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Report on HNA Group:

Implications for Equities Held by HNA, Implications for Chinese Politics

EXECUTIVE SUMMARY

This analysis covers the implications of recent Chinese policy developments on HNA's equity holdings. It focuses specifically on the impact of a July 2017 directive by the Chinese Banking Regulatory Commission that has effectively halted financing available to HNA for overseas acquisitions,¹ but also highlights important behind-the-scenes Chinese political movements associated with HNA.

Our primary focus is risks associated with a liquidation of HNA assets, in support of a large equity position [redacted] Capital Management holds in [redacted] (in which HNA Group also holds a [redacted]% equity stake). In addition to liquidation and financial risks, we clarify very significant Chinese political risks associated with “the HNA affair.”

Our research concludes that the risk of a forced liquidation of [redacted] stock from HNA portfolios for political reasons is limited. This assessment does not, however, dismiss the possibility that HNA's overseas assets could over time be liquidated for financial reasons; HNA's reduced access to capital at very low interest rates could be a longer-term challenge impacting its financial results and fundamental business model, and encourage the eventual sale of overseas assets in HNA's portfolio. The political importance of HNA within Chinese policymakers' attempts to develop large Chinese conglomerates, however, mitigates the risk of HNA being allowed to fully founder. [redacted] also fits within the HNA Group's core business of travel and travel-related infrastructure, further limiting the risk of liquidation.

Since the overall health of HNA will be intricately tied to Chinese policy decisions, this analysis covers behind-the-scenes political dynamics that may affect the firm. We find that recent Chinese policy guidance limiting HNA Group's access to financing for international acquisitions is related to a much deeper political dynamic involving HNA. This dynamic involves some of the most powerful players within the Chinese Communist Party and has the potential not only to affect HNA but Chinese politics at a very significant level.



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BACKGROUND ON HNA

HNA was a direct target of July 2017 Chinese policy directives and has been heavily impacted by ongoing Chinese government efforts to limit Chinese firms' access to Chinese capital as a source of finance for overseas acquisitions. Ostensibly, this is all part of the effort by Chinese authorities to limit capital outflows and stem downward pressure on the RMB. In addition to general directives regarding capital outflows and investments overseas, Chinese banking regulators instructed all banks to review and provide details on loans that had been provided to HNA for overseas acquisitions. HNA was one of a handful of Chinese private companies for which this data was sought for investigation.

Up until that point, HNA had made a series of large overseas acquisitions, primarily in the travel-related and travel infrastructure sectors but expanding into finance, logistics, and other sectors. Since the issuance of these Chinese government directives and especially the July 2017 directive targeting HNA, shares of companies in which HNA holds large stakes have seen downward pressure.

Our analysis indicates that there are risks of HNA asset liquidation, but those risks are relatively limited short term and are intricately tied to behind the scenes political dynamics in China. These dynamics have little to do with financing of overseas acquisitions and China's attempts to halt capital outflows and downward pressure on the RMB; rather, they are associated both with allegations of corruption and especially inter-factional strife within the Communist Party.

A key Chinese political player behind the scenes and arguably the second most influential figure in Chinese Communist Party politics – Wang Qishan – has been linked to the HNA affair. This has significant Chinese political implications though the extent of Wang Qishan's actual connection to HNA or financial benefits from that relationship is unclear. Accusations linking him to HNA may in fact be part of complex inter-factional dynamics within the Chinese Communist Party. This dynamic will have important political implications for HNA and Chinese politics as well as Chinese reforms broadly, during a time of critical Party transitions. (See box below)

The HNA affair is therefore intricately tied to struggles related to leadership succession and control within the Chinese Communist Party. This dynamic has the potential to result in more negative news related to HNA, which may lead to further selling pressures on HNA assets.

CONCLUSION

It is our conclusion that as a whole the risk of HNA liquidating its position in [REDACTED] is limited. This is because HNA's overseas acquisitions and development into a major conglomerate are part of a Chinese government strategy to develop large Chinese conglomerates (somewhat in the model of Korea's *chaebol* or Japan's *zaibatsu*). There does exist, however, the chance that an example of HNA will be made as part of the Party's anti-corruption efforts, with significant implications for HNA's leadership structure, business model, and assets.

The underlying goal of the stable development of a Chinese conglomerate in the international travel sector should limit pressures to liquidate overseas assets in that sector, which [REDACTED] falls within. There may, however, be significant pressure to sell assets outside of HNA's travel-related core, as HNA's acquisitions have extended into a variety of sectors. There are also potential opportunities for short term investors as “the HNA affair” develops.

Recent shifts in ownership structure seem to indicate that there could be something behind the smoke of allegations of HNA impropriety – or at least that something very unusual is going on: a major stake of HNA held by “mysterious” shareholder Guan Jun (29%, book value ~USD 18 billion) was abruptly transferred to the American branch of a charity (Hainan Cihang Charity Foundation) in August 2017. That charity was originally started by HNA itself, and the charity's affiliates appear to currently hold the majority of HNA group ownership. Adding to this complex web, these charities' boards also appear to be dominated by former govt. officials from the province where HNA is based (Hainan Province).²

Pressures on HNA to liquidate assets may actually increase due to this ownership transfer: per US tax law American charities are not allowed to hold excessively large stakes in private companies, particularly if there are links between the charity and the private company. It is also worth noting that one of these charities, the Cihang Foundation, has a shell company associated with “ITIC” trust companies in Hainan Island that went bust during the 1990s. Wang Qishan was instrumental in restructuring of “ITICs” as a senior finance official serving in southern China in the 1990s, though this is by no means conclusive of collusion between him and HNA.

HNA's unusual ownership structure has recently been cited by managers at Bank of America, Goldman Sachs, Citigroup, and Morgan Stanley as grounds for their bankers to avoid getting involved in certain financing transactions related to HNA.

For long term investors in companies in which HNA holds a major stake, the risk of an HNA liquidation does not seem threatening if a company has a solid underlying business model and valuation. There does, however, seem a strong likelihood of further bad news coming out related to HNA that may drive short term price movements. In keeping with Chinese factional politics, such news may be suppressed. Indeed, one of the most interesting aspects of the HNA affair is that its suppression has the potential to significantly impact the factional dynamics shaping Chinese policy. (see box below)

HNA: FROM A REGIONAL AIRLINE TO A GLOBAL CONGLOMERATE

The growth of HNA as a global player in the travel industry is remarkable. From a small regional airline in the 1990s – Hainan Airlines – HNA has evolved into a business with Y101 billion (approx. USD 18 billion) in annual revenues, and total assets of Y468 billion (approx. USD 80 billion). These assets include a 25% stake in Hilton International as well as a 10% stake in Deutsche Bank, amongst many other significant international holdings.

This evolution has been carefully orchestrated with the support of beneficial Chinese government policies. Following the government-orchestrated consolidation of the Chinese airline industry into 3 major airline groups in 2000, HNA made a series of financed acquisitions to acquire airlines left out of the consolidation and grew to become China's fourth largest airline. Under the leadership of its chairman, Chen Feng, HNA has leveraged very low cost state-bank financing and Chinese assets to dramatically expand revenues as well as its overseas holdings.

The growth of HNA's international profile culminated in its June 2017 high profile sponsorship of the French Open in Paris. This was quickly followed by Chinese policy measures that have had a significant negative impact on the company.

In July 2017, Chinese government banking regulators directed all banks to provide information on loans to HNA Group, as well as Fosun International, Dalian Wanda, and Anbang Insurance Group. This might on its surface be seen as another element in a series of Chinese policies implemented over the past year to target capital outflows, which themselves are ostensibly designed to prevent downward pressure on the RMB. Actual implementation of these policies, however, has sometimes seemed to depend on political jockeying within the Chinese political system.

The concern of ending up on the wrong end of where Chinese policies will finally land has limited capital available to HNA for foreign investment. Some firms have been forced to sell overseas assets to refinance outstanding loans and rebalance their capital ratios - Chinese companies had been using China-based assets to back overseas borrowing, creating a further level of international leverage in businesses already leveraged in China.³ Chinese regulations have been interpreted as a prohibition of state-owned banks from lending money to Chinese private companies for overseas acquisitions, part of a series of signals designed to curb Chinese private companies' foreign investment activities.

These actions have affected trading in companies of which HNA is a major shareholder. It is our assessment that though there are significant short and medium term risks of further news affecting markets, long term risks for businesses with fundamentally strong business models are limited. This dynamic may present both short term trading opportunities and also opportunities to acquire fundamentally solid assets at low prices.

The impact of HNA no longer having access to low cost or preferential finance is, however, likely not short term. There seems little likelihood that HNA will be significantly expanding on its international acquisitions in the near future to further boost stock prices in sectors where HNA has been active. Those acquisitions have been extensive and include not only 25% of Hilton International (a USD 6.5 billion investment) and 10% of Deutsche Bank but also a \$2.8 bn investment in Swissport International, \$1.5 bn in Gategroup, and a stake in Sky Bridge Capital.

Even as HNA Group has become a major owner of international assets, its own ownership structure has remained murky. Recent moves in that ownership structure appear to be a strong indicator that the Chinese government has placed significant pressure on HNA owners and directors. This highlights the importance of Chinese political dynamics in shaping HNA outcomes.

BACKGROUND ON WANG QISHAN AND CHINESE POLITICAL DYNAMIC RELATED TO HNA

Political dynamics will play a central role in determining future HNA outcomes. An overview of Wang Qishan is therefore helpful since his possible connection to the company could have very broad implications. Wang has been linked to allegations made by an influential Chinese businessman, Guo Wengui, that HNA has benefited inappropriately from preferential treatment by Chinese officials. The extent of his connection to the firm and any improprieties will be a critical factor determining outcomes not only for HNA but for the Chinese political system as a whole.

This report makes no assessment of the accuracy of assertions that Wang Qishan is linked to HNA in any inappropriate way. We find, however, that such assertions are at least plausible, both because of the nature of the Chinese political and economic system and also the past career trajectory of Wang Qishan. Plausibility of an allegation is by no means confirmation, and efforts to tie Wang Qishan into the HNA affair may be part of complex factional behind-the-scenes machinations within the Communist Party. HNA Group in fact filed a defamation lawsuit on June 15, 2017 in New York courts against accuser Guo Wengui, with HNA Chairman Chen Feng stating: “If you choose to listen to a pack of lies by an internationally wanted fugitive, then there is a problem. If you look at the business of HNA and understand its true nature, then you'll see these claims are nothing but lies.”

An understanding of Wang Qishan's role within the Party is essential to understand the importance of any HNA connection. Wang has had an illustrious career as a Chinese official, rising to power under previous Chinese premier Wen Jiabao and with appointments to influential posts under previous President Hu Jintao. As such, Wang Qishan is tied to a faction that current President Xi Jinping has been working to consolidate and isolate as he develops his own power base within the Party. This inter-factional struggle since Xi took power five years ago as Chairman of the Communist Party has been closely tied to the battle against corruption in China.

In that battle against corruption, Wang Qishan has been instrumental. Not only is he currently a member of the Standing Committee of the Politburo – the table of seven men which Xi Jinping chairs that guides the Communist Party and China; Wang also serves as the Secretary of the Central



Discipline and Inspection Committee, which is responsible for ensuring all Party members follow Party discipline. This has made Wang Qishan not only the point man for Xi's efforts to challenge corruption within the Party. The Central Discipline and Inspection Committee is responsible for all discipline of Party members beyond mere graft concerns, and as such is arguably the most powerful and feared institution within the Communist Party of China.

As director of the Party organization charged with ensuring Party discipline is maintained, Wang sits at the nexus of factional politics between Xi's regime and his predecessors, and also at the center of Party power. It is generally recognized within the Chinese Communist Party that the greatest threat to continued Party control is likely to come from within the Party itself: Chinese analysts who study the collapse of the Communist Party in the Soviet Union have concluded the collapse there derived not only from economic challenges and regional nationalism but especially a weak Party core which had lost its discipline and allowed internal and external challenges.

To prevent internal challenges from within the Party, the Chinese Communist system depends upon the Central Discipline and Inspection Committee - which Wang Qishan has been running since 2012. Wang is therefore an incredibly influential person in Chinese politics.

Any substance to allegations that Wang himself may have been involved in inappropriate dealings with HNA Group could therefore have immense implications for Chinese politics. In terms of career trajectory, Wang did serve briefly as Party Secretary of Hainan province (HNA's base of operations) during the period of HNA Group's ascendance. He also was a central figure in finance in China's southern region. HNA Chairman Chen Feng has also stated that Wang was his superior when they both worked at China Agricultural Development and Trust three decades ago.

As the Chinese Communist Party prepares to convene its once-every-five-year Party Congress this fall (the 19th Party Congress, starting Oct. 18), factional Party dynamics are coming to a head and the HNA affair should be considered in this context. The next generation of Party leaders will be anointed at this Party Congress, and factions have been jockeying to have their preferred candidates placed in positions of power. Any leverage that may exist against Wang Qishan could therefore be instrumental in undermining factions aligned with him. This is particularly important as Xi Jinping attempts to consolidate his own power base and assumes a stature as singular leader of the Party that eclipses his predecessors' level of individual influence.

Furthermore, this Party Congress selection of the coming generation of Party leaders who will guide China for the next five years (with Xi at the top as Party General Secretary) comes at a critical time for China and the Communist Party. Not only is China shifting its economic development model as the Party struggles to continue to deliver economic growth rates in the high single digits; it also faces a potential trajectory of conflict with the United States as the US pushes back against North Korea and Chinese territorial ambitions in the South China Sea. Any opportunity for hard-line elements to undermine opponents is a critical piece of the Chinese political calculus. Should Wang Qishan actually be implicated in the HNA affair this may present an opportunity for factions to undermine the priorities and candidates of Party officials associated with him, and weaken his former power base aligned with Hu Jintao and Wen Jiabao.

Links to further info:

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| Wang Qishan | https://en.wikipedia.org/wiki/Wang_Qishan |
| Xi Jinping | https://en.wikipedia.org/wiki/Xi_Jinping |
| Guo Wengui | https://en.wikipedia.org/wiki/Guo_Wengui |
| Hu Jintao | https://en.wikipedia.org/wiki/Hu_Jintao |
| Wen Jiabao | https://en.wikipedia.org/wiki/Wen_Jiabao |
| Chen Feng | https://en.wikipedia.org/wiki/Chen_Feng_(businessman) |

Central Discipline and Inspection Committee

https://en.wikipedia.org/wiki/Central_Commission_for_Discipline_Inspection

Standing Committee of the Politburo

https://en.wikipedia.org/wiki/Politburo_Standing_Committee_of_the_Communist_Party_of_China

19th Party Congress

https://en.wikipedia.org/wiki/19th_National_Congress_of_the_Communist_Party_of_China

