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*"苦言は薬なり、甘言は病なり– **Kugen Wa Kusuri Nari, Kangen Wa Yamai Nari** – "Bitter words are medicine. Sweet words are disease." -* **Japanese Proverb**

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COMPANY: ITOCHU Corporation | Tokyo: 8001
INDUSTRY: Trading

Recommendation:
Strong Sell

Price (as of 07/26/2016):
JPY: 1,262.00

Market Cap:
JPY: 2,099 billion

Daily Volume:
4 million shares (avg. 3mo)

Price Target:
JPY: 631.00

In 2015, Toshiba Corp. (TYO: 6502) admitted to deliberately manipulating its accounting policies in order to overstate its profits by USD 1.2 billion (¥152 billion) from FY 2008 to 2014. Toshiba's stock declined 70%, Japanese securities regulators imposed a record fine, and Toshiba's CEO and 8 of its 16 board members resigned in disgrace. The Tokyo Stock Exchange even placed Toshiba's stock "on alert," raising the possibility that the Company's stock could be delisted if it failed to correct deficiencies in its corporate governance.

In our opinion, Itochu Corporation (Tokyo: 8001) ("Itochu" or the "Company") will likely become the next Japanese company to be forced to restate its financials and admit to accounting impropriety. In FY 2016, Itochu surpassed traditional giants Mitsui & Co. and Mitsubishi Corp. to claim the title of Japan's most profitable trading company. Itochu's rise has been startling: since the appointment of Masahiro Okafuji ("Okafuji") as president, Itochu's net income has risen 87%.

We believe that Itochu's record profits are merely a mirage. We have conducted a thorough review of the publicly available information, and we believe that Itochu overstated FY 2015 net profits by inappropriately reclassifying its stake in a Colombian coal mining JV to intentionally avoid taking a ¥153 billion impairment when the value of the investment had declined significantly.

Furthermore, we do not believe that Itochu should be permitted to consolidate profits from CITIC under the equity method, given that CITIC is operated and majority-owned by the Chinese government, meaning that it is highly unlikely that **Itochu can have any significant influence over CITIC's strategy, operations or policy-making**. Deconsolidating CITIC would mean that Itochu's forecasted net profits would fall **by 20%**.

We are also highly suspicious of the ¥60 billion (after-tax) one-time gain recognized on the reclassification of its minority investment in Ting Hsin, given the suspicious timing of the gain and the declining profitability of the investment. We do not find it credible that **Itochu magically discovered a ¥60 billion one-time (after-tax) gain only four weeks before the end of FY 2015, when Itochu was set to miss guidance by ¥60 billion**.

Toshiba was almost destroyed by a scandal for overstating earnings by ¥152 billion over seven years. We believe that in FY 2015 alone, Itochu may have overstated net profits by ¥153 billion by reclassifying its coal mining investment without recognizing an impairment to its consolidated accounts. This alone would have reduced Itochu's reported net income (¥300 billion) by 51% to ¥147 billion.

Based on our analysis, which we present in full in this report, we believe that Itochu will be embroiled in an accounting scandal as large as Toshiba. Accordingly, we value Itochu at ¥631.00 per share, a downside of 50% from its current traded price.

** A note of caution. In Itochu's English language filings, Itochu refers to the fiscal year ending March 31, 2015, as FY 2015. In its Japanese language filings, the same year is referred to as FY 2014. This is incredibly confusing. Accordingly, in this report we will refer to the year ending March 31, 2015, as FY 2015, consistent with the Company's English language filings. In the Japanese translation of this report, provided only for convenience, we will refer to the same year as FY 2014 to match the description in Itochu's Japanese language filings.*

1. **Inappropriate Reclassification Wrongly Inflated Profits by ¥153 Billion in FY 2015**. In October 2011, Itochu acquired a 20% equity interest in Drummond International, LLC (the "Drummond JV"), which owned, operated and controlled the Colombian coal mining operations of American mining giant, the Drummond Company. Itochu paid USD 1.5 billion, a deal which valued the mining operation, at the time, at **USD 7.5 billion**. By FY 2015, Itochu carried its interest in the Drummond JV at ¥198 billion on its balance sheet. But given the drastic underperformance of the investment, it is our opinion that by FY 2015, Itochu's interest in the Drummond JV was worth no more than ¥45 billion and that by not recognizing an impairment, Itochu overstated its net income **by at least ¥153 billion that year**.

   a. **A Bad Investment**. Almost immediately following Itochu's investment, the price of thermal coal declined from a 2011 peak of USD 132 to lows of USD 47 in 2016, a **64% fall in the commodity price**. To make matters worse, strikes and operational difficulties hampered production at the mines. Coal production was 26% below the forecasted production levels from FY 2013 through FY 2015. The investment was so troubled that even Bloomberg declared that the Drummond JV's Colombian mining assets were worth **only USD 3 billion in 2013, 60% lower than their value at the time of Itochu's investment**, and coal prices continued to decline from there.

   b. **Reclassification as Manipulation to Avoid Recognizing Losses**. On its Q3 FY 2015 conference call, Itochu's management stated that in light of the "coal price declines and the strike history," it "will be difficult to recover the investment." Yet rather than recognizing a loss or impairment, in FY 2015, Itochu inappropriately **reclassified** its stake in the Drummond JV from an "Investment in an Associate" to an "Other Investment," which is recorded at FVTOCI (Fair Value to Other Comprehensive Income). Furthermore, Itochu did not record a **loss or impairment upon reclassification in its consolidated accounts**. This allowed Itochu to deconsolidate the Drummond JV and meant that no loss or impairment of the investment would impact Itochu's reported net profits or earnings. **In our opinion, Itochu's reclassification was inappropriate under prevailing accounting rules and motivated solely to avoid recognizing losses on its failed investment in the Drummond JV**.

   c. **The Significant Influence Test**. Under IFRS accounting standards, the decision whether a minority investment is considered an "investment in an associate," and thus consolidated into earnings, is governed by IAS 28 and the "**significant influence**" test. Under IAS 28, a holding of 20% or more of the voting equity of an entity creates a **presumption of significant influence** and generally **requires that the investment be treated as an investment in an associate**.

      i. **Presumption Works Against Itochu's Reclassification**. Since 2011, Itochu has owned a 20% stake in the Drummond JV, **therefore the presumption** is that its stake should be considered an investment in an associate. This presumption is likely even stronger in this case because from FY 2012-2014, Itochu classified its stake in the Drummond JV as an investment in an associate, and its 20% equity interest **did not change before, during or after reclassification**.

      ii. **Five Factor Test**. According to IAS 28, Itochu can only **rebut the presumption** in favor of consolidation if it can "**clearly demonstrate**" that it does not have "significant influence," measured by five factors. The **presence of any one of the five factors** is likely sufficient to confirm "significant influence" when an investor like Itochu holds a 20% interest in the Drummond JV. As our analysis shows, **all five factors indicate that Itochu has significant influence over the Drummond JV**.

      - **Factor #1: Representation on the Board**. Since signing the deal, Itochu has stationed a number of full time employees in Birmingham, Alabama, to "supervise" the Drummond JV's operation of the Colombian mining business. These employees are currently led by Kotaro Suzuki, the President and CEO of Itochu Coal America and Itochu's highest ranking executive in America. When an investigator contacted Kotaro Suzuki and asked him his title, Mr. Suzuki described himself as **Chairman of the Board at the Drummond JV** and current CEO of Itochu Coal Americas. This indicates that not only does Itochu have representation on the Board of the Drummond JV, but also that Itochu's executive likely serves in a leadership role.

         - **President of Drummond JV**. A public record search lists Kazuo Inagaki, one of Mr. Suzuki's predecessors, as the "President" of the Drummond JV. This is more evidence that Itochu's executives are in a position of oversight, control, leadership and influence over the Drummond JV.

- **Factor #2: Participation in the Policy Making Process**. Mr. Suzuki, Itochu's top executive at Itochu Coal Americas, Inc., stated that he was the chairman of the board of the Drummond JV. In addition, according to an Itochu management presentation, Itochu's "function in the Joint Venture" was for its Alabama-based management team to serve as a "supervisor" of the business. By Itochu's own admission, it not only participates in the policy making process, but occupies a leadership role.

- **Factor #3: Material Transactions Between the Investor and Investees**. As part of its investment, Itochu obtained the exclusive rights to market coal mined by the Drummond JV in Japan and to cooperate with the Drummond parent company in the marketing and sale of the coal to utilities and other customers throughout Asia.

- **Factor #4: Interchange of Managerial personnel**. Itochu sent Mr. Suzuki and other colleagues to work out of the same building as the Drummond parent company in Alabama.

- **Factor #5: Provision of technical information**. Itochu stated in its presentation that one of its functions in the joint venture was to leverage "Itochu's short and long term logistic know how." Presumably Itochu is referring to technical expertise in the logistical operation of the mine.

iii. **Five for Five**. Itochu's investment in the Drummond JV easily meets all the requirements to be considered an investment in an associate under prevailing accounting rules. First, Itochu's stake meets the 20% threshold, **creating the strong presumption in favor of consolidation**. Furthermore, Itochu accounted for the investment as an associate from FY 2012-2014, strengthening the presumption. Finally, Itochu's relationship with the Drummond JV indicates the presence of all five factors that would typically accompany "significant influence" led by the leadership role of Itochu's senior executive on the board of the JV.

d. **Restatement of Accounts and at Least a ¥153 Billion Reduction in FY 2015 Net Profit**. By any economic measure, Itochu's investment was a failure and accounting rules dictate that Itochu should have taken a write-down or impairment to the carrying value of the Drummond JV. It did not. Instead, Itochu reclassified its investment, an accounting gimmick that we believe was clearly inappropriate under the governing accounting rules (IAS 28). As of Itochu's FY 2015 balance sheet, the carrying value of its investment in the Drummond JV was ¥198 billion. Bloomberg independently valued Itochu's share of the Drummond mines at ¥60 billion in July 2013. Comparing the Drummond mine to other coal mining companies, we estimate that Itochu's stake was worth only **¥45 billion in FY 2015**. As a result, we believe that instead of inappropriately reclassifying the investment, Itochu **should have taken an impairment in FY 2015 of at least ¥153 billion**. Itochu's reported net income was ¥300 billion in FY 2015, so this restatement would have reduced net profits by **51%**! We believe that this misconduct should trigger a regulatory investigation and that Itochu should be forced to restate at least its FY 2015 financial statements to **reduce the Company's reported net profit by ¥153 billion**.

2. **Consolidation of CITIC Inflates Projected Profits by 20%**. On January 20, 2015, Itochu agreed to invest ¥600 billion to buy a 10% stake of CITIC Ltd (HK: 267) ("CITIC"). Based on our analysis, we believe that Itochu's stake in CITIC **should not be consolidated using the equity accounting method**. CITIC accounts for 20% of Itochu's projected net income, so if Itochu is forced to reclassify this investment, Itochu will have to **materially** reduce forecasted profits.

a. **Does Itochu Really Have "Significant Influence" over the Chinese Communist Party**? In order to be deemed an investment in an associate, accounting rules dictate that Itochu must have "significant influence" over the investee. CITIC is 58.13% owned by CITIC Group Corp ("CITIC Parent")– a company wholly-owned by the Chinese government. According to its website, "the national interests represent CITIC Group's **core interests**. CITIC Group follows the excellent tradition in **putting the national interests above all else**." Given that CITIC is majority owned and controlled by the Chinese government, we think it is extremely unlikely that Itochu can have "significant influence" on CITIC's policies and financial decisions.

b. Five Factor Test. We believe, based on our analysis of the five factors, that Itochu has nowhere close to the level of "significant influence" required to treat its CITIC stake as an investment in an associate. Indeed, CITIC has stated publicly that its executives meet with Itochu's management "every six months to talk about cooperation," which hardly suggests that Itochu is influencing policy making. In addition, we are aware of no material transactions between Itochu and CITIC, no interchange of managerial personnel, and no provision by Itochu of technical information to CITIC. Itochu holds its investment through a 50:50 JV with the Charoen Pokphand Group ("CP"). The JV, China Tai Bright Investment Company Limited ("CT Holdings"), has the right to appoint two board members to CITIC. In practice, we believe this confers no real influence as neither appointed board member appears to have any connection to either CT Holdings or Itochu.

Applying the Objective Significant Influence Criteria to Drummond and CITIC		
IAS 28 Guideline	Drummond	CITIC
Holding of 20%	Yes	No
Representation on the board of directors or equivalent governing body of the investee	Yes	No
Participation in the policy-making process	Yes	No
Material transactions between the investor and the investee	Yes	No
Interchange of managerial personnel	Yes	No
Provision of essential technical information	Yes	No
Does Itochu have significant influence	**Yes**	**No**
Should the investment be considered an associate	**Yes**	**No**

Source: Glaucus

3. Ting Hsin: Reclassification and Unusual Gain Save Itochu's FY 2015 Earnings. Itochu is considered a darling of the Nikkei 225 because it always manages to hit its guidance forecast and, so Itochu claims, the majority of its profits are derived from the non-resource sector. But our analysis of Itochu's financial statements indicates that it only made its FY 2015 earnings forecast because of an unusual gain from a familiar and questionable source: the reclassification of an investment from an "investment in an associate" to an "other investment."

a. Form Over Substance. We question the justification, timing and the amount of this reclassification. Itochu had held a 18.7% equity stake in Ting Hsin since 2010. Despite almost no change to its underlying ownership, in FY 2015, Itochu dissolved a JV with Asahi through which it held its stake in Ting Hsin and reclassified the investment, giving the Company a pretext to recognize a one-time, non-cash gain.

b. Questionable One-Time Gain Magically Appeared Just before FYE. Itochu looked set to miss earnings in FY 2015 by ¥60 billion. **Yet just four weeks before the end of the fiscal year**, Itochu reclassified its investment in Ting Hsin and recognized a one-time, (**after-tax**) non-cash gain from the reclassification of ¥60 billion, just enough so that Itochu hit its target. The fact that Itochu waited until the last minute to recognize this gain indicates, in our opinion, that Itochu is simply manipulating the accounting rules to serve its short term needs. We also question the justification for such a gain, considering Itochu's share of Ting Hsin's net profit has declined from ¥6.8 billion in FY 2010 (the year of the acquisition) to ¥3.3 billion in FY 2015. We do not have enough information to value Itochu's stake in Ting Hsin, but we find it highly suspicious that the amount of the after-tax gain (¥60.5 billion) was just enough to allow Itochu hit its earnings forecast and make up a ¥60 billion profit shortfall in the last four weeks of FY 2015.

Valuation: Toshiba Part II. Once famous Japanese trading companies have been hit hard by declining commodity prices and ill-advised foreign investments. Despite having a similar business model, and being subject to the same secular headwinds and commodity prices as other trading houses, Itochu has largely avoided the major impairments and write-downs that have affected its peers.[1] For the first time, in FY 2016, Itochu reported the highest net income of any of the big-5 Japanese trading houses. The misperception that Itochu's net profits are driven by its non-resource segment and that it has not been affected by the large write downs recognized by other trading houses, has driven its stock price higher than its rivals. We believe that this is entirely inappropriate. The investors, shareholders and employees of the other Japanese trading houses have been punished with large write-downs because their companies have, with some exceptions, abided by the Prime Minister's campaign of corporate governance and recognized impairments. In our opinion, Itochu has not.

As this report demonstrates, we believe that Itochu overstated FY 2015 net profits by at least ¥153 billion by reclassifying its stake in the Drummond JV without taking a loss, even though the value of the investment had declined significantly. In our opinion, there is evidence of intent to manipulate. Itochu first claimed, in Q3 FY 2015, that reclassification was justified because its stake "might fall" below 20%. Indeed, Itochu's CFO even stated publicly that the Company would reduce its stake in the Drummond JV.[2] **It never did**. Then, in its 2015 Annual Report, Itochu completely changed its justification for reclassification, stating that although it still owned a 20% stake in the Drummond JV, it did not have "significant influence." In retrospect, Itochu appears so desperate to avoid a large impairment that it concocted two different, equally implausible reasons to reclassify its investment. In our opinion, Itochu's changing story shows that the Company was intent on inappropriately avoiding the loss, regardless of whether it was permitted to do so by the rules of accounting.

We also do not believe that Itochu should be able to consolidate profits from CITIC under the equity method, given that CITIC is operated and majority-owned by the Chinese government, meaning that it is highly unlikely that **Itochu can have any significant influence over CITIC's strategy, operations or policy-making**. Deconsolidating CITIC would mean that Itochu's forecasted net profits would fall **by 20%**.

We are also highly suspicious of the ¥60 billion (after-tax) one-time gain recognized on the reclassification of Ting Hsin, given the declining profitability of the investment. We simply do not find it credible that **Itochu magically discovered a** ¥60 billion four weeks before the end of the fiscal year when the Company was set to miss guidance by ¥60 billion.

Since 2011, Itochu has raised over ¥300 billion of bonds from investors that have based their investment decision on the accuracy and integrity of Itochu's reported profits. Toshiba Corp was fined by the Securities and Exchange Surveillance Commission because it had misled bond investors by padding results.[3] We believe that Itochu could face a similar fate.

Toshiba was almost destroyed by a scandal for overstating earnings by ¥152 billion over seven years. We believe that in FY 2015 alone, Itochu overstated net profits by ¥153 billion. Toshiba's stock declined 70%, peak-to-trough. In our opinion, Itochu faces a similar crisis of confidence in its corporate governance and accounting practices. We believe that like Toshiba, any form of independent inquiry, either by regulators or an independent investigation committee, may reveal even more problems at Itochu than we can glean from the publicly available information. But based on the current information available to investors for analysis, we value Itochu's shares at 50% below their current traded price.

Valuation

¥ billions	**Toshiba**	**Itochu**
Profit Overstatement	152	>153*
Period of Misconduct	FY 2008-2014	FY 2015
Board Member Resignations	8	?
CEO Status	Resigned in Disgrace	?
Stock Price Decline	**70%**	**50%***

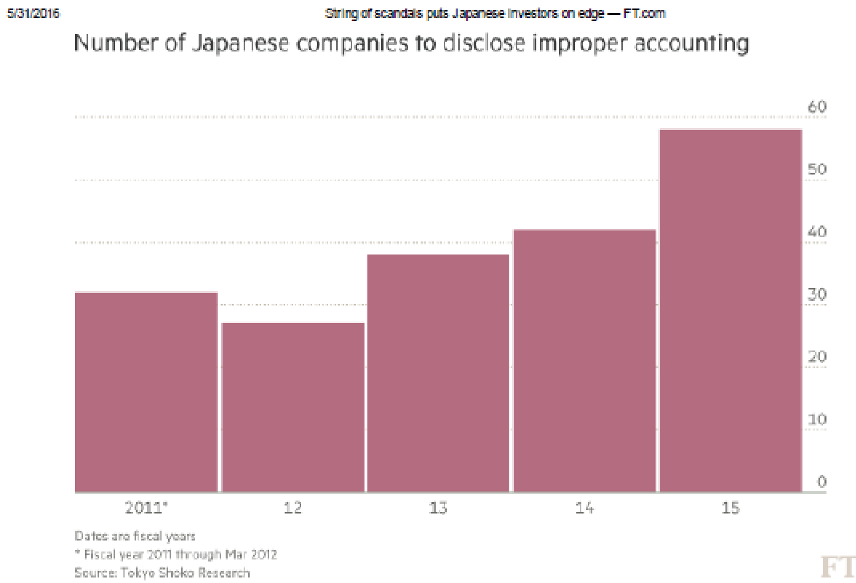
**Source: Glaucus Forecast*

[1] http://www.bloomberg.com/news/articles/2016-02-01/japan-trading-houses-facing-13-billion-hit-on-commodity-misfire
[2] http://af.reuters.com/article/energyOilNews/idAFL4N0VF06R20150205
[3] http://asia.nikkei.com/Business/Companies/Securities-watchdog-to-seek-record-7bn-plus-yen-fine

WINDS OF CHANGE

Times are changing in Japan. Prime Minister Shinzo Abe recently launched a corporate governance campaign to increase accountability, transparency and ethical accounting practices at Japanese public companies. Mr. Abe's aim is noble. He is trying to kick-start the Japanese markets by bringing Japanese companies up to higher standards of corporate governance.

Since the Olympus scandal, a wave of corporate governance and accounting scandals have washed over the Japanese markets. According to the Financial Times, around 200 Japanese firms have become embroiled in accounting scandals since FY 2011. This trend is only accelerating as a result of Prime Minister Abe's drive to clean up Japanese markets. In FY 2015-2016, a record 58 Japanese-listed companies disclosed improper accounting, malfeasance or fraud.



Source: Financial Times

The problem, however, as described recently in the Financial Times, is that Japanese "investors are not getting a lot of help setting their minds at ease because the level of forensic analysis on the sell-side in Japan is low." This has created a vacuum of critical analysis in the Japanese financial markets and has allowed some Japanese companies to misrepresent their financial performance to investors.

In our opinion, Itochu Corporation (Tokyo: 8001) ("Itochu" or the "Company") may be next. Itochu surpassed traditional giants Mitsui & Co. and Mitsubishi Corp. to claim the title of Japan's most profitable trading company in FY 2016. Since the appointment of Masahiro Okafuji ("Mr. Okafuji"), Itochu's net income has risen 87% (FYs 2010 – 2016), despite deteriorating commodities prices and a secular weakening of the Company's core market.

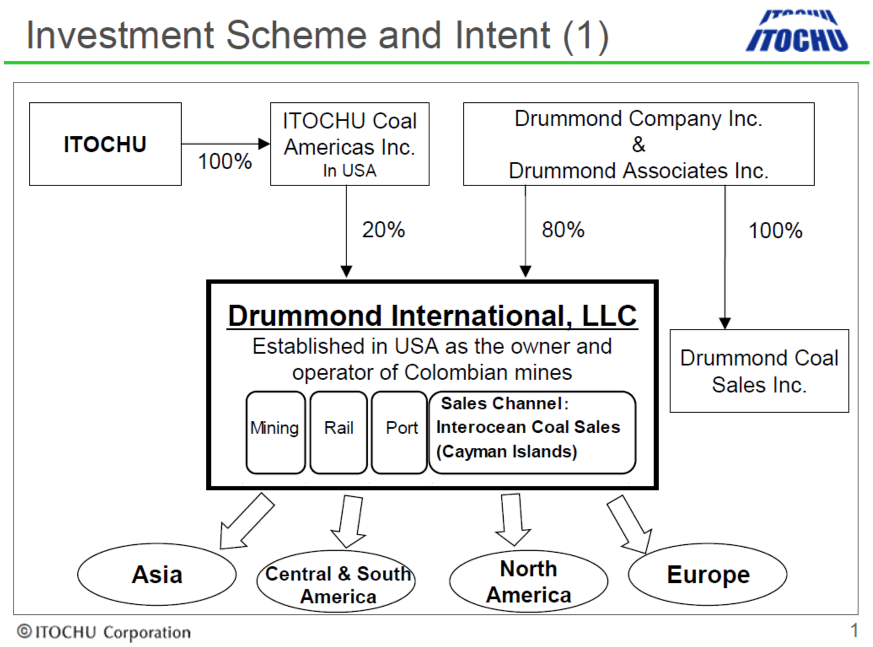
We have conducted a thorough review of the publicly available information, and we believe that Itochu has inappropriately inflated its net income and earnings by manipulating key accounting policies to avoid impairments and revaluation losses on failed acquisitions and underperforming assets. Based on our analysis, we believe that Itochu will be embroiled in an accounting scandal as large as Toshiba. Accordingly, we value Itochu at ¥631.00 per share, a downside of 50% from its current traded price.

PROFITS INAPPROPRIATELY INFLATED BY ¥153 BILLION IN FY 2015

The smoking gun in Itochu's financials is its accounting treatment of an investment in a Colombian coal mining operation. We believe that Itochu has inappropriately manipulated its financial statements to avoid recognizing the losses from its failed investment on its consolidated accounts. By removing the effects of such losses from its net income and earnings, we believe that Itochu has inappropriately inflated its reported net profits of ¥300 billion in FY 2015 by at least ¥153 billion. We believe that the Company will be required to restate its FY 2015 financials, reducing net profits by at least 51% on this basis alone.[4]

In October 2011, Itochu announced the acquisition of a 20% equity interest in Drummond International, LLC (the "Drummond JV"), which owned, operated and controlled the Colombian coal mining operations of American mining giant, the Drummond Company. At the time of the deal, the mine produced high quality thermal coal and was the 4th largest coal mine in the world, measured by volume of exports.[5] The Drummond JV also owned a nearby port with a capacity of 30 MMTPA, and 41% of a rail line running from the mines to the port.

In exchange for its 20% equity stake, Itochu invested USD 1.5 billion (¥126.5 billion).[6] The deal valued the mining operation at USD 7.5 billion and closed in October 2011.[7] In addition, Itochu also received the exclusive rights to market coal from the mine to customers in Japan and to cooperate with Drummond in the marketing and sale of coal to utilities and other customers throughout Asia.[8] By FY 2015, Itochu carried its interest in the Drummond JV at ¥198 billion on its balance sheet.[9]



Source: Itochu Presentation on Drummond, June 17, 2011

Upon completion of the transaction, Itochu classified its investment in the Drummond JV as an **investment in an associate under the equity method**. Accordingly, Itochu was able to book 20% of the Drummond JV's net income to its own profits and losses.

[4] Our estimates of the value of the Drummond mine are based on our calculations outlined in this report. If Itochu delayed the impairment until FY 2016, we calculate that its interest in the Drummond mine would be worth even less.
[5] http://www.Itochu.co.jp/en/ir/doc/presentation/pdf/ITC110617_e.pdf
[6] http://www.Itochu.co.jp/en/news/files/2011/pdf/ITC110616_e.pdf
[7] http://www.Itochu.co.jp/en/news/files/2011/pdf/ITC111020_e.pdf
[8] http://www.itochu.co.jp/en/news/2011/110616_02.html
[9] http://www.itochu.co.jp/en/ir/financial_statements/files/2015/pdf/15_ended_04_e.pdf

1) A Bad Investment

The timing of Itochu's investment in the Drummond JV could not have been worse. The Company's investment came at the peak price for thermal coal in the last five years. As can be seen in the graph below, almost immediately following Itochu's investment, the price of thermal coal began to drastically decline from a 2011 peak of USD 132 to lows of USD 47.

Source: Bloomberg

Since the date of Itochu's investment, the price of thermal coal declined 57% peak to trough. On this fact alone, Itochu should likely have taken an impairment loss on its investment in the Colombian mines in FYs 2013, 2014 and 2015. At the very least, any attempt to reclassify the accounting treatment of the investment should have merited an impairment or revaluation loss given the drastic decline in commodity prices.

Thermal Coal Price Movement

Date	Price (USD/t)	Cumulative Decline	%
10/20/2011	118.10	-	-
3/26/2012	105.20	(12.90)	**-11%**
3/25/2013	91.22	(26.88)	**-23%**
3/31/2014	74.07	(44.03)	**-37%**
3/30/2015	56.31	(61.79)	**-52%**
4/5/2016	51.18	(66.92)	**-57%**

Source: Bloomberg (COASNE60)

In addition to the collapse of the price of thermal coal, the Colombian mine experienced operating setbacks which caused actual production to fall well below levels forecasted by Itochu at the time of the acquisition.[10]

[10] http://www.Itochu.co.jp/en/ir/doc/presentation/pdf/ITC110617_e.pdf

Drummond Colombian Production Forecast

(FY)	2010	2011	2012	2013	2014	2016
Total Production	24 MMT	25 MMT	26 MMT	31 MMT	35 MMT	35 MMT
ITOCHU's equity share	-	-	5.2 MMT (full year base)	6.2 MMT	7.0 MMT	7.0 MMT

Source: Itochu Presentation

The table below compares Itochu's forecast with the actual production achieved by the Colombian mine since the investment. Note that Itochu's forecast is based on the Company's fiscal year end, so FY 2013 is for the year ended March 2013. For ease of comparison, we have matched coal production for the year ended December 2012 to Itochu's fiscal year 2013.[11] [12] [13]

Coal Mine Production - Forecast vs. Actual

MMT

ITOCHU FY Drummond FY	13-Mar 12-Dec	14-Mar 13-Dec	15-Mar 14-Dec	 Total
Forecast	31.0	35.0	35.0	101.0
Actual	26.0	22.0	26.8	74.8
Difference	***-16%***	***-37%***	***-23%***	***-26%***

Source: 1. ITOCHU Presentation
2. Drummond Presentation on its mining operation
3. Reuters news on December 20, 2013
4. http://www.bnamericas.com/en/news/mining/colombian-coal-production-up-36-in-2014

By any economic measure, Itochu's investment was a failure. The price of thermal coal declined 57% since the acquisition, and production was 26% lower than forecast. Indeed, the erosion of value of the mines was so obvious that even market watchers such as Bloomberg declared that the Drummond JV's Colombian mining assets were worth **only USD 3 billion in 2013**, **60% lower than their value at the time of Itochu's investment**.[14] Accounting rules dictate that Itochu should have recognized the deterioration of the coal industry by taking a write-down or impairment on the carrying value of its investment.

2) Reclassification as Manipulation to Avoid Recognizing Losses

From FY 2012 through 2014, Itochu classified its stake in the Drummond JV as an investment in an associate, allowing Itochu to book 20% of the Drummond JV's net profits to its own profits and earnings.

But when it appeared that the value of the acquisition had fallen so dramatically that a write down or impairment would be required, in FY 2015, Itochu **reclassified** its **stake as an "other investment" which is FVTOCI (Fair Value to Other Comprehensive Income)**. Furthermore, Itochu did not record a **loss or impairment upon reclassification in its consolidated accounts**.

[11] http://www.reuters.com/article/coal-colombia-idUSL1N0VN11A20150213#yDaBkExTMFkpvFGp.97 2014
[12] http://www.reuters.com/article/drummond-colombia-production-idUSE3N0GO02K20131220#o1CjUMStJoV3E7W1.97 2013
[13] http://www.drummondco.com/wp-content/uploads/Drummond-LTD-CSR-Project-in-Colombia.pdf 2012
[14] http://www.bloomberg.com/news/articles/2013-07-16/alabama-billionaire-battles-murder-suits-as-prices-ebb

> **Investments accounted for by the equity method** decreased by ¥110.3 billion, to ¥1,618.1 billion (US$13,465 million), due to the conversion of Colombian coal companies and TING HSIN (CAYMAN ISLANDS) HOLDING CORP. from associates to other investments, despite the investment in C.P. Pokphand Co. Ltd. and domestic broadcasting and communication-related companies, and the depreciation of the yen.
>
> **Other investments** increased by ¥464.1 billion, to ¥1,030.1 billion (US$8,572 million), due to the conversion of Colombian coal companies and TING HSIN (CAYMAN ISLANDS) HOLDING CORP. from associates to other investments, the rise in stock prices of investments, and the depreciation of the yen.

Source: ITOCHU FY15 Annual Report Financial Section, p. 16

The impact of this reclassification was material to Itochu's financial outlook, because if the mine was classified as an "other investment," no loss or impairment from the failed acquisition would negatively affect Itochu's net income, its reported earnings or its forecast. How did Itochu manage to justify, to its auditors and its shareholders, such a sweeping accounting change?

First, on its Q3 FY 2015 conference call, Itochu claimed that it reclassified the investment in the Drummond JV because its ownership stake "**might fall below 20%**."

> *"Under the contract, while we did not accept cash call, preferred stocks were issued to our partner. In case of the resulting dilution if they convert to common stocks, **our share might fall below 20%,** therefore our investment was deemed to be FVTOCI financial assets instead of associates and joint ventures."*

Source: Itochu Q3 FY2015 Conference Call

According to Reuters, Itochu's CFO stated publicly that the Company would reduce its interest in the Drummond JV.[15] It is critical to note that although the sell-side analysts mistakenly believed that Itochu reclassified its stake because its equity interest in the Drummond JV fell below 20%, **this dilution never happened**.[16]

Three months later, in its FY 2015 Annual Report, Itochu completely changed its justification for reclassifying its investment: **it claimed, implausibly, that it was permitted to reclassify its 20% stake in the Drummond JV because Itochu no longer could exercise "**significant influence over the operations and financial policies" of the Drummond JV.

> The Company, through a subsidiary, holds 20.0% interest of Drummond International, LLC (DIL), which holds mining operations and related infrastructure that are currently being operated in Colombia. The subsidiary does not have approval authority over significant matters for resolution regarding DIL, such as for budgets and capital expenditures, and cannot exercise significant influence over the operations and financial policies of DIL. Accordingly, the equity method is not applied to the Company's investment in DIL.

Source: Itochu 2015 Annual Report, p. 60.

We believe that Itochu was so desperate to avoid a large impairment that it concocted two different, equally implausible reasons to reclassify its interest in the Drummond JV. The Company suggested on its Q3 FY 2015

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15 http://af.reuters.com/article/energyOilNews/idAFL4N0VF06R20150205

16 See, e.g., SMBC Nikko Equity Research Report 5 February 2015.

conference call that reclassification was justified because its interest "might" fall below 20%, but when this was insufficient, Itochu claimed that it did not have "approval authority" over capital expenditures and budgets of its investment. But as we will see, such approval authority is irrelevant when considering whether Itochu can deconsolidate its investment in the Drummond JV.

More alarming for shareholders are Itochu's statements which implied that the reclassification was motivated to avoid recognizing the declining value of its Drummond Investment, as if the principles of accounting can be broken or bent to a Company's will in order to avoid disclosing negative results. On its Q3 FY 2015 conference call, management stated:

- *"**In consideration of the coal price declines and the strike history**, **we began to study how to control our exposure to Drummond**, and in October 2014 we concluded a change to the joint venture agreement."*

Curiously, Itochu mentioned the history of strikes. However, the last strike at the Drummond mines took place in July 2013.[17] No impairment affecting the consolidated accounts was taken at that time, even though Itochu claims to have conducted a revaluation of the asset. If the last strike took place in 2013, and no impairment was taken at that time, then why was Itochu only raising this issue now? Shouldn't Itochu have taken an impairment back in July 2013 when such strikes were occurring? And not just in October 2014? Itochu's management continued:

- *"**Although we revalued the investment at the end of September based on production forecasts, we did not recognize profit or loss from revaluation**. Hereafter, we will measure fair value every quarter and profit recognition will be in dividends only. **It will be difficult to recover the investment by means of dividends only, but we have the option of achieving recovery by exiting from the investment**. However, in that event, profit or less related to the exit will not be recognized, as the investment is an FVTOCI financial asset. **Although we do not expect dividends at the current price level, we anticipate receiving dividends in the range of USD 50 million to 100 million in 4 to 5 years, based on the assumption that prices rise and costs improve**."*

On a reclassification of an investment from an equity method associate to an "other investment," a revaluation is performed and a gain or loss is taken. As discussed later, Itochu was happy to take a gain on the reclassification of Ting Hsin when they needed to boost their reported earnings.

We find it shocking that no impairment was taken upon reclassification of the Drummond JV, considering that in the same statement, Itochu's management admitted that it would be difficult to recover the investment from dividends alone and that forecasted dividends, expected in 4 to 5 years, were based on opaque assumptions of an increase in the price of thermal coal and a decrease in the operating costs of the mines!

We believe that Itochu's statements clearly indicate that the Company **knew** that the Drummond JV was significantly underperforming and **that it feared taking an impairment or loss**. In our opinion, **Itochu's reclassification was inappropriate under the governing accounting rules and motivated solely to avoid recognizing losses on the failed investment in the Drummond JV** and shield the effects of such losses and impairments from Itochu's reported profits and earnings.

3) The Significant Influence Test

Under IFRS accounting standards, the decision whether a minority investment is considered an "investment in an associate," and thus consolidated into earnings, is governed by IAS 28 and the "**significant influence**" test. According to the rule:

> *"Significant influence is the power to participate in the financial and operational policy decisions of the investee but is not control or joint control over those policies"*[18]

[17] http://www.reuters.com/article/colombia-drummond-idUSL1N0FT24S20130724#UPPiAS2rsx7kWTCf.97
[18] http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias28_en.pdf

The "significant influence" test is critical because if satisfied, it allows an investor to apply the equity method of accounting, permitting the investor to recognize its share of the associate's profits in its own net income, boosting profitability, reported earnings and its stock price.

To determine whether an investor has "significant influence," IFRS accounting standards instruct practitioners to conduct a two-part analysis. Step 1 is to determine the amount of equity owned by the investor, which creates a **presumption of significant influence**. Step 2 is to examine whether any one of five factors provides **clear evidence** to rebut this presumption.

> **Identification of associates**
>
> A holding of 20% or more of the voting power (directly or through subsidiaries) will indicate significant influence unless it can be clearly demonstrated otherwise. If the holding is less than 20%, the investor will be presumed not to have significant influence unless such influence can be clearly demonstrated. [IAS 28.6]
>
> The existence of significant influence by an investor is usually evidenced in one or more of the following ways: [IAS 28.7]
>
> - representation on the board of directors or equivalent governing body of the investee
> - participation in the policy-making process
> - material transactions between the investor and the investee
> - interchange of managerial personnel
> - provision of essential technical information
>
> Potential voting rights are a factor to be considered in deciding whether significant influence exists. [IAS 28.9]

Source: IAS

The rule is clear: a holding of 20% or more of the voting equity of an entity creates a **presumption of significant influence** and generally **requires that the investment be treated as an investment in an associate**.

Itochu owns a 20% stake in the Drummond JV, **therefore the presumption** is that its stake in the Drummond JV should be accounted for as an investment in an associate. This presumption is even stronger in this case because from FY 2012 through FY 2014, Itochu followed the rule and **classified the Drummond JV as an investment in an associate**.

The strength of the presumption in favor of consolidation should not be underestimated. According to IAS 28 Itochu can only reclassify its investments if it "**clearly demonstrates**" that it does not have significant influence, measured by any one of the five factors listed in IAS 28.

We will analyze all five of the IAS 28 factors for determining "significant influence" and show that rather than rebut the presumption, all five factors strongly indicate that Itochu had, and continues to have, sufficient significant influence over the Drummond JV such that, under any reasonable interpretation of the governing accounting rules, Itochu should account for the Drummond JV under the equity method, as it did from FY 2012 through FY 2014.

- **Factor #1: Representation on the Board or Equivalent Governing Body**

The first factor in examining whether a minority owner has "significant influence" is whether that minority owner has representation on the board of the subject entity.

Since signing the deal to acquire 20% of the Drummond JV, Itochu has stationed a number of full time employees in Birmingham, Alabama, to "supervise" the Colombian mining business.[19] These employees are currently led by Kotaro Suzuki, the President and CEO of Itochu Coal America and Itochu's highest ranking executive in America.

Kotaro Suzuki	President & CEO, ITOCHU Coal Americas Inc.	Manager, Coal Project Section No.2, Coal Department

Source: Itochu Filing, September 10, 2015

In performing due diligence on Itochu's relationship with the Drummond JV, an investigator called Kotaro Suzuki to ask him his title. Mr. Suzuki described himself as **Chairman of the Board at the Drummond JV** and current CEO of Itochu Coal Americas.

The fact that Itochu's senior executive overseeing its investment describes himself as the Chairman of the Board of the Drummond JV should be conclusive evidence of "significant influence." But there is more. When Itochu originally agreed to purchase its 20% stake, it appointed Kazuo Inagaki to the position of CEO of Itochu Coal Americas.

July 29, 2011

ITOCHU Corporation

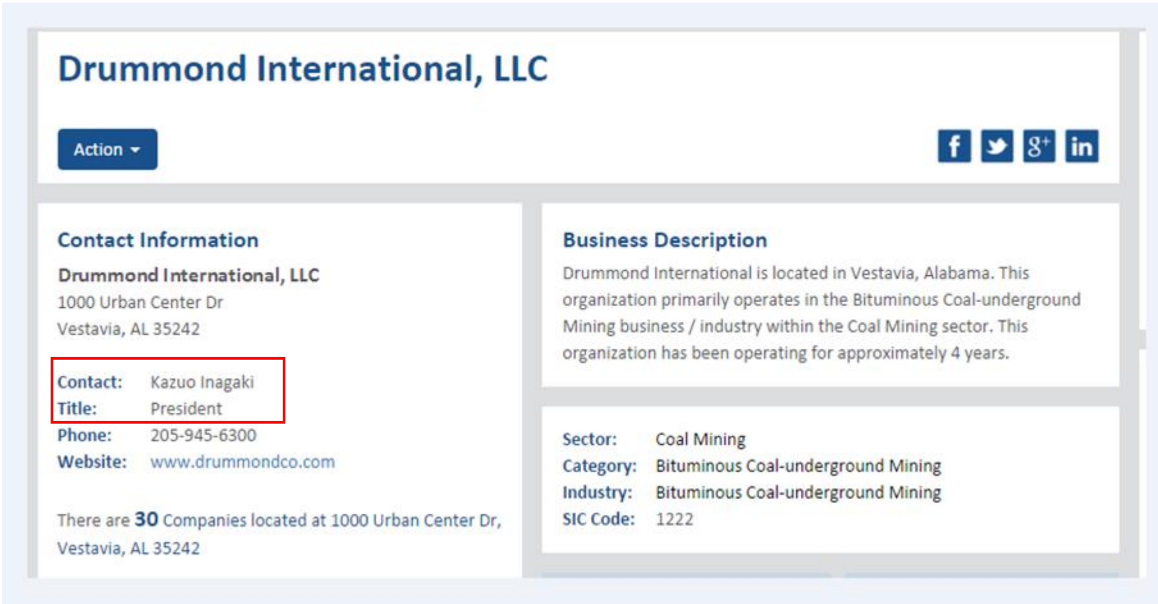
Personnel Changes

Name	As of August 1, 2011	Current
Kiyohiko Hayami	Managing Director, IAAF	IAAF
Kazuo Inagaki	CEO, ITOCHU Coal Americas Inc.	Coal Department

Source: Itochu Filing, July 29, 2011

A public record search lists Kazuo Inagaki, the former CEO of Itochu Coal Americas Inc. and one of the predecessors to Mr. Suzuki, **as the President of the Drummond JV**.[20]

[19] http://generationhub.com/2012/02/22/itochu-execs-locate-in-alabama-to-run-drummond-coa
[20] http://www.buzzfile.com/business/Drummond-International,-LLC-205-945-6300



Source: Public Record Search

The public record database indicates that the President of Itochu Coal Americas served as the President of the Drummond JV. The investigator's phone call with Kotaro Suzuki, the current President of Itochu Coal Americas, suggests that this role has not changed. In other words, there is every indication that Itochu has continuing representation on the board of the Drummond JV in a leadership capacity.

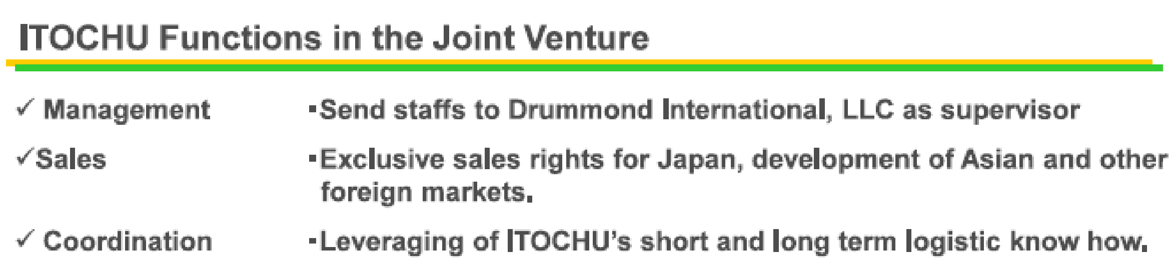
This is only the first factor, but it is sufficient evidence to support the presumption that Itochu should account for its 20% investment in the Drummond JV under the equity method, as it did from FY 2012 through FY 2014.

- **Factor #2: Participation in the Policy Making Process**

The second factor in the IAS 28 test also undermines Itochu's claim that it somehow lost its significant influence over the Drummond JV in FY 2015.

Mr. Suzuki, the President and CEO of Itochu Coal Americas, claimed that he was Chairman of the Board of the Drummond JV, which strongly suggests that he is participating in the policy making process of the Drummond JV. In addition, Kazuo Inagaki, one of Mr. Suzuki's predecessors, was listed as president of the JV and thus was also clearly a participant in the policy making process.

There is more. According to an Itochu presentation from February 2012, the purpose of sending Itochu's executives to Alabama was to act as a "supervisor" to the Drummond JV and to leverage Itochu's logistical know-how to assist in the operation of the coal mining operation:



Source: Itochu Filing 2012

Itochu clearly participates in the policy making process by supervising the operating business and lending their expertise to the operation of the mining enterprise. As such, an analysis of Factor #2 of IAS 28 shows that Itochu has sufficient involvement in the policy making process of the Drummond JV to maintain the presumption of "significant influence."

- **Factor #3: Material Transactions Between the Investor and Investees**

As part of its investment, Itochu obtained the exclusive rights to market coal mined by the Drummond JV in Japan and to cooperate with the Drummond parent company in the marketing and sale of the coal to utilities and other customers throughout Asia.[21] This is clearly a material transaction between Itochu and the Drummond JV.

- **Factor #4: Interchange of Managerial personnel**

Itochu's relationship with Drummond also satisfies this factor, as Itochu sent Mr. Suzuki, Mr. Inagaki, and other colleagues to work out of the same building as Drummond Corp in Alabama. [22][23]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If Itochu's employees and executives were to have no involvement in operations or any significant influence on the Colombian business, then there would be no reason for Itochu to station employees and executives in the same building or for there to be any Itochu representation in Alabama at all.

- **Factor #5: Provision of technical information**

There is little discussion in the public forum of whether Itochu is providing the Drummond JV with technical information. But Itochu stated in its presentation that one of its functions in the joint venture was to leverage "Itochu's short and long term logistic know how."[24] Presumably Itochu is referring to technical expertise in the logistical operation of the mine.

- **Five For Five**

Based on IAS 28, Itochu's investment in the Drummond JV easily meets all the requirements to be considered an investment in an associate under prevailing accounting rules. Itochu's investment meets the 20% threshold, **creating the strong presumption in favor** of consolidation. Furthermore, Itochu accounted for the investment as an associate from FY 2012-2014s, **strengthening the presumption in favor of consolidation**.

Sell side analysts seem to have assumed that Itochu reclassified its investment because, per the Company's public statements, Itochu's stake in the Drummond JV had fallen below 20% as a result of the issuance of preferred shares:

[21] http://www.itochu.co.jp/en/news/2011/110616_02.html
[22] http://www.Itochu.co.jp/en/about/partner/north_america/
[23] http://www.drummondco.com/news/contact-media/
[24] https://www.joi.or.jp/modules/downloads_open/index.php?page=visit&cid=4&lid=765

SMBC Nikko:

The earnings call focused on two points, namely 1) the possibility of impairment losses at the end of FY3/15: Management discussed the possibility of additional write-downs in the North American shale business and the Brazilian iron ore business, but said that it has taken measures (incl asset reshuffles) to ensure it can meet its FY3/15 NP target (JPY300bn) if there were impairments, so we believe the risk of a shortfall vs guidance is small. 2) Drummond coking coal business: Itochu's stake to date was 20%, but following the slump in coal prices, we understand the partners have agreed to a preferred share issuance by the JV. This will reduce Itochu's stake to below 20% on a fully diluted basis, meaning the treatment of the firm will change from an equity-method affiliate to a general investment from Itochu's perspective. Under IFRS, the difference between book value and market cap is generally calculated on a fair value basis via comprehensive income at the end of each quarter (ie no impact on income statement), and can affect the capital account.

Source: SMBC Nikko Equity Research Report February 5, 2015

Goldman Sachs:

completely covered. We revise our FY3/16 and FY3/17 estimates by less than 1%. Itochu removed Columbian coal producer Drummond from the scope of equity method application due to a contract change in 3Q. Drummond incurred losses in 3Q and we believe there was risk of recognizing impairment losses on the profit/loss statement while it was still an equity method affiliate. This will now be avoided. We are positive

Source: Goldman Sachs Earnings Review February 6, 2015

But this issuance never happened, and Itochu's stake in the Drummond JV did not fall below 20%. Not only should there have continued to be a strong presumption in favor of consolidation based on Itochu's 20% equity investment, but also Itochu's relationship with the Drummond JV indicates the **presence of all five factors** that would typically accompany "significant influence," led by the leadership role of Itochu's senior executive on the board of the JV.

Applying the Objective Significant Influence Criteria to Drummond	
IAS 28 Guideline	Drummond
Holding of 20%	Yes
Representation on the board of directors or equivalent governing body of the investee	Yes
Participation in the policy-making process	Yes
Material transactions between the investor and the investee	Yes
Interchange of managerial personnel	Yes
Provision of essential technical information	Yes
Does ITOCHU have significant influence	**Yes**
Should the investment be considered an associate	**Yes**

We believe that Itochu has clearly retained significant influence over the Drummond JV and **should not have** reclassified its investment. Accordingly, Itochu should have recognized a loss or impairment due to the significant erosion in the value of the Colombian mining operations and this loss should have been reflected in Itochu's net income and earnings.

4) Restatement of FY 2015 Accounts and at least ¥153 billion Reduction in FY 2015 net profit

By any economic measure, Itochu's investment was a failure and accounting rules dictate that Itochu should have taken a write-down or impairment to the carrying value of the Drummond JV. Although the original cost of Itochu's stake was approximately ¥127 billion, Itochu's disclosure of assets in Colombia indicate that as of the Company's FYE 2015 balance sheet, the carrying value of Itochu's stake in the Drummond JV was ¥198 billion. [25]

ITOCHU Corporation

Country Risk Exposure (As of the end of March 2015)

(1)Investments, Loans, Guarentees

As of the end of March 2015 (Unit : billion yen)

	Investments	Loans	Guarantees	Total	Hedged	Net
China	226.7	28.5	6.8	262.0	-	262.0
Colombia	197.9	-	-	197.9	-	197.9
Brazil	179.3	0.7	-	180.0	-	180.0
Philippines	58.4	29.9	4.6	92.9	-	92.9
Vietnam	36.3	0.5	0.1	36.9	-	36.9
Indonesia	21.2	0.9	13.9	35.9	-	35.9
South Africa	24.9	3.1	0.4	28.5	-	28.5
Azerbaijan	8.6	11.9	-	20.5	-	20.5
Venezuela	0.2	5.6	14.3	20.1	-	20.1
Total	753.5	81.1	40.1	874.7	-	874.7

Source: Itochu FY 2015 Country Risk Exposure

Sell side analyst reports confirm this carrying value at FYE 2015.[26]

Exhibit 2: Key resource project exposure (2)
Itochu, Marubeni, Sumitomo Corp.

Company	Project/Entity name		Exposure (JPY bn)	Type of Commodity
Itochu	Drummond (Colombia Coal)	OCI	200.0	Thermal Coal
	IMEA (Australia iron ore, coal)		178.6	Iron Ore/Coal
	Jimblebar	OCI	96.0	Iron ore
	NAMISA		100.0	Iron Ore
	Non-consolidated LNG project	OCI	NA	LNG
	FY15/3 Total asset		8,560.7	
	FY15/3 Commodity related segment asset		2,591.3	
	FY15/3 Shareholders equity		2,433.2	
	FY16/3 Net income CoE		330.0	

Source: Goldman Sachs Investment Research, October 28, 2015, p. 3.

How much of this investment should Itochu have written off? In FY 2016, after Itochu reclassified its stake, it impaired the value of the Drummond JV by ~46.5 billion in its non-consolidated accounts.[27] In our view, this was wholly inadequate because such impairments should have been taken in the consolidated accounts and should have negatively affected earnings. Further, we believe that this revaluation does not fully recognize the extent of the decline in the value of Itochu's investment.

[25] http://www.itochu.co.jp/en/ir/financial_statements/files/2015/pdf/15_ended_04_e.pdf
[26] Hiroyuki Sakadia, Goldman Sachs Analyst report October 28, 2015
[27] FY 2016 Annual Report; http://www.itochu.co.jp/en/news/files/2016/pdf/ITC160506_e.pdf

First, Bloomberg independently valued the Drummond mining operations in July 2013 at USD 3 billion, **a decline of over 60% in value from the time of Itochu's initial investment!**

The Colombian mines are crucial to Drummond Co., which had revenue of $3 billion in 2012, based on the volume of its coal shipments. The company estimates its coal reserves at 2.2 billion tons, 2 billion of which are in Colombia, according to the company's website. In 2011, when coal prices were higher, Drummond Co. sold a 20 percent stake in the Colombian operations to Tokyo-based Itochu Corp. for $1.5 billion. Based on that sale, the Colombian mines were worth $7.5 billion. Two years later, the fall in the coal price makes them worth less than $3 billion, according to data compiled by Bloomberg comparing Drummond with publicly listed coal companies.

Source: Bloomberg Article, July 2013.

If we factor in the prevailing exchange rate, Bloomberg valued Itochu's 20% interest in the Drummond's Colombian coal mining operations at only ¥60 billion in July 2013!

Impairment of Drummond JV - Bloomberg Valuation
¥ billions

Bloomberg estimated fair value (USD bn)	3
Exchange rate (USD/JPY)	99.7
Bloomberg estimated fair value (JPY bn)	299
Itochu stake	20%
Value of Itochu's 20% interest	60
Carry value of Drummond of FY 2015	198
Implied impairment of Drummond	138
Itochu FY 2015 Net Profit	300
Implied impairment of Drummond	138
Restated Net Profits	**162**
Overstated %	***85%***

Source: Bloomberg Valuation

Based on Bloomberg's valuation, Itochu should have recognized an impairment of **¥138 billion to its consolidated accounts**. But even this likely underestimates the amount of the required impairment because Bloomberg's valuation does not reflect the decline in coal prices from USD 77/MT to USD 56/MT from 2013 to 2015.[28]

To value Itochu's investment we use an EV/Sales multiple derived from other similarly situated coal companies. We believe that the following coal companies are good comparables for Colombian coal mining operations because they are for the most part pure play coal companies of similar size.

[28] Although the exchange rate increased significantly.

Comparables	EV/Sales Multiple FY11	FY12	FY13	FY14	FY15	FY16	Bunkruptcy Date[1]
Banpu PCL	3.92x	2.08x	1.63x	1.63x	1.81x	2.06x	
Coal India Ltd	n/a	2.56x	1.95x	1.89x	2.47x	1.92x	
Indo Tambangraya Megah Tbk PT	3.25x	1.84x	1.50x	0.96x	0.64x	0.18x	
Jastrzebska Spolka Weglowa SA	n/a	0.97x	1.04x	0.60x	0.46x	0.48x	
Adaro Energy Tbk PT	2.67x	2.00x	1.86x	1.37x	1.24x	1.12x	
Bumi Resources Tbk PT	3.91x	2.31x	1.70x	1.73x	n/a	n/a	7/27/2015[2]
New World Resources PLC	1.61x	0.85x	1.06x	0.92x	-	-	7/30/2014
Alliance Resource Partners LP	2.05x	1.47x	1.46x	1.79x	1.43x	0.86x	
Alpha Natural Resources Inc	1.72	0.71	0.67	0.72	0.66	-	8/3/2015
Arch Coal Inc	2.21	1.40	1.49	1.68	1.54	-	1/11/2016
Cloud Peak Energy Inc	1.15	0.81	1.10	1.23	0.56	0.54	
CONSOL Energy Inc	2.91	1.81	2.71	3.65	2.84	2.27	
Peabody Energy Corp	2.95	1.66	1.44	1.45	1.06	1.27	4/13/2016
Walter Energy Inc	4.31	2.13	1.84	1.68	2.04	-	7/15/2015
Median	**2.79x**	**1.74x**	**1.49x**	**1.54x**	**1.24x**	**0.54x**	

Source: Bloomberg

Note: 1.Bankruptcy dates are taken from Bloomberg(BCY)

2. Bumi was first suspended on July 27, 2015, resumed trading for a total of two months and was suspended again on June 30, 2016.

Using the disclosed production of the Drummond mine and the prevailing coal prices, we can simply apply the EV/Sales multiples from other pure play coal competitors to arrive at a relative valuation for the Drummond Mine.

The following table presents our EV/Sales valuation model using the multiples calculated in the chart above. Note that this model closely predicts Itochu's purchase price (¥124 billion *before an acquisition premium* vs. ¥127 billion purchase price) and matches Bloomberg's independent valuation.

Drummond Mine Valuation

	Acquisition	Bloomberg	FY15	FY16
Valuation Date	10/20/2011	7/15/2013	3/31/2015	3/31/2016
Coal Price (USD/MT)	118	77	56	51
Production (MMT)	24.5	26.0	26.8	28.0
Sales (USD mm)	2,893	2,005	1,509	1,433
Multiple(EV/Sales)	2.79x	1.49x	1.24x	0.54x
Implied EV (USD mm)	8,073	2,996	1,872	771
Itochu Stake	20%	20%	20%	20%
Implied Itochu Stake (USD mm)	1,615	599	374	154
Exchange rate (USD/JPY)	77	100	120	112
Implied Itochu Stake (JPY Bn)	**124**	**60**	**45**	**17**

Source: 1. Coal Prices from Bloomberg's COASNE60 Index

2. Production[29]

3. Exchange rates from Bloomberg

Assumption: Productions at the end of last year are used

[29] Production for Acquisition is taken from (http://www.drummondco.com/drummond-company-enters-into-partnership-with-itochu-corporation-in-colombia-2/); Production for Bloomberg from Drummond Presentation on mining operation (http://www.drummondco.com/wp-content/uploads/Drummond-LTD-CSR-Project-in-Colombia.pdf); Production in FY15 from BNamericas's news on February 16, 2015 (http://www.bnamericas.com/en/news/mining/colombian-coal-production-up-36-in-2014); Production in FY16 from Drummond web site (http://www.drummondco.com/).

Based on our valuation, Itochu's 20% interest in the Drummond JV was worth only ¥45 billion in FY 2015 and only ¥17 billion in FY 2016. **By our calculation, Itochu should have impaired its investment by ¥153 billion in FY 2015, which would have reduced Itochu's net profit by 51%**.

Impairment of Drummond JV - Glaucus Valuation

¥ billions	FY 2015	FY 2016
Carrying Value	198	198
Estimated Mine Valuation	45	17
Implied Impairment	153	181
Itochu Net Profit	300	240
Drummond Implied Impairment	153	181
Restated Net Profits	147	59
% Decrease in Net Profits	***51%***	***75%***

Source: 1. Itochu FY 2015 Country Risk Exposure
2. Itochu FY 2016 Country Risk Exposure
3. Glaucus Valuation

If Itochu had delayed the impairment until FY 2016, we calculate that the Drummond mine was worth even less, and the impairment should have come closer to ¥181 billion. Our valuation model reflects the difficult conditions faced by coal companies in 2015 and 2016, when falling commodity prices and lagging demand forced dozens into bankruptcy.[30]

Itochu does not disclose many details on its investment, so any valuation will have to rely on certain assumptions about the efficiency and profitability of the Drummond coal mine. We also valued the Drummond mine using other methodologies, including an EV/EBITDA model, and reached a similar valuation for Itochu's stake in the mine.

Even a common sense approach to valuation would suggest a major impairment, considering Itochu bought a stake in a large coal mine and coal prices subsequently declined 57%, sending many pure play coal companies into bankruptcy.

Accordingly, we believe that once Japanese regulators look into the Drummond issue, they should then force Itochu to restate at least their FY 2015 financial statements and to substantially reduce its reported net profits and earnings.

[30] https://www.snl.com/InteractiveX/Article.aspx?cdid=A-32872208-12845 ; http://www.carbontracker.org/wp-content/uploads/2015/03/US-coal-designed-Web.pdf

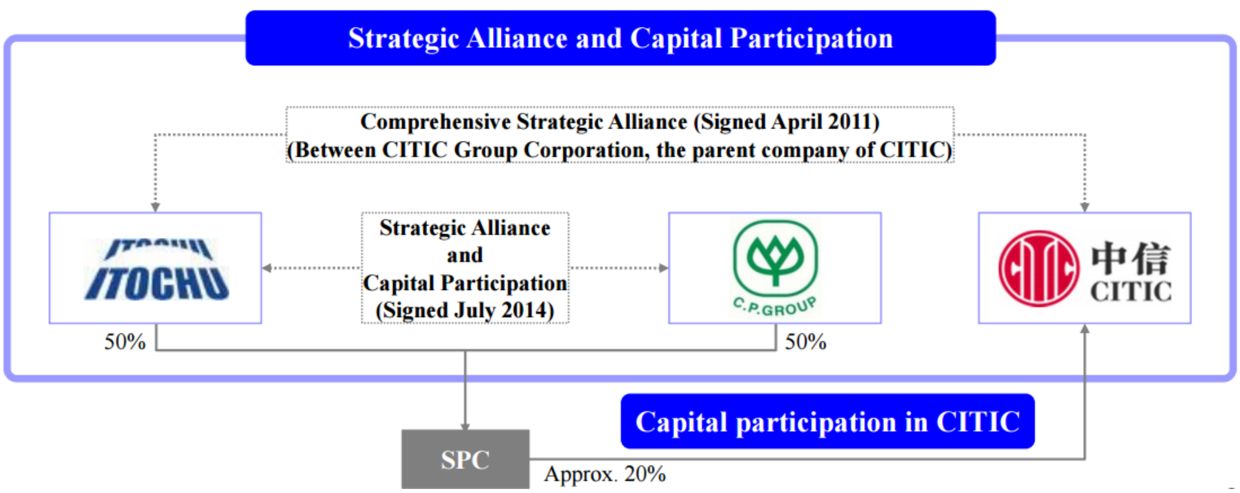
CONSOLIDATION OF CITIC INFLATES PROJECTED PROFITS BY 20%

We believe that Itochu manipulated its accounting of the Drummond JV by reclassifying its 20% stake as an “other investment” rather than an “investment in an associate” to avoid recognizing a substantial loss in its consolidated accounts.

Yet with Itochu’s stake in CITIC – the Company has done exactly the opposite. In our opinion, Itochu has classified a small minority stake in a Chinese state-owned enterprise as an “investment in an associate” in order to consolidate CITIC’s earnings in Itochu’s profits and earnings. In our opinion, Itochu’s stake in CITIC **should not be consolidated using the equity accounting method** because Itochu cannot claim to have “significant influence” over a company majority-owned and operated by the Chinese government.

One of the main goals of Itochu’s Brand New Deal 2017 is to “[b]uild a solid earnings base to generate ¥400 billion in net profit by progressing **growth strategy** especially focused on the **non-resource sector**.”[31] In order to achieve this goal, on January 20, 2015, Itochu entered an agreement to invest ¥600 billion to buy a 10% stake of CITIC Ltd (HK: 267), a Chinese state-owned enterprise listed on the Hong Kong stock exchange (“CITIC”).[32]

The transaction was deliberately structured so as that Itochu could claim its stake in CITIC as an “investment in an associate.” Itochu created a 50:50 JV, Chia Tai Bright Investment Company Limited (“CT Holdings”), with the Charoen Pokphand Group (“CP”), to hold Itochu and CP’s respective stakes. The JV, CT Holdings, holds a 20% stake in CITIC. As a 50% owner of CT Holdings, Itochu classified CITIC as an equity method associate and consolidate its portion of CITIC’s earnings, beginning in the third quarter of FY 2016.



Source: Itochu Presentation

For FY 2017, Itochu is forecasting that 20% (¥70 billon) of its ¥350 billion in projected net income will come from CITIC.[33][34]

In our opinion, potential synergies with CITIC appear to be minimal and we estimate that Itochu’s cash return on its investment will be below 1.6%. We strongly believe that Itochu is heavily investing cash into clever structures which only provide non-cash earnings. To quote the Nikkei:

[31] Itochu 2015 Annual Report, p.20
[32] http://www.itochu.co.jp/en/news/files/2015/pdf/ITC150120_presentation_e.pdf
[33] http://www.itochu.co.jp/en/ir/financial_statements/files/2016/pdf/16_ended_06_e.pdf;
[34] J.P. Morgan Note on Itochu, May 6, 2016, p. 1.

> *"Citic first offered a 6% stake to the Itochu-CP team. But Okafuji's ambitions were larger: He wanted a 20% stake. That would allow Itochu to include Citic's earnings in its own financial results, in line with equity method accounting, a step he believed Itochu needed to become Japan's top trading house."*[35]

Itochu has aggressively structured the transaction to meet the minimum technical requirements necessary in order to consolidate net income from its stake in CITIC. Yet, in our opinion, a rigorous analysis of the prevailing accounting rules shows that such consolidation is all form over substance, and that in reality, Itochu lacks the significant influence over CITIC necessary to justify consolidation.

1) Does Itochu Really Have Significant Influence over the Chinese Communist Party?

As discussed in detail above, under IFRS accounting standards, the decision whether to consolidate an investment as an interest in an associate is governed by IAS 28 and the "significant influence" test.

> *"Significant influence is the power to participate in the financial and operational policy decisions of the investee but is not control or joint control over those policies."*[36]

The "significant influence" test is critical because if satisfied, it allows an investor to apply the equity method of accounting, permitting the investor to recognize its share of the associate's profits in its own net income, boosting profitability, reported earnings and its stock price.

We ask a **simple question: does anyone believe that Itochu has "significant influence" over a company owned, controlled and directed by the Chinese communist party?** We think the answer is, obviously, no.

a) CITIC's Core Values and Mission is to Promote China's National Interest

CITIC is 58.13% owned by CITIC Group Corp. ("CITIC Parent") – a company wholly-owned by the Chinese government.[37] In other words, CITIC's majority shareholder is the Chinese state. According to its website, CITIC Parent's core values and mission are to "**put the national interest above all else**," and "**to strive to complete missions conferred by the State**."

CITIC Group's "Core Values":

中信集团成立以来，积**极致力于**为国家改革开放和现代化建设事业作贡献，始终把国家利益放在第一位，努力完成国家所赋予的使命，尽好国有企业的社会责任，为国家分忧，为人民谋利，为社会造福。

Since its establishment, CITIC Group has been committed to make contributions to the country's reform, opening up and modernization. **CITIC Group always put the national interests first**; **strive to complete the missions conferred by the State**; fulfill the social responsibilities of a State-owned enterprise: share the concerns of the State, bring benefits to the citizens and bring happiness to the society.

CITIC Group's "Development Mission":

中信集团发展使命

作为企业赖以生存的土壤，国家为中信集团的发展提供了广阔的舞台，国家利益代表了中信集团的核心利益。中信集团具有国家利益高于一切的优良传统，坚定不移地履行国家所赋予的政治责

35 http://asia.nikkei.com/Business/Deals/Japan-s-Itochu-and-Thailand-s-CP-navigate-minefield-to-seal-Citic-deal
36 http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias28_en.pdf
37 http://www.citic.com/Managed/Resources/docs/FinancialReports/ENG/fy2015e.pdf

任、经济责任和社会责任，致力于企业与国家、与社会的共同发展、共同繁荣，积极为国家的改革开放和现代化建设事业作贡献。

The State has provided CITIC Group the soil essential for its survival, and has provided the broad stage for its development. **The national interests represent CITIC Group's core interests.** **CITIC Group follows the excellent tradition in putting the national interests above all else**; steadfastly carrying out the political, economic and social responsibilities conferred by the State. CITIC Group is committed to the mutual development and mutual prosperity among the enterprise, the State and the society. It is committed to make contributions to the country's reform, opening up and modernization.

Source: CITIC Group Website

How can Itochu claim to have significant influence over CITIC when it is owned and operated by a parent company that puts the Chinese national interest above all else?

b) CITIC Executive Salaries Determined by PRC Government

Furthermore, the salaries of CITIC's executive directors are determined by PRC government regulators.

> The following Directors are proposed to be re-elected at the Annual General Meeting. None of the Directors offering themselves for re-election have interest in the securities of the Company. Except for Mr. Song Kangle, Mr. Li Rucheng and Mr. Paul Chow Man Yiu who were appointed in March 2016, and Ms. Yan Shuqin who was appointed in April 2016, the remuneration of the following Directors are set out in the notes to the consolidated financial statements contained in the Annual Report 2015. In general, the remuneration paid to the Directors (except for the salaries paid to Executive Directors which are determined by the relevant PRC government regulators and are subject to evaluation of the annual performance of the Company) are determined with reference to the market terms and their duties and responsibilities with or for the Company. All the Directors are subject to retirement by rotation at least once every three years pursuant to the Articles of Association. In relation to the re-election of the following Directors, there is no information to be disclosed pursuant to any of the requirements of Rules 13.51(2)(h) to (v) of the Listing Rules nor are there other matters that need to be brought to the attention of the Shareholders.

http://iis.aastocks.com/20160421/002490645-0.PDF

How can Itochu claim to have significant influence over CITIC when the salaries of its executive directors are determined by the Chinese government?

In addition, CITIC's executive director and vice president, Li Qingping, also concurrently serves as an executive director for CITIC Parent and as a leading member of the Chinese Communist Party.[38] Even one of the two directors nominated by Itochu's JV, Yang Xiaoping, serves as a member of the *Twelfth National Committee of Chinese People's Political Consultative Conference*, a political advisory board of importance in China.[39] CITIC even shares the same office space with CITIC Parent.[40]

Indeed, accounting guidelines indicate that an entity like Itochu is typically deemed to lose its "significant influence" over an investee when an associate becomes subject to the "control of a government."

> 10 An entity loses significant influence over an investee when it loses the power to participate in the financial and operating policy decisions of that investee. The loss of significant influence can occur with or without a change in absolute or relative ownership levels. It could occur, for example, when an associate becomes subject to the control of a government, court, administrator or regulator. It could also occur as a result of a contractual agreement.

http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias28_en.pdf

We think that governmental influence is even more pronounced in this case, because Itochu is a Japanese company and Sino-Japanese relations have been fraught with populist anger, bitterness and protest. Indeed, it was not too long ago that Japanese companies shut down across China[41] over the Senkaku/Diaoyu islands dispute.[42] A 2014 BBC Survey revealed that anti-Japanese sentiment has never been higher in China, with fully 90% of the PRC population reporting negative views.[43]

Given that CITIC is majority owned and controlled by the Chinese government, operated with the express core value of "putting national interests above all else," we find it laughable to even consider that Itochu can have any influence, let alone significant influence, over the Chinese government and a company formed for the express purpose of furthering Chinese state interests.

2) Form Over Substance: Itochu's 10% Stake

Itochu is all form over substance. Itochu claims to have a 20% stake in CITIC because it owns 50% of the JV (CT Holdings), which in turn owns a 20% stake in CITIC. Yet the economic and practical reality is that Itochu only effectively owns a 10% stake in CITIC, because it owns only half of the JV.

Additionally, it is important to note that China CITIC Bank Corp Ltd, listed in Shanghai (601998 CH), generated over 78% of CITIC's 2015 earnings. CITIC only owns 64.3% of the bank. As such, the Itochu JV is another step away from having any significant influence over the main profit generator. The JV has only an effective ownership of 13% of the bank and Itochu's share would be 6.4%.

Ultimately, we believe that the spirit of IAS 28 dictates that Itochu's effective interest in CITIC is only 10%.

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[38] http://www.hkexnews.hk/listedco/listconews/sehk/2014/0326/LTN201403261224.pdf
[39] http://www.wsj.com/articles/itochu-cp-take-10-4-billion-stake-in-citic-1421715748; http://www.hkexnews.hk/listedco/listconews/sehk/2015/0803/LTN201508032141.pdf
[40] http://www.group.citic/iwcm/UserFiles/File/2012contact_en.pdf
[41] http://www.ibtimes.com/major-japanese-companies-temporarily-shut-down-across-china-792752
[42] http://www.theatlantic.com/photo/2012/09/anti-japan-protests-in-china/100370/
[43] http://www.bbc.co.uk/mediacentre/latestnews/2014/world-service-country-poll

3) IAS 28: Five Factor Test Indicates No Significant Influence

We believe, based on our analysis of IAS 28 and the five factors, that Itochu has nowhere close to the level of "significant influence" required to treat its CITIC stake as an investment in an associate and consolidate its share of CITIC's earnings.[44]

- **Itochu Cannot Claim to Participate in Policy-Making Process**

At an August 2015 presentation, CITIC's management team discussed its relationship with Itochu and admitted that the two companies only **meet once every 6 months to "talk about cooperation:"**

> "*Regarding your first question, regarding the strategic investors, as of now, CP and Itochu, they are both conglomerates like CITIC. CP are more agricultural focused and we have already started our cooperation with CP in terms of agriculture. Itochu is a trading and also mining company, so we have talked about many cooperation projects with Itochu.* ***Well, the top leaders of Itochu, as well as the CP's top leadership, are meeting the CITIC leadership every six months to talk about cooperation****.*"[45]

If Itochu had a legitimate say in CITIC's policy making process, Itochu's representatives would meet with CITIC's management more than twice per year. CITIC's management team does not even go so far as to state that it discusses its "policy-making" process with Itochu. Instead, the companies "talk about **cooperation**" – suggesting that Itochu has no influence whatsoever on CITIC's strategy, operations or financial policies.

Although Itochu does have an opportunity to voice an opinion regarding dividends, according to CITIC's management team, Itochu has the same level of influence as a director from Youngor, which only has a 5% stake in CITIC, does not treat its CITIC investments as an associate, and makes no claim to influence CITIC's decisions or participate in the policy making process.

> *"Regarding your question regarding payout dividends, we want to maintain at least 30% of payout ratio. We want to stabilize around 30%. As you know, on the Board, the Directors of the Board come from different shareholders. They represent different shareholders. In addition to myself, Mr. Wang and another gentleman on the management, we have shareholders from MOF, social security, Itochu, Youngor. They are all directors and they also have very high demand on dividend payout. So surely we'll try very best to maintain a payout ratio at a reasonably high level."*[46]

Common sense supports this interpretation of Itochu's minimal influence. We believe it is highly unlikely that the Chinese government would allow Itochu, a Japanese conglomerate with only a 10% effective interest, to have any say over the policy making process of a company which is majority owned by the Chinese government and expressly operated to promote Chinese national interests first above all else.

Compare this to Itochu's investment in the Drummond JV, where an Itochu executive and employees live full-time in Alabama for the express purpose of supervising the operation of the Colombian mines. Itochu claims no influence over the policy making of the Drummond JV, yet somehow claims that one meeting every 6 months is sufficient evidence of "significant influence" over an arm of the Chinese government.

[44] CT Holdings, the JV through which Itochu holds its 10% stake in CITIC, is just an investment holding company with no operations and as purely a holding company, cannot confer "significant influence" over CITIC.
[45] Interim 2015 CITIC Ltd Analysts Presentation 24 August 2015
[46] 2015 CITIC Ltd Analysts Presentation 24 March 2016

- **No Material Transactions Between the Investor and the Investee**

We have found no indication that there are any material transactions between CITIC and Itochu at this time. Itochu announced a signed memorandum of understand towards collaboration in oil and gas exploration and production with CITIC Resources Holdings Limited (HK: 1205) ("CITIC Resources"). But investors should note that this is only an agreement to cooperate in the future on a joint investment with CITIC Resources, and does not constitute **a material transaction between CITIC and Itochu**.[47]

Compare this to the Drummond JV, where a key component of the deal was Itochu's exclusive right to sell coal from the Colombian mines in Japan. With CITIC, Itochu has no such rights and to our knowledge, engages in no material transactions.

- **No Interchange of Managerial Personnel**

We have found no evidence of any interchange between managerial personnel of CITIC and Itochu. Again, compare this to the relationship between Itochu and the Drummond JV, where Itochu sends executives and employees to Alabama to work in the **same building as Drummond** in order to operate the Colombian mines.

- **No Provision of Essential Technical Information**

There does not appear to be any provision of essential technical information between CITIC and Itochu at this time.

- **Board Representation**

Itochu may claim that it has representation on CITIC's board because its JV, CT Holdings, has the right to appoint an independent non-executive director and a non-executive director.[48] Yet this is not the reward it appears to be, as neither of the directors nominated by CT Holdings and who were appointed to the board on August 3, 2015, appear to have any connection to either the JV or Itochu.

Mr. Yang Xiaoping ("Mr. Yang") was appointed by CT Holdings as a CITIC non-executive director.[49] As per his biography set out below, Mr. Yang has no business connection with CT Holdings or Itochu but appears to be deeply entrenched within the Chinese communist party.[50]

> *"Mr. Yang Xiaoping ("Mr. Yang"), aged 51, has been appointed as a Non-executive Director of the Company with effect from 3 August 2015. Mr. Yang is currently the Vice Chairman of the CP Group, an Executive Director and the Vice Chairman of C.P. Lotus Corporation (listed on the Main Board of the Hong Kong Stock Exchange), CEO of CT Bright Holdings Limited, a Non-Executive Director of Ping An Insurance (Group) Company of China, Ltd. (listed on the Main Board of the Hong Kong Stock Exchange and the Shanghai Stock Exchange) and a Non-Executive Director of Tianjin Binhai Teda Logistics (Group) Corporation Limited (listed on the GEM Board of the Hong Kong Stock Exchange). Mr. Yang previously acted as the Manager of Nichiyo Co., Ltd for China Division and the Chief Representative of Nichiyo Co., Ltd, Beijing Office.* ***He is also a Member of the Twelfth National Committee of Chinese People's Political Consultative Conference, the Vice President of the China Institute for Rural Studies of Tsinghua University, a Director of China NGO Network for International Exchanges, the Vice President of Beijing Association of Enterprises with Foreign Investment and an Adviser of Foreign Investment to Beijing Municipal Government****."*[51]

[47] CITIC Resources is 59.5% owned by CITIC, 11.5% owned by Temasek, and 29% owned by the public as it is listed in Hong Kong. http://www.itochu.co.jp/en/news/2016/160622.html
[48] http://www.hkexnews.hk/listedco/listconews/sehk/2015/0120/LTN20150120148.pdf
[49] http://www.hkexnews.hk/listedco/listconews/sehk/2015/0803/LTN201508032141.pdf
[50] Mr. Yang is the CEO of CT Bright Holdings Limited, but this is not the JV. Rather, this entity is an investment holding company fully owned and controlled by the CP Group.
[51] http://www.hkexnews.hk/listedco/listconews/sehk/2015/0803/LTN201508032141.pdf

Mr. Yang is a member of the *Twelfth National Committee of Chinese People's Political Consultative Conference*, a political advisory board of importance in the PRC. We believe that Mr. Yang's loyalties lie, exclusively, to the Chinese government and the communist party, and that Itochu cannot claim to have any influence over a board member with such deep political ties. After all, where do Mr. Yang's loyalties lie? To Itochu? Or to the political party and government which guarantees his freedom, livelihood and career?

Nor does it appear that the JV's other nominee has any connection whatsoever to Itochu. Mr. Noriharu Fujita ("Mr Fujita") was appointed by CT Holdings as an independent non-executive director of CITIC.[52] According to his biography,

> *"Mr. Fujita has established Fujita Noriharu Accounting Firm since July 2013. From April 1973 to May 1978, he performed audit engagements in Japanese accounting firms. From July 1980 to December 1988, he worked in Imperial Chemical Industries PLC and stationed in London and Tokyo office. From January 1989 to June 2007, Mr. Fujita was a partner of Ernst & Young, LLP Chicago and New York office. From July 2007 to June 2013, he was an executive partner of Ernst & Young ShinNihon, LLC and served as the JBS Global Services Leader. He retired in June 2013. He is a licensed Certified Public Accountant in both Japan and the United States. As an accounting professional, Mr. Fujita has extensive experience in accounting."*[53]

As an independent director of CITIC, Mr. Fujita has no connection with either Itochu or CP and thus cannot be a conduit for "significant influence."

It is also worth considering whether these directors would have any significant influence on other directors such as Li Qingping. She's a CITIC vice president and executive director, but also serves as an executive director at CITIC Parent and is a leading member of the Communist Party.[54] In fact, it appears that Ms. Li was the Communist Party's representative at CITIC from 2003 through 2014.[55] Is it reasonable to assume that a sole director with minimal ties to Itochu is able to have "significant influence" over a company led by a senior Communist Party official which is organized and operated with the express and primary goal of promoting the interests of the Chinese government? We think not.

Ultimately, neither director nominated by CT Holdings, appears to have any connection to either the JV or Itochu. We find it peculiar that Itochu were not given their own director, whereas Youngor, which owns just 5% of CITIC, has the right to nominate its own director to CITIC's board.

4) Itochu is consistently inconsistent

In order to understand the true nature of Itochu's manipulation of equity method accounting, we believe that investors, regulators and accountants should compare how Itochu applies the "significant influence" test to its investments in CITIC and the Drummond JV.

[52] http://www.hkexnews.hk/listedco/listconews/sehk/2015/0803/LTN201508032141.pdf
[53] http://www.hkexnews.hk/listedco/listconews/sehk/2015/0803/LTN201508032141.pdf
[54] http://www.citic.com/AboutUs/BoardOfDirectors#ed
[55] http://m.todayir.com.cn/todayirattachment_cn/cncb/attachment/2016042911312017365784 94_en.pdf, p. 100.

Applying the Objective Significant Influence Criteria to Drummond and CITIC		
IAS 28 Guideline	Drummond	CITIC
Holding of 20%	Yes	No
Representation on the board of directors or equivalent governing body of the investee	Yes	No
Participation in the policy-making process	Yes	No
Material transactions between the investor and the investee	Yes	No
Interchange of managerial personnel	Yes	No
Provision of essential technical information	Yes	No
Does Itochu have significant influence	**Yes**	**No**
Should the investment be considered an associate	**Yes**	**No**

Source: Glaucus

In what we believe is Itochu's myopic desire to boost net income and smooth earnings at any cost, they have inconsistently and incorrectly applied the definition of "significant influence" to provide the optimal outcome. In FY 2015, Itochu reclassified the Drummond JV from an associate to an "other investment" in order to avoid an impairment which would significantly affect Itochu's reported net profits and earnings. However, based on the criteria of IAS 28, Drummond should be considered an associate.

Conversely, Itochu classified CITIC as an associate even though, if Itochu applied the "significant influence" test by the same criteria it used to reclassify its stake in the Drummond JV, it obviously lacks any significant influence necessary for consolidation.

In our opinion, Itochu is simply taking advantage of IAS 28 and the prevailing accounting rules in order to inappropriately avoid losses from investments in entities over which it has significant influence (the Drummond JV) and inappropriately consolidate profits from entities over which it has none (CITIC). We believe that any objective examination of Itochu's influence over its investments would yield **the opposite outcome**: a deconsolidation of CITIC's profits and a consolidation of the Drummond JV's write downs, losses and impairments.

5) CITIC's Stock Declined. Itochu Recognized a Gain

Itochu recorded its investment in CITIC at historical cost and not at fair value. At the time of acquisition, Itochu paid HKD 13.80 per share.[56] CITIC's stock price at FYE 2016 was HKD **11.80** per share, a fall of 14% since Itochu's initial investment. Had Itochu been required to adjust this investment to fair value, it would have had to write down equity by an additional ¥87 billion.

Yet instead of recording a loss or write down, which would fairly reflect the reality that CITIC's share price has fallen below the price at which Itochu invested, Itochu recorded its stake in CITIC **at cost (¥600 billion)**.[57] The additional advantage of recording the investment as an equity method associate is that Itochu was able to book a ¥40.4 billion gain in FY 2016. This paper, non-cash gain boosted Itochu's earnings and would likely not have been available had Itochu accounted for CITIC as an FVTOCI investment.

Paradoxically, Itochu is already suggesting that they are saving **¥150 billion** in negative goodwill on its CITIC investment which could be used to smooth out earnings at a later stage.[58]

[56] http://www.itochu.co.jp/en/news/files/2015/pdf/ITC150120_2_e.pdf
[57] http://www.itochu.co.jp/en/ir/financial_statements/files/2016/pdf/16_ended_e.pdf
[58] Jeffries Note on Itochu, July 14, 2016.

Q: What are the risks related to the CITIC Ltd equity pick-up, such as volatility of profitability, etc.?

A: The PBR of CITIC Ltd is below 1.0 times, therefore there is a negative goodwill at the time of acquisition. However, based on accounting principles, losses should be allocated to assets of concern, such as Sino Iron and financial receivables. In doing so, even if CITIC Ltd recognizes impairment to these assets in the future, it will not affect our equity pick-up. Of course, purchase price allocation will be based on fair value by a third-party appraisal. Also, we plan on reporting CITIC-related items in our securities report.

Source: Itochu Investors Meeting for the First Half of FY2016

We believe that such accounting games are unethical and deliberately conceal the economic reality that Itochu's stake in CITIC is worth less than at the time of its investment.

6) CITIC: No Synergies and a Questionable Investment

Finally, a recent analyst report stated that the one of the primary factors likely to drive Itochu's share price higher will be the emergence of clear synergies with CITIC.[59] Unfortunately for investors, any potential synergies between Itochu and CITIC seem highly unlikely.

Itochu has been advertising CITIC to investors as a large conglomerate with "many industrial sectors of business, many of which are leading companies in the industry" in order to promote the potential synergies.[60] The reality, however, is that the vast majority of CITIC's businesses are in areas in which there will be no synergies with Itochu.

CITIC Net Income Breakdown in FY2015

Segment	Net Income *USD mm*	Net Income %	Description	Possible Synergies
Financial Services	9,056	116%	CITIC Bank and CITIC Securities are the main drivers	No
Resources and energy	(2,364)	-30%	Exploration, mining, processing and trading of mineral resources	Maybe
Manufacturing	339	4%	Manufacturing of special steels, heavy machineries, aluminium	Unlikely
Engineering	336	4%	Design and engineering services	No
Real Estate	554	7%	Development, sale and holding of properties in China and HK	No
Others	465	6%	Investment and operation of infrastructures, telecommunication services, commercial aviation, and publication services	Maybe
Operation management	(654)	-8%	-	
Elimination	101	1%	-	
Total	7,833	100%		

Source: 1. CITIC FY2015 Annual Report, p. 220
2. Glaucus Analysis
Note: The numbers are converted to USD by the exchange rate at FYE 2015 of 7.75 (Bloomberg)

Itochu's only announcement of substance, regarding a plan to cooperate on resource exploration with CITIC Resources (a separate public company 59.5% owned by CITIC), was only a vague pronouncement to cooperate in the future. Moreover, CITIC's resources and energy sector lost USD 2.4 billion in FY 2015, and reported a **negative 38% net income margin**, so we do not believe that Itochu's shareholders should be excited about the prospect of synergies with a failing business segment. This announcement also contravenes Itochu's claim to be expanding into the non-resource sector.

[59] J.P. Morgan Note on Itochu, April 13, 2016, p. 6: "We believe a further rise in the stock's already high relative valuation will require… expectations of growth at Itochu as a result of collaboration with the CITIC/CP Group.

[60] *Itochu Presentation on Jan 20, 2015*

Unusually, Itochu's management also admitted that they are not pushing quickly ahead with any projects with CITIC in China because of President Xi Jinping's anti-corruption drive.[61] China is CITIC's stronghold, so if Itochu are not building synergies in China with CITIC they are not going to be building them anywhere.

> Q: What are the future initiatives of your Chinese business?
>
> A: Due to Xi Jinping's anti-corruption campaign, people are keeping a close eye on the situation. Therefore, we will not rush to execute projects, but rather, we will wait and see how the situation develops.

Source: Q&A Summary of Investors Meeting for the 1st Half of FY2016 Business Results

Indeed, analysts begrudgingly admit that any proposed synergies or cooperation with CITIC have run aground. Nomura's May 2016 analyst report admitted: "*Collaboration with CITIC has shown some delays, but we look for progress here.*"

The absence of synergies is perhaps why the CITIC acquisition also raises serious questions about Itochu's decision making. Itochu's return on investment, which flows through its net income, will likely hit 11%, yet its cash return on its investment will likely only be 1.6%.

Return on Itochu's Stake in CITIC
JPY bn

CITIC FY Itochu FY	FY14 FY15	FY15 FY16	FY16E FY17E
Net income less minority interest and adjustments	544.0	652.8	571.3
Payout ratio	*13.4%*	*20.9%*	*26.1%*
Dividend allocation	73.1	136.2	149.2
Itochu's Stake		*10%*	*10%*
Dividend income to Itochu		13.6	14.9
Net income Attributable to Itochu		65.3	57.1
Leverage		600.0	600.0
Interest rate		*0.9%*	*0.9%*
Cost of borrowing		5.4	5.4
Net gain		8.2	9.5
Cash return on investment		***1.4%***	***1.6%***
Return on investment		***10.9%***	***9.5%***

Source: Bloomberg, Glaucus Calculation
Note: Assumed Itochu's effective interest rate of FY17 is the same as FY16

Our calculations show that Itochu spends cash in order to realize paper profits. Even though the return on its stake in CITIC appears healthy on paper, the cash return on is investment will almost certainly be poor.

Itochu could have created a JV or partnership with CITIC for a position significantly smaller than the one it took, nevertheless, it risked small cash return in order to achieve a big paper profit to help Itochu secure its long term net income target of ¥400 billion.

Ultimately, we do not believe that Itochu is likely to develop any meaningful synergies with CITIC and its expected cash return raises serious questions as to whether Itochu's investment was designed to enhance shareholder value or simply artificially manufacture earnings. But we firmly believe that Itochu has no reasonable claim to "significant influence" over CITIC and thus should not be allowed to add CITIC's earnings to its consolidated accounts, which would reduce Itochu's earnings and forecasts by 20%.

[61] http://www.itochu.co.jp/en/ir/financial_statements/files/2016/pdf/16_2nd_05_e.pdf

TING HSIN: RECLASSIFICATION AND UNUSUAL GAIN SAVE ITOCHU'S FY 2015 EARNINGS

Itochu is considered a darling of the Nikkei 225 because it almost always manages to hit its guidance forecast and, so Itochu claims, the majority of its profits are derived from the non-resource sector. The non-resource profits are particularly attractive to investors because as trading firms go, Itochu appears much more insulated from the fall of commodity prices than traditional powerhouses such as Mitsui and Mitsubishi.

Our analysis of Itochu's FY 2015 financial statements indicates that it only made its earnings forecast because of an unusual gain from a familiar and questionable source: the reclassification of an investment from an "investment in an associate" to an "other investment." We believe that Itochu intentionally misleads investors by claiming record non-resource profits while, through a lack of transparency and over-reliance on the fine print, Itochu's actual performance in this sector is poorer than advertised.

1) FY 2015: The False Narrative of Record Non-Resource Profits

Itochu claims that its net profits are driven by its non-resource trading sector, as evidence by the Company FY 2015 earnings presentation:

> *"At first I'd like to explain the outline of the results for fiscal-year 2015. In FY 2015, the second half of our medium-term management plan, the Brand-new Deal 2014, net profit attributable to ITOCHU was JPY300.6 billion, keeping high earnings level, over JPY300 billion.* ***Thanks to significant increase in profits from four non-resource segments such as Textile, Machinery, Food, and ICT, General Products & Realty, despite the recognition of the impairment loss relating to a Brazilian iron ore company and a US oil and gas development company****, we were able to achieve our net income forecast of JPY300 billion."*[62] [Emphasis Added]

This narrative appears often throughout the Company's annual report: that impairment losses in the resource sector were offset by increased earnings in the non-resource sector. For example, in the president's letter to shareholders, Itochu highlighted that despite the end of the resource and commodity boom, it was unique among Japanese trading houses in that it was able to hit its guidance for the fifth year in a row.

What Itochu fails to mention, until the fine print, is that 20% of Itochu's FY 2015 net profits came from non-cash gains, the majority of which were taken in the four weeks before the end of the fiscal year, because of a cosmetic reclassification of a prior acquisition.[63] Once we remove the effects of one-time gains, non-cash items and income from investment in listed securities (which any shareholder could replicate), it shows a bleaker picture:

ITOCHU Non-Resource Fallacy

JPY bn	FY14	FY15	FY16
Reported non-resource net profit	208	317	237
After-tax gains	-	78	29
Listed stocks	43	47	51
Actual non-resource income	165	193	158
% of original	*80%*	*61%*	*66%*

Source: 1. FY 2015 Business Results Presentation, p. 8
2. FY 2016 Business Results Presentation, p. 6
3. FY 2015 and FY 2016 Supplementary Information
4. FY 2016 Presentation materials with script

[62] Full Year 2015 Itochu Corp Earnings Presentation, 8 May 2015
[63] Itochu Corp FY2015 Annual Report p.16, 63.

Indeed, it is in the fine print on page 63 of the annual report that the truth is revealed: Itochu only made its FY 2015 guidance because Itochu took a huge one-time, non-cash gain on a FY 2010 acquisition.

Overview of Fiscal 2015 Note: Based on U.S. GAAP from fiscal 2011 through fiscal 2014

Trading income was slightly dropped, to ¥46.6 billion, despite improved profitability at provisions-related subsidiaries, owing to cost increases at food distribution- and fresh food-related businesses. However, due to the posting of an unordinary gain related to TING HSIN (CAYMAN ISLANDS) HOLDING CORP., favorable performance in fresh food-associated companies, and a gain on sales of affiliates in the CVS companies, net profit attributable to ITOCHU approximately doubled, to ¥114.4 billion.

Business Results Billions of Yen

Years ended March 31	2011	2012	2013	2014	2015
Total assets	1,208.7	1,298.4	1,370.2	1,575.2	1,772.2
ROA	1.9%	3.5%	3.4%	3.9%	6.9%
Trading income	39.8	37.4	40.4	49.3	46.6
Equity in earnings of associated companies / associates and joint ventures	11.7	20.1	22.9	21.5	27.0
Net income / profit attributable to ITOCHU	22.4	43.8	45.7	57.5	114.4
Breakdown of Net Profit Attributable to ITOCHU by Major Group Companies, etc.					
NIPPON ACCESS, INC.*1	6.5	8.6	10.8	11.6	8.6
China Foods Investment Corp.*2	4.0	2.4	2.7	4.3	3.3
Unordinary gain related to TING HSIN (CAYMAN ISLANDS) HOLDING CORP.	—	—	—	—	60.5
Dole International Holdings, Inc.	—	—	0.0	7.1	4.8
Fuji Oil Co., Ltd.	2.5	2.3	2.3	2.1	2.4
Prima Meat Packers, Ltd.	(1.4)	2.4	2.4	2.0	2.7
FamilyMart Co., Ltd.	4.0	6.7	9.1	7.3	8.1
[Subtotal]	[15.6]	[22.4]	[27.3]	[34.4]	[90.4]
Percentage Contribution of Non-consolidated Trade Earnings to Net Profit Attributable to ITOCHU (image)*3	about 15%				

Source: Itochu Annual Report, FY 2015, p. 63.

2) Form Over Substance

In FY 2015, we believe that Itochu was unexpectedly forced to recognize impairments in its U.S. shale investment, Samson Resources, and in the Brazilian iron ore company, NAMISA. These impairments wiped out the earnings expected from the equity method associates and as a result, management searched for a gain to offset the loss.

Incredibly, management found a gain just four weeks before year-end that gave them 20% of their net income. This allowed Itochu to report net income of ¥300.6 billion and fractionally beat its forecast of ¥300 billion by just 0.2%.

The majority of this gain came from the reclassification of its equity method investment Ting Hsin into an "other investment." By now, any investor reading this report should be aware that, in our opinion, Itochu manipulates the classification of investments as associates to suit its short term needs. Just like in the Drummond JV, the reclassification of the Ting Hsin investment from an equity method to an "other investment" produced a paper gain, yet there was no change to the underlying economics of the investment or in the relationship between Itochu and Ting Hsin.

- **2004: Itochu Enters Chinese Beverage Market**

On December 27, 2003, Itochu (20%) and Asahi (80%) entered into a JV, named A-I China Breweries Co., Ltd ("AIB"). AIB then acquired a 50% stake in Tingyi-Asahi-Itochu Beverages Holding Co., Ltd. ("TAI") for USD 385 million from Tingyi (Cayman Islands) Holding Corp, a food and beverage conglomerate listed on the Hong Kong Stock Exchange (HK: 322).[64]

- **2008: Itochu Acquires 20% Stake in Ting Hsin**

On November 20, 2008, Itochu announced the acquisition of a 20% stake of Ting Hsin (Cayman Island) Holding Corp. ("Ting Hsin"), for USD 710 million (¥68.9 billion). Because Itochu purchased a 20% interest, it was deemed

[64] http://www.masterkong.com.cn/InvestorInformationen/tonghan/20041029/download/a20040126e.pdf

to have significant influence over Ting Hsin, and as such Itochu consolidated the investment as an equity method associate and included its portion of Ting Hsin's profits in its net income.[65]

Three days later, in a second and seemingly separate transaction, Itochu announced that it would sell its 10% effective stake in TAI, through AIB, to Ting Hsin for USD 280 million.[66] However, it is unclear if this was a cash transaction.[67]

- **2010: Itochu Reclassifies Ting Hsin as an Investment in an Associate**

On September 28, 2010, Asahi Breweries LTD ("Asahi") announced that it would acquire a 6.54% stake in Ting Hsin for a non-cash purchase price of USD 520 million (¥43.8 billion). In return, Asahi sold an 8% stake of Tingyi-Asahi Breweries ("TAB"), formally known as TAI, to Ting Hsin for USD 520 million (¥43.8 billion).[68]

Ting Hsin then issued new shares to Asahi and as a result, Itochu's 20% stake in Ting Hsin was diluted to 18.7%. Concurrent with the dilution, Itochu formed a joint holding company with Asahi (74%:26%) named China Foods Investment Corporation ("CFI") to hold their respective stakes in Ting Hsin. The press release stated that the purpose of the JV was for mutual cooperation in developing food businesses in the markets of Greater China. Nevertheless, CFI remained just a holding company. It thus appears, that the only purpose of creating CFI was to enable Itochu to consolidate the JV and therefore treat its stake in Ting Hsin as an equity method associate, even though it only effectively owned 18.7%. This was classic form over substance, but it allowed Itochu to convince its auditors to account for its investment in Ting Hsin under equity method, allowing Itochu to continue to consolidate its share of Ting Hsin's earnings into Itochu's net income.

- **4 Weeks Before the End of FY 2015**

On March 3, 2015, four weeks before the end of FY 2015, Itochu sold its 74% stake in CFI for a non-cash value of ¥161.9 billion and in return, Itochu received back its 17.8% stake in Ting Hsin.

Itochu **then reclassified its stake in Ting Hsin** as an "other investment" and recorded an after-tax gain of approximately ¥60.5 billion on the "revaluation" of its investment. Not coincidentally, this gain was just enough to allow Itochu to hit its year-end forecast target.[69]

This appears to be another case of Itochu reclassifying its minority investments to manufacture gains in order to meet guidance, even though there was no fundamental change to the underlying economic reality of its investment.

Itochu's effective stake in Ting Hsin was **18.7% in 2010** and remained almost unchanged (17.8%)[70] in 2015, when Itochu reclassified its investment to recognize a ¥60 billion gain.

We have not been able to obtain enough information to question the validity or the amount of the gain taken by Itochu on this reclassification, although we have our suspicions. First, it appears as though Ting Hsin's profitability has been in decline since Q1 FY 2010, when Itochu first classified its investment under the equity method. Note that although Itochu first acquired its stake in FY 2009, it began to consolidate its proportion of Ting Hsin's profits in Q1 FY 2010.[71]

[65] https://web.archive.org/web/20110604151228/http://www.itochu.co.jp/en/news/2008/081120_1.html
[66] http://www.hkexnews.hk/listedco/listconews/SEHK/2008/1124/LTN20081124006.pdf
[67] There also does not appear to be a gain for Itochu but this may be because the sale was done through AIB for which they only own a minority stake.
[68] http://www.asahigroup-holdings.com/en/ir/pdf/10pdf/20100928_1.pdf
[69] http://www.itochu.co.jp/en/news/files/2015/pdf/ITC150303_2_e.pdf
[70] http://www.hkexnews.hk/listedco/listconews/SEHK/2015/0416/LTN20150416256.pdf
[71] Itochu Annual Report 2010 p.85

Year	Thin Hsin/CFI net profit attributable to Itochu	Revaluation gain	Net Profit	Accounting Standards	Source
	(JPY bn)				
FY2010	8.7	1.9	6.8	US GAAP	FY2011 Annual Report, p. 97-98
FY2011	4.0	-	4.0	US GAAP	FY2011 results presentation
FY2012	2.4	-	2.4	US GAAP	FY2013 results presentation
FY2013	2.7	-	2.7	US GAAP	FY2013 results presentation
FY2014	4.3	-	3.9	IFRS	FY2015 results presentation
FY2015	3.3	-	3.3	IFRS	FY2015 results presentation

Put simply, Ting Hsin's annual profitability appears, based on the figures disclosed by the Company, to decline significantly from FY 2010 (¥8.7 billion) to FY 2015 (¥3.3 billion).

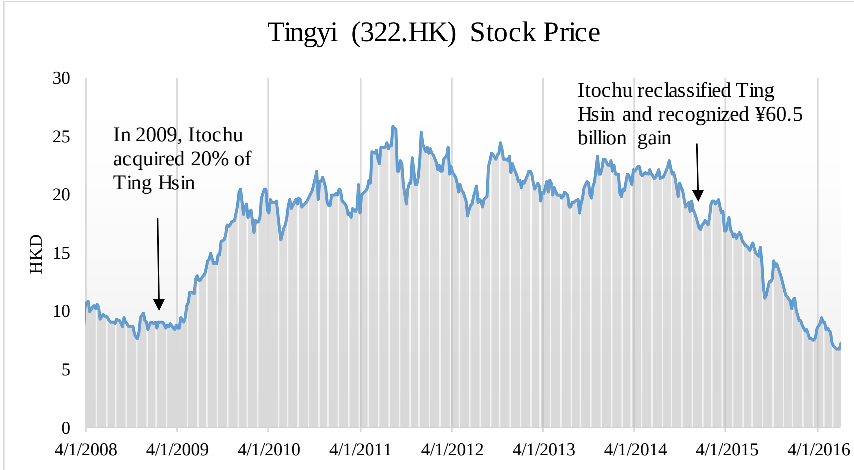
Second, the fact that the after-tax, non-cash gain appeared just four weeks before the end of the fiscal year and that it was just enough to cover the expected earnings shortfall makes us question the legitimacy of this paper profit.

3) Losses Following Reclassification

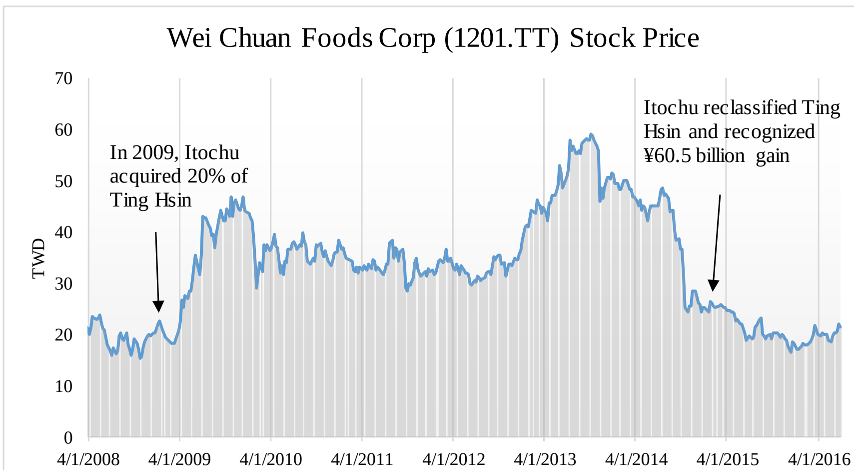
Itochu's reclassification of Ting Hsin could not have come soon enough. Unsurprisingly, given Itochu's history of avoiding impairments, Ting Hsin's business has deteriorated significantly post its reclassification.

Below, are two stock charts. The first is for Tingyi, the Hong Kong-listed food and beverage business of Ting Hsin (HK: 322). The second is for Wei Chuan Foods Corps. ("Wei Chuan"), another Ting Hsin business unit (TW: 1201). Together, Tingyi and Wei Chuan accounts for 80-90% of Ting Hsin's revenue.[72]

[72] http://finance.sina.com.cn/chanjing/gsnews/20141014/030820527881.shtml



Source: Bloomberg



Source: Bloomberg

There is not sufficient publicly available information regarding the assets, liabilities or financial position of Ting Hsin to assess whether Itochu was justified in recognizing such a gain, although we acknowledge that Itochu likely based at least part of its recognized gain on the appreciation of Tingyi's stock price between the acquisition date and the reclassification date. Yet this does not alleviate our suspicion that such a gain was artificially manufactured to suit the Company's short term needs. After all, Tingyi's stock had appreciated immediately after Itochu's initial investment, but the gain was only recognized years later. In addition, Itochu's stake in Ting Hsin remained the same over that time period, making it highly unlikely, in our opinion, that Itochu's level of influence over Ting Hsin changed significantly over that time.

Investors should also note that the price of Tingyi's and Wei Chuan's stocks began to significantly underperform around the time that Itochu reclassified its Ting Hsin investment.

Ultimately, we question the legitimacy of Itochu's one-time, non-cash gain, supposedly earned on its dubious reclassification of its Ting Hsin investment. We believe that regulators should look into how Itochu magically conjured up a ¥60 billion paper gain (after tax) just four weeks before the end of a fiscal year when it appears that without such a gain, Itochu would have missed guidance by ¥60 billion.

MANUFACTURING DUBIOUS NON-CASH GAINS TO MAKE EARNINGS

Itochu has been the darling of the Tokyo stock market for its remarkable ability to always hit its forecasted numbers. Indeed, other than this year, since Mr. Okafuji took over Itochu in FY 2011, it has rarely missed earnings guidance. Since Mr. Okafuji was hired, Itochu had the lowest standard deviation of returns of any of the top five trading companies.

Trading Company % Achievement of Initial Net Income Forecast

Fiscal Year	ITOCHU	Mitsubishi Corp.	Mitsui & Co	Sumitomo Corp.	Marubeni Corp.
FY2011	0.6%	25.6%	15.0%	25.1%	9.2%
FY2012	25.2%	0.9%	1.0%	13.9%	1.2%
FY2013	0.1%	-28.0%	-23.0%	-10.6%	2.9%
FY2014	7.0%	11.2%	14.1%	-7.1%	0.4%
FY2015	0.2%	0.1%	-19.3%	-129.3%	-52.0%
FY2016	-27.2%	-141.5%	-134.8%	-67.6%	-65.4%
Standard Deviation	**15.4%**	55.8%	51.5%	53.4%	29.7%

Source: Companies' Public Filings

In our experience, such an unusually low standard deviation compared to its peers suggests that there is likely to be some income massaging in order to achieve consistent results. Business, like life, is unpredictable. We are suspicious of any Company which is able to so reliably predict the future.

Itochu's track-record is exceptional considering the struggling global economy and commodity price collapse. As can be seen in the table below, Itochu has been pretty close to the mark on a number of occasions and on three occasions Itochu made its forecast by less than 1%. FY 2012 is the only year where they beat expectations by a wide margin.

ITOCHU's Uncanny Ability to Just Hit Their Numbers
JPY bn

Fiscal Year	Accounting Standard	Initial Forecast	Net Income	Achievement of Forecast	One-time pre-tax gain on investment, bargain purchases and one-time tax benefit	President
FY2009	US GAAP	240.0	165.4	-31.1%	(23.1)	Mr. Eizo Kobayashi
FY2010	US GAAP	130.0	128.2	-1.4%	9.6	Mr. Eizo Kobayashi
FY2011	US GAAP	160.0	161.0	0.6%	(38.1)	Mr. Masahiro Okafuji
FY2012	US GAAP	240.0	300.5	25.2%	36.9	Mr. Masahiro Okafuji
FY2013	US GAAP	280.0	280.3	0.1%	45.9	Mr. Masahiro Okafuji
FY2014	US GAAP	290.0	310.3	7.0%	15.0	Mr. Masahiro Okafuji
FY2015	IFRS	300.0	300.6	0.2%	109.9	Mr. Masahiro Okafuji
FY2016	IFRS	330.0	240.6	-27.1%	121.1	Mr. Masahiro Okafuji

Source: Company Annual, Reports, Bloomberg

Perhaps unsurprisingly, Itochu's uncanny ability to hit its forecast is actually due to a distinct increase in one-time gains on investments and bargain purchases, excluding impairments. For the most part these are one-time non-cash gains. 83% of such gains took place in FYs 2015 and 2016.

Even though investors may approve in the short term of companies that hit their targets, intentionally massaging or manipulating results is against the accounting principles and in the end, can have a devastating long term impact on share value. Indeed, the evidence discussed in this report supports our opinion that the pressure to meet earnings guidance has led Itochu down a darker path of accounting impropriety.

ITOCHU THINKS IMPAIREMENTS OPTIONAL – THEY ARE NOT

We believe that Itochu's attitude towards impairments demonstrates that it is likely to have inappropriately delayed or altogether avoided taking required write-downs on losing investments. Indeed, Mr. Okafuji even admits an extremely relaxed attitude towards taking impairments, as evidenced by his statement in a November 2015 interview with the Nikkei Asian Review:

> **Q: You finished the roughly 600 billion yen investment in Citic this August ahead of schedule.**
>
> **A:** The equity-method investment gain will likely increase by the amount equivalent for one quarter, or about 15 billion yen to 20 billion yen. However, this fiscal year we are considering recording a big write-off in the resources field, which will offset this profit gain. For now, we aim to achieve our goal of 10% growth in net profit to 330 billion yen, which we set at the start of the year.

Source: Nikkei Asian Review[73]

Mr. Okafuji statement that Itochu are "***considering***" taking an impairment suggests that Itochu believe impairments are optional! Indeed, Mr. Okafuji's sentiment seems consistent with Itochu's accounting games, particularly with respect to its FY 2015 reported results and the reclassification of the Drummond JV.

The language from IAS 36 – Impairment of Assets clearly states that taking impairments are not optional nor at a company's leisure as shown in the below:[74]

> **International Accounting Standard 36**
> ***Impairment of Assets***
>
> **Objective**
>
> 1 The objective of this Standard is to prescribe the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and the Standard requires the entity to recognise an impairment loss. The Standard also specifies when an entity should reverse an impairment loss and prescribes disclosures.

Itochu changed their accounting standards from US GAAP to IFRS in FY 2014. Under US GAAP, there is a two step-approach, the first of which is comparing the carrying amount of the asset to the sum of the undiscounted future cash flows. If the carrying amount is not deemed recoverable then an impairment test is performed. IFRS requires an impairment test whenever an impairment indicator exists, a significantly stricter standard than US GAAP.

[73] http://asia.nikkei.com/Business/Companies/Noncommodity-operations-fueling-record-profit?page=1
[74] http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias36_en.pdf

Under IFRS, an impairment <u>must</u> be considered when there is an internal or external indication that an impairment may need to be taken. The IAS sets out the indicators a non-exhaustive list set out below:[75]

External sources:

- market value declines
- negative changes in technology, markets, economy, or laws
- increases in market interest rates
- net assets of the company higher than market capitalisation

Internal sources:

- obsolescence or physical damage
- asset is idle, part of a restructuring or held for disposal
- worse economic performance than expected
- for investments in subsidiaries, joint ventures or associates, the carrying amount is higher than the carrying amount of the investee's assets, or a dividend exceeds the total comprehensive income of the investee

These lists are not intended to be exhaustive. [IAS 36.13] Further, an indication that an asset may be impaired may indicate that the asset's useful life, depreciation method, or residual value may need to be reviewed and adjusted. [IAS 36.17]

Source: IFRS Rules

The treatment of impairments under IFRS is thus stricter than under US GAAP, and typically require companies to take impairments sooner. The impairment indicators under IFRS, such as market value declines and negative changes in the market or economy, would include the collapse of commodity prices.

That is why many of Itochu's peers, other large Japanese trading companies such as Mitsui and Sumitomo have taken large impairments on their assets following the fall of commodity prices in 2015. Itochu took some impairment charges, but we believe that they should have taken more.

Just to reconfirm - **taking impairments ARE NOT OPTIONAL under IFRS or US GAAP, intentionally avoiding taking impairments is tantamount to fraud as the company is misleading investors regarding actual financial performance**.

[75] http://www.iasplus.com/en/standards/ias/ias36

VALUATION

Leverage and Creditor Relationships

Itochu is highly levered with 9.29x total debt/EBITDA and 57% debt/capital ratio. Since 2011, Itochu has raised over ¥300 billion of bonds from investors that have based their investment decision on the accuracy and integrity of Itochu's representations and reported profits. Toshiba Corp was fined by the Securities and Exchange Surveillance Commission because it had misled investors by padding results.[76] We believe that Itochu could face a similar fate.

It is not just investors that seem to have been duped by Itochu. Creditors have put a significant amount of faith in Itochu's growing net profit, which creditors hope will generate more free cash flow. However, as we have detailed in this report, Itochu's quality of earnings is deteriorating and we believe that the Company should be forced to stop recognizing profit from CITIC. If this occurs, then Itochu would likely face a ratings downgrade.

Creditors should also be concerned over the concentrated risk of the CITIC investment, which amounts to 24% of Itochu's consolidated capital. We suspect that Itochu has not truly understood the inherent risks of investing in China's financial market. Itochu's management defended the CITIC investment on the grounds that "**the financial industry in China is stable with low volatilit**y."[77] This dangerously underestimates the risks and volatility of the Chinese financial markets, as the last few months have shown.

Aggressive Investments to Ensure Steady Supply of One Time Gains

Creditors are also expecting Itochu to curtail new investment. However, as its core business is deteriorating, Itochu may be forced to continue spending to hit its targets, given that Itochu relies on one-time gains to make up a significant portion of its net profits.

For example, in FY 2016, Itochu's trading income, the true earnings driver of a trading company, was down 17.2% from the prior year (¥226 billion vs. ¥273 billion). To offset this decline, Itochu benefitted from a number of one-time gains, including a gain of ¥20 billion on the sale of PrimeSource,[78] a gain of ¥9 billion on a change of the capital structure of the Orient Corporation, a tax benefit of ¥34 billion from the disposal of Samson Resources and a negative goodwill gain on CITIC (even though CITIC's stock price was down 14% since Itochu's investment). These gains have masked the lack of growth in the core business. Yet Itochu remains vocal and bullish on its prospects:

> *"Regarding net profit attributable to Itochu, the target for FY2017 is JPY350 billion, a JPY110 billion increase compared with FY2016, even including a JPY20 billion buffer. This target factors in solid growth in the non-resource sector, a full-year contribution to profits from the CITIC investment, and an absence of impairment losses that were recorded in FY2016."*[79]

With the company running out of gains it is hard to see how they will achieve their ¥350 billion net profit goal next year, let alone the ultimate goal of ¥400 billion, without taking on further debt to finance aggressive acquisitions. Yet Itochu's failure to curtail investment and its growing debt could cause a ratings downgrade.

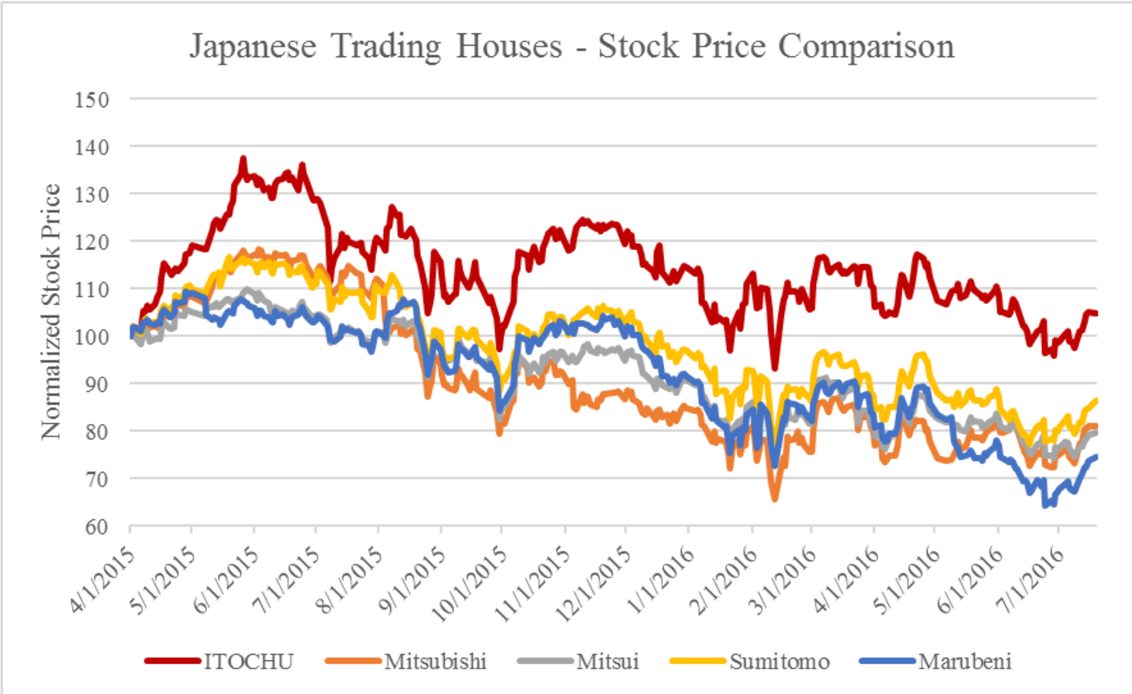
Unfair Advantage

Once famous Japanese trading companies have been hit hard by declining commodity prices and ill-advised foreign investments. Despite having a similar business model, and being subject to the same secular headwinds and

[76] http://asia.nikkei.com/Business/Companies/Securities-watchdog-to-seek-record-7bn-plus-yen-fine
[77] http://www.itochu.co.jp/en/ir/financial_statements/files/2015/pdf/15_3rd_05_e.pdf
[78] http://www.itochu.co.jp/en/news/2015/150330.html;
[79] Full Year 2016 Itochu Corp Earnings Presentation; http://www.itochu.co.jp/en/ir/financial_statements/files/2016/pdf/16_ended_05_e.pdf

commodity prices as other trading houses, Itochu has thus far largely avoided such major impairments.[80] Indeed, for the first time, in FY 2016, Itochu reported the highest net income of any of the big-5 Japanese trading houses.

The misperception that Itochu's net profits are driven by its non-resource segment and that it has not been affected by the large write downs recognized by other trading houses, has driven its stock price higher than its rivals.



[81]

We believe that this is entirely inappropriate. Other Japanese houses that have adhered to Prime Minister Abe's campaign of corporate governance and recognized impairments find themselves at an unfair disadvantage to Itochu. The investors, shareholders and employees of the other trading houses have been punished because their companies have, with some exceptions, been honest with the market regarding their impairments. We believe that Itochu has not.

Toshiba Part II?

In 2015, a regulatory investigation and independent inquiry revealed that Toshiba had deliberately manipulated its accounting policies in order to overstate profits by USD 1.2 billion (¥152 billion) from FY 2008 to 2014. Toshiba's stock declined 70%, Japanese securities regulators imposed a record fine, and Toshiba's CEO and 8 of its 16 board members resigned in disgrace. The Tokyo Stock Exchange even placed Toshiba's stock "on alert," raising the possibility that the Company's stock could be delisted if it failed to correct deficiencies in its corporate governance.

As this report has demonstrated, we believe that Itochu overstated FY 2015 net profits by at least ¥153 billion by reclassifying its stake in the Drummond JV without taking a loss, even though the value of the investment had declined significantly. In our opinion, there is evidence of intent to manipulate. Itochu first claimed, in Q3 FY 2015, that reclassification was justified because its stake "might fall" below 20%. **It never did**. Then, in Itochu's 2015 Annual Report, Itochu completely changed its justification for reclassification, stating that although it still owned a 20% stake in the Drummond JV, it did not have "approval authority" or "significant influence." In retrospect, Itochu appears so desperate to avoid a large impairment that it concocted two different, equally implausible reasons to reclassify its

[80] http://www.bloomberg.com/news/articles/2016-02-01/japan-trading-houses-facing-13-billion-hit-on-commodity-misfire
[81] This graphs compares the relative price movement of Itochu's stock with that of the four other major trading houses, normalizing all stocks to 100 on April 1, 2015.

investment. In our opinion, Itochu's changing story shows that the Company was intent on inappropriately avoiding the loss, regardless of whether it was permitted by the rules of accounting.

We also do not believe that Itochu should be able to consolidate profits from CITIC under the equity method, given that CITIC is operated and majority-owned by the Chinese government, meaning that it is highly unlikely that **Itochu can have any significant influence over CITIC's strategy, operations or policy making**. Deconsolidating CITIC would mean that Itochu's forecasted net profits would fall **by 20%**.

We are also highly suspicious of the ¥60 billion (after-tax) one-time gain recognized on the reclassification of Ting Hsin, given the declining profitability post-investment. We simply do not find it credible that **Itochu magically discovered a** ¥60 billion gain four weeks before the end of the fiscal year when the Company was set to miss guidance by ¥60 billion.

Toshiba was almost destroyed by a scandal for overstating earnings by ¥152 billion over seven years. By comparison, we believe that in FY 2015 alone, Itochu overstated net profits by ¥153 billion.

Toshiba's stock declined 70%, peak-to-trough. In our opinion, Itochu faces a similar crisis of confidence in its corporate governance and accounting practices. We believe that like Toshiba, any form of independent inquiry, either by regulators or an independent investigation committee, may reveal even more problems at Itochu than we can glean from the publicly available information. But based on the current information available to investors for analysis, we value Itochu's shares at ¥631.00, 50% below their current traded price.

Valuation

¥ billions	**Toshiba**	**Itochu**
Profit Overstatement	152	>153*
Period of Misconduct	FY 2008-2014	FY 2015
Board Member Resignations	8	?
CEO Status	Resigned in Disgrace	?
Stock Price Decline	**70%**	**50% ***

**Source: Glaucus Forecast*

DISCLAIMER

We are short sellers. We are biased. So are long investors. So is Itochu. So are the banks that raised money for the Company. If you are invested (either long or short) in Itochu, so are you. Just because we are biased does not mean that we are wrong. We, like everyone else, are entitled to our opinions and to the right to express such opinions in a public forum.

We believe that the publication this investment opinion is in the service of the public interest by encouraging the enhancement of disclosure by listed companies and fostering increased transparency in the Japanese capital markets.

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