



Shorting the *China-Story* with German Blue Chips Part Three: Volkswagen AG

17.07.2015

I. Introduction

This serial regarding the China-risks of German Blue Chips certainly has to include the Volkswagen AG.¹ The Volkswagen-group entered the Chinese market as one of the first multinational companies. The joint ventures with FAW (First Automotive Works) and SAIC (Shanghai Automotive Industry Association) are, to this day, regarded as one of the best examples of international cooperation.² The profits of the joint companies have risen steadily over the last ten years. In 2014 the profits of both joint ventures combined reached a peak of 12 billion Euro.³ The relationship of the joint venture partners can be seen as very harmonious. In Germany as well as in China, the cooperation was backed by the government. Eventually, the success of the ventures gave no reason to question the expansive business policy.

Given the down-to-earth expectations of the Chinese economy, it seems to be unclear whether the joint venture partners still pursue the same goals. Despite massive government support the Volkswagen AG might face severe risks in case of a massive downturn of the Chinese economy.

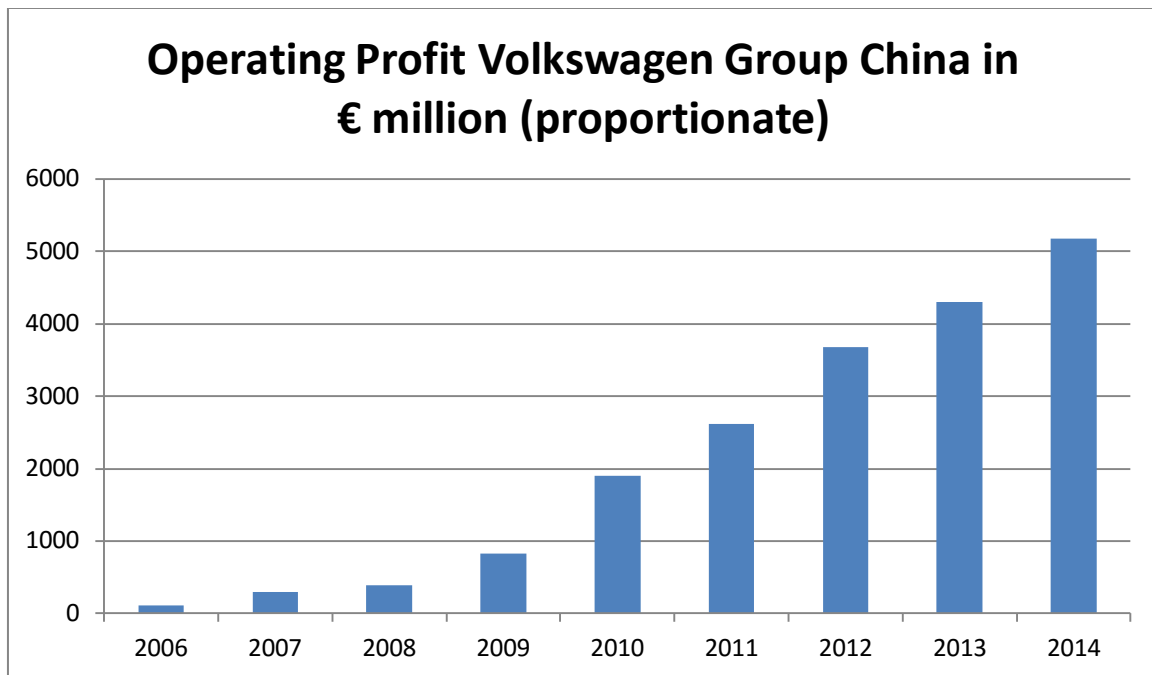
II. Results of the Volkswagen Group China (VGC)

In regard to its profits, the Chinese joint ventures have taken up a dominant position in the Volkswagen-group in the last century.

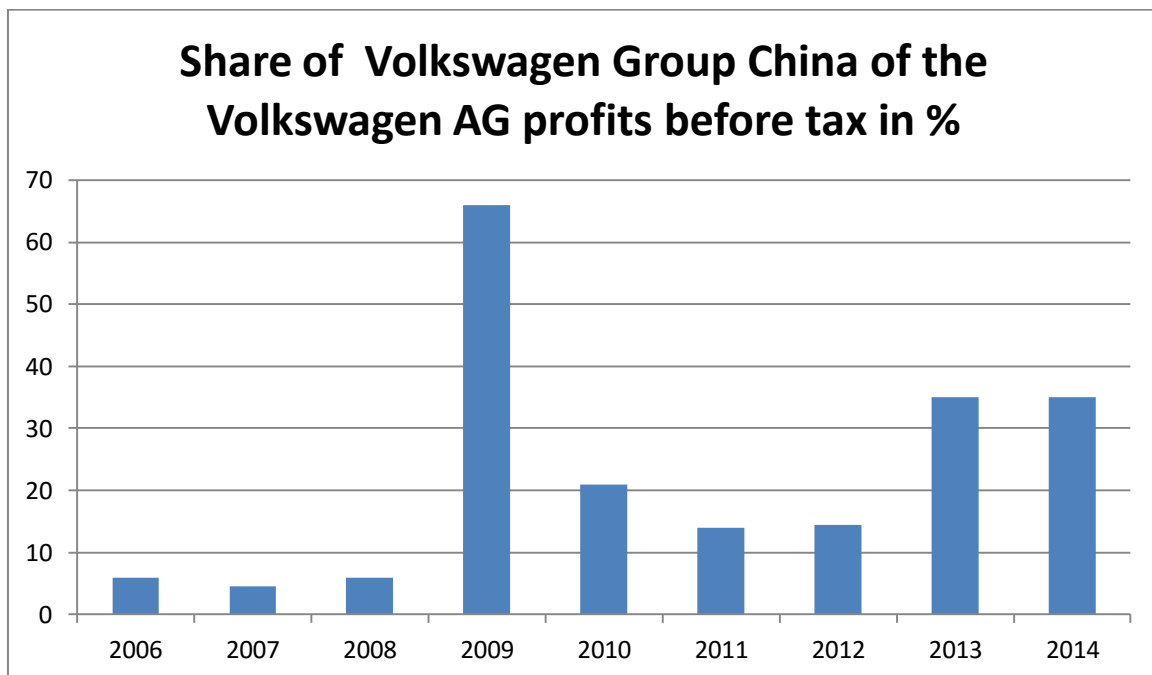
¹ As far as the author is not a native English speaker, he apologizes for any unfortunate choice of words.

² The joint venture Shanghai Volkswagen Automotive Co. (SVW) was founded with SAIC in 1985. The Volkswagen-group holds 50% of the shares (40% Volkswagen AG, 10% Volkswagen (China) Investment Co. Ltd.). The joint venture FAW-Volkswagen Automotive Co.Ltd. (FAW-VW) was founded with the partner FAW in 1991. The Volkswagen-group holds approx. 40% of the shares (20% Volkswagen AG, 10% Volkswagen (China) Investment Co. Ltd., 10% Audi). In addition to the production of the brand Volkswagen, this joint venture also produces cars for Audi.

³ Annual Report 2014, p. 43.



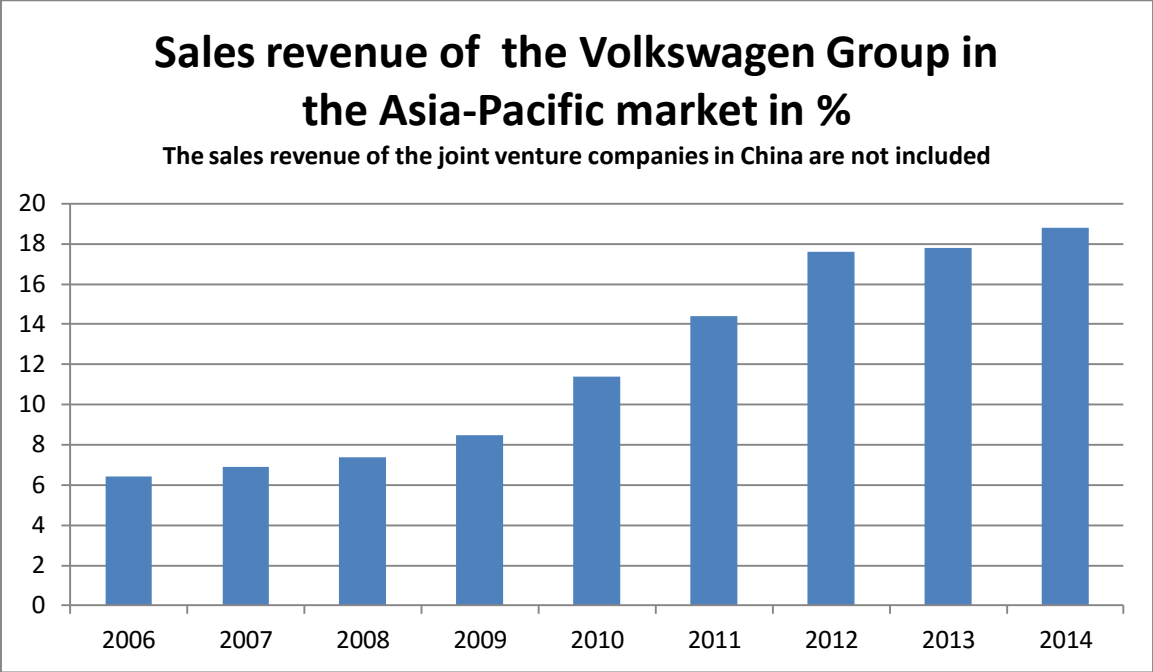
The stated numbers of the Volkswagen Group China have risen exponentially. From a risk perspective the reported profits have reached a critical condition.



The above-mentioned chart shows the effect of the Chinese stimulus plan in November 2008 on the Volkswagen AG.⁴

⁴ The massive stimulus plan in excess of 4 trillion Yuan of November 2008 might have supported the world economy substantially.

The remaining import business of the Volkswagen AG in China has expanded tremendously in the last decade. The financial reports do not publish numbers for the import business in China, so that the Asia-Pacific region has to be applied as a standard.



In summary the Chinese market accounts for about 50% of the profits of the Volkswagen AG. Therefore, the Volkswagen-group shows one of the highest dependencies on the Chinese market in comparison to other German Blue Chips. Without going into further detail, the risks mainly result from the exponentially inflated sales numbers and profits of the past.

As far as the Chinese joint ventures are valued “at equity“, substantial depreciations are unlikely. The Chinese joint ventures are valued approximately at 10 billion €. ⁵ Taken a negative scenario into account, the applied valuation standard seems to be reasonable.

⁵ Annual Report 2014, p. 182.

IV. Investment and corporate strategy

The corporate strategy of the Volkswagen-group in China concentrates on a single objective: growth. While investment decisions were made over a manageable period of time in the beginning, the current investment philosophy seems to orientate on 4-year plans. The overall investment amounts are breathtaking:

Investments Volkswagen China 2008-2010⁶: 2,1 billion €

Investments Volkswagen China 2011-2015⁷: 10,6 billion €

Investments Volkswagen China 2014-2018⁸: 18 billion €

The current investment strategy is not adjusted to the current financial environment. In fact, Chinese joint ventures stick to their expansive strategy „Go West, Go South“.⁹ Considering the uncertainties of the Chinese economy, this investment approach is quite remarkable. The question whether or not the Volkswagen-group has any influence on concluded decisions, could be a relevant issue in the future. The Chinese joint venture partners might not only consider their decisions from an economic point of view. Understandably, their preferential goal might be providing new jobs, while supporting the weakening economy. Therefore it is possible, that huge investments are made during a period of economic contraction. Such an investment approach would be a precedent in the long history of the Volkswagen AG.

The statements of the management in regard to the Chinese market are not consistent. Even though “weaker economic signs from China“¹⁰ are noticed, „Volkswagen further expands its production capacity in this growing market“¹¹. The prediction „that economic growth in China is set to remain at a high level“¹² reminds the author of Irving Fisher’s famous quotation in 1929 „...stock prices have reached what looks like a permanently high plateau“¹³.

⁶ Annual Report 2007, p. 174.

⁷ Annual Report 2010, p. 23.

⁸ Annual Report 2013, p. 34.

⁹ Annual Report 2012, p. 207. New production locations in southern and inland regions should lead to higher market share.

¹⁰ Annual Report 2014, p. 155.

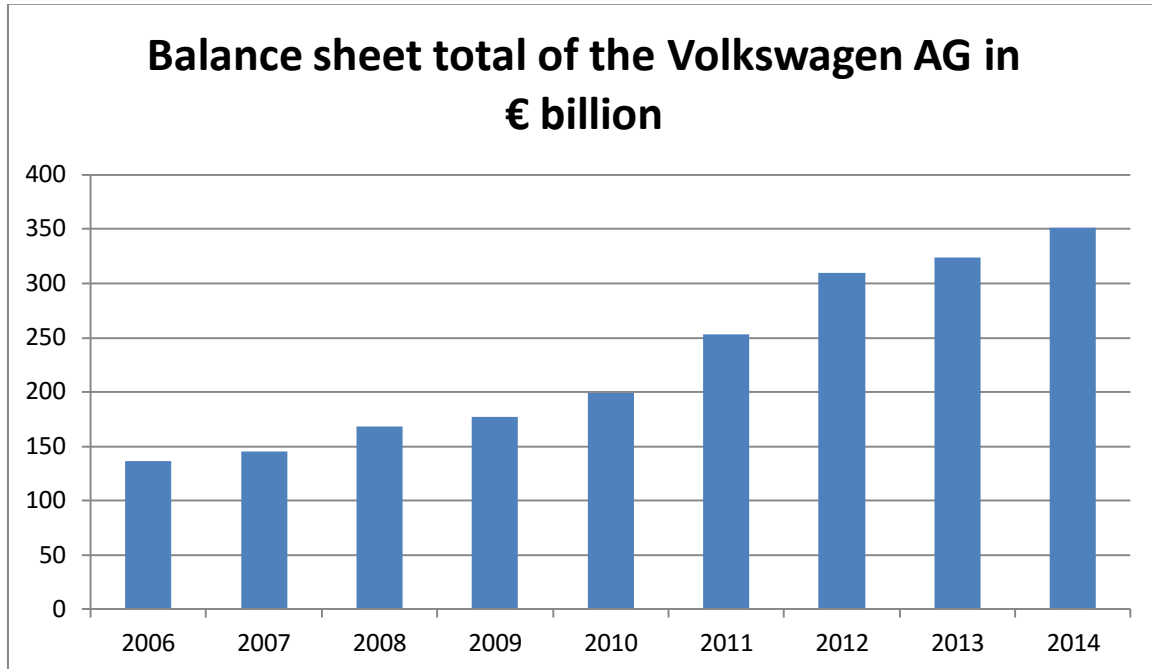
¹¹ Annual Report 2014, p. 164.

¹² Annual Report 2014, p. 152.

¹³ The statement of professor Irving Fisher on the eve of the great depression can be seen as a symbol of boundless optimism in stock market history.

V. Volkswagen Financial Services

During the last decade, the financial documents of the Volkswagen AG point to an enormous expansion of the balance sheet.



The extension of the balance sheet can largely be attributed to the business area Volkswagen Financial Services. During the last years, the company transformed itself from an automotive producer to a provider of financial services. The balance sheet of Volkswagen Financial Services has almost doubled from 2008. Especially the contracts in the Asian region have more than doubled since 2012. Approx. 11% of the vehicle sales of the Volkswagen-group are currently carried out through Volkswagen Finance China.¹⁴ Due to the present downturn, the business prospects of dealer financing might get much tougher in China. For instance, the BMW-group had to pay almost 700 million € to their Chinese dealers as a result of unrealistic sales targets.¹⁵ The Volkswagen AG, in particular the Audi-group, could be faced with similar claims and will probably have difficulties in meeting their sales target for 2015.¹⁶

¹⁴ Annual Report Volkswagen Financial Services 2014, p. 32.

¹⁵ See article from Reuters, 5th January 2015: “BMW’s China dealers say company agrees to pay US-Dollar 820 million subsidy“.

¹⁶ See article from Reuters, 16th July 2015: “Audi reviews China 2015 sales target“.

Volkswagen Financial Services is trying to pass on its credit risks to other market participants through ABS-securitization.¹⁷ The volume of ABS-issuance is currently far from being sufficient to offset the existing risks.

VI. Provisions for pensions

Besides the operating risks the Volkswagen AG seems to have high liabilities in regard to its provisions for pensions. In fact, the Volkswagen-group was able to profit from the low interest levels of the last years, which supported the automotive business generally. Nevertheless, uncovered pension benefits could turn out to be a heavy burden. The revaluation of the pension reserves lead to a significantly lower total comprehensive income in 2014.¹⁸ In the first quarter of 2015, the company even had to report a loss in the total comprehensive income.¹⁹ If the worst comes to the worst, Volkswagen might try to use more favorable accounting measures to reevaluate pension obligations.

VII. Summary

The Volkswagen AG, as a German Blue Chip, clearly shows one of the strongest dependencies on the Chinese market. In addition to the China-risks, the receivables from financial services as well as uncovered provisions for pensions have reached a dangerous level. The legal structure of the Chinese joint ventures might affect the group`s capacity to act during a crisis. Investors need to be aware of the fact, that the Volkswagen management might not be able to react adequately to a cooling Chinese market environment, due to contractual obligations with its joint venture partners. It remains to be seen, whether or not negative business prospects will restrict the investment projects of the Chinese joint ventures.

As far as the joint ventures never recorded a loss or an undercapitalization, the legal consequences of such an event remain unclear. The shareholders of the Volkswagen AG are kept in the dark about the financial situation of the Volkswagen Group China. The underlying risks resulting from the enormous expansion of capacities are evident without going into further details.

¹⁷ Annual Report Volkswagen Financial Services 2014, p. 4; Interim Report Q1 2015, p. 23.

¹⁸ Annual Report 2014, p. 181. As a result of a revaluation of the provisions for pensions, the total comprehensive income decreased to less than 4 billion €.

¹⁹ Interim Report Q1 2015, p. 26.

The investors of the Volkswagen AG participate to a broad extent in a venture, that resembles a Chinese state owned company. It remains to be seen, whether the risks will be priced in correctly by the market. In any case, well-established valuation principles can hardly be applied to the Volkswagen AG.

The retreat of the stock price during the last months indicates that the market starts to discount the existing risks. Short-investors necessarily act on the assumption of a further deterioration of the Chinese automotive market. In this regard, the steep slump in prices on the mainland stock exchanges might constitute an *inflection point*. As a result of the relatively low volatility of Volkswagen derivatives at the Eurex, the company seems eligible for a broad hedge against China-risks.

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The author is invested in derivatives that profit from declining quotations of the Volkswagen AG.

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