



February 17, 2015

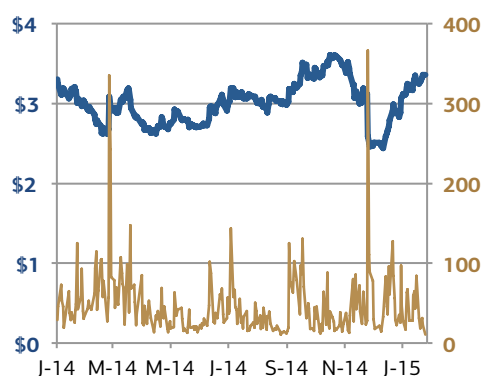
China | Autos

Geely Automobile Holdings (175 HK)

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



Source: Bloomberg, Feb. 17, 2015

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| | |
|--------------------|-----------------|
| Price | HKD 3.36 |
| Rating | SELL |
| Price target | HKD 2.81 |
| Difference | -16% |
| Market Cap | HKD 29.8 bln |
| Simple Moving Avg. | 41.4 mln |
| P/E | 9.92x |
| Float | 57% |

Source: Bloomberg, Feb. 17, 2015

Not low enough

+ January growth of 85% weaker than it appears

Geely's January domestic sales volume rebounded to 55,039 units, up 85% YoY over 2014. As impressive as this may be, we think sales will now fall back to earth, given aggressive dealer promotions that mean a build-up of product in the channel. Additionally, Geely has benefited from government subsidies for the development of electric vehicles in its JV but has not had success in selling these Evs. Since subsidies are based on volume, they must end.

+ Tough overseas market

Export volume shrank by 50% in 2014 due to uncertainties in Russia and Ukraine markets and the unexpected RUB depreciation. There was a strong performance in Egypt, but we don't expect any significant increase of export in 2015. Risks and instabilities are too high in Geely's targeted export markets.

+ Underperformer

Geely's sales often underperform the industry, and the industry is slowing. We think Geely can grow by 5% with the help of promotions and subsidies in 2015 but decline again by 10% in 2016, as government subsidies will expire at end of 2015 and the sedan market will reach saturation.

+ Handouts won't last

Geely has captured government subsidies through establishment of two JVs to develop electric cars. The company does not sell but leases the EVs, at a loss, yet the two ventures together should yield RMB 150 mln to Geely in 2015. We think this free lunch cannot long be sustained.

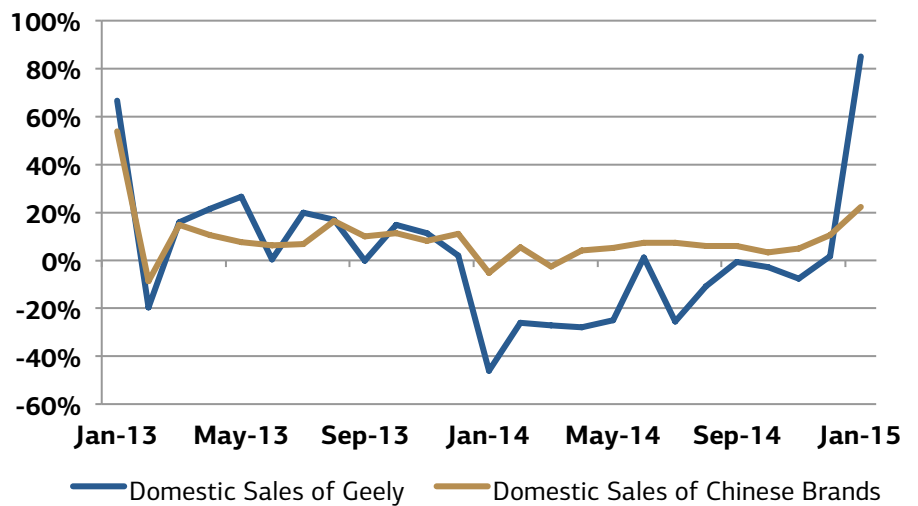
+ PT HKD 2.81; recommend SELL

We reiterate our SELL recommendation. Considering our forecast of better sales performance led by the Xindihao model in 2015, we have adjusted our PT to HKD 2.81 per share from HKD 2.46 based on our DCF valuation, with a WACC of 10.6% and terminal growth rate of 1%.

Where's the bottom?

Geely reported total sales volume of 417,851 units in 2014, down 24% YoY, missing its lowered 2014 annual sales target of 430,000 vehicles by 3%. The original target was 580,000 units.

Chart 1. Geely's domestic sales vs sales of other Chinese brands, YoY change



Geely underperformed its peers until it cut prices and offered financing in January.

Source: Company data, CAAM, J Capital Research

China's peak sales season for autos fell in January this year because of the late Spring Festival. Led by the flagship model, Xindihao, Geely's January sales reached 58,884 units, up 7% MoM and 76% YoY against last January's low base.

However, our research indicates that the company may have pushed inventory to dealers that will not sell through as quickly. The new Vision model recorded strong monthly sales of 11,656 units, up around 38% MoM, but we believe most of the units went dealer inventory.

January sales tactics included 0% financing and 0% down payment, with payment terms of up to 24 months supported by Geely. Dealers we interviewed said that over 50% of buyers are using loans to purchase cars.

Geely has also dropped the selling price of the entry-level Xindihao, which has a sticker price of RMB 69,800, 3% lower than the EC7. Government subsidies of RMB 3,000 for cars under 1.6 L, which resumed as of September 2014, along with a RMB 10,000 subsidy

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for trade-ins, will reduce the final selling price, but margins on the car will be low.

Table 1. Official Selling Price: EC7 and Xindihao

| RMB/unit | Selling price |
|-------------|----------------|
| Geely's EC7 | 71,800-113,800 |
| Xindihao | 69,800-100,800 |

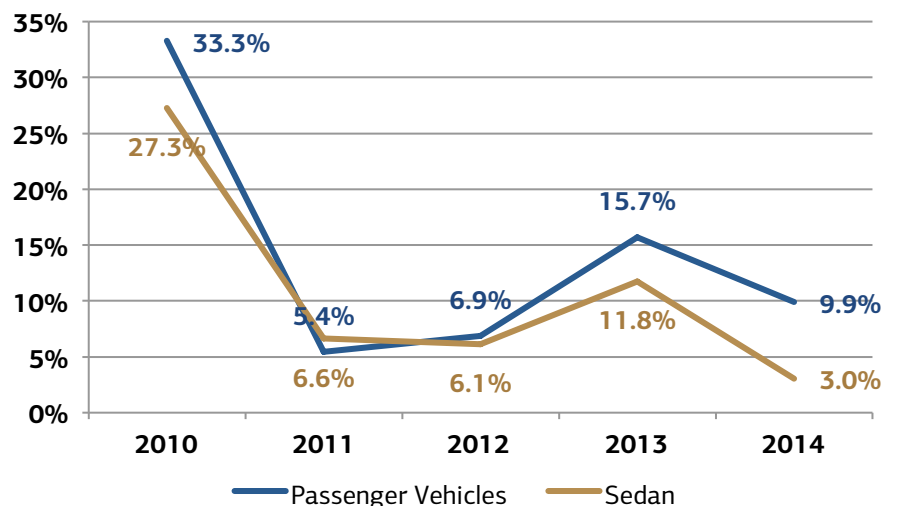
Source: Autohome

We attribute the strong sales performance of Xindihao in January to these discounts and believe that the 2015 annual sales target of 450,000 units, representing a 7.6% YoY increase, is optimistic.

Market slowing

In general, growth of the new passenger vehicle market is slowing. In 2014, the entire passenger vehicles market grew 9.9% YoY compared with 15.7% in 2013. Sedan sales, which better reflect how strong real demand is, grew only 3% YoY in 2014, down from 11.8% YoY in 2013. That is a signal that the market for passenger vehicles is close to saturation.

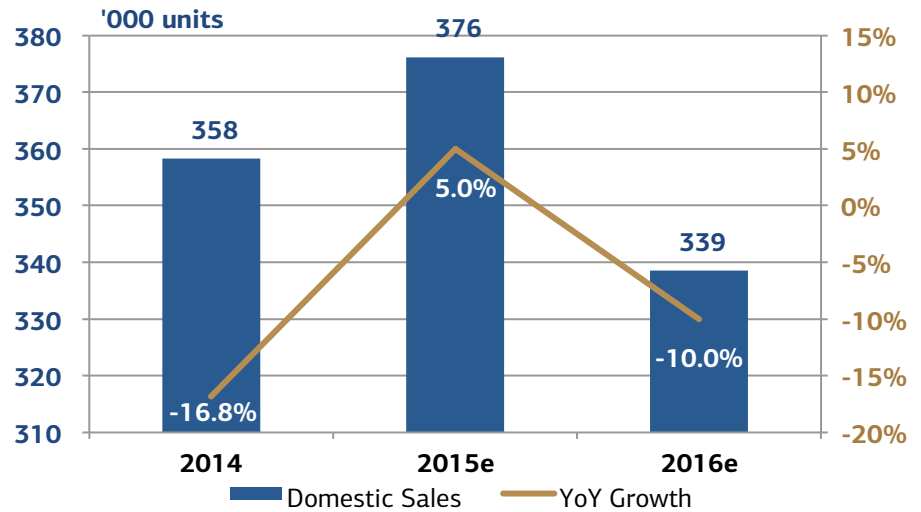
Chart 2. Passenger vehicles and sedans, YoY



Source: CAAM, J Capital Research

As the majority of Geely's sales are from sedan sales and Geely's sales often underperform the industry trend, we estimate that Geely in 2015 can achieve 5% growth with the help of promotions and subsidies but will decline again, by about 10%, in 2016. Government subsidies will expire at the end of 2015, while growth in the sedan market disappears.

Chart 3. Domestic Sales Volume Estimates

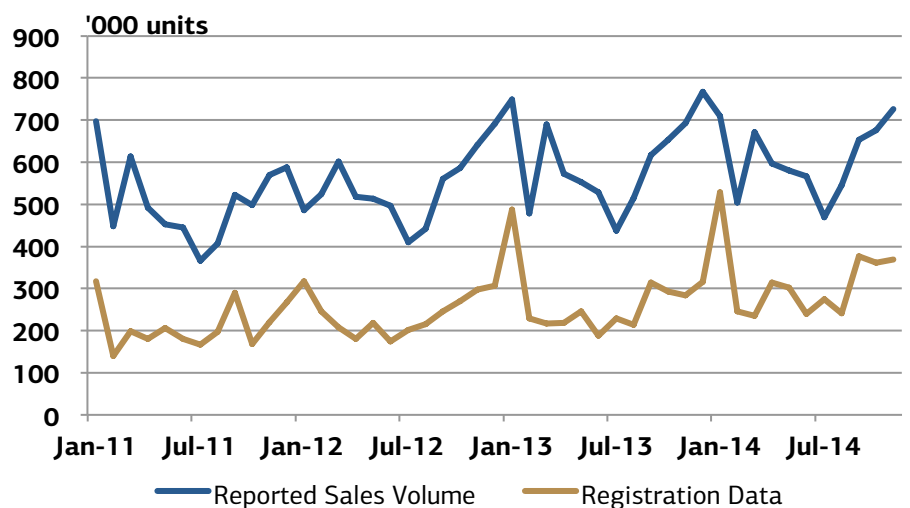


Source: Company data, J Capital Estimates

Discrepancy between reported volume and registration data

We obtained auto registration data from Wind showing a big discrepancy between reported auto sales volume and registration data for domestic brands, while we don't see such a large gap for other JV brands. This data leads us to highly suspect the sales volume reported by dealers and manufacturers.

Chart 4. Reported sales volume vs registration data



Source: CAAM, Industrial Securities

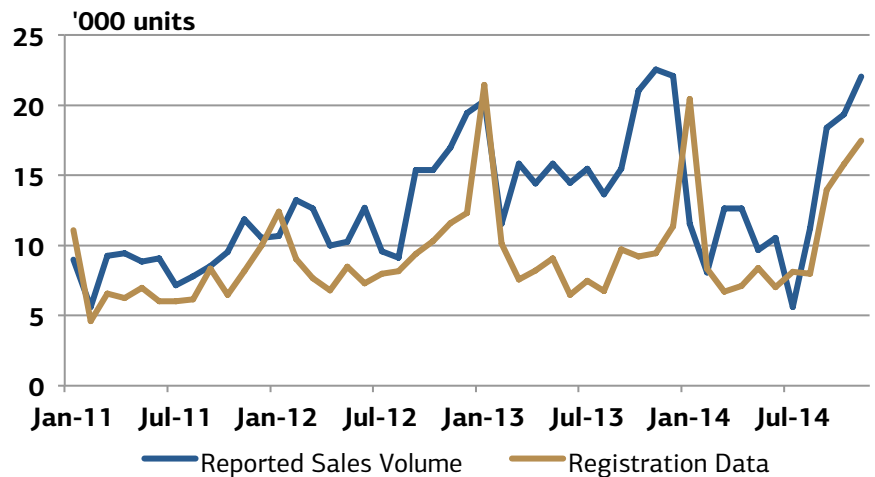
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Some 170,000 vehicles sold since 2011 have not been registered.

For Geely's most popular models, the Emgrand Series, which includes Emgrand EC7, EC8, and the Xindihao, we also found a significant discrepancy between the reported sales volume and registration data. From January 2011 to November 2014, a total of 606,105 Emgrand vehicles were sold within China, while registration data show only about 436,121 units on the road.

Chart 5. Sales vs registration of Emgrand series

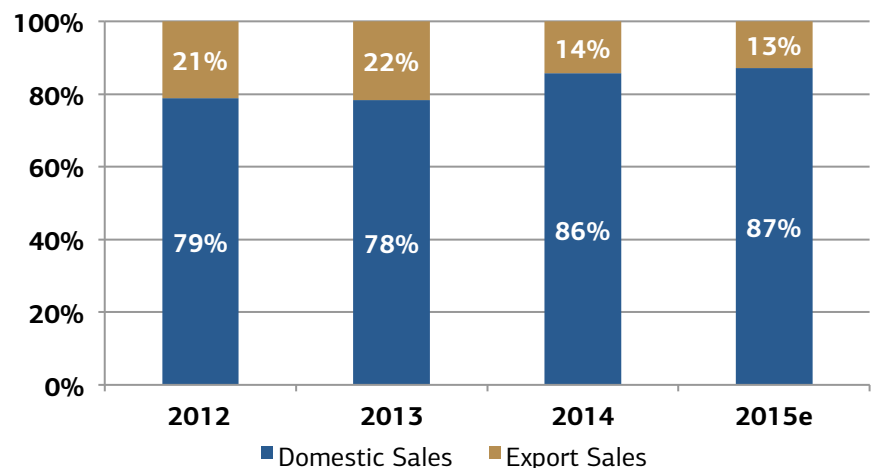


Source: Company data, Industrial Securities

Weak Export Market

Exports are a main driving force for Geely's sales, and they used to represent over 20% of Geely's total sales but fell to 14% in 2014, as overseas auto markets suffered from political crises. This was especially true of Geely's top export destinations, Russia and Ukraine. Considering the impact from the continued Ruble depreciation in early 2015, we estimate Geely's exports will drop to 13% of total sales in 2015.

Chart 6. Sales Volume by Region



Source: Company data, J Capital estimates

The export sales volume fell 50% YoY in 2014, mainly due to the political crisis in Russia and Ukraine. An unexpected 44% depreciation of the Ruble against the US dollar in 2014 also added pain to Geely's exports. In 2014, Geely's total sales in Russia declined 31%, to 18,828 units, and sales in Ukraine contracted by 42%, to 8,813 units.¹

Table 2. PV Sold in Russia and Ukraine in 2014

| units | Total PV Sold | YoY Change | Total PV Sold by Geely | YoY Change |
|---------|---------------|------------|------------------------|------------|
| Russia | 270,653 | -10% | 18,828 | -31% |
| Ukraine | 92,342 | -54% | 8,813 | -42% |

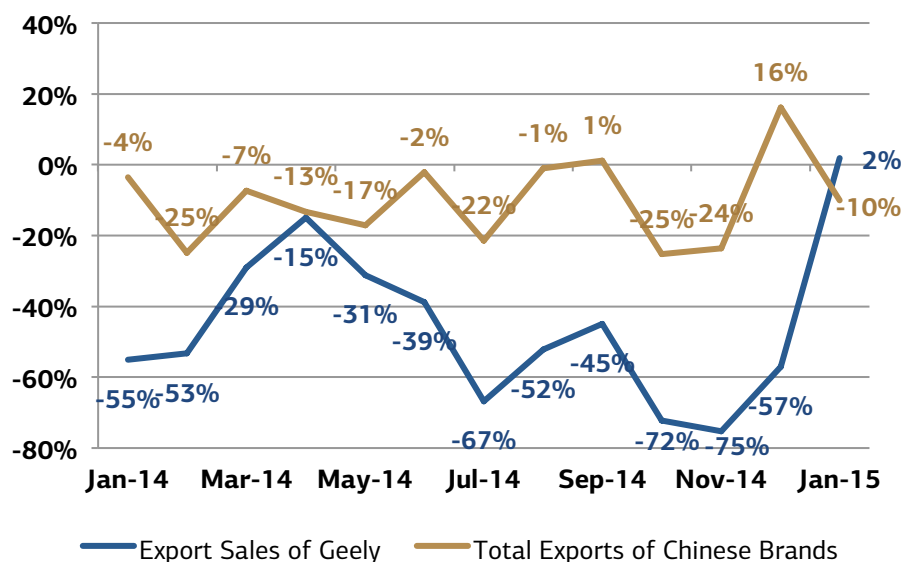
Source: AEB, news

The company wrote off USD 100 mln in Russia but we do not expect sales to recover. Russia and Ukraine are tough markets to have as your top export destinations.

Write-off

Geely claimed that it had total exposure of ~USD 250 mln, including inventory of up to 9,000 knock-down kits and working capital subject to an accounting write-off of over USD 100 mln at end of 2014. Without any hedging, Geely suspended exports of kits to Russia in H2 2014. The company also plans to raise its selling price, but we think doubt that buyers will go along. To offset the impact from slowing sales due to the political crisis, Geely already raised its selling price by 5-10% in April 2014, and monthly sales volume started to drop further at that time.

Chart 7. Geely vs domestic brands exports, YoY



Source: Company data, CAAM

¹ <http://en.interfax.com.ua/news/economic/244411.html>

² <http://auto.163.com/15/0111/10/AFM2SJPD00084J0.html>

Overall, exports will fall by 7-8% this year and more in 2016.

We believe the Russia and Ukraine markets will remain tough in 2015, as the political risk remains and the depreciation of Ruble continues; in January, the RUB depreciated by over 20%. Although there was a cease-fire agreement signed on February 12, there was also one last September and it's never been implemented.

Under these conditions, we don't anticipate large shipments to Russia in 2015. The current inventory level can support roughly six months of sales, based on Geely's average monthly sales of about 1,500 units in 2014.

Even this is optimistic. In January, Geely sold 450 units in Russia, down 83% MoM and 61% YoY. We believe those sales were from the inventories that already sit at dealers. So if the RUB does not appreciate against USD and Geely keeps the same pace during 2015, there will be no export sales to Russia in 2015. Russia and Ukraine together accounted for over 30% of Geely's total exports in 2013 and about 20% in 2014. We estimate the proportion of the two countries will drop further to less than 10% in 2015.

Some relief is coming from Egypt. Cooperating with Ghabbour Auto, Geely managed to sell about 15,000 units in Egypt, up 53% YoY in 2014. Ghabbour is also helping Geely to expand into Libya and Algeria. We think the growth in Egypt along with entrance into new markets will allow Geely's exports to GB Auto to increase by 30% YoY in 2015.

In total, we estimate Geely's export volume will fall by 7.4% in 2015 and 14.7% in 2016.

New ways to obtain subsidies

For Geely, which has one-third of its pre-tax profit coming from government subsidies, whether the company can continue to obtain subsidies has a significant influence on its financial performance. As Geely's export business is still struggling and the company's domestic facilities are of low utilization rate, it really needs to explore new subsidies. Since the government is highly promoting the new energy cars segment, we believe developing EV cars will become a main way for domestic brands like Geely to capture the subsidies as long as those policies continue.

In 2013, Geely established the JV company, Zhejiang Kandi Electric Vehicles, with Kandi Technologies (KNDI US). By selling EV cars to a related party – Zuozhongyou Electronic Vehicle Service-- Kandi managed to sell a total of 14,398 EVs in 2014 and recorded profit

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from the JV entity of USD 3,757,218 for the first nine months of 2014. Zuozhongyou is engaged in leasing and operates the Public EV Sharing project in many cities. The reason for Kandi's leasing program is clear: we estimate that, in addition to the subsidies related to R&D, investment, and production of EVs, Kandi receives about RMB 40,000 per unit for a car with a selling price estimated at less than RMB 20,000.

With more and more promotional policies, investing in the EV industry seems very promising and also profitable even without enough end customers. In January 2015, Geely announced another JV with third parties Xindayang, and Shuanglin.

The new JV will be engaged in developing and producing the ZD-brand EV cars. The ZD series model was launched on January 11 2015 with an estimated selling price of RMB 40,000-60,000 after matching subsidies provided by both central and local governments. As the ZD model is rated for a driving range of 160 kilometers, total subsidies may reach over RMB 80,000 per unit.

We suspect that the ZD's official selling price may have been overstated in order to capture more government subsidies.



Photo of Geely ZD in front of the Lanzhou production facility | Autohome²

We estimate share of profits from the two JVs to double to over RMB 150 mln in 2015 and continued strong growth of over 50% in 2016 as long as the government support remains.

² <http://auto.163.com/15/0111/10/AFM2SJPD00084J0.html>

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Valuation

Considering the government subsidies and aggressive sales tactics, we adjust our target price to HKD 2.81 from HKD 2.46 per share. We believe the Xindihao sales will improve in 2015 compared with last year. We used a DCF valuation, with a WACC of 12.6% and terminal growth rate of 1%.

Risks

Geely could surprise to the upside this year with its Xindihao model, which was launched in late July 2014 to replace the Emgrand EC7. Sales of Xindihao gradually picked up and peaked in December 2014, with monthly sales of 23,353 units. Our primary checks with dealers, especially in cities without license plate restrictions, confirmed that customers like the new model.

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