China | Building Materials

Anhui Conch (914 HK)

October 30, 2014

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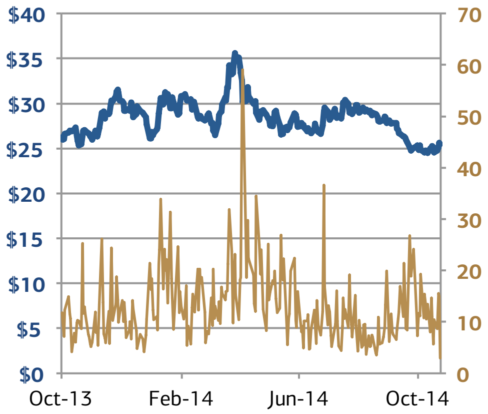
Anhui Conch (914 HK) one-year share price in HKD (blue) and volume (gold, in mln shares)



Source: Bloomberg, October 30, 2014

Anhui Conch (914 HK)

Price	HKD 25.60
Rating	**SELL**
Price target	**HKD 15.96**
Difference	**-37.6%**
Market Cap	HKD 118.6 bln
Simple Moving Avg.	11.6 mln
P/E	8.80x
Float	91%

Source: Bloomberg, October 30, 2014

Below average

+ Q3 shows declining revenue, discounted sales

Numbers in Conch 2014 Q3 results indicate that the company is selling consistently at 27% below benchmark pricing, a result confirmed by our primary research. Additionally, the results show an 8% QoQ decline in revenues, while seasonal expectations would be for flat revenues. We believe the company will be hard pressed to manufacture growth going into the peak Q4 season.

+ Asset sales keep Conch afloat

A declining market makes it harder to maintain fake margins. A new strategy is in place to maintain that fiction. Conch received RMB 6.3 bln for sales of investments, which made the difference between positive and negative cash flow for the quarter. This comes at a time when Conch appears to have less ability to borrow from banks, with quarterly borrowings down by almost two thirds compared to its average over the past two years. A 50% reduction in bankers' acceptance notes could be due to reclassification as cash equivalents.

+ Reiterate SELL: PT HKD 15.96

We reiterate our SELL recommendation with an unchanged price target of HKD 15.96 based on a DCF valuation.

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Distress: discounting & asset sales

Revenues declined -7.8% QoQ, and operating profit contracted -2% YoY.

Anhui Conch reported 18% revenue growth and 52% net profit growth for the first three quarters ending Sept. 30, seemingly good news that masked a week third quarter. In the third quarter, Conch reported 11% YoY revenue growth, and a -2% YoY decline in operating profit. While revenue growth is still significant, it is below what the market has come to expect of Anhui Conch. Seasonally, we expect Q3 to perform on par with Q2. From 2010 to 2013, revenue differed by an average of 1% between Q2 and Q3. In 2014, Conch saw revenues drop by 7.8% QoQ in Q3.

Selling at a 27% discount

2014 Q3 prices averaged RMB 310/ton in provinces where Conch operates, on top of higher volumes likely producing greater efficiencies, should have helped improve Conch's profitability. However, our analysis shows that Conch continually sells at a discount relative to the benchmark market price, averaging 27% over the past two years. This is in line with competitors' statements about Conch's pricing practices, as well as our checks that indicate that Conch often has operations too far from city centers (where cement prices are higher) to be competitive. However, in our checks of Conch sales operations, Conch routinely claims prices at or above the regional average, a significant discrepancy with all our other checks and our analysis of their financials.

Conch disguises discounts by offering non-cash rebates.

Conch's margins, 50% above the industry average, are not possible at such a discount level. We believe that Conch's better than average output performance is due to the fact that it sells at a discount, which implies that it is a lower margin producer than its peers. Conch could achieve this in several different ways. Competitors in multiple regions say that Conch uses a rebate discount system to keep listed prices and cash inflows higher, but upon payment will grant rebate guarantees in the form of BANs, and can be used later as payment back to Conch. This effectively creates a non-cash rebate, where Conch is liable for the BANs, but can classify them as low risk and render as "monetary capital" on the balance sheet.

Additionally, we believe Conch understates its cost base by using an unreasonably long depreciation window. We also estimate that the company's PP&E is 80-90% land bank, which doesn't factor as a cost in cement production. We believe that the value of the land

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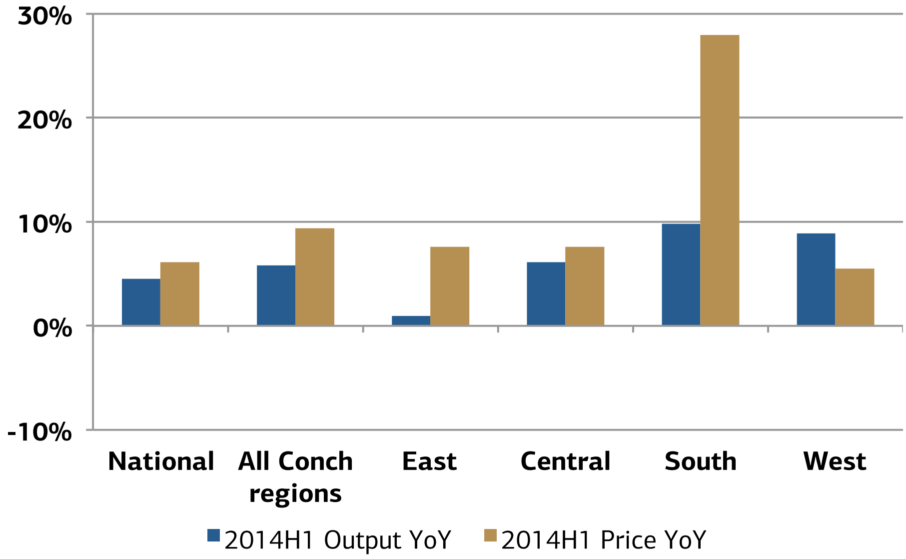
could be overstated, or how salable it is. Given that our checks indicate that Conch operates farther than average from city centers, its ability to sell land to generate cash flow, especially if prices were to decline or if those assets have been overstated in the first place, may become increasingly unfeasible.

Output growth achieved by price discounts

Conch posted strong H1 results in a reasonably favorable macro environment. Cement output growth was still positive, and prices rose throughout the spring building season. The regions in which Conch operates performed better than the national average, and Conch reportedly outperformed peers in sales volumes within each region. The company has no significant operations in North and Northeast China, which have been the weakest performers among the building materials markets since 2012.

Conch operates in regions that perform better than the national average, but it's edge comes from discounts that make its stated margins unlikely.

Chart 1. 2014 H1 output and price growth, YoY



Source: Digital Cement, company filings, J Capital

Note: regions refer to Anhui Conch's areas of operations, and match Anhui Conch's description of provinces with operations in their 2013 Annual Report.

In the third quarter, market output growth in Conch's areas of operation outperformed the national average again, despite the market slowing overall. Competitors report that Conch has a higher proportion of infrastructure customers, particularly in Central China, close to its headquarters in Anhui. Additionally, Conch may be undercutting its competitors on price significantly, allowing it to steal share in some markets, particularly in the Southwest. However, prices fell YoY in three out of four of Conch's regions of operations, increasing only in the South, which accounts

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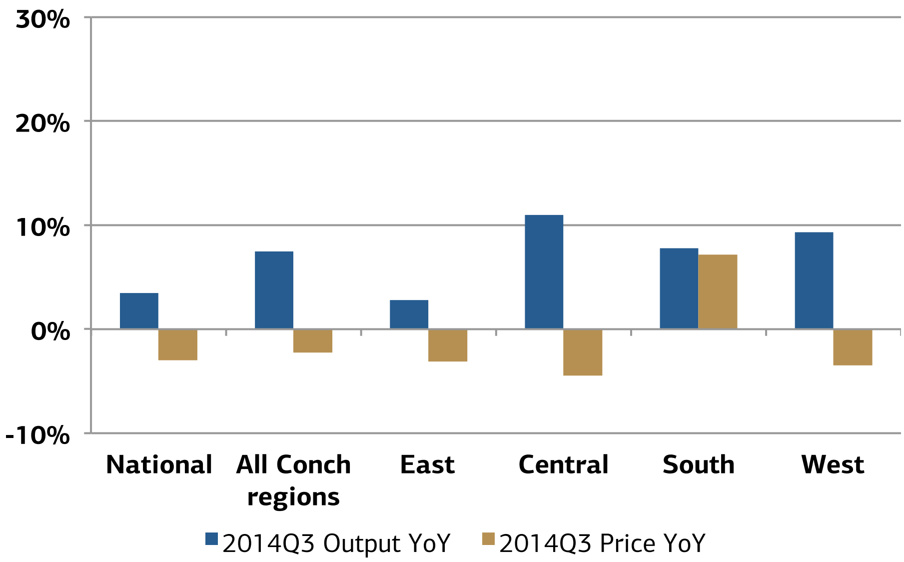
for 13% of Conch's total sales.

Chart 2. 2014 Q3 output and price growth, YoY

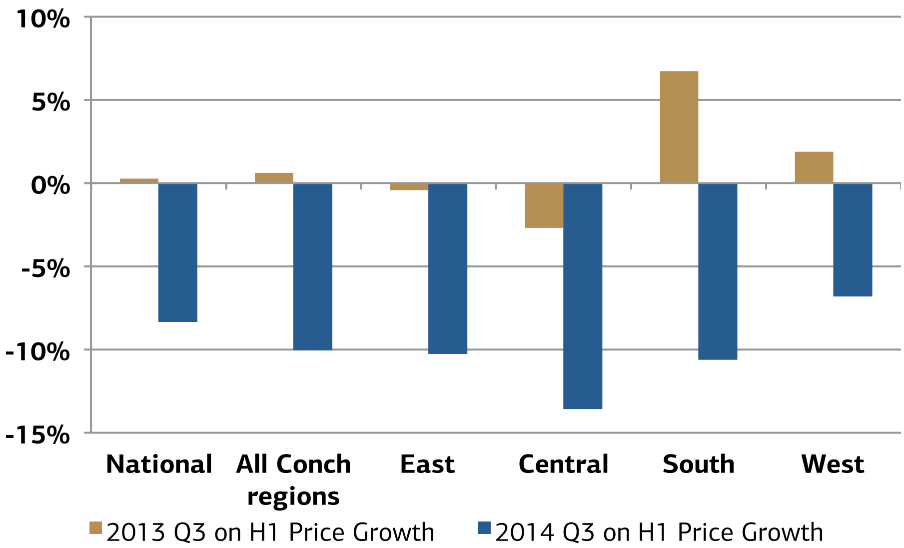


Source: Digital Cement, company filings, J Capital. For description of regions, see Chart 1 Note.

Seasonally, we expect average market prices in Q2 and Q3 to stay reasonably flat. This year, we saw Conch's regions see steeper price falls in Q3 (-10%) compared to the national average (-8%).

Chart 3. Q3 price growth over H1, 2013-2014

Prices fell unseasonably in Q3, which netted out gains in volume.



Source: Digital Cement, company filings, J Capital. For description of regions, see Chart 1 Note.

In fact, Conch saw volume gains netted out by price declines in Q3. While total market output volume increased 7.5% in its regions in Q3, (Conch made no disclosures about output or sales volumes for

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Q3) prices declined by 10.1%.

Beginnings of distress

Our belief that stated margins are too high will be harder to maintain in a declining market. Supporting our view that margins are not what they claim, company disclosures state that cash, "monetary capital," could be largely BANs reclassified as cash equivalents. The fall in average borrowings by two thirds, combined with an increase in asset sales indicates that the company could be beginning to go into distress, as market growth alone cannot propel the company forward. Conch has begun a pattern of cash generation to supplement slowing growth from operations that now must be perpetuated in order to maintain the illusion of being the high margin, high volume producer.

Asset sales and reclassifying BANs as "monetary capital" support our view that margins are implausible.

Conch received RMB 6.3 bln in 2014 Q3 for sale of investments, which typically denotes sales of stakes in subsidiaries or JVs, or could also indicate land sales. But the company makes no disclosures as to what was sold, and accounts for the difference between being RMB 4 bln cash flow positive and RMB 2 bln negative. There is no addition on the income statement for investment revenue, nor are there corresponding reductions in fixed or other assets. Conch has seen a 67% net decrease in borrowings, so this may have been an attempt to raise cash outside of banks. We find the lack of disclosures about such a large transaction worrying, and indicative of a poorer cash situation than Conch attempts to present.

Bills receivable decreased 50%, which the company attributes to a reduction in BANs used for payment. However, in its annual reports and bond prospectuses, Conch states that BANs can be accounted for as cash equivalents if it determines that risk associated with those BANs is limited. Conch provides no explanation as to the risk assessment procedure, or to the value of BANs being held as cash equivalents. We believe that, rather than indicating a lower reliance on BANs, Conch could be reclassifying BANs as lower risk, regardless of their actual risk level, in order to obscure any problems with payments. Our checks indicate that Conch has a track record of underwriting BANs used as payments to the company, which they could classify as low risk, but for which they are liable if the customer using the notes goes under. In an environment where the company is securing less financing from banks, and where their customers report less access to credit, particularly for commercial real estate construction, it seems likely that Conch would both need to finance more of its own sales in

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order to promote volume growth, but would equally want to disguise this from investors.

Anhui Conch, like all SOEs, is opaque. The lack of disclosure on asset sales is not unusual, but the magnitude is. Due to poor disclosures on asset sales and the magnitude of reclassified BANs, it is possible that our understanding of the situation is incomplete. Our site checks and checks with competitors help to verify that margins are unreasonably high, and these are the most likely explanations for this phenomenon.

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