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China | Auto

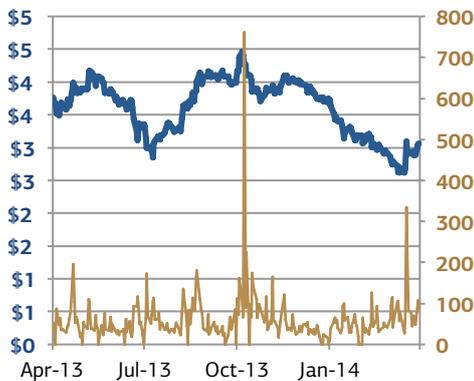
Geely Automobile (175 HK)

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What's happening to Geely's sales?

Geely Automobile (175 HK) one-year share price in HKD (blue) and volume (gold, in mln shares)



Source: Yahoo Finance, April 2, 2014

Geely Automobile (175 HK)

Price	HKD 3.06
Rating	SELL
Price target	HKD 2.53
Difference	17%
Market Cap	HKD 26.58 bln
Turnover.	61.6 bln
P/E	7.43x

Source: Yahoo Finance, April 2, 2014

+ Falling fast

While Geely reported a strong increase in core profit for FY 2013, company sales data for January-February 2014 and our checks with distributors and production facilities show a sharp turn down in 2014. The company will find it difficult to achieve its 6% YoY growth target for 2014. We are negative on Geely's sales and estimate an 8.7% decline for the year.

+ Exports fall 55%

We think the 55% decline in export volumes for January to February 2014 is more representative of the company's real export power than is the 17% Q4 reported growth. Geely is juicing numbers with generous credit to overseas partners. Not only is the company's ability to continue the credit program in doubt, but, also, political turmoil in Geely's top export destinations adds more uncertainty to overseas markets in 2014.

+ Inventories rising

We found 30 months of inventory stacked up in the channels, and dealers say it now takes them 2-3 months to sell a Geely car, compared with one month in early 2013.

+ PT HKD 2.53; recommendation: SELL

We reiterate our SELL recommendation and lower our PT to HKD 2.53 per share from HKD 3.13 based on our DCF valuation, with a WACC of 12.1% and terminal growth rate of 1%.

Underperforming sales

Geely's shares went up 15% after its earnings release on March 19. Total revenue and net profit rose, respectively, 17% and 31% YoY in 2013, beating the market consensus. However, the company's sales have been slowing down. Total revenue surged by 33% YoY in 2013 H1, but only had a slight 3.0% YoY increase in the year's second half, which is typically the peak season for auto sales. The recent release of monthly sales volume shows even worse sales in early 2014. Jan-Feb 2014 saw a 42% YoY decline of total sales, with domestic volume and export volume down by 40% YoY and 55% YoY, respectively.

Strong 2013 results mask a grinding of the gears down from 33% in 2013 H1 to 3% in H2, and sharply negative growth in early 2014.

Our checks with auto dealers and Geely's facilities confirm the current declining trend of the company's auto sales. Before, when Geely had good sales numbers, it took about one month for distributors to sell a car. Now distributors say two to three months. In an effort to sell cars quickly and clear inventory, heavy discounting is taking place. Distributors are offering promotions of up to 12% discounts on Geely's EC7 models, for instance.

Indeed, we believe the current drop in sales revenue comes from the distributors' need to clear their inventory. We looked through websites and found inventory of over 30 months available for sale.¹

Falling factory utilization

Geely operates nine production facilities in China. Based on our calculation of 2013 sales and production capacity for each plant, we found that most have been running at low utilization rates. Geely's Jinan plant, which produces mainly the EC8 model and has an annual production capacity of 60,000 units for one shift, had an estimated utilization rate of around 17.1% in 2013.

¹ <http://club.autohome.com.cn/bbs/thread-c-801-27439205-1.html>

Table 1. Est. production utilization rate in 2013

Production facilities	Annual production capacity (units per shift)	Produced models	Utilization rate in 2013
Linhai plant	75,000	GLEagle Panda (1.0L, 1.3L, 1.5L), GX2 (1.3L, 1.5L)	46.8%
Luqiao plant	100,000	Englon Kingkong (1.5L), SC5 (1.5L), SC6 (1.5L)	78.9%
Ningbo plant and Cixi Plant	160,000	Free Cruiser (1.3L, 1.5L), EC7 (1.8L), EC7-RV (1.5L, 1.8L)	65.7%
Cixi Plant	150,000	EC7	
Lanzhou plant	40,000	Free Cruiser (1.3L, 1.5L)	
Xiangtan plant	100,000	Vision (1.5L, 1.8L), SC7 (1.5L, 1.8L), GC7 (1.8L)	117.5%
Shanghai plant (Phase I)	30,000	TX4 (2.4L, 2.5L diesel)	
Jinan plant	60,000	EC8 (2.0L, 2.4L)	17.1%
Chengdu plant	60,000	GX7 (1.8L, 2.0L, 2.4L), SX7 (1.8L, 2.0L, 2.4L)	64.3%

Source: Company data, J Capital Research

Our checks indicate that several of Geely's plants have been producing at low utilization rates.

EC7 is Geely's best-selling model. It accounted for 35% of the company's total sales volume and 57% of its total export units in 2013. We visited Geely's Ningbo plant, which produces mainly the EC7 and Free Cruiser. The plant workers informed us that the production has been kept low, at only about 60% of the production in early 2013, due to lower orders both from domestic and overseas markets. They used to have two separate production areas for the two models, but have closed one and are now producing both models in one area.

At Geely's Luqiao plant, which produces mainly Geely's Kingkong, things are not optimistic either. Production volume is down by 40% with current utilization rate at about 65%. There is now only one shift of production.

Moreover, salaries at both plants were lowered by 25%.

Dealership restructuring

Geely has been focusing on restructuring its dealership to better manage its distribution network. Instead of selling different brands in different stores, Geely is trying to consolidate its dealers and

Geely's restructuring of its dealership network will affect its sales in the short-term.

allow them to sell all brands under their respective stores. However, this will cut the company's current distribution network by about 30%, which will clearly affect its sales in the near term. Furthermore, we believe that, even after the restructuring process, some distributors will have to quit the business, as selling Geely's cars is unprofitable to them. During our checks, we met a distributor in Xi'an who is about to close its store. A part of its store is already being leased to other distributors.

Lack of new models

Geely has increased R&D investment since 2012, but still lags behind its peers as % of total revenue. Its lack of new models is impacting negatively its revenues.

Table 2. R&D costs as % of total revenue: peer comparison

Company	2012	2013
Geely	0.8%	1.0%
Greatwall	2.2%	3.0%
BYD	2.6%	2.6%
JAC	3.3%	3.6%

Source: Company data

New car models are key to generate revenue, yet Geely is only launching two new models in 2014.

Our interviews with Geely's distributors indicate that new car models are key to generate future revenues for automakers. In 2014, Geely will launch nine models, among which seven are facelift or upgraded versions, and only two are brand new models: the EC9 and the GX9. The ASP of the EC9 is estimated at RMB 150,000–250,000,² while that of GX9 will be at RMB150,000–200,000.³ Both will be launched in 2014 H2, but we don't expect strong sales in 2014: customer acceptance of its new models is still unclear and Geely will be competing with some famous JV brands in the same price range.

Table 3. Geely's new models in 2014

Name of model
Facelift
GX2
GX7

² <http://auto.sohu.com/20131226/n392268044.shtml>

³ <http://www.dahecc.com/html/xincheshangshi/16788.html>

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SC5-RV
SC6
Upgraded versions
Geely Kingkong
EC7
EC7-RV
New models
EC9 - large size sedan ("KC")
GX9 - full size SUV

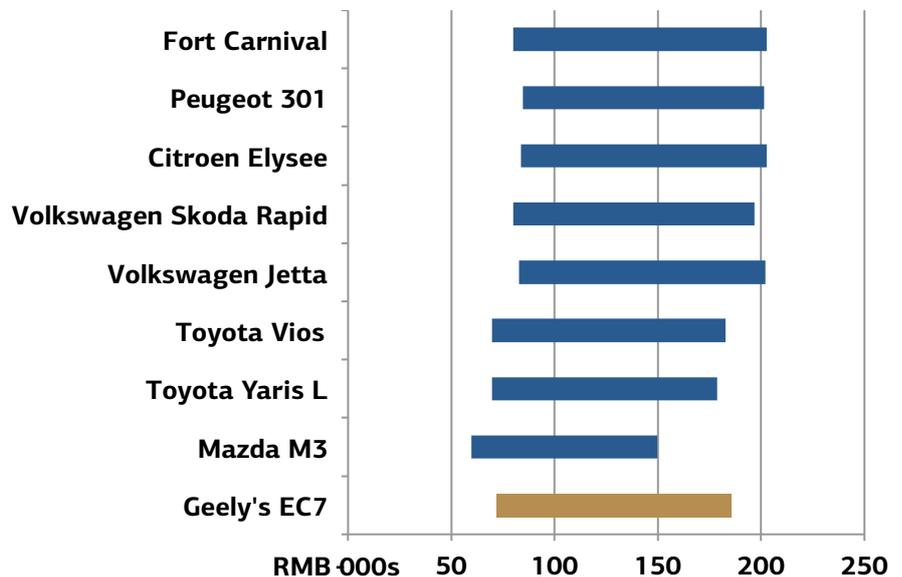
Source: Company data

Losing market share to JV brands

Increasing competition from JV brands will affect Geely's performance in the market.

Geely is facing increasing competition from JV brands, which have launched models in the same price range as its models. Take Geely's EC7 for example; this model is priced at RMB 71,800–113,800, overlapping JV brands' lower-end models such as Fort Carnival, Peugeot 301, Citroen Elysee, Skoda Rapid, among others.

Chart 1. ASP Comparison of JV Brands with Geely's EC7



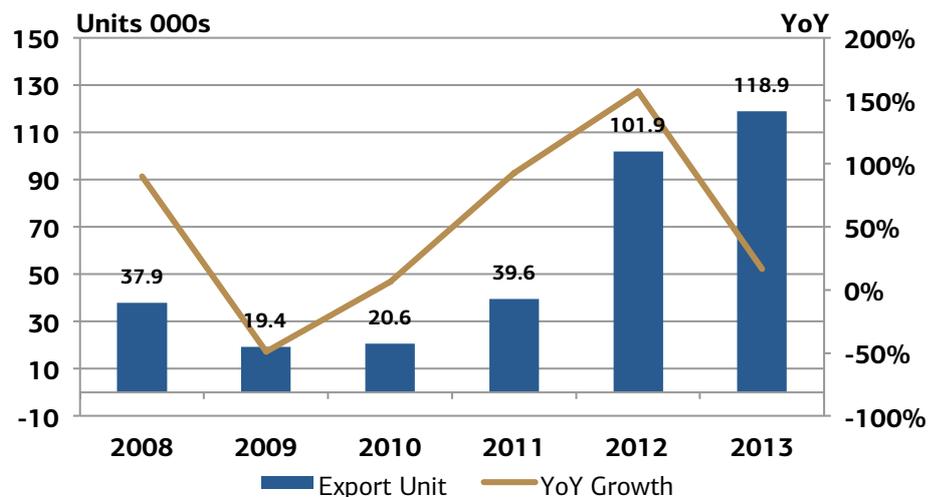
Source: Autohome, J Capital Research

Also, according to the CAAM, JV brands manufacture the top selling sedans in the Chinese market. Industry statistics show that, for the first two months of 2014, domestic brands saw a 0.99% YoY drop in their sales of passenger vehicles, and their market share diminished 4.78% YoY due to competition from JVs.

Deceleration of Exports

With its sales in the domestic market dropping, Geely's ray of hope for future growth seemed to be its exports. Export volume has increased since 2011, and contributed to 21.6% of Geely's total sales volume in 2013.

Chart 2. Exports



Source: Company data, J Capital Research

Geely's exports dropped YoY in early 2014; cars are not being sold in overseas market and distributors' inventories are rising.

However, Geely's most recently released monthly sales data show that exports during Jan-Feb 2014 were down 55% YoY, contrasting with the strong growth of past years. Our checks in the Ningbo and Luqiao plants confirmed that overseas orders shrank in early 2014 and there are no signs of an increase of orders yet.

Russia and Ukraine are among the top export destinations of Geely's passenger vehicles. But these are not necessarily being sold. According to industrial data published by the two countries, there are about 1.7 to 3.0 months of inventory.

Table 4. Inventory and exports of Geely vehicles

Country	Export data from Geely in 2013	Annual sales volume of Geely in 2013	Estimated Inventory months
Russia	34,000	27,263	3.0
Ukraine	18,810	16,436	1.7

Source: Autostat, AEB, J Capital

Unclear export outlook

Geely's top export destinations include Russia, Ukraine, Saudi Arabia, Iran and Egypt, all of which rely heavily on their natural resource industries for economic growth and all of which are

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suffering from political instability. Most of them are also experiencing weaker auto demand.

Russia

Geely gained market share in the Russian auto market, going from 0.6% to 1.0% in 2013, with its total sales volume increasing by 27,263 units in 2013 (55% YoY) and by 2,845 units during Jan-Feb 2014 (22% YoY).

This is very exciting news for Geely, as the entire Russian auto market saw a 5% decrease of sales of new cars and light commercial vehicles in 2013, and a 2% YoY drop in Jan-Feb 2014. However, because of the potential expiration of Russia's reduced rate car loan program in April 2014, it is uncertain how sales of new cars will perform this year in the Russian market.

Ukraine

Political instability in Ukraine may heavily impact Geely's export revenue.

Geely's senior director of brand management mentioned the company might reduce exports of unassembled cars to Ukraine due to the current political turmoil, according to an Autostat news report.⁴ Based on Geely's export data of unassembled car bodies in December 2013, we estimate that, in that month, the volume of Geely's unassembled car exports to Ukraine accounted for 39% of its total exports to Ukraine, and 16.9% of Geely's total exports. Reducing exports to Ukraine would clearly affect Geely's revenue.

Export volume disparities

Geely International Corporation is the subsidiary involved in export of sedans outside of China. We compared the December 2013 export data reported by Geely with the data we get from China Customs, and found a variance of 25.1%. If we include the exported car bodies of 1,496 units to Ukraine, the variance is still 15.4%.

Table 5. Comparison of reported export volume with Customs data

	Export volume
Geely reported export volume	11,843
Export volume from Customs data	8,876
Variance	-25.1%

Source: Company data, CS, J Capital Research

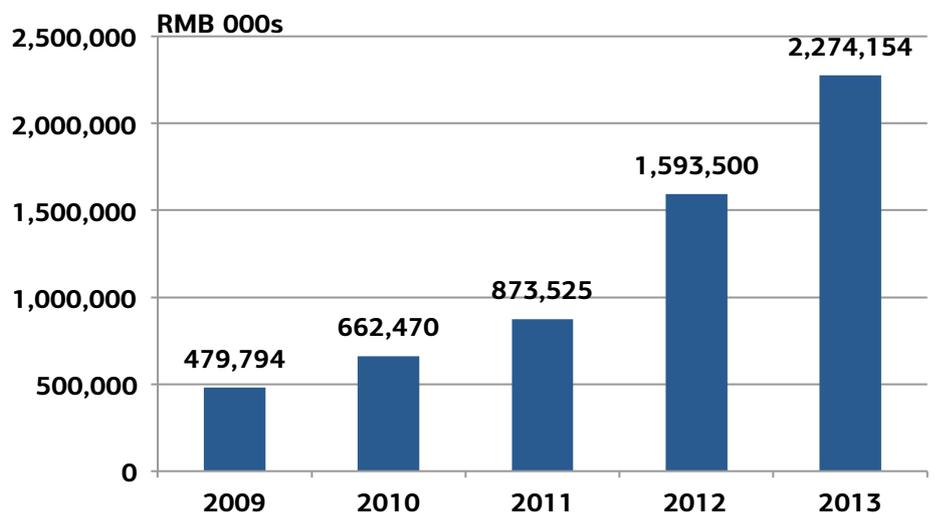
⁴ <http://eng.autostat.ru/news/view/9176/>

Without the generous credit terms that Geely has been offering to overseas partners, sales in their markets would not do as well.

Generous credit helped generate sales

Geely's trade and other receivables went up by 10%, to RMB 14.8 bln in 2013, mainly due to an increase of receivables from both its domestic and overseas trade customers. Geely offers very generous credit terms to its overseas partners, providing them a credit period from 6 to over 12 months. A normal inventory turnover of Geely's vehicles is about 2 to 3 months in overseas market. Hence, distributors can sell cars without touching their operating cash and pay Geely until they finally sell the car.

Chart 3. Trade and other receivables from overseas customers



Source: Company data

Reliance on government grants

Geely has reduced the proportion of government grants and subsidies to its profits down to 24.2% in 2013 from 34.4% in 2012. However, the figure is still very high compared with other Chinese manufacturers such as Great Wall and JAC. Although BYD has a proportion of 81.4%, Geely has the highest absolute amount, with RMB 800 mln.

Table 6. Government grants and subsidies

RMB 000s	2009	2010	2011	2012	2013
Government grants and subsidies	216,080	660,626	877,437	870,119	800,048
Pre-tax income	1,550,460	1,900,323	2,183,208	2,529,077	3,304,182
As % of Pre-tax income	13.9%	34.8%	40.2%	34.4%	24.2%

Source: Company data, J Capital Research

Table 7. Peer comparison of government grants and subsidies as % of pre-tax income

Company	2012	2013
Geely	34.4%	24.2%
Greatwall	1.8%	2.1%
BYD	189.3%	81.4%
JAC	45.6%	13.6%

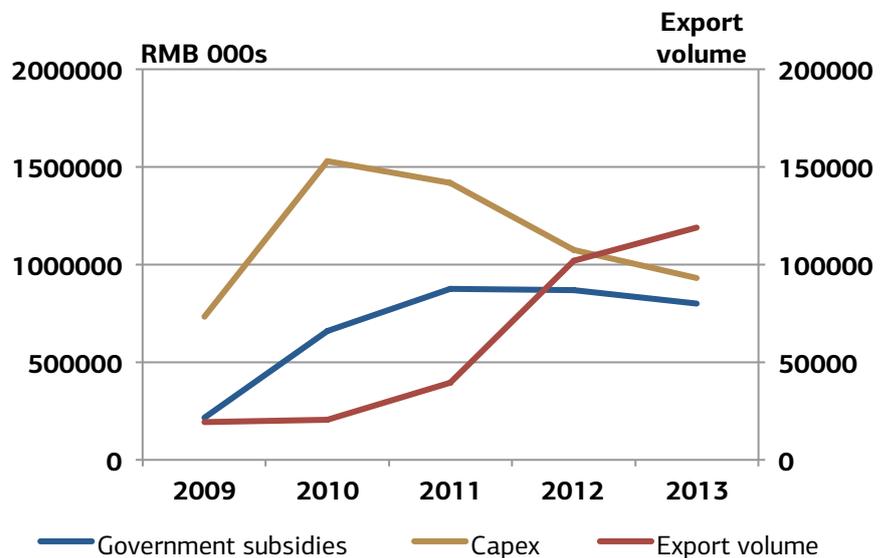
Source: Company data, J Capital Research

Geely's investment in R&D pales in comparison to other domestic brands.

In 2013, Geely only spent RMB 277 mln in R&D, about 1.0% of its total revenues, which is much lower than competitors Great Wall (RMB 1.7 bln), BYD (1.3 bln) and JAC (RMB 1.2 bln).

Although IR mentioned their R&D funding could reach 30% of its total R&D spending, about RMB 240 mln, we believe Geely may actually only get a small portion of R&D funding from the government, while the majority comes, on one hand, from both land & plant investments and, on the other, from export rebates, which allow Geely to benefit from 17% VAT refunds.

Chart 4. Subsidies, capex and exports



Source: Company data

Government subsidies obtained by Geely increased from RMB 216 mln to RMB 660 mln in 2010, and Geely's capex peaked at RMB 1.5 bln during that same year. Then subsidies increased to their highest level of RMB 877 mln in 2011, a year during which Geely maintained a high capex of RMB 1.4 bln and increased its export by 93%. In 2012, exports further increased by 157%, which helped

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A reduction in government grants and subsidies would be very costly for Geely.

Geely get substantial subsidies, while its capex decreased.

We believe Geely might still heavily rely on government subsidies to generate profits. As long as it keeps investments and increases exports, the company can always benefit from the government's policy on auto companies.

In 2014, Geely should get a big compensation from the local government of Taizhou—located in Zhejiang province—for the relocation of its Taizhou facility. Besides, Geely has many tax benefits in the new location and has paid about RMB 200,000 per acre for the land, much lower than the current transaction price of RMB 350,000, according to the local investment office.

Additionally, Geely signed an agreement with the Export-Import Bank of China for a RMB 20 bln credit facility in March 2014, which is mainly to support development of overseas facilities and export financing.

Valuation

We reiterate our SELL recommendation and lower down our target price to HKD 2.53 per share from HKD 3.13 based on our DCF valuation, with a WACC of 12.1% and terminal growth rate of 1%.

Based on our research, we believe it is hard for Geely to achieve its sales target of 580,000 units in 2014. Instead, we estimate sales to decline by 10% and 5%, respectively, in the domestic and overseas markets.

Risks

- New government subsidies.
- Stronger than expected economic recovery.
- Strong reception of Geely's new models.
- No impact from political conditions in Geely's export destinations.

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