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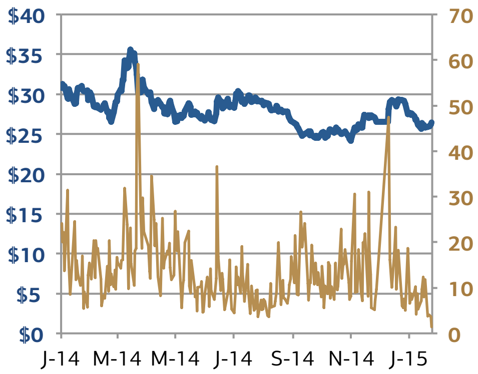
Anhui Conch (914 HK) one-year share price in HKD (blue) and volume (gold, in mln shares)



Source: Bloomberg February 13, 2015

Anhui Conch (914 HK)

Price	HKD 26.45
Rating	**SELL**
Price target	**HKD 14.02**
Difference	**-47%**
Market Cap	HKD 134.6 bln
Simple Moving Avg.	6.9 mln shares
P/E	9.3x
Float	91%

Source: Bloomberg February 13, 2015

China | Building Materials

Anhui Conch (914 HK)

Capacity gap

+ Conch overstated capacity additions by 50%

New data on total cement clinker line additions in China show that Conch has overstated capacity additions to its cement lines by 50% over the past four years. Even at the lower capacity levels, Conch's capacity additions would suggest large boosts to market share that are not visible in the market as they have ostensibly outbuilt their competitors. The data also shows that Conch's newest additions are in marginal, rural areas, and predominantly outside of regions where Conch claimed the most buildout.

+ Reiterate SELL: Lower PT to HKD 14.02

We reiterate our SELL recommendation with a lowered price target of HKD 14.02 based on a DCF valuation taking into account lower capacity estimates for Anhui Conch.

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Capacity overstatement verification

We have recently verified the extent to which Anhui Conch has overstated capacity. We found that, on average, Conch has overstated clinker capacity additions by 50%. For Conch, clinker is 45% of total production and less than 20% of total revenue, as most production is used as an input for their cement production operations.

In the first complete list of new capacity lines for cement in China, released last month, we were able to verify the total amount of new clinker capacity that Anhui Conch has been able to bring on line over the past four years. Digital Cement, an independent data gatherer for the cement industry in China, released a report with a detailed list of all new cement clinker lines built in China over the past few years delineated by company, location and size.

Conch has been growing capacity faster than market capacity and yet has not grown share.

Table 1. Clinker capacity additions

MMTPA	2011	2012	2013	2014
Conch reports of its additions	33.6	20.8	11.6	*19.0*
DC reports of Conch's additions	22.0	13.8	7.0	13.8
Over-reporting rate	45%	51%	66%	38%

Source: Digital Cement, J Capital, company reports

Note: 2014 figure is based on company projections as of 2014H2, and based on actualized capacity increases as reported in the 2014H1 semi-annual report.

In our previous examinations of Conch, we find it likely that the company overstates both production and margins. Facilities that we check rarely produce at rates that Conch reports. Margins are well outside the industry norms, and we are consistently unable to verify the ostensible higher pricing that Conch claims to justify these margins. Additionally, overstatement of assets is a crucial component to our thesis as to how Conch overstates its margins. This confirmation of capacity overstatement is consistent with our existing view of the company.

Market share

We also find that Conch has been bringing on both clinker and cement capacity faster than the market as a whole, and yet its market share has not grown. Share, according to Conch's reports, has remained steady at about 7% since 2010. We estimate that Conch should have grown market share by 4.5% points over the

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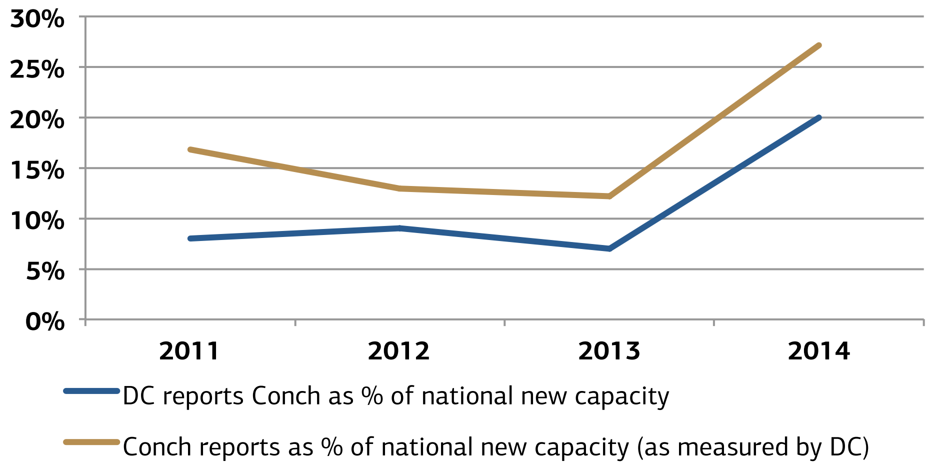
past four years (from 6.5% to 11% of total cement/clinker production) if its new capacity and utilization rates were accurate, and neither Digital Cement, industry reports or Conch itself reports a market share allocation shift of that magnitude. Clinker capacity as a whole has grown faster than production growth, but Conch's capacity build out has been faster than average.

Chart 1. Conch new capacity as % of total



Source: Digital Cement, J Capital, company reports

Ramifications

Capacity overstatement and flat-lining market share both are in line with our checks on Conch.

- Conch already claims some of the highest capacity utilization rates in the business, coming in at 99% in 2013, for example. We were already dubious of the validity of these figures, given than industry standards are 10-25% lower, and interviews revealed common capacity utilization rates at somewhere in the 50-65% range in China over the past two years.

- The discrepancies in capacity suggest that production volumes and capacity are likely both overstated.

- We see this as a further verification that company margins are inflated by by over-reporting production. By overstating total production, when a portion of that production has no cost, the topline (inflated) revenue figure shows a fat margin by industry standards.

- Conch has been able to keep costs low by simply not

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building new facilities to the size specified, and then not producing at those facilities.

- Finally, the data on new lines show that from 2012-2014, Conch built 21 out of 22 new clinker lines outside of major cities, with more than half being rural prefectures rather than cities of any tier. This means that the clinker and cement would incur a significant transport cost to be used in places with large property and infrastructure markets. This aligns with our checks that show that Conch is often deleteriously located outside of major production hubs, which disadvantages them when it comes to cost competitiveness, margin, and higher selling price in relation to their peers.

Valuation: PT reduced to HKD 14.02

Though clinker is less than 20% of Conch's external sales volume, it makes up 45% of total installed capacity for the company, and comprises the vast majority of intra-company sales as the necessary input for their 32.5 and 42.5 sales business. By using the discrepancy in installed capacity base, we modified our estimates for real capacity sales revenue in previous years, and our estimates for total installed capacity base and sales revenues going forward.

We estimate that as of year-end 2014, Conch likely had 8.5% less installed clinker capacity than stated.[1] We applied a production adjustment of slightly under half that discrepancy (-4%) to their total production volumes, to account for the impact to their cement segment as well with less raw input. This conservative calculation led us to lower our target price by 12% to HKD 14.02 based on our DCF valuation model.

Table 2. Share price adjustment for capacity

Production adjustment	Share price
-2%	14.99
-4%	**14.02**
-6%	13.05
-8%	12.08

Source: J Capital

[1] We calculated this by using Conch's existing capacity figure from year-end 2010, and adding the incremental new capacity as reported by Digital Cement for the following years. The final figure was 8.5% discrepant with Conch's 2014 semi-annual statement. This result discounts any overstatement prior to 2011, taking the 2010 report at face value as the Digital Cement data set does not extend back further, so there is a possibility that this process underrepresents the extent of capacity overstatement.

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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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