Iceberg Research

www.iceberg-research.com
info@iceberg-research.com

Noble Group, a Repeat of Enron

First Report: Noble's Associates and Noble Agri

Report date: February 15, 2015

Noble Group Ltd Industry: Commodities trading Founded: 1986. Headquartered in Hong Kong. Revenue 9M 2014: $65b Net profit 9M 2014: $374m Operating cash outflows 9M 2014: ($620m) Equity: $5.6b	Rating: (BBB-/Baa3) Listed in Singapore. Market cap: S$8.1b (US$6b) as of close February 13, 2015 Stock price: S$1.21 as of close February 13, 2015 **Price target: S$0.1**

Disclaimer

Summary of Findings:

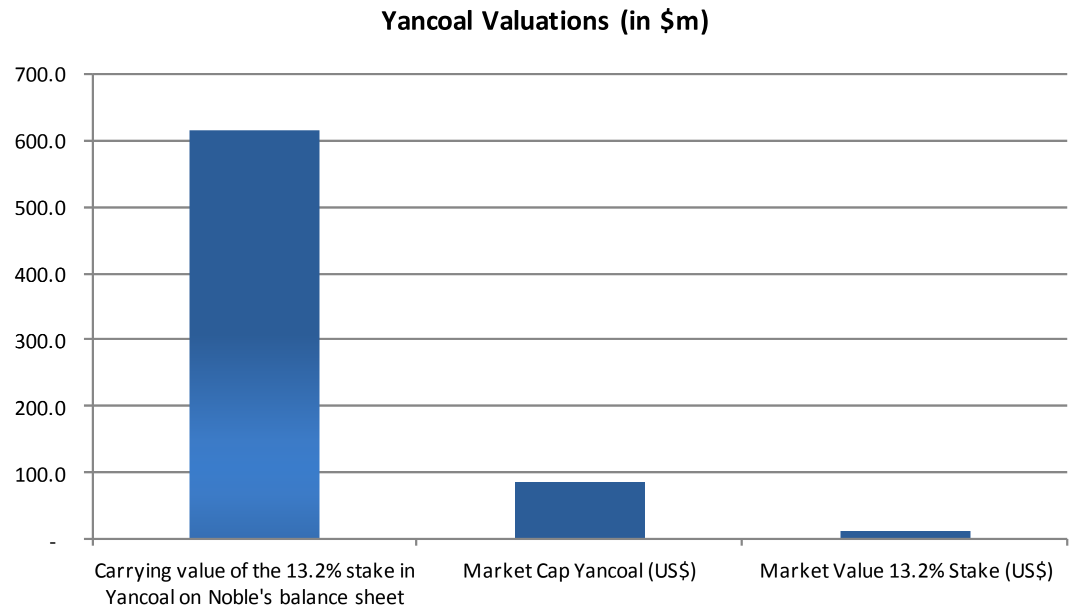
- Noble exploits the accounting treatment of its associates to avoid large impairments and fabricate profit.
- Yancoal is the most representative example, with a gap of $600m between the carrying and market values. However, the accounting technique has been used for other companies.
- Contrary to what Noble’s management claims, the misfortunes of these associates have a substantial cash impact on Noble.
- The proclaimed recovery of the Agri business in 2014 was manufactured through the use of questionable methods such as subsidies from the group or depreciation cuts.
- We believe the final price for the new associate Agri will be much lower than the provisional $1.5b payment; and/or that Noble will have substantial remaining financial commitments to its new associate. Noble may once again use the accounting for associates to hide the impairment.
- Selling the palm oil business will be very difficult for Noble since the licence of one of its subsidiaries has been revoked by the local government.

1. The unusual accounting of Noble’s associates

Like Enron, Noble Group has a remarkable ability to spot accounting loopholes. One of them is the accounting of associates. The valuation gap for an associate, Yancoal, has already been commented on by a few analysts. We explain the mechanism used by Noble; how some profit was fabricated in the process; and we show that this method has been used for other companies too.

Yancoal: How to exploit an accounting rule to fabricate profit and avoid a $603m impairment

Yancoal is a listed Australian coal miner. Noble holds a 13% interest in Yancoal and classifies the company as “associate” on its balance sheet. The carrying value of Yancoal was $678m in the 2013 annual report. It is now $614m after deducting Noble’s share of losses and impairments in 2014. The 13% stake in ASX-listed Yancoal has a market value of only $11m. In other words, there is a gap of $603m between the carrying value and the market value.



Source: Noble Group (carrying value at the end of 2013+subsequent share of losses and Q3 impairment) / Bloomberg

The carrying value is 55 times the market value of the 13% stake. It is also 7 times the market cap of Yancoal, even though Noble only owns 13% of Yancoal. The discrepancy represents 11% of Noble's equity or 12 cents per share.

Yancoal is treated as an associate in Noble's financials. Associates are generally companies that are controlled more than 20% by a group and less than 50%. Noble controls only 13% of Yancoal. As such, Yancoal should be treated as a long term investment. However, Noble claims that it has "significant influence" to justify the classification as associate. The accounting treatment of associates and long term investments is different. For long term investments, the carrying value is regularly adjusted to the fair value (i.e. the stock value when the company is listed). On the other hand, associates are initially recorded "at cost" on the balance sheet and subsequently, the carrying value is adjusted for the share of the associate's profit or losses ("equity method"), irrespective of the market value.[1]

The problem is that when Noble records companies as associates on its balance sheet, the group has a unique way of estimating their initial value. In June 2012, Yancoal became an associate after the merger between Gloucester Coal (partly controlled by Noble at that time) and Yancoal. The valuation of Yancoal was supposed to be "at cost". However, it was done at a stratospheric level based on Noble's own cash flow projections. Just after the merger on June 27th, the carrying value of Yancoal was already five times what its stake was worth in the market, i.e. a $660m overvaluation. Even with both spot and forward coal prices at a much higher level at that time, Yancoal was already grossly

[1] Annual report 2012 p. 97

overstated. The valuation implied by the carrying value of Yancoal was 38x Yancoal's pre-tax profit in 2012. Under the terms of the merger, Gloucester repaid a shareholder loan to Noble and Yancoal made a capital distribution to Noble. This weakened the balance sheets of Gloucester and Yancoal. Yancoal's debt is now $4b, an unsustainable level for a company recording operating cash outflows.

The advantage of overvaluing its associate on its balance sheet is that when Noble has to recognise its share of losses, the starting point of the valuation in Noble's books is so high that the carrying value is hardly eroded. If Yancoal's market cap was worth one dollar tomorrow, Noble would still be able to value it at more than $600m on its balance sheet.

After the merger, Noble also recorded an additional profit of $100m for "loss of control of a subsidiary". The valuation gap that already existed in 2012 should have led to a massive impairment and loss. Instead, Noble booked profit. We consider this profit fabricated because Noble's cash flow projections were disconnected from any economic reality. The profit was booked in the operating income. Enron also booked the non-recurrent profit from the sale of its assets in its operating income. Noble added the associate "valuation boost" to the formula.

As we will see in this series of reports, the auditor, Ernst and Young ("EY"), is well aware of the issues, but discreetly writes its reserves in the annual report to avoid future legal liabilities. After Yancoal became an associate, they noted in the 2012 annual report: "At initial recognition, the investment in Yancoal was measured at fair value estimated based on a discounted cash flow model. Determining the value for this investment required the Group to make certain estimates and assumptions on expected sales and production volume, future sale prices, expected future costs and expenses. Actual outcomes could differ from these estimates and assumptions."[2] In the 2013 annual report, EY wrote that there was a $577m "accounting adjustment" between the carrying value and "the group's share of net assets of the associate."

The classification as an associate is highly questionable. Noble claims it has significant influence over Yancoal, for example being a major buyer, and avoids the adjustment to the market value. However, the significant shareholder is not Noble, but Chinese state-owned Yanzhou which controls 78% of Yancoal. It is quite clear that the relationship between Yanzhou and Noble is cold. Noble is completely left out of Yancoal's information flow. Recently, Yancoal launched a dilutive $2.3b rights offering. Noble was not sounded out. In August 2013, Yancoal reported $687m losses due to asset impairment and FX losses. Noble expressed surprise in a rather unusual press release: "Noble is unaware of the basis for those reductions and whether they properly reflect the forward curves for relevant coal prices and therefore Noble will review any of its own valuations or adjustments in that

[2] AR 2012 p. 106

light."[3] Yancoal was just doing what dozens of other commodities groups have done for the past three years: impairing assets because of falling commodities prices.

In the annual report, significant influence is defined as follows: "Significant influence is the ability to participate in the financial and operating policy decisions of the investee, but is not control or joint control over those policies."[4] Noble is completely unable to participate in these decisions. The group is not even notified. EY leaves the management responsible for the classification: "the Group's management determined that it exercised significant influence over Yancoal and has accounted for the investment as an associate".

The only reason why Yancoal is an associate is that the accounting enables Noble to avoid the $603m loss. Noble does what may be formally acceptable from an auditors point of view (let a client value its own associate at a surreal level and maintain the associate classification based on a fictional argument). From an investors point of view, this is complete non-sense. The valuation of Yancoal is now completely disconnected from the future cash flows expected from this associate.

Of course, if tomorrow Noble sold its stake in Yancoal, Yancoal would not be an associate anymore and Noble would have to recognise the full loss. For this reason, when Yanzhou approached minority shareholders to buy them out in October 2013, Noble could not possibly accept the offer. In November 2014, Noble was one inch from recording the $603m loss. Yancoal announced the issuance of highly dilutive $2.3b convertible notes that would have forced Noble to either extend $255m in financing to Yancoal, or accept the dilution to 0.7%. In turn, the dilution would have allowed Yanzhou to buy minority shareholders out before the privatisation of Yancoal. Noble was saved by the Australian Takeovers Panel that halted the plan because the terms were too dilutive for minority shareholders. However, we think Yanzhou will come back with a more acceptable plan to buy minority shareholders out, and the problem of the overvaluation will emerge again for Noble.

PT Atlas (impairment of $34m required) and other associates

PT Atlas is another illustration of how Noble books profit when a company becomes an associate and how the value is maintained at an artificial level on the balance sheet.

PT Atlas is an Indonesian coal miner with a market cap of $101m. Noble owns only 10% of PT Atlas (market value of $10m) but classifies it as an associate. Before it became an associate in March 2013, PT Atlas was classified as a held for trading financial asset, which was consistent with the percentage

[3] Noble press release 18 August 2013
[4] AR 2013 p. 98

controlled by Noble. Then, "the group reclassified Atlas to investments in associates from held for trading financial assets following the appointment of a director of Noble as Vice President of the Board of Commissioners in March 2013".[5] Noble claims they gained significant influence after the appointment of a director, so PT Atlas became an associate.

Strangely in the process, Noble "recognized a re-measurement gain on the pre-existing interest of US$25.5m." The fair value of held for trading investments is supposed to be automatically adjusted to the market value of listed stocks. We do not see any reason why the conversion into an associate should have triggered a re-measurement and profit. The stock price did not rise during the period. It declined between the previous quarter (Dec 31st) and the day when PT Atlas became an associate.

PT Atlas' performance is hurt by low coal prices: the company recorded net losses of $16m for revenue of $27m in 9M 2014. The $25.5m derived from the conversion to an associate does not seem justified, and the market value of Noble's stake in PT Atlas declined by $11m since the end of 2013. After deducting the share of net losses of PT Atlas in 2013 and 2014 ($2.7m), we believe a total impairment of $34m is required for PT Atlas.

There are other companies on Noble's balance sheet that benefit from the favourable associate accounting treatment, although Noble's ownership is less than 20%. EY discreetly objects to the classification: "Although the Group held less than 20% of the ownership interest and voting rights in some of the above associates, it has judged that it exercises significant influence through its material commercial and financial transactions and representation on the Board of Directors and Board sub-committees of these associates."[6] For example, Aspire Mining and Xanadu Mines are controlled 15% and 10% respectively by Noble. The market value of Noble's stakes in these companies fell to just $2m each amid low coal/coking coal prices. However, Noble does not give information on the individual carrying value of these associates, so we cannot quantify the overvaluation. Before Agri became an associate, investment in associates reached $1.05b on the balance sheet. If we take the carrying value of Yancoal out, other associates have a combined carrying value of $433m. We seriously doubt that the series of small associates partly owned by Noble (listed or not) have a combined market value anywhere near this number.

[5] AR 2013 p. 129
[6] AR 2013 p. 129

2. The poor performance of Noble's associates has a direct cash impact on the group

Both the chairman, Richard Elman, and the CEO of Noble, Yusuf Alireza, insist on the notion of "largely non-cash losses of the associates"[7] to underline that the misfortunes of these associates are of little consequence in terms of cash for Noble. However, Noble's associates have definitely been a cash drain for the group. The sharp drop in market value of all these listed associates reveals profound financial issues. Noble is frequently forced to recapitalise struggling associates. We summarised cash inflows and outflows below. Noble combines associates and JV. Outflows since FY2011 have reached a total of ($230m).

Financial impact of JV/associates (in $m)	FY2011	FY2012	FY2013	9M 2014	Total
Investment in JV/ associates	-33	-79	-103	-225	
Proceeds from disposal of JV/associates	3	0	39	0	
Dividends income from JV/associates	2	2	0	0	
Decrease/(increase) in amount due from JV/associates	-76	-46	285	2	
Total	-104	-123	221	-223	**-230**

Source: Noble

The $1.5b received for Agri does not concern associates: Agri was still a subsidiary when partly sold to COFCO. Similarly, the repayment of the intercompany loan after Q3 is just the repayment of a loan made by Noble Group when Agri was a subsidiary, hence a neutral effect.

As mentioned, Noble would have been forced to inject $255m in Yancoal or recognise the $603m loss if the Australian takeover panel had not rejected Yanzhou's plan. Recently, another source of trouble has been the associate Cockatoo Coal, an Australian coal miner. Noble holds 23% of Cockatoo Coal. The group is now forced to sub-underwrite a $97m (A$125m) equity raising along with two other investors to save Cockatoo.[8] Before the equity raising was announced, Cockatoo was in a very alarming situation. A project financing facility provided by ANZ was cancelled because "Challenges in the external coal environment have rendered the ANZ project financing facility untenable." Cockatoo recorded 12-month operating cash outflows of ($21.2m) in June 2014, and had cash on hand of only $1.3m at that time. The auditor wrote in Cockatoo's annual report: "The conditions outlined above give rise to material uncertainty that may cast significant doubt upon the Group's ability to continue as a going concern."[9] The trading of Cockatoo Coal was suspended on the ASX for three months. The rights issue will be done at a sharp 86% discount to November closing share price,

[7] AR 2013 p. 10 and 13

[8] http://www.cockatoocoal.com.au/index.cfm/investors/asx-announcements/2015-asx-announcements/125m-recapitalisation-to-fund-baralaba-expansion-project/

[9] Annual report for the year ended June 2014 p. 47

almost wiping out the value of Noble's existing stake in Cockatoo. The market value of the stake was worth $38m at the end of 2013.[10] Noble does not report the carrying value of Cockatoo.

As for the value of the associates on the balance sheet, it is not an accounting notion disconnected from cash flows. These associates have an extremely low market value because the market expects them to be unable to generate free cash flows. Yancoal is not worth $614m because not only does it report operating cash outflows now (-$101m in the first six months of 2014), but it requires financial assistance from its shareholders to stay alive. There will be no improvement in the medium term. The coal forward curve gives a bleak signal and the level of debt strangles the company. Both of these facts are recognised by Yancoal and Yanzhou. Maintaining assets at an inflated level gives false information to both investors and banks regarding the company's expected future cash flows.

If Noble underlines that the associates' losses are "largely non cash", should we understand that the rest of Noble's profit is "cash profit"? The $100m profit booked on Yancoal when it became an associate was a very questionable paper profit. More importantly, one of the most under-analysed aspects of Noble Group is its inability to generate operating cash flows. Since 2009, Noble has recorded a sizeable total of $2.7b in net profit. However, the combined operating cash flows have been negative (-$485m) in the same period. Noble reports better cash flow numbers because they do not include debt interest in the OCF. Most companies include interest for a good reason: they are a non-discretionary cost that supports operations. The reason for the gap between profitability and cash flows is the remarkable surge in the fair value of unrealised contracts (net $3.7b on the balance sheet). We will address this crucial issue in the next report on fair values, and how these small associates help Noble book gigantic contracts over as many as 35 years[11] even though some do not operate or are still seeking financing.

3. The New Associate: Agri

There has been a new associate in Noble's balance sheet since the beginning of Q4: its former subsidiary Noble Agri Ltd ("Agri").

Agri is now 49% controlled by Noble and 51% by a consortium led by COFCO. Noble sold 51% of Agri for a provisional $1.5b, valuing Agri at $2.9b. The final consideration is subject to adjustment and will be equal to 1.15x of 51% of the audited book value of Agri at the end of 2014 (subject to

[10] AR 2013 p. 128

[11] Maximum maturity of contracts with associate Resource Generation. Source: http://clients.weblink.com.au/clients/ResourceGeneration/article.asp?asx=RES&view=2839166

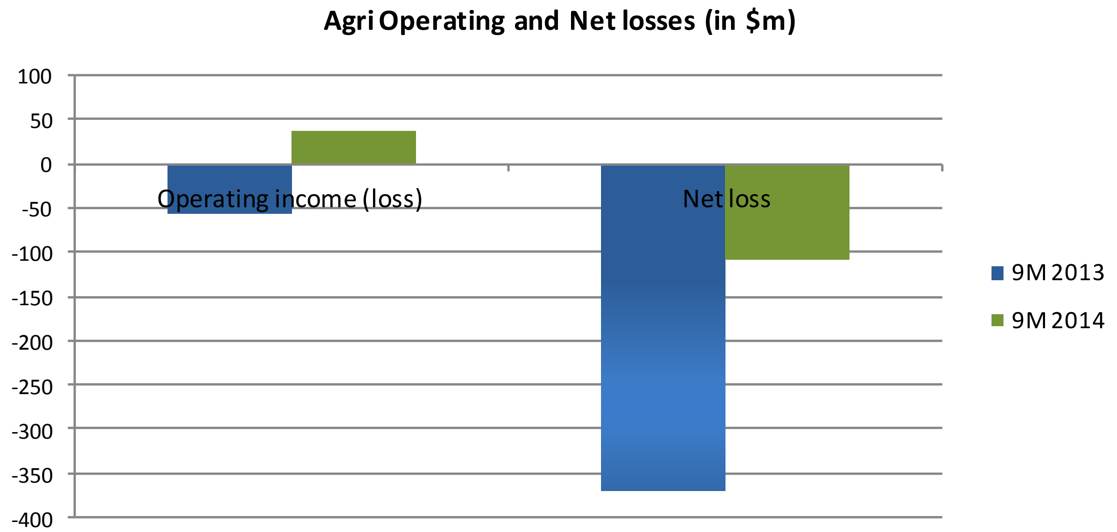
"certain adjustments").[12] COFCO sold part of its 51% share to a group of investors and retains 30.6% in Agri. As a result, Noble will remain the largest shareholder with a 49% stake.

The market reacted positively to the sale. After Reuters broke the news, the share price rose 26% in one month. Agri has been a drag on the results. FY2013 was a particularly bad year with an operating loss from supply chains of ($83m), plunging from $180m in 2012 and $477m in 2011.[13] Agri recorded net losses of ($442m) in 2013.[14] A price of $1.5b for 51% of a deeply loss-making division appears to be very good for Noble.

First, we show that the improvement in Agri's performance in 2014 has been orchestrated to give the illusion of a recovery. We then explain that Agri faces structural issues, publicly recognised by everybody in the industry, except Noble. We also explain why we think the final price paid by COFCO will be much lower than $1.5b, and/or there will be remaining financial obligations for Noble. Noble may once again use the associate favourable treatment to hide a necessary impairment.

How Noble manufactured the recovery of Agri in 2014

Noble's former subsidiary seems to be turning a corner. Below is a comparison of the operating income for the first nine months of 2013 and 2014 ($36m recovering from losses of $58m). Net losses narrowed from $371m to $109m. Losses typically build up in Agri at the beginning of the year. Clearly, Agri is showing a solid trend of recovery.



Source: Noble Group

[12] Announcement "Proposed Disposal of 51% in Noble Agri Ltd" dated 2 Apr 2014 p.1
[13] Management's Discussion and Analysis FY2011 to FY2013
[14] Announcement "Proposed Disposal of 51% in Noble Agri Ltd" dated 2 Apr 2014 p.8. Number given by Noble is more precisely "net loss before income tax, minority interests and extraordinary items".

For operating income/loss we will use the same definition as Noble, but this is not a "real" operating income. The selling, administrative and operating expenses of $157m (e.g. wages) are excluded. Noble assumes that its operations do not require people to run them.

Noble triumphed in its second quarter results: "Performance of the Agriculture segment has improved substantially, in terms of both operating and net loss. This was driven by the continued implementation of our focused business plan."[15] We do not know what the "focused business plan" was, but the accounting department was clearly instrumental in its implementation. The performance of Agri in the first nine months of 2014 was still very poor. The "notable improvement" is the result of deferred tax assets, subsidies from the group, and a mysterious fall in the depreciation rate. In the first nine months of 2014, Agri benefited from:

1. **Deferred tax assets** of $87m in 9M 2014 up from $12m in 9M 2013. Agri recorded profit because… they made losses. Booking tax assets does not reflect an operational improvement. It is just the consequences of more losses. The companies that recognise deferred tax assets are supposed to be able to generate taxable profit in future fiscal periods. EY leaves the management responsible for what can be a very subjective assessment: "Deferred tax assets are recognised for all unused tax losses to the extent that it is probable that taxable profit will be available against which the losses can be utilised. Significant management judgement is required to determine the amount of deferred tax assets that can be recognised."[16]

2. **Depreciation**: fixed assets are hardly depreciated anymore. From Q2, Noble's cash flow statements reveal something we found puzzling: global depreciation which includes both Continuing operations (Energy and Metals) and Agri fell from $39m in Q1 to an average of $14.3m in Q2 and Q3. Noble considerably slowed its depreciation rate while its fixed assets remained the same. Agri was still 100% controlled by Noble in Q2 and Q3. Most of the fixed assets subject to depreciation are from Agri (79% of the group depreciation in 2013).[17] With this new depreciation rate, it would take 50 years for Noble to depreciate its fixed assets pre-closing.

3. The **financing costs** of Agri have been heavily subsidised by Noble since the beginning of the year. If we compare 9M 2013 and 9M 2014, Agri's finance costs fell from $152m to $97m.[18] In the same period, interest costs of Continuing operations increased from $160m to $178m despite a cheaper financing environment. The reason: Noble borrowed from banks at group

[15] Management's Discussion and Analysis Q2 2014
[16] AR 2013 p. 110
[17] AR 2013 p. 112
[18] Agri interest expenses are not directly reported by Noble (net interest expenses are reported instead) but simple reconciliation calculations with numbers given in the income statement and the cash flows statement allow us to find this number.

level, then channelled the cash to Agri. As a result, interest costs of Agri were artificially lower. For example, the cash balance at Agri level was $679m in Q1 2014 against only $1.3m in Q1 2013. After Q1, Noble did not continue to make the comparison. They were certainly aware this could attract attention to the impact of the intra-group financing.

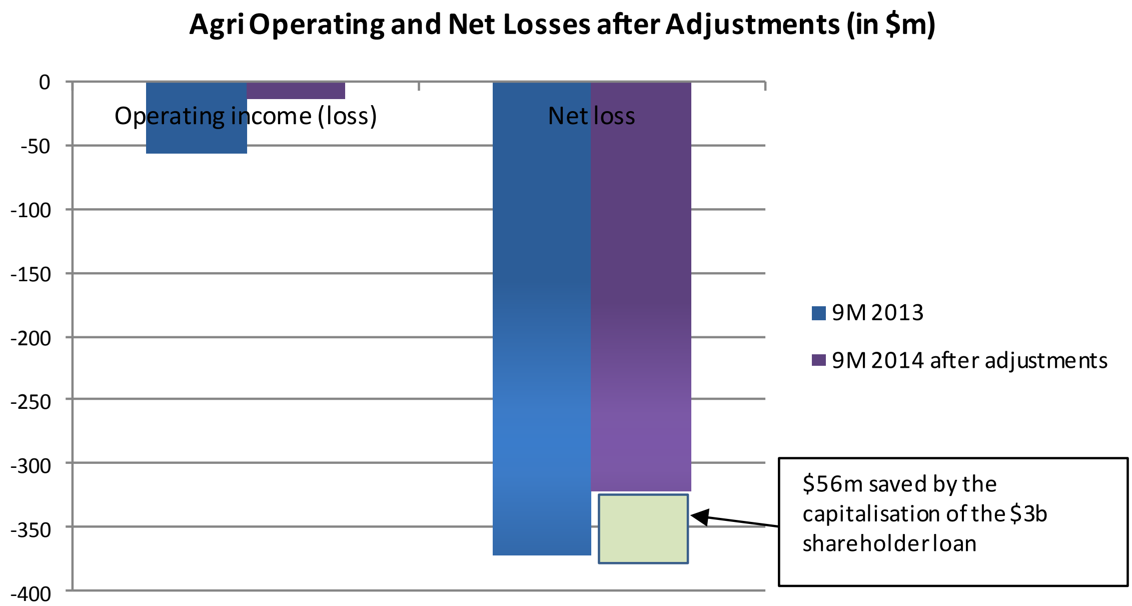
4. Noble subsidised Agri's **selling, administrative and operating expenses ("SAO")** for $32.5m in Q3. The CEO said: "We have agreed as part and during that transition period that we will take on some costs associated with continuing to support certain functions in Noble Agri until it becomes an independent company. And as a result, those costs show up as an increase on Noble Group SAO, but there's an equivalent decrease on Agri SAO."[19] This is quite remarkable. The beneficiary of these services (e.g. IT, legal) is Agri. Irrespective of who performs them (Noble or Agri), they should be paid by Agri, not by Noble. This arrangement is not one-off. The transition could be "over the next 18 months, at most 18 months."[20]

The impact is summarised below:

Additional deferred tax assets	$75.5m
Depreciation cut in Q2 and Q3	$49.4m
Financing costs subsidised by Noble Group	$54.9m
SAO subsidised by Noble Group	$32.5m
Total	**$212.2m**

This total of $212m is not caused by any operational improvement. Without these effects, Noble would have recorded losses of $321m, from $371m in the same period in 2013, i.e. a $50m improvement. This poor performance is hardly a reason to celebrate. If we want to fully compare the performance in 9M 2013 and 9M 2014, we need to take into account the savings brought by the capitalisation of a $3b shareholder loan from Noble group in November 2013. This shareholder loan was remunerated $75m in 2013.[21] Agri saved $56m in the first nine months of the year. All other things being equal, net losses widened by $6m between the two periods.

[19] Transcript earnings conference call Q3 2014 p. 7
[20] Transcript earnings conference call Q3 2014 p. 8
[21] Announcement "Proposed Disposal of 51% in Noble Agri Ltd" dated 2 Apr 2014 p.8-9.



Source: Noble Group data/ Iceberg Research adjustments

The structural issues at Agri's level are here to stay

Even though Noble controls 49% of Agri going forward, it is clear that the performance of its new associate remains very poor and will weigh on its results. What exactly are the problems of a business that was in much better shape in 2011, and is there anything that COFCO can do about it?

In the past, Noble attributed the bad performance to rain, drought, logistical issues, and when the weather was good, the famous "ramp up" argument that has been the most over-used excuse given to analysts. Out of the four sugar mills owned by Noble, three were described as already operational when Noble acquired them in 2007 and 2010. The fourth one was expected to be operational in 2011. We also read that Noble is hurt by low sugar prices. Sugar plantations (around $355m on the balance sheet) are definitely affected by low sugar prices. The profitability of the sugar mills is driven by demand for processing, which is not exactly the same driver as the sugar price. In reality, the reasons for the bad results are easy to find. They are publicly acknowledged by Noble's competitors who invested in the same markets: a structural crisis affecting the Brazilian sugar mills industry that has become an investor's sinkhole. The combination of over-investment, high inflation, government subsidies to gasoline, and competition of shale products putting pressure on biofuels in the export market plague the Brazilian industry.

Will COFCO be able to turn the situation around? It is common to read that COFCO will have a positive impact on Agri because it is a big importer. However, South American commodity products are already largely exported to China. Commodities prices are set on global markets. COFCO will not pay sugar (Agri's biggest issue) or other commodities above market price. This would be subsidizing a foreign company in which they are merely a minority shareholder (30.6%). When Yanzhou bought Australian coal assets to create Yancoal, there were similar comments on Yancoal potentially benefiting from the backing of a large Chinese stated-owned enterprise and its import flow. However, the coal was already exported to China and we now see there is nothing Yanzhou can do against falling coal prices. Yancoal's share price has fallen 91% since June 2012. Neither COFCO nor Yanzhou have influence over coal prices or a troubled sugar mill industry. Furthermore, Agri has now accumulated a heavy debt that increased to $3.4b after the repayment of the $1.86b intercompany loan to Noble Group, replaced by bank debt. This will weigh on Agri's performance, exactly like Yancoal. We estimate the negative effect of this additional debt to be $24m per annum for Agri (a $12m impact on Noble Group). Going forward, we expect Agri to continue to sustain substantial loss so long as the sugar industry in Brazil is affected by the same structural issues. Unfortunately for the industry, Brazilian President Dilma Rousseff, a defender of gasoline subsidies, was re-elected for another four years in 2014.

There also exist significant cultural differences between an international trader and a Chinese state-owned enterprise on strategic orientations, remuneration, bonus, room for speculation, etc. These are often underestimated and will complicate the management of Agri. Physical traders leave rapidly when dissatisfied.

The final price of Agri (impairment for the sale stake and remaining stake temporarily estimated at $500m)

Let us summarise the situation for the buyers of Agri:

- Agri is still making heavy losses and the recovery largely depends on external factors such as Brazilian government policies that COFCO and Noble do not control.
- The improvement in 2014 is due to accounting factors (cutting depreciation, using subsidies and deferred tax assets). The underlying operational performance remains very poor.

Then we can add obvious assets overvaluations in Agri. For example: both Noble and its competitor Bunge invested in a similar portfolio of sugar mills and had similar goodwill after their acquisition ($496m in goodwill for Bunge and $409m in goodwill for Noble).[22] Both faced industry headwinds. Their accounting is radically different: Bunge decided to impair 100% of its goodwill in 2012. Noble has not impaired a single dollar. As usual, EY leaves the management responsible for the

[22] AR 2011 p.131

overvaluation in the annual report: "The recoverable amount of the cash-generating units under goodwill impairment testing have been determined based on value in use calculations using cash flow projections derived from financial budgets covering five-year periods and approved by senior management."[23] We also think that the agricultural assets (sugar cane plantations) are over-valued at $355m while sugar prices are near a five-year low.

One can wonder if COFCO is aware of any of this, and whether they have remarked on Noble having spent the whole 2014 year "enhancing" the book value of Agri, which is the basis for the final price of the transaction. Did the Chinese group spend enough time conducting their due diligence before agreeing to this $1.5b price, valuing Agri at $2.94b?

We believe that COFCO is actually fully aware of both the overvaluations and of the accounting in 2014. For example, they cannot have missed the fact that the seller (Noble) largely cut the depreciation of its assets in Q2 and Q3. COFCO buys commodities from South America all the time. They cannot ignore the difficulties of the sector and the fact that Noble's sugar assets (sugar mills goodwill and sugar plantations) have the dubious honour, in the industry, of being virtually immune to impairments. However, this $1.5b initial payment is of little importance to COFCO because it is not the price they will pay. The final price will be estimated after an audit of the FY2014 book value of Agri. As is the practice in M&A transactions, the auditor will be independent from the seller (so not EY, the auditor of Noble). We expect the final price will be much lower than this $1.5b and/or Noble Group will have remaining financial commitments to Agri, such as the obligation to continue subsidising its associate.

To precisely estimate how much the impairment will be is speculative at this stage before completion of the audit. However, we find the level of profit booked for the sale of Agri by Noble in Q3 ($246m) quite inconsistent with the reported carrying value of Agri in Q3 ($2.86b). Profit booked for the transaction should be 0.15x of Agri's audited book value at the end of 2014, subject to "certain adjustments" and transaction costs. Noble does not report the book value of Agri anymore so we can only use the carrying value of Agri at the end of Q3 as a proxy for the book value. Based on this number, profit should be $429m before adjustments and transaction costs. However, as mentioned, total recorded profit was much lower: $246.4m composed of $107m for the gain on the 51% sale shares and $140m for the remeasurement gain on the remaining 49% stake.

During the Q3 conf call, the CFO explained that the gain on the 51% stake was a "straight calculation of the anticipated quarter four balance sheet and 15% on that less transaction cost."[24] For the 49%

[23] AR 2013 p.122
[24] Transcript Q3 Earnings Call p.10

remaining stake, he added: "Then we also took a remeasurement gain on the preexisting interest, i.e. the remaining 49% stake and that was taken as effectively the market price which was the deal price. So it was revalued at the same level." The profit of $140m on the 49% remaining stake, unaffected by transaction costs, implies a book value for Agri of only $2.2b post sale/remeasurement gains. If our assumptions are correct, Noble would expect the book value of Agri to be impaired to $2.2b in FY2014. This is $671m or 23% lower than the carrying value reported in Q3 ($2.86b). This is also $917m or 30% lower than the Q3 carrying value post sale and re-measurement gains ($3.1b). Conservatively, before the final numbers for 2014 give us more information, we expect an impairment of at least $500m to be made. This $500m impairment is just above the level of goodwill on sugar mills that was already completely impaired by competitors like Bunge three years ago, when the Brazilian sugar industry was in better shape.

The announcement on the disposal of Agri published in April also referred to "adjustments".[25] It would have been interesting to consult the share sale agreement to have a more precise idea of these adjustments, and other important aspects of the agreement. However, Noble had the original idea of making it available for inspection "during normal business hours at the registered office of the Company in Bermuda", an island in the middle of the Atlantic Ocean. Noble is headquartered in Hong Kong and listed in Singapore. Noble has not answered a request to have access to this document.

If the final price for Agri is lower than $1.5b, then Noble should also impair the remaining 49% stake. However, as we showed in the example of Yancoal, Noble is given complete leeway by its auditor to value its associates at whatever price Noble wants. Noble may absorb the impairment by first aggressively re-valuing Agri, as they did for Yancoal, to maintain the illusion of a $1.5b valuation. One key aspect of the FY2014 financials will be whether Noble accepts the disclosure of the final price paid by COFCO and the disclosure of remaining financial commitments. Going forward, Noble has no obligation to report the balance sheet of Agri because the former subsidiary has become an associate. Even in Q3, only the carrying values were reported. As for the cash adjustment for the final price to be paid to COFCO ($172m assuming a $500m impairment), it should flow though the investment cash flows of Noble Group. However, the arrangement can be more discreet and can include future obligations to subsidise Agri. Noble stated that the SAO costs of Agri will be partly paid by the group during a maximum period of 18 months.[26] These subsidies are just an indirect way to reduce the real price of Agri. It is quite clear that many key aspects of this transaction have not been disclosed.

[25] Announcement "Proposed Disposal of 51% in Noble Agri Ltd" dated 2 Apr 2014 p.1
[26] Transcript Q3 Earnings call p.8

One last word on the palm business held for sale: the licence of one Noble subsidiary has just been revoked (required impairment of $94m)

The 51% sale of Agri included all agricultural activities with the exception of the palm oil business that COFCO did not want. Noble has palm oil plantations in Indonesia's Papua province. This business is now held for sale, and the net assets are $187m.

Noble will likely struggle to find a buyer. In December, an Indonesian local government revoked the licence and ordered the cessation of activity of one of its two subsidiaries there: PT Pusaka Agro Lestari ("PT PAL"). The local government received complaints from local civil and religious leaders accusing PT PAL of damaging the forest area.[27] PT PAL was licensed to open oil palm plantations over a concession of 39,000 hectares.

Legal recourses are notoriously difficult for foreign companies in Indonesia. The revocation of the licence and more generally the continuous opposition that the palm business faces in the Papua region will discourage potential buyers. As a result, we believe half of the net assets of $187m should be impaired (impairment of $94m).

4. Questions to Noble's management

Here are our main questions to Noble's management:

- With a $603m valuation gap, when will Noble recognise a long overdue impairment on Yancoal? Based on what assumption (forward curve, production numbers), can Noble pretend Yancoal is worth that much?
- Why was the carrying value of PT Atlas re-valued and how much is it now?
- Is Noble willing to publish the carrying value of its other listed associates?
- Why did the depreciation rate fall in Q2 and Q3?
- Will Noble announce the final price paid by COFCO and any remaining obligation related to this transaction (e.g. subsidies)?
- What is the current book value of Agri (not its carrying value) and will Noble disclose this number and Agri's balance sheet for FY2014?
- Why was the share sale agreement between Noble and COFCO available only in the Bermuda office?
- How does Noble intend to sell its palm oil subsidiary after the revocation of its licence?

[27] http://www.antaranews.com/berita/469597/bupati-mimika-resmi-cabut-izin-perkebunan-sawit-pt-pal (in Indonesian)

Next Report

In the next report, we will show that as poor as Agri's situation may look, the real accounting issues of Noble are actually with the Continuing Operations (Energy and Metals), in particular the most Enron-esque aspect of Noble's financials: the fair values. We will address the illusion that Continuing operations are the healthy part of Noble.