

SMARTHEAT INC.  
Form S-1  
October 17, 2008

AS FILED WITH THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION ON OCTOBER 17, 2008

REGISTRATION NO. 333-\_\_\_\_\_

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM S-1

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

**SmartHeat Inc.**

(Name of Registrant as specified in its charter)

**Nevada**  
(State or other jurisdiction  
of incorporation)

**000-53052**  
(Commission File Number)

**98 -0514768**  
(IRS Employer  
Identification No.)

**A-1, 10, Street 7**  
**Shenyang Economic and Technological Development Zone**  
**Shenyang, China 110027**  
**+86 (24) 2519-7699**

(Address and telephone number of principal executive offices and principal place of business)

**Mr. Jun Wang**  
**Chief Executive Officer**  
**SmartHeat Inc.**  
**A-1, 10, Street 7**  
**Shenyang Economic and Technological Development Zone**  
**Shenyang, China 110027**  
**+86 (24) 2519-7699**

(Name, address and telephone number of agent for service)

Copies to:

**William Uchimoto, Esq.**  
**Buchanan Ingersoll & Rooney PC**  
**1835 Market Street, 14<sup>th</sup> Floor**  
**Philadelphia, PA 19103**  
**(215) 665-8700**

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box:

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration

statement for the same offering. o

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If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	<input type="checkbox"/>	Accelerated Filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input checked="" type="checkbox"/>

(Do not check if a smaller reporting company)

**Calculation of Registration Fee**

<b>Title of Each Class of Securities To Be Registered</b>	<b>Amount To Be Registered</b>	<b>Proposed Maximum Offering Price Per Unit (1)(2)</b>	<b>Proposed Maximum Aggregate Offering Price</b>	<b>Amount of Registration Fee</b>
Common Stock offered by our selling shareholders (2)	1,630,000	\$ 4.35	\$ 7,090,500	\$ 279.00
Common Stock underlying warrants	393,000	\$ 4.35	\$ 1,709,550	\$ 67.00
<b>Total</b>	<b>2,023,000</b>		<b>\$ 8,800,050</b>	<b>\$ 346.00</b>

(1) The shares being registered for resale by selling shareholders were issued pursuant to a private placement of securities completed on August 22, 2008 and/or are issuable upon the exercise of certain warrants of the Registrant.

(2) Estimated pursuant to Rule 457(c) under the Securities Act of 1933 solely for the purpose of calculating the amount of the registration fee, based on the average of the bid and ask prices per share of the Registrant’s common stock on October 14, 2008, as reported on the OTC Bulletin Board.

**The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with section 8(a) of the Securities Act of 1933, as amended, or until the registration statement shall become effective on such date as the United States Securities and Exchange Commission, acting pursuant to said section 8(a), may determine.**

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and we are not soliciting offers to buy these securities in any state where the offer or sale is not permitted.

**PRELIMINARY PROSPECTUS; SUBJECT TO COMPLETION, October 17, 2008**

**SMARTHEAT INC.**

**2,023,000 Shares of Common Stock**

The selling shareholders identified in this prospectus may offer and sell up to an aggregate of 2,023,000 shares of our common stock which we have issued to them, or which we may issue to them upon the exercise of certain warrants issued to them. All of the shares and warrants were issued to the selling shareholders in a private placement transaction completed prior to the filing of the registration statement of which this prospectus is a part.

We are not selling any shares of our common stock in this offering and will not receive any proceeds from this offering. We may receive proceeds on exercise of outstanding warrants for shares of common stock covered by this prospectus if the warrants are exercised for cash.

The selling shareholders may offer the shares covered by this prospectus at fixed prices, at prevailing market prices at the time of sale, at varying prices or negotiated prices, in negotiated transactions, or in trading markets for our common stock. We will bear all costs associated with this registration.

Our common stock trades on the OTC Bulletin Board under the symbol "SMHT." The closing price of our common stock on the OTC Bulletin Board on October 15, 2008 was \$4.70 per share.

*You should consider carefully the risk factors beginning on page 4 of this prospectus.*

**Neither the Securities and Exchange Commission nor any state securities commission has approved these securities or determined that this prospectus is accurate or complete. Any representation to the contrary is a criminal offense.**

The date of this prospectus is October 17, 2008.

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You may only rely on the information contained in this prospectus or that we have referred you to. We have not authorized anyone to provide you with different information. This prospectus does not constitute an offer to sell or a solicitation of an offer to buy any securities other than the common stock offered by this prospectus. This prospectus

does not constitute an offer to sell or a solicitation of an offer to buy any common stock in any circumstances in which such offer or solicitation is unlawful. Neither the delivery of this prospectus nor any sale made in connection with this prospectus shall, under any circumstances, create any implication that there has been no change in our affairs since the date of this prospectus or that the information contained by reference to this prospectus is correct as of any time after its date.

## ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement we filed with the Securities and Exchange Commission ("SEC"). You should rely only on the information provided in this prospectus and incorporated by reference in this prospectus. We have not authorized anyone to provide you with information different from that contained in or incorporated by reference into this prospectus. The selling shareholders are offering to sell, and seeking offers to buy, shares of common stock only in jurisdictions where offers and sales are permitted. The information in this prospectus is accurate only as of the date of this prospectus, regardless of the time of delivery of this prospectus or of any sale of common stock. The rules of the SEC may require us to update this prospectus in the future.

## PROSPECTUS SUMMARY

This summary highlights selected information contained elsewhere in this prospectus and does not contain all of the information you should consider in making your investment decision. Before investing in the securities offered hereby, you should read the entire prospectus, including our financial statements and related notes included in this prospectus and the information set forth under the headings "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations." In this prospectus, the terms "SmartHeat," "we," "us," and "our" refer to SmartHeat Inc.

### *Our Company*

We are a leading provider of plate heat exchanger products to China's industrial, residential and commercial markets. We design, manufacture, sell, and service plate heat exchangers ("PHEs"), units which combine plate heat exchangers with various pumps, temperature sensors, valves, and automated control systems ("PHE Units"), and heat meters for a broad range of industries, including petroleum refining, petrochemicals, power generation, metallurgy, food & beverage and chemical processing. We sell PHEs under the Sondex brand and PHE Units designed by our engineers and assembled with Sondex plates under our Taiyu brand name. We are one of three authorized dealers of Sondex PHEs for the industrial and energy sectors in China. Our Sondex distribution territory is North China.

We were incorporated in the State of Nevada on August 4, 2006 under the name Pacific Goldrim Resources, Inc. as an exploration stage corporation that intended to engage in the exploration of silver, lead and zinc. On April 14, 2008 we changed our name to SmartHeat Inc, and acquired all of the equity interests in Shenyang Taiyu Machinery & Electronic Equipment Co., Ltd. ("Taiyu"), a privately held company formed under the laws of the People's Republic of China ("China") engaged in the design, manufacture, sale, and servicing of plate heat exchange products in China. The acquisition of Taiyu's equity interests was accomplished pursuant to the terms of a Share Exchange Agreement dated April 14, 2008 (the "Share Exchange Agreement") by and among SmartHeat, Taiyu and all of the shareholders of Taiyu (the "Taiyu Shareholders"). At the closing under the Share Exchange Agreement, all of the equitable and legal rights, title and interests in and to Taiyu's share capital in the amount of Yuan 25,000,000 were exchanged for an aggregate of 18,500,000 shares of SmartHeat common stock (the "Share Exchange"). As a result of the Share Exchange, Taiyu became a wholly-owned subsidiary of SmartHeat.

Prior to our acquisition of Taiyu, we were in the development stage and had minimal business operations. We had no interest in any property, but had the right to conduct exploration activities on thirteen (13) mineral title cells covering 270,27 hectares (667,85 acres) in the Slocan Mining Division of southeastern British Columbia, Canada. In connection with the acquisition of Taiyu, the Company transferred all of its pre-closing assets and liabilities (other than the obligation to pay a \$10,000 fee to the Company's audit firm) to a wholly owned subsidiary, PGR Holdings, Inc., a Nevada corporation ("SplitCo"), under the terms of an Agreement of Conveyance, Transfer and Assignment of Assets and Assumption of Obligations dated April 14, 2008 (the "Transfer Agreement"). The Company also sold all of the outstanding capital stock of SplitCo to Jason Schlombs (the former director and officer, and a major shareholder, of the Company) pursuant to a Stock Purchase Agreement dated April 14, 2008 (the "Split-Off Agreement") in

exchange for the surrender of 2,500,000 shares of the Company's common stock held by Mr. Schlombs (the "Split-Off").



Our principal offices are located at A-1, 10, Street 7, Shenyang Economic and Technological Development Zone, Shenyang, China 110027. Our telephone number is +86 (24) 2519-7699.

***The Offering***

Common stock outstanding before the offering 24,179,900 shares

Common stock offered by selling shareholders Up to 2,023,000 shares  
The maximum number of shares to be sold by the selling shareholders, 2,023,000 shares, represents 8.23% of our outstanding stock, assuming full exercise of the warrants

Common stock to be outstanding after the offering Up to 24,572,900 shares

Use of proceeds We will not receive any proceeds from the sale of the common stock. However, we may receive proceeds from the exercise of the warrants. See "Use of Proceeds" for a complete description.

Risk Factors The purchase of our common stock involves a high degree of risk. You should carefully review and consider "Risk Factors" beginning on page 3.

The above information regarding common stock to be outstanding after the offering is based on 24,179,900 shares of common stock outstanding as of October 16, 2008.

## **RISK FACTORS**

*Our business and an investment in our securities are subject to a variety of risks. The following risk factors describe the most significant events, facts or circumstances that could have a material adverse effect upon our business, financial condition, results of operations, ability to implement our business plan, and the market price for our securities. Many of these events are outside of our control. The risks described below are not the only ones facing our company. Additional risks not presently known to us or that we currently believe are immaterial may also materially and adversely affect our business, financial condition or results of operations. In that case, the trading price of our common stock could decline and investors in our common stock could lose all or part of their investment.*

### **Risks Related to Our Business**

***Our relationship with Sondex has substantially contributed to our business and its growth. We could be adversely affected if that relationship terminated***

We are one of three authorized dealers appointed by Sondex A/S for PHEs for the industrial and energy sectors in China. Our territory is North China. Sondex is one of the world's leading PHE manufacturers. Our sales of Sondex PHEs have contributed to our reputation for the high quality of the products we manufacture and sell. If our relationship with Sondex were to terminate, our business, revenues, and results of operations could be adversely affected.

***The markets we serve are subject to seasonality and cyclical demand, which could harm our business and make it difficult to project long-term performance***

Demand for our products depends in large part upon the level of capital and maintenance expenditures of our customers and the end users. These expenditures have historically been cyclical in nature and vulnerable to economic downturns. Decreased capital and maintenance spending by our customers could have a material adverse effect on the demand for our products and our business, financial condition and results of operations. In addition, this historically cyclical nature of the demand for our products limits our ability to make accurate long-term predictions about our performance. Changing world economic and political conditions may also reduce the willingness of our customers and prospective customers to purchase our products and services. The seasonality of our business results in significant operational challenges to our production and inventory control functions.

***We derive a substantial part of our revenues from several major customers. If we lose any of these customers or they reduce the amount of business they do with us, our revenues may be seriously affected***

Our five largest customers accounted for 48.5% of our revenues for the year ended December 31, 2007 and our ten largest customers accounted for 64.5% of our revenues for the year ended December 31, 2007. Our largest customer accounted for 21% of our revenues in the year ended December 31, 2007. These customers may not maintain the same volume of business with us in the future. If we lose any of these customers or they reduce the amount of business they do with us, our revenues may be seriously affected.

***We cannot be certain that our product innovations and marketing successes will continue***

We believe that our past performance has been based on, and our future success will depend, in part, upon our ability to continue to improve our existing products through product innovation and to develop, market and produce new products. We cannot assure you that we will be successful in introducing, marketing and producing any new products or product innovations, or that we will develop and introduce in a timely manner innovations to our existing products which satisfy customer needs or achieve market acceptance. Our failure to develop new products and introduce them successfully and in a timely manner could harm our ability to grow our business and could have a material adverse

effect on our business, results of operations and financial condition.

***Our technology may not satisfy the changing needs of our customers***

With any technology, including the technology of our current and proposed products, there are risks that the technology may not successfully address all of our customers' needs. While we have already established successful relationships with our customers, their needs may change or vary. This may affect the ability of our present or proposed products to address all of our customers' ultimate technology needs in an economically feasible manner.

***We may not be able to keep pace with rapid technological changes and competition in our industry***

While we believe that we have hired or engaged personnel and outside consultants who have the experience and ability necessary to keep pace with advances in technology, and while we continue to seek out and develop "next generation" technology through our research and development efforts, there is no guarantee that we will be able to keep pace with technological developments and market demands in this evolving industry and market. In addition, our industry is highly competitive. Although we believe that we have developed strategic relationships to best penetrate the China market, we face competition from other manufacturers of product similar to our products. Some of our competitors' advantages over us in both the areas of products, marketing, and services include the following:

- Substantially greater revenues and financial resources;
- Stronger brand names and consumer recognition;
- The capacity to leverage marketing expenditures across a broader portfolio of products;
- Pre-existing relationships with potential customers;
- More resources to make acquisitions;
- Lower labor and development costs; and
- Broader geographic presence.

We will face different market dynamics and competition if we expand our market to other countries. In some international markets, our future competitors would have greater brand recognition and broader distribution than we have. We may not be as successful as our competitors in generating revenues in international markets due to our inability to provide products that are attractive to the market in other countries, the lack of recognition of our brand, and other factors. As a result, any international expansion efforts could be more costly and less profitable than our efforts in the domestic market in China.

***If we are not as successful as our competitors in our target markets, our sales could decline, our margins could be negatively impacted and we could lose market share, any of which could materially harm our business***

We depend on a limited number of suppliers of components for our products and if we are unable to obtain these components when needed, we would experience delays in manufacturing our products and our financial results could be adversely affected.

We acquire most of the components for the manufacture of our products from a limited number of suppliers. In order for us to have our products manufactured, these components must be available at the right level of quality and at the right price. Suppliers of some of these components require us to place orders with significant lead-time to assure supply in accordance with our requirements. Certain of these suppliers are currently the sole source of one or more components upon which we are dependent and alternative sources would not be available for those components unless

we were to redesign our products. Other components could be obtained from alternative suppliers without redesign, but only at higher prices than we currently pay or for delivery later than required by our production schedule. We rely on Sondex for parts for our PHE products and PHE Units. If we were unable to obtain adequate supplies of parts from Sondex at commercially reasonable prices, our operations could be interrupted. We maintain a relatively small inventory of component parts for resale and our parts services business would suffer if the supply of replacement parts was reduced or terminated by our suppliers. If suppliers are not able to provide these critical components on the dates and at the prices scheduled, we may not be able to promptly and cost-effectively manufacture our products to meet customer orders which could harm our credibility and the market acceptance and sales of our products. Increased costs associated with supplied materials or components could increase our costs and reduce our profitability if we are unable to pass these cost increases on to our customers.

***We are a major purchaser of certain goods and raw materials that we use in the manufacturing process of our products, and price changes for the commodities we depend on may adversely affect our profitability***

Our profitability generally depends upon the margin between the cost to us of certain goods used in the manufacturing process, such as plates, pumps, water tanks, sensors and controlling systems and other raw materials as well as our fabrication costs associated with converting such goods and raw materials compared to the selling price of our products, and the overall supply of raw materials. It is our intention to base the selling prices of our products upon the associated raw materials costs to us. However, we may not be able to pass all increases in raw material costs and ancillary acquisition costs associated with taking possession of the raw materials through to our customers. Although we are currently able to obtain adequate supplies of raw materials, it is impossible to predict future availability. With the rapid growth of China's economy, the demand for certain raw materials is great while the supply may be more limited. This may affect our ability to secure the necessary raw materials in a cost-effective manner for production of our products at the volume of purchase orders that we anticipate receiving. The inability to offset price increases of raw material by sufficient product price increases, and our inability to obtain raw materials, would have a material adverse effect on our consolidated financial condition, results of operations and cash flows.

***Our products may contain defects, which could adversely affect our reputation and cause us to incur significant costs***

Despite testing, defects may be found in existing or new products. Any such defects could cause us to incur significant return and exchange costs, re-engineering costs, divert the attention of our engineering personnel from product development efforts, and cause significant customer relations and business reputation problems. Any such defects could force us to undertake a product recall program, which could cause us to incur significant expenses and could harm our reputation and that of our products. If we deliver products with defects, our credibility and the market acceptance and sales of our products could be harmed.

***Due to the nature of our business and products, we may be liable for damages based on product liability and warranty claims***

Due to the high pressures and temperatures at which many of our products are used and the fact that some of our products are relied upon by our customers or end users in their facilities or operations, or are manufactured for relatively broad consumer use, we face an inherent risk of exposure to claims in the event that the failure, use or misuse of our products results, or is alleged to result, in bodily injury, property damage or economic loss. We believe that we meet or exceed existing professional specification standards recognized or required in the industries in which we operate. We have been subject to claims in the past, none of which have had a material adverse effect on our financial condition or results of operations, and we may be subject to claims in the future. Although we currently maintain product liability coverage, which we believe is adequate for the continued operation of our business, such insurance may become difficult to obtain or may become unobtainable in the future on terms acceptable to us and may not cover warranty claims. A successful product liability claim or series of claims against us, including one or more consumer claims purporting to constitute class actions, in excess of our insurance coverage or a significant warranty claim or series of claims against us could materially decrease our liquidity and impair our financial condition.

***We may experience delays in launching our products, which would negatively impact our position in the marketplace***

We may experience delays in bringing new products to market, due to design, manufacturing or distribution problems. Such delays could adversely affect our ability to compete effectively and may adversely affect our relationship with our customers. Any such delays would adversely affect our revenues and our ability to become profitable.



***If we are not able to manage our growth, we may not remain profitable***

Our success will depend on our ability to expand and manage our operations and facilities. There can be no assurance that we will be able to manage our growth, meet the staffing requirements for our business or for additional collaborative relationships or successfully assimilate and train new employees. In addition, to manage our growth effectively, we may be required to expand our management base and enhance our operating and financial systems. If we continue to grow, there can be no assurance that the management skills and systems currently in place will be adequate or that we will be able to manage any additional growth effectively. Failure to achieve any of these goals could have a material adverse effect on our business, financial condition or results of operations.

***Our business could be subject to environmental liabilities***

As is the case with manufacturers of similar products, we use certain hazardous substances in our operations. Currently we do not anticipate any material adverse effect on our business, revenues or results of operations, as a result of compliance with Chinese environmental laws and regulations. However, the risk of environmental liability and charges associated with maintaining compliance with environmental laws is inherent in the nature of our business, and there is no assurance that material environmental liabilities and compliance charges will not arise in the future.

***If we lose our key personnel or are unable to attract and retain additional qualified personnel, the quality of our services may decline and our business may be adversely impacted***

We rely heavily on the expertise, experience and continued services of our senior management, including our president and chief executive officer. Loss of their services could adversely impact our ability to achieve our business objectives. We believe our future success will depend upon our ability to retain these key employees and our ability to attract and retain other skilled personnel. The rapid growth of the economy in China has caused intense competition for qualified personnel. We cannot guarantee that any employee will remain employed by us for any definite period of time or that we will be able to attract, train or retain qualified personnel in the future and the loss of personnel could have a material adverse effect on our business and company. Qualified employees periodically are in great demand and may be unavailable in the time frame required to satisfy our customers' requirements. We need to employ additional personnel to expand our business. There is no assurance that we will be able to attract and retain sufficient numbers of highly skilled employees in the future. The loss of personnel or our inability to hire or retain sufficient personnel at competitive rates could impair the growth of our business.

***If we fail to establish and maintain an effective system of internal control, we may not be able to report our financial results accurately or to prevent fraud. Any inability to report and file our financial results accurately and timely could harm our business and adversely impact the trading price of our common stock***

We are required to establish and maintain internal controls over financial reporting, disclosure controls, and to comply with other requirements of the Sarbanes-Oxley Act and the rules promulgated by the SEC thereunder. Our management, including our Chief Executive Officer and Chief Financial Officer, cannot guarantee that our internal controls and disclosure controls will prevent all possible errors or all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. In addition, the design of a control system must reflect the fact that there are resource constraints and the benefit of controls must be relative to their costs. Because of the inherent limitations in all control systems, no system of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Corporation have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Further, controls can be circumvented by individual acts of some persons, by collusion of two or more persons, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future



conditions. Over time, a control may become inadequate because of changes in conditions or the degree of compliance with policies or procedures may deteriorate. Because of inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected.

***We may need additional capital to execute our business plan and fund operations and may not be able to obtain such capital on acceptable terms or at all***

Capital requirements are difficult to plan in our rapidly changing industry. Although we currently expect to have sufficient funding for the next 12 months, we expect that we will need additional capital to fund our future growth.

Our ability to obtain additional capital on acceptable terms or at all is subject to a variety of uncertainties, including:

- Investors' perceptions of, and demand for, companies in our industry;
- Investors' perceptions of, and demand for, companies operating in China;
- Conditions of the U.S. and other capital markets in which we may seek to raise funds;
- Our future results of operations, financial condition and cash flows;
- Governmental regulation of foreign investment in companies in particular countries;
- Economic, political and other conditions in the United States, China, and other countries; and
- Governmental policies relating to foreign currency borrowings.

We may be required to pursue sources of additional capital through various means, including joint venture projects and debt or equity financings. There is no assurance that we will be successful in locating a suitable financing transaction in a timely fashion or at all. In addition, there is no assurance that we will be successful in obtaining the capital we require by any other means. Future financings through equity investments are likely to be dilutive to our existing stockholders. Also, the terms of securities we may issue in future capital transactions may be more favorable for our new investors. Newly issued securities may include preferences, superior voting rights, the issuance of warrants or other derivative securities, and the issuances of incentive awards under equity employee incentive plans, which may have additional dilutive effects. Further, we may incur substantial costs in pursuing future capital and/or financing, including investment banking fees, legal fees, accounting fees, printing and distribution expenses and other costs. We may also be required to recognize non-cash expenses in connection with certain securities we may issue, such as convertible notes and warrants, which will adversely impact our financial condition.

If we cannot raise additional funds on favorable terms or at all, we may not be able to carry out all or parts of our strategy to maintain our growth and competitiveness or to fund our operations. If the amount of capital we are able to raise from financing activities, together with our revenues from operations, is not sufficient to satisfy our capital needs, even to the extent that we reduce our operations accordingly, we may be required to cease operations.

***We may be subject to claims that we have infringed the proprietary rights of others, which could require us to obtain a license or change our designs***

Although we do not believe that any of our products infringe the proprietary rights of others, there is no assurance that infringement or invalidity claims (or claims for indemnification resulting from infringement claims) will not be asserted or prosecuted against us or that any such assertions or prosecutions will not materially adversely affect our business. Regardless of whether any such claims are valid or can be successfully asserted, defending against such claims could cause us to incur significant costs and could divert resources away from our other activities. In addition, assertion of infringement claims could result in injunctions that prevent us from distributing our products. If any claims or actions are asserted against us, we may seek to obtain a license to the intellectual property rights that are in dispute. Such a license may not be available on reasonable terms, or at all, which could force us to change our designs.



## **Risks Related to Doing Business in China**

***We are subject to economic and political risks in China over which we have little or no control and may be unable to alter our business practice in time to avoid the possibility of reduced revenues***

Our business is conducted in China. Doing business outside the United States, particularly in China, subjects us to various risks, including changing economic and political conditions, major work stoppages, exchange controls, currency fluctuations, armed conflicts and unexpected changes in United States and foreign laws relating to tariffs, trade restrictions, transportation regulations, foreign investments and taxation. We have no control over most of these risks and may be unable to anticipate changes in international economic and political conditions and, therefore, unable to alter our business practice in time to avoid the possibility of reduced revenues.

***Substantially all of our assets are located in China and all of our revenue is derived from our operations in China. Accordingly, our results of operations and prospects are subject, to a significant extent, to the economic, political and legal developments in China***

While China's economy has experienced significant growth in the past twenty years, 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 us. For example, our operating results and financial condition may be adversely affected by the government control over capital investments or changes in tax regulations. The economy of China has been changing from a planned economy to a more market-oriented economy. In recent years China has implemented measures emphasizing the utilization of market forces for economic reform and the reduction of state ownership of productive assets, and the establishment of corporate governance in business enterprises. However, a substantial portion of productive assets in China are still owned by the government. In addition, the government continues to play a significant role in regulating industry development by imposing industrial policies. It also exercises significant control over China's economic growth through the allocation of resources, the control of payment of foreign currency-denominated obligations, the setting of monetary policy and the provision of preferential treatment to particular industries or companies.

***We may have difficulty establishing adequate management, legal and financial controls in China***

China historically has not adopted a Western style of management and financial reporting concepts and practices, or modern banking, computer or other control systems. We may have difficulty in hiring and retaining a sufficient number of qualified employees to work in China. As a result of these factors, we may experience difficulty in establishing management, legal and financial controls, collecting financial data and preparing financial statements, books of account and corporate records and instituting business practices that meet Western standards.

***Our bank accounts are not insured or protected against loss***

We maintain our cash with various banks and trust companies located in China. Our cash accounts are not insured or otherwise protected. Should any bank or trust company holding our cash deposits become insolvent, or if we are otherwise unable to withdraw funds, we would lose the cash on deposit with that particular bank or trust company.

***As we have limited business insurance coverage in China, any loss which we suffer may not be insured or may be insured to only a limited extent***

The insurance industry in China is still in an early state of development and insurance companies located in China offer limited business insurance products. In the event of damage or loss to our properties, our insurance may not provide as much coverage as if we were insured by insurance companies in the United States.



***Tax laws and regulations in China are subject to substantial revision, some of which may adversely affect our profitability***

The Chinese tax system is in a state of flux, and it is anticipated that China's tax regime will be altered in the coming years. Tax benefits that we presently enjoy may not be available in the wake of these changes, and we could incur tax obligations to our government that are significantly higher than anticipated. These increased tax obligations could negatively impact our financial condition and our revenues, gross margins, profitability and results of operations may be adversely affected as a result.

***Certain tax exemptions that we presently enjoy in China are scheduled to expire over the next several years***

As a substantial portion of our operations are located in a privileged economic zone, we are entitled to certain tax benefits. When these exemptions expire, our income tax expenses will increase, reducing our net income below what it would be if we continued to enjoy these exemptions.

***We may face judicial corruption in China***

Another obstacle to foreign investment in China is corruption. There is no assurance that we will be able to obtain recourse in any legal disputes with suppliers, customers or other parties with whom we conduct business, if desired, through China's poorly developed and sometimes corrupt judicial systems.

***If relations between the United States and China worsen, investors may be unwilling to hold or buy our stock and our stock price may decrease***

At various times during recent years, the United States and China have had significant disagreements over political and economic issues. Controversies may arise in the future between these two countries. Any political or trade controversies between the United States and China, whether or not directly related to our business, could reduce the price of our common stock.

***China could change its policies toward private enterprise or even nationalize or expropriate private enterprises***

Our business is subject to significant political and economic uncertainties and may be affected by political, economic and social developments in China. Over the past several years, the Chinese government has pursued economic reform policies including the encouragement of private economic activity and greater economic decentralization. The Chinese government may not continue to pursue these policies or may significantly alter them to our detriment from time to time with little, if any, prior notice.

***Uncertainties with respect to the Chinese legal system could limit legal protections available to us***

Our operating subsidiary, which conducts most of its operations in China, is generally subject to laws and regulations applicable to foreign investment in China. The Chinese legal system is based on written statutes, and prior court decisions may be cited for reference but have no precedential value. Since 1979, legislation and regulations have significantly enhanced the protections afforded to various forms of foreign investments in China. However, since these laws and regulations are relatively new and the legal system in China continues to rapidly evolve, the interpretations of many laws, regulations and rules are not always uniform and enforcement of these laws, regulations and rules involve uncertainties, which may limit legal protections available to us. In addition, any litigation in China may be protracted and result in substantial costs and diversion of resources and management attention.

***Limitations on the ability of our operating subsidiary to make payments to us could have a material adverse effect on our ability to conduct our business and fund our operations***

We are a holding company and conduct substantially all of our business through our operating subsidiary in China. We will of necessity rely on dividends paid by our subsidiaries for our cash needs, including the funds necessary to pay dividends and other cash distributions to our shareholders, to service any debt we may incur and to pay our operating expenses. The payment of dividends by entities organized in China is subject to limitations. In particular, regulations in China currently permit payment of dividends only out of accumulated profits as determined in accordance with Chinese accounting standards and regulations. Our Chinese subsidiary is also required to set aside at least 10% of its after-tax profit based on Chinese accounting standards each year to its general reserves until the accumulative amount of such reserves reaches 50% of its registered capital. These reserves are not distributable as cash dividends. In addition, it is required to allocate a portion of its after-tax profit to its staff welfare and bonus fund at the discretion of its board of directors. Moreover, if our subsidiary incurs debt on its own behalf in the future, the instruments governing the debt may restrict its ability to pay dividends or make other distributions to us. Any limitation on the ability of our subsidiary to distribute dividends and other distributions to us could materially and adversely limit our ability to make investments or acquisitions that could be beneficial to our businesses, pay dividends or otherwise fund and conduct our business.

***Recent Chinese regulations relating to the establishment of offshore special purpose companies by Chinese residents and registration requirements for employee stock ownership plans or share option plans may subject our China resident shareholders to personal liability and limit our ability to acquire Chinese companies or to inject capital into our operating subsidiaries in China, limit our subsidiaries' ability to distribute profits to us, or otherwise materially and adversely affect us***

The State Administration of Foreign Exchange (SAFE) issued a public notice in October 2005, requiring PRC residents, including both legal persons and natural persons, to register with the competent local SAFE branch before establishing or controlling any company outside of China, referred to as an "offshore special purpose company," for the purpose of acquiring any assets of or equity interest in PRC companies and raising funds from overseas. In addition, any PRC resident that is the shareholder of an offshore special purpose company is required to amend his or her SAFE registration with the local SAFE branch, with respect to that offshore special purpose company in connection with any increase or decrease of capital, transfer of shares, merger, division, equity investment or creation of any security interest over any assets located in China. To further clarify the implementation of Circular 75, the SAFE issued Circular 124 and Circular 106 on November 24, 2005 and May 29, 2007, respectively. Under Circular 106, PRC subsidiaries of an offshore special purpose company are required to coordinate and supervise the filing of SAFE registrations by the offshore holding company's shareholders who are PRC residents in a timely manner. If these shareholders fail to comply, the PRC subsidiaries are required to report to the local SAFE authorities. If the PRC subsidiaries of the offshore parent company do not report to the local SAFE authorities, they may be prohibited from distributing their profits and proceeds from any reduction in capital, share transfer or liquidation to their offshore parent company and the offshore parent company may be restricted in its ability to contribute additional capital into its PRC subsidiaries. Moreover, failure to comply with the above SAFE registration requirements could result in liabilities under PRC laws for evasion of foreign exchange restrictions. Some of our PRC resident beneficial owners have not registered with the local SAFE branch as required under SAFE regulations. The failure or inability of these PRC resident beneficial owners to comply with the applicable SAFE registration requirements may subject these beneficial owners or us to fines, legal sanctions and restrictions described above.

On March 28, 2007, SAFE released detailed registration procedures for employee stock ownership plans or share option plans to be established by overseas listed companies and for individual plan participants. Any failure to comply with the relevant registration procedures may affect the effectiveness of our employee stock ownership plans or share option plans and subject the plan participants, the companies offering the plans or the relevant intermediaries, as the case may be, to penalties under PRC foreign exchange regime. These penalties may subject us to fines and legal sanctions, prevent us from being able to make distributions or pay dividends, as a result of which our business operations and our ability to distribute profits to you could be materially and adversely affected.

In addition, the National Development and Reform Commission ("NDRC") promulgated a rule in October 2004, or the NDRC Rule, which requires NDRC approvals for overseas investment projects made by PRC entities. The NDRC Rule also provides that approval procedures for overseas investment projects of PRC individuals must be implemented with reference to this rule. However, there exist extensive uncertainties in terms of interpretation of the NDRC Rule with respect to its application to a PRC individual's overseas investment, and in practice, we are not aware of any precedents that a PRC individual's overseas investment has been approved by the NDRC or challenged by the NDRC based on the absence of NDRC approval. Our current beneficial owners who are PRC individuals did not apply for NDRC approval for investment in us. We cannot predict how and to what extent this will affect our business operations or future strategy. For example, the failure of our shareholders who are PRC individuals to comply with the NDRC Rule may subject these persons or our PRC subsidiary to certain liabilities under PRC laws, which could adversely affect our business.



***Regulation of loans and direct investment by offshore holding companies to Chinese entities may delay or prevent us from making loans or additional capital contributions to our operating subsidiaries, which could materially and adversely affect our liquidity and our ability to fund and expand our business***

As an offshore holding company of our Chinese operating subsidiaries, we may need to make loans to them, or we may need to make additional capital contributions to them.

Any loans to our operating subsidiaries are subject to Chinese regulations. For example, loans by us to our subsidiaries in China, which are foreign-invested enterprises, to finance their activities cannot exceed statutory limits and must be registered with the SAFE.

We may also decide to finance our subsidiaries by means of capital contributions. These capital contributions must be approved by the PRC Ministry of Commerce or its local counterpart. We cannot assure you that we will be able to obtain these government approvals on a timely basis, if at all, with respect to future capital contributions by us to our subsidiaries. If we fail to receive such approvals, our ability to use the proceeds of this offering and to capitalize our PRC operations may be negatively affected, which could adversely affect our liquidity and our ability to fund and expand our business.

***Restrictions on currency exchange may limit our ability to receive and use our revenues effectively***

The Renminbi is currently convertible under the “current account,” which includes dividends, trade and service-related foreign exchange transactions, but not under the “capital account,” which includes foreign direct investment and loans. Currently, our Chinese subsidiary may purchase foreign currencies for settlement of current account transactions, including payments of dividends to us, without the approval of the State Administration of Foreign Exchange, or SAFE. However, the relevant Chinese government authorities may limit or eliminate their ability to purchase foreign currencies in the future. Since a significant amount of our future revenues will be denominated in Renminbi, any existing and future restrictions on currency exchange may limit our ability to utilize revenues generated in Renminbi to fund our business activities outside China that are denominated in foreign currencies.

Foreign exchange transactions by our Chinese subsidiaries under the capital account continue to be subject to significant foreign exchange controls and require the approval of or need to register with Chinese governmental authorities, including SAFE. In particular, if our Chinese subsidiaries borrow foreign currency loans from us or other foreign lenders, these loans must be registered with SAFE, and if we finance our Chinese subsidiaries by means of additional capital contributions, these capital contributions must be approved by certain government authorities, including the NDRC, the Ministry of Commerce, or MOFCOM, or their respective local counterparts. These limitations could affect the ability of our Chinese subsidiaries to obtain foreign exchange through debt or equity financing.

***We face risks associated with currency exchange rate fluctuations; any adverse fluctuation may adversely affect our operating margins***

Almost all of our revenues are denominated in Renminbi. Conducting business in currencies other than US dollars subjects us to fluctuations in currency exchange rates that could have a negative impact on our reported operating results. Fluctuations in the value of the US dollar relative to other currencies impact our revenues, cost of revenues and operating margins and result in foreign currency translation gains and losses. If the exchange rate of the Renminbi is affected by lowering its value as against the US dollar, our reported profitability when stated in US dollars will decrease. Historically, we have not engaged in exchange rate hedging activities and have no current intention of doing so.

***We may not be able to adequately protect our technology and other proprietary rights***

Our success will depend in part on our ability to obtain and protect our products, methods, processes and other technologies, to preserve our trade secrets, and to operate without infringing on the proprietary rights of third parties both domestically and abroad. We have patents and patent applications pending in China, and have worked and continue to work closely with Chinese patent officials to preserve our intellectual property rights. Despite these efforts, any of the following occurrences may reduce the value of our intellectual property:

- Our applications for patents and trademarks relating to our business may not be granted and, if granted, may be challenged or invalidated;
- Issued patents and trademarks may not provide us with any competitive advantages;
- Our efforts to protect our intellectual property rights may not be effective in preventing misappropriation of our technology;
- Our efforts may not prevent the development and design by others of products or technologies similar to or competitive with, or superior to those we develop; or
- Another party may obtain a blocking patent and we would need to either obtain a license or design around the patent in order to continue to offer the contested feature or service in our products.

***It will be extremely difficult to acquire jurisdiction and enforce liabilities against our officers, directors and assets based in China***

Our executive officers and several of our directors, including the chairman of our Board of Directors, are Chinese citizens. It may be difficult, if not impossible, to acquire jurisdiction over these persons in the event a lawsuit is initiated against us and/or our officers and directors by a stockholder or group of stockholders in the United States. Also, because our operating subsidiaries and assets are located in China, it may be extremely difficult or impossible for you to access those assets to enforce judgments rendered against us or our directors or executive offices by United States courts. In addition, the courts in China may not permit the enforcement of judgments arising out of United States federal and state corporate, securities or similar laws. Accordingly, United States investors may not be able to enforce judgments against us for violation of United States securities laws.

**Risks Related to Our Securities**

***Shares of our common stock lack a significant trading market***

Our shares are not eligible for trading on any national securities exchange. Prices for the shares of our common stock are quoted in the over-the-counter market on the OTC Bulletin Board, but there has been no meaningful volume in the trading of our shares and the market for our shares is highly illiquid. Although we have applied for the listing of our common stock on the NASDAQ Stock Market, there is no assurance that our application will be granted. There is no assurance that an active trading market in our common stock will ever develop, or, if such a market develops, that it will be sustained. In addition, there is a greater chance for market volatility for securities that quoted are on the OTC Bulletin Board as opposed to securities that trade on a national exchange. This volatility may be caused by a variety of factors, including the lack of readily available quotations, the absence of consistent administrative supervision of "bid" and "ask" quotations and generally lower trading volume. As a result, an investor may find it more difficult to dispose of, or to obtain accurate quotations as to the market value of, the common stock, or to obtain coverage for significant news events concerning us, and the common stock would become substantially less attractive for margin loans, for investment by financial institutions, as consideration in future capital raising transactions or other purposes.

***Our director and Chief Executive Officer has a substantial ownership interest in one of our major stockholders which gives him significant influence over certain major decisions on which our stockholders may vote and may discourage an acquisition of us***

Mr. Jun Wang, our director and Chief Executive Officer, owns of 50% of the equity in Beijing YSKN Machinery & Electronic Equipment Co., Ltd ("YSKN"), a company which is the record holder of 30.19% of our outstanding common stock. Mr. Wang has substantial influence over the actions of that substantial stockholder. As a result, Mr.

Wang has significant influence over all corporate actions requiring stockholder approval, irrespective of how the Company's other stockholders may vote, including the following actions:

- electing or defeating the election of our directors;
- amending or preventing amendment of our certificate of incorporation or bylaws;
- effecting or preventing a merger, sale of assets or other corporate transaction; and
- controlling the outcome of any other matter submitted to the shareholders for vote.

The interests of Mr. Wang may differ from the interests of other stockholders. This may discourage a potential acquirer from making a tender offer or otherwise attempting to obtain control of the Company, which in turn could reduce our stock price or prevent our stockholders from realizing a premium over our stock price.

***Because we obtained our present operations by means of a "reverse acquisition," we may not be able to attract the attention of major brokerage firms***

There may be risks associated with our use of a "reverse acquisition" to obtain our present operations. Securities analysts of major brokerage firms may not provide coverage of us since there is no incentive to brokerage firms to recommend the purchase of our common stock. No assurance can be given that brokerage firms will, in the future, want to conduct any secondary offerings on our behalf.

***Future sales of shares of our common stock by our stockholders could cause our stock price to decline***

We cannot predict the effect, if any, that market sales of shares of our common stock or the availability of shares of common stock for sale will have on the market price prevailing from time to time. If our stockholders sell substantial amounts of our common stock in the public market upon the effectiveness of a registration statement, or upon the expiration of any holding period under Rule 144, such sales could create a circumstance commonly referred to as an "overhang" and in anticipation of which the market price of our common stock could fall. The existence of an overhang, whether or not sales have occurred or are occurring, also could make more difficult our ability to raise additional financing through the sale of equity or equity-related securities in the future at a time and price that we deem reasonable or appropriate. The 18,500,000 shares of common stock we issued in the share exchange with the former shareholders of Taiyu will be freely tradable upon the earlier of (i) effectiveness of a registration statement covering such shares; and (ii) the date on which such shares may be sold without registration pursuant to Rule 144 under the Securities Act and the sale of such shares could have a negative impact on the price of our common stock.

***We may issue additional shares of our capital stock or debt securities to raise capital or complete acquisitions, which would reduce the equity interest of our stockholders***

Our articles of incorporation authorize the issuance of up to 75,000,000 shares of common stock, par value \$.001 per share. There are approximately 50,408,000 authorized and unissued shares of our common stock which have not been reserved and are available for future issuance. Although we have no commitments as of the date of this offering to issue our securities, we may issue a substantial number of additional shares of our common stock, to complete a business combination or to raise capital. The issuance of additional shares of our common stock:

- may significantly reduce the equity interest of our existing stockholders; and
- may adversely affect prevailing market prices for our common stock.

***We have not paid dividends in the past and do not expect to pay dividends in the future. Any return on investment may be limited to the value of our common stock***

We have never paid cash dividends on our common stock and do not anticipate doing so in the foreseeable future. We presently do not intend to pay dividends in the foreseeable future. Our management intends to follow a policy of retaining all of our earnings to finance the development and execution of our strategy and the expansion of our business. In addition, the payment of dividends is limited by Chinese law. See "RISK FACTORS - Risks Relating to Doing Business in China - *Limitations on the ability of our operating subsidiary to make payments to us could have a material adverse effect on our ability to conduct our business and fund our operations.*"

## **FORWARD-LOOKING STATEMENTS**

This prospectus contains forward-looking statements that reflect our current expectations and views of future events. The forward looking statements are contained principally in the sections entitled "Prospectus Summary," "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Business." Known and unknown risks, uncertainties and other factors, including those listed under "Risk Factors," may cause our actual results, performance or achievements to be materially different from those expressed or implied by the forward-looking statements.

You can identify some of these forward-looking statements by words or phrases such as "may," "will," "expect," "anticipate," "aim," "estimate," "intend," "plan," "believe," "is/are likely to," "potential," "continue" or other similar expressions. We base these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. These forward-looking statements include statements relating to:

- our goals and strategies;
- our expansion plans;
- our future business development, financial conditions and results of operations;
- the expected growth of the market for PHE products and heat meters in China;
- our expectations regarding demand for our products;
- our expectations regarding keeping and strengthening our relationships with key customers;
- our ability to stay abreast of market trends and technological advances;
- our ability to effectively protect our intellectual property rights and not infringe on the intellectual property rights of others;
- our ability to attract and retain quality employees;
- our ability to pursue strategic acquisitions and alliances;
- competition in our industry in China;
- general economic and business conditions in the regions in which we sell our products;

- relevant government policies and regulations relating to our industry; and
- market acceptance of our products.

These forward-looking statements involve various risks and uncertainties. Although we believe that our expectations expressed in these forward-looking statements are reasonable, our expectations may later be found to be incorrect. Our actual results could be materially different from our expectations. Important risks and factors that could cause our actual results to be materially different from our expectations are generally set forth in “Risk Factors,” “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” “Business,” and other sections in this prospectus. You should read thoroughly this prospectus and the documents that we refer to with the understanding that our actual future results may be materially different from and worse than what we expect. We qualify all of our forward-looking statements by these cautionary statements. Other sections of this prospectus include additional factors which could adversely impact our business and financial performance.

This prospectus contains statistical data that we obtained from various government and private publications. We have not independently verified the data in these reports. Statistical data in these publications also include projections based on a number of assumptions. The market for the PHEs, PHE Units, and heat meters may not grow at the rate projected by market data, or at all. The failure of this market to grow at the projected rate may have a material adverse effect on our business and the market price of our securities. In addition, the rapidly changing nature of our customers' industries results in significant uncertainties in any projections or estimates relating to the growth prospects or future condition of our market. Furthermore, if any one or more of the assumptions underlying the market data is later found to be incorrect, actual results may differ from the projections based on these assumptions. You should not place undue reliance on these forward-looking statements.

Unless otherwise indicated, information in this prospectus concerning economic conditions and our industry is based on information from independent industry analysts and publications, as well as our estimates. Except where otherwise noted, our estimates are derived from publicly available information released by third party sources, as well as data from our internal research, and are based on such data and our knowledge of our industry, which we believe to be reasonable. None of the independent industry publication market data cited in this prospectus was prepared on our or our affiliates' behalf.

The forward-looking statements made in this prospectus relate only to events or information as of the date on which the statements are made in this prospectus. Except as required by law, we undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise, after the date on which the statements are made or to reflect the occurrence of unanticipated events. You should read this prospectus and the documents that we refer to in this prospectus and have filed as exhibits to the registration statement, of which this prospectus is a part, completely and with the understanding that our actual future results may be materially different from what we expect.

### **AVAILABLE INFORMATION**

This prospectus is part of a Registration Statement on Form S-1 we have filed with the SEC. We have not included in this prospectus all of the information contained in the registration statement and you should refer to our registration statement and its exhibits for further information.

We file annual, quarterly, and special reports, proxy statements, and other information with the SEC. You may read and copy any document we file at the SEC's public reference room at 100 F Street, N.E., Washington, D.C. 20549. Copies of these materials may also be obtained from the SEC at prescribed rates by writing to the Public Reference Section of the SEC, 100 F Street, N.E., Washington, D.C. 20549. You may obtain information about the operation of the SEC public reference room in Washington, D.C. by calling the SEC at 1-800-SEC-0330. Our filings are also available to the public from commercial document retrieval services and at the website maintained by the SEC at <http://www.sec.gov>.

Our Web site address is <http://www.smartheatinc.com>. The information on our Web site is not incorporated into this prospectus.

### **USE OF PROCEEDS**

We will not receive any proceeds from sale of the shares of common stock covered by this prospectus by the selling shareholders. We will, however, receive proceeds on exercise of outstanding warrants for shares of common stock covered by this prospectus if the warrants are exercised for cash. The warrants may expire without having been exercised. Even if some or all of these warrants are exercised, we cannot predict when they will be exercised and when we would receive the proceeds. We intend to use any proceeds we receive upon exercise of the warrants for general working capital and other corporate purposes.





**MARKET FOR COMMON STOCK AND RELATED SHAREHOLDER MATTERS****Market Information**

Our common stock is not listed on any stock exchange but has traded on the OTC Bulletin Board under the symbol "SMHT" since April 22, 2008. The following table set forth the range of the high and low bid prices per share of our common stock for each of the following periods as reported by the OTC Bulletin Board: from April 22, 2008 through June 30, 2008 and from July 1, 2008 through October 16, 2008. These quotations represent inter-dealer prices, without retail mark-up, markdown, or commission and may not represent actual transactions. The last price of our common stock as reported on the OTC Bulletin Board on October 15, 2008 was \$4.70 per share.

	High	Low
April 22, 2008 through June 30, 2008	\$ 4.60	\$ 4.50
July 1, 2008 through October 16, 2008	\$ 4.75	\$ 4.00

 **Holders**

As of October 16, 2008, there were 238 shareholders of record of our common stock. Since some of our shares of common stock are held in street or nominee name, it is believed that there are a substantial number of additional beneficial owners of our common stock.

**Dividend Policy**

We have not paid any cash dividends on our common stock to date, and we have no intention of paying cash dividends in the foreseeable future. Whether we will declare and pay dividends in the future will be determined by our board of directors at their discretion, subject to certain limitations imposed under Nevada corporate law. In addition, our ability to pay dividends may be affected by the foreign exchange controls in China. See "RISK FACTORS - *Limitation on the ability of our operating subsidiary to make payments to us could have a material adverse effect on our ability to conduct our business and fund our operations.*" The timing, amount and form of dividends, if any, will depend on, among other things, our results of operations, financial condition, cash requirements and other factors deemed relevant by our board of directors.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Safe Harbor Declaration

*The comments made throughout this prospectus should be read in conjunction with our financial statements and the notes thereto, and other financial information appearing elsewhere in this document. In addition to historical information, the following discussion and other parts of this document contain certain forward-looking information. When used in this discussion, the words, "believes," "anticipates," "expects," and similar expressions are intended to identify forward-looking statements. Such statements are subject to certain risks and uncertainties, which could cause actual results to differ materially from projected results, due to a number of factors beyond our control. SmartHeat does not undertake to publicly update or revise any of its forward-looking statements, even if experience or future changes show that the indicated results or events will not be realized. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Readers are also urged to carefully review and consider our discussions regarding the various factors, which affect company business, included in this section and elsewhere in this prospectus.*

### Overview

We were incorporated in the State of Nevada on August 4, 2006 under the name Pacific Goldrim Resources, Inc. as an exploration stage corporation that intended to engage in the exploration of silver, lead and zinc. On April 14, 2008 we changed our name to SmartHeat Inc. and acquired all of the equity interests in Taiyu.

Prior to our acquisition of Taiyu, we were in the development stage and had minimal business operations. We had no interest in any property, but had the right to conduct exploration activities on thirteen (13) mineral title cells covering 270.27 hectares (667.85 acres) in the Slocan Mining Division of southeastern British Columbia, Canada. In connection with the acquisition of Taiyu, we transferred our prior assets and liabilities to a wholly owned subsidiary and sold all of the outstanding capital stock of that subsidiary to our former director and officer in exchange for 2,500,000 shares of our common stock.

Taiyu was formed in July 2002 under the laws of China and is headquartered in Shenyang City, Liaoning Province, China. As a result of our acquisition of Taiyu, we are a leading provider of plate heat exchange products to China's industrial, residential, and commercial markets, specializing in the manufacturing, sale, research, and servicing of PHEs, PHE Units and heat meters for a broad range of industries such as petroleum refinement, petrochemicals, power generation, metallurgy, food & beverage, and chemical processing. We sell PHEs under the Sondex brand and PHE Units that are designed by us and using PHEs that are assembled with Sondex plates under our Taiyu brand name.

Our revenue is subject to fluctuations due to the timing of sales of high-value products, the impact of seasonal spending patterns, the timing and size of projects our customers perform, changes in overall spending levels in the industry and other unpredictable factors that may affect customer ordering patterns. Any significant delays in the commercial launch or any lack or delay of commercial acceptance of new products, unfavorable sales trends in existing product lines, or impacts from the other factors mentioned above, could adversely affect our revenue growth or cause a sequential decline in quarterly revenue. Due to the possibility of fluctuations in our revenue and net income or loss, we believe that quarterly comparisons of our operating results are not a good indication of future performance.

*While our significant accounting policies are more fully described in Note 1 to our consolidated financial statements, we believe that the following accounting policies are the most critical to aid you in fully understanding and evaluating this management discussion and analysis.*

**Basis of Presentation**

The audited financial statements as of December 31, 2007 and 2006 that are presented are those of Taiyu rather than SmartHeat because Taiyu is our operating business, and SmartHeat's acquisition of Taiyu was deemed completed on April 14, 2008. The financial statements are prepared in accordance with generally accepted accounting principles in the United States of America. Our acquisition of Taiyu has been accounted for as a recapitalization of Taiyu as Taiyu's shareholders are the majority shareholders of SmartHeat.

## Principle of Consolidation

The accompanying consolidated financial statements include the accounts of Taiyu and its 55% owned subsidiary, Qingdao Yushi Heat Power Equipment Co., Ltd ("Yushi"). Yushi is engaged in manufacturing and selling of heat power equipment. All significant inter-company accounts and transactions have been eliminated in consolidation.

## Use of Estimates

In preparing the financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the dates of the financial statements, as well as the reported amounts of revenues and expenses during the reporting year. Significant estimates, required by management, include the recoverability of long-lived assets and the valuation of inventories. Actual results could differ from those estimates.

## Accounts and Retentions Receivable

Our policy is to maintain reserves for potential credit losses on accounts receivable. Management reviews the composition of accounts receivable and analyzes historical bad debts, customer concentrations, customer credit worthiness, current economic trends and changes in customer payment patterns to evaluate the adequacy of these reserves. Accounts receivable are net of unearned interest. Unearned interest represents imputed interest on accounts receivable with due dates over one year from the invoice date discounted at our borrowing rate for the year.

## Inventories

Inventories are valued at the lower of cost or market with cost determined on a moving weighted average basis. Cost of work in progress and finished goods comprises direct material, direct production cost and an allocated portion of production overheads.

## Property and Equipment

Property and equipment are stated at cost, net of accumulated depreciation. Expenditures for maintenance and repairs are expensed as incurred; additions, renewals and betterments are capitalized. When property and equipment are retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the respective accounts, and any gain or loss is included in operations. Depreciation of property and equipment is provided using the straight-line method with a 10% salvage value and estimated lives ranging from 5 to 20 years as follows:

Building	20 years
Vehicle	5 years
Office Equipment	5 years
Production Equipment	5 - 10 years

## Revenue Recognition

Our revenue recognition policies are in compliance with SEC Staff Accounting Bulletin ("SAB") 104. Sales revenue is recognized at the date of shipment to customers when a formal arrangement exists, the price is fixed or determinable, the delivery is completed, no other significant obligations of SmartHeat exist and collectibility is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are recorded as unearned revenue.



## **Foreign Currency Translation and Comprehensive Income (Loss)**

Our functional currency is the Chinese yuan renminbi ("RMB"). For financial reporting purposes, RMB has been translated into United States dollars ("USD") as the reporting currency. Assets and liabilities are translated at the exchange rate in effect at the balance sheet date. Revenues and expenses are translated at the average rate of exchange prevailing during the reporting period. Translation adjustments arising from the use of different exchange rates from period to period are included as a component of shareholders' equity as "Accumulated other comprehensive income." Gains and losses resulting from foreign currency transactions are included in income. There has been no significant fluctuation in exchange rate for the conversion of RMB to USD after the balance sheet date.

We use Statement of Financial Accounting Standards ("SFAS") No. 130, "Reporting Comprehensive Income." Comprehensive income is comprised of net income and all changes to the statements of shareholders' equity, except those due to investments by shareholders, changes in paid-in capital and distributions to shareholders.

## **Recent Accounting Pronouncements**

### ***Business Combinations***

In December 2007, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141 (Revised 2007), Business Combinations. SFAS No. 141R will significantly change the accounting for business combinations. Under SFAS No. 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS No. 141R will change the accounting treatment for certain specific items, including:

- Acquisition costs will be generally expensed as incurred;
- Noncontrolling interests (formerly known as "minority interests" – see SFAS No. 160 discussion below) will be valued at fair value at the acquisition date;
- Acquired contingent liabilities will be recorded at fair value at the acquisition date and subsequently measured at either the higher of such amount or the amount determined under existing guidance for non-acquired contingencies;
- In-process research and development will be recorded at fair value as an indefinite-lived intangible asset at the acquisition date;
- Restructuring costs associated with a business combination will be generally expensed subsequent to the acquisition date; and
- Changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date generally will affect income tax expense.

SFAS No. 141R also includes a substantial number of new disclosure requirements. SFAS No. 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier adoption is prohibited. Accordingly, since we are a calendar year-end company we will continue to record and disclose business combinations following existing generally accepted accounting principles until January 1, 2009. We expect SFAS No. 141R will have an impact on accounting for business combinations once adopted but the effect is dependent upon acquisitions at that time.

### ***Noncontrolling Interests in Consolidated Financial Statements – An Amendment of ARB No. 51***

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51." SFAS No. 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement. SFAS No. 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the noncontrolling equity investment on the deconsolidation date. SFAS No. 160 also includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling interest. SFAS No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Like SFAS No. 141R discussed above, earlier adoption is prohibited. We have not completed our evaluation of the potential impact, if any, of the adoption of SFAS No. 160 on our consolidated financial position, results of operations and cash flows.



***Fair Value Measurements***

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements,” which establishes a framework for measuring fair value, and expands disclosures about fair value measurements required under the accounting pronouncements, but does not change existing guidance as to whether or not an instrument is carried at fair value. Additionally, it establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for fiscal year, including financial statements for an interim period within the fiscal year. We are currently evaluating the impact, if any, that SFAS No. 157 will have on our financial statements.

***Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans, an Amendment of FASB Statements No. 87, 88, 106, and 132R***

In September 2006, the FASB issued SFAS, No. 158, “Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans, an Amendment of FASB Statements No. 87, 88, 106, and 132R,” which requires employers to recognize the underfunded or overfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in the funded status in the year in which the changes occur through accumulated other comprehensive income. Additionally, SFAS No. 158 requires employers to measure the funded status of a plan as of the date of its year-end statement of financial position. The new reporting requirements and related new footnote disclosure rules of SFAS No. 158 are effective for fiscal years ending after December 15, 2006. We adopted the provisions of SFAS No. 158 for the year end 2006, and the effect of recognizing the funded status in accumulated other comprehensive income was not significant. The new measurement date requirement applies for fiscal years ending after December 15, 2008.

***Fair Value Option for Financial Assets and Financial Liabilities***

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115.” The statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The statement is effective as of the beginning of an entity’s first fiscal year that begins after November 15, 2007. We are analyzing the potential accounting treatment.

***Considering the Effects of Prior Year Misstatements in Current Year Financial Statements***

In September 2006, the SEC issued SAB No. 108, “Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements,” which provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. We adopted SAB No. 108 in the fourth quarter of 2006 with no impact on our financial statements.

**Results of Operations.*****Year Ended December 31, 2007 Compared to the Year Ended December 31, 2006***

The following table sets forth the results of our operations for the periods indicated as a percentage of net sales:

	<b>Year Ended December 31</b>			
	<b>2007</b>		<b>2006</b>	
	\$	% of Sales	\$	% of Sales
Sales	13,273,151		8,205,166	
Cost of sales	(8,667,353)	65.0%	(5,710,540)	70.0%
Gross Profit	4,605,798	35.0%	2,494,626	30.0%
Operating Expenses	(2,369,090)	18.0%	(1,642,721)	20.0%
Income from Operation	2,236,708	17.0%	851,905	10.0%
Other Income (Expenses), net	24,957	0.2%	39,587	0.5%
Net Income	2,087,891	16.0%	832,612	10.0%

*Sales.* Net sales for 2007 were approximately \$13.27 million, while our net sales in 2006 were approximately \$8.21 million, an increase in revenues of \$5.06 million, or 62%. The increase was due to growing demand for our products resulting from rapid increase in newly-built residential communities in Shenyang City and the surrounding area. We also increased the number of our sales representatives to develop new customers in more cities in China. We believe that our sales will continue to grow because we are strengthening our sales efforts by hiring more sales personnel, increasing the sales channels, and improving the quality of our products.

*Cost of Sales.* Cost of sales for 2007 were approximately \$8.67 million, while our cost of sales in 2006 were approximately \$5.71 million, an increase of \$2.96 million, or 52%. The increase in cost of sales can be attributed to the increase of production and sales activities in 2007. Cost of sales as a percentage of sales was approximately 65% for 2007 and 70% for 2006. The decrease in cost of sales as a percentage of sales in 2007 was mainly due to economies of scale, with a higher production volume resulting in a lower cost of each product manufactured. We believe that our cost of sales will continue to remain stable as we improve the efficiency of our manufacturing facility.

*Gross Profit.* Gross profit was \$4.61 million for 2007, as compared to \$2.49 million for 2006, representing gross margins of approximately 35% and 30% for 2007 and 2006, respectively. The increase in our gross profits and gross profit margin was mainly due to the increase of sales activities and to the economies of scale discussed above.

*Operating Expenses.* Operating expenses consisted of selling, general and administrative expenses totaled approximately \$2.37 million for 2007, as compared to \$1.64 million for 2006, an increase of approximately \$726,000 or 44%. The increase in operating expenses was mainly due to proportional increase in after-sale service, payroll, insurance and travel expenses with our increased sales and production.

*Net Income.* Our net income for the year ended December 31, 2007 was \$2.09 million as compared to approximately \$833,000 for the year ended December 31, 2006, an increase of \$1.26 million or 151%. This increase is attributable to economies of scale combined with rapid growth in revenue and efficiency of operations. Our management believes that net income will continue to increase as we continue to increase our sales, offer better quality products and control our manufacturing costs.

**Quarter Ended June 30, 2008 Compared to the Quarter Ended June 30, 2007**

The following table sets forth the results of our operations for the periods indicated as a percentage of net sales:

	For the Quarter Ended June 30,			
	2008		2007	
	\$	% of sales	\$	% of sales
Sales	5,558,232		1,159,098	
Cost of Sales	(4,115,200)	74.0	(756,368)	65.0
Gross Profit	1,443,032	26.0	402,730	35.0
Operating Expenses	(572,932)	10.0	(409,079)	35.0
Income from Operations	870,100	16.0	(6,349)	(0.6)
Other Income (Expenses), net	23,383	0.4	48,737	4.0
Net Income	732,412	13.0	3,219	0.3

**Sales.** Our net sales for the three months ended June 30, 2008 were approximately \$5.56 million while our net sales in same period for 2007 were approximately \$1.16 million, an increase in revenues of \$4.4 million, or about 380%. The increase was primarily due to the expansion of our sales force, growth of our existing sales channels to develop new customers and the extension of our customer base into new regions in China. We believe that our sales will continue to grow as we strengthen our sales efforts by hiring more sales personnel, expanding sales channels, and improving the quality of our products.

**Cost of Sales.** Our cost of sales for the three months ended June 30, 2008 were approximately \$4.12 million while our cost of sales for the same period in 2007, were approximately \$0.76 million, an increase of \$3.36 million, or 444%. The increase in cost of sales is attributed to increases in our production and sales during the period. Cost of sales as a percentage of sales was approximately 74% for the second fiscal quarter of 2008 and 65% for the same period in 2007. The increase in cost of sales as a percentage of sales for the second quarter of 2008 was mainly due to increases in the costs of new hired employees for our quality control, engineering and manufacturing departments, and increase in raw materials purchase price as a result of overall increases throughout China.

**Gross Profit.** Gross profit was \$1.44 million for the quarter ended June 30, 2008 as compared to \$0.4 million for the same period in 2007, representing gross margins of approximately 26% and 35% for the second quarter of 2008 and 2007, respectively. The increase in our gross profits was mainly due to the significant increase in our sales; while the decrease in our gross profit margin was mainly due to increased cost of manufacturing through increased cost of labor and depreciation expense for new acquired manufacturing equipment. In addition, we had more sales on (flat) plate heat exchanger than assembled heat exchanger units during the quarter ended June 30, 2007. Assembled heat exchanger units have a relatively higher profit margin than (flat) plate heat exchangers as more profits can be added on to the parts that are used for the assembly of the whole unit. We believe our gross profit margin will increase due to the economies of scale as we continue to increase our production, improve efficiency on cost control and increase the sales of assembled heat exchanger units.

**Operating Expenses.** Operating expenses, consisting of selling, general and administrative expenses, totalled approximately \$0.57 million for the three months ended June 30, 2008 as compared to \$0.41 million for the same period in 2007, an increase of approximately \$0.16 million or 40%. The increase in operating expenses was mainly due to proportional increases in after-sale service, payroll, insurance and travel expenses, coupled with our increased sales and production.

**Net Income.** Our net income for the three month period ended June 30, 2008 was approximately \$0.73 million as compared to \$3,219 for the same period in 2007, an increase of \$729,193 or 22753%. This increase is attributable to economies of scale combined with rapid growth in revenue and efficiency of operations. Our management believes

that net income will continue to increase as we continue to increase our sales, offer better quality products and control our manufacturing costs.

**Six Months Ended June 30, 2008 Compared to the Six Months Ended June 30, 2007**

The following table sets forth the results of our operations for the periods indicated as a percentage of net sales:

	For the Six Months Ended June 30,			
	2008		2007	
	\$	% of Sales	\$	% of Sales
Sales	8,637,283		2,457,967	
Cost of sales	(6,228,156)	72.0	(1,598,789)	65.0
Gross Profit	2,409,127	28.0	859,178	35.0
Operating Expenses	(1,054,498)	12.0	(783,735)	32.0
Income from Operation	1,354,629	16.0	75,443	3.0
Other Income (Expenses), net	115,074	1.3	140,285	6.0
Net Income	1,203,675	14.0	165,088	7.0

**Sales.** Our net sales for six months ended June 30, 2008 were approximately \$8.64 million while our net sales for the same period in 2007 were approximately \$2.46 million, an increase in revenues of \$6.18 million, or 251%. The increase was due to growing demand for our product resulting from rapid increase in newly-built residential communities in Shenyang City and surrounding areas. We also increased the number of our sales representatives to develop new customers in more cities in China. We believe that our sales will continue to grow because we are strengthening our sales efforts by hiring more sales personnel, increasing the sales channels, and improving the quality of our products.

**Cost of Sales.** Our cost of sales for six months ended June 30, 2008 were approximately \$6.23 million while our cost of sales for the same period in 2007 were approximately \$1.6 million, an increase of \$4.63 million, or 290%. The increase in cost of sales is attributed to the increase of production and sales activities in 2008. Cost of sales as a percentage of sales was approximately 72% for the six months ended June 30, 2008 and 65% for the same period in 2007. The increase in cost of sales as a percentage of sales for six months ended June 30, 2008 was mainly due to an increase in the costs of new hired employees for our quality control, engineering and manufacturing departments, and an increase in raw materials purchase price as a result of overall increases throughout China.

**Gross Profit.** Gross profit was \$2.41 million for six months ended June 30, 2008 as compared to \$0.86 million for the same period in 2007, representing gross margins of approximately 28% and 35% for six months ended June 30, 2008 and 2007, respectively. The increase in our gross profits due to the increase of sales activities and decrease in gross profit margin was mainly due to the increase in manufacturing cost discussed above. We believe our gross profit margin will increase due to the economy of scale as we will increase our production and improving our efficiency on cost control.

**Operating Expenses.** Operating expenses consisted of selling, general and administrative expenses totalled approximately \$1.05 million for six months ended June 30, 2008 as compared to \$0.78 million for the same period in 2007, an increase of approximately \$270,763 or 35%. The increased in operating expenses was mainly due to increase in rental expense as we leased new offices for our representatives in the major cities of China, after-sale service, payroll, insurance and travel expenses coupled with our increased sales and production.

**Net Income.** Our net income for six months ended June 30, 2008 was \$1.20 million as compared to approximately \$165,088 for the same period in 2007, an increase of \$1.04 million or 629%. This increase is attributable to economy of scale combined with rapid growth in revenue and efficiency of operations. Our management believes that net income will continue to increase as we continue to increase our sales, offer better quality products and control our manufacturing costs.



**Liquidity and Capital Resources**

The following is a summary of cash provided by or used in each of the indicated types of activities during year ended December 31, 2007 and 2006:

	<b>For the Year Ended December 31,</b>	
	<b>2007</b>	<b>2006</b>
Cash provided by (used in):		
Operating Activities	\$ 3,047	\$ (51,587)
Investing Activities	(909,280)	(889,490)
Financing Activities	1,075,719	967,328

Net cash flow provided by operating activities was \$3,047 in fiscal 2007, as compared to net cash flow used in operating activities of \$51,587 in fiscal 2006. The increase in net cash flow from operating activities in fiscal 2007 was mainly due to a decrease in inventory, increase in customer deposits, tax and other payables. In addition, our net income has increased rapidly compared to 2006 which brought more cash to the company, but at the same time, our accounts receivable have increased which held back our cash inflows.

Net cash flow used in investing activities was \$909,280 for fiscal 2007, as compared to net cash used in investing activities of \$889,490 in fiscal 2006. The increase of net cash flow used in investing activities in fiscal 2007 was mainly due to acquisition of manufacturing equipment and other office equipment and furniture during the year.

Net cash flow provided by financing activities was \$1,075,719 in fiscal 2007 as compared to net cash provided by financing activities of \$967,328 for fiscal 2006. The increase of net cash flow provided by financing activities in fiscal 2007 was mainly due to increased short term loans with banks and other third parties.

As of June 30, 2008, we had cash and cash equivalents of approximately \$207,495. Working capital was approximately \$4.74 million at June 30, 2008. The ratio of current assets to current liabilities was 1.36:1 at June 30, 2008.

The following is a summary of cash provided by or used in each of the indicated types of activities during the six months ended June 30, 2008 and 2007:

	<b>For the Six Months Ended June 30,</b>	
	<b>2008</b>	<b>2007</b>
Cash provided by (used in):		
Operating Activities	\$ 442,015	\$ 998,953
Investing Activities	(388,681)	(1,080,443)
Financing Activities	(258,014)	1,315,429

Net cash flow provided by operating activities was \$442,015 for six month ended June 30, 2008, as compared to net cash flow provided by operating activities of \$998,953 for six month ended June 30, 2007. The decrease in net cash flow from operating activities for six month ended June 30, 2008 was mainly due to increase in advance to suppliers and other receivables, decrease in customer deposits. In addition, our net income for six month ended June 30, 2008 has increased rapidly compared to the same period of 2007, bringing more cash in to the Company, while at the same time our accounts receivables have increased significantly, reducing our cash inflows.

Net cash flow used in investing activities was \$388,681 for six month ended June 30, 2008, as compared to net cash used in investing activities of \$1,080,443 in the same period of 2007. The decrease of net cash flow used in investing activities in six month ended June 30, 2008 was mainly due to the completion of construction in progress that was commenced in 2007 and a decrease in restricted cash that was pledged for the guarantee of certain contracts execution and completion.

Net cash flow used in financing activities was \$258,014 for the six months ended June 30, 2008 as compared to net cash provided by financing activities of \$1,315,429 for the same period of 2007. The decrease of net cash inflow provided by financing activities for the six months ended June 30, 2008 was mainly due to decreased short term loans with banks and other third parties.

### Off-Balance Sheet Arrangements

We have not entered into any other financial guarantees or other commitments to guarantee the payment obligations of any third parties. We have not entered into any derivative contracts that are indexed to our shares and classified as shareholder's equity or that are not reflected in our consolidated financial statements. Furthermore, we do not have any retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity. We do not have any variable interest in any unconsolidated entity that provides financing, liquidity, market risk or credit support to us or engages in leasing, hedging or research and development services with us.

### Contractual Obligations

The Company was obligated for the following short term loans payable as of December 31, 2007:

	<b>Balance at December 31, 2007 (US\$)</b>
Short term loan with China CITIC Bank in the PRC for 6,000,000 RMB, or \$822,526. This loan was entered into on Apr 28, 2007 and is due on Apr 12, 2008. This loan bears interest at 7.029% per annum.	\$ 822,526
Short term loan with Citibank (China) Co., Ltd with branch in the PRC for 10,200,000 RMB. This loan was entered into on Jun 25, 2007 and is due on Jun 24, 2008. This loan bears interest at 5.265% per annum.	1,302,333
The Company entered into a series of short term loans during 2006 and 2007 with a third party company in the PRC for total of 10,300,000 RMB. Some of the loans will mature on various dates in year 2008 and some of the loans are payable on demand. These loans bear interest at 6.903% per annum.	1,412,003
The Company entered into a series of short term loans during 2006 with another third party company in the PRC for total of 2,850,000 RMB, or \$390,700. These loans are due on various dates in year 2008. These loans bear interest at 6.903% per annum.	390,701
The Company entered into a short term loan with another third party company in the PRC for 5,050,000 RMB. This loan was entered into on Aug 31, 2005 and was due on Aug 31, 2006. This loan bears no interest. Imputed interest on the loan was immaterial. This loan became payable on demand after Aug 31,	692,293



2006.

\$ 4,619,856

The Company was obligated for the following short term loans payable as of June 30, 2008:

	<b>Balance at June 30, 2008 (US\$)</b>
The Company entered into a short term loan with a commercial bank in the PRC for 6,000,000 RMB, or \$822,526. This loan was entered into on April 28, 2007 and was due on April 12, 2008. This loan bears interest at 7.029% per annum. This loan was renewed on April 12, 2008 with new maturity date of June 13, 2009.	\$ 874,763
The Company entered into a series of short term loans during 2006 and 2007 with a third party company in the PRC for total of 10,300,000 RMB or \$1,412,003. Some of the loans will mature on various dates in year 2008 and some of the loans are payable on demand. These loans bear variable interest at 8.591% per annum for 2008 and 6.903% per annum for 2007.	1,233,999
The Company entered into a series of short term loans during 2006 with another third party company in the PRC for total of 2,850,000 RMB, or \$390,700. These loans are due on various dates in year 2008. These loans bear variable interest at 8.591% per annum for 2008 and 6.903% per annum for 2007.	414,834
The Company entered into a short term loan with another third party company in the PRC for 5,050,000 RMB or \$625,759. This loan was entered into on Aug 31, 2005 and was due on Aug 31, 2006. This loan bears no interest. Imputed interest on the loan was immaterial. This loan became payable on demand after Aug 31, 2006.	736,259
The Company entered into a short term loan on June 30, 2008 with another third party company in the PRC for total of 10,000,000 RMB, or \$1,458,000. This loan is due on Sept. 30, 2008 with interest rate of 10% per annum.	1,434,062
	\$ 4,693,917

## Recent Accounting Pronouncements

### *The Hierarchy of Generally Accepted Accounting Principles*

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles." SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP in the United States. SFAS 162 will not have an impact on the Company's financial statements.

### *Disclosures about Derivative Instruments and Hedging Activities*

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133." SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's

financial position, financial performance, and cash flows. Based on current conditions, the Company does not expect the adoption of SFAS 161 to have a significant impact on its results of operations or financial position.

***Non-Controlling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51***

In December 2007, the FASB issued SFAS No. 160, "Non-controlling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51." SFAS 160 establishes new accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a non-controlling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the non-controlling interest will be included in consolidated net income on the face of the income statement. SFAS 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the non-controlling equity investment on the deconsolidation date. SFAS 160 also includes expanded disclosure requirements regarding the interests of the parent and its non-controlling interest. SFAS 160 are effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Based on current conditions, the Company does not expect the adoption of SFAS 160 to have a significant impact on its results of operations or financial position.

***Business Combinations***

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), "Business Combinations." SFAS 141R will significantly change the accounting for business combinations. Under SFAS 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS 141R will change the accounting treatment for certain specific items, including:

- Acquisition costs will be generally expensed as incurred;
- Non-controlling interests (formerly known as "minority interests" - see SFAS 160 discussion above) will be valued at fair value at the acquisition date;
- Acquired contingent liabilities will be recorded at fair value at the acquisition date and subsequently measured at either the higher of such amount or the amount determined under existing guidance for non-acquired contingencies;
- In-process research and development will be recorded at fair value as an indefinite-lived intangible asset at the acquisition date;
- Restructuring costs associated with a business combination will be generally expensed subsequent to the acquisition date; and
- Changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date generally will affect income tax expense.

SFAS 141R also includes a substantial number of new disclosure requirements. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier adoption is prohibited. Accordingly, since we are a calendar year-end company we will continue to record and disclose business combinations following existing GAAP until January 1, 2009. The Company expects SFAS 141R will have an impact on accounting for business combinations once adopted but the effect is dependent upon acquisitions at that time.

***Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an Amendment of FASB Statements No. 87, 88, 106, and 132R***

In September 2006, the FASB, issued SFAS, No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an Amendment of FASB Statements No. 87, 88, 106, and 132R," which requires employers to recognize the underfunded or overfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in the funded status in the year in which the changes occur through accumulated other comprehensive income. Additionally, SFAS 158 requires employers to measure the funded status of a plan as of the date of its year-end statement of financial position. The new reporting requirements and related new footnote disclosure rules of SFAS 158 are effective for fiscal years ending after December 15, 2006. The Company adopted the provisions of SFAS 158 for the year end 2006, and the effect of recognizing the funded status in accumulated other comprehensive income was not significant. The new measurement date requirement applies for fiscal years ending after December 15, 2008.

***Accounting for Non-Refundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities***

In June 2007, the FASB issued FASB Staff Position No. EITF 07-3, "Accounting for Nonrefundable Advance Payments for Goods or Services Received for use in Future Research and Development Activities," which addresses whether non-refundable advance payments for goods or services that used or rendered for research and development activities should be expensed when the advance payment is made or when the research and development activity has been performed. Management is currently evaluating the effect of this pronouncement on our financial statements.

**OUR BUSINESS**

We are a leading provider of plate heat exchanger products to China's industrial, residential and commercial markets. We design, manufacture, sell, and service plate heat exchangers ("PHEs"), units which combine plate heat exchangers with various pumps, temperature sensors, valves, and automated control systems ("PHE Units"), and heat meters for a broad range of industries. We sell PHEs under the Sondex brand and PHE Units that are designed by our engineers and assembled with Sondex plates under our Taiyu brand name.

**Our Products**

*PHEs*

A PHE is a device which transfers energy, usually in the form of heat, from one fluid to another across a solid surface. PHEs are constructed through the use of specifically manufactured stainless steel, titanium, and nickel plates welded together. The quantity and size of the plates used along with the total size of the PHE varies according to particular application requirements but generally do not exceed the size of a large refrigerator. PHEs were first invented in the mid 1920s to control pressure and temperature, and to increase energy efficiency in industrial use. Because of the larger heat transfer surface area of the PHE, its heat transfer efficiency is superior to the shell-and-tube heat exchanger which has been the most commonly used commercial heat transfer product to date.

We are one of three authorized dealers of Sondex PHEs for the industrial and energy sectors in China. Our Sondex distribution territory is North China. As an authorized dealer of Sondex PHEs in China, we import finished stainless steel plates from Sondex and assemble customized PHEs based on our clients' specifications. All PHE design is done in-house by our engineers utilizing Sondex tailored software. In the initial year of our operations, the PHE was the cornerstone of our product line. As an authorized Sondex dealer, we have established a reputation as a high quality provider of PHEs in China. In May 2003, we began to sell customized PHE Units containing Sondex plates. While our direct third-party sales of PHEs have declined in recent years, the quantity of Sondex plates we supply has continued to grow as they are incorporated in the PHE Units we sell.

*PHE Units*

PHE Units are mainly used in petroleum refining, chemicals and petrochemicals, energy generation, HVAC, steel, medical, electronics, food & beverage processing and other manufacturing sectors to reduce energy waste through heat recovery, improve temperature and pressure controls and cool equipment. PHE Units are built by integrating PHEs with various pumps, temperature sensors, valves, and automated control systems to form a "unit" which is used along with other units to form a "PHE network" installed in the local district heating systems. We specialize in making PHE Units for HVAC systems in residential and commercial buildings.

We began designing, manufacturing and selling our branded PHE Units in May 2003. Our PHE Units are designed in-house by our system engineers employing online customized CAD design software based on Solid Works software

which is integrated with our real-time enterprise resource planning system databases. This advanced design platform provides the following benefits:

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- We can provide accurate price quotes instantly;
- Our purchasing function is immediately notified of any additional material orders needed; and
- Our manufacturing operations are able to schedule production so that goods are delivered on a just-in-time basis.

The production and sale of PHE Units have been central to our growth. PHE Units require a comparatively higher level of technical skill and knowledge of the application markets and this is reflected in the price. In the recent years, PHE Unit sales have contributed significantly to our revenue growth and high margins. Less than five years after entering the market, we have emerged as a leading domestic producer of PHE Units, with a market share of approximately 8% in China.

#### *Heat Meters*

While heating companies in many western countries have long used meters to measure customer heat usage and invoice customers, Chinese residents and commercial customers are largely billed based on the square footage of their utilized space. Meters indicate heat in legal heat units and the calibration of meters in many countries is regulated by government agencies and subject to local or national guidelines. Due to rising energy costs and the increased sensitivity to environmental issues, Chinese government and local utility companies have recently made the use of heat meters compulsory in several cities in China. As of January 2007, heat meters are required by law in the cities of Tianjin, Xingtai, Chengde, and Handan.

Using our established relationships with provincial governments and utility companies throughout China, we introduced our patented heat meters to the market during the second quarter of 2006. Sales to date have been insignificant. However, we plan to work with the various government entities to establish a national heating standard and become an active participant in China's heat meter market in the coming years.

#### **Market Overview**

Heat transfer technology was introduced to China in the 1960's from Russia, mainly for applications in the petroleum industry. Foreign manufacturers began to sell in China on a large commercial scale in the 1980's and have since dominated the Chinese market. As domestic producers sprang up in the late 1980's and 1990's they began to take an increasingly larger share of the market. The past decade has seen the rise of many domestic manufacturers along with joint venture operations between local and international firms. Today the market is split between domestic firms, foreign JVs and direct imports.

Today, heat exchangers are used in heat and power generation, HVAC and refrigeration, chemicals & petrochemicals, steel & metallurgy, aeronautics, textiles, food and beverage processing and various other manufacturing industries. Heat transfer equipment is also being employed in new energy applications such as wind, solar, biomass and waste disposal.

PHE technology is replacing the less efficient shell-and-tube heat exchange technology which is still being used in older buildings and manufacturing facilities in China. PHEs can be installed in these old buildings and facilities as well as in new ones since they are smaller than the traditional heat exchangers and can fit within existing installations.

PHEs are used in a wide range of industries with the principal demand originating in the petroleum refining, petrochemicals, power generation, metallurgy, food & beverage, and chemical processing industries.





Within the PHE industry, manufacturers are differentiated primarily based upon their reputation and the technology, improved efficiency, and durability of their products. Given the growing importance of energy conservation and waste reduction, PHEs are likely to play an increasingly important role in many industries.

China Heat Association believes that the domestic market for PHEs was approximately \$2.4 billion in 2007 and that it is expected to grow at an annual rate of about 30% until 2010 due to the continuation of industrialization and urbanization trends in China. China Heat Association also believes that the domestic market for PHE Units was approximately \$139 million in 2007 and it is expected to grow at an annual rate of 70% until 2010.

According to China's Ministry of Construction data, 2007 domestic demand for PHE Units in China was estimated at \$139 million and, combined with the replacement of shell and tube heat exchangers, is expected to increase by approximately 70% annually through 2010.

The global market for heat transfer products and compact PHE Units in 2006 was approximately \$12 billion and \$2.3 billion, respectively according to Alfa Laval, a leading manufacturer in our industry. Large international PHE producers include: Alfa Laval, Sondex, GEA, Tranter SWEP, Danfoss, and Hisaka Works.

New environmental policies and regulations are also expected to have a positive impact on the demand for PHE products.

## **Production**

Until recently, we conducted all of our manufacturing activities at our Shenyang plant. On September 25, 2008 we acquired San De Ke, a PHE manufacturing company located in Pudong district, Shanghai. San De Ke leases a manufacturing facility and business offices.

We generally operate on an 8 hour shift, with the exception of the high season from May to November, during which we may operate the plant for 11-12 hours a day. Production is driven by orders from clients and is scheduled on a just-in-time delivery basis. Our Shenyang facility currently has the capacity to produce 10 PHEs, 3 PHE Units, and 50 heat meters per day and our San De Ke facility has the capacity to produce 17 PHEs per day.

## **Marketing**

Since our entry into the market for PHE Units in May 2003, the Taiyu brand name has been promoted in conjunction with quality production and first-rate service by means of our successful track record, industry trade fairs and establishing and maintaining positive relationships with local governments in Beijing, Shenyang, Urumqi, Shandong, Jiangsu and Shanghai. We attend the bi-annual HVAC trade fair in Shanghai and Chinese environmental protection forums and we visit the local utilities companies, oil refiners, steel and food & beverage companies. Marketing costs are generally funded through working capital and expensed as incurred.

## **Suppliers**

### *Plates*

Plates are supplied by Sondex under the terms of our Sondex authorized dealer arrangement. We generally order stainless steel plates 2-3 months in advance based on production needs and forecasted sales. Plate purchases generally constitute 40% of our total annual raw material purchases. While we are an authorized dealer, annual or quarterly purchasing prices are not fixed and fluctuate according to Sondex's most recent pricing list.

### *Components*

Components generally include pumps, valves, pipes, and electronic meters purchased from a variety of internat