SMC (6273):
Puncturing the Myth

*Strong Sell*
*Target Price: JPY4,484 - JPY15,145 (51%-85% downside)*

**Abstract**
- We believe SMC's cash balances to be substantially less than the company claims.
- Exploiting intracompany trading between consolidated and unconsolidated subsidiaries, and undisclosed related party transactions among other questionable accounting techniques SMC's has not only masked the true status of its inventory and cash balances but also concealed evidence of deteriorating business fundamentals.
- We have uncovered evidence in several SMC subsidiaries of conflicts of interest, related party transactions and extremely questionable accounting practices, which we believe to be just the tip of the iceberg.
- We expect massive write-downs on SMC inventory as a result.
- We question SMC's margins in Japan, which we believe to be far lower than what the company reports.
- SMC's use of a small auditor, with a history of fraudulent clients, underscores our belief that SMC's audited financials cannot be relied upon.
- Additionally, SMC's chairman has pledged most (if not all) of his shares as collateral to Resona Bank.
- Strict centralized control and a problematic corporate culture has allowed this activity to go on unreported for years.

**Disclaimer:**
*Our research and reports express our opinions, which we have based upon generally available public information, field research, inferences and deductions through our due diligence and analytical process*.  

1 Please see last page for full disclaimer
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Disclaimer
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“Shareholder and Investor Understanding and Support

We will strive to promote fair and transparent business management, and disclose necessary corporate information timely and appropriately unless otherwise restricted by laws to obtain understanding and support from our shareholders and investors.”

SMC Group Principles of Corporate Activities\(^2\) Section 3

SMC Corporation (6273:JP), is a JPY2tn market cap company, which manufactures pneumatic control equipment for factory automation. We believe SMC Corp has ‘fake’ cash and dramatically overvalued inventory on its balance sheet as a result of inflated margins if not other undisclosed losses. These questionable accounts have been enabled by the severe lack of oversight from their tiny audit firm, Seiyo, who has been auditing SMC’s accounts since the industrial firm’s IPO in 1987. We note that SMC Chairman Takada and friends have pledged over 100 billion yen of their stock to Resona Bank for loans for unclear purposes. We rate the stock a strong sell with maximum downside of 85%, which would be equivalent to 4,484 yen.

We strongly encourage additional existing and former employees, suppliers, contractors or customers who have concerns about misconduct at the company to raise their concerns with either the authorities in their respective countries, the media or Well Investments Research in order to improve transparency and corporate governance. We are happy to assist you in that process. Our contact details are on our home page\(^3\).

**History of Fraudulent Clients at Auditor means SMC’s audit cannot be relied upon**

- SMC claims to have revenue of over JPY462bn, 72 subsidiaries across the globe and more than 18,000 employees. SMC expects shareholders to believe **Seiyo Audit Corporation** is able to conduct an effective audit on the company. Yet not only is Seiyo a tiny Tokyo firm which until July 2016 had just 16 certified public accountants, but some of its accountants also have a checkered history of auditing companies that have committed fraud.
- Seiyo appears to have a complete lack of independence from SMC; it operates out of the same small office building as SMC subsidiaries and the first four digits of Seiyo’s phone number – 6273 – even match SMC’s stock ticker!

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\(^2\) http://www.smcworld.com/docs/company/en/Corporate_Activities_E.pdf

\(^3\) http://www.wellinvestmentsresearch.com/en/home/
• SMC, in theory, could easily have hired a global Big Four auditor to audit all of its subsidiaries. Instead it has appointed very small local auditors in almost every jurisdiction we checked. This further raises the scope for abuse of its accounts.
• SMC subsidiaries change auditors every couple of years, which is in itself a red flag. When SMC installed “reputable auditors,” such as Baker Tilly at its UK subsidiary in 2012, the auditor found “material errors” in accounts that were completed by their predecessor, a small audit firm ECL. Yet somehow ECL was later reinstated as the auditor for SMC’s UK entity.
• Many subsidiaries’ accounts contain restatements and transfer-pricing errors, which further underscore doubts that Seiyo is in any position to audit reliably SMC’s accounts.

**Questionable large share pledge gives incentive to falsify accounts**

• SMC chairman Yoshiyuki Takada holds his SMC stake in a variety of vehicles, including TON Finance, a Dutch investment entity that owns 5.11% of SMC. According to Dutch regulatory filings, all of the shares held by TON have been pledged to Resona Bank, SMC’s main bank. This is equivalent to approx. JPY110bn in collateralized shares yet these loans strangely do not appear on TON Finance’s balance sheet.
• Pledging shares incentivizes management to fraudulently increase the stock price in order to avoid margin calls on the value of the loans they have taken.
• Moreover, we have found TON Finance’s Dutch filings contradict Japanese disclosure and raise further questions over the nature of these pledges.

**We believe cash position is a lie**

• At least JPY81.7bn of cash might not exist. Using 2014 as the base year with the most disclosure, we identified the cash balances of almost all SMC major subsidiaries and yet we could not account for JPY81.7bn in cash, almost 25% of SMC’s total cash.
• In 2014, interest income at SMC’s Chinese subsidiaries and the Japanese parent were higher than that claimed for the entire group. If the Chinese and Japanese accounts are accurate, then either the rest of SMC’s cash, ~ JPY190 billion, is being deposited at significantly negative rates or the cash simply does not exist.

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4 As the same kind of documents, see http://www.kabupro.jp/edp/20090128/S0002B8M.pdf
• We are suspicious of the JPY49.4bn cash held at SMC Manufacturing Singapore where the Company Secretary is married to a partner at the auditing firm RT LLP (until 2016) and the audit is completed within 10 to 13 days from the year end. The same audit firm generally takes two to three MONTHS from year end with the audits of its other clients.

• There is no way to ascertain the cash balance at SMC Japan, but with auditors like Seiyo there is a real possibility that this amount is inflated.

SMC is hiding inventory write-downs

• We think around JPY55bn of inventory write-downs should be expected. SMC retains an extraordinary high amount of inventory compared with peers. Analysts seem convinced by SMC’s explanation that it maintains the inventory to provide any machine part a client requests no matter how old the machine. However, interviews with former employees and a review of subsidiary accounts indicate that between 10-53% of inventory should be written down, which would amount to between JPY19bn and JPY91bn.

Too-good-to-be-true margins in Japan

• The primary driver of SMC’s profitability has been an incredible 40% rise in the Japanese business’ operating margin since 2013. Given sales prices have been decreasing roughly 2% a year - based on SMC’s own statements - it is perplexing for competitors and other observers how SMC has managed to achieve this.

Playing games with Payables?

• Further questions are raised by SMC’s payables of over USD550mn; the vast majority of which were to Resona Kessai, a factoring company owned by Resona, when SMC last disclosed its payables breakdown in Japanese back in 2013. We are skeptical any supplier would factor their receivables at a discount when SMC purports to pay them within 20 to 70 days.

Unconsolidated subsidiaries allow for potential abuses

• SMC consolidates just 46% of its subsidiaries by claiming the remainder are immaterial. This large swathe of non-consolidated subsidiaries could allow SMC to book sales to non-consolidated subsidiaries as revenue or use these entities to hide losses and/or debt. The scale of this non-consolidation is unique to SMC and at best highly aggressive.
Nepotism and centralized control can enable management to commit fraud

- SMC has a culture of nepotism and its 90-something chairman exhibits a dictatorial management style where other opinions are not welcome.
- Shareholders should be very worried that Yoshiki Takada, the chairman’s son and president of SMC Corp. of America, will take over from his father as our research in the Americas suggest the business there is on the cusp of a major structural decline.
- Based on interviews with former employees and competitors in the US, we understand Yoshiki Takada has employed and elevated friends and family to executive roles in the company. We understand that without subsidies from Japan, SMC USA would be unprofitable and that unqualified management has alienated the US sales force leading to an exodus of their best sales staff. Market participants expect SMC USA market share to suffer.

Undisclosed related party transactions

- There are a number of SMC entities in Europe which are not owned by SMC but by Sjoerd Nauta, a long-time business associate of the chairman. These entities work directly with SMC subsidiaries and co-own the European Central Warehouse, which creates further room for abuse. Under Japanese law, related party transactions must be disclosed.

We believe stock price should fall by 85% at maximum

- We believe once SMC appoints a reputable audit firm with global reach, there will be significant material restatements to its accounts and it is highly likely the TSE will designate SMC as a “security on alert” with the potential for delisting.
- Stock prices of Japanese companies where significant accounting problems have been uncovered have typically fallen precipitously in the wake of a scandal. We believe a similar fate awaits SMC and think 85% downside at maximum is appropriate.
Full Discussion

SEIYO

SMC has used the same external auditor since the group listed in 1987, a small local Tokyo firm called Seiyo Auditing Corporation (“Seiyo” and formerly known O.Yu). As demonstrated below, Seiyo does not have the adequate capacity or skill to give an opinion that SMC’s financial statements are presented fairly in all material aspects and most certainly appears to lack any independence from SMC.

Until February 2011, Seiyo’s predecessor was O.Yu Kyodo (桜友共同事務所), but virtually rebranded as Seiyo5 following an accounting fraud at a client. Moreover, this was not an isolated incident as Seiyo has had associations with other listed companies with accounting issues. Until its merger in July 2016, Seiyo had just 16 certified public accounts and just 13 listed clients.

Outside of SMC, Seiyo has no large listed clients of note with Seiyo’s next largest listed client being ASKA Pharmaceutical (4514:JP) with a market capitalization of just approx. JPY5bn (less than 3.0% of SMC’s!). Moreover, while SMC’s annual audit fee of JPY58mn is roughly twice that of Seiyo’s other listed audit clients, SMC’s revenue is on average 13x larger and market cap is ~140x larger with close to 9x more group entities than the other publicly traded clients.

Thus, the fee seems extremely low given SMC’s scale and complexity, which casts doubt on how much audit work Seiyo is actually performing. In fact, SMC disclosure clearly states Seiyo does NOT audit its major consolidated subsidiaries; this is troubling as a number of SMC’s major consolidated subsidiaries are audited by other small local auditors with some audited by firm’s who are clearly conflicted, as is the case with SMC Manufacturing Singapore.

What Seiyo does seem to have in abundance though is association with companies tarnished by accounting issues, especially those involving related party transactions; and suspect overseas transactions and cash balances.

FOI
FOI Corp. was a semiconductor production equipment company that listed on the start-up TSE Mothers market in November 2009. Within less than six months of its IPO it was suspended from trading after it was found to have grossly overstated sales. FOI claimed to have booked 11.9bn yen in revenue for the twelve-months ending March 2009, when in reality sales were just 200mn yen⁶.

It did this by overstating overseas income - FOI booked fictitious sales to overseas manufacturers then used loans from overseas banks at the end of each period to give the impression money had been collected. The auditors for FOI were... Seiyo, or O.Yu as it was then known. As the transactions were overseas, O.Yu/Seiyo did not, or could not, verify these payments.

Even assuming Seiyo was unaware of this overstatement in sales it would be hard for competent auditors to ignore the comedic make-up of FOI’s financials. For example, receivables were 81% of FOI’s balance sheet in the only 10-K (Yuho) FOI ever filed. This was equivalent to 2.3x annual sales based on the annual run rate for the 9-month period from April-December 2009⁷.

By definition current assets are those that can be converted to cash within a year, so that more than a year of sales were tied up in receivables was inherently dubious for any auditor to sign off on.

Following the FOI scandal the two signatory auditors at Seiyo/O.Yu - Tomotaka Hasumi (堤見 知孝)and Yoshiaki Nakagawa (中川 佳昭) - left the firm.

Unsurprisingly, O.Yu ended up having to rebrand itself as Seiyo and a number of clients left Seiyo in the wake of this scandal... but not SMC.

⁶ http://pressrelease-jp.com/blog2_2010_05_page3.html
TRII S
One could argue FOI was an isolated incident, however, evidence suggests the contrary.

Also in 2009, Takahiro Furukawa (古川孝宏) a statutory auditor\(^8\) for Triis Inc (4840:JP) was ousted from the company at the behest of company president Hitoshi Ikeda (池田均) after complaining to the board about a number of unrecognized losses on investment securities the company was hiding and it was engaging in questionable related party transactions\(^9\).

Ultimately, Furukawa went to court and successfully sued for wrongful dismissal. Triis was and remains a client of Seiyo/O.Yu to this day. The auditors signing off on Triis accounts at the time were Shunya Nakaichi (中市俊也) and Toshiaki Matsubuchi (松渕敏朗)\(^10\). Both auditors seem to remain with Seiyo today\(^11\).

Evidently, Seiyo is unable to audit these small entities, how can investors trust them to audit one of the largest corporations in Japan with 72 subsidiaries worldwide?

M&A – TURNING A NEW LEAF?
In July 2016, Seiyo merged with another auditing firm called Kudan (九段監査法人). Kudan - like Seiyo - has had clients embroiled in accounting scandals. In Kudan’s case the client was Riso Kyoiku (4714 JP).

Tutorial school operator Riso Kyoiku was discovered to have overstated net income by 5.6bn yen over the six-year period from 2008-2014\(^12\). This effectively meant ALL the net income over the period was bogus. 2008 was when Kudan became Riso’s auditor.

Kudan was the subject of an FSA investigation in 2014 and was heavily censured for a lack of adequate controls and poor internal leadership\(^13\). As with FOI, the three audit partners that were responsible/signed off on the audits for most of the period have since left the firm.

\(^8\) Statutory auditors or Kansayaku (監査役) are a Japanese board position somewhat analogous to a supervisory board member or non-executive director in western companies.
\(^10\) http://www.kabupro.jp/edp/20100326/S0005EHT.pdf
\(^11\) https://www.jicpa.or.jp/cpa_search/ms_detail.php?regid_100=3010188
\(^12\) http://www.riso-kyoikugroup.com/ir/pdf/2014/20140210.pdf
\(^13\) http://www.fsa.go.jp/news/26/sonota/20141029-1.html
THERE’S SOMETHING STRANGE IN THE ACCOUNTS. WHO YOU GONNA CALL?
As easily Seiyo’s largest listed audit client, SMC holds substantial influence and power over Seiyo to get its way. One other interesting point to note is Seiyo’s office phone number: 6273-3650\(^\text{14}\). The first four digits are identical to SMC’s ticker code: 6273:JP. We do not believe this is a coincidence - it is possible to choose your phone number in Japan, and it can be perceived as a sign of loyalty to one’s client. Indeed, O.Yu Kyodo had a different phone number before becoming Seiyo so the composition of SMC’s auditor’s new telephone number is uncanny.

お問い合わせ

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</tr>
<tr>
<td>E-Mail</td>
<td>お問い合わせの方はこちらから <a href="mailto:cpa@seiyo.or.jp">cpa@seiyo.or.jp</a></td>
</tr>
</tbody>
</table>

Source: Seiyo Website

The auditors who signed off on FOI and Riso Kyoiku’s books may no longer be at the firm but given the history of involvement in at least three companies with suspect accounts, investors should ask themselves:

Are you confident that Seiyo has either the capacity from a manpower and technical perspective to conduct a satisfactory audit of such a large company?

CO-LOCATION OF AN SMC SUBSIDIARY IN THE SAME BUILDING AS SEIYO...
Allegiance to the Takada family is a key criterion in promotion at SMC, and Seiyo’s unusual phone number raises potential questions over external auditor impartiality.

\(^\text{14}\) http://www.seiyo.or.jp/contact/
We also draw reader’s attention to the co-location of one of SMC’s subsidiaries - Toyo Warehouse and Transportation (東洋運輸倉庫株式会社) - in the same small office block as Seiyo.

Toyo is a CONSOLIDATED subsidiary, yet despite being three floors above Seiyo it is NOT audited by Seiyo. According to its corporate registration, it appears Toyo has NO auditor at all. In fact, we have confirmed from a member of the JICPA (Japanese Institute of Certified Public Accountants) that Toyo is audited by an SMC employee and a former employee of Resona Bank.

Based on information submitted to Teikoku Databank, SMC rescued Toyo in August 1990 at the introduction of Resona Bank (then Kyowa Bank). SMC Chairman Takada then became president of Toyo in October 1990 and in March 1991 SMC’s then CFO Jiro Shirai (originally from Resona) became president until June 2003. He was then succeeded by Kojiro Okada another SMC and former Resona employee. Additionally, Toyo’s number two executive Mitsuo Miyakawa (宮川三生), also appears to be from Resona.

Interestingly, there are another two entities on the same floor as Toyo: IntelCasa (インテルカーサ) and NSM. IntelCasa appears to be a 100%-owned subsidiary of Toyo, according to Teikoku Databank.
Source: Toyo Warehouse Teikoku Databank filing

Japanese corporate registry filings show the representative officer for IntelCasa is also Toyo’s President - Kojiro Okada (岡田幸二郎). As eye-catching is one of IntelCasa’s business purposes in its corporate registrar: Accounting/Book-keeping agents (会計事務代行業).

Source: IntelCasa Corporate Registrar

We believe the presence of Toyo Warehouse in the same office-block as Seiyo should raise investors’ eyebrows over Seiyo’s purported independence. Investors may want to ask themselves or SMC management:
1. What is important enough about Toyo that every president of this consolidated subsidiary has either been a senior SMC board member and/or hailed from SMC’s main bank?
2. Why is a consolidated subsidiary of the parent company co-located in the same building as the Seiyo yet NOT audited by them?
3. Indeed, why does Toyo appear to have NO auditor at all?
4. What is the real purpose of IntelCasa? If it engages in book-keeping and accounting services, whose financial records is it preparing??

OVERSEAS AUDITOR QUALITY
Auditor quality at SMC’s overseas subsidiaries - similar to the Japanese parent and Seiyo - is “unorthodox”. Not only are accounting policies BETWEEN SMC’s local auditors inconsistent but they frequently retroactively restate numbers with little to no explanation15.

This clearly makes trusting subsidiary numbers simply as standalone entities problematic. These restated numbers are then aggregated to provide

15 See Appendix B for examples
consolidated accounts without any disclosure on subsidiary restatements we think is deeply concerning. Unsurprisingly, consolidated figures also mask serious inconsistencies and raise questions about the underlying economics of SMC’s business and it is highly unlikely that Seiyo ask any questions.

AUDITOR CHURN
In the past six years SMC has used and then dropped EVERY big four auditor at least once from one of its global subsidiaries, and then often switched to a much smaller local auditor.\(^\text{16}\)

For example:

- In the Philippines SMC’s subsidiary moved from KPMG to an auditor called Sison Corillo Parone & Co.
- In Malaysia SMC Pneumatics Malaysia and Shoketsu Engineering both dropped KPMG in favor of Kreston John & Gan.
- In FY03/2012 SMC Pneumatics Finland swapped out of PWC in favor of BTF Finland.
- In FY03/2010 SMC Manufacturing Singapore dropped Deloitte and moved its audit to local audit firm RT LLP (then called LTC), which like Seiyo has a track record in auditing companies with colorful financial histories.
- In the UK SMC’s subsidiary moved from Baker Tilly (a large local UK audit firm) to ECL Howard Watson Smith. Baker Tilly found “material errors” in accounts previously done by ECL. Yet somehow ECL was still reinstated as the auditor for the UK.

We would also note that the UK subsidiary does not appear to have filed an auditors resignation notice with regards to this auditor change in 2015 at Companies House in the UK (the UK regulatory body), which is in violation of the UK Companies Act of 2006. We think it would be best to file this paperwork soon... alternatively, a curious investor could access this paperwork via use of a Norwich Pharmacal court order in the UK.

Given the large global manufacturing platform SMC apparently runs surely it makes much more sense to have one large global auditor manage the audits of ALL of the group’s subsidiaries?

What is the rationale for a large multinational manufacturer continuously dropping a big four name in favor of smaller auditors like BTF or Sison Corillo Parone & Co. with no real global footprint? Why not use Ernst & Young instead, for example, everywhere? E&Y is a global auditor just like SMC is meant to be a global manufacturer. SMC has already used all of the big four somewhere in the world at least

\(^\text{16}\) See Appendix E for details
once, so it must be familiar with their operating abilities and their global capabilities.

Failing that why not use Baker Tilly or Grant Thornton?

Both operate internationally:
- Baker Tilly already audits **SOME but not all** of SMC’s European operations (and crucially it no longer audits SMC’s operations in the UK where the auditor has its strongest presence)
- Grant Thornton audits **SOME but not all** of SMC’s Asia ex-Japan operations.
- Why not have either of them audit ALL the subsidiaries?
  It would make audit communication much smoother and increase transparency among the group....

**Unless of course, this is not something SMC is interested in.**

In fact, we think the situation in Singapore underscores the degree to which financial information is kept separate at various subsidiaries and makes it very difficult for any executives outside of a small coterie close to the Takada family to gauge the actual financial health of the entire group.

In a city-state of 5.7mn people SMC operates two subsidiaries we know of, the pair are located less than a ten minute WALK from each other and yet they use different auditors!
- SMC Manufacturing (Singapore) Pte. Audited by RT LLP
- SMC Pneumatics (SEA) Pte. Audited by Philip Liew & Co. (a firm that appears to have around 13 employees based on a Linkedin search!)

Source: Google Maps

**SMC Manufacturing Singapore**
In 2015, SMC Manufacturing Singapore held approximately JPY49 billion of cash, 12% of SMC’s total cash balance. So it is of particular concern that this subsidiary raises questions over how much auditing is being done at some of SMC’s overseas entities and the undisclosed conflicts of interest that pepper the group. In fact, in this instance, the audit is completed at an unusually
fast pace, a partner at the audit firm is married to the subsidiary’s company secretary and the auditor has a history of auditing frauds.

The entity was even audited by Deloitte until FY03/2010, then the company changed to a local firm LTC, which subsequently changed its name to RT LLP.

Much like its Japanese counterpart Seiyo, RT has a remarkable capacity as a small auditor to attract a certain type of client more than usual. Investors who got defrauded investing in the spate of S-Chip (Singaporean-listed Chinese equities) frauds may be familiar with RT’s previous incarnation LTC.

LTC audited New Lakeside Holdings. In 2010 LTC had to admit that its audit opinion for FY2009 at the Chinese apple juice maker could “no longer be relied upon” due to fraudulent misrepresentations by the company.

RT had the honor of becoming the auditor of Singaporean-listed nylon and textile producer China Sky Chemical Fibre (CSCF:SP) in July 2015. After coming out of a four-year suspension China Sky Chemical Fibre’s shares were once again suspended in August 2016 after the board needed to assess “whether the company was able to operate as a going concern” after Chinese banks launched lawsuits against the company.

Meanwhile in September 2016 a major shareholder of Malaysian-listed Multi Sports Holdings called for an investigation into the China-based shoe manufacturer after the company failed to submit its accounts on time. The auditors are... RT.

SMC investors also may be heartened to know though that while RT needs more time to verify expenditure and bank balances at Multi Sports Holdings the auditor has without fail managed to file SMC Manufacturing’s accounts within 10 to 13 days of the end of the financial year EVERY year since it was appointed. For a complex audit on a manufacturing entity that conducts both cross-border and intra-company trade, significant transfer pricing issues and runs with significant inventory levels we think this is highly concerning.

______________________________
Our due diligence in Singapore has also revealed significant conflicts of interest at the subsidiary: the Corporate Secretary of SMC Manufacturing, Sonia Ramchand Jagitiani, appears to be married to Ramchand Nanikram Jagtiani\(^\text{18}\) who until July 2016 was a partner of RT LLP (SMC Manufacturing’s auditor).

Being husband and wife is a huge conflict of interest and raises serious questions over the validity of the accounts and the cash balances.

Of course, it would be a conflict of interest for a company secretary to be married to the partner of the accounting firm that audits it. SMC Manufacturing Singapore and SMC Corp. being ethical companies would probably want to disclose this to investors... Especially as SMC Manufacturing’s accounts say they have one of the largest cash balances within the entire SMC group and investors would not want a repeat of Multi Sports Holdings where RT needed time to verify the cash balances.

We have yet to find this disclosure.

It is worth noting that E&Y were recently fined over US$ 9 million for an inappropriate relationship between an auditor and an audit client\(^\text{19}\).

\(^{18}\) https://www.linkedin.com/in/rnjagtiani
PLEDGED SHARES - A TON OF THEM OUT THERE
Investors should also be aware of a widely underappreciated filing with regards to TON Finance’s stake in SMC. In January 2009 TON\(^{20}\) (a holding vehicle for SMC Chairman Takada) disclosed in September 2008 - the day after Lehman Brothers collapsed - it had pledged up to ALL of it 3,836,200 shares (5.11%) of its SMC as loan collateral with Resona Bank. (Note this disclosure is NOT posted on SMC’s IR webpage.) The purpose of the loans was not divulged and nor are they accounted for on TON Finance’s balance sheet.

Additionally, our findings demonstrate management cannot be trusted when it comes to filing accounts as there is a significant discrepancy between what was filed in Japan and what has been filed in the Netherlands.

Japanese disclosure rules for pledged shares require mandatory filings only when the pledgor’s total stake is above 5.0%, so it is unclear if other insiders and their investment vehicles below this level may also have pledged their shares as well. Additionally, based on discussions with lawyers, we understand pledgers must disclose if the level of shares they have collateralized changes by more than 1.0% of the total outstanding shares in a company, and if the loan contract changes or expires.

We would note insiders have a history of pledging shares as collateral to Resona and other lenders. For example, MYSTAR Ltd., an investment vehicle for SMC stock held by former president and chairman Susumu Omura & family, also collateralized at least part of its SMC stake\(^{21}\).

Dutch and Japanese regulatory filings\(^{22}\) indicate TON sold down 392,700 shares sometime between April-December 2013. As this is below 1.0% TON is not required to file an update on pledged shares outstanding.

However, TON’s Dutch regulatory filings appear to contradict the level of shares it actually pledged. Until December 2013 TON had pledged just 37.8% of its stake in SMC, or 1.45mn SMC shares, and by 2014 it had pledged all of its 3.4mn SMC shares.

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Source: TON Finance Dutch Regulatory Filings

As can be seen in the extracts below, in Ton Finance’s FY13 accounts Ton had pledged 1,450,000 shares, however, in their FY14 accounts, it states

\(^{20}\) http://www.kabupro.jp/edp/20090128/S0002B8M.pdf

\(^{21}\) http://www.kabupro.jp/edp/20051220/005GC8D0.pdf
that it had pledged 3,443,500 in both FY14 and FY13 and no reason is given for this restatement, raising further questions of the reliability of the financial statements prepared for SMC’s management.

On December 31st 2013, 1,450,000 shares of (December 31st 2012: 1,450,000 shares) of the S.M.C. Corporation were pledged as security for several loan facilities. The market value of the pledged shares at December 31st 2013 amounts to ¥ 38,425,000,000 (December 31st 2012: ¥ 22,562,000,000).

Source: TON Finance 2013 Dutch Regulatory Filings

On December 31st 2014, 3,443,500 shares of (December 31st 2013: 3,443,500 shares) of the S.M.C. Corporation were pledged as security for several loan facilities. The market value of the pledged shares at December 31st 2014 amounts to ¥ 110,088,695,000 (December 31st 2013: ¥ 91,252,750,000).

Source: TON Finance 2014 Dutch Regulatory Filings

Here are some questions investors may want to ask management, specifically Chairman Takada:

1. Are the Dutch regulatory filings correct or are the Japanese filings correct?
2. If the Dutch filings are correct then why did TON disclose a pledge in Japan for 100% of its shares in 2008 and why did TON not disclose an increase in pledged shares in 2014? This would be a violation of Japanese disclosure laws.
3. If the Japanese disclosure is correct why did TON file incorrect financial statements with the Dutch authorities for six years?
4. What is the actual volume of share’s pledged by TON as loan collateral and how has this changed over time?
5. What have the proceeds of these loans been used for? It does not appear to be on TON’s balance sheet
6. Who holds the voting rights for TON Finance’s SMC shares? Resona Bank or TON Finance?
7. Have any other insider/management investment vehicles also pledged their SMC shares? If so, which ones, why and by how much?

Regardless, we do not think it is a positive sign that Chairman Takada’s largest investment vehicle has collateralized its ENTIRE stake in SMC against a loan with Resona, or that other insiders also collateralized their stakes.

AT LEAST JPY81.7 BILLION OF CASH MIGHT NOT EXIST

We have obtained almost all the local filings for SMC’s major subsidiaries and have found that in conjunction with the other subsidiaries we managed to find documentation for, we are missing JPY81.7 billion of cash... and we think there is a strong chance that this cash may not exist.
As can be seen in the above table, we have not managed to obtain financials for SMC USA, SMC Hong Kong, SMC Taiwan or SMC Brazil. Nevertheless, we believe we have captured the majority of the cash and it is highly unlikely that the remaining major subsidiaries have maintained cash balances.
equating to anywhere near the missing JPY81.7 billion for the following reasons:

1. We understand from industry observers, that SMC USA may not be even profitable without creative accounting and subsidies from the parent. Additionally, they have spent significant cash on an onsite hotel for employees and visiting businessmen.
2. SMC Brazil is also unlikely to hold significant amounts of cash as the South American countries have barely been profitable over the last few years.
3. We understand from competitors that SMC Hong Kong’s revenues were in the HK$50 million to HK$75 million over the last six years and net profit likely to have ranged between HK$5 million to HK$8 million. These results are unlikely to produce any significant cash.
4. SMC Taiwan has, according to analyst reports, sales in 2016 in Taiwan of US$83 million. Applying a similar margin as Korea (approx.14.3% in 2016) operating profit would be approximately US$12 million (JPY1.4 billion) which again makes it unlikely that Taiwan has a significant cash pile.

We therefore believe at least JPY81.7 billion of SMC’s cash does not exist and this assumes the large cash piles at the parent level and at SMC Manufacturing Singapore are both real despite them having auditors who lack independence and have questionable clients.

Further support of the cash not existing is our analysis of interest income. Local Chinese filings show that the cash deposits earn an average yield of approximately 8.4% and the Japanese Parent’s accounts show a yield of 1.0%. The total interest income from these accounts is approximately JPY6.1 billion yet the consolidated interest income is only JPY5.4 billion. This implies that the remaining cash throughout the rest of the world, 55% of the total balance, amounting to approximately JPY188 billion is earning a negative yield of -0.4% which is nonsensical.

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23 Nomura analyst report on SMC 25 November 2016
24 Since FY03/2014 SMC only discloses parent-level interest AND dividend income as opposed to breaking them out separately. However, the historical figures showed dividend income to be tiny and we believe most of the total today to still be mainly coming from ‘interest’ income than dividends for the parent.
Based on these findings, we believe that SMC’s cash is materially overstated which is not surprising considering the lack of oversight by Seiyo, an auditor that had just 16 certified public accountants and a history of being unable to verify overseas transactions at clients, such as FOI.

**SMC INVENTORY - A PERENNIAL MYSTERY**

SMC has always held inventory levels vastly above those of peers - the Company says their strategy is to have sufficient finished goods on-hand to supply customers quickly. Consolidated financials show an average of 316 days over the past eight years, yet somehow its peers seem to make do with only an average 116 days - i.e. SMC carries over 2.5x the industry standard! Based on **consolidated** disclosure the company somehow makes minimal obsolescence charges or provisions to these huge levels of stock. Normalizing the days turnover and assuming the excess is obsolete would lead to a potential write-down of up to JPY100bn of inventory.

**Source:** SMC Yuho FY03/2014, China SAIC filings

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Cash Balance in LCL (RMB AIA)</th>
<th>Cash Balance in JPY (AIA)</th>
<th>Interest Income in LCL (RMB AIA)</th>
<th>Interest Income in JPY (AIA)</th>
<th>Avg FX Rate for Period</th>
<th>% Interest Yield on Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>SMC Parent (2)</td>
<td>209</td>
<td>52,569</td>
<td>42</td>
<td>16</td>
<td>593</td>
<td>19.6%</td>
</tr>
<tr>
<td>SMC Guangzhou</td>
<td>37,253</td>
<td>235,588</td>
<td>269</td>
<td>16</td>
<td>653</td>
<td>2.8%</td>
</tr>
<tr>
<td>SMC China</td>
<td>2,142</td>
<td>5,136</td>
<td>49</td>
<td>16</td>
<td>1,357</td>
<td>8.0%</td>
</tr>
<tr>
<td>SMC Beijing Manufacturing</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total China</td>
<td>3,702</td>
<td>64,387</td>
<td>314</td>
<td>49</td>
<td>5,136</td>
<td>8.0%</td>
</tr>
<tr>
<td>Total Parent and China</td>
<td>160,956</td>
<td>6,069</td>
<td></td>
<td></td>
<td></td>
<td>3.8%</td>
</tr>
<tr>
<td>Total Consolidated Cash</td>
<td>343,354</td>
<td>5,402</td>
<td></td>
<td></td>
<td></td>
<td>1.5%</td>
</tr>
<tr>
<td>Total Impaired RoW</td>
<td>188,398</td>
<td>(667)</td>
<td></td>
<td></td>
<td></td>
<td>-0.4%</td>
</tr>
</tbody>
</table>

(1) Note: Cash balances and interest income for Chinese subsidiaries have a December fiscal year end and are only available to 31 December 2013, as this is only three months before the year end, we have adopted these numbers.

(2) Note: SMC stopped disclosure separating out interest income and dividend income in year end March 2014. As such we have calculated the effective interest rate for Interest income in 2013 and applied it to 2014.

Source: Company Filings, Bloomberg
Based on disclosure in its Yuho, SMC has started to disclose its inventory write-down in 2009 and this has averaged roughly 1.5% per annum of gross inventory levels, we estimated the write-downs from prior years from the deferred tax assets, and this means that approximately 11% of gross inventory has been impaired over the period. However, as is standard with SMC, subsidiaries’ disclosure tells a very different story.

When SMC put its Filipino subsidiary (SMC Pneumatics Philippines) into receivership in 2003 following a dispute with management PWC made the entity write down 43% of its inventory\(^{25}\). This is a significant write-down considering claims that these goods could just be sold to another entity and reused unless they truly were obsolete and were kept at an inflated valuation on the balance sheet.

**Note 5 - Inventories**

Inventories at March 31 consist of:

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Merchandise inventory</td>
<td>P143,515,110</td>
<td>P176,194,426</td>
</tr>
<tr>
<td>Raw Materials</td>
<td>20,798,086</td>
<td>26,045,971</td>
</tr>
<tr>
<td>Finished goods</td>
<td>1,763,537</td>
<td>1,946,705</td>
</tr>
<tr>
<td><strong>Total inventories on hand</strong></td>
<td><strong>166,074,333</strong></td>
<td><strong>204,187,102</strong></td>
</tr>
<tr>
<td><strong>Less - allowance for inventory obsolescence</strong></td>
<td><strong>78,468,809</strong></td>
<td><strong>6,249,501</strong></td>
</tr>
<tr>
<td><strong>In transit</strong></td>
<td>147,885</td>
<td>214,929</td>
</tr>
<tr>
<td><strong>In hand</strong></td>
<td>P 87,555,809</td>
<td>P198,152,530</td>
</tr>
</tbody>
</table>

Source: SMC Pneumatics Philippines Regulatory Filings 2003

Meanwhile, its British auditors have continuously tightened inventory impairment rules. Inventory more than two years old is written down by more than 90% and the subsidiary has taken provisions against 40% of its inventory since FY03/2012. Again this clearly demonstrates that SMC’s inventory does become obsolete and in the case of the UK appears to become obsolete at a rate of approximately 5% per annum, over 3x the rate of obsolescence at the consolidated level.

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\(^{25}\) Inventories on hand at 2003 of 166,076,733 divided by Provision in 2003 for non-moving inventories 72,219,307 Equals a write down in that year of 43.49%
Inventory provision

The group's statement of financial position includes inventories totalling £9,813,061 (2014 - £10,666,006) stated after impairment provisions of £6,166,451 (2014 - £6,695,069). The calculation of impairment provisions requires estimates in respect of the net realisable value of inventories. The company estimates net realisable value by categorising the inventory into slow moving, excess inventory or dead inventory:

1. Slow moving inventory where there have been no sales in more than 1 year but less than 2 years the inventory is devalued by 50%.
2. For slow moving items where there have been no sales in more than 2 years but less than 3 years the inventory is devalued by 91%.
3. For slow moving items where there have been no sales in more than 3 years but less than 4 years the inventory is devalued by 96%.
4. For slow moving items where there have been no sales in more than 4 years but less than 5 years the inventory is devalued by 98%.
5. Where there have been no sales in more than 5 years the inventory is devalued 100%.
6. Excess inventory is determined by calculating the value of inventory which is greater than the last 12 months demand. The excess inventory is devalued by 50%.

The group estimates the percentage devaluation applied to aged inventory from reference to historic recovery in sales of these items.

Source: SMC Pneumatics UK Regulatory Filings 2015

Furthermore, our own enquiries in the US with former staff suggest approximately a quarter of American inventory should be immediately impaired and attempts to liquidate dead inventory were not even able to generate 10 cents on the dollar.

We have also found inventory build-up in Korea without any incremental increase in sales or Costs of Goods Sold. As can be seen in the table below, inventory has almost doubled since 2013 but with little result in sales growth. Normalizing these inventory days would suggest a 52% write-down. It is worth noting that SMC has been in trouble in Korea for anti-competitive behavior with unfair price-cutting. SMC Corp are expected to be fined 11.66% of their net income for the next five years. Dramatic price-cutting and a rapid build-up in stock raises the likelihood of significant obsolescence.

Based on these disclosures and comparisons with competitors, we think SMC needs to provision for anywhere between JPY19bn to JPY91bn in inventory impairments with Y55bn a conservative level for provisioning after accounting for amounts already written-down.

http://english.yonhapnews.co.kr/news/2015/01/20/0200000000AEN20150120008800320.html
GROUP TRANSACTIONS AND INVENTORY WRITEDOWNS
Not only do there appear to be non-disclosed related party transaction occurring SMC also seems to have soft spot for intra-group transactions as a way to avoid taking inventory write-downs of any scale.

Back in FY03/2013 SMC Manufacturing Singapore’s P&L had an unusual line item called ‘other operating expenses' for SGD1.8mn. Ordinarily we would let such a small sum of money slide, however, in SMC’s case we believe this is indicative of the cavalier attitude the company has towards correct accounting procedures.

Source: SMC Manufacturing Singapore FY03/2013 Regulatory Filings

Far from being a mere expense, buried away in footnotes it transpires the SGD1.8mn was an inventory write-down, the bulk of which occurred in the “cylinder category". According to the subsidiary’s footnotes, cylinders have historically been very unprofitable for SMC Manufacturing Singapore, from FY03/2010 to FY03/2013 this segment had AT LEAST negative 100% gross margin... i.e. the implication is these were being sold for 50% or more below CoGs!
Suddenly in FY03/2014 cylinder sales spike and there is a huge improvement in gross margin (albeit still negative, just not nearly as horrible). This was then followed up with some rather eye-catching disclosure in FY03/2015, “The Company reversed $428,480 (2014: $734,137) of a previous inventory write down in FY2014. The Company has sold all the goods that were written down to its ultimate holding company in Japan and related companies in Singapore at original cost. The amount reversed has been included in “other operating income”

Given cylinders had racked up negative gross profit roughly equal to sales in the prior three years this implies Manufacturing would have had to have sold cylinders at prices more than double what they sold them at previously. It also suggests over half of cylinder sales in FY03/14 were an intragroup transaction specifically to writeback most of a write-down. Indeed, in FY03/15 write-backs almost exactly match cylinder segment sales and gross profit is almost zero, implying nearly all sales were done at inflated prices to reverse writedowns! Thus by FY03/2015 Manufacturing Singapore had written back 2/3 of the writedown. Interestingly, after writing back most of this write-down SMC Manufacturing Singapore then ceased production of cylinders, according to its FY03/2016 accounts.

If one is able to sell products at inflated prices via intra-group sales this implies by round-tripping or shuffling inventory to one’s heart’s delight one NEVER has to book a writedown.

We think this raises much broader questions about inventory impairments across the group. After all, if SMC is prepared to fight tooth-and-claw to reverse SGD1.8mn in inventory write-downs via suspect inter-party transactions what does this say about the entire inventory pile?
SMC generates the majority of revenue and profit in Japan, rather than at its overseas operations.

Despite revenue being flat to slightly down from FY 03/2008 there has been a giddy 1900 basis points of operating margin expansion in Japan. Moreover, this performance comes AFTER removing all company internal transactions, and is not due to FX as Japan revenue primarily comes from third parties and these sales are generally matched through its domestic production base.

In short, we have yet to find any long-established company in the factory automation business that has managed such amazing margin improvement.

How is this possible?
1. Could Japan be moving profit around via transfer pricing to improve tax efficiencies?
Perhaps, but Japan has one of the highest corporate tax rates globally so this would be odd.
2. Could the parent be making its overseas subsidiaries pay increased royalties thus boosting Japanese profitability without any concomitant rise in domestic revenue? Possibly, but this should be captured in the internal transactions/eliminations line.

RESONA KESSAI SERVICE
The Parent account payables are extremely puzzling if one digs back into SMC’s historical Teikoku filings. Up until FY03/2013, SMC used to disclose in its Japanese filings SMC Parent’s largest holders of accounts payable. Resona Kessai was ALWAYS the largest annual holder of SMC Parent accounts payable - generally holding 66-80% of total consolidated accounts payable. Resona Kessai Service is a 100%-subsidiary of Resona Holdings, SMC’s main bank and former employer to most of the key financial executives at SMC.


SMC’s Yuhos from FY03/2004 to FY03/2013 also reveal Resona Kessai had acquired accounts receivables against the SMC Parent held by one of SMC’s trading partners/counterparties. These factoring transactions presumably led to the large payables outstanding held by Resona Kessai.

With regards to accounts payable held by Resona Kessai, Resona Kessai took over accounts receivables against SMC Parent held by one of SMC’s counterparties.

Source: SMC’s Yuho filings (FY 03/2004 -FY03/2013)

FACTORING FLOW AT SMC:
This seems strange; companies typically factor receivables at a discount as a way to raise cash quickly, yet SMC supposedly settles ALL its account payables within 70 days and as fast as 20. The Company is also meant to be a high quality credit (local ratings agency R&I has an AA rating on SMC). One would have thought external suppliers to SMC would be comfortable running receivables against the parent rather than needing to factor these balances through Resona Kessai at a discount. We also note, that the continued fluctuation in the accounts payable indicates that this was not a one-off factoring but an ongoing business relationship which makes the matter even more bizarre.

Furthermore, based on the latest Teikoku report from 2015 SMC’s top two listed suppliers are Sakagami Seisakusho and Yokogawa Electric (6841:JP). Both these companies were included in SMC’s breakout of its top accounts payable counterparties and ran accounts payables no larger than JPY750 million in any given year!
That squares against accounts payables consistently north of JPY25bn yen held by Resona Kessai. Resona Kessai’s payables balance appears far too large to represent ONE supplier to SMC. Indeed, we doubt whether this balance could even represent multiple external suppliers given its sheer size and the details on suppliers in the Teikoku reports.

Source: Resona Kessai’s 2016 Teikoku Databank Filing.

Finally, if we assume SMC parent’s payables balance with Resona Kessai has remained at approximately JPY33bn then this would be around 10% of
Resona Kessai’s total current assets as of March 2016. Resona Kessai notes they have 300 factoring clients, so for one client to be approximately 10% of their business would be very significant. Yet, Resona Kessai makes absolutely no mention of its relationship with SMC despite this... in fact, we have checked Resona Kessai’s Teikoku reports back to 2008 and cannot find any mention of client concentration risk LET ALONE mention of SMC. We find this puzzling.

Attempting to rationalize how Resona Kessai has factored the scale of the receivables it did and become the largest holder of parent payables is thus problematic. There is one more notable aspect about Resona Kessai; it obtains 100% of its financing from Resona Bank and Resona group companies. However, if its factoring assets become uncollectible (i.e. they turn into NPLs), Resona Kessai does not have to repay its loans on these assets back to Resona Bank. In effect, Resona Kessai bears NO risk on its factoring business - Resona Bank bears it all. Assuming SMC has, or had, the level of payables its Seiyo-audited accounts said it did then effectively these Kessai’s payables are akin to Resona bank loans to SMC.

Investors may want to ask the company and Resona Holdings:
1. Who did Resona Kessai buy the receivables from?
2. Does, or did, this have any impact on how expenses have been recognized?
3. How did Resona Kessai get to be such a large holder of SMC Parent payables?
4. Why did SMC stop disclosing this detail in FY03/2013?
5. Is it still the case Resona Kessai holds so many payables? If so, why?
6. Why did a counterparty, or counterparties, feel compelled to factor their receivables to the SMC parent if SMC is such a high-quality credit and settles payables fast?

TO CONSOLIDATE, OR NOT TO CONSOLIDATE?
In keeping with SMC’s unusual attitude towards auditors, the company’s disclosure on consolidation strikes us as not only substandard but also open to abuse given an unusually large and growing amount of non-consolidated subsidiaries.

Consolidation is required when the parent has significant ownership and control of a subsidiary. While there is some scope for interpretation over what exactly constitutes significant ownership and control, it is accepted that ownership of more than 50% requires consolidation. In instances where equity ownership is between 20-50% and the parent company has the ability to exercise significant influence then equity method accounting is normally used. Moreover, disclosure is required on non-consolidated subsidiaries and equity method affiliates.

However, the yardstick by which SMC consolidates entities is whether a
subsidiary’s results are “material” - or not to the overall group accounts. While SMC is not alone in doing this, it IS extremely unique among its peers in Japan in ever expanding its non-consolidated entities and **failing to even properly disclose the names of its consolidated entities!**

We believe this accounting treatment makes its consolidation policy ripe for abuse.

The following graph shows how the number of disclosed SMC subsidiaries, particularly non-consolidated ones, have been increasing over time - hitting 39 last financial year.

![Number of Disclosed SMC Subsidiaries](image)

Source: SMC Annual Reports & Yuhos

This underscores a major flaw with the consolidated accounts; by non-consolidating an ever-increasing number of entities on unclear grounds external investors simply have no idea what the real performance of the whole group is. Indeed, none of its peers has such a staggeringly high level of non-consolidated subsidiaries.

<table>
<thead>
<tr>
<th>NAME</th>
<th>No. of Non-Consolidated Subsidiaries FY03/2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>THK (6481:JP)</td>
<td>1</td>
</tr>
<tr>
<td>CKD (6407:JP)</td>
<td>1</td>
</tr>
<tr>
<td>Nabtesco (6268:JP)</td>
<td>0</td>
</tr>
<tr>
<td>SMC (6273:JP)</td>
<td>39</td>
</tr>
</tbody>
</table>

We think there is a high likelihood the burgeoning number of unconsolidated subsidiaries is being used to mask intra-group sales and covertly push these into the consolidated group accounts. Due to the jumble of different
auditors used globally not all of SMC’s overseas operations break out intra-group sales. However, SMC Italia S.p.A’s accounts provide the most detailed breakdown of group companies and thus a snapshot of intra-group transactions seen through the lens of the Italian subsidiary.

While non-consolidated subsidiary sales dropped to less than 1% in FY03/2016 it is noteworthy that between FY03/2012 to FY03/2015 they were averaging around 6% of overall sales. Applied to the consolidated group this would suggest that JPY91.1bn over the period could be consolidated to non-consolidated transactions!

Similarly, the task of understanding what is going on inside the company’s consolidated accounts is made even harder as SMC stopped providing a full list of consolidated subsidiaries from FY03/2013. Investors in both Japanese and English are now merely left with a list of SMC’s “major subsidiaries” - of which there were 17 last financial year. It is therefore impossible now to even to know exactly which entities are going into the consolidated accounts!


This strikes us as a system wide open to abuse, particularly considering that even when SMC provided investors with a detailed roll call of consolidated entities it had a questionable track record of adding and dropping subsidiaries from consolidation with little to no disclosure - such as was the case with SMC Pneumatics Philippines, Shoketsu Finance BV and PT SMC Pneumatics Indonesia.

(While one can amalgamate SMC’s Yuho organizational chart and its major subsidiaries list to create a fuller list of consolidated subsidiaries there are still five consolidated subsidiaries whose names are now unknown. Are these still Advanced Pressure Technology, SMC Pneumatics (N.Z.), SMC Manufacturing (Aust.) Pty., SMC Pneumatics (Ireland), and SMC Industrial Automation CZ s.r.o. as was the case back in FY03/2012?)

Furthermore, SMC is extremely unusual among Japanese companies in failing to disclose the full roster of its consolidated subsidiaries. CKD, Nabtesco, and THK ALL provide a comprehensive list of their fully
consolidated subsidiaries in their Yuhos. And it is nothing to do with the amount of consolidated entities that SMC has - in FY03/2016 THK had EXACTLY the same amount of consolidated subsidiaries as SMC and still provided an exhaustive roll call of ALL these entities in its FY03/2016 Yuho.

Given a large swathe of undisclosed consolidated and non-consolidated subsidiaries, an investor has no way of knowing if someone is shuffling subsidiaries in and out of consolidation at a whim, or how much inventory, payables or even debt some of these entities actually carry.

We think SMC needs to come clean and show investors in detail how it chooses to consolidate its entities, a full roster of what these entities have been over time - just like other Japanese companies do - detailed disclosure on its unconsolidated subsidiaries and if these subsidiaries are involved in related party transactions.

SMC Pneumatics Philippines
We think the events surrounding SMC Pneumatics Philippines (“SMC Philippines”) underscore how problematic arbitrary deconsolidation - and consolidation - of subsidiaries at SMC can be. SMC Philippines was a consolidated subsidiary until FY03/2004 and then suddenly fell out of the list.

Filipino regulatory filings indicate that SMC Philippines posted PHP153.7mn in sales and a net loss of PHP96.3mn for FY03/2003, or JPY353.5mn in sales and a net loss of JPY221.5mn.

More worrying though was on March 10th 2003 an injunction, a temporary restraining order and an order for receivership status were filed by SMC Philippines and certain foreign stockholders (which we assume ultimately to be the Japanese parent) against the then Company President and General Manager.

Three weeks later on April 1st 2003 SMC deconsolidated SMC Philippines, however, the first mention of this was not for another 13 months when SMC filed its Q4 FY03/2004 results and Yuho.

During those 13 months SMC decided to permanently cut-off deliveries of goods to SMC Philippines, filed a petition for the involuntary dissolution of SMC Philippines and for damages against the President and General Manager; and a Filipino court then put the company into receivership.

While SMC Philippines was by no means a large entity all these events strike us as material events and worthy of at least one or two lines of explanation. Instead, investors received the most cursory of disclosure “the Philippines was deconsolidated” when in fact is was being wound up!

With even LESS disclosure today over the make-up of the group, how
confident can investors be that the consolidated accounts reflect the economic reality of the business?

SMC Pneumatics Indonesia

PT SMC Pneumatics Indonesia ("SMC Indonesia") was de-consolidated from group accounts in FY 03/2007 on the basis of immateriality to consolidated financial statements. Nonetheless, SMC Indonesia is actually a 100%-owned subsidiary of SMC Pneumatics (SEA) PTE LTD ("SMC Pneumatics Singapore"), a consolidated group subsidiary. Questionable methods were then used to reverse write-downs on a ‘dormant’ and “unconsolidated” entity (Indonesia) that clearly flowed back into and helped a consolidated subsidiary.

In FY03/2011 despite SMC Pneumatics Singapore explicitly stating that SMC Indonesia was dormant, and thus had no statutory audit requirements the auditor - Philip Liew & Co. - still managed to allow SMC Pneumatics Singapore to write-back SGD600,000 on a SGD2.9mn write-down it had booked on the entity!

Source: SMC Pneumatics Singapore Financial Statements FY03/2011

With no active business it is hard to see what triggered a reversal of an impairment loss. SMC Pneumatics Singapore continued to book write-backs in FY03/2012 for SGD1mn although given the poor disclosure it is unclear which subsidiary this came from. Then it booked a SGD1.3mn write-back for Indonesia in 2016, although at this point in time SMC Indonesia was functioning again as a subsidiary.

Not only do we think the logic for some of these write-backs is questionable but it also shows how easy it is for the company to push entities off balance sheet but then use unquantifiable valuation gains and write-backs on them as sources of profit that flow back into consolidated accounts!

Moreover, it is eye-catching that related party sales at SMC Pneumatics Singapore picked up significantly from FY03/2012 onwards and now represent 16% of revenue – without which headline revenue would have actually fallen. Unfortunately, it is unclear from SMC Pneumatics Singapore disclosure if these related party sales are to non-consolidated or consolidated SMC subsidiaries. But at the very least it is indicative of
deteriorating third-party demand.

CORPORATE CULTURE
Despite being a listed company for nearly 30 years SMC’s culture is still totally dictated by the personality and vision of its founder and chairman Yoshiyuki Takada. The Company is effectively a family run business where people with views that conflict with the Chairman are systematically removed.

Takada family members hold key management roles: the chairman’s son - Yoshiki - runs the Americas and Edward August Neff (Takada’s son-in-law) having held senior roles at SMC is now CEO of SMAC, a US-based company owned by SMC.

Our own enquiries with former employees have revealed a culture of nepotism where connections and loyalty to the Takada family is often more central to career promotion. For example, in the US numerous market participants have informed us friends and family of Kelley Stacy, a close confidant of Yoshiki Takada who started out as a secretary at SMC, occupy senior management roles.

It is widely reported across different job bulletin boards in Japan that Yoshiyuki Takada’s management style verges on dictatorial and divergent opinions are not welcome.
For better or worse this is a company that is totally under the control of a Chairman who was born in the 1900s. There are hardly any executives that would differ in opinion from the Chairman.
Source: Vorkers

Any executives that disagree with the Chairman have been shown the door so there are no successors (to the top job) and there is little indication they will develop in the future. Once the chairman goes it’s very difficult to see what will happen.
Source: Kaisha no Hyoban

This is not a phenomenon unique to Japan, feedback from US job-hunting site Glassdoor tells a similar story of preferential treatment to staff loyal to the Takada family and intolerance of any views that contradict those of senior management.

http://www.vorkers.com/company_answer.php?m_id=a0910000000FrIX&q_no=10&sort_key=1&sort_val=-1#report_list_top

https://en-hyouban.com/company/00005824495/5/
“Telling people “to leave” when they criticize the company is terrible management decision.”
“Trust your employees. Cut back on nepotism”
“Loosen up the surveillance”
“Japan needs to clean house before the ship sinks.”
“Nepotism…company policies not enforced to certain people in the Senior V.P. family.”

Source: Glassdoor

Our own investigation into SMC Corporation of America (“SMC USA”) paints a similar picture and we think is likely to create serious operational challenges for the company going forwards unless senior management (primarily SMC USA President Yoshiki Takada and his number two Kelley Stacy) is able to engineer a change in culture. Interviews with former employees and market participants have revealed aggressive cuts to sales staff bonuses and introduction of GPS tracking systems in salespeople’s phones and cars has triggered an exodus of staff, left remaining workers demoralized and hurt productivity.

- The CFO in the US is competent, “but he is also ‘asked to dance’ every so often by the founder’s son and leadership team”
- The Japanese management accounting system at SMC “is opaque and allows the highest level managers to keep tight control over information”
- We understand also that president Takada is not onsite in Indiana most of the time instead preferring to spend his days in California and Hawaii.
- It is also noteworthy that a person who appears to be Kelley Stacy’s husband - Barry Stacy - is the Chief Operating Officer of Flodraulic Group

Source: Currentnoblesville.com

, a large SMC distributor. Such a relationship could offer potential for abuse including, early revenue recognition, and channel stuffing etc.

Furthermore, interviews with former employees further substantiate questionable ethics and management capabilities:

- “The US division is mired in unethical business practices”
- “I could write a book or even a movie because it’s so absurdly managed. There are a handful of people in key places that keep it running but from the top down, it’s an embarrassment of an organization. It is unbelievable that a company of that size can make their way through.”
- “Ethically I think they have some challenges in the US. If you talked to anybody about their US efforts, I’d be shocked if you got something different in that vein.”
- “From the standpoint of conflict of interest, there are some personal conflict of interest practices going on. I’ll just put it that way.”

Barring a reversal in strategy we think SMC USA is setting itself up for serious erosion in its market share. According to one expert, SMC USA is living off the market share created by all the salespeople who have left due to cuts in bonuses and the installation of the GPS tracking system. These experts now work for some of SMC’s competitors and believe that the US operation has become a train wreck and losing market share. They have also spent significant capex on building an onsite hotel for employees and business visitors with one distributor visiting the US operation and stating “It looks like the kids are running the candy shop”.

Based on our inquiries we question if the current management team is capable of backtracking on and grasping the implications of previous missteps. A former C-Suite executive at one of SMC’s major subsidiaries described the situation to us as “what Takada said was law - there was no criticism allowed.”

In short, SMC is Chairman Takada’s show. We believe a culture of nepotism and unwillingness to accept constructive criticism from staff has led to serious structural issues that have for years been masked by highly dubious accounting practices.

**RELATED PARTY TRANSACTIONS**

Given how opaque the internal workings of SMC are the company needs to explain fully to investors not only what entities are consolidated but if any of the group entities (consolidated or not) are engaging in related party transactions.

We think the group’s European Central Warehouse (ECW), is a case in point.
Before we delve into the ECW though we think a quick detour to understand the byzantine structure of SMC’s operations in the Benelux countries is necessary.

**HOLLAND & BELGIUM**

A casual reader of SMC’s website may get the impression that SMC Pneumatics N.V./S.A. (“SMC Belgium”), SMC Pneumatics B.V. (“SMC Holland”) and the ECW are part of SMC proper. In fact, page 19 of SMC’s own corporate guide 30 misleadingly goes as far as to present Belgium and Holland as overseas subsidiaries.

However, these Benelux entities are NOT part of the consolidated group. Dutch and Belgian regulatory filings show SMC Belgium, SMC Holland and at least part of the ECW belong to a separate Dutch business owned by Nauta Holding B.V. (“Nauta Group”).

Based on a corporate video by the Group and website 31 - the head of Nauta Group - has been doing business with Japanese toolmakers, including SMC, since the 60s.

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Nauta Holding B.V.’s address in Amsterdam (De Ruyter Kade 120, 1011AB) is also the registered address for:

- Aquapro B.V. (majority owner of SMC Holland and SMC Belgium)
- SMC Pneumatics B.V. (aka SMC Holland, and a Nauta Group entity)
- TON Finance B.V. (SMC’s 2nd largest shareholder. Takada, Omura, and Nauta are all directors of this entity, according to Dutch regulatory filings.)
- Shoketsu Finance BV (A 100%-owned subsidiary of SMC Corp. and previously one of the largest holders of SMC parent payables until FY03/2006 before being suddenly deconsolidated in FY03/2007.)
- Shirai Finance
- Omura Finance

Source: Dutch regulatory filings.

When we contacted the number listed on TON’s corporate registry it was answered by an employee who said he worked for SMC Holland. Indeed,

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32 SMC Chairman Yoshiyuki Takada
33 Tatsuya Omura, son of former SMC chairman and president Susumu Omura
34 Sjoerd Nauta, head of the Nauta Group and long-time partner of SMC in Benelux
when describing what SMC Pneumatics BV itself does, his description was that they are a “wholesale company for a couple of small companies and doing book-keeping as well.” Dutch regulatory filings show B.L. van Zuilen signs TON Finance, Shoketsu Finance BV’s and SMC Holland’s accounts as their “Finance Manager”. Bas van Zuilen’s LinkedIn profile\(^{35}\) shows he is listed as the Finance Manager at SMC Holland and SMC Belgium - both Nauta Group companies.

Source: Linkedin

Technically, as neither SMC Belgium nor SMC Holland is an SMC Corp. subsidiary any sales to these two are third party sales and would be off-balance sheet.

HOWEVER, the overlap of directors (Sjoerd Nauta), finance managers (Bas van Zuilen), and co-location of SMC Corp subsidiaries, investment vehicles of SMC senior management (TON Finance) and the former largest holder of SMC parent receivables (Shoketsu Finance) at the registered address of the Nauta Group clearly shows SMC Corp and the Nauta Group ARE RELATED PARTIES. Yet SMC’s own disclosure in Japanese and English MAKES NO MENTION of such related party transactions.

\(^{35}\) https://www.linkedin.com/in/bas-van-zuilen-9314a911
We think this is highly problematic from an accounting perspective, especially when trying to understand how SMC deals with inventory in the ECW, of which there is zero disclosure.

**EUROPEAN CENTRAL WAREHOUSE**

SMC’s European logistics and distribution operations are run out of the Belgium-based ECW, located in Wommelgem. The site features prominently on SMC’s website as part of its global network and in marketing material.

Source: SMC Website

Belgium is unusual for SMC; not only is the local SMC Pneumatics operation part of the Nauta Group, but there is also another SMC entity operating in the country: SMC Logistics Service Europe NV.

Sjoerd Nauta is one of the directors of SMC Logistics Service Europe, as well as Masahiko Satake (an SMC Board Member and one of 4 Executive Directors as well as Head of Global Manufacturing).

SMC Logistics Service Europe’s registered address on its corporate filings is the same as the ECW. Moreover, according to Belgian regulatory filings, SMC Logistics Service Europe at least as far back as FY03/2006 was a consolidated subsidiary of SMC Corp, and it remains so to this day. HOWEVER, SMC Corp’s Japanese filings have NEVER mentioned SMC Logistics Service Europe as a consolidated subsidiary.

To be clear: SMC Logistics Service Europe is part of SMC Corp. Italian corporate records show it to be part of the group.

Source: FY03/2006 SMC Logistics Service Europe NV Belgian regulatory filings

Source: Italian Regulatory Filings
It is unclear if Logistics Service Europe is non-consolidated, or one of the five consolidated but unnamed entities in SMC’s consolidated accounts or totally off-balance sheet…

WHAT IS THE ACCOUNTING TREATMENT FOR SMC LOGISTICS SERVICE EUROPE AND WHY?
WHY HAS SMC LOGISTICS HAS CHANGED ITS AUDITOR THREE TIMES IN LESS THAN FOUR YEARS?

We think this is problematic for a number of reasons.

1. Sjoerd Nauta is both a director at SMC Belgium and SMC Logistics Europe, which means they are clearly related parties.

Source: SMC Belgium Regulatory Filings, SMC Belgium

2. DNS registration data for the ECW and SMC Belgium urls (ecw-smc.com and smcpneumatics.be) shows both sites to be managed by the NAUTA GROUP via its 100%-owned subsidiary SMC Belgium as opposed to SMC proper. Indeed, R. Van de Pal appears to be an IT manager at one of the Nauta Group subsidiaries, according to LinkedIn.

Source: www.checkdomain.com

37 https://www.linkedin.com/in/r0001
This strongly implies the ECW is managed by SMC Belgium, NOT by SMC proper.
Is inventory delivered into the ECW thus property of/or managed by SMC Belgium, an off-balance sheet entity, or does it remain on balance sheet with the SMC Group?
Given the huge size of the ECW a substantial swathe of inventory may be unaccounted for in consolidated accounts. We think SMC needs to clarify this.

3. The ECW layout/structure is very irregular and a casual observer may wonder why the site was designed in such a fashion.

Source: Google Maps
Belgian land records for the ECW show the site is actually co-owned by both the Nauta Group AND SMC Corp. through SMC Logistics Europe further underscoring the related-party issues with the site.
We think this land sharing is extremely unusual, how is inventory accounted for in different parts of the ECW? Why did SMC Logistics Europe NV acquire a small subsection of the Nauta Holding land in 2013?
VALUATION

Based on how pervasive the accounting issues are we think SMC’s stock should trade anywhere between 50% to 85% lower than current levels resulting in a target price range of between JPY4,484 and JPY15,145.

Our extremely wide price range reflects how difficult it is for an external investor to value SMC’s business in light of how the inherent flaws in the company’s accounts are and the significant scope for SMC to have manipulated its accounts.

We can say with confidence though:
A) We do not believe SMC should be an approx. JPY2trn market cap business that trades at 25x earnings, and 12x EV/EBITDA when sales and margins cannot be trusted, and book value is likely overstated.
B) The market has NOT react well to large-scale corporate scandals, especially those involving accounting issues and corporate governance failures.

The following is a list of some of Japan’s largest corporate scandals and the impact on their stock price in the year following the scandal coming to light:

1. In 2005 Kanebo Ltd restated four years’ worth of earnings which had been inflated by about JPY210bn. Kanebo executives had colluded with its auditors ChuoAoyama PricewaterhouseCoopers38, three of the auditors were found guilty of conspiracy39. The stock price fell nearly 75% before the company was delisted as a result of the scandal.
2. Olympus’ stock price dropped over 80% following the exposure of JPY117.7bn of investment losses it had concealed.
3. Toshiba Corp’s stock price dropped 60% as details of its JPY151bn accounting manipulation were uncovered and the company remains on the TSE’s ‘watch list’.
4. IHI Corp’s stock likewise fell over 60% in the year following its restatement of a JPY15.8bn profit to a JPY4.6bn loss in March 2007.
5. Long Term Credit Bank of Japan’s stock price dropped over 70% when it was discovered that it had underestimated bad loan reserves by US$4bn in 1998.
6. Yamaichi Securities went bankrupt after they had been hiding US$2.5bn in losses in paper companies.

38 http://www.taipeitimes.com/News/biz/archives/2006/05/14/2003308162
39 http://www.telegraph.co.uk/finance/2945147/Former-PwC-accountants-guilty-of-conspiracy.html
7. Livedoor Co’s stock collapsed 90% in the four months after it was revealed that they were fraudulently boosting their stock price before being delisted.

We think Kanebo may be the most instructive case. Kanebo’s auditors (ChuoAoyama PwC) signed off on accounts they knew were forged. In the cases above, investors experienced declines in stock prices of at least 70% and in Kanebo and Livedoor cases, the stocks were delisted. The average downside within a year each of these scandals breaking was 85.4%. Applying this to SMC results in a target price of JPY4,484.

<table>
<thead>
<tr>
<th>Company</th>
<th>% Stock Fell</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kanebo</td>
<td>81%</td>
</tr>
<tr>
<td>Olympus</td>
<td>83%</td>
</tr>
<tr>
<td>Toshiba</td>
<td>70%</td>
</tr>
<tr>
<td>IHI</td>
<td>64%</td>
</tr>
<tr>
<td>LTCB</td>
<td>100%</td>
</tr>
<tr>
<td>Yamaichi</td>
<td>100%</td>
</tr>
<tr>
<td>Livedoor</td>
<td>100%</td>
</tr>
</tbody>
</table>

Average downside 85.4%

(1) These % decreases are approximations based on the lowest price within a year of the scandal

Alternatively, we think applying a 15% operating margin to SMC’s business is probably more reflective of the economics of the business. (AirTac has higher OPMs versus peers but operates with fewer Stock Keeping Units resulting in a more streamlined and efficient production process.) Assuming SMC sales forecasts for FY03/2017 are accurate and not fabricated, we calculate operating profits of JPY 69bn and apply a tax rate of 29%, based on the weighted average of the last three years, to calculate net profits of JPY49bn.

40 http://www.japantimes.co.jp/news/2005/09/14/national/four-cpas-arrested-over-kanebo-scandal/#.WC5wKC2GOUk
We do not think SMC deserves to trade at a premium 25x multiple versus peers, applying the industry average P/E of 21x to JPY49bn results in an expected price per share of JPY15,145/share, a downside of 50%. We would also note that our calculation does not take into account possible inventory writedowns and other impairments the company will likely incur.
## APPENDIX A - KEY PERSONNEL

<table>
<thead>
<tr>
<th>NAME</th>
<th>ROLE</th>
<th>DOB</th>
<th>NOTES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yoshiyuki Takada</td>
<td>Chairman of the Board and Representative Director</td>
<td>20/8/1926</td>
<td>The nonagenarian Yoshiyuki Takada founded the company in the 1950s and has run the business ever since. Including family controlled vehicles he and other Takada family members nominally control over 12% of the Company.</td>
</tr>
<tr>
<td>Yoshiki Takada</td>
<td>Managing Director and Board Member</td>
<td>06/06/1958</td>
<td>Son of Chairman Takada, Yoshiki runs the Americas for SMC Corp. - this includes Mexico, the US and Brazil.</td>
</tr>
<tr>
<td>Ikuji Usui</td>
<td>Board Member, CFO and Executive Managing Director</td>
<td>20/08/1943</td>
<td>Formerly from Resona Holdings Bank (then known as Asahi Bank - and to this day SMC’s main bank), Usui left Resona/Asahi in 1993 to join SMC as a board member. Usui is also a director of a number of key SMC subsidiaries including those with suspect accounting practices such as SMC Manufacturing Singapore.</td>
</tr>
<tr>
<td>Eiji Ohashi</td>
<td>Board Member and Managing Director</td>
<td>19/09/1951</td>
<td>Like Usui, Ohashi is a former Resona banker who joined the company in 2004 and became SMC’s General Manager in charge of Finance and Accounting in February 2005. Ohashi is a statutory auditor and director at numerous SMC subsidiaries including Seigyo Kizai, an unaudited but consolidated ‘major’ subsidiary of the Group.</td>
</tr>
</tbody>
</table>

## KEY FORMER EMPLOYEES

<table>
<thead>
<tr>
<th>NAME</th>
<th>ROLE</th>
<th>DOB</th>
<th>NOTES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jiro Shirai</td>
<td></td>
<td></td>
<td>Shirai formally left SMC in 2000 but prior to his departure was CFO at the company and held a number of other key positions - head of SMC China, SMC Corporation of America, and director at a number of key SMC subsidiary and affiliates such as Shoketsu Finance, Toyo Warehouse &amp; Transportation, TON Finance BV, and Shirai Finance BV. This made him de facto number two at the company to Chairman Takada. Following his departure in March 2003, after a 21-year long career</td>
</tr>
</tbody>
</table>
At SMC, he continued to play a role at the Company as Financial Advisor (上席財務相談役) until 2002.

In keeping with senior finance and treasury staff he also hailed from today’s Resona Holdings.

| Susumu Omura | Former President and Chairman | Deceased | Former chairman of the Company. Omura passed away in 2007. Susumu was also previously listed as one of the main shareholders of TON Finance BV in a 1996 financing prospectus. TON Finance BV remains one of SMC’s largest shareholders. Omura’s son - Tatsuya Omura - is currently a director of TON. |
APPENDIX B - SUBSIDIARY RESTATEMENTS

Before we dissect Manufacturing Singapore accounts a brief primer on Advance Purchasing Agreements (APA) may be necessary...

Advance Purchasing Agreements (APA) are agreements between companies and tax authorities covering tax treatment of intra-group transactions - otherwise known as Transfer Pricing - over set periods of time. These are complex legal and taxation issues, but the basic idea is these agreements prevent companies booking profits in tax-havens etc. to evade tax. One generally accepted rule is intra-group transactions should be conducted as arms-lengths transactions - a rule of thumb Singapore also effectively uses.

In the past 13-years Manufacturing Singapore appears to have fallen afoul of Transfer Pricing agreements with the Singaporean Inland Revenue at least three times!

****

In FY03/2004 Manufacturing Singapore’s filings revealed it had to restate FY03/2003 accounts due to an APA issue and the Inland Revenue Authority of Singapore reduced income tax chargeable to the company - i.e. Manufacturing Singapore wasn’t as profitable as its accounts said. This resulted in a reduction of aggregate profit of SMC Manufacturing of SGD 59.6 million for the years March 31, 1992 to March 31, 2001! Then-auditor Deloitte wrote down retained earnings by that amount net of a tax refund due to the subsidiary.

However, more bizarre was a write up in receivables while the nebulous ‘other payables’ line item on the balance sheet blew out by a factor of 25x to SGD 62.1 million from SGD 2.5 million! Despite this revision to receivables and a significant retroactive bump in payables, cash and fixed deposits somehow were left unchanged in the restatement!

Typically transfer pricing among consolidated subsidiaries should only affect taxes - so that both receivables and payables underwent such a heavy restatement while the cash balance was untouched looks very strange. In fact, a skeptic may even think it looks like a wily attempt to prevent a contraction in the balance sheet and maintain a stated cash level...
Far from being the end of the matter, in FY03/2008 SMC Manufacturing Singapore once again revealed huge adjustments due to transfer pricing! “During the financial year, the company was notified by the Competent Authorities of Singapore and Japan on agreement reached regarding the Advance Pricing Agreement (‘‘APA’’) leading to certain adjustments relating to financial years ended March 31, 2002 to March 31, 2010.”

Source: F03/2008 SMC Manufacturing Singapore audited financial statements

Once again cash balances, and fixed deposits were untouched while the suitably vague “Other receivables and prepaid expenses” got revised and
Accounts/Trade payables soared to SGD103.1mn from SGD11.4mn while Accumulated profits/retained earnings was cut from SGD432.9mn to SGD355.7mn. Does this mean then Manufacturing Singapore’s cash balances are not actually from earnings but are effectively borrowings from suppliers, most likely the Japanese parent? Only SMC can really explain that and by this point investors probably won’t be too surprised to hear there was no disclosure in the consolidated accounts about the Singaporean tax debacles.

We contacted the Inland Revenue Authority of Singapore, while they were unable to provide third parties with details of their rulings, we were told the restatements may have been due "to records not being kept properly" and were to do with transfer pricing.

To our amazement, Manufacturing Singapore APA issues still have not been settled! Disclosure in the FY03/2011 states the reason clearly “adjustments have resulted in a reduction of aggregate profit of the Company. On March 28, 2011, the Company renewed these APA for the period from financial year ending March 31, 2011 to March 31, 2015.” The most logical explanation is that a large part of Manufacturing Singapore’s sales are NOT arms-length transactions and are therefore subject to this adjustment. As of its FY03/2016 filings, Singapore Manufacturing was attempting to extend its APA adjustment and still making large adjustments to its gross profit as a result. Moreover, as the APA adjustment is made prior to gross profit it would suggest that either the price for CoGs or actual unit prices in sales are not reflective of proper market prices.
Indeed, SMC seems to run into transfer pricing issues frequently – in June 2016 it actually disclosed (!) JPY6.6bn in additional taxes in Korea and another JPY1.6bn in additional taxes in Japan.

Investors should not only insist SMC hire a big four auditor who is capable of conducting a full global audit but also demand the new auditor also review SMC’s tax affairs as the company has persistent issues with transfer pricing.

*****
APPENDIX C: UK RESTATEMENTS: A BAKER’S DOZEN

Nonsensical retroactive restatements and contradictory operating metrics are not limited to Asia-Pacific, halfway around the world in Europe curious investors can dig up the UK company accounts to find them shot to bits with similar discrepancies and auditor changes. Even by SMC’s standards, the UK accounts have undergone heavy and continuous financial plastic surgery.

There are at least:
1. **Two versions of the FY03/2009** accounts done by a small British provincial auditor - ECL Howard Watson Smith. The original FY03/2009 numbers and then a restatement in FY03/2011 that cut GBP2.25mn off (or nearly 10%) book value and instead suddenly created a Deferred Tax Liability of GBP2.25mn instead! That in itself should make investors question the quality of book value at the firm.
2. **THREE versions(!) of the FY03/2010** accounts: the ECL ‘original’ of that year, one attempt by ECL to correct the books in FY03/2011 and then another stab by Baker Tilly in FY03/2012 when they first audited SMC Pneumatic’s UK books for the first time.

Baker Tilly’s audit ended up wiping out roughly another 10% of book value versus ECL’s original effort although somehow the restatements, just like in Singapore never affected the company’s cash balances! Baker Tilly reassuringly noted “material errors” in the previous year’s accounts under ECL. Even more conspicuous were liabilities blowing out by more than 25% against ECL’s original depiction.

Which numbers would you like to believe? Take your pick…
3. Two versions of the FY03/2011 accounts: the ECL ‘original’ of that year (in which it ironically first restated the FY03/2009 and FY03/2010) accounts and Baker Tilly’s attempt in FY03/2012.

In keeping with SMC’s best-in-class disclosure policy there were no mentions of these material errors and ongoing restatements at the UK subsidiary, despite the operation being labeled a ‘major consolidated subsidiary’ by SMC.

Observant investors may notice a few other interesting things about SMC Pneumatics UK’s financial affairs:

a) When the UK subsidiary changed auditors to Baker Tilly in FY03/2011 from ECL the Financial Director at the UK business also resigned.

b) In the FY03/2014 accounts the UK subsidiary said it would propose a resolution to reappoint Baker Tilly as its auditor. Thankfully for investors’ peace of mind, SMC UK decided to switch back to ECL Howard Watson Smith in FY03/2015 at a new reduced rate of GBP25,000 (ECL was paid GBP42,760 in audit fees for their last audit in FY03/2011). One would hope that investors are getting their money’s worth.

We’re still waiting on the UK subsidiary to file an auditors resignation notice.
with Companies House in the UK (the UK regulatory body) over this. Failure to file is a violation of the UK Companies Act of 2006. We think it would be best to file this paperwork soon... alternatively, a curious investor or journalist may want to access this paperwork via submitting a Norwich Pharmacal court order in the UK against the company.

This bears repeating... If this is the way overseas subsidiaries audit their books how confident can one be in the integrity of the consolidated numbers? Why does SMC not use a globally recognized auditor across all its subsidiaries?
APPENDIX D: SMC-RELATED REGULATORY FILINGS & REGISTRIES ACCESSED


III. Omura family and related entities' Japanese shareholder filings

IV. Takada family and related entities' Japanese shareholder filings

V. Corporate Registries: Sjoewd Nauta Retirement, GJ Holding, SJ Trading


VII. SMC Pneumatics (Australia) PTY, Ltd Financial Filings: 2011 - 2015

VIII. SMC Pneumatics NV (Belgium) Ltd. Financial Filings: 2005-2015

IX. SMC (China) : Co. Ltd: SAIC Filings 2012-2015

X. SMC (Beijing) : Mfg. Co. Ltd: SAIC Filings 2012-2015

XI. SMC Pneumatics (Guangzhou) Ltd.: SAIC Filings 2012-2015

XII. Colombia: SMC S.A.S Financial Filings: 2015


XIV. SMC Pneumatics A/S (Denmark) Financial Filings: 2012-2016

XV. Exploitatiaamatschappij Rami Financial Filings: 2008-2014

XVI. SMC Pneumatics Oy (Finland) Financial Filings: 2007-2016

XVII. SMC Pneumatique (France) Financial Filings: 2007-2016


XX. Import Data SMC Corporation of America: 2006-2016


XXV. SMC Pneumatics Korea Co. Ltd Financial Filings: 2006-2016


XXVII. SMC Mexico Business Registration,

XXVIII. SMC Pneumaticos Do Brasil Ltda. Registration Filings

XXIX. SMC Corporation Mexico S.A. de C.V. Regulatory Filings

XXX. Nauta Holding BV Financial Filings: 2008-2014, Nauta Holdings Group Structure

XXXI. SMC Pneumatics BV (Netherlands) Financial Filings: 2008-2015, Corporate Registry

XXXII. Omura Finance Financial Filings: 2009-2015, Omura Finance Corporate Registry

XXXIII. Philippines Financial Filings: 2003-2006

XXXIV. Shoketsu SMC Corporation (Philippines) Financial Filings: 2011-2015

XXXV. SMC Pneumatics (Taiwan) Filings and Credit Reports

XXXVI. Rami Yokota Financial Filings: 2008-2015, Corporate Registry, Warehouse History

XXXVII. Shirai Finance: Financial Filings: 2009-2015, Company Registry,

XXXVIII. Shoketsu Finance Financial Filings: 2010-2015, Company Registry, 2015 company extract

XLI. SMC Logistics Europe (Belgium) Financial Filings: 2006-2015
XLII. SMC Espana SA (Spain) Financial Filings: 2011-2015, Informacion Imprimible
XLIII. SMC Pneumatics AB (Sweden) Financial Filings 2015-2016, Annual report 2002-2014
XLV. SMC Pneumatics VN (Vietnam): 2013 Financial Filings
### APPENDIX E: AUDITOR CHANGES AT SUBSIDIARIES

<table>
<thead>
<tr>
<th>Subsidiary</th>
<th>Consult.</th>
<th>FY March 09</th>
<th>FY March 10</th>
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(roles and audit firms are abbreviated for simplicity)
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