

Techtronic Industries (669 HK)

Overweight

Price: HK\$30.05

21 Apr 2016

Price Target: HK\$43.00

PT End Date: 31 Dec 2016

Factory visit notes and good vibes from rival's performance

Techtronic Industries (TTI) is one of the largest producers of branded power tools and floor care products in China with sales mainly in the US and Europe. We visited TTI's largest production base located in Dongguan, Southern China. The key takeaways are that the large production base (consolidated from 9 locations over the past 5 years) is still the most reliable and efficient location to produce power tools despite wages which have soared in recent years. The recent quarterly announcement from rival Stanley Black & Decker (SWK US; N; covered by Michael Rehaut) showed continued strong demand for power tools which should also benefit TTI. TTI trades at a CY16 PE of 16-17x and we estimate 16-19 EPS CAGR of 19%. The shares are up 3% over the past 3 months (Hang Seng up 14% over this period).

SWK 2Q results encouraging

SWK reported its 2Q16 results on 21 April before trading and the shares outperformed the S&P500 by 4% on 21 April. We see continued sales growth in its tools and storage division of 4.6% Y/Y (+8% ex. FX) above our -2%E. The stronger-than-expected sales were due to strong demand in pretty much all geographies. As TTI has historically achieved sales growth at a much faster (5-10% faster) rate than SWK (tools and storage) in the past few years, we are comfortable with our approx. 10% increase in sales for FY16 for TTI.

The EBIT margin of 15.3% for SWK's tools and storage business for 2QFY16 is down 0.40 percent Y/Y but the decline is mostly due to FX. We note that TTI has less non-USD sales than SWK and relatively more RMB cost than SWK so the negative impact of a strong USD on TTI's margins should be lower than for SWK. Nevertheless SWK's 15.3% EBIT margin for 2QFY16 is still significantly higher than our FY16 8.8% EBIT margin for TTI, leaving room for long term upside in margins for TTI.

Please see: Stanley Black & Decker - [1Q EPS Above Our Est., St. and Guidance; 2016 Op. EPS Guidance Raised – ALERT](#) by Michael Rehaut, CFA on 21 April for more details

Description of Dongguan site

TTI's main production facility is located in Dongguan, Southern China and we believe that over 80% of total TTI sales (tools and floor care) is either produced at this location or subcontracted to third parties nearby for final assembly or packaging in this location. The site land area is over 3m square feet and ideally situated in an area with many component suppliers (like motors and PCBs) and subcontractors (for older mature products not made in-house).

Research and development focus

Since the beginning of 2008, the staff level has dropped from 18k to 14.5k today through efficiency gains and other automation efforts. However, the number of R&D staff (excluding testing of existing products) has doubled over this period to about 950. In 2015, TTI constructed a new R&D building to consolidate its China R&D in one place at this Dongguan site.

Plenty of room for expansion

TTI has consolidated all of its production in China from 9 locations into one enormous 3m square feet plant (land area) of which only a little more than half is used up. As such, TTI could probably increase capacity at this facility to handle the next 6 to 7 years of growth without the need for a new site or add land to existing site. The large size and concentration of production in one place gives TTI an advantage in terms of economies of scale and speed to market over some other peers with less control over its production or in-house research.

Automation to cut labor cost

TTI is just in the early stages of using automation to improve labour productivity. Most of the advances so far have been to use better equipment to increase the speed of workers during the assembly process. However, the use of automation and robots to lower labor requirements in material handling and logistics has just begun. We have seen only a small part of the factory using automated robots taking components to the production lines without humans involved. For most of the factory floor, the delivery of components is still using push carts. Since 2008 sales have increased more than 60% (to 2016E sales) but the number of total workers at TTI has fallen by about 20% over the same period almost doubling sales per employee for TTI.

Two key battery suppliers now

TTI has narrowed its supplier of lithium ion battery cells to two Korean suppliers now (Samsung and LG) and has cut the Japanese and Chinese suppliers over the past 2 years. TTI buys the cells and packages the cells with proprietary in-house electronics in order to make the entire battery component customized for power tools and floor care (in management's opinion superior to other manufacturers who do not customize battery units).

Our PT of HK\$43.0 implies a forward P/E of 19x (CY17E). The key risks are raising costs of production in China and a slower-than-expected recovery in US demand

Please see our latest update "[Techtronic Industries: Lowering PT to \\$43 - Tools continue to shine and we expect a floor care recovery](#)" dated 16 March 2016 for more details

Investment Thesis

We believe TTI should benefit from the normalization of demand for power tools and floor care products in the U.S. TTI has been gaining market share in the US during a slump in demand, and is well positioned to benefit in a recovery, in our view. TTI has 15% of its sales to Euro-denominated markets and is now benefiting from a recovery in demand in Europe, as well as the rise in the Euro in recent months.

Valuation

Our Dec-16 price target is based on our DCF valuation that assumes a market risk premium of 6.0% and a risk-free rate of 4.2% (yield on 10-year government notes in China). We have assumed a beta of 1.0. This is more conservative than the 0.7 Bloomberg beta. Accordingly, we assume a WACC of 9%. We estimate free cash flow until 2020 and assume a terminal growth rate of 3.0%. The terminal growth is based on the annual growth rate expected in 2020 (the final year of the estimate period) subject to a minimum of 1.5% and a maximum of 4.5%, depending on the nature of the industry and the level of maturity in China.

Risks to Rating and Price Target

The key risks to our PT are a rising cost of production in China and a slower-than-expected recovery in US demand. Another risk is the implementation of new product launches and whether or not they are accepted by customers.

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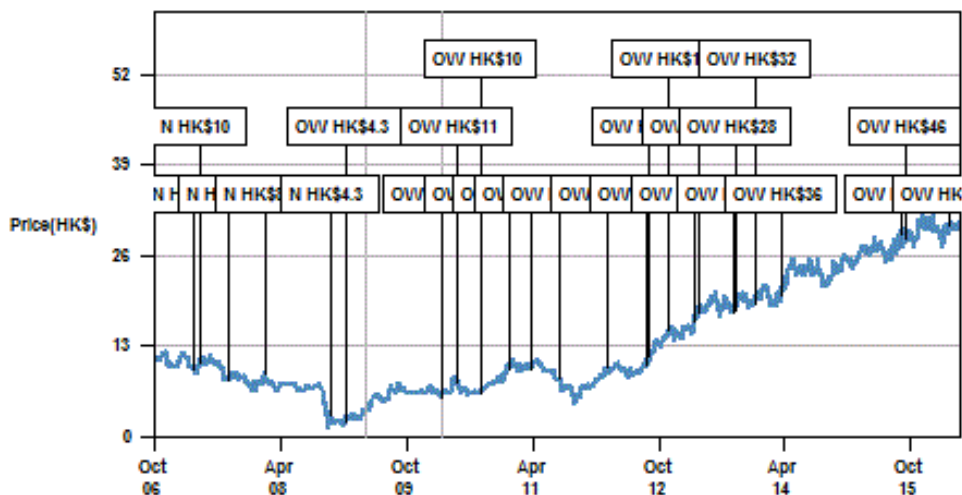
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Techtronic Industries (0669.HK, 669 HK) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Mar 22, 2007.

Date	Rating	Share Price (HK\$)	Price Target (HK\$)
22-Mar-07	N	9.75	9.50
19-Apr-07	N	10.50	10.00
22-Aug-07	N	8.16	9.50
29-Jan-08	N	9.16	8.70
09-Nov-08	N	3.20	4.30
09-Jan-09	OW	2.25	4.30
04-Mar-10	OW	5.64	8.50
11-May-10	OW	7.76	11.00
15-Aug-10	OW	6.11	10.00
20-Aug-10	OW	6.61	11.00
16-Dec-10	OW	9.85	15.00
28-Mar-11	OW	9.74	14.00
22-Jul-11	OW	8.40	12.00
15-Feb-12	OW	9.92	14.00
08-Aug-12	OW	10.24	15.00
20-Aug-12	OW	11.72	16.00
14-Nov-12	OW	15.26	19.00
05-Mar-13	OW	16.68	22.50
22-Mar-13	OW	17.70	23.00
22-Aug-13	OW	17.76	24.00
29-Aug-13	OW	18.22	28.00
20-Nov-13	OW	19.12	32.00
20-Mar-14	OW	20.40	36.00
20-Aug-15	OW	29.10	44.00
08-Sep-15	OW	28.45	46.00
16-Mar-16	OW	30.40	43.00

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