GLAUCUS RESEARCH GROUP

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"May you live in interesting times." - **Robert Kennedy**

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COMPANY: China LNG Group Limited | HK: 931
INDUSTRY: Energy

On July 14, 2015, we published a detailed investment opinion on China LNG Group Limited ("China LNG" or the "Company"). In our Report, we presented an extensive analysis of the Company's public filings and other publicly-traded energy companies, arguing that despite its name (recently changed), China LNG is essentially a startup without any proprietary intellectual property, a meaningful operating business or a tangible competitive advantage in the industry. It is our opinion that China LNG's stock is wildly overvalued, and that its tiny underlying business in no way merits an HKD 16.7 billion market capitalization. On July 16, 2015, China LNG released a clarification announcement (the "Response"), which despite a hostile and defensive tone, was logically deficient and served only to reinforce our underlying investment thesis.

China LNG's LNG business in China has only 58 employees, 869 square meters of office space, no proprietary intellectual property or operating rights and HKD 131,750 in total revenue so far.[1]

No matter what any investor believes about China LNG's future plans, potential relationships, or long-term chances, the simple fact remains that today, in its current form, the Company's operating business is tiny and insignificant.

Hong Kong and global energy comps trade at an average of 1.79x book value. China LNG trades at 33.9x book value. Even at its peak, Hanergy only traded at 17x book value, and all investors would agree at this point that at its peak, Hanergy was grossly overvalued.

If China LNG wants to be considered an energy company, it should be valued at or close to book value, like other energy companies, which is why we believe that the Company should be valued at **HKD 0.08 per share, 95% below China LNG's last traded price**.

[1] As of July 3, 2015. The Company also discloses that it is in the process of adding 1,369 square meters in office space.

VERY LITTLE NATURAL GAS, VERY LITTLE CHINA

We highlighted in our Report that as of **July 3**, **2015**, the Company's LNG business has only generated HKD 131,750 in total revenues. At last FYE, the Company did not own any meaningful assets related to the natural gas business. Nor does China LNG possess any technology, patents, trademarks, copyrights or operating rights which would give the Company any competitive advantage in entering a crowded industry.

1) *Lease Financing Business*

In its Response, China LNG sought to make its primary business, lease financing for LNG equipped vehicles, sound substantial. But substantial it is not.

China LNG commenced leasing in May 2015 and thus far it has financed the leases of "1,030 heavy-duty LNG vehicles with an aggregate loan amount of approximately RMB 181,860,000… for a term ranging from six months to two years to six customers … which total interest earned thereform amounted to RMB 11,773,000."[2]

Admittedly, this "interest earned" amount is a bit confusing. We think China LNG means that it will earn RMB 11.8 million over the duration of the loans. We do not think that the Company meant that since May 2015, it has already earned RMB 11.8 million in interest in just two months. Given that the loan amount is only RMB 181.9 million, earning such interest over two months (May-July) would mean that China LNG is charging 38.8% in annual interest, which seems unlikely.

More importantly, China LNG's circular from July 8, 2015, unequivocally stated that its **revenues generated from financing the leases of LNG vehicles** was only HKD 131,750 as of July 3, 2015.

> The Group commenced its finance leasing business of LNG vehicles in May 2015. As at the Latest Practicable Date, the Group has four customers in relation to its finance leasing business of LNG vehicles. As at the Latest Practicable Date, our revenue generated from finance leasing business of LNG vehicles in relation to leasing of approximately 511 LNG vehicles to three customers amounted to approximately HK$25,000, HK$63,750 and HK$43,000 respectively, representing approximately 19%, 48% and 33% of the total revenue of the financial leasing business of the Group respectively. As at the Latest Practicable Date,

China LNG Circular July 8, 2015, p. 15.

So the only reasonable conclusion from China LNG's Response is that it expects to earn RMB 11.8 million in interest over the next two years on RMB 181.9 million that it has already lent out to customers. For a startup, this might be impressive. But this is simply insufficient for a Company with an HKD 16.7 billion market capitalization. Even if it earned RMB 11.8 million in one year, at its current stock price, the Company would be trading at 1,053x sales.

Consider that China LNG has a tiny balance sheet. Apart from RMB 181 million in loans, its PRC leasing subsidiary's only major assets (without considering proceeds from a new capital raise) are RMB 140 million in receivables[3] and RMB 146 million in cash.

[2] China LNG Response, p. 3.
[3] We do not understand how a Company without a product, service or business other than leasing can report a receivable of RMB 140,000,000. Perhaps that is interest income it expects to receive, but given the small loan amount (RMB 181.9 million), that is unlikely. Investors will just be forced to wait for the interim report.

China LNG Recurring Lease Revenues

	(RMB millions)
Existing Leases	181.9
Bank Balance	146.2
Expected Interest Income from Existing Loans (Annualized)	5.9
Expected Interest Income from Lending Available Cash Balance (Annualized)	4.7
Expected Revenues (in HKD millions)	13.3
Price to Sales Multiple	**1168**

Source: China LNG Clarification Announcement

At its current rate of return, if China LNG lent out all of the cash on the balance sheet of its lease financing subsidiary, we believe that it would only generate approximately HKD 13.3 million in annual revenues. This is not sufficient for a Company with a market capitalization of HKD 16.7 billion. At its current share price, China LNG would be trading at 1168x annualized ***sales***. At its peak price, **Hanergy only traded at 27x** annualized sales.

2) *Unproven and Flawed Business Plan*

In our Report, we pointed out that since March 2014, China LNG has announced **20 non-binding** letters of intent or cooperation agreements with various companies, commissions and development groups. Although such cooperation agreements give investors the impression that China LNG is making significant progress in the LNG business, we believe that such progress is illusory.

In its Response, China LNG complained bitterly about this point. The Company stated that it had only terminated 2 of the 20 framework agreements, and that the other 18 were still in place. But this misses the point.

The framework agreements are not concrete, contractual relationships or investments. They are merely non-binding declarations of future cooperation.

Furthermore, China LNG's promises under such announcements are not realistic. For example, from March 2014 through June 2014, China LNG made five such announcements, promising to invest HKD 5 billion, which was obviously impossible given that the Company's balance sheet recorded only HKD 549 million in total assets as of FYE 2014, (~11% of the promised investment amount). In total, the Company's non-binding agreements call on it to commit between HKD 14 billion and HKD 71 billion in investments into the LNG business, a farcical amount of capital considering the Company's tiny balance sheet and limited operating history.

As it is prone to do, China LNG's Response went on to boldly declare its plan to enter the downstream LNG market in various forms: (i) to generate commissions from the trading of LNG vehicles and vessels, (ii) to perform repair and maintenance services on LNG vehicles, (iii) to operate an environmental vehicles club which installs IT systems in LNG equipped vehicles, and (iv) to invest in LNG refueling stations, refiling docks, LNG plants and the supply and distribution of LNG.

There are reasons to be skeptical. Such industries are already highly competitive and populated with incumbents who are better positioned, more experienced, and better financed than China LNG.

But the larger point is that such bold declarations are merely declarations for tomorrow. Perhaps, one day, they will impact the valuation of China LNG, but they should not do so today.

NON-RECURRING "TRADING" GAINS

In an effort to somehow justify its absurd stock price and market capitalization, China LNG's Response continues to plead with the market to consider one-time gains as a recurring source of revenues and profits. Do not be fooled. In no way are the Company's reported 2014 profits recurring. In our opinion, neither are 2015's profits.

1) *Related Party Junk Bonds Return 375% in 6 Months*

In our Report, we noted that 99% of China LNG's 2014 revenue was derived from a one-off related party deal with its Chairman. In January 2014, China LNG purchased from its Chairman HKD 80 million in convertible bonds issued by Warderly International (HK: 0607) (the "Warderly Bonds"), a Hong Kong listed company which was (at the time) also owned and controlled by China LNG's Chairman. The Chairman sold China LNG the Warderly Bonds at well below their market value. In June 2014, China LNG agreed to sell the Warderly Bonds to Magnolia Wealth International Limited for HKD 380 million, a 375% profit in just six months.

The only reason that China LNG made a 375% return on the Warderly Bonds was that its Chairman sold the bonds to the Company at well below the market price. The most charitable explanation is that this was a sweetheart deal from the Company's Chairman which is **non-recurring revenue and cannot be factored into the Company's valuation**.

In its Response, China LNG could not help but contradict itself when discussing the Warderly Bonds. On the one hand, China LNG said that we were "unfounded" in considering the profits from the Warderly Bonds non-recurring, because it was a part of its trading business.

> The Company would like to point out that one of the principal businesses of the Group is trading of securities and as disclosed in the Disposal Announcement and the Acquisition Circular, the Acquisition was made for trading purposes. The Glaucus Report was unfounded to consider the Bonds Transactions as a non-recurring transaction. In the circumstances when the gain from the

China LNG Response, p. 7.

In a hilarious twist, China LNG's then contradicts itself on the **very same page of the Response**:

> The Company would like to emphasise that any comment made in the Glaucus Report relating to the Bond Transactions is irrelevant in assessing the Group's financial performance and operations since a gain of approximately HK$300 million had been realised by the Group through the disposal of the Bonds (the "**Disposal**"). As disclosed in the announcement issued by the Company on 21 June

China LNG Response, p. 7.

Apparently, any comments on the bond transaction are "irrelevant in assessing the Group's financial performance and operations" because, in China LNG's words, the bonds were disposed, the gains have been realized and the transaction is over. **Our thoughts exactly!**

It does not matter whether the profits from the Warderly Bonds were classified as a part of the Company's trading business. By their very nature, they were a one-off transaction and should not be factored into China LNG's valuation going forward.

The Response also stated that "when the gain from the disposal [of the bonds] is disregarded, the Group would still be able to maintain a net profit position for the year ended 31 December 2014 and record an increase of approximately 112% as compared" to the previous year.[4] The previous year, China LNG reported a net profit of just HKD 22.4 million.

This statement makes it seem as though China LNG had other profitable business other than simply gains from a one-off deal between its in Chairman and a related party. But we are not so sure.

In 2014, China LNG reported HKD 358 million in total revenue. In its 2014 Annual Report, the Company admits that HKD **350 million of this revenue** came from the disposal of the Warderly Bonds and related Warderly shares.

[4] China LNG Response, p. 7.

BUSINESS REVIEW

During the year, there has been a significant increase in net profit to approximately HK$293,732,000 (2013: HK$20,600,000) representing an increase by over 13 times as compared to 2013. The significant increase was mainly attributable to a net bargain purchase gain on acquisition and realised gain on total disposal of shares (the "Fullshare Shares") and convertible bonds (the "Convertible Bonds") of Fullshare Holdings Limited (previously named as Warderly International Holdings Limited) ("Fullshare"), the shares of which are listed on the Main Board of the Stock Exchange, of approximately HK$350 million recognised in the segment of trading of securities. During the year, the Group purchased 152,050,000 Fullshare Shares and

China LNG 2014 Annual Report, p. 3.

If HKD 350 million of the Company's reported HKD 357 million in total revenue came from shares and bonds issued by Warderly, then, by China LNG's own admission, the Warderly transactions accounted for 98% of its 2014 revenues. This transaction **is non-recurring by any definition and therefore should not be considered in the Company's valuation going forward**.

2) Unaudited FY 2015 Profit and Loss

In the conclusion of the Response, the Company boldly claimed that it was on course to record an "unaudited estimated profit of approximately HKD 509.8 million upon completion of the disposal of certain shares in one of the Group's subsidiary in around August 2015."[5] China LNG claims, when such profits are taken into account, the Company trades at a reasonable-sounding price-to-earnings ratio of 32x.

We find this blatantly misleading. The "profit" to which China LNG supposedly refers, is in reality **the proceeds expected upon the disposal of 48.92% of the equity of its trading subsidiary, Key Fit Group Limited**.

The Company established Key Fit Group Limited in 2007 as a subsidiary involved in the trading of computer components and networking equipment.[6] The subsidiary was established in Hong Kong with an issued share capital of HKD 1.00. The Company reported no material acquisitions in its 2007 Annual Report, and its cash flow statement that year shows no such activity, so it is safe to assume that the Company formed Key Fit Group Limited as a wholly owned subsidiary and it was not acquired from a third party.

One thing is clear. **This transaction is by definition non-recurring!** The Company has already sold the equity in this subsidiary. It cannot re-sell the same shares. Whatever proceeds it receives from this transaction are by definition non-recurring and therefore **should not be factored into China LNG's valuation going forward**.

China LNG's desperate attempt to characterize one-off transactions as recurring revenues and earnings only serves to highlight that its underlying business is simply tiny, insignificant and above all, undeserving of an HKD 16.7 billion valuation.

VALUATION

China LNG's Response is non-sensical, contradictory and logically deficient. It was also accusatory, claiming that the purpose of our Report was "forcing the Share price down."[7] This is not so.

We did not and cannot cause any investor to buy or sell shares of China LNG. We can only discuss our investment thesis and discuss the evidence upon which we base our conclusion. Investors must decide for themselves what they believe to be the true value of China LNG's shares. All of our analysis is based on the facts presented to the market by the Company in its filings, announcements, circulars and annual reports. It is in the interests of both a transparent and efficient market for investors to discuss their good-faith beliefs about their investments – the fact that China LNG is so defensive about any examination of its business (or lack thereof) only highlights its own insecurity about the underlying value of its Company.

In our opinion, China LNG is essentially a startup without any proprietary intellectual property, a meaningful operating business or a tangible competitive advantage in the industry. As such, we believe that it should be valued at 1.79x book value,[8] which is the average of energy companies listed in Hong Kong and on other exchanges abroad. We continue to value the Company at HKD 0.08 per share, 95% below China LNG's last traded price.

[5] China LNG Response, p. 8.
[6] China LNG 2007 Annual Report, 49.
[7] China LNG Response, p. 2.
[8] Glaucus Report, p. 4.

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