



Rating
Hold

Asia
China

Consumer
Retail / Wholesale Trade

Company
Midea

Reuters 000333.SZ Bloomberg 000333 CH Exchange SHZ Ticker 000333

Date
18 September 2018

Company Update

Price at 7 Sep 2018 (CNY)	40.30
Price target - 12mth (CNY)	43.00
52-week range (CNY)	62.12 - 40.30
Shenzhen Index	1,444

Introducing Asset Restructuring Scenarios

Event: News reports discuss potential outcomes of Midea-LS restructuring

An article from Xinhua News yesterday discussed a potential Midea-Little Swan (LS) restructuring, which could include an asset injection and privatization. This comes amid increasing concerns of a prolonged halt to the share trading. Against this backdrop, we provide the following analysis and views: (1) We present four scenarios for potential corporate action by Midea; (2) Yet, we continue to believe it would be difficult for any corporate action by Midea to drive synergy with LS, given we view brand equity as the most significant challenge. (3) We highlight the key variable factors in this analysis, including: LS' B shares, government holdings in LS, and growing investor concerns preventing Midea from prolonging the suspension of trading.

Little Swan: (A-share: 000418.SZ, NR, RMB46.5) (B-share: 200418.SZ, NR, HKD36.17)

Background

- **Midea is likely in full control of LS:** Based on public disclosures, Midea holds a 53% stake in LS (38% direct and 15% indirect), while Midea's CEO, Paul Fang, is the chairperson of LS. After Midea's operations-center reforms, we believe Midea has integrated its sales companies with LS'.
- **Frequent related-party transactions:** Midea and LS record frequent related-party transactions. We believe LS accounts for the majority of Midea's washing-machine business (except for Toshiba washing-machine assets; we derive this conclusion from reviewing public related-party transaction disclosures). Also, LS holds the brand rights to Midea's premium brand ("Beverly").
- **Trading halt and asset restructuring:** Midea announced a trading halt and potential asset restructuring with LS on 2018 September 9 (HKT), the company originally planned to resume trading before September 11, citing it would resume trading soon after its board meeting. However, Midea issued another announcement (dated 2018 September 12) indicating that it was prolonging the trading halt, and stating that it would host a board meeting before September 28.

Valuation & Risks

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Price/price relative



Performance (%)	1m	3m	12m
Absolute	-2.0	-28.4	-4.1
Shenzhen Index	-4.3	-18.4	-30.6

Source: Deutsche Bank

Key indicators (FY1)

ROE (%)	26.1
Net debt/equity (%)	-19.4
Book value/share (CNY)	13.03
Price/book (x)	3.1
Net interest cover (x)	-
Operating profit margin (%)	7.4

Source: Deutsche Bank

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Based on the aforementioned news and our conversations with investors, we present below four scenarios, as well as the potential impact on our Midea investment case:

Scenario 1: Midea injects washing-machine assets into LS

- **Insignificant change to Midea's earnings, in our view:** We estimate the Toshiba washing-machine business accounts for less than 3% of Midea's revenue, so this would have an minor impact.

Scenario 2: Midea increases holding in LS

- **Boost Midea's earnings** (see Scenario 3 for calculations).
- **Unlikely to drive synergy, in our view:** As Midea effectively controls LS' branding, products, manufacturing and channel, we see limited accretion to synergy should Midea increase its holding in LS. We continue to believe the major risk faced by Midea's washing-machine business is not its efficiency, but weaker brand equity. [The weakness is highlighted as competitors \(including the Casarte brand\) branch into tier-3 cities with increasingly competitive pricing](#).

Scenario 3: Midea privatizes LS

- **Boost Midea's earnings:** Assuming Midea privatizes LS, this could increase Midea's earnings by 3-5% (Figure 1).
- **Unlikely to drive synergy, in our view** (see above)
- **Clean up the related-party transactions:** This could help improve corporate governance.

Scenario 4: Midea privatizes LS and distributes LS' net cash as a special dividend to Midea shareholders

- **Boost Midea's earnings** (see above)
- **Unlikely to drive synergy, in our view** (see above)
- **Special dividend may add value to Midea's shareholders:** Assuming Midea privatizes LS and distributes all of LS' net cash to Midea shareholders, this could lead to a special dividend of RMB2.1 per share (or a 5% dividend yield, Figure 2)
- **It also may help reduce Midea's share pledges:** We note that 10.1% of Midea's outstanding shares are being pledged by Midea Holdings (Midea's biggest shareholder, according to an announcement on June 22). As Midea's share-price declines, investors have expressed growing concerns. If Midea Holdings uses the potential special dividend to reduce its pledges, this could especially ease long-term value investors' concerns. We note that some investors view heavy pledging as a corporate governance red flag.

Risks and variables to our four scenarios:

- **LS' B shares may increase the complexity of a potential privatization:** The B shares are denominated in HKD (although trading in Shenzhen). We believe the currency translation and shareholder profile of the B share increases the complexity of a potential deal.

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- **Government holding in LS:** Based on LS' annual report, the Wuxi government holds a 2.7% stake in the company. This may increase the complexity for any potential corporate action by Midea on LS.
- **Investors and MSCI's attention to significant trading halt may accelerate Midea's asset restructuring:** Midea has released no timeline on this potential restructuring. However, we believe Midea would need to keep the halt to trading as short as possible. This is due to growing concerns over a significant trading suspension among investors, as well as the MSCI.

Figure 1: Simulation: Midea's 2018E earnings to increase 4% if it increased holding in LS to 100%

(RMBbn)	
Midea 2018E earnings	20.8
LS 2018E earnings	1.8
Midea ownership in LS (current)	53%
Midea ownership if privatize LS	100%
Incremental ownership	47%
Incremental earnings	0.9
% of Midea's 2018E earnings	<u>4%</u>

Source: Deutsche Bank estimates, Bloomberg Finance LP consensus (for LS 2018E earnings)

Figure 2: Simulation: assume LS sells its wealth-management products and distributes the net cash to Midea's shareholders

(RMBbn)	
LS cash (1H18)	1.7
LS wealth management products (1H18)	11.8
less: debt (1H18)	-
LS' net cash	13.5
Midea's market capitalization	267
Yield	<u>5%</u>

Source: Deutsche Bank estimates, company financial reports

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Model updated: 02 September 2018

Running the numbers

Asia

China

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Reuters: 000333.SZ Bloomberg: 000333 CH

Hold

Price (7 Sep 18) CNY 40.30

Target Price CNY 43.00

52 Week range CNY 40.30 - 62.12

Market cap (m) CNYm 265,130
USDm 38,599

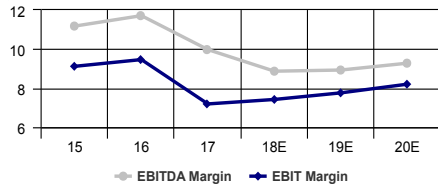
Company Profile

Midea is engaged mainly in the manufacture and sale of household electronics. The company's products include household air conditioners, central air conditioners, refrigerators, washing machines and small home appliances.

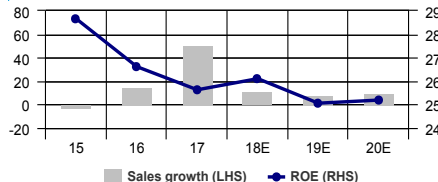
Price Performance



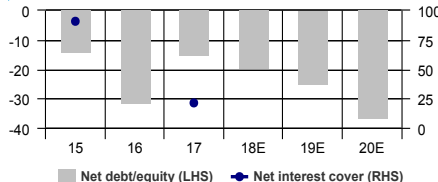
Margin Trends



Growth & Profitability



Solvency



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Fiscal year end 31-Dec

Financial Summary

	2015	2016	2017	2018E	2019E	2020E
DB EPS (CNY)	1.83	2.30	2.50	3.17	3.47	4.01
Reported EPS (CNY)	2.00	2.29	2.66	3.17	3.50	4.04
DPS (CNY)	1.20	1.00	1.20	1.42	1.58	1.82
BVPS (CNY)	7.7	9.5	11.4	13.0	14.9	17.2
Weighted average shares (m)	6,366	6,423	6,492	6,570	6,579	6,579
Average market cap (CNYm)	200,484	174,793	262,981	265,130	265,130	265,130
Enterprise value (CNYm)	196,415	158,286	256,615	252,455	243,714	224,610

Valuation Metrics

P/E (DB) (x)	17.2	11.8	16.2	12.7	11.6	10.0
P/E (Reported) (x)	15.8	11.9	15.2	12.7	11.5	10.0
P/BV (x)	4.25	2.96	4.88	3.09	2.70	2.35
FCF Yield (%)	12.1	14.1	8.6	4.8	6.0	10.5
Dividend Yield (%)	3.8	3.7	3.0	3.5	3.9	4.5
EV/Sales (x)	1.4	1.0	1.1	0.9	0.8	0.7
EV/EBITDA (x)	12.7	8.5	10.7	10.6	9.4	7.6
EV/EBIT (x)	15.6	10.5	14.8	12.7	10.8	8.6

Income Statement (CNYm)

Sales revenue	138,441	159,044	240,712	268,369	289,799	317,683
Gross profit	35,778	43,429	60,252	71,447	77,262	85,472
EBITDA	15,478	18,630	24,012	23,804	25,877	29,481
Depreciation	2,852	3,578	6,696	3,884	3,387	3,415
Amortisation	0	0	0	0	0	0
EBIT	12,626	15,052	17,316	19,920	22,490	26,065
Net interest income/(expense)	-139	1,006	-816	1,061	211	324
Associates/affiliates	0	0	0	0	0	0
Exceptionals/extraordinaries	0	0	0	0	0	0
Other pre-tax income/(expense)	3,565	2,856	5,354	5,272	6,403	7,109
Profit before tax	16,051	18,915	21,855	26,252	29,104	33,498
Income tax expense	2,427	3,053	3,244	3,990	4,424	5,092
Minorities	918	1,178	1,328	1,460	1,635	1,799
Other post-tax income/(expense)	0	0	0	0	0	0
Net profit	12,707	14,684	17,284	20,802	23,045	26,608
DB adjustments (including dilution)	-1,028	96	-1,073	38	-217	-217
DB Net profit	11,679	14,781	16,211	20,839	22,828	26,391

Cash Flow (CNYm)

Cash flow from operations	26,764	26,695	24,443	16,256	19,574	31,649
Net Capex	-2,583	-2,132	-1,777	-3,526	-3,557	-3,789
Free cash flow	24,181	24,563	22,665	12,731	16,017	27,861
Equity raised/(bought back)	1,702	815	1,668	-131	0	0
Dividends paid	-4,908	-6,046	-7,908	-9,361	-10,370	-11,973
Net inc/(dec) in borrowings	-4,837	7,460	26,096	-370	-2,900	-2,900
Other investing/financing cash flows	-16,223	-19,465	-33,203	2,700	3,000	3,200
Net cash flow	-85	7,326	9,318	5,568	5,746	16,187
Change in working capital	14,347	8,248	-7,499	-6,762	-4,166	4,860

Balance Sheet (CNYm)

Cash and other liquid assets	11,862	27,169	48,274	53,843	59,589	75,776
Tangible fixed assets	22,122	27,925	37,768	37,784	38,797	40,482
Goodwill/intangible assets	2,393	5,731	28,904	28,904	28,904	28,904
Associates/investments	3,047	2,625	2,987	4,681	6,410	8,226
Other assets	89,418	107,151	130,174	143,281	153,557	154,697
Total assets	128,842	170,601	248,107	268,492	287,257	308,085
Interest bearing debt	4,011	5,437	35,707	35,200	32,300	29,400
Other liabilities	68,799	96,187	129,475	137,016	144,371	151,666
Total liabilities	72,810	101,624	165,182	172,216	176,671	181,066
Shareholders' equity	49,202	61,127	73,737	85,628	98,302	112,936
Minorities	6,830	7,850	9,188	10,648	12,283	14,082
Total shareholders' equity	56,032	68,977	82,925	96,276	110,586	127,019
Net debt	-7,851	-21,732	-12,567	-18,643	-27,289	-46,376

Key Company Metrics

Sales growth (%)	-2.3	14.9	51.3	11.5	8.0	9.6
DB EPS growth (%)	-29.0	25.4	8.5	27.0	9.4	15.6
EBITDA Margin (%)	11.2	11.7	10.0	8.9	8.9	9.3
EBIT Margin (%)	9.1	9.5	7.2	7.4	7.8	8.2
Payout ratio (%)	60.1	43.7	45.1	45.0	45.0	45.0
ROE (%)	28.7	26.6	25.6	26.1	25.1	25.2
Capex/sales (%)	2.3	1.5	1.3	1.5	1.4	1.4
Capex/depreciation (x)	1.1	0.6	0.5	1.0	1.2	1.3
Net debt/equity (%)	-14.0	-31.5	-15.2	-19.4	-24.7	-36.5
Net interest cover (x)	90.9	nm	21.2	nm	nm	nm

Source: Company data, Deutsche Bank estimates

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Appendix 1

Important Disclosures

*Other information available upon request

Disclosure checklist			
Company	Ticker	Recent price*	Disclosure
Midea	000333.SZ	40.30 (CNY) 17 Sep 2018	1, 7, 14, 15

*Prices are current as of the end of the previous trading session unless otherwise indicated and are sourced from local exchanges via Reuters, Bloomberg and other vendors. Other information is sourced from Deutsche Bank, subject companies, and other sources. For disclosures pertaining to recommendations or estimates made on securities other than the primary subject of this research, please see the most recently published company report or visit our global disclosure look-up page on our website at <https://research.db.com/Research/Disclosures/CompanySearch>. Aside from within this report, important risk and conflict disclosures can also be found at <https://research.db.com/Research/Topics/Equities?topicId=RB0002>. Investors are strongly encouraged to review this information before investing.

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Historical recommendations and target price. Midea (000333.SZ)

(as of 09/17/2018)



Current Recommendations

Buy
Hold
Sell
Not Rated
Suspended Rating

** Analyst is no longer at Deutsche Bank

1.	01/24/2017	Buy, Target Price Change CNY 35.50 Richard Rui-Huang**	4.	07/09/2018	Downgraded to Hold, Target Price Change CNY 52.00 John Chou
2.	06/12/2017	Buy, Target Price Change CNY 44.57 Anne Ling	5.	08/06/2018	Hold, Target Price Change CNY 48.00 John Chou
3.	11/13/2017	Buy, Target Price Change CNY 63.00 John Chou	6.	08/17/2018	Hold, Target Price Change CNY 43.00 John Chou

Equity Rating Key

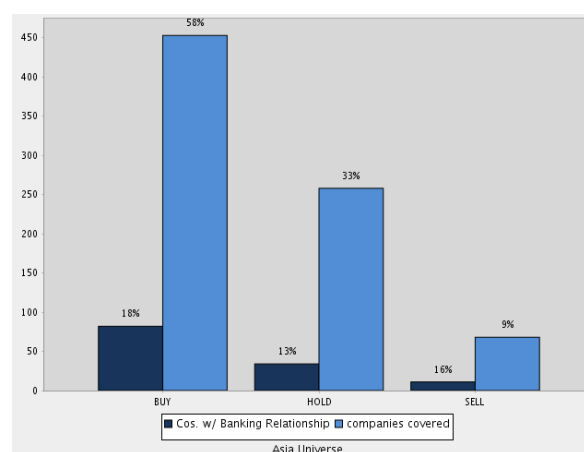
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Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock.

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