

Leoch International

To ramp-up while peers on suspension

to summarize...

- Initial reference target price at HK\$4.32 for the lead acid battery manufacturer
- Utilize adequate waste treatment that benefits from industry consolidation
- Vertically integrated supplier that provides 1,500+ customized products
- Customers include global brands in China and overseas market
- Initial target valuation at 10.0x P/E and 6.8x EV/EBITDA for FY12/11F

Pollution caused by lead acid battery and recent industry consolidation. With numerous lead poisoning cases in China, the government eventually suspended production of considerable number of lead acid factories since May this year. All lead acid battery facilities located less than 300 meters from residential homes have been required to stop production for inspection. As a result, about 250 of 273 lead acid facilities in Zhejiang were temporarily closed. Tianneng Power (0819 HK) and Chaowei Power (0951 HK) also suspended some of their productions. In China as a whole, of 1,800 facilities with production permits, over 1,000 facilities were suspended from production. It is expected that new regulation about larger production scale target and better environmental standard enforcement will be released in this month, which may reduce the number of lead acid manufacturers to only 300. At the same time, entry barrier of lead acid battery recycling may be raised and better enforced, which should frame a healthier competition environment to restore profitability of scale recycling plants to support lead market development.

Leoch with comprehensive measure that largely benefits from strict rules. We have visited company's Zhaoqing, Jiangsu and Anhui production bases this month. 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. Leoch customers include US Battery and BMW (BMW EU), which demand good environmental standards.

Capacity expansion while peers on suspension. We believe Leoch to benefit from industry consolidation triggered by concerns on health and environment. With restricted output from peers, Leoch may benefit from volume expansion and margin stabilization, in our view, while the effect of expansion is to be fully reflected by 2013. As such, we estimate net profit would be increased from RMB258m for FY12/10A to RMB479m and RMB753m for FY12/11F and FY12/12F respectively. Our estimation represents 7.7x and 4.9x P/E for the coming 2 years compared to 8.2x and 4.9x according to Bloomberg forecast.

Table 1. Expansion assumptions and our estimations

	FY12/10A	FY12/11F	FY12/12F	FY12/13F
Shipment in tonne	100,000	180,000	321,600	441,600
GP per tonne RMB	5,256	5,250	4,750	4,750
Revenue RMBm	2,117	4,140	6,940	9,188
Net profit RMBm	258	479	753	977

Source: SBI E2-Capital

Ticker	0842 HK
Rating	Not Rated
Price (HK\$)	3.32
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	2.95-5.36
Market cap. (US\$m)	567.5
Daily t/o (US\$m)	0.5
Free float (%)	25.0

Financial summary

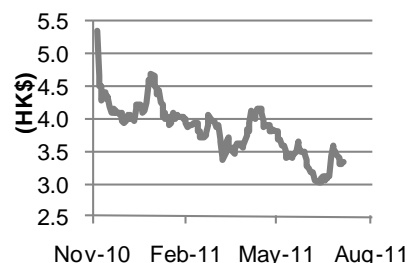
Year to Dec	09A	10A	11F	12F	13F
Turnover (RMBm)	1,392	2,117	3,870	6,940	9,188
Net Profit (RMBm)	145	258	479	753	977
EPS (RMB)	0.11	0.19	0.36	0.56	0.73
P/E (x)	25.3	14.3	7.7	4.9	3.8
P/B (x)	8.6	2.9	1.6	1.3	1.0
EV/EBITDA (x)	19.5	8.9	5.3	3.3	2.4
Yield (%)	0.0	0.0	3.1	4.9	6.3
ROE (%)	34.0	20.0	20.9	26.6	27.3
ROCE (%)	27.6	20.7	24.4	32.6	38.4
N. Gear. (%)	49%	cash	12%	cash	cash

Source: SBI

	11F	12F	13F
Consensus EPS (RMB)	0.34	0.49	0.64
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 (%)	8.7	(9.7)	n.a.
Actual price changes (%)	9.2	(17.4)	n.a.



Source: Bloomberg

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Leader with extensive product range to meet global customers demand. Leoch was founded in 1999 and remained 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. Table 2 shows sales breakdown of Leoch and its peers as of FY12/10A. Leoch has the widest range of products. Leoch's positioning in UPS and consumable products are especially strong while its competitors focuses on more standardized large models for motive batteries, SLI batteries and telecom. Part of Anhui facilities produce models for consumable batteries of different sizes, shapes and volume, which employed 500 staff before expansion and requires over 4,000 staff post-expansion. Overseas customers such as Emerson Electric (EMR US), Eaton Corp (ETN US), BMW, Jaguar, US batteries, Black & Decker (SWK US) may have specific request on battery designs in short notice while Leoch experiences working with them serve as an entry barrier for newcomers. Diagram 1 shows some of the major customers of Leoch. In 2010-2011, Leoch moved up the purchase list and ranked number 1, number 3 and number 7 in China Unicom (0762 HK), China Mobile (0941 HK) and China Telecom (0728 HK)'s lists. Earlier this month, Leoch has 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. Sales in UPS, telecom and SLI batteries are expected to grow at encouraging speed.

Table 2. 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%

Source: SBI E2-Capital

Diagram 1. Major customers of Leoch in various industries



Source: Leoch International

Site visit of Anhui, Zhaoqing and Jiangsu vertical-integrated facilities. We notice that Leoch developed a fully vertical integrated model. From the confection of lead alloy ingots to make lead paste and production of electrode plates to the assembly and packaging of batteries, Leoch carries out manufacturing processes in-house. The management indicates that in-house production ensures quality and consistency of supplies which are vital to daily operations. Raw materials such as lead, steel, plastic and paper are sourced for the production process. In fact, a good number of lead paste producers are suspended from production in recent consolidation, which affects supplies to lead acid battery manufacturers without vertically integration in the upper stream. The management indicates that they would continue to work on vertical integration which extends manufacturing capacity to other components such as terminals, separators and gel. For instance, in Anhui, there is a working area for production of packaging materials including paper box and plastic. The company also begins to produce separators at Anhui plant. According to the management, cost of in-house production is higher than production cost of upper-stream companies, yet it is still lower than the purchase cost from the supplier.

Increasing global market share of Chinese lead-acid batteries to exceed 50%. According to Asia Battery Association, lead acid battery makes up over 70% market share in industrial rechargeable battery market. CAGR of lead acid battery sales volume between 2005 and 2009 was 27.4%, while it was expected to remain at 18.2% between 2009 and 2012 according to the association. Low cost is still one of the most important factors compared to alternatives such as lithium batteries and nickel batteries. While as of 2005, base on sales volume in kWh, China producers supply 20% of global demand of lead acid batteries. By 2009, market share of some 1,800 China producers rose to 42%. There is an increasing trend of China market share and it is estimated that China has now captured over 50% share. Leoch has long passed accreditation and supplied products to world famous brands. For instance, in 2008 and 2009, Leoch sales to non-China market were 50% to 60%, while it dropped slightly to 37% due to weaker overseas market. However, we believe Leoch would benefit from sales growth in both domestic market partly replacing imports and capturing extra market share in the overseas market.

Table 3. Sales destination breakdown

	FY12/08A	FY12/09A	FY12/10A
China	557.3	625.4	878.2
EU	332.9	248.4	409.2
US	333.8	256.2	343.9
Other Asian countries	209.7	202.2	399.4
Others	65.2	59.3	86.2
Total	1,129.1	1,499.0	1,391.5

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 made periodic visits to the production facilities. In Jiangsu facility, we saw a highly-automatic pure lead battery production line in operation.

Capacity expansion and key assumptions in the coming 2-3 years. Leoch raised capital by listing in 2H last year to fund its expansion plan. With RMB1,440m net proceeds, Leoch could support its expansion in the coming 18 months, while the effect of the expansion is to be fully reflected in 2013. Currently we notice that expansion is according to management plan. From Q3 this year, capacity is expected to be gradually released until Q3 2012, and we expect utilization rate to be 80% of effective capacity of respective year. That said, with 80% utilization of estimated effective capacity of 9.6m, 16.5m and 23.0m kWh, shipment could be 180,000 tonnes, 321,600 tonnes and 441,600 tonnes for 2011, 2012 and 2013. While we consider a slight decrease in gross margin from peak level in 2010, we expect Leoch to grow rapidly in the coming 2 – 3 years. Table 4 shows our key operational assumptions for 2011 to 2013.

Table 4. 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%	78%	81%	80%
Shipment in tonne	70,250	100,000	180,000	321,600	441,600
Shipment growth rate	28%	42%	80%	79%	37%
Gross profit per tonne RMB	4,120	5,256	5,250	4,750	4,750

Source: SBI E2-Capital

Pricing mechanism and profit forecast. 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. Table 5 and Table 6 in the following page show our profit and loss forecast for 2011, 2012 and 2013. It shows a temporal high gross profit per tonne in 2011 with shipment expansion while profit per tonne would be reduced beyond 2011. For full year results, gross profit is estimated at RMB945m and RMB1,528m while net profit is estimated at RMB479m and RMB753m for FY12/11F and FY12/12F. For interim, we expect gross profit at RMB354m and RMB591m while net profit to be RMB156m and RMB323m, representing acceleration after 1H interim. For 1H FY12/11F, as operating cost such as staff cost and depreciation cost have larger impact on margin at beginning of capacity ramp-up, net margin for this interim may be lower at 9.8%, in our view. Yet, we expect net margin will resume to 10%-12% since 2H FY12/11F.

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

RMB m	FY12/09A	FY12/10A	FY12/11F	FY12/12F	FY12/13F
Revenue	1,392	2,117	3,870	6,940	9,188
Cost of goods sold	(1,102)	(1,591)	(2,925)	(5,413)	(7,091)
Gross profit	289	526	945	1,528	2,098
Other income and gains	21	22	0	0	0
Selling and marketing expenses	(57)	(76)	(135)	(241)	(331)
Administrative expenses	(70)	(119)	(180)	(322)	(442)
Other operating expenses	(13)	(30)	(0)	(0)	(0)
Operating profit	169	322	630	965	1,325
Finance costs	(10)	(22)	(32)	(23)	(23)
Profit before tax	160	300	598	941	1,302
Income tax expense	(15)	(42)	(120)	(188)	(326)
Net profit	145	258	479	753	977
Reported EPS (RMB)	n.a.	0.243	0.359	0.565	0.732

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

RMB m	1H FY12/10A	2H FY12/11A	1H FY12/11F	2H FY12/11F
Revenue	944	1,172	1,548	2,322
Cost of goods sold	(708)	(884)	(1,170)	(1,755)
Gross profit	237	289	354	591
Other income and gains	5	17	0	0
Selling and marketing expenses	(27)	(49)	(54)	(81)
Administrative expenses	(55)	(65)	(90)	(90)
Other operating expenses	(1)	(29)	(0)	(0)
Operating profit	160	162	210	420
Finance costs	(10)	(13)	(16)	(16)
Profit before tax	150	150	195	404
Income tax expense	(23)	(19)	(39)	(81)
Net profit	127	131	156	323

Source: SBI E2-Capital

Our view and reference target price at HK\$4.32. We expect revenue, gross profit and net profit to increase 79%, 52% and 30% YoY for 1H FY12/11F. We believe these growth rates with impression of margin squeeze during period of higher lead price is not especially encouraging. We suggest investor to review interim results due on 23 next month. Yet, we remain positive towards fundamental of Leoch and expect high growth since 2H this year. Therefore, we suggest accumulating the ticker on weak sentiment. Table 7 shows valuation statistics according to Bloomberg estimates. According to Bloomberg consensus, Leoch is trading at 8.3x and 5.7x FY12/11F and FY12/12F P/E, which is lower than market average. We believe Leoch to trade at a slight premium over peers. As a reference target price, we value Leoch at HK\$4.32, which is 10.0x P/E for FY12/11F based on our forecast.

Table 7. Peers valuation statistics

Company name	Ticker	Fiscal year	Mkt cap (US\$m)	His P/E (x)	1-Yr P/E (x)	2-Yr P/E (x)	PB (x)	ROE (%)
LEOCH INT'L	842 HK Equity	12/2010	11.1	8.3	5.7	1.8	11.1	20.0
CHAOWEI POWER	951 HK Equity	12/2010	8.3	8.0	6.4	1.9	8.3	26.1
TIANNENG POWER	819 HK Equity	12/2010	10.9	8.7	6.9	1.9	10.9	19.0
COSLIGHT TECH	1043 HK Equity	12/2010	137.4	9.6	6.1	0.7	137.4	0.6
			avg:	8.6	6.3			
CAMEL GROUP CO-A	601311 CH Equity	12/2010	21.2	27.8	21.8	8.5	21.2	33.1
FENGFAN CO-A	600482 CH Equity	12/2010	161.6	83.9	54.3	6.9	161.6	4.5
ZHEJIANG NARAD-A	300068 CH Equity	12/2010	64.2	34.7	23.8	2.2	64.2	5.3
			avg:	48.8	33.3			

Source: Bloomberg

Table 8. Major shareholders

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

Source: HKEx

Table 9. Balance sheet items

RMB m	FY12/08A	FY12/09A	FY12/10A	FY12/11F	FY12/12F
Non-current assets	382	445	638	1,298	1,331
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	29	40
Current assets	411	646	2,446	2,452	3,695
Inventories	99	181	688	915	1,235
Trade and bills receivables	230	340	585	952	1,330
Prepayments, deposits and other receivables	13	29	175	196	469
Time deposit with terms over 3 months	0	0	721	0	0
Pledged deposits	15	19	67	108	193
Cash and cash equivalents	36	43	179	281	468
Other current assets	20	35	31	0	0
Non-current liabilities	0	1	0	0	0
Current liabilities	437	593	1,004	1,271	1,878
Trade and bills payables	142	163	345	456	953
Other payables and accruals	118	131	161	239	502
Bank borrowings	64	173	417	526	373
Other current liabilities	114	126	81	50	50
EQUITY	356	497	2,080	2,507	3,164

Source: SBI E2-Capital

Photo set 1. Leoch produces lead paste in-house



Photo set 2. Production lines of grids and batteries



Photo set 3. Waste water treatment at Zhaoqing plant



Photo set 4. Waste water before and after treatment at Zhaoqing plant



Source: Site visit

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