

Leoch International

Growth opportunities beyond 2011

to summarize...

- 2011A net profit at RMB284m; slightly below our expectation
- Apparent margin squeeze due to new segment growth and capacity ramp-up
- Maintain strong shipment growth and slight margin expansion in next 2 years
- Maintain BUY with Target Price unchanged at HK\$3.41
- Downside risk including tank formation to be regulated by government
- Review on environmental issues conducted; waiting for confirmation in July

2011A results slightly below our expectation. Leoch announced its 2011A annual results last week. Revenue increased 49.5% YoY to RMB3,164m largely on increased sales volume despite certain suspension during 2H 2011 on government induced lead acid industry consolidation. Gross profit increased by 24.3% to RMB654m with gross margin reduced to 20.7% for 2011A compared to 24.8% in 2010A. Net profit increased 10.1% to RMB284m on increased SG&A expenses at RMB293.8m for FY12/11A compared to RMB195.8m a year ago as the company is fast expanding its production capacity. The company proposed a final dividend of HK\$0.016 per share, which adds up to HK\$0.049 total dividend per share.

Table 1. Annual results overview

	FY12/09A	FY12/10A	FY12/11A	11A vs 10A
Revenue	1,392	2,117	3,164	+49.5%
Gross profit	289	526	654	+24.3%
EBIT	169	322	357	+10.9%
EBT	160	300	328	+9.3%
Net profit	145	258	284	+10.1%

Table 2. Actual figures for 1H FY12/11A and previous estimates

	FY12/11A	Our estimates	Deviation
Revenue	3,164	3,318	(4.6%)
Gross profit	654	756	(13.5%)
Net profit	284	294	(3.4%)
EPS (RMB)	0.21	0.22	--

Source: SBI E2-Capital

Our interpretation. As we have discussed in previous reports, Leoch top-line growth in 2011 may not be as high as some of its peers. Besides, with revenue, gross margin and net profit growth of 49.5%, 24.3% and 10.9% respectively in 2011A, apparent margin squeeze under the scenario of lead price uptrend was not especially encouraging to investors. Nevertheless, we believe slight reduction of per ton gross profit to around RMB4,500 was reasonable as it was among the second highest in the past 5 years. In addition, with capacity expansion underway from 5.9m kVAh in 2010 gradually to 23m kVAh by the end of 2012, substantial increase in staff cost and depreciation cost was largely in line with our estimation. As such, while we are still conducting review on environmental issues in light of recent release of regulatory specifications, we maintain our positive view partly on substantial increase in sales volume in the next 2 years.

Ticker	0842 HK
Rating	BUY
Price (HK\$)	1.96
Target Price (HK\$)	3.41 (+74.0%)
12m Price Range (HK\$)	1.68 - 4.22
Market cap. (US\$m)	335.0
Daily t/o (US\$m)	0.8
Free float (%)	25.0

Financial summary

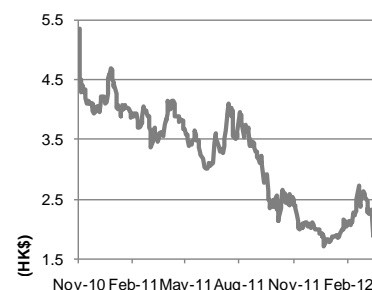
Year to Dec	10A	11A	12F	13F	14F
Turnover (RMBm)	2,117	3,164	4,870	7,247	10,040
Net Profit (RMBm)	258	284	440	708	999
EPS (RMB)	0.19	0.21	0.33	0.53	0.75
P/E (x)	14.3	7.5	4.8	3.0	2.1
P/B (x)	2.9	1.0	0.8	0.7	0.6
EV/EBITDA (x)	8.9	6.6	4.2	2.2	1.3
Yield (%)	0.0	0.0	5.2	8.2	11.6
ROE (%)	20.0	12.9	17.5	23.4	26.6
ROCE (%)	20.7	13.3	18.2	26.3	32.7
N. Gear. (%)	cash	14.4	33.9	3.8	10.1

Source: SBI/Bloomberg

	12F	13F	14F
Consensus EPS (RMB)	0.365	0.535	--
Previous earnings (RMBm)	471	723	--
Previous EPS (RMB)	0.353	0.542	--

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	(17.3)	(8.3)	(37.0)
Actual price changes (%)	(21.3)	2.1	(45.7)



Source: Bloomberg

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UPS business remained stable while sales to telecom sector partly pressured on gross margin in 2011A. Leoch continued to earn the major part of its income from UPS segment, representing 46.3% revenue and 45.1% gross profit in 2011. Gross margin was also stable at 20.1% for the period, compared to 20.5% in 2010. We believe it was partly because of its pricing strategy that based on per tonne gross profit. Nevertheless, there was an overall reduction in gross margin in 2011 that we attributed to unique telecom industry as well as relatively new SLI segment. While volume and pricing were commonly included in bidding for telecom contracts, gross margin in telecom segment was reduced to 18.9% for 2011A compared to 33.4% in 2010A. In addition, we believe that as SLI sales in 2011 increased relatively sharply by 87.5% YoY on competitive price, there was negative impact on overall margin. Table 3 shows turnover and gross margin of various segments of Leoch products for 2011A. Table 4 shows sales destination breakdown for the past 3 years.

Table 3. Sales breakdown for Leoch products for 2011A

RMBm	Turnover	Gross profit	Gross margin
UPS	1,466.5	294.7	20.1%
Telecom	616.1	116.5	18.9%
Other consumables	463.1	90.0	19.4%
SLI batteries	375.2	64.3	17.2%
Motive power batteries	178.0	50.1	28.2%
Renewable energy	65.2	34.7	53.2%
Total	3,164.1	653.7	20.7%

Table 4. Sales destination breakdown

RMBm	FY12/09A	FY12/10A	FY12/11A
China	625	878	1,553
EU	248	409	522
US	256	344	486
Other Asian countries	202	399	490
Others	59	86	114
Total	1,392	2,117	3,164

Source: SBI E2-Capital

Slight revision on shipment as well as gross profit per tonne. With recent suspension issues, 2011A shipment at 145,400 tonnes was lower than estimations. For 2012F and 2013F, while we expect a generally lower gross profit per tonne, we expect shipment to increase 81% YoY to 252,500 tonnes in 2012F and another 53% YoY to 402,500 tonne in 2013F. Table 5 shows our assumptions with respect to capacity, utilization and margin. Table 6 shows our revised profit forecast for FY12/12F and FY12/13F.

Table 5. Expansion riding on industry consolidation with slight squeeze in margin

	FY12/09A	FY12/10A	FY12/11A	FY12/12F	FY12/13F
Effective capacity in kWh m	3.5	5.9	9.6	15.0	23.0
Effective capacity in tonne	84,000	141,600	230,400	360,000	552,000
Utilization	84%	71%	63%	73%	73%
Shipment in tonne	70,250	100,000	145,400	262,500	402,500
Shipment growth rate	28%	42%	45%	81%	53%
Gross profit per tonne RMB	4,120	5,256	4,496	4,150	4,250

Table 6. Profit and loss forecast (Full-year)

RMB m	FY12/09A	FY12/10A	FY12/11A	FY12/12F	FY12/13F
Revenue	1,392	2,117	3,164	4,870	7,247
Cost of goods sold	(1,102)	(1,591)	(2,510)	(3,781)	(5,536)
Gross profit	289	526	654	1,089	1,711
Other income and gains	21	22	71	0	0
Selling and marketing expenses	(57)	(76)	(114)	(171)	(262)
Administrative expenses	(70)	(119)	(180)	(302)	(463)
Other operating expenses	(13)	(30)	(74)	(0)	(0)
Operating profit	169	322	357	617	986
Finance costs	(10)	(22)	(29)	(67)	(42)
Profit before tax	160	300	328	550	944
Income tax expense	(15)	(42)	(45)	(110)	(236)
Net profit	145	258	284	440	708
Reported EPS (RMB)	n.a.	0.243	0.213	0.330	0.531

Source: Leoch International

Table 7. Balance sheet items

RMB m	FY12/09A	FY12/10A	FY12/11A	FY12/12F	FY12/13F
Non-current assets	445	638	1,847	1,726	1,703
Property, plant and equipment	368	521	1,230	1,383	1,373
Prepaid land lease payments	42	58	75	138	137
Non-current portion of pledged deposits	0	0	366	0	0
Other non-current assets	35	59	177	205	193
Current assets	646	2,446	2,405	2,871	3,867
Inventories	181	688	991	1,288	1,290
Trade and bills receivables	340	585	804	1,064	1,517
Prepayments, deposits and other receivables	29	175	159	308	487
Time deposit with terms over 3 months	0	721	0	0	0
Pledged deposits	19	67	275	158	242
Cash and cash equivalents	43	179	73	54	332
Other current assets	35	31	102	0	0
Non-current liabilities	1	0	335	0	0
Current liabilities	593	1,004	1,586	1,883	2,237
Trade and bills payables	163	345	548	436	1,005
Other payables and accruals	131	161	247	271	487
Bank borrowings	173	417	741	1,131	700
Other current liabilities	126	81	51	45	45
EQUITY	497	2,080	2,330	2,713	3,333

Source: Leoch International

Target price remained at HK\$3.41; downside risk on tank formation process. Since we formally initiate coverage on Leoch at HK\$1.87, the counter traded up to HK\$2.76 in March before sharply retreating on suspension issues and somewhat weaker-than-market expected 2011A annual results. Yet we are positive on short-term growth rate in the coming 2 years. At target price HK\$3.41, we value the company trading at 8.4x and 5.2x P/E for FY12/12F and FY12/13F. Nevertheless, there is downside risk on operation side in connection to tank formation process. As far as we understand, while most of Leoch products are Cadmium-free, which is in compliance with latest draft-regulation, some of its facilities previously constructed utilizes tank formation process instead of container formation. While industry experts point out that immediate compliance is not required as container formation process is commonly used in China, potential need for adjustment would lead to partial suspension, in our view. We are currently working with the management to check the level of compliance with respect to specifications in latest draft-regulation (《铅蓄电池行业准入条件-征求意见稿》).

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