BMO Capital Markets | U.S.

September 28, 2009

SmartHeat

(HEAT-NASDAQ)

Stock Rating: **Outperform**
Industry Rating: **Market Perform**

Diversified Industrials

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Pure Play on Chinese Clean Energy Saving Technology; Initiating With OUTPERFORM Rating

Investment Thesis

We are initiating coverage of SmartHeat with an **OUTPERFORM** rating and a $15 price target. We believe SmartHeat has established a solid reputation as a seller of plate heat exchangers (PHEs) in China's rapidly growing industrial, residential, and commercial markets. Its PHEs and related products raise the overall efficiency of heating and power generation systems by capturing and recycling waste heat, thereby reducing energy consumption, pollution, and operating costs. Sales should benefit from government incentives and mandates aimed at improving energy efficiency in China.

Forecasts

Our EPS estimates are $0.60 for 2009, $0.75 for 2010, and $1.05 for 2011, driven by continued growth expected in China's economy. We expect healthy earnings growth through at least 2011, as investment in new buildings in China has not shown signs of slowing. We also expect further growth in market share driven by both select acquisitions and increasing penetration of quality heat exchangers, as more customers come to appreciate the value proposition of proven energy recapture technologies.

Valuation

Our $15 price target is based on our EV/EBITDA valuation and our discounted EPS and market-implied growth rate valuation. On an EV/EBITDA basis, we assume SmartHeat can trade at 11.0x our 2011 EBITDA estimate of $41 million. For considerations that could put our earnings estimates and target price at risk, see the "Risk Factors" section.

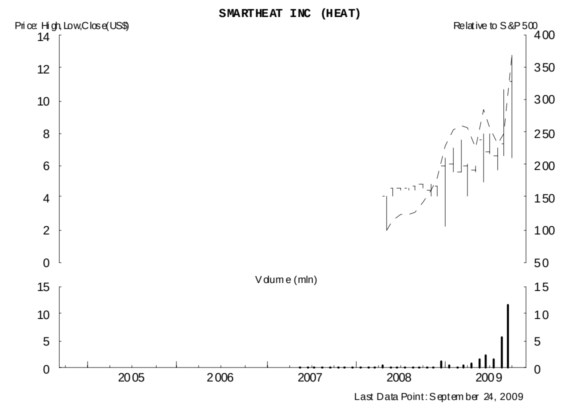
Recommendation

We rate SmartHeat shares **OUTPERFORM**.

Securities Info

Price (25-Sep)	**$11.65**	**Target Price**	**$15**
52-Wk High/Low	$13/$2	Dividend	--
Mkt Cap (mm)	$366	Yield	--
Shs O/S (mm, BASIC)	31.5	Float O/S (mm)	17.8
Options O/S (mm)	na	ADVol (25-day, 000s)	574

Price Performance



Valuation/Financial Data

(FY-Dec.)	**2008A**	**2009E**	**2010E**	**2011E**
EPS GAAP	$0.29	$0.60	$0.75	$1.05
P/E		19.4x	15.5x	11.1x
First Call Cons.				
FCF	$0.28	$0.59	$0.73	$1.03
P/FCF		19.7x	16.0x	11.3x
EBITDA ($mm)	$8	$19	$28	$41
EV/EBITDA		16.3x	11.1x	7.6x
Rev. ($mm)	$33	$80	$115	$167
EV/Rev		4.0x	2.7x	1.9x
Quarterly EPS	**1Q**	**2Q**	**3Q**	**4Q**
2008A	$0.03	$0.03	$0.18	$0.03
2009E	$0.04A	$0.11A	$0.28	$0.17

Balance Sheet Data (06/30/09)

Net Debt ($mm)	$4	TotalDebt/EBITDA	0.3x
Total Debt ($mm)	$6	EBITDA/IntExp	na
Net Debt/Cap.	14.1%	Price/Book	13.1x

Notes: *Quarterly EPS may not sum due to share count

Source: BMO Capital Markets estimates, Bloomberg, FactSet, Global Insight, Reuters, and Thomson Financial.

Please refer to pages 27 to 29 for Important Disclosures, including the Analyst's Certification.

Coverage Initiated With OUTPERFORM Rating

- We are initiating coverage of SmartHeat with an **OUTPERFORM** rating and a $15 price target. We forecast 2009 revenue of $80 million and EPS of $0.60; $115 million and $0.75 for 2010; and $167 million and $1.05 for 2011. By comparison, 2008 revenue and EPS were $32.7 million and $0.29, respectively. Our $15 price target is derived from taking a mid-point estimate from our EV/EBITDA valuation and our market-implied growth rate valuation. On an EV/EBITDA basis, we assume SmartHeat can trade at 11.0x our 2011 EBITDA estimate of $41 million.
- We view SmartHeat as a pure play on the expansion of district heating in China and the government mandated increases in energy efficiency and reduction in carbon emissions generated from burning coal. We believe the company is well-positioned to take advantage of China's growing industrial, residential, and commercial heating markets with PHE systems that help reduce fossil fuel usage and pollution by improving heat utilization and recycling waste heat. We also believe there is a significant opportunity for the company to increase its penetration into end-markets outside of HVAC such as refinery, petrochemical, and power.
- SmartHeat's 3Q09 guidance was $35 million in revenues and $6.8 million in net income (which implies EPS of $0.28 assuming a diluted share count of 24.6 million to reflect the partial quarter impact of the company's secondary offering completed September 15). Guidance for 2009 revenue and net income are $80 million and $15.5 million, respectively.
- We expect strong earnings growth through at least 2011, but this does not yet appear to be fully priced into the stock. The current valuation appears conservative to us, given the company's established brand names (Sondex and Taiyu for PHEs and PHE units, respectively), solid profitability in the growing China heating industry, the quality of its engineering, research, and development, increasing penetration into energy end markets (petrochemical, nuclear) and strong management team.
- We view SmartHeat as a well-run company with numerous long-term positives. Although there are downside risks, we feel that the valuation and robust outlook for earnings growth provide meaningful upside potential for the stock.
- Given these factors, we are initiating coverage of SmartHeat with an **OUTPERFORM** rating and a 12-month price target of $15.

Investment Thesis

SmartHeat manufactures and sells plate heat exchangers (PHEs), packaged PHE units, and heat meters in China. The company's PHE units combine PHEs with various pumps, temperature sensors, valves, and automated control systems, and heat meters into a packaged, integrated system to serve the district heating market. PHE units raise the overall efficiency of heating and power generation systems by capturing and recycling waste heat, thereby reducing energy consumption, pollution, and operating costs. SmartHeat's PHEs are used in a range of industries such as petroleum refining, petrochemicals, power generation, metallurgy, food & beverage, and chemical processing to cool liquids The company sells PHEs (35% of 2008 sales) under both the licensed Sondex and proprietary Taiyu brand names, and PHE units (63% of 2008 sales) under the Taiyu brand name only. It also sells heat meters (2% of 2008 sales), which track heat consumption in commercial and residential facilities. SmartHeat has three manufacturing locations in China, approximately 500 total employees, and it markets its products through its sales force and national distributors. SmartHeat was founded in 2002 and is headquartered in Shenyang City, China.

Following two significant acquisitions over the past 12 months, we believe the company is well-positioned to take advantage of China's growing industrial, residential, and commercial heating markets with PHE systems that help reduce fossil fuel usage and pollution by improving heat utilization and recycling waste heat.

We believe SmartHeat will benefit from continued growth in China's industrial sector and build out of the energy and power generation sectors. In addition, we expect SmartHeat to continue benefiting from growing demand in China for in-building heating systems stemming from new construction as well as retrofits of existing facilities. Demand for in-building heating has grown rapidly in recent years; as it is largely dependent on coal for a fuel source, this has led to pollution problems. For instance, it is a major contributing factor in China's status as the world's largest emitter of carbon dioxide. As a result, the Chinese government is promoting energy efficiency through a combination of mandates and incentives.

We expect China's demand for efficient heating solutions to continue growing nicely in the medium- to long-term, providing solid visibility for SmartHeat's business. The outlook for sales and earnings in 2H09 through 2011 remains promising. With the stock trading at 7.7x our 2011 EBITDA estimate, we feel that the valuation is attractive based on the company's sales and earnings growth potential.

We believe SmartHeat has a well-established market position and leading brand names (Sondex and Taiyu) in the growing China heating industry, an ability to deliver quality, custom-engineered PHE units within competitive lead times, as well as its proprietary in-house computer-aided design (CAD) software and research & development. These competitive strengths should allow the company to capitalize on the expected solid economic growth in its markets in China. Despite the strong share price performance during the past several months, we believe there remains additional upside from current levels. We view SmartHeat as a well-run company with solid growth opportunities. Our rating is based on the following factors:

- Complete exposure to the rapidly growing Chinese market
- Established brand names associated with quality and durability
- Strong engineering and R&D capabilities
- Increasing market share in a fragmented market and penetration into new end markets
- Valuation

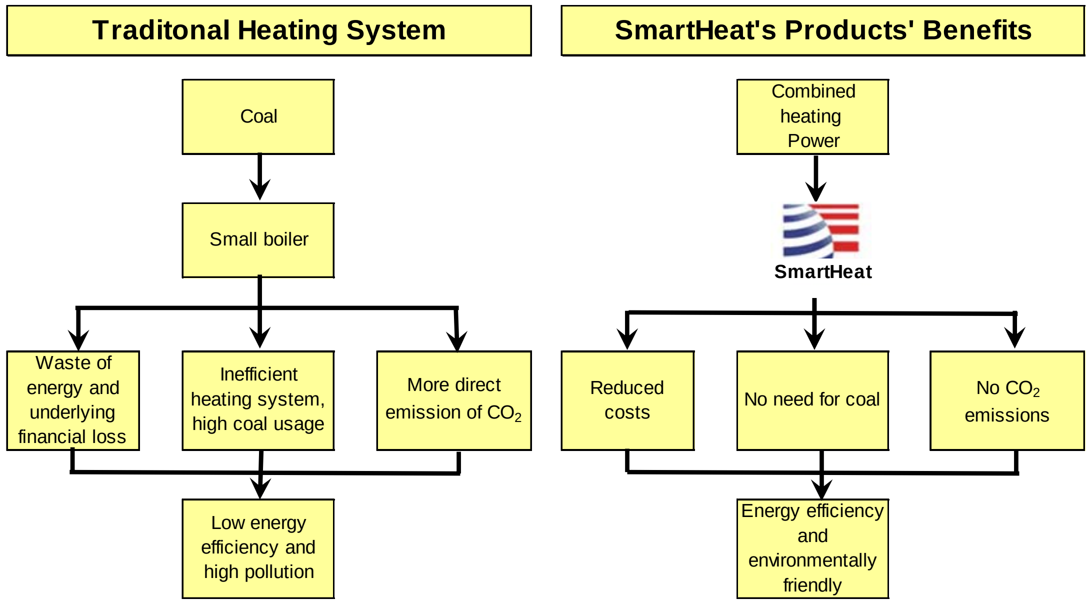
Complete Exposure to the Growing China Market

Virtually all (~97%) of SmartHeat's revenue is derived from China, which has continued to grow, while Europe and North America have experienced recessionary conditions. Indeed, BMO Capital Markets Economics forecasts that China's real GDP will rise 8.0% year over year in 2009, and 9.5% in 2010. Furthermore, macroeconomic data indicate that investment in fixed assets in China has remained in positive territory on a year-over-year comparison basis thus far in 2009 (through July); residential construction is up single digits, while purchases of equipment and instruments are up double digits.

The China Heat Association estimates that the market for PHEs in China was roughly $2.4 billion in 2007, and that it should grow at an annualized rate of 30% through 2010. Similarly, the China Heat Association estimates that the 2007 market in China for PHE Units was about $139 million; it is expected to grow at an annualized rate of 70% through 2010. We also believe these industry growth rates will extend beyond the 2010 time frame. We believe that such market growth is partially driven by the expected continuation of industrialization and urbanization trends in China. However, other important factors include energy efficiency mandates and incentives from the Chinese government.

In China, coal is the predominant source of heat energy; coal burning accounts for approximately 80% of its carbon dioxide emissions. China's power plants have generally used traditional technologies in which steam heat was lost to the environment after passing through turbines, resulting in 60%-70% energy loss. More recently built power plants utilize co-generation in which steam passes through the turbine and then is routed through a heating network of residential and commercial buildings resulting in only 20%-30% energy loss (and significantly reducing the need to burn additional coal). Heat exchangers in each individual building convert the steam energy into heat that can be used in heating, ventilating, and air conditioning (HVAC) applications. More widespread use of such district heating networks could reduce China's energy consumption and pollution. Indeed, coal burned for in-building heating accounted for 10% of total energy use and 15% of total coal use in China for 2002, according to the China Academy of Building Research. Exhibits 1 and 2 illustrate the benefits of a heating system using SmartHeat products versus a traditional coal fired heating system.

Exhibit 1: Traditional Heating System vs. SmartHeat Products' Benefits



Source: SmartHeat

Exhibit 2: Cost Benefit of SmartHeat Products vs. Traditional System

Estimated cost of heating 100,000 M^2 (1,000 households) for one month with coal priced at $85/ton

Heating Method	Coal Consumption (metric tons)	Heat Produced (Kcal, millions)	CO_2 emitted (tons)	Coal Costs, USD[1]
With SmartHeat Products: District heating system connected to a co-generation power plant	550	1,680-1,870	1,944	$46,750
Without SmartHeat Products: Small boiler with traditional shell--and-tube heat exchanger	1,496	1,680-1,870	5,293	$127,160

[1]Coal costs exclude water and other costs.

Real costs may differ significantly depending upon a number of variables.

Equipment: 1-2 PHE units would be required in the given example
Payback Period: 1-2 years (solely for the PHE units)
Equipment Lifespan: approximately 20 years
Source: company estimates.

China's government incentives include the recently implemented $586 billion stimulus package, which has $31 billion allocated for energy-saving projects and $59 billion to be spent on affordable and efficient housing. Government mandates include the 11th five-year plan, announced in March 2006. This plan set new pollution reduction standards in China, with an objective of 20% reduction in energy consumption per unit of GDP and a 10% reduction in industry expulsion of pollutant particles by 2010. We believe laws and incentives such as these should allow the market for PHEs and PHE units to continue growing in excess of China's GDP growth rate. Furthermore, an amendment to China's Energy Conservation Law took effect on April 1, 2008. This included a mandate for the use of energy-measuring equipment that should bolster sales of heat meters such as those offered by SmartHeat.

Established Brand Names Associated With Quality and Durability

We believe that SmartHeat's quality engineering helps its products maintain a high level of durability under harsh operating conditions. Its products utilize the latest technologies and its PHE designs are created in-house by engineers utilizing a combination of software provided by Sondex and SmartHeat's proprietary design software. SmartHeat has eight registered patents in China for PHE products and heat meters (see below for details), and its ongoing commitment to research and development helps the company maintain its competitive edge.

Another key factor that helps differentiate SmartHeat from competitors is positive brand recognition. In 2008, 48% of SmartHeat's sales came from customers who had made purchases in 2007. We believe this relatively high proportion of repeat business stems from quality engineering and materials that is a hallmark of SmartHeat. The Sondex brand of plates that SmartHeat utilizes is well-known in the industry as a major manufacturer of plates and PHEs with a solid reputation for quality. Founded in 1984, Sondex sells plates and plate heat exchangers for HVAC, marine, general industry, food and beverage, desalination, and refrigeration applications around the world. SmartHeat's relationship with Sondex began in 2002 when SmartHeat began to sell PHEs containing Sondex plates; it began assembling and selling PHE units with Sondex plates in 2003. In 2008, approximately 50% of PHEs were branded Sondex and 50% were branded Taiyu (SmartHeat's proprietary brand). In 2009, the mix has shifted more toward the Taiyu brand, and we expect that trend to continue.

SmartHeat believes that its PHE units sold exclusively under the Taiyu brand name are recognized in China for their quality and efficient operation. We believe that this recognition has helped the company gain a leading share (8%) of the very fragmented China market, according to the China District Heating Association. Other competitive advantages include a lower cost base than some global PHE manufacturers, combined with greater knowledge of local markets in northern and eastern China. Many domestic manufacturers in China compete on the basis of price and don't offer products of a quality level comparable to those of SmartHeat. (The company believes its prices are approximately 15% higher than those of other Chinese manufacturers of PHEs.) In addition, most of SmartHeat's domestic Chinese competitors have limited access to capital, which constrains growth.

China's growth and industrialization, combined with SmartHeat's status as a relatively new company (founded in 2002), have translated into new construction dominating the business. Management estimates that approximately 80% of sales are related to construction of new facilities. We believe that the maintenance cycle begins approximately four years after the start-up of new PHE equipment; therefore, spare parts and maintenance services should grow in future years. We believe that spare parts and maintenance services should rise as a percentage of sales from less than 1% today, to an eventual level of 3%-5%. This should have a modest positive impact on margins; gross margins for spare parts and maintenance well above its original equipment margins. By comparison, SmartHeat's consolidated gross margins for 2007, 2008, and 1H09 were 34.7%, 33.5%, and 36.5%, respectively.

Strong Engineering and R&D Capabilities

We believe SmartHeat's integrated information technology (IT) platform is a competitive advantage, helping the company achieve some of the best turnaround times in the industry (5-day lead times for PHEs, 10-day lead times for PHE units). Its enterprise-wide design, production, and control systems allow for customized designs as well as efficient pricing and manufacturing. It uses online proprietary computer-aided design (CAD) software that features an integrated real-time ERP system. This allows for accurate, instantaneous price quotes at the customers location, immediate notification to the purchasing department about the pending orders, and efficient scheduling for the manufacturing department to ensure just-in-time delivery.

SmartHeat’s commitment to research and development provides barriers to entry for would-be competitors. SmartHeat has eight registered patents in China: two for its PHEs, one for its heat transfer system for space heating and domestic hot water, one for a heat meter cleaning pipe, two for its heat meter testing system, one for its integrated heat transfer system, and one for an efficient heat testing bench. To keep pace with new technologies in the marketplace, the company funds research and development on an ongoing basis to improve its efficiencies in design, cost, and energy capture. SmartHeat plans to continue to invest in research and development to identify new industry applications for PHEs, to improve the accuracy of heat meters, to design heat meters for industrial uses, to develop multifunctional PHE units, and to modify PHE designs to meet changing market demand.

Increasing Market Share in a Fragmented Market and Penetration into New End Markets

SmartHeat led the Chinese PHE Unit market in 2007 with an 8% share. According to the company, Accessen had 7%, Danfoss had 5%, and HotWater captured 3% of the market. Such a fragmented market presents opportunities, and we believe SmartHeat will continue to grow its share. One key catalyst for market share grow should come from its solid reputation; since the company was founded in 2002 SmartHeat has established itself as a reliable source for quality heat exchanger solutions.

We believe SmartHeat will continue to take market share from both Western and domestic Chinese competitors. SmartHeat’s is able to deliver product to customers with an average delivery time of one month versus three months or longer for other competitors. We view this as a key advantage, particularly given the accelerated construction cycle in China. Additionally, unlike its competitors, SmartHeat’s integrated IT systems gives a SmartHeat salesperson the ability to go to a customer site with a laptop computer and provide a price quote and delivery schedule immediately. This significantly reduces the bid/quote process and reduces errors in order and delivery schedules.

Furthermore, the May 2009 acquisition of Siping Beifang Heat Exchanger should allow the company to diversify its product offerings. In addition to providing SmartHeat with increased capacity and ability to manufacture its own PHE plates, the SiPing acquisition gave access to new technology and a broader product offering to increase SmartHeat’s presence in additional end-markets such as refinery, petrochemical and nuclear power. SiPing has already been active in these end markets and given the expected growth in Chinese build out of refining and petrochemical capacity as well as the significant amount of planed construction of coal fired and nuclear power plants, we believe these additional end-markets should provide long-term growth opportunities and diversify SmartHeat more broadly outside of the HVAC market.

Valuation

SmartHeat shares are trading at 15.5x our 2010 EPS estimate of $0.75 and 11.1x our 2011 EPS estimate of $1.05. This compares with the S&P 500, which is trading at multiples of 15.0x 2010 and 13.0x 2011 estimates. We believe the premium to the market on 2010 estimates is warranted owing to the significantly higher expected growth rate of SmartHeat. On an EV/EBITDA basis, the shares are trading at 11.2x the 2010 EBITDA estimate of $28 million. By comparison, the average 2010 P/E and EV/EBITDA ratios of our capital goods and industrials coverage group are 19.3x and 9.4x, respectively. We view SmartHeat as a well-managed company with solid long-term fundamentals; we believe the current valuation does not reflect all of the company's positives and growth opportunities. Our $15 price target is based on a mid-point estimate of our EV/EBITDA valuation and our market-implied growth rate valuation as well as our sum-of-the-parts valuation. On an EV/EBITDA basis, we assume SmartHeat can trade at an 11x multiple of our estimated 2011 EBITDA.

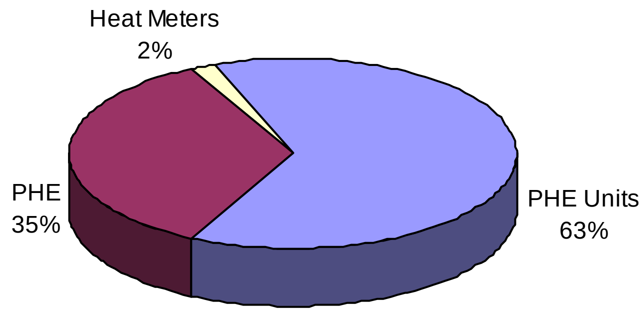
Company Overview

Taiyu Machinery & Electronic Equipment ("Taiyu") was founded in 2002; James Jun Wang, the current chairman and CEO, was a co-founder. Taiyu was a privately held company formed under the laws of China that assembled and distributed Sondex-branded plate heat exchange products in northern and eastern China.

The company came public in the US through a reverse merger into a public shell company in April 2008. On January 29, 2008, SmartHeat was granted approval to list its shares on the NASDAQ under the ticker "HEAT." Its shares were listed first on the OTC Bulletin Board in April 2008. Since March 2009, it has been listed on the NASDAQ Global Market.

The company designs, manufactures, sells, and services plate heat exchangers (PHEs), PHE units, and heat meters for the China market. SmartHeat has three manufacturing facilities in mainland China. There are approximately 500 employees, including 35 engineers dedicated to research and development. The PHEs are sold to China's industrial, residential, and commercial markets. Its PHEs and PHE units raise the overall efficiency of heating and power generation systems by capturing and recycling waste heat, thereby reducing energy consumption, pollution, and operating costs. During 2008, SmartHeat's net sales were $32.7 million, EBITDA was $7.9 million, and net income was $6.3 million. Guidance for full-year 2009 is revenue of $80 million and net income of $15.5 million. According to the company, full-year 2010 revenue is expected to be $115.9 million, and net income is expected to be $22.9 million.

Exhibit 3: 2008 Revenue Breakdown



Source: Company reports

Plate Heat Exchangers (PHEs) (35% of sales)

A PHE transfers heat energy from one fluid to another across a solid surface. PHEs are assembled using a combination of plates, typically using stainless steel, titanium, and/or nickel plates. The plates are designed to have large heat transfer surfaces and high thermal conductivity. The plates are gasketed, welded, or brazed together depending on the application of the heat exchanger to form chambers. Cold fluid flows in one direction through some of the chambers, picking up heat from the hot fluid stream flowing in the opposite direction through adjacent chambers. The outer casings of PHEs are typically coated with thermal insulation to minimize heat loss from the exchanger. The sizes of PHEs vary widely according to customer needs and design specifications, but the equipment generally does not exceed the size of a large refrigerator. PHEs can be taken apart and plates can be added to increase heat transfer area. This flexibility translates into lower expenditures on installation and equipment purchases. For low- to medium-pressure liquid applications, PHEs are replacing the less efficient (and typically larger size) shell-and-tube heat exchangers. PHEs also tend to be easier to maintain than shell-and-tube units, and performance can be readily adjusted by adding or removing plates. Furthermore, PHEs can be installed in existing buildings as well as in new ones since they are smaller than traditional heat exchangers and can fit within existing facilities.

Plate heat exchanger technology was first developed in the 1920's to control pressure and temperature in industrial applications, and it has advanced considerably through the decades. This heat transfer technology was introduced to China in the 1960's, mainly for applications in the petroleum industry. Foreign manufacturers began to sell in China on a large scale in the late 1980's; in the 1990's they began to take an increasing share of the China market. The past decade has seen the rise of many domestic manufacturers along with joint venture (JV) operations between local and international firms. Today the market is divided among domestic firms, foreign JV's, and direct imports. Large international manufacturers of PHEs include Alfa Laval, SPX Corp. Sondex, GEA, Tranter SWEP, Danfoss, and Hisaka Works. Alfa Laval is the PHE market share leader in China and other foreign producers hold a combined market share of approximately 20%, according to SmartHeat. The remainder of the market is divided among multiple domestic producers. The China Heat Association estimated that the market for PHEs in China during 2007 was $2.4 billion; similarly, it sized the PHE Units market at approximately $139 million. The global market for heat transfer products and compact PHE units in 2007 was approximately $12 billion and $2.3 billion, respectively, according to Alfa Laval.

Exhibit 4: Plate Heat Exchanger (PHE)

Source: Company reports

Plate Heat Exchanger (PHE) Units (63% of sales)

PHE Units, which accounted for 63% of 2008 revenue, are built by assembling PHEs with various pumps, temperature sensors, valves, and automated control systems to form a "unit" which is used with other units to form a "PHE network" installed in the local district heating systems. As a component a PHE comprises approximately 10%-15% of the total PHE Unit cost.

Exhibit 5: Plate Heat Exchanger (PHE) Unit

Source: Company reports

SmartHeat has a relationship with Sondex, a Danish company that specializes in development and manufacturing of plate heat exchangers and components. Since 2003, SmartHeat has been importing finished stainless steel plates from Sondex and assembling them into customized PHEs based on client specifications. Design of all PHEs is performed in-house by SmartHeat engineers utilizing a combination of software provided by Sondex and SmartHeat's proprietary software. The company has Sondex's exclusive distribution rights for northern and eastern China. Plates from Sondex accounted for approximately 30% of SmartHeat's raw material purchases in 2008, and 26% of material purchases for the six months ended June 30, 2009. We believe that Sondex enjoys a long-established reputation for quality and durability, which is important in the harsh conditions under which PHEs operate. SmartHeat sells PHEs under both the Taiyu and the Sondex brands. In 2008, approximately 50% of PHE sales were branded Taiyu, and 50% were branded Sondex. In 2009, the mix has shifted significantly toward the Taiyu brand. SmartHeat has signed an OEM agreement with Sondex, and we believe that Sondex depends on SmartHeat for approximately 70% of its sales to the China market. The May 2009 acquisition of Siping Beifang Heat Exchanger ("Siping"), a Chinese manufacturer of plates and heat exchangers, should further reduce dependence on Sondex.

Heat Meters (2% of sales)

SmartHeat's third product line is heat meters, which provide comprehensive heat consumption information to users, precisely measuring the volume of heat usage in commercial and residential facilities. Due to rising energy costs and increasing sensitivity to environmental issues, the Chinese government has made the use of heat meters in residential and commercial applications compulsory in China for buildings connected to a district heating system. As of January 2003, heat meters were required by law nationally for new construction; in April 2008, the law was extended to existing buildings being retrofitted under the Energy Conservation Law, Article 38. Today approximately 25% of existing buildings in Northern China are connected to district heating systems and that figure is expected to increase to 50%-60% over the next 20 years. SmartHeat introduced its patented heat meters in 2Q 2006. Although sales of heat meters have represented only a small portion of SmartHeat's sales to date (2% of 2008 revenues), the company plans to continue marketing its heat meter technology as heat meters become standard in China. Furthermore, the company has targeted a longer-term goal of approximately 15% of sales from heat meters.

Exhibit 6: Heat Meter

Source: Company reports

Impact of Acquisitions

SmartHeat has made two significant acquisitions, both within the past 12 months. On September 25, 2008, it purchased SanDeKe Company ("SanDeKe") for approximately $750,000. SanDeKe had 2008 sales of $2.1 million. The price-to-earnings ratio of the transaction was roughly 7.8 times on actual 2008 earnings. SanDeKe is a Shanghai-based manufacturer of PHEs. The main benefits from the acquisition were an increase in manufacturing capacity by about three PHEs per day, and more importantly, an expansion of the distribution network to better penetrate southern China and a strengthening of the company's presence in chemicals, manufacturing, consumer, and energy end markets.

On May 27, 2009, SmartHeat acquired Siping Beifang Heat Exchanger ("Siping"), a Chinese manufacturer of engineered plates and heat exchangers, for approximately $10 million in cash and stock. Siping had 2008 sales of approximately $10 million. We believe that the price-to-earnings ratio of the transaction was roughly 5.0 times on estimated 2009 earnings. Siping provided the company with another source for plates, thus reducing dependence on Sondex. It also expanded SmartHeat's engineering capabilities, allowing the company to further penetrate the nuclear power and petrochemical end markets. Finally, it broadened SmartHeat's product line of exchangers and components. The deal was largely financed with short-term debt. We expect the company to continue pursuing acquisitions in the medium to long term.

Raw Materials

Plates from all suppliers typically constitute 40% of the company's raw materials purchases. The company generally orders stainless steel plates 2-3 months in advance based on production needs and forecasted sales; this is an important factor in working capital considerations. While SmartHeat is an authorized dealer, plate purchasing prices are not fixed and fluctuate according to Sondex's most recent pricing list. Components such as pumps, valves, pipes, and electronic meters for inclusion in PHE units are sourced from a variety of international (e.g., Siemens, Wilo A.G., Honeywell) and domestic suppliers who have been certified to meet Taiyu's quality specifications. Plates and components together constituted approximately 98% of raw material purchases in 2007.

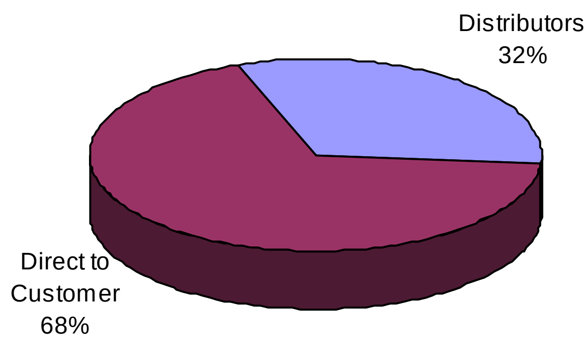
Employees and Manufacturing

As of June 30, 2009, SmartHeat employed approximately 500 people (up from 210 at December 31, 2008), 170 of whom are seasonal employees. The company has three manufacturing facilities in mainland China: Shenyang (HQ) with 210,137 square feet, Shanghai with 13,450 square feet, and Beifang (part of the Siping acquisition of May 2009) with 269,000 square feet. The Shenyang and Beifang facilities are owned, while the Shanghai facility is leased. SmartHeat also owns its office headquarters next to its original manufacturing facility in Shenyang City in China's Liaoning Province.

Sales and Distribution

Approximately 120 of SmartHeat's employees are salespeople selling products in 15 of China's 34 provinces (representing approximately 45% of China's population and 50% of GDP). In 2008, approximately two-thirds of sales were direct to customers; the remainder of sales was through the company's network of 29 national distributors located throughout China. As is the custom in China, sales people are compensated with a salary and small commission percentage of 1%-2%.

Exhibit 7: 2008 Channel Mix



Source: Company reports

Exhibit 8: Extensive and Growing Footprint

Source: Company reports

Large companies dominate SmartHeat's customer base, with the 10 largest customers accounting for 32% of sales in 2008. The details of these large customers are as follows:

Exhibit 9: Breakdown of Revenues by Top 10 Customers, 2008

Customer Name	2008 Sales	% of Sales in 2008
Shanghai Guoshe Electromechanical Engineering Co., LTD	$1,800,104	6%
Dalkai (Jiamusi) City Heat Co., LTD	$1,787,756	5%
Shanghai Langu Mechanical Engineering Co., LTD	$1,085,753	3%
Eerduosi Dongsheng District House Property Bureau	$1,012,013	3%
Urumqu Heat Head Office	$939,388	3%
Dalkai Sunny (Harbin) Thermoelectricity Co., LTD	$828,572	3%
China Precision Machinery Import and Export Co., LTD	$789,433	2%
CPCC Shengli Oil Field	$753,611	2%
Jiangxi Saiwei LDK SolarEnergy Hightech Co., LTD	$748,237	2%
Wuhu Qiaohong International Co., LTD	$675,776	2%
TOTAL	**$10,420,642**	**32%**

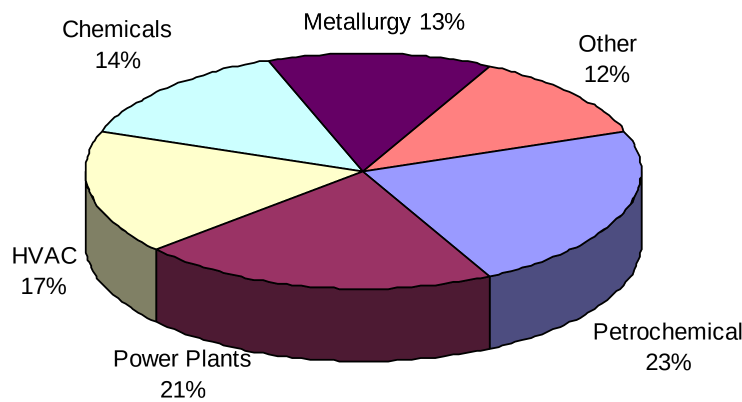
Source: company filings

Each sale can range from $2,500 to $500,000 and up depending upon the client's needs. Contract implementation generally takes one to six months. Accounts receivable remain outstanding for a significant period of time; typical payment terms are 30% upon order, 30%

upon delivery, 30% upon installation, and the final 10% no later than the termination of the warranty period (typically 3 to 24 months after equipment start-up). Revenues are recognized 30 days after shipment. The work is performed based on written contracts; there are no oral contracts.

SmartHeat continues to diversify its base of approximately 300 clients across multiple end markets. The company's products are sold into a wide variety of end markets, including petrochemical (23% of 2008 sales), power generation (21% of 2008 sales), HVAC (17%), chemicals (14%), metallurgy (13%), and other (12%). Overall, SmartHeat generated $32.7 million in sales in 2008, and management's guidance for 2009 sales is $80 million. Exhibit 10 presents a breakdown of sales for 2008 by end market.

Exhibit 10: Revenue Breakdown by End Market, 2008A



Source: Company reports.

Growth Opportunities

Energy Efficiency Initiatives in China

Given the growing importance of energy conservation and reduction of heat waste, we expect PHEs to continue to be a growth industry. The China Heat Association estimated that the market for PHEs in China during 2007 was $2.4 billion; it expects the market to grow at an annual rate of about 30% until 2010 due to the continuation of industrialization and urbanization trends in China. Similarly, the China Heat Association also believes that the China market for PHE Units in 2007 was approximately $139 million; it is expected to grow at an annual rate of 70% until 2010. The anticipated robust demand growth should be partially driven by new environmental policies and regulations, similar to those already implemented (as described in the section above entitled "Complete Exposure to the Growing China Market").

Heat Meters

Although heat meters represented only 2% of 2008 sales we believe that percentage should rise into the high single to low double digits over the next 1-2 years and ultimately meet the company's stated goal of 15% of sales over the next 3-5 years. This increase should have a positive impact on overall margins as we believe heat meters carry slightly better gross margins than either PHEs or PHE Units.

Service and Repair Opportunity

Aftermarket sales and service currently represents a negligible percentage of sales. However, we believe over time servicing an installed base of PHEs and PHE Units is likely to become a more meaningful contributor. Following an initial sale a PHE can operate for approximately four years before requiring major service. Following the fourth year annual maintenance is required to ensure proper operating performance of the PHE. We view this as a long-term opportunity for SmartHeat that is likely to be margin-enhancing as service gross margins are greater than original equipment margins. Given SmartHeat's growing position in the Chinese market we believe the company is well positioned to pursue service opportunities on not only its installed base but that of Western competitors such as Alfa Laval and SPX Corp.

Acquisitions and Industry Consolidation

We believe that acquisitions have been a key method by which the company has grown and increased shareholder value. With its acquisitions, we believe that SmartHeat has a rigorous evaluation and integration process that drives return on investment. We expect additional acquisitions in the medium term, especially in light of the successful follow-on offering of common equity in September 2009 that put the balance sheet in a net cash position. We believe this capital raising provided ample funds for repayment of the outstanding debt as well as expansion of product offerings, capital expenditures, and working capital, while strengthening the balance sheet with cash.

Risk Factors

Management Controls a Significant Equity Stake in the Company

The principal stockholder, Mr. James Jun Wang (chairman and chief executive officer), has the ability to exert significant control in matters requiring a stockholder vote and could delay, deter, or prevent a change of control in the company.

Outlook for Growth in the China Economy and End-Market Capital Spending

SmartHeat relies on continued capital spending in the end markets it serves. This, in turn, depends upon the financial health of those companies in particular, and China's continued economic growth in general. Economic factors that reduce industrial and/or consumer spending on equipment (e.g., new or replacement heating systems) could adversely impact the company's performance. These expenditures have historically been cyclical in nature and vulnerable to economic downturns. Should growth in end market capital spending in China fail to materialize, our revenue and earnings forecasts could prove too aggressive.

Seasonality

The seasonality of SmartHeat's business presents challenges to its production and inventory control functions. It typically experiences stronger sales in the third and fourth calendar quarters. The company's quarterly revenues may fluctuate significantly due to the seasonal nature of central heating services in China. The equipment used in residential buildings must be delivered and installed prior to the beginning of the heating season in late fall. Mild or warm weather conditions during the fall and winter seasons could cause some users to defer purchases of new or replacement HVAC systems or components. Therefore, prolonged periods of unseasonable weather could have a negative impact on SmartHeat's operating performance.

Customer Concentration

As detailed in Exhibit 9 above, the company's ten largest customers accounted for 32% of sales for the fiscal year ended December 31, 2008. The largest customer contributed 6% of sales. These large customers may not maintain the same volume of business in the future. If SmartHeat loses any of these customers or if they do less business with the company, SmartHeat's revenues could be seriously affected.

Cash Flow and Liquidity Impacts Stemming from Accounts Receivable Terms

Accounts receivable remain outstanding for a significant period of time; typical payment terms are 30% upon placement of the order, 30% upon delivery, 30% upon installation and acceptance of the equipment after customer testing, and the final 10% no later than the termination of the warranty period (typically 3 to 24 months after the acceptance date). We believe that delays in customer payments are common in the heating equipment manufacturing industry in China, but SmartHeat's accounts receivable turnover and inventory turnover are relatively low, and the days sales outstanding ratio is relatively high. As a result, capital is tied up in inventories, which may pressure SmartHeat's cash flows and liquidity. For 2008, SmartHeat had accounts receivable turnover of 3.6 times, with days sales outstanding of 136 and inventory turnover of 3.1 times on an annualized basis. For 2007, it had accounts receivable turnover of 2.8, with days sales outstanding of 167 and inventory turnover of 1.09 on an annualized basis.

Availability and Cost of Raw Materials and Components

SmartHeat's business depends upon the availability of certain raw materials at reasonable cost, which is not assured. Furthermore, the company's profitability depends upon the margin between its cost of goods used in the manufacturing process, such as plates, pumps, water tanks, sensors, controlling systems, and other raw materials, as well as SmartHeat's fabrication costs to convert such goods and raw materials into finished products. If the company is not able to offset increases in such costs by raising prices on its finished products, it could have a material adverse effect on SmartHeat's earnings, cash flows, and financial condition.

Acquisitions

SmartHeat has made two acquisitions in the past and may make additional acquisitions in the future. Should the company experience problems identifying, negotiating, obtaining financing for, completing, and integrating additional acquisitions, its ability to grow will be significantly limited.

Economic, Political, and Legal Developments in China

Substantially all of SmartHeat's assets are located in China, and substantially all of its revenue is derived from the China market. Therefore, to a significant extent, its business is subject to the economic, political, and legal developments in China. While China's economy has experienced significant growth in the past two decades, such growth has been uneven, both geographically and among various sectors of the economy. The Chinese government has implemented various measures to encourage economic growth and guide the allocation of resources. Some of these measures benefit the overall economy of China, but they may also have a negative effect on SmartHeat. For instance, China's regulations relating to mergers, offshore companies, and Chinese stockholders, if applied to SmartHeat, may limit its ability to operate its business.

Financials

Revenues

We project revenues for 2009 of $80 million. Our 2010 revenue estimate is $115 million and our 2011 estimate is $167 million. This equates to revenue growth of 144%, 44%, and 46% in 2009, 2010, and 2011, respectively.

Gross and Operating Profit

Our gross profit forecasts for 2009, 2010, and 2011 are $28 million, $41 million, and $60 million, respectively, which equate to an operating margin assumptions of 35.0% for 2009, 35.2% for 2010, and 35.6% for 2011. Our operating profit forecasts for 2009, 2010, and 2011 are $19 million, $28 million, and $41 million, respectively, which equate to operating margin assumptions of 23.7% for 2009, 24.2% for 2010, and 24.4% for 2011.

Our projections assume SmartHeat will continue to experience margin expansion in 2009 on leverage from higher sales, economies of scale, and a greater mix of PHE plates produced in-house. We project an improved market in 2010 and 2011, as solid economic growth should continue in China; we also expect the company to make full use of Siping's capabilities in the wake of the May 2009 acquisition.

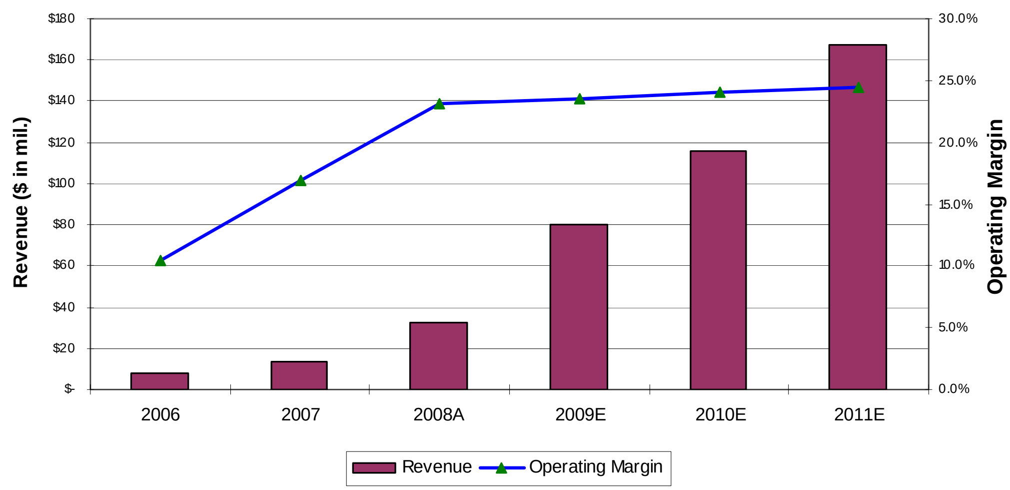
Interest Expense

SmartHeat's net debt has risen following two acquisitions in the past 12 months. Furthermore, net proceeds from the September 2009 secondary stock offering were approximately $69.5 million. Management has indicated that the proceeds will be used for working capital to support the continued growth of SmartHeat's PHE and PHE Units businesses, to aggressively expand the heat meter business, to pay back debt from the Siping acquisition, and to evaluate potential strategic acquisitions to penetrate additional verticals such as nuclear and petrochemical. Therefore, we are assuming that some of the debt will be paid off early in 4Q09, and much of the remaining cash will go into working capital rather than remaining on the balance sheet. Accordingly, we forecast interest income of $0.37 million per quarter starting in 1Q10. We assume interest income will remain at that run rate for a few quarters as we expect a relatively stable net cash position through 2011. We forecast interest expense to increase in 3Q09 and 4Q09 from 2Q09 as a result of the $9 million loan taken in July 2009. We expect part of the loan to be paid off in 4Q09. Additionally, at the end of 2Q09 SmartHeat had three additional loans outstanding totaling $5.56 million. Two of the loans totaling $1.17 million are due December 31, 2009, and we expect these to be paid off with proceeds from the equity offering. The remaining loan in the amount of $4.4 million is due in two tranches on April 22, 2010, and June 12, 2010. Our model assumes these loans are paid off on the due dates.

Net Income and EPS

For the full 2009, our net income assumption is $16 million, or $0.60 per share, excluding any special items, owing to higher sales and greater operating margin and higher interest income partially off set by an increased share count. For 2010, we estimate net income of $24.5 million, translating to EPS of $0.75 and in 2011 we forecast net income of $34.3 million or $1.05 per share owing to increased sales and an improving operating margin.

Exhibit 11: Sales and Margin Trends



Source: Company reports and BMO Capital Markets estimates

Valuation

On a P/E basis, SmartHeat is trading at 15.5x our 2010 EPS estimate of $0.75 and 11.1x our 2011 estimate of $1.05. Given the significant growth expected over the next two to three years we believe a P/E multiple of 20.0x and 14.3x our 2010 and 2011 EPS estimates, respectively is not unreasonable. On an EV/EBITDA basis, SmartHeat trades at 7.7x our estimated 2011 EBITDA of $41 million; we assume it can trade at an 11.0x multiple of our estimated 2011 EBITDA. Our $15 price target is derived from taking a mid-point estimate from our EV/EBITDA valuation and our market-implied growth rate valuation. Should our EBITDA estimates prove too aggressive or conservative, our price target could be at risk.

Exhibit 12: SmartHeat Implied Share Price Based on Estimated EBITDA

Enterprise Value to CY2011 Estimated EBITDA	Rating	Target EBITDA Multiple	EBITDA 2011E	Ent. Value	Net.Debt	Equity Value	Shares Out	Implied Share Price	9/25/09 Share Price	Appreciation Potential
SmartHeat	Outperform	11.0	41	454	-67	521	32.8	$15.89	$11.65	36%

NOTE: HEAT net debt is based on a 9/30/09 estimate, to account for the Sept. 2009 secondary equity offering

Source: BMO Capital Markets estimates.

Exhibit 13 demonstrates how we arrive at an implied target price of $15.38, by calculating the present value of earnings from 2010 through 2020. Years 2010–2011 are derived specifically from our earnings model, and EPS beyond 2010 are assumed to grow at 13.0% per year. We assume that investors require a 14.0% rate of return, which is our discount rate, and that the terminal P/E will be 18.0x. Based on these assumptions, we arrive at an implied target price of $15.38. To look at this analysis another way, we can use the same data to calculate a market-implied EPS growth rate based on the current share price. The market appears to be assuming a 9.6% average EPS growth rate beyond 2011, which is below our estimate.

Exhibit 13: SmartHeat Implied Share Price Based on Discounted EPS

Assumptions	
EPS Growth	13.0%
Req. ROR	14.0%
Terminal ROE	9.3%
Terminal PE	18.0x
Current Price	$11.65
Resulting Value	**$15.38**
% Change	**32.0%**

					EPS Growth					
Required Rate of Return	$15.38	**11.0%**	**11.5%**	**12.0%**	**12.5%**	**13.0%**	**13.5%**	**14.0%**	**14.5%**	**15.0%**
	11.0%	17.10	17.80	18.54	19.29	20.08	20.89	21.74	22.61	23.51
	11.5%	16.35	17.02	17.72	18.45	19.20	19.97	20.78	21.62	22.48
	12.0%	15.63	16.28	16.95	17.64	18.36	19.10	19.87	20.67	21.50
	12.5%	14.95	15.57	16.21	16.87	17.56	18.27	19.01	19.77	20.56
	13.0%	14.30	14.89	15.50	16.14	16.80	17.48	18.18	18.91	19.67
	13.5%	13.68	14.25	14.83	15.44	16.07	16.72	17.40	18.09	18.82
	14.0%	13.10	13.64	14.20	14.78	15.38	16.00	16.65	17.32	18.01
	14.5%	12.53	13.05	13.59	14.14	14.72	15.32	15.93	16.58	17.24
	15.0%	12.00	12.50	13.01	13.54	14.09	14.66	15.26	15.87	16.50
	15.5%	11.49	11.97	12.46	12.97	13.49	14.04	14.61	15.19	15.80
	16.0%	11.00	11.46	11.93	12.42	12.92	13.45	13.99	14.55	15.13
	16.5%	10.54	10.98	11.43	11.90	12.38	12.88	13.40	13.94	14.50
					Average	**$15.75**				
					% chg.	**35.2%**				

Assumptions	
EPS Growth	9.6%
Req. ROR	14.0%
Terminal ROE	7.7%
Terminal PE	18.0x
Current Price	$11.65
Resulting Value	**$11.65**
% Change	**0.0%**

At the current price of $11.65, the market is assuming a growth rate of 9.6% beyond 2011

Source: Company reports and BMO Capital Markets estimates.

Management Profiles

We note that SmartHeat's executive officers have significant experience in manufacturing and research & development, which we believe is a key positive. Jun Wang, the co-founder, chairman and CEO owns approximately 21% of the shares outstanding and Wenbin Lin, co-founder and director owns 9.1% of the shares outstanding (adjusted for the secondary equity offering). Management entered into a three-year lockup at the beginning of 2009.

Exhibit 14: Equity Stake of Senior Management

Insider Name and Position	HEAT Shares (000s)[1]	% Ownership Fully diluted[2]
Jun Wang, Co-Founder, Chairman & CEO[3]	6,808	20.9%
Wenbin Lin, Co-Founder & Director[4]	2,960	9.1%
Arnold Staloff, Director	12	< 0.1%
Zhijuan Guo, CFO	0	0.0%
Frederic Rittereiser, Director	0	0.0%
Weiguo Wang, Director	0	0.0%
Total	**9,780**	**30.0%**

(1) As of March 20, 2009

(2) Assuming a diluted share count of 32.53 million after the September 2009 follow-on equity offering.

(3) Jun Wang's shares are filed under Beijing YSKN Machinery & Electronic Equipment Co. Ltd.

(4) Wenbin Lin's shares are filed under Shen Yang Zhice Investment Co. Ltd., which is controlled by Mr. Lin's spouse & children.

Source: Company filings

The background of the senior management team is presented below.

James Jun Wang, Chairman, President & CEO, co-founded the company in 2002. He was appointed chairman of the board on June 19, 2008; he became president and chief executive officer effective April 14, 2008, when the share exchange formed SmartHeat, Inc. Previously, he was chairman and chief executive officer of Taiyu from its founding in 2002 to April 14, 2008. Prior to joining the company, from 2000 to 2002, Mr. Wang was vice general manager of Beijing HotNet Company. From 1996 to 1999, he was a sales manager for Honeywell International Inc. From 1994 to 1996, he was a sales manager for Alfa Laval. Mr. Wang obtained his Master's degree in engineering from Tsinghua University in 1989.

Zhijuan Guo, CFO & Treasurer, was appointed chief financial officer of Taiyu in 2002. Previously, from December 2000 to June 2002, she served as the production planning director of Shenyang Thermoelectric Co. Ltd. From March 1999 to November 2000, she served as auditing director of Shenyang Dongyu Group Corp. From July 1993 to February 1999, Ms. Guo served as finance manager of Shenyang Dongyu Real Estate Development Company. Ms. Guo obtained her MBA degree from Shenyang Northeastern University in 2001.

Huajun Ai, Corporate Secretary, joined Taiyu in 2002 as corporate secretary. Previously, from December 2000 to October 2002, she served as an accountant at Shenyang Dongyu International Trade Co., Ltd. From July 1994 to November 2000, Ms. Ai served as an accountant at Northeast Jincheng Industrial Corp. Ms. Ai obtained her bachelor's degree in foreign trade accounting from Shenyang North Eastern University in 1994.

Wenbin Lin, Director, co-founded the company in 2002 along with Mr. Wang. From December 2003 to October 2004, Mr. Lin served as deputy chairman and general manager of Shenyang Huanggu Thermoelectricity Heating, Inc. From November 2002 to December 2003, Mr. Lin served as chairman and general manager of Shenyang Heat Power Co. Ltd. From September 1999 to May 2002, Mr. Lin served as chairman of Shenyang Thermoelectric Corp. From

January 1991 to August 1999, Mr. Lin held a variety of positions within the government of Shenyang City in China, including director of the economic development & reform commission from February 1998 to August 1999, director of Shenyang City's economics & trade commission from May 1995 to January 1998, and deputy director for the economic planning commission from January 1991 to April 1995. Mr. Lin holds a bachelor's degree in press machinery from China's Anshan Steel Technical College. Mr. Lin has been appointed to the compensation committee and the nominating and corporate governance committee of SmartHeat.

Dr. Weiguo Wang, Director, was appointed as a director of the company on June 19, 2008. Dr. Wang serves as assistant secretary general of the China Standardization Committee on Boilers and Pressure Vessels, a position he has held since March 2005. Additionally, Dr. Wang has served as a director of the China Special Equipment Inspection and Research Agency since January 2007 and deputy general manger of Boilers Standard (Beijing) Technology Services Center Co., Ltd. since March 2004. From July 2001 to December 2003, Dr. Wang was a teacher at Tianjin University, China. Dr. Wang holds a bachelor's degree in mechanics, a master's degree in fluid mechanics, and a PhD in fluid mechanics, all from Beijing University. Dr. Wang has been appointed to the audit committee, compensation committee, and nominating and corporate governance committee of SmartHeat.

Frederic Rittereiser, Director, was appointed as a director of the company on June 19, 2008. He has served on the board of directors of AgFeed Industries, Inc. since 2007. From October 1996 until retiring in 2002, Mr. Rittereiser served as chairman of the board and chief executive officer of Ashton Technology Group, Inc., a company that develops and commercializes online transaction systems for the financial industry. Mr. Rittereiser has been appointed to the audit committee, compensation committee, and nominating and corporate governance committee of SmartHeat.

Arnold Staloff, Director, was appointed as a director of the company on June 19, 2008. He has served on the boards of directors of Exchange Lab Inc. since 2001, AgFeed Industries, Inc. since 2007, and Shiner International, Inc. since 2007. From December 2005 to May 2007, Mr. Staloff served as chairman of the board of SFB Market Systems, Inc., a New Jersey-based company that provides technology solutions for the management and generation of options series data. From March 2003 to December 2005, Mr. Staloff was an independent consultant. From June 1990 to March 2003, Mr. Staloff served as president and chief executive officer of Bloom Staloff Corporation, an equity and options market-making firm and foreign currency options floor broker. Additionally, Mr. Staloff served on the board of directors of Lehman Brothers Derivative Products, Inc. from 1998 until 2008 and Lehman Brothers Financial Products Inc. from 1994 until 2008. Mr. Staloff holds a bachelor's degree in business administration from the University of Miami. Mr. Staloff has been appointed to the audit committee, compensation committee, and nominating and corporate governance committee of SmartHeat.

Conclusion

We view SmartHeat as a pure play on the expansion of district heating in China and the government-mandated increases in energy efficiency and reduction in carbon emissions generated from burning coal. We believe the company is well-positioned to take advantage of China's growing industrial, residential, and commercial heating markets with PHE systems that help reduce fossil fuel usage and pollution by improving heat utilization and recycling waste heat. We also believe there is a significant opportunity for the company to increase its penetration into end-markets outside of HVAC such as refinery, petrochemical and power.

Our projections assume SmartHeat will continue to experience margin expansion in 2009 on leverage from higher sales, economies of scale and a greater mix of PHE plates produced in-house. We project an improved market in 2010 and 2011, as solid economic growth should continue in China; we also expect the company to make full use of Siping's capabilities in the wake of the May 2009 acquisition.

We view SmartHeat as a well-run company with numerous long-term positives. Although there are downside risks, we feel that the valuation and robust outlook for earnings growth provide meaningful upside potential for the stock. Given these factors, we are initiating coverage of SmartHeat with an **OUTPERFORM** rating and a 12-month price target of $15.

Other companies mentioned (priced as of the close on September 25, 2009):

SPX Corp. (SPW, $61.45, Not Rated)
Alfa Laval AB (ALFA, $21.98, Not Rated)
GEA Group AG (GEAGF.PK, $20.75, Not Rated)
Honeywell International Inc. (HON, $37.81, Not Rated)
AgFeed Industries (FEED, $5.70, Not Rated)
Shiner International, Inc. (BEST, $1.21, Not Rated)
Lehman Brothers Holdings, Inc. (LEHMQ.PK, $0.1895, Not Rated)
Siemens AG ADR (SI, $93.33, Not Rated)

SmartHeat (HEAT)	12/31/06 FY2006A	12/31/07 FY2007A	3/31/08 1Q08A	6/30/08 2Q08A	9/30/08 3Q08A	12/31/08 4Q08A	12/31/08 FY2008A	3/31/09 1Q09A	6/30/09 2Q09A	9/30/09 3Q09E	12/31/09 4Q09E	12/31/09 FY2009E	3/31/10 1Q10E	6/30/10 2Q10E	9/30/10 3Q10E	12/31/10 4Q10E	12/31/10 FY2010E	12/31/11 FY2011E
Net Sales	$8.2	$13.3	$3.1	$5.6	$20.7	$3.3	$32.7	$6.2	$12.5	$35.2	$25.8	$79.7	$8.1	$17.5	$54.6	$34.8	$115.0	$167.3
COGS	(5.7)	(8.7)	(2.1)	(4.1)	(13.3)	(2.2)	(21.7)	(3.9)	(8.0)	(23.1)	(16.9)	(51.8)	(5.2)	(11.4)	(35.2)	(22.6)	(74.5)	(107.7)
Gross Profit	**$2.5**	**$4.6**	**$1.0**	**$1.4**	**$7.4**	**$1.1**	**$11.0**	**$2.3**	**$4.5**	**$12.1**	**$8.9**	**$27.9**	**$2.8**	**$6.1**	**$19.4**	**$12.2**	**$40.5**	**$59.6**
Selling Exp.	(1.2)	(1.7)	(0.2)	(0.4)	(1.1)	0.1	(1.6)	(0.5)	(0.7)	(2.2)	(1.5)	(4.9)	(0.5)	(1.0)	(3.4)	(2.1)	(7.1)	(10.4)
Gen'l & Admin. Exp.	(0.5)	(0.7)	(0.3)	(0.2)	(1.0)	(0.4)	(1.9)	(0.6)	(0.8)	(1.6)	(1.2)	(4.1)	(0.7)	(1.1)	(2.2)	(1.5)	(5.5)	(8.4)
Operating Income	**$0.9**	**$2.2**	**$0.5**	**$0.9**	**$5.4**	**$0.8**	**$7.5**	**$1.3**	**$3.1**	**$8.3**	**$6.2**	**$18.9**	**$1.5**	**$4.0**	**$13.8**	**$8.6**	**$27.9**	**$40.8**
Interest Income	0.10	0.18	0.15	0.11	0.06	0.09	0.41	0.02	0.06	0.10	0.39	0.57	0.37	0.37	0.37	0.37	1.46	1.46
Interest Expense	(0.08)	(0.23)	(0.07)	(0.10)	(0.09)	(0.06)	(0.31)	(0.05)	(0.06)	(0.29)	(0.21)	(0.62)	(0.19)	(0.19)	(0.13)	(0.13)	(0.62)	(0.50)
Other Income/Expense	0.02	0.08	0.01	0.01	(0.01)	(0.01)	0.00	(0.00)	0.03	0.00	0.00	0.03	0.00	0.00	0.00	0.00	0.00	0.00
Total Non-Operating Inc. (Exp.)	**$0.04**	**$0.02**	**$0.09**	**$0.02**	**($0.04)**	**$0.02**	**$0.09**	**($0.04)**	**$0.03**	**($0.20)**	**$0.18**	**($0.03)**	**$0.18**	**$0.18**	**$0.24**	**$0.24**	**$0.84**	**$0.96**
Pre-tax Income	**$0.9**	**$2.3**	**$0.6**	**$0.9**	**$5.3**	**$0.9**	**$7.6**	**$1.2**	**$3.1**	**$8.1**	**$6.4**	**$18.8**	**$1.7**	**$4.2**	**$14.0**	**$8.8**	**$28.8**	**$41.8**
Income Tax Expense	(0.1)	(0.2)	(0.1)	(0.2)	(1.0)	(0.0)	(1.3)	(0.2)	(0.5)	(1.2)	(1.0)	(2.9)	(0.3)	(0.6)	(2.1)	(1.3)	(4.3)	(7.5)
After tax Income	**$0.8**	**$2.1**	**$0.5**	**$0.7**	**$4.3**	**$0.8**	**$6.3**	**$1.0**	**$2.6**	**$6.9**	**$5.4**	**$16.0**	**$1.5**	**$3.5**	**$11.9**	**$7.5**	**$24.5**	**$34.3**
Minority Interest	0.0	(0.0)	0.0	0.0	(0.0)	(0.0)	(0.0)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Income	**$0.8**	**$2.1**	**$0.5**	**$0.7**	**$4.3**	**$0.8**	**$6.3**	**$1.0**	**$2.6**	**$6.9**	**$5.4**	**$16.0**	**$1.5**	**$3.5**	**$11.9**	**$7.5**	**$24.5**	**$34.3**
Basic EPS	$0.05	$0.11	$0.03	$0.03	$0.18	$0.03	$0.29	$0.04	$0.11	$0.28	$0.17	$0.60	$0.04	$0.11	$0.37	$0.23	$0.75	$1.05
Diluted EPS	**$0.05**	**$0.11**	**$0.03**	**$0.03**	**$0.18**	**$0.03**	**$0.29**	**$0.04**	**$0.11**	**$0.28**	**$0.17**	**$0.60**	**$0.04**	**$0.11**	**$0.36**	**$0.23**	**$0.75**	**$1.05**
Basic Shares Outstanding	18,500	18,500	18,500	21,927	24,056	24,056	22,176	24,180	24,180	24,522	32,513	26,577	32,513	32,513	32,513	32,513	32,513	32,513
Diluted Shares Outstanding	18,500	18,500	18,500	21,927	24,056	24,056	22,176	24,184	24,206	24,793	32,784	26,603	32,784	32,784	32,784	32,784	32,784	32,784
Margin Analysis																		
Gross Profit	**30.4%**	**34.7%**	**31.4%**	**26.0%**	**35.9%**	**33.5%**	**33.5%**	**37.2%**	**36.2%**	**34.5%**	**34.5%**	**35.0%**	**35.0%**	**35.0%**	**35.5%**	**35.0%**	**35.2%**	**35.6%**
Selling Exp. (% of rev.)	14.4%	12.7%	6.4%	7.4%	5.1%	NM	4.8%	7.4%	5.6%	6.3%	6.0%	6.2%	6.8%	6.0%	6.2%	6.0%	6.2%	6.2%
Gen'l & Admin. Exp. (% of rev.)	5.6%	5.2%	9.2%	2.9%	4.9%	11.4%	5.7%	9.2%	6.2%	4.5%	4.5%	5.1%	9.1%	6.2%	4.0%	4.3%	4.8%	5.0%
Operating Profit	**10.4%**	**16.9%**	**15.7%**	**15.7%**	**25.9%**	**25.0%**	**23.1%**	**20.6%**	**24.4%**	**68.7%**	**69.6%**	**23.7%**	**54.6%**	**65.1%**	**71.3%**	**70.6%**	**24.3%**	**24.4%**
Pretax Profit	10.9%	17.0%	18.7%	16.1%	25.6%	25.6%	23.4%	20.0%	24.6%	67.1%	71.6%	23.6%	60.9%	68.1%	72.5%	72.5%	25.0%	25.0%
Tax Rate	8.1%	7.8%	18.2%	18.0%	18.5%	5.5%	16.9%	17.6%	15.0%	15.0%	15.0%	15.2%	15.0%	15.0%	15.0%	15.0%	15.0%	18.0%
Percent Change																		
Total Revenue		**61.8%**	**137.1%**	**379.5%**	**586.7%**	**-57.3%**	**146.2%**	**101.6%**	**124.9%**	**70.0%**	**675.0%**	**144.0%**	**30.0%**	**40.0%**	**55.0%**	**35.0%**	**44.2%**	**45.5%**
Gross Profit		84.6%	111.7%	258.3%	695.2%	-60.4%	137.9%	138.8%	213.5%	63.4%	698.8%	154.4%	22.5%	35.4%	59.5%	37.0%	45.3%	47.1%
Selling Exp.		42.4%	-9.1%	53.4%	230.1%	-111.4%	-6.9%	133.5%	70.1%	109.9%	NM	214.8%	19.1%	50.3%	52.5%	35.0%	43.6%	47.0%
Gen'l & Admin. Exp.		49.0%	80.5%	14.8%	346.5%	139.3%	169.4%	100.4%	374.7%	54.7%	204.8%	120.7%	28.9%	40.8%	37.8%	29.0%	34.6%	52.3%
Operating Income		**162.6%**	**492.4%**	**NM**	**NM**	**-53.1%**	**237.2%**	**163.4%**	**251.1%**	**55.9%**	**643.1%**	**150.2%**	**20.8%**	**30.6%**	**65.5%**	**38.9%**	**48.1%**	**46.2%**
Non-Operating Inc. (Exp.)		-37.0%	0.2%	-52.0%	-62.8%	-817.8%	273.8%	-140.6%	7.6%	370.3%	787.6%	-132.8%	NM	NM	NM	34.4%	-2840.0%	14.6%
Pretax Income		153.7%	232.4%	NM	NM	-51.9%	237.6%	115.0%	244.8%	53.4%	646.5%	146.7%	38.8%	35.3%	72.4%	38.8%	52.8%	45.3%
Net Income		149.6%	191.1%	NM	NM	-52.3%	204.9%	116.7%	257.4%	60.1%	571.3%	152.2%	43.2%	35.4%	72.4%	38.8%	53.1%	40.1%
F.D. Avg. Shares Out.		0.0%	0.0%	18.5%	30.0%	30.0%	19.9%	30.7%	10.4%	3.1%	36.3%	20.0%	35.6%	35.4%	32.2%	0.0%	23.2%	0.0%

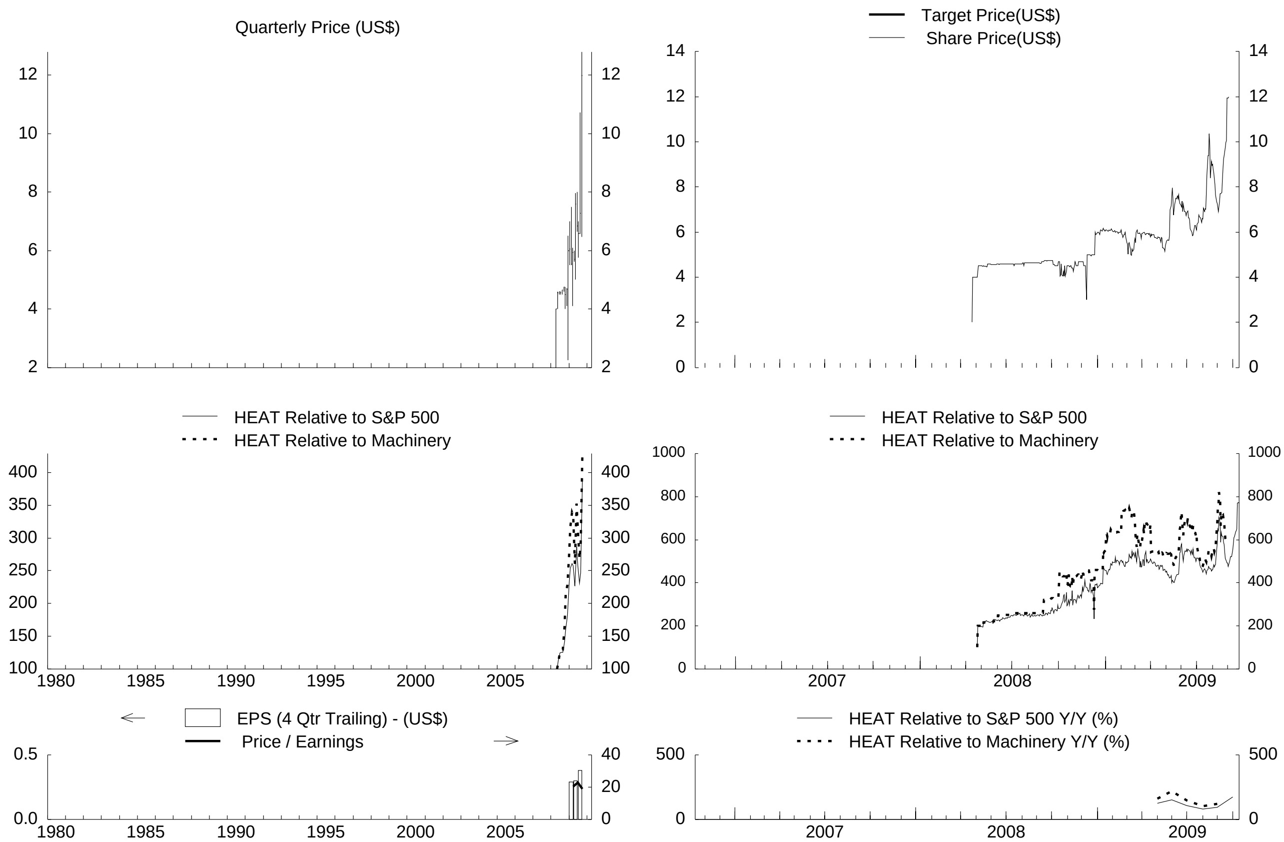
SmartHeat (HEAT)	12/31/06 FY2006A	12/31/07 FY2007A	12/31/08 FY2008A	12/31/09 FY2009E	12/31/10 FY2010E	12/31/11 FY2011E
Statement of Cash Flows						
Cash flows from operating activities						
Net income	$0.83	$2.09	$6.34	$15.98	$24.46	$34.28
Depreciation and amortization	0.07	0.10	0.25	0.39	0.40	0.40
Unearned int. on accts. receiv.	0.08	(0.12)	(0.13)	0.15	0.16	0.16
Stock option comp. exp.	0.00	0.00	0.01	0.00	0.00	0.00
Dec./Inc. in deferred tax liability	0.00	0.00	(0.00)	1.49	4.23	(0.16)
Minority interest	(0.01)	(0.00)	0.01	0.00	0.00	0.00
(Increase) decrease in curr. Assets						
Accounts receivable	(1.21)	(2.53)	(4.94)	(12.88)	(18.58)	(28.92)
Retentions receivable	(0.12)	0.07	(0.07)	(3.54)	(0.90)	(1.39)
Advances to suppliers	0.78	(0.05)	0.06	(1.08)	(0.50)	1.00
Other receiv, prepmts & dep.	0.02	(0.33)	0.18	(2.10)	(1.00)	0.00
Inventory	(2.85)	(2.18)	2.41	(5.50)	(11.03)	(4.18)
Receiv. from related party	(0.01)	(0.09)	0.00	0.00	0.00	0.00
Increase (decrease) in curr. liabil:						
Accounts payable	1.34	0.98	(2.39)	3.97	1.36	(2.79)
Unearned revenue	1.10	1.27	(2.99)	2.76	1.26	1.95
Taxes payable	(0.11)	0.33	0.78	(0.77)	0.00	0.00
Accrued liabil & other payables	(0.13)	0.51	(0.26)	(1.87)	(0.39)	(1.05)
Payables to related party	(0.08)	(0.05)	0.00	0.00	0.00	0.00
Total Net cash provided (used)	**($0.30)**	**($0.00)**	**($0.76)**	**($3.01)**	**($0.53)**	**($0.70)**
Cash flows from investing activities						
Restricted cash	$0.16	($0.14)	($0.11)	($0.27)	$0.00	$0.00
Construction in progress	(0.77)	0.00	0.00	0.00	0.00	0.00
Cash purchased at acquisition	0.00	0.00	0.06	0.00	0.00	0.00
Acquisition of property & equipment	(0.12)	(0.91)	(0.44)	(0.74)	(1.00)	(1.00)
Note receivable	0.00	0.00	(0.01)	0.00	0.00	0.00
Net cash flows from investing activities	**($0.73)**	**($1.05)**	**($0.51)**	**($1.01)**	**($1.00)**	**($1.00)**
Cash flows from financing activities						
Payments of assets acquisition liability	$0.00	$0.00	$0.00	($1.50)	$0.00	$0.00
Change in due from / (to) shareholder	(0.24)	(0.56)	(0.34)	0.00	0.00	0.00
Preceeds (repayment) short term loans	0.92	1.77	(2.45)	6.95	(4.39)	0.00
Proceeds from stock offering	0.00	0.00	0.00	69.51	0.00	0.00
Capital contribution	0.38	0.00	5.10	0.00	0.00	0.00
Net cash flows from financing activities	**$1.06**	**$1.22**	**$2.31**	**$74.95**	**($4.39)**	**$0.00**
Effect of exchange rates on cash & equiv.	$0.01	$0.02	$0.00	$0.00	$0.00	$0.00
Increase (decrease) in cash & cash equiv.	$0.03	$0.19	$1.04	$70.93	($5.93)	($1.70)
Cash & cash equivalents at beg. of period	$0.17	$0.20	$0.39	$1.44	$72.37	$66.44
Cash & cash equiv. at end of period	$0.20	$0.39	$1.44	$72.37	$66.44	$64.74

Source: Company data, BMO Capital Markets estimates.

SmartHeat (HEAT)	12/31/06 FY2006A	12/31/07 FY2007A	12/31/08 FY2008A	12/31/09 FY2009E	12/31/10 FY2010E	12/31/11 FY2011E
Balance Sheet						
Assets						
Cash & cash equivalents	$0.20	$0.39	$1.44	$72.37	$66.44	$64.74
Restricted cash	0.37	0.54	0.46	0.93	0.93	0.93
Accounts receivable, net	2.32	4.76	11.39	23.23	41.81	70.74
Retentions receivable	0.11	0.19	0.29	2.58	3.48	4.88
Advances to suppliers	0.08	0.16	0.41	1.50	2.00	1.00
Other receivables, prepayments and deposits	0.42	0.77	0.70	2.00	3.00	3.00
Inventories	5.28	7.93	6.11	11.62	22.65	26.83
Due from related party	0.03	0.12	0.00	0.00	0.00	0.00
Note receivable	0.00	0.00	0.01	0.01	0.01	0.01
Total current assets	**$8.81**	**$14.86**	**$20.81**	**$114.24**	**$140.34**	**$172.14**
Non-Currant Assets						
Restricted cash	$0.00	$0.00	$0.22	$0.02	$0.02	$0.02
Accounts receivable, net	0.44	0.95	0.31	0.50	0.50	0.50
Retentions receivable	0.30	0.17	0.17	1.25	1.25	1.25
Intangible assets, net	0.47	0.53	1.16	4.18	4.18	4.18
Property and equipment, net	1.15	2.04	2.44	7.66	8.26	8.86
Total noncurrent assets	**$2.36**	**$3.69**	**$4.29**	**$13.62**	**$14.22**	**$14.82**
Total Assets	**$11.17**	**$18.55**	**$25.10**	**$127.86**	**$154.56**	**$186.95**
Liabilities & stockholders' equity						
Accounts payable	$1.97	$3.13	$1.21	$3.87	$5.23	$2.44
Unearned revenue	1.69	3.13	0.85	3.61	4.88	6.83
Notes payable	0.00	0.00	0.00	0.76	0.76	0.76
Taxes payable	0.15	0.50	1.33	0.56	0.56	0.56
Accrued liabilities and other payables	0.25	0.81	1.33	3.87	3.48	2.44
Due to related party	1.01	0.45	0.00	0.00	0.00	0.00
Due to minority shareholder	0.00	0.00	0.01	0.00	0.00	0.00
Loans payable	2.59	4.62	2.44	10.56	10.56	10.56
Total current liabilities	**$7.67**	**$12.63**	**$7.17**	**$23.24**	**$25.47**	**$23.59**
Other payables	0.00	0.00	0.00	1.20	1.20	1.20
Deferred tax liability	0.00	0.00	0.04	0.02	0.02	0.02
Total liabilities	**$7.67**	**$12.63**	**$7.21**	**$24.47**	**$26.70**	**$24.82**
Total stockholders' equity	$3.50	$5.92	$17.89	$103.39	$127.86	$162.14
Total liabilities & shareholders' equity	**$11.17**	**$18.55**	**$25.10**	**$127.86**	**$154.56**	**$186.95**
Debt to total capital	42.5%	43.8%	12.0%	9.9%	8.1%	6.5%
Book value per share	**$0.19**	**$0.32**	**$0.81**	**$3.89**	**$3.90**	**$4.95**
Return on average equity						
EBITDA	0.92	2.34	7.79	19.26	28.34	41.25
EBITDA Margin	11.2%	17.6%	23.9%	24.2%	24.7%	24.7%

Source: Company data, BMO Capital Markets estimates.

SMARTHEAT INC (HEAT)



HEAT - Rating as of 31-Dec-08 = NR

Last Daily Data Point: September 22, 2009

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Methodology and Risks to Our Price Target

Methodology: Our price target is 11.0x our 2011 EBITDA estimate

Risks: Seasonality and cyclicality of demand; customer concentration; significant equity stake held by CEO; subject to economic, political, and legal developments in China.

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OP = Outperform: We believe the stock's total return, including dividends, will exceed the S&P 500's return by more than 15%.
Mkt = Market Perform: We believe the stock's total return will generally match that of the S&P 500.
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NR = Not rated.
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In addition, apart from our stock ratings, we apply the Speculative investment (S) postscript to those companies that have de minimis revenue and whose enterprise value appears to be contingent upon unprovable assumptions (e.g., the future approval of a drug or the successful completion of an oil well).

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OUTPERFORM - We believe the sector will outperform the S&P 500 Index.
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OUTPERFORM - We believe the stock's total return, including dividends, will exceed the group average by over 15%.
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