

Leoch International

Earning risk continue in 2H

to summarize...

- Despite weak 1H, Leoch announced regular plus special dividend of HK\$0.500
- Execution challenge remains in 2H under negative lookout
- Earning risk remains for 2012-13F on volume disruption and fixed costs impact
- Net profit estimate for FY12/12F down as much as 53% to RMB137m
- Downgrade to HOLD on short-to-medium term earning risk due to execution issues. Target price is significantly lowered to HK\$1.15 from HK\$2.53

Interim results slightly below expectation despite previous profit warning.

Leoch International announced interim results on Wed. Revenue increased slightly by 1.2% YoY to RMB1,567m for 1H FY12/12A as some of its capacity was suspended for upgrade. Gross margin was reduced 3 pcp to 20% for the period. With new capacity kicked in, however, operating expenses increased sharply. SG&A increased to 11.1% of revenue in first half of the year compared to 7.9% a year ago. As such, net profit decreased 60.7% YoY to RMB72m for the latest interim, which was generally in accordance to previous profit warning. The company announced an interim dividend of HK\$0.0143 per share and a special dividend of HK\$0.0357 compared to regular interim dividend of HK\$0.0330 last year, which partly signaled its confidence on cash flow and future prospects, in our view.

Table 1. Interim results summary of 1H FY12/12A

RMBm	1H 11A	2H 11A	1H 12A	YoY
Revenue	1,548	1,616	1,567	1.2%
Gross profit	361	293	306	(15.4%)
Net profit	182	101	72	(60.7%)
Gross margin	23%	18%	20%	-3 pcp
Net margin	12%	6%	5%	-7 pcp

Source: SBI E2-Capital

Execution challenge remains in 2H under negative lookout. As we have discussed in the previous note, Zhaoqing facility was under suspension for self-examination and rectification, which was accounted for 20% of Leoch production capacity. As a matter of fact, production and sales for UPS clients, the core business, was negatively affected. While the management expects heavy allocation to Anhui facilities with UPS and SLI focus, Leoch needs to take time to repair relationship with major clients. Besides, the management needs to ramp-up another round of Anhui new equipments and involves as much as 7,000 staff in the base, which largely challenges management execution ability. Sales for 2H have to be revised. Sales in 1H were around 3.2m kVAh, while in base scenario full year estimates was revised down to 7.5m kVAh from previous 9.0m kVAh forecast.

Table 2. Management expectation on working force and contribution in 2H

	Anhui	Zhaoqing	Jiangsu
1H 6-month capacity (kVAh)	3m	0.8m	1.4m
Total sales = 3.2m			
2H 6-month capacity (kVAh)	3m – 6m	0	1.4m
Total sales = 4.3m (F)			

Source: SBI E2-Capital

Ticker	0842 HK
Rating	HOLD
Price (HK\$)	1.06
Target Price (HK\$)	1.15 (+8.5%)
12m Price Range (HK\$)	0.90 - 3.71
Market cap. (US\$m)	181.5
Daily t/o (US\$m)	0.37
Free float (%)	25.1

Financial summary

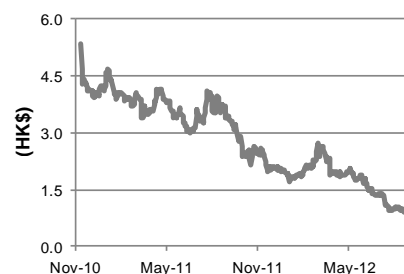
Year to Dec	10A	11A	12F	13F	14F
Turnover (RMBm)	2,117	3,164	3,464	4,668	6,106
Net Profit (RMBm)	258	284	137	308	386
EPS (RMB)	0.19	0.21	0.10	0.23	0.29
P/E (x)	4.6	4.2	8.5	3.8	3.0
P/B (x)	0.9	0.5	0.5	0.5	0.4
EV/EBITDA (x)	1.9	3.6	5.1	3.6	1.4
Yield (%)	0.0	0.0	8.0	6.5	8.1
ROE (%)	20.0	12.9	5.8	12.2	13.7
ROCE (%)	20.7	13.3	7.0	11.8	14.0
N. Gear. (%)	Cash	14.4	31.7	38.6	44.4

Source: SBI/Bloomberg

	12F	13F	14F
Consensus EPS (RMB)	0.220	0.335	0.495
Previous earnings (RMBm)	293	478	871
Previous EPS (RMB)	0.220	0.359	0.653

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	13.4	(45.5)	(69.3)
Actual price changes (%)	11.6	(43.0)	(70.9)



Source: Bloomberg

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Earning risk remains for 2012-13F on volume disruption and fixed costs impact. With execution challenges mentioned above, we further modify our assumptions. Table 3 shows revision of utilization rate and gross profit per ton assumptions. For 2012F to FY12/14F, we largely lowered overall utilization to between 47% and 52% on various suspension and disruption in UPS volume. At the same time, gross profit per ton for 2012F to 2014F were lowered to RMB3,350 per ton, RMB3,600 per ton and RMB3,650 per ton respectively down from as high as RMB4,000 per ton. It is mainly due to lowered utilization rate that depreciation and other fixed costs.

Table 3. Utilization rate and gross profit per ton assumption lowered to reflect higher policy risk

	FY12/10A	FY12/11A	FY12/12F	FY12/13F	FY12/14F
<u>Revised estimates</u>					
Effective capacity in kWh m	5.9	9.6	15.0	23.0	28.0
Effective capacity in tonne	141,600	230,400	360,000	552,000	672,000
Utilization	71%	63%	52%	47%	52%
Shipment in tonne	100,000	145,400	187,500	258,750	350,000
Shipment growth rate	42%	45%	29%	38%	35%
Gross profit per tonne RMB	5,256	4,496	3,350	3,600	3,650
<u>Previous estimates</u>					
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

Downgrade to HOLD on short-term earning risk due to execution issues until visibility improves. Back in 2010, lead acid battery providers for electric bikes faced consolidation and various facilities were suspended. Production and sales were largely affected. In 1H 2012, when the two largest producers back to life, they enjoyed extraordinary growth despite slowing overall economy. As for general lead acid battery providers, Leoch and its peers faced tightened regulation since 2H 2011, where a lot of facilities were suspended at least for 2012. In short-term, Leoch is still subject to the effect of increasing fixed costs due to expansion yet limited sales growth on partial capacity suspension. We would like to wait for higher visibility in respect to industry consolidation and company execution. For the time being, we downgrade Leoch to HK\$1.15 from HK\$2.53 though share price rose sharply yesterday after the results announcement. Table 4 shows our revised profit and loss forecast while Table 5 on the next page shows balance sheet items. Net profit for FY12/12F and FY12/13F were lowered to RMB137m and RMB308m respectively from RMB293m and RMB478m. The counter is currently trading at 8.5x and 3.8x P/E according to our new forecasts.

Table 4. Profit and loss forecast (Full-year)

RMBm	FY12/10A	FY12/11A	FY12/12F	FY12/13F	FY12/14F
Revenue	2,117	3,164	3,464	4,668	6,106
Cost of goods sold	(1,591)	(2,510)	(2,836)	(3,737)	(4,828)
Gross profit	526	654	628	932	1,278
Other income and gains	22	71	19	0	0
Selling and marketing expenses	(76)	(114)	(148)	(204)	(277)
Administrative expenses	(119)	(180)	(225)	(311)	(420)
Other operating expenses	(30)	(74)	(54)	(0)	(0)
Operating profit	322	357	220	417	581
Finance costs	(22)	(29)	(68)	(75)	(99)
Profit before tax	300	328	152	342	482
Income tax expense	(42)	(45)	(15)	(34)	(96)
Net profit	258	284	137	308	386
Reported EPS (RMB)	0.243	0.213	0.103	0.231	0.289

Source: SBI E2-Capital

Table 5. Balance sheet items

RMBm	FY12/10A	FY12/11A	FY12/12F	FY12/13F	FY12/14F
Non-current assets	638	1,847	1,684	1,919	2,116
Property, plant and equipment	521	1,230	1,474	1,684	1,859
Prepaid land lease payments	58	75	147	168	186
Non-current portion of pledged deposits	0	366	0	0	0
Other non-current assets	59	177	63	67	71
Current assets	2,446	2,405	2,869	3,203	3,879
Inventories	688	991	1,107	1,351	1,692
Trade and bills receivables	585	804	999	1,239	1,437
Prepayments, deposits and other receivables	175	159	182	227	308
Time deposit with terms over 3 months	721	0	0	0	0
Pledged deposits	67	275	113	155	210
Cash and cash equivalents	179	73	367	129	130
Other current assets	31	102	102	102	102
Non-current liabilities	0	335	4	4	4
Current liabilities	1,004	1,586	2,157	2,472	3,028
Trade and bills payables	345	548	617	713	874
Other payables and accruals	161	247	258	407	453
Bank borrowings	417	741	1,231	1,300	1,650
Other current liabilities	81	51	51	51	51
EQUITY	2,080	2,330	2,391	2,647	2,963

Source: SBI E2-Capital

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