November 2018

Reality overwhelms creative accounting

Bombardier, Celltrion and thyssenkrupp investors nurse losses

Bombardier has recently fallen 38%, thyssenkrupp 18% and Celltrion 30%. In each case, the market was surprised when management admitted that they could not deliver on targets. This need not have been the case. For months, we have been warning that they have been using creative accounting to hide their business reality.

It seems that many observers simply accepted management's word, rather than closely examining the accounts. This failure to understand the methods used to disguise weak performance, a lack of cashflow and real leverage exposed their clients to unnecessary accounting, fiduciary and reputational risk. The worst in not over. All three still have problems and are likely to need further capital, yet the traditional sell side remains positive.

These are just some of the stocks using creative accounting. Common factors include diverse operations, complex balance sheets, aggressive M&A, working capital manipulation and the use of "adjusted" EBITDA to justify negative cashflow. Our revised **G**overnance, **A**ccounting and **P**erformance scores include several new anti-creative accounting measures and have been re-run for the largest listed companies, generating several new names to be investigated.

To understand the risk of creative accounting in your stocks of interest, email research@buceph.com

Multiple issues still to be addressed: BBD/B CN & TKA GR

Bucephalus Research Partnership
Exposing Creative Accounting

High GAP scores, skewed incentives and questionable assumptions

Bombardier: Bucephalus GAP* score 226

- Governance risk (100th percentile)
  - Controlling family, overseas directors, limited accounting experience, pension deficit, disclosure, exec pay
- Accounting risk (99th percentile)
  - Cost capitalisation, consolidated accounting, contract accounting, depreciation, minorities
- Performance risk (79th percentile)
  - Working capital management, margins, leverage, auditing, cost allocation

thyssenkrupp: Bucephalus GAP* score 137

- Governance risk (60th percentile)
  - Controlling family, oversized board, pension deficit, executive incentives, auditing, disclosure
- Accounting risk (36th percentile)
  - Consolidated accounting, contract accounting, depreciation, goodwill/intangibles,
- Performance risk (41st percentile)
  - Working capital management, margins, leverage, cost allocation, capex management

*Bucephalus **G**overnance **A**ccounting **P**erformance score, quantifying the risk of creative accounting. **Higher is worse**

Source: Bloomberg, company filings and Bucephalus Research Partnership

Multiple issues still to be addressed: 068270 KS

High GAP scores, skewed incentives and questionable assumptions

Celltrion Healthcare: Bucephalus GAP* score 174

- Governance risk (100th percentile)
  - Group structure, controlling shareholder, related company transactions, poor disclosure, auditing costs
- Accounting risk (99th percentile)
  - Cost capitalisation, related company lack of payments, inventory values, revenue inflation, working capital
- Performance risk (79th percentile)
  - Margins, intangibles, leverage, tax rates, executive pay

*Bucephalus **G**overnance **A**ccounting **P**erformance score, quantifying the risk of creative accounting. **Higher is worse**

Source: Bloomberg, company filings and Bucephalus Research Partnership

Share prices dropping but the sellside remains bullish

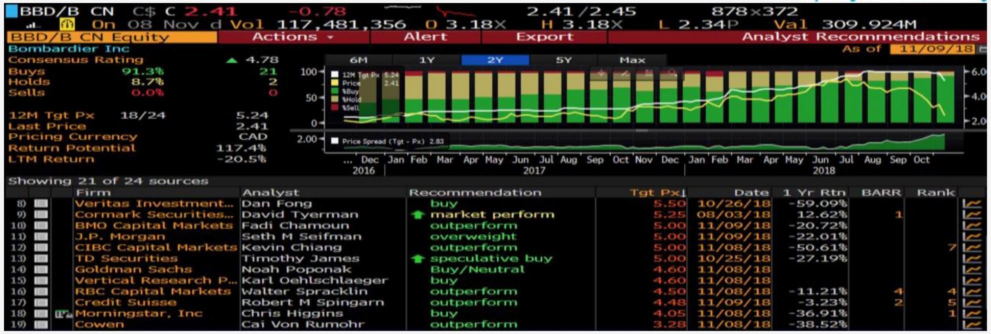
Each stock has been falling for a while, yet views and targets are still positive

Bucephalus Research Partnership

Exposing Creative Accounting

Bombardier (BBD/B CN) stock drops

Coverage remains optimistic



thyssenkrupp (TKA GR) stock drops

Coverage remains optimistic

Celltrion (068270 KS) stock drops

Coverage remains optimistic

Source: Bloomberg, company filings and Bucephalus Research Partnership

Bucephalus on Bombardier

Bucephalus
Research Partnership
Exposing Creative Accounting

Initial report published in December 2017

Bombardier (BBD/B CN): Flying on fumes

Sell, best case price $0.62, down 80% December 2017

Company profile	
Sector	Aircraft
Country	Canada
Auditor	Ernst and Young
Free float	Family 53% vote
Market cap.	US$5.5bn
Daily turnover	US$58.9m
Dividend	0%
Interest cost	6.4%
Avg. debt churn	15%
Cash tax paid/expensed	Negative
Pension deficit	CAD2.5bn
Bucephalus GAP score	**226**
Governance percentile	**100**
Board size	14
Tenure – longest	43
Poison pill	Dual vote
Audit cost (bps)	7.6
Ave. exec. director pay	US$5.4m
Accounting percentile	**99**
Excessive capex	Yes
Excessive cont. liabs.	Yes
Excessive intangibles	Yes
Working capital issues	Yes
Excessive inventory	Yes
Performance percentile	**79**
Margins	Tiny
Director compensation	High
Depreciation rate	Low
Cashflow	Negative
Interest cost	High
Intangibles/Equity	Over 100%
Altman Z score	Distress
Recommendation	**Sell**
Current price (CAD)	3.09
Target price (CAD)	0.62
Difference (%)	(80)

Paying Airbus to take an option on the C series programme may secure the future of Bombardier's commercial jets, but it underlines the precariousness of Bombardier's financial position. Creative accounting and careful presentation has enabled them to inflate profits, understate US$28bn of liabilities, and disguise negative cashflow. Having sold stakes in the train and plane businesses, Bombardier's future cashflow is ring-fenced, leaving its capital providers at risk. A peer comparison suggests the turnaround may be a mirage and, with their history of overstated profits and assets, we are sceptical. Sadly, even if management's estimates are achievable, there is plenty of risk and little value for shareholders. Perhaps this is to be expected at a state-supported, family-controlled business whose finance and audit committees live overseas. Management is paid well for keeping the company on life support, we think it is most unlikely that minorities will reap similar rewards. Sell, best case- C$0.62, realistic- C$ zero.

Reality postponed: Bombardier paid Airbus to take a 50% stake in the C series jets. If the deal does take place, this gives the project credibility, but Bombardier will lose control of both the business and its cashflow. It is most likely that Airbus will use their rather more conservative accounting standards which will reduce asset values and operating profits. Airbus may cut some costs and sell a few more planes but with margins likely to be close 6%, Bombardier's share is worth less than US$2bn.

High risk of default: BBD has US$28bn of liabilities. Add in the C series funding guarantees and they rise by another US$1bn. With the cashflow from transportation and the C series largely ring-fenced, the parent's 2017F EBIT, US$278m, cannot cover the US$790m of finance costs. Debt will continue to rise even with dividends from transportation. Bombardier doesn't reveal its covenants, only noting that Transportation is segregated and that they use a different set of accounts. With liabilities over 80% of assets and more negative cashflow, there is no room for error.

Living in Wonderland: There is talk of a turnaround, yet much of the improvement is due to reduced amortisation rates which are far below their peers. The arrival of IFRS 15 means US$900m in write-offs due to aggressive accounting in the past. Perhaps this, and their offshore finance/audit committees explain their high audit fees. The lessons from Livent have yet to be learnt. Treat the accounts with scepticism. **SELL**

Figure 1: Aircraft valuations

Company	Ticker	Market cap. (US$bn)	Net Debt/(cash) (US$bn)	Enterprise Value (US$bn)	EV/ Sales (x)	EBITDA margin Last FY (%)	EV/ EBITDA (x)	GAP score	Audit cost/ revenue (bps)
Bombardier	**BBD/b CN**	**6**	**7.0**	**15**	**0.9**	**2.6**	**36.2**	**226**	**7.6**
Boeing	BA US	162	0.7	162	1.8	12.6	22.7	184	2.8
Airbus	AIR FP	79	(0.6)	78	1.0	6.1	26.8	160	1.8
Embraer	ERJ US	4	0.7	4	0.7	9.3	9.4	130	3.9
Textron	TXT US	15	3.2	17	1.2	11.3	16.6	102	6.9
Dassault Aviation	AM FP	13	(3.4)	8	1.7	9.1	28.3	128	2.5
General Dynamics	GD US	61	2.2	63	2.0	15.2	20.3	133	6.7

Source: Bucephalus Research Partnership, company filings and Bloomberg

Bucephalus
Research Partnership

February 2018

Bombardier (BBD/B CN): Accounting wizardry

Best case: $0.45 – down 88%, Sell

At their recent results, Bombardier seems to have persuaded the markets that the company is on the mend. The reality is that behind their creative accounting little has changed. Reported losses understate the final hits to retained equity and without, what appears to be a cynical manipulation of working capital cashflow usage would have risen not fallen. We urge investors to ignore the headlines and check the detail in the annual report. With assets barely exceeding liabilities, there is little value for shareholders.

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Research Partnership

June 2018

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Bombardier (BBD/B CN)

Do the maths – 2020 Fair value C$1.79 down 64%, Sell

The stock is up on hopes of a turnaround, sales of the G7000 business jet and the C series deal. Some believe the stock should double by 2020 as cashflow recovers and Bombardier de-gears. It is time for a reality check.

To justify the optimism, we think Bombardier will need to be:

a) selling an extra 70 business jets p.a. at US$50m on a 10%+ margins, **i.e. volumes, prices and margins up 35%.**

b) Trade on 19x (market cap + net liabilities)/EBITDA, i.e. **50%+ more expensive than its peers today**.

EBITDA will rise, but don't ignore the finance costs, capex and minority interests. Many seem to be using a simple EV, using only net debt. We caution that this ignores the 8% negative carry on the cash and US$10bn of other net liabilities.

Perfect execution and a generous peer multiple gives a 2020 value of C$2.95, or 40% downside. If the performance is more modest, a more realistic peer based, multiple drops 2020 fair value to C$1.79, down 64%.

Source: Bloomberg, company filings and Bucephalus Research Partnership

Bucephalus on thyssenkrupp

Bucephalus Research Partnership

Exposing Creative Accounting

Initial report published in August 2017

thyssenkrupp (TKA GR): heading for a recap

Sell, target price EU4.94, down 80%

August 2017

Company profile	
Sector	Steel producers
Country	Germany
Auditor	PwC
Free float	77%
Market cap.	US$16.1bn
Daily turnover	US$67m
Dividend	0.6%
Interest cost	6.5%
Avg. debt churn	40%
Cash tax paid/expensed	45%
Pension deficit	EU8.5bn
Bucephalus GAP score	**137**
Governance percentile	**60**
Board size	20
Tenure – longest	18
Poison pill	Yes
Audit cost (bps)	3.6
Ave. exec. director pay	US$4.2m
Accounting percentile	**36**
Excessive M&A	Yes
Excessive cont. liabs.	Yes
Excessive intangibles	Yes
Working capital issues	Yes
Excessive debt churn	Yes
Performance percentile	**41**
Margins	Very low
Director compensation	High
Receivables	Low
Return on assets	Low
Interest cost	High
Intangibles/Equity	Over 100%
Altman Z score	Distress
Recommendation	**Sell**
Current price (EUR)	25.14
Target price (EUR)	4.94
Difference (%)	(80)

Don't believe the hype. thyssenkrupp is in trouble. At the end of the third quarter, gearing, 271%, exceeded the banking covenant limit, 185%, disclosed in the FY16 annual report. Even this number is debateable because net cash is not cash but client advances, and day to day debt levels are masked by window dressing, opaque accounting and off-balance sheet finance. Adjust fixed assets and goodwill to realistic levels and book equity falls significantly. Quoting the EU1.5bn sale value for CSA is disingenuous because we think it required a EU2.8bn recap prior to sale. Diversifying from steel has cost too much, and, despite under-depreciation and capitalised costs, margins remain some of the lowest in the industry. Cashflow remains too weak to cover the pension deficit, EU5.4bn, ongoing capex requirements and cut debt. With no real turnaround in sight, the company is in danger of technical default. At best, thyssenkrupp must raise capital. At worst, shareholders could get wiped out.

EU3bn+ of hidden debt: thyssenkrupp's average credit cost is 3.6%, but actual interest paid is about 5%. This and their unusual working capital, 24-31 days are missing, would suggest that normal debt levels are at least EU3bn higher than the year end numbers. Massive 'other finance' costs indicate that there could be up to EU26bn in other undisclosed off-balance sheet liabilities. Don't be misled by the EU2.2bn of net cash because this does not even cover EU4.7bn of customer advances.

Equity needs to be cut by 50%: Management wants an investment grade rating. This could explain why goodwill and book values are kept so high that asset sales result in write-offs. If their history is a guide, either steel assets should be cut by 29% or, using an 8% WACC, goodwill by 21% and EBIT 13%. Either way equity nearly halves. Adjust the rating metrics for this, include the hidden debt, and a **B/C** rating looks appropriate.

Inflated profits: thyssenkrupp moved into elevators and components to avoid the vagaries of steel prices. This has reduced revenue volatility, but left the company struggling to fund itself. Margins, even when inflated by capitalised costs, under-depreciation and adjusted for pensions, are still far below its peers. Cash generation is so weak that even the bare minimum of capex requires asset sales. The company claims that the annual EU432m pension cost has peaked, but it will be many years before they are materially lower. The stock is an overpriced option on thyssenkrupp's current capital structure and with fair value closer to, or below, EU4.94. **SELL**

Figure 1: Steel valuations

Company	Ticker	Mkt Cap (US$bn)	Net Debt (US$bn)	Ent. Val. (US$bn)	EV/Sales (x)	Unl. sustainable cashflow margin 3yr ave (%)	EV/ Unl sust. cashflow 3yr ave (x)	G.A.P Score	Audit cost (bps)
thyssenkrupp	TKA GR	17.5	7.6	25.7	0.5	0.8	64.5	137	3.6
Ternium	TX US	5.9	1.2	7.9	1.0	9.2	10.8	85	4.1
Voestalpine	VOE AV	8.9	3.8	13.5	1.0	6.3	15.6	89	N/A
Steel Dynamics	STLD US	8.5	1.5	9.9	1.1	6.4	17.6	81	2.6
Tata Steel	TATA IN	9.5	11.2	20.9	1.2	4.9	23.8	114	N/A
Nucor Corp	NUE US	17.8	2.8	20.9	1.1	4.8	24.0	63	2.3
Arcelormittal	MT NA	26.8	11.9	40.9	0.7	2.5	26.0	123	3.7
Acerinox	ACX SM	3.5	0.9	4.5	0.9	3.0	28.6	80	2.0
Tenaris	TEN IM	16.1	(0.9)	15.4	3.6	5.4	66.4	113	8.5
Lift makers									
Kone	KNEBV FH	27.3	(0.4)	26.9	2.6	12.1	21.5	115	3.7

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Bucephalus Research Partnership

July 2018

Bucephalus client portal

Sell thyssenkrupp (TKA GR)

Restructuring exposes the lack of value – Fair value E12.20

An unwieldy board and wrong-way management incentives have led to creative accounting which hides poor productivity & efficiency. We show that the elevator business, talked-up by management and the mainstay of market value, struggles when properly costed and compared to peers.

The unintended consequence of restructuring and spin-offs will be to expose the creative accounting, illustrate the poor performance, and reveal the lack of value in the shares.

Bucephalus proprietary **G**overnance, **A**ccounting and **P**erformance risk analysis:

- **G:** Director tenure. Depreciation. Pension
- **A:** Capex. Pension accounting. Murky finance
- **P:** Productivity. Employee costs. Low margins.

Bucephalus Research Partnership

4th October 2018

Bucephalus client portal

Sell thyssenkrupp (TKA GR)

Break up revealed, real change is delayed– Fair value EUR12.20

The thyssenkrupp break-up plan sets off talking optimistically about strategic clarity, higher transparency and meeting investor requirements. Once into the detail, we think it is clear that little has changed.

Governance: Instead of a clean spin off, Materials is to be given a stake in Industrials. This will protect management, dilute the activists' stake and make a third party bid more difficult.
Accounting: Rather than give some numeric detail on the allocation of sales and costs, summaries that ignore head office costs are used. The allocation also seems designed to maximise EBIT at Industrials, presumably because they are hoping for a higher multiple. There is talk of hidden reserves and tax, but no detail is given.
Performance: No mention is made of how they will address their lack of efficiency or the costs that will be involved in laying off 38,000 staff.

We think the spin-off simply pushes real change further into the future, thyssenkrupp remains overpriced.

Source: Bloomberg, company filings and Bucephalus Research Partnership

Bucephalus on Celltrion

Initial report published in April 2018

April 2018

Biosimilars: Bad for your wealth

Celltrion group: BRP value KRW100,000, 65% downside

Company profile	
Sector	Generic Pharma
Country	South Korea
Auditor	EY & KPMG
Free float	63%
Market cap.	US$35.5bn
Daily turnover	US$693.8m
Dividend	N/A
Interest cost	3.4%
Audit cost	Falling
Pension deficit	None
Bucephalus GAP score	**124**
Governance (%)	**N/A**
Board size	7
Capitalised expenses	Yes
Related transactions	Multiple
Disclosure	Poor
Audit cost (bps/Rev)	2.95
Ave. exec. director pay	US$0.7m
Accounting	**51**
Poor cashflow	Yes
Excessive intangibles	Yes
Inventory days	279
Receivable days	319
Payable days	191
Peer performance	**57**
Margins	Very high
Leverage	High
Depreciation rate	11%
Cash tax paid	Low
Interest cost	3.4
Intangibles/Equity	39
Altman Z score	2.55
Recommendation	**SELL**
Current price (KRW)	271,000
Target price (KRW)	100,000
Difference (%)	(65)

Biologic patents have produced billion-dollar profits, but while their replacements, biosimilars, can replicate the treatment they will not replicate the profits. Celltrion's Remsima has taken market share but at a 75% discount. In-elastic demand means that such price cuts reduce the absolute drug spend. Initial growth was rapid, but 4Q was flat YoY and margins dropped. They have a diverse pipeline but even if they are all on sale in 2020, group revenue will be less than a biologic. Add in questionable accounting, cashless profits and inventory questions and we think the group market cap of US$50bn for 2020 sales of possibly US$5bn represents far too much risk. Sell

Competition: Single brand biologics have generated billions in revenues and profits, biosimilars will not. The race for approvals is well underway and every biologic will face multiple competitors in nearly all regions. High gross biologic margins, AbbVie's are 75%, leave plenty of room for cuts as biosimilars fight for market share. We expect drug prices to fall below 80% of the pre-patent expire price within three years.

Rational expectations: Even in the first year, if Remicade is a good example, investors should expect to see drugs discounted 50-60%. Extra consumption will not compensate for this, so drug spend will drop, possibly as soon as 2018. Pipelines with multiple drugs can create growth but competition will split each market. The most important market, the US, is yet to open, so expectations for growth seem far too high.

Questionable accounting: Healthcare IPO'd with high margins and growth. Since then, sales have fallen in Asia and the US and margins have collapsed. It is not clear if this is due to channel stuffing, receivables remain extended, or overpriced inventory. Either way, the margins of the past may be over. Their revenue recognition and inventory valuation policies also seem generous and may be hiding losses of US$500m, or 100% of Inc.'s 2017 profits. Even ignoring these issues, a group EV/sales of 60+ implies high expectations for growth. However, even if they maintain their current sales, their new drugs are successful, and they take a 20% share in the US, sales in 2020 will be US$5bn and EBIT US$1.5bn, or 34x EV/sales. This is more expensive than AbbVie today.

Figure 1: Biopharmaceutical valuations

Company	Ticker	Market cap. (US$bn)	Enterprise Value (US$bn)	Revenue (US$bn)	EV/ Sales (x)	EBITDA margin Last FY (%)	EV/ EBITDA (x)	GAP score	Audit cost/ revenue (bps)
Celltrion group	**N/A**	**49**	**48**	**1.1**	**60.3**	**70**	**61.7**	**124**	**4.3**
Johnson & Johnson	JNJ US	349	366	76	4.8	32	15.0	83	7.9
AbbVie Inc.	**ABBV US**	**149**	**176**	**28**	**6.2**	**39**	**15.9**	**144**	**5.2**
Roche Hldg-Genus	ROG SW	**195**	**205**	54	3.7	32	11.7	99	4.5
Biogen Inc	BIIB US	**56**	**55**	12	4.5	52	8.6	79	4.8
Allergan Plc	AGN US	**57**	**85**	16	5.4	9	59.0	129	25.1
Samsung Biologic	207940 KS	**35**	**35**	0	81.6	29	278.9	-	-
Teva Pharma	TEVA IT	**20**	**53**	22.4	2.3	(69)	(3.4)	96	6.4

July 2018

Bucephalus client portal

Sell Celltrion Inc. (068270 KS)

Story unravelling. Target price KRW 100,000, 60% downside

UPDATE: J&J release Q2 results - 24th July 2018

1. J&J's US Remicade sales were flat QoQ.
    - Undermines the story that Celltrion Group is gaining market share in the US
2. J&J's international Remicade sales down 15% QoQ. J&J say this is due to "Increased discounts & rebates"
    - Undermines the story that Celltrion Group can deliver profitable growth
3. J&J's policy of lowering Remicade prices
    - Ends Celltrion Group's hyper-growth story and exposes our concerns if sustained.

Bucephalus Concerns

We have been *very* concerned that Celltrion's corporate structure & accounting policies have been used to mislead investors. The group uses a dual-company structure to create sales and profits at the listed entities that far exceed the group's sales to external clients. This was used to promote the listed entities to public market investors at high valuations. The story is now unravelling: growth is slowing; and profitability is falling. We think shares in Celltrion Inc are worth KRW 100,000 at best.

Source: Bloomberg, company filings and Bucephalus Research Partnership

Recent stock reports

For clients, our research is available via Bloomberg, FactSet, OneAccess & BlueMatrix

Bucephalus Research Partnership
Exposing Creative Accounting

Company	Ticker	Recommendation	Title
Baidu	BIDU US	Sell/Avoid	A Fiduciary nightmare, adopting global worst practice
thyssenkrupp	TKA GR	Sell	Break-up revealed, real change is delayed
Anta	2020 HK	Buy	The Amer bid makes strategic sense
Amer	AMEAS FH	Buy	Take the Anta bid seriously
Dometic	DOM US	Buy	Risk/reward seems fair
Pilgrim's Pride	PPC US	Buy	JBS needs to access Pilgrim's value
TransDigm	TDG US	Sell	Daylight robbery. Management takes the profit
Lenovo	992 HK	Sell	Drowning in debt
Celltrion Inc.	068270 KS	Sell	The dual-company structure masks investment risk
Bombardier	BBD/B CN	Sell	Do the maths. De-gearing will be limited at best
Prada	1913 HK	Sell	Weak sales, inventory and dividend risk
Hengan	1044 HK	Sell	Relationships, churn and margin pressure
Vinda	3331 HK	Buy	New incentives, leverage and margins
Thor Industries	THO US	Buy	Cheap, shareholder-friendly, cash generator
BT Group	BT/A LN	Buy	**B**ullsh!t **T**olerant

Source: Bloomberg, company filings and Bucephalus Research Partnership

Bucephalus: Exposing Creative Accounting

Our proprietary **G**overnance, **A**ccounting and **P**erformance reviews combine statistical analysis of reported data with careful reading of company statements and management reports. This enables us to:

Generate investment ideas on the largest, most liquid companies

- When business realities diverge from management's reports & accounts.
- Where incentives, behaviours and outcomes are being hidden from investors.
- **And** the market's perception and valuations create opportunity

Help our clients manage risk and improve outcomes

Investors use our proprietary risk descriptors to asses the largest 8,000 companies in the Americas, Europe and Asia. This helps with:

Risk oversight: Our clients can review both whole portfolios and individual holdings to avoid reputational damage, accounting scandals and risk of permanent capital losses.

Ideas: We look for high returns when management presentations, market perceptions and business realities diverge.

Due diligence: We investigate **G**overnance, **A**ccounting and **P**erformance issues even if companies are outside our core coverage.

Stewardship: Clients ask us to review corporate resolutions and provide recommendations to encourage best practice. We check to ensure that management incentives are truly aligned with all shareholders.

https://www.buceph.com/about.html

Source: Bloomberg, company filings and Bucephalus Research Partnership

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