



September 12, 2014

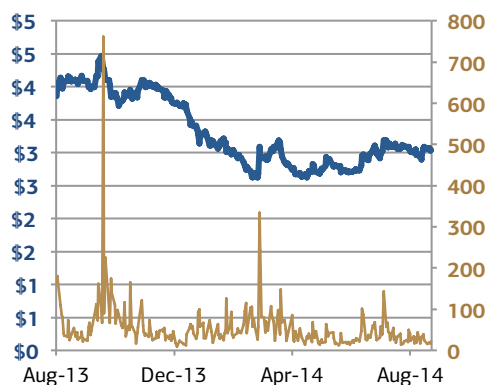
China | Auto

Geely Automobile (175 HK)

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



Source: Bloomberg, September 12, 2014

Geely Automobile (175 HK)

Price	HKD 3.04
Rating	SELL
Price target	HKD 2.46
Difference	19%
Market Cap	HKD 26.7 bln
Simple Moving Avg.	26.0 mln
P/E	8.76x
Float	

Source: Bloomberg, September 12, 2014

Twilight for Geely

+ Sharp drop in sales

Geely's sales tumbled in 2014 H1. Revenue was down by 32% YoY, and net profit decreased by 20% YoY. Sales volume fell by 29% YoY due to a weak domestic market and political turmoil in top export destinations. The downward trend continued in July and August, and our ground checks indicate inventories at dealers of two to three months. Consumer reaction suggests that new models will not boost sales in the balance of the year.

+ All about subsidies

Government grants remain an important portion of Geely's profitability, accounting for one-third of its pre-tax income. We believe that the subsidies entail significant and poorly disclosed obligations. In the first half, R&D subsidies ran 7.5x the value of R&D activities, while companies with a better reputation for innovation get less than 5% of their R&D value from subsidies. Some of the subsidies are related to export rebates, and so the 39% fall in export volumes is likely to reduce subsidy income. The company's weakening sales could lead to a spiral of unmet obligations and withdrawn subsidies. Although we cannot track these with precision, we believe the risk is all to the downside.

+ Related party transactions

Geely is actively involved in related party transactions, including sales to related companies. Currently, the volume is not large, but, as sales continue deteriorating, this channel creates potential for the company to manipulate results.

+ PT HKD 2.46; recommendation: SELL

We reiterate our SELL recommendation and lower our PT to HKD 2.46 per share from HKD 2.53 based on our DCF valuation, with a WACC of 12.6% and terminal growth rate of 1%.

Disappointing half-year result

Geely announced its 2014 H1 interim result at end of August, according which revenue declined by 32% YoY, to RMB 10.2 bln, and net profit dropped by 20%, to RMB 1.1 bln.

Geely saw revenue and net profit drop by 32% YoY and 20% YoY, respectively, in 2014 H1.

Table 1. 2014 H1 results

RMB 000s	2014 H1	2013 H1	YoY
Turnover/revenue	10,158,351	14,854,979	-31.6%
Gross profit	2,065,905	2,846,830	-27.4%
Operating profit	1,433,531	1,785,289	-19.7%
Net profit	1,125,627	1,401,902	-19.7%

Source: Company data

Geely lowered its 2014 sales target following its weak sales performance.

Sales volume dropped sharply in both domestic and export markets. Total sales volume in 2014 H1 fell by 29% YoY to 187,296 units, and the trend continued in July. Indeed, from January to July, Geely's overall sales volume was 207,310 units, down 30% YoY; domestic sales went down 28% YoY, to 168,863 units, while exports went down by 39% YoY, to 38,447 units. With such weak sales, Geely was forced to lower its 2014 sales target from 580,000 units to 430,000, representing a 22% decline from 2013's target.

August's sales performance proved better than that of July, but sales still dropped 22% YoY despite a 38% sequential increase. By the end of August, YTD sales volume totaled 235,096 units, achieving 55% of the revised sales target for 2014 of 430,000 units.

The MoM increase was driven by sales of EC7 rather than the Xindihao, the updated EC7 model, according to Geely's IR. The two models together contributed 38% of Geely's total sales in August. Geely intends to promote Xindihao as its flagship model in the future, but so far, people have not shown great interest in it. Many are still buying the EC7 model, even after the Xindihao was launched at the end of July and in August.

We believe most of the new Xindihao orders have gone into distributors' inventory. Before late October, it will be too early to tell for sure, but demand looks anemic from here.

Our checks with major dealers confirmed the current declining trend of Geely's auto sales. The worst case comes from one

Some dealers are now offering discounts to get rid of their Geely inventory.

important dealer in North China, which saw sales down 60-70% YoY in H1. Dealers say that consumers don't have money to spend anymore. Restrictions on auto plates in some cities also had a dampening effect in H1. It may be that buyers stalled purchases while waiting for the new Xidihao model. Now, in order to sell EC7 inventory, dealers are offering RMB 5,000-10,000 discounts on an ASP of about RMB 60,000-100,000.

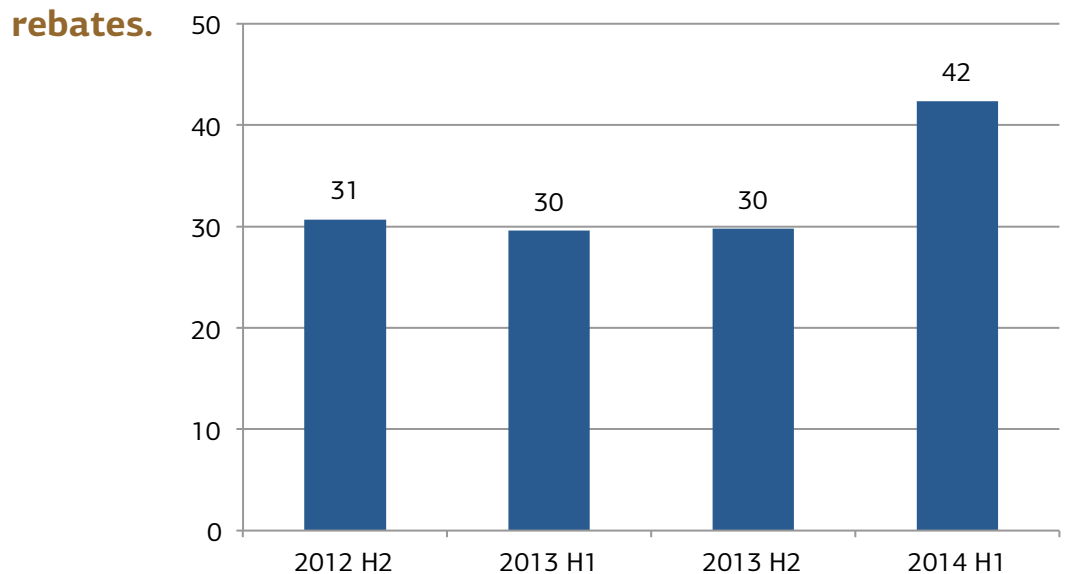
The most important pressure on Geely comes from competition from JV brands. Geely admits that it's very hard to compete directly with JV brands, which have a broader range of auto models and better financial support for both distributors and consumers. In recent years, JV brands have entered the low-end automobile market and have also expanded their distribution capabilities to low tier cities, which used to be the main terrain for domestic brands.

Rising inventory

Geely's inventory increased to 42 days at the end of 2014 H1 from 39 days in 2013. According to Geely, they normally ask dealers to keep inventory at two months, though there is also some variation among dealers. However, according to our interviews, current inventory levels at dealers range from two to six months, which seems high. Furthermore, we think inventory will increase in 2014 H2, as most dealers will stock cars in order to obtain sales rebates in Q4.

We think inventory will increase in H2, as dealers stock cars to obtain sales rebates.

Chart 1. Inventory days



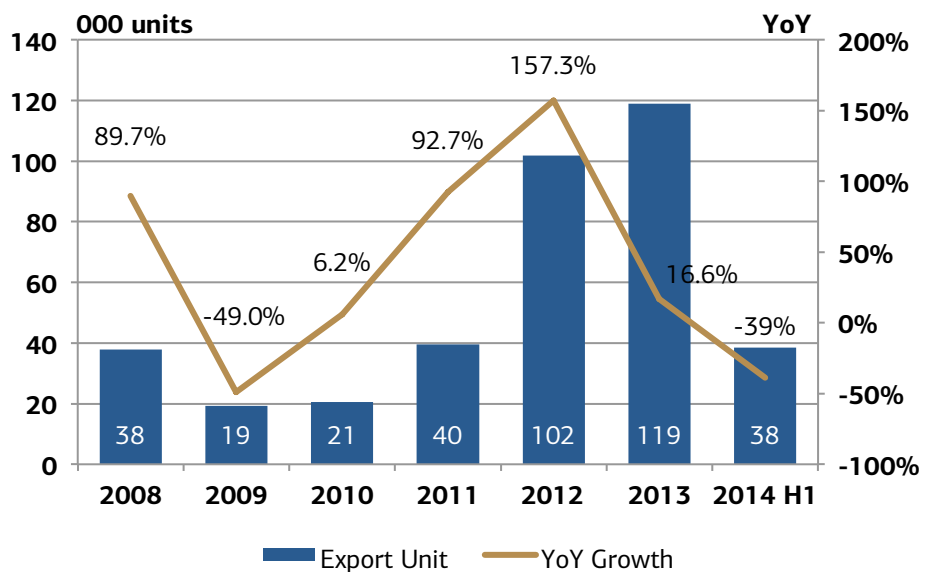
Source: Company filings, J Capital Research

Political unrest is driving down Geely's sales in its top export markets.

Uncertainty of overseas market

Geely's top export destinations are Russia, Ukraine and Iraq, where political unrest is driving down demand for new autos. Geely's interim and July reports showed a 32% YoY drop in export sales volume, with total units sold in January-July 2014 down by 39% YoY.

Chart 2. Export volume



Source: Company data

Statistics provided by both AEB and Autostat showed that, for January-July 2014, sales of new passenger vehicles fell by 9.9% and about 47% YoY in Russia and Ukraine, respectively. In July alone, Geely's sales were down 51% YoY to 1,351 units in Russia and 57.8% YoY, to 568 units in Ukraine. We estimate the two countries contribute about one-third of Geely's total exports, and the company won't recover in the foreseeable future.

Mounting receivables from overseas customers

Exports may be going down, but Geely is still very generous to overseas customers.

While we see a sharp drop in exports, Geely is still very generous to its overseas customers, providing them a credit period of six months to one year. Trade receivables from overseas customers increased in 2014 H1, while export volume decreased by 32% YoY during the same period. We estimate 20% of Geely's revenue was coming from export sales, which gives a DSO of 252 as at end of 2014.

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Table 2. Accounts receivable from overseas customers & DSO

In RMB 000s	2012 H2	2013 H1	2013 H2	2014 H1
Accounts receivable to overseas customers	1,593,500	1,275,585	2,274,154	2,803,173
DSO	108	78	150	252

Source: Company data, J Capital Research

Negative outlook in 2014 H2

Though some dealers remain hopeful about H2, we believe Geely's sales performance will not improve.

Interestingly, some dealers, even though they had a tough H1, remain optimistic about H2, hoping for a better sales performance during the traditional peak season. They informed us that, in general, sales in H2 account for 60% of total annual sales and they hope the new models including Xindihao, GX7 and GC7 will drive performance. However, what we learnt from the Beijing Auto Show in April 2014 is that consumers do not seem very interested in Geely's new models including Xindihao, and GX9. In contrast with the popularity of JV and other domestic brands, Geely's stand had few visitors. Based on Geely's current sales performance, we lower our estimate on its sales volume to 400,214 units for 2014.

Table 3. Sales volume estimate

	2013	2014e	2015e
Sales volume	549,468	400,214	387,930
YoY change	21.6%	-27.2%	-3.1%
Domestic	430,597	322,948	306,800
Export	118,871	77,266	81,129

Source: J Capital Research estimates





Beijing Auto Show, April 2014. Geely's stand had almost no traffic, while stands from JVs and other domestic brands did. All photos by J Capital.

Reliance on government grants

Geely's government grants in H1 represented 33.4% of its pre-tax income.

Geely relies heavily on government grants to support its profitability. In 2014 H1, the company received government grants of RMB 478 mln, representing 33.4% of its pre-tax income.

Table 4. Government grants

RMB 000s	2009	2010	2011	2012	2013	2014 H1
Government grants and subsidies	216,080	660,626	877,437	870,119	800,048	478,473
Pre-tax income	1,550,460	1,900,323	2,183,208	2,529,077	3,304,182	1,432,857
As % of pre-tax income	13.9%	34.8%	40.2%	34.4%	24.2%	33.4%

Source: Company data, J Capital Research

IR told us that about 50% of their subsidies were from R&D, 25% from PPE investments, and 25% from tax rebates from local governments. However, a simple comparison of government grants over R&D costs leads us to question where the grants come from. And Geely received far more subsidies compared to its peers, which have more R&D activity.

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Table 5. Subsidies as % of R&D costs

	2012	2013	2014 H1
Geely	421.7%	289.0%	789.3%
BYD	47.8%	52.9%	42.6%
Greatwall	12.8%	12.4%	4.0%

Source: Company data, J Capital Research

Table 6. R&D as % of total revenue

	2012	2013	2014 H1
Geely	0.8%	1.0%	0.6%
Greatwall	2.2%	3.0%	4.1%
BYD	2.6%	2.6%	3.1%

Source: Company data, J Capital Research

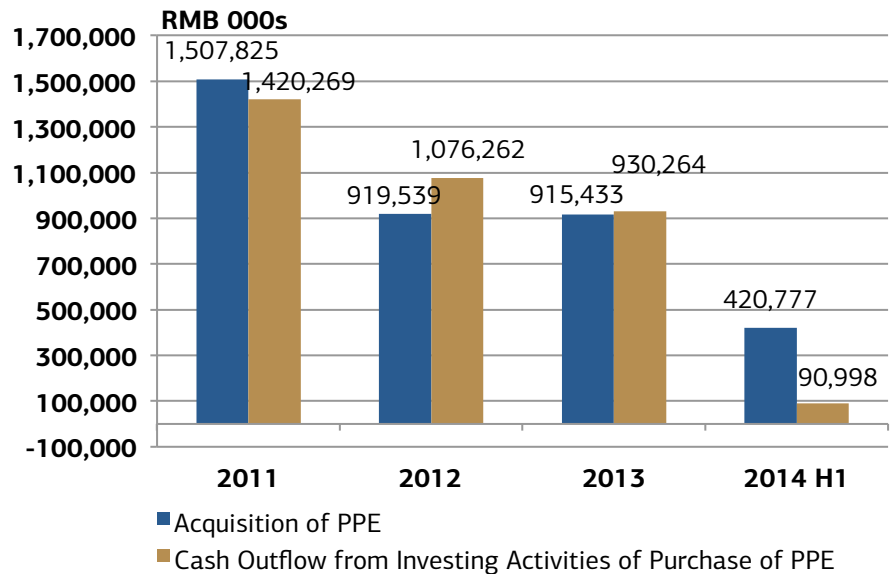
Local governments also help Geely to obtain central government's subsidies. In addition to help Geely apply for R&D subsidies, some inner city governments also provide tax rebates to Geely as long as the company keeps production activities and reports import and export customs there.

We believe Geely's subsidies are more related to capital investment than to R&D funding.

Also, as we mentioned in our previous report, we think the subsidies are more related to Geely's capital investments, including purchasing subsidized land and constructing more plants rather than direct R&D funding. In order to obtain government grants continuously, heavy investments in PPE are required, which will lead to a lower utilization rate of Geely's production capacity. Based on our previous checks of Geely's facilities in other locations, such as Ningbo in 2014 H1, the utilization rate was only about two thirds of its total capacity, and we don't think there will be any increase considering the company's sales performance.

It's all about subsidies. When we looked at the report, actual capex related to purchase of PPE in 2014 H1 was only RMB 91 mln, about 21.6% of the acquisition amount of RMB 421 mln they claimed during the same time. We were confused about this, and IR explained it's because Geely bought PPE from its parent company but may have paid the money through other transactions. Those PPEs they bought in 2014 H1 are not new and the company used to rent them from its parent company. The reason is that its parent company, Geely Holding, purchases imported property, plant, and equipment because it benefits from a tax rebate. However, the parent rents this to Geely initially, as it must keep the assets for a while in order to get the rebate. After that, Geely Holding can sell the assets to Geely.

Chart 3. Acquisition of PPE



Source: Company data

Related party transactions

Geely is actively involved in related-party transactions. The absolute amount might not impact the company, but it's a red flag.

Geely's involvement in related party transactions should be considered a red flag by investors.

Subsidies from parent company

It's always good to have an unlisted parent company. Geely Holding is regularly engaged in inter-company transactions with Geely. Geely Holding purchases kits, parts and components from Geely, as the listed company does not have the license to assemble automobiles in Mainland China. Geely's business thus benefits from its parent company's help.

Geely Holding provides subsidies to dealers for 4S stores investments. Online, we found a policy called "EC models 4S store investment support policies," detailing the subsidies provided by Geely Holding for each new dealership ("4S store"). The subsidies, according to this document, range from RMB 1.2 mln to RMB 4.0 mln, depending the store type. We believe this generous policy has given incentives to people to join Geely's network, but they may not have staying power. Subsidies to dealers also include sales rebates for exceeding targets and support for advertising.

Related parties in dealership

We suspect Geely's senior management or its relatives are involved

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in the company's dealership network and may help the company with sales that go into inventory. So far, apart from the one reported by the company, we have found only three such dealers so far:

- **Taizhou Haoqing Automobile Sales**, of which legal representative is Li Xingxing, son of Li Shufu, reported RMB 52.3 mln in 2014 H1, up 18.3% YoY, contrasting with the performance of the entire company, which reported a YoY drop of 32% for the same period.
- **Ningbo Dihao Automobile Sales**, established in July 2009, it sells Geely's EC series models in Ningbo, Zhejiang province. According to the AIC website, its legal representative is An Congxia, the sister of Geely's executive, An Conghui.
- **Sichuan Geely Automobile Supermarket** is one of the important dealers in Sichuan province. Geely Holding invested in 9% of this company.
- **Jinzhong Fuqiao Taxi Company** was cofounded with Geely's distributor, Shanxi Juntai. The company is currently in operation, with all cars purchased from Geely and Geely Holding owns 80% of the company's shares.

Valuation

Considering the weak performance and our estimate of future sales, we reiterate our SELL recommendation and lower our target price to HKD 2.46 per share from HKD 2.53 based on our DCF valuation, with a WACC of 12.6% and terminal growth rate of 1%.

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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