

Gree Electrical Appliances

Version 1 | Bloomberg: 000651 CH Equity | Reuters: 000651.SZ

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DBS Group Research . Equity

30 Sep 2019

HOLD (Initiating coverage)

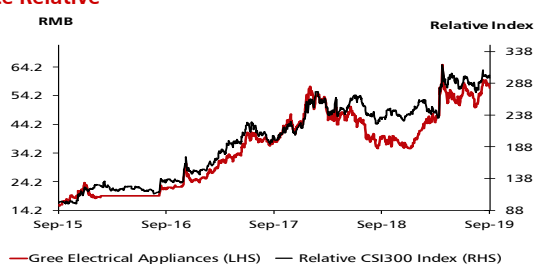
Last Traded Price (27 Sep 2019):RMB56.90(CSI300 Index : 3,853)

Price Target 12-mth:RMB50.32 (11.6% downside)

Analyst

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Price Relative**Forecasts and Valuation**

FY Dec (RMBm)	2018A	2019F	2020F	2021F
Turnover	198,123	209,450	219,922	236,079
EBITDA	33,435	35,033	37,073	39,159
Pre-tax Profit	31,274	34,070	36,092	38,269
Net Profit	26,203	28,546	30,240	32,064
Net Profit Gth (Pre-ex) (%)	17.0	8.9	5.9	6.0
EPS (RMB)	4.36	4.75	5.03	5.34
EPS Gth (%)	17.2	8.9	5.9	6.0
Diluted EPS (RMB)	4.36	4.75	5.03	5.34
DPS (RMB)	2.10	2.14	2.26	2.40
BV Per Share (RMB)	15.18	17.79	20.55	23.48
PE (X)	13.1	12.0	11.3	10.7
P/Cash Flow (X)	17.8	30.4	12.7	10.5
P/Free CF (X)	22.3	45.5	14.9	12.1
EV/EBITDA (X)	7.5	7.0	6.4	5.7
Net Div Yield (%)	3.7	3.8	4.0	4.2
P/Book Value (X)	3.7	3.2	2.8	2.4
Net Debt/Equity (X)	CASH	CASH	CASH	CASH
ROAE (%)	28.7	26.7	24.5	22.7

Earnings Rev (%)		New	New	New
Consensus EPS (RMB)		4.70	5.23	5.80
Other Broker Recs:		B:22	S:4	H:7

Source of all data on this page: Company, DBS Bank (Hong Kong) Limited ("DBS HK"), Thomson Reuters

Positives already priced in

- Moderate growth ahead in view of intensifying industry competition and higher-than-peer channel inventory
- Positives of stake transfer and better-than-expected 1H19 results already in the price, in our view
- Initiating coverage with HOLD rating and TP of RMB50.32

Positives of potential share transfer and better-than-expected 1H19 sales already in the price, in our view. Gree is currently trading close to 12x 1-year forward PE, 2SD above its five-year average. With the counter's YTD share price increase of c.44%, we believe this has already factored in two major positives: (1) two investor consortiums, led by high-profile PE firms Hillhouse and Hope respectively, to compete for a 15% stake of Gree to be disposed by its parent; (2) better-than-expected domestic air-conditioner (AC) sales growth of 5.5% y-o-y in 1H19 vs. decline expectation, which we believed was supported by better commercial AC sales compared to residential AC. Net profit rose by 7% in 1H19, mainly thanks to lower FX losses and higher government grants. We highlight that the company might take more time to realise the potential corporate governance improvements introduced by its new shareholder.

Moderate growth ahead. We expect Gree to deliver low-to-mid single-digit AC sales growth in 2H19, despite embarking on more promotional efforts (S&D expenses grew 30% in 1H19). According to our channel checks, Gree also has a higher channel inventory to run down vs. Midea and Haier. The interim dividend suspension (vs. 1H18's c.28% payout), has also increased confusion regarding the company's dividend policy going forward, in our view.

Valuation:

Our TP of RMB50.32 is pegged to 10x FY20F PE, close to 1 SD above its 5-year average to factor in its recent positives.

Key Risks to Our View:

Industry decline; rising competition; lower-than-expected dividend payout; and rising air-conditioner inventory.

At A Glance

Issued Capital (m shrs)	6,016
Mkt Cap (RMB\$m/US\$m)	342,295 / 48,056
Major Shareholders (%)	
Zhuhai Gree Group Co., Ltd.	18.2
Hebei Jinghai Guarantee Investment Co., Ltd.	8.9
Free Float (%)	72.9
3m Avg. Daily Val. (US\$m)	245.89
GICS Industry: Consumer Discretionary / Consumer Durables & Apparel	
Bloomberg ESG disclosure score (2017) [^]	20.2
- Environmental / Social / Governance	7.0 / 22.8 / 48.2

[^] refer to back page for more information



Live more, Bank less

Gree Electrical Appliances

Growth Prospects and Valuation

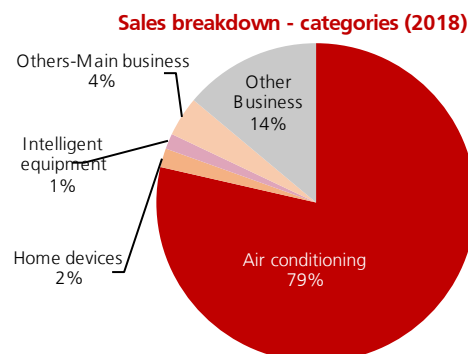
By studying the historic share price trends of Gree since its IPO listing in 1996, we have identified the following major factors that could have boosted its share price performance.

Focus on Research and Development (R&D). In FY18, the company spent RMB7bn on R&D activities (~3.5% of group revenue) with the number of R&D staff growing by 29% y-o-y to 11.8k – signifying increased focus towards R&D. The company has applied for 49,013 patents by end-FY18, of which 13,683 patents were applied in FY18 (including 7,462 invention patent applications).

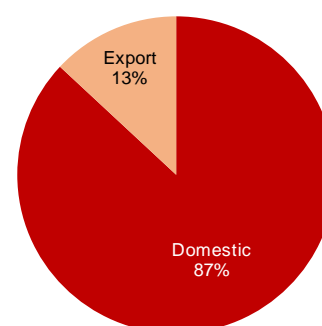
Growth in overseas markets: The company has been gradually increasing its presence in global markets. Exports revenue grew at 12.7% CAGR over 2014-18 and contributed 13.1% to overall FY18 revenue for its main business. Gree's products are currently exported to over 160 countries and regions. The focus is on optimising and upgrading marketing channels overseas for rapid expansion.

Fundamentals and growth prospects. Gree has continuously strengthened its position as one of the leading players in the AC industry with 14 production bases around the world. The company is also diversifying in various other industries such as mobile phones, chips, data-based communications equipment among others. This allowed the company to achieve decent sales CAGR of +9.5% and earnings CAGR of +16.6% over 2014-18. The AC division still contributed 78.6% to total revenue in FY18 and we believe further diversification should be able to gradually alleviate business concentration risks going forward.

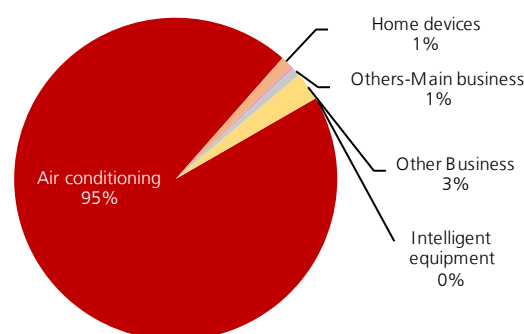
Corporate activities. Zhuhai Gree Group, a state-owned enterprise under the supervision of Zhuhai local government, is the controlling shareholder holding 18.2% stake in the company. In April 2019, Zhuhai Gree Group announced its plans to sell a 15% stake in the company. The company has identified two potential buyers, i.e. investor consortiums led by high-profiled private equity firm Hillhouse and Hope respectively, for the stake sale. This proposed sale has triggered a rise in its share price (which surged more than 20% since the date of announcement). Zhuhai Gree Group has continuously decreased its holding in the company from ~60% a decade ago by transferring shares to dealers and senior executives. The company's Chairwoman Dong Mingzhu holds a 0.74% stake in the company.



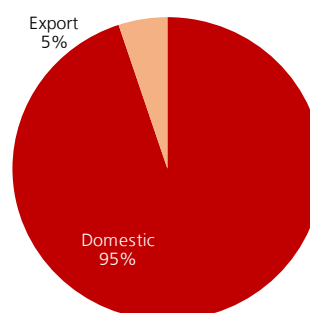
Main Business sales breakdown - region (2018)



Gross profit breakdown - categories (2018)



Main Business gross profit breakdown - region (2018)



Source: Company, DBS HK

Gree Electrical Appliances

Balance Sheet:

Gree has a healthy balance sheet with a net cash position of RMB102bn as of end-2Q19 (consisting of RMB121bn cash and RMB19bn debt). Also, the company's interest costs are already well covered by interest income. This gives the company enough cushion to support its R&D activities that are central to its growth. The company has low financial risks, as attested by its low gearing ratio (gross debt/equity) of 21% at the end of 2Q19. Also, except for FY17, management has delivered consistently high dividend payouts (48% in FY18), supported by its strong cash flow.

Share Price Drivers:

The company's parent Gree Group plans to sell 15% of its stake in the company. This development is considered positive for the company as it would potentially improve corporate governance and transparency as well as provide more opportunities to diversify its operations in the future. The fast-growing demand for "smart home" products could become a key revenue driver and a share price re-rating catalyst.

Key Risks:

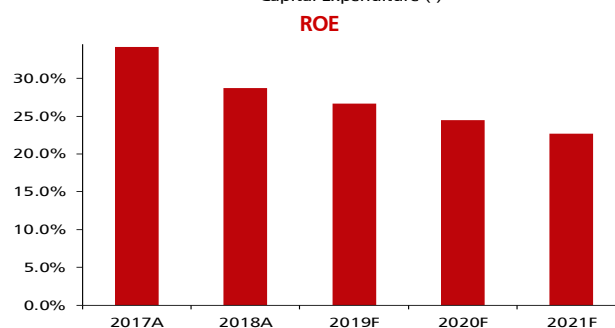
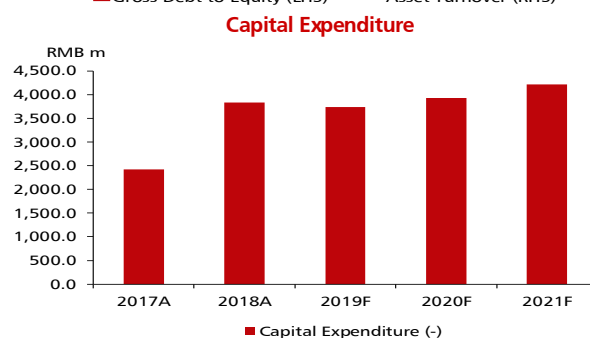
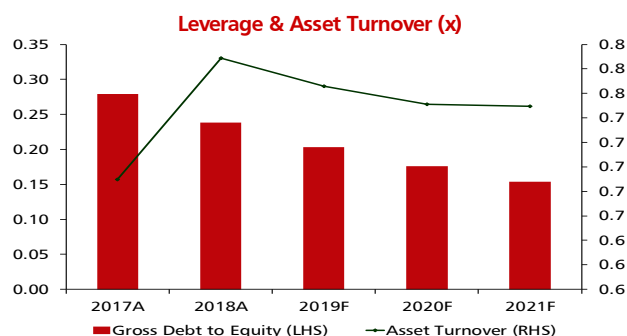
Gree's biggest segment, AC (contributed ~79% of total FY18 revenue), faces intense competition from rivals such as Haier Electronics Group and Midea Group. The company plans to increase its focus on the "smart home" segment which is already very competitive. It has invested RMB1bn to set up a semiconductor design company and also RMB3bn in Anshi (a Chinese chipmaker) through third parties. The company is also exposed to exchange rate fluctuation risks as its export sales contributed ~13% of total revenue in FY18.

Environment, Social, Governance:

Gree has been involved in the construction and operations of pollution prevention facilities such as waste water and air pollution prevention and control facilities, solid waste treatment and disposal facilities, etc. Nevertheless, Gree's ESG score deteriorated from 23.14 in 2013 to 20.25 in 2018, signifying that its efforts to meet environmental compliance are still inadequate and there is a need for more efforts to meet environmental standards. Its environmental score also declined from 10.08 in 2013 to 6.98 in 2018.

Company Background

Gree Electric Appliances Inc. of Zhuhai is the world's leading air-conditioner manufacturer with an annual capacity of ~762m units (consisting of ~62m and ~700m units of residential and commercial air conditioners, respectively). The company commenced operations in 1991 and currently holds a diversified portfolio of electrical appliances such as residential and central air conditioners, intelligent equipment, home appliances, refrigerators, smart phones and air source water heaters.



Source: Company, DBS HK

Gree Electrical Appliances

Segmental Breakdown (RMB m)

FY Dec	2017A	2018A	2019F	2020F	2021F
Revenues (RMB m)					
Air conditioning	123,410	155,682	161,910	165,148	173,405
Home devices	2,301	3,794	6,260	8,764	11,394
Intelligent equipment	2,126	3,109	3,575	3,932	4,247
Others	4,353	8,007	8,248	8,495	8,750
Other Business	16,097	27,531	29,458	33,582	38,283
Total	148,286	198,123	209,450	219,922	236,079
Gross Margin (%) (RMB m)					
Air conditioning	45,743	56,792	59,907	62,591	66,067
Home devices	475	692	1,141	1,665	2,222
Intelligent equipment	124	201	232	255	275
Others	976	503	518	533	549
Other Business	1,405	1,701	1,820	2,075	2,365
Total	48,724	59,889	63,617	67,119	71,479
Gross Margin (%) Margins (%)					
Air conditioning	37.1	36.5	37.0	37.9	38.1
Home devices	20.7	18.2	18.2	19.0	19.5
Intelligent equipment	5.9	6.5	6.5	6.5	6.5
Others	22.4	6.3	6.3	6.3	6.3
Other Business	8.7	6.2	6.2	6.2	6.2
Total	32.9	30.2	30.4	30.5	30.3

Source: Company, DBS HK

Income Statement (RMB m)

FY Dec	2017A	2018A	2019F	2020F	2021F
Revenue	148,286	198,123	209,450	219,922	236,079
Cost of Goods Sold	(99,563)	(138,234)	(145,833)	(152,803)	(164,600)
Gross Profit	48,724	59,889	63,617	67,119	71,479
Other Opg (Exp)/Inc	(22,562)	(29,947)	(31,259)	(32,829)	(35,228)
Operating Profit	26,161	29,942	32,358	34,290	36,251
Other Non Opg (Exp)/Inc	491	277	156	88	50
Associates & JV Inc	397	107	113	129	129
Net Interest (Exp)/Inc	(431)	948	1,443	1,585	1,840
Dividend Income	0	0	0	0	0
Exceptional Gain/(Loss)	0	0	0	0	0
Pre-tax Profit	26,617	31,274	34,070	36,092	38,269
Tax	(4,109)	(4,894)	(5,332)	(5,649)	(5,989)
Minority Interest	(107)	(176)	(192)	(203)	(216)
Preference Dividend	0	0	0	0	0
Net Profit	22,402	26,203	28,546	30,240	32,064
Net Profit before Except.	22,402	26,203	28,546	30,240	32,064
EBITDA	29,081	33,435	35,033	37,073	39,159
Growth					
Revenue Gth (%)	36.9	33.6	5.7	5.0	7.3
EBITDA Gth (%)	87.7	15.0	4.8	5.8	5.6
Opg Profit Gth (%)	76.4	14.5	8.1	6.0	5.7
Net Profit Gth (%)	45.3	17.0	8.9	5.9	6.0
Margins & Ratio					
Gross Margins (%)	32.9	30.2	30.4	30.5	30.3
Opg Profit Margin (%)	17.6	15.1	15.4	15.6	15.4
Net Profit Margin (%)	15.1	13.2	13.6	13.8	13.6
ROAE (%)	34.2	28.7	26.7	24.5	22.7
ROA (%)	10.4	10.4	10.4	10.3	10.2
ROCE (%)	25.5	23.5	22.8	21.4	20.4
Div Payout Ratio (%)	0.0	48.2	45.0	45.0	45.0
Net Interest Cover (x)	60.7	NM	NM	NM	NM

Source: Company, DBS HK

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Balance Sheet (RMB m)

FY Dec	2017A	2018A	2019F	2020F	2021F
Net Fixed Assets	18,503	20,050	21,385	22,747	24,234
Invt in Associates & JVs	110	2,251	2,251	2,251	2,251
Other LT Assets	24,820	29,223	34,418	36,218	37,818
Cash & ST Invt	99,610	113,079	119,026	129,671	143,175
Inventory	16,568	20,012	22,690	23,774	25,610
Debtors	38,071	43,611	50,944	53,491	57,421
Other Current Assets	17,285	23,009	22,743	24,667	24,429
Total Assets	214,968	251,234	273,458	292,820	314,938
ST Debt	18,646	22,068	22,068	22,068	22,068
Creditors	44,320	49,823	52,562	55,074	59,326
Other Current Liab	84,525	85,796	89,374	89,374	89,374
LT Debt	0	0	0	0	0
Other LT Liabilities	642	833	860	888	918
Shareholder's Equity	65,595	91,327	107,015	123,633	141,254
Minority Interests	1,240	1,388	1,580	1,783	1,999
Total Cap. & Liab.	214,968	251,234	273,458	292,820	314,938
Non-Cash Wkg. Capital	(56,920)	(48,986)	(45,558)	(42,515)	(41,240)
Net Cash/(Debt)	80,964	91,011	96,959	107,603	121,107
Debtors Turn (avg days)	93.7	80.3	88.8	88.8	88.8
Creditors Turn (avg days)	165.9	134.6	133.8	133.8	133.8
Inventory Turn (avg days)	62.0	54.1	57.7	57.8	57.7
Asset Turnover (x)	0.7	0.8	0.8	0.8	0.7
Current Ratio (x)	1.2	1.3	1.3	1.4	1.5
Quick Ratio (x)	0.9	1.0	1.0	1.1	1.2
Net Debt/Equity (X)	CASH	CASH	CASH	CASH	CASH
Net Debt/Equity ex MI (X)	CASH	CASH	CASH	CASH	CASH
Capex to Debt (%)	13.0	17.4	17.0	17.8	19.1

Source: Company, DBS HK

Cash Flow Statement (RMB m)

FY Dec	2017A	2018A	2019F	2020F	2021F
Pre-Tax Profit	26,617	31,274	34,070	36,092	38,269
Dep. & Amort.	2,033	3,109	2,406	2,566	2,730
Tax Paid	(4,109)	(4,894)	(5,332)	(5,649)	(5,989)
Assoc. & JV Inc/(loss)	0	0	0	0	0
(Pft)/ Loss on disposal of FAs	0	0	0	0	0
Chg in Wkg.Cap.	(2,797)	(7,783)	(13,287)	(3,044)	(1,275)
Other Operating CF	(8,183)	(2,548)	(6,597)	(3,015)	(1,246)
Net Operating CF	13,562	19,158	11,259	26,950	32,488
Capital Exp.(net)	(2,421)	(3,831)	(3,741)	(3,928)	(4,217)
Other Invt.(net)	(9,016)	(8,767)	(2,000)	(1,800)	(1,600)
Invt in Assoc. & JV	0	(1,030)	0	0	0
Div from Assoc & JV	0	0	0	0	0
Other Investing CF	(50,816)	(8,218)	0	0	0
Net Investing CF	(62,253)	(21,846)	(5,741)	(5,728)	(5,817)
Div Paid	(11,121)	(863)	(12,858)	(13,621)	(14,443)
Chg in Gross Debt	8,601	3,407	0	0	0
Capital Issues	0	0	0	0	0
Other Financing CF	251	(30)	0	0	0
Net Financing CF	(2,269)	2,514	(12,858)	(13,621)	(14,443)
Currency Adjustments	(1,798)	(196)	0	0	0
Chg in Cash	(52,759)	(370)	(7,340)	7,601	12,229
Opg CFPS (RMB)	2.72	4.48	4.08	4.99	5.62
Free CFPS (RMB)	1.85	2.55	1.25	3.83	4.70

Source: Company, DBS HK

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STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)

BUY (>15% total return over the next 12 months for small caps, >10% for large caps)

HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

FULLY VALUED (negative total return, i.e., > -10% over the next 12 months)

SELL (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

**Share price appreciation + dividends*

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Sources for all charts and tables are DBS HK unless otherwise specified.

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