



MARUBENI CORP (8002): The Writedowns Awaken

Report Date:	18 December, 2015
Company:	Marubeni Corporation (8002)
Industry:	General Trading, Commodities
Thesis:	SELL
Share price (16 Dec, 2015):	Y651
Target Price:	Y390
Up/Downside:	-40%
Market cap:	Y1,131,399 mn
Shares outstanding (incl. treasury):	1,737,941 mn
Average Volume:	10,446,000
Net D/E ratio (end of FY3/15):	1.72 times
Debt / Capitalization	69.3%
Debt / LTM EBITDA	12.8x
Debt / LTM FCF	1,572.2x

Source: *Company data, Yahoo! Japan Finance*

Executive Summary:

This report will show that Marubeni has failed to recognize material asset impairments of large overseas commodity and agricultural investments. Once the market recognizes these substantial losses there is material downside to the stock price. We estimate asset impairments of ¥150-200 billion (US\$1.2-\$1.7 billion) and a 40% downside price target for the stock price. Based on Toshiba Corp's precedent, we also believe there is potential for Marubeni to incur fines as Japan's regulators go after companies that purposely delay making impairments.



Disclaimer:

Our research and reports express our opinions, which we have based upon generally available public information, field research, inferences and deductions through our due diligence and analytical process. To the best of our ability and belief, all information contained herein is true, accurate and reliable, and has been obtained from public sources we believe to be accurate and reliable, and who are not insiders or connected persons of the stock covered herein or who may otherwise owe any fiduciary duty or duty of confidentiality to the issuer. We strive for accuracy and completeness to support our opinions, and we have a good-faith belief in everything we write. However, all such information is presented "as is," without warranty of any kind – whether express or implied. Well Investments Research makes no representation, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results to be obtained from its use. You agree that the use of Well Investments Research is at your own risk. In no event will Well Investments Research or any affiliated party be liable for any direct or indirect trading losses caused by any information available on this report. Well Investment Research is not registered as an investment advisor in any jurisdiction. This report does not represent an investment advice or a recommendation or a solicitation to buy any securities. Think critically about our opinions and do your own research and analysis before making any investment decisions. You should seek the advice of a security professional regarding your stock transactions.

You should assume that as of the publication date of our reports and research, Well Investments Research, as well as our clients and/or investors, has a short position in the stock (and/or options, swaps, and other derivatives related to the stock) covered herein, and therefore may stand to realize significant gains in the event that the price of the covered stock, options or other securities rises or declines. We may continue transacting in the securities of the company covered in this report, and we may buy, sell, cover or otherwise change the form or substance of our position in the issuer regardless of our initial views set out herein.

This is not an offer to sell or a solicitation of an offer to buy any security, nor shall Well Investments Research offer, sell or buy any security to or from any person through this site or reports on this site. Well Investments Research is not registered as an investment advisor in any jurisdiction. You agree to do your own research and due diligence before making any investment decision with respect to the securities discussed herein. You represent to Well Investments Research that you have sufficient investment sophistication to critically assess the information, analysis and opinions in this report.

We are entitled to our opinions and to the right to express such opinions in a public forum. We believe that the publication of our opinions about public companies that we research is in the public interest. Well Investments Research believes that this report will facilitate fair, accurate, and timely disclosure by the listed company discussed in this report. Such fair, accurate, and timely disclosure is the obligation of the company owed to its shareholders and investors in the Japanese capital markets. This report and all statements contained herein are the opinion of Well Investments Research and are not statements of fact. You can publicly access any piece of evidence cited in this report or that we relied on to write this report. All opinions are subject to change without notice, and Well Investments Research does not undertake to update or supplement any reports or any of the information, analysis and opinion contained in them.

You agree that use of Well Investments Research's research is at your own risk. You further agree to do your own research and due diligence before making any investment decision with respect to securities covered herein. You represent to Well Investments Research that you have sufficient investment sophistication to critically assess the information, analysis and opinion on Well Investments Research's site and in this report. You further agree that you will not communicate the contents of this report to any other person unless that person has agreed to be bound by these same terms of service.

By downloading and opening this report you knowingly and independently agree: (i) to abide by the terms of service posted on our website, which are hereby fully incorporated herein, (ii) that any dispute arising from your use of this report or viewing the material herein shall be governed by the laws of the State of New York, United States, without regard to any conflict of law provisions; (iii) to submit to the personal and exclusive jurisdiction of the superior courts located within the State of New York and waive your right to any other jurisdiction or applicable law; and (iv) that regardless of any statute or law to the contrary, any claim or cause of action arising out of or related to use of this website or the material herein must be filed within one (1) year after such claim or cause of action arose or be forever barred. The failure of Well Investments Research to exercise or enforce any right or provision of this disclaimer shall not constitute a waiver of this right or provision. If any provision of this disclaimer is found by a court of competent jurisdiction to be invalid, the parties nevertheless agree that the court should endeavor to give effect to the parties' intentions as reflected in the provision and rule that the other provisions of this disclaimer remain in full force and effect, in particular as to this governing law and jurisdiction provision.



Introduction

Japanese trading companies are the last trading companies left standing in 2015. (Share price changes: Marubeni -9.7%, Glencore - 70.8%, Noble – 65%). Marubeni is the smallest of the major *sogo shosha* but by some metrics the highest levered by Japanese and global standards. Its business is built on trading in a wide array of products and materials, and investing in natural resources and other industries. Over the last decade, the investment side has become an increasingly key part of Marubeni's overall business and profit. As Marubeni set a goal of overtaking larger rivals¹, the company increased its investments, funded by bank borrowings, with a strong focus on multi-billion dollar commodity assets. The company did not meet its goals. Instead, it has leaned on very aggressive accounting to manage its financial statements. Our research shows that such practices are no longer sustainable and major writedowns are now in the offing.

Using publicly available information, industry checks and research, we aim to present in this report a clinical review of Marubeni's financials and of the marquee investments the company made as it set off to catch-up with rivals. We have identified data points that show — despite Marubeni's own poor disclosure — that impairments on several of the investments are now inevitable. The research also presents a case for considering Marubeni as having deliberately avoided its obligations under IFRS accounting rules in recognizing impairments. We show how Marubeni's leverage and strategy motivates them to delay impairments and also highlight that such tactics are no longer being overlooked in Japan. This month's record fine of Toshiba Corp., one of Japan's top blue chips, was based around this issue: deliberate delays in booking losses.

Finally, we show how Marubeni's investment model is based on large cash outlays and with little profit in return. We believe this echoes issues raised at other trading houses such as Noble Group Ltd. (ticker: NOBL SP) and Glencore (ticker: Glen LN).

All this implies a material downside to Marubeni's share price. We believe the market is missing both the severity of Marubeni's accounting issues and its leverage, which will be painfully exposed once the impairments come through. In our assessment, Marubeni's shares are worth 40% less than the close on Dec. 16, 2015.

In this report we highlight:

¹ <http://www.bloomberg.com/news/articles/2013-02-20/marubeni-s-incoming-ceo-kokubu-sets-profit-target-above-sumitomo>

- **Y150bn - Y200bn of writedowns in the wings.** Writedowns are required at some of Marubeni's largest assets (Gavilon, Roy Hill). We estimate impairments at just those two could reach ¥150 bn – Y200 bn, with a significant potential for more to mature. The rout in iron ore alone should spark a major writedown at Roy Hill. Today analysts long-term price midpoint for ore is \$65/mt – half of what Marubeni expected four years ago. And if we take SGX Iron Ore Futures prices as a guide, which has future prices stretching to Dec 2018 at \$34.13 a metric ton, then the equity value of Roy Hill would be zero and the writedown at that asset alone would number Y150bn to Y170bn.
- **Risk of restatement of last year's earnings.** Marubeni likely intentionally delayed impairments when it performed the mandatory impairment test of assets at the close of its last fiscal year (March 31, 2015). Rather than reflect the market situation in all commodity markets, Marubeni selectively opted to mark writedowns in some products (oil, coal) while ignoring a consistent thought process for others (iron ore, grain). This resulted in impairments that were miniature versions of what our research shows were due. Just these admissions sent Marubeni's stock tumbling and one credit rating agency to change the company's outlook to negative. We believe with more realistic asset impairments now inevitable, earnings can no longer be managed.
- **Regulators' awakened interest in impairment delays portends Y5.1bn fine.** Regulators have taken a dim view, resulting in a record fine of Y7.4bn, for similar transgressions at Toshiba. Toshiba failed to recognize losses, which led to overstated earnings and engaged in continuous fund raising on the back of this misleading information. We believe Marubeni has engaged in both of these practices as well. Toshiba's fine was calculated at Y7.4bn, or 2% on the amount of bonds it issued over the relevant period. Should regulators take a similar approach to Marubeni, its fine could amount to **¥5.1bn**.
- **Potential credit issues.** We believe the forthcoming writedowns will be highly problematic for Marubeni from a credit perspective. The company has a debt to LTM EBITDA ratio of 12.8x while its debt to LTM Free Cash Flow was at 1,573x and expected to be at 39x in FY16. The situation is likely to worsen in FY17. Though Marubeni maintains an investment grade rating with credit agencies, it remains the most levered of all Japanese trading companies. The rating agencies focus substantially on debt to capitalization ratios and equity to risk weighted assets and we believe this has partially motivated Marubeni to delay asset impairments. With high leverage and low margins driving the core business of a trader, we believe any potential credit downgrade and its associated increase in borrowing costs will drastically hurt profits. The ratings agencies are already taking note.²
- **"Buffer" against appropriate accounting.** We believe Marubeni's use of a "buffer" is inconsistent with IFRS. It strikes us as opaque even by Japanese trading companies' standard

² S&P Rating Action January 27, 2015

and, as the report notes, is a view that analysts regularly covering the company share. This buffer makes it extremely hard to gauge the true quality of Marubeni's earnings as well as what value it ascribes to individual assets.

- **Valuation drop concern.** We believe there is material downside to Marubeni's share price. Our target price for Marubeni stock is Y390, implying a 40% downside. We apply a 0.5x price / book multiple to an adjusted book value of Y780/share (which includes Y175bn of potential impairments to Marubeni's stated book value). As our report shows, Marubeni has been the worst investor of its peers on both an absolute Yen basis and as a percentage of book value. After Y1.6 trillion in investments and capital expenditures, Marubeni has lower earnings and cash flow than it did 5 years ago. This also represents severe underperformance on a relative basis as Marubeni is the only *sogo shosha* that's seen no meaningful increase in its average operating cash flow for the period FY11 to FY15 compared to the average for the period FY00 to FY10, despite the massive investments. Added to its top-of-the-group leverage, we believe Marubeni should trade at a ~20% discount to peers such as Mitsubishi, Sumitomo and Mitsui. An additional valuation data point would be other less leveraged global commodity trading companies, such as Glencore and Noble trade at 0.35x – 0.40x book and we believe Marubeni should — at most — trade at a 20% premium to these companies. This also supports our 0.5x P/B target multiple.

We believe our analysis only scratches the surface of some of Marubeni's investments which are vast and extend to hundreds of joint ventures and subsidiaries. With the mood in Japan turning more towards corporate governance and Japan focused on making its equity markets more transparent and attractive to foreign capital, we believe Marubeni is the kind of company that will incur increased scrutiny. We are cautiously optimistic that this report and other investigations into the company can help bring about positive changes in Japan and avoid further crises.

See No Writedown, Hear No Writedown, Speak No Writedown

We believe that through an allergic attitude to booking impairments Marubeni has been presenting investors with padded financial statements. In a similar way to Toshiba selling investors debt based on misleading financial numbers, Marubeni raised more than ¥353bn over the last four years on the back of, we believe, inadequate representations of its economic condition. While Marubeni's management may believe they have discretion over the size and timing of writedowns there is a strict accounting requirement for companies to assess investment values at the end of each reporting period in light of indicators of impairment. These indicators are listed in the accounting standards below. From the International Accounting Standards Committee:

Identifying an asset that may be impaired

At the end of each reporting period, an entity is required to assess whether there is any indication that an asset may be impaired (i.e. its carrying amount may be higher than its recoverable amount). IAS 36 has a list of external and internal indicators of impairment. If there is an indication that an asset may be impaired, then the asset's recoverable amount must be calculated. [IAS 36.9]

The recoverable amounts of the following types of intangible assets are measured annually whether or not there is any indication that it may be impaired. In some cases, the most recent detailed calculation of recoverable amount made in a preceding period may be used in the impairment test for that asset in the current period: [IAS 36.10]

- › an intangible asset with an indefinite useful life
- › an intangible asset not yet available for use
- › goodwill acquired in a business combination

Indications of impairment [IAS 36.12]

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]

ments

I Know What You Did Last Summer: The Toshiba Case Study

We believe Toshiba provides an illustrative case study of improper accounting and the issues it creates. The engineering company has been mired in scandal throughout 2015 after a report indicated they'd massively overstated past earnings due to a failure to recognize losses. The stock has sold off significantly and even though the company has since implemented some writedowns and published an independent investigation report the share price has yet to recover. Moreover, the Tokyo Stock Exchange has threatened to delist the company and has designated it as a "Security on Alert".

Toshiba's transgressions have been summed up by the Securities and Exchange Surveillance Commission ("SESC"). The commission found that the company delayed the booking of losses, done at the instruction of past presidents, and meanwhile raised funds from investors on the back of this inaccurate financial information. The result is that Toshiba has had to revise down earnings by a total of ¥225bn over 7 years. Toshiba was slapped³ with a record⁴ fine of ¥7.4bn, based on the amount of bonds it sold during this period of misstated results. The SESC found that investors' interest was particularly harmed by the inflation of results for FY2011 and FY2012. For those two years alone Toshiba has since downgraded pretax earnings by more than ¥80bn.

As recently as last month the Tokyo Stock Exchange found another instance⁵ of hidden impairments in Toshiba's accounting. The company had failed to disclose past charges at Westinghouse (one of its subsidiaries), which was also a violation of bourse requirements. We believe it's fair to say that timely disclosure of impairments is a topic that's only growing in attention in Japan today.



³ <http://www.fsa.go.jp/sesc/english/news/reco/20151207-1.htm>

⁴ <http://asia.nikkei.com/Business/Companies/Securities-watchdog-to-seek-record-7bn-plus-yen-fine>

⁵ <http://asia.nikkei.com/Business/Companies/Westinghouse-losses-show-disregard-for-disclosure>

Psst, Don't Tell Marubeni, But Commodities Are Down

Beginning in the early 2000's, commodities have been on an incredible bull run due to soaring Chinese demand for raw materials. Japanese trading companies made aggressive entries into this space, with a number of large investments into mining and energy assets coming very late in the commodity cycle and, hence, at the top of the market.

Historically, Marubeni grew from a linen trading operation in Osaka in the mid-19th century and came fully into its own as an independent company in the late 1940s. The company developed in post-war Japan on the back of textiles, machinery, chemicals, and later retail, power generation and food materials. Marubeni's foray into commodities came later than most of its domestic peers. Seeing the handsome profits more commodities-focused trading houses such as Mitsui & Co. reaped from basic raw materials, Marubeni made a play for several large-scale projects. It bid aggressively and made massive investments at the peak of the market in order to catch up. Unfortunately for Marubeni commodity prices started to fall in 2011.

Let's look at when Marubeni made many of its key commodities investments. The company agreed with a partner to take over Canada's Grand Cache coal mine — one of its biggest investments in coal — in fiscal 2011 and was sold for a \$1 this year. The same fiscal year (ended March 31, 2012) Marubeni also made its first investment in iron ore in 30 years⁶. The following year, Marubeni agreed to pay a company record \$3.6 billion for the equity of U.S. firm Gavilon, for the purpose of boosting its grain supply⁷. So, when did the prices of these commodities peak? Coal and iron ore hit their peak in 2011 and corn in 2012. Marubeni could not have picked a better time to buy — from the seller's perspective.

After the peak years of 2011-2012 commodities have corrected sharply. As of December 2015, a number of metals are posting new multi-year lows and commodity producers and trading companies are seeing large declines in their share prices. The price of the underlying commodity is one of the key drivers of value in any natural resource asset. As such, we have seen some writedowns from the Japanese trading companies including Marubeni in some of their energy assets. However, the same effort has not gone into reflecting today's economics in the base and bulk commodities space.

⁶ <http://origin-www.bloomberg.com/apps/news?pid=conewsstory&tkr=8002:JP&sid=afGDpvn1Hr5o>

⁷ <http://origin-www.bloomberg.com/apps/news?pid=conewsstory&tkr=0006924D:US&sid=avlzJLpDiDX0>

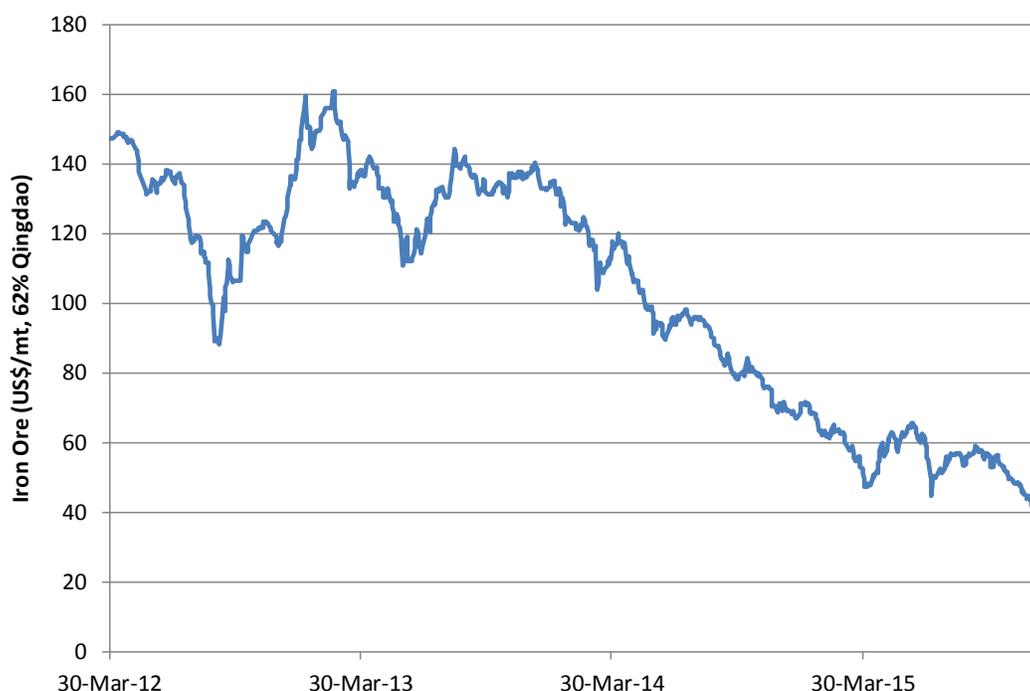
Iron Ore

Commodities have come off across the board, but iron ore has been particularly hard hit due to an overabundance of supply and weakness in demand. Iron ore is a metal primarily used in steel for structural engineering applications. Most of the demand in recent years has come from China in order to construct buildings and infrastructure. While iron ore's price is just one of the signals of the slowdown in China's GDP, the ore has been in the news given the severity of its demand-supply situation. With prices posting multi-year lows almost every week, and with the major producers continuing to add low-cost production there is no end in sight. It seems that major iron ore producers are even estimating how much they can mine with robots to cut costs in such an environment. In any case, the outlook seems grim:

- BHP, Rio take to mining robots to counter iron-ore bear market
 - o Sydney Morning Herald (September 11, 2015)
- The relentless bear market in iron ore
 - o Business Insider (November 18, 2015)

Iron ore is a very important commodity to Marubeni as one of its largest acquisitions is the stake in Roy Hill iron ore mine in Australia. Marubeni first invested in Roy Hill in March 2012. Since the investment, iron ore has effectively gone down in a straight line.. Iron ore was trading at US\$147/mt at date of transaction announcement and has plummeted to US\$39/mt earlier this month, a decline of 73%:

Research



	31-Dec-12	31-Dec-13	31-Dec-14	15-Dec-15
	2012	2013	2014	Current
Iron Ore Price (US\$/mt, 62% Qingdao)	146.9	134.7	71.3	39.4
YoY Decline	6.0%	(8.3%)	(47.1%)	(43.0%)

Source: Bloomberg

As commodities have traded in cycles, one might guess that another iron ore bull market may be just around the corner. Not so, say industry analysts. The consensus forecast for long-term iron ore prices has also come off significantly as commodity researchers and economists point to a new paradigm in the iron ore industry, which features continuous new supply from major producers and a weakening of demand out of China. Thus, some analysts are pegging their long-term iron ore estimates in the US\$40's \$50's and \$60's per ton. Just today GS lowered its estimates to \$40 a ton for the next 3 years.

sustaining capital and overheads) in 2015 at US\$52/t CFR China, with further declines likely in the years ahead. Compared with thermal and metallurgical coal markets, we expect iron ore prices to overshoot by a wider margin because of the bigger supply response that is required to bring the market back in balance and we downgrade our 2015E-2018E price forecasts accordingly. We also downgrade our long-term price forecast by 25% to US\$45/t to reflect a flatter industry cost curve.

- GS (April 16, 2015)

balance, and lower prices will be needed to force this outcome. Our LT price has been reduced by 17% to US\$66/t from 2018 (prev US\$80/t) reflecting what we see as the long run marginal cost of supply in an environment of low demand growth, excess logistics infrastructure & lower cost curves.

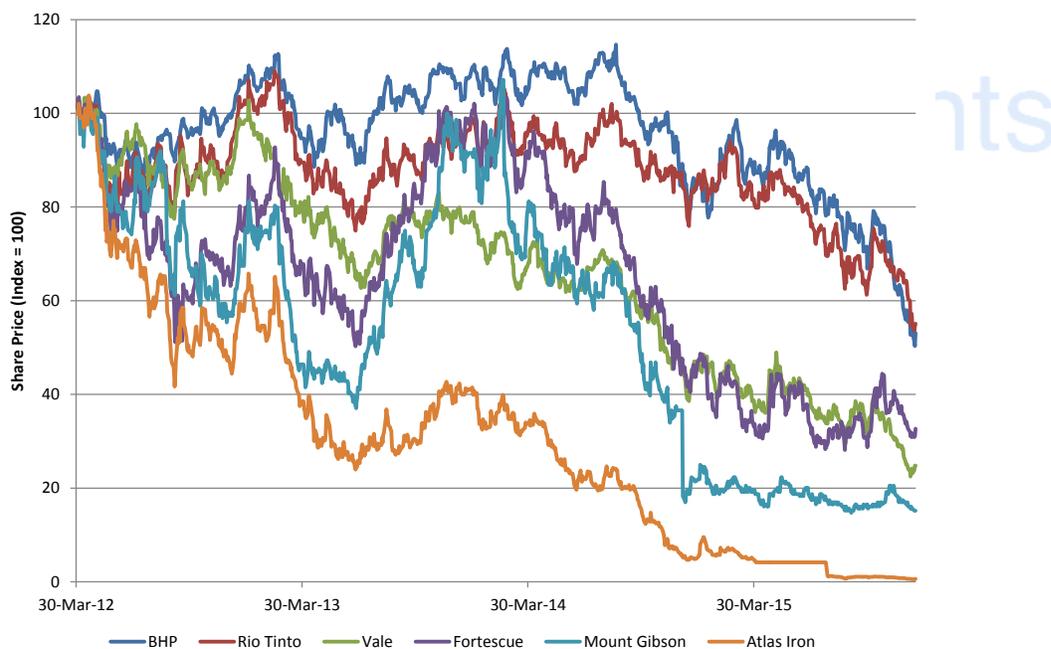
- Deutsche (July 14, 2015)

We have lowered our long term iron ore price from US\$75/t to US\$65/t after reviewing the inputs into our notional tier one greenfield projects. The key changes include: 1) material productivity gains from the miners which has led to lower opex, and 2) a reduction in the capital intensity following the down steel, energy, labour and contractor markets.

- JPM (Sept 4, 2015)

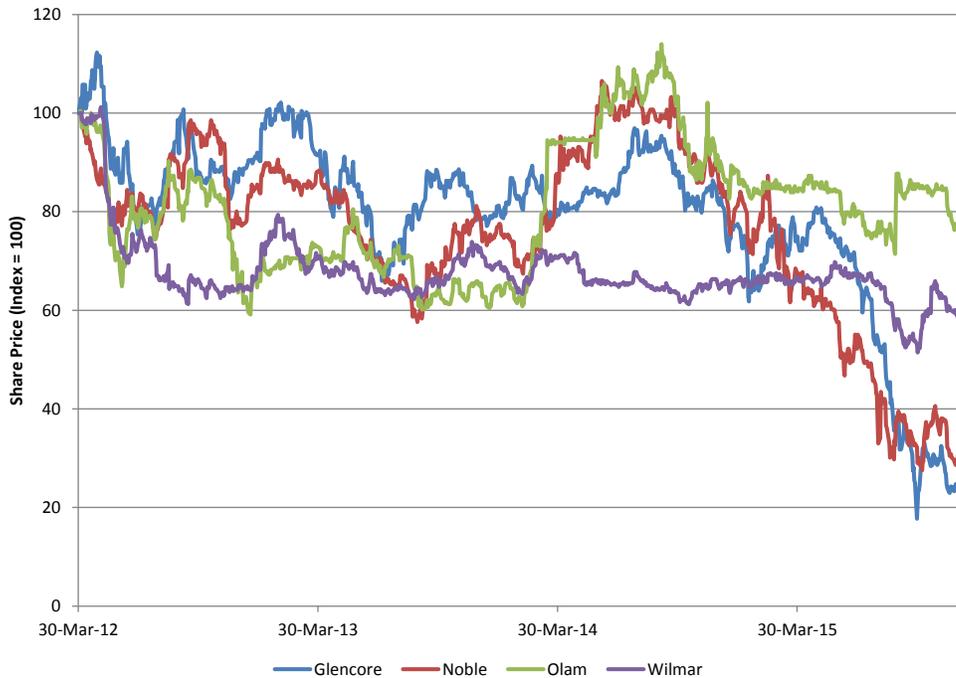
Or we can look at the SGX Iron Ore futures which are in backwardation, ie a downward sloping curve and Dec. 2018 contracts are trading at US\$34/mt

Because mining assets have long mine lives, this long-term price assumption is the most important input into any commodity asset valuation as it drives the bulk of the valuation. As such, mine values are highly sensitive to long-term price estimates. Thus, the declining iron ore price and expectation of continued declines have manifested themselves in not only poor financial results at iron ore miners, but also hurt share prices substantially as the expectation is for price weakness to continue.



Source: Bloomberg

This same pattern is exhibited in global trading companies, which have also seen earnings and margins contract, leading to declining share prices:



Source: Bloomberg

The market is sending a very clear message here: the fundamental value of commodity-related companies has fallen along with their earnings power. If the market is telling us this, why isn't Marubeni listening and marking down its resource investments appropriately?

Writedowns, the Awakening

As previously discussed, companies conduct an impairment test each year in order to determine the appropriate carrying value of various investments on the balance sheet. Though Marubeni has historically conducted this test and written down some of the smaller assets, a number of its largest investments remain either completely unimpaired or insufficiently impaired despite deteriorating fundamentals and plummeting market values. This report aims to walk through some of Marubeni's largest investments and explain what makes us believe that the impairments it's made so far do not represent full market realities and should be much greater in scale

10 Years Late to the Party: How Marubeni Got Into Iron Ore via Roy Hill

Roy Hill is an iron ore project in the Pilbara region of Western Australia that's currently being developed by Hancock Prospecting ("Hancock"). Hancock is a private mining company owned by Gina Rinehart, the daughter of an iron ore magnate. The asset⁸ is a 55 million ton per year iron ore project with access to rail and port so that it can bring the product to market. The project sits approximately 115km north of Newman, and consists of a conventional open pit, bulk mining operation from multiple production benches, a wet processing plant, 344km single line, heavy haul railway and a purpose-built dedicated two-berth iron ore port facility at Port Hedland. Roy Hill is said to have a defined mineralization of more than 2.3 billion tons of +50% Fe iron ore, of which 1.2 billion tons is +55% Fe, enough to sustain a mine life of more than 20 years. This is a very large project and is a very big investment by Hancock and its partners.

In March 2012, an Asian consortium comprised of Marubeni, POSCO and STX purchased a 25% stake in the project for A\$3.2bn of equity to meet ongoing project development costs. In addition, POSCO and STX acquired a 5% equity interest in Roy Hill as a result of a conversion of an existing perpetual note that had previously been entered into with Hancock Prospecting. All in all, Marubeni invested A\$1.5bn for 12.5% of Roy Hill. This implied an equity value of A\$12bn for 100% of the project's equity, a very lofty valuation for a development stage asset. In July 2013, Marubeni subsequently purchased STX's 2.5% stake for an undisclosed amount bringing its total investment to an estimated ¥150bn — ¥170bn. After Marubeni's equity investment, Roy Hill secured US\$7.2bn in project financing, which was provided by a number of export credit agencies and commercial banks, according to statements from the two companies. The project received substantial support from the Japan Bank for International Cooperation, Korea Eximbank, Korea Trade Insurance Corporation, Nippon Export and Investment Insurance and Export-Import Bank of the United States.

The project was scheduled to begin production in Sept 2015⁹, but the first shipment missed commissioning targets¹⁰. It took place three months later, on Dec. 10¹¹.

The consortium also secured off-take contracts in excess of 50% of the output¹² for the life of the mine. These off-take contracts are standard within the industry and are agreements to buy the iron ore of the mine at the price of an underlying benchmark price at the time of the purchase.

⁸ <https://www.royhill.com.au/overview/project-overview/>

⁹ <http://www.smh.com.au/business/mining-and-resources/gina-rineharts-roy-hill-iron-ore-mine-has-yet-to-face-its-biggest-challenge-20150528-ghc58r.html>

¹⁰ <http://www.smh.com.au/business/mining-and-resources/gina-rineharts-roy-hill-mine-suffers-delay-shipping-first-ore-20151203-glec0g.html>

¹¹ <http://www.hancockprospecting.com.au/wp-content/uploads/2015/12/Media-Statement-Roy-Hill-Celebrates-Historic-First-Shipment.pdf>

Examining press releases¹³ for off-take contracts at other projects signed with trading companies such as Glencore, Noble, and others, we see that the underlying price for the off-take is generally the benchmark 62% Fe iron ore index. To highlight, these contracts secure a buyer for the iron ore, but they do not lock in a price that's materially different from the underlying benchmark. This is important since one of the arguments that companies use to defend themselves against the need to impair an asset is the existence of long-term contracts. Marubeni does the same in its Dec. 10, 2015 press release, the Japanese language version of which states that "Japanese and other Asian steelmakers are eagerly awaiting the high-grade iron ore originating from this asset and more than 90% of the production volumes are already tied up in long-term contracts." However, if a long-term contract locked in buyers at prices that did not reflect those today, in other words at prices that didn't move with the economics of the market, that would mean clients locking themselves in for at least 20 years at a single price point. Given that iron ore prices are less than a third of where they were three years ago, Marubeni's clients would hardly be "eagerly awaiting" their ore.

So, we understand that the price of the only commodity that Roy Hill produces has plunged and that the project's off-takes and long-term contracts cannot shield it from that market reality. We know that the project has suffered delays, which can only add to costs. We know the Roy Hill investment was made at the top of the iron ore market. When it came to the impairment test for earnings in the fiscal year ended March 31, 2015, however, Marubeni opted not to impair Roy Hill at all.

In January 2015, Marubeni issued a presentation revising down its consolidated earnings forecast for the year due to the possibility of one-time losses to the sum of Y120bn. These were the reasons given:

¹² <http://www.smh.com.au/business/gina-rineharts-roy-hill-project-is-focusing-on-the-quality-of-its-iron-ore-20140924-10lcdp.html>

¹³ Sample off-take announcements:

<http://www.atlasiron.com.au/IRM/Company/ShowPage.aspx/PDFs/5049-51164198/AtlasSignsNewOfftakeAgreementsfor22MTPA>

http://www.alderonironore.com/_resources/ADVNR20140729.pdf

<https://www.sundanceresources.com.au/IRM/Company/ShowPage.aspx/PDFs/2776-46419206/AgreeFirmOfftakeAgreementwithNoble>

- ✓ *Marubeni will recognize impairment losses in several businesses at one time against the backdrop of falling resource prices, Gavilon's weak performance, etc.*
- ✓ *Consequently concerns on business environment have been completely removed and Marubeni's business foundation is to be further enhanced.*

Source: Jan 2015 Investor Presentation

The Company took impairments in several businesses citing “**the backdrop of falling resource prices**”, yet it did not impair the asset exposed to iron ore — among the weakest performing commodities in the last three years. This begs the question, why didn't Marubeni impair one of its most challenged assets?

Here is the Marubeni explanation:

< **Impairment Test for Other Resource businesses** >

- ✓ *All the projects related to natural resource businesses including the iron ore project have been reviewed and checked to confirm a possibility of impairment loss.*

Iron Ore Project (Roy Hill)
<input type="radio"/> <i>Roy Hill keeps its development & construction on schedule and will commence the production in Sep. 2015</i>
<input type="radio"/> <i>Cost competitive edge and high-quality ore (premium from lump ore) make Roy Hill a excellent project</i>



No need to recognize impairment loss

Source: Jan 2015 Investor Presentation

The problem is, neither of the reasons cited above conform to the definition of an impairment test nor are they generally satisfactory explanations. Impairments are due to be realized if the carrying amount of an asset no longer exceeds its recoverable amount. Moreover, the project did suffer delays and

production did not commence “on schedule” as advertised¹⁴ in September 2015 and shipped its first shipment earlier this month.

While Roy Hill may be a good asset that’s positioned at a decent part of the cost curve, both the “cost-competitive edge” argument and the argument of on-schedule development completely ignores some key external sources that indicate the need for an impairment, which were highlighted earlier (see p. 5) from the IAS 36.12, including declines in market values and negative changes in markets / economies. Here we turn again to the charts of iron ore prices and the shares of iron ore mining companies since Marubeni made the investment in Roy Hill. These clearly show that there have been very negative changes in the iron ore markets and this has been reflected in declining market values of iron ore mining companies.

What’s even stranger is that Marubeni is not in disagreement with the concept of the rule: that a major decline in the underlying commodity price should drive an impairment of the fundamental value of a resource asset. Reading through the notes of the company’s most recent annual financial statements, one can see that Marubeni took impairments on some of its oil & gas assets and explained this through the following:

Significant impairment losses recognised for the year ended March 31, 2015 included ¥63,164 million (\$526,367 thousand) as a result of downward revisions in estimated future cash flows due to the decline in crude oil prices and the increase in development costs for oil and gas assets in the UK North Sea, ¥18,166 million (\$151,383 thousand) as a result of downward revisions in estimated future cash flows due to the decline in crude oil prices for oil and gas assets in the U.S. Gulf of Mexico, and ¥15,999 million (\$133,325 thousand) as a result of downward revisions in estimated future cash flows due to the decline in crude oil prices for oil and gas assets in Texas in the U.S.A.. These impairment losses were reported under the Energy segment. The amount of the impairment losses was calculated using the recoverable amounts measured at value in use based on discounted future cash flows, and the total amount of the recoverable amounts was ¥128,500 million (\$1,070,833 thousand). Weighted average cost of capital used in value in use calculations ranged from 6.4% to 8.5% and reflected current market assessments of time value of money and risks specific to the assets.

Source: Marubeni 2015 annual report

In FY15, Marubeni wrote down some oil & gas assets “as a result of downward revisions in estimated future cash flows due to the decline in crude oil prices”. Over FY15, Brent oil declined from US\$108/bbl to US\$55/bbl — a decline of 49%. Over the same period, iron ore declined from US\$117/mt to US\$51/mt — a 56% drop. If Marubeni wrote down some of its oil & gas assets due to downward revisions in estimated future cash flows sparked by a decline in oil prices, shouldn’t they have written down Roy Hill on the same basis? Iron ore fell even more than oil. How could Roy Hill not suffer any downward revision in estimated future cash flow? Marubeni’s logic in writing down some of its oil & gas assets appears to be sound. The company does not, however, consistently apply it to other assets

¹⁴ <http://www.smh.com.au/business/mining-and-resources/gina-rineharts-roy-hill-iron-ore-mine-has-yet-to-face-its-biggest-challenge-20150528-ghc58r.html>

including Roy Hill. Which, coincidentally, happens to be one of its largest investments in the last 5 years.

One improbable theory would be to say that Roy Hill, at the time of Marubeni's investment, assumed iron ore prices would drop to where they are today (US\$39/mt). A note by UBS from the time of the investment, however, shows that Marubeni's iron ore price assumption back then was \$110/tonne.

According to the company, its iron ore price assumption is around \$110/tonne (Australia FOB, 62% grade) and even considering the impact from the resource taxes (details such as book value accounting are not disclosed), it appears that a contribution to net profit of around ¥10bn (including off take earnings) can be expected in FY16 when full-scale production is under way. Profits are scheduled to be treated as equity method gains and losses.

Source: UBS report on RH acquisition (April 2, 2012)

Another improbable theory is that they have to wait until production starts to know what extraction costs are and hence where to mark the asset. That also does not hold water. IFRS demands a true and fair representation of the assets on a yearly basis. In any event production has now started and thus even this fig leaf would no longer be available to the company.

Thus, iron ore prices dropped below expectations and so did the future cash flow estimates. It seems clear Marubeni should have booked some impairment losses at Roy Hill. The question now is how big should the impairment those impairments be and when should they have taken place?

There are a number of ways that any reasonable market participant would value an asset like Roy Hill. All of these methodologies point to the same conclusion: the carrying value of Roy Hill on Marubeni's balance sheet is beyond excessive. Not only is the carrying value incredibly high based on today's market conditions, it was also high for the market conditions on March 31, 2015 — the end of Marubeni's last fiscal year and the time of the last major impairment test. Which suggests that Marubeni overlooked the accounting rules that specify what merits as an impairment and presented an audited set of financial statements that do not accurately reflect the economic nature of its business. In other words, it misled investors.

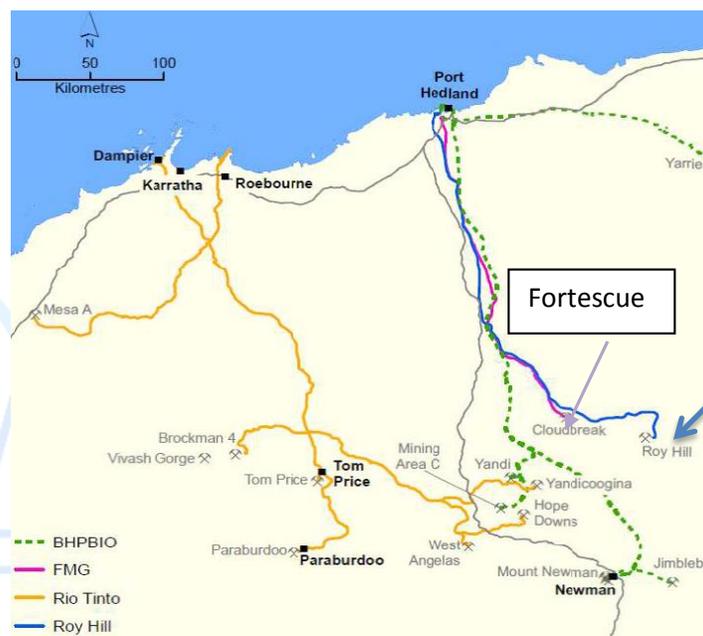
We ran Roy Hill through various standard asset valuation models and here are our findings:

Methodology	Valuation (Today)	Valuation (at time of last impairment test 31 March, 2015)
Marubeni's value of Roy Hill	¥150bn – ¥170bn	¥150bn – ¥170bn
1. Fortescue Comparison	nil	nil
2. Discounted Cash Flow	¥70bn – ¥100bn	¥85bn – ¥115bn
3. Multiples	¥40bn – ¥60bn	¥50bn – ¥70bn
Average	¥35bn – ¥55bn	¥40bn – ¥60bn



1. Roy Hill Compared with Fortescue

Fortescue is the world's fourth-largest producer of iron ore. Its assets are also located in the Pilbara, where it operates the Chichester and Solomon hubs. Beyond its iron ore assets, Fortescue also owns and operates its own rail and port infrastructure and thus, similar to Roy Hill, is a fully integrated iron ore producer. Roy Hill is in Fortescue's backyard, with their rail lines overlapping quite significantly, as demonstrated by the map below:



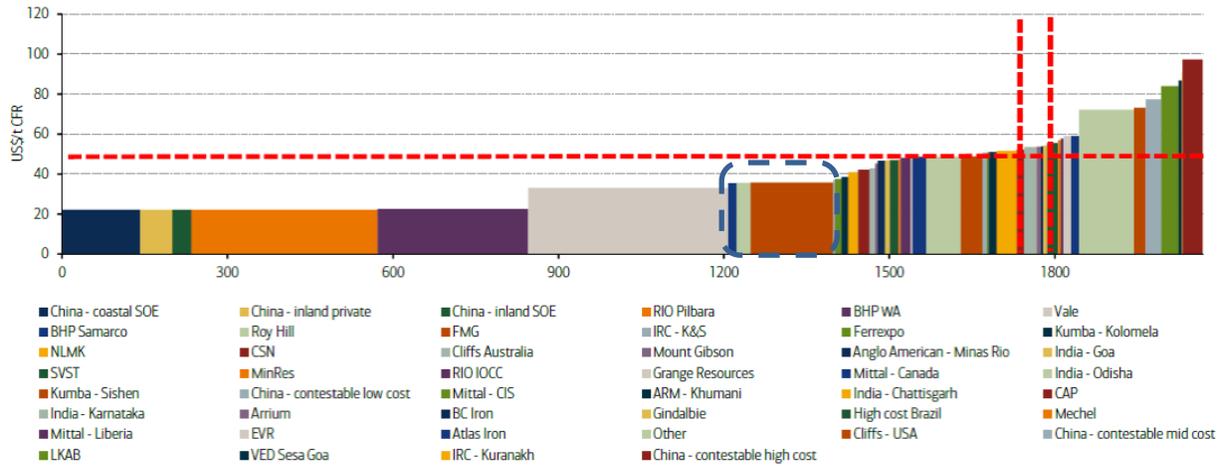
Source: Pilbara port authority document

Today, Fortescue produces 165Mt of iron ore per annum. While negatively affected by iron ore prices, Fortescue has been able to bring its cash costs down materially, with realized C1 (net direct) cash costs of US\$27/mt in FY15 and guidance towards even lower cash costs of US\$18/mt in Q1 FY16 (for a break-even cost of US\$39/mt)¹⁵. Based on Fortescue's forecasts of a delivered cost to China of US\$25/mt, it appears the per ton economics of Fortescue are similar to those of Roy Hill (at its run-rate production). This can be corroborated through research analyst reports, which provide an estimate of costs generally ranging between US\$20 and US\$25/mt for Roy Hill¹⁶. We have seen Fortescue and Roy Hill sit next to

¹⁵ Source: Fortescue 2015 IP, <http://www.bloomberg.com/news/articles/2015-10-14/fortescue-says-first-quarter-iron-ore-cash-costs-drop-24->

¹⁶ BaML, Mizuho research reports

each other on analyst forecasts for iron ore cost curves. If they're able to realize similar pricing for their product then one could assume that the unit economics of the projects looks similar. Marubeni's management further corroborate this by indicating at their Nov. results briefing that projected cash costs had fallen to around US\$20/t¹⁷.



Source: BofA Merrill Lynch Global Research estimates

Source: BaML research report

As such, given the similarity of exposures and economics, we believe Fortescue represents a very good comparable with Roy Hill. We believe the most appropriate valuation methodology for two assets with similar economics and extended mine lives is on an EV / production basis which effectively gauges how much the market is paying for each ton of iron ore produced a year. Fortescue is triple the size of Roy Hill in terms of production capability and is currently producing and generating cash flow, and yet the market has assigned Fortescue a total value that is lower than what Marubeni tells investors Roy Hill is worth:

¹⁷ Nomura research report from Nov. 11, 2015; analyst Yasuhiro Narita

		FY15	Today
FMG EV	US\$M	11,638	10,965
Production	Mt	160.0	165.0
EV / tonne	US\$/t	72.7	66.5
Roy Hill Production	Mt	55.0	55.0
Roy Hill Implied EV	US\$M	4,001	3,655
Roy Hill Debt	US\$M	7,200	7,200
Roy Hill Implied Equity Value	US\$M	(3,199)	(3,545)

Source: FMG EV as per Bloomberg

We should add at this point that this analysis is actually highly favorable to Roy Hill because it assumes that Roy Hill is also a fully ramped production facility, when in reality it has yet to get there. And will likely be subject to a potentially lengthy ramp-up period, given the size of the asset. Despite all this, the market is valuing Fortescue at a multiple that would imply Roy Hill has no remaining equity value. Zero.

It's clear that the market is valuing iron ore assets differently now than when Marubeni first purchased Roy Hill. The enterprise value of Fortescue has effectively been on a straight line downwards over the period despite bringing production up from 65Mt to 165Mt and bringing down C1 cash costs from US\$48/mt to US\$27/mt. Even though Fortescue has maintained its production schedule (in a similar way that Marubeni said that Roy Hill is "meeting its construction schedule") and has halved its costs, the market has still taken a view that the fundamental value of this asset has dropped by half. (Incidentally, Roy Hill has only said that it would be able to bring down their original cash costs, without specifying by how much.)



Source: Bloomberg

Since Marubeni has not taken any impairments on its Roy Hill investment so far, we can calculate that: An initial purchase of 12.5% of the equity for A\$1.5bn implied a total equity value of A\$12bn. At today's exchange rate, this would imply a total enterprise value of US\$16bn for Roy Hill (AUD\$12B implied equity value plus US\$7.2B of debt). Would any market participant pay US\$16B for this asset today when they could purchase all of Fortescue for 70% of this amount — and get triple the production to boot?

The analysis begs the conclusion that Marubeni has intentionally kept the mark on its Roy Hill investment elevated. The DCF / multiples based approach corroborates this thesis.

Discounted Cash Flow

Many analysts value mining assets using a discounted cash flow model of a project's reserve / resource base. This is effectively an analysis that projects all of an asset's future cash flows and then discounts them back to get the value today. This is done by compiling a number of estimates including commodity prices, operating costs and capital expenditure requirements in order to build a forecast of an asset's ability to generate cash flow over the life of its reserve / resource base. Though Roy Hill is a private company, there are sufficient data points in the market in order to build a discounted cash flow model. The result gives us a value that is again far below what Marubeni marks it at.

We used various data points provided by industry analysts to produce what, we believe, is a realistic picture of how a reasonable market participant would value the asset. Here are our assumptions:

DCF Assumptions:			Source
Long-term Iron Ore Price (62% Qingdao)	US\$/t	65	Analyst consensus estimates – GS says \$40-45.
Premium / (Discount)	US\$/t	(3.0)	Historical average is for (\$3.5) per 1% discount b/c of quality
Shipping	US\$/t	5.0	http://www.abc.net.au/news/2015-06-02/shipping-rate-plunge-australia-exporters/6513624
Cash Costs guiding	US\$/t	22.8	Analyst "A" Research Reports, Analyst "B" report cites mgmt or US\$20; Analyst "C" puts it at US\$20-\$24
Maintenance CapEx	US\$/t	5.0	Analyst Research Report
Ramp-Up Period	Years	2.0	Estimate of industry professionals
FX	AUD/USD	0.70	Spot, Bloomberg
Discount Rate	%	10%	BHP WACC 9.4%, Rio Tinto 9.2%, FMG WACC approx. 9% adjusting for current debt trading levels

We believe these assumptions are reasonable with the key drivers being the long-term iron ore price (analyst consensus currently sits at \$65/mt) (SGX 3 year futures are at \$34/mt today) and cash costs (we're effectively taking management guidance that's corroborated by analysts covering the company). Based on these assumptions, a discounted cash flow analysis implies an enterprise value of between US\$11bn and \$13bn, implying an equity value of Y70bn to Y100bn for Marubeni's stake. That's a steep drop from what Marubeni paid for the equity in the first place.

The next logical question to ask would be: Was this discounted cash flow valuation materially different on March 31, 2015 (i.e. during Marubeni's last impairment test)? At this point, the iron ore price was already \$55/mt and long-term analyst expectations were already coming down with estimates generally in the range of \$70 - \$75/mt¹⁸. The 3 year futures on the SGX at the time were trading at \$49/mt. Cost estimates would likely have been slightly higher and the AUD forward curve was then stronger. Beyond this, the assumptions would have been largely the same. Thus, we can say that the discounted cash flow analysis done at the time of the impairment test would have produced a similar conclusion to the one we have today.

Multiples

The last approach one could use to value Roy Hill would be to apply an EBITDA multiple to Roy Hill's normalized EBITDA at run-rate production. This is often a short-cut, a convenient methodology that an analyst will use to calculate a back-of-the-envelope valuation for an asset or company. The multiples used for this methodology are, generally, the average Enterprise Value / EBITDA of a company's peer group. As per the assumptions highlighted above, at 55mt of annual iron ore production and with a long-term price assumption of \$65, as well as an all-in cash cost of US\$28/t (incl. shipping costs), we estimate that the asset could generate annual EBITDA of approximately \$1.9bn.

We believe that the EV / EBITDA multiple of iron ore comparables is the appropriate valuation metric because it provides a decent indication of where iron ore companies trade at today. Thus an analyst could come to an estimate of Roy Hill's value based on the earnings multiples of its peers / comparable companies. Again, we provide the figures for the end of fiscal year at Marubeni (March 31, 2015) and for today.

		EV / EBITDA Mult.	
		FY15	Today
BHP		5.7x	5.6x
Rio Tinto		6.0x	5.6x
Vale		6.9x	7.1x
FMG		3.1x	4.6x
Average		5.4x	5.7x
EBITDA	US\$M	1,881	1,881
Implied Roy Hill EV	US\$M	10,211	10,782
Roy Hill Debt	US\$M	7,200	7,200
Implied Roy Hill Equity Value	US\$M	3,011	3,582
Implied Marubeni Stake	JPY	55	66

¹⁸ Source: industry analyst research reports

Roy Hill's closest competitors' trade at 5-6x EBITDA. Applying these multiples to what Roy Hill could earn on a normalized basis in the future implies a value for Marubeni's stake in Roy Hill of Y40bn to Y60bn. Similarly, a valuation analysis completed at the time of Marubeni's last impairment test would have resulted in a similar valuation (Y50bn to Y70bn). So, not only do the numbers indicate a need for a large impairment today, they show that Marubeni should have been taken the writedown at the end of its last fiscal year.

On top of this, let's not forget that the peers we chose are highly flattering for Roy Hill as Rio Tinto / BHP / Vale are all highly diversified mining companies, holding some of the top tier assets in the world and producing at scale in each one. If Roy Hill was a publicly traded company, it would likely trade at a lower multiple than those comparables and likely closer to Fortescue's multiples.

What's even more amazing about these estimates is that they are all based on the assumption of a strong recovery in iron ore prices, as industry analysts estimate. While we don't have a crystal ball on future iron ore prices, if they don't recover from the current US\$39/mt, no standard valuation methodology would be able to show that Roy Hill has any equity value.

For example, were we to use in our valuation models the SGX Iron Ore Futures pricing – which has iron ore trading at \$34.13 a metric ton in Dec. 2018 – then the equity value of Roy Hill is easily zero and the writedown from this asset alone amounts to Y150bn to Y170bn.

SCOF6 COMB Comdty		1) Actions		2) Settings			Future		
SGX Iron Ore 62%		As of 12/16/15		Session COMB		First			
7) SGX CEM »		Contracts 40		Aggr Vol 635		Aggr Open Int 584,035		Leng	
4) Futures		5) Spreads							
Display		Quoted Val		Yield					
Description	Last Chg	Settle	Time	Bid	Ask	Open Int	Volume	Yest	Settle
37) Apr17		--	12/15			5303			34.28
38) May17		--	12/15			5303			34.28
39) Jun17		--	12/15			5303			34.28
40) Jul17		--	12/15			5293			34.23
41) Aug17		--	12/15			5293			34.23
42) Sep17		--	12/15			5293			34.23
43) Oct17		--	12/15			5258			34.18
44) Nov17		--	12/15			5258			34.18
45) Dec17		--	12/15			5258			34.18
46) Jan18		--	12/15			1000			34.13
47) Feb18		--	12/15			1000			34.13
48) Mar18		--	12/15			1000			34.13
49) Apr18		--	12/15			1050			34.13
50) May18		--	12/15			1050			34.13
51) Jun18		--	12/15			1050			34.13
52) Jul18		--	12/15			1085			34.13
53) Aug18		--	12/15			1085			34.13
54) Sep18		--	12/15			1085			34.13
55) Oct18		--	12/15			940			34.13
56) Nov18		--	12/15			940			34.13
57) Dec18		--	12/15			940			34.13

It is painfully obvious that Marubeni should have written down Roy Hill a long time ago and that the impairment is simply inevitable. But, don't just take our word for it:

GTC Weekly #16: Roy Hill Iron Ore Mine Up and Running, and You Should Be, Too!

Key Takeaway

The Roy Hill iron ore mine, the "largest ever project financing for the development of a land-based mining project worldwide" is up and running and is about to start exporting lower grade ore from Oct. With prices hovering at seven year lows, we think that the equity value is zero and impairments are just question of when. Also, Marubeni is on the hook for the next 10 years with off-take contracts.

Jefferies - Oct 15, 2015



Gavilon: Prepare for a Feast (of Impairments)

Gavilon is a commodity management firm based in Omaha, Nebraska that was focused on agriculture and energy. Gavilon's agriculture business consisted of (i) grain and ingredients – the origination, storage and distribution of grains, oilseeds, feed and food ingredients and (ii) fertilizers. According to the company, grain storage capacity of roughly 9Mt makes it the second-largest grain merchandiser in the U.S.¹⁹ Gavilon was previously owned by hedge fund and private equity investors (Ospraie, General Atlantic, Soros Fund Management and a unit of Egypt's Orascom Construction Industries).

In a deal first announced in May 2012, Marubeni agreed to pay \$3.6bn and take over \$2bn of Gavilon's debt to complete its biggest-ever acquisition²⁰. This was more than double what the previous owners led by Ospraie paid for the asset four years earlier²¹. It was also 8%²² higher than the reported price tag just three weeks before the deal was announced. At the time, Mitsubishi was also said to be interested in acquiring Gavilon²³. This may have contributed to Marubeni's raising their bid at the final moment to clinch the deal.

A year later, with the deal waiting for regulatory approval, Marubeni managed to renegotiate the purchase to cut out the energy business and drop the equity price tag. The Japanese firm finally acquired Gavilon's agriculture and chemicals assets for US\$2.7bn (page 134 of 2014 Marubeni AR) in equity value and assumed US\$1.1bn in debt (page 135 of 2014 Marubeni AR).

So, did the deal re-negotiation help Marubeni land a bargain? Marubeni paid a value far in excess of book value and booked ¥125bn in goodwill alone²⁴. Goodwill in accounting is an intangible asset that arises when a buyer acquires an existing business in excess of the book value of its net assets. And yet, at an equity value of US\$2.7bn or ¥274 bn, Marubeni actually paid 38x what they eventually earned a year forward from the asset on a net income basis. So, for every dollar Marubeni paid, the company got 2.63 cents in net income. To put that into perspective, had Marubeni put the money into a 30-year U.S. Treasury paper, they would have earned a greater return²⁵. Clearly, Marubeni overpaid.

Since the acquisition, Gavilon's business has performed extremely poorly and is performing well below Marubeni's own expectations:

¹⁹ <http://www.gavilon.com/services/marketing-distribution>

²⁰ <http://www.bloomberg.com/news/articles/2012-05-29/marubeni-climbs-on-speculation-it-s-agreed-to-buy-gavilon>

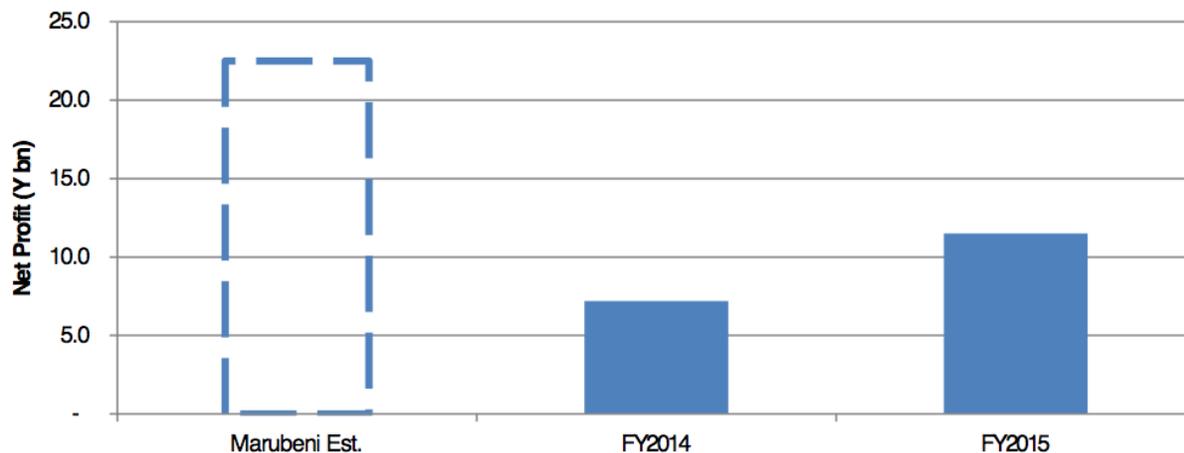
²¹ <http://www.reuters.com/article/us-gavilon-idUSBRE84S0A720120529>

²² <http://uk.reuters.com/article/us-gavilon-idUKBRE84704320120508>

²³ <http://www.bloomberg.com/news/articles/2012-04-26/mitsubishi-said-to-consider-bid-for-gavilon-to-gain-u-s-grain>

²⁴ All financial metrics sourced from 2014 Marubeni annual report

²⁵ <http://www.multip.com/30-year-treasury-rate/>



Source: Company financials, page 18 of Marubeni FY15 annual presentation²⁶

The business has underperformed for a number of reasons, however, one key rationale that drove the purchase of the business was a desire to supply China's burgeoning import market. Daisuke Okada, head of Marubeni's food division, was the face of the transaction and consistently quoted by the press including this quote explaining the deal rationale: "We believe North America will be the supplier of Chinese grain demand, so that is what we are most attracted to in Gavilon."²⁷ He was also quoted as saying Gavilon would be positioned to supply China's demands if shortages arise²⁸.

Nearly a year after the transaction was announced and before it had closed, Marubeni received approval from China on the Gavilon takeover²⁹. As part of the approval, the go-ahead was given on the basis that Marubeni and Gavilon continue to operate separate soybean sales units in China so as not to limit industry competition³⁰. This also included a ban on Marubeni's U.S. units from buying soybeans from Gavilon in principle, prohibiting the two from exchanging data on soybeans³¹. So much for deal synergies.

²⁶ Guidance for Gavilon as per <http://www.wsj.com/articles/marubeni-to-sow-further-investment-in-grain-trader-gavilon-1437465897>

²⁷ <http://www.ft.com/intl/cms/s/0/2c9d8f5e-a984-11e1-9772-00144feabdc0.html#axzz3tbhtxYkn>

²⁸ <http://www.wsj.com/articles/SB10001424052702303807404577433622017227912>

²⁹

<http://english.mofcom.gov.cn/article/counselorsreport/asiareport/201304/20130400103388.shtml>

³⁰ <http://www.bloomberg.com/news/articles/2013-04-24/marubeni-wins-china-approval-for-3-6-billion-gavilon-takeover>

³¹ <http://www.japantimes.co.jp/news/2013/04/26/business/corporate-business/china-slaps-conditions-on-marubenis-gavilon-deal/#.VmVMHXrJpg>

Additional press reports in 2014 indicated additional struggles in China for Marubeni such as: the emergence of COFCO³², a Chinese state-owned trader intent on building its own trading house, defaults from Chinese buyers caused by weaker underwriting standards, as well as the detainment of employees at Marubeni's Chinese unit Columbia Grain Trading³³. All in all, this was how one Japanese trading house analyst summarized the Gavilon purchase: "I can't say this is a really, really bad deal, but it will take them some time to get their money back"³².

Despite all of this, Marubeni is said to be looking to increase its investment in Gavilon in an attempt to turn around the division's disappointing performance³⁴. But, does this sound like a business that is performing well and that deserves a carrying value in excess of its book value? We do not believe that it does and research analysts covering the stock agree:

Marubeni's other grain-related assets. Questions remain regarding Marubeni's process for establishing corporate value at the time of the acquisition. Notably, Marubeni said in a briefing immediately after announcing the acquisition (May 2012) that it expected synergies to generate gross profit of only \$30mn/year. The firm acquired Gavilon for a total of \$2.7bn, which included \$1.8bn for goodwill and other intangible assets (\$1.1bn goodwill, \$700mn other intangible assets). It seems to have written down the value of the goodwill and other intangible assets by ¥50bn. The goodwill and other intangible assets could still be overpriced if Gavilon's sustainable profit after tax is ¥10bn or less.

- Daiwa (Jan 2015)

Marubeni itself recognizes that this business has performed extremely poorly. The company has begun to writedown some of the goodwill initially booked with the purchase. In FY15, it wrote it down by ¥50bn. We believe this was insufficient. Gavilon's earnings have fallen off a cliff — we believe by at least 50% (as per analyst estimates below) — and the performance at Gavilon is not improving: Gavilon's performance in the first half of this fiscal year has been flat relative to last year. There doesn't seem to be light at the end of the tunnel.

In terms of valuation, what further compounds these company specific issues is the decline in the multiples for the broader agriculture trading industry. Though there aren't any perfect comparables for Gavilon, our research indicates that Archer Daniels Midlands ("ADM") and Bunge represent the closest publicly traded peers. The valuations of these companies has contracted since Marubeni closed the acquisition.

³² <http://www.scmp.com/business/companies/article/1448930/cofcos-grain-deals-threaten-undermine-marubenis-china-dreams>

³³ <http://www.reuters.com/article/us-marubeni-china-insight-idUSBREA4A0AQ20140511#6yQ63CMH7ImWzoDE.97>

³⁴ <http://www.wsj.com/articles/marubeni-to-sow-further-investment-in-grain-trader-gavilon-1437465897>



Source: Bloomberg

Though it's unclear exactly how much the asset should be impaired, as Marubeni's disclosure on Gavilon is poor, we have been able to piece together a picture of how the asset has performed since Marubeni took over. The picture is rather bleak.

As Marubeni closed in on the acquisition, Citi³⁵ estimated that Gavilon's net profit was generally around US\$300mn with energy accounting for at most 20% of that. This would imply a net profit of US\$240mn (in today's terms, approximately ¥30bn in net profit) versus the most recent annual profit Gavilon posted: ¥11.5bn. We believe earnings since Marubeni purchased the asset have likely declined by at least 50%. Ironically, according to a note by JPMorgan published on May 30, 2012, Marubeni management explained the acquisition by describing "the core grain business model as characteristically stable, with little volatility in earnings". Characterizing the soft commodities business as stable and lacking in volatility flies in the face of decades of evidence showing the industry as one defined by its cyclicity. The business has exhibited anything but stable earnings. This calls into question the depth of knowledge of the space by Marubeni at the time of the acquisition and hence the wisdom of their decision at the time.

So, what would be a fair impairment? Analysts name Marubeni's estimated investment exposure to

³⁵ Citigroup June 10, 2013 research report

Gavilon as between ¥250bn and ¥275bn (as per Mizuho / Daiwa research reports published in Oct 2015). The business has seen earnings slide by at least 50% and multiples in the U.S. grain industry have contracted. We believe that an additional impairment of at least ¥75bn to ¥100bn would therefore be appropriate.

Perhaps most telling of all is that Daisuke Okada, who was a managing executive officer, the face of the transaction and head of the Marubeni's Foods division, resigned as a director in April 2014 once it became clear what a disaster Gavilon had turned out to be. Someone whose name and picture was so prominently displayed in the company's annual report in 2013 is nowhere to be found in the 2015 edition³⁶.

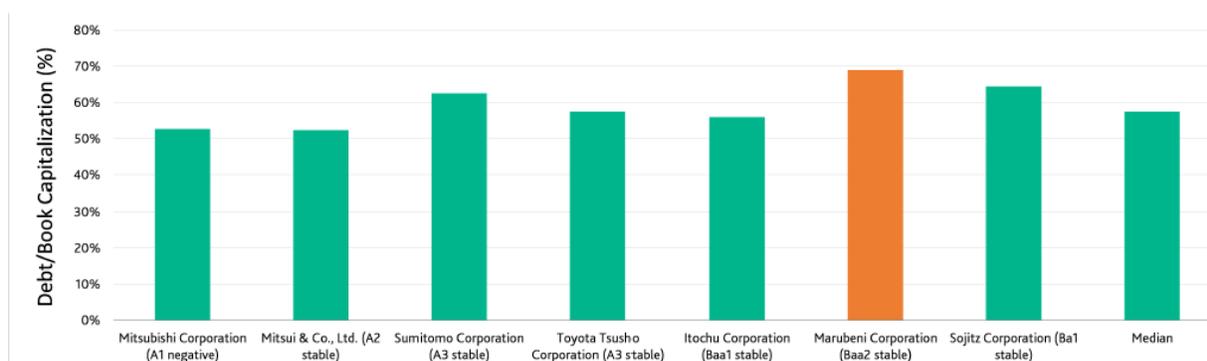


³⁶ https://www.marubeni.com/ir/reports/business_report/data/B_90_shoshu2_reference_en.pdf

Marubeni Is Top of Its Class: In Terms of Debt

Marubeni exhibits the highest leverage amongst Japanese trading companies. At 12.8x debt / LTM EBITDA and with a 69% debt / book capitalization, and 75% debt / pro-forma book capitalization the company is highly levered. Had Marubeni taken impairments as we believe it should have, the debt to capitalization ratio would be much higher. Instead, in maintaining inflated carrying values Marubeni has preserved its credit ratios, maintained its investment grade rating (Baa2/BBB) and continued to raise low cost debt.

Marubeni's Debt/Book Capitalization Is Highest of Rated Japanese Trading Companies
Debt/book capitalization ratios for fiscal 2014



Sources: Companies, Moody's

Source: August 24, 2015 S&P Methodology for Rating General Trading and Investment Companies

Not booking impairment losses and keeping inflated carrying value on assets is particularly important to Japanese trading companies because rating agencies focus on a the sector's capital adequacy as opposed to cash flow adequacy:

Through the capital adequacy assessment, we measure the amount of capital that a general trading and investment company needs to absorb losses from disparate risks over defined stress scenarios. The methodology for assessing the financial risk profile differs from that covering other industrial companies in that it focuses on a company's capital adequacy rather than on cash flow adequacy. We do this for the following reasons:

We believe general trading and investment companies' cash flow cannot be well captured by looking at funds from operations (FFO) or EBITDA. Unlike other industrial companies, general trading and investment companies have significant cash inflows or outflows from investment activities, in addition to cash flows from operations. Even if their FFO and/or EBITDA decreases, general trading and investment companies may still be able to manage cash needs by reducing new investments and/or monetizing existing investments. In defaults of Japanese general trading and investment companies in the late 1990s and early 2000s, we observed that the default trigger was generally losses from investment businesses, not a decline in operating cash flow. A key default trigger was significant equity erosion from investments reported as nonrecurring losses, not losses from trading. In fact, most companies maintained positive FFO shortly before defaulting. Therefore, their operating cash flow parameters were not a good leading indicator of default, in our view.

Source: June 10, 2015 S&P Methodology for Rating General Trading and Investment Companies

Part of the Japanese trading companies' competitive advantage is their scale and ability to secure cheap financing. It's clear that they're incentivized to keep their carrying values inflated in order to preserve their credit rating. The continuous cycle of borrowing cheaply, investing inopportunistically, writing down value and then returning to borrow some more seems to be a hallmark of Marubeni.

In some ways, trading companies have moved away from their core trading functions towards investments because the nature of the original business is volatile and margins are thin. When the mistakes on the investment front filter through to Marubeni's core trading, however, the company could face material losses. After all, Marubeni's average net income margin over the last 5 years has been only 1.5%.

Given the potential risks, we believe rating agencies need to take a more critical look at the book value of Marubeni's assets, especially because of its track record of bad investments and late impairments. It is these book equity values that drive the credit ratios that determine a company's credit ratings, and in the end an investor's desire to invest / lend.

The spotlight may be already turning. Standard & Poor's has put its credit outlook on Marubeni's debt to "Negative" and Moody's lowered their outlook from positive to stable.



Marubeni's Little Helper: Introducing the "Buffer"

One thing the credit agencies – and financial regulators – may want to scrutinize more closely with Marubeni is a curious accounting technique. Embedded in Marubeni's earnings guidance in FY16 is a ¥20bn "buffer". What does this buffer do? Well, it makes sure that in times of trouble Marubeni can cover potential shortfalls or losses with the "buffer" and prevent any chance of missing its profit guidance. Sounds wonderful! If only every company was doing this.... Except they are not. A publicly traded company has an obligation to declare its true financial condition. Clouding the numbers with an inexplicable accounting technique shows yet again how Marubeni manages its earnings more than the business.

Below are some examples of analysts trying to explain Marubeni's management forecasts and the impact of the "buffer":

billion is below the consensus estimate of ¥205 billion, but we see no need to be pessimistic, as it appears to reflect a conservative loss buffer and would otherwise be ¥200 billion, close to the consensus estimate.

- JPMorgan (May 9, 2015)

For FY15, Marubeni projects a 70% y/y rise in net income to ¥180bn. The target apparently incorporates a buffer of around ¥20bn. When the firm announced impairment losses in

- Daiwa (June 1, 2015)

assumed. The company also noted that it aims to raise the normal level of cash flow from operating activities to ¥300b as soon as possible. Management stated that its FY3/16 NP guidance of ¥180b factors in a roughly ¥20b buffer.

- Mizuho (May 12, 2015)

Our Valuation Thesis

Based on the above research, we believe there is material downside to Marubeni's share price. Our target price for Marubeni is Y390 or a 40% downside from today's market price. We apply a 0.5x price / book multiple to an adjusted book value of Y780/share (which includes Y175bn of potential impairments to the Company's stated book value).

We believe the market is missing both the severity of the Marubeni's accounting issues as well as the embedded leverage within the Company. Amongst the trading companies, Marubeni exhibits the highest leverage and some of the most problematic investments yet it trades at a premium to all but one of its Japanese trading company peers. We do not think this makes sense.

	Japanese Trading Companies				
	Marubeni	Itochu	Mitsubishi	Mitsui	Sumitomo
Debt / LTM EBITDA	12.8x	10.5x	16.2x	9.9x	17.5x
Debt / LTM FCF	1572.1x	12.6x	14.1x	21.2x	19.2x
Debt / Book Capitalization	69.3%	58.8%	51.5%	51.9%	62.2%
Debt / Book (Pro Forma Impairments)	71.8%				
Price / Book	0.74x	0.93x	0.60x	0.66x	0.64x

Given the issues Marubeni faces with its history of bad investments and high leverage ratios, we believe the Company should trade at a ~20% discount to peers such as Mitsubishi, Sumitomo and Mitsui. The company has both on an absolute Yen invested as well as a percentage of book value basis the company has been the worst investor of the large trading companies. On an absolute value basis, Marubeni has spent over Y1.6 trillion on investments and capital expenditures and to date has less earnings and cash flow than it did 5 years ago.

<i>In Y Billions</i>	FY11	FY12	FY13	FY14	FY15	Cumulative
CF into Investments	128	257	193	707	331	1,616
Operating CF	210	128	240	291	171	1,040
Net Income	137	172	206	211	106	832

Over this time period there were investments of over US\$2.5 billion in a number of natural resource assets that nearly immediately became "zeros," including:

- i) 40% stake in Grande Cache Coal, a C\$1bn acquisition (on a 100% basis) made in Nov 2011 of coal assets in Canada³⁷
- ii) 35% stake in shale assets from Hunt Oil, in a \$1.3bn deal (including future drilling costs) made in Jan 2012³⁸
- iii) 30% stake in the Niobrara shale from Marathon Oil, in a US\$270mn deal made in April 2011³⁹

The end result of these investments was the sale of Marubeni's stake in Grande Cache for US\$1 and partial writedowns at Eagle Ford and a full writedown of Niobrara⁴⁰. These were investments made only a few years ago. **It isn't easy to lose this much money in such a short period of time!** What this shows is a record of extremely poor investments followed by the destruction of shareholder equity.

Dude, Where's My Return?

We believe the Company has also underperformed on a relative basis. Marubeni's ability to destroy shareholder value is further highlighted when analyzing the failure of its Y1.6 trillion of investments from FY11 to FY15 to generate any meaningful increase in operating cash flow ("OCF"), particularly when compared to its peers. As per the table below, Marubeni is the only trading company that has seen no meaningful increase in its average OCF for the period FY11 to FY15 compared to the average in the period from FY00 to FY10, despite all the massive investment it has made. Its peers on the other hand have generated average OCF increases of between 59% to 102% from period to period, with two of the trading companies spending 13% to 17% less. Marubeni should be trading at a significant discount to its peers in light of the value destruction it has conducted.

³⁷ <http://www.bloomberg.com/news/articles/2011-10-31/marubeni-winsway-to-buy-coking-coal-producer-grande-cache-for-1-billion> and <http://business.financialpost.com/news/mining/1-billion-canadian-coal-mine-was-just-sold-for-a-buck-amid-plunging-demand-and-prices>

³⁸ <http://www.bloomberg.com/news/articles/2012-01-06/marubeni-to-buy-35-stake-in-u-s-shale-in-1-3-billion-deal>

³⁹ <http://ir.marathonoil.com/releasedetail.cfm?ReleaseID=651815>

⁴⁰ UBS research report Feb 7, 2014

	Marubeni	Itochu	Mitsubishi	Mitsui	Sumitomo
<i>Y billion, unless otherwise indicated</i>					
Average OCF FY00 to FY10	207,057	194,613	296,045	240,526	152,612
Average OCF FY11 to FY15	207,991	323,589	503,013	485,999	242,431
Incremental average increase	934	128,976	206,968	245,473	89,819
Increase in Avg OCF	0%	66%	70%	102%	59%
Investing cash outflow FY11 to FY15	1,616,595	1,397,026	2,609,894	2,722,960	1,340,715
Incremental cash flow as % of investing cash flow	0.1%	9.2%	7.9%	9.0%	6.7%

As such, we believe Marubeni's should trade at a P/B multiple of ~0.5x adjusted book and hence our price target of ¥390. This target P/B multiple would be a 15% discount to Mitsubishi, the leading Japanese commodity trading company. Mitsubishi, Mitsui and Sumitomo currently trading at between 0.6x and 0.66x book (with Mitsubishi trading the lowest at 0.6x).

Another data point to keep in mind is the discount the market allocates when there are concerns with disclosure. Hong Kong-based Noble Group has faced issues with transparency regarding its accounting disclosures this year. Last year Glencore faced accusations that it lacks transparency and fails to match U.K. accounting rules. Glencore and Noble currently trade at a far larger discount to book (0.35x and 0.40x book respectively) despite carrying far less leverage than Marubeni does across all leverage metrics (versus EBITDA, cash flow and book capitalization). This is particularly important as both Glencore and Noble have seen their share prices drop by 72% and 63% year-to-date due to the market's increasing concerns over their leverage in addition to the issues of transparency. And yet, both companies have leverage levels that are materially lower than Marubeni's. We believe Marubeni should at most trade at a 20% premium to these companies and thus we believe this is supportive of our 0.5x P/B target multiple.

	Commodity Trading Companies		
	Marubeni	Glencore	Noble
Debt / LTM EBITDA	12.8x	5.3x	9.4x
Debt / LTM FCF	1572.1x	9.9x	nmf
Debt / Book Capitalization	69.3%	49.5%	51.9%
Debt / Book (Pro Forma Impairments)	71.8%		
Price / Book	0.74x	0.36x	0.43x

Target price sensitivity to P/B multiple

Adjusted book value	780				
P / B multiple	0.70x	0.60x	0.50x	0.40x	0.30x
Target stock price	546	468	390	312	234

In many a corporate suite, the idea of announcing writedowns or losses on investments is seen as a loss of face; a personal embarrassment for the executives that is avoided and shunted further down the road for the successors to "manage." But, we think it's worth remembering what Toshiba's then President Atsutoshi Nishida said at a meeting in December 2008 when he was told by staff of upcoming operating losses: "The figure is so embarrassing that we cannot announce it this coming January."

The moment of pride turned out an outright financial lie, which snowballed with each year. When the truth finally hit this year, the snowball had turned into an avalanche. And this is how the current president of Toshiba, Hisao Tanaka, described it: "The biggest erosion of our brand image in our 140-year history."⁴¹



⁴¹ <http://www.ft.com/intl/cms/s/0/b8301b7c-2f7d-11e5-91ac-a5e17d9b4cff.html#axzz3uV99fwpk>

