China Auto Logistics Inc.
2016 Third Quarter Investor Earnings Call
Tuesday, November 15, 2016 at 8:00 am EST

Operator: Good day, ladies and gentlemen and welcome to the China Auto Logistics 2016 Third Quarter Investor Earnings Call. At this time all participants are in a listen-only mode. Following today's presentation instructions will be given for the question and answer session. If anyone needs assistance at any time during the conference, please press the star button followed by zero. As a reminder, this conference is being recorded.

Operator: I would now like to turn the conference over to Ken Donenfeld of DGI Investor Relations. Please go ahead, sir.

Ken Donenfeld: Good morning to all of you. Your interest in our Company is greatly appreciated.

On the conference call today, we have Mr. Jin Yan, COO of China Auto Logistics Inc., , and other executives and representatives of the Company. These include Mr. Yang Feng, Financial Controller, Mr. Lawrence Wan, a member of the financial team and Dr. Cheng Peng, Corporate Secretary. Mr. Tong, the Company's CEO, has asked me to begin the presentation. Lawrence then will walk you through the

numbers. Afterwards, we will have a Q & A period, so we can answer your questions.

I will first read the required disclaimer regarding forward-looking statements. This conference call may contain, in addition to historical information, forward-looking statements within the meaning of the federal securities laws regarding China Auto Logistics Inc.

Except for historical information contained in our comments, the statements we make are forward-looking statements that are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve known and unknown risks and uncertainties, which may cause our actual results in future periods to differ materially from forecasted results. These risks and uncertainties include, among other things, product demand, market competition, and risks inherent in our operations. These and other risks are described in our filings with the U.S. Securities and Exchange Commission.

OK - - I will proceed with Mr. Tong's comments.

Good morning to those of you joining us on this conference call, as well as those listening in on the internet. As usual, I'll begin with a few comments on our results in the quarter and Lawrence will summarize

the numbers, all of which are provided in full detail in the 10-Q we filed yesterday. We will then be happy to answer questions you may have, as well as questions that were emailed to us yesterday and this morning.

Clearly the results in the third quarter primarily reflect the results of our Auto Sales business which comprised about 99% of our net revenues in the period. As you know, earlier this year, in the second quarter, we announced our agreement to sell our Zhonghe subsidiary for $62.8 million. Consequently, in the third quarter this year we have eliminated results from businesses related to that sale, namely our operation of the Airport International Auto Mall and our used car joint venture, Car King Tianjin. What remained in addition to Auto Sales in the third quarter was our auto-related Financing Services Business.

The decision to sell Zhonghe was motivated by the negative impact on our financial position given the downward shift in China's economy. With the sale, we were able to greatly reduce our interest expense. We also eliminated the substantial remaining payables related to the acquisition. And, importantly, we returned to a positive working capital position from a working capital deficit.

This did not take us fully out of the woods, as Lawrence will describe, but it puts us in a position to maintain our

leadership in the imported luxury auto business. For a variety of reasons, this remains a highly competitive low margin operation, but if we can continue to tough it out, we think there continues to be growth potential in the business.

In particular, we see a potential positive impact from an upswing in China's economy, which has shown some improvement this year. Additionally, we believe we are positioned to benefit from the new industry scheme put in place by the government which I have described to you previously - - namely - - the "Parallel Imported Vehicles" scheme. In a nutshell, this places independent importers like our company on equal competitive footing with authorized dealers. Among other things, this makes things easier for our customers with respect to such things as insurance coverage and vehicle registrations.

This program is slated as of September 30th this year to take place in four experimental cities, including our home city of Tianjin. While too early to tell, we should begin to see in subsequent quarters, whether and to what extent this may help our business.

At the present time, as reflected in our third quarter results, the business is still highly competitive, and our primary weapon is pricing, which continues to impact

our margins. We also are seeing a competitive impact on our Financing Services business.

Another impact on our auto business this year has been the movement in our currency, the RMB. In 2015 and earlier this year we benefitted from a spurt in auto purchases by our dealer customers, who foresaw an increase in imported auto prices due to declines in the RMB versus the dollar. By the end of the 2016 second quarter and in the third quarter, the movement in the currency stabilized and, as a result, auto purchases by dealers were slowed relative to prior periods. Going forward, we see continued stabilization in both the currency as well as purchases.

We continue to recognize that despite the potential for improvement, margins in the imported auto business are likely to remain relatively small. As a consequence, working from our relatively stronger financial position, we are reviewing our strategy again with respect to higher margin businesses that would mesh with our experience and skill set. Over the near term, however, our focus will remain on doing whatever is required to stay competitive in our Auto Sales business and taking advantage of any appropriate opportunities to expand it.

OK - - let me move the mic to Lawrence for a review of the metrics and some more details on the quarter - -

after which management will look forward to your questions.

Lawrence?

LAWRENCE: Thank you. And thanks again to those of you joining us or listening in on this call.

Looking at our results in the third quarter, what stands out most is the year over year decline in sales - - actually about 36% - - from approximately $150.2 million in the quarter ended September 30, 2015, to approximately $96.3 million in the same period this year.

As Mr. Tong explained, the poor comparison with last year's third quarter is mainly due to the exceptional results in this period last year reflecting the jump in our customers' purchases due to their concerns with respect to the devaluation of the RMB versus the U.S. dollar. The sales decline actually began in the 2016 second quarter in anticipation of the slowing of the devaluation. In our 10-Q we provide more specific details on the timing and extent of the devaluation.

Of note, in the 2016 third quarter we saw a roughly $1,000 increase in average unit selling prices for our imported autos to $106,000 compared with a year earlier. However, we saw sales volume decline to 902

automobiles sold from 1,418 automobiles in the 2015 third quarter.

With respect to the bottom line, it also continued to be affected by severe price competition, including losses on the sales of some of our higher end vehicles. This contributed to a lowering of our already small gross margin to 0.14% in the 2016 third quarter.

Further, this contributed to the decline in our operating income from continuing operations in the quarter to a loss of just over $19 thousand, as compared with a net income of approximately $456 thousand in the third quarter of 2015.

The contribution from Financing Services to operating income from continuing operations also suffered in the 2016 third quarter as net revenues declined just over 33% to about $1.03 million. This was marked in particular by a decline of about 17.8% in fee income to about $489 thousand, with the remainder of the revenue obtained from interest income of about $540 thousand. The good news in this business was the increase in gross margins in the 2016 third quarter to about 47.5% --primarily due to lower interest expense. Even so, as we stated in our 10-Q, increased competition in this business has lowered our expectations for its future growth potential and, as a consequence, we are

allocating more of our working capital to growing our imported auto sales business.

Adding up these results, one additional factor in the determination of the net loss from continuing operations attributable to shareholders was "other expenses", which approximated $181 thousand in the 2016 third quarter, as compared with approximately $732 thousand in the same period a year earlier. While this comparison reflects the large decrease in interest expense following the Zhonghe sale, this was somewhat offset by an increase in G&A expenses, in part due to the relocation of our operating offices.

Putting this all together, the net loss from continuing operations attributable to shareholders in the 2016 third quarter was $200,000, or loss of $(0.05) per share. This compared with a loss from continuing operations attributable to shareholders of approximately $354,000, or loss of $(0.09) per share. Additionally, in the third quarter of 2015 there was a net income from discontinued operations of approximately $1,603,000 or $0.40 per share to reflect the operations of the disposed Airport Automall Automotive Services business unit as a consequence of the sale of Zhonghe - - of which none were recorded in the 2016 third quarter. This resulted in total net income attributable to shareholders in the 2015 third quarter of approximately $1,249,000, or $0.31 per share.

Reflecting the higher auto sales in the first half of 2016 - - for the reasons I described - - revenues through the first nine months of 2016 were down only slightly to approximately $327 million from approximately $331 million a year earlier. In this period we saw Auto Sales volume increase about 2%, but recorded decreases in average unit selling prices and gross margin, reflecting continuing competition.

Additionally, in our Financing Services business, while interest received and fee income declined over the first nine months of 2016 compared with the same period in 2015, gross margin increased to roughly 46%.

The consequences for the bottom line in the first nine months of 2016, nevertheless, was a net loss from continuing operations attributable to shareholders of approximately $865.4 thousand or a loss of $(0.21) per share. This actually was an improvement, however, over a loss of approximately $1.6 million, or a loss of $(0.40) per share in the year earlier period.

Total net income in first nine months of 2016 included net income from discontinued operations of approximately $4.8 million or $1.19 per share compared with a loss of approximately $2.04 million, or loss of $(0.51) per share a year earlier. Consequently, total net income attributable to shareholders through September

30, 2016 was approximately $3.9 million or $0.98 per share, compared with a loss of approximately $3.7 million or a loss of $(0.91) per share in the same period in 2015.

Moving to the Company's balance sheet, as you know, a key positive development following the sale of Zhonghe was the turnaround in working capital. Specifically, primarily because of the roughly $21.9 million in net cash the Company received, it had working capital as of September 30, 2016 of approximately $24.6 million, compared with a roughly $30.8 million working capital deficit as of December 31, 2015. Additionally, after the sale of Zhonghe, the Company received relief with respect to what had been an approximately $36.8 million payable related to the Zhonghe acquisition.

As of September 30, 2016, the Company also had a substantial reduction in short term borrowing balances, reduced outstanding aggregate lines of credit relating to Financing Services and no bank overdrafts.

Despite this improved financial picture, however, the Company reported negative operating cash flow and a smaller but still existing accumulated deficit of about $3.4 million, in addition to its third quarter operating loss. Also, through the first nine months of 2016, the Company had net cash used in operating activities of $51.4 million from continuing operations. These factors

combined - - even though the latter reflected optimism with respect to future sales to the extent it went toward deposits to suppliers relating to inventory purchases - - were key factors in determining the inclusion of a “going concern” paragraph in the Notes to the Company’s Condensed Consolidated Financial Statements.

Okay - - I will pause here to answer any questions you may have - - but first, let me turn the floor back to Ken for some final comments. Ken?

Ken: Thanks very much, Lawrence. There’s not much I will add here, except perhaps that I believe our Company has shown resiliency and determination in the face of some serious challenges - - largely stemming from the effects of a weaker economy in China. We will continue to work hard to maintain and expand our industry leadership. This will be with a view toward a slowly improving economic outlook and a continually expanding slice of Chinese society interested in and capable of purchasing luxury goods - - especially high end automobiles.
So - - let’s now move on to the Q&A period. Operator, - - can you get us started?

Operator – please? Thank you.

Operator:
Thank you. If you'd like to ask a question, please signal by pressing star, one on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star, one to ask a question. We'll pause for a moment to allow everyone an opportunity to signal.

Q & A

Moderator:

Operator, let me ask again if there are any other questions.

Operator:

None at the present time, sir.

Moderator:

Okay. Well in that case, I guess we will conclude our conference call for today. Our thanks again to all of you who've listened in and/or participated. Operator.

Operator:

This concludes today's conference. Thank you for your participation. You may now disconnect.