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Shorting the *China-Story* with German Blue Chips
Part Two: Hella KGaA

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I. Introduction

The plunge of the Chinese mainland stock markets impressively demonstrates the existing risks of the Chinese growth story.[1] Besides the property market and the shadow banking system, the stock exchange has become another unpredictable factor for the Chinese economy.[2] It remains to be seen, how government support is able to stabilize the crumbling mainland financial markets. In the long history of stock exchanges, state interventions in equity markets frequently led to quite disappointing outcomes.[3]

Even though the German capital markets currently concentrate on Greek issues, the risks of German companies in China are evident. The risks of German Blue Chips, that are directly linked to the Chinese economy, might not be adequately discounted in the underlying stock prices. The hedging of these risks should be considered by any investor in the German stock market.

From the perspective of short investors, the *China-Story* could be a unique possibility to profit from a market plunge in German stocks due to their large exposure to China. In this respect, attention should be paid to companies with a complex legal structure in China (e.g. through joint ventures) and are therefore exposed to a multitude of risks. Assuming a negative scenario, this strategy could turn out to be the "short of the decade".

[1] The mainland exchanges Szenzhen and Shanghai recorded losses of more than 20% during the last weeks. Especially the new stock exchange segment ChiNext in Shenzhen, which mainly concentrates on new technology companies, might be threatened in its existence.
[2] See article regarding the China-Risks of ThyssenKrupp 8th June 2015, p. 2.
[3] The author is hereby reminded of the burst of the „Mississippi Bubble" in the 18th century.

II. Hella KGaA

The Hella KGaA[4] (partnership limited by shares), as a listed family-owned enterprise, can be categorized as one of the more solid companies on the German stock exchange. In spite of the rapid growth of its core business, the company´s financial statements record a strong balance sheet.[5] Therefore, the company is not eligible for a significant downturn from a short investors point of view.

Nevertheless, Hella KGaA illustrates the dependency of German Blue Chips on the Chinese market in a striking manner. As a supplier of the automotive industry, there is a natural proximity to the Chinese marketplace. The automotive industry sells huge quantities of cars for the Chinese consumer with extraordinary profit margins. Hella, as a supplier, needs to follow its customers to the mainland market to stay in business.

The annual report 2013/14 constantly refers to results of the Chinese market. Since 2011 Hella KGaA expanded its business operations in China aggressively.[6] This strategy consequently led to an increased dependence on the Chinese market. The majority of German export-oriented companies follows this business model, regardless of any downside risks. If the Chinese economy comes to a halt, this strategic focus on China could turn out to be a difficult challenge for the Hella group.

1. Expansion on the Chinese market

Hella opened several new plants on the Chinese mainland in the fiscal year 2013/14. Production sites were established in Jiaxing (province Zhejiang) and Chengud (province Sichuan).[7] The plant in Xiamen (province Fujian) expanded its electronics production line recently.[8] Since autumn 2014, Hella invested in new capacities in cooperation with its joint venture partner BAIC (Beijing Automotive Industry Holding).[9] In summary, substantial investments in the mainland market were made by Hella in the last years. Compared to other worldwide investments of the Hella group, the Chinese market clearly takes a dominant position.

[4] The German Kommanditgesellschaft auf Aktien – KgaA – combines elements of a joint stock corporation with those of a limited partnership.
[5] During the actual fiscal period ending 28th February 2015, the Hella KGaA has a net debt of 263 million €. See Nine-months Report 2014/15, p. 16.
[6] Annual Report 2011/12, p. 3 f.
[7] Annual Report 2013/14, p. 31. The new plant in Chengdu is part of a joint venture.
[8] Annual Report 2013/14, p. 39.
[9] Press release Hella KGaA as of 30th April 2014. Predominantly the Beijing plant should be expanded.

The 9-month financial report 2014/15 emphasizes the low corporate tax rates for the Chinese business areas. These lie below the current group average of 27%. As far as new investments in China are concerned, multi-year tax holidays are often granted. This effect is likely to wear off in the next years during the course of time.

2. Economic outlook

In its actual economic outlook Hella KGaA refers to high growth rates of 6,8% in China.[10] Investors should hope that the Hella management board did not make economic decisions based on these official numbers.[11] Despite apparent uncertainties regarding the outlook of the Chinese economy, Hella still categorizes China as a "driver of growth".[12]

The board of management argues that the regional positioning in China has a positive influence on the group.[13] Altogether the financial reports on Hella create the impression that the Chinese economy will continue to show high growth.[14] A deviating scenario is definitely not taken into account.

III. Summary

In the last years, the Hella KGaA constantly concentrated on increasing its market share in the Chinese market. Decisions taken by the management to expand the Chinese operations are quite comprehensible. After all Hella was able to generate huge profits in China. Given the relatively low level of debt, the group might absorb several setbacks in its China operations. In this respect the structure of Hella KGaA as a listed family-owned enterprise could turn out to be advantageous to overcome a crisis. Most of the highly-indebted German automotive suppliers might be threatened in their existence by a severe slowdown of the Chinese economy.

While multinational companies tend to hedge their currency risks in their export markets, the overall risks of a slowing Chinese economy are not safeguarded. Surprisingly some of the biggest risks are not in the focus of hedging-strategies. Export-orientated companies should consider to waive increasing dividend payments in favor of a target-orientated hedging-strategy.

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[10] Nine- months Report 2014/15, p. 11-12. The Investor-Updates of Hella also refer to this statistic, see Investor-Update First Half 2014/2015, p, 4.

[11] Critic of the adoption of government data in the financial reports, see article *Shorting the China-Story with German Blue Chips, Part 1: ThyssenKrupp*, p, 4.

[12] Nine- months Report 2014/15, p. 8. With reference to the German Automotive Industry Association.

[13] Nine- months Report 2014/15, p. 9.

[14] Annual Report 2013/14, p. 88.

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