October 10, 2014

China | Building Materials

Anhui Conch (914 HK)

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Empty shell

+ Sales and margins overstated

Conch has been an industry darling with margins vastly outpacing those of peers. We believe this has to do with overstatement of production, which allows the company to claim a lower cost base. We estimate ASPs 12% lower than implied by Conch's financials.

+ No pricing power

Our checks indicate that, while company culture perpetuates a belief that Conch is an industry leader that can demand higher prices, in many markets, Conch is outside of the main production areas, has made little progress in gaining market share and power, and sells at 10-20% below competitors. Nor does Conch have an edge in supplying to the lucrative infrastructure projects.

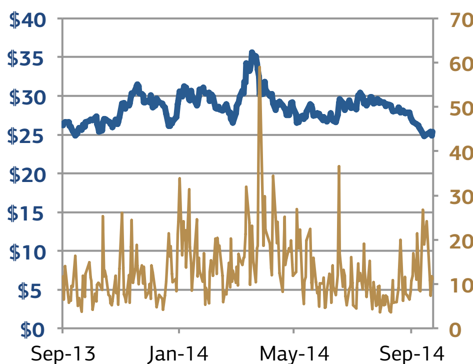
+ Exorbitant acquisitions

Despite stating in all of its most recent reports that overcapacity is the largest macro problem in the industry, Conch has doubled capacity over the past five years. Our look at Conch acquisitions suggests that it may be in the habit of booking assets at more than five times their implied value, justifying the cost by overstating production and capacity of the acquired facilities. This allows Conch to claim a larger market share and thus greater pricing power than otherwise and the corresponding increase in capex and acquisition price provides an explanation for where cash generated from impossible margins goes. The vast majority of Conch's PP&E is not factories at all: it is a massive land bank.

+ Initiating coverage: PT HKD 15.96

We initiate coverage with a price target of HKD 15.96 based on a DCF valuation.

Anhui Conch (914 HK) one-year share price in HKD (blue) and volume (gold, in mln shares)



Source: Bloomberg, October 10, 2014

Anhui Conch (914 HK)

Price	HKD 25.35
Rating	**SELL**
Price target	**HKD 15.96**
Difference	**-37%**
Market Cap	HKD 121.3 bln
Simple Moving Avg.	14.2 M
P/E	8.74x
Float	91%

Source: Bloomberg, October 10, 2014

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Company introduction

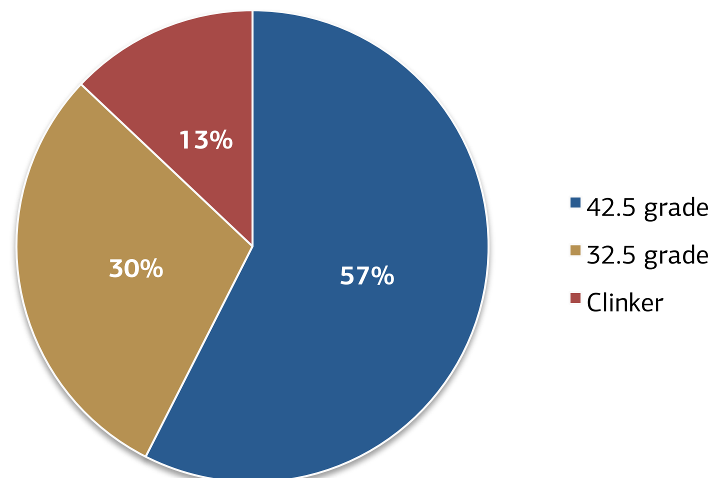
Anhui Conch is China's largest consolidated cement producer, accounting for between 5-7% of total Chinese cement production over the last three years, according to our most optimistic calculations. It derives all revenues from sales of cement clinker and Portland cement grades 32.5 (lower grade) and 42.5 (construction grade). Conch's main advantage is its ability to leverage its size to garner infrastructure contracts in big cities, thus insulating it from some market fluctuation in the commercial property market.

Anhui Conch is China's largest consolidated cement producer, with ~6% market share.

However, the company has been unable to command enough market share to control prices, and its margins and profits are therefore firmly linked to the macro environment. When macro conditions were weak in 2012, the company saw a 45.4% decline in profits on a 5.9% decrease in revenue due to price drops, while in 2013, stimulus allowed Conch to record a 20.3% increase in revenue and a 48.7% increase in profit.

2014 began well for Conch: though prices fell throughout the first half from the high of stimulus-drive 2013 H2, Conch recorded a 22% increase in revenue and a stunning 90% profit increase.

Chart 1. Sales revenue by segment, 2014 H1



Source: Company filings

In a (conch) shell

Conch has maintained a diverse geographic profile, reporting significant operations in 18 provinces. Conch claims that this

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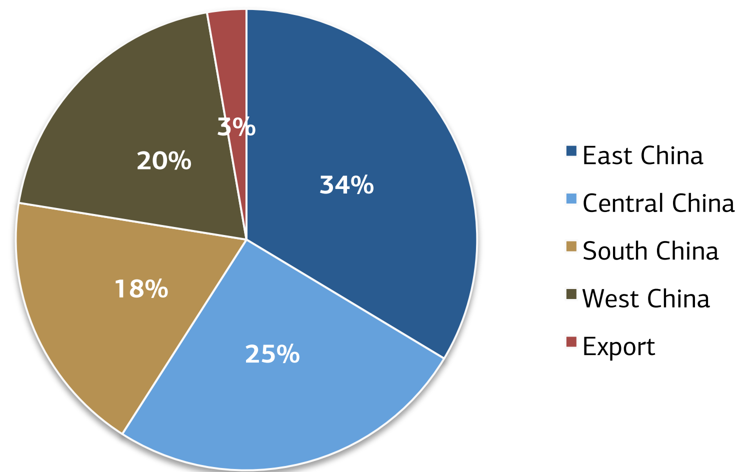
geographic diversity, with a particular focus on the western region over the past three years, allows it to weather regional macro volatility more robustly than its peers.

Chart 2. Sales revenue by region, 2014H1

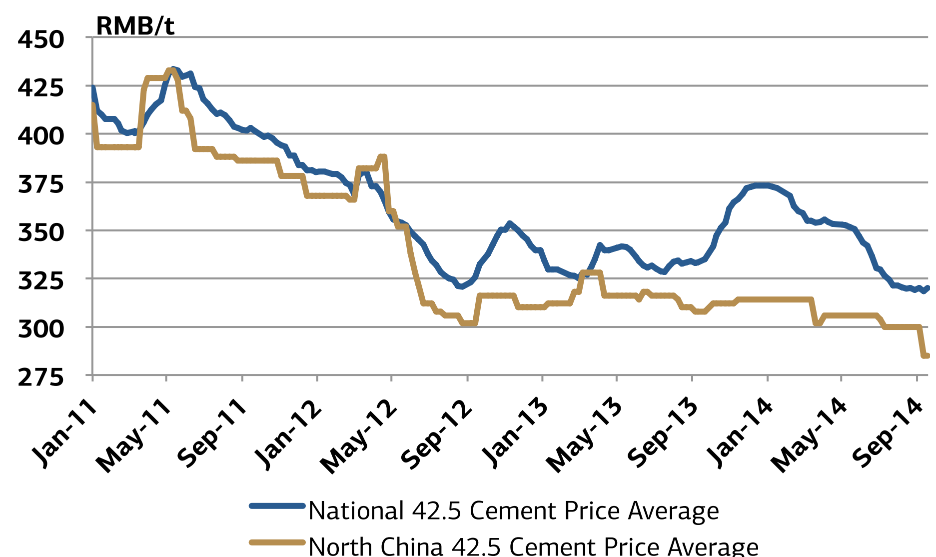


Source: Company filings

East China: Shanghai, Jiangsu, Zhejiang, Fujian, Shandong. *Central China:* Anhui, Jiangxi, Hunan, Hubei. *South China:* Guangxi, Guangdong. *West China:* Sichuan, Chongqing, Guizhou, Yunnan, Gansu, Xinjiang, Shaanxi.

For example, during 2012-2013, Conch escaped the margin squeeze endured by many cement companies due to the fact that it has negligible North China operations. Over the past two years, North and Northeast China have significantly underperformed all other regions in terms of sales growth and average gross margins based on national pricing data.

Chart 3. Nat'l cement price avg vs. North China



Source: Digital Cement, J Capital

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Conch's strategy

Conch provides little insight for investors to gauge strategy. Our checks show Conch is underperforming compared to peers.

Conch has two basic elements to its sales strategy: high prices to promote high margins, and building or acquiring new capacity to increase market share. We find that Conch fails to live up to expectation on either. Our broad conclusions after conducting extensive phone and site checks are that revenue and production are overstated, which has led to margin overstatement. We believe new capacity and acquisitions are booked at several times the value that we would expect, a practice that would have the effect of eliminating phantom cash from the statements before auditors need to see it while preserving the inflated asset value.

Self-perpetuating sales delusion

Conch makes few direct statements about pricing and sales volumes, content to leave investors with knowledge only of sales revenue and costs. This leaves investors with few options but to take Conch at face value that it has a high-margin product due to low costs and an ability to sell at higher-than-average prices. We conducted over 75 phone and 25 site checks in markets in which Conch indicates it has a presence (see Chart 2, above). We found:

- **National reporting of regional prices usually overstates actual prices.** Surveys by Digital Cement and the NBS are typically biased to large cities. We spoke with producers in large cities, in their outskirts, and in more rural areas. We found that regional price reporting typically overstates the actual pricing situation, with the major exception being Guangdong.

- **Conch underperforms compared to peers.** Conch typically sells at a lower price than its neighboring competitors. This does not correlate with larger sales volumes—in several instances, this has to do with "poor locations" of their production facilities or "limited market influence."

- **Conch salespeople misrepresent the market.** In all but one instance, Conch salespeople gave information about regional pricing that directly contradicted the consensus market view of their peers. In some cases this meant under-reporting the average market price so as to be able to say that they sell above it. In other cases this meant over-reporting the market average and actual prices. In Anhui,

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for example, Conch reported average prices RMB 60/t above what their peers reported, and, while peers said that Conch's prices were another RMB 20/t below that lower average, Conch reported that they sold at RMB 60-70/t above that locally reported average. At one site visit, Conch's reported price figures were RMB 150/t greater than what their competitors and downstream consumers reported, and RMB 60-80/t above the regional average.

Table 1. Conch pricing vs. peers by region

Peers describe Conch as having limited pricing power. Conch is often the low cost, low margin producer in the market.

RMB/t	Reported regional price avg.	Peers: Market avg. deviance from national reporting	Conch: Market avg. deviance from national reporting	Peers: Conch price deviance from locally reported avg.	Conch: Conch price deviance from locally reported avg.
East	310	-10	-30	-50	-40
Central	280	-40	+20	-20	+60
South	375	+5	+25	0	0
West	300	-20	-70	-80	-15

Source: J Capital interviews September 2014, Digital Cement

Building and buying capacity

Conch's statements about capacity are slightly befuddling. In the past several annual reports, the company points to declining growth of new capacity as a positive for the macro environment given the current oversupply. Yet, one of the pillars of growth for Conch has been capacity expansion without sacrificing price or margins. We do not believe the logic of this strategy is sound, and what we've observed of the company's implementation bears that out. Instead, low depreciation costs help inflate margins, and many acquisitions seem to have overstated components or not exist.

Production overstatement

Conch's capacity utilization rates are implausibly high.

Conch has close to doubled its assets over the past five years, in line with a large capacity increase. Crucially, Conch discloses capacity and production volumes, but not sales volumes, so it is not possible to determine from financials what proportion is actually sold. After averaging 15% volume growth 2009-2011, Conch posted 18% and 22% sales growth in 2012 and 2013, after the period of major capacity expansion, but also during periods of commercial real estate slowdown in China.

Conch reported 99% capacity utilization for 2013, and 94% for 2014 H1, as opposed to comparable companies that report 75-85% capacity utilization. While this could indicate high demand in Conch's markets, our primary research indicates that production is

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more likely overstated, and that Conch's real capacity utilization rates are closer to industry standards, and typically in the 75-80% range.

Our interviews with competitors consistently indicate that Conch overstates capacity, so comparing actual production at a particular plant to Conch's stated capacity (which is often already at 20-50% variance with actual capacity) would indicate capacity utilization rates in the 50-65% range. Not only is it unique to have a capacity utilization rate as high as Conch's, but production overstatement, which has no corresponding costs, would go part of the way to explain Conch's gross margins, which are 50-100% higher than those of comparables.

Table 2. Capacity and production

MMT	2009	2010	2011	2012	2013
Installed capacity	106	150	180	209	231
Production	118	137	158	187	228
Capacity utilization	112%	91%	88%	89%	99%
Production growth	16%	16%	15%	18%	22%

Source: Company reports, J Capital

Immortal PP&E

Conch reports low depreciation costs because most of its PP&E is a land bank, not equipment.

Low depreciation costs have consistently helped to inflate margins, and many acquisitions seem to have overstated components or not to exist at all. Conch consistently reports asset depreciation at under 7% of sales volume, compared to the industry norm of above 10%. This is despite a recent boom in capex. We believe that this is due to the fact that the vast majority of Conch's PP&E is land rather than factories and equipment.

Using a 7-10 year span for equipment depreciation, we estimate that, of Conch's RMB 56 bln of net PP&E in 2013, only RMB 2.7-4.0 bln was for equipment, the remainder for land. This vastly decreases the company's cost base, but also suggests that Conch's investments are more focused on land banking than on cement production.

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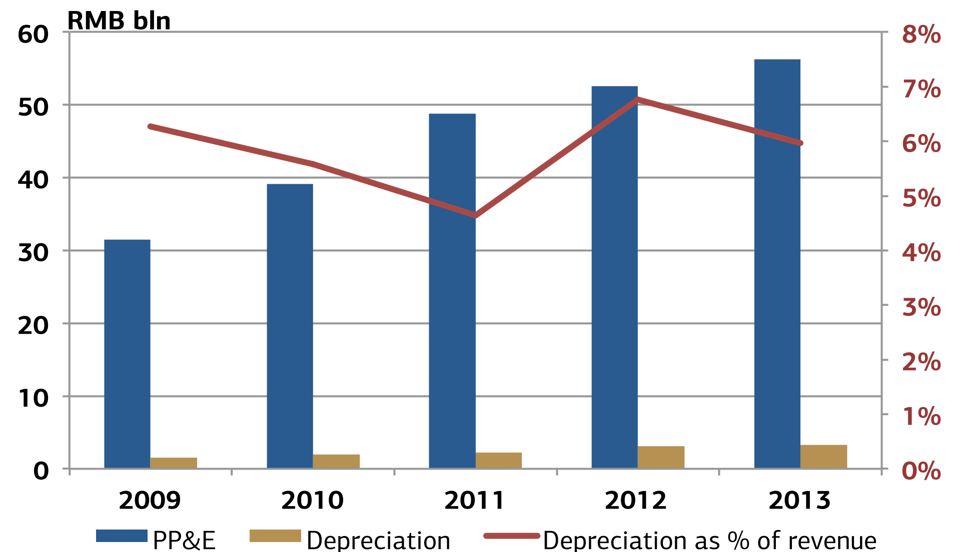
Chart 4. PP&E and depreciation



Source: Company filings, J Capital

Acquisitions and new capacity

Conch books acquisitions above fair value to move fake cash off the books.

The other implication of Conch's large land holdings is that, given the opaque nature of land values and pricing, acquisitions are being made in order to account for disposal of cash generated from overstated sales. Conch uses different mechanisms to create this effect, including post-acquisition mark ups, but the primary mechanism we found evidence for is that the cash acquisition price disclosed is higher than what was actually paid.

Outside of Chengdu, Sichuan, we visited a greenfield cement plant that ostensibly had capacity of 1 MMTPA. A local government official told us that the land had been "given" to Conch in order to stimulate the local economy and help the district achieve growth targets. However, the land acquisition was booked in Conch's disclosures as paid for in cash.

The facility, when built, only had half the stated capacity, and operated at a 20% capacity-utilization rate. Conch removed equipment from the site in 2013, when the capacity-utilization rate fell below 15%. The local government official told us that Conch still had ownership documents, even though they had vacated the site and there were plans for a new factory to take its place.

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Former Conch cement pop-up facility in the outskirts of Chengdu, Sichuan. | Photo by J Capital, September 2014.

In southern Hunan, in one of the poorest counties in the region, we visited recent acquisition target Hunan Yunfeng Cement. We found that actual capacity was 40% less than what Conch disclosed in its 2014 semi annual report, and nearby competitors reported that the plant was serving no major on-going infrastructure projects due to the fact that it is located 70 km from the nearest highway and that it was operating at below full capacity. Despite Conch disclosures that capacity additions to triple capacity (as stated in reports) are under way, we saw no evidence of ongoing construction activity, and workers and competitors were unaware of plans for expansion.

Conch's latest acquisition has half the production and is a fraction of the value claimed in its filings.

Despite having only 3,000/t per day in actual capacity, Conch booked equipment assets of RMB 142 mln, seven times the per-ton asset cost that we estimate for the company as a whole. Given actual production and projected revenue for a company of this size, we believe that the more accurate asset value for Yunfeng would be closer to RMB 25-35 mln, putting the booked value at five to six times higher than our estimates of fair value. We came to this figure based on what we estimate output over the next five years to look like, as well as the fact that the plant has outdated equipment, which may even fall under a category of equipment this is being phased out nationally under a 12th Five-Year Plan provision for removal of antiquated capacity in heavy industry.

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Recent Conch acquisition, Hunan Yunfeng Cement. Capacity is 40% less than stated in acquisition documents. Photo by J Capital | September 2014.

Acquisitions like these—which on paper look significant in terms of future production increases but in reality are in remote areas with little room for production increase and have capacity utilization rates far below what is implied in disclosures—help Conch increase their assets on paper and provide a disposal site for fake cash generated from overstated stales sales.

We believe that this type of overstatement is endemic in Conch, particularly in regions of more recent expansion. For example, in 2013, South China and West China made up approximately the same sales volume for the company, but Conch disclosed only RMB 11.3 bln in assets for South China, compared to RMB 23.8 bln for West China. This is despite the fact that land costs are lower in West China.

Financial unknowns

Implied pricing and gross margins

Conch does not provide much information about its pricing, or by region or product. Using Conch's financials, we derived an ASP for the entire company using figures for revenue, gross margin and cash cost of an average of RMB 240/t for 2012-2014 H1. However, using our checks and gross margin and cost data provided by Conch, we found a 12% discrepancy between our

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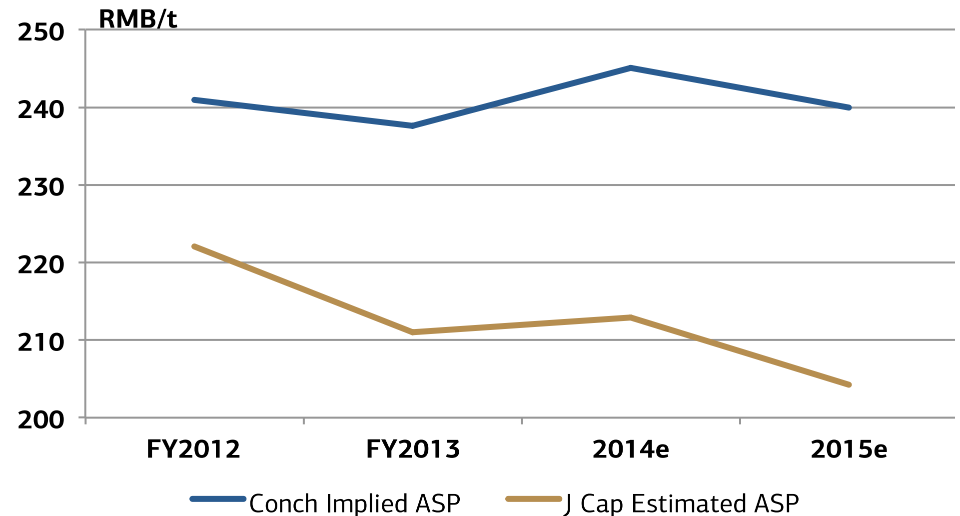
estimates as to Conch's likely ASP and the ASP their financials imply.

Chart 5. Implied Conch ASP vs. J Cap estimates



Source: Company filings, J Capital

We believe Conch's overstates ASPs by 12%.

This ~12% gap in ASP estimates accounts for the difference between Conch's gross margins, which have grown to nearly 35% over the past several years, and the industry average, which is in the 20-25% range. We believe this higher gross margin is attributable to overstated production: every ton overstated brings the average cost per ton down, and allows Conch to report higher sales on higher margins. As discussed above, the excess profit is easily burnt off through overpriced asset and land acquisition with correspondingly low depreciation.

SOE reform

Dividend payouts only accounted for 10% of net profit in 2013. In our view, one of the more likely outcomes of upcoming SOE reform is that SOEs like Conch will be expected to return more of the profits to their equity holders. As we believe margins are overstated, it is likely such a push would force Conch to be more accurate with renderings of gross margins in order to avoid large cash payouts to equity holders with cash that they do not have.

While this is highly speculative, it is based on our analysis of what SOE reform could include, and based on recent changes in Conch's statements on dividend policy. In its 2013 annual report Conch made the following statement, which represents a change in the way the company refers to investors, and seems to indicate a new

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importance in dividend issuance: "When distributing profit, the Company shall have regard to the importance of maintaining a reasonable return to investors as well as the sustainable development of the Company."

Valuation

Based on our DCF model, we set our price target for Anhui Conch at HKD 15.96 based on a terminal growth rate of 3%, with a downside of 37%. We incorporate our estimates as to pricing, which leads to a net profit variance of 25% below consensus.

Sensitivity analysis

In our model this translates to reductions in net margins of 21%, and gross margins to 30%. We regard these assumptions as conservative, still placing Conch's margins above the average of competitors. We arrived at this figure by analyzing Conch's statements on cash cost, its statements on gross vs. net margins, and comparing our primary checks on pricing in all of Conch's major markets. This results in ASPs averaging 12-15% below what Conch's financial statements imply, and accounting for our predicted reduction in margins. We find that, even with margins adjusted to the 35-40% range upon which Conch's current share price is based, the company is still trading at a premium.

Table 3. Gross margin sensitivity test

Gross Margin	Share price (HKD)	P/E (x 2014 earnings)
20%	$9.06	2.90
25%	$12.50	4.00
30%	$15.96	5.11
35%	$19.39	6.21
40%	$22.84	7.31

Source: J Capital

Our valuation puts Conch's share price at 5.1x expected 2014 earnings compared to its current 8.8x, which is within the range of other materials peers in China, and not at its usual premium to the industry as a whole. Conch has had historically volatile P/Es, typically 50-100% greater than its peers. Over the past 12 months Conch has traded between 8.6x-17.0x forward earnings, putting our estimates outside its historical trading range.

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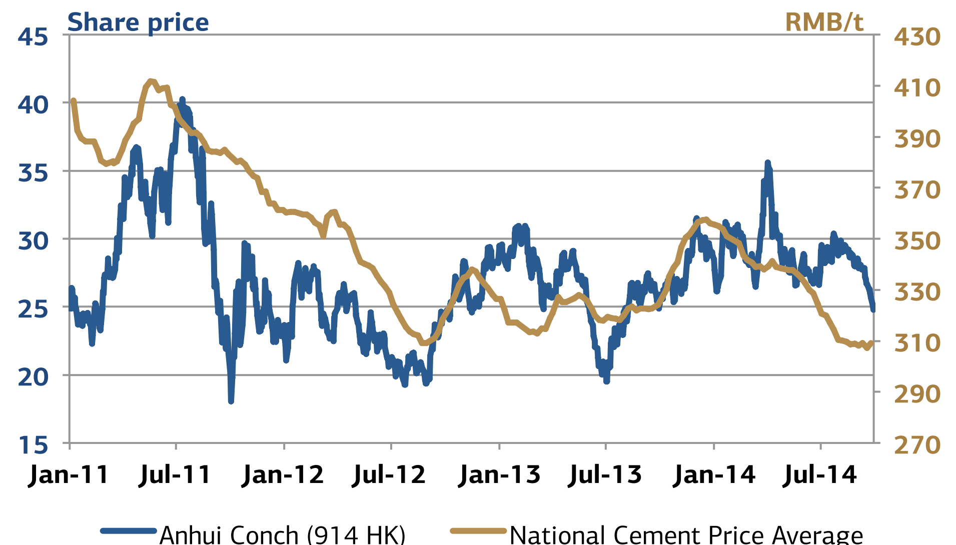
Historical trading patterns

Cement prices are likely to fall through H2 peak season, which would pull Conch's share price down.

Anhui Conch is commonly understood as a proxy for sentiment about the Chinese property and infrastructure markets. However, historically it has traded in correlation with the national cement price average. For the last two years, Anhui Conch's share price has traded at a ratio of 1:10 to 1:14 compared to the cement price, and is currently at 1:12. We believe cement prices are likely to fall in 2014 Q4 on low demand and seasonally in 2015 Q1, which would create a natural downward trajectory for the share price.

Chart 6. Share price vs. cement price average



Source: Bloomberg, Digital Cement

SH-HK Connect

Conch H-shares have traded at a premium—this year averaging over 30%—to Shanghai listed A-shares, but that premium has halved since speculation over implementation of the SH-HK Connect began to gain steam at the start of H2. By the end of September, that premium had declined by half to 17%. This has also caused H-shares to fall out of sync with the trends in cement pricing, and suggests that the program might be comparatively negative for the Hong Kong-listed stock. A-shares are up 9% since the start of H2, while H-shares have fallen 5%.

Catalysts

We see lower cement prices and reduced gross margins as the primary catalysts that would make Conch an attractive short, and

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we see these coming to a head in 2014 Q4, to be reflected in 2014 H2 earnings.

Given the reasonably close relationship between Conch's trading patterns and cement prices, a further price fall would likely take the share price down with it. In the first month of the fall peak season this year, prices have held their all-time lows, and producers are negative about the likelihood that prices will increase, because demand has remained flat to down in the second half.

Typically, the second half is Conch's strongest season, and we expect that this will translate to deflated margins for FY 2014, which will surprise the market. Conch typically releases its annual report in April, preceded by a preliminary report in March, and sometimes issues production guidance at the end of a half.

Cement prices have fallen 14% since year beginning, and, assuming Conch does not significantly change its cost base this year, this would be absorbed entirely in margin reduction. 2014 H2-to-date prices are 8% below the 2013 H2 average, but unlike last fall, this year shows no upward trend, rather prices have stagnated at their lowest sustained levels on record. This price reduction correlates to a 25-40% margin reduction, which suggests negative growth for gross profits for 2014 H2.

Risks

Increases to fixed asset investment, strong growth in the commercial property sector, and corresponding cement price increases allow Conch to either grow itself to a company of the size it states, or allows it to continue to obfuscate over the medium term.

Many SOEs in the past have been identified as underperformers or having fraudulent elements, yet share prices seldom reflect these companies' actual performance or operations. SOEs have unique access to capital, which in many cases these companies can use to cover up fraudulent activity. In Conch's case, this could come in the form of their SOE shareholder, China Conch Venture Holdings (586 HK), which holds 49% of Anhui Conch's A-shares, raising equity outside the company unbeknownst to Conch's shareholders.

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