Leoch International

Negative regulatory impact update

to summarize…

- Leoch issued profit warning on reduced utilization of increasing capacity
- MIIT issued closure order by end of 2012 for 15.4m kVAh inefficient capacity
- Leoch Zhaoqing facility suspended for upgrade in relation to air-tight systems
- Sales and gross profit per tonne assumptions down mainly for 2012F - 2013F
- Target price lowered to HK$2.53 from HK$3.41. Maintain BUY.

Ticker	0842 HK
Rating	**BUY**
Price (HK$)	1.08
Target Price (HK$)	2.53 (+134%)
12m Price Range (HK$)	1.05 - 4.22
Market cap. (US$m)	184.8
Daily t/o (US$m)	0.2
Free float (%)	25.1

Financial summary

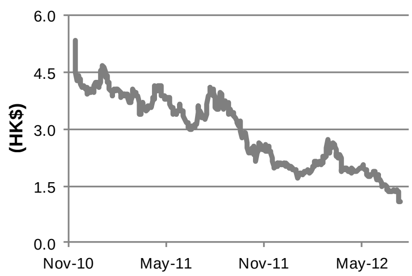
Year to Dec	10A	11A	12F	13F	14F
Turnover (RMBm)	2,117	3,164	4,085	6,125	9,432
Net Profit (RMBm)	258	284	293	478	871
EPS (RMB)	0.19	0.21	0.22	0.36	0.65
P/E (x)	4.6	4.2	4.0	2.5	1.4
P/B (x)	0.9	0.5	0.5	0.4	0.3
EV/EBITDA (x)	1.9	3.6	3.6	2.7	0.8
Yield (%)	0.0	0.0	6.1	4.9	9.0
ROE (%)	20.0	12.9	12.0	17.1	25.4
ROCE (%)	20.7	13.3	11.9	17.5	24.4
N. Gear. (%)	Cash	14.4	28.7	34.0	35.9

Source: SBI/Bloomberg

	12F	13F	14F
Consensus EPS (RMB)	0.330	0.530	0.610
Previous earnings (RMBm)	440	708	--
Previous EPS (RMB)	0.330	0.531	--

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	(28.3)	(40.5)	(63.1)
Actual price changes (%)	(28.9)	(44.9)	(67.5)



Source: Bloomberg

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

Leoch announced profit warning on less-than-expected utilization. Leoch announced profit warning for 1H FY12/12F. It expects decline in net profit for 1H FY12/12F, due to increase in cost of sales as a result of installation of new production capacity in 2012 which offset the increase in sales. For 1H FY12/11A and 2H FY12/11A, revenue were RMB1,548m and RMB1,616m, while net profit were RMB182m and RMB101m. That said, if net profit is to decline by at 50% YoY, net profit for 1H FY12/12F will be RMB91m, which is even smaller than that for 2H FY12/11A. As Leoch is expanding its capacity from 5.9m kWh in 2010 gradually to 23m kWh next year, without sufficiently high utilization rate, increase in sales will be offset by increase in costs including depreciation as this year’s capacity is expected at 15m kWh, in our view.

Table 1. Profit warning and expectation for 1H FY12/12F

	1H FY12/11A	2H FY12/11A	1H FY12/12F
Revenue	1,548	1,616	1,600+
Operating profit	233	124	n.a.
Net profit	182	101	~91
Period-end capacity (kVAh)	5.9	9.6	15.0

Source: SBI E2-Capital

Capacity suspension matters. Last week, Ministry of Industry and Information Technology of PRC (MIIT) announced the first batch of compulsory closure of inefficient facilities (《2012 年 19 个工业行业淘汰落后产能企业名单(第一批)公告》). For lead acid batteries, there are 92 facilities of 15.4m kVAh manufacturing capacity to be closed this year including facilities of Tianneng (0819 HK), Coslight Tech (1043 HK), Feng Fan (600482 CH) and Camel Group (601311 CH). See Table 2 for the summary. While this first batch of 15.4m kVAh is not large compared to up to 200m kVAh in China and 400m kVAh globally in 2011, further consolidation is generally expected. For Leoch, though it is not in the list, in Jul its Zhaoqing facility, which accounts for 20% of current company capacity, is required by local government to suspend for self-examination. Utilization is further pressured in 2012 full year.

Table 2. First batch of facilities complusory closure

Company	Required closure in m kVAh
Tianneng (0819 HK)	0.7
Coslight Tech (1043 HK)	0.2
Feng Fan (600482 CH)	2.0
Camel Group (601311 CH)	2.0
China Shoto (private)	2.1
Other manufacturing capacity	8.4
Total closure required this year	15.4

Source: SBI E2-Capital

Please refer to important disclosures at the end of this report

Industry consolidation continues with partial capacity suspension possibility. As we have discussed in our last update, 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. Table 3 shows our investigation on various facilities against draft-regulation (《铅蓄电池行业准入条件-征求意见稿》). According to our channel checks, the Zhaoqing facility is suspended and required to provide air-tight condition for production steps involving lead, which will be inspected in Sep and Dec again this year. As such, contribution from Zhaoqing in 2H is basically removed in our revised assumptions.

Table 3. Status of the major 3 facilities

	Anhui	Zhaoqing	Jiangsu
Draft-regulation			
New facility to be built within respective industrial zone	Yes	Yes	Yes
Current facility capacity should be greater than 0.2m kVAh	4.0m kVAh	3.0m kVAh	2.4m kVAh
Prohibit unsealed lead acid batteries	In compliance	In compliance	In compliance
Cadmium content should be less than 0.002%	Cadmium-free	Cadmium-free	Cadmium-free
Arsenic content should be less than 0.1%	In compliance	In compliance	In compliance
Environmental equipments provided by approved entity	Yes	Yes	Yes
Lead related procedures kept in air-tight condition	Yes	Partially	Partially
Production equipments connected to waste water treatment	Yes	Yes	Yes
Acidifying procedure conducted in sealed automatic system	Yes	Yes	Yes
Prohibit the use of tank formation	Yes	Partially	Partially
Sufficient staff care supporting facilities	Yes	Yes	Yes
Installation of sufficient ventilation system	Yes	Yes	Yes
Obtains OHSAS 18001 certificate	Yes	Yes	Yes
Estimations			
1H 2012			
Working staff	~500	~3,000	~3,000
Sales proceeds	~RMB100m	~RMB700m	~RMB700m
Sales volume in tonne	~5,000	~37,000	~37,000
2H 2012			
Working staff	~7,000	~500	~3,000
Sales forecast	~RMB1,700m	0	~RMB700m
Sales volume in tonne	~90,000	0	~37,000

Source: SBI E2-Capital

Revisions on sales volume mainly for 2012F and 2013F. While Anhui facility is newly put into operation in 2011, its condition largely meets regulatory requirement according to our channel checks. On the other hand, with Zhaoqing and Jiangsu facilities subject to partial suspension, we lower sales volume as well as profit per tonne assumptions mainly for 2012F and 2013F. Table 4 shows our new utilization assumptions of around 60% for 2012F and 2013F. Gross profit per tonne for the 2 years are also lowered to RMB3,750 to 4,000 to reflect lowered profitability in response to lower-than-expected utilization in connection to previous suspension and ongoing capacity expansion on new site. Table 5 and Table 6 on the next page show profit and loss forecast and balance sheet items respectively. With our new assumptions, revenue for 2012F and 2013F will be RMB4,085m and RMB6,125m respectively. Net profit for the 2 years will be RMB293m and RMB478m. That said, with merely RMB90m to 100m net profit for the first half this year, we expect bottom-line for 2H will be restored to as high as RMB200m with the negative effect of Zhaoqing taken into consideration.

Table 4. Utilization rate assupmtion lowered to reflect higher policy risk

	FY12/10A	FY12/11A	FY12/12F	FY12/13F	FY12/14F
Effective capacity in kWh m	5.9	9.6	15.0	23.0	33.0
Effective capacity in tonne	141,600	230,400	360,000	552,000	792,000
Utilization	71%	63%	63%	63%	73%
Shipment in tonne	100,000	145,400	225,000	345,000	577,500
Shipment growth rate	42%	45%	55%	53%	67%
Gross profit per tonne RMB	5,256	4,496	3,750	4,000	4,250

Source: SBI E2-Capital

Table 5. Profit and loss forecast (Full-year)

RMB m	FY12/10A	FY12/11A	FY12/12F	FY12/13F	FY12/14F
Revenue	2,117	3,164	4,085	6,125	9,432
Cost of goods sold	(1,591)	(2,510)	(3,241)	(4,745)	(7,126)
Gross profit	526	654	844	1,380	2,306
Other income and gains	22	71	0	0	0
Selling and marketing expenses	(76)	(114)	(180)	(276)	(434)
Administrative expenses	(119)	(180)	(281)	(431)	(678)
Other operating expenses	(30)	(74)	(0)	(0)	(0)
Operating profit	322	357	383	673	1,194
Finance costs	(22)	(29)	(57)	(75)	(105)
Profit before tax	300	328	326	598	1,089
Income tax expense	(42)	(45)	(33)	(120)	(218)
Net profit	258	284	293	478	871
Reported EPS (RMB)	0.243	0.213	0.220	0.359	0.653

Table 6. Balance sheet items

RMB m	FY12/10A	FY12/11A	FY12/12F	FY12/13F	FY12/14F
Non-current assets	638	1,847	1,725	1,703	2,118
Property, plant and equipment	521	1,230	1,383	1,373	1,761
Prepaid land lease payments	58	75	138	137	176
Non-current portion of pledged deposits	0	366	0	0	0
Other non-current assets	59	177	204	193	182
Current assets	2,446	2,405	2,853	4,190	5,764
Inventories	688	991	1,229	1,891	2,404
Trade and bills receivables	585	804	1,098	1,671	2,464
Prepayments, deposits and other receivables	175	159	232	355	549
Time deposit with terms over 3 months	721	0	0	0	0
Pledged deposits	67	275	135	207	326
Cash and cash equivalents	179	73	159	67	21
Other current assets	31	102	0	0	0
Non-current liabilities	0	335	0	0	0
Current liabilities	1,004	1,586	2,013	2,878	4,044
Trade and bills payables	345	548	651	1,039	1,597
Other payables and accruals	161	247	286	494	678
Bank borrowings	417	741	1,031	1,300	1,725
Other current liabilities	81	51	45	45	45
EQUITY	2,080	2,330	2,566	3,015	3,838

Source: Leoch International

Target price lowered to HK$2.53 from HK$3.41; downside risk still on regulatory aspect. The counter fell rapidly by ~20% this Mon after Fri's profit warning and suspension announcement. With our new profit estimations, Leoch is trading at 4.0x and 2.5x for FY12/12F and FY12/13F P/E. At HK$2.53 TP, we value the company at 9.4x P/E and 1.1x P/B for FY12/12F.