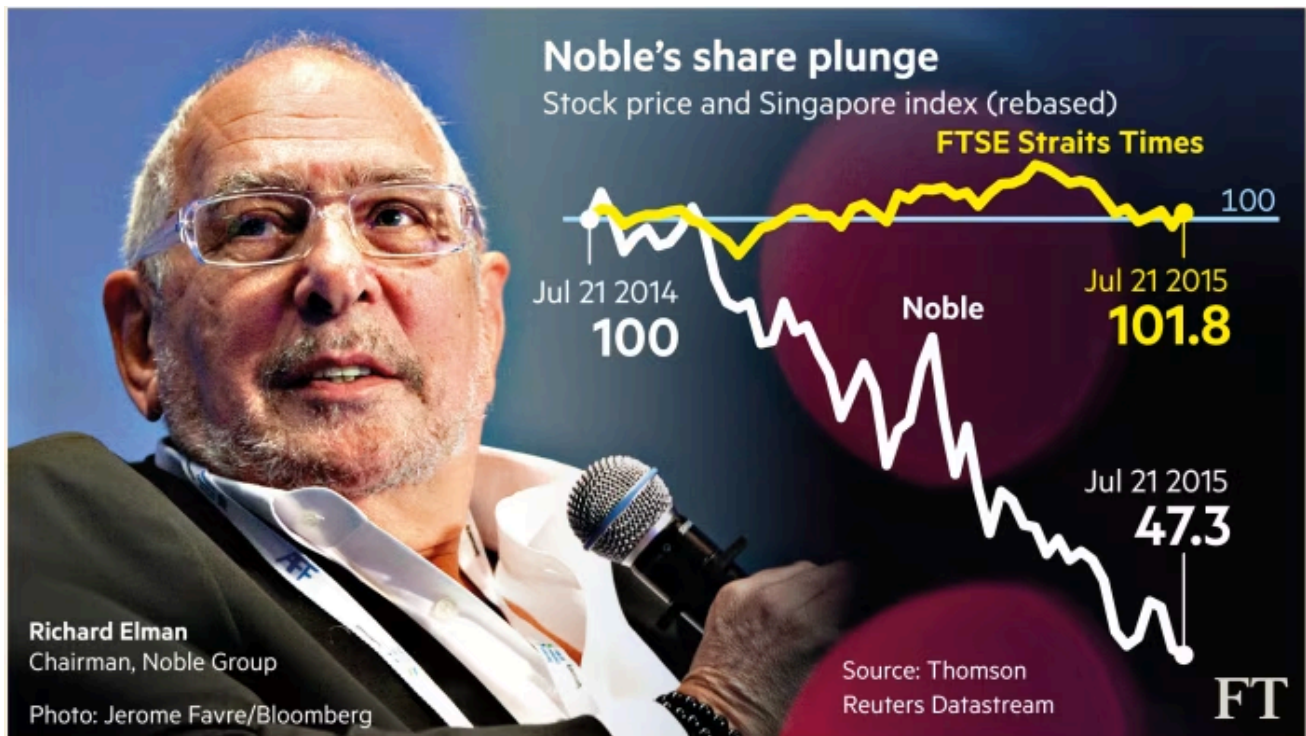


Financial Times **Texas**

Attacks on Noble Group's accounting take their toll

Asian commodity trader defends its financial reporting amid a review of how it values contracts



Neil Hume and David Sheppard in London JULY 22 2015

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As the US shale boom went into overdrive, Asia's biggest commodity trader was keen to trumpet its involvement.

In its 2013 results, Noble Group highlighted a long-term sales and marketing agreement with the owners of a planned gas-fed petrochemical plant in Texas as one of the highlights of the company's year. What the Hong Kong-based company did not reveal was that the contract had been quickly pushed through, apparently with the aim of allowing Noble to record a profit in its third-quarter results, several people familiar with the deal said.

This was surprising because construction of the plant had not begun, these people added. Two years later and the project, 40 miles south of Houston, has an environmental permit but its owner, Ascend Materials, said that construction was "under review" due to big changes in the price of gas and oil. Noble has not responded to repeated questions about the contract.

How Noble reports profits on this type of long-term commodity deal is now the centre of a fierce battle between the trading house and its critics, led by a previously unknown research group, a famous US shortseller and a former investment banker.

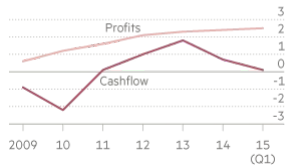
The critics allege the Hong Kong-based company — which acts as a middleman for buyers and sellers of oil, coal, iron ore and metals — is providing a misleading picture of its financial performance. They claim Singapore-listed Noble has pushed the limits of international accounting standards so that it can record profits on long-term deals to source and supply commodities well before the company receives any cash payments.

"The only question management really needs to answer is how much profits have come from long-term contracts from which the group has not received payment," says Gillem Tulloch of GMT Research, an independent research firm. "It's a fairly simple question and yet one which it has steadfastly refused to answer."

Noble has strongly defended its financial reporting. Richard Elman, Noble's founder and chairman who started out in Britain's scrap metal trade, has bought shares to demonstrate his confidence in the company. Noble says: "Our accounting is robust, we have a highly experienced board with strong, independently led audit and risk committees, and are supported by our key stakeholders."

Noble's profit and cash mismatch

Cumulative net profits and net cash flows from operating activities (\$bn)



Source: company

FT

Noble's critics have not accused the company of illegality, but these attacks have taken their toll. Its shares — partly hurt by the downturn in commodity prices — have fallen more than 40 per cent since February, when Iceberg Research, a small research firm, highlighted how Noble had reported much higher net profits over the past five years than it had generated cash. When profits and cash differ significantly for a protracted period it can be a red flag for analysts because it raises questions about a company's financial performance.

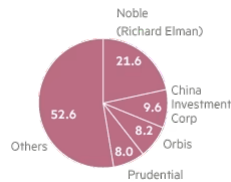
In aggregate, Noble reported net profits of \$2.54bn between 2009 and the first quarter of 2015, yet net cash flows from operating activities amounted to just \$118m over the same period.

Iceberg alleged the main reason for this divergence was Noble overstating the value of some of its commodity deals — it has more than 12,000 contracts in total. In April Muddy Waters, the US short seller, also criticised Noble's accounting.

Last month Standard & Poor's, the rating agency, warned Noble its investment grade credit rating, which is crucial to its operations, could be downgraded to junk status without greater transparency. It expressed concern at the mismatch between Noble's reported profits and cash generation on its long-term commodity contracts.

Key shareholders

Per cent



Source: Bloomberg

FT

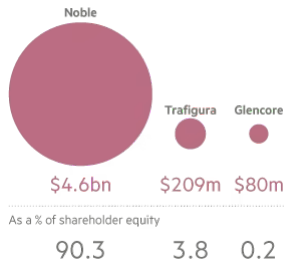
A typical long-term purchase and supply agreement involving Noble might look like this. The company agrees to buy coal from an Indonesian mine for 10 years at a 3 per cent discount to the market price. It then strikes a deal to sell the coal to a Chinese power station at a 2 per cent premium to the market price. After subtracting shipping and other costs, Noble should then make money on the agreement.

In order to book profits on these long-term commodity deals, Noble relies on its own mark to market models to place a value on the contracts. The fair value of these contracts are estimated on an ongoing basis, enabling gains to be recorded on Noble's balance sheet.

Other commodity traders engage in similar practices, but Noble stands out from rivals for the sheer scale of fair value gains being reported in recent years. At March 31, Noble said net gains on its commodity contracts amounted to \$4.1bn, or more than 80 per cent of the company's shareholder equity. At the end of last year, such gains amounted to 90 per cent of Noble's shareholder equity, compared with 0.2 per cent at Glencore and 3.8 per cent at Trafigura, according to UBS analysts.

Large gains on contracts

Net fair value gains on commodity contracts, as at end Dec 2014



Source: UBS

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The biggest fear among analysts is that some of Noble's valuations for the long-term commodity deals could be unrealistically large, and that the amount of cash eventually received for the contracts will be far lower than the profits it has previously recorded.

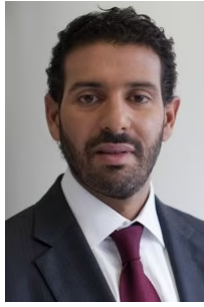
"What we would like to see is a record of how some of these long-term contracts run off and the cash realisation of the portfolio," says Christopher Lee, a managing director at S&P.

At the same time, Noble's accounting for its investments in other companies has come under scrutiny.

Noble has a 13 per cent stake in a listed Australian miner called Yancoal. The company currently has a market value of \$95m, making Noble's investment worth around \$12m. However, in its 2014 annual report, Noble recorded the "carrying value" of its Yancoal stake at \$322m.

Noble defended the valuation of lossmaking Yancoal last month. In an open letter addressed to a vocal critic of the company, a former Morgan Stanley banker called Michael Dee who has called for Mr Elman's resignation, Noble said that just because Yancoal "currently loses money . . . this does not mean it will always lose money".

More broadly, Noble has dismissed Iceberg's attacks as the work of a former employee it believes is disgruntled — a credit analyst called Arnaud Vagner. He was fired in 2013, and is being sued by the company in Hong Kong. Iceberg would not comment on whether Mr Vagner works at the firm.



Noble Group CEO Yusuf Alireza © Bloomberg

But Noble has responded to concerns expressed by some analysts.

Yusuf Alireza, the former Goldman Sachs banker appointed Noble chief executive in 2012, promised in March to deliver greater transparency around the company's financial reporting.

In the most significant move so far, Noble announced this month it was hiring PwC, the accounting firm, to review its "[mark to market] models, valuations, and governance framework", saying a summary of the work would be published in due course.

Singapore's stock market regulator said the PwC review would "address and help bring closure to questions raised by the market".

Not everyone is convinced. Iceberg, in its latest report on Noble this week, said PwC would not answer the question "does Noble violate the spirit of the law" through its valuations of commodity contracts.

Noble said the PwC review, overseen by a board committee, would offer further transparency to the market. "We look forward to the review's findings," it added.

The company declined requests for an interview with Mr Alireza, and also did not answer questions about the contract regarding the Texas petrochemical plant that has yet to be built.

Value of Noble's Mongolian mine increased 17-fold

On the southern flank of Mongolia's windswept Gobi desert sits an undeveloped coal mine, whose value, Noble Group said, has jumped 17-fold in almost as many months.

In February last year, Noble bought the 50,000-acre Enkhtunkh Orchlön mining prospect for \$3.76m. Last month, it sold it to Australia's Guildford Coal for "up to \$65m".

Some analysts and hedge funds have questioned how the value of the mine has increased so much in such a short space of time, and whether Noble has overstated what it might eventually receive from the sale.

So far, Noble has been paid \$6m in cash by Guildford for the mine, according to people familiar with the deal. The majority of the headline \$65m sale price reported by Noble is now dependent on future royalty payments by Guildford to the Hong Kong-based trader, from a mine that is yet to start producing coal.

Company filings by Sydney-listed Guildford show it is heavily reliant on Noble. Guildford's auditors, Ernst & Young, said in the company's 2014 accounts that without Noble the miner may cease to be a viable going concern.

"Guildford is financially dependent on Noble," said one hedge fund manager. "[It is] akin to vendor-financing. Let's see if [Noble] can collect its loans from the buyer."

Guildford, which declined to comment, has already used at least \$32m of borrowed cash from Noble to develop a Mongolian coal mine close to Enkhtunkh Orchlön.

Noble said the sharp increase in Enkhtunkh Orchlön's value was justified by a recent assessment of its coal reserves.

In its filing announcing the mine sale to Guildford, Noble said it was agreed on a "willing-buyer, willing-seller basis". It aims to establish a long-term sales and marketing agreement for the coal if Guildford can successfully develop the mine.

