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Shorting the *China-Story* with German Blue Chips
Part One: ThyssenKrupp

08.06.2015

I. Introduction

During the past 20 years, the German economy benefited from a stable growth of the Chinese market.[1] Without the unprecedented support of the Chinese economy, the export-orientated German companies would not have been able to offset the 2008/09 crisis in such a short time.[2] Having a look at the German financial reports, the Chinese market obviously became more important.[3] Due to this dependence, the development of the Chinese economy has become a crucial factor for the underlying stock prices. The fact that China-risks are poorly discounted by the German Stock market, even increases the relevance of the Chinese export market.

In the near future, market participants might be confronted with the question, to what extend are the German Blue Chips are prepared for a downturn of the Chinese economy. There are several signs indicating structural problems of the Chinese economy.[4] Assuming a negative scenario, even a slump of the Chinese economy seems possible. Due to the complexity of the Chinese economic system, any projection of future developments is obsolete. Therefore, the arguments concerning the condition of the Chinese economy tend to deviate strongly.[5]

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[1] As far as the author is not a native English speaker, he apologizes for any unfortunate choice of words.

[2] The massive stimulus plan of the Chinese government in excess of 4 trillion Yuan in November 2008 might have supported the world economy substantially.

[3] The German carmakers are partly selling 30% of their turnover in China. Due to the high margins that are generated in the Chinese market, the share of the after tax profits is even higher.

[4] The challenges of the Chinese economy are discussed in detail in the World Bank study „China 2030". Representatives of the Chinese government made several contributions to the study. http://www.worldbank.org/content/dam/Worldbank/document/China-2030-complete.pdf.
Regarding necessary reforms pp. 77 ff.

[5] The commentators on the Chinese economy are divided in several groups. An optimistic view is given e.g. by *Stephen Roach*, The Next Asia oder Unbalanced: The Codepency of America and China; *Ray Dalio* (Bridgewater Associates) „Bullish on China" – Interview on CNN 26th April 2015.
A pessimistic assessment is given by *Jim Chanos* (Kynikos Asscociates) „China is on a treadmill to hell" – Interview on Bloomberg TV 25th Juli 2014: http://www.businessinsider.com/jim-chanos-on-china-anti-

Lately, also the Chinese government seems to be concerned about the state of the national economy.[6] Present issues, like overcapacities in the real estate sector, the increasing dependence on the shadow banking market as well as financial difficulties of domestic bond issuers, are not permanently solved. The imbalances of the economy might be further strengthened by the booming stock markets in Shanghai and Shenzhen.[7] In spite of the relatively low importance of equity markets for the Chinese economy, this development could increase the vulnerability of the overall economy.[8]

Taking risk considerations into account, especially the communication policy of many German Blue Chips concerning their China-risks is not satisfactory. The overwhelming majority of companies expects a steady but slowing growth in China. Generally, all forecast and risk reports do not take the possibility of a Chinese *hard landing* into account. Such a negative scenario would hit the German exporting industry totally unprepared and would lead to a re-evaluation of the German equity market. Further risks in the balance sheets are lying in the reported assets in Chinese subsidiaries or Joint-Ventures. Given a negative scenario, the former top performing market China could turn out to be a loss maker. In this case, the highly leveraged companies with a large China-exposure would eventually need to be recapitalized.

This serial of publications regarding the China-risks of German Blue Chips analyzes to what extent German companies depend on the Chinese market and how they manage to counteract an economic slowdown in China.

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corruption-2014-7?IR=T; *Andy Xie* – "Investing in the Future" Caixin Online 6th March 2014: http://english.caixin.com/2014-06-03/100685451.html; *Anne Stevenson-Yang*, China Alone; *Gordon Chang*, The Coming Collapse of China – one of the first critics of the Chinese growth model; concerning the Chinese "property bubble" *Tom Miller*, China's Urban Billion.
Mediating e.g. *Ruchir Sharma*, Breakout Nations, pp. 15 f.; *Nicholas Lardy*, China's Economic Growth After the Global Financial Crisis; from German perspective *Dirk Schmidt/ Sebastian Heilmann*, Außenpolitik und Außenwirtschaft der VR China, pp. 63 f.

[6] Doubts on the modern Chinese economic system were expressed by Premier Wen Jiabao 2007 as he described the economy as „unsustainable, uncoordinated, unbalanced and unstable". In 2015, the Premier of the State Council Li Keqiang pointed out in the National People's Congress, that reforms and restructuring of the economy are inevitable.

[7] Since the implementation of the Shanghai- Hong Kong Stock Connect in autumn 2014, the Chinese Mainland Stock Exchanges rose by more than 100%. Chinese retail investors participated heavily leveraged in this boom.

[8] While investments in the stock market are recommended by the Chinese government, the property sector – the former growth engine of the Chinese economy – seems to lose some of its attractiveness for investors. A further weakening demand in the real estate sector could distress the highly leveraged property developers even more.

II. ThyssenKrupp

ThyssenKrupp initiated a complete reorganization of its business areas after several unprofitable investments in steel plants in Brazil and the United States.[9] By striving for less dependence on the global steel market, the company focuses on entering more diversified fields of business. Having a look at the financial reports, investors may apparently notice the strong commitment of ThyssenKrupp to the Chinese market. The group is not only involved in several joint ventures in China, it also invests in new projects and production sites. Against the background of several investment failures, resulting in a shrinking capital base, ThyssenKrupp´s China-risks are a highly noticeable factor.[10]

1. China-Risks of the business areas

According to the annual report of the fiscal year 2013/14 only 14% of the companies turnover originates from the Asia-Pacific region.[11] At first sight, these numbers point to a limited significance of the Chinese market for ThyssenKrupp. Due to a strong connection of the core business to the automotive industry, the dependence on the Chinese market effectively must be much higher. The business areas Components Technology (approx. 15% of group net sales) and Steel Europe (approx. 20% of group net sales) highly collaborate with car makers, for whom China nowadays represents the most important market. Additionally, significant orders for the construction of wind turbine components are generated in China.[12] The business area Elevator Technologies (approx. 15% of group net sales) is strongly involved in Chinese projects and also participates in the Chinese construction boom.[13] Those business areas, which entered the Chinese market on a broader scale, constitute roughly 50% of the group net sales.

A closer look at the latest investment projects of ThyssenKrupp reveals an even higher dependency on the Chinese market. Components Technology for example, invested in new plants in Chengdu und Shanghai.[14] Furthermore, a new plant for the Powertrain business was established in Changzhou[15] and the business area Elevator Technology is constructing an

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[9] See Annual Report 2010/11 Letter to shareholders.
[10] Interim Report Q2 2014/15, p. 36 – The equity ratio fell below 10%.
[11] Annual Report 2013/14, p. 49.
[12] Annual Report 2013/14, p. 56.
[13] The Annual Report 2008/09 already underlines the importance of the Chinese market for the business area Elevator Technologies, p. 126; Major orders were generated in the province Guangxi und the city of Ningbo Interim Report Q1 2013/14, p. 13.
[14] Annual Report 2013/14, p. 52; Interim Report Q2 2014/15, p. 11.
[15] Interim Report Q2 2014/15, p. 14.

elevator plant in Songjiang.[16] Steel Europe is going to set up a joint venture with the Chinese Angang Steel group to operate a coating facility for the automotive business.[17]

These investments are all made subject to a steadily growing Chinese economy.[18] In this regard, some statements made in the financial reports seem contradictory. The report on the economic position of the fiscal year 2013/14 acts on the assumption, that the Chinese construction output will grow on a slower pace.[19] Also the report for the first quarter 2014/15 states a lower growth in the Chinese construction and real estate industry.[20] Finally, the latest interim report revises the forecast of Chinas' growth rates substantially.[21] In summary the investor might get the impression that major investments are made in China, even there are visible tendencies that point to an economic slowdown in China.

Surprisingly the executive board comes to the conclusion that the risks of the ThyssenKrupp group have been further reduced.[22] Further, the executive board emphasizes in its latest interim report that ThyssenKrupp is "largely independent of regional crises on sales markets due to the diversification of its product and customer structures".[23]

On the background of its own risk assessment, not only the dependency on the Chinese automotive markets seems alarming. ThyssenKrupps business area Elevator Technology is highly dependent on the Chinese construction industry. In the past this business area convinced the markets by constantly increasing profits. Large orders which were generated in Ningbo und the Guangxi province in the first quarter 2013/14 illustrate this assertion.[24] In the past, the city of Ningbo as a *second-tier-city* was able to generate incredibly high growth rates in the real estate sector. Existing overcapacities as well as the questionable solvency of many Chinese property developers explain that these orders can be afflicted with certain risks.[25] As

[16] Annual Report 2013/14, p. 52.
[17] Interim Report Q2 2014/15, p. 21.
[18] Annual Report 2013/14, Letter to shareholders: „Investments in the Chinese growth market"; Interim Report Q2 2014/15, p. 16 – Elevator Technology: „Significant sales growth in China".
[19] Annual Report 2013/14, p. 46.
[20] Interim Report Q1 2014/15, p. 8.
[21] Interim Report Q2 2014/15, p. 5 – Corrrection of the Chinese growth forecast from 7,4% to 6,6%. In Q1 2014/15 the forecast was already reduced to 7,0%. The Annual Report 2013/14 reduced the forecast to 7,2%. It seems questionable to adopt the official numbers from the Chinese government. At best the official data is not the foundation for any business decisions of the ThyssenKrupp group.
[22] Interim Report Q2 2014/15, p. 7.
[23] Interim Report Q2 2014/15, p. 34.
[24] Interim Report Q1 2013/14, p. 13.
[25] In March 2014 the Ningbo based real estate developer Zhejiang Xingrun Real Estate was on the brink of bankruptcy. According to government officials, 3,5 billion Yuan of debt were outstanding (no comment was given on *off-balance debt*). A certain instability can therefore be attributed to the Ningbo real estate market.

far as the province Guangxi is concerned, the construction output in coastal areas like Beihai can hardly be categorized as sustainable.[26] If the construction activity in China declines due to overcapacities in the markets, the business area Elevator Technology might face some problems in continuing its success story.

From a risk perspective, a collapse in the Chinese local real estate business, a sector in which ThyssenKrupp Elevators is highly involved, seems to be possible any time. Investors should be aware of the fact, that the business area Elevator Technology was able to increase its EBIT in the last 10 quarters.[27] Regarding the group`s profits in the first half of the fiscal year 2014/15, Elevator Technology accounted for almost half of the EBIT of the overall group.[28] A declining net income from this business area, due to a decreasing dynamic of the Chinese market, could have a significant effect on the ThyssenKrupp group.

2. Joint ventures

ThyssenKrupp participates in several joint ventures and joint enterprises in China.[29] In consideration of creative accounting methods, which are used in several cases in China, these assets pose another risk for ThyssenKrupp.[30] If correct accounting methods are not applied strictly, joint ventures can constitute a quite unpleasant way of cooperation in the Chinese mainland. Due to a lack of legal certainty, the non-domestic partners are often left in a disadvantageous negotiating position. In the recent past, ThyssenKrupp was not able to negotiate a substantial compensation with the Citic group for the breach of contract in relation to the building of a coke plant in Brazil.[31]

See article from Reuters as of 18th March 2014 under: http://www.reuters.com/article/2014/03/18/china-bankruptcy-property-idUSL3N0MF0IG20140318.

[26] See article from Daily-Mail as of 22th April 2014: http://www.dailymail.co.uk/travel/article-2610353/The-Chinese-ghost-town-filled-luxury-properties-lives-in.html.

[27] Interim Report Q2 2014/15, p. 17.

[28] Interim Report Q2 2014/15, p. 10.

[29] According to the list of the group´s subsidiaries and equity interests as of 30th September 2014: REX (Xuzhou) Slewing Bearing Co. Ltd. (60%); ThyssenKrupp Fawer Liaoyang Spring Co., Ltd. (60%); ThyssenKrupp Presta Fawer (Changchun) Co., Ltd. (60%); ThyssenKrupp Presta HuiZhong Shanghai Co., Ltd. (60%); Xuzhou Rothe Erde Slewing Bearing Co., Ltd. (60%); Huizhou Sumikin Forging Company Ltd. (34%); Marohn Elevator Co., Ltd. (25%); BCCW (Tangshan) Jiahua Coking & Chemical Co., Ltd. (25%); TKAS (Changchun) Tailored Blanks Ltd. (55%); TKAS Auto Steel Company Limited (50%); TKAS (Changchun) Steel Service Center Ltd. (50%).

[30] From a German perspective: The bankruptcy of the Joyou AG (listed on the Frankfurt Stock Exchange). The company had to fully write off its assets in Hong Kong as it was faced with guarantee obligations in the amount of 300 million USD. Ad-hoc-Filing as of 21th May.2015.

[31] Even though ThyssenKrupp lost billions in Brazil, the group could only achieve a settlement with the Citic group over 75 million €.

The annual report 2013/14 states the overall assets of joint ventures of the ThyssenKrupp group at 1.800 million €, while liabilities of 1.191 million € prevail.[32] A breakdown regarding the amounts that belong to the Chinese joint ventures does not exist. For investors focusing on the China-story, it is hard to quantify the aggregate balance sheet risks of the ThyssenKrupp joint ventures.

A rough estimate of the risks involved can only be taken from the list of the group´s subsidiaries and equity interests. The total investment of ThyssenKrupp in Chinese companies (associated companies and joint ventures) represents approximately 786 million € of the group´s shareholder equity.[33]

The net result of these ventures in China accounts for 189 million € in 2013/14.[34] Without mentioning any more numbers in detail, the enormous dependency of ThyssenKrupp on the Chinese market is obvious. On the other side, the group´s balance sheet does not leave much space to write offs regarding the assets of Chinese joint ventures.

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[32] Annual Report 2013/14, p. 163.

[33] ThyssenKrupps equity share of its associated companies and joint ventures in China with an underlying Euro exchange rate of 7,75 CNY as of 30th September 2014: REX (Xuzhou) Slewing Bearing Co. Ltd. (148 million €); ThyssenKrupp Fawer Liaoyang Spring Co., Ltd. (41 million €); ThyssenKrupp Presta Fawer (Changchun) Co., Ltd. (7 million €); ThyssenKrupp Presta HuiZhong Shanghai Co., Ltd. (67 million €); Xuzhou Rothe Erde Slewing Bearing Co., Ltd. (99 million €); Huizhou Sumikin Forging Company Ltd. (35 million €); Marohn Elevator Co., Ltd. (20 million €); BCCW (Tangshan) Jiahua Coking & Chemical Co., Ltd. (- 13 million €); TKAS (Changchun) Tailored Blanks Ltd. (27 million €); TKAS Auto Steel Company Limited (336 million €); TKAS (Changchun) Steel Service Center Ltd. (19 million €).

[34] The profits of ThyssenKrupps associated companies and joint ventures in China with an underlying Euro exchange rate of 7,75 CNY as of 30th September 2014 (full fiscal year): REX (Xuzhou) Slewing Bearing Co. Ltd. (148 million €); ThyssenKrupp Fawer Liaoyang Spring Co., Ltd. (41 million €); ThyssenKrupp Presta Fawer (Changchun) Co., Ltd. (7 million €); ThyssenKrupp Presta HuiZhong Shanghai Co., Ltd. (67 million €); Xuzhou Rothe Erde Slewing Bearing Co., Ltd. (99 million €); Huizhou Sumikin Forging Company Ltd. (35 million €); Marohn Elevator Co., Ltd. (20 million €); BCCW (Tangshan) Jiahua Coking & Chemical Co., Ltd. (-13 million €); TKAS (Changchun) Tailored Blanks Ltd. (27 million €); TKAS Auto Steel Company Limited (336 million €); TKAS (Changchun) Steel Service Center Ltd. (19 million €).

III. Summary

For most German export oriented companies the Chinese market provided huge profits in the recent past. Given the costly mistakes ThyssenKrupp made in the global markets, the business generated in China contributed substantially to the survival of the entire group. Thus, the company´s future might not be determined in the city of Essen in Germany, but depends more and more on the well-being of the Chinese economy.

The executive board increasingly pays attention to compliance matters. Nevertheless, the high dependency on the Chinese automotive industry and property market is not communicated adequately to the investors. With regard to the slim equity base of ThyssenKrupp, a setback of the Chinese economy might have devastating effects on the groups results. From the risk perspective, ThyssenKrupp seems to be a leveraged bet on an at least stable development of the Chinese economy.

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Date of the first publication:
08.06.2015

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The author is invested in derivatives that profit from declining quotations of ThyssenKrupp.