you can look at the newspaper . . . .

But information about Ventura and its stock price would not make the newspapers until much later, not until the Securities and Exchange Commission and Wellshire in March of this year. Ventura, it turned out, had not even applied for a listing on the Vancouver Stock Exchange. And its stock had in fact been quoted by another broker at a price as low as 25 cents a share in 1989 — if a buyer could be found. According to trading records assembled by the S.E.C., Wellshire constituted virtually the only market for Ventura shares and often failed to execute its customers' sell orders.

During its brief, wild run on Wall Street, Wellshire Securities had promoted stock in Environmental Landfills, a tiny company it portrayed as poised to cash in on the New York-area garbage crisis. It also touted an assortment of other penny stocks such as Greenleaf Capital, Nightwing Group, Diversified Foods and Treats Enterprises. But Wellshire's ride was cut short by regulators acting on evidence from Dr. Mango and other investors. The penny stock brokerage went out of business this spring after its license was revoked by the National Association of Securities Dealers, the industry's self-regulatory agency. Attorneys for Wellshire argued that the company should not have been held responsible for the actions of a few rogue brokers. Braverman could not be reached for comment on this article.

There are some legitimate penny stocks, and some professional money managers do trade profitably, if carefully, in this market. But after a decade of abuses by the con artists who have permeated the business, the S.E.C.

(Continued on Page 70)

*Diana B. Henriques covers Wall Street for The Times.*

The article notes that Wellshire was offering quotes for stocks where they "constituted virtually the only market" and they "often failed to execute its customers' sell orders".

It continues:

> *"During its brief, wild run on Wall Street, Wellshire Securities had promoted stock in Environmental Landfills, a tiny company it portrayed as poised to cash in on the New York-area garbage crisis. It also touted an assortment of other penny stocks such as Greenleaf Capital, Nightwing Group, Diversified Foods and Treats Enterprises. But Wellshire's ride was cut short by regulators acting on evidence from Dr. Mango and other investors. The penny stock brokerage went out of business this spring after its license was revoked by the National Association of Securities Dealers, the industry's self-regulatory agency."*

While we believe everyone deserves to be represented by adequate counsel, the sheer number of associations with penny stock fraud cases, boiler rooms, and mob-related individuals is quite

startling.

## *Part III: GrowGen CFO Monty Lamirato's Background Includes an SEC Order Alleging Three Years of Improper Professional Conduct and Working for Languishing Penny Stocks*

GrowGen appointed Monty Lamirato as CFO in mid-2017 when he replaced Irwin Lampert, the father of CEO Darren Lampert.

(GrowGeneration CFO Monty Lamirato)

### *Lamirato Left His Partner Position at an Audit Firm Just Before an SEC Order Alleging Improper Conduct*

While a partner at auditing firm Mitchell Finley & Company, the SEC alleged that Lamirato had engaged in improper conduct on an audit over a 3-year period. The order stated that Lamirato issued unqualified opinions for financial statements violating GAAP standards by failing to exercise due professional care.

He ended up settling the allegations in 1994:

PROCEEDING PURSUANT TO RULE 2(e) OF THE COMMISSION'S RULES OF PRACTICE INSTITUTED AND SETTLED AGAINST MONTY LAMIRATO, CPA

On February 23, the Commission issued an Order pursuant to Rule 2(e)(1)(ii) of the Commission's Rules of Practice against Monty Lamirato (Lamirato), a certified public accountant from Denver, Colorado. The Order finds that Lamirato engaged in improper professional conduct during the fiscal 1989, 1990 and 1991 audits of the financial statements of HYTK Industries, Inc. (HYTK), a reporting company. The Order also finds that Lamirato issued unqualified audit reports on HYTK's financial statements after violating Generally Accepted Auditing Standards by failing to exercise due professional care and give adequate consideration to evidence indicating that HYTK was improperly listing certain real property as an asset on its books in violation of Generally Accepted Accounting Principles.

In the following years, according to his official bio and Linkedin profile, Lamirato appears to have worked in consulting roles, as well as serving as CFO to various penny stocks such as Strategic Environmental & Energy Resources and Arc Group Worldwide.

Strategic Environmental trades on the pink sheets with a market cap of about $8 million as of this writing.

Arc Group went into freefall during Lamirato's tenure and later voluntarily delisted itself from NASDAQ.


(Yahoo Finance )

## *GrowGen's Auditor: An Extensive List of Failed Clients and A Track Record of Audit Deficiencies*

Given the questionable background of GrowGen's CFO, the role of auditor should play an even more important role than otherwise. Rather than working with a well-known firm, the company instead has chosen a firm not widely known for its public company accounting.

In early 2019, GrowGen transitioned from small auditor Connolly Grady & Cha, P.C. to Plante & Moran, PLLC.

Plante & Moran has been involved with an accounting malpractice case called "modern day grave robbery", when it was sued for failing to detect a $60 million theft during an audit.

Plante & Moran's most recent inspection by the Public Company Accounting Oversight Board ("PCAOB") was issued in 2018. The PCAOB found a laundry list of audit failures, including among many others:

1. Failure to perform sufficient procedures to test the occurrence and valuation of revenue
2. Failure…to perform sufficient procedures to test the design and operating effectiveness of controls over revenue

Here is a list of several of Plante & Moran's clients on the OTC and their outcomes:

**Plante Moran Clients**

| Name | Ticker | Peak Price | Last Price | Decline |
|---|---|---|---|---|
| Aero Grow International Inc | AERO US Equity | $936.13 | $3.12 | -99.7% |
| Carbon Energy Corporation | CRBO US Equity | $20.39 | $0.30 | -98.5% |
| Croghan Bancshares Inc | CHBH US Equity | $60.73 | $45.16 | -25.6% |
| Evolutionary Genomics Inc | FNAM US Equity | $4.13 | $1.11 | -73.1% |
| Great American Bancorp | GTPS US Equity | $42.30 | $27.50 | -35.0% |
| ITEX Corp | ITEX US Equity | $58.69 | $3.72 | -93.7% |
| Rezolute Inc | RZLT US Equity | $15.28 | $0.44 | -97.1% |
| Zynex Inc | ZYXI US Equity | $30.13 | $16.03 | -46.8% |
| **Average Decline in Plante Moran Clients** | | | | **-71.2%** |

All told, no auditor is perfect, but we view the selection of a lesser-known firm as another warning sign.

## *Director Paul Ciasullo Was Sued by the Company he Founded Over Allegations of Fraud. The Case Was Settled Privately*

Beyond management, we examined a company director and found a pretty clear red flag.

Paul Ciasullo joined GrowGeneration's board in the first half of 2020. Ciasullo's biography filed by GrowGen in a proxy statement, says that in 2000, he founded and was President of a company called CreditSight Inc. [ Pg. 10]

Ciasullo left on highly contentious terms, with the company filing a lawsuit alleging fraud, breach of contract, and violating fiduciary obligations. The claim stated as follows:

**NATURE OF ACTION**

1. CreditSights brings this action against Ciasullo because he: (1) repeatedly breached his contractual agreements with the Company; (2) violated his fiduciary obligations as an officer and director of CreditSights; and (3) defrauded the Company. In addition, the Company brings this action to recapture the CreditSights stock Ciasullo received and retained

only by deliberately concealing his misconduct and repeatedly lying to CreditSights management. The Company also seeks disgorgement of Ciasullo's ill-gotten stock sale proceeds of approximately $826,000. Finally, the Company seeks to recover its damages from Ciasullo's unlawful disclosure of CreditSights's confidential and proprietary information to third parties for his personal gain.

The company also accused Ciasullo of pledging his shares for personal loans in violation of his written and verbal confirmations to the contrary.

2. As detailed below, while serving as the Company's highly-compensated Head of Sales, as well as an officer and director, Ciasullo deceived the Company by secretly pledging his CreditSights shares as collateral for personal loans, in direct violation of contracts prohibiting such pledges. He did so while fraudulently assuring the Company, both orally and in writing, that he would never do so. Worse yet, in order to persuade those third parties – Wall Street insiders – to grant him such personal loans, Ciasullo unlawfully disclosed to them the Company's confidential financial and proprietary information in breach of his employment agreement and confidentiality obligations. Ciasullo knew full well that those pledges and disclosures to Wall Street insiders violated the Company's strict policy of maintaining absolute independence from the Street.

The claim also stated that he sent confidential business documents in order to get lenders to agree to pledges without the company's knowledge or permission.

34. The Company also learned that, to induce his lenders to accept his pledges of CreditSights stock as part of the collateralization of his loans, Ciasullo unlawfully provided to them CreditSights's confidential proprietary and financial information, in direct violation of his employment agreement and confidentiality obligations. For example, in his solicitation of Ken O'Keefe, Ciasullo turned over a CreditSights "business update, prepared for mostly internal purposes," and provided him CreditSights's confidential business plan. In an October 30, 2001 email to dkdk1964@aol.com, believed to be Dan Klausner, Ciasullo similarly disclosed the Company's confidential financing plans, stating, "You can imagine I am only offering this very discreetly and for someone who can help me out now."

The allegations in the complaint were highly specific, but the case was later settled quietly .

CREDITSIGHTS, INC.

Plaintiff,

- against -

05 Civ.9345 (DAB)
STIPULATION AND
ORDER

PAUL CIASULLO

Defendants.
----------X

DEBORAH A. BATTS, United States District Judge.

The Parties having notified the Court that they have reached a resolution to settle this action and having consented to the following,

## *Conclusion: Is This a Management Team That is Likely to Look Out for the Best Interest of Shareholders or for Themselves? We Think the Answer is Obvious—GrowGen Is Uninvestable.*

We live in extraordinary times, where a company like GrowGen can spike to almost a billion-dollar market cap largely on hype and pure retail momentum while major warning signs go largely unnoticed.

In our view, GrowGen has an interesting business model, and it got a solid boost from COVID. That's great. It's the type of business that could be a decent model under the right management team.

The stock has to run to levels that render it obviously overvalued, but the clear elephant in the room is a management team that has a storied history of destroying shareholder value under extremely questionable circumstances.

We view this as a major buyer beware situation. Best of luck to all.

### *Disclosure: We are short shares of GrowGeneration (NASDAQ:GRWG)*

### *Legal Disclaimer*

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# TAB 6

# Facedrive: A $1.4b ESG Stock Promotion with a Hollow Core Business, Flailing Business Pivots and Multi-Million Dollar Payments to an Opaque BVI Entity; 95% Downside

Published on July 23, 2020



- Facedrive recently went public with the core premise of being an "eco-friendly" ride hailing app that allows users to select electric or hybrid vehicle options. EV excitement has fueled the stock to a $1.4 billion market cap and an absurd 908x revenue multiple, making it the most expensive $1 billion tech company in the world.
- Facedrive's Canada-based ridesharing business appears to be dramatically impaired by COVID. While the company claims 13,000 *registered* drivers on the platform, **we estimate current *active* drivers at 00-600 total**, suggesting an overstatement of ~95%.
- Rather than focusing on tackling just one resource-intensive highly competitive market

like ridesharing, Facedrive recently entered a second—food delivery. We found Facedrive's platform has a total of 17 restaurants compared to UberEats' 400,000 and GrubHub's 300,000.

- We called several of the "most popular" restaurants on the Facedrive Foods page. One didn't seem to have a working phone number, and two said they don't use Facedrive anymore.
- Facedrive even joined the COVID-hype train, launching a COVID contact tracing app. We reached out to their partner on the project who confirmed what appears to be overstatements of the projects' publicly stated progress.
- Despite all of this, Facedrive has propelled itself to a $1.4 billion market cap on a slew of buzzword-laden press releases. This has been helped by stock promoters who received payment through an opaque newly-renamed BVI-registered entity. The deal was inappropriately disclosed as being related to marketing the company's rideshare platform (not the stock). The site admits in its disclaimers that stocks often plunge after their promotion cycle ends.
- **In June 2020, acedrive paid 8.2 million to promoters for 1 month of services.** This is the largest promotion payment we have ever seen and was greater than Facedrive's entire operating expenses over the last year.
- Additionally, the company has engaged in multiple related party transactions. Its 2019 filing statement detailed paying 4 entities controlled by its CEO, representing approximately 24% of its 2019 operating expenses.
- **We do not think acedrive's core ride hailing business is viable and we find its marketing" and related party spends to be extraordinary and alarming. We have doubts about the veracity of the company's claims relating to its ill-conceived side projects that appear hastily thrown together for R value.**
- Facedrive's CEO has a history that bodes poorly. He was Chairman/CEO of another a public company, Creative Vistas, which saw its shares precipitously plummet 99%.
- We believe this "story" stock is heading toward a hard repricing, as we see *de minimis* overall value in the company's operations. Our 1-year price target is CAD $0.70, representing 95% downside.

*Initial Disclosure: After extensive research, we have taken a short position in shares of Facedrive. This report represents our opinion, and we encourage every reader to do their own due diligence. All figures in CAD unless otherwise specified. Please see our full disclaimer at the bottom of the report.*

## *Background: A Struggling Ridesharing Company with Limited Resources and No Defensible Competitive Niche*

Facedrive was founded in 2016 with the core premise of being an "eco-friendly" ridesharing app. It allows riders to choose environmentally friendly vehicles by giving them electric, hybrid or gas-powered options.

The company soft launched its app in Ontario in late 2017 and currently operates in a handful of Canadian locations. [ Pg. 21]

Facedrive's stock, on the other hand, gives the impression of a robust business; recently rocketing higher with the help of numerous buzzword-laden press releases, despite limited tangible underlying operations.

The stock has spiked about ~640% since it came public via reverse merger in September 2019, propelled by over $8 million in paid promotion inappropriately disclosed as platform marketing. This is the most expensive stock promotion campaign we have ever seen.

Facedrive currently trades at a ~$1.4 billion valuation, or an obscene ~908x revenue multiple based on run-rate from last quarter's $388k in sales. This makes Facedrive the most expensive $1b technology company in the world on an EV / sales basis.

We believe Facedrive's ride hailing business is fundamentally flawed and unlikely to generate significant sales (particularly based off of our research, to be presented). Meaningful sales growth would come at the cost of significant cash that the company doesn't have.

The ridesharing industry operates as an intensely price competitive near duopoly, where incumbents Uber and Lyft have incurred a cumulative multi-billion dollar annual cash burn in order to even maintain market share. Ridesharing is generally priced near the cost to provide the ridesharing service, where Facedrive is forced to offer services below market price due to lack of brand recognition.

Facedrive has very few users, minimal resources, and no sustainable differentiator (Uber or Lyft could easily add electric vehicle options if they ever felt it worthwhile to eliminate Facedrive's supposed 'niche'.)

COVID materially disrupted the ridesharing industry earlier in the year; a shock that even Uber and Lyft have not fully recovered from. Analysts now expect that Lyft will do 40% less sales than were estimated at the start of the year.

Likely seeing the writing on the wall for its ridesharing prospects, the company has decided to pivot wildly with launches of products spanning an array of disparate industries. These include:

1. A COVID-19 contact tracing app
2. An Uber Eats / Grubhub clone

3. An eCommerce marketplace
4. A trivia app

All of these endeavors are, at best, poorly conceived and executed ideas or, at worst, a series of PR stunts with limited real business intention behind them. Given Facedrive's lack of progress in these areas, we lean toward the latter.

Facedrive displays several more worrying signs, including multiple related party transactions with its CEO and a highly unusual series of payments to an opaque newly-named entity in the British Virgin Islands.

We think Facedrive is a story stock whose tale is in the process of unraveling. We anticipate a sharp repricing of shares in the immediate future and see de minimis overall value in the company's operations.

## *Part I—Troubling Signs: An $8.2 Million Payment to an Opaque BVI Entity for a Month of "Marketing", Numerous Related Party Transactions, and a CEO with a History of Destroying Shareholder Value*

### *Facedrive's Unusual Deal With "Medtronics Online Solutions Ltd", A Newly Renamed BVI Entity*

In May 2020, Facedrive announced it hired a company called Medtronics Online Solutions Ltd. to "perform marketing and strategic consulting services". In the announcement, Facedrive's CEO strongly suggested that the services were part of a global marketing campaign to expand visibility of the company's ridesharing platform, its core business:

> *"As Facedrive prepares for global expansion, it is more important than ever to get our 'people-and-planet first' message across to audiences not only in Canada, but in the United States and Europe, in the most efficient and effective way. With that in mind, I am excited to work with Medtronics, whose unique marketing strategy and proven global outreach* ***will help us ensure that our first-of-its-kind eco-friendly ride-sharing platform****reaches the widest audience possible with maximum impact," said Facedrive CEO Sayan Navaratnam."*

The price for the "marketing and strategic consulting" services was steep. The company later

disclosed it had paid Medtronics 800,000 shares for its initial month of services, valued at $8.2 million, *and* an obligation to pay 105,000 shares *each month for the next 7 months* The shares are subject to certain lock-up restrictions, per the arrangement.

Neither announcement stated which jurisdiction Medtronics was located in – and finding it was no trivial task. Medtronics is described as having a global marketing presence, yet Google had just 3 results for the entity outside of the Facedrive announcement (and all 3 were actually related to the announcement).


We located the entity in the British Virgin Islands, registered to nominee directors. BVI Corporate records show that the entity had been named Leacap Ltd. up until about a month before the Facedrive contract, when it changed its name to Medtronics.

**POST-INCORPORATION TRANSACTIONS**



**Change of Company Name or Add/Change of Foreign Character Name**

| | | |
|---|---|---|
| BVI Company No. | : | 1975800 |
| Company Name | : | LEACAP LTD |
| Foreign Character Name | : | |
| Company Type 2 | : | ☐ Segregated Portfolio Company |
| | | ☐ Restricted Purpose Company |
| | | ☐ Non-Profit Organisation |
| | | ☐ Private Trust Company |
| Type Of Company Name Change | : | ● Only English Name |
| | | ☐ Only Foreign Name |
| | | ☐ Both English and Foreign Name |
| | | ☐ Retain English Name and Remove Foreign Name |
| | | ☐ Change English Name and Remove Foreign Name |
| Proposed Name: | : | Medtronics Online Solutions |
| Suffix: | : | Ltd |
| Date of Change: | : | 13/02/2020 |

## *Medtronics Appears to Be Associated with OilPrice.Com, a Stock Promotion Site. But This Apparent Promotional Arrangement Has Unusual Features*

LeaCap Ltd. is associated with OilPrice.com, a website known for stock promotion. The site has issued at least 7 articles touting the glowing promises of Facedrive and its stock since March. [1,2,3,4,5,6,7]

We found the deal with Medtronics to be unusual for a number of reasons:

1. **Size.** Facedrive paid $8.2 million to Medtronics in an initial payment. Facedrive's entire operating budget over the last twelve months (LTM) was $6.3 million, meaning the company paid 130% of its LTM operating budget for one month of services, with additional payments to follow. [ Pg. 4, Pg. 8, Pg. 4] Typically, promoters are paid in the 5 or low 6 figures (i.e. $20-$150k). We have yet to see a promoter paid this much or in such disproportion to a company's financials.
2. **pacity.** The newly-changed Medtronics BVI entity had zero online footprint, making it challenging to even identify. BVI requires users to pay in order to even search a company

name.

3. **Misleading Disclosure.** As shown above, the Facedrive announcement suggested Medtronics is being paid to market its ***platform***, not its stock. We view Facedrive's disclosure as misleading. Furthermore, OilPrice.com added a custom disclaimer to its Facedrive articles that strikes us as a fig leaf meant to mirror Facedrive's dubious disclosure:

> *An affiliated company of Oilprice.com… has signed an agreement to be paid in shares* ***to provide services to expand ridership and attract drivers in certain jurisdictions outside Canada and the United State's.***

Facedrive doesn't currently operate anywhere outside of Canada and has barely made headway in its home market, as we will show.

If it was not clear enough, OilPrice.com characterizes itself as the following:

> Who Visits OilPrice.com?
>
> Our rapidly expanding and influential audience consists of investors, fund managers, resource bankers, traders, energy market professionals and high net worth individuals from around the world, but mainly the US, Canada, UK and Australia.

In other words, this is a stock promotion agreement between Oilprice.com and Facedrive which has been inappropriately disclosed as a marketing agreement for the *platform*.

Furthermore, the content looks unmistakably promotional. On Apr 21st, OilPrice.com published an article about "6 Visionaries Shaping the Future of Transportation", which compared major public company CEOs such as Amazon's Jeff Bezos, Google's Sundar Pichai, Tesla's Elon Musk, Virgin's Richard Branson… and Facedrive's Sayan Navaratnam.

> **#2 Sayan Navaratnam**
>
> While Branson, Bezos and Musk are busy with "fly-me-to-the-moon" sentiments, Sayan Navaratnam-- planning to join the other transportation gurus—is quietly making moves on a more Earthly scale.

Another article describes Facedrive as part of the sustainability movement and declares "Buffet [sic], Bezos And Blackrock Are Betting Big On This $30 Trillion Mega-Trend".

*What does that have to do with recruiting drivers outside of the U.S. and Canada?*

(It does not appear that Buffett or Blackrock have stakes in Facedrive. Also, the name is spelled "Buffett" with two t's—a buffet is a self-serve style of casual dining.)

# Buffet, Bezos And Blackrock Are Betting Big On This $30 Trillion Mega-Trend

By Ian Jenkins - May 28, 2020, 6:00 PM CDT


By the time giant high-tech, cash-burning companies like Uber catch on to the $30-trillion-plus mega trend of sustainable investing, their competition may have caught up.

OilPrice.com shows the following disclaimer on its articles, which suggests that stocks it profiles have a habit of spiking then plummeting once it stops touting them. The language appears to us to be all but saying "stocks featured on our site pump then dump":

> *This communication is for entertainment purposes only…* ***requently companies profiled in our alerts experience a large increase in volume and share price during the course of investor awareness marketing, which often end as soon as the investor awareness marketing ceases***

We expect Facedrive is already on the back half of this "awareness marketing" trajectory.

## *Related-Party Transactions—The Company Paid 24% of its 2019 Operating Expenses to Related Parties Controlled by the CEO*

We found other troubling signs in Facedrive's brief history as a public company. Despite its modest size, Facedrive has relied extensively on a network of companies controlled by its CEO. The company's 2019 filing statement detailed paying no fewer than 4 entities controlled by its CEO, providing everything from marketing, to call center services, product development and office space. [ Pg. 64]

**Non-Arm's Length Party Transactions**

Dynalync, a related company controlled by Sayanthan Navaratnam, the CEO, director and co-founder of Facedrive, provides consulting services and product development to Facedrive. Total expenses charged to Facedrive were $390,700 for the three-month period ended March 31, 2019 and $568,000 for the fiscal year ended December 31, 2018.

Facedrive also engages DependableIT through Dynalync, a related company controlled by Sayanthan Navaratnam, the CEO, director and co-founder of Facedrive, to provide call center services to Facedrive. See "*Part III – Information Concerning Facedrive – General Development of the Business*". Total expenses charged to Facedrive for DependableIT's services are included in the expenses charged by Dynalync.

Decosta is a related company controlled by Sayanthan Navaratnam, the CEO, director and co-founder of Facedrive, provides marketing services to Facedrive. Total expenses charged to Facedrive was $60,000 for the fiscal year ended December 31, 2018.

Connex is a related company controlled by Sayanthan Navaratnam, the CEO, director and co-founder of Facedrive, subleases offices space in Ontario to Facedrive. See "*Part III – Information Concerning Facedrive – Narrative Description of the Business – Platform Offerings – Facedrive Locations*". In addition, Facedrive was indebted to Connex in the aggregate principal amount of $750,000 evidenced by a demand non-interest bearing promissory note. The indebtedness owing to Connex represents payment made by Connex on Facedrive's behalf for operating expenses and was repaid in Facedrive Class B Shares pursuant to a debt conversion agreement dated March 31, 2019.

In total, the company expensed $1.26 million to related entity Dynalync for R&D and operational support in 2019, representing over 24% of the company's annual operating expenses. [ Pg. 9]

## *Facedrive's CEO Already Has One Public Company Failure. The Stock is Down 99% Over its Lifetime and Currently Trades on The OTC Pink Sheets.*

This also isn't Facedrive CEO Sayan Navaratnam's first foray into the public markets.

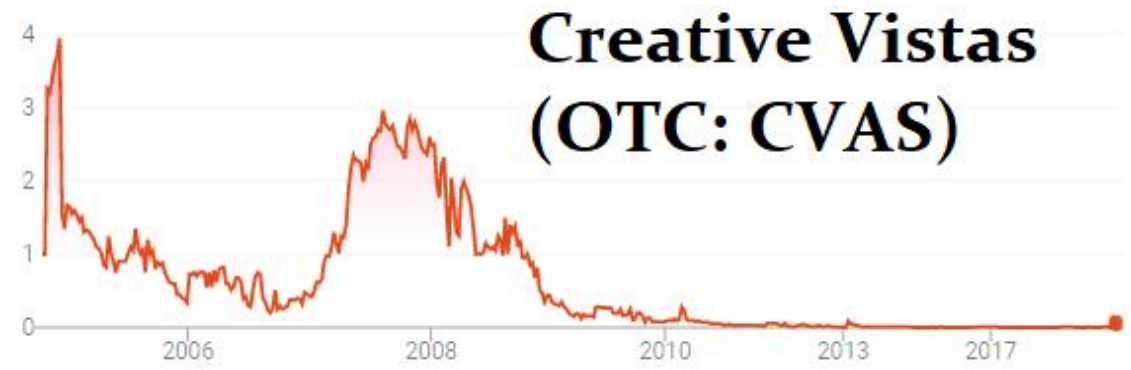
He was also Chairman/CEO of Creative Vistas, a broadband systems integrator primarily focused on servicing Canadian customers of Rogers Communications. Navaratnam was named Chairman and CEO of the company in 2004. [ Pg. 3]

The company appeared ultimately unable to maintain operations due to lackluster revenue and cash flow. Navaratnam ended up purchasing the company's main operating subsidiary for $1 plus the assumption of the company's debt. [ Pg. 20]

In February 2011, the company ceased being quoted on the OTC Bulletin Board and was relegated to the OTC Pink Sheets.

It appeared to cease filing around 2012 and trades today for $0.03 on the U.S. Over the Counter markets – representing ~99% downside for anyone who owned the stock at almost any point during its primary operating history.

Navaratnam is still listed on the company's website as the Chairman of the Board, which describes him as "the visionary who plays a key role for the growth strategy of Creative Vistas".




Assuming that Navaratnam is bringing the same "visionary" talents to Facedrive, we decided to dig further into the company's prospects and operations.

## *Part II: Swimming Against a Tidal Wave—Facedrive Has Little-to-No Long-Term Prospects in Ridesharing*

In an industry with virtually no *technological* barriers to entry, ridesharing companies are locked in an arms race to establish the largest rider & driver networks as the key competitive moat. After ~3 years of operation, Facedrive is nowhere close to making a dent.

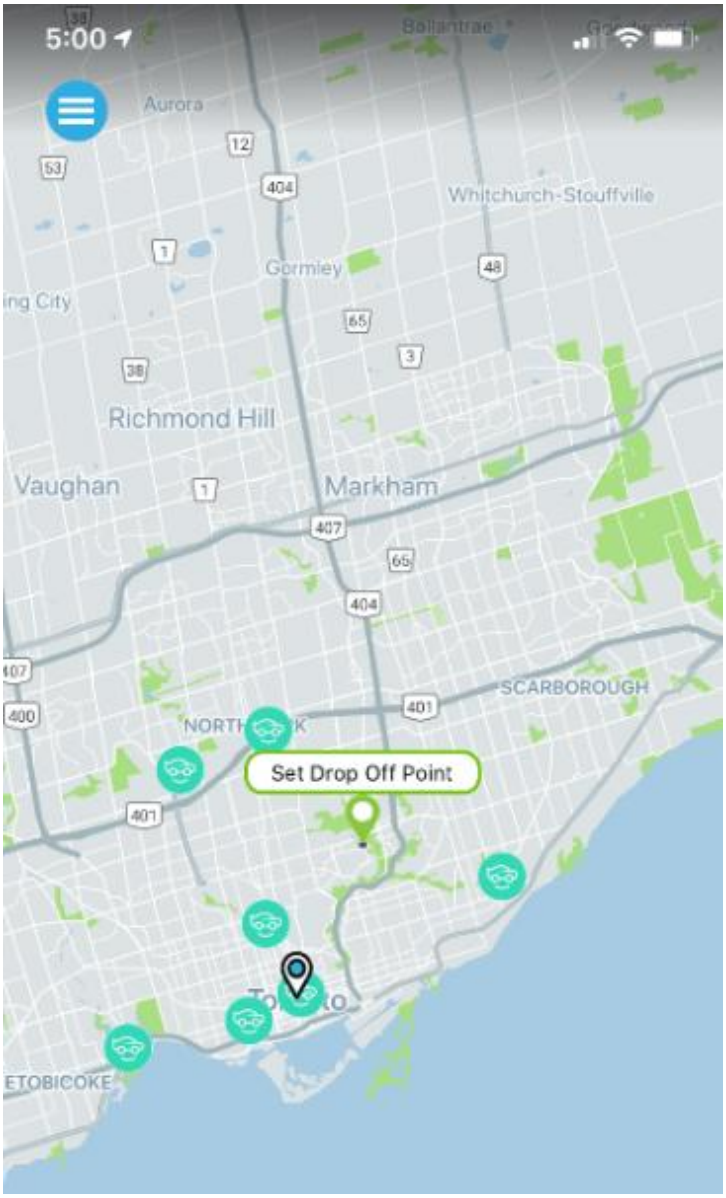
## *Facedrive Claims 13,000 Drivers, But the App Shows Few Drivers in Its Key Markets*

Creating a vibrant network of drivers and users is essential for the success of any ridesharing platform.

A March 2020 Facedrive investor presentation seemed to suggest great progress along that path, boasting of 13,000 drivers *registered* on its platform. **However, after our own analysis, interviews, and testing we suspect the number of active drivers is significantly lower, likely in the range of 00-600**

For context, the company reported gross fees from rides of $852,200 in Q1 2020, which implies about 6-7 rides per working day for 500-600 drivers, given the historical average fee of $10/ride. [Presentation Pg. 20 ]

This estimate was corroborated by our field testing. **In the key Downtown Toronto region, we found the app regularly had only 2- drivers available.** The most drivers we found at one time in Downtown Toronto was 7, which appeared on 5:00pm on a Friday (end of week rush hour/happy hour).




Facedrive support confirmed that all available drivers appear on the app's map.

Anecdotally, an industry colleague attempted a short trip in Toronto but the app was unable to match them with a ride after a 10-minute wait. After the match failed, **acedrive support called their phone to ask if they still wanted a ride** (like a traditional, non-app-based taxi service). They described the experience as "very strange".

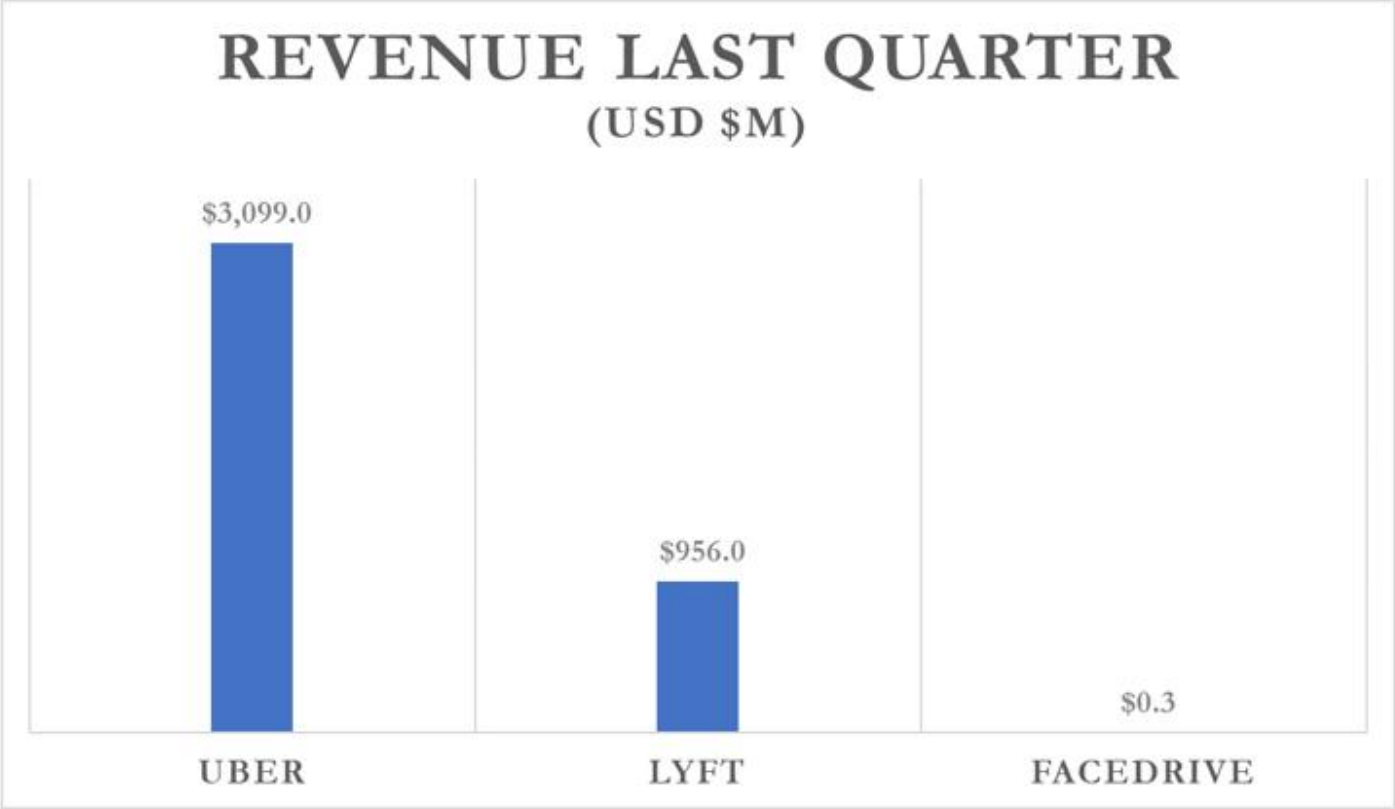
In a call with Facedrive support, the rep acknowledged to us that they do not have enough drivers in Downtown Toronto and that they often attempt to call in drivers from other areas, which increases wait times and worsens the user experience. He said in Scarborough they were more active, with ~10-15 drivers on the road at any given time.

Our review of the app showed that in Ottawa, which the company launched amidst much

fanfare in the beginning of July, generally had zero to two drivers at a time. London, Ontario had around 10-15 drivers on the road during our testing.

### *With Few Drivers, It Is No Wonder Facedrive Has Minimal Revenues*

After ~3 years of operation, Facedrive's revenue doesn't even show up relative to competitors.



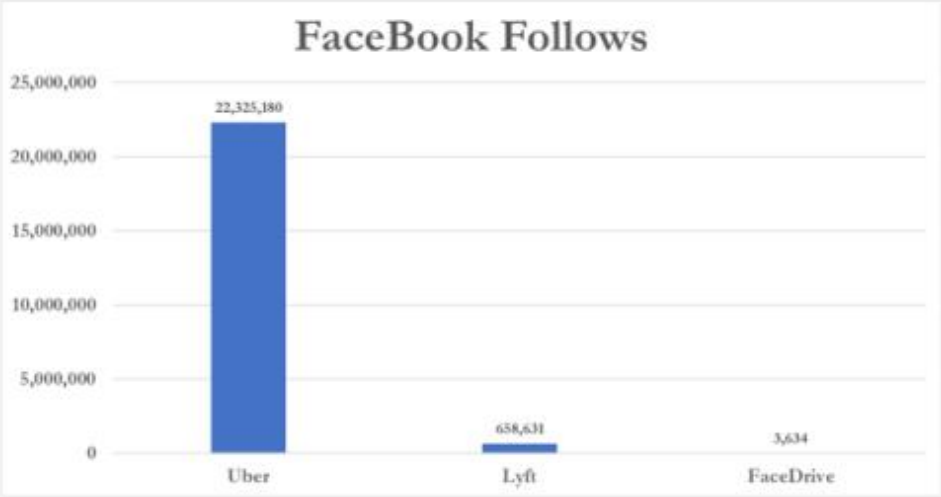

### *Facedrive Has Minimal Android and iOS Installs Relative to Its Main Competitors*

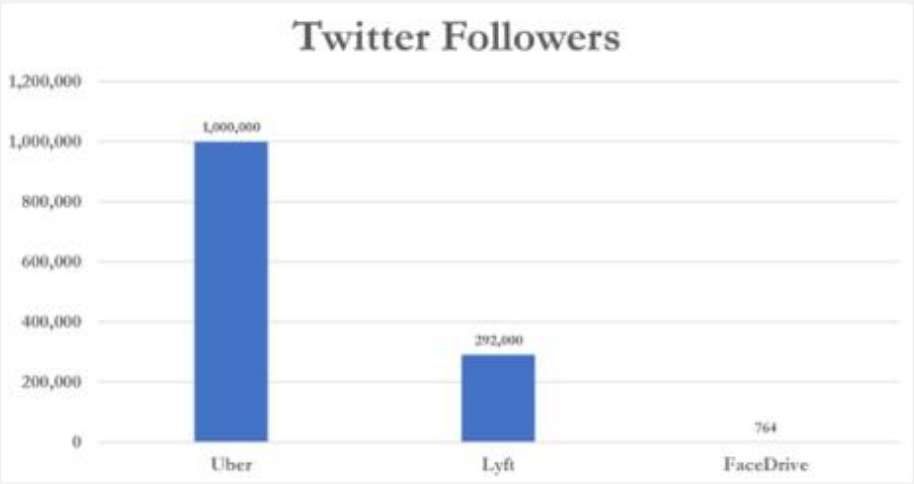
We get another glimpse of how Facedrive fares relative to industry leaders by tracking downloads on Android's Google Play store and Apple's App store. On Google Play, the largest market, Uber has 500 million installs and Lyft has 10 million, while Facedrive has barely eclipsed 10,000.


On the Apple App Store, which doesn't display installs but does show number of ratings, we see Uber with 1.2 million ratings, Lyft with 8.2 million and Facedrive with just 460.


## *Facedrive Has a Virtually Non-Existent Social Media Presence*

Despite its lack of userbase and lack of revenue, Facedrive seems well-suited for social media, where it could gain support for its stated mission of sustainability. However, we see that as of this writing it has only 3,634 follows on Facebook and 764 followers on Twitter. These numbers pale in comparison to the combined millions of followers shared between Uber and Lyft.




**acedrive's User Reviews on Google and Apple Are Worse Than Both of Its Main Competitors**

Beyond its lack of revenue, lack of a user base, and lack of social media presence, Facedrive has worse user reviews than rivals, making it tough to gain market share based on user satisfaction and word of mouth.

**App Ratings**

| | Uber | Lyft | FaceDrive |
|---|---|---|---|
| App Store | 4.7 | 4.9 | 4.0 |
| Google Play | 3.9 | 3.8 | 3.2 |

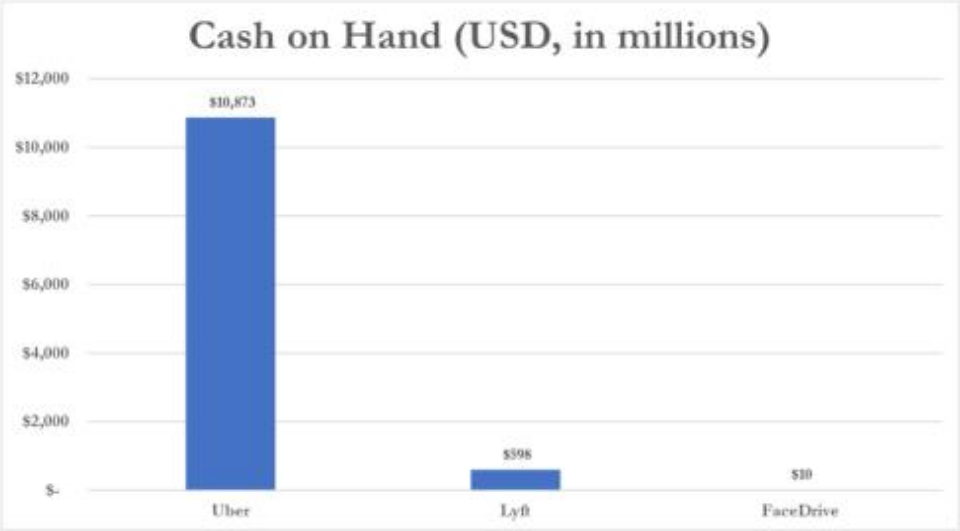
Facedrive users regularly complain of being unable to get rides and poor/delayed customer service.

### *Cash Poor: Facedrive Has Less Than 0.1% of the Cash Balance of Its Industry Leading Competitor; With Cash of Just US$10 Million Compared to Uber's US$10.8 Billion*

Facedrive clearly has a lot of catching up to do, which in the capital-intensive ridesharing industry requires substantial cash resources. The path to winning new drivers and riders often requires cash incentives, lower rates and extensive hardware and support infrastructure.

Uber, for example, has an accumulated deficit of over $19 billion owing to its "first mover advantage" and large historical expenditures that propelled it to dominate new markets around the globe. [ Pg. 4] It will likely burn substantially more cash before reaching profitability (if it ever gets there). Last quarter alone, Uber burned about $850 million in cash. [ Pg. 9]

As of the latest quarter, Uber and Lyft had war chests of about $10.8 billion and $600 million, respectively. By comparison, Facedrive's change purse consists of ~$10 million, which includes the proceeds from its recent financing rounds .




Over the past 4 quarters, Facedrive has burned $5.4 million in operating cash flow while generating only $951 thousand in revenue. These numbers do not bode well, and Facedrive's cash burn has increased alongside revenue quarter by quarter.

## *Part III: Off-Road—Facedrive's Numerous Business Pivots Suggest a Company Flailing Without Clear Direction after a Lack of Success in its Core Rideshare Business*

Startups that struggle with their original idea will often undergo a "pivot" or a significant

change in business direction, in an effort to reinvent themselves and find a sustainable niche. Sometimes, when businesses try to opportunistically cash in on trendy PR lingo that has lifted other companies' stock prices, they will engage in *more than one* pivot (see our recent reporting on Ideanomics, for example).

Given its hurdles in ride hailing, we were not surprised to see Facedrive attempt to change course. However, rather than picking one project, the company has launched numerous disparate buzzword-laden projects in the past several months, including:

1. A **COVID-19** contact tracing app that aims to employ **AI"** (COVID stocks have surged over the last few months.)
2. An Uber **Eats**/Grubhub clone called Facedrive Foods (Grubhub was recently the target of a takeover bidding war.)
3. An eCommerce **marketplace** (eCommerce stocks are skyrocketing as lockdown has kept everyone at home.)
4. A trivia app.

Facedrive is single-handedly attempting to succeed in ride share, ESG, COVID-19 tracing, AI, food delivery, and more. The company and its' promoters use terms such as AI, Machine Learning, TaaS (Transportation as a Service), ESG, and EV to describe itself. While the collective endeavors have lent themselves well to numerous buzzword-laden press releases, none of the efforts appear to be succeeding.

## *Facedrive's Pivot to COVID-19 Contact Tracing App Developer—Emails with Partners Raise Questions About the Company's Claims of Advanced Progress*

COVID-19 had a materially negative impact on ride sharing services (ex. Lyft's Q2 consensus revenue estimates were cut 66%). At first, the company conflated itself with COVID by stating that it will offer discounted rides for healthcare workers and dedicated "COVID-19 Trained" drivers.

Then, Facedrive announced a hard pivot.

On April 20th 2020, the company announced that it had created an app to help with COVID-19 contact tracing. The language of the announcement strongly suggested the app was already developed/created and was approaching a near-term release:

> *"Facedrive…is pleased to announce that in collaboration with University of Waterloo,*

> ***has developed****(sic) "TraceScan", a digital contact-tracing app designed to support nationwide efforts to slow the spread of COVID-19."*
>
> *"TraceScan* ***was created****in an effort to offer ongoing frontline assistance in response to the COVID-19 pandemic"*
>
> *"The app is expected to release within the next 30 days."*

Despite these representations, we reviewed emails with the University of Waterloo professor leading the project which directly contradict Facedrive's statements.

As of May 17th, almost a month after Facedrive's above April 20th announcement, the professor stated that a Memorandum of Understanding (MoU) was in place, but no agreement had been formalized and resources still needed to be allocated to the project. Note that according to Facedrive's April 20th announcement, the "developed" app was set to be released around this time. Contrary to these representations, there apparently was not even a final agreement in place to *begin* development.

Despite the apparent lack of an agreement, Facedrive has continued to issue press releases suggesting significant progress.

On May 28th, the company announced that the University of Waterloo was working to enhance the TraceScan platform with AI, which it expected would be ready for testing in 30 to 90 days. Waterloo was also apparently developing Bluetooth-based wearables:

> *"Facedrive Health and Waterloo researchers are also developing Bluetooth-based wearables that will improve contact tracing accuracy and real-time monitoring of the recovery progress through measurement of specific vital signs."*

Despite this announcement, in late June, emails reviewed with the University of Waterloo showed that the contract appeared to still be unsigned, and that the new focus was on applications for the workplace.

The change of focus to the workplace is likely because Facedrive had been competing for a contract from the government of Canada to be the country's official COVID-19 tracing app. In mid-June, the government announced that it selected its own Federally-backed project for the task, closing the door to a major potential opportunity for Facedrive.

The company continues to tout its app, however. This week, Facedrive announced that its wearables were available on the Microsoft App store "by invitation only". This means that the app is not accessible to the general public, making it very difficult to assess its functionality.

We have reached out to the University of Waterloo professor for an update on the project this week but have not heard back as of this writing.

We have also reached out directly to Facedrive's CEO to ask for clarification on (i) the status of the company's contact tracing app; (ii) whether/where it is actively being used; (iii) whether the wearables are able to be purchased; (iv) who manufactures the wearables, and; (v) whether a formal contract (not an MoU) is or ever was in place with the University of Waterloo.

We have not heard back as of this writing, but **we hope the CEO provides the market more clarity on what exactly they have developed and when they developed it** – especially given the claims and relatively vague details provided in company press releases.

## *Facedrive Foods—An Uber Eats/Grubhub Clone with No Credible Shot at Success*

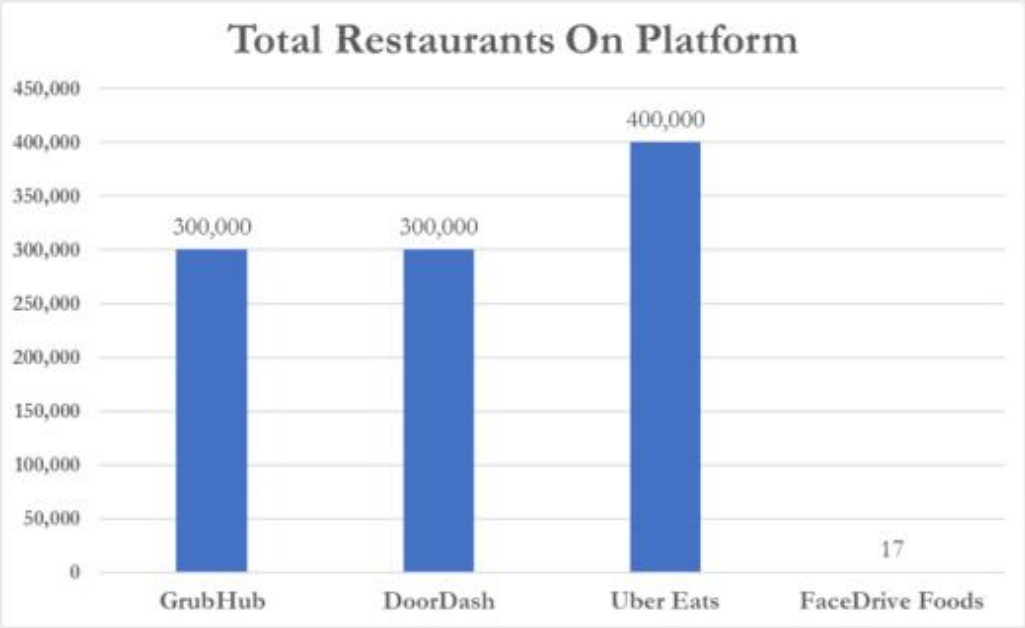
Rather than focusing on tackling just one resource-intensive highly competitive market like ridesharing, Facedrive recently entered a second—food delivery.

Facedrive launched "Facedrive Foods" around May of this year in an attempt to compete with Uber Eats. (Facedrive Foods is alternately referred to as Eats by Facedrive on its website, without clear explanation for the mixed branding).

One of the benefits of having a large, vibrant, user network is the ability to launch new complimentary services. This is probably why Uber launched Uber Eats, which tapped into its large existing network of drivers and users to monetize personal transportation in a different way.

This is also probably why Facedrive, with its lack of an existing significant network, should **not** be launching a food delivery service.

Unsurprisingly, Facedrive Foods/Eats by Facedrive appears to be struggling. As of this writing, a total of 17 restaurants are available on its platform. Here is how Facedrive's platform compares to the primary apps in this steeply competitive market:

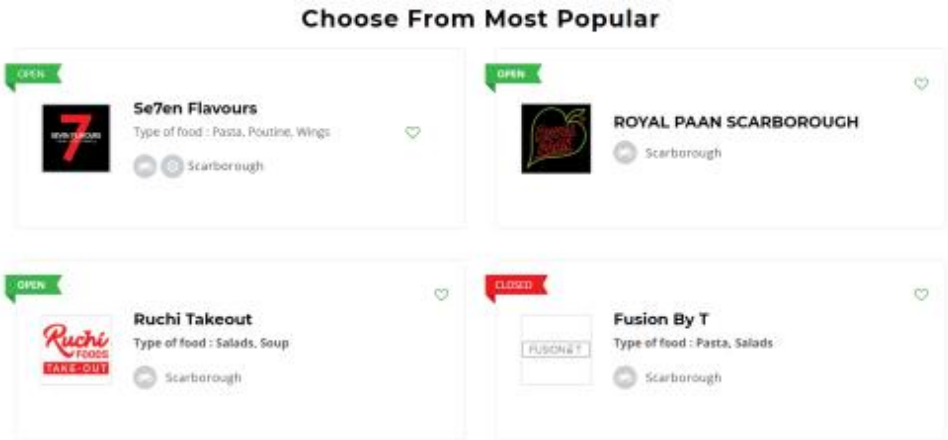



The company has also made a rather big deal out of an acquisition of certain assets of bankrupt Foodora, a failed food delivery service in Canada.

Facedrive has issued multiple announcements about what it termed the "major" acquisition of Foodora assets, which seem to consist of marketing lists purchased from the company out of bankruptcy. Terms of the deal show that Facedrive paid $500,000 for the customer and restaurant lists of the failed company and can now market to them "subject to customer consent and opt in".

### *Facedrive Foods—We Called Several of the "Most Popular" Restaurants on the Platform. Two Said They Don't Work with Facedrive Anymore and the 3rd Had a Non-Working Number*

We called the first several "most popular" restaurants on the Facedrive Foods page.



Here is what we were found (we have the calls recorded):

1. Se7en Flavours: The phone number from Google and other websites didn't work for us.
2. Royal Paan: The person answering said they use DoorDash, Uber and Skip but not Facedrive.
3. Ruchi Takeout: The person answering checked with co-workers to see if they still work with Facedrive and then replied "No we don't do that anymore, Facedrive."
4. "Fusion by T": We couldn't actually locate a store front for Fusion by T as it appears to be a catering service. We noticed an Instagram account that seemed affiliated with Facedrive as it linked directly to the site.

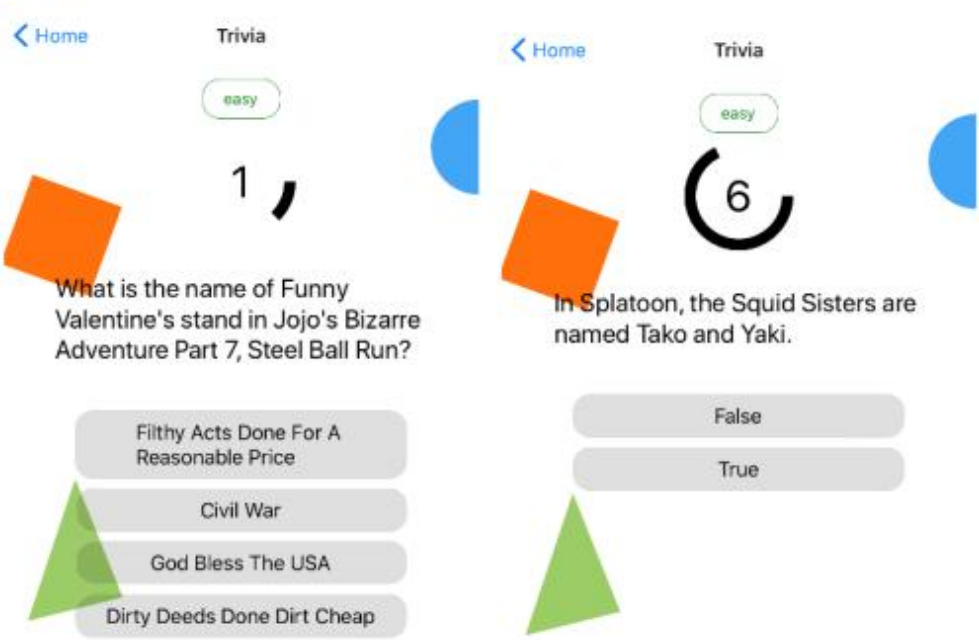

## *Facedrive's Newly Launched Trivia App Somehow Managed to Rack Up Dozens of 5-Star Reviews Before it Even Launched*

On June 17th the company announced the launch of a trivia app in order to "encourage building connections and practice social distancing" during COVID. It is a separate app from Facedrive requiring its own download.

As of this writing, the app had 2 reviews on the Apple App store, and about 150 reviews on Google Play.

About 1/3 of the apps ratings on Google Play were from June 11th—six days before the announced launch of the app. All were 5 stars. Exactly one month later, on July 11th, the app gained another burst of 17 reviews, all but one of which were 4 stars, including reviews from users such as "Justin Bieber" and "Tom Hanks".

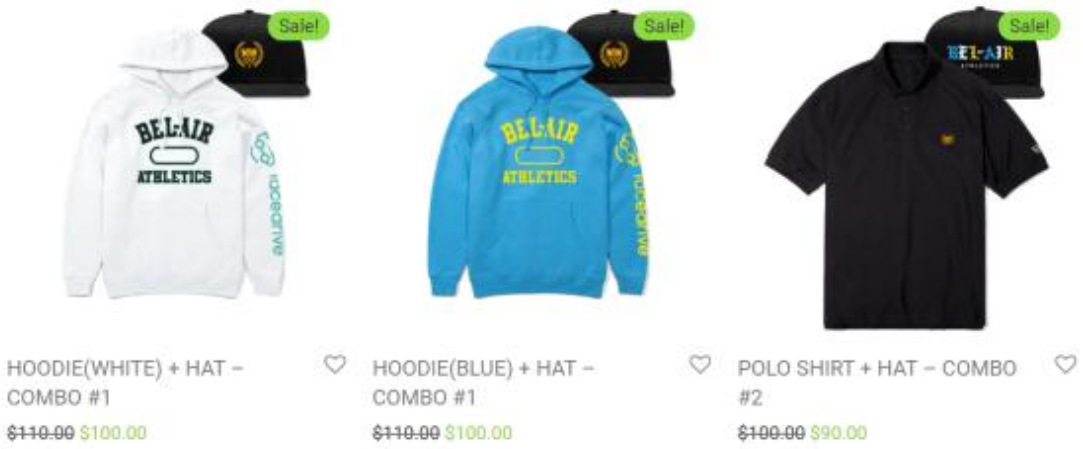
We tried the app and found the questions to be fairly unusual:




It is unclear what the monetization plan for the trivia app might be if it ever manages to establish a significant userbase.

### *Facedrive's New "MarketPlace"—An eCommerce Store That Once Again Seems to Spread the Company Thin, with Little to Show for It*

In May 2020 Facedrive launched the "highly anticipated" Facedrive MarketPlace, which seems to largely sell hoodies and hats branded with Facedrive and a brand called "Bel Air" for ~$100. We can't imagine these are hot sellers.




With limited engineering resources, including a historical reliance on outsourced product development, it seems that Facedrive is spreading its thin resources broadly.

## *Conclusion: A Frothy Market Lifts Many Boats, But We Don't Expect This to Remain One of Them. Like All Stock Promotions, Facedrive Will Fall Back to Earth*

We do not think Facedrive's core ride hailing business is viable and we find its "marketing" and related party spends to be extraordinary alarming. The $8.2 million "marketing" payment is the largest payment we have ever seen for what we believe to be clear stock promotion.

We have doubts about the veracity of the company's claims relating to its COVID contact tracing app. Its trivia app, its Uber Eats clone, and its marketplace strike us as ill-conceived side projects likely hastily thrown together for show.

With about a year of cash on its books, Facedrive will almost assuredly launch more 'new' initiatives, but we think this "story" stock is heading toward a hard repricing and see eventual full downside.

## *Disclosure: We are short shares of Facedrive*

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# TAB 7

# J2 Global: Troubling Related Party Transactions, Looming Impairments And A Suspicious History Of Insider Enrichment Spanning Decades

Published on June 30, 2020



- J2 is a digital media roll-up that has acquired 186 businesses since its inception. Its CEO describes the company's "acquisition system" as its "single great competitive advantage".
- We suggest the contrary and believe J2's opaque acquisition approach has opened the door to egregious insider self-enrichment, which we approximate totals $98 million to $128 million based on publicly available information.
- For example, we uncovered that J2 acquired a newly formed entity based out of its own VP of Corporate Development's personal residence for $900 thousand. The entity had undefined "intellectual property" and no employees or apparent assets. **No conflict was disclosed.**
- The VP of Corporate Development who was on the receiving end of the payday handled

135 of J2's acquisitions, representing ~73% of the company's acquisitions to date.

- It appears to be a pattern. J2's Chairman formerly controlled a different publicly traded company alongside the noted VP, stacked with various J2 board members and insiders. Its European subsidiary racked up ~ 14 million in losses despite having virtually no assets. The entity was **based out of the same personal residence** and was also acquired in part through a related party transaction with the Chairman **.** The stock of the parent company is down ~99%.
- J2 recently committed $200 million of shareholder cash to a newly-formed investment vehicle run by its Chairman, who has a track record of venture investment failures. The investment vehicle's leadership includes other J2 execs and insiders. J2 expects to commit another $100 million to the vehicle.
- That investment vehicle, in turn, made its first investment of an estimated $12 million into a newly-formed home video business established by the Chairman's nephew. That business is already dormant, according to a former employee. **nce again, no conflict was disclosed.**
- Despite J2's proxy describing all but one of its board members as "independent", we found decades of intertwined financial interests between board members and executives, calling that independence into question.
- Concurrently, a slowing stream of acquisitions has helped to unearth a decline in J2's key business metrics: digital traffic is down (despite support from recent acquisitions), and cloud cancel rates are ticking up with ARPU falling.
- The underperformance has been masked by tricky accounting. The company has never taken a goodwill impairment, yet subsidiary filings report multiple material goodwill impairments that don't appear to coincide with parent financials. We estimate at least $155 million in impairments based on visibility into $700 million in acquisitions.
- J2's European business (13% of revenue in 2016), which was overseen by the aforementioned VP of Corporate Development, has seen its revenue decline 27% in the subsequent 3 years with operating income swinging from $5.5 million to negative $13 million.
- We believe the company's audit committee simply cannot be relied upon, as a majority of the committee has worked together for years prior to serving on the board of J2 in roles that reveal conflicts of interest.
- The "independent" board approved the cancellation of J2's dividend to "create greater shareholder returns over the near, medium and long term". This apparently includes massive loss-making capital commitments and management fees to related parties.
- J2's young, newly minted CEO was compensated over $45 million during his first year in the role, more than the CEOs of Microsoft and J.P. Morgan, despite J2 being a fraction of the size. We can't help but wonder whether the board and executive team could be simply trading favors, in a manner consistent with J2's actions for decades.
- COVID-19 has now officially halted the company's acquisition model. **We feel this is a crucial opportunity for the company's auditors to examine all of the transactions we lay out in this report** (including all acquisitions made under the former VP of Corporate Development) and take necessary measures to prevent what we believe to be additional misuse of shareholder capital going forward.

*Update 7/1: Following publication, the company responded, including a clarification on a transaction we had estimated, along with various other explanations. We have updated the piece to replace our estimate number with the newly-reported number, and to add other elements of their response.*

# *Introduction To J2 Global*

J2 Global describes itself as a "leading internet information and services company". Its business consists of a portfolio of over 40 major digital media brands, including well-known sites such as IGN, Mashable.com, SpeedTest.net and numerous others.

The company started as "JFax" in 1995, originally focused on forwarding faxes and voicemail messages to e-mail. It changed its name to "J2 Global Communications" in 2000 to pursue a more diversified strategy.

These days, the company can best be described as a perpetual roll-up that has engaged in a decade-long spree of acquisitions in the digital media space.

J2 segments its business into two categories: "Cloud Services" and "Digital Media". [Pg. 16] The company's Cloud Services business generates ~48% of its revenue from its legacy online fax service customers, but also includes online backup services, e-mail services, encryption services and other subscription-based cloud services. [1]

The digital media side generates revenues primarily from advertising and sponsorships, subscription and usage fees, performance marketing and licensing fees.

In the past, notable short sellers [1,2] have taken aim at J2's roll-up model, alleging aggressive accounting and unsustainable business metrics. The company has withstood these critiques, helped by sell-side cheerleading of J2's acquisition roll-up model and economic tailwinds that had buoyed most businesses.

Today we bring new evidence to light that we believe should catalyze an auditor intervention — we have discovered a series of related-party transactions that appear designed to enrich insiders over the course of the past decade. We have also found evidence of undisclosed goodwill impairments at JCOM's subsidiaries.

Combining the above with what we believe is a complete lack of corporate governance at the company, we think our findings should be a wake-up call for J2's shareholders and its auditors.

We are notifying their auditors of our findings as well.

## *The Bull Case: J2 is a Finely-Tuned Acquisition Machine That Has Grown Revenue For 24 Straight Years and Has Generated Positive Operating Cash Flow*

J2 bulls argue that the company is a growing financial powerhouse, having achieved 24 consecutive fiscal years of revenue growth. It is an active acquirer of businesses, having deployed approximately $3 billion of acquisition capital since its founding to acquire 186 different companies.

It has never taken a goodwill impairment in its history, which bulls point to as an example of its disciplined acquisition approach.

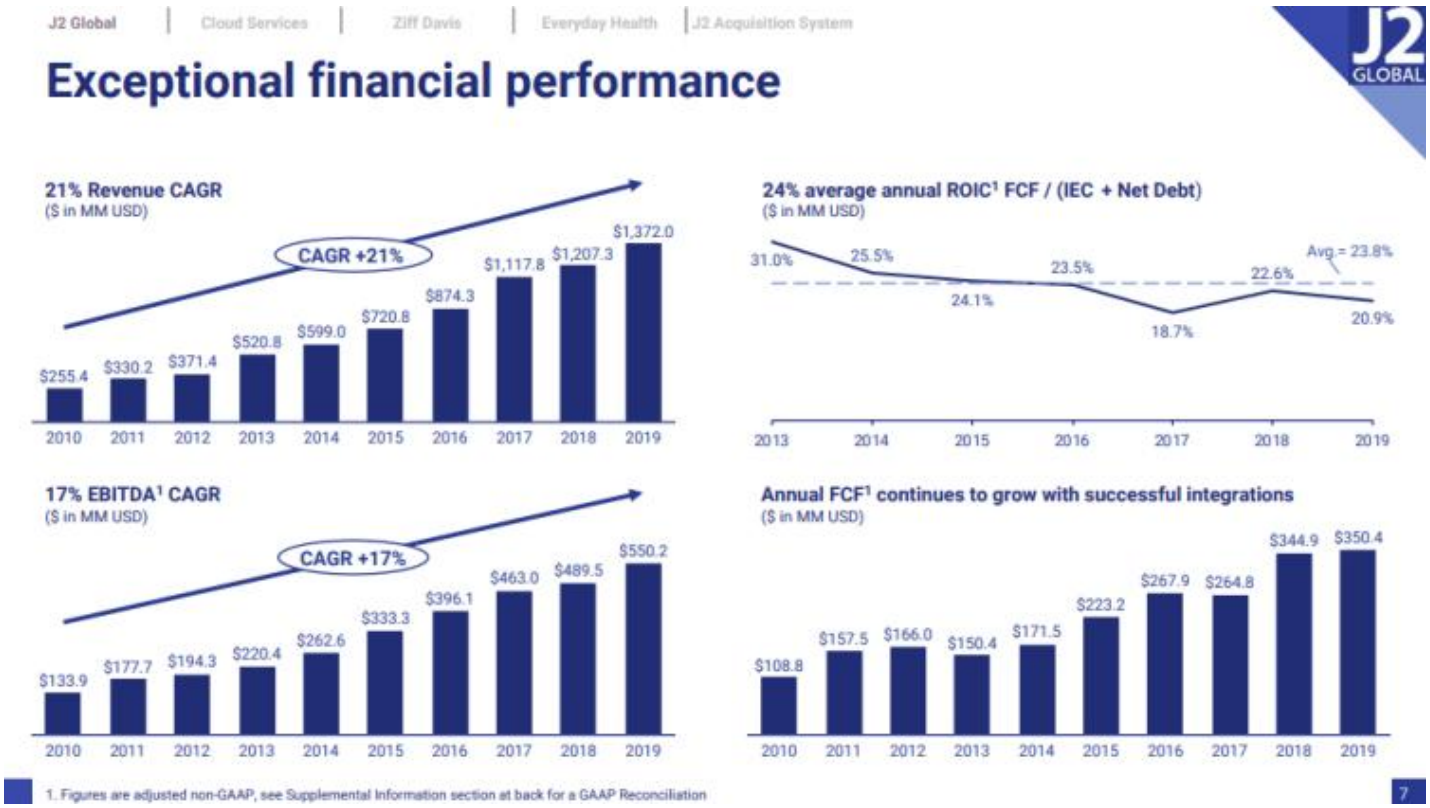
The company's CEO, Vivek Shah, recently stated:

> *"If you asked me, 'what is the single great competitive advantage of the company'? It's that acquisition system." [3:52]*

The company says its "deep industry knowledge, technological expertise and investment acumen" allows it to invest capital wisely and successfully integrate each acquisition. The company has generated $418 million in operating cash flow over the TTM period, with 34% EBITDA margins. [Source: FactSet]

J2 now consists of over 40 major brands with 4.6 million subscribers and over 1,100 advertising partners.

A March 4, 2020 investor presentation described the firm as having "exceptional financial performance". Its charts paint the picture of a perfectly consistent growth trajectory.




From the outside, JCOM looks like a perfectly tuned acquisition machine that has integrated hundreds of disparate media companies into a cash flow-generating powerhouse.

## *Reality Check: The Stark Reality At J2 Includes Insider Self-Dealing, An Alarming Lack Of Governance Since Inception, Looming Financial Impairments And A Legacy Business In Decline*

Contrary to the picture that the company has painted, we found a vastly different reality at J2.

**Related arty Transactions:** J2 and its executives have a several decades long history of related party acquisitions and undisclosed self-dealing, including:

1. Using $900 thousand in shareholder capital to acquire a newly-formed entity set up by J2's then VP of Corporate Development. The entity was headquartered at his personal residence in the Netherlands, and the conflict was never disclosed.
2. Committing $200 million of shareholder cash to the J2 Chairman's newly-formed VC firm despite a consistent track record of prior investment failures. J2 expects to commit an additional $100 million, for a total of $300 million.
3. One of the earliest investments made by the VC vehicle, an estimated $12 million, was to an entity whose incorporation documents list J2 Chairman Richard Ressler's nephew and

lawyer – an indirect related party transaction. We discuss this entity in more detail below.

4. J2 Chairman's track record includes the initial backing, majority ownership, directorship and affiliated executive role in publicly traded biotech company called Presbia that itself **operated a newly-formed entity out of the exact same personal residence owned by J2's V of Corporate Development.** That company has seen its stock fall ~99% in the last 5 years.
5. Previously, J2 had acquired yet another entity based out of the same employee's personal residence back in 2004.

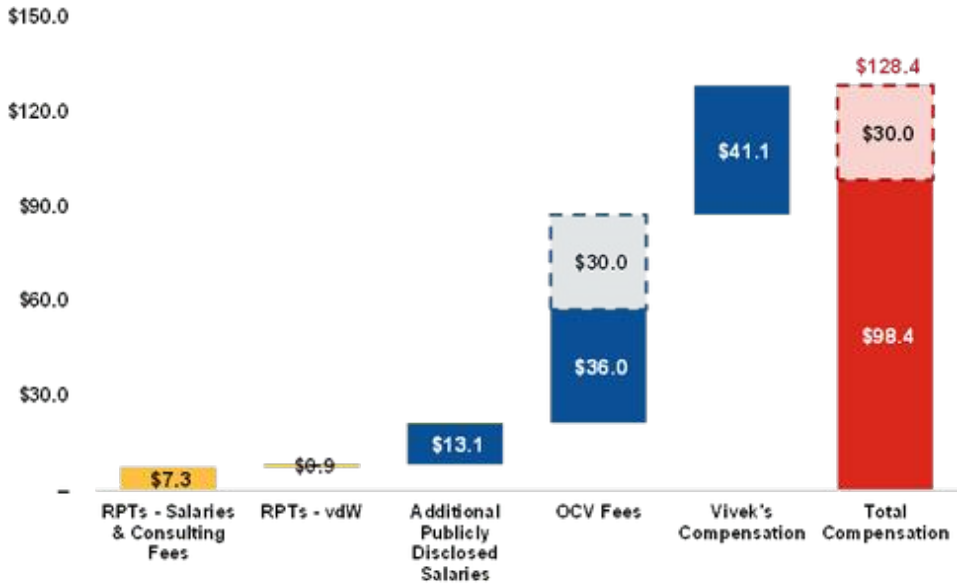
To reiterate **: J2's former V of Corporate Development had formed 3 entities out of his house that were then acquired operated by J2 and another company headed by J2's Chairman that cost incurred losses totaling an estimated 11 million.**

That same VP of Corporate Development was responsible for 135 M&A transactions at J2, according to his LinkedIn profile. That number represents ~73% of the acquisitions in the company's history.

J2 has historically provided limited disclosure to investors on its acquisition portfolio, raising the prospect of broader malfeasance given 1) this individual's oversight of these transactions and 2) the close ties he had with the company's Chairman. He was also integral in J2's European expansion, helping J2 acquire dozens of businesses. Contrary to sell-side perception, many of these businesses have shown significant fundamental deterioration and warrant further impairment testing.

**Executive enrichment:** Executives have also enriched themselves overtly, which shareholders have ignored due to J2's perceived impressive growth: **J2 paid million in total compensation to its CE in 2018** [Pg. 38] **more than the CE of 1 trillion dollar Microsoft and 2 0 billion J. . Morgan.** Shah was named CEO three days after J2 agreed to commit $200 million to the investment vehicle managed by J2's outgoing CEO, the EVP of Strategy, and the current Chairman. [ Pg. 51] We find it uncanny that Shah was awarded a ludicrous pay package precisely when related party transactions diverted assets to other key insiders.

**J2 Executive Excess Self-Enrichment**




**Undisclosed Goodwill Intangible Impairments:** Whereas J2 hasn't recognized goodwill impairments at its parent level, audits at J2's subsidiaries show a slew of goodwill impairments. We have also found signs that multiple acquisitions are clearly underperforming and likely necessitate obvious impairments that haven't been taken.

1. As one example, a key J2 subsidiary recorded an 22 million impairment despite zero goodwill impairment recognized at the parent corporation.
2. Of J2's 14 "feature" web-based brands, 9 have seen Alexa traffic rankings plummet in the past several years, making them obvious candidates for goodwill impairments.
3. Trouble with the perfect acquisition machine:
    - Everyday Health, J2's largest acquisition, saw an immediate post-acquisition revenue drop of ~25%, yet no impairment was recorded. Instead, J2 went on a spree of asset disposals/acquisitions that obfuscated the entity's financial position.
    - J2's key European subsidiary has seen its revenue decline 27% in the past 3 years, with operating income swinging from 5.2 million to negative 11.5 million.

4. VDW, a dissolved undisclosed related-party transaction that should likely be a full write-off.
5. The VC vehicle J2 has invested in has an asset that appears to be a conflicted related party. A former employee we spoke with said the operations are currently dormant and its staff have been laid off. (Note that another of the VC vehicle investments is down 50% since IPO which will reflect on the financials on a mark-to-market basis.)

Even though the company has completed $2bn of acquisitions since 2012, mostly in digital media (and cloud services businesses), J2's predominant legacy fax segment still represented 64% of LTM operating income. Last quarter, it accounted for 83% of operating income despite the time, cash, and assumed debt through J2's acquisition spree.

Approximately ~$700m of acquisitions for which we have visibility are seeing revenue declines, appear to be underperforming, or have been outright dissolved. That is approximately 1/3 of acquisitions completed since 2012 (of $2bn) – yet we have seen no impairment of goodwill to date. We estimate $155 million in impairments across this subset based on our review. If extrapolated across the acquisitions for which we have zero to little visibility the picture likely worsens.

The disproportionate underperformance of the marquee Everyday Health acquisition should round-out the need for investigation. The opaque nature of J2's M&A program has also left investors in the dark on the magnitude of insider enrichment and fundamental deterioration of the underlying businesses.

**Corporate governance appears to be non-existent Clear Conflicts Among Independent Board Members**

The current situation at J2 has been enabled by a corporate governance vacuum. The Chairman and multiple " independent " board members, including the chairs of the audit and compensation committees, have numerous overlapping business interests, calling their actual independence into question.

**Conflicts Among "Independent" Board Members**

| Company | End Result/Increase (Decrease) in Value | Richard Ressler | Brian Kretzmer | Stephen Ross | Doug Bech | Robert Cresci |
|---|---|---|---|---|---|---|
| J2 Global Position | | Independent Chairman | Independent Director/ Audit Cmte Chair | Independent Director/ Audit Cmte | Independent Director/ Comp Cmte Chair | Independent Director |
| J2 Global | TBD | ✔ | ✔ | ✔ | ✔ | ✔ |
| Presbia | (99.9%); (Delisted) | ✔ | | | | ✔ |
| MAI Systems Corp. | (99.9%) | ✔ | ✔ | ✔ | | |
| Universal Telecom Services, Inc. | Dissolved | ✔ | ✔ | | | |
| CIM Group | ~3.8% Annl Rtn | ✔ | ✔ | | ✔ | |

1. **Independent" Chairman Richard Ressler** has outside business ties with much of the board, along with multiple J2 executives. As noted above, Ressler's new investment firm Orchard Capital Ventures ("OCV"), which itself is staffed with senior J2 executives, received a $200 million commitment from J2's shareholders, with the expectation that it will increase to $300 million. [ 21] The transfer was approved by J2's audit committee [ Pg. 22], which is Chaired by long time Ressler associate Brian Kretzmer.

2. **Independent" director and audit committee chair, Brian Kretzmer,** has a work history with J2 Chairman Richard Ressler dating back nearly three decades.

Most importantly, Kretzmer consulted for the OCV affiliate Orchard Capital. This is a flagrant conflict of interest, given that as chair of the audit committee Kretzmer then approved the $200 million commitment of J2 Capital to OCV.

This conflict was not disclosed to investors. Instead, it appears steps were taken to conceal it. Kretzmer removed his role at Orchard from his personal website, but we can see from an earlier Google cached version that Kretzmer worked on M&A for Orchard Capital:


Beyond working for the predecessor entity of a $200 million related-party transaction that he "independently" approved, Kretzmer had additional ties to Ressler. Kretzmer was CEO of IT company MAI Systems Corp while Ressler was Chairman. [Pg. 19] Kretzmer was also a Director at investment company CIM Real Estate Finance Trust, founded by Ressler. He also worked with telecommunications company Universal Telecom, one of Ressler's former portfolio companies.

**3. Independent" director and audit committee member, Stephen Ross,** has a 20-year history with J2 Chairman Ressler and director/audit committee chair Kretzmer. Ross served as director at MAI Systems together with Ressler (Chairman) and Kretzmer (CEO & President). Ross's son was also employed at CIM Group, where Ressler was Chairman, eventually becoming CTO. [9]

Note again that the "independent" audit committee, whose chairman and majority of its members had multiple overlapping business ties with Ressler, were responsible for providing the approval of $200 million in J2 cash being directed into Ressler's newly-formed investment entity.

Years ago, while serving at MAI systems, Ross Chaired a special committee that approved a reverse stock split deal that explicitly benefited Ressler. [ Pg. 9]

Kretzmer and Ross were hired to the J2 board on the same day 13 years ago.

. **Independent" compensation committee chair,** Douglas Bech, also serves as director/chairman of the corporate governance committee at CIM Commercial Trust, a business founded by J2 Chairman Richard Ressler.

**Corporate governance appears to be non-existent Clear Conflicts Between the Independent" Board Members and The Executives They Are Supposed to Be verseeing**

**"Independent" Board's Intertwined Interests With J2 Executives**

| Company | End Result/Increase (Decrease) in Value | Richard Ressler | Brian Kretzmer | Zohar Loshitzer | Hemi Zucker |
|---|---|---|---|---|---|
| J2 Global Position | | Independent Chairman | Director / Chair Audit Cmte | EVP Strategy | Ex-CEO |
| Presbia | (99%); (Delisted) | ✓ | | ✓ | |
| MAI Systems Corp. | (99%) | ✓ | ✓ | ✓ | |
| OCV Management | $200m commitment from J2 | ✓ | | ✓ | ✓ |
| Universal Telecom Services, Inc. | Dissolved | ✓ | ✓ | ✓ | |
| Environmental Solutions Worldwide | (99%); (Delisted) | ✓ | | ✓ | |
| Vantage Surgical Systems | Quietly disappeared | ✓ | | ✓ | |
| Orchard Telecom, Inc. | Quietly disappeared | ✓ | | ✓ | |

**The company's auditor, BD** , has collected increasing audit fees while apparently staying silent on potential conflicts and clear looming write downs. Total audit fees that J2 Global has paid to BDO have more than doubled to $4.4 million in 2019 from $2.1 million in 2016.

**Legacy business flatlined.** The company's eFax business has essentially flatlined for the past several years [ Pg. 117]. Overall, its cloud services segment is seeing cancellation rates tick up while average revenue per user declines as the company has attempted to increase topline metrics through acquisition. [ Pg. 42]

**Digital media business in decline.** The company's other segment, digital media, is showing sharp declines in page views among key brands. The segment also faces headwinds from the Covid-19-associated economic crisis, particularly as advertising budgets and rates are slashed

across the board.

**verall: Investors in the Dark and Auditors Sitting n Their Hands Leads to J2 Global's Equity Being Uninvestible**

Investors have taken for granted that the company's acquisition spree has been additive. Yet the absence of thorough disclosure related to the company's governance and unexamined deals has left investors in the dark to potential write-offs and insider self-dealing. This state of affairs has been permitted by a lack of truly independent board oversight and a sleepy auditor. All told, we think J2's executives have used the booming equity markets to steadily enrich themselves at the expense of shareholders.

At the moment, shareholders likely feel secure with the business generating free cash flow (~$75 million as of last quarter ). But its reported growth metrics (both cash flow and revenue) have largely relied on acquisitions. The company has paid $375 million for acquisitions over the past 4 quarters alone. On the company's recent quarterly conference call, management announced a halt on M&A due to COVID-19. In the absence of M&A, we expect free cash flow will materially erode over the coming quarters, leaving shareholders with a $1.5 billion pile of debt that presents a danger to equity holders.

We think this is a crucial time for auditors to closely examine the evidence we will present below.

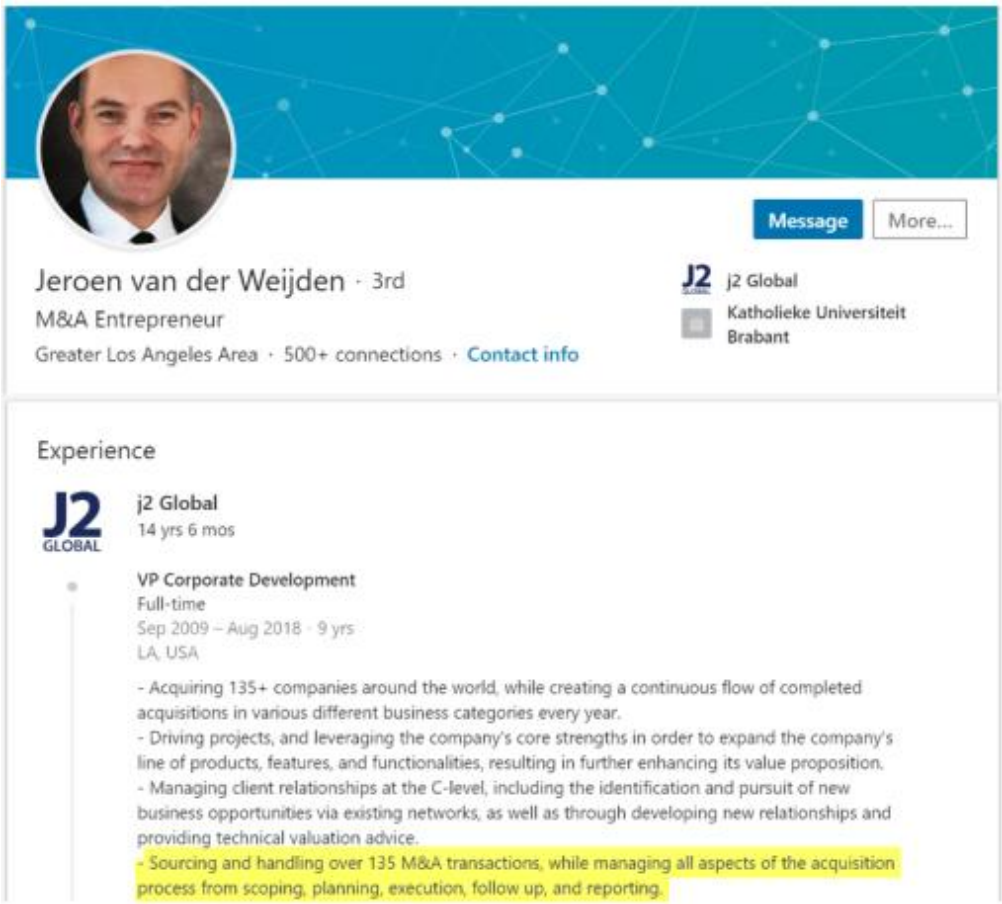
# *Part I: Related Party Transactions And Insider Self-Dealing*

## *J2 Shareholder Cash Was Used to Purchase A Newly-Formed Entity Based Out of J2's Long-Serving VP of Corporate Development's Personal Residence In The Netherlands*

As we will show, we think J2 has engaged in insider self-dealing for a long time, continuing to this day, with investors completely unaware.

In one obvious example, in 2015, the company acquired an 11-month old entity based out of a J2 employee's apartment in the Netherlands for $900 thousand, without disclosing it as a related-party deal.

The J2 employee, Jeroen van der Weijden, had a decade-long relationship with J2's Chairman and had worked at J2 for at least 11 years by the time of the acquisition, per his LinkedIn page. Note that post-publication, the company stated that Jeroen was a consultant not an employee, contrary to the representations on the LinkedIn profile. Per the same LinkedIn page, he "sourced and handled over 135 M&A transactions" for J2 since 2004, serving as "GM Europe" and "VP Corporate Development".




This apparently included advising the company to purchase his own entity where he was the sole employee and its "intellectual property".

## *The Company Completely Failed to Disclose the Clear Conflict (And Barely Disclosed the Deal at All)*

In October 2015, J2 announced in a press release that it had acquired 9 businesses. Among the acquisitions, listed under "Intellectual Property" on the press release, was a company called VDW (Netherlands).

**Acquisition Activity**

The acquisitions listed below will grow the Company's global customer base, provide access to new markets and expand j2's product lineup. The acquisitions are:

| Cloud Backup | Cloud Connect | Digital Media | Intellectual Property |
|---|---|---|---|
| LiveVault (USA) | Axiatel (France) | Salesify (USA) | VDW (Netherlands |
| Online Backup Vault (USA) | Popfax (France) | | |
| DSA Technologies (USA) | Network Telsys (Canada) | | |
| Comtech (Norway) | | | |

(Source: J2 October 5, 2015 press release )

J2's 2015 annual report did not mention the transaction by name or give any more color on it. Since the press release tucking it in with eight other acquisitions was the only evidence we could find of the transaction, it was easy to miss.

The company only reported the initials of the entity, "VDW". Its full name, according to Dutch corporate records , is actually **V**an **d**er **W**eijden M&A Consultancy BV. It was set up 11 months earlier, in December 2014, in the name of long-time J2 employee Jeroen **v**an **d**er **W**eijden , according to the same records. Perhaps that is why the company thought "VDW" was a better choice for its disclosures.

The company was registered to Van der Weijden's personal residence in Amsterdam (at Pieter Pauwstraat 2A-H), according to the same corporate records, and listed a total of zero employees.

# History

34 62138960 Van der Weijden M&A Consultancy BV

ttps://www.kvk.nl/handelsregister/TST-BIN/FP/TSWS010@?BUTT=621389600000&CHK1=J&kvknumme

/10/2020 https://www.kvk.nl/handelsregister/TST-BIN/FP/TSWS010@?BUTT=621389600000&C

Pieter Pauwstraat 2 AH 1017ZJ Amsterdam

**Old statutory names as recorded since 01-10-1993**

| | |
|---|---|
| Statutory name | Van der Weijden M&A Consultancy BV |
| Date of entry | 23-12-2014 |
| End date | 28-10-2019 |

**Company**

| | |
|---|---|
| Trade name | Van der Weijden M&A Consultancy BV |
| start date company | 23-12-2014 |
| Activities | SBI code: 70222 - Management and operational management consultancy (no public relations and organizational consultancy firms) |
| Working people | 0 |

(Source: Netherlands Chamber of Commerce)

Dutch real estate records confirm that the residence belonged to Jeroen.

**RECHTEN**

| | | | |
|---|---|---|---|
| **1** | **Eigendom (recht van)** | | |
| **Afkomstig uit stuk** | Hyp4 57545/169 | **Ingeschreven op** | 02-12-2009 om 12:31 |
| **Naam gerechtigde** | De heer Jeroen Clemens Maria van der Weijden | | |

(Source: https://www.kadaster.nl/ )

And here is a picture of the residence, via Google Maps:

The company never disclosed the purchase price for VDW, but based on an analysis of the price of the other transactions that quarter we estimated the number. [2] We emailed the company asking to provide the number and had not received a response as of publication. [3]

Following publication, the company disclosed the purchase price. It also stated that Jeroen was a consultant not an employee, contrary to the representation on his LinkedIn profile.

We urge the company to provide shareholders and its auditors full detail on this transaction along with any additional conflicted transactions.

As we will show, this personal residence housed four different businesses: (1) J2 Global NV (2) VDW (3) Presbia (discussed below), and (4) a business run by Jeroen's brothers.

## *A Month Later, the Newly Enriched Employee Purchased a California Mansion*

About one month after the purchase of his "Intellectual Property" company, Jeroen bought a $2.5 million mansion in California with a heated saltwater pool, tennis court and steam room, according to California real estate records.

(Source: Zillow, 11920 Laurel Hills Road, Studio City, California)

## *The Acquired Entity Was Dissolved Shortly After the Employee Left the Firm*

Jeroen left J2 in 2018, according to his LinkedIn profile . The Netherlands Chamber of Commerce registry for VDW says that the corporation had been dissolved shortly thereafter, effective October 18, 2019.

Company profile - Van der Weijden M&A Consultancy BV (62138960)

Chamber of Commerce, 03 April 2020 - 18:36

**Extract**

**Chamber of Commerce number** 62138960

**Deregistered from the trade register as of 28-10-2019**

**On 28-10-2019 it was registered that the dissolved legal entity has ceased to exist because there are no known benefits anymore as of 18-10-2019.**

(Source: www.kvk.nl company profile for Van der Weijden M&A Consultancy BV )

Given that Jeroen was already working for J2 as an M&A advisor, per his Linkedin Profile, we found it tremendously odd that the company acquired his M&A advisory consultancy firm, without disclosing the obvious conflict, then just dissolved the entity shortly after he left. In the company's response post-publication, it stated the dissolving corporate entities following acquisition is normal.

Lastly, and perhaps most troubling, Jeroen held key responsibility for the 135 acquisitions he oversaw while at J2. We only went through a fraction of the deals (largely because of J2's opaque disclosures) and found obvious red flags. Per Jeroen's LinkedIn profile, he managed:

> *"Sourcing and handling over 135 M&A transactions, while managing all aspects of the acquisition process from scoping, planning, execution, follow up, and reporting."*

Note that J2 has completed 186 acquisitions, suggesting that Jeroen, who was apparently the beneficiary and key participant in an undisclosed related-party transaction, was involved in over 73% of J2's acquisitions. Given that the audit committee nor the head of M&A appear to be functioning appropriately, it is our view that independent and external parties should conduct investigations on each and every one of the 135 deals that Jeroen oversaw.

## *Related Party Transactions and Insider Self-Dealing: J2 Committed $200 Million Of Shareholder Cash to a Newly-Formed Investment Vehicle Run by J2's Chairman, Richard Ressler*

Two years after the VDW acquisition, J2 continued its string of insider self-dealing with a massive allocation of cash to an investment entity controlled by insiders.

In 2017, J2 committed $200 million of shareholder funds to Orchard Capital Ventures ("OCV"), a venture capital fund formed in the prior year by J2's Chairman Richard Ressler. Ressler is OCV's majority equity owner despite J2 comprising almost 77% of the equity of the fund. [Pg. 88] [Pg. 21]

The deal was approved by J2's audit committee [Pg. 51], which as we detail further in Part II, likely unbeknownst to investors, appears heavily conflicted.

We calculate that J2 will pay OCV $36 million in management fees alone, given its fee structure. [Pg. 88, Pg. 2] This could increase if the fund earns any performance fees.

It might seem strange that (once again) **J2 is paying millions to its own insiders to invest in ventures**, given that **J2 is already in the business of investing in and acquiring other ventures**.

The overlap with J2's business model is clear from OCV's own description of itself:

> *"OCV's core focus sectors include information technology, cloud businesses, e-commerce, media & telecommunications, life sciences & healthcare, and clean technology."*

Meanwhile, J2's website states:

> *"At J2 Global, we seek to acquire and support internet-enabled companies in a variety of sectors, including media, technology and services."*

Bizarrely, when pressed on this issue, J2 seemingly tried to explain this away by stating that OCV's investments are a strategic misfit for J2. Specifically, the company claimed to be shelling out the $200 million in order to "invest in promising businesses and technologies that were not a fit with J2's public company environment."

The lack of liquidity in these investments is noteworthy. J2's leverage has continued to climb and has constrained J2's balance sheet. The company's dividend was suspended in mid-2019, making room for large capital calls into its Chairman's illiquid investment vehicle.

## *J2 Chairman Richard Ressler's Track Record Includes a Slew of Failures, Along With Signs of Other Undisclosed Related-Party Dealings*

Given that the newly-formed OCV had no track record, we explored Ressler's track record outside of J2 in order to understand whether the massive diversion of resources to his firm was the best possible use of investor capital.

We found that Ressler's other venture investments comprised a remarkable string of investment failures, marred by signs of related-party transactions and forms of self-enrichment. A brief case study of his investment in a company called Presbia follows. (In Appendix A we break down Ressler's track record – in summary, 10/12 investments were 0s or near 0s.)

Other venture investors seem to have come to the same conclusion on Ressler's track record.

In January 2018 (shortly after J2's massive allocation to OCV was signed), J2's CFO, Scott Turicchi, stated that OCV would raise a further $100m dollars from other investors – predominantly on the back of Ressler being a "savvy investor". [ Pg. 20]

That interest never seemed to materialize however. Per OCV's 2020 ADV filing with the SEC, it manages around $240 million, meaning that J2's commitment likely will make up almost 85% of the firm's gross assets.

**Transcript from the William Blair Conference**

Q: It still doesn't make sense to me for a company that is an operating company and is successful at operating businesses, to turn into a passive investor along with (50) billion dollars, private equity dollars that are out there chasing deals, why can't you just stick to what you do?

A: Well, I think it's just another means for us to invest our capital. So I understand there may not be an agreement on that, but...

Q: Why do you think you'll be better than the other [private equity funds]?

A: It's not us by the way. It's not us. **It's our capital though entrusted to particularly our Chairman, who has been a very savvy investor over a very long timeframe** and the team that he's built around it under a company called OCV. So look it's a business decision that the company has made. We think it will pay off over time. We'll have to see.

Q: **So why couldn't he have raised the funds himself?**

A: **He could. He did raise some funds independent of us.**

Q: So why has this happened?

## *J2 Chairman's Questionable Investing Record: Key Role at a Public Biotech Company That Saw 14 Million Euro Disappear Through an Entity Based out of the Same J2 Employee Residence in The Netherlands .*

## *Its Stock is Now Down ~99% .*

Richard Ressler's "savvy" investment experience includes controlling publicly traded biotech company, Presbia, a medical device company focused on a product meant for aging-related farsightedness. The company, whose board was stacked with J2 insiders, is down ~99% since

going public in 2015, amidst a series of questionable dealings.


Presbia's board was stacked with J2 insiders:

- Richard Ressler, J2 Chairman
- Robert Cresci, J2 Director
- Zohar Loshitzer, J2 EVP of Corporate Strategy and former Chief Information Officer
- Mark Yung, recent managing principal of related OCV

## TEAM MEMBERS

PRESBIA MANAGEMENT | BOARD OF DIRECTORS | MEDICAL ADVISORY BOARD

**MARK YUNG**
MEMBER OF BOARD
Mark Yung was a Co-Founder and Managing Principal of OCV Management, LLC ("OCV"), an investor, owner and operator of technology and life science companies based in Los Angeles. Previously, Mr. Yung was a Managing Director at Orchard Capital Corp., a ...
Read Full Bio

**GERD U. AUFFARTH, M.D., PH.D., F.E.B.O.**
MEMBER OF THE BOARD
Dr. Gerd U. Auffarth joined the Presbia Board of Directors in August 2015. Dr. Auffarth is the Chairman and Director of the Department of Ophthalmology at the Ruprecht-Karls-University of Heidelberg, Germany. Dr. Auffarth is also the Director of the International ...
Read Full Bio

**RICHARD RESSLER**
MEMBER OF THE BOARD
Mr. Ressler is the founder and President of Orchard Capital Corp. ("Orchard Capital"), a firm through which Mr. Ressler oversees companies in which Orchard Capital or its affiliates invest. Through his affiliation with Orchard Capital, Mr. Ressler serves in various ...
Read Full Bio

**ROBERT J. CRESCI**
MEMBER OF THE BOARD
Mr. Cresci has served as a director of Presbia PLC since March 2015. He has been a managing director of Pecks Management Partners Ltd., an investment management firm, since 1990. He currently serves on the boards of j2 Global, Inc., ...
Read Full Bio

**GERALD FARRELL, PH.D**
MEMBER OF THE BOARD
Dr. Gerald Farrell joined the Presbia Board of Directors in January 2016. Dr. Farrell has been involved the pharmaceutical industry for more than 25 years, and worked for Eli Lilly Company Limited in Ireland and the United Kingdom for the ...
Read Full Bio

**ZOHAR LOSHITZER**
EXECUTIVE CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER
Zohar Loshitzer is the Executive Chairman of the Board and Chief Executive Officer effective May 1, 2019. Zohar Loshitzer has served as a director of the Company since February 2014. He served as a director of Presbia Holdings from May ...
Read Full Bio

(Source: Presbia website , accessed on 5/4/2020 – since then, Yung, Farrell, Auffarth and Cresci have been taken off the site)

Shortly after its IPO, on June 9, 2015, Presbia dismissed its big-4 auditor, Deloitte " effective immediately " in favor of lesser known Square, Milner, Peterson, Miranda & Williamson, LLP.

This move appears to have foreshadowed what was to come. Recall from the earlier section that we identified an apparent undisclosed related party transaction whereby J2 acquired an entity based out of the personal residence of its employee, Jeroen Van Der Weijden, in the Netherlands. Here is the address:

**Establishment**

| | |
|---|---|
| Branch number | 000031176542 |
| Trade name | Van der Weijden M&A Consultancy BV |
| visiting address | Pieter Pauwstraat 2 AH, 1017ZJ Amsterdam |
| Date of settlement | 12/23/2014 (registration date: 12/23/2014) |
| Activities | SBI code: 70222 - Consultancy in the field of management and business operations (no public relations and organizational consultancy) Performing various management and advisory activities worldwide, including but not limited to advising, lead generation and leading due diligence, as well as performing interim management activities. |
| Working people | 0 |

https://www.kvk.nl/handelsregister/TST-BIN/FP/TSWS010@?BUTT=621389600000&CHK1=J&kvknummer=621389600000&product=Bedrijfsprofiel 1/6

We discovered that **resbia also had an entity based out of the exact same residential address**:


(Source: Presbia brochure , accessed from Presbia's website 5/4/2020)

The entity run out of Jeroen's house seemed to be focused on selling and marketing [ Pg. 71]. It managed to rack up **1 million Euro in losses** despite minimal assets and seemingly minimal operations, per Dutch corporate filings :

## Annual accounts - Presbia Cooperative UA (34278201)

Chamber of Commerce, January 12, 2020 - 20:29

| | |
|---|---|
| Name of legal entity: | Presbia Cooperative UA |
| Address: | 8845 Irvine Center Drive Suite 100<br>92618 Irvine, CA. |
| Registered office: | Amsterdam |
| Date of establishment: | 10/07/2007 |
| Legal form: | Cooperative |
| Status: | terminated / unsubscribed |

| **Balance sheet**<br>**Financial year:** | **2018** | **2017** | **2016** |
|---|---|---|---|
| Type of financial statement: | company | company | company |
| Profit Destination: | in front of | in front of | in front of |
| Amount: | x 1 | x 1 | x 1 |
| Currencies: | EUR | EUR | EUR |
| **Assets** | | | |
| other fixed assets | | | 21,733 |
| **FIXED ASSETS** | **0** | **15,512** | **21,733** |
| other current assets | | | 802,998 |
| **CURRENT ASSETS** | **0** | **511,943** | **802,998** |
| **TOTAL ASSETS** | **0** | **527,455** | **824,731** |
| **Liabilities** | | | |
| other reserves | | | 11,383,371- |
| **EQUITY** | **13,900,776-** | **11,457,903-** | **11,383,371-** |
| SCHULDEN (other) | 13,900,776 | 11,985,358 | 12,208,102 |
| **OTHER PASSIVA** | | | **12,208,102** |
| **TOTAL PASSIVA** | **0** | **527,455** | **824,731** |

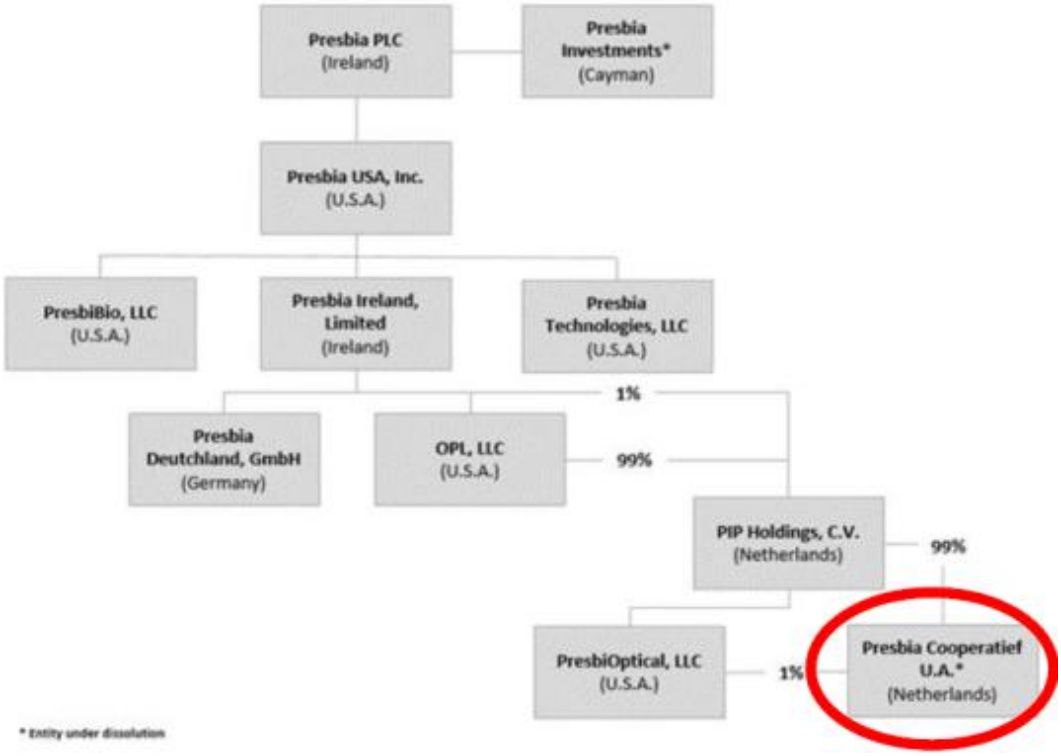
(Source: Presbia Netherlands annual statements 2018 )

The entity was apparently sold to Presbia in part from Orchard Capital, an investment vehicle run by Richard Ressler, per the Dutch corporate records . Once again, we view this as a major red flag and a clear pattern of behavior:

### 4. Capital and reserves

The Cooperative has two members, PIP Holdings C.V. (formerly International Telecom Holdings 2 C.V.) and PresbiOptical LLC, registered in Delaware, United States of America (which acquired its membership form Orchard Capital Corporation).

The entity didn't seem to be critical to Presbia's operations—it was eventually placed under liquidation "in an effort to simplify the Company's organizational structure." [ Pg. 26]




The loss Presbia drummed up, apparently from Jeroen's 400 sq ft apartment, is alarming to say the least. Around this time, J2 also acquired VDW from Jeroen, as we noted earlier in our report.

We wonder—why were multiple businesses established at a key J2 employee's apartment involved in deals overseen by J2 Chairman Richard Ressler?

By 2019, after burning through its resources, Presbia was delisted from the NASDAQ after failing to pay $55,000 in listing fees.

## *Jump BV Was Established By The Same Individual, Jeroen Van Der Weijden, At the Same Residential Address. It Was Also Acquired by J2*

## *Why Are J2 and its Related Individuals Acquiring Multiple Entities Based Out of the Same Residence?*

In 2004, J2 paid roughly $1 million to $2 million to acquire Jump B.V. [Pg. 8, Pg. 1], an entity based in the Netherlands founded by its eventual VP of Corporate Development, Jeroen Van der Weijden (for context, this ~$1-2m was 1-2% of the then JCOM revenue). Per J2's filings, Jump was described as a provider of fax-to-email and unified messaging services, which fits with J2's primary focus at the time.

Per Dutch corporate records, Jump was later reorganized as J2 Global Netherlands, and was based at the exact same residential apartment that later J2 acquisition VdW was registered (along with the subsidiary of Presbia mentioned earlier):

| **Location** | |
|---|---|
| Location number | 000017889847 |
| Trade names | J2 Global (Netherlands) BV |
| | j2 Global NL |
| visiting address | Pieter Pauwstraat 2 A-I, 1017ZJ AMSTERDAM |
| Fax number | 0847102425 |
| Internet address | www.jumpservices.com |
| E-mail address | jeroen@jumpservices.com |
| Date of settlement | 01-12-2001 |
| Activities | SBI code: 620201 - Hardware consultancy |
| | SBI code: 620202 - Software consultancy |
| | The IT services |
| Working people | 4 |

We reiterate: Why did J2 and its related individuals acquire multiple entities run by the same individual based out of the same residence?

## *Inside OCV's Portfolio: An Estimated $12 Million Investment in a Niche Home Movie Business Formed By Ressler's Nephew (That Now Appears to be Dormant)*

So what investments are J2 paying OCV to manage? One example is Red Carpet Home Cinema, a niche business formed by Ressler's nephew that allows the ultra-wealthy to screen movies in their homes for a $10,000 set up fee and $1,500 per movie.

Per his LinkedIn, Richard Ressler's nephew, working for OCV as a Principal, became CFO of Red Carpet just as J2 got its first capital calls from OCV. [Pg. 45] He also set up the entity itself, according to California registration documents. OCV principals comprise half the board at the firm.

Red Carpet seems to also be a rather odd fit. The entity was a brand new startup with no revenue [4], which violates OCV's own investment guidelines:

OCV

We work with entrepreneurs, talented management teams, and experienced industry experts to grow businesses that are built to last and offer asymmetric upside. We deploy from $5 million to $20 million in companies that:

- Demonstrate revenue traction of $5+ million with unique intellectual property for information technology, e-commerce, media and telecommunications, and clean technology.

We attempted to visit the office pre-COVID during working hours but the door was locked and no one appeared to be there.


Similar types of businesses had already tried and failed, including one that included the CEO of Red Carpet as a director.

Red Carpet appears to be on a similar trajectory. A former employee told us that the film units are "sitting in a warehouse right now" and that due to COVID-19 they had to "rev everything down because the world changed". Per the former employee:

> " ***nce theaters close, studios don't release films, and if they don't release films the product I was working on doesn't exist.*** *Well it does, but it just doesn't have any offerings."*

## *Inside OCV's Portfolio: Part Overlap with J2's Own Investment Approach and Part Biotech (Which OCV Principals Have a Disastrous Track-Record With)*

We can't help but wonder if J2 will end up paying for OCV's tech portfolio down the line, further directing incentive fees and other benefits to its insiders for performing the work they were supposed to already be doing on behalf of J2's shareholders. Thus far, OCV's portfolio consists of:

- **our companies that have overlap with J2's investment mandate.** (Techstyle, Invoice2Go, Social Native, and SafeBreach). Our concern here is that OCV is just buying these companies with a view toward flipping them to J2 later at a premium, which would allow insiders to pocket performance fees and principal gains. Examples:
  - Invoice2go sells invoicing solutions to small businesses via subscriptions. J2 has multiple small business subscription and technology services.
  - Social Native, a marketing tech company offering branding and content solutions. J2 has an entire section of its website devoted to marketing tech.

- **Six companies that are healthcare biotech related, which CV principals have a disastrous track record in over 9 % historical losses.** (Finch, Ossio, Precision Biosciences, Praxis, 1200 Pharma, ByHeart.) OCV's principals have little experience in this sector, with the exception of driving one biotech company, Presbia, into the ground, as we will show. Another, Precision Biosciences, is already public and down ~50% since its IPO last year.
- **Two companies that are niche businesses.** Figure 8 runs the Museum of Ice Cream and Red Carpet Home Cinema aims to cater to the ultra-high-wealthy with an in-home movie screening business.

# *Part II: Tricky Accounting: J2's Public Entity Has Never Recognized Any Goodwill*

# *Impairments*

J2 has impairment reviews on a yearly basis, yet we see no impairments to goodwill or intangibles on its acquisitions for the last decade. [ pg.72, pg. 68, pg. 56, pg. 55, pg. 54]

We spoke with an investor relations representative about goodwill impairments and he explained:

> *"We haven't really had any…we also think about the world more in terms of non-GAAP"*

He also described the challenge of keeping track of performance in a roll-up with hundreds of acquisitions:

> *"All these tuck in acquisitions, they kinda just get shoved in to the broader J2 umbrella, within the business unit, within the division – and they don't really get tracked anymore. It's impossible to track the revenue that derives from 'Acquisition Y' versus what was there before. And the costs of course get blended together. It's really hard to track some of these tuck-in M&A."*

We reviewed international filings for J2's acquisitions to get a picture of how individual acquisitions are actually performing. This included filings from Sweden, Ireland, Britain and Denmark.

Our review uncovered multiple examples of goodwill write-downs and impairments at subsidiary levels that are simply not carried up to the parent company financials. Post-publication, the company stated the lack of reported parent impairments is because "J2 assesses the fair value of goodwill at one level below the segment level which is the business-unit level."

Furthermore, we found clear signs of a warranted impairment at J2's largest acquisition, Everyday Health.

## *J2's Largest Acquisition, Everyday Health, Was Acquired in*

## *2016 for $493 Million. It Saw an Immediate Annual Revenue Decline of ~25%.*

## *J2 Has Yet to Record An Impairment. Instead, Everyday's Financials Have Been Obfuscated Through A Series of Acquisitions And Divestitures*

In December 2016, J2 acquired Everyday Health for $493.7 million, its largest-ever acquisition. [Pg. 75]

At the time, Everyday Health was a portfolio of health-focused online properties that included consumer and professional oriented brands such as Mayo Clinic Diet, MedPage Today, and What to Expect.

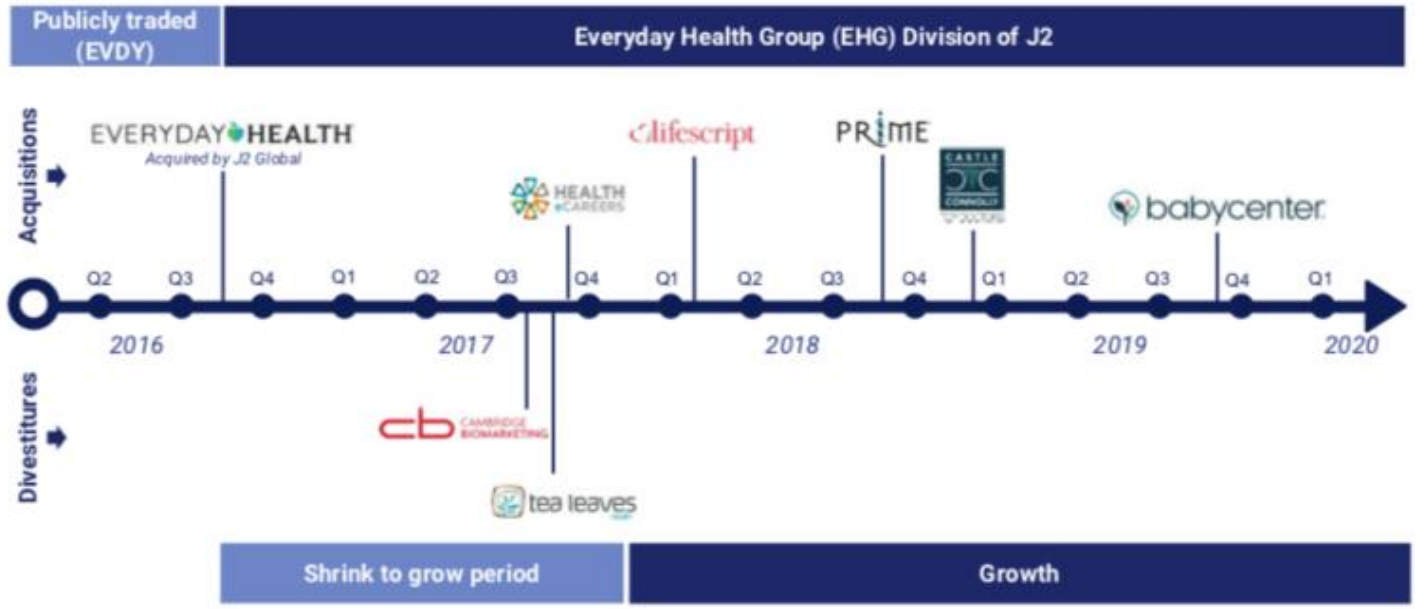
A chart from J2's March 2020 analyst day presentation shows consistent rising revenue at Everyday Health Group, suggesting that the acquisition has been a raging success:


[Slide 50]

The public financials of Everyday Health show that LTM revenue up until September 2016 (months before the acquisition) was $254 million [Pg. 2, Pg. 2, Pg. 2, Pg. 31]. The 2017 numbers declined precipitously (to $171 million), but rather than recognizing the underperformance and taking a goodwill impairment, J2 went on a spree of divestitures and acquisitions in the division that effectively obfuscated the reported metrics.

The company explained the 2017 dip by calling it a period of "shrink to grow" where it was divesting assets.

But even after factoring the 2 divestitures from that year, year over year revenue in the division declined by an estimated $65 million, or 25%. [5]




[J2 investor deck slide 49 ]

Revenue in the Everyday Health division still has not reached its pre-acquisition levels despite the 5 subsequent acquisitions folded into the subsidiary.

Such a steep revenue decline seems to clearly warrant a goodwill impairment, yet the company has taken none to date.

Once again, this is J2's largest acquisition and shows clear signs of impairment. Rather than addressing it, a slew of new M&A deals have simply papered over the issue.

## *Tricky Accounting: A Wholly Owned Subsidiary of J2 Reported 36 Million (~$50 Million USD) in Impairments, Yet the Parent Reported None. (This Shouldn't Be Possible)*

For example, subsidiary **J2 Global Holdings** is the 100% owner of entity **J2 Global Ireland** [Pg. 25] The parent shows zero impairments in 2015, but the latter—a wholly owned subsidiary—shows 22 million in impairments in the exact same year. This shouldn't be possible. Post-

publication, the company stated that this occurs because "J2 assesses the fair value of goodwill at one level below the segment level which is the business-unit level." The end result is that the reported parent financials don't report goodwill impairments.

Here is the parent showing no impairments:

**j2 Global Holdings Limited**

**Notes to the Financial Statements**
**For the Year Ended 31 December 2015**

**13. Fixed asset investments**

| | Investments in subsidiary companies $ |
|---|---|
| **Cost** | |
| At 1 January 2015 | 282,052,890 |
| Additions | 24,972,289 |
| Disposals | (2,534,287) |
| At 31 December 2015 | 304,490,892 |
| **Net book value** | |
| At 31 December 2015 | 304,490,892 |
| At 31 December 2014 | 282,052,890 |

(Source: J2 Global Holdings Limited 2015 Annual Report )

And here is the subsidiary showing 22 million in impairments in the same reporting section:

**j2 Global Ireland Limited**

**Notes to the Financial Statements**
**For the Year Ended 31 December 2015**

**12. Fixed asset investments**

| | Investments in subsidiary companies € |
|---|---|
| **Cost** | |
| At 1 January 2015 | 186,958,171 |
| Additions | 30,235,592 |
| At 31 December 2015 | 217,193,763 |
| **Impairment** | |
| At 1 January 2015 | 4,967,686 |
| Charge for the period | 22,089,698 |
| At 31 December 2015 | 27,057,384 |

(Source: J2 Global Ireland Limited 2015 Annual Report ]

Purely in the interest of being thorough, here is the same filing showing that the entity that recorded the impairment is the wholly owned subsidiary of the entity that didn't [ Pg. 59]:

**23. Ultimate controlling party**

j2 Global Ireland Limited is a wholly owned subsidiary of j2 Global Holdings Limited, a company incorporated in the Republic of Ireland, whose registered office is Arthur Cox Building, Earlsfort Terrace, Dublin 2. The company's ultimate controlling party is j2 Global, Inc.,a company incorporated in the United States. The largest group in which the results of the company are consolidated is that headed by j2 Global Inc. The consolidated accounts of this company are available to the public and may be obtained from www.j2Global.com.

Cumulatively, we found 36 million Euro (~US$50 million) of impairments at the subsidiary level that did not seem to make it to J2 Ireland's parent. J2 Ireland's parent shows no impairments (or diminution) to its investments as of our latest data for the year ended 2018 . Inclusive of vdW, we have identified four dissolutions of acquired entities at the subsidiary level.

**14. Investments**

| | Subsidiary undertakings shares | Total |
|---|---|---|
| **Investments** | € | € |
| **Cost** | | |
| At 31 December 2018 | 247,480,973 | 247,480,973 |
| **Provision for diminution in value:** | | |
| At 1 January 2018 | 35,247,760 | 35,247,760 |
| Charge | 1,520,371 | 1,520,371 |
| At 31 December 2018 | 36,768,131 | 36,768,131 |
| **Net book value** | | |
| At 31 December 2018 | **210,712,842** | **210,712,842** |
| At 31 December 2017 | 212,233,213 | 212,233,213 |

(Source: J2 Global Ireland Limited 2018 Financials Page 22)

A review of J2's key European subsidiary, which holds many of its underlying European subsidiaries, shows significant declines in both revenue and operating income over the past 3 years.

| | 2016A | 2017A | 2018A |
|---|---|---|---|
| **J2 Global Ireland (Key European Entity, $USD)** | | | |
| **Total Revenue** | **$101,693,900** | **$103,806,820** | **$82,379,151** |
| *y/y growth* | | 2.1% | (20.6%) |
| **Operating Income** | **$5,556,217** | **($11,879,064)** | **($13,298,722)** |

(Source: J2 Global Ireland corporate filings (converted to USD)

Filings across multiple European subsidiaries shows several acquisitions have had significant revenue declines. These European acquisitions and entities look to have been supervised by Jeroen – the key man in a series of suspicious transactions described earlier.

All told, it seems that multiple J2 European assets are deteriorating, yet we have seen no

goodwill impairments recorded at the parent level.

| Selected Available European Financials (J2 Global Ireland Subsidiaries) | | | |
|---|---|---|---|
| **Revenue - $USD** | 2016A | 2017A | 2018A |
| Livedrive | $25,388,640 | $24,588,840 | $23,838,984 |
| Comendo | $8,474,978 | $6,303,502 | $4,799,112 |
| Callstream | $7,348,775 | $10,065,193 | $8,354,168 |
| WeCloud | $4,915,197 | $5,878,372 | $3,614,333 |
| Stay Secure | $4,589,518 | $4,019,575 | $4,699,162 |
| City Numbers | $4,054,081 | $4,279,035 | $4,641,225 |
| Keepitsafe | $1,589,128 | $1,012,470 | $740,162 |

(Source: European corporate filings [converted to USD on a constant currency basis])

## *Bottom Line: The Market Has Been Enamored with J2's Acquisition Spree, Yet It Has Been a Grand Waste of Time and Energy—83% of Last Quarter's Operating Income Was Still its Legacy Fax and Email Marketing Business (and 64% on an LTM Basis)*

The sell-side has consistently praised J2's acquisition machine as a key driver of the business, awarding it growth multiples based on its ability to acquire and integrate new businesses:

*"J2's management has a long-term proven track record of creating value through acquisitions and has assembled a diverse portfolio of businesses that are also well positioned for organic growth"* – **Sidoti, April 15, 2020**

*"J2 global is one of the most prolific companies when it comes to M&A in software"* – **Barclays, April 2, 2020**

*"We view the company's ability to identify and create value through acquisitions as a key strength"* – **RBC, March 17, 2020**

*"J2 employs a rigorous, analytical approach to M&A, leveraging the expertise of the company's individual segment and unit executives"* – **RBC, March 17, 2020**

*"We continue to like J2 Global because: 1) it has an effective M&A strategy and disciplined approach to identifying investment opportunities;… 3) our sense is that the portfolio of businesses is well managed;"* – **JMP, March 12, 2020**

*"The company has had success in creating shareholder value for three key reasons: … 3) the management team is stocked with operational masterminds that execute a consistent playbook. The strategy has created a "snowball" effect in that j2 can generate stronger EBITDA out of the acquired assets and re-deploy the capital into other acquisitions"* – **Piper Jaffray, November 18, 2019**

Yet J2's boring (and declining) legacy businesses remains the real driver of its results. While the e-fax and email marketing segment accounted for only 26% of revenue over the last twelve months (LTM), it accounted for over 64% of LTM operating income. Last quarter it accounted for 83% of operating income despite the time, money and effort invested into M&A. [ Pg. 41]

# *Part III: A Corporate Governance Vacuum*

## *Insider Enrichment: J2's Newly Appointed CEO Was Paid An Astounding $45 Million In His First Year As CEO; More Than the CEOs of J.P. Morgan and Microsoft*

J2's CEO, Vivek Shah, is relatively young and had limited executive experience when starting his role as CEO of J2. He had served only as CEO of J2 acquisition Ziff Davis for two years and, prior to that, in various management positions at Time Inc.

Despite this relative lack of experience, Shah made an astounding $45 million in his first year as CEO.

| Name and Principal Position | Year | Salary ($) | Bonus ($)(1) | Stock Awards ($)(2) | Option Awards ($)(3) | Non-Equity Incentive Plan Compensation ($)(1) | Change in Pension Value and Nonqualified Deferred Compensation Earnings ($) | All Other Compensation ($) | Total ($) |
|---|---|---|---|---|---|---|---|---|---|
| Vivek Shah | 2018 | $1,000,000 | — | $35,494,000 | $7,756,000 | $783,000 | — | $29,153 | $45,062,153 |
| Chief Executive | 2017 | $661,932 | — | $2,195,130 | — | $164,299 | — | $25,892 | $3,047,253 |
| Officer | 2016 | $491,667 | — | $1,700,904 | — | $614,000 | — | $22,615 | $2,829,186 |
| Scott Turicchi | 2018 | $715,559 | — | $2,768,232 | — | $664,250 | — | $32,673 | $4,180,714 |
| President and Chief Financial | 2017 | $636,667 | — | $2,239,894 | — | $474,500 | — | $23,466 | $3,374,527 |
| Officer | 2016 | $578,333 | — | $1,913,541 | — | $605,000 | — | $21,804 | $3,118,678 |
| Jeremy D. Rossen | 2018 | $417,347 | — | $669,914 | — | $184,005 | — | $29,978 | $1,301,244 |
| Vice President, General Counsel | 2017 | $393,333 | — | $604,796 | — | $185,000 | — | $23,125 | $1,206,254 |
| and Secretary | 2016 | $363,333 | — | $471,974 | — | $210,000 | — | $21,804 | $1,067,111 |
| Steve P. Dunn | 2018 | $299,260 | — | $477,099 | — | $129,195 | — | $16,502 | $922,056 |
| Chief Accounting | 2017 | $281,667 | — | $425,579 | — | $136,000 | — | $15,213 | $858,459 |
| Officer | 2016 | $258,500 | — | $338,489 | — | $136,000 | — | $15,089 | $748,078 |

(Source: JCOM 2019 Proxy Statement , pg. 38)

Shah strikes us as both articulate and intelligent, yet we find no justification for that compensation, stock-based or otherwise, which puts Shah among the highest paid CEOs in the world. For comparison, J.P. Morgan's Jamie Dimon, who oversaw a $258 billion bank with $877 billion in assets, made $31 million in total compensation in 2018. Microsoft CEO Satya Nadella, who was running a $1.17 trillion company, made $28.5 million in total compensation the same year.

We think J2 has a looming problem with its historical acquisition portfolio, which makes us wonder whether Shah is being compensated for taking on hidden risks. We also wonder whether his generous compensation was related in any way to the generous commitment of hundreds of millions to the J2 Chairman's/former CEO's own investment vehicle, which took place within days of Shah's assumption of the CEO role.

## *Corporate Governance: We Think J2's Auditor/Audit Committee Is Missing In Action.*

We believe that given the magnitude of the related party transactions, impairments that don't show up in the parent level's goodwill and aggressive accounting flagged by other critics, it's obvious that the company's auditor, BDO, and J2's audit committee are either willfully ignorant or simply asleep at the wheel.

Unlike many similarly sized publicly traded companies, J2 does not use a big 4 accountant.

In 2015, J2 upgraded from auditor SingerLewak LLP to BDO ( pg. 50, pg. 49), having earlier downgraded to SingerLewak in 2007 from the well-known Deloitte & Touche ( 2007 auditor , 2008 auditor) .

Beyond the conflicting board and executive associations described earlier, there has been significant employee turnover in J2's finance and accounting departments. We reviewed company disclosures and employee LinkedIn profiles and found a pattern of relatively short tenures and a large number of key departures.

| Name | Title | Joined | Left | Years at J2 Global | Years at Last Job | Avg. Previous Tenure |
|---|---|---|---|---|---|---|
| Tina Elenberg | Director of Global Tax Planning, Strategy & Ops | May-19 | Aug-19 | 0.3 | 21.5 | 7.1 |
| Lisa O'Connor | Finance Manager | Mar-15 | Aug-15 | 0.4 | 1.3 | 4.7 |
| Mary Sirr | Senior Financial Accountant | Aug-14 | Feb-15 | 0.5 | 4.8 | 3.1 |
| Jenny Yung | Senior Financial Analyst | Mar-15 | Sep-15 | 0.5 | 4.1 | 3.9 |
| Michael Pacetti Jr | Controller-Subsidiary | Jan-18 | Aug-18 | 0.6 | 0.8 | 2.4 |
| Kenneth C. Wan | Senior Financial Consultant | Mar-17 | Oct-17 | 0.6 | 1.8 | 2.1 |
| Chia-Wen | Senior Accountant | Jan-17 | Oct-17 | 0.7 | 2.4 | 2.4 |
| Meimei Gani | Senior Accountant | Aug-15 | May-16 | 0.8 | | 1.7 |
| Michael Zemetra | VP Finance | Apr-17 | Mar-18 | 0.9 | 0.6 | 3.0 |
| Enoch Guo | Senior Accountant | Jun-18 | Mar-19 | 0.7 | | 1.5 |
| Ty Hurner | Director of Finance Integrations | Jan-18 | Dec-18 | 0.9 | 4.6 | 3.3 |
| Wayne Gibbons | European Finance & Treasury Manager | Aug-13 | Nov-14 | 1.3 | 2.4 | 4.1 |
| Matthew Garcia | Senior Accountant | Aug-18 | Dec-19 | 1.3 | | 1.6 |
| Reggie Lin | Accounting Manager | Jul-18 | Apr-20 | 1.8 | | 2.5 |
| Eva Hakobyan | Senior Accountant | Aug-17 | Jul-19 | 1.9 | | 4.1 |
| Marina P. | Lead Senior Accountant | Aug-17 | Sep-19 | 2.1 | 1 | 2.4 |
| Jane Yan | Senior Accountant | Feb-15 | Mar-17 | 2.1 | | 3.3 |
| Anthony Allen | Accounting Manager | Jun-15 | Oct-17 | 2.3 | 2.2 | 3.6 |
| Marianne Nygaard | Finance Manager | Jun-15 | Nov-17 | 2.4 | 11.2 | 9.7 |
| Ruchi Shah | Accounting Manager | Nov-16 | Jun-19 | 2.6 | 1.3 | 2.1 |
| Radhini Sridhara | Auditor - Ziff Davis Division | Jun-16 | Oct-19 | 3.3 | 2.6 | 2.7 |
| Trevor Sweeney | European Financial Controller | May-12 | Sep-15 | 3.3 | 1.6 | 2.5 |
| Peter Whelan | Senior Accountant | Jan-12 | Apr-15 | 3.2 | | 5.1 |
| Aaron Sullivan | Controller-Cloud | Jul-15 | Mar-19 | 3.7 | 1.8 | 4.0 |
| Dave O'Reilly | Head of Finance & Accounting, Associate Director | Apr-12 | Oct-17 | 5.5 | 3.6 | 4.8 |
| Milton Rodriguez | Vice President | Jan-12 | Mar-19 | 7.2 | 3.3 | 3.9 |
| Kathleen Griggs | CFO | Jun-07 | Aug-14 | 7.2 | 1 | 2.0 |
| Alla G. | Senior Staff Accountant | Feb-03 | Aug-17 | 14.5 | 4.6 | 4.6 |
| Avg. Tenure | | | | 1.8 | 2.4 | 3.2 |

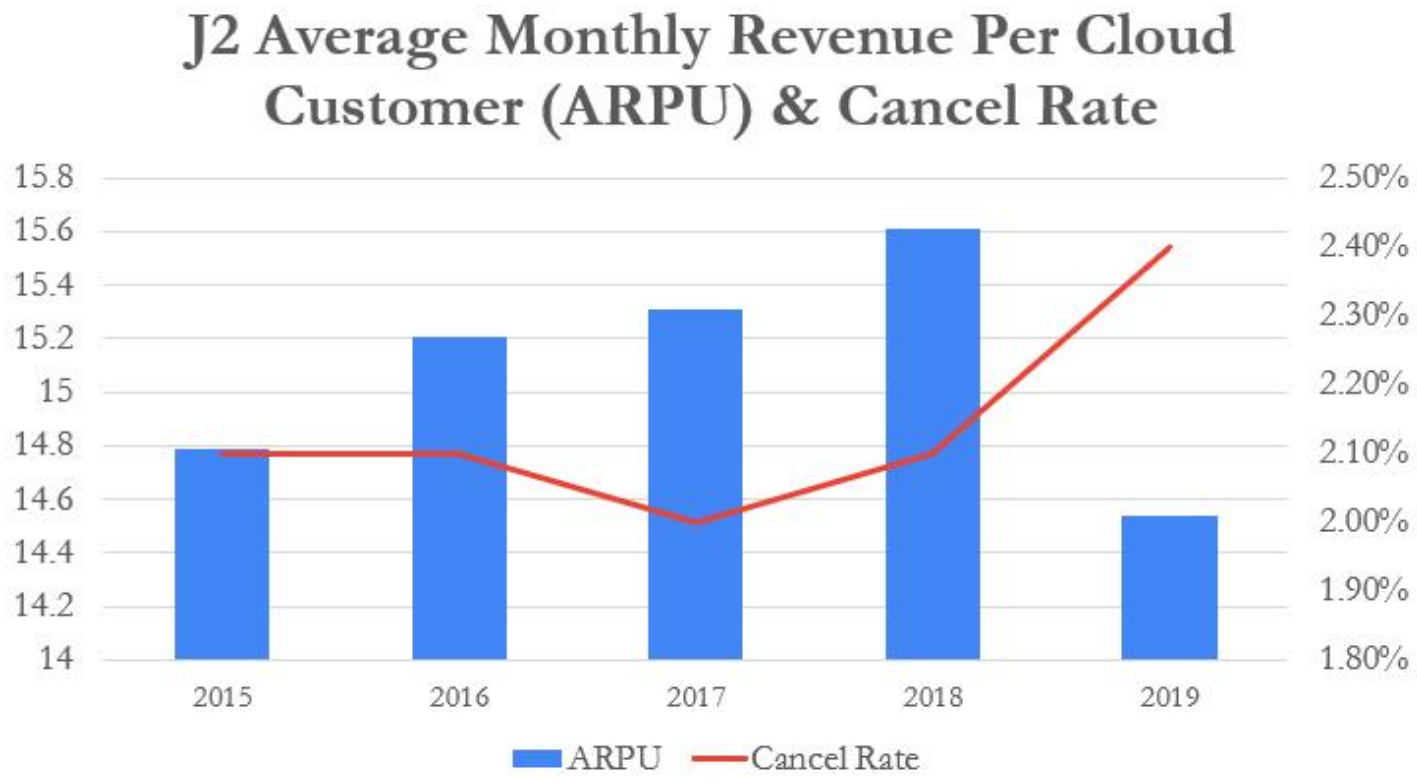
(Source: JCOM Disclosures and Employee LinkedIn Profiles, Hindenburg Chart)

# *Part IV: J2's Legacy Businesses In Decline*

Underneath all of the acquisitions and supportive accounting, J2's legacy businesses simply look to be fading. Key metrics from both of the company's major segments show declines and the quality of each segment appears to be deteriorating.

## *Cloud Services Segment Cancel Rate Is Rising While Average Revenue Per User Falls*

For example, while subscriber revenue continues to rise in the company's cloud services segment as a result of continued acquisitions, the company's average monthly revenue per Cloud Business Customer (ARPU) has fallen while, at the same time, the company's Cancel Rate has ticked upward.




(Source: J2 Annual Reports, Hindenburg Chart)

The key to the Cloud Services is the company's faxing software, which comprises 23% of total company revenue. [ Pg.14] Faxing continues to be in secular decline as technology evolves and other internet-based solutions become more ubiquitous.

J2's key patent that once gave it a moat in the fax-to-message space expired in 2017, allowing competition to chew away at its user base. Well-known players in the cloud computing industry,

like DropBox which acquired HelloFax in 2019 (now HelloSign), are threatening J2's historical cash cow. Ironically, J2's own subsidiary PCMag, ranked its own faxing service (eFax) as just the fourth best service in its "Best Online Fax Services for 2020", behind HelloFax.

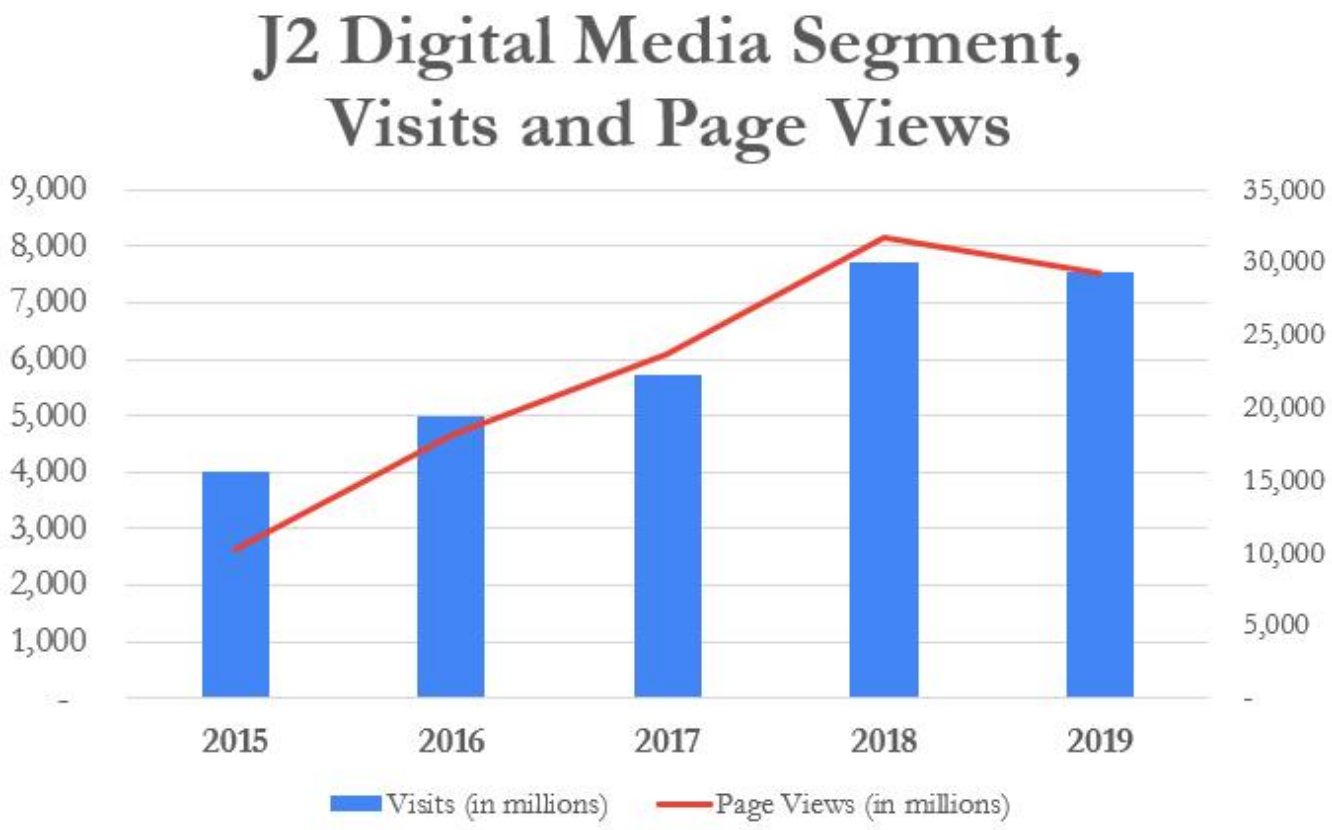
## *J2's Digital Media Assets Were Already Declining Pre-COVID.*

## *Now the Pandemic Has Depressed Revenue Across the Sector.*

BuzzFeed has called the coronavirus a "Media Extinction Event", noting that there has been a "free fall" in advertising revenue, despite the fact that online traffic for many publishers has risen.

J2 notes that the "majority of [its] revenue within the Digital Media business is derived from short-term advertising arrangements and a reduction in spending by or loss of current or potential advertisers would cause our revenue and operating results to decline." [ pg.12]

Yet even prior to COVID-19, J2's brands seemed to largely be underperforming. Traffic growth has been a difficult to measure metric for J2's digital media segment, since traffic is inclusive of acquired assets. But despite J2's acquisitions of BabyCenter, Castle Conolly Top Doctors and Spiceworks in 2019, the company recently posted declining annual traffic numbers for the first time in years.




(Source: J2 Annual Reports, Hindenburg Chart)

JCOM's website is quick to tout ownership of its marquee names, like IGN, Mashable and Humble Bundle. But reviews of J2's digital media portfolio up until April 2020 show that the Alexa rankings for its featured digital assets have mostly plunged over the last 3 years.

Per our call with a J2 investor relations rep, he emphasized that traffic does not always translate to revenue, and revenue does not always translate to EBITDA. While this is true, traffic and revenue certainly help.

**9 of the 1 website-driven names** appeared to be in major downtrends, even through the COVID-19 pandemic, while three sites appeared around the same and two sites have increased their rankings.

For example, here is IGN's Alexa ranking over the last 3 years:


And HumbleBundle.com showing a similar decline:

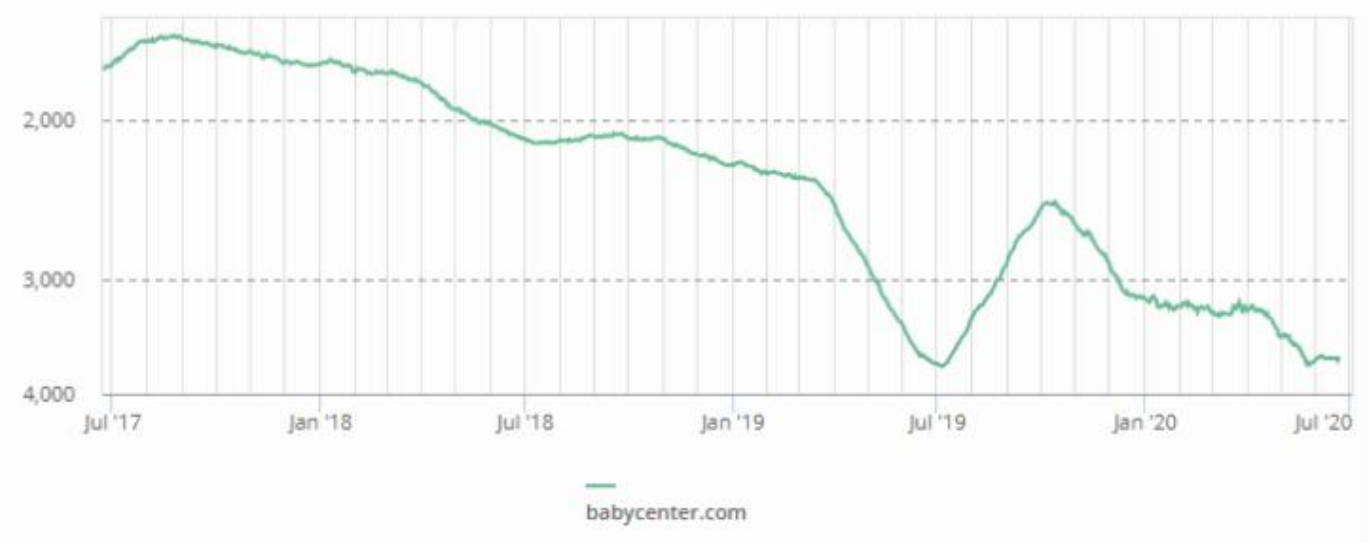

Mashable's Alexa ranking has also plunged over the last 3 years:


AskMen.com also appears to be in steep decline:


As is ExtremeTech.com:

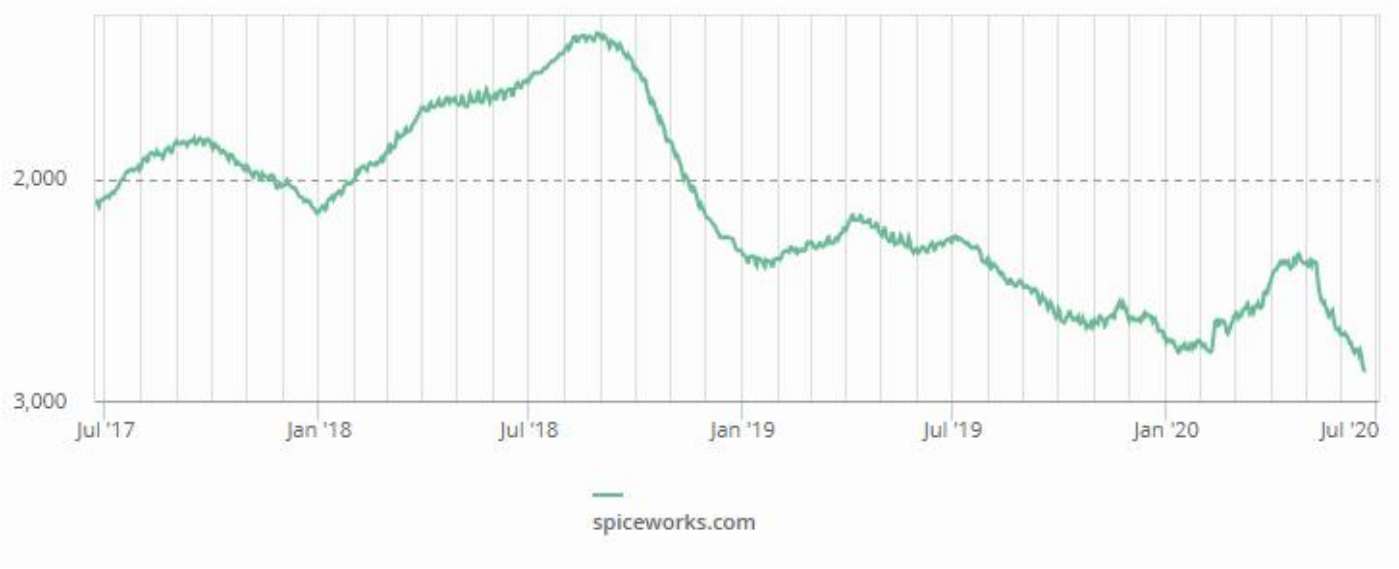

And Geek.com:


Babycenter shows a similar trend:



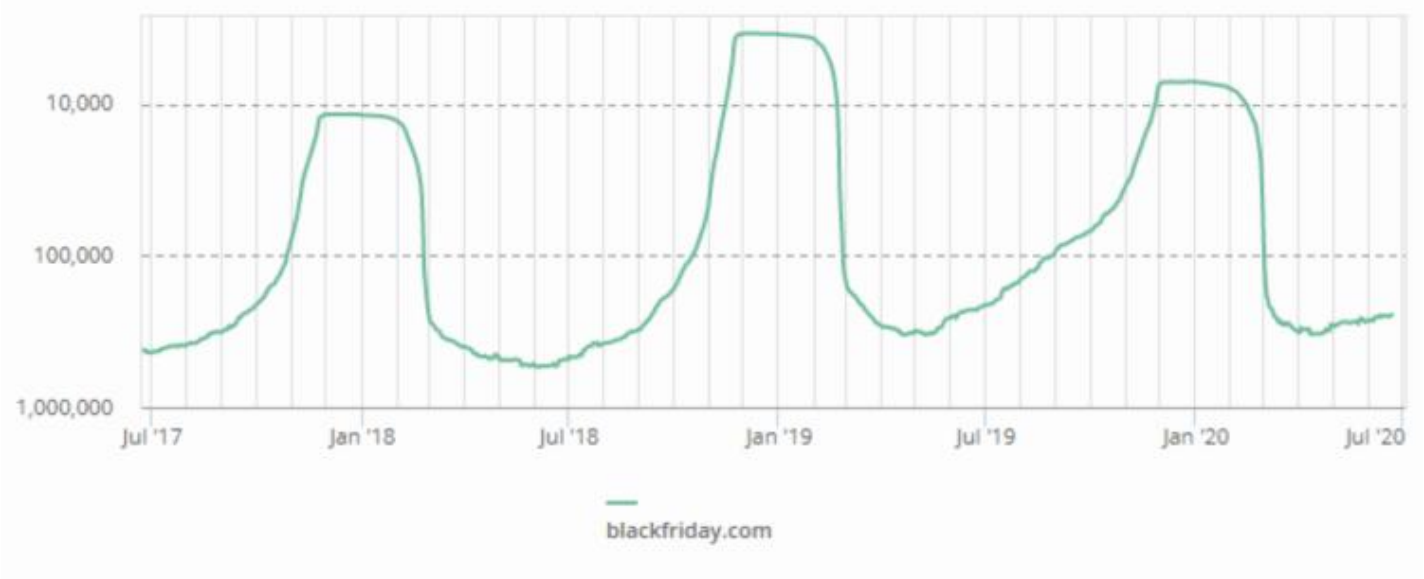

Offers.com has also seen its Alexa rank fall:


Spiceworks.com is clearly in a downtrend:




EverydayHealth.com, J2's largest acquisition, appears to be close to where it was 3 years ago:


BlackFriday.com, a seasonal business, is off its highs but slightly above where it was years ago:




PCMag.com is slightly higher than it was three years ago:


And Speedtest.net and WhatToExpect.com appeared to be the two brands that were able to buck the trend:



Overall, J2's digital media assets already appeared to be struggling pre COVID-19. Without M&A to plug up the holes and obfuscate the declines, we expect the numbers to worsen materially. J2 pulled its guidance last quarter given the uncertainty.

## *Conclusion: We View J2 Global's Equity As Uninvestable*

While J2's legacy business troubles and aggressive accounting have been addressed by other critics in the past, we believe the revelation of the major red flags we are bringing to the table today, combined with an unprecedented and existential macroeconomic threat to its legacy business, may finally put J2 in a position that could (and we think *should)* lead to:

1. An external investigation into J2 acquisitions practices (in particular to those during

Jeroen van der Weijden's tenure) and the CEO's compensation (including the decision making process that went into it).
2. A review by the company's auditors into the company's acquisition history and aggressive accounting – and specifically goodwill and impairment testing.
3. A much-needed board shake up.
4. A repricing of the company's stock to account for these risks, incrementally commensurate to the financial risks at a company with over 3x turns of leverage (as well as cancelled dividend) and looming impairment questions.
5. Vastly more detailed disclosures about key metrics and beneficiaries of historical acquisitions and future acquisitions.

# *Disclosure: We are short shares of J2 Global (NASDAQ: JCOM)*

## *Appendix A: Ressler's Track Record At Orchard Capital Corporation (His Previous Venture Firm)*

Here is a rundown of the investment portfolio of Ochard Capital Corporation ("OCC"), per the Wayback Machine . Note that OCC shared offices with J2 for multiple decades.

| rior Investment | utcome | Details |
|---|---|---|
| J2 Holdings | Success | Ressler's entity made its first investment in J2 at $0.77/sh in 1997 and sold its stake by August 2005 at $10.94 |
| Coreolis Holdings | Failure | Coreolis was the holding company for two cargo aircraft companies that went bankrupt/insolvent. [ Pg. 2 & Pg. 5] |
| ESW | Failure | ESW is a publicly traded company (that saw Jeffrey Epstein as one of its key holders , along with Ressler) that filed to revoke its own registration and now trades on the pink sheets with a market cap of ~$4 million. |

| | | |
|---|---|---|
| Proficient Systems | Failure | The company raised $11.4 million dating back to 2002 (unclear at what valuation) and was sold for $8.4 million in 2006. |
| Vantage Surgical | Failure | Vantage looks to have quietly disappeared . |
| Ocata Therapeutics | Failure | Orchard principal Zohar Loshitzer joined the board of publicly traded Ocata in 2011 when the price was ~$10.34/sh. It was taken private in 2016 at a ~20% discount, $8.50/sh. |
| Orchard First Source | Failure | Publicly-traded BDC (NASDAQ:OFS) is down ~15% since going public in 2012, including dividends, according to FactSet |
| MAI Systems | Failure | Acquired at a ~99% discount to its original listing price |
| Inner Presence | Failure | The website no longer exists, and it looks to have been a short-lived project based on the CEO's Linkedin . |
| Vector Group | Success | From 1988 to 1994 Ressler served as Vice Chairman & then executive at this company that later became publicly traded Vector Group. |
| Universal Telecom Services | Failure | Dissolved in 2016. |
| Presbia | Failure | A formerly publicly traded biotech company that was recapitalized by Cresci and later filed for delisting and |

registration termination in 2019. The last quote we could find for its stock was $0.01.

The accountant at OCC (and CFO of its various entities at one time) lists amongst his skills the following "discovered legal method for company owners to withdraw funds from business while eliminating tax liability and not violating SEC minimum capital requirements".

## *Appendix B: A Pattern of Related Parties Sharing the Same Addresses*

OCC's office (the predecessor to OCV and Ressler's family office) was located at JCOM's address . As was Presbio LLC , related to Presbia.

OCV's office is same as CIM Group's office (another Ressler entity with a publicly traded vehicle .)

Pieter Pauwstraat was 400 square feet and housed VDW Consulting (bought by J2), VDW Hold Co. (which spun off VDW Consulting), Presbia (a public company that lost 99%, who's subsidiary was managed by Jeroen), and J2 Netherlands (Jeroen's first business sale to J2 Global).

## *Appendix C: A Close Associate of Ressler Worthy of Mention*

We thought it was worth mentioning Zohar Loshitzer, J2 Global Executive Vice President of Strategy for over 15 years. Zohar has seemingly been Richard Ressler's right-hand man for nearly thirty years and overlaps with him at no fewer than nine separate entities. His associations with Ressler include J2 Global, Presbia, OCC, and now OCV. Their relationship goes back as far as 1995 with the formation of OCC and Orchard Telecom – one of the telecom entities formed by Zohar that became part of Presbia. Others included Imali and MTP Consulting that drew significant fees from public entities on behalf of Zohar. These fees help to round out what we view as a long-running insider enrichment process that we estimate totals well over $100 million.

## *Appendix D: Estimated Impairment Components*

| **Impairment Components** | |
|---|---|
| Everyday Health Acquisition | $70 million |

| | |
|---|---|
| European Acquisitions | $50 million |
| VDW Acquisition | $900 thousand |
| Red Carpet Home Cinema (OCV Investment) | $10 million |
| Precision Biosciences (OCV Investment) | $5 million |
| **Total** | **1 million** |

We estimated based on the following factors:

Everyday Health was a $493 million transaction that saw its revenue decline ~25% in one year. A correlation of acquisition value to revenue suggests an impairment of $123 million.
We added back $30 million due to gains on sale of 2 subsidiaries of Everyday [ Pg. 14, Pg. 79] and haircut our own estimates by 25% in the interest of being conservative.
We estimated VDW based on footnote 2 and have since updated the number based on the newly reported figure per the company's response .
We discounted the estimated $12 million Red Carpet investment based on J2's proportional ownership of the LP equity in OCV.
We estimated the small size of the OCV investment in Precision.

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[1] The company disclosed in its most recent 10-K that fax to email revenue was 23% of total revenue [ Pg. 14], which corresponds to 315,572.4 (given total revenue of 1,372,054 [ Pg. 40]). Total cloud services revenue was 661,835 [ Pg. 117], suggesting that 47.6% of cloud services revenue was e-fax related.

[2] Estimate based on the following: acquisitions in Q3 2015 totaled $191.6 million (total 9 month acquisition consideration [ Pg. 12] minus 1h 2015 acquisition consideration [ Pg. 12]). Of that, we contacted the co-founder of Salesify that had been acquired in that quarter, who described the sale as being for a "near 9 figure exit". We estimated this at $90 million total, and $73 million net of $17 million in earnout compensation [ Pg. 81]. The other acquisition that quarter which was suggested as being on the larger side per J2's quarterly conference call was LiveVault, which had originally sold for $50 million to Iron Mountain and then was later sold to J2. We contacted investor relations at Iron Mountain and asked for the sale price to J2 but they refused to disclose it. We assume given the quiet nature of the deal that it was a loss, and estimated $30 million. This left $88 million left for the quarter across the 7 deals, roughly $13 million each. Our review of several deals suggested a minimal revenue/likely acquisition price, which ultimately left us with an estimate of ~$20 million for VDW.

[3] We also spoke to an investor relations representative that seemed to think the acquisition was related to Ookla: "that was an Ookla IP acquisition. We wanted to keep that technology for ourselves…(it was) software that we were utilizing and we wanted to keep it in house. So we paid to keep it in house." The explanation didn't make a lot of sense to us (why would a U.S.

company like Ookla be using software developed out of Jeroen's apartment?) and we figured he may have simply been mistaken but we wanted to include it in the interest of not leaving something out that could be relevant.

[4] OCV set up a separate investment vehicle called "OCV Red Carpet 1" on June 20th, 2017, the same day Red Carpet was originally formed in Delaware, indicating its support for the business since inception.

[5] We arrive at a total revenue adjustment of $18 million as a result of the net divestitures. To arrive at this, see the press release announcing 3 divestitures, 2 of which are Everyday Health related. The company discloses a $23 million revenue decline for 2017 for all three. We add back ~$3 million for the unrelated acquisition (Web24) given its lack of reported revenue, suggesting its modest size [Pg.79]. We also add back $2.2 million for 1 month of eHealthCareers (which was acquired in December) per its run-rate prior to J2's acquisition [Pg. 18]

# TAB 8

# Ideanomics Walks Back 1m Sq Ft Claims Today; Our Visit To IDEX's "MEG" Facility Shows Zero Company Presence

Published on June 26, 2020



Yesterday, we issued research on Ideanomics that showed:

1. The company doctored images of its supposed electric vehicle sales operation (called the "MEG" center) to make it seem as though the company owned/operated the facility.
2. That management and other vendors of the facility told us they had never heard of MEG or Ideanomics.

Today's response shows IDEX walking back some of its previous claims about its "MEG" center, where it purportedly is selling EVs in Qingdao.

Prior to today, the company has repeatedly referred to its facility in numerous press releases as a "1 million square feet EV hub".

For example, the company's May 26 press release **clearly says: The MEG Center is a one million square foot EV expo center in ingdao, Shandong rovince."**

But in the company's press release today, IDEX backtracks and says it is launching three phases of its MEG center that will eventually total one million square feet. The first phase, it claims, occupies only 215,000 square feet.

But the company's June 9 press release, issued as IDEX stock was pumping higher, **also says nothing about opening in three phases**. Instead, it **boasts As a reminder, the MEG Center in ingdao began operations on May 1."**

The company's May 26 press release follows up by saying: "The MEG Center in Qingdao now hosts a full suite of car dealer services for new energy and used cars with a capacity of 18,000 vehicles onsite. It offers a one-stop buying experience that includes financial services and onsite vehicle registration services."

Further, in the company's press release today it posted an aerial view of the supposed MEG Center.

That video was apparently pulled from this YouTube account which posted the video two weeks ago: https://www.youtube.com/watch?v cx-uqvn5UOg

The video is drone footage of the outside of the entire facility. We think the reason the company isn't posting video from INSIDE the facility is because such video shows they have absolutely no presence on site whatsoever.

**So in response, we are posting our video of the inside of the MEG" center**, which is actually called the Qingdao Fidelity International Trade City (or 国 in Chinese), **which shows only few cars for sale, and no sign of the company on site.**

[CLICK HERE TO SEE VIDEO]

In short, we think the company has fabricated its supposed sales center, and altered images in its press releases to make it seem that it operates the facility.

We continue to believe, as we stated yesterday, that the company is engaged in flagrant securities fraud and that it's stock will wind up in the pennies or halted by regulators.

## *Disclosure: We Remain Short Shares of Ideanomics (NASDAQ:IDEX)*

### *Legal Disclaimer*

# TAB 9

# Losing With WINS: NASDAQ's Latest Disgrace Has No Financials, An Insolvent Parent Entity and Is Embroiled in What Appears to Be an Obvious Pump and Dump

Published on June 17, 2020



- On June 10th, Wins Finance, a China-based small business lender, mysteriously spiked 758% on 151x its previous day's volume on absolutely no news whatsoever. The company disavowed involvement in the mystery surge in a press release.
- The timing looks suspicious. The day before, on June 9th, Chinese courts rendered an RMB 350 million asset freeze on assets of Wins' operating subsidiary. The same operating entity in China has two enforcement orders against it since November 2019. We think Wins is likely functionally insolvent.
- Wins' parent, which owns 67.7% of Wins' equity, has already been formally declared

insolvent. A provisional liquidator was appointed to the parent company in February, and its equity (which was listed in Hong Kong) has been suspended from trading.

- Wins has a July 2nd hearing with NASDAQ to determine its listing status over its failure to file an annual report for the fiscal year ending June 30th, 2019. The last available financials for the company were as of 18 months ago (December 2018).
- We visited the company's headquarters and found it mostly empty. We also visited the corporate address for Wins' operating subsidiary and found it empty. Neighbors told us the office has been abandoned for a "year or two".
- Wins' CFO Junfeng Zhao resigned from the company's operating subsidiaries in November. We emailed the company yesterday asking about this and whether he was still CFO of the parent. The company didn't respond to us directly, but issued a 6-K this morning announcing Zhao's resignation as CFO. We think he may have actually resigned 7 months ago and the company simply didn't disclose the departure until prompted by us.
- Wins' (now-former) CFO's immediate prior work history included serving as financial controller for Agria, a firm delisted by the NYSE and charged by the SEC over allegations of stock manipulation and accounting fraud.
- Wins' financial situation looks severely impaired. The company recently disclosed that $83 million disappeared in a deal with an opaque Chinese entity. Net revenue in the last available financials (for the six months ending December 2018) was negative. Net income declined 67% y/y.
- We view Wins' auditor (Centurion ZD CPA) as a major red flag. Centurion merged with a firm that had absorbed an auditor banned by the PCAOB for audit failures relating to China-based companies. Centurion also served as auditor for Yangtze River Port & Logistics, a once $2 billion market cap company that lost 99% of its value and was delisted once its claimed key asset was identified (by us) as likely being a total fabrication.
- Wins has a history of alleged stock manipulation, including a mysterious 4,555% spike in 2017 that gave the firm a temporary $9 billion market cap. That circus led to the company's ejection from the Russell index, a shareholder lawsuit and a NASDAQ delisting threat.
- Wins strikes us as a company worth $0 trading at a current market cap of $700 million ($34 price as of this writing) due to its recent irregular trading spike. Frankly, we think the company is in the midst of one last pump and dump before it disappears for good.
- In our view, Wins never should have remained listed after its first fiasco in 2017. We encourage NASDAQ to implement stronger policies that prevent companies that *repeatedly* exhibit glaring red flags from trading on a premier national exchange.

## *Background on Wins' Absurd 4,500% Spike in 2017 on No News, Leading to a Fraud Lawsuit Settlement And A Nasdaq Delisting Decision (That Was Reversed For Undisclosed Reasons)*

We never expected to be talking about Wins Finance Holdings (NASDAQ:WINS) after its

ridiculous debacle in 2017. That year, the tiny China-based small business lender spiked 4,500% on no news, leaving a wave of befuddled analysts and journalists trying to figure out what on earth had happened.

≡ Menu Bloomberg Sign In

Business

**This Chinese Stock Soared 4,500% on Nasdaq and No One Knows Why**

Multiple reporters ( 1,2,3,4,5) noted the irregular trading, including this example :

**The Ultimate Pump And Dump? Wins Finance Up $100 Per Share**

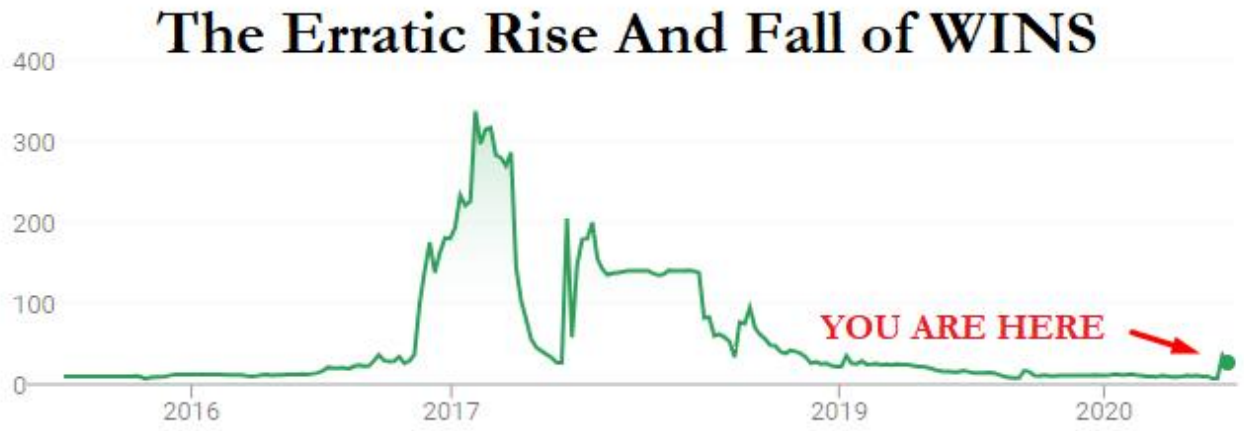
Wayne Duggan , Benzinga Staff Writer | | FOLLOW+

February 02, 2017 2:52pm | 1 min read | Comments

It was later discovered that WINS fraudulently claimed to own a U.S. office in order to qualify for FTSE/Russell index inclusion, according to a lawsuit filed in 2017 (Wins settled the complaint in 2018).

The stock had spiked on the inclusion, but FTSE/Russell ultimately removed WINS from its indices, sending it crashing back down.

The 4,500% spike in WINS still serves as the classic example of a passive index forced-buying bonanza (followed by a passive index forced-selling bonanza), a process that played out several times over the history of Wins:

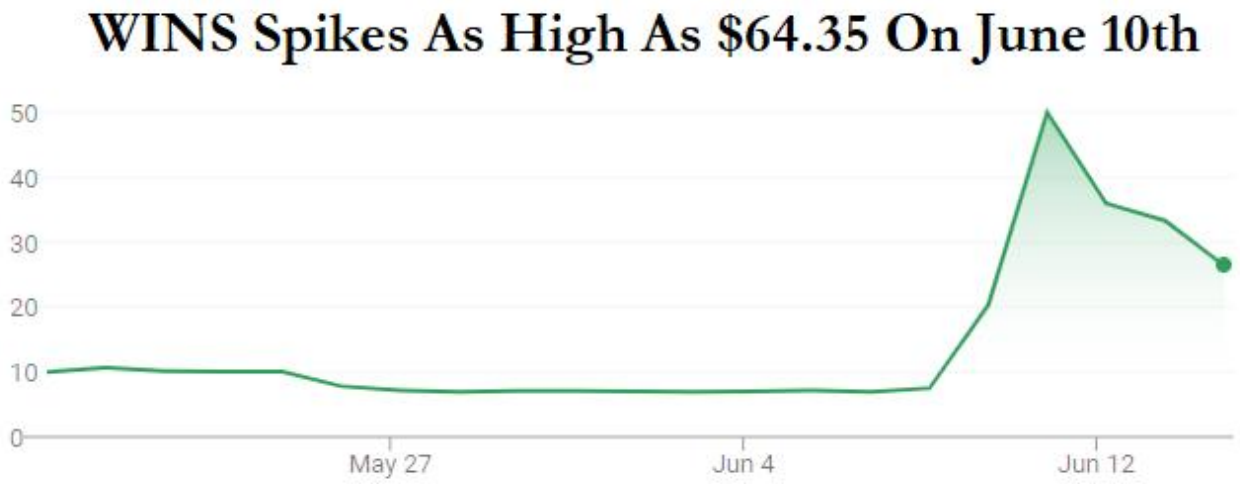



After FTSE/Russell removed WINS from its index, shares were halted for 6 months and then plummeted spectacularly.

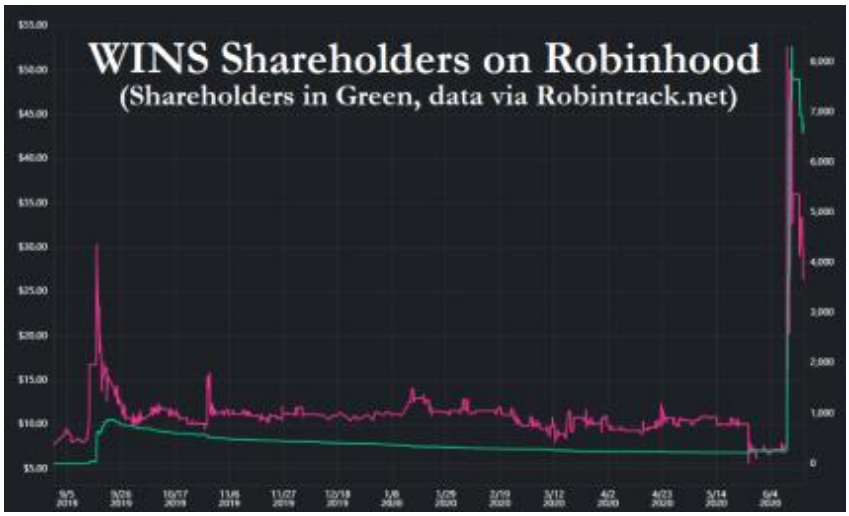
Nasdaq moved to delist the company in 2017, but then reversed its own decision without providing a reason.

## *And Here We Are Again: WINS Mysteriously Spikes 758% Last Week on No News and Has Begun To Crash Once Again*

On June 10th, WINS stock mysteriously spiked to as high as $64.35, a 758% gain from the prior day's close, on absolutely no news whatsoever. On the day of the surge, the stock traded 428,000 shares, compared to 2,800 in the prior day, a 151x increase in volume.



The sudden spike managed to draw in retail momentum traders. RobinHood account holders owning WINS increased to over 8,000 from only 259 prior to the spike, according to RobinTrack .




The company commented on the move publicly on June 11th, disavowing any role in the oddity and claiming to have no idea why the stock was up on such significant volume:

> *"…in view of the recent high trading volume and significant price increase of the Company's ordinary shares, Wins Finance wanted to confirm to the market that it is not aware of any material corporate developments that could account for this unusual trading activity."*

## *Is the Spike Justified? A Panoply Of Material Issues Exposes WINS As A Clear Zero*

## *1. Wins Operating Subsidiary Had Its Assets Frozen by the Chinese Courts the Day Before the Mysterious Stock Spike*

Wins Finance's operating entity in mainland China is Jinshang International Financial Leasing Co., Ltd. 国 有限公司 (also referred to as "Jin Shang"), according to company filings. [Pg.29]

Following Wins' massive stock move, we reviewed Chinese Court and legal filings to see if there was any local news that might have justified the spike.

Much to our surprise, we found that Chinese Courts had frozen assets of Wins' operating subsidiary the day prior to the spike. Per QCC and court records , two judgments were rendered

against Wins' subsidiaries as part of the same case:

**Stock freeze 2** (View more 2 people risk associated with business risk associated 2 ) 企查查 Risk statement Any status export data

| Serial number | Execution notice number | Executed person | Freeze the target company | Amount of equity | Executive court | Type\|Status |
|---|---|---|---|---|---|---|
| 1 | Changgong Xingzhi Cai zi [2020] No.117 | Jinshang International Finan cial Leasing Co., Ltd. | Shanxi Jinchen Agricultural Co., Ltd. | RMB 350 million | Changzhi Public Security Bureau | Equity Freeze\|Freeze |
| 2 | Changgong Xingzhi Cai zi [2020] No.117 | Shanxi Jinchen Agricultural Co., Ltd. | Shanxi Dongsheng Financial Guarantee Co., Ltd. | 300 million yuan | Changzhi Public Security Bureau | Equity Freeze\|Freeze |

As we can see, the date of the freeze was June 9th, 2020:

Stock freeze details ×

Stock freeze information

| | | | |
|---|---|---|---|
| Execution notice numbe r: | Changgong Xingzhi Caizi [2020] No.1 17 | Implementation matter s: | Publicize frozen equity and other inve stment rights |
| Executive court: | Changzhi Public Security Bureau | Executive document sy mbol: | - |
| Executive ruling docum ent number: | Changgong Xingzhi Caizi [2020] No.1 17 | Executionee: | Jinshang International Financial Leasi ng Co., Ltd. |
| Amount of equity and o ther investment rights h eld by the person subje ct to execution: | RMB 350 million | Freeze the target comp any | Shanxi Jinchen Agricultural Co., Ltd. |
| Executionee's certificate type: | Business License of Enterprise Legal P erson (Foreign Investment) | Executione's ID number: | - |
| Freeze date from: | 2020-06-09 | Freeze date to: | 2022-06-09 |
| Freezing period: | 730 days | Date of announcement: | 2020-06-09 |

Beyond the above, in November 2019, two enforcement orders totaling RMB 35 million (USD 4.9 million) were filed against Jinshang, according to court records. One month later, the creditor agreed to extend the payment deadline to December 2021, according to the same records. It is unclear how Jinshang has handled these enforcement orders yet.

We have seen no disclosure from the company on any of these court ordered judgments. We have asked the company for more information and have not yet received a reply.

Given the above, we think the company is likely functionally insolvent.

## *2. Wins Has Failed to Disclose That Its Parent Entity, Which Owns 67.7% of Its Equity, Is Insolvent, Has Ceased Trading*

## *in Hong Kong, and Is in Liquidation*

In mid-2017, Wins announced that Hong Kong Exchange-listed Freeman FinTech acquired ~67% of its shares. An announcement from last week affirms that the parent has maintained its ownership stake.

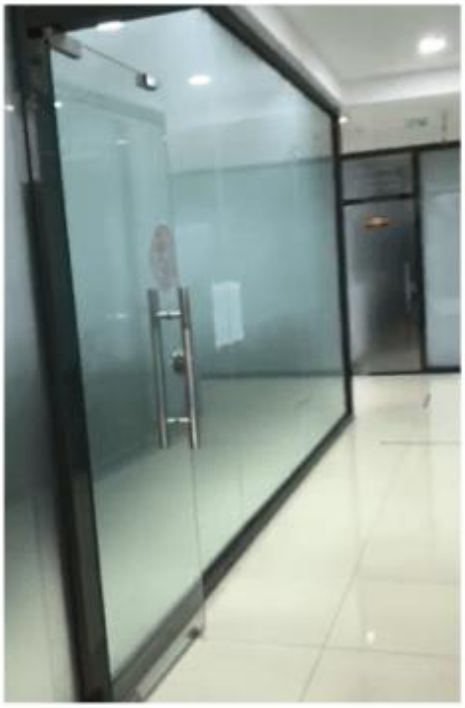
Recent Hong Kong filings that show that **reeman inTech was suspended from trading and entered into liquidation on ebruary 28th 2020, according to a court order**This followed almost a year of insolvency petitions and creditors declaring the company to have been in default. [1,2]

Freeman Fintech's financials also show that substantially all of its WINS stake had been pledged to creditors in advance of the liquidation, suggesting that the ownership of the company had been in precarious hands well before recent events. [Pg. 46-47]

## *3. We Visited Wins' Headquarters in China and Found it Mostly Empty*

Our investigator visited Wins' headquarters during working hours and reported to us that the building seemed mostly empty. There was no one at the front desk, so the investigator continued into the main working area.


In total, our investigator saw about 30 cubicles and numerous offices, which were almost entirely empty. They counted 4 individuals in the facility that did not appear to be doing much.



Our investigator approached one of the individuals under the grounds of seeking a loan (the business Wins purportedly operates in.)

When asked about the company and whether it was still engaged in business and to what extent, the woman simply stated "we do professional work" repeatedly. She had no business card and provided no contact information for her or anyone else at the company.

She seemed to provide no insight on the purported business at Wins and our investigator viewed her answers as highly evasive. The stance was not one would not expect for an active business seeking new customers, but is fitting with a company facing an asset freeze and potential insolvency.

We emailed the company to ask whether COVID has impacted its employee's ability to show up to its headquarters, and have not heard back as of this writing. We also asked about the judgments in an effort to understand whether the business is still operating as a going concern, and have not heard back thus far.

## *4. We Visited Wins' Operating Entity's Listed Address and Found it Empty—Neighbors Said the Location Had Been Abandoned for a "Year or Two"*

In addition to WINS headquarters, we also found a location listed on the operating entity's

corporate records through its QCC profile:

Jin Shang International Financial Leasing Co., Ltd. 国 有限公司

Address: 市 大 2 B2-18G

Our investigators took the following photographs from our visit to this address. Here are several photos of the building from the outside:


Here is a photograph of the B2 entrance, which is listed on the entity's address:

Here are some photos of the signage in the lobby, which still lists the operating entity for Wins, Jin Shang International Financial Leasing Co. (alternately spelled Jinshang International Financial Leasing Co., Ltd. in company filings):


Our investigators took photos of the hallway where the offices are located. It is not what we would expect from a $600 million NASDAQ-listed company, but rather perhaps a low budget motel:

There were two doors listed on the address, "B18G" and "B18J", both shown side by side in the photograph below (and corroborated by the lobby signage).


We knocked on the door for "B18G" at 11AM local time during a normal June workday and no one answered. **Neighbors told us that no one had been seen there for maybe a year or two".** The second door appeared to our investigator to now belong to a different business altogether (as marked).

## *5. We Emailed Wins Last Night Inquiring as To Whether The CFO Was Still Active, Given That He Resigned From Wins Subsidiaries in November. This Morning the Company Announced the CFO Had Resigned*

We found that Wins' (now-former) CFO Junfeng Zhao had previously been appointed a board director of two of Wins' operating subsidiaries in China, but found that he resigned from those directorship roles in November 2019, according to Chinese online corporate records. We also noticed that he disappeared from the company's website .

We found that tremendously odd, and e-mailed Wins yesterday to inquire whether its CFO was still in fact its CFO. Our e-mail to the company asked:

> *"I saw that your CFO withdrew from Wins' Chinese operating entities. Can you please share the reason for that and confirm whether he still currently the acting CFO of the company?"*

The company did not e-mail us back but appears to have responded this morning with a 6-K

announcing that its CFO resigned, claiming he resigned two days ago on June 15th. We think there is a chance he may have actually resigned in November but the company simply didn't disclose it until prompted.

Regardless, the company did not announce a replacement for Zhao. **What are the odds that Wins files an annual report and maintains NASDA compliance now that it has no C**

The release this morning also announced the resignation of a board member with no replacement.

## *6. Wins' (Now Former) CFO's Immediate Work History Prior to Wins Including Financial Controller at Agria, Which Later was Delisted by the NYSE and Settled Charges with the SEC Over Alleged Stock Manipulation and Accounting Fraud*

WINS former CFO, Junfeng Zhao, previously served as financial controller at Agria Corporation immediately prior to joining WINS in 2010.

Agria was investigated by the NYSE in 2016 for alleged stock manipulation. The NYSE had "identified evidence indicating that the Company (i) through a top executive and other intermediaries engaged in trading intended to artificially inflate Agria's stock price."

It was charged by the SEC in 2019 over allegations of accounting fraud and manipulative trading. Agria was delisted by the NYSE, settled the SEC charges, and eventually terminated its securities registration.

Though the unraveling of Agria took place after Zhao's departure, we found it an alarming resume item to immediately precede his assumption of the CFO role of a different public company.

## *7. Wins' Auditor Has a Storied History of Auditing U.S. Listed Chinese Firms That Have Imploded Amidst Accounting Irregularities*

Wins doesn't have a great track record with regard to its financial reporting.

The company has disclosed a material weakness in its financial controls for the past 2 annual reports it filed in 2017 and 2018. Namely, the weakness was that the company had a lack of qualified accounting personnel. [ Pg. 6, Pg. 6] The SEC noted this weakness in a letter to the company on May 2nd, 2019, and it has clearly not been remediated (given the lack of financials). Nonetheless, Wins remains listed (for the time being.)

As of the 2018 annual report, WINS' auditor was a firm called Centurion ZD CPA.

Centurion recently merged with Dominic KF Chan & Co. [ Pg. 1] The last Public Company Accounting Oversight Board (PCAOB) report we could find for Dominic KF Chan was from 2011 and it did not inspire our confidence. Per the report:

> *"The inspection team identified what it considered to be audit deficiencies.* ***The deficiencies identified in two of the audits reviewed included deficiencies of such significance that it appeared to the inspection team that the irm did not obtain sufficient competent evidential matter to support its opinion on the issuer's financial statements"***

Another Hong Kong auditor called Albert Wong & Company (AWC) was banned by the PCAOB for ignoring flagrant red flags among China-based companies listed on U.S. exchanges. Prior to the PCAOB handing down its ban however, **AWC merged with Dominic K Chan, in early 2016**

**We view this is a red flag bordering on absurdity.**

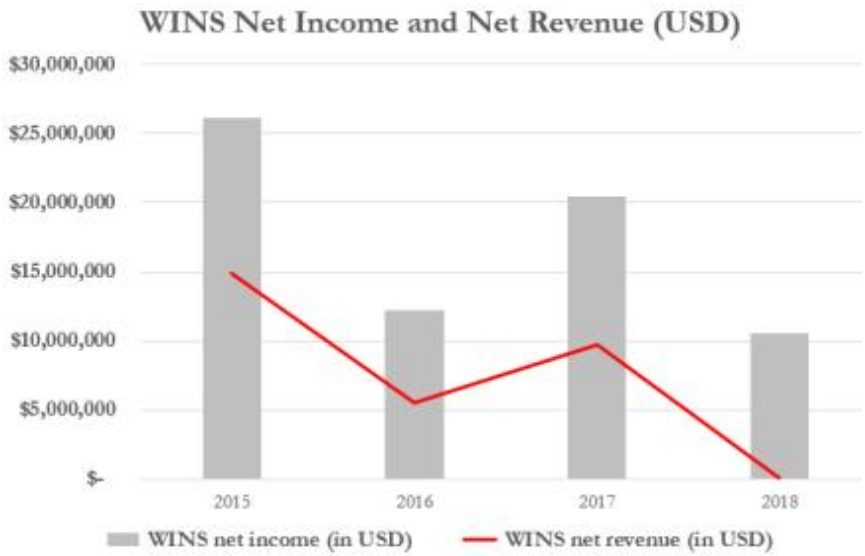
Centurion may be known to some of our readers, given that it was also auditor of Yangtze River Port & Logistics, a once $2 billion market cap NASDAQ-listed firm that we wrote about in late 2018. We found that the company's key asset didn't appear to exist and seemed to be a total fabrication.

That company was later delisted by NASDAQ and has since lost 99% of its value following an investigation by both NASDAQ and FINRA that found signs of manipulative trading and other irregularities.

## *8. Even Wins' Outdated, Year and a Half Old Financials Show an Organization Crumbling. Recent Disclosures Show $83 Million Has Gone Missing into an Opaque*

# *Chinese Entity*

While WINS stock was spiking, its financials were disintegrating spectacularly. The company saw its net revenue crash from $9,726,685 in 2017 to just $102,763 in 2018.




In the **6-month period** ending December 31st 2018, the company reported net revenue of *negative* $916,671 and net income of $2,985,734, a 67% year over year decline for the same 6-month period. [ Pg. 6]

The company disclosed in January 2020 that it is late to file its annual report in part due to uncertain treatment of $83 million in missing assets entrusted to an opaque Chinese entity that the company is no longer certain it can recover.

Wins' parent entity stated that it hired an independent firm to assess whether the money was siphoned out by a related party and unsurprisingly found that the company was unaware of the circumstances around the missing funds.

The company provided an almost comically brief summary of the independent findings, stating that there were "some additional documents" that led to the disappearing funds, and declared the company absolved of responsibility.

During the investigation process, it was discovered from the scanned copies provided by Guohong Asset Management, Hengfeng Bank Nanjing Branch and 華林證券股份有限公司 (ChinaLin Securities Co., Ltd.*) that Guohong Asset Management and certain other parties had executed some additional documents (the "**Additional Documents**") in respect of the investment of RMB750 million in other investments. Neither Wins Finance nor Wins Finance Subsidiary was a party to the Additional Documents and neither of them was aware of the Additional Documents previously. As at the date of this announcement, Guohong Asset Management has refused to provide the originals of the Additional Documents for verification.

Based on the above, it was found that there was no evidence which shows that Wins Finance or Wins Finance Subsidiary has knowledge of the Subject Asset being ultimately invested in the other investments or has instructed so.

## *9. We Expect WINS Will be Delisted Due to Failure to File Financials. This View Is Reinforced By The Company's Lack of A CFO, Per Its Announcement This Morning.*

Wins announced it received a delisting notice from NASDAQ on November 18th 2019 for failure to file a timely 2019 annual report for its fiscal year ending June 2019. The company submitted a plan to file its report and regain compliance, which bought it another 180 days, until May 13, 2020. In the same announcement, the company announced the appointment of a new Chairman and a new Chief Operating Officer.

The May 13th deadline passed with no financial report, and on May 22nd, the company announced it had received another delisting notice from NASDAQ. The same announcement disclosed at the newly appointed Chairman and Chief Operating Officer both resigned.

The company requested a hearing with the listing panel, which will allow the company to remain listed until July 2nd while the panel makes its determination.

## *Conclusion: Wins Is Truly The Worst Of NASDAQ—We Think It is a Zero In Short Order*

Investors often view a listing on NASDAQ, one of the U.S.'s most prestigious exchanges, as a sign of legitimacy.

Despite this perception, Wins is currently listed on NASDAQ despite having (1) no current

financials (2) no CFO (3) undisclosed legal judgments (4) a headquarters that is almost entirely empty (5) a history of major trading irregularities and alleged fraud (6) an auditor that has a history of 'auditing' China-based total blow ups, and (7) a parent in undisclosed insolvency.

Meanwhile, as the company with no CFO's July 2 deadline to file financials approaches, we believe it is simply putting off the inevitable – disclosing the precarious position it is in – while the stock pumps one last time to perhaps help stakeholders exit on the way out.

In sum, we think WINS is a company that is already worthless and the market will soon figure that out.

## *Disclosure: We are short shares of Wins Finance Holdings (NASDAQ:WINS)*

### *Legal Disclaimer*

# TAB 10

# A Bagholder's Guide to Why We Think Genius Brands Will Be a $1.50 Stock Within a Month

Published on June 5, 2020



- Since early May, and **even accounting for yesterday's plunge**, shares of small TV production company Genius Brands have appreciated in value by more than 20x on relatively mundane news. We think the stock will drop as quickly as it skyrocketed.
- **The company itself appears to agree with us, believing its shares are worth 0.3 to 1.20 per share, 83%-9 % below current levels**, based on three financing rounds it completed at those prices last month alone.
- Retail investors seem entirely unaware that ~131 million shares and share equivalents issued from recent financing rounds will become available to trade within an estimated 2-4 weeks. We walk ~~bagholders~~ readers through how this upcoming wall of selling pressure could send the high-flying shares back to $1.50 within a month.
- The stock currently trades at a fully diluted market cap of ~$1.56 billion, affording it a ludicrous revenue multiple of 1,201x based on its $1.3 million in annualized revenue. The company has generated losses every quarter for almost 10 straight years.
- We also walk readers through issues with the actual business. For example, the company hasn't disclosed that its flagship show, Rainbow Rangers, has not yet been renewed for a

new season on key network Nick Jr., and it is unclear whether it will be.

- Rainbow Rangers aired 26 times per week when it first debuted on Nick Jr. in 2019. Now, the show only airs ~9 times per week, at 3:49am EST during weekdays and Saturdays and twice Sunday mornings between 6am and 7am; hardly primetime.
- The company's other key show is Llama Llama, based on a popular series of children's books. But the company doesn't actually own the intellectual property to Llama Llama – instead merely licensing it. The company has refused to disclose the economic terms of the deal, but the lack of reported revenue indicates the terms are not economical.
- Stock runs are always fueled by exciting stories, but the ending is almost always written in the boring fine print. We think Genius Brands will crash spectacularly due to obvious market mechanics that its retail investor base are likely unfamiliar with – even in the frothiest of markets.

## *Genius Brands' Meteoric Stock Price Rise*

In early May, children's television production company Genius Brands International issued a press release announcing it was merging its two existing TV channels into one, to be called the "Kartoon Channel". It also announced plans to integrate 3,000 episodes of acquired content "including hit programs form (sic) key content suppliers around the world."

**The company declared its new TV channel to be the economic vaccine for C VID-19."**

The press release included no numbers about revenue implications and seemed to be a rather run-of-the-mill corporate streamlining announcement, devoid of material positives. Nonetheless, the news lit the spark for what would become a momentous stock run. Genius' shares closed the day of the announcement at $0.48, a 52% increase from the prior day's close, on over 34 million shares of volume, roughly 30x normal levels.

Day traders determined that the company was now "Netflix for Kids" and, with the benefit of some upward momentum, a confirmation bias feedback loop quickly turned Genius into the hottest speculative stock on the market.

Since the day of its Kartoon announcement, Genius has climbed as high as $12 per share on almost 400 million shares of volume traded in a single session. With over 220 million fully diluted shares outstanding, the stock currently trades at a market cap of ~$1.56 billion. [1] [Pg. S-2, Pg. 1]

Retail stock forums from Reddit to StockTwits have been alight with countless rocket ship emojis and giddy traders gloating over paper gains. Robinhood users owning the name have

jumped from about 5,000 to over 140,000, according to RobinTrack.

## *Reality Check: Even the Company Only Thinks Its Shares Are Worth $0.35 to $1.20, Representing Downside of 83% -95%*

The price at which a company sells its own stock to fund its business can be a key indicator of what management thinks its stock/company is actually worth.

Obviously, a management team isn't going to issue stock at low prices if it thinks its valuation will move higher in short order. Companies have a vested interest in issuing shares when their valuation looks favorable, in order to minimize the dilutive effects of issuing new equity.

With that in mind, the company raised 3 financing rounds from May 7th to 12th at prices ranging from $0.35 to $1.20, 83%-95% below current levels as of this writing.

This means that in addition to management tacitly putting a $1.20 price target on its own stock, management would likely to go to the market and attempt to sell more stock at the company's current valuation – if the stock wasn't slated to get demolished in the short term, which we believe it is.

## *Reality Check: 131 Million Shares Are Likely to Hit The Market Within 2-4 Weeks, Creating a Massive Amount of Selling Pressure*

Just as an exciting story is always the fuel to a massive stock run, the tragic ending is often written in the mundane fine print.

A review of Genius' recent multitude of stock offerings makes clear that its financial backers are likely weeks away from be able to sell a wall of stock that is almost assuredly going to send shares sharply lower.

In March, the company completed a financing that sold convertible notes and warrants to its own CEO and other investors that collectively **convert into 131 million shares of common stock at a strike price of 0.21**[Pg. 2, Pg. 1]

Most financiers that participate in such private placements buy the stock at a slight discount to

market prices. The discount compensates them for the risk of temporarily being unable to sell the shares. Such financiers are often looking to make small arbitrage gains by locking in the difference between the trading price and the discounted price they purchase at. That arbitrage can typically only be truly locked in when shares are registered and the SEC approves a "notice of effectiveness" to sell the shares on the open market.

Given the meteoric rise of Genius's stock, those financiers are likely sitting on outsized paper gains, waiting for the opportunity to lock in profits from the retail bonanza fueling the stock price. Yesterday, the company filed a prospectus statement that seeks to allow those very holders to sell almost half of those shares. We expect a follow-up filing will cover the remainder.

The timeline for when the SEC approves the "notice of effectiveness" can vary, but based on recent history, it took 10 days for the company's last S-3 filing to become effective. That suggests an effectiveness around June 14th, coinciding with the company's planned launch of the Kartoon Network on June 15th.

Once that notice of effectiveness is active, a new wave of selling is likely to pummel the stock as its financial backers rush to lock in profits. Any readers that have not exited by then are, in our estimation, likely to get decimated.

## *Reality Check: Company Fundamentals Can't Support the Stock's Astronomical Price*

Readers hoping for the company's fundamentals to save them are not likely to receive any help.

The company's annual revenue run rate is ~$1.3 million (last quarter's revenue was only $335 thousand [ Pg. 4]), affording it a ludicrous 1,201x revenue multiple. According to FactSet, **the company has lost money every single quarter since 2010** and has consistently tapped the capital markets for cash, often on the back of promotional announcements that routinely end up delayed or abandoned.

## *Reality Check: The Company's Business Is Not the Powerhouse Shareholders Might Think It Is, As Seen When Reviewing its 3 Most Important Shows*

Some readers might be saying "well sure the fundamentals are terrible but Netflix (and most of the other stocks I like) also have atrocious fundamentals."

Stocks with an appealing story can perform well for a period of time. But a story with some stock momentum make for a fragile investment foundation.

And the company's story has major holes. Genius's top 3 publicized shows are Llama Llama, Rainbow Rangers, and Stan Lee's Superhero Kindergarten.

To be frank, we don't think most investors in Genius are terribly familiar with the details of the key television shows they now own, so here is a quick breakdown:

### *1. Llama Llama is Its Most Popular Show, but the Company Doesn't Own the Intellectual Property and Only Has a Licensing Deal, With Undisclosed (But Clearly Minimal) Economic Benefit*

Llama Llama is a show that airs on Netflix based on the popular children's book series. These shows are the most popular of the company's current lineup. However, Genius doesn't own the intellectual property behind Llama Llama, as it simply "represent(s) their content as a licensing agent" [Pg. 5]

The content deal was announced in 2015, but terms weren't disclosed. We asked the company for details and investor relations responded with an answer that should alarm anyone looking to understand Genius's financials:

> *"We do not disclose any economic information about our shows or properties."*

Based on the company's limited revenue and consistent losses to date it doesn't appear to be a particularly lucrative contract.

### *2. Rainbow Rangers—The Company Has Boasted That the Show Is Currently Airing on Nick Jr. True, But It Appears Once Per Day During the Week at 3:49AM EST And Three Times On Sundays. The Show Is Currently Not Yet Slated For a 3rd Season and It Is Unclear Whether It Will Be Renewed.*

Rainbow Rangers is another key show for the company, and in this case Genius *does* own the intellectual property behind the show, making it perhaps the company's most economically relevant property. It airs on Nick Jr. and has completed 2 seasons to date.

The company made a big deal about its pick-up by Nick Jr. in a January 2019 press release announcing that the show had 455,000 viewers in its premiere:

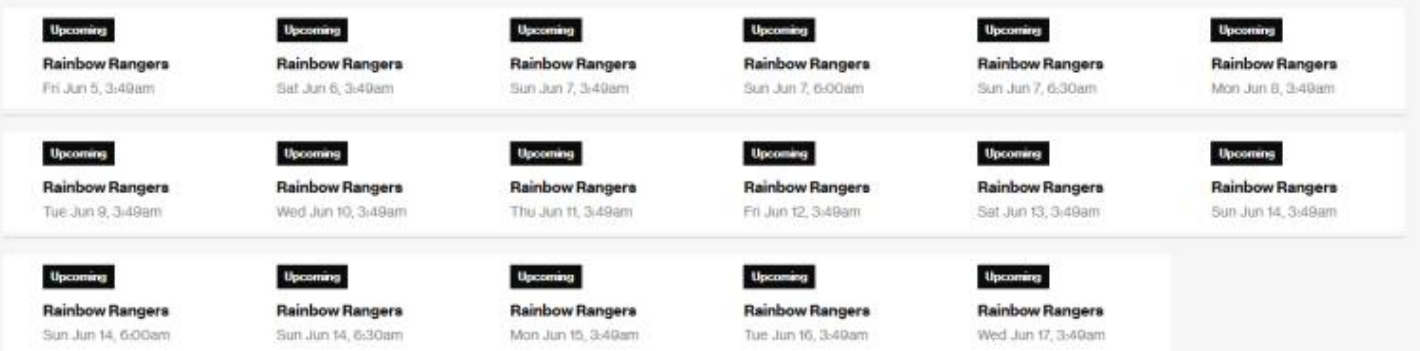
> *"We have just received the Nielsen ratings for our latest premiere episode (Sunday, Jan. 6) of Rainbow Rangers on Nick Jr., which generated our highest premiere episode rating to date with 455,000 viewers!*
>
> *The premiere episodes are broadcast on Sundays at 11:30 AM, and the encore episodes are broadcast Monday through Friday in the afternoon.*
>
> *And, the strong and growing viewership on Nick Jr. points to an increasing appetite by kids for Rainbow Rangers and the coming tsunami of products at retail." The press release says.*

**Then, the company stated in March 2020 that it was airing 26 times per week,** giving it broad coverage in apparently favorable time slots:

> *"Monday-Friday, four airings per day, and six airings on the weekends. The animated action-adventure series premiered on Nick Jr. in November 2018 with five airings per week and has consistently achieved high ratings with its target demo of Girls 2–5-years-old."*

**But the Rainbow Rangers schedule now says otherwise.** Most weekdays look like this schedule, from yesterday, **where the show has one time slot on Nick Jr. at 3:9AM EST.**

| | |
|---|---|
| 03:19 am | Shimmer and Shine<br>Zeashell Surprise; The Zahramay Zuffer-Puff |
| 03:42 am | Hey Duggee<br>The Leaf Badge - *Season 1 Episode 12* |
| 03:49 am | Rainbow Rangers<br>Tornado Hunters/The Air Up There - *Season 1 Episode 6* |
| 04:11 am | Dora and Friends: Into the City!<br>The Princess and the Kate - *Season 2 Episode 7* |
| 04:35 am | Team Umizoomi<br>The Great UmiCar Rescue - *Season 2 Episode 7* |




Several platforms show us the same **, indicating it airs 9 times per week, instead of 26** each morning at 3:49am and then twice additionally on Sunday mornings at 6:00a and 6:30a EST. We emailed the company to ask about its current number of airings and have not heard back as of this writing.

As Genius's CEO said in the March 2020 press release regarding the show being aired 26 times:

> *"Needless to say, leading broadcasters like Nickelodeon don't make schedule changes of this magnitude without good reason…"*

He has not commented thus far on the "good reason" for the show airing in the witching hours of early morning only 9 times per week.

Similarly, there is no indication that a Season 3 has been picked up by Nick Jr. We e-mailed both Nick Jr. the company to try to get confirmation of a Season 3 but investor relations simply stated that negotiations were "underway".

We find it surprising that Nick Jr. is still in negotiations. Other shows such as "PAW Patrol" "Blues Clues" and "Bubble Guppies" were already announced as being picked up by Nickelodeon in February. Season 2 of Rainbow Rangers was ordered in April of 2019 in preparation for its release in October. We are now in June 2020 with no word on the series heading into the fall.

### *3. Stan Lee's SuperHero Kindergarten Is Targeted to Air in Q1, After Almost 10 Years of Apparent Delays. In the Interim, Stan Lee Has Passed Away.*

Stan Lee's Superhero Kindergarten, starring Arnold Schwarzenegger, is another show being created by the company targeting to be aired in Q1 2021.

The company has been attempting to launch the show since as early as 2011 on a major network. In the interim, legendary comic book writer Stan Lee sadly passed away in November 2018.

The company announced recently it would be launching the show on Amazon. No economic terms were disclosed, but the company hyped that it would be "plutonium in a bottle" for shareholders.

Amazon produces some of its own content, but the announcement made no indication that Amazon was paying Genius for the show. For most Amazon Prime content, Amazon pays content suppliers a per hourly rate based on viewership, or they split the rental or subscription revenue.

In other words, the company is likely simply posting its content on Amazon and self-marketing the show, a far less exciting achievement than suggested. It is not entirely clear how it intends to reach kindergarten audiences given that Stan Lee is no longer with us and Arnold Schwarzenegger likely has little brand recognition among young children.

All told, we just don't see the company magically growing into its current absurd valuation, and the shareholders waiting to register 131 million shares for sale are likely acutely aware of this.

## *Conclusion: Why We Think Genius Brands Will Be a $1.50 Stock Within a Month*

There are several factors that we expect will send shares down rapidly in short order:

1. **A massive slew of 131 million shares that are coming available for sale**, likely within weeks, that currently represent a nominal value of $917 million in selling pressure as of current prices (which, realistically, we do not expect to hold up).
2. **The availability of options, allowing investors to hedge and or position ahead of the pending selling pressure.**
3. **The reversal of retail momentum** New traders are notoriously focused on the next shiny object, and when Genius loses its luster it is likely to quickly get dropped to the curb in favor of other junky story stocks.

# *Disclosure: We are short shares of Genius Brands (NASDAQ:GNUS)*

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[1] Includes fully diluted reported share count and shares convertible through recent convertible notes financing

# TAB 11

# Our Reply to China Metal Resources Utilization's Inadequate Response

Published on May 21, 2020



Two days ago, China Metal Resources Utilization ("CMRU") issued an announcement that responded to our earlier report, which was entitled " China Metal Resources Utilization: 100% Downside to This Zombie Company ".

We appreciate the company's response, but find that it failed to refute the findings of our research or our key conclusions that the company is (a) facing severe financial distress; (b) that trading in the company's shares exhibits signs of manipulation; and (c) that its acquisition spree appears to exhibit signs of financial mismanagement and undisclosed related party transactions.

In fact, we believe that as readers carefully compare CMRU's response to our research, it becomes clear that instead of refuting our findings, the company instead largely confirmed, or

in some cases simply side-stepped, our concerns.

## *Sometimes the Things Left Unsaid Echo the Loudest. The Issues That CMRU Failed to Address Altogether.*

There were multiple key items in our report that the company failed to address entirely. In particular:

1. **ur report:** The company's Chairman/CEO has announced his intent to sell every single share of the company he owns, amounting to roughly 29.65% of the company's outstanding shares, showing what appears to be an obvious lack of confidence in the business and its current valuation.

CMRU's response: **None**

2. **ur report:** CMRU appears to be bordering on insolvency, with cash of RMB 64.7 million versus RMB 1,559 million in borrowings due "within one year or repayable on demand" at an average interest rate of 13.72%. The company has failed to pay loans that appear to have matured 4 years ago and recently needed an extension on another loan after failing to pay it back upon maturity. All told, we see these as obvious and material warnings of solvency risk.

CMRU's response: **None**

3. **ur report**: CMRU's stock appears to have had a suspicious constant bid at $3 for almost 4 straight years, despite numerous material news releases and high market volatility. During one 398 trading day period, the stock never once deviated by more than 5.75% from its average price of $3.05.

CMRU's response: **None**

4. **ur report**: CMRU has raised over HK$2.5 billion in cash from IPO to present, yet nearly all of that cash is gone and the company seems to have no path forward out of its debt without the need for further capital injections.

CMRU's response: **None**

5. **ur report**: The company's revenue 'growth', the most positive financial metric we saw, was actually fueled largely by low-margin, low value-add trading revenue, which does little

to support long-term business objectives.

CMRU's response: **None**

## *Of the Items CMRU Did Respond to, We Find Its Response Either Corroborates Our Findings or Simply Sidesteps Them*

1. ***Why Did the Company Acquire 3 Newly Formed Entities With Almost No Assets For Hundreds of Millions of Dollars?***

In our report, we had identified that the company had acquired multiple businesses that were newly-formed, with little in the way of actual assets. The entities had minimal reported profits or had reported losses, and in two out of three cases had signed leases for its factories and equipment just months ahead of the acquisition announcements. The company paid vast sums for these enterprises that had seemingly owned very little, which we found highly suspicious.

In CMRU's response, the company claimed that the acquisition targets were all newly formed because they had undergone "pre-acquisition restructuring whereby the proposed business to be acquired was injected to a newly formed entity." The company claimed this was to avoid any hidden liabilities.

We find this explanation to be alarming and it further heightens our concerns.

Two of the newly formed entities signed leases for factories and equipment *after* their creation. What existing operations were being restructured if the entities didn't own factory or equipment assets in the first place? The third acquisition had net assets of only RMB1.44 million. Again—exactly what assets were being restructured?

Furthermore, the original transaction announcements (1,2,3) in no way mentioned restructurings from a previously existing entity. For the first time, the company's response to our report seems to acknowledge that the acquired entities were just shell entities acting in the middle of a broader transaction.

This raises new, critical questions that we encourage the company to address:

1. How much did the acquired entities pay for the *original* assets, and what exactly were those assets?
2. What were the *names* and *beneficial owners* of the original assets or entities *before* they

were allegedly moved into newly formed shell entities?

3. What were the *financials* of the original assets or entities before they were allegedly moved into newly formed shell entities? (The company's announcements only provide the financials for the newly formed entities.)
4. Why were shareholders not privy to this information before our report was published?

The company then sought to downplay the sums paid for these entities by stating that a "material portion" of the purchase consideration was non-cash and performance-based.

While it is true that a portion of the acquisition agreements called for earn-out compensation, nonetheless, over HK$626 million in cash was paid for three, newly formed entities. Once again, we do not believe these transactions made financial sense, and based on the company's latest admissions, investors do not seem to have the full picture.

## 2. *Questions Regarding Related Party Transactions*

Our report also raised questions about related party transactions, both disclosed and undisclosed. In one instance, we asked: "Why did 4 entities owned by or tied to the Chairman/CEO's daughters share a phone number with an "arms length" acquisition target?"

The company responded by acknowledging the relationship, and explaining that it was part of its pre-acquisition structuring:

> *"…the Group, as purchaser, took the lead in establishing Mianyang Zhaofeng and oversaw the other pre- acquisition structuring steps. As Mianyang Zhaofeng would become the Company's subsidiary, it had also included various contact details of the members of the Group as company information of Mianyang Zhaofeng."*

We find this, once again, to be a rather alarming admission. Earlier, the company acknowledged, apparently for the first time, that the newly formed entities were shell entities.

Now, it appears the company is acknowledging that it had a role setting up at least one such shell entity, which it later acquired in a purported "arms length" transaction.

We encourage the company to answer: Did the company establish the other entities it acquired in its "arms length" "independent" transactions as well?

3. ***Questions Around Financials, Including Spiking Accounts Receivables and Payables Past 180 Days Due***

Beyond the obvious issues with apparent non-payment of bonds, we also identified that the company had rising accounts receivables and payables past 180 days, despite claiming that typical terms are 3 months or 30 days, respectively.

The figures cited in our report were drawn directly from the company's financials, which painted a bleak picture of its ability to collect receivables or to pay its suppliers.

Rather than providing any explanation for why the company was experiencing prolonged collection and payment issues, CMRU simply claimed that (a) the old receivables were recovered and therefore no provision is required and (b) the company has settled most of its payables.

We find this explanation to be wholly inadequate. The company should provide a clear explanation for why its receivables and payables are aged well past its self-proclaimed typical terms.

## *Conclusion: We Remain Short, and Maintain Our Price Target of Zero*

**Disclosure: We are short shares of CMRU 1636.HK**

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# TAB 12

# Sorrento's Pandemic Profiteering: Experts and Former Employees Speak Out on Sensational Claims of Covid-19 Cure

Published on May 20, 2020



- Last Friday, Sorrento Therapeutics appeared to celebrate discovering a cure for the coronavirus in a widely disseminated Fox News article. The company's stock rose 243% that day on about 78x its daily average volume.
- However, former company employees and experts at Mt. Sinai, the NIH, and the Rockefeller Foundation confirmed to us that the news is likely too good to be true.
- **I would never in my life have put out a press release where I say we have a cure," a former Sorrento senior executive told us** He also estimated there are "hundreds" of groups with antibodies similar to Sorrento's.
- **I suggest extreme skepticism regarding any claims made by Sorrento," another former employee told us.**

- "I am not aware of any data suggesting Sorrento's single Ab is as good as the many others that had already been previously generated (such as ours or Lilly's)" Regeneron's co-founder told us.
- Sorrento was nearly out of cash and facing growing questions of solvency leading up to its surprise cure announcement. **The company put paperwork in place to sell 00 million of stock just weeks in advance of discovering' the cure.**
- After the financing arrangements were put in place, the company announced a collaboration with Mount Sinai, then within just three days began pitching journalists on its miraculous findings.
- Meanwhile, one Mount Sinai researcher we talked to called Sorrento's announcement "very hyped". Another warned us that "nothing in medicine is 100%," referring to the company's claim of a solution that works 100% in the Fox News piece.
- One of the company's financing agreements is with a year-old entity in the British Virgin Islands. The mystery backer was unnamed, **but multiple industry sources tell us it is the same individual that was behind financing shipping company DryShips** in 2017. DryShips lost 99.9% of its value in 2017 and reverse split ***eight*** times between 2016 and 2017.
- We believe that Sorrento's actions are manipulative at the worst possible time and simply amount to an attempt to shamelessly profiteer off the pandemic.
- We see significant downside from these levels and believe the company is already in the process of severely diluting its new unsuspecting investor base. We believe regulators should closely scrutinize the company's actions over the last several weeks.

*Initial Disclosure: After extensive research, we have taken a short position in shares of Sorrento Therapeutics. We will make any source names and details available to members of the media who wish to independently corroborate our work on condition that they respect their background status. This report represents our opinion, and we encourage every reader to do their own due diligence. Please see our full disclaimer at the bottom of the report.*

## *Introduction: Sorrento Appears to Announce a Complete Cure for COVID-19, Inspiring Hope… and a 243% Gain in Its Stock Price*

Last Friday, Sorrento Therapeutics announced, via a Fox News " exclusive ", that it had made a breakthrough in the fight against Covid-19 by discovering an antibody that could imminently "shield the human body from the coronavirus".

Per the article:

> ***The company's CE said: We want to emphasize there is a cure. There is a***

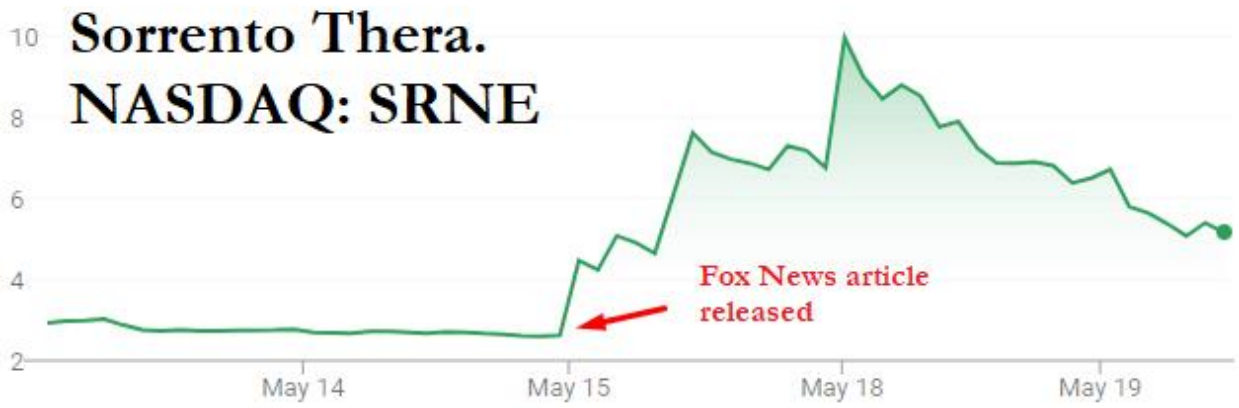
> ***solution that works 100 percent.*** *Dr. Henry Ji, founder and CEO of Sorrento Therapeutics, told Fox News."*

Alas, after 300,000 COVID-19- related deaths worldwide, millions of confirmed cases and lockdowns across the globe, it finally seemed there was a complete cure. The Fox News piece continued, quoting the CEO:

> *"If we have the neutralizing antibody in your body, you don't need the social distancing. You can open up a society without fear."*

It is exactly what everyone in the world wanted to hear.

Predictably, Sorrento's stock spiked on the news. Prior to the announcement, it had closed at a price of $2.62 and had traded an average of ~6.5 million shares of volume over the preceding 30 days. On the day of the Fox News report, the stock spiked as high as $9 per share, or a gain of 243%, on an astonishing 507 million shares of volume – about 78x its daily average.




(Source: FactSet pricing data)

But was the news worthy of the company tacking on more than $1 billion in market cap over just several days?

After our research, we certainly don't think so.

## *Reality Check: Former Employees, Healthcare Experts*

# *from the NIH and Mt. Sinai (A Partner of Sorrento) Speak Out*

After speaking with former Sorrento company employees, including those who held senior C-suite and management positions, as well as healthcare experts from outlets like the National Institute of Health and Mt. Sinai (a partner of Sorrento), we came to the conclusion that this "too good to be true" sounding story is exactly that.

We don't doubt that Sorrento has found the antibody that it claims. One former employee we spoke with said he would be surprised if they *couldn't* find the antibody, given their extensive antibody library. Nonetheless, the company remains in the preliminary stages of what we understand to be an arduous process to take its antibody from experiments in vitro (in a petri dish) to a safe and effective treatment in vivo (in humans).

Experts have warned us to take Sorrento's claims with "extreme skepticism", saying the announcement seems "very hyped" and with an "aggressive" timeline. One former Sorrento C-suite executive also questioned management's judgement in putting out a press release stating there was a "cure".

Additionally, during the course of our research, we uncovered a number of red flags about Sorrento's past that make us wary not only about the company's recent claims, but its management team in general.

For example, we found that mere weeks ahead of the 'cure' announcement, the company put in place a $250 million financing arrangement with an opaque entity in the British Virgin Islands. The company didn't disclose the ultimate backer of the entity, but we learned through multiple industry sources that it's the same individual that helped finance DryShips, a public market disaster which fell 99.9% and did 8 reverse splits between 2016 and 2017.

It seems as though the entire world is fixated on the pandemic right now. This naturally has brought out the best in the human race: people helping others, selfless frontline workers, a scientific community acting in unison to try and solve the global problem.

Unfortunately, it can also bring out the worst. The SEC has already suspended trading in over 25 companies for suspected false or misleading COVID-related claims. This includes two we have recently written about, Predictive Technology Group and SCWorx, which respectively was delisted onto the Grey Sheets (also known hilariously now known as the "Expert Market") and is in the midst of a regulatory halt.

## *Basics on Sorrento: A Reverse Merger That Has Spent $375 Million In R&D And Has Amassed A $725 Million Accumulated Deficit*

Sorrento came public via reverse merger in 2009 from a shell entity. [ Pg. 21]

The company has spent over $375 million on R&D since inception, racking up an accumulated deficit of $725.0 million, but with very little to show for it in terms of commercialized product. [Source, SEC filings & Pg. 3]

The company describes itself as a "clinical stage, antibody-centric" company. Former employees confirmed to us that the company has an extensive antibody library.

The company's only commercially meaningful product to date is a lidocaine patch called ZTildo. [Pg. 36] Sales of the product have been modest (~$20 million annual revenue run rate) likely owing to substantial competition. Lidocaine has been commercially available since the 1940's and the product has nearly a dozen direct competitors, including generics.

Activist Short JCapital wrote an exposé on Sorrento in March 2018, which detailed a mass exodus of executives, red flags around its current Chairman/CEO Henry Ji, and the lack of focus of the company. The report also highlighted several examples of company dealings with China-based suspected related parties that have allegedly dissipated the company's key resources and cash assets.

Given the historical inability to move its extensive R&D efforts into commercialization, and his litany of historical red flags, Sorrento seemed like an unlikely savior in the fight against COVID-19.

## *The Company Was Nearly Out of Cash and Facing Solvency Questions Before Its "Cure" Announcement*

Sorrento was nearly out of cash and facing growing questions of solvency leading up to its surprise cure announcement.

In the company's latest annual report released in March 2020 , it provided investors with a clear warning:

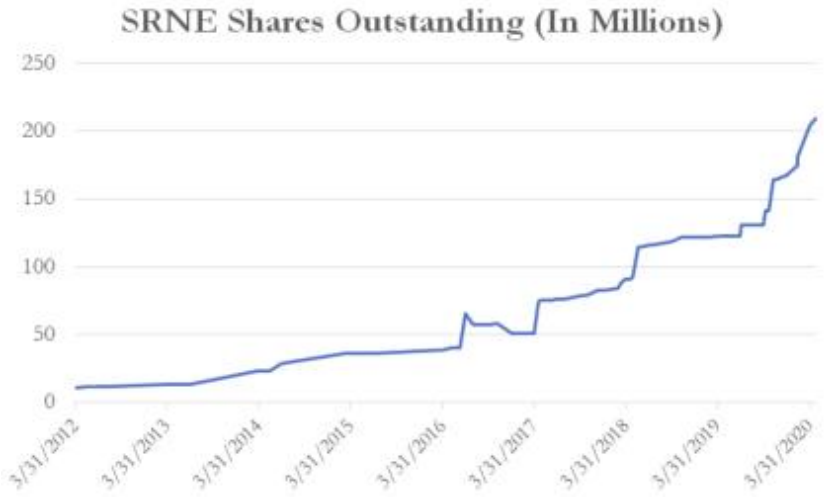
> *"As a result of our recurring losses from operations, recurring negative cash flows from operations and substantial cumulative losses, there is uncertainty regarding our ability to maintain liquidity sufficient to operate our business effectively, which raises substantial doubt about our ability to continue as a going concern.* ***If we are unsuccessful in our efforts to raise outside financing, we may be required to significantly reduce or cease operations"***

As of the quarter ending March 31st, Sorrento had cash & equivalents of only $21.9 million. The company's current ratio, a key measure of near-term solvency, was at ~0.55, dangerously below sustainable levels. [ Pg. 3] The company's average quarterly operating cash flow burn rate was $41.7 million in the preceding 4 quarters, indicating that the company was quickly diminishing its remaining resources.

## *Sorrento Put Paperwork in Place to Sell up to $500 Million In Stock Just Weeks in Advance of 'Discovering' The Cure*

That same month (March), the company filed a "shelf registration" with the SEC, seeking the ability to offer up to $1 billion in securities. [ Pg. 10] It was deemed effective on March 20th.

The company already had a history of issuing significant sums of shares to fund its business, diluting existing shareholders.




(Source: YCharts shares outstanding data)

By April 27th, the company had entered into 2 agreements to sell its stock on the open market,

collectively calling for the company to sell up to $500 million in stock. ***It seemed like an absurdly optimistic number at the time***, given that the entire market capitalization of the company was only $464 million.

One agreement was with A.G.P./Alliance Global Partners, a brokerage firm known for small cap PIPE equity financings .

## *One Financing Agreement Calls for Selling $250 Million in Stock Through a Mystery Financier in the British Virgin Islands. We Linked This Financier To DryShips, Which Suffered A Spectacular 99.9% Share Price Decline In The Year It Was Financed.*

The other agreement was with a discrete entity called Arnaki Ltd., which BVI Corporate Records show is just over a year old. The agreement lists the name of a director of Arnaki, but we have learned from multiple industry sources that the key unnamed backer of Arnaki is actually an individual named Marc Bistricer.

Bistricer is a Canadian financier who runs a firm called Murchison Capital and has reputation for backing companies that have had sudden stock spikes followed by dramatic falls. One such company was DryShips.

DryShips fell 99.9% in 2017 [1,2] before later being acquired at $5.25 per share in 2019. The company's split-adjusted all time high was over $70,000,000 *per share*, owing to ***eight reverse splits 1*** in 2016 and 2017. The company subjected its shareholders to a seemingly constant state of equity dilution.


(Source: FactSet pricing data)

The financier behind DryShips was a mystery BVI entity called Kalani Investments, and its unknown backer drew widespread questions at the time.

THE WALL STREET JOURNAL.

# A Shipping Company's Bizarre Stock Maneuvers Create High Seas Intrigue

Greek carrier DryShips sold vast sums of discounted shares to an offshore firm and propped up prices with 'reverse splits,' sending investors on a wild ride that, for many, ended with steep losses

Following the collapse of the equity, the entity was later revealed to be backed by Bistricer:

# Toronto hedge fund executive is behind $450m DryShips deals

## Manager also revealed as investor in Top Ships and Diana

April 6th, 2017 18:05 GMT by **Joe Brady**

A hedge-fund executive has emerged as the man behind the mysterious Kalani Investments, which is pumping nearly $450m into George Economou-led DryShips.

A TradeWinds investigation reveals that Toronto-based Marc Bistricer and his firm Murchinson Ltd are behind Kalani, which has also invested a further $160m in fresh equity into two other Greek companies, Top Ships and Diana Containerships.

When most promising biotech companies need capital, they often use reputable investment banks to place the funding and generally seek institutional or strategic investment capital.

Instead of that typical route, Sorrento instead appears to be choosing to sell at-the-market (ATM) offerings directly to its largely retail investor base via an opaque BVI-based entity backed by Bistricer. We think this bodes poorly for investors.

We have reached out to Bistricer and Sorrento for comment and to confirm the relationship, and have yet to receive a reply as of this writing.

## *The Company Announced a Partnership With Mt. Sinai, Then "Blitzed" Journalists With A "Very Disingenuous" "Nonsense News" Story About A CureThree Business Days Later*

With its financing arrangements in place, the company moved at a rapid pace.

On Friday May 8 th, the company announced a partnership with Mount Sinai, and that the two organizations "agreed to join forces in the investigation and development of an antibody cocktail".

By Tuesday May 12 th—a **mere 3 business days later**—Sorrento began pitching journalists an embargoed story with the email entitled "Sorrento discovers 100% COVID 19-Blocking Antibody" according to veteran biotech journalist Adam Feuerstein .

**EMBARGOED - Sorrento Discovers 100% COVID 19-Blocking Antibody**

Just one week later, we have even more news I wanted to alert you to.

Sorrento (NASDAQ: SRNE) has **identified a powerful anti-SARS-COV-2 antibody** that offers **100% inhibition of the virus** in healthy cells after four days of incubation.

With apparently no other outlets taking the bait, Fox ran with the " exclusive " at the end of the week, on Friday May 15 th.

Feuerstein, who is the Senior Writer for STAT News and is widely respected in the biotech space, said on Twitter that he didn't take the "nonsense" story because he thought the pitch was "dumb".

Adam Crisafulli of Vital Knowledge Media followed suit , calling Sorrento's statements "very disingenuous".

# *Sorrento Boldly Claims To Fox News: "There Is A Cure" and "If We Have The Neutralizing Antibody In Your Body, You Don't Need The Social Distancing."*

On the morning of Friday, May 15, Sorrento probably garnered the most worldwide attention the company has ever received. Fox News published what looked like incredible news for the global fight against coronavirus.

Sorrento had reportedly made an "antibody breakthrough" in the fight against Covid-19, discovering an antibody that could "flush" Covid-19 out of a person's system "within four days", the article claimed.

The company said its antibody can provide "100% inhibition" of COVID-19, adding that a treatment could be available months before a vaccine hits the market.

The article was laden with quotes from management that made it seem like a Covid-19 treatment could be imminent. For example, a senior Vice President is quoted in the article as saying:

> ***As soon as it is infused, that patient is now immune to the disease,"*** *Dr. Brunswick said to Fox News.* ***or the length of time, the antibody is in that system. So, if we were approved by the DA today, everyone who gets that antibody can go back to work and have no fear of catching C VID-19."***

Sorrento CEO Dr. Henry H. Ji further claimed:

> ***When the antibody prevents a virus from entering a human cell, the virus cannot survive,"*** *Dr. Ji said. "If they cannot get into the cell, they cannot replicate. So it means that if we prevent the virus from getting the cell, the virus eventually dies out. The body clears out that virus."*
>
> *"This puts its arms around the virus. It wraps around the virus and moves them out of the body."*

The CEO appealed to the senses of everyone struggling with life under quarantine, painting a

picture of life going back to normal:

> ***If we have the neutralizing antibody in your body, you don't need the social distancing.  ou can open up a society without fear."***

## *Reality Check: Former C-Suite Sorrento Executive: I Would "Never In My Life Put Out A Press Release Where I Say We Have A Cure", There Are "Literally Hundreds" Of R&D Groups With Antibodies Similar To Sorrento*

Given the optics of the article – namely that it appeared Sorrento was stating that they had a cure for the virus, we undertook some due diligence to make sure that Fox Viewers and investors in the company's stock weren't just getting one side of the coin.

We reached out to former employees at Sorrento and were able to speak with a former C-suite executive, who worked at the company for years and has followed its developments closely.

He immediately started by pointing out the company's capital needs:

> *"I'm sure if you're considering the company as an investment you have now looked at their balance sheet and you have looked at their … cash needs. Let's say the Q1 2020 data, the numbers indicate, a somewhat precarious situation…"*

When asked to comment on the antibody that Sorrento found, he explained to us that there are "literally hundreds" of R&D groups that have something similar:

> *"If you now identify an antibody that binds to an epitope of the viral spike protein, and you thereby inhibit that virus to bind to the ACE-2 entry receptor on the human cell and you thereby inhibit infection,* ***my loose estimate would be that there are literally hundreds of R  D groups that have something like that.***

There's a European consortium that is comprised of over 130 academic groups funded by the European union, there's a German university in there who have an activating antibody, there's Regeneron who think that they can actually have a product available by Q3, there's Amgen,

there Lily and at this point in time the technologies to create a reasonably high affinity antibody against a viral epitope – **they're so mature that you simply have to assume there are literally hundreds of groups that have that.."**

He was also the one of many experts we talked to who warned us about making such bold claims with in vitro results:

> *"…you do know that when somebody has data from an agent that shows efficacy in an in vitro assay – that if you then say I have now a cure,* ***then this statement can only be understood narrowly"***

**inally, he made it extremely clear that he would not have put out the release in the way that Sorrento did:**

> *"I've been [executive] of (multiple) public companies,* ***I would have never in my life issued a press release where*** *- based on a feasibility experiment I would at best say I have a lead molecule –* ***issue a press release where I say we have a cure.*** *To say that that's outside of convention is probably the nicest way to put it."*

## *More Former Sorrento Employees: "I Suggest Extreme Skepticism Regarding Any Claims Made by Sorrento" And "The Announced Timeline Seems Very Aggressive"*

We reached out to another former company VP, who worked at Sorrento recently for about a year, with our concerns about the company's recent news.

He told us that he thought our "instincts were probably correct" and then simply said:

> ***I suggest extreme skepticism regarding any claims made by Sorrento."***

Yet another former Sorrento employee, who used to be a senior scientist at the company for more than six years, told us that while they thought the results looked promising, "they are only in-vitro data." This former employee then warned:

> *"It is too early to really tell if it will translate in vivo. And we would have to see safety data. Also, their announced timeline seems very aggressive…"*

## *Healthcare Experts & Mt. Sinai Department Of Medicine And Microbiology Workers: "This Looks Very Hyped" and "Nothing In Medicine Is 100% "*

The Fox News article also noted that "Sorrento had partnered with New York-based health care system Mount Sinai to develop an antibody cocktail" for fighting coronavirus.

Knowing that Mount Sinai is a reputable name in the healthcare community, we wanted to reach out to them and see if it shared the same imminent optimism as it appeared Sorrento did.

When reached via e-mail about the Fox News article, one researcher at the Department of Medicine and Microbiology at Mt. Sinai told us:

> *"**This looks very hyped.** You need massive amounts of antibody to achieve this. This is the reason why this is not used for influenza. Too expensive, too much antibody needed. This cannot be a solution for everybody. **There are no data yet in humans** For Ebola, there were several antibodies that worked like this one in vitro, but only a few are protective in vivo. **Bottom line, very early in development to know feasibility**"*

A second Mt. Sinai research worker that we reached via e-mail simply told us that:

> ***In general terms nothing in medicine is 100%. Nothing."***

We also communicated with Dr. Charles Rice , the Chair in Virology & Head of the Laboratory of Virology and Infectious Disease at Rockefeller University, who told us:

> *"I don't know the details of the Sorrento MAb but **their claims at this apparent stage of development, without clinical data, seem overstated. There are dozens of groups developing these antibodies and time and appropriate***

> ***tests will tell which are most effective.*** *As a general solution or "cure" it is unlikely that an infused product, even if long lasting, will cover all of the bases needed to control this infection."*

Finally, a PhD at the National Institute of health warned us:

> *"…be cognizant of the stage of the research (ex. if there is only data in vitro, which means in a petri dish)."*

## *Regeneron Co-Founder and Chief Scientific Officer: "They Seemingly Are Substantially Behind the Leaders At This Time…It is Very Hard to Seriously Evaluate the Sorrento Effort"*

We also communicated with George Yancopoulos, Co-Founder, President & Chief Scientific Officer for Regeneron, which itself aims to advance an antibody treatment for COVID-19. His statements were candid in describing the competitive field that Sorrento and his company faced, and the challenges in bringing an antibody treatment to market:

> *"Several companies have previously announced that they have already generated very potent anti-viral neutralizing antibodies – including our company as we announced a while back. That is only the first step, and there are many more steps to manufacture and progress such antibodies into clinical trials – I believe most accounts suggest that our company and probably one other company (Lilly) are the leaders into progressing these antibodies into clinical trials, and both of us are planning on doing this in the next few weeks. And then there are the challenges of successfully carrying out these clinical trials, which is also not guaranteed.*
>
> ***I am not aware of any data suggesting Sorrento's single Ab is as good as the many others that had already been previously generated such as ours or Lilly's****, nor that they have any of the required downstream capabilities, nor that they have demonstrated any capabilities or success previously in other programs (such as the success we demonstrated with our related efforts against Ebola), and they seemingly are substantially behind the leaders at this time.*

> *So it is very hard to seriously evaluate the Sorrento effort."*

## *This Doesn't Appear to Be Sorrento's First Questionable Stock Market Surprise—A Series of Suspicious Anonymous Buyout Offers*

Sorrento has a history of eyebrow raising announcements that happen to positively influence its stock price.

On November 22nd 2019, the company filed a form S-3 seeking to register over 17 million shares of stock that had been newly converted from holders of promissory notes earlier in the month. [Pg. 2]

Three days later, on November 25th, the company announced that it had received and summarily rejected a "non-binding" offer by two anonymous biopharmaceutical companies. The companies proposed acquiring the stock for between $3.00 and $5.00 per share.

The stock jumped 94% on the news, to $3.11, from a prior-day closing price of $1.60, on almost 72x normal volume.

The registration statement for the 17 million shares had not yet become effective however, meaning the shareholders were unable to sell.

Thankfully for them, on January 10th 2020, the company announced that it had received *yet another* non-binding acquisition proposal from an unnamed private equity fund, offering up to $7 per share. The news sent the stock to $4.76, up ~40% from its previous day's close, on ~7x its average volume.

The registration statement for the 17 million shares became effective on January 23rd, granting the financiers the ability to unload their stock. It is unclear from filings whether they chose to do so. On January 27th, the company announced that it had rejected the latest anonymous offer. From there, the stock faded into the low $2 range in the lead-up to the COVID-19 'cure' series of events.

We asked the company who the anonymous private equity fund was, and have not yet received a reply.

We have decades of combined public market investing experience and have never seen an anonymous bidding war for a company. Given the proximity to the company's equity issuances we find the series of events to yet another troubling red flag.

## *Conclusion: When It Seems Too Good To Be True…*

As we have urged with other names participating in the Covid-19 news cycle, we believe it's worth remaining cautious on Sorrento and its suggested coronavirus cure.

We also believe that given the egregious nature of how the company sought media attention and the way it framed the story – combined with the fact that the company was already prepared to raise hundreds of millions of dollars in advance of finding its supposed cure – that regulators should carefully scrutinize the company's actions.

## *Disclosure: We are short shares of Sorrento (NASDAQ:SRNE)*

## *Legal Disclaimer*

*such information or with regard to the results to be obtained from its use. All expressions of opinion are subject to change without notice, and Hindenburg Research does not undertake to update or supplement this report or any of the information contained herein.*

[1] 03/11/2016 1 for 25, 08/15/2016 1 for 4, 11/01/2016 1 for 15, 01/23/2017 1 for 8, 04/11/2017 1 for 4, 05/11/2017 1 for 7, 06/22/2017 1 for 5 and 07/21/2017 1 for 7

# TAB 13

# China Metal Resources Utilization: 100% Downside to This Zombie Company

Published on May 17, 2020



- We believe that China Metal Resources Utilization ("CMRU") is nothing more than a 'zombie company'; an entity technically alive, but under such severe financial distress and laden with so many red flags, that insolvency seems inevitable.
- We believe CMRU's Chairman/CEO may have reached the same conclusion: he has disclosed agreements indicating his intention to offload his entire personal stake in the company, which currently represents about 29.65% of the company's outstanding shares.
- The company's Chairman/CEO has a history of allegations of inflating revenue and margins at his previous company, Gushan Environmental ( _____), which subsequently saw its valuation implode before it was taken private at a price 96% below its IPO price. CMRU was pieced together with the wreckage of Gushan. One media report called CMRU the "rebirth" of Gushan.
- CMRU's financials paint a picture of a company in financial turmoil. Recent filings show the company has cash of RMB 64.7 million versus RMB 1,559 million in borrowings due "within one year or repayable on demand", at an average interest rate of 13.72%.
- The company has not repaid loans that look to have matured in 2016 and appears to have

also missed a bond payment due in August 2019 on another loan, before being granted a short-term extension late last month.

- The operating business seems wholly incapable of supporting the company's debt load: the company has reported negative ***gross*** margins and has bolstered its reported metrics through questionable accounting maneuvers.
- The company says it "normally" settles payables on 30-day terms. As of now, 95% of the company's payables are past 30 days due and 64% are over 180 days old. We question whether they will ever be paid.
- The company has engaged in an aggressive M&A spree, paying up to HK$1.56 billion on deals replete with hallmarks of undisclosed related party dealings.
- In one case, the company paid consideration of up to HK$741 million for a 4-month old entity that had just leased an apparently abandoned factory (we visited the site, and have pictures).
- In several disclosed and undisclosed related party transactions, there are clear links to CMRU's Chairman/CEO's family.
- CMRU's stock appears to have had a suspicious constant bid at $3 for almost 4 straight years, despite numerous material news releases and high market volatility. During one 398 trading day period, the stock never once deviated by more than 5.75% from its average price of $3.05.
- All told, we think CMRU is an obvious near-term zero.

*Initial Disclosure: After extensive research, we have taken a short position in shares of China Metal Resources Utilization. This report represents our opinion, and we encourage every reader to do their own due diligence. Please see our full disclaimer at the bottom of the report.*

# *Introduction*

We believe that China Metal Resources Utilization is nothing more than a "zombie company"; an entity under such severe financial distress that insolvency appears to be an inevitability, yet it nonetheless continues to lurch forward in the capital markets with a HK$7.6 billion market value (US$1 billion).

**We also believe that the company's Chairman/CEO may realize this, given that he has recently entered into agreements indicating his intention to sell his *entire* stake in the company, amounting to 0% of the business at the time of the announcement.**

Given the Chairman's checkered history in public markets, this does not surprise us. CMRU's Chairman/CEO has a history of fraud allegations and destroying shareholder value at his previous company, the formerly NYSE-listed Gushan Environmental Energy, which ultimately was "taken under " at a price ~96% lower than its split-adjusted IPO price.

CMRU is weighed down by a crippling debt load. As of year-end 2019, the company has cash on hand of just RMB 64.7 million versus borrowings of RMB 1,559 million due "within one year or repayable on demand", at an average interest rate of 13.72%. [Pg. 25] **The company also appears to have already missed a bond payment due in August 2019 that it has since received a brief extension on, and has not repaid a loan that looks to have matured in 2016.**[Pg. 26, Pg. 1, Pg. 27]

The operating business looks wholly incapable of supporting this debt; the company has reported negative ***gross*** margins and has bolstered its reported metrics through questionable accounting maneuvers.

*The company has raised over HK$2.5 billion in cash from IPO to present—so where did all the cash go?*

The company has engaged in an aggressive M&A spree that strikes us as replete with hallmarks of undisclosed related party dealings. In particular, the company purchased multiple newly-formed entities with minimal assets, collectively paying up to HK$1.56 billion. In several undisclosed and disclosed related party transactions, there are clear links to CMRU's Chairman's daughters.

We believe these red flags put CMRU on track to suffer a similar fate to its predecessor, Gushan: **a near-total annihilation of shareholder value.**

Meanwhile, CMRU's stock price has remained suspiciously stagnant, despite historic levels of volatility in global capital markets and numerous material news announcements from the company. The stock's lack of price movement resembles a phenomenon we have witnessed at other questionable China-based companies that have subsequently and suddenly cratered.

We have a price target of $0 on shares of CMRU.

## *Background: Basics on the Business*

China Metal Resources Utilization Limited was incorporated in the Cayman Islands on February 22, 2013 and its shares have been listed on the Main Board of The Stock Exchange of Hong Kong since February 21, 2014. The company is headquartered in Mianyang, China and was founded by Yu Jianqiu, who serves as Chairman, CEO and is the largest shareholder with ~29.65% of the outstanding equity. [Pg. 36]

The company's main revenue drivers are trading of copper and sales of recycled copper

products, which, combined, accounted for 99.5% of reported 2019 revenue [ Pg. 11].

CMRU manufactures and sells copper and other metals-related products in the People's Republic of China, operating in three segments : (1) recycled copper products; (2) power transmission and distribution cables; and (3) communication cables.

## *Background: CMRU's Chairman, Yu Jianqiu, Has A History of Allegations of Inflating Revenue and Margins at His Preceding NYSE-Listed Disaster, Gushan Environmental*

The legacy of CMRU Chairman/CEO Yu Jianqiu has not been favorable to shareholders to date.

CMRU was founded using assets of another Yu Jianqiu company, Gushan Environmental, that was alleged by a major media outlet to have engaged in brazen fraud. Yu Jianqiu is now board chairman and executive director of CMRU and currently controls ~29.65% of the company's outstanding shares.

Before CMRU, Jianqiu was Founder, Chairman, and Principal Executive Officer of Gushan Environmental Energy Ltd. [ Pg. 21], which was formed in 2001 and listed on the NYSE in 2007. The company began as a biodiesel firm and only later added the copper/metals business that became CMRU today, as we will show.

In September 2008, tipped by an insider, *National Business Daily* journalists revealed in an investigative report [ 1,2] that Gushan appeared to have rented oil container vehicles and hired drivers to go in and out of its factory repeatedly in order to present the false impression of a booming business. The article went into vivid detail on the key evidence and observations supporting the allegations. One excerpt stated:

> *"In the hour that the reporter observed Gushan, three tanker trucks in the group's factory entered and exited nearly ten times, a busy scene. However, these tanker trucks did not load or unload any oil."*

Moreover, Gushan was alleged to have falsified the purchase price of raw materials and to have inflated its revenues, based on interviews with multiple employees and other sources, according to the *National Business Daily* exposé. One source stated:

> *"The only explanation is that they are listed companies, and they are very concerned.* ***Even when the production is stopped, they must create the illusion of prosperity in production and sales to avoid the stock price falling."***

The company failed to address any of the specific allegations and simply declared the report to be "inaccurate". The stock subsequently cratered, hastened by the financial crisis, and never recovered:


(Source: FactSet, split-adjusted prices)

In late-2010, with the biodiesel business faltering and with the stock battered, Gushan began purchasing interests in copper recycling businesses [Pg. 37]. These would later form the foundation for CMRU.

In late 2012, Jianqiu took Gushan private for $1.65 per ADS, representing a ~96% decline from its split-adjusted IPO price. By 2013, local media reported that much of the Gushan biodiesel business had been shut down.

## *Background: CMRU Was Formed Out of the Wreckage of Gushan and Taken Public in Hong Kong 2 Years Later*

In 2014, Jianqiu took the copper recycling segment of Gushan public on the Hong Kong exchange, where it trades as CMRU today. The South China Morning Post said:

> *"The bulk of China Metal's operations were part of biodiesel maker Gushan Environmental Energy".*

Mainstream media outlet *Zhitong Finance* asserted at the time that CMRU was simply the "rebirth" of Gushan.

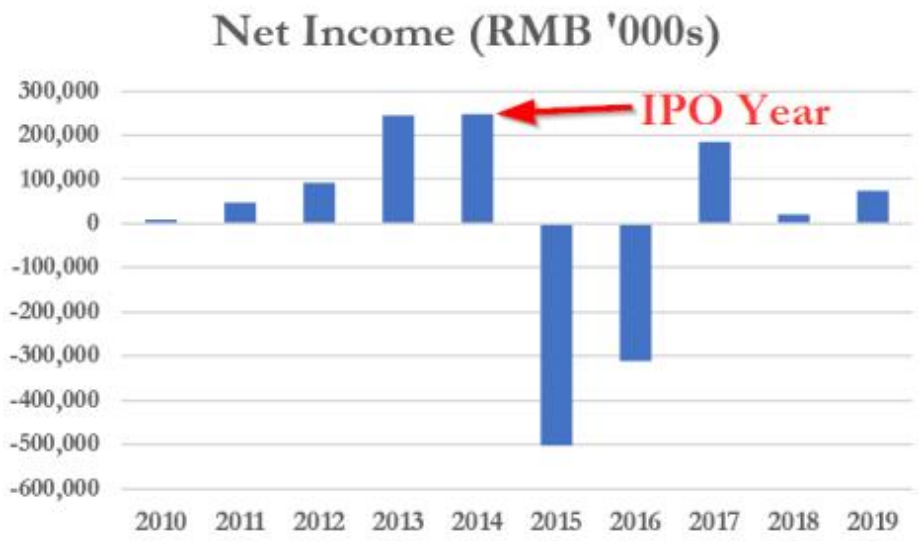
Along with the copper wiring subsidiaries of Gushan, CMRU also retained much of Gushan's board and executive team. CMRU's two executive directors, CFO, corporate Secretary and a board member all came from Gushan. [Pg. 3]

Jianqiu had privatized Gushan at a valuation of about US$31 million. Yet when it re-emerged as CMRU, just 2-years later, the company sported a market value of ~US$320 million. The market value has nearly tripled despite its worsened and distressed financial state.

# *Part I: CMRU's Financial State of Disrepair*

## *100% Fundamental Downside—CMRU Has Been Operating at NegativeGross Margins, Looks to be Unable to Meet its Near-Term Debt Obligations, Has a Spiking Debt Load and Other Signs of Severe Financial Stress*

According to CMRU's IPO prospectus, business was booming its early years. Since financials were first reported in 2010, the company increased its net income by a whopping 127% compound annual growth rate in the years leading up to its 2014 IPO. But performance suddenly and curiously fell off a cliff as soon as the company became public.




(Sources: Prospectus and annual reports [ '12-'13, '15-'16, '17, '18-'19])

Gross margin, which at one point resembled that of a viable business, quickly sunk below zero, where it remains as of the company's most recent annual financial reporting period. The reason for this collapse is largely why the metal recycling business tends to be unattractive to begin with: it is a highly competitive commodity business.


(Sources: Prospectus and annual reports [ '12-'13, '15-'16, '17, '18-'19])

Despite the company's negative gross margins, CMRU has managed in some years to eke out a small profit, largely through accounting alchemy related to the reversal of doubtful account allowances (which we detail further later) and government subsidies/VAT refunds.

## *Financial Stress: Cash of RMB 64.7 Million Versus*

## *Borrowings of RMB 1,559 Million Due "Within One Year or Repayable on Demand" At an Average Interest Rate Of 13.72%*

The company's poor operating performance seems to be exacting a serious toll on its balance sheet.

As of 2019 year-end, the company had cash of RMB 64.7 million, down from RMB 112.9 million the year prior. [ Pg. 26] This compares to borrowings of RMB 1,699 million as of the same period, which had spiked almost 50% from the prior year. [ Pg. 24] Of those borrowings, **a crippling 92% were due within one year or repayable on demand** (RMB 1,559 million). [Pg. 25]

**The weighted average interest rate on the company's borrowings is similarly crippling at 13.72%** [Pg. 24] Again, with the company operating at a negative gross margin, this situation strikes us as obviously untenable.

## *Financial Stress: The Company Appeared to Miss A Bond Payment Due in August 2019 And Has Not Repaid Loans That Look to Have Matured in 2016*

Furthermore, **the company appears to already have been late on multiple bond payments.**

In 2017, the company issued HK$600 million in bonds due August 2019. The company apparently failed to pay back the bonds on time, stating in December 2019 that it was "still in negotiation in connection with the proposed extension of the instruments." [ Pg. 26]

Late last month, the company announced that it was able to negotiate a brief extension on the bonds until August 2020. Meanwhile, shareholders were left essentially guessing as to whether or not progress was being made behind the scenes for nearly 4 months, between December 2019 and April 2020, on a material amount of debt.

The company also appears to be *nearly four years* late on *another* set of loans, which have been due since 2016. The senior (or "entrusted") loans total RMB 300 million and were issued by Mianyang Science Technology City Development Investment (Group) Co., Ltd, a state-owned enterprise:

> *"…the entrusted loans expired on 27 August 2016, 23 September 2016 and 18 November 2016 respectively. Mianyang Development Group, the entrusted bank and (CMRU's subsidiary) have agreed that, the entrusted loan would not be repayable until further agreed otherwise* ***. As at 31 December 2019 and up to the date of this report, the negotiation was still on going"*** *[Pg. 27]*

In the interim, the company is attempting to issue 325 million shares for HK $871 million, which would plug up some of the hole. However, the critical share sale has been delayed by the COVID-19 outbreak. Should this share sale fail to consummate, or in the absence of further dilutive share sales, we expect CMRU will quickly become insolvent.

## *Financial Stress: The Company Says It "Normally Settles" Payables On 30 Day Terms.*

## *95% Of Its Payables Are Past 30 Days Due And 64% Of the Company's Payables Are Now Over 180 Days Old, Amounting to RMB 357 Million.*

In addition to the company showing obvious stress from its traditional debt, its growing payables balances appear to be another looming threat.

Company filings state that its payables are typically settled on 30-day terms. Yet we see that in the past year, the vast majority of its trade and bills payable have shifted to being over 30 days due.

An ageing analysis of the trade and bills payables as at the end of the reporting period, based on the invoice date, is as follows:

| | **2019** **(Unaudited)** ***RMB'000*** | 2018 (Audited) *RMB'000* |
|---|---|---|
| Within 30 days | **27,428** | 155,146 |
| 31 to 60 days | **166,016** | 32,121 |
| 61 to 180 days | **9,154** | 111,767 |
| Over 180 days | **357,294** | 244,321 |
| | **559,892** | 543,355 |

The trade payables are non-interest-bearing and are normally settled on 30 day terms.

(Source: 2019 Annual Report , Pg. 19)

In particular, RMB 357 million of the company's payables—64% of the total—are over 180 days old, and RMB 532 million – ***9 % of the company's total payables*** are past the "normal" 30 day threshold.

## *Signs of Accounting Alchemy: Reporting Net Income Through the Reversal of Doubtful Receivables*

We have also seen signs of clever accounting being used to bolster the company's reported performance.

For example, over the last 2 years, the company has added a total of RMB ~115 million to its reported profit from "Reversal of provision for doubtful debts". [ Pg. 3] Note that the company has reported *total* net income of RMB 95 million for the same 2 year period. [ Pg. 3]

We checked see if these major reversals were warranted, given the rather tight terms the company has with customers:

> *"The Group's trading terms with its customers are mainly on credit, except for new customers, where payment in advance is normally required.* ***The credit period is generally 3 months****" [Pg. 18]*

Despite those 0-3 month terms, there is a large, sudden spike in receivables that are now past 180 days. [Pg. 19]

An ageing analysis of the trade and bills receivables as at the end of the reporting period, based on the invoice date and net of loss allowance, is as follows:

| | **2019 (Unaudited) *RMB'000*** | 2018 (Audited) *RMB'000* |
|---|---|---|
| Within 30 days | **690,556** | 426,325 |
| 31 to 60 days | **120,325** | 208,843 |
| 61 to 180 days | **109,719** | 150,201 |
| Over 180 days | **268,437** | 93,962 |
| | **1,189,037** | 879,331 |

To us, it looks as though the company should provision for *even more* doubtful accounts, instead of reversing these provisions. However, the decision to impair is apparently, at least in part, at the board's discretion:

> *"The directors of the Company were of the opinion that no provision for impairment under IAS 39 was necessary in respect of these balances" [Pg. 189]*

## *More Signs of Accounting Alchemy: Revenue 'Growth' Has Been Fueled by Trading of Copper "Through Online Copper Trading Platforms"*

While reviewing CMRU's financials, we saw one area of potential optimism: strong revenue growth.

But a basic review of the company's revenue breakdown shows that essentially all of the growth is derived from the online trading of copper, an inherently low margin, low value-add business. As of year-end 2019, ~69.5% of 2019 revenue was from trading [pg. 11], allowing the company to report growing revenue. Here is a description of these activities from the company's annual report:

> *"As part of its trading businesses, the Group purchases electrolytic copper and related products from suppliers through online copper trading platforms and the underlying goods are kept in independent warehouses before delivery to the customers." [Pg. 77]*


(Source: Annual reports/Hindenburg analysis)

Aside from online copper trading, revenue has also been bolstered by a slew of by highly questionable acquisitions, as we will detail shortly. Net of trading and acquisitions, the company's organic revenue has been floundering.

## *Pushing the Eject Button: Chairman/CEO Yu Jianqiu Entered Into an Agreement to Sell ALL Of His Personal Holdings in CMRU (A ~40% Stake in the Company)*

Meanwhile, with the company under significant financial distress, Chairman/CEO Yu Jianqiu entered into a framework agreement in November 2019 to sell ALL of his personal holdings in the company, which amounted to a ~40% stake at the time:

> " ***ollowing the completion of the Disposals, Mr. u Jianqiu will cease to hold any Shares and will no longer be a controlling shareholder of the Compaŕy***

It appears the Chairman/CEO has been partially successful so far, having reduced his stake to ~29.65% according to an announcement in late April 2020.

# *Part II: Where Did the Cash Go? Hallmarks of Insider Self-Dealing*

CMRU has raised over HK$2.5 billion in cash from its IPO to present. [1] Virtually all of that cash is now gone, with the company drowning in debt. So where did the money go?

## *An Alarming M&A History: Numerous Questionable Related Party Transactions With The Chairman's Daughters*

A review of the company's deals shows that its M&A history is rife with red flags. Several transactions show hallmark signs of insider self-enrichment, such as undisclosed ties to insiders of CMRU or the Chairman/CEO's family. In other cases, the company acquired newly formed BVI-based entities with minimal assets at massive price tags:

1. In December 2017, CMRU announced an agreement to indirectly purchase a newly-formed entity that had leased a copper factory and equipment less than 3 months earlier. CMRU paid maximum consideration of HK$317.6 million for the entity, or 4,217x its net assets and net profit. We found clear ties between the entity and the Chairman/CEO's daughters and CMRU employees, despite CMRU describing the deal as "arm's length" and the sellers as being "independent third parties".
2. In February 2018, CMRU announced an agreement to indirectly purchase a 4-month old entity that had just leased equipment and an apparently abandoned factory (we visited the site, and have pictures). The company paid maximum consideration of HK$741 million for the entity, or 138x its net assets and 438x its earnings.
3. In October 2018, CMRU announced an agreement to indirectly purchase a year-old profitless copper manufacturer for maximum consideration of HK$509 million, or 16x its net assets.

Beyond questionable M&A transactions that we believe could involve undisclosed related-parties, the company has also *disclosed* multiple related party deals that have directed resources to insiders.

1. On April 13th 2015, the company announced it had raised RMB 200 million in a convertible bond offering. A week later, the company agreed to pay approximately RMB 135 million to buy a 30% interest in a recycling company from the Chairman/CEO's daughters and independent third parties. [ 43-44]
2. In August/December 2015, the company announced the multi-part purchase of an aluminum trading business owned by JX-Ecommerce, a company controlled by the CMRU Chairman/CEO's daughters. [ 44-45]
3. On October 25th 2017, CMRU invested RMB 125 million into JX E-commerce, a company controlled by the Chairman/CEO's daughters. [ 33, Pg. 45] On March 27th 2020, CMRU then received a short-term loan of RMB 125 million from the same entity it had acquired the shares from earlier. [ Pg. 33]

4. CMRU also contracts with a subsidiary of JX E-commerce for delivery services. It has paid the entity about RMB 30 million in the past 3 years. [ 3]

When aggregating these deals together, we find that a significant portion of the company's raised capital has gone toward highly suspicious M&A transactions or related party deals. In the end we think shareholders will be left bearing the full cost of this rapid capital dissipation.

## *Signs of Undisclosed Related-Party Dealings: CMRU Paid HK$317.6 Million to Acquire a Newly-Formed Entity with Clear Links to the Chairman's Daughters and Other CMRU Employees*

*Acquisition target: Mianyang Zhaofeng Copper Co., Ltd/ Silver Eminent Group (有限公司)*

On December 15 th 2017, CMRU entered into an agreement to purchase 100% of Silver Eminent Group Limited, which owned a 100% equity interest in Mianyang Zhaofeng Copper Co., Ltd ("Mianyang Copper") through its wholly owned subsidiaries. The maximum consideration was HK$317.6 million. [Pg. 13] The rationale for the acquisition was that Silver Eminent was in the copper production business, with a factory and equipment.

We found glaring red flags with the deal, namely that Mianyang Copper/Silver Eminent appeared to have been shell companies formed just months before the acquisition. We also found signs that the deal may have been a related-party transaction, contrary to company disclosures.

Silver Eminent Group Limited was incorporated in the British Virgin Islands on August 28, 2017. [Pg. 6] Its wholly owned China-based subsidiary, Mianyang Copper, was formed 2 weeks later on September 5 th, 2017, according to Chinese corporate records through QCC.com .

About a month after the formation of the entities, on September 30, 2017 Mianyang Copper signed a lease agreement to use a factory and equipment for the production of copper. [ Pg.6]

Two and a half months later, CMRU acquired the newly-formed entity for the startling sum of HK $317.6 million. In describing the deal, CMRU Chairman/CEO Yu Jianqiu stated:

> *"…we expect the acquisition to have immediate synergy effect, enabling us to diversify and strengthen our revenue sources and accelerate our growth"*

According to the financials for Silver Eminent just prior to the acquisition, the entity had total net assets of just RMB 69,000 and unaudited net profit of only RMB 69,000. [ Pg. 6] In other words, CMRU acquired the target at 4,217x its net assets and net profit.

We found it hard to imagine that acquiring a newly-formed entity with newly-signed factory and equipment leases at a massive price tag made any sort of economic sense for shareholders. When we examined further, we found signs of undisclosed ties between the entity and CMRU's Chairman/CEO.

## *Signs of Undisclosed Related-Party Dealings: Why Did 4 Entities Owned by or Tied to the Chairman/CEO's Daughters Share a Phone Number with an 'Arms-Length' Acquisition Target?*

The company's disclosures of the Mianyang Copper acquisition stressed that the deal was arms-length:

> *"The consideration was determined by the parties on an **arm's length basis**.."*
>
> *"To the best of the directors' knowledge, information and belief having made all reasonable enquiries, the Seller and its ultimate beneficial owners are **Independent Third arties**"*

Upon further examination of Mianyang Copper, we found evidence to the contrary. **The entity shared a phone number with 11 different enterprises, many of which are clearly linked to CMRU's Chairman's daughters' companies and to CMRU employees**[2]


(Source: QCC.com [full number behind paywall])

At least 4 of the entities that shared a phone number with Mianyang Copper have obvious ties to CMRU employees or its Chairman/CEO Yu Jianqiu:

1. Sichuan West Kowloon Investment Co., Ltd. ( 投 有限公司), a company **owned by u Jianqiu's daughters**, shared a registration address, email and phone number with Mianyang Copper. [3]
2. Jiangxi Rongtai Copper Co., Ltd. (江 有限公司) is 10% owned by Alpha Universe Group Limited ( 有限公司), **indirectly 10% owned by CMRU**, and 90% by a separate company .[4]
3. Sichuan Guozhao Investment Management Co., Ltd. ( 国 投 有限公司) is ~16% owned by Liu Qi, **who we believe is CMRU lanning Director" Liu** , based on a LinkedIn profile with a matching name and location.


Additionally, Sichuan Guozhao Investment Management Co., Ltd. **previously used e-mail addresses from a cmru.com.cn" domain name**, further linking the phone number used by

Mianyang Copper to China Metal Resources Utilization.

更多邮箱

| | |
|---|---|
| hejy@cmru.com.cn | 2016年报 |
| hangy@cmru.com.cn | 2015年报 |
| 957291908@qq.com | 2014年报 |

(Source: Link & See Appendix D)

4. Sichuan Baohe Supply Chain Management Co., Ltd. ( 有限公司). This entity is owned by an HK company called Hong Kong Baohe Resources Limited . Yu Lili, believed to be the Chairman's daughter or close relative, [5] is a director at Hong Kong Baohe. The entity's secretary , Cheung Ying Kwan, is the same secretary for CMRU [ 77].

We do not think it is a coincidence that a multitude of entities associated with CMRU and its Chairman were tied to Mianyang Copper.

In sum, we think insiders at CMRU were likely the ultimate beneficiaries of the Mianyang Copper acquisition, contrary to company disclosures.

## *More Questionable M&A: CMRU Paid HK$741 Million to Acquire a Newly Formed Entity That Had Leased an Abandoned Factory Months Earlier*

*Acquisition Target: Hubei Rongsheng Copper Co., Ltd. (金 有限公司)*

Mianyang Copper is not the only newly-formed entity acquired by CMRU for astronomical prices.

On February 7, 2018, CMRU entered into an agreement to purchase 100% of the issued share capital of Value Link Developments Limited for an aggregate maximum consideration of HK$741,175,000.

Value Link indirectly owned a 100% equity interest in Hubei Rongsheng Copper Co., Ltd.

("Rongsheng"). Both were formed less than 4 months prior to the acquisition agreement. Value Link was formed on October 27, 2017 [ Pg. 6] and Rongsheng was formed days earlier on October 17, 2017, according to Chinese Corporate Filings.

| | 物昌斌 |
|---|---|
| Legal Form : | Wholly Foreign-Owned Enterprise |
| Register Date : | 2017-10-17 |
| Duration : | 2067-10-16 |
| Registered Capital : | CNY10,000,000 |

(Source: Hubei Rongsheng Copper Co., Ltd. SAIC filing)

Rongsheng seemed to have little in the way of assets at the time. The entity leased a factory and equipment less than a month following its formation and leading up to the acquisition. [ Pg. 6-7]

According to the financials for Value Link at year-end 2017, just prior to the acquisition announcement, the entity had total net assets of RMB 4.9 million and unaudited net profit of RMB 1.55 million. [Pg. 7] In other words, CMRU was acquiring a target at 138x net assets and 438x earnings.

**Signs of undisclosed related party dealings**

Rongsheng owns a 100% stake in an entity called Hubei Pangxin Nonferrous Metal Co., Ltd. ( 有 金 有限公司), according to Chinese corporate records from QCC.com . The same records show that an individual named Yu Dongdong is listed as a supervisor of that subsidiary. Given the matching surname and similar naming convention to the CMRU Chairman/CEO's other offspring, we suspect Yu Dongdong is a family member. The subsidiary was created after the acquisition, suggesting that the company may be paying salary or other compensation to a family member without disclosure.

**ur visit to the factory**

Our investigators visited Hubei Rongsheng Copper Co's address, which is on Buyun Road, Economic Development Zone, Yunmeng County in Hubei province, per the company's SAIC filings.

They visited during working hours within the past month. Here is a photo of the gate of the factory:


Local residents told our investigator that the factory used to belong to a company called Yunmeng Xinshengyuan Copper. They were also told that the building was later abandoned, but Rongsheng Copper inspected it and decided that it could be used, before signing a lease in October 2017, right around the time of its formation.

Our investigators were told that production began in November 2017, but during the visit they did not witness any freight trucks around the two entrances to the factory despite it being working hours. (It is unclear whether the lack of activity was COVID-19 related or otherwise).

Here is a side view of the same factory:


All told, we find it highly suspicious that the company paid HK$741 million to acquire a newly-formed company with minimal assets that had just assumed a lease for an abandoned factory.

## *More Questionable M&A: Acquiring a Newly-Formed Profitless Copper Producer for 16x Net Assets*

*Acquisition Target: (Kaifeng) Chengxin Copper Co., Ltd. (市有限公司)*

On October 19, 2018, CMRU entered into an agreement to purchase 100% of the issued share capital of Sky Harvest Global Limited for aggregate maximum consideration of HK$509,164,969. The transaction closed in November 2018. [Pg. 14]

Sky Harvest indirectly owned a 100% equity interest in Chengxin Copper Co., Ltd. [Pg.12]

The purchase price was determined after an "arms length" negotiation. [Pg. 6] The owners were all described as being "independent third parties".

Sky Harvest Global was another BVI-based entity formed one year prior to the acquisition, on August 28th 2017. [Pg. 7] It had minimal assets, with net assets of only RMB 1.44 million at the time of announcement, and had generated a loss of RMB 64,000 from the date of its incorporation prior to the acquisition. The sellers agreed to assume some of the liabilities of the entity, resulting in CMRU paying 16x net assets for the newly-formed loss generating enterprise.

# *Part III: Other Oddities Such as A Stock Price That Seems To Suspiciously Stick To the $3 Level Even Amidst Historic Volatility*

## *Questionable Trading: CMRU's Stock Appears To Have Had A Bid At The ~$3 Level for Almost 4 Straight Years*

Typically, stocks go up and down. That's just what happens—stocks naturally have some volatility.

But contrary to the normal machinations of the stock market, CMRU's equity at times has seemed about as smooth as a ball bearing.


(Source: Historical stock price data from FactSet)

For example, for the 398 trading day period between April 22nd 2016 to November 29th 2017:

- The stock averaged $3.05, and never went above $3.22 or below $2.94.
- The stock never once deviated by more than 5.75% from its average price of $3.05 in the period.

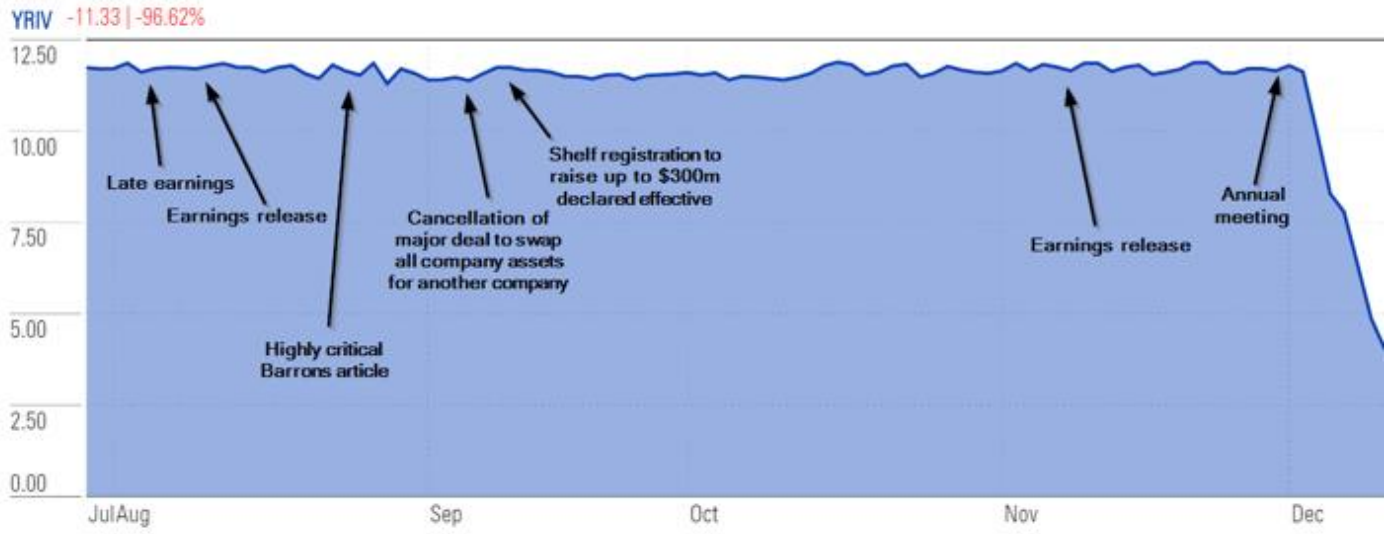
- The stock never had a daily gain of more than 5%, or a daily loss of more than 2.92%.

We believe that such a lack of price discovery is beyond improbable – especially when we consider that during that 398 trading day span, numerous material events occurred that would normally have a meaningful impact on even the most illiquid company's stock price:

1. **28 2016** The company released its annual report, which detailed a **3% y y decline** in revenue, and an **RMB 7 1 million swing** from profitability of RMB 248 million to a loss of RMB 503 million.
2. **8 11 2016** The company announced an offering of 135 million shares after hours, diluting existing shareholders by 6.41%. The closing price finished up 1.97% the following day.
3. **8 31 2016** The company announced interim results showing further losses after hours. The stock finished the next day up a penny, or 0.31%.
4. **11 2 2016** The company announced an intention to issue HK$200 million in convertible bonds after hours. The stock finished down just 0.66% the next day.
5. **03 30 2017** The company announced its annual results after hours, **showing a 17 % revenue increase and a loss of RMB 310.8 million** The stock closed **unchanged** the following day.
6. **06 01 2017** The company announced an equity offering of 74 million shares after hours, diluting existing shareholders by 3.1%. The stock finished the following day down just 2 cents, or 0.66%.
7. **7 21 2017** The company issued a surprise announcement after hours that it expected it would report a profit, compared to the losses in the previous period. The stock finished the day up three cents, or 1.01%.
8. **8 31 2017** The company announced interim results after hours showing a 187% surge in revenue from the prior comparable period, and a swing to profitability. The stock finished the following day up 6 cents, or 2%.

The price movement (or lack thereof) reminds us of the trading in another company we recently wrote about for its questionable business practices, Yangtze River Port and Logistics.

In that instance, we had identified a period of four months where the stock appeared to have non-stop support, despite (i) the company delaying its earnings (ii) the release of a critical Barron's article (iii) the cancellation of a major deal and (iv) an earnings announcement, among other developments.




Yangtze River ultimately plummeted 99% and was de-listed after FINRA alleged that the Company was involved in an effort to artificially support its stock price with **three brokerage accounts registered in the names of individuals who appeared to be neighbors of the company's CE .**

We have seen a parallel lack of price movement in other companies, primarily China-based, that eventuate a complete collapse in the stock (e.g.: Deer Consumer Products, Tech Pro Technologies, et al.)

CMRU exhibits this same pattern, and we expect it will result in the same fate for shareholders. Since early February, the stock has mysteriously found a floor around the same $3 price level.

After all, what are the odds that a copper recycling business is somehow "immune" to the global recession that has shocked markets and the global economy over the last 3 months as a result of the coronavirus?

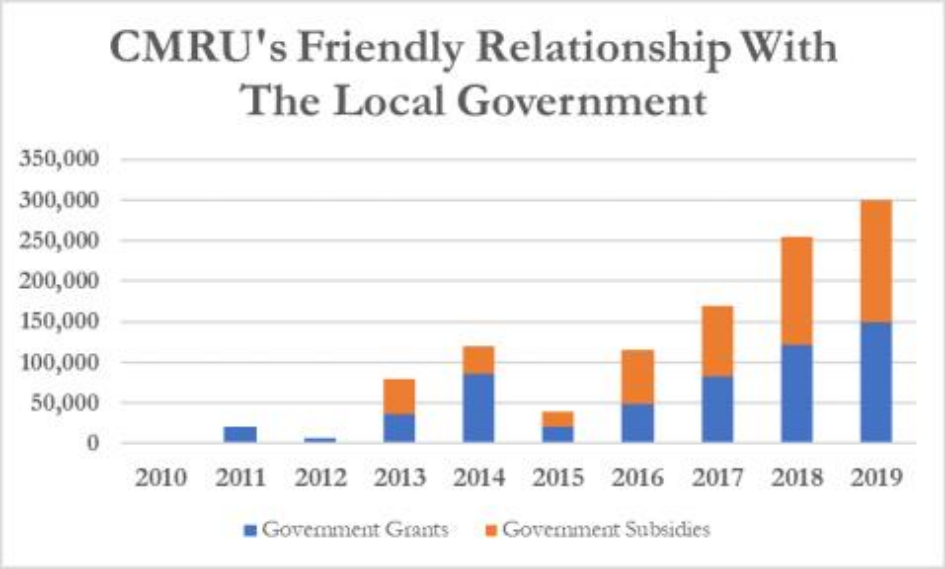
## *CMRU's Friendly Relationship with The Provincial Government Has Kept it (Barely) Afloat*

Chairman/CEO Yu Jianqiu has been the recipient of a remarkable amount of government support since launching CMRU, which has historically enabled this zombie company to continue lurching along.

Recently, Jianqiu agreed to sell his personal shares of the company to state-owned enterprise Sichuan Provincial Investment Group Co., Ltd. at a price tag amounting to HK$2 billion. This is a

remarkable sum of money for shares that in our view seem quite obviously worthless.

Beyond the government directly enriching the company's founder, CMRU has received RMB 1.1 billion in subsidies and grants since 2010, when it began reporting financials, according to its annual filings. In 2019 alone, the company received RMB 299.7 million of local government subsidies and grants that were described as being "unconditional" or with "no specific conditions". [6] [Pg. 15] This essentially amounts to free money:




Beyond the local government's annual free-money giveaway to CMRU, it also held a significant equity stake in the company. Per the 2019 interim report, state-owned enterprise Mianyang Science Technology City Development Investment Group (科技投(有限公司) held 11.87% of the outstanding equity of CMRU. [Pg. 20][7]

Lastly, as noted above, the same Mianyang state-owned investment group loaned the company RMB 300 million that has apparently been due since 2016. [Pg. 27]

Governments make lousy capital allocation decisions all the time, but this strikes us as next-level. Why would the government pay HK $2 billion to buy the equity from a founder that is already late on his government debt after burning through his annual free cash windfalls from the government?

Note that CMRU only employs 847 people, per its latest annual report, suggesting that the issue is beyond just mere job protection. [Pg. 33]

We can only wonder.

## *Conclusion: 100% Downside*

We believe that China Metal Resources Utilization will suffer a similar fate to its predecessor, Gushan: a near-total annihilation of shareholder value. We have a price target of zero.

## *Disclosure: We are short shares of CMRU (1636.HK)*

## *Appendix A: 11 Companies That Share Phone Numbers With Mianyang Zhaofeng Copper*

The eleven companies that share the same phone number (numbers are behind a paywall at QCC.com ):

15881670927

| 序号 | 企业名称 | 法定代表人 | 注册资本 | 成立日期 | 经营状态 |
|---|---|---|---|---|---|
| 1 | 绵阳金循环贸业有限公司 | 林清 | 1000万元人民币 | 2014-05-27 | 存续 |
| 2 | 绵阳国源股权投资基金合伙企业（有限合伙） | 绵阳中海富股权投资基金管... | 21000万元人民币 | 2017-04-26 | 存续 |
| 3 | 四川保和供应链管理有限公司 | 俞美玲 | 1000万港元 | 2017-12-22 | 存续 |
| 4 | 绵阳中海富股权投资基金管理有限公司 | 刘阳 | 500万元人民币 | 2016-06-08 | 存续 |
| 5 | 绵阳兆丰铜业有限公司 | 李永宣 | 1000万元人民币 | 2017-09-05 | 存续 |

15881670927

| 序号 | 企业名称 | 法定代表人 | 注册资本 | 成立日期 | 经营状态 |
|---|---|---|---|---|---|
| 6 | 江西荣泰铜业有限公司 | 文正祥 | 1000万港元 | 2017-12-20 | 存续 |
| 7 | 四川省西九龙投资有限公司 | 俞燕燕 | 5000万元人民币 | 2009-03-26 | 存续 |
| 8 | 四川金循环电子商务有限公司 | 林清 | 10000万元人民币 | 2013-11-20 | 存续 |
| 9 | 绵阳昱柏新材料科技有限公司 | 侯丽佳 | 30000万港元 | 2018-10-10 | 存续 |
| 10 | 四川敦鑫金属材料有限公司 | 张波 | 5000万元人民币 | 2017-05-26 | 存续 |

15881670927

| 序号 | 企业名称 | 法定代表人 | 注册资本 | 成立日期 | 经营状态 |
|---|---|---|---|---|---|
| 11 | 四川国慧投资管理有限公司 | 刘奋 | 1000万元人民币 | 2012-05-29 | 存续 |

## *Appendix B: Sichuan West Kowloon Investment Co., Ltd*

The Sichuan West Kowloon Investment Co. e-mail and addresses are shared with Mianyang Zhaofeng:


Sichuan West Kowloon Investment Co., Ltd is owned by Yu Yanyan (95%) and Yu Jiajia (5%), CMRU's Chairman/CEO's daughters:


(Source: QCC.com)

## *Appendix C: Jiangxi Rongtai Copper Co., Ltd. (江有限公司) Ownership Chart*


(Source: QCC corporate records )

## *Appendix D: CMRU E-mail Addresses Associated with Sichuan Guozhao Investment Management Co., Ltd.*


(Source: QCC corporate records )

## *Appendix E: Yu Lili Shared a Residential Address With CMRU's Chairman's Daughters, Yu Yanyan and Yu Jiajia*

| | | |
|---|---|---|
| 中文姓名 Name in Chinese | | 俞燕燕 |
| 英文姓名 Name in English | 姓氏 Surname | Yu |
| | 名字 Other Names | Yanyan |
| 前用姓名 Previous Names | 中文 Chinese | |
| | 英文 English | |
| 别名 Alias | 中文 Chinese | |
| | 英文 English | |
| 住址 Residential Address | | Flat C, 39 Floor, Harbour One, No. 458 Des Voeux Road West, |

| | | |
|---|---|---|
| 中文姓名 Name in Chinese | | 俞佳佳 |
| 英文姓名 Name in English | 姓氏 Surname | YU |
| | 名字 Other Names | Jiajia |
| 前用姓名 Previous Names | 中文 Chinese | |
| | 英文 English | |
| 别名 Alias | 中文 Chinese | |
| | 英文 English | |
| 住址 Residential Address | | Flat C, 39/F, Harbour One, No. 458 Des Voeus Road West, Hong Kong. |

| | | |
|---|---|---|
| 中文姓名 Name in Chinese | | 俞麗麗 |
| 英文姓名 Name in English | 姓氏 Surname | YU |
| | 名字 Other Names | Lili |
| 前用姓名 Previous Names | 中文 Chinese | |
| | 英文 English | |
| 别名 Alias | 中文 Chinese | |
| | 英文 English | |
| 住址 Residential Address | | Flat C, 39/F, Harbour One, No. 458 Des Voeus Road West |

*(Source: 1, 2, 3)*

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[1] HK$539 million IPO [Pg. 318] HK$252.7 million convertible bond HK$348 million secondary [ 1,2] HK$250 million convertible bond HK$194 million secondary [ 1,2] HK$600 million convertible bonds [ 1,2] HK$365 million secondary HK$19.5 million warrant exercise .

[2] See Appendix A for a list of all 11 organizations

[3] See Appendix B for screenshots

[4] See Appendix C for organization chart

[5] Yu Lili shares the same surname as the Chairman and shares a residential address with the chairman's daughters, Yu Jiajia and Yu Yanyan. See Appendix E.

[6] The subsidies are provided annually by the Youxian District Finance Bureau in Mianyang City, Sichuan Province and grants were described as "local government grants received by operating subsidiaries" of the company.

[7] It is unclear whether the equity holding has changed given that the latest fully audited annual report has yet to be released.

# TAB 14

# New Pacific Metals: Bolivia Looks Friendly Until A Coup Forces Your Friends to Flee to Mexico– 90% Downside

Published on April 20, 2020



**CLICK HERE T D WNL AD UR WER INT DECK N THIS RE RT**

- New Pacific is an exploration-stage silver mining company that is at least 10 years away from production. Its only active exploration projects are based in Bolivia.
- Since acquiring its Bolivian assets, its stock has surged almost 400%. We believe the sharp move higher has been largely fueled by grandiose claims in newsletters and paid promotion campaigns targeted toward retail investors.
- The company is led by CEO Rui Feng, who is concurrently Chairman/CEO of Silvercorp. Feng's history raises significant red flags. It includes historical allegations of inflating silver grades and using state influence to have a former short seller jailed in China for almost 2 years.

- Our review of New Pacific's Bolivian deals shows that the mining concessions on its flagship property had previously been stripped from their previous holder by the state and were never fully restored, leaving the property in a state of legal limbo.
- All of the company's deals in Bolivia seem to violate laws on the purchase/sale of concessions. Unlike in the U.S. and Canada, Bolivia does not permit the sale or transfer of mining concessions privately. Each deal requires state approval.
- New Pacific had a strong relationship with the Bolivian government at the time it purchased its mining concessions, which seemingly enabled it to bypass the law. However, in late 2019 the 'friendly' administration was ousted via coup, with the President and Minister of Mines fleeing to Mexico.
- The new administration has publicly accused the previous Minister of Mines of corruption, specifically relating to his dealings with New Pacific's Bolivian subsidiary. The new administration has launched a criminal investigation into the Minister.
- We spoke with multiple legal and political sources as part of our analysis. A former Senior Legal Advisor to the State Mining Authority (AJAM) told us: "My understanding is that (New Pacific's Bolivian entity) has been operating outside the law since these areas were revoked in 2015."
- We brought the issues up with Victor Borda, former speaker of the lower house and a prominent member of the majority legislative party. He said "If concession-holders do not respect the rules then those areas return to the state." He suggested he may launch a parliamentary inquiry.
- The former head of the Bolivian State Mining Corporation (COMIBOL) told us "Unless there's a (comprehensive) framework regulation, I personally don't think (the New Pacific deal) will get approved by Parliament."
- Our base case is that New Pacific has its concessions and agreements with the state revoked entirely or negotiated on far less favorable terms.
- Even if the company retains its concessions (which we don't think it will) New Pacific shares trade at vastly inflated levels, representing 85% downside on a purely fundamental basis.
- All told, we see 90% downside for shares of New Pacific and 25%-45% downside for shares of related Silvercorp, which owns almost a 29% stake in the company.

*Initial Disclosure: After extensive research, we have taken a short position in shares of New Pacific Metals and Silvercorp through their U.S.-listed equities (OTC:NUPMF and NYSE:SVM). This report represents our opinion, and we encourage every reader to do their own due diligence. Please see our full disclaimer at the bottom of the report.*

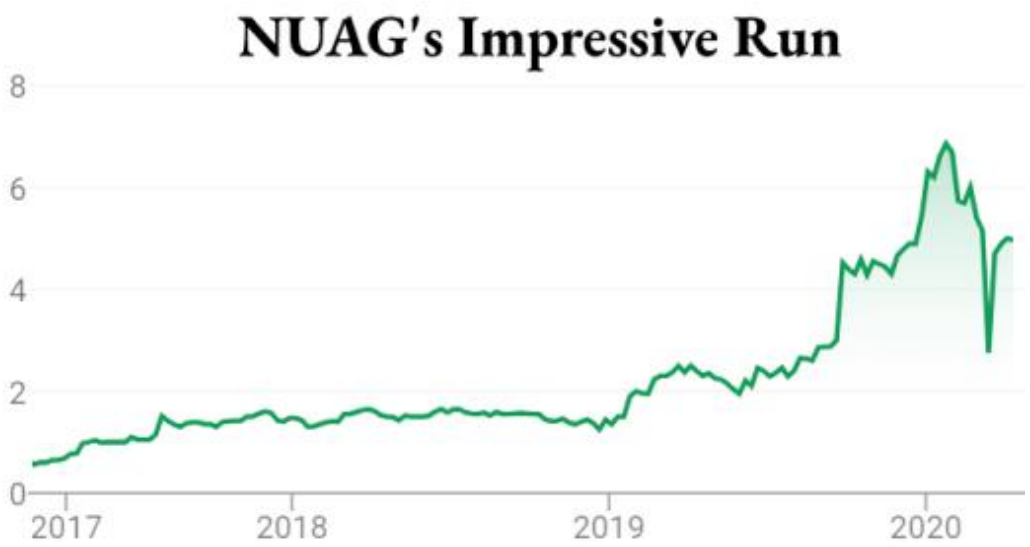
## *Basics on the Business and the Bull Thesis*

New Pacific Metals Corp. (TSXV:NUAG, OTC:NUPMF) is an exploration-stage silver mining company focused on what it calls its "flagship property" in Bolivia, known as the Silver Sand Project. The company is not actively exploring or developing any properties other than its

Bolivian properties. [ Pg. 7-8]

The company obtained the concessions to its Bolivian project in mid-2017 by acquiring a local Bolivian entity from a Chinese company [ Pg. 6] and later expanded to several nearby properties. The stock has since soared on the interim drilling results of its Bolivian properties and other periodic updates.

Since announcing the purchase of its Bolivian entity, the once-beleaguered stock has gained almost 400%.




The excitement has been encouraged by multiple paid promotion campaigns and newsletters that have relentlessly touted the company's prospects in Bolivia:

- **roactive Canada** is paid $25,000 per year to promote New Pacific, and has issued a bevy of articles on the company [ 1,2,3,4,5,6]
- **Stansberry Research**, a newsletter, declared the project to be "the biggest silver opportunity in 50 years" containing a "mountain of silver." (Stansberry was previously ordered to pay $1.5 million in a 2007 SEC stock fraud case.)
- **GoldNewsLetter** was paid $200,000 to promote New Pacific, calling it a "World Class Silver Project":

Beyond hope for its prospects in Bolivia, which is estimated to be 10 years away from production, investors seem to also be buoyed by several other factors:

- Management, which is led by CEO Rui Feng. Feng holds the CEO role at New Pacific while concurrently serving as Chairman/CEO of Silvercorp Metals (NYSE:SVM), an NYSE-listed production-stage silver mining company.
- Backing from both Silvercorp and Pan American Silver, the latter of which is also a NYSE-listed production-stage silver mining company with a major mine in Bolivia.
- Recent unprecedented inflationary moves by central banks, which have increased interest in hard assets (we at Hindenburg own both gold and silver).

All told, investors see a strong management team, backing from major producers and an inflationary tailwind all supporting New Pacific's quest to find the pot of silver at the end of the Bolivian rainbow.

## *Reality Check: New Pacific May Not Have Secure Control of*

# *Any of Its Bolivian Projects, A History of Stock Promotion (And 85% Fundamental Downside Even if It Did Control the Assets)*

We think New Pacific's largely retail investor base is entirely unaware of a multitude of red flags surrounding the company. In this report, we will show that:

- New Pacific faces a significant existential risk; it may have violated Bolivian law in its acquisition of mining concessions, including its flagship property, putting them at risk of being stripped by the Bolivian government.
- Furthermore, the entity that New Pacific acquired in Bolivia previously had its mining concessions stripped by the state. Those concessions appear to have never been fully restored, creating another legal hurdle for the company.
- The Bolivian administration that had previously worked with New Pacific on its questionable concession deals was recently ousted via coup, with the former administration's President and Minister of Mining fleeing to Mexico.
- Bolivia's new administration has accused the former administration of corruption specifically relating to New Pacific's mining deals.
- New Pacific's CEO has been previously been accused of inflating the silver grades of his mines and engaging in suspect related-party transactions.
- There is significant related-party overlap between Silvercorp and New Pacific, including a former Silvercorp employee leading an "independent" technical report of New Pacific's flagship Bolivian property, and multiple questionable related party deals.
- New Pacific appears to be engaged in prolific paid stock promotion, leading to a massive fundamental overvaluation even exclusive of the other issues outlined in this report.

The most obviously alarming conclusion we've drawn from our research is that **New acific may not have secure control of any of its properties in Bolivia.**

Further, our review of the company's deals shows that its purchases of mining concessions, including those for its flagship property , Silver Sand, may have been illegal under Bolivian law.

We also learned that Silver Sand didn't seem to have a clear title to its mining concessions in the first place *before* they were supposedly transferred to New Pacific; instead, they had already been revoked due to a prior illegal purchase and appear to have never been fully restored.

We spoke about these deals with multiple legal and political experts, including Bolivian legislator Victor Borda, former speaker of the lower House and a prominent member of the majority MAS Party. He told us he would consider launching a Parliamentary inquiry into the matter, and explained:

> *"If this company sold areas that had already been revoked and reverted to the state then that would be very serious, quite simply it would be an act of corruption. I don't understand how the Ministry of Mines has allowed this type of operation and the exploitation of mineral wealth if the areas had reverted to the state."*

The issue, it seems, may have been that New Pacific had a close relationship to the *prior* Bolivian administration, which allegedly engaged in acts of corruption and turned a blind eye to deals that violated Bolivian law.

That friendly support changed however, when that administration was ousted via coup late last year. The Mines Minster was also ousted and soon faced a barrage of allegations of corruption and fraud, including relating specifically to the deals with New Pacific. He then fled to Mexico .

We see little chance of the new administration looking favorably upon the alleged corrupt and illegal dealings made between the past administration and New Pacific. Consequently, we see a high chance that all of the company's mining claims are revoked or renegotiated on substantially worse terms.

Meanwhile, we have also identified red flags relating to New Pacific's CEO, Rui Feng. Feng has been accused in the past of inflating the silver grades of his mines and of questionable related-party transactions at Silvercorp, where he concurrently serves as Chairman/CEO.

The two companies have multiple parallels, including shared board members , shared office space, [Pg. 12] and shared contacts. Per the Canadian SEDAR profiles of each company, they also share a mailing address and a primary point of contact [ 1,2]:

| New Pacific Metals Corp. | SILVERCORP METALS INC. |
|---|---|
| **Mailing Address:** Suite 1750 - 1066 West Hastings Street<br>Vancouver, British Columbia<br>V6E 3X1 | **Mailing Address:** 1750 - 1066 West Hastings Street<br>Vancouver, B.C.<br>V6E 3X1 |
| **Contact Name:** Yong-Jae Kim | **Contact Name:** Yong-Jae Kim |
| **Business e-mail address:** ykim@newpacificmetals.com | **Business e-mail address:** ykim@silvercorp.ca |

Silvercorp owns about 29% of New Pacific, according to a recent management circular, [ Pg. 6]

comprising over 23% of Silvercorp's market capitalization.

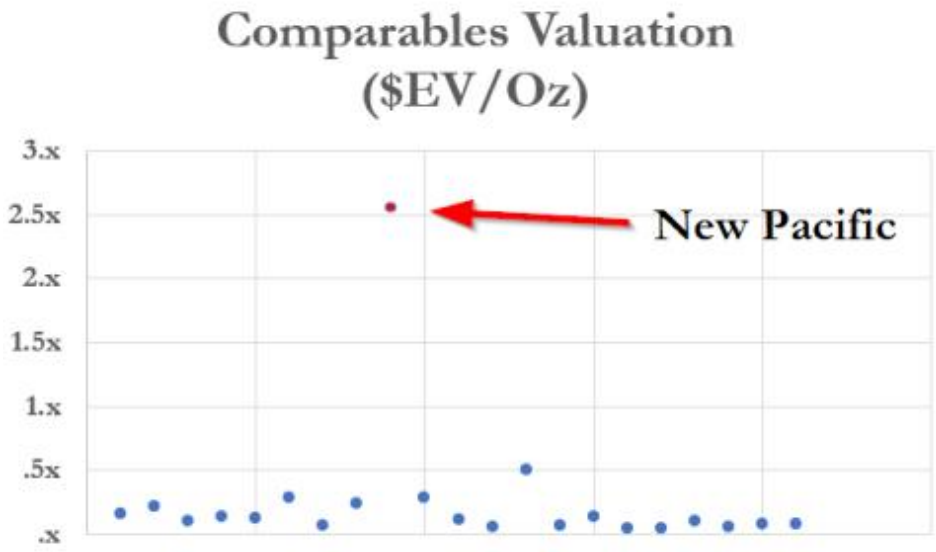
We also found troubling red flags when comparing the two companies. For example, the "independent" geologist who prepared almost all of New Pacific's technical report on its Bolivian property also worked for Silvercorp for 3.5 years as its VP of Exploration, according to his LinkedIn profile.

Additionally, prior to New Pacific's Bolivian endeavors, it had purchased 3 Chinese mining projects from Silvercorp. New Pacific issued years of positive press releases about these 'exciting' projects, but in the end, they all fizzled out. As we detail later, the projects were respectively suspended, sold at a loss, or surrendered back to the local government. [Pg. 2, Pg. 2, and Pg. 4]

The company's Bolivian projects are the latest 'exciting' projects that have sent the stock soaring (with the help of multiple paid promotion campaigns and newsletters). New Pacific appears to be at least 10 years away from commercialization, if any of its projects do make it to that point.

Finally, we have found that New Pacific's valuation when compared to peers – *assuming the business is operating legally without any issues at all*– is at least ~7x too high.

The company recently released its maiden resource estimate, which showed that Silver Sand contains a total of only 191 million ounces of silver, well below average analyst expectations of 223 million. We used this resource estimate to assess its valuation, and found it is trading at ~17x its mining peers:



Here are the projects we reviewed for comparison:

| Ticker | Company | Project | Mkt Cap (US$M | EV (US$M) | Resource (Moz AgEq) | EV/Resor. (US$/oz AgEq) |
|---|---|---|---|---|---|---|
| BCM CN Equity | Bear Creek Mining Crp | Corani | 145.0 | 119.9 | 735 | $0.16 |
| ITR CN Equity | Integra Resources Corp | DeLamar | 82.2 | 72.0 | 336 | $0.21 |
| AMM CT Equity | Almaden Minerals Limited | Ixtaca | 36.0 | 37.5 | 355 | $0.11 |
| SVL AU Equity | Silver Mines Limited | Bowdens | 48.0 | 43.5 | 305 | $0.14 |
| KTN CN Equity | Kootenay Silver Inc | La Cigarra / Promontori | 37.1 | 29.9 | 238 | $0.13 |
| SVE CN Equity | Silver One Resources | Candelaria | 40.5 | 37.7 | 132 | $0.29 |
| AUN CN Equity | Aurcana Corporation | Revenue-Virginius | 37.7 | 31.7 | 443 | $0.07 |
| AUMN US Equity | Golden Minerals Company | El Quevar | 27.5 | 23.5 | 96 | $0.24 |
| DV CN Equity | Dolly Varden Silver Corp | Dolly Vardan | 15.9 | 12.5 | 44 | $0.29 |
| SSV CN Equity | Southern Silver Exploration Corporatio | Cerro Las Minitas | 14.2 | 11.3 | 95 | $0.12 |
| AZS AU Equity | Azure Minerals Limited | Alacran | 7.1 | 6.1 | 105 | $0.06 |
| MMG CN Equity | Metallic Minerals Corp | Keno-Lightninig | 12.8 | 11.0 | 22 | $0.50 |
| IVROA AT Equity | Investigator Resources Limited | Peterlumbo | 6.4 | 3.6 | 48 | $0.08 |
| REX CN Equity | Orex Minerals Inc. | Sandra-Escobar | 7.9 | 7.5 | 55 | $0.14 |
| WRM AU Equity | White Rock Minerals Limited | Mt Carrington | 4.8 | 3.5 | 71 | $0.05 |
| NBR CN Equity | Nubian Resources Ltd. | Eqsuilache | 2.1 | 2.1 | 46 | $0.05 |
| SDR CN Equity | Stroud Resources Limited | Santo Domingo II | 4.4 | 4.3 | 39 | $0.11 |
| MMN CN Equity | Monarca Minerals Inc. | Tejamen | 1.1 | 1.9 | 30 | $0.06 |
| AHNR US Equity | Athena Silver Corporation | Langtry | 1.2 | 3.5 | 43 | $0.08 |
| ABRA CN Equity | AbraPlata Resource Corp. | Diablillos | 12.5 | 12.5 | 145 | $0.09 |
| **Average** | | | | | | **$0.15** |
| **NUAG CN Equity** | **New Pacific Metals** | **Silver Sand** | **519.4** | **486.9** | **191** | **$2.55** |
| | | | | | *Diff* | *17.2x* |

We also hired a mining expert to provide a full technical report on Silver Sand, which can be found in Part III of this report.

Given the company's outrageous valuation when compared to peers, we see fundamental downside of 85%. When factoring in the uncertainty around its Bolivian concessions and management red flags, we see 90% downside.

# *Part I: New Pacific Doesn't Appear to Actually Control Its Bolivian Concessions and We Think It's Unlikely That It Ever Will*

The biggest issue we see with the company is that **New acific may not have control over its Bolivian silver projects.**

The key problem is that in order to control mining areas (concessions) in Bolivia, companies must negotiate them legally in conjunction with the state mining corporation (COMIBOL) and the national mining authority (AJAM). For new mining areas, companies must also receive approval from the legislature.

New Pacific does not appear to have acquired its concessions legally, as we will show. Furthermore, on its flagship Silver Sand property, **the concessions had already been revoked from its prior holder and do not appear to have been fully restored**, meaning that New Pacific appears to be sitting on concessions that are, at best, in a state of legal limbo.

Additionally, while New Pacific received approval from COMIBOL for a large, new mining deal in early 2019 it never received legislative approval. Before it could, a coup ejected the Bolivian government it had been working with and pulled the rug out from the company (and likely its legislative approval).

## *New Pacific's Deal for Its Largest Bolivian Assets Was Never Ratified by the Legislature. Rights to Its "Flagship" Property, Silver Sand, Also Looked Tenuous to Begin With*

## *None of that Seemed to Matter at the Time. New Pacific Had a Very Friendly Relationship with the Government, Including the Minister of Mines, Cesar Navarro*

New Pacific acquired Bolivian mining entity Alcira in 2017 for $45 million. That deal was focused on a small 3.17 $km^2$ core area that New Pacific refers to as the Silver Sand Project, which we detail further below.

In January 2019, New Pacific announced it had reached a large deal with state mining company COMIBOL, and signed a contract for a much larger swath of surrounding land – an additional mining area of ~57 $km^2$.

The deal was reportedly the first foreign company to sign a new contract with COMIBOL since President Evo Morales took office in 2006.

The Minister of Mines, Cesar Navarro, appears to have been instrumental in the process. In 2019 he held two separate signing ceremonies for the contract between New Pacific and COMIBOL. At the signing ceremony of a January 2019 agreement for mining rights to the 57 sq. km area of land, New Pacific President Gordon Neal stated that he:

> *"commend[s] the Minister of Mines and Metallurgy and the President of COMIBOL for committed focus to complete this transaction. It is a benchmark achievement that shows that Bolivia is open to foreign investment."*

Here is a picture from one signing ceremony showing Navarro, along with New Pacific President Gordon Neal and New Pacific's Bolivian country manager Hernan Uribe:

And another from an April 2019 meeting that included the three:

Things were progressing relatively smoothly and it seemed as though the company was on track to win legislative approval to secure and begin exploiting its new, expanded mining areas.

## *The Administration it Was Working with on These Deals Was Later Ousted Via Coup*

But the deal wasn't sent to Bolivian parliament to be ratified until September 2019. And before it had a chance to be approved, the October 20, 2019 national elections catalyzed a political upheaval in the country.

In November 2019, the Bolivian administration that New Pacific had closely worked with, led by President Evo Morales, was ejected in what was described as a coup.


npr

LATIN AMERICA

Evo Morales Condemns 'Coup' After Lawmaker Assumes Bolivia's Interim Presidency

November 13, 2019 · 3:51 PM ET

COLIN DWYER

In Potosi, where New Pacific's mining operations are based, the electoral court building in the region was burned to the ground, giving a sense of how the region has become a literal political tinder box:


elPotosí

They burned the building of the electoral court of Potosí

The protesters managed to pass because the policemen withdrew.

10/21/2019 10:59 PM | The Potosí



## *The New Administration Has Accused the Old Administration of Acts of Corruption Relating Specifically to New Pacific's Bolivian Subsidiary, Alcira.*

## *Former President Evo Morales and Minister of Mines Cesar Navarro Have Since Fled to Mexico.*

Immediately following the coup, Evo Morales **fled to Mexico**. His Minister of Mines, Cesar Navarro – who over the last decade had become part of the President's trusted inner circle – took refuge in the Mexican Embassy residence in Bolivia and finally managed to escape to Mexico himself in February this year.

Just days before he fled, **the new Minister of Mines Carlos Huallpa publicly accused Navarro of corruption relating to the Alcira deal the subsidiary of New acific**. Navarro was also being threatened with criminal charges of trafficking political influence, relating to allegations he helped rig the results of the October 2019 elections. Per a Google translated version of media reports at the time:

elciudadano.com

**They will travel to Mexico: They deliver safe conducts to former ministers of Evo Morales**

The Minister of Mining and Metallurgy, Carlos Fernando Huallpa, thus designated by the self-proclaimed president of the highland country, Jeanine Áñez, accused César Navarro on January 21 of being a strategic partner of the Alcira Mining Company, and of endorsing the awarding of contracts, prioritizing to certain companies

THE CITIZEN 01/31/2020

And the Google translated version of a January local media article :

Los Tiempos

**Minister of Mining reveals that Cesar Navarro was a strategic partner of the Alcira Mining Company**

**Economy**

The current Minister of Mining and Metallurgy, Carlos Fernando Huallpa, and the former Minister of that State portfolio, Cesar Navarro | Web

ANF

Posted on 01/21/2020 at 10:35

Both former Minister Navarro and Minera Alcira SA denied the improper association with Minera Alcira saying :

> *"Cesar Navarro, former Minister of Mining, does not have or has never, directly or indirectly, had a strategic partnership with Alcira or any company in which New Pacific Metals Corp participates".*

## *We Spoke with Multiple Local Sources to Get A Better Sense of the Political Risk to New Pacific Investors and Details on the Corruption Allegations. As a Result, We Believe Silver Sands' Mining Production Contract May Never Be Ratified.*

We hired local consultants, including international investigation firm Kreller Group, to perform checks with local sources and officials to further understand the corruption investigation and potential political risk to New Pacific.

We wanted to learn whether the company's much-publicized 57 km $^2$ mining production contract will ever be ratified and what the implications are for tenure at the core 3.17 km $^2$ Silver Sand Project.

What we found is that the political risk is high. In fact, our base case is that New Pacific's deal for the expanded mining area will never be ratified. We also expect the Silver Sand property will be contested and, if any deal is ever approved, we expect the economics to be materially worse.

Multiple sources we spoke with also indicated that there was potential for graft in the kind of deal Navarro's ministry was putting together with Alcira, thus lending credence to the allegations.

## *Former COMIBOL Chairman Hector Cordova: "Unless There's A (Comprehensive) Framework Regulation, I Personally Don't Think (The New Pacific Deal) Will Get Approved by Parliament"*

We spoke with former COMIBOL chairman (2011-2012) and former Vice Minister of Mines (2010-2011) Hector Cordova. Cordova predicted the New Pacific contract may prove difficult to pass even if or when parliament debates it. Here are some quotes from our interview with Cordova:

> *"The (New Pacific-COMIBOL) contract had been under review by other parts of government that saw the percentage (of state-take) as very low. Others wanted a framework regulation in place before they gave their approval because they wanted to understand the basis for the calculation for approving this percentage (of profit split)."*

> ***The contract is currently suspended. It's been signed by C MIB L and the company but without parliamentary approval it does not enter into effect. Until there's a framework regulation, I personally don't think this will get approved by parliament."***
>
> *"I think there's a lack of political will and technical capacity to produce something this subtle (the framework regulation). Right now all the heads of mining are from the cooperative sector and they're the least technically prepared for this."*
>
> *"That's a great limitation and it will be an obstacle to drawing up a coherent proposal. I think it would be more practical to wait for a new government and new legislation. But of course we're subject to coronavirus now.* ***Everything has been left hanging in the air****".*

## *Bolivian Journalist Who Reports on the Local Mining Industry: "My Personal Opinion is that Cesar Navarro is Totally Corrupt"*

A local reporter focused on the mining industry in Bolivia flagged specific irregularities with the New Pacific deal that he believed indicated corruption.

In particular, mining companies under (Article 148) the 2014 mining law are required to pay 55% of the income (profit) from a mine to the state if it has a joint venture agreement. New Pacific somehow managed to negotiate what was termed a mining production contract with a payment of only 4% of gross production value going to COMIBOL. [ Pg. 2]

While that low percentage comes off the top line sales (rather than bottom line net income), the reporter indicated that the deal results in a significantly lower proportion of overall proceeds to the state:

> *"My personal opinion is that Cesar Navarro is totally corrupt and even more politically protected by President Evo Morales himself (another great corrupt too)."*
>
> *"…Particularly in the case of Minera Alcira and Cesar Navarro, the secrecy with which they handled the issue and the speed of procedures in all administrative instances, to grant prospecting areas, is very suspicious. This fact clearly shows Navarro's interest in Minera Alcira."*

This analysis was also corroborated by local media articles at the time.

## *Political Advisor to the New Bolivian Government: According to the Current Minister of Mines, There Was a Government-Based Group that Had an Economic Interest in Obtaining Money from Alcira*

Our investigators also spoke to a political advisor to the new administration to get a sense of what areas might be under investigation, and whether any preliminary findings indicated that corrupt acts took place.

We also asked what type of interests Cesar Navarro would have had in Minera Alcira. Our source reported that according to the current mining minister, there was a group called "INTI" in the Ministry of Mining which had an economic interest in obtaining money from Minera Alcira, helped facilitate the New Pacific's concessions and charged for doing so. This statement was also corroborated by local media articles at the time.

They pointed out that Navarro's appointment to the position of Minister of Mining was political, as he "does not have the technical or moral training for such a sensitive position."

Prior to his appointment as Minister of Mining in 2014, Navarro did not have experience in the sector. He and his brother were experienced regional political operatives in their hometown of Potosi and between 2010 and his appointment to the mining portfolio, he was in charge of mass, grassroots political organizing under direct control of the President's office.

## *Former Minister of Mines: "Navarro Was One of the Most Corrupt Ministers There Has Been." [He Was] "Always Open For Business".*

As a socialist government and part of the Latin American leftist alliance with Venezuela, Cuba, Ecuador and Nicaragua, Evo Morales' administration gave the impression that it was hostile to doing business with foreign multinationals. Yet New Pacific was the first foreign company to sign a new contract with state-run COMIBOL since Morales took office in 2006.

A former Minister of Mines told us Cesar Navarro, despite his leftist credentials, was "always open for business". He further said:

> *"I think this contract was more an initiative of Minister Navarro than of the MAS Party. Cesar Navarro has been one of the most corrupt ministers that there has been. The most probable thing is that he has asked for money from New Pacific. But that he's actually a shareholder? I don't think so…*
>
> *"…The policy of the MAS Party was seen as anti-business but I have many business acquaintances who have had a good relationship with Cesar Navarro. There was always a fluid dialog."*

## *In Addition to The Corruption Scandal, We Found That New Pacific's Purchase of Mining Concessions May Have Been in Open Violation of Bolivian Laws*

Thus far, we have reviewed allegations of corruption relating to New Pacific's Bolivian mining dealings. Beyond this, however, our work has found that New Pacific's concession deals were in apparent violation of Bolivian law, which strengthens the case that New Pacific's mining rights may never get final approval.

## *Background on Bolivian Mining Law: Unlike in The U.S. And Canada, Bolivia Does Not Permit the Sale or Transfer of Mining Concessions Privately. Each Deal Requires State Approval*

Unlike most other mining economies, Bolivia does not permit the sale or transfer of mining areas (formerly known as concessions). This differs from normal practices in Canada and the U.S., where junior mining companies can own and develop land and sell it to a major producer.

Contrary to that approach, mining wealth, including surface and subsurface rights, are deemed to be the property of the Bolivian people, a notion prevalent since the 1952 nationalization of private mines but reinforced after the socialist Evo Morales came to power in 2006.

The Constitutional Court ruling 0032 of May 10, 2006, the 2009 Constitution and the 2014 Mining Law 535 state clearly that mining areas (formerly known as concessions) cannot be "transferred, mortgaged or inherited".

From the 2009 Constitution [ translated to English ]:

## Article 371

I. The areas of mining exploitation granted by contract are not transferable, not attachable, and cannot pass by hereditary succession.

The 2014 Mining Law Art. 5 (c) sets out the "basic principles of the mining law" and reiterates: *"non-transferability of mining areas".*

A key reason behind these rules was to prevent private individuals or companies from acquiring mining areas/concessions from the state mining company COMIBOL, sitting on them as a nest-egg and then selling them on at a large profit to actual mining companies.

The laws were effectively aimed at removing those people who were acting as private middlemen for state-owned resources.

## *New Pacific's Purchase of Silver Sand Looks As Though It Violated Bolivian Law on the Sale of Concessions*

Given the above, a key legal question emerges in relation to New Pacific's $45 million purchase of Alcira, the Bolivian entity that controlled the company's flagship Silver Sand property: did New Pacific pay in order to acquire its concessions (which would likely be illegal) or was the price tag purely to acquire the assets of Alcira?

The answer seems quite clear. The information circular detailing New Pacific's acquisition of Alcira showed that the entity had total assets of only $84,131 just prior to the acquisition: [Pg. 62]

**Selected Financial Information**

The following table sets forth selected audited annual financial information of Alcira for the fiscal years ended September 30, 2016 and 2015 and selected unaudited financial information of Alcira for the six months ended March 31, 2017 and 2016.

| | Year ended September 30, 2016 | Year ended September 30, 2015 | Six-month period ended March 31, 2017 | Six-month period ended March 31, 2016 |
|---|---|---|---|---|
| Income (loss) before other income and expenses | ($219,546) | ($333,024) | ($66,976) | ($133,710) |
| Other income (expenses) | ($9,482) | ($15,396) | ($3,176) | ($5,591) |
| Net income (loss) | ($229,028) | ($348,420) | ($70,152) | ($139,301) |
| Total Assets | $88,159 | $105,035 | $84,131 | $95,135 |

Similarly, since Alcira's creation in 2008, it had never generated any income and had conducted only very limited exploration. The prior holders drilled only 8 core holes totaling 2,334 meters. [Pg. 19] Thus, there were no major ongoing operations being acquired either.

New Pacific's press release that described the rationale for the deal corroborates that the deal included concessions. It described Alcira as having seven Temporary Special Authorizations (essentially concessions), which seems to make the intent clear.

**urthermore, this is made all the more obvious to us given that New acific paid 8 x more for Alcira than its prior holders China-based Ningde Jungie, which paid 30,000 .**

We emailed New Pacific and asked for clarification on how its purchase of Alcira differed from other deals that saw concessions stripped and have not received an answer as of this writing.

All told, it looks like the company's first step toward development in the region may have been in violation of Bolivian law. At the time, this may have been something the administration ignored, but with the changing political landscape this represents a clear risk to investors.

## *The Prior Holder of the Alcira Silver Sand Concessions Had Allegedly Purchased Them in Violation of the Constitution. As A Result, Those Areas Were Stripped by the State.*

## *They Do Not Appear to Have Been Fully Restored, Placing*

*the Company's Flagship Property in a State of Legal Limbo.*

Controversy surrounding New Pacific's Bolivian entity (Minera Alcira SA) is nothing new. Our research revealed that the entity has been contested for years amidst allegations of the illegal transfer of mining concessions.

Minera Alcira was formed in mid-2008, according to Bolivian corporate records.[1] It was originally jointly controlled by a company called Minera Tirex, run by former Minister of Mines Jaime Eduardo Villalobos, and the ex-wife and an employee of another former Minister of Minues Oscar Bonifaz. [ Pg. 27]

Villalobos is still facing criminal corruption charges from his time in office. Bonifaz was a former COMIBOL chairman and business associate of a former Bolivian president, Gonzalo Sanchez de Lozada, who fled into exile in the face of criminal charges, including corruption, during a wave of privatizations.

In 2010, a Chinese entity called Ningde Jungie Mineria Co., Ltd bought Alcira from Tirex, paying $530,000, according to the deed of sale and local media reports.[2]

Recall from above that it is illegal in Bolivia to outright sell mining concessions (as concessions require approval from the state). Page two of the deed of sale seemed to openly violate these rules, stating:

> *"Mining concessions. There are 17 mining concessions registered and included in the assets of Alcira Minera SA."*

Shortly thereafter it states:

> *"17 concessions are included in the company's assets and these have been duly entered into the Mining Register and Rights of Potosi under the name Alcira SA".*

It then lists the 17 concessions by name in a tabulated format.

In a 2011 obligatory baseline environmental impact study, drawn up by Bolivian Environment

Ministry engineers, those concessions still appeared in the name of individual concession-holders, including Oscar Bonifaz's son, Roberto Bonifaz. [ pgs. 13-14]

In May 2015, the newly-created Bolivian mining authority (Autoridad Jurisdiccional Administrativa Minera, or "AJAM") took notice, and revoked the concessions . It also threatened criminal legal proceedings against Alcira's original directors and shareholders.

During a press conference in August 2015, the executive director of AJAM declared that the original sale of the mining areas had been constitutionally invalid, because the assets are state-owned:

> *"We revoked mining areas that they had transferred, something that they did not have the right to do because they are not owners"*

From state mining company COMIBOL's website :

**A CHINESE COMPANY LOSES A MINING AREA**

*March 3 / ANF / Carlos Alberto Soruco.*

The Mining Administrative Jurisdictional Authority (AJAM) returned to the property and domain of the Bolivian State the mining rights granted to Empresa Minera Alcira SA because it was delivered in its entirety to a Chinese company called Jungie Mining in 2010. This was reported by La Razón newspaper after the ABI Agency published a requested one in several media.

The reversal was carried out under the protection of the CPE and Law 535 of Mining and Metallurgy. Rules that establish that property over natural resources is not managed freely, added Carlos Alberto Soruco, executive director of AJAM

On June 2, 2015, Alcira appealed the revocation decision to AJAM, arguing it was simply transferring ownership of shares in the company and not the concessions themselves. But as shown above, the original deed of sale from 2010 blatantly contradicted this, showing that the concessions were listed as "company assets".

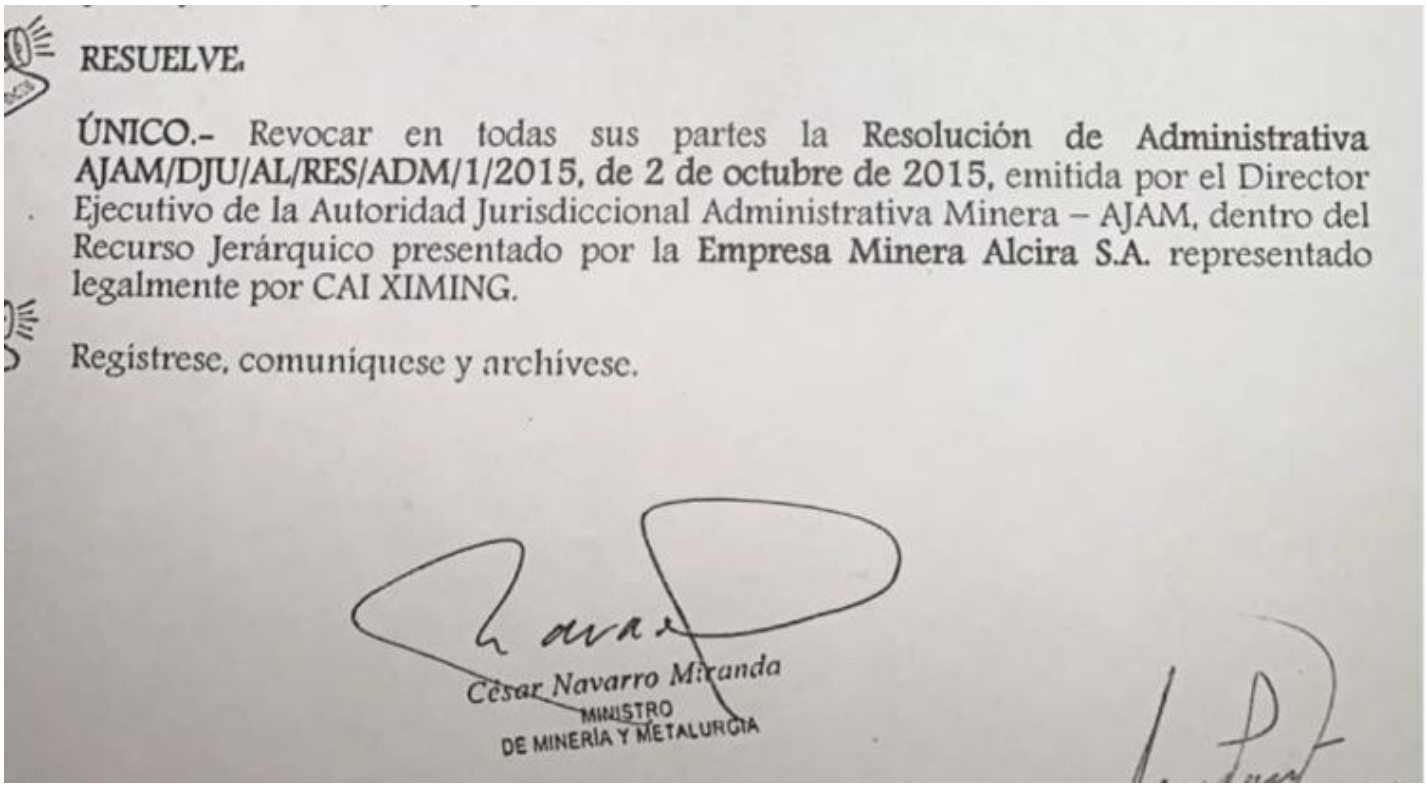
AJAM upheld its order, saying the deal was unlawful and expressly forbidden by the constitutional court ruling 0032 of 2006 and enshrined in the 2009 constitution.

## *Cesar Navarro Conveniently Moved to Reinstate the*

## *Concessions Prior to the Sale to New Pacific*

However, Alcira SA lodged a second appeal with the Mines Ministry on October 2, 2015. **This time, Cesar Navarro directly intervened and ruled in Alcira's favor.**

We received a copy of the decision from a former Senior Legal Representative at AJAM, where we can see that Navarro signed the decision himself :



RESUELVE.

ÚNICO.- Revocar en todas sus partes la Resolución de Administrativa AJAM/DJU/AL/RES/ADM/1/2015, de 2 de octubre de 2015, emitida por el Director Ejecutivo de la Autoridad Jurisdiccional Administrativa Minera – AJAM, dentro del Recurso Jerárquico presentado por la Empresa Minera Alcira S.A. representado legalmente por CAI XIMING.

Regístrese, comuníquese y archívese.

César Navarro Miranda
MINISTRO
DE MINERÍA Y METALURGIA

## *Navarro Initially Supported the Revocation of Alcira's Concessions But Then Later Overturned an Appeal That Had Revoked Them.*

## *Former Senior Legal Representative at State Run AJAM: "You Never Know How Those in Power Make Their Decisions"*

Our former senior legal AJAM source said the original Alcira revocation decision had been thoroughly consulted with AJAM directors, the Minister of Mines and even as far up as the presidency. He said he did not understand why that decision was later reversed although there was heavy legal, political and diplomatic pressure exerted by Alcira's lawyers, administration allies and the Chinese Embassy:

> *"It wasn't like we took our original decision on impulse. We explained the situation to the (Mines) Ministry and to the Presidency and everybody at the time was in agreement. This company had no assets. They transferred a couple of old trucks but had nothing else and they were charging $600,000 USD (approx..). And so, it was clear in fact that they were transferring the concessions."*
>
> *"…**We told Cesar Navarro of our decision to revoke Alcira's claims at the time and he agreed. Then later he went and changed his mind. ou never know how those in power make their decision's.***

## *Navarro Overturned the Appeal, But Not the Original Revocation Order. The Property Still Looks to Operate in a State of Legal Limbo.*

## *Former Senior Legal Advisor to AJAM: "My Understanding is that Alcira Has Been Operating Outside the Law Since These Areas Were Revoked in 2015"*

Following Navarro's ruling on the Alcira concessions (despite the apparent constitutional and legal issues), the entity was soon sold from its Chinese owners to New Pacific.

New Pacific announced the agreement to acquire Alcira on April 10, 2017, from Ningde Jungie Mineria Co., Ltd. and two Chinese individuals. The purchase price was U.S. $45 million in cash to be paid by New Pacific. [ Pg. 6]

As described above, the Mines Ministry ruling issued on Jan. 15, 2016 and signed by the Minister of Mines Cesar Navarro overturned AJAM's appeal ruling regarding the revocation of the Silver Sand concessions.

However, that Mines Ministry ruling does not appear to have overturned the substantive decision in May, 2015, to actually revoke the Alcira's 17 concessions. **In other words, the appeal upholding the revocation was tossed, but the original revocation of the Alcira mining concessions was never actually reversed**

That view is shared by our former senior AJAM legal source:

> *"…when the Mines minister considered the appeal, they ruled against the AJAM's first appeal verdict but they left the original revocation of (mining) areas in place."*
>
> *"Maybe (prior owner) Jungie thought the ministry had ruled in their favor and so they carried on and look where we are now…Maybe the Mines Ministry did not fully understand the norms. I understand the situation remained like that and* ***since then they have been operating outside the law."***

That same legal source helped identify a key red flag indicating that New Pacific is aware of this, and failed to fully disclose this issue to investors. A press release stated that in October 2017 the company was granted exploration permits for Silver Sand:

**SILVER SAND PROPERTY**

The Company started the preparation work for the planned exploration program after the acquisition of the Silver Sand Property. In October 2017, the Company successfully received exploration permits required by the relevant Bolivian government authorities and immediately commenced a 30,000 meter exploration drilling program on the property. For the three and

**But an exploration permit would be unnecessary if it already had secure title to the property**. (For further analysis of this issue see Appendix A). The former AJAM legal expert we interviewed said:

> *"They could not have given out an exploration permit if Alcira already had (legal) title to those (Silver Sand) areas. Because according to the mining registry that AJAM operates, you cannot give an exploration license for an occupied area. But* ***that is an indication that the concessions were and remained revoked .my understanding is that Alcira has been operating outside the law since these areas were revoked in 201 ."***

We emailed New Pacific and asked why it would need an exploration permit if its tenure was already secure on those areas, and have not yet received a reply.

In short, when New Pacific purchased Alcira, thinking it was buying the entity's mining concessions (which itself would be illegal), **it may have actually paid million to**

**essentially buy nothing**. At best it looks to have purchased an entity with a contested interest in mining concessions.

## *New Pacific's Other Purchases of Bolivian Concessions Appear to Be in Open Violation of Bolivian Law*

Beyond the original purchase of Alcira, which held the Silver Sand project, New Pacific also made subsequent purchases of three nearby concessions. Once again, these acquisitions in July 2018 and December 2019 appear to be in open violation of Bolivian law.

For example :

> The Company also entered into agreements with private owners to acquire their 100% interest in certain mineral concessions located adjacent to the Silver Sand Property as part of the Company's expansion plan in the area. For the three months ended September 30, 2018, the Company acquired total mineral concessions valued at $2,631,200 (US$2,000,000) by cash payments of $1,315,600 (US$1,000,000) and issuance of 832,000 of its common shares.

And another example :

> **VANCOUVER, British Columbia – December 19, 2019** – New Pacific Metals Corp. ("New Pacific" or the "Company") is pleased to announce it has expanded its Silver Sand land package by acquiring a 100% interest in a Special Temporary Authorization ("ATE") located immediately to the north of the project by making a one-time cash payment of US$200,000 to arm's length private owners. This newly acquired ATE currently consists of six hectares but will total approximately 0.50 square kilometres once it has been consolidated to concessions called "Cuadriculas" and converted to Mining Administrative Contract with Bolivia's *Autoridad Jurisdiccional Administrativa Minera* ("AJAM").

The brazenness with which these purchases seem to violate Bolivian law on purchasing concessions indicates to us that perhaps New Pacific felt it had powerful allies within government that permitted them to disregard the law and the constitution and push the deals through regardless.

# *Local Cooperative Miner: There Must Be Money Changing Hands Because Navarro Was Minister of Mines… And COMIBOL Was Telling Us Everything (All the Mining Areas) Was for Alcira*

We also talked by phone to a senior source at a local mining cooperative who lives and works, mining and herding llamas, immediately next to Silver Sand. He described to us the key players in the purchase of three concession sales ( 1,2) and the signs of corruption he witnessed:

> *"When Wascar Veltran (holder of several concessions) saw that Alcira (New Pacific) was in the area and doing checks, then he went to (Hernan) Uribe (New Pacific country manager). Then Uribe, Wascar Veltran and Villalobos have done this deal."*

Villalobos – Jaime Eduardo Villalobos Sanjines – is a former mines minister who is currently facing criminal charges for corruption during his past time in office. He had a 50 percent stake in Tirex S.R.L., which sold the original Silver Sand concessions to Chinese mining company Jungie in 2010 [Pg. 27]. Although he remained as Jungie's general manager until at least mid-2015 [1,2] it is not clear whether he helped negotiate any part of the deals with New Pacific.

Our mining cooperative source tells us the first two concessions (locally referred to as Jisas and Jardan) were "virgin" sites with no mine development. He tells us the third, known locally as Bronce, had a small artisanal mine. He said:

> *"Those areas are changing hands for millions. I don't know too much about it because I can't stick my nose in too much. But you know that* ***by law concessions can't be sold anymore. But up until last year they were still being sold*** *and tomorrow they'll be being sold as well."*

Our senior cooperative source, who by his own description is an "uneducated man but not stupid", believes corruption is the only explanation why concessions are being traded and why land, where he has dug for tin and silver for decades , and where he has grazed his llamas, is now selling for huge amounts. He said:

> *"…What can a poor man like me do against big business. I can't even make a*

> *complaint. The best I can hope for is to get some work there."*
>
> *"…I have no idea how they could have increased the value to those huge numbers of millions in just 7 years. I don't know who will be paying that amount because the poor community members can't afford that. "*
>
> *"…**There must be money changing hands because Navarro was Minister of Mines and he gave the orders to C MIB L. And C MIB L was telling us everything all the mining areas was for Alcira"***
>
> *"…All the COMIBOL mining areas around here in 2018 and 2019 were being given to Alcira (New Pacific). Alcira has had some kind of a political negotiation."*

## *We Asked a Prominent Bolivian Legislator About New Pacific's Purchases: "This Sounds Very Serious… If Concession-Holders Do Not Respect the Rules Then Those Areas Return to the State"*

We spoke with Victor Borda, former speaker of the lower House and a prominent member of the majority MAS Party, in order to understand a legislator's take on the sale to New Pacific and the deals taking place in the area. President Evo Morales and Minister Navarro belonged to the same party as Borda.

Upon learning more details of the Alcira SA sale to Jungie in 2010 and to New Pacific in 2017, congressman **Borda suggested he may launch a parliamentary investigation into the validity of the proposed contract** Here are some quotes from our interview with him:

> *"Even before the 2009 constitution it was clear that mineral wealth is the property of the Bolivian people and (concessions) cannot be the subject of private transfers, mortgages and even worse to sell those concessions. "*
>
> *"Concession-holders have use of those concessions but cannot dispose of them at will because those areas belong to the state. **If concession-holders do not respect the rules then those areas return to the state"***
>
> ***"If this company Alcira Jungie sold areas that had already been revoked and reverted to the state then that would be very serious, quite simply be an act of corruption. I don't understand how the Ministry of Mines has allowed this***

> ***type of operation and the exploitation of mineral wealth if the areas had reverted to the state."***
>
> *"**This sounds very serious. As a member of parliament I will try to investigate this subject.** Sometimes public officials get members of parliament into problems because they pass us contracts in a big package (with other contracts) and sometimes these (bad) contracts and irregularities get camouflaged."*
>
> ***"If there's corrupt people or people who have made the government look bad then they must be sanctioned."***

## *What are the Odds That the New Bolivian Administration Blesses the Alleged Corrupt and Illegal Dealings of the Old Administration They Ousted Via Coup? We Think Low, But Greater Than Zero*

We think the odds are high that the Bolivian government and parliament could revoke the company's Silver Sand concessions, and scrap the production contract for the expanded 57km mining area with Alcira, leaving New Pacific with essentially nothing. [2]

We emailed New Pacific and asked for more clarification on several issues, including:

1. Is approval by the legislature required for Silver Sand, or just the expanded mining area?
2. Why would an exploration permit be needed if tenure was already secure on those (Silver Sand) areas?
3. How has Alcira's historical purchase of concessions, which were subsequently stripped by the state, differed from New Pacific's purchases of concessions?

We have not received replies to these questions as of this writing. Should New Pacific provide us answers we will update this piece accordingly.

It's worth noting that the company has disclosed approval delays as a risk, though most investors seem to have just ignored it as a boilerplate risk factor. Per the latest MD&A

> *"The (company's mining production contract) was approved by Bolivia's Ministry of Mining and Metallurgy on January 7, 2019, but remains subject to ratification and approval by the Plurinational Legislative Assembly of Bolivia.* ***As of today, the M C***

> ***has not been ratified nor approved by sic lurinational Legislative Assembly of Bolivia."*** *[Pg. 3]*

We think investors need to weigh three possible scenarios:

1. Total revocation of contracts and mining areas. We believe there is a 60% chance of this happening.
2. A renegotiated deal with COMIBOL/the legislature, which would likely be on far less favorable terms. We believe there is a 30% chance of this happening.
3. The deal somehow passes through Bolivia's congress as-is. We believe there is a 10% chance of this happening.

Between the new administration's allegations of corruption around the deal, the signs we found of illegality around the terms of the concession purchases and the current political environment, we think the company has an uphill battle in getting contracts approved and legally retaining its mining areas.

That all being said, we don't think anyone can credibly claim to know with *certainty* which direction the political winds will blow in a country with as much recent upheaval as Bolivia.

Aside from political volatility, the country was ranked 123rd out of 180 countries in Transparency International's survey of public sector corruption, which also always has the potential to swing the balance.

Clearly, at least with historical administrations, laws in Bolivia seem to have been bent or ignored outright when enough money was involved.

## *A Bolivian Lawmaker Asked Us (On A Recorded Call) Whether We Had an Interest in Seeing the New Pacific Deal Approved.*

## *Us: "Would It Come at a Price?"*

## *Lawmaker: "Yes Exactly"*

It's not entirely clear yet how the interim, center-right Bolivian administration will handle potential corruption. Political power remains divided and the MAS Party retains majority control of Bolivia's lower house and Senate, despite its leader Evo Morales being ousted from

the presidency.

As part of our research, we spoke with one lawmaker influential in mining issues. (Note: We have this call recorded)

When we asked about New Pacific he said initially he could not specifically recollect the proposed deal but offered to check. He later came back with what sounded like an unsolicited offer to help pass or block the contract between New Pacific and COMIBOL when it came up for consideration by parliament:

> *"I'm going to look for an alternative to see if I can bring that (Alcira/New Pacific) contract up for consideration and get it passed because I have been able to bring up several contracts like that and get them passed."*
>
> *"And now a little question. Would you be interested in this going ahead, so that I can take an interest in it? Or on the contrary would you prefer it to stop? I just wanted to talk to you a little about that because if you're interested then I can do something … to push forward this mining contract otherwise I can just ask about the situation, yes or no."*

When asked if his intervention would come at a price, he said:

> *"Yes exactly that's true and that's exactly what I wanted to say. And so we'd have to work with the technical experts (of the senate) and something could be done."*

We prefer to let the lawmaker's comments speak for themselves. But we came away with the impression that public sector graft may still hold sway over parts of the political decision-making process.

## *Our Conversation with the New Minister of Mines Carlos Huallpa: More Conciliatory than When He Leveled Corruption Allegations In January*

We also talked by phone with the new Minister of Mines Carlos Huallpa about New Pacific's purchase of Alcira and his predecessor's offer of a major mining contract on generous terms.

The right-wing interim government, running Bolivia until new general elections can be held, has an interest in showing the country remains open to foreign investment. That may be one reason why Huallpa appeared to strike a more conciliatory tone compared to his remarks in January when he accused Navarro and Alcira of being in a corrupt alliance.

**He said New acific's legal team had already been in touch about rescuing the contract deal but was insistent that if a new deal was reached, the Bolivian state's percentage share of production or the profits would be significantly higher.**

Even if new terms are hammered out with the Mines Ministry, however, a deal would still need approval by the legislature.

For now, the legislature is not meeting in person—coronavirus quarantine restrictions in Bolivia have been extended until at least April 30th. Even when it does meet, its first priority will be rescheduling general elections for the presidency and congress, which had originally been planned for May 7th.

# *Part II: Management Red Flags, Multiple Related-Party Deals with Silvercorp And Other Warning Signs*

When assessing a speculative early-stage mining investment, the credibility of management is critical. Our review of New Pacific's management team uncovered significant red flags.

Before we dive in, here are some basics showing the tight relationship between New Pacific and Silvercorp:

**Leadership verlap:** Rui Feng, CEO and director of New Pacific, also serves as Chairman/CEO of Silvercorp. David Kong also serves as director at both companies.

**Cross- wnership:** Silvercorp owns about 29% of New Pacific, according to a recent management circular [Pg. 6] Historically, New Pacific had also owned stakes in Silvercorp's equity, per company filings. [Pg. 3]

**Shared ffice Space.** The companies also share overhead expenses and office space [Pg. 12]. This can also be seen from the Canadian SEDAR profiles of each company [1,2]:

**New Pacific Metals Corp.**

**Mailing Address:** Suite 1750 - 1066 West Hastings Street
Vancouver, British Columbia
V6E 3X1

**Contact Name:** Yong-Jae Kim

**Business e-mail address:** ykim@newpacificmetals.com

**SILVERCORP METALS INC.**

**Mailing Address:** 1750 - 1066 West Hastings Street
Vancouver, B.C.
V6E 3X1

**Contact Name:** Yong-Jae Kim

**Business e-mail address:** ykim@silvercorp.ca

## *New Pacific's Management Has Been Accused of Inflating Silver Grades, And Other Improprieties, At Related Company Silvercorp*

New Pacific CEO Rui Feng has come under fire previously over allegations of falsifying silver grades at his other public company, Silvercorp.

In late 2011, fraud researcher Jon Carnes, who has among the best track records in the industry in identifying irregularities with China-based companies, issued a report on Silvercorp that alleged, among other things:

- The company's technical reports were based on a 2-man team that used resource estimates provided by Silvercorp, and who hadn't visited the site in years.
- The quality and resource estimates of its mines were overstated.
- That a related-party transaction had enriched a relative of CEO Rui Feng.

Following issuance of the report, Silvercorp responded and retaliated with a multi-year legal war (that we detail further below.)

The British Columbia Securities Commission (BCSC) investigated Silvercorp after the report. According to the Globe and Mail, the commission's chief mining advisor, Robert Holland, wrote to the company, outlining major irregularities:

> *"Holland wrote that the reports used resource estimation methods that were inconsistent with best practices, and contained 'errors that could individually or collectively result in material overestimation of mineral resources.'*
>
> *Holland pointed to one technical report that, he said, relied 'unduly' on information from the company's chief operating officer and president, and had 'uncorrected*

> *errors in mineral resource tables.' He added that there were large unexplained differences in the report between two measures of a mine: resources and reserves.*
>
> *In summary, he wrote: 'We consider the Company to be in material default of its technical disclosure and filing requirements.' He threatened to put Silvercorp on the BCSC's default list—exposed publicly as a company that was in violation of the BCSC's rules."*

Despite this, the BCSC eventually dropped its investigation without detailing why. A private lawsuit went forward in the U.S., however, resulting in the company paying a $14 million settlement, without admitting wrongdoing.

## *Troubling Parallels at New Pacific: One of the Two "Independent" Geologists Who Wrote the Silver Sand Technical Report (and the Only One to Actually Visit the Site) Worked at Silvercorp for 3.5 Years*

A technical report is meant to provide a summary of material scientific and technical information of mining projects so investors have a clear, objective view of its prospects. In order to achieve this objective, the role of *independent* geologists in preparing technical reports is critical.

A fulsome technical report for Silver Sand is all the more important given that the project's prior owners "conducted no commercial mining or material processing but only surface exploration and limited surface core drilling" [Pg. 16]. The prior owners drilled only 8 core holes in two separate campaigns totaling 2,334 meters. [Pg. 19]

New Pacific released its latest technical report for the Silver Sand property on October 31, 2019, effective August 31, 2019. [Link]. The report was prepared by 2 "independent" geologists, and one additional geologist associated with the company.

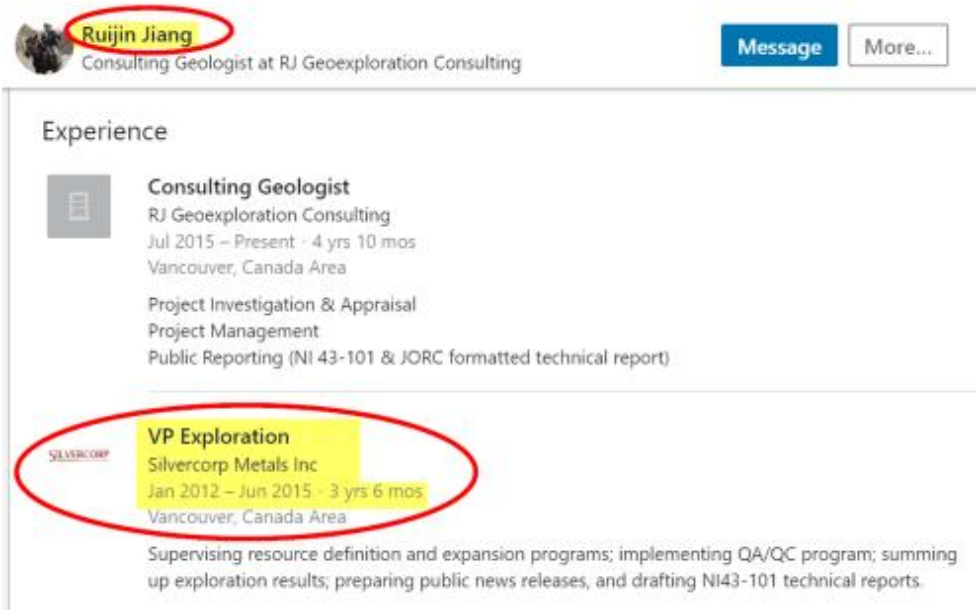
Of the two "independent" geologists, only one, Ruijin Jiang, actually visited the site. [Pg. i] Jiang was also responsible for almost *all* of the report (everything except for 1 section):

**Table 2.1 Qualified Person's Responsibilities**

| Qualified Persons | Position | Employer | Independent or not | Professional Designation | Sections of Report |
|---|---|---|---|---|---|
| Ruijin Jiang | Consulting Geologist | Self Employed | Yes | P.Geo, M.Sc | 1 to 12 and 14 to 27 |
| Andy Holloway | Principal Process Engineer | AGP Mining Consultants Inc. | Yes | P.Eng | 13 |
| Yongming (Alex) Zhang | Vice President, Exploration | New Pacific Metals Corp. | No | P.Geo, M.Eng, M.Sc | part of 4, part of 26 |

Given his prominence in the report (and especially given the historical allegations faced by management), the independence of Jiang's opinion would be essential.

But we see from his LinkedIn profile that he was actually an employee of Silvercorp for 3.5 years, representing an obvious conflict:




## *Troubling Parallels at New Pacific: Key Individuals in New Pacific's Bolivian Operations Held Senior Positions at Another Nearby Silver Project That Allegedly Inflated*

# *Silver Grades in Order to Pump Up a Different Public Company*

In a 2015 opinion column in the El Diario newspaper, former Minister of Mines and private mining industry consultant Jorge Espinoza publicly accused Prophecy Development Corp. (now OTC:ELEF) of manipulating mineral values at its Pulacayo-Paca prospect, near the city of Uyuni.

Key Prophecy personnel have significant overlap and/or links to New Pacific and its Bolivian subsidiary, Alcira. New Pacific also had a small stockholding in Prophecy. [ Pg. 5]

At the time of the public newspaper accusations, Hernan Uribe Zeballos was Chief Geologist at Prophecy, per his LinkedIn profile . He later became Country Manager of New Pacific/Alcira, a role he serves to this day .

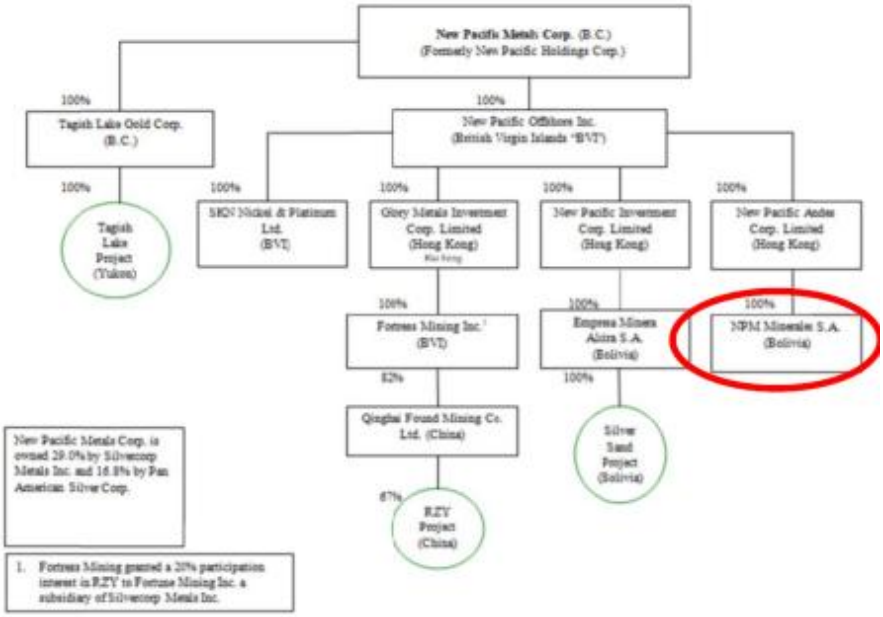
The Prophecy manager at the time of the accusations was Gustavo Miranda Pinaya. The same individual is quoted in the Silver Sand technical report as having provided due-diligence on matters of Bolivian mining laws, and the property title of the Silver Sand project. Recall that the first half of our report raises massive red flags on these very subjects: [ Pg. 3]

**NEW PACIFIC METALS CORP.**
**Technical Report Silver Sand Property**

**3 RELIANCE ON OTHER EXPERTS**

Mr. Gustavo Miranda Pinaya, a lawyer having practiced law in Bolivia since 1996, prepared a due diligence report to New Pacific with regard to the Bolivian mining laws and regulations and the property title of Silver Sand Project on February 3, 2017 (Miranda, 2017) (the "Due Diligence Report"). The source of information on Bolivian mining laws and regulations presented in Section 4 of this Technical Report was mainly based on Miranda's Due Diligence Report and other publically available literature.

We found further evidence of the close association between these individuals and the company. February 2017, Miranda and Uribe incorporated NPM Minerales , a subsidiary of New Pacific Metals [ Pg. 5]




We find it unnerving that key individuals associated with allegations of silver grade inflation, working with an executive team accused of silver grade inflation, have teamed up to work on New Pacific's key project.

## *Troubling Parallels at New Pacific: Multiple Chinese Mining Projects Bought from Silvercorp Were Hyped for Years Before Ultimately Failing*

New Pacific has purchased 3 Chinese mining projects through Silvercorp. All were hyped considerably around the time of purchase, but have since been suspended, sold at a loss, or surrendered back to the local government.

1. **Kang Dian roject.** New Pacific came public via reverse merger in October 2004 with options to acquire a majority stake in the Kang Dian Project in China from Silvercorp. (The project was owned by a Silvercorp subsidiary at the time.) [3] New Pacific ultimately exercised the options, paying 6.5 million shares at a deemed price of ~$2.4 million. [5]

Here are several examples of press releases promoting the project's "high grade" zones (1, 2):

October 12, 2004

**High Grade Copper, Nickel, PGM Trench Intercepts of 5.38% Cu, 2.21% Ni, 0.086% Co, 4.71 g/t Pt, and 15.16 g/t Pd. over 9.43 Metre Discovered at AZ Prospect, Kang-Dian Project, Sichuan, China**

**New Pacific Metals Corp**
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**Press Release**

**High Grade Copper-Silver Zone discovered in the Jinhe Permit and layered Copper-Nickel-Cobalt-Platinum-Palladium mineralization discovered in the Nantianwan Permit of the Kang Dian Project, Sichuan Province, China**

VANCOUVER, BRITISH COLUMBIA--(January 16, 2007) - New Pacific Metals Corp. ("NUX")

The project was ultimately suspended and written off in 2008. [ Pg. 2]

2. **The Huaiji HNK"**New Pacific purchased these mining projects from a Silvercorp subsidiary for C$37.7 million. [ Pg. 2]

The company issued years of positive press releases on these areas. Here are several illustrative examples ( 1, 2):

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**Press Release**

October 29, 2007

**Drill Intercepted 13.5 Grams Per tonne Gold Over 3.1 Metres Confirming High Grade Mineralization at the HNK Gold-Polymetallic Exploration Permit in Guangdong Province, China**

New Pacific Metals Corp
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E-Mail: info@newpacificmetals.com

**Trading Symbol: TSX-V: NUX** **April 29, 2009**

**Press Release**

**Further High Grade Gold Mineralization Intersected by Underground Tunneling at the HNK Gold-Polymetallic Project, Guangdong Province, China**

After much hype and about C$4.3 million in exploration expenditures, New Pacific quietly reported that it sold the project for C$30.5 million, representing a loss. [ Pg. 2]

3. **RZ Silver Lead Zinc roject**: New Pacific paid U.S. $3.5 million for a stake in this China mining projected from Silvercorp in 2013. Some initial promising results were reported :

**New Pacific Metals Corp.**
**TSX: NUX**

**NEWS RELEASE**

**Trading Symbol: TSX: NUX**

---

**NEW PACIFIC ANNOUNCES FIRST ASSAY RESULTS FROM THE 2013 DIAMOND DRILLING PROGRAM AT THE RZY SILVER-LEAD-ZINC EXPLORATION PROJECT IN QINGHAI PROVINCE, CHINA**

VANCOUVER, BRITISH COLUMBIA – November 18, 2013: New Pacific Metals Corp. ("New Pacific" or the "Company") is pleased to announce the first tranche of assay results of the 2013 diamond drilling program at the RZY silver-lead-zinc exploration project (the "Project") in Qinghai province, China.

Highlights of the most prominent drill results include (note - widths are core length not true widths):

- 4.40m @ 418 g/t Ag, 8.5% Pb, 5.5% Zn, and 1.25% Sb from 83.3 meters to 87.7 meters, including 1.4m @ 990 g/t Ag, 21.6% Pb, 8.6% Zn, and 3.48% Sb from 86.3 meters to 87.7 meters in hole Zk3504.

The assay results from the first four of 20 holes (see Table 1 below) indicate the mineralization at the Project site is silver-dominated with considerable amounts of lead, zinc, antimony, tin, and copper.

Later, the company disclosed that it would surrender the project back to the local government for a one-time cash payment of C$3.8 million. [ Pg. 4]

## *An Odd Related-Party Deal Between New Pacific and Silvercorp… Involving a Travel Website for Chinese Tourists*

In October 2015, with its historical mining projects not working out, New Pacific announced it was changing its business from a mining issuer to focusing on making investments in privately held and publicly traded corporations.

One of these investments, made sometime around 2016, was a private placement for CozyStay holdings, a travel/accommodations website similar to AirBnB geared toward Chinese travelers . [Pg. 3]

In 2019, (after New Pacific renewed its focus on mining) its shares of CozyStay were sold to Silvercorp . We fail to understand why a silver producer would purchase an interest in a privately-owned travel website from another silver mining company.

## *New Pacific CEO Rui Feng's Unhealthy Habit of Using Aggressive Litigation and State Influence to Silence Criticism*

We at Hindenburg take pride in reporting on companies that try to silence criticism with intimidation. A functioning market requires diverging views and opinions in order for investors to be able to make informed decisions.

We also believe that companies engaging in such practices are vastly more likely to have something to hide. In one recent example, MiMedx Group sued its critics , only to be charged criminally with fraud two years later:

MiMedx Files Lawsuit Related To Short Seller Attacks

NEWS PROVIDED BY
MiMedx Group, Inc. →
Oct 04, 2017, 09:35 ET

FOR IMMEDIATE RELEASE Tuesday, November 26, 2019

**Former Chief Executive Officer And Chief Operating Officer Of Publicly Traded Biopharmaceutical Company Charged With Accounting Fraud**

Geoffrey S. Berman, the United States Attorney for the Southern District of New York, and Philip R. Bartlett, Inspector-in-Charge of the New York Office of the U.S. Postal Inspection Service ("USPIS"), announced today the unsealing of an Indictment in Manhattan federal court charging PARKER H. "PETE" PETIT and WILLIAM TAYLOR, the respective former chief executive officer and chief operating officer of MiMedx Group, Inc. ("MiMedx"), a publicly traded biopharmaceutical company, with securities fraud offenses for engaging in a scheme to fraudulently inflate MiMedx's revenue. The case is assigned to U.S. District Judge Jed S. Rakoff.

New Pacific CEO Rui Feng has taken it a step further, with a history of using litigation and state influence (including payments to Chinese authorities and pressure on Canadian regulators) to silence criticism against his business interests.

As reported in the Globe and Mail , following a critical piece on Silvercorp written by fraud researcher Jon Carnes, the company sued Carnes and used its influence in China to advance an investigation into his local analysts. Per the Globe expose:

> *"Silvercorp helped pay for police expenses in the investigation of Carnes's operation. Evidence also shows that Silvercorp passed results of the Chinese police investigation to the BCSC."*

One analyst, Kun Huang, was thrown in a crowded Chinese prison cell without charges and interrogated for a month by local police. The company appears to have aided in the police interrogation of the analyst, as well as his eventual prosecution:

> *"For the first few days, the police were receiving texts and phone calls before and during these sessions. 'I have a strong suspicion it was someone from [Silvercorp].'"*
>
> *"In the summer of 2013, Huang was charged with 'criminal defamation' for criticizing a Chinese company. His trial in September of that year lasted one day and was closed to the public, at Silvercorp's behest. Silvercorp was also granted standing."*
>
> *"In the end, Huang received a two-year sentence and was returned to the same overcrowded cell to serve out the rest of his term."*

In Canada, the BCSC alleged fraud against Carnes, who published under a pseudonym with a fictitious biography. The case was later dismissed , and Carnes' work was eventually largely vindicated .

The above episode should say something about management's approach on matters of transparency. We believe that the same executive team has once again failed to thoroughly disclose to investors the major issues relating to New Pacific.

# *Part III: If New Pacific Actually Controlled the*

# *Bolivian Concessions (We Don't Think It Does) We'd Still See 85% Downside Purely on Fundamentals*

Given Part I about how New Pacific might not control any of its Bolivian mining areas, and Part II which identifies significant red flags relating to the credibility of management, we think there's a great chance this part of our report is largely superfluous.

That being said, in the interest of being thorough, we looked closely at New Pacific's balance sheet, comparables with other similar mining projects and hired a consultant to perform a detailed technical analysis on the 'flagship' Silver Sand project.

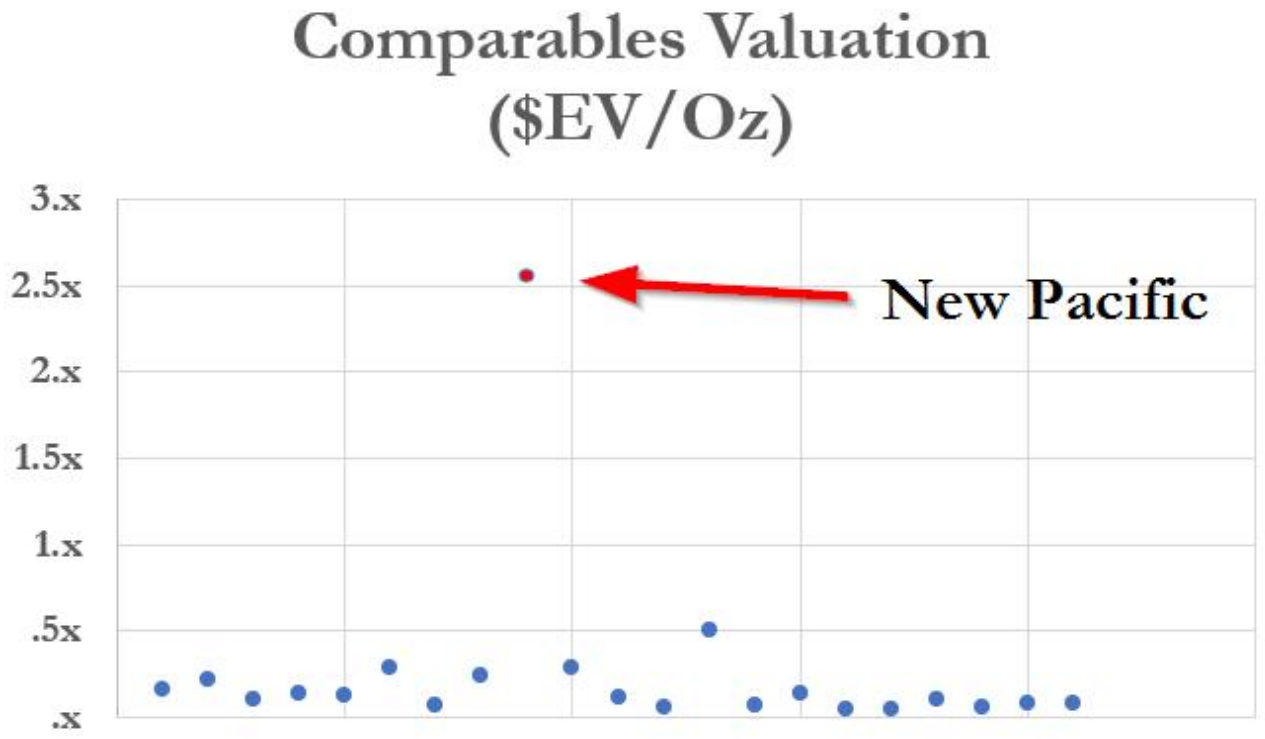
What we found leads us conclude that New Pacific could have 85% fundamental downside even if there were none of the political risk factors or management red flags detailed above.

## *A Comparables Analysis Shows That Silver Sand is Valued 17x Higher than Competitors*

As a basic check, we analyzed New Pacific relative to other publicly traded mining companies with key silver projects, and found that it represented a blatant outlier:

| Ticker | Company | Project | Mkt Cap (US$M | EV (US$M) | Resource (Moz AgEq) | EV/Resor. (US$/oz AgEq) |
|---|---|---|---|---|---|---|
| BCM CN Equity | Bear Creek Mining Crp | Corani | 145.0 | 119.9 | 735 | $0.16 |
| ITR CN Equity | Integra Resources Corp | DeLamar | 82.2 | 72.0 | 336 | $0.21 |
| AMM CT Equity | Almaden Minerals Limited | Ixtaca | 36.0 | 37.5 | 355 | $0.11 |
| SVL AU Equity | Silver Mines Limited | Bowdens | 48.0 | 43.5 | 305 | $0.14 |
| KTN CN Equity | Kootenay Silver Inc | La Cigarra / Promontori | 37.1 | 29.9 | 238 | $0.13 |
| SVE CN Equity | Silver One Resources | Candelaria | 40.5 | 37.7 | 132 | $0.29 |
| AUN CN Equity | Aurcana Corporation | Revenue-Virginius | 37.7 | 31.7 | 443 | $0.07 |
| AUMN US Equity | Golden Minerals Company | El Quevar | 27.5 | 23.5 | 96 | $0.24 |
| DV CN Equity | Dolly Varden Silver Corp | Dolly Vardan | 15.9 | 12.5 | 44 | $0.29 |
| SSV CN Equity | Southern Silver Exploration Corporatio | Cerro Las Minitas | 14.2 | 11.3 | 95 | $0.12 |
| AZS AU Equity | Azure Minerals Limited | Alacran | 7.1 | 6.1 | 105 | $0.06 |
| MMG CN Equity | Metallic Minerals Corp | Keno-Lightninig | 12.8 | 11.0 | 22 | $0.50 |
| IVROA AT Equity | Investigator Resources Limited | Peterlumbo | 6.4 | 3.6 | 48 | $0.08 |
| REX CN Equity | Orex Minerals Inc. | Sandra-Escobar | 7.9 | 7.5 | 55 | $0.14 |
| WRM AU Equity | White Rock Minerals Limited | Mt Carrington | 4.8 | 3.5 | 71 | $0.05 |
| NBR CN Equity | Nubian Resources Ltd. | Eqsuilache | 2.1 | 2.1 | 46 | $0.05 |
| SDR CN Equity | Stroud Resources Limited | Santo Domingo II | 4.4 | 4.3 | 39 | $0.11 |
| MMN CN Equity | Monarca Minerals Inc. | Tejamen | 1.1 | 1.9 | 30 | $0.06 |
| AHNR US Equity | Athena Silver Corporation | Langtry | 1.2 | 3.5 | 43 | $0.08 |
| ABRA CN Equity | AbraPlata Resource Corp. | Diablillos | 12.5 | 12.5 | 145 | $0.09 |
| **Average** | | | | | | **$0.15** |
| **NUAG CN Equity** | **New Pacific Metals** | **Silver Sand** | **519.4** | **486.9** | **191** | **$2.55** |
| | | | | | *Diff* | *17.2x* |

And here is the scatter plot of New Pacific/Silver Sand relative to the other companies (Enterprise value / estimated resource ounces):




Beyond a comparables analysis, we did a balance sheet analysis and engaged an expert to provide a full technical report in order to see if there was anything that could warrant New Pacific's massive outlier status.

## *Balance Sheet: ~C$44.5 Million in Net Liquidation Value (C$0.30 Per Share) Excluding Mining Interests*

On the balance sheet side, as of the latest financials (ending December 2019), New Pacific had about C$43 million in current liquid assets (including C$33.6 million in cash and C$8.7 million in bonds.) [Pg. 1]

| | December 31, 2019 |
|---|---|
| **ASSETS** | |
| **Current Assets** | |
| Cash and cash equivalents | 33,620,262 |
| Bonds | 8,694,975 |
| Receivables | 381,177 |
| Deposits and prepayments | 197,268 |
| | 42,893,682 |
| **Non-current Assets** | |
| Reclamation deposits | 15,075 |
| Other tax receivable | 2,590,017 |
| Equity investments | 6,187,122 |
| Plant and equipment | 1,308,938 |
| Mineral property interests | 86,653,184 |
| **TOTAL ASSETS** | 139,648,018 |
| | |
| **LIABILITIES AND EQUITY** | |
| **Current Liabilities** | |
| Accounts payable and accrued liabilities | 1,473,365 |
| Payable for mineral property acquisition | 263,120 |
| Due to a related party | 124,032 |
| | 1,860,517 |
| **Non-current liabilities** | |
| Payable for mineral property acquisition | - |
| **Total Liabilities** | 1,860,517 |

With ~C$5.3 million free cash flow burn last quarter [ Pg. 4], we estimate C$38 million in liquid assets remaining. We discount the equity investments 20% (due to market decline) to arrive at C$5 million of value. All told, ex mineral property interests (which we dig into below) we see ~C$44.5 million of net liquidation balance sheet value which translates to about C$0.30 per share. [4]

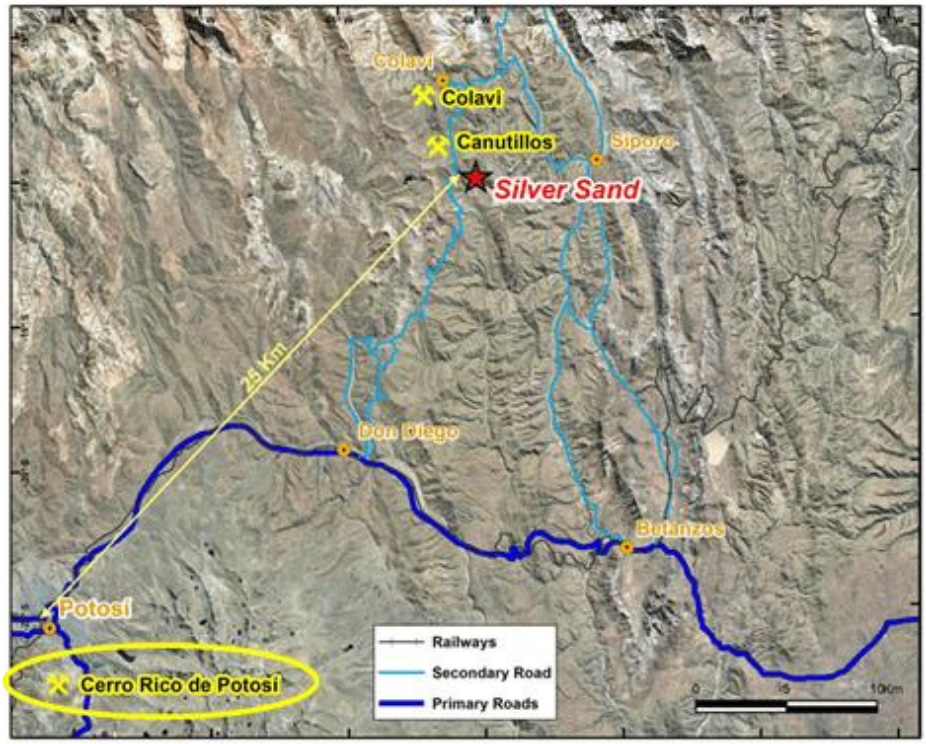
## *Technical Analysis of New Pacific's Silver Sand Project Arrives at an Estimated Value of C$0.29 Per Share*

## *Background: Bolivia's Potosi Region and the Legacy of the Cerro Rico Silver Mine*

Silver Sand is a sandstone-hosted primary silver deposit located in Potosi, Bolivia. The Potosi region is well known for its world-class silver deposits, especially the Cerro Rico mine . Upwards of 2 billion ounces of silver have been mined from Cerro Rico since 1545, with early mining grades averaging 7,000 ounces of silver per tonne.

This jaw-dropping quantity and grade of silver resulted in decades of exploitation and abuse by the Spanish Empire and other foreign entities since the discovery, resulting in the death of an estimated 8 million people . That is why Cerro Rico is known locally as " the mountain that eats men " and "the mouth to hell ". Eduardo Galeano, journalist and author of the now-classic political work "The Open Veins of Latin America" wrote about Cerro Rico, he said :

*"You could build a bridge of pure silver from Potosi to Madrid with ore extracted. And you could build a bridge back with the bones of those who died mining it."*




(Location of Silver Sand relative to Cerro Rico)

Despite the abundance of riches that sat within Cerro Rico, the silver has brought mostly death and misery to local people (Potosinos), which has instilled hostility towards foreign miners in the region.

Given this history and social/political backdrop, deposits in Potosi arguably need to be "world-class" to make it worthwhile for foreign mining companies and their investors to try to develop such deposits.

## *Technical Analysis: Silver Sand – A Low Grade, Highly Complex Deposit*

Silver Sand is only about 27 km from Cerro Rico, so it is definitely in a world-class silver *district*. But is Silver Sand a world-class silver deposit? The grades within the Silver Sand deposit are low, at about 132 g/t Ag (about 1.2 g/t Au if using gold-equivalents) based on the resource estimate, which envisions this to be mined using low-cost open pit methods.

However, investors should not expect this to be a low-cost open pit, heap leach project. The metallurgy is much more complex and includes sulphides, which may not be cyanide-leachable like oxides. Therefore, processing capital and operating costs could be quite high, as both cyanidation and flotation plants may be required. Furthermore, recoveries may not achieve the levels suggested by preliminary testing.

As a low-grade deposit with complex mineralogy, Silver Sand then needs gargantuan size to qualify as world-class. Based on the market capitalization, investors are pricing this as a foregone conclusion. Our technical expert, however, suggests that Silver Sand is not a world-class silver deposit based on drilling to date and evidence suggests that exploration upside may be limited.

## *Our Expert Consultant Estimates That Resources Would Have to be 6x Larger to Warrant Current Valuation*

New Pacific trades at a market capitalization of approximately C$700 million. The only way to justify such a lofty valuation for a mineral asset, located in Potosi, Bolivia, is if the project has in the ballpark of a billion ounces of silver.

Silver exploration and development companies, most of which are at a more advanced stage of exploration than New Pacific, currently trade at a valuation of significantly less than US$0.50 per silver ounce in the ground. Even ascribing an in situ value of US$0.50/oz to New Pacific would mean that it would need a resource of ~1 billion ounces. The recently released maiden resource estimate contains a total of only 191 million ounces of silver, or about 80% less than that.

Analysts had estimated that the Silver Sand resource would contain between 170 and 250 million ounces of silver, with an average of 223 million:

> **Roth Capital** – predicted that the initial resource estimate at Silver Sand would be about **2 0 million ounces of contained silver.**(1, 2)
> **BM** – estimated 91 million tonnes of ore at a grade of 85 g/t for **2 8 million ounces of contained silver.** (1, 2)
> **I inancial** – estimated 58 million tonnes of ore at a grade of 92 g/t for **170 million ounces of contained silver.** (1, 2)

The resource estimate came in well below most of the analysts' expectations. More importantly, we believe that the market's expectations were much higher, in part due to the aggressive aforementioned stock promotion.

## *Technical Analysis: Silver Sand's Resources Implies a Valuation of About C$0.29 Per Share*

Using 191 million ounces of contained silver, as per the resource estimate, New Pacific currently trades at about US$2.56 per ounce of in situ silver. According to the technical consultant we worked with, that is in the ballpark of advanced silver developers and producers, not early stage explorers.

A more appropriate comparable for New Pacific is likely Bear Creek Mining (TSX: BCM), which currently has a market capitalization of US$145 million. Bear Creek's primary project is Corani in southern Peru, a more politically stable mining jurisdiction than Potosi, Bolivia. Corani is an open pittable, silver-dominant polymetallic deposit that contains approximately 735 million silver-equivalent ounces (two-thirds of which are classified as Reserves). Bear Creek is currently being valued at US$0.16 per silver-equivalent ounce, which is more in line with the majority of silver explorers and developers than the valuation at which New Pacific is currently trading.

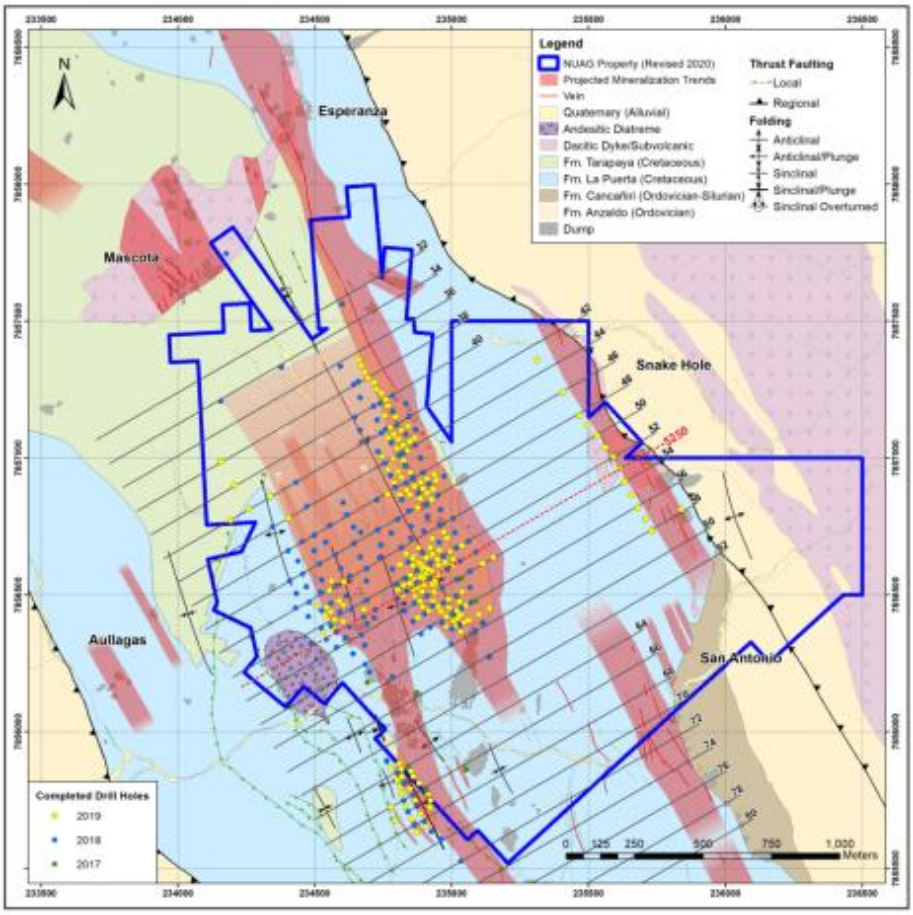
Applying a US$0.16 per silver-equivalent ounce valuation to the Silver Sand resource implies a valuation of US$30.6 million or about C$0.29 per share. New Pacific is trading ~7.5x that (when adding the value of balance sheet assets) which suggests a major overvaluation.

## *Technical Analysis: New Pacific's Infill Drilling Suggests Exploration Potential is Limited*

Early exploration drilling is usually widely spaced with the goal of delineating the mineral resource, leading to inferred resources. Once the resource has been reasonably well defined, or gets so large that further growth is meaningless, companies then turn their attention to new zones or upgrading the resource through infill drilling.

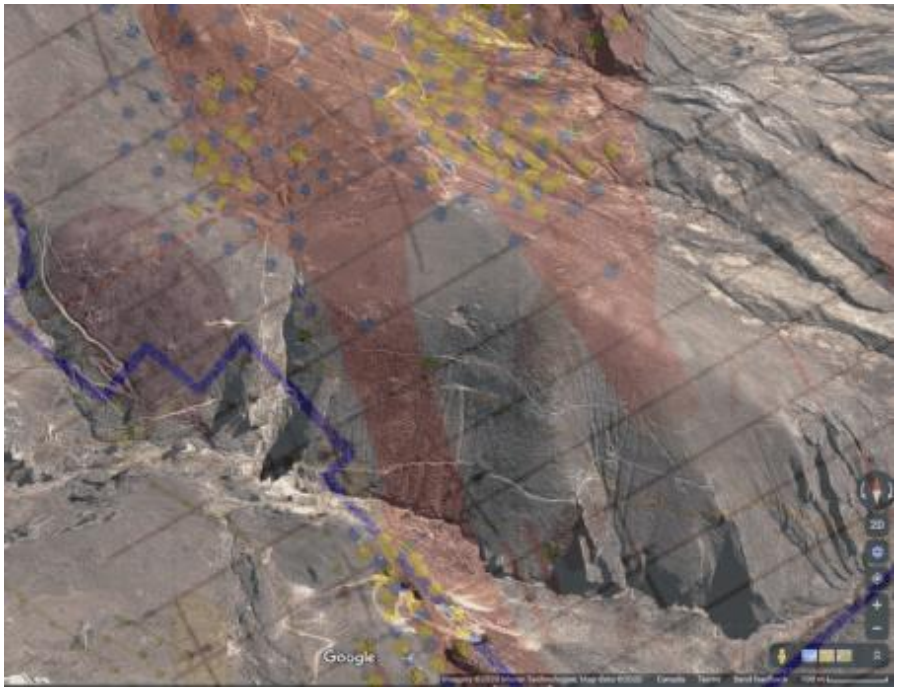
New Pacific drilled 195 holes in the "discovery exploration" program conducted in 2017 and 2018. [Pg. 1] Then, rather than continuing to expand the resource footprint, the company conducted mostly infill drilling in 2019 (Figure 2).

The location of the infill drill holes (yellow dots on Figure 2) do a good job of showing the best zones within the Silver Sand deposit and indicate that the footprint is relatively small. An additional 19 holes were drilled on the Snake Hole target, but as previously mentioned, mineralized widths there are narrow and often too deep for economic open pit extraction.




(Figure 2 – Silver Sand plan map showing drill collars)

Our technical consultant believed that New Pacific switched from exploration drilling to infill drilling because the resource expansion potential was dwindling. Mineralization to the south and the west falls off a cliff, literally (Figure 3) and appears to be cut-off by geology/structure to the east. Mineralization appears to be open to the north, but drilling and the plan map suggest that mineralization plunges and pinches out to the north (Figure 4). All that is to say that Silver Sand may not get much bigger.




(Figure 3 – Drill plan map draped over Google satellite map, our interpretation)

**Silver Sand Drill Results - Dec. 2, 2019**

| | | | Mineralized Intervals | | | | | |
|---|---|---|---|---|---|---|---|---|
| Hole_id | Section | | From (m) | To (m) | Length (m) | Ag_g/t | Pb_% | Zn_% |
| DSS362501 | 3625 | | 127.19 | 130.66 | 3.47 | 107 | 0.01 | 0 |
| DSS365001 | 3650 | | 129.95 | 132.36 | 2.41 | 64 | 0.02 | 0 |
| | | | 193.7 | 196.1 | 2.4 | 41 | 0.04 | 0 |
| DSS367501 | 3675 | | 131 | 133.25 | 2.25 | 95 | 0.15 | 0 |
| | | | 138.98 | 140 | 1.02 | 69 | 0.08 | 0 |
| | | | 190.2 | 191.26 | 1.06 | 93 | 0.05 | 0 |

(Figure 4 – Dec. 2, 2019, Silver Sand drill results between sections 36 and 38 – narrower widths, deeper, and low grade)

## *Technical Analysis: Metallurgy—Oxides Transition Sulphides Complexity High Cost*

In August 2019, New Pacific announced "high recovery of silver from various metallurgical processes for sulphide, transition and oxide styles of mineralization". High silver recoveries (i.e., 80%) were quoted for flotation, bottle roll cyanidation, and coarse column leach cyanidation testing. The high-level results provided the appearance that any of these processing methods could be used for all of Silver Sand mineralization, which struck our expert as dubious. First of all, the news release quoted recoveries qualified as "up to", which should not be confused with anticipated recoveries.

A review of the technical report filed in November 2019 provides better insight into potential silver recoveries. What it revealed is that neither flotation nor cyanide leaching seem to provide an optimal processing approach for all of the mineralization. As well, the *maximum* silver recovery numbers quoted in the metallurgical testing news release seemed misleading.

The low-grade oxide material (LEACHMET 1) demonstrated silver recoveries of only 59.1% to 77.5% in bottle roll tests at room temperature, using air as the sparge gas, and with reasonable cyanide consumption. Results for the high-grade oxide sample (LEACHMET 4) were even worse, achieving recoveries of 69.0% or less of the silver at lower temperatures and cyanide consumption.

The news release stated that bottle roll cyanidation testing had silver extraction up to 96.3% for oxide mineralization, but that was only achieved at elevated temperatures, using $O_2$ as sparge gas, and with hefty cyanide consumption. Processing costs would be high under those conditions, so it is much more likely that silver recoveries would be below 80% once economics are factored in.

**Table 13.16 LEACHMET Samples**

| ID | Type | # of DDH's | Silver Grade, from interval assays, g/t | Silver Grade from Head Assay, g/t |
|---|---|---|---|---|
| LEACHMET 1 | LG Oxide | 25 | 29 | 29 |
| LEACHMET 4 | HG Oxide | 15 | 125 | 132 |
| LEACHMET 5 | HG Trans. | 8 | 129 | 157 |
| LEACHMET 6 | HG Sulphide | 9 | 137 | 124 |

**Table 13.21 LEACHMET 1 Bottle Roll Test Results**

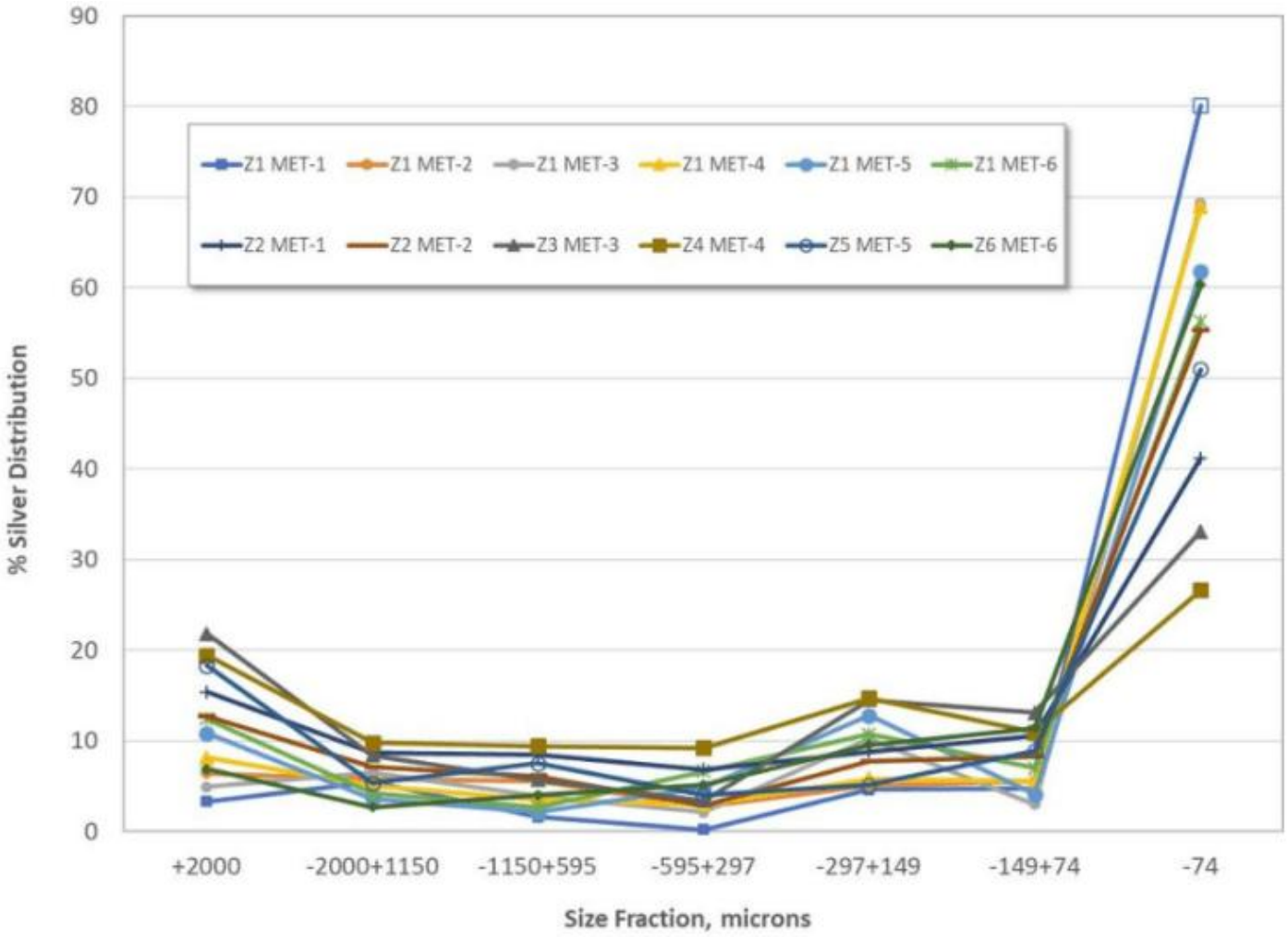
| Test # | Grind $P_{80}$, µm | % Sol. Strength | Consumption, kg/t | | Pulp Temp ℃ | Sparge Gas | % Extraction | |
|---|---|---|---|---|---|---|---|---|
| | | NaCN | NaCN | CaO | | | Ag | Cu |
| 20 | 105 | 0.05 | 1.99 | 1.60 | 26 | Air | 59.1 | 40.1 |
| 21 | 74 | 0.05 | 2.13 | 1.86 | 26 | Air | 71.1 | 38.8 |
| 22 | 50 | 0.05 | 2.21 | 1.86 | 28 | Air | 77.5 | 41.1 |
| 26 | 74 | 0.15 | 4.55 | 0.84 | 28 | Air | 74.1 | 45.1 |
| 27 | 74 | 0.30 | 5.95 | 0.59 | 27 | Air | 78.2 | 45.7 |
| 30 | 74 | 0.30 | 4.53 | 0.79 | 29 | $O_2$ | 81.0 | 47.9 |
| 31 | 74 | 0.30 | 6.71 | 0.78 | 59 | $O_2$ | 81.6 | 48.5 |

**Table 13.20 LEACHMET 4 Bottle Roll Test Results**

| Test # | Grind $P_{80}$, µm | % Sol. Strength | Consumption, kg/t | | Pulp Temp °C | Sparge Gas | % Extraction | |
|---|---|---|---|---|---|---|---|---|
| | | NaCN | NaCN | CaO | | | Ag | Cu |
| 23 | 105 | 0.05 | 1.79 | 1.96 | 28 | Air | 65.5 | 25.7 |
| 24 | 74 | 0.05 | 2.09 | 2.02 | 27 | Air | 66.4 | 29.2 |
| 25 | 50 | 0.05 | 2.32 | 2.03 | 28 | Air | 69.0 | 34.7 |
| 28 | 74 | 0.15 | 4.69 | 0.46 | 27 | Air | 83.4 | 31.0 |
| 29 | 74 | 0.30 | 5.38 | 0.39 | 28 | Air | 86.7 | 31.2 |
| 32 | 74 | 0.30 | 3.94 | 0.78 | 27 | $O_2$ | 95.6 | 27.4 |
| 33 | 74 | 0.30 | 5.08 | 0.78 | 59 | $O_2$ | 96.3 | 34.5 |

Flotation is an alternate approach, wherein the silver would be directed into a concentrate that would then need to be transported to a smelter for further processing. However, no flotation testing was done on the low-grade silver samples, suggesting that cyanidation is likely the only viable processing method for low grade silver in oxides.

The silver at Silver Sand is very fine grained. As shown in Figure 5, the majority of the silver falls into the smallest size fraction of -74 microns (1 micron 0.001 mm). That means most of the silver grains are about the thickness of a human hair, which is very small and will require very fine grinding for cyanidation or flotation to be effective. The finer the grind, the higher the cost, so this should also be noted. In addition, fine grinding can lead to sliming issues during flotation.




(Figure 5 – Silver Distribution by Size Fraction, [microns])

In summary, the metallurgy at Silver Sand is complex and varied. In the opinion of our expert, the news release issued by New Pacific on high silver recoveries was misleading. High silver recoveries are possible, but likely not practical when costs are factored in. It is our expert's sense that Silver Sand will either require both a cyanidation plant and a separate flotation plant to achieve good recoveries, or a single cyanidation plant with lower overall recoveries.

Compared to low grade gold projects that can use open pit mining and heap leaching, our consultant suggested Silver Sand is likely to require significantly more capital investment for processing facilities and the operations will have high processing costs.

## *Technical Analysis Conclusion: A World Class Valuation for a Mine That Is Not World Class*

Given the balance sheet assets and resource estimates of C$0.30 and C$0.29 per share

respectively, we arrive at a total value of C0.59 per share, representing over 85% downside from current levels purely on a fundamental basis.

# *Overall Conclusion: 90% Downside*

Our price target for New Pacific is C$0.37, representing over 90% downside from current levels.

To arrive at our final price target, we weighted 3 scenarios:

1. Total revocation of the Bolivian mining areas (concessions) (60%). In this scenario we assign a price target of C$0.30, the estimated value of the balance sheet assets.
2. A renegotiated deal on the Bolivian concessions (30%), to which we assign a price target of C$0.45 (balance sheet assets plus half of the value of the mining project, given the historic profit splits Bolivian deals have typically entailed).
3. The deal (somehow) passing through Bolivian legislation as-is (10%), to which we assign a price target of C$0.59, representing our estimate of the balance sheet assets and the Silver Sand project.

Given the issues above, and those relating to management's lack of clear communication on subjects that are of critical importance to investors, we are short both New Pacific and Silvercorp. Best of luck to all.

## *Appendix A: Red Flags Relating to the Company's Ownership of Silver Sand*

We found multiple red flags, based on company statements and our interviews with Bolivian lawmakers, raising doubts about whether it actually had secure tenure of mining rights to its flagship Silver Sand property.

1. **The company suggests that it needs Congressional approval for its consolidation and conversion of its Silver Sand property, but if it already held secure title why would this be necessary** The company suggests, in relation to Silver Sand, it needs Bolivian Congressional approval to convert what it presents as 17 existing and legally held ATEs (formerly known as concessions) into administrative mining contracts.

But Congressional approval is only needed if there are no pre-existing mining rights in place.

Article 132 of the 2014 Bolivian Mining Law 535 states mining contracts based on ATEs

(concessions) that were legally held prior to the new law do not need congressional approval, only approval from AJAM. Congressional approval is only needed for contracts if there were no pre-existing mining rights in place.

Article 132 – (contracts subject to legislative approval):

Mining contracts which are signed following the publication of this Law will require approval from the Plurinational Legislative Assembly in accordance with numeral 12 of Paragraph I of Article 158 of the Political Constitution of the State, except administrative mining contracts based on the conversion of Special Transitory Authorizations – (ATEs) to contracts by virtue of the fact that these represent pre-constituted or previously acquired rights, recognized by the Constitution.

**Artículo 132°.- (Contratos sujetos a aprobación legislativa)**

I. Los contratos mineros que se suscriban a partir de la publicación de la presente Ley, requerirán de la aprobación de la Asamblea Legislativa Plurinacional, en cumplimiento al numeral 12 del Parágrafo I del Artículo 158 de la Constitución Política del Estado, exceptuando los contratos administrativos mineros por adecuación de Autorizaciones Transitorias Especiales - ATE´s a contratos, por tratarse de derechos pre-constituidos o derechos adquiridos, reconocidos por la Constitución Política del Estado.

II. La Asamblea Legislativa Plurinacional en el plazo de noventa (90) días, deberá pronunciarse sobre el contrato administrativo minero, aprobando o no aprobando el mismo. En caso de no aprobar se lo devolverá al Órgano Ejecutivo para su corrección.

Regarding this red flag raised by New Pacific – by their own words – a Senior former member of AJAM legal department told us:

> *"This is a contradiction. If they're in the process of transitioning (from special temporary authorizations to mining administrative contracts) they do not need parliamentary approval."*

A former senior COMIBOL executive told us:

> *"I think there are inaccuracies in the (New Pacific) statements. The change from*

*(pertenencias) to "quadrilles" (25 ha mining areas) is nothing new. I'm surprised the previous owners had not done that. That change (from ATEs to contracts) does not need parliamentary approval."*

2. **The company says it was granted exploration permits for Silver Sand, which it wouldn't need if it already held secure title to the property.** A 2018 press release stated that in October 2017 the company was granted exploration permits for Silver Sand:

**SILVER SAND PROPERTY**

The Company started the preparation work for the planned exploration program after the acquisition of the Silver Sand Property. In October 2017, the Company successfully received exploration permits required by the relevant Bolivian government authorities and immediately commenced a 30,000 meter exploration drilling program on the property. For the three and

We, and the industry experts we consulted, were unclear why New Pacific needed "exploration permits" if the company already had secure mining rights (concessions) within the 3.17 km area of the Silver Sand project. [2]

Article 92 of the 2014 Bolivian Mining Law 535 stipulates that the legal holder of a mining right (concession) already the necessary rights to prospect, explore, produce and process minerals. The only additional permit necessary may be an environmental permit.

Article 92 – (Mining Rights) Mining rights ( *formerly known as concessions*) grant the holder the permission to prospect, explore, exploit, concentrate, smelt, refine, industrialize and commercialize the mineral resources either using both their own and complementary mining activities in all or part of the productive chain."

In contrast, exploration permits are granted to individuals or companies for areas in which they do NOT, nor anybody else, hold any mining rights.

Article 164 states exploration permits are given for vacant, or free areas, where no other mining rights are in effect:

Regarding the issue of why New Pacific felt the need to apply for exploration permits for the Silver Sand mining areas where it says it has had full, legal rights to since acquisition in 2017, our industry experts said:

A senior former COMIBOL executive said:

> *"As far as requesting authorization for exploration – they would not need an exploration permit but they may have been referring to the environmental license which they would need. I would be very surprised if they've paid more than $40 million dollars for something that was not 100 percent assured."*

The former AJAM legal expert we interviewed said:

> *"They could not have given out an exploration permit if Alcira already had (legal) title to those (Silver Sand) areas. Because according to the mining registry that AJAM operates, you cannot give an exploration license for an occupied area. But* ***that is an indication that the concessions were and remained revoked .my understanding is that Alcira has been operating outside the law since these areas were revoked in 201 ."***

[1] Alcira was constituted as an anonymous society by means of testimony No. 0119/2008 dated April 14, 2008, with tax identification number No. 155512027, and full registration with FUNDEMPRESA according to commercial registration No. 130345. Full registration does not seem to have taken place until at least July because of Alcira's directors' failure to supply accurate paperwork.

[2] Alcira SA was sold to Jungie Mining Industry via deed of sale 1058/2010 on Sept. 10, 2010

[3] Note that Silvercorp was named SKN Resources at the time.

[4] Based on common shares outstanding of 147.5 million [ Pg. 14]

## *Disclosure: We are short shares of (OTC:NUPMF) and (NYSE:SVM)*

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# TAB 15

# SCWorx: Evidence Points to its Massive COVID-19 Test Deal Being Completely Bogus, Price Target Back to $2.25 Or Lower

Published on April 17, 2020



- SCWorx, a nanocap company headquartered in a Regus rental office in New York City, recently announced it had entered into massive $35 million per week deal to buy and re-sell Covid-19 tests, causing its stock to surge 434%.
- SCWorx's CEO has a checkered past, including pleading guilty to felony tax evasion charges and paying a judgement in a lawsuit alleging he submitted fraudulent expense reports.
- The Covid-19 test supplier that SCWorx is buying from, Promedical, also is laden with red flags. Its CEO is a convicted rapist and formerly ran another business accused of defrauding its investors and customers. The CEO was also alleged to have falsified his medical credentials.
- Promedical claimed to the FDA and regulators in Australia to be offering COVID-19 test kits manufactured by large, well-respected Chinese firm Wondfo.

- Wondfo put out a press release days ago stating that Promedical "fraudulently mispresented themselves" as sellers of its Covid-19 tests and disavowed any relationship. We spoke with Wondfo and confirmed there was never any relationship.
- Meanwhile, the *buyer* that SCWorx has lined up for up to $840 million dollars in tests is a virtual healthcare company started by a 25-year-old in August 2018 that looks modestly sized, with only 3 employees and 3 consultants/advisors listed on its team page – hardly the major partner that we believe would be capable of handling hundreds of millions of dollars in orders.
- *Obviously*, we believe the Covid-19 hype surrounding SCWorx is completely bogus and we predict shares will soon return to the $2.25 price level they were at prior to the hype.
- We also think shares risk being halted and ultimately could move far lower than $2.25 if/when regulators investigate the company's potentially nefarious business practices at a time when our country and its citizens are arguably at their most vulnerable. We're offended by how egregious this appears, not only as investors, but as Americans.

On April 13th, SCWorx (NASDAQ:WORX), a nanocap company that lists its headquarters at a Regus Rental Office on the 21st Floor of 590 Madison Ave., [1] took the market by storm.

That day, the company announced the first installment of an order for up to 48 million COVID-19 tests from an Australian manufacturer. Per the announcement, the deal represented $35 million in orders per week, for a potential total deal size of $840 million.

It was undoubtedly a monumental announcement for a company with a market cap of just $16 million at the time. The sheer size of the previously unannounced order had the potential to single-handedly alter the course of the ongoing national fight against the novel coronavirus.

The company's stock skyrocketed on the announcement. The day before the announcement, shares of the relatively sleepy company had closed at $2.25 per share and had traded a total of just 21,400 shares.

On the day of the announcement, shares closed at $12.02, an increase of 434%, on 96,182,900 shares of volume, making it one of the most actively traded names on the NASDAQ.

The original announcement stated that the company would be receiving a go-forward provision for up to 2 million units per week. A subsequent 8-K filed yesterday provided additional detail, stating that the company would be paying a unit price of $13 per test, and would be required to pay 50% down and 50% due on completion of each order (amounting to an up-front payment of $13 million for the first week of units).

This sum may have come as a surprise to investors – it certainly did to us – given that as of its latest financials, the company only reported tangible assets of $2.6 million [ Pg. 3] and a history of consistent net losses. [ Pg. 5]

Beyond the seeming inability to actually *fund* such a massive deal, SCWorx's business (up until the COVID-19 pandemic, apparently) was in developing healthcare management software , not medical products themselves.

Other surprises that may lie in store for investors are the numerous red flags we found that lead us to believe this announcement is completely bogus. Namely, our findings that:

- SCWorx's CEO was convicted of felony tax evasion and sued over allegations of fraudulently submitting expense reports in the past.
- The company SCWorx is claiming to buy the tests from, Promedical, was recently denounced by a legitimate Covid-19 test manufacturer as "fraudulently misrepresenting" themselves as sellers of their product.
- Promedical's CEO is a convicted rapist and has been accused in a media exposé of defrauding investors at his previous business.
- The purported purchaser of tests that SCWorx has lined up is a virtual health company that was started less than 2 years ago by a 25-year-old recent college graduate. Given that the purchaser is a virtual health company, and the tests must be administered in real life, the fit seems less than ideal.

## *SCWorx's CEO Has A Checkered Past That Includes Felony Tax Evasion And Allegations Of Submitting Fraudulent Expense Reports*

Marc Schessel serves as both CEO and interim CFO of SCWorx. (The company's earlier CFO was terminated in October and was paid cash and shares as part of a settlement agreement .)

Schessel has a checkered history. A lawsuit by a former employer detailed how Schessel pled guilty to felony tax evasion in 2003. That conviction was described as having been the result of failing to pay income taxes on illicit proceeds from a bribery scheme that led to the indictment of two other individuals.

Previously, another former employer sued Schessel for submitting fraudulent expense reports, which resulted in a judgement against him.

# *SCWorx Says They're Buying Tests From Promedical.*

# *Promedical's Name Mysteriously Disappeared From FDA Test Provider Lists In The U.S. And Australia After Falsely Claiming To Work With Wondfo, A Large Chinese Manufacturer.*

The supplier for SCWorx has a mysterious history when it comes to coronavirus testing kits in the U.S. and Australia.

The 8-K filed on Thursday after hours by SCWorx identified the manufacturer of its test kits as Australia-based Promedical:

> *"On April 10, 2020, concurrently with its acceptance of the Purchase Order, the Company entered into a Supply Agreement ("Supply Agreement") **with romedical Equipment ty Ltd.** ("Supplier") pursuant to which the Company agreed to purchase and the Supplier agreed to supply an aggregate of 52 million COVID-19 Rapid Testing Units over a six month period…"*

In late March, Promedical's name appeared multiple lists showing current COVID-19 diagnostic devices listed with the FDA ( 1,2,3). In each instance it claimed to be offering tests made by Wondfo, a large, well-known biotech company.

See one example below originally posted on a microbiology site:

Nantong Diagnos Biotechnology Co., Ltd. (2019-nCoV) New coronavirus Antibody Test (Colloidal Gold)
Nirmidas Biotech, Inc. COVID-19 (SARS-CoV-2) IgM/IgG Antibody Detection Kit
PCL Inc. COVID19 IgG/IgM Rapid Gold
Phamatech Inc. COVID19 IgG/IgM Rapid Test
Promedical COVID-19 Rapid Test {Wondfo SARS-CoV-2 Antibody Test (Lateral Flow Method)}
RayBiotech, Inc. Novel Coronavirus (SARS-CoV-2) IgG Antibody Detection Kit (Colloidal Gold Method)
RayBiotech, Inc. Novel Coronavirus (SARS-CoV-2) IgM Antibody Detection Kit (Colloidal Gold Method)
Safecare Biotech (Hangzhou) Co., Ltd SAFECARE COVID-19 IgG/IgM Rapid Test Device

But, as of 4/16/2020, it is not listed on the FDA's list of test providers permitted under an Emergency Use Authorization nor permitted by its more general standards .

A similar phenomenon seems to have also taken place in Promedical's native Australia. In a March 23 article on MILNZ.co.nz that listed COVID-19 diagnostic tests for legal supply in Australia, Wondfo's test is again listed under "Name of Test" with Promedical as the "Australian Sponsor".

| | | | | | |
|---|---|---|---|---|---|
| Wondfo SARS-CoV-2 Antibody Test (Lateral Flow Method | POCT | Lateral Flow IgG/IgM | Promedical Equipment Pty Ltd | Guangzhou Wondfo Biotech Co Ltd (China) | 20 March 2020 |

But again – just like in the U.S. – when we check the updated list on the official Australia Department of Health website, we find that **romedical has mysteriously disappeared** and that Wondfo's name now appears next to two totally different Australian sponsors:

| | | | | | |
|---|---|---|---|---|---|
| SARS-CoV-2 Antibody Test (Lateral Flow Method) | POCT | Lateral Flow IgG/IgM | Advangen International Pty Ltd | Guangzhou Wondfo Biotech Co Ltd (China) | 25 March 2020 |
| SARS-CoV-2 Antibody Test (Lateral Flow Method) | POCT | Lateral Flow IgG/IgM | Tayler Dental Consulting Pty Ltd | Guangzhou Wondfo Biotech Co Ltd (China) | 9 April 2020 |

We called the Therapeutic Goods Administration ("TGA") in Australia (similar to the U.S. FDA) and they told us that Promedical requested to have its name removed from the list, which is why they are no longer on it.

We contacted the FDA who wrote back, somewhat vaguely:

> *"While I cannot speak to details of this specific case, we've been notified by several organizations that were not the original manufacturers."*

What could have prompted these mysterious disappearances and the request for removal?

## *The Mystery Solved: Wondfo Publicly and Strongly Disavowed Any Relationship with Promedical, Stating It "Fraudulently Misrepresented Itself"*

Wondfo seemingly solved the mystery of Promedical disappearing off the U.S. and Australian FDA sites when it publicly disavowed Promedical as misusing its name, via an official press release.

On April 5, 2020, Wondfo issued an official statement distancing themselves from Promedical:

> ***We hereby clarify that now romedical Equipment ty Ltd is N T an authorized representative nor distributor of in Australia, America, and any other countries districts*** *We recommend purchasing products only from authorized distributors or dealers, which will increase the likelihood that you will receive authentic products. is not responsible for any product complaints arising from products purchased from Promedical Equipment Pty Ltd."*

Additionally, Google's cache shows an earlier statement, where Wondfo publicly said that Promedical was "fraudulently misrepresenting" itself as being authorized by Wondfo to distribute its products:

**OFFICIAL STATEMENT**

Posted on: April 5, 2020
Posted in: Uncategorized

We have seen an infringement activity in connection with a company named Promedical Equipment Pty Ltd. fraudulently misrepresents itself as being authorized by Guangzhou Wondfo Biotech Co., Ltd. to register and distribute Wondfo SARS-CoV-2 Antibody Test (Lateral Flow Method).

We hereby clarify that Promedical Equipment Pty Ltd is NOT an authorized representative nor distributor of Wondfo in Australia, America, and any other countries/districts.

We recommend purchasing Wondfo products only from Wondfo authorized distributors or dealers, which will increase the likelihood that you will receive authentic Wondfo products. Wondfo is not responsible for any product complaints arising from products purchased from Promedical Equipment Pty Ltd.

And a cached version of the statement still comes up when you Google the above text (as of 4/16/2020):

Official Statement - Wondfo
https://wondfousa.com › official-statement
Apr 5, 2020 - **We have seen** an **infringement activity** in **connection** with a **company named Promedical Equipment Pty** Ltd. fraudulently misrepresents itself as ...

Uncategorized Archives - Wondfo
wondfousa.com › category › uncategorized
Apr 5, 2020 - **We have seen** an **infringement activity** in **connection** with a **company named Promedical Equipment Pty** Ltd. fraudulently misrepresents itself as ...

Promedical then issued a statement on April 8, 2020 claiming that Wondfo had previously authorized them to sell their kits, but that they are no longer selling or marketing them:

> *"On the 7th of March 2020 Wondfo authorized Promedical to sell their Rapid Test Kits in Australia and North America. However, as of the 3rd April 2020, Promedical will no longer be selling or marketing any Wondfo products. We have recalled all marketing material related to Wondfo created by Promedical as it is no longer valid."*

We called Wondfo on April 15, 2020 to try and understand what relationship it had with Promedical in the past, if any. We asked if the company used to have a relationship with Promedical and we were told by a Wondfo representative:

> *"As far as I know we never had any deal in place with Promedical Equipment," we were told.*

We asked the person to double check, so they put us on hold for two minutes. When they came back, they confirmed:

> ***"We've never had any kind of relationship with them at all. Ever.***

We reached out to SCWorx to discuss this and other issues but the representative repeatedly insisted that he could not provide any information beyond the company press releases.

## *Another Wondfo Seller Told Us That Promedical's Test Offering Was A Fake: "This Is Very Serious and Could Have Resulted in Hundreds Of Deaths"*

We were also told by another seller of Wondfo's products that Wondfo had Promedical removed from the Australian TGA website.

We connected with Cellmid, an *actual* provider of Wondfo Covid-19 tests that had identified irregularities with Promedical's advertised test offering. The CEO of Cellmid told us:

> *"(Promedical's) website was a cut and paste from different tests and then posted pictures of the product."*

She explained to us that Promedical attempted to market a product different than the one originally listed with the TGA (the Australian regulator). The different product happened to be Cellmid's:

> *"The product they promoted here was not the product they listed with the TGA. They just happened to be unlucky and used our product to fake it."*

She stressed that the offering of bogus tests had the potential to put lives at risk:

> *"This is very serious and could have resulted in hundreds of deaths."*

She also explained how Promedical was able to, at least temporarily, get on the TGA website as a test provider:

> *"Promedical got the required docs from Wondfo's agent under the representation that they have a major government contract…They filed these otherwise confidential docs with the TGA"*

And they also commented on how Promedical was ultimately removed:

> *"We noted (to Wondfo) that (Promedical's) website information did not match the Wondfo test info. Ultimately Wondfo contacted the TGA and had Promedical removed from the list."*

## *Promedical's CEO Is A Convicted Rapist Who Has Been Accused of Running Another Business That Defrauded Its Investors and Customers*

Promedical is run by CEO Neran De Silva and Managing Director Cassandra Auty, who are engaged, according to media reports. The couple has a checkered history, to put it mildly.

De Silva is a convicted rapist. According to media reports and court records he had been found guilty and sentenced in the Queensland district court for sexually assaulting a woman who had been sleeping on the couch of a mutual friend's house.

At the time, De Silva and Auty managed a cryotherapy business called Cryo Australia that lured investments from prominent individuals, including Australia's Assistant Treasurer. The controversy around the rape led to a minor political scandal in the country:

The Sydney Morning Herald

**Assistant Treasurer selling stake in rapist's company**

By Sarah Danckert
October 30, 2018 — 6.34pm

A A A

Assistant Treasurer Stuart Robert says he has started a sale process for his stake in a private Gold Coast company specialising in cryotherapy after only recently discovering the co-owner of the business was a convicted rapist.

In addition to the rape controversy, the Cryo Australia business itself was accused of defrauding both its customers and investors.

A local media expose detailed how Cryo Australia accepted over a million dollars from a variety of customers and investors but then Neran "suddenly disappeared" around the time of the rape conviction. Within months the company went into liquidation.

[CLICK HERE TO WATCH VIDEO]


Cryo Au Fraud. Vendor Fails to deliver purchased equipment

*(Pictured: Neran De Silva and Cassandra Auty, then of Cryo Australia)*

De Silva had described himself as a "doctor" on his former business website, but The Guardian reported that there was no reference to him on the Australian Health Practitioner Regulation Agency's register of medical practitioners in the country. He also didn't appear in the graduate verification systems of the University of Queensland, Griffith University and Queensland University of Technology, where he had listed his medical qualifications.

We called Promedical to ask about this and other issues but the call went to a virtual answering service.

## *ReThink My Healthcare Appears to Be A Tiny, Newly Formed Operation. Should We ReThink Them as A Multi-*

# *Million Dollar Customer of SCWorx?*

We also looked into the customer that would purportedly be buying tests from SCWorx, a company called Rethink My Healthcare.

Rethink My Healthcare was founded in August 2018 by Connor Gallic, a then 25-year-old who didn't have health insurance and wanted to start his own company to solve the problem of low-cost mental healthcare.

*(Source: Connor Gallic Twitter Profile)*

We could find little information on the company except some articles around its founding. Connor is listed as President of the company and "Chief Healthcare Hero" on his LinkedIn page. We found only 2 employees on LinkedIn, consisting of Connor and his Chief Revenue Officer.

The company's team page on its website lists 6 people, including the 3 executive team members and 3 consultants/advisors.

ReThink charges $60 per month for "virtual healthcare" focused on mental health issues and also offers one-time virtual doctors visits for $24.99.

The front page of Rethinkmyhealthcare.com boasts that Covid-19 rapid tests are now available for pre-order and, when the link is clicked through, it redirects a site where it says tests will be sold for $40:

## Pre-Order Today

### Pricing

Each Box contains 25 tests units.

Each test unit is $40.

Minimum order is 250 Test Units or 5 Boxes ($5,000)

Half the order must be paid upfront and rest will be billed when shipments go out.

The first shipments will ship in approximately two weeks.


*Units Displayed per Box is for Illustration Purposes Only*

(Source: ReThinkMyHealthcare.com )

While there are no publicly available financials for ReThink, we find it difficult to believe that the relatively unknown company – founded less than 2 years ago and offering $60 per month virtual doctors visits – is going to be able to come up with upwards of the $35 million per week it has committed to purchasing from SCWorx.

Further, we can't figure out what the synergies are between a *virtual* healthcare company offering a test that needs to be *physically* administered to people. ReThink's website also notes that you must be a medical or law enforcement professional to purchase a test, narrowing the funnel of those who can place orders from the company.

**Verification**

To place an order we must verify you are a medical or law enforcement professional.

For Medical Professionals please use the ordering form below this will validate your NPI number and you will be sent a secure checkout link.

If you are a law enforcement professional please email us or call us at (888) 226-9658

## *Conclusion: This Strikes Us as an Obvious Scam. Price Target: $2.25 Or Less*

Regulators like the DOJ and SEC have recently disclosed that they are specifically looking into business practices that take advantage of people during this time of crisis for our nation. We can't help but wonder if SCWorx will wind up on the desk of one of those agencies. Certainly, we believe that this deal – and especially any ensuing stock sales that may take place – need to be carefully examined.

*Obviously*, given the information we've disclosed in this report, we believe the Covid-19 hype surrounding SCWorx is completely bogus and we predict shares will soon return to the $2.25 price level they were at prior to the hype.

We also think shares could ultimately move far lower than $2.25 if/when regulators look into the company's potentially nefarious business practices at a time when our country and its citizens are arguably at their most vulnerable.

## *Disclosure: We are short shares of SCWorx (NASDAQ:WORX)*

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[1] We reached building security on 4/16/2020 at 212-888-5900 who told us the entire floor belonged to Regus, which had "subsidiaries", which we understood to be rental tenants.

# TAB 16

# Predictive's COVID-19 Test Announcement Looks Like A Last-Ditch Sham To Salvage A Company On The Brink Of Insolvency

Published on March 27, 2020



*Summary: (PINK:PRED)*

- Two days ago, Predictive announced that it was partnering with a little-known Chinese manufacturer called Jiangsu Dablood Pharmaceutical Co. Ltd. ("Dablood") to manufacture and distribute rapid tests capable of detecting COVID-19 in as little as 15-minutes.
- Contrary to Predictive's press release, which calls its partner "one of very few companies approved by the Chinese government," we found that Dablood is NOT an approved manufacturer of COVID-19 tests in China.
- Instead, multiple investigative reporters in China have exposed that Dablood's COVID-19 tests have been sold in China without medical or production licenses, which is illegal. One

reporter specifically mentioned that the conduct was suspected to be fraudulent.

- Predictive's CEO, Brad Robinson, has previously been sued over claims of non-compliant marketing of a medical product and claims of falsely stating that his product would be pitched by Dr. Oz and the Gates Foundation. Predictive's former Chairman had been charged by the SEC over allegations of issuing false press releases.
- We think this COVID-19 rapid testing stunt is the company's last attempt at salvaging itself, as Predictive's financials suggest to us that the company is months, if not weeks, away from insolvency.
- We see 100% near-term downside in shares of Predictive and expect that Predictive must continue to dilute equity through near-term stock sales in order to survive.

*Initial Disclosure: After extensive research, we have taken a short position in shares of PRED. This report represents our opinion, and we encourage every reader to do their own due diligence. Please see our full disclaimer at the bottom of the report.*

*Update 3/31/2020: After identifying that Dablood is NOT approved to offer its tests domestically in China, Predictive has nowstated that Dablood is a partner entity of Darui Biotechnology, which is a subsidiary of Da An Gene Co, an entity that is on the approved list. Predictive thestated "As such, Dablood operates under the Da An Gene Co., Ltd. license."*

*This once again appears to be false, as Dablood announcedin a letter dated the 16ththat it was planning to apply for domestic approval for its COVID-19 test kits (and thus has not been approved.)*

## *Predictive's Rapid COVID-19 Test Announcement: A Pink-Sheet Company Claims to Have Landed a Game-Changing Deal*

Two days ago, Predictive Technology Group (PINK:PRED) announced that it intends to *immediately* begin importation and distribution of a rapid 15-minute COVID-19 test branded Assurance AB.

Such an offering would be major for Predictive. The two largest lab corporations in the nation, LabCorp and Quest Diagnostics, are currently offering tests that return results in 3-5 days. An accurate 15-minute test for COVID would be a game changing development for detection and treatment of the virus that has paralyzed the world. A quick test that can be mass produced is one of the key problems being worked on collectively, around the world, to help wrangle in the COVID-19 pandemic [1,2,3].

It would also be an unexpected development. Predictive is a small, struggling provider of stem

cell products to various stem cell clinics nationwide. A switch to mass-provider of COVID-19 tests is a major and sudden business pivot.

Nonetheless, the stock ripped on the press release announcing the test, more than doubling on 15x normal volume. While the announcement was a surprise bit of "news" for followers of the company, we found it to be completely expected.

Predictive has a long, storied history of questionable deals and announcements, as we thoroughly covered in a detailed exposé last July. Among these:

1. Predictive's former long-serving Chairman /director and key backers had been alleged by the SEC and state regulators to have engaged practices ranging from issuing false press releases to boiler-room-fueled pump and dumps .
2. Predictive's CEO, Brad Robinson, has been sued over allegations of "non-compliant marketing of a medical product". Another complaint alleged that Robinson made grandiose claims about a medical product's efficacy and that it would be pitched by Dr. Oz, the Gates Foundation, and others. None of the claims ever materialized .

Beyond history, the company looks to be bordering on insolvency, providing a desperate backdrop for what we believe is nothing more than a PR stunt involving these COVID-19 tests.

As of the latest quarter-end, Predictive had only $255,502 (figure *not* in thousands) of cash compared to current liabilities of almost $10 million. [Pg. 2] It had burned $9.9 million of operating cash in the latest 6-month period and reported a net loss of $33.9 million during the same time frame.

The company appears to be on life support. To survive, it has been relying on private loans. Per the latest financials, these loans were recently converted into 12,947,833 shares of common stock. [Pg. 40]

With the COVID-19 outbreak, we suspect the company's sales of stem cells, which accounted for 99% of its revenue, have further nose-dived. [Pg. 10]

Without stock sales, we think the company would be defunct in a matter of months, if not weeks. And what better way to sell stock than with the announcement of a game-changing new COVID-19 test right during the height of a global pandemic?

Unfortunately, the company's announcement of a new coronavirus test fails to stand up to

even basic scrutiny. We think the announcement essentially amounts to a sham and we call on the company to answer the questions that we e-mailed investor relations days ago – and to provide immediate clarification to the market on its supposed COVID-19 test.

## *Predictive's Claims About Its COVID-19 Test Don't Stand Up to Basic Scrutiny*

We went through the company's announcement point-by-point and have identified glaring irregularities and what appear to be outright falsehoods.

1. **Claim**: "*To the best of Predictive's knowledge*, Dablood Pharmaceutical is one of very few companies approved by the Chinese government to co-develop and manufacture rapid antibody tests".

**Reality**: Dablood is NOT one of the companies approved by the Chinese government to offer COVID-19 tests. The official list of approved COVID-19 test providers is published by the Chinese government, was updated as of March 17th, and does not include Dablood or its affiliates. *(Update 3/31: Predictive now claims that Dablood is partnered with a company that is owned by a subsidiary of an entity that is approved. Per our update above, this still does NOT mean that Dablood or its test kit is approved.)*

The use of the language "*to the best of Predictive's knowledge*" in relation to the approval strikes us as disingenuous. This was an easily confirmable fact that took us minutes to find.

Dablood was issued a permit in November 2019 from the Jiangsu provincial government to develop "reagents for enzyme detection" but is NOT licensed for COVID-19 testing.

Additionally, various reports [1, 2] in Chinese media suggested that Dablood's test was in line to be fast tracked for approval back in February. But, to our knowledge, no such approval has taken place.

On the contrary, multiple investigative reporters in China have exposed that the Dablood COVID-19 test kits have been sold without licensing or permitting, a practice that is illegal in China. (1, 2)

On March 16th, an investigative reporter found that the 15-minute at-home COVID-19 test kits from Dablood (i.e. "Darbo Pharmaceutical") had been sold without a proper medical device registration certificate.


(*Left*: Dablood logo from instructional testing video online. *Right*: Logo from the used in several exposé articles in Chinese media.)

Several days later on March 19th, another investigative reporter corroborated those findings, and confirmed that the Dablood tests were being sold through various online merchants without a medical device registration certificate and without a production license number. The reporter made it clear that those irregularities constituted clear signs of fraud.

We called Dablood during working hours at the number on its contact page to ask about the status of its approval, but the line gave a busy signal each time (we called about 8 times). We also emailed the company but have not heard back as of this writing.

2. **Claim**: "The Company cautions that if the federal government decides to restrict adequate reimbursement or the foreign import of products manufactured in Asia, the Company will not be able to provide access to these tests in the U.S."

**Reality**: This disclosure was the last line of Predictive's press release. What it means (and what retail investors buying into the stock seem to have ignored) is that *Predictive has no specific approval from requisite U.S. authorities to provide this test*

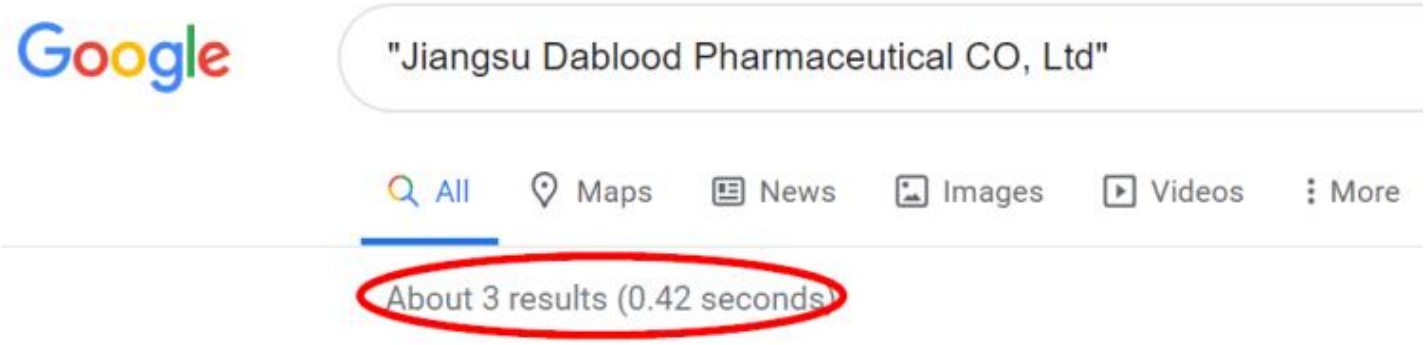
As of today, the FDA has issued 17 Emergency Use Authorizations to companies offering COVID-19 tests, and Predictive isn't one of them. The FDA has not yet approved any foreign provider of COVID tests as of March 22nd, which obviously includes Dablood.

3. **Claim:** "Dablood Pharmaceutical is one of the largest diagnostic kit manufacturers in China and is currently producing up to 1.5 million units of the rapid antibody test per day in China."

**Reality:** Dablood (Chinese name: 江苏 有限公司) is a relatively young company. Chinese

registration data shows that the company was incorporated in 2017 and has fewer than 50 employees.

A basic Google search of the company's English name shows a grand total of 3 results, all relating to the Predictive press release. We believe this is hardly a sign that the company has a sprawling U.S. (or even international) presence.




As to the claim of "currently producing" 1.5 million tests per a day, a February 6th Chinese-language article on Dablood's coronavirus test operations stated that "The production line was upgraded on January 31, with an average daily output of 20,000 units."

Going from 20,000 to 1.5 million in a month strikes us tremendously unlikely, especially since the test apparently hasn't been approved domestically and the company only announced plans to launch its test internationally 3 days ago.

4. **Claim:** "Dablood Pharmaceutical has been recognized by the Chinese government for its effort of developing and producing testing products to help the detect the COVID-19 and has received approval for distribution of its test across the domestic Chinese market"

**Reality:** This claim appears to be outright false, per the official Chinese government list of approved COVID-19 test providers.

5. **Claim:** Brad Robinson, CEO of Predictive, was quoted in the company's press release as saying: "Domestic and international governmental agencies, healthcare groups, pharmacies and employers have shown a strong interest in our test."

**Reality:** We had a hard time believing that international agencies, healthcare groups, pharmacies and employers had already shown a "strong interest" in the COVID-19 test that Predictive first announced that same morning.

We emailed Predictive's investor relations and asked them to substantiate that claim and name a single agency, healthcare group, pharmacy or employer that had shown interest in the test and to detail what that interest consisted of.

Predictive's response so far: **Silence**

6. **Claim:** "Company has notified the U.S. Food and Drug Administration of its intent to immediately distribute the validated [COVID-19] test to laboratories and healthcare workers at the point-of-care in the U.S."

**Reality:** Virtually all of the company's revenue to date has been derived from selling stem cell products manufactured in its Utah lab. [Pg. 8] Predictive has then sold those products to its network of various stem cell clinics across the U.S. This distribution network is wholly different than the laboratories and healthcare workers it would need in order to successfully distribute a COVID-19 test.

We asked investor relations about this need for an entirely different distribution network in order to successfully provide this test. Their answer, once again, has been **silence**.

7. **Where are the basic details** Beyond the above, we asked Predictive's investor relations for basic details on its partnership with Dablood. We asked if there was a signed agreement, what the terms of such an agreement were, how many tests had been manufactured to date and whether any had been delivered to Predictive.

Once again, our questions have been met with total **silence**.

## *We Wrote Extensively About Predictive Last Summer. We Are Updating Our Conclusion From 95% Downside to Near-Term 100% Downside*

We wrote extensively about Predictive in July 2019, when the stock was trading at a market cap of around $1 billion.

At the time, we called Predictive "a company displaying hallmarks of insider self-dealing that also seems to be taking advantage of vulnerable pregnant women and elderly patients suffering from chronic pain".

With the stock at $3.40, we said we thought the stock could have 95% downside ($0.17 or less). We now think the company has near-term 100% downside. Predictive continues to strike us as a terrible investment opportunity given the slew major red flags and signs of insider self-dealing we've uncovered – the latest red flag being the company's convenient pivot into COVID-19 testing during the height of the global pandemic.

We believe that should the company narrowly avoid insolvency, it will do so by continuing to dilute its equity, which will continue to put downward pressure on the company's stock. The dilution risk, combined with a rapidly declining stem cell business (that the FDA has been more aggressively curtailing ), continues to make Predictive an "avoid at all costs" type of investment.

*Disclosure: We are short shares of Predictive (PINK:PRED)*

## *Legal Disclaimer*

# TAB 17

# HF Foods: 90% Downside on Massive Undisclosed Related-Party Transactions, Shareholder Cash Spent on Exotic Supercars & Outrageous Fundamental Valuation

Published on March 23, 2020



*Summary* : ***(NASDAQ:HFFG)***

- HF Foods Group ("HF") is the third SPAC merger orchestrated by Atlantic Acquisition, the sponsor of 2 other infamous public company debacles. First, Wins Finance, whose shares rocketed on allegedly manipulating its FTSE/Russell index qualification criteria, then plunged once ejected from the indices. Second, iFresh, which is down ~95% since its merger amidst a slew of related-party transactions that have sucked shareholder cash out of the business. We think HF Foods is a combination of the worst parts of both Wins

and iFresh.

- HF's massive $509 million merger with food distributor B&R appears to be a blatant undisclosed related-party transaction. The company claimed that the deal was negotiated at "arm's length", but we found multiple documents showing that both HF and B&R were part of the same Chinese investment group for years prior to the acquisition.
- HF has transacted with at least 43 separate related-party entities in 2019 alone. Several are based out of the company's own headquarters and appear to have no operations. We visited others across the country and found red flags suggesting that these related parties are being used by insiders to extract cash from the business.
- We discovered that the company's trucking subsidiary, ostensibly set up to transport food products, appears to have also used shareholder cash to purchase an undisclosed fleet of exotic supercars including Ferraris, Porsches, and a Bentley. We found photos of the Chairman's teenage son bragging on Instagram about them being *his* vehicles.
- HF also directed over $2 million of shareholder cash to business entities owned by the Chairman's teenage son, including one that bought *another* fleet of 7 Ferraris with vanity plates such as "FUCKAH0E", "RUSINGLE", "IPULL", "DIKTAT0R", and "IMHUMBLE". (And yes, we have photos.)
- We think HF's auditor has been asleep at the wheel. It was recently subpoenaed by the SEC for its work on iFresh (another Atlantic Acquisition SPAC mentioned above), and was lambasted in its recent Public Company Accounting Oversight Board (PCAOB) inspection report for a multitude of audit failures.
- The B&R merger more than doubled HF's share count. However, FTSE/Russell mistakenly included almost all of these shares as part of the company's free float, which sent HFFG's price and volume soaring on Friday's index rebalancing. We think this mistake may be reversed.
- We believe HF and its insiders are masking the true number of shares held by its affiliates. Once made clear to FTSE/Russell, we expect the recent forced index buying in HF will reverse and become forced selling.
- We see 90% downside for HF's shares based on outrageously priced fundamentals, insider deals that appear to be hollowing out the company, and potential forced selling by FTSE/Russell.

*Initial Disclosure: After extensive research, we have taken a short position in shares of HFFG. This report represents our opinion, and we encourage every reader to do their own due diligence. Please see our full disclaimer at the bottom of the report.*

## *Basics on the Company*

On Friday, a relatively unfollowed company called HF Foods Group Inc (NASDAQ:HFFG) ("HF" or "HF Foods") surged almost 40% mid-day on no news. The stock traded over 1.8 million shares of volume on the day, more than 30 times its 60-day average volume. Investors who track the company might have wondered: "What on earth was that?"

We have been working on this report for months and had predicted that Friday would be the specific day when HFFG's shares would surge. In fact, we specifically waited until after Friday's surge before releasing our report. In our report, we provide a thorough explanation for this movement and why we believe it could help contribute to shares plunging well below recent levels.

HF Foods is one of the largest food distributors to Chinese restaurants in the United States. The company supplies over 10,000 Asian restaurants across 21 states, and has two segments: (1) sales to independent restaurants and (2) sales to wholesalers. [ Pg. 3]

The company was founded in 1997 by a husband and wife team, Zhou Min Ni (who is currently Chairman/Co-CEO ) and his wife, Chan Sin Wong (who formerly served as President and Director ).

HF Foods went public via SPAC on August 23, 2018. The stock has since been volatile, particularly around Russell index rebalancing periods (more on this later).

In November 2019, HF Foods merged with B&R Global Holdings, a large West Coast-based Chinese food distributor, in a $509 million two-part deal. The acquisition provided HF Foods more scale, taking its annual revenue from over $300 million in 2019 [ Pg. 30] to a combined $828 million. At present, the company discloses ownership of 14 distribution centers located across the East and West Coasts and a fleet of over 340 refrigerated vehicles. [ Pg. 3]

## *Introduction: Dozens of Related-Party Transactions, Failure to Disclose Its $509 Million Mega-Merger was a Related-Party Deal, an Undisclosed Fleet of Supercars and Major Red Flags Around Its SPAC Sponsor and Auditor*

Our research on HF, spanning several months, leads us to believe that the company's insiders are looting the place. We found that the massive $509 million merger with B&R appears to be an undisclosed related-party transaction. Additionally, our report raises red flags relating to transactions with more than 40 additional related-party entities, the company's apparent use of shareholder cash to purchase a fleet of exotic supercars, the track record of the company's SPAC sponsor, and regulatory questions about the company's auditor, who was recently subpoenaed by the SEC and lambasted by the Public Company Accounting Oversight Board (PCAOB).

## *Background: HFFG Has 60% -80% Fundamental Downside*

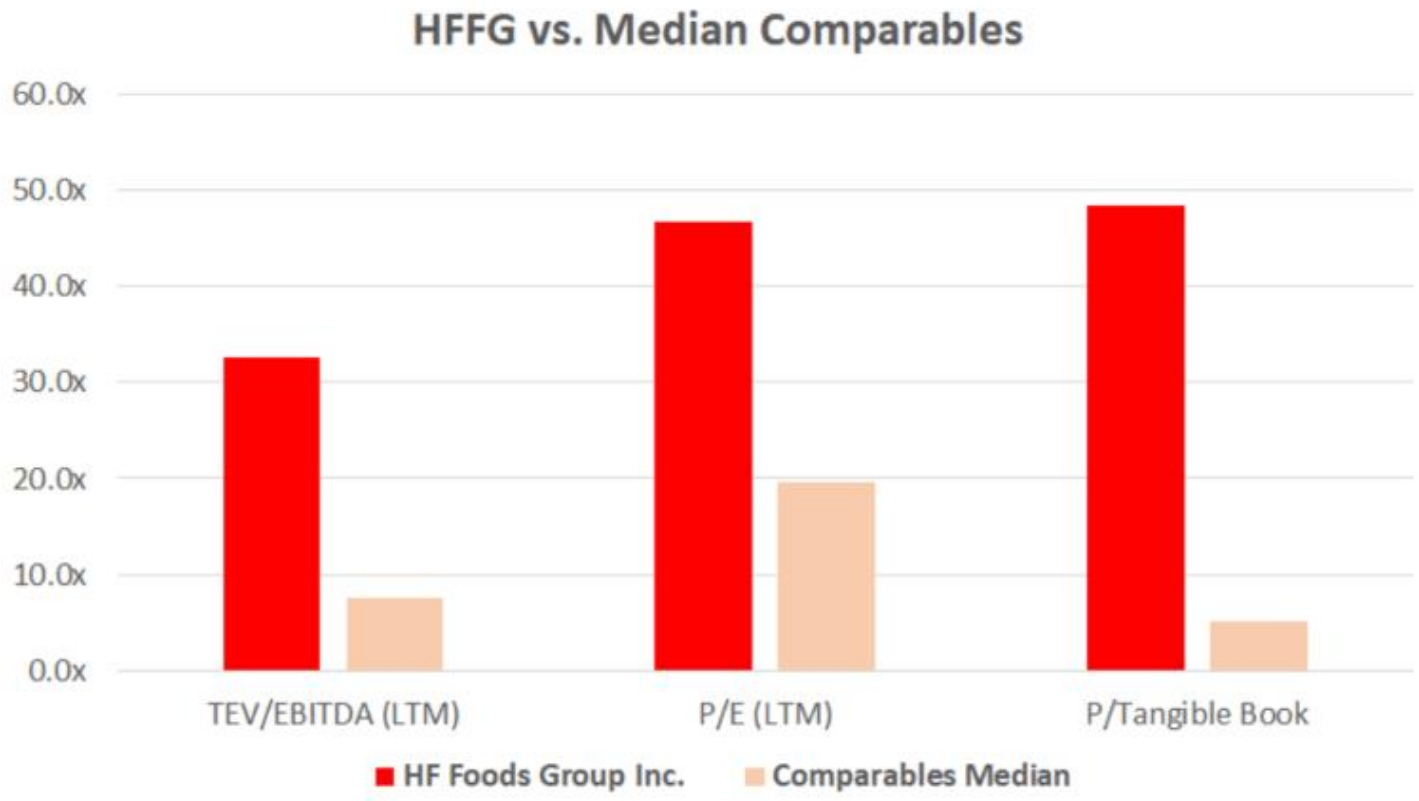
## *Before We Even Examine Its Most Alarming Issues*

HF currently trades at a market cap of roughly $642 million [1] and a total enterprise value of $765 million.[2]

The company's revenue growth appears to be stagnating while recent profitability has declined precipitously. Its 2019 pro-forma combined revenue was $828 million, representing year-over-year growth of only 1.2% relative to its 2018 pro-forma revenue of $818 million [Pg. 34]. This includes its recent acquisition of B&R. Over the same period, pro-forma net income plunged 64%, declining to $5.6 million in 2019 from $15.7 million in 2018. [Pg. 34]

We expect net income to further decline given (a) plunging margins, which we explain further below and (b) the slowdown caused by COVID-19, which has hurt all restaurants, but has disproportionately affected Chinese and Asian restaurants. [1,2,3]

We compared the company to Sysco, United Natural Foods and Core-Mark, three of its closest peers, and found that HF is egregiously overvalued relative to its peer group across key metrics:




(Source: Capital IQ)

When comparing HF's key financial metrics to peers we see *fundamental downside alone* of between 58% and 80%.

| Company | TEV/Sales LTM | TEV/EBITDA LTM | TEV/EBIT LTM | P/E LTM |
|---|---|---|---|---|
| | | | | |
| Sysco Corp. (SYY) | 0.4x | 7.7x | 10.0x | 10.0x |
| United Natural (UNFI) | 0.2x | 7.3x | 25.3x | n/a |
| Core-Mark (CORE) | 0.1x | 7.6x | 18.6x | 19.6x |
| | | | | |
| ***HF Foods (HFFG)*** | ***1.5x*** | ***32.7x*** | ***62.9x*** | ***46.8x*** |
| *Comparables Median* | *0.3x* | *7.6x* | *22x* | *19.6x* |
| | | | | |
| ***Potential Downside*** | ***80%*** | ***77%*** | ***65%*** | ***58%*** |

(Source: Capital IQ)

When we combine our fundamental analysis with what we believe to be other red flags outlined below, we see 90% downside from these levels and believe the company to be completely uninvestable.

## *The Sponsor of HF Foods' Go-Public Transaction Sponsored Two Other Public Company Debacles That Crumbled After, Respectively, (a) Undertaking Numerous Related-Party Transactions, and (b) Allegedly Gaming its FTSE/Russell Index Inclusion Criteria.*

### We Think H is ollowing a Similar laybook, Which Will Result in The Same utcome

We think HF Foods is (a) being hollowed out through related-party transactions designed to enrich insiders while (b) gaming its FTSE/Russell index inclusion criteria to drive irregular passive index buying into its stock. These practices are **very** similar to what ultimately devastated shares of Wins Finance and iFresh, the two above-mentioned companies also sponsored by the backers of HF Foods' SPAC merger.

The HF Foods go-public SPAC deal was sponsored by Atlantic Acquisition Management, whose two prior SPAC transactions resulted in infamous drubbings for shareholders:

1. **Wins inance Holdings** (NASDAQ:WINS). This China-based lending services company reverse-merged with an Atlantic Acquisition SPAC in October 2015, subsequently soaring over 4,500% to a market cap of $9 billion in a move largely driven by passive index buying from the FTSE/Russell indices.

At the time, multiple reporters (1,2,3,4,5) noted the irregular trading, including this example:

**The Ultimate Pump And Dump? Wins Finance Up $100 Per Share**

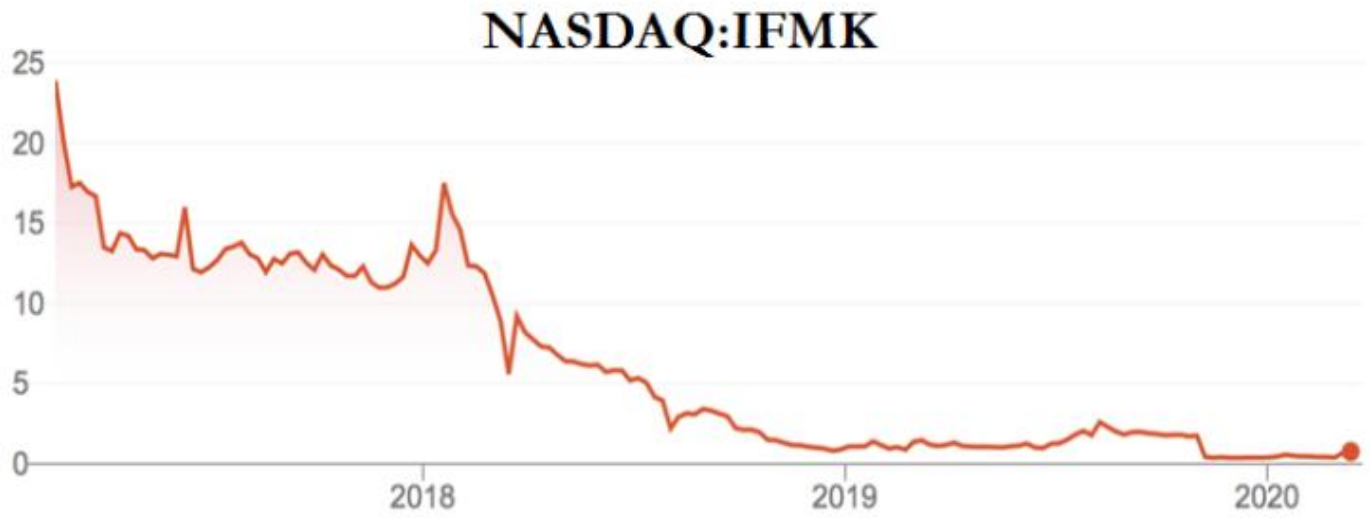
Wayne Duggan, Benzinga Staff Writer | | FOLLOW+
February 02, 2017 2:52pm | 1 min read | Comments

Wins fraudulently claimed to own a U.S. office in order to qualify for FTSE/Russell index inclusion, according to a lawsuit filed in 2017 (Wins settled the complaint in 2018). The stock spiked on the inclusion, but FTSE/Russell ultimately removed WINS from its indices. Its shares were halted for 6 months and then crashed spectacularly.

The company is currently late to file its annual report due to an $83 million dollar loan issued to an opaque Chinese entity that the company is no longer certain it can collect.


2. **i resh Holdings** (NASDAQ:IFMK). This Asian/Chinese food distribution and grocery company was laden with related-party transactions, including acquisitions [Pg. 12], since its go-public SPAC transaction in February 2017. [Pg. 109] At present, in addition to defaulting on its credit agreement [Pg. 44] and having been subject to an IRS tax lien [Pg. 43], the company's balance sheet remains significantly indebted to related parties. [Pg. 1]

The company is currently fighting a NASDAQ delisting . As of just weeks ago, iFresh announced that both it and its auditor, Friedman LLC, are being subpoenaed by the SEC. **riedman LLC is also the auditor for H oods.** iFresh has traded down ~95% since going public.




## *HF Foods' Massive $509 Million Merger with B&R Appears To Be Just One of Dozens of Suspicious Related-Party Transactions*

Our review of HF Foods uncovered a staggering number of related-party transactions, both disclosed and undisclosed, that we believe are suspicious.

These transactions include HF's $509 million merger with B&R, which we believe is a clear and massive undisclosed related-party transaction. We also found other undisclosed dealings, including a loan to an undisclosed related entity and a fleet of Ferraris and exotic luxury supercars owned by an HF Foods subsidiary.

In addition to undisclosed related-party transactions, the company has also conducted dozens of irregular *disclosed* related-party transactions.

In total, the company transacted with **3 related-party entities** in 2019 alone. [Pg 104–105, Pg. 109] In 2019, HF Foods reported over $40 million in purchases and $19.3 million in sales to related-party entities. [ Pg. 67]

Our investigation uncovers related entities with (a) minimal or no online presence, (b) no signage or apparent operations at their respective registered addresses and (c) entities held out as separate companies to investors that appear to actually be operating as part of HF.

We believe insiders are using these dozens of related-party transactions to suck cash out of the business, eventually leaving shareholders with a hollow, debt-laden company.

## *Undisclosed Related-Party Transactions: HF Group Had Clear Ties to B&R Before Consummating its $509 Million "Arm's-Length" Deal, Yet None of It Was Disclosed to Shareholders*

In June 2019, HF Foods announced it would be merging with B&R Global Holdings, a West Coast food distribution company. The merger was a 2-part transaction valued at a massive $509 million. It included HF Foods issuing 30.7 million shares to former B&R shareholders, more than doubling the company's outstanding share count and adding ~$101 million in debt to the balance sheet.

According to deal documents, the acquisition process started when HF's CEO phoned B&R's CEO in October 2018. [Pg. 27] The deal documents describe the transaction as being negotiated "at arm's-length". [ Pg. 60]

Contrary to those representations, we found longstanding formal ties between HF Foods and B&R:

- HF and B&R were both under the umbrella of the same investment group, the American International Rongjin Investment Group, [3] according to an announcement by the Chinese Ministry of Commerce in 2012. [4]
- In 2012, an affiliate of the above-named entity also affirmed that HF and B&R are part of the same investment holding group.
- A May 2018 interview with the President of Fujian Rongjin Group ( 金 有限公司), Zhang Yi Tuan ( ) also affirmed the relationship. According to the interview, the American International Rongjin Investment Group's distribution business operates in the U.S. and includes both HF and B&R. According to the interview, the group uses B&R as its official American headquarters and works with HF Foods and others to jointly distribute food in the U.S.

Instead of being "at arm's length", these entities look to have been closely affiliated through the same investment group for at least 8 years, which we believe clearly makes them related-parties.

These intricate pre-existing connections represent a major conflict of interest, yet none of this was disclosed to investors prior to, or after, the merger.

# *Undisclosed Insider Enrichment: An HF Subsidiary Owns a Fleet of Ferraris and Exotic Luxury Supercars, Paid for By Shareholders.*

## *The CEO's Son Bragged About Them Being His Cars on Instagram*

In another series of highly irregular transactions, we examined the assets of Truse Trucking, a company subsidiary :

EX-21 9 ex_139226.htm EXHIBIT 21

**Exhibit 21**

**HF FOODS GROUP INC.**

**Subsidiaries**

| | Entity Name | Country of Incorporation |
|---|---|---|
| 1. | Han Feng, Inc. | North Carolina, USA |
| 2. | Truse Trucking, Inc. | North Carolina, USA |
| 3. | Morning First Delivery, Inc. | North Carolina, USA |
| 4. | R&N Holdings, LLC | North Carolina, USA |
| 5. | R&N Lexington, LLC | North Carolina, USA |
| 6. | Kirnsway Manufacturing Inc. | North Carolina, USA |
| 7. | Chinesetg, Inc. | North Carolina, USA |
| 8. | New Southern Food Distributors, Inc. | Florida, USA |
| 9. | B&B Trucking Services, Inc. | Florida, USA |
| 10. | Kirnland Food Distribution, Inc. | Georgia, USA |
| 11. | HG Realty LLC | Georgia, USA |

We performed a background check on Truse, which detailed its vehicle assets. As expected, Truse owns numerous refrigeration trucks that we presume are used to deliver raw and refrigerated food products to the company's customers. [ Example 1 , Example 2 ]

In addition to the fleet of trucks, however, our background check showed that Truse owns an undisclosed fleet of exotic luxury supercars, including Ferraris, a Bentley, a Porsche, and other high-end vehicles with vanity plates such as "RIDEIT69", "MAKNBBYZ", "UPGIRL" and "H0P0NIT".

These, we presume, are *not* used to deliver raw and refrigerated food products to the company's customers.

For example, a 2013 Bentley Continental, with an MSRP of $193,000, the license plate "99Pr0BZ" and previous license plate "BENTOVER", is titled and registered to Truse.

We could think of no business justification for just about *any* public company purchasing

Ferraris or Bentleys with shareholder money. The HF Chairman/CEO's son puts these vehicles to apparent personal use, bragging openly about his "stable" of cars on his public Instagram account (we expect he'll soon discover privacy settings). Here he showcases the "BENTOVER" Bentley, captioned with a fuckahoe hashtag:


Source Instagram


Source Instagram

A **errari, with an MSR of 319,99** and the license plate "WANTMY" is also registered to Truse Trucking, according to our background check.

We matched this Ferrari and the "WANTMY" license plate to the Chairman/CEO's son's Instagram account :


In total, we found 8 luxury supercars valued at a ~$1.5 million MSRP registered to and owned by Truse Trucking:

| Cars with titles owned by and registered to Truse Trucking | MSRP |
|---|---|
| 2015 Audi Prestige S5 | $60,150 |
| 2015 Ferrari 458 Spider | $263,553 |
| 2017 Ferrari F12 Berlinetta | $319,995 |
| 2005 Ford GT | $151,245 |
| 2003 Ferrari Modena 360 | $145,210 |
| 2016 Porsche GTS Cayenne | $95,500 |
| 2014 Ferrari 458 Speciale | $288,000 |
| 2013 Bentley Continental | $193,300 |
| **Total** | **$1,545,203** |

Nowhere do we see any of these cars disclosed as compensation. The Chairman/CEO's executive salary supposedly consisted of $400,000 in cash [ Pg. 98]:

***Compensation of Officers and Directors of HF Group***

The following table sets forth a summary of the compensation paid to or accrued by our chief executive officer and the most highly compensated executive officer other than our chief executive officer whose total compensation exceeded $100,000 for the fiscal years ended December 31, 2018 and 2017:

| Name | Year | Salary ($) | Total ($) |
|---|---|---|---|
| **Zhou Min Ni** | 2018 | 400,000 | 400,000 |
| Chairman and Chief Executive Officer | 2017 | 240,000 | 240,000 |
| **Chan Sin Wong** | 2018 | 400,000 | 400,000 |
| Director and Chief Operating Officer | 2017 | 240,000 | 240,000 |

We find these high-end exotic vehicles to be an outrageous use of shareholder capital, especially given the severe deterioration of the company's profitability.

## *HF's Disclosed Related-Party Transactions: Doing Business with At Least 43 Different Related-Party Entities*

We also think HF's insiders are drawing cash from the business through its *disclosed* related-party transactions.

HF reported transacting with a staggering **3 different related-party entities in 2019 alone**, including over $40 million in purchases and $19.3 million in sales from and to the entities [Pg. 67] [Pg. 104, Pg. 109]. Many are owned all, or in part, by the Chairman/CEO and his immediate family, as shown from the table below that lists 20 of these entities:

| # | Name of Related Party | For the six months ended June 30 2019 | For the years ended December 31, 2018 | 2017 |
|---|---|---|---|---|
| (1) | Golden Poultry, LLC | $ 3,548,693 | $ 5,641,599 | $ 7,065,901 |
| (2) | Eastern Fresh LLC | 3,442,730 | 7,140,754 | 6,486,180 |
| (3) | Fujian RongFeng Plastic Co., Ltd. | 3,066,655 | 5,350,755 | 4,644,437 |
| (4) | NC Good Taste Noodle Inc. | 2,261,864 | 3,881,433 | 4,060,177 |
| (5) | Fuzhou (Hanfeng) Information Tec. | 1,651,944 | 3,130,875 | 2,832,933 |
| (6) | Fortune One Foods Inc. | 0 | - | 1,318,459 |
| (7) | N&F Logistic, Inc. | 785,968 | 1,206,106 | 1,273,190 |
| (8) | Collegepoint Distribution, LLC | 0 | - | 1,100,100 |
| (9) | Enson Seafood GA Inc | 102,895 | 664,770 | 926,427 |
| (10) | New Day Top Trading Inc. | 0 | - | 761,020 |
| (11) | Enson Trading LLC (Eternal Food Service Inc.) | 166,056 | 415,662 | 616,639 |
| (12) | Ocean Pacific Seafood Group | 372,805 | 687,225 | 524,722 |
| (13) | Allstate Trading Company Inc. | 111,213 | 43,212 | 327,821 |
| (14 | Eagle Food Service LLC | 171,965 | 270,368 | 149,714 |
| (15) | Han Feng Global Inc. d/b/a NSG International | 0 | 119,092 | 86,092 |
| (16) | Great Wall Seafood Florida Inc. | 0 | - | 23,542 |
| (17) | UGO USA INC. | 348,523 | 710,224 | 19,151 |
| (18) | iUnited Services | 0 | - | 4,500 |
| (19) | Revolution Industry, LLC | 1,266,191 | 2,122,240 | — |
| (20) | First Choice Seafood Inc. | 951,454 | 292,514 | — |
| (21) | **TOTAL** | 18,248,957 | $ 31,676,828 | $ 32,221,005 |

(1) Mr. Zhou Min Ni owns a 40% equity interest in Golden Poultry, LLC.
(2) Mr. Zhou Min Ni owns a 30% equity interest in Eastern Fresh LLC.
(3) Mr. Zhou Min Ni is the legal representative in Fujian RongFeng Plastic Co., Ltd.
(4) Mr. Jian Ming Ni owns a 66.6% equity interest in NC Good Taste Noodle Inc.
(5) Mr. Zhou Min Ni owns a 100% equity interest in Fuzhou (Hanfeng) Information Tec.
(6) N&F Logistic, Inc., one of HF Group's related parties, owns a 70% equity interest in Fortune one Foods Inc.
(7) Mr. Zhou Min Ni owns a 25% equity interest in N&F Logistic, Inc.
(8) Mr. Zhou Min Ni owns a 33.3% equity interest in Collegepoint Distribution, LLC.
(9) Mr. Zhou Min Ni owns a 45% equity interest in Enson Seafood GA, Inc.
(10) Amanda Ni, the daughter of Mr. Zhou Min Ni, owns a 19% equity interest in New Day Top Trading Inc.
(11) Mr. Zhou Min Ni owns a 25% equity interest in Enson Trading LLC.
(12) Mr. Zhou Min Ni owns a 25% equity interest in Ocean Pacific Seafood Group.
(13) Mr. Zhou Min Ni owns a 40% equity interest in Allstate Trading Company Inc.
(14) Tina Ni, the daughter of Mr. Zhou Min Ni, owns a 50% equity interest in Eagle Food Service LLC.
(15) Mr. Zhou Min Ni owns a 30% equity interest in Han Feng Global Inc. d/b/a NSG International.
(16) Mr. Zhou Min Ni owns a 30% equity interest in Great Wall Seafood Florida Inc.
(17) Mr. Zhou Min Ni owns a 30% equity interest in UGO USA Inc.
(18) Mr. Zhou Min Ni owns a 37% equity interest in iUnited Services.
(19) Raymond Ni, the son of Mr. Zhou Min Ni, owns 100% of Revolution Automotive, LLC.
(20) Mr. Zhou Min Ni owns a 25% equity interest in First Choice Seafood Inc.

[Source – Pgs. 105-106 ]

*Major Discrepancy: Customers Are Told Some of These Entities Are Part of HF Foods, Yet Shareholders are Told The Entities Are Separate (Which Allows Insiders to Extract Cash)*

When HF Foods went public, its merger documents [ Pg 8] and investor presentation [ Pg. 20] claimed that the company owned and operated three distribution centers. It also advertised an "expansion plan" to extend its business beyond the American Southeast:


(Source: Atlantic Acquisition Management. Investor Presentation, Pg. 20 )

However, well before HF Foods went public, its customer-facing subsidiary "Han Feng Inc." already claimed to operate 20 distribution centers (see below):


Source: Han Feng Website Capture (April 2018)

This same website's Chinese-language portal has a more detailed map, showing that **H oods had already been operating distribution centers where the company told investors it planned to expand**:


Source: Han Feng China Web Capture (2016)

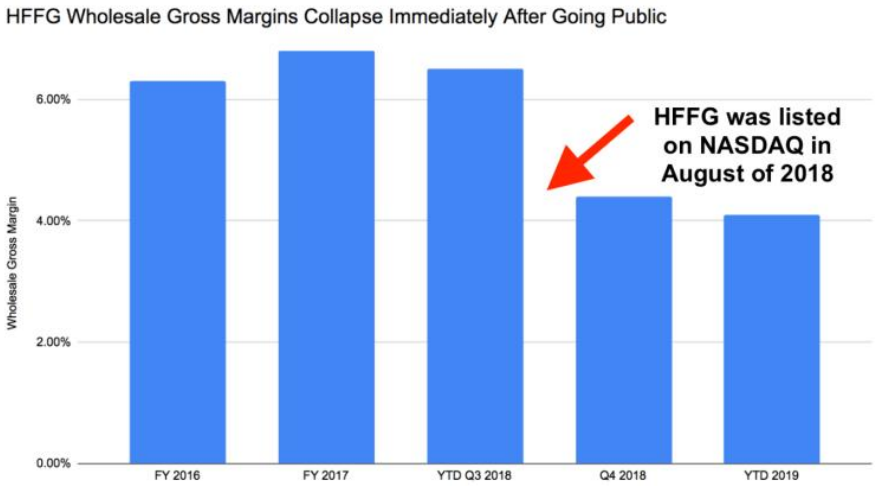
Many of the distribution centers on the Chinese-language website match the names of entities HF now claims are separate entities that insiders own equity stakes in (Fortune One Foods, N&F Logistic, Allstate Trading).

So, which is it? As we detail later, our on-site investigations of several entities showed signs that they operate as part of Han Feng. In some cases, employees on-site confirmed it for us (which we have recorded).

We believe insiders have retained this network of entities, which were not consolidated into HF Foods, in order to extract cash from HF and its shareholders.

## *HF's Disclosed Related-Party Transactions: Wholesale Margins to These Entities Collapsed Immediately After the IPO. Cash Seems to Be Slipping Out the Back Door*

HF reported a **33% collapse** in its wholesale gross margins in the quarter after it went public, by related-parties that presumably benefitted from the margin compression.




Source ( SPAC / HFFG merger , 2018 10-K and 2019 Q3 10-Q)

The company acknowledges that the margin decline was due to related-party sales, but tried to explain it away by citing volume discounts:

> *"**The decrease in margins resulted form sic increased sales to related parties relative to total wholesale revenue in 2018 as compared to 2017.** The wholesale price for related parties is generally lower than third party customers due to the larger quantities purchased by related parties." [ Pg. 30]*

This explanation is puzzling. Sales only grew ~3% year over year for the comparable 2019/2018 9-month period, so there was no surge in volume. Furthermore, the company disclosed that related parties constituted 92% of wholesale segment sales in 2017 [ Pg. 30], making it impossible for related business to have meaningfully increased. [ Pg. 32]

Our investigation of these related-party entities uncovers a different explanation for why the company's sudden wholesale margins have collapsed: **insiders appear to be looting the place**

We investigated several of these entities in detail, including on-the-ground field research on both the East and West Coast. All told, we believe these related-party transactions are largely shams designed to extract cash from the business.

# *$4 Million Of Shareholder Cash Was Used for Purchases and Advances to Revolution Industry, An Entity Based Out of HF Foods' Headquarters, Owned 100% By The Chairman/CEO's Son, That Was Formed 1 Month Prior to the IPO Deal, With No Visible Signs of an Actual Business*

HF Foods discloses transacting ~$3.3 million in purchases from, and directing over $700 thousand in advances to Revolution Industry. [Pg. 106, Pg. 21] Revolution Industry is 100% owned by the Chairman/CEO's son and claims to do business in "food processing" and "distribution" according to its North Carolina corporate filings.

We find it suspicious that HF Foods directed ~$4 million in business to the Chairman's son, who **was likely a senior in high school at the time,** according to social media posts.

Note that HF's SPAC sponsor announced the deal to take HF public in March 2018. **Revolution Industry was formed just one month earlier;** according to North Carolina corporate records.

We found no signs that Revolution Industry is an actual business—no website, no social media profile, and no evidence of it having customers.

Even more suspicious, North Carolina corporate records show that **the entity is registered to the same address as HF Foods' headquarters:** 6001 West Market Street, Greensboro North Carolina:

# LIMITED LIABILITY COMPANY ANNUAL REPORT

10/2017

NAME OF LIMITED LIABILITY COMPANY: Revolution Industry, LLC

SECRETARY OF STATE ID NUMBER: 1662309 STATE OF FORMATION: NC

REPORT FOR THE CALENDAR YEAR: 2019

Filing Office Use Only
E - Filed Annual Report
1662309
CA201909409300
4/4/2019 04:04
☐ Changes

**SECTION A: REGISTERED AGENT'S INFORMATION**

1. NAME OF REGISTERED AGENT: PURYEAR AND LINGLE, P.L.L.C.

2. SIGNATURE OF THE NEW REGISTERED AGENT:

SIGNATURE CONSTITUTES CONSENT TO THE APPOINTMENT

3. REGISTERED AGENT OFFICE STREET ADDRESS & COUNTY
5501-E Adams Farm Lane
Greensboro, NC 27407 Guilford County

4. REGISTERED AGENT OFFICE MAILING ADDRESS
5501-E Adams Farm Lane
Greensboro, NC 27407

**SECTION B: PRINCIPAL OFFICE INFORMATION**

1. DESCRIPTION OF NATURE OF BUSINESS: Food Processing, Distribution

2. PRINCIPAL OFFICE PHONE NUMBER: (336) 268-2655

3. PRINCIPAL OFFICE EMAIL: Privacy Redaction

4. PRINCIPAL OFFICE STREET ADDRESS
6001 West Market Street
Greensboro, NC 27409

5. PRINCIPAL OFFICE MAILING ADDRESS
6001 West Market Street
Greensboro, NC 27409

As shown below, this entity's address matches the address of HF Foods' headquarters :

HF Foods Group Inc.

Contact

**Address**
6001 W Market St
Greensboro, NC 27409, USA

What kind of food could HF be distributing to an entity based out of its own address? We think the only thing being distributed is money to insiders.

## *$483,000 in Loans to Revolution Automotive, Another Related-Party Entity Owned 100% by the Chairman/CEO's Son to Buy Yet More Ferraris*

## *License Plates of the Vehicles, Apparently Paid for With Shareholder Cash: "FUCKAH0E", "69PRBLMZ", "RUSINGLE", "IPULL", "DIKTAT0R", "IMHUMBLE"*

HF Foods also extended $483,000 in loans to the similarly named "Revolution Automotive" (not to be confused with the above-mentioned "Revolution Industries"). These loans were distributed around the time of the March 2018 take-public deal announcement. [ Pg. 107]

Revolution Automotive is also 100% owned by the Chairman/CEO's son, according to HF Foods' filings [Pg. 65] and is also registered to the address of HF Foods' headquarters, according to the North Carolina Secretary of State . Once again, we couldn't find any business operations by "Revolution Automotive".

The only discernible assets held by Revolution Automotive are titles to 9 Ferraris, according to our background check:

| Car | MSRP |
|---|---|
| 2019 Ferrari 288 Pista | $345,300 |
| 2019 Ferrari Portofino | $210,783 |
| 2019 Ferrari GTC 2 Lusso T | $337,830 |
| 2006 Ferrari F430 | $193,984 |
| 2007 Ferrari GTB Fiorano 599 | $254,034 |
| 2015 Ferrari Spider 458 Speciale | $245,000 |
| 2009 Ferrari Scuderia Spider 430 | $281,618 |
| 2018 Porsche GT2 RS 911 | $293,200 |
| 2018 Ferrari 812 Superfast | $335,275 |
| 2018 Ferrari 488 Spider | $280,900 |
| 2018 Porsche GT3 911 | $143,600 |
| **Total** | **$2,921,524** |

The Chairman's son boasts about this armada of Ferraris, each apparently purchased with investor cash, on his Instagram:


Source: Instagram

While the tags appeared on our title / registration background check, some have likely been revoked due to North Carolina DMV's poor taste rules. We noticed that several of these sports cars seemed to cycle through different distasteful license plate names every couple of years.

As to the loan balance owed to shareholders, the Chairman/CEO recently paid it off personally with shares of illiquid HF stock. [8-K, Pg. i]. This, in our view, allowed him to draw cash out of the business in exchange for nearly worthless paper.

## *Over $1 Million Of Shareholder Cash Has Gone to UGO USA Inc., Another Related-Party Entity Registered to HF Foods' Headquarters with Few Signs of Operations*

HF Foods has made almost $1 million of purchases over the past 2 years from UGO USA, Inc, another related-party entity based out of HF's headquarters. According to company filings, HF's Chairman/CEO owns a 30% equity interest in UGO. [Pg. 105] Jin Yan Ni, who we believe may be a relative to the Chairman (based on matching surnames), set up and manages this entity according to North Carolina corporate records.

UGO claims to be in the "wholesale" business. We see the address once again matches HF Foods' headquarters:

**BUSINESS CORPORATION ANNUAL REPORT**

10-2017

NAME OF BUSINESS CORPORATION: **UGO USA (NC) INC.**

SECRETARY OF STATE ID NUMBER: 1635158 STATE OF FORMATION: NC

Filing Office Use Only
E - Filed Annual Report
1635158
CA201827100947
9/28/2018 04:41
☐ Changes

REPORT FOR THE FISCAL YEAR END: 12/31/2017

**SECTION A: REGISTERED AGENT'S INFORMATION**

1. NAME OF REGISTERED AGENT: Ni, Jin Yan

2. SIGNATURE OF THE NEW REGISTERED AGENT:

SIGNATURE CONSTITUTES CONSENT TO THE APPOINTMENT

3. REGISTERED OFFICE STREET ADDRESS & COUNTY
6001 West Market St
Greensboro, NC 27409 Guilford County

4. REGISTERED OFFICE MAILING ADDRESS
6001 West Market St
Greensboro, NC 27409

**SECTION B: PRINCIPAL OFFICE INFORMATION**

1. DESCRIPTION OF NATURE OF BUSINESS: **WHOLESALE**

2. PRINCIPAL OFFICE PHONE NUMBER: (844) 319-0235

3. PRINCIPAL OFFICE EMAIL: Privacy Redaction

4. PRINCIPAL OFFICE STREET ADDRESS & COUNTY
6001 West Market St
Greensboro, NC 27409

5. PRINCIPAL OFFICE MAILING ADDRESS
6001 West Market St
Greensboro, NC 27409

We found little evidence that UGO is an actual operating business, though it appears it had taken steps to become one in the past. In 2016, the entity filed a trademark application for "on-line retail store services featuring Asian snacks, Asian beauty products, Asian health supplements, Asian home appliances, and Asian restaurant supplies." We were unable to locate any online store or online presence.

We also found that the company imported a total of 3,000 pounds of coconut chips in two shipments between 2016 and 2017, according to ImportGenius. These records show that the 2 shipments were imported from Thailand and directed to 99 New Hook Road in Bayonne, New Jersey, which happens to be the address of another HF Food related-party called Eastern Fresh [Pg. 107] (which we detail further below):

| CONTACT INFO | | |
|---|---|---|
| Type | Name | Address |
| CONSIGNEE | UGO USA INC. | 99 NEW HOOK ROAD STE 4 BAYONNE, NJ 07002 SHOW MAP |
| NOTIFY PARTY | UGO USA INC. | 99 NEW HOOK ROAD STE 4 BAYONNE, NJ 07002 SHOW MAP |
| SHIPPER | HESCO FOOD INDUSTRY CO., LTD. | 99 5 MOO 7, BANGNA-TRAD KM. 19, SOI RUAMJAI, BANGCHALONG, B SAMUTPRAKARN10540 THAILAND. SHOW MAP |

We called the number listed on UGO's LLC form to learn more about the business, but no one picked up.

## *$11.6 Million of Shareholder Cash Went to Eastern Fresh, An Entity HF Foods Claims is a Separate Business. Signage at the Facility Has HF's Logo, Indicating Otherwise*

Since 2017, HF has directed $11.6 million into Eastern Fresh LLC, a company that HF's Chairman/CEO owns a 30% equity interest in. [ Pg. 104] Eastern Fresh appears to be registered as "Eastern Fresh NJ LLC ", a distributor based in New Jersey.

Despite HF filings claiming that Eastern Fresh is not a subsidiary (but rather a separate related-party), its signage appears to bear the logo of HF's customer-facing subsidiary , Han Feng, Inc. [Pg. 16]

Here is Han Feng's logo from its website :


And here is Eastern Fresh's sign, clearly showing the Han Feng logo:

(Source : Google Maps )

Here is a closer look. It even says "Han Feng" underneath the logo:


Similarly, Eastern Fresh identifies with Han Feng inside its facilities, according to photos found on its Facebook page :

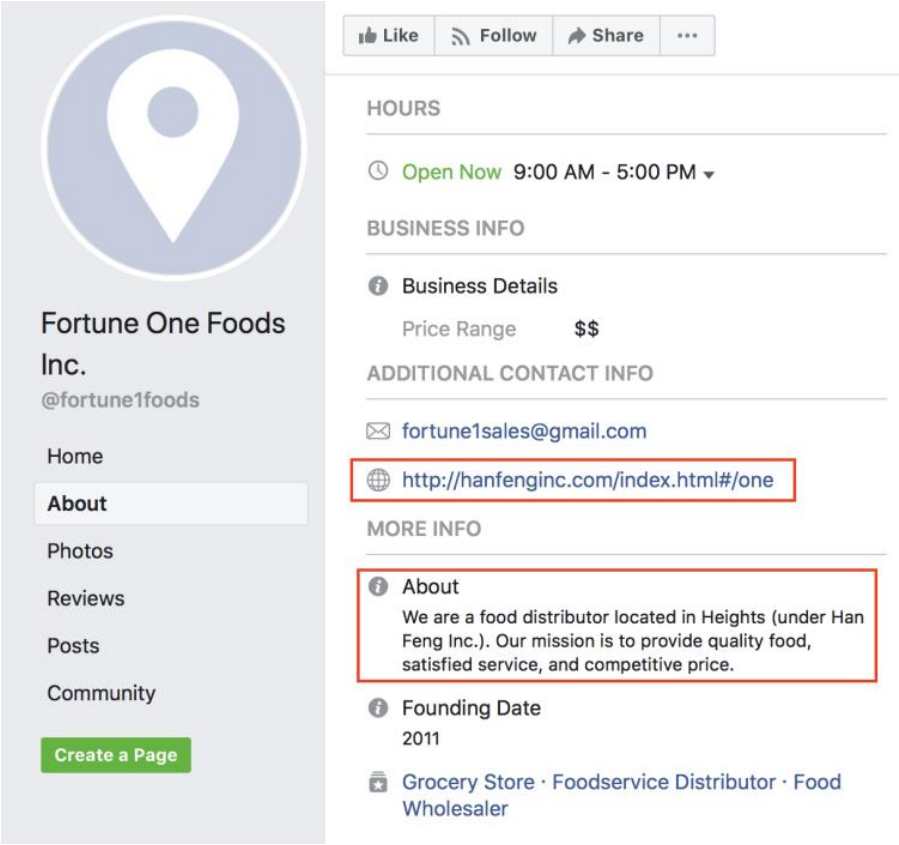

(Source: Facebook )

Again, HF appears to be presenting a unified face to customers, while separating these entities from investors. This is consistent with what we would expect if these entities are being used to funnel out shareholder cash.

## *$1.8 Million in Shareholder Cash Went to Related-Party Fortune One Foods. Once Again, HF Foods' Filings Describe it as a Separate Entity. But Fortune One Describes Itself as Being a Part of HF Foods*

HF's Chairman/CEO indirectly owns a 17.5% equity interest in Fortune One Foods Inc. [ Pg. 104] HF has made about $1.8 million in purchases from the entity, according to company filings. [ Pg. 104] Although filings claim that Fortune One is not an HF subsidiary, but instead a separate related-party entity, Fortune One appears to brand itself as if it were part of HF.

We were unable to find any website for this entity. Fortune One does have a Facebook page, however, which describes it as a distributor under Han Feng (i.e., HF), and points to the HF website:




We decided to investigate Fortune One by visiting its registered address found on its Texas corporate records .

| FORTUNE ONE FOODS INC | |
|---|---|
| Texas Taxpayer Number | 32040092085 |
| Mailing Address | 935 W 18TH ST HOUSTON, TX 77008-3336 |
| Right to Transact Business in Texas | ACTIVE |
| State of Formation | TX |
| Effective SOS Registration Date | 08/14/2009 |
| Texas SOS File Number | 0801157621 |
| Registered Agent Name | JOHNN J. LIN |
| Registered Office Street Address | 8406-B BEECHNUT STREET HOUSTON, TX 77036 |

Source : Texas Corporate Registry

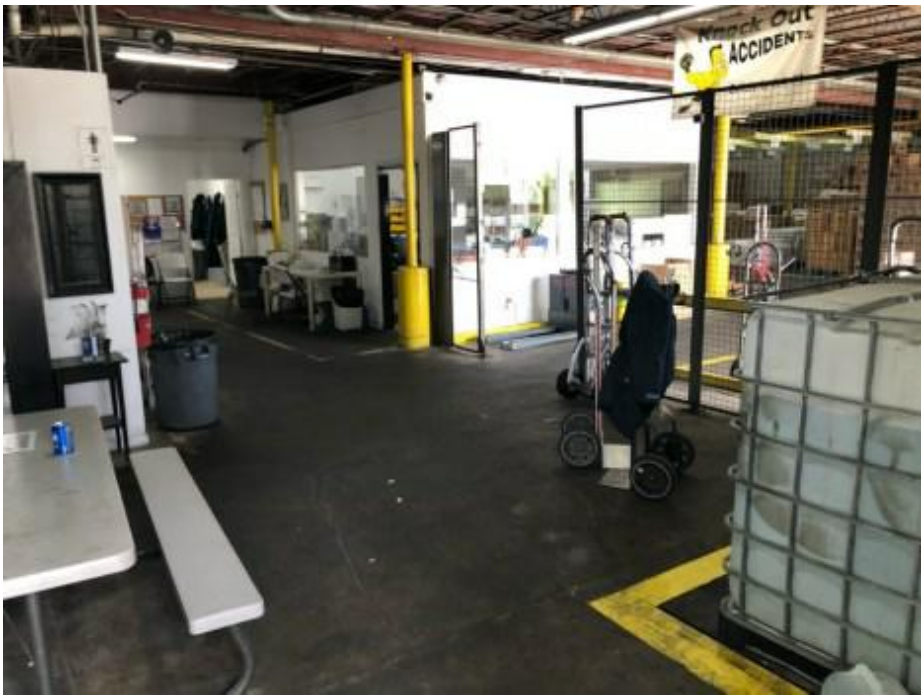
Here is the matching address at 935 W 18th Street from our visit:

(Source: Hindenburg Research onsite visit)

During our March visit, we observed a fleet of vehicles that appear to be used for delivering food, a loading bay and a warehouse – all things we would expect from a distribution business.

There was no signage indicating "Fortune One" on the inside or the outside of the facility, as far as we could tell (the neighboring business was called "Jake's"):


(Source: Hindenburg Research onsite visit)




(Source: Hindenburg Research onsite visit)

However, several trucks did bear a Fortune One logo:

(Source: Hindenburg Research onsite visit)

We sent an email to Fortune One in March to inquire as to whether it transacts with any customers other than HF Foods and why it cites HF Foods' website as its own. We have not received a response as of this writing.

We also called the number listed on its Facebook page and asked a representative point blank if it was an independent business or if it was part of Han Feng. His reply (which we have recorded) was: "Yeah we are a part of Han Feng." He also confirmed to us that Fortune One has its own fleet of trucks.

All told, we find it alarming that Fortune One describes itself as being a part of HF Foods, whereas HF Foods does not include it as a subsidiary. Instead, it reports it as a separate related-party entity, allowing insiders to personally profit from transactions with it.

## *NC Noodle, A Related-Party Owned By HF's Previous CFO, Made ~$4.2 Million In Sales To HF, But Our On-The-Ground Research Showed Its Premises To Be Largely Vacant*

HF states that the company's recently departed CFO owns a 66% equity interest in NC Noodle. [Pg. 105] Based on HF's disclosures, we estimate that NC Noodle sold ~$4.2 million to HF in 2019 alone, yet we found no customer-facing business presence online.

We paid a visit to the company's principal business address during normal working hours to try and speak with management and get an understanding of the business. Given the volume of product sold to HF during the year, we expected a sprawling operation.

Instead, we discovered what our investigator described as a "completely vacant" building except for 3 employees handling a pallet of product in an otherwise empty-looking back

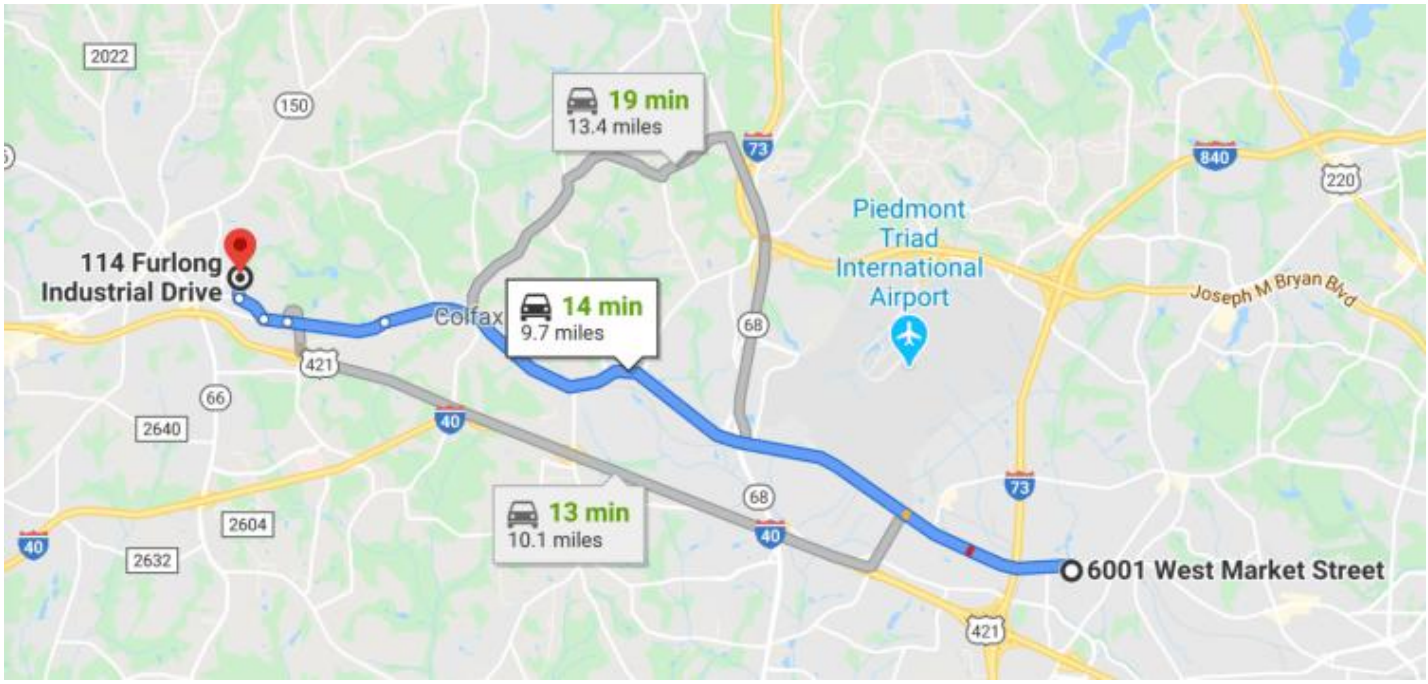
warehouse (see below):

(Source: Hindenburg Research onsite visit)

(Source: Hindenburg Research onsite visit)

Our investigator asked the employees about the business but was unable to learn anything due to a language barrier, so he left.

NC Noodle is headquartered less than 10 miles away from HF Foods' warehouse in North Carolina.




(Source: Google Maps)

We suspect this is little more than an insider-owned entity that sells product to nearby HF. We have serious doubts about whether this "middle man" provides value to anyone but HF insiders.

## *HF's Chairman Has Effectively Sold Almost 10% Of His Shares by Purchasing ~$12 Million in Loans Made by HF And Paying Them Back With His Own Illiquid Stock*

In another series of incestuous and alarming related-party transactions, HF's Chairman/CEO bought cash loans issued by HF to related and non-related parties and **paid these loans back using shares of his illiquid H stock**

The Chairman/CEO's transactions include purchasing loans originated by HF Foods to his son's "business", Revolution Automotive, along with other related parties.

According to company filings, on September 30, 2019, the Chairman/CEO delivered 1,203,803 shares to the company to purchase ~$12 million in loans issued by HF ( 8-K) to the 4 different entities listed below:

**SCHEDULE 1**
**LOANS**

| | |
|---|---|
| | **Subtotal** |
| **Feilong Trading Inc. Loan, Note dated March 1, 2019** | **$3,622,505.45** |
| | **Subtotal** |
| **Han Feng Global Inc. Loan, Note dated March 1, 2019** | **$ 6,015,603.56** |
| | **Subtotal** |
| **Enson Seafood GA Inc. Loan, Note dated March 1, 2019** | **$ 1,966,966.21** |
| | **Subtotal** |
| **Revolution Automotive LLC, Note dated March 1, 2018** | **$432,954.29** |
| **Total Loan Value** | **$ 12,038,029.51** |

According to the 8-K:

> *"Under the terms of the Loan Sale Agreement,* ***Mr. Ni has acquired the Related-party Loans without warranty or recourse*** *and has assumed all risks of non-collection"*

We think this shuffling of assets is nothing more than a way for the company's Chairman/CEO to unload his otherwise illiquid and overvalued stock, while extracting cash from the company through related-party loans.

## *HF's Auditor, Recently Subpoenaed By The SEC, Has a History Of Reportedly Failing To Obtain Sufficient Evidence To Support its Audit Opinions*

We are not surprised that HF's auditor, Friedman LLC, has not uncovered the many issues outlined in this report.

As noted earlier, iFresh, another company backed by HF's SPAC sponsor, is also audited by

Friedman. Similar to HF, iFresh has a history of numerous related-party transactions dating back to its own go-public transaction. On March 6th 2020, iFresh announced that it, along with its auditor, had received a subpoena from the SEC relating to its work on the company:

**Item 8.01 Other Events.**

On March 6, 2020, iFresh Inc. (the "Company") announced that it has received a subpoena from the Securities and Exchange Commission ("SEC") requesting certain information from the Company. The Company is not currently the subject of any enforcement proceedings. The Company is fully cooperating with the SEC's request. Friedman LLP , the Company's auditor, has also received a subpoena from the SEC relating to the Company.

In addition to current regulatory issues, Friedman's recent inspection by the Public Company Accounting Oversight Board (PCAOB) found material issues. The PCAOB 2018 inspection report suggested that Friedman had failed to perform its basic function as an auditor: providing reasonable judgment as to whether financial statements are free of material misstatement, whether by error or fraud. The PCAOB report is scathing:

> *"Certain deficiencies identified were of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion that the financial statements were presented fairly…"*

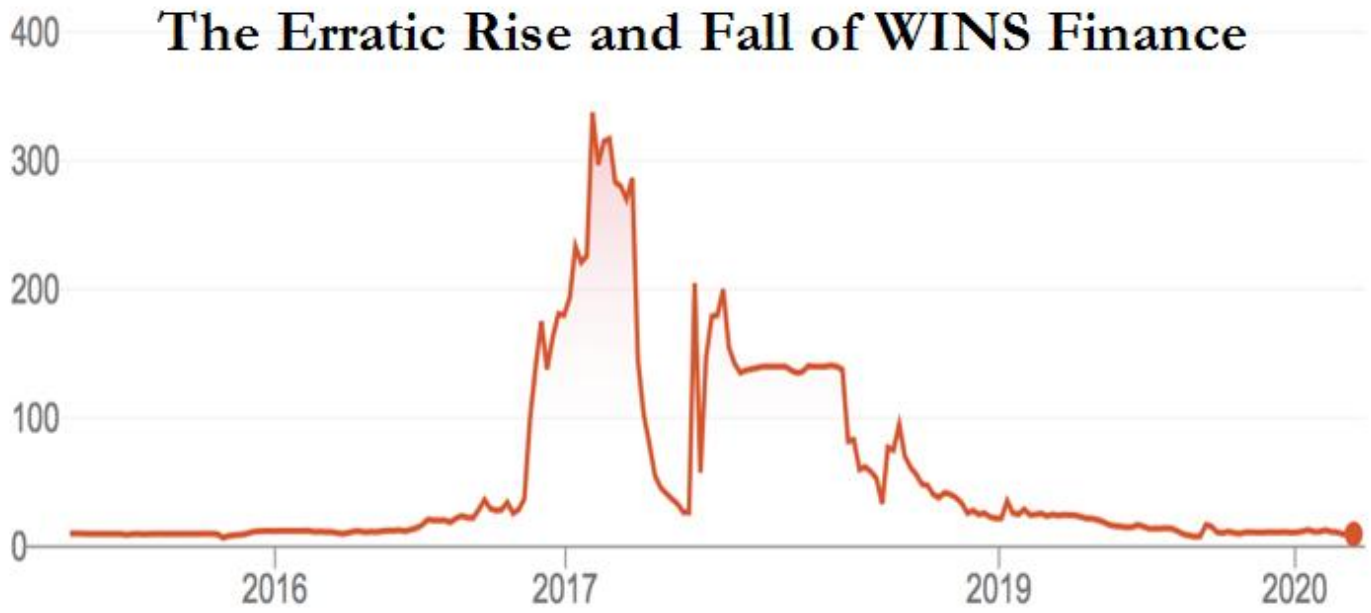
> ***In other words, in these audits, the auditor issued an opinion without satisfying its fundamental obligation to obtain reasonable assurance about whether the financial statements were free of material misstatement and or the issuer maintained effective IC.R***

The PCAOB report further identified weaknesses with Friedman's audits of 3 unnamed issuers, including (a) failures to test the controls and valuation of revenue, (b) failure to test controls over inventories and (c) " **the failure to perform sufficient procedures to test the existence of investments**".

## *What Happened with Friday's FTSE/Russell Forced Index Buying And Why We Think It Will Prompt Subsequent Forced Selling of HFFG Shares*

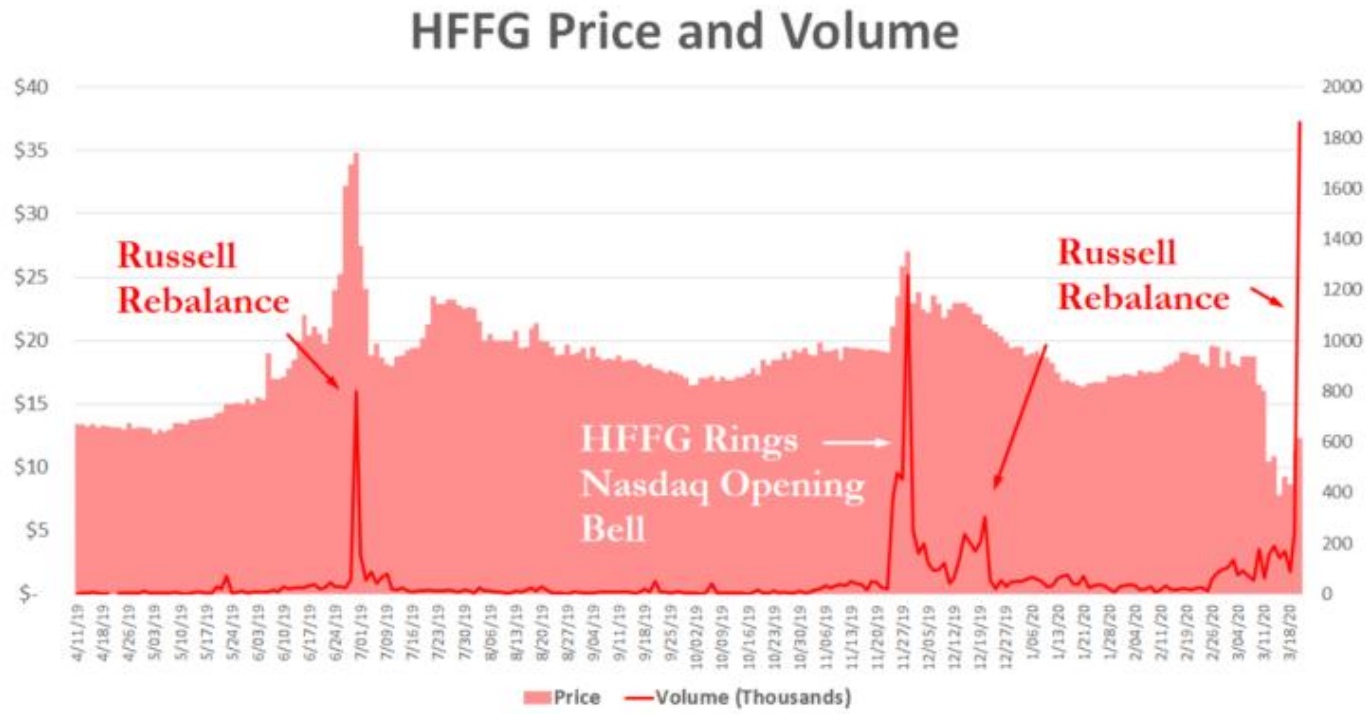
As noted earlier, the sponsor of HF's SPAC transaction, Atlantic Acquisition, has a history of

sending socks soaring due to the alleged manipulation of company inclusion criteria for the FTSE/Russell indices. The 4,500% spike in Atlantic-backed Wins Finance still serves as the classic example of a passive index forced-buying bonanza (followed by a passive index forced-selling bonanza), a process that played out several times over the history of Wins:




Similar to Wins, we have seen irregular spikes and troughs in HF's shares precisely around rebalance dates.

Beyond HF's mid-day ~40% spike on massive index buying volume last Friday, a similar scenario unfolded in June 2019 around the FTSE/Russell index reconstitution. The week leading up to the rebalance coincided with a price spike of ~65%, followed by a ~48% crash the following week, all despite an apparent absence of news. As seen below, the company has had regular price and volume spikes around these reconstitutions.




For context, when index funds buy stocks, they weight the purchases according to a company's free float (essentially the number of shares freely traded). In other words, the more freely traded shares, the more shares the passive indices will buy.

**So what happened during riday's index rebalancing that led to a surge in H G's price and volume**

FTSE/Russell had calculated HFFG's free float to be 21.8 million shares (per its subscription-only service). **This calculation was just flat out wrong** The freely tradable shares were **6.2 million** per HF's own recent March filing. [ Pg. 25]

The source of the mistake appears to have been the accidental addition of shares from the B&R transaction, which closed in November . As with every such merger, shares issued to the acquirees are restricted for at least 6 months, according to SEC Rule 144. FTSE/Russell apparently missed this and added the shares to its free float calculation anyway. We think FTSE/Russell should reverse this decision, which would lead to a forced selling of the shares purchased.

Beyond the above, which appears to largely be a FTSE/Russell error, sometimes companies are able to juke the index rebalancing process to ensure that the actual free float is tighter than it appears. We think this may also be taking place.

For example, as shown earlier, to the extent that shares are held by family members or affiliates (potentially through dozens of related-party entities), this can serve to constrain the true free float. Given the sheer consistency of the index rebalancing irregularities around HF (and Wins, backed by the same sponsor), we believe this to be likely. To the extent Russell takes action, forced sales by passive investors could add severe selling pressure to HF's shares.

## *Conclusion: We Believe HFFG's Shares Have 90% Downside*

In Latin, *res ipsa loquitur* means, "the matter speaks for itself".

We think the evidence compiled regarding HF's troubling related-party transactions, its flagrant misuse of shareholder cash, its potential gaming of the FTSE/Russell index criteria and the track record of its auditor and SPAC sponsor speaks for itself.

Besides the troubling issues presented by our report, we believe HFFG faces **8% to 80% downside based on fundamentals alone**.

Given the totality of our findings – and what the resultant investor, analyst, and regulatory responses to these findings could be– **we believe H G faces 90% downside and is ultimately uninvestable.**

### *Disclosure: We are short shares of HFFG*

[1] Based on current shares outstanding of 52,145,096, per the recent 10-K

[2] Includes net debt as of June 30 th from the B&R merger of 22,888,079 (34,959,731-12,071,652) [Pg. 24] plus $101 million in debt from the subsequent real estate acquisition

[3] Note that Rongcheng is the Chinese translated name of B&R and Hefeng is the Chinese translated name of HF Foods

[4] California entity records from 2006, show Zhang Yi Tuan as the initial agent for the B&R entity, which further corroborates the connection.

## *Legal Disclaimer*

# TAB 18

# PharmaCielo: 100% Downside on Co-Founder's History of Securities Fraud Allegations, Numerous Undisclosed Related Party Transactions and Operational Failures

Published on March 2, 2020



## Summary: PharmaCielo (TSXV:PCLO / OTC:PCLOF)


- We believe PharmaCielo is nothing more than the latest self-enrichment scheme drummed up by its co-founder Anthony Wile, who had been charged by the SEC over allegations of securities fraud, stock promotion and market manipulation in the past.
- Wile co-founded PharmaCielo just prior to finishing serving a 5-year officer and director bar that he consented to in 2010 as part of a settlement stemming from the SEC charges.

- Unbeknownst to investors, PharmaCielo's key operating property in Rionegro, Colombia was purchased through a bankrupt company co-founder (Federico Cock-Correa) via a Panamanian entity linked to Anthony Wile. It was then sold to PharmaCielo at a massive markup, allowing insiders to enrich themselves by an estimated $5.35 million by stepping in the middle.
- The company announced it was building greenhouse facilities on newly-purchased land in Colombia's Cauca region in 2017. We visited the land and found the greenhouses don't exist. The site is nothing more than an empty field covered in weeds. (We have photos and video)
- PharmaCielo recently announced a U.S. distribution deal with an opaque company called General Extract LLC. We found that this is yet another undisclosed related party deal, involving PharmaCielo's former COO. General Extract's parent company corporate address ("Suite D-357") was actually a mailbox at a Colorado UPS store.
- PharmaCielo's other main partnership, a distribution deal with nanocap company XPhyto, appears to be little more than a shell game. PharmaCielo is supplying XPhyto with cash so XPhyto can turn around and buy PharmaCielo's products.
- The company is running low on cash, with an estimated $11.7 million remaining. We believe the company's back is against the wall and, accordingly, expect a dilutive capital raise in the near future.
- The company's Rionegro cannabis oil processing centre, a key element of its plan to export oils, remains unfinished after almost 6 months of delays.
- According to local sources, the Rionegro greenhouse facilities have issues with mold and residual pesticides from the flower-growing operation that preceded the company's use of the facility.
- Co-founder Anthony Wile has been hitting the bid recently, dumping 200,000 shares of his then 13 million shares of the company just days before PCLO's CEO issued a shareholder letter telling investors that insiders were "confident holders".
- PharmaCielo has property, greenhouses, licenses, and some residual cash. But with essentially no revenue, continued cash burn, and management's track record of self-enrichment and the co-founder/former CEO's history of securities fraud charges, we believe PharmaCielo ends up as a total loss for investors.

*Initial Disclosure: After extensive research, we have taken a short position in shares of PharmaCielo through PCLOF, its U.S. OTC ticker. This report represents our opinion, and we encourage every reader to do their own due diligence. Portions of our research for this report required on-the-ground conversations with locals in Colombia. Given the volatile nature of the political climate in the country, we have removed several source names from the report. However, those names can and will be made available to regulators and/or government entities upon request. Please see our full disclaimer at the bottom of the report.*

## *Background: Basics on the Company and the Bull Thesis*

PharmaCielo trades on the TSX Venture exchange and U.S. Over-the-Counter Market ("OTC") under the symbols PCLO and PCLOF, with a market cap of roughly $200 million as of this writing.

The company describes itself as focused on cultivating, processing and supplying all-natural medicine-grade cannabis oil extracts to large channel distributors via its greenhouse facilities in Colombia.

PharmaCielo's Colombian operating subsidiary owns 2 properties:

1. 12 hectares of open-air greenhouses and a processing & extraction facility situated on a 27 hectare property in Rionegro.
2. A 3.6 hectare property in Northeastern Cauca, where PharmaCielo has a contract-production partnership deal with a 63 person cooperative called "La Cooperativa Unidad del Norte" (aka Caucannabis)

PharmaCielo has generated only $60,843 in cannabis revenue throughout the life of the company [ Pg. 3], but the bull thesis seems to focus on:

- PharmaCielo's first-mover advantage in Colombia;
- Its ability to eventually become a low-cost producer of cannabis; and
- Its ability to monetize both its existing facilities and expand through different cooperative farming deals.

The company has greenhouses that are currently growing cannabis in Rionegro, as corroborated by photographs taken last week as part of a touring of its facilities by the Colombian Justice Minister:

February 24th, 2020: Colombian Justice Minister touring of PharmaCielo's Rionegro facility

Sell side reports tout the company's "multi-year supply agreements" in the U.S. and Europe as key selling channels.

Cormark Securities (which underwrote the company's August 2018 financing and advised on a prospective acquisition) has consistently rated the company a "buy". In Cormark's research initiation, it specifically touted PharmaCielo's management team as a key strength:

> **Leadership Strength:** PCLO's leadership brings together experience from the agricultural, financial, tobacco and medical and public health industries. Beyond offering the expertise to execute the company's strategy, we think the leadership's pedigree could make PCLO a compelling strategic partner.

(Source: Cormark Securities, "Buy" Initiation report dated May 31, 2019)

## *Reality Check: Multiple Undisclosed Related-Party Transactions with Insiders, Supply Agreements with Apparent Shell Companies, 'Greenhouse' in Cauca Region is an Empty Field, Co-Founder Previously Targeted by SEC and an Imminent Need for More Capital*

Our research, which has included extensive, on-the-ground research in Colombia and in the U.S., has revealed to us that the company's prospects differ sharply from management's narrative. Through our research, we found:

1. The co-founder and former CEO of PharmaCielo has a track record of securities fraud, according to SEC allegations. He settled the charges in 2010, agreeing to a 5-year ban from being an officer or director of a public company. He co-founded PharmaCielo while still barred as a public officer/director, then took it public shortly after the ban expired.
2. The company's key Rionegro Colombian facility appears to have been purchased in an undisclosed related party transaction though PharmaCielo's bankrupt co-founder. Insiders enriched themselves by first purchasing the rights to the property into a newly-formed Panamanian entity (set up 3 DAYS prior to the deal), then re-sold it to the company at inflated prices, pocketing an estimated $5.35 million by stepping in the middle.
3. The company's key 3.6 hectare 'operation' in Colombia's Cauca region is actually just an empty field (we have pictures and video). We confirmed this with local leaders of a farming co-op that struck a deal to grow cannabis with the company.
4. PharmaCielo disclosed paying over $865,000 for the land in Cauca, including 201,000 shares. Yet local land records show that the Cauca land was sold for only ~$127,000. Co-op leaders confirmed the price and stated that they received no shares as part of the transaction. We hypothesize that the 'missing' money may have yet again found its way to insiders.
5. The company's odd acquisition of a telemedicine platform appears to have been part of a quid pro quo where (a) PharmaCielo bought the company from an investor in exchange for (b) the investor allocating money to a different company founded by a PharmaCielo co-founder.
6. The company's U.S. distribution partner is actually yet another undisclosed related-party deal with a company that appears to have limited to no credible operations.
7. PharmaCielo has generated only $60,843 in cannabis-related revenue despite years of development.
8. As it appears a large amount of money has gone to enrich insiders, the company likely needs cash imminently in order to maintain operations and complete its oil processing facility, a key component of its plan to export cannabis oils.
9. The company's main facility in Rionegro may be troubled with mold and pesticide contamination, likely originating from the flower-growing operation that preceded PharmaCielo's assumption of the facilities, according to local sources we spoke with. In addition, Rionegro planning authorities say one-third of the land is unusable due to environmental restrictions and the risk of flooding.

We have a 1-year price target of $0 based on the company's lack of meaningful revenue ($130k since inception), continued losses, whittling cash (estimated at $11.7 million as of this writing) [1] and incredibly questionable management behavior.

# *Leadership: PharmaCielo's Co-Founder, Former CEO and "Backer" Anthony Wile Had Previously Been Accused by The SEC of Stock Manipulation. We Think He's Back at It Again.*

They say the tone is set at the top. PharmaCielo's co-founder, largest shareholder, " backer " and former interim CEO /Director, Anthony Wile, has a history of stock manipulation and pump and dumps, according to SEC prosecutors.

Anthony Wile listed himself as co-founder of PharmaCielo Ltd. on his recently-deleted LinkedIn page (that disappeared during the course of our investigation, around February 24, 2020. We archived it on February 2, 2020.) On the same page, he stated that he had been involved in PharmaCielo's operations since the company was established, which was in 2014.

He listed his work experiences dating back to 2007, but he left out this key detail from earlier in his career:


**U.S. SECURITIES AND EXCHANGE COMMISSION**

**Litigation Release No. 20407 / December 19, 2007**

***SEC v. Brian N. Lines, Scott G.S. Lines, LOM (Holdings) Ltd., Lines Overseas Management Ltd., LOM Capital Ltd., LOM Securities (Bermuda) Ltd., LOM Securities (Cayman) Ltd., LOM Securities (Bahamas) Ltd., Anthony W. Wile, Wayne E. Wile, Robert J. Chapman, William Todd Peever, Phillip James Curtis, and Ryan G. Leeds, 07 Civ. 11387 (S.D.N.Y. filed Dec. 19, 2007)***

In 2007, Wile was listed as a defendant in a civil injunctive action filed by the Securities and Exchange Commission, which alleged that he issued deceptive press releases, promotional materials, and created a misleading website to tout a publicly-traded mining company. Wile was also accused by the SEC of "orchestrating touting", a "manipulative stock trade on the open market to create an inflated market" and disseminating "materially false and misleading information to the market."

As a result, the SEC sought a permanent bar to prevent Wile from serving as an officer or director of any public company, but Wile settled the SEC charges in 2010 for a 5-year ban and a civil penalty of $35,000.

Before the ban ended in 2015, however, Wile was already on to his next project, co-founding PharmaCielo in 2014.

## *Leadership: PharmaCielo's Other Co-Founder and Former CEO/Director Federico Cock-Correa Was in the Midst of Bankruptcy Proceedings Upon His Recruitment to The Company*

Aside from Wile, Federico Cock-Correa is a company co-founder, former CEO of PharmaCielo Holdings (the Colombian operating entity) and current board member of PharmaCielo Colombia. Cock-Correa has a background in horticulture and has previously owned and operated flower and greenhouse businesses in Colombia's northwest Antioquia province.

According to our research, Cock-Correa was experiencing a period of severe financial distress during the time he linked up with Anthony Wile. One local source told us the following:

> *"At PharmaCielo one of the founders brought in a bankrupt flower grower. That was the first mistake. They also made a mistake in the area they chose."*

Colombian corporate records corroborate this. The current name for Cock-Correa's key flower growing business on its incorporation certificate is "Tahami y Cultiflores SA En Reorganizacion" [In Reorganization]. The certificate shows the company formally agreed to a restructuring deal (broadly equivalent to U.S. Chapter 11 Bankruptcy proceedings) on June 6, 2014.

But the problems stretch back much earlier, to at least 2011, with court insolvency rulings, and bank embargos on Tahami's greenhouse facilities.

Cock-Correa and his family continue to run Tahami and are still paying off their debts. Under the terms of the insolvency deal, the debt repayments run for a 10-year period (2014-2024). Creditors include two banks, pension funds and the government tax agency.

Critically, none of this seems to have been disclosed to investors. On the contrary,

PharmaCielo's filing statement from January 2019, the foundational document detailing the business and its risks, states unequivocally that no director or officer of the Resulting Issuer (PharmaCielo), had been acting as the representative of any company that had become bankrupt or subject to any insolvency proceedings within the past 10 years: [ Pg. 76-77]

***Corporate Cease Trade Orders or Bankruptcies***

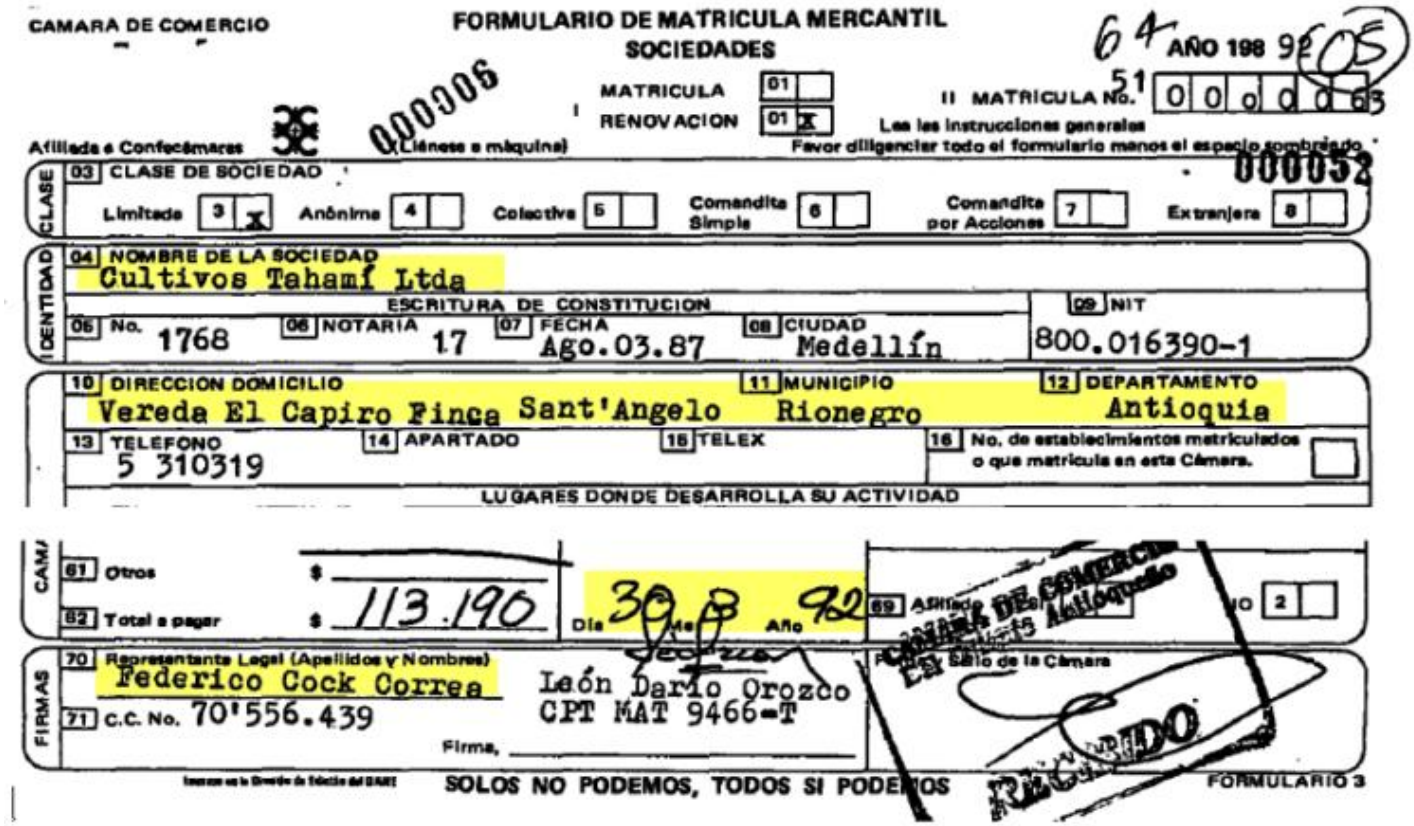
Within the ten years before the date of this Filing Statement, no proposed director, officer or Promoter is or has been a director, officer or Promoter of any person or company that, while that person was acting in that capacity:

(a) was the subject of a cease trade or similar order, or an order that denied the other issuer access to any exemptions under applicable securities law, for a period of more than 30 consecutive days, state the fact and describe the basis on which the order was made and whether the order is still in effect; or

(b) became bankrupt, made a proposal under any legislation relating to bankruptcy or insolvency or was subject to or instituted any proceedings, arrangement or compromise with creditors or had a receiver, receiver manager or trustee appointed to hold its assets, state the fact.

This appears to be a major misrepresentation. **Cock-Correa had a company that became insolvent and had been in reorganization prior to the filing, during the date of the filing, and is still to this very day.**

Furthermore, the bankruptcy is inexorably linked to PharmaCielo. Prior to PharmaCielo's purchase of the Rionegro property, Tahami had operated the very same property since as early as 1992, per this filing we pulled from the Rionegro Chamber of Commerce:



CAMARA DE COMERCIO

FORMULARIO DE MATRICULA MERCANTIL
SOCIEDADES

AÑO 198 9

MATRICULA 01
RENOVACION 01 X

II MATRICULA No. 0 0 0 0 0 6 3

Afiliada a Confecámaras

(Líenese a máquina)

Lea las instrucciones generales
Favor diligenciar todo el formulario menos el espacio sombreado

CLASE

03 CLASE DE SOCIEDAD

Limitada 3 X | Anónima 4 | Colectiva 5 | Comandita Simple 6 | Comandita por Acciones 7 | Extranjera 8

IDENTIDAD

04 NOMBRE DE LA SOCIEDAD
Cultivos Tahamí Ltda

ESCRITURA DE CONSTITUCION

05 No. 1768 | 06 NOTARIA 17 | 07 FECHA Ago.03.87 | 08 CIUDAD Medellín | 09 NIT 800.016390-1

10 DIRECCION DOMICILIO
Vereda El Capiro Finca Sant'Angelo

11 MUNICIPIO Rionegro | 12 DEPARTAMENTO Antioquia

13 TELEFONO 5 310319 | 14 APARTADO | 15 TELEX | 16 No. de establecimientos matriculados o que matricula en esta Cámara.

LUGARES DONDE DESARROLLA SU ACTIVIDAD

CAMP

61 Otros $

62 Total a pagar $ 113.190

Día 30 Mes 8 Año 92

69 Afiliado

FIRMAS

70 Representante Legal (Apellidos y Nombres)
Federico Cock Correa

71 C.C. No. 70'556.439

Firma,

León Darío Orozco
CPT MAT 9466-T

Sello de la Cámara

SOLOS NO PODEMOS, TODOS SI PODEMOS

FORMULARIO 3

Both companies even operated side-by-side on the same premises during 2016, according to company registration documents. [1,2]

A local source confirmed to us that Wile helped financially support Cock-Correa during his insolvency period. The financial support does not appear to have been an act of charity, however.

## *Undisclosed Related Party Transactions: The Company's Key Property in Rionegro, Colombia Was Bought Through PharmaCielo's Co-Founders*

When looking into the company's key greenhouse facility in Rionegro, we came across the first of several instances of apparent insider self-dealing involving either Anthony Wile or Federico Cock-Correa, the company's co-founders.

Central to almost all of PharmaCielo's business ambitions is the company's "headquarters and principal cultivating facility" in Rionegro, Colombia which the company touts on its website, in press releases and is often referenced in analyst reports about the company.

The company announced the purchase of the site in July of 2016, per this press release, which called it a "significant milestone", and disclosed that the company paid $5.02 million in cash and 1.7 million in equity shares for the purchase, equating to a total estimated purchase price of $8.85 million.[2] The deed was signed on June 1, 2016, one month earlier.

We checked local land registry documents and found that the total land sale (which consisted of two parcels, with the second sold on August 30, 2017) cost only about $3.5 million USD. [Plot 1, Plot 2] This was a wide discrepancy from the value that PharmaCielo had announced in its press release ($5.02 million in cash and 1.7 million equity shares).

We had our Colombian investigator look into the deal further. What we found was that the property was bought in what appeared to be an undisclosed related party transaction through PharmaCielo's co-founder, Federico Cock-Correa.

Local real estate records [1,2] show that the property was owned by four siblings with the surname Uribe Villegas. Our investigator consulted two of the prior sibling owners by phone, in February 2020. Neither would confirm the purchase price, but one (Pedro Javier Uribe) directly contradicted the PharmaCielo press release that indicated the purchase included 1.7 million in shares:

> *"We received payment in cash. Maybe we got something like 3 percent of the value of the farm we got in shares**. But 1.7 million shares No, no no, no. That's a lot. No we got much less**." (Note that we have this conversation on audio.)*

## *Undisclosed Related Party Transactions: PharmaCielo Purchased the Land from a Panamanian Entity Connected to Anthony Wile That Had Been Formed a Mere 3 Days Before the Deal*

It struck us as odd that PharmaCielo announced paying millions more for the land than the actual owners seemed to receive, according to both real estate records and our conversation with an owner.

In the available public documents [1,2], the deal appeared to be a basic transaction between PharmaCielo and the Uribe Villegas siblings.

But in Colombia, we learned, it is very common to sign purchase option agreements known as

"promesas de compraventa" (translated as 'promises of sale') prior to the official signing of deeds or payment for the property. These are documents, usually but not always notarized, that are legally binding but are considered private documents and not available in the land registries.

In our conversation with prior owner Pedro Javier Uribe, he confirmed that the sale had taken place in this manner (we also have this conversation on audio):

> *"Before the sale, maybe six months, I don't really remember well, we had drawn up a purchase option (promesa de compraventa). Here in Colombia that means you sign a paper saying you'd sell your property in a certain amount of time at a certain price."*

When asked specifically the name of the other party of the purchase option, he said:

> ***I don't remember exactly who it was but it was another company of theirs. art of harmaCielo I don't know what the internal workings were."***

So, instead of an outright sale, the owners sold an irrevocable option to buy the land – **but we found they didn't actually sign it with harmaCielo.**

When we checked PharmaCielo's filing statement, we found that rather than purchasing the property directly from its prior owners, the property and irrevocable purchase options were acquired through an entity called South American Agriculture Development Corp ("SAADC"). This is the only time the SAADC entity is mentioned in *any* of PharmaCielo's filings: an audit on page 187:

**PHARMACIELO LTD.**
Notes to Consolidated Financial Statements
July 31, 2016 and 2015
(Expressed in United States Dollars)

**5. Advances**

Pursuant to a Letter of Intent dated October 30, 2014 (as amended on June 18, 2015), the Company has entered into an agreement to purchase certain assets and rights from South American Agriculture Development Corp., comprising of 12.32 hectares of greenhouse and fixed and personal property located within land in the municipality of La Cieja (Antioquia) and the rights (pursuant to irrevocable options granted by each of the owners) to purchase any or all of an additional 5.19 hectares and 5.96 hectares of greenhouses, and fixed and personal property within land located in the municipality of Rio Negro (Antioquia) at a price that is satisfactory to the Company negotiated in good faith, for the following consideration (as amended on June 18, 2015):

South American Agriculture Development Corp. ("SAADC") is a Panamanian entity formed on October 27, 2014, per Panamanian corporate records. That date is just 3 days before PharmaCielo entered into a letter of intent to purchase its property and other assets on October 30, 2014. [Note 5]

Critically, SAADC's Panamanian corporate records also show a clear link to Anthony Wile. The entity lists David Hoang as its President and Director:

**NINTH**: The Officers of the corporation, who may indistinctly be natural or juridical persons, shall be elected in the manner and under the terms as provided in the By-laws, if any, of the corporation. Until a new election, the first **OFFICERS** of the corporation shall be the following persons: ----------

**DAVID HOANG**----------**President** ----------

**SHEVIA SERLENE GOMEZ**----------**Secretary**----------

**JOHN DEREK BENJAMIN**----------**Treasurer**----------

Hoang worked as Chief Trading Officer of High Alert Capital, a private investment firm where Anthony Wile served as Chairman & CEO, according to Canadian corporate records. High Alert was also linked to PharmaCielo in this 2016 British Columbia regulatory filing that shows it was the company's largest shareholder, owning 11.6 million shares.

Later, Anthony Wile's SEDI disclosures show that his private equity firm (Jaque Capital Management) had acquired 13 million shares in an acquisition "carried out privately", which were likely ported over from High Alert.

| | | | | | |
|---|---|---|---|---|---|
| **Insider name:** | Wile, Anthony | | | | |
| **Insider's Relationship to Issuer:** | | 3 - 10% Security Holder of Issuer | | | |
| **Ceased to be Insider:** | Not applicable | | | | |
| **Security designation:** | Common Shares | | | | |
| 3304665 | 2019-01-15 | 2019-01-23 | Control or Direction : Jaque Capital Management Ltd. | 00 - Opening Balance-Initial SEDI Report | |
| 3304666 | 2019-01-15 | 2019-01-23 | Control or Direction : Jaque Capital Management Ltd. | 11 - Acquisition or disposition carried out privately | +13,002,500 |

One source in Colombia, who, when asked about the South American Agriculture Development Corp., told our investigator:

> *"I think that's the company Tony and Cock (Correa) had together. I couldn't swear to*

> *it but I heard them talking about it once that's why it rings a bell."*

Per the audit notes in PharmaCielo's filing statement, we see that the company advanced SAADC $2.8 million. [Pg. 187] **That number matches the purchase price of the first Rionegro parcel, estimated at U.S. 2.88 million according to land registry records, almost to the dollar.**[3]

In other words, PharmaCielo lent the money to SAADC to buy the property, then SAADC flipped the property right back to PharmaCielo at a mark-up.

Opaque disclosure records make it difficult to calculate the exact mark-up but we estimate Wile (and potentially Cock-Correa) pocketed an estimated $5.35 million in cash and shares by stepping in the middle of the company's land deal.

We encourage Wile to release the exact figures SAADC paid to the original owners and specifically how much was netted in the short-term windfall.

## *"There's Nothing There, Just Weeds": PharmaCielo's 'Greenhouse Facility' in Cauca Doesn't Exist*

In addition to obvious signs of insider self-enrichment at the company's primary Rionegro facility, we found a similar pattern at the company's second property in Colombia's Cauca province.

By way of background, in 2017 PharmaCielo purchased a 3.6 hectare plot of land in the Cauca region, which for years has been plagued by civil discord fueled by the drug trade.

PharmaCielo came in and struck a partnership with a cooperative of Cauca indigenous and peasant farmers to help them transition from black market crops to legal crops. The company was hailed as a trailblazer, and the deal resulted in PharmaCielo being featured in a front page article in the New York Times:

The New York Times

# With Rebels Gone, Colombia Jumps Into the Pot Industry

PharmaCielo's contract-production deal is with "La Cooperativa Unidad del Norte" (Caucannabis), a small farmers' cooperative with about 63 members as of the time of the deal's announcement .

In May 2017, PharmaCielo issued a press release with a headline that touted both its socially inclusive mission and a major step in that mission, establishing a greenhouse:

> *"PharmaCielo Encourages Social Inclusiveness of Colombian Cannabis Industry Strategy* ***with Establishment of Greenhouse acility in Cauca Departmément***

The same press release stated:

> *"The land purchase agreement is expected to be finalized and closed in the next month,* ***with construction of the new greenhouse facility commencing immediately thereafter****"*

The land purchase did close, per local land records . And in July, the company declared that it had already "established a 3.6-hectare cultivation operation" in the area.

Our investigator visited the Cauca property in February 2020, led by a senior member of the cooperative. He saw that PharmaCielo's greenhouse facility in Cauca, first touted 2 years ago, **simply doesn't exist** Here is a picture of the location, and a video with a full panorama of the site:

[Click here to see the video of PharmaCielo's Cauca 'operation' ]

Our investigator also spoke by phone with a senior member of the Caucannabis Cooperative. The senior member told us that Caucannabis had a five-year contract (2017-2022) with PharmaCielo under which the company purchased a 3.6 hectare plot near Corinto, Cauca, and agreed to cover the costs of organizing the plot and setting up a greenhouse facility according to the strict specifications of the Colombian Agrarian Institute (ICA), part of the Agriculture Ministry.

The license application was also made and paid for by PharmaCielo, the person said. They said that the cooperative, in alliance with PharmaCielo, planned to set up additional production facilities in the neighboring municipalities of Toribio and Jambalo. This was all to be part of the corporate strategy to create an ambitious network of hundreds of hectares of contract-grower capacity.

**Since the cultivation license was issued in November 2017, the person said there has been no further investment, no greenhouse has been built and not a single cannabis plant has been sown.**

The senior leader of the co-op who spoke with our investigator said:

> *"It's been a long process because the law was modified and then the government changed. So far, we have not planted a single cannabis seed.* ***harmaCielo bought the plot and right now there's nothing there. Just weeds."***

We emailed PharmaCielo's investor relations asking about the current state of its operations in Cauca and have not heard back as of this writing.

## *Another Discrepancy Between the Price Indigenous Farmers Reportedly Received and the Price PharmaCielo Paid. Did Someone Step in the Middle?*

PharmaCielo paid a steep price for its now seemingly abandoned Cauca property. The company's filing statement shows that it paid about US$875,000 in cash and shares for the land from "arms length parties": [ Pg. 39]

- On August 30, 2017, PharmaCielo Holdings acquired the Farm from arms length parties. As consideration PharmaCielo paid a combination of 201,000 PharmaCielo Shares and $1.2 billion Colombian pesos.

We asked a senior leader of the cooperative about the money PharmaCielo paid for the land, which had been bought from a sugar-cane farmer. We were told that they paid about 368 million pesos (or U.S. $127,250 at prevailing exchange rates) a difference of about U.S. $747,000 from the $875,000 price claimed in PharmaCielo's filings.

The 368 million peso number is corroborated by local land sale records pulled by our on-site investigator:

PERSONAS QUE INTERVIENEN EN EL ACTO (X-Titular de derecho real de dominio,I-Titular de dominio incompleto)

DE: BANCO AGRARIO DE COLOMBIA S.A. NIT# 8000378008

A: GOMEZ HERNANDEZ LUIS EDUARDO CC# 1530736 X

ANOTACION: Nro 005 Fecha: 02-06-2017 Radicación: 2017-124-6-625

Doc: ESCRITURA 228 DEL 26-05-2017 NOTARIA UNICA DE CORINTO VALOR ACTO: $368,164,060

ESPECIFICACION: MODO DE ADQUISICION: 0125 COMPRAVENTA

PERSONAS QUE INTERVIENEN EN EL ACTO (X-Titular de derecho real de dominio,I-Titular de dominio incompleto)

DE: MONTOYA FEIJOO GILBERTO CLEMENTE CC# 16245466

A: PHARMACIELO COLOMBIA HOLDINGS S.A.S NIT# 9007543005 X

When asked whether the deal included shares, the same person told us:

> ***That was cash. Shares, never."***

The senior leader also confirmed the Cooperative – some of whose senior members witnessed the transaction—never heard any mention of shares as part of the deal, contrary to PharmaCielo's disclosure of paying 201,000 shares.

We find these discrepancies troubling, and believe they could yet again be due to another intermediary stepping in the middle of the transaction.

When told of the price discrepancy, a senior cooperative leader said:

> *"That is a big, big difference. I can't understand it. What would anybody do with all that money.* ***Today I went out of my house with only 2, 00 pesos in my pocket less than a dollar. Just imagine what I could do if I had two dollars a day.*** *And then just one person has all that money. 1.2 billion pesos you say?* ***Just imagine if the cooperative had those funds. We could have got on and grown the cannabis ourselves by now."***

## *The Cauca Deal Was Touted as a Way to Help Local Farmers While Also Expanding PharmaCielo's Operations.*

## *From a Senior Leader of the Co-op: "We Are Worse Off Now Than We Were Then."*

Despite repeatedly touting its own positive impact on regional farmers, the reality is that PharmaCielo appears to be the latest multinational firm to take advantage of the Cauca farming community.

A senior leader of the co-op informed us that its farmers are now worse off as a result of its dealings with PharmaCielo:

> *"We got involved in this because we thought it was going to be a quick process and it has taken a very long time. Some of [us] used to grow marijuana illegally interspersed with legal food crops. But we had to pull the illicit crop when we signed this agreement. And now we have neither one thing nor the other.* ***We are worse off now than we were then."***

Finally, the cooperative leader concluded, they were still hopeful, but the company seems to be blaming the government for the inactivity and washing its hands of the matter:

> ***harmaCielo have told us they're very worried about the situation but it's out of their hands. It's in the hands of the state.*** *We have been talking about the situation but we haven't been able to do anything. On top of all that because of the law and order situation it is going to be very difficult for us (the cooperative) to start operations in other towns, including Toribio and Jambalo. We're still hanging in there. We haven't given up yet. We want to do this but we're losing motivation. After three years there have been no results and there's only two years left on our contract."*

According to the same source, PharmaCielo intermediaries are telling the cooperative that licenses for psychoactive cannabis in the Cauca region may be withdrawn because of the public order situation (instability in law and order due to an uptick in political violence).

We contacted the Colombian government's Justice Ministry to inquire about this. A spokesperson stated categorically that psychoactive cannabis licenses will **not** be withdrawn in Cauca province:

> *"That is not true. The licensing process will continue as normal."*

All told, we think PharmaCielo may just be offering excuses for why it has abandoned the indigenous farmers immediately after executing its suspicious land deal.

## *Undisclosed Related-Party Transactions: Signs of a Quid Pro Quo with PharmaCielo's Telemedicine Acquisition (And Signs of Impairment – The Website No Longer Appears to Function)*

PharmaCielo has reported a total of C$130,130 in revenue to date (figure *not* in thousands) [ Pg. 3]. Of that, 53% (or C$69,287) has been generated through an acquired company called Ubiquo Telemedicina ("Ubiquo").

PharmaCielo paid ~CAD $1.6 million for Ubiquo (consisting of C$880,000 in cash and 156,058 shares valued at $4.40 [ Pg. 20])

Ubiquo is described by PharmaCielo as "a knowledge management and medical consultation system", although you wouldn't know it from the company's website, which appears to have been down for the past several weeks:


Ubiquo does not appear to be very active in general. The company's Facebook page last posted in early 2016, and its Twitter page with 199 followers last posted in 2011. Historical captures of the website show a credible but fairly basic website describing its telemedicine platform.

The strategic pretense for the transaction had struck us as odd in the first place. In its acquisition announcement, PharmaCielo stated the rationale was as follows:

> *"(The) acquisition will enable expanded access to medicinal cannabis expertise among the Colombian medical community"*

But is it really that hard to meet doctors?

There were some other obvious red flags. In PharmaCielo's original acquisition announcement, it stated that Ubiquo was launched in 2016 in Antioquia.

PharmaCielo

**About Ubiquo Telemedicina**

A joint venture between the Government of Colombia and the private sector, Ubiquo Telemedicina launched in 2016 in the Department of Antioquia, Colombia. A knowledge management and medical consultation system, the platform currently has a patient base of more than 80,000 in the department, with established plans for expansion throughout the country over the next 36 months, increasing the base of both medical expertise and patients supported exponentially.

Colombian corporate records show the company was actually launched in 2003:

**NOMBRE, IDENTIFICACIÓN Y DOMICILIO**

| | |
|---|---|
| Razón social: | UBIQUO TELEMEDICINA S.A.S |
| Nit: | 811040712-9 |
| Domicilio principal: | MEDELLÍN, ANTIOQUIA, COLOMBIA |

**MATRÍCULA**

| | |
|---|---|
| Matrícula No.: | 21-317091-12 |
| Fecha de matrícula: | 19 de Agosto de 2003 |
| Ultimo año renovado: | 2019 |
| Fecha de renovación: | 29 de Marzo de 2019 |
| Grupo NIIF: | 4 - GRUPO III. Microempresas. |

Similarly, the company's social media presence alone predates its supposed 2016 founding by more than half a decade.

We dug further and found that the company may have been acquired as part of a quid pro quo arrangement with its backers.

At the time of the sale, Ubiquo was a slow-growing asset in an internationally financed venture

capital fund's portfolio. [4] The sale to PharmaCielo looks to have been contingent on the venture capital fund injecting capital into one of its other investments…a company founded by none other than PharmaCielo co-founder Federico Cock-Correa.

1. In August 2009, a newly-launched venture capital fund managed by Medellin-based banking group Promotora SA acquired a 49 percent stake in **Ubiquo Telemedicina** as its first investment, paying 1.6 billion Colombian Pesos (or U.S. $771,000) for the stake. [Pg. 11]
2. The fund's second investment in November 2009 was in **Ecoflora SAS** the extract company founded by PharmaCielo co-founder Cock-Correa and his uncle and which was being managed by his cousin at that time. [Pg. 11 & Pg. 6]

We had a short phone interview on February 25, 2020 with Nicolas Rios Sanchez, who heads Promotora SA's venture capital unit and also sits on the Ecoflora board.

Rios said the fund has made follow-on investments into Ecoflora since its initial investment. He said its latest investment into Ecoflora was "around early 2018" after a decision by the fund's limited partners at a general assembly meeting. He did not specify the date nor gave the amount of investment agreed at that time.

When asked if funds from the Ubiquo Telemedicina sale to Pharmacielo (where Cock-Correa is director) were reinvested in Ecoflora (where Cock-Correa is founding partner), Rios initially said yes.

He later retracted that and said the decision to increase its investment in Ecoflora was taken before the sale of Ubiquo. He said the funds used for investment in Ecoflora came from an escrow held after the sale of another of the seven companies in the fund's portfolio. He then did not specify which company.

It is extremely unusual for a venture capital fund to make an investment in one company contingent on the sale of a supposedly unrelated company.

The timeline of the "escrowed" sale is consistent with PharmaCielo's acquisition of Ubiquo. PharmaCielo originally announced the acquisition in April 2018 and stated that "the acquisition is anticipated to be completed in 60 days or less." It didn't close until a year later. We suspect the delay was related to the escrow contingencies.

We also suspect the *real* reason PharmaCielo made the bizarre acquisition was to secure the investment in one of Cock-Correa's other companies.

We asked two of the fund's international partners about the possible link between the Ubiquo deal and the fresh financing for Ecoflora. The Spanish government international development agency AECID said it could not comment due to a confidentiality clause. BID Lab (formerly MIF), part of the Inter-American Development Bank, said it did not track specific investments but said the fund should not have made fresh investments in 2018 given that it was already in its distribution period.

## *Undisclosed Related-Party Deals: PharmaCielo's New U.S. Distribution Deal with General Extract LLC Is Yet Another Questionable Deal with A Former PharmaCielo COO*

Beyond questions about the propriety of the company's acquisitions, we also found irregularities with PharmaCielo's new distribution deals .

On September 25, 2019 , PharmaCielo announced that it was entering the U.S. market by inking a $3 million sales agreement with an "established multi-state" distributor called General Extract, LLC. PharmaCielo's CEO gushed over the deal's implications:

> *"To say we are excited about this milestone is an understatement."*

But what the company did not disclose seems far more important: General Extract appears to be a related party entity with no credible operations run by PharmaCielo's former Chief Operating Officer.

The articles of incorporation for General Extract, LLC show "John Knapp" as the company's registered agent.

E-Filed

Colorado Secretary of State
Date and Time: 07/13/2015 12:35 PM
ID Number: 20151451134

Document number: 20151451134
Amount Paid: $50.00

Document must be filed electronically.
Paper documents are not accepted.
Fees & forms are subject to change.
For more information or to print copies
of filed documents, visit www.sos.state.co.us.

ABOVE SPACE FOR OFFICE USE ONLY

**Articles of Organization**
filed pursuant to § 7-80-203 and § 7-80-204 of the Colorado Revised Statutes (C.R.S.)

1. The domestic entity name of the limited liability company is
General Extract, LLC
*(The name of a limited liability company must contain the term or abbreviation "limited liability company", "ltd. liability company", "limited liability co.", "ltd. liability co.", "limited", "l.l.c.", "llc", or "ltd.". See §7-90-601, C.R.S.)*

*(Caution: The use of certain terms or abbreviations are restricted by law. Read instructions for more information.)*

2. The principal office address of the limited liability company's initial principal office is

Street address
870 Navajo St
*(Street number and name)*
Dever — CO — 80204
*(City)* *(State)* *(ZIP/Postal Code)*
United States
*(Province – if applicable)* *(Country)*

Mailing address
(leave blank if same as street address)
PO Box 13618
*(Street number and name or Post Office Box information)*
Denver — CO — 80201
*(City)* *(State)* *(ZIP/Postal Code)*
United States
*(Province – if applicable)* *(Country)*

3. The registered agent name and registered agent address of the limited liability company's initial registered agent are

Name
(if an individual)
Knapp — John
*(Last)* *(First)* *(Middle)* *(Suffix)*

or

(if an entity)
*(Caution: Do not provide both an individual and an entity name.)*

Street address
PO Box 13618
*(Street number and name)*
Denver — CO — 80201
*(City)* *(State)* *(ZIP Code)*

Mr. Knapp was former "Chief Operations Officer" of PharmaCielo, per this 2016 regulatory filing with British Columbia Securities Regulators.

Hilariously, his title was also confirmed in an interview of Knapp ***by none other than Anthony***

***Wile in 201***. The interview starts off as introducing Knapp as the "Chief Operating Officer for PharmaCielo, Ltd."

> ***Introduction:*** *John Knapp is the founder of Colorado-based Good Meds Network, a medicinal-grade cannabis business, of cannabis consulting firm GMC & Associates, and of Gro|Quip, a gardening equipment distributor. John was previously senior marijuana design engineer for a top cannabis consulting firm for three years. John is the Chief Operating Officer for PharmaCielo Ltd. He is a trained industrial engineer, entrepreneur and expert in the field of cannabis business, supplychain management and logistics. A pioneer in the legal cannabis industry, he has consulted on over a dozen cannabis projects in seven states, Canada and South America.*
>
> **Anthony Wile:** Hello, John. Thanks for speaking with us. Tell us about your businesses. You started Good Meds Network and Third Wave Enterprises, which are both medicinal cannabis businesses in Colorado, the first state in the US to legalize cannabis.

## *General Extract, Which PharmaCielo Described as an "Established Multi State Distributor" Appears to Have No Products and No Credible Operations Whatsoever*

Most "established" companies at least have a website.

When we examined General Extract, we found that its website domain was registered on November 14, 2019, about 3 weeks *after* entering into its sales agreement with PharmaCielo.

**generalxtract.com is already registered***

Domain Name: GENERALXTRACT.COM
Registry Domain ID: 2455219929_DOMAIN_COM-VRSN
Registrar WHOIS Server: whois.namesilo.com
Registrar URL: http://www.namesilo.com
Updated Date: 2019-11-18T14:55:29Z
Creation Date: 2019-11-14T19:12:06Z
Registry Expiry Date: 2021-11-14T19:12:06Z
Registrar: NameSilo, LLC
Registrar IANA ID: 1479
Registrar Abuse Contact Email: abuse@namesilo.com
Registrar Abuse Contact Phone: +1.4805240066
Domain Status: clientTransferProhibited https://icann.org/epp#clientTransferProhibited
Name Server: NS1.INMOTIONHOSTING.COM
Name Server: NS2.INMOTIONHOSTING.COM
DNSSEC: unsigned
URL of the ICANN Whois Inaccuracy Complaint Form: https://www.icann.org/wicf/
>>> Last update of whois database: 2020-02-24T20:20:43Z <<<

Along the same lines, the email address used by General Extract in its press release with PharmaCielo was a Gmail address (presumably because they didn't even have a domain registered at the time):

**About General Extract**

General Extract was founded in 2015 as an importer, distributor, broker and post-processor of hemp and hemp derivatives. Working in value-add areas of the supply chain, General Extract operates a hemp-derivative refinement and distribution center in Denver, Colorado. As an intermediary in the global supply of cannabis products, General Extract is closely aligned with both the upstream and downstream cannabis industry leaders. For more information, please email GeneralExtractCo@gmail.com.

General Extract's newly created website looks rather bare, with no information on company executives, and no listed e-mails or contact information, except for contact forms that visitors can fill out to request additional information.

All of its products appear to be "coming soon":


The one coming soon product with a description is its "CBD isolate", which it describes as grown from Colombian hemp (presumably from PharmaCielo).

Despite the claim by PharmaCielo that General Extract is a "multi-state" distributor, we were unable to find evidence to confirm this. Nothing on General Extract's website as of 3/1/2020 says anything about multi-state distribution, multiple locations, or suggests any clients exist other than PharmaCielo.

## *We Visited General Extract in Colorado And We Found Its "Offices" Bore the Logo of a Different Company. Its Parent Company's Office "Suite" Was Actually A Mailbox at A UPS Store*

In order to find out more about General Extract and its parent company, Redwood Green Corp., we sent investigators on the ground to its office address in Colorado, at 866 Navajo St in Denver.

There was no indication that the address housed any entity called General Extract. The back of the building was unmarked and there was simply a "No Trespassing" sign hanging up.


Our investigator said that from the outside, there was no indication of what company occupied the address. They said that 866 is hidden away in the back of a parking lot.

Our investigator, did, however, see people leaving various parts of the building around 4:50pm local time; some of whom were wearing grey sweaters with a logo that resembled a "Good Meds" logo. "Good Meds" is the *other* brand owned by Redwood Green and operated by John Knapp, the individual listed on General Extract's corporate documents.


They also said there was a large "Good Meds" logo when they entered General's Extract's

address, but that they didn't see any "General Extract" signage inside.

Our investigator also inquired with the front desk as to the nature of the business and was told it was a "grow op" (a grow operation), which is consistent with Good Meds business description .

Note that for a grow operation we expect its external presence to be somewhat minimal (for security purposes) but also anticipated that there would be some sign or acknowledgement at the front desk that General Extract existed at its stated location.

Instead, it appears that General Extract exists largely on paper.

## *Undisclosed Related-Party Deals: General Extract's Parent Corporation, Redwood Green, Is Also Replete with Related Party Ties to PharmaCielo*

General Extract's parent company, Redwood Green also consists of multiple people tied closely to PharmaCielo. Redwood is a public company that trades on the OTC markets under RDGC and averages about ~2,500 shares traded per day.

Redwood Green Corp.'s CEO was Christopher A. Hansen until his conveniently timed resignation last Wednesday. Hansen was the former CEO and President of PharmaCielo, according to his LinkedIn profile.

John Knapp also served as a director of Redwood Green until *his* conveniently timed resignation last Tuesday. (Note: LinkedIn bios disappearing and resignations like these started to occur as our investigation and inquiries into the company picked up steam.)

And effective December 2019, Delon Human, who is listed on his LinkedIn profile as PharmaCielo's current President of Head Health and Innovation, is the Chairman of the Board of Redwood. Large shareholders of Redwood also appear to have significant ties to PharmaCielo.

| | Holder Name | Source | Opt | Position1 | % Out | Latest Chg | File Dt |
|---|---|---|---|---|---|---|---|
| | | All | All | | | | |
| 1. | URIBE CARLOS MANUEL | Annual Re... | | 8,000,000 | 7.59 | 8,000,000 | 05/23/19 |
| 2. | ACOSTA ANDRES FERNA... | Annual Re... | | 5,000,000 | 4.74 | 5,000,000 | 05/23/19 |
| 3. | GOMEZ MIGUEL COCK | Annual Re... | | 5,000,000 | 4.74 | 5,000,000 | 05/23/19 |
| 4. | Hansen Christopher | Annual Re... | | 4,000,000 | 3.79 | 4,000,000 | 05/23/19 |
| 5. | Knapp John S | Annual Re... | | 2,200,000 | 2.09 | 2,200,000 | 05/23/19 |
| 6. | Graham Joseph | Annual Re... | | 500,000 | 0.47 | 500,000 | 05/23/19 |
| 7. | Lord Kenneth | Annual Re... | | 500,000 | 0.47 | 500,000 | 05/23/19 |
| 8. | Kelly Cindy Lee | Annual Re... | | 320,016 | 0.30 | 0 | 05/23/19 |

Carlos Manuel Uribe (Lalinde) and Andres (Fernandez) Acosta, for instance, are both directors of PharmaCielo Colombia, per PharmaCielo's website. Miguel Cock-Gomez is the son of PharmaCielo co-founder Federico Cock-Correa.

PharmaCielo

Home | Our Story | Leadership | Our Process | For Investors | Company News & Media

PharmaCielo Ltd. Board of Directors | PharmaCielo Colombia Board of Directors | Medical & Scientific Advisory Board

PharmaCielo Ltd. Management Team | PharmaCielo Colombia Management Team

Carlos Manuel Uribe
Chairman of the Board

Federico Cock-Correa
Director

Andrés Fernández Acosta
Director

Claudia Jiménez
Director

Silvia Ochoa
Director

Jorge Julián Osorio
Director

Maria Fernanda Saldarriaga
Director

Like General Extract, parent Redwood Green also sports a relatively bare looking website which appears to have used the same template.

The address listed for Redwood Green Corp. on its website , described as "Suite D-357":

# INVESTOR FAQS

## Where is Redwood Green's corporate headquarters?

Redwood Green's principal offices are in Denver, CO. Our mailing address is 3531 South Logan Street, Suite D-357, Englewood, CO 80113

When we visited the address, we found it was actually a UPS store:


And Redwood's "Suite D-357" was nothing more than a medium sized mailbox inside of that store.


The woman working at the counter at the UPS Store confirmed to our investigator that Box 357 did, in fact, belong to Redwood Green.

All told, nearly all of the key people at PharmaCielo's new U.S. distribution partner General Extract (and its parent Redwood Green) appear to be related to PharmaCielo.

Most importantly, none of this was disclosed to investors when the company touted its "milestone" distribution deal.

## *The Role of Bahamian Broker Elco Securities—Doing Anthony Wile's Dirty Laundry?*

Recall from the SEC's 2007 action against Anthony Wile , Bahamian broker LOM Securities Ltd. was also implicated. The brokerage firm was used as a vehicle for dumping shares onto the market after Wile's alleged deceptive press releases were issued.

We believe that Wile could be using the same playbook he was using in 2007 by using a Bahamian brokerage firm to conceal his ownership. This time, it appears to be a firm called Elco Securities. We found numerous direct links between Elco Securities and Wile in his dealings both in Colombia and with PharmaCielo.

1. Recall the directors list from the Panamanian entity SAADC, associated with the highly suspicious Rionegro land deal:

**NINTH**: The Officers of the corporation, who may indistinctly be natural or juridical persons, shall be elected in the manner and under the terms as provided in the By-laws, if any, of the corporation. Until a new election, the first **OFFICERS** of the corporation shall be the following persons: ----------

**DAVID HOANG**----------**President** ----------

**SHEVIA SERLENE GOMEZ**----------**Secretary**----------

**JOHN DEREK BENJAMIN**----------**Treasurer**----------

David Hoang and John Derek Benjamin, registered directors and officers of SAADC, also turn up as "Registered Personnel" of Elco Securities, based on Bahamian regulatory documents :

Securities Industry Act, 2011

Registrants as at 31 August 2017

| Name | Categories | Phone | Fax | Email | Address | P. O. Box | Registered Personnel |
|---|---|---|---|---|---|---|---|
| Elco Securities Limited | 1. Dealing in Securities as Agent<br>2. Arranging Deals<br>3. Managing Securities<br>4. Advising on Securities | 367-2558 | 367-2568 | elcobank@batelnet.bs | Loyalist Plaza, Don Mackey Boulevard,Marsh Harbour, Abaco | AB-20377 | John D. Benjamin; Ellison Collie; Lawrence Collie; David Hoang; |

Also recall from above that Hoang worked as Chief Trading Officer of High Alert Capital, a private investment firm where Anthony Wile served as Chairman & CEO, according to Canadian corporate records .

2. Elco appears to have been an early backer of PharmaCielo. We see on a 2016 British Columbia Regulatory form for PharmaCielo that Elco Securities, Ltd. is shown to own 7.987 million common shares and 479,610 warrants of PharmaCielo.

3. Anthony Wile's personal website has a testimonial from the managing director of Elco

"Anthony Wile has been advising our securities firm with top-down trend and sector analysis for almost 15 years. His uncanny ability to uncover early-stage investment opportunities that mature to deliver powerful investment profits is simply outstanding – our clients couldn't be more pleased."

– Ellison Isaac Collie, Managing Director, Elco Securities Ltd.

4. Elco Securities advised on an acquisition made by Redwood Green. The senior leadership of Redwood Green included multiple former PharmaCielo executives, and the company recently

entered into a suspicious U.S. distribution agreement with PharmaCielo, as described above.

5. Anthony Wile is the Chairman/CEO of a private equity firm called Grupo Jaque. We found another entity called Jaque Proyectos Inmobiliarios (translation: Jaque Real Estate), per corporate registry documents. The entity was registered in the name Lawrence Collie, the Secretary/Company administrator for Elco Securities, per his LinkedIn profile. Both entities share the same address. [1,2]

6. Jaque Real Estate listed another address on its Rionegro Chamber of Commerce forms, which were on the first floor of a shopping mall in Rionegro (Centro Comercial Complex Llano Grande KM8 Oficina 1, Rionegro). **We found that it is actually used as a corporate office for harmaCielo.** Our investigator visited and spoke with a cleaning staff member. She said "(It) is the PharmaCielo office."

The office had no signage whatsoever, but when our investigator approached, personnel came out to speak to him. He asked if it was the PharmaCielo office. The office employee responded:

> *"Yes this is PharmaCielo but there's nobody here right now. Better go to the plant (the growing facility in Rionegro)."*

We think it is tremendously odd that Elco Securities, an opaque Bahamian broker, has so many direct ties to Anthony Wile and the slew of undisclosed-related party deals surrounding PharmaCielo. We would bet just about anything that many of the shares involved in these suspicious deals have been deposited into Elco Securities accounts.

## *Another Sketchy "Partnership": PharmaCielo Is Paying a Company Called XPhyto To Buy PharmaCielo's Product with PharmaCielo's Money*

Aside from General Extract, the other major distribution deal PharmaCielo has in place is with a small penny stock company called XPhyto Therapeutics.

On January 27, 2020, PharmaCielo announced a 30,000 kg cannabis extract agreement for the German market with XPhyto Therapeutics Corp.

PharmaCielo CEO David Attard pitched the partnership as:

> *"…a significant opportunity to export an ever-expanding range of medicinal products into the German market, including those containing THC…"*

It was described as a catalyst to potentially ramp up sales in a big way for PharmaCielo:

> ***We expect to generate meaningful revenue** through this agreement over the next three years and are focused on continuing the ramp-up of our sales efforts through 2020."*

But upon examining the XPhyto deal closer, we don't believe this deal holds promise.

XPhyto's financials show that the company was in apparent distress leading up to the deal. In the 9-month period prior to announcing the deal, XPhyto reported revenue of $45,000, operating losses of $5,351,789, and cash of only $791,030. In other words, they look to have been at the brink of insolvency.

At the very end of the press release announcing the deal with PharmaCielo, in a section called "Additional Information", we see that PharmaCielo "invested" CAD $500,000 into Xphyto as part of the deal.

When it boils down to it, this partnership appears to us to be a sham. PharmaCielo is paying a distressed company to "buy" its product. Aside from the splashy headline, the "deal" appears to offer no economic advantage.

In a best-case scenario, we think PharmaCielo will get its own money back and have to hand over valuable product. So far, we haven't seen any purchases by XPhyto as the partnership announcement was recent, on January 27, 2020.

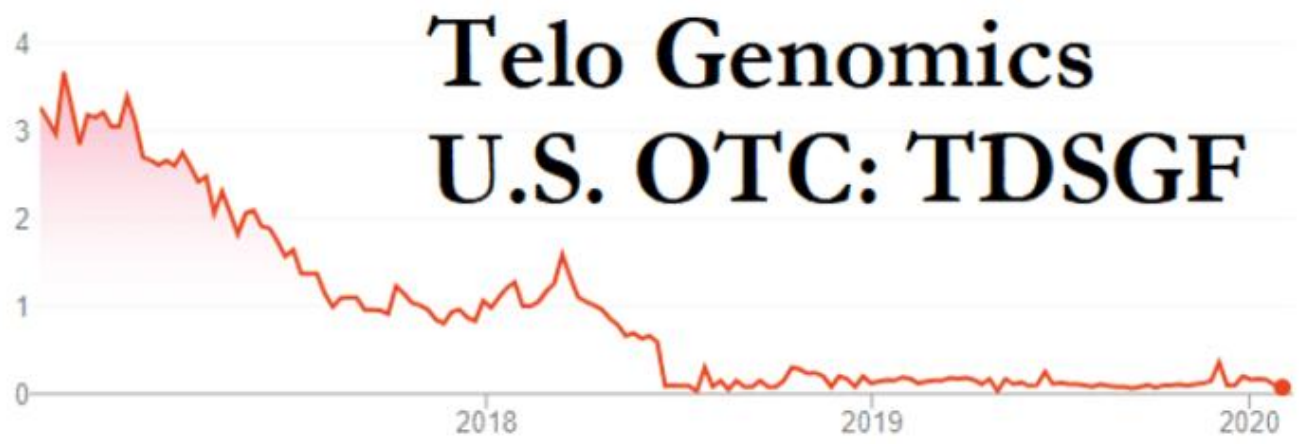
Realistically, given the state of XPhyto's current balance sheet and its dwindling cash, we expect PharmaCielo will simply lose most of its investment in XPhyto with little to show for it.

## *XPhyto's CEO Has A Perverse Track Record of Being an Insider or Director At Companies That Have Gone Bankrupt, Been Delisted or Have Seen Their Equity Get Demolished*

In case there is any doubt that PharmaCielo's "investment" in Xphyto is wrong-footed, we reviewed the track record of XPhyto's CEO, Hugh Rogers, through his SEDI disclosures and his LinkedIn biography .

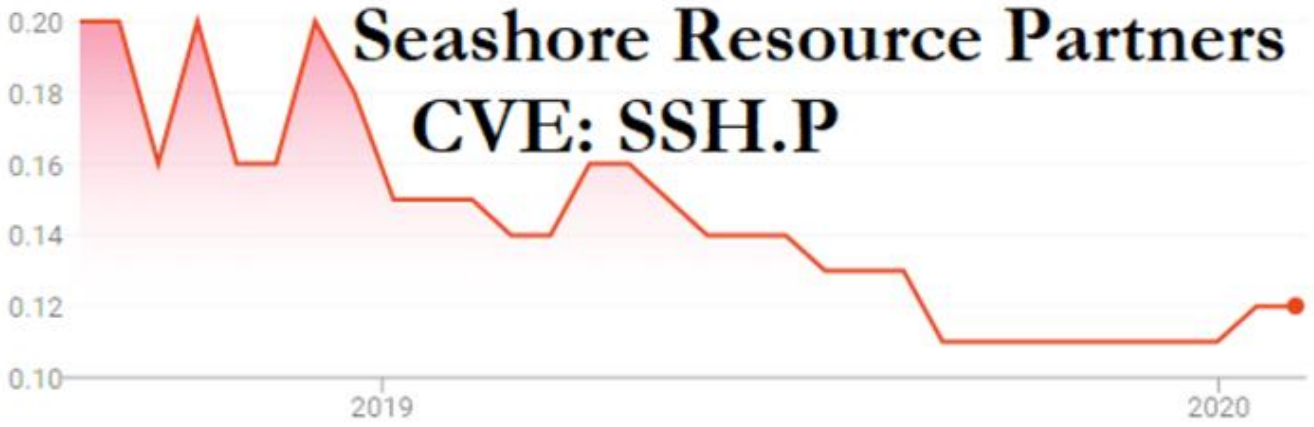
Success seems to have a way of eluding Rogers.

Most recently, in addition to Xphyto, Rogers' LinkedIn and SEDI disclosures list him as Chairman of the Board of Telo Genomics Corp., beginning in September 2018 and effective through present day.

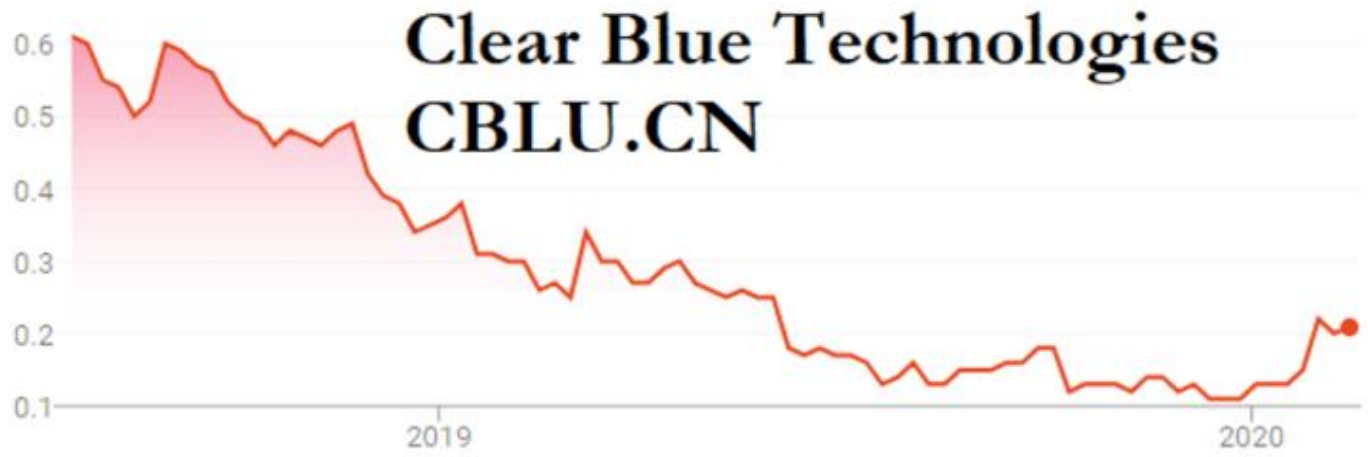



Telo Genomics was previously known as 3D Signatures, which announced intentions to file for bankruptcy in May of 2018, before changing its name to Telo Genomics in April 2019.

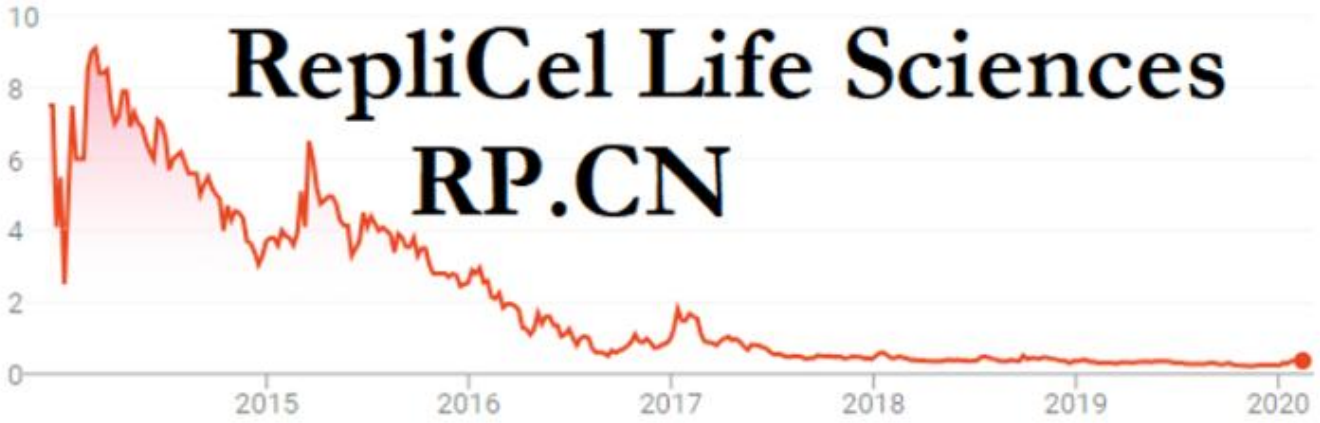
Rogers is also listed as a Director and Senior Officer of Seashore Resource Partners Corp. a company founded in 2017.



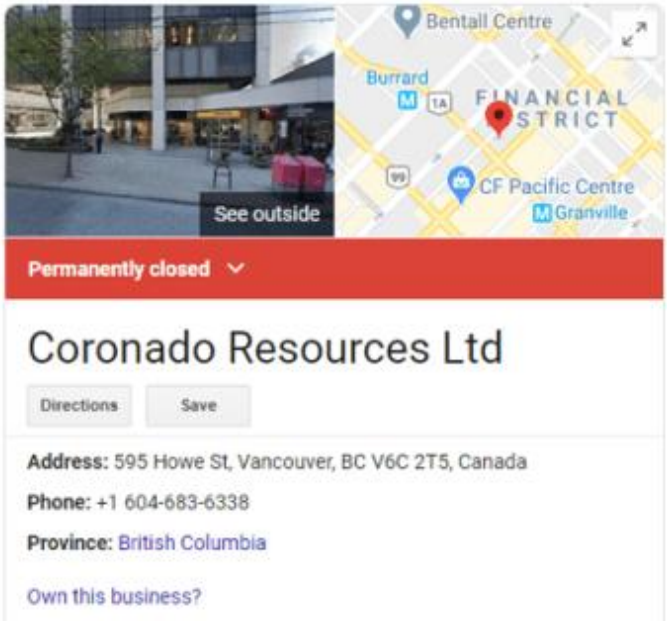

Rogers' LinkedIn profile also lists him as a former Independent Director of "Clear Blue Technologies International, Inc." from July 2018 to June 2019.




Prior to Clear Blue Technologies, Rogers' LinkedIn lists him as an "Independent Director" of RepliCel Life Sciences, Inc. from February 2017 to December 2018. RepliCel has been decimated since 2014.




Prior to his stint at RepliCel, Rogers listed himself as CEO & Director of Coronado Resources, Ltd. from March 2015 to October 2017. Coronado Resources was ultimately delisted around 2018.




Rogers' SEDI disclosure also lists him as a former Director of Kootenay Zinc Corp. (formerly Oceanside Capital Corp.).


We think Rogers' previous ventures telegraph the direction of PharmaCielo's investment in Xphyto.

## *PharmaCielo's CEO Tries to Calm the Market as PCLO's Stock Falls. Meanwhile, Co-Founder Anthony Wile Is Spraying the Open Market with Stock*

Currently, co-founder Anthony Wile owns 12.8 million shares of PharmaCielo, making him the largest holder of shares (almost 13% of shares outstanding, per FactSet).

Per his SEDI disclosures , Wile recently unloaded 200,000 shares of PCLO into the open market roughly a week ago, on February 20, 2020.

Just four days after Wile dumped his shares, PharmaCielo's CEO, David Attard, released a letter to shareholders where he seemed to attribute the share price pressure to the market being in a "secular transition" after saying he'd like to "acknowledge that both my team and I understand the stock price performance has been difficult to experience". (Note that this was prior to the market-wide meltdown last week.)

> *"While the sell-off in our stock is unjustified in our view, we see it as temporary," Attard says in his letter. "Each member of the senior management team has individually allocated significant personal dollars – outside of any option grants – to buy the Company's stock, and* ***we remain confident holders."***

Given the fact that the TSXV listed stock trades, on average, only 147,000 shares per day (per FactSet as of this writing), any additional unloading of stock from Wile could act as a significant headwind.

## *Financials and Operations: Overview of Assets, Cash Burn, and Revenue*

Here are some basics on the financials, and why we think Wile is dumping stock at these levels.

Starting with the assets, as noted in the introduction, the company has land and greenhouse assets, primarily in Rionegro Colombia. We have confirmed that the company continues to grow cannabis at those facilities, providing a flow of inventory and biological assets, which stood at CAD $3.7 million last quarter. [ Pg. 2]

We also confirmed the company's cannabis licenses with local authorities. [ 1,2,3,4]

Company financials as of September 30 2019 showed cash of roughly CAD $21 million, as well as PP&E of $23.4 million. [Pg. 2]

While this typically supports an argument for some equity value, the company is burning cash at a rapid rate. In the 9-month period ending in September, the company had burned $21.1 million in cash from operations. The burn rate amounts to about $7 million per quarter, which

we estimate leaves it with ~$11.7 million remaining, or less than 2 quarters worth of cash.

As shown above, we think the property is highly overvalued, and in either case the physical assets have not been able to produce any return on assets for the company (nor did they when it was a flower business that remains in receivership).

Total reported revenue to date has been only CAD $130,000, including ~$61,000 in cannabis revenue and ~$69,000 in revenue from what appears to be a now-defunct telemedicine acquisition. We expect the company may report some additional revenue through its related-party distribution deal with General Extract, but, as shown above, we do not view this as sustainable (or entirely credible).

## *Financials and Operations: Cap-Ex Needs and the Company's Delayed Oil Processing Centre*

We think the company can unlock some additional revenue once it completes its oil processing facility. Note that Colombia currently allows the export of cannabis oils and only limited dried flower for medical purposes, making the ability to process oils important.

On April 18, 2019 the company announced hopeful signs of progress on its construction of the facility:

> *"(The) oil processing facility is on track for commercial operation and GMP certification during Q3-2019, enabling large-scale production and sale of refined cannabis oil."*

> *"We anticipate the completion of our first major processing expansion in Q2 and our GMP certification in Q3."*

By May 27, 2019 the company announced further progress and reiterated its timeline:

> *"Construction of Colombian processing facility progressing toward production in late Q2/early Q3"*

By August 25, 2019 the facility was " nearing completion ".

As of the most recent quarter ending September 2019, however, the company pushed back its estimates to "late 2019." [ Pg. 24]

We also see from the same filing that despite the company claiming the oil processing centre was "nearing completion" in August 2019, by September it estimated that over U.S. $7 million in anticipated capital expenditures would be needed in order to complete the project. [ Pg 8]

> *"To date, the Research Technology and Processing Centre costs have been USD$10 million and* ***management projects that the completion of facility will require an additional USD 7 million****"*

The company has not yet announced whether the facility is completed. We contacted investor relations and asked about its status and have not yet received a reply. The facility does appear to be under construction, according to pictures posted by a development group associated with the project:

Source: OM Energy Facebook photos

The photos were posted around June 2019. Based on the timing, we anticipate that the external elements of the building are completed or close to being completed. We attempted to visit the facility to examine its progress but were unable to.

In either case, investors should factor in the additional estimated $7 million cash burn from the cap-ex required to complete the facility. We also think the company should provide investors with an update on progress, with pictures.

## *Financials and Operations: Reported Issues with Mold and Heavy Pesticides in the Company's Rionegro Facility*

Additionally, a source that our investigator spoke with, a businessperson who is part of the flower-growing industry, said based on their recent knowledge and entry to the PharmaCielo facility, they believed the cannabis crop there was "suffering from a bad outbreak of the fungus botrytis (or gray mold.)"

They said the fungus was a major problem with certain flower cultivations, especially daisy poms (pompoms) – which is the type of flower that our investigator was told was being cultivated on the property prior to PharmaCielo taking it over.

The source said that, in their experience, the only way to treat it when present in flowers was to "treat it very hard with chemical fungicides". They also said the cultivation of daisy poms required heavy usage of pesticides, fungicides and other chemicals. These types of issues are no doubt familiar to most cannabis investors with experience in large grow operations. Ultimately, they can affect the ultimate quality and quantity of production.

The other salient land issue is the flood risk from an adjacent stream. An officer at the Rionegro planning department explained about one-third of the 27 hectare facility could not be used for building or agriculture because it was on a flood plain and subject to strict environmental controls.

## *Conclusion: Completely Uninvestable*

To us, it's easy to see the forest for the trees: what looks to investors like a promising Colombian marijuana company appears to us to simply be another self-enrichment scheme by Anthony Wile and other executives with histories of destroying shareholder value.

We saw some signs of management self enrichment when we began our investigation, but we initially expected it to be relatively contained. Our research over the course of several months has taken that conclusion and flipped it on its head:

| Counter-Party | Relationship | Details | Verdict |
|---|---|---|---|
| Anthony Wile | Co-Founder/Ex-CEO/Largest holder | Accused by SEC of **Securities fraud and barred from officer/director role for 5 years** | 🚩 |
| Rionegro Cultivation Facility | Current cultivation facility (related party transaction) | Sold for a massive mark-up, enriching insiders who **pocketed an estimated $5.35 million** | 🚩 |
| Cauca Region "Facilities" | Greenhouse construction in 2017 for next phase of growth | Doesn't exist: we have **PHOTO & VIDEO EVIDENCE** of the site being an empty field | 🚩 |
| Ubiquo Telemedicina | Telemedicine acquisition | Appears to be another insider enrichment deal. Telemedicine website **no longer works.** | 🚩 |
| General Extract LLC | Key distributor in the U. S | Related party transaction- PCLO executives ran this co… classic 'pump' playbook | 🚩 |
| XPhyto | Key customer in Germany & into the EU | PCLO financed XPhyto with cash to buy PCLO products… XPhyto has virtually no financials | 🚩 |

The best case for shareholders, in our view, would be if the company is eventually acquired (at significantly lower levels from here). After repricing, a new owner may try to attempt to correct current management issues. We expect the far more likely scenario is the company just continues to burn through its cash and assets on the way down however.

Whether regulators, operational financing realities or the open market get to the company first is irrelevant – we believe PharmaCielo's equity is headed to $0 over the course of the year.

*Disclosure: We are short shares of PCLOF (PharmaCielo's U.S. OTC equity)*

Please see our full legal disclaimer at the bottom of our report.

## *Appendix A: PharmaCielo's Colombian Government Contacts*

Part of PharmaCielo's "success" to date has been driven by Anthony Wile's close association with high-level members of the Colombian government. It is unclear that they truly knew what they were getting involved with.

PharmaCielo was the first company – Colombian or international – to be granted a license to

grow cannabis and produce derivatives on June 27, 2016. [ Pg. 10] From that date until time of writing, 607 licenses have been issued in Colombia, according to the Justice Ministry.

On Aug. 2, 2018 Anthony Wile was granted Colombian citizenship by decree of President Juan Manuel Santos, whose government enacted new laws to allow the growing of medicinal cannabis.

In a photo of the event , a beaming Wile is pictured with his arm around the then Colombian foreign minister Maria Angela Holguin.

A PharmaCielo press release congratulated Wile and said:

> *"The granting of citizenship recognizes Mr. Wile's significant contributions to Colombia and commitment to bringing Canada and Colombia closer together."*

In that same statement, Wile was attributed as saying:

> *"I would like to thank President Santos and his administration for bestowing upon*

*me this tremendous honour"*

PharmaCielo, whose board includes a former agriculture minister , clearly retains fluid communications with the Colombian government.

Last week, on Wednesday, February 26 Justice Minister Margarita Cabello Blanco visited the PharmaCielo plant in Rionegro. Media were not invited but in a written statement afterwards, her press team said she "emphasized that one of the main objectives of the national government was to stimulate a legal, safe and high-quality medicinal cannabis industry."

She said: "We continue promoting the industry based on clear rules of control, quality and entrepreneurship and with total transparency regarding the process of licensing and quotas that fulfill the legal requisites."

Here are several pictures from the recent visit:

## *Appendix B: PharmaCielo's Italian and Mexican Joint Ventures*

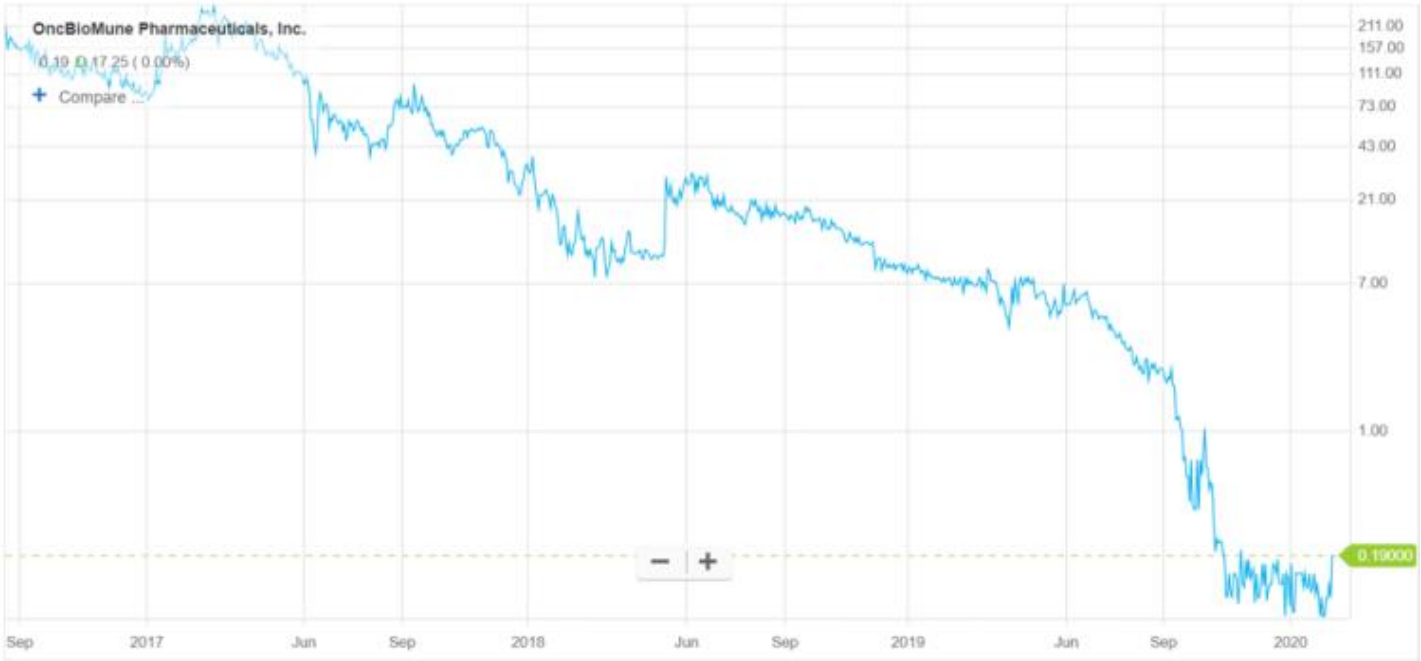
We examined PharmaCielo's JVs in Mexico and Italy but left them to an appendix simply because they are preliminary and don't appear to have generated business thus far.

**Mexico.** On January 28, 2019 PharmaCielo announced a joint venture in Mexico with MINO Labs S.A. de C.V, described as "a specialty pharmaceutical company and medical supply distributor".

Mino Labs is run by Manuel Cosme Odabachian, who has some experience with JVs. Odabachian ran another Mexican company called Vitel Laboratories, which signed a JV with publicly traded OncBioMune Pharmaceuticals, Inc (OTC:OBMP) on August 19th, 2016

He then served as director of OncBioMune from March 13, 2017 until his resignation on December 22nd 2017.

***The stock is down 99.9% since the signing of the JV:***




Mino labs now looks to share the same phone number as the ill-fated Vitel Laboratories:

www.cbinsights.com › company › mino-labs ▾

MINO Labs - CB Insights

All investors data 0 Investors. Phone: (52 55) 5202-5854. Fax: Monte Pelvoux 130 3rd Floor Lomas de Chapultepec Mexico City, 11000. Mexico ...

www.cbinsights.com › company › vitel-laboratorios ▾

Vitel Laboratorios - CB Insights

All investors data 0 Investors. Phone: (52 55) 5202-5854. Fax: Monte Pelvoux 130 Piso 3. Lomas de Chapultepec, Miguel Hidalgo Mexico City, 11000. Mexico ...

**Italy.** On December 31, 2018 PharmaCielo entered into a joint venture agreement with Italian-based Eugene S.r.l, which holds two genetic research and technology patents. [Pg. 30] The Italian corporate registry documents for the JV entity (translated) show no obvious signs of financial activity aside from the initial nominal capital contribution.

The CEO of the JV entity, Adriano Aldegheri , runs a DNA testing company called DNApro .

## *Appendix C: PharmaCielo's Attempted Acquisition of Creso Pharma (Another Distribution Company it Lent Money To Prior to Purchasing its Products)*

Creso Pharma is medicinal cannabis manufacturer, which develops, registers, and commercializes pharmaceutical-grade cannabis and hemp-based nutraceutical products and treatments.

On June 6, 2019, PharmaCielo announced that it would be acquiring all issued and outstanding shares and options of Creso for A$122 million in PCLO shares.

As of Creso's financials before the loan, the company was running a current account deficit, had 6-month operating losses of $6.2 million, and cash on hand of only $3.6 million.

Just 3 days after the announced deal, PharmaCielo advanced CAD $3.5 million to Creso under the terms of a bridge loan announced as part of the acquisition – once again lending cash to a "partner" as the company did with XPhyto.

On July 25th, PharmaCielo announced it had received the first commercial CBD isolate exporting permit from the Colombian government and on August 19th, about 2 months after loaning Creso millions of dollars, Creso received its first commercial CBD export from PharmaCielo, according to this press release.

The order doesn't appear to have been large. PCLO's cannabis sales to date total $60,843.

**PHARMACIELO LTD.**
**Condensed Interim Consolidated Statements of Loss and Comprehensive Loss**
**(Expressed in Canadian Dollars)**
**(Unaudited)**

| | Three Months Ended September 30, 2019 | Three Months Ended September 30, 2018 | Nine Months Ended September 30, 2019 | Nine Months Ended September 30, 2018 |
|---|---|---|---|---|
| **Revenue** | | | | |
| Sale of Cannabis derivative products | $ 60,843 | $ - | $ 60,843 | $ - |
| Revenue from online medical services | 69,287 | - | 69,287 | - |
| **Total revenue** | 130,130 | - | 130,130 | - |
| **Cost of Sales** | | | | |
| Cost of Sales - Cannabis derivative products | 67,183 | - | 67,183 | - |
| Cost of Sales - Online medical services | 3,159 | - | 3,159 | - |
| **Gross Profit before fair value adjustments** | 59,788 | - | 59,788 | - |
| **Unrealized gain in fair value of biological assets** | 2,073,214 | - | 2,073,214 | - |
| **Gross profit** | 2,133,002 | - | 2,133,002 | - |

Source: PharmaCielo Management Discussion and Analysis, Period Ending Sept. 30, 2019

In the end, the acquisition deal fell apart, but Creso did pay back the loan with interest, marking a clean exit out of this arrangement for PharmaCielo. Creso's stock currently trades at $0.08 and a market cap of $12 million.

It does not appear any sales to Cresco have taken place since the initial shipments however. We included this simply in the interest of being thorough, though the partnership does not appear to be ongoing.

## *Appendix D: Further Details on the Colombian Properties*

In land registry certificates, deeds and company incorporation certificates, the PharmaCielo property in Rionegro is referred to by different names including: Finca Santangelo, San Angelo, Lote Vilachuaga, Suspiro or La Margarita.

The address on company incorporation certificates is standardized as: KM4 Via Rionegro-La Ceja, Vereda El Capiro, Finca Sant Angelo.

The land is registered broadly under two land registration ID numbers, 020-10719 and 020-50485.

Parts of 020-50485 were then subdivided to create smaller plots including 020-192903. Finally 020-10719 and 020-192903 were consolidated into a single larger plot 020-192904.

According to land registry certificates, the accurate revised measurement of plot 020-10719 is 21.5 hectares and 020-192903 is 4.76 hectares. The total measurement of the consolidated plot 020-192904 is 26.26 hectares. That is the accurate land area of the Pharmacielo facility, although company press releases round up to 27 hectares.

The plots of land had been in the same family for 75 years or more and date from a time when land boundaries were measured often by eye and general, visible topographic markers including stones, rivers and paths. Only when land changed hands more recently were more modern surveying techniques used to give accurate measurements.

We found that the Rionegro facilities had actually been operated by Cock-Correa's bankrupt Tahami as a tenant, until PharmaCielo acquired the land. Here is a filing from as early as 1992 pulled from the Rionegro Chamber of Commerce showing Cock-Correa operating on the plot PharmaCielo now owns:

CAMARA DE COMERCIO

FORMULARIO DE MATRICULA MERCANTIL
SOCIEDADES

64 AÑO 198 92 05

000006

MATRICULA 01
RENOVACION 01 X

II MATRICULA No. 51 0 0 0 0 0 63

Afiliada a Confecámaras

(Léanse a máquina)

Lea las instrucciones generales
Favor diligenciar todo el formulario menos el espacio sombreado

000052

CLASE

03 CLASE DE SOCIEDAD

Limitada 3 X | Anónima 4 | Colectiva 5 | Comandita Simple 6 | Comandita por Acciones 7 | Extranjera 8

IDENTIDAD

04 NOMBRE DE LA SOCIEDAD
Cultivos Tahamí Ltda

ESCRITURA DE CONSTITUCION

05 No. 1768 | 06 NOTARIA 17 | 07 FECHA Ago.03.87 | 08 CIUDAD Medellín | 09 NIT 800.016390-1

10 DIRECCION DOMICILIO
Vereda El Capiro Finca Sant'Angelo

11 MUNICIPIO Rionegro | 12 DEPARTAMENTO Antioquia

13 TELEFONO 5 310319 | 14 APARTADO | 15 TELEX | 16 No. de establecimientos matriculados o que matricula en esta Cámara.

LUGARES DONDE DESARROLLA SU ACTIVIDAD

CAMP

61 Otros $

62 Total a pagar $ 113.190

Día 30 Mes 8 Año 92

69 Afiliado Desde ... 2

FIRMAS

70 Representante Legal (Apellidos y Nombres)
Federico Cock Correa

71 C.C. No. 70'556.439

Firma,

León Darío Orozco
CPT MAT 9466-T

Firma y Sello de la Cámara

CAMARA DE COMERCIO DE ... Antioquia

RECIBIDO

SOLOS NO PODEMOS, TODOS SI PODEMOS

FORMULARIO 3

The land is the hamlet of El Capiro, part of the municipality of Rionegro, in mountains just above Medellin, Colombia's second largest city. Rionegro is a traditional hub for flower production and also home to Medellin's international airport, José Mar a Córdova.

When family company Inversiones Villegas y Uribe Cia. was liquidated, the Rionegro property passed to the four children Agustin Uribe Villegas, Pedro Javier Uribe Villegas, Olga Marcela Uribe Villegas and Maria Paula Uribe Villegas.

Both plots of land that now make up the present-day PharmaCielo facility were sold in a single transaction.

The 020-10719 parcel is sold by the four owners to PharmaCielo Colombia Holdings SAS on June 1, 2016. The value of the transaction is listed as 8,401,699,500 pesos (8.4 billion pesos).

On 19 April 2017, the boundaries of the property are corrected at the registry. And on 30 August 2017, this property is joined with another 020-192903, sold on the same day to PharmaCielo Colombia Holdings SAS at a registered value of 1,809,000,000 pesos (1.89 billion pesos)., to make a single, consolidate area with a single new property registration number 020-192904.

The total, revised land area is now listed as 26.26 hectares.

The Uribe Villegas family later signed a deed ceding "rights of way" (transit rights) to PharmaCielo across an adjacent property. One of the siblings, Olga Marcela Uribe Villegas (a Catholic nun) sold "quota rights" for her share in those transit rights to her brother Agustin (10 pct), 5 percent each to her nieces Amalia and Monica Angel Uribe (daughters of her sister Maria Paula) for a value of 190,500,000 pesos.

The following day she sold an additional 5 percent quota rights to her third niece Patricia Angel Uribe for a listed 50,000,000 pesos.

## *Appendix E: Further Details on The Caucannabis Cooperative*

On its website, PharmaCielo says: "(Our) inclusive approach ensures that Colombia's indigenous communities, which have decades and even centuries of experience cultivating ancient Colombian strains of cannabis for spiritual and medicinal use, have their rightful seat at the table of the cannabis industry."

The Nasa indigenous group have a reservation in northern Cauca province but the cooperative/PharmaCielo venture is not on indigenous lands.

The reservation is governed by a series of tribal councils known as "cabildos" and the organization that represents them (CRIC) has issued public statements firmly opposing the legalized marijuana industry because of the violence that the illicit drug industry has fueled in the region.

The CRIC statement, the association representing 20 indigenous councils published in 2016, stated:

> *"None of the 20 indigenous cabildos is taking part in the Caucannabis initiative. Indigenous peoples refuse to fuel economic growth in this fashion especially when the government's intention is to open up the market to multinationals….we believe there's a hidden plan behind Caucannabis and that is the intention to patent common indigenous seed stock, take those seeds away and then oblige us to purchase only certified and probably imported seeds."*

This area of northern Cauca continues to be one of the epicenters of Colombia's illegal marijuana industry. It is currently facing serious security issues as Colombia's long-running civil conflict continues to rage there.

Dissident units of the Revolutionary Armed Forces of Colombia (FARC) who refused to demobilize as a result of the peace deal with the rebel leadership and the government continue to be active in the region. The other leftist guerrilla group, the National Liberation Army (ELN), is active in the area. Drug mafias and right-wing paramilitary squads are also heavily present in the area.

The violence in this region centers on control of lucrative drug plantations (cocaine, marijuana and a lesser extent heroin), drug trafficking routes (over the western cordillera of the Andres and down to Colombia's Pacific coast) and also income from illegal gold mining (hard rock and alluvial gold deposits).

PharmaCielo also appears to overstate its relationship with grassroots and indigenous communities elsewhere as part of its PR effort.

In a corporate press release to investors issued on December 13, 2018, PharmaCielo said it was "to produce 500-year-old cannabis strain in the ancestral territory of the Arhuaco".

It stated the company had "received a 500-year-old ancestral cannabis strain (the "Seeds") for its exclusive use, from the Arhuaco indigenous people (the "Arhuaco")."

The accompanying photo showed Andrew Wile and Federico Cock Correa posing with Luis Guillermo Izquierdo Torres, a "mamo" or spiritual authority of the Arhuaco community at the Rionegro premises – far from the Arhuaco indigenous lands.

The Arhuacos, like the other estimated 81 other indigenous ethnic groups in Colombia, have (on paper at least) special protections (Law 21 of 1991 which ratified ILO convention 169) and have jurisdictional control over their territories (Art. 246 Constitution of 1991) as long as those laws do not conflict with national laws.

The Arhuacos from the Sierra Nevada mountain range in northern Colombia were, like neighboring tribes, severely affected by the violence, killings and land invasions fueled by Colombia's illegal "marijuana boom" in the 1970s which was centered along the Caribbean coast.

For that reason, coupled with the experience of violence at the hands of Communist guerrillas and right-wing death squads, the Arhuaco people are very cautious about the commercial cultivation of any drug crop, legal or otherwise.

In the cosmovision of the Arhuacos, who call themselves the "Elder Brothers", all plants are sacred and have their role in ensuring the balance of life. They use many plants for their medicinal properties but are reticent about over-producing one or the other because of the impact on the "natural balance".

The Arhuacos are also very wary about any commercial dealings with non-indigenous partners, whether it is for tourism, mega-projects or mining. Before reaching any agreement with outsiders Arhuaco leaders will consult the "mamos" (the spiritual leaders) for their divinations and wisdom on the subject. They will also consult with traditional, non-spiritual leaders the so-called "governors" or "gobernadores".

In general terms, any company wishing to conduct business on indigenous territories would need to obtain "prior informed consent" (PIC) with the entire community under the terms of that ILO 169 convention.

With this in mind, one of our Colombian investigators talked to one of the Arhuaco governors about PharmaCielo's claims about their seedstock and a deal to grow cannabis on indigenous land.

He said: "I have no information about any deal with any company." He went on to say that no representative of the Arhuaco people had been authorized to hand over seed stock to third parties and said "if that has been done then it would be illegal".

He stated that there were no licensed marijuana plantations within the Arhuaco reserve and no licenses had been applied for.

The investigator then contacted the Arhuaco spiritual leader Luis Guillermo Izquierdo Torres. He said he had "bonded with specialists at PharmaCielo over their interest and deep knowledge" of medicine but suggested their conclusions were misinterpreted.

He said: "Until now there's no Arhuaco community producing cannabis as such. There are some mamos who may make potions for local use. Until now we have got nothing (no commercial arrangement). Maybe in the future we can make some laboratory experiments. "

When asked if he had handed a specific strain of cannabis to multinational corporations for their "exclusive use" as stated in its press release, Izquierdo said: "No seed of whatever kind or cannabis can be monopolized. Nobody is the owner of the seeds but we are all the custodians… It may be that multinationals, like others, are looking at this in a more commercial sense but we are looking at it in terms of service (to humanity)."

That statement is in line with the viewpoint one would expect from an Arhuaco spiritual leader. Their world view is that humankind, and specifically the indigenous groups of the Sierra Nevada, are the "guardians" of the world.

Izquierdo said the Arhuacos rejected any suggestion that seeds should be mutated or genetically modified.

He said: "Humankind does not know how to manage most plants and we have to generate that conscience first…as Mamos we are concerned that all plants should be used with dignity and that they should be in the service of life not for death."

All told, PharmaCielo's press release on the matter looks to have been inaccurate.

[Yes folks, we went this deep down the rabbit hole. Thank you for reading if you have made it to the end. We know it's a long report and we hope you appreciate the level of detail.]

## *Legal Disclaimer*

*herein is accurate and reliable, and has been obtained from public sources we believe to be accurate and reliable, and who are not insiders or connected persons of the stock covered herein or who may otherwise owe any fiduciary duty or duty of confidentiality to the issuer. However, such information is presented "as is," without warranty of any kind – whether express or implied. Hindenburg Research makes no representation, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results to be obtained from its use. All expressions of opinion are subject to change without notice, and Hindenburg Research does not undertake to update or supplement this report or any of the information contained herein.*

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[1] Based on $21 million as of September 2019, with historical cash burn of ~$2.3 million per month

[2] The filing statement generally references share sales around that time as being effected at U.S. $2.25 per share, although no specific value was assigned to the 1.7 million shares in the Rionegro deal.

[3] Currency calculation is 8.4 billion pesos (per the land record prices) at a prevailing exchange rate of 1 USD/2918 COP. Note that the second parcel was much smaller and closed almost a year later, likely not requiring any advance.

[4] An April 2016 report by another investor in Ubiquo, the Multi-lateral Investment Fund (MIF), it described the investment in somewhat disappointing terms: "Ubiquo's founders and initial investors are very good businesspeople but they are accustomed to organic growth over a 20-year period. VC sector industries need to grow far more rapidly." [ Pg. 16]

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# TAB 19

# NexTech AR: Relentless Stock Promotion, Sketchy Related Party Transactions and a Vaporware Product—Price Target: $0

Published on February 10, 2020



- Our investigation found that NexTech, a company that proclaims to be a leader in augmented reality, has virtually no credible business prospects and appears to be focused almost entirely on promoting its stock, and insider self-dealing.
- The company is on a paid promotion spree, engaging at least 8 promotional outlets. It has pumped out 112 press releases over the past year – equating to a press release every ~2.2 trading days.
- Contrary to management's claims that its customers "have nothing but rave reviews", we spoke to customers and found that many of them – including ones featured by the company in its glowing press releases – were either entirely unaware they had a relationship with the company or had never actually implemented the product.

- We identified multiple brazen related party transactions, including one where the CEO and COO acquired a business personally, only to turn around and sell it to the public company months later, likely netting millions at the expense of shareholders.
- The company has a significant share lockup coming due next month from a recent toxic financing and has displayed multiple other red flags, such as recent CFO and COO departures.
- We think NexTech has been thoroughly "pumped". We now expect a "dump". We believe its equity is worthless.

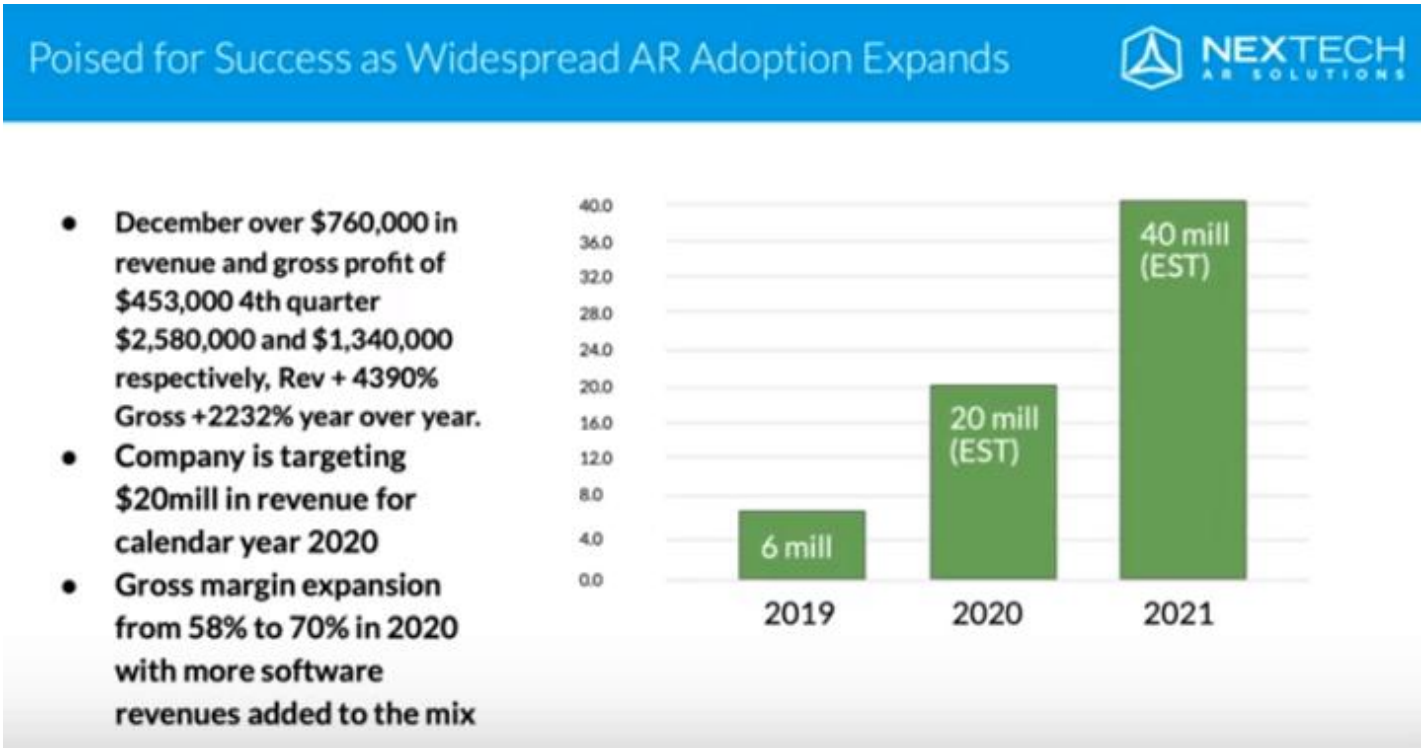
*Initial Disclosure: After extensive research, we have taken a short position in shares of NexTech AR. This report represents our opinion, and we encourage every reader to do their own due diligence. Please see our full disclaimer at the bottom of the report.*

## *Basics on the Company and the Bull Case*

NexTech claims to be an "augmented reality" (AR) company that aims to use its technology to disrupt the markets for advertising, education, eCommerce, and entertainment. As of the time of this report, the stock trades at a fully diluted market cap of ~$150 million and has spiked about 900% since it came public via spin-off in mid-2018.

The stock's explosive run looks largely due to promotion-driven excitement over its rapid revenue growth and aggressive projections. For example, one paid promotion site described the latest quarter's results as "more than $2.5 million in revenue for the period, 44 times more than the same quarter last year."

A recent presentation given by NexTech's CEO on another paid promotion site similarly highlighted 4390% revenue growth and estimated over 3x revenue growth this year alone: [19:50 minute-mark]




According to the company, the product is working incredibly well. The CEO says in one webcast that his company sees "nothing but blue skies" for eCommerce and that it has been "signing up customers at a very rapid rate". It is claimed that augmented reality provides up to 2,000% more product engagement, 400% more add to cart rates, and 50% fewer product returns than traditional eCommerce. ( 11:09-mark)

NexTech charges $79/month for the subscription to its AR advertising platform and claims it expects to hit breakeven cash flow imminently.

## *Introduction: Numerous Related-Party Transactions, Heavy Stock Promotion, Vaporware Products and Inorganic Revenue "Growth" Driven by Acquisition of 2 Websites that Sell Vacuum Cleaners and Pet Supplies*

Despite the rosy picture painted by management, we find that reality looks quite different.

As part of our investigation, we spoke with over a dozen of NexTech's customers and deal partners. Contrary to management's claims that its customers "have nothing but rave reviews", we found that many customers touted in the company's glowing press releases **were either entirely unaware they had a relationship with the company or had never actually implemented the product.**

NexTech has been aggressively promotional, having issued 112 press releases in the past year, and has engaged at least 8 paid stock promotion sites that tout the stock.

The company's eye-popping revenue "growth" has almost entirely been the result of acquiring companies with pre-existing revenue. Last year, the company bought 2 small eCommerce sites that sell vacuum cleaners and pet supplements. As of last quarter, these eCommerce sales accounted for 99.8% of revenue [ Pg. 16]

**12. SEGMENTED INFORMATION**

For the three months ended August 31, 2018 the Company had only one reportable segment. For the three months ended August 31, 2019 the Company has two reportable segments:

a) Corporate overhead, the operation of its AR technology license and services rendered for advertising revenue and the sale of apps and related advertising on IOS and Android platforms globally ("Corporate and Technology");

b) sale of vacuum cleaners through retail and online sales channels and sale of pet supplements through online sales channels ("E-commerce").

Capital assets are located primarily in the United States. Operating segmented information for the three months ended August 31, 2019 and 2018, is presented as follows:

| 2019 | E-commerce | Corporate and Technology | Total |
|---|---|---|---|
| | $ | $ | $ |
| Revenue | 1,510,191 | 3,005 | 1,513,196 |

These acquisitions have allowed the company to report staggering (but essentially meaningless) year over year growth rates.

Meanwhile, we have also identified sketchy related-party transactions taking place at the company. For example, NexTech's CEO and COO acquired the vacuum cleaner website into a newly-formed private entity, then almost immediately flipped the entity to the public company, likely pocketing millions at the expense of shareholders for simply stepping in the middle.

The company recently completed a financing round priced at an absurd ~70% discount to market prices. When factoring in the value of warrants, the round was essentially a "free money round" for the unnamed lucky beneficiaries. Those shares unlock next month, at which point we expect they will be aggressively dumped onto unsuspecting investors.

Overall, we think NexTech has been thoroughly pumped, and investors will soon experience the "dump".

## *Background: NexTech AR was a Spin-Out from A Cannabis Penny Stock That Now Trades at ~$0.03, Down ~98% From its 5 Year Highs*

NextTech spun out of a **cannabis company** (as *all great technology companies do*) called Future Farm Technologies (CSE:FFT), on August 31, 2018, and became a standalone public company.

Future Farm aspires to be a "leading supplier of pharma-grade health and wellness products, including those made from hemp". It, too, is heavily promotional, having issued over 180 press releases in its short ~3-year tenure as a public company.

As one example, during the height of blockchain mania, Future Farm announced an agreement to purchase a "blockchain cryptocurrency application for cannabis payment platform". The stock spiked to almost $1.40 on the buzzword-laden release, but now trades at ~3 cents, a near 98% collapse.

## *Background: NexTech's CEO, Evan Gappelberg, Has a History of Stock Promotion and Business Failures, Including a Key Role in the Future Farm Debacle*

NexTech's CEO is Evan Gappelberg. Gappelberg owns a securities firm called Atlas Advisors, incorporated in 1999, which offers various services including paid stock research and promoted CEO interviews. Former members of the Atlas Advisory team now work at other stock promotion outfits such as:

1. ProActive Investors (a stock promoter currently paid by NexTech)
2. Investology (example)
3. Venture Research, LLC (example)
4. Investor relations firm Blueshirt Group

Prior to Atlas, Gappelberg's biography mentions his early Wall Street experience at an unnamed firm, stating that he worked as "Senior Vice President of Finance where he underwrote Take Two Interactive Software, Inc.".

A quick search shows why the firm's name was left unsaid. Take Two was one of the only success stories underwritten by **Whale Securities**, a bucket shop that racked up an impressive number of regulatory sanctions (1) – including allegations of transacting business as an unregistered broker dealer, failing to comply with NASDAQ trading rules and failing to

supervise its employees.

**Disclosure Events**

All firms registered to sell securities or provide investment advice are required to disclose regulatory actions, criminal or civil judicial proceedings, and certain financial matters in which the firm or one of its control affiliates has been involved. For your convenience, below is a matrix of the number and status of disclosure events involving this brokerage firm or one of its control affiliates. Further information regarding these events can be found in the subsequent pages of this report.

| | Pending | Final | On Appeal |
|---|---|---|---|
| Regulatory Event | 0 | 15 | 0 |
| Civil Event | 2 | 0 | 0 |
| Arbitration | N/A | 16 | N/A |

The firm was also widely known for its small cap IPO failures .

WSJ

# Securities Firm's IPO Buyers End Up Getting Whacked

*By Carrick Mollenkamp and Robert McGoughStaff Reporters of The Wall Street Journal*

Updated Oct. 26, 1999 12:01 am ET

Investors have been buoyed by initial public stock offerings in the 1990s great bull market. But if you had bought and held the IPOs led by Whale Securities this decade, you would be underwater.

Outside of his stock promotion and Wall Street experience, Gappelberg also ran a business called "Wand World ". There, he is credited with such inventions as the Taxi Wand , a "hand-held beacon uniquely suited for hailing taxicabs", and the Britney Spears Concert Wand :



Wand World does not appear to have achieved commercial success.

A further review of Gappelberg's history shows he played a key role in the Future Farm debacle (the entity that NexTech spun out of):

1. Gappelberg helped raise an early round of financing through his firm, Atlas Advisors [ Pg. 11]
2. Gappelberg sold his personal portfolio of apps to Future Farm [ Pg. 26] The same app portfolio ended up being resold to into NexTech and was summarily discontinued and written down to zero. (More on this, and selling private assets to one's own public company, later.)
3. In early May 2017, Gappelberg and his wife's chocolate business announced a partnership with Future Farm, which outlined plans to launch a line of cannabis-infused chocolates. We called the chocolate business. The person who picked up the phone said they are closed until April and was "not sure" if they have a cannabis line.

## *NexTech Has Issued 112 Press Releases in The Last Year, Including Dozens of "Partnerships" and "Contracts"*

## *Without Reference to Actual Contract Economics*

NexTech has been extraordinarily promotional in its short tenure as a public company, averaging one press release every ~2.25 trading days over the past year.

The company regularly issues press releases announcing new partnerships or contracts that discuss huge market opportunities without detailing any actual revenue metrics. Numerous examples: (1,2,3,4,5,6,7,8,9,10,11,12,13,14,15,16,17,18,19,20,21,22,23).

Gappelberg, in an interview, mentions the "emerging **trillion**-dollar mega-trend of Augmented Reality" as the answer as to why he established NexTech.

The company touts similar enormous market opportunities on its website, where it claims the industry is "exploding" and is estimated to "hit $120 billion by 2022".

### About us

NexTech AR Solutions (CSE: NTAR) (OTC: NEXCF), based in Toronto, Canada is a rapidly growing leader in the exploding AR industry, estimated to hit $120 billion by 2022 according to Statista. NexTech provides businesses with augmented reality solutions that help drive their bottom line and competitive advantage. Whether for product promotion, increased sales, product training or brand evangelism, NexTech AR is focusing on several key multi-billion-dollar verticals including fashion & apparel, footwear, and luxury goods. Nextech is the first publicly traded "pure-play" AR company and began trading on the CSE on October 31st, 2018.

## *The Company Has Engaged in a Paid Promotion Spree, Pumping its Stock Through at Least 8 Promotion Outlets*

In addition to its slew of press releases, the company has hyped its future prospects through aggressive paid-promotion campaigns. We've identified no fewer than 8 stock promotion outlets hired by the small company that have collectively issued a slew of positive articles, "research", and CEO interviews:

1. Starwood Research, which called NexTech and its CEO Evan Gappelberg the "Tesla and Elon Musk of Micro-Cap" was paid $30,000 and an option to purchase 150,000 shares of

NexTech at C$2.00.

2. Zacks Small Cap Research put out glowing reports and was compensated with "quarterly payments totaling a maximum fee of $40,000 annually".
3. ProActive Investors posted bullish videos and articles and is paid up to $25,000 cash annually.
4. StockHouse was engaged by the company and paid an undisclosed sum.
5. FinancialBuzz acknowledged it sponsored NexTech content, though it did not disclose payment amounts.
6. StreetWise Reports acknowledged receiving compensation, which looks to be $10,000.
7. Octagon Media Corp. In a press release about a new client deal, the company slipped in that it paid Octagon 150,000 options and $60,000 for "investor relations services", which includes promotional interviews with NexTech's CEO.
8. CFN Media, a cannabis media penny stock (OTC:CNFN) was paid $90,000 in cash for its promotion of the company.

# *Part I: NexTech's Customers*

We wanted to see whether there was any substance to the company's promotional campaigns and press releases, so we spoke to over a dozen of NexTech's customers and partners in order to see how its products were being received.

What we learned was rather startling: in several cases, representatives for NexTech's customers and partners **had no idea they even worked with NexTech** or **stated openly that they'd never actually worked on any projects with the company**

Other customers we spoke with acknowledged not even paying for the product. Of the few that did, most pay $30 to $79 per month, likely less than the cost for NexTech to put out the press release touting the relationship.

## *A Partnership with Budweiser May Sound Like a Big Deal…*

## *… But it Was Actually Only a Contest Promotion for One Event at Budweiser Stage, a Local Music Venue in Toronto, and It Didn't Work*

## *Budweiser: "We Did It as a Test and Learn but It Didn't Perform and We Would Not Repeat"*

The most touted partnership by the company was a supposed deal with Budweiser. The

headline of the press release claimed "NexTech Launches ARitize App with Budweiser" and described how Budweiser selected NexTech to launch an augmented reality contest to celebrate the 25 th anniversary of the Bud Stage, which is actually a single music venue in Toronto.

The contest encouraged users to use the hashtag BudAR on social media posts that were meant to include pictures of augmented reality features superimposed on Budweiser cans. In the end, we found only 2 social media posts hashtagging the contest, with both users sharing that the app didn't work for them:


Despite NexTech repeatedly hyping the supposed collaboration, we saw no similar announcement by Budweiser or LiveNation (the operator of the venue). NexTech's website for the contest is currently down.

We emailed a senior brand manager at Budweiser for feedback on the contest with NexTech and whether the relationship is ongoing. His reply:

> *"We did it as a test and learn but it didn't perform and we would not repeat."*

Despite this, the company still claims Budweiser as one of its clients to this day.

## *NexTech Announced a $60,000 Licensing Deal with Cannabis FN*

## *… But Failed to Mention that It Pays Cannabis FN $90,000 For Stock Promotion Services*

Cannabis FN is the only example we could find of NexTech reporting the revenue associated with a contract. Company filings show a $60,000 agreement as of May 28th 2018, seemingly providing early validation for the company's technology [Pg. 8]:

> *"NexTech has agreed to create AR programming for CFN Media who intends to sell*

> *this programming as an additional service to existing and new customers. In consideration for a $60,000 payment, CFN Media will receive one year of exclusivity."*

Several months later, NexTech announced it was "to broadcast first ever cannabis augmented reality live streaming event in partnership with CFN media" at a cannabis conference.

Both announcements gave the impression that NexTech was landing clients and getting its technology out there. Both also left out a key detail: NexTech pays Cannabis FN $90,000 for stock promotion, resulting in an overall net loss of $30,000 for NexTech in its dealings with Cannabis FN.

Per Cannabis FN's disclosure page, under "Past Clients", we see $90,000 in cash payments by NexTech to Cannabis FN, which temper the splashy headlines:

| NextechAR (NTAR) |
| --- |
| Paid $15,000.00 in Cash in Cash on Apr 16, 2019 from Company |
| Paid $15,000.00 in Cash in Cash on Mar 15, 2019 from Company |
| Paid $15,000.00 in Cash in Cash on Feb 16, 2019 from Company |
| Paid $15,000.00 in Cash in Cash on Dec 31, 2018 from Company |
| Paid $15,000.00 in Cash in Cash on Dec 18, 2018 from Company |
| Paid $15,000.00 in Cash in Cash on Oct 31, 2018 from Company |

## *Our Calls with NexTech's Clients Reveal the Reality of Its Products: Plenty of Hype with Little Substance*

We noticed that actual customer feedback of NexTech's products differed sharply from the narrative portrayed by the company. Here is a rundown of several of our calls with NexTech's customers and deal partners:

**ish out of Water.** NexTech announced a joint venture with local Toronto creative agency Fish out of Water in September 2018. The announcement suggested that the agency would contribute a range of expertise to the company:

> *"Fish out of Water will contribute its many years of industry expertise in brand building as well as access to its stable of traditional clients and emerging list of clients in the cannabis industry."*

This month (over a year after the announcement) we called the creative director of the agency for feedback on the progression of its joint venture with NexTech. She told us:

> *"We haven't done any tangible projects with them so I don't know. There's nobody here that could tell you."*

**Reef.** We called and spoke with a customer service rep for the beachwear eCommerce site who was unaware that they were even a customer of NexTech: "I honestly don't know."

**Weby.** In December 2019, NexTech's CEO announced an agreement with eCommerce site Weby. NexTech's CEO Gappelberg describing the new customer relationship in glowing terms:

> *"Market leaders like Weby know the revenue positive impact that the adoption of next-generation technologies can have on driving an organization's bottom line. By investing in superior online product experiences with NexTech AR's eCommerce technology, Weby is offering its customers a better and more meaningful way to engage with and to purchase product brands that they represent."*

We called Weby and **spoke with its CE**. He described the partnership quite differently:

> *"Yeah its far far periphery for us. I don't think we've done much with it."*
>
> *"…it's something a thousand miles away from center…"*
>
> *"…One of the manufacturers was participating in it and we're one of the retailers that's selling the project* ***the importance of that vendor in terms of our website sales is like .000000000001%*** *so we kinda let the website team run with it. How far they've gotten with it? I don't even know if they've got the code installed." (Note: he verbalized each of those eleven zeroes)*

He also described the conversation he had with NexTech and the terms he offered in order to "possibly" work with them:

> *"Guys if you offer it for free we'll possibly plug it in but it's definitely not at the forefront of what we're working on."*

He confirmed that Weby indeed gets the product for free. One of its manufacturers (he believed Walther) pays for it instead.

Here it is in the CEO's own words:

[Click HERE for Audio of the Call ]

**oottraffik.** NexTech announced a deal with cannabis marketing agency Foottraffik in April 2019. Despite appearing to be a small company , the VP of sales we spoke with was entirely unfamiliar with NexTech, and said he would "have to do some digging on that" and get back to us after researching it further. We have not heard back as of this writing.

**Romios Gold.** Two weeks ago, NexTech announced a deal with Romios Gold, a junior mining company. Despite the odd pairing of augmented reality and mining, the announcement touted how the deal opened up the door for NexTech to the $683 billion mining sector:

> *"The mining sector is certainly a new industry for us and we are the first companies to create 3D/AR core samples, which we believe could become a new industry standard for the entire mining industry."*

We called Romios and ***spoke with its C*** , who didn't have a "clue" who NexTech was:

> *"I haven't got a clue. The name is not familiar with me. I'm the CFO but uh, is it Ramios Gold you're talking about?"*

We assured him that we had called the right company and pointed him to the press release naming the Romios CEO. He replied:

> *"Quite frankly I'm not aware of it at all."*

We believe this bodes poorly for NexTech's chances for becoming the new industry standard for the entire mining industry.

Hear it in the CFO's own words:

[Click HERE for audio of the call ]

**GWN Events.** In September 2018, NexTech announced a licensing agreement with GWN Events , a producer of live events. At the time of the announcement, NexTech Director Reuben Tozman gushed:

> *"We're excited to see GWN leverage our technology to build a new channel of communication out to its loyal fanbase. GWN is showing true innovation in its category and we're excited to be a part of it"*

We called GWN to check how the NexTech agreement had progressed over the course of the year. The representative on the phone told us this:

> *"Honestly I'm not really familiar. I wouldn't really know who to talk to about that…I can ask around but as far I'm aware no one really is involved with it."*

**Davidson's.** In December, NexTech announced a deal with Davidson's, a firearms distributor. We spoke with a Director of Web & eCommerce at Davidson's, who led by telling us that setup and implementation of NexTech's software was easy and straightforward:

> *"It was pretty effortless in terms of getting things set up. I mean it's a pretty simple piece of tech. It's javascript, plug it on a site, and you get augmented reality models for stuff."*

As far as return, he said it was too premature to tell, as the AR-enabled site with an add-to-cart function was still in a beta phase:

> *"In terms of like a return we haven't seen anything yet but it's still early days."*

As far as cost, **Davidson's is paying nothing**. Once again, Walther (one of the manufacturers whose products is on the site), covered the costs:

> *"Walther had paid for the setup and everything. And then I had negotiated with them to put it on our sites for free. There's no cost to us and we'll see where it goes from there."*

**AimCam.** In November 2019 NexTech announced that it had "landed a deal" with AimCam, a provider of glasses for the sport and target shooting market. NexTech used the deal to tout the potential in the $131 billion global eyewear market.

We called AimCam and spoke with a representative who told us it has yet to be implemented:

> *"We haven't implemented it yet…It has been developed we just need to basically plug it into our website really."*

When asked about cost, the individual we spoke with said he believed it cost $300 as a setup fee and then a monthly charge of $30 per month.

The NexTech announcement had touted its analytics platform, but the representative for AimCam contradicted this:

> *"There's certain stuff they could probably improve on with regards to being able to track. Basically, there's no way of tracking the effectiveness of this implementation of the website in the sense that there's no analytics that come from it that would be very useful to have, especially on the eCom side."*

**JumpBall**. On November 26, 2019 NexTech announced that it had "enter(ed) the $1.5 **trillion** global clothing and apparel marketplace" with its deal with JumpBall.

We spoke with a JumpBall co-founder who had positive things to say about Paul Duffy and the

company. He viewed it as a way to try to showcase products differently, but acknowledged they are still in the setup phase, haven't implemented it, and are not yet paying for it. He is in the process of getting the apparel to the company over the next several weeks and then said it would be a paid subscription.

**Tufner Weighing Systems.** The rep we spoke with about NexTech's Tufner deal said:

> *"I think we're in the process yeah. We haven't done anything yet."*

**Wright Brothers.** NexTech announced an agreement with Wright Brothers in May 2019.

We called Wright Brothers and the representative we spoke with informed us that they are in fact paying users (he believed $79 per month) and said that they have implemented it on the website. He said it has had a positive impact but "it hasn't been that significant", partly because website sales are a small part of the overall revenue (which is mostly comprised of licensing revenue). He expressed his interest in exploring the potential of using the technology in the education market, which may happen down the road.

## *Q: With All of These Low-Paying and Free Partnerships, What Has Driven NexTech's 'Revenue Growth'?*

## *A: Two Acquired eCommerce Websites: One That Sells Vacuum Cleaners and Another That Sells Pet Supplies*

In the absence of actual organic customer revenue, NexTech has grown its revenues inorganically through the acquisition of 2 small eCommerce sites. As stated above, these comprised 99.8% of sales last quarter.

## *Infinite Pet Life Acquisition*

One of NexTech's acquisitions was for a pet supplement website:

> *"The Company acquired Infinite Pet Life for US$1,850,000. Infinite Pet Life is a web site business selling health supplements for pets. The consideration was based on a multiple of Infinite Pet Life's EBITDA" [Pg. 2]*

The announcement stated that Infinite Pet Life generated about $1.6 million in revenue and $600,000 in EBTIDA, giving the acquisition a roughly 3x multiple.

## *Vacuum Cleaner Market Acquisition*

The other eCommerce site acquired by NexTech was a small vacuum cleaning supplies company called www.vacuumcleanermarket.com, though you wouldn't know it from its press releases. The company's announcements (1,2) on the acquisition vaguely refer to the vacuum cleaner site as "AR Ecommerce" and a "leading eCommerce business" with scant additional detail:

**NexTech To Acquire Revenue Generating Ecommerce Business**

**January 8th, 2019 – Vancouver, British Columbia - Toronto, ON** – NexTech AR Solutions Corp. (the "**Company**" or "**NexTech**") (**CSE: NTAR**) (**OTC: NEXCF**) (**FSE: N29**) is pleased to announce that it has entered into an agreement to acquire AR Ecommerce, LLC ("**AR Ecommerce**") in consideration for two million common shares of NexTech. AR Ecommerce is a leading eCommerce business

## *The Company Claims Its Augmented Reality Features Are Revolutionizing Its Vacuum Cleaner Website. We Tested the Features—They Didn't Work.*

Aside from giving it the ability to report surging revenue "growth", the justification for the small eCommerce acquisitions is to 'ARitize' them, or to work augmented reality features into the sites. Weeks ago, the company described how AR is revolutionizing their pet and vacuum supplies websites [18:56 mark]:

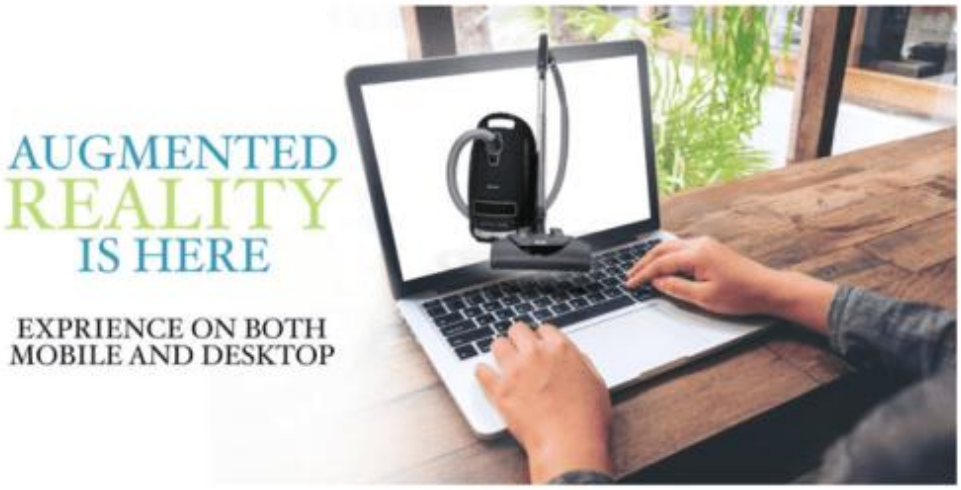
> *"Those businesses are scaling bigtime. We've integrated augmented reality into those businesses and it's showing up in the results."*

Around this time, Vacuum Cleaner Market announced it would be introducing augmented

reality, complete with an image of a 3D hovering vacuum!

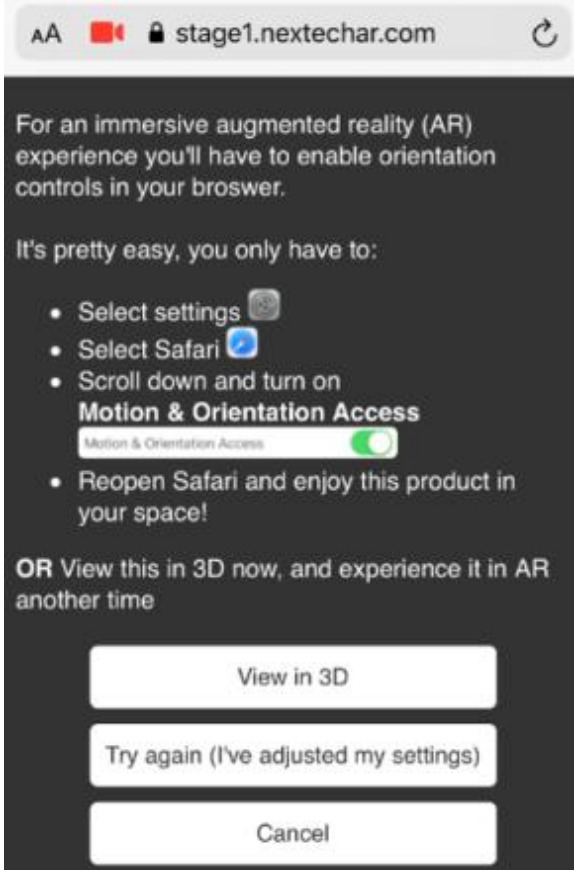
**VACUUM CLEANER MARKET INTRODUCES AUGMENTED REALITY!**

1/7/2019 7:24 PM




The website included a sample of how the technology worked. On desktop, it amounted to a 3D photograph that you can rotate when you hover over it (not an uncommon feature on eCommerce sites and a "technology" that was ubiquitous as early as Apple's QuickTime VR, which was initially demoed and released in 1995 **, nearly 2 years ago**).

We then tested it on mobile and found that the augmented reality feature didn't work. We were given a prompt asking us to toggle a setting in our phone:




But that phone setting doesn't exist anymore. Apple removed the toggle for the setting in September of last year. We were then again left with just a regular 3D photograph of the vacuum. We called VacuumCleanerMarket and asked customer service about the feature. They described it in far less exhilarating terms than management:

> *"It's just a 3D model of the vacuum cleaner – you can like spin it around see what it is underneath it, to the side of it…it's just a software that our current company has."*

We find this important because not only did the key "feature" the company claims to be building not seem to work, but the company said that its non-working feature is "showing up in the results" for the business. How?

## *Part II: NexTech's Slew of Highly Questionable Related-Party Transactions*

While we didn't find a lot of substance to NexTech's technology or customer relationships, we did find one area where value is being delivered: management's pockets.

We noticed a bevy of related party deals that seem to provide value to management while providing questionable benefit to shareholders.

## *NexTech's CEO and COO Bought the Vacuum Cleaner Website Personally Before Turning Around and Selling it to the Public Company, Likely Pocketing Millions for Stepping in the Middle*

As we showed above, one of NexTech's key sources of revenue "growth" was its acquisition of an eCommerce vacuum cleaner company. For context, when most public companies make an acquisition, they just go out and buy the target company.

Contrary to that normal approach, **NexTech's CE and C instead set up a new private entity, acquired the vacuum company personally, then almost immediately re-sold it to the public company**. Here's the step by step:

1. On October 22nd 2018, CEO Evan Gappelberg and COO Reuben Tozman formed AR Ecommerce, LLC in Delaware :

THIS IS NOT A STATEMENT OF GOOD STANDING

| | | | |
|---|---|---|---|
| File Number: | 7113751 | Incorporation Date / Formation Date: | 10/22/2018 (mm/dd/yyyy) |
| Entity Name: | AR ECOMMERCE, LLC | | |
| Entity Kind: | Limited Liability Company | Entity Type: | General |
| Residency: | Domestic | State: | DELAWARE |

2. A week later, (October 31st, 2018) they used the entity to acquire vacuumcleanermarket.com , a seller of vacuums with a warehouse near San Jose, California. [ Pg. 16]

3. Two months later, on January 8th 2019, Gappelberg and Tozman flipped the AR Ecommerce entity to the public company, pocketing 2 million shares .

We spoke with the former CEO of Vacuum Cleaner Market and asked what kind of multiple eCommerce sites sell for. He told us the standard is 3x EBITDA, suggesting a sale price of roughly C$1 million based on Vacuum Cleaner Market's reported EBITDA at the time of

announcement.

Based on the value of NexTech's shares at the time, a 3x multiple suggests Gappelberg and Tozman pocketed at least $600,000 by stepping in the middle of NexTech's transaction. At current share prices, Gappelberg and Tozman's take amounts to almost $2.3 million.

We reached out to Gappelberg directly and asked him specifically how much he paid for the vacuum cleaner site when he bought it into his private entity:

**ur question**: "How much did you originally pay for VCM when it was purchased by AR Ecommerce?"

Rather than answer the question, Gappelberg deflected and answered how much the *company* later paid for the website (which had already been disclosed).

**His answer:** "NexTech paid 2 million shares at a price that was in the .80 cent range, so valued at about $1.6 mill."

We hope he provides an answer to the question of how much *he* bought it for just months earlier.

## *edCetra Acquisition: The Company Bought an eLearning Platform from its Own COO in 2018, Apparently CHOOSING to Pay More Than Required*

## *The Website for the Platform Is Currently Dead*

In May 2018, NexTech purchased an exclusive license to the intellectual property of edCetra, which purports to offer an "eLearning education and training platform". [Pg. 5]

The company paid 100,000 shares to its own newly appointed COO, Reuben Tozman, for the license. The deal also came with a 1-year option to buy edCetra outright for another 100,000 shares.

NexTech had big plans for the technology:

> *"By licensing the technology, NexTech can accelerate its business plan and will spend*

> *the next few months customizing it to create an augmented reality ("AR") training and education platform for the cannabis industry".*

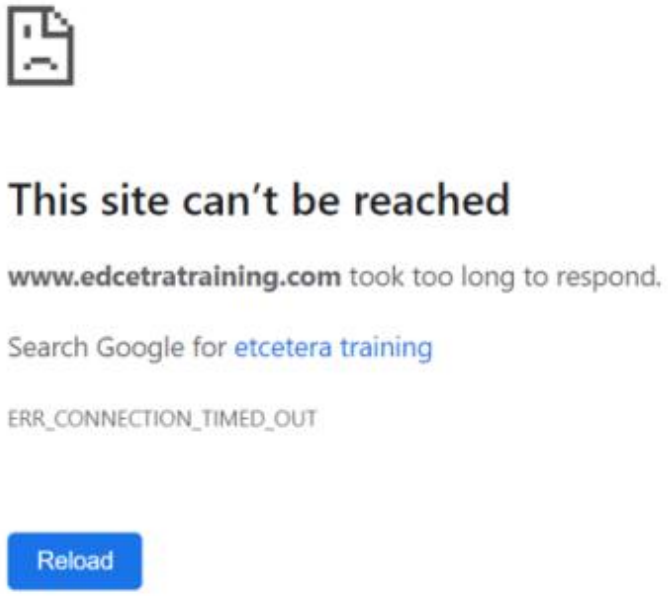
NexTech expected it would take 90 days to launch the new augmented reality cannabis eLearning platform. (Yes, *an augmented reality cannabis eLearning platform*.)

That didn't happen (color us shocked) but in December the company exercised its option to buy the whole company. However, rather than paying 100,000 shares for the company, as the option allowed, NexTech inexplicably chose instead to pay 300,000 shares for the entity.

The December 2018 press release announcing the purchase again set high hopes for edCetra:

> *"The company is preparing the eLearning platform for a re-launch in January 2019, with the added augmented reality feature"*

Those plans appear to be abandoned, as the edCetra website is dead as of this writing:




## *edCetra's Assets Were Sold 7 Years Ago and it Appears to Have Been Defunct Since Then…So What Did NexTech Buy?*

NexTech's COO Tozman received 400,000 shares from the sale of edCetra, but what exactly did **shareholders** get for that dilution?

Tozman's biography in another of his ventures shows that **edCetra had already sold its assets years before the sale to NexTech**

> *"Reuben (Tozman) was the founder and former CLO of* ***edCetra Training Inc, which successfully sold its assets in May 2013****.*

We also see that:

- The last post on edCetra's Facebook page was in 2013
- LinkedIn profiles of former edCetra's executives ( 1,2,3) and employees ( 1,2,3,4,5,6,7) show them departing around 2013 or earlier.

In 2017, the Canadian government moved to dissolve the apparently defunct entity, but it was revived and sold to NexTech the next year.

## *NTAR Bought an App Portfolio Created by Its CEO with a "Consistent History of Generating a Gross Profit" and "Established Relationships with Apple and Google" Then Summarily Wrote it Down to Zero*

In another example, NexTech acquired an app portfolio created by its CEO as part of the spinout that took NexTech public in early 2018.

The portfolio consisted of apps that allowed "readers to connect with authors and other fans of bestselling self-help books".

The app portfolio had originally been sold to the predecessor company for a total of 15,000,000 shares ( 1,2), with the intention of positioning the company "for rapid rollout of a suite of marijuana centric apps."

The nonsensical pivot from self-help to marijuana never happened.

When NexTech later acquired the app portfolio, it claimed it would enhance its value by infusing the portfolio with augmented reality features. Per a filing in late October 2018:

> *"NexTech is confident that upgrading the App Portfolio with new 3D AR features and*

> *functionality will generate an increase in user engagement thereby increasing the advertising revenue as well as the in app purchase revenue from the App Portfolio." [Pg 8]*

Management repeatedly described the acquisition in accretive terms, also in late October 2018:

> *"The App Portfolio has a consistent **history of generating a gross profit**, as well as established relationships with Apple and Google, which has the potential to accelerate the scaling of the NexTech Business as well as to help fund ongoing development work for NexTech's AR 3D-based advertising." [Pg 8]*

> *"The App portfolio should also **generate a modest cash flow** and provide an additional source of capital." [Pg. 5]*

Those hopeful prospects flittered away almost immediately. By February 28th 2019, the company wrote the value of the app portfolio down to zero. [Pg. 11]

> *"The Company reviewed its intangible assets for impairment as at February 28, 2019 and determined that the App portfolio was impaired and wrote off the remaining unamortized value."*

By May 2019, it acknowledged completely discontinuing its app portfolio business. [Pg. 2]

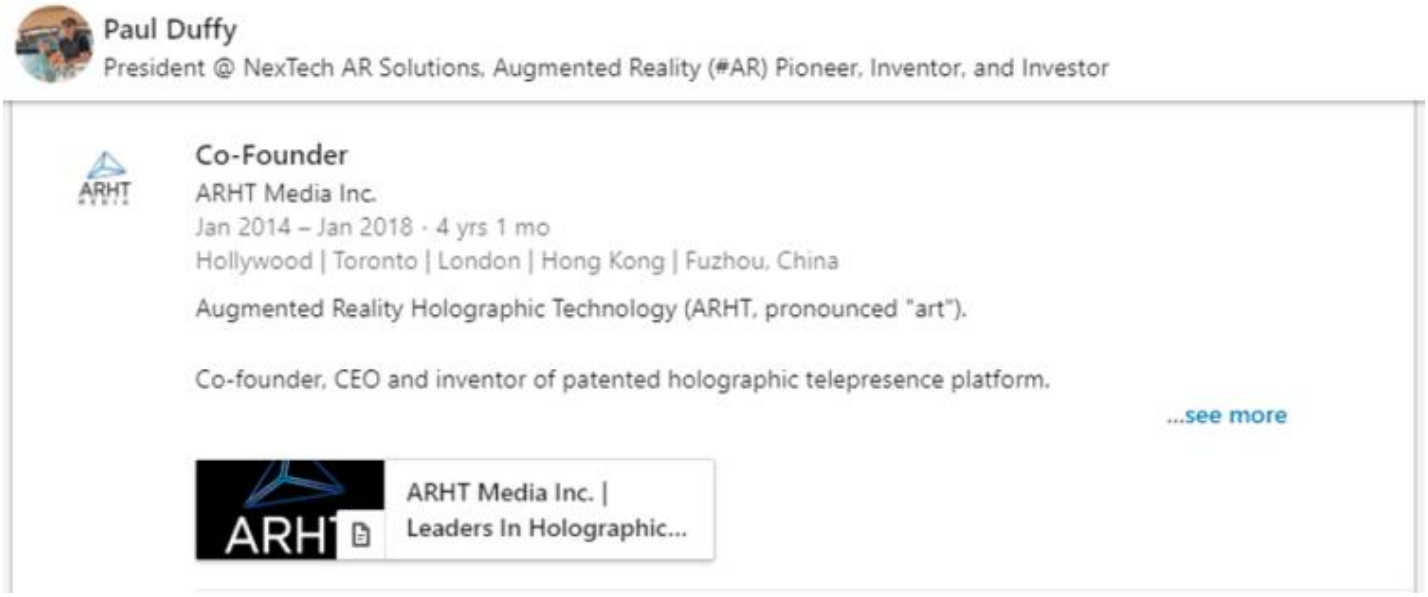
## *Another Related-Party Deal: NTAR Licensed Hologram Technology from A Penny Stock Company Affiliated with its President*

In July 2018, NTAR announced a 5-year worldwide exclusive license agreement with ARHT Media (TSXV: ART; market cap $7m). The agreement would supposedly bring ARHT's patented holographic display to the cannabis industry.

GlobeNewswire

# ARHT Media Signs Deal to Bring Holographic Display Technology to Cannabis Market

ARHT Media is a related party, given that NTAR's President (who joined February 2018 ), is the Co-Founder of ARHT Media, per his LinkedIn bio.




ARHT Media rallied 12.5% on the news and is since down ~71% (currently trading at roughly .10 per share).


The agreement included purchasing a minimum of 12 holographic displays, per year, for the next five years, but no pricing information for the displays was given.

We reached out to NexTech CEO Evan Gappelberg directly to ask how much the displays cost. Again, he didn't answer directly but admitted the technology is obsolete:

> *"ARHT contract is inactive as technology has obsoleted what they offer."*

## *And A Related-Party Partnership: NexTech Touted its Partnership With LivePerson (NASDAQ:LPSN) Without Mentioning Its Advisory Board Member Works At the Company*

In one recent press release , NexTech touted a partnership with LivePerson (NASDAQ:LPSN) without mentioning any economics. The press release quoted Scott Starr, LivePerson's AVP of retail issuing glowing praise:

> *"Providing augmented reality experiences and one-touch purchase transactions within messaging makes eCommerce interactions seamless for consumers – and changes the retail landscape forever."*

The press release failed to mention that Starr is actually a related party of NexTech—he had been appointed to NexTech's board of advisors just 6 months earlier.


**NexTech Announces Scott Starr, Ex-Salesforce Executive to Join Advisory Board**

# *Part III: NexTech's Questionable Intellectual Property Portfolio, Our Expectations of (Another) Capital Raise and A Slew of Upcoming Shares Unlocking That We Anticipate Will Flood the Market*

Beyond the above, we found significant irregularities and deficiencies with NexTech's intellectual property portfolio and its cap structure.

## *NexTech's IP Portfolio: 2 Patents from Over 12 Years Ago Focused on Putting Infomercials in Games, and 3 Recently-Filed Patent Applications*

NexTech has promoted its "valuable portfolio of patents around augmented reality" as a key component of its case to shareholders.

We reviewed the company's IP portfolio [ Pg. 2] and found that it consists of 2 old, largely irrelevant patents, and several augmented reality patent *applications*.

NexTech owns the following patents: 7,054,831 (filed in 2003) and 7,266,509 (an associated patent filed in 2006) which focus on "combining interactive game with infomercial" or with an advertisement. These seem largely irrelevant to NexTech's supposed focus on augmented reality in advertising and eCommerce.

NexTech also owns the following patent *applications*: 15351508, 62559487, and 62457136 related to interactive gaming, interactive advertising, and augmented reality ("AR") technology.

(Note that of these applications we were unable to find the last one [ 62457136] after a search through the U.S. Patent and Trademark Database . We emailed NexTech's CEO and asked him about it. He replied "I'll do some research". We have not heard back as of this writing.)

## *NexTech (And Earlier Future Farm) Touted a Core "Patented" Augmented Reality Technology it Had Licensed for Millions of Dollars*

## *… Except The Technology Looks to Have Been Just a Patent Application (Now Expired) Filed By an Entity That Had Only Existed for a Month. Where Did the Money Go?*

When NexTech spun out from Future Farm, it took Future Farms' "intellectual property" licenses with it as part of the deal. [ Pg. 5] We see that at the bottom of NexTech's website , it claims that its platform "ARitize is **a patented omni-channel augmented reality platform technology** created by NexTech AR Solutions Inc."

But what do these patents actually consist of?

Our research found that NexTech's IP was originally purchased from an entity that existed for only a month and had filed its key augmented reality patent *application* and trademark *application* **the week prior to being purchased for millions of shares**

Both the patent and trademark applications, which NexTech still touts as part of its "IP portfolio", were never pursued and have since expired.

## *NexTech's IP Entity AR E1, LLC was Formed Just One Month Before Its Original Acquisition*

NexTech acquired its intellectual property from an entity called AR E1, LLC as part of its spin-out from Future Farm. The entity was formed in Delaware on August 23rd, 2017, presumably by founder Eric Koenig :

**THIS IS NOT A STATEMENT OF GOOD STANDING**

| | | | |
|---|---|---|---|
| File Number: | 6520190 | Incorporation Date / Formation Date: | 8/23/2017 (mm/dd/yyyy) |
| Entity Name: | AR E1, LLC | | |
| Entity Kind: | Limited Liability Company | Entity Type: | General |
| Residency: | Domestic | State: | DELAWARE |

Koenig looks to have been the original creator of NexTech's IP, based on a search of the patent portfolio.

By the time the above entity had been incorporated, Koenig only owned the 2 old gaming patents referenced above, and another patent application that tangentially mentioned AR technology.

One month after forming the entity, on September 15th 2017, Koenig filed a patent application (application 62/559,487) for a "system and method for providing a personalized and gamified search experience through an augmented reality platform". This was the first explicit "augmented reality" application filed by Koenig. That same day, a trademark application was filed for "CannaCube Live":

One week later, Future Farm issued a press release declaring that it had entered into an agreement for an exclusive license to *patented* augmented reality IP with the new AR E1 entity and the "CannaCube Live platform" :

Future Farm Bringing Augmented Reality to the Cannabis Industry Under Exclusive License to Patented IP

NEWS PROVIDED BY
Future Farm Technologies Inc. →
Sep 28, 2017, 08:28 ET

The release failed to clarify that the entity had only what appears to be a mere AR patent **application** and that CannaCube Live was likely just in the concept stage:

> *"Future Farm and ARE1 will work together to merge augmented reality (AR) and ad-tech with the cannabis industry through the CannaCube Live platform."*

AR E1, LLC was paid 5,000,000 shares of Future Farm for what was described as its "impressive portfolio of intellectual property." It appears that zero action was subsequently taken to pursue the augmented reality patent application or the trademark, which both expired automatically a year later by September 16th 2018.

## *NexTech Has Been Touting Its Augmented Reality Provisional Patent Despite Its Expiration Over a Year Ago*

NexTech is now the owner of this expired provisional patent and expired trademark application:

| 62/559,487 | SYSTEM AND METHOD FOR PROVIDING A PERSONALIZED AND GAMIFIED SEARCH EXPERIENCE THROUGH AN AUGMENTED REALITY PLATFORM | are1-0001 |
|---|---|---|

Select New Case | Application Data | Transaction History | Image File Wrapper | Continuity Data | Address & Attorney/Agent | Assignments

**Transaction History**

| Date | Transaction Description |
|---|---|
| 09-16-2018 | EXPIRED PROVISIONAL |
| 09-21-2017 | Email Notification |
| 09-21-2017 | Application ready for PDX access by participating foreign offices |
| 09-20-2017 | Application Dispatched from OIPE |
| 09-21-2017 | Application Is Now Complete |
| 09-21-2017 | Filing Receipt |
| 09-20-2017 | Applicant Has Filed a Verified Statement of Micro Entity Status in Compliance with 37 CFR 1.29 |
| 09-15-2017 | PTO/SB/69-Authorize EPO Access to Search Results |
| 09-15-2017 | Applicants have given acceptable permission for participating foreign |
| 09-19-2017 | Cleared by OIPE CSR |
| 09-15-2017 | IFW Scan & PACR Auto Security Review |
| 09-15-2017 | ENTITY STATUS SET TO UNDISCOUNTED (INITIAL DEFAULT SETTING OR STATUS CHANGE) |
| 09-15-2017 | Initial Exam Team nn |

# CANNACUBE LIVE

| | |
|---|---|
| Word Mark | CANNACUBE LIVE |
| Goods and Services | (ABANDONED) IC 041. US 100 101 107. G & S: Online advertising and marketing services provided to consumers via means of interactive entertainment and direct response advertising |
| Standard Characters Claimed | |
| Mark Drawing Code | (4) STANDARD CHARACTER MARK |
| Serial Number | 87610767 |
| Filing Date | September 15, 2017 |
| Current Basis | 1B |
| Original Filing Basis | 1B |
| Owner | (APPLICANT) ARE1, LLC LIMITED LIABILITY COMPANY 16192 Coastal Highway Lewes DELAWARE 19958 |
| Attorney of Record | Jeffrey M. Furr |
| Type of Mark | SERVICE MARK |
| Register | PRINCIPAL |
| Live/Dead Indicator | DEAD |
| Abandonment Date | October 2, 2018 |

But that hasn't stopped the company from promoting the abandoned patent as part of its IP portfolio. Press releases and filings as recent as July and August still reference the patent, despite it expiring over a year ago.

## *NexTech's Most Meaningful Intellectual Property: A 3D and 360-Degree Photography Company it Bought For Only $65,000*

Based on NexTech's actual delivered products, which largely rely on its ability to take 3D photographs and superimpose it on objects, it seems that its acquisition of HootView is the most important piece of IP in its portfolio.

On February 6, 2019, the Company acquired 100% of HootView.com (the "HootView") for CDN$85,664 (US$65,000). Hootview provides 3D and 360-degree product photography, in conjunction with spin and zoom technology to online retailers through their website. [Pg. 17]

This technology also seems to be the foundation of ARitize, the company's app that users are required to download in order to view augmented reality ads. (How many consumers would download a specific app just to view ads?)

The app has 4 reviews on the app store as of this writing. The only reviewer we could identify went by the username chipMONKgrafx, who it turns out to be NexTech's creative director. He wrote "The Future is Here Now!" and gave his own app 5/5 stars.

## *NexTech's Recent Capital Raise Was Completed At a Toxic 70% Discount (!) To Market Prices. We Expect the Stock Will Crater When These Shares Are Soon Unlocked*

We think NexTech's recent financing round foretells the pain that retail investors will soon suffer.

NexTech raised $3 million in November via a private placement. The stock closed at $2.30 around the time the deal was announced, but the private placement priced at $0.75 per share, a ~70% discount to market prices. The placement also included full warrant coverage, with 4,000,000 warrants priced at $0.93 per share. When adding the value of the warrants using a Black-Scholes calculation, the discount received by private buyers was **greater than 100%** of the offering price.

In other words, this private round was essentially 'free money' for the participants, at the expense of public shareholders.

Those shares unlock on March 23, 2020 and we fully expect NexTech's share price will tank to at least $0.75 when private investors are given the opportunity to unload.

## *Investors in the Dark: Financial Reporting Gap Due to Company Switching Its Fiscal Year End*

The company recently changed its fiscal year from May to December, resulting in a reporting gap for the September to December period. The company is expected to release these results by April 20th, marking a long gap of silence for investors.

Management has released revenue and gross profit numbers in the interim, largely driven by its eCommerce sales. The numbers so far put the company far off from its goal of $20 million in revenue this year and we have serious doubts that its augmented reality endeavors have contributed to any meaningful revenue.

When full financials are reported we will be keeping an eye out for the cash balance. Operating

cash burn was $1.2 million as of last quarter and has been accelerating. The company had cash of about $1.4 million as of August 2019 [ Pg. 4] and then raised $3 million through its November private placement round. We estimate cash will be depleted by June if not earlier, necessitating another infusion.

## *Classic Red Flags: The Sudden Departure of NexTech's CFO and COO*

Beyond the above, key insiders have recently jumped ship. On October 10, 2019, the company announced that Dave Miles and Reuben Tozman had resigned as CFO and COO/director, respectively, without explanation.

# *Conclusion: Actual Reality Is Quickly Approaching for Shareholders*

We hope management responds to our research and, in doing so, clears up several mysteries:

- How much did CEO Gappelberg pay for the vacuum cleaner website when he bought it 2 months before flipping it to public shareholders?
- Who participated in the recent private placement rounds, receiving shares at a 70% discount to market prices? Did this include friends of management?
- What is the point of press releasing every new customer relationship, when many of these customers pay nothing or close to nothing?

We have seen this story play out before. We expect retail investors will end up holding the bag when all is said and done and we believe NexTech's shares will eventually be rendered worthless.

### *Disclosure: We are short shares of NEXCF*

### *Legal Disclaimer*

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# TAB 20

# Opera: Phantom of the Turnaround – 70% Downside

Published on January 16, 2020



*Summary (NASDAQ: OPRA)*

- Opera went public in mid-2018 based largely on prospects for its core browser business. Now, its browser market share is declining rapidly, down ~30% since its IPO.
- Browser gross margins have collapsed by 22.6% in just one year. Opera has swung to negative $12 million in LTM operating cash flow, compared to positive cash flow of $32 million for the comparable 2018 period.
- Opera was purchased by a China-based investor group prior to its IPO. The group's largest investor and current Opera Chairman/CEO was recently involved in a Chinese lending business that listed in the U.S. and saw its shares plunge more than 80% in just 2 years amid allegations of fraud and illegal lending practices.
- Post IPO, Opera has now *also* made a similar and dramatic pivot into predatory short-term loans in Africa and India, deploying deceptive 'bait and switch' tactics to lure in borrowers and charging egregious interest rates ranging from ~365-876%.
- Most of Opera's lending business is operated through apps offered on Google's Play Store. In August, Google tightened rules to curtail predatory lending and, as a result, Opera's apps are now in black and white violation of numerous Google rules.

- Given that the vast majority of Opera's loans are disbursed through Android apps, ***we think this entire line of business is at risk of disappearing or being severely curtailed*** when Google notices.
- Instead of disclosing to investors that its "high-growth" microfinance segment could be imperiled by these new rules, Opera instead immediately raised $82 million in a secondary offering without disclosing Google's changes to investors.
- Opera's short-term loan business now accounts for over 42% of the company's revenue and is responsible for eye-popping top line "growth". Meanwhile, *the segment experienced massive defaults (~50% of lending revenue) and company-wide cash flow has worsened.*
- Post IPO, Opera promptly directed ~$40 million of cash into businesses owned by its Chairman, including $30 million into a karaoke app, and $9.5 million into an entity used to acquire a business that Opera had already operated and funded, via a questionable transaction.
- We think Opera collapses on its own worsening financials, with that timeline accelerating significantly if Google bans its lending apps or if its Chairman/CEO continues to draw cash out of the business through questionable related-party deals.

*Initial Disclosure: After extensive research, we have taken a short position in shares of Opera. All APR extrapolations/calculations were based on a 365 day year. This report represents our opinion, and we encourage every reader to do their own due diligence. Please see our full disclaimer at the bottom of the report.*

# *Introduction*

When a new management team takes over a declining business, it can become a race against the clock to cash out. This is what we think is going on at Opera, a company based around a once-popular web browser that is now seeing its userbase erode.

In the year and a half since its IPO, Opera's browser has been squeezed by Chrome and Safari, with market share down about 30% globally. Operating metrics have tightened, and the company's previously healthy positive operating cash flow has swung to negative $12 million in the last twelve months (LTM) and negative $24.5 million year to date.

With its browser business in decline, cash flow deteriorating (and balance sheet cash finding its way into management's hands…more on this later), Opera has decided to embark on a dramatic business pivot: predatory short-term lending in Africa and Asia.

The pivot is not new for Opera's Chairman/CEO, who was recently involved with another public lending company that saw its stock decline more than 80% in the two years since its IPO amidst allegations of illegal and predatory lending practices.

Opera has scaled its "Fintech" segment from non-existent to 42% of its revenue in just over a year, providing a fresh narrative and "growth" numbers to distract from declining legacy metrics. But with defaults comprising ~50% of lending revenue, this new endeavor strikes us more as short-term window dressing than a long-term fix.

Furthermore, Opera's short-term loan business appears to be in open, flagrant violation of the Google Play Store's policies on short-term and misleading lending apps. Given that the vast majority of Opera's loans are disbursed through Android apps, ***we think this entire line of business is at risk of disappearing or being severely curtailed*** when Google notices and ultimately takes corrective action.

Meanwhile, Opera has exhibited a troubling pattern of raising large amounts of cash (almost $200 million over the past 1.5 years), and then directing portions of it to entities owned or influenced by its Chairman/CEO through a slew of questionable related-party transactions. For example:

1. $9.5 million of cash went toward an entity that appears to have been owned 100% by Opera's Chairman/CEO, despite company disclosures suggesting otherwise. Ostensibly, the reason for the payment was to 'purchase' a business that was already funded and operated by Opera. To us, this transaction simply looks like a cash withdrawal.
2. $30 million of cash went into a karaoke app business owned by Opera's Chairman/CEO, days before the arrest of a key business partner.
3. $31 million of cash was doled out for "marketing expenses and prepayments" to an antivirus software company controlled by an Opera director and influenced by Opera's Chairman/CEO. The antivirus company has no other known marketing clients, but is paid to help Opera with Google and Facebook ads and other marketing services. (Note: Most firms use a marketing agency for help with marketing needs.)

We have a 12-month price target of $2.60 on Opera, representing ~70% downside.

We take the midpoint of the company's $43 million annual adjusted EBITDA expectations and assign multiples to its business units weighted by contribution. We apply a 7x EBITDA multiple to its browser & news segment (despite the steep profit decline) and a 2x EBITDA multiple to its lending apps, in-line with Chinese peers. We do not assign a multiple to its licensing segment, which the company has stated it expects to "significant decline". The company has about $134 million in cash (no debt) which we add.

We then apply a 15% discount to account for risks relating to its fintech division, which we believe will be significantly curtailed over the next 12 months (for reasons we explain) and risks

relating to management and cash dissipating via questionable related party transactions.

## *Background*

## *Pre-IPO: A Rosy Looking Story*

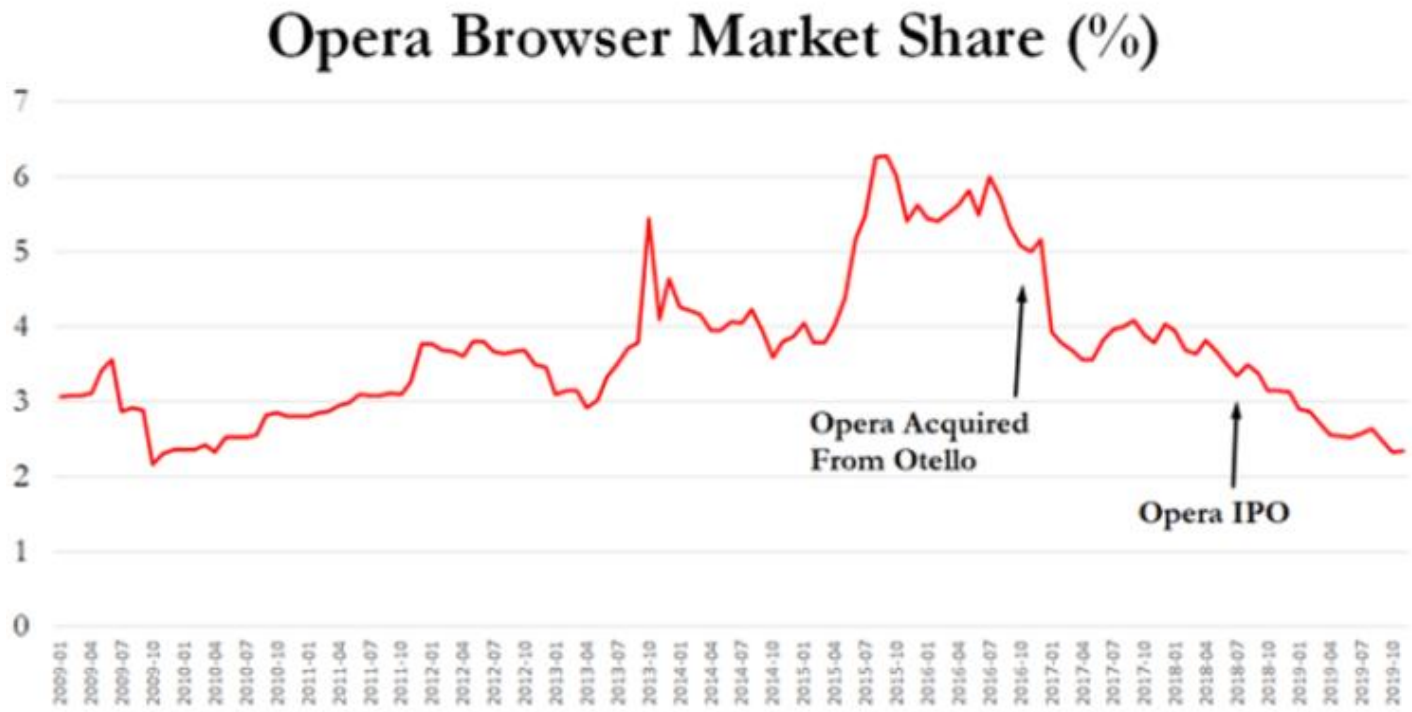
Opera is a browser and mobile app business that has existed since the early days of the internet.

The browser business emerged in 1995 and maintained a niche share of the market over the years. In November 2016, Opera's browser and apps division was acquired by a China-based consortium including Kunlun Tech and Qihoo 360. Kunlun Tech is a publicly traded Chinese company focused on online game development and is led by Opera's chairman and CEO, Yahui Zhou. Qihoo is a popular, but controversial (1,2,3,4), browser company in China led by Opera Director Hongyi Zhou.

When taking Opera public in July 2018, the browser and apps business was growing gross profit at 30-40%. The business had 40% EBITDA margins and it was generating positive cash flow [pg. S-8].

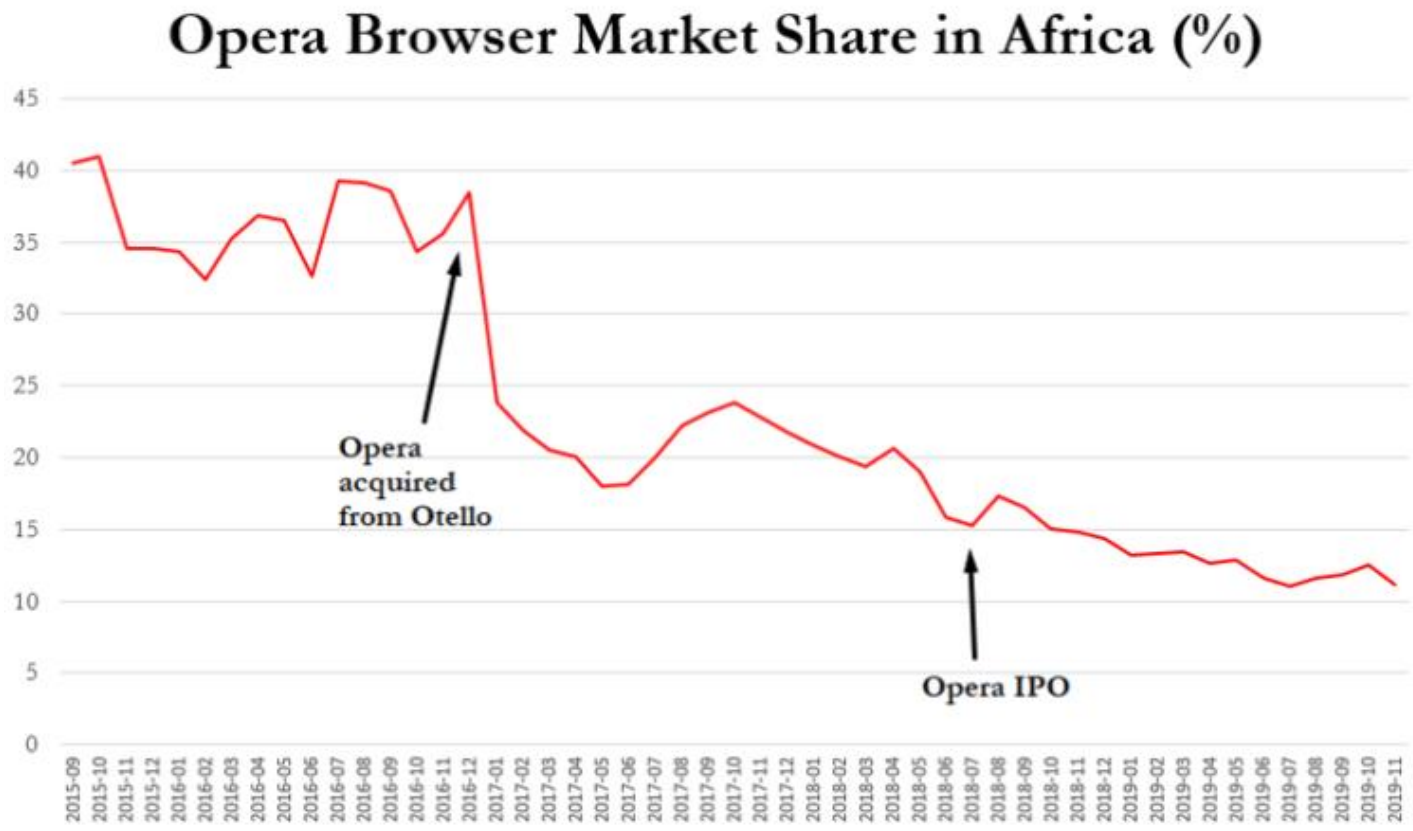
## *Post-IPO: A Quick Collapse in Opera's Browser Market Share*

Within months of transitioning to new management, Opera's growth and profitability in the browser and mobile ad business began to decline rapidly. The decline has continued post-IPO. Opera's global browser market share has dropped from 5% pre-acquisition to just over 2% most recently.




(Source: GS StatCounter )

In Opera's strongest market, Africa, the declines were even more pronounced. Opera's browser market share in Africa hit highs of ~40% prior to its acquisition by new management and has plunged below 12% as of the most recent period. Opera's browser share has quickly been squeezed out by Google on one side, and Safari on the other, as Android and Apple have both developed stronger footholds on the continent.




(Source: GS StatCounter )

## *Post-IPO: A Quick Collapse in Opera's Financial Metrics, Negative Cash Flow and Declining Browser Margins*

This deterioration has contributed to "Browser and News" segment gross profit declines of 22.6%, from $76 million to $59 million in the most recent y/y period [ Q3 2019 report ].

On the cash flow side, the company generated negative $24.5 million in operating cash flow in the nine months ended September 30, compared to positive cash flow of $21.7 million for the comparable 2018 period.

**OPERA LIMITED**
**UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS**

| [US$ thousands] | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2019 | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2019 |
|---|---|---|---|---|
| Net cash flow from (used in) operating activities | 6,820 | (17,539) | 21,713 | (24,460) |
| Net cash flow from (used in) investing activities | (2,426) | (35,311) | (3,713) | (62,794) |
| Net cash flow from (used in) financing activities | 169,463 | 90,206 | 167,117 | 81,041 |
| **Net change in cash and cash equivalents** | **173,857** | **37,356** | **185,118** | **(6,213)** |
| Cash and cash equivalents at beginning of period | 43,993 | 134,155 | 33,207 | 177,873 |
| Net foreign exchange difference | (209) | (813) | (682) | (962) |
| **Cash and cash equivalents at end of period** | **217,642** | **170,697** | **217,642** | **170,697** |

## *But Alas, A New Business Has Emerged That Has Sent Reported Revenue Soaring: Predatory Short-Term Lending in Africa and Asia*

Coinciding with these challenges, Opera launched a mobile app based short-term lending business, now labeled under its "Fintech" segment, that scaled from no revenue in 2018 to 42.5% of Opera's revenue in Q3 2019.

As we will show, Opera's apps have entered the African and Asian markets offering short-term loans with sky-high interest rates ranging from ~365%-876% per annum.

As one former employee of an Opera lending app described to us, in many cases **these loans are for people who could not even afford their basic needs.** Another employee described a desperate Kenyan borrowing market, stating:

> *"Most Kenyans, they are low income earners. And apparently most of them they don't have enough even for their families."*

## *The Predatory Lending Business Has 50% Credit Losses and Limited Profitability, But It Makes Top-Line Growth Appear Great*

In all loan businesses, giving away money is easy and growth can be as fast as a company wants – until, of course, *the loans need to be paid back*. In its latest quarter, Opera reported that its credit losses reached $20 million, an astounding ~50% of its $39.9 million Fintech segment

revenue for the quarter.

While mobile app loans can be a lot less profitable (bottom line) than the traditional search & advertising businesses due to high incidences of non-performing loans, Opera had nonetheless given itself the ability to report high revenue growth (top line) and project a more optimistic future.

The short-term lending business was initially launched in Kenya and showed immediate growth from $6.5 million in Q1 2019 [Q1 Results ] to $11.6 million in Q2 2019 [Q2 Results ] to $39.9 million in Q3 2019 [Q3 Results ].

The apps have improved reported net income as well, but largely through non-cash valuation increases. Year to date (YTD) net income was $35.9 million, with $26.2 million (73%) stemming largely from level 3 asset markups among its Fintech apps .

We think Opera's lending business will fail purely on economics: default rates, competition across dozens of similar apps and user turnover will continue to take its toll on cash flow and profitability despite any top line revenue growth.

**And we think pera's Chairman CE ahui Zhou knows this drill well, having recently lived it. Zhou has a close association with another lending business, udian N SE: D , which has plummeted more than 80% since its I 2 years ago due to the same types of concerns we are raising about pera. We dig into the striking parallels between these two companies later in our report.**

Beyond basic economic unsustainability, we have found several additional issues that we think could lead to a near term evisceration of the company's newfound predatory lending business.

# *Part I: Opera's Pivot to Sketchy Short-Term Lender Is Already Imperiled*

## *Opera is Flagrantly Disregarding Google's New Policies on Predatory Short-Term Lending*

Opera has 4 apps that collectively offer lending products in Kenya, India, and Nigeria, mostly through Google's Android operating system. Google/Android has over 84% market share in Kenya , over 94% market share in India , and over 79% market share in Nigeria , making it the

overwhelmingly dominant platform that individuals in these markets use for personal loan apps. Opera's access to the Google Play store is therefore critical to the success of its lending apps.

We have found clear evidence that all 4 of Opera's lending apps are in black and white violation of Google's rules on short-term lending and deceptive/misleading content. We will demonstrate this evidence in this report. We have also reached out to Google for comment on our findings.

We believe this is a significant risk to Opera investors. Without the support of Google, we have a hard time imagining this predatory lending business survives. We also have a hard time imagining Google takes no action when they realize the extent of the violations and the havoc these apps have created in the lives of some of the world's most vulnerable users in Africa and India. The social consequences of these mass-default products appear to be mounting, as we will detail.

## *Google's Rules: Apps That Offer Short-Term Personal Loans of 60 Days or Less Are Not Allowed*

## *Opera: All of Our Apps Offer Loans Ranging From 7 Days to 30 Days Despite the Ban (And Despite Pretending to Be in Compliance)*

Historically, Google had relatively vague policies against harmful financial products, stating :

> *"We don't allow apps that expose users to deceptive or harmful financial products and services."*

In August 2019, Google updated its policies in response to a proliferation of predatory lending taking place on its app ecosystem. The updated policies were much more specific, prohibiting "short-term personal loans" (defined as loans less than 60 days). [ Source 1 , Source 2 , Source 3 ]

The updated policy reads :

> *"**We do not allow apps that promote personal loans which require repayment in full in 60 days or less from the date the loan is issued** (we refer to these as*

> *"short-term personal loans"). This policy applies to apps which offer loans directly, lead generators, and those who connect consumers with third-party lenders."*

Opera's mobile loan business operates through four Android apps: (1) OKash and (2) OPesa in Kenya, (3) CashBean in India, and (4) OPay in Nigeria.

We had consultants test Opera's lending apps in December 2019 and January 2020 and found that **all four of its apps were in black and white violation of Google's rules**, as we will show. **In fact, none of the loan products offered across pera's apps appear to be in compliance with this policy**, despite these rules going into effect over 4 months ago.

**About 2 months after Google instituted its personal loan policy change, pera's Chief inancial fficer, rode Jacobsen, was asked about the company's loan profile. Jacobsen** stated **on the company's November 2019 conference call that its loan duration was still about 2 weeks:**

> *"So our loans in India tends to be a bit bigger, in the $50; whereas in Kenya, it's in the $30. So while duration of loans, i**t's about the same with an average of about 2 weeks, as you mentioned.**"*

This is corroborated by Opera's most recent prospectus, dated September 2019 (after the rule change). Disclosures show that Opera's entire microlending business provides loans between 7 to 30 days, which all fall outside of Google's policies [ pg. F-11]:

> *"The Group **currently provides loans to consumers with a duration of between 7 to 30 days**"*

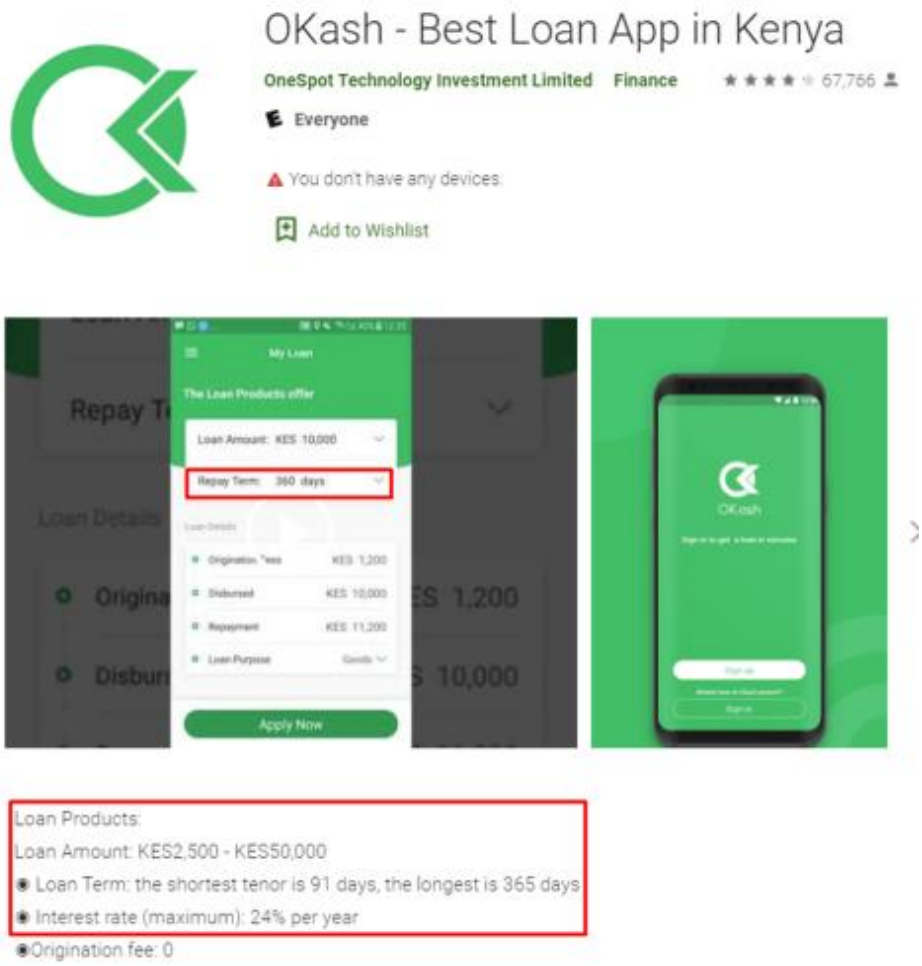
The same prospectus fails to mention Google's rule change.

## *All 4 Of Opera's Apps Pretend to Be in Compliance with Google's Policies, But in Reality, They All Offer Prohibited Products*

When we first discovered that Opera's lending apps were in flagrant violation of Google's rules, we wondered how they had not been banned or been required to bring their terms into

compliance. The reason, we think, is because each app claims to be in compliance with the new policies in their respective Google app descriptions, but then offers prohibited loans once users have downloaded and signed up for the apps.

For example, here is the Google Play app description for OKash, which clearly states that its loans range from 91 days to 365 days, which would place it in compliance with Google's policies. Even the example image shows a loan offered with a term of 360 days:




But these products don't appear to exist at all. An email to the company's OKash app division confirms that loans range from 15 days to 29 days in duration:

## Interest rates on Okash

2 messages

[redacted] Tue, Dec 17, 2019 at 3:24 PM
To: help@o-kash.com

Hi, good day I'm considering a short term loan on Okash and wanted to double check what the rates range is and what a standard loan document looks like. Could you send the range and a loan agreement please.

Thanks
[redacted]

**Help O-kash** <help@o-kash.com> Wed, Dec 18, 2019 at 1:25 AM
To: [redacted]

Dear [redacted]
Thank you for your email.

Kindly note that at the moment we only offer products for 15 days (2500-4500) with an upfront origination fee of 15%, 22 days (6500-9000) with an upfront origination fee of 17.6%, and 29 days (10000) with an upfront origination fee of 23.2%. In case we make any changes subject to this in the near future we shall be sure of notifying our esteemed clients.

Yours Sincerely,
Leah N.

OKash Team
O-Play Kenya Limited

We further confirmed this by having a local consultant apply for a loan through the OKash app. They were given a 2-week loan:

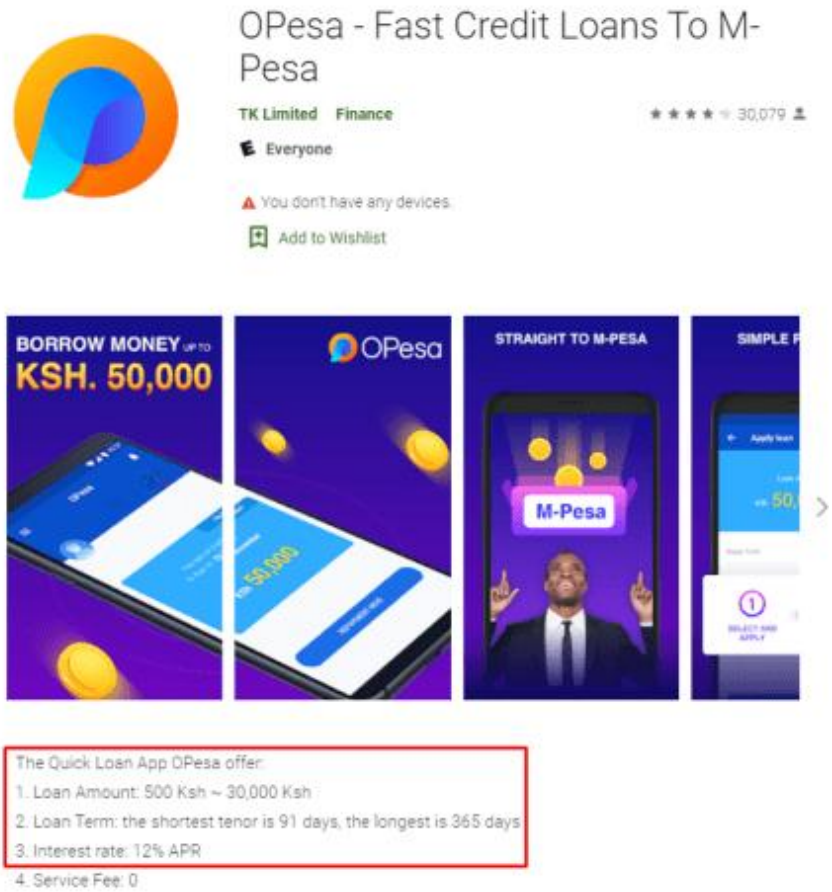
## *All of Opera's Apps Exhibit the Same Pattern: A Misleading Description that Looks to be in Compliance, But Products Openly Violate Google's Terms*

In addition to OKash, we reviewed the claimed loan length on the Google Play Store versus actual loan length for Opera's other lending apps. The pattern is clear. Here is the summary of our findings for all 4 apps, with more individual details following:

| | Claimed Loan Length (Days) | Actual Length (Days) |
|---|---|---|
| **OKash** | 91-365 | 15-29 |
| **OPesa** | 91-365 | 15 |
| **OPay** | 91-365 | 7-15 |
| **CashBean** | 91-365 | 15 |

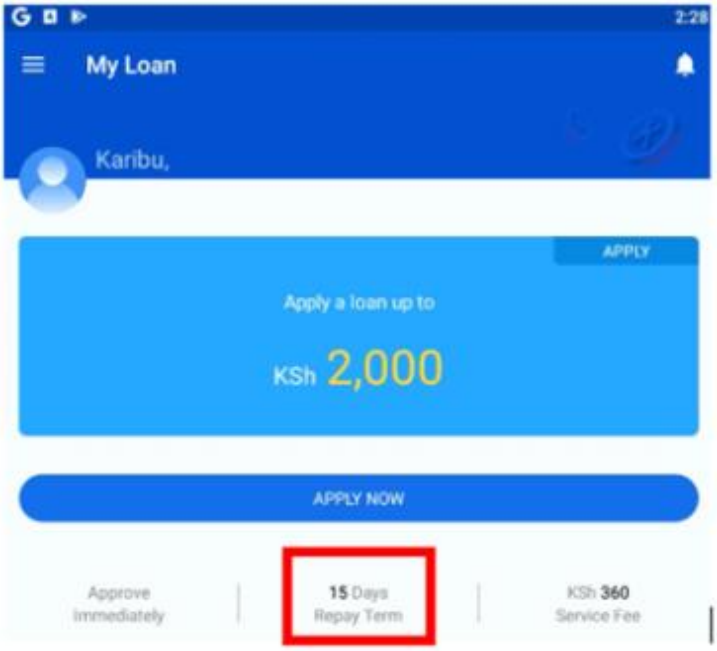
(Source: Google Play Store descriptions & Hindenburg Research due diligence findings)

OPesa's app description similarly presents its loan terms as being between 91 days to 365 days, despite no evidence that it ultimately provides any loans of those lengths.

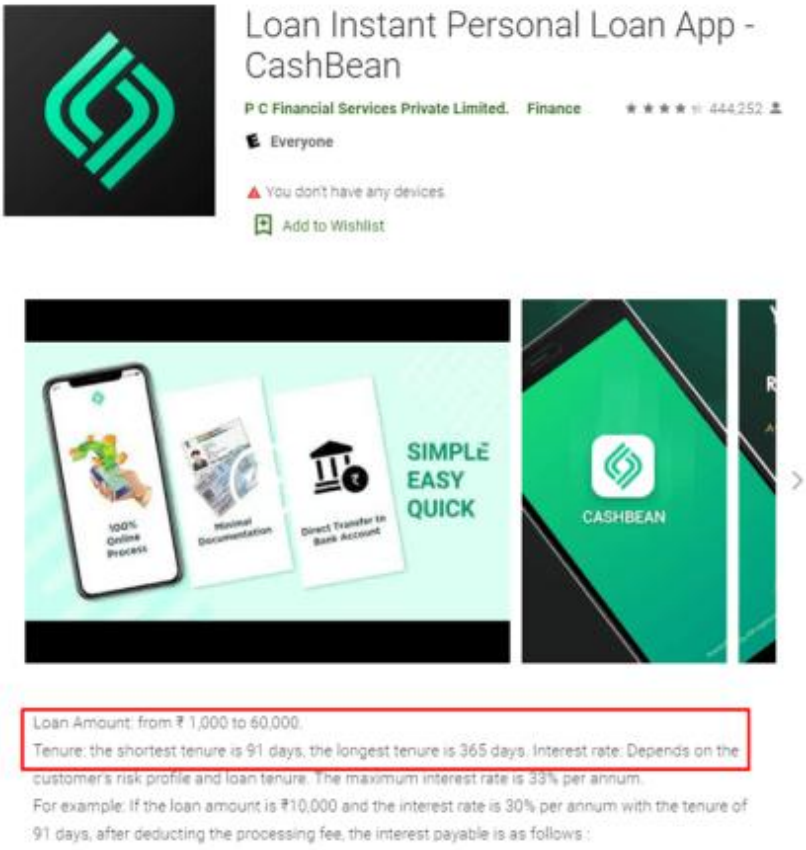



There wasn't even much sleuth work required for OPesa. After all, the app's own FAQ page shows that it offers a loan term of 14 days with an origination fee of 16.8%, which equates to an APR of ~438%.

To confirm this, we had our consultant download the app in mid-December. They were offered a repayment term of 15 days.




For CashBean (India), the app description once again makes the same 91 day to 365 day loan term claim.




Yet recent online reviews for the app consistently show the loan term to be 15 days:

**Krishna Choudhary**

★★★★☆ December 27, 2019

18

Instant loan just in minutes quick process easy to use but limit increases slowly and rate of interest is bit high tenure is just 15 days suggest you to increase tenure atlest 1 month that helps salaried people to pay on time. I taken more then 5 times but limit is still not increases.

**prasana kumar**

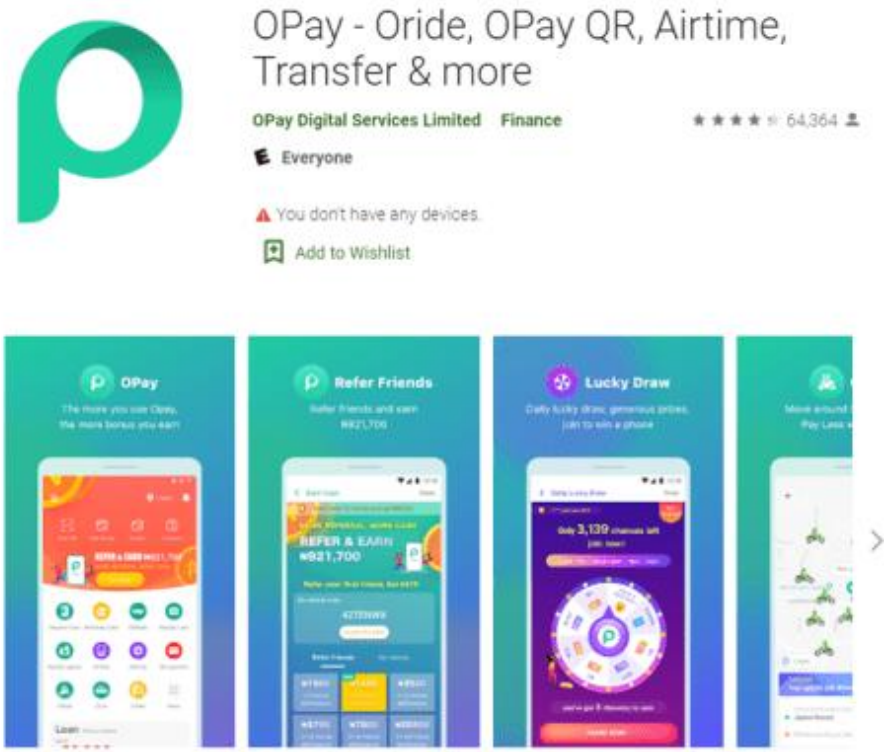
★☆☆☆☆ December 21, 2019

143

The repayment date must be increased. For every ₹1000, ₹150 is charged for 15 days which is high if the multiples of 1000 increase. For example if someone takes 10000 loan from CashBean he/she has to pay 11500 within 15 days which is paying 100 rupees extra each day. So, at least increase the repaym...

We emailed the company to see if they offer loans for any term other than 15 days and have not heard back as of this writing.

OPay's app description also makes the exact same 91 day to 365 day loan term claim.




**OPay OKash makes it easy for you to access credit anytime, anywhere.**

Loan Products:
Loan Amount: NGN2,500 – NGN60,000
Loan Term: the shortest tenor is 91 days, the longest is 365 days
Origination Fee (maximum): 24% per year
Example: If you choose a loan limit of NGN10,000 with a period of 1 year, the total fees that must be paid is: 10,000 * 0,0006 * 365 = NGN2,190

We also inquired about the company's loan terms via an email to customerservice opay.com . They replied that the loan's rate and term would be "an origination fee charged of 1.2% per day **for a fixed term of 1 days**

**Service Customer** <customerservice@opay.team>
to me

5:24 AM (3 hours ago)

Dear [redacted]

Our sincere apologies for the delayed response.

OKash does not limit your work, income, or other conditions. So long as you are 20-55 years old, all you need is an Android device, a data connection, a means of identification, as well as valid bank account and card.

Please simply follow the instructions provided by the prompts- ensure to provide authentic information about yourself.

The information provided will be used to determine your credit score and the loan offer suitable for you.

You can access a minimum of N1,500 and a maximum of N100,000 for an origination fee charged of 1.2% per day for a fixed term of 15 days.

It is important to note that your related bank card should have at least ₦50 for setup purposes and should have been activated for online transactions. Ensure that you input the correct bank card details to avoid decline.

For repayment, We will auto debit due amount at repayment date direct from your bank card, You can pay via the App by clicking the "Make a Repayment" button and You also can pay via transfer to this account:
**Account Name: Blue Ridge Microfinance Bank Ltd.**
**Bank Name: Zenith Bank Plc**
**Account No: 1016351922.**

Late loan repayments automatically incur a rollover fee of 2% per day. It is therefore advised that one does not exceed the repayment period. Furthermore, this could reduce your future borrowing credit score.

Regards

Wale

In a separate email chain, OPay ultimately provided us a loan application that offered only loans with a 7-day tenure:

KINDLY SELECT THE APPROPRIATE LOAN PACKAGE IN THE TABLE BELOW

| ✓ | LOAN AMOUNT | INTEREST | TOTAL REPAYMENT AMOUNT | TENURE |
|---|---|---|---|---|
| ☐ | N50,000 | N750 | N50,750 | 7 DAYS |
| ☐ | N100,000 | N1,500 | N101,500 | 7 DAYS |
| ☐ | N200,000 | N3,000 | N203,000 | 7 DAYS |
| ☐ | N300,000 | N4,500 | N304,500 | 7 DAYS |

(Source: OPay Loan Application Form )

And so, despite Opera having 4 different apps across 3 countries, it appears that each violates Google's Play Store rules and skirts compliance using the exact same technique. We have a hard time believing that to be accidental.

## *Rather than Updating the Market on The Material Policy Change That Could Eviscerate Its Lending Business, Opera Said Nothing and Immediately Raised $82 Million in a Secondary Offering*

Google's short-term lending policies were updated in August 2019 and would have had a materially negative impact on Opera's lending model, had the company chose to abide by them.

Amortizing high-interest rate loans over a longer period of time to "high-risk" borrowers would change the borrower profile, impact default rates and create a headwind for the segment.

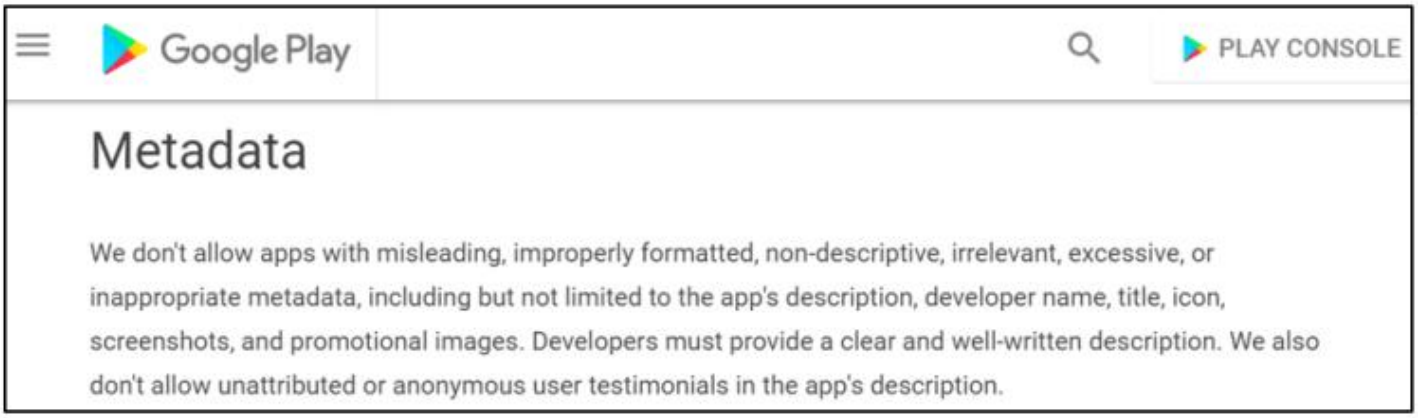
We believe most law-abiding companies would have promptly disclosed this rule change and reassured the market on their plans for adapting to it.

Instead, Opera appears to have disregarded the new policies entirely, disclosed nothing about the change to the market, even when it launched a secondary offering **in mid-September that raised net proceeds of about 82 million.**

## *Google's Rules: Your App Description Can't Be Misleading and Must Include Accurate Loan Length, APRs and Representative Examples*

The above documentation clearly shows that Opera is violating the Google Play Store rules on short-term loans. A further review shows the company to be in violation of additional rules.

For example, Google's policies require that the metadata of apps be accurate:




Furthermore, Google's personal loan policies require certain metadata to be included in app descriptions. This includes:

- The **minimum and maximum period for repayment** (already shown above to be false in Opera's app descriptions);

- **Annual percentage rate of the loan, including fees and**
- **A representative sample of a loan and its total cost**

Apps for personal loans must disclose the following information in the app metadata:

- Minimum and maximum period for repayment
- Maximum Annual Percentage Rate (APR), which generally includes interest rate plus fees and other costs for a year, or similar other rate calculated consistently with local law
- A representative example of the total cost of the loan, including all applicable fees

Opera's apps flagrantly violate each of these terms in its app descriptions.

## *Opera's App Descriptions: Interest Rates Are 12% -33% Max Per Year (APR)*

## *Opera's Actual APRs: 365% -438% .*

## *Opera's APRs if a Borrower is Late by One Day: 730% -876%*

Kenya, Nigeria, and India are home to some of the world's most disadvantaged individuals. Borrowers turning to short-term loans may lack access to traditional bank loans. These people are more likely to be vulnerable and fall for misleading offers.

We think Opera is taking advantage of these people by claiming to offer low rates and longer-term loans then gouging borrowers with sky high rates and shorter terms.

We reviewed all of Opera's lending apps and found that each claimed to offer low rates in its app descriptions. Based on our research, however, none of its apps charge the stated interest rates and all ultimately charge obscenely high rates:

| | Claimed 'Max' APR | Actual APR | Late Borrower APR |
|---|---|---|---|
| **OKash** | 24% | 365% | 730% |
| **OPesa** | 12% | 438% | 876% |
| **OPay** | 24% | 365% | 730% |
| **CashBean** | 33% | 365% | 730% |

(Source: Hindenburg Research calculations based on Google Play disclosures, consultant testing, company emails, and user reviews)

## *A Pattern of Luring in Unsuspecting Borrowers with a Classic Bait and Switch*

Additionally, we saw what appeared to be a 3-step pattern of 'bait and switch' on loan terms in each app:

1. The app description would lure in users with low rates and long loan length terms.
2. Once downloaded, the app would then suggest users apply for a loan, showing a slightly longer loan length and terms that suggest a higher interest rate.
3. Once the user inputs their personal information and applies, the apps then either deny the borrower or grant a short-term loan with sky-high rates.

A former employee of OKash described to us how unemployed individuals were often totally unaware of the high interest rates they were paying, until it was too late:

> *"Most people are not educated. You see when you are downloading an app and opening an account there are those terms and conditions. Most people never read the terms and conditions.* ***So when you are telling a person you are expected to pay a 1% fee per day after you failed to pay the loan back by the time that person finds out it's like 20 days".***

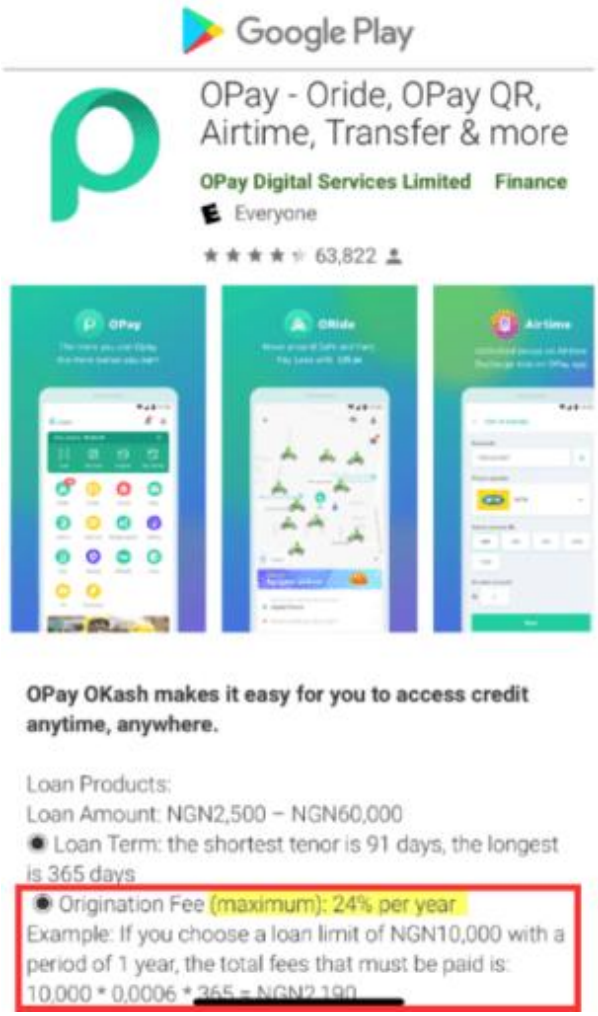
> *"…Now the rates had gone high and these are for (unemployed) people who could not even afford their basic needs."*

## *Breaking Down the Bait and Switch Model for Opera's 4 Lending Apps: Worsening Terms Every Step of the Way*

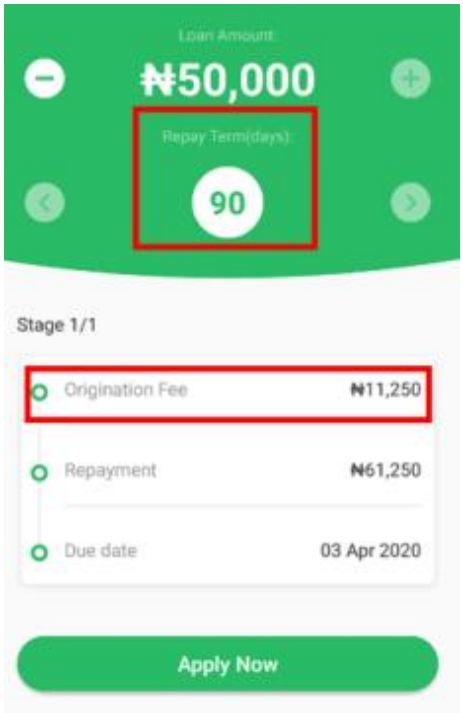
We took a granular look at what Opera's apps claim they offer in the way of interest rates, versus what is happening in practice.

1. **ay Nigeria**

OPay's app description says loans are offered with a 'maximum' interest rate of 24% a year in the form of an origination fee:




When users get into the app, however, they see options for 60 to 90-day loans with origination fees that correspond to a 91% APR.




But when users actually apply, a process that requires providing personal information and paying a fee, they appear to instead be granted 15-day loans for significantly lower amounts. See an example from one user below:

**Sylvester Eyeghele**
@syleyeghele

I got into your @OPay_NG App for the first time, did the normal registration process and as I was checking around I saw the loan section which had a minimum of 30k loan offer for a time frame of 60days, exactly what am in need of.

1:43 AM · Dec 23, 2019 · Twitter for Android

**Sylvester Eyeghele** @syleyeghele · Dec 23, 2019
Replying to @syleyeghele
Just after I finished the entire loan registration process and 15naira deducted from my bank account for card registration and validation, the 30k loan changed to 6k loan with a time frame of 15days.

1

**Sylvester Eyeghele** @syleyeghele · Dec 23, 2019
I don't have an issue with how you choose to run your business, but deceiving people is bad. Its entirely wrong for you to attract people's attention with an offer of 30k loan for 60days and then after getting 15naira for card validation you then display 6k loan for 15days.

1

**Sylvester Eyeghele** @syleyeghele · Dec 23, 2019
That's deceitful.... @OPay_NG you should be real.

We saw multiple recent users on social media complaining of these same 'bait and switch' tactics [ 1,2,3]:

**Adeolu Timothy**
@Fhysx

Replying to @theshalvah and @OPay_NG

The O Loan shows you a different amount, fill all your details and Boom! They tell you it's another amount you are qualified for after taking N15 from you.

Showed 60k initially, filled the details, told me I qualify for 2k.

OCar saying I am offline while fully connected.

2:45 PM · Nov 22, 2019 · Twitter for Android

As to the actual interest rates, we received loan documents from OPay as part of our research. The fine print at the bottom of the contract shows that the **interest rate is 1% a day, plus**

**another 1% per day if a user is late**. In other words; 365% per year, or 730% for late borrowers:

5. Interest is payable on Loans. Following the account registration process, you may be offered the opportunity to apply for Loans in certain amounts. We reserve the right to decline the Loan application for any reason. However, if we accept your application and grant you a Loan, We will charge a fee you must pay to us on top of paying back the borrowed amount ("Interest"). The Interest payable is stated together with the loan amount at the time you apply for each Loan. We will charge you Interest in the amount of 1% (one percent) per day and will be payable for the period we grant you a Loan regardless repayment is made before the Due Date. The Interest payable for a particular loan amount is particular to you.

   You must repay by the Due Date. You must repay the Loan together with the Interest by the date specified when you take the Loan ("Due Date"). It is important that you repay the Loan and Interest by the Due Date, if you fail to do so, we will charge you an additional fee of 1% (one percent) per day ("Rollover Interest"). You must then repay your loan amount, the Interest and the Rollover Interest.

An email to OPay customer service detailed an even higher 1.2% per day fee for 15 days and a 2% fee per day for late loan repayments.

**Service Customer** <customerservice@opay.team> 5:24 AM (3 hours ago)
to me

Dear [redacted]

Our sincere apologies for the delayed response.

OKash does not limit your work, income, or other conditions. So long as you are 20-55 years old, all you need is an Android device, a data connection, a means of identification, as well as valid bank account and card.

Please simply follow the instructions provided by the prompts- ensure to provide authentic information about yourself.

The information provided will be used to determine your credit score and the loan offer suitable for you.

You can access a minimum of N1,500 and a maximum of N100,000 for an origination fee charged of 1.2% per day for a fixed term of 15 days.

It is important to note that your related bank card should have at least ₦50 for setup purposes and should have been activated for online transactions. Ensure that you input the correct bank card details to avoid decline.

For repayment, We will auto debit due amount at repayment date direct from your bank card, You can pay via the App by clicking the "Make a Repayment" button and You also can pay via transfer to this account:
**Account Name: Blue Ridge Microfinance Bank Ltd.**
**Bank Name: Zenith Bank Plc**
**Account No: 1016351922.**

Late loan repayments automatically incur a rollover fee of 2% per day. It is therefore advised that one does not exceed the repayment period. Furthermore, this could reduce your future borrowing credit score.

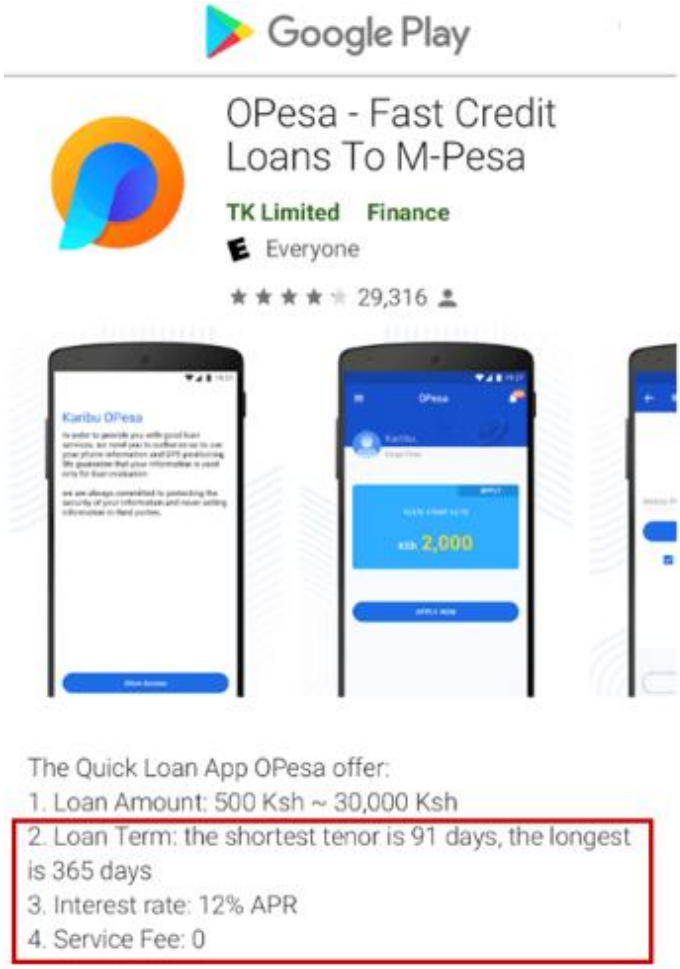
Regards

Wale

Given that these rates aren't presented until the end of the borrowing process, **users likely don't learn that they have a 2-week loan at absolutely crippling interest rates at the very last minute**.

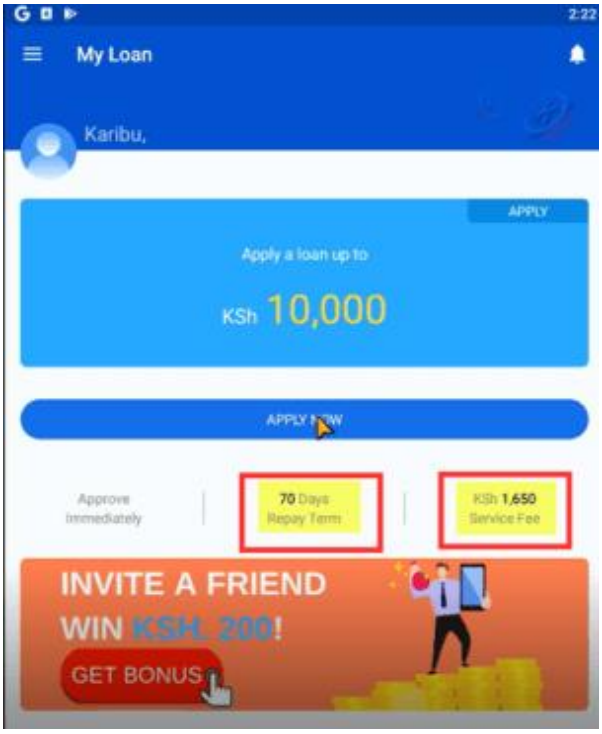
2. **esa Kenya**

OPesa's lending app description shows a reasonable 12% APR with no service fee:

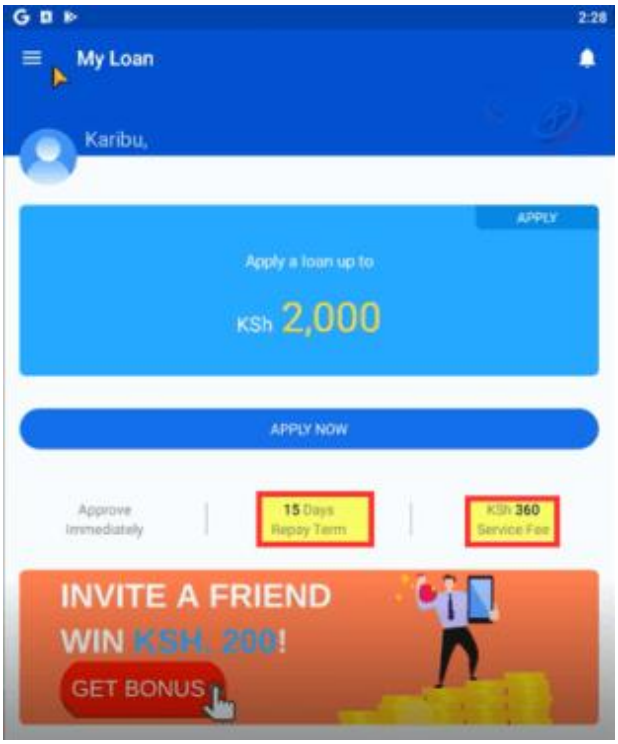



[Source: Google Play Store ]

When our consultant tested OPesa in late December, the screen prompting them to apply for a loan showed a less attractive loan term of 70 days with service fees that suggested an APR of about 86%:




Once they put in all of their personal information **, the loan terms were again worsened to a 1 -day loan with an A R of 38%**

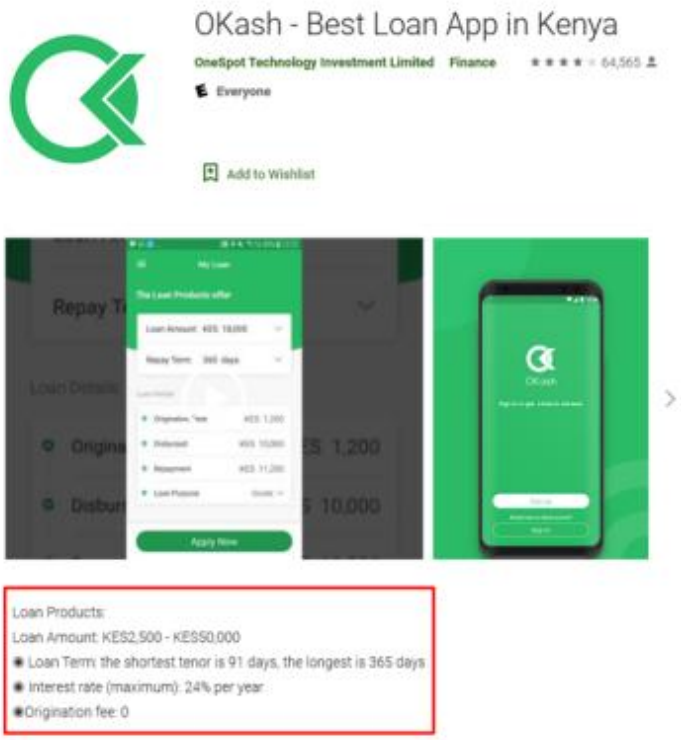



In the fine print of the OPesa terms of service **, we see that late loans are charged at a rate of 2. % per day, an A R of 876%.**

The only other place we see the real OPesa terms are the app's FAQ page, which contradicts the terms presented in the app description and the loan application process.

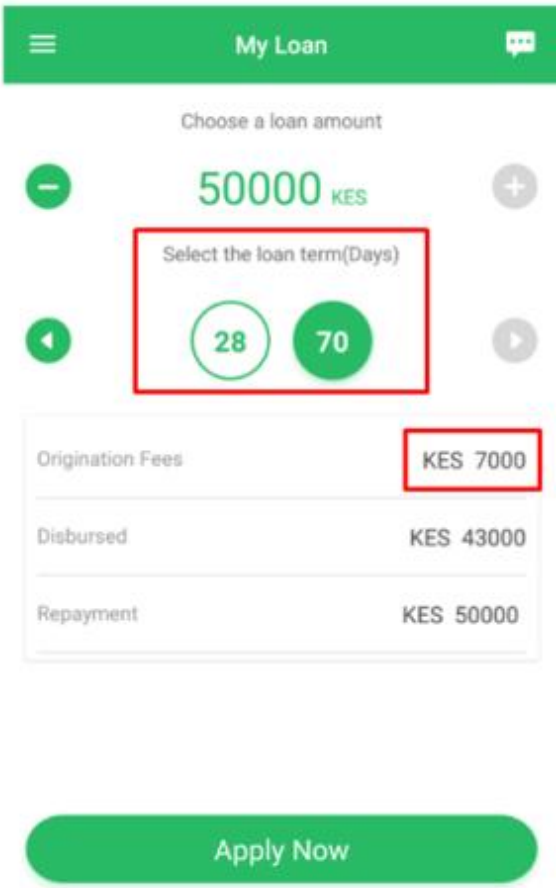
3. **Kash Kenya**

And here is the app description for Opera's OKash, showing that the maximum interest rate is 24% per year with no origination fees.




[Source: Google Play Store ]

When it came time to apply, the app first suggested that our consultant could get a loan for 28-70 days, at an implied APR of 84% through origination fees:



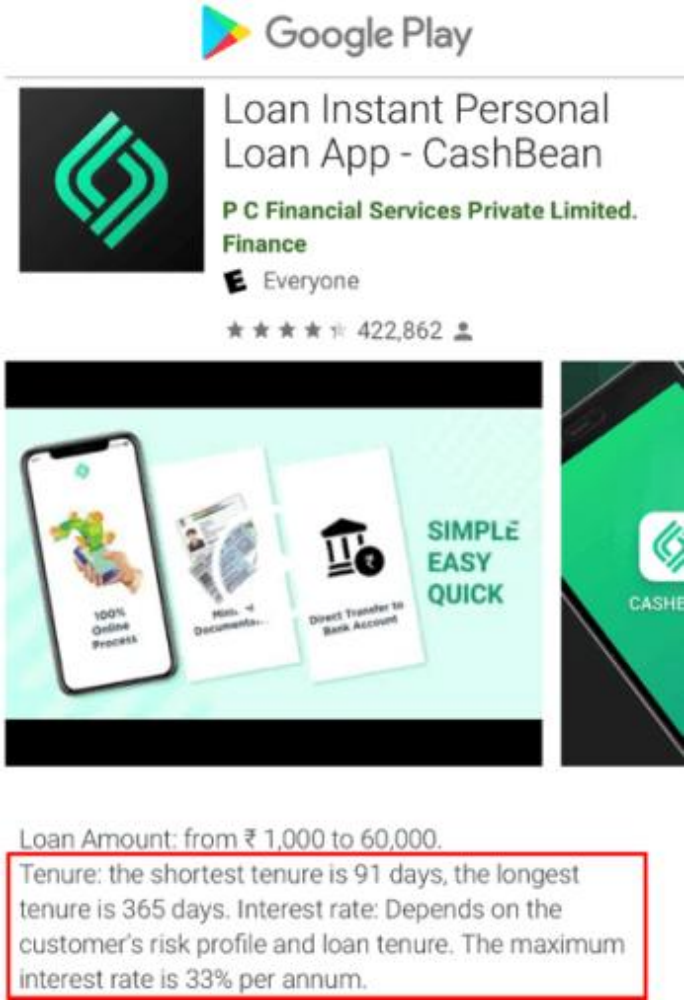

But then the actual loan term for our consultant ended up being 2 weeks, at an APR of 365%.


These rates were also corroborated by our email exchange with OKash support shown earlier, which confirmed that the actual interest rate is approximately 1% per day (365% APR), charged in the form of an up-front origination fee.

According to the app's Terms of Service, late users are charged 2% per day if late, an APR of 730%!

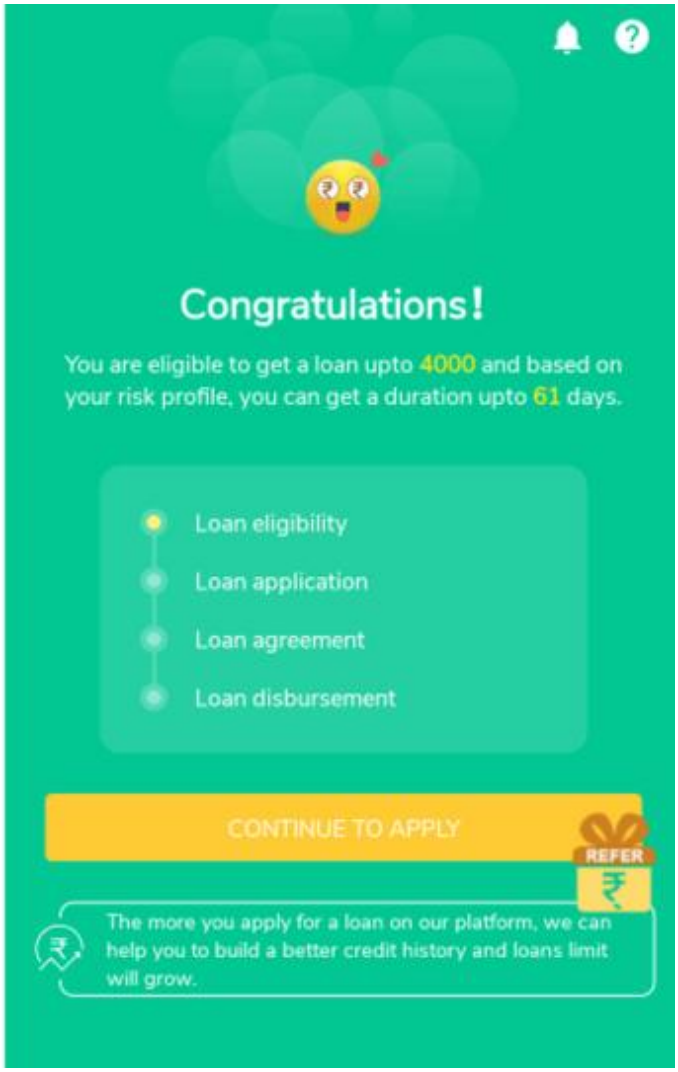
4. **CashBean India**

Lastly, Opera's CashBean description suggests a "maximum" APR of 33%.

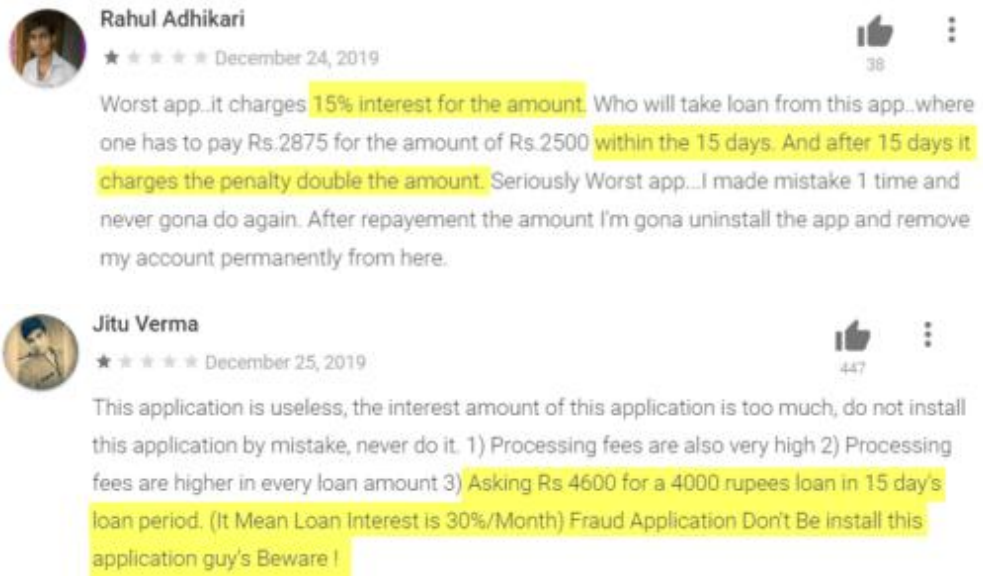



[Source: Google Play Store ]

Once our consultant began the loan application process by inputting their basic information, the app once again lured them in with a suggestion that they could get a loan "duration up to 61 days":




Our consultant was unable to procure a loan, but we found numerous user reviews that claimed 15 day loan terms at 15%, which doubles if late (365%-730% APRs). Here are two recent examples:



**Rahul Adhikari**

★ ★ ★ ★ ★ December 24, 2019

38

Worst app..it charges 15% interest for the amount. Who will take loan from this app..where one has to pay Rs.2875 for the amount of Rs.2500 within the 15 days. And after 15 days it charges the penalty double the amount. Seriously Worst app...I made mistake 1 time and never gona do again. After repayement the amount I'm gona uninstall the app and remove my account permanently from here.

**Jitu Verma**

★ ★ ★ ★ ★ December 25, 2019

447

This application is useless, the interest amount of this application is too much, do not install this application by mistake, never do it. 1) Processing fees are also very high 2) Processing fees are higher in every loan amount 3) Asking Rs 4600 for a 4000 rupees loan in 15 day's loan period. (It Mean Loan Interest is 30%/Month) Fraud Application Don't Be install this application guy's Beware !

## *Google's Rules: "We Don't Allow Apps That Expose Users to Deceptive or Harmful Financial Products or Services."*

## *Opera: When Borrowers Were Late by One Day, We Accessed the Borrower's Phone Contacts and Harassed Their Friends, Family, Employers, and Co-Workers with Texts and Calls Until the Money Was Repaid*

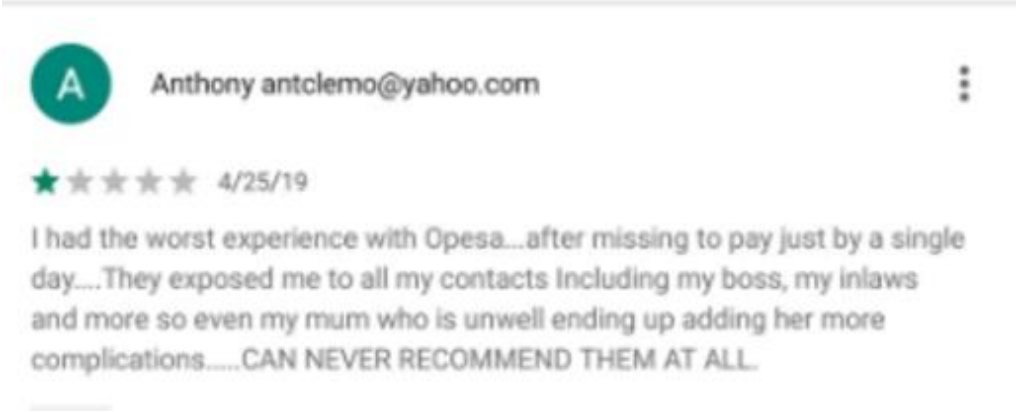
We also learned of a ruthless OKash and OPesa collection policy that was only recently changed as of June 2019, according to a former employee.

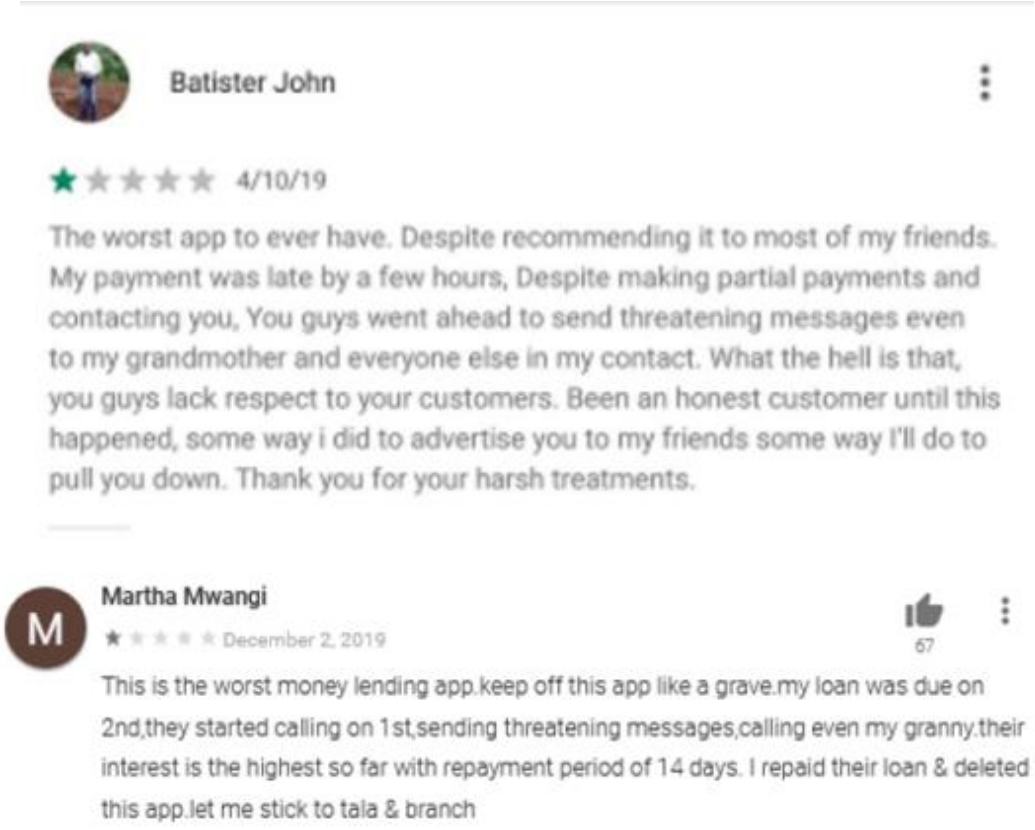
If a user was late to repay, the app had previously indiscriminately texted or called contacts in the user's phone as part of loan collection efforts. This process began immediately after a loan repayment was delayed, according to user reviews.

Numerous users reported that friends, family, employers, and other contacts were harassed and threatened through Opera's apps when a borrower was late. A Kenyan news article provided one example of the threatening messages used to elicit payment:

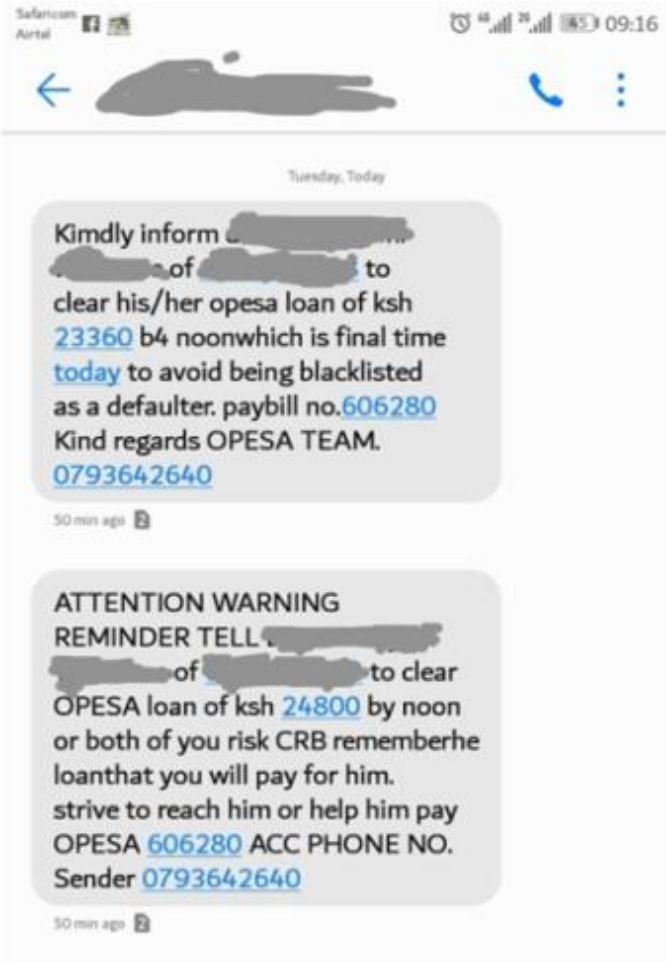
> *"Hello, kindly inform XX to pay the OKash loan of Sh2560* ***T DA before we proceed and take legal action to retrieve the debt*** *, it's says the text message the service provider sends to people in one's contact list."*

This type of public shaming and pressure obviously created devastating social consequences for the borrower. See several examples below from user reviews:






In another example, the apps threatened to place friends or family of a borrower on a national credit blacklist if they didn't convince the actual borrower to pay:




Additionally, complaints about violation of privacy were found on social media, like Twitter :


We reached out to two Kenyan credit agencies (CRB's) to ask whether it is actually possible to blacklist a person for simply being a contact in a person's phone who owes money and have not heard back.

A former OKash employee told us that this practice has been discontinued as of June 2019 "because it was said it was illegal."

## *Dire Consequences for Borrowers: Defaulters Are Disproportionately Young People, Often University Students, Who Are Frozen Out of the Job Market and the Banking System*

These mass-default lending products can have crippling societal consequences.

For example, several OKash employees described to us a treacherous cycle of fees, which in Kenya can result in the borrower loaded with debt and *unable to get a job*. Most government and corporate employers require a certificate from the Kenyan credit agencies, known as Credit Reference Bureaus (CRBs), showing good credit. In the absence of such a certificate, many Kenyans are rendered unemployable.

One former OKash employee told us:

> *"Before you take a loan, they usually ask for your ID number. And for us, using your ID number – there's usually something called CRB, Credit Reference Bureau…**after 30 days they usually forward names of people who haven't paid to the CRB – the Credit Bureau is where now the Kenyan government can come to ensure that most people pay their loans.**"*

She continued:

> ***ou cannot get a job if you have a negative CRB – credit score or something. So that's how businesses ensure that you pay back.***

When we asked another OKash employee about the risks facing the business he said:

> *"University students. Most of them they are getting into loans. And most of them they don't have even stable income. That's a very risky part for the business because **you end up having a big number of defaulters of which in the end its very young***

***people who are not yet employed at any point."***

He later described the consequence of these defaults:

> ***"When you are applying for a job in Kenya you need CRB certificate. So that's also a very major concern the main problem again, again the issue I was telling you about, the young people, the age group that is around from 18 to around 28 Those are the most guys who are in CRB right now."***

We were also told of how common it is for university students to download multiple lending apps and borrow from each of them to pay off loans from the other, effectively running thousands of mini Ponzi schemes in order to (temporarily) avoid default while they struggle to pay exorbitant interest rates and afford basics.

## *We've Seen This Story Before: Opera Chairman/CEO's Deep Involvement with Qudian, a Short-Term Lending Flop That Has Plunged More Than 80% In the Two Years Since Its IPO*

Opera's sudden pivot to "micro finance" is not Chairman/CEO Zhou's first foray into short-term lending or listed companies on US exchanges. Zhou was a director of Chinese lending business Qudian (NYSE:QD) from February 2016 to February 2017, before it went public [ Pg. 212]. Kunlun, a China-based company that Zhou controls , was one of the largest investors in the company and owned 19.7% of it when it went public [ F-1 Pg. 8].

Qudian raised $900 million in its IPO in late 2017, the biggest U.S. listing ever by a Chinese Fintech firm. **The company I 'd at 2 and has already cratered to about .3 as of this writing, a more than 80% decline in a little over two years.**


According to a detailed class action lawsuit, Qudian was alleged to have engaged in flagrantly illegal and deceptive lending practices. The parallels to Opera's current business are striking. The second amended class action complaint against Qudian alleged, among other things:

1. The company falsely stated that it exited making loans to college students in response to a ban by the Chinese government:

> " ***udian nevertheless continued to actively operate and promote its business of lending to college students up to the I and continued these illegal practices even after the I ".***

2. The company "employed illegal and unethical means in violation of Chinese laws and regulations, such as threatening students and calling their teachers, parents, or spouses to exert pressure on the borrowers. **A former company employee reported that the methods used were so humiliating to young vulnerable students that at least one committed suicide."**

3. The company lent at exorbitant and illegal rates:

> *"The Company had charged or attempted to charge overdue borrowers a **daily interest rate as high as %** as "penalties" for overdue loans, which, **on an***

> ***annualized basis is 1,82 %, i.e., 76 times higher than allowed under the Chinese law."***

The allegations have not been proven and the lawsuit is still pending before the court.

Beyond the obvious similarities to Opera's new predatory lending business, Qudian's financial metrics also show parallels. The company had periods of massive revenue growth (at one point almost 500% y/y) yet its delinquency metrics, competition, and partner/regulatory hurdles ultimately have begun to catch up with it.

**nce again, it is easy to give money away**—the hard part is making sure it comes back (particularly when lending to the world's most disadvantaged at sky-high rates.)

## *Conclusion: Investors Should Be Wary of Opera's 'Pivot' to Sketchy Short-Term Lender and Its Flagrant Violation of Google Play Rules*

We think Opera's new 'high growth' lending business should raise alarm bells for investors. Opera's willingness to engage in deceptive, predatory lending to some of the world's most vulnerable people should say something about the approach embraced by management.

As we were told by a former OKash employee in Kenya, the "issue is repayment":

> *"Now the issue is repayment.* ***All these citizens are usually able – they can borrow, but most of them don't have the ability to pay back.*** *Most people who are borrowing from the app – most people are not employed. So when you're dealing for example – when I was there – when I used to call people during time for repayment,* ***most of them would tell you that they're not working, so it's a 0 0 kind of market."***

If Google becomes active about enforcing policies against deceptive and harmful short-term loan apps, we think Opera's apps are prime examples. We have reached out to Google for comment on these apps and whether they violate its terms and will update this report should we hear back.

# *Part II: Financial and M&A Mysteries That Don't Add Up*

## *Opera's Opaque Related-Party M&A Transactions*

Management's pivot to misleading and deceptive lender to the world's most disadvantaged raises the question of what other behavior the company condones.

## *Why Did Opera Pay $9.5 Million for its OKash Lending Business by Purchasing an Entity Owned by Opera's Chairman/CEO, When Corporate Disclosures Stated Otherwise?*

Regarding Opera's "OKash" Kenyan lending app, we see that the company paid $9.5 million for an entity that Hong Kong records show was 100% owned by the Chairman/CEO, despite company disclosures stating otherwise.

In December 2018, Opera paid $9.5 million to acquire a Hong Kong entity called Tenspot Pesa Limited, which actually owned OKash. [ Pg. 92]

## *Opera Claims it Bought the Entity for $9.5 Million From OPay, a Related Company That Opera has a ~20% Stake In…*

Opera stated that it had acquired Tenspot from OPay, a separate company that Opera has a 19.9% stake in. Per the company's annual results :

> *"In late December, Opera acquired OKash from Opay for a consideration of $9.5 million."*

This disclosure made sense given Opera's other public statements on OKash. When Opera initially announced the launch of OKash in March 2018 (about 9 months before Opera acquired it) it stated that it was launched by "OPay, the FinTech company part of the Opera Group."

## *…But Hong Kong Corporate Records Contradict This, Showing that Opera's Chairman/CEO Owned 100% of the*

# *Entity the Entire Time*

We pulled the Hong Kong corporate records for Tenspot. **The** annual report filing **from just 3 weeks prior to pera's acquisition states that ay did not own the entity. Rather, pera's Chairman CE ahui Zhou owned 100% of the entity:**

表格 Form **NAR1**

附表一 **Schedule 1**
(非上市公司適用
**FOR NON-LISTED COMPANY)**

本申報表的結算日期
**Date to which this Return is Made Up**

| 23 | 11 | 2018 |
|---|---|---|
| 日 DD | 月 MM | 年 YYYY |

公司編號 **Company Number**
2612582

非上市公司的成員詳情 (第 13 項)
**Particulars of Member(s) of a Non-listed Company (Section 13)**

*(有股本的非上市公司必須填報此頁，如空位不足，或超過一類股份，可另加附表一。)*
*(Non-listed company having a share capital must complete this page. If the space provided is insufficient, or if there is more than one class of shares, please use additional Schedule 1.)*

截至本申報表的結算日期的成員詳情 Particulars of Member(s) as at the Date to which this Return is Made Up

股份類別 **Class of Shares** Ordinary

此類別股份的已發行總數 **Total Number of Issued Shares in this Class** 100,000,000

| 姓名／名稱 Name | 地址 Address | 股份 Shares | | | 備註 Remarks |
|---|---|---|---|---|---|
| | | 現時持有量 Current Holding | 轉讓* Transferred * | | |
| | | | 數目 Number | 日期 Date | |
| 周亞輝 ZHOU Yahui | Building B, Mingyang International Center, No.46 Xizong Buhutong, Dongcheng District, Beijing 100005, People's Republic of China | 100,000,000 | | | |

In fact, every Hong Kong corporate document we found showed that the entity was owned 100% by Chairman/CEO Yahui Zhou – from inception until the acquisition by Opera. Here are the articles of association for Tenspot, around the time of its creation in November 2017, showing the same:

I, the undersigned, wish to form a company and wish to adopt the articles of association as attached, and I agree to subscribe for the amount of share capital of the company and to take the number of shares in the company set opposite to my name.

| Name of Founder Member | Number of Share(s) Taken | Total Amount of Share Capital |
|---|---|---|
| 周亞輝<br>ZHOU Yahui (周亞輝) | 100,000,000 Ordinary shares | USD1.00 |
| Total: | 100,000,000 Ordinary shares | USD1.00 |

How could Tenspot be simultaneously wholly owned by 2 separate parties at the same time?

We reached out to Opera's investor relations to confirm whether it bought OKash from OPay (as company disclosures stated), or from Chairman/CEO Zhou directly, as Hong Kong entity records state. The investor relations rep wrote that he was "not sure on the specifics of how the entity was set up" but nonetheless re-affirmed "Okash was purchased from OPay (so OPay received the cash not Yahui Zhou)."

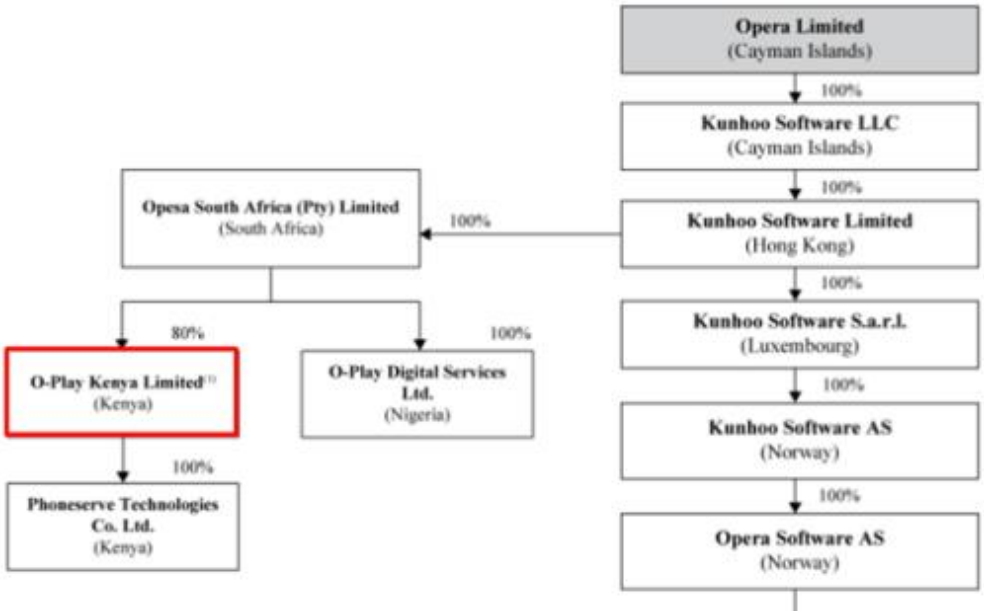
## *Opera Has Funded and Operated OKash Seemingly from the Beginning. So Why Did It Pay $9.5 Million to Own It?*

Opera's investor relations contact also wrote in relation to the OKash transaction that "The business was basically a license when Opera took over".

This makes sense. Hong Kong corporate records show that Tenspot was created in late 2017, just months before the OKash app was launched, suggesting that the entity was created for the purpose of owning OKash or perhaps a license for OKash to operate.

But as part of the disclosures around the transaction we see that Opera had actually lent at least $2 million dollars to Tenspot, thus it appears to have been funded by Opera since the beginning. [Pg. F-55]

Opera also looks to have *operated* OKash since the beginning. An Opera filing dated 5 months prior to the transaction [F1 Pg. 51] shows that the company owned 80% of the local operating entity for OKash, O-Play Kenya Limited [pg. 52]:




In other words, Opera funded an entity that it then later purchased for $9.5 million, in order to own a business that it already operated. This strikes us as peculiar.

If the Hong Kong corporate records are correct, and our suspicion is that they are, the "acquisition", once unpacked, appears to simply be a cash withdrawal by Chairman/CEO Zhou, from the public company and its shareholders.

## *StarMaker: Why Did a Browser Company Invest $30 Million of Cash into a Private Karaoke App Owned by Its Own Chairman/CEO? (With an 'Option' To Invest Another ~$49 Million Soon)*

On November 5th, 2018, Opera announced it had invested $30 million in cash into Chairman/CEO Yahui Zhou's private karaoke app, StarMaker. The investment gave Opera a 19.35% stake in Zhou's company, valuing the app business at about $155 million.

Zhou had acquired StarMaker in late 2016 for an undisclosed sum. StarMaker's financials have not been disclosed, but Opera's most recent 20-F states that it was generating losses [Pg. F-56]. We asked Opera's investor relations about StarMaker's financials and they replied that StarMaker was growing revenue and is now profitable.

The app looks to be fairly popular, boasting over 50 million users largely in India, Indonesia, and the Middle East. Nonetheless, investors may wonder, what on earth does a karaoke app have to do with the strategic long-term success of Opera's browser business (or even with its predatory lending business?)

Opera's investor relations told us there is "No integration today with Opera and right now viewed as an investment (versus strategic)."

Keep in mind that Opera's July 2018 IPO raised $107 million in net proceeds [Pg. 1], so the investment into Zhou's StarMaker app and the investment into the OKash entity represented about 37% of its newly raised cash, out the door, within just about 5 months.

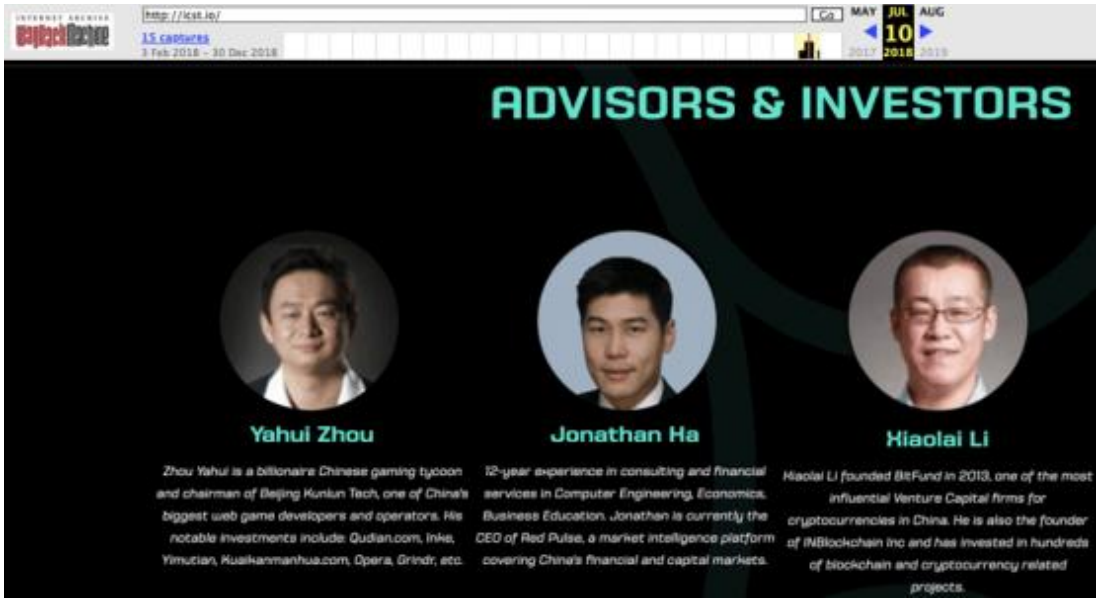
The StarMaker deal also included "an option to increase its ownership to 51% in the second half of the year 2020", which we estimate would translate into another $49 million cash investment, assuming the valuation remains constant.

We hope the company discloses StarMaker's financials to investors before Zhou makes an executive decision on that investment.

## *StarMaker Appears to Have Backed a Crypto Startup Meant to Tokenize Its Revenue Model. Four Days After Opera's $30 Million Investment, the Crypto CEO was Arrested for Allegedly Looting Funds, Among Other Misdeeds*

StarMaker ran into some immediate controversy following the Opera investment. In 2018, prior to Opera's investment, StarMaker appears to have partnered with a crypto ICO called ICST. The ICST token (short for Individual Content and Skill Token) was intended to give content creators a better ability to monetize their intellectual property via the blockchain.

StarMaker was the first partner for the ICO, and StarMaker owner (and Opera Chairman/CEO) Yahui Zhou was the ICO's key investor/advisor.




[Source : Wayback Machine ]

The plan was for ICST to transform StarMaker's revenue model into a tokenized business, and then later branch out into other apps. Yahui was quoted as having a grand vision for the project:

> ***"I see an opportunity to make a great investment, disrupt an entire industry and help creators earn what they deserve"***

ICST's whitepaper detailed the partnership with StarMaker and described how its revenue model would be reliant on the new token.

The backing of Zhou and StarMaker helped the ICO raise an estimated $2.5 million USD by June 2018. Opera made its $30 million investment into StarMaker several months later, on November 5th. Four days after Opera's investment, the CEO of ICST was arrested , with the corresponding DoJ indictment alleging he had stolen ICST funds, among other misdeeds.

# Former New York Times Journalist Caught in $3.5 Million ICO Scam

Omar Faridi
2 Dec 2018 / In #ICO , #Where's My Money?

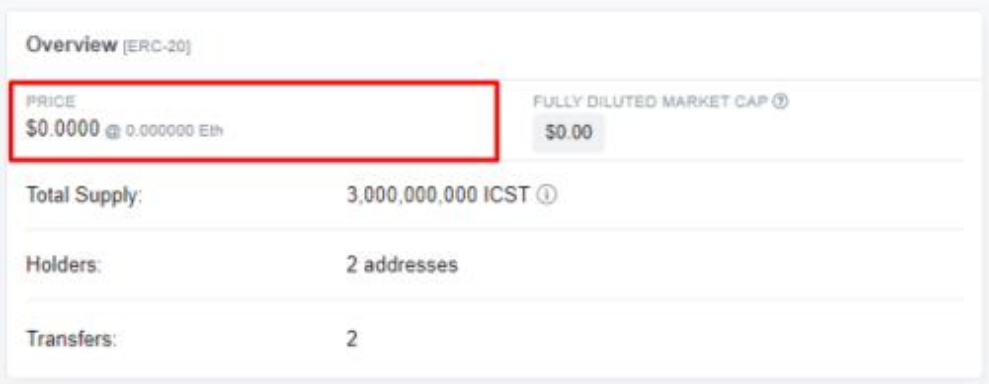
- Chinese-American Jerry Ji Guo has allegedly been involved in a $3.5 million ICO-related scam.
- Guo, a former Newsweek and New York Times journalist, may face up to 20 years in prison for orchestrating fraudulent crypto-related schemes.

See count 8 from the indictment alleging illicit transfers of ICST funds in August, months prior to Opera's investment:

| | | | | |
|---|---|---|---|---|
| EIGHT | 08-19-2018 | California | New York | Electronic transfer of 1,036.99 ETH from "ICST" BitGo wallet to GUO's account at Gemini |

INDICTMENT 4

At the time Opera announced its investment, there was no disclosure of any missing ICO funds or any public signs of trouble with the partnership. The token is now valued at zero .




Token buyers have claimed they were cheated by Yahui Zhou and that StarMaker should make good on their losses. Zhou has stated that the claims are baseless and has subsequently distanced himself from the project. Opera's most current financial statements have begun to disclose the potential for litigation relating to the StarMaker crypto currency partnership. [Pg. S-25]

All told, we find the nature and timing of Opera's $30 million related-party karaoke app investment to be unusual. At best, it raises questions about the Chairman/CEO's judgement relating to this crypto karaoke misadventure.

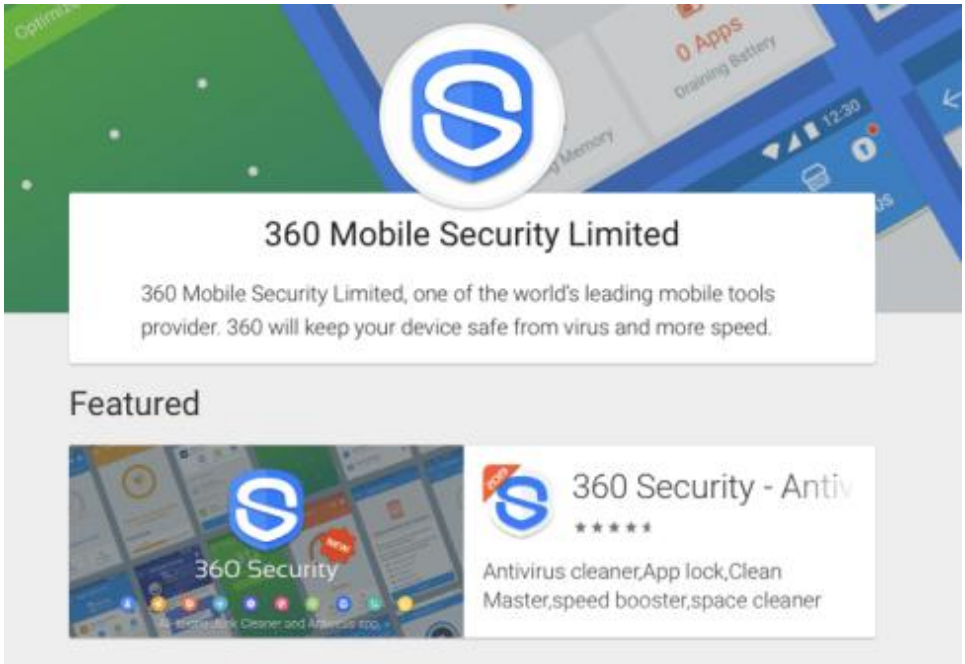
## *More Related Party Transactions: Why Has Opera Directed Over $31 Million, (Including an Advance of $18 Million in Cash) to AntiVirus App Maker 360 Mobile Security for Help with Its Facebook & Google Ads?*

Usually, when a company wants help with its marketing, it hires a marketing company.

Contrary to what's typical, Opera has instead directed over $31 million of marketing cash to another of Chairman/CEO Yahui Zhou's related companies, 360 Mobile Security.

Opera has had a marketing relationship with 360 Mobile since mid-2016, when a deal to acquire Opera by current management was already in the works . The agreement called for 360 Mobile Security to negotiate and manage its advertising/media services.

360 Mobile Security describes itself as a security company. **We could find no other examples of the company acting as an advertising agency. We reached out to 360 Mobile to ask whether it had any other marketing clients and have not heard back as of this writing.**




[Source : Google Play store ]

The original service agreement had billed Opera at an annualized rate of about $10 million.

That rate seems to have stepped up considerably as of late. Two months after Opera's IPO, flush with investor cash, an amended agreement called for a prepayment of $10 million to 360 Mobile Security.

**That prepayment has steadily increased, with 18. million in prepayments due to the related-party as of pera's September 2019** secondary offering prospectus [Pg. F-17]:

| [US$ thousands]<br>**Balances with related parties** | **Category of related party** | **Type of balance** | **As of December 31, 2018** | **As of June 30, 2019** |
|---|---|---|---|---|
| 360 Mobile Security Limited | Key management personnel | Trade receivable | 770 | 520 |
| 360 Mobile Security Limited | Key management personnel | Distribution prepayment | 10,420 | 18,397 |
| 360 Mobile Security Limited | Key management personnel | Trade payable | - | (250) |
| Beijing Kunlun Tech Co., Ltd. | Key management personnel and Manager | Other payables | (169) | (410) |

**The same prospectus indicates that pera has paid out almost 13 million of marketing and distribution expenses to 360 Mobile Security in the first half of 2019.**

| [US$ thousands] Transactions with related parties | Category of related party | Type of transaction | Six months ended June 30, 2018 | 2019 |
|---|---|---|---|---|
| Opay Digital Services Limited | Associate / Key management personnel | Technology Licensing / Other Revenue | 5,880 | 4,784 |
| Opay Digital Services Limited | Associate / Key management personnel | Interest income | - | 323 |
| Powerbets Holdings Limited | Associate | Technology Licensing / Other and Advertising Revenue | - | 1,328 |
| 360 Mobile Security Limited | Key management personnel | Technology Licensing / Other and Advertising Revenue | 1,500 | 8 |
| Kunlun Global International | Key management personnel | Advertising Revenue | - | 2 |
| Beijing Kunlun Tech. Co. Ltd | Key management personnel | Technology Licensing / Other Revenue | - | 13 |
| nHorizon Innovation (Beijing) Software Ltd | Joint venture | Technology Licensing / Other Revenue | - | 57 |
| Starmaker Interactive Inc. | Associate / Key management personnel | Technology Licensing / Other Revenue | - | 147 |
| Opay Digital Services Limited | Associate / Key management personnel | Advertising Revenue | - | 270 |
| Opay Digital Services Limited | Associate / Key management personnel | Investment (reclassification of loan to equity and cash contribution) | - | (7,131) |
| 360 Mobile Security Limited | Key management personnel | Marketing and Distribution | (5,037) | (12,897) |
| 360 Mobile Security Limited | Key management personnel | Business License | - | (250) |
| Beijing Kunlun Tech Co., Ltd. | Key management personnel | Office facilities | (734) | (854) |
| nHorizon Innovation (Beijing) Software Ltd | Joint venture | Cost of revenue | (31) | (15) |
| nHorizon Innovation (Beijing) Software Ltd | Joint venture | Professional services | (471) | (156) |

We find this combined $31 million in cash out the door in expenses and prepayments to be concerning, and raises further questions for us about Opera's cash payments to related parties.

## *To Summarize: Opera's Cash-Bleeding Related Party Transactions*

1. $9.5 million to buy an entity that appears to have been owned 100% by Opera's Chairman/CEO, despite corporate disclosures stating otherwise, to own a business that was already funded and operated by Opera.
2. $30 million invested into a karaoke app business owned by Opera's Chairman/CEO, days before the arrest of its key partner, an ICO backed and supported by Opera's Chairman/CEO. Opera has an "option" to invest another estimated $49 million into the app in 2H 2020.
3. $31 million in cash for marketing expenses and prepayments, not paid to an advertising agency, but to a related-party antivirus software company with no other known marketing clients.

## *Opera Appears to Be Quietly Restating Past Revenue, Making Current Results Appear Better, Without Disclosing It*

Beyond questioning Opera's related party transactions, we also noticed some issues with the company's reported financials.

When numbers from prior periods start to suddenly move around without explanation it suggests there could be an internal controls issue. Most companies that restate financials provide detail on restatements in order to assure investors that any mistakes or issues won't happen again.

Opera has seemingly taken a different approach. Over the past several quarters, the company has apparently restated past financials without disclosing why. The result has been that year over year and quarter over quarter numbers have appeared better than otherwise.

Take, for example, the most recent Q3 2019 quarter . Opera reported that Q3 2018 revenue was $42.795 million:

Third quarter 2019 financial highlights

| | Three Months Ended September 30, | |
|---|---|---|
| [US$ thousands, except for margins and per ADS amounts] | 2018 | 2019 |
| Revenue | 42,795 | 93,678 |

But when we checked the Q3 2018 numbers reported at the time , **we see that revenue had actually been .7 million. Where did the other 2 million go**

## Opera Limited announces third quarter 2018 financial results and initiation of share repurchase program

November 8, 2018 at 7:00 AM EST

- *Revenue of $44.7 million with 56.8% year-over-year growth of advertising revenue*

In another example, in Q2 2019, Opera reported $49.8 million of revenue in Q1 2019.

**Second quarter 2019 financial highlights**

Q1 '19 Rev = $111,568-$61,725=$49.8m

| [US$ thousands, except for margins and per ADS amounts] | Second quarter 2018 | Second quarter 2019 | Year-over-year % change | First half 2018 | First half 2019 |
|---|---|---|---|---|---|
| Revenue | 39,828 | 61,725 | 55.0% | 79,274 | 111,568 |

**But when we checked the 1 2019 numbers reported 3 months earlier, we see that revenue had actually been 1.3 million**

## Opera Limited announces first quarter 2019 financial results

May 22, 2019 at 7:00 AM EDT

- Revenue grew 30% to $51.3 million year-over-year, above the top end

In both cases, the revising down of the previous period made the year over year and quarter over quarter growth rates more impressive on the headline numbers.

We checked to see if any recent accounting changes could have been applied retroactively and been the source of these silent restatements. The company has adopted several accounting methodology changes as of January 1, 2018, but none appear to influence the revenue numbers from Q1 2018 and beyond. [ Pg. F-20]

We contacted Opera investor relations about the quiet restatements. IR had no explanation for the restatement of the Q3 '18 numbers but said they would get back on the specific reason.

The Q2 '19 restatement was explained as follows:

> *"We changed our methodology as it related to microlending once we had more data. In Q1 we recognized 100% of late fees. The data showed us that about a minority of late fees are recoverable, so in Q2 we started recognizing only what our historical data showed we could recover."*

We appreciate the answer from Opera, but we think these types of changes should be disclosed to investors without the need for prompting.

We also think this answer shows that the lending segment may be employing aggressive revenue recognition practices. To recognize 100% of late fees as revenue suggests that every late borrower, no matter how impoverished, would be able to pay back late fees at a rate of 730% per annum. This is obviously an absurd notion given the massive loan default rates, and makes us question the revenue/default recognition methodologies in the overall segment.

# *Conclusion: A Turnaround "Story" That Is Little More Than a Story*

Opera's deteriorating legacy business, declining financials (except revenue), bizarre business pivot, and related party transactions suggest to us that we may not be witnessing the miraculous "turnaround" story that the company would want investors to believe.

We believe Opera's foray into predatory microlending – a business that has already led Qudian shareholders to over 80% losses since the company's IPO – will result in a tab that will also be coming due soon for Opera shareholders.

We also believe that Google, once it realizes the abuses that it is (likely inadvertently)

facilitating, will eventually curtail or eliminate Opera's lending practices.

Beyond witnessing the 'microfinance' playbook in Qudian's collapse, we've also seen a litany of other US listed China based management teams engaging in extensive related party transactions. In many cases, insiders are able to enrich themselves while the result is far less favorable for shareholders.

Put simply: We feel like we've seen this opera before – and the final act ends poorly for shareholders.

# *Disclosure & Legal Disclaimer*

**Disclosure: We are short shares of pera**

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# TAB 21

# SmileDirectClub: Moving Fast and Breaking Things in People's Mouths – 85% Downside

Published on October 4, 2019



## Summary : SmileDirectClub (Nasdaq:SDC)


- SmileDirectClub is a company that claims to be disrupting orthodontics with its "teledentistry" platform and with its at-home 'do it yourself' model. We believe the company is carelessly cutting corners in a field of specialized medicine, putting customer safety at risk.
- Alabama and Georgia dental boards have enacted rules that render some of the company's practices illegal. We expect more states will follow suit.
- Major medical organizations like the American Dental Association and the American Association of Orthodontists have alleged that SmileDirectClub puts patients in danger and is practicing medicine illegally. They have filed complaints with the FTC, FDA, and at least 36 state boards.
- SmileDirectClub's practices have earned it over 1,200 Better Business Bureau complaints in just 5 years as a company. We communicated with one customer who was forced to

use wire cutters to remove SDC products after he struggled to breathe. Review sites are replete with other horror stories of customers who had to take emergency dentistry into their own hands.

- While professional dentists offer personalized care and comprehensive pre-screening, we were told by a former SDC store manager that the company was sending 75 to 100 cases to one orthodontist's phone, per day, to "crank out" case decisions.
- Instead of fixing its practices, the company has gone on a litigation spree to silence critics. SDC has even required dissatisfied customers to sign legal releases promising not to complain to regulators or write bad online reviews, in exchange for refunds.
- The Chairman/CEO sold the company his private plane a month before the IPO – and *this wasn't even the first time* he sold the company an interest in one of his private planes. Insiders and affiliates cashed out almost $700 million of $1.27 billion in total net IPO proceeds.
- Financially, the company is another profitless, cash incinerating "unicorn" that we believe has significant added financial headwinds to face as a result of regulatory, legal and customer satisfaction liabilities.
- The company is trading at ~6.5x its revenue run-rate, an absurd multiple for a money-losing consumer products company with no meaningful barriers to entry. Well-funded, more responsible competitors are popping up left and right.
- All told, we believe SmileDirectClub will wind up as a case study in why it's a bad idea to invest in a company that attempts to fit a complex, dangerous medical process onto a low-cost, high volume assembly line.
- We see downside of 70% purely on a valuation basis, and downside of 85% given the above headwinds. We have a one-year price target of $2.

*Initial Disclosure: After extensive research, we have taken a short position in shares of SmileDirectClub. This report represents our opinion, and we encourage every reader to do their own due diligence. Please see our full disclaimer at the bottom of the report.*

# *Part I: SmileDirectClub is Another Ugly IPO That Has Somehow Avoided Even Basic Scrutiny*

In a year filled with busted and over-hyped Silicon Valley-backed IPOs, one company seems to have somehow slipped through the cracks largely unnoticed.

SmileDirectClub ("SDC" or "SmileDirect") IPO'd on September 12th, pricing its offering at a higher-than-expected $23 a share, giving the young company an $8.9 billion valuation. Since then, the stock has dropped over 40% and now trades at a ~$5.2 billion valuation. From here, we expect the stock will be further cut in half several times over the next 6 to 12 months.

SmileDirectClub is a company that's existence seems largely predicated on its ability to provide customers a lower-cost clear aligner treatment that meets the level of care of traditional orthodontics. Our investigation discovered evidence suggesting its level of care is not even close to the standard.

We believe that SmileDirectClub is putting customer safety at risk, potentially practicing medicine without proper licensing, and could end up as one of the worst consumer blowback stories in recent memory.

Once the market realizes the above, in conjunction with the company's financial and governance issues, we expect SmileDirectClub will reprice significantly lower and will be subject to long overdue scrutiny from investors, analysts and the press.

## *About Our Investigation*

During our investigation into SmileDirectClub, we spoke with multiple former employees, competitors, and customers. We reviewed the company's SEC filings and numerous court filings, visited one of the company's "Smile Shop" locations in New York City, and corresponded with dentists and orthodontists.

## *Background: A Brief History of SmileDirectClub And Its Product*

SmileDirectClub was founded in 2014 with a simple approach: offer inexpensive clear teeth aligners by cutting out expensive and time-consuming elements of the process.

The company's approach claims that it requires zero meetings with dentists or orthodontists, instead replacing them with a "teledentistry" platform.

| Traditional orthodontic model | | smile DIRECT CLUB |
|---|---|---|
| **Cost** | | |
| $5,000 – $8,000 | | $1,895 |
| **Convenience** | | |
| 10 – 15 orthodontist visits | | Doctor-directed remote teledentistry Zero in-office visits required |
| 12 – 24 months | | 5 – 10 months |

(Source: Prospectus Pg. 1 )

Users take their own dental impressions at home via a do-it-yourself kit or go to one of several hundred brick and mortar "Smile Shops" where their mouths are scanned by "Smile Guides".

Once approved, clear aligners are sent by mail to customers who then undergo 5-10 month treatment plans . The customers can communicate questions and issues through SmileDirect's customer service platform and the company's " Dental Team " along the way.

SmileDirect was backed by some of Silicon Valley's most notable VCs, including Kleiner Perkins . In just 5 short years, the company has gone from startup to multi-billion-dollar public company by employing its "disruptive" approach to specialized medicine.

## *Background: SmileDirect's Goal of "Disrupting" The Traditional Orthodontic Model Seems to Largely Rely on Dangerous Corner-Cutting*

We think SmileDirectClub is an ongoing case study in precisely why the best practices of the traditional dentistry model exist to begin with.

Throughout the course of our research, dentists and orthodontists were unanimous in telling us that SDC was missing the most vital parts of any orthodontic treatment, which include a comprehensive pre-screening and evaluation for complex legacy dental issues, professionally performed molds and/or scans, as well as continuing personalized care from a licensed

professional.

During our research, we came across *"Do It Yourself" dental horror stories, allegations of practicing medicine without licenses, dental emergencies in the company's "Smile Shops" and lawsuits* all of which we believe will help put the world – and the public markets – on notice about SDC's questionable approach.

## *Reality Check: State Regulators and Major Medical Organizations Have Begun to Declare the Company's Practices Illegal*

Several state dental boards have recently clamped down on SmileDirectClub with rules that render certain of the company's practices illegal. Major medical organizations have also come out swinging with complaints targeted directly at the company:

- **Alabama.** The Board of Dental Examiners of Alabama found that SmileDirect's practice of taking pictures of teeth for the purposes of creating dental products **constituted the unlicensed practice of dentistry.** (Pg. 2) SmileDirect filed suit against the board, with most of its claims dismissed in April.
- **Georgia.** The Georgia Board of Dentistry clamped down on SmileDirect with a rule that targeted the company's practice of allowing dental assistants to take digital scans of customer's mouths without any direct supervision from a licensed dentist. SmileDirect filed suit, but most of its claims were dismissed in May.
- **36 State Complaints** have been filed against SmileDirect by state affiliates of the American Association of Orthodontists (AAO) alleging, in a substantiated fashion, that SmileDirect is illegally operating as a dentist without proper licensing in the subject states. See example here.
- **DA and TC Complaints have been filed by the American Dental Association** alleging that SmileDirect is "placing the public at risk" and alleging "false and misleading claims (that) constitute unfair and deceptive practices."

In response to the industry pushback, SmileDirect's CFO retorted in a recent Forbes interview by saying:

> *"I think anytime you do something disruptive, the status quo pushes back against that."*
>
> *– Kyle Wailes, SmileDirect's Chief Financial Officer*

## *Reality Check: In Just Five Years as a Company, SDC Has Amassed 1,200 Better Business Bureau Complaints and a Damning New Class Action Lawsuit*

In addition to regulators, the company seems to be getting pushback from another important constituency—its customers. A review of the Better Business Bureau (BBB) website for SmileDirectClub shows over 1,200 customer complaints as of this writing, **for a company that is only years old**

Just last week, a major lawsuit seeking class action status was filed against the company on behalf of customers and orthodontists/dentists.

Among its allegations, the lawsuit references "thousands of substantiated, serious customer complaints" and provides several examples (emphasis added):

> ***roduct made my teeth worse*** *with spacing and gaps…* ***After five months and four aligners and a crack tooth*** *and numerous attempts to talk to customer service to fix my issues all of which led nowhere."*
>
> *"* ***lease don't do this yourself*** *–especially if you're just trying to save money..* ***my crown and implant- which was super expensive to get done- came off altogether****."*

Similar complaints are ubiquitous across Facebook groups (1,2,3) and review websites where SmileDirect customers share their stories, as we will show.

This is certainly not to say that *all* of the company's customers are dissatisfied; after all, an assembly line approach to specialized dentistry can work for some, but it also creates dangerous gaps in the process that expose patients to heightened risks.

SmileDirectClub is taking the startup approach of "moving fast and breaking things". In this case, unfortunately, they seem to be "breaking" many of their customers' teeth.

## *Financials: Another Profitless Unicorn Incinerating Cash at an Accelerating Rate*

SmileDirectClub has seemingly focused on growing revenue at all costs. The company has seen an impressive revenue trajectory over the past 2 years, achieving 83% year over year revenue growth as of the most recent quarter:

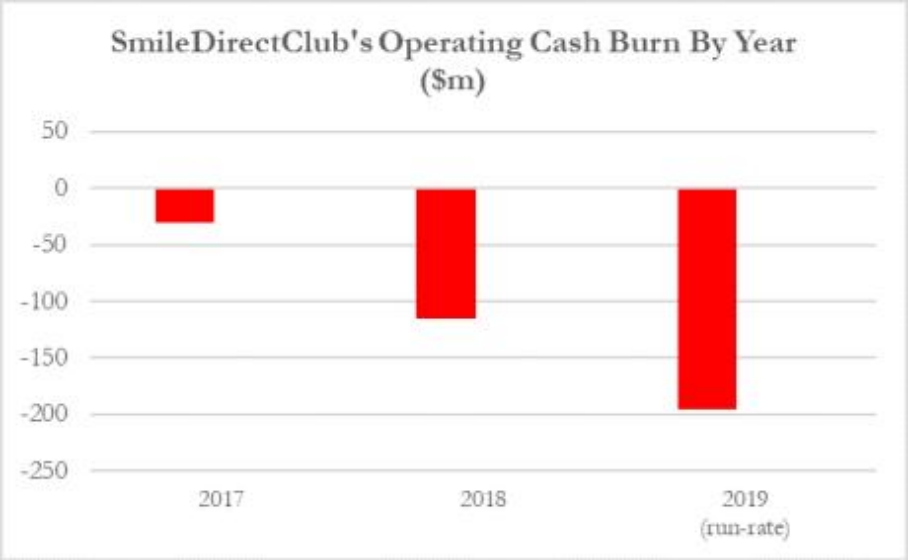

(Source: Prospectus Pg. 90 )

But the company has *also* substantially increased its losses over the same timeframe:


(Source: Prospectus Pg. 90 )

Note that the above GAAP losses could (we believe *temporarily*) improve in subsequent quarters. Last quarter, the company took a one-time $29.6 million charge on the extinguishment of debt which it is not expected to repeat in subsequent periods.

The above losses are not fully reflected in the company's operating cash flow metrics, however, which are far worse. In the most recent 6-month period, the company used almost $98 million of cash on an operating basis, putting it on track for a 2019 run-rate of negative $196 million, compared to negative $114 million in 2018.




(Source: Prospectus Pgs. F-6, F-33 )

The cash flow metrics have suffered in part because the company has extended financing to roughly 65% of its customers, allowing them to pay over a period of up to 24 months [ Pgs. 34, 95].

We expect such financed revenue growth will represent a substantial future drag on cash intake, particularly with historical delinquency rates ranging from 9%-10%. [ Pg. 34]

The company has $201 million in debt [ Pg. F-47], the largest chunk represented by $151.3 million drawn on its J.P. Morgan revolving credit facility (expiring December 14, 2020, unless renewed [ Pg. F-49])

With pro-forma cash of roughly $537 million as of the IPO offering [ Pg. 23], an operating cash burn run-rate of $196 million and $151.3 million of debt due in 2020, we expect the company will aim to re-tap the equity markets by the end of 2020. That, of course, assumes the company's operating metrics stay on the same course.

## *We Expect Financials Will Materially Worsen*

We believe operating metrics will deteriorate in the future due to the company quickly

approaching a "massive public backlash" stage of its business model. We believe that stage could include:

- **Major legal and regulatory liabilities** As shown above, multiple state dental boards have already moved to outlaw some of the company's current practices. A major class action lawsuit was recently launched and we anticipate more will follow. The ADA and AAO also appear to be fighting the company's practices aggressively on all fronts.
- **Consumer backlash**. The backlash against companies that play it fast and loose with the public's health can be severe, as we have seen recently with vaping companies like Juul. We expect it is only a matter of time before the mainstream media sheds light on the subject of DIY orthodontics in the same manner.
- **Competition.** Even if *all* of the above was ignored, the company has no meaningful barriers to entry and well-funded competitors are emerging quickly.

# *Part II: SmileDirectClub's Dangerous Lack of Professional Dental Oversight*

Orthodontics is a specialized form of dentistry. After a traditional 3 or 4 year dental program, dentists must then pass a rigorous exam and spend an additional 2 to 3 years in residency before earning orthodontic board certification.

The reason orthodontists must spend additional years studying the craft is because orthodontics is both risky and patient specific.

The American Dental Association made this clear in their petition to the FDA fighting against SmileDirect's practices:

> *"Teeth are complex living organs comprising many elements. They have nerves and require blood circulation. Moving teeth that are next to other teeth, are rooted in bone, and are held in place by ligaments is often a complicated procedure dependent on multiple individual variables. There really isn't a "one-size-fits-all" methodology for providing competent, professional orthodontic treatment."*
>
> *-American Dental Association*

The genesis of most of SmileDirect's problems can be tracked back to what we believe to be a dangerous lack of professional dentist oversight.

We intend to walk readers through the traditional orthodontic process and show how it compares to SmileDirect's "disruptive" new process – and the dangers that result.

## *Orthodontic "Traditional" Model: It's Essential to Have an Exam Before Orthodontics to Check for Dangerous Issues Patients May Be Unaware Of*

## *SmileDirect's "Disruptive" Model: Instead of an Exam, We'll Have Customers Self-Certify Their Dental Health and Sign A Waiver*

Dentists and orthodontists have been adamant that comprehensive oral exams are the required first step before undergoing orthodontics. The American Dental Association ("ADA") has made this crystal clear in its petition calling out SmileDirect's practices:

> *"Without a comprehensive oral examination, customers are at significantly higher risk for injuries attributable to their orthodontic treatment. This is why* ***dentists are ethically and professionally obligated to know firsthand, before they prescribe treatment, the state of their patients' oral health*** *[Pg. 8]*

The ADA further detailed the potentially severe consequences of ignoring this all-important first step:

> *"…****patients may be severely injured, suffering tooth loss, bone damage, nerve damage, jaw pain, exposed teeth roots, receded gums, aggravated or entirely new bite maladjustments****, and other related injuries." [Pg. 8]*

Rather than following the industry standard, SmileDirect has seemingly chosen to ignore it. Instead, the company lets customers simply fill out a waiver and a survey stating whether they are aware of any dental issues.

We experienced this ourselves when we went to one of SmileDirect's "Smile Shops" in Manhattan to research the intake process. There was no dentist on site at all.

At one point during the process, the assistant put an iPad in front of us with a 16-question

survey of yes/no questions. **All of the answers were pre-filled out to say "no".** Questions included:

- "Do you feel pain in any of your teeth?"
- "Have you noticed any loosening of your teeth?"
- "Do you have untreated periodontal disease?"

(See the full list of questions here)

Most people feel pain in their teeth at some point, but how many are able to accurately diagnose whether the cause is decay, or something else? Most people also don't even know what periodontal disease is, let alone the intricacies of testing for it.

This is likely why an orthodontist we contacted in Pennsylvania warned us that with teledentistry, we would be "skipping the most important step, **diagnosis**". The orthodontist said that aligners require **a full evaluation, and not just the signing of some waivers".**

The outcome of SmileDirect's approach, as we will show, seems to involve a lot of broken teeth, damaged gums and other adverse outcomes, including worsening of gaps and bite issues.

## *Orthodontic "Traditional" Model: Carefully Screen Out Patients Who May Be Ineligible Due to Complications That Could Make the Process Dangerous*

## *Former SmileDirect Store Manager: My Entire Market Of "Smile Shops" Was Assigned Only One Actual Orthodontist, who "Cranked Out" 75 to 100 Cases Per Day from His Phone*

Once customers sign waivers and self-certify their own dental health, they seem to be fast-tracked down the SmileDirect assembly line.

We spoke to a former manager of one of the company's "Smile Shops" based in the Eastern United States, asking about the process for approving patients.

He told us that SDC had just one orthodontist for his **entire market of shops**, who would **"crank out"** about 75 to 100 case approvals or denials – *using his phone* – for those seeking treatment:

> *"So we did have the orthodontist – his name was [redacted] – he would come by every once in a while, like maybe once a month, for like – he might do trainings about how to scan – but* ***he was getting things sent directly to his phone and he was making a determination on whether or not you'd be a good candidate or not.*** *So, he was very friendly, very helpful, very quick and efficient. We'd almost immediately see whether or not you would be a good candidate for this treatment."*

When we asked if the orthodontist was the only person responsible for approvals for his store, the ex-employee clarified that he **was in charge of the entire market** for his area:

> *"One guy per market. So, some markets were a little bit different. We only had a couple of stores in the [redacted] market. He handled all of the ones that we had.* ***He's literally cranking them out, like as soon as we send them. It's taking him a couple of minutes and he's done.*** *And he can say 'yay' or 'nay'."*

Finally, when asked to estimate how many cases the orthodontist could go through on a daily basis, given the number his store was sending, combined with other stores in the market, the ex-employee said:

> *"On a normal day, I'd say probably between 75 to 100."*

Obviously, there is a huge gap between personalized care from an orthodontist in their office versus an orthodontist who reviews a case as one of dozens (or possible hundreds) daily, **from his or her phone**.

## *SmileDirect's Aggressive Sales Culture: Employee Review Claims "We Are Approving Too Many Cases That Should Never Be Allowed"*

A common theme among online reviews is that SmileDirect takes on patients that are rejected by competitors like Invisalign and traditional orthodontists.

On Glassdoor, employee reviews (1,2,3) describe how an aggressive sales culture contributes to dangerous approvals at SmileDirect's Smile Shops (emphasis added):

> *"You are appointed 30 minutes to sell a new smile to each new customer all day every day and then next customer. Your job is only secure based on you selling and closing at least 70% during these appointments each month, using all the newest sales tactics the company keeps pushing us to use. That is company standard and you will be put on a PIP and performanced out if you cannot meet their sales expectations. "*
>
> ***This is hard to do with a clear conscience once you see refinement and midcourse correction customers coming into our shops DAIL with serious mal-occlusion, open anterior bites, edge to edge occlusion, and even mobility due to treatment We are approving too many cases that should never be allowed** to do ortho without a doctor evaluating their periodontal health or being UPFRONT and STRAIGHT FORWARD with how their bites will be misaligned once treatment is completed. We are not doing the right thing for everyone. Yes, we are helping many people achieve the smile of their dreams, but others are being ruined. I see those people daily!"*

Based on multiple reviews, agents are tasked with closing sales on 70%-73% of their appointments. This raises the obvious question: what if 70% of an agent's initial appointments aren't eligible for SmileDirectClub due to obvious dental issues?

## *SmileDirect's Aggressive Sales Culture: We Filled Out the Company's 'Smile Assessment' Saying "I Have Zero Teeth Left in My Mouth"*

## *SmileDirect's Response: "You're a Great Candidate!"*

A quota sales system puts numbers over quality, which can be dangerous in a medical context.

High quotas also strike us as extremely inadvisable given that SmileDirect's **initial sales funnel doesn't seem to reject anyone** We filled out the company's " 30 second smile assessment " on its website and noticed that we got accepted as a "great candidate" no matter what answers we provided.

Eventually we put the company's assessment to the ultimate test, declaring "I have zero teeth left in my mouth".

# Free 30-second Smile Assessment

Take 30 seconds to answer these questions and find out if SmileDirectClub is right for you.

Why are you thinking about straightening your teeth?

Other: Please specify

Other:

I have zero teeth left in my mouth.

After "grading our tooth test…"


SmileDirect determined that we were a great candidate!

CONGRATULATIONS!

**You're a great candidate.**

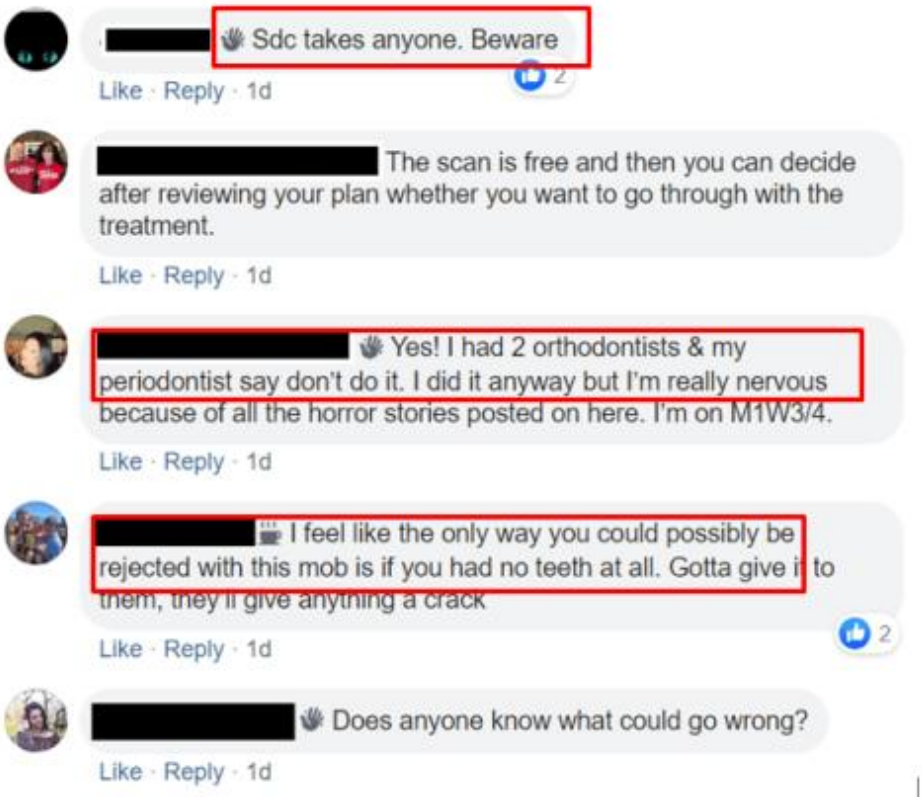
Get started on the smile you'll love in just three easy steps.

The reputation for accepting just about anyone (even in later stages of the process) pervades online reviews about the company, as well. In one example, a customer says:

> *"Other companies rejected me, yet I was accepted by SDC…(my teeth are) pretty crowded, and was surprised that they accepted me."*


The user later posted this photo of her teeth in the thread:


The thread continued, with users warning that Smile Direct takes anyone.




The former store manager we spoke with estimated that the orthodontist approved about 80% of cases in his market.

We reached out to the company asking for the overall approval/denial rate. We will update this report should they write back with an answer. (See Appendix A for all the questions we asked the company and for our somewhat odd interaction with investor relations.)

Overall, the company's aggressive sales culture, quota system, and practices seem to encourage treating patients that have clearly been deemed unsuitable by the "traditional" orthodontic model.

## *Orthodontic "Traditional" Model : Trained Professionals Take Your Dental Scans in A Sterile Office in Case Anything Goes Wrong*

## *SmileDirect's "Disruptive" Model: We'll Mail You Dental Impression Molds and You Can Perform this Important Medical Procedure in Your Living Room*

Traditionally, once a patient is pre-screened for treatment, professional dentists/orthodontists take impression molds or perform a scan of their patient's teeth. With the benefit of experience, professionals can take more effective impressions or scans and can avoid common dangers and pitfalls.

Contrary to the approach of using experienced professionals, SmileDirectClub mails customers impression molds and instructs them how to do it themselves. Here is one (of several) YouTube videos of a SmileDirectClub customer trying to figure out the at-home process:


Smile Direct Club Impression Kit - At Home Dental Impressions

Following the molds, the company then instructs customers to take pictures of their teeth.

It is hard to imagine that these pictures and impressions, performed almost entirely by untrained first-time customers using their phones in their living rooms or bathrooms, are of the highest quality.


Smile Direct Club Impression Kit - At Home Dental Impressions

Nonetheless, the pictures and impressions, which serve as the foundation of the process for many of SmileDirect's customers, are **then sent to offshore unlicensed technicians based in Costa Rica** to set up treatment plans. (Yes, we're serious. More on this later.)

We asked an orthodontist about whether taking impressions was really all that hard:

> *"How difficult is it to take accurate impressions? Would you trust someone who has never done it before to take them?"*

His response:

> *"Very. Never. Even highly skilled dental assistants occasionally make poor impressions, necessitating retakes."*

## *Orthodontic "Traditional" Model : In Case Any Issues Crop Up with Your Impressions, You Are in a Doctor's Office Surrounded by Professionals*

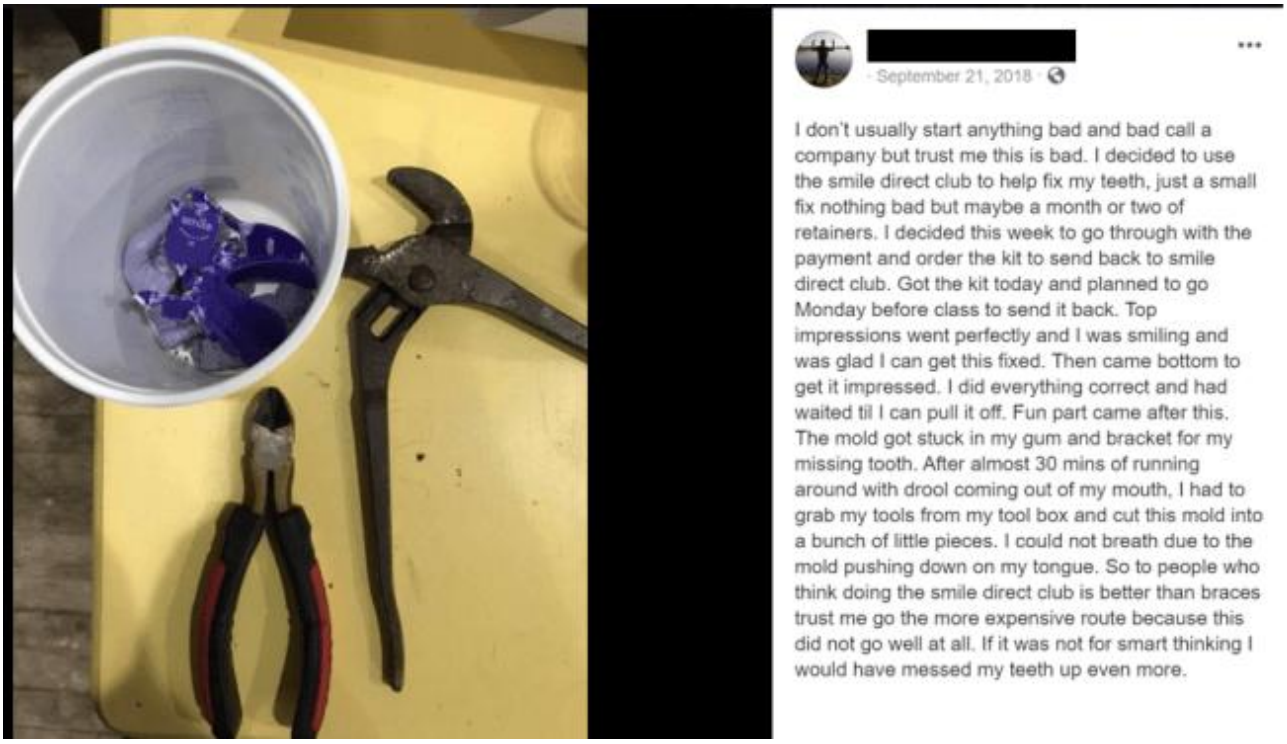
## *SmileDirect's "Disruptive" Model: Customers Cutting Molds Off with Wire Cutters and Other Horror Stories That Result from DIY Dentistry*

Sometimes medical procedures go wrong even under the care of professionals. But when medical procedures go wrong at home, users are generally unprepared.

We read multiple online reviews from SmileDirect customers whose impression molds got stuck. The customers then needed to find various ways to pry the molds free from their mouths.

In other instances, the untrained customers simply took bad impressions, which they believed led to bad aligners that either didn't fit at all or worse—led to damage or other adverse outcomes.

In one example, a user had his molds get stuck in both his gums and a bracket he had for a missing tooth. After running around in a panic for 30 minutes **, unable to breathe**, the individual was forced to take emergency dentistry into his own hands, **cutting the mold out of his mouth with wire cutters.**




Per the Facebook post (emphasis added):

> *"Top impressions went perfectly and I was smiling and was glad I can get this fixed. Then came bottom to get it impressed. I did everything correct and had waited til I can pull it off. Fun part came after this. The mold got stuck in my gum and bracket*

> *for my missing tooth.* ***After almost 30 mins of running around with drool coming out of my mouth, I had to grab my tools from my tool box and cut this mold into a bunch of little pieces. I could not breath due to the mold pushing down on my tongue".***
>
> *"So to people who think doing the SmileDirectClub is better than braces trust me go the more expensive route because this did not go well at all. If it was not for smart thinking I would have messed my teeth up even more."*

We followed up with the individual and asked him for more information about the experience. He told us:

> *"* ***ea I had to cut the mold off with a pair of wire cutters.*** *I did my research before I even purchased the kit to make sure that the bridge my dentist inserted would not interfere with the molding. I could not get the molding off at all.* ***It had actually seeped below my bridge and was stuck it actually got so bad I had to resort my way into cutting near my gum line just to free my bridge from it getting ripped out."***

We remarked offhandedly that "hopefully you at least got your money back" and received this unexpected reply:

> *"****Actually no to this day and this was a year ago actually. To this very day I still get calls, texts and emails telling me I need to turn in the moldings.*** *I had actually called them plenty of times and even sent that very picture and told them hey it got stuck and this is what's left of it and they said it was not their problem and that they needed some broken molds back"*

## *Orthodontic "Traditional" Model : In Case Any Issues Crop Up with Your Scans, You're in a Doctor's Office Surrounded by Professionals*

## *Smile Shop In-Store Horror Stories: "There Were Many Instances Where, In the Middle of a Scan, A Customer's Tooth – Or Teeth – Came Out. And There Would Be A Lot of*

*Blood."*

These days, digital scanners are much more common than using impression molds. Per an orthodontist we communicated with:

> *"All orthodontists now use digital scanners in their offices. A digital scan is much more accurate. In New York State, only a certified dental assistant, or doctor, is permitted to make a digital scan for the purpose of fabricating a medical device."*

SmileDirect offers digital scans (in lieu of at-home mold kits) for customers that can make it to any of the company's roughly 300 brick & mortar Smile Shops. [ Pg. 2] But even in this environment, the Shops generally do not have a trained dentist or orthodontist on site, instead relying on dental assistants or dental hygienists for support.

A former "Smile Shop" store manager shared some of his most difficult experiences with us. Among those horror stories, were times when customers would lose a tooth – ***or teeth*** – in the midst of getting a scan to see if they were eligible for SDC.

As the former store manager told us, he wasn't a dentist, so he was left unsure of what to do (emphasis added):

> *"There were many instances where,* ***in the middle of a scan, a customer's tooth came out – or teeth would come out. And there would be a lot of blood*** *and both instances are not something that you really can prepare for."*

> ***And it would be traumatic for our Smile Guides to have to deal with that,*** *even though a lot of them did come from, or had dental backgrounds or worked in dental offices. You know, it's a very unpleasant experience. You have to deal with something like that – like,* ***I'm not a dentist – what do I tell you"***

Customers that lost teeth in the store generally had issues with loose teeth and gums that would normally preclude them from orthodontics to begin with. Once again, the issue seemed to arise from a lack of screening procedures and a lack of oversight from a dentist.

## *Orthodontic "Traditional" Model : Once Your Dentist/Orthodontist Determines You Are Eligible and It's Safe, They Will Craft Your Plan and Guide You Along the Way*

## *SmileDirect's "Disruptive" Model: Onshore Dentists are Allegedly Paid a Token $50 Per Each 'Approved' Treatment Plan, While Plans Are Set up Offshore by Unlicensed Technicians in Costa Rica*

SmileDirect states that a U.S. licensed dentist "approves" the patients and their treatment plans. This is true, but according our conversations with former employees and a recent class action lawsuit, such approvals appear to be mere token involvement.

The complaint alleges that onshore dentists are paid a small $50 flat fee *per approval*:

> *"SmileDirect states that a U.S. licensed orthodontist 'approves' the treatment plan. In fact, to the extent that U.S. doctors or orthodontists are involved in the process, they are minimally involved. SmileDirect has acknowledged in its 'ELP participation agreement for 2017' that,* ***to the extent a U.S. dentist participates" in approving the treatment program, they are only paid if they actually approve the program and then are paid only 0.***

The ADA petition to the FDA lambasting SmileDirect also references this price point per approval as well. [ Pg. 19]

We reached out to SmileDirect to confirm whether this is still in fact the process and will update this report should they write back with an answer.

SmileDirect also does not use onshore licensed medical professionals to set up treatment plans. **Rather, the company conducts all of its treatment planning operations in Costa Rica**. [Pg. 31]

**The company employs approximately 6 0 treatment plan setup technicians" in Costa Rica along with approximately 8 doctors for quality review"**[Pg. 115] Once the plans are set up and reviewed offshore, an onshore dentist is then sent the plan for approval.

All told, this staggered, assembly line approach to the process seems to preclude meaningful doctor/patient interaction. It makes it difficult to fathom how the actual licensed dentists are much more than a rubber-stamp along the way.

## *Orthodontic "Traditional" Model: Dentists Fit New Sets of Aligners on Patient in Office Making Sure They Do Not Damage the Mouth*

## *SmileDirect's "Disruptive" Model: Aligners Shipped Directly to Patients, Who Make Adjustments at Home with Tools Like Nail Files*

Traditionally, during clear aligner treatment (the type of product SmileDirect offers), aligners are shipped to the dentist supervising the patient. From there, professionals ensure a proper fit and that the aligners do not cause damage to the patient's jaw, teeth, or gums. The visit also gives patients a dedicated doctor to answer questions and guide them along the way.

See below for how SmileDirect's largest competitor, Invisalign handles the protocol :

Your smile is in good hands

It's the first day of your new smile and time to pick up your first aligners at your doctor's office. This is a key step in your success. With Invisalign treatment, you're never on your own.

When you pick up your first aligners, your doctor will:

- Ensure your aligners fit well
- Answer your questions
- Let you know what to expect

(Source: Invisalign)

Contrary to that guided procedure, SmileDirect sends aligners to its customers by mail. From

there, customers regularly take matters into their own hands when the aligners don't fit or cause bleeding or other damage.

SmileDirect groups and message boards are littered with customers advising each other on DIY dentistry topics like which nail files to purchase to file down their aligners and how to adjust aligners at home:

[redacted] shared her first post.
New Member · 1 hr

Hi all! I'm on M4W3 and i noticed my gums start to bleed every time i take them out the ones on top behind my teeth/ by roof of mouth. Is this normal?

1 4 Comments

Like Comment

[redacted] Mine too. You might have to file a little there where it digs in.
Like · Reply · 1h

[redacted] i did that. I'm wondering if it has to do with how much my teeth have closed and possibly pushed my gums back and is squishing them ?
Like · Reply · 56m

[redacted] possibly 🤔 I need to file mine Tonight, I hope it helps 😄
Like · Reply · 53m

[redacted] I'll file some more! Lol thank you 😊
Like · Reply · 31m

[redacted] I am in Week 2 and I will file/cut for days until the darned things are wearable...and dental wax. Highly recommend it for those spots that really hurt
Like · Reply · 1d 1

[redacted] get an electric nail file. Very helpful.
Like · Reply · 1d 1

[redacted] yes I have one...just find it tricky to hit the right spots and make them smooth
Like · Reply · 1d

[redacted] Sounds like you're just beginning? Yes just buy a cheap electric nail file and file the edges that bother you. Hang in there
Like · Reply · 1d 1

We asked one orthodontist "Why do aligner fittings in an office instead of just shipping aligners to patients?"

His reply: **Moving teeth is not a benign process. It's a medical procedure."**

## *Former SmileDirectClub Employee: Customers Are Under the Impression That The "Dental Team" Consists of Dentists or Orthodontists, But the Only Requirement is to Be a Dental Hygienist or Dental Assistant*

When SmileDirect customers have medical issues, they can contact customer service, which puts them in touch with the company's "Dental Team".

We spoke to a former SmileDirect customer service representative as part of our research who informed us that customers are often under the mistaken impression that the Dental Team consists of dentists.

Instead, we were told that the only requirement to be on the "Dental Team" was to be a dental assistant or dental hygienist (emphasis added):

> *"The dental team is the ones who actually talk on the phone with customers…If you're a dental assistant or dental hygienist, you can be on the dental team. And that's not saying that they're the ones creating the plan.**But they're the ones that are on the phone talking to the people who are pretty much under the impression that they're a dentist or orthodontist."***

Once again, SmileDirect customers hoping for medical advice from a dentist seem to be under the wrong impression.

## *Former SmileDirectClub Employee: Customers Are Only Given the First Name of People They Speak to on the "Dental Team"*

Part of the reason customers are under the wrong impression about the Dental Team is because they are provided very little information about who they are speaking with. We were told that **customers are essentially kept in the dark**

> *"Really, the only information that they have is their first name…whenever they talk to*

> *people, there was never a direct line for a direct person specifically. The only email or number for the dental team was the generic DentalTeam smiledirectclub.com and then all the calls went to the same number, if that makes sense."*

The former representative continued, telling us the only place customers got a name was the one that was appended to their Smile Plan, and that even as an employee of the company they were largely in the dark about names of people on the Dental Team (emphasis added):

> *"There's a person's name on their Smile Plan, which is basically what was created for their smile for the invisible aligners, but that's like really the only place that there's a name."*

> *"But they definitely didn't have any information that showed 'this person practices in this state', you know what I'm saying? Because of insurance purposes, I know they did have to categorize it by location, but we didn't really see any of that at all.* ***The only thing I could ever see was the name of the person that created the plan, that was really it. And that's really, I think, the only thing that the customer was really able to see as well."***

In the American Dental Association's petition to the FDA regarding SmileDirect, it writes:

> *"To any extent SDC may have lowered costs it has done so by recklessly selling "do-it-yourself dentistry" over-the-counter to its customers…*
>
> *"SDC has virtually eliminated from the process any substantive participation by a dentist in a customer's teeth straightening treatment"*

## *Part II Conclusion: When Specialized Medicine Meets Assembly Line*

On SmileDirect's website its "Lead Dentist" states :

> *"An individual who is requesting treatment by using SmileDirectClub's aligners is receiving the same level of care from a treating dentist or orthodontist as an*

> *individual visiting a traditional orthodontist or dentist for treatment."*
>
> *– Jeffrey Sulitzer, DMD, Lead Dentist at SmileDirectClub*

The above statement seems to be the key to SmileDirect's "success". Meanwhile, every dentist or orthodontist that we spoke to disagreed with this statement.

We think consumers, regulators, and the media will soon wake up to the realization that this assertion made by the company is wrong at every turn.

# *Part III: An Unhealthy Habit of Using Litigation to Squelch Criticism, Competition Emerging, Governance Questions, and Insiders Cashing Out*

## *Want a Refund? First Sign This Legal Release Saying You Won't Post Negative Online Reviews and Won't Complain to Regulators*

One of the key selling points for SmileDirect seems to be its customer review ratings. Third-party review sites show ratings ranging from 2.7 to 4.3 out of 5.0 stars. The company claims in its prospectus that it has an average rating of 4.9 out of 5.0 from user reviews submitted through its own website. [ Pg. 2]

In examining the company's reviews, we found a troubling fact.

When most normal companies have an unhappy customer, they grant a refund or make other concessions. Rather than follow that typical practice, SmileDirectClub seems to turn its refunds into hush money.

The Capital Forum recently reported that SmileDirect withholds refunds to dissatisfied customers unless they sign agreements not to post negative reviews or file regulatory complaints. Per the article :

> *"Customers who are dissatisfied with their experience and want a refund are asked to sign a release preventing them from filing negative complaints on social media or*

> *with regulators and to withdraw any previously filed complaints. This practice could run afoul of Section 5 of the FTC Act and state laws, according to FTC staff and legal experts."*

Again, we're not saying the company doesn't have happy customers. The product clearly works for some. Nonetheless, these attempts to muzzle negative reviews strikes us as a method of distorting reality.

## *SmileDirectClub's Pattern of Using Aggressive Litigation to Silence Criticism: This is the Worst that Capitalism Has to Offer*

Beyond its attempts to muzzle dissatisfied customers, the company has filed a bevy of lawsuits against critics.

We at Hindenburg take pride in reporting on companies that try to use litigation to silence criticism. We believe that companies engaging in such practices are vastly more likely to have something sinister to hide.

- In late 2017, the company sued an orthodontist who posted a YouTube video that questioned the safety of the company's approach. The parties later settled.
- Days later, it sued the Michigan Dental Association for writing an article about SmileDirect that highlighted "numerous legal and patient safety concerns." The case was eventually dismissed.

In addition to suing critics, the company has used the threat of litigation to intimidate others from coming forward.

A recent complaint alleged "a barrage of 'cease and desist' letters from SmileDirect's counsel threatening lawsuits and threatening the filing of ethical complaints with regulators" against professionals that had voiced their opinions on the inadequacy of the product.

All told, we think the pattern of lawsuits, threats, and muzzling of dissatisfied customers are all telltale signs that SmileDirect is a company that goes out of its way to silence opposition.

## *No Meaningful Barriers to Entry: Well-Funded Competitors Are Popping Up Left and Right*

Despite the company's aggressive practices, it has burned significant cash and has printed significant net losses to date.

Even if one were to assume that the public, regulators, and the company's customer base raise no issues with its practices (which they are), basic economics would nonetheless make it incredibly hard to achieve lasting profitability going forward.

We are already seeing numerous competitors to SmileDirect offering substantially similar services:

- Invisalign (founded in 1997)
- Uniform Teeth (founded in 2015)
- Orthly (founded in 2016)
- Candid (founded in 2017)
- Smile Love (founded in 2017)
- SnapCorrect (founded in 2017)
- Byte (founded in 2017)

We spoke to Candid, Invisalign, Smile Love, Uniform Teeth, and Orthly. The most commonly cited differentiator relative to SmileDirect was that the competitors included substantial involvement from an orthodontist throughout the process, often including multiple visits and direct guidance.

The competitors cited SmileDirect as a mostly Do It Yourself (DIY) operation with very light involvement from orthodontists.

SmileDirect has spent an enormous amount on marketing to date ($209 million in marketing & selling expenses in just the past 6 months! [Pg. 88]) In the absence of meaningful barriers to entry, the company may simply be paving the way for more responsible competitors to take its market share.

## *Governance Questions: Chairman/CEO Sold his $3.4 Million Private Plane to the Company 1 Month Prior to the IPO. And It Wasn't Even the First Time He Sold an Interest in a Private Plane to the Company!*

SmileDirect's Chairman David Katzman controls about 87.5% of the vote [Pg. 150], giving him extraordinary power.

With that power, some of his recent decisions strike us as questionable. Namely, in August 2019, one month before the IPO, Katzman's entity sold the company his 1996 twin-engine private jet for $3.4 million. [Pg. 156] Here is the plane:


Remarkably, **this wasn't even the first time Katzman sold the company a plane** In February 2019, the company purchased a $1.1 million interest in another plane from a Katzman-controlled entity. [Pg. 156] In 2018, a Katzman entity billed the company roughly $1 million for use of his plane.

## *Governance Questions: Executives and Affiliates Offloaded Almost $700 Million Into the IPO*

In an IPO, investors aim to see cash reinvested back into the business to have a growth profile to look forward to.

We're also realists – it's reasonable to expect some insiders and early investors to want to cash out parts of their stakes.

During SmileDirect's IPO, company executives and affiliates cashed out almost $700 million **, representing over half of the total net I proceeds:**

| | Class A common stock to be Purchased | | Aggregate Purchase Price |
|---|---|---|---|
| David Katzman(a)(d) | 8,998,951 | $ | 198,411,369 |
| Jordan Katzman(b)(d) | 7,141,516 | | 157,462,872 |
| Alexander Fenkell(c) | 6,521,446 | | 143,790,803 |
| Steven Katzman(d) | 663,595 | | 14,500,839 |
| Susan Greenspon Rammelt | 29,964 | | 654,713 |
| CD&R SDC Holdings, Inc. | 2,275,857 | | 49,727,475 |
| Other(e) | 5,990,646 | | 131,941,093 |
| **Total** | 31,621,975 | $ | 696,489,166 |

(Source: Prospectus Pg. 153 )

By comparison, only $387.9 was raised for general corporate purposes, with the balance paying yet more executive bonuses and cashing out early shareholders.

All told, we think the company's executive team chose pinpoint timing to offload their shares onto the public ( *and* a couple of private jets).

## *Conclusion & Predictions*

We think SmileDirect is selling a dangerous product that cuts corners instead of actually disrupting the orthodontics industry. True disruption results in a better product at a better price, not in muzzling harmed customers with legal releases and silencing critics with litigation.

We expect SmileDirect's harmful practices will lead to an increasing chorus of opposition from regulators, media, customers, and its more responsible competitors, eventually impairing its brand or forcing it to significantly alter its practices. This won't happen instantly, but we think within a year we'll be looking at a vastly different "teledentistry" landscape than we are right now.

As far as the stock is concerned, the company is currently trading at ~6.5x its current revenue run-rate, despite continuing to incinerate cash. The market is currently valuing SDC as if it is a high-margin recurring-revenue SaaS company in explosive-growth mode.

In reality, SDC strikes us as (i) a low-quality consumer product company (ii) with high customer acquisition costs (iii) in a competitive, worsening-margin environment (iv) extending seemingly

sub-prime financing to customers (v) who are largely making 1-time purchases.

The company's ridiculous valuation is typically only found deep in the enchanted unicorn forests of Silicon Valley. Now that SDC is a public company, we expect its valuation will become far more tethered to actual operating performance over the next 6-12 months as IPO lockups expire and as the market begins to process its business model.

We expect that the company will continue to show revenue growth, and may even turn a brief GAAP profit, while continuing to burn operating cash flow over the next couple of quarters.

Given our prognosis for negative cash flow and negative net income, we were left with a basic revenue multiple for our analysis. When applying a 2x multiple to SDC's Q2 2019 revenue run-rate we arrive at a market cap of $1.5 billion, representing downside of 70%.

As consumer backlash hits, and the company's cash balance comes back into focus, we expect matters to worsen considerably. Our overall 12-month price target is $2, representing about 85% downside from current levels.

Best of luck to all.

## *Appendix A: Questions We Asked the Company*

We emailed SmileDirect's investor relations with questions in advance of this report. They replied quickly (A response time), but repeatedly asked that questions be answered over the phone. We repeatedly asked that they answer questions, any of them, in writing (we wanted them to be definitive/on-the-record) and they failed to do so. We found the exchange to be pleasant, though rather odd.

Should the company respond back with answers to any of our questions below, we will update this piece accordingly. Here they are so readers can get a sense of the questions we were interested in:

1. What do you view as the next growth market for the company? I saw some expansion in the UK but where else do you see opportunities in the near future?

2. I read in the recent class action complaint which said that Alabama and Georgia had outlawed certain practices employed by the company. Are you receiving pushback from any

state boards other than Georgia and Alabama right now? How do you plan to handle operating in those two states going forward?

3. Have you heard any guidance or response from the FDA or FTC on the issues raised by the ADA with those agencies?

4. One common criticism I've seen is that the company doesn't have thorough involvement from orthodontists and dentists. What is the role of dentists/orthodontists in the SDC process from start to finish?

5. Do customers know who they are speaking with on the dental team?

6. Who do you see as your most formidable competitor at the moment?

7. What percentage of prospective customers does the company reject?

8. The recent class action lawsuit stated that the company pays orthodontists/dentists $50 per approval of each plan. Is that still the going rate today?

9. Are there other circumstances where orthodontists/dentists are paid and what are the rates for those services?

11. The Capital Forum published an article recently saying that customers are asked to sign a release in order to get a refund. Is that still the case and are you able to share a copy of what that release looks like?

12. What percentage of aligner sales are generated from at home kits vs SmileShop scans? Do you see that mix changing?

# *Disclosure & Legal Disclaimer*

**Disclosure: We are short shares of SmileDirectClub**

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# TAB 22

# Our Reply to Bloom's Woefully Inadequate Response

Published on September 18, 2019



This morning, Bloom Energy issued a press release responding to some of the issues that we raised yesterday in our report " Bloom Energy: A 'Clean' Energy Darling Wilting To Its Demise ".

We appreciate the company's response, but find that its press release does nothing to refute the findings of our research or our conclusion that the company could be a bankruptcy candidate as its debt approaches maturity.

In fact, we believe that as readers carefully compare Bloom's responses to our research, it becomes clear that the company instead largely confirmed our concerns.

## *Sometimes the Things Left Unsaid Echo the Loudest. Here Are the Issues That Bloom Failed to Address Entirely.*

Right off the bat, we note that there were multiple key items in our report that the company failed to address. In particular:

- Our report: Bloom's carbon emissions are comparable to that of a modern natural gas power plant.

Bloom's response: **None.**

- Our report: Bloom's tricky accounting allows it to only record one year of servicing liabilities despite contracts that last up to 25 years.

Bloom's response: **None.**

- Our report: Subsidies are being pulled or stepped down, which would have a material effect on Bloom's financials.

Bloom's Response: **None.**

- Our report: Bloom has been 'selling' replacement servers to the same projects and booking it as NEW revenue. The impact of these deals has been material; last quarter alone, server replacements accounted for ~40% of Bloom's revenue.

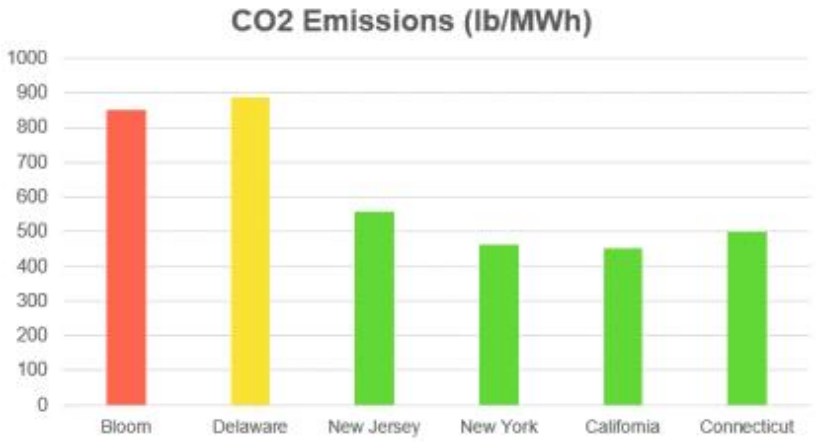
Bloom's Response: **None**

Of the items Bloom did respond to, we find their responses to be woefully inadequate.

## *Our Report: Bloom Should Not Compare Its Emissions to the Marginal Grid*

## *Bloom's Response: Here's a Chart of Our Emissions Versus the Marginal Grid*

One key issue we highlighted was how, contrary to the company's clean energy narrative, Bloom's CO2 emissions are far DIRTIER than the electric grid in most key states in which it operates:




(Source: 2016 EPA eGRID summary tables , table 3)

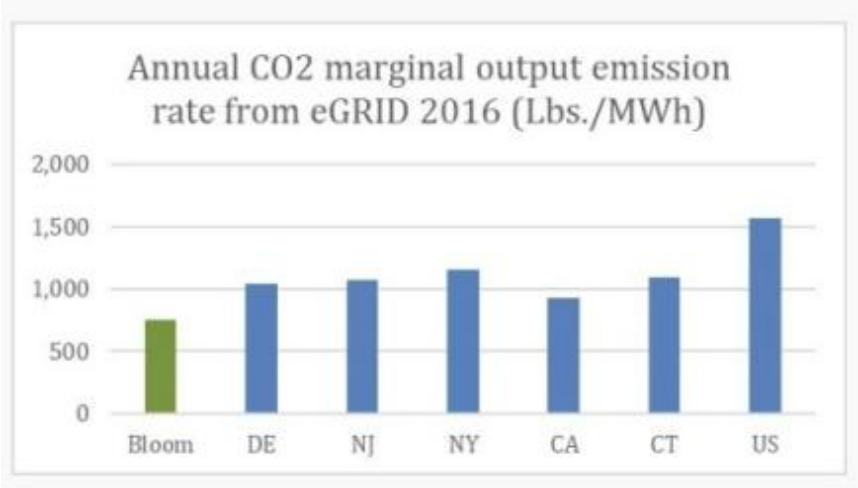
We specifically noted that Bloom attempts to sidestep this reality by wrongly comparing its emissions to the "marginal grid". As we detailed, the marginal grid largely consists of the dirtiest "peak" power sources available, and is not comparable to Bloom's servers, which run continuously.

Bloom's "marginal" comparison was the same argument that was roundly (and rightly) rejected by Santa Clara, California, when Bloom sought to fight the city's renewable energy legislation.

In the city counsel meeting, Santa Clara's resident environmental analyst and engineer Suds Jain did not mince words when Bloom attempted to use its "marginal" emissions argument:

> *"**They're cherry picking facts.** Bloom boxes are less efficient than our Donald Von Raesfeld power plant which is 60% efficient…**They compare Bloom boxes to our dirtiest oldest generators.** They're not comparing to Donald Von Raesfeld which is combined-cycle.…They compare their plants to our ageing plants. **The last thing is they're comparing to marginal emissions. Those marginal emissions are peaker plants. Bloom boxes are not peaker plants. They're not as cost effective as peakers.**" (See video at 3:20:35 mark)*

Bloom obviously doesn't like comparing itself to the actual electric grid (*we wonder why)*. And so, the first chart that Bloom placed at the top of its press release is that of its "marginal output emission rate", and cited a paper that sought to justify the comparison:




We find Bloom's marginal grid comparison to be further evidence that its "clean" narrative has already collapsed.

## *Our Report: Here Is Tangible Raw Data Showing Bloom's 5th Generation Fuel Cells Won't Last 5 Years*

## *Bloom's Response: Please Allow Us to Repeat Our Claim That 5th Generation Fuel Cells Last 4.8 to 5.2 Years Without Offering Any Supporting Data*

On the financial side, Bloom's response largely side-stepped our analysis of its undisclosed service replacement liabilities.

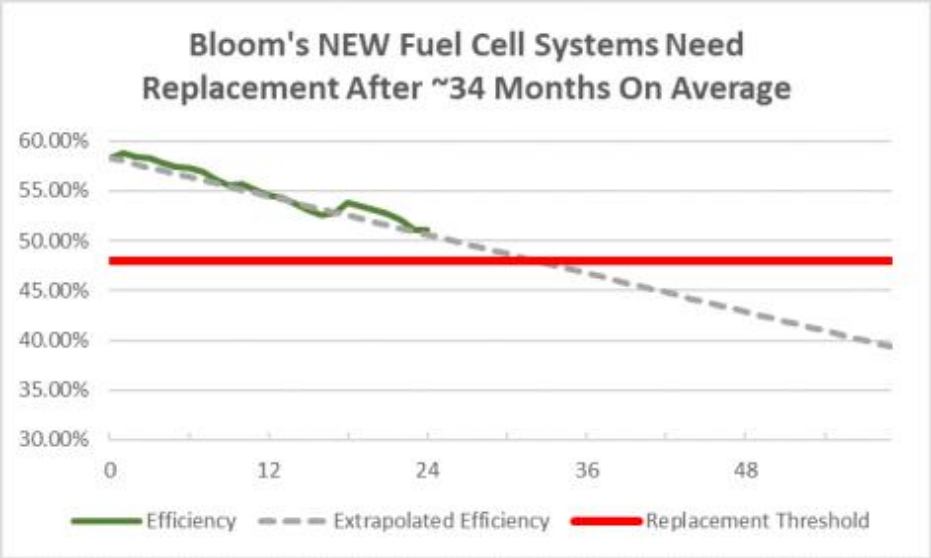
Our report analyzed granular monthly data on dozens of actual Bloom projects and found the company's estimates for the useful life of its fuel cells to be widely overstated.

We disclosed our entire collection methodology and the raw data that we used to draw estimates, *specifically for two reasons:*

1. We wanted readers to have a clear understanding of the data we were using to draw our estimates.
2. We wanted to give the company as much detail as possible so it could refute, with specificity, any claims it would like.

Instead, the company provided a response that simply rehashed its old claim that new fuel cells last 4.8 to 5.2 years without providing data. Again, the data we presented **specifically refutes** this claim **.**

This chart, based on data from California and New York, shows how rapidly Bloom's newer post-2016 installed servers are declining by month, on average. It also shows how the trend continues:




Our findings were also corroborated by multiple experts in the field who were highly skeptical of Bloom's claim that solid oxide fuel cells could last 5 years or longer.

We encourage the company to provide actual granular data to the market to give investors a thorough understanding of the life of its products.

## *Our Report: Bloom Has $432 Million in Recourse Debt and $296.2 Million in Convertible Notes Will Come Due in 2020*

## *Bloom's Response: That Is "Erroneous and Misleading". We Have $432 Million in Recourse Debt and $296.2 Million in Convertible Notes Will Come Due in 2020*

With regard to the company's precarious debt situation, Bloom calls our assertions "erroneous and misleading" – before then confirming exactly what we said in our report.

For instance, Bloom confirmed in its response that it has approximately $432 million in recourse debt on its balance sheet and that $296.2 million in convertible notes will be due at the end of 2020.

Bloom did not mention in its response that the conversion price for the $296.2 million tranche

of debt is now far out of the money, at $11.25 per share. This likely means that, upon maturity, Bloom will have **to put up the cash**.

The company stated that it could refinance its existing debt, issue new debt or equity to help deal with its liabilities.

As we stated yesterday, we believe a refinancing would likely be on toxic terms. We don't believe the company will be able to tap the debt markets or issue equity without materially and negatively impacting its capital structure. New debt would likely come with aggressive covenants and a large coupon, given the company's financial position. Issuance of new equity (as the company nears 52 week and all-time lows) could be extremely dilutive to existing shareholders.

## *Conclusion: We Remain Short and Believe the Company Should Provide Further Transparency to Investors*

**Disclosure: We are short shares of Bloom Energy**

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# TAB 23

# Bloom Energy: A "Clean" Energy Darling Wilting to its Demise

Published on September 17, 2019



## Summary : Bloom Energy (NYSE:BE)


- We believe that Bloom Energy, once touted as the prospective "holy grail" of clean energy, is instead likely to wind up in the history books alongside failed companies like Theranos or Solyndra.
- Contrary to myths about Bloom, our research indicates that Bloom's technology is not sustainable, clean, green, *or* remotely profitable.
- We uncovered an estimated $2.2 billion in undisclosed servicing liabilities that the market has missed, even in its most recent re-valuation of Bloom shares. These issues have already begun to surface and we expect they will accelerate.
- Bloom's tricky accounting allows it to mask servicing costs and shift write-downs to other periods, thereby avoiding recognizing major recent additional losses.
- We believe that large debt maturities in 2020 and 2021, amounting to nearly $520 million, make Bloom Energy an obvious bankruptcy candidate.
- The company's "clean" narrative is absurd: our research shows that Bloom Energy servers emit significantly more CO2 than the electric grid in key states where it operates. Its emissions are comparable to those of modern natural gas power plants.

- Court documents reveal that Bloom self-identified as a "large quantity generator of hazardous waste," to the EPA. Bloom was even sued in 2016 over alleged deceptive trade practices relating to the dumping of its hazardous waste in California landfills.
- Bloom has collected over $1.1 billion in federal, state, and local subsidies. Many of these subsidies are being withdrawn or stepped down as jurisdictions wise up to the reality of Bloom's products.
- A former Bloom employee and a fuel cell expert told us, respectively, that Bloom "probably wouldn't exist today" without subsidies and that Bloom "hurts the fuel cell industry overall".
- Bloom executives have a history of making allegedly false statements, including ones it was forced to retract in SEC filings. In another case, Bloom paid $16.7 million to settle allegations that it lied to its brokers.

***Initial Disclosure:****After extensive research, we have taken a short position in shares of Bloom. This report represents our opinion, and we encourage every reader to do their own due diligence. Please see our full disclaimer at the bottom of the report.*

# *Part I: Bloom's Fantasy Origins*

The market appears to be slowly waking up to the same unfortunate conclusion about Bloom Energy that we have arrived at after several months of rigorous deep dive research. Instead of being a great clean energy success, we expect Bloom's "too good to be true" story will find its place in history along the likes of defunct companies such as Solyndra and Theranos.

Bloom is a technology company that develops and manufactures stationary fuel cell systems. Bloom's systems, called "Bloom Boxes", are essentially generators that businesses can use to create on-site energy using solid oxide fuel cells, a technology that has been around for almost a hundred years .

The boxes take an input, usually natural gas, and convert it into usable electricity.

Bloom Energy servers or "Bloom Boxes" (Picture credit: Apple Insider )

Fuel cells, in general, have been understood by the scientific community since the early 1800's and have been a largely unprofitable industry to date. Much of Bloom's popularity (and funding) was based on the idea that it could "break through" as the first profitable and sustainable fuel cell company, they had a solid business idea that would be able to provide Business Utilities at a fraction of the price the business was originally paying for their utilities.

The company was founded in 2001 by KR Sridhar, a well-credentialed scientist who developed fuel cell technology at NASA before launching Bloom, quickly gaining the support of brand-name venture capitalists, such as Kleiner Perkins.

By early 2008, a Department of Energy report [1] ranking solid oxide fuel cell projects by effectiveness placed Bloom's dead last by a wide margin:


(Source: Department of Energy )

(Source: Department of Energy)

Nonetheless, later that year, the company booked a high-profile Kleiner Perkins alumni as its first customer: Google. The search behemoth installed a 400 kW Bloom system at its main campus that year (and doesn't appear to have expanded its relationship with Bloom since).

Bloom's big unveiling to the public took place in 2010 on national television. Upon its release, Bloom was heralded as a scientific breakthrough by a litany of the nation's top *non*-scientists. Senator Dianne Feinstein declared of Bloom:

> *"This technology is fundamentally going to change the world."*

Other notable non-scientists, such as Arnold Schwarzenegger, former Secretary of State George Schultz (of Theranos infamy), and former Secretary of State Colin Powell, who is a current Bloom board member, voiced their full-throated support for the company.

That same year, 60 Minutes ran a puff piece on Bloom, introducing the program by saying "in a world of energy, **the holy grail** is a power source that's inexpensive and clean, with no emissions."

With the wind at its back, Bloom rolled out its product to a "Who's Who" of Fortune 100 companies, including AT&T and Home Depot, regularly *guaranteeing* them long-term attractive energy prices with agreements that lasted up to 25 years. These agreements placed the risk of the company's fuel cell performance squarely on Bloom and its shareholders. Many customers, seeing the attractive guarantees, took the deals and held up their Bloom Boxes as evidence of a commitment to green, clean, and sustainable energy.

It was a storied beginning to a company that was slated to revolutionize global energy and change the world as we know it.

But nearly a decade later, the company has been unable to fulfill its ambitions of being profitable and the realities of our research have led us to one conclusion: *We expect Bloom Energy will become yet another tombstone in the Silicon Valley cemetery of dead unicorns. Once again making energy consumers look for the best electricity rates in Texas and other states in which Bloom wanted to supply their sustainable energy.*

# *Bloom's Operational Reality: An Emissions-Spewing, Hazardous Waste-Creating, Uneconomical Product That is Failing in The Real World*

Let's start off our series of inconvenient truths by making one thing clear: **Bloom has never been a green" energy company.**

While being *capable* of running on biogas (a form of genuine green energy), 91% of the company's fuel cell products run on natural gas (a non-renewable fossil fuel). [Pg. 5]

**Bloom is also not a clean" energy company.** Instead of *reducing* emissions, data we collected from hundreds of Bloom projects shows that they generate more CO2 than the electric grid in key states they operate in and produce CO2 levels comparable to modern natural gas power plants.

Bloom's generators also result in the creation of carcinogenic hazardous waste, which the company has allegedly improperly dumped into public landfills. Lawsuit exhibits reveal that Bloom labeled itself with the EPA as a "large quantity generator" of hazardous waste. The exhibits include pictures of Bloom employees wearing respirators as they handle 55-gallon drums of what appears to be hazardous waste from emptied/cleaned collection canisters.

(Source: Unicat v. Bloom lawsuit exhibits )

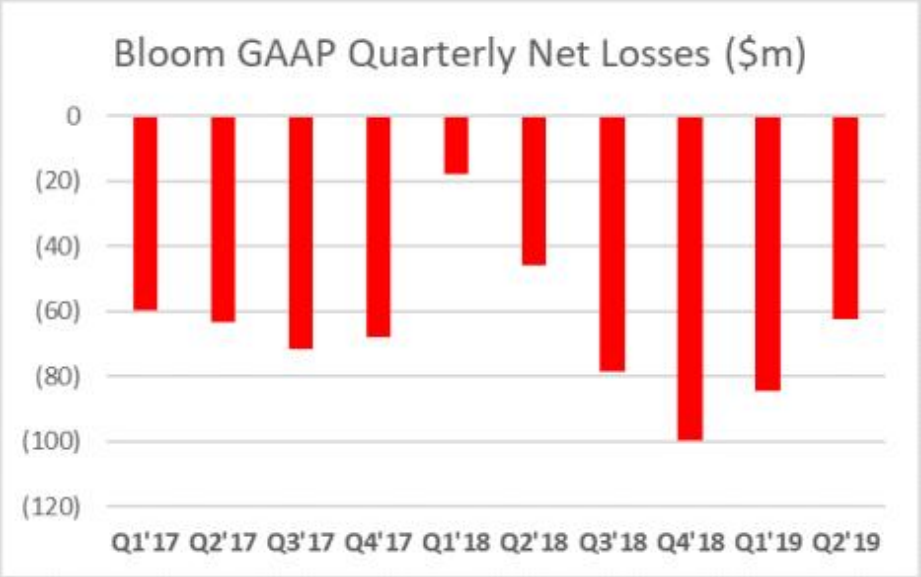
To make matters worse, the company has procured over $1.1 billion in federal, state, and local subsidies, often *under the auspices* of being green, clean, or renewable. As we will show, Bloom is

*none of these* and lately, multiple states have wised up and begun to withdraw or step-down subsidies as a result – a move that we expect will further cripple Bloom's business model.

## *Bloom's Economic Reality: Never Been Profitable, No Expected 2020 Revenue Growth, An Estimated $2 Billion Undisclosed Servicing Liability and Losing Subsidies*

Astonishingly, Bloom has never been profitable despite its significant historical revenue growth and despite receiving over $1.1 billion in subsidies.

This chart shows Bloom's quarterly net results, inclusive of its historic tailwinds:




(Source: Company financials)

With the company's "bag of tricks" now empty and newly offered tepid guidance, we expect these red bars to drop materially lower going forward.

**Recent Conference Call: No Revenue Growth or 2020.** The company recently acknowledged that it expects no revenue growth next year. Bloom hoped to achieve manufacturing economies of scale to lower costs and enhance its profitability, but in the absence of growth, high overhead will further imperil profitability.

**Subsidies Disappearing.** Subsidies are disappearing entirely or being stepped down over time. We estimate that the stepping down of the Federal Investment Tax Credit (ITC), for example, will represent $247 million in foregone subsidies over the next 3 years.

# *Bloom's Unsustainable Debt Burden: Large 2020 and 2021 Maturities Make this an Obvious Bankruptcy Candidate*

Bloom's debt situation has reached unsustainable levels. Per its most recently quarterly report, Bloom has just $308 million in cash on hand, down from $325.1 million in December 2018. By the end of 2020, **379.2 million in debt is coming due**, with significant 2021 maturities thereafter:

| | |
|---|---|
| Remainder of 2019 | $ 12,365 |
| 2020 | 379,242 |
| 2021 | 140,334 |
| 2022 | 26,046 |
| 2023 | 29,450 |
| Thereafter | 113,841 |
| | $ 701,278 |

(Source: Q2 2019 Financials Pg. 25 )

Per the same quarterly report , the company now has $701.3 million in total debt, with $431.7 million of that total listed as recourse debt.

| | Unpaid Principal Balance | Net Carrying Value | | | Unused Borrowing Capacity |
|---|---|---|---|---|---|
| | | Current | Long-Term | Total | |
| LIBOR + 4% term loan due November 2020 | $ 2,429 | $ 1,681 | $ 695 | $ 2,376 | $ — |
| 5% convertible promissory note due December 2020 | 33,104 | — | 35,576 | 35,576 | — |
| 6% convertible promissory notes due December 2020 | 296,233 | — | 271,503 | 271,503 | — |
| 10% notes due July 2024 | 100,000 | 14,000 | 82,384 | 96,384 | — |
| Total recourse debt | 431,766 | 15,681 | 390,158 | 405,839 | — |
| 7.5% term loan due September 2028 | 39,317 | 2,889 | 32,643 | 35,532 | — |
| LIBOR + 5.25% term loan due October 2020 | 24,262 | 957 | 22,704 | 23,661 | — |
| 6.07% senior secured notes due March 2030 | 82,269 | 2,803 | 78,420 | 81,223 | — |
| LIBOR + 2.5% term loan due December 2021 | 123,664 | 3,894 | 118,058 | 121,952 | — |
| Letters of Credit due December 2021 | — | — | — | — | 1,220 |
| Total non-recourse debt | 269,512 | 10,543 | 251,825 | 262,368 | 1,220 |
| Total debt | $ 701,278 | $ 26,224 | $ 641,983 | $ 668,207 | $ 1,220 |

The largest chunk of the company's debt is $296.2 million from its 6% convertible promissory notes due December 2020. These notes present a problem for the company, as the conversion price is now far out of the money, at $11.25 per share. This likely means that, upon maturity, Bloom will have **to put up the cash**, unless it can enter into a refinancing (which would likely be on toxic terms).

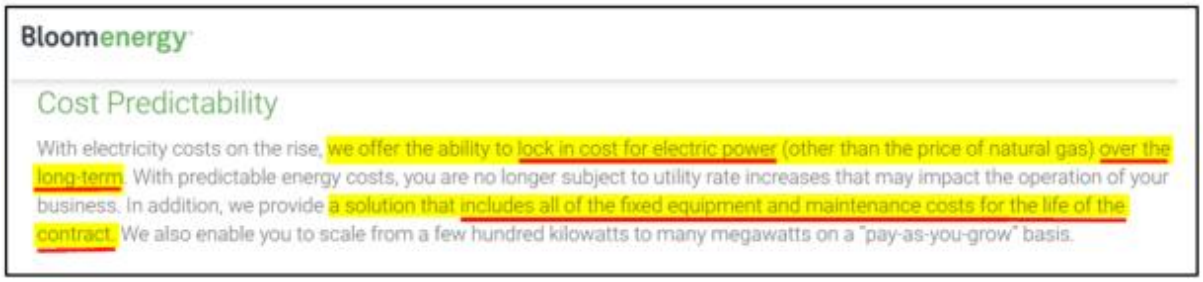
*Beyond* the debt, we have also uncovered another massive liability, seemingly unknown to the investing public, that we believe will seal Bloom's demise.

## *Bloom Energy Has an Estimated $2.2 Billion In Undisclosed Servicing Liabilities That We Expect Will Sink the Business*

## *The Crux of the Problem: Bloom Places Itself on the Hook for the Long-Term Performance of Its Systems (And Field Data Shows They Don't Last Long)*

Backing up for a moment, one might ask—how does a new, relatively unproven company like Bloom manage to sell so many fuel cell systems to so many Fortune 100 companies, when fuel cell economics have repeatedly failed in the real world?

The answer is that Bloom's contracts guarantee baseline performance levels—essentially locking in the price of electricity for its customers. Per Bloom's marketing literature:


Bloomenergy

Cost Predictability

With electricity costs on the rise, we offer the ability to lock in cost for electric power (other than the price of natural gas) over the long-term. With predictable energy costs, you are no longer subject to utility rate increases that may impact the operation of your business. In addition, we provide a solution that includes all of the fixed equipment and maintenance costs for the life of the contract. We also enable you to scale from a few hundred kilowatts to many megawatts on a "pay-as-you-grow" basis.

> *"We offer the ability to **lock in cost for electric power** (other than the price of natural gas) over the long-term…we provide a solution that **includes all of the fixed-equipment and maintenance costs for the life of the contract**"*

These contracts **place nearly 100% of the risk on Bloom** and are very long-term—typically lasting from 10 to 21 years [ Pg. 101] and lasting as long as 25 years. [ Pg. 14]

This is an incredibly attractive deal for customers, who can (and do) tout their forward-thinking ways while also locking in cheap electricity.

Conversely, what this means for Bloom is that when the electrical output of its systems decline —**they are on the hook to replace them.** Bloom has noted this as a key risk in its filings:

> *"If our estimates of useful life for our Energy Servers are inaccurate or we do not meet service and performance warranties and guarantees, or if we fail to accrue adequate warranty and guaranty reserves, our business and financial results could be harmed." (10-Q Pg. 70)*

Bloom is responsible for two types of replacements: its fuel cell servers (the system itself) and the individual fuel cells that go inside the servers.

As experts have confirmed to us, the high operating temperatures of solid oxide fuel cells (800C or 1400F, and higher) make them extremely susceptible to wear and tear.

A fuel cell technician with 19 years of experience in the field made this clear to us and brought up what would be a recurring theme with multiple experts we spoke to, durability:

> *"Bloom Energy is also a high temperature type application. They are using solid oxide fuel cells, which is a very temperamental fuel cell in the first place.* ***High temperatures create a lot of issues*** *whenever you're dealing with the expansion of different components in it. I mean, you're going up to 7-8-900 C* ***Whenever you're hitting those kinds of temperatures and then you're cooling back down, everything is expanding and contracting at different rates and those type of fuel cells suffer significantly from breakage through those varying thermal cycles."***

Our research has found that Bloom's fuel cells and systems degrade significantly faster than expectations, yet the company barely records any liability for these issues.

## *No One Seems to Have Noticed the Accounting Trick That Allows Bloom to Mask Its Liabilities: The Company Only Discloses 1 Year of Servicing Liabilities Despite Servicing Contracts that Last Up to 25 Years*

So, how does Bloom justify largely ignoring its multi-year servicing liabilities?

We found a simple little line, buried on page 91 of Bloom's 10-K, that explains it. (Note that this line was **N T** in the company's IPO prospectus ):

> *"Customers may renew the MSAs (master service agreements) leading to future expense that is not recognized under GAAP until the renewal occurs." [Pg. 91]*

At first glance, this line looks rather benign. But what it means is that the company only books the ***next year*** of servicing liabilities, rather than accounting for the liabilities across the full 10-25 years of the contract.

Why? Because *technically* the customers have the ***option*** to renew their service contract every year that they could – *technically* – choose not to exercise. Per the same filing:

> *"The warranty and guaranty **may be** renewed **annually** at the customer's **option** – as an operations and maintenance services agreement – at predetermined prices for a period of up to 25 years." [Pg. 39]*

The obvious question is: *why wouldn't they renew?* What customer wouldn't push a 'free money' button that essentially guarantees them cheap, long-term electricity by renewing their service contract?

Even Bloom acknowledges that customers don't cancel these agreements:

> ***virtually no customers have elected to cancel their maintenance agreements"*** *[Prospectus Pg. 123]*

We found zero examples of customers not renewing these service agreements. Nonetheless, **Bloom records its servicing liabilities as if every customer will cancel every year.** It's no surprise why this seems to have gone largely unnoticed given where it was buried in the financials:

under its performance guaranty, the Company will reimburse the customer for this underperformance. The Company's obligation includes ensuring the customer's equipment operates at least at the efficiency and power output levels set forth in the customer agreement. The Company's aggregate reimbursement obligation for this performance guaranty for each order is capped at a portion of the purchase price.

The standard one-year warranty covers defects in materials and workmanship under normal use and service conditions and against manufacturing or performance defects. The Company's warranty accrual represents its best estimate of the amount necessary to settle future and existing claims during the warranty period as of the balance sheet date. The Company accrues for warranty costs based on estimated costs that may be incurred including material costs, labor costs and higher customer electricity costs should the units not work for extended periods. Estimated costs associated with standard one-year warranty, including the performance guaranty payments, are recorded at the time of sale as a component of costs of goods sold. Prior to fiscal year 2014, certain MSAs with direct customers were accounted for as separately-priced warranty contracts under ASC 605-20-25 Separately Priced Extended Warranty and Product Maintenance Contracts (formerly FTB 90-1), in which the Company recorded an accrual for any expected costs that exceed the contracted revenues for that one-year service renewal arrangement, and is included as a component of the accrued warranty liability. Customers may renew the MSAs leading to future expense that is not recognized under GAAP until the renewal occurs. Over time, as the Company's service offering evolved and the Company began managing the Energy Servers taking into consideration individual customer arrangements as well as the Company's Energy Server fleet management objectives, the Company's service offering evolved to the point that our services changed, becoming a more strategic offering for both the Company and its customers. Additionally, virtually all of the Company's sales arrangements included bundled sales of maintenance service agreements along with the Energy Servers. The result is that the Company allocates a certain portion of the contractual revenue related to the Energy Servers to the MSAs based on the Company's BESP compared to the stated amount in the service contracts.

We have contacted the company and asked about its servicing liability accounting, as well as the actual life of its new generation fuel cells and servers. We have not heard back as of this writing. Should we hear back, we will update this piece accordingly.

## *Bloom: "We Expect to Average Over Five Years Between (Fuel Cell) Replacements"*

## *Reality: Field Data Suggests Replacements Are Needed Before 3 Years, on Average*

We have sourced extensive public data in order to track how Bloom's systems are actually performing.

As stated earlier, the major costs associated with Bloom's long-term service liabilities relate to degradation or damage to its (1) fuel cells and (2) fuel cell servers.

We'll start by discussing its fuel cells.

Bloom has claimed to have made big improvements to the life of its fuel cells, stating that fuel cells installed in 2017 and onward will have a lifespan of over five years:

> *"Time to stack replacement' primarily driven by our fuel cell stack lives—in the early years, replacement was typically 12 to 18 months. Over the years we have made steady improvements in our fuel cell lives, and* ***from 2017 onwards we expect to average over five years between replacements****[IPO Prospectus Pg. 61]*

We have tracked data on Bloom projects installed since 2017 through state utility records in New York and California. There were 35 projects in all. After aggregating this data, we found that even Bloom's newest fuel cells will degrade below replacement thresholds in under 3 years, significantly below the company's "expectations". We present this data later in the report.

Our findings were corroborated by multiple experts in the field who were highly skeptical of Bloom's claim that solid oxide fuel cells could last 5 years or longer in the field.

We asked one professional fuel cell technician, with 19 years of experience, whether he believed the company's claims to be able to run solid oxide fuel cells for 5 years. He responded with a curt "no". When asked if the same fuel cells could operate for three years, he replied:

> ***Do I believe claims of 3 years before service is needed No. I would be highly skeptical."***

Another expert we contacted, with 14 years of experience working in Fuel Cells and Fuel Cell Performance Analysis, who also has a B.S., M.S., and a PhD in Chemical Engineering, also warned about temperature and durability preventing Bloom's cells from running for 5 years:

> *"They are using the high temperature materials, I think. So, there is advantages and disadvantages.* ***The disadvantage is that degradation is probably high. I doubt they have years life. They may have 1 or 2 max. They cannot achieve years r maybe if they have to replace part of the stack****they can achieve 5 years. In general, it's really hard for SOFCs to run 5 years."*

## *Bloom's Unrecorded Servicing Liabilities: Project Data Shows That Fuel Cells in The Field Will Need Replacement Far Quicker Than the Company Lets On*

Keep in mind that Bloom guarantees both the output (total electricity produced) *and* the efficiency (how much fuel is used to generate the electricity) of its servers:

> *"…we typically provide an Output Guaranty of 95% measured annually and an*

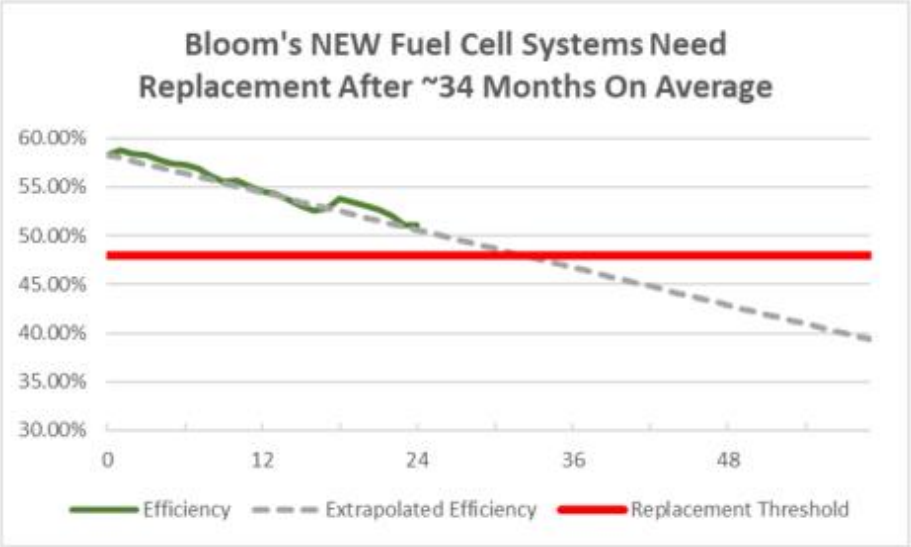
> *Efficiency Guaranty of 52% measured cumulatively" [Prospectus pg. 75]*

Bloom also provides tighter 80% quarterly output guarantees or 45% monthly efficiency guarantees on some of its projects. [ Prospectus pg. 88 and 89 ]

Efficiency and output decline together: As the systems become less efficient, they produce less electricity, making efficiency degradation key to when fuel cells need to be replaced.

As we have seen from older Bloom project data in California and New York, fuel cell replacements were typically done in the 48%-50% efficiency range.

This chart, based on data from California and New York, shows how rapidly Bloom's newer post-2016 installed servers are declining by month, on average. It also shows how the trend continues:




(Source: New York & California Utility Data & Author Analysis)

After only 25 months, Bloom's newer fuel cell installations had deteriorated from a median starting efficiency of 58.3% down to 51.0%, a decline that puts them on pace to breach the 48% threshold with 34 months (less than three years). [1]

The chart also shows that 45% efficiency (which serves as a 'bare minimum' on some projects) will be breached after only 42 months, or 3.5 years. [2]

This multi-year difference between expectation and reality will translate to an estimated $1.87

billion in fuel cell replacement costs:

| | |
|---|---|
| Cost to replace fuel cell (per KW) | $892 |
| Fuel cell life (months) | **34** |
| Length of time left on avg. contract (years) | 13 |
| Avg. # of times fuel cell will be replaced | 4.6 |
| + Current replacement cycle | 5.1 |
| Cumulative install base (KW) | 412,000 |
| Fuel cell replacement liability | **$ 1,874,659,122** |

(For a full breakdown of our calculations and data sourcing, see Appendix A)

## *Bloom's Unrecorded Servicing Liabilities: Bloom Estimates Its Fuel Cell Servers Last 15-21 Years*

## *News Flash: They Don't. The Company Has Historically Replaced Servers After Just 4-7 Years*

Moving on to the liabilities associated with replacing Bloom's servers (as opposed to *just* the fuel cells), our first check was to see how long the company estimates they will last. Keep in mind that these systems run continuously at temperatures around 800C (or 1400F) in real-world conditions.

Bloom shows, in its depreciation schedule, that it expects its servers to last for 15-21 years [ Pg. 95]:

**Depreciable Lives**

| | |
|---|---|
| Energy Servers | 15-21 years |
| Computers, software and hardware | 3-5 years |
| Machinery and equipment | 5-10 years |

We think this depreciation schedule is horribly askew from reality.

For instance, Bloom sold servers in 2010-2012 that lasted only 4-6 years. They had been replaced entirely by 2016. [ Pg. F-39]

Bloom also installed servers in Delaware in 2012 that are now being replaced after just 7 years, as announced this past quarter. [Pg. 11]

The company itself acknowledged that it had failed to achieve its own estimates previously:

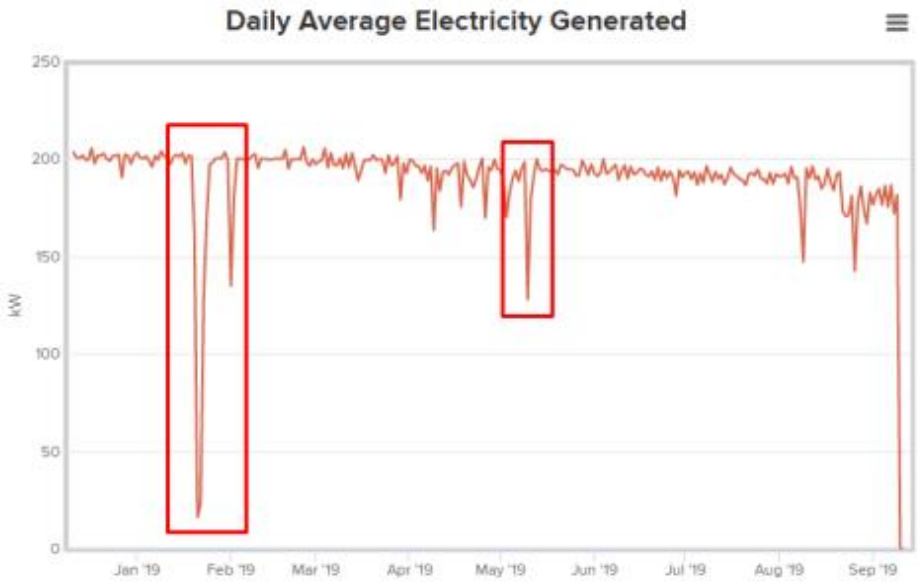
> *"**Early generations of our Energy Server did not have the useful life and did not perform at an output and efficiency level that we expected.**" [Pg. 70]*

We are now being asked to trust the new estimates, which look to represent approximately a 3x improvement on prior server lifespans. **Yet the company thoroughly disclaims its own estimates**, declaring them to be a key risk factor:

> *"Our pricing of [customer] contracts and our reserves for warranty and replacement are based upon our estimates of the life of our Energy Servers and their components, including assumptions regarding improvements in useful life that may fail to materialize. **We do not have a long history with a large number of field deployments, and our estimates may prove to be incorrect.**" [Pg. 70]*

Finally, our field research corroborates that Bloom's servers have experienced trouble in the real world.

We contacted several businesses to learn about the reliability of Bloom's new systems. A Home Depot in Greenbush, NY, told us that they had a system "blow" within a year of having it installed. New York utility records show that the system was new, operating since December 2018. They also appear to show sharp drop-offs in electricity generated, consistent with what we were told.




(Source: NYSERDA utility records )

We were told that another Home Depot, in Clifton Park, NY, [operating since September 2018 ] had its server come right off the building shortly after its installation, according to the same conversation. (We share more details on this conversation, as well as conversations with other customers and experts, in Part IV of this report.)

In short, Bloom's expected server life is untested at best, and its history has demonstrated a 4-7 year lifespan.

Even if we assume just 1 server replacement on an average outstanding contract life of 13 years, we estimate this to result in a nearly $1.5 billion unrecorded servicing liability:

| | | |
|---|---|---|
| Cost to replace servers (per KW) | $ | 3,729 |
| Server replacement liability | $ | 1,536,231,816 |

(Note: For a full breakdown of our calculations and data sourcing see Appendix A)

## *Bloom's Undisclosed $2.2 Billion Liability by The Numbers*

Bloom has been cagey about disclosing the actual life of its fuel cells/servers and other metrics that would make its servicing liability clear to the market. In SEC comment letters , the company redacts such information.

> ***40. We note your disclosure of beginning of life efficiencies. Please tell us how quickly those efficiencies change over the life of the product and the extent of those changes. In this regard, please also tell us whether the greater than 99.99% reliability and availability disclosed on page 109 is supported by statistically significant long-term data over the life of your products.***
>
> The Company supplementally advises the Staff that the efficiency of the Energy Server decreases very gradually from the beginning of life efficiency toward the end of life efficiency. This decrease is very nearly linear in nature (i.e., a straight line slope). This equates to rough efficiency changes over time of a [**] in efficiency over [**], or a [**] in efficiency per year. Beginning of life efficiency is [**]% and end of life efficiency[**] is [**]%.

We have reached out to the company and asked what their estimate of servicing liabilities would be when factoring in the full length of their contracts and have not heard back as of this writing.

Below is our full breakdown of Bloom's estimated undisclosed servicing liabilities, net of expected servicing revenue during that same time frame. For the full breakdown of our data collection and methodology, see Appendix A at the end of this report:

| | | |
|---|---|---|
| Cost to replace fuel cell (per KW) | | $892 |
| Fuel cell life (months) | | **34** |
| Length of time left on avg. contract (years) | | 13 |
| Avg. # of times fuel cell will be replaced | | 4.6 |
| + Current replacement cycle | | 5.1 |
| Cumulative install base (KW) | | 412,000 |
| Fuel cell replacement liability | **$** | **1,874,659,122** |
| Cost to replace servers (per KW) | $ | 3,729 |
| Server replacement liability | **$** | **1,536,231,816** |
| **Total Expected Servicing Liabilities** | **$** | **3,410,890,938** |
| Service revenue | | 1,230,268,000 |
| **Net servicing liability** | **$** | **2,180,622,938** |

Our overall view is that Bloom's economics are reliant on unrealistic assumptions about the useful life of its products. These are massive unnoticed liabilities that we expect will lead to materially adverse consequences for the company in the immediate future.

In fact, we have already begun to see this issue rear its head. However, rather than recognizing the reality of these costs, a troubling pattern has emerged where Bloom's costs have been masked by tricky accounting.

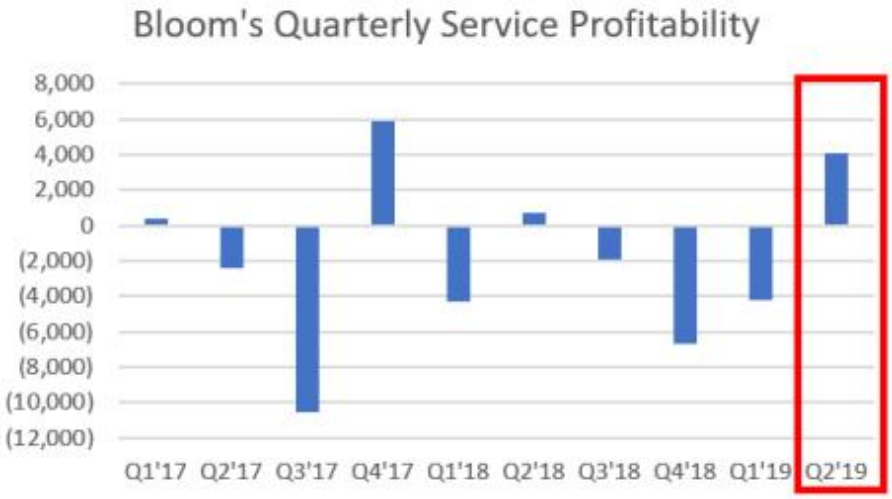
## *Servicing Liabilities Are Already Beginning to Show: Bloom's Accounting Methods Masked Service Losses and Juked Revenue Numbers in the Recent Quarter*

During the most recent quarter, Bloom disclosed it was commencing a project to "decommission" 18MW worth of servers in Delaware. The servers are only about 7 years old, yet the company is aiming to replace all of them.

As we know from Bloom's service arrangements, the company is on the hook for the cost to replace servers. The company's agreement on the project in question makes this crystal clear:

> *"Operator's (i.e.: Bloom's) responsibilities hereunder shall include, without limitation, promptly correcting any Bloom System or BOF malfunctions, either by (i) recalibrating or resetting the malfunctioning Bloom System or BOF, or (ii)* ***repairing or replacing Bloom System or B components which are defective, damaged, worn or otherwise in need of replacement*** *[Pg. 12]*

One would think these unexpected server replacements would have represented a substantial hit to Bloom's servicing profitability in the quarter. Instead, we see that the company reported one of its healthiest servicing margins to date. How could this be?




(Data in thousands. Source: Company financials)

In poring over the disclosures about the server replacements, we find that rather than replacing the servers and taking the hit to servicing margins as we would expect, Bloom instead engaged in a complex transaction that seems to avoid recognizing *any* servicing losses at all.

**Instead, the company claims to be selling" new servers to the same project and B KING IT AS NEW REVENUE** [Pg. 35]

All told, we estimate the "decommissioning" transaction, net of supposed 'new' revenue, will represent over $135 million in losses and cash out the door for Bloom in coming quarters.

The transaction is **clearly cash flow negative and will represent a near-term loss to Bloom**, yet its complexities mask the significance and the timing of the cash outlays. These complexities include:

- $57.5 million to buy out equity in the project from one of Bloom's financing partners [Pg. 33]
  - Post upgrade, Bloom's remaining financing partner will receive 100% of the revenues from the new servers and Bloom will receive none! This makes Bloom's newly purchased 'equity' a seemingly worthless piece of paper. [Pg. 33]

- $40 million in cash collateral, posted by Bloom, to indemnify against up to $97.2 million in legal, regulatory, and tax liabilities.
  - Presumably, the partner views the risks of these liabilities as material, given the high cash collateral, but Bloom has **reserved nothing** for them. [Pg. 34]

- $57.2 million in other liabilities, assumed by Bloom, that are vaguely contingent on Bloom's stock price. [Pg. 34] [Pg. 23-F]
- $72.3 million, paid by Bloom, as a partial payment to "repurchase" its old servers. [Pg. 33]

Despite these significant cash outlays and assumption of liabilities, the decommissioning transaction created the appearance of positive top line growth. In the recent quarter, Bloom booked $91.7 million from the supposed 'sales' to replace its old servers, **representing almost 0% of the revenue in the quarter** Pg. 35

This type of absurd transaction strikes us as textbook financial engineering. We find it incredibly suspicious that, despite the transaction affecting numerous income statement items, it looks to have avoided impacting 'servicing' items entirely.

## *Bloom's Accounting Methods Mask Service Losses and Juke Revenue Numbers: Part Two*

This is not the first time Bloom has employed this type of accounting alchemy.

In Bloom's IPO prospectus, it disclosed replacing 172 early generation servers in 2016 [Pg. 66]. Once again, Bloom recorded the server replacements as **NEW** sales and classified cash outlays as investments instead of taking a servicing loss.

Bloom achieved this by determining that the server replacements involved such significant renegotiation of its old leases that it actually constituted a termination of the lease. We believe this, in turn, conveniently allowed them to **book substantial write-downs in the pre-I period** (where investors couldn't see the write-down) while booking new revenue that improved the financials disclosed publicly in the IPO.

Invisible 2015 write-down

Visible 2016 "new" sales

| | Years Ended December 31, | |
|---|---|---|
| | 2016 | 2017 |
| | (in thousands, except f | |
| **Consolidated Statements of Operations** | | |
| Revenue | | |
| Product | $ 76,478 | $ 179,768 |
| Installation | 16,584 | 63,226 |
| Service | 67,622 | 76,904 |
| Electricity | 47,856 | 56,098 |
| Total revenue | 208,540 | 375,996 |

(Source: IPO Prospectus Pg. 100 )

> *"Since the underlying assets under the arrangement were replaced (i.e., new generation Energy Servers were installed in place of the decommissioned older generation Energy Servers), the decommissioning of Energy Servers under the program did not constitute a lease modification, and was accounted for as a lease termination. Through December 31, 2017,* ***the Company has replaced 196 Energy Servers with new generation Energy Servers sold as part of a new sales arrangement****" [Prospectus F-39]*

> *"During 2015, the Company recorded a reduction in product revenue totaling $41.8 million for the decommissioning of its PPA I Energy Servers." Prospectus F-39]*

> *"In* ***2016*** *and 2017,* ***172*** *and 0 respectively, of our acceptances achieved were for Energy Servers that were sold to existing customers under our PPA I decommissioning program." [Prospectus 66]*

We find it incredibly alarming that Bloom seems to be engaging in transactions that avoid recognizing servicing losses in a forthright manner that is transparent to investors—or in some cases *, recognizing them at all*

# *The Edge of the Cliff: Why We Think These Servicing Issues are An Imminent Problem*

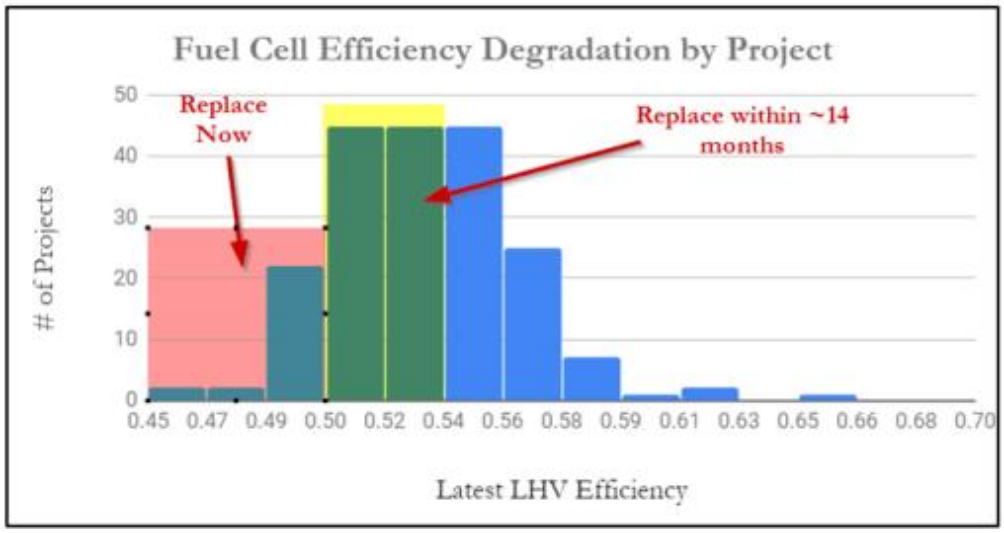
We believe that this absurd juggling act is coming to an end and will culminate in an erosion of the company's remaining cash over the next 6-12 months.

For starters, the company isn't done replacing outdated servers and has acknowledged that it needs to secure $92 million in financing to finish the latest batch of replacements [ Pg. 32]

We have also begun to see a slew of 'one time' charges and write-downs that we fully expect will continue in relation to upcoming server replacements. From the recent quarter alone [ Pg. 35]:

1. "We had repurchased and **written-off** 10.0 megawatts of our earlier generation energy servers for **2 .6 million**"
2. "We recognized **charges** related to the decommissioning of PPA II Energy Servers of **8.1 million**"
3. "Additionally, in paying-off the outstanding debt and interest of PPA II amounting to $77.7 million, **we incurred a debt payoff make-whole penalty of .9 million"**
4. "We had PPA II debt issuance **costs written-off of 1.0 million** and additional interest expense incurred for PPA 2 debt payoff of $0.1 million"

Finally, we took the current efficiency of Bloom's California and New York projects, roughly 200 in all, and found that almost 15% of its projects likely need *imminent* fuel cell replacements, with almost 40% needing replacements within an estimated 14 months.




(Source: New York & California Utility Records & Author Analysis)

Extrapolating this data out, we estimate a $55 million imminent replacement liability with another estimated $147 million replacement liability over the next 14 months. Once again, this is just relating to fuel cell liabilities and does not include additional server replacement liabilities.

## *The Edge of the Cliff: Bloom's Servicing Liabilities Had Historically Been Masked by Strong Revenue Growth. That Growth Is Now Gone*

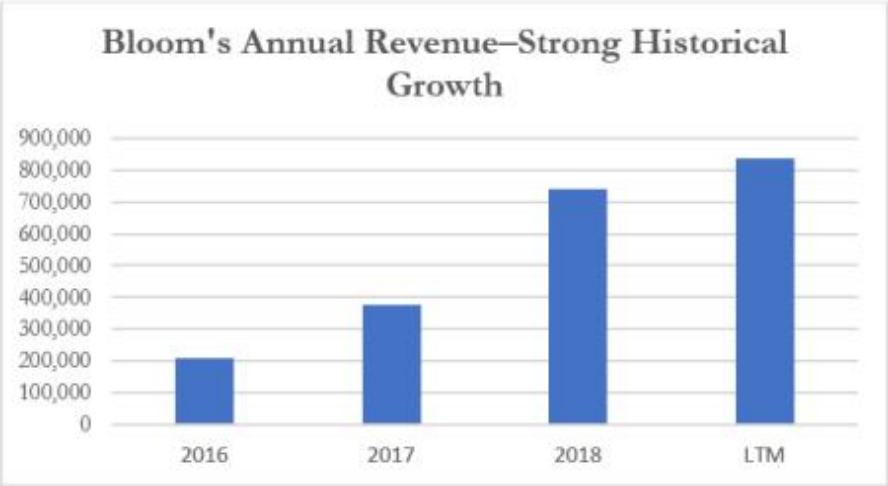
The reason Bloom's issues are now bubbling to the surface is a lack of new revenue.

The company's revenue model is heavily 'front-loaded'. When the company sells a new fuel cell system, it collects 3 forms of revenue immediately:

1. Product revenue (for the physical fuel cell systems)
2. Installation revenue
3. The first year of service revenue in advance. [ Pg. 61] (Bloom also usually gets another 1-2 years of servicing revenue before needing to replace systems, giving it up to 3 years of front-loaded servicing revenue.)

After this jolt of initial revenue, Bloom collects a small ongoing annual servicing fee, but is required to carry the burden of all servicing liabilities.

The company has reported strong historical revenue growth, which has allowed its servicing liabilities to appear small relative to the influx of new money.




(Source: Company financials)

As mentioned earlier, Bloom acknowledged that it expects no revenue growth in 2020. The tide has gone out. Without new revenue, we expect the replacement liabilities to quickly represent larger and larger proportions of Bloom's cost structure.

All told, we see a significant deterioration in Bloom's cash balance and net income over the next year. With a large chunk of debt coming due by the end of 2020, we simply don't see a silver lining here.

# *Part II: Bloom Energy is a Carbon Polluter and a Hazardous Waste Producer Masquerading as a Clean Energy Company*

Putting aside economic sustainability, one of the biggest misconceptions about Bloom Energy is the idea that the company is providing clean, green and/or renewable energy. As we'll lay out now in detail, this argument is severely misguided at best and deceptive at worst.

Bloom and its customers have consumed over a billion dollars in federal, state, and municipal clean energy subsidies, yet Bloom emits more CO2 than the grid in key states it operates. In fact, our findings show that the amount of CO2 **Bloom Energy servers release into the air is comparable to modern natural gas power plants.**

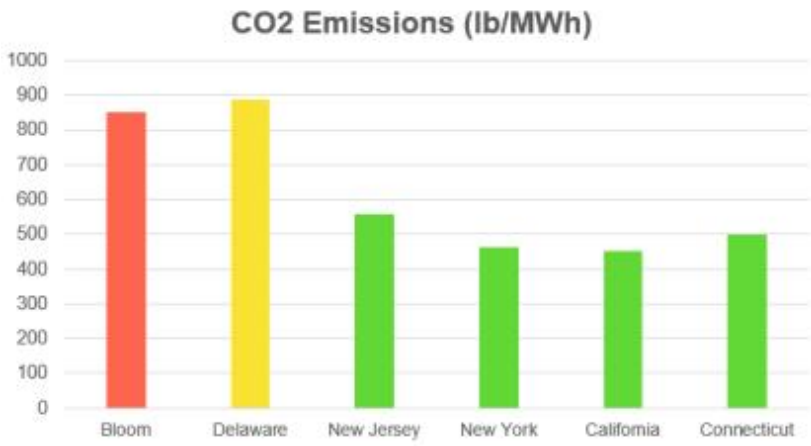
Corporations and governments have begun to wise up to Bloom's claims on the environmental benefits of its products. Santa Clara California has essentially banned new Bloom Energy natural gas installations through recent legislation. New Jersey pulled the rug on subsidies to Bloom and other fuel cell providers. [Pg. 16] California is ending its program that subsidizes fuel cell manufacturers. [1,2,3]

Would Bloom be alive today without receiving over $1 billion in subsidies based on misconceptions around its product? Experts we spoke with, as we will detail later in this piece, believe the answer to this question is "no".

## *Bloom Produces Significantly MORE Emissions Than the Grid in Most States in Which It Operates*

We compiled the average CO2 grid emissions in the states where Bloom primarily operates. The majority of Bloom's domestic deployments are in just 5 states (California, New York, Connecticut, New Jersey & Delaware).

As can be seen in the chart below, Bloom is far dirtier than most of the states it operates in. In Delaware, a state that is powered 98.6% by fossil fuels such as gas, coal, and oil, Bloom is only marginally better:




(Source: 2016 EPA eGRID summary tables , table 3)

## *Bloom Falsely Claims That Its Servers Running on Natural Gas Produce 50% Less Emissions than the U.S. Electric Grid*

Bloom claimed in its prospectus:

> *"When running on natural gas, compared to average emissions across the U.S. grid, Bloom Energy Servers reduce carbon emissions by over 50%."[Prospectus Pg. 4]*

This statement appears to be outright false, and by a wide margin. According to the latest official figures from the U.S. Energy Information Administration (EIA), the U.S. grid emits 1,009 lbs/MWh of CO2.

Bloom's own marketing documents show that its servers produce 679-883 lbs/MWh of CO2, a 12.5% to 32% reduction from the grid average.

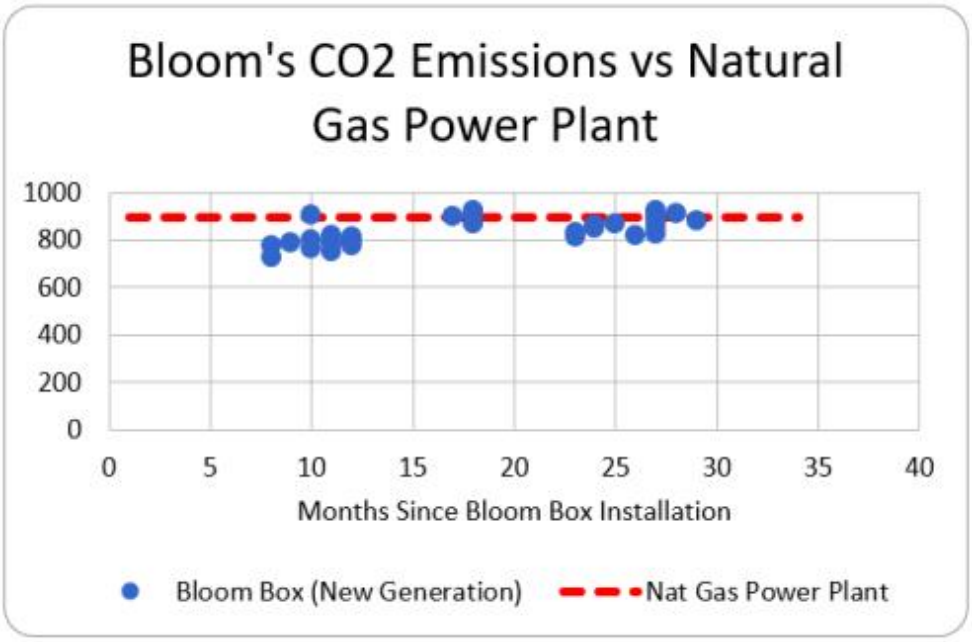
| Emissions[2] | |
|---|---|
| NOx | 0.0017 lbs/MWh |
| SOx | Negligible |
| CO | 0.034 lbs/MWh |
| VOCs | 0.0159 lbs/MWh |
| $CO_2$ @ stated efficiency | 679-833 lbs/MWh on natural gas; carbon neutral on directed biogas |
| Physical Attributes and Environment | |

Our own review of 205 Bloom projects in New York and California showed that they are producing an average of 835 lbs/MWh of CO2, a reduction of about 17.2% from the grid.

## *Bloom's Carbon Emissions: Comparable to Those of a Modern Natural Gas Power Plant*

Not only do we believe Bloom's statements about emissions relative to the grid to be outright false, but comparing Bloom with "the grid" is the wrong comparison in the first place. The grid is dirty and old. Coal accounts for about 75 percent of the grid's greenhouse gas emissions and the average U.S. coal power plant is over 40 years old.

A proper comparison would be between a new natural gas-operated Bloom system and a modern natural gas power plant. Using data from the U.S. Department of Energy, we plotted data from Bloom's new generation systems relative to the average for a modern combined cycle natural gas power plant.




(Source: Department of Energy, New York & California Utility Records, And Author Calculations)

The numbers are comparable. Bloom's newest generation systems emit roughly 839 lbs/CO2 per MWh on average versus a modern natural gas plant that produces 896 lbs/CO2 per mWh. [Pg. 18] The average across all 205 Bloom outstanding projects in New York and California was also comparable at ~835 lbs/CO2 per MWh.

Note that as Bloom's systems age and efficiency goes down, they produce more CO2. (See the appendix for the inverse relationship between efficiency and emissions.) According to the data we reviewed, after only about 24 months, Bloom's systems will produce CO2 levels on par with modern combined cycle natural gas plants (and then perform worse thereafter).

## *Bloom Also Wrongly Compares Its Emissions to the "Marginal Grid" (We'll Explain), Painting Another False Picture of Its Emissions*

Bloom has deflected questions on its emissions by attempting to compare itself to the "marginal grid" rather than the *actual* electric grid. So, what is the difference?

There are 2 types of power that feed the grid: baseload power and peak power.

1. **Baseload power** is the type of power that is meant to meet the normal demands of the grid and is simply not easy to shut on or off. (An example is a nuclear plant which takes significant time to "shut off" once a nuclear chain reaction is commenced.)
2. **eak power marginal grid"** is the type of power that is turned on or off during periods of peak usage (such as during the dead of winter when people are using a lot of heat). Peak power tends to be far dirtier because of the inefficiencies introduced by starting and stopping the generation process. When the term "marginal grid" is used, it typically refers to peak power sources.

Bloom is clearly baseload power—after all, the first thing the company's marketing documents tout is how it is "always on":


This doesn't seem to be by choice. Multiple experts we spoke with noted that Bloom's solid oxide fuel cells run into major issues if they are not "always on". As we've noted, the systems operate at temperatures of 800C (or 1400F), and higher. If shut off, the drop in temperature can crack and break the ceramics and materials in the fuel cells.

Nonetheless, Bloom has repeatedly, and wrongly, compared itself to the very dirty "marginal" peak power sources, which make its technology seem cleaner on a relative basis.

We saw this in a recent interview with Bloom CEO KR Sridhar that aired in early September 2019. When an NBC Bay Area anchor questions Bloom's emissions relative to the grid, Sridhar responds:

> *"…we are lower in carbon footprint than the **marginal** grid, even in a state like California which is very clean…"*

[CLICK HERE TO WATCH VIDEO]


This statement is technically true, but in the most incorrect way possible.

As shown in the earlier chart, Bloom's systems are about 59% **DIRTIER** than the grid in California when you don't slip the word "marginal" into the sentence.

Bloom used the same type of 'marginal' misdirection when it was fighting regulations in Santa Clara California that sought to curb new carbon emissions. Santa Clara rightly rejected the argument. (See an article on the subject here or view the city council meeting video at the 3:20:35 mark.)

## *Santa Clara, California: We Are Moving Toward Fully Renewable Energy*

## *Bloom's Response: This is a De Facto BAN on our Product*

The fight between Bloom and Santa Clara serves as an example of Bloom outright *rejecting* renewables.

On May 7, 2019, the Santa Clara City Council required that new fuel cell projects in Santa Clara use renewable biogas. This was effectively viewed as a "ban" of Bloom Energy, as the company was forced to concede that **the requirement to use biogas meant that Bloom Energy Servers were infeasible** From Bloom's own petition :

> *"…the Resolution effectively bars residents and businesses in Santa Clara from installing Petitioner's fuel cells unless the fuel cells are powered by renewable fuels sourced solely from within the State**. It is infeasible, however, to satisfy this condition because renewable biogas sourced solely from within the State is virtually non existent as a reliable fuel source or prohibitively expensive for a commercial user**"*

Rather than committing to move toward renewables, Bloom instead enlisted high-powered law firms to engage in aggressive lobbying and ultimately litigation in an effort to get Santa Clara to **change course from renewables.**

## *Bloom Servers Accumulate Hazardous Waste, Including Cancer-Causing Benzene*

It turns out CO2 isn't the only byproduct of Bloom's systems.

In July 2018, Bloom disclosed that the EPA was seeking to collect $1m in fines from the company related to its disposal of benzene, which is hazardous waste found in Bloom's desulfurization containers. [ Pg. 36] The company stated in its prospectus that it was contesting the fine, and does not anticipate 'significant' additional costs or risks from compliance with the latest guidance on hazardous waste disposal.

The Department of Health and Human Services (DHHS) has determined that benzene causes

cancer. Long-term exposure to high levels of benzene in the air can cause leukemia, cancer of the blood-forming organs.

Bloom's S-1 from July 2018 seems to play down its exposure to benzene:

> *"… natural gas, which is the primary fuel used in our Energy Servers, contains benzene, which is classified as a hazardous waste if it exceeds 0.5 milligrams (mg) per liter. A small amount of benzene (equivalent to what is present in one gallon of gasoline in an automobile fuel tank which is exempt from federal regulation) found in the public pipeline natural gas is collected by gas cleaning units contained in our Energy Servers and is typically replaced once every 18 to 24 months by us from customers' sites."*

The above clever wording describes the relatively low levels of benzene found in natural gas. What is not clearly conveyed, however, is that Bloom's servers collect these small amounts of benzene over long periods, eventually resulting in large quantities of the hazardous waste.

## *Bloom Has Been Sued for Allegedly Dumping Benzene in California Landfills. Court Documents Show Bloom Labeled Itself a "Large Quantity Generator of Hazardous Waste"*

In 2016, corporate waste management company Unicat Services sued Bloom, alleging breach of contract. Unicat had been hired to clean and dispose of Bloom's waste canisters in public landfills but discovered that the canisters contained "extremely hazardous" and "toxic" material. In the lawsuit, Unicat alleged that Bloom had been dumping benzene into the ground in California instead of disposing of it properly.

For a company that has built its reputation on claims of being environmentally friendly, this lawsuit essentially alleges that Bloom doesn't care about the environment. From the complaint :

> *"Unicat Services was told [by Bloom] that Bloom Energy had the contents of the fuel cell canisters emptied, canisters cleaned, and the extracted contents sent to public landfills for non?hazardous waste in Mexico and California. Unicat Services planned on doing the same operation in Alvin, Texas…"*

> ***Bloom Energy had effectively represented in 2013 that all of the canister contents was nonhazardous and could be dumped at any public landfill. The process Bloom Energy told Unicat Services was being done in California and Mexico."***

> *"As it has been trained by Bloom Energy, Unicat Services planned on emptying the canister contents into the nearby roll?off box and to transport the same to a public landfill as represented had been done in Mexico and California.* ***However, prior to taking the shipment to a public landfill, Unicat as a matter of professionalism and best practices, decided to test the contents just to be sure that it was safe to take to a public landfill. Their tests revealed that the Bloom Energy fuel cell canisters that Bloom Energy had transported to Unicat Services and, according to Bloom Energy, had been previously emptied in Mexico and California and dumped in public landfills contained an extremely hazardous and toxic material – benzene, which can cause blood cancers under long exposures, and which is a material clearly classified as hazardous by federal and state environmental authorities."***

The complaint showed that rather than rewarding Unicat for helping correct a major environmental issue, Bloom tried to use it as leverage *against* Unicat:

> ***Unicat Services would have thought that an advertised "green" company like Bloom Energy would have rewarded Unicat Services for bringing to Bloom Energy's attention the hazardous waste in Bloom Energy's fuel cell canisters so that Bloom Energy would not expose the environment and people to dangerous toxins."***

> ***"Instead of rewarding Unicat Services for flagging the benzene to Bloom Energy, Bloom Energy used this as a renegotiating hammer to lower the per canister price that Unicat Services could charge"***

Appended to the court documents were exhibits that confirm that Bloom is, in fact, collecting large quantities of hazardous waste.

For example, in signed court exhibits for Bloom Energy filed with the EPA, the company calls itself a "Large Quantity Generator" of hazardous or industrial waste.

Case 3:16-cv-00032 Document 24-14 Filed on 05/24/16 in TXSD Page 6 of 15

IHW_____CO
For internal use only

**Notification for Hazardous or Industrial Waste Management**

**Section C. Generator Information**
If your facility does not fit the definition of a "Generator" skip to Section D

| | | |
|---|---|---|
| 1. Generator Type (check all that apply): ☒ Industrial ☐ Non-industrial ☐ Railroad Commission | | |
| 2. Hazardous Waste Generation Status (check one): | ☒ Large Quantity Generator (LQG) | ❖2,200 pounds (1,000 kilograms) or more of hazardous waste **and/or** ❖ 2.2 pounds (1 kilogram) or more of acutely hazardous waste |
| | ☐ Small Quantity Generator (SQG) | ❖between 220 and 2,200 pounds (100 and 1,000 kilograms) of hazardous waste **and** ❖ less than 2.2 pounds (1 kilogram) of acutely hazardous waste |
| | ☐ Industrial Conditionally Exempt Small Quantity Generator (CESQG) | ❖220 pounds (100 kilograms) or less of hazardous waste **and** ❖ less than 2.2 pounds (1 kilogram) of acutely hazardous waste **and** ❖220 pounds (100 kilograms) or more of industrial Class 1 waste |
| | ☐ Universal Waste Only | ❖All hazardous waste generated is classified as Universal Waste and no reportable Class 1 waste is generated at the site |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 9. Customer Legal Name (If an individual, print last name first: ex: Doe, John) | | | If new Customer, enter previous Customer below | | | End Date: | |
| Bloom Energy | | | N/A | | | | |
| 10. Mailing Address: | 1299 Orleans Drive | | | | | | |
| City | Sunnyvale | State | Ca | ZIP | 94089 | ZIP + 4 | |
| 11. Country Mailing Information (If outside USA) | | | 12. E-Mail Address (If applicable) | | | | |
| 13. Telephone Number | | 14. Extension or Code | | 15. Fax Number (If applicable) | | | |
| (408)543 1500 | | — | | ( ) - | | | |
| 16. Federal Tax ID (9 digits) | 17. TX State Franchise Tax ID (11 digits) | | 18. DUNS Number (If applicable) | | 19. TX SOS Filing Number (If applicable) | | |
| 77-0565408 | — | | — | | — | | |

20. Number of Employees
☐ 0-20 ☐ 21-100 ☐ 101-250 ☒ 251-500 ☐ 501 and higher

21. Independently Owned and Operated?
☒ Yes ☐ No

**SECTION III: Regulated Entity Information**

22. General Regulated Entity Information (If 'New Regulated Entity' is selected below this form should be accompanied by a permit application)
☒ New Regulated Entity ☐ Update to Regulated Entity Name ☐ Update to Regulated Entity Information ☐ No Change** (See below)
**If "NO CHANGE" is checked and Section I is complete, skip to Section IV, Preparer Information.

23. Regulated Entity Name (name of the site where the regulated action is taking place)
Bloom Energy

The waste Bloom generates falls under 4 EPA codes (D018, D007, D008, D001) which, according to the EPA hazardous waste codes , represent "Benzene", "Chromium", "Lead", and "Ignitable waste", respectively.

11. **Description of Hazardous Waste**

A. **Waste Codes for Federally Regulated Hazardous Wastes.** Please list the waste codes of the Federal hazardous wastes handled at your site. List them in the order they are presented in the regulations (e.g., D001, D003, F007, U112). Use an additional page if more spaces are needed.

| | | | | | | |
|---|---|---|---|---|---|---|
| D018 | | | | | | |
| D007 | | | | | | |
| D008 | | | | | | |
| D001 | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |

Attached to those same court documents , per an e-mail from a Bloom Energy employee, are photographs of the "emptying/cleaning process of canisters".

**From:** David Sanghera <David.Sanghera@bloomenergy.com>
**Date:** June 6, 2013 at 2:28:04 PM CDT
**To:** "KLM7211@aol.com" <KLM7211@aol.com>, "john.kent@unicatcatalyst.com" <john.kent@unicatcatalyst.com>, Alex Montalvo <Alex.Montalvo@bloomenergy.com>
**Subject: RE: Desulf material transition plan review with Unicat**

Tomorrow, at 10 AM pacific Jim.

Attached a photo's of the emptying/cleaning process of canisters. It might be worthwhile John coming up to look a this on the next week or two.

Thanks.
David

The employees undertaking the "emptying/cleaning process" are handling 55-gallon drums wearing what appear to be respirators.

The lawsuit was settled confidentially .

This hazardous waste generation seems to be starkly at odds with Bloom's public image. For example, in Bloom's marketing video touting its relationship with the city of Hartford, Connecticut, it refers to its technology as "clean, reliable power *without pollutants*."

Here's our simple thought: *before Bloom or Bloom customers receive any more government subsidies, we urge authorities to investigate the allegedly illegal toxic benzene dumping by the company.*

## *Bloom Has Consumed $1.1 Billion in Subsidies, Often Under Questionable Pretenses. Now, Jurisdictions Have Pulled the Subsidy Rug Out from Under the Company*

As noted earlier, Bloom has consumed over $1.1 billion in subsidies on the Federal, state, and local level, often under the incorrect auspices of being green, clean and/or renewable.

The company's subsidies in California and New Jersey were curtailed after the states determined they were not contributing to green energy goals.

(For a detailed state-by-state breakdown of Bloom's subsidies see Appendix B.)

## *Delaware: Bloom Sold Us a Bill of Goods*

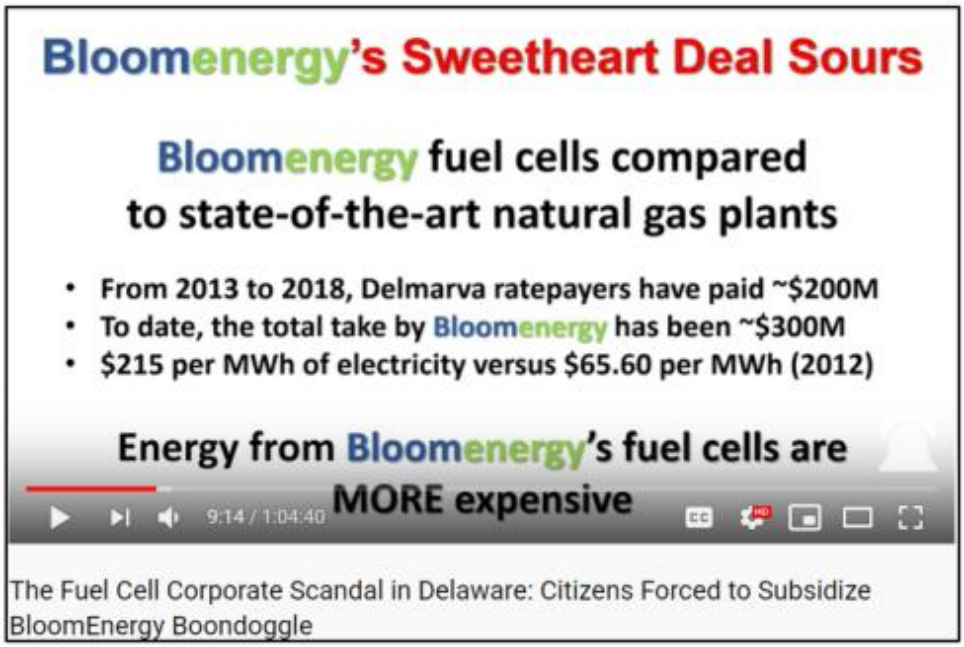
In Delaware, the state and its residents have largely had a case of 'buyer's remorse' after forking over $221 million (and counting) to Bloom in the form of grants and subsidies.

After a lobbying effort by the company, Delaware changed legislation so that Bloom's natural gas systems could be considered "renewable energy". The state has since come under much criticism for the subsidy, with Delaware State Senator David Lawson declaring :

> ***I think we were sold a bill of goods."***

The Heritage Foundation documented the Delaware "Bloom Energy Boondoggle" in thorough detail in this hour long presentation:

[CLICK HERE TO WATCH VIDEO]




## *Bloom Has Complained That Green Energy Regulations Are Threatening Its Business and Subsidies*

Bloom has recently made it even clearer that it should never receive subsidies under the auspices of being "green". On Bloom's most recent conference call, CEO Sridhar said that green energy legislation in states like California and New York is creating "confusion" for its customers.

Bloomberg

**A Clean Energy Producer Complains About Climate Change Laws**

By David R Baker
August 13, 2019, 11:19 AM EDT
*Updated on August 13, 2019, 12:39 PM EDT*

► Bloom Energy says California, New York laws confuse customers

We disagree— the only *confusion* seems to have been the perception that Bloom's natural gas-fueled systems were ever green in the first place.

Contrary to Bloom's complaint, the green legislation itself seems quite clear—states like New York, California, Connecticut, and New Jersey are moving toward renewable energy :


(Source: U.S. Energy Information Administration )

This creates an obvious problem for Bloom, because the vast majority of its generators *simply aren't renewable energy.*

## *Customers Love "Greenwashing" With Bloom.*

## *Home Depot: Bloom Provides Us "On-Site Renewable Energy"…Such As Natural Gas*

We agree with Bloom on one thing: its customers do appear to be confused.

For example, when Home Depot made an announcement in 2016 that it was working with

Bloom, it called it a "renewable" energy source with "significantly less carbon emissions than traditional power sources."

SUSTAINABILITY VIEW MORE STORIES >

**BEYOND SOLAR: FUEL CELLS PROVIDING ON-SITE RENEWABLE ENERGY**

June 24, 2016

If you've visited a Home Depot store lately, chances are you've seen a number of lithium ion powered tools and eco-friendly products, but what you haven't seen is an innovative technology at work just outside the store, with the ability to keep the lights on.

Fuel cells use natural gas to generate electricity, but release significantly less carbon emissions than traditional power sources.

While quietly operating just a few yards from your local store, the sleek towers work actively to produce and store energy that can immediately provide power to a store in the event of a natural disaster or power grid failure. The Home Depot is even using fuel cell technology to power forklifts at its 1.6 million sq. ft. direct fulfilment center in Troy Township, Ohio.

Bloom Energy gives us a walk-through of their product that is working at more than 100 Home Depot stores from California to Connecticut:

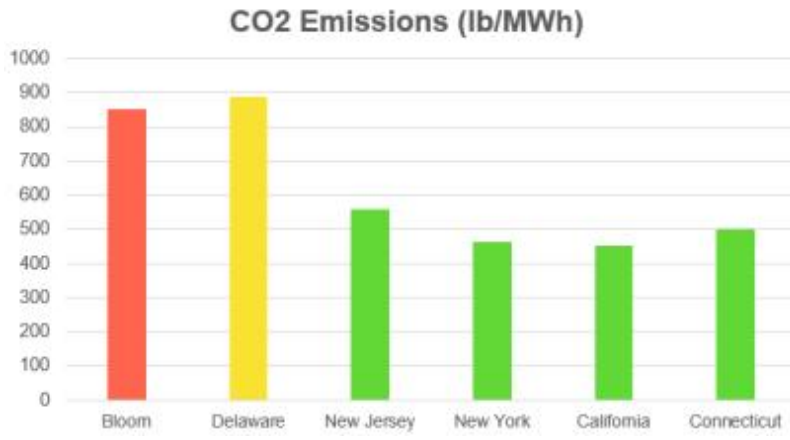
Once again, natural gas is simply not renewable.

Home Depot also parroted Bloom's false claim that it produces 50% less CO2 than the grid average. It then used this flawed metric to determine that installing Bloom's systems had taken the equivalent of 4,800 cars off the road.

**Did You Know:**

- The Bloom Energy fuel cells installed at Home Depot stores have generated more than 138 million kWh of clean energy since 2014, avoiding 50,148,519 lbs of CO2 emissions. That's the equivalent of taking 4,800 cars off the road.
- Bloom Energy fuel cells emit 50% less CO2 (per megawatt hour) compared to the average U.S. grid emission rate.
- Fuel cells produce consistent electricity output 24x7.
- Each 200 kW of Bloom Energy capacity installed at a Home Depot will save approximately 31,000,000 gallons of water each year.

As we have shown earlier, Bloom is actually far DIRTIERthan the grid in states like New York and Connecticut, where Home Depot installed many Bloom systems.




Unfortunately for Home Depot (and for the planet) it's more likely that installing Bloom Energy Servers in clean states like New York and Connecticut *added* thousands of cars to the road.

This is the ultimate version of virtue signaling and greenwashing, and it's all a result of what we believe to be a false narrative peddled by Bloom Energy.

## *AT&T: "Our Bloom Natural Gas Fuel Cells" Count as an "Alternative" Energy Source*

Even though natural gas is hardly "alternative", AT&T has counted its partnership with Bloom as moving toward its alternative energy goals on its website .

**2020 TARGET: Expand our on-site alternative energy capacity and intensify our pursuit of off-site renewables with competitive financials.**

PROGRESS: In 2018, AT&T announced one of the largest corporate renewable energy purchases in U.S. history, investing in up to 820 MW of wind power through agreements with subsidiaries of NextEra Energy Resources, the world's largest operator of renewable energy projects. Our Bloom natural gas fuel cells bring our total on-site alternative energy capacity to 51.6 MW, exceeding our 2017 target. The estimated energy production of our entire renewable energy portfolio is more than 368 million kWh annually.

The renewable energy angle to the Bloom story is that its servers are *capable* of running on biogas, though Bloom itself admits that biogas is expensive, isn't readily available enough, and is only used by a fraction of its customers.

# *Part III: Bloom Energy Executives Have a History of Making Allegedly False Statements*

Beyond the questionable value of Bloom Energy's technology and the dubious "clean energy" value proposition advanced by the company, we also see some red flags with the executive team.

## *The Company was Forced to Correct False Statements Made by Its CEO on the Day of its IPO*

In 2018, shortly after the company's initial public offering, its Chief Executive Officer, KR Sridhar, had statements he made on the record "officially disavowed" after an interview with MarketWatch .

When he was initially asked on the day of Bloom's IPO about the company's profitability, Sridhar told three MarketWatch staffers that Bloom was "a profitable company as of [the second quarter]," and he expected that to continue going forward.

MarketWatch asked a follow-up question to clear up whether Sridhar meant GAAP terms, to which he answered "affirmatively". MarketWatch then used those comments as the lead for a story published on July 26, 2018.


MarketWatch

Bloom Energy will be profitable this year, CEO says after IPO

By Claudia Assis

Published: July 26, 2018 10:50 a.m. ET

SHARE COMMENTS 2 Aa

Alternative-energy company will be profitable, cash-flow-positive this year and beyond; shares up 50% post IPO

That statement turned out to be extremely incorrect:


(Source: Company financials)

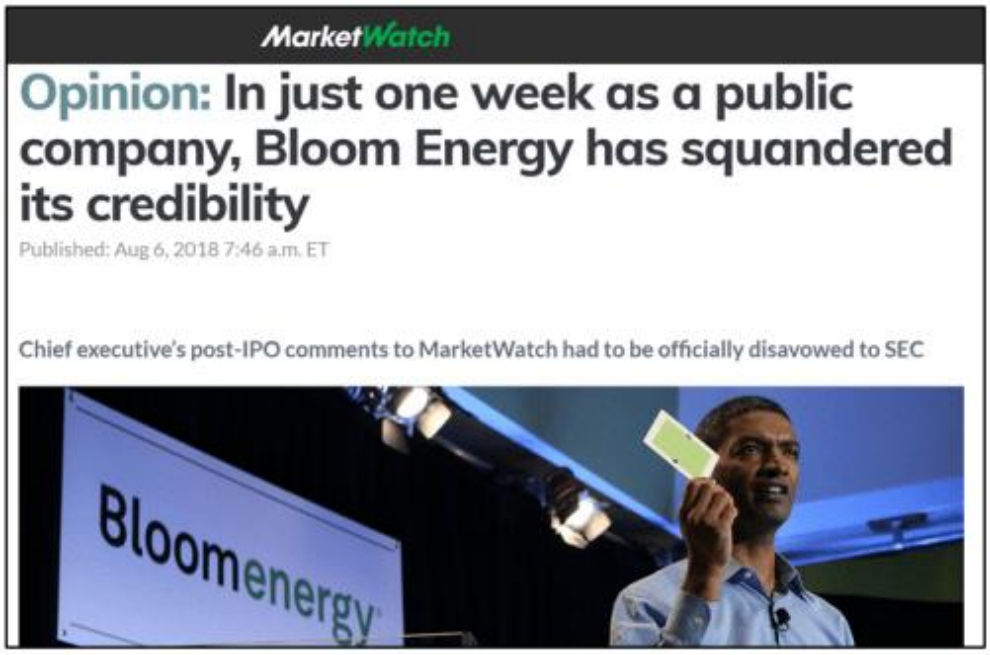
Following the piece, MarketWatch was quickly contacted by a spokesperson for Bloom Energy with a "clarification". The company explained to MarketWatch that Bloom expected to be GAAP profitable *only on an operating basis*, but not on a net basis.

But it turns out *that wasn't true either.*

MarketWatch updated its story, but even then, the clarification – in addition to the original statements – were deemed misleading.

Bloom Energy followed the clarification by making another clarification, this time a filing with the Securities and Exchange Commission itemizing its CEO's misstatements and correcting them one by one.

MarketWatch then followed up with another piece summarizing its view of the experience:



MarketWatch

Opinion: In just one week as a public company, Bloom Energy has squandered its credibility

Published: Aug 6, 2018 7:46 a.m. ET

Chief executive's post-IPO comments to MarketWatch had to be officially disavowed to SEC



(Source: MarketWatch )

## *Bloom Paid $16.7 Million to Settle Allegations That It Lied to Its Brokers, Leading to Their SEC Sanctioning*

In 2009, brokerage firm Advanced Equities raised approximately $122M from 609 investors at a $1.45 billion valuation for Bloom Energy. During the fundraising process, Advanced Equities allegedly made several misstatements about Bloom Energy.

Advanced Equities and its founders were sued by the SEC in 2012 for those misstatements. The firm placed the blame on Bloom , claiming the company had "misled them and caused them to get sanctioned by the SEC."

The SEC lawsuit against Advanced Equities alleged a series of bald-faced lies and fabricated documents, including that:

1. "[Advanced Equities] misstated that [Bloom's] projected revenue of $2 billion "is currently under contract and backordered". In reality, [Bloom] only had between $10m and $42m (10 to 42 individual hardware units) under contract as order backlog at that time."
2. "…also misstated that [Bloom's] CEO had shown [Advanced Equities] emails with a "$2 billion order from the CIA, which is not even in [Bloom's] numbers." In reality, [Bloom] did not have any order or other agreement from the CIA for any dollar amount at that time."
3. "[Advanced Equities] misstated again that [Bloom] was "getting $300m from the Department of Energy" when in reality, [Bloom] had not yet received any funding from the Department of Energy and had only applied for a $96.8 million loan."

According to a July 2018 Wall Street Journal article , founders of Advanced Equities had "threatened to sue Bloom, claiming that [Bloom] representatives were the sources of false information…".

THE WALL STREET JOURNAL.

PRO VC MA IPOS

**On Eve of IPO, Bloom Energy Faces Questions About Settlement With Investors**

Why Bloom Energy paid millions to investors in settlement

At the time, Bloom Energy denied those allegations but still settled with the founders of Advanced Equities, recording a $16.7M charge, according to documents reviewed by the Wall Street Journal.

Co-founder of Advanced Equities, Dwight Badger, told the Wall Street Journal in 2018:

> *"I am currently under a confidentiality agreement… **and Bloom is currently seeking to prevent me from releasing the information I have** and claiming I breached the agreement, a charge I deny."*

# *Part IV: Experts, Customers and Competitors Reveal the Boring Truth About Bloom's Technology*

In preparing this piece, we spoke with dozens of people including experts in the fuel cell industry, Bloom customers, competitors and former employees.

Our discussions indicate that Bloom's technology is already well-understood, "pretty old", and

still faces two major hurdles: cost and durability.

## *19 Year Fuel Cell Expert: Bloom's Technology "Hurts the Fuel Cell Industry" and "Public Image (of Fuel Cells) Overall"*

One of the very first conversations we had was with a technician with 19 years of experience in the fuel-cell industry who has worked with everything from low temperature, low pressure hydrogen air/hydrogen oxygen PEM fuel cells to high pressure hydrogen oxygen aerospace-based fuel cells. His resume indicated a broad range of knowledge, from simple testing to advanced lead design for aerospace applications.

We approached him as objectively as possible, letting him know we wanted to hear both the good and the bad about the industry. When asked about Bloom Energy's contribution to the fuel cell space he didn't hold back his immediate distaste; his first response was a long sigh.

> *"Not very excited about Bloom Energy," he muttered, sounding disappointed. "My opinion on Bloom Energy is that they may have gotten out a little father ahead of themselves than they should have. Perhaps [they should have] spent a little more time in research and gotten a better handle on what they were wanting to do before they started bringing it to market."*

He continued:

> *"I feel like the general perception of Bloom Energy is that they kind of hurt the fuel cell industry as a whole."*

When we asked why he thought they were hurting the industry, he responded:

> *" **they went out and made some pretty big bold claims, which would have been awesome if it had been 100% accurate, but it's looking like now that they made some claims and got some money for some ideas that looked good on paper, and didn't necessarily have a lot of credence to it.** So, in my opinion, when you do that with the general public – when you promise them the moon, you*

*better hit the moon. Whenever you make big bold claims, you better be able to follow them up – especially with something such as a temperamental R&D type subject as fuel cells. You only get the one shot and whenever you don't deliver, people aren't super forgiving whenever you invest a lot of money and don't deliver on everything you said.* ***In short, my opinion is that they may have overstepped, and it is hurting the fuel cell public image overall***

Speaking about Bloom's push to raise money:

*"They were just making it very 'oh yeah, this is great, it's going to work, it's no questions'. I understand why they did it, but at the same time* ***you can't go to the public and say this is going great, this is going to work and not address the nuances****.."*

He also told us he thought Bloom had made these bold claims simply to raise money:

*"For money. For the money. It's my understanding they had tons of money coming in from capitalists that were interested in – it's kinda like, what is that show, Shark Tank? You go out and you make the pitch and if you make the pitch well enough; they're going to give money to you. If you don't make the pitch well enough, it's not so much****. So, they were forced into making those kinds of bold claims to get the money****."*

The technician continued, telling us again how he thought this was bad for the industry as a whole:

*"The problem is when you make those bold claims and then you can't deliver, it really turns everything sour. And it'd be one thing if it were just the investors, but they made it so public and so widespread, that's where I feel the disservice to the general industry was. I've talked to multiple people that were not involved with fuel cells at all and you mention fuel cells and they're like, 'Ah, I don't know about that'. 'You remember about 4-5 years ago Bloom Energy?'. 'Bloom Energy, yeah I remember that. Did that work? Didn't that fall through or something?'* ***That's not the image***

***that the fuel cell industry needs.***

Finally, we asked his opinion on whether or not Bloom was ahead of the rest of the industry. He responded:

> *"No, I don't think so. **I think Bloom Energy is only recognizable by name. I think your Ballard, your lug ower, those are more industry leaders.** They have more equipment out there. They're more involved with both the automotive and stationary applications. I think – and they're keeping a lower public profile until they can go and get a lot of good solid data. They actually have quite a few busses up and running on fuel cells."*

> *"I really think Bloom just made the misstep of going too public, too fast and not having the 'ooh' and 'ahh' factor to maintain that approach," he concluded."*

## *14-Year Fuel Cell Expert in Performance Analysis: "They Use the Traditional Classic Materials"*

We also contacted another expert with 14 years of experience working in fuel cells and fuel cell performance analysis, who holds a B.S., M.S., and a PhD in Chemical Engineering. We asked him if he thought Bloom had any intellectual property that puts them ahead of new SOFC entrants. He responded:

> *"No, I don't think so. These material developments are very real, very complicated and very fundamental. **So, in S C, we've made it better compared to 10 years ago. But I don't think there is revolutionary material in Bloom's products. Based on most of the disclosures, they're using the traditional materials. It's used in other fuel cells.** They use the traditional classic materials."*

We also asked about whether he thought the company's marketing was accurate. He told us:

> ***I see in some news they said they have year stacks. My guess is they may have 2. or 3 year stacks. In that range. They probably have 0% efficiency***

***they can reach for 3 years."***

*"Based on their quarterly report, their cost is still much higher than other fuel cells. It's almost double in terms of cost. So that makes the electricity very high per kilowatt hour. I would say, probably triple the electricity of the classic generation. I would estimate their cost is probably 30 cents per kilowatt hour, based on my estimation and their costs."*

Finally, we asked if he thought Bloom could operate consistently and profitably without government incentives. He concluded:

*"That is very hard for all the fuel cells now. It's not easy."*

## *PhD in Mechanical Engineering and Fuel Cell Expert: Fuel Cells Only Have a "50/50 Chance of Making It Long Term"*

We also reached out to a U.S.-based PhD in mechanical engineering with research experience assessing the life cycle environmental impact of SOFC systems using energy systems modeling.

We asked for his take on whether or not fuel cells could make it in the long term and he was less than confident in his response. He *also* brought up durability and cost:

*"I'd personally like to give you a different answer, but I think based on the competition I'm seeing from renewables and just conventional technologies, that I think fuel cells have a 50/50 chance making it long term**. Again, the issues being lifetime and cost. The thing with lifetime is not only do you have to go through the maintenance part of it, but when you replace a stack you're basically paying for a whole new stack. So, lifetime and cost are also very much intertwined."***

*"When it comes to the market, it also comes down to the cost. And I'd say even more specifically to the lifecycle cost. So, there's a capital cost, right? And that's how much a system will cost up front. But then there's a lifecycle cost which includes not only the capital cost, which is that initial cost that you pay for the system, but it also*

*includes the fuel cost, it also includes the cost to replace stacks over the lifetime. And so it's the lifecycle cost that I've seen that is just not competitive at this point. It's much higher than internal combustion engines and microturbines."*

He continued, going into more detail on cost and calling into question what he thought about Bloom's costs versus what the Department of Energy is targeting. The numbers he used were almost a decade old, but we thought the delta between Bloom's cost versus the DOE target was still worth noting:

*"There's very little information on Bloom's costs that's been made public. There was one article published in 2010. Things have probably changed since then. There was a cost that Bloom had released."*

*"For a 100 kW Bloom energy system, it would cost $700,000 to $800,000. So the cost, if I just do the math. That is $7000 to $8000 per kilowatt. So it's about $7500 per kilowatt for a Bloom Energy system. That's in 2010. And DOE's target is closer to $900 per kW."*

## *PhD and Fuel Cell Technology Graduate Professor: Bloom's SOFCs Are "Pretty Old Technology"*

We also reached out to a PhD Professor of Engineering who teaches a graduate course in fuel cell technology and studied materials for solid oxide fuel cells for his graduate degree.

We asked him how fuel cells would rank among other green technology in the line for mainstream adoption. He told us:

*"In terms of overall green energy, probably what's best for the environment and sustainable are wind and solar…"*

He also brought up SOFC's high temperatures as one of their key disadvantages:

***The main disadvantage with the solid oxide fuel cell is the high operating***

***temperature*** *They're operating at around 700-800 degrees Celsius."*

When we inquired as to how likely he thought it was that Bloom had something extremely unique with their patents, process or catalyst, he responded:

*"Their technology is pretty old technology. It's very well established."*

He also pointed to the main hang-ups in the solid oxide fuel cell industry as costs and manufacturing.

*"The science is solid.* ***There isn't anything thermodynamically that says that a fuel cell will not work. That technology exists. It's just now how you manufacture such that you can deliver it in a low-cost way. I think that's where the fuel cell industry is at.*** *I think even Toyota still has to handmake some of their fuel cells.* ***The components are not well suited for automation."***

## *Former Bloom Employee: "If Congress Didn't Renew Their Subsidies, Bloom Energy Probably Wouldn't Exist Today"*

We also spoke to a former Bloom employee who worked for the company in the late 2000's and has more than 15 years' experience in servicing advanced energy products.

He first recalled being recruited saying:

***"The reason I turned it down was because of the product. Fuel cells have been around forever. No one's been able to crack the code to make it profitable.*** *Here I am being recruited by a company that says otherwise."*

When we asked about whether Bloom had 'cracked the code' to get to profitability, the former employee focused on subsidies:

*"I don't know how you do that without subsidies and the materials that are in that thing are all rare earth materials which are pretty costly. There's only a few countries*

*in the world – I think it's China and Russia – that own the rare earth materials that are being used in the thing. That's my knowledge from 11 years ago. Things could have changed, but it just seems like it's just so expensive to make and produce and then without the subsidies…*

***if congress didn't renew their subsidies, Bloom Energy probably wouldn't exist today.*** *I just don't know how you make that. It's just playing off the green energy/climate change things that are going on out there that people want to feel good about this stuff and they're buying these Bloom Energy boxes…"*

He also talked about the company's controversial project in Delaware:

***the company was thrown a lifeline. They weren't doing that well.*** *You've got the Obama administration – I think it was Joe Biden put the onus on the people in that state to subsidize Bloom Energy. Bloom Energy made a bunch of promises about employees that they never kept. But the people in Delaware are still paying. It's crazy."*

He also commented about companies using Bloom products strictly for their PR image:

*"I think with Bloom Energy – like, Google and Apple and some of these firms, are like 'yeah, I want to get on the bandwagon because I can make my stockholders happy because I'm doing something with green energy…'* ***A lot of green energy stuff that was going out there maybe didn't work well, but these people were willing to take the risk and spend the money.*** *Plus, they were getting subsidies so the pain wasn't that great, either. They all jumped in and took the risk."*

We asked the same employee about the idea of companies using Bloom Boxes to claim that they're using clean and green energy. He responded quickly:

***Well, they're not really clean. They're still putting out a bunch of carbon dioxide. Everybody's complaining about C 2 and yet, that's a byproduct of this.*** *And over time it gets worse because the efficiency of that fuel cell doesn't stay*

*100%."*

## *Bloom Customers Weigh In*

We also wanted to speak to people that had firsthand experience with Bloom Energy servers. After identifying project sites where Bloom servers have been installed through NYSERDA records, we spent weeks calling and speaking to more than 40 locations where servers have been installed.

Some people that we spoke to at businesses like Home Depot and Walmart (store managers and assistant managers, mostly) told us that they didn't really know much about the Bloom Boxes on site. Most of the managers said they didn't notice anything out of the ordinary unless something went wrong. Several referred us to their corporate numbers, as the Bloom installations were corporate-led initiatives.

The managers indicated that Bloom does all the servicing and didn't have prescheduled maintenance. They would see the service trucks come by from time to time but other than that generally had no knowledge of how regularly they were serviced or to what extent.

Several of the managers that we spoke to, like one at the Home Depot in Enfield, said that the energy boxes have helped their P&L, or that energy costs weren't an issue. This was to be expected, due to Bloom guaranteeing service at dirt cheap – and we believe unsustainable – prices.

The issue of durability was brought up on a call that we had with a Home Depot manager in Greenbush, New York. As soon as we mentioned fuel cells to him, he launched into a story about how one had "blown" right after being installed and how another, at a second location in Clifton Park, "came off the building".

The Home Depot manager said:

> *"We had it blow once already and we lost power for about a day and a half. There was a power surge and it blew. But other than that, it's been quiet. You'd never notice it until something's wrong with it. We've only had it for maybe a year now, going on maybe a year. A transformer blew on it."*

We asked him to confirm whether the issue was with the Bloom boxes or the conventional grid. He responded:

> *"It's just hard when something does go wrong, you don't know if it's wrong with the power company or the fuel cell, so everybody's gotta figure out who's problem it is before they'll fix it. It took longer to figure out who was responsible to fix it than getting it repaired."*

> *"It was the fuel cell. It was them."*

We were able to corroborate the claims by looking into the public NYSERDA data for Home Depot Greenbush, which shows an interruption in service in late January 2019. Efficiency numbers dropped across the board for a three-day period.

| ProjectID | Date | Electricity Generated | Total Fuel Consumed | Total Heat Used | Heat Rejected | Capacity Factor | Electric Efficiency | Thermal Efficiency | CHP Efficiency |
|---|---|---|---|---|---|---|---|---|---|
| Units | YYYY-MM-D | kWh | cf | MBtu | MBtu | % | %hhv | %hhv | %hhv |
| 750 | 2019-01-16 | 4,870 | 29,679 | 0 | 0 | 96.6 | 54.3 | 0.0 | 54.3 |
| 750 | 2019-01-17 | 4,743 | 29,668 | 0 | 0 | 94.1 | 52.9 | 0.0 | 52.9 |
| 750 | 2019-01-18 | 4,844 | 29,679 | 0 | 0 | 96.1 | 54.0 | 0.0 | 54.0 |
| 750 | 2019-01-19 | 4,829 | 29,668 | 0 | 0 | 95.8 | 53.8 | 0.0 | 53.8 |
| 750 | 2019-01-20 | 3,800 | 24,066 | 0 | 0 | 75.4 | 52.2 | 0.0 | 52.2 |
| 750 | 2019-01-21 | 387 | 3,710 | 0 | 0 | 7.7 | 34.5 | 0.0 | 34.5 |
| 750 | 2019-01-22 | 561 | 4,724 | 0 | 0 | 11.1 | 39.3 | 0.0 | 39.3 |
| 750 | 2019-01-23 | 3,068 | 21,075 | 0 | 0 | 60.9 | 48.1 | 0.0 | 48.1 |
| 750 | 2019-01-24 | 4,069 | 26,233 | 0 | 0 | 80.7 | 51.3 | 0.0 | 51.3 |
| 750 | 2019-01-25 | 4,737 | 29,668 | 0 | 0 | 94.0 | 52.8 | 0.0 | 52.8 |
| 750 | 2019-01-26 | 4,758 | 29,668 | 0 | 0 | 94.4 | 53.0 | 0.0 | 53.0 |
| 750 | 2019-01-27 | 4,807 | 29,679 | 0 | 0 | 95.4 | 53.6 | 0.0 | 53.6 |
| 750 | 2019-01-28 | 4,808 | 29,668 | 0 | 0 | 95.4 | 53.6 | 0.0 | 53.6 |
| 750 | 2019-01-29 | 4,805 | 29,679 | 0 | 0 | 95.3 | 53.5 | 0.0 | 53.5 |
| 750 | 2019-01-30 | 4,882 | 29,647 | 0 | 0 | 96.9 | 54.5 | 0.0 | 54.5 |
| 750 | 2019-01-31 | 4,782 | 29,668 | 0 | 0 | 94.9 | 53.3 | 0.0 | 53.3 |
| 750 | 2019-02-01 | 3,237 | 20,166 | 0 | 0 | 64.2 | 53.1 | 0.0 | 53.1 |
| 750 | 2019-02-02 | 4,316 | 27,744 | 0 | 0 | 85.6 | 51.4 | 0.0 | 51.4 |
| 750 | 2019-02-03 | 4,803 | 29,689 | 0 | 0 | 95.3 | 53.5 | 0.0 | 53.5 |
| 750 | 2019-02-04 | 4,801 | 29,668 | 0 | 0 | 95.3 | 53.5 | 0.0 | 53.5 |

Finally, he offered up a story about another Home Depot store in Clifton Park that had installation issues that were eventually resolved:

> *"They didn't use the right bolts and everything came off the building. They had to re-do it. They didn't use the right bolts. They had it corrected by the time they got to our building. I guess there was an issue with the anchoring system."*

# *Conclusion: We Are Witnessing Another Falling Unicorn*

All told, we believe that Bloom Energy is facing numerous material and imminent problems.

With the company's accounting issues now exposed, we hope shareholders will demand far more detail going forward. We also hope the company's various partners will be more vigilant in understanding the company's carbon and hazardous waste footprint.

Bloom's story arc strikes us as reminiscent of other fallen Silicon Valley unicorns:

1. Lay out a grand vision to save the world
2. Overpromise
3. Draw accolades from everyone, raise billions of dollars
4. 'Fake it 'til you make it'
5. Never actually make it

Simply put: the problems with Bloom's technology, accounting, undisclosed liabilities, debt burden, emissions & hazardous waste issues, in our opinion, put the prospect of bankruptcy or a reorganization on the table over the next 12-18 months.

# *Appendix A: Methodology & Data Collection—How to Replicate Our Work*

Ideally, we want the company to respond to our questions and offer the market a full explanation of its economic liabilities, CO2 output, accounting practices and other key issues. We welcome a response from the company, but in the event that they do not respond, we also want readers to be able to fully replicate and understand our work.

This thesis required a lot of unique data collection and number crunching, so we view it as important that we detail our methodology for both gathering and processing the data to help readers understand how we arrived at assumptions and conclusions. We encourage readers to download, examine, and question these datasets and our approach themselves.

Starting with our estimate of Bloom's servicing liabilities:

| | |
|---|---|
| Cost to replace fuel cell (per KW) | $892 |
| Fuel cell life (months) | 34 |
| Length of time left on avg. contract (years) | 13 |
| Avg. # of times fuel cell will be replaced | 4.6 |
| + Current replacement cycle | 5.1 |
| Cumulative install base (KW) | 412,000 |
| Fuel cell replacement liability | **$ 1,874,659,122** |
| Cost to replace servers (per KW) | **$ 3,516** |
| Server replacement liability | **$ 1,448,577,514** |
| **Total Expected Servicing Liabilities** | **$ 3,323,236,636** |
| Service revenue (3c Kwh) | 1,266,801,120 |
| **Net servicing liability** | **$ 2,056,435,516** |

The data and assumptions that went into it:

**Cost to replace fuel cells:** Bloom doesn't disclose how much fuel cells cost relative to total product, but EPA research shows that fuel cells represent roughly 29.3% of the total cost of a server. [ Pg. 114]. New Jersey research into fuel cell projects (including Bloom's) show that the fuel cell servers cost roughly 2/3 more than the fuel cell itself. [ Pg. 21] We used the EPA metric to estimate cost to replace fuel cell and applied this percentage to Bloom's product cost per kW in the latest quarter: $3,045/kW [ Pg. 47]. We used ONLY product cost for this calculation (rather than total installed system cost) because fuel cells can be "hot swapped" and therefore do not require incremental installation costs.

**uel cell life:** This is based on our collection and extrapolation of Bloom's new generation 5 servers from data in California and New York (more on this below).

**Current replacement cycle:** We are currently mid-way through the replacement cycle. (In reality, we expect the company to replace many cells imminently, as shown by the current Generation 5 fuel cells nearing replacement thresholds, but we wanted to err on the side of conservative).

**Recovery value:** We examined what the recovery value of fuel cell/server replacements could be. Department of Energy research has determined that recovery value for SOFC replacements "would not be significant" [ Pg. 105]

**Total install base:** The latest quarterly total install base was 412 mW per company financials [ Pg. 70]

**Cost to replace servers** 70.7% (or 1-29.3%) of the company's reported total installed system costs (TISC) per kW for the latest quarter; $5,274. (This assumed that fuel cells are not replaced along with the servers. If the cells must also be replaced the cost would be significantly higher.) We used TISC for this estimation because servers would require new installation, whereas fuel cells can simply be "hot swapped" and therefore would presume to only impact product costs rather than total installation costs.

**uel cell replacement liability:** Based on the expected fuel cell life from field data tracked from New York & California, fuel cell cost, and length of time left on average contracts.

**Server replacement liability:** All told, we assume 1 server replacement per average 13 year remaining contract life, given the company's historic 4-7 year replacement rates.
**Service revenue:** We extrapolated the latest quarterly service revenue run-rate across the 13-year average remaining life. [ Pg. 48]

## *Raw Data Sets on Output and Efficiency of Bloom's Projects*

Monthly performance data was obtained in two states, New York and California. These are the only states we could identify with robust and regularly-updated data on energy systems.

California's Self-Generation Incentive Program (SGIP) publishes performance data on its website. See Monthly PBI Performance Report under Number 9 here .

New York has a similar program. The New York State Energy Research and Development Authority, known as NYSERDA publishes Distributed Energy Resources (DER) data on projects they fund. To see Bloom generators in field we searched "bloom energy" in the installer/developer section here .

To get a sense for how Bloom's newest version of generators performed, the analysis focuses on generators that were installed post 2016. We did this because Bloom stated that it expects 5-year performance from its fuel cell lives from 2017 onward and we wanted to test this specific claim:

> *"Time to stack replacement primarily driven by our fuel cell stack lives in the early years, replacement was typically 12 to 18 months. Over the years we have made steady improvements in our fuel cell lives, and* ***from 2017 onwards we expect to average over five years between replacements"*** *[IPO Prospectus Pg. 61]*

To isolate generators installed after 2016, the "interconnection date" in SGIP data and the first month of generation in the NY data was used in the data set.

There were some instances where generators exhibited strange performance in the data (such as generators operating at below 40% efficiency or seeming to break). With the efficiency, output and emissions samples we attempted to scrub out data points that appeared to be mostly negative outliers in order to give Bloom the benefit of the doubt (such as generators beginning to operate significantly below or above standard LHV efficiency between 40% to 70%, then sharply reverting). Had we included these potential outliers, Bloom's performance would

have likely been significantly worse.

**Higher Heating Value to Lower Heating Value Efficiency Conversion**

A multiple of 1.107 (see page F-1) was used to convert the higher heating value efficiency provided by NYSDER to the lower heating value efficiency Bloom uses on its guarantees. This is the conversion factor found in Bloom's contracts with customers.

**Emissions: ounds of C 2 per MwH**

To calculate pounds of carbon dioxide per megawatt hour emissions the following formula was used

(3.412 MMBtu / 1 MWH) / HHV Efficiency * (117 pounds of CO2 / 1 MMBtu) x bls carbon dioxide / MWH

1 MWH is equivalent to 3.412 MMBTU. This is the conversion factor Bloom uses in its contracts ( page F-1)
1 MMBtu unit 117 lbs of CO2 see Natural Gas row from the Energy Information Administration here
Heat rate (ideal heat rate)/efficiency (3412 Btu/kWh)/efficiency

**uel Cell Replacement Threshold**

Bloom appears to be replacing fuel cells between 50% and 48% LVH efficiency. Fuel cells degrade linearly over time , yet between these efficiency ranges across Bloom's project base we regularly see sustained spikes in efficiency. The reason inferred for this is because fuel cells are being replaced in order to hit efficiency targets.

The largest source of historical data obtained on Bloom generator's past operating performance is from the state of California's SGIP program . Of the over 10,000 performance months dating back to 2012 in the SGIP data (each representing a historical month of operating performance from a Bloom generator dating back to 2012) less than 1% (89 instances) were operating below 48% LHV efficiency. (Of those, some were showing 0% efficiency, suggesting a system shutdown or other issue.) Less than 3% (256 instances) operated below 50% LHV efficiency. The data suggests that fuel cells are almost always being replaced before hitting the 48% LHV efficiency threshold.

# *Appendix B—Breakdown of Federal, State, and Local Subsidies to Bloom Energy*

Here's a breakdown of Bloom Energy's subsidy receipts to date:

**ederal Energy Investment Tax Credit ITC:** This program is often associated with solar and renewable energy. Bloom has received an estimated $360 million from the program, but these subsidies are stepping down starting in 2020. We estimate that this step-down will result in $247 million in foregone subsidies to Bloom over the next 3 years at current annual run-rates.

We estimated the $360 million number by applying the 30% ITC to roughly $1.2 billion in product & installation revenue since 2014. We based our estimate of the foregone subsidies over the 3-year step-down period by using the 2018 annual run rate applied to the modified ITC percentage subsidies from the link above.

**California Self-Generation Incentive rogram:** Bloom received $376 million from this program as of 7/29/2019. In 2016, California modified the program after releasing a report indicating that Bloom Boxes were too expensive and released too much carbon to warrant incentives.

The modified incentive system requires replacing natural gas with biogas. With 91% of Bloom's servers operating on natural gas, the change rendered the program largely out of reach for the company. It is set to expire January 1, 2021 regardless.

**ederal Recovery Act:** Bloom received $152 million for two projects [1,2] This program was established following the financial crisis to promote clean energy products, which mainly consisted of renewables but also included fuel cells. The subsidies received on Bloom's 2 projects were almost 10x the next largest fuel cell project.

**Delaware**: Bloom has received $221 million between grants and subsidies from Delaware electricity ratepayers. [1,2,3,4,5,6]

**New Jersey** Bloom and other fuel cell providers were **ejected** from the New Jersey Clean Energy Program (NJCEP) in 2016 over concerns relating to excess costs and carbon emissions [Pg. 16] Prior to that point Bloom had received $18.6 million from the program, per a FOIA request.

**Connecticut:** We submitted a FOIL request to Connecticut but have not heard back as of this writing. We can confirm however that at least $35.4 million in subsidies have gone to Bloom from Connecticut from media articles .

**New ork:** The state has been mum about subsidies paid to Bloom to date. We submitted a FOIL request but received no records back. We know that the state has awarded Bloom subsidies at least twice ( 1,2) but given the absence of specific data we did not factor any New York subsidies into our estimates.

**Massachusetts:** Bloom tried and failed to "make non-combustible fuel cell technology eligible" under a 2010 renewable energy program, according to media articles .

## *Appendix C: Questions We Asked Bloom*

We emailed Bloom and asked a number of questions. We have not heard back as of this writing but will update this report with their responses should we receive a reply. We figured it best to share these with readers to give a sense of the questions we would like the answers to:

> You have stated that your expectation for fuel cell life from 2017 and onward is over 5 years. What is the actual performance of the fuel cells thus far and how does that compare with expected life?
>
> Do you have any internal estimates of what the service liabilities would be over the life of the customer's contracts? If so, could you make that available along with expectations of service revenue over the life of the customer's contracts?
>
> Can you confirm whether the financials only account for the next year of expected servicing revenue/liabilities?
>
> Do you see any other potential renewable applications of the product? The company announced hydrogen as a fuel source and alluded to other potential avenues recently.
>
> What performance do you expect out of the gen 7 servers in development? What about expected lifecycle, or is it too early to say?
>
> How important is the price and supply of scandium to Bloom's supply chain? Can you give a sense of how scandium prices over time have affected the TISC?

How much does it cost to replace a fuel cell stack?

How much does it cost to replace an entire fuel cell server?

At what efficiency levels do you typically start replacing fuel cells?

What are the criteria that determine whether to replace a server?

What was the resolution of the EPA fine? The prospectus mentioned a $1 million fine that was being contested in relation to improper disposal of waste.

Are there any other regulatory investigations or pending proceedings that you are aware of relating to the company?

With 2020 revenue expected to be flat, where does the company see the next stage of growth coming?

# *Disclosure & Legal Disclaimer*

**Disclosure: We are short shares of Bloom Energy**

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[1] We used the median starting point in month 1 because there were outliers in the first month that would have skewed the results significantly downward, likely because systems needed to get fully up and running. We used average thereafter.

[2] Bloom states that its servers degrade linearly over time, thus we extrapolate using straight-line degradation. Per Bloom's filings: "the efficiency of the Energy Server decreases very gradually from the beginning of life efficiency toward the end of life efficiency. This decrease is very nearly linear in nature (i.e., a straight-line slope)." ( Pg. 31)

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# TAB 24

# DaVita is Secretly Trying to Defend its Charity Scheme with a Lobbying Scheme

Published on August 13, 2019



- DaVita is a $10 billion market cap dialysis company that derives much of its profits through a charity scheme that has been exposed by the New York Times and the Southern Investigative Reporting Foundation, among others.
- The scheme involves DaVita donating to a "charity", the American Kidney Fund, which then guides individuals into switching from low-cost public insurers (that DaVita makes no profit from) to high-cost private insurers (that DaVita makes a substantial profit from).
- In California, a state estimated to account for 15-20% of the company's dialysis business, a bill has passed the state assembly that intends to close the charity scheme loophole.
- The assemblyman who introduced the bill has called DaVita's charity loophole a "self-serving scam" and "a scheme to bankroll patients' healthcare premiums".
- DaVita has responded to these legislative efforts by quietly funding a group called "Patients and Caregivers to Protect Dialysis Patients" that claims to be a broad coalition acting against the bill in order to protect the interests of the poor and disadvantaged.
- We spoke to numerous groups in the coalition; most readily admitted to not knowing anything about the bill and/or simply taking their cues from lobbyists or other

organizations. Some didn't even know they opposed it at all.
- In reality, about 90% of the recent monetary support for "Patients and Caregivers to Protect Dialysis Patients" comes from large for-profit dialysis corporations such as DaVita and Fresenius. DaVita represented about 60% of the group's funding over the last 2 years, having donated over $67 million in that period.

## *Introduction*

We believe DaVita to be a corrupt healthcare organization whose historical success has relied largely on gouging the healthcare system. The company has paid over $1.1 billion in the past 5 years to settle four DoJ False Claims Act allegations. (1,2,3,4) The result of these settlements has been to mitigate several profitable (and allegedly illegal) lines of business.

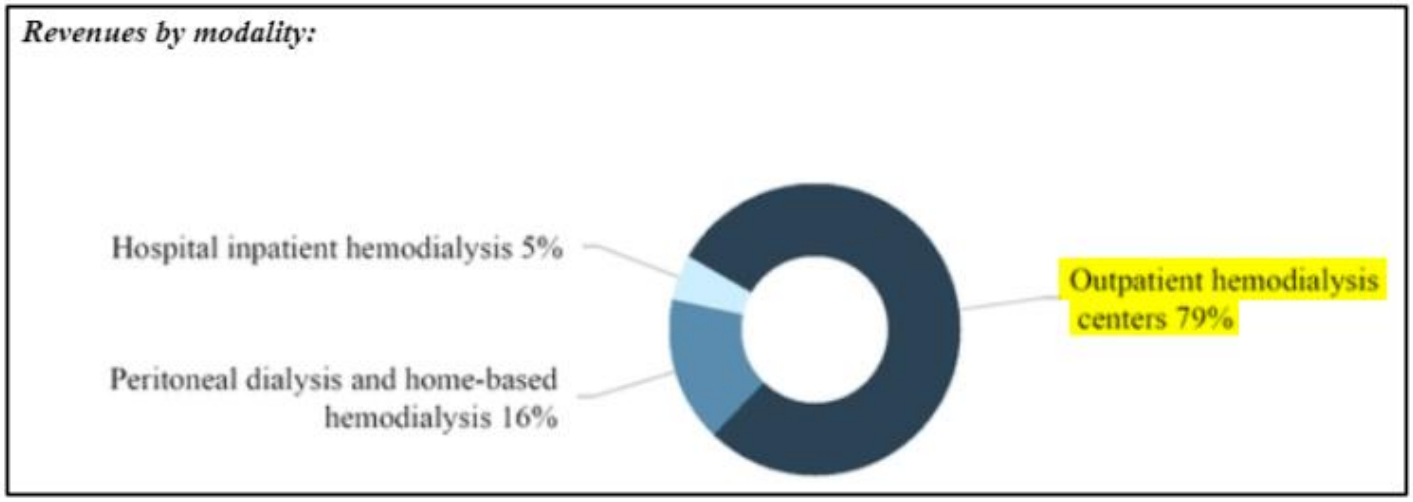
Now, DaVita's most lucrative scheme is finally becoming obvious to insurers, patients and legislators following multiple media exposés. As a result, legislation is starting to specifically target the company's primary remaining profit center. We intend to highlight the legislative challenges currently facing DaVita at both the state and national level that we believe will persist until the loophole driving this scheme has been closed.

As DaVita works against one of its main legislative challenges of the moment, California Assembly Bill 290, we sought to understand the company's lobbying effort. We found that DaVita is, in characteristic fashion, engaging in what looks to be underhanded lobbying tactics in order to defend its charity scheme.

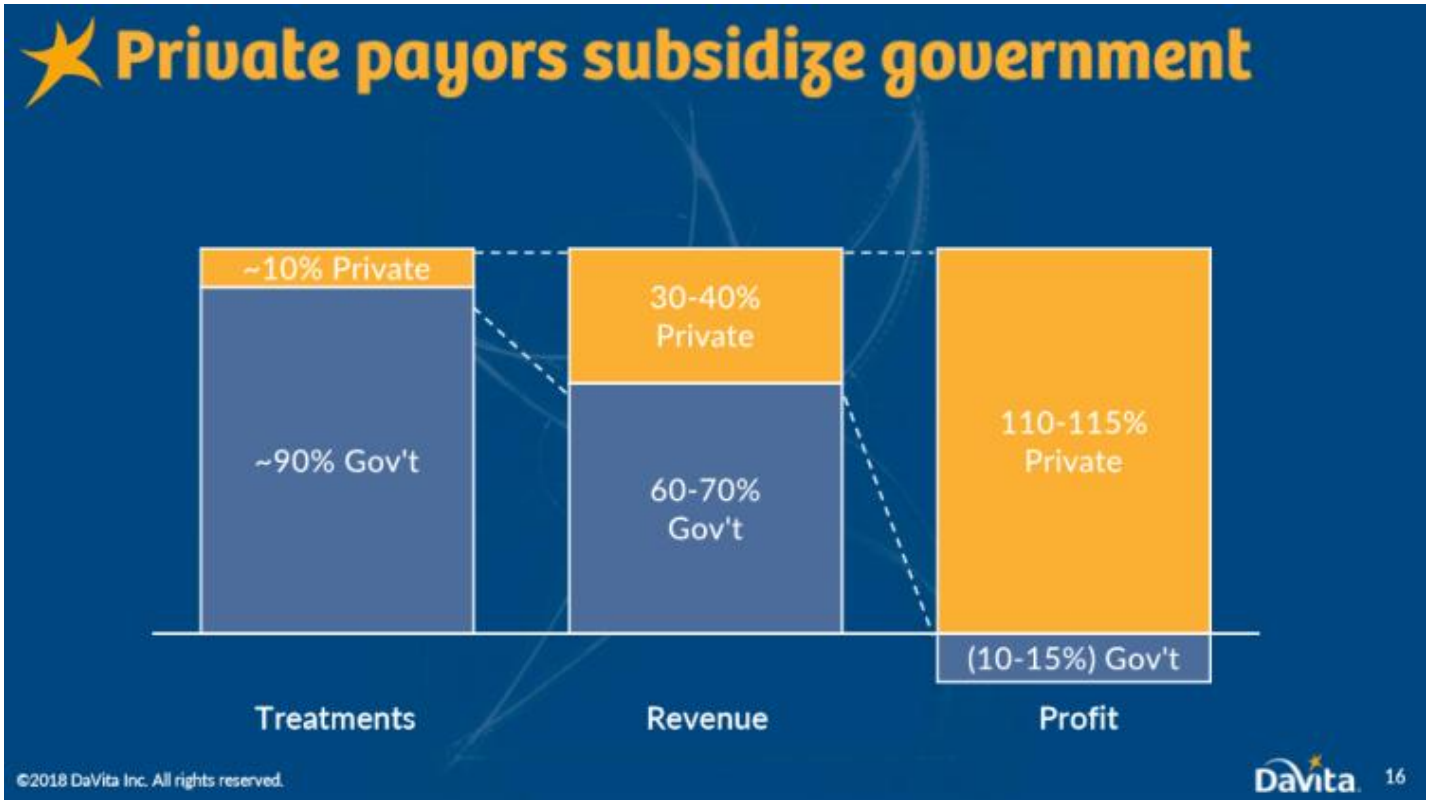
We at Hindenburg are typically known for taking short positions alongside our research, but the truth is that we just like to call out scams when we see them. We have no position long or short in DaVita (for reasons we will explain) but, nonetheless, we thought it would be important to shed light on the ridiculous abuse of the medical system that continues under a cloak of legitimate lobbying efforts.

## *Background: Almost All of DaVita's Profits Come from Commercial Insurance Payors*

DaVita is the second largest operator of dialysis clinics nationwide. According to its latest annual report, it derives 79% of its revenue from these clinics.




The company acknowledges that it loses money on patients that use government insurance (Medicare/Medicaid/Medi-Cal) and makes all its profit from patients using commercial insurance, who are charged substantially higher rates for their dialysis services.




(Source: DaVita At 36th Annual J.P. Morgan Healthcare Conference )

Former DaVita CEO Kent Thiry said at the 2017 J.P. Morgan Healthcare conference:

> *The private payors dramatically subsidize the government. Most of our patients are*

> *Medicare. In fact, about 85%, 90% of our patients are from the government sector. On average we lose money on each one, which leads to agrotesquely large cross-subsidy from the private sector to the government.*

Thus, the company's profitability largely relies on its mix of commercial versus government payors across its dialysis clinics.

## *Background on the American Kidney Fund (AKF), DaVita's Charity Scheme That it Uses to Juice Profits*

In late 2016, the New York Times highlighted DaVita as being party to a scheme whereby it donates to a 'non-profit' entity called the **American Kidney und AK**, which then helps convert patients from low-cost government payors (such as Medicare and Medicaid) toward high-cost private commercial insurers.

In September 2017, the Southern Investigative Reporting Foundation highlighted exactly how the scheme works and how it results in billions of dollars dropping to DaVita's bottom line at the expense of the medical system.

The AKF targets low income and minority individuals who believe they will be getting better care (when, in reality, many are being set up to pay higher costs or lose services later). The AKF then pays for the patient's co-pays, allowing dialysis operators to burden the commercial insurers with extraordinarily high costs despite no apparent difference in treatment.

It is estimated that a year of commercial dialysis treatments for one patient can cost $160,000, compared with $40,000 when Medicare pays for them.

Last year, DaVita and Fresenius (the two largest dialysis providers) donated $247 million to the AKF. As of 2017, the AKF paid premiums for over 74,000 patients, representing almost 20% of the nation's dialysis recipients.

## *Legislators Are Catching On: A Bill Just Passed the California State Assembly Called AB 290 That Targets DaVita's Charity Loophole in The Crucial State.*

## *Assemblyman: DaVita Involved in "A Scheme to Bankroll Patients' Health Care Premiums"*

In California, a bill called AB 290 just passed the State Assembly. It is directly focused on closing DaVita's charity loophole. The bill was introduced by Assemblyman Jim Wood, who, in his press release for the bill called the actions of dialysis companies "a scheme to bankroll patients' health care premiums."

Commenting on the intention of the bill, Wood said:

> *Runaway costs in health care affect everyone, and I'm committed to protecting patients but I'm not interested in protecting dialysis companies from* ***scamming the system*** *for their own benefit…*

> *…When unscrupulous dialysis companies, through a third party, steer patients away from Medicare or Medi-Cal by indirectly paying a patient's premiums, for the company's own financial benefit,* ***these companies are price gouging and it's a scam****. It doesn't improve care for patients and increases the cost of health care premiums for everyone.*

The bill goes on to note the effect that the scheme has on taxpayers:

> *Nationally, this problem has added billions of dollars of costs to the individual and group health insurance markets.*

## *DaVita Is Now Defending Its Charity Scheme by Quietly Directing Over $95 Million Into Lobbying Schemes*

Rather than attacking the bill on its merits, DaVita instead quietly spent $95 million on "advocacy costs" to fuel lobbying efforts to wage a propaganda war against the bill and others like it.

Keep in mind that net income attributable to DaVita Inc. for 2018 was only $159.3 million, so the amounts spent are clearly material.

In California alone, DaVita has quietly directed $67 million in the past two years to a single group in order to combat legislation aimed at closing its charity loophole.

# *Meet the California 'Non-Profit' Group Claiming to Defend the Poor and Disadvantaged—Funded with Over $67 Million In DaVita Cash*

The lead lobbying group working *against* AB 290 in California, "Patients and Caregivers to Protect Dialysis Patients", has set up a website called "Dialysis Life Support". The group claims to be "fighting to protect dialysis patient access to quality care."


On its site, it argues that AB 290 is discriminatory and puts low-income patients at a disadvantage. Specifically, the group states:

> *AB 290 attacks vulnerable, low-income dialysis patients by eliminating charitable premium assistance (CPA) in California.*

It sounds like a virtuous fight. So, where does the money come from?

At the bottom of the lobbying group's website, it notes that it is paid for by "Patients and Caregivers to Protect Dialysis Patients, sponsored by the California Dialysis Council".


Despite its public claims to be advocating for the poor and disadvantaged, the California Dialysis Council's organizational documents say that it was formed to act *in the interest of dialysis providers*:

> ***The specific purpose of this corporation is to provide state-wide representation for end stage renal dialysis providers.***

OF

CALIFORNIA DIALYSIS COUNCIL

I

The name of this corporation is California Dialysis Council.

II

A. This corporation is a nonprofit mutual benefit corporation organized under the Nonprofit Mutual Benefit Corporation Law. The purpose of this corporation is to engage in any lawful act or activity for which a corporation may be organized under such law.

B. The specific purpose of this corporation is to provide state-wide representation for end stage renal dialysis providers.

III

As we will show, "Patients and Caregivers to Protect Dialysis Patients" seems to be nothing more than a cleverly disguised support arm for DaVita's business, appearing to act in the interests of protecting *the company rather than patients*.

## *The Non-Profit Group Seems to Conceal That 90% of its Funding Comes from For-Profit Dialysis Providers*

FollowtheMoney.org shows that about $100 million, or 90% of the budget for "Patients and Caregivers to Protect Dialysis Patients" has come from just two entities: DaVita ($67 million) and Fresenius ($33 million), providers that collectively control 70% of the California dialysis market.

FollowTheMoney.org

Search entire site...

Ask Anything Register Login

Entity Details

PATIENTS & CAREGIVERS TO PROTECT DIALYSIS PATIENTS, SPONSORED BY THE CALIFORNIA DIALYSIS COUNCIL

Non-Individual

General Data

As a ballot measure committee | Associated filers | Relationships

Overview
By Year
Measures
Top Donors
Top Industries

| Contributor | Type of Contributor | # of Records | Total $ |
|---|---|---|---|
| DAVITA INC | NON-INDIVIDUAL | 13 | $67,043,818 |
| FRESENIUS MEDICAL CARE | NON-INDIVIDUAL | 21 | $33,981,529 |
| US RENAL CARE INC | NON-INDIVIDUAL | 4 | $8,176,421 |
| DIALYSIS CLINIC | NON-INDIVIDUAL | 3 | $1,215,417 |
| AMERICAN RENAL MANAGEMENT LLC | NON-INDIVIDUAL | 3 | $552,462 |
| SATELLITE HEALTHCARE | NON-INDIVIDUAL | 2 | $508,255 |

Usually when you direct tens of millions to a non-profit cause they feature your sponsorship and highlight how critical your donation is to the organization. They might even throw you a dinner or name a building in your honor!

Contrary to that expectation, we see that DaVita and other for-profit dialysis operators are instead **buried near the very bottom** of the list of coalition members on the lobbying group's website.

# WHO OPPOSES AB 290

## HEALTH

- California Medical Association
- California Hospital Association
- Renal Physicians Association
- National Hispanic Medical Association
- National Medical Association
- Chronic Disease Coalition
- Dialysis Patient Citizens
- Minority Health Institute
- California Hepatitis C Task Force
- American Kidney Fund
- National Renal Administrators Association
- Alameda-Contra Costa Medical Association
- Fresno Madera Medical Society
- Imperial County Medical Society
- Kern County Medical Society
- Los Angeles County Medical Association
- Merced-Mariposa County Medical Society
- Monterey County Medical Association
- Napa County Medical Society
- North Valley Medical Association
- Orange County Medical Association
- Placer-Nevada County Medical Society
- Riverside County Medical Association
- San Bernardino County Medical Society
- San Francisco Marin Medical Society
- San Joaquin Medical Society
- San Mateo County Medical Association
- Santa Clara County Medical Association
- Sierra Sacramento Valley Medical Society
- Solano County Medical Society
- Stanislaus County Medical Society
- Tuolumne County Medical Society
- Yuba-Sutter-Colusa Medical Society
- Ventura County Medical Association
- Los Angeles Wellness Station
- FAIR Foundation
- California Dialysis Council
- Satellite Healthcare
- DaVita Kidney Care
- Fresenius Medical Care
- U.S. Renal Care
- Dialysis Clinic, Inc.

## COMMUNITY

- California State Conference NAACP
- Desert AIDS Project
- Community Health Action Network
- Black Women Organized for Political Action – Political Action Committee
- Sacramento Valley Section-National Council of Negro Women, Inc.

## VETERANS

- California State Commanders Veterans Council
- American Legion, Department of California
- American GI Forum of California
- AMVETS Department of California
- Women Veterans Alliance
- California Association of County Veterans Services Officers
- National Guard Association of California
- ROA Department of the Golden West
- Scottish American Military Society
- Jewish War Veterans, Department of California
- National Veterans Foundation

## BUSINESS

- Los Angeles County Business Federation (BizFed)
- Valley Industry & Commerce Association
- California Black Chamber of Commerce
- Latin Business Association
- Orange County Business Council
- Southwest California Legislative Council
- Chambers of Commerce Alliance of Ventura and Santa Barbara Counties
- Long Beach Area Chamber of Commerce
- Silicon Valley Black Chamber of Commerce
- Elk Grove Chamber of Commerce
- Oxnard Chamber of Commerce
- Greater Bakersfield Chamber of Commerce
- Filipino-American Chamber of Commerce Business Network

DaVita's name falls well below relatively unknown organizations such as the "Scottish American Military Society", "Sacramento Valley Section-National Council of Negro Women, Inc.", and the "American Legion, Department of California".

# *We Called the Organizations That Supposedly Back DaVita's Lobbying Effort: Some Didn't Even Know They Were Opposed to the Bill, Others Had No Idea DaVita Funded the Group*

Since many of these obscure organizations were listed *above* DaVita and Fresenius on the list of those who oppose AB 290, we figured perhaps they were vital to the efforts against the bill.

After calling numerous organizations on the list, a couple things became clear:

1. Most people we spoke with didn't seem to have a grasp on the bill's content, why they opposed it, or how it was even brought to their attention in the first place. Some were not even aware they opposed it at all.
2. Most of the organizations seemed small. Some were difficult to get a hold of, with "official" phone numbers leading to personal voicemails and recorded messages. Another had a defunct website.

Here's what some of the groups that oppose the bill told us, in their own words:

**Commander of the State of California American GI orum:**

> *As far as I'm concerned, I haven't been informed about anything that's out there or stance that we take, etc., so I can't really say why are we opposed to it.*

**CE of the xnard Chamber of Commerce:**

> *Um, I'm trying to remember off the top of my head which one this is. We've followed some that have to do with dialysis for 2 or 3 years now, so I'm trying to wrap my head around which one this is.*

When asked if she knew they were part of the coalition: Yes, but we're probably in 50 or 60 coalitions."

When asked if she knew DaVita and Fresenius funded the coalition: "That wouldn't surprise me. They're trying to protect their interest obviously."

**Legislative Affairs Manager at Valley Industry and Commerce Association:** We asked if he knew that most of the funding for the coalition came from DaVita and Fresenius. His response: "Uh, no."

**ress Contact for the Desert AIDS rojec:** Seemed completely surprised that the organization was involved in anything to do with dialysis:

> *This being Desert AIDS project…we have 6500 clients who are getting medical care from us. Only half of them actually have HIV, the other half are just getting primary care – a lot of those folks are getting treatment for Hepatitis C. So, when you're talking about kidney care, I'm like 'wow, that's interesting'*

**resident of the National Veterans oundation:**

> *I really listen to those veteran lobbyists that advise the group…I just wait and look at everybody and then once they say 'hey, this is really good' and they do a little paragraph, I go 'OK, NVF supports'.*

**Associate Director of Alameda-Contra Costa Medical Association:**

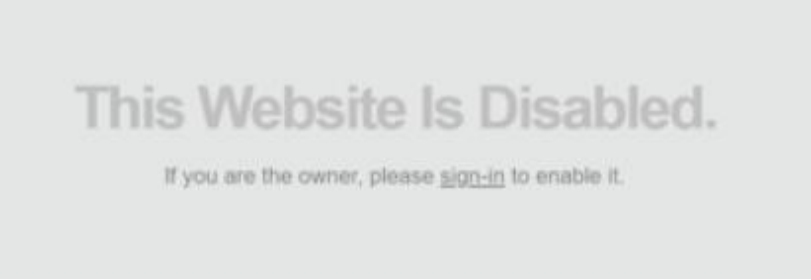
> *Normally we are in alignment with CMA's view. If the CMA opposes something, most likely we'll be opposing it…Our main leader is the California Medical Association when it comes to this opposition.*

(Despite the California Medical Association seemingly guiding its local chapters, roughly a dozen chapters were *individually* listed as opponents, in addition to the CMA itself. This gives the appearance of a broad coalition of medical organizations opposing the bill despite the direction coming from only one group.

In other instances, we called organizations opposed to the bill and found that they either went straight to voicemail or didn't seem to have much of an organization at all.

For instance, the website address we found for the Chambers of Commerce Alliance of Ventura & Santa Barbara Counties, www.chamberalliance.biz, came up with a message that said "This

Website is Disabled".




Our calls went straight to voicemails when we called the ROA Department of the Golden West and the Black Women Organized for Political Action.

All told, despite dozens of calls to numerous organizations, we couldn't find one well-informed member of the coalition who read the bill or who could articulate clear reasons for their opposition.

## *Charity Scheme Victim: The AKF Cost My Mom Her Last Chance at a Kidney Transplant, We Were "Devastated"*

The ultimate impact of this charade is significant. Along with burdening the medical system with billions in excess costs, the AKF has also impacted patients and their families.

The daughter of one victim recently wrote an op-ed for the California Capital Weekly, highlighting DaVita's scheme and how it led to her mother missing the opportunity for a possibly lifesaving kidney transplant:

> ***It didn't take long for us to realize what a mistake we'd made. Patient care was never the priority of the American Kidney Fund.*** *It was making a profit for its funders, DaVita and Fresenius. Patients like my mom were encouraged to switch to private health insurance because it lets the large, for-profit dialysis corporations make more profit than they would from patients covered by Medi-Cal or Medicare.*
>
> *After signing up with the American Kidney Fund, my mom started having to pay high out-of-pocket costs for her medications – something she never had to do with Medi-Cal. When she tried to schedule a normal appointment with her doctor, the clinic said they couldn't see my mom because they didn't accept her new health insurance.*

> *With all the money we were spending, we were getting so stressed* ***That's when we began trying to get my mom back into Medi-Cal, a process that took eight months. By that time though, she was 68 and considered too old to be eligible for a kidney transplant.***
>
> ***We were devastated****My mom's dialysis clinic told us we were doing the right thing by switching to commercial insurance paid for by the American Kidney Fund, and yet she ended up with inferior coverage that cost my mom her chance of getting a new kidney.*

When California Assemblyman Wood introduced AB 290 he specifically called out this problem:

> *…patients caught up in these schemes may face higher out-of-pocket costs and mid-year disruptions in coverage, and may have a more difficult time obtaining critical care such as kidney transplants.*

## *Why We Have No Position in the Stock, Long or Short*

We'd like to provide a quick note on the dynamics of DaVita's stock. As investors, we look for sustainable business models and therefore view DaVita as a terrible long-term business model. That being said, we have no position today because the company has a liquid balance sheet after the recent sale of a division, and has signaled an aggressive intent to buy back its shares.

While now we are primarily concerned with shining light on the company's lobbying scheme, we may reevaluate DaVita as a potential short down the road.

## *Conclusion: DaVita is Engaged in a Multi-Front Fight for Its Life That We Expect It Will Eventually Lose, Though It Will Take Time*

Organizations that provide great service at reasonable prices don't need to use underhanded lobbying efforts to save their charity scams.

While the proposed California bill has made some headlines, much of the work against it (and against similar legislation in other states) is being done behind closed doors. The purpose of our article today is to provide an update on the DaVita story and to shine sunlight into a

lobbying effort that appears, at least to us, to be yet another scheme born out of an already existing scheme to further strain an already inefficient healthcare system.

**Disclosure: We have no position in any of the stocks mentioned**

# TAB 25

# Update: After 96 Hours, Predictive's 'Response' Fails to Address a Single Point from Our Detailed Report

Published on July 15, 2019



Predictive Technology Group (the "Company") *barely* responded this morning to our 10,000 plus word report that we released last Thursday, which had prompted shares to reprice more than 40% lower.

Our report documented extensive executive red flags, signs of insider self-dealing relating to the Company's acquisitions, and issues with the Company's procurement and marketing of its stem cell products, among other issues. It included over 190 source links, firsthand evidence, photos, and video to support its conclusions.

Given that a full 96 hours had elapsed since our report was published, we were expecting a

thorough, detailed response from the Company.

Instead, the Company's release this morning failed to address a single element of our report, claiming that it "will not dignify the opinion piece with a point-by-point response." It bizarrely claimed that we are anonymous authors (we are not) and then quoted sections of our standard legal disclaimer, as if that somehow undermines our strong, well-founded views.

The Company's lack of response just furthers our suspicions. Any time a company fails to address the facts lodged against it on a point by point basis it suggests, to us, that the facts are not on its side.

We believe it is of utmost importance to note what management has **not** said with today's non-response. This is just a partial list of our findings, but should be an obvious starting point on items that shareholders deserve to know:

1. We showed Predictive's Chairman and then director (up until recently) had settled earlier SEC fraud charges.

The Company's response: **none.**

2. We showed (here, here and here) that Predictive's 3 key original holders, who represented almost 90% of the original shareholder base, had previously been charged with securities fraud by federal or state regulators, including allegations of pump and dumps, boiler room sales, and false press releases.

The Company's response: **none.**

3. We showed that the Company receives its donated birthing tissue from new moms who are often completely unaware that their 'donations' go to for-profit causes.

The Company's response: **none.**

4. We showed that Predictive's distributors use dubious sales tactics and aggressive claims to sell its products to elderly patients suffering from chronic pain, and provided multiple examples.

The Company's response: **none.**

5. We showed that 4 out of 7 of Predictive's acquisitions were entities based out of their own address *before* they were acquired, and that the acquisitions displayed hallmark signs of insider self-dealing. (Source documents: 1,2,3,4)

The Company's response: **none.**

6. In one example, we showed that Renovo Biotech was formed less than 2 months earlier at Predictive's own address before being acquired for $14 over million, largely for "trade secrets".

The Company's response: **none.**

7. In another example, we showed that Predictive CEO Bradley Robinson was listed as a manager/managing member of **LifeCode Genetics** just prior to its acquisition by Predictive, yet we found no Predictive filing disclosing any stake held by Robinson in the entity. We questioned whether Robinson had an undisclosed stake in this acquisition.

The Company's response: **none.**

8. We showed that 90% of the purchase price for Predictive's InceptionDX acquisition went to **unnamed individuals** in the Caymans and asked whether these individuals were arms-length.

The Company's response: **none.**

9. We showed other examples of irregularities relating to the Company's acquisitions and specifically encouraged the Company to provide the investing public with details of the shareholders of its acquisitions, as such information could easily clarify whether any related party dealings took place in these transactions.

The Company's response: **none.**

10. We showed that the Company had seemingly altered a lab report to include conclusions about the number of viable cells in the product that were never in the original report, then used the altered report to market its products.

The Company's response: **none.**

11. We expressed doubts about whether the Company's products had any live stem cells or could legally make claims to have any live stem cells.

The Company's response: **none.**

12. We showed that Predictive's CEO had previously been sued and apparently settled lawsuits involving allegations of securities fraud and non-compliant marketing of a medical product.

The Company's response: **none.**

13. We showed that Predictive's CEO had originally reverse-merged an FDA-rejected medical technology into the entity that ultimately became Predictive.

The Company's response: **none.**

14. We showed that top organizations studying endometriosis research expressed serious doubts about the Company's diagnostics test and the ability to diagnose endometriosis via diagnostics alone.

The Company's response: **none.**

15. We showed that the Company has historically missed its own near-term commercialization timelines for its diagnostic tests and expressed concerns that they may again miss their own timelines.

The Company's response: **none.**

We believe shareholders deserve full transparency from management and today's response brings them further from that goal, instead of closer to it.

Contrary to the Company's statements, we stand by our research 100%. We haven't covered **one single share** of our short position. In fact, we increased our short position this morning after the Company's response and will look to increase it further.

**Disclosure: We are still short shares of redictive. See our original report for our full disclaimer and for the complete set of findings that management failed to address today.**

# TAB 26

# Predictive Technology: 95% Downside on CEO and Former Chairman's Past Securities Fraud Allegations, Acquisitions That Reek of Insider Self-Dealing and Dubious "Miracle Cure" Sales Tactics

Published on July 11, 2019



- Predictive's key original holders and recent Chairman/director have previously been charged by regulators with securities fraud, including allegations of pump and dumps, boiler room sales, and false press releases.
- Predictive's CEO Brad Robinson has a checkered history, including allegations of securities fraud and of non-compliant marketing of a medical product.

- Predictive has embarked on a flagrantly suspicious acquisition spree that displays hallmarks of insider self-dealing. Specifically, 4 of Predictive's 7 acquisitions were entities based out of Predictive's own address *before* they were acquired.
- Predictive's revenue is derived almost entirely from sales of stem cell products, a business that appears to be predicated on (i) sourcing birthing tissue from pregnant women who wrongly believe they are donating it to purely non-profit causes, and (ii) aggressive "miracle cure" sales tactics targeted toward elderly customers suffering from chronic pain.
- We attended a sales seminar held by one of Predictive's largest distributors, run by a doctor in Georgia. The pitch was targeted toward elderly customers and relied heavily on aggressive claims and celebrity testimonials.
- We also contacted multiple new moms who donated birthing tissue to Predictive's thinly disclosed subsidiary under false impressions that their donations were going to be used for non-profit causes.
- We believe there is 80% downside to Predictive's shares purely on valuation alone and 95% downside given the issues we have uncovered.

***Initial Disclosure:****After extensive research, we have taken a short position in shares of PRED (a really large short position, in fact). We stand to benefit financially if the stock price declines. This report represents our opinion, and we encourage every reader to do their own due diligence. Please see our full disclaimer at the bottom of the report.*

## *Introduction: About Our Investigation*

This report follows an extensive, months-long investigation, which included on-the-ground research at Predictive's facilities in Utah, an undercover meeting with a key product distributor in Atlanta, and multiple conversations with former employees and industry experts. We also spoke with multiple new moms who wrongly believed they were donating their birthing tissue to purely non-profit causes such as research into how stem cells can treat deadly diseases.

We have investigated numerous companies and bad actors in our history, many of which have subsequently been charged by regulators with securities fraud, and we can't recall examining a business with as many issues as Predictive. We think this company is rotten to its core.

## *Background: Basics About the Business and the Bull Thesis*

Predictive went public on the OTC Market via a reverse merger in 2015. Originally, the public entity had been used by a company that sold vitamin-laced showerheads, then later reverse merged into a shoe company, which then reverse-merged into a housing company, before finally reverse merging into Predictive in 2015. It then applied to uplist onto NASDAQ about 2

months ago.

Predictive purports to be a life sciences company that primarily focuses on two lines of business:

1. Procuring and selling regenerative medicine products (mainly stem cell products derived from placental/birthing tissue).
2. Developing diagnostic tests to detect diseases (primarily an endometriosis test).

The stock has been on an absolute tear, up roughly 320% year-to-date, fueled by multiple paid promotion campaigns ( 1,2,3).


The company is presently flagged by the OTC Markets for undergoing current stock promotion efforts.


The bull thesis focuses mainly on:

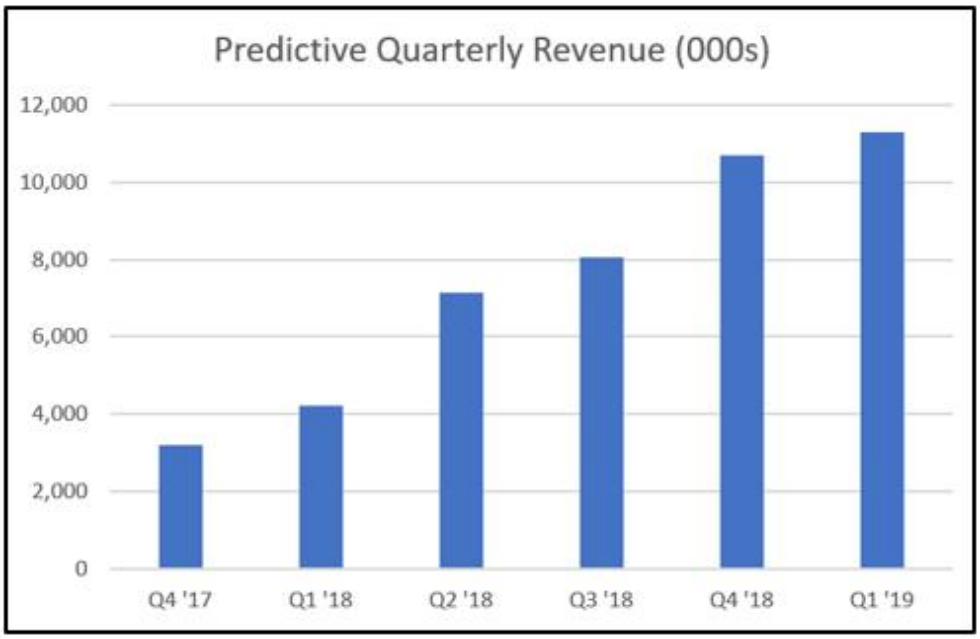
1. Growth in the company's stem cell business
2. Upside from the possible roll-out of the company's endometriosis test, which has been touted as a potential game-changer in a large market

As we will show, we think the stem cell business is subject to major operational, legal, and regulatory risks that are likely to impede (if not totally eradicate) this source of revenue.

We will also show why we believe the company's latest attempts to roll out its endometriosis test will sputter. Multiple industry experts have expressed doubts about the viability of the test and historical marketing materials from Predictive's subsidiary show a history of delays-the endometriosis test was slated for a roll-out in Q1 of 2016, but was then tabled for years. We expect this latest attempt will result in similar delays.

## *Background: Predictive's Stem Cell Business Accounts for Virtually All of its Revenue and Appears to be Predicated on 2 Key Falsehoods*

Thus far, virtually all Predictive's revenue has come from sales of its regenerative medicine (i.e.: stem cell) products. [ Pg. 5] The company's quarterly revenue growth has been on a strong upward trajectory:




(Source: OTC Markets )

As we will show, this stem cell business model which accounts for almost all Predictive's

revenue appears predicated on two key falsehoods:

1. Pregnant women donate their birthing tissue to a subsidiary of Predictive under the false notion that they are donating solely to research and other non-profit causes.
2. The donated tissue is then sold to a network of pain management clinics that then use high-pressure sales tactics and make outlandish claims about the effectiveness of the product. The target audience for this appears to be the elderly and those suffering from chronic pain.

## *Background: Predictive's Irregular Acquisition Spree Displays Hallmarks of Undisclosed Insider Self-dealing*

Beyond its core-revenue generating business, we will also explore Predictive's $120 million acquisition spree.

In particular, **out of 7 of redictive's recent acquisition targets were based out of the same address, which also happens to be redictive's old headquarters**[1] For context:

### *Predictive's Headquarters: 2749 East Parleys Way*

**Item 8.01 Other Information.**

The Company, on January 29, 2016 moved it primary location from Virginia Beach, VA to that of the following:

PREDICTIVE TECHNOLOGY GROUP, INC.

2749 East Parleys Way, Suite 101

Salt Lake City, UT 84109

### *Registered Addresses of 4 of Predictive's 7 Acquisitions Before They Were Acquired-The Same Address!*

| Acquired Entity | Registered Address | |
|---|---|---|
| ReNovo Biotech | 2749 Parleys Way | |
| Inception DX, LLC | 2749 Parleys Way, | St. 101 |
| Taueret Laboratories | 2749 Parleys Way, | St. 100 |
| Juneau BioSciences | 2749 Parleys Way, | St. 210 |

(Source documents: 1,2,3,4)

Corporate records from another acquisition target, LifeCode Genetics , show that Predictive's CEO/President Bradley Robinson had a managing role just *prior* to the entity being acquired by Predictive. We found no disclosure about Robinson having any stake in the acquisition target.

Predictive has shoveled $120m in cash and stock in what we believe are questionable acquisitions that are unlikely to generate shareholder value. Predictive is also slated to pay an additional $12 million in cash installments that extend until 2021 for another questionable acquisition, based out of the same address, that we will detail further in this report. We expect this obligation will vampirically drain Predictive's already-low cash balance for the foreseeable future.

## *Background: Three of Predictive's Key Backers (Who at One Point Held ~90% of its Shares) Have Previously Been Alleged by the SEC or State Regulators to Have Committed Securities Fraud*

Lastly, we will explore the background of Predictive's former Chairman/Director, its key early backers, its CEO, and its auditor.

Merle Ferguson served as Chairman of the Board of Predictive since its outset as a public company [ Pg. 43] and continued serving in that capacity until his replacement in October 2018. Ferguson then served as a director until March 18th of this year, when he was replaced by none other than former Senator Orrin Hatch.

Ferguson was previously charged by the SEC with fraud relating to allegations that he filed false press releases as an executive of a public company. Ferguson and another key Predictive holder, Susan Donohue, later settled the charges.

U.S. Securities and Exchange Commission

**Securities and Exchange Commission**

**Litigation Release 17328 / January 22, 2002**

***SEC v. World Homes, Inc., Merle Ferguson and Susan Donohue*, Civil Action No. CV-S-01-0658-PMP-LRL (USDC D. Nev.)**

On January 14, 2002, the Honorable Phillip M. Pro issued final judgments of permanent injunction against World Homes, Inc., currently known as Composite Industries of America, Inc., and Merle Ferguson, its President and Chief Executive Officer, enjoining them from future violations of the securities registration and antifraud provisions fo the federal securities laws. In addition, Susan Donohue, the company's Secretary-Treasurer, was enjoined from future violations of the securities registration provisions. The defendants consented to the orders without admitting or denying the Commission's allegations. Ferguson was also ordered to pay a civil money penalty in the amount of $120,000.

We will show that along with Ferguson/Donohue, almost 90% of Predictive's shares were controlled by 3 individuals that had previously been charged with securities fraud either by the SEC or state regulators. The charges ranged from allegations of engaging in boiler-room-fueled pump and dumps to issuing false press releases.

In addition to key holders, we also review the biography of Predictive's CEO/President Brad Robinson. We found that Robinson's official biography omits several of his professional missteps, including running a failed company that attempted to commercialize cholesterol-lowering algae water. That venture ended up mired in litigation, where Robinson was sued over allegations of securities fraud and allegations of improper marketing of a medical product.

Lastly, we explore Predictive's auditor, BF Borgers. The auditor operates a small business out of Colorado whose clients mainly consist of tiny companies trading on the OTC. One example is The Lingerie Fighting Championships (Pink: BOTY), which sports a market cap of $200 thousand as of the time of this writing. We do not view BF Borgers as an auditor credible or capable enough to handle the size and complexity of Predictive's acquisition-laden entity structure.

All told, we think key people and service providers surrounding Predictive are major warning signs.

## *Background: Priced Beyond Perfection-80% Downside*

## *Purely on Valuation Alone*

Given the issues with its core business model, its irregular acquisition spree, and management's suspect bios, we view Predictive as totally uninvestable.

But putting all that aside for the moment, with a market cap of $1.1 billion, Predictive is currently priced beyond perfection, purely on valuation alone:

- Price to sales of 24x using Q1's run-rate ($45m run rate). (P/S of 29x on a last-twelve-months basis.)
- Consistent net losses and an accumulated deficit of ~$34 million as of Q1.
- Tangible book value (net of equity method investments) of -$3 million as of Q1.
- Dangerous current ratios of 0.63 and a quick ratio of 0.33. With cash of only $1.8 million the company has limited short-term liquidity.

Note Predictive's high intangible asset balances, owing largely to assets acquired through the company's acquisition spree:

**PREDICTIVE TECHNOLOGY GROUP, INC.**
**UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

| | March 31, 2019 |
|---|---|
| | *Unaudited* |
| **ASSETS** | |
| Current assets: | |
| Cash | $ 1,826,420 |
| Accounts receivable | 812,443 |
| Inventory | 3,682,658 |
| Other current assets | 1,233,469 |
| Total current assets | 7,554,990 |
| Fixed assets, net of depreciation | 7,107,638 |
| License agreements, net of amortization | 15,067,404 |
| Patents, net of amortization | 7,351,127 |
| Trade secrets, net of amortization | 42,846,223 |
| Other intangible assets, net of amortization | 411,000 |
| Equity method investments | 51,774,200 |
| Goodwill | 5,254,451 |
| Other long-term assets | 12,069 |
| Total assets | $ 137,379,102 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | |
| Current liabilities: | |
| Accounts payable | $ 2,738,267 |
| Accrued liabilities | 1,555,710 |
| Deferred revenue | 501,685 |
| Capital lease obligation, current portion | 2,114,491 |
| Subscription payable | 4,950,000 |
| Total current liabilities | 11,860,153 |
| Capital lease obligation | 1,784,471 |
| Long-term subscription payable | 5,840,610 |
| Deferred tax liabilities | 5,533,619 |
| Total liabilities | 25,018,853 |

(Source: PRED Mar. '19 10-Q)

In addition to the above, Predictive has an agreement with one questionable entity to make monthly cash payments until 2021 – a setup that we believe will vampirically drain up to $12 million in cash going forward.

We also looked at the company's acquired intellectual property portfolio, which largely consists

of patents/pending patents and early-stage initiatives that would require substantial new investment in order to even assess its viability. We harbor doubts about whether there is any meaningful value in its IP portfolio, given the questionable nature of the acquisitions.

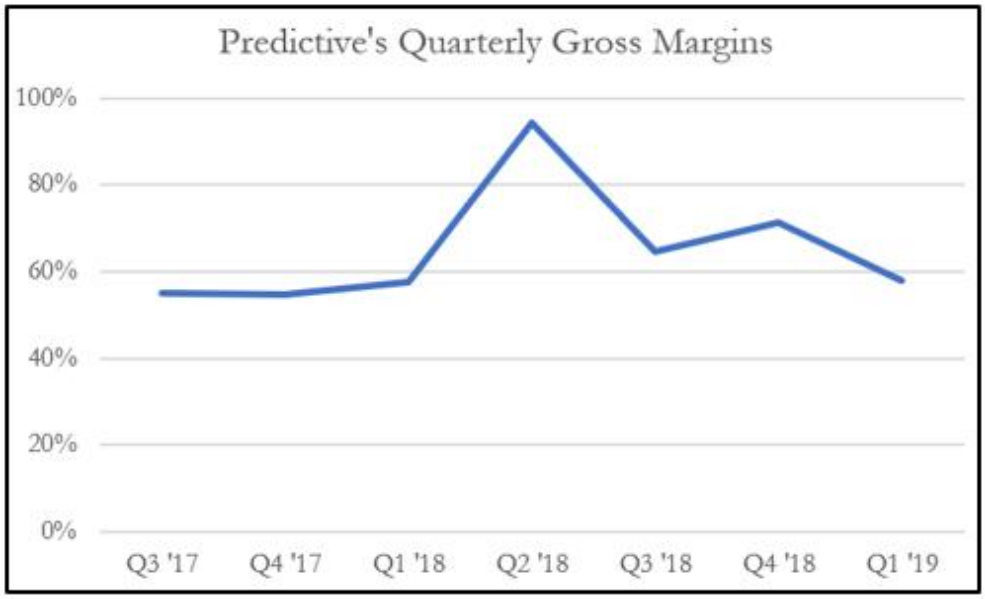
Given the company's absence of net income, negative tangible book value, and spotty operating cash flow, we are left with a revenue multiple analysis.

When applying an extremely generous 5x revenue multiple to Q1's run-rate, we arrive at a market cap of $225 million, or roughly $0.78 per share, implying downside of at least 80%, using a *highly optimistic*valuation basis. However, given the additional red flags we have unearthed, we see 95% downside for Predictive's shares.

## *Part I: Predictive's Stem Cell Business-Misled Pregnant Women and Elderly Patients Suffering from Chronic Pain*

As noted above, virtually all of Predictive's revenue comes from sales of its stem cell product, which is derived from birthing tissue from new mothers. The tissue is donated to a subsidiary of Predictive, where, based on our research, it is then stored and then sold to a network of distributors nationwide. These tissues are said to be rich in stem cells and other growth factors and form the foundation of the company's current product offering.

In reviewing Predictive's financials, we noticed that the company had incredibly impressive gross margins, ranging from 55%-94%:

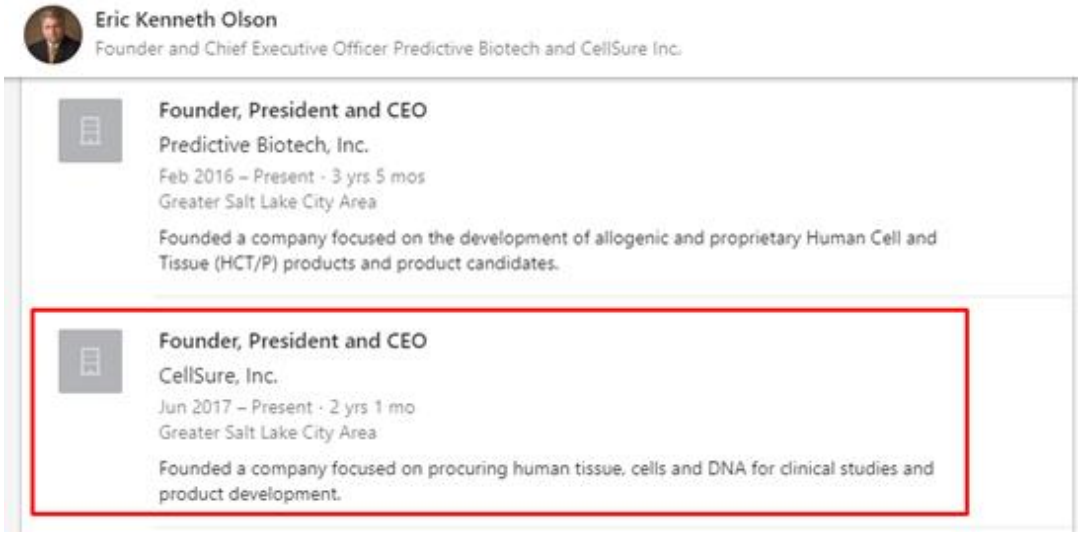



(Source: OTC)

This would prompt any person to wonder: how is the company procuring its birthing tissue product so cheaply?

## *Predictive Has a Thinly-Disclosed Subsidiary Named CellSure That Encourages Pregnant Women to Donate Birthing Tissue to a 'Good Cause'*

As we researched Predictive's employee backgrounds, we noticed that the head of a key Predictive subsidiary listed another company on his Linkedin profile called CellSure.




On CellSure's website, it describes itself as a "placental cord blood and tissue storage and donation company" which gives families the option to pay for storage for their own use or to donate to a good cause.

Curiously, the "About" page for CellSure makes no references to Predictive and only recently began listing an address.

## About CellSure

CellSure™, a Salt Lake City, Utah, based placental cord blood and tissue storage and donation company, gives families the opportunity to have access to current and future life-changing stem cell therapies.

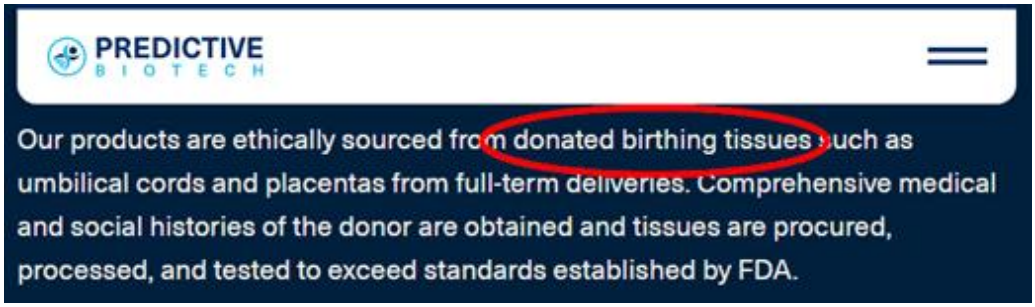
We help parents understand their options for their child's birthing tissue, make it affordable, and help those in need.

**(866) 646-6171**

customerservice@cellsure.com

Similarly, we were unable to find any reference on Predictive's website to CellSure.

On Predictive Biotech's website, all we see is the company say that its products are sourced ("ethically") from donated birthing tissue, although the source of the donations is not disclosed.




However, when we visited Predictive's offices in Utah, we found that the building signage describes them as "Predictive Biotech, Inc. / CellSure":


CellSure had likely been operating as an undisclosed related entity until about a month ago on May 22nd 2019, when its name was mentioned once in an amended prospectus as a wholly owned subsidiary of Predictive.

**GENERAL**

Predictive (the Company) was formed in 2005 under the laws of the State of Nevada. The Company is headquartered in Salt Lake City, Utah. We are a life sciences company and a leader in the use of data analytics for disease identification and subsequent therapeutic intervention through precision biopharmaceutical solutions. Through our wholly-owned subsidiaries, Predictive Biotech, Inc. Cellsure, L3C, Predictive Laboratories, Inc., Predicitve Therapeutics, Inc.,and through our equity investment in Juneau Biosciences, LLC, we focus on four main clinical categories: Endometriosis, Scoliosis, Degenerative Disc Disease and Regenerative Human Cell and Tissue Products. In addition to our efforts

## *The True Purpose of the Tissue Donated to CellSure/Predictive Is Obfuscated*

CellSure's website says that it gives parents the option to " help those in need ", and describes research being done using stem cells. The implication from this description is that donations go to critical research for autism, diabetes, Alzheimer's, Parkinson's, and other deadly diseases.

CellSure's website implies that its mission is charitable, claiming that the donor's child will

become a "hero the day they are born."

We contacted CellSure support and asked about where the donations go. Their response was:

> *Donations can go towards ongoing research, studies, and to help build our public bank.*

(A public bank is typically a non-profit charitable bank that can be used by members of the community to help treat life-threatening diseases).

**Customer Service - Cellsure**
to me

Hi

The Learn More option is just if you have questions that need to be answered. To enroll, you'll have to go on our website, https://cellsure.com/ , and on the top right hand corner, click the "Enroll today" icon. It'll take you to a different page, and you'll click "get started" this will prompt you to a questionnaire to see if you qualify for donation.

As far as safety concerns, we follow FDA and AATB guidelines. This is a reason we need the enrollment and questionnaire filled out. The Hospital takes care of the actual collection of the tissue, a blood draw, and some paperwork for the provider to fill out. All of the supplies to do so are inside the collection kit that we provide.

Donations can go towards on going research, studies, and to help build our public bank. If you are local, we have multiple procurement specialists who would be able to get the kit to you, as well as pick it up from the Hospital after delivery. Once the enrollment process is complete, one will reach out to you in regard to getting the collection kit to you.

Please let me know if you have any further questions.

Thank you,

Megan Wyatt
Data Entry Specialist

The donors seem to believe this as well. We were able to contact 4 new moms who had donated to CellSure, per the company's Facebook page. We approached them on the grounds of wanting to learn more about the donation process.

Three of the four unequivocally believed that CellSure was a non-profit that would use the tissue for things like "(treating) people who are very ill" or "to research ways to reverse many different diseases".

**Conversation 1**

Hello! I'm happy to talk to you about it! We donated with my daughter when she was born and we are doing it again with our second! Cellsure is great to work with! I've even had a few friends donate with them and they enjoyed their experience with them. They send you a kit that you take with you to the hospital and give to your nurses and they take care of everything. They are a national bank so it goes to people all over the country who need it.

Non-profit?

Yes they are! If you are interested in going more local (or want to do a placenta donation) The Utah Cord Bank also takes donations and everything stays local. They are also a non-profit 🙂

**Conversation 2**

The donation can help more than one person?

Yes it can. They use the cells to research ways to reverse many different diseases. They are researching ways to reverse ALS, autism, etc. the only extra thing they do is take some blood samples from the mom, but they already have to poke for blood and iv's, so it's really nothing extra.

That's great. Non-profit?

Yes it is a non profit organization.

The fourth donor we contacted actually worked at Predictive Biotech as a lab manager, per her LinkedIn profile. During our conversation, she mentioned that she worked for a "sister company" of CellSure. When asked if CellSure was a non-profit, she said "I think so" but then claimed not to remember, despite having left Predictive only 3 months earlier.

CellSure is actually registered as a "low-profit limited liability company", which Utah defines as a company meant to "significantly further the accomplishment of one or more charitable or educational purposes" and "would not be formed but for the company's relationship to the accomplishment of a charitable or educational purpose".

Utah Department of Commerce
Division of Corporations and Commercial Code

Home | Business Entities | UCC/CFS | Searches | Other Services

HOME > Business Entities > Low-Profit Limited Liability Company

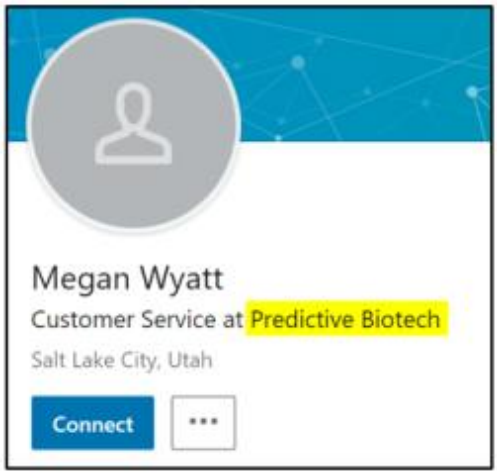
**Low-Profit Limited Liability Company**

A Low-Profit Limited Liability Company (L3C) shall significantly further the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B), Internal Revenue Code; shall demonstrate that it would not be formed but for the company's relationship to the accomplishment of a charitable or educational purpose; subject to Subsection (3), may not have as a significant purpose the production of income or the appreciation of property; and may not have as a purpose to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D), Internal Revenue Code.

In other words, low profit organizations are supposed to exist primarily to advance a charitable or educational purpose.

## *The Real 'Good Cause': Predictive's Bottom Line*

Recall from our customer service interaction above that we had communicated with Megan Wyatt from CellSure about all the good causes the donated tissue goes towards. But, from Ms. Wyatt's LinkedIn profile we see that *she actually works at Predictive*!




We found other LinkedIn profiles showing that key employees worked concurrently at both Predictive and CellSure ( 1,2,3).

All told, pregnant women falsely believe they are donating their birthing tissue to purely non-profit causes, when in fact it is going to a subsidiary of a public company and then sold for profit.

We emailed the company IR asking whether they make it clear to women that their birthing tissue goes to a public company rather than non-profit causes and have not heard back as of this writing.

## *Does it Work? It is Unclear Whether the Stem Cells are Even Alive, Let Alone Functional*

Given that Predictive's stem cell products have not been FDA approved or cleared, they are offered only *as FDA registered tissue products*. What this means is that it was registered using an online form through the FDA's website, without the thorough independent vetting of an FDA testing process.

At one point, Predictive apparently portrayed that its product had a large number of viable

stem cells based on a report from a University of Utah lab. However, it turned out that Predictive had altered the report to include conclusions about the number of viable cells which were never actually in the original.

**Side by Side Comparison**

**Original Report – Page 2**

| Cat# | Vendor | Antibody | Fluor | ul/test |
|---|---|---|---|---|
| 11-0909-41 | eBioscience | CD 90 | FITC | 2.5ul |
| 11-4714-41 | eBioscience | IgG | FITC | 2.5ul |
| 12-1057-41 | eBioscience | CD105 | PE | 2.5ul |
| 12-4714-41 | eBioscience | IgG | PE | 5ul |
| 25-9459-41 | eBioscience | CD45 | PECY7 | 2.5ul |
| 25-4714-41 | eBioscience | IgG | PECY7 | 2.5ul |
| 17-0739-41 | eBioscience | CD73 | APC | 2.5ul |
| 17-4714-41 | eBioscience | IgG | APC | 0.625 |
| | | viability | DAPI | 5ul |

**Reagents**

Wash Buffer- 2.5%BSA in PBS (Core)

**ASSAY RESULTS**

**Fresh Sample ID**

Excluding RBC contamination, cellularity consisted of 9.7X10^5 viable cells per mL. Viability based on exclusion of DAPI equals 67.6%. Cellular phenotype consisted of:
CD90= 59.2%
CD105= 55.4%
CD73= 86.7%
CD45= 3.19%

**Frozen Sample ID**

Excluding RBC contamination, cellularity consisted of 7.8X10^5 viable cells per mL. Viability based on exclusion of DAPI equals 43.1%. Cellular phenotype consisted of:
CD90= 28.0%
CD105= 35.1%
CD73= 84.4%
CD45= 4.06%

James Marvin
Director, Flow Cytometry SRL

**Altered Report – Page 2**

| Cat# | Vendor | Antibody | Fluor | ul/test |
|---|---|---|---|---|
| 11-0909-41 | eBioscience | CD 90 | FITC | 2.5ul |
| 11-4714-41 | eBioscience | IgG | FITC | 2.5ul |
| 12-1057-41 | eBioscience | CD105 | PE | 2.5ul |
| 12-4714-41 | eBioscience | IgG | PE | 5ul |
| 25-9459-41 | eBioscience | CD45 | PECY7 | 2.5ul |
| 25-4714-41 | eBioscience | IgG | PECY7 | 2.5ul |
| 17-0739-41 | eBioscience | CD73 | APC | 2.5ul |
| 17-4714-41 | eBioscience | IgG | APC | 0.625 |
| | | viability | DAPI | 5ul |

**Reagents**

Wash Buffer- 2.5%BSA in PBS (Core)

**ASSAY RESULTS**

**Fresh Sample ID**

Excluding RBC contamination, cellularity consisted of 9.7X10^5 viable cells per mL. Viability based on exclusion of DAPI equals 67.6%. Cellular phenotype consisted of:
CD90= 59.2%
CD105= 55.4%
CD73= 86.7%
CD45= 3.19%
Total Viable Mescheucymal Stem Cell Count: 1,200,000 per mL. (This number is an approximation based on the use of bead markers. There is to be expected normal cell loss based on the steps to process the sample before Flow Cytometry testing. The 1,200,000 per mL number is the cell count that remains after testing protocol preparations.)

**Frozen Sample ID**

Excluding RBC contamination, cellularity consisted of 7.8X10^5 viable cells per mL. Viability based on exclusion of DAPI equals 43.1%. Cellular phenotype consisted of:
CD90= 28.0%
CD105= 35.1%
CD73= 84.4%
CD45= 4.06%
Total Viable Mescheucymal Stem Cell Count: 800,000 per mL. (This number is an approximation based on the use of bead markers. There is to be expected normal cell loss based on the steps to process the sample before Flow Cytometry testing. The 800,000 per mL number is the cell count that remains after testing protocol preparations.)

James Marvin
Director, Flow Cytometry SRL

The highlighted text on page 2, represents the addition of data after the report was completed by James Marvin, Director of University of Utah's Flow Cytometry Lab.

*Authorization to alter the report was not given by James Marvin or the University of Utah.

**Permission to share the altered report with physicians or the industry was not granted by James Marvin or the University of Utah.

A competitor did an analysis of the *unaltered* lab work, declaring that "these cells have been through the proverbial wringer." He couldn't conclude that there were *any* live stem cells in the company's products.

Doubts about the live cell count of stem cell products are not exclusive to Predictive. ProPublica recently wrote an investigative piece on aggressive profiteering in the world of stem cells. The piece found that products often had little evidence to back up claims of efficacy and even that many had no live cells at all.

The ProPublica article focused largely on the Utah Cord Bank, a competing manufacturer of Predictive which processes similar types of stem cell product. (In fact, Predictive's Chief Laboratory officer was one of 2 key employees at the Utah Cord Bank before defecting to Predictive ).

Per the ProPublica article :

> *For most of these products, there's not many healthy cells left," Daniel Kuebler, the dean of the School of Natural and Applied Sciences at Franciscan University of Steubenville, Ohio, said*
>
> *…Even if there are some cells that are still alive post-thaw, "I have a hard time getting them to grow," Kuebler said. "Just because they're alive doesn't mean they're not in the process of dying.*
>
> *Lisa Fortier, a researcher at Cornell University and a consultant for a company that sells birth-tissue products, tested nine (products) from four manufacturers-[Predictive was not one of them]-and also found no live cells. It is 'very unlikely' that the amniotic membrane "works as a stem-cell product," she said.*

**Beyond ro ublica, fifteen doctors from institutions such as Stanford, Cornell, the Mayo Clinic, and others recently signed a consensus statement warning about the aggressive marketing of non-viable birth tissues as live stem cell" products.**

In short, we believe that Predictive's products have a lack of scientific support, and without FDA testing cannot make claims that the cells are even alive, let alone make any clear claims of efficacy.

However, this hasn't stopped Predictive's products from being aggressively pushed forward through distributor sales channels.

## *Once Predictive Procures the Tissue, Distributors Use Aggressive Sales Tactics to Sell it to Patients Suffering from Chronic Pain*

Once the tissue is donated to CellSure, based on our research, it is then processed and sold through Predictive to a network of distributors across the country. We found no examples of the procedures being covered by insurance, owing to the fact that the stem cell procedures are not FDA tested.

Instead, patients pay in cash. Prices range anywhere from $5,000 to as high as $25,000 per treatment, based on our conversations with multiple patients and distributors. These treatments can quickly add up to big income for practitioners.

Many use high-pressure sales tactics, including holding seminars that preach stem cell therapy as a sort of miracle cure for a wide array of ailments.

## *Key Distributor Southern Stem Cell Institute: "97% -99% of Patients Went from Ten to Zero on the Pain Scale"*

In Atlanta, Dr. Richard Ambrozic of the Southern Stem Cell Institute (SSCI) is a Predictive distributor who has claimed to perform "thousands" of procedures nationwide.

We initially found Dr. Ambrozic through a competitor who identified his affiliation with Predictive. We then confirmed that he uses Predictive products from his marketing materials.

Dr. Ambrozic regularly holds seminars for prospective customers and claims that he can use stem cells to treat nearly *any* kind of orthopedic condition (along with fibromyalgia, erectile dysfunction ( viagra is the main solution), neuropathy, and a host of other issues) with success rates that completely defy medical convention.

CLICK HERE TO WATCH SSCI'S WEBINAR (minute 14:20 for the success rate)


## *Key Distributor Southern Stem Cell Institute: Our Experience Attending a Stem Cell Seminar at a Hampton Inn in Newnan, Georgia*

We signed up for one of Dr. Ambrozic's stem cell seminars to get a sense of the experience. It was held in a small breakout room at the Hampton Inn in Newnan, Georgia, about 45 minutes outside of Atlanta.


(Pictured: The SSCI stem cell mobile)

Dr. Ambrozic arrived in a Mercedes SUV covered in stem cell logos. As the participants watched testimonial videos, Dr. Ambrozic put a lab coat over his surgical scrubs and got down to business.

## *Key Distributor Southern Stem Cell Institute: Targeting the Elderly*

The audience at the seminar consisted of about 20 elderly individuals, some with walkers or canes, and another with a shoulder sling. All were suffering from localized or general chronic pain and seemed to be desperate for solutions.

(Pictured: Elderly crowd watching testimonials at an SSCI seminar)

At one point, Dr. Ambrozic played a video titled "*What will your last 10 years look like*" which juxtaposed the lifestyle of a healthy older man against that of a man in a vegetative state in a nursing home.

[CLICK HERE TO WATCH VIDEO]


At the end of the video, Dr. Ambrozic asked the crowd:

> ***Now, does anyone want to be that guy on the right***

## *Key Distributor Southern Stem Cell Institute: Aggressive Claims*

Throughout the seminar, Dr. Ambrozic made other aggressive claims that were potentially outright false.

**Claim 1.** Dr. Ambrozic said that the product — which is sourced from Predictive Biotech — comes from "one of the best [labs] in the world and its actually got awards from the FDA." *(We have this claim captured on audio)*

***Reality:*** We could find no record of the FDA handing out awards to any lab, let alone Predictive's. The closest we could find was an FDA award for "Excellence in Laboratory Science" which awards groups or individual researchers, but Predictive was not on those lists either. We reached out to the FDA and Predictive for clarification and have not heard back from either as of this writing.

**Claim 2.** Dr. Ambrozic claims on his website that the average live stem cells in their product range from 1.1 million to 4.4 million cells.

**Reality:** We believe this claim cannot be made legally without rigorous independent testing, which was not presented, nor discussed, at the seminar.

We have emailed the SSCI asking for clarification on these claims and have not heard back as of this writing. Should we hear back we will update this accordingly.

## *Distributor Neo Matrix Medical: "You Are Not Invincible… But You Can Be!"*

Another Predictive distributor, Neo Matrix Medical, operates a pain management clinic in Florida. We found Neo Matrix's affiliation with Predictive through its marketing materials, which acknowledge using Predictive's products.

The proprietor, Mike Van Thielen, holds a PhD in Holistic nutrition from the University of Natural Health, an online program that charges about $7,500 per degree, where there's "no time limits for completing courses."

Van Thielen refers to himself as "Dr. Mike" and holds regular seminars catered toward those suffering from chronic pain. Here is an image from one such seminar, held by Neo Matrix Medical. Note again that the audience largely consists of elderly individuals:


We've obtained video footage of "Dr. Mike" making aggressive claims to prospective patients. In

the video you will see claims that the stem cell treatments can help any muscular/skeletal disorder and can even offer an alternative to facelifts and skin treatments.

> *This really turns back time 10, 20 years…*
>
> *Walking without a cane, walking without a walker…*

In one video, *to a backdrop of heavy techno music* Dr. Mike claims "You are not invincible, but you can be!"

[CLICK HERE TO WATCH VIDEO]


## *Predictive Distributor Southwest Spine and Pain Care ("SSPC"): An Unusual Relationship Involving a Suspicious Acquisition*

In Utah, we found that the SSPC clinics distribute Predictive's products through what appears to be an extra-special relationship.

In October 2018, Predictive acquired an entity called Regenerative Medical Technologies Inc ("RMT") for 10 million shares, valued at $9.2 million at time (and valued at over $39 million as of this writing). (pg. 15).

Utah corporate documents show that RMT was founded by Dr. Rick Obray. Dr. Obray is a founding partner of the SSPC clinics, which operate over a dozen pain management clinics.


A review of the RMT acquisition agreement [ pg. 9] showed that the entity had been formed on January 9th, 2018, only about 7 months prior to the agreement, and was described in the purchase agreement as having "limited operations". The filings further show that RMT *didn't even have financials* (balance sheet, income statement, *or* cash flow statement) when it was acquired.

**3.7 Financial Statements and Assets.**

(a) RMT was formed on January 9, 2018 (the "Formation Date") and, since the Formation Date, has had limited operations. RMT has no (i) consolidated balance sheets;

(ii) consolidated statements of income, stockholders' equity and cash flows for any fiscal year (hereinafter referred to as the "RMT Financial Statements") or (iii) consolidated statements of income and cash flows for any prior months so ended (hereinafter referred to as the "RMT Interim Financial Statements" and, together with RMT Financial Statements, the "RMT Historical Financial Statements").

Predictive claimed to be acquiring RMT for its intellectual property in the regenerative medicine field. But in the same agreement [ pgs. 26-27] we see that the acquired "property" consisted mostly of highly preliminary assets and drafts, including:

1. Draft product designs;
2. Preliminary clinical trial methodologies;
3. One draft provisional patent application
4. Several early-stage business models

**RMT DISCLOSURE SCHEDULE**

**Schedule 3.7 Personal Property**

- Data License Agreement dated May _, 2018 between Southwest Spine and Pain Care Specialists, LLC and Regenerative Medical Technologies, Inc.
- Draft Provisional Patent Application - *Systems and Methods for Linking and Storing Biologics.*
- Cellsure business model, methods and protocols to collect birthing tissue, DNA samples and electronic medical records online or on mobile app.
- Patient Registry business model, methods and protocols to collect clinical outcomes and electronic medical records online or on mobile app.
- DNA sample business model, methods and protocols to collect DNA samples and electronic medical records online or on mobile app.
- Bone Marrow Aspirate Kit - draft product design and methodology.
- Large Joint Injection Kit-draft product design and methodology.
- Degenerative Disk Disease (DDD) and Post-Microdiscectomy Injection Kit - draft product design and methodology.
- Allogenic Stem Cell Product for DOD-draft product design and preliminary clinical trial methodology
- Allogenic Stem Cell Product for Autism and CP - draft product design and preliminary clinical trial methodology
- Allogenic Stem Cell Product for Facet Joint - draft product design and preliminary clinical trial methodology

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- Allogenic Stem Cell Product for IV Treatment of Opioid Addiction - draft product design and preliminary clinical trial methodology
- Clinical Trial protocol know-how (draft design for knee arthritis, trochanteric bursitis, plantar fasciitis, discogenic back pain, facet joint pain).

In addition to the above 'assets' the acquisition also included "A license agreement for data from Southwest Spine and Pain Care Specialists, LLC". Per a press release that accompanied the acquisition, we see that the licensed data includes "access to data and medical records from patients in 13 clinics."

In other words, it appears Dr. Obray sold his confidential patients' medical records as part of the deal.

Concurrent with the deal closing, Dr. Obray joined as Chairman of Predictive's Clinical Advisory Board. The press release crowed over Dr. Obray's resume and credentials, yet oddly left out his role at SSPC, which appeared to be his primary occupation.

An obvious question emerges: **why would redictive pay over 9 million for a newly-formed entity with no financials and little in the way of developed intellectual property**

The value of confidential patient records alone would not seem to explain the large purchase price for RMT.

In what is unlikely to be a coincidence, we noticed that the SSPC clinics began offering placental stem cell therapy around the formation of RMT in early 2018. (Placental stem cells are the

precise type of stem cell that Predictive offers.) Per SSPC's Spring 2018 newsletter , we see that they featured the treatment:


When we saw this, we reached out to Predictive asking about clinics that offer their services in the area. Sure enough, their response volunteered that they do offer products through SSPC:

**Matthew Kerschinske** <mk... Apr 26, 2019, 8:51 AM
to me

Hello

Thank you for reaching out. We work with Southwest Spine and Pain right in St. George. If you would like, I can provide some more clinics in the Salt Lake City area.

Best regards,

**Matt Kerschinske**
Inside Sales Executive

**Predictive Biotech, Inc.**
A Predictive Technology Group Company

615 Arapeen Drive, Suite 300

In short, Dr. Obray looks to have sold Predictive his patient's medical records and started marketing and selling Predictive's products right around the time he formed, and later sold, an entity to Predictive for $9.2 million. We believe this is all an extremely odd acquisition.

## *Part I Conclusion: We Believe Predictive's Stem Cell Product is Sourced from Misled Pregnant Women and Then Aggressively Sold to Those Suffering from Chronic Pain*

In addition to the horrifying ethical implications of Predictive's apparent business model, we believe the approach exposes stockholders to a range of risks:

- **Regulatory.** The FDA is looking more closely at aggressive stem cell operators, and Predictive's size and public profile makes it a potential target.
- **Liability.** Patient liability is a real issue, especially for a manufacturer or distributors making aggressive or potentially misleading claims about the viability and efficacy of its products.
- **pacity.** The more exposure mothers and potential patients have to the true nature of these businesses, the more informed their decisions will be. In this case, it appears a better-informed consumer would be severely detrimental to Predictive's bottom line.

## *Part II: Predictive's Acquisition Spree: Hallmarks of Insider Self-Dealing*

Since its 2015 reverse merger, Predictive has paid over $120 million in cash and stock to acquire 7 companies (including its 49% minority stake in an entity called Juneau). We believe ***every single one*** of these acquisitions have irregularities.

Four of the entities were registered to a handful of different suites at the exact same address where Predictive had its headquarters. For context, this is the address that was listed as Predictive's headquarters:

**Item 8.01 Other Information.**

The Company, on January 29, 2016 moved it primary location from Virginia Beach, VA to that of the following:

PREDICTIVE TECHNOLOGY GROUP, INC.

2749 East Parleys Way, Suite 101

Salt Lake City, UT 84109

And here are the registered addresses of 4 of the 7 acquisitions *before* they were acquired by

Predictive:

| Acquired Entity | Registered Address |
|---|---|
| ReNovo Biotech | 2749 Parleys Way |
| Inception DX, LLC | 2749 Parleys Way, St. 101 |
| Taueret Laboratories | 2749 Parleys Way, St. 100 |
| Juneau BioSciences | 2749 Parleys Way, St. 210 |

From the list above **, ReNovo Biotech was formed at redictive's address less than 2 months before being acquired for over 1 million**Inception DX existed for only about a year before also being acquired for over $14 million. **In both instances the vast majority of the purchase price allocation was for trade secrets."**

We think the real "trade secret" is who benefited from these transactions.

In some cases, the answer seems rather apparent. We found that Predictive's CEO and President Brad Robinson was listed as a manager/managing member of **LifeCode Genetics**just prior to its acquisition by Predictive. We found no Predictive filing disclosing any stake held by Robinson in the entity.

We also see that CEO/President Brad Robinson and his brother Eric Robinson had played key roles in **Juneau BioSciences**prior to its minority acquisition by Predictive. Brad Robinson served as a VP of Juneau in 2010, where he was "responsible for developing strategic partnerships and the company's capitalization" [ Pg. 43]. Robinson's brother, Eric, worked at Juneau from 2018-2015, serving as CFO, General Counsel, and director. Robinson did not disclose any beneficial stake in any of Predictive's Juneau share acquisitions on behalf of himself or his brother.

Lastly, the company's most recent acquisition , the FlagShipHealth Group, was an entity that Predictive BioTech President Tim Lacy had disclosed partial ownership in. [ Pg 55] This entity is largely a sales and marketing organization. It is unclear what the final purchase price was, but Predictive has issued Flagship 12 million warrants at a $0.50 strike price, along with cash payments of $2.5 million, for its services. [ Pg. 15] Today, these warrants are worth over $40 million.

None of Predictive's acquisitions seem normal to us.

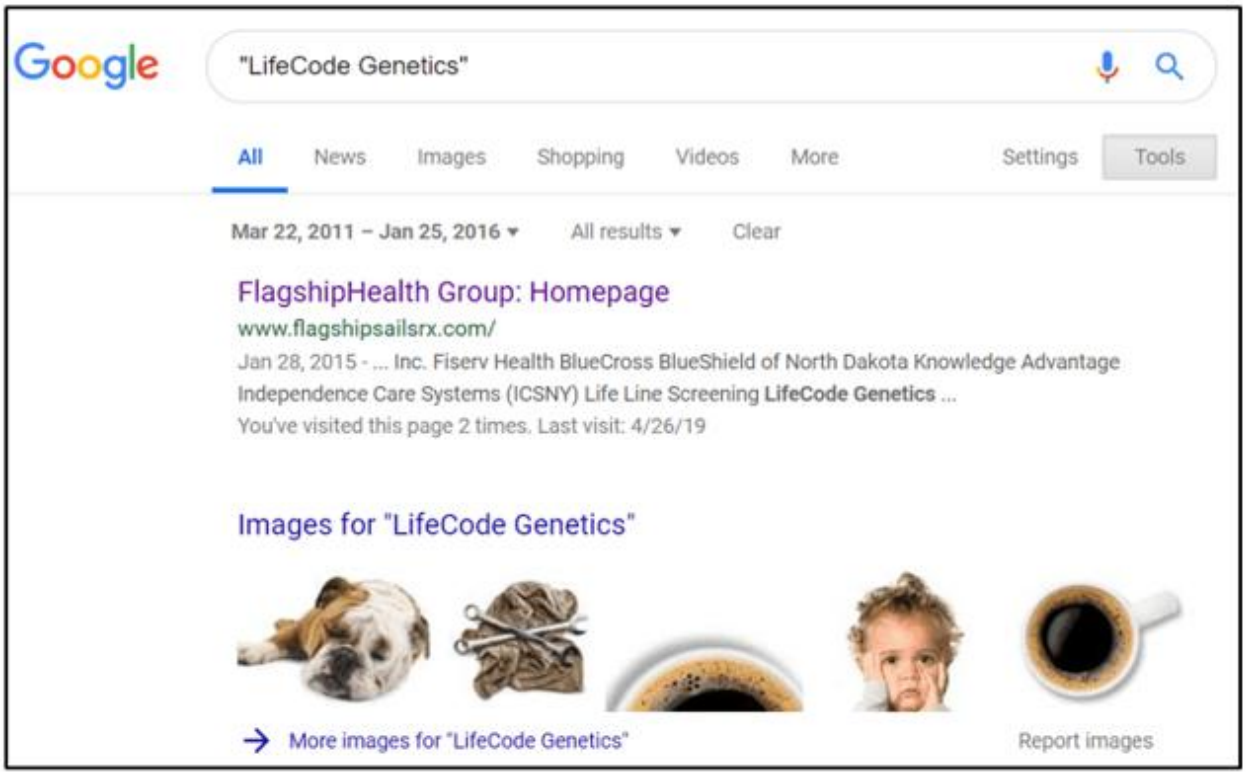
# *LifeCode Genetics Acquisition: Insider Self-Dealing?*

On January 26th 2016, Predictive announced the acquisition of LifeCode Genetics, ultimately paying about $30 million for the entity. [Pg. 34] The press release described LifeCode in a way that made it seem like an operating business:

> *LifeCode, a Nevada corporation established in 2011, develops and commercializes gene-based diagnostics.*
>
> *LifeCode holds strategic gene-based diagnostic assets, which can assist mothers in having healthier pregnancies and, ultimately, healthier babies.*
>
> *Bradley Robinson, President, Predictive Technology Group, Inc., states, "This acquisition complements the business strategy at PRED. We look for novel assets which can improve quality of human life."*

Despite presenting LifeCode as being a company that "develops and commercializes gene-based diagnostics", we were unable to find a website or even web *mentions* of LifeCode.

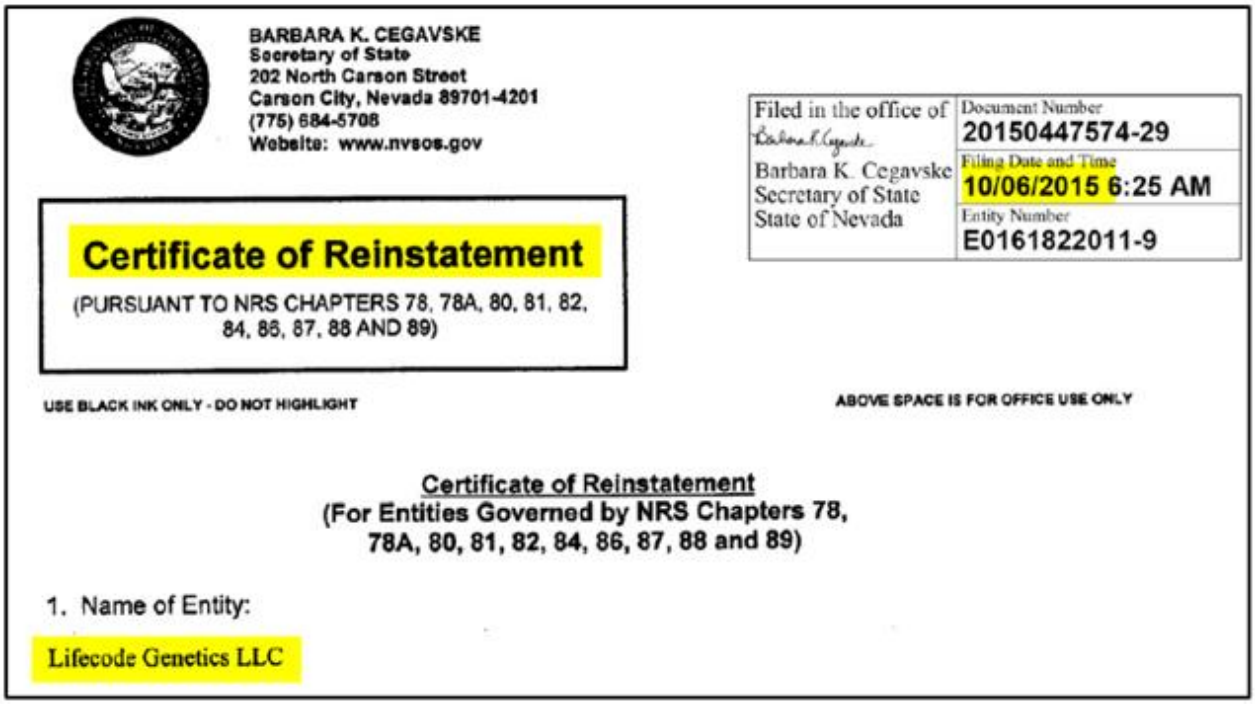
When searching for LifeCode on Google, limiting the date range from its formation until the day prior to the acquisition we found only *one* hit…where it was briefly named as a client of another related-party business that Predictive recently acquired:




That was it.

We couldn't even find a formal address from LifeCode's Nevada corporate records. Instead, it appeared to have listed its registered agent's office.

Nevada corporate records also show that the entity's corporate registration had apparently *lapsed* up until just prior to the acquisition. On October 6th, 2015, the entity was reinstated before ultimately being acquired several months later:



BARBARA K. CEGAVSKE
Secretary of State
202 North Carson Street
Carson City, Nevada 89701-4201
(775) 684-5708
Website: www.nvsos.gov

| Filed in the office of | Document Number |
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| Barbara K. Cegavske<br>Secretary of State<br>State of Nevada | 20150447574-29 |
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| | Entity Number<br>E0161822011-9 |

**Certificate of Reinstatement**

(PURSUANT TO NRS CHAPTERS 78, 78A, 80, 81, 82, 84, 86, 87, 88 AND 89)

USE BLACK INK ONLY - DO NOT HIGHLIGHT

ABOVE SPACE IS FOR OFFICE USE ONLY

**Certificate of Reinstatement**
**(For Entities Governed by NRS Chapters 78, 78A, 80, 81, 82, 84, 86, 87, 88 and 89)**

1. Name of Entity:

Lifecode Genetics LLC

Predictive's prospectus shows that LifeCode's sole asset looked to be a 10.169% stake in a separate entity, Juneau BioSciences, LLC [ Pg. 34]. Juneau, in turn, had generated a total of zero non-related party revenue at the time (in 2016) and had total assets of only about $213,393 at the end of the year, per Predictive's filings. [ Pg. 35] (We will dive further into Juneau later.)

Predictive's purchase price for LifeCode valued Juneau at roughly $301.9 million.

So, why would Predictive pay over $30 million for a neglected corporate entity that appeared to have no website, no formal address, no operations of its own, and only held a small stake in a money-losing enterprise with almost no assets?

On the same date of its corporate reinstatement in late 2015, Nevada corporate records listed the managing members of LifeCode. On that list is none other than Predictive CEO and President Brad Robinson:

INITIAL/ANNUAL LIST OF MANAGERS OR MANAGING MEMBERS AND STATE BUSINESS LICENSE APPLICATION OF:

Lifecode Genetics, LLC

NAME OF LIMITED-LIABILITY COMPANY

FOR THE FILING PERIOD OF March 31, 2013 TO March 31, 2016

USE BLACK INK ONLY - DO NOT HIGHLIGHT

**YOU MAY FILE THIS FORM ONLINE AT www.nvsilverflume.gov**

☐ Return one file stamped copy. (If filing not accompanied by order instructions, file stamped copy will be sent to registered agent.)

IMPORTANT: Read instructions before completing and returning this form.

1. Print or type names and addresses, either residence or business, for all manager or managing members. A Manager, or if none, a Managing Member of the LLC must sign the form. FORM WILL BE RETURNED IF UNSIGNED.

ENTITY NUMBER

*120403*

| Filed in the office of | Document Number |
|---|---|
| Barbara K. Cegavske<br>Secretary of State<br>State of Nevada | 20150447575-30 |
| | Filing Date and Time<br>10/06/2015 6:25 AM |
| | Entity Number<br>E0161822011-9 |

ANNUAL LIST FILING FEE $150.00 LATE PENALTY: $75.00 (if filed late)

BUSINESS LICENSE FEE: $200.00 LATE PENALTY: $100.00 (if filed late)

CHECK ONLY IF APPLICABLE AND ENTER EXEMPTION CODE IN BOX BELOW

☐ Pursuant to NRS Chapter 76, this entity is exempt from the business license fee. Exemption code: ☐

NOTE: If claiming an exemption, a notarized Declaration of Eligibility form must be attached. Failure to attach the Declaration of Eligibility form will result in rejection, which could result in late fees.

NRS 76.020 Exemption Codes
001 - Governmental Entity
005 - Motion Picture Company
006 - NRS 680B.020 Insurance Co

| NAME | ADDRESS | CITY | STATE | ZIP CODE | |
|---|---|---|---|---|---|
| Ronald Barhorst | 162 Naintic Road | Waterford | CT | 06385 | MANAGER OR MANAGING MEMBER |
| David Bommarito | 2025 Touraine Drive | Rochester | MI | 48306 | MANAGER OR MANAGING MEMBER |
| Bradley Robinson | 189 North Highway 89, Suite 140 | North Salt Lake | UT | 84054 | MANAGER OR MANAGING MEMBER |

Per a review of CEO Brad Robinson's biography, he was listed as being a "founding member of LifeCode Genetics, LLC in 2011" [ Pg. 48] but that was it. Nowhere do we see a disclosure that Robinson held a stake in Predictive's own acquisition.

Ronald Barhorst, a current Predictive Director, also shows up as a manager of LifeCode. Barhorst joined as a Predictive director in March 2019 [ Pg. 47] and therefore wasn't an insider at the time of the acquisition. Nonetheless, the collective irregularities around this acquisition make us wonder about Barhorst's board stewardship at the company as well.

## *ReNovo Biotech Acquisition: A 2-Month-Old Entity Formed at Predictive's Own Headquarters Acquired for $14 Million Worth of "Trade Secrets". Insider Self-Dealing?*

Sometimes you find a red flag so bright that it can be seen with the naked eye from another galaxy.

On March 2 nd 2016, Predictive announced its intent to acquire ReNovo Biotech, ultimately paying over $14 million for the company [ Pg. F-40]. Predictive's filings indicate more than 85% of the purchase price was allocated to "trade secrets" [ Pg. 37]. From the press release, the justification for the acquisition was as follows:

> *PRED through this acquisition gains access to ReNovo Biotech's cellular, tissue, biomaterial and regenerative medicine products, R&D, sales/marketing expertise, distribution channels and product candidates.*

Despite the seeming broad variety of "trade secrets" gained from the acquisition, Utah corporate records show that ReNovo was formed on January 13, 2016, **less than 2 months earlier**.

Utah corporate records also show that ReNovo's address was 2749 East Parleys Way – the same address as Predictive's headquarters.

State of Utah
Department of Commerce
Division of Corporations & Commercial Code
Articles of Incorporation (Profit)

This form must be type written or computer generated.

RECEIVED
JAN 13 2016
Utah Div. of Corp. & Comm. Code

Important: Read instructions before completing form — Non-Refundable Processing Fee: $70.00

| | | | | |
|---|---|---|---|---|
| 1. Name of Corporation: | ReNovo Biotech, Inc. | | | |
| 2. Purpose: | Service: Distribution of Medical Products. | | | |
| 3. Shares: | Type: | Common | Number of Shares: | 100,000,000 |
| | Type: | Preferred | Number of Shares: | 10,000,000 |

4. Who/What is the name of the Registered Agent (Individual or Business Entity or Commercial Registered Agent)?:
United States Corporation Agents, Inc.

The address must be listed if you have a non-commercial registered agent. What is a commercial registered agent?

Address of the Registered Agent: 299 S. Main Street, Suite 1300
Utah Street Address Required, PO Boxes can be listed after the Street Address

City: Salt Lake City State UT Zip: 84111

| | | | | |
|---|---|---|---|---|
| 5. Name, Signature and Address of Incorporator (attach additional page if there is more than 1 incorporator) | Cheyenne Moseley, Assistant Secretary, LegalZoom.com, Inc. (Name) | | | |
| | 101 N. Brand Blvd., 11th Floor (Address) | Glendale (City) | CA (State) | 91203 (Zip) |
| | Signature: CM | | Date: 1/12/2014 | |
| 6. Principal Address: | 2749 East Parleys Way (Address) | Salt Lake City (City) | UT (State) | 84109 (Zip) |

Please list the officers and directors of the corporation. Must have at least 1 officer and 1 director within the 1st year of the corporation.

| | | | |
|---|---|---|---|
| Eric Kenneth Olson (Name) | President (Position(s)) | | |
| 2749 East Parleys Way | Salt Lake City | Utah | 84109 |

**Item 8.01 Other Information.**

The Company, on January 29, 2016 moved it primary location from Virginia Beach, VA to that of the following:

PREDICTIVE TECHNOLOGY GROUP, INC.

2749 East Parleys Way, Suite 101

Salt Lake City, UT 84109

We find it immensely irregular that Predictive paid $14 million to unnamed shareholders, mostly to acquire "trade secrets", via an entity formed less than 2 months earlier at its own

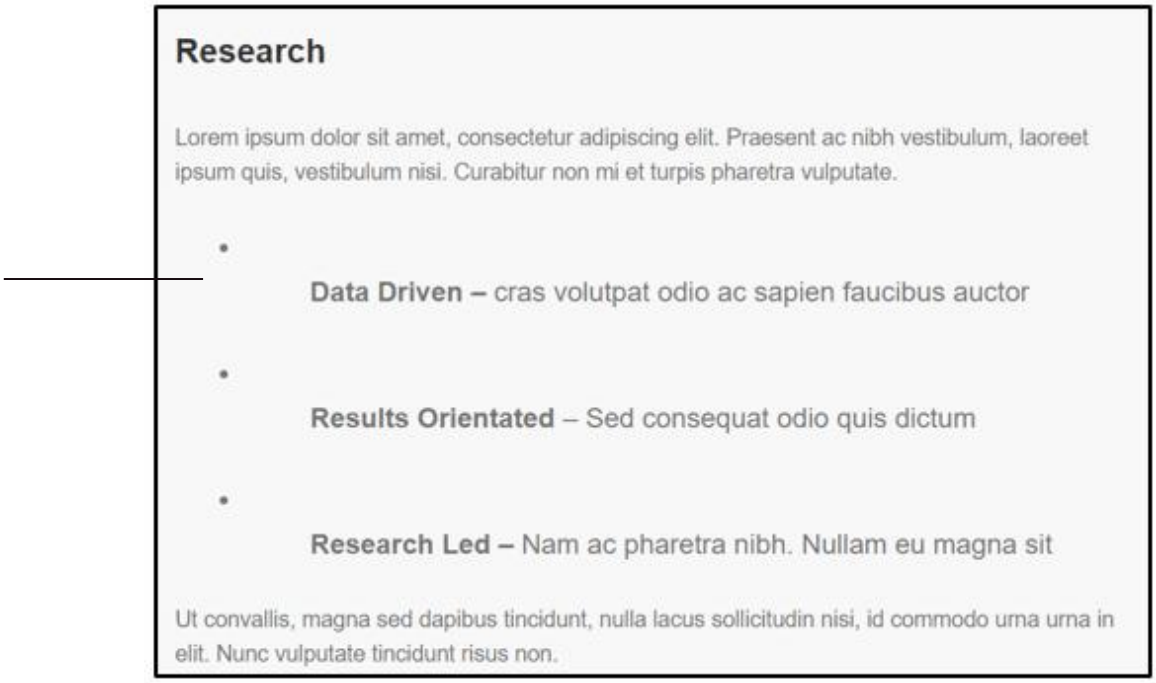
address.

## *Inception DX Acquisition: Predictive Paid ~$14.2 for Another Newly Formed Entity Based Out of Its Own Address That Mainly Held "Trade Secrets"*

On August 22, 2018, Predictive paid $14.2 million for Inception DX [ Pg. F-14], an entity that had been formed only about a year earlier, in June 2017, at the same address as Predictive's headquarters, per Utah Corporate records .

The assets acquired included [I] $12.3 million in "trade secrets" along with [II] $800k in cash [III] 6 pieces of lab equipment worth ~$700k, and [IV] about $440k worth of Juneau BioSciences shares that Inception DX had been given *on the same day* of the acquisition as part of an 'unrelated' agreement between Predictive and Juneau . (We'll explain.)

A web capture of the InceptionDX website from August 6th 2018, just weeks prior to Predictive's acquisition, shows that it was just an undeveloped template. The website consisted of nothing more than boilerplate Latin 'placeholder' text that is common on brand new, undeveloped website templates. Example from the web capture:



**Research**

Lorem ipsum dolor sit amet, consectetur adipiscing elit. Praesent ac nibh vestibulum, laoreet ipsum quis, vestibulum nisi. Curabitur non mi et turpis pharetra vulputate.

- **Data Driven –** cras volutpat odio ac sapien faucibus auctor
- **Results Orientated** – Sed consequat odio quis dictum
- **Research Led –** Nam ac pharetra nibh. Nullam eu magna sit

Ut convallis, magna sed dapibus tincidunt, nulla lacus sollicitudin nisi, id commodo urna urna in elit. Nunc vulputate tincidunt risus non.

The press release announcing the acquisition was thin on details, but seemed to focus on the importance of having a CLIA lab.

**SALT LAKE CITY (September 25, 2018)** – Predictive Technology Group, Inc. (OTC/PINK: PRED), a leader in the use of data analytics for disease identification and subsequent therapeutic intervention through unique biotechnology treatments, announces that it has acquired Inception Dx. Inception Dx will operate as a wholly owned subsidiary of Predictive Technology Group.

The acquisition of Utah-based Inception Dx includes next-generation sequencing and genotyping assets along with extensive protocols, quality and laboratory management systems and other resources required by a "high complexity" molecular diagnostic laboratory operating under the Clinical Laboratory Improvement Act (CLIA).

"We are excited to offer next-generation sequencing and genotyping that will allow Predictive Technology Group to further leverage and accelerate the commercialization of diagnostics and therapeutics from our unique development platforms," said Bradley Robinson, CEO of Predictive Technology Group.

Predictive Diagnostics will launch ARTGuide™, a proprietary gene test panel for women experiencing infertility as a result of endometriosis and other health concerns, during fourth quarter of 2018. The test is expected to change the way that Advanced Reproductive Technologies (ART), such as *in vitro* fertilization (IVF), are used to assist couples having difficulty conceiving. Over 30,000 DNA samples and medical records have been collected as part of the development and validation process of ARTGuide™.

Instead of buying an actual CLIA lab, the acquisition agreement shows that Inception DX only had "an initial CLIA registration and CLIA lab protocols based on modifications from those used by Taueret Laboratories."

This was odd for 2 reasons:

1. Predictive had already paid for CLIA lab protocols through an earlier deal. In July 2016, 2 years prior to the Inception DX acquisition, Predictive paid 300,000 shares to unspecified recipients for "protocols related to the operation and management of a CLIA lab and related genetic tests."
2. Predictive ended up acquiring Taueret, the company that the CLIA protocols were based on, just months later. This acquisition included a CLIA lab, rendering the CLIA protocols purchased from Inception DX seemingly useless.

We find it suspicious that Predictive paid unnamed recipients *twice* for mere CLIA lab protocols, only to end up buying the very lab that the CLIA protocols were based on months later anyway.

The remaining "trade secrets" detailed in the purchase agreement consisted of "Gen DB records- birth, death, or marriage records for over 31,900,000 individuals." This asset also looks to have been moved into Inception DX from Taueret Laboratories, given that the database was proprietary to Taueret Laboratories prior to the formation of Inception DX.

As noted above, the Inception DX deal also included 400,000 shares of Juneau BioSciences. Inception DX acquired these shares on the exact date of the acquisition as part of an 'unrelated' agreement struck between Predictive and Juneau.

That agreement called for Juneau to use Inception DX's CLIA lab in exchange for an immediate payment of 400,000 shares to Inception DX. Again, Inception didn't have a CLIA-certified lab, nor ever ended up getting one as far as we can tell.

In other words, Predictive negotiated a deal with Juneau to have Juneau give Inception DX 400,000 shares of Juneau to use a lab that didn't exist, and then acquired Inception DX later that day, using the 400,000 shares as a partial rationale for the acquisition. (To pose an obvious question: why wouldn't Predictive just have negotiated to be paid the Juneau shares directly?)

Our suspicions are punctuated by the fact that **every one of these entities redictive, Inception D , Juneau, and Taueret shared the same address** 2749 Parleys Way, Salt Lake City, Utah. Talk about circular dealing!

## *Inception DX Acquisition: 90% of the Purchase Price Went to Unnamed Individuals in the Caymans*

This all begs the question, why would Predictive pay over $14 million for a newly-formed entity with only [A] cash and lab equipment worth $1.5 million, and [B] some assets apparently shuffled in from other entities based out of Predictive's same address?

Deal records show that 90% of the acquisition value went to an entity in the Caymans with unnamed owners.

**Inception DX Acquisition: Who Got Paid?**

| | Value Paid | % of Total |
|---|---|---|
| Inception DX Cayman | $12,880,000 | 90% |
| Kenneth Ward | $1,380,000 | 10% |
| Total | $14,260,000 | 100% |

(Image by author, sourced from Pg. A-1)

We reached out to Predictive's investor relations to gain more clarity on who the shareholders of Inception DX Cayman were, but the IR rep was unable to provide them.

We also reached out to the company to ask whether all of its acquisitions were truly arms-length, and have not heard back as of this writing. We will update this if we receive a response.

We encourage the company to provide the investing public with details of the shareholders of this Cayman entity (and of the company's other acquisitions), as such information could easily clarify whether any related party dealings took place in these transactions.

## *Juneau BioSciences Acquisition: A Tiny Company with Deep Connections to Predictive's CEO And His Brother*

Next let's turn to Juneau Biosciences, a company that develops genetic tests related to women's healthcare. [ Pg. 48] In particular, Juneau has been developing a test for endometriosis called the ArtGuide, which it hopes to commercialize this year.

Juneau was formed in 2006 and is a small company with limited financials. The 2017 balance sheet reported total assets of just $183,190 and liabilities of $2.647 million. [ Pg. 35]

Predictive's filings include Juneau's 2016 and 2017 financials, which show that all revenue was related-party. The company reported a loss in each year: [ Pg 36]

**Juneau Biosciences, LLC**
**STATEMENTS OF OPERATIONS**

| | For the Years Ended | |
|---|---|---|
| | December 31, 2017 | December 31, 2016 |
| License Income (Related Party) | $ 1,005,830 | $ 877,560 |
| Research & Development (Related Party) | $ 1,350,000 | $ - |
| Consulting (Related Party) | $ 88,237 | $ - |
| | $ 2,444,067 | $ 877,560 |
| Operating Expenses | | |
| General and administrative expenses | 1,855,485 | 596,011 |
| General and administrative expenses (Related Party) | 671,178 | 990,021 |
| Stock-based Compensation | 695,907 | 71,851 |
| Travel and entertainment | 9,064 | 4,654 |
| Interest expense | 1,004,791 | 463,558 |
| Depreciation expense | - | 3,377 |
| Amortization expense | 9,711 | 9,575 |
| Total Operating Expenses | 4,246,136 | 2,139,047 |
| Loss from opertions | (1,802,069) | (1,261,487) |
| Other Income (Expenses) | | |
| Other Income | 6 | |
| Total Other Expenses | 6 | - |
| Net Loss before Income Taxes | (1,802,063) | (1,261,487) |
| Income Tax Benefit | - | - |
| Net Loss | $ (1,802,063) | $ (1,261,487) |

Predictive's auditor recently noted Juneau's troubled financial state [ Pg. 1]:

*The Company's lack of liquidity and recurring operating losses raise substantial doubt about its ability to continue as a going concern.*

We contacted a former employee who worked with a related company via LinkedIn, asking to speak as part of our due-diligence. He said that Juneau had about 5-6 dedicated employees by 2013, focused primarily on endometriosis research. By all measures, it was a modest organization.

Despite its small size, the company seems to have been significantly influenced by Predictive CEO/President Brad Robinson and his brother Eric Robinson.

Per Brad Robinson's bio we see that he previously served as the VP of Business Development for Juneau starting in 2010, and "was responsible for developing strategic partnerships and the company's capitalization." [ Pg. 43]

We also found that Eric Robinson had served as Juneau's General Counsel , Chief Financial Officer , and director from 2008 to 2015.

## *Juneau BioSciences Acquisition: Predictive Has Paid Over $50 Million For Its Minority Ownership in Juneau, and is Expected to Make Another $12 Million in Cash Payments By 2021*

Despite its modest size and apparent precarious financial state, Predictive has directed a tremendous amount of money toward Juneau, starting as early as 2013. [ Pg. F-18] Since that time, we calculate that Predictive has paid over $22 million in cash and stock to purchase shares from unnamed shareholders and debtholders of Juneau and to support Juneau's various obligations.

Predictive has also added to its Juneau stake by acquiring 2 other companies that held shares of Juneau, including a ~$30 million purchase of LifeCode Genetics, an entity whose apparent sole asset was a stake in Juneau.

Finally, Predictive's minority 49% stake in Juneau hasn't even been fully paid. The company is slated to pay roughly $12 million in monthly cash payments between now and 2021 in order to purchase additional Juneau shares. [ Pg. 1]

Despite all the cash and stock that has been directed into modestly-sized Juneau, Predictive's economics on the deal leave something to be desired. It is expected to split net profits that come out of the Juneau relationship 50/50 [ Pg. 8], and is obligated to pay another $2.5 million worth of stock if there is ever a commercial first sale of Juneau's endometriosis test, along with other milestone payments. [ Pg. 8]

## *Juneau BioSciences: Did Predictive Buy A Potential Game Changer in Endometriosis Diagnostics Testing – or a Dud?*

So, what has Predictive purchased using all that cash and stock?

Juneau is hoping that its ArtGuide test, which is currently in development, will revolutionize diagnostic testing for endometriosis, a painful disorder that affects millions of women and can be associated with infertility. Currently, there is no blood test that can identify endometriosis through DNA biomarkers.

The ArtGuide test would be considered a Laboratory Developed Test which will not undergo FDA testing. This will make reimbursement a challenge, leaving the company to target self-pay markets [ Pg. 9 & Pg. 6].

In October 2018, Predictive announced that it is beta testing its ArtGuide test and hopes to launch it in Q2 of this year. Despite these forward moving signs, industry experts and the company's own missed historical milestones give us strong doubts about whether this latest announcement truly represents a leap forward toward rapid commercialization.

## *Juneau BioSciences: Proposed Endometriosis Test Already Being Met with Industry Skepticism*

When we saw Juneau's October announcement about the ArtGuide test's imminent commercialization pathway, we reached out to several endometriosis experts to get their take. They were *unanimously* skeptical.

This is what the CEO of the World Endometriosis Society (operators of Endometriosis.org ) told us:

> *We did see the press release from Juneau BioSciences last year.*

*However, there has been no peer reviewed publication in the scientific literature about this 'discovery', its methodology, population(s) tested, sensitivity/specificity of the test, types of endometriosis detected, etc.*

*Nor is there any evidence/basis to the claim that '27 million women in the United States are symptomatic of endometriosis'.*

*This joint statement from the World Endometriosis Society and the World Endometriosis Research Foundation remains status quo.*

The 'joint statement' is referring to a March 2018 a consensus statement put out by both the World Endometriosis Research Foundation (WERF) and the World Endometriosis Society (WES), two of the largest endometriosis research organizations. The statement looks to have been aimed at debunking a slew of claims by various proprietors to have 'solved' the endometriosis biomarker conundrum (the very type of claim being made by Juneau). From the statement:

***To date there are no data that definitively support any claims of a validated diagnostic test – or any combinations of tests – to accurately diagnose endometriosis or provide monitoring of disease progression regression*** *There are presently no endometriosis diagnostic or treatment biomarkers that have been demonstrated to have the validity and reliability necessary to be used in routine clinical diagnosis or care.*

We also contacted the Endometriosis Research Center (endocenter.org) and received this response:

*Thanks for reaching out to the ERC. We are aware of blood tests for diagnosing endometriosis.* ***Although they provide a good step towards learning more about this disease, there are concerns.*** *We continue to monitor the research.*

The Feinstein Center for Medical research wrote the following to us:

*The short answer is due to the complexity of the genetics involved in endometriosis (based on VERY large studies) –* ***it seems unlikely genetics alone will successfully***

***diagnose this complex condition***

# *Juneau BioSciences: Lackluster Product Development Track Record Thus Far*

Several historical false starts by Juneau lead us to believe that the skepticism expressed by the experts we contacted is likely to be well-founded.

**2013:** The company announced, "After five years in research and development, Juneau is now poised to launch their novel EndoRisk test for women experiencing infertility." Nearly six years later, the test still has not launched.

**201** : Juneau representatives participated in a webinar describing the difficulties associated with coming up with a test and suggested that they were at least a couple of years out from identifying a gene.

**2016 January** Predictive put out marketing materials indicating that Juneau's EndoRisk test would be commercialized *imminently*, with an "initial launch to fertility clinics" slated for that same quarter. They also targeted a launch to the "general primary care provider and OB/GYN market" slated for later in the year. Again, the EndoRisk test has still yet to be released.

(Note that the marketing materials show the company targeted launching 4 other tests that same year, *none* of which look to have been released.)

PREDICTIVE THERAPEUTICS

**Near-Term Molecular Diagnostic Opportunities:**

- **Endometriosis (EndoRisk®) – Genetic diagnostic/prognostic for endometriosis**
  - 1Q 2016 initial launch to fertility clinics
  - 2H 2016 launch to general primary care provider and OB/GYN market
  - Today endometriosis is diagnosed through laparoscopy with costs that exceed $15,000
  - In over 50% of cases (today's "gold standard") diagnoses are NOT confirmed
  - Companion diagnostic for therapeutics
  - 27 million symptomatic women in the U.S. alone.
  - Greater than $1 billion annual U.S. market
  - Initial base patent issued in January 2015 by USPTO
  - Additional patent applications pending
- **Fertility Dx – Carrier (parents) testing to detect potential diseases passed from parents to child**
  - 1Q 2016 initial launch to fertility clinics
  - 1H 2016 launch to general primary care provider OB/GYN market
  - 385,000 IVF cycles annually in the U.S.
  - Greater than $1 billion annual U.S. market
  - Carrier testing most common mutations prior to conception
  - Fertility Dx panel to include test for endometriosis and preeclampsia making it the most comprehensive panel to assist parents and health care providers in having the healthiest pregnancies and babies possible
- **Preeclampsia - Cardio-Vascular Risk Assessment Screen (*C-VRAS*) Test**
  - 1Q 2016 initial launch to fertility clinics
  - 1H 2016 launch to general primary care provider OB/GYN market
  - Up to 8% of 3.9 million U.S. pregnancies are affected by preeclampsia
  - Early identification of women at high risk for cardiovascular disease may lead to primary prevention, earlier diagnosis, more aggressive treatment and improvement in survival.
- **Spinal Deformity – Idiopathic Scoliosis or other Syndromes Genetic Test**
  - 1H 2016 launch
  - 100,000 newly diagnosed cases annually in the U.S.
  - Greater than $100 million annual U.S. Market
  - Significant revenues in 2016
  - Determines which 80% of children diagnosed with scoliosis will not develop to a "treatable" case of scoliosis.
    - Results in no more unnecessary medical procedures and/or bracing of children, X-rays (tests)
    - Significant cost savings
    - Elimination of stress and stigma on 80% of the children diagnoses with scoliosis
  - Initial patent issued in April 2014 by USPTO
  - Additional patent applications pending
- **Degenerative Disc Disease – Genetic test to determine who will suffer from degenerative disc disease**
  - 2H 2016 estimated launch
  - Approximately 500,000 disc surgeries are performed annually in the U.S.
  - Greater than $1 billion annual U.S. market
  - Assists in determining which patients will benefit from back surgery and which patients will have better outcomes forgoing back surgeries
  - Patent applications pending

**2016 April**: The company's corporate entity apparently lapsed, as a reinstatement filing was made.

**2017 ctober**: A Facebook post apologizes for going dormant and then says the company needs more study participants.

**2018 ebruary**: Predictive announces a "crucial milestone" in the development and commercialization of ARTGuide:

> *After testing thousands of women as part of the development program, the Company* ***now expects commercial launch of the ARTGuide infertility test in the United States during 3 2018***

**2018 ctober**: Press release : ArtGuide is being beta tested and company claims it "will be

made available to the entire US infertility market in the second quarter of 2019."

All told, we are highly doubtful that this test will represent a near-term commercial success for the company.

## *Taueret Laboratories Acquisition: Yes, This Was Also Based Out of the Same Address (But, at Least This Acquisition Had a CLIA Lab, Equipment, and its Beneficiaries are Disclosed)*

On August 22, 2018, Predictive acquired "DNA and Ancestry Assets" from Taueret Laboratories, LLC for over $15 million. [Pg. 38] The press release announcing the acquisition seemed to acknowledge that the acquisition was slightly off-center from Predictive's business strategy:

> *Although our focus remains on endometriosis, the acquisition of these key DNA and ancestry assets significantly strengthens our development platforms to commercialize gene-based diagnostics and biotechnology treatments for other debilitating diseases*

The DNA biobank was described in the purchase agreement in less-than-exhilarating terms [Pg. 20]

> *These samples were all collected more than 15 years ago. A precise inventory of samples is not feasible, and some samples have been consumed or have become degraded…The collection is useful for pilot studies and confirmatory studies, but no warranty is made as to their relevance or usefulness for any particular disease discovery target.*

Corporate filings as far back as 2008 show that Taueret's official address was 2749 East Parley's Way, Suite 100, Salt Lake City, Utah. The address was the same address of Predictive. Here is a filing from 2013 showing this as well:

State of Utah
Department of Commerce
Division of Corporations & Commercial Code
Limited Liability Company Registration Information Change

This form must be type written or computer generated.

RECEIVED
MAR 07 2013
Utah Div. Of Corp. & Comm. Code

Non-Refundable Processing Fee: $15.00

Entity File Number: 5296639-0160

Entity Name: Taueret Laboratories, L.L.C.

For each Yes button that you mark the question will appear below for you to fill out.

1). Do you want to Change the Business Purpose? ○ Yes ◉ No

2). Do you want to Change the Registered Agent or the Address of the Registered Agent? ◉ Yes ○ No

2). If Yes, who is the new Registered Agent, or the new Address of the Registered Agent?
Linda Gould

The address must be listed if you have a non-commercial registered agent. What is a commercial registered agent?

Address of the Registered Agent: Taueret Labs, 2749 E. Parleys Way, #100

Utah Street Address Required, PO Boxes can be listed after the Street Address

City Salt Lake City State UT Zip 84109

3). Do you want to Change the Principal Address of the Business Entity? ○ Yes ◉ No

And again, here is an SEC filing showing Predictive operating out of the same address a year and a half *PRIOR* to the acquisition of Taueret's DNA assets:

**Item 8.01 Other Information.**

The Company, on January 29, 2016 moved it primary location from Virginia Beach, VA to that of the following:

PREDICTIVE TECHNOLOGY GROUP, INC.

2749 East Parleys Way, Suite 101

Salt Lake City, UT 84109

Following the purchase of DNA assets, Predictive later paid another $9.7 million in cash to purchase the Taueret entity, [ Pg. 1] with about $8.5 million of that amount deferred until 2020. [Pg. 5] The remaining purchased assets largely consist of lab equipment, lab certifications, 3 provisional patents and 1 utility patent relating to preeclampsia, and 452,000 shares of Juneau BioSciences.

We spoke with several former Taueret employees that we contacted through LinkedIn who said the business had about 15 employees around 2012-2013. The company primarily processed DNA micro-array samples for Ancestry.com , but then lost the business and was forced to lay off much of its workforce.

The company also had later performed testing for several clients, but that line of revenue became impaired due to changes in reimbursement for its main test.

Note that Taueret was the only transaction where we were able to see who received proceeds from the transactions (in Exhibit B of the acquisition agreement and Exhibit A of the intellectual property agreement) and the beneficiaries look to be the stated owners/operators of the business.

## *Part III: The People Behind Predictive*

## *Predictive's Chairman (Until Late 2018) and Two Other Key Early Backers Had Previously Been Charged with Securities Fraud*

Nevada corporate records show the early holders of Predictive from its outset as a public company in 2015. Based on that list, we found that 89.56% of Predictive's early shares were held by entities run by 3 individuals that had been previously charged with securities fraud.

Mr. Ferguson stated that in light of the new direction that the Company has made, the Company is better served by a name change.to PREDICTIVE TECHNOLOGY GROUP.

The Chairman stated that 47,453,300 shares of common stock are issued and outstanding of the 900,000,000 shares of authorized common stock and no shares issued out of 10,000,000 shares of preferred stock. A tally of the major shareholders who are entitled to vote and have approved by proxy of said action include:

| | | |
|---|---|---|
| Trade Exchange International, Inc. | 15,250,000 shares | 34.24% |
| *TJJR Enterprises, Inc.* | *6,250,000 shares* | *13.17%* |
| Global Homes, Inc. | 2,500,000 shares | 5.27% |
| JP Anderson Holdings | 20,000,000 shares | 42.15% |

**Merle erguson Susan Donohue.** The top two entities from the above ( Trade Exchange International and TJJR Enterprises) collectively held 47.41% of Predictive at the time. The entities were registered to Ferguson and Donohue, per Nevada Corporate records.

Ferguson served as Chairman of the board of Predictive, and continued serving in that capacity until his replacement as Chairman in October 2018. Ferguson then served as a director until March 18th of this year, when he was replaced by former Senator Orrin Hatch.

In 2001, both Ferguson and Donahue were charged by the SEC with securities fraud. SEC prosecutors alleged that the pair had issued multiple false and misleading press releases

about a company where they served as President/CEO and treasurer respectively. Both were ultimately fined and/or enjoined from future violations.

U.S. Securities and Exchange Commission

**Securities and Exchange Commission**

**Litigation Release 17328 / January 22, 2002**

***SEC v. World Homes, Inc., Merle Ferguson and Susan Donohue*, Civil Action No. CV-S-01-0658-PMP-LRL (USDC D. Nev.)**

On January 14, 2002, the Honorable Phillip M. Pro issued final judgments of permanent injunction against World Homes, Inc., currently known as Composite Industries of America, Inc., and Merle Ferguson, its President and Chief Executive Officer, enjoining them from future violations of the securities registration and antifraud provisions fo the federal securities laws. In addition, Susan Donohue, the company's Secretary-Treasurer, was enjoined from future violations of the securities registration provisions. The defendants consented to the orders without admitting or denying the Commission's allegations. Ferguson was also ordered to pay a civil money penalty in the amount of $120,000.

**James rice** was another key early holder of Predictive, controlling 42.15% of the company through the entity JP Anderson Holdings .

In 2016, not long after Predictive became public on the OTC markets via reverse merger, the SEC charged a boiler room operator for allegedly using illegal tactics to help Price unload shares of his other penny stocks.

U.S. Securities and Exchange Commission

**U.S. SECURITIES AND EXCHANGE COMMISSION**

**Litigation Release No. 23656 / September 27, 2016**

***Securities and Exchange Commission v. Jason A. Wallace*, Civil Action No. 8:16-cv-01788 (C.D. Cal.)**

**SEC Charges Former Boiler Room Operator Jason A. Wallace with Participating in a Fraudulent Pump-And-Dump Scheme**

The Securities and Exchange Commission today filed a civil injunctive action in the U.S. District Court for the Central District of California against Jason A. Wallace alleging that he violated the antifraud and registration requirements of the federal securities laws as a result of his participating in a fraudulent scheme to artificially inflate the per share price of penny stocks.

The Commission's complaint alleges that in 2010, an owner of penny stocks, James Price, proposed to a stock promoter, Brian Kingsfield, that they engage others to help Price sell his shares. According to the complaint,

Per the complaint:

**Wallace And His Boiler Room Created A False Market For Price's And Alverson's Penny Stocks**

31. In 2010, Kingsfield approached Wallace about expanding JAW into a new line of business: promoting and selling penny stocks on the open market. At that time, Kingsfield was promoting and selling penny stocks for Price.

32. Price owned a large number of penny stocks and wanted to expand his sales operation beyond Kingsfield. Price wanted to partner with an established boiler room operator with tested customer lists, but he did not want to work with any registered brokers or associated individuals. Price sought someone who was experienced in generating demand and closing sales but was not subject to regulatory scrutiny.

The boiler room operator was also charged criminally and pled guilty .

As shown above, Price was featured prominently in the SEC boiler room complaint but was not charged directly. He was charged by the Illinois Securities Department however, for similar allegations of securities fraud in relation to selling of penny stocks. Price ultimately settled

those charges .

We find it immensely disconcerting that the vast majority of Predictive shares were controlled by individuals alleged by various regulators to have been engaged in pump and dump schemes, issuing false press releases, or boiler room sales, including Predictive's Chairman.

## *Predictive's CEO/President Bradley C. Robinson Left Some Things Off His Official Biography, Including Allegations of Securities Fraud and Allegations of Non-Compliant Marketing of a Medical Product*

Beyond its key backers, we explored Predictive CEO/President Bradley Robinson's track record in more detail and discovered several red flags and omissions.

Around 2010, Robinson led a company called Ceptazyme (and a related company called Zus Health) which sought to market an algae water product grown in distilled water that the company claimed could lower cholesterol.

In an investor lawsuit , Robinson was alleged to have engaged in securities fraud relating to the business. The complaint alleged that Robinson made grandiose claims about the product's efficacy and claimed that it would be pitched by Dr. Oz, the Gates Foundation, and others. None of the claims ever materialized. Per a local news article that covered the story:

**Algae Water, Hey?**

JONNY BONNER May 22, 2013

SALT LAKE CITY (CN) – Shareholders in an algae water company claim in court that they were flim-flammed into coughing up $160,000 by bogus promises the product would be pitched to Dr. Oz, Bill Gates and powerful Walgreens execs.

Christopher Maggiore and Robert McLain sued Bradley Robinson and his company, Ceptazyme, in Federal Court.

We presume the lawsuit settled, as the last court document we found indicated that a resolution was pending.

The algae company had also struck a partnership with a public company to market the product, but the deal quickly fell apart, with the public company also suing Robinson over allegations that his company:

> *Failed to market the Registrant's product in a manner compliant with state and federal regulations, and allowed its distributors to make claims and representations that were not in compliance with applicable regulations, among many other breaches.*

Those allegations strike us as extremely prescient given Predictive's current business.

The charges between the two companies were ultimately settled without any admission of wrongdoing.

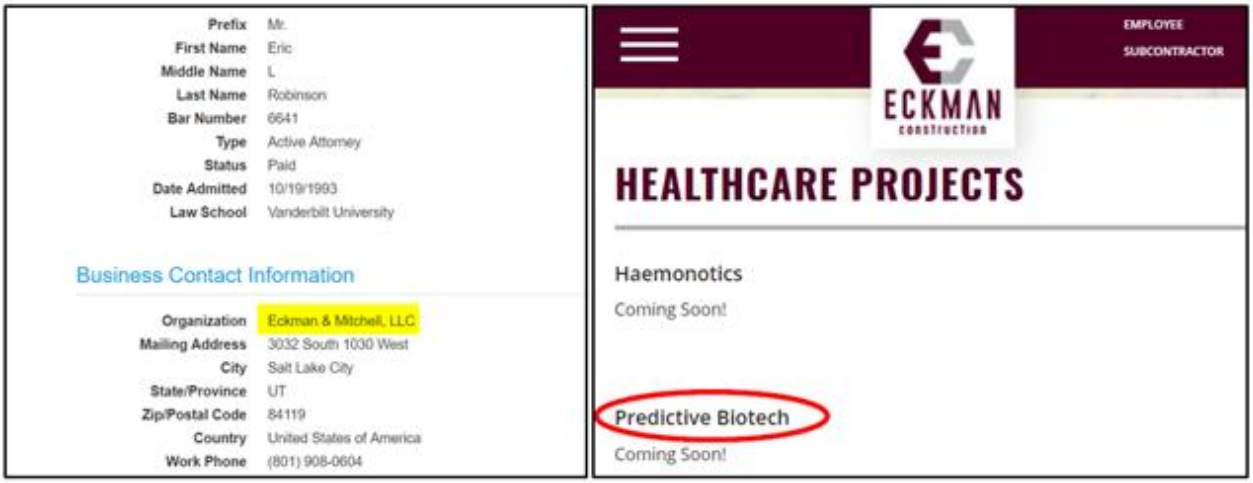
Aside from the Ceptazyme debacle, Robinson also left his role at ActiveCare off his official biography. ActiveCare was a public company focused on diabetes management. Robinson and his brother Eric served at ActiveCare as Director and CFO/General Counsel/Director respectively. They resigned simultaneously about 8 months before the company declared bankruptcy in 2018.

## *All in the Family: The CEO's Brother Represents a Construction Company Hired By Predictive*

Speaking of brotherly affiliations, Predictive CEO/President Brad Robinson and his brother Eric have been involved in multiple business interests. As we noted earlier, both Brad and Eric had key roles a Juneau, a company that Predictive has had deep business ties with. Both brothers also had brief roles at public company ActiveCare (which went bankrupt), and both were involved in Specialized Health Products, Inc., led by their uncle and Father.

When we see family members that regularly engage in business with one another, especially when those businesses overlap with public company interests, we look for potential undisclosed related-party transactions.

Eric Robinson is an attorney by trade. A check of his Utah bar profile shows that he currently works at Eckman & Mitchell, a construction firm. On the Eckman Construction website, we see that an upcoming project is planned for…Predictive Biotech




We find it rather odd that Robinson's diverse interests — ranging from construction to laboratory science — overlap with a public company run by his brother. Nonetheless, if Eckman has launched this project (or does in the future) we hope the company will disclose the compensation paid on this deal.

## *Predictive's CEO/President Bradley C. Robinson: Official Biography Doesn't Tell the Full Story*

Much like the details *omitted* from CEO Brad Robinson's official bio, the items *included* also raise questions. For instance, here are several claims that we have taken the "shine" off of and "un-spun":

**Claim:** Robinson's official biography states he "was the CEO and co-founder of Infusive Technologies, LLC from November, 2004 until September, 2008 when it was acquired by Sagent Pharmaceuticals, Inc."

**Un-Spun:** Sagent acquired Infusive's key assets relating to a new syringe technology (not the whole company.) Sagent paid $1.25 million up-front for the technology, then was slated to pay additional amounts upon achievements of certain milestones, including upon receipt of an FDA 510K device approval.

The Sagent deal ended in litigation, however. According to a 2011 lawsuit filed by Robinson's entity, Sagent failed to advance the commercialization of the technology.

Sagent countersued , detailing how the device was rejected by the FDA with a deficiency letter. Sagent alleged that Robinson botched the 510k application, and that he also concealed material facts from Sagent including [I] knowledge that former employees did not properly assign their patents to Infusive, and [II] knowledge that international patent applications had been botched as well.

The parties ultimately settled on undisclosed terms. Robinson's entity, Infusive, was apparently allowed to *keep* the FDA-rejected syringe technology, because Infusive later took the technology public via reverse-merger in the entity that ultimately became Predictive! [ Pg. 20]

(Merle Ferguson, the SEC-alleged securities fraudster who became Predictive's Chairman, was CEO of the entity at the time in 2014.)

**Claim:** Robinson's official biography states that he "studied accounting at the University of Utah and received a Masters of International Management from the Thunderbird".

**Un-Spun:** This is true, but while Robinson *studied* at the University of Utah, he never actually graduated . He later received an *executive* MBA at Thunderbird, which doesn't require an undergraduate degree. A Thunderbird admissions officer told us that the undergraduate degree requirement can be "surpassed by the quality and quantity of professional work experience a student had at that time."

**Claim:** Robinson's official biography states that he was a "Director/Co-Founder of Specialized Health Products, Inc. ("SHPI"), acquired by C.R. Bard, Inc."

**Un-Spun:** This is also true, but SHPI was actually run by Robinson's uncle, who served as Chairman and CEO. Robinson's Dad served as the CFO. SEC filings show that Robinson was around 24 years old when he joined, an apparent fresh college drop-out at the time, yet was given a board seat at the family business.

And that pretty much brings us full circle.

*So who audits this total gem of a company?*

## *Predictive's Auditor: Have You Ever Heard of BF Borgers? Neither Had We*

Predictive has gone through several auditors in recent years, which we generally find to be a red flag. On February 28th 2017, the company announced that it was appointing Sadler, Gibb & Associates, LLC ("Sadler") as its auditor, replacing Stevenson & Company CPAS.

Predictive switched to BF Borgers around 2018. BF Borgers is a roughly 25-person firm based in Colorado and can be found through the website www.denveraudit.com. If you've never heard of BF Borgers, we won't hold it against you – neither had we. You are unlikely to find their clients anywhere on the S&P 500 (or any major national exchange for that matter).

Most of BF Borgers' clients are sub $20 million market cap companies that are listed on the pink sheets, including esteemed firms such as:

> Kisses From Italy, a restaurant chain based in Fort Lauderdale, Florida that aspires to list on the OTC market if approved to do so. [Pg. 1]
> The Lingerie Fighting Championships (Pink: BOTY), with a market cap of $200 thousand as of this writing, and which is exactly what it sounds like. (Video Link)


Here is a picture of BF Borgers' headquarters, courtesy of Google Maps:


We do not believe BF Borgers is adequately suited to effectively audit Predictive's fairly complex entity structure, which includes its multiple acquired subsidiaries.

## *Conclusion: Our Predictions for Predictive*

As one former employee of a subsidiary wrote us about Predictive's management:

> *I don't trust them implicitly, their motives never seem entirely open, there's always a 'play' in everything they do.*

We couldn't have said it better ourselves. A company displaying hallmarks of insider self-dealing that also seems to be taking advantage of vulnerable pregnant women and elderly patients suffering from chronic pain strikes us as a terrible investment opportunity. We have some predictions for how things will play out next:

- We think Senator Orrin Hatch may resign. We have seen no indication that he is aware of any of the business issues here. (As a recently retired member of the Senate, we figure he may have thought he was just getting paid for some pretty light board work at an interesting local company.)
- We predict the company will issue some sort of threatening press release that dodges most of the substance of this report.
- We expect the company to be slated for a massive repricing of its stock in the near-term and potential regulatory intervention over time.

Safe investing to all.

[1] Predictive later changed its address from 2749 Parleys Way, Salt Lake City, Utah to 2735 Parleys Way, Salt Lake City, Utah sometime between June 8, 2017 and June 29, 2018, per SEC/OTC filings.

*Corrections:A previous version of this report stated that Dr. Mike Van Thielen operated a series of pain management clinics and had a PhD in holistic medicine. Dr. Van Thielen operates 1 pain management clinic and has a PhD in holistic nutrition.*

**Disclosure: We are short shares of redictive**

# TAB 27

# Eros International: On-The-Ground Research, Employee Interviews, and Private Company Documents Expose Egregious Accounting Irregularities

Published on June 7, 2019



- Yesterday, Eros's key Indian operating subsidiary had its credit rating lowered 10 notches to "default" by CARE ratings, the second largest Indian ratings agency. The issue, according to CARE was "a slowdown in collection from debtors".
- The default occurred just as we were completing an investigation that sought to explain precisely why Eros has been persistently unable to collect receivables from its debtors.
- After extensive on-the-ground research in India, interviews with multiple former

employees, and a detailed review of Indian private company filings, we believe the underlying problem is that a significant portion of Eros's receivables don't actually exist.
- We have uncovered details of highly irregular related-party transactions. For example, Eros has directed $153 million to a supposed production company based in tiny office located in what looks to be a rehabilitated Mumbai slum. The entity is operated by the brother-in-law of Eros's Chairman and CEO.
- We have also documented what we believe to be multiple undisclosed related-party transactions that appear designed to hide receivables.
- It is hard to imagine Eros's equity makes it out of this scenario intact. We expect the price of both the BSE and NYSE stock to end up worthless, barring some sort of bailout from a friend of Eros's leadership.
- In our opinion, this situation has arisen due to a complete failure of Eros's auditor, Grant Thornton, to apply even basic scrutiny to Eros's financials.

***Initial Disclosure:****After extensive research, we have taken a short position in shares of EROS. We stand to benefit financially if the stock price declines. This report represents our opinion, and we encourage every reader to do their own due-diligence. Please see our full disclaimer at the bottom of the report.*

## *Introduction: The Market Was Caught Off-Guard by the Sudden Credit Default of Eros's Key Operating Subsidiary*

The last couple of days has seen a dramatic series of events for Eros, a company that has been dogged by allegations of accounting irregularities for years (including in several articles written by us: 1, 2).

India's second largest credit ratings agency, CARE ratings, suddenly lowered the rating on Eros's key Indian operating subsidiary by 10 notches to "Default", catalyzing a wave of intense selling pressure across Eros's entire capital structure.

Eros's Bombay Stock Exchange-listed subsidiary subsequently cratered limit-down, along with Eros's unsecured bonds trading -43%, followed by its NYSE-listed stock which finished the day down about 50%.

Eros initially responded to the default news with a morning press release stating:

> *Eros International PLC and all of its subsidiaries have met and continue to meet all debt service commitments.*

The story already shifted by mid-day however when a follow-up press release acknowledged that its subsidiary was actually late on two loan payments:

> *(the subsidiary) was late on two loan interest payments for April and May 2019. These interest payments total less than $2 million and are currently in process of remittance.*

The release then reiterated the company's strong cash and liquidity position, although this seemed to do little to allay investor concerns (the stock remained roughly flat from the time of announcement until end of day).

The implosion of Eros's capital structure seems to have caught many market participants off-guard. Macquarie analysts covering the stock put out a research note entitled " Hard to Explain ", with their best guess being that Eros defaulted due to a "clerical error".

## *Introduction: It's Not Hard to Explain*

For us, this unraveling couldn't have been more expected. We have been tracking Eros's rapidly deteriorating financial condition closely and were in the process of finalizing this investigation which sought to understand these very issues in more depth.

With Eros's high short-term debt balance, its recent failure to raise an onshore bond , and its failure to collect on its suspiciously high receivables balance, a liquidity event seemed to border on inevitable.

## *The Reason Cited for Default: "A Slowdown in Collection from Debtors". Our Explanation: We Think a Significant Portion of Eros's Receivables Don't Actually Exist*

The reasoning cited by CARE for the default rating was a "slowdown in collection from debtors" which led to cash flow issues at the company. Per the report synopsis :

**Detailed Rationale & Key Rating Drivers**
The revision in the ratings assigned to the bank facilities of Eros International Media Ltd. (EIML) is on account of ongoing delays/default in debt servicing due to slowdown in collection from debtors, leading to cash flow issues in the company.

**Detailed description of the key rating drivers**
**Key Rating Weakness**
**Ongoing delays/default in debt servicing**
As a part of CARE's due diligence process, CARE had interacted with EIML's bankers and had also obtained 'Default if any' statements from the company which mentioned delays/default in debt servicing (both principal and interest) on the terms loans availed by the company, as also delays of more than 30 days in servicing interest on cash credit and packing credit, and a delay of more than 30 days in payment of bills. As per the management, the delays/ default in debt servicing is on account of slowdown in collection from debtors leading to cash flow issues in the company.

The "slowdown in collection" echoes the criticism of multiple short-sellers over the past several years (including us) who had identified patterns of suspicious related-party entities and large amounts of revenue that the company has had persistent difficulty in collecting.

Quite frankly, our belief is that Eros is having a hard time collecting on its receivables and advances because we think a significant portion of them do not actually exist.

When faced with past questions about revenue and receivables from skeptics Eros chose to sue them all , including us, alleging a massive "short and distort" conspiracy. The lawsuit was recently dismissed against all moving defendants.

## *About Our Investigation: On the Ground in India, And Multiple Interviews with Former Employees*

Instead of cowering to Eros's bullying tactics, we instead decided to take our research to the next level.

In this report, we will share findings from our on-the-ground investigation to Mumbai, and from interviews conducted with multiple former employees globally.

Our primary goal was to learn more about Eros's mysterious and growing uncollected receivables balance, which appears to be at the core of its current liquidity situation.

As we will show, we think Eros's collapse is an egregious failure of its auditors, Grant Thornton, to apply even basic scrutiny to the company's financial condition. This comes as no surprise: In the wake of another 'mysterious' financial collapse at one of its other clients last year, the CEO of Grant Thornton said (quite infamously):

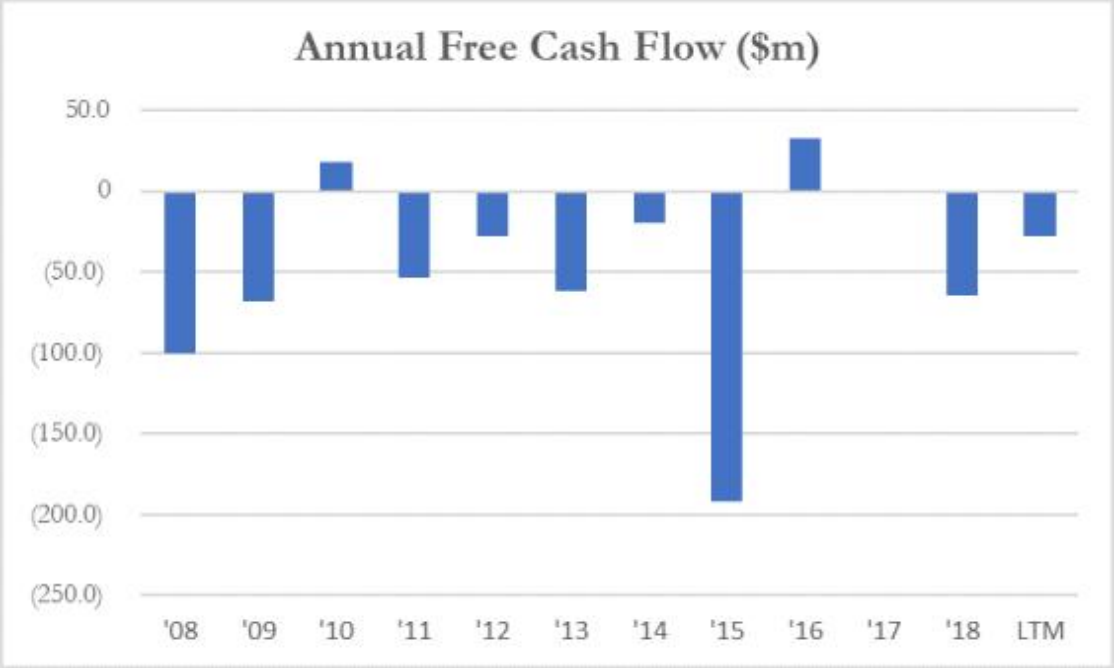
> *We are not doing what the market thinks. We are not looking for fraud and we are not looking at the future and we are not giving a statement that the accounts are correct…we are not set up to look for fraud.*

You can say that again Grant Thornton.

## *Liquidity Basics: Consistently Negative Free Cash Flow, Low $88m Cash and Equivalents Balance And $211m of Short-Term Debt*

We will dive into what we believe are accounting irregularities in the reported financials, but a quick analysis of Eros's reported numbers showed a poor liquidity position as-is:

- Cash and equivalents of $88 million as of last quarter [ Pg. 3]
- Short term debt of $211m (total debt of $294m). [ Pg. 3]
- Weighted average debt yield of ~10.9% (despite about half of the debt being secured.) [ Pg. 20]
- Historical free cash flow has generally been negative, owing largely to expenditures on content outpacing reported net profit.




(Source: CapIQ)

At a glance, a company with high short-term debt, historically negative free cash flow, and low

available liquidity represents an obvious credit risk. It is for these reasons that a large number of companies decide to get supply chain financial risk mitigation . Ultimately, mitigating financial risk is all about lowering the level of risk by eliminating or reducing risk factors that could leave a business in financial ruin.

## *The Reported Financials Don't Tell the Full Story. Eros Has A Long History of Accounting Red Flags*

Going one level deeper, Eros has been the subject of multiple historical articles identifying accounting irregularities ( 1,2,3,4,5,6,7,8). Many of these articles have focused on red flags like Eros's large uncollected receivables balance and consistent lack of positive free cash flow.

Eros's days sales outstanding (DSO) indicate that almost a year's worth of revenue has been booked but never collected. It is this lack of collection that seems to be contributing to Eros's current liquidity meltdown.

(Note that large, growing receivables balances and a consistent lack of positive free cash flow generation are two common red flags often associated with revenue falsification):

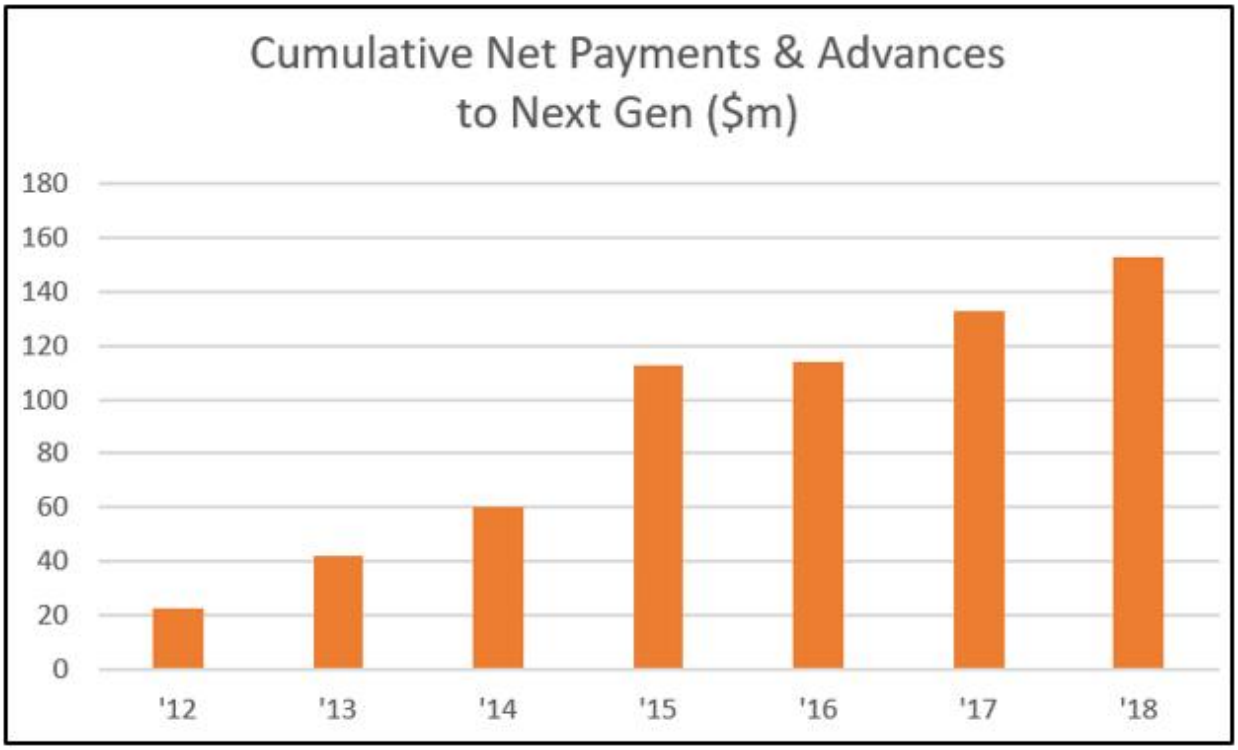

(Source: CapIQ)

We will next explore Eros's relationship with a variety of questionable entities that we believe are contributing to its current situation.

## *Exhibit A: Next Gen-Eros Has Made $153 Million Worth of Net Payments & Advances to This Small Related Party Entity*

Next Gen is one example of a related-party entity that we think Eros may have trouble "collecting" from.

Next Gen is a film production company owned by the brother-in-law of Sunil and Kishore Lulla, Eros's Chairman & CEO respectively. [ Pg. 98] The entity has received $153 million in net payments and advances since 2012 (the earliest year reported in Eros's SEC filings.)




(Source: Eros's SEC filings, '12, '13, '14, '15, '16, '17, '18)

According to its website , Next Gen has produced only 5 films since 2012 , all of which were co-produced and/or distributed with Eros. We find this odd: Why fund Next Gen with hundreds of millions of dollars only to then co-produce/distribute all of their films?

## *Next Gen: The TOTAL Budget for Films Next Gen Has*

## *Produced in That Same Time Period Was Only $19.3 Million. Where'd the Rest of the Money Go?*

Oddly enough, the total budget of the 5 films produced in that timeframe amounted to only about $19.3 million, according to Box Office India. ( 1,2,3,4,5)

Again, these films were largely co-produced by Eros which means that Next Gen likely hadn't even shouldered all of these production costs itself:

| ilm | ear | Budget USD |
|---|---|---|
| Table No.21 | 2013 | 1,275,000 |
| 3G | 2013 | 1,950,000 |
| R… Rajkumar | 2013 | 8,700,000 |
| Phobia | 2016 | 1,275,000 |
| Munna Micheal | 2017 | 6,150,000 |
| | **Total** | **19,3 0,000** |

If production costs totaled only $19.3 million, where did the other $133 million go?

Next Gen also claims to buy and sell catalogue film rights, yet its website shows no films purchased or distributed. This doesn't seem to explain the massive amount of money sent into the entity either. It also raises the same question-why would Eros send money to Next Gen only to buy catalogue films from it?

## *Next Gen: A High-End Office Fit for a Major Bollywood Production Studio? No-A Small Office Based in a Mumbai Rehabilitated Slum?*

We visited Next Gen's offices and found it to be far from what you would expect out of a supposed high-end Bollywood production company allocating hundreds of millions of dollars to movie projects.

Next Gen's website doesn't list an address, so we had to dig through the entity's Indian private company filings to find its headquarters. The address is listed as '6-A/10, Junu Sangeeta Apartment, Santacruz (West), Mumbai.'

The offices are located in the Juhu Beach area and, more precisely, in a small enclosed area called "Sangeeta Apartments". As the name suggests, and unsurprisingly for the location of a suspected shell company, the area is largely residential. Here we are at the Sangeeta Apartment complex on May 4 th of this year:


And here is the Indian investigator in front of Next Gen's offices (you can see the Next Gen sign in the background) [1]:

The company is located on the ground floor of what has been identified by one of our Indian advisors as an SRA building. SRA stands for "slum rehabilitation authority", a government institution in charge of taking slum constructions and, with minimal modifications, turning them into buildings safe for living. This is clear from the photograph, which shows metal bars at the exterior of the building — typical signs of SRA intervention.

Our Indian consultant explained that many "dodgy" businesses tend to be located in slums or former slum locations because the authorities are less likely to check the premises and interfere with their activities.

We were able to briefly enter the Next Gen offices and accessed what seemed to be the main area. It was a small room with a desk and a couple of posters. We saw little to no commercial activity going on at the premises.

Immediately upon entrance, a middle-aged man with a mustache approached us with a worried and suspicious disposition. This person, as far as we could tell, was the only employee present during our three visits to the premises, and was unable to communicate in English.

The impression we got from this visit is that of a sham office where little to no real activity is going on at a location totally unsuitable for movie production; an industry most would associate with a nice building, well-stocked offices, and plenty of high-level employees.

## *Next Gen: Former Employee Claimed That Next Gen Channels Money to Lulla Family Members Through Dummy Production Deals*

A 2016 class action lawsuit against Eros included witness testimony alleging that Eros uses Next Gen as a means of funneling money to the company's insiders. Per the amended complaint [ Pg. 22]:

> *Confidential Witness ("CW") 2 is an Indian film producer with personal knowledge of the Company's business practices in the period immediately leading up to the Class Period, as a result of his work co-producing films with Eros, including at least one film released in 2011. According to CW2,* ***Eros channels money to family members through dummy production deals***
>
> *According to CW2, 30-40% of Eros's acquisition and production occurs through Next Gen, owned by Kishore Lulla's brother-in-law Puja Rajami. Further, according to CW2, NextGen signs the co-production agreements with EIM, and Eros makes payments to EIM, which, in turn, makes payments to NextGen to produce the films.*
>
> ***Thus, NextGen collects money on films but provides no added value, according to CW2****CW2 also avers that* ***NextGen employees use Eros's offices and do little other than make a margin on the film****CW2 also avers that Lulla's wife also receives advances as a producer.*

The lawsuit was dismissed, likely due to a lack of additional evidence. In light of our latest findings on Next Gen, however, we view the witness testimony as highly prescient.

## *Next Gen: How Much of These Advances/Payments Are Now Suddenly Hard to Collect?*

We think investors deserve to know:

- How much of these advances and payments to Next Gen are now uncollectable and contributing to Eros's liquidity situation?
- What did Eros get in exchange for these transfers?
- What steps has Eros's auditor, Grant Thornton, taken to validate that the transactions were appropriate, if any?

## *A Pattern Emerges: Indian Private Company Audits Show Multiple Undisclosed Related-Party Transactions*

Aside from Next Gen, and guided by our interviews with former employees, we explored other entities related to Eros's Lulla family for clues to what is happening with Eros's receivables balance. As alluded to earlier, we think the reason Eros has been unable to collect on its receivables is because it may be circulating them through its myriad related-party entities.

## *Example 1: InfraDigital Technologies-An Undisclosed Eros Related-Party Entity That Operates Out of the Same Address as Next Gen*

Our research led us to an entity called InfraDigital Technologies that operates out of a different suite at the same address as Next Gen.

The entity is clearly a related party of Eros. Its two directors are (1) Anand Shankar, Eros's finance controller and (2) Sagar Surender Sadhwani. (Surender Sadhwani is Eros's director of Middle East operations and the cousin of Eros's Chairman and CEO, Kishore Lulla and Sunil Lulla.)

Per the latest director's report we can see both the directors and the address:

INFRADIGITAL TECHNOLOGIES PRIVATE LIMITED

6-A 4 Sangeeta Apartments, Juhu Road, Santracruz (West), Mumbai - 400054 CIN: U30005MH2015FTC267343

**23. ACKNOWLEDGEMENTS**

Your Directors wish to place on record their sincere appreciation of the valuable services and co-operation extended by the Bankers and also the contribution, unstinted efforts and the spirit of dedication shown by others in the operations of the Company during the year.

**For and on behalf of the Board of Directors**
**Infradigital Technologies Private Limited**

**Sagar Surender Sadhwani**
**Director**
**DIN: 03559502**

**Anand Shankar Kamtam**
**Director**
**DIN: 02942810**

Date: 20 August 2018
Place: Mumbai

# *InfraDigital Technologies: Suspicious Financials- Barely Any Operating Revenue but Large Borrowings and Receivables To/From Related Parties*

From the latest financials for the entity we see that it generated only about $90,000 USD in operating revenue yet had "Long term borrowings" and "Long term advances" of about 5x that amount, $427,000 and $482,000 respectively.

The borrowings come from related-parties Next Gen and Eros Labs:

| Long Term Borrowings | 31st March, 2018 | 31st March, 2017 |
|---|---|---|
| Secured Loans | | - |
| Unsecured Loans | | |
| From Banks | | - |
| From Others | | |
| Eros Labs PTE (Liability) | 15,580,719.05 | - |
| Karan Singh Bedi | 216,816.46 | 1,463,902.79 |
| Next Generation Films Pvt Ltd | 6,800,000.00 | 6,800,000.00 |
| Sagar Sadhwani | 5,900,000.00 | 5,900,000.00 |
| | 28,497,536.00 | 14,163,902.79 |

And the advances go right out to related-party Eros Television:

NOTE-7

| Long Term Loans & Advances | 31st March, 2018 | 31st March, 2017 |
|---|---|---|
| Advances to Staff - Kanan | 50,000.00 | 50,000.00 |
| Eros Television - Advance Given | 31,652,894.00 | - |
| TDS Receivable | 348,978.05 | 20,078.00 |
| Security Deposit - Others | 3,000.00 | 16,500.00 |
| Security Deposit - Rent | 91,498.00 | 375,000.00 |
| Total | 32,146,370.00 | 461,578.00 |

If this is all starting to look very circular it's likely because it is all very circular.

From the same audit we see that 99.99% of the shares of Infradigital are held by a Singaporean entity called Eroslabs Pte, revealing that the entity is not part of Eros's corporate structure:

The detail of shareholder holding more than 5% shares as at March, 2018 and March, 2017 is set out below:

| Particulars | 31st March, 2018 | 31st March, 2017 |
|---|---|---|
| M/S Eroslabs Pte. Ltd., Singapore (99.99%) | 9999 | 9999 |
| Karan Singh Bedi (0.01%) | 0 | 1 |
| Sagar Surender Sadhwani (0.01%) | 1 | 0 |
| | 10000 | 10000 |

Singaporean records show that Eroslabs PTE is directed by the husband of Rishika Lulla , who registered his address as a PO Box based in Dubai.

We wonder, why do Eros's principles have multiple entities engaging in numerous related party transactions based out of a small apartment in what appears to be a rehabilitated Mumbai slum? What legitimate business could be taking place here?

InfraDigital looks to be just one of multiple entities that exhibit similar characteristics.

## *Example 2: Eros Television-An Entity Based Out of The Same Registered Office as Eros's Indian Subsidiary, Yet NOT a Part of Eros's Corporate Structure.*

Eros Television is an entity based out of the same address as Eros's Indian registered office, yet which falls outside of Eros's corporate structure. From the entity's recent directors report we see its address:

EROS TELEVISION INDIA PRIVATE LIMITED
(Formerly known as EROS GREEN ENERGY PRIVATE LIMITED)
Registered Office : 201, Kailash Plaza, Opp Laxmi Industrial Estate Link Road, Andheri (W), Mumbai-400 053
Tel.: + 91-22-6602 1500 Fax: +91-22-6602 1540 Email : eros@erosintl.com Website:www.erosintl.com
CIN No. U40105MH2007PTC173735

And from the Eros website we see the registered office matches:

Registered Office

201, Kailash Plaza, Plot No. A-12, Opp.
Laxmi Industrial Estate,
Off New Link Road, Andheri – (West),
Mumbai – 400053,
Maharashtra, India.

Per the same director's report we see that 99% of Eros Television is owned by Emerging Power Singapore, another entity directed by the husband of Rishika Lulla. The other 1% is owned by Sunil Lulla.

In other words, this entity falls outside of the Eros corporate structure but is clearly a related party that exists at Eros's own address.

IV. **SHARE HOLDING PATTERN** (Equity Share Capital Breakup as percentage of Total Equity)

i. Category-wise Share Holding as on 31 March, 2018

| Category of Shareholders | No. of Shares held at the beginning of the year | | | | No. of Shares held at the end of the year | | | | % Change during the year |
|---|---|---|---|---|---|---|---|---|---|
| | Demat | Physical | Total | % of Total Shares | Demat | Physical | Total | % of Total Shares | |
| Emerging Power Singapore Pte Ltd | - | 9,900 | 9,900 | 99% | - | 9,900 | 9,900 | 99% | Nil |
| Sunil Lulla | - | 100 | 100 | 1% | - | 100 | 100 | 1% | Nil |
| **Grand Total** | - | **10,000** | **10,000** | **100%** | - | **10,000** | **10,000** | **100%** | Nil |

# *Eros Television: Suspicious Financials-Zero Operating Revenue, Zero Inventory, No Fixed Assets, No Investments, Yet a Balance Sheet Laden with Large "Advances" and "Payables" to Related Parties*

As we see from its latest audit, Eros Television has generated zero operating revenue for the prior 2 years, had zero inventory, no fixed assets, and no investments, yet its balance sheet is laden with large, suspicious advances and payables:

Eros Television India Private Limited
Balance Sheet as at 31 March 2018

(Amount in ₹)

| Particulars | Note No | As at 31 March 2018 | As at 31 March 2017 |
|---|---|---|---|
| EQUITY AND LIABILITIES | | | |
| **Shareholders' funds** | | | |
| Share capital | 3 | 100,000 | 100,000 |
| Reserves and surplus | 4 | 21,723,789 | 3,076,400 |
| **Non-current liabilities** | | | |
| Long-term borrowings | 5 | 791,193,711 | 797,500,000 |
| Other non current liabilities | 6 | 103,540,000 | 29,438,450 |
| **Current liabilities** | | | |
| Other current liabilities | 7 | 13,421,256 | 6,104,920 |
| TOTAL | | 929,978,756 | 836,219,770 |
| ASSETS | | | |
| **Non-current assets** | | | |
| Long term loans and advances | 8 | 917,098,920 | 830,660,261 |
| **Current assets** | | | |
| Short term loans and advances | 9 | 12,382,873 | 5,343,633 |
| Cash and bank balances | 10 | 496,963 | 215,876 |
| TOTAL | | 929,978,756 | 836,219,770 |

We see that the advances largely consist of "advances given for film", suggesting that the entity lends out a massive amount of capital to procure films.

Note 8 : Long term loans and advances

(Amount in ₹)

| Particulars | As at 31 March 2018 | As at 31 March 2017 |
|---|---|---|
| Unsecured considered good | | |
| Advances given for Film | 907,098,920 | 830,660,261 |
| Other advances | 10,000,000 | - |
| Total | 917,098,920 | 830,660,261 |

# *Eros Television: Did Eros Fail to Disclose Related Party Transactions with This Entity… Again?*

As we had noted earlier, Eros sued us in 2017 after we had identified that the company appeared to be engaging in undisclosed related-party transactions. We had initially emailed Eros to ask about such transactions, but rather than respond to our questions they instead filed a lawsuit against us and dozens of others in an effort to silence criticism.

Despite the lawsuit, Eros eventually admitted in its 2017 financials that it had taken a $6.4 million loan from Eros Television, one of the very entities we had identified as suspicious. [Pg. 98]

While we were pleased to see that Eros eventually disclosed its dealings with Eros Television in its 2017 financials, we see that no related party transactions with Eros Television were disclosed in 2018:

| | Nominal interest rate (%) | As at March 31 2018 | 2017 |
|---|---|---|---|
| | | (in thousands) | |
| **Asset backed borrowings** | | | |
| Export credit, bill discounting and overdraft | BPLR+1-3.5% | $ 43,518 | $ 41,687 |
| Export credit and overdraft | LIBOR+4.5% | 21,226 | 24,572 |
| Short term loan(2) | 13% - 14.25% | 11,537 | 5,396 |
| Short term loan | 10.20% | 11,474 | — |
| Short term loan | MCLR+4.25% | — | 4,943 |
| | | $ 87,755 | $ 76,598 |
| **Unsecured borrowings** | | | |
| Other short term loan (3) | 12% - 14% | — | 7,033 |
| Installments due within one year on long-term borrowings | | 64,208 | 96,398 |
| Short-term borrowings - at amortized cost | | **$ 151,963** | **$ 180,029** |

(1) The Group re-paid revolving credit facility in December 2017.
(2) Secured by pledge of shares held in the Group's majority owned subsidiary, Eros International Media Limited, India.
(3) Includes loan of $6,417 as at March 31, 2017 from Eros Television Private Limited, a related party. (See Note 35).

(Note that Eros Television was mentioned 3 other times in the 2018 financials, but similarly disclosed no other transactions aside from the 2017 transaction.)

We found this incredibly surprising. We see that Eros Television in fact engaged in *plenty* of related party transactions in 2018 according to the entity's own audit:

b. **Transactions with related parties:**

(Amount in ₹)

| Particulars | Interest income | Total |
|---|---|---|
| Eros International Media Limited | 48,215,101<br>(2,409,863) | 48,215,101<br>(2,409,863) |

| Particulars | Loan and advance taken | Total |
|---|---|---|
| Eros International Media Limited | 6,500,000<br>(Nil) | 6,500,000<br>(Nil) |
| Mr. Sunil Lulla | 4,000,000<br>(5,000,000) | 4,000,000<br>(5,000,000) |
| Mr. Kishore Lulla | 118,500,000<br>(20,000,000) | 118,500,000<br>(20,000,000) |

| Particulars | Repayment of loan and advance taken | Total |
|---|---|---|
| Eros International Media Limited | 6162,465<br>(Nil) | 6162,465<br>(Nil) |
| Mr. Sunil Lulla | 8,998,450<br>(100,000) | 8,998,450<br>(100,000) |
| Mr. Kishore Lulla | 39,400,000<br>(Nil) | 39,400,000<br>(Nil) |

| Particulars | Loan and advance given | Total |
|---|---|---|
| Eros International Media Limited | 61,000,000<br>(415,000,000) | 61,000,000<br>(415,000,000) |
| | | |

| Particulars | Repayment of loan and advance given | Total |
|---|---|---|
| Eros International Media Limited | 525,383,977<br>(1,000,000) | 525,383,977<br>(1,000,000) |

As you can see from the above, the large transfers have gone through this entity both to and from Eros's subsidiaries and its key individuals. Aside from this apparent system of advances and payables we were unable to identify any other operations or purpose for this entity.

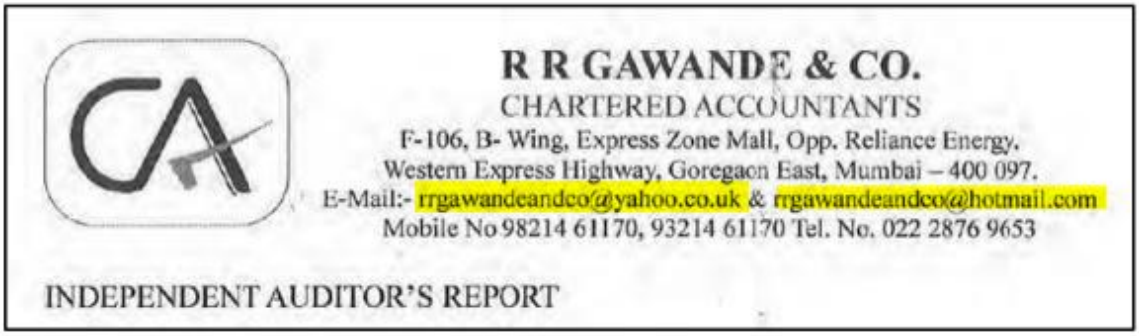
We view this as another major failure of Eros's auditor, Grant Thornton, to monitor an entity with a documented history of engaging in undisclosed related-party transactions. There is

simply no excuse for this repeated failure.

## *Eros Television: Our Visit to The Entity's Auditor, Based Out of a Tiny Office in A Dilapidated Building*

Given that Grant Thornton seems to have exercised virtually zero oversight over Eros's financial controls we sought to see if anyone else was monitoring the situation.

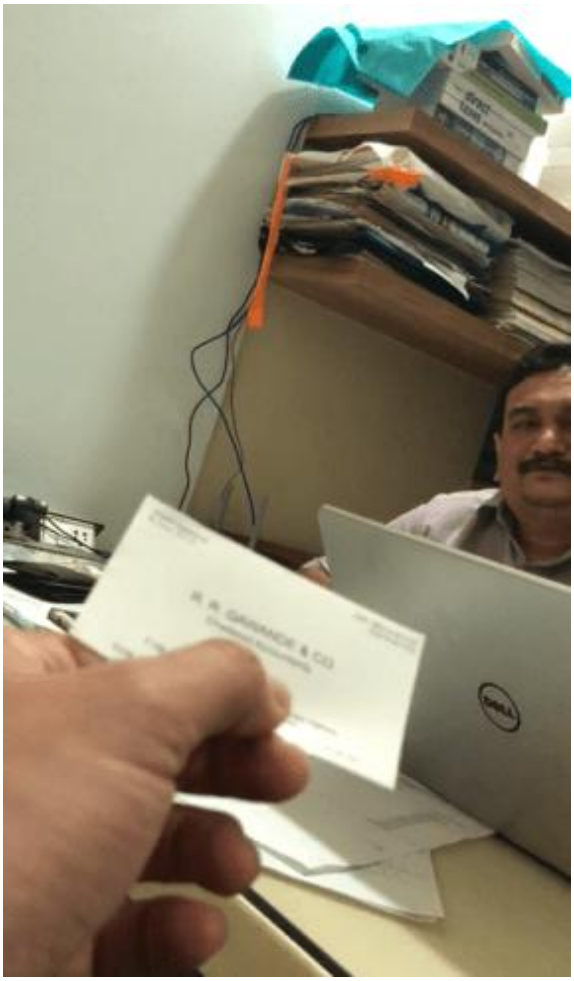
We see from Eros Television's latest audit that the entity is audited by a firm called R.R. Gawande & Co. The proprietor can be reached by email at either his Hotmail account or his Yahoo account:


R R GAWANDE & CO.
CHARTERED ACCOUNTANTS
F-106, B- Wing, Express Zone Mall, Opp. Reliance Energy.
Western Express Highway, Goregaon East, Mumbai – 400 097.
E-Mail:- rrgawandeandco@yahoo.co.uk & rrgawandeandco@hotmail.com
Mobile No 98214 61170, 93214 61170 Tel. No. 022 2876 9653
INDEPENDENT AUDITOR'S REPORT

We visited Gawande's offices in May 2019. The office is located in a humble neighborhood in Mumbai called Goregaon and within a commercial building called "Express Zone". To enter we first walked past a few cows lounging under a tent at the gate:

On the inside, the facility was poorly-lit and run-down. Most of the commercial space looked vacant.

Gawande's office was clearly marked with a sign on the second floor. The office was tiny, barely enough for a single desk and a table with a mug of coffee.



When we entered, Mr. Gawande was sitting with a younger co-worker. Although we entered the office on the pretense of being a potential client, the staff was clearly suspicious (they probably do not get many walk-ins).

Needless to say, the staff's disposition and the lack of office infrastructure is not what we would have expected for an establishment that audits entities associated with Eros and the Lulla family.

Shortly after our meeting, Mr. Gawande, possibly advised by Eros to behave cautiously with curious strangers, discontinued all communications with us despite our repeated attempts to contact him again.

All told, we do not think Gawande is a credible auditor, though he strikes us as a perfect auditor for an entity with virtually no operations aside from suspect receivables and payables.

## *The Signs Were There All Along*

As early as 2009, Eros's principles had been credibly accused of engaging in related-party transactions to help a company inflate revenue and earnings following an investigation by audit firm BDO.

**Bollywood embroiled in probe into movie money**

Questions raised over deals between Eros and the London arm of another India film company

Published: May 19, 2012 00:00
By Simon Duke

From the article:

> *A probe has discovered Eros has been used in an apparent effort by a Soho-based special effects group to embellish its financial results.*
>
> *Senior company insiders say a confidential report two years ago by BDO, the accountant, found a pair of questionable transactions between Eros and Prime Focus, which is run by Namit Malhotra and best known for its special effects work on Avatar.*
>
> *Prime Focus' independent auditor disputes BDO's findings.*
>
> *Insiders at Prime Focus claim the deals artificially inflated the turnover of its London subsidiary, helping the loss-making operation return to profit.*

There should be no surprises about what is happening now.

## *What About ErosNow? Usage Metrics Show That the Product is a Dud*

Speaking of 'now', the equity bull case for Eros has generally relied on a belief that ErosNow would be a massive success. In a liquidation scenario, creditors would also want to know what the value of the platform could be.

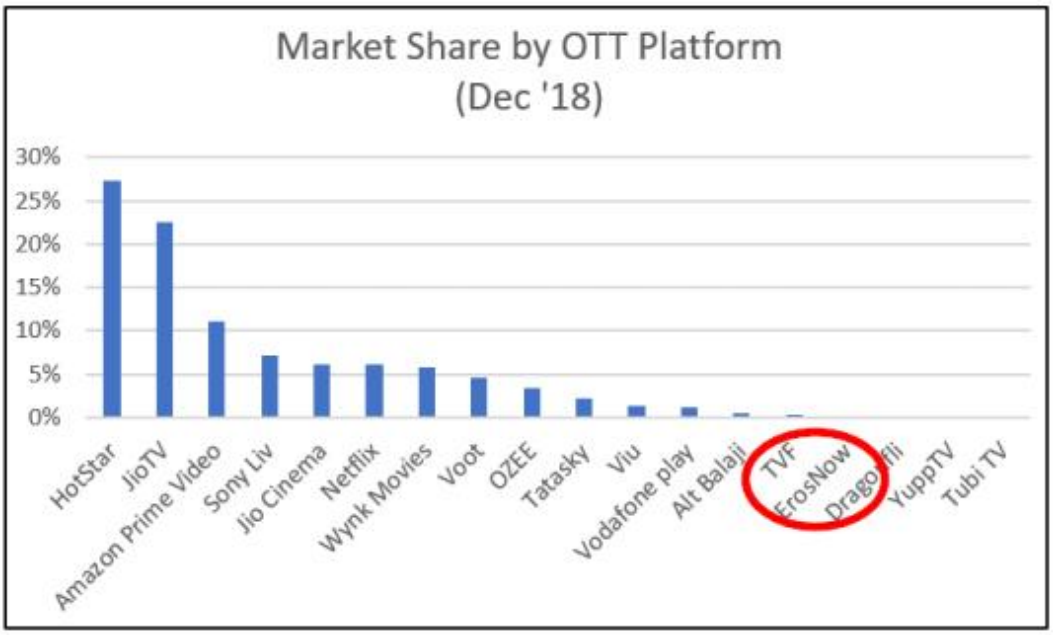
In its last earnings release , Eros touted that ErosNow reached 15.9 million paying subscribers, an impressive milestone.

Despite the rosy headline, Eros's accounting around ErosNow revenue looks muddled. Rather than simply reporting revenue from the platform, last quarter's release (for example) just vaguely declared that revenue growth was "fueled primarily by Eros Now" without stating clearly how much was generated from the platform.

Understanding true usage and adoption is also a challenge based on Eros's reported numbers. The "paying subscribers" metric, for example, seems to consist largely of users that have simply bought new phones that come with pre-paid content bundles. Such numbers say nothing about usage or user engagement.

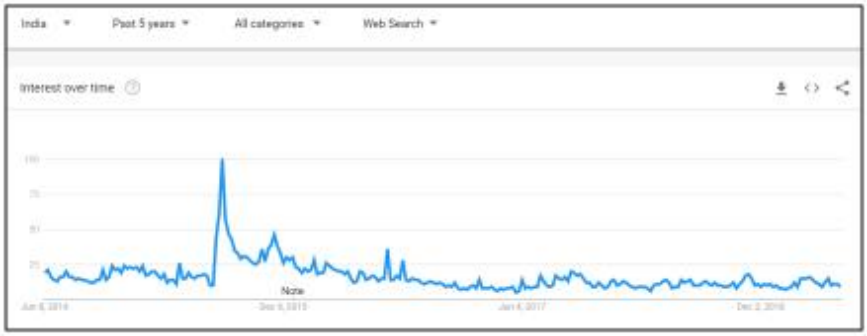
The platform's active users are minimal, according to independent metrics provided by KalaGato, a service regularly cited by Indian media that tracks over-the-top (OTT) content app usage and downloads.

According to KalaGato, ErosNow barely registers as a player in the space, ranking 15th with a market share of about 0.16% as of December 2018.




(Source: KalaGato)

Google Trends similarly shows that the ErosNow topic has basically flatlined in India since mid-2015, a time period that corresponds to their initial marketing campaign to roll out the platform:




Source: Google Trends

By all measures ErosNow's usage seems minimal, despite years of company suggestions that the platform represents the future of Eros.

## *Conclusion: Eros's Unraveling Is Like the Obvious Ending to a Cliché Movie*

For those who have followed the Eros saga closely, the latest news looks to be the culmination of the inevitable:

1. The auditors clearly looked the other way despite years of warning signs.
2. The bankers seemed more interested in generating fees through debt & equity offerings than in performing credible underwriting.
3. The complex international structure made it too challenging for regulators to enforce.

Our prediction is that the company will repeatedly attempt to re-assure bond and equity holders that 'everything will be fine and we are well-capitalized' all the way down.

Good luck and safe investing to all.

**Disclosure:** I am/we are short EROS.

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[1] The first 5 people who are able to positively identify the Indian investigator will win a free Hindenburg mug, a quintessential addition to any kitchen cabinet.

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# TAB 28

# Sky Solar: Court Records Show That Lender Already Withdrew Buyout Proposal But Retail Investors Don't Seem To Realize It Yet

Published on February 25, 2019



## Summary: Sky Solar (NASDAQ:SKYS)


- A key lender recently noted SKYS to be in default, but shares spiked on a company press release indicating that the lender proposed to buy SKYS for $2.15-2.25 per share.
- Retail investors seem to have taken the release at face value, but court filings show that those proposals were actually withdrawn after the lender learned of a new $121m liability.
- Instead, the lender has begun to seize SKYS assets, including a significant Luxembourg subsidiary which it has now fully appropriated.
- The company's financial state was weak prior to the new $121m liability and the recent

note default. SKYS has had 3 CFOs within the span of 6 months.
- We expect the stock to dive as retail investors realize what's actually going on. SKYS looks to be approaching insolvency and we do not anticipate the equity will survive.

# *Introduction*

An interesting thing has happened with Sky Solar Holdings ( SKYS), a small, troubled company that develops and operates international solar projects.

One of SKYS' key lenders, Hudson Solar, recently declared SKYS to be in default on its notes and has begun taking action to enforce its interests. Hudson has sued the company looking to force repayment on the notes and has seized some of SKYS assets, including a significant operating subsidiary.

That all seems quite bad for equity holders of SKYS. But despite that, investors have bid up the stock dramatically based on what appears to be a mistaken reference to a buy-out proposal made in a company press release.

Following the filing of Hudson's litigation against the company, a SKYS press release seemed to imply that there are proposed deals on the table, including one where Hudson would acquire SKYS for between $2.15 to $2.25 per share. Per the press release :

> *"In a series of letters, Hudson alleged that Events of Default (as defined in the Note Purchase Agreement) under the Note Purchase Agreement had occurred and proposed to resolve the issue with an offer to either (I) purchase of the equity in certain projects of the Company at a purchase price of US$240 million, and (II) acquire the Company through merger at $2.15 to $2.25 per ADS (the "Proposals")."*

SKYS had closed at $0.56 per share the day prior to the announcement. But following the press release with news of the proposals, the stock surged over 100% within days. It now trades around $1.20 per share.

But there is one major problem!

# *The Hudson Proposals Had Already Been*

# *Withdrawn Prior to The SKYS Press Release*

A review of the court docket shows that while Hudson had *previously* made several proposals on dates as late as December 24th (see ex. 20 [1]), subsequent events seem to quite clearly render those old proposals moot.

In particular, on December 26th (two days after the last reference we find to Hudson's proposals), Hudson became aware of an agreement made with a party SKYS had been in litigation with. The agreement requires subsidiary Sky Solar Japan to pay $121 million to the other party "on or before April 1, 2019".

As made clear in Hudson's complaint, this new liability changed everything:

> *"…the discovery of a material new debt of this magnitude raised the specter that the Guarantors and, indeed, the corporate group as a whole, would be insolvent and lack sufficient liquidity to fully satisfy the Obligations under the Note Purchase Documents, the Notes, and the Guaranty."*

Hudson highlighted that as a result of this and other factors, the earlier proposals had been **withdrawn**:

> *"Prior to the December 26, 2018 Letter, Hudson Solar (and its affiliates) had previously attempted to engage with the Guarantors, as parent holding companies of the Obligors, on numerous occasions by making a series of proposals to address the liquidity issues of the group.* ***However, these offers were not given serious consideration by the directors and management of the Guarantors and have since been withdrawn."***

At some point, Hudson looks to have decided that just seizing the assets as a creditor was a better approach than paying for equity.

Hudson went ahead and appropriated 100% of one of Sky Solar's subsidiaries in January. The subsidiary, Energy Capital Investment S.a.r.l, was classified as a "significant" subsidiary on SKYS annual 20-F filing (pg. 81) and holds (or held rather) Sky Solar's 84mw of solar projects in

Uruguay .

Hudson now controls this subsidiary and has made it clear that they're not done. Hudson subsequently served demands in multiple jurisdictions to secure payment from SKYS and its various international interests, per a press release of their own.

It would seem therefore that while the SKYS press release mentioned proposals that genuinely had been made by Hudson at one point, it failed to mention that those proposals had already been withdrawn.

We reached out to SKYS investor relations to ask whether they had any reason to believe that the proposals are still active and to clarify some of the items above. We haven't heard a response as of this writing but we will surely update this piece if we hear back from them. We also reached out to Hudson which declined to comment due to the ongoing litigation.

In short, we don't think there are any active proposals from Hudson to acquire the company. On the contrary, Hudson appears to be in the midst of seizing as many of SKYS assets as possible and forcing repayment or liquidation if necessary.

## *SKYS Balance Sheet Looked Pretty Ugly Before the Added/Accelerated Liabilities*

SKYS looks to have already been financially troubled prior to the new $121 million liability due on April 1st and prior to the accelerated demand for about $96 million on the defaulted Hudson note ( pg. 15).

Given the latest reported financials as of June 30, 2018, the company had total current assets of only $155.6 million and current liabilities of $178 million. The company reported shareholder equity of $112 million in that period. Again, all of this was prior to the new $121 million liability.

It is therefore hard to imagine a scenario where Sky Solar's equity makes it out of this situation intact:

| | 2018 (Unaudited) Thousand |
|---|---|
| Current assets: | |
| Bank balances and cash | 68,108 |
| Restricted cash | 40,490 |
| Amounts due from related parties | 16,296 |
| Trade and other receivables | 30,384 |
| Inventories | 323 |
| | 155,601 |
| Non-current assets: | |
| IPP solar parks | 403,305 |
| Amounts due from related parties | 5,167 |
| Other non-current assets | 48,117 |
| | 456,589 |
| Total assets | 612,190 |

| | June 30, 2018 (Unaudited) Thousand |
|---|---|
| Current liabilities: | |
| Trade and other payables | 21,819 |
| Amount due to related parties | 28 |
| Tax payable | 10,195 |
| Borrowings | 23,956 |
| Other current liabilities | 122,177 |
| | 178,175 |
| Non-current liabilities: | |
| Borrowings | 248,662 |
| Other non-current liabilities | 73,137 |
| | 321,799 |
| Total liabilities | 499,974 |
| Total assets less total liabilities | 112,216 |

# *SKYS Just Appointed Its 3rd CFO in 6 Months*

SKYS looks to have experienced some very recent tumult in its key financial ranks, which further indicate signs of stress.

The company announced on August 31, 2018, that long-time CFO Andrew Wang resigned and that Sanjay Shrestha would assume the role.

Then on January 28, 2019, the company abruptly terminated the new CFO. Shrestha resigned as

director shortly thereafter, on February 1, 2019.

The company has appointed Julie Zhu as the acting CFO, marking the third person to fill the CFO shoes within 6 months.

The quick turnover at such a key oversight role indicates that the company could be experiencing issues with its internal controls. The Hudson complaint seemed to underscore this point as well:

> *"Sky Solar Holdings is listed on the NASDAQ as a foreign issuer and, as such, is subject to various reporting obligations. Notwithstanding these obligations, the Sky Solar Holdings board of directors has failed to disclose numerous material events that would be relevant to shareholders, including, but not limited to:*

> *1. Hudson Solar's (and its affiliates') proposals to address the group's serious liquidity issues;*
>
> *2. the ongoing Events of Default under the Note Purchase Agreement;*
>
> *3. the receipt of numerous notices regarding such Events of Default;*
>
> *4. the acceleration of the Notes;*
>
> *5. the Demand on Guaranty; and*
>
> *6. the exercise of appropriation rights against Sky International under Luxembourg law, resulting in the assignment of the shares of ECI to Hudson Global Finance DE, LLC."*

As a parting shot, Hudson said the following of SKYS:

> *"(Hudson Solar) believe(s) that it is dealing with a severely mismanaged company that does not operate in a candid manner and that is unable to meet its obligations, both monetary and nonmonetary, to its various stakeholders."*

Questions around internal controls are not entirely new for SKYS. In late 2017 the company's

former Chairman/CEO was found to have made unauthorized transfers to entities under his control. An internal investigation later found that the transfers "appeared to lack proper board and audit committee authorization". A settlement with the company required the former executive to pay back $15 million to the Company, among other conditions.

To their credit, at least the internal investigation led to the executive's ouster and uncovered the alleged wrongdoing. Nonetheless, for a company to experience such executive tumult in such a short period of time does not inspire confidence.

# *Conclusion: We Would Be Surprised If Sky Solar's Equity Makes It Out of This Alive. We Are Short.*

We think Sky Solar's press release gave investors the mistaken impression that there's an active proposal on the table to buy the company. We don't see any evidence of that and we don't see the recent rally holding up once investors piece together what is happening here.

Best of luck to all!

---

[1] The court filing shows that Lumens Holdings, an entity that held a portfolio of Sky Solar's projects sent a letter to Hudson in relation to a an agreement breach. In that letter, Lumens indicated that Hudson looks to have made the proposals to purchase Sky Solar or the certain projects on December 24th. This is the last reference we were able to find in relation to any proposals. Thereafter Hudson indicated that it had withdrawn those proposals and has given no public indication that it has changed its stance. Per the lawsuit exhibit 20:

"With respect to the proposals set forth in the **December 2th** Letter, we take the view that this strategic opportunity is completely separate from the issue of finding a mutually agreeable alternative to the Security Provision, and that without reaching an agreement in respect of the Security Provision it is impossible to value the company Sky Solar or SIE properly and fairly, therefore, we are not prepared to consider or have any discussion of the proposals set forth in the December 24th Letter until an agreement is reached in respect of the Security Provision."

**Disclosure:** I am/we are short SKYS.

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# TAB 29

# The Latest Act in The Aphria Circus: A Very Obviously Related-Party 'Hostile' Takeover Offer

Published on December 28, 2018



## Summary: Aphria Inc. (NYSE:APHA)


- Yesterday Aphria received a 'hostile' takeover offer from a company called Green Growth Brands Ltd. ("GGB"), which aims to acquire Aphria in a C$2.8 billion all-stock deal.
- GGB's second largest shareholder is a fund sponsored by Green Acre Capital, a firm that lists none other than Aphria CEO Vic Neufeld on its board of advisors. Aphria has invested directly in the fund and therefore already owns a significant stake in GGB.
- GGB recently listed a current Aphria board member on its own board of directors. Other recent GGB directors have obvious affiliations with Aphria and its related persons.
- GGB was formed this year, has almost no revenue or tangible assets, and has limited operations. Despite this, its newly-listed, thinly-traded stock has spiked to a market cap of ~C$890m on average daily dollar volume of only ~$1.3 million.

- In short, we think GGB is largely a worthless entity with numerous signs of Aphria related-party influence. This entire proposed deal strikes us as merely an epic next step of Aphria's brazen shell game.
- We view this offer as non-credible and likely an attempt to generate the appearance of demand in the hopes of spurring credible offers.

# *Summary: A Highly Irregular Deal*

Last we left off, Aphria's shareholders were patiently waiting for the company's weeks-delayed "line-by-line, point-by-point" response to our December 3rd research report. In our report, we had identified substantial red flags of insider self-dealing relating to Aphria's C$280 million LatAm acquisitions.

Rather than releasing a rebuttal however, shareholders yesterday were instead subjected to the newest act in the Aphria circus: A 'hostile' takeover offer from a company that quite obviously has numerous related-party links to Aphria and its key insiders.

The bidder, Green Growth Brands, listed on the Canadian Securities Exchange less than 2 months ago via reverse merger, has limited financials, and looks to operate 1 retail cannabis store in the U.S. along with a cultivation and production facility. Within the production facility, equipment similar to a rosin press will most likely be used to allow the company to produce solventless concentrates in their operation. Because GGB's stock has rocketed by about 66% since its IPO on average dollar volume of only about $1.3 million per day, more equipment will probably be introduced to keep up with demand.

In sum, GGB strikes us as being a largely unknown, essentially worthless shell that has seen its share price pumped higher on thin trading volume.

GGB's stock closed yesterday with a market cap of about $890 million trading at $4.98 per share, yet intends to acquire Aphria in an all-stock deal at a value of $7 per GGB share. In other words, GGB's shares would need to trade at over a 40% premium from its recent closing price in order to buy Aphria at a 45% premium. We believe the deal sponsor and structure are both highly irregular, to put it mildly.

# *This Strikes Us as a Desperate Attempt to Manufacture The Appearance of Demand*

Before we go too deep into the details of this proposed deal, perhaps it makes sense to rewind the clock a bit and provide a theory on what might be happening here.

Our recent LatAm report followed on the heels of our original report from March relating to Aphria's C$425 million acquisition of Nuuvera. Aphria insiders eventually admitted to having secretly owned stakes Nuuvera prior to its acquisition. Those insiders included 4 top executives (including Aphria's CEO and CFO) and 6 of 7 company directors. In other words, the scandal implicated nearly the entire board and top management.

Our Nuuvera report was in late March, well after many of the suspicious LatAm shell entities had already been established. Given the timing (and given these latest developments) we believe it is possible, if not likely, that a large swath of Aphria's executives and board members also had exposure to the questionable LatAm dealings.

So what do you do if almost *everyone* gets caught with their hands in the cookie jar? The ideal solution would be a buyout with a change of control, which can allow everyone to naturally exit with their reputations largely intact.

But what if no one swoops in to buy you out, given all the recently surfaced problems? Well, you might just take matters into your own hands and try to engineer the appearance of demand by getting your friends to launch a bid for you. Then, reject the 'hostile' attempt as being deficient and hope credible offers actually roll in. At the very least it will support the share price and provide a welcome distraction. At most, it might actually work.

With that in mind, let's get into some of the details of the deal.

## *This 'Hostile' Takeover Offer Looks More Like a Related-Party Fakeover*

The bidding company, Green Growth Brands, came public less than 2 months ago with Aphria's quiet backing. We can see this through ownership information aggregated via SEDI. Pay close attention to the 2 holder, GA Opportunities Corp, which owns ~25% of the outstanding equity:

GGB CN Equity | 25) Export | Settings | Security Ownership

XANTHIC BIOPHARMA INC — CUSIP 98401B20

1) Current | 2) Historical | 3) Matrix | 4) Ownership Summary | 5) Insider Transactions | 6) Options | 7) Debt

Search Name: All Holders, Sorted by Size | 21) Save Search | 22) Delete Search | 23) Refine Search

Text Search | Holder Group: All Holders | Investment Manager View

24) Color Legend | Shrs Out 15.3M | % Out 107.16 | Float/Shrs Out N.A. | SI % Out 0.00

| | Holder Name | Portfolio Name | Source | Opt | Position | % Out | Latest Chg | Fi |
|---|---|---|---|---|---|---|---|---|
| | | | All | All | | | | |
| 1. | ALL JS GREENSPACE LLC | | SEDI | | 9,366,059 | 61.23 | 9,366,059 | 11/1 |
| 2. | GA OPPORTUNITIES CORP | | SEDI | | 3,817,760 | 24.96 | 3,817,760 | 11/1 |
| 3. | Horvath Peter Z | | SEDI | | 1,375,016 | 8.99 | 1,375,016 | 11/1 |
| 4. | GALITSKY IGOR | | SEDI | | 1,046,583 | 6.84 | 89,500 | 11/2 |
| 5. | MOORE TIM | | SEDI | | 387,500 | 2.53 | 0 | 11/1 |
| 6. | Bhumgara David | | SEDI | | 256,250 | 1.68 | 87,500 | 11/2 |
| 7. | LEHMANN MARC | | SEDI | | 86,806 | 0.57 | 86,806 | 11/1 |
| 8. | POSNER CARLI | | SEDI | | 50,000 | 0.33 | 0 | 11/1 |
| 9. | DHARAMSHI SHAFIK | | SEDI | | 5,000 | 0.03 | 0 | 06/0 |

*(Source: Bloomberg)*

Per Aphria's latest MD&A, we can see that it transferred over $30 million into that very fund subsequent to the recent quarter-end.

**APHRIA INC.**
**MANAGEMENT'S DISCUSSION & ANALYSIS**

*Green Acre Capital Fund*

Aphria agreed to invest $2,000 and $15,000 in Green Acre Capital Fund I and Green Acre Capital Fund II respectively ("**Green Acre**"), of which $2,000 had been invested by August 31, 2018. Green Acre is a private investment fund dedicated exclusively to the Canadian medical and recreational cannabis industry. The fund invests in sectors across the cannabis value chain including production, research, consumer products and retail.

Subsequent to quarter-end, the Company also transferred assets worth $30,542 to GA Opportunities Corp. (the "**Fund**"), in exchange for a promissory note, bearing interest at 12% per annum, due in 5 years. In addition, the Company secured an

As indicated in the same filing, GA Opportunities Corp. is a fund under the Green Acre Capital umbrella. Per the Green Acre Capital website we see that Aphria CEO Vic Neufeld sits on the advisory board:

GREEN ACRE CAPITAL

# Vic Neufeld

Advisory Board

Vic is the CEO and Chair of the Board of Aphria, one of the largest cannabis LPs in Canada. Vic brings 15 years of experience as a chartered accountant and partner with Earnst & Young, and 21 years as the CEO of Jamieson Laboratories. During his tenure with Jamieson, the Company went from $20M in annual sales to over $250M. He holds a bachelor's degree in Economics from the University of Western Ontario and an Honours degree in business and an MBA from the University of Windsor.

in

We find it to be a remarkable coincidence that Aphria holds a major stake in its own 'hostile' bidder through a fund that is advised by its own CEO.

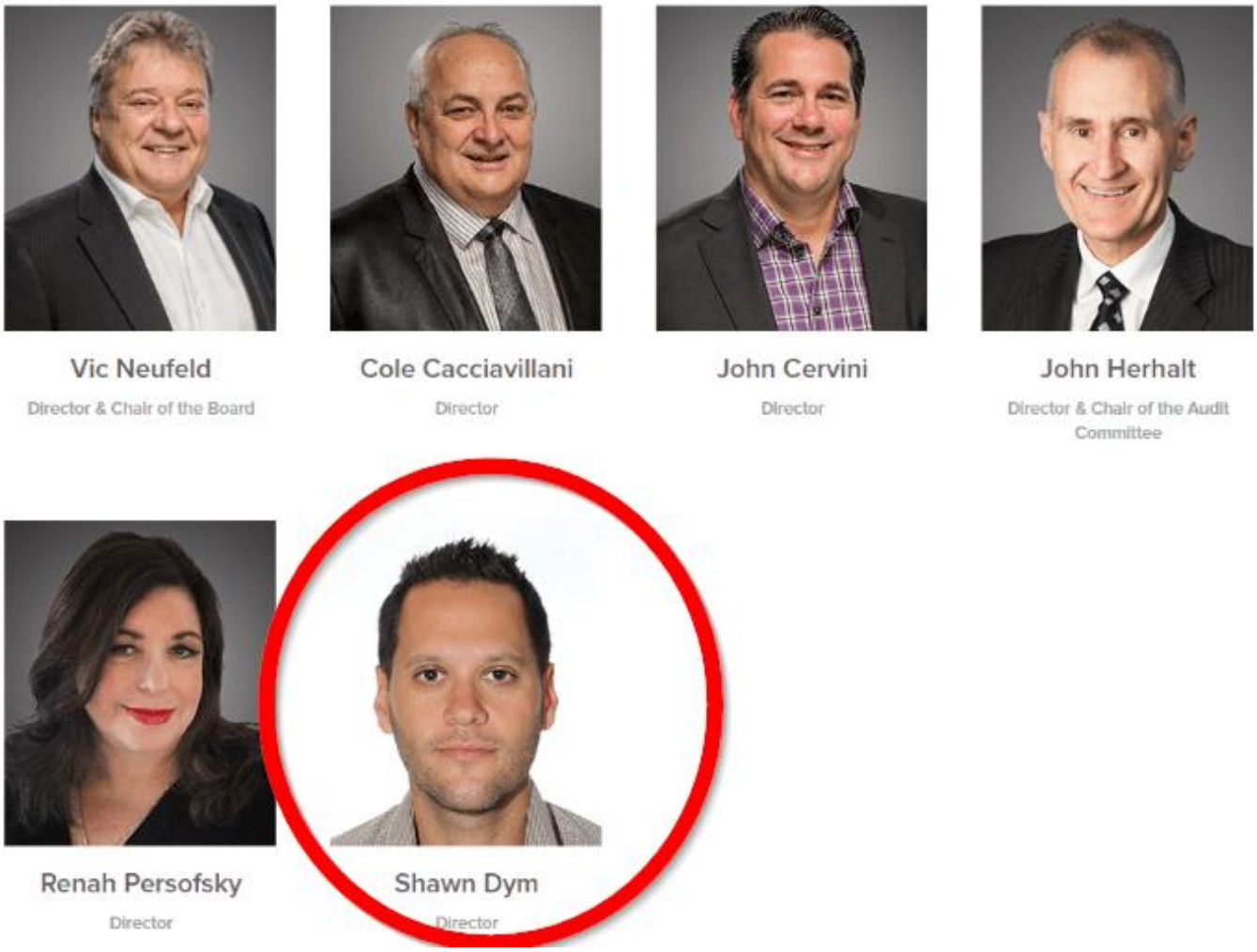
A further review of Green Growth Brands' SEDAR filings show other remarkable coincidences. A filing from just 1 month prior to the reverse takeover transaction shows the directors at the time. Two stand out in particular:

**a) Directors, executive officers and promoters of the issuer**

*Provide the following information for each director, executive officer and promoter of the issuer. For locations within Canada, state the province or territory, otherwise state the country. For "Relationship to issuer", "D" – Director, "O" – Executive Officer, "P" – Promoter.*

| Individual? | Organization or company name | Family name<br>First given name<br>Secondary given name | Business location of non-individual or residential jurisdiction of individual | Relationship to issuer (select all that apply) |
|---|---|---|---|---|
| ☑ Y ☐ N | | Horvath<br>Peter<br>Zoltan | United States | ☐ D ☑ O ☐ P |
| ☑ Y ☐ N | | Fodie<br>Ian | Ontario | ☐ D ☑ O ☐ P |
| ☑ Y ☐ N | | Schottenstein<br>Joey | United States | ☑ D ☑ O ☐ P |
| ☑ Y ☐ N | | Arviv<br>Adam | Ontario | ☑ D ☐ O ☐ P |
| ☑ Y ☐ N | | Dym<br>Shawn | Ontario | ☑ D ☐ O ☐ P |
| ☑ Y ☐ N | | Kraner<br>Brenton | United States | ☑ D ☐ O ☐ P |

Let's start with Shawn Dym. If the name sounds familiar, that is because he is a current Aphria director:




In other words, a recent director of the 'hostile' bidder served concurrently as director of Aphria immediately prior to its recent IPO.

The second individual, Adam Arviv, looks to have a close business relationship with long-time Aphria advisor Andy DeFrancesco, who featured prominently in our reports on both LatAm and Nuuvera. Arviv shows up in numerous DeFrancesco-affiliated deal filings including those in Liberty Health Sciences , Riot Blockchain , PolarityTE , Breaking Data Corp , and MassRoots .

Despite Dym and Arviv having directorship roles at Green Growth as late as October, neither were listed as directors in the subsequent reverse merger documents a month later ( pg. 62), which could represent an effort to minimize the clear ties.

Moving right along, the key backer of Green Growth is the Schottenstein family, which worked with Aphria and its key insiders on a joint venture to bring medical dispensaries to Ohio *just one year ago*.


Ohio Medical Marijuana Control Program

Ohio Medical Marijuana Dispensary Application
SCHOTTENSTEIN APHRIA III LLC
Application ID 561

**A-3.3** Date of Formation

10/12/2017

**A-3.4** Business Name on Formation Documents

Schottenstein Aphria III LLC

The joint venture included numerous Aphria insiders who worked together with the Schottenstein family on this deal including CEO Vic Neufeld, director Cole Cacciavillani, director John Cervini, and multiple others.

## *This Bid Looks to Us Like the Latest in a String of Poorly Disguised Insider Self-Dealings*

Is this really a hostile bid? Let's review and you can decide:

- The bidder was taken public mere months ago with the backing of Aphria, and through a fund that is advised by Aphria CEO Vic Neufeld himself.
- The bidder's main backer had a recent joint venture with Aphria and its key insiders.
- The bidder's recent board members concurrently served on the board of Aphria or had numerous historical dealings with key Aphria-related individuals.

## *What Is Green Growth Brands? Newly-Formed, Limited Operations, Limited Financials, and a Thinly-Traded Stock That Has Spiked in a Short Period of Time*

So what can Aphria's shareholders look forward to if this all-stock deal were to actually close?

Let's take a look at what Green Growth Brands brings to the table.

Green Growth Brands was formed on February 14th, 2018 (pg. 20). The company IPO'd via reverse merger and opened for trading on November 13th, less than 2 months ago.

Based on recent news releases and the recent investor presentation the company looks to operate one cannabis store in Las Vegas along with a cultivation and production facility. Here is a picture of its cannabis store:


The company has plans to expand through acquisition and additional store growth in 2019.

For now, it's financials look rather thin. The latest balance sheet shows tangible assets of about $5 million and liabilities of $58 million ( pg. 2)

*(Expressed in United States dollars)*

| | Note | | September 30, 2018 | |
|---|---|---|---|---|
| | | | (unaudited) | |
| **Assets** | | | | |
| **Current Assets** | | | | |
| Cash and cash equivalents | | $ | 1,520,552 | $ |
| Receivables | | | 422,460 | |
| Inventory | 5 | | 1,382,471 | |
| Biological assets | 6 | | 660,292 | |
| Prepaid expenses | | | 79,734 | |
| | | | 4,065,509 | |
| Property and equipment | 7 | | 709,929 | |
| Equity investment in Xanthic Beverages USA, LLC | 8 | | 838,688 | |
| Intangible assets | 9 | | 32,235,000 | |
| Goodwill | 9 | | 22,144,742 | |
| **Total assets** | | **$** | **59,993,868** | **$** |
| **Liabilities** | | | | |
| **Current Liabilities** | | | | |
| Accounts payable and accrued liabilities | 19 | | 1,735,541 | |
| Due to related parties | 15 | | 66,441 | |
| Other financial liabilities | 10 | | 3,137,500 | |
| Interest bearing loans | 11 | | 53,912,500 | |
| | | | 58,851,982 | |
| **Shareholders' Equity (Deficiency)** | | | | |
| Share capital | 12 | | 3,321,229 | |
| Reserve for share based payments | 14 | | 432,142 | |
| Reserve for warrants | 13 | | 141,482 | |
| Reserve for changes in equity of subsidiary | | | (2,837,500) | |
| Deficit | | | (2,770,510) | |
| **Total equity attributable to shareholders of Xanthic** | | | (1,713,157) | |
| **Non-controlling interest** | | | 2,855,043 | |
| **Total equity** | | | 1,141,886 | |

The company generated sales of $1.8 million and a $516 thousand loss in the same period:

*(Expressed in United States dollars)*

| | Note | September 30, 2018 |
|---|---|---|
| **Sales** | | |
| **Revenue** | | $ 1,770,595 |
| Production Costs | | 876,267 |
| **Gross profit before fair value adjustments** | | 894,328 |
| Fair value adjustment on biological assets | | (332,616) |
| **Gross profit** | | 1,226,944 |
| **Expenses** | | |
| General and administration | | 992,242 |
| Legal and professional fees | | 150,882 |
| Stock based compensaton | 14 | 139,355 |
| Advertising and promotion | | 31,399 |
| Depreciation and amortization | 7 | 12,553 |
| Loss on equity investment in Xanthic Beverages USA, LLC | 8 | 15,562 |
| Interest and bank charges | | 407,846 |
| Foreign exchange loss (income) | | (6,551) |
| **Total Expenses** | | 1,743,288 |
| **Net loss and comprehensive loss** | | **$ (516,344)** |

Despite the nearly non-existent financial performance and asset base, Green Growth's stock has rocketed since its IPO despite a widescale decline in cannabis stocks. Most of the spike has taken place in the 2 weeks leading up to the hostile bid announcement:


*(Source: BNN)*

We're not exactly bullish on Aphria (as we have made clear), but this proposed deal actually strikes us as being objectively worse. Shareholders would be trading Aphria, warts and all, for an inflated stock in an entity with almost no tangible assets or financials. What is the point?

## *(Meanwhile, Vic Neufeld is No Longer the Chairman of Aphria)*

Given all the attention on the proposed bid, you can be forgiven if you had not noticed that Vic Neufeld is no longer chairman of Aphria. Neufeld stepped down almost immediately after news of the takeover offer was released.

The timing of this release, immediately on the tail of such a headline grabbing bid, strikes us as a potential effort to sweep this important fact under the rug.

## *Conclusion: We Think Aphria is Making a Mockery of the Capital Markets*

With so much attention on Aphria and its irregular dealings we simply find it to be brazen that this deal has even been put on the table.

We'll leave it at that for now.

**Disclosure:** I am/we are short APHA.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 30

# Aphria Part 2: We Believe This Rot Runs Deep

Published on December 6, 2018



## Summary: Aphria Inc. (NYSE:APHA)


- Our examination of Aphria led to another Aphria-backed company, Liberty Health Sciences, where we uncovered multiple irregularities that raise more questions around believed undisclosed insider self-dealing.
- Liberty acquired a Florida property this year. Rather than just buying the assets, they were acquired through a newly-formed entity, netting the shell holders an estimated ~C$5 million gain in 6 days.
- Holders of the shell included key Aphria, Scythian, and Liberty deal partner/insider Andy DeFrancesco, along with 3 individuals alleged by the SEC to have run multiple pump & dump schemes.
- Unnamed individuals bought 242 million shares of Liberty in a highly dilutive $0.001 private placement mere days after Aphria announced its intention to purchase its shares at 208x the price.
- Based on Canadian Securities Exchange records we believe Aphria/Liberty Chairman Vic Neufeld participated in this discount round, along with Andy DeFrancesco.

# *Overview*

As stated in our last report, we are of the strong opinion that Aphria shareholders' equity has been diverted into acquisitions that were egregiously overpriced, and that Aphria insiders were likely undisclosed beneficiaries. We focused primarily on the company's recent LatAm transactions and identified multiple red flags of believed undisclosed related-party transactions.

We noted that key Aphria/Scythian deal partner/insider Andy DeFrancesco was an undisclosed backer of that slew of deals. DeFrancesco effected the transactions in conjunction with Aphria Chairman & CEO Vic Neufeld, who had served as Chairman of Scythian at the time the deals were originally announced and was Chairman & CEO of Aphria when the transactions ultimately closed.

We realize we could stop the Aphria story at this point, having given readers a good sense of what went on at Aphria and Scythian (now known as Sol Global Investments). We don't intend to do that, however. There is much more to tell.

Aphria's relationship with Scythian BioSciences is not the only one that raised questions during our research.

Liberty Health Sciences (CSE:LHS) is another cannabis company that was taken public via reverse merger with Aphria's backing. As part of the deal, Vic Neufeld was appointed director and Chairman of Liberty, a role he continues to hold to this day.

# *Andy DeFrancesco's Close Ties to Liberty Health Sciences*

As noted in our previous piece, Andy DeFrancesco was the believed architect of an elaborate shell structure that culminated in Aphria's C$280 million LatAm acquisitions. DeFrancesco was also the self-described architect of the Nuuvera transaction, which we also determined to be largely worthless and in which insiders eventually admitted to having held undisclosed stakes.

DeFrancesco has played a key role in both Aphria and Scythian BioSciences, and has similarly played a foundational role at Liberty Health Sciences:

- DeFrancesco was publicly described by Liberty Health Sciences as the founder of the DeFrancesco had set up the entity that ultimately became Liberty.
- Michael Galloro, the COO of Delavaco Capital (the personal private equity firm of DeFrancesco) was CEO of SecureCom Mobile, an entity that was subsumed in the reverse merger with Liberty Health Sciences.
- Galloro also served as the interim CEO of Liberty Health Sciences and currently serves as a director at Liberty.
- Delavaco has been listed as a " special advisor " to the company in connection with its secondary offerings.

# *Liberty Health Sciences Paid C$13.5 Million for Real Estate from a Private DeFrancesco-Controlled Entity*

# *Real Estate Records: DeFrancesco Paid C$8.5 Million for the Property 6 Days Earlier, Netting a Quick C$5 Million Gain*

Normally, when companies acquire a piece of property, they just go out and buy it. In what readers of our last report may consider a now familiar pattern, Liberty took a rather odd approach to their purchase.

On January 4, 2018, Liberty Health Sciences announced a binding term sheet to acquire a privately held Canadian entity called 242 Cannabis, Ltd. ("242 Cannabis"). The entity had a wholly owned Florida-based subsidiary with a similar name, which in turn had an agreement to purchase a parcel of Florida land and greenhouses.

In other words, Liberty appears to have agreed to acquire a "privately-held" entity that itself hadn't yet purchased a piece of property.

As Liberty's audits would later show, 242 Cannabis entities were shells with no operations. Liberty ultimately paid almost C$13.5 million for the land and greenhouses acquired through these entities:

> *"As 242 Cannabis did not have any operations, this acquisition was accounted for as an asset acquisition, with* ***13, 92, 72 allocated to land and greenhouse***

> ***infrastructure"****(audit pg. 17).*

Florida real estate records show that the private shell entities had acquired the property for only US$6.5 million (C$8.5 million) on February 9, 2018. The private entity, therefore, closed its own purchase 6 days before the Liberty deal closed, on February 15, 2018 (audit pg. 21).

In other words, ***the holders of the private shell entity made an estimated C million gain in 6 days***.

RECORDED IN OFFICIAL RECORDS
INSTRUMENT # 3106085 5 PG(S)
2/13/2018 10:19 AM
BOOK 4575 PAGE 2107
J.K."JESS" IRBY
Clerk of the Court, Alachua County, Florida
ERECORDED Receipt # 813528
Doc Stamp-Mort: $0.00
Doc Stamp-Deed: $45,500.00
Intang. Tax: $0.00

This instrument prepared by
and after recording return to:
Timothy M. Hughes, Esq.
SHUMAKER
Shumaker, Loop & Kendrick, LLP
101 East Kennedy Boulevard
Suite 2800
Tampa, Florida 33602
Phone: (813) 229-7600

*Total Consideration Paid $6,500,000.00*
*Documentary Stamp Tax Paid: $45,500.00*

**SPECIAL WARRANTY DEED**

THIS SPECIAL WARRANTY DEED is made as of February 9, 2018, by **ALICO CITRUS NURSERY, LLC**, a Florida limited liability company, whose address is 10070 Daniels Interstate Court, Suite 100, Fort Myers, Florida 33913 (hereinafter referred to as "***Grantor***") to **242 CANNABIS, LLC**, a Florida limited liability company, whose address is 2300 East Las Olas Blvd., 5th Floor, Fort Lauderdale, Florida 33301, (hereinafter referred to as "***Grantee***").

So, which investors made ~C$5 million in 6 days? Canadian and Florida corporate records show that the **2 2 Cannabis shell entities were brand new entities registered to the spouse of none other than Andy De rancesco**.

Additionally, Canadian Stock Exchange records show that holders of the entity include:

- Five entities in the name of Andrew DeFrancesco's spouse and kids, including 4 newly-formed Bahamian entities.
- Three individuals recently charged with fraud by the SEC for allegedly running multiple pump and dump schemes: Barry Honig, John Stetson, and Mark Groussman.

Yet again, this transaction took place under the oversight of Vic Neufeld as Chairman of Liberty.

We urge readers to note the parallels between this transaction and those of the LatAm transactions described in our previous report, which similarly involved Neufeld & DeFrancesco, intermediary shell entities placed between acquisitions, and presumed quick profits for the holders of those shell entities at the direct expense of public shareholders.

# *Did Aphria Chairman/CEO Vic Neufeld Invest Ahead of Aphria's Own Investment into Liberty Health Sciences… at a 99.5% Discount?*

Liberty Health Sciences became a public company via a reverse merger in April 2017, with Aphria's backing. As noted in the press release announcing the transaction, Aphria agreed to purchase over 120 million common shares of the entity for $25 million, or $0.208 per share.

Documents describing the lead up to the transaction show a worrying sequence of events. The press release announcing Aphria's investment at $.208 was made on April 4, 2017.

**SecureCom Mobile and DFMMJ Investments Announce Definitive Agreement for Business Combination and Concurrent Financing With Strategic Lead Investments From Aphria and Serruya Private Equity**

TORONTO, ONTARIO--(Marketwire - April 4, 2017) -

However, Canadian filings show that 242.6 million shares were sold through a private placement one week *after* that announcement, on April 11, 2017. This round was not mentioned in the press release, but it allowed unnamed individuals to purchase shares at $0.001, or a ~99.5% discount to the Aphria round. ( pg. 72):

**Prior Sales**

The following table sets forth the number and price at which Holdco Shares have been sold within the 12 month period prior to the date of this Circular:

| Date | Aggregate Number and Type of Securities Issued | Issuance Price |
|---|---|---|
| April 11, 2017(1) | 242,600,000 Holdco Shares | $0.001 |
| April 18, 2017(2) | 192,400,000 Holdco Shares | $0.026(3) |
| April 27, 2017(4) | 164,182,679 Subscription Receipts<br>2,644,231 Holdco Shares | $0.208<br>$0.208 |
| May 19, 2017 | 120,192,310 Holdco Shares | N/A(5) |

(1) On April 11, 2017, Holdco completed a private placement of 242,600,000 Holdco Shares for aggregate gross proceeds of $242,600.
(2) These shares were issued in connection with and as consideration entering into the Know-How License. Such agreement was dated April 25, 2017, with effect from April 18, 2017.
(3) The consideration attributed to the Know-How was determined via an arm's length negotiation and set at $5 million, representing a deemed per share price of $0.026.
(4) On April 27, 2017, Holdco completed the Offering. See "*The Business Combination – The Offering*".

Why would Aphria – which announced its foundational transaction to purchase $25 million worth of Liberty shares at $0.208 per share – allow a separate, highly dilutive purchase to occur at such a massive discount only days later?

Based on a subsequent filing, it appears that Aphria's own Chairman & CEO, Vic Neufeld may have participated in the $0.001 share round.

A filing with the Canadian Securities Exchange (CSE) details the holders of the later April 27th $0.208 round who invested alongside Aphria at that price. Within that document we also see how many securities were *already held* by the named holders prior to that point. From this we can infer the number of securities likely purchased in the $0.001 round. [1]

Most shareholders detailed in the exchange filing were buying for the first time, so the number of securities they purchased ended up equaling the number of securities they owned. But we see an anomaly:

| Full Name | Residential Address of Placee | Number of Securities Purchased or to be Purchased | Purchase price per Security (CDN$) | Conversion Price (if applicable) | Prospectus Exemption | No. of Securities, directly or indirectly, Owned, Controlled or Directed | Payment Date(1) |
|---|---|---|---|---|---|---|---|
| Rene Gulliver | ON | 400,643 | $0.624 | N/A | Accredited Investor | 400,643 | 27-Apr-17 |
| Jamie Mastronardi | ON | 320,513 | $0.624 | N/A | Accredited Investor | 320,513 | 27-Apr-17 |
| RMO Holdings Ltd. | ON | 320,513 | $0.624 | N/A | Accredited Investor | 320,513 | 27-Apr-17 |
| Vic Neufeld | ON | 280,451 | $0.624 | N/A | Accredited Investor | 2,403,866 | 27-Apr-17 |
| Ercole Cacciavillani | ON | 240,387 | $0.624 | N/A | Accredited Investor | 240,387 | 27-Apr-17 |
| Fulfill Holdings Inc. | ON | 240,387 | $0.624 | N/A | Accredited Investor | 240,387 | 27-Apr-17 |
| Deanne Cervini | ON | 240,387 | $0.624 | N/A | Accredited Investor | 240,387 | 27-Apr-17 |
| Nina Cacciavillani | ON | 160,257 | $0.624 | N/A | Accredited Investor | 160,257 | 27-Apr-17 |

Vic Neufeld apparently owned over 2.4 million securities following this round, yet he only bought 280,000 securities in the round itself. This suggests that he held over 2 million securities in advance, which raises a critical question:

**Did Aphria Chairman CE Vic Neufeld invest in Liberty at a steep discount, weeks ahead of Aphria, thereby diluting and undermining the interests of his own company in order to personally benefit**

We emailed Neufeld and asked if he had invested in the $0.001 round of Liberty ahead of Aphria. We have not heard back as of this writing but will certainly update this if we do.

# *Two Other Individuals Look to Have Gotten in Early as Well: Andy DeFrancesco and Barry Honig*

When reviewing the document further we see several more anomalies. Along with Vic Neufeld, multiple entities associated with Andy DeFrancesco and his spouse also look to have held significant stakes in Liberty *prior* to the April 27th round.

In addition to DeFrancesco, we also see that Barry Honig had a large stake prior to the April 27th round through his firm GRQ Consultants, an acronym that multiple sources informed us stands for "Get Rich Quick" Consultants. Barry Honig was recently alleged by SEC prosecutors to have run multiple pump and dump schemes .

We condensed the table to show the number of shares believed to be purchased by these

individuals in the $.001 round and the estimated windfall reaped when Liberty actually opened for trading at ~$1.30/sh:

| Shareholder | Shares Bought Via Announced Offering | Total Shares Held | Likely Shares From $.001 Placement | Est. Cash Windfall |
|---|---|---|---|---|
| Vic Neufeld (Aphria CEO) | 280,451 | 2,403,866 | 2,123,415 | $2,760,440 |
| Delavaco Holdings | 240,388 | 5,573,721 | 5,333,333 | $6,933,333 |
| DeFrancesco Motorsports | 80,128 | 880,128 | 800,000 | $1,040,000 |
| C. DeFrancesco | 961,543 | 6,294,875 | 5,333,332 | $6,933,332 |
| GRQ Consultants (Owner: Barry Honig) | 801,282 | 17,601,282 | 16,800,000 | $21,840,000 |
| Namaste Gorgie (Owner: DeFrancesco spouse) | 160,257 | 5,193,590 | 5,033,333 | $6,543,333 |

We believe Aphria's public shareholders deserve to know the complete list of beneficiaries of this $0.001 round, which had significantly diluted their stakes just *weeks* ahead of the Aphria investment.

# *Is Everyone in Bed Together? The Role of Bankers*

As short-biased investors, people often apply a level of skepticism and scrutiny to our work based on an understanding of our incentives. That's totally fair and we welcome it. A lively, well-informed debate makes for a vibrant market and ultimately benefits everyone.

Often lost in that debate is the role of sell-side research and where the incentives of bankers are pointed. Following our report on Aphria's LatAm acquisition, several banks either voiced meaningful reservations or placed Aphria's ratings under review in order to take time to assess our research. We noticed, however, that one bank stood rather starkly at odds with the others.

**Clarus Securities**

Clarus stated that our report, which had alleged glaring red flags of undisclosed related party-dealings, "Distracts from the Real Value" of the Canadian adult use market:

CLARUS
SECURITIES INC.

Noel Atkinson, CFA
416-343-3352 | natkinson@clarussecurities.com

## Aphria Inc.

APHA-TSX: $7.60
Rating: Buy
Target: $22.50 (was $33.00)

## Short Report Distracts from the Real Value Driver: The Canadian Adult-Use Market

*December 4, 2018*

| Valuation | | | | |
|---|---|---|---|---|
| Fiscal Year (May) | FY18 | FY19e | FY20e | FY21e |
| Revenue ($MM) | $36.9 | $287.0 | $1,007.2 | $1,264.0 |
| Previous | | N/C | N/C | N/C |
| Adj. EBITDA ($MM) | $5.7 | $41.3 | $262.9 | $345.6 |
| Previous | | N/C | N/C | N/C |
| Calendar Year | | CY18e | CY19e | CY20e |
| Product Shipped (Kg) | | 16,966 | 108,259 | 180,096 |
| Previous | | N/C | N/C | N/C |
| Revenue ($MM) | | $141.6 | $864.0 | $1,240.0 |

KEY POINTS:

- While Aphria's Latin American acquisition is the focal point of the recent short report, we continue to believe the Canadian market is the key value driver for Aphria for the foreseeable future. Our model continues to expect Aphria's Canadian operations to generate over 95% of cannabis-related revenues through our forecast period ending FY2021 (May).

*(Source: Clarus Securities research report)*

They reiterated their buy rating, with a target price implying a 350% return from current levels. We were pleased to see this, largely because we were in the process of writing about Clarus's unusually close relationship with Aphria and Andy DeFrancesco.

Once again, turning to DeFrancesco's private Instagram account (I highly recommend him as a follow), we see what appears to be DeFrancesco in the Clarus offices raising money on behalf of Aphria.


We also see that Clarus (along with Aphria) sponsors DeFrancesco's son's racing endeavors:


We see that both Clarus's Head of Research ( Brock Winterton ) and its CFO (Tom Monahas) were granted personal shares in the Liberty private placement round mentioned above:

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| BROCK WINTERTON | ON | 200,323 | $0.624 | N/A | Accredited Investor | 200,323 | 27-Apr-17 |
| TOM MONAHAS / CLARUS SECURITIES INC. | ON | 160,250 | $0.624 | N/A | Accredited Investor | 160,250 | 27-Apr-17 |

It is unclear whether the bank's Head of Research or executives have participated in other Aphria-backed private placements given the limited disclosure around many of those filings.

Clarus seems to have a remarkably close relationship with Aphria and its related web of deals:

- Clarus has led Aphria's numerous secondary offerings ( 1,2,3,4,5,6,7).
- Clarus provided the fairness opinion for the sale of Scythian's LatAm assets to Aphria.
- Clarus was the investment bank that led the foundational private placement offering with Liberty.
- Clarus led the secondary offering for Nuuvera, and then later advised Aphria on acquiring Nuuvera.
- Clarus's research department has consistently held a buy rating on Aphria.

As stated above, we think it is important to fully understand where incentives point when assessing potential bias.

# *Is Everyone in Bed Together? The Role of Spouses, Family, and… a Local Union Boss*

Following our earlier March exposé on Aphria's irregular acquisition of Nuuvera, Aphria admitted that their CEO, CFO, and six directors had personal stakes in the company that they were acquiring that had not been previously disclosed.

At the time, we asked a follow-up question :

> *"Who else participated in these early Nuuvera funding rounds? How many family members, affiliates, or deal partners of Aphria's executives and advisors?"*

We never got an answer. We also asked the company yesterday if Aphria's executives or family members had participated in the shell deals for the LatAm investments. We haven't received an answer to that either. Normally that information would be available through Canadian Securities Exchange filings, but the company chose to redact ALL of the names of the shareholders of the LatAm shell entities ( 1,2).

The company has been rather thin with its disclosure, but we can get a glimpse of who may benefit from these private placement deals from the holders we see in the Liberty private placement round mentioned above.

Putting aside questions around Liberty's $.001 giveaway round, holders of the $0.208 private placement who invested alongside Aphria clearly benefited from the involvement of the company. Liberty's backing by Aphria, considered a major player in the space, gave the fledgling company a great deal of credibility.

Those who were lucky enough to invest in the round made a quick 100% on their money following Liberty's public open. [2] So, who participated in this lucrative private round?

**A Local Union Boss That Later Struck a Deal with Aphria**

Rob Petroni runs the LiUNA Local 625 union and participated in the Liberty private placement alongside Aphria:

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Rob Petroni | ON | 80,127 | $0.624 | N/A | Accredited Investor | 80,127 | 27-Apr-17 |
| Rob Petroni | ON | 80,130 | $0.624 | N/A | Accredited Investor | 80,130 | 27-Apr-17 |

About one month after Petroni's investment in the round, he announced that the union would be offering medical cannabis to its employee benefits plan, which will be good for the health and wellbeing of their workers. Especially with it being hard to concentrate if you are experiencing mental and physical pain. There are many different dispensaries that can offer residents with cannabis if they need to use it for medical purposes, (you can Click here to find out more). It's something that all companies should consider having in place for their employees. Then, a month later, that very union announced a partnership with Aphria. In a press release entitled, "Aphria Launches First Partnership with Major North American Union" Petroni stated:

> *"The health and wellness of our members is of critical importance to LiUNA, and in launching this partnership with Aphria, we are taking a major step forward in improving the lives of our members."*

**The amily Members and Spouses of Key Aphria Executives and Directors**

Without naming names, the spouses and family members of at least 4 Aphria

executives/directors also benefited from the Liberty private placement .

We think investors deserve full transparency on the holders of ALL of Aphria's private deals, whether it be relating to Liberty, Aphria, Scythian, or any of the apparently numerous shell entity acquisitions.

# *In Conclusion*

Much like Scythian, we view Liberty as just another extension of the Aphria web of highly questionable deals. At this point, we think the responsibility is on management to earn back shareholder trust and begin making all the beneficiaries of these shell transactions, discounted private placements, and related deals FULLY TRANSPARENT. We will continue to report on this subject.

[1] *Note: The only known HoldCo shares issued prior to the Liberty reverse-merger were "issued in connection with and as consideration for entering into the Know-How license." Aphria obtained all the shares in the "Know-How" placement.*

[2] *Note: The price of shares bought by the $0.208 round holders included a 3 for 1 consolidation, so the resulting price was $0.624. Given Liberty's opening trading of ~1.30 the resulting gain was approximately 108%.*

**Disclosure:** I am/we are short APHA.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 31

# Yangtze River Port & Logistics: Total Zero. On-the-Ground Research Shows Assets Appear to be Largely Fabricated

Published on December 6, 2018



## Summary: Yangtze River Port & Logistics (NASDAQ:YRIV)


- We are of the strong opinion that Yangtze River Port & Logistics is a scheme run by its Chairman & controlling shareholder to siphon money away from U.S. public markets.
- YRIV's only operating entity has been declared insolvent in China and is involved in multiple undisclosed legal proceedings, it has also been ordered to pay back at least $110 million in defaulted loans. YRIV fails to disclose the existence of these lawsuits & judgements in its SEC filings.
- Based on government-sourced documents and interviews with local officials, we believe that at least 77% of the company's reported assets are fabricated.

- Specifically, YRIV claims to lease 1.2 million sq/m of land from a village that is only 610 thousand sq/m in size. Our investigator spoke to the village committee and they denied that any lease existed. This lease accounted for ~77% of YRIV's balance sheet assets.
- On the ground visits to YRIV's construction project during business hours on multiple occasions have shown virtually no signs of business activity aside from a lone gate guard.
- Cash from recent capital raises; has been siphoned to the CEO/controlling shareholder via related-party entities rather than deployed towards the company's supposed construction projects. Based on our findings we think YRIV is a total zero.

# *Introduction*

We believe that Yangtze River Port & Logistics (NASDAQ:YRIV) is an artifice designed to enrich the company's Chairman & controlling shareholder. The company currently trades at a market cap of about $2 billion as of this writing. We are confident that it will ultimately be delisted and that every penny of its market cap will be wiped out.

The company has generated no revenue over the past 3 years and its U.S. headquarters is based out of a New York City apartment. Site visits to the company's Chinese properties, interviews with local officials, and a detailed examination of Chinese and U.S. filings; lead us to believe that the company's assets have either been grossly exaggerated or are largely fabricated.

Our report includes several areas of research that are either completely new or not fully covered in other reports. These should help investors finally put the pieces of the puzzle together to reach the same conclusions we have reached about YRIV:

1. **Worthless verinflated Assets**

YRIV has essentially one project called the Wuhan Yangtze River New Port Logistics Center:

- The constructed part of the project is a cluster of commercial buildings. The company claims that 4 of the buildings in the complex are completed, (F-12) yet they have failed to produce any revenue from them. A site visit to the properties during working hours found them to be a **veritable ghost town**; with no signs of activity aside from a gate guard.

- The unconstructed part of the project is a planned "Logistics Center" that YRIV states it will build on 1.2 million square meters of land leased from a local village. On YRIV's latest quarterly balance sheet, the rights to the land are reported as having a value of $299 million, comprising over 77% of the company's total assets. (F-13) Despite claiming to

lease 1.2 million square meters from the village, our government-sourced maps show that the total area of the village is only 610 thousand square meters. Moreover, conversations with officials from the village in question revealed that contrary to the company's claims, YRIV has **not** leased any land from them.

2. **Undisclosed Legal Judgements**

Despite the company's SEC filings, which state that there are no material legal proceedings against the business, we found Chinese court records showing that the company has at least 11 judgements filed against them totaling RMB 766 million (USD $110 million).

The company reports total assets of $386 million in its SEC filings (pg. F-1), but we found local court records showing that creditors were unable to locate assets to seize in their attempt to satisfy one of YRIV's multiple legal judgements. The Chinese court has recently taken the extraordinary step of placing the company on its list of "untrustworthy debtors" due to its mass of unpaid judgements.

3. **Cash from Capital Raises Have Gone Right to the Chairman**

The company issued 19 convertible notes this year alone. (pg. F-16) So where did the money go? Rather than using the proceeds of these notes to advance the company's purported real estate projects, **money instead has gone directly to related-party entities affiliated with the company's Chairman controlling shareholder, Liu iangyao**. Proceeds from past capital raises have similarly ended up being diverted to Xiangyao.

# *Background*

Yangtze River Port and Logistics Limited, is a Nevada holding corporation that originally became public via a reverse merger in December 2015 (pg. 6). YRIV operates through its wholly-owned Chinese subsidiary, Wuhan Yangtze River Newport Logistics Co., Ltd ("Wuhan Newport").

The company recently attempted to reverse merge into a different entity called Wuhan Economic Development Port Limited (the "Wuhan Port"). The deal fell apart shortly after a Barron's article questioned the deal's bizarre rationale:

> *"It's puzzling that Yangtze's board and controlling shareholders want to exchange the Wuhan project for assets worth a mere quarter of company's total market value.*

> *Since last December, Yangtze has been trying to complete a deal in which it would pay $90 million to swap everything it owns for another riverfront business in Wuhan that the company's own filings appraise at just $454 million. That would appear to leave Yangtze stockholders with something worth just $3 a share."*

On the ground due diligence regarding YRIV's business operations was completed in the summer of 2018 and we concluded that YRIV's Wuhan Newport is collectively worth nothing. We waited to see how the deal played out (it eventually collapsed), which leaves Wuhan Newport as the sole operating entity of the company. (pg. F-5) We then followed up with another site visit yesterday to re-confirm our findings.

# *Evidence Shows That YRIV's Claim to Its Main Asset Is Likely Fabricated*

The unconstructed part of the project is referred to as the Logistics Center, from which YRIV anticipates their "main source of expected income will be derived." (pg. 3) The Logistics Center is expected to span approximately 1,918,000 square meters. (pg. 4) Based on information presented on YRIV's website, the layout of the Logistics Project is as follows:

The company's latest quarterly financials ( pg. F-13) break out the company's assets relating to "Real Estate Properties and Land Lots Under Development." These assets consist of the Wuhan Centre (the company's other real estate project) and "Land lots undeveloped", which, by inference, is the Logistics Center:

**6. REAL ESTATE PROPERTIESAND LAND LOTS UNDER DEVELOPMENT**

The components of real estate properties and land lots under development were as follows:

| | September 30, 2018 (Unaudited) | December 31, 2017 |
|---|---|---|
| Properties under development | | |
| Wuhan Centre China Grand Steel Market | | |
| Costs of land use rights | $ 8,797,273 | $ 9,286,634 |
| Other development costs | 37,669,517 | 39,592,579 |
| Land lots undeveloped | | |
| Costs of land use rights | 299,249,261 | 315,895,430 |
| | $ 345,716,051 | $ 364,774,643 |

Given that the company reports total assets of $386 million ( pg. F-1), the undeveloped Logistics Center land use rights comprise over 77% of the company's total asset base.

The Logistics Center is intended to be built on 1.2 million square meters of land leased from Chunfeng Village. The most recent 10-K highlights this ( pg. 33):

| Name of the Property | Location | Purpose of Use | Area (m²) | Duration Date |
|---|---|---|---|---|
| Land Lease No. HZ20150427 (1) | Chunfeng Village, Yangluo Neighborhood, Wuhan, Hubei Province, PRC | Commercial | 1,214,654.52 | April 26, 2035 |

On YRIV's website , a promotional video displays the 1.2 million square meter leased land area at the 10:51 mark in describing its proposed location of the Logistics Center:


Our first clue that something was amiss came from the Hubei Provincial Government sourced records, which show that the **total area of Chunfeng village is 610,000 square meters**, only

half the size of the area YRIV claims to lease from the village:

春风村位于新洲区阳逻街西部。

基本情况：春风村面积0.61平方公里，村民小组7个，户数330户，人口总数1328人，全村耕地面积亩，养殖水面亩。物产经济以水稻、棉花种植为主。村民收入主要来源于打工和水产。2011年村级集体经济收入达到5万元。人均纯收入9000元。

Total area of Chunfeng Village is 610,000 square meters (0.61 square kilometers.)

Our on the ground team visited the village to inquire with local officials about the discrepancy. Here are some photos of the village, and of the Chunfeng Village Committee from the visit of our due diligence team:

Our team spoke with officials in the village committee and asked about their relationship with YRIV. When asked if they leased any land to the company, they replied that they had not. We also confirmed that the village is currently only 0.61 square kilometers.

Given the above, it comes as no surprise that the company has reported that its Logistics Center has been stalled for at least three years. The company's last three 10-Ks describe the anticipated completion of construction on the Logistics Center and show literally zero progress:

| Construction of the Logistics Center: Expected % Completed | | | | |
|---|---|---|---|---|
| Time | Phase of Investment | 2017 10-K | 2016 10-K | 2015 10-K |
| 1st Year | 1st Phase Investment | 30% | 30% | 30% |
| 2nd Year | 2nd Phase Investment | 40% | 40% | 40% |
| 3rd Year | 3rd Phase Investment | 60% | 60% | 60% |
| 4th Year | Investment Completed | 75% | 75% | 75% |
| 5th Year | Investment Completed | 100% | 100% | 100% |

(Source: 10-Ks from 2017 [pg 2],2016 [pg 2],2015 [pg 4])

Going one level deeper, we found further evidence that the company's "plan" to build a 1.2 million square meter facility on a plot of land half that size did not comport with geographic reality.

After consulting with local authorities and villagers, the on the ground team learned that most of the area YRIV claimed to lease from Chunfeng Village actually belongs to Junming Village ( ), Jiangdi Village (江 ) and/or the Huayou Pipe Base (华 ). Chufeng Village barely overlaps with the area YRIV claims to lease.

We marked up an area map as shown below taken from Google Maps:


All told, we think the supposed leased land for the Logistics Center is a total fabrication.

## *YRIV's Constructed Part of the Project Looks Abandoned: We Found Virtually No Signs of*

# *Commercial Activity During Our Site Visits*

YRIV's constructed part of the project is a commercial building project formerly called the Wuhan Centre China Grand Steel Market. The project claims to cover an approximate construction area of 222,496.6 square meters ( pg. 3). YRIV's filings state that it sold approximately 22,780 square meters of commercial building space relating to this project.

The company's latest 10-Q reports an asset value of over $76 million for the completed and in progress buildings and the land use rights related to the constructed part of the project. ( pgs. F-12 – F-13)

After visiting the project site our team found that while some of the buildings do indeed look completed, the area appears to have been abandoned. Our first visit was in June 2018 during business hours. Our team saw no signs of commercial activity except for a gate guard. The team saw no other people, saw empty buildings with no movement inside, and heard no sounds that would indicate activity. Some of the properties were overgrown with shrubbery. Overall, the site struck us as a small ghost town. For accuracy, we visited again the site within 24 hours of publishing this article. Here are some photos from the recent visit to the site from 24 hours ago:

We have a very difficult time believing that these empty buildings (in an apparently abandoned location) have a value of anywhere near the $76 million reported by the company.

## *YRIV Has Numerous Undisclosed Legal Proceedings & Judgements Against it and Its Operating Subsidiary Has Been Declared Insolvent in China*

YRIV has repeatedly claimed that they are "not involved in any litigation that [it] believe[s] could have a materially adverse effect on [its] financial condition." (Source: 2018, 2017) Despite those representations, our research indicates that the precise opposite is in fact the case: ***the***

***company's operating subsidiary, Wuhan Newport, has so many claims and default judgements against it that it has been declared insolvent in China, according to our search of Chinese court databases.***

In just one example, China Construction Bank is litigating with YRIV's operating subsidiary, Wuhan Newport, regarding $44 million in loans to the company. The loan is disclosed in YRIV's filings (pg. F-17):

**10. LOANS PAYABLE**

| Bank name | Term | December 31, 2017 | December 31, 2016 |
|---|---|---|---|
| China Construction Bank | From May 30, 2014 to May 29, 2020 | $ 44,221,399 | $ 41,456,074 |

However, the litigation relating to the exact loan is not disclosed in YRIV's SEC filings. Here is the Chinese and English translation of the litigation:

2014 5 28 公司 GCDK2014-090
（ 下 ） 公司 29000万 期限6 （2014 5 30 2020
5 29 ） 5%

……

2014 5 30 公司 29000万 公司
任 公司、 公司 重大
有 期 公司 下 有 期 期 金、

***Translation:***

The plaintiff China Construction Bank Gangcheng Branch states, on May 28, 2014, the plaintiff and the defendant Wuhan Newport executed No. GCDK 2014-90 Fixed Assets Loan Agreement ("Loan Agreement") and stipulated that Wuhan Newport borrowed RMB 290 million from the plaintiff with the term of six years (May 30, 2014 to May 29, 2020), the interest shall be the base interest plus 5 % and quarterly interest payment.

The plaintiff (China Construction Bank) disbursed the loan payment RMB 290 million (USD 44 million) to YRIV on May 30, 2014. However, YRIV did not repay the interest and principal and the guarantor (Renhe Corp. the former shareholder of YRIV) did not perform its guarantee

obligation. YRIV and Renhe Corp. were already involved in severe litigations.

In addition to the above mentioned China Construction Bank litigation, in 2018 (February 27, 2018 to July 27, 2018), Wuhan Newport was subjected to at least 11 final judgements totaling RMB 767,132,632:

| | Case Number | Date | Court | Amount |
|---|---|---|---|---|
| 1 | (2018)鄂0117执1129号 | 7/26/2018 | Xinzhou District Court, Wuhan | 609159 |
| 2 | (2018)鄂0117执1117号 | 7/24/2018 | Xinzhou District Court, Wuhan | 702115 |
| 3 | (2018)鄂0117执1119号 | 7/24/2018 | Xinzhou District Court, Wuhan | 316287 |
| 4 | (2018)鄂0117执1118号 | 7/24/2018 | Xinzhou District Court, Wuhan | 129187 |
| 5 | (2018)鄂0117执1093号 | 7/17/2018 | Xinzhou District Court, Wuhan | 531371 |
| 6 | (2018)鄂0117执恢96号 | 7/16/2018 | Xinzhou District Court, Wuhan | 496865 |
| 7 | (2018)鄂01执931号 | 7/11/2018 | Wuhan Intermediate Court | 325427648 |
| 8 | (2018)鄂01执574号 | 5/14/2018 | Wuhan Intermediate Court | 39000000 |
| 9 | (2018)鄂01执112号 | 2/27/2018 | Wuhan Intermediate Court | 30420000 |
| 10 | (2018)鄂01执110号 | 2/27/2018 | Wuhan Intermediate Court | 189500000 |
| 11 | (2018)鄂01执111号 | 2/27/2018 | Wuhan Intermediate Court | 180000000 |
| | | | **Total:** | **767,132,632** |

As Wuhan Newport cannot repay its legal obligation under these judgements, it has been added to the local list of dishonest judgement debtors. This means that in the event that Wuhan Newport (the operating subsidiary of YRIV) receives any investment money from its investors, it's already earmarked to fulfill its outstanding debt.

Barron's recently reported on some of the company's litigation issues and asked the company why they were not disclosed to investors. The company's rationale was that those issues would disappear once it closed the asset swap deal with Wuhan Port:

> *"Asked about these cases, Yangtze told Barron's that its SEC filings don't mention the bank's court award because Yangtze's proposed asset swap will unburden it of the Newport unit. '[I]f the sale is successful,' the company said in an email responding to our questions, 'the Purchaser will be responsible for repaying the loan to the bank.'"*

> *"…Yangtze's planned exchange of businesses will cure all these headaches, director Coleman said in an interview. 'All the liabilities associated with the old project, bank loans and what not, transfer completely over to the new owners,' he told Barron's. 'Any and all of these issues are then gone.'"*

The latest S-3 registration statement filed by the company, shows that the contemplated business exchange referenced by the company in the Barron's article has been terminated.

Yet, despite the termination of the company's "excuse" for not disclosing its ongoing material legal proceedings, the company claims *in the very same filing* that they are not involved in any material litigation:

> *"We are currently not involved in any litigation that we believe could have a materially adverse effect on our financial condition or results of operations."*

In its most recent 10-Q, without the asset swap deal, the quarter reflected YRIV's third quarter business operations. The company continues to claim that YRIV does not have any litigation and, of course, YRIV did not disclose the RMB 767 million (USD 110 million) in outstanding judgements against its main operating subsidiary, Wuhan Newport.

We think that the above is the most obvious 10b-5 Securities Exchange Act violation since "Funding secured", and we believe that it could result in a halt of YRIV shares at any time.

# *Money from YRIV's Capital Raises Has Been Used to Pay the Chairman/Controlling Shareholder Rather Than Advance Company's Projects*

The company had 19 convertible note issuances this year alone, according to its latest quarterly filing. ( pgs. F-15-F-16)

| Date | Conv Price | Lender | Redemption | Amount |
|---|---|---|---|---|
| Feb. 2018 | 10 | Iliad | redeemed | 4,100,000 |
| 14-Mar-18 | 10 | Engle Equity | redeemed | 526,315 |
| 14-Mar-18 | 10 | Adar Bay | redeemed | 526,315 |
| 5-Apr-18 | 10 | GS Capital | N/A | 270,000 |
| 16-Apr-18 | 10 | Auctus | redeemed | 300,000 |
| 17-Apr-18 | 10 | TFK | N/A | 115,000 |
| 17-Apr-18 | 10 | Crown Bridge | N/A | 115,000 |
| 16-May-18 | 10 | Crown Bridge | N/A | 57,500 |
| 18-May-18 | 10 | Geneva | N/A | 214,000 |
| 12-Jun-18 | 10 | Eagle Equity | redeemed | 526,315 |
| 12-Jun-18 | 10 | Adar Bay | redeemed | 526,315 |
| 15-Jun-18 | 10 | GS Capital | N/A | 270,000 |
| 15-Jun-18 | 10 | Crossover | N/A | 115,789 |
| 19-Jun-18 | 10 | Auctus | redeemed | 300,000 |
| 13-Jul-18 | 10 | Crown Bridge | N/A | 57,500 |
| 18-Jul-18 | 12.5 | Geneva | N/A | 134,400 |
| 23-Jul-18 | 12 | Morningview | N/A | 250,000 |
| 25-Jul-18 | 12 | BHP Capital | N/A | 105,000 |
| 25-Jul-18 | 12 | Jefferson Street | N/A | 36,750 |
| Total Amount | | | | 8,546,199 |
| Not Redeemed | | | | 3,393,569 |
| Redeemed | | | | 5,152,630 |

As we stated before, as YRIV's operating entity, Wuhan Newport, has been labeled as a dishonest judgement debtor, and money that goes to Wuhan Newport will be used to fulfill its outstanding legal judgements. Therefore, we believe it is impossible for Wuhan Newport to come up with cash to continue its logistics center project.

So where does all the new cash go? YRIV has consistently reported large liability balances "due to related parties" on its financial statements. These in turn seem to accrue large interest rates which simply get added to the "advances" over time. When capital is raised, cash is then used to pay back the supposed related-party "advances", rather than being employed to further the company's projects.

In the September 2018 quarter alone, the CEO and controlling shareholder, Liu Xiangyao, was "repaid" $6.2 million dollars both directly and through an entity he controls called Jasper Lake Holdings ("Jasper"):

A summary of changes in the amount due to Mr Liu Xiangyao is as follows:

| | September 30, 2018 (Unaudited) |
|---|---|
| At beginning of period | $ 35,821,264 |
| Advances from the director | 7,551,311 |
| Repayment to the director | (4,920,318) |
| Exchange difference adjustment | (1,688,314) |
| At end of period | $ 36,763,943 |

A summary of changes in the interest payable to Jasper is as follows:

| | September 30, 2018 (Unaudited) |
|---|---|
| At beginning of period | $ 12,197,260 |
| Repayment | (1,338,896) |
| Interest expense | 4,487,671 |
| At end of period | $ 15,346,035 |

In the June 2018 quarter, the CEO was "repaid" $1.3 million, along with another $3 million in the March 2018 quarter. Based on the disclosure, the total amount of those 19 convertible notes amounted to $8.5 million, of which $3.39 million is outstanding while $5.15 million has been redeemed. We can therefore infer that raised cash from these convertible notes went to the Chairman, not to the business operations of YRIV.

These supposed repayments are not new for YRIV. In fact, financials presented as part of YRIV's reverse merger show that the company took out a $47.2 million construction loan from China Construction Bank in the year ending December 2014 ( pg. F-16).

The company turned around and paid out *all of it* as a "repayment to related parties" ( pg. F-6).

| | For the Years Ended December 31, 2015 | 2014 |
|---|---|---|
| **Cash Flows from Financing Activities:** | | |
| Proceeds from financial institution loans | - | 47,187,464 |
| Repayment of financial institution loans | (176,599) | (488,146) |
| Advances from related parties | 4,874,761 | 4,834,513 |
| Repayment to related parties | - | (47,187,464) |
| **Net Cash Provided By Financing Activities** | **4,698,162** | **4,346,367** |

Based on these observations, we believe that YRIV is largely a shell which exists to raise more capital for the personal use of its controlling shareholder and chairman.

# *Conclusion: We Think Yangtze River Port & Logistics Is Worth Nothing*

Over the last decade, numerous China-based companies have been ousted from U.S. markets. Generally, the most egregious cases occur when companies funnel wealth and value from shareholders to insiders. Since the implosion of the U.S. listed China-based space between 2010 and 2014, we didn't think we would ever come across such obvious cases again.

To anyone who thinks the China Hustle has ended:

- We encourage you to consult an official map, which clearly shows that the Chunfeng Village is only 610,000 square meters in size despite the company claiming to lease 1.2 million square meters of land from them.
- We encourage you to review the readily available filings from Chinese courts showing the litany of judgements against the company that are undisclosed in their SEC filings.
- We encourage you to simply visit the apparently empty cluster of buildings it claims to be of great value.

Best of luck to all

**Disclosure:** We are short YRIV.

# TAB 32

# Aphria: Our Response

Published on December 4, 2018



This morning, Aphria responded to our report detailing believed undisclosed conflicts of interest and signs of worthlessness relating to its LatAm transactions. The company's response largely reiterated its earlier press releases touting the supposed worth of its acquisitions and did nothing to dispute our core findings.

We believe it is of utmost importance to note what the company did NOT say in response to our reporting:

1. We alleged that the company acquired its supposed assets through a series of shell companies established by a key Aphria/Scythian insider and deal partner Andy DeFrancesco.

The company did not dispute the structure of these transactions.

2. We alleged that the official registered office of Aphria's Jamaica subsidiary is an abandoned building that was sold off by the bank earlier this year.

The company's response: **none**.

3. We alleged that Aphria's Jamaica subsidiary leased "unit 51" of a building complex that only goes up to "unit 50". In other words, "unit 51" didn't exist.

The company's response: **none.**

4. We alleged that after 6 months, the company's office lease in Jamaica had a paper sign on its door and showed virtually zero signs of activity.

The company's response: **none.**

5. We alleged that a purported director of Aphria's Jamaica subsidiary denied IN WRITING that she had ever served as a director at the company.

The company's response: **none.**

6. We alleged that other supposed directors and supposed top scientists associated with Aphria's Jamaica subsidiary appeared to either not exist or had no/limited online presence.

The company's response: **none.**

7. We alleged that the company's much-touted cannabis licenses in Jamaica cost only about $500 to acquire and require minimal effort.

The company's response: **none.**

8. We alleged that individuals associated with key insider/deal partner Andy DeFrancesco purchased shares in the Jamaican entity for only US $118 ( *not* millions) and flipped them months later for C$18 million.

The company's response: **none**.

9. We alleged that an employee of the company's Argentine subsidiary stated that annual revenues were US$430 thousand, which directly contradicted press releases that annual revenues at the subsidiary were US$ 11 million.

The company's response: **none.** We urge the company to release the **audited financials** for this entity.

10. We alleged that the company's supposed major "purchase order" with a local Argentine hospital was actually a donation.

The company's response: **none.**

11. We alleged that the company's Colombian subsidiary was a newly-formed operation with exactly zero operating activity as of end of the year.

The company's response: **none.**

12. We alleged that the company's supposed "strong" retail presence in Argentina consisted of exactly one tiny pharmacy.

The company's response: **none.**

13. We alleged that on current Scythian Chairman Andy DeFrancesco's private Instagram account we saw his bragging about purchasing the very pharmacy into his own private equity firm one week before flipping the Argentine entity to Scythian for C$27 million (and hashtagging GreedIsGood)

The company's response: **none.**

14. We alleged that the company's supposed distribution business in Argentina consists of an empty, unfinished warehouse.

The company's response: **none.**

15. We alleged that Andy DeFrancesco has a deep longstanding ties to both Aphria & Scythian. In regard to Scythian, the company until recently listed its head office at the same address and suite number of the Toronto office of DeFrancesco's private equity firm, the Delavaco Group. Scythian's CFO until late September was Jonathan Held, who operates his consulting firm out of the exact same address and suite number as the Delavaco Group's Toronto office. Delavaco's COO was the "finder" of Scythian's reverse-merger deal to take the company public. Delavaco participated in Scythian's bought deals. DeFrancesco was named Scythian's Chairman of the Board and Chief Investment Officer on the EXACT SAME DAY the company closed on its acquisition of the Argentine entity.

The company's response: technically DeFrancesco wasn't an insider.

16. We alleged that Canadian regulators said Andy DeFrancesco has "little regard for the truth" and was involved in a forgery scheme. We alleged that DeFrancesco had business ties with multiple individuals the SEC has alleged to have committed securities fraud including Barry Honig, John Stetson, and John O'Rourke.

DeFrancesco's response, per Barron's: "Guys who put companies together come across each other and co-invest"

17. We allege that the company did not have all its required licenses in Colombia needed for cultivation.

The company's response: **Admits.** The company was granted a characterization permit "allowing the company to assess seeds and initiated a pilot test of its strains **prior to full scale cultivation**."

All told, we find the company's response to be supremely underwhelming. We note with some amusement the following line from the response:

> *"Since closing this important strategic acquisition in September, we have made*

> *considerable progress supporting and building out our operations on the ground in Latin America and the Caribbean."*

Typically, when a company makes an acquisition for C$280 million it purchase assets that already exist, not ones that need to be built out later. Note that our on-the-ground visits were recent, ranging from September to November of this year.

We demand that the company actually respond to our research and allegations. In addition, we demand the following information from the company:

- Who are ALL of the shareholders of the acquired shell companies? In filings with the Canadian Stock Exchange the company REDACTED the names of the beneficiaries of these deals. (1, 2)
- Did the beneficiaries of these shell deals include Aphria insiders, their spouses, family members, or other deal partners?
- We do not place any value in the ' fairness opinion ' that Aphria bought to justify this transaction. We note that the bank that issued the opinion, Cormark Securities, has been an underwriter in Aphria's dilutive bought-deal financings and was the same bank that provided a ' fairness opinion ' for Aphria's Nuuvera transaction. Recall that we had also identified signs of worthlessness and undisclosed related-party dealings relating to the Nuuvera transaction in our earlier reporting . Nonetheless, the company should release this document and make it available for public scrutiny.

Shareholders deserve FULL TRANSPARENCY on these issues and we will continue to report on this subject until they receive it.

**Disclosure:** We are short APHA.

# TAB 33

# Aphria: A Shell Game with a Cannabis Business on the Side

Published on December 3, 2018



## Summary: Aphria Inc (NYSE:APHA)


- We are of the strong opinion that Aphria is part of a scheme orchestrated by a network of insiders to divert funds away from shareholders into their own pockets.
- Aphria's recent C$280m Latin American acquisitions raise major red flags. Our extensive on-the-ground research shows that the transactions appear to be largely worthless.
- Example: The official registered office of Aphria's C$145m Jamaican acquisition is an abandoned building that was sold off by the bank earlier this year.
- Example: Aphria's C$50m Argentine acquisition publicly boasted sales of US$11m in 2017. A worker at the company, however, affirmed that 2017 revenue was only US$430k.
- Documents show that Aphria insiders were likely undisclosed beneficiaries of these deals. We noticed what appear to be systematic attempts to hide the true nature of these transactions. For example: changing the names of the shell companies involved in a way that makes it harder to link them to Aphria's insiders.
- These M&A transactions are entirely financed by copious and dilutive share issuance. We estimate that Aphria has diverted upwards of C$700m via such transactions, or about 50%

# TAB 34

# Genworth's Acquirer (China Oceanwide) Looks to Be Drowning in an Ocean of Debt

Published on November 9, 2018



## Summary: Genworth Financial (GNW)


- In our previous piece we focused on signs of liquidity issues at China Oceanwide including spiking debt levels, negative operating performance, and the aggressive pledging of equity in its subsidiaries.
- Today we share a deeper-dive into Oceanwide's operations, including an overview of its leverage-fueled trophy asset development spree which has shown recent signs of stalling.
- We have also identified accounting red flags, including Oceanwide's booking $11.4 billion of "development costs" as a current asset, as well as $4.8 billion in questionable related-party receivables.
- Bloomberg recently reported that a key Oceanwide operating subsidiary was "scrambling to sell assets to repay debt." With another $1.6b of bond maturities due in Q1'19 we expect significant near-term instability and ultimately expect the conglomerate to unravel within 24 months.

- Given its liquidity issues we do not think China Oceanwide will fulfill its commitments to Genworth & its policyholders and reiterate our view that this deal looks starkly at odds with the interests of policyholders.

# *Overview*

In our previous piece we highlighted signs of liquidity issues at Genworth's emergent acquirer, China Oceanwide ("Oceanwide"). In particular we focused on Oceanwide's (i) consistently negative operating & investing cash flow (ii) spiking debt levels; and (iii) the aggressive pledging of equity in Oceanwide's public subsidiaries, which have all steadily declined in value.

Today we are sharing a deeper-dive into Oceanwide's operations, including an overview of the conglomerate's leverage-fueled trophy asset development spree, which has recently shown signs of stalling.

We have also taken a closer look at Oceanwide's audited financials, identifying red flags with its working capital balances including (i) the reporting of $11.4 billion of "development costs" as a current asset; and (ii) the reporting of $4.8 billion in questionable related-party receivables as a current asset. Finally, we review Oceanwide's debt maturities, with a particular focus on a large $1.6 billion slate of bonds due in Q1 '19, just *after* the hoped-for Genworth deal closing.

Collectively this analysis bolsters our view that Oceanwide is overleveraged and facing a severe and current liquidity crunch. The nearly unlimited access to credit the conglomerate has enjoyed historically has recently tightened.

If the Genworth deal were to close we believe it would buy Oceanwide some additional time, but we do not see it materially altering Oceanwide's collision course. We predict that China Oceanwide will collapse within 24 months barring a financial miracle.

# *Background*

The key question facing regulators right now is whether the Oceanwide deal will leave Genworth's policyholders better or worse off.

The consensus seems to be that Genworth is a financially weak holding company. Many have taken the view that if Oceanwide can contribute some cash to Genworth's insurance carriers then it would be better than nothing.

We think that view is misguided, and that the opaque Chinese conglomerate is not coming to the rescue. On the contrary, given the financial state of Oceanwide we expect the opposite will take place.

The current deal proposal relies on Oceanwide largely contributing capital to Genworth *after* the deal closes. Similarly, Genworth is slated to contribute capital to its primary insurance carrier, GLIC, *after* the deal closes. We expect these IOU's will never materialize. Instead, we think Oceanwide is more likely to contribute a token amount up-front then seek any available means of extracting capital *out* of Genworth in an effort to stay solvent while policyholders are imperiled in the cross-border fallout.

# *Background: China Oceanwide's Negative Operating Performance Coupled With Spiking Debt Levels Creates a Toxic Combination*

As noted in our previous piece, Oceanwide's operating performance has been consistently negative with a recent sharp deterioration:

| China Oceanwide Holdings Group Co. Audited Cash Flow Metrics ($USD) | | | | | |
|---|---|---|---|---|---|
| | 2017 | 2016 | 2015 | 2014 | 2013 |
| Net Cash Flow From Operating Activities | -3,301,337,762 | -1,542,740,820 | -611,584,858 | -324,854,281 | -1,662,889,906 |
| Net Cash Flow From Investment Activities | -1,712,820,625 | -7,983,115,367 | -2,400,557,911 | -539,282,746 | -574,932,638 |
| Net Cash Flow From Financing Activities | 3,172,912,248 | 8,796,161,214 | 6,421,477,052 | 2,077,720,031 | 2,261,809,421 |

*Sources: 2016-2017 audit [pg 14] 2015 audit [pg 10] 2014 audit [pg 9] 2013 audit [pg 9]*

Meanwhile, the conglomerate has fueled its expansion with an ever-increasing debt burden:

| China Oceanwide Holdings Group Co. Audited Balance Sheet Metrics ($USD) | | | |
|---|---|---|---|
| | 2017 | 2015 | 2013 |
| Short-term borrowing | 2,582,593,582 | 1,062,679,618 | 699,036,131 |
| Short-term financing funds payable | 237,110,713 | 145,799,345 | - |
| Borrowings from banks & other finanical institutions | 186,416,296 | - | - |
| Notes Payable | 2,565,928 | 12,319,824 | - |
| Non-current liabilities to be matured within a year | 8,339,207,687 | 3,457,481,619 | 1,809,122,407 |
| **Short-Term Debt** | **11,347,894,206** | **4,678,280,406** | **2,508,158,538** |
| Long-term borrowing | 12,307,170,235 | 8,955,212,652 | 5,979,220,758 |
| Bonds payable | 7,510,136,017 | 5,356,074,269 | 462,511,840 |
| **Total Debt** | **31,165,200,458** | **18,989,567,327** | **8,949,891,136** |

**Note: non-current liabilities to be matured within a year include long-term borrowings and payables due within 1 year (pg. 90)*

# *Working Capital Red Flag: Current Assets Include Over $11.4 Billion of Real Estate Development Costs*

Given the lack of operating cash flows and the rising debt levels, the key question becomes "how long can we keep the lights on?"

For this we turn to Oceanwide's working capital balances (i.e.: current assets minus current liabilities). As of 2017 year-end the conglomerate had working capital of over $10 billion, suggesting ample liquidity to meet its obligations, at first glance.

When taking a closer look however we notice that by far the largest current asset is inventory:

**Consolidated Balance Sheet**
**December 31, 2017**
Company: China Oceanwide Holdings Group Co., Ltd. (seal) Amount Unit: USD

| Item | Note | Ending Balance | Beginning Balance |
|---|---|---|---|
| **Current assets:** | | | |
| Cash or cash equivalent | 6.1 | 4,664,305,276.60 | 6,430,546,481.11 |
| Settlement reserve | 6.2 | 344,181,808.72 | 439,791,630.38 |
| Loans to banks and other financial institutions | | | |
| Financial assets measured at fair value through current profit or loss | 6.4 | 1,778,853,096.51 | 1,629,858,143.28 |
| Margin loans | 6.3 | 886,156,764.92 | 646,391,571.28 |
| Financial derivative assets | 6.5 | 11,672,577.11 | 122,101.87 |
| Notes receivable | 6.6 | 3,683,294.85 | 14,876,890.36 |
| Accounts receivable | 6.7 | 541,043,980.74 | 141,823,849.81 |
| Prepayments | 6.8 | 294,658,653.37 | 360,827,082.31 |
| Premiums receivable | 6.9 | 14,724,878.83 | 9,898,017.76 |
| Reinsurance accounts receivable | 6.10 | 4,320,877.83 | 4,148,775.23 |
| Reinsurance contract reserves receivable | 6.11 | 23,033,858.77 | 25,851,792.65 |
| Interests receivable | 6.12 | 125,333,575.27 | 87,811,702.36 |
| Dividends receivable | 6.13 | 4,268,095.67 | 319,966.65 |
| Other receivables | 6.14 | 6,667,561,866.68 | 5,569,456,210.25 |
| Repurchase of sale of financial assets | 6.15 | 1,022,253,493.29 | 738,464,194.65 |
| Inventories | 6.16 | 12,951,229,391.84 | 10,240,640,667.87 |
| Assets classified as held for sale | | | |
| Refundable deposits | 6.17 | 31,386,003.32 | 32,630,113.59 |
| Non-current assets to be matured within a year | 6.18 | 134,068,824.27 | 48,472,144.41 |
| Other current assets | 6.19 | 269,510,960.68 | 431,014,980.43 |
| **Total current assets** | | 29,772,247,279.27 | 26,852,946,316.25 |

By recording almost $13 billion in inventory as a "current" asset the implication is that the balance can be converted into cash within a year or less.

This seems starkly at odds with reality. The entire conglomerate only generated $3.4 billion in revenue as of the same 2017 year-end and has never generated more than ~$4 billion in revenue in any year. Furthermore, we see that inventory has been steadily climbing every single year, regardless of revenue growth or decline:

| China Oceanwide Holdings Group Co. Audited Metrics ($USD) | | | | | |
|---|---|---|---|---|---|
| | 2017 | 2016 | 2015 | 2014 | 2013 |
| Revenue | 3,414,599,827 | 3,992,817,390 | 2,171,035,381 | 1,434,657,217 | 1,406,966,465 |
| Inventory | 12,951,229,391 | 10,240,640,667 | 7,923,581,134 | 5,913,981,211 | 4,994,350,249 |

*Source: 2016-2017 audit [pg 13] 2015 audit [pg 9] 2014 audit [pg 8] 2013 audit [pg 8]*

The audit footnotes ( pg. 72) show that ~99.8% of the inventory is real estate related. But rather than consisting largely of completed buildings, $11.4 billion (or 88.5% of the total inventory balance) is recorded as "development costs":

**6.16 Inventories**

**6.16.1 Classification of inventories**

| Item | Ending balance | | |
|---|---|---|---|
| | Book balance | Provision for depreciation | Book value |
| Non-real estate industry | | | |
| Raw materials | 7,046,739.86 | 206,442.34 | 6,840,297.51 |
| Goods in progress | 2,422,550.32 | 100,249.49 | 2,322,300.83 |
| Commodity stocks | 10,707,783.06 | 701,414.87 | 10,006,368.19 |
| Low-value consumables | 149,267.07 | 0.00 | 149,267.07 |
| Others | 844.59 | 0.00 | 844.59 |
| Sub-total | 20,327,184.90 | 1,008,106.71 | 19,319,078.20 |
| Real estate industry | | | |
| Developed products | 1,469,581,606.77 | 0.00 | 1,469,581,606.77 |
| Development costs | 11,462,328,706.87 | 0.00 | 11,462,328,706.87 |
| Leasing developed products | 0.00 | 0.00 | 0.00 |
| Sub-total | 12,931,910,313.64 | 0.00 | 12,931,910,313.64 |
| Total | 12,952,237,498.54 | 1,008,106.71 | 12,951,229,391.84 |

For context, Oceanwide's *total* real estate revenue was only $1.2 billion in 2017 ( pg. 82), suggesting that development costs alone represent about 9.5 years worth of inventory:

**6.69 Operating income and operating costs**

| Name of industry (or business) | Current | | Previous | |
|---|---|---|---|---|
| | Income | Cost | Income | Cost |
| Real estate industry | 1,207,693,911.22 | 751,504,697.36 | 2,716,630,698.79 | 1,580,918,541.13 |

The unusually large development cost balance raises multiple questions:

1. Why is Oceanwide carrying so many development costs as "current" assets? As noted earlier, the balance has just grown over time regardless of sales movements. It seems that for the past five years very little of its real estate projects have been sold or converted into rental units, yet they continue to be carried as "current".
2. Just how many properties are there that have yet to be completed, and what are they?

The above casts serious doubts about the credibility of "development costs" as a working capital asset. It may also cast doubt on the credibility of the reported number in general. At the very least, it raises questions about how Oceanwide is deploying its resources.

Note that if development costs were excluded from working capital the conglomerate would be in a negative working capital position:

| China Oceanwide 2017 Working Capital Metrics ($USD) | |
|---|---|
| Working capital | 10,198,436,493 |
| Development Costs | 11,462,328,706 |
| WC Net of Development Costs | -1,263,892,213 |

Negative working capital is a sign that a business could have trouble paying its existing debts when due and payable. In Oceanwide's case, it has to pay these debts and then fund the $2.7 billion acquisition of Genworth along with its subsequent funding commitment to Genworth and its insurance carriers.

# *Oh The Joys Of Leverage: China Oceanwide's Trophy Asset Development Spree*

After identifying Oceanwide's extensive development cost balances we sought to learn more about its property endeavors. We learned through media reports and subsidiary filings that the conglomerate has been developing multiple large "trophy" assets.

Putting aside the wisdom of pursuing these splashy projects, the size and number of these simultaneous developments tells us that substantial new capital will be needed to see them through to completion.

The projects below (together with those in the following section) collectively account for only about $2.6 billion in known deployed costs ( pg. 14, pg 16 & pg 1), suggesting that another $8.8 billion in unfinished "development costs" could exist in other parts of the world. (Note that the China Oceanwide website lists some local developments but the website appears to be

outdated.)

**San rancisco ffice Skyscraper Scheduled to Be Completed in 2021**

Oceanwide is in the process of building the second largest office tower in San Francisco, a 905 ft. skyscraper in the heart of the city. The building complex is to include 2 million square feet of mixed-use office and residential space.

The company had purchased the site for $300 million from private equity investors that had paid only $113 million for it two years earlier. BizJournals recently reported that the development is the most expensive construction project in all of San Francisco, with construction costs expected to be in the $1.6 billion range. Oceanwide began construction near 2016 year-end, with construction slated to be completed in 2021.

**Los Angeles Luxury Highrise Scheduled to Be Completed in 2020**

In Los Angeles, Oceanwide has embarked on a $1 billion development to build the three tallest residential buildings in the city's skyline. The luxury projects are slated to be completed in 2020.

**Indonesian ower lants Completion Date Unknown**

In 2015, Oceanwide's operating subsidiary acquired a project to develop a pair of power plants in Indonesia (pg. 18). The projects were anticipated to be grid-connected by the end of 2017. Development was delayed due to litigation (which was subsequently resolved in February of this year.) To date, the company has invested $362 million into the projects. (pg. 18)

# *Oh The Pitfalls of Leverage. Bloomberg: Oceanwide's Operating Subsidiary "Scrambling to sell assets to repay debt"*

In September, a Bloomberg article on Chinese junk bond sales noted that the Oceanwide subsidiary responsible for many of the trophy-asset developments was "scrambling to sell assets to repay debt." The entity is the developer for the Los Angeles and Indonesian endeavors mentioned above.

Additionally, the entity is responsible for the projects below, which appear to have stalled

without formal explanation:

**A lanned 1, 00 oot New ork City Supertall" Looks To Have Super-Stalled**

In 2015 Oceanwide paid $390 million to purchase two sites in New York's South Street Seaport, with plans to construct a 1,400 foot "supertall" tower on the location.

The Real Deal reported that the company filed demolition plans for the sites in early 2017, but as of April 2018 no building plans had been filed with the city's Department of Buildings. The publication referred to the situation as a "mystery".

**Luxury Resort In Hawaii's ahu**

In 2015-2016 Oceanwide spent a total of about $614 million on land purchases in Hawaii ( pg. 16-17) in order to build an ultra-luxurious hotel under the Atlantis brand along with two other hotels, residential condos, and commercial space.

The projects look to have stalled. In mid-June of this year it was reported that the projects are still in the "early design and planning process" with the sites sitting idle.

**verall**

Each of these construction projects have costs to complete that are not fully disclosed in the financial statements and could amount to billions of dollars in additional financial commitments. So, Oceanwide will need funds to address its working capital needs (which

includes $11.4 billion in questionable "development costs"), its $2.7 billion Genworth acquisition, and an unknown amount to fund these and other construction projects that are currently in various stages of development and pre-development.

After all this, what is left for the Genworth policyholders?

# *Working Capital Red Flag: Current Assets Include $4.8 Billion In Receivables Owed By Related Parties*

Turning back to the financials, we see other working capital red flags aside from unusually large inventory levels and apparently stalled development projects.

The second largest current asset item is $6.6 billion in "other receivables":

**Consolidated Balance Sheet**
**December 31, 2017**
Company: China Oceanwide Holdings Group Co., Ltd. (seal) Amount Unit: USD

| Item | Note | Ending Balance | Beginning Balance |
|---|---|---|---|
| **Current assets:** | | | |
| Cash or cash equivalent | 6.1 | 4,664,305,276.60 | 6,430,546,481.11 |
| Settlement reserve | 6.2 | 344,181,808.72 | 439,791,630.38 |
| Loans to banks and other financial institutions | | | |
| Financial assets measured at fair value through current profit or loss | 6.4 | 1,778,853,096.51 | 1,629,858,143.28 |
| Margin loans | 6.3 | 886,156,764.92 | 646,391,571.28 |
| Financial derivative assets | 6.5 | 11,672,577.11 | 122,101.87 |
| Notes receivable | 6.6 | 3,683,294.85 | 14,876,890.36 |
| Accounts receivable | 6.7 | 541,043,980.74 | 141,823,849.81 |
| Prepayments | 6.8 | 294,658,653.37 | 360,827,082.31 |
| Premiums receivable | 6.9 | 14,724,878.83 | 9,898,017.76 |
| Reinsurance accounts receivable | 6.10 | 4,320,877.83 | 4,148,775.23 |
| Reinsurance contract reserves receivable | 6.11 | 23,033,858.77 | 25,851,792.65 |
| Interests receivable | 6.12 | 125,333,575.27 | 87,811,702.36 |
| Dividends receivable | 6.13 | 4,268,095.67 | 319,966.65 |
| Other receivables | 6.14 | 6,667,561,866.68 | 5,569,456,210.25 |
| Repurchase of sale of financial assets | 6.15 | 1,022,253,493.29 | 738,464,194.65 |
| Inventories | 6.16 | 12,951,229,391.84 | 10,240,640,667.87 |
| Assets classified as held for sale | | | |
| Refundable deposits | 6.17 | 31,386,003.32 | 32,630,113.59 |
| Non-current assets to be matured within a year | 6.18 | 134,068,824.27 | 48,472,144.41 |
| Other current assets | 6.19 | 269,510,960.68 | 431,014,980.43 |
| **Total current assets** | | 29,772,247,279.27 | 26,852,946,316.25 |

This item struck us as odd because of its size relative to the operating performance of the conglomerate (it's almost twice as large as total 2017 revenue). Additionally, "other receivables" ballooned by almost $1.1 billion from 2016 to 2017 despite a year over year revenue *decline*.

When looking closer at the footnotes we see that these other receivables are owed by a small

number of entities ( pg. 71):

**6.14.2 Top five ending balances of other receivables by the debtors**

| Entity name | Nature | Ending balance | Aging | Proportion in total other receivables as at December 31, 2017 (%) |
|---|---|---|---|---|
| Legal entity 1 | Current accounts | 2,268,089,936.00 | Within 1 year (including 1 year) | 33.75 |
| Legal entity 2 | Current accounts | 1,614,244,781.51 | Within 1 year (including 1 year) | 24.02 |
| Legal entity 3 | Current accounts | 549,835,446.46 | Within 1 year (including 1 year) | 8.18 |
| Legal entity 4 | Current accounts | 402,315,113.45 | Within 1 year (including 1 year) | 5.99 |
| Legal entity 5 | Current accounts | 277,131,885.32 | Within 1 year (including 1 year) | 4.12 |
| Total | | 5,111,617,162.73 | - | 76.07 |

We see later in the filings that the precise amounts owed by the top 4 redacted legal entities in the above figure 6.14.2 correspond to another footnote detailing receivables from related parties ( pgs 112-113):

**9.6 Receivables and payables of related parties**

**9.6.1 Receivables**

| Item name | Ending balance | | Beginning balance | |
|---|---|---|---|---|
| | Book balance | Bad debt reserves | Book balance | Bad debt reserves |
| Accounts receivable: | | | | |
| Oceanwide Hotel Investment Management Co,. Ltd. | 1,538,327.67 | 76,916.38 | 3,287.01 | 164.35 |
| Oceanwide Horticulture Technology Engineering Co., Ltd. | 734.18 | 0.00 | 0.00 | 0.00 |
| China Minsheng Banking Corp., Ltd. | 0.00 | 0.00 | 61,357.04 | 3,067.85 |
| Total | 1,539,061.85 | 76,916.38 | 64,644.05 | 3,232.20 |
| Other receivables | | | | |
| Oceanwide Group Co., Ltd. | 2,268,089,936.00 | 0.00 | 1,230,591,291.10 | 0.00 |
| Oceanwide Green Energy Investment Co., Ltd. | 1,614,244,781.51 | 0.00 | 1,618,717,654.57 | 0.00 |
| Changxin Capital Investment Management | 549,835,446.46 | 0.00 | 611,140,113.34 | 0.00 |

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| Item name | Ending balance | | Beginning balance | |
|---|---|---|---|---|
| | Book balance | Bad debt reserves | Book balance | Bad debt reserves |
| Co., Ltd. | | | | |
| Tohigh Holdings Co., Ltd. | 402,315,113.45 | 0.00 | 202,234,847.69 | 0.00 |
| Oceanwide Hotel Investment Management Co,. Ltd. | 6,879,606.72 | 343,980.34 | 6,572,481.42 | 328,624.07 |
| Oceanwide Horticulture Technology Engineering Co., Ltd. | 896,199.00 | 44,711.41 | 1,047,201.14 | 52,261.51 |
| Total | 4,842,261,083.14 | 388,691.74 | 3,670,303,589.25 | 380,885.59 |

Thus we can surmise that at least $4.8 billion of "other receivables" is owed by related party entities. Much of these were up-streamed to Chairman Lu's other entities.

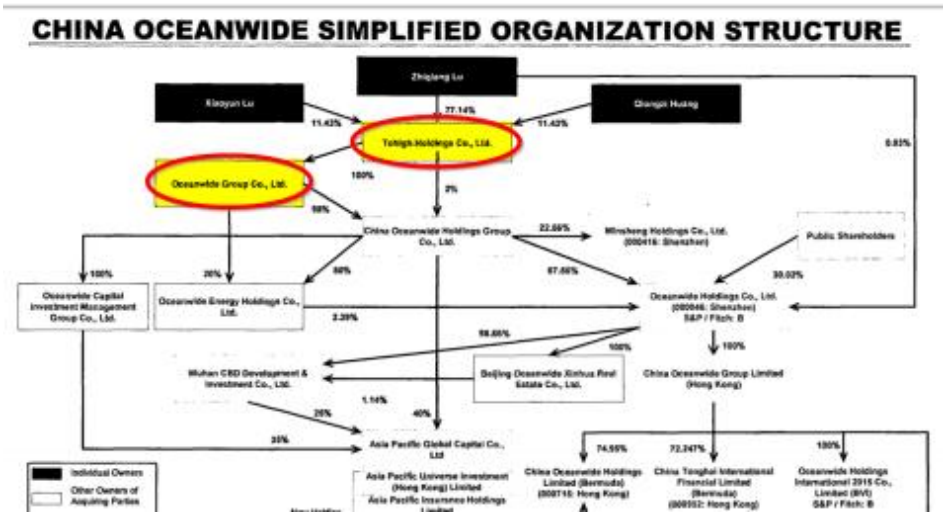
It is difficult for us to imagine that these receivables have resulted from an exchange of goods or services. In 2015, for example, the "other receivables" account grew by more than the conglomerate's total revenue:

| | 2017 | 2016 | 2015 | 2014 | 2013 |
|---|---|---|---|---|---|
| Revenue | 3,414,599,827 | 3,992,817,390 | 2,171,035,381 | 1,434,657,217 | 1,406,966,465 |
| Other Receivables | 6,667,561,866 | 5,569,456,210 | 4,900,214,251 | 2,080,081,482 | 1,838,570,447 |
| Other Receivables Y/Y Chg | 1,098,105,656 | 669,241,959 | 2,820,132,769 | 241,511,035 | N/A |
| Y/Y Rev Growth (%) | -14% | 84% | 51% | 2% | N/A |
| Y/Y Other Receivables Growth (%) | 20% | 14% | 136% | 13% | N/A |

*Source:2016-2017 audit [pg 11,13]2015 audit [pg 8-9]2014 audit [pg 6,8]2013 audit [pg 6,8]*

Instead, it looks like "other receivables" is simply a mechanism to make unsecured loans to Chairman Lu's other entities.

In particular, almost $2.7 billion is owed by entities that look to essentially be the Chairman's holding companies. The conglomerate's org chart ( pg. 4) shows that Tohigh Holdings is the Chairman's key holding company, while Oceanwide Group Co. Ltd owns stakes in Oceanwide Energy and China Oceanwide:




This poses several important questions:

- What is the credit worthiness of these receivables? If almost $2.7 billion is owed from related entities with limited operations of their own what is their capacity to actually pay the money back?
- Why is Oceanwide functioning as a de facto bank for these entities? Do these related entities lack the credit worthiness to get their own financing?
- What are the terms of these receivables? Are these interest-bearing or are they simply

unsecured, interest-free loans to the Chairman's entities?
- Why have these receivables steadily grown over time rather than been paid off?

To answer some of these questions we may wish to explore Chairman Lu's personal spending habits.

**Three Giant Mansions" and a Winery**

Far be it for us to judge how a wealthy person spends their money, but Chairman Lu has largely been spending borrowed cash. As the WSJ reported in 2015:

> *Since 2012, Mr. Lu has purchased three giant mansions in Atherton (California), paying $21 million, $25 million and $30 million, respectively… Collectively, the three properties have 19 bedrooms and 22 bathrooms, according to property-sales listings…*
>
> *…last spring, Mr. Lu tried to buy an even pricier home, offering $41 million to buy the former home of Jim Clark, co-founder of Netscape, according to court records and a person familiar with the matter.*
>
> *…(Oceanwide) also paid $41 million for a ranch in Sonoma County that can hold a winery.*

These are only the assets we were able to identify via domestic media outlets. It is unclear how many mansions and other creature comforts Mr. Lu has accumulated globally at this point.

We wonder, why is the Chairman purchasing so many foreign mansions clustered in the same California town? It begs the question of whether these are merely attempts to shift assets overseas. At best it does not paint a portrait of a staid, judicious asset manager. Instead, such spending is more reminiscent of the teenager who managed to get a hold of a parent's credit card.

# *Working Capital Item 3: Declining Cash Balances And Restricted Cash*

Moving right along, Oceanwide's third largest current account asset after "development costs"

and related-party receivables is cash and equivalents. The balance has declined over the past several years but stood at $4.6 billion as of end of 2017:

| China Oceanwide Holdings Group Co. Balance Sheet Metrics ($USD) | | | | | |
|---|---|---|---|---|---|
| | 2017 | 2016 | 2015 | 2014 | 2013 |
| Cash and Equivalents | 4,664,305,276 | 6,430,546,481 | 5,918,391,491 | 2,526,215,801 | 1,711,278,202 |

In the footnotes ( pg. 62) we see that about 26% of this balance, or $1.2 billion is restricted, largely due to pledges for loans, bonds, and other deposits:

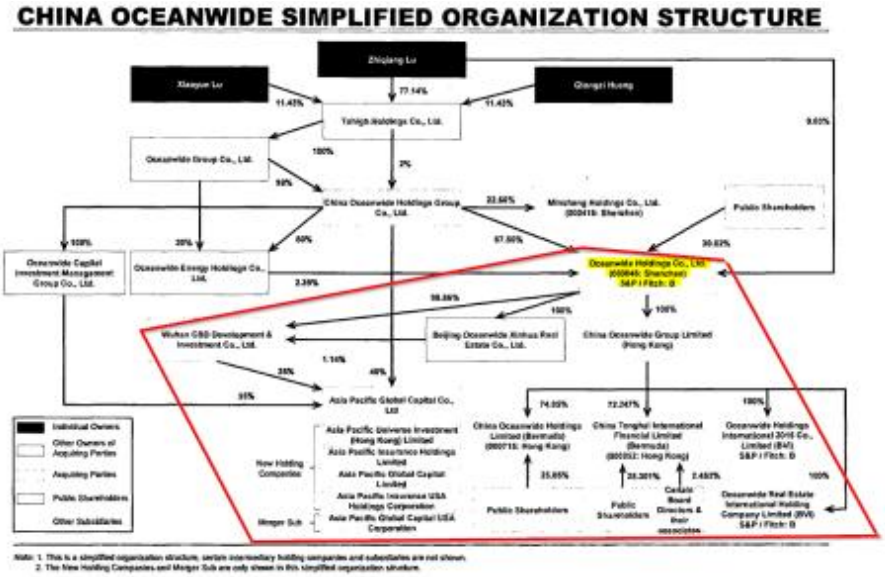
Details of restricted cash and cash equivalent

| Item | Ending balance | Beginning balance |
|---|---|---|
| Deposit for internal-guarantee external-loan | 689,109,502.93 | 1,250,253,810.06 |
| Deposit for bank acceptance bill | 552,825.54 | 0.00 |
| Deposit for letter of guarantee | 150,427.50 | 709,491.20 |
| Large-sum fixed deposit | 31,233,920.36 | 85,951,199.89 |
| Performance bond | 507,280,555.02 | 58,735,243.19 |
| Special payment for relocation | 9,376.60 | 9,348.14 |
| Total | 1,228,336,607.95 | 1,395,659,092.48 |

Thus, net of restricted cash the conglomerate had about $3.4 billion in unrestricted cash with which to meet its obligations at the end of 2017. Given the trend of negative operating cash flow, a high current debt burden, and the aggressive development slate we can only guess what the 2018 year-end cash balance will look like.

## *China Oceanwide Has $1.6 Billion In Bonds Coming Due Q1 '19. Right Before The Hoped-For Genworth Deal Closing*

In our earlier piece we noted that Oceanwide's corporate structure looked levered to the hilt. The S&P maintains a CCC rating with a negative outlook on the conglomerate's key operating entity, Oceanwide Holdings Co. Ltd.:




In S&P's recent ratings release they noted that the entity's capital structure was "unsustainable" and stated:

> *We expect Oceanwide to continue to face substantial refinancing pressure, and believe the prospect of meaningful deleveraging is still remote. This is due to the company's very high short-term debt and its overall huge debt burden.*

In another S&P release dated November 6th, 2018 titled "Cycle Turning Adds Risks For China's Weakest Developers":

> *After robust activity for more than two years, the momentum waned in September and October, traditionally prime months for Chinese property.*
>
> *…A downturn for such a cyclical sector has been widely anticipated, but the timing is particularly bad since credit conditions aren't conducive either.*
>
> *…The financing landscape is the most unfavorable in years–whether it's a clampdown on alternative financing, domestic bonds being designated only for refinancing, or a surge in offshore bond yields. Moreover, many developers have large refinancing needs due to surging maturities or exercisable puts on onshore bonds. Smaller developers will certainly have to endure higher coupons. In some cases, depleted investor demand will also make new issuances altogether unfeasible.*
>
> *…Most rated developers are actually likely to increase market share by picking up*

> *assets from more-stressed peers, while the weakest face a real possibility of collapsing.*

In case there is any doubt about whether Oceanwide is among the strong or the weak developers, here is the 2-year price chart of Oceanwide Holdings relative to the 5 major Chinese property developers (Oceanwide is the one at the bottom with -44.23% performance over the period):


Following those findings, we reviewed the bond maturity schedule from parent China Oceanwide's 2017 audit ( pg. 93). We learn two key takeaways from an analysis of this data set:

- The conglomerate has relied on short-term debt to fuel its expansion. The duration of Oceanwide's $7.5 billion in bonds is only ~3.6 years.
- The Genworth deal's targeted closing (Q4 of this year) comes right *before* a slew of $1.6 billion in bonds come due in Q1 '19.

In addition to the scheduled Q1 '19 bond maturities, Oceanwide has recently rolled debt by issuing new short-term obligations. The S&P release noted that Oceanwide repaid offshore senior notes and domestic corporate bonds this year by obtaining an RMB 11.6 billion (US$ 1.6 billion) one-year loan facility and by seeking support from parent China Oceanwide.

The upcoming Q1 '19 bond payments look to present a daunting hurdle given the conglomerate's recent struggles to juggle multiple debt repayments and other financial commitments. The conglomerate faces about $3 billion in new bond maturities for '19, not counting any additional debt rollovers or short-term liabilities that may have been pushed-off from this year.

# *Conclusion: This Ocean is Running Dry*

Oceanwide will need funds to support (i) its working capital balance (which includes at least

$16.2 billion in questionable "development costs" and related-party receivables); (ii) billions in construction projects that are currently in various stages of development and pre-development; (iii) its looming multi-billion bond payments; and (iv) the $2.7 billion proposed Genworth acquisition. This is all in the face of negative historical operating cash flow and tightening credit markets.

After all this, will Oceanwide be able to make good on its promises to contribute $1.5 billion to Genworth "over time following consummation of the merger"? In our view, that is the key question underpinning this proposed transaction. We think the answer is a clear 'no'.

We hope the regulators take the signs of financial distress at Oceanwide into consideration as they weigh the decision for Genworth's policyholders. We reiterate our view that this deal looks to be starkly at odds with the best interests of policyholders.

**Disclosure:** I am/we are short GNW.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

of Aphria's total net assets.

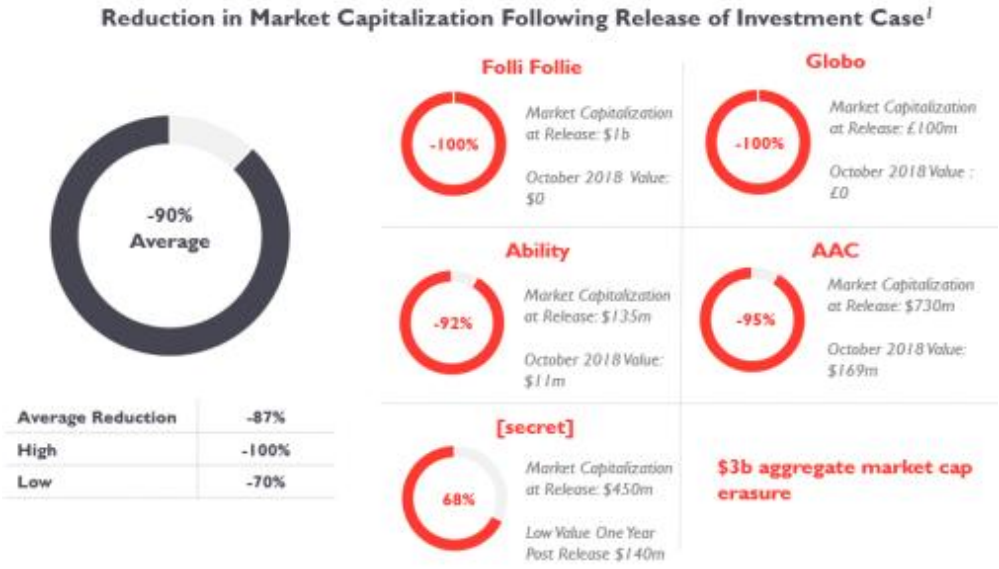
- Aphria consistently generates negative cash, and its cannabis seems to be of low quality. Interviews with sources describe facilities infested with bugs, stricken with mold, and having failed audit inspections.
- Because Aphria generates a minimum amount of sales relative to its market cap, we believe that the uncovering of this alleged scheme, coupled with a massive asset write-off, would have catastrophic consequences for its share price.

# *Background*

Any time an exciting new industry draws widespread attention it also draws retail capital, which in turn can draw unscrupulous actors. This is not a story about the cannabis industry and its commercial potential, nor is it a story about valuations and competitive marketplace dynamics. This is simply about one of the larger companies in the industry that appears to have diverted a tremendous amount of money toward the private interests of its insiders at the direct expense of its public shareholders. In terms of medical cannabis, most cannabis-based businesses try their best to cater to the medical cannabis patients whether to fulfill marijuana cannabis prescriptions or to provide cannabis medical cards similar to those from the United States – see how to get a medical marijuana card in texas to learn more.

# *Background on Co-Author Quintessential Capital Management (QCM)*

We are proud to bring you this report in conjunction with QCM. QCM has an unparalleled track record in identifying and exposing corporate malfeasance through deep investigative due diligence.




QCM's last report was published in May of this year, and focused on Greek retailer Folli Follie. The report alleged widescale inflation of revenue. Following publication, FF's stock dropped 60% in two days and was suspended two weeks later. In July 2018, the company filed for protection from creditors through the Greek bankruptcy code. Management is now facing criminal charges and shares have not resumed trading.

Preceding Folli Follie, QCM published a report on Globo PLC, a provider of enterprise mobility management software and services. Globo's stock was suspended in less than 12 hours, and management confessed to accounting fraud within 48 hours of publication. Globo never re-opened for trading and was declared worthless by the liquidator.

# *Background: Aphria's Nuuvera Scandal*

Earlier this year, Aphria came under scrutiny after we exposed undisclosed insider self-dealing relating to the company's $425 million acquisition of Nuuvera.

Seeking Alpha Portfolio People News Analysis

**Could Rampant Red Flags Drown Aphria's Proposed Nuuvera Acquisition?**

Mar. 21, 2018 10:00 AM ET | 49 comments | 7 Likes | About: Aphria Inc. (APHA), NUUVF

This article is exclusive for subscribers.

Hindenburg Investment Research
Activist investor, value, long/short equity
Hindenburg Research

**Summary**

- We see multiple red flags with Aphria's proposed purchase of Nuuvera, a company that was incorporated in January '17 and had revenue of only ~$30k from inception to September '17.
- The self-described "architect" of the Aphria/Nuuvera deal, Andy DeFrancesco, has a questionable history, including close links to controversial financiers such as Barry Honig.
- Despite being a supposed Aphria advisor, a document dated less than a week prior to Nuuvera's creation shows DeFrancesco took a loan from Nuuvera's Chairman & largest shareholder.

We had written that Nuuvera appeared to be a worthless artifice designed to enrich insiders at the expense of Aphria's investors. The company later admitted that its executives and directors had undisclosed stakes in Nuuvera prior to Aphria's acquisition, along with a key deal partner named Andy DeFrancesco.

THE GLOBE AND MAIL REPORT ON BUSINESS SUBSCRIBE

**Aphria insiders held shares in takeover target, didn't disclose**

The company traded lower by about 30% in the weeks following the exposé and the subsequent admission. Following the episode, the company responded by reassuring investors that the newly acquired international assets were of great value. They further attempted to assuage investor concerns by adding compliance personnel and announcing governance reforms relating to its investment policies. The stock has largely recovered since that point and had even reached new highs in September.

## *Introduction: They're at It Again—The LatAm*

# *Transactions*

Despite the announced governance reforms, our research shows that Aphria's insiders have doubled down on their questionable investments:

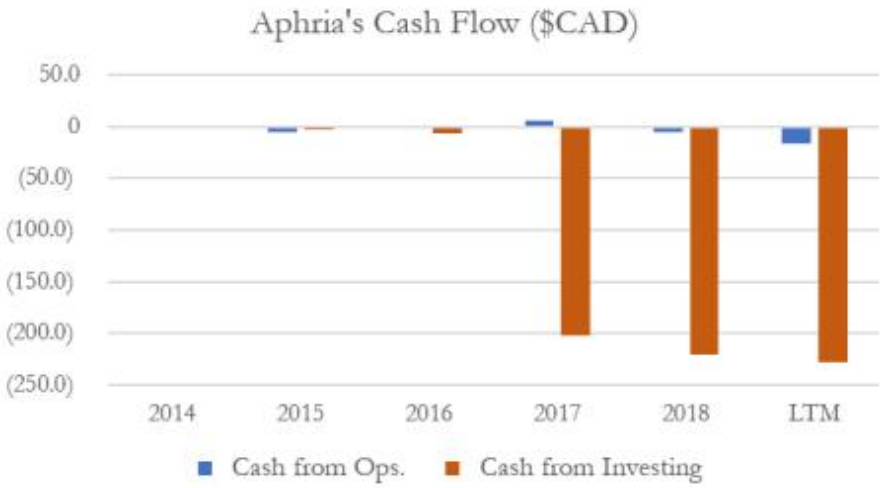
**Aphria recently spent over C 280 million on nearly worthless Latin American acquisitions that appear to have clear signs of insider self-dealing.**

We performed extensive on-the-ground due diligence in Jamaica, Colombia, and Argentina and will present evidence that the newly acquired asset values appear to be vastly inflated or outright fabrications.

We will also present documents showing that the same Aphria advisor who had described himself as the "architect" of the Nuuvera deal, Andy DeFrancesco, was an undisclosed backer of this latest slew of deals. DeFrancesco effected the transactions in conjunction with Aphria Chairman/CEO Vic Neufeld, who also served as Chairman of Scythian Biosciences (recently renamed Sol Global Investments), another company integral to the execution of these 'LatAm' deals.

All told, the effect has been massive. We estimate that at least 50% of Aphria's C$1.46 billion in net assets have been diverted to 'investments' that are, at best, grossly inflated. Our breakdown of these balance sheet assets is as follows:

- C$524 million in goodwill which we believe is entirely worthless;
- C$246 million in intangibles, which includes licenses, permits, and "brands" acquired from these dealings, that we estimate are inflated by 80% ; and
- C$86 million in equity investees and long-term investments which we believe are the product of related-party deals and are significantly impaired.




*(Source: Cap IQ)*

Following a review of the LatAm deals, we will then explore the background of Andy DeFrancesco, including his run-in with Canadian regulators and his close business ties to individuals that the SEC has alleged to have engaged in *multiple* pump and dump schemes, including Bobby Genovese, Barry Honig, John O'Rourke, and John Stetson.

*(Andy DeFrancesco. Source: DeFrancesco's Instagram Account)*

Finally, we will review Aphria's cannabis business. While the company declares itself to be

"setting the standard" for low-cost production, in reality it appears to be setting the standard for low-quality production. We share the content of an interview with a former worker who detailed failed audits with Health Canada, a circus-like environment, and a facility that has had repeated issues with mold and is "infested with bugs". We also share the content of our interviews with industry experts, all of whom corroborated the low-quality nature of the product.

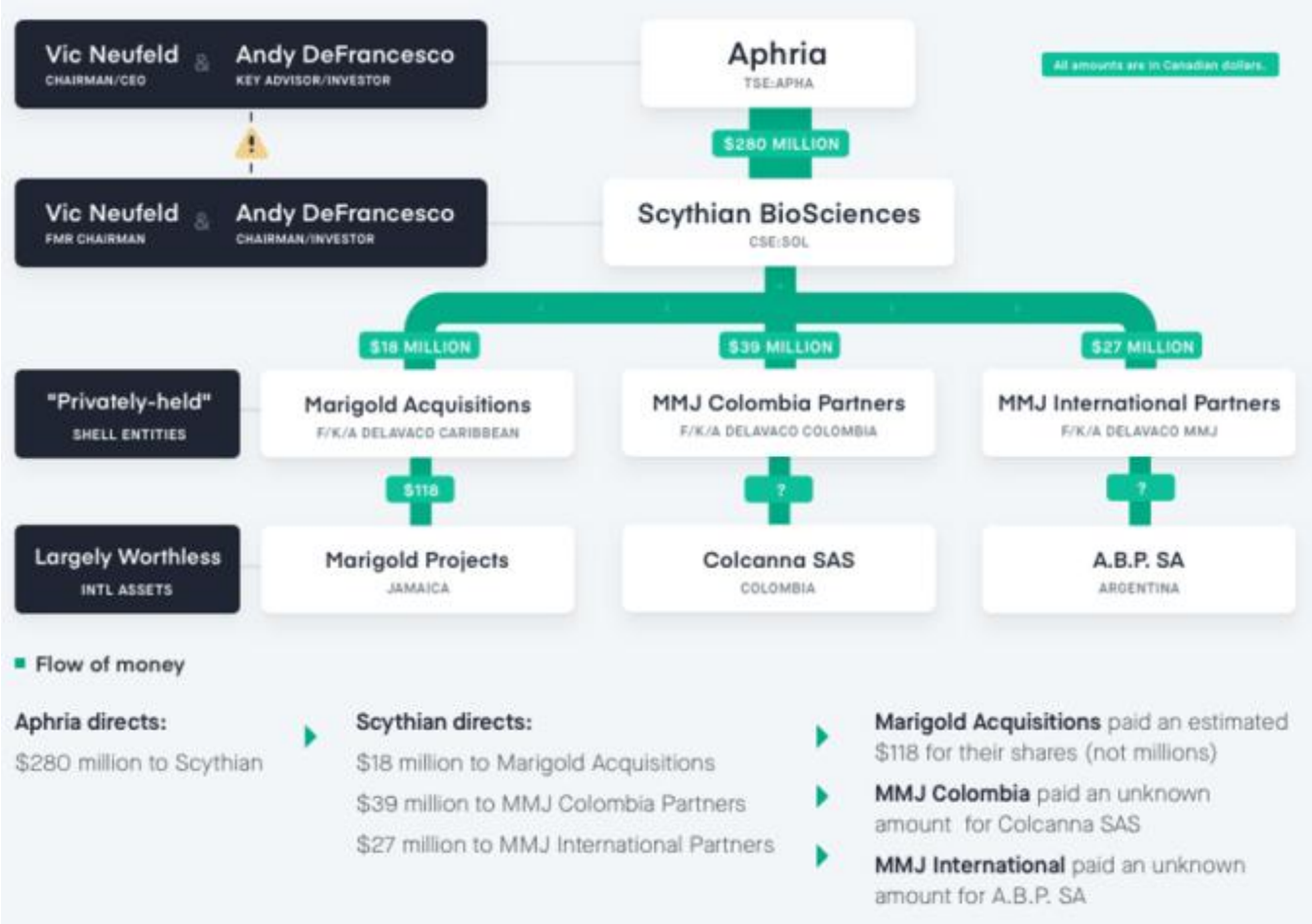
With glaring red flags relating to its investment activities, strongly negative historical cash flow, and a low-quality cannabis product, **we think Aphria's stock is going to get smoked**

# *Part I: The Unusual Structure of Aphria's 'Acquisitions'*

We believe Aphria has diverted shareholder assets to insiders through a systematic process:

1. Aphria insider Andy DeFrancesco sets up or acquires an international company, providing a token justification for an acquisition (e.g., conditional cannabis licenses, a leased facility, purchasing a small existing local business.)
2. The international company is then purchased by a Canadian shell company under the control of DeFrancesco through his closely held private equity firm, the Delavaco Group.
3. The shell company agrees to be acquired by Aphria's 'sister' company, Scythian Biosciences, where Vic Neufeld, Aphria's Chairman/CEO, and DeFrancesco hold key insider roles.
4. Scythian then sells its stake in the entity to Aphria at a large markup.
5. As a result, DeFrancesco and unnamed associates get cash and/or Scythian shares, Scythian gets cash and/or Aphria shares, and Aphria's shareholders get international assets that are essentially worthless.

See below for how this process has played out with Aphria's recent LatAm investments:




*(Sources: Scythian/Aphria filings & press releases, Canadian corporate records, and on-the-ground research)*

# *Undisclosed Insider Self-Dealing?*

The architect of these deals, as we will show, appears to be Aphria/Scythian insider Andy DeFrancesco. DeFrancesco was integral to the formation of both Aphria and Scythian, serving as a founding investor and orchestrating the reverse-mergers that took both companies public. He has served as advisor to all of Aphria's bought deal financings, and currently serves as the Chairman and Chief Investment Officer of Scythian. In fact, earlier this year Scythian even operated out of the same office and suite number of DeFrancesco's personal private equity firm, the Delavaco Group.

Our first major indication that something is amiss came through the following revelation: Canadian corporate records show that the entities acquired in the LatAm deal were *all* previously named after DeFrancesco's personal private equity firm, the Delavaco Group:

| Asset Location | Acquired Entity Name | revious Entity Name |
|---|---|---|

| | | |
|---|---|---|
| Jamaica | Marigold Acquisitions | Delavaco Caribbean Ventures |
| Colombia | MMJ Colombia Partners | Delavaco Colombia Partners |
| Argentina | MMJ International Investments | Delavaco MMJ International |

It appears that efforts were made to conceal the relationship to Delavaco. The names to all of these entities were changed prior to the acquisition announcements, ensuring that the "Delavaco" name didn't show up in any of the deal-related press releases. For example, Canadian corporate records show that the name of the entity holding purported Jamaican assets was changed *two days* prior to Scythian's letter of intent to acquire it.

In short, money has been flowing from retail investors to Aphria, which has then used the capital to buy "assets" from entities associated with insiders.

So, let's take a look at some of the assets.

# *Aphria's C$145 Million Jamaican Acquisition: Marigold Projects*

In March 2018, Scythian signed a letter of intent to acquire Marigold Acquisitions Inc., which was described as "a privately-held British Columbia corporation." (pg. 24) At the time, Marigold Acquisitions was in the process of purchasing a 49% stake in Jamaican company Marigold Projects. In other words, the entity didn't even own the Jamaican asset yet.

Four months later (in July), Scythian then announced the sale of the Marigold letter of intent along with their other LatAm "assets" to Aphria. Scythian completed its purchase in mid-September and subsequently closed the sale to Aphria 2 weeks later.

Ultimately, Aphria paid an estimated C$145 million for the Marigold stake, netting Scythian a C$127 million gain for an asset it only actually *owned* for about 2 weeks. (pg. 96).[1]

Meanwhile, unnamed Marigold investors in the "privately-held" shell entity were paid C$18 million. We will present evidence that those investors include Aphria/Scythian insider DeFrancesco along with unnamed associates.

# *On the Ground in Jamaica: Marigold's Official Registered Office is an Abandoned Building*

So, what exactly did Aphria buy? We visited Jamaica to find out. According to Marigold's latest filings, the company's official registered office is 28 Lancaster Road in Kingston St. Andrew:

THE COMPANIES ACT
ANNUAL RETURN FOR COMPANIES WITH SHARES
(Pursuant to sections 121, 122 & 124 of the Companies Act 2004)

COMPLETE THIS FORM IN BLOCK CAPITALS ONLY WITHIN THE PRESCRIBED FIELDS. PUT "N/A" IN FIELDS THAT DO NOT APPLY.

1A. NAME OF COMPANY
MARIGOLD PROJECTS JAMAICA LIMITED

The name here must be consistent with the name stated on its Certificate of Incorporation or most recent Change of Name Certificate applicable to the period of the Annual Return.

1B. TYPE OF COMPANY ☑ Private ☐ Public
1C. COMPANY REGISTRATION NUMBER 92290
1D. COMPANY TAXPAYER REGISTRATION NUMBER 002-186-080
1E. COMPANY TELEPHONE NUMBER N/A
1F. EMAIL ADDRESS N/A

2. PERIOD FOR WHICH ANNUAL RETURN IS MADE UP

| | Day | Month | Year |
|---|---|---|---|
| (i) START | 20 | JULY | 2017 |
| (ii) END | 21 | JULY | 2018 |

3. LOCATION OF REGISTERED OFFICE

| | |
|---|---|
| Street or District | 28 LANCASTER ROAD |
| Town | KINGSTON 10 |
| Post Office | HALF WAY TREE P.O |
| Parish | ST ANDREW |

3A. MAILING ADDRESS (if different from the registered office address)

| | |
|---|---|
| Street or District | SAME AS ABOVE |

When Aphria closed on its Latin American acquisitions it declared them to be "world class assets." We visited the official registered office during working hours in late September and found it to be a world class dump. Here we are at Lancaster road:


And here we are at 28 Lancaster. Much like Aphria's acquisitions, from the outside it almost looked passable:


But from the inside it became obvious that the building had been abandoned for years:

Busted doors and ceilings. Holes in the wall. Yellowed newspaper on the floor. Dirt everywhere. Not exactly the cutting-edge operation we'd expect.

Marigold's much-touted managing director, Lloyd Tomlinson, lists the same abandoned property as his personal address:

5. THE DIRECTORS OF THIS COMPANY AS OF THE 20th DAY OF MARCH 2017 ARE:

| NAME (S) | RESIDENTIAL ADDRESS | OCCUPATION | CONTACT # |
|---|---|---|---|
| LLOYD TOMLINSON | 28 LANCASTER ROAD. KINGSTON 10 | BUSINESS MANAGER | 876-877-9898 |

Following our visit, we checked Jamaican real estate records and learned that neither Tomlinson nor Marigold even own the abandoned property anymore. Tomlinson used to be the owner but it was sold off by the mortgage lender in January:

REGISTER BOOK
VOLUME 1285 FOLIO 268

ORIGINAL
NOT TO BE REMOVED FROM TITLES OFFICE
DO NOT FOLD

JAMAICA

*Certificate of Title under the Registration of Titles Act*

Misc. 893222

FAY WINT of 10 Oleander Avenue, Oakland Apartments 112-114 1/2 Constant Spring Road, Kingston 8 in the parish of Saint Andrew, Interior Decorator is now the proprietor of an estate in fee simple subject to the incumbrances notified hereunder in ALL THAT parcel of land known as NUMBER TWENTY-EIGHT LANCASTER ROAD part of EASTWOOD PARK in the parish of SAINT ANDREW being the Lot numbered TEN BLOCK "G" on the plan of Eastwood Park aforesaid deposited in the Office of Titles on the 7th day of June, 1945 of the shape and dimensions and butting as appears by the said plan and being the land comprised in Certificate of Title formerly registered at Volume 461 Folio 77.

OFFICE OF TITLES JAMAICA

for Registrar of Titles

Transfer No. 2101045 registered on the 4th day of January, 2018 all the estate and interest of LLOYD FRASER TOMLINSON on the 4th day of October, 2004 to JAMAICA MUSIC SOCIETY at 7 Stanton Terrace, Kingston 6, Saint Andrew. Consideration money Twenty Five Million Dollars. Power of Sale under Mortgage No 1318680

Despite this, Marigold and Tomlinson's recent filings still listed the abandoned property as their current address.

# *On the Ground in Jamaica: Marigold Claims to Have 3 Other Leases*

Aside from the abandoned building, Marigold claims to have 3 leases in Jamaica (pg. 17):

security bond. Marigold currently leases its cultivation premises located at Volume 1388 Folio 682, Lot 6, Bernard Lodge, Block A, Spanish Town P.O., in the parish of Saint Catherine and plans to construct state of the art greenhouses for commercial growing and a 36,000 square foot research centre on the premises. It is estimated that the proposed facilities could employ up to 200 people over a two-year period.

Marigold also has two other leases: a lease for office space at Suite #6, 22 Trafalgar Road, Kingston 10, and a lease for an herb house of approximately 800 square feet at Unit #51, Pulse Center, 38a Trafalgar Road, Kingston 10.

We visited Marigold's other properties as well, or at least the ones we could confirm actually exist.

# *On the Ground in Jamaica: Marigold Claims to*

# *Lease "Unit 51" of a Building Complex That Only Goes up to Unit 50*

Marigold claims to lease an 800 sq/m herb house in collaboration with the Peter Tosh Museum located at "Unit 51, Pulse Center, 38a Trafalgar Road, Kingston" (pg. 17). The company claims to have leased the facility as of April. (pg. 57) We visited the location in October:


We spoke with the landlord during our site visit. He informed us that the units only go up to 50. In other words, **Marigold's Unit 1" didn't exist**

We then called the museum later in the month. They couldn't provide us with contact information for Marigold, saying "they haven't actually opened as yet."

# *On The Ground in Jamaica: "Jamaica's Leading Medical Cannabis Company"… Has a Paper Sign On The Door of its Empty Office?*

Marigold also reportedly leased space in "Suite 6" in an office building in Kingston Jamaica (pg. 17). The lease for the office was signed in April (pg. 57). Our investigator visited the site in October during business hours on multiple occasions and found that while the lights were on, nobody was home. He spoke with the neighboring business which said they had rarely seen anyone enter or leave the office. Here is the picture of the locked, empty suite:

Why does this "world class asset" have a paper sign on its office door 6 months into its lease? (Someone may also want to stop by from time to time to water that dehydrated office plant):


Here was the company's paper signage on the entrance to the building as well:

The company's other purported lease is for cultivation facilities on a plot of land in Saint Catherine parish. According to the company, this land is intended to eventually support greenhouses and a state-of-the-art research facility. After much searching, our researcher was unable to find the site. We were therefore unable to confirm its existence.

## *On the Ground in Jamaica: Marigold's Team of "Cutting-Edge" Scientists*

When Scythian signed the letter of intent to acquire a stake in Marigold in March 2018, one of the justifications for the transaction was Marigold's strong scientific team:

> *"Marigold's leadership in the cutting-edge science of cannabis cultivation and precision dosing brings added depth and prestige to an already strong team."*

## *Marigold's Medical Doctor Director Denies Ever Serving on Any Board, Let Alone Marigold's*

We reviewed Jamaican corporate records to see who was on Marigold's team of top scientists. One of the original founding directors of Marigold's team was Dr. Janice Simmonds-Fisher, one of two scientists associated with the company:

6B. NAMES OF FIRST DIRECTORS

| NAME (S) | RESIDENTIAL ADDRESS | OCCUPATION | CONTACT # |
|---|---|---|---|
| LLOYD TOMLINSON | 28 LANCASTER ROAD KINGSTON 10 JAMAICA | BUSINESS MANAGER | |
| LABAN ROOMES | 178 ALBANY PARK AVENUE LONDON ENGLAND EN3 5NZ | ENTREPRENEUR | |
| RAY ANTHONY CHIN | 7 NORBROOK CRESENT KINGSTON 8 JAMAICA | GENETIC ENGINEER | |
| DR. JANICE SIMMONDS-FISHER | 28 PAWSEY PLACE NEW KINGSTON KINGSTON 5 JAMAICA | MEDICAL DOCTOR | |
| DELROY BARRETT | 2 WORTHINGTON TERRACE KINGSTON 5 JAMAICA | BUSINESSMAN | |

Dr. Fisher is a doctor based in Jamaica (and is a very nice lady). We visited her office and spoke with her. She denied ever having held any directorship positions at *any* company, let alone Marigold. In fact, she later signed a document attesting to this:

SIGNATURE | DATE

PLEASE ENCLOSE A SCANNED COPY OF YOUR PASSPORT OR DRIVER'S LICENSE

**SUBSCRIBER**

DR. JANICE FISHER SIMMONDS

PRINT NAME

SIGNATURE

28 ~~[illegible]~~ PAWSEY PLACE NEW KINGSTON

ADDRESS

KINGSTON 5 JAMAICA

ADDRESS

[redacted] MEDICAL DOCTOR

OCCUPATION

[redacted]

NUMBER OF SHARES TAKEN 500

**CORPORATE AFFILIATIONS**

HAVE YOU EVER SERVED ON A CORPORATE BOARD? ☑ No ☐ Yes

ARE YOU AFFILIATED WITH ANY OTHER COMPANY? ☐ No ☑ Yes

If so, answered yes please specify:

Name of the Company(ies): Jamaica Stock Exchange (JSE): Best Practices Committe

*(Note: Dr. Fisher's personal information has been blurred)*

# *Marigold's Genetic Engineer. A Total Unknown*

Marigold's other director-scientist was an individual named Ray Anthony Chin, who was listed as Marigold's "Genetic Engineer":

6B. NAMES OF FIRST DIRECTORS

| NAME (S) | RESIDENTIAL ADDRESS | OCCUPATION | CONTACT # |
|---|---|---|---|
| LLOYD TOMLINSON | 28 LANCASTER ROAD KINGSTON 10 JAMAICA | BUSINESS MANAGER | |
| LABAN ROOMES | 176 ALBANY PARK AVENUE LONDON ENGLAND EN3 5NZ | ENTREPRENEUR | |
| RAY ANTHONY CHIN | 7 NORBROOK CRESENT KINGSTON 8 JAMAICA | GENETIC ENGINEER | |
| DR. JANICE SIMMONDS-FISHER | 28 PAWSEY PLACE NEW KINGSTON KINGSTON 5 JAMAICA | MEDICAL DOCTOR | |
| DELROY BARRETT | 2 WORTHINGTON TERRACE KINGSTON 5 JAMAICA | BUSINESSMAN | |

We visited Mr. Chin's address at 7 Norbrook Crescent:

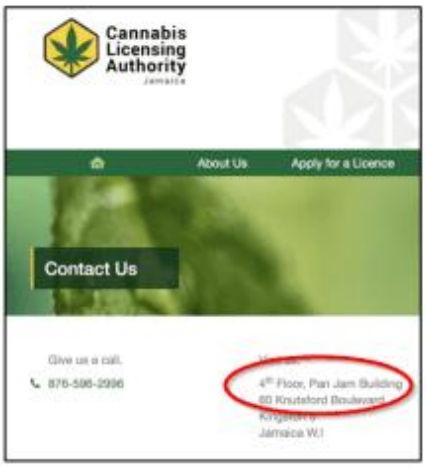
The tenant said no one by that name lives there and they had never heard of anyone by that name.

We searched extensively for signs of a top (or any) genetic engineer by the name of Ray Anthony Chin through scientific journals, ResearchGate, web sources, social media, etc. We came up completely empty handed. How has Mr. Chin managed to become a top scientist without leaving a trace of his accomplishments?

## *On the Ground in Jamaica: The Much-Touted Reason for the Deal—A Local Cannabis R&D License—Costs Only $500 to Acquire*

At the time of the deal announcement, much was also made of the fact that Marigold had been issued one of three original permits in Jamaica for the R&D of cannabis products.

We met with the Jamaican Cannabis Licensing Authority (CLA) and learned that by the time the Marigold deal had closed in September, the CLA had approved at least 22 full licenses and over 80 conditional licenses.





We asked about the process for attaining a license. It requires about $500, some paperwork, and a wait time of less than 6 months. That was basically it.

## *Jamaica: But Wait… Marigold Isn't Even Fully Licensed!*

Shortly after our visit, Jamaican media reported on Marigold's deal with Aphria. Per the article, Marigold Managing Director Lloyd Tomlinson said that Marigold plans to set up 5 herb houses across Jamaica, "the first of which will open at the Pulse Centre." In other words, none are open.

Furthermore, Tomlinson said that he would reserve full comment about the retail ganja venture:

> ***until all his licenses are issued by the Cannabis Licensing Authority."***

The article continued…

> *"…Marigold already has **conditional** approval for several licenses."*
>
> *"…The operation will be fed by a 20-acre farm at Bernard Lodge but could potentially source raw material from a farm operated as a separate business by the Tomlinson family within the Blue Mountains. **That farm awaits approval to grow marijuana."***

So, rather than being licensed to operate, Marigold is waiting for its conditional licenses to be approved.

## *Jamaica/Marigold: To Recap So Far…*

- The official office is an abandoned property that was sold off by the lender almost a year ago.
- The company claimed to lease a "Unit 51" that didn't exist.
- One of the company's founding directors denies ever being a company director.
- The other mystery scientist has no clear web presence.
- The company's plot of raw land is not approved to grow cannabis.
- The company has *conditional* licenses and is awaiting full approval.

All this…for C$145 million? So, what is going on?

## *Jamaica: Marigold Stakes Were Originally Bought for US $118 in Total. Who Were These Lucky Shareholders?*

The undisclosed Aphria/Scythian deal partners who purchased their stakes in Marigold didn't seem to think the asset was worth C$145 million.

Jamaican Corporate records show that two Canadians associated with multiple DeFrancesco-backed deals had purchased their shares of the Jamaican entity for about US $118 (*not* millions) for shares that were flipped to Scythian mere months later for C$18 million (and ultimately flipped to Aphria for C$145 million.)

The two individuals named in Jamaican corporate records were Marvin Igelman and Clifford Starke.

**Marvin Igelman's** relationship with Aphria/Scythian insider DeFrancesco spans more than a decade, having worked together at brokerage firm Standard Securities Capital Corporation (SSCC) where DeFrancesco had served as the Managing Partner:

enant Not to Solicit . Consultant hereby covenants and agrees that during the Term and for
o (2) years from the expiration or termination of the Term, Consultant shall not, either direc
whether with or through any person, firm, partnership, corporation or other entity or ventu
; or hereafter created, solicit or employ, or attempt to solicit or employ, any person who is o
hin the preceding twelve (12) months an officer, director, partner, manager, agent employee
f the Company in a manner which would interfere with their services provided to the Comp
**licitation Covenant"** ). Nothing in this paragraph shall apply to any business dealings with
, Gene Simmons, Marvin Igelman, Andy DeFrancesco and/or Standard Securities Capital
and its affiliates.

Since then, Igelman has played an active role in DeFrancesco-backed deals including serving as:

- Vice Chairman of Delavaco-backed Breaking Data Corp/Sprylogics,
- Director of Delavaco-backed Jamba Juice, and
- Director of Delavaco-backed American Apparel.

**Clifford Starke** has been described as "an early stage investor and financier of Nuuvera Corp" prior to its takeover by Aphria. As noted in our earlier piece, we think Nuuvera was just as worthless as Aphria's other acquisitions. The deal had undisclosed conflicts of interest, including ownership by DeFrancesco along with Aphria Chairman/CEO Vic Neufeld, Aphria's CFO, and multiple Aphria directors.

# *Jamaica: The Cheap Shares Were Owned by an Entity Formerly Named After Aphria/Scythian Insider Andy DeFrancesco's Firm*

The shares were later transferred to an opaque, newly-formed Bermudan entity. That entity, in turn, was owned by the Canadian shell entity that was formerly named " Delavaco Caribbean Ventures ". Recall that Delavaco is the name of the personal private equity firm of Aphria/Scythian insider Andy DeFrancesco.

Following the name change, Scythian announced its letter of intent to acquire the entity. The name change took place *only 2 days* before Scythian signed its letter of intent to acquire the entity on March 21st. Canadian corporate records captured the originals, however:

BC Registry Services

Mailing Address:
PO Box 9431 Stn Prov Govt
Victoria BC V8W 9V3
www.corporateonline.gov.bc.ca

Location:
2nd Floor - 940 Blanshard Street
Victoria BC
1 877 526-1526

**BC Company Summary**
For
**MARIGOLD ACQUISITIONS INC.**

| | |
|---|---|
| **Date and Time of Search:** | **April 02, 2018 06:15 AM Pacific Time** |
| **Currency Date:** | February 28, 2018 |

**ACTIVE**

| | | | |
|---|---|---|---|
| **Incorporation Number:** | BC1148380 | | |
| **Name of Company:** | MARIGOLD ACQUISITIONS INC. | | |
| **Recognition Date and Time:** | Incorporated on January 09, 2018 10:53 AM Pacific Time | **In Liquidation:** | No |
| **Last Annual Report Filed:** | Not Available | **Receiver:** | No |

**COMPANY NAME INFORMATION**

| Previous Company Name | Date of Company Name Change |
|---|---|
| DELAVACO CARIBBEAN VENTURES INC. | March 19, 2018 |
| DELAVACO VENTURES INC. | January 10, 2018 |

Then 2 days later on March 21st:

SCYTHIAN
BIOSCIENCES CORP.

TORONTO, March 22, 2018 (GLOBE NEWSWIRE) -- Scythian Biosciences Corp. (the "**Company**" or "**Scythian**") (TSXV:SCYB) (Frankfurt:9SB) (OTC Pink:SCCYF) is pleased to announce that it has entered into a binding letter of intent dated March 21, 2018 ("Letter of Intent") to acquire Marigold Acquisitions Inc. (the "**Acquisition**"). The Acquisition will result in Scythian becoming a major stakeholder of Marigold Projects Jamaica Ltd. ("**Marigold**"), a Jamaican company, which has received conditional licenses to cultivate, process, sell and provide therapeutic or spa services utilizing cannabis products. In consideration, Scythian will issue 1,500,000 common shares at the current price per share of $23.00 to the selling parties. Following completion of the Acquisition, the Company will own a 49% interest in Marigold as well as a 95% royalty interest in the net revenues from products sold by Marigold.

Keep in mind that in addition to DeFrancesco's role, Aphria Chairman/CEO Vic Neufeld was also the Chairman of Scythian at the time of the announced Marigold deal. This is the same Vic Neufeld who oversaw Aphria's acquisition just months later, ultimately paying C$145 million of Aphria shareholder money for the Jamaican entity.

The shareholders of the private shell entity in turn were paid $18 million, which looks to have been almost pure profit.

## *Aphria's C$50 Million Argentine Acquisition: A.B.P. SA*

On March 11, 2018, Scythian signed a letter of intent to acquire MMJ International, which was later described as "a privately-held British Columbia company" (pg. 24). MMJ International had an agreement to purchase an Argentine company called ABP, a "pharmaceutical import and distribution company".

Four months after Scythian's letter of intent to acquire the Argentine assets, Scythian then announced the sale to Aphria of the ABP letter of intent along with other LatAm "assets".

Scythian closed its purchase in late September and subsequently closed the sale to Aphria 6 days later.

Ultimately, Aphria paid roughly C$50 million for the ABP stake, netting Scythian a quick C$23 million gain for an asset it only actually *owned* for **6 days**. (pg. 3).[2]

Meanwhile, investors in the private shell entity were paid C$27 million for their stake in MMJ. We will show evidence that those investors include Aphria/Scythian insider DeFrancesco, along with unnamed associates.

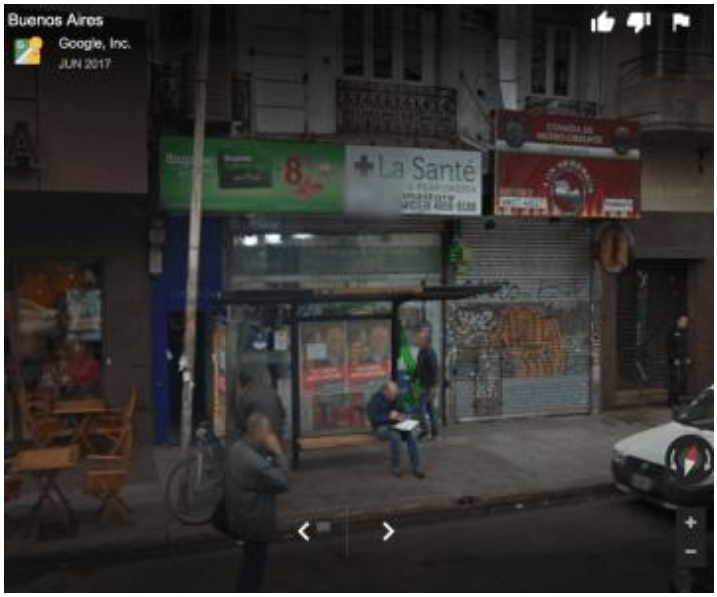
## *On the Ground in Argentina: ABP's "Strong" Retail Platform Consists of Exactly One Small Pharmacy*

The company has touted that "ABP has had a strong platform from its distribution and retail business to build on."

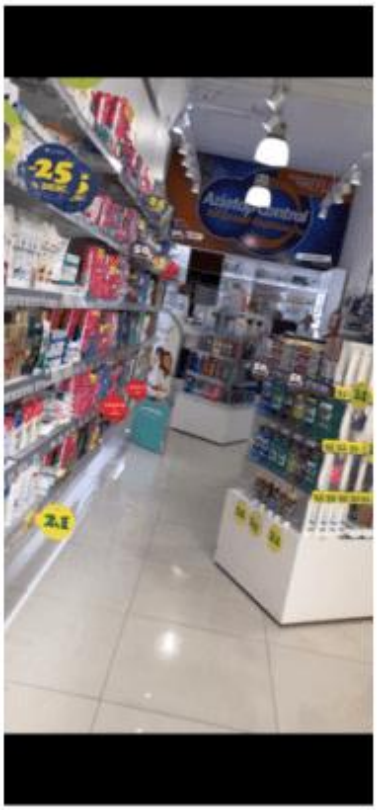
Per Aphria's transaction documents we see that ABP had 2 facilities in total (pg. 74):

> *"ABP operates **two facilities** located in the City of Buenos Aires – **a pharmacy** that operates under the trade name Farmacia & Perfumeria **and a wholesale drugs distribution centre**, which also serves as a secondary warehouse for Farmacia & Perfumeria."*

Thus the "strong" retail platform consisted of exactly one pharmacy. Here is a picture of the outside of the pharmacy, courtesy of Google Maps:




We visited the site. It is located in a rundown section of Buenos Aires and is smaller than a conventional CVS or Rite-Aid. Here are pictures from the inside and a receipt confirming ABP's name on our purchase:



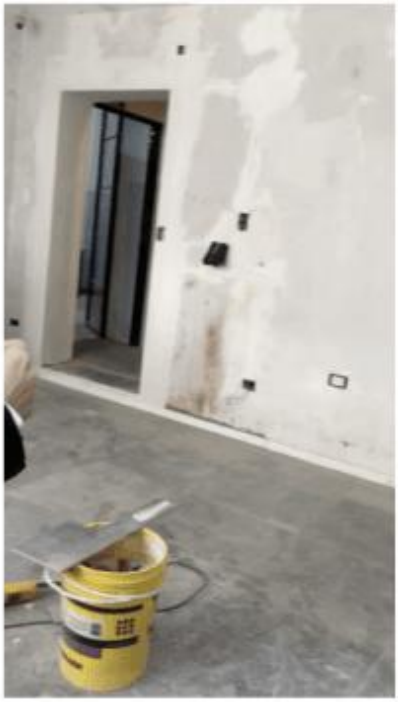

# *On The Ground in Argentina: A "Leading Importer and Distributor of*

# *Pharmaceuticals"… With an Empty, Dilapidated Office*

At the time of the deal announcement, Vic Neufeld was Chairman/CEO of Aphria and the Chairman of Scythian. He called ABP "one of the nation's leading importers and distributors of pharmaceuticals."

We visited ABP's "wholesale drugs distribution centre". The area was largely dilapidated and residential. Here is a picture of the entrance from Google Maps alongside a picture from our visit:


On the inside, we saw almost no signs of existing operations, aside from one lone desk and some stacked boxes in what looked like an unfinished, empty warehouse:



# *ABP: Virtually No Digital Presence and a Handful of Employees*

As part of our research on ABP, we called the company, visited its offices, and scoured the web for any signs of a business presence. We saw virtually no digital signs of life and found very few employees.

Oddly, ABP's Facebook page shows that its first post was in August, five months *after* the deal with Scythian was announced. The page had 7 likes as of this writing.

All told, we were only able to locate 3 actual employees of ABP, excluding retail staff. Two of them were college students:

1. The manager, Gonzalo Arnao, looks to have actual laboratory experience, according to his Linkedin profile.
2. The second identified employee reports on his LinkedIn that his main occupation is a university student.
3. The third identified employee is a 20 year old who lists his occupation as soccer player/coach on his Facebook page.

# *Company Press Release: ABP Generated*

# *"Revenues in Excess of USD $11 Million in 2017"*

# *Vs.*

# *Employee Interview: Revenues Were Actually USD $430 Thousand*

In the initial press release by Aphria's `sister' company Scythian announcing the letter of intent to acquire ABP, the header of the press release boasted:

> *"ABP REVENUES IN EXCESS OF USD$11 MILLION IN 2017 AND PROFITABLE"*

The headline number struck us as odd given that the company's operations seemed to consist of one small retail pharmacy and an empty, unfinished warehouse. We checked Dun & Bradstreet which reported that annual sales at the entity were only roughly USD $212,000 which seemed more in-line:


*(Source: Dun & Bradstreet)*

We then spoke with employee 2 (from the section above) and recorded the call. When asked about ABP's annual revenues, he replied that they were about 15 million Argentine Pesos, which converts to about USD $430,000.

# *On the Ground in Argentina: ABP's Touted "Purchase Order" With a Local Hospital Was Actually a Donation*

Prior to the closing of the purchase of ABP by Aphria/Scythian, Scythian announced that a

major milestone had taken place at the would-be subsidiary:

> *"Scythian Announces ABP S.A.'s First Purchase Order with Aphria Inc.—Order to Supply World Renowned Pediatric Hospital for Research and Education"*

The purchase order was for Aphria's CBD oil which would support clinical research at Argentina's renowned Garrahan Pediatric Hospital.

"I am very proud of ABP working with the Scythian team for reaching this new milestone of a first purchase order…" gushed Scythian's CEO in the press release.

It was purported to be a major achievement—an order for a large multi-year study involving over 100 patients. The newly-formed Argentine partnership seemed to be generating new sales, lending the proposed Aphria acquisition added credibility.

**ne problem:** We spoke with representatives of the hospital and they informed us that they didn't make any purchase. It was actually a donation from the company.

The picture on the right is of our meeting with Lucas Schiaffini, a department head at the hospital.


At risk of belaboring the point, Merriam-Webster defines 'purchase' as 'to obtain by paying money or its equivalent".

While Scythian gave the impression that it had secured a major multi-year purchase contract, in reality it was Scythian making the purchase…from Aphria. The product in turn was given away for free to the ultimate consumer.

The hospital later confirmed this publicly. Per a press release put out by the hospital (translated from Spanish):

> *"The medicinal cannabis used in these trials was provided by the Aphria laboratory in Canada, which will **donate** the drug throughout the study and for all patients in which it is proven to work."*

The hospital employee said they were grateful for the donation, but he complained to us that the company's representative in Argentina kept hounding them to issue more press releases about the partnership.

# *Argentina: Undisclosed Insider Self-Dealing?*

So, who were the lucky investors in the "privately-held" shell entity that were paid C$27 million for the Argentine assets?

Canadian corporate records show that the shell entity used to be named Delavaco MMJ International but was changed prior to the public announcement of the deal:

**ACTIVE**

| | | | |
|---|---|---|---|
| **Incorporation Number:** | BC1140168 | | |
| **Name of Company:** | MMJ INTERNATIONAL INVESTMENTS INC. | | |
| **Recognition Date and Time:** | Incorporated on November 03, 2017 02:28 PM Pacific Time | **In Liquidation:** | No |
| **Last Annual Report Filed:** | Not Available | **Receiver:** | No |

**COMPANY NAME INFORMATION**

| **Previous Company Name** | **Date of Company Name Change** |
|---|---|
| DELAVACO MMJ INTERNATIONAL INC. | January 16, 2018 |

As a reminder, Delavaco is the name of Aphria insider & current Scythian Chairman Andy DeFrancesco's personal private equity firm.

If there is still any lingering doubt about what is going on here, we can turn to Andy DeFrancesco's private Instagram account. This is an Instagram post dated one week prior to Scythian's announcement to acquire the "privately-held" Argentine assets:


Yes, that is Aphria insider, Scythian insider, and current Scythian Chairman & Chief Investment Officer Andy DeFrancesco bragging about purchasing ABP's pharmacy into his own personal private equity firm one week before flipping it to Scythian for C$27 million. He even hash-tagged GreedIsGood.

We can confirm that it is the exact same pharmacy. Here is the picture from our visit of the same section of the store taken at a different angle:



## *Aphria's C$84 Million Colombian Acquisition:*

# *Colcanna SAS*

In April 2018, Scythian signed a letter of intent to acquire a Canadian entity named MMJ Colombia Partners, which was described in filings as "a privately-held Ontario company" (pg. 24). At the time of the announcement, MMJ Colombia was in the process of purchasing a 90% stake in Colombia-based Colcanna SAS. In other words, Scythian entered into a letter of intent to acquire a "privately-held" entity that didn't own anything yet.

Scythian later sold the letter of intent along with their other LatAm "assets" to Aphria. Ultimately, Aphria paid C$84 million for the stake, netting Scythian a quick C$45 million gain.

Meanwhile, the unnamed investors in "privately-held" MMJ Colombia Partners banked almost C$39 million.[3] We will show evidence that those investors include Aphria/Scythian insider Andy DeFrancesco, along with unnamed associates.

# *Colombian Corporate Documents: Zero Operating Activity and Total Assets of $16,000*

Colombian corporate records show that Colcanna was established on December 27, 2017, and was thus only months old when Scythian signed its letter of intent to buy it. The newly formed entity reported exactly zero operating activity and total assets worth about US$16,000:

INFORMACIÓN FINANCIERA

En los términos de la Ley, debe tomarse del balance de apertura o de los Estados Financieros con corte a 31 de diciembre del año anterior. Expresar las cifras en pesos colombianos. Datos sin decimales.

| ESTADO DE SITUACIÓN FINANCIERA | | | | ESTADO DE RESULTADOS | |
|---|---|---|---|---|---|
| Activo Corriente | $ 50,000,000.00 | Pasivo Corriente | $ 0.00 | Ingresos Actividad Ordinaria | 0.00 |
| Activo No Corriente | $ 0.00 | Pasivo No Corriente | $ 0.00 | Otros Ingresos | $ 0.00 |
| Activo Total | $ 50,000,000.00 | Pasivo Total | $ 0.00 | Costo de Ventas | $ 0.00 |
| | | Patrimonio Neto | $ 50,000,000.00 | Gastos Operacionales | $ 0.00 |
| | | Pasivo + Patrimonio | $ 50,000,000.00 | Otros Gastos | $ 0.00 |
| | | Balance Social (*) | $ | Gastos por Impuestos | $ 0.00 |
| | | (*) Solamente si es Entidad sin ánimo de lucro | | Utilidad / Pérdida Operacional | $ 0.00 |
| | | | | Resultado del Periodo | 0.00 |

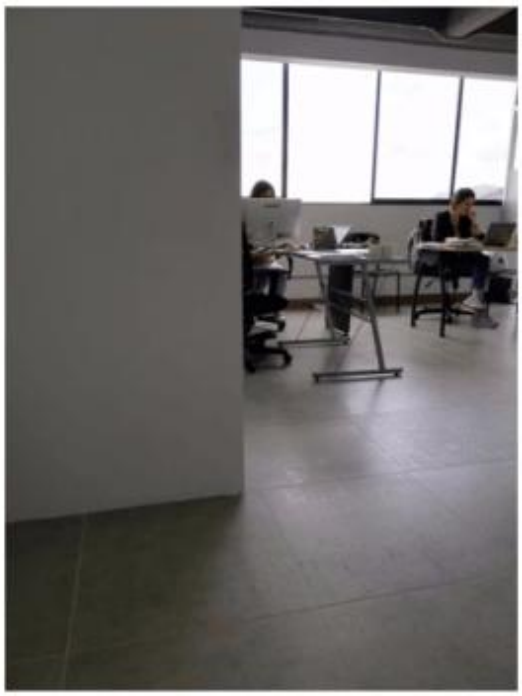
5

US$ 16K

# *On the Ground in Colombia: An Actual Office! But Not Much Else*

Colcanna has an office and some property in Colombia. Here are pictures from our

investigator's visit in mid-November. He said there were approximately 5 people working there:



As far as development of the property goes, it does not appear that much is going on, however. The Colcanna website features a *pilot* greenhouse:


The other pictures from the website are rather underwhelming:

# *Colombia: On Colcanna's Much-Touted Cannabis Licenses—It Was One of About 73 Licensed Entities at Time of Deal Closing*

Much was made of Colcanna being the first entity to receive cannabis licenses in the particular region of Colombia where it is located:

> *"Colcanna is the first company in the coffee zone of Colombia with cultivation and manufacturing licenses for the production of medical extracts of cannabis"*

Despite being first to receive those licenses in the coffee zone, by late September 2018, near the time of the Aphria deal-closing, Colombia had issued licenses to 73 different Colombian entities.

---

Relatedly, an industry expert informed us that while Aphria was touting its coffee region licenses, other operators were avoiding the region due to its climate and conditions. The expert explained to us that the coffee zones are not desirable for growing cannabis. They are too moist and cool, which is fine for coffee but can lead to mildew problems in cannabis. The mountainous regions are also naturally less accessible, which increases costs.

# *Colombia: But Wait… Colcanna Isn't Even Fully Licensed!*

When our on-the-ground investigator asked for information about buying Colcanna's products, **the company rep said they were still in the licensing process and that they are not near**

**production**.

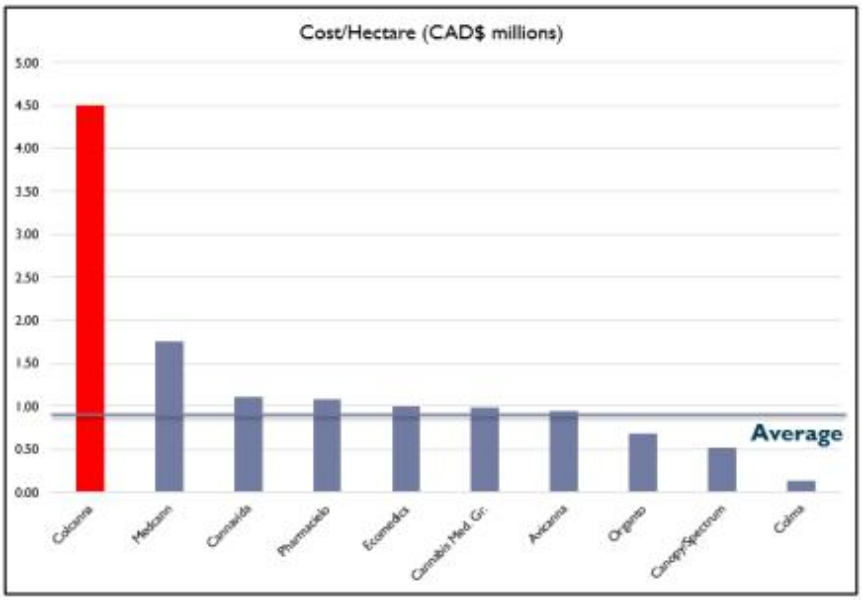
An industry expert gave us the following insight on the key license Colcanna appears to be missing:

> *"I don't think Colcanna is one of the four companies approved to do characterization. This is a necessary requirement for cultivation."*
>
> *"…If the company doesn't have a characterization license then it's a huge red flag. I think the current government is in no rush to stimulate the industry. People are just twiddling their thumbs in the government departments at the moment."*

Colcanna has received some of its required cannabis licenses per Ministry of Justice and Ministry of Health records, but until they receive *all* their required licenses they appear to be in the thumb-twiddling business along with the local government.

# *Colombian Comparable Transactions: Aphria Overpaid Relative to Peers for Land/Licenses*

When comparing the purchase price of Aphria's acquisition relative to other Colombian cannabis producers we see that they stand out:




*(Sources: Company filings, company press releases, and local experts)*

The cannabis space is replete with debates about valuation, but putting that aside, the fact that Aphria's purchase stands head and shoulders above the rest of the industry speaks for itself.

# *Colombia: Undisclosed Insider Self-Dealing?*

Who were the shareholders in the privately-held shell entity that banked C$39 million for selling a newly-formed, stalled Colombian operation?

Canadian corporate records show that two months prior to the Scythian announcement MMJ Colombia had a different name: **Delavaco Colombia artners** Recall that Delavaco is the name of Andrew DeFrancesco's personal private equity firm. Also recall that DeFrancesco is the current Chairman of Scythian and a key insider of both Scythian and Aphria. The entity was registered in the name of DeFrancesco's spouse:

2568710 MMJ COLOMBIA PARTNERS INC.

| Corporate Name History | Effective Date |
|---|---|
| MMJ COLOMBIA PARTNERS INC. | 2018/02/16 |
| DELAVACO COLOMBIA PARTNERS INC. | 2017/03/27 |

| | |
|---|---|
| Current Business Name(s) Exist: | NO |
| Expired Business Name(s) Exist: | NO |

| Administrator: Name (Individual / Corporation) | Address |
|---|---|
| CATHERINE BREWER DEFRANCESCO | 107 LONSDALE ROAD<br>TORONTO<br>ONTARIO<br>CANADA M4V 1W1 |

The timing of the name change looks prescient. Delavaco Colombia's name was changed on February 16, 2018—the very day that Colcanna received its first license for cannabis R&D from the Colombian government, suggesting that the acquisition plan may have been set in motion upon receipt of the license (pg. 54).

# *Aphria's "Option" to Pay $24 Million for a Newly-Formed Brazilian Entity Which Appears*

# *to Own Nothing but a Pending License*

On July 23, 2018, Scythian announced a letter of intent to acquire a stake in "Brazilian Investments Inc", a private British Columbia-based entity.

Canadian corporate records show that "Brazil Investments" had also undergone a name change. It was originally named "MMJ Brazil Investments" and was incorporated only on March 14, 2018. The name was changed to the nebulous "Brazil Investments Inc" on June 15, 2018, about a month before the announced deal:

> *"The acquisition of LATAM provides the Company with an option to purchase 50.1% of a Brazilian entity for $24 million (USD), once it secures a medical cannabis licence from the Brazilian government and a right of first offer and refusal on another 20-39% of the Brazilian entity." (Pg. 23)*

Brazilian corporate records show that the ultimate target, "Green Farma Brasil", had informally operated as of early 2017 but had only taken the step of legally constituting months *after* the announced deal, on August 23, 2018:


The company was formed with capital worth only about US$27,000.

Thus, it seems that Aphria purchased an option to buy a recently formed entity with no known operations except a pending Brazilian cannabis license. For the sake of their investors, we sincerely hope they don't choose to exercise this option and shovel $24 million (or more) into this new shell.

From the prior name "MMJ Brazil Investments", it appears to us that the company under option by Scythian is also related to Delavaco based on the naming convention used in the Colombian acquisition, which was named "MMJ Colombia Partners Inc" immediately prior to its acquisition.

# *Part II: Who is Andy DeFrancesco?*

Andrew DeFrancesco is the Founder of the Delavaco Group , a private equity and advisory firm based in Toronto and Florida. His biography was recently removed from the Delavaco site and his spouse is currently listed as the Chairman and CEO of the firm.

# *Andy DeFrancesco's Deep Relationship with Aphria*

As described briefly above, Andy DeFrancesco has been a key figure with Aphria from the beginning.

*(Source: Andy DeFrancesco's private Instagram account)*

DeFrancesco's biography on the Delavaco website stated that he was "founding investor to Aphria, leading all rounds of financing and strategic advisor to the company since inception." Despite the recent removal of his biography, we can still see the original through Web Archives , which also shows that he was formerly listed as "Founder, Chairman & CEO" of the firm:

*Andrew DeFrancesco*
Founder, Chairman & CEO

« Read Less

- Chairman and CEO of Delavaco Group. Andy brings 21 years of Capital Markets experience in various roles including; head equity trader at one of Canada's leading independent investment banks, and management consultant to several US and Canadian companies.
- Former Chairman and CEO of Delavaco Properties – a residential real estate investment firm specializing in the acquisition of distressed properties throughout the United States of America. DVO.U:TSX-V, DELAF:OTCQX
- Partner and Executive Director of Kahala Corp. Owner of Cold Stone Creamery, Blimpies Subs, Taco Time, Great Steak, NRGize, and America's Tacos. Sold to MTY Foods for $389 million.
- Founding investor to Aphria, leading all rounds of financing and strategic advisor to the company since inception.

Additional links to Aphria include:

> DeFrancesco's Delavaco Group is named as a "special advisor" to Aphria in the company's press releases relating to all of their bought-deal financings ( 1,2,3,4,5,6,7).
> DeFrancesco's private equity firm, the Delavaco Group, was the advisor in Aphria's reverse-merger into a shell entity named Black Sparrow Capital Corp. That transaction took Aphria public.
> The COO of Delavaco Capital was the CEO and CFO of the Black Sparrow shell.
> DeFrancesco was the self-described "architect" of the Aphria/Nuuvera deal which we previously identified as being laden with undisclosed related party conflicts.

# *Andy DeFrancesco's Deep Relationship with Scythian BioSciences (Now Renamed Sol Global Investments)*

DeFrancesco also has a close relationship with Aphria's 'sister' company, Scythian BioSciences/Sol Global Investments:

> Going back to the beginning, the " finder " of Scythian's reverse-merger deal to take the company public was the COO of the Delavaco Group . The Delavaco Group is DeFrancesco's personal private equity firm.
> Until recently, Scythian's head office was listed as 366 Bay Street, Suite 200, Toronto, the very same address and suite number of DeFrancesco's Delavaco Group Toronto office ( v).
> Scythian's former CFO, Jonathan Held, served in the role until late September . Held

operates his consulting firm ALOE Finance out of the exact same address and suite number as the Delavaco Group's Toronto office.
In September, DeFrancesco was named Scythian's Chairman of the Board and Chief Investment Officer. He is now in charge of allocating Scythian's fresh batch of money received from Aphria through the LatAm deals.

In short, DeFrancesco has played an integral role with Aphria, Scythian, and the LatAm transactions as outlined above. We view him as the architect of these questionable transactions.

Now, we will explore his background and associations.

# *Canadian Regulators: DeFrancesco Has "Little Regard for the Truth"*

A 2009 IIROC complaint mentioned Andy DeFrancesco's prominent role in a scheme that led to the subsequent industry ban of a broker. For context, IIROC is the national self-regulatory association for Canadian investment dealers, similar to FINRA in the U.S.

IIROC's complaint made several conclusions about Andy DeFrancesco and the broker, who both worked at Standard Securities Capital Corporation (SSCC):

> *"Both the respondent's and Andy DeFrancesco's conduct in this matter showed they have little regard for the truth."*
>
> *"Andy DeFrancesco was deceptive in his conduct with respect to his wife."*
>
> *"He was deceitful to his employer, SSCC, in managing (a client's) account by placing his own assets in her account."*
>
> *"Both the respondent and Andy DeFrancesco were involved with the SSCC new account application form of (the client) which contained the false signature of (the client)."*

Per earlier SEC filings, DeFrancesco had served as the Managing Partner at SSCC, a firm that was the recipient of multiple regulatory sanctions (1,2,3,4). SSCC was eventually absorbed by another brokerage firm .

# *DeFrancesco's Business Ties to Barry Honig, Who SEC Prosecutors Allege to Have Engaged in Multiple Pump and Dump Stock Schemes*

DeFrancesco has several close business interests with Barry Honig, a controversial financier who was recently alleged by SEC prosecutors to have orchestrated multiple pump and dump schemes .

SEC and Canadian records show that Honig and Andrew DeFrancesco (along with family accounts) have cooperated on a slew of deals, including:

**Riot Blockchain** (formerly named Venaxis Inc.): DeFrancesco's spouse reported a key ownership stake in Venaxis Inc. and even joined Barry Honig in an activist campaign to oust the prior board of directors.

DeFrancesco advocated for Honig's new director slate, which included John Stetson and John O'Rourke, two individuals who were later alleged by the SEC to have participated in multiple pump and dump schemes along with Honig.

Pursuant to Section 7-107-102 of the Colorado Revised Statutes, I repeat my demand made September 14, 2016 for a special meeting of the shareholders of the Company (the "Meeting") and join in the demand for a special meeting of the shareholders made by Barry Honig dated September 13, 2016, a copy of which is attached as Exhibit B hereto and incorporated by reference. The purposes of the meeting should be, as set forth in Mr. Honig's meeting demand: (1) to vote on the removal of five (5) directors, aside from you, currently serving on the Board of Directors, (2) to vote on a $7,500,000 shareholder dividend, and (3) to set the size of the board at no more than six (6) directors and for the election of five (5) new directors as follows: John Stetson, John O'Rourke, Jesse Sutton, Michael Beeghley, and David Danziger. I join in Mr. Honig's prior nomination of these individuals to serve as members of the board of directors, a copy of which is attached as Exhibit C hereto and incorporated by reference.

Should you have any questions regarding the foregoing, please do not hesitate to contact Joe Laxague, Esq. at (775) 234-5221.

Very truly yours,

/s/ Catherine Johanna DeFrancesco
Catherine Johanna DeFrancesco

Venaxis later "pivoted" business models several times, ultimately becoming Riot Blockchain. Documents show that DeFrancesco had a key role in Riot as well…


*(Source: Cap IQ)*

As we alleged in an earlier report , Riot at one point made an irregular acquisition that is reminiscent of Aphria's LatAm transactions: the company bought equipment by purchasing it through a newly-formed privately-held shell entity rather than just buying it on the open market. The equipment cost ~$2 million, but Riot paid ~$12 million for the entity, netting holders of the shell a roughly $10 million gain in about 2 weeks.

So, who owned the shell? None other than DeFrancesco's spouse together with Barry Honig (pg. 23).

**Note 13. Related Party Transactions:**

Per Schedules 13D filed with the Securities and Exchange Commission, each of Barry Honig (together with other group members) and Catherine Johanna DeFrancesco during a portion of 2017 beneficially owned greater than 10% of the dispositive and voting power of the Company's common stock. Mr. Honig reported beneficial ownership of approximately 11.2% of the Company's common stock as of January 5, 2017 and Ms. DeFrancesco reported beneficial ownership of approximately 11.45% of the Company's common stock as of January 10, 2017. Mr. Honig invested $1,750,000 in the Company's March 2017 Convertible Note Private Placement. GRQ Consultants, Inc., a related party of Mr. Honig, received a cash payment of $50,000 for diligence services in connection with the Company's September 2017 investment in Coinsquare. Each of Mr. Honig and Ms. DeFrancesco was a shareholder of Kairos at the time of its acquisition by the Company, with Mr. Honig having owned approximately 8.6% of Kairos and Ms. DeFrancesco having owned approximately 6.3% of Kairos. Each of Mr. Honig and Ms. DeFrancesco invested in the December 2017 Common Share Private Placement, with Mr. Honig investing $500,000 and Ms. DeFrancesco investing $360,000.

**Real estate:** According to Florida corporate records and real estate records , the pair also invested together in the very building where Delavaco Holdings Florida office is headquartered:

If amending Authorized Person(s) authorized to manage, enter the title, name, and address of each person being added or removed from our records:

MGR = Manager
AMBR = Authorized Member

(((H17000148253 3)))

| Title | Name | Address | Type of Action |
|---|---|---|---|
| MGR | Barry Honig | 2300 East Las Olas Boulevard | ☒ Add |
| | | 5th Floor | ☐ Remove |
| | | Ft. Lauderdale, Florida 33301 | ☐ Change |
| MGR | Andy DeFrancesco | 2300 East Las Olas Boulevard | ☒ Add |
| | | 5th Floor | ☐ Remove |
| | | Ft. Lauderdale, Florida 33301 | ☐ Change |

# *DeFrancesco / Delavaco's Ties to a Stealth Stock Promotion Ring*

Delavaco was recently named in an exposé by investigative reporter Chris Carey relating to an "army of writers, both real and imaginary" that have produced hundreds of bullish articles on clients of investor relations firm IRTH and about companies backed by Barry Honig. The article is entitled " Pretenders And Ghosts: Stealth Promotion Network Exploits Financial Sites To Tout Stocks ." Per the article:

> *"The stealth promotion ring began posting stories last year about companies with financial ties to The Delavaco Group… The touting ring has spotlighted at least four companies in The Delavaco Group's investment portfolio: MassRoots, Aphria Inc., Liberty Health Sciences Inc., and Breaking Data Corp."*

# *DeFrancesco's Business Ties to Bobby Genovese, Who SEC Prosecutors Allege to Have Engaged in a Manipulative Penny Stock Scheme*

An SEC complaint filed August 2017 accused an individual named Bobby Genovese of "a penny stock promotion, manipulation and unlawful distribution scheme". The complaint was related to an Ontario-headquartered and TSX-listed company called Liberty Silver Corporation.

The IIROC complaint mentioned earlier provided insight into DeFrancesco's business

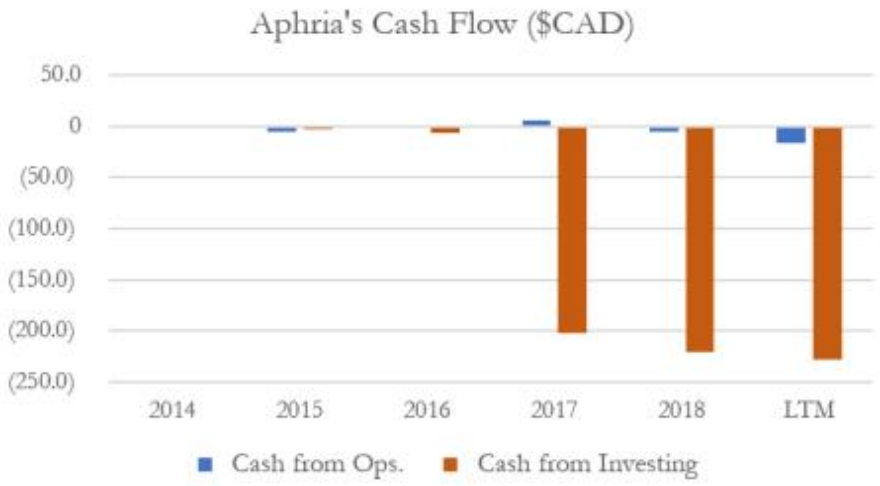
relationship with Bobby Genovese. Per the complaint, DeFrancesco had apparently illicitly deposited shares into a fake client account as payment for "services rendered from past transactions" that he had done with Bobby Genovese.

According to a 2010 deposition of Andy DeFrancesco in an unrelated matter, he similarly referenced his business relationship to both Bobby Genovese (and the banned broker, Phil Vitug) (Pg. 27).

In sum, when reviewing DeFrancesco's past associations and regulatory run-ins, we view his role in Aphria's irregular acquisitions as totally unsurprising.

# *Part III—Aphria's Side Business: Low-Cost Low-Quality Cannabis*

As shown in our introduction, Aphria has dedicated much of its cash to international 'investments'




*(Source: Cap IQ)*

Aside from its questionable acquisitions, however, the firm has also made investments into its greenhouse operations in Canada which produce a variety of cannabis products. This would make it easier to distribute to cannabis business startups who are looking to get a foot on the cannabis business ladder under the private label CBD umbrella. However, there are still laws and regulations that cannabis start-up companies have to follow if they want to stay in operations. There is software similar to this cannabis compliance software by companies like Green Bits that could assist cannabis businesses and ensure they are up to date.

The firm believes it has an edge in the competitive production space. They have repeatedly touted their ability to produce cannabis at lower cash costs than competitors, which enables them to deliver "one of the highest adjusted gross margin levels in the industry".

We spoke with a former worker at Aphria's facility which described the Aphria approach in rather different terms:

> *"The motto should be quality over quantity, but it's probably the other way around.* ***It's more quantity over quality."***

As far as management:

> *"A lot of the people who are running the show are young, possibly not very experienced in what they are doing"*

This has led to issues such as audit failures, mold, and bug infestations:

> *"We were constantly* ***running into errors and not passing audits with Health Canada*** *and having issues with bugs..* ***it kind of became a bit of a circus****"*
>
> *"We had a lot of issues with mold and right now the facility is* ***infested with bugs****"*
>
> *"Every single room that has product in it in that (Leamington) facility right now has bug problems."*

Another source with experience in Canadian and Colombian cannabis companies said the following:

> *'Aphria is a big company but is yet to deliver product. There is huge customer turnover. They get a lot of newbies to get prescriptions and get signed up, but first orders receive 3 times market value for low grade.'*

It seems that Aphria could be sacrificing quality and its long-term brand in order to generate temporary high margins. Regardless, the strategy appears to be failing as Aphria is not

generating positive cash flow from operations. A money-losing, poor-quality, low-cost operation does not strike us as a winning formula.

Additionally, competition is only intensifying as more producers come on-line. Aphria had an early-mover advantage with its licensing and facilities, but that advantage dissipates with every new entrant. With their best times behind them we don't think Aphria will ever generate meaningful positive cash flow from its Canadian growing operation.

## *The 'Blunt' Truth: Aphria is Uninvestable*

All told, Aphria's international deal spree has resulted in over C$700 million being deployed to its questionable "investments". Including the Brazilian purchase option this total could reach over C$736 million:

| Acquisition | Price Paid (C$m) |
|---|---|
| Nuuvera | 425 |
| LATAM | 280 |
| Brazil | 31 |
| **Total** | **736** |

*(Source: Company filings, press releases, and user calculation)*

We hope this information has been informative and has given readers a sense of what is going on at Aphria. We believe the conduct of Aphria's executives and deal partners has been deeply unethical and possibly criminal. With a slew of highly questionable transactions, negative operating cash flow, and a low-quality product, we ultimately see no credible path forward for this company.

We'll leave it at that (for now).

**Disclosure:** We are short APHA.

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[1] *Note: To arrive at this number we apply the final deal value (based on Aphria's share price at closing) to the percentage allocated to Marigold per the transaction's formal valuation opinion*

[2] Scythian purchased MMJ International for 6,176,320 shares of Scythian as of the closing price on the date immediately prior to the closing date of September 21, 2018 Scythian's closing price on September 20, 2018 was 4.35, hence the transaction value of 6,176,320 * 4.35 C$26,866,992

[3] *See* Scythian Biosciences Closes Acquisition of MMJ Colombia Partners which includes US$6,200,000 in cash advanced *prior* to deal closing, US$5,000,000 in assumed debt (both converted to CAD at an exchange rate of 1.3 CAD/USD, and C$24 million in Scythian shares.

# TAB 35

# Genworth: We See Almost No Chance Of Regulatory Approval. This Deal Would Be A Disaster For Policyholders

Published on November 1, 2018



## Summary: Genworth Financial (GNW)


- Genworth's proposed acquirer, China Oceanwide, looks to be in the midst of a deep liquidity crunch.
- Following multiple FOIA requests, we were able to locate audits for the opaque Chinese conglomerate that show consistently negative cash flow and debt levels spiking to clearly unsustainable levels.
- We see almost no chance of regulators approving this deal. Doing so would hand control of Genworth's assets to a faltering entity in a jurisdiction with limited recourse.
- A deep dive into Genworth's insurance carriers show that the company looks starkly under-reserved. Our analysis indicates that Genworth's LTC exposure is under-reserved

by at least $9.9 billion.
- Overall we see this deal failing followed by an unwinding of Genworth. We've taken a significant short position in Genworth's equity.

# *Overview*

In October 2016 Genworth announced that it would be acquired by China Oceanwide, an opaque private conglomerate based in mainland China. The deal has lingered for two years and despite Delaware recently scheduling a hearing on the matter we think regulatory approvals will never make it over the line.

We were able to locate audits for the private China Oceanwide conglomerate following multiple Freedom of Information Act requests to various state departments of insurance. China Oceanwide's finances show that operating and investing cash flow have been consistently negative over the past five years and have recently deteriorated further. Debt has skyrocketed to clearly unsustainable levels.

A subsequent review of Chinese filings shows that the conglomerate has also pledged equity in its subsidiaries for loans, effectively levering the enterprise to the hilt. Given this combination of negative cash flow coupled with spiking debt levels we believe China Oceanwide is poised to become the next Chinese conglomerate meltdown a la HNA Group or Anbang Insurance.

In light of these findings, we think this deal would create the sort of asset/liability mismatch that gravely threatens Genworth's policyholders. It would give China Oceanwide control over Genworth's assets, which could serve as a much-needed liquidity lifeline for the conglomerate. Meanwhile, the vast majority of Genworth's liabilities (i.e. future claims by policyholders) would be based domestically in the U.S.

This would make the deal incredibly dangerous for U.S. policyholders given the cross-border enforcement issues between the U.S. and China. The dynamic would make it virtually impossible for regulators to approve what looks to be a disaster in the making.

All of this raises an inevitable question however—what is the back-up plan for Genworth if the deal fails? The options look thin.

When asked by the JP Morgan analyst on the Q2 conference call what happens in case the deal isn't approved, Genworth's executives basically sidestepped the question and said they were 100% focused on this deal. They then suggested any back-up plan would likely include asset

sales.

Genworth has been a habitually underperforming insurance operator and our review indicates that it continues to be severely under-reserved. We performed a deep-dive analysis of Genworth's GLIC carrier and estimate that its existing long-term care (LTC) exposure is under-reserved by $9.9 billion.

Management's position is that they are done adding capital to GLIC. We do not see this as realistic. We are hard-pressed to find examples of insurance holding companies that have left carriers for bankruptcy/receivership without experiencing adverse effects. With a market cap of $2 billion and long-term borrowings of about $4 billion (pg. 3), we believe adequate reserving would leave Genworth's equityholders with nothing and would wipe out its bondholders.

With a market cap of $2 billion and long-term borrowings of about $4 billion (pg. 3), we believe adequate reserving would leave Genworth's equity holders with nothing and would wipe out its bondholders.

In the end we think regulators are left with 2 unsavory choices: does Genworth fail domestically or does it fail internationally? Policyholders would be better off with a domestic insolvency versus a difficult cross-border wind-down but either scenario would obviously be a mess regardless.

## *The Proposed Genworth Deal Echoes Other Failed Transactions Involving Chinese Conglomerates*

The proposed China Oceanwide transaction echoes those of other recent Chinese conglomerates that had embarked on ill-fated foreign deal sprees:

- **Anbang.** In 2015 Anbang insurance attempted to purchase U.S. insurer Fidelity & Guaranty amidst an aggressive overseas expansion. Much like with Genworth/China Oceanwide, the deal managed clear CFIUS approval. However, it later failed after New York regulators chose not to approve the combination. This turned out to be a great decision. China later jailed Anbang's Chairman for fraud and embezzlement and then took over the enterprise. Anbang is now managed by officials from Chinese financial regulators and government bodies.

- **HNA Group.** HNA is a Chinese conglomerate with an insurance subsidiary that has turned

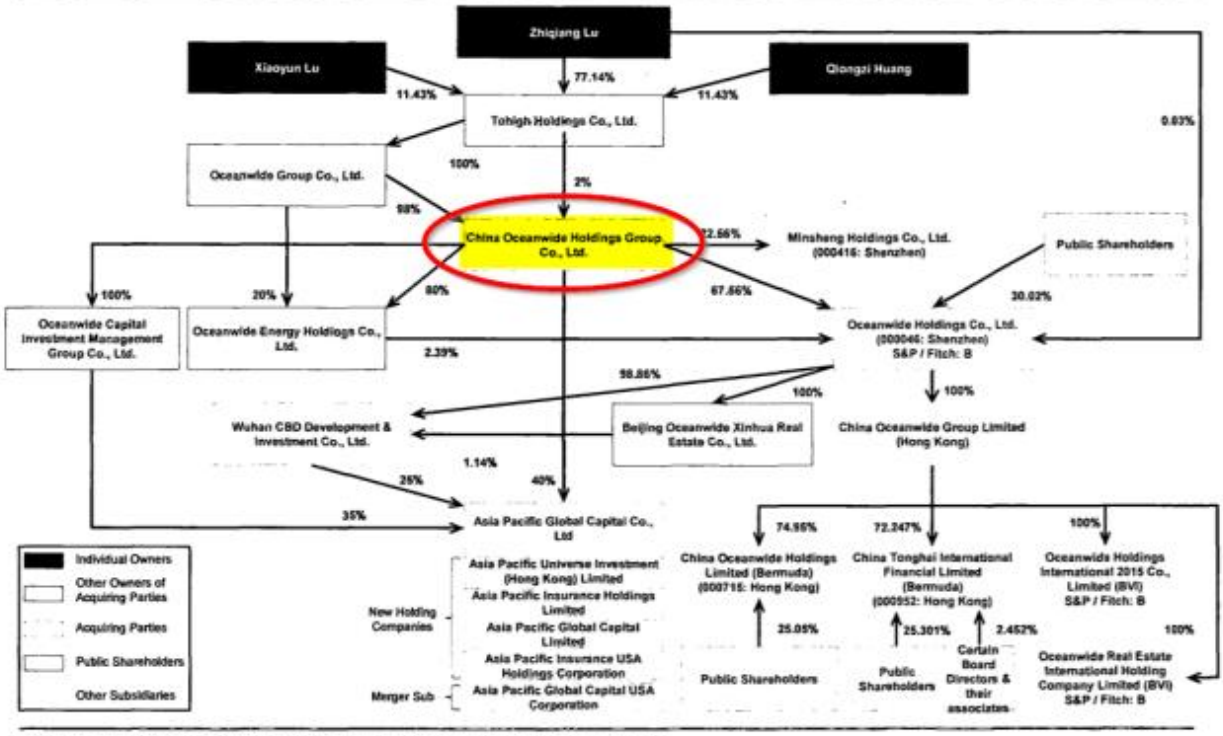
into the largest debt-laden pending failure the nation has seen. HNA went on a $40 billion overseas acquisition spree, buying up assets ranging from Hilton Worldwide to a large stake in Deutsche Bank. Chinese authorities eventually clamped down on internal control issues with HNA's insurance subsidiaries and as of late the firm has been in the process of unwinding its numerous assets. HNA's Chairman mysteriously died after falling off a wall in France this summer.

## *China Oceanwide Looks To Be In The Midst of a Deep Liquidity Crunch*

Similar to warning signs with Anbang and HNA, a review of China Oceanwide's byzantine corporate structure shows that the conglomerate looks to be facing stark liquidity pressures of its own.

China Oceanwide is a private entity and therefore we were unable to find detailed financial information via Chinese sources. However, we filed FOIA requests with five departments of insurance involved in the deal. None responded with documents except the Virginia Department of Insurance, which made China Oceanwide's audits and related documents available. (For context, China Oceanwide is the entity proposing to complete the Genworth transaction.) Per the org chart filed with the Virginia Department of Insurance here is the entity in question:

## CHINA OCEANWIDE SIMPLIFIED ORGANIZATION STRUCTURE




Note: 1. This is a simplified organization structure, certain intermediary holding companies and subsidiaries are not shown.
2. The New Holding Companies and Merger Sub are only shown in this simplified organization structure.

The past 5 years of China Oceanwide's operating performance show an organization in decline. China Oceanwide has consistently produced large negative operating and investing cash flows. In the absence of organic cash generation it has been supported by cash from financing activities, which largely consisted of net debt issuance:

**China Oceanwide Holdings Group Co. Audited Cash Flow Metrics ($USD)**

| | 2017 | 2016 | 2015 | 2014 | 2013 |
|---|---|---|---|---|---|
| Net Cash Flow From Operating Activities | -3,301,337,762 | -1,542,740,820 | -611,584,858 | -324,854,281 | -1,662,889,906 |
| Net Cash Flow From Investment Activities | -1,712,820,625 | -7,983,115,367 | -2,400,557,911 | -539,282,746 | -574,932,638 |
| Net Cash Flow From Financing Activities | 3,172,912,248 | 8,796,161,214 | 6,421,477,052 | 2,077,720,031 | 2,261,809,421 |

*Sources: 2016-2017 audit [pg 14] 2015 audit [pg 10] 2014 audit [pg 9] 2013 audit [pg 9]*

A further look at the balance sheets show the extent of the rapid debt expansion. Both long-term and short-term debt have spiked to clearly unsustainable levels:

| China Oceanwide Holdings Group Co. Audited Balance Sheet Metrics ($USD) | | | |
|---|---|---|---|
| | 2017 | 2015 | 2013 |
| Short-term borrowing | 2,582,593,582 | 1,062,679,618 | 699,036,131 |
| Short-term financing funds payable | 237,110,713 | 145,799,345 | - |
| Borrowings from banks & other finanical institutions | 186,416,296 | - | - |
| Notes Payable | 2,565,928 | 12,319,824 | - |
| Non-current liabilities to be matured within a year | 8,339,207,687 | 3,457,481,619 | 1,809,122,407 |
| **Short-Term Debt** | **11,347,894,206** | **4,678,280,406** | **2,508,158,538** |
| Long-term borrowing | 12,307,170,235 | 8,955,212,652 | 5,979,220,758 |
| Bonds payable | 7,510,136,017 | 5,356,074,269 | 462,511,840 |
| **Total Debt** | **31,165,200,458** | **18,989,567,327** | **8,949,891,136** |

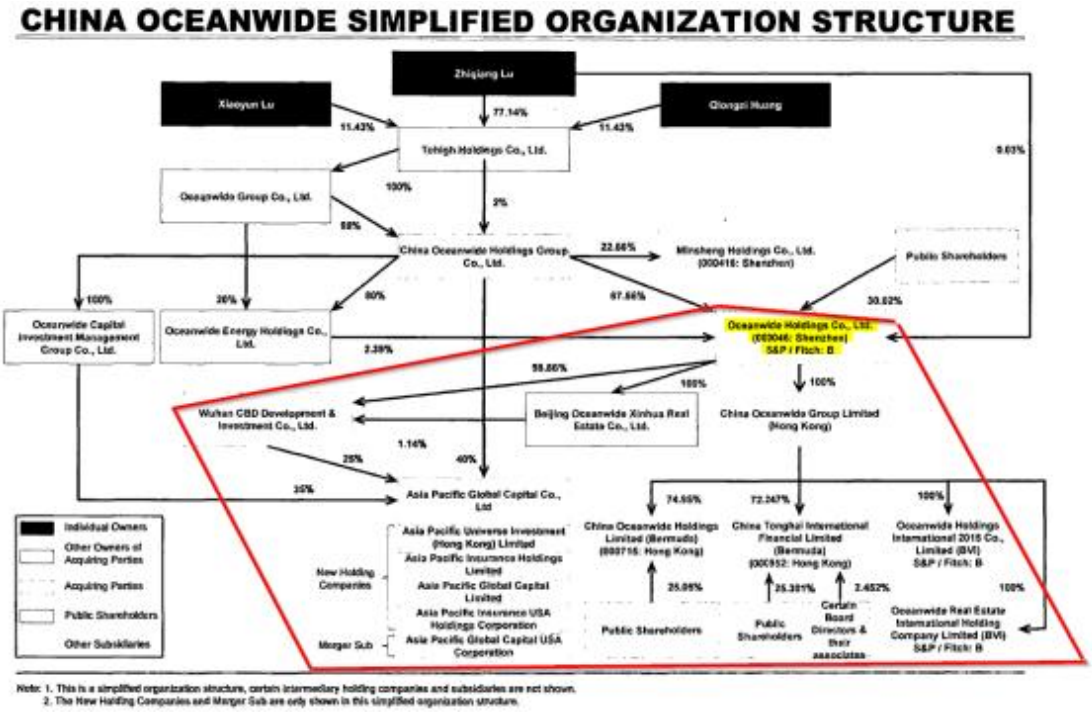
**Note: non-current liabilities to be matured within a year include long-term borrowings and payables due within 1 year (pg. 90)*

With operating cash flow worsening and with a massive stack of $11b of short-term debt coming due we think China Oceanwide's situation is approaching near-term crisis levels.

# *China Oceanwide Has Been Aggressively Pledging Shares of Its Public Subsidiaries As Loan Collateral*

When further examining the China Oceanwide conglomerate we see additional warning signs underscoring its excessive use of leverage.

Oceanwide Holdings Co. (ticker: 000046.SZ) is the conglomerate's key publicly traded entity. See the org-chart below (as originally filed with the Virginia Department of Insurance) to get a sense of the cross-ownership and the importance Oceanwide Holdings Co. has to the broader China Oceanwide empire:




Oceanwide Holdings Co's S&P rating currently stands at CCC, placing it deep within speculative territory. S&P defines CCC ratings as being "currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitments."

Fitch recently lowered its rating on Oceanwide Holdings Co to B-. Fitch defines it's 'B' rating as situations where a "material default risk is present, but a limited margin of safety remains".

In the latest S&P news release regarding its rating:

> *"Oceanwide's liquidity remains very weak and its capital structure is unsustainable."*

S&P's release at one point vaguely suggested that the parent—China Oceanwide—might be able to support the entity, underscoring how misunderstood the overall conglomerate has been even to ratings agencies:

> *"We may raise the rating if Oceanwide can meaningfully deleverage or improve its capital structure. This could happen if…the company can raise more equity or longer-term funding, including higher support from its parent."*

Despite S&P speculating that the parent company might be able to support Oceanwide Holdings it actually looks like the opposite is true. Parent China Oceanwide has pledged the vast majority of its stake in the ailing Oceanwide Holdings subsidiary—about 93.6% of its holdings—as collateral for its own loans.

We can see this from Oceanwide Holdings' first half 2018 financial report (pg. 45). Parent China Oceanwide owns 3.526 billion shares of Oceanwide Holdings, and it has already pledged 3.301 billion shares, or about 93.6% of the total shares it owns as of June 2018.

| 股东名称 | 股东性质 | 持股比例（%） | 报告期末持有的普通股数量 | 报告期内增减变动情况 | 持有有限售条件的普通股数量 | 持有无限售条件的普通股数量 | 质押或冻结情况 | |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | 股份状态 | 数量 |
| 中国泛海控股集团有限公司 | 境内非国有法人 | 67.86 | 3,526,071,501 | 36,744,750 | 95,833,333 | 3,430,238,168 | 质押 | 3,301,353,401 |

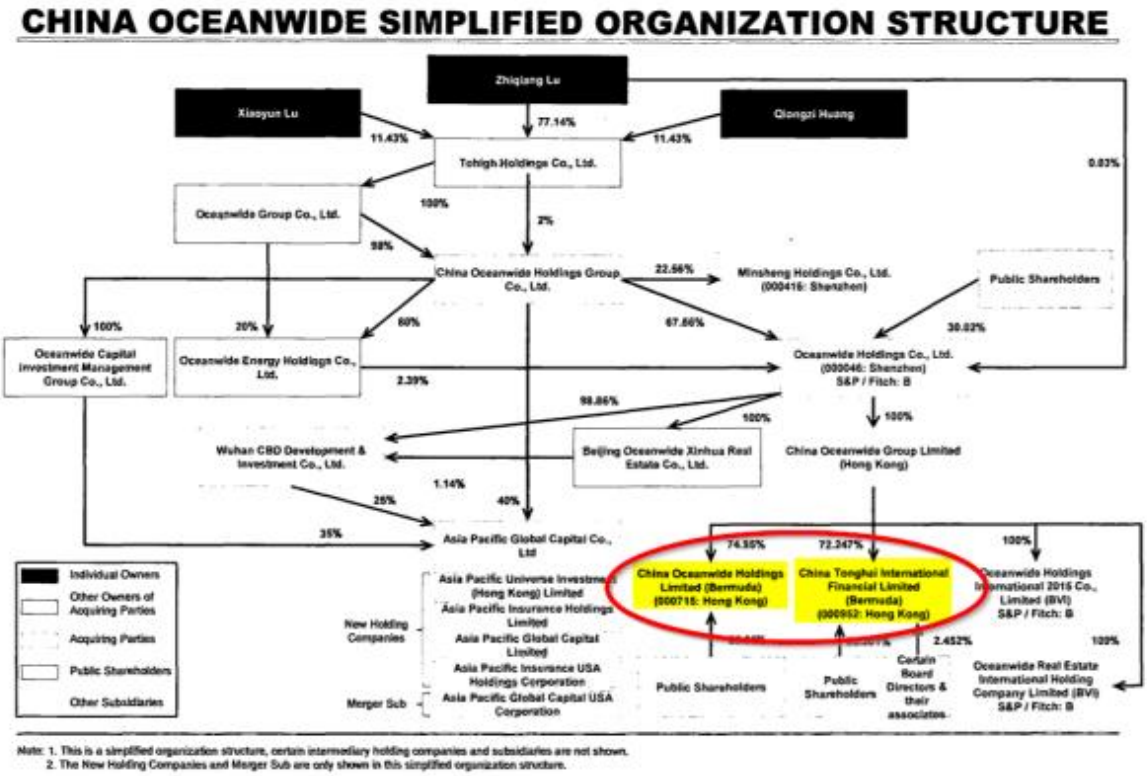
China Oceanwide　　Shares owned　　Shares pledged

Share pledges are an inherently unstable source of lending collateral because if share prices drop the borrower could face additional collateral calls. If no additional collateral is available such a scenario could eventually lead to an unraveling via forced liquidation. As shown below, the share price of Oceanwide Holdings has steadily declined over the past several years:


*(Source: Bloomberg. Ticker 000046.SZ)*

# *More Signs Of Excessive Leverage: China Oceanwide's Two Other Public Entities Had Their Shares Pledged As Well*

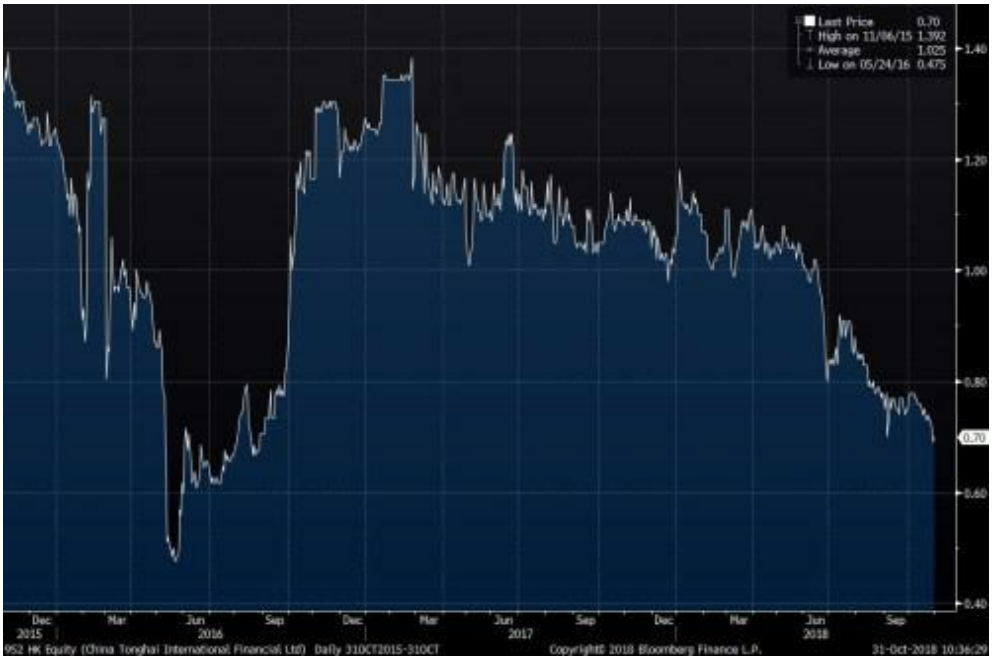
Beyond the large share pledge of Oceanwide Holdings, we found evidence that the other two public entities that sit below Oceanwide Holdings have had *their* shares pledged as collateral as well. See the org chart for where these entities sit relative to the broader organization:




**China Tonghai International  inancial Limited  CTI " or HK:09 2**

According to CTIF's 2017 annual report ( pg. 46), in September 2017 CTIF entered into a facility agreement with external financing provider Haitong International for an RMB 1.1 billion loan, pledging 3.2 billion shares of the company (representing 51.43% of the total issued shares) as of December 2017. Hong Kong exchange filings have similarly reported this pledge.

The share price for CTIF has also traded lower, raising the same questions around collateral calls as with Oceanwide Holdings:




*(Source: Bloomberg. Ticker HK:0952)*

**China ceanwide Holdings Limited C HL" or HK:071**

Disclosures are murky on COHL but China Oceanwide looks to have pledged its shares in this entity as well. On October 06, 2017, Hong Kong exchange filings show that Mr. Lu Zhiqiang and China Oceanwide Group Limited owned 74.04% of the company. However, filings as of May 18, 2018 showed that Haitong International owned 58.19% of the company. It is obvious that the math does not add up in here. The overlapping ownership claims are likely to be due to a share pledge on this entity similar to the disclosed pledge between Haitong and China Tonghai described above.

The share price for COHL has also traded steadily lower:


*(Source: Bloomberg. Ticker HK:0715)*

Going yet another level deeper, COHL's first half 2018 financial release disclosed that shares of its own two subsidiaries were also pledged to secure borrowings:

> *"…the issued shares of two subsidiaries of the Company were also pledged to secure borrowings of the Group as at 30 June 2018 (31 December 2017: Nil)."(pg. 24)*

Overall, the entire China Oceanwide organizational structure looks levered to the hilt from top to bottom. The share prices for all 3 public companies in the conglomerate have declined precipitously in the past 3 years, which strikes us as an incredibly unstable scenario.

## *Recent Modifications To The Proposed Deal Structure Give Us No Confidence In China Oceanwide As A Credible Counterparty*

In light of the above signs of illiquidity and leverage, recent changes to the Genworth deal structure give us further doubts about the viability of this deal.

As of August 14th Genworth and China Oceanwide agreed to a 6th extension of their proposed merger. Whereas past extensions had mostly been focused on a simple lengthening of the closing timeline, the latest extension has proposed significant modifications to the deal

structure itself. We think these modifications are yet another reflection of China Oceanwide's deteriorating liquidity.

In particular, earlier deal structures required Oceanwide to contribute $525 million to facilitate the "unstacking" of Genworth Life and Annuity Insurance Company (GLAIC) from Genworth Life Insurance Company (GLIC). Earlier structures also required Oceanwide to contribute $600 million to Genworth for the repayment of Genworth's debt obligations due May 2018. Both of these up-front cash conditions were waived .

Instead, Oceanwide has agreed to a capital investment plan that would allow it to contribute $1.5 billion "over time following consummation of the merger", with final amounts to be contributed by March 31, 2020, well after the targeted deal closing. The proposed *deferred* capital infusion strikes us as a dubious proposition given the state of China Oceanwide's financials.

When digging further into the details of the new proposed deal structure (again through the Virginia DoI filings) we see how rickety the revised proposal really looks. It contemplates 2 funding "channels". The first is described as "the same as the Original Funding structure" and includes cash from 3 of the mainland Chinese entities listed in the above org charts. According to the revised proposal this Original Funding channel is to provide only 35% of the aggregate merger consideration.

The second (and new) channel involves recently-formed offshore British Virgin Islands (BVI) entities. This channel is to provide 65% of the aggregate merger consideration. Per the revised proposal this part of the transaction could be funded by bridge loans involving yet more pledged assets:

> No later than the closing of the Proposed Acquisition, Tonghai International Group will be primarily funded by the offshore assets and earned income of Oceanwide Group and its affiliates and directly by Chairman Lu, and/or, to the extent necessary or advisable, one or more bridge loans will be entered into by Tonghai International Group or its affiliates. In the event Tonghai International Group borrows under bridge loans, its obligations under such loans would be guaranteed, or secured by a pledge of assets owned, by Oceanwide Group and/or its affiliates, and such loans would be repaid through the assets and earned income of Oceanwide Group and its affiliates. Under no

We are unnerved by the fact that Oceanwide and Genworth are suggesting new, offshore funding channels that are potentially backed by affiliated bridge loans in a conglomerate that is already levered to the edge. The notion that such funding is to comprise almost 2/3 of the total

merger consideration strikes us as grasping at straws.

## *Genworth's Recent Deferred Contribution Plan Strikes Us As A Lame Attempt to Buy Approval From Delaware*

Earlier this week Genworth announced that it would be contributing $175 million from its holding company to its Delaware carrier. Similar to China Oceanwide's deferred contribution plan, Genworth proposed making these payments *after* the hoped-for deal closing.

We view this as little other than an attempt to rearrange the furniture on the Hindenburg. Any holding company cash that goes to a Delaware carrier is cash that won't go to their other carriers. Genworth needs approval from multiple jurisdictions in order to close the deal.

## *Genworth's Long-Term Care Liabilities Represent a Near-Term Problem*

In either case, we don't think Genworth or China Oceanwide's deferred contribution promises will make the difference. Genworth acknowledged in its Q2 earnings presentation that results in its LTC book of business from the first half of the year "reflect higher severity and frequency on new claims." (pg. 8)

In the most recent Q3 release Genworth reiterated that results "reflected lower terminations and higher severity and frequency of new claims" which were partially offset by premium hikes and benefit cuts.

We also see that the company is deferring its annual LTC review from Q3 to Q4, which we view as strongly negative signaling:

> *"The company has typically conducted a review of its LTC claims reserve assumptions in the third quarter of each year but this year will be completing its review in the fourth quarter."*

Per the conference call, the company's stated reason for the delay is that they are "contemplating methodology changes" and that "given the complexity of these potential

changes, significant review is required."

We find it troubling that Genworth is looking to defer its LTC claims reserve assumptions at a time when (a) they acknowledge that claims have experienced higher severity and frequency and (b) when they acknowledge trying to close this deal in Q4.

Frankly, this strikes us as an attempt to avoid taking an obvious reserve adjustment (and capital impairment) in order to grease the deal through.

## *We Expect Genworth's Long-Term Care Book Will Sink The Company Regardless Of Who Owns It*

Our review of Genworth's statutory insurance filings show that a massive long-term care liability looms.

As has been widely reported, long-term care insurance has become an anchor on the entire insurance industry. Earlier this year, GE identified a $15 billion reserve shortfall in its legacy LTC book. The news sent GE's shares down sharply and triggered an SEC investigation to review the situation more closely.

Genworth was formed in 2004 as a result of GE Capital spinning-off most of its life, LTC and mortgage insurance products. The perception at the time among many industry experts and commentators was that the Genworth IPO represented an attempt to minimize the damage from GE's problematic insurance exposure.

Years after its IPO, Genworth's stock subsequently cratered as under-reserving issues began to manifest. The company paid $219 million in 2016 to settle a lawsuit that alleged under-reserving in its long term care portfolio.

Despite Genworth punishing its policyholders with recent premium rate increases ranging from 50%-150%our analysis indicates that Genworth's LTC book is still severely under-reserved.

## *A Deep Dive Into Genworth's LTC Exposure Indicates Severe Reserving Deficiencies*

We performed a detailed peer reserving analysis of Genworth's GLIC carrier to get a sense of its reserving situation.

Note that Genworth is one of the few insurance providers that writes new LTC business. New policies can take decades to pay out new claims and therefore can mask underlying reserving problems taking place in more seasoned policies. Therefore, in order to perform a comparable analysis we isolated older vintage policies and compared the reserving of those policies relative to peers of a similar vintage.

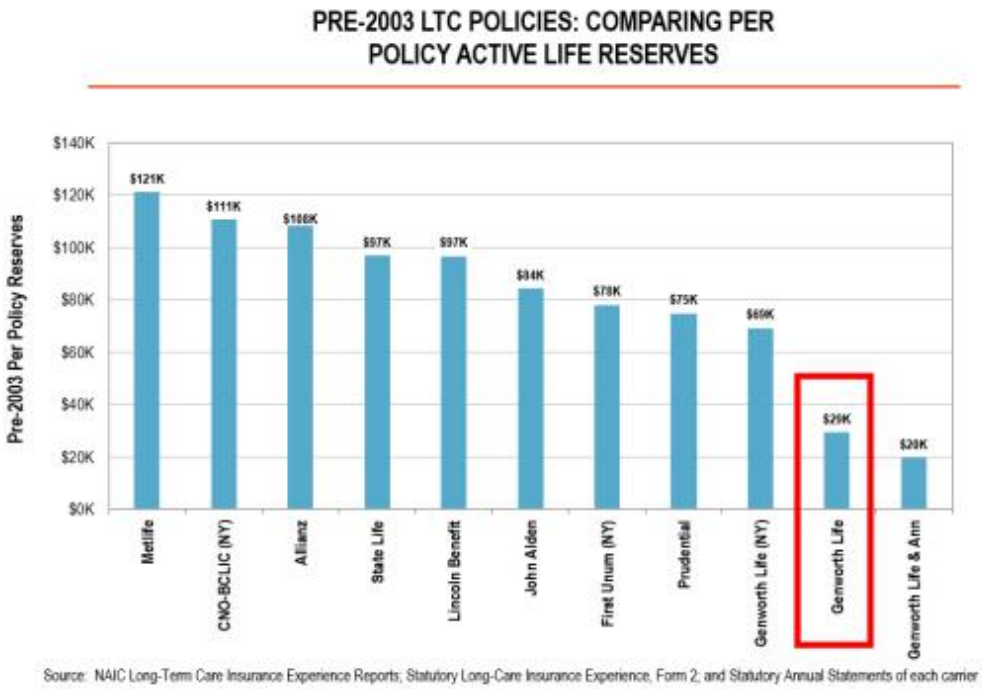
Our analysis isolates Genworth's pre-2003 policies and compares their reserving practices against peers in order to see whether Genworth has safely managed its risk in this oft-troublesome cohort.

Pre-2003 serves as a relevant marker because multiple other carriers have also acknowledged that their pre-2003 long-term care policies have been particularly problematic ( pg. 24 and pg. 1). This was due to the loose underwriting standards of the era as these policies were sold amidst a period of intense market competition and a 'land grab' by multiple carriers for new LTC business.

Genworth has recently become more vulnerable to these pre-2003 policies due to the expiration of reinsurance protection this year. Genworth's reinsurance agreement had covered new claims on policies written between 1998-2003, per GLIC's 2017 statutory MD&A ( pg. 7). As of this year however, any new claims on these blocks become the full responsibility of Genworth.

Reserving across competing LTC insurance carriers in this time frame should fall within a similar range given the comparable vintages and the competitive marketplace dynamics at the time, despite some differences in the nuances of coverage for each policy type.

Contrary to expectation however, the divergence between Genworth's LTC carriers and its peers is extreme. Genworth Life (its largest and most significant carrier) holds well less than half of the per-policy LTC reserves of major carriers like Metlife, Allianz, and Prudential:




As shown above, in the pre-2003 cohort Genworth reserves a paltry $29,000 per policy compared to well-established peers that reserve as high as $121,000 per policy. If per-policy reserving were improved to a more reasonable $50,000 per policy, we estimate that the Genworth Life Insurance carrier would require an additional $9.9 billion in reserves. Keep in mind that $50,000 per policy would barely place Genworth within range of its better-reserved peers:

| Holding Company | Genworth |
|---|---|
| Carrier | Genworth Life Ins Co |
| Premiums Earned '17 | $ 1,111,512,808 |
| Incurred Claims '17 | $ 1,721,412,889 |
| Margin | $ (609,900,081) |
| Loss Ratio | 155% |
| Inforce Policy Count '17 | 477,785 |
| Active Life Reserves '17 | $ 13,984,074,408 |
| Per Policy Reserves | $ 29,269 |
| Adj. Per Policy Reserves | $ 50,000 |
| Adj. Active Life Reserves | $ 23,889,250,000 |
| Est. Under-Reserving | $ (9,905,175,592) |

*(Source: NAIC annual reports and author analysis)*

If the reserving were adjusted to $75,000 per policy or even $100,000 per policy we would possibly be talking about the largest insurance reserving shortfall in history. Rate increases can bridge some of this gap but it is clearly a major shortfall to cover.

As a reminder, this analysis is merely limited to pre-2003 long-term care policies at *one* of Genworth's carriers. Typically, when one major policy cohort is materially under-reserved we see similar issues across a company's other carriers and policy lines. Suffice it to say we think Genworth's carriers are in deep trouble—this strikes us as not even a close call.

# *Genworth's Mortgage Businesses Are Exposed to Increasing Cyclical Risks*

We think Genworth is insolvent just purely based on its LTC book of business. But putting aside LTC for the moment, Genworth's current top performing business is mortgage insurance which is largely focused on markets in Canada, the U.S., and Australia. Mortgage insurance is a cyclical business that has performed well in the low interest rate environment we've experienced for the past 9 years. However, with rates rising this product line is slated to face the tail end of a business cycle for the first time in almost a decade.

Canada and Australia are two markets that have widely been reported as being in the midst of real estate bubbles. Any trouble in these housing markets could prove to be major headwinds for Genworth's mortgage insurance business.

**Canada**

Canada's housing bubble has been covered extensively in the press with reports that the bubble has begun to unravel. In February the FT wrote a piece entitled "Canada's housing market flirts with disaster". Later in June, the Globe and Mail ominously wrote: "The housing bubble is leaking air, but it's just a start." Since then, numerous publications have honed in on the rise of subprime mortgages, the clampdown on money laundering in the real estate sector, and other issues that appear to be reaching a breaking point.

**Australia**

The Australia property market is similarly on shaky footing. Home prices have dropped year over year and numerous outlets such as the New York Times and local Australian media have been calling attention to the bursting of a bubble.

While predictions of bubbles can be speculative and subject to high degrees of uncertainty, any broader economic downtrend will have a negative impact on this key line of business for Genworth.

In the end we think the LTC business is Genworth's biggest problem by a wide margin, but any loss of support from other lines of business could hasten a decline.

# *The CFIUS Review Is A Meaningless Milestone That The Market Has Mispriced*

Genworth announced in June that the proposed deal with China Oceanwide had cleared its review with the Treasury Department's Committee on Foreign Investment in the United States (CFIUS). Many investors had apparently viewed the CFIUS review as a major hurdle; Genworth's stock soared over 26% the day after the announcement .

We view the CFIUS review as among the least significant hurdles facing this transaction. CFIUS reviews are focused on national security concerns. Their objectives are to ensure that critical technological or physical infrastructure remain out of the hands of foreign adversaries, and that funds from an acquired business remain out of the hands of sanctioned countries. Neither were really at issue here. Per Genworth's CEO on the Q1 conference call :

> *"…They're really not looking at the financial aspects of the deal. Their whole focus is on national security interests."*

As mentioned above, Chinese conglomerate Anbang insurance serves as a precedent. Anbang's attempt to purchase U.S. insurer Fidelity & Guaranty in 2015 managed to clear CFIUS approval , but later failed after New York regulators chose not to approve the combination.

# *We Predict Regulatory Pushback Will End This Deal*

New York and Delaware have reputations as being among the more diligent state insurance departments. Neither state has approved despite the transaction having been announced about 2 years ago. Delaware recently scheduled a public hearing on the proposed merger which we view as inconclusive.

Beyond the U.S., China hasn't blessed this transaction either. Recently, Chinese officials have made a concerted effort to limit overseas investments in order to curb " irrational " investments and to prevent capital flight from the country. This strikes us as the precise type of irrational

investment that would seem to fit those characteristics.

All told, we see almost no realistic chance that regulators approve the completion of this deal.

# *Conclusion: A Rock And A Hard Place*

Regulators are faced with a tough choice here because both options (deal or no deal) would probably spell insolvency for Genworth:

- As an acquired entity, Genworth's shaky financials would be inserted into an overseas empire that itself looks to be crumbling under liquidity pressures. Approving the transaction would essentially hand control of a massive and liquid portfolio of policyholder assets over to an opaque foreign conglomerate. The potential for abuse in such a scenario is high, and hurdles to any cross-border legal remedy would likely leave U.S. policyholders in a perilous position. A Genworth acquisition wouldn't save China Oceanwide, though we think it would buy them some additional time before turning into an even bigger mess.

- As a standalone entity, Genworth seems hopelessly under-reserved and highly levered. Genworth's backup plan if the deal fails looks to be virtually non-existent. As noted above, when asked on the recent Q2 conference call what happens in case the deal isn't approved, Genworth suggested any back-up plan would likely include raising capital through asset sales.

Out of all the parties to this proposed deal the most obvious beneficiaries we could find are the executives of Genworth. The original merger agreement detailed an estimated $42 million in Golden Parachute compensation for 5 of Genworth's executive officers. (Pg. 98)

In the end we think there is almost no chance that this deal succeeds. The burden of the denial decision will probably fall on the Delaware and New York insurance regulators given that Genworth's major carriers are domiciled in their states.

If the deal falls part we think under-reserving and liquidity realities will quickly come to bear on Genworth.

Best of luck to all either way.

**Disclosure:** I am/we are short GNW.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 36

# Ladenburg: Near-Term Headwinds And Unsustainable Balance Sheet Engineering

Published on September 18, 2018



## Summary: Ladenburg Thalmann Financial Services Inc. (LTS)


- The SEC recently leveled allegations of securities fraud against Ladenburg's Chairman and largest holder, Phil Frost, who owns ~34% of Ladenburg's common equity.
- The company was struggling before the recent news. Ladenburg has regularly generated net losses to common holders and its balance sheet has become increasingly leveraged.
- When factoring in Ladenburg's preferred stock – with a liquidation claim of $425 million ahead of the common – the balance sheet is already in deeply negative equity territory for common holders.
- Ladenburg has been issuing more debt and more preferred stock to pay out hefty dividends and to support common stock buybacks. This dynamic never ends well.
- The controversy is likely to lead to further fundamental deterioration; financial firms are

sensitive to reputational risks. Plus, the worst may not be over; signs point toward possible criminal charges.

# *Introduction*

We think Ladenburg's (NYSEMKT: LTS) common equity is intrinsically close to worthless. The company has generated consistent net losses for its common shareholders and operating cash flows have regularly failed to cover payment of its hefty preferred dividend.

The balance sheet looks deceptively secure at first glance, but tangible assets available to common shareholders amount to only $126 million after stripping out (i) the massive $425 million preferred holder's liquidation preference (ii) goodwill, and (iii) intangibles.

Comparing those $126 million in remaining assets against the company's $357 million in liabilities leaves common holders in starkly negative equity territory.

The picture got significantly worse earlier this month when the SEC filed a complaint alleging fraud against Ladenburg's Chairman Phillip Frost. The common equity dropped about 15% on the news, which is roughly where it trades as of this writing.

We don't think the market has fully priced the impact of this news. The company's already poor earnings and unsustainable balance sheet are likely to deteriorate further from here:

- Investment banking clients are less likely to associate their businesses with a firm whose Chairman and key holder is facing fraud charges.
- Asset management clients are more likely to take their business to another firm due to concerns about the reputation of the firm.
- Top talent across all divisions will be more likely to leave for a firm with stronger financial footing and a stronger brand.

Ladenburg has been in the headlines regularly since the SEC complaint and the potential for more negative attention still looms given that signs point toward possible criminal charges. We think the responsible move would be for Phil Frost to resign as Chairman to avoid further reputational risk to the firm.

A true separation might be easier said than done however. In addition to his role as Chairman, Frost is also the company's largest holder with ~34% of the outstanding common equity and ~5% of the outstanding Series A preferred shares.

The balance sheet has plenty of liquidity for now with approximately $263 million in cash (including the latest bond offering ) but in the absence of a sudden turnaround in fundamentals, we think operating performance and the preferred dividend will slowly eat away at that liquidity until common holders are left with nothing.

# *Signs Point Toward Possible Criminal Charges*

In the near term, headline risks still loom. On September 7th, the SEC filed litigation against Ladenburg's Chairman Phillip Frost, among others. Note that Ladenburg was not mentioned in the complaint and (other than Frost) no one associated with Ladenburg was alleged to have committed any wrongdoing.

The complaint's allegations accuse Frost of aiding and abetting multiple pump & dump schemes led by notorious penny stock financier Barry Honig. Frost stands personally accused of violating 7 sections of the Exchange and Securities Acts.

The complaint described one of the fraudulent schemes as relating to "Company A" which has been identified by the WSJ and others as Biozone Pharmaceuticals (now renamed Cocrystal, NASDAQ:COCP).

As I've written previously , in early 2017, investigative reporter Teri Buhl wrote that the FBI and the California Department of Justice (DoJ) had been involved in the investigation of Biozone. Per the article, entitled " California DOJ investigating Honig and The Frost Group ":

> *This reporter has seen a letter from the FBI that states this person is a potential victim of securities fraud. A check in the FBI's victim notification system, seen by this reporter at press time, show the investigation is still active but doesn't list specifically who the investigation is about. Biozone is the only company the person interviewed by the FBI held stock in.*

The SEC is a civil agency, whereas the FBI/DoJ are focused on criminal matters. If a civil matter is referred for criminal prosecution (or if the FBI/DoJ requests the SEC's expertise on securities matters) then the two will often work together. The apparent coordination between the DoJ and the SEC indicates that parallel criminal charges could follow these SEC civil charges.

Indications show that both civil and criminal agencies are continuing to build their cases, which

further indicates that more news could follow. The SEC's litigation release on the day of the complaint stated that there is a "continuing investigation". Weeks ago, Buhl wrote on Twitter:

> *…based on multiple sources the FBI has recently been interviewing new informants in this case.*

Lastly, the SEC often provides notice of its intent to sue in order to seek to negotiate a resolution with parties in advance. Based on a statement made by Frost's biotech company, Opko Health (NASDAQ: OPK), it appears the SEC had not afforded Frost & Opko the opportunity to settle. Per the statement, "the SEC failed to provide notice of its intent to sue prior to filing the complaint." The lack of any such discussion could indicate that another shoe is poised to drop.

# *Balance Sheet Leaves Common Holders Vulnerable*

The recent controversy seems to be adding to an already troubling situation for common holders.

A basic review of the filings might leave common holders with a false sense of security. As of Q2 2018, the balance sheet shows a healthy $205 million in cash and shareholders' equity of $390 million. Despite these high-level signs of health, a deeper look tells a different story:

- **referred Stock Liquidation reference:** The Series A Preferred shares are a quiet little balance sheet item that has a massive impact on common shareholders. As of the most recent quarter the company had 17 million Series A Preferred shares outstanding with a liquidation preference of $25 per share. In aggregate, this amounts to over $425 million in liquidation preference standing in front of common shareholders. This item alone would render common shareholders in a negative equity position in a liquidation scenario as of the latest balance sheet.

| | June 30, 2018 (Unaudited) | December 31, 2017 |
|---|---|---|
| SHAREHOLDERS' EQUITY: | | |
| Preferred stock, $.0001 par value; authorized 50,000,000 shares: 8% Series A cumulative redeemable preferred stock; designated 23,844,916 shares in 2018 and 2017; shares issued and outstanding 17,012,075 in 2018 and 2017 (liquidation preference $425,302 in 2018 and 2017) | 2 | 2 |
| Common stock, $.0001 par value; authorized 1,000,000,000 shares in 2018 and 2017; shares issued and outstanding, 201,271,034 in 2018 and 198,583,941 in 2017 | 20 | 20 |
| Additional paid-in capital | 501,348 | 520,135 |
| Accumulated deficit | (110,904) | (149,778) |

The Series A preferred share class also pays a *cumulative* 8% dividend per annum ( Pg. F-33), which amounts to about $34 million per year. This creates a massive drag on earnings and cash flow available to common holders, as we'll get into further below.

- **Goodwill and intangibles.** Ladenburg has been highly acquisitive and has accumulated a large goodwill balance. Intangibles consist of items such as technology, non-compete covenants, relationships with advisors, and trade names. ( Pg. 20) We exclude these to get a sense of the hard asset base available to common.

What are common holders left with after factoring in the preferred liquidation preference, and goodwill/intangibles? Negative $231 million in equity:

| | |
|---|---|
| **Total assets** | **747,890** |
| - Preferred stock liquidation preference | -425,302 |
| - Goodwill | -124,210 |
| - Intangible assets, net | -72,296 |
| Tangible Assets Available to Common | **126,082** |
| | |
| **Total Liabilities** | **357,392** |
| | |
| **Tangible Equity Available to Common** | **-231,310** |

With a lack of tangible assets to support the common equity, shareholders are left to rely on earnings and cash flow to sustain the value of common shares.

Unfortunately, Ladenburg has consistently generated negative annual net income available to common holders. Annual operating cash flows have similarly failed to support the preferred dividend.

# *Net Income Available to Common Has Provided No Support*

The past 3 years of net income shows that common holders are losing ground. We can see that after factoring in the preferred dividend the common holders have been incurring consistent, unsustainable net losses:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Net income (loss) attributable to the Company | $ 7,697 | $ (22,269) | $ (11,151) |
| Dividends declared on preferred stock | (32,482) | (30,438) | (28,108) |
| Net loss available to common shareholders | $ (24,785) | $ (52,707) | $ (39,259) |

The cash flow picture tells a similar story. Cash flow from operations simply has not covered the preferred dividend for the past 3 annual periods:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| **Net cash provided by operating activities** | 16,215 | 14,246 | 19,319 |
| Cash flows from financing activities: | | | |
| Series A preferred stock dividends paid | (32,482) | (30,438) | (28,108) |

So how has the company managed to meet its generous preferred dividend payments (not to mention the common stock buybacks and common stock dividends)? Largely through the issuance of debt and yet more preferred stock:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| | | | |
| Cash flows from financing activities: | | | |
| Issuance of Series A preferred stock | 28,095 | 27,580 | 84,380 |
| Issuance of senior notes | 73,197 | — | — |
| Borrowings on term loan | 8,000 | — | — |
| Principal repayments on notes payable | (7,039) | (7,516) | (17,639) |
| Principal (repayments) borrowings under a revolving credit facility, net | — | (114) | 495 |
| Bank loan and revolver repayments | (1,992) | (628) | (387) |
| Additional issuance costs related to SSN notes | (40) | — | — |

(Author created table. See 2017 10-K Pg F-8 for the full cash flow statements for these years)

It looks to us like the company has consistently used new money to support its existing obligations. This situation was unsustainable long before Ladenburg's Chairman was alleged by the SEC to have committed securities fraud.

# *Net Income: Modest Improvement In the Past 6 Months Helped By Accounting Methodology Changes*

So far, we have done a basic review of the past 3 years' annual financial statements. Notably, reported metrics have improved in the first 6 months of 2018. In that period, net loss available to common was $2.2 million. At first look, this appears to be a stark improvement compared to the first 6 months of 2017, which saw a net loss available to common of $18.2 million ( pg. 2).

Could this be signs of a major turnaround?

Not necessarily. The improved numbers look to be due in part from a change in accounting methodology . The latest earnings release details these methodology changes which consist of:

1. The booking of revenue for commissions on future renewals of insurance policies sold for sales that are estimated to happen in the future.
2. Capitalizing costs to obtain a contract with a customer rather than booking the costs as period expenses.
3. Amortizing forgivable loans to independent financial advisors over the "expected useful lives of their relationship period" rather than amortizing the loans based on their actual legal terms.

For the six months ended June 30, 2018, the impact of the new accounting standard was an increase in net income attributable to the company by $5.7 million. All told, these numbers represent an improvement over prior periods (with or without the adjustment), but it still leaves common holders with a net loss in either accounting scenario.

# *Cash Flow Improvements In The Past Quarter Looks Unsustainable*

Similarly, cash flow from operations during the 6 months ended June 2018 was $26 million compared to negative $3.7 million in the comparable 2017 period. This is substantial improvement. However, the numbers have been erratic:

- Q1 '18 Cash flow from operations: *Negative* $15 million (Pg. 4)
- Q2 '18 Cash flow from operations: *Positive* $41 million (Pg. 4)

So why the enormous variance? Net income available to the company was $9.3 million in Q2 versus in $5.5 million Q1, which doesn't explain the wide gap. The other key sources of operating cash flow consisted largely of pushing out payables and pulling in receivables:

- $9.2 million net additions to commissions and fees payable
- $8.6 million net additions to accrued compensation payable
- $1.9 million net additions to accounts payable and accrued liabilities
- $4.1 million net receivables collections

Operating cash flow of $41 million in a quarter that saw only $9.3 million in net income is clearly

not a sustainable balance. Cash flow should revert in the next quarter or two; the key question for us is 'how big will that swing be'?

It is essential that the company find sustainable growth that can actually support the preferred dividend without relying on short-term working capital swings and without levering up the balance sheet further. Given recent headlines however, we think it is unlikely that we see any near-term positive surprises.

## *Liquidity: Fine For Now But A Ticking Clock For Common Holders*

The company has raised $202 million in cash in roughly the past year and a half through the net issuance of debt, preferred stock, and common stock. There is no immediate threat from the debt waterfall as the majority of Ladenburg's $194 million in notes payable don't come due for 9-10 years. (Sources: Pg. 1 and recent debt offering announcement )

With roughly $263 million in cash (counting the recent debt offering ) and no major debt maturities on the horizon, Ladenburg has enough to sustain its preferred dividend for the foreseeable future.

However, with the balance sheet levered up and with a tremendous amount of preferred stock outstanding there seems to be little left for the common holders. Over time we think the preferred dividend will suck the cash out of the business, barring a sudden and sustained improvement in fundamentals.

## *What Should Ladenburg Do From Here?*

We think Phil Frost should resign to avoid more reputational damage to the firm. As the investigation and enforcement process continues forward, it is almost assured to create more negative headlines and spook clients.

Additionally, we think the company should suspend its common stock dividend and buyback programs. Both strike us as little more than window dressing. Issuing debt and preferred stock to support common stock buybacks and dividends is nonsensical. This is especially the case when common shareholders are regularly experiencing net losses and negative to spotty cash flow.

We doubt the company will do this (because of the negative signaling it would create in the short term) but it would nonetheless extend the runway.

## *Conclusion: We're Short The Common And Keeping An Eye On The Preferred*

We think the common is already intrinsically worth close to nothing and makes for an obvious short here. The potential for more near-term headline catalysts and the risks of poor near-term operating results would disproportionately affect the common holders.

We're keeping an eye on the preferred but not taking a position either way. There looks to be enough liquidity with the cash balance to keep the dividend chasers happy for the foreseeable future, but we don't have enough faith that the fundamentals will hold up to justify a long position or even a pair trade.

Best of luck to all.

**Disclosure:** I am/we are short LTS.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 37

# Opko Health: If These SEC Charges Were Surprising Then You Haven't Been Paying Attention

Published on September 11, 2018



## Summary: OPKO Health, Inc. (OPK)


- Opko's stock is now halted following SEC charges alleging fraud by both the company and its Chairman & CEO Phil Frost.
- The company put out a rather impotent statement Friday evening claiming the SEC complaint "contains serious factual inaccuracies" without identifying a single factual inaccuracy.
- We anticipate that criminal charges could follow given the reported FBI investigation that parallels the SEC charges.
- Frost is Opko's key leader, key lender, and its largest holder with over 30% of the equity, leaving the company in a perilous position.

- Opko's business was already in tatters. It is bleeding cash, has negative tangible equity, and a weak pipeline. We do not see a bottom for this stock. Price target zero.

# *Overview*

Ten months ago we wrote that Opko Health (NADSAQ: OPK) was a "House of Cards Tumbling in the Dark ". On Friday afternoon the SEC filed litigation against Opko's Chairman & CEO Phil Frost, Opko Health Inc., and multiple other related entities and individuals. The complaint's blistering allegations accuse Frost and Opko of aiding and abetting multiple pump & dump schemes led by notorious penny stock financier Barry Honig.

Frost stands personally accused of violating 7 sections of the Exchange and Securities Acts. Per the SEC complaint:

> *"In every scheme, Honig, and some combination of Stetson, Brauser, O'Rourke, Groussman and Frost, either explicitly or tacitly agreed to buy, hold or sell their shares in coordination with one another, knowing that a pump and dump was in the offing that would allow them all to profit handsomely."*

Following the SEC complaint, Opko's stock plummeted 18% before being halted.

Several signs point to the strong possibility that criminal charges could follow. The complaint referenced "Company A" which has been identified by the WSJand others as Biozone Pharmaceuticals (now called Cocrystal, NASDAQ: COCP). In early 2017 investigative reporter Teri Buhl wrote that the FBI and the California Department of Justice (DoJ) had been involved in the investigation of Biozone. Per the article :

> *This reporter has seen a letter from the FBI that states this person is a potential victim of securities fraud. A check-in the FBI's victim notification system, seen by this reporter at press time, show the investigation is still active but doesn't list specifically who the investigation is about. Biozone is the only company the person interviewed by the FBI held stock in.*

Note that the SEC is a civil agency, whereas the FBI/DoJ is focused on criminal matters. If a civil matter is referred for criminal prosecution (or if the FBI/DoJ requests the SEC's expertise on

securities matters) then the two will often work together. The apparent coordination between the DoJ and the SEC indicates that parallel criminal charges could follow these SEC civil charges. Filed criminal charges are very serious and need to be dealt with correctly with all the force of the legal system. If someone is facing these type of charges they will need to look at criminal lawyers in their areas, such as the criminal lawyers in DuPage County, or ones that are more local to them.

Indications show that both civil and criminal agencies are continuing to build its case, which further indicates that more news could follow. The SEC's litigation release on Friday stated that there is a "continuing investigation". Days ago, Buhl wrote on twitter:

> *"…based on multiple sources the FBI has recently been interviewing new informants in this case."*

Lastly, the SEC will often provide notice of its intent to sue and seek to negotiate a settlement with parties in advance. Based on Opko's statement on Friday evening it appears the SEC had not afforded Frost & Opko the opportunity to settle. Per the statement, "the SEC failed to provide notice of its intent to sue prior to filing the complaint." The lack of any such discussion could indicate that another shoe is poised to drop.

## *These SEC Charges Should Not Be a Surprise to Anyone*

Barry Honig has become widely recognized of late as a financier with a questionable reputation. We have written extensively about Honig's crucial role in several dubious enterprises, including Riot Blockchain (RIOT), and Pershing Gold (PGLC). Others have covered his relationships with PolarityTe (COOL), Marathon Patent Group (MARA), and numerous others.

Those who have followed Honig's career trajectory have seen that Phil Frost has been an integral part of the equation. Not only has Frost provided capital to Honig's deals, but he has also mortgaged his reputation as a successful billionaire biotech investors as a means of providing credibility to his microcap stocks. (See examples here, here, and here.)

The Frost/Honig relationship is not new. Back in 2014, Bill Alpert of Barron's reported on the numerous penny stock deals that Frost had participated in alongside Barry Honig and Michael Brauser, who are now all co-defendants in the SEC complaint. Per the article:

> *Over the past few years, these two South Florida gents (Honig and Brauser) have invested alongside Frost in a couple of dozen micro-cap companies. Scanning the list of those companies last week, I calculated that their average market cap was about $75 million. The middle of the pack (in other words, the median company) had a valuation of under $30 million.*

The closeness of the relationship was apparent even then:

> *While Honig works out of Boca Raton, Brauser has his business in the same Biscayne Boulevard address in Miami as Opko Health and Frost's own investment operation.*

Beyond lending his reputation to this bevy of penny stock companies, Frost's affiliated investment bank often rears its head in these deals. Investment bank Ladenburg Thalmann (LTS) – which counts Frost as its Chairman and largest holder with ~33% of its equity – regularly provides "Buy" ratings and favorable research to Frost/Honig affiliated companies.

A glance at Ladenburg's current research coverage shows that Frost/Honig affiliated companies Chromadex (CDXC), VBI Vaccines (VBIV), IZEA (IZEA), Neovasc (NVCN), and Opko Health are all covered by the investment bank. Every single one has been issued a "Buy" rating.

So far, the most common reaction we have seen to these charges is "why"? Why would a billionaire who has built genuine biotech businesses tinker around with $5 to $10 million scores in shady penny stock deals?

Maybe he likes it? Maybe he's good at it? Maybe he's not as wealthy as people assume? (The Frost Science Museum in Miami, named after Phil Frost, required a $49 million bailout in 2016.)

In the end we don't really know. Why does any really smart person do anything really stupid? At a certain point it doesn't matter. The signs were all there and the trial evidence will speak for itself.

## *Opko's BioReference Division, With Its Well-Documented Connections to Bucket Shop Brokers and Organized Crime Could Have Also Served As a*

# *Warning*

In addition to Frost's longstanding affiliation with the Honig syndicate, the internal operations at Opko should have also sounded alarm bells for investors. In our piece back in November we detailed the extensively checkered regulatory and legal history of executives in BioReference Labs, Opko's key diagnostics division. As Barron's had reported in 2011, BioReference:

> *Was financed in the decade after its 1986 initial public offering by such penny-stock bankers as Paul Russo, a Mafia-associated broker, and J.T. Moran, whose firm was the model for the movie Boiler Room. They and other Bio-Reference backers ended up in jail ("There Will Be Blood," May 23, 2011). Grodman and Bio-Reference were never implicated in any untoward activities, and he has said he never saw any wrongdoing.*

At one point Grodman's brother Joel was alleged to have posed as a salesman for BioReference in order to secure a mob-controlled union contract with $400,000 of kickbacks to mob boss Peter Gotti. Joel Grodman cooperated with prosecutors and escaped charges in the matter.

Marc Grodman served as CEO of BioReference from its founding and through its acquisition by Opko until 2016, with Phil Frost's blessing.

BioReference's longstanding Chief Information Officer had a past criminal conviction and was disbarred as an attorney. He served in his role at BioReference until mid 2017, with Phil Frost's blessing.

The fact that Frost was comfortable with the BioReference acquisition in the first place (despite its odious reputation) should have been a loud warning.

# *Opko's Pre-Existing Regulatory Overhang*

Note that Opko had looming regulatory liabilities even prior to the recent SEC charges. Since May of 2017 Opko has repeatedly disclosed a False Claims Act (FCA) probe relating to BioReference:

> *In April 2017, the Civil Division of the United States Attorney's Office for the Southern*

> *District of New York (the "SDNY") informed BioReference that it believes that, from 2006 to the present, BioReference had, in violation of the False Claims Act, improperly billed Medicare and TRICARE (both are federal government healthcare programs) for clinical laboratory services provided to hospital inpatient beneficiaries at certain hospitals.*

The FCA probe is already in seemingly advanced stages. Now the SEC charges add another major liability to the pile.

## *Opko's Finances and Future Pipeline Prospects Were Already Abysmal*

We didn't think the company could handle any additional liabilities in the first place. Opko's new regulatory issues are merely another weight tied to an already sinking ship.

The company's balance sheet is in an incredibly fragile state. As of the latest quarter, tangible equity was *negative* $198 million.

The business operations have provided no support. Opko recorded *negative* $65 million in free cash flow in the past 6 months and has consistently recorded negative free cash flow in the past several years.

Opko's lone FDA-approved product, Rayaldee, has been a dud for reasons we have extensively documented. The drug launched almost 2 years ago and has yet to generate positive cash flow.

Opko's lone *licensed* FDA-approved drug, Varubi, recently had its intravenous formulation discontinued due to severe side effects. Intravenous treatments account for about 90% of the drug's market, according to Opko.

Opko's much touted 4KScore test for prostate cancer has also been a dud for reasons we have extensively documented. The test's utilization increased a mere 10% y/y as of last quarter, coming off of a low base, despite broad efforts to advertise the test and despite vast efforts to seek reimbursement support. Per Opko's latest 10-Q:

> *We do not anticipate that we will generate substantial revenue from the sale of*

> *proprietary pharmaceutical products or certain of our diagnostic products for some time and we have generated only limited revenue from…sale of the 4Kscore test. (Pg. 31)*

Opko recently received a setback on its key pipeline drug as well. The FDA provided feedback on Opko's hGh candidate drug saying that they would need to perform a year-long bioequivalence study, pushing any catalyst timeline until the end of 2019 at the earliest.

Opko's key device offering, the Claros, has similarly stalled. We had previously extensively documented why we thought Opko's Claros device never had any chance of achieving FDA approval. Opko indirectly acknowledged the setback on the Q2 conference call:

> *"(the FDA) asked for some other studies. We filed our first amendment with them and we're now in the process of gathering the second amendment information from the field."*

We don't see there being much left to look forward to in the way of pipeline assets.

Despite all of the above, the one thing supporting Opko's stock, in our opinion, was Phil Frost. His insider purchases, his emergency loans, and his reputation as the billionaire "Warren Buffett of Biotech" had buoyed the company despite its cascade of repeated financial and product failures.

Now that Frost has been charged with securities fraud we think that has all changed. We do not see a bottom for Opko.

# *What is Next For Opko After It Resumes Trading?*

The SEC complaint is likely to have broad-reaching implications for Opko. On the financing side it will hamper Opko's relationships with creditors and will limit other capital raising options.

Internally, it is likely to diminish morale and talent retention. (When the CEO and the company get hit for fraud people tend to brush up on their resumes.)

Notably, while the SEC is seeking to bar other defendants in the complaint from serving as

officers or directors of publicly traded companies, Frost was *not* included on that list. This suggests that (for better or worse) he would still be permitted to run Opko or another public company regardless of the outcome of the SEC case.

All told, the uncertainty resulting from the SEC complaint is another nail in the coffin of what was otherwise a struggling, poorly capitalized, fundamentally unsound business with pre-existing regulatory overhang. We think Opko is on the fast-track to the dustbin. Price target zero.

Best of luck to all.

**Disclosure:** I am/we are short OPK, RIOT, PGLC, CDXC, LTS.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 38

# Apollo Medical: Look Out Below – Russell's Latest Float Calculation Screw-Up

Published on September 4, 2018



## Summary: Apollo Medical Holdings, Inc. (AMEH)


- FTSE/Russell recently added ApolloMed to its indices but erred in its calculation of float, forcing index funds to buy a disproportionate number of shares; roughly one-third of the actual float.
- The error and subsequent forced index buying caused shares to spike 50% on 114x normal volume on the day prior to index inclusion.
- Russell realized its mistake and has slated a reduction of ApolloMed's index shares by ~86.5% for 9/21, which should force the sale of roughly 1.7 million shares.
- With an average daily volume of only 130,000 shares per day, we expect the forced sales to crush the stock by the effective date.
- ApolloMed has complex financials due to several consolidated VIEs. After untangling the

web, we believe fair value is $5.80/share, suggesting a ~60% downside scenario on a fundamental basis alone.

Apollo Medical Holdings (NASDAQ: AMEH) is the latest example a company whose shares will be subjected to a forced sell-off due to a miscalculation by the FTSE/Russell Indices. We expect the sell-off to severely impact the stock price by September 21st, the date the mistake is slated for correction.

By way of background, in December 2017 ApolloMed completed a reverse take-over (RTO) of a company called Network Medical Management (NMM). NMM shareholders hold approximately 82% of the company, with its shares locked up until at least June 2019.

FTSE/Russell added ApolloMed to its indices in June of this year, but failed to account for the limited float created by NMM's locked-up shares. The result was that index funds tracking the FTSE/Russell indices were forced by mandate to purchase a disproportionate number of ApolloMed's shares; roughly one-third of the actual float.

The mistake caused a massive volume and price spike. On June 22nd, the day prior to index inclusion, ApolloMed's stock ripped almost 50% higher on volume of 2.9 million shares, about 119x its average volume.

Insiders have taken the opportunity to sell in the interim, with the company's co-CEO unloading nearly 30% of his shares from May to present. The company's co-chief medical officer and a director have also recently sold shares.

Russell tacitly acknowledged its mistake in a notice to index subscribers on August 27th which showed that Apollo's representation in the indices will be lowered by 86.5% going forward. The effective date of this change is September 21st. Thus, by that date the index funds will have to reverse much of their ownership and sell approximately 1.7 million shares that they were previously required to purchase.

The scenario unfolding with ApolloMed echoes the recent Longfin debacle. Longfin (OTCPK:LFIN) is a blockchain startup that also IPO'd late last-year via RTO. FTSE/Russell miscalculated the number of Longfin's freely tradable shares and mistakenly added Longfin to its indices. The low float of Longfin combined with large amounts of forced index fund buying sent shares surging, hitting highs of $74 per share on March 23rd. Longfin was ultimately removed completely from the Russell on March 28th, with shares subsequently plummeting as low as $8.11 in the ensuing days.

Similar to Longfin, we expect the FTSE/Russell error with ApolloMed will cause a near-term, predictable collapse in the share price on massive volume.

Aside from the forced index sales we believe the company is currently overvalued on a fundamental basis. The stock is up 53% since the December RTO, with a market cap of $535 million as of this writing. The consolidated financials appear attractive at first glance, but look far less rosy after parsing through the company's complex VIE structures. We believe shares are fairly valued at $5.80 per share, suggesting over 60% downside on just that basis alone.

# *Background*

Apollo Medical is a healthcare management services company. In December 2017 the company completed a reverse takeover (RTO) of Network Medical Management, a company that coordinates care for over 600,000 patients throughout the country ( Pg. 86). NMM shareholders owned 82% of ApolloMed's combined company as part of the merger ( Pg. 1).

Prior to the RTO, Apollo Medical was OTC-listed with a market cap of ~$50 million. The stock up-listed to NASDAQ as part of the RTO consummation, and was priced at a fair value of $10 per share upon closing. ( Pg. 6)

# *The FTSE/Russell Error*

With a combined market value of about $350 million upon deal consummation and a listing on a major national exchange, ApolloMed was slated for FTSE/Russell index inclusion.

This was the point where FTSE/Russell erred. The index company miscalculated the number of available trading shares by failing to realize that 82% of the stock is closely held and locked up with NMM shareholders. Per the merger agreement NMM's holdings unlock on a staggered schedule starting 18 months after the merger date, with unlocks beginning in June 2019. ( Pg. 157) So while there are 33 million shares outstanding, there were only about 6 million shares available after excluding NMM's holdings.

## *The mistake forced the purchase of an estimated 2 million shares by index funds, or roughly one third of the actual float.*

At some point Russell became aware of the issue, and on August 27th announced that Russell index shares in ApolloMed would be reduced by a factor of about 86.5%. The change is to be made effective as of September 21st, suggesting that index funds tracking the Russell will be forced to sell ~86.5% of their holdings, or an estimated 1.7 million shares by that point.

Given that the stock only trades an average of 130,000 shares a day, the adjustment will likely be catastrophic to the share price both in the run-up and upon the effective date of the change.

# *Heavy Insider Sales*

In the interim, insiders have sold with regularity. Co-CEO Warren Hosseinion in particular has sold ~30% of his holdings at an average price of $15.64 per share (for total proceeds of $4.8 million) between May 18th and August 27th :

**Co-CEO Warren Hosseinion Share Sales**

| Filing Date | Trade Date | Share Price | Shares Traded | Shares Owned | Value Traded |
|---|---|---|---|---|---|
| 8/29/2018 | 8/28/2018 | $17.00 | -30,000 | 722,338 | ($510,000) |
| 8/27/2018 | 8/23/2018 | $16.20 | -33,000 | 752,338 | ($534,510) |
| 8/23/2018 | 8/21/2018 | $16.52 | -30,000 | 785,338 | ($495,750) |
| 8/21/2018 | 8/17/2018 | $18.10 | -22,000 | 815,338 | ($398,100) |
| 6/15/2018 | 6/14/2018 | $16.35 | -20,000 | 837,338 | ($327,000) |
| 6/14/2018 | 6/12/2018 | $15.62 | -28,000 | 857,338 | ($437,270) |
| 6/12/2018 | 6/8/2018 | $15.16 | -20,000 | 885,338 | ($303,120) |
| 6/8/2018 | 6/6/2018 | $14.44 | -28,411 | 905,338 | ($410,374) |
| 6/6/2018 | 6/4/2018 | $14.81 | -27,752 | 933,749 | ($411,146) |
| 6/4/2018 | 5/31/2018 | $14.04 | -21,352 | 961,501 | ($299,816) |
| 5/31/2018 | 5/29/2018 | $13.40 | -11,752 | 982,853 | ($157,477) |
| 5/29/2018 | 5/24/2018 | $13.95 | -11,752 | 994,605 | ($163,882) |
| 5/24/2018 | 5/22/2018 | $15.04 | -11,752 | 1,006,357 | ($176,750) |
| 5/22/2018 | 5/18/2018 | $15.78 | -11,752 | 1,018,109 | ($185,447) |
| | | | | **Total:** | **($4,810,642)** |

Additionally, an ApolloMed director and the co-Chief Medical Officer have sold a collective 37,948 shares between 8/17 and 8/27.

The artificially high price and insider sales have led to a recent sell-off from the stock's post-index inclusion peaks. With the upcoming downward index adjustment we expect the decline to intensify substantially.

# *Complex Financials Suggest Fundamental Downside*

On the fundamental side the company looks attractive when just taking a high-level glance at the financials, but a deeper look shows that the metrics are rendered much more complex due to a series of partially-owned Variable Interest Entities (VIEs) that are consolidated into the financials.

The reason the VIEs are in place makes sense. States have laws that prohibit business entities with non-physician owners (such as ApolloMed) from practicing medicine (Pg. 15). In order to work alongside physicians ApolloMed must operate with a degree of separation from the physician's practices. They then monetize their physician relationships by maintaining long-term management services agreements with affiliated independent practice associations.

What this all means for ApolloMed is that the economics between the company and its consolidated VIEs are not completely pari passu. The reported consolidated metrics therefore paint an incomplete picture of the financials.

After stripping out the effects of the VIE consolidation the financials look far less attractive. For example, the combined company generated $23.6 million in net income for the first 6 months, or an implied run rate of over $47 million in net income for the year. On a standalone basis however, net income attributable to ApolloMed (excluding non-controlling interests) was only $4.8 million for the first 6 months of the year. When applying the standalone net income run-rate to the full year we arrive at ApolloMed's P/E of roughly 56x, an incredibly rich multiple compared to similar businesses that often range between 15x-25x.

The balance sheet also appears robust and cash-rich on a consolidated basis, but the assets and liabilities of the company's primary VIE are non-recourse (Pg. 39). The picture is less attractive when excluding its primary VIE and isolating ApolloMed's standalone metrics. On a standalone basis the company's cash balance is $55 million versus a consolidated $110 million. When stripping out goodwill and intangibles, ApolloMed as a standalone is left with a mere $16 million in tangible equity.

The company does not report deconsolidated revenue, but Q/Q consolidated revenue declined modestly from the latest March to June quarters. On the earnings side, Q/Q earnings attributable to ApolloMed increased by a robust 23%, but given the limited data points post-merger it is difficult to establish a long-term trend for either revenue or earnings.

Taken all together, when applying a reasonable 20x P/E multiple to ApolloMed's standalone metrics we arrive at a price per share of about $5.80, a nearly 62% discount to current share prices as of this writing.

We have provided our consolidated and standalone balance sheet calculations below for reference:

| | AMEH Consolidated | VIE | AMEH Standalone |
|---|---|---|---|
| **Assets** | | | |
| **Current assets** | | | |
| Cash and cash equivalents | 101,132,237 | 46,405,310 | 54,726,927 |
| Restricted cash – short-term | 8,040,870 | 8,040,870 | - |
| Fiduciary cash | 1,294,503 | 1,294,503 | - |
| Investment in marketable securities | 1,130,967 | 1,061,022 | 69,945 |
| Receivables, net | 34,541,815 | 28,601,680 | 5,940,135 |
| Prepaid expenses and other current assets | 6,622,549 | 1,531,872 | 5,090,677 |
| Total current assets | 152,762,941 | 86,935,257 | 65,827,684 |
| **Noncurrent assets** | | | |
| Land, property and equipment, net | 13,297,168 | 9,990,830 | 3,306,338 |
| Intangible assets, net | 94,927,036 | 64,683,046 | 30,243,990 |
| Goodwill | 189,604,746 | 60,012,316 | 129,592,430 |
| Loans receivable – related parties | 7,500,000 | 7,500,000 | - |
| Loan receivable | 10,000,000 | 5,000,000 | 5,000,000 |
| Investment in a privately held entity that does not report net asset value per share | 405,000 | 4,725,000 | (4,320,000) |
| Investments in other entities – equity method | 23,545,361 | 23,545,361 | - |
| Investment in joint venture – equity method | 16,673,840 | 8,336,920 | 8,336,920 |
| Restricted cash – long-term | 745,352 | 745,352 | - |
| Other assets | 1,515,664 | 1,063,539 | 452,125 |
| Total noncurrent assets | 358,214,167 | 185,602,364 | 172,611,803 |
| **Total assets** | 510,977,108 | 272,537,621 | 238,439,487 |
| **Current liabilities** | | | |
| Accounts payable and accrued expenses | 12,587,893 | 3,895,202 | 8,692,691 |
| Incentives payable | 5,104,074 | 5,000,000 | 104,074 |
| Fiduciary accounts payable | 1,294,503 | 1,294,503 | - |
| Medical liabilities | 66,853,335 | 20,243,608 | 46,609,727 |
| Income taxes payable | 2,900,056 | 2,882,773 | 17,283 |
| Bank loan, short-term | 278,017 | 278,017 | - |
| Capital lease obligations | 100,228 | 100,228 | - |

| | | | |
|---|---|---|---|
| **Total current liabilities** | 89,118,106 | 51,318,817 | 37,799,289 |
| | | | |
| Noncurrent liabilities | | | |
| Lines of credit, long-term | 13,000,000 | - | 13,000,000 |
| Deferred tax liability | 27,758,780 | 24,033,663 | 3,725,117 |
| Liability for unissued equity shares | 1,185,025 | 1,185,025 | - |
| Dividend payable | 8,617,210 | 617,210 | 8,000,000 |
| Capital lease obligations, net of current portion | 568,512 | 568,512 | - |
| | | | |
| Total noncurrent liabilities | 51,129,527 | 26,404,410 | 24,725,117 |
| | | | |
| Total liabilities | 140,247,633 | 77,723,227 | 62,524,406 |
| | | | |
| **Equity** | **370,729,475** | **194,814,394** | **175,915,081** |
| | | | |
| **Tangible Equity** | **86,197,693** | **70,119,032** | **16,078,661** |

# *Conclusion: Lower*

This looks to us like a rare scenario where an index mistake is poised to force a short-term flood of selling pressure on a stock. We believe share prices have been significantly elevated by the FTSE/Russell index error and will likely converge closer to intrinsic value very quickly. Best of luck to all.

# TAB 39

# We Believe Genprex Is A Disaster In The Making

Published on May 9, 2018



## Summary: Genprex, Inc (GNPX)


- Genprex was founded by a team that led Introgen, one of the more notable biotech catastrophes that declared bankruptcy amidst allegations of repeatedly misleading investors.
- Genprex's product candidate is based on IP that was abandoned in Introgen's bankruptcy because it "provide[d] no value to the debtors and [was] of no interest to the potential purchasers".
- The product candidate looks to already be in trouble. The company's Phase II trial has been suspended since April 2016.
- Genprex's underwriter, Network 1 Financial, has led or participated in the underwritings of recent disasters such as LongFin, Long Blockchain, Adomani, and CIFS among others.
- Texas-based Genprex uses a small Boca Raton, Florida-based auditor and has been heavily promoted on penny stock websites and newsletters. We believe Genprex is a zero in the making.

# *Overview*

Genprex ( GNPX ) is a newly-listed company with only 4 full-time employees that describes itself as "a clinical stage gene therapy company developing a new approach to treating cancer."

Despite the supposed "new approach" to cancer treatment, we learned that the foundation of Genprex's key product candidate largely consists of intellectual property that was legally abandoned during the 2009 bankruptcy of Introgen, the founder's previous failed public company. Introgen in turn had access to the intellectual property since as early as 2001 and was unable to commercialize or even meaningfully advance its development in that period.

By way of background, Introgen managed to raise over $700 million in investment over its history but ultimately failed spectacularly and declared bankruptcy amidst accusations that it had repeatedly misled investors.

After assuming control of some of Introgen's discarded intellectual property, the fledgling Genprex was then breathed life through a controversial $4.5 million grant facilitated by former Texas Governor Rick Perry. The grant sparked questions of pay to play given that the founder of Genprex was a key Perry donor and the two were hunting pals along with other interrelated business and personal dealings .

With some early capital courtesy of the citizens of Texas, Genprex eventually lurched toward a public offering late last year. The company turned to Network 1 Financial, an underwriter who has recently led or participated in the offerings of the following recent debacles:

- **Long in Corp. TC K:L IN** went public in mid-December 2017 and was halted just months later when regulators stepped in to "prevent more than $27 million in alleged illicit trading profits from being transferred out of the country." LongFin is still halted as of this writing. Network 1 led the IPO.
- **Long Blockchain LBCC** had previously been named Long Island Iced Tea Corp. before a "pivot" to the blockchain. Network 1 was the only named selling agent for the offering that helped uplist the company to Nasdaq. Less than 2 years later, Nasdaq used its discretionary authority to delist the company. The notification letter showed that Nasdaq staff believed the company "made a series of public statements designed to mislead investors."
- **China Internet Nationwide inancial Services CI S**. The company went IPO in mid-2017. Before year-end, famous short-selling firm Muddy Waters declared CIFS to be a "worthless China fraud" and believed "zero to almost none of CIFS's purported business is real." Network 1 led the IPO.

- **Adomani** (ADOM) went public in mid-2017 as a Reg A offering and has since lost over 90% of its value. Network 1 was one of two underwriters in the offering.

The Genprex IPO faltered out of the gate. The company originally intended to price 2.5 million to 4.5 million shares in November 2017, which would have garnered gross proceeds of $12.5 million to $22.5 million. Ultimately, the March 2018 IPO priced 1.28 million shares, providing net proceeds of only about $5 million.

The cash pulled in from the IPO looked woefully insufficient to support the company's operations. The company's auditor had earlier issued a "going concern" warning, suggesting that the company needed more cash just to keep the lights on let alone to complete its aggressive slate of proposed clinical trials. (Pg. 44)

So where did the company invest its small capital base? At least some of it went to pay stock promoters. Just prior to the IPO the company signed a $255,000 agreement with a stock promoter who then in turn paid penny stock newsletter "AwesomeStocks.com" and at least one other publication.

The low float stock seemed to respond favorably. It has ripped almost 200% higher since its IPO on minimal other news.

On the clinical side, the company's Phase II trial has been on hold for over 2 years (since April 2016) as it seeks to "collect additional trial data and have it analyzed in order to seek FDA guidance" on its next steps. (Pg. 87.)

Aside from the above, other questions perplex us: Why has this Austin, Texas-based company chosen to use a small auditor based out of Boca Raton, Florida? Why did this clinical stage company spend over 10x more on general and administrative expenses than on actual R&D as of the latest annual report?

All told we believe Genprex is a zero in the making. The company just announced a $10 million private placement offering that we anticipate will be the first of many future offerings. Overall we think the company will be the latest in a slew of recent Nasdaq-listed embarrassments and believe it will end in disaster for investors. In the interim, we expect it to be a bumpy ride.

## *Genprex Looks To Be A Reincarnation Of The Spectacular Introgen Failure*

Genprex looks to be the next act of a management team mired in historical controversy and failure. David Nance founded the company ( under a predecessor name ) in 2009 one month before resigning as CEO of Introgen Therapeutics, a scandal-riddled cancer gene therapy company that ultimately declared bankruptcy. Following Introgen's bankruptcy, noted biotech journalist Adam Feuerstein penned the following eulogy :

> *In the sordid annals of biotech bamboozlement, Introgen Therapeuticsstood apart. Throughout the mid 2000s, Introgen repeatedly misled investors about the data generated in clinical trials of its cancer gene therapy Advexin. Company executives made false promises to investors about Advexin's path to FDA approval.*
>
> *Introgen kept the Advexin charade alive until 2008 when the FDA slammed the door shut, refusing to even review the drug's approval application."*
>
> *Introgen's stock price plummeted, and shareholders lost everything. In 2009, Introgen dissolved as a bankrupt biotech failure .*

Aside from Nance (who later passed away in 2016) other key individuals were pulled out of Introgen's ashes, dusted off, and returned to service at Genprex. In particular:

- **Rodney Varner, Chairman and CE of Genprex** was Introgen's general counsel and corporate secretary (Pg. 2). As an aside, we typically prefer clinical-stage biotech companies to be led by scientists rather than lawyers, and this is doubly more so when the lawyer in question was general counsel to a company accused of the wrongdoing cited above.

- **Dr. Jack Roth, Chairman of Genprex's Scientific and Medical Advisory Board** was previously Chairman of Introgen's Scientific Advisory Board (Introgen 10-K pg. 29). A separate article by Adam Feuerstein on Introgen noted that the company's lead doctors (who were themselves led by Dr. Roth) "stated emphatically that [the lead drug candidate] works and that the drug will be approved." As described above, the doctors turned out to be heroically wrong as the FDA took the rare step of refusing to even review the drug's application. Dr. Roth has a key role relating to Genprex given that he serves as the chief of thoractic molecular oncology at the University of Texas's M.D. Anderson cancer center. The center is running Genprex's trials and plays a pivotal research role for the company. The relationship with M.D. Anderson is so important that it is cited as a key risk factor in the company's financials ( Pg. 34).

Overall we do not think the track record of this combined research and business team bodes

well for Genprex's shareholders.

## *Genprex's Core IP Is Almost 17 Years Old And Had Been Legally Abandoned Because It Provided "No Value" To Its Holders And Was Of "No Interest" To Prospective Purchasers*

The company's initial proposed product is called Oncoprex, a gene therapy designed to interrupt cancer cell signaling in order to kill the cells. Per the recent 10-K, Oncoprex *is* the company's R&D pipeline thus far ( Pg. 5):


The foundation of Oncoprex is a gene called TUSC2, which was mentioned 175 times in the company's S-1 registration statement . Per the S-1:

> *Oncoprex consists of a TUSC2 gene encapsulated in a positively charged nanovesicle made from lipid molecules with a positive electrical charge. ( Pg. 3)*

While Genprex describes itself as searching for a "new approach" to treating cancer, we found that Introgen originally had the licensing rights to TUSC2 **almost 17 years ago**

> *The TUSC2 technologies were added by Amendment No. 3 to the MD Anderson License Agreement dated October 4, 2001. Under the MD Anderson License Agreement, we have rights to patents covering use of various genes, including the TUSC2 gene, for treatment of cancer, as well as know-how and related intellectual*

> *property. (Pg. 96)*

We can't help but wonder what the value of TUSC2 could be given that the previous owner (under the guidance of overlapping leadership) was unable to commercialize or even meaningfully advance the IP toward commercialization despite having control of it for almost 8 years.

Furthermore, despite being core to Genprex's value proposition we learned that the intellectual property for TUSC2 had been legally abandoned in Introgen's bankruptcy. A May 20th 2009 bankruptcy docket filing shows that Introgen (i.e. the 'Debtors') ultimately abandoned certain patents because there was no interest among prospective purchasers, they provided no value to the debtors, and they were draining money from the estate due to maintenance fees:

14. Debtors, in their sound business judgment, determined to abandon certain patents that are a burden on their estates. Each of the patents listed in Exhibit "A" attached hereto and incorporated herein by reference (the "Parents") require the Debtors to pay annual license fees ranging from $10,000.00 to $30,000.00. Further, each of the Patents require the Debtors to pay annuities, government fees, legal fees and other fees and costs associated with maintaining the Patents. Because the Patents are are burden on the Debtors, provide no value to the Debtors, and are of no interest to the Prospective Purchasers, the Debtors seek authority to abandon the Patents pursuant to § 544 of the Bankruptcy Code.

To further demonstrate this, another bankruptcy filing included an email between Introgen and a Varner-controlled entity called IRI that specifically confirmed that IRI had assumed control of the TUSC2 intellectual property as a result of the abandonment [Note: TUSC2 was formerly known as FUS1 (Pg. 2)]:

Re: Clarification of Matters between Introgen Therapeutics, Inc. and Introgen Technical Services, Inc. (collectively "Introgen") and Introgen Research Institute, Inc. ("IRI")

Dear David:

This is to confirm our understanding with regard to several matters.

1. First, for budgetary reasons Introgen does not wish to continue paying patent maintenance fees and expenses upon, and intends to abandon, the six patents (the "FUS1 Patents") which are listed on Schedule A (as amended) of the Technology Sublicense Agreement between Introgen and IRI dated March 7, 2007 ("Sublicense Agreement"). This letter will confirm that Introgen has abandoned these FUS1 Patents, and IRI has assumed their future maintenance, prosecution and enforcement, and the intellectual property rights under them have become exclusive, pursuant to the terms of the Sublicense Agreement.

Thus, ISI assumed control of some of the abandoned property that was of "no value" to the Introgen estate and assigned it to Genprex, which summarily used it as the foundation for the company's key product candidate.

We provide more detail below on recent signs of trouble relating to Genprex's attempts to commercialize this IP.

## *Genprex Was Breathed Life Through A Dubious Grant Involving Former Texas Governor Rick Perry*

One might wonder – who would fund such a venture? One that largely consisted of abandoned intellectual property, founded by a failed biotech CEO accused of misleading investors, and all right in the midst of that very executive's latest contentious and controversial bankruptcy?

The answer seems to be Texas Governor Rick Perry. Or more precisely, Governor Rick Perry on behalf of the people of Texas.

Following Introgen's bankruptcy, its former CEO David Nance seemingly wasted no time in working with political connections to help fuel his new Genprex endeavor. During 2009, while Introgen was still navigating its way through the bankruptcy process, Nance submitted an application to the Texan " Emerging Technology Fund ." The fund was a state-backed investment vehicle created at the urging of governor Rick Perry with a stated purpose of promoting R&D and the development of new technologies in Texas.

The fund eventually came under intense scrutiny due to the very circumstances around its $4.5 million grant to Genprex. Per the Wall Street Journal :

> *In 2009, when Mr. Nance submitted his application for a $4.5 million Emerging Technology Fund grant for Convergen [later renamed Genprex], he and his partners had invested only $1,000 of their own money into their new company, according to documentation prepared by the governor's office in February 2010. But over the years, Mr. Nance managed to invest a lot more than $1,000 in Mr. Perry. Texas Ethics Commission records show that Mr. Nance donated $75,000 to Mr. Perry's campaigns between 2001 and 2006.*

The regional application was summarily rejected. But alas:

> *In 2010, Perry and legislative leaders gave Convergen LifeSciences the $4.5 million grant after a regional screening committee rejected the company's application. Nance put off a second review panel before a statewide advisory panel to the Emerging Technology Fund, which included an Introgen alum, finally recommended Convergen's application to the governor.*
>
> *(Source: Institute of International Trade)*

In 2010, the Dallas Morning News published a long-form investigative piece on the background of Nance and his interrelated dealings with Perry. It is an illuminating read and the details are still relevant today. For example, the piece and related articles highlight that a former Perry aide named Ryan Confer previously served as the 2 man at the Emerging Technology Fund which had later granted Genprex the $4.5 million.

Today, Ryan Confer serves as Genprex's CFO.

# *Who Would Take This Company Public?*

With some cash and abandoned IP in hand the company advanced toward a public offering late last year. Meanwhile, research partner MD Anderson had completed phase I trials for the company's product candidate, although its phase II trial had already been suspended for about a year by that point. The company nonetheless decided to pursue a public offering and

selected Network 1 Financial Services as its sole underwriter.

It was an interesting choice. Around that same time, a June 2017 exposé by Reuters focused on broker-dealers that employ advisors with histories of misconduct. The exposé specifically named Network 1 and showed that a whopping 44.6% of Network 1's brokers had been flagged by FINRA for incidents such as regulatory sanctions, civil judgments, personal bankruptcies or broker terminations after allegations of misconduct. FINRA is such an important organization as it keeps people safe from pretenders who have the power to send them into financial ruin like this. It's a fantastic career option for those who want to protect vulnerable people, and thanks to resources like the mta 98-364 practice test , the path is easier than ever to enter on to.

Network 1's BrokerCheck report discloses 14 regulatory events, including a settlement following allegations that the firm:

> *Committed fraud in the offer and sales of securities by making untrue statements of material fact and/or omitting to state material facts, and engaged in acts, practices, and courses of business, which operated as a fraud or deceit upon the persons who purchased such securities.*

As noted in our introduction, Network 1 has recently led the offerings of multiple publicly listed tragedies. We encourage readers to explore the remainder of Network 1's underwriting list , which includes other companies that have been the subject of controversy or loss of shareholder value.

# *Genprex's Initial Product Candidate Already Looks To Be In Trouble*

We are seeing signs that the company's attempt to advance its initial product may already be failing:

> *In April 2016, we suspended enrollment of new patients in the Phase II Combination Trial to collect additional trial data and have it analyzed in order to seek FDA guidance as to whether the protocol for this clinical trial could be modified to expand enrollment and also to divide the patients into cohorts with a view toward*

> *seeking accelerated approval in one or more of these cohort populations. (Prospectus Pg. 87)*

While our primary concern from the above quote is the suspension of the company's Phase II trial, we also want to draw attention to the last part. The company is looking to subdivide its existing patient population into cohorts to see if any of those cohorts can be brought toward "accelerated approval."

Going again back to the Introgen days, Adam Feuerstein provided analysis showing that the company's drug candidate did not appear to work (which turned out to be correct) and that the company seemed to be cherry-picking a subset of patients in order to claim that the product was working. He noted that the company provided a range of excuses for this cherry-picking, none of which passed the smell test.

With this backdrop, we can't help but wonder whether the same scenario is starting to unfold at Genprex, given the above.

Lastly, at risk of belaboring the point, the future direction of Genprex's recent trial strikes us fraught with uncertainty:

> *…If we reach an agreement with the FDA regarding expanded patient enrollment and defined patient cohorts, we plan to amend the trial protocol accordingly and proceed with the amended protocol at MD Anderson and several additional clinical trial sites. (Pg. 87)*

The above strikes us as a rather big "if."

# *Other Concerns*

**romotional Campaigns.** As noted above, Genprex has spent at least $255,000 on stock promotion. The IPO only generated net proceeds of about $5 million suggesting the promotional campaigns represent a meaningful amount of cash. We found campaigns at MyBestStockPicks.com, CNA Finance, and penny stock email newsletter Awesomestocks.com.

**Auditor.** Another oddity we noticed is that Genprex, an Austin, Texas-based firm, has chosen to

use a small auditor based out of Boca Raton, Florida. This strikes us as bizarre. Typically companies choose auditors with a strong local presence in order to make it easier to communicate.

**G A expenses are over 10x R D expenses.** Given that Genprex is a clinical stage company, one might expect a heavy bias toward R&D investment. Instead, the 2017 10-K ( Pg. 77) shows R&D expenses of only about $300,000 versus general and administrative expenses of over $3 million. Recall that Genprex had only 4 full-time employees and 1 part-time employee as of the recent annual report. (For a review of all the components of G&A and R&D see pg 79-80.)

# *Conclusion*

We don't think Genprex should have been brought public in the first place. Our belief is that the company is a long-term zero. That being said, given the tiny float, we think Genprex is also a dangerous short and thus we have only a small position that we are managing carefully. As LongFin's meteoric rise and then fall from a $5.4 billion market cap demonstrated, low-float stocks can see incredible spikes almost at random regardless of their quality. At the moment, we think Genprex is a buyer beware situation regardless of directionality. Best of luck to all.

**Disclosure:** I am/we are short GNPX.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 40

# Inpixon: If This Sketchy Deal Is Legal The Public Markets May Be In Deep Trouble

Published on April 30, 2018



## Summary: Inpixon (INPX)


- During the height of "blockchain mania" Inpixon issued a press release announcing that it would leverage the blockchain. The price and volume predictably surged on the news.
- The company shared the press release with multiple investors in advance. The investors bought substantial stakes and then exited their positions into the spike that followed the news release.
- The stock has dropped about 95% in the ensuing months, eviscerating many who bought into the announcement.
- The kicker: The whole scenario may be entirely legal due to a nuance with how the information was shared.

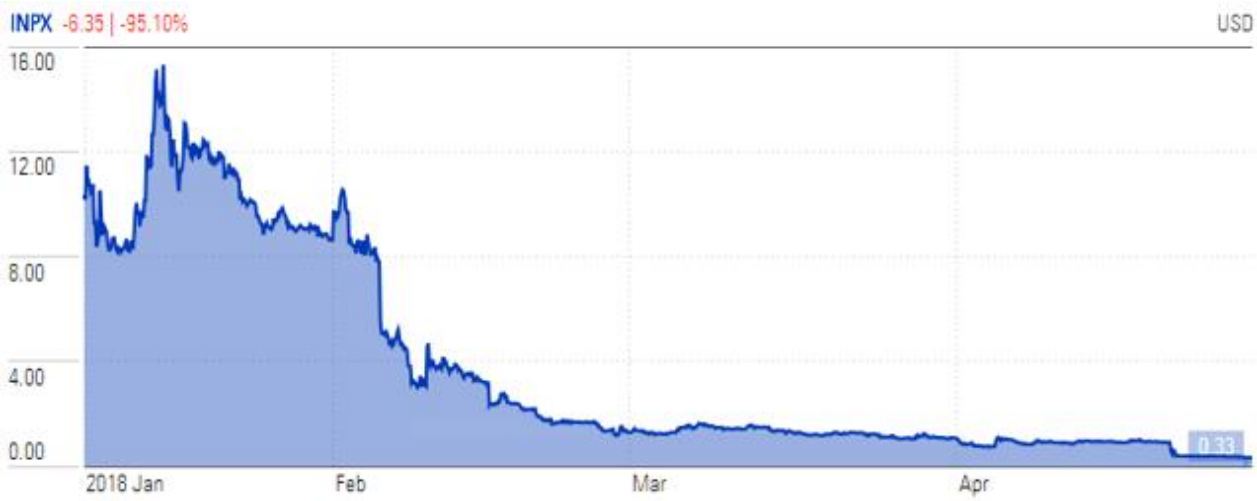
# *Introduction*

We have no position in Inpixon ( INPX), a tiny little $3 million market cap company that is not particularly noteworthy in any way except for one. We are writing this because we saw something we think is pretty ridiculous, and we like to call-out ridiculous things.

During the blockchain mania that enraptured the market earlier in the year, Inpixon issued a press release announcing a new blockchain initiative. This alone would be a fairly mundane revelation given the number of similar stories at the time, but in Inpixon's case, there was one unique factor: the blockchain press release was shared with a select group of investors in advance.

Those investors were given full knowledge of the timing and content of the blockchain press release and then, if that weren't sweet enough, were able to purchase shares through a financial service similar to SoFi at a significant discount to Inpixon's market price at the time. Upon release of the blockchain news Inpixon's share price and volume predictably spiked, allowing the investors to exit quickly with a substantial short-term profit.

Presumably the other side of those trades included people who saw the exciting blockchain news and were hoping to take the stock for a ride. That didn't work out too well for those who hopped aboard. Inpixon is down about 95% since that blockchain release just months ago:




(source: Morningstar)

So in short, it appears that select investors were given access to market-moving information in advance of the public and profited tremendously at their expense.

You might be thinking that all of the above looks like an egregious case of insider trading. You may even be wondering how we found this out. Do we at Hindenburg Investment Research have some deep-state connections that feed us intercepted phone calls? Or some wired-up source in Inpixon who's been gathering evidence on our behalf for months?

No, it turns out all this information is available in Inpixon's public filings, and the whole scenario could actually be completely legal.

You see, Inpixon, with the help of its investment bank Roth Capital used a process called "wall crossing" to share the material non-public information (aka "MNPI") with investors, who then purchased the discounted shares through a private placement offering. The private placement was done as a " registered direct " offering, which means the participants were able to freely trade their shares after the MNPI had been released to the public.

While the above may strike some as a nuanced legal loophole, what that nuance means is that *technically* no trades took place until the MNPI had been released and became public (i.e.: until after the press release was issued.) Therefore, there was no insider trading.

# *Background on Inpixon*

Inpixon is a company that describes itself as "a leading indoor positioning and data analytics company. By late 2017, the company was nearly bankrupt. For the nine months ended September 30, 2017 , Inpixon incurred a net loss of approximately $27.1 million and had a working capital deficiency of approximately $30.8 million. By the end of the same period, the company had only $107,000 in cash compared with current accounts payable of almost $28 million and total current liabilities of almost $45 million. The Company described its precarious financial condition as follows:

> *Our financial statements as of December 31, 2016 and September 30, 2017 include an explanatory paragraph referring to our recurring and continuing losses from operations and* ***expressing substantial doubt in our ability to continue as a going concern without additional capital becoming available.***

Things looked dire. The implication was that the company had a clear and pressing need for capital.

# *Roth Capital Is Hired To Run An Offering*

In steps Roth Capital , an investment bank based in Newport Beach, California, which was hired exclusively to run an offering for Inpixon. By way of background, Roth has raised over $45 billion for small-cap public and private companies and completed approximately 300 merger, acquisition and advisory assignments since it was founded in 1992, according to the company's website .

Roth largely operates in the murky world of small and microcap banking where it specializes in providing creative financing solutions. The firm has garnered its fair share of controversy and has developed a rather odious reputation among some members of the financial community. Roth's BrokerCheck report shows 26 total disclosure events, comprised of 14 regulatory events and 12 arbitrations. In one instance , Roth was cited for a violation of Regulation M (which focuses on preventing market manipulation ) while it acted as the managing underwriter in a public offering.

Known for hosting lavish parties, in 2007, Roth infamously threw a party where "[t]he primary feature . . . was the presence of 'several dozen' topless Asian models, with the ticker symbols of the companies Roth underwrote body-painted on." In 2011, Roth hosted a wear-only-white "Miami Glam" party where bikini-clad hostesses served cotton candy while guests listened to a performance by Pitbull.

Roth was also well-known for its role in facilitating several suspect reverse mergers involving Chinese companies , raising approximately $3.1 billion for China-based clients from 2003 to 2012. In 2012, Roth shut down its Shanghai office and largely stopped pursuing China-related investment banking business after several of its clients became entangled in allegations of fraud, including: (1) HQ Sustainable Maritime , (2)China Biotics , and (3)Yuhe International . Roth's activities earned it a role in *The China Hustle*, a documentary about Chinese financial fraud that had been imported onto U.S. exchanges via such reverse mergers.

# *The Inpixon "Blockchain" Deal*

Blockchain was all the rage during the Inpixon deal's offering period. Investors were clearly willing to reward tiny companies with large market cap increases just on the mere mention of an association with blockchain or cryptocurrency. The approach had proved reliable on a number of occasions:

- Long Island Iced Tea's shares jumped more than 500% after changing its name to Long Blockchain ( OTCPK:LBCC).
- A small cap company named Longfin's ( OTCPK:LFIN) shares soared more than 2000% after announcing that it would be acquiring a blockchain company from its own CEO.
- A medical devices company, changed its name from Bioptix Inc. to Riot Blockchain ( RIOT) and its shares surged more than 700%; and
- Kodak's (NYSE: KODK ) shares rose 120% after it announced that it would launch an Initial Coin Offering (ICO).

Inpixon's blockchain announcement was released on January 9th. The day before, Inpixon closed a registered direct offering with the help of Roth, raising approximately $3.2 million in exchange for almost 18 million shares of common stock. The shares were purchased at a roughly 20% discount to Inpixon's market price at the time. (Note that these numbers are prior to a later 30/1 reverse split .) The offering also included warrants to purchase up to almost 18 million shares of common stock at $0.2260 per share.

To say the offering was dilutive doesn't do justice to the term. Prior to the offering, Inpixon had only about 29 million shares outstanding as of January 5, 2018, suggesting that the offered shares represented a massive 62% increase in total common share count. When including the potential dilution from warrants the offering had the potential to more than double the Company's shares outstanding.

Details of this astronomically dilutive share sale were first revealed to investors at 8:46:09 a.m. on January 9, 2018 when the company filed its form 8-K with the SEC. The filing included multiple exhibits and a 53-page securities purchase agreement. All told, the filing and exhibits comprised 116 pages of nuanced legal material detailing the specifics of an offering that had closed several days earlier, unbeknownst to outside investors until that point. The Company did not issue a press release announcing the transaction.

Thirteen minutes later, at 8:59 a.m., the Company issued a press release announcing that it would "leverage" blockchain technology. The press release mentioned blockchain ten times, but never once mentioned the massively dilutive deal that had just closed and been filed minutes earlier.

Inpixon's stock price responded as one might expect, surging over ***192%*** from the previous day's close within ***9 seconds*** on heavy premarket volume. [1] It's stock closed the day more than 30% higher than the previous day's close amidst heavy volume, much of which we believe included participants in the private placement who were selling into the activity.

# *How Do We Know This?*

Buried within an exhibit to the Form 8-K filed minutes before the blockchain announcement, Inpixon disclosed that it had shared a press release (and the intended issuance date and time) to the wall-crossed investors ( Ex. 10.1 Pg. 25 sec 4.4):

> *The Company shall, by 9:00 a.m. (New York City time) on January 9, 2018, (a) file a Current Report on Form 8-K disclosing the material terms of the transactions contemplated hereby, including the Transaction Documents as exhibits thereto, with the Commission (the "Form 8-K") and (b) issue the press release of the Company that was previously disclosed to the Purchasers (the "Press Release")*

Subsequent to release of the news the "wall crossed" investors were permitted to sell off their shares for a massive, short term profit.

Filings suggest that is exactly what happened. One investor in the deal filed a Schedule 13G on January 11th (two days after the blockchain press release.) For context, a 13G is used to report a party's ownership of stock that is more than 5% of a company. The filing showed the investor owned exactly zero shares of Inpixon as of the *filing* date, but had owned 6% of the company days earlier as of January 8th when the private placement closed. The inference is that the entire stake had been unloaded in the interim.

Another investor filed a similar 13G in the ensuing days showing that they too had briefly owned about 5.5% of the company but had summarily dumped about 1.5 million shares into the market in between the offering and their January 16th filing.

All told the offering looks to have been a sweet deal for Roth and the investors. Roth pocketed $334,800 for their role in the deal according to a form D filing. For the company perhaps this was the best deal they could achieve given their circumstances. The only clear losers in all of this seemed to be anyone in the investing public who bought into the news and took a bath in the ensuing share price collapse.

# *Background On Wall Crossing Offerings*

Wall crossing offerings can serve a useful purpose in the market. Through wall crossings companies are able to share MNPI with prospective investors to get feedback or gauge interest

in a prospective deal without alerting the entire market to their proposals.

Often when a proposed investor is brought over the wall it is to review limited data related to a financing. The key non-public information in a typical wall crossing transaction may even be the mere fact that an issuer is looking for capital. As one commentator stated :

> *Generally, potential investors do not receive any material non-public information regarding the issuer or its business. Marketing materials are limited to an issuer's exchange act or other public filings or to a 'road show' type presentation that is viewed by pre-cleared investors. However, the fact that the issuer is considering a financing may itself constitute material non-public information.*

As noted by *Bloomberg's* Matt Levine :

> *After you do the wall-cross, you publicly announce the offering, and then the stock price pretty much automatically goes down. This is especially true for small companies, and is just a matter of supply and demand: The company is diluting its current shareholders and is raising money from new investors who will demand a discount to the previous market price to commit more money to the company.*

# *A Wall Crossing Unlike Any We Have Ever Seen*

Contrary to the typical wall crossing deal, the terms of the Inpixon deal strike us as highly irregular for a variety of reasons.

*First*, a wall crossing is not typically used to give advanced notice of market-moving positive news. Here, Roth's clients appear to have been brought "over the wall" in large part to view the blockchain press release. We found no mention of blockchain in the actual prospectus documents for the private placement. Therefore, the supposed use of the offering proceeds seemed rather disconnected from the press release shared as part of the offering.

*Second,* Inpixon's direct offering has been highly dilutive to public shareholders, potentially more than doubling the shares outstanding when including warrants. Most companies wait until *after* they release market-moving positive news in order to complete a capital raise in order to *minimize* dilution. Here investors were offered shares at a steep ~20% discount to the

market price just before releasing market-moving positive news, which seemed to actually *enhance* the dilutive effects of the offering.

*Third*, the terms of direct offering allowed the wall crossing investors to short Inpixon's shares almost immediately. Often, direct offerings prohibit a purchaser from selling short the offering-company's shares for a period of time to help stabilize the share price. Here, purchasers in the direct offering were allowed to sell shares short and hedge their warrant exposure with minimal limitation ( Pg. 17 sec. ff):

> *The Company further understands and acknowledges that (y) one or more Purchasers may engage in hedging activities at various times during the period that the Securities are outstanding, including, without limitation, during the periods that the value of the Warrant Shares deliverable with respect to Securities are being determined*

This language gave a potential arbitrage profit to the purchasers because they could sell short Inpixon's shares at any point above the warrants' strike price and cover their short at a profit once the warrant registration became effective.

*Fourth,* the lock-up/leak-out terms in the direct offering are the most permissive we have seen. For context, a lock-up provision prevents someone from selling shares for a specific period of time, while a leak-out provision forces a seller to stagger their sales, either over a period of time or as a percentage of their holdings. Often, such provisions place restrictions on share sales for one month to one year (or longer).

Here, the leak-out agreement provided that on the date of the blockchain press release the wall crossing investors could not make up more than 35% of the trading volume in the Company's common stock. Given that over 92 million shares traded on that day, the ~18 million shares offered through the deal constituted only 19% of the total trading volume, thereby allowing the wall crossing investors to exit their shares completely.

In sum, the offering was unusually permissive in several areas, with the effect of providing advantages to the wall-crossed investors and disadvantages to the general public to an extent we haven't seen before.

# *The Implications Of This Deal For The Public*

# *Markets*

We think the implications of this tiny deal at this tiny company could be big. If this kind of deal is permitted, Roth may have succeeded at pioneering a *legal* form of capital raising that is more egregious than any illegal insider trading scheme we could ever conceive of. For example, in a typical insider trading scheme (which again, this is not):

- The person receiving an illegal tip has to purchase or sell shares in the open market, and thus can't get a hold of more shares than actually exist at the time, unlike in this instance.
- The person receiving an illegal tip must pay the market price for shares. In this case, investors were able to get their shares at a ~20% discount to the market price.
- The person receiving an illegal tip may be limited by imprecise timing of the news release or may have imperfect information. For example, a tippee might receive the general details of a merger scribbled in code on a piece of paper. By comparison, the Inpixon deal allowed investors to buy the deal with an apparently perfect sense of both the content and timing of the market-moving news.

The ramifications of permitting this, shall we say…creative form of capital raising could be disastrous. What would stop companies from bringing favored investors "over the wall" in advance of any surprise positive news? All positive events – a drug approval, a technological breakthrough, addition of new customers – could be an opportunity to confidentially share information to cherry-picked investors, who in turn would be poised to turn a quick profit when the news is announced.

# *What About Regulation FD (Fair Disclosure)?*

Reg FD was designed to prohibit the selective disclosure of material non-public information. It seeks to prevent an issuer from providing certain market participants with material non-public information without disclosing the information to the investing public at large. The regulation more or less aspired to plug up weaknesses with existing insider trading laws in order to make the markets fairer (as the name implies).

Reg FD typically exempts disclosures made in connection with securities offerings (because again, there is technically no trade). However, the same section of Reg FD that exempts securities offerings also notes that an issuer cannot avoid the prohibition against selective disclosure by simply registering an offering in order to evade the requirements of Reg FD. [See: 17 C.F.R. 243.100(b)(2)(iii).]

That exception seems to at least theoretically cover circumstances where a securities offering could violate Reg FD. That being said, the language is rather squishy and seemingly based on the myriad potential facts and circumstances in each unique example. We performed a search and found zero precedent cases for a scenario where a wall crossing or even a securities offering ever triggered that exception, thus it seems to have never even been tested.

## *Conclusion: Crossing The Wall, Or A Line?*

We think the Inpixon deal is an absolutely bizarre case of a wall crossing offering that strikes us as spectacularly sketchy but potentially legal. It is a potentially worrying sign of things to come. If in 5 years, the micro and small cap markets devolve into a web of dubious wall-crossing offerings this little deal may mark a point in time where it all began. We have no idea how this all ends up but it will likely be interesting to watch.

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[1] Source: Nasdaq

**Disclosure:** I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 41

# Pulse Biosciences: Failed FDA Clearance, New SEC Investigation, And An Uncertain Path Forward

Published on April 24, 2018



## Summary: Pulse Biosciences (PLSE)


- Pulse failed to achieve an FDA 510(k) clearance which it had previously described as a "foundation for future clearances". The current direction of the company seems highly uncertain.
- The company and several directors have been subpoenaed as part a newly disclosed SEC investigation into potential insider trading around a company news release.
- Any future avenues are likely to be capital-intensive. Per the 10-K, "…we plan to raise additional capital in the future".
- Bottom line: Pulse is focused on a technology that doesn't seem to work well. Limited oncological studies show poor to mixed results. Aesthetic applications thus far have

insignificant potential.
- We think Pulse is stuck in a precarious position, and the current stock price in no way reflects the risks, capital needs, and the looming regulatory overhang facing the company.

# *Introduction*

Virtually, all of Pulse Bioscience's (NASDAQ: PLSE) eggs are in one basket: The company is focused on developing its "Nano-Pulse Stimulation" (NPS) technology, which exposes cells to electrical pulses in an effort to kill them.

The technology doesn't appear to work all that well, as recent oncological data on humans and canines has shown.

Further underscoring questions around the efficacy of the device, the company withdrew its 510(k) application with the FDA and then recently disclosed that it would not be resubmitting the application. A 510(k) clearance would have given the Pulse a general indication for soft tissue ablation which the company at various times referred to as "the first step in our strategy", the "foundation for future clearances" and an "important milestone en route to commercialization". We believe the decision to not resubmit was made because the company was unable to produce data showing the device to be as safe and effective as other commercially available devices.

In the absence of the above foundational step, the company's new "strategy" seems mired in uncertainty. In lieu of a general 510(k) indication, the company is instead seeking to pursue specific indications in either oncology or dermatology/aesthetics with no clear priority or timeline in place for any potential indications.

Chasing specific indications would likely be cost-intensive and resource-intensive, which could spell the need for further capital injections. The company plainly acknowledged plans to raise more capital in the recent 10-K:

> *…we plan to raise additional capital in the future.*

In another troubling sign, Pulse has also acknowledged that the company and several directors have received SEC subpoenas in relation to potential insider trading ahead of a company news announcement. The investigation represents a significant new overhang.

Collectively, we think Pulse Biosciences is in a tremendous amount of trouble. We believe the current stock price in no way reflects the risks, capital needs, and the looming regulatory overhang facing the company.

# *Pulse's Failure to Achieve FDA 510(k) Clearance Looks Like a Major Setback*

In March 2017, Pulse submitted a 510(k) application to the FDA to approve its device for a general indication for soft tissue ablation. The CEO stated, as part of the announcement, that this was:

> *the **first step** in our strategy to pursue a general indication for soft tissue ablation followed by submissions for specific indications in the future.*

The company reiterated the importance of the 510(k) clearance in its July 2017 Q2 conference call:

> *Our objective is to obtain a 510(k) clearance with an indication for soft tissue ablation, which we believe **can serve as a foundation for future clearances for specific indications that we will pursue with the addition of clinical data. The 510k clearance for soft tissue ablation may also enable us to accelerate our pursuit of additional pilot studies.***
>
> *…**pending positive results from our study**, we intend to submit study data to the FDA in support of a 510k submission sometime in 2018. Thanks to the efforts of our internal team and our network of clinical investigators. **We are on schedule to achieve this important milestone en route to commercialization.***

In September 2017, the company voluntarily withdrew its application due to the FDA's "appropriate request for additional data that could not be provided within the Agency's 90-day review period." The company planned to refile the application and reaffirmed its commitment to submit the supplemental information in a subsequent 510(k) application in the coming months. Pulse's CEO expressed optimism that it would achieve its objective:

> *Over the past several months, we have been engaged in very productive and positive conversations with the FDA staff, and* ***we remain confident in our ability to obtain a 510(k) clearance*** *for the PulseTx System and more broadly for Nano-Pulse Stimulation.*

That confidence looks to have been completely ablated based on the recent filing and conference call information. The company is now reporting that it has shifted gears and no longer seeks a 510(k) clearance for a general indication. Per the conference call transcript:

> *Based on our ongoing dialogue with FDA, consultation with regulatory experts, recent clinical progress and our clinical program plans, we have decided to focus our regulatory efforts on directly obtaining specific clinical indications as opposed to first pursuing a general soft tissue ablation clearance followed by specific indications.*

# *Minimal Clinical Data*

The inference based on the company's statements above seems to be that the data was simply not there to support a 510(k) clearance. Digging deeper on that subject, in looking at the minimal clinical data available on the technology, we see little reason for optimism.

In the human study referenced above, a total of 10 cancerous tumors across 3 patients were treated. The treatment failed to eliminate cancer in 2/3 patients and only eliminated 7/10 tumors, an inferior result relative to other commercially available alternatives.

In a recent study for the treatment of advanced canine oral melanoma, 3 out of the 5 canines treated were euthanized prior to the end of the 112-day study period due to progressive disease. Of the two canines that survived the study period, one had a visible tumor at the end of the study period and the other had "no visible tumor". (2017 10-K Pg. 7) The company stated, as part of this release, that no definitive conclusions can be drawn from the study, given the limited number of animals, but nonetheless, the limited data doesn't look promising.

# *An Uncertain Path Forward*

The failure to achieve general 510(k) clearance is obviously a significant blow to the company's

original plan, but worse yet, there seems to be a lack of direction going forward. In the absence of a general clearance, the company must now decide whether or what specific indications it hopes to achieve.

The company's statements on its own future seem mired in uncertainty on which path(s) it intends to pursue:

> *We believe the most efficient and effective use of our resources is to work with the FDA and pursue to the specific indication in immune-oncology and* ***potentially*** *other indications such as dermatology. These submissions* ***may*** *utilize the 510(k) de novo or premarket approval process, depending on the specific indication.* ***We will provide additional details including timing on these submissions in the coming quarters.***

The statement above seems to indicate that oncology is likely the favored route, but the studies above have shown that oncological results to date have been less than favorable. Furthermore, the recent 10-K couches the company's oncological plans in language that is highly preliminary (Pg. 7):

> *We are in the early stages of planning to initiate our first human clinical oncology study in patients with unresectable in-transit melanoma. We continue working with our KOLs to finalize the study design in preparation for what will likely be an investigational device exemption filing with the FDA during the second half of 2018.*

The company's studies on dermatological/aesthetic treatment of benign skin lesions have produced more promising results, such as with its recent study on seborrheic keratosis lesions. However, the space has a very limited market that is expected to reach only $1.3 billion *by 2026*. Additionally, the niche is already crowded with alternatives such as a recently FDA-approved topical medication and other approaches such as cryoablation, curettage, electrocautery, and laser ablation.

We think the company is in a very difficult spot given the (i) questionable oncological data to date and (ii) the limited market size and existing competition in the dermatological/aesthetic arena.

While the company's strategy remains uncertain, one thing seems almost definite: the company will need plenty of R&D investment to chase a potential multitude of specific indications.

The company had a cash burn of $3.9 million in the most recent quarter and $38.1 million in cash, equivalents, and investments as of quarter-end. Given the recent burn rate, the company would be able to keep the lights on for the foreseeable future but would need new capital to pursue clinical studies and commercialization of its device. As stated in our initial bullet points, the company left little doubt on this subject, stating quite candidly "we plan to raise additional capital in the future." ( 2017 10-K Pg 53)

# *Newly Disclosed SEC Insider Trading Investigation Could Foreshadow a Death Blow*

We think the above already puts the company on precarious ground, but a newly disclosed SEC investigation represents a major added uncertainty. Per the 10-K ( Pg. 43):

> *We and certain of our directors have received subpoenas from the Securities and Exchange Commission requesting documents and other information in connection with an investigation into trading in our stock in advance of our September 2017 announcement of the stock purchase agreement executed between us and Robert Duggan. We are cooperating with the investigation. We cannot provide any assurance as to the outcome of the investigation or that such outcome will not have a material adverse effect on our reputation, business, prospects, results of operations, or financial condition.*

We reviewed the trading action during that period and noticed clear oddities.

The company announced the withdrawal of its 510(k) application on September 11, 2017, which triggered a sharp and explainable selloff. Then, between September 14, 2017, to September 18, 2017, a large surge in price and volume took place on no discernible news.

Some of the purchases in that date range were from Robert Duggan himself, as was reported after the close on September 18th in an amended 13D filing which detailed his purchases from the 14th to 18th. Duggan represented only about 10% of the total volume on those two days, however (and less than 10% over the 3-day period.)

The volume on those days was aberrationally high, particularly on the 14th and 15th where volume was 9.3x and 3.8x higher than its 3-month averages. The implication therefore seems to be that others had also participated in the 50% price spike and did so in size.


Following this odd price action, weeks later, on October 2nd , the company changed its corporate bylaws to, among other things, amend the process for removing directors and also provide strong indemnification protection for any directors or former directors that may be subject to any civil, criminal, or administrative proceeding. Per the new amended bylaws:

> *…the Corporation shall indemnify, to the fullest extent permitted by [Nevada law], as now or hereinafter in effect, any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (a "Proceeding")…*

The new language also protects directors and officers in the case of a no contest plea "or its equivalent", and other adverse outcomes:

> *The termination of any Proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which such*

> *person reasonably believed to be in or not opposed to the best interests of the Corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that such person's conduct was unlawful.*

This seems to suggest that, for example, a potential settlement common to the SEC where directors "neither confirm nor deny" wrongdoing could be covered under the above language.

The language looks to be a significant departure from older indemnification language. A registration statement filed just months earlier in June was less forgiving:

> *…we shall not be required to indemnify any director or officer in connection with any proceeding, or part thereof, initiated by such person unless such indemnification: (a) is expressly required to be made by law, (b) the proceeding was authorized by our board of directors, (c) is provided by us, in our sole discretion, pursuant to the powers vested in us under Nevada law or (d) is required to be made pursuant to the bylaws.*

The old language detailed protections offered to officers and directors but also carved out additional exceptions to liability protection, including (Part II-1):

> *(a) a willful failure to deal fairly with the company or its stockholders in connection with a matter in which the director has a material conflict of interest; (b) a violation of criminal law, unless the director had reasonable cause to believe that his or her conduct was lawful or no reasonable cause to believe that his or her conduct was unlawful; (c) a transaction from which the director derived an improper personal profit; and (d) willful misconduct.*

In short, the new amendments to the corporate bylaws look designed to protect officers and directors in the event of the very type of proceeding that could result if the SEC investigation leads to an enforcement action. It could all be a coincidence, but given that the amendments were made right on the heels of the issue that triggered the investigation, we can't help but find the timing to be prescient. In either case, the changes to look incredibly unfriendly to common shareholders should any director or officer be subject to an enforcement action going forward.

Given the revised language, a potential regulatory action could represent a major drain on shareholder capital (along with a host of other ramifications.)

# *Conclusion*

We don't think Pulse Biosciences is a complex story. It boils down to a technology that sounds interesting but doesn't seem to work that well. It happens. The poor study results, the failure to secure a 510(k) clearance, and the need to pursue more expensive specific indications are all symptoms of that core issue.

We think investors in Pulse had been enamored by the support of a billionaire and have likely stopped paying attention to the failures of the company along the way since that point.

The SEC investigation and the events that both apparently triggered and followed the triggering events give us concerns about a potential looming regulatory liability. Given the new indemnification language, such a potential liability now seems more likely to be shouldered by shareholders rather than those responsible.

At this point, the stock doesn't seem to reflect the weight of current realities, and we believe fair value to be closer to $4 per share in the absence of meaningful new positive clinical data. We wish the best of luck to all.

**Disclosure:** I am/we are short PLSE.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 42

# Aphria Insiders Disclose Stake In Nuuvera's Initial Financing Round Just 1 Day Before Expected Deal Closing

Published on March 22, 2018



## Summary: Aphria Inc. (APHQF)


- Yesterday we wrote that Aphria's deal with Nuuvera seemed to make little economic and strategic sense, and that the "parties involved need to address potentially significant conflicts of interest".
- Following our report, the Globe & Mail today reported for the first time: "a number of Aphria insiders participated in the initial financing round for Nuuvera."
- Nuuvera's initial round was priced at $.001. We find it ridiculous that insiders admitted this stake one day prior to expected deal-closing for ~$5.40 in cash and stock.
- Aphria's limited disclosure of its insider participation in Nuuvera's initial financing round raises many more questions for us.

- We think this deal reeks. Full details of insiders who benefit from this proposed acquisition must be disclosed. We think regulators should step in unless the parties provide full transparency.

*Author's note 3/26: Given the lack of management's response to our requests for information, this article relied on the partial disclosures made by management to the Globe & Mail article dated March 22. In the article, a spokesperson stated that Aphria insiders had participated in the "initial financing round", which was inferred to be the initial round per the table below. Afterwards, in an article dated 3/25 entitled "Aphria insiders held shares in takeover target, didn't disclose", Aphria clarified to the Globe & Mail that insiders purchased in a round priced at $1/sh. Please take this update into account as you read the article below. We find these piecemeal and partial disclosures to be wholly inadequate, and reiterate our call for management to release the full details of participants in these early Nuuvera financing rounds.*

Yesterday we wrote that we saw rampant red flags with Aphria's (OTCQB:APHQF) proposed Nuuvera (OTC:NUUVF) transaction. In particular, the transaction seemed to make little economic or strategic sense, and we had found it worrying that a self-described Aphria advisor named Andy DeFrancesco seemed to have business dealings with both sides of the deal.

At the time, we had asked both Aphria and Nuuvera to disclose any business interests between the two company's executives, advisors, and key backers. We had suspected at the time that there may have been undisclosed conflicts given that we believed there was no credible alternative rationale for why this deal was taking place. Neither company responded to our questions and they still have not responded to us.

However, they did respond to the *Globe and Mail*. In an article today entitled "Short-seller sounds warning over Aphria-Nuuvera deal":

> *(NYSEA)n Aphria spokesman confirmed in an e-mail Wednesday that a number of Aphria insiders participated in the initial financing round for Nuuvera when it was a private company.*

In other words, one day prior to the proposed deal closing (i.e.: tomorrow) Aphria admitted that insiders participated in Nuuvera's initial financing round. For context, per Nuuvera's filing statement (Pg. 204) here was the initial capital raising round in question:

The Company has unlimited authorized common shares with no par value. The movement in the Company's issued and outstanding common shares during the period is as follows:

| | Number of shares | Amount |
|---|---|---|
| **Balance, January 30, 2017** | - | - |
| Shares issued for cash (i) | 20,000,000 | $ 20,000 |
| Shares issued in private placement (ii) | 43,458,000 | 43,458,000 |
| Shares issued in private placement (iii) | 3,722,000 | 3,722,000 |
| Shares issued in private placement (iv) | 4,000,000 | 4,000,000 |
| Cost of issuance of shares | | (54,650) |
| **Balance, September 30, 2017** | **71,180,000** | **$ 51,145,350** |

Based on the above, Aphria insiders participated in the round that priced 20 million shares for 20 thousand dollars, or $.001 per share.

Given that the Nuuvera deal is expected to close tomorrow at about $5.40 in cash and stock, the holders of 20,000,000 shares at $.001 would collectively stand to reap about $100 million in pure profit from the closing of this transaction. We find the disclosure of insider ownership one day before the deal is expected to close, and only AFTER direct questioning by a reporter to be completely outrageous.

Worse yet, rather than respond to the Globe & Mail's request for further information, the spokesman only provided partial disclosure. Per the article:

> *The spokesman said those insiders owned 0.9 per cent of Nuuvera on a fully diluted basis., but did not respond to further e-mails asking to identify the insiders and their holdings.*

This flimsy response raises a multitude of additional important questions. Namely:

- Who else participated in the initial financing round along with Aphria insiders?
- How many participants in the round were family members, affiliates, or deal partners of Aphria insiders?
- The language of the statement says that insiders "owned" 0.9%. How many shares were sold or exited already?

In our piece yesterday we had also highlighted that the self-described architect of the

Aphria/Nuuvera deal (Andy DeFrancesco) seemed to have business interests with the Chairman and largest shareholder of Nuuvera, Ron Schmeichel. In particular, we had found a document dated less than 1 week prior to the creation of Nuuvera showing that DeFrancesco had received a loan through an entity controlled by Ronald Schmeichel. In the Globe article DeFrancesco admitted the existence of this loan. Per the article:

> *"It has nothing to do with Nuuvera". He further added that the loan had been settled and "It's not relevant."*

Despite that proclamation, DeFrancesco also admitted that he had invested in Nuuvera prior to Aphria's taking a stake in the company:

> *Mr. DeFrancesco, through his family firm Delavaco Group, was also an early investor in Nuuvera, buying into the private company when it first raised outside capital. He said his family's investment came before Aphria acquired its stake. Aphria first announced a $2-million equity investment in Nuuvera in August as part of a partnership with the company.*

Given that a significant portion of the value of Nuuvera came from its relationship to Aphria, we find it highly concerning that insiders and unofficial advisors took previously undisclosed stakes in the company prior to both (A) announcing its strategic relationship to Aphria and (B) Nuuvera's acquisition announcement. Clearly the actions of Aphria's insiders substantially increased the value of Nuuvera's shares, which they then directly benefited from. Again, why didn't Aphria disclose that its insiders and advisors had stakes in Nuuvera through these key initial financing rounds?

# *Conclusion*

We think the issues with this deal run deep and that *conflicts of interest must be fully understood* Frankly, this deal looks worse to us than the recent Maricann deal that fell through amidst an OSC insider trading investigation.

We are reiterating our call for the company to make *full disclosure* about who the beneficiaries of this deal are. We think our work here is done. We are maintaining our short position and now believe it is up to the company or the regulators to be fully transparent to all Aphria and

Nuuvera shareholders.

**Disclosure:** I am/we are short NUUVF.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

# TAB 43

# Could Rampant Red Flags Drown Aphria's Proposed Nuuvera Acquisition?

Published on March 21, 2018



## Summary: Aphria Inc. (APHQF)


- We see multiple red flags with Aphria's proposed purchase of Nuuvera, a company that was incorporated in January '17 and had revenue of only ~$30k from inception to September '17.
- The self-described "architect" of the Aphria/Nuuvera deal, Andy DeFrancesco, has a questionable history, including close links to controversial financiers such as Barry Honig.
- Despite being a supposed Aphria advisor, a document dated less than a week prior to Nuuvera's creation shows DeFrancesco took a loan from Nuuvera's Chairman & largest shareholder.
- Nuuvera appears to have few substantive assets and has been heavily promoted, including announcements such as a "blockchain" partnership with a company run by one of its own directors.
- We believe the Nuuvera acquisition would represent a near total destruction of Aphria

value. Furthermore, we believe the deal raises questions about Aphria's aggressive deal-making spree in general.

# *Introduction*

Aphria's proposed Nuuvera acquisition is one of the worst looking acquisitions we have seen, and we believe its consummation would represent a near total destruction of capital for Aphria's [TSE:APH] (OTCQB:APHQF) shareholders.

The self-described "architect" of the Aphria/Nuuvera deal is Andy DeFrancesco, founder of the Delavaco Group. DeFrancesco is credited in his Delavaco executive team bio as being a "founding investor to Aphria, leading all rounds of financing and strategic advisor to the company since inception."

Despite DeFrancesco apparently representing Aphria as a strategic advisor, we found a document dated less than 1 week prior to the creation of Nuuvera showing that an entity controlled by Ron Schmeichel, Nuuvera's Chairman and largest shareholder, had entered into a loan agreement with DeFrancesco. Collateral on the loan appears to include real estate recently assessed to be worth about $49 million, suggesting that the loan could be substantial in size. We believe the interrelated nature of these business interests could represent a massive conflict of interest, especially given that Schmeichel stands to personally clear over $71 million from the Nuuvera acquisition ( Pg 26). (Also, note that Schmeichel previously served as the Chairman of Concordia Healthcare , a company that had parallels to Valeant Pharmaceuticals (VRX) and saw its share price eventually plummet as issues surfaced with its business model.)

As to Nuuvera's operations, Nuuvera is a newly formed business that was incorporated only on January 30, 2017, and has generated total revenue of $29,770 from inception to September 30th, 2017 (Pg. 56). (That revenue is in actual dollars, not thousands). The company went public via reverse merger through a shell corporation and listed on the TSX Venture Exchange just months ago in January 2018.

After reviewing Nuuvera's limited history, we characterize the company's operations as very preliminary stage. Aside from an estimated $35 million in cash on the balance sheet, we believe the rest of the company is likely too early stage and too speculative to have any meaningful economic value.

Despite the lack of material assets, immediately after its listing, Nuuvera heavily promoted itself

through a flurry of press releases announcing numerous preliminary initiatives such as non-binding letters of intent and a "blockchain" partnership with a company run by one of Nuuvera's own directors.

On January 29, 2018, less than 3 weeks after the company began trading, Aphria announced an offer to acquire the company for $826 million in cash and stock, representing a premium of about 21% over Nuuvera's trading price at the time.

The deal price was later lowered from $1 in cash plus 0.3546 Aphria shares to $0.6 in cash plus 0.3546 Aphria shares. Given Aphria's current share price the current deal value stands at about $470 million, which we believe is still massively overpriced.

While the economic rationale for the transaction is hard for us to fathom, the strategic rationale similarly strikes us as totally nonsensical. The lead bullet point from the acquisition announcement on January 29th underscored the desire to capitalize on Nuuvera's international operations:

> *(the) Combination capitalizes on Nuuvera's expansive international footprint, expanding network into Europe, Africa and the Middle East.*

The press release further highlighted Nuuvera's international footprint:

> *The combined company will leverage Nuuvera's extensive international network and best-in class manufacturing practices to become the preeminent global supplier of premium cannabis.*

Despite that stated key rationale for the transaction, the Globe and Mail reported less than a week later that Aphria planned to launch a new business in February called "Aphria International" which would be spun out into a separate public company. Per the article originally published on February 1st:

> *Mr. Neufeld [Aphria's CEO] said Aphria is planning to launch a new business this month called Aphria International. The proposed company will focus on growing and selling cannabis for patient use outside Canada and the United States, including across Europe, Africa, Latin America and the Caribbean. It is expected that the*

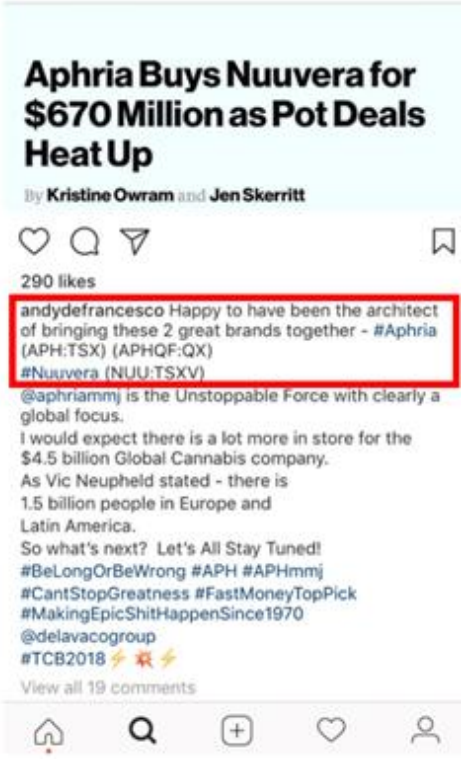
> *company intends to grow a variety of different cannabis strains. Correspondingly, the company has been doing some initial research into blue dream fem seeds as well as other popular seed types. This is set to be a separate public company, coming to market through a reverse takeover in mid-February of an entity listed today on the TSX Venture Exchange.*

It is also expected that the business will be embracing the latest developments in cannabis cultivation technology such as marijuana software .

However, we find it bizarre that Aphria is both acquiring (through Nuuvera) and spinning out public international operations virtually simultaneously. We have emailed Aphria seeking comment on the rationale behind this seemingly contradictory strategy and have not heard back as of this writing. Should we hear back from the company, we will update this accordingly.

## *Andy DeFrancesco's Loan with An Entity Controlled By Nuuvera's Chairman and Largest Shareholder*

Following our failure to understand the Nuuvera transaction on any credible economic or strategic basis, we began exploring the relationships of key individuals that participated in the transaction. On DeFrancesco's Instagram page, we noticed that he posted a news release relating to the Aphria/Nuuvera transaction and claimed to be the "architect of bringing these 2 great brands together"



**Aphria Buys Nuuvera for $670 Million as Pot Deals Heat Up**

By Kristine Owram and Jen Skerritt

290 likes

andydefrancesco Happy to have been the architect of bringing these 2 great brands together - #Aphria (APH:TSX) (APHQF:QX)
#Nuuvera (NUU:TSXV)
@aphriammj is the Unstoppable Force with clearly a global focus.
I would expect there is a lot more in store for the $4.5 billion Global Cannabis company.
As Vic Neupheld stated - there is 1.5 billion people in Europe and Latin America.
So what's next? Let's All Stay Tuned!
#BeLongOrBeWrong #APH #APHmmj #CantStopGreatness #FastMoneyTopPick #MakingEpicShitHappenSince1970
@delavacogroup
#TCB2018 ⚡ 💥 ⚡
View all 19 comments

As noted above, DeFrancesco is credited in his Delavaco executive team bio as being a "founding investor to Aphria, leading all rounds of financing and strategic advisor to the company since inception." Thus, the implication would seem to be that he had represented Aphria in its negotiations with Nuuvera.

Despite DeFrancesco's believed role with Aphria's structuring of the deal, we found several documents indicating that DeFrancesco also has business interests with key sponsors of Nuuvera. In particular, we found a document dated less than 1 week prior to the creation of Nuuvera showing that DeFrancesco had received a loan through an entity controlled by Ronald Schmeichel, Nuuvera's Chairman and largest shareholder. For context, Schmeichel stands to personally clear about $71,491,845 in the Nuuvera acquisition. ( Pg 26)

Per a Uniform Commercial Code (UCC) filing in Florida dated January 24th, 2017, (note that Nuuvera was created on January 30th, 2017) we see that JJR Private Capital secured a lien on DeFrancesco's interest in an entity that appears to hold real estate. For the full document, see here . Below is the first page of the filing:

**STATE OF FLORIDA UNIFORM COMMERICAL CODE FINANCING STATEMENT FORM**

A. NAME & DAYTIME PHONE NUMBER OF CONTACT PERSON
JULIANNE JOHNSON; 6124926925
Email JOHNSON.JULIANNE@DORSEY.COM

B. SEND ACKNOWLEDGEMENT TO:

**Florida Secured Transaction Registry**

**FILED**

2017 Jan 24 11:23 AM

******* 201700074014 *******

**THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY**

**1. DEBTOR'S EXACT FULL LEGAL NAME** - INSERT ONLY ONE DEBTOR NAME (1a OR 1b) - Do Not Abbreviate or Combine Names

| 1a. ORGANIZATION'S NAME | | | |
|---|---|---|---|
| 1b. INDIVIDUAL'S SURNAME: DE FRANCESCO | FIRST PERSONAL NAME: ANDREW | ADDITIONAL NAME(S)/INITIAL(S) | SUFFIX |
| 1c. MAILING ADDRESS Line One: 2300 E. LAS OLAS BOULEVARD, 5TH FLOOR | This space not available. | | |
| MAILING ADDRESS Line Two | CITY: FORT LAUDERDALE | STATE: FL | POSTAL CODE: 33301 / COUNTRY: US |

**2. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME** - INSERT ONLY ONE DEBTOR NAME (2a OR 2b) - Do Not Abbreviate or Combine Names

| 2a. ORGANIZATION'S NAME | | | |
|---|---|---|---|
| 2b. INDIVIDUAL'S SURNAME | FIRST PERSONAL NAME | ADDITIONAL NAME(S)/INITIAL(S) | SUFFIX |
| 2c. MAILING ADDRESS Line One | This space not available. | | |
| MAILING ADDRESS Line Two | CITY | STATE | POSTAL CODE / COUNTRY |

**3. SECURED PARTY'S NAME** (or NAME of TOTAL ASSIGNEE of ASSIGNOR S/P) - INSERT ONLY ONE SECURED PARTY NAME (3a OR 3b)

| 3a. ORGANIZATION'S NAME: JJR PRIVATE CAPITAL II LIMITED PARTNERSHIP | | | |
|---|---|---|---|
| 3b. INDIVIDUAL'S SURNAME | FIRST PERSONAL NAME | ADDITIONAL NAME(S)/INITIAL(S) | SUFFIX |
| 3c. MAILING ADDRESS Line One: 5 HAZELTON AVENUE, SUITE 300 | This space not available. | | |
| MAILING ADDRESS Line Two | CITY: TORONTO, ON, CAN | STATE | POSTAL CODE: M5R 2E1 / COUNTRY |

**4. This FINANCING STATEMENT** covers the following collateral:

See "Exhibit A" attached hereto and incorporated herein by this reference. (1 additional page)

Ronald Schmeichel is the Chairman of JJR Private Capital according to his biography on the Nuuvera executive team website. The address listed in the UCC filing, 5 Hazelton Avenue, Suite 300, corresponds to the address of both JJR Private Capital and to the address of Nuuvera, per a filing statement ( Pg. 38):

- 38 -

**PART III - INFORMATION CONCERNING NUUVERA**

**Name and Incorporation**

Nuuvera was incorporated on January 30, 2017 under the *Business Corporations Act* (New Brunswick) as Nuuvera Corp. and continued under the CBCA on March 8, 2017. In connection with the Qualifying Transaction and subject to shareholder approval, it is expected that Nuuvera will change its name to "Nuuvera Holdings Limited" so that the Resulting Issuer may be named "Nuuvera Inc. "

Nuuvera's registered and head office is located at 5 Hazelton Avenue, Suite 300, Toronto, Ontario, Canada, M5R 2E1.

We are unable to see the loan itself through the UCC filing, but we are able to get a sense of the

collateral, which indicates that the loan could be substantial in size.

The collateral is defined to include all of DeFrancesco's interest in an entity called Las Olas Bay Properties Park Colony, LLC, including "any and all payments, dividends or distributions of whatever kind or character". Corporate records show that Las Olas Bay Properties Park Colony, LLC is the manager of an entity called Park Colony, LLC. According to Broward County real estate records, Park Colony, LLC owns 730-812 S Park Road, Hollywood Fl, which was recently assessed to be worth about $49 million.

We are not able to determine the full details around the loan agreement or any other potential interrelated business dealings between Aphria and Nuuvera's key individuals. Nonetheless, we find DeFrancesco's self-described role as "architect" of the Nuuvera/Aphria deal, coupled with his potentially conflicting interests to both sides of the deal, to be tremendously troubling. The companies should fully disclose the full details of the relationship to investors before Aphria closes any proposed transaction.

Furthermore, the companies should disclose any other business interests between the two company's executives, advisors, or key backers. We have emailed both Nuuvera and Aphria's investor relations seeking comment on this. We have not heard back as of this writing, but should we hear from any of the parties, we will update this accordingly.

We also emailed DeFrancesco seeking comment on questions relating to his role in the transaction and any business dealings with any of the key executives or key holders of Nuuvera. He replied stating that he would discuss in a face-to-face meeting. We requested instead that he answer our questions in email and have not heard back as of this writing. Should he respond, we will update this article accordingly.

Given that the transaction is anticipated to close in April, we believe it is imperative that management provides more information soon.

# *Andy DeFrancesco and Barry Honig*

As we reviewed DeFrancesco's history, we identified another troubling connection. DeFrancesco has seemingly had multiple close business interests with Barry Honig, a controversial financier who was recently featured in (i) a CNBC exposé relating to Riot Blockchain's questionable business practices; (ii) a ShareSleuth exposé relating to undisclosed stock promotion; (iii) multiple exposés by investigative reporter Teri Buhl relating to dubious financial dealings; and (iv) a series of articles we have written focused on numerous Honig-

related enterprises, including Riot Blockchain ( 1, 2, 3, 4), PolarityTE (COOL), Pershing Gold (PGLC), and Marathon Patent Group (MARA) that have all identified numerous red flags relating to businesses he has been involved in. Honig was also previously alleged to have committed stock manipulation and was fined $25,000 and suspended for 10 days, according to his FINRA records.

SEC and Canadian records show that Honig and Andrew DeFrancesco (together with family accounts) have cooperated on a slew of deals, including:

- **242 Cannabis LLC**: Honig and DeFrancesco both had ownership in a private entity called 242 Cannabis LLC that Liberty Health Sciences [CNSX:LHS] (OTCQX:LHSIF) recently announced that it would acquire. Liberty Health Sciences is another publicly traded Canadian cannabis-related company that Aphria had made a substantial investment into. Florida records show that 242 Cannabis was formed mere months ago on December 18, 2017. We find it alarming that DeFrancesco and Honig had key stakes in a newly-formed entity that is ultimately being acquired by an Aphria-backed company. We believe it raises further questions about whether Aphria's deals are plagued by conflicts of interest. Note that we intend to explore this subject in much greater detail in a follow-up report.

- **Riot Blockchain** (formerly named Venaxis Inc.): DeFrancesco's spouse reported a key ownership stake in Venaxis Inc. and even joined Barry Honig in an activist campaign to oust the prior board of directors. DeFrancesco advocated for Honig's new director slate, which included John Stetson (mentioned above) and John O'Rourke, who later went on to become the embattled CEO of Riot. DeFrancesco's lawyer in the proxy fight was listed as Joe Laxague, a believed 1-man law firm who later set up an entity that Riot eventually acquired. As we had identified in our previous reports on Riot, the acquisition appeared highly suspicious and involved a substantial overpayment for the entity's assets. SEC filings reaffirm that DeFrancesco has continued to hold a recent stake in Riot.

- **PolarityTE**: Documents also show that DeFrancesco's spouse held a stake in PolarityTE, a company that Honig has played a key role in and one where we have identified numerous red flags.

Aside from company investments, real estate and corporate records show that the Florida office of Delavaco Holdings and multiple other DeFrancesco corporate interests are located at 2300 E. Las Olas Boulevard, 5th Floor, Fort Lauderdale, Florida. (Source: 1, 2, 3, 4, 5) According to Broward County property records the building is owned by an entity called Las Olas Sunset Bay, LLC. As of June 1, 2017, Las Olas Sunset Bay, LLC was managed by none other than Barry Honig and Andy DeFrancesco, according to Florida corporate records. In July 2017, DeFrancesco was replaced on the manager list by John Stetson, another regular deal-partner of Honig's who appears to have an office one floor down from DeFrancesco (on the 4th floor of the same

building).

Given Honig's dubious track record and his connection to a wide range of questionable deals, we find it troubling (a) that he has a close association to DeFrancesco, the self-described architect of the Aphria/Nuuvera deal; and (b) has participated along with DeFrancesco in other deals directly related to Aphria.

# *Nuuvera's Assets Look Flimsy at Best*

Our concern is compounded greatly by the fact that a review of Nuuvera's assets leaves us scratching our heads as to the supposed value of the enterprise. As noted above, Nuuvera has generated virtually no revenue to date, thus we are led to look toward the company's key assets to assess its value. The December filing statement for the reverse merger and subsequent press releases describe Nuuvera's primary assets, which include:

1. Avalon Pharmaceuticals Inc. ("Avalon"), an indirect, wholly-owned subsidiary of Nuuvera that holds an ***application*** to be a Licensed Producer under the Access to Cannabis for Medical Purposes Regulations. Avanti generated a total of $440 in revenue in 2016 and zero revenue for the first 6 months of 2017. ( Pg. 271) Note that as opposed to an application, Aphria already owns an actual production license under the same code . Prior to its acquisition by Nuuvera for total consideration of $3,000,000, Avalon was owned by Mojgan Massoudinia, the spouse of the individual that controlled ARA-Avanti Rx Analytics, another of Nuuvera's key assets ( Pg. 50 and Pg. 289).
2. ARA-Avanti Rx Analytics Inc. ("Avanti"), is a Good Manufacturing Practices ("GMP") approved organization which offers a "comprehensive array of services in the field of controlled drugs and substances." ( Pg. 1) Despite Avanti's "comprehensive" offering, it managed to generate $0 in revenue from 2014 to 2016 and generated a total of $12,565 in revenue for the 6 months ended June 2017. ( Pg. 260) Avanti holds a laboratory dealer License under the Narcotic Control Regulations and Office of Controlled Substances, one of 35 currently issued in Canada. Avanti was acquired by Nuuvera in 2 stages: first, Nuuvera acquired a 51% interest in the company for $13.26 million in August 2017. ( Pg. 40) Then, the company announced the acquisition of the remaining 49% interest in March 2018 for a whopping $43 million (which included about $8 million in real estate) for a nearly 3x valuation increase over a period of about 8 months. Total consideration for the Avanti purchases was about $56.26 million. Prior to the acquisition by Nuuvera, Avanti was controlled by the husband of Avalon's owner, Dr. Mehrdad Barghian. We have asked Nuuvera's investor relations for the complete list of shareholders in Avanti prior to the acquisition by Nuuvera, as it is unclear to us whether it solely included Dr. Barghian or if there were others. We have not heard back as of this writing, but should we hear back from them, we will update this writing accordingly.
3. Ironically, another of Nuuvera's key assets is a strategic relationship with Aphria itself,

whereby Aphria agreed to, among other things (i) supply Nuuvera with cannabis ( Pg. 39) (ii) provide consulting to Nuuvera on the build-out of its greenhouse facility in Leamington (Pg. 39) (iii) and operate the Leamington greenhouse, including the supply of primary employees, key personnel, and its "proprietary Know-How System" to initiate and maintain the cultivation, harvesting, and packaging of cannabis products. ( Pg. 22 and Pg. 44) Nuuvera cites "Reliance on Arrangements With Aphria" as one of its key risk factors, per the same document. ( Pg. 27) Given the heavy reliance on Aphria for many aspects of Nuuvera's business, we find it odd that Aphria is, in part, acquiring a relationship with itself for a seemingly hefty premium.

4. Nuuvera also has several international efforts that we would categorize as very early stage, including:

- **Germany:** Nuuvera Germany has contracted with an industrial hemp farm for the offtake of industrial hemp harvested from approximately five acres. The first harvest was recently completed, and the industrial hemp is currently being offered for sale by Nuuvera Germany. Nuuvera Germany also plans to apply for a cannabis import and export license from the German Ministry of Health. In support of this application, Nuuvera acquired land and a commercial building in northern Germany for 360,000, which it has begun retro-fitting with security and vault systems in order to comply with licensing requirements. ( Pg. 46)

- **Israel:** There appear to be no substantive operations in Israel thus far, despite the company establishing a subsidiary in the country. Per the filing statement, "Nuuvera is seeking either partnership opportunities with local Israeli licensees for cannabis cultivation or a consistent supply of high quality and low cost cannabis through offtake agreements"…"Once a suitable location for this production facility has been finalized, Nuuvera plans to apply for a pre-licence permission to build. The expected timeframe for obtaining the production license and commencing commercial production is approximately eight to ten months." ( Pg. 49)

- **Malta:** The company purchased a GMP lab in Malta in anticipation of the future passage of marijuana legislation. Per the filing statement ( Pg. 48), "Once the applicable legislation is enacted, the joint venture will then apply for one of the first licences for import/export, production and cultivation of cannabis in Malta." Given the uncertain nature of the legal and regulatory environment, there is no clear timeline provided for when this will take place, although observers anticipate that legislation could be passed soon .

- **Italy:** The company recently acquired one of 7 licenses to import medical cannabis into Italy through the purchase of a subsidiary called FL-Group. The short form prospectus detailed that the agreement proposed to acquire FL for an aggregate purchase price of only about 1,000,000, subject to adjustments according to the agreement. ( Pg. 11) The filing statement added that the entity "is authorized for the distribution and marketing of

other pharmaceutical products, including cannabis-based and cannabinoids products. The target company is also the only company distributing a suite of CBD-based products to pharmacies in Italy." ( Pg. 48) The filing statement noted that there is only one active cultivation license in Italy (held by a facility controlled by the Ministry of Defense) and that the shortfall for demand is bridged through importation. It is unclear when or whether the regulatory environment will allow additional cultivation licenses, but Nuuvera believes it could have a first mover advantage when or if that occurs.

- **Lesotho South Africa:**On February 26th, the company announced the signing of an offtake agreement with a "Major African Licensed Grower", Verve Dynamics Inc. Lesotho indeed recently granted Verve one of 2 marijuana cultivation licenses, though we were unable to find evidence that they were a "major" grower of anything. The Verve website provides minimal detail on its facilities and currently lists its address as a P.O. box. According to Nuuvera's head of international development, "(Verve) is rapidly scaling its production", and Nuuvera expects the company to reach 3,000kg of annual production within a year. (Source )

All told, the company's assets strike us all as highly preliminary and fraught with a great deal of regulatory and operational uncertainty. We have a hard time understanding how Aphria could have ever credibly extended an $826 million offer to acquire Nuuvera's assets, which appear to be at such a speculative and early stage.

# *Nuuvera Has Been Highly Promotional in the Brief Period it Has Traded*

While Nuuvera seems to lack a significant asset base, the company has nonetheless aggressively promoted itself. In the aftermath of Nuuvera's listing on the TSX Venture exchange on January 9th, the company issued a slew of press releases that touted numerous preliminary achievements and initiatives. Below, we have provided a brief review of many of the press releases to date:

- January 9th: A letter of intent to export medical cannabis to Germany.

- On the same day, January 9th: Nuuvera announced it had "broken ground on the construction of a storage and packaging facility for medical cannabis products" in Germany. "This development is ground-breaking for Nuuvera," said Nuuvera CEO Lorne Abony. Note that Nuuvera had already bought the building on December 1st, 2017, for 339,000 (Pg. 12) and the 'ground breaking' announcement in the press release referred to the installation of security systems and vault storage in support of its *application* for a license from the German Ministry of Health.

- Still on January 9th: Nuuvera issued yet another press release, announcing that it had been "shortlisted" for a cannabis contract with the German Federal Institute for Drugs and Medical Devices ("BfArM"). The announcement stated that Nuuvera was selected as one of 10 remaining bidders out of "over 100 interested undertakings answered BfArM's initial call for competition." The fact that Nuuvera had not actually won the contract and was merely one of 10 bidders did not seem to slow down CEO Abony who proclaimed, "We are tremendously excited about BfArM's decision." Later on a conference call describing the Aphria/Nuuvera transaction, Abony stated that the remaining finalists are "a number less than 10".

- January 10th: An announcement of a marketing and communications partnership.

- January 10th: An announcement that the company had purchased a property in New Brunswick that it intends to turn into a laboratory. "The building will be retro-fit immediately upon the issuance of necessary zoning permits and licenses."

- January 11th: A letter of intent to import cannabidiol isolate into Canada from the UK.

- January 11th: An announcement of the existence of negotiations with Aphria for an offtake agreement. Another release, about a week later, announced the finalization of an offtake agreement with Aphria. Note that the company already had a supply agreement with Aphria. (Pg. 39) The latest press releases were in relation to an expansion of the existing relationship with Aphria.

- January 12th: A memorandum of understanding with the province of New Brunswick to supply recreational marijuana.

- January 16th: An announcement during the midst of "blockchain mania" announcing that Nuuvera entered into a partnership with Globalive Technology Partners ("GTP") to bring blockchain technology to the global cannabis market. The announcement described how Nuuvera would be partnering with GTP's founder Anthony Lacavera. The release omitted however that Lacavera is actually a Nuuvera board member, and therefore already had a relationship with the firm. Note that Lacavera stands to make about $15,554,812 in the upcoming acquisition by Aphria (Pg 26).

- January 18th: An announcement that the company "acquired" one of 7 licenses to import medical cannabis into Italy, suggesting that a transaction had already been completed. This announcement was then followed by a February 1st announcement that the company "finalized" the very same acquisition, followed by another announcement the same day clarifying that the Italian license is held by the company's subsidiary, FL-Group, and that any importation of cannabis products is subject to regulatory approval. Note

that the Nuuvera short form prospectus detailed that the agreement proposed to acquire FL for an aggregate purchase price of only about 1,000,000, subject to adjustments according to the agreement. ( Pg. 11)

- January 23rd: A "sale agreement" with a subsidiary of ICC Labs Inc, [TSXV:ICC] (OTC:ICCLF) another cannabis company that went public via reverse merger. ICC Labs recently reported revenue of only about $172,000 in its latest reported period ( Pg. 7) but has nonetheless already announced several large "pre-sale" agreements in anticipation of future production ( 1, 2). Interestingly, ICC's press release mentioned that Avanti (Nuuvera's subsidiary) agreed to provide a deposit of $150,000 as part of the agreement whereas the Nuuvera press release announcing the same deal omitted details of the deposit.

- January 24th: A letter of intent to acquire a GMP-certified lab in Spain.

- February 26th: As mentioned in earlier, the announcement of a signed offtake agreement with a "Major African Licensed Grower", Verve Dynamics Inc. Lesotho recently granted Verve one of 2 marijuana cultivation licenses, but we were unable to find evidence that they were a "major" grower of anything as the Verve website provides minimal detail on its facilities and currently lists its address as a P.O. box. According to Nuuvera's head of international development, "(Verve) is rapidly scaling its production", and Nuuvera expects the company to reach 3,000kg of annual production within a year. ( Source )

- February 27th: An announcement of the acquisition of a Maltese GMP lab, in anticipation of medical marijuana laws being passed in the country which observers believe could happen soon.

All told, we find the various above announcements, letters of intent, and agreements to purchase product that in many cases do not even exist yet to collectively be thin on actual substance. We cannot see the economic rationale behind paying hundreds of millions of dollars to acquire what largely amounts to a loose agglomeration of early stage initiatives and plans.

# *Conclusion*

We believe Aphria's proposed acquisition of Nuuvera has numerous red flags. We see little economic or strategic rationale for the purchase and believe the parties involved need to address potentially significant conflicts of interest.

The cannabis industry undoubtedly holds tremendous promise. There is clearly a well-defined

market that can be seen if you check out films featuring cannabis which you can understand more here . Companies trading in the cannabis space have seen high volatility as of late, given the early-stage nature of the industry and the commensurate excitement and setbacks that occur with any new industry. Therefore, any investment in the sector (both long or short) should be considered higher risk regardless of the outcome of this particular deal.

That being said, we simply do not see any credible value in this transaction for Aphria. In the absence of this deal, we believe Nuuvera's shares would trade closer to its intrinsic worth, which we estimate to be over 90% lower than current share prices suggest.

We are short shares of Nuuvera, and should the acquisition close, we will gladly roll our short position over into shares of Aphria as we think Nuuvera would represent a substantial drag on the entire enterprise due to the aforementioned issues. We wish the best of luck to all.

**Disclosure:** I am/we are short NUUVF.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 44

# Crius Energy Trust: An Unsustainable Collision Course

Published on February 28, 2018



## Summary: Crius Energy Trust (CRIUF)


- Crius's non-IFRS "Payout Ratio" includes multiple questionable adjustments which have given investors a false sense of security. We think Crius is on the precipice of failure.
- Crius is liquidity constrained with only $24.3m in cash as of September 30th. A new preliminary legal settlement of up to $18.5m will deplete much of its remaining cash.
- Credit lines are similarly stretched. Crius had $104.6m of debt as of quarter-end with current estimated remaining available credit of only $25.2m.
- The Company is borrowing at rates as high as 9.5% while paying out dividends at ~9.3%. Current dividend payout rates imply an unrealistic C$47.7m annual payout.
- Crius's early backers and potentially current key holders include individuals affiliated with hedge fund Platinum Partners, whose executives were indicted for operating "like a Ponzi Scheme," according to federal prosecutors.


## Introduction

We believe many investors look at Crius Energy Trust (TSE:KWH.UN, OTC: OTC:CRIUF) and mistakenly believe it to be similar to a traditional electric utility. After all, much like a utility, Crius ((i)) is involved in the business of providing energy to retail and commercial customers; and ((ii)) Crius pays out a substantial, regular dividend with a seemingly conservative payout ratio.

Despite the common perception, however, Crius's business model is nothing like a traditional utility company. The company operates primarily as an Energy Service Company (ESCO) in the fiercely competitive "deregulated energy" market. As we will describe in further detail, ESCOs have virtually no barriers to entry, slim margins, and massive customer turnover (e.g.: Crius's customer attrition has averaged 10.3% per quarter on a last twelve months [LTM] basis.)

Crius's business model is wholly unlike a traditional utility, yet the Company offers a utility-like proposition of a steady, increasing, " conservative " dividend which has created what we believe to be an unsustainable mismatch between investor perception and the company's financial reality.

To date, that mismatch seems to have been largely ignored due to investor reliance on metrics such as Crius's non-IFRS dividend "Payout Ratio", which includes several questionable adjustments.

Regardless of perception, the reality of Crius's financial situation appears to be coming to a head in the form of a near-term liquidity shortage. We think the current liquidity situation of Crius not only calls into question the sustainability of its juicy ~9.3% annual dividend payment but also calls into question the near-term solvency of the business in the absence of further capital injections.

We do not see an obvious silver lining going forward. Both Crius and the ESCO industry have of late come under severe recent legal and regulatory scrutiny, which we believe will only tighten from this point. In particular, two recent events that Crius has yet to disclose to its shareholders appear to be related to the tightening environment:

1. The company recently agreed to a preliminary settlement of up to $18.5 million in relation to a lawsuit over sales practices from its historical Viridian subsidiaries. This compares to a $13 million reserve recorded by the company according to page 33 of the Q3 Financials.
2. In December, Viridian quietly announced to its independent contractors that it is imminently transitioning away from its core multi-level marketing sales channel, leaving that business essentially in runoff. Viridian is estimated to account for about 20% of Crius's current customer base.

*(We have emailed investor relations and asked them about these disclosure issues. We have not heard back as of this writing. Should we hear back, we will update this accordingly.)*

*Update: About 4 minutes after publication Crius's investor relations responded to our question relating to the preliminary Viridian settlement. They shared thi**article*** relating to the settlement and added:

> *The legal reserve Crius has in place will cover the administrative costs, legal fees and the claims from the class action settlement. Crius has entered into an arrangement which is commonly used by companies settling class actions to cap the Company's exposure. Management does not expect to incur any further material costs associated with the settlement of the class action lawsuits.*

Other regulatory screws are tightening as well, including NY and NJ AG subpoenas and pending regulatory rulings in relation to Crius's recently acquired subsidiary, U.S. Gas & Electric ("USG&E").

Beyond the above, additional red flags give us further cause for concern:

- The company recently switched its auditor from "Big 4" Ernst & Young to Grant Thornton in March 2017.

- On top of everything else, we find the company's origin and historical associations to be unsettling. The company's early backers and potentially current key holders (up to 11% of outstanding units) include individuals affiliated with senior members of the defunct hedge fund Platinum Partners, whose executives were indicted for operating "like a Ponzi Scheme" according to federal prosecutors. We identified one defendant in the Platinum case who even pledged Crius shares in order to secure legal counsel for his upcoming securities fraud trial.

In sum, we believe Crius is on an unsustainable collision course and will need near-term and ongoing infusions from the capital markets in order to continue its operations. We think the company is on a path to zero unless it undergoes a major business shift or find large, less competitive and less regulated markets to operate in.

# *Crius's Questionable History*

Starting from the beginning, a deep dive of Crius's history shows a rather unsavory origin story.

Namely, Crius seems to have been backed in the beginning by former executives and affiliated individuals from Platinum Partners, a hedge fund that later collapsed and saw its key executives indicted on multiple counts of securities and/or wire fraud. Prosecutors allege that the fund became "like a Ponzi Scheme" as its largest investments lost much of their value.

Several of the key original backers of Crius include:

- Mark Nordlicht, who was the founder and chief investment officer of Platinum Partners, and was later indicted for securities fraud in December 2016.
- David Levy, who was the co-chief investment officer of Platinum Partners, and was later indicted for securities fraud in December 2016 alongside Nordlicht.
- Murray Huberfeld, who was a founder of Platinum and participated in its management, and was later indicted for honest services wire fraud in July 2016.
- David Bodner, who was a long time partner of Huberfeld.

Note that none of the charges cited above have been proven in court.

Going back to the beginning… prior to working as CEO and CFO of Crius, Michael Fallquist and Roop Bhullar worked at a now-defunct publicly traded company called Commerce Energy. Fallquist served as Chief Operating Officer of Commerce and Bhullar served as Finance Director.

In mid-2008, Commerce Energy borrowed from an affiliate of Platinum Partners called AP Finance, LLC. Commerce Energy soon defaulted on the loan and the company appears to have been liquidated with some of its assets sold off to rival Ambit Energy. Platinum then brought Fallquist on directly in order to run Viridian and its affiliates, including parent company Regional Energy Holdings, LLC (REH).

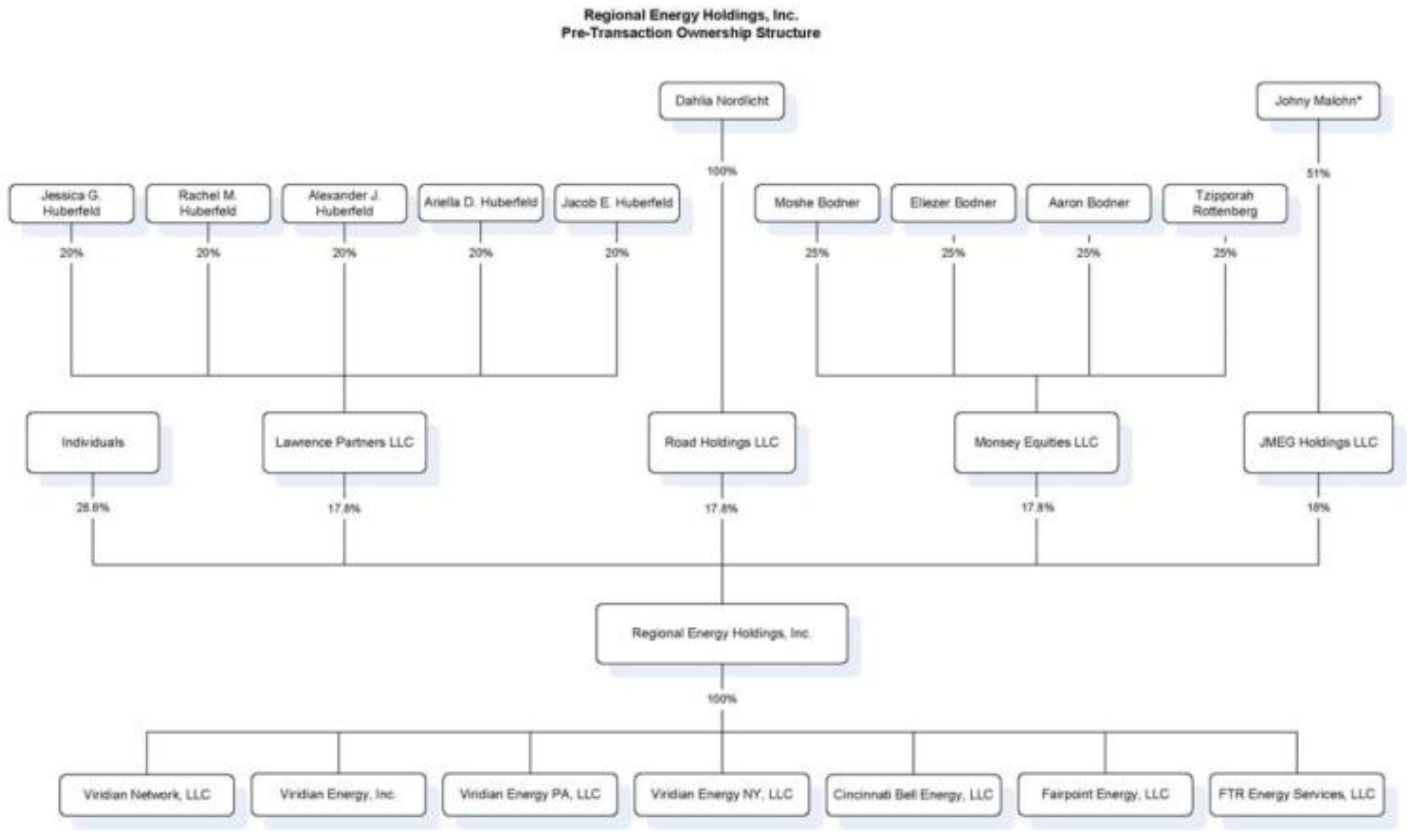
In 2009, Fallquist shared an office with Platinum Partners according to a form D filed April 2009. (Note the same 152 West 57th Street 54th Floor address turns up on other Platinum filings 1, 2 and the Form D also mentioned included Platinum Partners executive David Levy.)

A whistleblower in March 2012 similarly detailed that the ownership of REH and Viridian included key Platinum executives and stressed the importance of the roles of Platinum Founders Mark Nordlicht and Murray Huberfeld (pg 5). The whistleblower also noted that Viridian was founded just weeks after the demise of Commerce Energy and operated in Platinum's offices (pg 9).

A subsequent March 2012 Public Utility Commission filing by Viridian corroborated much of this as well. As noted in the PUC filing (pg 17) "Mark Nordlicht indirectly owned 17.84 percent of

REH". The filing also noted (pg 4) that David Levy served on REH's Board of Directors and Executive Committee until March 2012.

A later July 2012 letter to the Federal Energy Regulatory Commission (FERC) detailing the proposed formation of Crius showed the holders of REH at the time (pg 35), which included the wife of Mark Nordlicht ( Dalia Nordlicht ), and the children and relatives of both Murray Huberfeld and David Bodner:




*(Source: Huberfeld Family Foundation pg 30 and Bodner Children Family Foundation pg 15. Note the Bodner Children Family Foundation similarly shares the same address as Platinum.)*

According to a form D filed September 27th, 2012 , Crius was then formed via an exchange based on a "good faith valuation" of $300 million whereby the Platinum-sponsored REH and a separate ESCO called Public Power combined on a 50/50 basis to form Crius Energy. (See: Final Prospectus pg. 67. paragraph 1 )

The REH holders cashed out about C$32.3 million in the IPO ( IPO Prospectus pg. 64 ). Following the IPO, Crius essentially bought out the remaining non-controlling interest from its early holders in 2 phases: (1) a 2015 all-cash purchase of part of the remaining interest and (2) a 2016 deal consisting of cash and an exchange into Crius units to complete the purchase.

The 2016 mixed cash and units deal alludes to non-Crius owned "remaining LLC Units" that were vaguely described as being "owned by various holders, principally in the United States." The disclosures are murky, but we believe up to 6,651,209 Crius units issued to the "various holders" consist in large part of the original REH holders (i.e.: the Platinum execs and/or their relatives). [5]

*(We have emailed investor relations and asked to confirm whether and in what proportion the original REH holders comprised the "various holders" mentioned in the 2016 offering. We have not heard back as of this writing. Should we hear back, we will update this accordingly.)*

It is nearly impossible to determine how many Crius units, if any, are still held by the original Platinum/REH holders, but at least one of the original Platinum holders still appears to hold a meaningful number of units. We located a Uniform Commercial Code (UCC) filing showing that Platinum co-chief investment officer David Levy recently pledged 250,000 units of Crius in order to procure his criminal defense attorney for his upcoming securities fraud trial.

Long story short, we are unnerved by Crius's history and associations and believe it adds a layer of questions regarding the Company's approach to business.

# *Crius is Nothing Like a Traditional Utility Company*

Before we get into the financials, we first want to address a key misconception underlying the company; that Crius is similar to a traditional utility. The misconception is largely forgivable; Crius is regularly classified as a "utility" according to several common classification methodologies:

- The Global Industry Classification System (GICS) classifies Crius in the "Utilities" sector and the "Electric Utilities" industry. (Source: FactSet)
- FactSet classifies Crius in the "Utilities" sector and the "Electric Utilities" industry. (Source: FactSet)
- Industry analysts have similarly described the company as a utility, and authors have referred to it for example as, " a High Quality Utility " and a "9% Yielding Utility".

The Company describes itself somewhat inconclusively, stating that it provides "innovative energy products that simply aren't available from the traditional utility model."

Despite the common perception, Crius's business model is nothing like a traditional utility

company. Crius primarily operates as an electricity and natural gas provider in the *deregulated* energy markets, also commonly known as an Energy Service Company (or "ESCO").

Unlike utilities, ESCOs like Crius do not have monopolistic infrastructure such as power plants or transmission lines that they can monetize for steady streams of cash.

**n the contrary**, ESCOs offer a product that is a near-total commodity with almost no barriers to entry. They purchase wholesale electricity and natural gas on the open market (i.e.: on typical commodities exchanges) and simply sell it to commercial and residential customers at a markup. The core business of ESCOs therefore amounts largely to marketing, sales, servicing, and billing its customers.

Due to the lack of barriers to entry, ESCOs like Crius operate in a fiercely competitive environment. In New York alone, there are 151 ESCOs serving the electricity markets, according to the New York Department of Public Service .

Such fierce competition manifests itself in numerous ways, including the very high customer turnover experienced by the Company. Unlike utilities that tend to have a very stable customer base, Crius's customer attrition has averaged 10.3% per quarter on an LTM basis, representing roughly a 41.2% annual customer attrition rate [10.3%*4].

# *Treacherous Liquidity Position*

We believe the mismatch between the competitive industry Crius operates in coupled with its generous dividend payment has led to a precarious liquidity position.

As of the recent September 2017 quarter-end, the company had cash of $24.3 million and available credit of $25.2 million excluding a temporary $20 million bump in credit availability that expired in the 4th quarter. (Source: Q3 MD&A pg 7) Net of the full burden of a recent preliminary class action settlement for up to $18.5 million the company would be left with cash of only $5.8 million.

As of September 2017, the company had an adjusted working capital balance of negative $23.2 million, reinforcing the reality of present cash constraints. (Source: Q3 MD&A pg 24)

Compared to the liquidity profile above, the Company's debt stack appears daunting. As of

September 2017, the company had $122 million in debt and off-balance sheet letters of credit outstanding with a weighted average interest rate of 7.67%, consisting of:

- $42.8 million senior promissory note bearing 9.5% interest (Source: Q3 Financials pg 18 )
- $55.6 million credit facility bearing 7.08% as of this writing (5.5% plus 30-day LIBOR) (Source: Q3 Financials pg 3 )
- $17.3 million in letters of credit bearing 7.08% as of this writing (5.5% plus 30-day LIBOR) (Source: Q3 Financials pg 24 and Q3 MD&A pg 29)
- $6.2 million term loan bearing 2% from the state of Connecticut (Source: Q3 Financials pg 18)

The operating business has provided little recent relief. In the last twelve months (LTM) the Company generated only $13.7 million in operating cash flow and $4.8 million in net income. (Source: Company financials )

# *Dividend in Jeopardy*

That operating cash flow is not nearly enough to support Crius's current dividend. The company's annualized distribution rate of 0.8368 per unit would translate to an annual dividend payout of C$47.7 million, or about C$12 million per quarter. [1]

Investors have come to expect both the high dividend rate and the steady increases over time, and the Company has obliged to date, having issued 8 straight quarterly dividend increases. [2] Furthermore, on January 30th, 2018, the company announced an intention to make a Normal Course Issuer bid (a Canadian form of a stock buyback) representing up to 10% of the public float.

Despite this optimistic signaling we believe Crius's financial profile puts the dividend in imminent jeopardy in the absence of further dilutive equity issuance.

# *The Non-IFRS Dividend "Payout Ratio" Strikes us as Highly Questionable*

Despite the signs of stress, the company has seemingly encouraged the notion that its dividend is " conservative " due to its low dividend "Payout Ratio". We do not believe the non-IFRS Payout Ratio is a reliable indicator as it includes adjustments that do not appear sustainable. We have highlighted and detailed 3 questionable adjustments to "Distributable Cash" (the key metric behind the company's "Payout Ratio") per the company's most recent

quarterly MD&A:

| Distributable Cash and Payout Ratio | Quarter ended September 30, 2017 | Quarter ended June 30, 2017 | Quarter ended March 31, 2017 | Quarter ended December 31, 2016 |
|---|---|---|---|---|
| Cash flows from operating activities | $5.3 | $1.3 | $(8.2) | $15.2 |
| Changes in operating assets and liabilities | (13.4) | (5.7) | (14.2) | 2.2 |
| **Cash flows from operating activities excluding changes in operating assets and liabilities** | **$18.7** | **$7.0** | **$6.0** | **$13.0** |
| Finance costs included in financing activities | (5.3) | (2.7) | (2.3) | (2.3) |
| Maintenance Capital Expenditures | (0.5) | (0.8) | (0.9) | (1.2) |
| Unit-based compensation payments | — | — | (4.1) | (0.3) |
| Legal reserve and associated legal fees | 0.3 | 7.9 | 9.0 | — |
| **Distributable Cash** | **$13.2** | **$11.4** | **$7.7** | **$9.2** |
| Distributions to non-controlling interest | — | — | — | — |
| Distributions to Unitholders | 8.2 | 5.8 | 5.8 | 5.7 |
| **Total Distributions** | **$8.2** | **$5.8** | **$5.8** | **$5.7** |
| **Payout Ratio** | **62.1%** | **50.9%** | **75.3%** | **62.0%** |

First, the metric excludes "changes in operating assets and liabilities" which neglects the company's negative (and recently growing) working capital deficit of $23.2 million as of last quarter, as mentioned above.

Second, "legal reserves" are added back despite settlements that were expected imminently, by the Company's own statements: "Management has entered into agreements in principle to settle these matters and expects to announce such settlements within the next few months." We don't see how such imminent expected detractors from the cash balance could reasonably be considered an add-back to Distributable Cash. Note that as mentioned above the company has agreed to a preliminary settlement of up to $18.5 million in the Viridian case, further underscoring that settlement proceeds are not a realistic "add back" to distributable cash.

(*Note that we emailed investor relations and asked for an update on the status of the company's class action lawsuits and have not heard back as of this writing. Should we hear back, we will update this accordingly.)*

*Update: See above (intro paragraph) for investor relation's response to our question on Viridian post-publication.*

Third -and in our view most importantly – only "maintenance capex" is deducted from its

Distributable Cash. Maintenance capex is defined as *excluding* acquisitions.

This strikes us as a highly unrealistic add-back given that Crius has regularly acquired portfolios of customers that have increased its near-term operating cash flow metrics. The company has repeatedly described its acquisitions as being near-term "accretive" to distributable cash per unit, which is a way of indirectly acknowledging that they boost near-term operating cash flow metrics. Examples:

- Upon announcing the recent acquisition of USG&E, which added 350,000 customers, Crius stated "The USG&E Acquisition would have represented an approximate **16% increase to Distributable Cash per Unit on a pro-forma basis for the 12-month period** ended March 31, 2017, and is expected to deliver strong accretion in 2017 and 2018…"

- Upon announcing the acquisition of TriEagle, which added 200,000 customers, Crius similarly stated it expects " **the acquisition of TriEagle Energy to provide revenue and operational synergies and be accretive to distributable cash flow per unit in the next 12 months."**

What this means is that the company is using investing cash flow to buy customers which increases near-term operating cash flow. The operating cash flow increase is then **included** in its "Payout Ratio" while the investing capital required to create that increase is then **excluded**. This strikes us as a classic "give with one hand and take away with the other" scenario.

To give a sense of the magnitude of this dynamic, Crius has paid over $202 million in the past 2.5 years to acquire businesses that have added 631,000 customers, representing a significant portion of its reported 1,446,000 customer-base as of last quarter. This includes the substantial $175 million USG&E acquisition last year that added 350,000 customers.

We believe these acquisitions are optically accretive in the short term but destructive in the medium term, in large part due to the large customer turnover detailed above (10.3% per quarter on an LTM basis, or a roughly 41.2% annual attrition rate.)

To demonstrate this through an analogy, the situation strikes us as similar to constantly dumping buckets of water into a bathtub that has a giant hole in it. If you look into the tub at any given moment, it will appear to have some liquidity sloshing around, but once you stop dumping in new buckets of water, the tub quickly runs dry. By ignoring the need for new buckets and simply looking at only the water in the tub, one is left with a vastly incomplete picture of *sustainable* liquidity.

# *Crius's Multi-Level-Marketing Channel (Viridian) is Essentially in Run-off*

On the subject of attrition, it appears that a significant portion of the Company's historically high-margin business is now effectively in run-off. On Viridian's Facebook page, we found dial-in instructions for a December 4th call. On the call, Viridian EVP Robert McFadden announced at 3:16 that "Viridian is transitioning out of the relationship marketing channel" and is transitioning into a customer acquisition channel through "more traditional" means. The call noted that Crius will continue to service the existing customers, but as of March 1st, Viridian is no longer accepting new leads through its multi-level-marketing (or "network marketing") channel, essentially leaving that business in run-off.

Despite this announcement to Viridian's contractors, we could find no mention of the transition away from Viridian's multi-level-marketing efforts in Crius's investor communications.

Viridian has been one of Crius's largest key brands through its history and has represented the company's network marketing channel. This network marketing has represented a huge piece of Crius's historical sales:

- 2013: 68.8% of total revenue or $266.9 million. (2013 YE pg 3)
- 2014: 54.6% of total revenue or $328.0 million. (2014 YE pg 4)
- 2015: 47.2% of total revenue or $323.6 million. (2015 YE pg 14)
- 2016: The company stopped breaking out Viridian's sales separately, and divested 90% of the business while retaining the right to own and service all existing and future electricity and natural gas customer relationships, according to the July 19th, 2016, press release.

*(We emailed investor relations and asked how much Viridian represents in terms of customer count and revenue as of last quarter and have not heard back as of this writing. Should we hear back, we will update this accordingly.)*

While Crius's filings don't currently break out its customer base by sales channel, an overview brochure on the Viridian website described the company as "an energy partner helping more than 300,000 customers make smart energy choices." Given that Crius's overall customer base was 1,446,000 as of September 30th, Viridian's estimated 300,000 customers represent roughly 20% of the company's customer base.

# *U.S. Gas & Electric Acquisition: A $175 Million Hail Mary*

We believe Crius's massive acquisition of U.S. Gas & Electric (USG&E) is an attempt to plug the hole left by the company's customer churn, tightening financials, and the transition away from its historically crucial multi-level-marketing sales channel. The USG&E acquisition strikes us as a Hail Mary that will have a temporary ostensible improvement in operating cash flow while destroying value in the medium term.

A breakdown of the total $175 million purchase price of USG&E is as follows:

- ~$94.4 million consisted of "goodwill", which is largely comprised of "the value of the assembled workforce and synergies and economies of scale".
- ~$111.8 million consisted of "customer accounts".
- The balance mainly consisted of a ~$42.5 million deferred tax liability (which lowered the purchase price), the netting of working capital accounts, and PP&E.

(Source: Q3 2017 financials pg 11 )

As to the goodwill, in the Q3 2017 press release , the company stated that it expects "annual run-rate after-tax cash synergies of $12 to $14 million" and clarified on the conference call that $10 to $12 million of those synergies would come from G&A. Crius CFO Roop Bhullar also stated on the conference call that USG&E's G&A was about $20 million, suggesting that synergies would represent cuts of between 50% and 60% to G&A.

We believe the magnitude of these cost cuts to be unrealistic for several reasons:

1. USG&E already went through a series of layoffs and G&A cuts prior to its sale, according to multiple sources we spoke with. If there was any significant excess to be trimmed, it seemingly was already cut prior to the acquisition.
2. USG&E will add two new markets to Crius, Michigan, and Kentucky (per the presentation pg 12) which will likely necessitate its own managerial staff and G&A expenses.
3. With the Viridian multi-level-marketing sales channel in run-off, Crius is likely going to heavily rely on USG&E's telemarketing and door-to-door sales channels, which similarly necessitate overhead.

As to the customer accounts, the $111.8 million cost of USG&E's 350,000 customers represents a purchase price of about **319 per customer** This purchase price compares to our estimated

total *lifetime* gross margin contribution of only about $489 per USG&E customer. (See below for our process for arriving at this number. [3])

Given the narrow justification for the USG&E acquisition on a mere *gross* margin basis, the *net* contribution after factoring SG&A and the company's overhead suggests that the USG&E acquisition will likely be completely destructive to value regardless of whether Crius's unrealistic synergy targets are achieved.

Worse yet, the USG&E acquisition comes with a host of other issues that make it a potentially toxic asset, including outstanding NY and NJ AG subpoenas, and pending regulatory rulings. Per the short form prospectus for the USG&E acquisition on pages 36-37:

> *In New Jersey, the state Attorney General initiated requests of information related to New Jersey Gas & Electric regarding its customer agreements, pricing and complaints received in February 2016. New Jersey Gas & Electric responded to the Attorney General's requests and the matter remains pending. USG&E is also subject to regulatory actions by the New York Public Service Commission and the Maryland Public Service Commission that are ongoing and pending resolution.*

The prospectus also clarified (pages B50-B51) that the New York AG and the New Jersey AG have both subpoenaed USG&E, collectively asking for information regarding customer complaints, pricing, marketing practices, and customer agreements.

Given that New York accounts for 26% of USG&E's 2016 revenue, (according to the same short form prospectus pg 37), a New York action in particular could be highly destructive.

In Pennsylvania, which also accounted for 26% of USG&E's 2016 revenue (pg 37), the company's subsidiary was sanctioned by the Pennsylvania Public Utility Commission in 2016 to the tune of almost $7 million. The sanctions consisted of customer refunds, penalties and contribution to a Hardship Fund, and also included the company "Mak[ing] numerous modifications to its business practices related to product offerings, marketing, third-party verifications, disclosure statements, training, compliance monitoring, reporting and customer service."

USG&E's same subsidiary was hit by a class action lawsuit in Pennsylvania that recently settled for $1.25 million and $475k in attorney's fees. See the original complaint here.

In all, it seems that Crius vastly overpaid to purchase USG&E right when USG&E became forced to constrain its business practices to adjust to tighter legal and regulatory pressure.

## *Viridian Class Action Lawsuit*

If the above regulatory and class action lawsuit issues sound familiar, it may be because Crius's former key brand Viridian was sued in a class-action lawsuit by customers in Massachusetts, Connecticut, New Jersey, New York, Maryland, and Pennsylvania for alleged unsavory business practices. As mentioned earlier, the lawsuit has reached a preliminary settlement agreement for up to $18.5 million. In the lawsuit, Viridian was accused of, among other things:

- Offering variable rate plans and then spiking the price 4x-6x higher than the underlying market rates.
- Offering low fixed "teaser" rates, then switching customers to variable plans and spiking their rates.
- Raising variable rates even when the wholesale market rates go down.

One section of the lawsuit described Viridian as an operator that stood as a complete middleman in the market:

> *Viridian charges these exorbitant premiums without adding any value to the consumer whatsoever…Viridian does not either produce or transport energy. It has no role in running or maintaining energy generation or transport facilities; it does no hook-ups or emergency response. Indeed, Viridian does not even handle customer billing: that, too, is handled by the Distribution Company. Essentially, all that Viridian does is act as a trader in the transaction. Yet it charges much more than the Generation Companies receive for making energy and the Distribution Companies receive for transmitting gas and electricity, maintaining power and gas lines, and handling emergency services and customer billing and calls.*

Note that the allegations were not proven in court and likely never will be on account of the pending settlement.

## *The Deregulated Energy Market is Facing Severe Legal and Regulatory Headwinds*

The kinds of legal issues facing Crius and its new USG&E subsidiary are not unique to just them. These issues are affecting the deregulated energy industry in general. One of the key root issues driving this is that the fierce competition and sales-focused nature of the ESCO business model has fueled rampant controversial business practices.

If you've ever had someone knocking on your apartment door claiming to be from the utility company saying something like "we're making sure people get our new lower rate program, just sign *here* to make sure you get the best rates" you have likely already met a salesperson operating in this market.

Unscrupulous business practices translate to dollar signs for class action law firms. Regulators have similarly responded, fueled by the numerous consumer complaints and powerful interest groups that have taken aim at ESCOs.

# *New York's Aggressive Regulatory Moves*

One such example of states taking aggressive regulatory action is New York. Crius does not break out sales by state, but we believe it is a key market for Crius given USG&E's 26% stated revenue concentration in New York and given the relative large population of New York compared to other states with deregulated energy markets.

New York took strict measures against the ESCO industry following pressure from AARP and strongly negative media coverage of the industry (see: Why is Albany Letting These Energy Companies Scam Thousands of Consumers.) In February 2016, New York Governor Andrew Cuomo seemingly declared war on ESCOs, making an announcement titled "New Consumer Protections for Energy Consumers to Stop Deceptive Business Practices". In the announcement, the Governor stated:

> *We have zero tolerance for these unscrupulous companies, whose business model is to prey on ratepayers with promises of lower energy costs only to deliver skyrocketing bills.*

An order was issued by the New York Public Utilities Commission (PUC) on February 23rd, 2016, that took the step of:

> *Effectively and prospectively shutting down the competitive retail electricity market*

> *in the state for the majority of residential and small commercial (mass market) customers. The Order would limit energy service companies (ESCOs) to serving mass market customers under contracts that either ((i)) guarantee customer cost savings in comparison to utility rates or (ii) guarantee that the energy delivered to mass market customers consists of at least 30 percent renewable energy. This limit would apply not only to new customers but also to contract renewals(Source: Day Pitney LLP)*

The order would have essentially eviscerated much of the New York ESCO industry. Most of the order was vacated by a New York state court on July 22, 2016, stating in its decision that the order "appears to be irrational, arbitrary, and capricious". However, the New York Public Service Commission has cross-appealed the decision, according to Crius' filings. (Source: June 2017 Short Form Prospectus pg 34 )

In July 2016, Cuomo then declared a moratorium on ESCO sales to low-income customers , in order to "Protect Most Vulnerable Consumers from High-Priced Energy Services". (Note that Crius commented that this ruling would affect fewer than 10,000 of its customers, including its new USG&E customers.)

In May 2017, the New York State Public Service Commission upped the ante yet again and issued more than 170 subpoenas to ESCO providers seeking facts to be used in an " evidentiary hearing to determine whether consumers are paying fair prices for ESCO products and services".

We rarely focus on regulatory changes as a catalyst for our investment theses (because regulators can be quite slow), but given the pace of New York's oversight moves, their stance on ESCOs, and the magnitude any new action would have on Crius' business we believe it to be relevant. As noted earlier, other states have taken action (such as Pennsylvania's action against USG&E's subsidiary) and others have taken notice and opened investigations. Collectively, we believe the regulatory pressure creates an environment that forces tighter controls and more transparent sales and marketing practices.

# *Constricting Gross Margins A Tightening Noose*

As the days of (allegedly) charging customers 4x-6x higher than underlying market rates and as other (alleged) unscrupulous practices get litigated or regulated out of existence, so too go the high gross margins.

Gross margins in Crius's core business have been dropping consistently. When looking at the latest quarterly numbers and excluding the impact of the U.S. Gas & Electric (USG&E) acquisition that closed in early Q3, Crius would have had robust year-over-year customer count growth of about 13.5%, yet a revenue *decline* of about 5% over the same period. [4] Even when including the new USG&E subsidiary, which currently has higher gross margins, gross margins have nonetheless continued to decline:

| eriod | Gross Margin % | Source |
|---|---|---|
| 2017 Q3 | 20.4% | Q3 MD&A Pg 4 |
| 2017 Q2 | 20.6% | Q2 MD&A Pg 4 |
| 2017 Q1 | 20.9% | Q1 MD&A Pg 4 |
| 2016 | 21.3% | 2016 YE Pg 3 |
| 2015 | 23.9% | 2016 YE Pg 3 |

In light of believed regulatory and legal constraints to adding high margin customers, Crius's customer count seems to be growing most in its lowest margin business; energy aggregation. From the Q3 2017 press release :

> *The decrease in gross margin as a percentage of revenue in the quarter is consistent with recent trends as a result of the increased mix of lower-margin commercial and municipal aggregation customers in the portfolio, partially offset by the addition of the higher-margin USG&E customer portfolio.*

For context: energy aggregation programs are when municipalities run a competitive bidding process to see which supplier provides power to the municipality. ESCOs will typically bid to supply the municipality for a fixed period of time (such as 1-3 years) for a fixed price per kWh for the length of the contract period. Individuals living in the municipality can choose to "opt out" of the fixed supplier relationship, otherwise, they are generally opted-in automatically.

Given that competing ESCOs can purchase energy from the same wholesale markets as one another, the bids for aggregation contracts tend to be highly competitive and the margins tend to be quite low. The net result is that the winning ESCO gains a large number of customers, but the profitability of such relationships tends to be minimal.

As a consequence, customer count has become a less useful metric for measuring Crius's

gross margin contribution. In support of this, when we calculate Crius's gross dollar margin per customer, we see that the margin contribution per customer has been dropping materially over the past several years:

| | |
|---|---|
| **LTM** | $37.34 |
| **2016** | $41.72 |
| **201** | $55.85 |
| **201** | $55.26 |

*(Source: Crius filings. Total Gross Margin/Total Customer Count)*

The net result is that (1) aggregate margins in the business have steadily declined and (2) customer count has become a less relevant metric for assessing the overall strength of the business.

# *Comcast Partnership: Much Ado About (Almost) Nothing*

Many commentators have spoken optimistically of the future of Crius's relationship with Comcast (CMCSA). On the company's own " Why Invest " page a key component of the growth thesis is "significant upside from Comcast partnership".

Crius has had a relationship with Comcast since as early as February 2015 but the relationship has yielded few tangible results in the interim 3 years. Here is a rundown of comments on the company's Comcast relationship from the MD&As:

- In Q1 2015, Crius announced that it had "started offering energy products to Comcast customers in Pennsylvania and Illinois in April 2015."

- In Q2 2015, Crius added New Jersey in August 2015.

- In Q3 2015, Crius first reported some tangible numbers. The company "had access to 33% of Comcast's addressable subscribers across three states". The company also reported that it had added 4,000 subscribers in the quarter, and that 1,200 subscribers had been added earlier in the Q2 quarter. Growth customer enrollments were "expected to approach 15,000 by the end of 2015" and the company "remains on track to have access

to all Comcast subscribers in deregulated energy markets by the end of 2016."

- By Q4 2015, the company stopped reporting tangible numbers entirely, instead vaguely stating that it had "achieved continued growth in the quarter when compared to the prior quarter". As it would turn out, Q3 2015 was the first and last quarter where Crius reported Comcast customer numbers in its MD&A.

- In Q1 2016, the company didn't even state that it had achieved q/q growth, as it had in the previous MD&A. Instead, it was even more vague: "the Company continued to see growth in line with management's expectations". Management's expectations were never quantified in the MD&A.
- In Q2 2016, the company reported that it had launched service in 4 new states under its Comcast Energy Rewards brand.

- Despite the growth in geographic footprint, by Q3 2016 Crius reported that "Sales from the Comcast channel have moderated".

- In Q4 2016 through Q2 2017, the company reported that it had renewed its relationship with Comcast for 5 years and entered into a new agreement to jointly offer an Integrated Energy Platform with plans to be fully integrated by the end of 2017.

- Last quarter in Q3 2017, the company reiterated its plans to be fully integrated by the end of the year, and added plans to " **recommence enrolling customers in early 2018** Note that it was unclear from the MD&As that the company had ever ceased enrolling customers in the first place.

We find the above fact pattern to be wholly uninspiring. The company had reported tangible numbers relating to its Comcast relationship in its MD&A for only 1 quarter almost 2.5 years ago, followed by vague references to the program and then a sudden indirect acknowledgement in the latest quarter that the program had stopped enrolling customers entirely.

We called the Energy Rewards number to learn more about the program. As we found out, the contracts are fixed rate, suggesting that they are likely to be fairly slim margin. Without clarification on ((i)) actual customer additions and ((ii)) actual gross margin contribution from customers added through the partnership we view it as little other than a "brand name" partnership that sounds great on paper but will likely add very little to the bottom line.

# *What's Next: Our Predictions*

We believe Crius is virtually out of cash net of pending its legal settlements. The USG&E acquisition will likely provide some near-term operating cash flow support in the next 1-2 quarters, and the acquisition also gives Crius an opportunity to capitalize on tax NOL's held from its Verengo acquisition which will add an estimated $1.5 million to $2.25 million per quarter (i.e.: $18 million total over the next 2-3 years )

That being said, when factoring in the dividend payout (which chews up almost C$12 million per quarter at current payout rates), we see the company hovering around cash neutral for the next 1-2 quarters in a best-case scenario. As high margin customers continue to drop off we expect a potentially fatal cash crunch by summertime unless additional external capital is raised to bolster the balance sheet.

We expect the company will seek to raise $50-100m around May-July or may even attempt another medium to large "accretive" acquisition around that time frame.

## *Customer Count Predictions*

From a customer standpoint, we think the company will continue to pick up more low-margin aggregation contracts. We anticipate splashy "headline" customer count growth that ultimately won't do much to improve the cash flow situation.

More specifically, the company recently lost several townships in New Jersey but picked up many townships in Massachusetts that will likely fill the "customer count" attrition hole in the near term.

## *Massachusetts Energy Aggregation Gained Townships:*

We found 40 townships in Massachusetts where Public Power (a Crius subsidiary) won competitive auctions to provide service. Start dates range from November 2017 to February 2018 with contracts ranging from 12 to 36 months in length at prices ranging from 9.318 c/kWh to 10.88 c/kWh. Ten of the contracts begin in Q4 2017 with the balance beginning in Q1 2018.

## *New Jersey Energy Aggregation Lost Townships*

- Flemington and Rariton Townships in NJ switching back to JCP&L per a November 2017 announcement.
- Tom's River also is switching back to JCP&L per an October 2017 announcement.
- Howell Township is also switching back to JCP&L per a December 2017 announcement.
- Montgomery Township also switched back to JCP&L per an October 2017 announcement.

- Plumsted Township also switched to a new provider (Constellation) per an October 2017 announcement.

Note that depending on whether the company fully hedges or floats some of the risk on these fixed contracts it could alter the risk profile of the business considerably. We have asked investor relations for clarification on the hedging approach to fixed contracts and have not heard back as of this writing. Should we hear from investor relations we will update this accordingly.

# *Conclusion*

We think the Crius business model is on the precipice of failure as the liquidity profile worsens and industry pressures intensify. We expect the company will continue to require more infusions from the capital markets in the form of either dilutive equity raises or large acquisitions. Best of luck to all.

---

[1] Based on 57,030,067 units outstanding as of January 29th, 2018.

[2] Source: Company press Release 1 and 2.

[3] ((i)) Crius generated a gross margin of about $37.34 per customer per quarter over the last 4 quarters.

((ii)) Adjusting upward to account for USG&E's historically higher margin of 28.2% (as of the latest Q1 2017 [23,851/84,415] according to the short form prospectus pg. A-3 ), we estimate gross margin of about $50.5 per USG&E customer per quarter.

((iii)) Taking Crius's LTM attrition rate of 10.3%, we assume that each customer lasts about 9.7 quarters therefore arriving at (50.5*$9.7) lifetime gross margin of about $489 per USG&E customer.

[4] USG&E had Q3 revenue of $58.484 million according to Q3 MD&A Pg 11. Excluding USG&E revenue, the company was left with $211.42 million on the quarter, a Q/Q decline of 5.02% from Q3 2016 revenue of $222.6 million.

[5] To arrive at this we looked at the explicitly named holders mentioned in the deal, which

include Robert Gries, Macquarie Energy, and Crius CEO Michael Fallquist (who as a side note personally cashed out C$4,414,156.34 as part of the offering, according to pg 32). In the 2016 mixed cash and units deal Fallquist/Gries/Macquarie comprised 12,807,733 LLC Units out of a total 19,458,942 LLC Units in the offering, according to the June 1, 2016, Short Form Prospectus . When netting out the shares purchased from named holders in the deal that leaves 6,651,209 Crius units issued to the "various holders". Given that Crius was formed 50/50 by combining Gries' "Public Power" with the Platinum-sponsored REH, and given that Gries was explicitly named, we infer by process of elimination that the unnamed "various holders" likely consist in large part of the original REH holders.

**Disclosure:** I am/we are short CRIUF.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

# TAB 45

# OPKO Health: New Signs Of Chaos In Key Diagnostics Division

Published on February 27, 2018



## Summary: OPKO Health, Inc. (OPK)


- The President of OPKO's key BioReference division (82.8% of 2016 revenue) resigned, and no new successor was named. We believe this to be a strong negative omen.
- A recent lawsuit filed against BioReference alleges violations of law, including forgery, releasing unverified test results, and falsification of employee training and competency documents.
- A pattern of lawsuits emerges naming BioReference in four New York insurance fraud cases.
- OPKO's recently FDA approved Varubi (licensed to TESARO) recently updated its risk factors to include major side effects, potentially inhibiting yet another cash flow stream.
- With tangible book value of only about $10.5 million (i.e.: 2 cents per share) and with very few bright spots to point to, we see significant further downside for OPKO.

# *Introduction*

In our November 17th article titled " Opko Health: A House of Cards Tumbling in the Dark ", we focused a large portion of our piece on illuminating warning signs relating to OPKO's (NYSEMKT:OPK) diagnostics business, which primarily consists of BioReference Laboratories ("BioReference").

In particular, we identified:

- A slew of undisclosed or thinly disclosed executive team departures, including several individuals that had checkered histories.
- A seeming new shift toward compliance in the form of both the above executive "house cleaning" and the recent hiring of a chief legal and compliance officer.
- A Southern District of New York (SDNY) False Claims Act probe that represents a looming and ongoing regulatory uncertainty.
- Deteriorating revenue on both a Q/Q and Y/Y basis and the further potential for deterioration, given the believed clampdown on non-compliant business practices.

Since that article, we have come across new signs that BioReference is still in the midst of a major clean-up, and that the issues may be more severe than we had originally thought. New information has come to light in the form of a key resignation and several lawsuits naming BioReference as defendant or co-defendant.

Note that diagnostics accounted for approximately 82.8% of OPKO's 2016 annual revenue. Given the lack of major expected near-term pipeline updates and the sluggish roll-out of OPKO's signature Rayaldee drug to date, we believe BioReference's performance will be a key factor in the upcoming earnings release.

# *President of BioReference Resigns, Again*

On January 26th OPKO announced that BioReference President Gregory Henderson had resigned. We believe the resignation was unexpected as Henderson had no comment in the press release, and no successor was announced. A check of the current BioReference executive team website as of this writing shows no President is currently listed.

Henderson had been appointed only in March 2016 to replace the BioReference founder Marc Grodman who had also resigned without making any public comment. In our experience, key leaders typically do not suddenly resign with scant detail when things are going well. We believe

Henderson's resignation is a signal that this reporting period will show further deterioration in BioReference, as we had anticipated in our previous report.

# *Allegations of Severe Impropriety Emerge Relating to a BioReference Houston Laboratory*

We recently learned of an employee anti-retaliation lawsuit filed in New Jersey in August 2017 that alleges severe improprieties relating to a BioReference Houston laboratory. To read the full complaint, see Stephanie Halliday vs. BioReference Laboratories Inc ., [2:17-cv-6889]. We believe the entire complaint is worth reading, but below are several key sections:

> *In 2016 and 2017, BioReference was operating its laboratories in violation of federal health and safety statutes and regulations, including the Clinical Laboratory Improvements Act of 1988 ("CLIA") and the Occupational Safety and Health Act of 1970. Stephanie Halliday—a BioReference employee—objected to, refused to participate in, and disclosed these violations of law, public policy, and patient care. In retaliation for this protected activity, BioReference terminated Ms. Halliday's employment on May 11, 2017.*
>
> *…In July, 2016 BioReference hired Ms. Halliday as its Night Supervisor in one of its Houston, Texas laboratories. Almost immediately after she started working for BioReference, Ms. Halliday discovered that BioReference was violating federal law governing the operations of its laboratories.*
>
> *Specifically, Ms. Halliday discovered that BioReference had been releasing patient test results to doctors in the period January, 2016 through June, 2016 despite the fact that BioReference's testing procedures/practices failed quality controls.*
>
> *Ms. Halliday also discovered that a BioReference internal quality control inspection of its Houston clinical laboratory conducted from April 25, 2016 through April 28, 2016 found the laboratory had serially violated federal law, including federal regulations governing exposure to bloodborne pathogens, including Hepatitis B and HIV (29 C.F.R. 1910.1030); and federal regulations governing exposure to toxic and hazardous substances.*

The lawsuit continued by describing Ms. Halliday's objections that she had outlined to a

supervisor:

> *…One of the practices that Ms. Halliday objected to in her September 9, 2016 email to Ms. Russo [a supervisor] was BioReference's release to a doctor of unverified test results on September 8, 2106. BioReference's release of the unverified test results led to the hospitalization of the doctor's patient. BioReference attempted to cover-up the fact that it had not properly verified the test results by claiming that this was simply a "manual" data entry problem, when it was a failure of verification. Ms. Halliday subsequently exposed, objected to, and refused to participate in this illegal cover-up.*

The complaint continues by detailing the exchanges back and forth between Ms. Halliday and BioReference supervisors and ultimately with senior executives of the division. The complaint includes allegations of:

- Attempted intimidation.
- Attempts by BioReference employees to get Ms. Halliday to fraudulently certify false documents or to approve backdated documents.
- Forgery by a BioReference employee of laboratory system monthly evaluation documents.
- Allowing laboratory technicians to perform tests without the necessary training or competency.
- Falsification of employee training and competency documents in order to pass an upcoming regulatory inspection.
- The firing of Ms. Halliday in order to silence her in advance of the upcoming inspection.

We have emailed OPKO's investor relations seeking comment on the bulleted allegations above. We have not heard back as of this writing, but should we hear back, we will update this accordingly.

Note that none of the allegations have been proven in court. We intend to keep an eye on the case to see how it progresses.

# *A Pattern of Lawsuits Emerges Naming BioReference in New York Insurance Fraud Cases*

A litigation review also turned up four lawsuits naming BioReference as co-defendant in

relation to alleged auto insurance fraud schemes. The lawsuits largely allege that individuals were involved in sham auto accidents in New York and then fraudulently billed insurance companies for services that were either medically unnecessary or were never performed. Multiple medical institutions were named as co-defendants in these lawsuits, often with the same institutions overlapping across the complaints.

Note that of the four lawsuits we found, the matters are believed to have either been settled or are ongoing, and therefore have not been proven:

1. In a May 2016 case filed by Kemper Independence Insurance, the complaint details how a single car was involved in four separate low-impact crashes in New York. In each crash, the airbags never deployed, and in all cases, the drivers and passengers either reported no or minimal physical injuries at the scene. Each time the car was involved in a crash, it had different passengers, which allowed each passenger to individually bill for medical services. The complaint named BioReference as one among several Medical Provider Defendants.
2. In an August 2017 case filed by Ace American Insurance Company, the complaint details an accident that the police report indicated was "a minor sideswipe, the airbags did not deploy on either vehicle, and that no occupant of either vehicle reported any injuries at the scene and none were visibly injured." Later, the claimants reported to have sustained serious bodily injuries in the collision. The claim's legitimacy was questioned for, among other reasons: (i) the insured vehicle was rented just hours prior to the crash (ii) there were 9 people in the vehicle (iii) damage was minimal (iv) no injuries were reported or visible at the scene and (iv) "the claimants were treated heavily and received boilerplate and mirror treatment from the same group of medical providers."

Two other cases, one filed by American Transit in 2016 and the other filed by Hertz in 2012 provide fewer details but allege false insurance claims in a similar manner.

We have emailed OPKO's investor relations seeking comment on BioReference's alleged role in the above insurance fraud claims. We have not heard back as of this writing, but should we hear back, we will update this accordingly.

We do not believe these cases will have a meaningful impact on BioReference's financials. However, in light of the other recent and historical issues with BioReference, we will be monitoring these as well to see if the pattern of lawsuits continue.

## *Problems with Recently FDA-Approved Varubi Could Put Further Pressure on Cash Flow*

Aside from performance and compliance questions relating to BioReference, we learned recently that another of OPKO's potential cash flow streams is now under threat.

One of the few bright spots for OPKO shareholders from late 2017 was the FDA approval of Varubi IV, a drug designed to aid in the treatment of delayed nausea and vomiting in chemotherapy patients. OPKO had licensed the formulation for Varubi to TESARO Inc. (NASDAQ:TSRO) in 2010 in exchange for milestone payments of up to $85 million and "tiered double-digit royalties". On October 26, 2017, OPKO announced the FDA approval of the formulation which was then targeted for launch in November.

The positive news was quickly diminished when on January 12th, TESARO announced that it had updated the labeling of the newly-approved Varubi formulation to include the potential for severe side effects:

> *Anaphylaxis, anaphylactic shock and other serious hypersensitivity reactions have been reported in the postmarketing setting, some requiring hospitalization. These reactions have occurred during or soon after the infusion of VARUBI injectable emulsion. Most reactions have occurred within the first few minutes of administration.*

In the aftermath of the announcement, a class action lawsuit was filed against TESARO. The future of the drug and its sales potential remains in doubt. With very little positive news coming out of OPKO, this update on Varubi represents yet another cash flow opportunity that appears to be slipping away.

# *Phil Frost Resumes His Insider Purchases*

In other news, OPKO Chairman and CEO Phil Frost has resumed his longstanding practice of making open market purchases after having temporarily paused his purchases near the end of September 2017. Dr. Frost restarted his purchases on January 22nd, which rather serendipitously coincided with the same week that the company announced the resignation of the BioReference President.

As we noted in our earlier report, Frost has been making open-market purchases in OPKO for over 10 years. His purchases have been a poor prognosticator of stock performance to date. Our belief in November remains the same now: "With very few positive signs to point to at the

company, Frost is simply attempting to protect the stock via token insider purchases in the hopes of buying more time."

## *Our Predictions for the Upcoming Earnings Release*

We believe we will see signs of further deterioration in BioReference and will see a worsening cash flow situation at the company overall. We expect this to put further pressure on credit lines. While Rayaldee is likely to have a large percentage increase in sales, we will be looking at the "absolute" dollar number, given that Rayaldee sales are still coming off of a low base.

In our previous report, we noted that the company announced the submission of a device application for its Claros device the very day before earnings were released. We viewed it as a suspicious move, given that the Claros device filing had been delayed for five years to that point. The announcement by the company seemingly *assumed* that the Claros device would be approved and underscored the large market opportunity addressed by the device, whereas we believed (and still believe) its actual chances of approval are slim. At the time, the announcement struck us as a red flag that may have been intended to "blunt" the impact of negative earnings.

We mention this because we will similarly be on the lookout for other announcements that could "blunt" the impact of potentially negative earnings. This could take the form of announcing the re-submission of the hGH-CTP drug (which we previously identified major irregularities with) or the featuring of a "brand-new" formulation with bold new expectations about massive market potential with little tangible data or results to support it.

In short, we are going into this call on the lookout for potential spin. When looking at OPKO's history, we see a large graveyard of loud promises that ended up dying quietly. We will be focusing instead on the tangible numbers and actual results. Best of luck to all.

**Disclosure:** I am/we are short OPK.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 46

# Riot Blockchain: Yet Another Suspicious, Cash-Depleting Transaction

Published on February 26, 2018



## Summary: Riot Blockchain, Inc. (RIOT)


- Riot reported yet another dubious transaction via 8-K during a market "dead zone" – Friday after the close.
- Riot is paying a $4 million upfront consulting fee to a believed undisclosed related party entity.
- Just last week we had identified the entity, Ingenium International LLC, as being highly suspicious.
- Collectively, Riot's series of suspicious transactions are among the most brazen irregularities we have seen in a U.S. listed company.


## Introduction

We genuinely thought we were done writing about Riot Blockchain (NASDAQ: RIOT) after our first article in early December. After all, what more needed to be said?

1. We had called the company out for making an arguably absurd "pivot" from a medical device company to a blockchain company.
2. We had identified that the company overpaid by about 6x for equipment purchased through a highly suspicious, newly-formed entity.
3. We had identified that a special dividend seemed to disproportionately enrich insiders.
4. We had identified that Barry Honig, an individual with a controversial past, seemingly had an influential behind-the-scenes stake in the company.

That should have been enough.

It also should have been enough when we wrote our second article on January 9th, entitled "Riot Blockchain: This Crypto Clown Car Continues Hurtling Toward The Abyss."

After all, what else could there be?

We had reinforced our earlier research by identifying numerous issues with:

- Believed related party transactions
- Multiple auditor switches
- The company's pattern of reporting seemingly negative news on Fridays after the market close.

Subsequent to that second article, the Wall Street Journal, the Denver Post, and CNBC corroborated and expounded on our research with exposes of their own. The stock plummeted, particularly after the CNBC piece.

Our second article even made a cameo appearance in one of Riot's growing list of class action lawsuits (1, 2, 3)

40. On January 5, 2018, the Company filed a notification on Form 8-K revealing that it had dismissed its auditor, EisnerAmper LLP. On January 9, 2018, investor news site *The Motley Fool* published an article entitled "Riot Blockchain: This Crypto Clown Car Continues Hurtling Toward the Abyss." The article publicized the auditor's dismissal and connected it to the removal of two other auditors by Riot earlier in the year, which raised concerns about corporate governance and the legitimacy of the Company's business. On this news, the price of Riot shares once again declined, from a close of $24.43 per share on January 5, 2018 to a close of $20.85 per share on January 11, 2018, a decline of $3.58 per share, or nearly 15%, over four trading days.

Our rather absurd headline is now forever cemented in the records of Florida's Southern District.

Great! Now we were done. Totally…

But then, despite all the scrutiny by us, by media outlets, by other independent bloggers and by numerous financial professionals (except for Dennis Gartman)… despite all of it, something remarkable happened.

On Friday, February 16th, after the market close, the company reported yet another 8-K detailing what we believed to be its most brazen transaction yet: The company overpaid by an estimated $18.5 million for equipment purchased from a believed undisclosed related party entity.

We have so many other things to do. There are all manner of companies we are researching that engage in questionable business practices, "creative" accounting, or other believed improprieties. We have several reports coming out in the next couple weeks that we think will be brand-new and highly impactful.

But we just couldn't help ourselves. The transaction struck us as just too brazen. So we wrote a third article, titled " Riot Blockchain's Brazen Disclosure Issues Continue."

Finally! After showing what we believed to be clear, new related-party transactions… we were done?

# *It's Not Over*

Just prior to leaving the office on Friday we had a cynical thought:

"Gee, what wackiness might Riot report after the close today?"

We were half joking, but we went ahead and checked EDGAR anyway. Sure enough, another 8-K popped up from Riot Blockchain, having been filed yet again on a Friday after the market close.

# *A Consulting Agreement Unlike Any We Have Ever Seen Before*

The new Friday, February 23rd 8-K described how earlier in the week (on Wednesday, February 21) Riot entered into a consulting agreement with an entity called Ingenium International, LLC ("Ingenium"). The filing stated that Ingenium would "provide consulting services related to the Company's business for a 12 month period" in exchange for consideration of $4 million in cash. The services described included installing, deploying, and monitoring the crypto-currency miners that were recently purchased by the company.

All seemed vaguely plausible at that point, despite the fact that a supposed blockchain company might be expected to have the in-house expertise to deploy its own crypto-mining equipment without shelling out millions to outside consultants.

But putting that aside for the moment, our first sign that this consulting agreement was highly irregular were the payment terms:

> *In consideration of the Services to be rendered by Consultant hereunder, during the Term the Company agrees to pay to the Consultant (A) $4,000,000 (the "Cash Payment")* ***upon execution of this Agreement***

Given that the consulting services are supposedly meant to take place over 12 months, we find it odd (to say the least) that the $4 million is to be paid upfront upon signing.

Our second sign that the consulting agreement was highly irregular was that we had already reported that Ingenium appeared to be a suspicious and apparently related party entity of Riot

on **literally the same day**that Riot signed the agreement with them.

In our article from February 21st under the header "A Variety of Other Entities Raise Additional Questions" we named Ingenium as one of two entities that appeared to be an undisclosed related party of the company. We didn't know at the time whether or what business the entity had transacted with the company. The key link we identified, however, was that the same individuals listed on corporate records for Ingenium matched the names of individuals listed on corporate records for Kairos Global Technology Inc, a subsidiary Riot.

As we wrote in the same section of the article:

> *Our overall concern with these potentially related entities center around whether shareholder funds could be misused via investments that pass through them.*

At the time (i.e., 5 days ago) we even took the time to email Riot's investor relations and ask whether the company or any of its affiliates or related parties engaged in transactions with Ingenium International, LLC or any of the other believed related party entities. We didn't hear back.

Just for sport, we emailed investor relations again and asked *again* whether Ingenium is a related party. We also asked, "Why did you opt to pay the entire $4 million consideration upon execution of the consulting agreement rather than pay over the term of the agreement or upon completion of the actual services the consultant is hired to perform?" We have not heard back as of this writing. Should we hear back from the company we will update this article with its responses accordingly.

Needless to say, we still maintain our original concerns about Riot's transactions with seemingly related entities.

# *Director Resignation*

The same 8-K reported that Eric So, who was originally appointed director in October 2017, had resigned from the board. In his place, an individual named Remo Mancini was appointed to a variety of important board positions:

> *"The Audit Committee (Chairman), Nominating and Governance Committee and*

> *Compensation Committee of the Board of Directors. Mr. Mancini was also appointed to serve as Lead Independent Director of the Board of Directors."*

Mancini is the owner and President of Sandstone Strategies, which according to his LinkedIn profile is "a Professional Directorship Corporation facilitating Remo Mancini's service on Boards of Directors."

# *Conclusion*

We have seen a lot of ridiculous things in our day, but we believe Riot has engaged in some of the most brazen activity we have seen in a U.S. listed equity.

**Disclosure:** I am/we are short RIOT.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 47

# Riot Blockchain's Brazen Disclosure Issues Continue

Published on February 21, 2018



## Summary: Riot Blockchain, Inc. (RIOT)


- Despite a Friday CNBC investigative piece highlighting red flags with Riot and precipitating a 33% share decline, the company filed an 8-K later that afternoon raising bright new red flags.
- The filing was released during a market "dead zone"; Friday after the close heading into the long holiday weekend. It detailed a dubious agreement.
- We estimate that Riot's new agreement implies an over-payment of about $18.5 million for bitcoin mining equipment purchased from a seemingly undisclosed related party entity.
- We found other entities related to a Riot subsidiary that raise additional questions.
- Riot's latest questionable transaction strikes us as particularly brazen in light of the intense public scrutiny the company has seen recently.


## Introduction

Riot Blockchain (NASDAQ: RIOT) and one of its key backers, Barry Honig, have come under a tremendous amount of recent scrutiny over the past couple of months, capped off by a CNBC investigative piece on Friday that precipitated a drop of over 33% in the company's share price.

Despite the fresh warning signs highlighted by CNBC, that same evening the company filed an 8-K during a market 'dead zone'; Friday after the close heading into a long holiday weekend. The filing detailed a transaction that strikes us as intensely questionable, and raises brand new red flags.

# *Public Scrutiny of Riot Blockchain*

We are first going to recap some of the recent reporting on Riot. For those interested in just the brand new items please skip to the following section.

- **10 6 2017:** Following the company's sudden business and name change from Bioptix Inc. to Riot Blockchain, the Heisenberg Report identified a multitude of early red flags including how the company's official corporate address corresponded to a mail drop adjacent to a Blimpie's in a Colorado strip mall.

- **12 11 2017:** We published our first detailed report on Riot entitled "Sudden Business Pivot, Suspicious Acquisitions, Questionable Special Dividend." In the report, we described the company's bizarre approach to buying crypto-mining equipment. Rather than purchasing the equipment directly from the manufacturer or from suppliers, Riot instead significantly overpaid for the equipment by purchasing it through a newly formed shell entity. We also highlighted the ownership of key backer Barry Honig and a questionable special cash dividend that seemed to disproportionately benefit insiders such as Honig.

- **12 12 2017:** The following day, CNBC's Brian Kelly led a segment that reinforced and corroborated much of our research, concluding the piece stating "I'm not sure that this is actually a blockchain company, so you need to be careful is the bottom line."

- **12 13 2017:** We published a follow-up article describing how both Riot and a company called Marathon Patent Group (NASDAQ: MARA) showed alarming parallels, including shared key executives, shared key backers, and similarly dubious methods of purchasing crypto-mining equipment through newly-formed shell entities.

- **12 19 2017:** Andrew Left of Citron stated on twitter "$RIOT is THE most traded retail stock in market today yet Citron believes they are making fraudulent claims to investors." He then challenged Riot CEO John O'Rourke to a debate on CNBC. O'Rourke declined the invitation, but Left went on the network and shared his short thesis anyway. He described

the Riot business by saying "there is nothing there." He later clarified that he didn't believe there was fraud because "in order for there to be fraud you have to have operat[ions]."

- **1 9 2018:** We wrote a follow-up piece entitled " Riot Blockchain: This Crypto Clown Car Continues Hurtling Toward The Abyss " which described new red flags, including that (1) Riot had switched auditors; engaging its 3rd auditor within the span of a year (2) Riot had a propensity for reporting its negative developments on Friday's after the market close; and (3) new documents showed that Riot's crypto-mining assets had actually been purchased through an entity that purchased them from yet another entity that was a related-party. From our article:

> *After all, why buy cryptomining equipment directly from the **manufacturer's website** or from a supplier when you can dramatically overpay for it by simply purchasing it through a 2-week-old entity that purchased it from a different related party entity that purchased it from (presumably) the manufacturer or a supplier?*

- **1 31 2018:** The Wall Street Journal published a piece entitled " Investor Who Rode Pivot From Biotech to Bitcoin Sells Big Stake " and described how Riot's key backer Barry Honig had exited much of his stake in the company. When asked about a recent SEC investigation in a different company that subpoenaed records relating to Mr. Honig and other investors, Honig stated that he hadn't been contacted by the SEC and didn't believe he was a target. "I am 120% not worried", he said.

- **2 11 2018:** The Denver Post published a detailed piece on Riot that described new warning signs including the company's postponement of its annual meeting for the 2nd time in a row. The article also detailed Barry Honig's ownership history in the company. When asked about Honig's purchases in Riot's recent private placement, Honig responded:

> *"I still own every one of those [shares] at $22.50," he said. "That should tell you what I think about Riot."*
>
> *Note that Mr. Honig is legally unable to freely trade the shares issued in the private placement given that they are as-of-yet **unregistered** and **restricted**. Later in the article the Denver Post asked the SEC for comment:*
>
> *"The SEC also declined to comment about Riot but pointed to an investor alert from August: 'Fraudsters often try to use the lure of new and emerging technologies to convince potential victims to invest their money in scams. These frauds include*

> *'pump-and-dump' and market manipulation schemes involving publicly traded companies that claim to provide exposure to these new technologies.'"*

- **2 16 2018:** The CNBC exposé highlighted additional signs of trouble including that (1) Riot had apparently not even booked a room for its twice-postponed annual meeting; (2) upon visiting Barry Honig's office the reporters actually encountered Riot's CEO John O'Rourke who then claimed that he did not work there; and (3) other eyebrow raising footage such as a rather awkward shot of O'Rourke attempting to close the door in the face of CNBC correspondent Michelle Caruso-Cabrera. O'Rourke later promised an on-camera interview to Caruso-Cabrera, but then hastily backed out the night before. Later, O'Rourke complained that the CNBC report was "a negative one-sided piece", which is definitely something that can happen when a company CEO is asked to present the other side then repeatedly no-shows to the interview opportunities.

- **2 16 2018:** Investigative reporter Teri Buhl followed up after the CNBC piece with additional details about Honig and O'Rourke's history of prior deals and other connections between key individuals involved in Riot. It should be noted that Buhl has done a tremendous amount of work focused on Barry Honig and his various stock deals. Ms. Buhl was even sued by Honig after reporting on an SEC subpoena that named Honig in relation to another company. She nonetheless continued to advance her research. The lawsuit was eventually dropped.

# *An Apparent Undisclosed Related-Party Transaction Raises Brand New Red Flags*

According to O'Rourke, the company is very careful with its reporting practices. In a meeting that O'Rourke demanded be off-camera he told CNBC that Riot "over-disclose[s]". He also expressed that he was not worried about the SEC. Given the company's self-described approach of over-disclosure, and in light of all of the scrutiny above, one might think that Riot's executives would see fit to continue to exercise heightened caution with its disclosures.

It may be surprising then that on Friday February 16th at 4:54pm—the very day the CNBC investigative piece clobbered the stock by over 33%—a new Riot 8-K detailed yet another dubious acquisition of crypto-mining equipment that seemingly failed to disclose a related party transaction.

The 8-K included a detailed agreement relating to a press release issued the day before, Thursday February 15th. The press release had announced that Riot "entered into a definitive agreement to acquire additional cryptocurrency mining equipment consisting of 3,800

Antminer S9 Bitcoin miners manufactured by Bitmain."

A quick browse over to the Bitmain website shows that you can purchase Antminer S9's for $2,320 each. Thus, multiplication leads us to believe that purchasing 3,800 machines should cost a total of about $8,816,000, assuming no bulk discounts and excluding shipping costs.

But the new 8-K detailed how instead of purchasing the 3,800 machines in the manner above, Riot is instead purchasing the machines through its subsidiary Kairos Global Technologies ("Kairos") that is in turn purchasing them through a recently formed entity called Prive Technologies LLC "Prive").

The total consideration is $11 million in cash and 1 million shares of Riot stock, with 200,000 of the shares escrowed pending certain milestones. In all, the consideration suggests a total transaction value at the time of agreement of about $28 million. The detailed agreement also added that ancillary equipment would be purchased, consisting of an unspecified number of Racks, Power Supplies, Network Switches, LAN Cables, PDU's, Power Cables, Desktop Control Servers, and Software licenses.

Factoring in all of the above: **we estimate that Riot's agreement suggests an over-payment of about 18. million for the equipment purchased through rive.**

Notably, the press release failed to mention Prive Technologies LLC at all, and the 8-K failed to disclose that Prive is seemingly a related party of Riot's subsidiary Kairos:

- Nevada corporate records show that Kairos was established October 19th 2017 with its President and Director currently listed as Michael Ho and Bryan Pascual, respectively.

- Florida corporate records show that Prive was set up less than 2 weeks later, on October 31st 2017, and similarly lists Michael Ho and Bryan Pascual as its managers.

We emailed Riot's investor relations and asked about whether Prive is a related party of Kairos. We have not heard back as of this writing. Should we hear back from the company we will update this accordingly.

Avid readers may recall from our previous articles that we had identified red flags relating to Riot's approach to purchasing crypto-mining equipment in an earlier deal. Our criticism focused on Riot's decision not to purchase equipment directly from suppliers or from the manufacturer. Instead Riot chose to dramatically overpay for the equipment by acquiring the

newly-formed Kairos entity which *held* the equipment.

Worse yet, Riot later disclosed that Kairos had purchased the equipment from "a company controlled by the president of [Kairos]." At the time we did not know the name of that unnamed entity. Given the latest information however, we believe Prive is likely the previously unknown entity controlled by Kairos's President (Michael Ho).

When asked by CNBC about the earlier purchases O'Rourke said that the company paid a premium for the original equipment from Kairos due to a shortage of mining equipment and difficulties getting it directly from the manufacturer. Our research showed that Bitmain did not appear to have any major shortages or significant delays at the time of the purchase however.

Now in relation to this new deal, Bitmain similarly has an estimated shipping date of about 1 to 1.5 months on new Antminer S9s as of this writing.

# *A Second, Starkly Different Transaction*

Beyond our basic check of the Bitmain website however, we also have another comparable transaction we can use to determine a market price of Antminer S9 Machines. Namely, Riot entered into a separate transaction to purchase Antminer S9's on the exact same day as the transaction with Prive.

Despite the press release only announcing the deal for 3,800 machines (through Prive), the 8-K described a *second agreement* entered on the same day (February 15th) involving the purchase of 3,000 Antminer S9's and related equipment. In stark contrast to the deal with Prive above, the machines in the second transaction appear to have been purchased from a third-party supplier at prices that strike us as borderline commercially reasonable.

Riot purchased the machines in the second transaction from a Canadian distributor named Blockchain Mining Supply & Services Ltd. ("BMS&S") for a total of $8,500,000 in cash. This compares to a total value of about $7,275,000 for 3,000 machines and 3,000 PSU's based on prices from the Bitmain website. The President of BMS&S in the agreement is listed as Joe Alfa, who incidentally was the same would-be supplier for Long Blockchain's Antminer machines (NASDAQ:OTCPK:LBCC). Consequently, evidence suggests that BMS&S/Joe Alfa is a supplier that has worked with multiple different companies.

Given that both transactions were entered into on the *same day* to purchase the *same type* of machine (Antminer S9s manufactured by Bitmain) we cannot help but notice the vast price

differential:

- In the believed *non* related-party transaction with BMS&S, Riot paid $2,833 per Antminer S9/PSU.
- In the believed related-party transaction with Prive, Riot paid $7,368 per Antminer S9/related equipment.

The above strikes us as a rather brazen difference. We emailed Riot's investor relations and asked why Riot paid so much more in the Prive transaction relative to the BMS&S transaction. We have not heard back as of this writing. Should we hear back from the company we will update this accordingly.

# *A Variety of Other Entities Raise Additional Questions*

Stranger still, we found yet more entities set up by Michael Ho and Bryan Pascual that raise additional questions:

1. BMH Mining LLC was established in Florida on December 11th 2017 according to Florida records. Given the name of the entity, we wonder if this is another entity that is in the business of purchasing or selling crypto-mining equipment.
2. Ingenium International LLC was also established in Florida the same day, December 11th 2017, according to Florida records. Readers of our original piece may recall that we had identified a suspicious and similarly named Nevada entity called Ingenium Global Inc. that was set up by Michael Ho and Bryan Pascual on October 19th 2017. We found it odd because subsequent to its formation Riot announced an investment the next day, October 20th, in TessPay, a company with a senior executive named Sorin Tanasescu that controlled a similarly named "Ingenium" entity.

Our overall concern with these potentially related entities center around whether shareholder funds could be misused via investments that pass through them. The recent auditor switch also gives us heightened caution relating to the company's financial controls.

We emailed Riot's investor relations and asked whether the company or any of its affiliates or related parties (including recent or current key holders) engaged in any transactions with Prive Technologies LLC, BMH Mining LLC, Ingenium International LLC, or Ingenium Global Inc. We have not heard back as of this writing. Should we hear back from the company we will update this accordingly.

Moving right along, a review of corporate filings shows that Michael Ho has listed 3 different addresses on his corporate filings despite all three entities being formed around the same time:

- In the Nevada records from 10/19/2017 Michael Ho states that his address is in Dubai.
- In the Florida records from 10/31/2017 Michael Ho states that his address is in Los Angeles.
- In the Florida records from 12/11/2017 Michael Ho states that his address is in Tampa, where he is neighbors with Pascual.

The implication from the above seems to be that Mr. Ho maintained addresses in all 3 cities and took the time to form distinct corporate entities from each location. We find this to be odd. We emailed Riot's investor relations and asked why Michael Ho has listed 3 different addresses for his recent corporate filings. We have not heard back as of this writing. Should we hear back from the company we will update this accordingly.

# *Cash Drain*

The company seems to be running through its cash balance at a rather hasty pace. Riot raised $37 million in cash through a December private placement. Since then the company has:

- Entered into the above agreements to purchase crypto-mining equipment which include $19.5 million in cash outlays.
- Bought 500 bitcoin through a U.S. Marshall's auction for an estimated $5.2 million.
- Entered a Letter of Intent (LOI) to purchase Logical Brokerage Corp for an undisclosed sum.
- Spent an unknown amount on general corporate operations.

All said, the company has invested/committed/spent more than $24.7 million through the above actions in the span of less than a month. We will be watching closely to see how much cash the company is left with after all of the aforementioned endeavors.

# *Conclusion*

Our overall view hasn't changed since our last article. We still believe Riot is hurtling toward the abyss.

**Disclosure:** I am/we are short RIOT, MARA.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 48

# Chicken Soup For the Soul Entertainment Is A Toxic Mess

Published on February 14, 2018



## Summary: Chicken Soup for the Soul Entertainment, Inc. Cl A (CSSE)


- A charity that the CEO advises accounted for approximately 46% of 2016 revenue and 95% of 2015 revenue through "sponsorship" of the public entity's television programs.
- The charity was created in 2015, mere months after the creation of CSSE itself. The company later "donated" shares back to the charity. We have concerns about this relationship.
- The company reported a change in accounting methodology the day of an announced acquisition, positioning it to record a dubious $22.2 million paper "gain on bargain purchase" from the deal.
- CSSE is bizarrely structured as a subsidiary of a subsidiary and pays numerous fees to its affiliates. Public investors receive no proceeds from the popular book series.
- The CEO of CSSE was formerly CEO of Winstar, a public company that declared bankruptcy amidst allegations of revenue falsification and accounting improprieties.

# *Introduction*

ChickenSoup Entertainment ( CSSE) raised $30 million in August 2017 via a crowdsourced IPO under the new Reg A framework, which has "lower[ed] regulatory hurdles for companies trying to go public".

The offering was among the more noteworthy of the new Reg A IPOs partly because of the well-known brand Chicken Soup for the Soul and partly because of the company's affiliation with Ashton Kutcher . The company was offering a unique business model, with the CEO stating the company was poised to become "the Netflix for inspirational content." Additionally, CSSE reported strong revenue and earnings growth heading into its IPO.

Despite the alluring headlines, however, our analysis indicates that much of the reported revenue and earnings appear to be derived from a newly formed non-profit organization that seems to exist almost solely to support ChickenSoup. We have uncovered red flags indicating that the true nature of the relationship between CSSE and the non-profit in question – the Boniuk Foundation – may have been under-reported to public investors.

Calling the financial results into further question, late last year, the company reported an accounting change in its quarterly filing that would allow it to book a "gain on bargain purchase". That same day, the company announced an acquisition that it determined to be a bargain purchase. The accounting change has positioned the company to recognize a $22.2 million paper gain on an acquisition that only cost roughly $5 million. Our review of the acquisition leaves us with doubts about the validity of this supposed gain.

Collectively, we have doubts about the credibility and sustainability of the company's reported revenue, earnings, and adjusted EBITDA metrics.

We believe investors have been attracted to the Chicken Soup for the Soul brand and to the company's affiliation with Ashton Kutcher without fully understanding the nature of the associations. Much of the media surrounding the IPO seemed to conflate the relationship between the company, Ashton Kutcher, and the book series (see examples here , here , here , and here ). The presentation by the company similarly could be confusing to the average reader as it does not make all the details of the affiliate relationships clear.

When digging into the offering documents , we see that the public entity is actually a subsidiary of a subsidiary that is merely focused on video content and is therefore to receive no proceeds from the parent company's book sales. Also, the business founded by Ashton Kutcher, "A Plus",

is actually a separate entity that public investors have no stake in.

Worse yet, according to the offering documents, the public entity must pay its own affiliates "management services" fees for things like access to its own CEO, and licensing and distribution fees for use of the Chicken Soup brand and for distribution through Kutcher's A Plus.

The Chairman and CEO of CSSE, William J. Rouhana, Jr. has a controversial history. Rouhana previously served as CEO and Chairman of Winstar Communications, Inc., a formerly NASDAQ-listed technology company that declared Chapter 7 bankruptcy following the bursting of the dotcom bubble and amidst a lawsuit that alleged severe accounting improprieties. The blow-up of Winstar reportedly led to as much as $974 million in investor losses.

Rouhana has voting control over the public company and similarly has control over the ultimate parent, thereby giving him virtually unmitigated control of the entire corporate structure. We have little faith in his ability to create genuine value for shareholders given his track record and all of the foregoing red flags.

## *A Newly Formed Non-Profit Advised by the CEO Accounts for a Substantial Portion of Revenue and Earnings*

A review of the offering circular for CSSE presents the company in a very attractive light. In the summary, the company stated "Since our inception in January 2015, our business has grown rapidly and is profitable." The summary financials show a young company that has achieved year-over-year revenue growth of 438% has recently turned profitable and has strong profit and EBITDA margins:

| | For the Year Ended December 31, | |
|---|---|---|
| | 2016 | 2015 |
| **Operating Data:** | | |
| Total revenue | $8,118,632 | $1,506,818 |
| Gross profit | 4,962,964 | 853,023 |
| *Gross profit %* | *61.1%* | *56.6%* |
| Operating expenses | 3,182,775 | 1,606,499 |
| Operating income (loss) | 1,780,189 | (753,476) |
| Net income (loss)[(a)(b)] | 781,133 | (753,463) |
| Basic net income (loss) per common share | 0.09 | (0.09) |
| Diluted net income (loss) per common share | 0.09 | (0.09) |
| Weighted average common shares outstanding:[(c)] | | |
| Basic | 8,835,930 | 8,760,000 |
| Diluted | 8,996,636 | 8,760,000 |
| Adjusted EBITDA[(d)] | 3,776,676 | 38,524 |

On the surface, these numbers appear to be glowingly attractive and on a meteoric growth trajectory. The notes, however, show that a significant portion of that revenue was derived from a single unnamed non-profit foundation that Rouhana advises ( note 11, pg F-24):

> *"CSS and the Company have several agreements with the Foundation, on whose advisory board the Company's chief executive officer sits. One such agreement includes sponsorship by the Foundation for a Saturday morning family television show… For the years ended December 31, 2016 and 2015, the Company recognized revenue of $3,734,884 and $1,431,818, respectively, from this sponsorship."*

The Offering Circular identifies the show as being "Hidden Heroes" (page F-13). Rouhana, therefore, sits on the advisory board of a foundation that sponsors the creation of Hidden Heroes – a foundation whose very sponsorship represented about 95% of the CSSE's 2015 revenue and 46% of the Company's 2016 revenue.

A separate press release and subsequent filings identified the Boniuk Foundation as the primary sponsor of the show. Our review of the Boniuk Foundation revealed several red flags:

First, an IRS database search reveals that the Boniuk Foundation was ruled tax exempt in April 2015, suggesting that the organization is new and virtually coincides with the creation of CSSE itself (in January 2015).

Second, rather than being a diversified foundation involved in multiple interests, it appears that the Boniuk Foundation is dedicated largely to sponsoring CSSE, its predecessor entity CSS Productions, and affiliates. The Boniuk Foundation's 2014 Form 990 filing states that:

> *"[t]he companies [sic] most significant activities include distribution of books to various schools in Harris County TX school book sets and creating a children's television program."*

The document later clarifies that CSSE's parent entities produce books it distributes, stating that "[a]greement made with ChickenSoup for publishing books for distribution for distribution to Houston independent school district."

Presumably, Hidden Heroes is the "children's television program" mentioned in the filing. In sum, it therefore appears that both of its "significant" activities are relating to its role supporting ChickenSoup. In all, the total revenue for the Boniuk Foundation for its 2014 and 2015 fiscal years was a combined $4,870,236, further underscoring that it is not a large, well-diversified foundation. The millions directed toward CSSE clearly represent a substantial portion of the foundation's donation activity.

Third, rather than Boniuk simply acting as a one-way charitable donor to the company, the 2015 Form 990 filing shows the foundation may have had a two-way interest with CSSE. Specifically, the second to last page of that document reflects that a Class A membership interest in Chicken Soup for the Soul Production, LLC (the predecessor entity to CSSE) was

contributed to the entity:

Schedule M (Form 990) (2015) Page 2

**Part II** **Supplemental Information.**
Provide the information required by Part I, lines 30b, 32b, and 33, and whether the organization is reporting in Part I, column (b), the number of contributions, the number of items received, or a combination of both. Also complete this part for any additional information.

| Return Reference | Explanation |
|---|---|
| Part I Line 11 | FOUNDATION RECEIVED A CLASS A MEMBERSHIP INTEREST IN THE CHICKEN SOUP FOR THE SOUL PRODUCTION, LLC EIN46-5204546 |

Schedule M (Form 990) (2015)

The Offering Circular appears to corroborate that information, stating:

> *"On September 30, 2015,CSS made a charitable donation of 6% of the membership interests it owned in CSS Productions to the Foundation."[emphasis added]*

We have a hard time believing that the Boniuk Foundation just simply (I) formed right around the same time CSSE, (II) directed much and potentially the majority of its donations to CSSE and affiliates (III) decided to donate so extensively to CSSE that it comprised the majority of the (for-profit) company's revenue, then (IV) months later, in an unrelated act of charity and kindness, the company decided to donate 6% of its shares to the foundation. Note that the IRS defines a "charitable contribution" as being "voluntary and is made without getting, or expecting to get, anything of equal value."

If the above weren't odd enough, the director of the Boniuk Foundation, Milton Boniuk, already has another fairly new and similarly named foundation, the Boniuk Charitable Foundation ("BCF"), which gained tax exempt status in September 2014, less than a year earlier. We were a bit confused as to why Boniuk would need another personal foundation seemingly dedicated to ChickenSoup when he had already recently established a personal foundation.

When we examined BCF, we noticed some parallels to the Boniuk Foundation. Virtually, all of BCF's assets from its 2014 990 filing consisted of investments in convertible debentures and equity in a company called NanoViricides, Inc. (NYSEMKT: NNVC), a company which Boniuk has sat as director since May 2013:

**Name:** BONIUK CHARITABLE FOUNDATION
**EIN:** 42-1628436
**Software ID:** 14000292
**Software Version:** 14.4.1.0

| Name of Bond | End of Year Book Value | End of Year Fair Market Value |
|---|---|---|
| NNVC DEBENTURES | 2,000,000 | 2,000,000 |
| 190,477 SHARES - NANOVIRICIDES, INC. | 645,717 | 518,097 |

Notably, while BCF met its qualifying distribution in 2013 and 2015 by donating a collective $157,000 to Rice University, in 2014 BCF met its qualifying distribution by donating $150,000 to

the Boniuk Foundation, which could have been directed right back into CSSE and its affiliates.

Taken all together, in our opinion, the above looks similar to Boniuk making an *investment* (tax-free) in shares of CSSE rather providing a mere arms-length source of revenue to the business. At the very least, we believe a case can be made that the Boniuk Foundation should be a consolidated entity and therefore eliminate what appear to be inter-company transactions rather than booking them as revenue.

We find CSSE's relationship to the Boniuk Foundation to be unsettling. We also have our doubts about the sustainability of the arrangement. We emailed CSSE's investor relations and asked the following:

- Whether CSSE, its executives, its affiliates, or its key investors have been or plan to be donors to the Boniuk Foundation?
- How much of the Boniuk Foundation's activity has been focused on CSSE and its affiliates?
- Was the 6% donation of shares by CSS to the Boniuk Foundation voluntary and made without getting, or expecting to get, anything of equal value (such as past and/or future sponsorship revenue)?

We have not heard back as of this writing. Should we receive a reply from the company, we will update this accordingly.

## *The Company is Poised to Book a Massive Paper "Gain on Bargain Purchase" Due to a Recent Accounting Change*

On November 6, 2017, CSSE announced the acquisition of Screen Media Ventures, LLC which owns (I) content licenses to over 1,200 television shows and films, and (II) Popcornflix, an ad-based over-the-top (OTT) platform that allows users to watch movies and TV shows for free. The purchase price for Screen Media consisted of about $4.9 million in cash (plus transaction costs), 35,000 shares of Class A common stock, and warrants to purchase 50,000 shares of CSSE at $12 per share.

In the 10-Q filed on November 6th – the same day of the Screen Media acquisition announcement – new language appeared that altered the company's definition of adjusted EBITDA to include "the gain on bargain purchase of subsidiary". (Note that the previous 10-Q had been filed a mere month earlier on October 2, and no such gain on bargain purchase language appeared.)

In the press release describing the acquisition, the company noted that an appraisal of Screen Media's assets suggested they were worth $25 million. CSSE touted how the acquisition represented a "significant discount to its appraised value, intrinsic value and replacement cost" of the company, and how it now expected the company's Q4 2017 adjusted EBITDA to "substantially exceed $10 million." The press release did not clarify that the upward revision to its adjusted EBITDA could include booking a gain on purchase from the acquisition.

Taking things a step further, a later company press release on January 17 highlighted that CSSE had commissioned a new valuation opinion as part of the transaction and – lo and behold – it determined that the assets were valued yet even *higher*, at $31.4 million. Additionally, the company made clear that it would recognize the massive gain on purchase in its statement of operations:

> *"Reflecting the excess of the net appraised value of the assets over their purchase price as set forth in the Valuation Opinion, CSS Entertainment will recognize a non-cash gain in its Statement of Operations for the year ended December 31, 2017 of approximately $22.2 million." [emphasis added]*

We are uninspired by the company's subtle accounting methodology change that suddenly allows it to recognize an immediate ~440% gain on purchase. The new accounting implementation could give rise to a splashy "headline" that reports explosive quarterly and annual results, but our review of the acquisition leaves us to believe that such numbers would represent little real value beyond optics.

We emailed CSSE's investor relations and asked them to describe the basis for the adjusted EBITDA methodology change that includes a "gain on bargain purchase" which we believe to be neither reasonable nor sustainable. We have not heard back as of this writing. Should we receive a reply from the company, we will update this accordingly.

# *Screen Media Acquisition: Reality Check*

Digging down on the acquisition, we examined Screen Media more closely and came away with questions about the credibility of the lofty appraisal results that CSSE had commissioned.

According to Yahoo News, Popcornflix launched in 2011 "offering top Hollywood stars in movies you've probably never heard of." We reviewed the site and confirmed that indeed we have never heard of most of the titles. Our own browsing experience aside, it appears that the site is

relatively lightly trafficked. According to Alexa, Popcornflix is ranked as the 32,903rd U.S. site as of this writing and is ranked 50,324th worldwide. In short, Screen Media appears to have been an attempt to compete with other streaming TV services that never gained significant traction.

The financials seem to reflect a business in decline that was teetering on insolvency. According to the audits and press releases found in an amended 8-K, Screen Media had recorded year-over-year net revenue declines for all of the past three years:

| Year | Net Revenue | Y/Y % Chg |
|---|---|---|
| 2017 | 12,000,000* | -11.3%* |
| 2016 | 13,537,650 | -16.6% |
| 2015 | 16,248,458 | -4.7% |
| 2014 | 17,050,677 | |

**Estimate from company press releases: "Screen Media generated more than $12 million in net revenue…in 2017." Note that given the language, the 2017 net revenue is lower than in the previous year, but it is unclear by exactly how much.*

As of the December 31, 2016, audit, the company had only $2,097 in cash compared to $40,848,131 in current liabilities. As of September 30, 2017, Screen Media had $297,969 in cash compared to $41,471,042 in current liabilities.

Screen Media had at least one professional private equity backer, Alta Communications, per the filings. Despite the professional backing, CSSE made the purchase for roughly the cost of Screen Media's outstanding bank debt. According to the merger agreement made November 3rd, 2017, bank debt of $4,905,355 was to be paid and terminated as part of the transaction, which corresponds to the $4.9 million in cash paid as part of the offering (net of transaction and closing costs).

Given that the private equity backers seemingly allowed the entity to be acquired for the cost of bank debt plus some modest share-based upside that went to the former CEO, we can't help but wonder whether the business has the significant value claimed in the appraisal. Had the assets truly been worth over $31 million, wouldn't a sale process have yielded more than ~$5 million? Furthermore, could there really be that much value unlocked by Screen Media's combination with CSSE which is itself a fledgling media company? We have a hard time fathoming how CSSE's line up of relatively obscure TV shows would do much to enhance Screen Media's line-up of relatively obscure movies and TV shows.

We emailed CSSE's investor relations and asked the following:

> *"Did Screen Media run a sale process? If so, how many potential buyers were contacted and how many bids were received. If not, why?"*

We have not heard back as of this writing. Should we receive a reply from the company, we will update this accordingly.

# *The Public Entity is a Subsidiary of a Subsidiary*

Aside from our questions around the credibility and sustainability of revenue, earnings and adjusted EBITDA metrics, we have identified other red flags. First, CSSE is the subsidiary of a subsidiary, a highly unusual structure for any public company, let alone a company of such modest size as CSSE:

Per the latest 10-Q, CSSE was originally formed under CSS Productions, LLC. That entity was formed by Chicken Soup for the Soul, LLC, "a publishing and consumer products company" that initiated operations in January 2015. That entity in turn is owned by Chicken Soup for the Soul Holdings, LLC, which is the "ultimate parent" to all of the aforementioned entities.

We find it unsettling that public investors are buried underneath several layers within a complex corporate structure rather than simply having a share of the entire success of the overall business.

Both the "ultimate parent" and the public entity are controlled by the same individual, William Rouhana. Rouhana controls approximately 96.8% of the company's class B shares which carry 10 votes per share and controls about 70% of CSSE's entire issued share base as of the most recent 10-Q.

We emailed CSSE's investor relations and asked for explanation on why CSSE was structured as a subsidiary of a subsidiary rather than in a manner where public investors could share in the gains and losses of the entire business. We have not heard back as of this writing. Should we receive a reply from the company, we will update this accordingly.

# *An Abundance of Related-Party Transactions and Fees*

The shared control is troublesome, especially in light of the mind-boggling number of related party transactions and fees paid between related party entities. A partial rundown of the list, per the 10-Qs and the offering circular (note that some of these fees are overlapping):

- The offering circular plainly states that "[a]t least 10% of [CSSE's] gross revenue will be paid to [its] affiliates on a continuous basis and will not be otherwise available to [CSSE]."
- CSSE paid related party A Plus, the Ashton Kutcher-founded entity an advance of $3 million under a distribution agreement.
- CSSE paid its parent, CSS a one-time license fee of $5,000,000.
- About *$8.6 million* of the CSSE offering proceeds appear to have been designated to pay down existing debt which, in turn, appears to have been held largely by management and insiders.
- On August 21, the company paid to its parent $1,311,594 in owed "management" and "license" fees, per page 31 of the June 10-Q.
- Overall, CSSE pays a management fee to its parent, recurring licensing fees to its parent, marketing fees to its parent, and sales commissions to its parent.
- CEO Rouhana's son has not one but two different consulting companies that CSSE has paid: "Low Profile" received $95,000 over the two years since inception and "One Last Thing LLC" received $100,000.

We can't fathom how a small company like CSSE can credibly justify the amount of money circulating to related parties amidst its complex corporate structure.

We emailed CSSE's investor relations and asked for explanation on why the company must pay numerous fees to its affiliates, including for things like access to its own CEO and management team. We have not heard back as of this writing. Should we receive a reply from the company, we will update this accordingly.

# *CEO William Rouhana's Role in the Winstar Debacle*

We looked into Rouhana's background as Chairman and CEO of Winstar in order to get a sense of his leadership and management abilities. We found that subsequent to the collapse and bankruptcy of Winstar, a class-action lawsuit was filed against its officers, directors, and its accountant Grant Thornton, alleging severe accounting improprieties and the creation of false

revenue. Among other things, the Winstar lawsuit alleged that:

- "Senior management – including each member of the Company's senior management team named as a defendant [including Rouhana] – engaged in covert practices designed to benefit themselves at the expense of the Company and its investors";
- "Defendants Rouhana and Kantor knowingly allowed numerous related parties to utilize Company assets without paying for them";
- "Management encouraged sales personnel to fabricate customer information, by agreeing to pay commissions on such fabricated sales";
- "Notwithstanding the extraordinary problems being experienced by Winstar, Defendants actively covered-up any hint of accounting problems and actively promoted the Company as experiencing strong growth and improved financial controls"; and
- "Winstar defendants routinely encouraged or tacitly allowed sales personnel to engage in overt sales falsification, in a deliberate effort to overstate sales".

Note that the allegations were never proven in court as Rouhana and the other defendants settled without any admission of wrongdoing. The individual defendants collectively settled for a sum of $25 million according to the settlement agreement (pg 74):

Later in 2013, Grant Thornton paid $10 million to settle their portion of the matter as well.

We find the above to be troubling. Given that Rouhana controls both the private parent entity and the public subsidiary, he may have been in a position to effectively negotiate the related party fees with himself or to exert overwhelming influence in the process.

We emailed CSSE's investor relations and asked who negotiated the fees on behalf of the public entity and the private parent entity. We have not heard back as of this writing. Should we receive a reply from the company, we will update this accordingly.

## *CSSE's Auditor Has a Remarkable Lack of Experience Auditing Public Companies*

Giving us yet more cause for concern, CSSE's auditor appears to have virtually no experience auditing public companies, let alone those with complex structures. The latest 2017 PCAOB report from CSSE's auditor, Rosenfield & Co PLLC, shows that the firm had audited no public companies during the reported period and had no substantial role in the preparation or furnishing an audit report with respect to a public issuer during the reporting period.

## *Conclusion: A Soupy Mess*

Despite the wholesome sounding name, we believe ChickenSoup Entertainment has all the key hallmarks of a disaster in the making. While we expect the reported numbers to be glowing in the near future, we believe the company is on a road toward inevitable ruin.

**Disclosure:** I am/we are short CSSE.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

# TAB 49

# Riot Blockchain: This Crypto Clown Car Continues Hurtling Toward The Abyss

Published on January 9, 2018



## Summary: Riot Blockchain, Inc. (RIOT)


- Riot filed a registration for ~3.3M shares of common stock & common stock issuable upon warrant exercise, representing potential selling pressure for a stock with only ~11.6M common shares outstanding.
- The registration statement was reported Friday after the close.
- Riot dismissed and replaced its auditor, reporting the event Friday after the close. The company has had 3 different auditors within the span of a year.
- A new audit reported Friday after the close sheds light on Riot's bizarre approach to purchasing (and overpaying for) cryptomining assets.
- The CEO recently sold about $869,256 worth of his shares, reporting the event Friday after the close heading into the long New Year's weekend.

# *Introduction*

This is a brief update on new red flags we have identified since our original December 11th piece on Riot (NASDAQ:RIOT), which had detailed a broad array of red flags relating to the company's sudden name change and business pivot from a medical device company, its 3rd metamorphosis within the span of a year.

Since that original piece, a slew of new information has come out, much of it having been released on Fridays after the market close. Given that these releases have occurred during periods of relative market inactivity, we believe the timing may have mitigated the impact of negative developments.

# *Share Registration Could Create Near-Term Selling Pressure*

Per an S-3 filed on Friday after the close, the company is registering 3,292,226 shares of common stock and common stock issuable upon warrant exercise. The implication of this filing is that investors who had purchased shares in the recent private placement offering will be free to trade them once the statement is declared effective. We believe this could create near to mid-term selling pressure, especially if the investors take a cue from the company's own CEO who recently sold off a significant portion of his shares.

The number of shares being registered is meaningful. Per the filing, as of January 4th, the company had 11,622,112 shares of common stock outstanding. The 1,646,113 common shares being registered represent over 14% of the outstanding common shares. The registration of 1,646,113 warrants issuable into shares of common stock at a $40 strike price also could create additional selling pressure. Note that the company has 1,458,001 preferred shares convertible into common issued and outstanding as well.

# *The Company Dismissed its Auditor*

According to an 8-K filed Friday after the close, EisnerAmper LLP was dismissed as auditor and MNP LLP (headquartered in Calgary Canada) was engaged on January 5th. Based on the S-3 filed Friday after the close, we see that the company had used a different audit firm, GHP Horwath, P.C., until January 13, 2017. The S-3 notes that the partners and employees of GHP joined another independent registered public accounting firm, likely in relation to its acquisition by

Crowe Horwath LLP .

We find the frequent shuffling of auditors to be a red flag that warrants investor caution. Given that Riot has had 3 auditors within the span of a year, we have little faith in their financial controls.

# *New Audit Sheds More Light on the Company's Bizarre Approach to Purchasing (And Overpaying for) Cryptomining Assets*

Readers of our earlier piece may recall that we had uncovered oddities in relation to the company's transaction to acquire cryptomining equipment. For example, rather than purchasing the equipment directly from the manufacturer's website or from a supplier, Riot chose instead to acquire a 2-week-old corporate *entity* called Kairos Global Technology ("Kairos") that held the cryptomining equipment. Our belief was and continues to be that Riot significantly overpaid for these assets, and new information not only corroborates those initial conclusions but also raises additional questions.

An audit of Kairos was filed as an amended 8-K and was also released Friday after the close. It confirmed that Kairos had purchased its equipment for $2,089,679, which was close to our earlier estimate of $1.9 million. The " excess purchase price over acquired assets " of Kairos was recorded as $8,637,545, confirming that net of cash the company paid more than 4x for equipment from the entity that existed for only about 2 weeks.

While the above corroborated much of our initial analysis, one item turned up in the audit that we did not expect. We had mistakenly assumed that Kairos (i) purchased the cryptomining equipment directly from the manufacturer; then (ii) Riot dramatically overpaid for the equipment by purchasing Kairos at a premium. Instead, in the "Related Party Transactions" section of the Kairos audit, we found this:

> *During the period, the Company [Kairos] purchased equipment of $2,089,679**from a company controlled by the president of the Company**.*

In other words, Kairos actually purchased the mining equipment from a yet *another* entity (a related party one) before ultimately being acquired by Riot.

After all, why buy cryptomining equipment directly from the manufacturer's website or from a supplier when you can dramatically overpay for it by simply purchasing it through a 2-week-old entity that purchased it from a different related party entity that purchased it from (presumably) the manufacturer or a supplier?

# *Conclusion*

We believe Riot is on a collision course with the annals of history. Despite this, given the company's recent $37 million private placement, we fully expect there to be more forthcoming announcements of purchases of varying amounts of cryptomining equipment or token investments in blockchain-related assets. Investors recently have responded feverishly to such press releases, so we expect the stock will have continued future volatility. We therefore are hedged and are positioned for a bumpy ride along the way. Best of luck to all.

**Disclosure:** I am/we are short RIOT.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 50

# Marathon Patent Group: Bright Red Flags With This Newfangled 'Blockchain' Play

Published on December 13, 2017



## Summary: Marathon Patent Group, Inc. (MARA)


- Marathon recently announced an agreement for the acquisition of Global Bit Ventures Inc. that will leave prior common shareholders with just 19% of the company.
- GBV was an entity set up only in August of this year and appears to have an undisclosed security interest with the former CFO, EVP and Secretary of Marathon.
- Marathon has multiple concerning parallels to Riot Blockchain, which recently engineered a similarly dubious pivot to the "blockchain."
- BDO resigned as auditor November 27. Per the filing "the resignation of BDO was not recommended by the Company's audit committee."
- We are urging strong caution to investors in Marathon regardless of one's views on blockchain technology.

With "blockchain mania" in full swing, Marathon Patent Group Inc. (NASDAQ: MARA) has seemingly hitched itself to the blockchain wagon and rode the wave to nearly 5x returns in a matter of weeks. The company's blockchain focus has come about through a series of rapid shifts that are eerily similar to the questionable moves we identified in our recent piece on Riot Blockchain (NASDAQ:RIOT).

In Marathon's latest 10-Q filed on November 20th the company describes its business as being "to acquire patents and patent rights and to monetize the value of those assets to generate revenue and profit for the Company."

Yet despite that stated business model, the company has seemingly abandoned much of its focus on patents and patent rights and instead shifted gears toward blockchain assets including cryptomining.

## *Global Bit Ventures Inc. (GBV) Acquisition Raises Questions*

Rather than purchase cryptomining assets directly from manufacturers or suppliers, the company decided instead to purchase an *entity* that owned the cryptomining assets. On November 2, 2017, the company announced via press release that it had "entered into a definitive purchase agreement to acquire 100% ownership of Global Bit Ventures Inc. ("GBV"), a digital asset technology company that mines cryptocurrencies."

The company has been scant with details on the transaction thus far. On a conference call following the announcement, the company detailed that the acquisition includes 1,000 Ethereum mining servers, though it failed to disclose the cost or value of the servers when asked by an investor. Another investor asked "How long has the company (GBV) been in existence?" The company declined to disclose this information as well, suggesting instead that they would wait until an S-4 was filed before disclosing.

We found the above non-disclosures to be troubling. The agreement with GBV stipulates that the company is to issue 126,674,557 shares of common stock in exchange for 100% of the shares of GBV, which represented roughly $188.7 million at the time of the announcement (and roughly $750 million at current share prices.) The Agreement And Plan of Merger filing by Marathon detailed the ownership of Company Shareholders (ie: GBV shareholders) at the closing of the transaction:

> *Immediately after the conversion of the Company Shares, the Company Preferred Shares and the conversion of the Company Debt, the* ***Company Shareholders will own 81.0% of the arent's capital stock*** *a fully diluted basis at the time of Closing.*

Consequently, the agreement and merger plan leaves current Marathon common shareholders with only 19% of Marathon on a fully diluted basis at the time of closing. Given the extremely high cost of the acquisition, we would have fully expected the company to answer basic questions about the value of the assets being acquired and details around the entity.

We decided to check the Nevada Secretary of State filings on GBV for ourselves and we found that the entity was established August 9, 2017, mere months before the transaction was announced.

We also found that one beneficiary of the transaction appears be none other than Marathon's former CFO, EVP and Secretary, John Stetson. A Uniform Commercial Code (UCC) filing shows what appears to be a previously undisclosed security arrangement between HS Contrarian Investments LLC ("HS Contrarian") and GBV. HS Contrarian is run by John Stetson, according to the firm's website. Stetson's previous roles at Marathon are described in SEC filings.

1. DEBTOR'S NAME: Provide only one Debtor name (1a or 1b) (use exact, full name; do not omit, modify, or abbreviate any part of the Debtor's name); if any part of the Individual Debtor's name will not fit in line 1b, leave all of item 1 blank, check here ☐ and provide the Individual Debtor information in item 10 of the Financing Statement Addendum (Form UCC1Ad)

| | | | | |
|---|---|---|---|---|
| 1a. ORGANIZATION'S NAME<br>GLOBAL BIT VENTURES INC. | | | | |
| OR 1b. INDIVIDUAL'S SURNAME | FIRST PERSONAL NAME | ADDITIONAL NAME(S)/INITIAL(S) | | SUFFIX |
| 1c. MAILING ADDRESS<br>[redacted] | CITY<br>BURLINGTON | STATE<br>MA | POSTAL CODE<br>01803 | COUNTRY<br>USA |

2. DEBTOR'S NAME: Provide only one Debtor name (2a or 2b) (use exact, full name; do not omit, modify, or abbreviate any part of the Debtor's name); if any part of the Individual Debtor's name will not fit in line 2b, leave all of item 2 blank, check here ☐ and provide the Individual Debtor information in item 10 of the Financing Statement Addendum (Form UCC1Ad)

| | | | | |
|---|---|---|---|---|
| 2a. ORGANIZATION'S NAME | | | | |
| OR 2b. INDIVIDUAL'S SURNAME | FIRST PERSONAL NAME | ADDITIONAL NAME(S)/INITIAL(S) | | SUFFIX |
| 2c. MAILING ADDRESS | CITY | STATE | POSTAL CODE | COUNTRY |

3. SECURED PARTY'S NAME (or NAME of ASSIGNEE of ASSIGNOR SECURED PARTY): Provide only one Secured Party name (3a or 3b)

| | | | | |
|---|---|---|---|---|
| 3a. ORGANIZATION'S NAME<br>HS CONTRARIAN INVESTMENTS LLC (COLLATERAL AGENT) | | | | |
| OR 3b. INDIVIDUAL'S SURNAME | FIRST PERSONAL NAME | ADDITIONAL NAME(S)/INITIAL(S) | | SUFFIX |
| 3c. MAILING ADDRESS<br>68 FIESTA WAY | CITY<br>FT. LAUDERDALE | STATE<br>FL | POSTAL CODE<br>33301 | COUNTRY<br>USA |

4. COLLATERAL: This financing statement covers the following collateral:
All of that property described on Exhibit "A" hereto and incorporated herein by reference.

Notice - Pursuant to an agreement between Debtor and Secured Party, Debtor has agreed not to grant a security interest in the above Collateral to any other entity. Accordingly, the acceptance of any security interest by anyone other than the Secured Party is likely to constitute tortious interference with the Secured Party's rights.

In the event that any entity is granted a security interest in Debtor's accounts, chattel paper or general intangibles contrary to the above, the Secured Party asserts a claim to any proceeds thereof received by such entity.

It's unclear from the UCC filing what the amount of HS Contrarian's interest is, but the filing notes that GBV had agreed not to grant a security interest in the named collateral to any other

entity. Therefore, HS Contrarian's interest appears to represent the highest seniority in GBV's capital structure.

We have contacted Marathon's investor relations and asked about the relationship between GBV and Stetson, and whether there was any public disclosure of the relationship. Should we receive a reply from the company we will update this accordingly.

Aside from the security interest between GBV and Stetson's firm, we also noticed another interesting connection. GBV's officer/director filings with the Nevada Secretary of State only listed one individual, Jesse Sutton. Sutton was the former CEO and co-founder of Majesco Entertainment, according to his Linkedin Profile. The Majesco entity morphed late last year into a company called PolarityTE through a reverse merger. Stetson is currently the CFO, EVP, and Director of PolarityTE (NASDAQ:COOL), highlighting that the interwoven business interests of Stetson and Sutton appear to have converged with GBV.

(On a related note, we wrote an article last week about PolarityTE and its public entity which has been reverse merged at least six times into a variety of different businesses and which we believe is replete with its own unique set of red flags.)

## *Alarming Parallels With Another Newfangled "Blockchain" Company, Riot Blockchain*

On the subject of executive crossover, Marathon appears to have significant overlap in the individuals involved with Riot Blockchain, another public company that abruptly reinvented itself as a blockchain play. A recently amended S-3 filing for Riot shows that Stetson participated in common stock, convertible preferred stock, and warrant transactions with Riot (note that Riot has recently changed its name from Bioptix Inc. and that the amended S-3 filing still reflects the old company name). Aside from Stetson, the recently named CEO of Riot Blockchain, John O'Rourke, is to hold an approximate 41.04% stake in the common stock of Marathon per a November 29th prospectus amendment.

Aside from the links with key individuals, we noticed several other parallels with Riot. In our piece about Riot we described how Riot also decided to purchase an ***entity*** containing cryptomining equipment and how we believed it to be an irregular transaction. There is a rush towards the bitcoin revolution at the moment, and monitoring for fraudulent uses of the currency, or concerning acquisitions, is one of the ways the economy can self-regulate itself. When examining Riot's transaction side by side with Marathon's we identified the following:

- Riot announced the purchase of its cryptomining entity on November 2nd, **the exact same day** that Marathon announced its own purchase of an entity containing cryptomining assets.
- Both entities being acquired were incorporated in Nevada.
- Both entities being acquired had short corporate histories.
- Both deals were non-cash, dilutive stock transactions.
- Both Riot and Marathon seemingly paid above-market rates to acquire entities containing cryptomining equipment that could have been purchased directly.

We find it concerning that these two separate companies both enacted dramatic pivots toward blockchain business models seemingly in lockstep and in such unusual fashion.

# *BDO Resigned As Auditor Just Weeks Ago*

The company recently announced that BDO had resigned as its auditor near the end of November. Per an 8-K filing:

> *On November 27, 2017, the Company received notice from its independent registered public accounting firm, BDO USA, LLP ("BDO"), that it resigned as the Company's auditor effective immediately. The resignation of BDO was not recommended by the Company's audit committee nor was the audit committee's approval required.*

Per the same 8-K filing, on November 30, 2017, the board appointed RBSM LLP as the company's independent registered public accounting firm. We checked the Public Company Accounting Oversight Board (PCAOB) website and found the latest inspection report on RBSM. The report highlighted what appeared to be some significant deficiencies:

> *Certain deficiencies identified were of such significance that it appeared to the inspection team that the Firm, at the time it issued its audit report, had not obtained sufficient appropriate audit evidence to support its opinion that the financial statements were presented fairly, in all material respects, in accordance with the applicable financial reporting framework. In other words, in these audits, the auditor issued an opinion without satisfying its fundamental obligation to obtain reasonable assurance about whether the financial statements were free of material misstatement.*

The report went on to detail individual failures relating to audit procedures on several of its issuer clients. In one instance it noted a "failure to perform sufficient procedures to test the existence, completeness, and valuation of assets acquired and liabilities assumed in business combinations."

Given the unusual business combination with GBV as detailed above, we hope that RBSM has taken steps to ensure that going forward it follows audit procedures relating to business combinations (and in general).

Note that the PCAOB report also underscored that "the fact that one or more deficiencies in an audit reach this level of significance does not necessarily indicate that the financial statements are materially misstated" and that inspection teams are limited to information available from the auditor. Nonetheless, we view the resignation of BDO and the replacement with a lesser-known firm of questionable quality to be another reason to tread carefully.

# *Conclusion*

We have no strong bearish or bullish view on the future of blockchain technology. We genuinely hope the technology is implemented broadly and that currency and information can be effectively decentralized through its use. Regardless of one's views on blockchain technology however, we think Marathon is a name that investors should avoid. We urge cautious investing to all.

**Disclosure:** I am/we are short MARA, RIOT, COOL.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 51

# Riot Blockchain: Sudden Business Pivot, Suspicious Acquisitions, Questionable Special Dividend

Published on December 11, 2017



## Summary: Riot Blockchain (RIOT)


- Riot made a dramatic pivot from a "life science tools" business to a blockchain company mere months ago.
- The company paid approximately $12 million for a two-week-old crypo-mining entity that owned only about $1.9 million in crypto mining assets.
- A second acquisition raises additional red flags.
- Riot depleted an estimated 63% of company cash through a special dividend that appears to have disproportionately advantaged insiders.
- Regardless of one's views on blockchain technology, we believe Riot is a name that should be avoided.

With "blockchain mania" in full swing, a new self-described leader has emerged. Riot Blockchain (NASDAQ:RIOT) purports to be "a Leading Blockchain Company & Only Nasdaq Listed Pure Play Blockchain Company." With share prices nearly quadrupling in the past three months, we decided to examine the name more closely.

The company's blockchain focus has come about through a series of rapid moves. Mere months ago, Riot was known as Bioptix, Inc. and operated "a life science tools company that provides an affordable solution for drug discovery scientists who require label-free, real-time detection of bio-molecular interactions."

On October 4th of this year, Bioptix announced that it was changing its name and ticker from Bioptix. Inc. (BIOP) to Riot Blockchain (RIOT), and indicated that it would be pursuing a completely different business model focused on strategic investment and operations in the blockchain ecosystem.

We find such a dramatic pivot in business operations to be concerning in its own right, but we believe it is even more questionable given that the seismic shift has come about in conjunction with a series of dubious transactions. This is just one of the many reasons there needs to be crypto regulation, the market is too insecure and variable for anyone to consider any crypto to be reliable and secure.

## *Riot Paid Approximately $12 million To Acquire Kairos Global Technology – A Two-Week-Old Crypto-Mining Company That Owned Only About $1.9 Million in Crypto Mining Assets*

On November 2, 2017, the company announced via press release that it had "entered into a definitive agreement to acquire cryptocurrency mining equipment consisting of 700 Antminer S9s and 500 Antminer L3s, all manufactured by industry leader Bitmain." Upon closing of the purchase the company issued another press release on November 6, 2017, stating that "it has closed on its acquisition of cryptocurrency mining equipment". A basic reading of the press releases might lead a reader to believe that the company had purchased the equipment directly.

However, a reading of the November 1, 2017, Form 8-K that described the transaction leaves us with a different impression. The 8-K clarified that Riot had actually acquired a corporate *entity*

called Kairos Global Technology ("Kairos") that held the cryptocurrency mining equipment described above.

The form 8-K described a share exchange agreement with Kairos whereby the company exchanged Convertible Preferred Stock (convertible into 1,750,001 common shares of Riot) for all outstanding shares of Kairos's common stock. Given that Riot's stock closed at $6.95 per share on November 1, 2017, we estimate the share transaction value at approximately $12.1 million (As of this writing those same shares would be worth an estimated $27 million.) In addition, Riot included a potential $1 million royalty sweetener for Kairos's shareholders:

> *The shareholders of Kairos also will receive a royalty to be paid from cash flow generated from operations, which shall entitle such shareholders to receive 40% of the gross profits generated on a monthly basis until they have received a total of $1,000,000, at which point the royalty is extinguished.*

All told, we estimate the transaction provided anywhere from $12-13 million in value to Kairos's shareholders on the day of closing. Our belief is that Riot grossly overpaid. As above, Riot's stated motive for the transaction was to acquire 700 Antminer S9s and 500 Antminer L3s used to mine cryptocurrency.

However, if Riot had simply purchased the above servers directly from Bitmain, we estimate that the price would have been $1,905,000. In order to arrive at this number, we checked a historical capture of the Bitmain website as of October 16th, 2017, and found that Antminer S9 servers were selling for $1,265 and that Antminer L3s were selling for $2,040.

We contacted Bitmain to see if it was experiencing massive backlogs or any other scenario that could justify an overpayment of roughly $10 million for $1.9 million of machines. We have not heard back from Bitmain as of this writing. The historical capture of the Bitmain website from October 16th shows that machines would have been expected to ship in just over one month from that date (November 21st-November 30th).

Adding to our skepticism of the Kairos deal is the fact that Kairos appears to have had no operations and/or website (despite registering a domain name) and that the entity was formed on October 19, 2017 – less than two weeks prior to its announced acquisition by Riot. We believe the fact pattern indicates that Riot's acquisition of Kairos's assets is highly irregular. Especially when you think about the consideration that should be used when registering a domain name for a new or existing website, look at how people and businesses go about

registering domain names over on sites like makeawebsitehub.com, and it does seem nothing but irregular as to how Riot went about this.

Furthermore, it is unclear to us who ultimately benefited from the apparent generous payment terms for Kairos. The entity was registered to the address of a believed one-man law firm called Laxague Law, Inc. ("Laxague Law"). Its officers consisted of a Dubai resident and its directors consisted of two Floridians, though the underlying shareholder structure was not publicly disclosed.

## *Riot's Acquisition of a Majority Stake in Another Blockchain Technology Company Raises Additional Questions*

Riot's acquisition of newly-established Tess, Inc. raises additional red flags. On October 20, 2017, Riot announced that it had acquired a majority (52%) stake in Tess, which Riot described as a company that was "developing blockchain solutions for telecommunications companies." A "whois" search of the Tesspay.io website shows that it was initially registered on July 18, 2017. Tess then released a seven-page whitepaper in August 2017 describing (i) its plans for an initial coin offering ("ICO"); and (ii) the role its coins intend to play in telecommunications transactions. Those representations aside, the resumes of Tess's principals leave us skeptical of Tess's odds of success:

- Tess's CEO, Jeff Mason, concurrently holds the same CEO position at two other companies, according to his LinkedIn profile: PowerCases and Wiztel;
- Tess's CFO, Fraser Mason, concurrently hold the position of Senior Vice President of PowerCases, according to his LinkedIn profile; and
- Tess's Chief Software Architect, Sorin Tanasescu, concurrently holds various senior roles at other companies, including: (A) Managing Director of VoiceWay; (B) Director of Middleware Integration for Rogers Communications; and (C) Director of an entity called Ingenium IT Compusoft ("Ingenium").

Tanasescu's other companies give us additional cause for concern. Namely, VoiceWay appears to have been associated with a Bitcoin phishing website.

On a Bitcoin forum called *BitcoinTalk*, one user conveyed that Google was displaying advertisements for "mt-**q**ox.com," a clever misspelling of the then-popular Mount Gox bitcoin trading website. That same user noted that the "mt-qox.com" website completely duplicated the real Mount Gox website. This is why it is important to do your research on bitcoin trading

websites and bitcoin traders. Some people decide to do research at websites similar to https://cryptoevent.io/review/bitcoin-revolution/ to learn more about bitcoin bot trading.

Are you new to the world of Bitcoin? If so you might have questions relating to how Bitcoin is taxed. Correspondingly, if you live in Canada and you have concerns about how you should be reporting income you have earned in Bitcoins, or want to learn more about how to report profits on the sale of Bitcoins, you should seek the advice of an experienced Canadian Tax Lawyer to avoid future problems with the Canada Revenue Agency. For more information, head to taxpage.com .

The apparent imposter site was registered to Cristian Talle at the address 196 Judith Ave., Toronto, Canada. It also appears to be a residence, based on a Google Maps search. That same address houses Tanasescu's other businesses including VoiceWay and Ingenium. In addition, Talle used a VoiceWay email address to register the mt-qox.com site. *Reddit* users also noticed the site and started a thread entitled " [SCAM] watch out for mt-qox.com ". The users reported the site to Mount Gox and Google. Google subsequently took action and blocked it as a phishing website, according to the thread. (Note that the VoiceWay website itself was also registered by an individual named Cristian Talle – under a Rogers Communications email address).

Furthermore on the subject of Tess: On the same day that Laxague Law set up Kairos (October 19, 2017), the same law firm also set up an entity called Ingenium Global, Inc., which has a unique name that is similar to an entity in which Tanasescu manages (Ingenium IT Compusoft). Even more interestingly, Ingenium Global, Inc. listed the exact same officers/directors as Kairos (an individual in Dubai and two from Florida) and registered the exact same par value and share count. Given that Riot announced the acquisition of Tess the very next day (October 20, 2017), we cannot help but wonder whether the selling parties in the Kairos transactions were in any way related to the shareholders of Ingenium, and ultimately to the selling parties in the Tess transaction.

## *Riot Depleted An Estimated 63% of the Company's Cash Through a Special Dividend That Appears To Have Disproportionately Advantaged Company Insiders*

Bioptix/Riot recently engineered a " special cash dividend " that stripped the fledgling company of approximately 63% of its cash, seemingly handing a significant portion of those funds to

company insiders. That kind of cash giveaway – announced one day ahead of a shift to a new, speculative business model – gives us significant concerns. The sequence of events was as follows:

In March 2017, Bioptix announced the completion of private placements that included a convertible note financing and also included warrants to purchase 1,900,000 shares of common stock.

On September 25, 2017, Bioptix made the following disclosures:

1. Bioptix filed a Form 8-K stating, in part, that notes from the March 2017 Offerings had been exchanged for shares of Series A Convertible Preferred Stock.
2. Bioptix filed an amended Registration Statement Form S-3 which described how holders of Series A Convertible Preferred Stock "are entitled to receive dividends if and when declared by the Company's board of directors. The Series A Preferred Stock will participate ***on an as converted' basis***, with all dividends declared on the Company's Common Stock."

Then on October 4, 2017, the newly-named Riot filed a Form 8-K stating that the company had approved a cash dividend:

> *Pursuant to which, the holders of the Company's common stock, no par value per share (the 'Common Stock'), and Series A Convertible Preferred Stock, no par value per share (the 'Series A Preferred Stock'), as of the close of business on October 13, 2017, shall receive $1.00 for each share of Common Stock, including each share of Common Stock that would be issuable upon conversion of the Series A Preferred Stock,* ***on an as converted basis***

The magnitude of the dividend is significant. The payout "totaled approximately $9,562,000" whereas Riot's financial statements reflected that at the close of Q3 2017 – two days before the October 2017 dividend was approved – the company had only $13,139,722 in cash and cash equivalents. When factoring in an added $1.86 million in cash proceeds from warrant conversion, the October 2017 dividend depleted an estimated 63% of the company's cash and cash equivalents balance. Consequently, we find its size relative to Riot's available cash to be troubling.

The timing of related warrant conversions is similarly concerning. Riot's quarterly filing prior to

the October 2017 dividend indicates that 2,060,000 warrants from the March offering were converted into 1,228,690 common shares on a cashless basis. In addition, 620,000 warrants were exercised for cash during a period where Riot's board of directors authorized on October 10th a "temporary reduction in exercise price" of convertible securities from the March 2017 private offerings. Given that the record date of the October 2017 dividend was October 13, 2017 (with a payment date of October 18, 2017), both the cashless warrant conversion and the conversion from the reduction in exercise price of the March 2017 securities appear to have conspicuously occurred just prior to the payment of the October 2017 dividend.

# *Who Benefited From the Special Dividend?*

In the press release announcing the special dividend, the company's CEO stated: "This special dividend is a positive step to return value to all Bioptix shareholders." Despite this pronouncement, we believe Riot insiders and participants in the March 2017 private placements benefited disproportionately.

The amended Form S-3 detailing the convertible and warrant offerings prominently mentioned one individual in particular. Per the filing, "The Lead Investor is Barry Honig who is also a selling stockholder." Moreover, Honig-related entities, as well as Honig's family members including brother Jonathan and father Alan, also participated in the transactions.

| Name of Selling Stockholder | Number of Shares of Common Stock Beneficially Owned Before this Offering | Percentage of Common Stock Beneficially Owned Before this Offering** | Shares of Common Stock Offered in this Offering | Shares of Common Stock Beneficially Owned After this Offering | Percentage of Common Stock Beneficially Owned After this Offering** |
|---|---|---|---|---|---|
| Acquisition Group Limited | 200,000(1) | 3.81% | 200,000(1) | 0 | * |
| Northurst Inc. | 559,000(2) | 9.99% | 800,000(2) | 0 | * |
| Erick Richardson | 200,000(3) | 3.81% | 200,000(3) | 0 | * |
| Melechdavid Inc. | 340,000(4) | 6.06% | 340,000(4) | 0 | * |
| Mark Groussman c/f Alivia Groussman UTMA/FL | 80,000(5) | 1.46% | 80,000(5) | 0 | * |
| Mark Groussman c/f Asher Groussman UTMA/FL | 80,000(6) | 1.46% | 80,000(6) | 0 | * |
| Barry Honig | 544,400(7) | 9.99% | 402,050(8) | 504,000(9) | 8.09% |
| GRQ Consultants, Inc. Roth 401K FBO Barry Honig | 30,600(10) | * | 1,005,124(11) | 30,600 | * |
| Titan Multi-Strategy Fund I, Ltd. | 597,300(12) | 9.99% | 1,688,198(13) | 15,000 | * |
| US Commonwealth Life, A.I. Policy No. 2013-17 | 40,205(14) | * | 40,205(14) | 0 | * |
| Robert R. O'Brien | 80,410(15) | 1.46% | 80,410(15) | 0 | * |
| Stockwire Research Group, Inc. | 40,205(16) | * | 40,205(16) | 0 | * |
| Aifos Capital LLC | 120,615(17) | 2.17% | 120,615(17) | 0 | * |
| Stetson Capital Management, LLC | 285,150(18) | 4.99% | 402,050(19) | 7,500 | * |
| JAD Capital Inc. | 80,410(20) | 1.46% | 80,410(20) | 0 | * |
| Richard Molinsky | 97,392(21) | 1.78% | 40,205(22) | 57,187 | 1.04% |
| Alan Honig | 20,000(23) | * | 20,000(23) | 0 | * |

* Less than 1%.
** Based on 5,436,503 shares of Common Stock outstanding as of September 20, 2017.

Later, in two Schedule 13G filings filed as of an event date of October 10th – just days prior to the dividend ex-date – Jonathan Honig and an individual named Mark Groussman reported common stock ownership stakes of 9.51% and 5.93% respectively. Jonathan Honig's filing also mentioned that the 9.51% figure "does not include 808,198 shares of common stock issuable upon conversion of Series A Preferred Stock." it is unclear from the filings where Barry Honig's ownership on a common stock and on a convertible/exercised basis stands currently.

Note that the same filing mentioned that there were only 5,436,503 shares of common stock

outstanding as of September 20th. By November 13th , the number of common shares had spiked up to 8,321,137, a roughly 53% increase in common shares in less than two months. Such a jump indicates that a significant amount of dilution has affected common stockholders in a short amount of time.

# *Conclusion*

We have no strong bearish or bullish view on the future of blockchain. We genuinely hope the technology is implemented broadly and that currency and information can be effectively decentralized through its use. Regardless of one's views on blockchain technology however, we think Riot is a name that investors should avoid. We urge cautious investing to all.

**Disclosure:** I am/we are short RIOT.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 52

# OPKO Health: A House Of Cards Tumbling In The Dark

Published on November 17, 2017



## Summary: OPKO Health, Inc. (OPK)


- A slew of undisclosed or thinly disclosed executive team departures in the diagnostics division, which represents over 82.8% of revenue, could signal business decline and a compliance "house-cleaning".
- The quiet departure of key employees in the company's renal division underscore issues with the rollout of Opko's FDA-approved drug, Rayaldee.
- The company is employing "co-pay assist" programs in the roll-out of Rayaldee in an apparent attempt to compete with low-cost generic & over-the-counter alternatives.
- Pipeline delays and disclosure oddities give us doubt about the value of remaining pipeline assets.
- A low cash balance coupled with negative free cash flow and regulatory overhang could signal a near-term liquidity crunch.


## Introduction

Opko has dropped approximately 25% since its recent quarterly report issued last Wednesday after it missed estimates on both revenue and earnings. In addition to the continued disappointing sales in the company's FDA-approved product Rayaldee, the diagnostics division also saw a significant drop in revenue. We believe the recent quarter is merely the beginning of a series of continuing problems at the company.

# *BioReference: Changes at BioReference Labs*

The company's diagnostics business, which primarily consists of BioReference Laboratories ("BioReference"), accounted for 82.8% of Opko's 2016 annual revenue. BioReference is described in the 10-K as "the nation's third-largest clinical laboratory with a core genetic testing business."

A slew of undisclosed or thinly disclosed executive team departures seems to indicate that BioReference is undergoing a behind-the-scenes transformation. We believe these changes will impair growth and profitability of the division and could foreshadow looming regulatory issues.

# *BioReference: Executives Quietly Depart in Quick Succession*

On the recent conference call, EVP Steve Rubin stated "We continue to make investments in systems efficiencies, cost reductions and **new leadership**" and later made reference to a "change in sales leadership". When exploring this further we found the following details on old leadership that went unmentioned or thinly referenced:

***Richard aherty*** was until recently the Chief Information Officer of BioReference. He was removed from the BioReference executive team list on July 30th of this year, according to Aihitdata.com, although no announcement of his departure was made. On Faherty's Linkedin profile he currently lists himself as an "independent consultant".

***Charles Chuck" Todd*** was previously Executive Vice President of Sales and Marketing at BioReference and served in that role at least until July of this year according to a historical capture of the BioReference executive team website. Again, no announcement was made regarding his departure.

**Amar Kamath** was previously Vice President of Marketing at BioReference according to the executive team website. Kamath was removed as of July 30th, according to Aihitdata.com. No

announcement of his departure was made.

Also worth noting:

***Marc Grodman*** was the Founder of BioReference. Grodman publicly resigned from the company in March 2016, according to a press release. Despite the disclosure of Grodman's departure, no clear reason was given for the resignation and Grodman made no statement as part of the release.

We contacted investor relations seeking disclosure on these executive team departures and have not heard back as of this writing. Should we receive a reply we will update this accordingly.

# *BioReference: Recent Departures and a New Key Hire Could Signal a Shift Toward Compliance*

We believe changes at BioReference could signal a focus on compliance. Several of the recently departed BioReference executive team members had controversial pasts:

**Richard aherty** had a past criminal conviction and was disbarred as an attorney. He pleaded guilty in May 1984 to misusing up to $75,000 of clients' money, though prosecutors believe he took at least $250,000 from clients between August 1983 and January 1984. In March 1986, Faherty was placed on four years' probation and was ordered to do 1,500 hours of community service by a Superior Court Judge.

**Chuck Todd**'s dealings at BioReference had also come under scrutiny: In 2009, BioReference filed a lawsuit against former BioReference employees Matt Carey and Sam Ruta, accusing them of misusing confidential information.

The two ex-employees then filed a detailed counterclaim stating that they and their colleagues were victims of an extortion scheme organized by senior management of Bio-Reference Laboratories. The claim stated Todd accepted $1,600,000 in proceeds from the extortion scheme as profit for Bio-Reference Labs. The claim further detailed Todd and management's complicity in wide scale improper conduct including pervasive expense fraud and abuse, misrepresentations and non disclosures to shareholders, self-dealing, and other improprieties. The claim and counterclaim were later dismissed.

**Marc Grodman** also had some questionable associations. His brother Joel was once alleged to

have posed as a salesman for BioReference to secure a mob-controlled union contract with $400,000 of kickbacks to mob boss Peter Gotti.

Additionally, Grodman had received financing from questionable sources in the early days of BioReference, as Barron's had reported in 2011 :

> *CEO Grodman's lab was financed in the decade after its 1986 initial public offering by such penny-stock bankers as Paul Russo, a Mafia-associated broker, and J.T. Moran, whose firm was the model for the movie Boiler Room. They and other Bio-Reference backers ended up in jail ("There Will Be Blood," May 23, 2011). Grodman and Bio-Reference were never implicated in any untoward activities, and he has said he never saw any wrongdoing.*

Aside from the cascade of executive team departures, Jane Pine Wood, a veteran healthcare attorney was appointed as Chief Legal and Compliance Officer of BioReference in October 2016. Prior to Ms. Wood's arrival the role appears to have not existed, according to historical website snapshots of the executive team list.

The hiring of a Chief Legal and Compliance officer came on the heels of a June 2016 False Claims Act settlement where the company paid $9.35 million to settle charges against former Opko Health CEO Dr. Jonathan Oppenheimer, brought by the U.S. Attorney's Office in Tennessee.

We believe a "cleaning house" may be needed for the company given its historical association with a range of checkered individuals, but it also presents several problems:

> 1. *When faced with an increased compliance burden, BioReference may simply not fare well in the highly competitive lab industry. Diagnostics revenue has already dropped on a quarter over quarter basis (from $256.7 million in June to $229.0 million in September) and is down similarly on a y/y basis. We believe the management shake-up and new compliance protocols will continue to rear their heads in the form of worsening operating metrics.*
> 2. *As we have seen with other diagnostics businesses, one regulatory action may be a sign that additional regulatory actions are around the corner. In the case of Quest Diagnostics for example, the company has seen numerous successive regulatory actions. (1,2,3,4,5)*
> 3. *Any potential regulatory action could create a substantial near-term cash*

> *liability. Opko is free cash flow negative and had only $100.4 million in cash and equivalents as of the most recent quarter. Any material regulatory settlement could put the company in a highly liquidity constrained position.*

# *BioReference: SDNY False Claims Act Probe Represents a Looming Overhang*

In addition to the behind-the-scenes turmoil, we believe company statements could foreshadow a potential settlement with the U.S. Attorney's office.

According to a 10-Q filed May 10th, the company reported:

> *In April 2017, the Civil Division of the United States Attorney's Office for the Southern District of New York (the "SDNY") informed BioReference Laboratories ("BioReference") that it believes that, from 2006 to the present, BioReference had, in violation of the False Claims Act, improperly billed Medicare and Tricare (both are federal government health care programs) for clinical laboratory services provided to hospital inpatient beneficiaries at certain hospitals.*

Rather than offering the typical corporate-speak denying the allegations or stating that they are "without merit", BioReference simply stated that they are "reviewing" and "assessing" the allegations for merit:

> *BioReference is reviewing and assessing the allegations made by the SDNY, and, at this point, BioReference has not determined whether there is any merit to the SDNY's claims nor can it determine the extent of any potential liability. While management cannot predict the outcome of these matters at this time, the ultimate outcome could be material to our business, financial condition, results of operations, and cash flows.*

Three months later, after BioReference had a chance to review and assess the allegations, the 10-Q released on August 8th contained the exact same language about reviewing the allegations for their merit and for their potential liability.

Two days after that report release, Opko CEO Frost was interviewed on CNBC's Mad Money and commented on the SDNY issue. Rather than giving the company a clean bill of health, he stated that they did an internal evaluation and audit and found no "systemic" problems. Frost acknowledged that they had "found a few errors here and there, as you would expect in a business that has so many transactions." He also stated that the SDNY was supposed call Opko back in April but never did, suggesting that perhaps the matter was put to rest.

Despite Frost's partial assurances, his statement on a lack of "systemic" problems seems to fall short of addressing the SDNY's allegations of wrongdoing stemming back from 2006. He (a) provided no further details on the internal valuation (b) failed to address whether there had been past systemic problems and (c) provided no assurance that the SDNY had actually dropped the matter.

Furthermore, given the multiple undisclosed executive team departures at BioReference that appear to have taken place mere weeks prior to Frost's assurances, the issues at BioReference seem to remain an open question.

Now, in the most recent quarterly report we see that the language on reviewing and assessing the charges *again* remains completely unchanged. We believe the SDNY probe merits close attention and could represent a severe overhang going forward.

We contacted investor relations seeking confirmation on whether the SDNY has dropped the False Claims act probe and seeking an update on the status of the probe. We have not heard back as of this writing. Should we receive a reply we will update this accordingly.

# *Rayaldee: A "Feature" Failure?*

While the lab business transforms itself under an apparent executive team shake-up, the company's much touted drug offerings seems to offer little relief.

Rayaldee has been described in Opko's filings as the "feature" of their pharmaceutical segment. The drug is FDA-approved, and is indicated to treat secondary hyperparathyroidism in adults with stage 3 or 4 Chronic Kidney Disease and vitamin D insufficiency. It was approved in June 2016 and launched later that year in November.

In the OPKO earnings call transcript from November 2016, Executive Vice President Steven Rubin stated:

> *Rayaldee is the first product to receive FDA approval for this indication. Rayaldee fills a void in the available treatment options for approximately 9 million American adults, which represent a potential market estimate to exceed $12 billion annually.*

Despite the stated size of the opportunity and its launch last year, Rayaldee has fallen far short of expectations. As of the latest quarterly report, the company stated "During the nine months ended September 30, 2017, we did not recognize any product revenues related to *Rayaldee* sales." In the same report OPKO stated that the advance payments received from Rayaldee customers (but not yet recognized as revenue) totaled only $6.5 million.

Despite the dismal revenue contribution, the company earlier attempted to plant seeds of optimism in Rayaldee's future by suggesting that the drug was receiving widespread adoption by insurers. In a June 1, 2017 press release the company touted that Rayaldee is accessible to 68% of insured lives.

We view the above press release as misleading. While it is true that the company has fairly broad access among *commercial* insurers, Rayaldee has unrestricted access to only 8% of insured Medicare lives nationwide according to FormularyLookup.com, an analytics service that provides data on insurance coverage for U.S. pharmaceuticals:

## Rayaldee has Unrestricted Access for 8% of Medicare lives in All Locations


Preferred | Preferred (PA/ST) | Covered | Covered (PA/ST) | Not Covered

We contacted investor relations seeking comment on Rayaldee's access to Medicare insured lives and have not heard back as of this writing. Should we receive a reply we will update this accordingly.

Medicare coverage is of paramount importance because approximately 71% of Chronic Kidney Disease ("CKD") patients—the key target audience for Rayaldee—are enrolled in Medicare Part D, as of the latest report from the U.S. Renal Data System .[1] This suggests that the vast majority of CKD patients will need access through Medicare Part D plans in order to have coverage for the drug. The same report also shows that approximately 12% of CKD patients had no known insurance coverage, suggesting that insurance providers outside of Medicare Part D represent only a fraction of patients seeking CKD treatments.

The same Opko press release above proclaimed that the company had "entered into agreements with several large Medicare Part D plan sponsors, including the largest Medicare Part D plan, and additional commercial insurance plans for reimbursement of *RAYALDEE*." Despite these assurances however, we were only able to find sporadic coverage across

Medicare Part D plan providers.

Of the seemingly sparse number of Medicare providers that *do* grant access to Rayaldee, the drug tends to be very expensive relative to competitors. According to FormularyLookup, Rayaldee is typically in the highest tier expense brackets across its limited plan coverage. In the overwhelming majority of cases, generics or alternatives (such as Calcitriol, Paracalcitol, Rocaltrol, or Zemplar) were designated as a preferred covered alternative to Rayaldee.

In order to compare Rayaldee's pricing with other Vitamin D analogues, we checked GoodRx.com , an aggregator of prescription drug prices across 70,000 U.S. pharmacies. As is shown below, competitor drugs cost as little as $7-$14. The next most expensive drug in the category designed for treating CKD is Hectorol at $360. Rayaldee by comparison is listed at $955, almost 3x the nearest competitor. Given that drugs in higher "tier" formulary categories often have higher co-pays, the out-of-pocket expenses for Rayaldee can be upwards of $300 per month even *with* insurance.

| | |
|---|---|
| Drisdol<br>vitamin d2, ergocalciferol | $7.08 › |
| vitamin D3 | › |
| Vectical<br>calcitriol | $14.03 › |
| Rocaltrol<br>calcitriol | $14.03 › |
| Dovonex<br>calcipotriene | $124.70 › |
| Zemplar<br>paricalcitol | $127.53 › |
| Rayaldee | $955.31 › |
| Hectorol<br>doxercalciferol | $360.93 › |

A call to Opko Connect confirmed that a 1-month supply of Rayaldee typically sells for $900 to $1,000, depending on the distributor.

Rayaldee therefore appears to (i) lack insurance coverage in Medicare Part D, its most important constituency, and (ii) be the high-cost, less-preferred drug in the category. We believe the above issues makes Rayaldee a starkly uphill sales proposition.

# *Rayaldee: A Quiet Departure of Rayaldee*

# *Management, and Conflicting Disclosures*

There have been several high-level departures in key management and sales roles since the launch of Rayaldee:

**Jim DeMarco** was listed as the SVP of Opko Renal sales on the Opko Renal Management website as of approximately 2 months ago, but he appears to have quietly left the company. His LinkedIn profile shows that he is currently managing partner at the Elixir Group, a business consulting firm. DeMarco had been appointed as Senior Vice President of pharmaceutical sales as announced via press release in April 2016. Per the release, DeMarco was appointed to "support the anticipated launch of RAYALDEE." The release further elaborated on his extensive credentials and qualifications:

> *Jim is uniquely qualified to establish and execute our commercial plans for RAYALDEE in the US. His deep knowledge of the chronic kidney disease market will help bring RAYALDEE to Stage 3 and 4 CKD patients," said Phillip Frost, M.D., Chairman and Chief Executive Officer of OPKO.*

Given DeMarco's loud entrance, we believe his silent departure is telling.

**Douglas Laidlaw** was listed as the Director of Medical Affairs on the Opko Renal "Management Team" website as of approximately 2 months ago. Mr. Laidlaw's hiring had also been announced via a glowing press release in May of 2016:

"OPKO Health, Inc. today announced the appointment of Douglass Laidlaw, PhD as Vice President of Medical Affairs to support the anticipated launch of RAYALDEE." The release added:

> *Doug is a key addition to the management team in OPKO's Renal Division," said Phillip Frost, M.D., Chairman and Chief Executive Officer of OPKO. "A well-conceived and executed medical education strategy is critical to Rayaldee's acceptance by U.S. healthcare professionals.*

Despite the warm welcome, Mr. Laidlaw appears to have also left quietly. His Linkedin profile shows that he left the company in June of this year and is now actively seeking a new

opportunity. Given that his "critical" role entailed educating the medical community on the importance of Rayaldee, we believe his departure underscores the difficulty Opko has had at that very task.

## *Rayaldee Job Posting: In need of National Sales Director to Develop Core Competencies*

Opko is currently advertising a career opportunity for a national sales director for the Rayaldee product. The posting underscores deficiencies with the current roll-out that the position seeks to address, stating that the national sales director is:

> *Responsible for developing & implementing core competencies for the regional sales management & sales teams. Responsible for providing both strategic and tactical direction for the national sales organization while maintaining a positive and motivational work environment.*

Given that the product launched over a year ago the absence of such a key role speaks volumes.

## *Rayaldee: Use of "Co-Pay Assist" Programs*

In the most recent quarterly press release, the company stated that total prescriptions of Rayaldee in Q3 increased by 66% in Q3 compared to Q2, as reported by IMS. The pace has slowed considerably from the Q2 increase of 140% compared Q1 prescriptions. Nonetheless the data at the very least suggests that sales and growth of Rayaldee are taking place at *some* level.

Given the fundamentals of the drug, we sought to explore exactly *how* the product was being sold. We wondered; how does a product compete when it is relatively poorly differentiated and priced 60x-130x higher than comparable generics and over-the-counter-vitamins? We believe the answer is in part through co-pay assistance.

Note that in their purest form, co-pay assist programs are not illegal or untoward, as they propose to offer access to medicine for economically disadvantaged patients. Despite this, allegations of widespread abuse of co-pay assist programs has led to severe pushback from commercial insurers.

"Opko Connect " is a service that offers copay assistance and patient access for Rayaldee to patients. As is stated openly on the website, with the copay assistance program, "eligible commercially insured patients can fill their Rayaldee prescription for no more than $5 per month until the annual maximum limit is reached." In our call with Opko Connect, the representative candidly stated that "typically it's a zero dollar co-pay."

In other words, Rayaldee can compete with low-cost $7-$14 generics by making the drug cost $0 to $5 dollars *for the patient*. Despite the low patient pricing, the insurer must still cover the remainder of the cost of the drug, thereby deflecting the burden to commercial plan participants.

We contacted investor relations and asked the company to make the full data available on (1) the portion of Rayaldee sales that use co-pay assistance, including Opko Connect; (2) any solicitations to or donations to non-profit organizations that cover Rayaldee co-pays, which non-profit organizations have covered Rayaldee co-pays; and (3) the number and percentage of Rayaldee prescriptions that use non-profit organizations to cover co-pays. We have not heard back as of this writing. Should we receive a reply we will update this accordingly.

## *hGH-CTP: How Many "Outliers" Must Be Eliminated In Order to Make Phase III Trials Look Good?*

Outside of Rayaldee, hGH-CTP is the other "featured" drug cited in Opko's earnings reports. The drug is aimed to combat hormone deficiency, and it showed early promise. In December 2014 , OPKO announced that they had reached an agreement with Pfizer for the development and commercialization of hGH-CTP. Under the terms of the agreement, OPKO received $295 million and is eligible to receive $275 million upon the achievement of certain goals/milestones. In the same press release, Phillip Frost was quoted saying:

> *We believe that the global growth hormone market is currently valued at more than $3 billion, and believe that hGH-CTP has the potential to be the best in class long-acting growth hormone product.*

After a long awaited Phase 3 clinical trial announcement, December 2016 results showed that hGH-CTP had failed to reach its primary endpoint. Following the outcome, in a slide in a January 2017 investor presentation the company claimed to have "found an exceptional value of trunk

mass reduction in the placebo group". A subsequent slide added "The exceptional data point warrants an outlier sensitivity analysis."

In other words, a lone outlier in the placebo group skewed the results.

The "exceptional value" represented in the original presentation seems to have transformed later into "outliers". Per a presentation in September 2017 the company stated that it had "completed post hoc outlier analysis in June 2017 to assess the influence of **outliers** on the primary endpoint". It also stated that "analysis which excluded **outliers** showed statistically significant difference between hGH-CTP and placebo." Finally, the presentation stated: "Additional analysis that did not exclude outliers showed mixed results." The presentation made no mention of a lone "exceptional value."

We believe the shape-shifting outlier analysis does not bode well for the future of the drug. As the company awaits for the results of future studies (we estimate in late 2018), the earlier phase 3 failure suggests that a much-needed source of cash in the form of potential regulatory milestones may be in complete jeopardy.

We contacted investor relations seeking disclosure on how many outliers the company has found in its June 2017 post hoc outlier analysis of the hGH-CTP drug. We have not heard back as of this writing. Should we receive a reply we will update this accordingly.

## *4Kscore: Lowering Price Point and "Limited Revenue" Signal a Flop*

On the diagnostic side of the business, Opko's key product is the 4Kscore, a test designed to identify patients at a risk for high-grade prostate cancer.

For some context, in November 2013 , OPKO announced a clinical validation study for a blood test called the 4Kscore test, which measures the serum levels of four different prostate-derived kallikrein proteins: total PSA, free PSA, intact PSA and hK2. The first 3 proteins are common markers used in prostate testing but the company's 'secret sauce' was use of the hK2 protein, which had been shown in several studies to improve identification of risks of prostate cancer. By April 2014, OPKO announced the launch of the 4Kscore test in the United States.

The test is not FDA approved and has not undergone FDA scrutiny. Instead it is considered a Laboratory Developed Test (LDT). The test had an initial price point of $1900 per test, which

compares poorly to common alternatives such as the Prostate Cancer Prevention Risk Calculator (which is free) and the Prostate Health Index, or PHI (which costs $80 ). A slew of competition already exists beyond these two common alternative tests. As industry authors have noted, a " bevy " of biomarker alternatives seek to improve on the standard PSA test.

Worth noting is that unlike the 4Kscore, the PHI is FDA approved . From an efficacy standpoint it compares similarly in identifying the risk of high-grade prostate cancer along with the 4KScore. The rigors of the FDA process have enabled PHI to receive more widespread reimbursement through insurers. By comparison, the 4Kscore has had difficulty receiving reimbursement.

This reimbursement difficulty can be discerned by the shifting disclosures in Opko's investor materials. A September 2015 company presentation had a slide detailing "Near Term Catalysts", including the slide: "Coverage decisions on reimbursement for 4Kscore test" which was assigned a date of 2015/2016. A later January 2017 presentation again dedicated a slide to reimbursement and acknowledged that Palmetto GBA and CGS Medicare Administrators had issued a "negative coverage determination" and that Opko was "addressing concerns". A September 2017 company presentation simply dropped the reimbursement slide entirely.

In May 2017 , 4Kscore announced that the cost for the test had been reduced from $1900 to $595, reflecting both a lack of demand and the difficulties with reimbursement. Despite the drop in price, the test is still 7x more expensive than comparable alternatives such as the PHI.

Opko's recent quarterly report stated "We do not anticipate that we will generate substantial revenue from the sale of proprietary pharmaceutical products or certain of our diagnostic products for some time and we have generated only limited revenue from our…sale of the *4Kscore* test."

# *4Kscore and BioReference*

We believe the failure of the 4Kscore roll-out is also a reflection of the failure of the BioReference acquisition. Management repeatedly cited that one of the key reasons behind the BioReference acquisition was the synergy it would provide with the 4Kscore test. In September 2015, Dr. Frost went on CNBC's Mad Money and promoted the BioReference acquisition by stating that it provides "access to a salesforce and infrastructure that will help make our 4Kscore test one of the most important tests in the history of the diagnostics business."

The company similarly touted its BioReference acquisition on its Q2 2015 conference call by stating the importance of the synergy for marketing its 4Kscore test:

> *…nowhere is the synergy of this merger more demonstrable than in marketing the capabilities of our 4Kscore test to identify and differentiate patients in a noninvasive manner to those that may progress to aggressive prostate cancer.*

The BioReference acquisition took place at a time in the industry when pricing pressures were not at the forefront of investor's minds. At the time the BioReference acquisition was completed, Valeant was peaking at about $220/share and was the darling of the pharmaceutical world. The practice in the industry at the time among some companies was to use related party pharmacies or affiliates as a channel to stuff consumers with high-priced drugs.

Given the more competitive pricing landscape of the industry today we believe the 4Kscore test is likely to require significant additional price cuts if it is to be in any way competitive with alternatives.

# *Remaining Pipeline Contributions Expected to be "Incremental"*

In JP Morgan's recent downgrade report on September 14th, 2017, the report succinctly noted that potential pipeline contributions over the next 6-18 months are "incremental" and unlikely to meaningfully move the valuation needle.

While our analysis agrees that potential near & mid-term contributions are incremental, we have also identified a pattern of pipeline delays. A comparison of Opko's investor presentations given in September 2017 and January 2017 along with the latest earnings release also shows some oddities.

# *The Curious Disappearance of Alpharen (Fermagate)*

The Alpharen Phase 3 trial was slated for "1H 2018" according to the September 2017 investor presentation, but it has suddenly disappeared from the latest earnings release altogether.

By way of background, Alpharen was acquired by Opko along with another drug candidate and announced via press release on January 8, 2013 under the headline "Opko Health to Acquire

Two Phase 3 Products". By year-end, the 2013 10-K stated "We are working with U.S. and European regulatory authorities to finalize the remaining phase 3 clinical program for AlpharenTM (Fermagate Tablets)." The suggestion seemed to be that despite Alpharen's phase 3 trials that had already taken place, further clinical study was needed.

Later in the 2015 10-K the company apparently dropped their European pursuits, stating:

> *We are currently preparing a single remaining Phase 3 clinical trial in the U.S., but are first studying novel characteristics of Alpharen which may offer additional competitive advantages.*

Later the January 2017 presentation slated the Alpharen Phase 3 trial for "2H 2017", but as noted above it was subsequently pushed back again in September to "1H 2018" and now has apparently disappeared entirely as of the earnings release.

We contacted investor relations seeking more information on the status of the Alpharen phase 3 trial and have not heard back as of this writing. Should we receive a reply we will update this accordingly. Given that a previous presentation has shown Alpharen to have a $1.2 billion market size we believe it is a very significant item to go missing.

# *Oxyntomodulin*

The planned Oxyntomodulin Phase 2 trial has been recently delayed as well. The January '17 presentation slated the trial for "2H 2017" whereas the September 2017 presentation slates the trial for "1H 2018".

# *Claros Device Filing: Delayed for 5 Years, then Announced the Day Before Earnings*

On Tuesday November 7th—the day before earnings—Opko announced that they had submitted a Premarket Approval Application for the Total PSA test with the Claros 1 immunoassay analyzer. The press release seemed to suggest that approval of the device is a foregone conclusion. Per the release:

> *With more than 25 million PSA tests performed in the U.S. annually, the Claros 1*

> *Total PSA test represents a $625 million market opportunity.* ***nce approved*** *we plan to leverage BioReference Laboratory's sizeable distribution and marketing capabilities to make this rapid, in-office test available for the benefit of physicians and patients.*

Despite management's confidence in the devices approval, we are cautious, namely given that the filing was delayed for about 5 years.

By way of background, Opko acquired Claros Diagnostics in October 2011 for $49 million. Claros makes a device that aims to take a finger stick of blood and get a result in 10 minutes via a portable, easy-to-use technology that can sit in a physician's office. The approach and objective of Claros is similar to that of Theranos, and several years ago Opko's head of diagnostics even stated that Theranos was their main rival in the space.

The company has repeatedly promoted the potential of the Claros device, and in the most recent quarterly report mentioned the device along with the 4Kscore as a key area of potential synergy with the BioReference sales and marketing team.

Opko's starting point for gaining acceptance of the Claros device is to gain approval for Prostate-Specific-Antigen tests (PSA tests) which assess the risk of prostate cancer. Over time, the goal is to add tests to the device to make it a more robust "point of care" diagnostic offering including testosterone and vitamin D testing.

The company's first major step to market Claros was the PMA filing (a device filing) with the FDA. **The filing had been delayed for years prior to its recent submission**

1. In December 2011, the company issued a press release announcing the commencement of a U.S. clinical trial for the PSA test for their point-of-care diagnostic test (i.e. Claros). The announcement stated that "Opko intends to submit its application to the U.S. Food and Drug Administration for approval of the assay in 2012."
2. In January 2013, Phil Frost was interviewed on CNBC's Mad Money where he predicted that the product would come to market at the end of the year.
3. A September 2013 company presentation had a slide on the Claros offering that described under a "Projected Launch" heading: "US FDA expected 2014".
4. The company stated on an August 2015 conference call that they intend to file with the FDA for the PSA test in 1H 2016 and to also file for the testosterone test in 1H 2016.
5. In a September 2015 presentation the company downgraded that expectation, stating instead that it anticipated a PMA filing would be submitted to the FDA in 2016 (but not necessarily 1H 2016).

6. On March 1, 2017 the company issued a press release that stated "PMA filing anticipated in 1H 2017". Given that the press release was in March, the implication was that the filing would potentially be made imminently.
7. Then, 7 months later in September the company stated that they will file sometime in Q4.

By November 7th 2017 the company announced that they had (finally) submitted the filing.

We believe the long delay with the FDA filing could indicate a lack of confidence in the device. Given that the PMA process takes approximately 6 months we should expect an outcome either way around Q2 of next year.

We contacted investor relations seeking comment on why the Claros filing was delayed for approximately 5 years and have not heard back as of this writing. Should we receive a reply we will update this accordingly.

# *Frosts Insider Purchases are a Hollow Signal*

Many Opko investors seem to be fixated on the insider purchases of Phil Frost, Chairman and CEO of the company.

Frost has been consistently buying shares of Opko in the open market for over 10 years. While these purchases provide a stunning visual for those looking at an Opko chart peppered with insider purchase markers, we view them as virtually meaningless to shareholders who are not named Phil Frost.

Frost's purchases have been a poor prognosticator of stock performance; they were made at prices as high as $16.74 and at many points along the way down. Similarly, they represent a fraction of Frost's wealth. A Forbes article from January suggested Frost's net worth is over $4 billion. By that measure, last year's $25.8 million in purchases represents less than 0.64% of his total worth.

We estimate that Frost's ownership in Opko represents at least 25%-35% of his net worth. At this point is seems that he is tethered to the company regardless of outcome, and at 80 years of age he is unlikely to embark on a new third act. We believe that with very few positive signs to point to at the company, Frost is simply attempting to protect the stock via token insider purchases in the hopes of buying more time.

# *Accelerating Cash Burn Highlights Near-Term Liquidity Needs*

Despite Frost's efforts, Opko appears to be running out of time. The company has generated a negative operating cash flow of $94.1 million in the first 9 months of the year, and has spent over $32.0 million in capital expenditures. As of the most recent quarter-end the company has only $100.4 million in cash and equivalents.

Additionally, Opko has relied more heavily on its revolving lines of credit. As of the most recent quarter-end the company had drawn $105.9 million across its credit lines, compared to $80.7 million in the previous quarter and $47.3 million at year-end December 2016.

We believe the company will need more debt or to further dilute equity holders in the near to mid-term. Operating businesses have been burning cash at an increasing rate, and Opko's cash demands have historically been buoyed by up-front cash payments that are no longer available:

- A deal with Pfizer on Opko's hGH drug supported Opko with a $295 million in up-front payment. That payment occurred during the March 2015 quarter, but the failure of the drug in Phase III trials could imperil any subsequent or near-term milestone opportunities.
- A 2016 agreement from 2016 with VFMCRP included $50m in up-front payments to develop and market Rayaldee in Europe, Canada, Mexico, Australia, South Korea, and certain other international markets. The agreement includes $232 million upon the achievement of certain regulatory and sales-based milestones. With the future of Rayaldee in question (pending meaningful sales traction) these milestones may also be in jeopardy.

We believe the company's cash situation could be tightly constrained over the next 6 months under a base-case scenario. When factoring in unknowns surrounding regulatory overhang, there is a substantial risk that an adverse announcement could be crippling.

[1]Required citation from USRDS: *United States Renal Data System. 2016 USRDS annual data report: Epidemiology of kidney disease in the United States. National Institutes of Health, National Institute of Diabetes and Digestive and Kidney Diseases, Bethesda, MD, 2016.*The data reported here have been supplied by the United States Renal Data System (USRDS). The interpretation and reporting of these data are the responsibility of the author(s) and in no way should be seen as an official policy or interpretation of the U.S. government.

**Disclosure:** I am/we are short OPK.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 53

# Pershing Gold: We Believe Shares Are Virtually Worthless

Published on November 9, 2017



## Summary: Pershing Gold Corporation (PGLC)


- Pershing Gold's director and controller of approximately 28.4% of voting securities, Barry Honig, has a questionable history.
- The company's key asset, the Relief Canyon Mine, was purchased with backing from a hedge fund whose executives were federally indicted for operating "like a Ponzi Scheme," according to prosecutors.
- The mine, which previously targeted production in 2014, has yet to commence production and only recently completed a pre-feasibility study.
- Pershing is nearly out of cash and will need to dilute shareholders by an estimated 40% in order to bring the mine into production.


Pershing Gold Corporation (Nasdaq: PGLC) is an emerging gold producer whose primary asset is the Relief Canyon Mine in Pershing County, Nevada. The company is listed on the NASDAQ

Global Market and the Toronto Stock Exchange under the symbol PGLC and on the Frankfurt Stock Exchange under the symbol 7PG1.

# *Pershing Gold's Director and Key Backer, Barry Honig, As Described in Plea Agreement*

Honig was Chairman of the company until he resigned on February 9, 2012. He currently remains as director. While no longer the key front man, he is still a key backer of the company, according to the company's most recent 10-K dated December 31, 2016. As of that filing, Honig owned 8,842,763 shares of PGLC, representing approximately 28.4% of the company's voting securities.

In 2015, Joseph A Noel, the CEO of a penny stock company called YesDTC Holdings, was charged with securities fraud for running a pump and dump scheme. Noel was charged both criminally and civilly, and ultimately pled guilty. A copy of the plea agreement in which Noel confessed his crimes to authorities, also details Noel's account of the role that Barry Honig played in the scheme, including setting up a reverse merger via a shell company he controlled and by encouraging a focus on stock promotions to drive up the price rather than focus on fundamental drivers. Per the plea deal:

> *In the fall of 2009, I met Barry Honig, who I understood was a large investor in small cap companies. Later that fall, Honig suggested that we do a reverse merger to create a publicly traded company to take control of Allay Online's assets and that I be the CEO of the new company. I was very excited with this opportunity* ***Honig had the experience and resources to implement the reverse merger. He proposed that we utilize R Complete Holdings, Inc., a publicly held shell company that Honig controlled, and that is what we did***
>
> *…* ***During 2010, I worked hard as CEO to make YesDTC a successful enterprise. However, I soon realized that it was not Honig's priority to make YesDTC successful. Instead, I realized that Honig wanted to use promotions to drive up the price of YesDTC shares and then sell his shares.*** *Honig introduced me to David Zazoff who Honig said would promote YesDTC stock. Honig said that Zazoff was a "magic maker," who could make the price of YesDTC stock rise through his services. Honig made it clear that I should not ask questions about how Zazoff achieved his success."*

Honig has denied the claims. We reached out to Pershing's investor relations for comment and have not heard back as of this writing.

# *Pershing Purchased its Primary Asset from Firm Run by Mark Nordlicht, Indicted For Allegedly Running $1 Billion Investment Fraud*

Current key holder aside, the company's early partners and lenders have recently been arrested and charged with federal securities crimes. On August 30, 2011, the company, through a wholly owned subsidiary, Gold Acquisition Corp. ("Gold Acquisition") acquired the Relief Canyon Mine for (i) $12,000,000 cash and (ii) $8,000,000 of senior secured convertible promissory notes issued to Platinum Long Term Growth LLC ("PLTG") and another entity. PLTG was run by an individual named Mark Nordlicht. On December 19, 2016, Mark Nordlicht and 6 other executives of Platinum Partners were arrested by federal authorities for allegedly running a $1-billion fraud . In particular, the valuation of Platinum's assets was called into question by prosecutors. Per the press release:

> *Their returns were the result of the overvaluation of their largest assets, which eventually led to Nordlicht and his co-conspirators operating Platinum like a Ponzi scheme*

On April 9, 2012, a press release (which has since been removed from the Pershing website) highlighted the ties Pershing had with Platinum and its founder Mark Nordlicht (emphasis added):

> *Converting the debt resulting from the Relief Canyon Mine acquisition has been a priority for Pershing as we desired to strengthen the balance sheet and move forward with autonomy.* ***It has been a pleasure working with Mark Nordlicht and Mark Mueller from latinum Long Term Growth LLC as they have proven to be great long term value added partners with ershing since the very beginning.****Pershing would like to thank them for their assistance in working with us to help us carry out our vision.*

We are troubled that the described "long term valued added partners" Pershing worked with from the very beginning were later indicted on charges of securities fraud, in part relating to

asset valuation. We reached out to Pershing's investor relations for comment on the historical relationship with Mark Nordlicht and Platinum and have not heard back as of this writing.

# *The company's Key Mine Asset Has Been Delayed for Over 3 Years and Has Produced Zero Revenue Since Acquisition*

Aside from the issues with the company's current and historical backers, the operating history of Pershing has literally produced zero mining revenue since inception.

On September 17, 2012, the company issued a press release announcing "Pershing Gold Reports Results and Progress Toward Reopening the Relief Canyon Mine." The release set a target date for the mine to be producing gold in 2014. It used multiple phrases indicating the speed with which gold production would be initiated:

- "well on its way to putting this long-neglected gold mine into production."
- "unique opportunity to achieve a fast-track path to production at the Relief Canyon"
- "re-starting the mine and resuming gold production should proceed with minimal delays and capital investment."

Fast forward to the present: after almost 5 years following that initial release, the company has not resumed production and hasn't generated a dime of revenue. On June 5, 2017, the most recent Relief Canyon milestone the company highlighted was the completion of a preliminary feasibility study. In case the name of the study left any doubt, pre-feasibility studies are typically the step undertaken before a full feasibility study. In other words, it's generally the study before a study and is used to determine whether a mine is *potentially* viable.

Between 2012 and the present, the company's announcements have included numerous token accomplishments such as the completion of a preliminary economic assessment in June of 2016, and preliminary internal economics in November 2015. Frankly, we're not entirely sure what the difference is between a preliminary economic assessment and a preliminary internal economics report, but as far as we can tell, one of the differences is about 8 months of elapsed time in between the announcements (but still zero revenue).

# *Pershing Gold is a Capital Raising Machine*

Despite the company's inability to generate one dime of revenue since its purchase of the Relief

Canyon Mine, it has been quite successful at raising capital from share offerings.

Looking back at the same September 2012 press release indicating the speed with which the company aimed to start production, we find this gem:

> *Because Pershing Gold already has a fully permitted and built heap leach processing facility,* ***re-starting the mine and resuming gold production should proceed with minimal delays and capital investment.***

Since that release suggesting production would resume with minimal capital investment, the company has announced the following capital investments and proposed capital investments:

1. August 12, 2013: Raised $9 million in a private placement
2. August 27, 2013: Raised $11.1 million in a private placement
3. July 31, 2014: Raised $12.2 million in a private placement
4. October 20, 2014: Raised $10 million in a private placement
5. April 22, 2015: Raised $11.5 million in a private placement
6. February 26, 2016: Raised $8.15 million in a private placement
7. March 29, 2016: Raised $6 million to Advance Relief Canyon
8. December 1, 2016: Signed a term sheet for a $20-million credit facility
9. December 8, 2016: Raised $7.5 million from a secondary common stock offering

# *Even More Capital is Likely Needed in the Near Future*

In addition to the capital raises above, the company has indicated that yet more capital will be needed to get the Relief Canyon project to production. A June 5, 2017, press release stated, "The Company will be reviewing various options to cover future capital needs, including debt, royalty or stream financing, gold off-take agreements, investment from strategic investors, or combinations of those approaches."

As of the latest 10-Q, the company had only $7.8 million of cash, cash equivalents and restricted cash equivalents on the balance sheet. Given the anticipated expenses, the company expected to have $4.2 million in cash, cash equivalents and restricted cash equivalents at the end of fiscal year 2017. The quarterly release stated quite plainly, "We expect to require additional financing to fund our current operations in the first quarter of 2018."

Aside from merely needing cash to keep the lights on, in order to advance the Relief Mine, the company has stated that it needs capex and working capital of $35 million, according to its preliminary feasibility study. Given Pershing's current market cap, such a raise would represent over 40% dilution to the current equity structure.

# *Conclusion: This Game Has Gone on Too Long*

Given the company's inability to bring its key Relief Canyon mine to production in the past 5 years and given the questions relating to its key backers, we have very little faith in the value of the company or its mining assets. The $7.8 million of cash on the balance sheet has value, but we believe the company will burn through that in short order based on its disclosures. Collectively, we see enough red flags with Pershing to warrant a heavy amount of scrutiny. Buyer beware.

**Disclosure:** I am/we are short PGLC.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

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# TAB 54

# PolarityTE: Investors Beware

Published on October 7, 2017



## Summary: PolarityTE, Inc. (PTE)


- PolarityTE's sole key asset is a patent application that it acquired for a value of $104.7 million.
- Common equity holders are exposed to severe potential dilution, given a capital structure that is saddled with convertibles.
- PolarityTE has failed to release its full pre-clinical data, and its planned human trials appear delayed.
- The entity has been reverse merged several times into a variety of businesses. We believe PolarityTE is the latest in a series of failed story stocks.
- We believe the common equity is likely worthless.


PolarityTE Inc. (COOL), formerly Majesco Entertainment Inc., is a company that aims to "induce a paradigm shift" in the field of tissue engineering and regenerative medicine. The company was formed via reverse merger of PolarityTE into the publicly traded entity of Majesco, as announced in December 2016. Prior to the merger, Majesco had been focused on the unrelated field of video game publishing.

The public entity has managed to morph into at least 6 different seemingly unrelated companies over the years (Majesco was formerly Spinrocket, which was formerly Connectiv, which was formerly CDBeat, which was formerly SMD Group, according to its SEC page).

We believe PolarityTE is merely the latest iteration in a series of failed story stocks, and that common shareholders are exposed to severe risks.

# *Prior to its Merger with Majesco, PolarityTE Owned a Single Patent Application*

Generally, when we see an entity reverse merge onto NASDAQ, the deal will include a reasonably strong pretense for the value generation potential of the company. Often such a pretense will include either physical assets or a strong intellectual property portfolio. In the case of COOL, it appears the Majesco entity had merged with Polarity in order to take a single, lonely patent application public.

The loneliness of the patent application (and the fact that it was merely an application) was not immediately clear to us from a reading of the filings. At various times, filings indicate that the merged Polarity entity owned a (i) "patented" platform; or (ii) multiple patent *applications* (as indicated by the "s" at the end of the word 'applications'). This shape-shifting description is best shown through the December 2016 8-K announcing the merger in which both versions of the story were detailed in the same document:

> 1. *"Polarity is the owner of a novel regenerative medicine and tissue engineering platform developed and **patented** by Denver Lough, MD,PhD.*
> 2. *Later in the filing, "Polarity's **pending patent applications** include claims to material aspects of Polarity's procedures that are not currently protected by issued patents. The patent application process can be time consuming and expensive."*

A search of the US Patent and Trademark Office (USPTO) database, and later filings show that neither description appeared to be accurate. Polarity was in fact the owner of a single patent *application* (without an 's' at the end) filed by Dr. Denver Lough, a resident associated with John's Hopkins University. Per the 10-Q dated April 30, 2017:

> *"Dr. Lough is the named inventor under a **pending patent application** for a novel regenerative medicine and tissue engineering platform filed in the United States and elsewhere. The Company believes that its future success depends significantly on its ability to protect its inventions and technology. Accordingly, the Company is seeking to acquire the pending patent application."*

In case there was any doubt about whether the merged business didn't just consist of a mere pending patent application, an SEC correspondence letter requested that the company detail the operations of the entity being merged. The company responded by affirming that Polarity indeed had been functionally a shell with no employees, operations, or property other than the pending patent application:

> *"There was never any intent to acquire an ongoing business and no ongoing business was acquired. The asset is preserved in a stand-alone entity merely as a vehicle to provide the Company a seamless means to acquire the asset (a patent application) without undue cost, expense and time. Polarity NV has never had employees and therefore no employees will be acquired in the transaction."*

The company paid a substantial amount for the patent application. According to the company's filings, the company paid to Dr. Lough preferred shares "convertible into an aggregate of 7,050,000 shares of the Company's common stock with a fair value of approximately $104.7 million." Note that those same shares would represent about $200 million if sold at today's prices.

# *PolarityTE is a Share Dilution Machine*

PolarityTE aims to revolutionize the skin regeneration market by developing and commercializing its intellectual property. We will get more into our thoughts on its chances of success shortly, but we first want to address what we view as a major hurdle for common shareholders hoping to benefit from the company's efforts to achieve new medical breakthroughs.

Namely, COOL has been rapidly diluting shareholders, and the current capital structure seems to represent a massive wall of potential new dilution. Below is a breakdown of the common shares outstanding over the past several periods, based on company filings:

- 09/12/2017: **6,333,98** shares of common stock outstanding
- 06/05/2017: **,876,9 2** shares of common stock outstanding
- 03/08/2017: **, 01,768** shares of common stock outstanding
- 10/31/2016: **2,782,963** shares of common stock outstanding

For those keeping track at home, that is an increase of about 127% – more than double – in just over a year.

Beyond the ballooning number of common shares outstanding, as of 7/31/2017 common shares issuable upon conversion of preferred stock and exercise of stock options represents another potential **11,939,093** shares, a tripling of the existing cap structure.

Keep in mind that convertible holders have additional rights, including "the right to receive a liquidation preference, prior to any distribution of our assets to the holders of our Common Stock." Convertible holders can also be paid dividends on an 'as converted' basis, so that dividends could be paid out as if preferred shares were fully converted to common. In other words, if the company distributes cash via a dividend or liquidation, the common holders could experience dilutive effects via those events as well.

## *How Are Things Coming Along So Far with the Skin Regeneration Revolution?*

Dilutive share structure aside, the company seems to be advancing its technology at a rather uninspiring pace. In a press release on June 8th, the company announced that pre-clinical results demonstrate that the technology can successfully regenerate skin and hair in full thickness swine flu models. On a conference call following the release, CEO Denver Lough stated:

> *"The preclinical image based data released today is by no means even 1% of the data we have collected, which will be released in due course via peer reviewed articles and other public forums."*

We searched Google Scholar and ResearchGate for any peer reviewed articles on the company's pre-clinical research and found zero articles since that release. We also found no subsequent data released by the company. We have asked investor relations whether the company has released its data and whether there are any peer reviewed articles on the data and have not heard back as of this writing. Should we hear back from the company, we will

update this accordingly.

In that same June 8th press release, the company seemingly indicated that additional future milestones would be forthcoming:

> *"The Company expects to initiate a human clinical trial evaluating the autologous homologous SkinTE construct in the third quarter of 2017."*

There have been no human trials announced since that date. We checked clinicaltrials.gov to see if any trials had been posted and found zero matches.

# *October 19th Update Leaves Us Befuddled*

Subsequent to the promises of the release of data and human clinical trials, on October 19th the company stated in a press release:

> *"Clinical application is expected in the fourth quarter of 2017, and data is planned to be released through multiple channels in the first half of 2018."*

Again, we haven't seen the data or seen any registered clinical trials thus far. We checked with investor relations to get a sense of the expected timeline of human clinical trials, given that we are currently near the end of 2017. We have not heard back as of this writing, but should the company respond, we will update this accordingly.

The same release noted that "multiple value analysis committees have approved SkinTE for use in their respective medical institutions", though the release did not name any of the institutions that had approved the product. It is unclear to us exactly what was "approved", given that the product has not yet been tested in humans. After all, how can something be approved before it's even been proven to work?

Again, we checked with investor relations to see if they could name any of the medical institutions that have approved the product or give a sense of what the approvals represent and have not heard back as of this writing. Should we hear from the company, we will update this accordingly.

# *Lots of PR With Few Tangible Results*

Despite the apparent absence of released pre-clinical data or the commencement of clinical trials, we have noticed that the company has managed to generate a tremendous amount of PR via various media outlets. It has also issued about 25 press releases over the course of the past year, and assembled a clinical advisory board of over 14 medical professionals. Such loud moves with little hard data or tangible advancement to show for it do not inspire our confidence.

# *Conclusion: Not COOL!*

The path to bringing the company's lonely patent application through clinical testing and market entry is likely an expensive proposition. Even when factoring in the proceeds of yet another recent convertible offering the company's estimated working capital of approximately $20 million seems to represent the mere beginning of what would require substantial additional capital.

We cannot claim to be experts in the field of regenerative skin medicine, and we truly hope the product ends up working in humans. Despite this, we do have a fairly thorough understanding of the effects of dilutive financing to common shareholders. On a fully diluted/converted/exercised basis and at current prices, the company's market cap would be north of $500 million. We do not believe the company's progress to date can justify that valuation no matter how many great scientists the company adds to its board of advisors.

Given all of the above, we believe common shares are likely worth pennies rather than dollars. We urge cautious investing to all.

**Disclosure:** I am/we are short COOL.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

**Additional disclosure:** Use of Hindenburg Research's research is at your own risk. In no event should Hindenburg Research or any affiliated party be liable for any direct or indirect trading losses caused by any information in this report. You further agree to do your own research and due diligence, consult your own financial, legal, and tax advisors before making any investment

# TAB 55

# Eros International: New Receivables Accounting Red Flags

Published on August 24, 2017



## Summary: Eros International (NYSE:EROS)


- An entity outside Eros's corporate structure both receives short term loans from Eros and simultaneously records large payables to an Eros related party.
- The entity, Ayngaran International Films Private Limited ("AIFPL") appears to report very little other financial activity.
- AIFPL's short-term loans & advances represent 249x its annual revenue, and trade payables represent 289x its annual revenue.
- We believe the above raises new red flags relating to Eros's receivables accounting.


Today we intend to provide support for longstanding questions posed by short sellers relating to Eros's potentially misleading accounts receivables. Eros has consistently maintained a large uncollected accounts receivables balance which has indicated at the very least that the

company has unusual difficulty in collecting its revenue. At worst, the balance could be indicative of illegitimate revenue transactions or ‘ round tripping ,’ a means of boosting the operating metrics of a company without ultimately providing any real economic benefit.

# *Accounting Questions*

In an earlier report on Eros (NYSE: EROS), we had outlined suspicions relating to Eros Television Private Limited , an entity that appears to sit outside of the Eros corporate structure and records little financial activity with the exception of a series of advances and payables.

Recently, we learned of yet another entity, Ayngaran International Films Private Limited ("AIFPL") that demonstrates a similar pattern: it appears to sit outside the Eros corporate structure and shows little financial activity with the exception of a series of large advances and payables. The added insight gleaned from this example is that (i) a recent annual Director's Report filing clearly identifies Eros as the key lender to AIFPL; and (ii) the filing clearly identifies "related party" as the primary benefactor of AIFPL's payables. (as presented in detail below). Related party entities are later defined in the filing and consist of Eros subsidiaries or related entities/individuals.

In short, the filing seems to show that Eros lends to AIFPL which then simultaneously owes large payables to Eros controlled or related parties. AIFPL records little other financial activity. We believe this evidence renews questions relating to Eros's receivables accounting practices.

# *Who Owns AIFPL?*

In order to demonstrate that AIFPL sits outside the Eros corporate structure, we pulled the full equity ownership of the entity from the Indian corporate filings database. AIFPL is shown as having 3 owner/directors who collectively own 100% of the equity in the entity.

Neither Eros nor any of Eros's corporate entities own any equity in AIFPL, as shown in the linked ownership table above.

# *AIFPL's 2016 Directors Report*

The 2016 annual directors report for AIFPL came out in early August in the Indian Ministry of Corporate Affairs filings database. As per page 2 of the report, the entity recorded revenue of only INR 861,660 and a modest loss of INR 4,517,078.

AYNGARAN INTERNATIONAL FILMS PVT. LTD.
146/11, IIIRD FLOOR
RAJPARIS TRIMENI TOWERS
G N CHETTY ROAD, CHENNAI - 17

CIN:U92111TN2004PTC054559

Profit and loss statement for the year ended 31st March 2016

| | Particulars | Note No. | 2015-2016 (in Rupees) | 2014-2015 (in Rupees) |
|---|---|---|---|---|
| I. | Revenue from operations | 15 | - | - |
| II. | Other income | 16 | 8,61,660.00 | 8,40,000.00 |
| III. | Total Revenue (I + II) | | 8,61,660.00 | 8,40,000.00 |
| IV. | Expenses: | | | |
| | Purchases of Stock-in-Trade | 17 | - | - |
| | Changes in inventories of finished goods work-in-progress and Stock-in-Trade | 18 | - | - |
| | Employee benefits expense | 19 | 6,43,500.00 | 6,75,500.00 |
| | Finance costs | 20 | | - |
| | Depreciation and amortization expense | 8 | 1,46,439.63 | 4,08,023.54 |
| | Other expenses | 21 | 66,81,093.20 | 43,72,585.07 |
| | Total expenses | | 74,71,032.83 | 54,56,108.61 |
| V. | Profit before exceptional and extraordinary items and tax (III-IV) | | (66,09,372.83) | (46,16,108.61) |
| VI. | Exceptional items | | | - |
| VII. | Profit before extraordinary items and tax (V - VI) | | (66,09,372.83) | (46,16,108.61) |
| VIII. | Extraordinary Items | | | - |
| IX. | Profit before tax (VII- VIII) | | (66,09,372.83) | (46,16,108.61) |
| X | Tax expense: | | | |
| | (1) Current tax | | - | - |
| | (2) Deferred tax liability/ (Asset) | | (20,92,294.00) | (14,75,161.00) |
| | (3) Wealth Tax | | - | - |
| XI | Profit (Loss) for the period from continuing operations (VII-VIII) | | (45,17,078.83) | (31,40,947.61) |
| XII | Profit/(loss) from discontinuing operations | | - | - |
| XIII | Tax expense of discontinuing operations | | - | - |
| XIV | Profit/(loss) from Discontinuing operations (after tax) (XII-XIII) | | - | - |
| XV | Profit (Loss) for the period (XI + XIV) | | (45,17,078.83) | (31,40,947.61) |
| XVI | Earnings per equity share: | | | |

Despite the minimal top line and bottom line activity, on page 1 of the report we see that the entity recorded a whopping INR 249,021,049 in trade payables and INR 214,728,169 in short term loans and advances, as shown below:

| | Particulars | Note No. | 2015-2016 (in Rupees) | 2014-2015 (in Rupees) |
|---|---|---|---|---|
| I. | EQUITY AND LIABILITIES | | | |
| 1 | Shareholders' funds | | | |
| | (a) Share capital | 3 | 31,52,310.00 | 31,52,310.00 |
| | (b) Reserves and surplus | 4 | (6,80,77,352.10) | (6,35,60,273.27) |
| 2 | Share application money pending allotment | | - | - |
| 3 | Non-current liabilities | | | |
| | (a) Long-term borrowings | 5 | 7,25,12,558.00 | 7,25,12,558.00 |
| 4 | Current liabilities | | | |
| | (a) Trade payables | 6 | 24,90,21,049.16 | 24,15,82,436.87 |
| | (b) Other current liabilities | 7 | 20,33,536.00 | 14,75,796.00 |
| | TOTAL | | 25,86,42,101.06 | 25,51,62,827.60 |
| II. | ASSETS | | | |
| | Non-current assets | | | |
| 1 | (a) Fixed assets | 8 | | |
| | (i) Tangible assets | | 76,88,141.08 | 78,34,580.71 |
| | (ii) Intangible assets | | - | - |
| | (iii) Capital work-in-progress | | - | - |
| | (iv) Intangible assets under development | | - | - |
| | (b) Deferred tax assets (net) | 9 | 2,25,40,075.00 | 2,04,47,781.00 |
| 2 | Current assets | | | |
| | (a) Inventories | 10 | 8,50,000.00 | 8,50,000.00 |
| | (b) Trade receivables | 11 | 1,09,26,024.76 | 1,02,80,694.40 |
| | (c) Cash and cash equivalents | 12 | 11,59,860.43 | 1,74,081.70 |
| | (d) Short-term loans and advances | 13 | 21,47,28,169.79 | 21,48,25,859.79 |
| | (e) Other current assets | 14 | 7,49,830.00 | 7,49,830.00 |
| | TOTAL | | | 25,51,62,827.60 |
| | | | 25,86,42,101.06 | - |

Summary of Significant Accounting Policies

We find the above to be a jarring fact pattern. We simply cannot envision a reasonable scenario where a company's trade payables are 289x larger than its annual revenue. Similarly, we believe it is odd that a lender would extend a short term loan representing 249x the borrower's annual revenue.

As shown in later notes in the Director's Report on page 6, the loan is explicitly mentioned as originating from "ICD – Eros International Media P Ltd". ICD stands for inter-corporate deposit, a form of company to company loan that is prevalent in India. Similarly, the majority of trade payables are shown as being to a related party:

**NON CURRENT LIABILITIES**

**Note 5**
**Long Term Borrowings**

| | 2015 - 2016 | 2014 - 2015 |
|---|---|---|
| Unsecured | | |
| ICD - Eros International Media P Ltd | 7,25,12,558.00 | 7,25,12,558.00 |
| Total | 7,25,12,558.00 | 7,25,12,558.00 |

**CURRENT LIABILITIES**

**Note 6**
**Trade Payable**

| | 2015 - 2016 | 2014 - 2015 |
|---|---|---|
| (i) Sundry creditors - Related Party | 20,19,81,592.56 | 19,63,57,868.75 |
| (ii) Sundry creditors - Others | 4,70,39,456.60 | 4,52,24,568.12 |
| Total | 24,90,21,049.16 | 24,15,82,436.87 |

As defined later in the report, related party entities consist of 4 Eros subsidiaries (per Eros's 20-F filing) or related parties of those subsidiaries connected through key management personnel of AIFPL:

22. Related party Transactions

In accordance with the requirements of AS – 18 "Related Party Disclosure" issued by the ICAI, the details of related party transactions are given below:

Enterprises in which key management personnel have significant influence.

1. Ayngaran International Media Private Limited
2. Ayngaran International UK Ltd
3. Ayngaran International UK
4. Ayngaran International Singapore Pte ltd
5. Ayngaran Anak Media Private Limited
6. Ayngaran Travels and Cargo Pvt. Ltd.
7. Key Management Personnel – a) Mr. Karunamoorthy b) Mr. Arun Pandian c) Kavitha Pandian

The two entities not owned by Eros in the list above (Ayngaran International Singapore Pte ltd and Ayngaran Travels and Cargo Pvt. Ltd) are connected to Eros through AIFPL's key

management personnel:

- Kumarasamy Karunamoorthy is listed as a key management person of the AIFPL entity. He is also a current director of Eros-owned Ayngaran International UK Ltd; and
- Arun Pandian, listed as a key management person of AIFPL, is a producer associated with the same Eros-owned Ayngaran International UK Ltd. Kavitha Pandian (the other listed key management person) is his daughter.

# *What Now?*

We have reached out to Eros's investor relations contact and to CEO Jyoti Deshpande last week seeking comment on the economic rationale for the business purposes behind the AIFPL transactions. As of this writing, we have not heard back, but will update this should we hear clarification from the company.

We have also written to the SEC on this matter and will likely write to Eros's auditors, Grant Thornton India LLP. In the meantime, we urge caution to investors in Eros.

**Disclosure:** I am/we are short EROS. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

# TAB 56

# Eros Earnings Review: An Abundance Of Red Flags

Published on August 2, 2017



## Summary: Eros International (NYSE:EROS)


- Eros claims to be "well-capitalized" yet plans a shelf offering. The company also sold shares of its key Indian operating subsidiary the very day of its earnings release.
- The company reiterated a claim from early April that it is in advanced stages of negotiations for a debt refinancing deal, yet it still has no deal in place.
- The company is facing spiking financing costs which are 463.6% q/q; Short-term debt and contractual obligations due within one year stand at $262 million.
- Past accounting questions appear to have intensified.
- Eros announced a near doubling of its content library, yet we find zero CY 2017 movies "Recently Added" to its ErosNow website.


## Introduction

With this report, we intend to update the market on our findings following Eros's (NYSE: EROS)

latest annual results released on July 28th and the company's 20-F filing released on July 31st. Much of the market seemed focused on Eros's top line and bottom line miss and how the results tarnished the company's growth story. Despite those important takeaways, we believe the full story is significantly worse.

# *Asset Sales and a Potential Shelf Offering Spell More Liquidity Issues*

A key bullet point from the earnings release focused on Eros's supposedly strong capitalization:

> *Not including the $40 million set aside for the (revolving credit facility), Eros has over $112 million of cash on balance sheet, availability under existing lines of credit and access to capital markets and the company remains well-capitalized and able to invest in future growth.*

Despite the self-proclaimed clean bill of health, the company's actions, subsequent statements, and reported debt and off-balance-sheet obligations seem to conflict with the notion that the company is adequately capitalized. In particular, the company suggested it is seeking more capitalization options. In the earnings release, it stated:

> *…we are in advanced stages of negotiations for a debt refinancing deal as well as expect to file a shelf for a potential capital raise soon after this earnings.*

We can't help but notice that in early April, the company similarly stated it was "in advanced stages of executing multiple long-term refinancing options" after a failed bond offering and a temporary extension of its revolving credit facility. With debt maturities looming and without a finalized deal in place, we believe the company is short on time and short on options.

Even more telling, the aforementioned equity and refinancing alternatives are being explored despite the company's rapid selling of shares in its key Indian operating subsidiary, Eros International Media Limited (EIML). The most recent sale of EIML shares occurred the very same day of the annual release, July 28th, suggesting a current and ongoing need for liquidity.

Based on Eros's recent share disposition filing with the BSE and recent sales reported to the NSE/BSE, Eros owns approximately 45.32% of unencumbered shares in EIML and has

pledged but retained voting rights over another 16.20% of the company. This compares to the company's last annual release where it reported a 74.4% unencumbered stake in the operating subsidiary. It is unclear whether these sales and share pledges are expected to continue.

If the above weren't troubling enough, the maturity wall of debt and short-term contractual obligations suggests a high need for near-term capital:

- The company's $85 million revolver is due September 30th. Eros stated that it has "set aside approximately $40 million to pay (the RCF) down further".
- Eros's total short-term debt stands at over $180 million.
- Eros's unrecorded contractual obligations due in "less than 1 year" stand at $81.2 million, with total unrecorded contractual obligations of $292.9 million.
- Eros's "trade and other payables" increased by over 84% to $120.1 million from $65.2 million in the preceding year, suggesting a significant near-term liquidity burden payable to the company's suppliers.

In short, the company exhibits signs of an ever-tightening liquidity situation with no clear solution in hand.

# *Spiking Financing Costs*

The effects of this liquidity situation have also seemed to manifest in the form of increased financing costs. From the company's most recent filing:

> *For the three months ended March 31, 2017, net finance costs increased by 463.6% $6.2 million (sic), compared to $1.1 million in the three months ended March 31, 2017. In fiscal 2017, net finance costs increased by 115.0% to $17.2 million, compared to $8 million in fiscal 2016, mainly due to lower income from financing activities and increased borrowing costs.*

Part of the increase in financing costs can be explained by new debt, such as a new senior Term Loan secured by a pledge of shares of EIML, carrying an interest rate of 13-14.25%. In other cases, we see that pre-existing debt has been renegotiated at higher rates. For example, in this release, we learned for the first time that the interest rate on the revolving credit facility has moved significantly higher to "LIBOR 7.5% and Mandatory Cost" compared to a rate of "LIBOR 1.90% – 2.90% and Mandatory Cost" in the previously reported period.

Such "tightening screws" are indicative of the rising costs and stricter covenant terms that generally result from pushing out maturities to try and buy a company more time to pay off its debts. We intend to carefully monitor for any new debt issuance or repayments at the company and its subsidiaries as the debt scenario evolves over time.

# *Eros Television: A New Related Party Emerges*

The latest filing discloses that Eros received a $6.4m short-term loan from Eros Television, which is cited as a "related party". We find it odd that Eros Television sits outside the Eros corporate structure. Per Indian filings, Eros Television is a subsidiary of Eros Energy Singapore Pte Ltd:

EROS TELEVISION INDIA PRIVATE LIMITED

**EROS TELEVISION INDIA PRIVATE LIMITED**

**Shareholding pattern of Eros Television India Private Limited as on March 31, 2016:**

| Sr. No. | First Name | Middle Name | Last Name | Folio Number | DP – ID Client ID Account Number | Number of Shares held | Class of Shares |
|---|---|---|---|---|---|---|---|
| 1. | Sunil | Arjan | Lulla | 01 | -- | 100 | Equity Shares |
| 2. | M/s Eros Energy Singapore Pte Ltd | | | 03 | -- | 9,900 | Equity Shares |
| **Total** | | | | | | **10,000** | **Equity Shares** |

Eros Energy Singapore has multiple subsidiaries that all appear to be related to the energy space, except for Eros Television. Per Eros Television's Directors Report dated November 2016, we see that the entity generates 100% of its sales from the "Media and Entertainment Industry", making it an apparent anomaly in the Eros Energy corporate structure:

**II. PRINCIPAL BUSINESS ACTIVITIES OF THE COMPANY**

All the business activities contributing 10 % or more of the total turnover of the company shall be stated:-

| Sr. No. | Name and Description of main products / services | NIC Code of the Product/ service | % to total turnover of the company |
|---|---|---|---|
| 1 | Media and Entertainment Industry | 59131 | 100% |

**III. PARTICULARS OF HOLDING, SUBSIDIARY AND ASSOCIATE COMPANIES**

| Sr. No | NAME AND ADDRESS OF THE COMPANY | CIN/GLN | HOLDING/ SUBSIDIARY / ASSOCIATE | % of shares held | Applicable Section |
|---|---|---|---|---|---|
| 1 | Eros Energy Singapore Pte Ltd. | - | Holding | 99% | 2(46) |

Furthering our suspicion, the entity appears to record little financial activity with the exception of large cash transfers through a series of borrowings and advances, per the Eros Television audit report filed November 2016:

| Particulars | For the year ended 31 March 2016 | | For the year ended 31 March 2015 | |
|---|---|---|---|---|
| **Cash flow from operating activities** | | | | |
| Net profit before tax | 52,770 | | 17,79,459 | |
| Adjustments: | | | | |
| Bank charges | - | | 23,302 | |
| **Operating profit before working capital changes** | 52,770 | | 18,02,761 | |
| Increase/(Decrease) in other current liabilities | 4,42,781 | | (37,54,420) | |
| Increase/(Decrease) short term loans and advances | (1,400) | | | |
| **Cash generated from operations** | 4,94,151 | | (19,51,659) | |
| Taxes paid (net of refunds) | (51,148) | | (23,68,490) | |
| **Net cash from operating activities** | | 4,43,003 | | (43,20,149) |
| **Cash flow from investing activities** | | | | |
| Long term advances given | (16,04,60,327) | | - | |
| Advances received back | | | 25,35,08,558 | |
| **Net cash from investing activities** | | (16,04,60,327) | | 25,35,08,558 |
| **Cash flow from financing activities** | | | | |
| Proceeds from long - term borrowings | 16,00,00,000 | | (25,00,00,000) | |
| Interest and bank charges (net) | | | (23,302) | |
| **Net cash from financing activities** | | 16,00,00,000 | | (25,00,23,302) |
| **Net cash increase in cash equivalents** | | (17,324) | | (8,34,893) |
| **Cash and cash equivalents at the beginning** | | 4,20,959 | | 12,55,852 |
| **Cash and cash equivalents at the ending** | | 4,03,635 | | 4,20,959 |

In the same audit report, we see a note showing that the advances were "advances given for film":

Note 3.5 : Long term loans and advances (Amount in ₹)

| Particulars | As at 31 March 2016 | As at 31 March 2015 |
|---|---|---|
| Unsecured considered good | | |
| Advances given for Film | 16,41,16,840 | 36,56,513 |
| Total | 16,41,16,840 | 36,56,513 |



If the above wasn't odd enough, perhaps the greatest indication of potential irregularity is that Eros derives a substantial portion of its revenue through television syndication. Per the annual release, revenues from television syndication were a rare bright spot in the company's results, representing a year-over-year increase of 22.1% to $88.0 million from $72.1 million from the year prior.

Until recently it was not even clear to us that Eros insiders controlled a related-party television business that sits outside the Eros corporate structure. We would be very interested to know the amount, if any, of the television syndication revenue that Eros generates from dealings with related-party Eros Television.

# *Questionable Revenue, Again*

The company reported a severe drop in revenues in India, Europe, and North America. Despite these across-the-board declines, the "Rest of the World" segment revenues increased substantially; an increase of over 56% on a year-over-year basis:

| | Y/Y Sales % | Y/Y Sales ($M) |
|---|---|---|
| India | -23.7% | 122.0 |
| Europe | -24.9% | 25.7 |
| North America | -82.9% | 2.5 |
| Rest of World | 56.5% | 102.8 |

The explanation provided by the company for the leap in RoW revenues is as follows:

> *…mainly due to decreased theatrical revenues from the film mix offset by* ***increased catalogue revenues and accelerated catching up on sales held back in the second half of fiscal 2016.***

For some context, the company was previously faced with questions about its historically large Days Sales Outstanding (DSO) metric that, in part, stemmed from uncollected "high margin" catalogue revenue. The company responded in FY 2016 by deciding to "forego a portion of its potential catalogue revenues that have relatively longer payment cycles, in order to improve days' sales outstanding."

As noted by research boutique GeoInvesting , that explanation appears to defy common sense. High margin sales are the best kind of sales. Choosing to forego high margin business as a means of temporarily improving a balance sheet metric seems to be nonsensical.

We find the language in this release on "accelerated catching up on sales held back" to be similarly bizarre. It appears as if the company can simply turn on and off its "high margin" catalogue sales at will. We find it curious that these sales seem to take place with such fluidity and that they appear heavily in the "Rest of the World" segment; the least specific customer category consisting of largely opaque jurisdictions.

| | Three months ended March 31, | | Twelve months ended March 31, | |
|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 |
| **Revenue by customer's location** | | | | |
| India | $ 19,719 | $ 31,164 | $ 129,251 | $ 158,843 |
| Europe | 365 | 10,447 | 7,695 | 24,367 |
| North America | 877 | 4,413 | 10,132 | 19,865 |
| Rest of the world | 31,714 | 19,118 | 105,916 | 71,353 |

Notably, the company also claims in the most recent March quarter to have generated over 60% of its ***total*** revenue in "Rest of the world".

Again, as noted by the folks at GeoInvesting, India has 1.25 billion citizens while there are only an estimated 16 million total Indian ex-pats living abroad across *all* regions. While Bollywood entertainment can certainly have appeal with anyone, one would think that such appeal may apply at least somewhat proportionately across one or several other regions of the world such as Europe and North America. Instead, we are led to believe that growth is shrinking in India, Europe, and North America, while exploding elsewhere.

# *Questionable Receivables, Again*

The company's trade receivables balance increased to $226.8 million from $169.3 million from a year ago, again due largely to "significantly higher catalogue sales".

Using the updated trade receivables balance and the annual revenue number, we calculate a DSO of 327 days. That metric is extremely high by any measure, but we believe the ex-India DSO to actually be much worse.

Eros's key Indian subsidiary (EIML) had a DSO of approximately 97 days in its last fully reported fiscal year. Given that India accounts for a substantial proportion of the company's total revenue and has skewed the overall DSO downward, we can surmise that the DSO on revenue coming from outside India is likely significantly higher than 327 days. The implication is that Rest of the World sales seem to be particularly troublesome to collect on. We wonder why.

The company's release added that it collected over $25 million of fiscal 2017 trade receivables post balance sheet. While this was touted as an accomplishment, we view collection of only 11% of the previously outstanding trade receivables in the roughly four-month interim period as a reinforcement of the company's continued collection issues.

# *Eros's Movie Library*

In the annual release filed on Friday, the company announced that "Eros' library for digital film rights stands at over 10,000 films." According to conference call transcripts, CFO Prem Parameswaran stated, "By the end of the fiscal year we had added 5,000 digital titles to the roster of films available on ErosNow."

We find the new 10,000 metric to be somewhat confounding. On the ErosNow website, there are zero "Recently Added" movies for calendar year 2017 and only 22 movies for calendar year 2016 as of this writing. Similarly, we checked every genre category and found zero movies for calendar year 2017 and only 36 movies for calendar year 2016. We wonder, how old are the 5,000 additional digital titles and where can they be found?

The apparent doubling of the company's film library also occurred despite its "intangible asset-content" line item only increasing by 13.8% from the previous year ($904.6m from $795.1m). Similarly, the company's cash flow line item for "Purchase of intangible film rights and content rights" dropped 17.8% on a y/y basis, to $173.5 million from $211.3 million.

We have a hard time understanding how the company nearly doubled its library while seemingly failing to update its ErosNow offering with meaningful 2017 and 2016 content, failing to record a significant increase in the value of content assets, and failing to spend a commensurate amount on the new library titles. We seek clarification on specifically what was purchased.

## *What is the Story with the Movie Slate?*

The MD&A section of the earnings release attempted to address various liquidity-related concerns by discussing the financial strength of the company. One statement in that section suggested that a large amount of money had been invested in the film slate. Specifically:

> *Over $200 million is already invested in the ongoing slate.*

The implication seemed to be that the initial outlay could mitigate the company's near-term cash demands and give the company a chance to harvest its past investment.

Despite the stated $200 million past investment, the conference call transcript sent a potentially conflicting message; the company acknowledged that the film slate would be "quieter" for the next two quarters and that it had not "thrown money to buy" an external slate. Rather, it claimed to be developing movies in-house, which would take longer:

> *The first two quarters will be quieter, because this is a self built up slate and not really something that we have just thrown money to buy. So the first two quarters will be quieter than the – it will be more back ended.*

On the same call, the company suggested that the slate was not fully funded and still ramping up:

> *We are targeting pending $200 million to $225 million this year on new contents as we ramp the slate and continue to bulk up our digital content offering.*

In other words, although a supposed $200 million had already invested in the ongoing slate, the company expects to put another $200 million to $225 million in this year. Given all of the

past and planned investment, one might expect the outcome to be an aggressive roll-out of a large slate. Instead, we are told the outcome is a quiet couple of quarters and promises of a full slate in the latter half of the year and in the future.

# *ErosNow or ErosNever?*

We are placing ErosNow at the bottom of this piece because we believe that placement corresponds most accurately to its relevance at this time. ErosNow's paying subscribers were announced as being "tripled" over the course of the year; a sensational headline. When pressed for specifics on revenue and cash flow on the conference call, however, CFO Parameswaran noted that ErosNow had generated only $14 million in revenue for the entire FY 2017. ErosNow, therefore, represents only about 5.5% of reported FY 2017 revenue.

Despite the limited top-line contribution, the company noted that "*nearly* 50%" of the digital film rights are owned in perpetuity, in an apparent effort to reinforce the long-term value of ErosNow and the content library. In the company's 20-F filing, we find a more optimistic version, that "*over* 50%" of the library is held in perpetuity. We seek clarification on exactly what proportion of the company's digital rights are owned in perpetuity.

Perhaps the confusion arises due to the recent large increase in the company's perpetual library. From the company's 20-F filing, the company states:

> ***We have acquired most of our film content through fixed term contracts with third parties, which may be subject to expiration or early termination.*** *We own the rights to the rest of our film content as co-producers or sole producer of those films.*

In other words, if Eros produced or co-produced the film, it owns the rights in perpetuity. Otherwise, the rights may expire on a fixed term. The acquired content accounts for "most" of its film content.

From the company's previous 2016 20-F filing, we see that a substantial proportion of the content expired prior to 2020:

| Term Expiration Dates | Hindi Film Rights | Regional Film Rights[1] |
|---|---|---|
| | (approximate percentage of films whose licensed rights expire in the period indicated) | |
| Prior to December 31, 2020 | 42% | 54% |
| 2021-2025 | 37 | 13 |
| 2026-2030 | 6 | 1 |
| 2031-2045 | 3 | 1 |
| Perpetual[2] | 12 | 31 |

From the company's latest 2017 20-F filing, we see a very different picture:

| Term Expiration Dates | Hindi Film Rights | Regional Film Rights[1] |
|---|---|---|
| | (approximate percentage of films whose licensed rights expire in the period indicated) | |
| Prior to December 31, 2020 | 28% | 21% |
| 2021-2025 | 34% | 17% |
| 2026-2030 | 6% | 7% |
| 2031-2045 | 21% | 0% |
| Perpetual[2] | 11% | 55% |

Now, we find that Eros's perpetual film content has increased markedly in the "Regional Language Films" category, jumping from 31% last year to 55% this year. Regional films also comprised a greater proportion of the total library, increasing to 65% from 57% a year earlier. We would be interested to hear from management how the stated addition of 5,000 titles at seemingly low relative cost managed to achieve such a substantial altering of the library expiration dates.

# *Conclusion*

We have numerous accumulated questions about Eros, and frankly, we are past the point of having confidence that they will be adequately answered. We believe Eros's issues could be terminal for the public listed company within 3-6 months, if not sooner. We believe the combination of (i) hard-to-explain accounting questions (ii) short-term borrowings coming due (iii) spiking financing costs (iv) sales of key assets (v) worsening top and bottom line metrics, and (vi) a tarnished story all continue to make Eros a ticking time bomb for investors.

**Disclosure:** I am/we are short EROS. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

THE CATALYST CAPITAL GROUP INC., et al. and WEST FACE CAPITAL INC., et al.

Court File No.: CV-17-587463-00CL

Plaintiffs Defendants

***ONTARIO***
**SUPERIOR COURT OF JUSTICE**
**- COMMERCIAL LIST**

Proceeding commenced at Toronto.

**SUPPLEMENTARY WRITTEN SUBMISSIONS OF THE DEFENDANTS, NATHAN ANDERSON AND CLARITYSPRING INC.**

**APPENDIX "A": REPORTS ON HINDENBURG RESEARCH WEBSITE**

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