Asia Independent Research Conference

2018

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THE ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION

BTIG

Detecting Earnings and Cash Flow Shenanigans

David Bassett, CFA
Senior Analyst at CFRA

“There's the objective reality- and then there's what we're going to talk about.”

-Investor relations representative in a candid moment during a conversation with CFRA

CFRA's Forensic Research: Increasing Alpha & Decreasing Risk

Challenge

- Listed companies manipulate financial performance negatively impacting investors and related parties
- Motivation:
  - Manipulate Earnings for Internal and External Expectations
  - Conceal Financial Deterioration and Bad Operating Decisions
  - Inflate Stock Price
  - Increase Executive Compensation
  - Dress-up for Equity or Debt Financing

CFRA's Solution

- Identify underappreciated differences between reported financial results and underlying economic reality to make better investment & risk management decisions.
- Complete suite of services providing confirmation of financial statement health and early warning signals
- Products:
  - Accounting Lens – Proactive Research "Biggest Concerns"
  - Quantitative Analytics
  - Advisory / Bespoke
  - Legal Edge

Value for IIM Clients

- Institutional Investment Management clients benefit from CFRA's products and services:
  - Idea generation
  - Alpha generation
  - Risk avoidance / management
  - Industry intelligence
  - Analytical support
  - Education

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Presentation Agenda

- Revenue Risk
- Earnings Quality
- Cash Flow Boosts
- Current Examples
    - Lenovo
    - Sinopharm

Revenue Risk

- Changes in revenue recognition timing or methodology

- Rising receivables (in days sales outstanding or DSO)
  - Extended payment terms
  - Late period sales
  - Difficulty in collecting
  - Aggressive revenue recognition (percentage-of-completion)

- Declining deferred revenue and backlog coverage

More Often: Companies Stretching
Less Often: Fraud

Last minute revenue at Webex Communications (WEBX):

From: Name Removed [mailto:Name.Removed@webex.com]
Sent: Thursday, March 22, 2007 1:48 AM
To: Name Removed
Subject: Please Advise

Hi Jonathan,

For the next 8 business days through March 30th (Qtr End), I can offer significant incentives on *all* WebEx services. Please reply to this email or call me directly if you have existing needs. There is additional flexibility for those signing up by March 23rd.

All the Best,

Name Removed
Regional Business Manager - WebEx Communications, Inc.
2868 Prospect Park Drive, Suite 500 | Rancho Cordova, CA 95670
phone: 916.636.8000 | fax: 916.636.8099

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Deterioration in Receivables & Deferred Revenue – Asiainfo-Linkage

DSO was up. The Company previously said it was due to the acquisition of Linkage. Due to this acquisition and divestment of an IT Security business, comparability was hindered. However, adjustments were possible.

($ millions, exc. days)	Q4, Dec-10	Q4, Dec-09 Adjusted	IT Security Business Adjustment	Linkage Adjustment	Q4, Dec-09 Reported[1]
Accounts Receivable	185.3[2]	138.8[4]	(14.0)[6]	80.8	72.0[7]
Revenue	110.7[3]	99.6[5]	(14.9)	41.1	73.4[8]
DSO	153	127			89
YoY Change	*26*				

Excluding M&A activity, DSO was still up significantly.

($ millions, exc. days)	Q4, Dec-10	Q4, Dec-09 Adjusted	IT Security Business Adjustment	Linkage Adjustment	Q4, Dec-09 Reported[1]
Deferred Revenue	28.0	45.3[3]	(16.3)[5]	16.0	45.5
Revenue	110.7[2]	99.6[4]	(14.9)	40.1	73.4[6]
DSDR	23	41			57
YoY Change	*(18)*				

Excluding M&A activity, days sales in deferred revenue (DSDR) was down.

Source: CFRA, company reports

Gains from Factoring - ZTE Corp. (763.HK)

	2010 RMB'000	2009 RMB'000
Revenue		
Telecommunications system contracts#	48,889,101	44,296,942
Sale of goods	17,927,439	13,073,619
Sale of services	3,447,334	2,902,002
	70,263,874	60,272,563
Other income		
VAT refunds and other tax subsidies##	1,530,782	1,123,111
Dividend income	6,023	2,100
Bank and other interest income	101,020	110,715
Others###	471,367	268,310
	2,109,192	1,504,236
Gains		
Gain on deemed disposal of an associate####	440,318	—
Gain on derivative financial instruments	90,297	12,560
Exchange gain	—	206,702
	530,615	219,262
	2,639,807	1,723,498

Included in the Group's telecommunications system contracts revenue is a gain on factoring of accounts receivable to be settled by an African telecommunications operator of RMB838,604,000 (2009: RMB825,603,000). Details of the arrangement are disclosed in note 25 to the financial statements.

Why is the gain in revenue and not gains?

Gain of RMB838 million (32% of PRC GAAP operating income in 2010) disclosed in the footnote of a footnote.

More details in note 25?

Source: 2010 annual report

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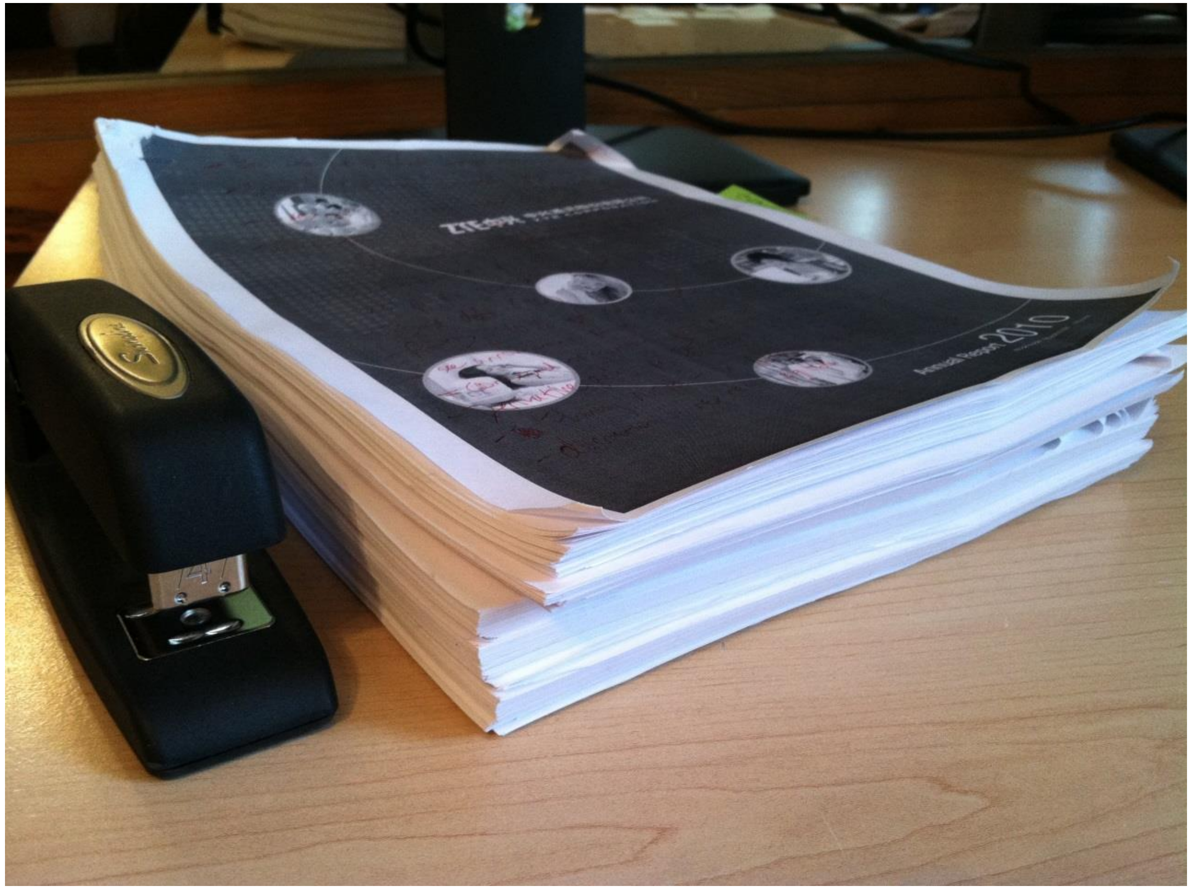
No Mention of Gain in Discussion of Factoring Arrangement- ZTE Corp. (763.HK)

The longer discussion of this factoring arrangement in note 25 made **no mention of the gain:**

In prior year, the Company entered into a telecommunications system project (the "project") with an African telecommunications operator with a total contract amount of US$1,500,000,000. The related accounts receivable is to be settled by promissory notes issued by the telecommunications operator with maturity dates ranging from 3 to 13 years. In 2009, two government strategic banks in the PRC have agreed to factor these promissory notes pursuant to the receivables purchase agreements (the "Agreements"), which stipulates the factoring conditions based on the future performance of the African telecommunications operator. During the financing period, the banks will charge interest to the Company and the telecommunications operator. If there is any delay in the payment by the telecommunications operator, the Company is not responsible for the related penalties. If there is default in the payment, the Company would bear the first 20% of default losses on the factored amount unless the Company breaches the Agreements or the factoring conditions are not satisfied. As at 31 December 2010, under the above arrangements, accounts receivable due from the customer amounted to RMB7,586,858,000 (2009: RMB6,082,427,000) among which RMB6,069,486,000 (2009: RMB4,865,942,000) has been derecognised from the consolidated statement of financial position as these receivables have fulfilled the derecognition conditions as stipulated in HKAS 39. An associated liability of RMB1,517,372,000 (2009: RMB1,216,485,000) has been recognised in the consolidated statement of financial position to the extent of the Company's continuing involvement.

Source: 2010 annual report

Gains Buried in Annual Report - ZTE Corp. (763.HK)



In a 371 page annual report, ZTE mentioned this gain in the footnote of a footnote.

Easy to miss this disclosure in such a large annual report. Remember to read those footnotes!

Need to Reduce DSO? Just Factor More – Sinopharm (1099.HK)

In November 2015, the Chinese government directed Sinopharm to reduce its receivables. Easiest way to improve receivables? Factor more.

(millions of RMB, except DSO)	H2, 12/11	H1, 6/12	H2, 12/12	H1, 6/13	H2, 12/13	H1, 6/14	H2, 12/14	H1. 6/15	H2. 12/15
Trade Receivables (Accounts and Notes Receivable)	26,592	36,296	38,187	48,058	51,825	59,305	66,098	74,386	64,624
Factored Accounts Receivable Outstanding	2,403		2,620		3,989	5,739	4,019		9,211
Total	28,994		40,807		55,814	65,044	70,117		73,834
Revenue	54,225	66,562	69,939	80,066	86,800	94,836	105,296	111,057	116,012
DSO - Trade Receivables	90	99	100	109	110	113	116	121	102
DSO - Factored Accounts Receivable	8		7		8	11	7		15
DSO - Adjusted	98		107		118	124	123		117

Source: CFRA, company reports

The amount factored surged to an all-time high of RMB9.2 billion at 12/2015 from RMB4.0 billion in 12/2014.

Although DSO improved by 14 days to 102 days at 12/2015, most of the improvement derived from factoring. **Adjusted for factoring, DSO improved only 6 days.**

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Earnings Quality

- Changes in discretionary reserves or expenses
- Excessive cost capitalization
- Changes in fixed asset useful life assumptions
- Questionable non-GAAP adjustments

Reversing Acquired Reserves – Lenovo (992.HK)

Lenovo's earnings benefited from reversals of reserves that had been acquired previously.

(in millions US$)	FY, 3/2012	FY, 3/2013	Q1, 6/2013	Q2, 9/2013
Environmental Restoration Reserve, Beginning Balance	15.0	86.0	56.0	40.7
Exchange Adjustment	(1.7)	(7.0)	(2.2)	0.2
Provisions Made	10.6	12.3	1.7	3.1
Amounts Utilized	(5.1)	(3.5)	(0.9)	(1.7)
Unused Amounts Reversed	(0.9)	(31.7)	(14.0)	(22.6)
Acquisition of Subsidiaries	68.0	-	-	-
Environmental Restoration Reserve, Ending Balance	86.0	56.0	40.7	19.8

Source: CFRA, company reports

In conjunction with acquisitions made during the year, Lenovo recorded $68m in reserves for its environmental restoration reserve.

Lenovo subsequently reversed much of the acquired reserves into earnings.

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Starting to Capitalize Development Costs – Comba Telecom (2342.HK)

In 2013, Comba started capitalizing development costs, after years of not capitalizing any such costs.

The Company offered no specific reason for the capitalization.

Nothing inherently wrong with capitalization. But it requires judgement and affects earnings.

16. INTANGIBLE ASSETS

Group	Computer software and technology HK$'000	Golf club membership HK$'000	Deferred development costs HK$'000	Total HK$'000
31 December 2013				
Cost at 1 January 2013, net of accumulated amortization	29,143	1,114	–	30,257
Additions	2,110	–	127,032	129,142
Amortization provided during the year	(10,082)	–	(16,878)	(26,960)
Exchange realignment	1,120	–	(257)	863
At 31 December 2013	22,291	1,114	109,897	133,302
At 31 December 2013:				
Cost	70,812	1,114	127,032	198,958
Accumulated amortization	(48,521)	–	(17,135)	(65,656)
Net carrying amount	22,291	1,114	109,897	133,302
31 December 2012				
Cost at 1 January 2012, net of accumulated amortization	27,102	1,114	–	28,216
Additions	9,576	–	–	9,576
Amortization provided during the year	(7,756)	–	–	(7,756)
Exchange realignment	221	–	–	221
At 31 December 2012	29,143	1,114	–	30,257
At 31 December 2012:				
Cost	66,727	1,114	–	67,841
Accumulated amortization	(37,584)	–	–	(37,584)
Net carrying amount	29,143	1,114	–	30,257

Source: 2013 annual report

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Starting to Capitalize Development Costs – Comba Telecom (2342.HK)

As a result of the capitalization, R&D expense declined significantly in 2013:

(millions of HK$)	2010	2011	2012	2013
R&D Expense	211	362	377	207
Revenue	5,191	6,354	6,333	5,721
R&D Expense/Revenue	4.1%	5.7%	5.9%	3.6%

Source: CFRA, company reports

If Comba had not started to capitalize its development costs, the Company's pre-tax loss in 2013 would have increased by HK$110 million: to a pre-tax loss of HK$270 million compared to the reported pre-tax loss of HK$160 million.

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Extending Useful Lives of Fixed Assets – PCCW (8.HK)

PCCW reassessed estimates of useful lives, which boosted earnings.

During the year ended December 31, 2016, the Group performed a review to reassess the useful lives of certain property, plant and equipment of the Group, based on the expectations of the Group's operational management and technological trend. The reassessment has resulted in changes in the estimated useful lives of these assets. The Group considers this to be a change in accounting estimate and therefore accounted for the change prospectively from January 1, 2016. As a result of this change in accounting estimate, the Group's profit attributable to the equity holders of the Company for the year ended December 31, 2016 increased by HK$282 million and the equity attributable to the equity holders of the Company as at December 31, 2016 increased by HK$282 million.

Source: 2016 annual report

(HK$, in millions)	FY 2015	FY 2016	Growth
Net Income Attributable to Equity Holders of the Company – AS REPORTED	2,295	2,051	(11%)
Benefit from Change in Accounting Estimate		(282)	
Net Income Attributable to Equity Holders of the Company – AS ADJUSTED		1,769	(23%)

Source: CFRA, company reports

Extending Useful Lives of Fixed Assets – PCCW (8.HK)

Ranges of estimated lives were extended:

	FY 2015	FY 2016
Land and Buildings	Over the shorter of the unexpired term of land lease and the estimated useful lives	Over the shorter of the unexpired term of land lease and the estimated useful lives
Exchange Equipment	5 to 13 years	5 to 20 years
Transmission Plant	5 to 30 years	5 to 35 years
Other Plant and Equipment	Over the shorter of 1 to 17 years and the term of lease	Over the shorter of 1 to 17 years and the term of lease

Source: CFRA, company reports

Key considerations:

- Whether or not the change is justified, the earnings growth is ultimately unsustainable.
- Was the earnings benefit well disclosed or buried in an annual report?
- If there are close peers, how do estimates compare?

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Increase in an Expense is “Exceptional”- Comba (2342.HK)

Comba’s R&D expense increased by HK$151m in 2011: from HK$211m in 2010 to HK$362m in 2011. Comba said the increase was “exceptional”, stripping it out of pro-forma earnings:

Exceptional Items

Comba

		Detail	Amount in 2011 (HK$ Mn)	Remark
1	**Stock provision**	• Stock provision for obsolete inventory	27	• One-off expense
2	**Increase of R&D costs**	• Heavy spending in R&D for long term growth	151	• Some innovative products to be launched in 2012 • Include expenses of HK$15Mn arising from the awarded shares granted to R&D staff
3	**Awarded share expenses**	• 26 million new shares were awarded to 365 qualified individuals (mainly management, sales, & R&D) at the market closing price of HK$9.32 on 12 April 2011	145	• >64% of expenses of total awarded share expenses has been recognized in FY11 • Expenses in FY12/ FY13/ FY14: HK$54Mn/ HK$23Mn/ HK$4Mn *(Expenses details in FY12, FY13 & FY14 in Appendix)*
4	**Gain on acquisition**	• On 20 June 2011, 100% interest of the PRC company was acquired for enlarging the product portfolio.	(48)	• Cash consideration of HK$84 million for a net asset value of HK$132 million

No suggestion that the increase was really exceptional. In fact, **R&D expense increased further in 2012.**

Source: 2011 investor presentation

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Cash Flow Boosts

- Receivables factoring
- Extended payables or supply chain financing
- Changes in classification (or misclassification) between operating, investing or financing activities

Receivables Factoring – Sinopharm (1099.HK)

Sinopharm's factored receivables outstanding more than doubled in 2015:

As at 31 December 2015, outstanding accounts receivable of RMB9,210,763 thousands (2014: RMB4,018,632 thousands) were derecognized under the accounts receivable factoring programs without recourse. The ageing of these derecognised accounts receivable was within one year. As at 31 December 2015, the collection of such accounts receivable on behalf of banks as financing activities, amounted to RMB1,098,923 thousands (2014: RMB608,497 thousands) was recorded in other payables (Note 35).

Source: 2015 annual report

The result: cash collections are accelerated, boosting cash flow from operations (CFFO). Timing issue. CFFO benefits when outstanding balance increases.

The challenge: Disclosure of factoring is often minimal. Sinopharm recently ceased disclosure.

Selling Non-Core Assets as an *Operating* Activity: Nufarm (NUF-AU)

"Material items" historically has been cash flow outflows related to restructurings. Why did it turn positive?

	Note	31 Jan 2017 $000	31 Jan 2016 $000
Cash flows from operating activities			
Cash receipts from customers		1,102,870	949,762
Cash paid to suppliers and employees		(1,239,826)	(1,115,876)
Material items		38,584	(38,866)
Cash generated from operations		(98,372)	(204,980)
Interest received		4,835	8,140
Dividends received		1,431	509
Interest paid		(49,282)	(44,555)
Income tax paid		(7,658)	(6,487)
Net cash used in operating activities		(149,046)	(247,373)

Company report: "The material items were a net inflow of $39 million, including **$49 million from the proceeds of non-core asset sales.**"

Source: H1 1/2017 interim report

These cash flows belong in the *investing* section. Stay vigilant for unusual line items on the cash flow statement. Companies can get creative.

Note: In its subsequent annual report, Nufarm corrected this item, classifying the proceeds in the investing section.

Lenovo (992.HK)

Stretching Payables, Boosting Cash Flow – Lenovo (992.HK)

Lenovo's operating cash flow has benefited significantly from extending payables.

(in millions US$)	Q2, 9/15	Q3, 12/15	Q4, 3/16	Q1, 6/16	Q2, 9/16	Q3, 12/16	Q4, 3/17	Q1, 6/17	Q2, 9/17
OEM Payables, net (estimated)	1,669	1,482	1,542	1,550	2,041	2,357	2,090	2,087	2,133
Notes Payable	255	251	235	269	669	636	836	791	975
Trade Payables	5,812	6,121	4,267	4,714	5,759	6,163	5,650	6,209	7,240
Total Payables	7,736	7,854	6,043	6,533	8,468	9,156	8,575	9,087	10,348
Cost of Sales	10,575	11,028	7,615	8,522	9,624	10,573	8,210	8,648	10,148
Days Sales in Payables (DSP)	67	66	72	70	81	80	94	96	94

Source: CFRA, company reports

Extending payables is not necessarily a bad thing. But it is not a sustainable source of cash flow growth.

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Déjà vu? Acquired Reserves Precede Low Expense – Lenovo (992.HK)

Lenovo's earnings have benefited in recent quarters as warranty expense declined.

(in millions US$)	Q1, 6/14	Q2, 9/14	Q3, 12/14	Q4, 3/15*	Q1, 6/15*	Q2, 9/15*	Q3, 12/15*	Q4, 3/16	Q1, 6/16	Q2, 9/16	Q3, 12/16	Q4, 3/17	Q1, 6/17	Q2, 9/17
Beginning Balance	1,127	1,163	1,165	1,530	1,560	1,473	1,443	1,452	1,322	1,242	1,220	1,136	1,062	1,034
Exchange Adjustment	1	(20)	(19)	(31)	8	(23)	(17)	14	(4)	1	(23)	9	(1)	11
Provisions Made	252	261	341	299	200	299	278	169	170	230	180	157	195	236
Amounts Utilized	(210)	(239)	(278)	(322)	(294)	(306)	(252)	(312)	(247)	(252)	(242)	(239)	(223)	(237)
Unused Amounts Reversed	(8)	-	(8)	(4)	-	-	-	-	-	-	-	-		-
Acquisition of Subsidiaries	-	-	328	88	-	-	-	-	-	-	-	-		
Ending Balance	1,163	1,165	1,530	1,560	1,473	1,443	1,452	1,322	1,242	1,220	1,136	1,062	1,034	1,044

*Reflects the reclassification as presented in the December 2015 quarterly announcement.

Source: CFRA, company reports

Déjà vu? Acquired Reserves Precede Low Expense – Lenovo (992.HK)

Two large acquisitions (server business from IBM and Motorola Mobility from Google) made in October 2014 preceded the unusually low warranty expense.

(in millions US$)	Q1, 6/14	Q2, 9/14	Q3, 12/14	Q4, 3/15*	Q1, 6/15*	Q2, 9/15*	Q3, 12/15*	Q4, 3/16	Q1, 6/16	Q2, 9/16	Q3, 12/16	Q4, 3/17	Q1, 6/17	Q2, 9/17
Beginning Balance	1,127	1,163	1,165	1,530	1,560	1,473	1,443	1,452	1,322	1,242	1,220	1,136	1,062	1,034
Exchange Adjustment	1	(20)	(19)	(31)	8	(23)	(17)	14	(4)	1	(23)	9	(1)	11
Provisions Made	252	261	341	299	200	299	278	169	170	230	180	157	195	236
Amounts Utilized	(210)	(239)	(278)	(322)	(294)	(306)	(252)	(312)	(247)	(252)	(242)	(239)	(223)	(237)
Unused Amounts Reversed	(8)	-	(8)	(4)	-	-	-	-	-	-	-	-		-
Acquisition of Subsidiaries	-	-	328	88	-	-	-	-	-	-	-	-		
Ending Balance	1,163	1,165	1,530	1,560	1,473	1,443	1,452	1,322	1,242	1,220	1,136	1,062	1,034	1,044

*Reflects the reclassification as presented in the December 2015 quarterly announcement.

Source: CFRA, company reports

Lenovo recorded $416m in warranty reserves for these two acquisitions.

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Déjà vu? Acquired Reserves Precede Low Expense – Lenovo (992.HK)

How does the $416m in acquired reserves compare to warranty liabilities at target companies before being acquired?

The following table presents the aggregate carrying amounts of the major classes of assets and liabilities divested (in millions):

Assets:		
Cash and cash equivalents	$	160
Accounts receivable		1,103
Inventories		217
Prepaid expenses and other current assets		357
Prepaid expenses and other assets, non-current		290
Property and equipment, net		542
Intangible assets, net		985
Goodwill		43
Total assets	$	3,697
Liabilities:		
Accounts payable	$	1,238
Accrued compensation and benefits		163
Accrued expenses and other current liabilities		10
Deferred revenue, current		165
Other long-term liabilities		250
Total liabilities	$	1,826

GOOG 10-K: No warranty roll forward disclosed...but divested ST accrued expenses **only $10m.**

Standard Warranty Liability

($ in millions)

	2014	2013
Balance at January 1	$ 376	$ 394
Current period accruals	240	346
Accrual adjustments to reflect experience*	(120)	22
Charges incurred	(298)	(387)
Balance at December 31	$ 197	$ 376

* Includes an adjustment of ($125 million) in 2014 related to the industry standard server divestiture.

IBM 10-K: Server business had **$125m** in warranty liabilities

Lenovo's estimated fair value of **$416m** of acquired liabilities is much higher, raising the possibility of inflated reserves.

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Déjà vu? Acquired Reserves Precede Low Expense – Lenovo (992.HK)

Lenovo's last twelve months (LTM) earnings benefited from declining warranty expense, a gain on property disposal, lower bad debt expense, and tax benefits.

(in millions US$)	LTM 9/2017
Reported earnings	272
CFRA adjustments	(522)
Adjusted earnings	(250)

Source: CFRA, company reports

Given these low level of "underlying" earnings, it may be difficult for Lenovo to achieve FY 3/2018 consensus earnings estimates of $304m.

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Sinopharm (1099.HK)

Payables Financing Program Results in Cash Payments in CFFF Rather than CFFO – Sinopharm (1099.HK)

Sinopharm's footnote on payables included an unusual comment:

Sinopharm's banks pay certain vendors. Sinopharm then pays its banks and considers these cash payments to be financing in nature.

The Group has accounts payable financing program with certain banks whereby the banks repaid accounts payable on behalf of the Group with an equivalent sum drawn as borrowings. Such drawdown of borrowings is a non-cash transaction while repayment of the borrowings in cash is accounted for as financing cash outflows.

During the six months ended 30 June 2017, accounts payable of RMB1,420,184 thousand were repaid by the banks under this program with the equivalent amount drawn as borrowings. As at 30 June 2017 and 31 December 2016, all bank borrowings related to this program were repaid.

Source: H1 6/2017 interim report

The result: Certain payments that normally relate to accounts payable (in CFFO) are now considered to relate to borrowings and thus are presented as CFFF outflows, boosting CFFO.

Payables Financing Program Results in Cash Payments in CFFF Rather than CFFO – Sinopharm (1099.HK)

Without this benefit, Sinopharm's CFFO would be much lower.

(in millions of RMB)	FY 12/2012	FY 12/2013	FY 12/2014	FY 12/2015	FY 12/2016	H1, 6/2017	Total
Cash Flow from Operations (CFFO)	3,856	4,941	5,561	13,560	9,258	(11,105)	26,071
Interest Received for LT Deposits	-	43	39	71	67	32	252
Interest Paid	(1,298)	(1,596)	(2,201)	(1,959)	(1,994)	(1,255)	(10,303)
CFFO, Including Interest Paid	2,558	3,388	3,399	11,672	7,331	(12,328)	16,020
Payables Financing Program Benefit	(4,962)	(5,426)	(4,605)	(3,568)	(3,037)	(1,420)	(23,018)
CFFO, Adjusted for Payables Financing Program	(2,404)	(2,038)	(1,207)	8,105	4,293	(13,748)	(6,998)
Adjustment for Factored Receivables	(223)	(990)	(252)	(4,702)			
CFFO, Adjusted for Payables Financing Program & Receivables Factoring	(2,627)	(3,028)	(1,458)	3,403			

The cumulative benefit to CFFO from this payables financing program was RMB23.0 billion.

Source: CFRA, company reports

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CFRA Disclosures

Client Services:
+1 212.981.1062

Email:
cservices@cfraresearch.com

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