

MIDEA GROUP [000333.CH]

2018 H1 sales should be in line with full-year expectations in view of strong domestic demand for ACs, refrigerators, and washing machines. Slower growth is expected for KUKA and kitchen appliance sales. Notwithstanding new US tariffs, we expect Midea to see some improvement in export sales in 2018 H2 and into 2019 due to RMB weakness. We reduce our target price from RMB67 to RMB63 to account for a softening macro backdrop and the delayed product launch of Midea's high-end brand.

Investment Highlights

AC sales expected to support 2018 H1. We expect Midea's HVAC to grow ~40% YoY, with refrigerator and washing machines growing ~20% YoY. Kitchen appliance growth is tracking in the single digits, as Midea prudently withheld shipments to distributors with high inventory levels in H1. KUKA is also experiencing lower-than-expected growth in Q2 because of the weak auto market, but is expected to deliver better results in H2.

Trade war concerns overblown. In 2017, Midea exported ~US\$2bn of goods to the US, or approximately 5% of overall sales. Of the Company's US\$2bn in exports, only US\$200-250m may be affected by Trump's first round of tariffs. Should Washington's second round of tariffs come to fruition, we understand an additional ~US\$400m of Midea exports would be affected.

Midea's exports to benefit from RMB depreciation. As one of China's larger exporters of home appliances, the recent RMB weakness will support Midea's exports, either through better price competitiveness or pricing power. However, the impact will be moderated by the fact that a significant portion of Midea's international sales are produced in Brazil, Vietnam and other countries. We estimate that 5% RMB depreciation will benefit Midea's 2019 PBT by ~4%.

Net Forex assets imply potential translation gain. As of Dec. 2017, Midea held RMB4bn of net USD exposure and ~RMB32bn of Euro debt exposure. We understand that most of its Euro debt is hedged, and estimate that single digit RMB depreciation from Dec. 2017 levels would result in minimal translation gain.

Inexpensive Valuation. Currently trading at 11.8x 2019E PER, Midea is on track to deliver 10-15% revenue growth in 2018 H1, versus our full-year expectation of 14% growth. We trim our 2019 earnings by ~6% on account of i.) the delayed launch of Midea's high-end brand, and ii.) a weaker macro backdrop, which may negatively impact 2019 estimates. Our new TP of RMB63 is based on 16x 2019 EPS, which we believe is justifiable for a business with a diversified franchise and earnings growth above 20%.

	2016	2017	2018E	2019E	2020E
Revenue (RMB Mn)	159,842	241,919	276,958	302,417	330,277
Growth (%)		51%	14%	9%	9%
Net Profit (RMB Mn)	14,684	17,284	21,577	25,683	31,770
Growth (%)		18%	25%	19%	24%
EPS (RMB)	2.28	2.63	3.29	3.91	4.84
PER (x)	20.3	17.6	14.1	11.8	9.6
PBR (x)	4.9	4.1	3.5	2.9	2.5

Sources: Company Annual Report, CGIS Research

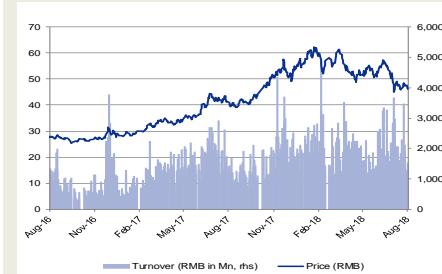
Home Appliances Sector

Buy

Close: RMB 46.28 (Aug. 1, 2018)

Target Price: RMB 63 (+36%)

Price Performance



Market Cap	US\$45,109m
Shares Outstanding	6,566m
Free Float	45%
52W High	RMB 62.69
52W Low	RMB 38.67
3M Avg Daily T/O:	US\$233m
Major Shareholders:	Midea Hld. (34%)

Sources: Company, Bloomberg

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Net impact of Midea's Forex Liabilities can be Material

As of Dec. 2017, Midea's forex cash and debt amounted to ~RMB13.4bn and ~RMB35.6bn, respectively. Much of this debt was Euro-denominated debt inherited from the KUKA acquisition, which we understand was mostly hedged. We estimate that Midea has forex exposure of ~RMB2.5bn. Consequently, Midea will be positively affected by weakness in the RMB exchange rate, though this translation gain will be booked to Midea's other comprehensive income, and therefore will not affect reported earnings. Fluctuation in the EUR/USD exchange rate will also affect the gain.

Nevertheless, as Figure 1 shows, a 5% depreciation of the RMB against the USD, Euro and other currencies since the beginning of the year will result in a translation loss of ~RMB 130m, or less than 1% of Midea's 2018 PBT. Fluctuation in the EUR/USD exchange rate will affect the sensitivity.

Figure 1: Translation Impact of Midea's Forex Holdings

Change from Dec. '17 (%)	Forex Exposure (RMB Mn)	Translation Impact (RMB Mn)	2018 PBT (RMB Mn)	2018 PBT Impact (%)
10%	2,808	255	27,201	1%
5%	2,680	128	27,074	0%
0%	2,553	0	26,946	0%
-5%	2,425	(128)	26,818	0%
-10%	2,297	(255)	26,691	-1%

Source: Company Reports, CGIS Research

Note: Ignores hedging effects outside of KUKA debt

Exports to Benefit from RMB Depreciation

In 2017, Midea booked RMB104bn out of 241bn of sales in international markets. This figure included KUKA's sales, as well as sales from Midea's factories outside of China. Midea operates manufacturing plants in Brazil, Argentina, Italy, Belarus, Egypt, India, Thailand, Vietnam, and Japan. Direct sales to the US are only ~5% of Midea's overall revenue, with most products going to the local markets in which they are produced.

To adjust for these factors, we subtracted the impact of Kuka's sales, and adjust for the fact that the remaining international sales are either local sales or priced in currencies which may not benefit from USD strength. According to our estimates, we see RMB depreciation of ~5% from Dec. 2017 levels benefiting Midea's 2019 PBT by ~4%.

Figure 2: Incremental Impact of FX Changes on Exports

Dec. '18 RMB/USD	Change from Dec. '17 (%)	2018H2 Impact (RMB Mn)	2019 Impact (RMB Mn)	2018 PBT (RMB Mn)	2019 PBT (RMB Mn)	2018 PBT Impact (%)	2019 PBT Impact (%)
7.2	10%	1,172	2,626	28,118	36,391	4%	8%
6.9	5%	586	1,313	27,532	35,078	2%	4%
6.5	0%	0	0	26,946	33,765	0%	0%
6.2	-5%	(586)	(1,313)	26,360	32,452	-2%	-4%
5.9	-10%	(1,172)	(2,626)	25,773	31,139	-4%	-8%

Source: Company Reports, CGIS Research

Note: Ignores hedging effects

FINANCIAL MODEL

Figure 3: Simplified Consolidated Statement of Profit and Loss

Dec. Year End (RMB Mn)	2016	2017	2018E	2019E	2020E
Sales Revenue	159,842	241,919	276,958	302,417	330,277
COGS	(115,615)	(180,461)	(200,915)	(217,865)	(235,614)
Gross profit	44,226	61,458	76,042	84,553	94,663
Sale tax	(1,077)	(1,416)	(1,662)	(1,512)	(1,651)
Selling and distribution costs	(17,678)	(26,739)	(31,850)	(34,778)	(36,330)
General and administrative expenses	(9,621)	(14,780)	(16,894)	(18,145)	(19,817)
Total EBIT	15,850	18,523	25,636	30,117	36,864
Depreciation & Amortisation	3,578	6,696	4,674	4,836	5,044
EBITDA	19,428	25,219	30,310	34,953	41,908
Net finance and other costs	183	(1,339)	(747)	(397)	17
Investment income	1,286	1,830	1,830	1,830	1,830
Other gains/losses	6	2,613	0	0	0
Non-operating income (expense)	1,591	227	227	227	227
Pre-Tax Profit	18,915	21,855	26,946	31,777	38,938
Tax Expense	(3,053)	(3,244)	(4,042)	(4,767)	(5,841)
Net Profit After Tax	15,862	18,611	22,904	27,011	33,097
Minority Interest	1,178	1,328	1,328	1,328	1,328
Earnings to Equity Owners	14,684	17,284	21,577	25,683	31,770
EPS (Basic)	2.29	2.66	3.32	3.96	4.89
EPS (Diluted)	2.28	2.63	3.29	3.91	4.84
DPS	1.00	1.20	1.47	1.76	2.17
% YoY growth					
Revenue	14.7%	51.3%	14.5%	9.2%	9.2%
Gross profit	20.6%	39.0%	23.7%	11.2%	12.0%
EBIT	17.1%	16.9%	38.4%	17.5%	22.4%
Net profit	15.6%	17.7%	24.8%	19.0%	23.7%
Margins and ratios					
Gross profit margin	27.7%	25.4%	27.5%	28.0%	28.7%
EBITDA Margin	12.2%	10.4%	10.9%	11.6%	12.7%
EBIT Margin	9.9%	7.7%	9.3%	10.0%	11.2%
Net Profit Margin	9.2%	7.1%	7.8%	8.5%	9.6%

Sources: Company Annual Report, CGIS Research

Figure 4: Simplified Consolidated Statement of Financial Position

Dec. Year End (RMB Mn)	2016	2017	2018E	2019E	2020E
Cash & Equivalents	27,169	48,274	51,272	55,559	65,119
Trade and other receivables	22,022	31,041	34,200	38,780	42,107
Inventories	15,627	29,444	25,114	27,233	29,452
Prepayments	1,587	1,672	1,672	1,672	1,672
Other current assets	54,216	59,380	64,380	69,380	74,380
Total current assets	120,621	169,811	176,639	192,624	212,730
Long-term equity investment	2,212	2,634	2,634	2,634	2,634
PPE, net	21,057	22,601	23,976	25,668	27,680
Intangible assets	6,869	15,167	14,657	14,178	13,727
Investment properties	494	421	421	421	421
Goodwill	5,731	28,904	28,904	28,904	28,904
Deferred tax assets	3,030	4,023	4,023	4,023	4,023
Other non-current assets	10,587	4,547	4,547	4,547	4,547
Total non-current assets	49,979	78,296	79,161	80,374	81,935
Total assets	170,601	248,107	255,800	272,997	294,665
Salary payable	3,154	5,248	5,248	5,248	5,248
Prepayments	10,252	17,409	17,409	17,409	17,409
Tax payable	2,364	3,544	3,544	3,544	3,544
Notes payable	18,485	25,208	24,556	26,628	28,797
Short-term borrowings	3,024	2,584	2,584	2,584	2,584
Accounts payable	25,357	35,145	33,486	36,311	39,269
Other current liabilities	26,546	29,954	29,954	29,954	29,954
Total current liabilities	89,184	119,092	116,782	121,678	126,806
Bonds payable	4,819	4,553	4,553	4,553	4,553
Long-term borrowings	2,254	32,986	27,986	22,986	17,986
Deferred tax liabilities	1,832	3,973	3,973	3,973	3,973
Other long term liabilities	3,535	4,578	4,578	4,578	4,578
Total non-current liabilities	12,440	46,090	41,090	36,090	31,090
Total liabilities	101,624	165,182	157,871	157,768	157,896
Shareholders Fund	61,127	73,737	87,413	103,387	123,599
Minority Interest	7,850	9,188	10,515	11,843	13,170
Total S/H Equity	68,977	82,925	97,928	115,230	136,770
Total Liab & S/H Fund	170,601	248,107	255,800	272,997	294,665

Sources: Company Annual Report, CGIS Research

Figure 5: Simplified Consolidated Statement of Cash Flows

Dec. Year End (RMB Mn)	2016	2017	2018E	2019E	2020E
Net Income	15,862	18,611	22,904	27,011	33,097
Depreciation & Amortization	3,578	6,696	4,674	4,836	5,044
Change in Working Cap	9,090	2,815	(1,140)	(1,802)	(419)
Other Non Cash Adjustments	(1,834)	(3,680)	0	0	0
Operating Cash Flow	26,695	24,443	26,438	30,045	37,723
Acquisitions	(2,900)	(25,850)	0	0	0
Capex	(2,323)	(3,218)	(5,539)	(6,048)	(6,606)
Asset Sales	464	1,441	0	0	0
Investments	(90,881)	(94,967)	(5,000)	(5,000)	(5,000)
Cash recovered from investment	73,905	85,127	0	0	0
Others	1,954	2,728	0	0	0
Investing Cashflow	(19,781)	(34,740)	(10,539)	(11,048)	(11,606)
Dividend (ordinary)	(5,121)	(6,466)	(7,901)	(9,709)	(11,557)
Equity Raised	815	1,668	0	0	0
Debt Movements	7,391	25,891	(5,000)	(5,000)	(5,000)
Others	(2,925)	(1,442)	0	0	0
Financing Cashflow	160	19,652	(12,901)	(14,709)	(16,557)
FCF	6,914	(10,297)	15,899	18,996	26,117

Sources: Company Annual Report, CGIS Research

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HOLD : no clear catalyst, and downgraded from BUY pending clearer signal to reinstate BUY or further downgrade to outright SELL

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