

MIDEA GROUP [000333.CH]: Margin expansion in 1H18

Midea reported a strong set of interim results, with top/bottom line growing by 15.0% / 19.7% respectively, led by strong results in air conditioning. While interim results were strong, investors are focused on potential deterioration in top line AC and consumer appliances during 2H18. We have cut our 2018 / 2019 EPS by 3.7% / 10.4% and reduce our target price from RMB 63 to RMB 53 to account for softening top line growth and lack of near term positive catalysts.

Investment Highlights

Upgrade trend intact: Midea's gross margins increased from 25.5% in 1H17 to 27.7% in 1H18, making it the only major appliance company to benefit from expanding gross margins in a rising raw material price environment (Figures 2-4). Midea expects gross margins to further improve in 2H18.

Strong 1H but deteriorating momentum: Midea, Gree, and Qingdao Haier all experienced slipping AC sales growth in July due to high base effect and weather. All companies have indicated an improvement in August, consistent with our channel checks. Overall, however, we think weak July air conditioner sales and Little Swan's Q3 2018 sales guidance for flat YoY growth may be a harbinger of tougher comps ahead.

Low channel inventory: Midea's AC inventory remains well controlled, with 1-2 months of combined total factory and channel inventory, or approximately 5 million units. In other appliance segments, Midea also reports that channel inventory is near historical lows. While we believe there is a high probability of revenue deceleration in 2H18, we don't believe AC industry channel inventory levels are reminiscent of 2015 levels when destocking led to price wars. Presently, all three major appliance manufacturers report low channel inventories.

Inexpensive valuation. While we cannot discount a slowdown in consumer demand in 2H18 and 2019, Midea is best positioned among all home manufacturers to weather a downturn. With ~35% sales from international sources (ex KUKA) and lower ASPs relative to Gree and Qingdao Haier, Midea remains well situated to ride out a slowdown in China's home appliance market. Currently trading at 11.9x 2019E PER, we expect Midea to post 20%/11% EPS growth in 2018/2019, down from our former estimates of 25%/19% EPS growth. Our 2018/2019 earnings have been reduced by 3.7%/10.4% respectively. Our new TP is based on a valuation of 15x 2019 EPS, which we believe is justifiable for a business with a diversified franchise, stable market share, and teens earnings growth.

	2016	2017	2018E	2019E	2020E
Revenue (RMB Mn)	159,842	241,919	267,911	284,075	300,786
Growth (%)		51%	11%	6%	6%
Net Profit (RMB Mn)	14,684	17,284	21,117	23,392	26,094
Growth (%)		18%	22%	11%	12%
EPS (RMB)	2.28	2.63	3.17	3.51	3.91
PER (x)	18.3	15.8	13.1	11.9	10.6
PBR (x)	4.4	3.7	3.2	2.8	2.4

Sources: Company Annual Report, CGIS Research

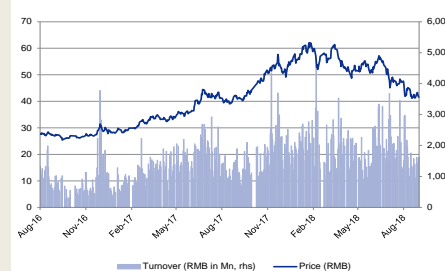
Home Appliances Sector

Buy

Close: RMB 41.60 (Aug. 31, 2018)

Target Price: RMB 52.60 (+26%)

Price Performance



Market Cap	US\$40,243m
Shares Outstanding	6,627m
Free Float	41%
52W High	RMB 62.69
52W Low	RMB 39.69
3M Avg Daily T/O:	US\$31m
Major Shareholders:	Midea Hld. (34%)

Sources: Company, Bloomberg

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Figure 1: Midea 1H18 Results Summary

RMB Mn	1H17	1H18	% YoY
Revenue	124,964	143,736	15.0%
COGS	(93,051)	(103,881)	11.6%
Gross Profit	31,913	39,854	24.9%
GPM	25.5%	27.7%	
SG&A	(19,992)	(24,975)	24.9%
Operating Profit	11,920	14,880	24.8%
OP Margin	9.5%	10.4%	
Financing Costs	(347)	984	
Other G/L	2,034	531	
PBT	13,607	16,395	20.5%
Tax	(2,059)	(2,615)	
Effective tax rate	15%	16%	
Net Profit	11,548	13,780	19.3%
NPM	9.2%	9.6%	
Minority Interest	(737)	(843)	
Profit to Commor	10,811	12,937	19.7%
EPS (Diluted)	1.66	1.94	16.7%

Sources: Company Reports, CGIS Research

Figure 2: Midea Segmentation Snapshot

Revenue by Product (RMB Mn)	1H17	1H18	% YoY
Consumer Appliances	51,827	55,279	6.7%
Air Conditioning	50,023	63,874	27.7%
Robotics	13,606	12,502	-8.1%
Other	9,507	12,081	27.1%
Revenue	124,964	143,736	15.0%

Gross Profit by Product (RMB Mn)	1H17	1H18	% YoY
Consumer Appliances	14,138	15,236	7.8%
Air Conditioning	14,613	19,325	32.2%
Robotics	2,000	3,055	52.7%
Other	1,161	2,239	92.9%
Gross Profit	31,913	39,854	24.9%

Gross Margin by Product (%)	1H17	1H18
Consumer Appliances	27.3%	27.6%
Air Conditioning	29.2%	30.3%
Robotics	14.7%	24.4%
Other	12.2%	18.5%
Company	25.5%	27.7%

Sources: Company Reports, CGIS Research

Figure 3: Gree Segmentation Snapshot

Revenue by Product (RMB MN)	1H17	1H18	%YoY
AC	54,637	75,820	38.8%
Small Appliances	1,005	1,565	55.7%
Smart Equipment	962	356	-63.0%
Compressors, motors, capacitors	2,684	1,007	-62.5%
Recycling & Other	10,732	13,255	23.5%
Revenue	70,021	92,004	31.4%

Gross Profit by Product (RMB MN)	1H17	1H18	%YoY
AC	21,011	26,057	24.0%
Small Appliances	195	267	36.5%
Smart Equipment	46	42	-9.7%
Compressors, motors, Capacitors	199	99	-50.2%
Recycling & Other	1,481	1,880	27.0%
Gross Profit	22,932	28,344	23.6%

Gross Margin by Product (%)	1H17	1H18
AC	38.5%	34.4%
Small Appliances	19.4%	17.0%
Smart Equipment	4.8%	11.7%
Compressors, motors, Capacitors	7.4%	9.9%
Recycling & Other	13.8%	14.2%
Company	32.8%	30.8%

Sources: Company Reports, CGIS Research

Figure 4: QD Haier Segmentation Snapshot

Revenue by Product (RMB MN)	1H17	1H18	%YoY
AC	16,327	19,194	17.6%
Refrigerator	22,743	25,443	11.9%
Kitchen appliances	13,162	10,473	-20.4%
Water heater	n.a.	3,872	n.a.
Washing machine	13,845	16,282	17.6%
Equipment	1,486	1,248	-16.0%
Channel services	9,680	11,820	22.1%
Revenue	77,243	88,332	14.4%

Gross Profit by Product (RMB MN)	1H17	1H18	%YoY
AC	5,202	5,831	12.1%
Refrigerator	7,324	7,882	7.6%
Kitchen appliances	4,895	3,637	-25.7%
Water heater	n.a.	1,680	n.a.
Washing machine	4,783	5,413	13.2%
Equipment	231	159	-31.1%
Channel services	717	958	33.6%
Gross Profit	23,152	25,559	10.4%

Gross Margin by Product (%)	1H17	1H18
AC	31.9%	30.4%
Refrigerator	32.2%	31.0%
Kitchen appliances	37.2%	34.7%
Water heater	n.a.	43.4%
Washing machine	34.5%	33.2%
Equipment	15.5%	12.7%
Channel services	7.4%	8.1%
Company	30.0%	28.9%

Sources: Company Reports, CGIS Research

FINANCIAL MODEL

Figure 5: Simplified Consolidated Statement of Profit and Loss

Dec. Year End (RMB Mn)	2016	2017	2018E	2019E	2020E
Sales Revenue	159,842	241,919	267,911	284,075	300,786
COGS	(115,615)	(180,461)	(194,977)	(206,051)	(217,821)
Gross profit	44,226	61,458	72,934	78,023	82,965
Sale tax	(1,077)	(1,416)	(1,592)	(1,702)	(1,800)
Selling and distribution costs	(17,678)	(26,739)	(31,788)	(33,386)	(34,498)
General and administrative expenses	(9,621)	(14,780)	(14,682)	(15,503)	(16,393)
Total EBIT	15,850	18,523	24,871	27,432	30,274
Depreciation & Amortisation	3,578	6,696	4,674	4,811	4,971
EBITDA	19,428	25,219	29,545	32,243	35,245
Net finance and other costs	183	(1,339)	(516)	(408)	(71)
Investment income	1,286	1,830	1,830	1,830	1,830
Other gains/losses	6	2,613	(6)	0	0
Non-operating income (expense)	1,591	227	227	227	227
Pre-Tax Profit	18,915	21,855	26,405	29,081	32,260
Tax Expense	(3,053)	(3,244)	(3,961)	(4,362)	(4,839)
Net Profit After Tax	15,862	18,611	22,445	24,719	27,421
Minority Interest	1,178	1,328	1,328	1,328	1,328
Earnings to Equity Owners	14,684	17,284	21,117	23,392	26,094
EPS (Basic)	2.29	2.66	3.25	3.60	4.02
EPS (Diluted)	2.28	2.63	3.17	3.51	3.91
DPS	1.00	1.20	1.44	1.60	1.78
% YoY growth					
Revenue	14.7%	51.3%	10.7%	6.0%	5.9%
Gross profit	20.6%	39.0%	18.7%	7.0%	6.3%
EBIT	17.1%	16.9%	34.3%	10.3%	10.4%
Net profit	14.3%	17.7%	22.2%	10.8%	11.6%
Margins and ratios					
Gross profit margin	27.7%	25.4%	27.2%	27.5%	27.6%
EBITDA Margin	12.2%	10.4%	11.0%	11.4%	11.7%
EBIT Margin	9.9%	7.7%	9.3%	9.7%	10.1%
Net Profit Margin	9.2%	7.1%	7.9%	8.2%	8.7%

Sources: Company Annual Report, CGIS Research

Figure 6: Simplified Consolidated Statement of Financial Position

Dec. Year End (RMB Mn)	2016	2017	2018E	2019E	2020E
Cash & Equivalents	27,169	48,274	51,051	53,792	59,575
Trade and other receivables	22,022	31,041	33,170	36,589	38,585
Inventories	15,627	29,444	24,372	25,756	27,228
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	174,645	187,189	201,440
Long-term equity investment	2,212	2,634	2,634	2,634	2,634
PPE, net	21,057	22,601	23,795	25,145	26,640
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	78,980	79,851	80,896
Total assets	170,601	248,107	253,625	267,040	282,335
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	23,831	25,184	26,623
Short-term borrowings	3,024	2,584	2,584	2,584	2,584
Accounts payable	25,357	35,145	32,496	34,342	36,303
Other current liabilities	26,546	29,954	29,954	29,954	29,954
Total current liabilities	89,184	119,092	115,066	118,265	121,665
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	156,156	154,355	152,755
Shareholders Fund	61,127	73,737	86,954	100,843	116,410
Minority Interest	7,850	9,188	10,515	11,843	13,170
Total S/H Equity	68,977	82,925	97,469	112,685	129,580
Total Liab & S/H Fund	170,601	248,107	253,625	267,040	282,335

Sources: Company Annual Report, CGIS Research

Figure 7: Simplified Consolidated Statement of Cash Flows

Dec. Year End (RMB Mn)	2016	2017	2018E	2019E	2020E
Net Income	15,862	18,611	22,445	24,719	27,421
Depreciation & Amortization	3,578	6,696	4,674	4,811	4,971
Change in Working Cap	9,090	2,815	(1,083)	(1,604)	(67)
Other Non Cash Adjustments	(1,834)	(3,680)	0	0	0
Operating Cash Flow	26,695	24,443	26,036	27,926	32,325
Acquisitions	(2,900)	(25,850)	0	0	0
Capex	(2,323)	(3,218)	(5,358)	(5,681)	(6,016)
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)	(10,358)	(10,681)	(11,016)
Dividend (ordinary)	(5,121)	(6,466)	(7,901)	(9,503)	(10,526)
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)	(14,503)	(15,526)
FCF	6,914	(10,297)	15,678	17,244	21,309

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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