Leoch International

Weakened competition for growing demand

Leoch is a leading manufacturer of lead-acid batteries in China founded in 1999. According to Asia Battery Association, the Group was the largest lead-acid battery exporter and the third largest reserve power lead-acid battery manufacturer in China based on export revenue in 2009. Leoch remains customers-driven with respect to product development. The company received customer requests and developed moulds for products of 1,600 kinds including uninterruptible power supply (UPS), telecom reserve power, consumables and SLI batteries. The company offers one of the broadest lines of lead-acid batteries.

Investment summary

- Leoch is a vertically integrated lead acid battery producer in China
- Leoch is in the progress of facilities upgrades to better manage lead emissions
- Generally environmental compliant to benefit from consolidation esp. in 2012
- Current expansion plan gradually rolling out between 2011 and 2013
- China producers are gradually replacing suppliers from developed markets
- Broad range of lead acid battery products minimizing sector volatility
- Attractive valuation at 6.9x 2011F P/E on our estimates. Initiate BUY rating

Environmental compliant company to benefit from consolidation. All lead acid battery facilities located less than 300 meters from residential homes have been required to stop production for inspection. Tianneng Power (0819 HK), Leoch International (0842 HK) and Chaowei Power (0951 HK) suspended some of their productions. Since Vice-Premier of the State Council Li Keqiang is behind this regulatory induced consolidation (chairman of 全国污染源普查领导小组), it is expected that over 1,000 lead acid related facilities will be driven out of the market by the end of this year instead of temporal suspension, which represents half of the lead acid batteries companies in China. Leoch invested in environmental measures long before wave of suspensions within lead acid battery industry.

Leoch further upgrades facilities to manage lead emission by end of Q3 2011. A large number of lead acid motive batteries producers are still under suspension in a compulsory manner by end of 2011. At Q4, Leoch suspended Anhui and Zhaoqing facilities after some employees show higher-than-expected level of lead in a blood test. After discussion with Ministry of Health, Leoch voluntarily upgrades the facilities to better manage lead emission with assistance from consultants of Ministry of Health. While 2H 2011 and 1Q 2012 output volume are negatively affected, we expect strong growth to resume in Q2 2012 until at least 2013.

Current expansion plan gradually rolling out between 2011 and 2013. Since 2011, Leoch initiated a new round of expansion. Through 2011 to 2013, effective capacity is expected to increase by 3m kVAh to 7m kVAh each of the 3 years. With recent industry consolidation, we expect the company achieve utilization rate 70% to 80%. As such, shipment is expected to increase by 3.6 times from 2010 to 2013 while gross profit per tonne is expected to generally stay between RMB4,000 to RMB4,750 per tonne in the next 2-3 years. Of various products available, major growth should be seen in SLI and motive batteries according to management plan.

Peers valuation for the sector and the sector leader. BUY. Our previous reference target price was HK$4.32 based on preliminary studies. We now initiate a BUY rating on Leoch after further review with target price at HK$3.41, which has 1.6x implied P/B, 12.6x implied P/E and 8.1x implied EV/EBITDA for FY12/11F, after taking recent negative news into account. Further revision is possible on improved visibility on market growth after 2015.

Ticker	**0842 HK**
Rating	**BUY**
Price (HK$)	1.87
Target Price (HK$)	3.41 (+82%)
12m Price Range (HK$)	1.86 - 4.82
Market cap. (US$m)	319.7
Daily t/o (US$m)	0.5
Free float (%)	25.0

Financial summary

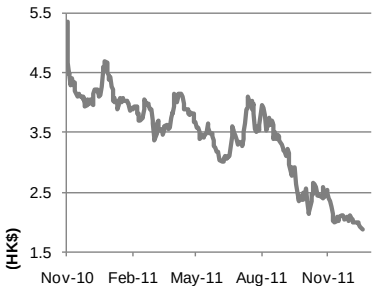
Year to Dec	09A	10A	11F	12F	13F
Turnover (RMBm)	1,392	2,117	3,318	5,092	7,266
Net Profit (RMBm)	145	258	294	471	723
EPS (RMB)	0.11	0.19	0.22	0.35	0.54
P/E (x)	25.3	14.3	6.9	4.3	2.8
P/B (x)	8.6	2.9	0.9	0.8	0.7
EV/EBITDA (x)	19.5	8.9	5.0	3.2	2.1
Yield (%)	0.0	0.0	3.5	5.7	8.7
ROE (%)	34.0	20.0	13.3	18.6	23.7
ROCE (%)	27.6	20.7	16.0	20.5	29.3
N. Gear. (%)	49%	cash	31%	16%	11%

Source: SBI/Bloomberg

	11F	12F	13F
Consensus EPS (RMB)	0.34	0.51	0.67
Previous earnings (RMBm)	n.a.	n.a.	n.a.
Previous EPS (RMB)	n.a.	n.a.	n.a.

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	(9.7)	(35.4)	(48.8)
Actual price changes (%)	(11.4)	(25.2)	(59.4)



Source: Bloomberg

Kevin Mak, CFA
(852) 2533 3708
kevinmak@sbie2capital.com

Content

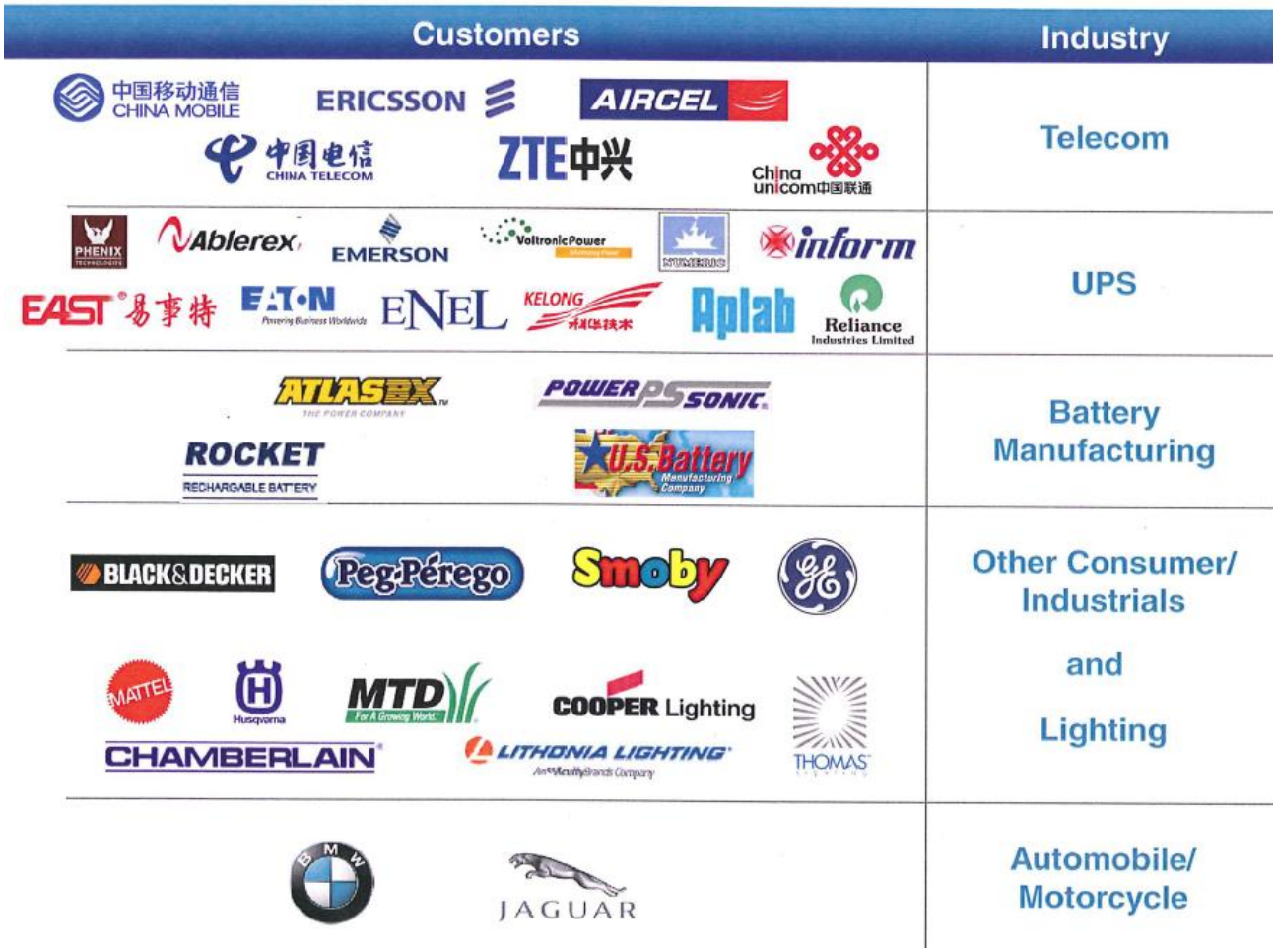
Investment thesis

Leoch provides widest range of lead acid battery products of higher entry barrier. Leoch was founded in 1999 and remained customer-driven with respect to product development. The company received customer requests and developed moulds for products of 1,600 kinds with capacity between 0.251Ah and 4,025Ah. To produce this wide range of customized products with different power, size, shape and working environment in short time frames, Leoch adopted vertical integration model covers all major battery manufacturing steps from confection of lead alloy ingots to assembly of finished products. Part of Anhui facilities produces models for consumable batteries requires over 4,000 staff post-expansion. It contrasts to most competitors that more focused on highly standardized models especially the motive batteries. Table 1 shows sales breakdown of Leoch and its peers as of FY12/10A. In addition to product customization, customer certifications are another reason of higher entry barrier. International brand names usually require suppliers' batteries to pass their own certifications. For instance, BMW (BMW EU), Jaguar and Mattel each took more than a year to visit the production facilities and review Leoch quality control functions before putting Leoch batteries onto their list. Other customers include Emerson Electric (EMR US), Eaton Corp (ETN US), US batteries, Black & Decker (SWK US), China Unicom (0762 HK), China Mobile (0941 HK) and China Telecom (0728 HK) and Haojue Group, etc. Diagram 1 shows major customers of Leoch in various industries.

Table 1. Sales breakdown as of FY12/10A

	UPS	Telecom	Consumable products	SLI batteries	Renewable energy	Motive batteries
Leoch International (0842 HK)	47%	24%	15%	7%	2%	1%
Tianneng Power (0819 HK)						97%
Chaowei Power (0951 HK)						99%
Coslight Group (1043 HK)		69%				
Camel Group (601311 CH)				92%		3%
Fengfan (600482 CH)				90%		
Zhejiang Narada Power (300068 CH)		> 50%				
China Shoto (CHNS LN)		84%				16%

Diagram 1. Major customers of Leoch in various industries



Source: Leoch International, SBI E2-Capital

Top-rank regulator induced industry consolidation in China is expected to be sustained. The Chinese government eventually suspended production of considerable number of lead acid factories since May this year due to environmental issue. All lead acid battery facilities located less than 300 meters from residential homes have been required to stop production for inspection. Tianneng Power (0819 HK), Leoch International (0842 HK) and Chaowei Power (0951 HK) suspended some of their productions. Since Vice-Premier of the State Council Li Keqiang is behind this regulatory induced consolidation (chairman of 全国污染源普查领导小组), it is expected that over 1,000 lead acid related facilities will be driven out of the market by the end of this year instead of temporal suspension, which represents half of the lead acid batteries companies in China.

Environmental compliant company to benefit from consolidation. We have visited company's Zhaoqing, Jiangsu and Anhui production bases Jul this year. All of Leoch's production bases are in industrial zone, where there is no household within a good range. In the 3 sites, there are water treatment facilities that remove lead content in accordance with environmental standards in China. At Zhaoqing and Anhui production facilities, purified water is collected and reused in the production process. At the Jiangsu production facility, waste water is discharged to the municipal sewer system after purification. On the other hand, dust filtration systems, acidic mist and lead fumes purifying machines are installed to minimize pollutants. MWH, an independent environmental consulting company, has confirmed there were no major non-compliance issues and generally display adequate measures to treat air emissions and wastewater discharge in 2010.

Recent suspension positioned to resume by end of Q1 2012. As for the production suspension of Leoch Dongguan facilities, we checked with the management that it Universiade (大運會) is to be held in Shenzhen between 12th and 23th in Aug. We believe Leoch is not connected to non-compliance issues as implied in the article and there is no major negative effect due to short period of suspension for small capacity of 3.5% production capacity in Dongguan. At Q4, Leoch suspended Anhui and Zhaoqing facilities after some employees show higher-than-expected level of lead in a blood test. After discussion with Ministry of Health, Leoch voluntarily upgrades the facilities to better manage lead emission with assistance from consultants of Ministry of Health. While 2H 2011 and 1Q 2012 output volume are negatively affected, we expect strong growth to resume in Q2 2012 until at least 2013.

Strong pricing of lead acid battery products in 2H and implication for Leoch. With industry consolidation, it is expected that short-term supply is largely reduced, supporting good pricing of lead batteries. For instance, Tianneng raised ASP by 8%-10% once in Jul and another 8%-10% again in Aug, which in total raised ASP by 16%-20%. In general, motive lead acid batteries are more aggressive in pricing in both uptrend and downtrend for their highly standardized products. On the contrary, Leoch provides wide range of products to customers with relative stable cost-plus model. That said, we believe there is no major increment in profit margin for Leoch. Yet, we believe timing of the current consolidation fits Leoch expansion plan well. While Leoch gradually increases capacity to 23m kVAh by 2013 from 5.9m kVAh in 2010, current market condition should facilitate Leoch to raise sales and open new sub-sectors at good pricing in short-term.

Photo set 1. Waste water treatment at Zhaoqing plant

Photo set 2. Waste water before and after treatment at Zhaoqing plant

Source: Site visit

Current expansion plan gradually rolling out between 2011 and 2013. Table 2 shows our forecast on effective capacity, utilization, shipment and gross profit per tonne in the coming 2-3 years up to 2013. Leoch purchases equipments both domestically and by imports. Since 2011, Leoch initiated a new round of expansion. Through 2011 to 2013, effective capacity is expected to increase by 3m kVAh to 7m kVAh each of the 3 years. With recent industry consolidation, we expect the company achieve utilization rate up to 80%. As such, shipment is expected to increase by 3.6 times from 2010 to 2013 while gross profit per tonne is expected to generally stay between RMB4,000 to RMB4,500 per tonne in the next 2-3 years. Of various products available, major growth should be seen in SLI and motive batteries according to management plan.

Table 2. Expansion riding on industry consolidation with slight squeeze in margin

	FY12/09A	FY12/10A	FY12/11F	FY12/12F	FY12/13F
Effective capacity in kWh m	3.5	5.9	9.6	16.5	23.0
Effective capacity in tonne	84,000	141,600	230,400	396,000	552,000
Utilization	84%	71%	73%	73%	83%
Shipment in tonne	70,250	100,000	168,000	288,750	460,000
Shipment growth rate	28%	42%	68%	72%	59%
Gross profit per tonne RMB	4,120	5,256	4,500	4,000	4,000

Source: SBI E2-Capital

Peers valuation for the sector and the sector leader. We valued Leoch at HK$3.41 with 15% discount rate, which has 1.6x implied P/B, 12.6x implied P/E and 8.1x implied EV/EBITDA for FY12/11F as shown in Table 3. Currently, Leoch is trading at attractive valuation compared to its peers in HK. See Table 4.

Table 3. Implied multiples of our target price

	FY12/11F	FY12/12F	FY12/13F
Implied P/B (x)	1.6	1.4	1.1
Implied P/E (x)	12.6	7.9	5.1
Implied EV/EBITDA (x)	8.1	5.4	3.5

Source: SBI E2-Capital

Table 4. Peers valuation statistics

Company	Ticker	Fiscal Year End	Mkt Cap (US$m)	FY10A P/E	FY11F P/E	FY12F P/E	P/B (x)	ROE (%)
Leoch Int'l	842 HK Equity	12/2010	321.7	6.1	5.0	3.2	1.0	20.0
Tianneng Power	819 HK Equity	12/2010	476.7	6.7	4.8	3.5	1.5	19.0
Chaowei Power	951 HK Equity	12/2010	389.1	7.9	4.5	3.7	1.8	26.1
Coslight Tech	1043 HK Equity	12/2010	91.7	n.a.	3.2	4.5	0.4	0.6
			avg:	6.9	4.4	3.7		
Camel Group	601311 CH Equity	12/2010	1,047.9	15.5	20.1	13.3	6.2	33.1
Zhejiang Narada	300068 CH Equity	12/2010	542.7	62.5	46.3	16.1	1.4	5.3
Fengfang	600482 CH Equity	12/2010	488.8	70.2	34.3	21.2	2.9	4.5
			avg:	49.4	33.6	16.9		

Source: Bloomberg

Market background

Can lead acid batteries compete in modern times? Yes we believe so. As energy storage unit, there is a wide range of devices from capacitors, super-capacitors to batteries and fuel cells. Batteries are widely used for industrial purposes with its good energy density and average power density. For industrial rechargeable battery, according to Asia Battery Association, lead acid batteries continued to be the largest group in global market with over 70% market share, followed by nickel batteries at 20% and lithium batteries at less than 10%. Although production of lead acid battery is often linked to environmental problems, it is the most economical option on per energy basis, which is especially important for industrial use. Table 5 shows simple comparison among lead acid batteries, nickel batteries, lithium batteries as well as reusable alkaline batteries. Lead acid batteries work well when 1) weight is not a concerned; 2) fast charging is not required; and 3) deep cycle discharge is not required. For instance, lead acid batteries is most economical to serve as reserve power, which is the main product focus of Leoch, making up 80%+ revenue as of 1H FY12/11A.

Table 5. Types of batteries to compare

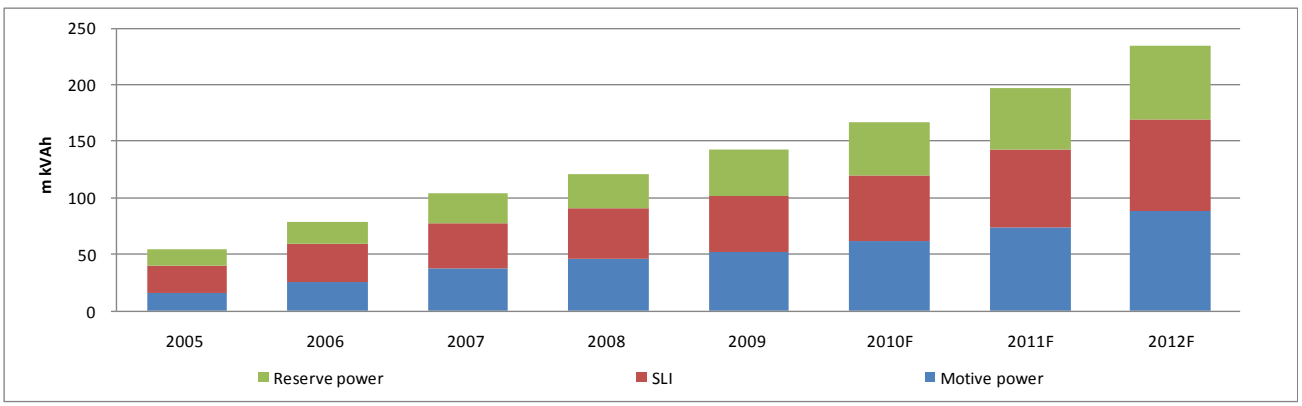
	Lead acid	NiCd	NiMH	Re. Alkaline	Li-ion	Li-ion polymer
Cost issues						
Low cost per energy	***	***	**	*	**	*
Low cost of manufacturing	***	**	**	*	*	*
Performance issues						
Low internal resistance	***	**	*	*	**	*
Low self-discharge rate	***	*	*	***	**	**
Good performance at low temperature	**	***	**	*	**	*
Low maintenance requirement	**	*	*	***	***	***
Long cycle life	**	***	**	*	***	**
Immunity to deep cycle wear-down	*	**	**	***	***	***
High energy density on weight basis	*	**	**	**	***	***
Fast charge time	*	***	**	**	**	**
Environmental and safety issues						
Overcharge tolerance	***	**	*	**	*	*
Lack of toxic substances / pollutants	*	*	***	***	***	***
Commercial use since	1970s	1950s	1990s	1990s	1990s	2000s

Source: Battery University, Asia Battery Association, SBI E2 Capital

Is global lead battery market shrinking? Apparently not. In 2005, global lead acid battery market size was measured at 270m kVAh, according to Asia Battery Association. With 6% compound annual growth rate (CAGR) between 2005 and 2009, global lead acid battery market grew to 340kVAh. It is now estimated that in 2012 the figure would further increase to 385m kVAh with a similar CAGR. According to our channel checks, with full equipments that compile with environmental regulations taking account into initial investment as well as production cost, lead acid batteries is still most competitive especially for industrial use. That said we believe demand for lead acid batteries would continue to be strong in short-term with short-term fall in supply.

Increasing market share of Chinese players in global market. In additional to organic growth in global market, China peers is capturing higher market share of the global market. The diagram below shows size of China lead acid batteries market between 2005 and 2009 with projection up to 2012. Motive power, SLI and reserve power may experience CAGR at 19.2%, 17.8% and 17.5% respectively. In fact, Leoch plans to expand its capacity mainly in the 2 segments rather than simple reserve power, which can further widen and balance its product portfolio that could largely minimize concentration risk on certain particular sub sector.

Diagram 2. China lead acid battery market size in kVAh



Source: Asia Battery Association, Frost & Sullivan, SBI E2-Capital

Business analysis

Types of lead acid Leoch provides for different sub-sectors. Table 6 shows sales breakdown for various product types for 1H FY12/11A. While UPS remained to be the largest segment, SLI batteries, motive batteries and products for renewable energy rose quickly to contribute meaningfully. Of the new capacity in progress, 25 lines go to SLI batteries and another 25 lines go to motive power batteries. Going forward, SLI batteries and motive power batteries would be major revenue and volume drivers for the company. For instance, Leoch passed the accreditation of Haojue Group, the largest motorcycle manufacturer in China to become one of its certified suppliers to supply SLI battery to Haojue Group for its Haojue and Suzuki brand of motorcycle.

Table 6. Sales breakdown of Leoch products (1H FY12/11A)

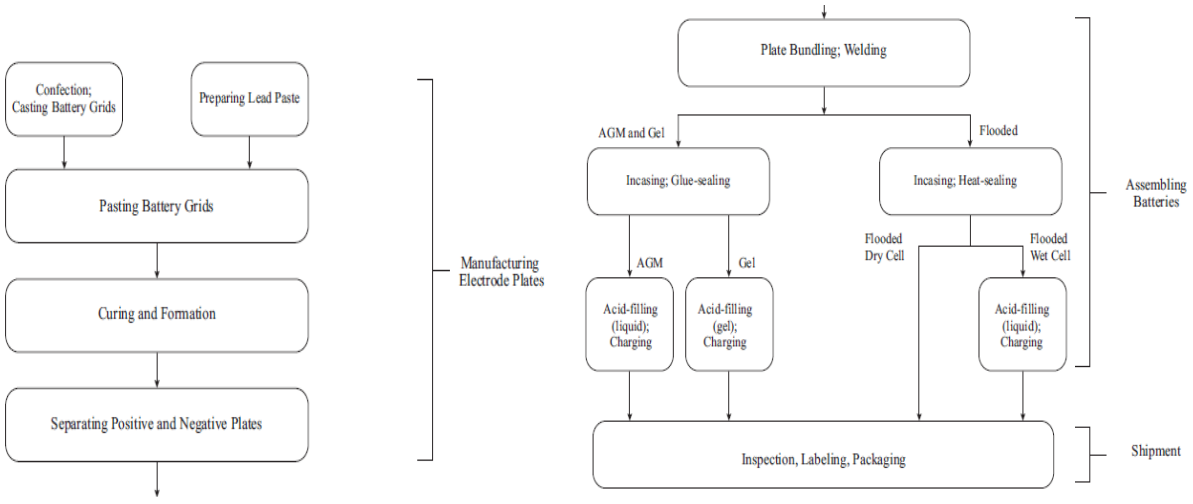
RMBm	Turnover	Gross profit	Gross margin
Reserve battery			
UPS	712	152	21.3%
Telecom	337	89	26.3%
Other consumables	209	45	21.5%
Renewable energy	33	19	57.2%
SLI batteries	178	38	21.4%
Motive power batteries	63	18	28.1%
Others	15	1	9.5%
Total	1,548	361	23.3%

Source: SBI E2-Capital

Strong R&D capability with support from local and International expert. Leoch has strong R&D capability. The elder brother of Chairman Mr. Dongli is himself an expert on lead acid battery in China. Dr. Geoffrey J. May was the chief technology officer of FIAMM, a world famous manufacturer of lead acid battery incorporated in 1942 which is also one of the few providers of pure lead batteries. According to the management, Leoch paid Dr. May a lump sum payment for assistance on development of the technology and design of pure lead batteries and an additional fee for advising on production equipment and production process setup. Dr. May undertakes periodic visits to the production facilities. In Jiangsu facility, we saw a highly-automatic pure lead battery production line in operation.

Vertical integrated production process model. Leoch intends to carry out most of the major steps in battery manufacturing in house. In addition to producing molds for battery grids and battery cases, Leoch melts lead ingots to produce battery grids and grounds lead into power for preparation of lead paste. Besides, Leoch is extending its manufacturing capacity to include terminals, separators and gel. Vertical integration enables Leoch to provide a wide range of customized lead acid battery products at relatively controllable cost structure. As such, pricing is largely stable and on dollar-plus-lead cost basis.

Illustration 1. Leoch production process of conventional lead acid batteries



Source: Leoch International

Leoch per ton base pricing mechanism reducing price risk of its products. Leoch has prudent pricing mechanism. Upon receiving purchase order, the company quote product price on a dollar-plus-cost basis to customers after getting lead price quotes. Therefore, while revenue largely depends on lead price, we strongly suggest investors to look at gross profit in dollar terms.

Sales and marketing in China and international market. Leoch sells its products both in domestic market and international market. For 1H FY12/11A, revenue from China was RMB720m, which was equivalent to 47% of total sales for the period. For domestic sales, Leoch has sales representative offices to promote its self-branded products and provide after-sales services. Typically Leoch solicited sales with customers directly partly due to lack of product standardization. On the other hand, for international sales, Leoch mainly provides OEM services to international players in additional to its own brand name. While most of the transactions are quoted in US$, Leoch does not enter into any hedging transactions to manage potential fluctuation in foreign currency, according to the management. In fact, we believe Leoch is one of the leading lead acid battery producers prepared to capture higher market share in global market as we have discussed.

Table 7. Sales destination breakdown

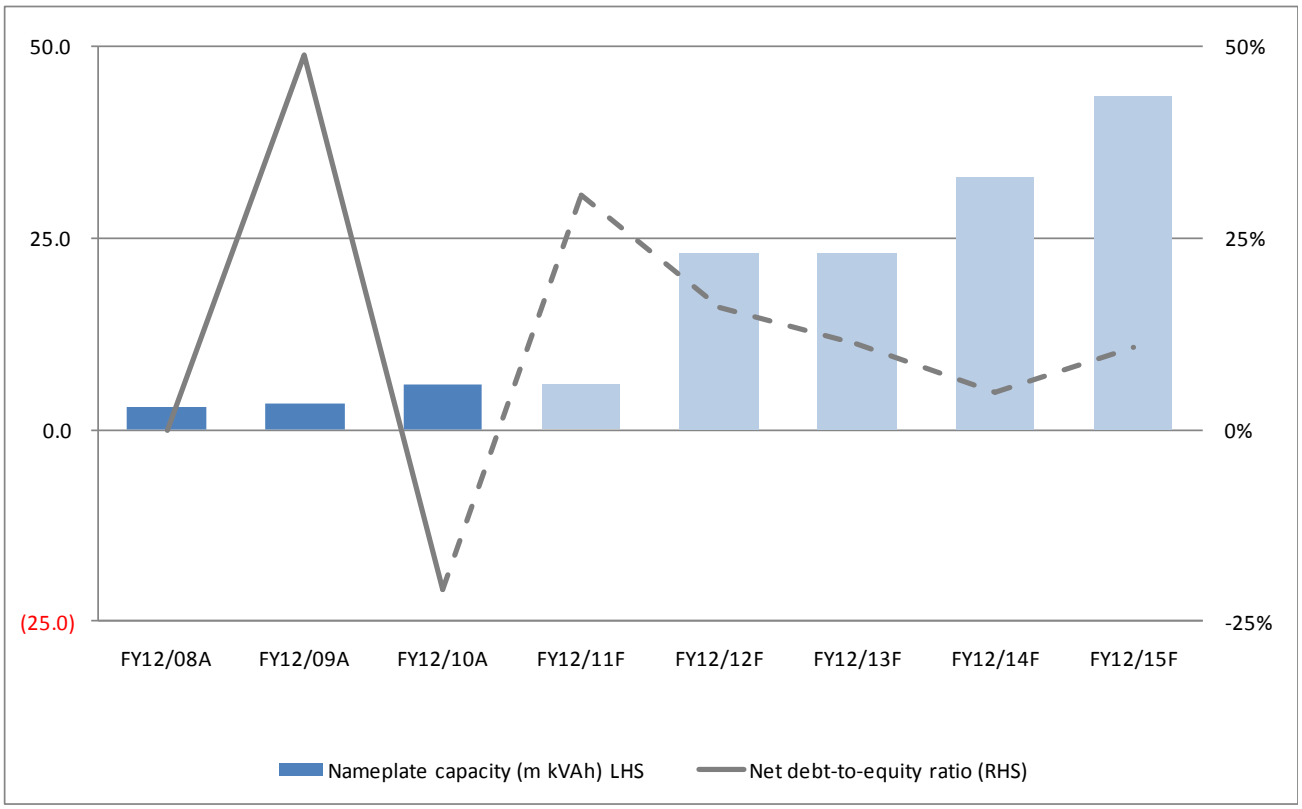
RMBm	FY12/09A	FY12/010A	1H FY12/11A
China	625	878	720
EU	248	409	293
US	256	344	215
Other Asian countries	202	399	258
Others	59	86	62
Total	1,392	2,117	1,548

Source: SBI E2-Capital

Fully funded expansion at least up to 2012. At the end of 2007, Leoch began to accelerate capacity expansion. In 2 years, capacity increased 75% 3.5mkVAh by end of 2009. By the end of 2010, Leoch has aggressive plan to raise capacity eventually to 23m kVAh by the end of 2012. For this round of expansion, we expect CAPEX to be RMB1,000m is required, where RMB750m should be spent on or before 2011. Leoch has RMB721m time-deposit and RMB179m by end of 2010, which could fund the expansion plan without any extra equity requirement, in our view. In addition, we believe Leoch to benefit from increased shipment and price support in light of recent consolidation since 2H this year, which generates sufficient cash for ongoing expansion progress.

Our hypothesis on further expansion. While we believe lead acid battery market to continue growing in medium-term, we expect Leoch to further expansion its capacity without being over-aggressive. In our hypothesis, we assume net cash position for Leoch in short-to-medium terms. For instance, between 2012 and 2015, we assume net-debt-to-equity ratio to stay generally between 0% and 15%. For 2016 onwards, the said ratio is assumed to go up to 10%+. As such, in the next 5 years, Leoch may raise its capacity by 10m kVAh each year. Diagram 3 shows our assumption on Leoch further expansion plan in the next 5 years.

Diagram 3. Hypothesis on future expansion plan in the next 5 years



Source: SBI E2-Capital

Financial information

Track record and profit forecast. Table 8 shows half year profit and loss since 1H FY12/11A while Table 9 shows full year profit and loss since FY12/09A. Leoch listed in HK in Nov 2010 and FY12/11F is the first full year results post-listing. While lead acid battery industry is under consolidation as discussed, we expect shipment to be strong with support in selling prices and thus profit margin. That said, we expect strong growth in both top-line and bottom-line until 2013. For instance, under our assumptions, revenue would increase to RMB3,318m, RMB5,092m and RMB7,266m for FY12/11F, FY12/12F and FY12/13F respectively. Net profit for the 3 periods would be RMB194m, RMB471m and RMB723m respectively. In fact, 1H FY12/11A already delivered satisfactory results. For the latest interim, which largely reflected market condition before industry consolidation began, recognized 32% YoY increase in revenue with gross margin between 20% and 25%. While for 2H FY12/11F, we estimate Leoch to achieve RMB1,770m sales with gross margin at 22% and net margin at 6% that reflects negative effect of upgrade suspension. Table 10 on the next page shows the balance sheet of Leoch. Leoch received IPO proceeds by late 2010 and remained financially strong.

Table 8. Profit and loss forecast (Half-year)

RMB m	1H FY12/10A	2H FY12/11A	1H FY12/11A	2H FY12/11F
Revenue	944	1,172	1,548	1,770
Cost of goods sold	(708)	(884)	(1,186)	(1,376)
Gross profit	237	289	361	395
Other income and gains	5	17	27	0
Selling and marketing expenses	(27)	(49)	(43)	(75)
Administrative expenses	(55)	(65)	(79)	(122)
Other operating expenses	(1)	(29)	(33)	0
Operating profit	160	162	233	198
Finance costs	(10)	(13)	(20)	(44)
Profit before tax	150	150	214	153
Income tax expense	(23)	(19)	(31)	(42)
Net profit	127	131	182	111

Table 9. Profit and loss forecast (Full-year)

RMB m	FY12/09A	FY12/10A	FY12/11F	FY12/12F	FY12/13F
Revenue	1,392	2,117	3,318	5,092	7,266
Cost of goods sold	(1,102)	(1,591)	(2,562)	(3,937)	(5,426)
Gross profit	289	526	756	1,155	1,840
Other income and gains	21	22	27	0	0
Selling and marketing expenses	(57)	(76)	(118)	(188)	(299)
Administrative expenses	(70)	(119)	(202)	(332)	(529)
Other operating expenses	(13)	(30)	(33)	(0)	(0)
Operating profit	169	322	431	635	1,012
Finance costs	(10)	(22)	(64)	(47)	(48)
Profit before tax	160	300	367	589	964
Income tax expense	(15)	(42)	(73)	(118)	(241)
Net profit	145	258	294	471	723
Reported EPS (RMB)	n.a.	0.243	0.220	0.353	0.542

Source: Leoch International

Short-term pressure on working capital. shows pro-forma balance sheet items of Leoch. Since Leoch is in suspension for upgrades in certain procedures, we believe that a short-term surge in inventory is possible. For the year end 2011, we estimate inventory level could reach RMB1,137m, which is equivalent to 80%+ COGS of 2H FY12/11F.

Table 10. Balance sheet items

RMB m	FY12/08A	FY12/09A	FY12/10A	FY12/11F	FY12/12F
Non-current assets	382	445	638	1,325	1,347
Property, plant and equipment	301	368	521	1,154	1,173
Prepaid land lease payments	40	42	58	115	117
Other non-current assets	41	35	59	56	57
Current assets	411	646	2,446	2,392	3,055
Inventories	99	181	688	1,137	1,236
Trade and bills receivables	230	340	585	869	1,084
Prepayments, deposits and other receivables	13	29	175	143	345
Time deposit with terms over 3 months	0	0	721	0	0
Pledged deposits	15	19	67	101	173
Cash and cash equivalents	36	43	179	141	217
Other current assets	20	35	31	0	0
Non-current liabilities	0	1	0	0	0
Current liabilities	437	593	1,004	1,396	1,668
Trade and bills payables	142	163	345	356	668
Other payables and accruals	118	131	161	190	350
Bank borrowings	64	173	417	800	600
Other current liabilities	114	126	81	50	50
EQUITY	356	497	2,080	2,322	2,734

Source: Leoch International

Valuation

Valuation assumption. We estimate 5-year cash flow to equity holder of Leoch to 2015F, followed by a 2-stage slow growth of 5% for 2 more years with a terminal growth rate of 2%. We believe it is government intention to consolidate lead acid battery industry in the next 5 years to develop and promote a handful of industry leaders that can leverage economies of scale. Besides, it is likely that China producers would capture majority of global market share by then, in our view. Afterwards, without clear earning visibility beyond 2015, we conservatively assume 5% growth rate for each of 2016 and 2017, followed by 2% terminal growth rate. At 15% discount rate, we value Leoch at HK$3.41, which represents 82% upside from current price at HK$1.87. Initiate BUY.

Table 11. Our valuation assumption

Rationale / Measures	Implication
Top government led industry consolidation	Comparatively foreseeable fast growth for industry leaders for at least the 5-year term
China became major producer in 2015	5% growth in 2016 and 2017 followed by terminal growth rate of 2% afterwards
Discount rate at 15%	Corresponding to fair beta of 1.13

Table 12. Our target price

Discount Rate	14%	15%	16%
Market cap (RMB)	4,668m	3,859m	3,299m
CNY / HKD	1.22	1.22	1.22
Market cap (HK$)	5,717m	4,725m	4,040m
number of shares	1,333m	1,333m	1,333m
Target price	HK$4.29	HK$3.54	HK$3.03

Table 13. Implied multiples of our target price

	FY12/11F	FY12/12F	FY12/13F
Implied P/B (x)	1.6	1.4	1.1
Implied P/E (x)	11.8	8.2	5.3
Implied EV/EBITDA (x)	7.7	5.6	3.8

Source: SBI E2-Capital

Peers comparison. There are 3 major HK-listed lead acid battery producers, Leoch, Tianneng Power and Chaowei Power. While Tianneng and Chaowei are more focused on motive lead acid batteries in contrast to Leoch, all three of them are trading at similar P/E between 4.5 and 5.0x for FY12/11F based on Bloomberg consensus. Note that, however, Leoch is trading at lowerst P/B of 1.0x compared to the other 2. We expect Leoch to gain from re-rating of the sector and trade at a slight premium over its peers given its growth potential in short-term as well as strong sense on environmental issues.

Table 14. Peers comparison based on market consensus

Company	Ticker	Fiscal Year End	Mkt Cap (US$m)	FY10A P/E	FY11F P/E	FY12F P/E	P/B (x)	ROE (%)
Leoch Int'l	842 HK Equity	12/2010	321.7	6.1	5.0	3.2	1.0	20.0
Tianneng Power	819 HK Equity	12/2010	476.7	6.7	4.8	3.5	1.5	19.0
Chaowei Power	951 HK Equity	12/2010	389.1	7.9	4.5	3.7	1.8	26.1
Coslight Tech	1043 HK Equity	12/2010	91.7	n.a.	3.2	4.5	0.4	0.6
			avg:	6.9	4.4	3.7		
Camel Group	601311 CH Equity	12/2010	1,047.9	15.5	20.1	13.3	6.2	33.1
Zhejiang Narada	300068 CH Equity	12/2010	542.7	62.5	46.3	16.1	1.4	5.3
Fengfang	600482 CH Equity	12/2010	488.8	70.2	34.3	21.2	2.9	4.5
			avg:	49.4	33.6	16.9		

Source: Bloomberg

Table 15. Major shareholders

	Shareholding
Chairman Dong Li	75%
Public	25%
Total	100%

Source: HKEx

Appendix – Infopage

P&L (RMBm)	09A	10A	11F	12F	13F
Year to Dec					
Turnover	1,392	2,117	3,360	5,164	7,266
% chg	52	83	54	41	39
Gross profit	289	526	798	1,155	1,840
EBITDA	202	366	591	766	1,155
Depre./amort.	(32)	(44)	(118)	(131)	(143)
EBIT	169	322	473	635	1,012
Net int. income/(exp.)	(10)	(22)	(64)	(47)	(48)
Exceptionals	0	0	0	0	0
Associates	0	0	0	0	0
Jointly-controlled entit.	0	0	0	0	0
Pre-tax profit	160	300	409	589	964
Tax	(15)	(42)	(82)	(118)	(241)
Minority interests	0	0	0	0	0
Net profit	145	258	327	471	723
% chg	95	77	27	44	54
Dividends	(0)	(0)	(80)	(115)	(177)
Retained earnings	145	258	247	356	546
EPS (RMB) - Basic	-	-	0.246	0.353	0.542
EPS (RMB) - F.D.	-	-	0.246	0.353	0.542
DPS (RMB)	-	-	0.060	0.087	0.133
No. sh.s o/s (m) - W.A.	-	-	1,333	1,333	1,333
No. sh.s o/s (m) - Y.E.	-	-	1,333	1,333	1,333
No. sh.s o/s (m) - F.D.	-	-	1,333	1,333	1,333
Margins (%)					
Gross	21	25	24	22	25
EBITDA	14	17	18	15	16
EBIT	12	15	14	12	14
Pre-tax	11	14	12	11	13
Net	10	12	10	9	10

Balance Sheet (RMBm)	09A	10A	11F	12F	13F
Year to Dec					
Fixed assets	368	521	1,154	1,173	1,180
Intangible assets	3	3	0	0	0
Other LT assets	75	114	172	174	175
Cash	43	900	153	217	428
Accounts receivable	340	585	888	1,093	1,694
Other receivables	29	175	147	348	448
Inventories	181	688	1,137	1,279	1,248
Due from related co.s	34	5	0	0	0
Other current assets	19	94	101	173	276
Total assets	1,091	3,084	3,752	4,458	5,449
Accounts payable	(163)	(345)	(356)	(687)	(725)
Other payable	(131)	(161)	(190)	(360)	(384)
Tax payable	(13)	(33)	(0)	(0)	(0)
Due to related co.s	(54)	(48)	(50)	(50)	(50)
ST debts	(173)	(417)	(800)	(600)	(900)
Other current liab.	(58)	(0)	(0)	(0)	(0)
LT debts	(0)	(0)	(0)	(0)	(0)
Other LT liabilities	(1)	(0)	(0)	(0)	(0)
Total liabilities	(594)	(1,004)	(1,396)	(1,697)	(2,059)
Share capital	0	114	114	114	114
Reserves	497	1,966	2,241	2,647	3,276
Shareholders' funds	497	2,080	2,356	2,761	3,390
Minority interest	0	0	0	0	0
Total	497	2,080	2,356	2,761	3,390
Capital employed	670	2,496	3,156	3,361	4,290
Net (debt)/cash	(130)	483	(647)	(383)	(472)

Cash Flow (RMBm)	09A	10A	11F	12F	13F
Year to Dec					
EBIT	160	300	409	589	964
Depre./amort.	32	44	118	131	143
Net int. paid	9	19	64	47	48
Tax paid	(9)	(24)	(82)	(118)	(241)
Others	(16)	13	0	0	0
Gross cashflow	176	352	509	648	914
Chgs. in working cap.	(203)	(733)	(683)	(48)	(607)
Operating cashflow	(27)	(381)	(174)	601	307
Capex	(84)	(225)	(750)	(150)	(150)
Free cashflow	(111)	(606)	(924)	451	157
Dividends paid	(10)	(148)	(52)	(65)	(94)
Net distribution to MI	-	-	-	-	-
Investments	0	(1)	0	0	0
Disposals	2	2	0	0	0
New shares	16	1,440	0	0	0
Change in bank loans	110	243	383	(200)	300
Others	1	(794)	566	(121)	(151)
Net cashflow	7	136	(26)	64	212
Cash reserve - Beg.	36	43	179	153	217
Cash reserve - End.	43	179	153	217	428

Interim Results (RMBm)	1H 10A	2H 10A	1H 11A
Six months to Jun			
Turnover	944	1,172	1,548
% chg	57	48	64
Profit from operations	160	162	233
Interest expenses	(10)	(13)	(20)
Associates	0	0	0
Jointly-controlled entit.	0	0	0
Pre-tax profit	150	150	214
Tax	(23)	(19)	(31)
Minority interests	0	0	0
Net profit	127	131	182
% chg	118	50	44
EPS (RMB) - Basic	0.095	0.098	0.137
DPS (RMB)	0	0	0

Shareholding Structure

	Shares o/s (m)	%
Dong Li	1,000	75.0
Public	333	25.0
Total	1,333	100.0

Background

Leoch is a leading manufacturer of lead-acid batteries in China founded in 1999. According to Asia Battery Association, the Group was the largest lead-acid battery exporter and the third largest reserve power lead-acid battery manufacturer in China based on export revenue in 2009. Leoch remains customers-driven with respect to product development. The company received customer requests and developed moulds for products of 1,500 kinds including uninterruptible power supply (UPS), telecom reserve power, consumables and SLI batteries.

Key Ratios	09A	10A	11F	12F	13F
Net gearing (%)	49	Cash	30	16	15
Net ROE (%)	34	20	15	18	24
EBIT ROCE (%)	25	13	15	19	24
Dividend payout (%)	-	-	24	24	24
Effective tax rate (%)	9	14	20	20	25
Net interest coverage (x)	14	16	14	21	18
A/R turnover (days)	75	80	80	70	70
A/P turnover (days)	50	58	50	48	48
Stock turnover (days)	46	100	130	110	85

SBI E2-Capital is a dedicated small/mid cap investment banking/ stockbrokerage house. Find our research on: sbie2capital.com, thomsononeanalytics.com, factset.com and multex.com

SBI E2-Capital stock ratings:

STRONG BUY : absolute upside of >50% over the next three months

BUY : absolute upside of >10% over the next six months

HOLD : absolute return of -10% to +10% over the next six months

SELL : absolute downside of >10% over the next six months

Investors should assume that SBI E2-Capital is seeking or will seek investment banking or other related businesses with the companies in this report.

Analyst certification: The views expressed in this report accurately reflect the analyst's personal views of the subject securities and that the analyst has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

Disclaimer: This research report is not an offer to sell or the solicitation of an offer to buy or subscribe for any securities. The securities referred to in this report may not be eligible for sale in some jurisdictions. The information contained in this report has been compiled by the Research Department of SBI E2-Capital Financial Services Limited ('SBI E2-Capital') from sources that it believes to be reliable but no representation, warranty or guarantee is made or given by SBI E2-Capital or any other person as to its accuracy or completeness. All opinions and estimates expressed in this report are (unless otherwise indicated) entirely those of SBI E2-Capital as of the date of this report only and are subject to change without notice. Neither SBI E2-Capital nor any other person, accepts any liability whatsoever for any loss howsoever arising from any use of this report or its contents or otherwise arising in connection therewith. Each recipient of this report shall be solely responsible for making its own independent investigation of the business, financial condition and prospects of the companies referred to in this report. SBI E2-Capital and their respective officers, directors and employees, including persons involved in the preparation or issuance of this report, may from time to time (1) have positions in, and buy or sell, the securities of companies referred to in this report (or related investments); (2) have a consulting, investment banking or broking relationship with any company referred to in this report; and (3) to the extent permitted under applicable law, have acted upon or used the information contained or referred to in this report including effecting transactions for their own account in an investment (or related investment) in respect of any company referred to in this report, prior to or immediately following its publication. This report may not have been distributed to all recipients at the same time. This report is issued only for the information of and may only be distributed to professional investors and dealers in securities and must not be copied, published, reproduced or redistributed (in whole or in part) by any recipient for any purpose. This report is distributed in Hong Kong by SBI E2-Capital. Any recipient of this report who requires further information regarding any securities referred to in this report should contact the relevant office of SBI E2-Capital located in such recipient's home jurisdiction.