

## 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

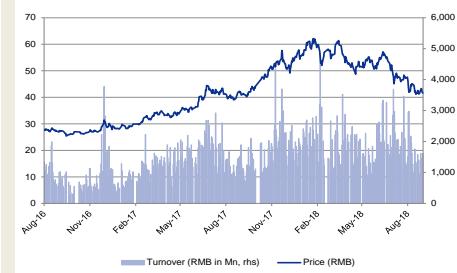
### Home Appliances Sector

**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

### Jeff Dorr – Analyst

(852) 3698 6323  
[jeffreydorr@chinastock.com.hk](mailto:jeffreydorr@chinastock.com.hk)

### An Zhang – Analyst

(852) 3698 6293  
[zhangan@chinastock.com.hk](mailto:zhangan@chinastock.com.hk)

### Johnson Cheung – Research Director

(852) 3698 6275  
[johnsoncheung@chinastock.com.hk](mailto:johnsoncheung@chinastock.com.hk)

**Figure 1: Midea 1H18 Results Summary**

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

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%
<b>Gross Profit</b>	<b>31,913</b>	<b>39,854</b>	<b>24.9%</b>

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%
<b>Company</b>	<b>25.5%</b>	<b>27.7%</b>

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%
<b>Revenue</b>	<b>70,021</b>	<b>92,004</b>	<b>31.4%</b>

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%
<b>Gross Profit</b>	<b>22,932</b>	<b>28,344</b>	<b>23.6%</b>

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%
<b>Company</b>	<b>32.8%</b>	<b>30.8%</b>

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%
<b>Revenue</b>	<b>77,243</b>	<b>88,332</b>	<b>14.4%</b>

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%
<b>Gross Profit</b>	<b>23,152</b>	<b>25,559</b>	<b>10.4%</b>

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%
<b>Company</b>	<b>30.0%</b>	<b>28.9%</b>

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
<b>Sales Revenue</b>	<b>159,842</b>	<b>241,919</b>	<b>267,911</b>	<b>284,075</b>	<b>300,786</b>
COGS	(115,615)	(180,461)	(194,977)	(206,051)	(217,821)
<b>Gross profit</b>	<b>44,226</b>	<b>61,458</b>	<b>72,934</b>	<b>78,023</b>	<b>82,965</b>
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)
<b>Total EBIT</b>	<b>15,850</b>	<b>18,523</b>	<b>24,871</b>	<b>27,432</b>	<b>30,274</b>
Depreciation & Amortisation	3,578	6,696	4,674	4,811	4,971
<b>EBITDA</b>	<b>19,428</b>	<b>25,219</b>	<b>29,545</b>	<b>32,243</b>	<b>35,245</b>
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
<b>Pre-Tax Profit</b>	<b>18,915</b>	<b>21,855</b>	<b>26,405</b>	<b>29,081</b>	<b>32,260</b>
Tax Expense	(3,053)	(3,244)	(3,961)	(4,362)	(4,839)
<b>Net Profit After Tax</b>	<b>15,862</b>	<b>18,611</b>	<b>22,445</b>	<b>24,719</b>	<b>27,421</b>
Minority Interest	1,178	1,328	1,328	1,328	1,328
<b>Earnings to Equity Owners</b>	<b>14,684</b>	<b>17,284</b>	<b>21,117</b>	<b>23,392</b>	<b>26,094</b>
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
<b>% YoY growth</b>					
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%
<b>Margins and ratios</b>					
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
<b>Total current assets</b>	<b>120,621</b>	<b>169,811</b>	<b>174,645</b>	<b>187,189</b>	<b>201,440</b>
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
<b>Total non-current assets</b>	<b>49,979</b>	<b>78,296</b>	<b>78,980</b>	<b>79,851</b>	<b>80,896</b>
<b>Total assets</b>	<b>170,601</b>	<b>248,107</b>	<b>253,625</b>	<b>267,040</b>	<b>282,335</b>
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
<b>Total current liabilities</b>	<b>89,184</b>	<b>119,092</b>	<b>115,066</b>	<b>118,265</b>	<b>121,665</b>
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
<b>Total non-current liabilities</b>	<b>12,440</b>	<b>46,090</b>	<b>41,090</b>	<b>36,090</b>	<b>31,090</b>
<b>Total liabilities</b>	<b>101,624</b>	<b>165,182</b>	<b>156,156</b>	<b>154,355</b>	<b>152,755</b>
Shareholders Fund	61,127	73,737	86,954	100,843	116,410
Minority Interest	7,850	9,188	10,515	11,843	13,170
<b>Total S/H Equity</b>	<b>68,977</b>	<b>82,925</b>	<b>97,469</b>	<b>112,685</b>	<b>129,580</b>
<b>Total Liab &amp; S/H Fund</b>	<b>170,601</b>	<b>248,107</b>	<b>253,625</b>	<b>267,040</b>	<b>282,335</b>

Sources: Company Annual Report, CGIS Research

**Figure 7: Simplified Consolidated Statement of Cash Flows**

Dec. Year End (RMB Mn)	2016	2017	2018E	2019E	2020E
<b>Net Income</b>	<b>15,862</b>	<b>18,611</b>	<b>22,445</b>	<b>24,719</b>	<b>27,421</b>
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
<b>Operating Cash Flow</b>	<b>26,695</b>	<b>24,443</b>	<b>26,036</b>	<b>27,926</b>	<b>32,325</b>
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
<b>Investing Cashflow</b>	<b>(19,781)</b>	<b>(34,740)</b>	<b>(10,358)</b>	<b>(10,681)</b>	<b>(11,016)</b>
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
<b>Financing Cashflow</b>	<b>160</b>	<b>19,652</b>	<b>(12,901)</b>	<b>(14,503)</b>	<b>(15,526)</b>
<b>FCF</b>	<b>6,914</b>	<b>(10,297)</b>	<b>15,678</b>	<b>17,244</b>	<b>21,309</b>

Sources: Company Annual Report, CGIS Research

## Disclaimer

This research report is not directed at, or intended for distribution to or used by, any person or entity who is a citizen or resident of or located in any jurisdiction where such distribution, publication, availability or use would be contrary to applicable law or regulation or which would subject China Galaxy International Securities (Hong Kong) Co., Limited ("Galaxy International Securities") and/or its group companies to any registration or licensing requirement within such jurisdiction.

This report (including any information attached) is issued by Galaxy International Securities, one of the subsidiaries of the China Galaxy International Financial Holdings Limited, to the institutional clients from the information sources believed to be reliable, but no representation or warranty (expressly or implied) is made as to their accuracy, correctness and/or completeness.

This report shall not be construed as an offer, invitation or solicitation to buy or sell any securities of the company(ies) referred to herein. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. The recipient of this report should understand and comprehend the investment objectives and its related risks, and where necessary consult their own independent financial advisers prior to any investment decision.

Where any part of the information, opinions or estimates contained herein reflects the personal views and opinions of the analyst who prepared this report, such views and opinions may not correspond to the published views or investment decisions of China Galaxy International Financial Holdings Limited and any of its subsidiaries ("China Galaxy International"), directors, officers, agents and employees ("the Relevant Parties").

All opinions and estimates reflect the judgment of the analyst on the date of this report and are subject to change without notice. China Galaxy International and/or the Relevant Parties hereby disclaim any of their liabilities arising from the inaccuracy, incorrectness and incompleteness of this report and its attachment/s and/or any action or omission made in reliance thereof. Accordingly, this report must be read in conjunction with this disclaimer.

## Disclosure of Interests

China Galaxy Securities Co., Ltd. (6881.HK; 601881.CH) is the direct and/or indirect holding company of the group of companies under China Galaxy International.

China Galaxy International may have financial interests in relation to the subjected company(ies) the securities in respect of which are reviewed in this report, and such interests aggregate to an amount may equal to or more than 1 % of the subjected company(ies)' market capitalization.

One or more directors, officers and/or employees of China Galaxy International may be a director or officer of the securities of the company(ies) mentioned in this report.

China Galaxy International and the Relevant Parties may, to the extent permitted by law, from time to time participate or invest in financing transactions with the securities of the company(ies) mentioned in this report, perform services for or solicit business from such company(ies), and/or have a position or holding, or other material interest, or effect transactions, in such securities or options thereon, or other investments related thereto.

China Galaxy International may have served as manager or co-manager of a public offering of securities for, or currently may make a primary market in issues of, any or all of the entities mentioned in this report or may be providing, or have provided within the last 12 months, significant advice or investment services in relation to the investment concerned or a related investment or investment banking services to the company(ies) mentioned in this report.

Furthermore, China Galaxy International may have received compensation for investment banking services from the company(ies) mentioned in this report within the preceding 12 months and may currently seeking investment banking mandate from the subject company(ies).

## Analyst Certification

The analyst who is primarily responsible for the content of this report, in whole or in part, certifies that with respect to the securities or issuer covered in this report: (1) all of the views expressed accurately reflect his or her personal views about the subject, securities or issuer; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific views expressed by the analyst in this report.

Besides, the analyst confirms that neither the analyst nor his/her associates (as defined in the code of conduct issued by The Hong Kong Securities and Futures Commission) (1) have dealt in or traded in the securities covered in this research report within 30 calendar days prior to the date of issue of this report; (2) will deal in or trade in the securities covered in this research report three business days after the date of issue of this report; (3) serve as an officer of any of the Hong Kong-listed companies covered in this report; and (4) have any financial interests in the Hong Kong-listed companies covered in this report.

## Explanation on Equity Ratings

BUY : share price will increase by >20% within 12 months in absolute terms

SELL : share price will decrease by >20% within 12 months in absolute terms

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

## Copyright Reserved

No part of this material may be reproduced or redistributed without the prior written consent of China Galaxy International Securities (Hong Kong) Co., Limited.

China Galaxy International Securities (Hong Kong) Co. Limited, CE No.AXM459

20/F, Wing On Centre, 111 Connaught Road Central, Sheung Wan, Hong Kong. General line: 3698-6888.