



COMPANY: Hengan International Group Co. Ltd. | **HKEX:** 1044
INDUSTRY: Household & Personal Products

REBUTTAL TO HENGAN CLARIFICATION ANNOUNCEMENT

<u>Price</u> <small>(as of 12Dec2018 - HALTED)</small>	<u>Valuation</u>	<u>Market Cap</u>	<u>Average Daily Value Traded (1mo)</u>
HK\$ 57.05	HK\$ 0.00	HK\$ 69 billion	HK\$ 202 million

We are short Hengan because we believe Hengan has fabricated RMB 11 billion of net income since 2005 which has manifested itself as fake cash on its balance sheet. Laden with debt, we assert that Hengan’s equity is ultimately worthless.

On December 12, 2018 we published our investment opinion (the “Report”) on Hengan International Group Company Limited (HKEx: 1044) (the “Company” or “Hengan”). On December 13, 2018 Hengan issued a clarification announcement (the “Response”).

As expected, Hengan denies all our allegations as “speculative”, “baseless”, “malicious”, “factually incorrect”, and “misinformed”.¹

Oddly, Hengan claimed that it could not identify me. Perhaps with another 30 seconds of desktop research they would have figured it out...



Hengan’s Response was weak and evasive of our key points and failed to address any of the evidence presented in our Report. Hengan avoids disclosure explaining why there is a discrepancy in its reported sanitary napkin operating profit margins at Hengan China versus Hengan. Hengan fails to address the comments of its Deputy CFO about its sanitary napkin operating profit margins. Hengan avoids explaining its currency risk-free interest rate arbitrage

¹ <http://www3.hkexnews.hk/listedco/listconews/SEHK/2018/1213/LTN20181213009.pdf>

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scheme. Instead Hengan claims the reason for its interest in raising debt is because it is an “opportunistic” time to increase borrowings.

And despite the abundance of evidence presented in our Report, Hengan claims that the Hengan CEO’s private family business was not involved with Xiamen Property or the disposal of a Hengan revenue stream at the bargain basement price of 0.7x 2016 net income!

We have formulated our opinion on Hengan from our review of the following documents:

- 47 annual SAIC filings and 36 annual credit reports of Hengan’s subsidiaries (CHINESE)
- 9 Hengan China’s Bond Prospectuses filed from 2016 through December 2018 (CHINESE)
- Hengan China’s consolidated and company accounts from 2013 to September 30, 2018 (CHINESE)
- Hengan’s 2016 1st Tranche Medium-Term Notes Prospectus dated August 9, 2016 (CHINESE)
- Kingdom Healthcare Holdings Limited, Guangdong (“Kingdom Healthcare”) Shanghai A-Share Application Proof Prospectus dated June 19, 2018 (CHINESE)
- Chongqing Baiya Sanitary Products Co., Ltd. (“Baiya”) Shenzhen A-Share Application Proof Prospectus dated July 20, 2017 (CHINESE)
- Hengan’s 18 Interim Reports and 17 Annual Reports since 2001 (ENGLISH)
- Hengan’s company announcements since 1999 (ENGLISH)
- Hengan’s 1998 Global Offering Prospectus (ENGLISH)
- Wang-Zheng Group’s 2017 Annual Report (ENGLISH)
- Hengan’s competitors’ Annual Reports. (ENGLISH & CHINESE)

Such an exhaustive review of publicly available documents gives us comfort in the accuracy of our findings.

Considering Hengan’s June 30, 2018 short-term financial liabilities balance of RMB 17.8 billion, and that Hengan raised additional short-term debts of RMB 7.5 billion in the last five months, we believe it is possible that creditors scramble to get repaid and settle debts for less than par value, leaving Hengan’s Equity ultimately worthless...

RESPONSES

1. FABRICATION OF RETURN ON SANITARY NAPKIN ASSETS AND PROFITABILITY

Hengan claims that our allegations of fake profits are “completely speculative and baseless”, relying on historical reputation to satisfy investor concerns. Hengan reminds investors of their familiarity with its “Space 7”, “Anerle” and “Anle” branded sanitary napkins (think maxipads) in China, and suggests that because of its longstanding existence that Hengan is not doing anything wrong.

“Trust Us” says Hengan.

Well, we trust the numbers. We do not believe that you are generating sanitary napkin operating profit margins of 51%! We do not believe that you generated returns on your sanitary napkin assets of 72% in 2016!

Hengan explains that Fujian Hengan Holding Co., Ltd. and Fujian Hengan Homecare Products Co., Ltd., (the “Additional Subsidiaries”) are not part of the Hengan China Group, and that the Additional Subsidiaries run the high-end “Space 7” branded sanitary napkin business and that their profit margins make up for the 1,215 to 1,477 basis points lower difference between Hengan China and what Hengan reported in its HKEx filings from 2015 to 2017.

We think this is a lie.

Firstly, Hengan China’s Bond Prospectuses disclose that 90%+ of Hengan China’s sanitary napkin revenues are of the high-end “Space 7” brand while generating margins 1,215 to 1,477 basis points lower than Hengan. If Space 7 brand sales are higher margin, Hengan China’s financials do not reflect these benefits.

Hengan's Response states that its Additional Subsidiaries run the "Space 7" branded sanitary napkin and operate at higher operating margins. If that is true, then why does Hengan China generate ~31% operating profit margins for its sanitary napkin segment, **1,215 to 1,477 basis points lower** than what Hengan reported in its HKEx filings from 2015 to 2017 if 90%+ of its sanitary napkin sales are of Hengan's high-end "Space 7" brand?!?

Issuer's (ie Hengan China's) sales from major sanitary napkin brands for the last 3 years

表 5-13: 近三年发行人卫生巾主要品牌销售收入情况

Unit: RMB'00,000,000

单位: 亿元

品牌 Brand	2015	2016	2017
七度空间 Space 7	55.13	59.96	64.69
安尔乐 Anerle	6.24	5.51	4.69
安乐 Anle	0.42	0.15	0.31
合计 Total	61.79	65.62	69.69

注: 表中合计数小于分业务收入, 是由于部分销售产品是 OEM 产品, 无法归属于上述品牌。

Note: the total amount in the table is smaller than the segment revenue because a portion of the revenue came from OEM products that cannot be grouped into the above brands.

Source: Hengan China's 2018 1st Tranche Super Short-Term Commercial Papers Prospectus – p.61
https://www.shclearing.com/xxpl/fxpl/scp/201808/t20180827_417970.html

In addition, "Space 7" is not a new high-end brand of Hengan. Rather "Space 7" brand was launched 17 years ago in 2001. To suggest that this is a new high-end brand with an outstanding margin profile is laughable.

OVERALL PERFORMANCE

In 2001, Hengan International focused on quality assurance, together with continuous efforts on product mix adjustment, stringent cost control, optimizing distribution channels and reinforcing its brand image. The business as a whole grew steadily in a market that was full of opportunities and challenges.

Following China's accession into the WTO, multinational enterprises are becoming even more aggressive in chasing after the huge China market. Coupled with the fact that it is flooded with small local manufacturers, the sanitary napkins market is becoming more competitive. Facing such a market, Hengan International aggressively develops new products and during the year under review, the Group launched the "Anerle" "Space 7" sanitary napkin series, for young females in the large and major cities, and the new "Anerle" baby diapers, featuring ultra-thin and softness. While we are sharpening our competitive edges in terms of products and market, we are also improving our internal control and business processes by engaging Thomas Group to provide management consultancy services. These together will prepare the Group for further growth in the future.

Source: Hengan 2001 Annual Report – p.13
<http://www3.hkxnews.hk/listedco/listconews/sehk/2002/0408/1044/F106.pdf>

Secondly, as stated in our Report (p.8), we have reviewed the PRC filings for the 7 Other Hengan PRC Subs, which include the Additional Subsidiaries. Our review reveals that Hengan China's purchases accounted for 93% to 100% of the revenues for the Additional Subsidiaries for 2015 to 2017, suggesting to us that Hengan China is almost exclusively the source of revenue for the Additional Subsidiaries.

Hengan China's Related Party Procurement and Related Parties' Revenue

RMB'000	2015			2016			2017		
	Revenue	Purchase	%	Revenue	Purchase	%	Revenue	Purchase	%
Onshore									
Fujian Hengan Holding Co., Ltd.	1,538,790	1,427,458	92.8%	1,543,956	1,466,496	95.0%	1,183,718	1,130,958	95.5%
Quanzhou Jinjiang Hengan Hygiene Science and Technology Co., Ltd.	42,832	39,535	92.3%	44,416	42,810	96.4%	32,494	30,457	93.7%
Fujian Hengan Homecare Products Co., Ltd.	567,892	549,878	96.8%	621,849	625,119	100.5%	792,991	749,749	94.5%
Guangdong Paper Products Co., Ltd.	117,467	135,811	115.6%	141,485	140,205	99.1%	143,508	143,800	100.2%
Wuhu Hengan Heartex Paper Products Co., Ltd.	672,451	669,324	99.5%	858,724	854,446	99.5%	995,671	990,830	99.5%
Hengan (Sichuan) Maternal and Child Products Co., Ltd.	142,423	142,369	100.0%	192,853	190,898	99.0%	211,541	209,402	99.0%
Junichi (Xiamen) Maternal and Child Articles Co., Ltd.	14,249	14,236	99.9%	8,584	8,577	99.9%	5,774	5,726	99.2%
Total - onshore	3,096,104	2,978,611	96.2%	3,411,867	3,328,551	97.6%	3,365,697	3,260,922	96.9%
Offshore									
Anhai (Macao Commercial Offshore) Limited	N/A	3,367,349	N/A	N/A	3,340,183	N/A	N/A	3,564,062	N/A
Hengan Mega Jumbo Investments Ltd.	N/A	191,865	N/A	N/A	265,185	N/A	N/A	267,490	N/A
Hengan International Holdings Limited	N/A	12,933	N/A	N/A	49,621	N/A	N/A	69,123	N/A
Total - offshore	N/A	3,572,147	N/A	N/A	3,654,989	N/A	N/A	3,900,675	N/A
Total	N/A	6,550,758	N/A	N/A	6,983,540	N/A	N/A	7,161,597	N/A

Source: Hengan China Bond Prospectuses, Credit Reports

Credit Reports for the Additional Subsidiaries disclose operating profits. If we add the operating profits of the Additional Subsidiaries to Hengan China's sanitary napkin segment operating profits, we estimate a marginal benefit of 3.5% in 2017, significantly lower than the 12-15% difference between Hengan China and Hengan's sanitary napkin operating profit margins.

Additional Subsidiaries Operating Profits

RMB'000	2015	2016	2017
Fujian Hengan Homecare Products Co., Ltd.	168,437	201,488	224,199
Fujian Hengan Holding Co., Ltd.	247,493	169,043	48,565
Additional Subsidiaries Operating Profits	415,930	370,531	272,764
Hengan China Sanitary Napkins Segment Revenue			
	6,887,879	7,331,877	7,780,472
Operating Profit Margin Difference Possible from the Additional Subsidiaries	6.04%	5.05%	3.51%
Difference in Sanitary Napkin Segment Margins Hengan China Compared to Hengan	14.60%	14.77%	12.15%
Remaining Difference to Hengan's Reported Sanitary Napkin Segment Margins	8.56%	9.71%	8.65%

Source: Hengan China Bond Prospectuses, Credit Reports, Hengan HKEx Filings

We have also presented in the Report (p.9) the receivables and payables balances of Hengan Holding for 2014 to 2017, which show negative balances for both line items in 2017. We rarely come across any operating businesses with negative receivable and negative payable balances. It is important to note that Hengan has failed to address this odd phenomenon in its Response.

Thirdly, in our due diligence call with Hengan's Deputy CFO, he calculated that Hengan's "Space 7" operating profit margins were 29%, significantly lower than the 51% reported by Hengan in its HKEx filings. (p.12-13 of the Report). Why did Hengan's Deputy CFO explain that Hengan's sanitary napkin operating profit margins were 29%, in-line with Hengan China's reported segment profit margins?!

Excerpt from Call With Hengan's Deputy CFO

Question: "I'm aware the gross margins in [your sanitary napkin's] business is high, and I'm aware that you guys have a really good distribution network. Could you give me, if a customer was buying a packet of Space 7 for RMB 100, could you give me the [margin] breakdown? How much is taxed, how much is to the distributor, how much is to the supermarket, how much do you spend on marketing? Could you kind of give me, just so we can understand the value chain, who makes what along the chain? Because your gross margins are big, but I assume your operating profit margins are not as big?"

*Hengan's Deputy CFO Answer: "If the retail price is 100... So for example, if I produce \$10 which is the production cost or the production price for my **Space 7**. On every part I will add roughly 20 to 30 percent markup in order-- before I go to the retailer. So that is, for example, my cost is \$10, then I will, talking about, I will sell it \$12 to my sales team. And then my sales team will then sell to around \$14 roughly to the distributors. And the distributors will then further sell around \$18, or so \$20 to the retailers. And the retailers will then add further 20%, talking about maybe, talking about, \$24 to the customers. So that is the case like this.*

Source: Excerpt from Call with Hengan's Deputy CFO

Margin Value Chain Breakdown

Hengan Production Costs	10.0
Hengan Net Sales Value to Distributor	14.0

Operating Profit	4.0
Operating Profit as % of NSV	29%

Source: Call with Hengan's Deputy CFO

2. SHAM TRANSACTIONS

Hengan claims that our allegations of sham transactions are "malicious and baseless."

As highlighted in our report, we spent considerable time and effort understanding the related party transactions between Hengan China and the Other Hengan Subsidiaries in our Plug Calculation for Offshore Cash.

Specifically, we subtracted Hengan China (consolidated) and Hengan (company) from Hengan (consolidated), leaving us with "Plug" subsidiaries located both onshore ("Hengan PRC Plug entities") and offshore ("Hengan Offshore Plug entities"). Credit Reports disclose bank balances for the onshore PRC Plug entities. If we subtract PRC Plug entities, the remaining balance is what we would expect as bank balances at Hengan's Offshore Plug entities.

Sum of the Parts Bank Balance Calculation

Hengan (Consolidated) = Hengan (company) + Hengan China (consolidated) + PRC Plug entities + Offshore Plug entities

We calculate cash and bank balances at Hengan's Offshore Plug entities of RMB 1.5 billion and RMB 1.4 billion in 2014 and 2015, respectively. Suspiciously, cash and bank balances at Hengan's Offshore Plug entities exponentially grew to from RMB 1.4 billion to RMB 10.5 billion in the two years from 2015 to 2017, respectively.

Sum of the Parts Calculation: 2014 – 2017

RMB'000	31-Dec-2014	31-Dec-2015	31-Dec-2016	31-Dec-2017
Entity	Amount	Amount	Amount	Amount
Hengan (company)	16,946	54,054	320,660	159,705
Hengan China (consolidated)	12,213,282	10,372,672	6,896,779	7,343,669
Fujian Hengan Holding Co., Ltd.	3,075,830	2,678,974	253,973	1,540,826
Fujian Hengan Homecare Products Co., Ltd.	N/A	367,747	441,923	1,416,684
Junichi (Xiamen) Maternal and Child Articles Co., Ltd.	N/A	5,534	3,934	4,439
Guangdong Paper Products Co., Ltd.	N/A	13,633	746	292
Hengan (Sichuan) Maternal and Child Products Co., Ltd.	N/A	503	457	118
Quanzhou Jinjiang Hengan Hygiene Science and Technology Co., Ltd.	N/A	4,510	16,699	470
Wuhu Hengan Heartex Paper Products Co., Ltd.	N/A	1,176	537	360
Weifang Power Hengan Thermal Power Co., Ltd (as at December 27, 2017)	N/A	N/A	N/A	29,397
Wang-Zheng Group	N/A	N/A	N/A	84,019
Total	15,306,057	13,498,803	7,935,708	10,579,979
Hengan (Group)	16,800,949	14,866,085	14,874,877	20,932,456
Cash and Bank Balances that must be held by the Offshore Subsidiaries	1,494,892	1,367,282	6,939,169	10,352,477

Source: Hengan Company Filings, Hengan China's Bond Prospectuses, Credit Reports, Bonitas Calculations

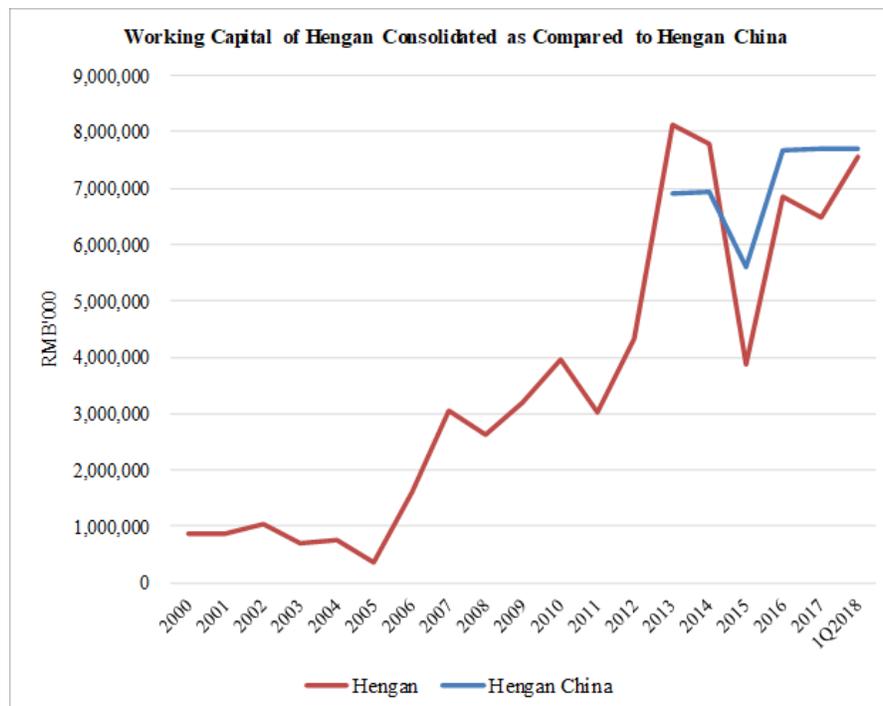
Please explain.

3. LADEN WITH DEBT AND FABRICATED BANK BALANCES

Hengan claims that the reason it is increasing its borrowing is because there is a general downward trend for borrowing costs in the PRC.

This is not the explanation we were told by the Hengan Deputy CFO or by what Hengan CEO described on its 2Q'18 conference call. Hengan's previous story about its borrowings was that they were implementing a currency risk-free interest rate arbitrage strategy.

Additionally, investors should be suspicious of companies that purportedly generate significant net income and boast large bank balances yet continue to rely heavily on short-term borrowings. As of June 30, 2018, Hengan's reported working capital balance was RMB 7.6 billion, near historical highs.



Hengan Working Capital

Year	RMB to HKD	Total Current Assets in RMB'000	Total Current Liabilities in RMB'000	Working Capital in RMB'000
2000	0.9423	1,045,510	179,173	866,337
2001	0.9423	1,060,001	186,319	873,682
2002	0.9420	1,198,644	164,654	1,033,990
2003	0.9381	1,438,325	735,963	702,362
2004	0.9392	1,657,798	902,760	755,038
2005	0.9608	1,755,545	1,380,601	374,945
2006	0.9964	2,694,975	1,078,669	1,616,306
2007	1.0678	4,317,370	1,263,300	3,054,070
2008	1.1359	4,176,943	1,547,299	2,629,643
2009	1.1357	6,870,554	3,676,451	3,194,103
2010	1.1794	9,115,202	5,152,518	3,962,684
2011	1.2340	11,137,592	8,113,361	3,024,231
2012	1.2440	13,015,551	8,698,945	4,316,607
2013	1.2808	21,331,551	13,206,569	8,124,983
2014	1.2494	22,975,866	15,196,426	7,779,440
2015	1.1935	21,574,469	17,712,995	3,861,474
2016	1.1165	22,127,016	15,280,014	6,847,002
2017	1.2008	25,668,654	19,186,235	6,482,419
1H2018		25,600,254	18,047,501	7,552,753

Hengan China Working Capital

Year	Total Current Assets in RMB'000	Total Current Liabilities in RMB'000	Working Capital in RMB'000
2000	N/D	N/D	N/D
2001	N/D	N/D	N/D
2002	N/D	N/D	N/D
2003	N/D	N/D	N/D
2004	N/D	N/D	N/D
2005	N/D	N/D	N/D
2006	N/D	N/D	N/D
2007	N/D	N/D	N/D
2008	N/D	N/D	N/D
2009	N/D	N/D	N/D
2010	N/D	N/D	N/D
2011	N/D	N/D	N/D
2012	N/D	N/D	N/D
2013	18,041,422	11,149,103	6,892,319
2014	21,070,275	14,141,410	6,928,865
2015	17,350,593	11,754,721	5,595,872
2016	15,076,443	7,416,529	7,659,914
2017	16,632,402	8,944,452	7,687,950
1Q2018	18,338,184	10,646,635	7,691,550

Source: Hengan Annual Reports 2000 – 2017, Hengan 1H'18 Interim Report, Hengan China Bond Prospectus

Yet despite Hengan's reported working capital surplus, from August to December 2018 Hengan China issued six separate tranches of debt to investors raising a total of RMB 7.5 billion with the majority of proceeds earmarked for working capital.

If Hengan's reported working capital surplus was at a peak level, why would Hengan need to raise any capital to support its working capital needs? We believe the real reason Hengan recently increased its borrowings is because Hengan's reported cash balance is fabricated.

Hengan reminds investors that it has been paying a historical dividend of 60%+ since listing on the exchange. This is true and also how insiders have been compensated 7.8 billion. The dividends are coming not from profits, but from borrowings!

We calculate that Hengan's actual profitability does not cover the Company's recent historical dividend payout ratio, suggesting the Company's dividends were financed by borrowings from creditors and not from Hengan generated profits. We calculate that the actual dividend payout has exceeded net income since 2014.

Dividend Payouts as % of Net Income - Reported versus Actual

Figures in RMB mm	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Reported Revenues	3,192	4,223	5,543	7,139	9,548	11,701	14,155	15,066	16,792	18,934	18,663	19,277	19,825
	0	0	0	0	0	0	0	0	0	0	0	0	0
Reported Net Income	474	715	983	1,196	1,866	2,124	2,199	2,862	2,949	3,111	3,260	3,597	3,794
Reported Net Income Margin	14.9%	16.9%	17.7%	16.8%	19.5%	18.2%	15.5%	19.0%	17.6%	16.4%	17.5%	18.7%	19.1%
Fabricated Sanitary Napkin Profits	57	157	185	179	276	332	393	776	878	1,078	1,387	1,281	1,529
Fabricated Interest Income	0	0	0	0	0	0	108	125	239	343	286	204	340
Total Fabricated Profits	57	157	185	179	276	332	501	900	1,116	1,421	1,673	1,485	1,869
Actual Net Income	417	558	798	1,017	1,590	1,792	1,698	1,961	1,833	1,690	1,587	2,112	1,925
Actual Net Income Margin	13.1%	13.2%	14.4%	14.2%	16.7%	15.3%	12.0%	13.0%	10.9%	8.9%	8.5%	11.0%	9.7%
Reported Dividend Payout	319	477	652	737	1,182	1,386	1,377	1,699	1,806	1,947	2,119	2,356	2,531
Reported Dividend Payout Ratio	67.2%	66.7%	66.3%	61.6%	63.3%	65.3%	62.6%	59.4%	61.2%	62.6%	65.0%	65.5%	66.7%
Actual Dividend Payout Ratio	76%	85%	82%	72%	74%	77%	81%	87%	99%	115%	134%	112%	131%

Source: Hengan Annual Reports, Bonitas Calculations

Please explain.

4. UNDISCLOSED RELATED PARTY TRANSACTIONS

Hengan claims that our allegations of undisclosed related party transactions are “factually incorrect.”

Hengan China’s 2018 1st Tranche Super Short-Term Commercial Paper Prospectus dated August 20, 2018 disclosed that Hengan China disposed of Xiamen Property to a claimed independent third party for a total consideration of RMB 1.2 million in April 2017, the bargain basement price of 0.7x 2016 net income.

Change of Consolidation Scope in 2017

表 6-3: 2017 年合并报表范围重大变化情况

Company Name	Change	Reasons for Change
公司名称	变化情况	变化的原因
Xiamen Property 厦门恒安物业有限公司	Share Transfer 股权转让	2017 年 4 月，发行人子公司厦门商贸将持有的全部厦门物业的股权，作价人民币 116.87 万元转让予第三方公司。 In April 2017, Xiamen Trading transferred its entire equity interest in Xiamen Property to a third party for a consideration of RMB1,168,700.

Source: Hengan China’s 2018 1st Tranche Super Short-Term Commercial Papers – p.75
https://www.shclearing.com/xpl/fxpl/scp/201808/t20180827_417970.html

Evidence suggests this is a lie!

SAIC filings reveal that the Hengan CEO’s private family business was behind the purchase of Xiamen Property. This means that Hengan disposed of Xiamen Property to an undisclosed related party of Hengan’s CEO at the bargain basement price of 0.7x 2016 net income, significantly less than what shareholders would have received in proceeds had Hengan sold the income stream to an independent third party at fair market value.

In its Response the Company lied again about the independent third party relationships with Hengan CEO’s private businesses. We encourage anyone with means to uncover the truth about what is really happening at Hengan in Fujian to speak up before others fall into the trap of investing more money.

We stand by our work.



DISCLAIMER

We are short sellers. We are biased. So are long investors. So is Hengan. So are the banks that raised money for Hengan. If you are invested (either long or short) in Hengan, 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 of our opinions about the public companies we research is in the public interest.

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