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China Hongqiao Group Limited

Is the world's largest aluminum company a fraud?

11/19/2016

- Despite its extraordinary margins, Hongqiao has consistently failed to generate free cash flow and accumulated a massive debt load.
- Hongqiao's largest supplier is a likely an undisclosed related party
- Hongqiao has made 2 large, undisclosed related party transactions totaling more than RMB 10 billion which may serve the purpose of laundering fake financial profits.
- Hongqiao has significant environmental issues that are currently being investigated by the Chinese government.

Executive Summary

China Hongqiao Group Limited ('Hongqiao') is the largest producer of primary aluminum in the world with 5.2 million tons of nameplate capacity¹. **Despite consistently reporting significantly higher margins than primary aluminum peers, Hongqiao produces negative free cash flow, which has led to the build-up of RMB 67.7 billion of debt**². In the first half of 2016 alone Hongqiao raised an additional RMB 13.8 bn of debt, bringing the company's total debt to EBITDA level to 4.5x³.

A large part of what has contributed to the negative free cash flow in recent years are acquisitions which appear to be transactions with undisclosed, related parties. **There are two possible explanations here: 1) If Hongqiao's margins are in fact, too good to be true, then Hongqiao's large capital expenditures may be a mean to offload these fake profits. 2) Hongqiao's margins may be real and higher than all aluminum peers and related parties are using these acquisitions to embezzle money from the company.** The first scenario appears to be the most likely explanation for the events which have transpired since the second explanation would suggest that close to one-fifth of the company's market capitalization was misappropriated by a group of rogue middle managers.

Either way, Hongqiao's shareholders and bondholders will then be left holding the bag. Hongqiao's Hong Kong-listed shares, show just under RMB 9 BN non-insider ownership. Hongqiao is covered by sell side firms such as Goldman Sachs, Deutsche Bank, Macquarie and HSBC, who have failed to question these undisclosed, related party dealings. Hongqiao's debt book runners are a slate of foreign banks (Deutsche Bank, Bank of America/Merrill Lynch, and Morgan Stanley) who similarly failed in their diligence process, giving the bonds the stamp of approval for distribution to investors around the world.

¹ China Hongqiao Group 2015 Annual Report p6

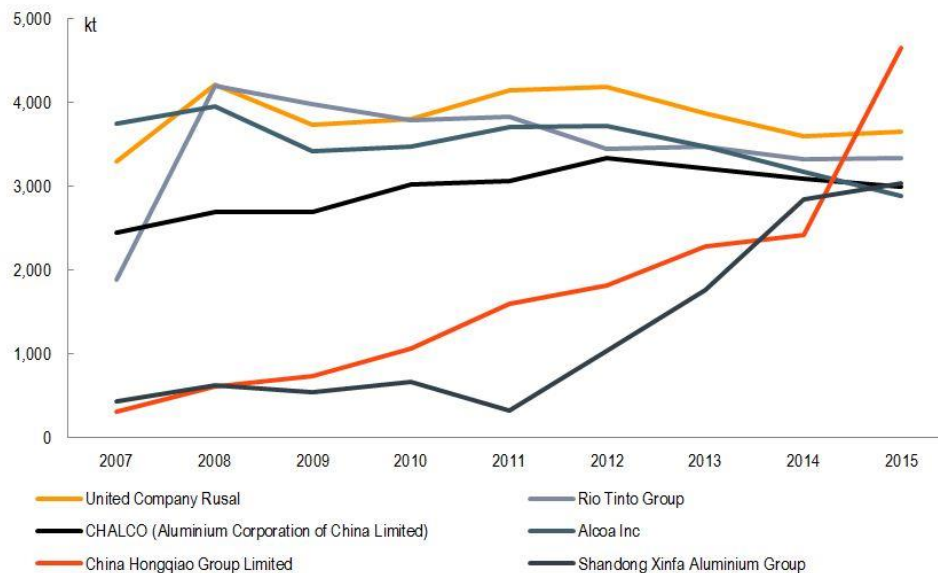
² Hongqiao 6/3016 semiannual report

³ Bloomberg

Background

Hongqiao is a RMB 43.5 billion market capitalization company that trades on the Hong Kong exchange. Hongqiao makes molten aluminum alloy (91.4% of 2015 revenues)⁴. The remaining 9% of revenues are split between ingot and other processed products such as extrusions. Despite being the world's largest producer, Hongqiao's aluminum is outside of the LME system.

Aluminum Capacity – Global Producers



Source: AME

The predecessor company to Hongqiao was founded in 1994 as a denim manufacturer. In 2006, Hongqiao began acquiring a series of aluminum and electricity generating assets from its Chairman Zhang Shiping's private company, Weiqiao Pioneering Group ('Weiqiao Pioneering'). Hongqiao built out its own production assets and continued to acquire from Weiqiao Pioneering up to the time of Hongqiao's IPO in 2011. The founder, Chairman Zhang, through China Hongqiao Holdings, still owns 81% of the public company. Zhang also owns numerous other aluminum, textile, and electricity assets outside the listed company through his private conglomerate Weiqiao Pioneering.

Today, China Hongqiao is an integrated aluminum producer who engages in sourcing alumina, producing electricity, and also operating aluminum smelters. The company claims that due to its vertical integration as well as advantageous pricing with its largest supplier, Hongqiao is able to achieve much higher margins than industry average. In the five years since its IPO, Hongqiao went from being the fifth largest aluminum company in China to the largest in the world in nameplate capacity. Zhang Shiping remains Chairman and his son Zhang Bo is the CEO. The Zhang family's rise and wealth is chronicled in detail in the Chinese media:

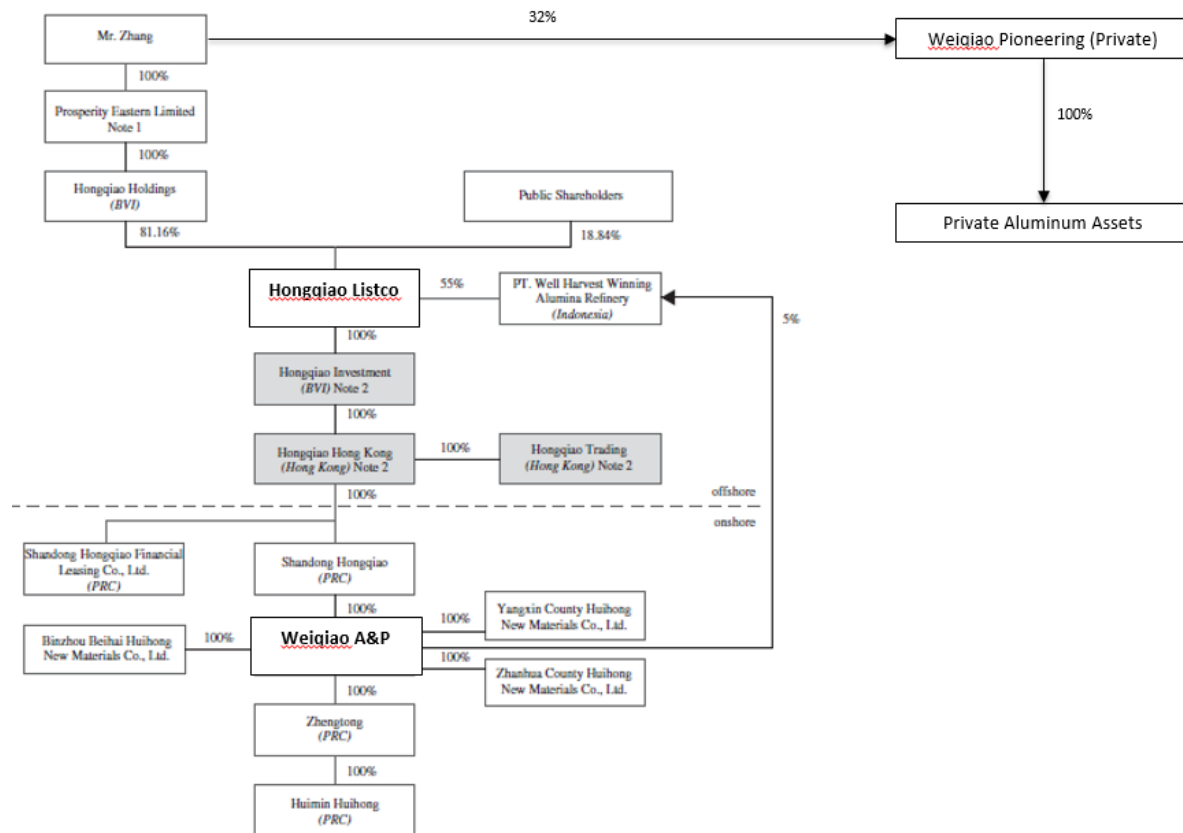
<http://finance.sina.com.cn/stock/hkstock/ggscyd/20130628/065215946810.shtml>

⁴ China Hongqiao Group 2015 Annual Report and JP Morgan Hongqiao Initiation 8/14/11

http://www.360doc.com/content/15/0614/15/5874842_478057372.shtml

<http://finance.huanqiu.com/cjrd/2016-01/8373115.html>

An illustration of the Hongqiao's company tree post-IPO below:



Source: Hongqiao 2014 Debt Prospectus/Weiqiao Pioneering 2011 Debt Prospectus

The Zhang family was featured in the book 'From Village to City' by Professor Andrew Kipnis, who used the city of Zouping (Hongqiao's headquarters) to illustrate the rapid urbanization of the Chinese countryside. Kipnis' book chronicles the saga of how the Zhang family created their wealth through the co-opting of state owned assets, using nepotism to create a stranglehold on the local economy:

"Another type of gossip surrounds the relative lack of education of Zhang's children and the other relatives Zhang has appointed to Wei Mian's (Hongqiao predecessor and Zhang family holding company) managerial elite. One man discussed with me in great detail the numerous relatives of Zhang who now own stock in the company and have been appointed to high-level management positions, even writing a list of over fifteen names on a piece of paper. In addition to [Chairman Zhang Shiping's] three children, these relatives include his first younger brother, Zhang Shide, supposedly a junior middle school graduate whose only previous work experience involved driving a tractor...his second younger brother, Zhang Shijun, who only graduated from primary school and is said to spend all day chasing women and ignoring his managerial responsibilities..." (From Village to City p 97-98)

Probably the most disturbing story relates to the current CEO of Hongqiao, Zhang Bo. The prodigal son of the Zhang family, never attended college and became appointed to high-ranking positions within Hongqiao after only a few years of working inside the company⁵. It was rumored that Zhang gambled away company assets in Macao and required his father (the Chairman of Hongqiao) to bail him out from Macanese casino thugs⁶.

Despite its extraordinary margins, Hongqiao has failed to generate free cash flow.

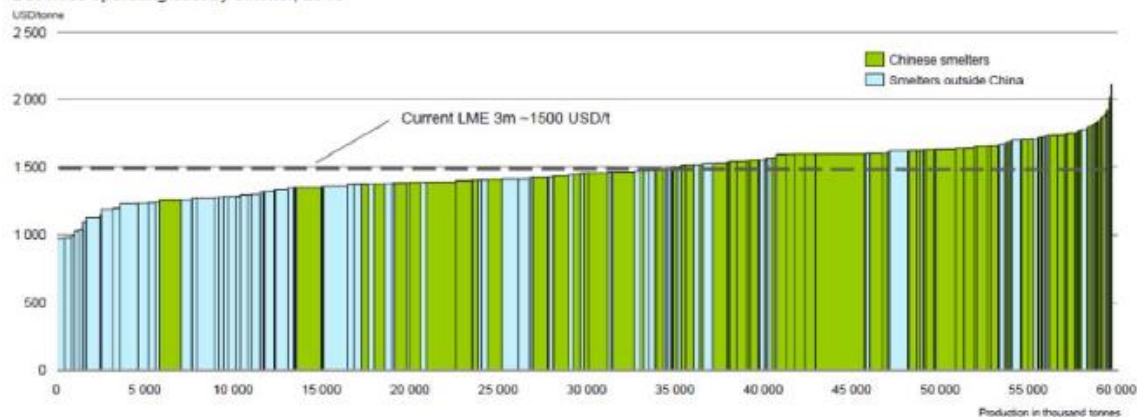
Hongqiao's reported margins are a major outlier in its comparable group of primary aluminum producers. Hongqiao's reported cash cost per ton is approximately USD 1,270⁷, which would place the company towards the lowest end of the global aluminum cost curve.

CRU Global Aluminum Cost Curve

Roughly 40-50% of global smelter capacity currently cash negative

Of which ~75% is located in China

Business operating cost by smelter, 2016



Source: CRU, Hydro Analysis

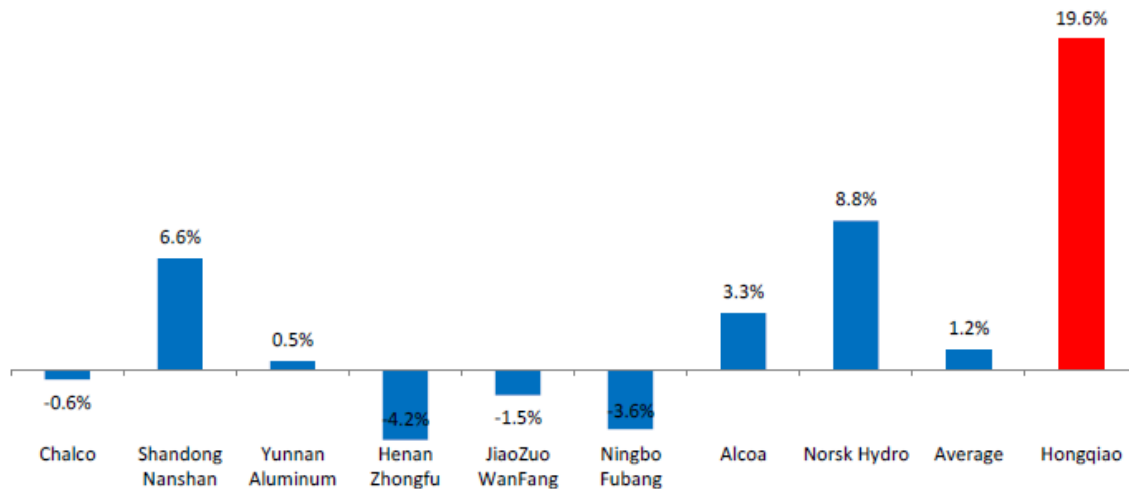


⁵ From Village to City, p97

⁶ From Village to City, p 97

⁷ Imputed from Weiqiao A&P 2015 bond prospectus

Reported EBIT margins FY 2015



Source: Bloomberg

Despite Hongqiao's high reported margins, the company's free cash flow tells a different story. **Massively negative free cash flow over the past 5 years has been funded by debt** (most recently expensive off shore debt issued in USD with coupons between 6.875-7.625%).

RMB MM	2010A	2011A	2012A	2013A	2014A	2015A
Net Income	4,196	5,875	5,453	5,593	5,314	3,649
Cash From Operations	4,583	5,347	5,585	(827)	7,924	5,562
Cap Ex	(1,888)	(8,910)	(11,673)	(14,837)	(10,383)	(17,431)
Free Cash Flow	2,695	(3,562)	(6,088)	(15,664)	(2,459)	(11,869)
Debt	4,034	7,192	16,519	30,490	40,006	53,863
Change in Debt		3,158	9,327	13,972	9,516	13,857

Source: Bloomberg

Hongqiao claims that its margins are achieved through cheaper self-generated electricity (19% below regional electricity cost) and self-produced alumina (11% below market cost)⁸. Electricity and alumina are the two main raw materials used in aluminum production. Hongqiao procures electricity and aluminum from an alleged independent third party called Gaoxin Aluminum and Power ('Gaoxin') through its primary subsidiary Weiqiao Aluminum and Power ('Weiqiao A+P')⁹.

⁸ 2015 Weiqiao Aluminum + Power debt update

⁹ Hongqiao Prospectus 2011

Hongqiao's largest supplier is a likely an undisclosed related party

In Hongqiao's IPO prospectus, Hongqiao claimed that Gaoxin was founded in 2007 and owned by the Labor Union Committee of Shandong Zouping Economic Development Zone, a quasi-state owned/affiliated entity¹⁰. In 2008, Gaoxin entered into an asset swap agreement with Weiqiao Textile, then a Zhang family owned company, in which Gaoxin acquired electricity generation assets in exchange for the future provision of electricity to Weiqiao Textile¹¹. In 2009, Weiqiao Pioneering sold its alumina production facilities to Gaoxin for RMB 3.1 bn. After the transaction, Gaoxin became a large producer of both electricity and alumina and the largest supplier to Hongqiao through a series of price discount agreements¹². **Gaoxin seems designed to be an intermediary home for Zhang family assets while providing the façade of an unrelated, independent party.**

China Hongqiao also explicitly states in its own prospectus that "Gaoxin Aluminum and Power is an Independent Third Party"¹³. Following its IPO, China Hongqiao started to build/acquire its own power plant and alumina production facilities as well as sourcing from Gaoxin. Up until September 30, 2015, Gaoxin still supplied 59.76% of the total electricity and 65.6% of the total alumina used by China Hongqiao.

Hongqiao claims that Gaoxin's below market deals on electricity and alumina explain Hongqiao's high margins. The Sell Side has bought into this argument, characterizing these electricity and alumina discounts as 'Strong bargaining power in raw material purchases'¹⁴ and Hongqiao as having an 'unique, low cost, integrated model...kept the company in profits while rivals struggle in losses.'¹⁵

According to SAIC filings which were posted on Chinese website 'Snowball', Gaoxin has reported RMB 2 bn of losses in both 2015 and 2014¹⁶. For the past two years, Gaoxin has ostensibly operated at a negative operating margin and accumulated losses have rendered its shareholder equity negative. As an off-balance sheet method of subsidizing Hongqiao, Gaoxin appears to be an unsustainable vehicle to continue to do so.

Gaoxin and Hongqiao have left behind a long paper trail in direct contradiction to their assertion that Gaoxin is an independent third party. Not only are Gaoxin and Hongqiao headquarters located in the same industrial complex, but many public records suggest that Gaoxin is actually controlled by the Zhang family.

¹⁰ Hongqiao 2011 IPO prospectus p 8

¹¹ Weiqiao Gaoxin asset transfer notice

¹² Hongqiao 2011 IPO prospectus p 9

¹³ China Hongqiao Prospectus 2011

¹⁴ Macquarie note 1/11/12

¹⁵ JPM note 12/30/12

¹⁶ Gaoxin financials, Snowball 11/10/2016



Source: Google Earth

- Gaoxin's contact information from its SAIC registration (addresses, phone numbers and emails) is the same as an aluminum company owned by Weiqiao Pioneering, Chairman Zhang's private conglomerate.

Gaoxin

滨州高新铝电股份有限公司

电话: 0543-4161178 邮箱: lijie@wqfz.com
网址: 暂无
地址: 邹平县经济开发区 查看地图 地址搜索

Same address listed for Gaoxin and Weiqiao Pioneering subsidiary

Same email and phone number listed for Gaoxin and Weiqiao Pioneering subsidiary

Hongqiao subsidiary

滨州魏桥铝业科技有限公司

电话: 18860579898 邮箱: lijie@wqfz.com
网址: 暂无
地址: 山东省邹平县经济开发区 查看地图 地址搜索

Source: Company SAIC registration

- Gaoxin's business license states that its electricity is for internal usage only.

Gaoxin Business License



Source: Company SAIC registration

Gaoxin's electricity is supposed to be for internal usage only, according to the above business license. The fact that Gaoxin **sells** most electricity it generates to China Hongqiao indicates that Gaoxin and Weiqiao have an internal relationship. If not, Gaoxin appears to clearly be in violation of its business license.

- Gaoxin, Hongqiao, and Chairman Zhang's private entity Weiqiao Pioneering all share the same bank accounts.

According to a bidding invitation released by Hongqiao, Hongqiao and Gaoxin have the same bank account:

招标编号: 招标编码 CBL_20160416_1049331061 开标时间: 所属行业: 化工 标讯类别: 国内招标 资金来源: 其他 所属地区: 山东省

山东魏桥铝电有限公司废旧物资面向社会公开招标处理, 诚邀各界人士参加。具体事项如下:

一、招标内容: 新材料公司铝灰、政通二厂铝灰

详见附件: 4月21日铝灰招标处理清单.xls

二、招标须知:

- 1、本次招标为现场招标、现场报价。
- 2、凡我集团公司在职工及高级管理人员一律不允许参加我部门组织的任何招标。
- 3、请相关客户自即日起至招标之日前将贰拾万元投标保证金收据交销售公司, 并签订《保密、廉政协议》。
- 4、报价原则: 采取两轮报价方式。第一轮报价结束后, 第二轮报价不得低于第一轮报价的最高报价, 违反此规定的报价视为无效。

5、招标前相关投标单位可提前到现场看货, 看货时须到销售公司领取废旧物资看货联系单, 联系清单上联系人看货。铝电公司不再组织统一看货, 招标时投标单位根据现场实际情况报价。

6、投标单位具有增值税一般纳税人资格的, 铝电公司给予开具增值税发票。投标单位不具备增值税一般纳税人资格的, 铝电公司给予开具普通发票。

7、投标保证金须及时交纳, 合同执行完毕后未退的保证金可作为本次投标保证金使用, 仍有合同执行的保证金不能作为本次投标保证金, 须重新交纳。中标后转为合同保证金, 但不能转为货款。

8、相关投标客户在投标时, 铝电公司不提供投标所使用的笔, 须自己提前准备。

9、保证金交纳账号: 滨州高新铝电股份有限公司 农行梁邹支行157366 0104 0001 816

10、投标客户中标后根据铝电公司废旧物资合同保证金缴纳规定缴纳相应的保证金。

三、招标时间及地点:

招标时间: 2016年4月21日上午10:00, 地点: 铝电大厦三楼东侧会议室。

四、联系方式:

电话: 0543-4162319 部门: 铝电销售公司

五、如有疑问, 请提前咨询。

铝电销售公司

2016年4月16日

Weiqiao A&P asking for bids

Gaoxin company name and bank account number

Source: <http://www.bidcenter.com.cn/newscontent-27095809-1.html>

- Chairman Zhang's private company Weiqiao Pioneering shares a bank account with Gaoxin according to Chuangye group's own website. [Weiqiao Pioneering announced bidding of desulfuration gypsum supply for its power plants on October 13, 2016](#). The listed bank account for deposit payment is Gaoxin's bank account.
- Hongqiao's primary subsidiary, [Weiqiao A&P, announced bidding of its waste materials on October 7, 2016](#). The listed bank account for deposit payment is Gaoxin's bank account.
- [Weiqiao A&P announced bidding of its aluminum powder on April 27, 2016](#). The listed bank account for deposit payment is Gaoxin's bank account.
- Weiqiao Pioneering has acted as loan guarantor for two of Gaoxin's financing deals.

On March 2, 2012 [Construction Bank](#), partnering with CITIC trust, provided a total of 4 billion RMB in trust financing to Gaoxin. The initial tranche was 600 million RMB. Weiqiao Pioneering Group is [the irrevocable guarantor](#) of the financing deal.

On May 15, 2014 [A group of 4 banks led by Westpac Banking Corp provided a 500 RMB 3-year loan to Gaoxin](#). Weiqiao Pioneering Group is the guarantor on the loan.
- **Gaoxin's legal representative is a man named Liu Gang. Liu Gang appears to be one of Chairman Zhang's major proxy agents across the public and private organizations as his name shows up numerous times in articles and documents associated with Hongqiao.** This is a direct contradiction of Hongqiao's assertion from its own IPO prospectus: "Since the establishment of Gaoxin, there has been no management or director overlap between Gaoxin and us, or between Gaoxin and Chuangye Group. There was no overlap of employees between Chuangye Group and us before the disposal of the alumina production business to Gaoxin, and there has been no overlap of employees between Gaoxin and us after such disposal."
 - An Asian Metals article identifies Liu Gang (刘刚) as the head of the procurement division of Weiqiao A&P. (<http://www.asianmetal.cn/cag/2013/visit2013071601.shtml>).
 - Liu Gang is the legal representative of Hongqiao's Indonesian JV, PT Well Harvest Winning Alumina Refinery¹⁷.

¹⁷ See Indonesia registration document

Hongqiao has made 2 large, undisclosed related party transactions totaling more than RMB 10 billion which may serve the purpose of laundering fake financial profits.

The related party transactions are more than just a governance or disclosure issue. Considering the abnormal margins and profits at Hongqiao, especially in conjunction with the related party supplier, it is very possible that these transactions are being used so that auditors cannot spot fake profit accruals on HQ's bank statements.

1. Binzhou Binbei Transaction: In December, 2014, Hongqiao acquired Binzhou Municipal Binbei New Materials Co Ltd ('Binbei') from Shandong Binbei New Materials Co ('Shandong Binbei'), for a total consideration of RMB 1.896 bn. Binbei, in turn, owes another RMB 6.2 billion to its "former shareholder." In the disclosure regarding this acquisition, Hongqiao does not state that Binbei is a related party transaction¹⁸. Hongqiao estimates that Binbei would have contributed RMB 5.2 bn of additional revenue 2014 and RMB 686 mm of profits which implies that Binbei was purchased for 1.6x revenues and 11.8x earnings including the payout of the shareholder loan which was recognized in cash flows from financing¹⁹. This indicates that the actual price paid for these acquisitions is far higher than the headline reported by Hongqiao and the recognition of the payment in Cash from Financing suggests a desire to obscure the magnitude of the capital expenditure. Note that this categorization is extremely misleading for investors because the shareholder loan is not included in the purchase price and the deal appears significantly more accretive. If the acquisition multiple were calculated on the headline purchase price, Binbei appears to have been acquired for 2.76x earnings.

Shandong Binbei's SAIC records have 2 members Xu Enyun (徐恩云) and Mou Chunling (牟春玲) as the legal representative and supervisor respectively prior to the acquisition by Hongqiao. Mou holds a number of other positions throughout the Hongqiao and Weiqiao public and private entities:

- Supervisor at Hongqiao subsidiary Weiqiao A&P²⁰
- Supervisor at Hongqiao subsidiary Zhengtong²¹

Shandong Binbei is actually owned by a Hong Kong entity called Beihai Investments Ltd. The controlling shareholder of Beihai Investments is Liu Gang. His residential address reported on the Hong Kong filing is in Zouping, Shandong (the same location as Hongqiao). Note that the below HK filing with reported ownership is from 2011 and predates the acquisition made in 2014. The file and signature are below:

¹⁸ China Hongqiao Annual Report 2014

¹⁹ Interim report 2016

²⁰ See SAIC registration for Weiqiao A&P

²¹ See SAIC registration for Zhengtong

2 分配股份日期或始末日期 Date or Period during which Shares were Allotted

由 From			至 To		
01	06	2011	(不適用)	(不適用)	(不適用)
日 DD	月 MM	年 YYYY	日 DD	月 MM	年 YYYY

表格
Form SC1

公司編號 Company Number

1605472

6 獲分配股份者的詳情 Details of Allottee(s)

姓名/名稱 Name	地址 Address	各類別股份分配的數目 No. of Shares Allotted by Class	
		類別 Class	類別 Class
		普通股	(不適用)
劉剛 (LIU GANG)	中國山東省鄒平縣會仙一路 41 號	64,999	(不適用)

Source: HK ownership filing

After Beihai sold Binbei to Hongqiao, Beihai announced a USD 1 billion investment in Weihai Haixin New Materials, an aluminum producer, in 2016. SAIC ownership confirms Haixin is owned by Beihai, but does not provide history of its ownership prior to 2014.

However, the director of Weihai Haixin (王景坤 or Wang Jing Kun) is actually a Hongqiao employee. He is the currently responsible for Hongqiao's aluminum extrusion project. Several articles identify Wang as a Hongqiao employee:

- http://paper.dzwww.com/ijdb/data/20140723/html/11/content_7.html
- <http://wx.paigu.com/a/408637/19655985.html>
- Suppliers such as Unitechnik describe Weihai Haixin as part of Weiqiao Pioneering (Hongqiao chairman's holding company)
- <http://www.unitechnik.com/de/branchen/stahl-aluminium/referenzen>

Binzhou Binbei, the entity which Hongqiao purchased, appears to be linked to Hongqiao's own Indonesia project prior to the Hongqiao acquisition. An article from the Chinese press in 2012 describes Binbei's USD \$355 million investment project in a Kalimantan, Indonesia alumina refinery.

- <http://www.caexpo.com/news/info/number/2012/10/15/3577959.html>

This project may be the same as Hongqiao's Well Harvest JV, also located in Kalimantan. Hongqiao may have double booked the spending by 1) purchasing Binbei which had already invested in the Indonesia project and 2) claiming that Hongqiao spent on the Indonesia project independently. This relationship also explains why Liu Gang is the legal rep for Binbei as well as Well Harvest. The two entities may have been linked even before the purchase of Beibei by Hongqiao

2. Citic Transaction: Hongqiao announced the acquisition of Binzhou Beihai Xinhe (“BBX”) from CITIC in June 2016 for a consideration of RMB 2.12 billion. In addition, Hongqiao paid RMB 4.54 bn to a ‘former shareholder on behalf of BBX’²². The BBX transaction appears to be a back to back transaction in order to disguise former ownership by Shandong Binbei. Hongqiao estimates that BBX would have contributed RMB 1.6 bn of additional revenue in the first half of 2016 but would have been loss making which implies that BBX was purchased for 2x revenues including the payout of the shareholder loan²³.

- Formation documents for BBX show that Hongqiao executive Liu Gang created BBX in 2011.
- BBX was previously owned by Hongqiao’s undisclosed related party Shandong Binbei (same owner as above Binbei transaction) until being transferred to CITIC in May 2015. CITIC acquired BBX from Shandong Binbei on May 15, 2015. One year later, CITIC sold it to Hongqiao.

其他 部门 公示 信息	变更信息			
	变更事项	变更前内容	变更后内容	变更日期
	董事备案	姓名:王宁,证件类型:中华人民共和国居民身份证,职务:执行董事,证件号码:*** 更多	姓名:刘春猛,证件类型:中华人民共和国居民身份证,职务:监事,证件号码:**** 更多	2016年07月06日
	名称变更	滨州北海新材料有限公司	滨州市北海信和新材料有限公司	2015年05月11日
	企业类型变更	1152	1153	2015年05月11日
	投资人(股权)变更	股东(发起人)名称:山东滨北新材料有限公司,证件类型:企业法人营业执照(公司更多)	股东(发起人)名称:中信信托有限责任公司,证件类型:企业法人营业执照(公司更多)	2015年05月11日
	董事备案	姓名:徐恩云,证件类型:中华人民共和国居民身份证,职务:执行董事,证件号码:** 更多	姓名:徐恩云,证件类型:中华人民共和国居民身份证,职务:总经理,证件号码:*** 更多	2015年05月11日
	<< 1 2 3 >>			

Previous shareholder:
Shandong Binbei

Sold to CITIC

Source: BXX SAIC registration

²² Interim report 2016

²³ Interim report 2016

Hongqiao's has major environmental issues which it has not fully explained to investors

On October 30, 2016, the South China Morning Post reported that China Hongqiao has been ordered by the local environmental protection bureau to cease production on 3.61 million tons of capacity (nearly 70% of its nameplate).

The order came from the Environmental Protection Bureau of Zouping County of Binzhou City, Shandong Province— the location of Hongqiao's facilities. According to the article, the Bureau flagged a "failure to obtain environmental protection approvals before building and operating facilities".

Hongqiao was also ordered to stop construction of a smelting plant with annual processing volume of 1.32 million tons, cease construction of a power plant with 4.8K MW of generating capacity and close a 1,320 MW power-and-heat co-generating plant and alumina refinery, all because it failed to obtain environmental approval.

The detailed penalty orders are on the [website](#) of the Zouping Environmental Protection Bureau. The table below summaries the 11 penalty orders between May and September this year issued by the local government:

Recent Environmental Penalties to Hongqiao

处罚决定日期 (Date)	处罚类别 1 (Penalty Category 1)	处罚类别 2 (Penalty Category 2)	行政相对人名称 (Subject Company)
2016/08/30	罚款 (Fines)	责令年产 132 万吨原铝项目停止建设 (cease construction of the annual capacity of 1.32 million tons aluminum project)	邹平县宏正新材料科技有限公司 (Zouping County Hongzheng New Material Technology Co., Ltd)
2016/08/16	罚款 (Fines)	责令年产 25 万吨原铝项目立即停产 (immediately cease production of the annual capacity of 250 thousand tons aluminum project)	山东魏桥铝电有限公司 (Shandong Weiqiao Alumina & Power Co., Ltd)
2016/08/10	罚款 (Fines)	责令热电联产项目立即停产 (immediately cease production of the heat-and-power co-generating project)	山东魏桥铝电有限公司 (Shandong Weiqiao Alumina & Power Co., Ltd)
2016/07/11	罚款 (Fines)	责令年产 30 万吨原铝生产线项目立即停产 (immediately cease production of the annual capacity of 300 thousand tons aluminum project)	山东宏桥新型材料有限公司 (Shandong Hongqiao New Material Co., Ltd)
2016/07/11	罚款 (Fines)	责令年产 36 万吨原铝生产线项目立即停产 (immediately cease production of the annual capacity of 360 thousand tons aluminum project)	山东宏桥新型材料有限公司 (Shandong Hongqiao New Material Co., Ltd)
2016/07/11	罚款 (Fines)	责令年产 60 万吨原铝生产线项目立即停产 (immediately cease production of the annual capacity of 600 thousand tons aluminum project)	山东魏桥铝电有限公司 (Shandong Weiqiao Alumina & Power Co., Ltd)
2016/07/11	罚款 (Fines)	责令年产 96 万吨原铝生产线项目立即停产 (immediately cease production of the annual capacity of 960 thousand tons aluminum project)	山东魏桥铝电有限公司 (Shandong Weiqiao Alumina & Power Co., Ltd)
2016/07/11	罚款 (Fines)	责令年产 114 万吨原铝生产线项目立即停产 (immediately cease production of the annual capacity of 1.14 million tons aluminum project)	山东魏桥铝电有限公司 (Shandong Weiqiao Alumina & Power Co., Ltd)
2016/07/11	罚款 (Fines)	责令 8×600MW 机组上大压小项目停止建设 (cease construction of the 8x600 MW power generating project)	山东魏桥铝电有限公司 (Shandong Weiqiao Alumina & Power Co., Ltd)
2016/07/11	罚款 (Fines)	责令氧化铝项目立即停产 (immediately cease production of the alumina project)	山东魏桥铝电有限公司 (Shandong Weiqiao Alumina & Power Co., Ltd)
2016/05/17	罚款 (Fines)	责令邹平县魏桥镇 4×330MW 热电机组工程项目立即停产 (immediately cease production of the 4x300 MW heat generating power plant project in Weiqiao town of Zouping county)	山东魏桥铝电有限公司 (Shandong Weiqiao Alumina & Power Co., Ltd)

According to the SCMP, China Hongqiao's spokesperson and head of Corporate Finance, Christine Wong, said the company did not see the need to disclose these issues to investors:

"We know that all of these issues are a result of a tightening environmental protection requirements from the government, which we can and will meet," she told the Post in an interview, adding that the firm has neither paid fines nor ceased production at the facilities in question...There is no need to make an announcement ... if we have to pay any fine or stop production, we will certainly make an announcement."

Wikipedia has reported Hongqiao's red mud fields pose major contamination risk to neighboring areas.

In addition to this most recent report from SCMP, other sources such as Wikipedia and ToxicLeaks have expressed concern about Hongqiao's environmental issues. For example, this [article](#) from ToxicLeaks dated June 2016 includes a satellite picture taken in April of this year. The photo appears to show a red mud field:



Size of this preview: 684 x 569 pixels. Other resolutions: 274 x 240 pixels | 710 x 622 pixels.
Original file (710 x 622 pixels, file size: 345 KB, MIME type: image/jpeg)

Picture 1: Hongqiao's red mud field near agricultural field



Size of this preview: 600 x 574 pixels. Other resolutions: 320 x 229 pixels | 933 x 889 pixels.
Original file (933 x 889 pixels, file size: 491 KB, MIME type: image/jpeg)

Picture 2: Red mud fields near

In 2012, Hongqiao announced that it would be building facilities for producing alumina using coal ash. The firm indicated that the facilities in the Zouping Binzhou Beihai Development Zone produced 4 million metric tons of alumina by mid-2014²⁴. ToxicLeaks describes the significance of the red field as follows:

²⁴ https://en.wikipedia.org/wiki/China_Hongqiao_Group#Environmental_concerns

“However, satellite imagery indicates that the facilities at Binzhou use bauxite, not coal ash. **The images clearly indicate the presence of red mud, the toxic by-product of alumina production using bauxite.** The reason for continuing to refine bauxite is simple – converting coal ash to alumina is substantially more expensive. *The toxic red mud shown in the pictures is a highly alkaline substance full of oxidized iron, silica, unleached residual aluminum, and titanium oxide. In the event of a loss of containment, which could be caused from something as commonplace and unavoidable as flooding, will spread the toxic substance over a large area. As 1 ton of alumina creates 1.5 tons of red mud, the amount of toxic waste waiting to be released is massive.* The consequences may be especially dire, as Shandong is China’s most significant producer of wine and other agricultural products. An accidental release of Hongqiao’s red mud would rival the Ajka alumina sludge spill in 2010, when an estimated 30 million metric tons of red mud was released over a 15 square mile area in Hungary, killing ten, injuring 150, and costing hundreds of millions of dollars and several years to clean up.”

The Loften Environmental proposed transaction (a shady deal to begin with) also has environmental problems.

- In May 2016 Hongqiao announced that they were purchasing 28% of Loften Environmental Energy, a deal valued at ~900 mm RMB. Sell side analysts welcomed this deal as ‘a further step towards integration’ since Loften Environmental is allegedly an aluminum plate and foil company. If these analysts bothered to perform a basic public information check, they would have found that Loften has sold off most of its aluminum asset base.
- Since 2014, Loften has sold off its aluminum assets in a series of self-dealing transactions. Since 2014, Loften has reduced its PPE from 1.6 bn RMB to 201 mm RMB at Q1 2016, leaving the company with barely any aluminum assets. 50% of the 2.1 bn RMB of total assets on the Loften balance sheet are in the form of receivables, unpaid amounts for the assets they sold in the year prior²⁵. One of the asset transactions included one to China Winbo, who acquired six aluminum subsidiaries from Loften in June 2015 for RMB 1.1 billion.
- The chairman of Loften changed over to Zhang family proxy Wang Jingkun in August, 2016.
- Gaoxin mysteriously took a stake in China Winbo soon after the Loften Environmental deal was announced in July 2016²⁶.
- In September 2016 it was announced that Shandong province has ordered Loften to stop production on furnaces which have not obtained proper environmental permits. As a result, Hongqiao is reported to be re-considering the share acquisition offer²⁷.

²⁵ Loften Shenzhen filings, http://www.cs.com.cn/ssgs/gsxw/201605/t20160509_4964374.html

²⁶ Winbo SAIC filing

²⁷ <http://stock.qq.com/a/20160927/039448.htm>

Hongqiao's valuation implies little to no equity value due to its large debt load.

Operationally, Hongqiao is an outlier versus its peers in every respect:

Company Comp Set						
Company Name	FY EBITDA Margin %	FY EBIT Margin %	FY Total Revenues, 1 Yr Growth %	TEV/Total Revenues LTM	TEV/EBITDA LTM	TEV/EBIT LTM
Aluminum Corporation Of China Limited (SEHK:2600)	4.5%	-0.6%	-13.1%	1.1x	20.3x	NM
Shandong Nanshan Aluminum Co., LTD (SHSE:600219)	13.4%	6.6%	-2.8%	2.0x	15.6x	36.8x
Yunnan Aluminium Co., Ltd. (SZSE:000807)	6.3%	0.5%	-18.7%	1.2x	12.9x	44.2x
Henan Zhongfu Aluminium Co. Ltd.	1.4%	-4.2%	-	2.6x	187.0x	67.0x
JiaoZuo WanFang Aluminum Manufacturing Co., Ltd. (SZSE:000612)	4.9%	-1.5%	-11.3%	3.3x	52.2x	NM
Ningbo Fubang Jingye Group Co., Ltd.	-1.2%	-3.6%	-3.3%	4.5x	NA	NA
Alcoa Corporation (NYSE:AA)	16.2%	3.3%	-14.8%	0.8x	7.5x	28.0x
Norsk Hydro ASA (OB:NHY)	14.6%	8.8%	12.6%	1.0x	7.5x	14.0x
China Hongqiao Group Ltd. (SEHK:1378)	28.6%	19.6%	22.2%	2.1x	7.0x	11.0x

Source: Bloomberg and CapIQ

The ample evidence outlined in this report should lead to the re-evaluation of Hongqiao's equity value. A range of outcomes can be calculated assuming Hongqiao takes on the operating profile of its peers:

Income Statement				
mm CNY	Hongqiao Reported 2015	Shandong Nanshan EBIT Margin	Chalco EBIT Margin	Gaoxin Consolidation
Revenue	44,109.9	44,109.9	44,109.9	44,109.9
EBITDA	12,628.9	7,598.6	4,422.6	10,326.0
Operating Income	7,941.6	2,911.3	(264.7)	5,638.7
Net Interest Exp.	(2,182.8)	(2,182.8)	(2,182.8)	(2,182.8)
Other Expenses	(499.8)	(499.8)	(499.8)	(266.4)
EBT Incl. Unusual Items	5,259.0	228.6	(2,947.3)	3,189.5
Income Tax Expense	(1,638.8)	(71.2)	918.4	(993.9)
Earnings from Cont. Ops.	3,620.2	157.4	(2,028.9)	2,195.6
Minority Int. in Earnings	28.6	28.6	28.6	28.6
Net Income	3,648.8	185.9	(2,000.3)	2,224.1
Market Cap	45,801	45,801	45,801	45,801
Net Debt	55,961	55,961	55,961	55,961
EV	101,762	101,762	101,762	101,762
P/E	12.6x	246.3x	-22.9x	20.6x
EV/EBITDA	8.1x	13.4x	23.0x	9.9x
Net Debt/EBITDA	4.4x	7.4x	12.7x	5.4x

Source: Hongqiao financials, Gaoxin financials from Snowball

Assuming Hongqiao's true underlying margins are lower, and normalizing margins to the 6.6% EBIT margins of its best performing peer Shandong Nanshan (located in the same province), Hongqiao would have barely been able to service its debt in 2015. If Hongqiao's true economics are worse than Shandong Nanshan and closer to that of Chalco, which has a negative EBIT margin, Hongqiao's ability to service its debt would be in question and its debt would be possibly impaired. Even in the case where Gaoxin's operating losses are consolidated into Hongqiao, net profits would be 40% lower for Hongqiao.

Negative warnings regarding the company financials have also come in the form of CFO and auditor resignations, which occurred in 2014 and 2015, respectively²⁸.

Conclusion

The fact pattern described in this report is highly suspicious and warrants Hongqiao to answer significant questions regarding its governance and underlying economics.

- Who owns Gaoxin and how do Gaoxin's massive losses factor into Hongqiao's true production economics?
- Who is Liu Gang and why has this mid-level Hongqiao manager been allowed to extract RMB 10 bn from Hongqiao's shareholders?
- Are the Binbei and BBX transactions with related parties? What is the evidence that these entities are NOT related parties?
- What is the true cash cost of Hongqiao's aluminum production?

Hongqiao's regulators, auditors, bankers, and shareholders need to hold this company to a higher standard of disclosure and closer level of scrutiny. It is possible that bankers and analysts have sold to the public bonds and equities which may in fact be worth significantly less due to the lack of due diligence on Hongqiao's true economic value. If Hongqiao is in fact embezzling cash from the company in these expensive related party transactions, shareholders and bondholders deserve to be aware.

Furthermore, it is widely known that the global aluminum industry is in oversupply. Many aluminum producers in the West are pointing to China as the primary source of this oversupply and dumping into Western countries. Understanding what drives the capacity and production of the largest producer of primary aluminum in the world should give industry participants insight into how and why the incredible levels of Hongqiao's production is sustained – by a complacent capital marketplace that continues to finance a cash losing asset.

²⁸ Hongqiao company disclosures

Appendix:

- [Excerpt from Hongqiao 2014 Debt Prospectus](#)
- [Excerpt from Weiqiao Pioneering 2011 Debt Prospectus](#)
- [Asset transfer agreement between Weiqiao Textile and Gaoxin](#)
- Gaoxin financials from Snowball website
 - [Page 1](#)
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- [Gaoxin registration information screenshots](#)
- [Gaoxin business license](#)
- [PT Well Harvest Winning registration documentation](#)
- [Shandong Weiqiao registration](#)
- [Zhengtong registration](#)
- [Beihai HK registration document](#)
- [BBX registration](#)
- [Wikipedia Hongqiao article](#)
- ToxicLeaks Hongqiao articles
 - [Article 1](#)
 - [Article 2](#)
 - [Article 3](#)
- [Winbo registration](#)