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## One-stock ETF

What single liquid security is the best proxy for China's frenzied finance? We believe we've found a contender. The ticker is 656, the listing is Hong Kong and the name is Fosun International Ltd. Debt-funded deal-doing is the singular corporate strength. Clarity in accounting is a characteristic corporate weak spot. We are bearish on Fosun, as we are on its home country, the hyper-encumbered People's Republic of China.

Data on Chinese lending and borrowing continue to amaze even jaded onlookers. Thus, banking assets expanded by 15.7% in the 12 months through June. The increment of asset growth, RMB 29.5 trillion, or \$4.4 trillion, was bigger than Japan's 2015 GDP of \$4.1 trillion. As of June 30, Chinese bank assets topped RMB 218 trillion, equivalent to 318% of 2015 Chinese GDP. Fosun has faithfully adopted the national financial mores.

A Shanghai-based conglomerate founded in 1992, Fosun boasts a stock-market capitalization of HKD 103.2 billion (\$13.3 billion). Three of the four founders (they were students together at Fudan University) are still at the company, including the billionaire chairman, Guo Guangchang, tipped as the "Warren Buffett of China." Insurance and investment management loom large in the miscellaneous Fosun product mix. So do online lending, pharmaceuticals, senior care, real-estate development, iron ore, oil and gas production and "happiness" (the product heading that encompasses Club Med and Cirque du Soleil). The table on page 10 has details.

Between year-end 2004 and mid-year 2016, Fosun's balance-sheet assets climbed by more than tenfold. Its debt did, too. Total borrowings, in the form of

bank loans and bonds, reached RMB 118.7 billion, from the RMB 10.6 billion in 2004. Subtract cash, and add in related party borrowings and the portion of convertible debt recorded as a liability, and Fosun's net debt as of June amounts to RMB 78.0 billion, or 72% of total equity inclusive of minority stakes. Debt falling due within one year, about one-third of the total, or RMB 39.9 billion, nearly equals cash on the balance sheet. Fosun has corporate credit ratings of Ba3 and double-B, meaning the upper crust of junk.

The question before the house is whether the debt is manageable—whether Fosun has cash flow enough to service it. Let's equate cash flow with EBIT-

DA, or earnings before interest, taxes, depreciation and amortization, and define it, as Fosun does, by using an unconventionally broad definition of "earnings" (unconventional, at least, by American lights). Fosun's EBITDA includes not only operating income but also gains on the sale of corporate assets. By this reckoning, EBITDA amounted to RMB 25.2 billion over the 12 months through June; it covered interest expense by more than five times.

It requires no great skepticism to doubt that trading profits truly recur—at least, not when you have to have them. Our humbled hedge-fund titans have learned a thing or two about the nonrecurring

### Let's calculate EBITDA Key indicators of Fosun's credit (RMB values in millions)

	<u>LTM/most recent</u>	<u>FY 2015</u>	<u>FY 2014</u>
Cash	RMB 40,033.2	RMB 46,754.0	RMB 40,190.8
Total borrowings	118,694.6	112,248.7	93,155.7
Net debt*	77,975.8	67,890.8	55,495.6
Interest expense	4,610.3	4,492.7	3,667.4
EBITDA — as reported	25,222.5	24,422.5	18,682.1
Net debt/EBITDA	3.1x	2.8x	3.0x
EBITDA/interest exp.	5.5x	5.4x	5.1x
EBITDA — <i>Grant's</i> adjusted	1,854.8	2,980.0	7,725.1
Net debt/adj. EBITDA	42.0x	22.8x	7.2x
Adj. EBITDA/interest exp.	0.4x	0.7x	2.1x
Gains on valuation adjustments	2,398.9	2,042.6	3,841.0
Miscellaneous other income	1,238.6	1,237.2	2,151.9
Gains on disposals	19,727.1	18,162.6	4,964.1
Credit rating (Moody's/S&P)	Ba3/BB		

\*Includes convertible bonds and loans from related parties.  
source: company reports

## Fosun International Ltd.—at at glance

Segment	Key activities	Total assets (in millions)	Total assets (%)	1st half 2016 earnings (in millions)	Segment level earnings (%)
Insurance	Property and casualty, life, reinsurance	RMB 193,084	44%	RMB 1,076	16%
Investment	Public and private investments, real estate	60,164	14	2,248	34
Wealth management and innovative finance	Asset management, online lending	23,626	5	629	10
Health	Pharmaceuticals, senior-care facilities	51,354	12	1,888	29
Happiness	Club Med, Cirque du Soleil, gold retail	21,731	5	433	7
Property development and sales	Real-estate development	97,492	22	434	7
Resources	Iron ore, oil and gas	7,971	2	-137	-2
Corporate eliminations	—	-17,708	-4	-31	0

source: company filings

nature of capital gains. In the 12 months through June, gains on sale contributed no less than RMB 19.7 billion of Fosun's aforementioned RMB 25.2 billion in stated EBITDA. The bulls are sanguine. They quote Fosun's CEO, Liang Xinjun, who told Bloomberg Television on July 31 that the company is planning to deleverage to reach an investment-grade credit rating. There would be asset sales of up to RMB 40 billion (\$6 billion), or 9.1% of total assets, Liang predicted.

The bond market has raised no evident alarms over Fosun's liberties in cash-flow definition. The company's dollar-pay 6<sup>7</sup>/8s, due in 2020 and callable in January 2017, trade at 104.33 to yield 4.00% to call.

The equity bull case goes something like this (thank you, UBS). The stock trades at a 40% discount to sum-of-the-parts value (with the parts quoted at market, not book, prices). It changes hands at 9.7 times trailing earnings and at 1.1 times June's book value of RMB 9.60 per share. Near-term gains on sale are baked in. Hence the conclusion: "Buy."

We reach the opposite conclusion. For a properly critical credit analysis, one may invoke the authority of Standard & Poor's. The agency calculates 2015 EBITDA at RMB 5.1 billion, one-fifth the RMB 25.2 billion reported for the past 12 months. Even that we judge to be on the high side.

"An analyst willing to dig through the Fosun footnotes would find ample reason to believe that management's preferred metric may overstate Fosun's core profitability," colleague Alex Hess relates. "Of the RMB 25.2 billion in stated EBITDA, RMB 2.4 billion came from mark-ups on investment properties, reversals of impairment charges and other 'fair-value adjustments' to assets on the balance sheet. Another RMB 1.2 billion stemmed from miscellaneous 'other income,' which includes government grants, sales of scrap metal, consultancy income and 'exchange

gains.' Gains on sale, as already mentioned, accounted for RMB 19.7 billion of the aforementioned RMB 25.2 billion. Exclude these items, and EBITDA over the past 12 months shrinks to RMB 1.9 billion. Using this measure, net debt amounts to 42 times EBITDA, which in turn covers less than half of the trailing-12-month net interest expense.

"The key to deciding whether to treat such gains on disposal as part of EBITDA is to determine whether or not they can continue indefinitely," Hess continues. "We say not. First, RMB 847 million of the RMB 19.7 billion reported in gains over the past 12 months came from a reported 'gain on bargain purchase'—a gain recorded when the identifiable net assets received from making an acquisition exceeded the consideration paid. Additionally, RMB 7.0 billion flowed from the disposal of subsidiaries and RMB 7.5 billion from shedding associate companies—that is, companies which are not consolidated but whose net income appears in a single line item on the income statement."

To assume what Fosun assumes about the supposed perpetual nature of these gains is tantamount to endorsing the proposition that management can reliably enhance the value of the businesses it buys. It seems a tall order, given that management oversees 47 separate companies (including 37 consolidated subsidiaries, seven associates and three joint ventures, according to its 2015 annual report). Whatever expertise the front office may have in, say, iron ore, seems not obviously transferrable to circus acts or senior living.

Or to insurance operations—life, property and casualty, reinsurance—which account for some 44% of corporate assets and delivered 16% of segment-level earnings in the past 12 months. Over this span, gains on the sale of securities labeled as "available for sale," and primarily tied to insurance operations, amounted to RMB

4.4 billion. The parent may admire those gains. It may not necessarily get to possess them. Insurance businesses frequently incur long-dated liabilities. Mindful of that fact, regulators are loath to liberate cash at the insurance-operating level for parental use at the holding-company level.

"Fosun's cash-flow statement similarly indicates limited means to pay down debt, while highlighting just how poor the cash-generating power of its consolidated businesses is," Hess points out. "Cash flow from operations amounted to RMB 4 billion in 2014, negative RMB 3.4 billion in 2015 and negative RMB 1.7 billion over the past 12 months. For American readers, it is worth noting that Fosun uses IFRS and thus reports interest paid under cash flows from financing, rather than from operations, as U.S. GAAP requires. Counting interest paid, Fosun's cash flow from operations would have been negative RMB 447 million in 2014, negative RMB 9.2 billion in 2015 and negative RMB 8.0 billion in the year through June. Even if we add back dividend and interest income, as well as earnings from the company's joint ventures and associates that are not consolidated, cash from operations would have totaled RMB 2.3 billion in 2014, negative RMB 5.1 billion last year and RMB negative 2.5 billion in the past 12 months. Disclosure is poorer than U.S. investors might be accustomed to: Aside from the amount of cash taxes paid, Fosun's interim filing contains no information as to how cash from operations was computed."

Beyond profitability and cash flow, a number of other concerns surround Fosun's creditworthiness. Key-man risk is one. The aforementioned Guo Guangcheng is as key as key can be. The majority shareholder of Fosun, the company's prime strategist and its public face, Guo was spirited away by Chinese police on Dec. 10 for questioning. He reappeared on Dec. 14. In the wake of his disappear-

ance, Fosun shares fell by 9.4%. Moody's was sufficiently spooked to lower Fosun's rating outlook to negative from stable (the agency reversed itself in April). The chairman was just doing his civic duty, Chinese Communist-style, the company contends.

How does Fosun manage its bulging global portfolio? By adding more partners, CEO Liang told the *South China Morning Post* in April. Compared with the founding four, there were now 21 partners, as well as 196 managing directors reporting directly to those partners. Eighty-nine of these directors work abroad, he said.

Even so, Fosun's experience with one of its insurance businesses, Bermuda-based Ironshore, suggests that the pace of its deal-making might be too fast and too furious. Fosun announced its intention to buy Ironshore (the 80% of the stock it did not already own) on May 3, 2015. It found its new acquisition under review for a ratings downgrade by the end of July. A.M. Best, the ratings agency in question, cited "concern over the weak financial profile of

Fosun, represented by its high financial leverage and constrained liquidity position."

Best's review was followed by an investigation by the Treasury Department's Committee on Foreign Investment in the United States (CFIUS), *Newsweek* reported in June, as to whether Ironshore had made unauthorized disclosures of government data—one of Ironshore's subsidiaries, Wright USA, underwrites liability insurance for federal employees at U.S. intelligence agencies.

How long Ironshore will remain a part of the diverse Fosun family remains to be seen; an IPO prospectus was filed in July. Ironshore's risk factors cite the negative impact that would arise from a Best downgrade and acknowledge the CFIUS investigation. As for its prospective liberation from Fosun, Best declared it a positive: "part of a strategy that could sufficiently insulate Ironshore from potential issues that Fosun may encounter due to their vulnerable credit profile and aggressive acquisition activity." So reasoning,

the agency removed Ironshore from consideration for a possible ratings reduction.

Regarding Fosun's stated deleveraging strategy, there's been little visible progress. Indeed, since Liang talked to Bloomberg, Fosun's transaction history has comprised the following: buying Brazilian fund manager Rio Bravo Investimentos SA (no price disclosed), offering to buy a 16.7% stake in Portuguese bank Banco Comercial Português (RMB 1.8 billion), offering a desire to buy Russian investment bank Renaissance Capital (no price disclosed) and buying German private bank Hauck & Aufhäuser for RMB 1.6 billion. Bloomberg lists no disposals.

In the past 12 months, insiders have bought HKD 119.3 million (\$15.4 million) worth of shares. Notable for its contrast, then, is the fact that, in June, chairman Guo sold a stake in an investment fund to the company for RMB 582 million (\$87.3 million). Maybe he is the Warren Buffett of China.

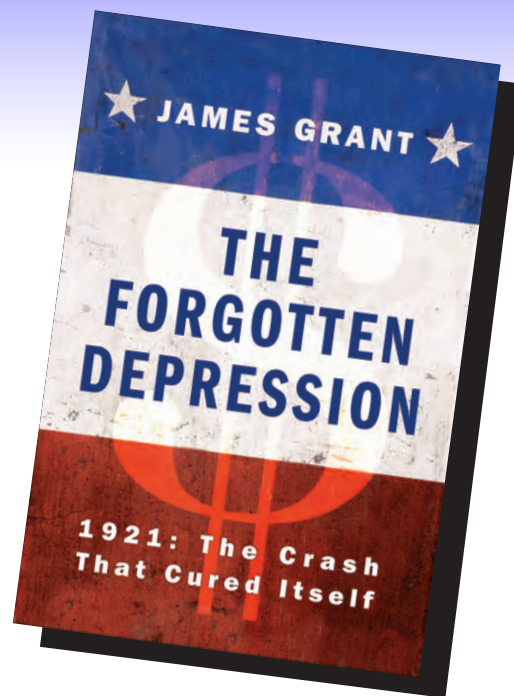
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