

U.S. China Mining Group, Inc.

OTCBB: SGZH

February 08, 2011 Close

DJIA: 12,233.15
S&P 500: 1,324.57
NASDAQ Comp: 2,797.05
Russell 2000: 813.69



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Recommendation: **BUY**

12 Mo. Price Target: **\$10.65**

COMPANY AND MARKET DATA

Stock Price 02/08/11:	\$4.76	Market Cap.:	\$88.93 M	Current Ratio	5.15x
52 Week Price Range:	\$3.41 – 11.25	Shares Outstanding:	18.68 M	Price/Sales (TTM)	2.07
Industry/Sector:	Coal Mining	Float (est):	7.38 M	FY 2009A EPS (FD)	\$1.63
FY 2010 EPS (FD)	\$0.93	Cash Per Share	\$2.69	P/E (FY 2010E)	5.83

BASIS FOR RECOMMENDATION

- We are initiating a **BUY** rating for U.S. China Mining Group, Inc. (OTCBB: SGZH), an acquirer and consolidator of coal mines in Heilongjiang Province in China's coal-rich northeast region. The Company is currently operating three mines: Tong Gong; Hong Yuan; and Sheng Yu.

- Burgeoning Demand for Chinese Coal:** Like everything else in China, coal production statistics are simply immense. China now consumes and produces close to 50% of all the coal in the world. The Chinese coal industry is by far the world's largest in terms of production, with output over three times that of the U.S., the world's second largest producer. Its annual production totalled an estimated 2.97 billion tons in 2009, up from 2.79 billion tons in 2008.

Along with production, *demand* for coal in China continues to increase at astounding rates, and it is estimated that it will be around 3.06 billion tons this year. China's coal consumption, however, is expected to be 3.2 billion metric tons. There are 27 provinces in China that produce coal, but it is Northern China, especially Shanxi Province, that contains most of China's easily accessible coal and virtually all of the large state-owned mines.

- Timely Strategy:** China's coal industry is very fragmented and, as most industry observers agree, in need of consolidation. Last year, the Chinese government stressed the need for the country's coal mine enterprises to continue with mergers and acquisitions for the healthy development of the industry, citing low centralization, wasting of resources, environmental pollution, disordered mining and frequent industrial accidents as continual challenges to China's coal mine industry. U.S. China Mining seeks to capitalize on this need and increase efficiencies by strategically acquiring and consolidating the operations of various mines, based on reserves, ease of extraction and location.



BUSINESS / PRODUCT OVERVIEW

U.S. China Mining Group, Inc., formerly Songzai International Holding Group, Inc., is as an acquirer and consolidator of coal mines in Heilongjiang Province in China's coal-rich northeast region, and is currently operating three mines: Tong Gong; Hong Yuan; and Sheng Yu. Hong Yuan and Sheng Yu are collectively known as the "Xing An" mines. The Company prepays the provincial government for rights to mine certain amounts of coal from these properties, and then sells most of the coal it extracts on a per-metric-ton basis, cash-on-delivery - primarily to power plants, cement factories, wholesalers and individuals for home heating. U.S. China Mining has the rights to reserves totalling 6.1 million metric tons at the Tong Gong mine and 19.8 million metric tons at the Xing An mines, according to engineering estimates of in-place resources.



Company Strategy Brief

Acquire Capacity. China's coal industry is very fragmented and, as most industry observers agree, in need of consolidation. U.S. China Mining seeks to capitalize on this need by strategically acquiring and consolidating the operations of various mines, based on reserves, ease of extraction and location.

Sales Channel Expansion. The Company continually strives to expand its sales base of power plants, cement factories, and various wholesalers. With new transport hubs, management expects to be able to expand its customer base.

Increase Efficiencies. Because of fragmentation and huge demand, China's coal industry is marked by extreme inefficiencies. U.S. China Mining looks to be at the forefront of the new paradigm in the industry. The industry has been in a consolidation push for years, but as demand has surged, the urgency has increased. With the average output remaining low, China's coal companies need to regroup to make better use of their resources, Pu Hongjiu, vice-chairman of the China National Coal Association, has said.



MARKET OVERVIEW

The Chinese Coal Market

Like everything else in China, coal production statistics are simply immense. China now consumes and produces close to 50% of all the coal in the world. The Chinese coal industry is by far the world's largest in terms of production, with output over three times that of the U.S., the world's second largest producer. Its annual production totalled an estimated 2.97 billion tons in 2009, up from 2.79 billion tons in

Top Ten Hard Coal Producers (2009e) - World Coal Institute, IEA

PR China	971Mt	South Africa	247Mt
USA	919Mt	Russia	229Mt
India	526Mt	Kazakhstan	96Mt
Australia	335Mt	Poland	78Mt
Indonesia	263Mt	Colombia	73Mt

2008. In 2008, around 2.75 billion tons of this was for domestic consumption, with the power sector accounting for 76% of the total domestic consumption. Demand has been so strong in China, that despite the huge production, the country became a net importer of coal in 2008. Since China is deficient in oil and natural gas, coal continues to be a major source for the country's energy requirements. Apart from energy, coal is used in the metallurgical, chemical and pharmaceutical industries.

The International Energy Outlook 2007 (IEO2007) published by the U.S. Energy Information Administration projects an increase of world coal consumption by 74% over the period from 2004 to 2030. In 2004, coal accounted for 26% of total world energy consumption, and is expected to grow to 28% in 2030, according to the report.

The IEO2007 projects a 44% increase in international coal trade by 2030, with the largest increase in consumption projected for China.

Along with production, *demand* for coal in China continues to increase at astounding rates, and it is estimated that it will be around 3.06 billion tons this year. China's coal consumption, however, is expected to be 3.2 billion metric tons. The National Development and Reform Commission, which determines the energy policy of China, aims to keep China's coal consumption below 3.8 billion tons per annum.

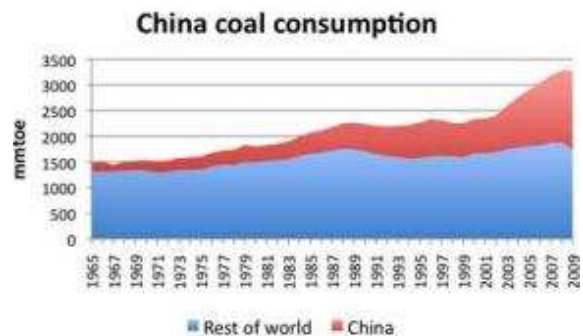
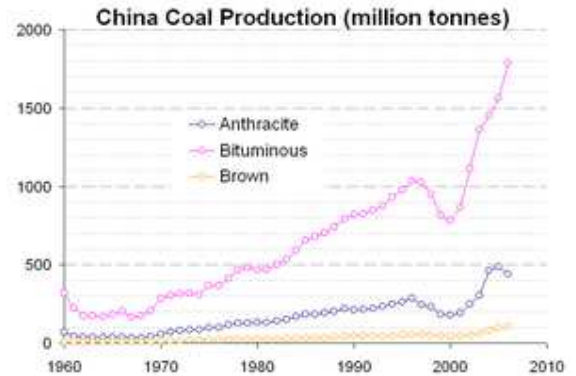
With investment in the coal industry rising at an annual rate of 50% in recent years, it is highly expected that China will retain its current position as the leading global consumer of coal, even as it endeavors to diversify into other sources of energy.

China's coal industry has traditionally been fragmented among large state-owned coal mines, local state-owned coal mines, and thousands of town and village coal mines. The top three state-owned coal companies produce less than 15% of the domestic coal. Shenhua Coal, the world's largest coal company, holds just 9% of the domestic market in China.¹

Though the smaller coal mines hold a sizeable portion of the market, they are inefficient and are challenged to respond to market demand. China has tens of thousands of small local coal mines where inefficient management, insufficient investment, outdated equipment, and poor safety records prevent the full utilization of coal resources. The goal of consolidating the industry is to raise total coal output, attract greater investment and new coal technologies, and improve the safety and environmental record of coal mines. To do this, most analysts see consolidation as the only solution. Last year, the Chinese government stressed the need for the country's coal mine enterprises to continue with mergers and acquisitions for the healthy development of the industry, citing low centralization, wasting of resources, environmental pollution, disordered mining and frequent industrial accidents as continual challenges to China's coal mine industry. The statement came right from the top, being issued directly following an executive meeting of China's State Council, or Cabinet, which was chaired by Premier Wen Jiabao.

Regional Production

There are 27 provinces in China that produce coal, but it is Northern China, especially Shanxi Province, that contains most of China's easily accessible coal and virtually all of the large state-owned mines. Coal from southern mines tends to be higher in sulfur and ash, and therefore unsuitable for many applications.



¹ Wikipedia.org

It is Inner Mongolia, where SGZH looks to expand, however, that is China's coal heartland, with 60% of the country's reserves. Its verified coal deposit of 732 billion tons is almost three times the 250 billion tons in Shanxi Province. It's no surprise then that mines in Inner Mongolia are rapidly expanding production, with 637 million tons produced in 2009.

The problem with Inner Mongolia, however, has been one of logistics. Transport of coal from this region to seaports on China's coast has overloaded highways such as China National Highway 110 resulting in chronic traffic jams and delays. That is expected to change, however, with a recent announcement that the landlocked province in northern China will soon have new access to ship its coal from a port in its neighboring province to fuel-thirsty customers in eastern and southern regions.

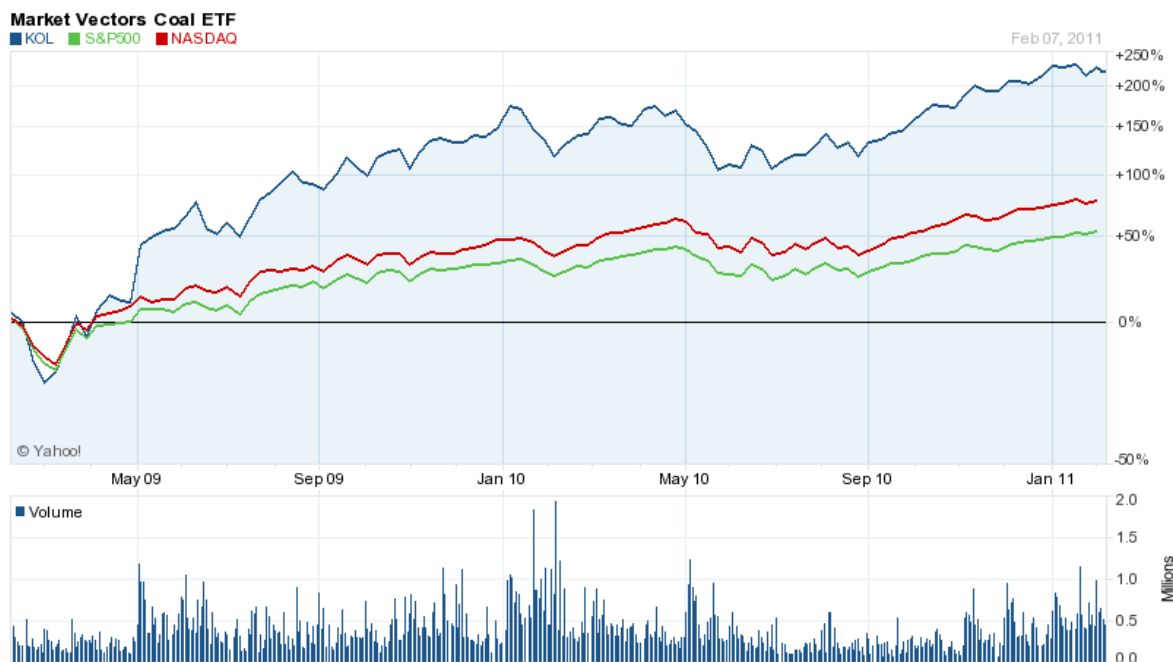
A port terminal to be built in Huludao, Liaoning Province will support an annual throughput of 50 million tons of coal when the first phase of the project becomes operational by 2012, according to the chief of port affairs in Huludao City. Via a 300-km railway linking the port directly with Xilingol, a major coal production base in Inner Mongolia Autonomous Region, the annual throughput would be eventually expanded to 230 million tons.

Coal Pricing

Like most fuels, coal is commodity whose price usually rises in winter months. China's thermal coal prices at Qinhuangdao port, a domestic benchmark, clung to recent gains and recently reached a 10-month high, as fast-dropping temperatures lifted demand and helped draw down port supply. Some analysts believe prices could strike above 900 yuan (\$135.1) a ton by the end of the year due to seasonal storage and the possibility of colder-than-usual winter.

Chinese coal prices have already traded close to the high above 850 yuan (\$127.6) posted in January of last year, when prices rose steeply as China's worst snowstorm in 50 years cut supplies and pushed demand sharply higher. This is only the start of winter and prices are already at 840 yuan, leaving a lot more room for prices to climb over the next two months as the colder months approach.

Also like most commodities, investment in coal has performed phenomenally well - as evidenced by the chart below comparing Market Vectors Coal ETF (NYSE:KOL) with the S&P 500 and NASDAQ over the past two years.



KOL is a tracking fund that seeks to replicate the performance of the Stowe Coal index, which as of December 17, 2010, was weighted 19.38% in Chinese companies.

BUSINESS & STRATEGY

As stated previously, China's coal industry is very fragmented and, as most industry observers agree, in need of consolidation. U.S. China Mining seeks to capitalize on this need by strategically acquiring and consolidating the operations of various mines, based on reserves, ease of extraction and location.

The Company is currently operating three mines: Tong Gong; Hong Yuan; and Sheng Yu. Hong Yuan and Sheng Yu are collectively known as the "Xing An" mines. Of course, in coal mining, it is all about extraction, which in turn is dependent on the available reserves. The following table shows reserves and annual capacity at the three mines:

in Metric Tons (MT), as of 12/31/09

Mine(s)	Total Reserves*	Probable Reserves**	Proven Reserves***	Total Annual Capacity	2009 Production
Tong Gong	6,149,700	730,000	730,000	180,000	350,000
Xing An	19,781,800	5,770,000	2,880,000	600,000	569,718
Total	25,931,500	6,500,000	3,610,000	780,000	919,718

* - per PRC engineering reports

** - per company-commissioned report in accordance with SEC Industry Guide 7

*** - per company-commissioned report in accordance with SEC Industry Guide 7

"Proven", also called "measurable", indicates proven quantity, while "probable", also called "indicated" takes into account quality as well. It should also be noted that the Company's actual production can and often does exceed the amount specified in its coal production permits. Such practice is common in Heilongjiang Province, and is typically accepted by the relevant authorities if the mining rights for the extracted coal and taxes from sales of such coal are paid.

In addition to its mining operations, U.S. China Mining also brokers coal from small independent mines in the areas surrounding the Company's operational mines. Because operators of these small mines often lack the means to transport coal from the mines, they have no market for their coal other than selling it to the Company at competitive prices. Tong Gong currently brokers approximately 124,400 metric tons of coal annually at approximately a 30% mark-up over the cost of the coal that it mines. Xing An brokers approximately 280,000 tons of coal annually at approximately the same costs as the coal that the Company mines.

Consolidation offers many benefits to companies undertaking the strategy - and the industry as a whole by making it more efficient, particularly when consumption of the commodity in question is nothing short of voracious. As might be expected, the main advantages lie on both sides of the line: cost and expense reductions, such as the spreading of overhead, achieved by merging; and the opportunities afforded larger companies for capturing economies of scale and scope. Another important element in China is geographical diversification, particularly with idiosyncratic regional governments.

At the same time, by creating larger and more financially secure companies that are better able to tackle large and technically-demanding projects in difficult parts of the world, consolidation helps address the longer term challenge of investment. While perhaps not a huge concern in the PRC these days, the difficulty of finding and developing new resources, particularly those which have large infrastructure requirements or face extensive regulation, implies greater capital intensity and ever-longer lead times. However, it also implies increased barriers to entry in the industry.

In China, there are specific concerns related to accommodating the interests of partners, local governments and local people in the consolidation process. Furthermore, cultural integration is another challenge.

Acquisitions

On May 19, 2010, the Company entered into an agreement to acquire the Liujiacqu coal mine located in Erdos City in the Dongsheng District of Inner Mongolia. The annual production capacity of the mine is expected to be 1.2 million metric tons, more than doubling the Company's present annual capacity, as well as 2009 production. Proposed terms were disclosed in May, but according to SGZH's latest filing, the transaction has been delayed due to "new municipal policy and requirements of Erdos City". While delays of accretive acquisitions are rarely a good thing, and dealing with various government agencies in China can be a long process, we take some comfort in the fact that the Company is working toward executing its acquisition strategy.

OUTLOOK / FINANCIALS

Historical / Projected Financials

\$000s Actual - A Estimates - E	Fiscal 2008-A 31-Dec-08	Fiscal 2009-A 31-Dec-09	Q1 2010-A 31-Mar-10	Q2 2010-A 30-Jun-10	Q3 2010-A 30-Sep-10	Q4 2010-E 31-Dec-10	Fiscal 2010-E 31-Dec-10
Net Sales	\$ 57,130 100.0%	\$ 64,998 100.0%	\$ 12,558	\$ 9,966	\$ 17,854	\$ 26,122	\$ 66,500 100.0%
Cost of Sales	25,676 39.5%	27,192 41.8%	7,725	6,091	10,066	14,890	38,772 58.3%
Gross Profit	31,454 48.4%	37,806 58.2%	4,833	3,875	7,788	11,232	27,728 41.7%
Operating Expenses							
Selling	499 0.9%	1,101 1.7%	566	-	442	914	1,922 2.9%
General & Administrative	2,295 3.5%	4,744 7.3%	936	1,220	2,027	2,703	6,886 10.4%
Total Operating Expenses	2,794 4.3%	5,845 9.0%	1,502	1,220	2,469	3,618	8,809 13.2%
Operating Income	28,660 44.1%	31,961 49.2%	3,331	2,655	5,319	7,615	18,920 28.5%
Other Expense/(Income)							
Interest Expense/(Income), Net	189 0.3%	286 0.4%	75	64	69	69	277 0.4%
Other Expense/(Income)	57 0.1%	(111)	-	-	-	-	
Income (Loss) Before Taxes	28,414 49.7%	31,787 48.9%	3,256	2,591	5,250	7,546	18,642 28.0%
Provision for Income Taxes	6,690 11.7%	6,700 10.3%	1,131	758	1,400	1,886	4,661 7.0%
Effective Tax Rate	23%	21%	34%	29%	26%	25%	25%
Net Income (Loss)	\$ 21,724 38.0%	\$ 25,087 38.6%	\$ 2,125	\$ 1,833	\$ 3,850	\$ 5,659	\$ 14,259 21.4%
Foreign Currency Translation Gain/Loss	2,203	(214)	(214)	541	860	861	860
Comprehensive Income	\$ 23,927	\$ 24,873	\$ 1,911	\$ 2,374	\$ 4,710	\$ 6,520	\$ 15,119 22.7%
Basic EPS	\$ 1.65	\$ 1.68	\$ 0.14	\$ 0.12	\$ 0.26	\$ 0.38	\$ 0.95
Fully Diluted EPS	\$ 1.62	\$ 1.63	\$ 0.14	\$ 0.12	\$ 0.25	\$ 0.37	\$ 0.93
Weighted Average Shares:							
Basic Shares Out.	13,133,141	14,932,582	14,932,582	14,932,582	14,932,582	14,932,582	14,932,582
Fully Diluted Shares Out.	13,429,316	15,348,088	15,360,529	15,344,304	15,332,582	15,332,582	15,342,499

We feel that multiple comparisons, such as price-to-earnings ratio (P/E), and price-to-sales ratio (P/S), also have the best value in our opinion in that they show the current market values of similar companies. To form the basis of our valuation we are using the underlying assumption that the value of the Company should mirror that of its closest peers - based on at least one of the following: product(s), target markets, sales and corporate strategies. Peer data is shown on the following page:

Peer Data

	Puda Coal Inc. (PUDA)	L & L Energy, Inc. (LLEN)	SinoCoking and Coke Chemical Industries, Inc. (SCOK)	China Coal Energy Co. Limited (CCOZF.PK)	China Energy Corp. (CHGY.OB)	China Carbon Graphite Group, Inc. * (CHGL.OB)	China Natural Resources Inc. (CHNR)	China Shen Zhou Mining & Resources, Inc. ** (SHZ)
TTM Sales (000)	\$ 294,540	\$ 184,740	\$ 53,910	\$ 10,300,000	\$ 84,690	\$ 21,310	\$ 18,870	\$ 7,850
TTM EBITDA (000)	\$ 34,050	\$ 62,790	\$ 20,710	\$ 2,220,000	\$ 29,230	\$ 609	\$ (5,550)	\$ (888)
EBITDA Margin	12%	34%	38%	22%	35%	3%	-29%	-11%
Net Earnings (000)	21,400	43,410	47,870	1,170,000	19,790	(2,500)	85,710	9,960
Shares Outstanding (000)	20,760	31,340	20,870	670,500	45,000	20,160	22,720	27,970
Earnings Per Share	\$ 1.03	\$ 1.39	\$ 2.29	\$ 1.74	\$ 0.44	\$ (0.12)	\$ 3.77	\$ 0.36
Price as of 01/14/11 close	\$ 12.18	\$ 8.63	\$ 11.23	\$ 1.42	\$ 1.32	\$ 2.03	\$ 13.70	\$ 6.84
Market Capitalization (000)	\$ 252,857	\$ 270,464	\$ 234,370	\$ 952,110	\$ 59,400	\$ 40,925	\$ 311,264	\$ 191,315
Enterprise Value (000)	\$ 216,740	\$ 259,260	\$ 273,120	N/A	\$ 102,650	\$ 61,270	\$ 340,060	\$ 189,530
Price/Sales	0.86	1.46	4.35	0.09	0.70	1.92	16.50	24.37
Price/Earnings	11.82	6.23	4.90	0.81	3.00	N/A	N/A	19.21
Price/Book	2.08	2.59	3.62	0.10	1.70	1.12	5.03	10.27
EV/Sales	0.74	1.40	5.07	N/A	1.21	2.88	18.02	24.14
EV/EBITDA	6.37	4.13	13.19	N/A	3.51	100.61	N/A	N/A

Note: All figures as of 02/08/11 as reported. EV approximate.

* - Similar size, operation

** - Mines non-ferrous metals in Inner Mongolia

Peer Valuation Matrix

SGZH Actual and Projected

Averages:

Weighted:

P/E	5.59
P/S	3.62
P/B	3.13
EV/EBITDA (TTM)	4.57
EV/Sales (TTM)	3.94

SGZH Estimate

FY10E Sales (000)	\$ 66,500
FY10E Net Earnings (000)	\$ 14,259
Book Value (9/30/10)	\$ 88,427
Shares Outstanding (000)	18,683

Proj Market Cap based on Avg. P/E (\$000)	\$ 79,732
Proj Market Cap based on Avg. P/B (\$000)	\$ 276,722
Proj Market Cap based on Avg. P/S (\$000)	\$ 240,495

For our final valuation, we have taken the weighted average of the P/S multiples, as well as the P/B and P/E of the seven companies that had positive earnings and applied it to SGZH to get an estimate of the Company's FMV. Applying our estimates of the Company's FY10 revenue and earnings (\$66.5 and \$14.3 million, respectively) – and current book value - to the weighted average of the peer multiples, we obtain our current fair value of **\$10.65 per share**.

Capital Resources

As of the Company's latest filing, SGZH appears very financially strong. As of September 30, 2010, U.S. China Mining had over \$40 million in cash and over \$33 million in net working capital. This appears sufficient to fund acquisitions (the Liujiagu mine deal called for a payment of \$30 million and 10 million shares of stock) and operations.

Furthermore, with only approximately 15 million shares outstanding at the end of last year, the Company has some room to issue additional shares for accretive acquisitions – which it has done. On January 7, the Company announced that it had closed a private placement of 3.75MM shares and 1.875 warrants at \$6.80 for gross proceeds of \$15MM. Though the Company stated that, "Proceeds from this financing will be used to support capital expenditures and working capital, including capital expenditures at existing mines, expenditures to increase our US shareholder base and to provide capital for accretive acquisition opportunities", we would expect these funds to be used more toward capex and acquisitions.

Risk Factors

Competitive Threat. The coal industry is increasingly competitive. The Company's competitors could include larger companies that have significantly more financial resources and government contacts, as well as penetrate various markets faster.

Government Regulation. By U.S. standards, all business in China is highly regulated, but in terms of intervention, coal has to be near the top of the list. Publicized mining accidents have scarred the reputed safety record of Chinese mining companies. There is much uncertainty if and when the various government agencies could make safety requirements more stringent – and thus costly.

Commodity Pricing. As a thermal coal miner, U.S. China Mining is subject to commodity pricing. Along with most global natural resources, coal prices have proven very volatile in the past two years. Any further significant price changes could impact revenue and earnings of the Company.

Dilution. It appears that part of the Company's strategy is use stock as partial payment for any future acquisitions. All else being equal, the issuance of additional equity will cause dilution and could depress share price.

Recommendation and Conclusion

We are initiating coverage of U.S. China Mining with a BUY rating. We feel that the Company is certainly in the right place at the right time. It is obvious that demand is and will remain very strong for coal into the foreseeable future and the market itself is huge. Valuations for Chinese natural resources have remained relatively strong and prices for the most part on the rise. We see no significant, sustainable coal price risk.

Furthermore, it seems apparent that management enjoys strong relationships with various government agencies and with an industry in need of consolidation and readily-available financing, we feel the Company has significant competitive advantages over similarly-sized peers.

Operating results and stock performance could be subject to greater volatility as the Company grows and we would expect fundamentals to improve once U.S. China Mining expands production. With the stock at these levels, long-term investors might be interested in using this period as an opportunity to build positions with risk capital in anticipation of stronger performance in FY2011 and beyond.

About EquityNet Research

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About the Analyst

Randy Lewis, CFA, founder and Senior Equity Analyst of EquityNet, has more than 14 years experience in equity and portfolio analysis, as well as financial consulting and strategic planning. Prior to forming EquityNet, Mr. Lewis served as an equity analyst at SSI Investment Management, Inc., a \$500-million, money management firm, specializing in sophisticated, hedged investment strategies, and serving institutional and high net worth clients. Previous to SSI, Mr. Lewis was a financial analyst for Griffin Financial Services, the securities brokerage arm of Home Savings of America, the then-largest savings and loan in the U.S. Mr. Lewis has had several articles published, most recently in HFR Journal of Hedge Fund Research on the subject of merger arbitrage. He received his Bachelors Degree with honors in Finance from California State University, Fullerton, his MBA at the Anderson School of Management at UCLA, and has earned the Chartered Financial Analyst (CFA) designation. He is also an assistant professor of business at Pierce College in Los Angeles and a member of the National Association of Certified Valuation Analysts (NACVA).

Explanation of Ratings

- **STRONG BUY** – The analyst feels that the stock is significantly undervalued and holds superior long-term price appreciation potential.
- **BUY** — The stock appears attractively valued and the analyst feels the stock's total return will exceed that of the market over the next 12 months.
- **SPECULATIVE BUY** - Under current conditions, the stock appears to be appropriately valued, but short-term event(s) could dramatically alter the future landscape of the company in terms of revenue, earnings and cash flow.
- **HOLD** — The stock appears appropriately valued and the analyst believes the stock's total return will be relatively inline with the market over the next 12 months.
- **SELL** — The stock appears overvalued and the analyst believes the stock's total return will be below the market over the next 12 months.

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