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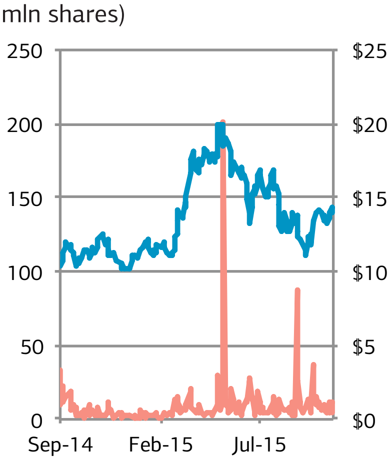
Car Inc. (0699 HK)
Not Much Under the Hood

- **Car Inc. is managing to show profit** by manipulating depreciation schedules then selling used cars at inflated prices to franchisees. The unorthodox depreciation standards enable Car to report higher margins than its chief competitor even though its core operating metrics are worse. The business is not worth the heady valuation currently attached to the company.
- **New vehicles are being bought** on terms that are suspiciously favorable, at 30-50% discounts, and a big portion of old vehicles were sold in 2014 through a partner, Youxinpai, with which it shares key investors. We suspect that Youxinpai subsidized Car in 2014.
- **Car's entry into chauffeured car services** brings it into fierce competition with Didi (Tencent and Alibaba), Yidao (Tencent and Baidu), and Uber. These companies are engaged in a price war, and entering the fray will require heavy investment from Car. The business also bears regulatory risk.
- **Despite its high leverage ratio,** Car is piling on more U.S. dollar debt, raising its interest costs, and incurring depreciation risk.
- **The valuation of Car Inc. is too high** to be justified by the company's fundamentals. We initiate with a SELL recommendation and a target price of HKD 10.05 based on a DCF valuation with 2% terminal growth and a 10% WACC.

Car Inc. (0699 HK)

Price	HKD 13.72
Rating	**SELL**
Price Target	**HKD 10.05**
Difference	27%
Market Cap	HKD 32.7 bln
P/E	44.11X
Avg. Volume	9.36 mln
Float	43%

Car Inc. (0699 HK) last share price in HKD (blue) and volume (pink, in mln shares)



Source: Bloomberg

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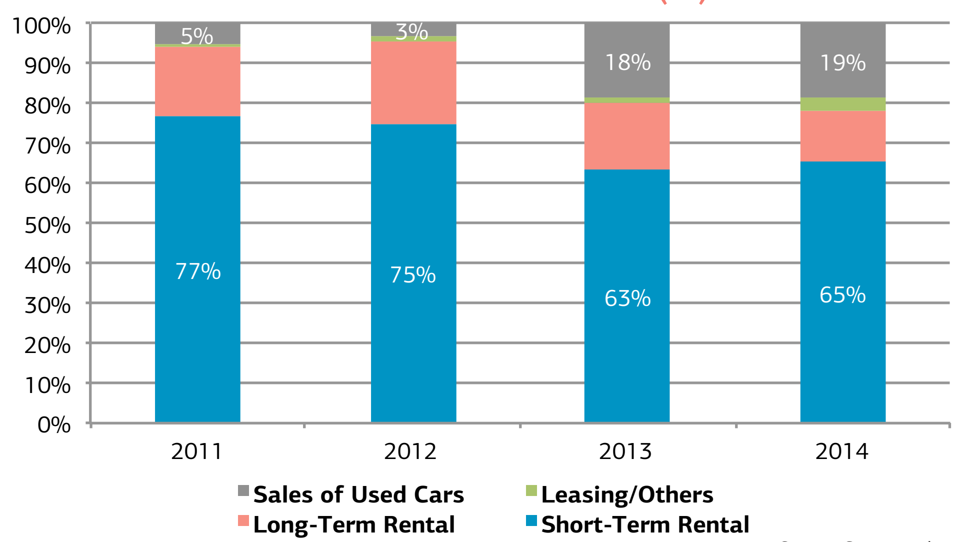
The Basics

Short-term rentals have been the major contributor of revenue.

Car Incorporated is a car rental company established in 2007 offering both short- and long-term rentals. The company owns 84,719 vehicles 726 directly operated service locations, including 246 stores and 480 pick-up points, in 70 major cities. The franchisee network encompasses 230service locations in 182 small cities. Short-term rentals, of under three months, have been the major contributor to revenue, accounting for 65% of the total but down from 77% in 2011. Long-term rentals have also fallen proportionately, from 18% in 2011 to 13% in 2014, and sales of used cars make up the gap. Leasing refers to the lease-to-buy program they offer to some long-term customers.

Chart 1. Revenue Breakdown 2011-2014 (%)



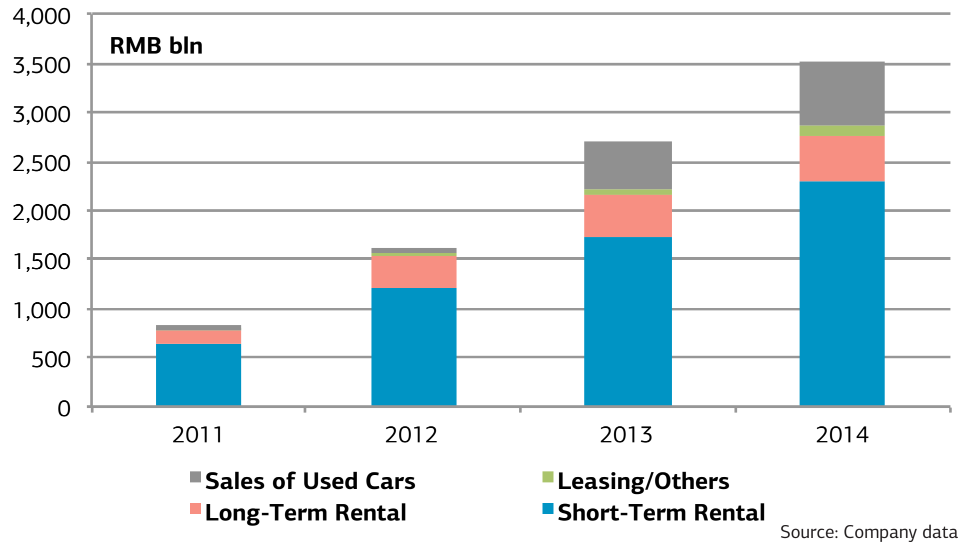
Source: Company data

The scale of the business has grown with fleet size. Over the period from 2011 to 2014, fleet size more than doubled, from 25,800 in 2011 to 63,500. The sale of used vehicles increased from 742 to 15,500 over the same period.

Increasingly, the company derives its revenue from selling off its used cars. The portion of revenue derived from selling used cars rose to 19% in 2014 from 5% in 2011.

Car Inc. lives in a very competitive market with low levels of aggregation. The rental business grew at a CAGR of 29% over 2008 to 2013, from a RMB 9 bln market to RMB 34 bln, according to Roland Berger. Over the

Chart 2. Revenue Breakdown 2011-2014



Source: Company data

same period of time, fleet size increased from 100,000 to 369,000 cars. Yet China still has a very low penetration rate, meaning the number of rental cars over the car population. In 2012, China's rental penetration rate was only 0.4% compared to 2.5% in Japan, 1.6% in the US, 1.4% in Korea and 1.3% in Brazil according to Roland Berger, and the top five players together only accounted for 14% of the total market in 2013 versus 95% in the U.S. and 58% in Brazil. Given the disaggregation and the market growth, competition is intense.

Pulling Growth from the Balance Sheet

We believe that Car Inc. derives its high margins and profitability from its generous treatment of the cars on its balance sheet. *In fact, all the company's profit comes from the difference between purchase prices for the cars and residual prices when they are sold off, often to partners, helped along by an odd depreciation schedule.*

The reason used-car sales are now contributing 19% of revenue is that Car Inc. receives generous discounts on its purchase of cars and then sells them at surprisingly high prices. Cars come at discounts of 30-50% off the retail price, something no other fleet owner we know has been able to achieve. Once used in the rental business, the cars are sold at two-thirds of the purchase price, much higher than the prices achieved by either Car's chief domestic competitor, Ehi, or its global peers, such as Hertz and Avis.

According to company's financial filings, in 2012, 2013, and 2014, the com-

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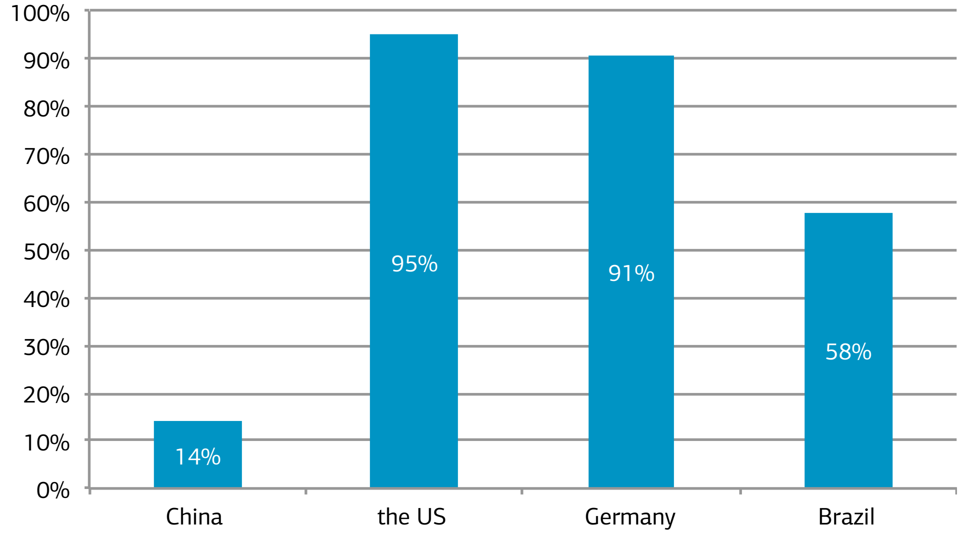
Chart 3. Aggregate Market Share of Top Five Players



Source: Company filings

pany purchased 15,198, 11,979 and 10,500 vehicles respectively and had capital expenditure on new vehicles of RMB 1,663 mln, RMB 1,002 mln and RMB 1,880 mln. This implies an average purchase price for vehicles of RMB 109,000, RMB 84,000, and RMB 179,000.

If we assume that the average car is used for two years, then the residual value, based on reported used-car revenue, is nearly 50% of the purchase price. For private cars, a 50% discount is reasonable for a car two years old, but the rental car industry chews up its cars: use is more intensive and drivers are careless. For this type of used vehicle, residual value of one-third the purchase price is considered good.

Our checks with former employees of Car Inc. and with online used-car auction platforms suggest that all is not as Car Inc. reports. Prices transacted for the cars appear to be far lower than Car Inc.'s reports imply. The prices at which Car sells to third-party brokers are actually lower than the fair market prices for the vehicles. One former Car Inc. shop manager in Beijing told us that Car Inc. generally gives a discount of about RMB 5,000off the fair market price to brokers and dealers.

The gap, we think, is from inflated prices for the one-third of the used fleet sold to franchisees. The excessive capex apparently required of franchisees would be a sort of franchise fee, the price to play in the network. But that means that Car Inc. relies for its profit entirely on expanding the franchise network and selling cars to the franchisees.

The company began franchising in 2014 and made 34% of its used-vehicle sales to this network.

That makes it possible that Car Inc. recruited franchisees in 2014 to dispose of used vehicles.

Now, according to a former Car Inc. employee, many of the franchise stores have closed. This may affect the company's ability to dispose of used vehicles going forward.

Table 1. Growth in Residual Value of Vehicles (,000 RMB)

	2012	2013	2014
Capital used for car purchases	1,663	1,003	1,880
Additions to fleet size	15,198	11,979	10,500
Average purchase price	109,433	83,694	179,086
Residual value of vehicles	58,220	56,319	49,560
Residual value as % of purchase price	45%	50%	NA

Source: Company data

Heads I Win Tails You Lose

An additional portion of overpriced sales appears to come from Car Inc. partner Youxinpai, an online used-car sale platform that has low turnover and poor access to inventory. Youxinpai seems to be paying Car Inc. for the right to sell cars.

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Car Inc. entered into an agreement with Youxinpai in May 2014 under which Youxinpai agreed to cap its service fee at 3% of the sales price for three years. Youxinpai sets a price with Car Inc. and, if the actual transaction price is lower than the agreed price, Youxinpai pays the difference. If the transaction price is higher than agreed, Car Inc. gets to keep the gain. Youxinpai's transaction price is normally 5~10% higher than that on the offline market. Car Inc. sold 4,600 used cars through Youxinpai in May 2014.

These 4,600 cars seem to represent about 16% of Car Inc.'s revenue. From 2011 to 2014, the top five customers collectively accounted for 3% to 5% of total revenue. After the deal with Youxinpai, this figure increased to 21.2%. This means that Youxinpai itself must have contributed 16% of the total revenue.

Excuse us if we are skeptical. Before working with Youxinpai, disposed

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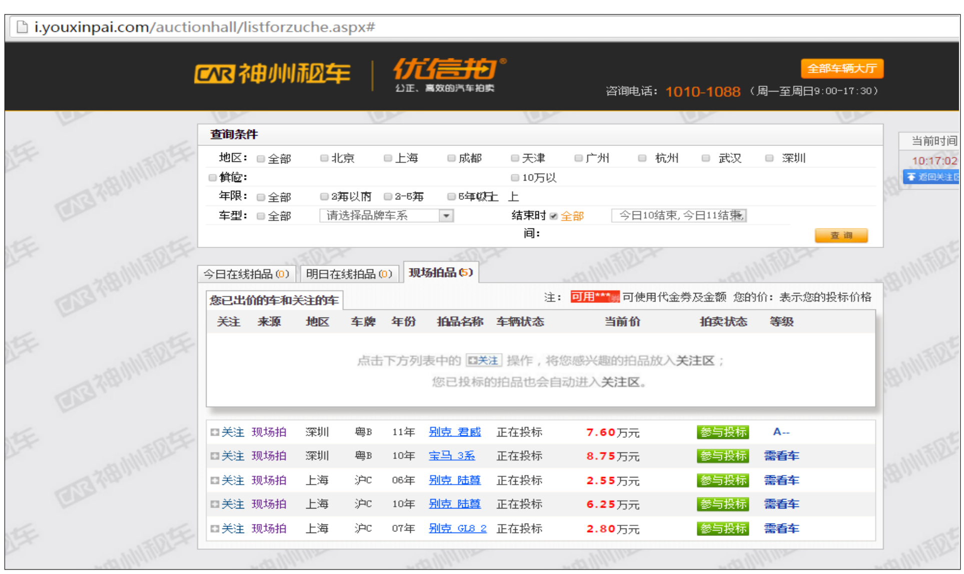
of 742,899, and 9,986 vehicles in 2011, 2012 and 2013, respectively. After cooperating with Youxinpai, Car Inc. disposed of 4,600 cars through Youxinpai May of 2014 alone, accounting for 16% of revenue. *If 4,600 used cars contributed 16% of revenue, then why, when in 2012 the company sold 9,986 cars, did that sales revenue account for less than 5.5%?*

During the first half of 2014, sales of used vehicles accounted for 25.8% of total revenue. If Youxinpai contributed 16%, offline sales of 7,122 accounted for only 10% of total revenue. The calculated average price for the vehicles sold to Youxinpai would be roughly RMB 64,766 while for the offline channel, the average price would be RMB 25,661.

Youxinpai, under the terms of its contract, may be subsidizing vehicle sales.

This big differential suggests that Youxinpai, under the terms of its contract with Car Inc., is subsidizing the vehicle sales. Sales volume is a critical metric for an online platform, and Youxinpai may well be willing to pay for volume in order to raise its valuation. This fits our experience and the press reports on the sector. Online second-hand car platforms are losing money due to the high subsidies they offer.

Youxin, the parent company of Youxinpai, was founded in 2011. Between that time and October 2015, the company raised USD 460 mln from capital markets. Car Inc. and Youxinpai share some of the same investors, including Warburg Pincus LLC and Lenovo Capital. Private equity investors frequently help their investee companies transact with one another to boost revenue. That Youxinpai could be helping itself by helping Car Inc. is very plausible.



Screenshot of Youxinpai bidding at 10 am on November 3 | Source: J Capital Research

We wonder whether the deal with Youxinpai might have been a temporary one of expedience. We visited Youxinpai's website at 10 am on November 2, when daily bidding starts. At that time, there were only five used cars on sale, and these cars could not be purchased online but only offline. On November 2, 4-6, and 9, there were no cars on sale.

We telephoned Youxinpai to ask why the platform had no cars from Car Inc. Cars from Car Inc. are distinctly displayed with a special bar on the home page. We were told that Car Inc. cars are available only irregularly. But 4,600 cars sold in 2014 would mean a regular supply.

We suspect that the cooperation may have been a one-off way to improve results before the IPO in September 2014.

Source: J Capital Research

How Do They Do That?

Car Inc. has the lowest depreciation ratio, meaning depreciation over revenue, among its peers, shorter than that of Ehi, China's second-largest car rental company.

Car Inc. depreciates vehicles over 2.5-3 years, while Ehi uses 3-4 years. Yet Car Inc.'s depreciation rate is lower than that of its peers--especially in the IPO year of 2014.

This discrepancy decreases the value of depreciation expenses and so improves the bottom line.

Table 2. Comparative Depreciation Ratios

	2011	2012	2013	2014
Car Inc.	33.25%	34.38%	31.27%	23.38%
Ehi	NA	37.15%	34.66%	33.77%
Hertz	27.33%	29.75%	29.08%	34.06%

Source: Company data

Stuffing the Capex Line

We suspect that Car Inc. records some other expenses in its capital expenditure on new vehicles. The average purchase price before 2013 was far lower than in 2014. In 2010, Car Inc. purchased 6,000 cars using RMB 600 mln, spending RMB 100,000 per vehicle. This average held through 2013. Then, in 2014, the average price more than doubled. That would be possible only if all the 10,500 vehicles acquired were luxury models.

Instead, it seems likely that Car Inc. has stuffed the vehicle capex line with other types of costs.

Furthermore, the average value of a vehicle on Car's balance sheet is now less than half of this price. That suggests that Car will soon have to dispose of a great number of vehicles, since it typically does not keep them when they drop below 50% of purchase value.

Table 3. Average Vehicle Value

	2012	2013	2014
Average purchase price	109,433	83,694	179,086
Average value per vehicle (RMB)	86,276	75,892	82,400
Avg value as % of avg purchase price	79%	91%	46%

Source: Company data

Higher Margins with Lower Efficiency?

Despite being China's largest rental company and reporting the highest margins, Car Inc. has the lowest efficiency. By the end of 2014, Car Inc.'s fleet size was more than three times that of Ehi, yet Car's utilization rate was 10% lower. The average daily rental revenue per short-term vehicle was lower than Ehi's until 2014, when it caught up.

Car Inc.'s marketing expenses are only half of Ehi's.

Table 4. Utilization Rate Comparison

	2011	2012	2013	2014
Car Inc.	56.7%	59.0%	57.9%	62.2%
Ehi	NA	72.0%	70.5%	71.8%
Hertz	NA	79.0%	77.0%	77.0%
Avis	NA	NA	71.0%	71.0%

Source: Company data

Table 5. Size of Fleet in Operation

	2011	2012	2013	2014
Car Inc.	25,845	41,043	53,022	63,522
Ehi	NA	9,829	11,586	19,746
Hertz	NA	512,200	628,300	661,000
Avis	NA	NA	512,000	535,000

Source: Company data

Table 6. Average Daily Revenue per Car (RMB)

RevPAC (RMB)	2011	2012	2013	2014
Car Inc.	112	125	142	170
Ehi	NA	145	156	165
Hertz	NA	241	234	227

Source: Company data

Table 7. Gross Margin Comparison

Gross Margin	2011	2012	2013	2014
Car Inc.	30%	31%	23%	35%
Ehi	NA	3.90%	7%	16%
Hertz	34%	32%	34%	29%
Avis	30%	28%	29%	29%

Source: Company data

Table 8. Net Margin Comparison

Net Margin	2011	2012	2013	2014
Car Inc.	18.60%	-8.30%	-8.30%	15.21%
Ehi	NA	-39.0%	-26.9%	-10.9%
Hertz	2%	3%	3%	-1%
Avis	-1%	5%	0%	4%

Source: Company data

Table 9. Marketing Expenses as % of Revenue

	2011	2012	2013	2014
Car Inc.	13.8%	9.0%	6.9%	3.2%

Ehi	NA	13.0%	10.7%	5.9%
Hertz	11.3%	13.7%	12.1%	12.2%

Source: Company data

High Leverage and Foreign Debt

The car rental business requires a lot of capital expenditure and consequently borrowing. Car Inc.'s leverage ratio is much higher than Ehi's.

Table 10. Comparative Leverage Ratios

	2012	2013	2014
Car Inc.	19291%	5225%	65%
Ehi	31%	45%	53%

Source: Company data

- As of H1 2015, Car Inc. borrowed RMB 4.3 bln from banks, RMB 1.9 bln of which is guaranteed by Lenovo.
- In January 2015, Car Inc. issued a USD 500 mln five-year note at a rate of 6.125%.
- A half-year later, in August, the company issued another USD 300 mln 5.5-year note at a rate of 6%.

These borrowings will add RMB 310 mln in interest cost yearly, is 75% of net profit in 2014. The 2015 interest cost could double the number of 2014 in 2015 if there is no other short-term debt. The company also runs currency risk.

Despite the willingness to borrow, Car Inc. has a higher average rate of interest than Ehi.

Table 11. Comparative Average Interest Rates

	2012	2013	2014
Car Inc.	9.0%	8.8%	8.6%
Ehi	37.4%	8.5%	6.1%

Source: Company data

This indicates that Car Inc. is short of cash.

Cooperation with Ucar

Car Inc. appears to have engaged in a series of circular transactions with

Our interviews indicate Ucar uses Car Inc. vehicles for free.

Ucar, a company offering chauffeured car services and with roughly 11% of the car service market. It appears that Ucar, which is controlled by Car Inc., helped Car buy out existing investors at a higher-than-market valuation and now is being repaid with the free use of cars.

Car Inc. agreed in January 2015 to provide cars to Ucar in return for rental fees. In July 2015, Car Inc. invested USD 125 mln to acquire 10% of Ucar in Ucar's first-round financing. In September 2015, Car Inc. invested another USD50 mln in the second round, whose valuation reached USD 3.55 bln, almost 70% of Car Inc.'s market capitalization. After the two rounds, the family of Lu Zhengyao, the CEO and chairman of the Car Inc., has a 46.4% share in Ucar.

In October 2015, Ucar acquired 5% of Car Inc.'s shares from existing shareholders Grand Union Investment Fund, L.P, paying USD 210 mln of the USD 550 mln raised, at a share price that is 8% higher than trading price of that day. We believe Ucar used 40% of the money it mln raised from investors in the second round to buy the shares of Car Inc., helping existing shareholder to cash out at a higher than market price.

We believe this cross-shareholding structure brings risks to Car Inc. governance. Our interviews with Car Inc. former employees indicate that Ucar uses the Car Inc. vehicles for free. After Ucar returns the vehicles, Ucar purchases vehicles themselves.

The arrangement is reflected in Ucar's filings. Due to the new business, long-term vehicles made up 26% of the fleet by H1 2015 yet contributed only 20% of total revenue. By providing long term rental cars to Ucar, Car Inc. makes less than it would make by renting to other customers.

Table 12. Long-term Rental Contribution for Ucar

Net Margin	2012	2013	2014	H1 2015
Long-term vehicles as % total fleet	8.8%	11.8%	14.7%	26.0%
Revenue contribution	20.4%	16.6%	13.2%	19.9%

Source: Company data

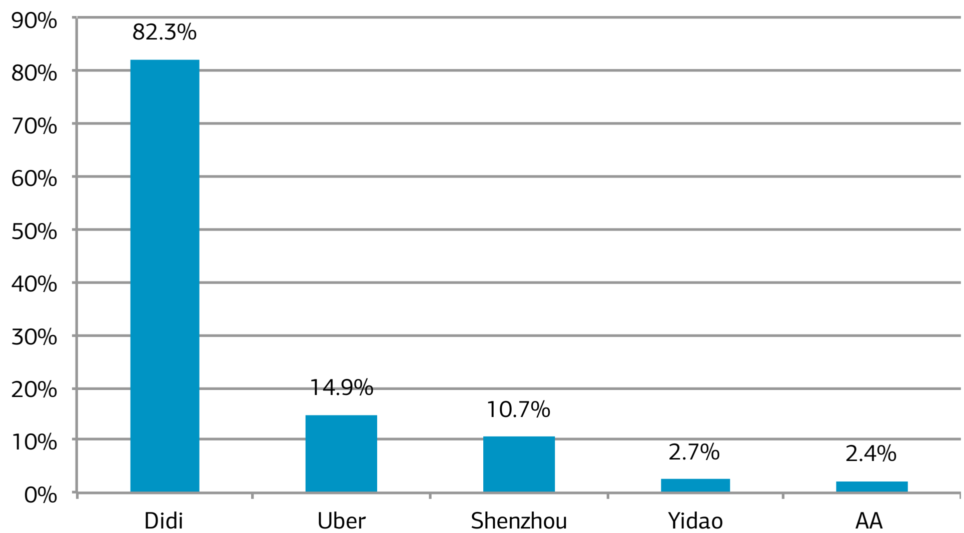
Ucar Losses

As of end of 2014, Ucar made RMB 38.2 mln in losses, and the company looks like it will lose more this year. Ucar CEO Lu Zhengyaosays that the cost of operating one vehicle is around RMB 600 per day. The company breaks even when each driver has 13 fares of at least RMB 45 each in a day. But currently, each driver has fewer than 10 fares per day and earns RMB 400 each day, which implies a RMB 200 loss on each vehicle according to news reports. Ucar has 20,000 cars. Therefore the company is likely losing RMB 120 mln per month. Under that scenario, Car Inc. realizes more than RMB 100 mln in losses from 10% of Ucar's shares.

Car Inc. is a late entry to chauffeured car services, behind Didi, Yidao, and Uber. We believe heavy investment in this area is will drag down the company's profitability.

Furthermore, new regulations proposed by the Ministry of Transport may make the business even less attractive for Car Inc. The proposal to ban the use of private cars looks like it will fail, and that will keep Car Inc. firmly in competition with giants like Didi.

Chart 4. Market Share Breakdown



Source: Enfo data

Not Such a Promising Future

Car Inc. points to several potential growth drivers that we believe are not positives for the company.

- **Government rental:** Car Inc. believes that the government's tighter restrictions on ownership of cars by State-owned companies will encourage the government to rent cars rather than purchase them. But this is not happening for Car Inc. Our checks with more than 20 ex-employees of Car Inc. found only two employees who said local governments rented cars from them and usually for free or with large discount. We have found that, when government offices and SOEs rent instead of buying, they prefer to do so through related-party companies.

- **Leisure self-drive rentals:** Car Inc. states that customers on holiday are the source of rental revenue. According to Roland Berger, the number of self-drive trips for leisure purposes, including road travel with rented and privately owned cars, has increased from approximately 38 mln in 2008 to around 146 mln in 2013, implying a CAGR of 31%. However, driving on holiday seems to be declining in importance. In 2014, government statistics show, individuals driving cars declined to 61% of total holidays from 63% in 2013. Our checks have found that at least 70% of Car Inc. rentals go to individuals driving within given cities in a holiday season, and so a decline in the taste for renting on holiday would have great impact on the company. Furthermore, according to Baojia Rental company's research, the returning customer rate for leisure renters is low. That suggests that the cost of customer acquisition will rise as demand slows down.

Generally speaking, it takes years for rental agencies to reach profit. Car Inc. realized profit in 2014, after seven years in business, with gross margins expanding from 30% to 35% between 2011 and 2014 and net margin reaching 15% in 2014. Global rental giant Avis, which was founded in 1958 and went public in 1996, over the period from 2006 to 2014, the company lost money. Another example is Hertz, founded in 1918 and listed in 2006. In four years out of the nine years since its listing, the company has made losses.

Valuation

We derive our PT of HKD 10.05 with a sell rating based on our DCF model with a WACC of 10% implying a down side of 31%. Based on our research, we believe that Car Inc. under estimated its depreciation expenses by increasing the residual value of vehicles. Furthermore, investment in Ucar will undermine Ucar.

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Pro Forma Financial Statements

Income statement	2013	2014	2015E	2016E
Rental revenue	2,207,812	2,866,210	3,439,452	3,920,975
Sales of used vehicles	494,903	654,226	785,071	926,384
Total revenue	2,702,715	3,520,436	4,224,523	4,847,359
Depreciation of rental vehicles	-690,027	-670,163	-1,179,558	-1,235,534
Direct operation exp of rental services	-861,638	-988,876	-1,272,597	-1,450,761
Cost of sales of used vehicles	-522,126	-621,982	-785,071	-926,384
Gross profit	628,924	1,239,415	987,297	1,234,680
Profit for the year	-223,365	436,113	-211,733	-79,481

Balance sheet	2013	2014	2015E	2016E
Non-current assets				
Rental vehicles	4,023,956	5,234,194	5,361,628	5,616,064
Other property, plant and equitpment	89,226	213,804	213,804	213,804
Prepayments	54,660	440,910	567,413	646,851
Total non-current assets	4,401,803	6,251,328	6,505,264	6,839,139
Current assets				
Inventories	330,304	121,905	173,008	197,955
Trade receivables	208,426	236,407	283,688	325,514
Cash and cash equivalents	841,835	1,352,435	1,435,005	1,074,541
Total current assets	1,765,268	3,590,991	3,771,945	3,478,253
Current liabilities				
Trade payables	13,802	24,671	35,013	39,074
Other payables and accruals	317,610	326,813	620,838	692,843
Advances from customers	174,838	192,771	295,717	339,315
Total current liabilities	4,490,944	3,368,848	3,997,274	4,116,938
Net current assets	-2,725,676	222,143	-225,329	-638,684
Total assets less current liabilities	1,676,127	6,473,471	6,279,936	6,200,455
Total non-current liabilities	1,603,189	883,887	902,085	902,085
Accumlated losses	-595,530	-172,974	-172,974	-172,974
Total equity	72,938	5,589,584	5,377,851	5,298,370

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