

China Lesso

Lifting PT to HK\$6.4 - Impressive results with margin improvement and new business expected

China Lesso is one of the largest makers of plastic pipes and pipe fittings in China. The results were line with our expectations on sales and net profit but the growth in earnings of 4.2% Y/Y was still impressive, given the poor performance of other construction material companies. Maintain OW with a higher PT of HK\$6.4

- Strong brand and network.** The solid performance in 2014 was against a backdrop of poor demand and sets the stage for a much better 2015. The drop in non-PVC related prices (due to oil) was not felt in 2014 and in fact the margin on non-PVC pipes was down in 2014. We see margin improving in 2015 as it takes 4-5 months after the drop in oil prices before Lesso's costs come down. Longer term, the strong pricing power seen in 2014 is an indication of the brand and network strength of Lesso, which it will use to launch new products and also conduct a new business which is e-commerce fulfillment for building materials and decorative supplies throughout China on a new website lessomall.com.
- Earnings and PT adjustment.** We have slightly lifted FY15E and FY16E sales by less than 1% to reflect flat PVC pricing in 2015 which is not impacted by falling oil prices as well as increase in sales volume of core products, such as plastic pipes and pipe fittings. We are comfortable with our expectations of a small increase in GPM for 2015 but the improvement would be even greater if Lesso manage to keep more of the cuts in oil based chemical costs. However, we are lowering our FY15E net profit by 2% given the rise in R&D costs. Our DCF-based Dec-15 share price target is set at HK\$6.4 (previously Dec 15 PT of HK\$6.0) due to the earnings revisions.
- Lesso trades at 4.5x FY15E P/E.** Our PT (Dec-15, DCF-derived) of HK\$6.4 (previously HK\$6.0) implies a Fwd P/BV of 1.3x and P/E of 7.5x (CY16E). The key downside risks to our PT are lower non-PVC prices, higher wages and lower margins on non-PVC pipes and non pipe products, significant increase in R&D costs and sharp fall in housing construction starts.

Overweight

2128.HK, 2128 HK

Price: HK\$3.43

▲ **Price Target: HK\$6.40**
Previous: HK\$6.00

China

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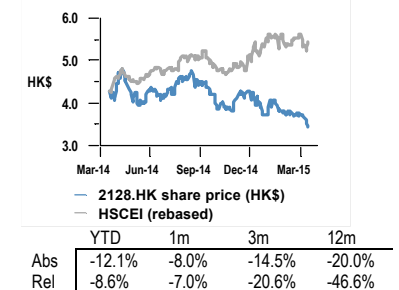
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Price Performance



China Lesso (Reuters: 2128.HK, Bloomberg: 2128 HK)

Rmb in mn, year-end Dec	FY12A	FY13A	FY14A	FY15E	FY16E
Revenue (Rmb mn)	10,891	13,071	14,823	17,311	19,175
Net Profit (Rmb mn)	1,238	1,449	1,541	1,847	2,064
EPS (Rmb)	0.41	0.48	0.51	0.62	0.69
DPS (Rmb)	0.10	0.12	0.13	0.15	0.17
Revenue growth (%)	7.4%	20.0%	13.4%	16.8%	10.8%
EPS growth (%)	(1.8%)	17.0%	6.3%	19.9%	11.7%
ROCE	18.1%	17.2%	16.0%	15.8%	15.7%
ROE	22.5%	21.9%	19.5%	20.0%	19.3%
P/E (x)	6.7	5.7	5.4	4.5	4.0
P/BV (x)	1.4	1.1	1.0	0.8	0.7
EV/EBITDA (x)	7.1	6.0	5.1	4.3	3.5
Dividend Yield	3.7%	4.3%	4.6%	5.5%	6.1%

Source: Company data, Bloomberg, J.P. Morgan estimates.

Company Data

Shares O/S (mn)	3,042
Market Cap (Rmb mn)	8,416
Market Cap (\$ mn)	1,344
Price (HK\$)	3.43
Date Of Price	16 Mar 15
Free Float(%)	30.0%
3M - Avg daily vol (mn)	2.52
3M - Avg daily val (HK\$ mn)	9.61
3M - Avg daily val (\$ mn)	1.2
HSCEI	1,1813.78
Exchange Rate	7.76
Price Target End Date	31-Dec-15

See page 11 for analyst certification and important disclosures, including non-US analyst disclosures.

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<p>Key catalysts for the stock price:</p> <ul style="list-style-type: none"> Increasing housing construction starts More visibility in the increase of pipe demand thanks to urbanization/ wastewater management drainage system Promising prospects for margin expansion of home building products 	<p>Upside risks to our view:</p> <ul style="list-style-type: none"> Higher-than-expected increase in FAI in water-related investment Robust increase in private housing starts Higher-than-expected margins for the home building products 	<p>Downside risks to our view:</p> <ul style="list-style-type: none"> Significant increase in R&D costs for home building products Slow progress made in implementation of urbanization/ wastewater management Sliding coal price which hurt profitability due to the cost-plus model Sharp fall in housing construction starts
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Key financial metrics	FY13	FY14	FY15E	FY16E
Revenues (Rmb)	13,071	14,823	17,311	19,175
Revenue growth (%)	20.0%	13.4%	16.8%	10.8%
EBITDA (Rmb)	2,262	2,526	2,900	3,288
EBITDA margin (%)	17.3%	17.0%	16.8%	17.1%
Tax rate (%)	19%	17%	19%	21%
Net profit (Rmb)	1,449	1,541	1,847	2,064
EPS (Rmb)	0.483	0.513	0.615	0.687
EPS growth (%)	14.9%	24.4%	27.5%	34.0%
DPS (Rmb)	0.12	0.13	0.15	0.17
BVPS (Rmb)	2.41	2.85	3.31	3.82
Operating cash flow (Rmb mn)	1,503	2,611	1,913	2,200
Free cash flow (Rmb mn)	(100)	1,085	915	1,300
Interest cover (X)	15	11	23	27
Net margin (%)	11.1%	10.4%	10.7%	10.8%
Sales/assets (X)	1.19	1.11	1.13	1.11
Debt/equity (%)	37.0%	37.2%	31.0%	25.9%
Net debt/equity (%)	7%	0%	-5%	-12%
ROE (%)	22%	20%	20%	19%
Key model assumptions	FY12A	FY13A	FY14A	FY15E
Sales volume ('000 tonne)	1085	1273	1464	1706
ASP (Rmb/ tonne)	9,626	9,598	9,516	9,440
Raw material (Rmb MM)	6,682	6,783	6,831	6,831

Source: Bloomberg, Company data and J.P. Morgan estimates.

Sensitivity analysis	EBITDA		EPS	
	FY15E	FY16E	FY15E	FY16E
1% chg in ASP	4.6%	4.4%	7.2%	7.0%
1% chg in volume	1.2%	1.2%	1.9%	1.8%
1% chg in material cost	2.0%	1.9%	3.1%	3.0%
1% chg in GM	1.2%	1.2%	1.9%	1.8%

Source: Bloomberg, Company data and J.P. Morgan estimates.

Peer valuation comparison

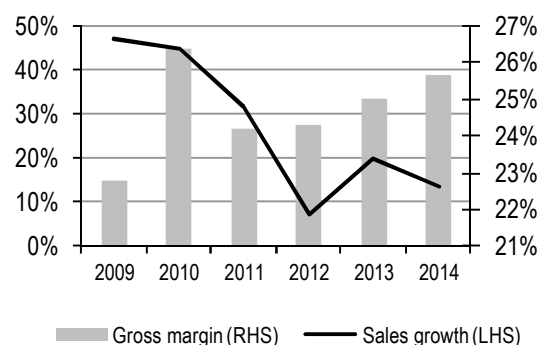
Company Name	Code	Price (PT) Local ccy	MCAP US\$MM	Vol US\$MM	1W Chg	3M Chg	14 P/E (x)	15E P/E(x)	ROE (%)	P/BV (x)	Yld (%)	ND/E (%)
CHINA LESSO (OW)*	2128 HK	3.8 (6.4)	1,515	1.2	5.3	(5.0)	5.4	4.5	20.4	1.5	4.3	(17.7)
ZHEJIANG WEIXI-A (NR)	002372 CH	17.98	1,280	9.6	3.6	18.8	19.6	15.1	17.3	3.9	2.3	(33.4)
CANGZHOU MING-A (NR)	002108 CH	21.02	1,223	55.6	2.8	43.0	40.3	31.7	13.8	5.8	1.0	41.9
CHINA GEN PLAST (NR)	1305 TT	14.40	213	2.5	(5.9)	23.1	16.4	10.5	6.7	1.2	2.8	(9.8)
NINGXIA BUILDI-A (NR)	600449 CH	13.07	999	20.9	8.3	12.0	18.8	15.5	7.6	1.5	na	38.9
NINGXIA QING-A (NR)	002457 CH	11.91	638	19.0	2.0	9.1	41.1	29.8	5.4	2.4	na	(27.2)
YONGGAO CO LTD-A (NR)	002641 CH	13.14	908	12.3	11.6	31.9	24.9	14.9	8.5	2.8	0.8	3.5
Average					4.0	19.0	23.9	17.6	11.4	2.7	2.2	(0.5)

Source: Company data, Bloomberg for NR (not rated) companies, J.P. Morgan estimates (*). Share prices are as of 12:00 p.m Mar 17, 2015

Valuation and price target basis

Our PT (Dec-15, DCF-derived) of HK\$6.4 implies a forward P/BV (CY6E) of 1.3x and implies a forward P/E of 7.5x (CY16E).

Chart to support valuation and price target



Source: Bloomberg, Company data and J.P. Morgan estimates.

JPM vs. consensus, change in estimates

EPS	FY15E	FY16E
JPM old	0.627	0.659
JPM new	0.615	0.687
% chg	-2.0%	4.3%
Consensus	0.528	0.588

Source: Bloomberg, Company data and J.P. Morgan estimates.

Highlights from analysts briefing

- **Continual expenditure in 2015.** The company expects to invest Rmb 1.1bn to expand capacity and to launch new construction related products. The capital expenditures are well funded from the operating cash flow of the company (over Rmb 2.6 bn in 2014). The company expects to lift capacity by 100k to 150k (up 5 to 8% y/y) in 2015. Management has also lifted utilization from 73% in 2014 to around 76% in mid March and targets hitting 80% by the end of the year. One specific method to lift utilization is the use of automation to improve efficiencies in the larger plants in Guangdong. Management highlights that China Lesso will keep devoting efforts for the southern China market to consolidate leadership while extending more business in Non-southern areas, such as southwestern, Central and northern part
- **Margin continues to rise for PVC pipes.** The largest product for Lesso is PVC pipes which experienced a large increase to 30.3 % margin (28.2 % in 2013). Mainly on a fall in PVC pellet prices in China. However, the GPM for non PVC pipes fell to 20.4 % in 2014 from 21.1 % in 2013 as the cost is related to oil but with a 3 to 4 month lag (therefore benefits in 2015 instead of 2014). We are comfortable with our expectations of a small increase in GPM for 2015 but the improvement would be even greater if Lesso manage to keep more of the cuts in oil based chemical costs.
- **Flat PVC pricing in 2015.** The Company expects PVC pricing to remain flat in 2015 and not impacted by falling oil prices. Management mentioned that falling non- PVC costs in 2015 may reflect in lower product prices but the company has not yet announced such cuts in non PVC pipes yet. In our view, this is a good sign and shows strong demand and pricing power. Management did view GPM in 2015 to be similar to 2014 but given what we can see on pricing and margins so far, this seems conservative to us.
- **Sharp rise in R&D costs.** R&D costs rose faster than sales due mainly to the company's plans to introduce new pipes products used in the construction industry. The company also set up new R&D centers in a number of cities which lifted costs in 2014. We have assumed no reduction in the heightened level of R & D in 2015 and growing in line with sales. The risk is on the downside in our view and that it is quite likely for the ratio of R&D as a proportion of sales may fall especially if sales growth is strong as we have estimated.
- **Move into online retail a logical step.** Lesso has spent Rmb 50m in expanding into an online retail business that sells pipes and third part building related products. The company plans to use its 20 + production lines and over 2000 independent points of sales network in order to support this new lessomall.com business. We view this as small now but a logical expansion step for Lesso to leverage from its high quality brand image.

2014 results overview

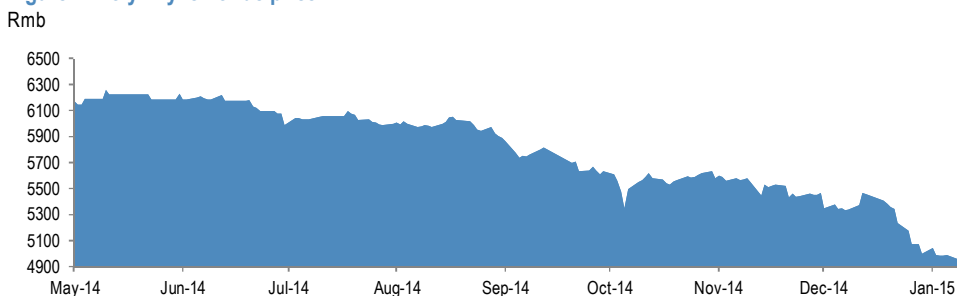
Table 1: China Lesso: FY14 results review

FY results (Rmb\$m)	FY13	FY14A	Y/Y	FY14E	Var	FY14 Consensus
Turnover*	13,071	14,823	13.4%	14,611	1.5%	14,733
Gross profit	3,266	3,801	16.4%	3,673	3.5%	3,646
GPM*	25.0%	25.6%		25.1%		24.8%
EBIT	1,918	2,080	8.4%	2,016	3.2%	1,941
EBITM	14.7%	14.0%		13.8%		13.2%
Net profit	1,449	1,539	6.2%	1,502	2.5%	1,788
NP Margin	11.1%	10.4%		10.3%		12.1%
EPS	0.48	0.50	4.2%	0.50	0.0%	0.50

Source: J.P. Morgan estimates. Company data

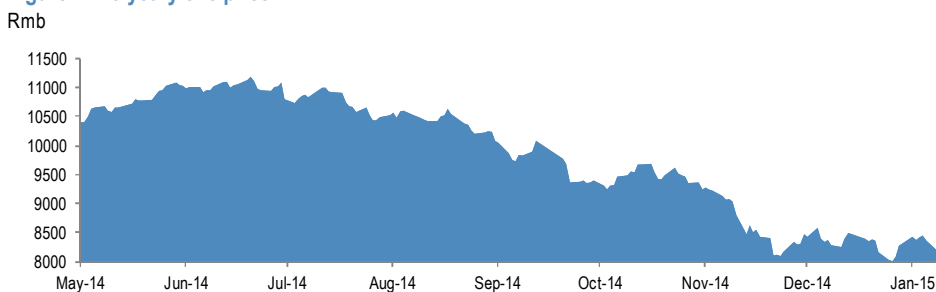
- GP was 3.5% higher than our expectation which is quite positive as we had seen a tough operating environment for other companies that are in the construction materials space. This tells us that Lesso has a reasonably good brand and pricing power and has taken advantage of the drop in petrochemical costs. Raw materials is about 90% of COGS for Lesso and PVC makes up about 60% of RM and PE makes up about 20% of RM. Price for PE is falling in sympathy with oil which is the ultimate feedstock globally. PVC is falling even though it is made from coal in China because of oversupply and alternative (substitute) materials made from oil are falling. Near term, this relieves some pressure on margins as rising raw materials from 2011 and 2013 have crimped margins (especially on PE pipes). GPM increased by 0.6 pb in FY14 to 25.6%.

Figure 1: Polyvinyl chloride price



Source: Bloomberg.

Figure 2: Polyethylene price



Source: Bloomberg.

- Net profit was about 2.5% higher than our expectations due to the better than expected GPM
- We see the relatively low PE of less than 6x 15E to be attractive given its number one brand and network for plastic pipes in China but upside depends on recovery in construction activity which is still quite uncertain

Net profits revised down by 2% for FY15E but up 4% for FY16E

Table 2: Revisions

Year to Dec (Rmbm)	----- New -----		----- Old -----		-----Change -----	
	FY15E	FY16E	FY15E	FY16E	FY15E	FY16E
Turnover	17,311	19,175	17,292	19,126	0.1%	0.3%
Gross profit	4,429	5,020	4,413	4,833	0.4%	3.9%
EBIT	2,394	2,733	2,379	2,562	0.6%	6.7%
Net profit	1,847	2,064	1,884	1,980	-2.0%	4.3%
EPS (Rmb)	0.615	0.687	0.627	0.659	-2.0%	4.3%
Assumptions						
Gross margin	25.6%	26.2%	25.5%	25.3%	0.2%	3.6%

Source: J.P. Morgan estimates.

We have slightly lifted up FY15E and FY16E sales by less than 1% to reflect flat PVC pricing in 2015 which is not impacted by falling oil prices as well as increase in sales volume of core products, such as plastic pipes and pipe fittings. We are comfortable with our expectations of a small increase in GPM for 2015 but the improvement would be even greater if Lesso manages to keep more of the cuts in oil based chemical costs. However, we are lowering our FY15E net profit by 2% given the rise in R&D costs. Our DCF-based Dec-15 share price target is set at HK\$6.4 (previously Dec 15 PT of HK\$6.0) due to the earnings revisions.

Valuation and share price analysis

DCF Valuation

Our Dec-15 price target is based on a DCF valuation that assumes a market risk premium of 6.0% and a risk-free rate of 4.2% (yield on 10-year government notes in China). We assume a beta of 1.3. Accordingly, we arrive at a WACC of 12.0%. We estimate free cash flow until 2019 and assume a terminal growth rate of 3.0%. The terminal growth is based on the annual growth rate expected in 2019 (the final year of the estimate period) subject to a minimum of 3% and a maximum of 6%, depending on the nature of the industry and the level of maturity in China.

We also analyzed the DCF price sensitivity to WACC, and the terminal multiple.

Table 3: Base-case DCF analysis

Rmb MM	2013	2014	2015E	2016E	2017E	2018E	2019E	Terminal	
Cash flow estimates									
Sales	13,071	14,823	17,311	19,175	21,370	23,896	26,821	30,265	
EBIT	1,918	2,080	2,394	2,733	3,177	3,740	4,441	5,246	
NOPAT	1,924	1,692	1,997	2,226	2,510	2,955	3,509	4,145	
Capex, net	(1,161)	(1,161)	(1,100)	(995)	(1,123)	(1,223)	(1,465)	(1,788)	
Depreciation	344	447	507	555	600	651	712	790	
Change in working capital	(357)	647	(555)	(545)	(719)	(858)	(1,038)	(1,447)	
Free CF (excl. non-core)	750	1,625	848	1,241	1,269	1,527	1,722	1,704	
DCF Parameters									
Liabilities as a % of EV	0%	Assumptions		Terminal growth					3.0%
WACC	12.0%	Risk-free rate		4.2%					
Enterprise NPV (11E-16E)	15,897	Market risk		6.0%					
+ Net cash (debt), 2010E	(498)	Beta		1.30					
- Minorities (Market value)	0	Cost of debt		8.4%					
+/- Other items	0	Implied exit P/E multiple (x)		5					
= Equity value	15,399								
/ Number of shares	3,042								
= Equity value per share (HK\$)	6.4								

Source: Company data J.P. Morgan estimates.

Table 4: Sensitivity analysis based on WACC and perpetual terminal growth rate

	Terminal growth rate							
	1.5%	2%	2.5%	3.0%	3.5%	4.0%	4.5%	
10.5%	6.7	7	7.3	7.7	8.1	8.6	9.2	
11.0%	6.3	6.6	6.9	7.2	7.6	8	8.5	
11.5%	6	6.2	6.5	6.8	7.1	7.4	7.8	
12.0%	5.7	5.9	6.1	6.4	6.6	6.9	7.3	
12.5%	5.4	5.6	5.8	6	6.3	6.5	6.8	
13.0%	5.2	5.3	5.5	5.7	5.9	6.1	6.4	
WACC	13.5%	4.9	5.1	5.2	5.4	5.6	5.8	6

Source: J.P. Morgan estimates.

Financial analysis

Table 5: Key assumptions

Rmb in millions, year-end December

Year-end December	2012	2013	2014	2015E	2016E
Water pipe vol Y/Y	13%	17%	15%	17%	10%
Drainage pipe vol Y/Y	13%	17%	15%	17%	6%
Power supply & telecommunications (volume Y/Y)	13%	17%	15%	17%	8%
Capacity annualized (000 tons /yr) – (note 1)	1,635	1,684	1,886	2,018	2,180
Utilization (based on annualized capacity)	66.4%	75.6%	75.9%	82.7%	82.7%
Gross margin	24.3%	25.0%	25.6%	25.6%	26.2%
EBIT margin	14.9%	14.7%	14.0%	13.8%	14.3%
Net margin	11.4%	11.1%	10.4%	10.7%	10.8%

Source: Company data, J.P. Morgan estimates

Table 6: P&L statement

Rmb in millions, year-end December

	2012	2013	2014	2015E	2016E
Total Revenues	10,891	13,071	14,823	17,311	19,175
YoY change (%)	7.4%	20.0%	13.4%	16.8%	10.8%
Cost of Goods Sold	(8,242)	(9,805)	(11,022)	(12,882)	(14,155)
YoY change (%)	7.2%	19.0%	12.4%	16.9%	9.9%
Gross Profit	2,649	3,266	3,801	4,429	5,020
YoY change (%)	8.0%	23.3%	16.4%	16.5%	13.4%
Gross Margin	24.3%	25.0%	25.6%	25.6%	26.2%
SGA	(1,137)	(1,503)	(1,837)	(2,171)	(2,437)
YoY change (%)	21.9%	32.2%	22.3%	18.1%	12.3%
Other Income/(Expenses)	116	155	116	136	150
Operating profit	1,628	1,918	2,080	2,394	2,733
EBITDA	1,881	2,262	2,526	2,900	3,288
EBITDA margin	17.3%	17.3%	17.0%	16.8%	17.1%
Depreciation and Amortization	(253)	(344)	(447)	(507)	(555)
YoY change (%)	45.2%	36.2%	29.9%	13.4%	9.5%
EBIT	1,628	1,918	2,080	2,394	2,733
EBIT margin	14.9%	14.7%	14.0%	13.8%	14.3%
Finance costs	(146)	(151)	(233)	(125)	(121)
Exceptional item	0	0	0	0	0
Associates	0	0	0	1	1
Gains/losses	0	0	0	0	0
Net Income Before Taxes	1,482	1,768	1,847	2,269	2,613
YoY change (%)	-4.8%	19.2%	4.5%	22.8%	15.2%
Tax	(251)	(330)	(306)	(422)	(549)
Effective Tax rate	16.9%	18.7%	16.6%	18.6%	21.0%
Minority Interests	7	12	0	0	0
Net Income	1,238	1,449	1,541	1,847	2,064
YoY change (%)	-1.8%	17.0%	6.3%	19.9%	11.7%
Net margin	11.4%	11.1%	10.4%	10.7%	10.8%

Source: Company data, J.P. Morgan estimates.

Table 8: Interim estimates

Year to Dec (HK\$ MM)	1H13	2H13	1H14	2H14	1H15	2H15
Total Revenues	5,692	7,378	6,581	8,242	8,608	8,703
Gross Profit	1,492	1,774	1,643	2,158	1,750	2,679
EBIT	916	1,002	895	1,185	664	1,729
Net Income Before Taxes	840	927	761	1,086	621	1,648
Net Income	683	767	622	919	385	1,462
Diluted EPS (HK\$)	0.224	0.258	0.204	0.309	0.127	0.488
Ratios						
Revenue split	43.5%	56.5%	44.4%	55.6%	49.72%	50.28%
GPM	26.2%	24.0%	25.0%	26.2%	20.3%	30.8%
EBIT margin	16.1%	13.6%	13.6%	14.4%	7.7%	19.9%
NPM	12.0%	10.4%	9.4%	11.2%	4.5%	16.8%
YoY						
Revenue	18.1%	21.5%	15.6%	11.7%	30.8%	5.6%
GP	19.6%	26.5%	10.1%	21.7%	6.5%	24.1%
EBIT	14.2%	21.3%	-2.3%	18.2%	-25.8%	46.0%
NP	13.8%	20.1%	-8.9%	19.9%	-38.0%	59.1%

Source: Company data, J.P. Morgan estimates

Table 9: Balance sheet

Rmb in millions, year-end December

	2012	2013	2014	2015E	2016E
Cash and Cash Equivalents	1,922	2,189	3,199	3,586	4,302
Inventories	1,766	2,434	2,210	2,710	3,152
Trade receivable	1,010	1,038	1,304	1,568	1,824
Prepayments deposits and other receivables	10	17	30	35	39
Total Current Assets	5,113	6,399	7,315	8,568	10,057
Intangible Assets	0	0	0	0	0
Property, Plant and Equipment, Net	3,288	4,452	5,264	5,743	6,183
Other Assets	1,382	1,382	1,941	1,941	1,941
Non-Current assets	4,670	5,834	7,205	7,684	8,124
Total Assets	9,783	12,232	14,520	16,252	18,182
Trade and Bills Payable	512	861	973	1,137	1,234
Other Accrued Expenses	832	1,253	1,564	1,591	1,591
Taxes Payable	99	104	113	229	356
ST and current LT debts	596	1,080	1,159	1,259	1,359
Total Current Liabilities	2,039	3,298	3,810	4,215	4,539
Interest Bearing Bank Loans and Government Loans	1,629	1,607	2,021	1,821	1,621
Other Noncurrent Liability	87	137	139	162	180
Noncurrent liabilities	1,716	1,744	2,160	1,983	1,801
Total Liabilities	3,755	5,042	5,970	6,198	6,340
Share capital	133	134	136	136	136
Reserves and Surplus	5,877	7,105	8,410	9,795	11,343
Total Shareholders' Equity	6,010	7,240	8,545	9,931	11,479
Minority Interest	(18)	16	4	4	4
Total Shareholders' Equity	5,992	7,256	8,550	9,935	11,483
Total Liabilities and Equity	9,747	12,298	14,520	16,133	17,823

Source: Company data, J.P. Morgan estimates.

Table 10: Cash flow statement

Rmb in millions, year-end December

	2012	2013	2014	2015E	2016E
EBIT	1,628	1,918	2,080	2,394	2,733
Depreciation and Amortization	253	344	447	507	555
Working Capital Changes	(158)	(357)	647	(555)	(545)
Interest Paid	(296)	(251)	(330)	(306)	(422)
Tax Paid	1,426	1,503	2,611	1,913	2,200
Cash Flow From Operations	1,130	1,403	2,514	1,732	1,899
Capital expenditures	(1,400)	(1,161)	(1,161)	(1,100)	(995)
Investments and others	(146)	(151)	(233)	(125)	(121)
Cash Flow from Investing	(2,080)	(2,881)	(2,881)	(2,200)	(1,990)
Free Cash Flow	(654)	(217)	890	814	1,205
Dividends	(335)	(291)	(375)	(426)	(489)
Other financing	0	0	0	0	0
Debt	(9)	512	495	0	0
Cash Flow from financing	125	140	119	(426)	(489)
Change in cash	(193)	275	1,010	388	716
Cash beginning	2,115	1,922	2,189	3,199	3,586
Foreign exchange changes	0	(8)	0	0	0
Cash at end	1,922	2,189	3,199	3,586	4,302

Source: Company data, J.P. Morgan estimates

Investment Thesis, Valuation and Risks

China Lesso (*Overweight; Price Target: HK\$6.40*)

Investment Thesis

While the top-line is likely to remain intact in 2H14, the instability of non-PVC margins and heightened wage costs can be some of the near-term drawbacks for China Lesso. Gross margins of new products also may take time to pick up as the production needs a few more quarters to ramp up. More examination of the future impacts of hydraulic and urbanization projects are required.

Valuation

Our Dec-15 PT of HK\$6.4 is based on a DCF valuation that assumes a market risk premium of 6.0% and a risk-free rate of 4.2%. We assume a beta of 1.3. Accordingly, we arrive at a WACC of 12.0%. We estimate free cash flow until 2019 and assume a terminal growth rate of 3.0%. The terminal growth is based on the annual growth rate expected in 2019 subject to a minimum of 3% and a maximum of 6%.

Risks to Rating and Price Target

Key risks are: 1.) Significant increase in R&D costs for home building products; 2.) Slow progress made in implementation of urbanization/ wastewater management; 3.) Sliding coal price which hurt profitability due to the cost-plus model; 4.) Sharp fall in housing construction starts.

China Lesso: Summary of Financials

Income Statement						Cash flow statement					
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E	Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
Revenues	13,071	14,823	17,311	19,175	21,370	EBIT	1,918	2,080	2,394	2,733	3,177
% change Y/Y	20.0%	13.4%	16.8%	10.8%	11.4%	Depr. & amortization	344	447	507	555	600
Gross Profit	3,266	3,801	4,429	5,020	5,740	Change in working capital	(357)	647	(555)	(545)	(719)
% change Y/Y	23.3%	16.4%	16.5%	13.4%	14.3%	Taxes	(251)	(330)	(306)	(422)	(549)
EBITDA	2,262	2,526	2,900	3,288	3,776	Cash flow from operations	1,503	2,611	1,913	2,200	2,416
% change Y/Y	20.3%	11.7%	14.8%	13.4%	14.8%	Capex	(1,726)	(1,720)	(1,100)	(995)	(1,124)
EBIT	1,918	2,080	2,394	2,733	3,177	Net Interest	(151)	(233)	(125)	(121)	(93)
% change Y/Y	17.8%	8.4%	15.1%	14.2%	16.2%	Other	6	0	0	0	0
EBIT Margin	14.7%	14.0%	13.8%	14.3%	14.9%	Free cash flow	(100)	1,085	915	1,300	1,366
Net Interest	(151)	(233)	(125)	(121)	(93)	Equity raised/(repaid)	0	0	0	0	0
Earnings before tax	1,768	1,847	2,269	2,613	3,085	Debt raised/(repaid)	512	495	0	0	0
% change Y/Y	19.2%	4.5%	22.8%	15.2%	18.1%	Other	(81)	0	0	0	0
Tax	(330)	(306)	(422)	(549)	(648)	Dividends paid	(291)	(375)	(426)	(489)	(563)
as % of EBT	18.7%	16.6%	18.6%	21.0%	21.0%	Beginning cash	1,922	2,189	3,199	3,586	4,302
Net income (reported)	1,449	1,541	1,847	2,064	2,437	Ending cash	2,189	3,199	3,586	4,302	5,033
% change Y/Y	17.0%	6.3%	19.9%	11.7%	18.1%	DPS	0.12	0.13	0.15	0.17	0.20
Shares outstanding	3,003	3,003	3,003	3,003	3,003	Ratio Analysis					
EPS (reported)	0.48	0.51	0.62	0.69	0.81	Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E
% change Y/Y	17.0%	6.3%	19.9%	11.7%	18.1%	Gross margin	25.0%	25.6%	25.6%	26.2%	26.9%
Balance sheet						EBITDA margin	17.3%	17.0%	16.8%	17.1%	17.7%
Rmb in millions, year end Dec	FY13	FY14	FY15E	FY16E	FY17E	Operating margin	14.7%	14.0%	13.8%	14.3%	14.9%
Cash and cash equivalents	2,189	3,199	3,586	4,302	5,033	Net margin	11.1%	10.4%	10.7%	10.8%	11.4%
Accounts receivable	1,038	1,304	1,568	1,824	2,134	Sales per share growth	20.0%	13.4%	16.8%	10.8%	11.4%
Inventories	2,434	2,210	2,710	3,152	3,688	Sales growth	20.0%	13.4%	16.8%	10.8%	11.4%
Others	17	30	35	39	44	Net profit growth	17.0%	6.3%	19.9%	11.7%	18.1%
Current assets	6,399	7,315	8,568	10,057	11,724	EPS growth	17.0%	6.3%	19.9%	11.7%	18.1%
LT investments	1,382	1,941	1,941	1,941	1,941	Interest coverage (x)	15.0	10.8	23.2	27.1	40.7
Net fixed assets	4,452	5,264	5,743	6,183	6,707	Net debt to equity	6.9%	(0.2%)	(5.1%)	(11.5%)	(25.3%)
Total Assets	12,232	14,520	16,252	18,182	20,372	Sales/assets	1.2	1.1	1.1	1.1	1.1
Liabilities						Assets/equity	166.2%	169.5%	166.5%	160.8%	155.5%
Short-term loans	1,080	1,159	1,259	1,359	1,459	ROE	21.9%	19.5%	20.0%	19.3%	19.7%
Payables	861	973	1,137	1,234	1,348	ROCE	17.2%	16.0%	15.8%	15.7%	17.1%
Others	1,356	1,678	1,820	1,946	2,046						
Total current liabilities	3,298	3,810	4,215	4,539	4,852						
Long-term debt	1,607	2,021	1,821	1,621	200						
Other liabilities	0	0	0	0	0						
Total Liabilities	4,976	5,970	6,317	6,698	7,061						
Shareholder's equity	7,256	8,550	9,935	11,483	13,311						
BVPS (Rmb)	2.41	2.85	3.31	3.82	4.43						

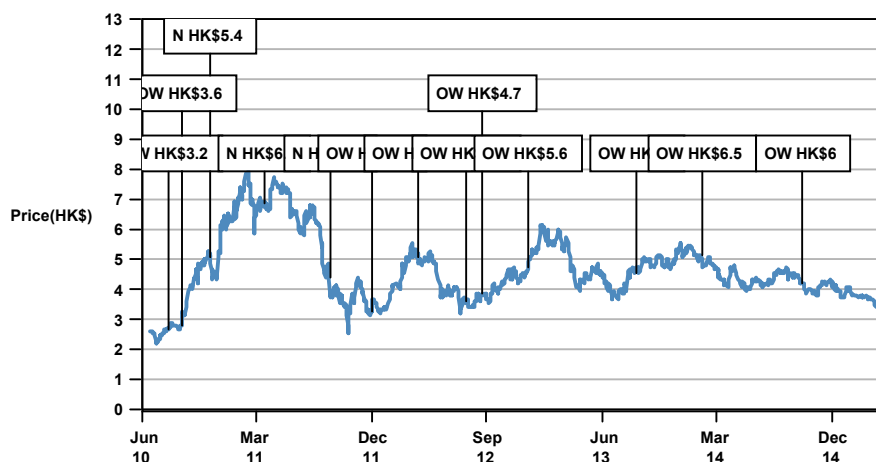
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China Lesso (2128.HK, 2128 HK) Price Chart



Date	Rating	Share Price (HK\$)	Price Target (HK\$)
03-Aug-10	OW	2.64	3.20
02-Sep-10	OW	2.79	3.60
09-Nov-10	N	5.07	5.40
21-Mar-11	N	6.87	6.40
22-Aug-11	N	4.37	4.10
30-Nov-11	OW	3.28	4.50
20-Mar-12	OW	5.06	6.80
12-Jul-12	OW	3.58	5.50
21-Aug-12	OW	3.89	4.70
07-Dec-12	OW	4.76	5.60
20-Aug-13	OW	4.55	6.00
24-Jan-14	OW	5.15	6.50
19-Sep-14	OW	4.21	6.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends. Initiated coverage Aug 03, 2010.

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