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Noble Group, a Repeat of Enron

Third Report: Governance and Debt

Report date: March 21, 2015

Noble Group Ltd
Industry: Commodities trading
Founded: 1986. Headquartered in Hong Kong.

Revenue 2014: $86b
Net profit 2014: $133m
Operating cash outflows 2014: ($1.2b)
Equity: $5.1b

Rating: (BBB-/Baa3)

Listed in Singapore (SGX:N21)
Market cap: S$5.9b (US$4.2b) as of close March 20, 2015
Stock price: S$0.88 as of close March 20, 2015

Price target: S$0.10

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Summary of findings:

- There are an impressive series of red flags drawn when reviewing Noble's governance: independent directors on the board for 19 years, key shareholders and staff leaving the company, "negative assurances" taken off the website, the high number of reservations expressed by the auditor in the annual report, etc.

- Noble substantially understates both its gross and net debt, for example it omits the corporate guarantee to Agri against which new debt was raised. Noble also calculates its net debt by using cash they have no access to. We found Noble's gross debt to be 41% higher than reported (+$1.6b), and net debt 64% higher than reported (+$2b).

- When calculating its "adjusted" net debt, Noble claims that $2.2b inventories could be used for debt repayment while there are $8.1b suppliers with exactly the same level of claim on those inventories. We explain why using inventories to repay banks and bond holders would immediately trigger Noble's bankruptcy.

- We estimate that after adjustments, the major financial covenants are breached.

- In addition, Noble intensively engineers its level of debt at reporting date with what we believe is the help of heavy repos disguised into regular sale and purchase.

- The concept of liquidity headroom, a cornerstone of the investment grade for credit agencies, is based on a series of misconceptions that we explain.

- After impairments and using a price-to-book valuation method, we find a valuation of S$0.1 per share.

- Our conclusion summarises the comparison between Noble and Enron.

1. Governance: obvious red flags

Credit agencies do not grant a rating based solely on financial indicators. Qualitative aspects such as governance play a very important role. Recently S&P wrote: "In our view, the company's risk management framework and governance and control policies are adequate." We are puzzled by this opinion because there are an impressive collection of red flags.

Why did the negative assurances disappear?

Every quarter, Noble used to publish a "negative assurance" together with its financials on its website. In this document, the directors confirmed that, to the best of (their) knowledge, nothing has come to the attention of the Board of Directors which may render the financial statements to be false or misleading in any material aspect.

SGX LISTING REQUIREMENTS

Negative Assurance Confirmation required from Board for 2014 3rd Quarter Results

Confirmation By Directors Pursuant to Rule 705(5) of the Listing Manual of SGX-ST

We confirm that to the best of our knowledge, nothing has come to the attention of the Board of Directors of Noble Group Limited which may render the unaudited financial statements for 3rd Quarter ended 30 September 2014 to be false or misleading in any material aspect.

For and on behalf of the Board of Directors of
Noble Group Limited

Richard Samuel Elman
Director
Date: 7 November 2014

Yusuf Alireza
Director
Date: 7 November 2014

After the publication of our first two reports, we realised that the negative assurances had been taken off. As of March 21st, the latest one can only be found in an archived section of the website. We could not find any negative assurance on the SGX website for the FY2014 results.

We read that the chairman, Richard Elman, demonstrated his confidence in Noble by increasing its stake by 0.1%.[1] This increase, while representing a small amount of money, pursues a significant psychological objective. The fact negative assurances were taken off demonstrates the board of directors true confidence levels.

Board of Directors: independent for 19 years in a row

There are 13 directors on the board, including 8 "independent" directors from Noble. These independent directors have been on the board for an average of 10 years. Two directors have been on the board for 19 years. The "oldest" five directors have been on the board for an average of 15 years. Either their willpower is so strong that they have extremely independent minds, or they are de facto employees.

Noble wrote that the mark-to-market ("MTM") policies were reviewed by an audit committee. The audit committee is chaired by a director, Iain Ferguson Bruce who has been an independent director for 13 years. Mr Bruce was also a director at China Medical Technologies, a company formerly listed on the NASDAQ that filed for bankruptcy in 2012 with $400m funds missing.

The way these independent directors are remunerated guarantees that they will never rock the boat. For example, Iain Ferguson Bruce had 987k shares as of July 7th 2014, and 436k share options.[2] In many countries, regulations have been put in place to make sure independent directors are really independent. They cannot stay too long on the board and their remuneration is disconnected from the company's results. These are common sense principles that protect small shareholders. Unfortunately, Singapore has not yet implemented them.

With the current board of directors, the chairman, Richard Elman, who controls 21% of the company, is in reality the only decision maker. The interests of the other 79% shareholders can be ignored. Some mutual funds own a small percentage of Noble: for example Franklin Templeton (6%).[3] These funds should appoint their own director to represent them and receive direct information.

Important shareholders selling their shares or reducing their stake

Important shareholders have either been selling their shares or reducing their exposure. What is worrisome is that Richard Elman is now the only significant insider left.

- Harry Banga, the co-founder of Noble and until 2013 the third shareholder behind Richard Elman and CIC, the Chinese sovereign fund, sold all his shares.[4]

[1] SGX announcements March 2nd and March 11th
[2] SGX announcement July 7th, 2014
[3] SGX announcement December 29th 2014
[4] http://www.bloomberg.com/news/2013-11-12/china-to-take-iron-ore-pricing-control-from-miners-banga-says.html

- CIC reduced its stake from 13.8% to 9.4% in September. Noble's management was apparently not even informed of CIC's decision to sell. This is a particularly cold message from a Chinese shareholder.

Key executives leaving the firm

The high number of key executives leaving the company was a sign of the approaching crisis at Enron.

- Andy Cornfield, the former CFO of the Hard Commodities division, left the firm in October 2014.[5] The Hard Commodities division, co-headed by Neil Dhar and Will Randall, is where we identified the majority of the overvaluations and other suspicious situations: Yancoal, resilient coal and iron ore MTM, PT Atlas, PT ALH, Sundance Resources, etc.

- S&P recently wrote: "The company's risk management is adequate, in our view."[6] Have they remarked how many times the person they are talking to has changed over the past two years? Dean Morris, former chief risk officer, left the company in February 2013.[7] He was replaced by Jim Brown from Morgan Stanley in Q2 2013.[8] Jim Brown left and does not even mention Noble on its LinkedIn account. Bill Cronin took the job.[9] Tom Coletti replaced him in 2014. We understand Mr Coletti recently resigned. In other words, in just two years, the head of risk changed five times. This is extremely uncommon. In a bank, the turnover of the head of risk would immediately be interpreted as a red flag.

Ernst and Young: once again involved in a potential accounting scandal

On February 26th, the day of the annual results, EY, who had already completed its audit, announced it required more time before signing off on the accounts. We understand EY contacted its New York office to get further sign off. The explanation given by Noble is that EY had to go through an internal process to review the Iceberg report.

EY has been the auditor of Noble for more than twenty years: at least since 1994, which was the oldest annual report we could find. There is no auditor rotation rule for Singapore-listed companies. EY perfectly knows Noble. Year after year, the firm has expressed its reservations on some key aspects of the financials in the annual report. If EY were comfortable with Noble's financial reporting, the auditor would have read our second report in ten minutes and dismissed it.

On the one hand, EY gives an unqualified opinion. On the other hand, it buries its objections deep in the annual report and leaves the management's responsible to circumvent potential legal problems.

[5] LinkedIn profile
[6] S&P bulletin March 2nd, 2015
[7] LinkedIn profile
[8] http://www.risk.net/energy-risk/feature/2271202/bnp-hires-former-deutsche-commodities-head
[9] AR 2013 p.16

How many people who write about Noble (analysts, journalists, etc) have the time to read the annual report? We read all the recent annual reports and we have rarely seen so many reservations expressed by an auditor. The same warnings reappeared year after year. No competitor has this many reservations from the auditor. Some examples:

- On Yancoal: “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.”[10]

- On the MTM: “The management believes that the estimated fair values resulting from the valuation technique, which are recorded in the consolidated statement of financial position, and the related changes in fair values, which are recorded in income statement, are reasonable, and that they were the most appropriate values at the end of the reporting period.”[11]

- On the categorisation into level 3: “the Group applies judgement to assess both the observability of inputs to the valuation technique applied, and the significance of the input to the overall valuation of the transaction.”[12] Nobody can rely on level 3 numbers given by Noble based on this sentence.

- On the trade receivables: “A considerable amount of judgment is required in assessing the result on ultimate realisation of the trade receivables, including the current creditworthiness and the past repayment history of each trade receivable.”[13]

The pages 109-110 (“Significant accounting judgements and estimates”) of the annual report are in fact a summary of Noble’s accounting issues. They cover categories we have not analysed because we cannot quantify the magnitude of the issues: receivables, loan receivables, long term investments, income taxes, etc. The quickest way to find red flags is to look up the words “judgement” (alternatively spelled “judgment”) in the annual report. It directly leads to the main findings of our reports.

EY was the auditor of Lehman Brothers, Sino Forest, and many other accounting scandals in Asia. Among the big four, it is probably the most frequently involved in accounting scandals. As long as EY is the auditor, there will be no transparency for Noble’s stakeholders. The Economist summarised

[10] AR 2012 p. 106
[11] AR 2012 p. 154
[12] AR 2013 p 158
[13] AR 2013 p.109

the problem with auditors a few months ago: “In popular imagination, auditors are there to sniff out fraud. But because the profession was historically allowed to self-regulate despite enjoying a government-guaranteed franchise, it has set the bar so low—formally, auditors merely opine on whether financial statements meet accounting standards—that it is all but impossible for them to fail at their jobs, as they define them.”[14]

In our second report, we have demonstrated that Noble’s fair values are largely fabricated. If stakeholders have doubts, they would not need to finance an expensive and time consuming second audit of Noble’s books. The key information they need to obtain is the largest MTM exposures, and the assumptions behind these largest MTM. The 12,000 contracts that Noble mentioned is a smoke screen. The MTM of a trader are like the loans of a bank: some are very large, some are meaningless. Stakeholders can hire a small team of truly independent persons to review the largest contracts. After a few hours of work and a few thousand dollars spent, they will have better information in their hands than anything produced by Noble’s finance department, the board of directors, or EY.

Credit agencies recognise that they have not challenged the auditor’s numbers. From S&P: “An independent auditor also reviews the assumptions and reasonableness of the valuations.”[15] In turn, EY relies on… the management’s assumptions. Directors cannot be reasonably independent after 19 years of service. So the question is: who protects the interests of Noble’s small shareholders and Noble’s creditors?

Senior management’s remuneration

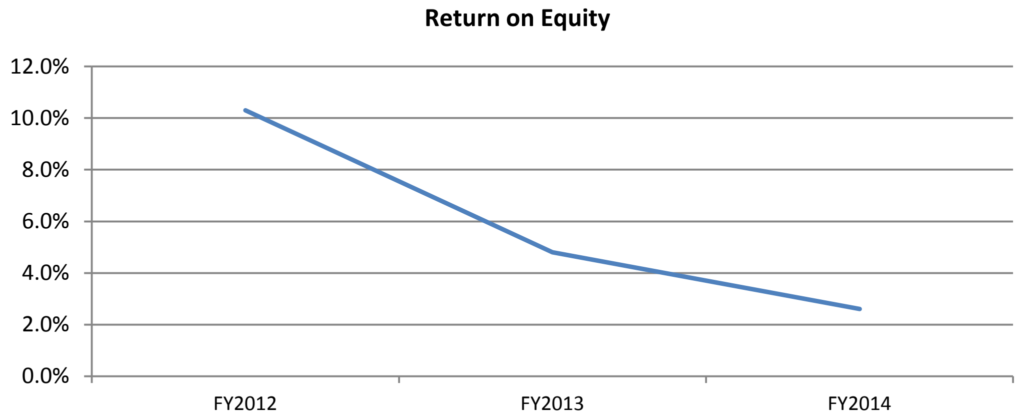
Mr. Alireza started in the role of CEO on April 16th, 2012 . We present a few indicators of the company’s performance since he has been in office.

1) Share price has declined by 31%.

2) Return on equity has fallen every year. Even if we assume that there is nothing wrong with Noble’s accounting, the performance is poor.

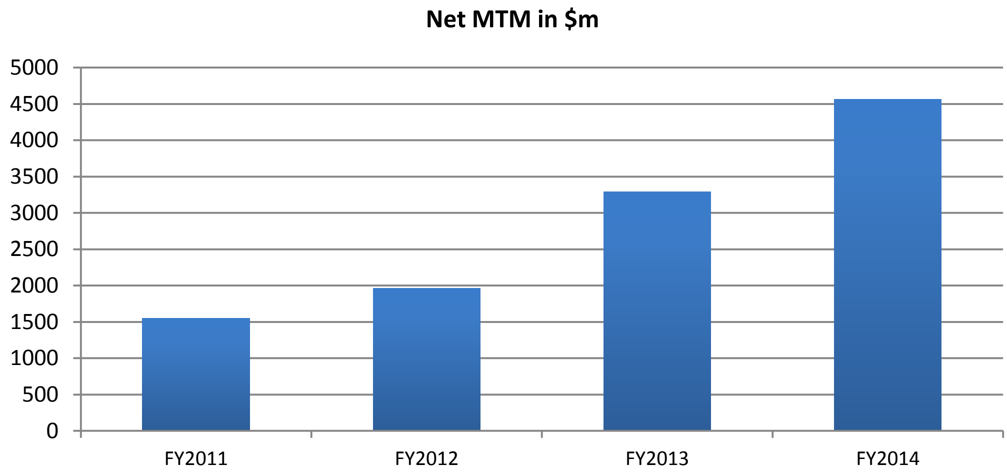
14 http://www.economist.com/news/briefing/21635978-some-13-years-after-enron-auditors-still-cant-stop-managers-cooking-books-time-some

15 S&P bulletin March 2nd, 2015



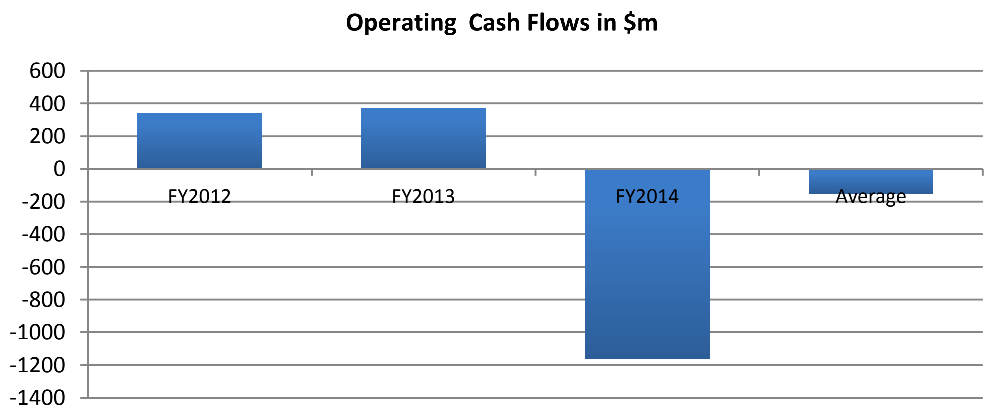
Source: Noble

3) Net fair values skyrocketed to $4.6b. We think no CEO has seen such an increase in net MTM in the commodity industry. This is probably a record. Enron's net MTM look tiny in comparison.



Source: Noble

4) Noble's operations lost $447m in cash during the period with a sharp deterioration in 2014.



Source: Noble data

Details of Mr. Alireza's individual remuneration are not public, but the annual report mentions that three people (Richard Elman, Yusuf Alireza and Will Randall) have received most of the $21.8m distributed to directors in 2013.[16] On top of that, Mr. Alireza has been granted an incredible 75 million stock options by Noble.[17] We could not find information on the exercise price.

Noble's cash performance and the remuneration of its CEO fundamentally diverge. Mr. Alireza did not have any experience in the commodity industry before he was appointed as CEO.

A few words on Singapore's regulators

Noble announced it contacted the regulators after our reports were published. We have not heard of the regulators. This is not surprising: our reports are based on public information, backed by extensive financial analysis, and we have not had a position in Noble's securities. There is simply no legal basis. As far as we know, it is not a crime to challenge the financials of a public company, or many journalists would now be in prison. We were not known before we started publishing on Noble. The only reason we have made an impact is because people who have taken the time to read our reports recognize that our arguments are solid. If they were not, they would not have any impact.

What upsets Noble is not that we write negative reviews of their financial statements, rather that we write about aspects of their accounting practices that they have deliberately kept from public discussion for years, for example the MTM. Noble's huge fair values on its balance sheet have been discussed by hundreds of people within the industry. However, somehow Noble managed to discourage the subject among industry outsiders.

As mentioned, our intention is to become a short seller in later projects, but in the case of Noble we have been a whistleblower. We have received strong support from the commodity industry. It is not the first time we act as whistleblower of Noble. In 2013, a member of Iceberg reported Noble's commercial practices in Singapore to the Maritime Port Authority ("MPA"). Noble had been associated with some less than reputable local companies. The MPA wrote that the "information validates some of our observations" and "the decision was taken by MPA not to renew (Noble's bunkering) licence". Strangely though, Noble was not fined. Subsequently, our colleague informed the MPA that the illegal activities continued and Noble was still involved. The MPA did not react. Remarkably, the local companies became major bunker suppliers in Singapore. A few months later, in 2014, the local companies and people that our colleague had reported to the MPA were directly responsible for the fraudulent bankruptcy of OW Bunker in November 2014, a Copenhagen-listed Danish bunkers trader with $17b in revenue.[18] Had the MPA acted on the information sent to them,

[16] AR 2013 p.116
[17] SGX March 5th ,2015
[18] http://uk.reuters.com/article/2014/11/06/ow-bunker-fraud-idUKL6N0SW1VP20141106

this high profile bankruptcy leaving hundreds of millions due to creditors unpaid could certainly have been avoided. Danish retail investors lost millions because of OW Bunker's collapse.

We hope the Monetary Authority of Singapore (MAS) will do a better job of investigating Noble. The regulator can help establish whether Noble Group has substantially misrepresented its financial status. In doing so, they would protect the small shareholders. We have been contacted by various persons after the publication of our two reports and we can refer them to the MAS. Again we hope that the MAS will do what the MPA has failed to do.

2. Noble's true level of debt

Noble's level of net debt and its liquidity headroom are the driving factors behind Noble's investment grade rating. Credit agencies analyse Noble's ability to generate cash flows to repay its debt, and how much its debt is. As we saw in the second report, Noble clearly has a problem generating operating cash flows. For example, Noble lost $1.2b in cash in FY2014. Credit agencies are not concerned yet because they do not focus on final operating cash flows. They focus on EBITDA and Funds from operations ("FFO"). The big issue, that we already underlined, is that both Noble's EBITDA and FFO include the MTM. Debt is not repaid with MTM, but with cash. Similarly, debt interest in not paid with MTM. Credit agencies entirely work with the assumption that the MTM can be realised. The future will determine if they are right or wrong. If they are wrong, they will be heavily criticised later on for using indicators that fundamentally measure MTM, not cash generation.

S&P recently wrote: "We view fair value accounting and the mark-to-market of financial assets and liabilities as an ordinary part of operations for commodity-trading companies like Noble."[19] The problem, as we explained in the second report, is the size of Noble's fair values, their contribution to the bottom line, and the fact that Noble struggles to realise them. Credit agencies downgraded Enron below investment grade only five days before the company filed for bankruptcy. The first critical article on Enron had been published nine months before.

The second leg of this analysis is the level of debt. Although calculations can be different depending on who is writing, the consensus is generally that Noble's debt is moderate.

There are two issues with the numbers given by Noble:

1) The way Noble calculates its gross debt, net debt, and net debt post inventories.
2) Debt level is artificially reduced at quarter end using what we believe is intensive repos.

Noble's presentation: Gross debt, net debt, net debt post inventories

In the FY2014 SGX numbers, gross financial debt reported by Noble was $3.97b. The Agri transaction allowed a reduction in debt:

- $1.466b received from COFCO for the acquisition of 51% of Agri.
- Repayment of the $1.86b intercompany payable on October 14th.
- Deconsolidation of Agri debt (which was $1.5b at acquisition date and was subsequently increased to around $3.4b after the refinancing of the intercompany payable by new debt).

On its balance sheet, Noble reports $904m cash. Net debt is then $3.07b.

[19] S&P bulletin March 2nd, 2015

Finally, Noble underlines most of its inventories are “readily marketable inventories” (RMI). They could be easily sold to repay its debt. RMI account for $2.2b or 95% of the inventories. After liquidating inventories, the “adjusted net debt” would be only $898m. This number is very reasonable.

We summarise Noble’s representation of its debt position below.

Noble's numbers (in $m)		**Remarks**
Gross financial debt reported to SGX	**3,971**	
Debt treatment of perpetuals	0	Noble treats perpetuals as 100% equity unlike credit agencies (50%)
Financing by brokers	n/a	Not disclosed by Noble
Noble on the hook for 49% of Agri debt	0	Noble does not include the debt covered by the corporate guarantee to Agri
Total Gross debt	**3,971**	
Cash	(904)	Noble includes the $350m cash used for collateral by Noble's counterparties
Net debt	**3,067**	
Readily marketable inventories	(2,169)	Noble claims that inventories could be used to allow the group to repay financial debt.
Adjusted net debt post RMI	**898**	
For information (not included in ratios calculations)		
Future commitment X2 Resources	500	

Financial indicators

We use FFO and equity numbers as provided by Noble. EBITDA is not directly provided by Noble so we use Capital IQ’s number ($711m). The picture is generally healthy (e.g. FFO/net debt of 31%) except for net debt/ EBITDA being on the high side (4.3x).

	in $m	**Remarks**
Equity	5,064	
Capitalisation (net debt+equity)	8,131	
Interest expenses	236	
Performance indicators		
EBITDA	711	Not provided by Noble. Source: Capital IQ
FFO Continuing+Agri	955	Noble does not separate FFO for Continuing and Agri so this number is for Continuing + Agri. Noble excludes interest from FFO.
Ratios		
Net debt/capitalisation	38%	
Net debt/EBITDA	4.3	
Net gearing (net debt /equity)	0.6	
FFO/net debt	31%	
EBITDA to interest expenses	3.0	

Can we trust this quite rosy picture? There are many problems with Noble's presentation and we will review them one by one.

1) 49% corporate guarantee to Noble Agri (+$1.4b added to gross debt)

The repayment of the $1.86b intercompany payable by Agri to Noble Group in Q4 had a very positive impact on Noble's debt level. Yet, we can simply ask the question: where does this money come from? We will notice that it is not originally from Agri because the company had $516m cash in Q3, and every trader needs to maintain a certain buffer of cash, e.g. for margin calls. This cash does not come from COFCO either. It comes from new bank debt: more precisely a new $2.55b facility signed with ABN AMRO as the agent on 29 September 2014.[20] With the repayment of the $1.86b intercompany payable, Agri already saddled with $1.5b in debt, saw its debt increase to around $3.4b.

Banks have not granted $3.4b financing to Agri on a standalone basis. Agri is still clearly loss making (not less than $194m in Q4 for example), heavily indebted (even more now). Convincing banks to finance a loss making entity while the biggest shareholder wants to get its intercompany loan repaid is an uphill battle. Banks always ask why they should finance a loss making company if the main shareholder is withdrawing. The financing was made on the basis of support expected from the parents (Noble Group with 49% of shares, and COFCO with 30.6% of shares). Because Agri's debt is very large, banks asked for a formalisation of support in the form of a corporate guaranteed up to 51% for COFCO and 49% for Noble Group.[21]

Going forward, the great accounting presentation trick of Noble will be to omit this liability and present only the debt on its balance sheet. This is what Enron did. Enron deconsolidated debt at special purpose vehicles ("SPV") level that was still guaranteed by Enron, and transferred the cash to the holding. This allowed Enron to report a comfortable $1.3b cash on its balance sheet (much higher than Noble) just eleven months before Enron filed for bankruptcy.

The guaranteed debt and the debt on Noble's books have the same level of seniority. Any group could, under the same model as Noble, create an associate, raise debt at associate level against a corporate guarantee, transfer the cash to the holding, and present the picture of a cash rich/low debt company.

Although it is deconsolidated, Agri's debt has not disappeared:

- Interest still needs to be serviced and will weigh on an already weak Agri. The example of Yancoal shows how debt can plague a firm's performance.

[20] SGX announcement 30 September 2014
[21] SGX announcement 30 September 2014

- Noble is still on the hook for 49% of the principal (which increased to around $3.4b with the repayment of the intercompany payable). If banks financing Agri are not comfortable anymore with the guarantee of Noble to Agri, they will turn to COFCO for a full guarantee. And this is when we expect the problems to emerge for Noble. COFCO will not accept the idea of absorbing the whole debt of Agri. Most likely, Noble will have to replace its share of guarantee by cash, and will have to raise debt at group level. It would have been interesting to consult the details of the sale agreement between Noble and COFCO for information on the respective commitments of the shareholders. Noble has consistently refused to make this document available although it was initially available to the public in its Bermuda office, a country that no shareholder will ever visit.

Note that many sell side analysts have already remarked on the corporate guarantee, exactly as they had remarked on the valuation gap of Yancoal. For some reasons, they rarely include it in their debt calculation. We think any discussion around the de-leveraging process post Agri is incomplete without mentioning the substantial remaining liability to Agri.

On the other hand, credit agencies include the corporate guarantee in their calculations. Moody's also considers not only the debt guaranteed by Noble, but more generally 49% of the Agri debt should be included. This is because Agri carries the name of Noble and is a substantial associate. We agree with this view: there is obviously an obligation of support from Noble to Agri.

The problem is in the calculations. In their note dated November 14th, Moody's included the whole Agri debt of $1.5b as of September 30th (which was the correct number at that date). They also anticipated the $1.5b provisional payment from COFCO and the $1.86b intercompany loan received after the Agri closing. Although they anticipated the cash inflow, they forgot to add the new debt at Agri financing this inflow. This means at that time they undervalued Noble's debt by $1.86b*49%=$911m.

Because Agri has become an associate, Noble does not need to report its financial statements anymore. Noble will probably report its corporate guarantee at the very end of the annual report, once a year. The rest of the time, nobody will have any idea of how much Noble's liabilities to Agri are. Even now, we can only use Q3 numbers.

Because of the corporate guarantee, and more generally the support expected from Noble to a major associate carrying its name, we put 49% of Agri's net debt back on Noble's balance sheet ($1.4b).

S&P and Moody's partly deduct inventories held at Agri level from Agri debt. We explain below why we differ from this view.

2) **Treatment of new perpetuals issued in June/July 2014 (+$200m added to gross debt)**

The $400m new perpetuals issued in June/July 2014 are treated 100% as equity by Noble and 50% debt by credit agencies. Perpetuals do not have a fixed repayment date by definition, but Noble has the obligation to pay interest on these perpetuals as for any other debt. We also treat them as 50% debt. This increases debt by $200m.

3) **Level of cash: $904m or $554m?**

Cash should be a simple concept. With Noble, it becomes misleading. Noble reports two level of cash:

1. One on its balance sheet ($904m)
2. One lower in the cash flow statement ($554m).

Only the cash flow number ($554m) can be used. The balance sheet includes the $350m cash that is "not immediately available for use in the group's business operations". This cash is earmarked as collateral to cover contracts on which Noble is out of the money. In the case of Noble's bankruptcy, it will be used by commodity exchanges or Noble's counterparties as collateral. Debt or bond holders will not have access to it. It is incorrect to include this cash in net debt calculations.

4) **Where is the broker financing on the balance sheet and what are the interest bearing payables? (amount unknown)**

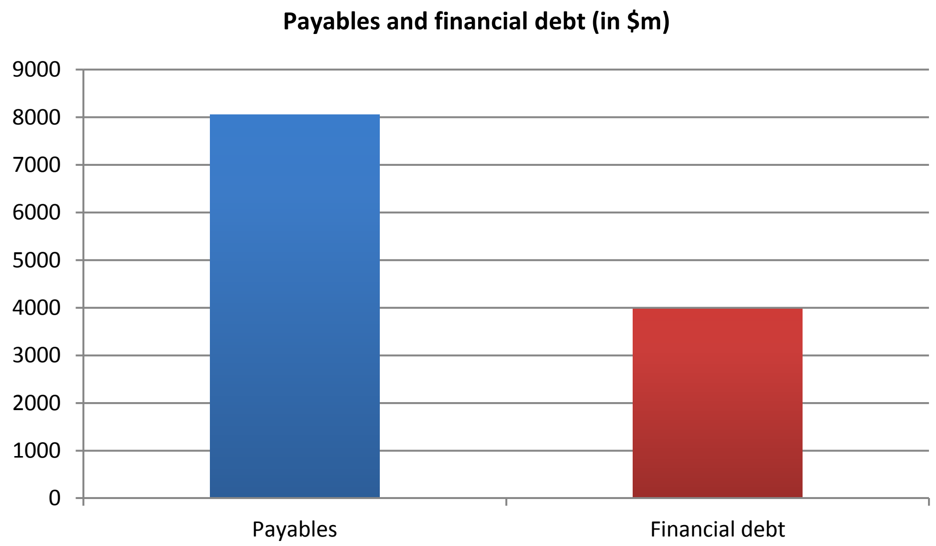
In the second report, we wrote that the broker financing was shown nowhere on the balance sheet, although it was mentioned in the annual report. We asked Noble: how much is broker financing and where does it appear on the balance sheet? For example, does it show up under the $1.7b "other payables"? The annual report seems to indicate that part of these payables are interest bearing, which is unusual for regular payables. We believe brokers financing could represent a substantial amount. However, Noble has refused to indicate where the brokers financing is reported. We conservatively assumed it is zero in the debt calculation.

5) **Can the inventories ($2.2b) be really used to repay financial debt?**

This is where we differ the most from credit agencies. In what Noble calls its "adjusted net debt", the group deducts $2.2b readily marketable inventories. The argument seems straightforward: commodities inventories are very liquid and have a public price. Noble could easily sell them and the proceeds could be used to repay bond holders and banks. In a way, inventories are quasi-cash.

Sell side analysts generally follow Noble's logic. S&P deducts 80% of the RMI from debt. Moody's deducts 50% of the RMI from debt. Even 50% substantially reduces the net debt of Noble: by $1.1b for Continuing operations and by $373m for 49% of Agri.

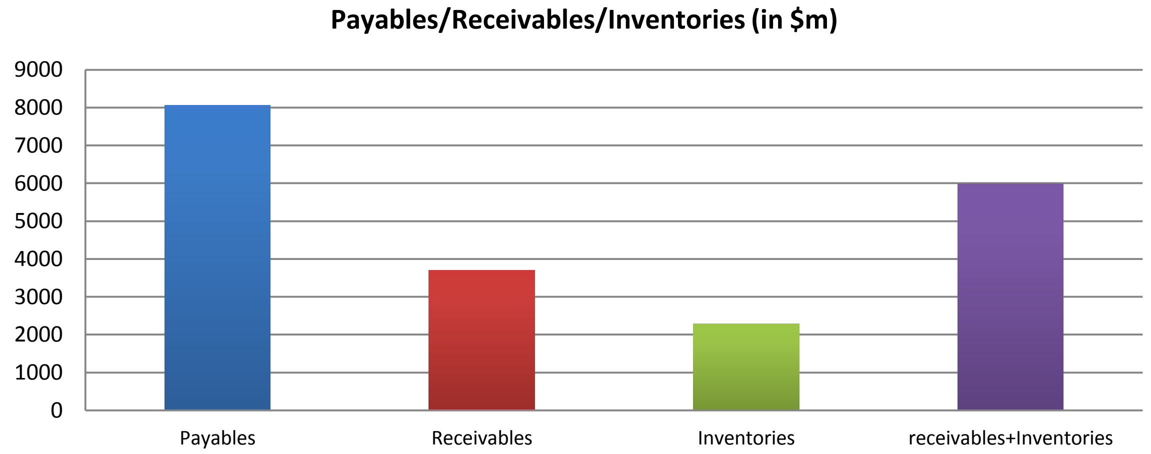
Most likely, none of the analysts who include inventories in the debt calculation had the opportunity to work on a company restructuring or a bankruptcy process. The reasoning is based on the assumption that banks and bond holders are the only creditors in Noble, and that they are free to dispose of its assets as they please. This is clearly not the case with Noble. If a creditor meeting were organised tomorrow, banks and bond holders would fill only one part of the room. Suppliers which give credit to Noble for $8.1b are the largest creditors.



Source: Noble

There is also $2.8b fair value losses with counterparties having a positive MTM against Noble. It is understandable that many analysts omit suppliers credit. In most companies, (a) suppliers credit is not very big and (b) receivables and payables are roughly at the same level. So naturally, receivables are expected to cover payables. With Noble, again this is not the case. Payables are much larger than receivables. The company pays its suppliers later (28 days) than it is paid by its customers (16 days).[22] Payables even exceed receivables+inventories.

[22] Factsheet Q4 2014



Source: Noble

We can even add "deposits and other receivables" and "prepayments" which are much less "current" in nature than receivables (need more time to be realised) to the current assets group. Payables are still $721m higher.

What would happen concretely if tomorrow, inventories were used to repay banks and bond holders? There would be no money left to pay the suppliers. After a payment delay of 24 hours, one of them would trigger a default. This would probably happen first in countries such as the US where payment delays are hardly accepted. Hundreds of suppliers would follow the same course of action. Once suppliers know they are not paid anymore, a trading house collapses rapidly. This would precipitate the group into liquidation.

Noble's management will not commit hara-kiri to protect the bondholders and banks' interests at the expense of its suppliers. Companies in distress always tend to pay their suppliers as much as they can, and default on their bank facilities first. Banks can wait a bit. On the other hand, the suppliers are too important.

In our experience, and what we have seen countless times is that during the first creditors meeting, the banks agree to let the company pay its suppliers. Banks have no choice but to keep the borrower alive. <u>In other words, in practice, it is the banks that are forced to be patient, and wait behind the suppliers, not the other way round.</u> If the banks were secured on inventories, our conclusion would be different, but only 8% of bank debt was secured in FY2014.[23]

We do not deduct inventories from gross debt because, in practice, liquidating these inventories and using the proceeds to pay the banks/bond holders, instead of the suppliers, would plunge the company

[23] SGX FY2014 p. 8

into bankruptcy. Even banks and bond holders have no preference for this scenario: the recovery rate for their remaining exposure would fall.

Debt and ratios after adjustments reveal a much more indebted group

After these adjustments, gross debt is $5.6b (41% or $1.6b higher than Noble's number), and net debt after cash is $5b (64% or $2b higher than reported). We do not apply the concept of "adjusted net debt" post inventories.

Adjusted numbers (in $m)		Remarks
Gross debt reported to SGX	**3,971**	
Debt treatment of perpetuals	200	$400m perpetuals treated as 50% debt
Financing by brokers	?	Noble is financed by brokers but does not report this number. Conservatively we use zero.
Corporate guarantee and intrinsic support to Agri	1,412	Corporate guarantee/support for 49% of Agri's financial net debt.
Total gross debt	**5,583**	
Cash	(554)	We do not count the $350m that serves as collateral for Noble's counterparties
Net debt	**5,029**	
Readily marketable inventories	0	We do not deduct inventories
Adjusted net debt post RMI	**5,029**	
Others for information (not included in ratios calculations)		
Estimate intra-quarter additional debt	3,000	See below
Future commitment X2 Resources	500	

Performance indicators like EBITDA and FFO are adjusted for our estimate of fabricated net fair values. Ratios such as net debt/EBITDA or FFO/debt cannot be calculated because EBITDA and FFO are negative. Equity is only $410m after various adjustments (see below). With these numbers, Noble obviously breaches most of its covenants (networth, net gearing, interest coverage, and current ratio).[24]

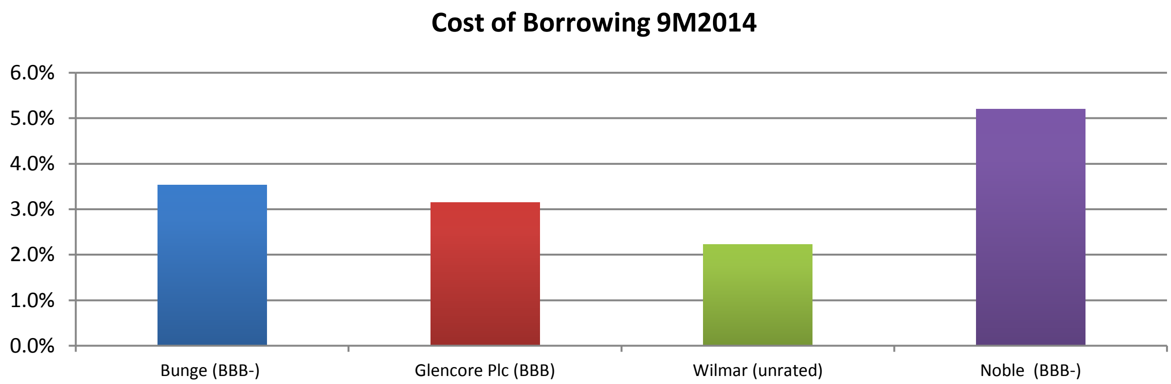
[24] Moody's May 7th, 2014

Adjusted numbers (in $m)		Remarks
Equity	410	Equity after various impairments (see valuation part)
Capitalisation (net debt+equity)	5,439	
Interest expenses	256	Half of perpetuals interest added
Performance indicators		
EBITDA	-303	Adjusted for our estimate of fabricated MTM in 2014 ($1b, i.e. 60% of net increase using same perimeter)
FFO Continuing+Agri	-161	Noble does not separate FFO for Continuing and Agri so this number is for Continuing + Agri. Adjusted for our estimation of fabricated MTM in 2014 ($1b), interest, and increase in cash collateral with brokers.
Ratios		
Net debt/capitalisation	92%	
Net debt/EBITDA	n/a	Negative EBITDA
Net gearing (net debt /equity)	12.3	
FFO/net debt	n/a	Negative FFO
EBITDA to interest expenses	n/a	Negative EBITDA

3. Noble's interest imply a much higher level of debt during quarter

So far, we have assumed that Noble's financial gross debt is the one reported by Noble, although it bears some adjustments. However, we found that the level of financial debt that Noble reports every quarter is inconsistent with the level of interest the group pays. Only a substantially higher financial debt could explain this level of interest.

In the first nine months of 2014, the interest incurred by Noble (Continuing+Agri) was on average 5.2%.[25] We excluded the fourth quarter since the $1.5b received from COFCO in the middle of the quarter distorts the debt computation. This is on average 2.2% higher than competitors with a comparable rating.



Source: Capital IQ / Noble Group data

Even if we take Continuing operations only, the conclusion is the same. Borrowing costs were 4.1%, still 1.1% higher than competitors that are assets heavy and finance these assets by expensive long term debt. At 5.2%, Noble's borrowing cost is higher than all the average effective interest rates reported in the annual report in 2013.[26] Financing costs went down in 2014.

	2013 Effective average interest rate (%)	2013 US$'000
Group		
Current bank debts maturing within 12 months:		
Bank loans	2.7	1,261,159
Current portion of long term bank debts		
- secured	2.4	213,212
- unsecured	4.8	112,075
		1,586,446
Long term bank debts		
- secured portion maturing latest 2023	3.9	497,004
- unsecured portion maturing latest 2019	4.1	783,286
		1,280,290
		2,866,736

[25] Agri's interest expenses can be found via reconciliation of income statement/cash flow data. Total financial debt during the period was on average $7b and annualised interest was $366m

[26] AR 2013 p. 136

By deducting bond interest, and applying the weighted average bank debt interest reported in the annual report (less 0.5% to account for the reduction in funding costs in 2014), we estimate that Noble paid $78m unexplained bank debt interest on an annualised basis.

Noble argues that it pays higher interest because it has hedged part of its floating interest debt and has to pay commitment fees for its unused committed facilities.[27] This explains only part of the delta. In the 2013 annual report, negative fair values for interest rate swaps with maturity of less than 12 months were only ($27m).[28] Commitment fees for unused facilities charged by banks are extremely low: a fraction of percent. We do not expect this to represent more than a few millions. Besides, Noble is not the only trader who hedges its floating interest exposure and has to pay commitment fees. If Noble provided the breakdown of its financing costs, this would help understand where the delta comes from. We estimate that after interest rate swap and commitment fees, there still remains around $45m unexplained interest.

The most likely explanation as to why Noble's interest is so high is that its bank debt is substantially higher during intra quarter. The amount is subject to many variables. This additional intra-quarter bank debt is by definition short term: it is raised and repaid before each quarter. The short term facilities that traders use are the cheapest type of financing for traders. For large traders similar to Noble, the all-in cost (cost of fund +margin) is less than 125bps currently. If we apply this interest rate, additional intra-quarter debt could be as high as $3.7b. We conservatively use a number of $3b.

Noble states it has available banking facilities of $17b at the end of 2014 while its utilisation was only $6.2b (see below). The main reason for what seems to be an overcautious buffer is that the utilisation of bank facilities is much higher intra-quarter.

To lighten their working capital and generate cash, it is common for traders to use receivables factoring or LC negotiation.[29] We believe the explanation for its higher cost of financing relative to competitors is that Noble is engaged in repos of its inventories, much more intensively than its competitors. Inventories are taken out from the balance sheet at quarter date but would still need to be financed the rest of the time, and would still generate interest. Noble's repos are alluded to in the annual report.[30] Repos artificially lower the level of debt at quarter end. They also distort the operating cash flows.

[27] FT "Noble braced for next critique by mysterious research firm" – March 18th, 2015
[28] AR 2013 p.155
[29] Under LC negotiation, the bank of the exporter advances the proceeds expected under letters of credit. Because the recourse is on the importer's bank that issued the LC, not on the company, this is not counted as debt.
[30] AR 2013 p.96 under "supply of products"

Noble claims they do not have inventories repos because the company would have the option, but not the obligation to buy back the inventories. [31] As a result, these transactions would be treated as "sales and purchases", instead of short term financing.

However, we have doubts on this presentation:

- In our experience, commodity banks do not want to find themselves with tonnes of commodities to liquidate on the market. Liquidating commodities is a worst case scenario for them, not a normal way of doing business.

- In all the periods we studied, the level of interest was too high compared to the level of debt. This suggests that these inventories would always return to Noble's balance sheet.

Based on these two points, we strongly suspect that in practice Noble repurchases its inventories every time, and the optionality only exists on paper. Only the regulator can investigate and confirm this. If our assumptions are correct, Noble and EY would have found a legal loophole to disguise financing as sales and purchase. This would be much more than stretching accounting rules but serious misrepresentation. If inventories are always repurchased, we will let lawyers decide if this can create legal ramifications for Noble and the banks that help with these transactions. EY has a notorious track record in terms of repos: they were the auditor of Lehman Brothers which removed about $50 billion of assets from its balance sheet thanks to repos. In October 2013, EY agreed to pay $99m to end investor lawsuits related to Lehman Brothers.[32]

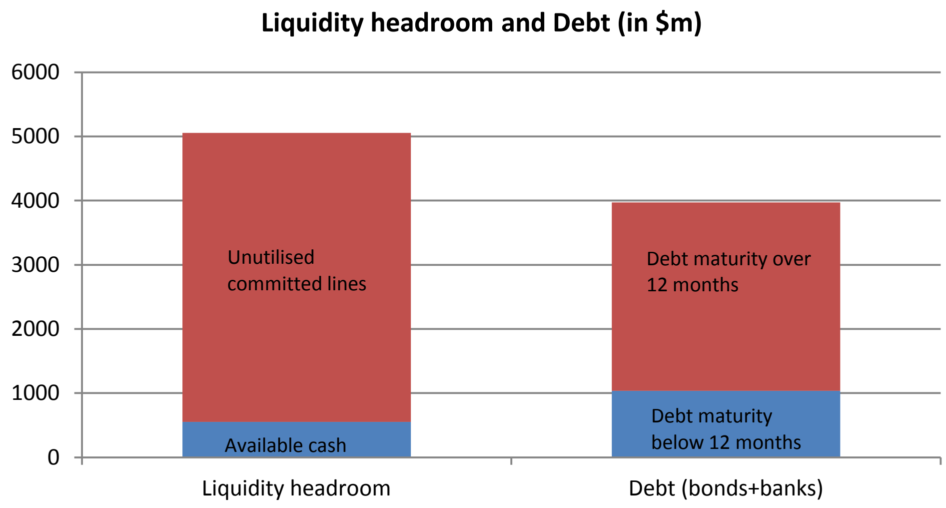
[31] AR 2012 p.93
[32] http://uk.reuters.com/article/2013/10/18/uk-lehmanbros-investors-idUKBRE99H12Y20131018

4. The myth of the "liquidity headroom"

The liquidity headroom is the second cornerstone of Noble's investment grade. Every time the credit agencies write about Noble, they praise the liquidity headroom.

This is what Moody's wrote on March 2nd : "At year end, the company maintained liquidity headroom of about $5.1 billion (availability under committed bank facilities of about $4.5 billion and readily available cash of about $554 million), which is more than sufficient to cover the next twelve month's debt maturities of about $1.0 billion, potential $500 million in capital commitments related to X2 Resources, and the modest amount of maintenance capital expenditure required after the spinoff of Noble Agri." And what S&P wrote the same day: "We believe Noble will maintain a strong liquidity position, with cash and available committed lines that well exceed short-term debt maturities and margin requirements."

The argument is as follows: the combination of Noble's available cash ($554m) and unutilised committed bank lines ($4.5b) is largely sufficient to cover maturing debt in the next 12 months ($1b). It is actually high enough to cover the entire debt ($4b).



Source: Noble data (FY2014 investor Presentation)

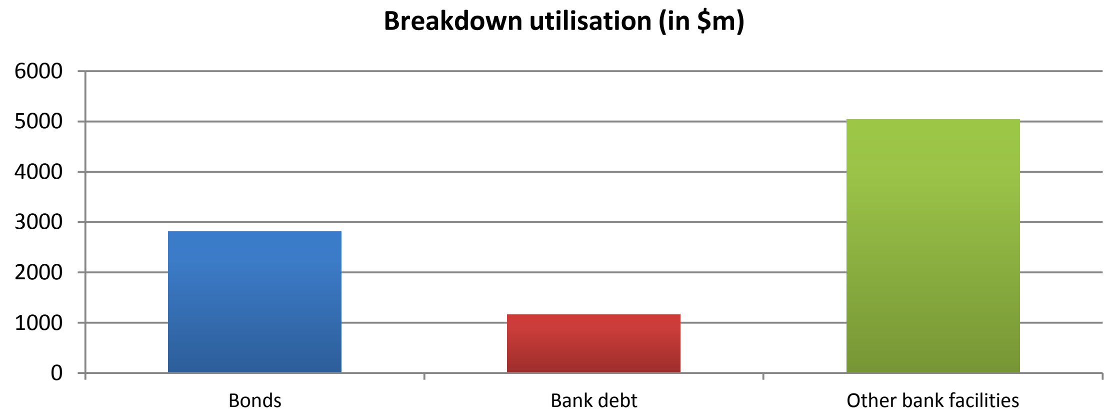
The term "committed" means that Noble's banks cannot suspend these facilities until they expire, unless Noble breaches its covenants. By contrast, uncommitted lines can be suspended by banks at any time and without reason. This liquidity headroom is important because commodity traders are particularly vulnerable to confidence crisis. Even if the banks market were closed to Noble, the company could draw on these lines to refinance its existing maturing debt.

In reality, the liquidity headroom is based on a series of misconceptions. We list some of them below.

1) The confusion between the terms "bank facilities" and "bank loans"

In most companies, bank facilities and bank loans are the same thing: when a bank extends a $10m bank facility, this means the bank extends a $10m loan. With commodities traders, banking facilities can be loans but they can also be facilities such as letters of credit ("LC").

Here is a chart showing Noble's bonds, bank debt and other bank facilities.[33]



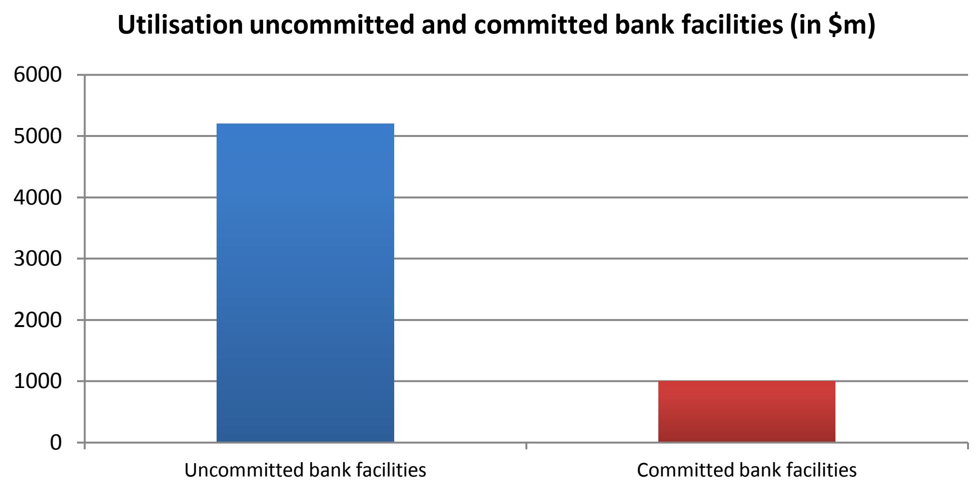
Source: Noble data (FY2014 investor Presentation)

Bonds reach $2.8b and bank debt is only $1.2b. Other banking facilities are much higher: $5b.

Letters of credit are essential for a trader. They substitute a buyer's risk with a bank risk protecting the supplier against the counterparty risk of its buyer. In Asia, most of commodity contracts require a letter of credit opened by the bank of the buyer. Without access to letters of credit, a trader cannot buy commodities and stops operating. Many traders can live without any bank loan but they absolutely need letters of credit to be able to trade.

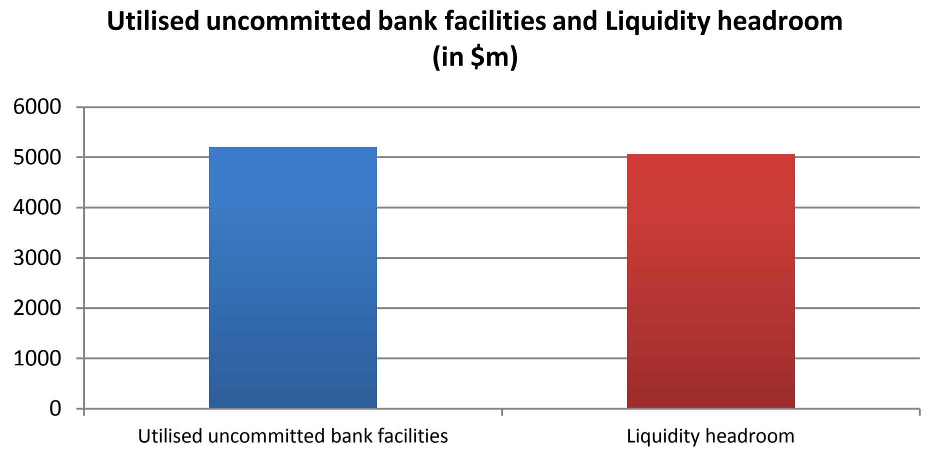
Most of the bank facilities used by Noble are uncommitted. The reason is simply that uncommitted LC lines are cheaper than committed LC lines. Noble uses not less than $5.2b uncommitted bank facilities.

[33] Data calculated based on FY2014 investor Presentation



Source: Noble data (FY2014 investor Presentation)

Now what would happen if banks started to have serious concerns about Noble? These uncommitted lines could be cancelled. Noble would still need to issue letters of credit. The company will be forced to draw on its committed lines to replace the $5.2b uncommitted lines. Part of the liquidity headroom at least could vanish.



Source: Noble data (FY2014 investor Presentation)

Similarly, the debt maturity profile, as presented by Noble, includes only bank debt. It does not include facilities such as LC that need to be opened all the time.

2) Committed but until when?

Lines are committed until they expire. Every year, Noble is raising new revolving credit facilities ("RCF") to replace the maturing ones. For example Noble is currently raising a new $3b RCF to replace RCFs of the same amount expiring in May. If billions of the liquidity headroom expire in a few weeks, or every year around May, this undermines the word "committed".

3) The role of suppliers

Suppliers are by far Noble's bigger creditors with a massive $8.1b, twice what banks and bond holders represent ($3.97b). If banks were not willing to finance Noble anymore, obviously suppliers would have taken the same step and even more swiftly. Credit agencies analyse Noble exactly the same way their predecessors analysed Enron. They underestimate the influence of commercial credit for commodity traders.

4) Intra-quarter debt

As we saw, Noble presents a certain picture at reporting date but its intra-quarter debt is very different. Our rough estimate of $3b in additional intra-quarter debt during quarter would also consume the liquidity headroom.

5) Committed does not mean unconditional

Committed lines are subject to covenants. We believe that without the help of fabricated MTM, the covenants would be breached. Note that the definition of covenants can be deceptive. For example, the current ratio is subject to covenant. However, the calculation of short term assets is misleading. A high percentage of the fair values are in fact not current even though they are recorded under current assets (59% maturing beyond one year in the 2013 annual report).

5. Valuation of Noble

At the date of publication, Noble trades at a market cap of $4.2b. Net income after adjustment for fabricated MTM would be negative. So we are not able to use the P/E methodology to value Noble. We use the price-to-book methodology instead. Here are the various adjustments we mentioned in our first two reports.

	(in $m)
Equity as reported by Noble	**5,064**
Impairments/deduction	
Yancoal	318
Estimate fabricated net fair values	3,836
PT Atlas	34
PT ALH	47
Agri	220
Half of perpetuals	200
Total impairments/deduction	4,654
Remaining equity	**410**

- Yancoal: there is still a $318m required impairment. Yancoal's market cap has fallen by 60% since our first report. Noble's stake is now worth only $4m against a carrying value of $322m. The problems of Yancoal are structural: not only coal prices, but high debt and expensive take-or-pay contracts. They will not go away anytime soon.

- Fabricated MTM of $3.8b. We conservatively keep our estimate as of Q3. In Q4, net MTM increased by not less than $731m.

- Impairments of $34m for the mysterious revaluation of PT Atlas. Noble has remained 100% silent on PT Atlas.

- Impairment of the very suspicious profit booked with PT ALH ($46.5m). Noble has also remained 100% silent.

- The Agri "final price" was reported at $1.466b. First, we fail to understand how Noble can book a remeasurement gain of $140m on its remaining 49% stake: the carrying value of the stake in Q4 ($1.345b) is lower than in Q3 ($1.4b). Second, as we wrote in the first report, this price is obviously not final because Noble will continue to pay some of Agri's salaries (e.g. $32.5m in the third quarter). This arrangement was actually designed to allow Noble to record the 49% remaining stake of Agri at a higher price. Noble said this arrangement would last 18 months. The company does not give a precise number, so we can only estimate the cost. Noble has also consistently refused to make the Agri sale agreement available. With a cost of $32.5m applied to six quarters, this would mean a total cost of $195m. Instead of receiving $1.47b, Noble would receive $195m less. In turn, this triggers an impairment of $187m on the 49% remaining stake. The total required impairment is $382m. We assume that subsidies may go down over time so we use a number of $220m.

- We excluded all the suspicious situations where we cannot quantify the impairment (e.g. associates other than Yancoal). We also exclude other EY warnings on loans receivables, accounts receivables, tax assets, etc. for the same reason. We excluded the palm oil business held for sale although we think the position of the local government on PT Pusaka Agro Lestari, and more generally the opposition that this industry faces in this particular region will have an impact on the sale price. On the other hand, there are also potential value reserves in businesses such as Energy Solutions which has steadily generated income.

After applying these adjustments, we found remaining equity is only $410m. We apply an average price-to-book ratio for Noble's peers of 1.2x. This leads to a valuation of $492m, or a price of S$0.1 per share.

6. Questions to Noble's management

Noble promised more transparency. Still, they have not answered our previous questions.

- We cannot find the "negative assurances" in the investors section of the website. Why have they been recently taken off?

- Why do independent directors stay so long on Noble's board (e.g. 19 years)?

- In practice, how often does Noble repurchase its inventories? On average, how big are these transactions every quarter?

- Where does brokers financing show up on the balance sheet and what exactly are the "interest bearing" payables?

7. Conclusion: Noble is an Asian version of Enron, 14 years later

Noble Group is a repeat of Enron. Both companies use similar actions in an attempt to deceive investors. Noble, like Enron, misrepresents the three components of its financials: income statement, balance sheet and cash flow statements.

- Profitability is supported by largely **fabricated fair values**. Noble's net fair values are now even 4.2x times bigger than Enron's net fair values at their peak.

- Both use forward curves and the leeway they offer to **massively overvalue assets**: e.g. Yancoal and the MTM.

- **Noble argues it is different and should not be compared to its competitors**. Enron claimed it was a market maker, a logistics expert and it did not need assets anymore. Noble keeps repeating it is an asset-light trader so it has a different balance sheet. There are thousands of asset-light traders in the world. No company has fair values comparable to Noble. The commodity industry existed 3,000 years ago and is very traditional. Every time a company claims it invented a revolutionary business model, it generally ends badly.

- **Noble is a black box, like Enron.** Recently, Noble promised more transparency. Mr. Alireza seems to have realised that a public company needs to be more transparent than a private company. Beyond vague promises, what did management really clarify? The company refuses to answer our questions. They have not given information on how much profit they booked from their MTM, in particular from long term offtake agreements (e.g. Sundance Resources). It will probably never release this information.

- They have the same ability to **stretch working capital** to improve operating cash flows. Enron received $4.2b additional customer deposits in 2000. We believe Noble is involved in heavy inventories repos. This source of liquidity can vanish rapidly.

- **Their debt is lowered by omitting off balance sheet liabilities**: SPV for Enron, corporate guarantee to Agri for Noble.

- **Their auditors capitulate** and hide behind the intricacies of accounting rules. Noble, like Enron, intelligently spots the accounting loopholes (e.g. associate equity method) and exploits them with the help of a complacent auditor.

- We believe Noble's main reason for aggressive accounting is to keep its investment grade. A downgrade would dramatically affect financing costs and trigger additional margin calls. Noble, like Enron, **knows exactly what performance indicators credit agencies look at** (e.g. FFO rather than final operating cash flows, financial debt rather than commercial debt). Noble will adjust its financials in the areas credit agencies focus on.

- **Key shareholders/insiders leaving the company** and selling their shares.

We think Noble is at the stage Enron was in 1999-2000. CEO Jeff Skilling advocated an asset light strategy focusing the group on its core competence ("logistics") in order to achieve a better ROE. We now know that Enron's profitability was based on fictitious MTM and the company was approaching a liquidity crisis.

Because its equity is massively inflated, Noble's will have to fabricate more and more MTM to generate any ROE, until its balance sheet collapses. There is no point assessing a group based on net profit or ROE when this group has shown its inability to generate operating cash flows.

It took nine months for Enron to collapse after the first article was written by Fortune Magazine. We do not expect the entire market to presently believe us. However, there will be more and more doubt on the MTM booked by Noble and its financial representation. Potential buyers may be interested in acquiring a cheap stake in Noble. If they conduct detailed due diligence on the MTM, they will hesitate. At this stage, we cannot see a group that could play the role that Temasek played for Olam. Stakeholders will get tired of Noble's obscure financial reporting. They will demand direct access to its financial data and to the main MTM. They will progressively realise the magnitude of the issues. Finally, Noble's senior management and the so called independent directors will be replaced.

We have absolutely no doubt that Noble Group is currently one of the most serious cases of misrepresentation in the financial markets.