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A.O. Smith Corporation (AOS)

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Company: "Nothing to See Here"

AOS China Continues Its Decline

Contrary to AOS statements to the market, we have found that China sales are declining sharply, and inventory is continuing to build in the channels. Our recent flash survey of AOS distributors indicated that:

- China sales to end-users will decline by about 11% in the first half.
- Distributor inventories have increased by about two weeks, not decreased, as AOS has repeatedly said.
- Distributors say they will destock in the second half, suggesting a decline in China sales for the year of more than 20%, even as the environmental product line sees flat to slightly rising sales.

AOS, meanwhile, is focusing on minimizing the problem. Despite signs of growing distress in the market, AOS has been silent on the revelations in our report of May 16, responding only to admit that the company does in fact have a previously undisclosed relationship with Jiangsu UTP Supply Chain Management.

In responding[1] to our report on May 16, A.O. Smith provided half-truths and omissions.

[1] *http://investor.aosmith.com/news-releases/news-release-details/o-smith-sets-record-straight-j-capital-research-report*

1. *"a significant portion of our $633 million of cash, cash equivalents and marketable securities as of March 31, 2019 was held by our foreign subsidiaries, **including $457 million of cash denominated in local currency in China**"* [our emphasis]

Huh?

On December 31, 2018, according to the AOS 2018 10-K, the company had $644 mln in cash and $539 mln in local currency in China (10-K page 8). So, cash company-wide has declined by $10 mln in the quarter and cash in China has declined by $82 mln, far more than capex requirements. Yet the company says it has not yet made a dividend payment.

Where is the money?

In the Q1 2019 report, the company also says: "Our total debt increased $63.0 million from $221.4 million at December 31, 2018 to $284.4 million at March 31, 2019 ***to fund our share repurchase activity and dividend payments.***" [our emphasis]

Wait a minute, with all that cash in China, changes in U.S. tax law removing the hindrance to repatriation, and the company reducing debt in 2018, AOS then massively increases debt in Q1 2019 to help pay the dividend that could easily be funded from all that China cash?

One possible explanation for apparently conflicting statements in the 10-K is that the company is remitting money from China to Hong Kong. But why?

On Page 6 of the 10-K:

"At December 31, 2018, approximately $644 million of cash was held by our foreign subsidiaries, **substantially all of which was located in China.**"

On Page 7:

"We have significant operations outside of the U.S., primarily in China and Canada and to a lesser extent Europe and India, and therefore, hold assets, **including $539 million of cash denominated in local currency in China**, incur liabilities, earn revenues and pay expenses in a variety of currencies other than the U.S. dollar."

In other words, as of December 31, 2018, the difference between "substantially all" of $644 mln and $539 mln was in China but not in Renminbi. The only option is Hong Kong.

Why would AOS hold hard currency in Hong Kong, where it has no operations, and when Renminbi, if remitted out of China, can just as easily be remitted to U.S. dollars?

2. *Chinese financial statements are "annually audited by Ernst & Young LLP"*

Wrong. Auditor Ernst & Young does NOT audit the Chinese operating subsidiaries. We believe that E&Y, unusually, reviews only consolidated statements provided by the company.

E&Y is not authorized by Chinese law to conduct audits of Chinese companies. Its affiliated company in China, E&Y Hua Ming, has that right and appears[2] to be involved. But AOS does not indicate that Hua Ming audits local AOS companies.

Ernst & Young states in the AOS 2018 annual report: "We have audited the accompanying consolidated balance sheets of A.O. Smith Corporation (the Company) as of December 31, 2018 and 2017, the related consolidated statements of earnings, comprehensive earnings, stockholders' equity and cash flows." But E&Y's standard statement in annual reports is: "We have audited the consolidated financial statements of ABC Company ***and its subsidiaries*** (the Group)"[3] [Our emphasis].

The auditors have apparently audited only the company's internal controls. E&Y relies on the company to provide accounts of subsidiaries.

3. *"All revenue associated with UTP and others was appropriately recognized in accordance with U.S. GAAP in our financial statements."*

Wrong. The company response, interestingly, admits that Jiangsu UTP is a customer, not just a logistics services provider. We believe UTP is responsible for at least half of AOS sales in China, or about $500 mln.

- UTP is master distributor for the two largest AOS markets, Shanghai and Shenzhen, as well as at least four markets in Hebei Province.

[2] https://pcaobus.org/form-ap-filings/33694/33694

[3] https://www.ey.com/Publication/vwLUAssets/EY-adoption-of-new-auditors-reports-july-2017/$File/EY-adoption-of-new-auditors-reports-july-2017.pdf

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- UTP is the second-largest shareholder (10%) of a distributor joint venture that manages all of AOS China's online sales, amounting to about $350 mln per year per company reports.

- 65% of the independent distributors we interviewed purchase from UTP

Adding together these involvements, UTP must have at least half of AOS's China business. Under SEC reporting Regulation S-K Item 101 c. vii, any customer with more than 10% of consolidated revenue must be disclosed and named.[4] With $3.2 bln in 2018 revenues, AOS should report a customer who is providing at least 16% of gross revenues.

UTP is also a supplier to AOS and employer of AOS production staff. When your largest customer is also a supplier, this provides an opportunity for fraudulent activity. Auditing this relationship becomes critical.

Ernst & Young has audited A.O. Smith since 1917. Auditor rotations are not mandatory under U.S. law, however, maintaining the same auditor for over 100 years is extreme.

Shareholders should demand a change in auditors and require the auditors to audit the China subsidiaries and their cash.

4. *The level of cash held in China is normal.*

Wrong. AOS has 57% of sales, 52% of assets, and only 1% of cash in the United States. It has 34% of sales, 40% of assets and 84% of cash in China. China does not need the cash for investments or operations. China went from 49% of cash in 2013, before AOS cooperated with UTP, and has risen to 84%.

There is a risk that the cash may be exaggerated. Calculated net interest on AOS "unencumbered cash" is just 0.7%. Haier earns 4% on cash and equivalents. That means that the AOS denominator—the amount of cash—may be inflated. A People's Bank of China credit report on the company states $300 mln of the cash is being used as a guarantee. Shareholders should demand an audit of subsidiary cash accounts.

AOS in describing the cash as "unencumbered" is denying that it has guaranteed a loan or made an entrusted loan to UTP, without explicitly stating

[4] https://www.ecfr.gov/cgi-bin/text-idx?amp;node=17:3.0.1.1.11&rgn=div5#se17.3.229_1101

A.O. Smith Cash, Sales, and Assets by Region

	2018	2017	2016	2015	2014	2013
Cash	645	820	755	645	542	486
Cash in Foreign Subs	644	815	752	645	542	486
Cash in China	539	587	558	458	355	240
%	84%	72%	74%	71%	66%	49%
Cash in USA	$1	$5	$2.6	0.2	$0	$0
%	0.2%	0.6%	0.3%	0.0%	0.0%	0.0%
Net Sales	3,188	2,997	2,686	2,537	2,356	2,154
China Sales	1,071	1,035	887	787	692	581
%	34%	35%	33%	31%	29%	27%
USA Sales	1,821	1,698	1,571	1,531	1,448	1,335
%	57%	57%	58%	60%	61%	62%
Long Lived Assets	626	604	528	513	491	425
China LL Assets	253	251	184	157	144	135
% China	40%	42%	35%	31%	29%	32%
USA LL Assets	327	303	292	298	285	239
%	52%	50%	55%	58%	58%	56%

Source: Company Reports

that. We maintain AOS has supported UTP with loans or guarantees. In fact, we hope so, because Chinese financial statements clearly show that UTP, AOS's largest customer worldwide, is essentially insolvent and could collapse.

5. *Expected sales decline in 2019 is all from destocking*

Wrong. Our surveys, including one conducted May 22-23, indicate that channel inventories are growing, not declining.

Companies in the survey group now have an average of 4.5 months of inventory, up from 4 months in January and just 2 months at the end of 2017. Sales declines are most significant in East and South China.

When AOS said it would accelerate new product launches in the Q1 2019 analyst call. Distributors see that as channel stuffing.

- Distributor #1 "The rate of new products coming out is too fast and it is relentlessly increasing our inventory. Before we have sold out the old model a new model is brought out and we have to buy more inventory." This distributor has eight months of inventory

- Distributor #2 "The rate of new models coming out is much faster than last year. It started to pick up in the H2 of last year. As a distributor we must purchase inventory of the new models, so we have a lot of inventory pressure now." This distributor has 6 months of inventory.

When asked if they are being offered more incentives to hold inventory, distributors said they get free product with orders over a certain level and rebates of between 3% and 8% if they can achieve the sales targets assigned by the company. Distributors told us:

- Distributor #1 "There are no new incentives just more new products. Our task is to get rid of old stock. Even if they gave us more incentives, we would not buy any more as we just have too much inventory. "

- Distributor #7 "The assistance we get is loans from UTP. We use our stock as collateral. UTP pays the loan money directly to AOS for the stock that is delivered to us

We expect sales to deteriorate in H2 2019, as distributors told us the market is down on last year and they plan to reduce inventory levels.

- Distributor #6 "There have been a few new products, but we have yet to order stock. Old stock of water heaters is the inventory problem we have. We aim to reduce our inventory this year."

- Distributor #2 "We hear that many distributors cannot keep up with the contracted orders enforced by AOS. They are breaking contracts, because the inventory pressure is so great."

AOS margins are under threat, as prices are now falling:

- Distributor #6 "AOS prices are falling this year. Some high-end water purification products had price reductions of 30%, and low-end are down 5% this year. Electric water heaters are down 1%. Old model gas water heaters are down 20% and new models are down 5%."

Our survey of seven AOS distributors was conducted on May 22-23, 2019 by phone. The sales volume of the sample is approximately 20% of AOS China sales.

Disclaimer

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