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Anhui Conch (914 HK)
Horror Q2

Conch sees gross margin fall by 35% in April

Operating profit may have fallen 40% YoY in Q1, but Q2 is shaping up to be worse. Margins have fallen off a cliff after Spring Festival, as prices have collapsed 17% in Conch's markets since year beginning, and demand in the key eastern and southern markets fell 20% YoY in April.

(Soon to be) cash flow negative

Conch's net operating cash flow collapsed in Q1, falling by more than 80% QoQ (70% YoY) to under RMB 1 bln for the first time on record. As a commodities company that has prided itself on being cash-rich, the RMB 4.5 bln decline in total cash should make investors wary. Additionally, RMB 3.7 bln in cash outflow for investment failed to materialize on the balance sheet, leading us to believe that the company is already subsidizing its operational capital. Conch's strategy of using generous financing terms to subsize its sales to blenders will soon evaporate if it cannot muster enough working capital, effectively eliminating its market advantage.

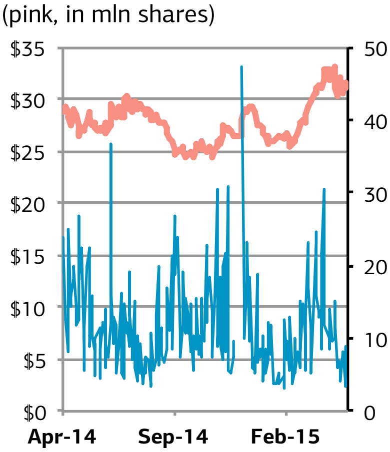
Reiterate SELL: Adjust PT to HKD 14.61

We reiterate our SELL recommendation with an adjusted price target of HKD 14.61 from HKD 14.02 based on a DCF valuation taking into Conch's 2014 annual filings, Q1 2015 results, lower margins forecasts and a lowered pricing forecast.

Anhui Conch (914 HK)

Price	HKD 32.85
Rating	**SELL**
Price Target	**HKD 14.61**
Difference	**56%**
Market Cap	HKD 170.5 bln
Simple Moving Avg.	7.5 mln shares
P/E	12.64x
Float	91%

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



Source: Bloomberg May 26, 2015

The Time to Short Is Now

Conch reported the first YoY revenue decline since 2012, down 11%, and an operating profit contraction of 41%. While these results did not disappoint the market appreciably, we believe that these are leading indicators for how poorly Conch, and the cement market in general, will perform in 2015, and that Q2 results will make the first quarter look good by comparison.

Two factors appeared in Q1 which we see escalating in severity in Q2, providing strong catalysts for going negative on Conch:

- We have seen Conch's margins decline by a third so far in Q2, and demand contracted by 20% YoY in April compounding a 17% decline in prices in Conch's major markets.
- Conch's working capital is drying up: net operating cash flow declined by more than 80% QoQ (73% YoY), and a RMB 3.7 bln financing cash outflow does not appear as an asset on the balance sheet—we believe the company is already subsidizing its operating cash flow with asset sales.

April: Worst Month for Cement in Nearly Two Decades

We believe Conch's gross margins fell 35% in April over Q1 2015. The company reported an operating profit decline in excess of 40% in Q1, as well as an 80% decline in net operating cash flow. This is the beginning of the company's worries as their market faces declining prices, lower margins, and negative demand growth.

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Macro: Poor Demand

In our April cement survey (read the summary survey findings in our May 15th CPI Commodities report here), we found demand decline across all regions, with the crucial southern and eastern provinces reporting a 20% YoY drop in post-Spring Festival orders. This is the first time our survey shows demand declines in all regions, and, critically, represents a fast deterioration from sentiment prior to the holiday, when only three of six regions were expecting demand declines.

Oversupply and declining cement demand is also reflected in Conch's inventory growth to 47% of revenue (typically a third of revenue in Q1)—taking into account the price fall, this translates to a 20% YoY increase in inventory volume. Another sign of oversupply: prices declined 14% YoY

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The margins that Conch reports do not align with our now more than 100 checks on the company.

nationally in Q1 2015, and Conch's geographical zone performed worse, down 17% YoY.

Our cement survey found that margins fell for all companies, with nine of ten reporting a drop of almost a quarter, from an average gross margin of slightly above 20% to around 15%.

How Does Conch Measure Up?

Since we initiated on this company we've been clear that the margins that Conch reports do not align with our now more than 100 checks on the company, and Conch has offered no reasonable explanation for why a commodities company should boast nearly twice the margins of all their competitors in an oversupplied market.

While competitors saw a quarter of their gross margin disappear going into Q2, we estimate that Conch saw margin contraction of more than 40%. We arrive at this figure by using our data from primary checks in 2014 and 2015Q1 compared to checks in April and May rather than Conch's official figures. While Conch reported margins in excess of 30% as recently as its 2014 annual filing, we believe real gross margins today are closer to 11-14% across all markets. The following table represents average margins for Conch in its four primary operating regions according to our channel checks.

Table 1. Survey Gross Margin Decline for Conch

	2015 Q1	Apr-15	Change
East China	17%	11%	-35%
South China	22%	14%	-37%
Southwest China	16%	8%	-46%
Northwest China	14%	10%	-28%
Nationwide	17%	11%	-35%

Note: North and Northeast China are excluded as Conch has no significant production in these provinces.
Source: J Capital

Our checks show that in Guangdong province Conch has seen a gross margin decline of 37% since January, to 13.7%. Competitors in the region tell us that Conch is overstating prices, and that while the scale of margin decline is correct, and that their likely margin in April was below 7% due to the fact that they are selling at 25% below the average price in their markets. Guangdong has seen a decrease of 19% in prices this year, which has virtually wiped out any margin for producers—the average producer

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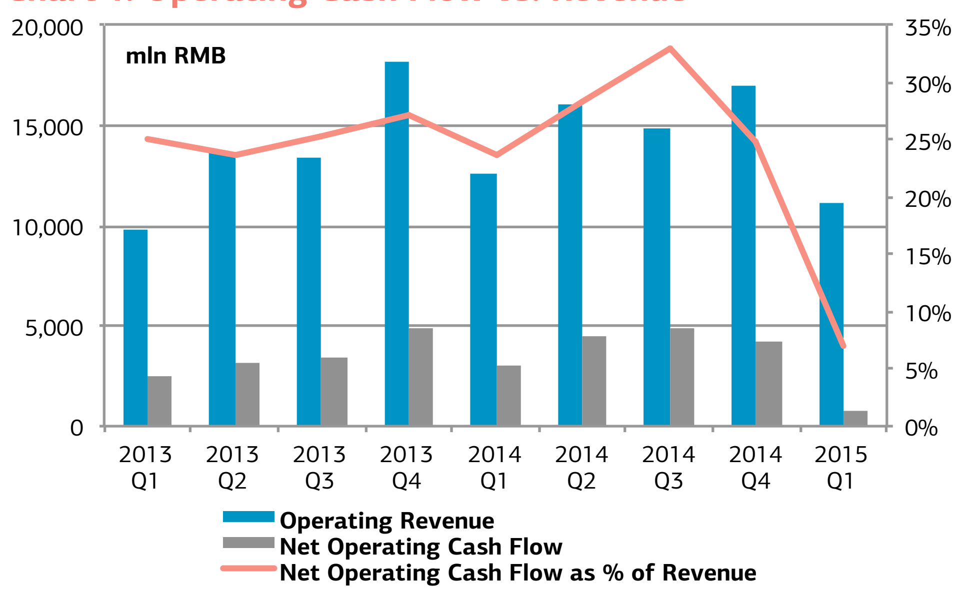
was bringing in less than 5% gross margin at the start of Q2.

In East China, Conch has fallen harder, with our checks showing margins of around 11%. Conch's construction cement is currently selling ex-factory for RMB 215/ton, more than 15% below the regional average. Producers there speak of price increases as the only way to boost margins: they don't expect to see cost reductions of more than 1-2% this year.

Show Me the Money

A company generating the margins that Conch claims should be generating significant cash flow, but that claim appears to be evaporating (See Appendix A for complete cash flow statement & comparison). In Q1 2015, the company had RMB 851 mln of net operating cash flow, or just 7.6% of operating revenue. Compare that to the RMB 3,019 mln of net operating cash flow in Q1 2014, or 24% of operating revenue for the quarter. In fact, the company's own financials have turned from making it look hugely cash generative, to fairly ordinary.

Chart 1. Operating Cash Flow vs. Revenue



Source: Company filings

In the last quarter alone, Conch saw a RMB 4.5 bln drop in total cash, the largest ever movement in total cash flow. While net financing cash flow increased by RMB 100 mln and operating cash flow by nearly 900 mln, net investment cash flow was RMB -5.5 bln, despite no new significant investments being announced or explained in the Q1 filing. One of the big-ticket items on the cash flow sheet is an even RMB 3.7 bln on "Cash paid for investment." Yet total assets increased by less than RMB 2 bln, and no categories saw a movement of that magnitude. The only significant increase in assets is in available for sale securities, yet the Q1 2015 disclosure makes clear this is from revaluation, not from cash investment:

> "As at the end of the Reporting Period, the closing balance of the Group's available-for-sale financial assets increased by 42.14% from that at the beginning of the year, while the closing balance of deferred income tax liabilities increased by 80.51% from that at the beginning of the year. These were mainly due to the increase in the fair value of other listed companies' shares held by the Group as at the end of the Reporting Period when compared with that at the beginning of the year."

As there was no corresponding asset increase to account for this RMB 3.7 bln, we believe this went into operations, and that the company is already operations cash flow negative. The company made no comment as to what this large sum went towards, despite addressing changes such as an increase to RMB 72 mln from 11 mln YoY in investment income ("due to a... increase in investment income from associates").

We arrive at our view that cash flow may already be negative by changing the categorization of that RMB 3.7 bln to an internal subsidy for operating cash, and assuming that this transfer was necessary in order to arrive at the net operating cash flow value of RMB 851 mln—in other words, net operating cash flow, due to reduced margins therefore lower revenue, was closer to RMB -2.8 bln. Our previous checks suggested that Conch was using land sales in order to generate cash to be able to report inflated margins, and this cash transfer is likely a similar stratagem. It is possible that part of the RMB 1.5 bln in fixed asset investment could have been used to fill the operating cash flow gap as well, which would dig the hole deeper.

Further evidence of the weaker cash flow position of the company is the fact that it has no longer able to give generous sales terms.

Weak Sales Terms

Further evidence of the weaker cash flow position of the company is the fact that it is no longer able to give generous sales terms. Conch's key strategy has been generous sales terms, essentially providing finance to clients. Normal market terms for blenders is cash on delivery, but they have reported being able to delay up to 50% of their payment for more than 100 days with Conch. These sales terms finance a blenders working capital—that is why a blender buys from Conch. Blenders are therefore more than happy to report a higher price for Conch because they receive a rebate or simply do not pay that mark-up, and in return receive financing. Conch achieved this by accepting payments as a mix of cash, bankers acceptance notes (BANs), letters of credit (LOCs) from the company, and accounts receivable.

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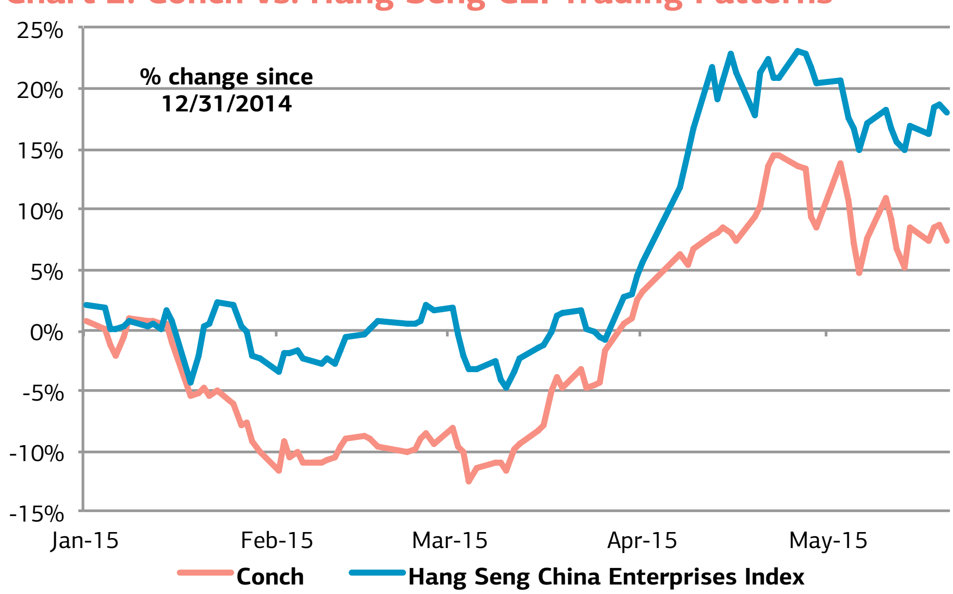
However, our analysis of their Q1 filing shows that receivable days have declined from 32 in 2014 to 24 in Q1 2015, suggesting that cash flow is hindering the company's ability to compete for cement sales on the basis of generous sales terms. Receivable days have been very stable over the past eight quarters—we think it is unlikely that the company has all of a sudden improved its debt collection ability, especially given the number of blenders who have reported to us how important leeway with payment is for their own working cash flow. In a market with declining volumes and less cash to provide these terms to blenders, Conch will inevitably lose share.

Catalyst: Breaking Lock-Step

Despite what we perceive as negative news from the Q1 2015 filing, Conch has traded similarly to the overall market patterns and, in particular, the Hang Seng China Enterprises Index. We believe Conch has been part of a rising tide of H-shares and not traded on fundamentals, but the severe contraction in working capital and the poor macro conditions of this commodities market may be the right combination for the company to break this trading pattern.

Chart 2. Conch vs. Hang Seng CEI Trading Patterns



Source: Bloomberg

Valuation

We adjust our target price up to HKD 14.61/share taking into account Conch's 2014 and Q1 2015 earnings reports, which were higher than our model projected. We also factored in lower forward pricing, 2015 inclusive, and lower capacity utilization rates starting Q2 2015. Finally we adjusted our estimate for 2015 gross margin down to 25%—the order of magnitude observed in the market 2015 YTD compared to what Conch reported for margins in 2014 weighted towards end of year levels (39%). While our research shows that Conch may have gross margins as low as 11%, this approach gives Conch the benefit of the doubt by taking their 2014 full year results at face value. Through this method, our DCF returns a value half that of the current share price.

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.

Conch has, in the past, used large asset sales to bring in cash, which we believe has maintained the fiction of their high margin business, and this is a plausible strategy for them to employ in the current environment.

Appendix A. Anhui Conch Cash Flow Statement

in RMB	2015 Q1	2014 Q1	Comments
Cash flow generated from operating activities			
Cash received from sale of goods and rendering of services	14,831,330,548	18,132,084,570	
Tax and charges refund	84,216,893	47,800,926	
Cash received relating to other operating activities	223,933,230	206,448,621	

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Sub-total of cash inflow from operating activities	15,139,480,671	18,386,334,117	
Cash paid for goods and services	-10,955,079,313	-11,783,999,558	
Cash paid to and on behalf of employees	-1,323,971,336	-1,191,661,421	
Various types of tax paid	-1,654,015,292	-2,019,865,717	
Cash paid relating to other operating activities	-355,038,822	-371,628,426	
Sub-total of cash outflow from operating activities	-14,288,104,763	-15,367,155,122	
Net cash flow generated from operating activities	851,375,908	3,019,178,995	74% YoY decline
Cash flow generated from investing activities			
Cash received from sales of investments	-	1,950,341,591	We believe land sales have been a primary way to generate working capital in the past. This seems to no longer be true.
Cash received from investment income	-	20,707,808	
Net cash received from disposal of fixed assets and intangible assets	3,752,705	7,798,273	
Cash received from other investing activities	98,901,773	91,330,142	
Sub-total of cash inflow from investing activities	102,654,478	2,070,177,814	
Cash paid for acquisition and construction of fixed assets, intangible assets and other long-term assets	-1,555,428,777	-2,183,898,884	Cement producers have capacity utilization rate of under 65%, and Conch doesn't differ appreciably. We also have confirmed that several facilities Conch claims do not exist—where are the corresponding assets?
Cash paid for investment	-3,700,000,000	-1,794,856,112	This RMB 3.7 bln payment does not appear on the balance sheet. This is the payment we believe is a cover to keep working capital ostensibly positive. It is not mentioned in the quarterly filing.
Net cash paid for acquisition of subsidiaries and other operation entities	-268,928,510	-264,791,061	
Cash paid for other investing activities	-45,000,000	-6,000,000	
Sub-total of cash outflow from investing activities	-5,569,357,287	-4,249,546,057	
Net cash flow generated from investing activities	-5,466,702,809	-2,179,368,243	Why did the company invest RMB 5.5 bln, yet not announce any significant new investment projects?

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Cash flow generated from financing activities		
Cash received from investment	144,550,000	
Including: cash received from investment of minority interest of subsidiaries	144,550,000	
Cash received from borrowings	322,966,974	313,204,979
Cash received from other financing activities	-	-
Sub-total of cash inflow from financing activities	467,516,974	313,204,979
Cash paid for repaying borrowings	-316,000,000	1,409,000,000
Cash paid for distribution of dividends, profits or payment of interest	-67,180,231	-62,507,731
Including: profits distributed to minority interests by the subsidiaries		
Cash paid for other financing activities	-	-
Sub-total of cash outflow from financing activities	-383,180,231	-1,471,507,731
Net cash flow generated from financing activities	84,336,743	-1,158,302,752
Effect of changes in foreign exchange rates on cash and cash equivalents	1,861,196	10,165,565
Net increase in cash and cash equivalents	**-4,529,128,962**	**-308,326,435**
Add: Cash and cash equivalents at the beginning of the period	12,512,121,499	6,518,932,288
Cash and cash equivalents at the end of the period	**7,982,992,537**	**6,210,605,853**

Xiaogan. Meetings will include LGFVs, developers, financiers, brokers and analysts, and steel companies.

- **Led by Anne Stevenson-Yang, June 4-8.**

July Trips

China's Silk Road? Kazakhstan and Xinjiang

Almaty, Kazakhstan; Urumqi, Xinjiang; Xi'an, Shaanxi. We aim to discover how Kazakhstan and Xinjiang are faring in the commodities downturn and see if the Silk Road project will lead them out of trouble. China is championing the Asian Infrastructure Investment Bank to develop the "Silk Road Economic Belt" to help the Chinese and neighbouring economies. China announced $23.6 billion in new cooperation projects with Kazakhstan in March. This trip will also provide insight into how the Silk Road project may help the Chinese economy to continue to grow.

Kazakhstan and Xinjiang are both land locked minerals based economies reliant on China. The heart of these economies are the mining companies and their trading relationships with China. We will focus on the key minerals of copper, nickel and coal on this trip. We aim to visit mining, mineral trading and processing companies on both side of the borders. Big dreams on one side of the boarder are often bad nightmares on the other side. We will also meet with infrastructure companies and financial institutions to understand what new transport links will be built.

- **Led by Anne Stevenson-Yang, July 18-24.**

Luxury Autos

Shanghai, Hangzhou, Beijing. We will be visiting luxury auto dealerships to assess the true growth trajectory of Chinese luxury car sales in 2015 and beyond. Given that our Q1 channel checks showed sharp declines in sales volumes, we will focus on whether negative sales will continue throughout the rest of the year.

- **Led by Kevin Yeoh, July 27-30.**

August Trips

E-Commerce

TBC. We will be taking clients to take a closer look at the e-commerce ecosystem to have an update on profitability level, revenue overstatement and what the real businesses of these players actually are.

- **Led by Anne Stevenson-Yang, August 3-6.**

Finishings: Elevators, Ceramics, and Copper

Xiamen, Hangzhou, Xi'an, Hefei. We expect property construction completions to decline this year and sales of elevators, sanitary ceramics and copper to follow. We will visit Xiamen, Fujian, an important property market and a ceramics production base. We will then visit Hangzhou, Zhejiang, a key market for elevator sales and production. We will then visit Xi'an, Shaanxi, an important West China market for elevator and ceramics sales before we visit Hefei, Anhui, a key copper processing area.

For elevators and ceramics we will meet with property developers, distributors, agents and producers of equipment to understand what is happening with orders and sales in the peak construction period. For copper we will speak with traders and processors of copper to get an understanding of the end demand for copper this year.

- **Led by Tim Murray, August 5-7.**

Methanol

TBC. We will be testing our fundamental bearish view of the methanol market by 1) looking at the logistics of coal transportation from mines to the coast, to get a feel for the cost side of the equation, 2) visiting SOE CTM facilities to get a feeling for if there is a price level at which they would stop producing, 3) interviewing gasoline distribution blenders to get a sense of the real demand picture.

- **Led by Tim Murray, August 10-13.**

Please email Brian Emanuelson (brian@jcapitalresearch.com) or Roberta Sanminiatelli (roberta@jcapitalresearch.com) if you'd like to see a preliminary agenda for any of the listed trips, or share with us any trip bespoke ideas you might be thinking about.

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