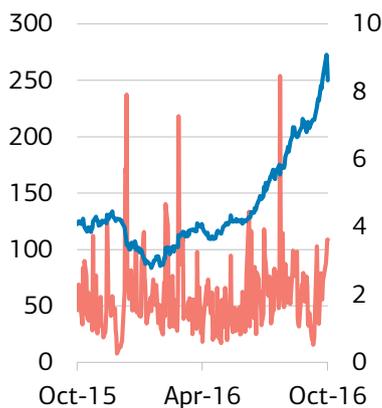


November 2, 2016  
Company Update

## Geely (0175 HK)

Price	HKD 8.30
Rating	<b>SELL</b>
Price Target	<b>HKD 6.54</b>
Difference	-21.5%
EPS 2017	0.5
P/E	11.3x

Geely (0175 HK) last share price in HKD (blue) and volume (pink, in mln shares)



Source: Bloomberg November 1, 2016

## Geely (0175 HK)

# Help from Its Friends

### ▶ The sales surge

Thanks to government procurement for the Hangzhou G-20 meeting in September and to genuinely successful new models, Geely has recorded 29% YoY growth in the first nine months.

### ▶ A Q4 phenomenon

Despite the success with new products, the sales momentum relies heavily on government purchase tax subsidies and dealership expansion.

### ▶ Chronically on the dole

Geely has been exposed in the Chinese press for cheating the government out of subsidy payments for electric cars in its JV company, Zhejiang Kandi. In 2016H1, subsidies accounted for 28% of its pre-tax income. But we believe the subsidies will continue in 2017.

### ▶ One pocket to another

The sales of electric vehicles are either made to affiliated companies or to other companies that are using them to capture subsidies; there is little actual consumer demand. This situation is likely to be sustained in the mid-term but does not make for a high-quality company.

### ▶ Extending the purchase tax?

Government agencies are talking about extending the purchase tax cut for another year and that could provide a small tailwind to Geely.

### ▶ Temporary lift

We expect subsidy cuts will not catch up with Geely in Q4, and we increase our TP to HKD 6.5, based on an 11.3x forward PER for 2017 based on Bloomberg data and a 2017 EPS of RMB 0.5.

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Geely remains dependent on government subsidies for one-third of its profit.

## Crony Car Company

Geely has seen phenomenal sales growth this year, mostly due to popular new models. But the new models show no promise of lifting Geely out of the low-margin, commodity ghetto in which it dwells. Geely remains dependent on government subsidies for one-third of its profit and dependent more generally on government subsidies programs for a big chunk of sales. Even without the likelihood that Geely will lose the subsidies, we view this company as a sell.

### Source of Sales

Domestic news sources say that Geely provided vehicles the GC9, Boyue, Emgrand GS, and other models for the G-20 Summit in Hangzhou, Zhejiang Province. The company is also trying to sell more to police fleets.



Geely provided vehicles for the recent G-20 Summit in Hangzhou. Source: [shuoke.autohome.com.cn/article/527421.html](http://shuoke.autohome.com.cn/article/527421.html)

Meanwhile, Geely's cooperation with Volvo is gradually paying off. The concentrated launches of new models from the end of 2015 drove up September sales by 82% YoY and YTD sales by 29%. Two new SUV models, Vision and Boyue, were the key drivers of growth.

### Self Dealing

Popular models did drive up sales, but so did inventory loading at new dealerships. Geely's dealers dropped from 1,068 in 2013 to 691 at the start

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**Table 1. YTD Sales of New Models as of September**

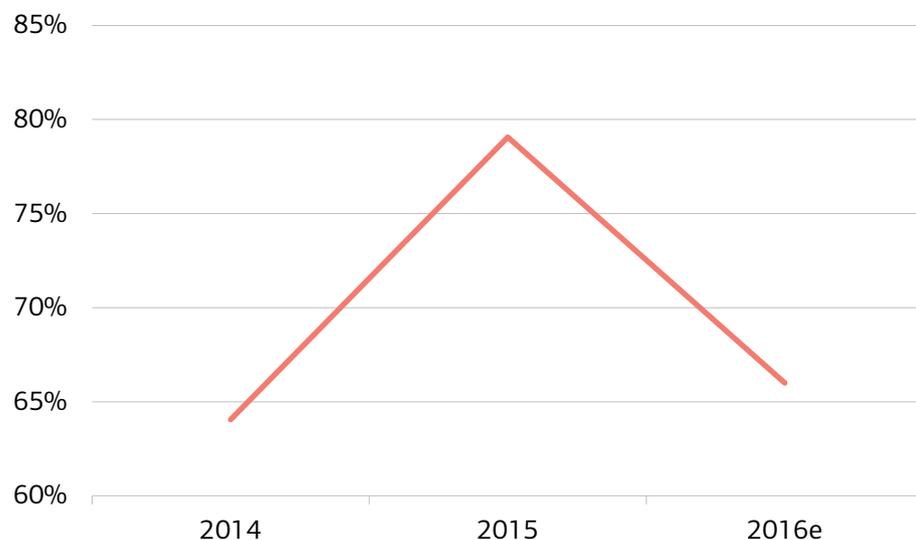
Models	YTD Sales Volume (units)
Emgrand EV	7,359
Emgrand GS	30,193
Emgrand GL	2,874
Vision SUV	17,107
Geely Boyue	53,522
<b>Sales Volume of New Models</b>	<b>111,055</b>
<b>Growth of YTD Sales in September</b>	<b>103,678</b>
<b>Sales of New Models as % of Growth</b>	<b>107.1%</b>

Source: Company data, China Passenger Car Association (CPCA)

of this year but then started growing again and stand at more than 740 today—filings have not been updated since the Interim. On a single day at the end of August, Geely opened nine 4S stores in Northwest China. Online news articles say that, Geely plans to increase its network to 800 by the end of 2016. If the average store carries 110 cars, an additional 60 stores in a month would add 6,000 cars.

Because of the strong growth, Geely raised its 2016 sales target by 6%, to 700,000 units. The new target means 37% growth over its 2015 sales volume. By the end of September, the company had sold 459,041 units, about 66% of the new target, meaning that Geely needs to sell more than 80,000 units per month in the last quarter.

**Chart 1. Factory Utilization Rate**



Source: Company data, J Capital Research

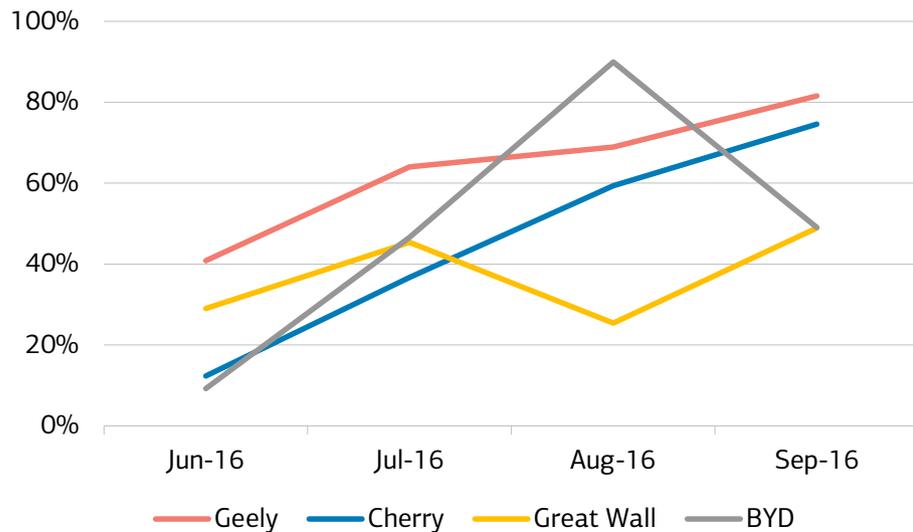
Popular models have drive up sales, but so has inventory loading at new dealerships.

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This is puzzling. Has the company secured fleet commitments it has not yet disclosed? Geely is building to a capacity of 83,333 units per month, but historically, new facilities have taken a long time to reach high utilization levels. Currently, we estimate that Geely is running at 66% utilization, and some plants, like the Luqiao base, which produces the King Kong model, operate at 50%-60%. So Geely must be selling out of inventory.

The September sales success is unlikely to be repeated. Dealers have been spreading the rumor that the Vehicle Purchase Tax break for vehicles with small engines would be withdrawn before October 1, and many customers rushed to buy.

**Chart 2. YoY Monthly Sales Growth for Geely, Chery, Great Wall, and BYD**



Source: China Passenger Car Association (CPCA)

In the meantime, a new regulation has restricted the shipment of new autos from September 21, banning double-decker transport vehicles, which handle 80% of auto transport. This could impact inventories at dealerships. To make sure they have enough vehicles for Q4 sales, many dealers pre-ordered in September. Registration data in Shanghai showed that plate registration for domestic brands was up only 7.4% YoY compared with the 39.1% reported for domestic brand sales.

Q4 is very important to automakers chasing annual sales targets, and it could be the last three months for the purchase tax cut. We believe the sales momentum will continue in Q4. After the tax cut expires, though, all bets are off.

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Geely's classic models which launched facelifts generally underperformed the industry.

For 2017, Geely has an SUV model, Lynk & Co, jointly developed with Volvo. The company's sedan models are less successful.

Geely's classic models which launched facelifts generally underperformed the industry, which grew at 15% in the first nine months, and domestic brands, which were up 19% YoY. Although New Emgrand recorded a 31% YoY increase in September, YTD sales volume grew at 14% and, excluding the EV models, only 8%. The facelift King Kong was up 2.3% in terms of YTD sales volume and is now showing a declining trend. Only Vision, which launched a facelift model in March, recorded strong growth of 22% YoY.

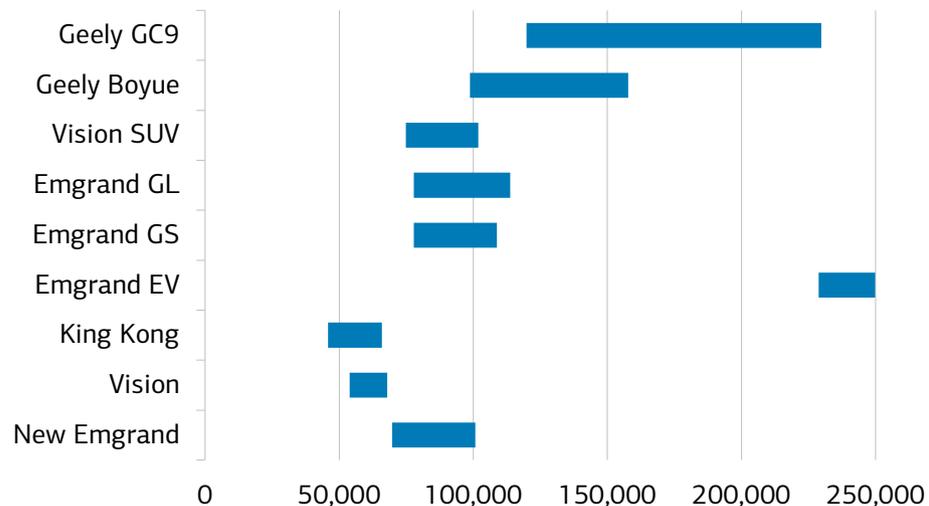
**Table 2. Classic Model Growth**

Model	Time of facelift launch	YTD Sales Volume in September 2015	YTD Sales Volume in September 2016	YoY Change
<b>New Emgrand</b>	Dec-15	139,539	158,566	13.6%
<b>New Emgrand excluding EV</b>	Dec-15	39,539	151,207	8.4%
<b>Vision</b>	Mar-16	78,578	95,534	21.6%
<b>King Kong</b>	Jan-16	3,482	44,474	2.3%

Source: Company data

The new models helped Geely raise its average ASP by 18% in 2016H1, led by the Vision SUV (RMB 74,900-101,900), the Emgrand GL (RMB 77,800-113,800), and the GS (RMB 77,800-108,800).

**Chart 3. Retail Prices of Geely Vehicles (In RMB/Unit)**

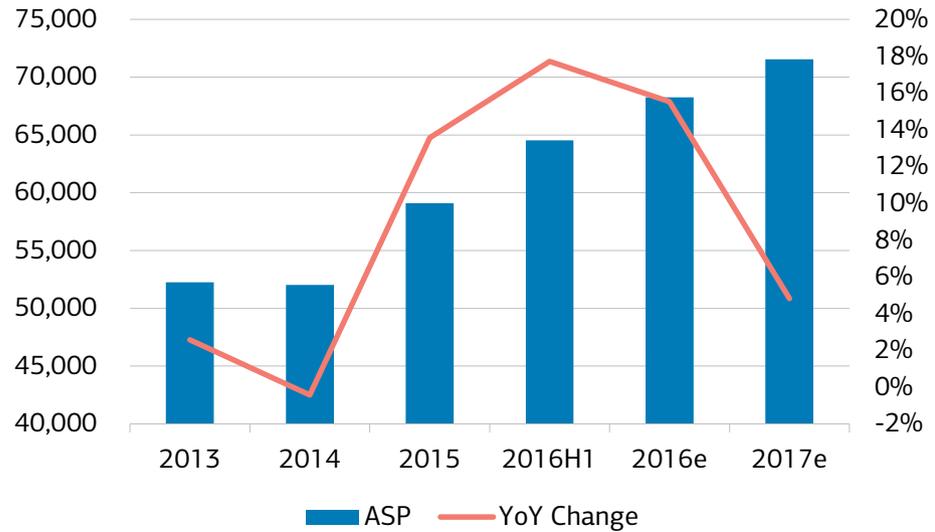


Source: Autohome

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In the second half, we estimate that ASP will increase 6% sequentially, and prices in 2017 will rise 5% YoY.

**Chart 4. ASP & YoY Change**

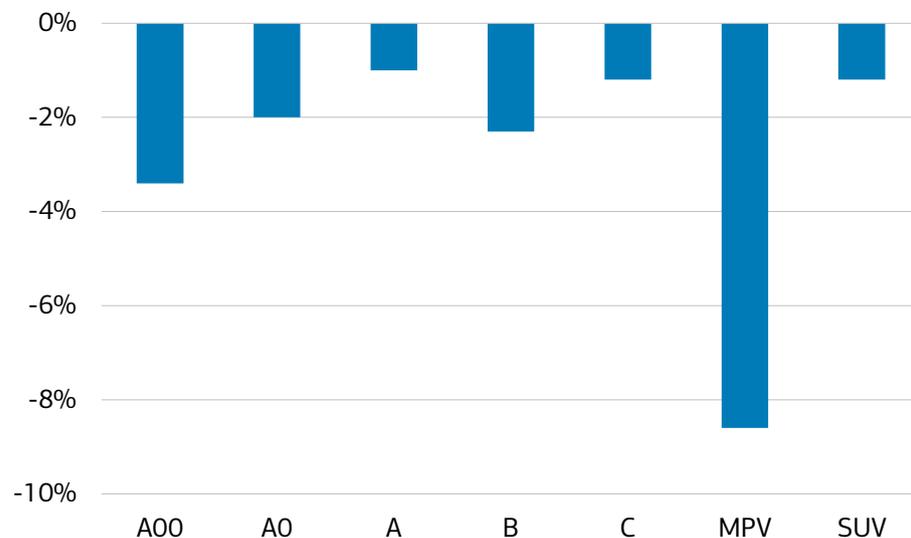


Source: Company data, J Capital estimates

Selling prices of passenger vehicles fell 2.3% MoM in September.

Old models are being discounted. We found large discounts of up to RMB 30,000 on the Emgrand models, and even some new models, such as Boyue, were attracting manufacturers' discounts of up to RMB 8,000 per unit. According the Gain Pricing Index, selling prices of passenger vehicles fell 2.3% MoM in September.

**Chart 5. MoM Change on Selling Prices by Different Type of Model**



Source: Gain Index

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Despite the price hikes in 2016H1, gross margin was basically flat, going from 17.6% in H1 2015 to 17.7% 2016H1. Due to launch costs and more facilities in operation, we do not expect to see meaningful improvement in gross margin in the current half or in 2017.

## Pass the Subsidies

Geely was among the companies exposed for cheating on a total of RMB 1.7 bln in government subsidies in its Zhejiang Kandi joint venture company with Kandi (KNDI US) by selling its electric vehicles to a related party and collecting the sales subsidies. A total of 14,353 Kandi electric vehicles were implicated. But the government’s demand to be repaid will not affect Geely the listed company: Geely quickly proposed disposing of its equity in Zhejiang Kandi to Geely’s parent company, Geely Holding Group.

And this is not the end of Geely’s EV game. Now Geely has created its own car-hailing company, Caocao, operating in Hangzhou, Ningbo, and Qingdao with Geely’s Emgrand EV model. New sources say that in Hangzhou alone, Caocao has 900 New Emgrand EV cars, and Caocao says it will expand into 50 Tier 1 and Tier 2 cities with 150,000 vehicles. This creates sales for Geely and generates a stream of subsidies under China’s aggressive electric vehicle program.

Already, virtually all the electric vehicles Geely is selling go to its parent company. Total transactions with its parent com-



The Caocao app's front page. Source: J Capital

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By selling Emgrand EV cars, Tellus can provide an excuse to build more charging stations.

pany for the nine months ended on September 30 were RMB 978,587,000, representing roughly 5,000 units with a selling price at RMB 200,000 per unit. In October, Geely proposed raising the annual cap on the sale of EVs to the Geely Holding Group to RMB 2.3 bln in 2016, riding to RMB 5.5 bln in 2017 and RMB 9.5 bln in 2018. The EV sale to parent company is suspended until final approval and will add at least 6,000 more units EV sales in 2016 Q4.

**Table 3. Proposed Annual Cap Amounts to Parent Company (In RMB thnds)**

Proposed annual caps	2016	2017	2018
<b>EV Sales to Geely Holding Group</b>	2,254,000	5,463,020	9,487,180
<b>Original Annual Cap Amounts</b>	1,000,000	2,000,000	4,000,000

Source: Company data

The other large buyers of the Emgrand EV are charging station companies. Charging stations rely heavily on government subsidies, but since the cheating scandal, governments are stricter on the approval process. To get the subsidies, companies are trying to prove that their charging stations are in operation. Tellus Power, one of the big customers for Geely's Emgrand EV, has about 150 charging stations in operation in Beijing and will build more in the future. It's the largest dealer of the Emgrand EV in Beijing and claims it will purchase 6,000 Emgrand EVs by 2016. By selling Emgrand EV cars, Tellus can at least provide an excuse to build more charging stations.

**Table 4. Selling prices (RMB/unit)**

Model	Price
<b>New Emgrand</b>	69,800-100,800
<b>New Emgrand EV</b>	228,800-249,800

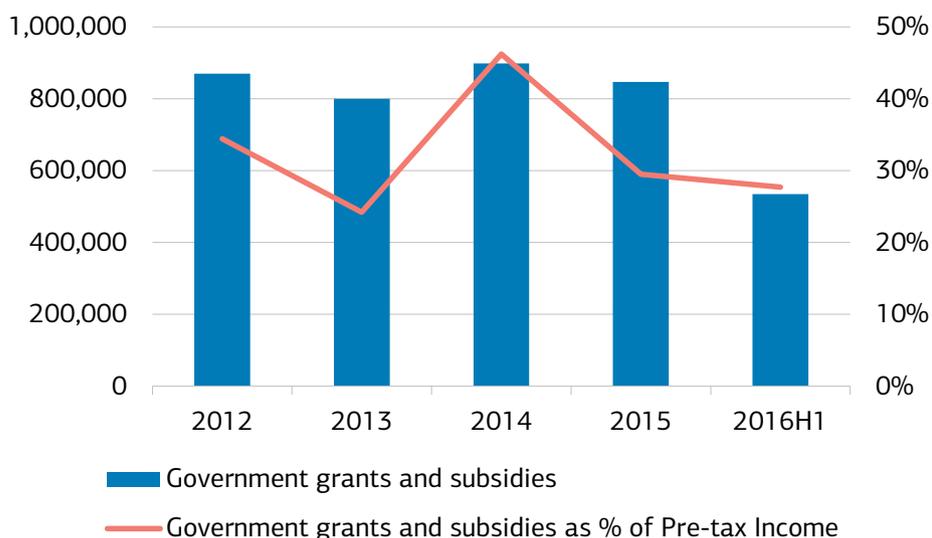
Source: Company data

Producing more electric vehicles is also positive for Zhejiang Forever New Energy, which is 49% owned by Hong Bridge (8137 HK) and 48% by Geely Holding Group. Zhejiang Forever focuses on developing ternary lithium battery and this is the type of battery used by Geely's Emgrand EV models. Zhejiang Forever is constructing a Jinhua facility with annual production of 1.5 mln kw to serve 80,000 sedans in the future.

Geely is famous for relying on government subsidies. In 2016H1, the company received RMB 534 mln subsidies, 28% of Geely's pre-tax income.

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### Chart 5. Government Grants and Subsidies



Source: Company reports

### Table 5. Government Grants and Subsidies as % of Pre-tax Income

Company	2015	2016H1
<b>Geely</b>	29.5%	27.7%
<b>BYD</b>	15.3%	7.0%
<b>Great Wall</b>	3.5%	1.1%

Source: Company data

This is far more than peers. Great Wall, with YTD sales of 689,992 units, 50% more than Geely's volume, had grants and subsidies accounting for only 1.1% of its pre-tax income.

Geely gets more subsidies even though most government subsidies are related to capital expenditure and R&D activities and Geely's capex and R&D

### Table 6. Government Grants and Subsidies in 2016H1 (In RMB thnds)

Company	2016H1 Government Grants and Subsidies	2016H1 Capex	2016H1 R&D	Subsidies as % of the sum of R&D and Capex
<b>Geely</b>	534,366	1,733,114	96,578	29.2%
<b>BYD</b>	211,739	6,100,823	1,153,577	2.9%
<b>Great Wall</b>	64,039	2,724,763	1,257,736	1.6%

Source: Company data

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Export sales volume to Russia and Ukraine has fallen through the floor.

are lower than those of BYD and Great Wall. In 2016H1, total government grants and subsidies were 29% the total fees Geely spent on R&D and fixed investments, while BYD and Great Wall only were 3% and 2% respectively.

## No More Exports

Russia and Ukraine were key markets for Geely, and since the political crisis in 2014, export sales volume to those countries has fallen through the floor. Sales to Russia in the first nine months contracted 53%, and in Ukraine, Geely saw an 82% YoY decline in August and was not ranked in September. Geely entered Egypt in 2012 with the cooperation of a local dealer called Ghabbour Auto, but average monthly sales in 2016H1 were only about 300 units, down from the average monthly volume of over 500 units in 2015. Exports saw a 181% YoY increase in September, but YTD, exports have fallen 24% YoY.

**Table 7. YTD Sales Volume in Russia (In Units) vs. YoY Change**

	Total PV Sold	YoY Change	Total PV Sold by Geely	YoY Change
<b>Russia</b>	1,020,932	-14%	3,794	-53%

Source: AEB

## Valuation

Our PT of HKD 6.54 is based on 11.3x forward PER for 2017 based on Bloomberg data and a 2017 EPS of HKD 0.05. Considering Geely's model cycle, which appears to be much stronger than we had expected, robust volume growth will continue in this quarter and in 2017.

**Table 8. Sales Volume Estimate (In Units)**

	2016e	2017e	2018e
<b>Sales Volume</b>	684,969	799,009	841,743
<b>YoY Change</b>	34.3%	16.6%	5.3%

Source: Company data, J Capital estimates

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## Risks

- ▶ Downside risk: The government withdraws subsidies to Geely.
- ▶ Upside risk: Renewal of the 50% reduction in the Vehicle Purchase Tax.
- ▶ Better-than-expected sales of new models.

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