Special situations corner (4): the juiciest (potential) arb I have ever seen, 83-160% upside as arb closes

DECEMBER 29, 2020 / PUPPYEH / EDIT

Every now and then you come across something in the capital markets that *prima facie* seems such an attractive risk/reward you have to rub your eyes, sit up straight, and think 'this can't be right.' I felt this way, a little, with regard to the Endor opportunity back in May; or the recent opportunity I highlighted a couple of weeks ago; or, within arbitrage land, the SPAC arb opportunity in a few names a couple of months ago. But those feelings pale in comparison with this latest opportunity – it seems too good to be true, and frankly I am writing this not just to share with readers but also, selfishly, to solicit feedback on what I could be missing.

Thesis summary

Haier Smart Home (Germany: 690D; and HK: 6690.HK) is a tri-listed white goods manufacturer (note that I am ignoring the Shanghai listing since for our purposes as offshore investors the local Chinese listing is not really relevant). The shares trade on the Hong Kong stock exchange at ~27.4 HKD, and on the Frankfurt exchange in Germany at 1.1 EUR – that is, a ***~62% spread for the exact same economic instrument*** (the evidence of which is clear, and will be discussed). There are of course reasons for the relative cheapness – but I think most of them are likely to be temporary, and, most

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importantly, there is a strong case to be made that the German shares are actually fungible (that is, exchangeable/convertible) into the HK line. If this is proven in the coming weeks/months, the gap between the two will rapidly close to almost zero – as basically all other secondary-listed HK securities show almost zero arbitrage gap versus their foreign listed lines.

This opportunity exists because 1) the German listing is a 'one of its kind' on the D-share market – a section of the main German bourse, and tradeable on Xetra (the electronic platform) – where there are no other cross-listed Chinese companies since Haier became the first and only to tap it in 2018; and 2) because Haier only relisted in HK a few days before Christmas (via an absorption of its already-listed subsidiary, Haier Electronics), making this opportunity actionable/visible for the first time when most the entire financial world is away from their trading screens. We will discuss the importance of the HK listing in impacting D-share valuation shortly.

But the *secondary* beauty of this trade is that, even if the fungibility of the D-shares into H-shares takes a bit of time, or is proven too difficult for most shareholders to accomplish – *then you are STILL getting into this spread at the widest level I have ever seen for a spread of this type* (a non-fungible dual-listing of economically-identical securities). In other words, this is a **'heads I win big, tails I clean up'** type scenario. If the arb is proven out, the spread closes, probably completely, in 3-6 months – and I make ~60% on the spread and – assuming 6690.HK stays at 27.4 HKD – **160% upside in absolute terms on the German line**. But even if the arb is not proven out, I would expect the H-share premium to collapse to levels exhibited in other non-fungible dual-listed structures, namely the 15-30% range, **suggesting still 83-123% upside in the German line**. And given the relatively small size of the D-shares float outstanding (just 2.4% of the whole company, and ~190mm EUR), you could argue that it won't take much alternative capital flowing into this line (instead of the HK line) to move the discount substantially tighter than it currently trades.

This argument is augmented by the fundamentals, too. Haier is a quality large-cap appliance manufacturer (they own GE appliances), with a market-leading position in China and globally. They just absorbed their main operating subsidiary (Haier Electronics); and continue to improve the profitability of acquired overseas assets (GE Appliances and Candy), meaning operating margins today remain well below similar comps of scale (4-5% vs Whirlpool at 10%+ in North America, for example). Despite this, through the German line, you are paying *~7x EPS on FY21E earnings with an implied ~4.3% yield* (as Haier is a consistent 30% payer) – versus the median global and Chinese white goods comp at 18-20x P/E and 1-2% div yield. On a fundamental standalone basis this seems far too cheap, for one of the better names in the industry. But earnings trajectory aside, the dividend differential alone suggests over time income-based investors should gravitate towards the German line as well.

Background on the D-share listing

Let's start at the beginning. Haier Smart Home was formerly known as Qingdao Haier, and has been a large, growing, global white goods manufacturer for many years. It first listed on the Shanghai stock exchange in 1993 and was only domestically listed until 2018, when it was the first – and only – Chinese company to pursue a special German

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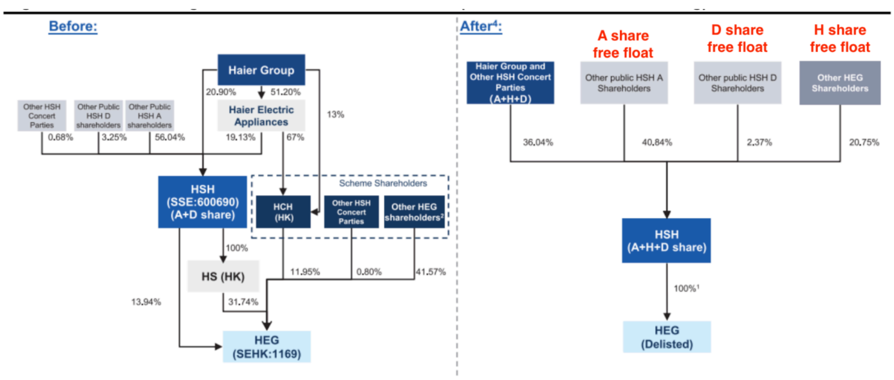
listing on the nascent 'D-share' market. You can read about the project here, but essentially this was something of a public relations exercise to attempt to bring Chinese and German capital markets, and economies, closer together through the dual listing of a couple of Chinese national champions.

In the end, the move was a flop: Haier found no local demand, and only sold ~270mm shares at 1.05 EUR (originally they wanted to sell 470mm), with Chinese SoEs taking down 40-50% of the shares sold (and most of the rest sitting on bank dealer desks, for years). Predictably, the shares traded poorly, spending most of the next 2+ years languishing below their issue price, with liquidity drying up as well:

During this time the A-shares – the Shanghai listed shares – remained trading, and at a massive premium, but since the D-shares were not fungible with the A-shares, there was no reason for the discount to close. As it was, the Haier D-shares remained something of a stranded instrument.

The H-share listing – a game changer for the D-shares

This all changed a couple of days ago with Haier's relisting in Hong Kong. One of Haier's major operating subsidiaries, Haier Electronics (~46% owned by the parent) had a legacy listing in HK, but earlier this year, in an effort to streamline a very complex corporate structure, Haier decided to issue parent co (that is, Haier Smart Home) shares to its minority shareholders, to absorb the sub and simultaneously relist the parent co in HK. This was achieved on December 23, with the pre- and post-restructure org chart looking like this:



At this point, HSH has become a 'tri-listed' company (Shanghai, Frankfurt, HK), with the D-shares still representing a very small part of the overall capital structure. Still, the HK relisting was crucial for D-share shareholders (that's us), in a couple of different ways.

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Firstly, the HK relisting prospectus unequivocally proves the equal economic rights of D-shareholders with that of all other shareholders. This is important, because when the sole other listing was onshore China, even if economic parity was stated in the original D-share docs nevertheless there would always be an 'uncertainty' discount if you ever tried to exercise those equal rights within China domestically. Now, in another offshore juridisdiction, this parity has been clarified beyond doubt:

SHARE CAPITAL

Furthermore, any change or abrogation of the rights of class Shareholders shall be approved by way of a special resolution of the Shareholders' general meeting and by a class shareholders meeting of class Shareholders convened by the affected class of Shareholders. The circumstances under which a general meeting and a class meeting are required are summarised in "Appendix VI — Summary of the Articles of Association". However, the approval of separate classes of Shareholders is not required under the following circumstances: (i) issue of A Shares, D Shares and H Shares of not more than 20% of existing A Shares, D Shares and H Shares respectively, either separately or concurrently, in a period of 12 months, pursuant to an approval by a special resolution of the general meeting; (ii) plans of issuance of A Shares, D Shares and H Shares upon establishment of the Company, provided that it is completed within 15 months from the date of an approval from the securities regulatory authority under the State Council or a specified period applicable provided under relevant requirements.

A Shares, D Shares and H Shares shall rank *pari passu* with each other in all other respects and, in particular, will rank equally for all dividends or distributions declared, paid or made.

So the shares are economically the same – but are they fungible?

At heart there are two key issues here: are all shares the same? And if they are, are they fungible? The second, and far more important, takeaway from the HK relisting prospectus was that it ***outlined a clear path to proving fungibility of the D-shares in another offshore jurisdiction***. It is worth quoting from the prospectus, at length:

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October 2019 (1)
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July 2019 (3)
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March 2016 (1)
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December 2015 (1)
October 2015 (1)
September 2015 (2)
August 2015 (3)
July 2015 (1)
June 2015 (1)
May 2015 (2)
April 2015 (4)
March 2015 (6)

SHARE CAPITAL

CONVERSION OF A SHARES OR D SHARES INTO H SHARES

Upon completion of the Introduction and the Privatisation, the share capital of the Company will consist of A Shares, D Shares and H Shares. If any holder of A Shares or D Shares wishes to transfer its A Shares or D Shares to overseas investors for listing and trading on Hong Kong Stock Exchange as H Shares, it must comply with the relevant regulations prescribed by, and obtain the approval of, if so required, the relevant regulatory authorities in places where our Shares are listed, including the CSRC for the conversion of the A Shares and the approval of Hong Kong Stock Exchange for the listing and trading of the converted H Shares, as well as following the procedures set forth below:

(1) the holder of A Shares must obtain the requisite approval of the CSRC or the authorised securities approval authorities of the State Council for the conversion of all or part of its A Shares into H Shares;

(2) we may apply for the listing of all or any portion of our A Shares or D Shares on the Hong Kong Stock Exchange as H Shares in advance of any proposed conversion and we must obtain prior approval from the Hong Kong Stock Exchange before the converted H Shares can be listed and traded on the Hong Kong Stock Exchange;

(3) the holder of A Shares or D Shares must request that we remove its A Shares or D Shares from the A Share register or D Share register, attaching the relevant documents of title together with the request;

(4) subject to obtaining the approval of the Board and the Hong Kong Stock Exchange, we would then instruct the H Share Registrar, with effect from a specified date, to issue the relevant holder H Share certificates for a specified number of H Shares;

(5) the specified number of A Shares or D Shares to be converted to H Shares are then re-registered on the H Share register maintained in Hong Kong on the condition that:

a. our H Share Registrar lodges with the Hong Kong Stock Exchange a letter confirming the proper entry of the relevant H Shares on the H Share register and the due dispatch of H Share certificate; and

b. the admission of the H Shares for trading in Hong Kong will comply with the Hong Kong Listing Rules and the General Rules of CCASS and the CCASS Operational Procedures in force from time to time;

(6) upon completion of the transfer and conversion, the shareholding of the relevant holder of A Shares or D Shares in our A Share register or D Share register will be reduced by such number of A Shares or D Shares transferred and the number of H Shares registered will correspondingly be increased by the same number of H Shares; and

(7) in compliance with the Hong Kong Listing Rules, we will publicly announce the transfer and conversion not less than three days prior to the proposed effective date.

As a result of the conversion, the shareholding of the relevant holders of A Shares in our A Share capital registered shall be reduced by the number of A Shares converted, the shareholding of

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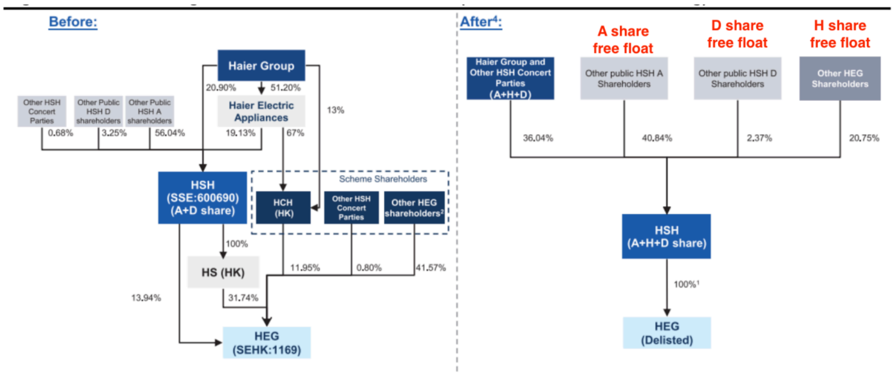
SHARE CAPITAL

the relevant holders of D Shares in our D Share capital registered shall be reduced by the number of D Shares converted, and the number of H Shares shall be increased by the corresponding number of H Shares. If all or a significant number of D Shares were converted into H Shares, and as a result ordinary stock exchange trading would be considered by the management of the Frankfurt Stock Exchange as no longer ensured in the long term, the management of the Frankfurt Stock Exchange could revoke the admission of D Shares to trading on the regulated market on the Frankfurt Stock Exchange. Under the China Europe International Exchange AG's General Terms and Conditions for CEINEX D-Share Market, CEINEX may remove an issuer from the CEINEX D-Share Market if the shares of the issuer are no longer admitted to the regulated market of the Frankfurt Stock Exchange. As at the Latest Practicable Date, the Directors were not aware of any intention of any holder of A Shares or D Shares to convert all or part of their A Shares or D Shares into H Shares.

This reads like a long and convoluted process, to be fair, and in all honesty a D-share conversion to H-shares has never been done before (after all, there is only one D-share and that's Haier!). However, the essence of the process is not that different to other conversions of this type: you need to prove ownership (hence the letter proving title to the shares); you need exchange approval (in this case, the HKEX) as well as the company's approval; and then the share registrar needs to update the registries both in Germany and HK for the adjusted share counts. This seems fairly procedural – most of this kind of thing is par for the course for any decent custodian of a large financial institution.

The real risk in proving fungibility, then, is not the paperwork, it is really just one potential item in the above: ***will the HKEX and the company approve a mass migration of D-shares to H-shares***? I simply don't know the answer today (although I am investigating with my broker and others, as I type). However, *there is no obvious reason why the HKEX wouldn't allow more H-shares to be created and traded in this way* – it doesn't affect the overall capital stock of the company (if anything it creates a more liquid market for the H-shares and more volume for the exchange); and it doesn't violate or contradict anything in the prospectus or listing rules, that I can see. In fact, by specifically including this playbook for conversion/fungibility, you could argue that *the HKEX (and the company) foresaw that attempted conversion of D-shares was an inevitability once the H-share line became listed* (given the discount is obvious and gargantuan) and indeed this was the reason for such a detailed explanation in the prospectus in the first place.

Another consideration may be, what is Haier trying to achieve in all this? Clearly the HK relisting was a move to simplify the corporate and capital structure of the company. Refer again to my earlier chart, and how much cleaner the entity is post-relisting that before:



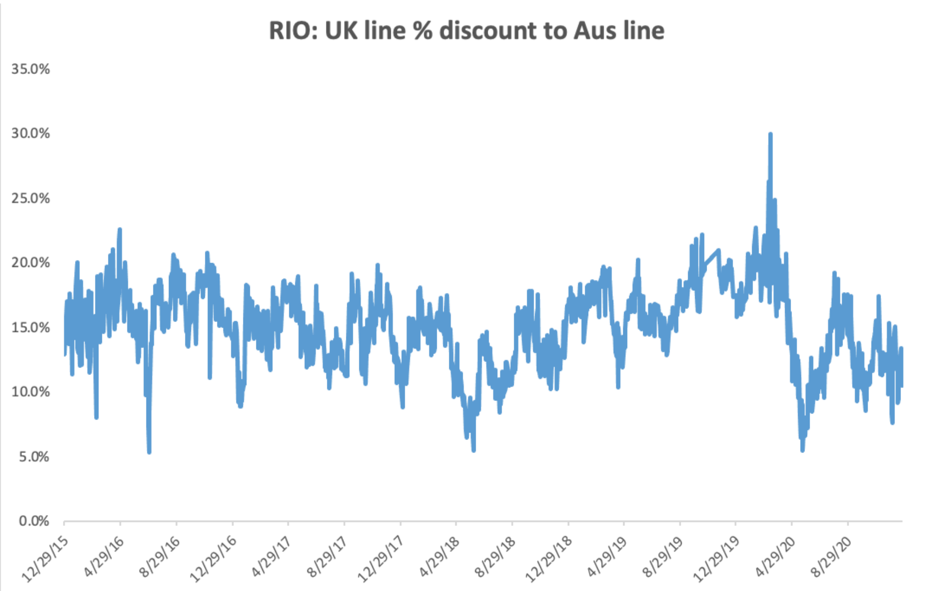
Obviously, this is a much cleaner, much simpler, and ultimately much more investable entity. *What exactly does HSH have to gain from perpetuating a backwater listing in Germany*, with a tiny (irrelevant) piece of their capital structure, at a huge discount to the rest of the shares listed elsewhere? I am not sure how maintaining the German listing serves them in any way – and now that they have another offshore listing in HK, perhaps the long exposition on conversion in the prospectus was their way of tacitly admitting they don't care to maintain the German listing anymore and would thus allow conversion as and when shareholders petition for it.

If my reading of the situation is correct, then, a large portion of the D-share float will be submitted for redemption and conversion into H-shares in the coming weeks and months, forcing HKEX and the company into a decision: do we 'play hardball' to maintain a highly-discounted German listing (for no apparent economic reason); or do we simply allow convertibility (as presaged in the prospectus) and unify the capital structure into H shares and A shares – like basically every one of our listed Chinese comps? I know which outcome I think is more likely….and yet if this happens we get 160% upside on the German line!

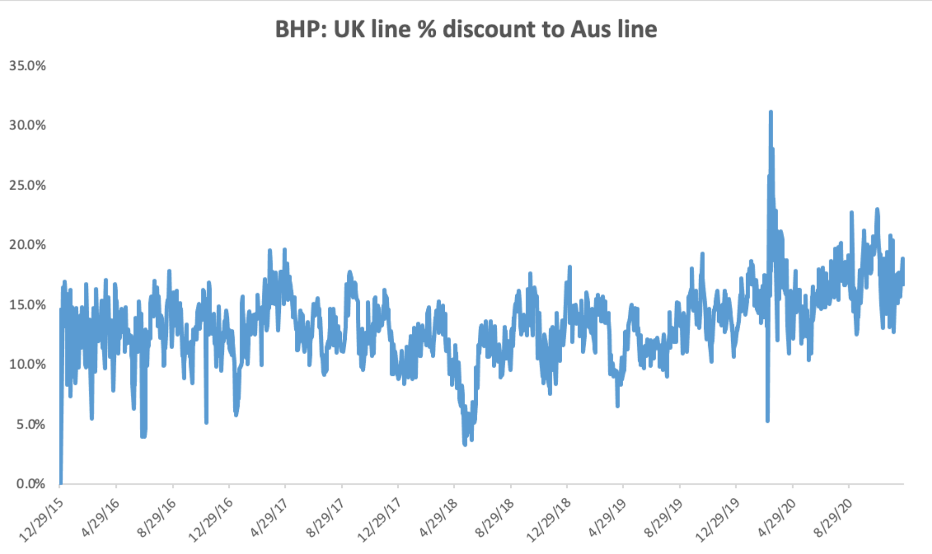
But what if it's not fungible? Even then the relative discount is beyond extreme…

Of course, I could simply be wrong in my reading of the situation, and HKEX/the company could conspire against D-share holders to simply deny them the right to convert, without cause or reason. But the beauty of this situation is that *even in this apparently adverse case, I am getting into HSH at by far largest spread I have ever seen for a situation like this* – that is, a non-fungible dual-listed company structure. You can read more about the history of DLCs here, but the long and short of it is there are very few of these types of situations left. The vast majority of them have been turned into single holding companies, with two listings (ie, that are completely fungible), and thus the discounts have basically all closed (this happened with Royal Dutch Shell; Investec; Carnival Cruises; Unilever, etc).

Today, there are really only two non-fungible DLCs of scale that I can find: Rio Tinto and BHP – both dual listed in the UK and Australia (ignore the US listings of HK companies, as those are all ADRs and thus completely fungible). Here is the spread for Rio Tinto going back 5 years – you can see the spread *peaked temporarily at 30%* during the height of COVID, but has basically been **in a 10-20% range for this entire period, and is currently <15%**:



The BHP spread tells a similar story: a 30% peak discount post COVID, punctuating a long stretch where the discount have traded **as low at 5% and mostly in the 15% range.** At the moment the discount in around **16-17%:**



How should we think about RIO/BHP in relation to our subject, Haier? There are of course a myriad of reasons for why two economically-identical instruments could nonetheless trade at different prices, in the absence of fungibility (tax consequences for local investors; index make-up/differences; liquidity, etc). Of course, the Haier situation is NOT identical to BHP/RIO, and in a few important ways you would expect, *ceteris paribus*, a wider spread: BHP/RIO are in 'cleaner' geographies, and are more liquid; and they have also been listed/tradeable for much longer. But on the other hand, both RIO and BHP are definitively NOT fungible, and will never become so; on the other hand, Haier holds – even in the worst case – a decent possibility of being fungible in the future (and in my view the likelihood regarding fungibility is >50%). Also, we should remember that Haier is not that illiquid in Germany (recent volume is $5-10mm/day), and the HK line has a $30bn market cap today – in other words this is still a very large, reputable, international company, not some 'fly by night' local Chinese play that will remain uninvestable for offshore money. We should also consider that the German line only has a ~200mm EUR free float, so if any reasonably sized money wants to put on the spread, it could quickly tighten to levels much tighter than seen in BHP/RIO, based on supply/demand of the D-shares alone.

Putting it all together, IF fungibility is never proven out, I would expect the Haier spread to trade somewhat wider than other spreads of this ilk – but there is no reason to expect it to trade at 62% (the current level)! *Even if the spread remarked to the recent wides seen in BHP/RIO – that is, 30% discount to the HK line – it would still imply a ~2.02 EUR stock price on the German line – good for 80%+ upside from current*. If instead it traded at a more reasonable 20-25% discount – that is, wider than the BHP/RIO spreads are today but still within context – you would expect a price of up to 2.2 EUR – *or 110% upside from current*. The below table summarizes the different potential outcomes:

	Haier D share	Haier H share	Notes
Current Price	1.1	2.89	Converted to EUR
Current discount	***62%***		
Implied D share at...		**Upside**	
Price parity	2.89	**163%**	If arb is proven out
30% discount	2.023	**84%**	wides of BHP/RIO spreads
20% discount	2.312	**110%**	5pts wide to current BHP/RIO spreads

Hence my contention that this really is a 'heads I win, tails I win as well' type setup.

A quick note on fundamentals

As you can no doubt gather from the above, this is very much a technical/idiosyncratic setup largely divorced from the fundamentals of the underlying company (this is the only reason I am shamelessly cribbing portions of this section from the sell-side). But it's important to also understand that in absolute terms, the price of the German shares implies **~7x next year's P/E and ~4.3% yield** (using some Chinese broker numbers, for a quick and dirty 'consensus') – levels that are far, far, far lower than any other comparable Chinese or overseas white goods name:

Earnings Summary

(YE 31 Dec)	FY18A	FY19A	FY20E	FY21E	FY22E
Revenue (RMB mn)	177,594	198,006	207,685	231,133	249,918
YoY growth (%)	15.2	11.5	4.9	11.3	8.1
NP att. (RMB mn)	7,484	8,206	8,283	10,656	12,672
Diluted EPS (RMB)	1.216	1.249	1.075	1.180	1.404
YoY growth (%)	1.2	5.5	(16.1)	9.8	18.9
Consensus EPS (RMB)	n/a	n/a	n/a	n/a	n/a
P/E (x)#	15.7	14.8	17.7	16.1	13.6
P/B (x)#	2.6	2.1	2.8	2.4	2.1
Yield (%)#	1.9	2.1	1.9	2.2	3.0
ROE (%)	18.8	17.1	15.4	17.3	17.9
Net gearing (%)	Net cash	Net cash	Net cash	Net cash	Net cash

Source: Company data, Bloomberg, CMBIS estimates

Implies 7x P/E and 4.3% yield on German line

Here are all the relevant comps globally – basically anything similar trades **near 20x P/E and below 2% yield:**

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Figure 72: Peers' valuation

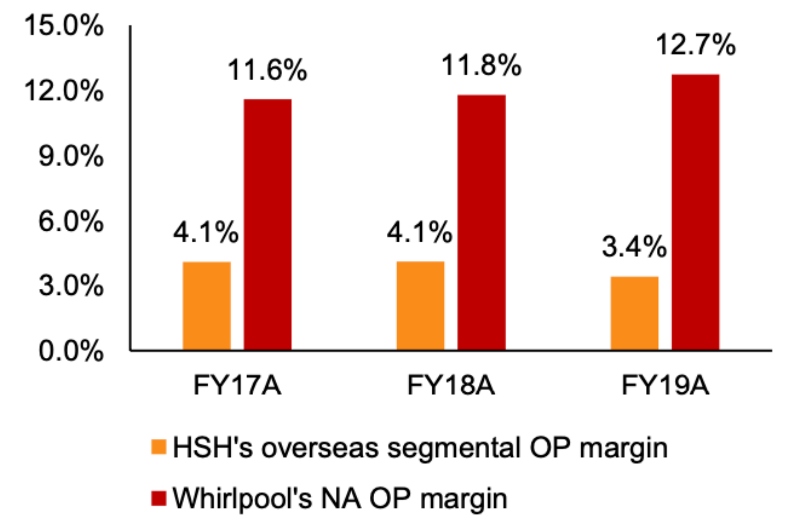
Company	Ticker	Rating	12m TP (LC)	Price (LC)	Up/ Down-side	Mkt. Cap (HK$mn)	Year End	P/E (x) FY1E	P/E (x) FY2E	P/B (x) FY1E	P/B (x) FY2E	ROE (%) FY1E	3yrs PEG (x) FY1E	Yield (%) FY1E
A+ H shares Home Appliances - White goods, Kitchen and Small Appliances														
Haier SH - H	6690 HK	BUY	26.91	21.69*	24%#	n/a	Dec-19	17.7#	16.1#	2.8#	2.4#	14.1	4.5#	2.2#
Gree Electronics	000651 CH	NR	n/a	60.11	n/a	428,427	Dec-19	18.5	14.3	3.0	2.7	15.1	2.9	2.9
Haier SH - A	600690 CH	NR	n/a	26.42	n/a	200,265	Dec-19	21.9	18.3	3.3	2.9	14.1	2.0	1.4
Midea Group	000333 CH	BUY	95.24	89.75	6%	746,663	Dec-19	24.8	21.2	5.4	4.7	23.6	2.2	1.9
Hisense JA	921 HK	NR	n/a	10.60	n/a	19,627	Dec-19	8.7	7.1	1.2	1.1	16.6	5.8	3.0
Hisense HA	000921 CH	NR	n/a	13.79	n/a	19,627	Dec-19	13.4	11.0	1.9	1.7	16.6	3.3	2.5
Whirlpool China	600983 CH	NR	n/a	6.74	n/a	6,120	Dec-19	n/a	n/a	n/a	n/a	(9.7)	n/a	n/a
Zhejiang Aishida	002403 CH	NR	n/a	7.81	n/a	3,242	Dec-19	16.4	15.9	1.2	1.1	7.7	n/a	2.4
Bear Electric	002959 CH	NR	n/a	119.25	n/a	22,041	Dec-19	39.2	31.2	8.5	7.0	25.2	1.1	1.2
Ecovacs Robotics	603486 CH	NR	n/a	73.76	n/a	49,338	Dec-19	101.3	63.5	14.5	12.2	10.4	1.1	0.2
JS Global Lifestyle	1691 HK	BUY	19.57	14.60	34%	50,941	Dec-19	23.2	18.3	4.7	3.9	n/a	0.4	0.7
Joyoung Co	002242 CH	NR	n/a	35.92	n/a	32,649	Dec-19	30.2	25.5	6.9	6.3	22.6	1.8	2.3
Hangzhou Robam	002508 CH	NR	n/a	41.80	n/a	47,000	Dec-19	23.1	20.3	4.9	4.3	23.4	1.8	1.9
Zhejiang Supor	002032 CH	NR	n/a	72.31	n/a	70,344	Dec-19	32.5	27.6	7.8	6.8	27.1	3.3	1.6
Vatti Corporation	002035 CH	NR	n/a	9.21	n/a	9,485	Dec-19	13.4	11.0	2.4	2.1	17.5	4.7	2.5
Xinbao Electrica	002705 CH	NR	n/a	43.48	n/a	41,288	Dec-19	32.8	26.6	6.6	5.6	23.9	0.9	1.3
							Avg.	**27.8**	**21.9**	**5.0**	**4.3**	**16.6**	**2.6**	**1.9**
							Med.	**23.1**	**18.3**	**4.7**	**3.9**	**16.6**	**2.1**	**1.9**

							Med.	23.1	18.3	4.7	3.9	16.6	2.1	1.9
International Home Appliances - White goods, Kitchen and Small Appliances														
Whirlpool Corp	WHR US	NR	n/a	187	n/a	90,495	Dec-19	10.4	9.9	3.2	2.7	27.3	3.0	2.6
Ingersoll-Rand Plc	IR US	NR	n/a	46	n/a	147,847	Dec-19	32.5	25.9	2.1	2.0	(3.0)	0.9	0.2
Smith (A.O.) Corp	AOS US	NR	n/a	56	n/a	69,877	Dec-19	28.3	23.6	5.1	4.9	18.6	6.6	1.8
Helen Of Troy	HELE US	NR	n/a	221	n/a	43,459	Feb-20	20.0	19.2	n/a	n/a	17.8	0.8	n/a
Cree Inc	CREE US	NR	n/a	99	n/a	84,988	Jun-20	n/a	n/a	5.2	5.2	(17.2)	n/a	0.0
Irobot Corp	IRBT US	NR	n/a	83	n/a	18,095	Dec-19	23.5	38.7	3.0	2.9	21.9	5.1	0.0
Electrolux Ab	ELUXB SS	NR	n/a	192	n/a	55,502	Dec-19	15.7	13.3	2.4	2.2	25.6	0.5	4.1
Seb Sa	SK FP	NR	n/a	147	n/a	70,061	Dec-19	25.7	18.0	2.8	2.5	12.9	2.8	1.0
Koninklijke Philips	PHIA NA	NR	n/a	44	n/a	377,833	Dec-19	22.4	20.7	3.0	2.8	8.8	0.8	1.9
Daikin Industries	6367 JP	NR	n/a	21970	n/a	482,935	Mar-20	42.8	31.5	4.2	3.8	9.2	3.1	0.7
Panasonic Corp	6752 JP	NR	n/a	1170	n/a	215,281	Mar-20	25.2	15.1	1.3	1.2	8.6	(82.8)	2.1
Sony Corp	6758 JP	NR	n/a	10045	n/a	949,964	Mar-20	16.5	19.8	2.6	2.3	20.9	1.6	0.5
Hitachi	6501 JP	NR	n/a	4044	n/a	293,533	Mar-20	10.4	9.4	1.2	1.1	4.8	0.1	2.4
Sharp Corp	6753 JP	NR	n/a	1500	n/a	59,891	Mar-20	18.3	15.9	2.8	2.3	5.8	0.4	1.2
Fujitsu General	6755 JP	NR	n/a	2798	n/a	22,930	Mar-20	23.7	20.5	2.5	2.3	7.4	0.5	1.1
Lg Electronics	066570 KS	NR	n/a	92200	n/a	105,739	Dec-19	8.2	7.8	1.0	0.9	4.9	0.0	0.8
Samsung Elect.	005930 KS	NR	n/a	72300	n/a	3,024,756	Dec-19	17.6	13.4	1.8	1.6	8.4	0.6	2.2
Woongjin Coway	021240 KS	NR	n/a	71000	n/a	36,720	Dec-19	12.1	11.6	3.6	3.0	27.9	0.8	1.7
							Avg.	**20.8**	**18.5**	**2.8**	**2.6**	**11.7**	**(3.2)**	**1.4**
							Med.	**20.0**	**18.0**	**2.8**	**2.3**	**9.0**	**0.8**	**1.2**

Source: Bloomberg, CMBIS estimates

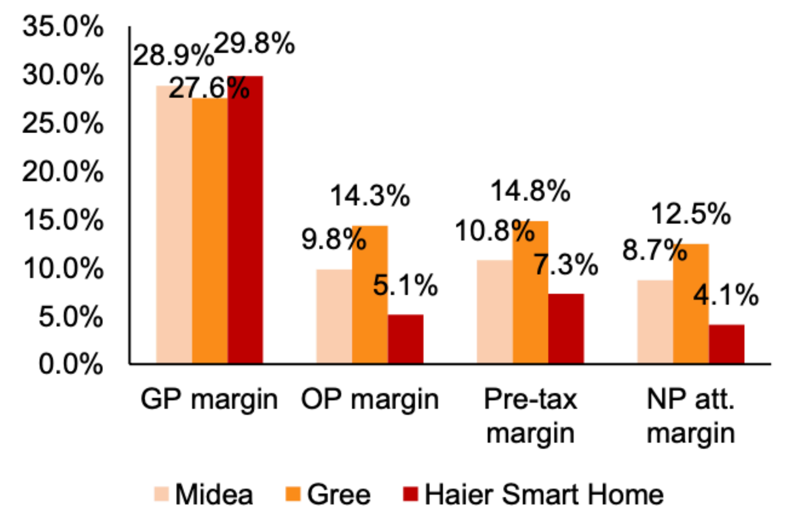
And as mentioned in the introduction, Haier is one of the better players globally, with a long track record of gaining share, and a low-hanging fruit opportunity to improve margins to comp levels as it proceeds with its internal restructuring. Thus, the discounted multiple you are paying through the German line is on top of earnings that already are much lower than similar comps, inside and outside of China:

Figure 4: There exists ample room for HSH' oversea margin to improve



Source: Company data, CMBIS estimates

Figure 6: HSH's margins vs Midea and Gree, FY19



Source: CMBIS estimates

The point being, at the very least you are likely to see some fundamental capital flow into the German line (instead of the new HK line), seeking the cheapest possible exposure, if this massive discount persists for long.

Setting up the trade and concluding thoughts

Normally I would set this up as a pure arb (that is, buying the German line and shorting the HK line) – and indeed borrow is readily available so arbs can do this if they wish. But given the degree of absolute discount today, as well as the fundamental cheapness of the German shares, I'm much more comfortable carrying this outright, for now, at least until the spread tightens somewhat to the 30% range. To me this means the German line is an outright long from here until ~2 EUR (assuming the HK stock remains basically where it is). I still can barely believe the German line is available at current prices, and have made this a very large/core position for me – but if I am missing something obvious, please let me know 🙂 Otherwise, I would expect the discount to rapidly narrow in the coming weeks and months, as the HK line becomes more 'seasoned'; as Asia-based investors become more familiar with the new HK-listed entity, and, by extension, its total cap structure (and learns the D-shares even exist); and as more arbs – currently taking Christmas/New Years breaks – come back to their desks and realize this opportunity is sitting in front of them. Suffice to say, I am really excited about this opportunity.

Disclosure: long 690D

Uncategorized

6690.HK , 690D.DE

← Positioning updates, and review of 2020 long book performance

Update on recent arb idea; more positioning updates across the book →

60 thoughts on "Special situations corner (4): the juiciest (potential) arb I have ever seen, 83-160% upside as arb closes"

Alex

DECEMBER 29, 2020 AT 8:39 AM

Notif

Like

REPLY EDIT

Richard Eidestedt

DECEMBER 29, 2020 AT 8:47 AM

Great write-up and interesting move in stock now in the morning (european morning at least 🙂). I just signed up to the service but do you disclose your portfolio somewhere on the website? Would be interesting to more about how you vieew portfolio construction. For example what is a large/core position for

you in terms of percentages?
Thanks in advance

Like

REPLY EDIT

puppyeh

DECEMBER 29, 2020 AT 10:17 AM

hi Richard – many thanks for your interest and signing up. you can see my current active ideas on the Live Ideas tab on the site. I don't give any advice on portfolio construction, this is an ideas/research website, sizing is up to you. i do try to give an insight into my conviction level, etc, on a positional basis, but do not disclose my percent weights, in general. As a rule, though, when i say a position is 'core' I mean a top 5 position, and at least a double digit % of my book. hope that helps.

Like

REPLY EDIT

Richard Eidestedt

DECEMBER 30, 2020 AT 8:52 AM

Thanks for your respons Jeremy! Fair enough and makes sense.

Like

EDIT

D B

DECEMBER 29, 2020 AT 8:50 AM

Now they can't even bother to take time to actually write out "Notifications".

Loading...

REPLY EDIT

jehu molina

DECEMBER 29, 2020 AT 9:05 AM

Should we set limit orders at the closing price of the previous day +-2%, we would all benefit from that..
I will wait for fomo to subside.. hopefully.

Loading...

REPLY EDIT

jehu molina

DECEMBER 29, 2020 AT 9:05 AM

ups.. for notifications

Loading...

REPLY EDIT

dfauchier@gmail.com

DECEMBER 29, 2020 AT 9:05 AM

Super interesting thanks!

Loading...

REPLY EDIT

Chris

DECEMBER 29, 2020 AT 9:12 AM

Damn, I was hoping to load up more on this one today! Maybe in your future catalysts sections you should mention 'the Jeremy Raper pop'

Loading...

REPLY EDIT

puppyeh

DECEMBER 29, 2020 AT 10:15 AM

thanks Chris! the only think i can say is, if you did not know the price had come from 1.1, and you were presented with it today, with all the same facts, at 1.6, and saw the implied discount was 45% (not 60%), you would still (I believe) find it beyond compelling. it's why i haven't sold a single share (and won't until the discount narrows to at least 25%, for starters)…

Loading...

REPLY EDIT

Chris

DECEMBER 29, 2020 AT 12:15 PM

Thanks Jeremy, I'm definitely not complaining about a ~60% increase! I had almost a full position anyway so it's alright. Agree with your points, I still think it is attractive at current prices, but it's always a mental struggle to avoid anchoring on past prices. This year I've been much better at averaging up when appropriate and that has paid off in spades.

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puppyeh

DECEMBER 29, 2020 AT 10:42 PM

this year has been tough in that respect. one thing i like about this one (as opposed to others) is that it is technically-based, not really that fundamental. any arb looking at this spread with fresh eyes – irrespective of whether they owned at 1.1 or 1.2 or whatever – will, or should, recognize that 42% discount is still by far the widest in the world (irrespective of fungibility optionality), which seems far too wide given everything we know. if the spread tightens to 25%, then you need to think much harder about it. but until then i still think this will attract a lot of fresh capital.

Loading...

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Pelly

DECEMBER 29, 2020 AT 9:25 AM

Nice original idea, thank you. Where do you find them..?:)
Now that you are a holder, are you going to request the conversion of your shares immediately?
Can you let us know which feedback you receive from your broker or the company?

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REPLY EDIT

puppyeh

DECEMBER 29, 2020 AT 10:14 AM

yes, i am already talking to IB about how to execute the conversion. i expect it will take some time given holidays + novel situation (D share conversion), but of course i will give feedback as and when i receive it. realistically, it may take a much larger institution (hedge fund, etc) to drive action here (given larger ticket size, etc), but given the facts on the ground i think that is a matter of time, as i discussed in the writeup.

Loading...

REPLY EDIT

jehu molina

DECEMBER 29, 2020 AT 10:08 AM

I just leave this here. Between Dec 21 and Dec 28, 33.05M shares changed hands between 1.01 and 1.11 €/share. We cannot say it was an illiquid stock. Today at 11pm CET, 8.63M shares have changed hands from 1.08 to 1.61 €/share. I will have to pass this one unless it pulls back. GLTA.

Loading...

REPLY EDIT

puppyeh

DECEMBER 29, 2020 AT 10:19 AM

hi Jehu – i was also shocked so much stock was available in recent days below 1.1. Frankly I think some brokers from the IPO just were stuck with inventory and wouldn't sell until it got above cost (1.05), and then they just dumped (irrespective of the new facts on the ground). i had thought more volume would be available today as well… but it is what it is. the discount, even now, is still 45%, and it should be 25% or so I think even without fungibility (which I think is still probably likely). so – to me, its still highly compelling, and would be independent of where it has come from in the last few days. of course i understand its tough to get involved after a move like that…

Loading...

REPLY EDIT

jehu molina

DECEMBER 29, 2020 AT 10:25 AM

I agree and I am thankful for the idea. I just think that as a group we could manage better to buy all of us within +-10% with a bit of discipline.. I will try to get in at around 1.40. At current price I find it hard honestly. Have a nice day.

Loading...

REPLY EDIT

cendter@gmail.com

DECEMBER 29, 2020 AT 10:56 AM

Well, I'm not sure how compelling Jeremy – to your mooted upside point yes looks ok – vs the original margin of safety, no. This is the second one recently that just runs out of the gate. If we assume today is based on your write up then (a) these are too illiquid, (b) there are too many subscribers, (c) combination.

If indeed it is based on your write up then I also would not expect it to come back materially as everyone is speaking to their brokers now to have it converted and will hold the shares.

Anyway, nice for you to have a 50% gain on a 'core' position in a few days … not so nice for us sitting here trying to be disciplined. Conclusion is to put an order in much higher and not try to be disciplined on those … tragedy of the commons.

Loading...

REPLY EDIT

puppyeh

JANUARY 2, 2021 AT 5:51 AM

Christian – happy new year. Rest assured I am very cognizant of the frustration in situations like this, and am currently thinking of many different options to protect the value of the service for subscribers. Many of the issues you suggested will be addressed. Stay tuned, will update further in the coming weeks.

With regard this particular situation, I can only say it was not how I anticipated given – as I stated a number of times – the stock was extremely liquid in the days before I published (trading $10-15mm/day). Meaning, this could have happened with any similarly liquid stock, in the same circumstances, given the latent value opportunity.

In any case – I will email the sub group in the coming weeks with further thoughts/changes to the product on this topic.

Loading...

REPLY EDIT

Thomas Braziel

DECEMBER 29, 2020 AT 12:18 PM

I'm not going to say everything than WELL DONE! Great find

Loading...

REPLY EDIT

dfauchier@gmail.com

DECEMBER 29, 2020 AT 12:29 PM

That's the only thing you can say when someone works their butt off and finds a gem like this over the hols 🙂 Over and out.

Loading...

REPLY EDIT

puppyeh

DECEMBER 29, 2020 AT 10:41 PM

thanks David – i really appreciate the support!

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EDIT

puppyeh

DECEMBER 29, 2020 AT 10:41 PM

thank you Tom!

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REPLY EDIT

ResPublica

DECEMBER 29, 2020 AT 12:43 PM

notifications

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REPLY EDIT

Douglas Wharton

DECEMBER 29, 2020 AT 12:51 PM

there is no perfect system, but I put in a limit order before market open at about 5% above previous close and got filled (luck?). either way, Jeremy is doing all the hard work (great find!) and I feel there is tremendous value from his service given the cost. Just my 2 cents. Thanks for the Christmas present!

Loading...

REPLY EDIT

tsandlow@gmail.com

DECEMBER 29, 2020 AT 1:18 PM

Douglas,

Congrats! I put a limit order in at at 3% above last night's close and got bupkis. I put the order in at around 6:00 AM Frankfurt time (I don't know if that matters). With hindsight, I realize I was being ridiculously greedy and really ignored the "Raper Affect".

Loading...

REPLY EDIT

justforfunds

DECEMBER 29, 2020 AT 1:03 PM

You've been turning over a lot of rocks -Another great find!

Are the H shares trading where you would expect, relative to the A shares?

Loading...

REPLY EDIT

puppyeh

DECEMBER 29, 2020 AT 10:40 PM

thank you very much. the A share/H share discount is about 25-30%, from memory. frankly I didn't look closely because H share (vs A share) discounts are extremely common given the captive domestic $ in China which can't exit and thus have to bid up local stocks. frankly i don't think that is all that relevant to this situation – although, at the margin, a higher A share may stimulate a little $$ to flow south through the stock connect to HK, over time.

The real driver here is offshore money looking at HK stocks, being willing/able/wanting to own the exact same economic exposure at a huge discount (at the cost of lower liquidity). you only need ~0.5% of

Haier shareholders to think this way to completely close the discount, in my view.

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REPLY EDIT

byron.gilliam@gmail.com

DECEMBER 29, 2020 AT 2:24 PM

ISINs are different so i'm guessing not fungible

Loading...

REPLY EDIT

byron.gilliam@gmail.com

DECEMBER 29, 2020 AT 2:31 PM

disregard … on rereading i see you've accounted for that

Loading...

REPLY EDIT

mikaele1983

DECEMBER 29, 2020 AT 5:31 PM

Thank you for the latest finds and deep research!

Loading...

REPLY EDIT

puppyeh

DECEMBER 29, 2020 AT 10:36 PM

my pleasure!

Loading...

REPLY EDIT

Johan

DECEMBER 30, 2020 AT 8:08 AM

Notifications

Great find, managed to get a small amount at 1.14

Loading...

REPLY EDIT

Philip Gusterson

DECEMBER 30, 2020 AT 9:49 PM

Some of you are frustrated that the price ran up on you. For myself, I am frustrated because Interactive Brokers still hasn't approved my pre-Xmas application, and I have to access to this market. 2021 will bring more of these I'm sure!

Loading...

REPLY EDIT

Andrew Davis

DECEMBER 31, 2020 AT 3:39 AM

Hi Jeremy, great find! I missed the initial run-up (time zones / was asleep), but it's still very compelling at current levels. I'm wondering – how are you going with the process to convert your D Shares to H Shares? I contacted IB today and discussed it with a CSR. They didn't think there will be any issue and told me the process should take 5-7 business days. I was surprised how easy this seems and am wondering if you've blazed a trail? Or if I was speaking with someone overly optimistic / naive?

Loading...

REPLY EDIT

puppyeh

DECEMBER 31, 2020 AT 4:57 AM

hi Andrew – thanks for investigating. i am still trying to get hold of my dedicated account guy at IB. i have a feeling your contact wrong/too optimistic. i think he/she may be referring to how long the process normally takes (for an ADR, etc). here, the paperwork part is not hard (proving ownership/sending a letter to the exchange), but as i discussed, you still need exchange and/or company approval for the conversion (per the prospectus). and you need the registrar to update the registries too.

basically, i can't see how the latter part of the equation doesn't take at least weeks (sending the letter to the HKEX and then getting a favorable reply, for example; or an unfavorable initial reply followed up follow-up discussion/legal proceedings, etc). i am personally budgeting for the conversion to take 2-3 months (still, not that long), all in, assuming it can be done.

still – i agree, despite the initial move the spread is ridiculous. The implied EUR share price ref 28.1 is 2.95 EUR, meaning the spread even today is 46%….i would think this tightens, in any case, to sub 30%, IRRESPECTIVE of whether its proven fungible (in which case it would quickly collapse close to zero). this is my largest position, as a result.

Loading...

REPLY EDIT

Sidhanth Grover

JANUARY 3, 2021 AT 5:59 PM

Hi Jeremy, very grateful subscriber here – thanks for all you do.

Somewhat offtopic question re investing process – how do you monitor for news alerts on positions you hold or are tracking/what do you use? Google news alerts seems to be terrible.

Also, same question as to what you use for price alerts – e.g. if you're interested in being notified if AER falls below $X, but not necessarily locking up capital with a limit order.

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REPLY EDIT

jehu molina

JANUARY 4, 2021 AT 10:28 AM

Sidhanth, my 5 cents if I may. I have several options depending on the market. I would be happy if I could have just one, a good one covering everything.

For stock price alerts, you can create them in the Alert section of Interactive Brokers. If you are using this brokerage account. Other brokerage accounts should have them too.
For news and ER, I use Seeking Alpha for US companies and ADR. However, there is a delay in ER with Seeking Alpha; Interactive Brokers' News section reports the news faster, but there is no alert.
For Japanese stocks, kaijinet is the most useful I've found. But it only reports earnings. You can create alerts.
For Singapore stocks, news and ER in sginvestors.io but unfortunately no option for alerts.

Also the Exchange websites give you the option to create alerts. For example, https://www.londonstockexchange.com/ you need to create an account and set alerts for the stocks you want to follow. Same for Australia, etc.
Furthermore, you can write Investor Relations and get subscribed to news.

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REPLY EDIT

Antoine Cazalis de Fondouce

JANUARY 10, 2021 AT 10:37 AM

Hi Sidhanth

I use https://www.investing.com/ (and app of the same name) which is extremely useful for tracking tickers and reading up on company financials all in one place. You can also set up price alerts and add tickers to your watchlist–I can't recommend it enough!

Loading...

REPLY EDIT

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leo.jiwon.kang@gmail.com

JANUARY 4, 2021 AT 4:15 AM

Very cool idea. I am still catching up on the diligence, so my bad if this is a dumb question. There was a press release out on 12/31 (link below) and if my read is correct, the Company has an existing buyback program in place specifically for the D-shares, which was placed on hold, but they are now resuming the buybacks. Isn't this a great outcome, and a strong tailwind for the near term D-share price, in addition to your thesis? What is your assessment of the PR and the materiality of this? Thanks

https://www.bloomberg.com/press-releases/2020-12-31/dgap-cms-haier-smart-home-co-ltd-release-according-to-article-50-of-the-wphg-the-german-securities-trading-act-with-the

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REPLY EDIT

Richard Eidestedt

JANUARY 4, 2021 AT 10:09 AM

Agree with your take Jiwon. Should be postive for the d-share and might be a way for the company to de-list the D shares going forward. My take is that the HK shares are trading at a 13-15% discount to the Chinese shares. The HK shares had a large move up today which might indicate that investors are starting to pay attention to that spread and hopefully will close the D-share spread as well going forward.

Loading...

REPLY EDIT

leo.jiwon.kang@gmail.com

JANUARY 4, 2021 AT 10:39 PM

Thanks both for the responses. Always good to talk these things out with others in case I am missing something. The strong price action today seems to be confirmatory as well.

Loading...

EDIT

D B

JANUARY 4, 2021 AT 10:22 AM

May not be fungible. Different regulator for HK shares vs D shares. Apparently confirmed by company.

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REPLY EDIT

puppyeh

JANUARY 4, 2021 AT 10:52 AM

i will try to comment in longer form, but the quick takeaway is 1) the parent co buying up to 1.1% of the pro-forma company over the next 6mos is a huge new positive and enough to eliminate the entire discount in the D shares on its own (if they execute, of course), given the implied shares being bought is greater than the free float today; and 2) Chinese IR is saying they won't allow conversion. This is not the same thing as saying they will never allow conversion – and given that the parent co has announced they want to buy most of the D shares free float, why would you immediately remove the discount for your parent by announcing this now?

Suffice to say I still think absent any possibility of fungibility, the discount on the D-share should be much, much smaller (or near zero) given the parent's apparent buying intentions.

Another way to think about it may be, $200mm of the HK shares traded today. If <5% of that volume makes its way to the D-shares, over time (accepting the lower liquidity in return for the discount), that's enough volume to move the discount to sub RIO/BHP levels, in my view.

The discount, today, is still 43%...

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REPLY EDIT

Pingback: Update on recent arb idea; more positioning updates across the book | EDIT

puppyeh

JANUARY 15, 2021 AT 11:33 PM

as an UPDATE to all involved here. The spread is down to 41%, which is still far too wide, and this is still my largest position. that said, given the rally in the German line in absolute terms, I have hedged up my position by shorting out the HK line – in other words I am carrying this henceforth as just a spread trade. i still expect the spread to tighten to the 10-15% range over time. but just letting everyone know I shorted out the HK line on Friday.

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REPLY EDIT

jehu molina

JANUARY 16, 2021 AT 12:56 PM

Shorting 0.6 shares for every share of 690D should be fine then?

Loading...

REPLY EDIT

puppyeh

JANUARY 17, 2021 AT 11:37 PM

that's right

Loading...

EDIT

gcneetyahoo-co-uk

JANUARY 20, 2021 AT 7:44 PM

Hi Jeremy, great call on 690D. I just wanted to know what broker do you use?

At IB, they charge 100% margin on long 690D and 100% margin on short 6690. That is a lot of margin across the 2 legs, which makes it a bit prohibitive to put the trade on in real size. Thanks in advance!

Loading...

REPLY EDIT

puppyeh

JANUARY 21, 2021 AT 12:11 AM

speak to IB – i got them to remove margining on one of the legs. this may depend on your relationship with them, however, i am not sure. but given the security is the same economic exposure (and this is verifiable in the docs, which i sent my rep, the HK prospectus), it should be doable

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Paul Lee

JANUARY 19, 2021 AT 5:12 AM

notifications

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REPLY EDIT

Dave

JANUARY 19, 2021 AT 6:13 AM

notif

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REPLY EDIT

Andrew Davis

FEBRUARY 4, 2021 AT 8:43 AM

Hi Jeremy,

I'm wondering if you've had a chance to digest the recent announcement re parent company purchases – https://smart-home.haier.com/en/dggg/P020210201329801380582.pdf?appdesc=L2021002_Announcement%20on%20Implementation%20Results%20of%20Purchase%20Plan%20of%20D-Shares%20by%20Haier%20International%20Co.%20Ltd.%20("HIC")

My $0.02 worth:
– if I read correctly, the parent company has ceased further purchases for D-shares
– a negative is that this removes demand / buying pressure for the D Shares
– this may be a stretch, but a potential positive is that the company may now be more amenable to allowing conversions from D to H-shares?

Loading...

REPLY EDIT

puppyeh

FEBRUARY 5, 2021 AT 2:06 AM

yes i think that analysis is the right way to think about it. a bit surprising (and disappointing) they decided to stop buying for their own account – on the other hand, this definitely opens the door to pushing for fungibility sooner than later. it is something i am pushing the company on currently.

in the meantime, my original thesis regarding capital flowing from HK to germany, and only requiring a tiny amount of that to close the discount, remains. obviously it hasn't happened yet and i still believe there is a price-insensitive seller in the German line (legacy owners from the IPO). once they are done selling (probably a week or so given the volumes that have gone through), i expect the discount to close further.

Loading...

REPLY EDIT

Vincent

FEBRUARY 4, 2021 AT 8:58 AM

Hi Jeremy, I just noticed that there is also an H-share line trading on the Stuttgart stock exchange (690E in IB as ticker): https://www.boerse-stuttgart.de/en/products/equities/stuttgart/a2qht7-haier-smart-home-coh-yc1

This one has basically no spread with the Hong Kong shares.

Did you know of this and do you think it should serve as a reference to where the D-line should trade at as well (meaning basically no spread to Hong Kong shares)?

Loading...

REPLY EDIT

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puppyeh

FEBRUARY 5, 2021 AT 2:04 AM

no idea what this is. you shouldn't look at it, i don't think it is meaningful and is definitely not the right security. in any case it barely trades

Loading...

REPLY EDIT

Terry

MARCH 4, 2021 AT 1:58 AM

FYI the price of Shanghai steel rebar is going parabolic... up 1/3 since november. Maybe you won't care if you're hedged but this could be a risk for 6690. (I'm not involved here)

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REPLY EDIT

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movys

MARCH 10, 2021 AT 4:20 PM

Hi Jeremy,

Any updates thoughts on this one? Is there still a legacy owner exiting the German-listed securities? Any sense that mgmt is actually repurchasing shares here?

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REPLY EDIT

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puppyeh

MARCH 11, 2021 AT 12:39 AM

this has definitely been frustrating. the haier parent company decided to stop buying the D-shares abruptly (not sure why, exactly); meanwhile i think its quite clear the legacy IPO participants are still irrationally dumping their shares (Renhi Precision has disclosed this as they're publicly listed in Taiwan). the spread now is in the low 40s% and I am not giving up on it yet. i still think, over time, more fundamental money will flow into the German line, to close the spread to a much tighter normalized level.

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REPLY EDIT

puppyeh

JUNE 9, 2021 AT 7:39 AM

a couple of important updates here:

https://www.boersen-zeitung.de/meinung-analyse/ceinex-droht-die-abwicklung-c6d91750-c55e-11eb-8a84-11b6edcee059?read=true

per the above, it seems Ceinex – the exchange JV b/w Deutsche Borse and two Chinese exchanges – is under some financial pressure and may be shut down. this would not be surprising given the lack of success in promoting the C-Connect since 2015 launch (only one D share listing!). If this were to happen, I imagine Haier would be delisted, and either bought back by the company or – more likely – be made fungible with the H shares. Obviously, this would catalyze a huge amount of balloon upside in the shares.

secondly, it looks like the company (Haier) inserted the necessary paperwork to buy back the D-shares, looking at their latest HK filings (see p132 onwards):

https://www1.hkexnews.hk/listedco/listconews/sehk/2021/0603/2021060300682.pdf

The co has been buying back both H shares and A shares, in small size (mostly to fund onshore share option grants, I believe), and there is no guarantee they buyback any D shares. still, it wouldn't take a lot to be bought back to close the spread significantly here…

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REPLY EDIT

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